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Cambodia
Seizing the Global Opportunity
Investment Climate Assessment and Reform Strategy for Cambodia
Prepared for the Royal Cambodian Government by the World Bank Group

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Poverty Reduction and Economic Management Sector Unit
Financial and Private Sector Development Unit
East Asia and the Pacific Region

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Abbreviations and Acronyms

AQIP	Agricultural Quality Improvement Project
APSARA	Authority for the Protection and Management of Angkor and the Region of Siem Reap
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
BCC	Business Cooperation Contract
BMO	Business Membership Organization
BOT	Build-Operate-Transfer
CamControl	Cambodia Import Export Inspection and Fraud Repression Department
CCC	Civil and Commercial Code
CDC	Council for the Development of Cambodia
CDRI	Cambodia Development Resource Institute
CED	Customs and Excise Department
CIB	Cambodian Investment Board
COM	Council of Ministers
CSR	Corporate Social Responsibility
EAC	Electricity Authority of Cambodia
EDC	Electricté du Cambodge
ELVIS	Electronic Information Visa System
ESSP	Education Sector Support Program
EU	European Union
FDI	Foreign Direct Investment
FAO	Food and Agriculture Organization of the United Nations
FIAS	Foreign Investment Advisory Service
GATT	General Agreement on Tariffs and Trade
GMAC	Garment Manufacture Association Cambodia
GNI	Gross National Income
GTZ	German Agency for Technical Cooperation
ICA	Investment Climate Assessments
IFC	International Finance Corporation
ILO	International Labor Organization
IPA	Investment Promotion Agency
IPP	Independent Power Production
IRL	Indochina Research Limited
KAMSAB	Kampuchea Shipping Agency and Brokers
LFS	Labor Force Survey
MAFF	Ministry of Agriculture, Fisheries, and Forestry
MEF	Ministry of Economy and Finance
MIME	Ministry of Industry, Mines, and Energy
MOE	Ministry of Environment
MOWRAM	Ministry of Water Resources and Meteorology
MPDF	Mekong Project Development Facility
MPTC	Ministry of Post and Telecommunications
MRD	Ministry of Rural Development
MPWT	Ministry of Public Works and Transport
NGO	Non-Governmental Organization
NPRP	National Poverty Reduction Program
NPRS	National Poverty Reduction Strategy
PAP	Priority Action Program
PICS	Productivity and Investment Climate Survey
PP	Phnom Penh
PPI	Private Participation in Infrastructure
PPIAF	Public-Private Infrastructure Advisory Facility
PSD	Private Sector Development
PSF	Government-Private Sector Forum
REE	Rural Electricity Enterprises
RGC	Royal Government of Cambodia
SITF	Special Inter-Ministerial Task Force
SME	Small and Medium-sized Enterprise
SSCA	State Secretariat of Civil Aviation
TBT	Technical Barriers to Trade
TFP	Total Factor Productivity
TRIMS	Trade-Related Investment Measures
TRIPS	Trade-Related Intellectual Property Rights
UNIDO	United Nations Industrial Development Organization
VAT	Value Added Tax
WDR	World Development Report
WG	Working Groups
WTO	World Trade Organization
VOIP	Voice-Over-Internet Protocol

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Abstract

Seizing the Global Opportunity: Investment Climate Assessment and Reform Strategy has been accepted as a key input to Cambodia's private sector development strategy following extensive consultations with the Royal Government of Cambodia, its development partners and the private sector. It was prepared to help these stakeholders identify and prioritize policy reforms to achieve three related objectives: to enable the private sector to lead growth, to help diversify the economy, and to increase the role of the private sector in public service delivery. The report takes as its starting point Cambodia's pro-poor trade strategy, which recognizes that as a small country, exports are critical to expanding job opportunities. However, Cambodia's policymakers are aware that the export opportunities cannot be captured if firms face an uncompetitive domestic business environment. The report employs an investment climate survey of 800 urban, rural, and informal firms to identify how the policy and institutional environment impacts individual firms, and benchmarks the responses of Cambodian firms with those in China, Bangladesh, India and Pakistan. It builds on (a) *Towards a Private Sector Strategy for Cambodia: Value Chain Analysis* (2003); (b) a study of the policy and institutional environment for private participation in infrastructure; (c) the Bank's Doing Business indicators for Cambodia, attached as Annex IV; and (d) options for trade facilitation reform included in Chapter 5.

The report begins by noting the profound link between economic growth and productivity. In spite of Cambodia's rapid growth and a remarkable recovery in the last several years, the data suggest that both total factor productivity and labor productivity are low in comparison with countries that Cambodia must compete with in international markets, including Bangladesh, India, China, and Pakistan. Some key factors that contribute to low productivity, including corruption, weak rule of law, informal practices and complex and costly regulation, are identified and benchmarked. Among the more surprising results, the share of sales revenue paid by Cambodian firms in the form of bribes is over twice that of Bangladesh and by far the highest among the comparators. Cambodia also has the most annual inspections, the highest cost per capita to officially register businesses, the second highest amount of time for management to deal with officials (after China). Trade facilitation practices are particularly constraining, with the second longest clearance times after Pakistan and some of the highest observed incidence of unofficial costs. In contrast with Cambodia's reputation as a liberal environment, in several key respects Cambodia appears to be a restrictive market due to the cumulative impact of multiple agencies operating in an uncoordinated fashion. The governance findings are so acute that they overwhelm visible deficiencies such as finance, infrastructure, and human capital/skills. This is not to suggest that these factors are not relevant, but rather that the private sector is not in a position to be constrained by them because of more urgent concerns.

The structure of Cambodia's private sector is a reflection of the investment climate. There is a high degree of informality, and little long-term investment in productive assets outside of sectors which enjoy either policy-based market advantages or unique cultural assets. The strategy of remaining informal appears to make short-term sense: informal firms as well as rural firms are less constrained. As a long-term prospect, the strategy is limited as the informal sector has a reduced capacity to trade with the formal sector, to obtain credit and to grow. Overall, the result appears to be a negative cycle in which firms remain small and informal, denying the Government the revenue base needed to improve public sector performance, which in turn contributes to weaknesses in the investment climate.

Diversifying the private sector is an important goal of the National Poverty Reduction Strategy, and most observers agree that Cambodia has the potential to grow through post-harvest agro-industry. The report explores diversification by exploring the constraints facing rural, non-farm agro-industrial firms. From a cost standpoint, it appears that agro-industry can be competitive. But the agro-industrial sector, which comprises the vast majority of private manufacturing, is unable to trade outside of local markets, and is largely limited to personal relations with customers and suppliers. Here the finding is less about constraints imposed by the public sector, although they exist. Rather the key issue appears to be

fragmentation of markets due to the absence of institutions that reduce the risk and cost of making formal, arm's length transactions with distant counterparts. One symptom is that rural firms keep extraordinarily high inventory levels as a buffer against supply disruption. Another is their weak linkage to the large-scale formal sector. Because markets are not integrated in key parts of the value chain, the basic driver of productivity – competition between firms – is not strong enough to spur productivity gains. As a result, revenues and productivity are very low and the basis to increase employment does not exist. The challenge here is to develop trade-supporting institutions – both public and private- without creating some of the problems associated with the urban, formal investment climate. Institutions typically evolve slowly, with significant input of the private sector. The strongest institutions are those which are accountable to stakeholders. It is therefore important to build the voice and participation of the rural and urban private sector through strengthening business associations, leveraging private value chains, and continuing the successful Government-Private Sector Forum.

Cambodia's poverty reduction strategy places an important priority on improving delivery of public services, which were particularly weakened by years of conflict and neglect. The poor state of infrastructure raises the cost of doing business and limits access to markets. Because needs are so acute and resources so limited, we argue that the state should yield a substantial role for delivery of public services to the private sector. In fact the private sector is involved in electricity, telecommunications, water, transport, education and health care. In this respect, the private sector's most important contribution is not necessarily resource mobilization, but efficiency – to increase the return on infrastructure spending, whether by the taxpayer or user. Unfortunately, the practice of private participation in infrastructure in Cambodia is frequently characterized by a lack of competition and transparency, undermining the efficiency goal. Because of the nature of public services, most of the efficiency gains can only be captured at the point of transaction. To increase the impact of private participation, the report focuses on the governance framework for transactions, and identifies a number of legal gaps, institutional overlaps, and a lack of clarity at each stage. The process is sufficiently "broken" as to require firms to circumvent it to secure transactions – a process that prevents effective competition and denies Cambodia most of the benefits of private participation.

A number of recommendations are proposed, with a particular focus on improving trade facilitation practices, integrating markets through institutions such as private value chains, and injecting competition and transparency in private participation in infrastructure. The most important reforms are questions of political will, and as such are facilitated as much by frank, factual discussion as by technical recommendations. The intent is also to contribute to the quality of discussion surrounding private sector development, particularly through the Government-Private Sector Forum.

The response by the Government to this report indicates that the political will exists to confront the main challenges and "seize the global opportunity." A draft of this analysis was presented to the Government in February 2004, and was discussed in a series of Cabinet-level meetings. Through Prime Minister's Decision No. 12/2004 (see Chapter 6) and Decision No 44/2004 the Government established a Special Inter-Ministerial Task Force on Trade Facilitation and Investment Climate, Chaired by the Minister of Economy and Finance and Vice-Chaired by the Minister of Commerce. This body has defined an integrated program of reform to address the most urgent impediments raised in the report. The reform measures agreed – establishing a cross-agency reform team, consolidating inspection mandates across agencies and introducing selective inspections based on risk, implementing a Single Administrative Document and Single Window process, automating information flows across agencies, streamlining business registration procedures and recognizing ethical behavior in the private sector – will be initiated in July 2004 be implemented on an urgent basis by December 2005. These reforms address some of the more urgent constraints and strongly complement Cambodia's entry into the World Trade Organization.

The details of the reform program are described in the Executive Summary as well as in Chapter 6, which also documents the Government's reforms in a number of areas of interest to the private sector.

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Executive Summary

The Challenge of Private Sector Development

The Government's National Poverty Reduction Strategy (NPRS) states that "the central objective of the Royal Government's policy is to promote broad-based sustainable economic growth with equity, with the private sector playing the leading role."[1] Cambodia is a small, predominantly rural country of 13.1 million people, with per capita income of $280. As a result of decades of conflict, international embargo, and post-war population growth, the development challenge is immense. According to the NPRS, 36 percent of the total population lives below the poverty line of US$0.46-$0.63 per day, and 50.4 percent of children under age five are underweight. In a recent speech, insisting on the need to accelerate reform, Prime Minister Hun Sen explained that if business will continue as usual his country was not on track to halve poverty, but rather would expect poverty incidence of 28% in 2015.

The growth of the private sector in Cambodia over the past decade has been remarkable in light of the destruction wrought by years of conflict and has proven that private investment can create jobs at wage levels that can reduce poverty. In the period 1997-2001, industrial employment grew by an average of over 43 percent per year, compared with less than 2 percent growth of both agricultural and service employment. This growth was driven by the export performance of the garment sector, which has grown from $28 million in 1995 to over $1.35 billion in 2002.

Real GDP Growth by Sector, 1997-2003

Growth Rates (%)	1997	1998	1999	2000	2001	2002	2003 (est.)
GDP	6.8	3.7	10.8	7.0	5.7	5.5	5.2
Agriculture	6.4	5.8	3.4	-1.5	2.2	-2.7	9.2
Industry	19.6	-2.5	19.3	30.7	12.9	17.7	6.7
(o.w. Garments)	89.9	30.0	34.6	63.4	22.7	21.0	15.0
Services	3.4	4.8	10.9	5.7	4.2	4.5	1.6
(o.w. Hotels and Restaurants)	3.3	-1.3	18.5	14.4	18.1	11.4	-10.0

Distribution of Employment, 2001

	Total employment	Self-employment	Wage employment
Subtotal, Ag., forestry, fisheries	*70.2*	*69.2*	*22.7*
Agriculture, hunting, forestry	66.0	63.1	20.0
Fishing	4.2	6.0	2.7
Manufacturing	*8.7*	*7.8*	*26.4*
Services, of which:	*18.0*	*22.8*	*32.7*
Of which:			
Wholesale/ retail trade	10.3	16.7	2.3
Transport, storage, communications	2.7	3.9	6.7
Construction	1.5	0.6	7.6
Education	1.4	0.0	8.6
Other services	0.9	1.1	2.2
Private households	0.4	0.1	2.6
Health, social work	0.4	0.2	2.0
Real estate, renting, business act.	0.3	0.2	0.8
Public administration, defense	*2.4*	*0.0*	*14.6*
Other	*0.7*	*0.2*	*3.6*
Total	*100.0*	*100.0*	*100.0*

The employment impact of this growth, however, has been narrow and has failed to reach the

[1] Royal Government of Cambodia, *National Poverty Reduction Strategy*, February 2003. p. iv.

majority of the population. In terms of a share of its total exports, Cambodia has the second highest degree of specialization in the garment sector in the world – other sectors have simply failed to match the performance of garments.[2] Moreover, with the garment sector increasingly subject to international competition, the engine of growth and poverty reduction is at risk. Overall, the manufacturing sector still employs less than 9 percent of the workforce, compared with over 70 percent of employment in agriculture, forestry, and fisheries.[3]

Manufacturing jobs can have a dramatic impact on poverty. Private sector development has proven to be an effective strategy to reduce poverty in Cambodia. Households headed by those with industrial employment had only 4 percent poverty incidence, while 80 percent of families in which the head of household was employed in agriculture were poor.

As a small country competing in a globally-integrated, dynamic, and fast growing region, Cambodia's private sector-led growth strategy must be anchored in trade. Cambodia borders on Thailand and Vietnam – each growing rapidly with distinct factor advantages. Cambodia itself has a small domestic market, due to its small population base, its poverty, and the fact that this population is only 18 percent urban. In light of this, the country's leadership has wisely chosen the route of globalization. To the Cambodian authorities, WTO represents an opportunity to reap gains from integration with the global economy and broaden its industrial base, particularly in light of its small domestic market. The Royal Government's commitment to private sector-led growth has been clearly demonstrated by the range of reforms being pursued as a package by a cross-ministerial team led by Commerce. Accession to WTO will afford Cambodia market access to member country markets on a most-favored nation basis, but will also intensify competition. Unless steps are taken to remove impediments to domestic enterprises, it is unlikely that many of Cambodia's entrepreneurs will benefit in the short-run from market access.

Recent history destroyed institutions that support productive economic exchange, and human and financial resources in the public sector are overstretched. Any private sector development strategy must address this gap. Cambodia's challenge is compounded by the legacy of internal conflict that not only depleted the country's reserves of human talent on which entrepreneurship is based, but also disrupted the continuity of social institutions and formal and informal rules that provide the framework for trade and investment. The economic landscape reflects this lack of key institutions, most notably the rule of law. It also reflects an attempt by the Government to fill the institutional vacuum through administrative measures that have largely not worked, and created opportunities for corruption. Beyond human and social capital, physical infrastructure is lacking. Basic public services are absent for much of the population.

The decade from its first elections in 1993 has been spent consolidating peace and taking important steps toward a market-based economy, including dismantling much of the central planning and state-trading infrastructure, selling state-owned enterprises, establishing macroeconomic stability, liberalizing trade, freeing prices, and passing basic laws that enable private investment. The right to private property was enshrined in the constitution. FDI responded very well in the early years of liberalization, but gains from the first generation of reforms appear now to have peaked prior to the combination of political instability and regional economic crisis in 1997-1998. The perception of entrepreneurs inside and outside of Cambodia is that corruption is widespread, the rules of the game are not fair or do not exist, and that the country is prone to instability. Consequently, foreign direct investment has fallen consistently since 1999.

Cambodia now faces an historic opportunity to change its growth path. The Royal Government

[2] Calculation of revealed comparative advantage by ITC based on UN COMTRADE data for 2001.
[3] Labor Force Survey 2001.

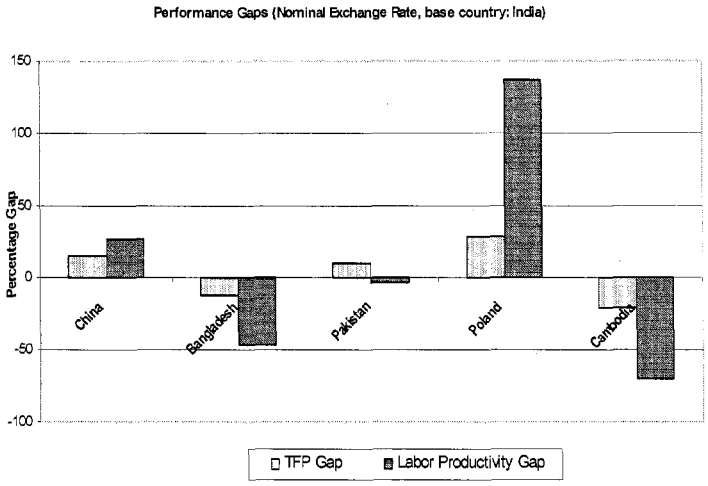
of Cambodia enters its second decade having held relatively stable elections,[4] and in the broader context of a growing, stable, and integrating East Asian region. This provides a good context to undertake a second generation of reform not focused on establishment of a market economy, but on enabling broad-based growth. The process of accession to the World Trade Organization has been accompanied by a wide range of legal and trade-policy reforms and proposals that define the broad outlines of a new growth platform. Specific reforms that enable the private sector would constitute an important part of this platform.

Stimulating growth and employment will require development of a policy reform package that rebuilds the confidence of the private sector. Much of the current status of the private sector, particularly the garment sector, responded to the first wave of policy reforms – from 1993 to 1997. The impact of this package was cut short both by political violence and the regional crisis. A new package is now needed to reinvigorate investment and job growth. Such a package must address the real costs and issues that reduce productivity and profitability for the private sector -- to encourage growth-- and also address the issues that are perceived as risks that impact the confidence of the private sector --to encourage new investment.

Because of the magnitude of the issues, reforms required, and limited resources, private sector development implies strategic choice. The process of setting priorities, making choices, and undertaking reforms is what is referred to as private sector development strategy supported by this document.

1. The Productivity Challenge

The first challenge of private sector development is to address the productivity gap. Cambodian firms and workers are less productive than China, India, Pakistan, and Bangladesh.[5] *Total factor productivity* is some 18 percentage points below India, 24 points below China, while roughly even with Bangladesh. Because of its scarcity, the productivity of capital is high. However, TFP is brought down by *labor productivity*, which is roughly 65 percent behind India, 62 percent behind China, and about 10 percentage points below Bangladesh. Labor costs are low, but do not compensate for low productivity levels. The ratio of labor costs to value added is actually higher than China, India, and Pakistan.



Source: The World Bank, PICS for each respective country.

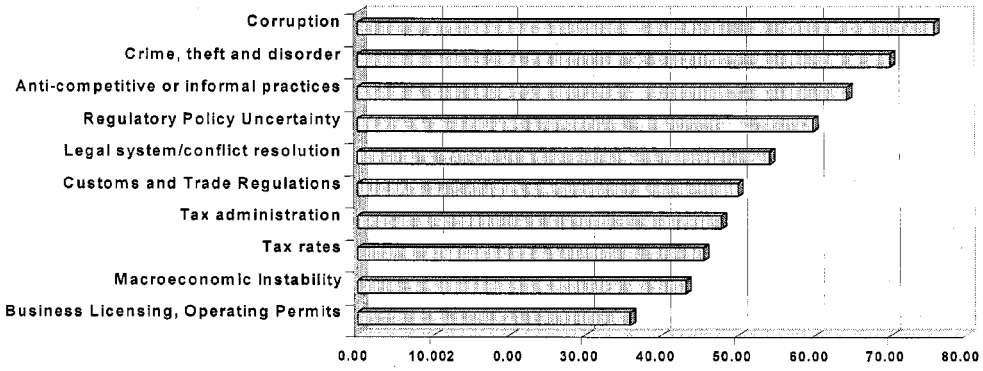
The message from the survey is one of weak rule of law, bureaucratic costs, and corruption. Cambodia firms identify corruption as their leading constraint.

[4] The elections, while considered fair by international observers, were followed by a protracted period of negotiation to form a new government. At time of writing, these negotiations have not been completed.

[5] To enable benchmarking, comparator data unless otherwise noted in this report is drawn from parallel questions asked in Productivity and Investment Climate Surveys (PICS) undertaken by the World Bank in each of these other countries. Vietnam, which may have also been a useful comparator, has not completed the PICS.

- Four-fifths of the private sector sampled acknowledges the necessity of paying bribes, and 71% of large firms report that these payments are frequent. The private sector estimates that unofficial payments cost firms an average of 5.2% of total sales revenue.[6]
- Business's view of agency integrity is alarmingly negative, with the Judiciary and Customs viewed the most negatively.
- Comparing these ratings to results from a related 1999/2000 survey, perceptions of corruption have not improved. Unfair and informal competition and the functioning of the judiciary are now rated as more constraining than before.

Cambodia: Top 10 General Constraints to Private Enterprise Operation and Growth



The formal private sector faces myriad transaction costs and barriers to establishment and operation. It takes 94 days to start a business in Cambodia – 30 days longer to start than in Vietnam and 52 days longer than in Thailand. Staying in the informal sector appears to be a rational response to the investment climate, because informal firms face lower taxes and bribes. They benefit little from formality.

Trade facilitation practices in Cambodia stand out in having high official and unofficial costs, delays, uncertainty, and discretion – a critical problem for a country that must rely on exports for growth. In contrast to the public perception of the Cambodian economy as largely free of red tape,[7] Cambodian firms are subject to an unusually high number of inspections, averaging 16 per year, second only to Pakistan and more than China among comparators. There is a high "time tax" associated with government inspections, and in this regard, Cambodia is second only to China.

The corruption problem is so acute that it crowds out the poor functioning of factor inputs – finance, skills, and infrastructure – as constraints identified by managers, but this is more likely a result of a lack of competition rather than adequate supply of these important factors.

- Cambodian firms receive little external finance, except through informal networks of family and friends. Commercial banks provide only 1 percent of working capital, and demand for formal

[6] Government officials argue that this unofficial payment is likely to include all the costs of intermediaries/facilitators often employed by the private sector to go through regulatory processes which raise the governance issue both within the public and private sectors. That should be addressed simultaneously.

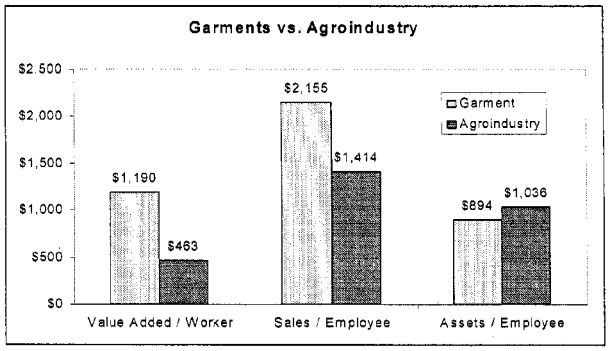
[7] For example, the Canadian Department of Foreign Affairs website on Doing Business in Cambodia states that "Cambodia's open free market system, *lack of government red tape*, plentiful natural resources, and low-cost labor force offer many opportunities to investors." July 2002.

financing is limited. Less than 4 percent of the firms who do not have a loan have actually applied and been rejected. Cambodia is a cash economy, and the lack of an adequate payment system is one of many impediments to trade.

- Similarly, skills are not identified as a serious impediment at present despite 63 percent functional illiteracy in rural Cambodia.
- Infrastructure is not viewed as an immediate constraint despite having the lowest infrastructure indicators (e.g., electrification, road density, telephone density) in the region.

As the private sector grows in size and sophistication of transactions, it will quickly confront the weaknesses in finance, human capital, and infrastructure as constraints. Given that these factors take time to develop, impediments in the markets for these factors need to be understood and addressed.

2. The Diversification Challenge



Source: The World Bank, Cambodia PICS 2003.

The second challenge of private sector development is to broaden the base of economic opportunity and jobs. The private sector is exceptionally narrowly-based. The garment sector contributed nearly four-fifths of Cambodia's total official exports of $1.44 billion. Yet, employment and the great majority of enterprises numerically are concentrated in agriculture and agro-industry,[8] which exports little and has a labor productivity less than half than in the garment sector. For reasons of equity, risk, and poverty reduction, the country needs a broader base of firms and sectors that operate at higher productivity levels. From a cost and resources standpoint, Cambodia may have a comparative advantage in agro-industry. If value added can be raised, agro-industry can contribute to diversifying the economy by shifting more rural employment to manufacturing. The diversification challenge requires answers to the questions of why value added is low, and what actions may be taken to raise it. To shed some light, the report uses PICS data to compare the larger urban formal sector, represented by the garment sector; with largely small-scale and informal agro-industrial sector.

Diversification appears constrained by fragmented markets which limit competition and productivity gains. Integrating markets depends on institutions that support a transition from local, personal exchange to arm's length transactions over a wide geographical area. The increased market scope enabled by formal trade is the basis for *competition*, which in turn creates specialization and *productivity gains*. The key factors affecting this transition are the extent to which institutions exist to reduce the risk and cost of exchange, including quality, price, and contractual risks, and the cost of coordinating production, finding partners, and executing transactions. We compare the institutional environment for garments and agro-industry.

The garment sector has proven its ability to export and grow, but it now faces the prospect of lower prices and therefore the need to increase its efficiency. Like garment exporters throughout the world, Cambodian firms must contend with the liberalization of garment trade at the end of 2004. Cambodia's garment sector has grown in an environment of preferential access to the US and EU markets. Through the WTO Agreement on Textiles and Clothing, the US has given Cambodia a quota in its protected

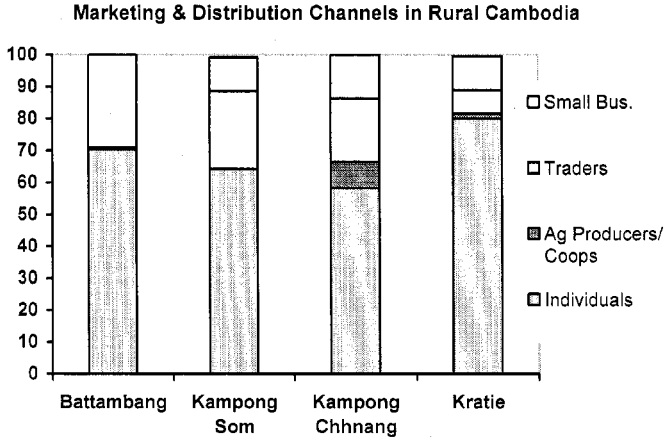
[8] Both statistics are somewhat misleading, since a large share of agricultural trade and employment is informal and not captured in official export or industrial data.

market, the volume of which depends on labor practices. Such agreements will be replaced by competition in 2005. There is a possibility that corporate social responsibility practices will become a source of competitive advantage, but Cambodia competes in high-volume segments where demand is likely to be cost-sensitive. The evolution of price behavior in Cambodia's non-quota exports to the US suggest declining margins. As the global industry consolidates to reap economies of scale, Cambodia's industry is at risk. Therefore, the focus is on reducing excessive and overlapping bureaucratic processes and high associated costs – particularly in trade facilitation.

There is a substantial gap in the scope of trade-supporting institutions in the two sectors (see Table 3.5 in Chapter 3 for full table). Trade in the garment sector is supported by well-developed institutions that provide confidence and trust in Cambodia's exporters, even in absence of the formal rule of law. These institutions authenticate country of origin, manage quota allocation, verify compliance with labor standards, verify fulfillment of quotas both on the Cambodian side and in the export destination, verify compliance with duty exemptions, and manage quality. Disputes are resolved overseas. Unions exist to organize and express the needs of labor, and the voice of the Garment Manufacturer's Association of Cambodia has clearly influenced policies that support the needs of the sector.

	Garments	Agro-Industry
Value Added/Worker	$1,190 (low by international standards)	$462 (extremely low by international standards)
Firm Size	600+ employees	~7 employees
Market Scope	Global markets: US 71%, EU 38%	Local, informal: 70% individual
Trade-Supporting Institutions	GSP, Agreement on Textiles and Clothing Labor Law, ILO compliance monitoring, Corporate social responsibility norms, Quota management systems, ELVIS Certificates of Origin, Duty Exemptions, tax incentives, Foreign dispute resolution (e.g., Singapore)	None
Informal/Private Institutions	Garment Manufacturers' Association, Corporate networks	Village and community-based or NGO-driven
Quality measurement	CamControl	CamControl inspections
Source: The World Bank, Cambodia PICS 2003.		

Agro-industry does not benefit from trade-supporting institutions, so the vast majority of producers are small, informal, and serve local markets or middlemen. In Battambang, which includes many rice millers, 70 percent of output is sold directly to consumers and the balance to local business. Competitive wholesale marketing and distribution is absolutely essential to productivity, but there are signs of some monopolies in distribution. The risk environment causes firms in rural areas to keep high inventory levels: 57 days of inventory in Battambang, 27 days in Kampang Cham, 37 days in Kampong Chhnang, and 35 days in Kratie. Firms indicate that if they had better financing, they would keep even inventories of over half a year.



Source: The World Bank, Cambodia PICS BIS 2003.

Since the scope of trade in agro-industry is local, exposure to competition – the driver of productivity- is severely limited. Demand for skills and capital is low. Extremely low levels of educational attainment and high levels of functional illiteracy characterize the working population in rural areas. Firms in the food sector provide little training to their employees. Firms do not report that infrastructure is a constraint, yet it takes rural firms 2.6 hours to reach their most important market, 3.6 hours to reach the supplier of their main input, and 3.6 hours to get to a financial institution. Commercial funding is almost absent for the agro-industrial sector – only 3 percent of working capital is met from commercial sources.

To support diversification, the focus is on integrating agro-industry and other rural firms into urban, and ultimately, international markets. This will require (a) removing impediments in such areas as trade facilitation, inspections, and exclusive licensing and (b) building trade-supporting institutions including dispute resolution, product quality and standardization, and market information systems. The rule of law – particularly the enactment and enforcement of contract law embedded in the civil and commercial code – will be required, along with efforts to raise awareness among entrepreneurs of their legal rights and obligations. Because most industries outside of textiles/garments and tourism are at a formative stage, the role of both the private sector in organizing itself and of institutional learning are essential. Given weaknesses in public administration, the report suggests a focus on the development of effective non-state institutions, including business and trade associations.

3. The Service Delivery Challenge

The third challenge of private sector development is to play a role in improving access to efficient and affordable water, electricity, transport, and telecommunication services. This can have major impacts on Cambodian living standards and on the investment climate. Efficient infrastructure is essential to sustain economic growth and industrial competitiveness. Cambodia has one of the lowest electrification rates outside sub-Saharan Africa; it has no power transmission system and has no large generation capacity. Where electricity is available, firms and individual consumers face some of the highest energy costs in the world. Cambodia has the least developed road network in the region with the smallest percentage of paved roads.

It is difficult to see how Cambodia can address these backlogs in a short period of time using internal resources alone. Inadequate domestic revenue mobilization and skewed public expenditure allocations have kept Cambodia heavily dependent on foreign aid for financing the provision of basic goods and services. A 2002 study revealed that 65 percent of the costs of all infrastructure projects to be undertaken between 1999 and 2001 had no identified source of funding.[9] Further, government resources are able to cover less than one-third of the total annual cost of rehabilitation and maintenance.[10]

There is scope for the private sector to bridge the financing gap, but the most essential role for the private sector and market forces is to ensure that efficient choices are made in delivery and management of services. There is growing recognition around the world that the private provision of infrastructure, within an appropriate contractual and regulatory framework, can offer services at lower unit costs, with faster implementation, reduced whole life costs, better risk allocation, better incentives to perform, improved management of quality, enhanced public management, and at times generate revenues. The need for efficiency in service delivery is a key driver for change and creates an opportunity for growth.

[9] World Bank and the Public-Private Infrastructure Advisory Facility (2002). *A Country Framework Report: Private Solutions for Infrastructure in Cambodia.*

[10] World Bank and Asian Development Bank (2003). *Cambodia - Enhancing Service Delivery through Improved Resource Allocation and Institutional Reform: Integrated Fiduciary Assessment and Public Expenditure Review.* Report.

A number of international firms have already made substantial investments in power, telecom, transport, and airports. Moreover, the local private sector is entrepreneurial and willing to contribute their own equity.

However, PPI practices prevent Cambodia from enjoying the benefits of private participation:

- There is a general lack of transparency in the negotiation and management of contracts between government and investors. Few if any concession agreements or negotiated contracts have been made available for review, publication, audit, or public scrutiny.
- Significant gaps pervade in the legal framework in a number of sectors, with some over-arching sector laws still in draft, and persistent bypassing of existing laws and processes.
- Scant respect is paid to examining and documenting contingent and ongoing liabilities taken on by the public sector.
- Planning processes across sectors are generally inadequate, and as a result, private firms frequently present unsolicited offers independent of sector plans or in conflict with previously negotiated concessions.
- Little auditing of concessions takes place prior to or after implementation.
- The allocation of roles and responsibilities between institutions is unclear. In several sectors there are multiple agencies providing oversight, licenses, and permissions to operate, but limited coordination between them. In some instances officially designated roles and responsibilities have been over-ridden by more senior individuals.
- The power sector is well-developed from a regulatory standpoint, but other sectors lag.

The consequences of these problems include unbankable projects, higher than necessary prices, unavailability of information on the efficiency of services and limited protection of the public interest. The deficiencies in the legal framework are reinforced by problems at various stages of the project cycle:

- **Policymaking, planning, and project identification.** Current laws and regulations do not provide a process for agreeing policy on development of PPI nor for setting priorities across projects or sectors.
- **The approval process prior to award.** Once individual projects have been identified, the 1993 Financial Budgetary Law requires all PPI contracts, regardless of the sector, to be approved by the Ministry of Economy and Finance (MEF) prior to signing. However, this legal requirement is generally not followed.[11]
- **Negotiation and award of projects.** A number of cross-sectoral laws reflect the principle that contracts with the private sector should generally be awarded by competitive tender. However, these laws are simply not followed.
- **Project implementation.** Once agreement has been reached, investors must begin the burdensome task of requesting all necessary approvals, permits, consents, licenses, and authorizations from multiple governmental entities.
- **Management of PPI contracts.** The legal framework does not make provision for post award management of PPI contracts. In practice, there is little evidence of effective project monitoring or management.
- **Regulation of infrastructure projects**. In many sectors, the law is unclear as to which entity has the power to regulate projects.

The RGC will need to making immediate and fundamental changes to the current regulatory and institutional environment for PPI – focusing on transparency, predictability, competition, and accountability.

[11] It should be noted, however, that there appears to be at least one recent instance in which the Minister of Economy and Finance used the provisions of the 1993 Law to refuse to sign an implementation agreement for a power generation, transmission, and distribution contract, until such time as his Ministry has had the time to review the draft contract in more detail.

It will need to reinforce government performance risk by using political risk guarantee instruments to protect foreign investors and lenders not only against war, currency transfer, and expropriation, but also against government breach of contract risks. It will need to make a transition from subsidized tariffs to full cost recovering tariffs and connection subsidies to connect some of the poorest households, employing private partners to ensure effective delivery of subsidies and recognizing that at least some of the investment to achieve build-out targets will need to be kick-started by public finance.

4. Guiding Principles for Reform

Private sector development is an evolving process, and a successful reform can only emerge from a continual effort to improve the investment climate. The following guiding principles emerge from the analysis as filters to help identify priorities:

Ease the burden on business: a shift from a culture of control to a culture of facilitation. Streamline institutional overlaps, particularly in trade facilitation, and reduce the large number of inspections and licensing requirements, particularly those related to ensuring quality.

Empower markets and competition. The healthy development of the private sector depends on removing policy distortions that prevent market signals from reaching the private sector and helping shape economic decisions. This includes elimination of exclusive dealing arrangements.

Do not go beyond the limited capacity of public institutions. Given capacity constraints, it is necessary to leverage non-state actors and to streamline the role of the public sector. The strategy should reposition the state to provide effective governance, accountability to the public, and a focus wherever possible on using well designed partnerships to deliver services rather than use limited public resources.

Focus on reforms that are empirically shown to relate to improving competitiveness and productivity. There is a range of institutions and reforms that can help the private sector, but in consideration of the survey and value chain analysis, a few that impact productivity the most. Increasing labor productivity is the most sustainable way to increase job growth.

Use private institutions to integrate rural and informal sectors. Integration means removing policy-related impediments, both formal and informal, that raise the cost of doing business for firms that are now limited to either informal or small-scale, local trade. This will be achieved by (1) reducing policy-based impediments, particularly in such areas as trade facilitation and business inspections and (2) reducing entry barriers, such as unnecessary licenses and the high cost of registering businesses.

Focus on institutions that reduce risk and transaction costs. Reduce the cost of measurement of quality and quantity by building standards and, where feasible, sustainable alternatives to state or donor-funded measurement systems.

Focus on institutional learning, given the early stage of private sector development. Explore the role of local business organizations, scaling up the success of garment, rice millers and rural electricity enterprise associations.

Introducing greater accountability in policy formulation and performance. No strategy or economic policy can have impact unless it is monitored and there are consequences for objectives and milestones that are not achieved. In Cambodia, donors currently provide a monitoring role. This is inconsistent with a program designed to achieve sustainability. The strategy should strengthen private sector and citizen monitoring of public performance (including corruption) and capability to participate in policy dialogue – both to support Government-Private Sector Forum and rural areas.

Reform Initiatives

The analysis suggests a number of reforms that are clearly linked to restoring confidence and raising productivity – prerequisites for new foreign or domestic investment. The following eight reforms emerge as initial priorities that (a) address some of the key problems raised in the analysis that are closely associated with raising the cost of doing business, and (b) address what the private sector perceives as the key problems, and (c) support the WTO accession and the related legislative package.

1. Trade Facilitation. Any trade-led private sector development strategy depends on efficient trade facilitation. As described in the value chain analysis, Cambodia's trade facilitation practices are markedly inefficient, both in cost and time terms, due to a combination of administrative overlap, inefficient processes, a lack of automation, and high unofficial and official costs.

- **Overlapping and obsolete roles and responsibilities should be eliminated**. Rationalizing roles and responsibilities for shipment clearance, including documentation, inspection, and payment will entail some cross-training as well as a clearly defined process for sharing information across agencies. KAMSAB's role as agent of record is now obsolete, since commercial shipping agents have entered the market. Pre-shipment inspection should continue to be outsourced, with an eventual transition to CED as it acquires skills.
- **Documentation should be radically reduced.** Currently, over 45 documents – most requiring the same basic information - are required to import one shipment. This plethora of documents should be replaced with a Single Administrative Document that consolidates the information requirements of all agencies. This information should be shared by the government to minimize the necessity of interface between the private sector and agencies.
- **Processes should** be **streamlined and the automated.** CED's current streamlining program – which is already defined – should eliminate a number of non-value adding steps. Following this, comprehensive automation should be introduced, including documentation related to documentation, export licensing, certificates of origin, and risk management. Inspections should be conducted on each container, but only on those that clearly fall within risk parameters, which can be automated. The process should be reengineered as a single window with flat fee for service, governed by service level agreements with the private sector.

2. Removing Impediments to Diversification. A set of administrative requirements, including some parts of the business registration process, licensing, and inspections, should be eliminated as they are frequently ignored, and as currently designed, contribute to informality bribe payments.

3. Strengthen the Rule of Law. Contract law, as embedded in the Civil and Commercial Code, is of critical importance to a trade-led private sector development strategy.

4. Leveraging Private Sector Value Chains. This recommendation focuses on the use of supplier development programs and value chain incentives to create linkages, rather than relying extensively on public institutions. This involves facilitating FDI in retailing, logistics, and agribusiness.

5. Review the role of CamControl. CamControl serves several functions, including regulating quality and public safety. Some of these mandates are vital for public safety, but the way it currently executes its mandate needs to be modernized. It should base the import inspection activities on a risk management approach and it should strengthen the efficiency of its knowledge-providing role, with its laboratories used more on a voluntary basis to facilitate product testing and trade. The review should consider the possibility of merger with Customs, retaining as is, or establishing a new Food and Drug authority.

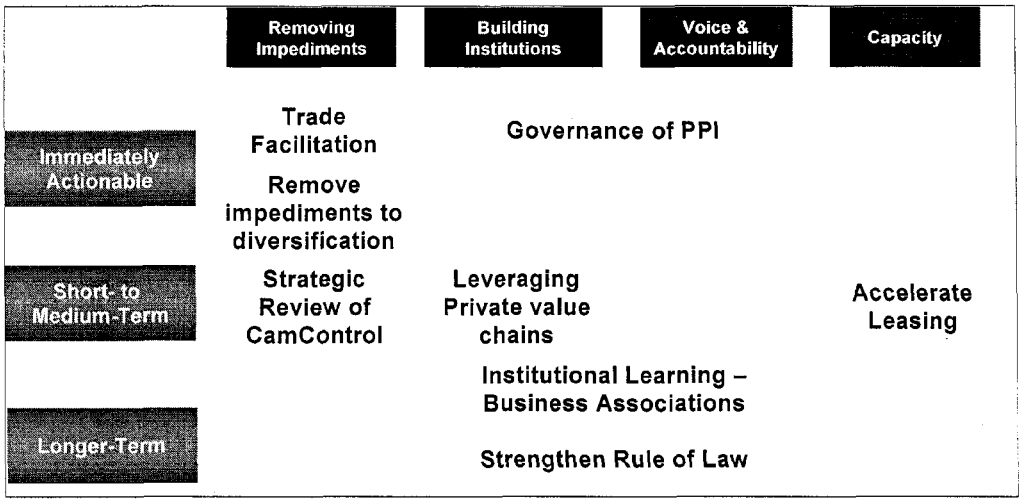
6. Strengthen Governance for Increased Private Participation in Infrastructure. A reform plan would rationalize institutional overlap and clarify processes at each stage of the project life cycle: primary and secondary approvals, responsibility for granting contracts, contract management and monitoring, and capacity building.

7. Strengthen Institutional Learning through Business Associations. Particularly at the early phases of organizing the private sector's response to increased market opportunity, it will be important for the private sector to coordinate and share the cost of learning. Business Associations can increase access to market information. Over time, it is important that the private sector develop its own capacity to monitor development of policy and to advocate sectoral interests within a fair political process.

8. Accelerate leasing. While access to capital did not appear as a high priority to many firms, it is clear that it will constrain firms that compete. Leasing is potentially viable as a form of finance that depends least on a fully-functioning legal system, since title typically does not change hands during the transaction.

Prioritizing Reforms

During stakeholder workshops and consultations in December, February, March and June, the reforms were discussed in terms of their impact, urgency, degree of further analysis needed, and their ease of implementation. The outcome of the workshops suggested that trade facilitation and removing of impediments to diversification such as licenses would be the most immediate and actionable areas, despite significant political will required. This is largely due to the end of garment quotas, which will require rapid reduction in costs to remain competitive.



Government Actions and Commitments

The Bank team presented the findings of the Investment Climate Assessment to the Government in February 2004. The Senior Minister of Economy and Finance, the Minister of Commerce, with the support of the Prime Minister, called for a Government-wide discussion which took place in a series of government discussions in March. In one such the discussion, the findings of the report were presented to a meeting of approximately 90 senior Government officials. From these discussions, the Prime Minister issued Decision No 12/2004 on March 22, 2004, creating a Special Inter-ministerial Task Force (SITF) for Improving the

Investment Climate and Trade Facilitation. This task force has the task of proposing immediate measures to reduce trade facilitation costs, reduce duplication and simplify processes, reduce the time required, and increase official Government revenue. On

The Bank team met with the SITF on March 25, 2004 and agreed in principle to focus on (a) reducing product inspection burden, (b) implementing a single window, (c) developing a performance measurement system, and (d) restructuring human resources management. The Government, via the task force, decided to take several short-term reform measures in these areas as a response to the findings of the ICA as discussed below. The Bank and Government mutually agreed on a two month period to develop these reforms.

Following the two-month period, the Bank met with the Special Inter-Ministerial Task Force (SITF) again on 7 June 2004. During this second meeting, the Government committed to a number of critical reforms to be undertaken over an eighteen-month period from June 2004 to December 2005. A cross-agency reform team was identified to lead this effort, including all key agencies involved in investment climate and trade facilitation issues: Ministries of Economy and Finance, Commerce, Agriculture, Labor and Social Welfare, Interior, Industry, the CDC, and the Port Authority of Sihanoukville. The reform team will report to the Special Inter-Ministerial Task Force Chaired by the Minister of Economy and Finance, will work closely with the Bank, and interact with the private sector.

The Special Inter-ministerial Task Force (SITF) committed to developing a transparent performance measurement system, measuring the steps, time and cost to import and export product, including all relevant agencies. The private sector will play a role in the monitoring system. SITF agreed to replace the current frequent and discretionary inspections with a risk management approach, in which inspections will be selective, based on the risk profile of the shipment only. The SITF will lead the a process of simplifying and streamlining the process, including removing redundant steps, and replacing all current documents with a Single Administrative Document to be filled out once by the private sector. Rather than have the private sector meet with each agency involved in trade facilitation separately, a Single Window process will be established and the roles of various agencies will be rationalized. The SITF also agreed to simplifying licensing and registration processes, and automation of the trade facilitation process.

On 26 July, 2004, the Prime Minister's Decision 44/2004 end the mandate of the Inter-ministerial Special Task Force for Investment Climate Improvement and Trade Facilitation and formed a Steering Committee for Private Sector Development, which will serve as the Government's focal point in determining, leading, implementing, and monitoring the implementation of the Rectangular Strategy on Private Sector Development, including improving the investment climate, trade facilitation, SME promotion, and PPI.

Implementing the reform program will require the engagement of all stakeholders. To help ensure that the private sector contributes to a new investment climate characterized by better governance, the Government will encourage, through the Government-Private Sector Forum, the development of codes of ethics in the private sector, and the creation of a national award for good corporate governance and citizenship. The Government has also encouraged the donor community to develop a Sector-Wide Approach (SWAp) to align its support, which is currently fragmented, to an agreed set of policy priorities. This report has been discussed with donors, and there is broad agreement on its relevance as a policy platform that donors can support. Other important efforts to be integrated include those of UNDP, Asian Development Bank, JICA, the European Union, AusAID, GTZ, and Danida. On the Government's request, the Bank is preparing a project to finance some of the outlined reforms.

Details on all of these areas and on actions agreed by the Task Force and the Bank can be found in Chapter Six. Chapter Six also includes previous reforms undertaken by the Government in related areas.

Chapter 1: The Challenge of Private Sector Development in Cambodia

1.1 Poverty, Productivity and Service Delivery

The recent National Poverty Reduction Strategy (NPRS) states that "the central objective of the Royal Government's policy is to promote broad-based sustainable economic growth with equity, with the private sector playing the leading role."[12] This statement reflects both an important insight and a set of challenges. It is a recognition that the private sector is key to sustainable poverty reduction, but challenges policymakers to (a) identify ways to increase its growth; (b) do so in a way that improves the distribution of wealth, or at a minimum, broadens the base of higher-productivity enterprise; and (c) do so in a way that is sustainable.

The challenge is formidable and long-term. Cambodia is a poor, rural country of 13.1 million, with over a third of its people living in poverty; over 80 percent in rural areas. More than two decades of conflict, followed by embargo, have marked its history since independence in 1953. It is well understood that among the many tragic consequences of Cambodia's political history was a depletion of many of Cambodia's most skilled people – intellectuals, craftsmen, artists, engineers, and others – who may have helped form a nucleus of a growing entrepreneurial class in the right enabling environment. Along with the depletion of human resources was the loss of the social institutions – organizations, norms, rules, and basic trust – that supported the productive interaction of citizens in the form of economic exchange. As Nobel Laureate Douglass C. North put it in his prize lecture, "it is the admixture of formal rules, informal norms and the enforcement characteristics that shapes economic performance. While the rules may be changed overnight, the informal norms usually change only gradually."[13] Cambodia's lack of a strong industrial tradition and the extent to which its governance has either been externally influenced or unresponsive to the needs of domestic entrepreneurs has meant that Cambodia has not benefited from a long history of experiences crystallizing themselves in the laws, institutions, services, marketplaces, information channels, and norms that form the basis enabling environment for the private sector.

Another feature of Cambodia's post-conflict transition is the fact that the human and financial resources in the public sector are overstretched. This has several implications. First, basic services to be delivered by the Government are lacking, and the scarcity of those services (electric power, water, etc.) is an important feature of the business environment since the scarcity is reflected in pricing. Second, in part because salaries are necessarily lower than would be without a severe budget constraint, many civil servants appear to be exploiting opportunities to seek rents. This complicates the business environment and links progress to civil service reform. Thirdly, any strategy going forward to improve the business environment must consider, wherever feasible, better targeting of public resources. This may take the form of redefining the role of the state away from resource-intensive roles and towards policy setting and protecting service delivery standards. It also means leveraging, where possible, the role of the private sector and civil society in establishing institutions and market-based accountability mechanisms. In the public and private sectors, institutions required to effectively carry out a more focused and market-based mandate are weak, and capacity building must be considered integral to private sector development.

[12] Royal Government of Cambodia, *National Poverty Reduction Strategy*, February 2003. p. iv.
[13] Douglass C. North, *Economic Performance Through Time*. Lecture to the memory of Alfred Nobel, December 9, 1993.

The economic landscape reflects this lack of key institutions, most notably the rule of law. A large share of the private sector operates informally, including businesses that operate on a small scale and other businesses that operate illegally. Rural businesses appear to serve only local markets, primarily individuals and other small businesses located in the immediate vicinity. Light manufacturing or capital- and knowledge-intensive agribusiness with longer payback periods are eschewed in favor of trading businesses, garments, services or tourism, which depend on either low capital costs, high margins, or in the case of tourism, unique cultural assets. Cambodia has also been home to many businesses that have taken advantage of the lack of established rule of law to exploit human or natural resources, including trafficking of people, smuggling, and illegal logging. The Government's understandable reaction to this type of activity has been to impose bureaucratically-enforced regulations and inspections. These tools have not always had the desired effects, and form an important part of the perceptions of businessmen. Clearly, any PSD strategy must offer more efficient tools to manage risks and protect the public interest.

Beyond human and social capital, physical infrastructure is lacking. Cambodia's indicators for road density, teledensity, electricity generation capacity, and availability of water are among the lowest in the East Asia and Pacific region. The absence of public services has resulted in extremely high levels of self-provision of services at high cost. Over 40 percent of small firms in rural areas, and 39 percent of all firms, generate their own electrical power, while 73 percent of small firms in rural areas have their own well (24 percent of all firms). The authorities have taken a pragmatic and open approach to the private provision of infrastructure. Private provision of public services in Cambodia takes several forms, ranging from entry of entrepreneurs in rural power and water, contracting of health services, privatization, joint ventures in telecommunications, and concessions to private operators to manage existing state assets in transport. The issue in Cambodia is not only to open to private investment but to ensure that it is done competitively, transparently, and has the highest possible development impact. Since service providers are often granted long-term rights to manage monopoly assets, the only opportunity for obtaining the benefits of competition comes during contracting. Unfortunately, competition and transparency are not frequently features of infrastructure transactions in Cambodia. Because they are not conducted through competitive processes, these deals cannot hope to extract the efficiency gains that are the central promise of private provision. It is clear, therefore, that private sector strategy must consider infrastructure service delivery both as a feature of the investment climate, and as an important source of growth. This is the subject of Chapter 4.

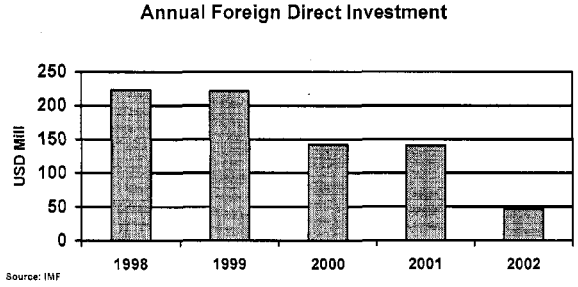
Yet, despite the burden of political and economic history and the absence of key institutions and infrastructure, the private sector has been able to grow. The garment sector in particular has clearly indicated the potential impact of a thriving private sector, growing from $20 million in exports in 1995 to over $1.4 billion in 2002. The recent past suggests that the private manufacturing activity can provide jobs at wages that dramatically change poverty incidence. In the period 1998 to 2000, industrial employment grew by an average of over 43 percent per year, compared with less than 2 percent growth of both agricultural and service sector employment. Households headed by those with industrial employment had a less than 4 percent poverty incidence, while families in which the head of household was employed in agriculture or services had poverty incidence of roughly 80 percent and 10 percent, respectively.[14]

This growth was highly concentrated and shows signs of being unsustainable. As recently as 1995, the Survey of Business Establishment identified only 829 firms with ten or more employees.[15] In part due to the small base, growth performance was impressive over the 1996-2000 timeframe, in which total manufacturing output grew at 19.1 percent, driven by textile/garment at 64.3 percent, followed by electricity and water at 8 percent, and construction and mining at 3 percent each.[16] Growth is exceptionally dependent on FDI, which comprised over 50 percent of fixed capital formation in 1998. However, FDI inflows have

[14] RGC, Ministry of Planning (2002), *Cambodia Statistical Yearbook 2001*.
[15] Cambodia Development Resource Institute (CDRI) (2002), *Annual Economic Review 2002*.
[16] RGC, MOP (2001), *Socio-Economic Development Plan II 2001-2005*.

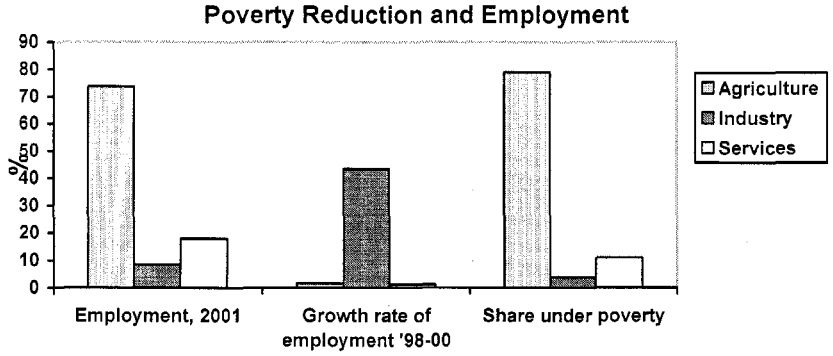
dropped each year since 1998, falling from over $230 million in 1998 to just $113 million in 2001 and comprising 40 percent of fixed capital formation. FDI was closely tied to Cambodia's ability to obtain a share of the protected US and EU garment and textiles markets. The country crossed the $1 billion export threshold several years ago, and exported $1.4 billion in 2002, of which 80 percent were garments.

FIGURE 1.1



Because it started so recently from such a low base, the impact of the sector has been small relative to the magnitude of poverty, and the growth of formal sector jobs has not kept pace with new entries into the job market. Measured by income or other social indicators, Cambodia is among the poorest countries in the world, ranking 136th of 174 in the UN's Human Development Index. According to the recent National Poverty Reduction Strategy, 4.5 million Cambodians, 36 percent of the total population is in poverty, living on less than US$0.46-0.63 per day, and 50.3 percent of children under age five are underweight. Economic growth averaged 6.8 percent between 1994 through 2001, but declining back to 5.5 percent in 2002 and is projected to drop further to 5.2 percent in 2003.[17] Cambodia's low Gross National Income (GNI) per capita in 2002 of US$280 was in fact lower than that of Lao PDR (US$310), Vietnam ($430/capital), and Thailand (US$1,980).[18] Half of Cambodia's poor would be lifted out of poverty if six percent growth could be sustained for eight years.[19] Roughly 200-250,000 Cambodians enter the job market each year, sometimes including demobilized soldiers. Many are absorbed by the informal sector.

FIGURE 1.2



Source: Ministry of Planning, ***Cambodia Statistical Yearbook*** 2001.

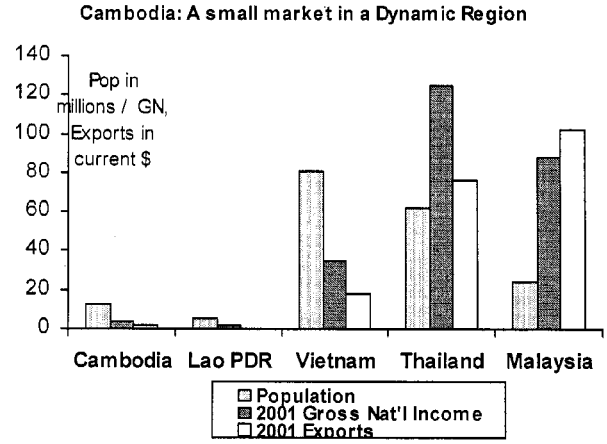
[17] Source: World Bank estimates.
[18] National poverty line is measured at a daily subsistence level of US$0.50 per day.
[19] UNDP (2001), *United Nations Development Goals: Cambodia 2001.*

1.2 The Competitive Environment

Cambodia competes in a globally-integrated, dynamic, and fast growing region. With the exception of Lao PDR, Cambodia's neighbors have all chosen to pursue globalization as economic strategy, have trade to GDP ratios that far exceed the world average, and used the decade of the 1990s to extend this lead. Furthermore, the economies of the region are integrating rapidly through regional trading arrangements such as the ASEAN Free Trade Area at the official level, through networked supply chains in electronics and automotive manufacturing, through increasingly efficient logistics infra-structure and services, and through investment in road networks.

Cambodia is bordered on Thailand and Vietnam – each growing rapidly with distinct factor advantages relative to Cambodia that make it difficult to identify a growth strategy based on its own urban markets. In the battle for the hearts, minds, and purchasing power of the Cambodian consumer, Thailand and Malaysia are certainly better equipped to provide high-value products that depend on technological or capital intensity, while Vietnam is certainly better prepared to provide inexpensive or labor-intensive products. Cambodia itself has a small domestic market, due both to its small population base and to the fact that this population is only 18 percent urban, compared with 25 percent in Vietnam and 22 percent in Thailand. Cambodia's urban consumers are increasingly sophisticated and exposed, but will constitute the critical mass necessary to drive investment in a limited number of sectors.

FIGURE 1.3



In light of this, Cambodia has wisely chosen the route of globalization. To the Cambodian authorities, WTO represents an opportunity to reap gains from integration with the global economy and broaden its industrial base, particularly in light of its small domestic market. Cambodia completed its negotiations with its Working Party in July 2003 and was unanimously admitted in September 2003. Following endorsement by Cambodia's General Assembly, expected by early 2004, Cambodia will become the first least developed country to join the World Trade Organization through a full working party process. This is a substantial milestone not only for Cambodia but for all Least Developed Countries that seek to leverage the benefits of trade. The working party appeared to be influenced by the following reforms and commitments, which represent effort by a broad range of Ministries:

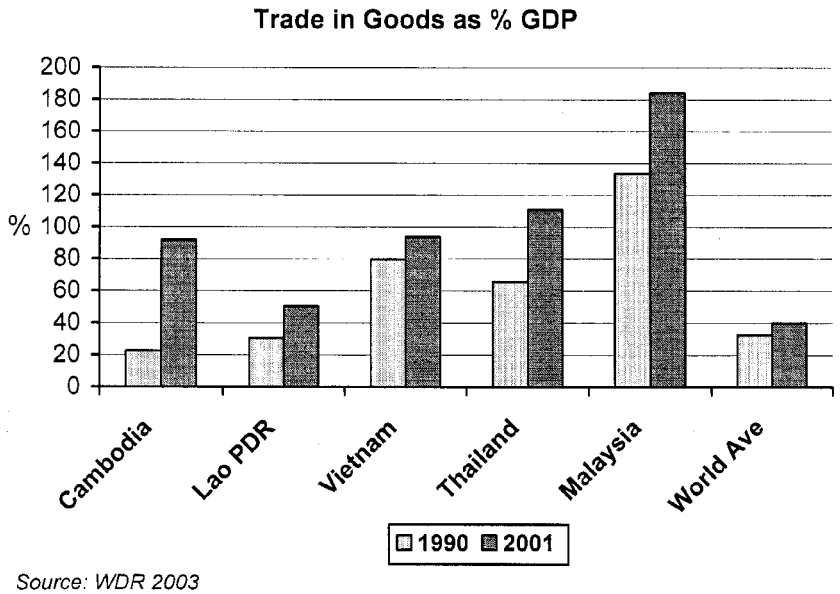
- Cambodia's work toward macroeconomic stability based on a flexible exchange rate;
- New tax and investment regimes, including amended Law on Investment;

- Commitments to further progress on legal and judicial reform, including establishment of commercial courts, as the code of civil procedure, commercial code, and bankruptcy code;
- Transparency and continued reform of state-owned enterprises and any state-controlled prices;
- Reform of import licensing regimes;
- Reform of customs duties and charges and the provision of a dispute settlement mechanism;
- Immediate implementation of the Trade-Related Investment Measures (TRIMS) Agreement;
- Implementation of the WTO Rules of Origin Agreement by January 1, 2005;
- Implementation of the Trade-Related Intellectual Property Rights (TRIPS) Agreement by 2007;
- Implementation of the WTO Customs Valuation Agreement by January 1, 2009;
- A commitment to publish all laws and regulations on a website according to WTO requirements;
- Binding export subsidies for agriculture at zero.

The Royal Government's commitment to private sector-led growth has been clearly demonstrated by the range of reforms being pursued as a package by a cross-ministerial team led by Commerce. Many of the listed reforms – particularly the legal and judicial reforms – are substantial undertakings that were catalyzed and rewarded by the accession process. However, many of these laws remain in the General Assembly and constitute a large pipeline of pending legislation.

The message is clear – Cambodia has chosen not to protect, but to compete. Accession to WTO will afford Cambodia market access to member country markets on a most-favored nation basis, but will also intensify competition from foreign goods and enterprises in both domestic and international markets. WTO accession creates opportunities, but will also create a more competitive market environment for which an effective, competitive supply response is needed. As such, Cambodia's investment climate will need to converge towards international norms by removing the impediments that put its exporters at a disadvantage relative to other exporters competing for similar markets – including China and Vietnam in textiles.

Figure 1.4

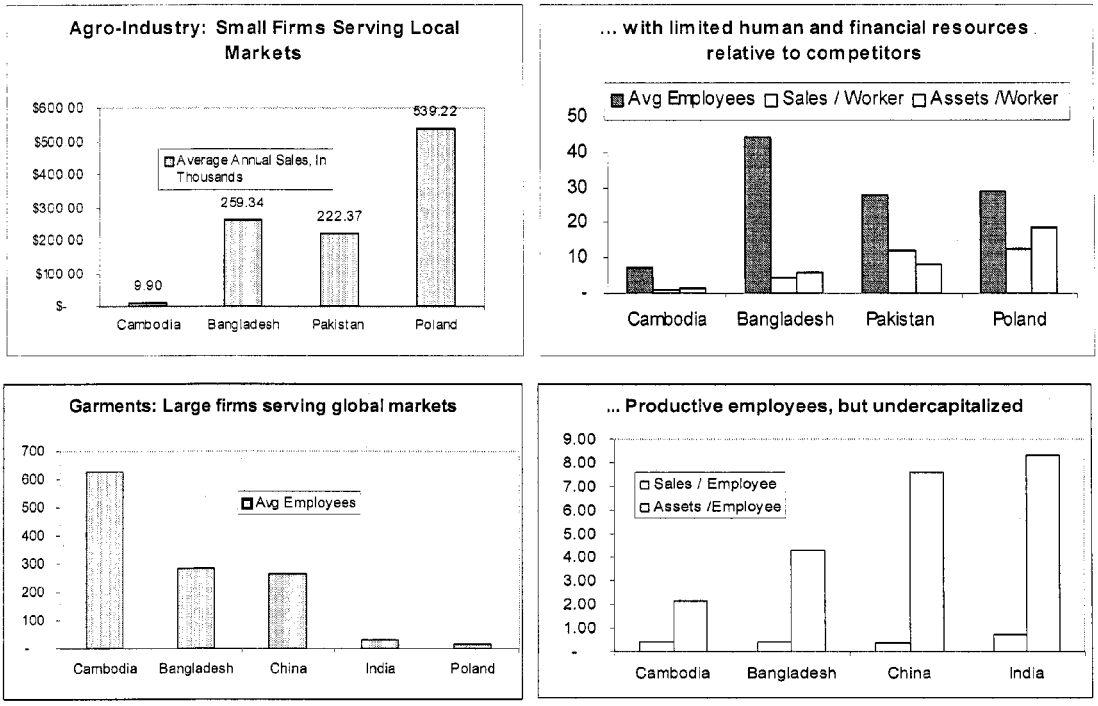


Source: WDR 2003

1.3 Characterizing the Cambodian Enterprise

While the investment climate provides the enabling environment for competition, it is enterprises that actually compete. Cambodia's enterprises are typically small, and currently often not integrated with global – or even national markets. The majority of the private sector are in services, but within manufacturing, the bulk of the private sector consists of small agro-industrial firms (e.g., fish paste producers or rice millers). As will be examined in detail in Chapters 2 and 3, Cambodia's domestic supply chains are characterized by substantial impediments created both by the public and private sector, high transaction costs, and uncertainty, which limit these local firms to local, personal markets. The contrast between the size of a typical agro-industrial firm in Cambodia and Bangladesh or Pakistan is striking.[20] Cambodian agro-industrial firms have average turnover of just $10,000 per year, achieved by seven employees. Bangladeshi and Pakistani firms are 22 to 26 times larger in terms of sales, but with only 4 to 6 times the number of employees. Clearly, labor productivity is at issue, and Cambodia cannot hope to achieve the broad-based growth objectives it has described with dramatic change in labor productivity. The garment sector, by contrast, is designed from the outset to serve global markets and has competitive levels of output per employee. However, capital investment is smaller, with implications of any value-upgrading strategy. Chapters 2 and 3 try to identify the specific factors – regulatory, financial, skills, infrastructure – that contribute to this, while Chapter 3 focuses on the question of integration and formalization.

FIGURE 1.5



Source: The World Bank, Productivity and Investment Climate Surveys (PICS) for each respective country.

[20] These data are generated from Productivity and Investment Climate Surveys (PICS) conducted in each observed country. As Cambodia is the first IDA member to have carried out a PICS in the East Asia region, sound comparisons with other firms in East Asia and Pacific are not currently available but are expected over the next two years.

1.4 The Strategic Challenge

A decade after the elections of May 1993, Cambodia faces a historically-important opportunity. As recently as 1989, all enterprises were state-owned, prices were controlled, and economic planning was centralized. During the initial decade of democracy, pricing and exchange rates have been liberalized, macroeconomic stabilization was largely achieved, a two-tier banking system was introduced and subsequently reformed, trade liberalized, prices freed, and the number of state enterprises was substantially reduced through privatization and leases. A public enterprise law was enacted that legislated a level playing field between state and privately-owned firms, and many of the most obvious examples of direct state ownership have given way gradually to private investment. In 1994, the creation of an investment climate open to foreign investment was signaled through the passage of the Law on Investment, resulting in a substantial increase in FDI.[21] During this time, the Cambodian economy has withstood a number of shocks, including political violence and killings, particularly in 1997, the Asian financial crisis, floods, anti-Thai riots, and SARS, and generally exceeded 5 percent growth. The year 1997 appears in retrospect to have been a turning point, to the extent that FDI has declined progressively since that point. However, over the decade, it has never (a) broken the frequent impression of both foreign and domestic investors that corruption is not only tolerated but a basic way of doing business; (b) truly cleared the legacy of economic history by fully empowering the market and moving away from direct contact and control of producers; and (c) firmly established confidence among domestic and foreign investors that the political risk and uncertainty are of the past. Many observers point to the Government-Private Sector Forum, an open and constructive mechanism for dialogue designed around seven working groups,[22] as an indication of recent progress. Clearly, despite the Forum and other mechanisms, policymakers have not fully convinced investors that Cambodia is on the path to sustainable private-led growth. Why is today different?

The Royal Government of Cambodia faces its second decade with a mandate from relatively smooth elections,[23] new acceptance into the international community through WTO accession, security in the sub-region, an absence of economic crisis, signs of growth in all major markets, and increasing partnership among donors. These are many of the pillars on which a new platform of economic growth can be built. What remains to be achieved is a credible program of reform that addresses the most fundamental issues impacting the private sector.

The basic problem, as described above, is to accelerate and broaden the process of establishing formal private enterprise and integrate into global markets. As Country Economist Nick Stern advised the Cambodian authorities, "the lesson from countries that gain from integration – improve the investment climate and invest in people. For Cambodia, addressing governance can raise productivity and integrate the informal sector."[24] The Investment Climate Survey and value chain analysis provide a starting point to help understand the status of the institutions, formal and informal, that govern performance. While it is widely known that a variety of administrative and market-based barriers impede the development of the private sector in Cambodia, very little baseline data currently exists, particularly regarding the performance of the private sector, to help guide the Government in making sound policy decisions. The objective of this project is to identify specific administrative and market-based barriers to growth, quantify

[21] World Bank (1999a), *Cambodia Public Expenditure Review*.

[22] The Government-Private Sector Forum working groups are Banking and Finance; Export Processing and Trade Facilitation; Manufacturing and SMEs; Energy and Infrastructure; Agriculture and Agribusiness; Tax, Law and Good Governance; and Tourism. Each Working Group is co-chaired by a nominee of the Government, typically a Minister, and a nominee of the private sector. The IFC provides coordination and support to the Forum.

[23] The elections, while considered fair by international observers, were followed by a protracted period of negotiation to form a new government. At time of writing, these negotiations have not been completed.

[24] "Building a Climate for Investment, Growth & Poverty Reduction in Cambodia." Presentation by Nicholas Stern, Vice President and Chief Economist, World Bank, May 2003.

the impact of these barriers on the competitiveness of companies operating in Cambodia, and to shed light on possible policy options to help remove distortions that impede the development of the economy.

Because of the magnitude of the issues and reforms required, private sector development implies strategic choice. Institutional development and structural reform call for considerable financial and managerial resources. It is important, therefore, that considerable effort be invested in deciding which institutions are most important, and sequencing and focusing these in a way that is most conducive to sustainable reform. This does not necessarily mean "picking winners." Rather, what it means is evaluating the potential consequences of various reform options on Cambodia's strategic goals, sustainable private sector-led growth with equity/broad-based employment growth, in order to provide a coherent path most likely to provide a payoff. At an aggregate level, there are many impediments that face the entire private sector, for which the decision to prioritize is non-controversial. However, with many policy or institutional investment options, particularly at the sectoral level, there will be tradeoffs: equity vs. efficiency, rural vs. urban, short-term investment vs. sustainability, human capital vs. physical capital. We note, for example, that Export Processing Zones have come into favor. They have a particular logic that rests on labor costs and geographical advantage, but it is not clear that they would have the type of broad-based impact that is the imperative of the NPRS. The Government's strategy of agricultural modernization and diversification through agricultural-based manufacturing may have a broad impact, if impediments can be removed.

To help prioritize and undertake reforms and investments, the Royal Cambodian Government is developing a private sector growth strategy, anchored in Cambodia's success as the first least-developed country to join to the World Trade Organization. WTO accession will result in substantially improved market access for Cambodian producers; yet WTO does not provide the supply response to the market. It is clear to the RGC that opportunities afforded by WTO will not result in growth of productive employment unless business environment constraints are removed and market-supporting institutions built. The RGC has asked the World Bank Group, including the World Bank, Mekong Project Development Facility, and International Finance Corporation, to support the development of this strategy, and the Bank has agreed to provide analytical inputs to the strategy in three stages:

1. ***A Value Chain analysis***, which was delivered in June 2003. It employed a channel mapping technique to help quantify both production and administrative costs associated with operating a business in Cambodia. The use of this technique resulted in a detailed breakdown of both administrative and production costs, which were then selectively benchmarked against costs incurred in similar enterprises operating in other countries. The administrative barriers identified through this process were then matched against specific laws and regulations to help focus the attention of the Government in introducing policy reform initiatives.

2. ***Investment Climate Assessment***, based on a survey of 502 urban firms, 200 rural firms, and 100 urban informal firms. The results of this survey are described in the current document. The importance of this approach is that it is based on the private sector's own views and based on comparing answers provided by the private sector in Cambodia with similar answers provided by the private sector in other countries. Since Cambodia has taken the commendable policy route of economic openness, it is important that it employs benchmarking with other countries as a tool for policy reform because, in many ways, its investment climate must now be seen as part of its international competitiveness.

3. ***PPI Governance Framework.*** The third part of this series will be a framework to improve the role of the private sector in the delivery of public services.

The Productivity and Investment Climate Survey was conducted to focus on the microeconomic and structural dimensions of the business environment, viewed in an international

perspective. To this end, the remainder of this chapter looks in detail at factors constraining the effective functioning of product markets, financial and non-financial factor markets, and infrastructure services, including in particular, weaknesses in an economy's legal, regulatory, and institutional framework. It does so by identifying three things: the reform priorities of Cambodian businesses, areas of elevated costs and delays, and the relationship of key investment climate variables to firm performance. However, a survey by itself will not fully reveal the reform agenda for Cambodia's economy because firms express private benefits (e.g., lower taxes) while governments must be concerned with public benefits (e.g. public revenue for social purposes), the deviation between private and public time horizons (e.g. government may wish to invest in reforms with a long-term payoff that are of little interest to entrepreneurs today), and the limited nature of the private sector given existing weaknesses in distortions (i.e. surveys cannot interview investors who never entered the market).

Table 1.1.

ICA Main Survey Sample Structure	
Firm Size (%)	
	Sample
Micro (<10 emps)	46.53
Small (10<=x<100 emps)	37.35
Large (100+ emps)	16.12
Market Orientation (%)	
Exporter (>= 5% sales)	15.71
Non-Exporter	84.29
Firm Ownership (%)	
Sole proprietorship	68.59
limited Partnership	9.54
Single member Private Ltd. Co	8.75
Joint Venture	7.36
General Partnership	1.39
Private Limited Co.	3.38
Public Limited Co.	0.2
Unregistered	0.8
Firm Activity (%)	
Textile	0.4
Garment	12.33
Rural Water & Drinking Water	5.37
Construction Materials-services/Metals	10.54
Restaurants & Hotels	11.33
Information Technology/Electronics	9.34
Tourism	10.54
Agro / Processing (Rubber, sugar cane..	13.92
Transportation / Shipping	6.76
Trade	9.74
Electric Power Providers	9.74
Firm Location (%)	
Phnom Penh	60.24
Battambang	7.55
Siem Reap	15.11
Sihanouk Ville	9.94
Kampong Cham	7.16

The World Bank Group oversaw a survey of over 500 enterprises in five main cities. The survey questionnaire was built upon the Bank's standard core investment climate survey and implementation methodology, which has been or will be administered in over 60 countries worldwide. The survey allows countries to understand enterprise performance in international comparative perspective, as well as to better understand which investment climate conditions may be impeding growth or imposing excess costs that constrain competitiveness. The questionnaire contained additional questions to explore the issues of governance, regulatory and administrative compliance costs, and logistics. The sample is organized into key sectors, so that performance (productivity and growth of investment, sales, and employment) can be meaningfully measured and related to investment climate variables. The survey, successfully administered by Indochina Research Limited (IRL) in early June, interviewed managers of 502 enterprises in 10 sectors in five major Cambodian cities: Phnom Penh, Siem Reap, Kampong Cham, Sihanoukville, and Battambang. These enterprises ranged in size from micro (fewer than 10 employees) to large (over 100 employees) and included both domestic firms and those with foreign ownership. This sample is the basis for most of the analysis in this chapter and the next.

In addition to the main survey, a survey of 200 rural non-farm enterprises was conducted, evenly divided between rural firms around Battambang, Kampong Som, Kampong Chhang, and Kratie. Comprised entirely of firms that were private, domestically-owned, and non-exporters, the random sample included 82 percent micro enterprises and 18 percent SMEs. 44 percent of firms were registered, while 56 percent were not. By activity, firms were divided between consumer services (30 percent), retail (30 percent), and food processing (40 percent).

Finally, to better understand the urban informal sector, 100 unregistered urban firms were randomly sampled in Phnom Penh. 95 percent of these were micro enterprises, all were private, and none exported. The firms were divided by activity, with 40 percent in consumer services, 42 percent in retail, and 19 percent in food processing.

The recommendations presented herein require strong leadership. We have presented what we believe is a credible program of reform; one that does not avoid difficult issues or suggest sweeping, non-specific change. We take as an assumption that the General Assembly will ratify the protocol to join the World Trade Organization and complete the legal and institutional agenda to which the country has committed. The following represents a program of reform that attempts to leverage this opportunity. These reforms are based both on the Government's own statements and commitments, particularly through the NPRP and WTO Working Party Report, and on the confidential views of over 800 firms throughout Cambodia. The reforms will be difficult. But they represent what we believe, and what firms have expressed, are the most urgent actions necessary to unleash the potential of the private sector throughout the country.

Chapter 2: The Productivity Challenge

NPRS Goals:

Ensure a competitive, and efficient investment climate for foreign and domestic businesses.[25]

Ensure an enabling environment that facilitates a vibrant micro, small and medium-sized enterprise sector able to increase productivity and employment. – NPRS[26]

Chapter Summary. This chapter examines the challenge this poses to Cambodian firms to become more productive, and hence more competitive. As Chapter 1 makes clear, Cambodia's accession to WTO will bring unprecedented market access in export markets, but will also intensify competition from foreign goods and enterprises in both domestic and international markets. Even without WTO, global integration would have inevitably posed these challenges. Cambodian firms lag behind firms in other Asian nations both in labor and total factor productivity. While part of this effect may be attributed to differences in worker skills and firm capabilities, investment climate conditions are significantly associated with firm productivity and growth. Critical investment climate conditions include the quality of governance (and the burden of corruption), regulatory burden, and the weakness of the court system and legal environment for market competition. These are urgent areas of reform. Comparative data on the transactions costs of firms dealing with key legal and administrative procedures indicates Cambodian firms face both excess costs (in time or money) and uncertainties. Factors that were not highlighted by firms in the survey – finance and infrastructure – are nonetheless critical for the long-term IC agenda.

Productivity is the single most important factor in explaining national income differences among nations. Hall and Jones' review of international evidence suggests that over two thirds of country differences in national income can be accounted for by productivity, rather than the contribution of physical or human capital. This suggests the central role productivity is playing in economic growth. Other work has clearly shown that the income of the poor rises in rough proportion to overall economic growth, indicating that a growing economy is the single best anti-poverty strategy. The effects of growth for poverty alleviation can be strengthened through appropriate investments in people.

Evidence on productivity indicates that Cambodian firms and workers are generally less productive than those in a variety of countries in the world, including major Asian producers such as China, India, Pakistan, and Bangladesh.[27] Whether in nominal or purchasing power parity (PPP) terms, Cambodian firms are not as productive as firms in these comparator countries. Total factor productivity is some 18 percentage points below India, 24 points below China, while roughly even with Bangladesh. However, the labor productivity is roughly 65 percentage points behind India, 62 percentage points behind China, and about 10 percentage points below Bangladesh. Comparative data suggests that Cambodia's low labor costs do not wholly compensate for the lower productivity of its workers.

[25] Royal Government of Cambodia, National Poverty Reduction Strategy (February 2003), p.184.
[26] Ibid. p. 185.
[27] Value added was calculated based on survey data provided by firms. TFP was then estimated using a Cobb-Douglas production function in the following specification (TFP is the residual):
$\ln(Output_i) = con + \beta_m \ln(Material_i) + \beta_l \ln(Labor_i) + \beta_c \ln(Capital + SectorDummies) + \sum_{n=1} \beta_n D_n + \varepsilon_i$

FIGURE 2.1

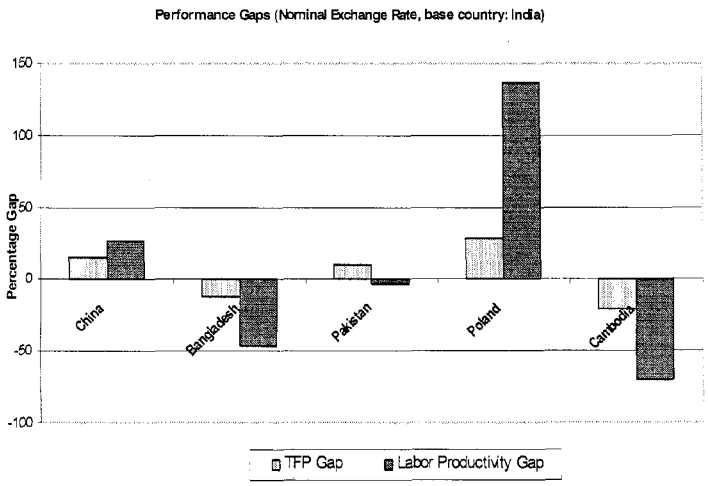
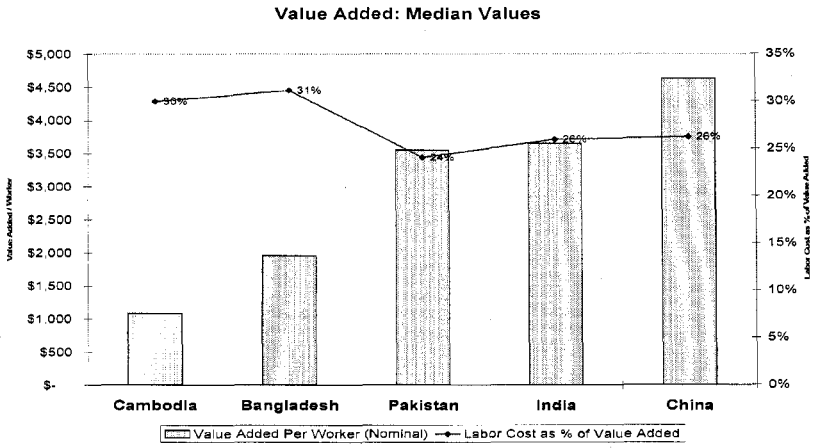


FIGURE 2.2



Source: The World Bank, PICS for each respective country.

2.1 What Drives Productivity?

Productivity results from investment in people, institutions, and the investment climate. Further international work clearly shows the important impact of investment climate conditions on economic growth. For example, countries that globally integrated during the 1990s experienced growth rates of more than three and a half times the rate of countries that did not.[28] Other work clearly demonstrates that key conditions including corruption, regulation, and the rule of law are strongly associated with economic growth.[29] It is thus important to understand how Cambodia compares to other countries

[28] Dollar and Kraay, Trade, Growth and Poverty (World Bank, June 2001).
[29] Kaufmann and Kraay, "Growth Without Governance", *Economia*, Volume III, Number 1 (Fall 2002).

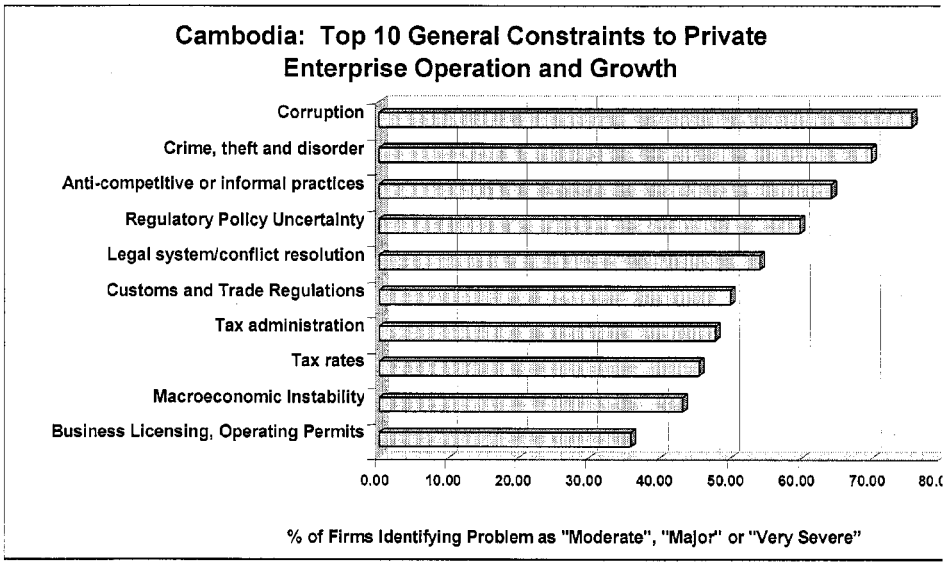
along these critical dimensions As Cambodia moves towards full global integration, how will other conditions affect its growth? How can the opportunity of WTO be capitalized upon to best benefit the Cambodian people? And what should be the policy priorities in seeking to maximize these gains?

Douglass North (1990) discussed how transaction costs, shaped by institutions, critically affect the ability of economies to realize the gains made possible by increasing specialization and division of labor.[30] The analysis that follows points to Cambodia's elevated transaction costs, created in large part by policy and institutional weaknesses. These weaknesses must be addressed as priority reforms if Cambodia is to attain sustained and rapid economic growth, required to meet its daunting poverty.

2.2 Investment Climate Priorities

The top priorities of firms focused on governance, rule of law and regulation. Cambodia firms identify corruption as their leading constraint to the operation and growth of Cambodia, followed by crime and anti-competitive practices and/or informal competition. A number of regulatory concerns rank in the top 10 constraints, including regulatory policy uncertainty, customs and trade regulations, taxes and tax administration, and business licensing and operating permits. The fifth-ranking constraint, however, relates to the legal system and formal conflict resolution. The ninth-leading constraint concerns macroeconomic instability. Somewhat surprisingly, neither financing nor infrastructure placed among the top 10 obstacles as rated by the 2003 sample.

FIGURE 2.3



Source: The World Bank, Cambodia PICS 2003.

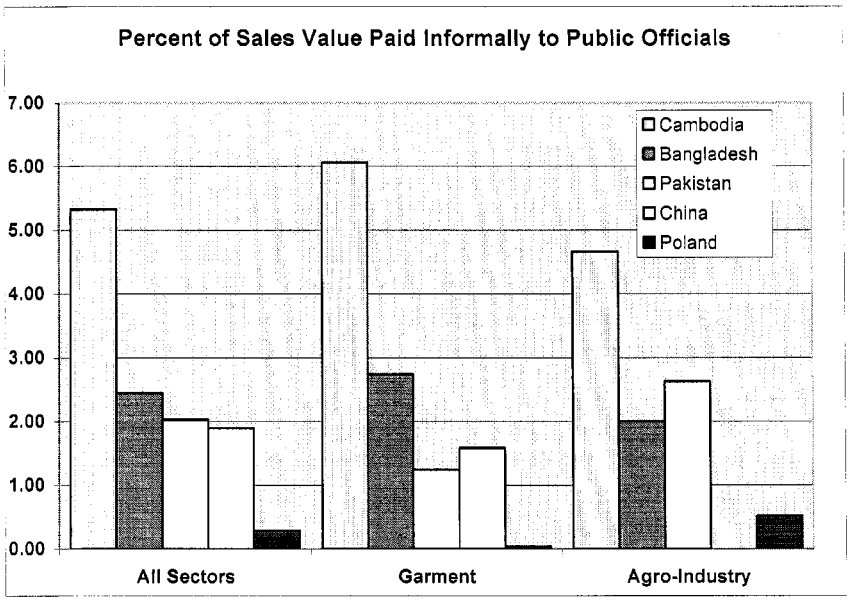
Comparing these ratings to a parallel question in the 1999/2000, two constraints are rated as more severe: unfair and informal competition and the functioning of the judiciary. While generally there are improvements in the rating of major constraint severity, the perception on the severity of corruption as a constraint remains virtually unchanged.

[30] Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

2.3 Governance and Corruption

The governance problem is reportedly pervasive, and most firms acknowledge that payments to public officials are frequently, mostly, or always required to "get things done". Of the 447 firms that answered the question on bribe payments 82 percent (368 firms) reported a positive level of bribe payments. Some 71 percent of large firms suggest such payments are frequent. The private sector estimates that the magnitude of payments exceeds 5 percent of annual sales revenue, on average, but increases with firm size and formality, exceeding 6 percent of total sales value for large firms in the main sample.[31] Firms' financial data suggests that unofficial payments are a large component of the cost of doing business.

FIGURE 2.4



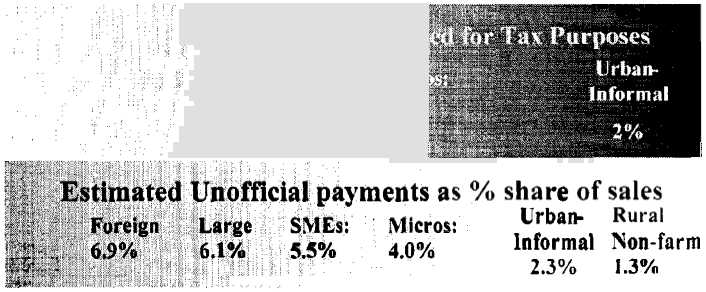
Source: The World Bank, PICS for each respective country.

The share of revenue consumed by unofficial payments is more than double that found in a parallel survey in Bangladesh, Pakistan or China. Clearly, some types of firms pay more than others, and the international comparison for the garment sector paints a particularly poor picture of the relative costs of corruption in Cambodia. The implications either for the total cost to business or foregone revenue to government are substantial. Yet unofficial payments are not the only form of corruption – firms also acknowledge than an average of 5 percent of contract value must be paid to secure business with public agencies.

[31] Government officials pointed out that the estimated figure is disputable in its nature and content, since it likely includes the high cost of intermediaries/facilitators used to comply with regulations. Even if the actual amount of unofficial payments to public officials may be somewhat less, the Government acknowledges the seriousness of the problem and is determined to address it through reform both in the public and private sector.

In many countries, unofficial payments are seen as a mechanism to expedite delivery of services. In Cambodia, this does not appear to be true. Larger firms tend to be more "formal" as measured by the share of income reported for tax purposes. Large firms report over 60 percent, micro-enterprises report 33 percent, and firms in the urban informal sample, less than 2 percent. The larger and more "formal" the enterprise, the higher the bribes as a share of sales. Firms of all sizes acknowledge paying bribes. Statistical analysis of bribe data suggests that it is rent-seeking, with bribe revenue disproportionately extracted from firms with higher profitability, more workers, and capital.

FIGURE 2.5



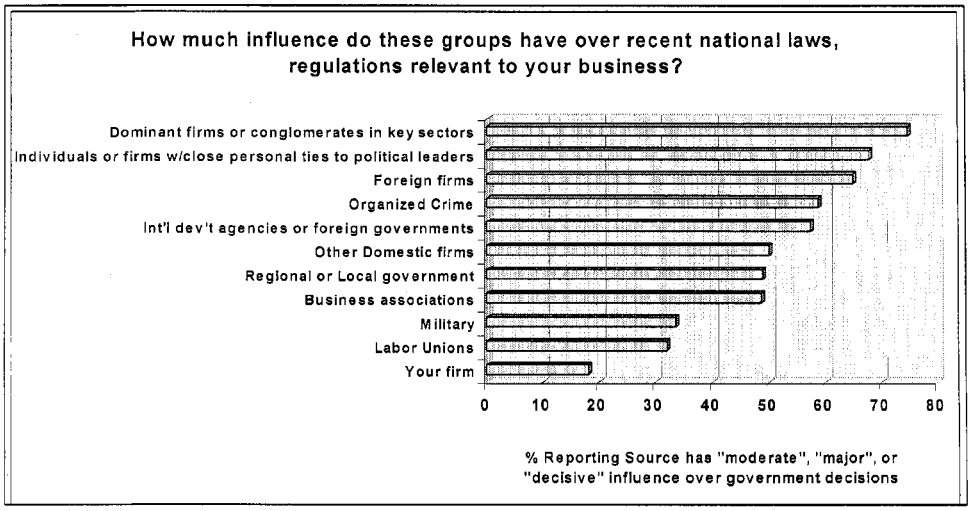
Source: The World Bank, Cambodia PICS 2003

The "efficiency grease" theory of corruption – that bribes expedite service – does not appear to hold true. Firms note that bribes are routinely required for connection to public services, including power and telephones. There is no statistical difference between the speed of administrative procedures for firms reporting higher versus lower ratios of bribes as a share of sales for essential services such as utility connections.

Overall, business's view of agency integrity is alarmingly negative, with the Judiciary and Customs viewed the most negatively. Over 80 percent of firms perceive the judiciary and customs negatively. More than 60 percent of firms gave negative ratings to the Ministry of Commerce office dealing with trade, the military, and central government leadership. Finally, more than half of all respondents negatively rated pre-shipment inspection services and then national assembly. Taken in total, these reviews suggest a widely-held view that government corruption is pervasive.

Firms perceive influence to be concentrated among certain privileged groups. Over 70 percent of respondents view "dominant firms or conglomerates in key sectors" and two-thirds see individual or firms with close personal ties to political leaders as wielding substantial influence over national laws and regulations affecting firms. Foreign firms, organized crime, and international development agencies and foreign governments round out the groups perceived by the majority of respondents as wielding at least moderate influence over national decisions.

FIGURE 2.6



Source: The World Bank, Cambodia PICS 2003.

2.3.1 Crime and Security

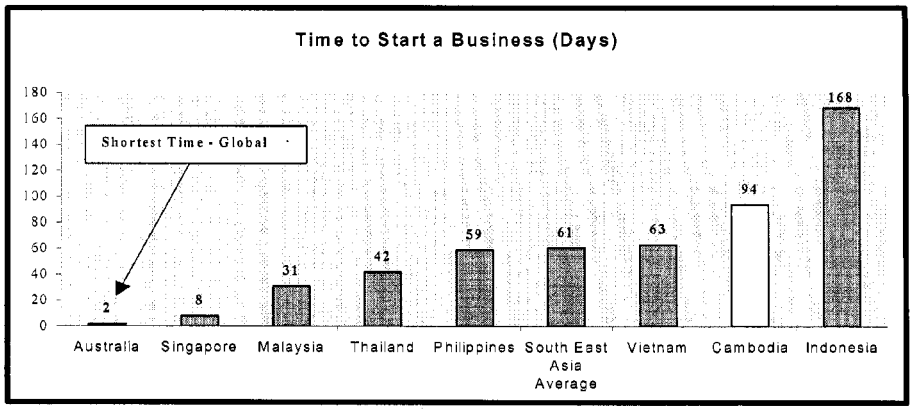
Crime, theft, and disorder was the second-leading constraint identified by enterprises in the main sample. Among the sample of 502 firms, 317 (63 percent) report spending money on security measures to protect themselves from crime. 101 firms identified themselves as having sustained positive losses due to theft, robbery, or other crimes in the last year. For these firms, the average loss to crime as a percentage of sales was 2.3 percent. A significant minority of firms (30) reported losses of at least 10 percent of their sales value from theft and other crime. Firms were apparently somewhat reluctant to report incidents of crime to police – two-thirds of firms suffering crimes sometimes reported them to police, but on average they did so in only 59 percent of incidents. Among responding firms, they suggested that police solved 40 percent of cases reported. Compounding this is the perceived failure of the judicial system to enforce laws.

2.4 Barriers to Entry and Competition

2.4.1 Business Registration

The business registration process - one of the slowest and least affordable systems for business entry in the East Asia region –is being reformed. .According to the 2003 Doing Business study, it takes 94 days to start a business in Cambodia - 30 days longer to start than in Vietnam, and 52 days longer than in Thailand. Especially slow steps include incorporation in the commercial register, VAT registration, and Ministry of Labor notification. Doing Business measures entry costs in terms of per capita GDP, and by this standard, Cambodia has the least affordable costs in the region at 554 percent of per capita GDP. This compares to a cost of 30 percent of per capita GDP in Vietnam and 7 percent in Thailand. The Minister of Commerce has undertaken rapid measures to both reduce the time and cost of registration. He has committed to reducing the incorporation cost component from $650 to $280 or less, with a ten-day turnaround time (see Section 5.2 for the detailed process steps).

FIGURE 2.7



Source: The World Bank, Doing Business Database 2003; Djankov et al. (2003).

2.4.2 Anti-Competitive Practices

A majority of firms identified unfair or informal competition as at least a moderate problem. Firms gave a number of indications of the ways in which they viewed the economic playing field as uneven. Of a variety of potential practices of competitors evaluated, over a third of firms suggested that competitors conspiring to limit their access to markets and suppliers was a major or very severe problem. This suggests that dominant firms can act with some impunity to prevent entry of potential rivals. 32 percent of respondents identify the issue of competitors subsidies or toleration of arrears as at least a major problem, suggesting the perception that government does not treat all firms equally. 31 percent suggested that violation of intellectual property rights posed at least a major constraint. Interviews suggest that part of this problem lies in the prevalence of fake or fraudulent products, which can undermine retailers' relationships with increasingly quality-conscious consumers. Exporters, who are generally larger, are more likely to have foreign ownership, are subject to more regulatory scrutiny, and are dramatically more likely than non-exports to identify unfair or informal competition as a major or very severe constraint. This difference is

especially striking with regard to competitors' violation of intellectual property rights, failure to pay duties or observe trade regulations, avoidance of taxes, and avoidance of labor regulations and taxes.

Table 2.1. Practices of Competitors as Obstacles to Own Firm

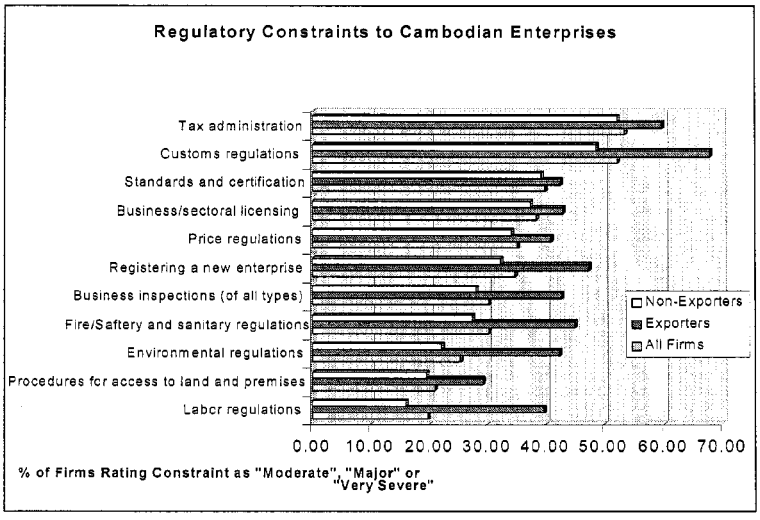
Practices of Unfair or Informal Competition (% finding it a "major" or "very severe" obstacle)	All	Micro	SME	Large	Exporter	Non-Exporter
Conspire to limit my access to markets/suppliers	34.39	34.21	34.43	36.71	41.77	33.02
Receive subsidies (including toleration of arrears)	31.81	31.58	31.15	34.18	37.97	30.66
Violate copyrights, patents or trademarks	31.41	31.58	29.51	37.97	40.51	29.72
Don't pay duties or observe trade regulations	25.05	22.81	25.14	34.18	40.51	22.17
Avoid sales tax, VAT or others taxes	22.47	16.23	25.68	35.44	40.51	19.10
Avoid labor taxes/regulations	20.68	14.04	26.23	30.38	40.51	16.98

Source: The World Bank, Cambodia PICS 2003.

2.5 Trade Facilitation

Trade facilitation practices in Cambodia stand out in the high costs of corruption and long delays for clearances procedures. Import and export processing, involving a multiplicity of steps, introduce substantial delays, uncertainty, and discretion into the process of trading goods. Among the major steps reported by trading firms are customs clearance, Ministry of Transportation border authorization or border police, veterinary and phytosanitary inspection, and CAM control. Each involves delays, formal costs and informal payments. Customs clearance by itself imposes substantial delays and great variation, and hence, unpredictability. On average, firms report that imports take 6.5 days to clear customs, while exports take 4.5 days. However, this timing is variable, and firms report that in the last year they have had to wait an average of over 11 days for at least one shipment, and 16 days to clear an export shipment. Firms report documentation problems in 56 percent of cases for imports and 41 percent of cases for exports.

FIGURE 2.8

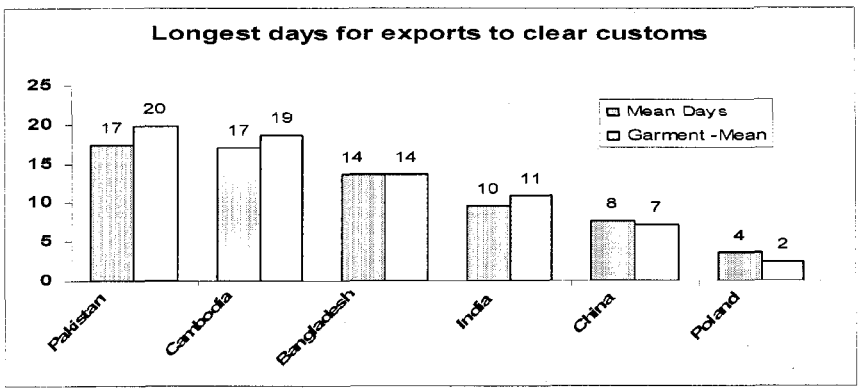


Boundaries between the responsibilities of agencies involved in control over importations are ambiguous, and lead to overlaps. In addition to Customs, CamControl is responsible for the inspection of goods, both when they enter the country and in the domestic markets. While Customs are in charge of revenue collection, protection of the economy, and trade facilitation measures, CamControl operates under a legislation that provides that agency with broadly similar powers of investigation and control. Although controls made by CamControl at the borders should be coordinated, they are often overlapping, and there is apparently no integration of procedures between the two agencies.

Arriving ships are placed under the control of numerous agencies, yet their roles are not clearly identifiable, and their functions could be easily delegated to the key administrations (viz., Customs and the Immigration authorities). Clearance usually involves several agencies, including the Port Authorities, Border Police, Customs, and CamControl. While the role of Customs brokers or clearing agents would be to facilitate interaction with these authorities, there is substantial evidence that practices of some brokers and agents contribute to the unofficial costs. Certification of Customs brokers would in the short term contribute to an increase in their professionalism and improve efficiency and transparency.

Procedures are unclear and superfluous. Clearance at the port of Sihanoukville involves, for Customs purposes only, twelve steps, which mainly consist in visiting, sometimes repeatedly, key officials. Importers must see during the clearance (i) Customs headquarters, (ii) twice the chief of Customs at Sihanoukville, (iii) twice the chief of port Customs, and (iv) twice his deputy; two different positions are responsible for affixing stamps on the declarations. Each step may involve long waits, and possible negotiations. It is likely that numerous other bureaucratic steps are also necessary at factory premises, and for outward processing, export licensing and duty exemption in Government offices. All cargo that is neither sealed nor pre-inspected by SGS is submitted to a routine X-ray scan (with very limited rates of detection of irregularities), after which a decision is made whether or not to inspect the shipment. All goods taken out of the port can be re-examined at the gate.

FIGURE 2.9



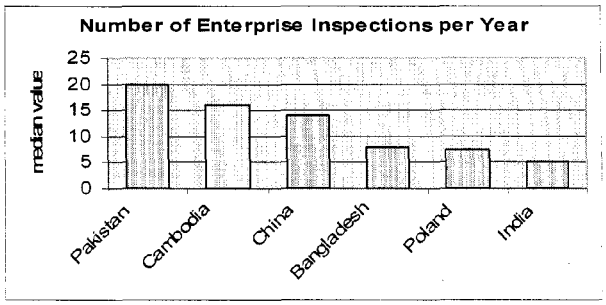
Source: The World Bank, PICS for each respective country.

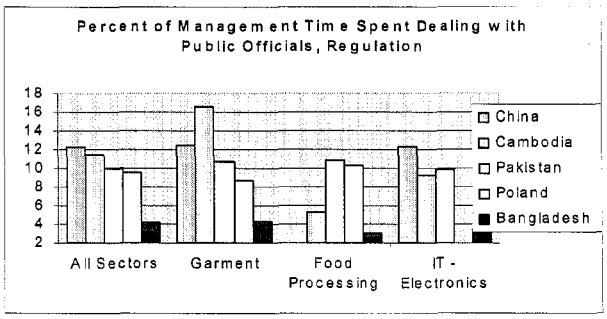
2.6 Legal & Regulatory Environment

2.6.1 Regulatory Inspections

Cambodian firms are subject to an unusually high number of inspections, averaging 16 per year. A key issue in the application of regulations is the discretionary and often corrupt use of bureaucratic powers when firms interact with public officials. While officials assert that this is caused by widespread informal and often illegal activities, an international perspective suggests that inspections are both frequent and imposing. The most common and time consuming inspection reported is by tax officials, but visits by police are also quite common.

FIGURE 2.10





Source: The World Bank, PICS for each respective country.

Regulatory interactions require a substantial amount of the time of the senior management of Cambodian firms. In general, Cambodian firms are just behind Chinese firms in the amount of time managers spend dealing with regulations (over 11 percent), but are well-ahead of Pakistani and Bangladeshi firms. However, in the garment sector, regulatory interactions consume over 16 percent of senior management time.

The private sector's estimated unofficial payments as a share of sales revenue rales was noted above. However, in addition, specific regulatory and administrative interactions were evaluated in terms of typical informal payments required. The largest average payment was associated with import and export transactions, but smaller payments were often associated with numerous areas of regulation, including taxation, business registration and licensing and every form of business inspection.

2.6.2 Tax administration

There was an improvement in the perception of the private sector on tax administration since the 1999/2000 business environment survey, but it still appears to impose substantial costs, both formal and informal. The Tax Department has, with IMF support, undertaken a range of reforms to increase revenue and the results of this work have been impressive. However, there is a gap between stated policies of the Tax Administration and results reported by the private sector. For example, roughly a third of firms

should receive a tax audit each year according to policy. But of firms subject to tax inspections, the average number reported per firm in the last year was just over 7. The average inspection lasted 2 days, generally involved fines, and also involved informal payments in many cases.

2.6.3 Confidence in the Judiciary

As Cambodia's economy grows and formalizes, the judiciary will become more important as a means to protect economic rights of businesses and uphold contracts (including the enforcement of debt). As noted above, of a number of public institutions and agencies rated for their integrity, the judiciary rated lowest. In specific ratings of the courts, 91 percent of respondents say that the judiciary is only "sometimes", "seldom", or "never" fair or impartial, 83 percent rate it negatively in terms of quickness, and 70 percent give a negative review for affordability and enforcement of decisions. The 2003 Doing Business ratings indicate that Cambodia is both a costly place to enforce a contract: "The indicators make clear that contract enforcement in Cambodia is very expensive in comparison to many other countries in the region, and five times the regional average as measured by percent of per capita income. In terms of time, contract enforcement appears on a par with Thailand and below the regional average. However, other nearby countries, including Singapore and Vietnam, resolve conflicts in much less time."

The 2003 Doing Business ratings assign Cambodia a zero, the lowest possible score, in its legal creditor rights index. It notes: "Cambodia clearly lacks essential structure in both fields – creditor rights and information sharing. There is neither a debtor-oriented rehabilitation procedure in Cambodia nor institutions that assure credit information sharing. The decision to rehabilitate is made by a creditor meeting, once insolvency proceedings have commenced and foreclosure is stayed throughout this process. Direct liquidation is the most likely procedure to be used in the case of insolvent debtor firms."

2.6.4 Regulatory and Policy Uncertainty and Regulatory Burden

Beyond specific regulations, Cambodia especially stands out in enterprises' evaluation of the consistency and predictability of regulatory interpretation. About 55 percent of Cambodian firms agree that interpretations of regulation are "consistent" and "predictable", while over 44 percent disagree. This compares favorably to Pakistan, but unfavorably to Bangladesh and China. Among larger firms, less than 49 percent agreed that regulatory interpretations are consistent and predictable, while just 46 percent of firms with foreign ownership agreed. Policy predictability and, in particular, the formulation and implementation of regulations, was identified as a substantial constraint to firms surveyed. Around 76 percent of firms surveyed identified laws and policies affecting them as to some extent "unpredictable". This negative perception declines somewhat with firm size; nonetheless, over two-thirds of large firms find such changes affecting them hard to predict.

Closely linked to both policy predictability and informal competition is the issue of regulation. Regulations are generally regarded as constraining, with a majority of firms identifying tax and customs regulations as moderate or greater constraints. The Index of Economic Freedom rates Cambodia a 4 in regulation, indicating a "high level": *"Cambodia's bureaucracy is politicized, cumbersome, and inefficient, and this creates problems for both potential and existing businesses. Non-transparent regulation and the lack of infrastructure continue to burden business."* Certain categories of regulation clearly constrain exporters considerably more than firms producing exclusively for the domestic market, including customs and trade regulations, business registration, business inspections, fire and safety regulations, environmental regulations, and labor regulations.

2.7 Factor Markets

2.7.1 Access to Capital

Although finance is not viewed as a leading constraint by the enterprises surveyed, Cambodian firms receive little external finance, except through informal networks of family and friends. Cambodia is a cash-based economy, and local commercial banks provide only 1 percent of working capital overall and a similar share of investment capital (foreign banks provide slightly more). Within Cambodia, by sector, loans are much more common among manufacturing firms, where 21 percent have a bank loan, compared to only 4 percent of trade firms and 6 percent of service firms. Large firms and foreign firms are more likely to have bank credit than small firms: 22 percent of large firms versus 5 percent of micro firms have bank loans.

Demand for formal financing is limited, especially among smaller firms. The survey reveals that less than 4 percent of the firms who do not have a loan have actually applied and been rejected. Conversely, more than 94 percent of the Cambodian firms who do not have a loan have never applied for one. When asked why, about 83 percent of these firms responded that they did not need a loan.

Cambodia is a cash economy. One important explanation is the large amount of cash kept outside of the banking system. Family and friends provide an unusual amount of finance (roughly one-fourth all finance overall). These personal networks appear to be preferred to the formal financial system, which requires disclosure of closely-guarded financial information and may carry a certain stigma among the more traditional firms. For the generally very small enterprises in both the rural non-farm and urban informal samples, family and friends provided close to 50 percent of overall financing. Growth in Cambodia is financed through the use principal (borrowing cash from friends and family) rather than leveraging principal to gain access to debt instruments. In the absence of debt as a growth tool, the rate of economic growth is limited by the availability of cash.

Table 2.2. Working and Investment Capital of Cambodian Firms

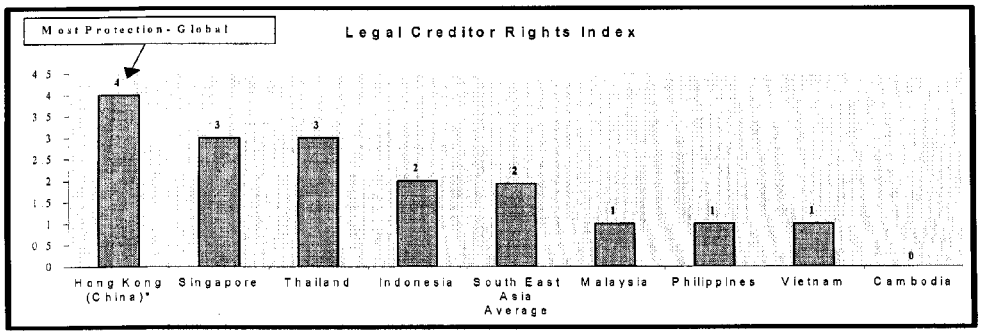
	All Firms	Micro	Small	Large	Foreign-Invested	Domestic
Working Capital						
Internal Funds and Equity	65.1	61.1	67.7	69.8	74.8	62.9
Family, Friends	26.7	33.2	24.1	16.2	9.9	30.5
Banks	2.2	0.9	2.4	4.8	6.3	1.3
Trade Credit (supplier or customer credit)	2.0	2.3	2.2	0.9	2.1	2.0
Investment Funds, Special Development	1.3	0.5	1.1	4.2	5.3	0.4
Other	2.7	2.1	2.4	3.9	1.6	2.9
Investment Capital						
Internal Funds and Equity	64.7	60.6	71.0	61.9	73.4	62.8
Family, Friends	24.0	29.6	19.5	20.3	13.0	26.4
Banks	2.8	1.5	2.0	8.1	7.9	1.7
Trade Credit (supplier or customer credit)	1.5	2.2	0.7	1.9	1.2	1.6
Investment Funds, Special Development	1.2	0.5	1.0	4.1	4.3	0.6
Other	3.3	2.1	3.5	3.8	0.3	4.0

Source: The World Bank, Cambodia PICS 2003.

The enabling environment is not conducive to secured lending. Bankers note high reserve requirements contribute to higher interest rates. Limited competition, poor information and high risk contribute to a general reluctance of banks to lend to all but well-known and trusted firms. Specifically, in Cambodia much of the land and capital that might serve as collateral is unregistered, enterprise financial records are generally weak and unreliable, and enforcement through the court system is difficult. Efforts to

foreclose on collateral generally yield lengthy court procedures with multiple appeals, and the outcomes are seen as determined by the "highest bidder". Accounting practice is poor, making client evaluation more costly. Furthermore, there is no credit bureau and sharing of credit records between banks has been discouraged by privacy regulations. In addition to these business climate factors, credit skills in the banking sector are weak and in need of development.

FIGURE 2.11.



2.7.2. Worker Skills and the Cambodian Economy

Both the economic literature and much of past analysis of Cambodian human resources suggest the strong role that worker education and skills play in productivity. Much of the NPRS discussion focuses on the question of employment. Over 200,000 Cambodians enter the job market each year, including demobilized soldiers. The key questions are (a) whether or not the private sector can increase employment at a rate commensurate with new entries and (b) whether the skill composition of the labor force poses a constraint to employment growth, economic growth, and/or income growth. The nature of employment is predominantly temporary and agriculture, a low-skill sector and by far the largest employer. The lack of technological content of agriculture keeps down the demand for skilled labor.

Nonetheless, wage employment has increased considerably in recent years, especially in the garment and tourism sectors. However, for the most part these two sectors have done little to increase overall demand for skilled workers. Overall, the standard sources of demand for skilled labor internationally – technology, trade, foreign direct investment (FDI), and the intensity of formal training provided by firms – appear to be weak in the Cambodian labor market.

Table 2.3. Schooling and Skill Content of Major Non-Agricultural Wage Sectors[32]

	Skill Content		Schooling
	Skilled	Unskilled	
Manufacturing			
Total	3.04	96.96	5.39
Garment	1.09	98.91	5.83
Construction	1.64	98.36	5.29
Public administration & defense	42.92	57.08	8.19
Education	99.24	0.76	10.75
Total wage employment (non-agricultural)	26.00	74.00	6.94

Source: The World Bank, Cambodia PICS 2003.

[32] Notes: Fishing is also excluded. Schooling refers to mean years of schooling. Skilled occupations are legislators, senior officials, managers, professionals, technicians, and associate professionals. Unskilled occupations are clerks, service and sales workers, craft and related trades workers, pant/machine operators and assemblers, armed forces, and elementary occupations.

Formal Sources of Demand for Worker Skills. As noted above, technology, trade, FDI, and the intensity of formal training provided by firms are normally key drivers of demand for skilled workers. Cambodia, however, has few of these. The formal-sector, urban-based sample of the ICA survey captured the upper end of the Cambodian labor market in terms of skills. Table 2.4 reports, for each sector, the number of firms and workers, the percentage of skilled workers, and the percentage of workers with upper secondary education or higher. It nonetheless reinforces the lack of a dynamic demand for skills. Only 15.71 percent of the firms surveyed export some percentage of their sales (either directly or indirectly through distributors), in spite of the recent surge in garment exports. Foreign investors owned some share of 18.49 percent of firms. Again, the garment industry has the highest average percentage of foreign ownership (71.78 percent), followed at a distance by transportation/shipping/trade and water (Table 14). However, as we have seen, the garment industry in Cambodia is not skill-intensive.

Table 2.4. Skill and Education Composition of the Workforce by Sector[33]

	No. firms	No. workers	% Skilled	% U. Sec +
Garment and textile	63	79,130	79.19	33.26
Water	28	592	70.95	35.88
Construction	53	2,588	47.37	13.08
Restaurants, hotels & tourism	110	2,225	60.09	62.04
Information technology/electronics	47	826	56.17	87.26
Food processing	70	725	58.48	13.56
Transportation, shipping & trade	83	1,987	58.03	53.09
Electric power	49	183	85.79	40.19
Total	503	88,256	76.87	34.21

Source: The World Bank, Cambodia PICS 2003.

Altogether, 19 percent of workers in the sample use a computer in their jobs (Table 2.5). IT/electronics is the sector with the highest provision of computers (68.01 percent), followed by transportation, shipping and trade, restaurants, hotels and tourism, and garments. A small percentage of firms do spend on R&D (16.5 percent), with this percentage being highest in garment, followed by restaurants, hotels and tourism, and IT/electronics. Thus, although technology is a potentially important source of demand for skilled workers, it is unlikely to be a major source in the context of the current labor market in Cambodia. Table 2.5 also indicates that the majority of firms report having adopted new technology (60.44 percent), particularly in the garment industry. This may indicate that there has been a technology-induced increase in the demand for skilled labor in recent times.

Table 2.5. Technology Use and Change, by Sector

	Computers	R&D	New technology
Garment and textile	18.74	28.57	71.43
Water	7.41	10.71	53.57
Construction	3.88	9.43	66.04
Restaurants, hotels & tourism	24.01	26.36	68.18
Information technology/electronics	68.01	21.28	65.96
Food processing	1.08	1.43	51.43
Transportation, shipping & trade	27.46	15.66	54.22
Electric power	0.55	8.16	44.90
Total	18.83	16.50	60.44

Source: The World Bank, Cambodia PICS 2003.

Finally, only 22.47 percent of firms provide formal training to workers. Altogether, 16.18 percent of workers in the sample receive training. In general, the most technologically-advanced sectors are those with the highest demand for training, which highlights the importance of technology-skills

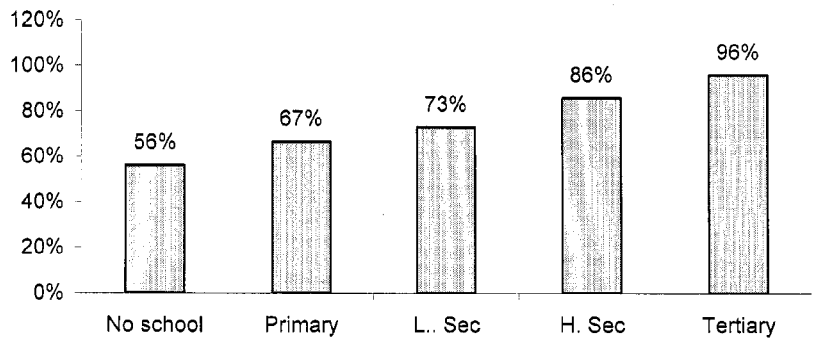
[33] % Skilled is the percentage of total workers in the sector in skilled occupations (managers, professionals, and skilled production workers). % U. Sec is the percentage of workers in the sector with upper secondary education or higher. This information is as reported by the employer.

complementarities. However, the overall demand for training is small. The average duration of training (in weeks per year) in the sample is 8 weeks.

In spite of the limited demand, there are positive, sizable, and increasing returns to schooling in the labor market both in terms of wages/earnings and employment-related outcomes. A profit analysis of the 2001 Labor Force Survey data indicates that the returns to schooling in terms of paid employment are very sizable. Having primary school completed increase the chances of working for pay by 12 percent with respect to no school level completed. Wage returns to schooling increase with school level, but this is more accentuated at the lower and upper ends of the wage distribution. These returns reflect shortages in the supply of educated workers and reflect, at least in part, differences in productivity.

FIGURE 2.12

Estimated Probabilities of Paid Employment by School Level



Is the current supply of skills a constraint to the development of new sources of growth (as opposed to current sources of growth)**?** The current sources of dynamism in the economy, garment and tourism, are likely to do little to increase the overall demand for skilled workers in the labor market. Godfrey (2002) argues that Cambodia enjoys a current comparative advantage in natural resource-based production, initially involving relatively unskilled labor, rather than in the non-agricultural labor-intensive activities for which countries like the Philippines and Vietnam, with high skill levels and labor/land ratios, are better suited. Even if the economy adopts the path dictated by its underlying comparative advantage, the supply of skills is likely to be a constraint as the use of irrigation and modern farming technologies require skilled workers.

2.8 Infrastructure and Logistics

Access to infrastructure in Cambodia is relatively poor compared to its neighbors and countries of similar income levels. Cambodia's low income, low population density, and history of conflict are reflected in the poor coverage, quality, and efficiency of much of its infrastructure. The services that exist are mainly concentrated in urban areas, and the substantial rural population suffers from lack of access to markets, unsafe and unreliable water supplies, and dependence on traditional biomass forms of energy or high-cost alternatives. Efforts to augment public capacity and financing through private provision has thus far yielded concessions that were awarded in an uncompetitive and nontransparent fashion, generally yielding high costs to consumers.

Power. Cambodia has one of the lowest electrification rates outside sub-Saharan Africa; it has no power transmission system and has developed no large generation capacity. Where electricity is available, firms and individual consumers face some of the highest energy costs in the world. Electricté du Cambodge (EDC), the state-owned utility, operates 22 isolated systems, which serve Phnom Penh and the capital towns of the provinces. The private sector has also emerged as an important provider, through independent power production (IPPs) providing generation to EDC; through small-scale provision in rural areas; and through auto-generation for individual domestic and business consumers. In addition, there is extensive self-provision. The survey finds that 63 percent of large businesses and 39 percent overall own a generator.

Table 2.6. Cambodia's Infrastructure Access/Coverage Indicators

	GDP per capita[1]	Roads (100 km / km^2 surface area)	Electrical grid (% households with connections)	Telephone lines / 1 000 population[2]	Improved sanitation facilities (% of population with access)	Piped Water network (% of population with access)
Cambodia	317	5.9	10	19	17	30
Lao PDR	465	9.2	20	15	30	37
Thailand	2,853	12.3	87	222	96	84
Vietnam	390	7.1	51	53	47	77
Tanzania	197	9.3	8	16	90	68
Uganda	355	4	5	17	79	52
Tajikistan	420	9.6	–	36	90	60

[1] Constant 1995 US$

[2] Includes both mobile and fixed line

Source: The World Bank, World Development Indicators 2002; *ITU Yearbook 2002.*

Water and Sanitation. Although over 90 percent of the population lives outside the capital, Phnom Penh is the only city with a municipal water system with significant coverage of its population (roughly 70 percent). There is little sewerage and no wastewater treatment in the country. Solid waste management consists of open dumping sites. Water supply coverage in other cities and towns is substantially lower, at approximately 13 percent of residents, while only about 23 percent of rural residents have access to safe water. The majority of the systems are publicly owned and operated, but sixteen licenses have been awarded to private providers, offering treated, piped water delivery to parts of provincial and district communities. Water self-provision is even more common than power self-provision among Cambodian businesses (44 percent of respondents overall), but declines with firm size.

Table 2.7. Electricity and Water Self-Provision

	Cambodia	Micro	Small	Large	Exporter	Non-Exporter
Have own generator (%)	38.97	27.63	43.72	63.29	54.43	36.08
Have own well (%)	44.14	50.88	45.36	29.11	16.46	49.29

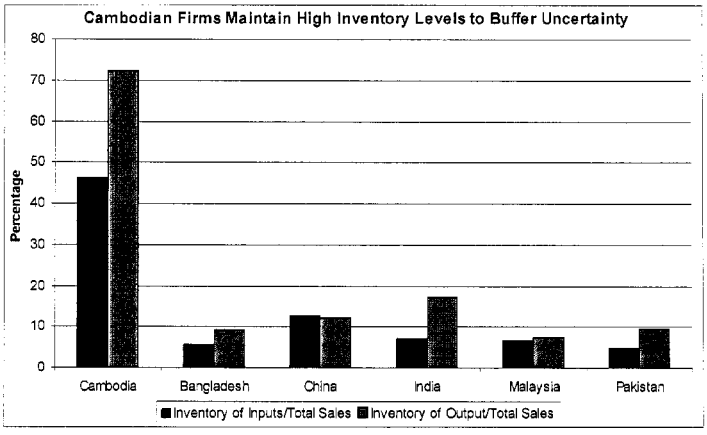
Source: The World Bank, Cambodia PICS 2003.

Telecommunications. Cambodia's fixed line telecommunications network is a public monopoly covering little more than Phnom Penh. Four mobile companies offer services and internet access that are now available in the capital and even in some provincial towns. In addition, two private companies operate international gateway services in a joint venture arrangement with the Ministry of Post and Telecommunications (MPTC). Mobile services are used for basic telephony because the quality of the fixed network is so poor and coverage so low. However, the combined fixed and mobile penetration rate is currently only around 1.91 per 100 inhabitants (0.25 for fixed; 1.66 for mobile telephony), which is low by both regional and international standards. Cambodia has both high telecom charges relative to other countries in the region, although they have come down in recent years. Residential connection rates, for example, are almost five times those for Malaysia and about double those for Lao PDR. Business monthly subscription tariffs are seven times those of Lao PDR, almost four times those of Thailand and Vietnam. As with the energy sector, Cambodia has failed to reap all the benefits of competition and private involvement in service provision in the telecommunications sector because each private license or cooperation agreement has been promulgated in a nontransparent manner that does not encourage competition.

Transport. Despite substantial government and donor investments in transport from the early 1990s, the network elements of the sector – roads, rail, and waterways – still struggle with insufficient maintenance, degradation from floods, and lack of investment funds, all in the face of increasing demand. Cambodia has the least developed road network in the region with the smallest percentage of paved roads. Cambodia's railroad is single-line, slow (average speed of only about 15 km/h), and inefficient (subject to regular delays and cancellations). The country's rail infrastructure and rolling stock capacity is considerably smaller than that of all its neighbors, the network remains unconnected to Thailand, and its efficiency is extremely poor. Cambodia's one deep-sea port at Sihanoukville is an inefficient public monopoly, used mainly for general cargo and container traffic, and is the primary channel for imports and exports, handling approximately 70 percent (by weight) of all cargo in and out of the country. It is also one of the most expensive in the region when unofficial charges for container handling, CamControl, customs, policing, etc. are included.

There is evidence that poor transportation has a significant negative impact on the operation and growth of Cambodian firms. Cambodian firms maintain extremely high levels of inventory compared to firms in other developing countries, indicating greater unreliability of delivery and/or high transaction costs of individual shipments. Inventory of inputs (i.e., raw materials excluding fuel) as a percentage of total sales averages 46.3 percent for Cambodian firms compared to 5.5, 12.6, 7, 6.6, and 4.7 percent in Bangladesh, China, India, Malaysia,

FIGURE 2.13



Source: The World Bank, Cambodia PICS 2003.

and Pakistan, respectively. Even more striking is the disparity in the level of output inventories (i.e., finished good and work-in-progress). For Cambodian firms, inventory of output averages 72.4 percent of total sales, while the means for Bangladesh, China, India, Malaysia, and Pakistan are 9.3, 12, 17, 7.5, and 9.6 percent, respectively.[34]

Furthermore, Cambodian firms experiencing transportation and finance problems suffer greater sales loss due to delivery delays from suppliers. For firms that perceive transportation to be an obstacle to the operation and growth of their business, the average loss due to delivery delays from suppliers is 5.9 percent of total sales, while those that do not perceive transportation to be a problem lost 3.6 percent in sales. For large firms, SMEs, and exporters that face transportation problems, the losses are particularly acute at 4.8, 9.9, and 11.5 percent of total sales, respectively. Large firms, SMEs, and exporters who did not perceive transportation to be an obstacle reported much lower losses due to delivery delays from suppliers of 1.5, 3.2, and 3.7 percent of total sales, respectively.

Similarly, the need to maintain high levels of inventories in order mitigate uncertainty in supply chains is reflected in the negative impact lack of access to financing has on the operations and growth of Cambodian firms. Better access to finance allows for the flexibility and means to stock up on crucial inputs necessary for continuous production. Expectedly, firms that perceive access to financing to be an obstacle suffer greater sales loss due to delivery delays from suppliers than those that do not, 6 versus 3.7 percent of sales, respectively. For SMEs and exporters that face access to financing problems, the losses are particularly acute at 8.1 and 8.8 percent of total sales, respectively. SMEs, and exporters who did not perceive access to financing to be an obstacle reported much lower losses due to delivery delays from suppliers of 4.4 and 3.7 percent of total sales, respectively. The working capital demands imposed by unreliable and costly transport is especially visible among rural nonfarm enterprises surveyed separately, which keep much higher inventories than their urban counterparts (see below).

Cambodia has the least developed road network in the region with the smallest percentage of paved roads. Given the fiscal constraints facing the Cambodian government, private provision of services is an important tool to achieve service delivery goals. In the absence of an appropriate legal, institutional and regulatory framework, however, many of the benefits frequently associated with private provision are weak.

Despite the poor quality, quantity, efficiency, and cost-effectiveness of most of Cambodia's infrastructure system, infrastructure does not appear among the leading constraints rated by the 2003 survey sample, even among rural non-farm firms. There are a number of likely explanations for the "low" ranking of infrastructure among the key constraints. These are explored in some detail in Chapter 4, which also describes the relevance and importance of an enhanced role for the private sector in infrastructure and public service delivery to Cambodia's overall PSD strategy.

2.9 Rural, Urban, and Informal Investment Climate

In the context of understanding the possibility of diversification, it is important to understand how the investment climate may be different outside of the capital. It is clear that the investment climate in Battambang and Kampong Cham, two important areas for agro-industry, needs particular attention. While investors/enterprises in Kampong Cham appear extremely displeased across all categories, investors in Battambang appear particularly concerned about anti-competitive practices by other firms and corruption. Firms in Sihanoukville and Siem Reap appear to be the least constrained, perhaps indicating a favorable environment for investment in tourism.

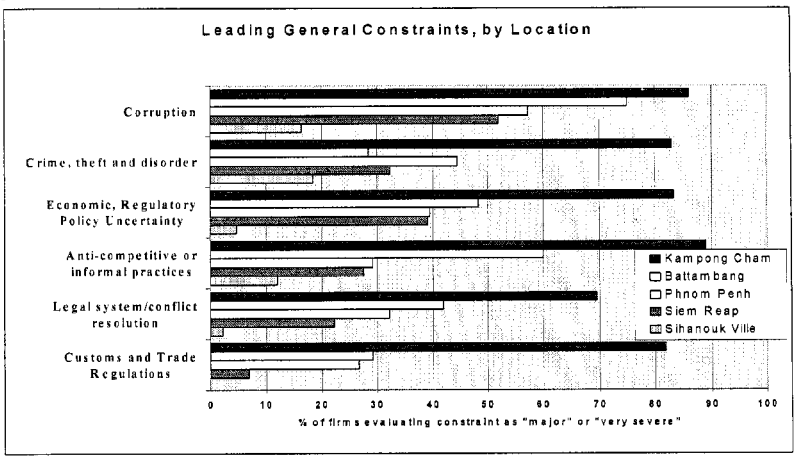
[34] All firms with inventory shares 3 times the interquartile range above the third quartile are classified as outliers and dropped from the calculations.

The national government is viewed unfavorably by those outside of Phnom Penh, and this appears associated with degree of formalization. In light of the problems firms encounter with corruption and regulation, it is understandable that 60 percent of firms, and fully 67 percent of micro enterprises, regard national government as unhelpful. Local government is held in higher regard – only 36 percent of firms regard provincial government as unhelpful, while 33 percent view municipal government as unhelpful. Perspectives on government helpfulness varied substantially by location, with the most favorable views generally prevailing in Phnom Penh and Battambang, and the least favorable in Kampong Cham. It is worthwhile to note that the three cities with the lowest rating on national government helpfulness are also characterized by the lowest firm estimates for how much of firm's income is reported for tax purposes.

A supplemental survey of 200 rural non-farm enterprises in 4 locations was conducted to understand the similarities and differences between urban and rural non-farm enterprises. These firms were found to be mostly very small – 90 percent classified as micro-enterprises (fewer than 10 employees) and 10 percent classified as SMEs (10 to 100 employees). A second supplemental survey was administered to 100 urban informal enterprises – of which 95 percent were micro-enterprises and 5 percent were SMEs. Virtually all firms were unregistered with the central government, although over a quarter of the rural firms had licenses from local governments. The rural non-farm sector is principally run by sole proprietors: 95 percent of businesses are run by one principle owner, while the rest hire external individuals to manage their businesses. Within the urban informal sector, either sole entrepreneurs or their families own 90 percent of businesses, while 10 percent of the businesses take the forms of partnerships. Almost 10 percent of both samples are registered with local authorities.

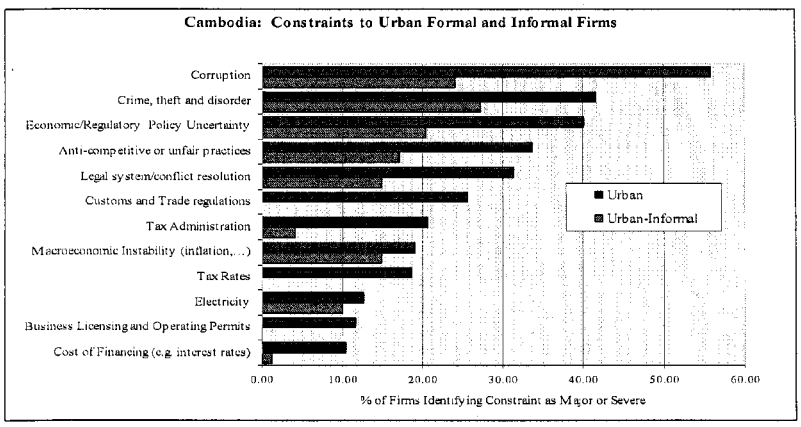
Being informal pays - a comparison of formal vs. informal firms shows systematic advantages to informality. It also shows that formality is a continuum, and even large and foreign-owned firms are not wholly formal. First, urban informal firms report themselves to be systematically less constrained than urban formal firms. They suffer less impact from corruption, weakness of the legal system, tax administration, and every other manifestation of public control of the economy. Labor regulations, trade regulations and tax rates were not rated as a major or greater constraint by any urban informal firms, showing the great advantage of informality in avoiding regulatory and tax burden.

FIGURE 2.14.



Source: The World Bank, Cambodia PICS BIS 2003.

FIGURE 2.15.



Source: The World Bank, Cambodia PICS BIS 2003.

Overall, while rural non-farm enterprises generally reported themselves less constrained than urban formal firms, they rated three factors as more constraining than did the main group: macro-instability, infrastructure (power, transport), and the cost of finance. Macroeconomic stability is a concern despite relatively stable exchange rates and low inflation. While agreeing on corruption, crime, and economic and regulatory policy uncertainty as their top three constraints, they placed macroeconomic instability next on their list. Like the urban sample, anti-competitive and informal practices was among their top 5 constraints.

Table 2.8. Top Constraints: Main Sample, Informal, and Rural Non-Farm

Urban – Main Sample	Urban – Informal	Rural Non-farm
Corruption	Crime, theft and disorder	Corruption
Crime, theft and disorder	Corruption	Crime, theft and disorder
Economic/Regulatory Policy Uncertainty	Economic/Regulatory Policy Uncertainty	Economic/Regulatory Policy Uncertainty
Anti-competitive/unfair practices	Anti-competitive/unfair practices	Macroeconomic Instability
Legal system/conflict resolution	Legal system/conflict resolution	Anti-competitive/unfair practices
Customs and Trade regulations	Macroeconomic Instability (inflation,...)	Cost of Financing (e.g. interest rates)
Tax Administration	Electricity	Legal system/conflict resolution
Macroeconomic Instability)	Transportation	Electricity
Tax Rates	Tax Administration	Transportation
Electricity	Skills & Education of available workers	Tax Rates

Source: The World Bank, Cambodia PICS 2003 and Cambodia PICS BIS 2003.

Second, all measured costs imposed by the formal economy are substantially less for both urban informal and rural firms. Along a number of regulatory dimensions, both informal and rural firms benefit from being somewhat "under the radar screen" of public officials. Urban informal firms regard bureaucratic behavior as equally arbitrary as do formal firms, and rural firms have an even more negative view than urban firms of the consistency of regulatory enforcement. However, both rural and informal firms are subject to far lower compliance costs, due to their greater informality and smaller average size.

They spend much less time dealing with regulations and inspections, report paying fewer unofficial payments, and typically report far less of their income for tax purposes, and hence, pay very little in revenue-based taxes. Formal firms' visibility not only requires higher formal payments to government, but

also appears to invite greater attention and harassment from public officials.

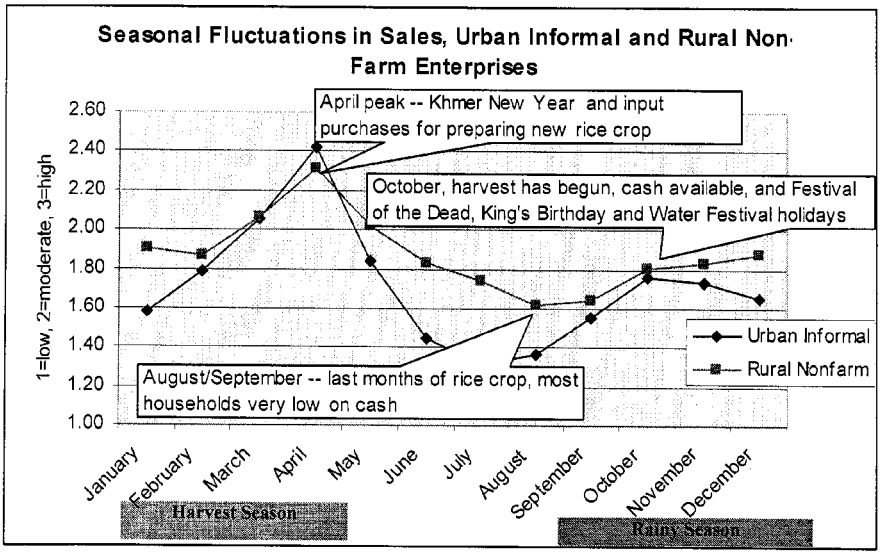
Table 2.9. Business-Government Relations

	Main Sample	Rural Area	Urban Informal
Interpretations of regulations consistent, predictable (% disagreeing)	44.35	53.62	45.54
% senior management's time spent dealing with regulations	11.12	2.37	1.08
Total days spent in inspections or required meetings with officials (days)	22.70	11.80	12.24
% revenues typically paid to officials to "get things done"	5.18	1.27	2.30
% total firm revenues typically reported for tax purposes	48.00	4.95	1.65

Source: The World Bank, Cambodia PICS 2003 and Cambodia PICS BIS 2003.

On the other hand, the main survey makes clear that formal participation in the economy brings relatively few of the traditional benefits that it might be expected to bring in a better-developed economy. The legal system is held in low regard and protection of property and contractual rights is poorly rated. Formal firms have extremely limited access to finance, with banks supplying only 2 percent of their needs. Anecdote and the value chain study also suggest that informal markets may in some respects function more efficiently than formal ones – for example, smuggling is highly developed, quick, and relatively inexpensive, while formal border logistics are weak, slow, and costly.

FIGURE 2.16.



Chapter 3: Diversification and Growth

NPRS Goal: Export Diversification: "reduce Cambodia's dependence on GSP exports and leverage market access opportunities of WTO to diversify range of exported commodities"

Chapter 2, on improving productivity, discussed impediments facing the existing manufacturing base in Cambodia. Chapter 3 discusses diversification – broadening the base of higher productivity enterprises to include new sectors. The garment sector has driven export growth in the past, but for reasons of equity, risk diversification and poverty reduction, policymakers are interested in broadening the base of growth to include new sectors and economic activities, particularly those that may raise income for the rural poor. Accession to the World Trade Organization and other initiatives, such as the ASEAN-China Early Harvest agreement, provide an opportunity to expand the export base, particularly in agro-industry. But can agro-industrial enterprises replicate some of the productivity performance of the garment sector? To understand the challenge of diversification, this chapter compares the conditions and factors contributing to the performance of two sectors, which are meant to capture the two extremes currently in Cambodia: that which has benefited from globalization – the urban, large scale, and formal sector, represented by the garment industry; and that which remains primarily a local industry: the rural, largely small-scale, and informal sector, represented by agro-industry. The key message that emerges is that expanding productivity overall is about removing impediments, but diversification rests to a large degree on creating new institutions.

3.1 The Challenge of Diversification

Cambodia's NPRS calls for more than growth – it calls for the expansion of economic opportunity. For reasons of equity, risk and poverty reduction, diversifying and broadening the base of private sector growth is an important goal. From an equity standpoint, the diversification policy is a response to imbalanced growth – garments and tourism have expanded at a much faster pace than the national economy since 1997, while sectors that include the vast majority of workers remained stagnant.

Table 3.1. Real GDP Growth by Sector, 1997-2003

Growth Rates (%)	1997	1998	1999	2000	2001	2002	2003 (est.)
GDP	6.8	3.7	10.8	7.0	5.7	5.5	5.2
Agriculture	6.4	5.8	3.4	-1.5	2.2	-2.7	9.2
Industry	19.6	-2.5	19.3	30.7	12.9	17.7	6.7
(o.w. Garments)	89.9	30.0	34.6	63.4	22.7	21.0	15.0
Services	3.4	4.8	10.9	5.7	4.2	4.5	1.6
(o.w. Hotels and Restaurants)	3.3	-1.3	18.5	14.4	18.1	11.4	-10.0

Source: The World Bank.

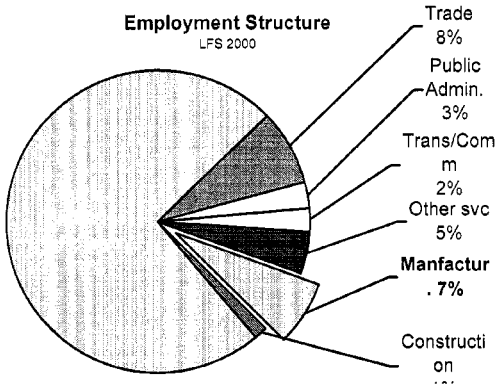
There are risks created by excessive dependence on one sector for a large share of productivity and exports. Garments contributes four-fifths of Cambodia's total official exports of $1.44 billion, but the risks created by the end of the Agreement on Textiles and Clothing are well known. Tourism has grown rapidly, but the SARS experience is indicative of the volatility of this sector.

From a poverty reduction standpoint, the case for diversification rests on the fact that a majority of workers are located in low-productivity, low-growth, non-exporting jobs and firms. 20,000 firms are involved in agro-industry,[35] a sector that largely does not export. The contribution of agriculture to value added has declined from around 48 percent in 1998 to around 37 percent in 2001.[36] Industry, with only 8 to 9 percent of employment, has increased its contribution to GDP from 14 to 22 percent due to its higher productivity. This imbalance is in part a result of policies that focused on or forced labor into agriculture. In 1968, there was a far larger share of employment in trade and industry.[37]

Increasing post-harvest agro-industrial investment can raise productivity of agriculture and create jobs. From equity, risk, and poverty reduction standpoints, there is a compelling case for rural agribusiness. As Binswanger recently observed empirically, agro-industry can have a beneficial impact both on inter-village and within-village inequality by (a) locating in villages with the lowest wages and (b) first employing the landless within those villages, and ultimately, in nearby villages.[38]

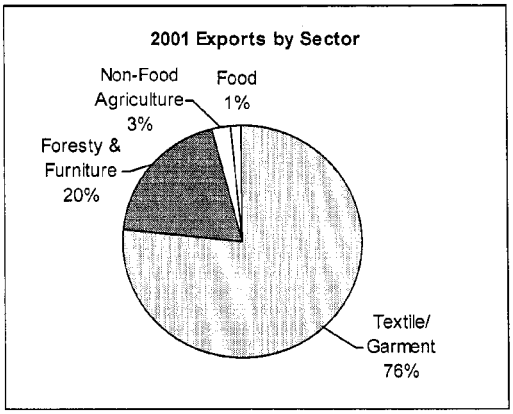
Diversification means continuing the growth of existing sectors and enabling new sectors to raise their value added so that they attract more FDI and domestic investment. Agro-industry is highlighted in this chapter because it offers real possibilities in Cambodia and because it is typical of the challenges any new sector may face. To understand the factors that may help close the productivity gap, it is necessary to explore influences on the productivity of small, informal firms.

FIGURE 3.1.



Source: The World Bank, Cambodia PICS 2003.

FIGURE 3.2.



Source UNCTAD / ITC.

[35] Both statistics are somewhat misleading, since a large share of agricultural trade is informal and not captured in official export or industrial data. Furthermore, a large share of workers who report employment in agriculture are engaged in informal, off-farm employment.

[36] World Bank, World Development Indicators 2003.

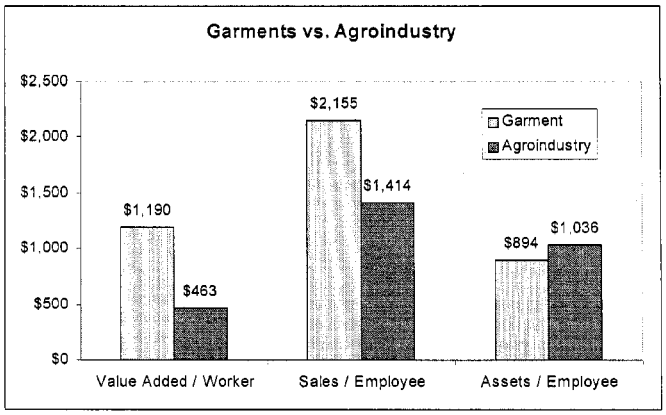
[37] Ros Chantrabot, *La République Khmere: 1970-1975*, Paris, 1993, quoted in "Cambodia's Economic Development and History: A Contribution to the Study of Cambodia's Economy," Undergraduate Thesis, Sophal Ear, March 1995.

[38] Binswanger (2003) is based on empirical evidence from India. It differs from a 'factor market dualism' approach, which suggested that the way to increase output per capita was to affect migration to more productive urban employment, thereby increasing average landholding for the remaining farmers. Variants of this phenomenon occur through the region, as labor left villages for factory jobs or EPZs. However, this does little to address the urban informality that often accompanies rural-urban migration, the stress on infrastructure, or the unequal distribution of gains. Binswanger's evidence suggests that off-farm investment at the village level is equity-enhancing.

3.2 What Contributes to Diversification?

The data suggest that value added per worker is 2.6 times higher in garments than agro-industry. Understanding this gap is key to diversification. Removing impediments that reduce the productivity of agro-industry could raise value added and attract both foreign and domestic investment. The key, argued in this chapter, is that agro-industry isn't subject to as much competitive pressure as the garment industry. In well-functioning markets, competition forces firms to specialize, raise productivity levels, satisfy customers more effectively than competitors. Firms that fail to do so perish or are acquired by more competitive firms. Survivors stay in the market by raising productivity. This competitive dynamic has influenced garments to a much greater degree than agro-industry. Why? For a line of economists from Smith to Sachs, a key issue is the *geographical scope of markets.*[39] Garment firms compete globally, but agro-industrial firms may compete only locally due to transport or communication barriers, therefore limiting the intensity of competition for customers. Given the state of infrastructure in Cambodia, physical market access is certainly a factor, and one that is frequently cited by outside observers.[40]

FIGURE 3.3.



Source: The World Bank, Cambodia PICS 2003.

But building infrastructure does not necessarily create trade. The new institutional economics (following North, Coase, Hayek, Stiglitz and others) has focused less on physical impediments and more on transaction costs – the cost required to search for exchange partners, execute contracts for exchange, and coordinate the production process.[41] North (1987, 1990)[42] observed that transaction costs are high in absence of formal and informal ***institutions*** that emerge to reduce particular risks and costs – the time required to identify buyers and suppliers, the cost of measuring the value of traded products, and the risk of a failure of trading partners to make good on their commitments. He saw economic development is essentially one of graduating from informal, personal markets with high transaction costs to formal, arm's

[39] "The division of labor, so far as it can be introduced, occasions, in every art, a proportionate increase of the productive powers of labor... as it is the power of exchanging that gives occasion to the division of labor, so the extent of this division must always be limited by the extent of that power, or, in other words, by the extent of the market." Adam Smith, *The Wealth of Nations*. Ch.3. See also Rodrick.

[40] See for example, World Bank (1999), *Cambodia Poverty Assessment*, pp 66-71, which focuses on inadequate infrastructure, transport costs, and particularly, credit to explain the lack of integration with urban markets.

[41] Coase (1988), *The Firm, the Market, and the Law*.

[42] North (1987), "Institutions, Transaction Costs and Economic Growth", *Economic Inquiry*; North (1990), *Institutions, Institutional Change and Economic Performance*.

length markets that have lower costs. Institutions (clear rules) create efficient markets, which create competition, which create productivity. A strong base of empirical research has supported the view that institutions go far to explaining differences in productivity among developing countries.[43] Particularly in rural Cambodia, the absence of key institutions such as legal infrastructure is easily observable, but little empirical research exists that explains the impact of the institutional environment on transaction costs.

To have policy relevance, it is insufficient to simply identify that institutions matter or that physical infrastructure may limit the geographical scope of markets. The task is to help point to specific institutions. For reasons described in Chapter 1, it is clear that the legal, political, and regulatory environment is at an early stage of development, and this limits competition. For the same reasons, it is also clear that the state of physical infrastructure limits the geographical scope of markets, particularly in rural Cambodia. While both are relevant, from a policy standpoint the implications are dramatically different – one explanation would suggest a focus on building rural transport and communication linkages, while the other may focus on market-supporting, human capital investments such as commercial courts. While both may be necessary, the government must prioritize and sequence these investments.

Furthermore, there are problems with an approach that depends exclusively on the state. While acknowledging the role of non-formal institutions, the process of development described by North ultimately depends on the emergence of the state as a neutral party, independent of exchange partners, to enforce contractual commitments. Development of formal institutions is a largely political dynamic, facilitated by democratic processes. At present, however, given the lack of organization of rural enterprises, low levels of literacy and awareness, the rural private sector is only partially able to influence the design of formal institutions.[44] But in Cambodia, an approach to institutions that rests on state enforcement can only be viable in the long-term, because the state's capacity has been depleted by conflict. As described in Chapter 2, the role of the state is also associated with corruption and rent-seeking.

In East Asia and Pacific, a strong case can be made that non-state, informal, and private institutions play an unusually large role in private sector development. Much of the private sectors of Taiwan, Thailand, Japan, and China have evolved from informal trading networks (based frequently on ethnic commonality) to highly sophisticated production networks, largely without highly developed formal legal systems enforced by effective judiciaries. Hayami (1998) provides an example of the role of informal institutions, suggesting that relational contracting mechanisms between rural manufacturers and urban buyers in East Asia (Japan, Thailand, Taiwan) are facilitated by personal ties, well-developed community norms, and obligations.[45] These community-based institutions have contributed to growth despite absence of the formal rule of law. *World Development Report 2002: Building Institutions for Markets* (2002) also recognized the potential contribution of informal institutions, but also suggested limits. Informal institutions could exclude groups that did not share its cultural characteristics, and could break down when the number of participants or the complexity of transactions grew.

The private sector itself develops ways to cope with high transaction costs. In coordinated value chains,[46] leading firms establish governance standards – rules for how products will be exchanged, verification, and enforcement mechanisms – for large numbers of suppliers. Large buyers

[43] See especially Hall and Jones (1999), "Why Do Some Countries Produce So Much More Output per Worker than Others?," *Quarterly Journal of Economics*; and Keefer and Knack (1997), "Why Don't Poor Countries Catch Up: A Cross National Test of an Institutional Explanation," *Economic Inquiry*.

[44] Donors are active in advising the government on design of formal institutions, but the extent to which the results reflect the institutional requirements of the local private sector, as opposed to donor experience, is a source of debate.

[45] Yojiro Hayami, "Toward an Alternative Path of Economic Development" in Hayami (ed.) (1998), *Toward the Rural-Based Development of Commerce and Industry: Selected Experiences from East Asia*.

[46] As an analytical tool, the value concept popularized by Michael Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, helps to illustrate the economic actors and agents value-adding processes both inside and outside the firm.

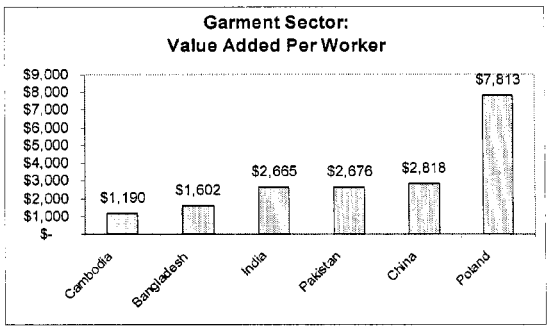
may often outsource verification to third parties, or may provide technical, financial, or material support to help value chain participants meet their obligations.[47] Suppliers are rigorously measured against standards that often are more rigorous than regulatory norms, and those that cannot adhere to the established norms simply exit the chain. This form of governance clearly addresses North's variables – standardization/ measurement, transaction processes, and enforcement, but without relying heavily on public institutions. The incentive to join and remain in a Carrefour, Toyota, or Motorola supply chain is strong because of the larger firm's market power and its dependence on suppliers to meet customers' cost, quality, and delivery requirements. This same incentive may in other contexts be provided by legal liability to make good on contractual terms. This is not to suggest that the rule of law is less important – production networks are often led by investors for whom the rule of law is a *sine qua non*. But in Cambodia today, one can observe several instances of value-chain driven trade, as discussed in Volume 1.

To understand the diversification challenge, it is therefore necessary to understand the competitive dynamics at the sector level, and how trade-supporting institutions, geography, industry structure, and factor markets create the conditions for specialization and productivity gains.

3.3 The Garment Sector

Compared with regional peers, productivity and value added in Cambodia appears to be at the low end for both garments and agro-industry. Value added per worker in garments is around $1,190 for sampled firms, compared with $462 per worker in agro-industry. However, the Labor Law is currently not enforced in the agro-industry sector, meaning that despite the low value added, the cost structure of Cambodian agro-industry appears competitive with Bangladesh, India, China, and Poland. The picture in garments is somewhat different. The ratio of labor cost to value added is the highest among the major garment sector exporters in the region, but lower than Poland, which operates in a higher-value niche than Cambodia. This suggests that cost competition – which is more likely to be the case as international quotas in textiles are abolished, will pose a challenge for Cambodia.

FIGURE 3.4.



Source: The World Bank, PICS for each respective country.

3.3.1 Competitive Dynamics

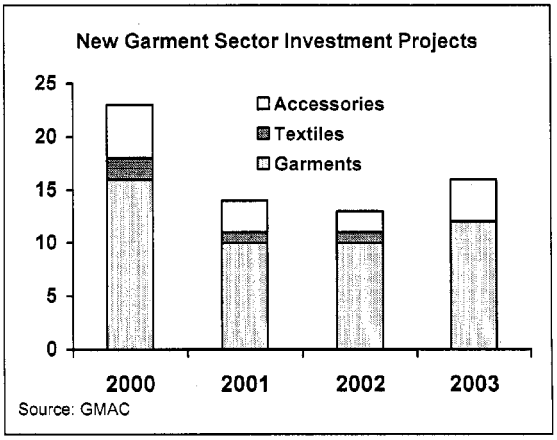
The garment sector is by far the most dynamic part of the private sector. Much attention is paid to Cambodia's garment sector[48] as a symbol of the impact of private investment and trade on poverty, and because of its explosive growth from exporting $20 million in 1995 to over $1.4 billion in 2003. Cambodia is on track to export over $1.26 billion to the US market alone in 2003, and is now the 14th largest supplier to the US market in volume terms and the 21st largest in value. The sector has provided employment to over 200,000 factory workers and, assuming a ratio of four dependents for each worker, income for up to one million Cambodians. Along with tourism, it is the largest source of foreign exchange. The sector has been a key driver of Cambodia's integration into the world economy, through both bilateral and multilateral agreements. Particularly through the bilateral agreements, Cambodia's garment sector has pioneered the practice of corporate social responsibility and has embedded these principles in the Labor

[47] Raphael Kaplinsky (2000), "Spreading the Gains from Globalization: What can be Learned from Value Chain Analysis?," Institute of Development Studies Working Paper 110.

[48] The sector is currently the subject of studies or projects by UNCTAD, UNDP, ADB, and ILO. A full profile of the sector was included in Volume 1, Value Chain Analysis.

Law, adherence to which is monitored by the International Labor Organization (ILO). Some of the most important economic institutions have been first initiated in the garment sector, including labor unions and business associations.

FIGURE 3.5.



Despite the upcoming transition to free trade, new investment continues to flow. Following two successive years of decline, sixteen new garment and accessories investment projects with a total value of $25 million were approved by the Cambodian Investment Board in 2003. In addition, over $39 million in expansion projects were approved for 2003.

The scope of competition in garments is not limited by geography infrastructure. The ICA sample of 55 garment firms directly exported 70.5 percent of their production and indirectly exported another 19.7 percent. The U.S. is the destination of 71 percent of Cambodia's garment exports, the EU 27 percent, and the remainder is distributed among a range of European and Asian countries. Interviews with industry representatives in Cambodia suggest that, while Cambodia has MFN/GSP relationships with a number of countries in industrialized markets[49] and countries with economies in transition,[50] the single most important export market continues to be the U.S. Most garment factories are located near Phnom Penh, Sihanoukville, and along National Road 4. The location of factories appears to reflect sources of labor and transport.

The structure of the industry is concentrated due both to policy and market causes, but does not appear to reflect monopoly power in the private sector. The garment sector has never been a protected industry and has been export-oriented and foreign-invested from its origin. While it is difficult to determine how many independent corporate entities are actually represented in the sector, as some may belong to a common overseas parent, owners of the 186 garment factories in Cambodia come from Hong Kong, Taiwan, China, Singapore, Cambodia, South Korea, and the US. Currently, slightly over 8 percent (15 companies) of the factories command over 50 percent of sales. This high concentration ratio is likely the result of both market and policy causes. Much of Cambodia's exports are in mass-market medium-quality garments that require large production volumes, implying high concentration. Since the banking sector does not provide much of the sector's working capital, larger, well-capitalized firms have a clear advantage. The concentration does not appear to result from larger firms exercising monopoly power.

3.3.2 Impediments to Competition: Quotas and Bureaucracy

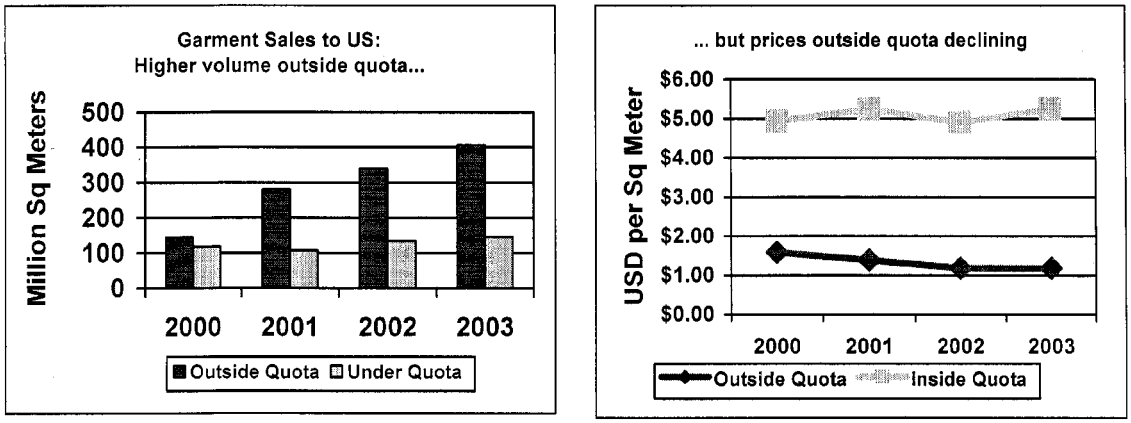
While the playing field is not distorted by inter-firm competition, it certainly is distorted by international trade rules. International trade in garments is managed by the Agreement on Textiles and Clothing (ATC), signed as part of the General Agreement on Tariffs and Trade (GATT) in 1994. The ATC lays out a process for liberalization of yarns, textiles, and garments from 1994 through 2005. Cambodia's industry emerged at the mid-point of this process – within the period of managed trade. The US-Cambodia Bilateral Textile Agreement of 1999 offered Cambodia a quota in lucrative segments,[51] which could be increased by up to 18 percent per year based on adherence to core labor standards. The quota for 2003 was

[49] Countries include: Australia, Canada, South Korea, Japan, New Zealand, Norway, Switzerland, US, and EU.
[50] Countries include: Belarus, Bulgaria, Czech Republic, Hungary, Poland, and Slovakia.
[51] In the trouser segment, Cambodia produces for Levi, Original, Old Navy, Union Day, No Boundaries, and LA. Jeans.

12 percent larger than the previous year, and the quota for 2004 was increased by14 percent. This economic rent is shared between government, public officials, labor, and factories. Quotas are auctioned, which also favors well-funded firms able to maximize the volume under a specific quota and match this to customer orders. A precise calculation of welfare gains and losses attributable to the quota is beyond the scope of this report, but it is clear that the arrangements shielded participants from direct competition and offered them artificially high prices. This has helped attract some firms to Cambodia.

As the quotas are eliminated, the garment sector will need to adjust, and this could be painful. When the ATC is finally eliminated at the end of 2004, Cambodia will access the US market on a most-favored nation basis, along with other WTO members, unrestricted by quotas. In this short run, Cambodia may see an increase in investment as garment factories in non-WTO members – who will still be subject to quotas- shift to Cambodia. In the long-run, without reform, cost pressure may force consolidation. It is fair to assume that the post-2005 garment sector will roughly follow the example of current non-quota exports to the US.[52] Cambodia already sells much more in volume terms outside the quota than inside, and non-quota business has expanded very rapidly. However, prices for products restricted by quota are nearly five times higher than non-quota prices. Furthermore, prices for non-quota sales have declined continuously since 2000 and are now barely above $1 per square meter. As volumes increase and prices decline, the industry is likely to (a) depend heavily on cost competitiveness; (b) become, to a greater extent than before, a volume-driven business; (c) become even more concentrated, with fewer very large factories dominating the sector; and (d) consolidate across borders, as firms that are currently located in multiple locations decide to concentrate production to enjoy economies of scale. While none of these factors are expected to be immediate, it is not clear how long Cambodia will remain a large garment exporter.

FIGURE 3.6.

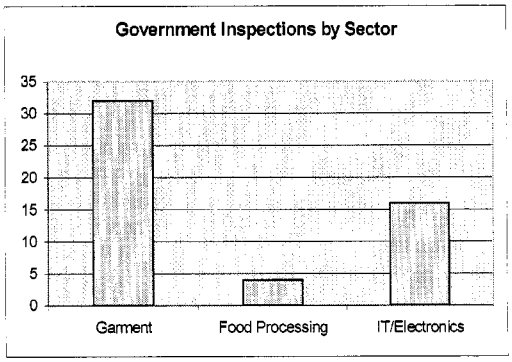


Source: US Customs Data, Bank Staff Analysis

[52] The U.S. does not place quantitative restrictions on all garment product categories. The current non-quota sales do not perfectly represent the post-2005 situation, as the dynamics of the protected products may be considerably different, and producers in different countries may choose to leave or continue to compete in many sectors.

Cambodia is trying to differentiate itself through corporate social responsibility (CSR), but this may impact only a small share of current exports. The ILO synthesis report[53] is influential in confirming the compliance with internationally recognized core labor standards and the Cambodian labor law, and thereby provided the US confidence that Cambodia was largely adhering to its international labor commitments. Even after the quotas end, the Government would like to maintain CSR as a potential source of advantage. The Foreign Investment Advisory Service (FIAS) is currently engaged in an effort to quantify the impact of Cambodia's CSR approach in order to evaluate CSR as a survival strategy. There is no doubt that some buyers will prefer Cambodia for this reason, and the FIAS work will help identify both the size of this potential market niche and what will be required to support it on a sustainable basis. This strategy would be even more viable in combination with other efforts to raise skills to pursue higher value product niches. However, necessary investments in skills have not been made.

FIGURE 3.7



Source: The World Bank, Cambodia PICS

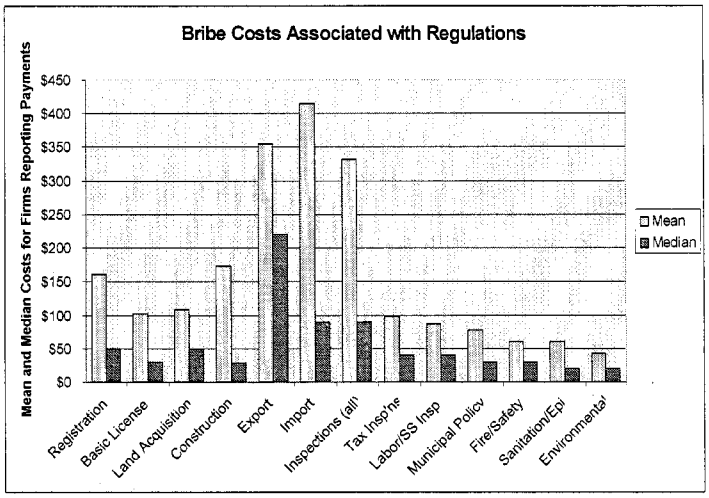
A more viable strategy for all segments may require *both* raising value (including through corporate social responsibility) and reducing the cost of bureaucracy and related corruption that cannot be passed to buyers in a fully-competitive environment. As described in Chapter 2 and in the Value Chain Analysis, export and import transactions are closely associated with bribe payments to a number of agencies. The average cost of each bribe is also highest for importing and exporting, which the garment sector must do for each order. As Cambodia moves toward a highly competitive free trade environment, the incremental cost of bureaucracy and corruption may outweigh the competitiveness of Cambodian labor. Using the example of Denim Jeans from the Value Chain Analysis, the labor content of a typical order 5 button 10/12 weight denim jeans is just 15 percent.

Table 3.2. Estimated Administrative Costs:
40 ft container Denim Jeans

Stages of Production	Admin. Costs
Pre-production Import clearance Transport	$448.20 (44%)
Production Cutting/layering Sewing/assembly	$30.83 (3%)
Finishing Finishing Packing/loading	$132.08 (13%)
Post Production Transport Export clearance	$406 (40%)
Total	**$1,017.37**

Source: Value Chain Analysis

FIGURE 3.8



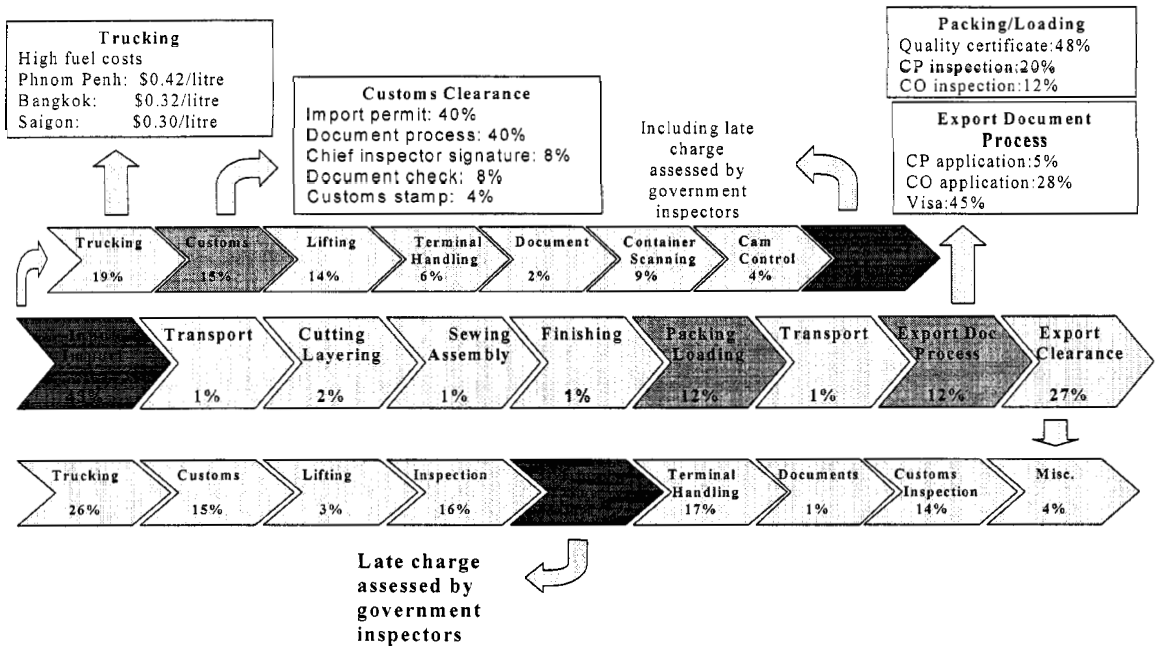
Source: The World Bank, Cambodia PICS 2003.

[53] International Labor Organization (2002), *Second Synthesis Report on Working Conditions in Cambodia's Garment Sector.*

Consequently, even if labor productivity is improved, that alone would have limited any impact on the overall competitiveness of Cambodian garment exports. Thus, focus must also be directed at understanding factors that contribute to reducing material input costs, which dominate the overall cost of production. The value chain analysis reveals that administrative costs associated with importing denim material and accessories, producing and exporting denim jeans in a 40 foot container may cost as much as $1,017.37 before transport costs and GSP quota fees.[54]

FIGURE 3.9

Administrative Interventions – Import/Production/Export of 40 Ft Container of Denim Jeans



Source: The World Bank (2003c), Towards a Private Sector-Led Growth Strategy for Cambodia – Volume 1: Value Chain Analysis.

As evident from the value chain,[55] much of the administrative costs are incurred during importing and exporting stages of production, particularly by the Ministry of Commerce/CamControl and Ministry of Economy and Finance/Customs, and packing and loading finished goods were often cited by factory managers as disruptive and unnecessary. In some cases, government inspectors would arrive late while containers were already being loaded to meet a shipping deadline. In such instances, loaders are required to unload the already filled container to allow inspectors to check the cargo. In another instance, inspectors come to the factory site merely to inspect the quality of the boxes in which the finished goods are being packed. Such disruptions are contributing to investor frustration, as well as costly delays, both resulting from overtime payments for factory workers and inspectors, and sometime missing shipments.

[54] A 40 foot container can carry approximately 2,250 dozen trousers.

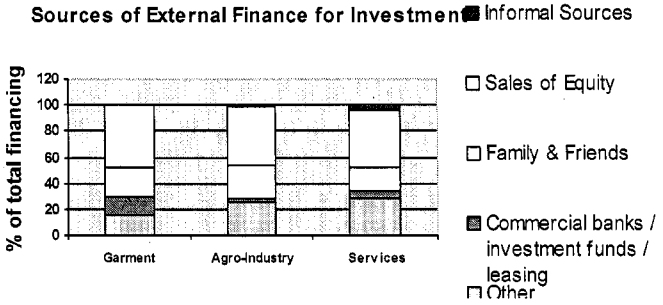
[55] The question of linkages is a longtime staple of development literature, going back to Albert Hirschman (1958), *The Strategy of Economic Development*, and linked closely to national competitive advantage and productivity by Michael E. Porter (1990), *The Competitive Advantage of Nations*, -- see p. 105, on Japanese silk industry, particularly relevant to Cambodia, and Michael Fairbanks (1997), *Plowing the Sea*, p. 76-92. A large literature explores supply chains in the context of understanding spillovers from FDI. The supply chain is increasingly relevant to looking at SMEs.

3.3.3 Efficient Factor and Product Markets

Labor is the critical input, and appears to be available because the garment sector pays wages that exceeded prevailing wage levels. Skilled labor comprises only 1.1 percent of labor use and unskilled labor 98.9 percent, according to the Labor Force Survey. Training unskilled labor is more of a concern. While there has been a vocational institution supporting the garment sector with Japanese funding, skilled labor, primarily foremen and supervisors, were frequently imported by garment factories from other overseas operations of the parent company. The average years of schooling of workers in the garment sector is 5.29 years. Because the current operations are not particularly skill intensive, the availability of skills does not appear to be a severe constraint on productivity. However, should more complex, value-added strategies be employed in light of full competition, skill shortages would ensue

The Garment sector obtains capital from parent companies. While all firms in Cambodia lack access to capital relative to international peers, it is clear from the analysis that the garment sector has superior access to commercial banking and investment funds. Nearly 15 percent of external financing needs for investment are from formal sources including banks, investment funds, credit cards, and leasing.

FIGURE 3.10



Source: The World Bank, Cambodia PICS 2003.

Infrastructure. Infrastructure adds to the cost of production, but reliability of power inputs does not appear to be a major constraint due to a high incidence of self-provision. 67.2 percent of surveyed garment firms have their own generator, and 19.7 percent have their own well. While the degree of self-generation is extremely high by international standards, only 3.2 percent of production was seen as lost due to power failures. Containerized shipments are typically trucked down NR4 to the Port of Sihanoukville. A large number of firms report losing sales due to delays, related in part to management of infrastructure. Trucking services are fairly competitive, and the key issue appears to be unofficial charges in transit.

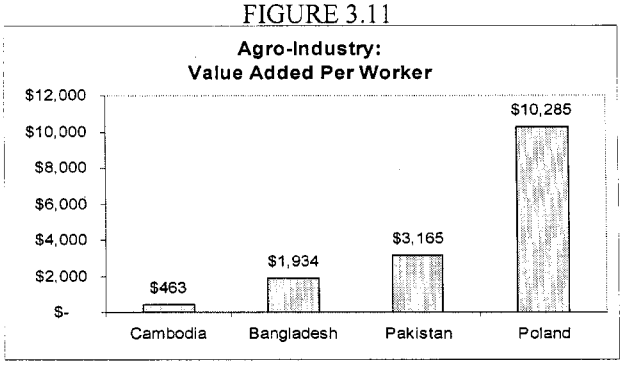
3.3.4 Trade-Supporting Institutions

The success of the garment sector has depended on both formal and informal institutions that link Cambodia with network partners, provide trust, and enforce terms of transactions. Formal institutions exist to establish and authenticate country of origin, to manage quota allocation, to verify compliance with labor standards, to verify fulfillment of quotas both on the Cambodian side and in the export destination, to verify compliance with duty exemptions, and to manage quality. As a private institution, the Garment Manufacturer's Association of Cambodia is by far the most effective business association in Cambodia and has played a very active role in negotiating the US-Cambodia Bilateral Textile Agreement, raising policy issues with the Government, co-Chairing the Export Processing and Trade Facilitation working group, developing policy approaches, sharing potential solutions to problems of logistics, and shares information on market conditions among the 192 or so active members. While not explored in depth, it is likely that informal institutions such as linguistic and cultural linkages with members of the garment industry outside of Cambodia elements play an import role in facilitating trade. The key issue is to make the formal institutions more effective and efficient. Trade facilitation costs in particular pose a threat to the viability of this sector, and any sector that exports in cost-sensitive markets.

3.4. Agro-Industry

International trading opportunities favor agro-industry. The Early Harvest program with China offers Cambodia and its ASEAN neighbors the potential to export nearly 300 products tariff free. Increased exports of agricultural commodities will create demand for post-harvest agribusiness, including grading, handling, and logistics. Substantial opportunity for processed product both domestically and internationally. Furthermore, the lack of fertilizer and pesticide use creates opportunities for organics. However, rural enterprises tend to be informal and serve local markets or middlemen. A number of signals would suggest there is an opportunity for growth. But this depends on removing the obstacles that put Cambodia's productivity levels far lower than comparator countries.

FIGURE 3.11

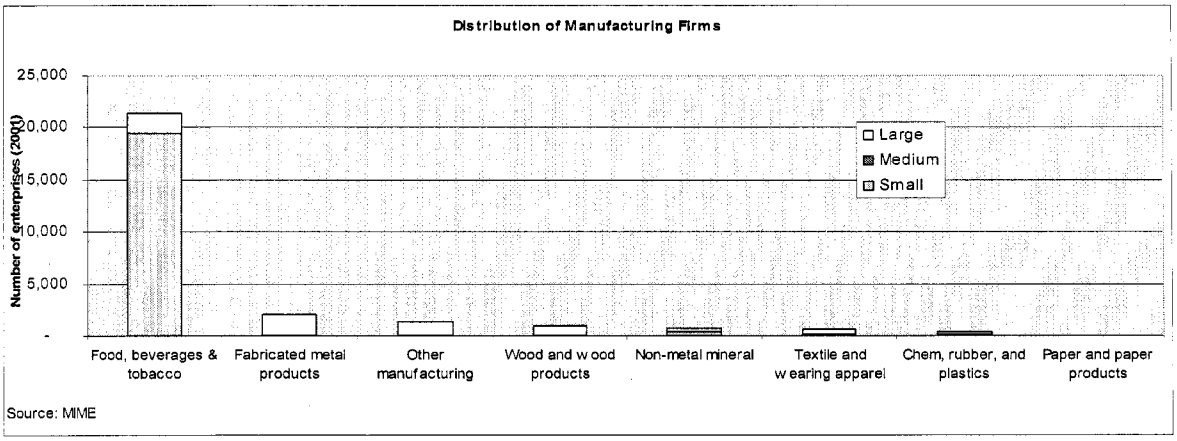


Source: The World Bank, PICS for each respective country.

3.4.1 Competitive Dynamics

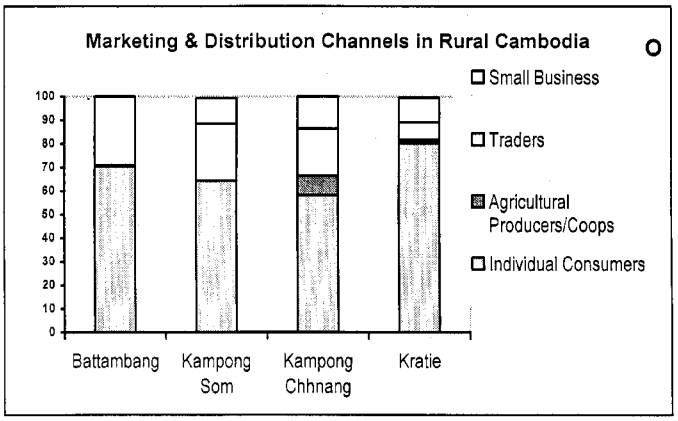
Industry structure is atomistic and dispersed. The agro-industrial sector consists of a large number of small and micro-enterprises, which comprise the vast majority of manufacturing firms in Cambodia – even as a small number of large manufacturers, textiles and garments dominates output. Of over 21,300 agribusiness firms, 91 percent are small, employing less than five employees, and having a capital outlay of less than $1,000. The few large firms in the sector do not constitute a large share of employment, but do play important roles in production and distribution.

FIGURE 3.12



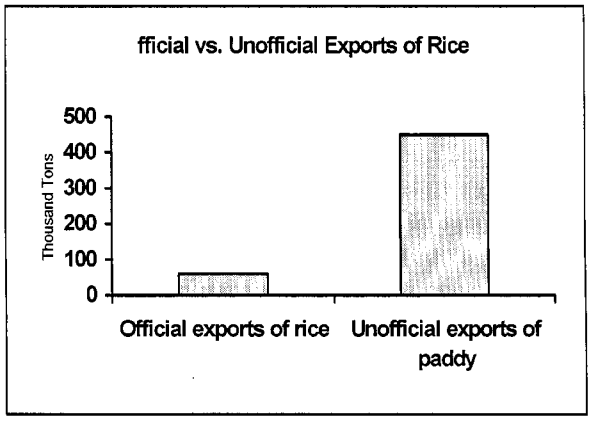
Domestic micro-enterprises and SMEs are not linked as suppliers to large companies and multinationals. Specifically, urban informal firms supply none of their output to either large domestic firms, multinationals, or government and only 5 percent of output to traders who might serve as intermediaries. Rural firms also supply nothing to large or multinational companies or to government, but supply a greater amount of output to traders. Whether this output goes to other firms or to consumers cannot be determined. But the general finding suggests that large companies rely very little on small domestic firms for their inputs and supplies.

FIGURE 3.13



Source: The World Bank, Cambodia PICS 2003.

FIGURE 3.14



Source: The World Bank, Cambodia PICS 2003.

Most sales go to individual consumers or is exported informally. Little goes directly to processors – and very little contract farming takes place. In Batambang, which includes a large number of rice millers, 70 percent of output is sold directly to consumers and the balance to small local businesses. Kampong Som and Kampong Chhnang have considerable volumes, roughly 30 percent of output, sold through traders, and in Kampong Chhnang there is also some sales through agricultural producers and cooperatives. Less than 1 percent of rural firms' product is sold to government, large enterprises, or multi-national companies. On average in the urban informal sector, 86 percent of product is being sold to individual customers, 5 percent to trade or merchant intermediaries, and 8 percent to other small businesses. In Kratie, the vast majority of trade is to individual consumers. Overall, trading behavior for rural Cambodia suggests that exchange relationships are still at an early stage of formalization. This is consistent with an earlier finding from the value chain analysis that much of the output of rural Cambodia is exported with no value added. Unofficial exports of rice far outstrip official exports. Given that local agro processors are limited to personal markets, it follows that they would only have the capacity to purchase a small share output.

This implies that traders and intermediaries are the crucial link to the large and formal economy, to the extent that one exists. Given the many anecdotal accounts of weaknesses in distribution and monopolization in some regions, concern (and future analysis) about rural firms' access to markets and supplies might suitably focus on the role played by these traders and intermediaries. Rural micro-enterprises supply 72 percent of their product to individual consumers, and substantially less to small businesses and through intermediaries than do rural SMEs. Also, rural firms keep higher inventories than similar urban firms, potentially indicating either greater unreliability of delivery (since firm maintain inventories to avoid running out in case of delays) or high transaction costs of individual shipments. High inventories may imply weak and/or unreliable supply systems or the need to order in bulk. In the urban sample, microenterprises and SMEs keep around 20 days of inventory. By contrast, rural firms keep 57 days of inventory in Battambang, 27 days in Kampang Cham, 37 days in Kampong Chhnang, and 35 days in Kratie. Firms indicate that if they had better financing, they would keep exceptionally large inventories covering from half a year to a year's worth of their main input.

3.4.2 Uncompetitive Distribution Channels

If competition is the key to productivity gains, then competitive marketing and distribution channels are essential. There are signs that these are not in place. As described in Chapter 2, around 35 percent of firms frequently cite informal practices – attempts by competitors to limit market access as a major or severe problem. As is typical in many post-conflict countries, many firms grew during earlier stages of the economy as a result of their ability to provide a needed commodity during a time of restricted trade. Once trade is opened, some such firms are unable to make a transition to competition based on quality and cost, and therefore try to maintain an environment of restricted trade and exclusivity. There is plenty of anecdotal evidence for this, including the attempt to monopolize export of Neung Mali rice. Any restrictions on distribution channels, however, negatively impacts diversification objectives three ways:

(a) The bargaining power of suppliers is reduced, so that their ability to obtain reasonable prices, supplier credit, or improvements in distribution services is also reduced;
(b) Feedback from customers on product quality, cost, or delivery requirements is muted; and
(c) Access to new customers, particularly for new products, is severely limited.

Licensing requirements are excessive but ignored. Despite Cambodia's clear transition away from state ownership of productive assets, a large number of state-sanctioned exclusive trading arrangements and local monopolies still exist. For example, only pharmaceutical company registered with the Ministry of Commerce and authorized by the Ministry of Health and agricultural technicians and his company registered with Ministry of Commerce and authorized by the Ministry of Agriculture, Forestry, and Fisheries are eligible to apply for licenses to import or trade agricultural inputs. Agricultural inputs including raw materials, semi- and finished products are subject to import licensing maintained under the Law on Drug Management of May 9, 1996 and the Sub-Decree on Standards and Management of Agricultural Materials of October 28, 1998. Only 5-6 firms are known to have registered, and given the low population density in Cambodia, any given agricultural region is unlikely to be supported by more than 1-2 of the registered firms. CDRI's recent study of the tree resin trade suggests that no firms have actually applied for a license since 2000 years, despite an annual trade exceeding $6 million.[56]

Table 3.3. Partial List of Licenses and Permits Required

Ministry	License	Department	Comment
Ministry of Industry, Mines & Energy	Operating License for SME	Small Industry & Handicraft at Municipal Level	Annual
	Certificate of Processing	Department of Industrial Technique	For export order, requires on-site inspection
	Certificate of Scales	Department of Metrology	Market scales
	Certificate of Product Registration	Department of Industrial Standards	For product registration, labeling, product safety and health.
Ministry of Health	Certificate of Hygiene	Hospital Department	For food processors, restaurants.
Ministry of Commerce	Import License	Department of Foreign Trade	
	Export License	Department of Foreign Trade	Exemptions for GSP exports
	Business License	Legal Department	
	Trademark License	Intellectual Property Dep't	
	Operating License	Municipal level	
	Certificate of Inspection	CamControl	quality of traded items.
	Certificate of Origin	GSP Department	
Ministry of Social Affairs	Individual Health Certificate	Department of Labor, Inspection & Health	To work in a factory all employees and employer
MAFF	Fish purchasing permit		
Ministry of Land Mgmt, Urban Planning	Land/Property Certificate	Land Cadastral Department	Property and land ownership

Source : Development Consulting International / Asian Development Bank Private Sector Assessment (2003)

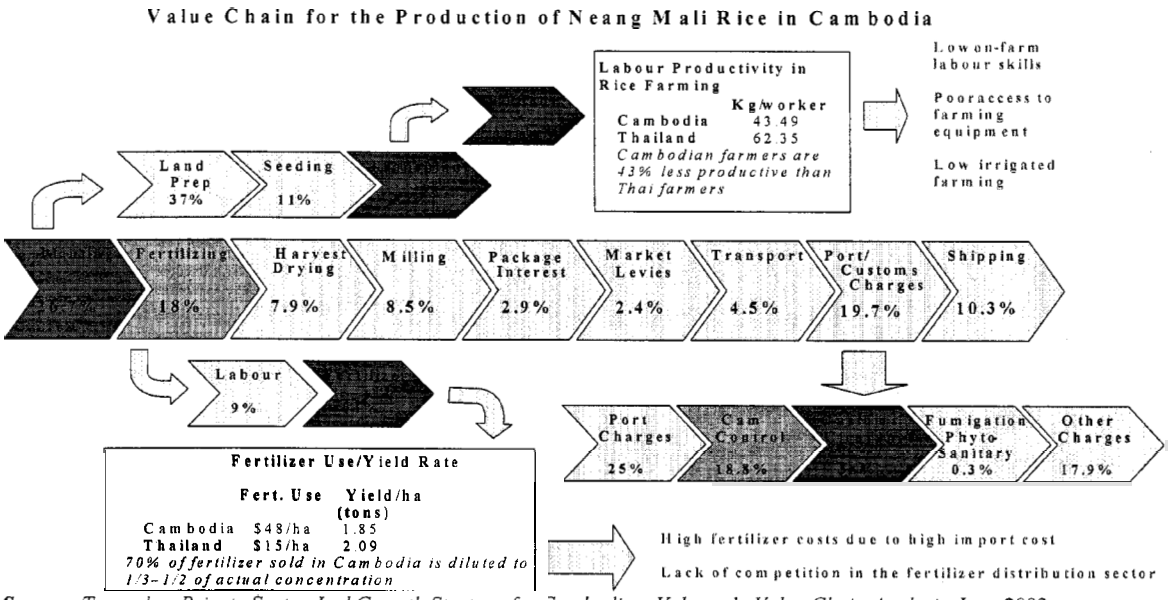
[56] CDRI study on resin trade, quoted in *The Cambodia Daily*, Wednesday, May 7, 2003.

Inspection requirements are not as onerous as in the garment sector. Quality assurance is an important part of the institutional support needed to enable arm's length, impersonal, long-distance trade and is in support of the public interest. However, the Government's policy for assuring quality is a disincentive to full competition. *CamControl's authorizing legislation, the Law on the Management of Quality and Safety of Products and Services, prohibits the commercialization of any product that has not been inspected.* While there is some detection of smuggled, expired, and illegal goods, the regulatory cost is high and creates the perplexing reality that most normal commercial activity is, in fact, illegal. While it is obviously not possible for a government to inspect all commercial activity, this type of regulation can be used to suppress specific businesses and to limit competition. In a recent case in Kampong Chhnang, an ice wholesaler was apparently blocked from selling low-priced ice by officials who believed that the ice was imported illegally from another province in which the cost of producing ice is lower.[57] The inspection requirements have an important indirect effect: they create an atmosphere of intimidation and discretionary authority that undermines investor confidence.

3.4.3 Value Chains are Not Integrated

Whether described as cluster analysis, backward- and forward-linkages, or value chains, the role of inter-firm linkages and supplier industries in creating productivity is well understood. It is particularly important in agro-industry, where the perish ability of product demands efficient handling at each stage. However, there are a number of supply chain gaps. Cold chains – refrigerated storage, refrigerated transportation, pre-chilling – do not exist. Milling capacity is insufficient. Cambodia produces nearly 4.12 million tons of paddy each year, but milling capacity is only 1.31 tons, creating a deficit of 2.81 tons. More than 50 percent of available capacity is in inefficient village mills where the paddy to polished rice conversion ratio is less than 55 percent (the conversion ratio of village mills in Cambodia are lower than the average conversion ratio in Lao PDR where it is 60 percent, as opposed to Japan and China, which achieve a conversion ratio of over 73 percent).

FIGURE 3.15



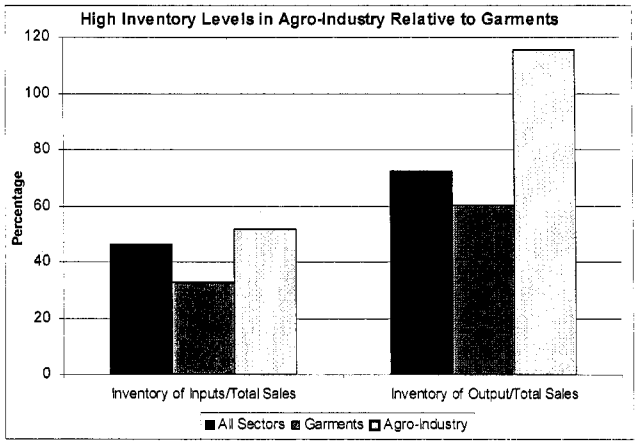
***Source:**, Towards a Private Sector-Led Growth Strategy fo Cambodia – Volume 1: Value Chain Analysis*, June 2003.

[57] "Police Block Ice Wholesaler," *The Cambodia Daily*, Wednesday October 8, 2003.

In addition to the lack of available high quality milling capacity, millers themselves face a problem of accessing adequate working capital financing as commercial banks do not recognize capital equipment, even large scale high equipment, as collateral. The lack of access to working capital has the effect of forcing millers with high quality equipment to underutilize their milling capacity as millers are unable to shore up paddy during harvest season, which in turn force rice farmers to rely on poor quality village mills or to sell paddy at a discount to Vietnamese and Thai rice traders. Once commercial mills have a stockpile of rice, it must now confront high electricity and fuel costs, high custom clearance charges, CamControl inspections, and port charges before it can make a shipment to markets in Europe and Asia. High administrative costs combined with uncompetitive energy prices add yet another layer of costs that diminish the competitive potential of enterprises operating in Cambodia and their ability to integrate.

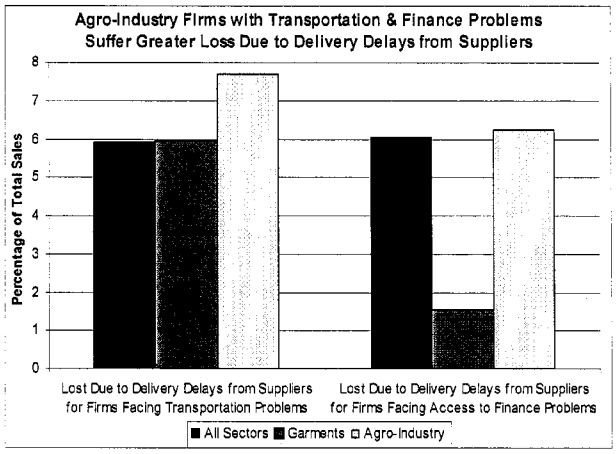
The data suggest that agro-industry faces greater uncertainty and sales loss due to investment climate constraints, and have reacted by raising inventory stocks. Agro-industry firms maintain higher inventory levels than those in garments as well as other sectors, which may indicate a greater need to buffer against uncertainty. Inventory of inputs (i.e., raw materials excluding fuel) as a percentage of total sales averages 51.6 percent for agro-industry firms compared to 32.7 percent for garment firms. The level of inventory for all firms is 46.3 percent. Even more striking is the disparity in the level of output inventories (i.e., finished good and work-in-progress). For firms in the agro-industry sector, inventory of output averages 115.6 percent of total sales, while the means for garments and all sectors are 60.1 and 72.4 percent, respectively.[58]

FIGURE 3.16



Source: The World Bank, Cambodia PICS 2003.

FIGURE 3. 17



Source: The World Bank, Cambodia PICS 2003.

Agro-industry firms experiencing transportation and finance problems suffer greater sales loss due to delivery delays from suppliers. For agro-industry firms that perceive transportation to be an obstacle to the operation and growth of their business, the average loss due to delivery delays from suppliers is 7.7 percent of total sales. For garment firms that perceive transportation to be an obstacle, the average loss is lower at 6 percent of total sales, which is similar to the average loss of 5.9 percent for all sectors.[59] For firms that perceive access to finance as an obstacle to the operation and growth of their business, the average loss is 6.3,

[58] All firms with inventory shares 3 times the interquartile range above the third quartile are classified as outliers and dropped from the calculations.

[59] In stark contrast, for firms that do not perceive transportation to be an obstacle to the operation and growth of their business, the average loss due to delivery delays from suppliers is 0.2, 1.5, and 3.6 percent of total sales for agro-industry, garment, and all sectors, respectively.

1.5, and 6.1 percent of total sales for agro-industry, garments, and all sectors, respectively.[60]

3.4.3 Factor Markets

Human capital. Demand for skilled labor in agro-industry is low, and availability of skills is not reported as a constraint by agro-industry firms. This is a reflection of the low level of sector development and could change quickly. At prevailing levels of value added, firm sizes averaging seven employees, and annual revenues of less than $10,000, there is little scope for job specialization and the productivity levels to enable higher wages is absent. Firms therefore do not report major problems obtaining sufficiently skilled manpower. More skilled personnel are likely to quickly sense the higher returns to their skills in other sectors.

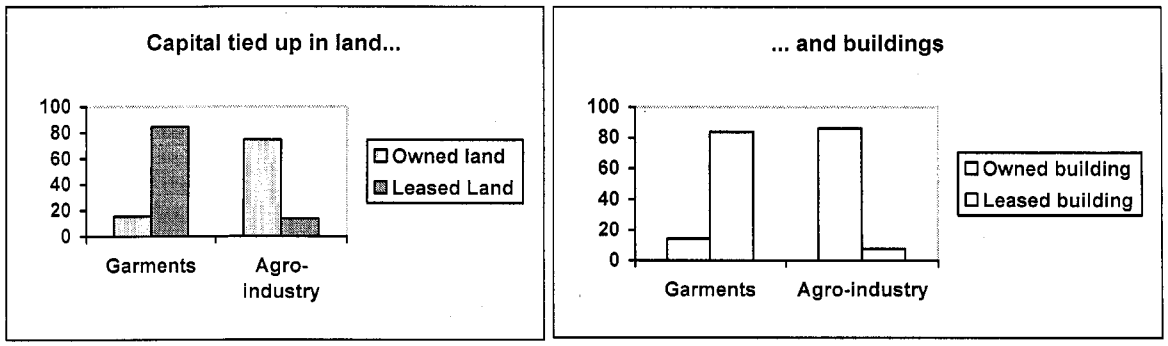
Table 3.4. Intensity of Formal Training

	% of workers	Duration	
		Mean	Std. Dev
Garment and textile	16.58	8.14	9.87
Water	5.91	3.00	0.00
Construction	12.33	9.87	11.28
Restaurants, hotels & tourism	16.76	6.29	5.93
Information technology/electronics	21.22	16.40	7.27
Food processing	**1.62**	**0.00**	**0.00**
Transportation, shipping & trade	12.06	5.87	4.85
Electric power	4.95	1.00	0.00
Total	16.18	8.09	8.58

Source: The World Bank, Cambodia PICS 2003.

What is of a larger concern is the extremely low levels of educational attainment, and high levels of functional illiteracy for the working population in rural areas, combined with the lack of training provided by the food sector. Whereas the garment, construction, and tourist sectors provide some training to their workforce, the food sector is at the bottom in terms of training provided, despite food processing being somewhat technology-intensive. This means that any attempt to increase quality or introduce technical sophistication into operations to add value will almost immediately hit a skill constraint. While in aggregate there may be skills available in Cambodia to supply a more technically sophisticated sector, they are currently concentrated in urban areas and are unlikely to move to rural areas.

FIGURE 3.18

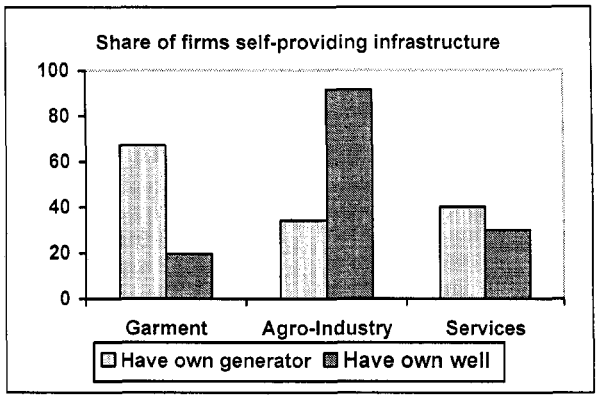


[60] In stark contrast, for firms that do not perceive access to finance to be an obstacle to the operation and growth of their business, the average loss due to delivery delays from suppliers is 0.3, 0.9, and 3.7 percent of total sales for agro-industry, garment, and all sectors, respectively.

Only 3 percent of working capital is met from commercial sources – and the capital is used inefficiently. As noted above, inventory levels are high, meaning that excess capital is used to maintain extra stocks. Unlike the garment sector, which primarily leases property, 75 percent of land and 86 percent of buildings in agro-industry is owned. This accounts for a much higher ratio of assets per employee and overcapitalization relative to garments. However, given the high failure rates in the industry, there may be a reluctance to borrow commercially and pledge real property, which may also serve as a home and the most important store of wealth. Firms do not report this to be an issue, but clearly access to capital is a hidden cost and contributes to the loss of sales to better funded foreign buyers. In the short-run, however, increasing the availability of commercial lending would not be a complete solution because of the underlying risk. Mechanisms, such as leasing, in which agro-industry firms would not take title, could be viable.

Infrastructure. Reported shipment losses are low and infrastructure is not perceived to be a constraint – but this is another reflection of the low level of development. The key infrastructure gaps are in the quality of tertiary roads to obtain market access and the high rates of self-provision of infrastructure. Over 91 percent of surveyed agro-industrial firms maintained their own well for provision of water – a critical input to almost any food production process, and over 30 percent generated their own power. It is clear that this puts Cambodian agribusiness at a cost disadvantage and accounts for some loss of value-added. Moreover, logistics is at an early stage in its development.

FIGURE 3. 19



Source: The World Bank, Cambodia PICS 2003

On average, it takes rural firms 2.6 hours to get to their most important market to sell products or services, 3.6 hours to get to the market or supplier of their main input, and 3.6 hours to get to a bank or financial institution. Businesses travel 16 times per month to product markets, 7 times per month to input markets, and twice a month to banks. It is possible that some trips are multipurpose – for example, firms may buy inputs and sell products in the same towns, or they may stop at the bank while traveling to product markets. This establishes a possible range of travel time from 83 hours (two standard workweeks) to 148 hours per month. Travel time varies substantially by location, with longer travel times to product markets in Sihanoukville and Battambang regions and very long travel times for Kratie firms to input markets, due to weak ground transportation.

Should Cambodia diversify its agricultural base, it is likely that the road density, lack of a viable rail option, and lack of cold chain logistics service providers ranging from refrigerated warehousing to transport would quickly become constraints. Without such innovation and investment, post-harvest losses for perishable items would be prohibitively high. Infrastructure investment would need to be both physical and managerial. Significantly better use could be made of back-haul capacity from shipments of consumer goods going from Phnom Penh to rural Cambodia.

3.5. Institutions to Support a Diversified Private Sector

Competition between agro-industrial firms, which is a prerequisite to raising productivity levels is insufficient, and the key reason appears to be a lack of formal or informal institutions to support market linkages. The high cost of search, coordination, and contracting are not supported by institutions that reduce the cost of measurement and the cost of contracting or increase enforcement capability. This is reflected throughout the ICA results and appear to be more of a constraint than the

availability of working capital or physical infrastructure. Intuitively this makes sense. Even if agro-industrial firms had easier access to credit, the risk of contracting with many small suppliers is a binding constraint.

Firms are coping with the risk environment by staying small, building high inventories, and limiting themselves to trading partners they know well. Both property rights and secure transactions need to be strengthened. But the development and behavior from these institutions, as North reminded us, are not created overnight. Institutions result from discovery, repeated interaction, learning processes, and at times, the formal legislative process. Many of the institutions – particularly the rule of law – imply a political decision to empower markets to a much greater degree than exists today, so that the rule of law and markets overcomes bureaucracy. Market institutions that would reduce transaction costs, such as information systems, commodity exchanges, and broker certification, need to be better understood.

Cambodia will need to build public sector institutions – but any realistic strategy has to rely on the private sector organizing itself. Private value chains, self-regulation and advocacy are central. A number of good international models exist of institutions that have helped set market standards and promoted competitiveness in agro-industry. ProChile, The Chilean Trade Commission, for example, support and advance Chilean business interests in the global marketplace by assisting in the development of the export process, establishing international business relationships, attracting foreign investment and forging strategic alliances. It does so through its market research, international trade data and networking, with a focus on promoting non-traditional products. It also does extensive research on customs regulations to ensure that exporters are in full compliance with international trade laws.

Table 3.5. Summary: A Substantial Institutional Gap

	Garments	Agro-Industry
Value Added/Worker	$1,190 (low by international standards)	$462 (extremely low by international standards)
Firm Size	600 + employees	~ 7 employees
Market Scope	Global markets: US 71% EU 38%	Local, informal: 70% individual
Trade-Supporting Institutions	GSP, Agreement on Textiles and Clothing Labor Law, ILO compliance monitoring Corporate social responsibility norms Quota management systems, ELVIS Certificates of Origin Duty Exemptions, tax incentives Dispute resolution outside of Cambodia (e.g., Singapore)	None
Informal/Private Institutions	Garment Manufacturers' Association Corporate networks	Village and community-based
Quality Measurement	CamControl	CamControl inspections
Technology, Standards	MIME / CamControl getting started	Some donor-funded projects, Some TA by Thai suppliers
Dispute Resolution	Foreign arbitration used. New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958); ASEAN Protocol on Dispute Settlement.	Commune-based, informal
Skills	Some firm-provided training	No firm-provided training
Finance	14.1% commercial/institutional credit	2.7% commercial/institutional credit
Policy Advocacy	Strong business association, Government-Private Sector Forum	Nascent business associations (rice millers, rural electricity providers)
Critical Constraint	***High transaction costs due to excessive/overlapping government intervention***	***High transaction costs due to absence of trade-supporting institutions***

3.5.1 Private-Led Value Chains

Value chains are an important part of private sector development in the East Asia and Pacific Region and should be seen as a type of governance institution. As described at the outset of the chapter, networked production is a hallmark of trade in East Asia, and the rules governing this trade are often set by supply chain participants. Large buyers – assemblers, retailers, and processors – have transitioned from vertically-integrated manufacturers to brand managers and supply-chain "orchestrators." While the automotive supply chain is perhaps the most evolved, value chain integration also takes place in the agro-industrial sector. Carnation, for example, provides technical assistance to coffee growers and dairy farmers in Thailand in return for the security of an adequate supply and quality of raw materials.

In the absence of an enabling environment that encourages value added production, several companies such as Angkor Kasekam and Manhattan Textiles have established their own out grower/ contract farming schemes. These out grower schemes have effectively linked a wide range of smallholder farmers in rural areas with processing facilities in urban areas to create an environment that fosters market segmentation and specialization, adherence to quality standards that reflect international norms, and contracting mechanisms that in some respects stabilize relationships in the absence of strong rule of law.

Examples of successful vertical integration of local farmers and enterprises can be found in the poorest parts of the world such as Zambia and Central Kazakhstan, where enterprises have effectively integrated small local suppliers into a vertical supply chain. In Zambia, a number of enterprises in the high value horticulture sector have established out growers schemes, some covering over 1,000 local smallholder farmers, where output is sold through the world's top companies such as Tesco, Walmart, Saintbury, and McCormick Spices. Similarly, in Central Kazakhstan, the world's fourth largest steel company operates a supplier development program in the steel sector. In both examples, the country suffers from a poor enabling environment where the rule of law is not observed, and the market is represented by an absence of institutional capacity and support infrastructure. Such out grower schemes have been effective in vertically integrating rural smallholder farmers into a global supply chain, while at the same time creating an effective network and support infrastructure through which rural smallholder farmers now gain access to working capital to purchase inputs, cheaper access to input material, skills training, access to improved seed varieties and farming techniques, access to markets, and other services. These programs have broad spillover effects and can redefine industry standards. In Thailand, Royal Ahold/TOPS has created a supply chain development program that has upgraded post-harvest practices throughout the fresh produce industry.

Box 3.1. TOPS/Royal Ahold Supply Chain Development Program: Catalyzing Supplier Upgrading

In 1998 Royal Ahold, a leading global retailer, TOPS Thailand, a retail chain, Rabobank, Kasetsart University in Thailand, SGS, TNT Logistics and the Thai Department of Agriculture conducted a value chain project with the goal of improving the performance of the supply chains for perishable products in terms of efficiency (cost), dependability/continuity, flexibility, and quality including food safety. Prior to the program's establishment, TOPS had around 250 domestic suppliers of fresh fruit and vegetables, including growers and wholesalers. They suffered from an unstable supply, long lead times, uncertain quality, and high product deterioration (shrink) in the 60 hours it took from the point produce was delivered to the back of TOPS stores to shelves. Farmers trading practices were primarily personal, agricultural production was simple and executed with poor quality equipment, there was an absence of grower associations, and a lack of trust which prevented effective standardization of product and a multiplicity of middlemen handling small volumes of product. The net result was an inability to offer a consistent quality to TOPS customers at a reasonable price.

TOPS invested in a distribution center to handle incoming product flow, and in parallel, a program of upgrading suppliers. Elements of the program included:

- A value chain analysis to identify bottlenecks and potential improvement areas;
- A preferred supplier program was developed to move from spot transactions among 250 suppliers to strategic relationships with a more limited number;
- A food safety and quality assurance program for suppliers, which would be certified by a third party;
- Capacity building in good agricultural practices was provided to participating suppliers;
- Training by the Wageningen School of Management, which resulted in the creation of the Kasetsart Supply Chain Management program;

While there were some difficulties, the 250 suppliers were eventually narrowed to 60 preferred suppliers. Suppliers were provided with operational criteria supporting the goals of cost, quality, flexibility, and dependability, and trained in integrated pest management and value-added post-harvest functions (pre-cooling, washing, sorting, grading, packaging). All 60 suppliers were eventually certified for food safety and quality practices and became capable of the necessary value-added functions and delivering a high quality of produce.

In less than four years, the TOPS distribution center's service level reached 98% of its maximum, and the fresh produce section of TOPS supermarkets is now among the best in Thailand and one its key marketing advantages. The key lessons learned: without selective incentives, there was little cooperation among suppliers, but suppliers responded well to capacity building clearly tied to increases in volume. Personalized business relationships were a threat to preferred supplier programs, and in general, there were substantial intercultural gaps in the measurement of performance, the role of standards, and the management of public-private partnerships. Despite these obstacles, the project has stimulated not only standardization and quality among suppliers, but throughout the Thai fresh produce industry.

Source: *Business Case Description: TOPS Supply Chain Project, Thailand.* Dave Boselie, KLICT International Agri Supply Chain Development.

3.5.2 From Rule of Bureaucracy to Rule of Law?

Many of the investment climate issues result from the lack of a functioning legal system that secures property rights. Property rights –the right to use, control and benefit from a resource– are essential to investor confidence. Clear property rights depends on clarity in the role of the state, and withdrawal from roles better performed by markets. The intent of inspection processes is to ensure public safety and quality; hence a policy that depends on 100 percent inspections and licensing requirements, which are often ignored. Were the rule of law to prevail, this would be entirely unnecessary, since buyer of goods that violated legally-defined standards could simply seek satisfaction through the courts, and the likelihood of such a decision being carried out and enforced would deter selling of unsafe or expired goods. The burden of monitoring, detection, and enforcement shifts from an over-stretched civil service to the market, whereas the state's role shifts from inspection to the definition of standards.

An effective Civil and Commercial Code is particularly important since it encourages arm's length transactions, but only one-third of firms have confidence in the judiciary. The law is in draft form and being reviewed at time of writing. A recent review of the Cambodian legal system suggested that there remain a number of severe challenges before the CCC is accepted, disseminated, understood, applied, and enforced. [61] Simply put, the Judiciary will need substantial capacity building to demonstrate a track record of impartial and effective judgments before this perception is changed. Furthermore, the judiciary needs to rebuild public confidence and trust, especially given the widespread allegations of corruption. All of this can only be seen as a medium-term agenda, something that will emerge gradually. Clearly, an interim approach is needed that will enable more confidence in trade and investment decisions.

3.5.3 Complements to Formal Legal Institutions

Given that establishing the rule of law will take considerable time, are there non-state alternatives? In de Soto's words, an essential part of deregulation "should include delegating functions and authority to those formal or informal private institutions which, as we have seen, are today operating better than the state."[62] The Government's Legal and Judicial Reform Strategy seeks the establishment of a system of arbitration and mediation to deal with commercial disputes and what are termed 'minor disputes' at the community level. A draft Law on Commercial Arbitration is before the National Assembly, and an organization has been established. In addition, the promotion of village level mediation would appear to be a more practical and helpful approach in order to increase access to means of alternative dispute resolution.

A legal empowerment approach focusing on increasing awareness and demand for rights, but also utilizing alternatives to formal courts and lawyers, would seem relevant to Cambodia's private sector and a recognition that informal dispute resolution mechanisms do exist in absence of the formal rule of law. Defined as "emphasizing civil society, including legal services and development NGOs, as well as community-based groups; using whatever forums (often not the courts) the poor can best access in specific situations; encouraging a supportive rather than lead role for lawyers; cooperating with government wherever possible, but pressuring it where necessary; using community organizing or group formation; developing paralegal resources; integrating with mainstream socioeconomic development work; and building on community-level operations to enable the poor to inform or influence systemic change in laws, policies, and state institutions."[63] More needs to be understood about the effectiveness of this form of dispute resolution in order to determine if it could serve the needs of expanded trade.

[61] World Bank (2003a), *Cambodia: Legal and Judicial Sector Assessment.*
[62] Hernando de Soto (1989), *The Other Path: The Invisible Revolution in the Third World*, pp. 249-251.
[63] Stephen Golub (2003), "Beyond the Rule of Law Orthodoxy: The Legal Empowerment Alternative," Carnegie Endowment Working Paper.

3.5.4 Business Associations/Membership Organizations

BMOs are intermediary, networking, and self-regulative bodies. As such, they represent an increasingly important form of participatory development in countries such as Cambodia. Because of their size, BMOs have extensive outreach capabilities and can contribute to improving the framework conditions for the private sector through facilitating a common understanding of the formal rules of commerce, taking collective action, delivering central services, and networking among members and other stakeholders. It is this unique combination of strengths that makes them effective tools to increase the growth of firms in a given country.

Social capital and networks are important to trade, specialization, and innovation. Business membership organizations[64] (associations) can play a critical role, but need to overcome an atmosphere of distrust in the private sector. Business associations can facilitate exchange by improving information flows and by facilitating learning through policy advocacy, through facilitation or direct provision of demand-driven services, and through advocacy aimed at creating a better business environment. As described above, the private sector in Cambodia exhibits a dual structure – a few large, modern, capital- as well as import-intensive enterprises on the one end of the spectrum and a majority of micro- and small enterprises serving local markets with simple and traditional technologies on the other. The smaller firms face a number of constraints, including resource endowments, economies of scale, demand conditions, market size, as well as available technologies and institutions. There are additional constraints facing the private sector as a whole, such as bureaucratic complexity and a weak legal and judicial system.

BMOs in Cambodia are typically characterized by poor organizational capacity and technical skills, lack of proper accounting systems and governance, and lack of demand-driven orientation resulting in low levels of sustainability. Another characteristic of Cambodian BMOs is that board members do not understand fully their role and responsibilities and do not realize that they work as representatives of a community. Conflict of interests can arise and board members do not spend the time necessary for this voluntary work. The most important areas for intervention are the development of services, advocacy, and BMO management. MPDF is actively involved in helping to create well-functioning BMOs with professional staff and a board of directors who understand their role and responsibilities. The indicators for measuring the impact of these projects are: the growth of membership/ membership retention; the variety of business services to members; the self-sustainability of the BMO; recognition by the Government and third parties as being representative of a particular group; the solution of at least two advocacy issues per year; the satisfaction rate of members; and the participation rate of members to the activities of the association.

3.5.5 Government-Private Sector Forum

The Government-Private Sector Forum, designed as a bi-annual meeting of the Cabinet of the Royal Cambodian Government and representatives of the private sector, is a useful vehicle for public-private dialogue and enjoys considerable support of high-level officials and the private sector. It is essential that the Government and private sector engage in a constructive dialogue in identifying and overcoming the policy constraints to trade. In Cambodia, the Government-Private Sector Forum (PSF) is a framework to encourage consultations between the private and public sector. The PSF meets twice a year and is chaired by the Prime Minister. There are seven sector focused Working Groups (WG's) under the

[64] BMOs have to be defined as non-profit and democratically guided membership organizations that finance themselves by a mix of membership dues, service fees, as well as subsidies from government or donors. There is no law regarding the regulation of business enterprises associations in Cambodia. With the exception of a few BMOs, such as the Chamber of Commerce, which has been established by law, most BMOs simply declare their existence with the Ministry of Interior.

PSF. They are: (1) Law, Tax & Governance, (2) Agro Business & Agro Processing, (3) Energy & Infrastructure, (4) Banking & Financial Services, (5) Tourism, (6) Manufacturing & SME's and (7) Export Processing & Trade Facilitation. The Cambodia Development Council (CDC) provided the Secretariat to the seven working groups. The International Finance Corporation (IFC) supports the Government-Private Sector Forum mechanism with the Coordinating Bureau. This position is effectively that of an honest broker and is a conduit between the private sector, government, and the donor community. The WG's are co-chaired by a government minister and a representative of the private sector (e.g. the WG on Law, Tax & Governance is co-chaired by the Minister of Economy and Finance and the President of the International Business Club and the Export Processing and Trade Facilitation WG is co-chaired by the Minister of Commerce and the President of Garment Manufacture Association Cambodia (GMAC)).

Recent Government-Private Sector Forum meetings have been postponed due to the political cycle and the anti-Thai rioting, but Working Groups have continued to meet both in the private sector and with the Government and a substantive dialogue continues to take place. Although there have been achievements, including the high level of consultation on the Law on Investment and Law on Tax, the introduction of private sector monitors within the Customs Department, and negotiations on cost reform at the Port of Sihanoukville, the private sector in general, nevertheless, feels a level of frustration given the slow pace of reform. In particular, there is dissatisfaction with the failure to meaningfully address issues of law enforcement and corruption. The challenge is to encourage the government to undertake the needed reforms and to support the public-private consultation process by addressing substantive issues that are identified obstacles to private sector development in Cambodia.

Strengthening the advocacy capacity of business will also make the Government-Private Sector Forum more relevant to the provincial business environment. The Ministry of Commerce has begun to implement a strategy to discuss WTO and its implications at the provincial level, in order to raise awareness of the need for an effective supply response.

Chapter 4: Enhancing the Role of the Private Sector in Public Services

4.1 Introduction

As Chapter 2 makes clear, access to infrastructure in Cambodia is not only relatively poor compared to its neighbors and countries of similar income levels, but also where it is available, services tend to be both extremely unreliable and expensive. The country's electrification rate is one of the lowest outside sub-Saharan Africa; reliable, widely available, and safe drinking water supplies are limited to Phnom Penh, even though 90 percent of the population lives outside the capital; rates of fixed and mobile telecom penetration are low by both regional and international standards at only around 1.91 per 100 inhabitants; and the country's road network is the least developed in the region.

It is difficult to see how Cambodia can address these backlogs in a short period of time using internal resources alone. Inadequate domestic revenue mobilization and skewed public expenditure allocations have kept Cambodia heavily dependent on foreign aid for financing the provision of basic goods and services. A 2002 study revealed that the gap between the cost of the required investments and the resources at hand is remarkable – with 65 percent of the costs of all infrastructure projects to be undertaken between 1999 through 2001 remaining with no identified source of funding.[65] More recent figures suggest that just rehabilitating and maintaining the existing road network with current resource availability reveals a shortcoming of enormous magnitude, with Government resources able to cover less than one-third of the total annual cost. External donor financing, though it will help close the gap, looks to be insufficient, at least over the medium term, to meet expenditure needs.[66]

This suggests that there is significant scope for the private sector to play a large role in bridging the gap between the enormous financing requirement and the equally large financial shortfall in available public funds for infrastructure provision. However, mobilizing private capital for the accelerated provision of infrastructure, thereby reducing dependence on government budgets, is not the only or even the most important role for the private sector in infrastructure provision. Internationally, there is a growing recognition that the private provision of infrastructure offers a number of additional "efficiency" advantages over public service delivery, including faster implementation, reduced whole life costs, better risk allocation, better incentives to perform, improved quality of service, enhanced public management, and sometimes even opportunities for the generation of revenue.

The need for efficiency in service delivery is a key driver for change, given Cambodia's lack of tax revenue, its substantial reconstruction and maintenance needs, and the poor record of public provision of services. This challenge is not unique to Cambodia. While many governments have attempted to improve the performance of public sector monopolies through corporatization and, in some cases, through the introduction of more formal arrangements such as performance contracts, these

[65] The World Bank and the Public-Private Infrastructure Advisory Facility (2002), *A Country Framework Report: Private Solutions for Infrastructure in Cambodia.*

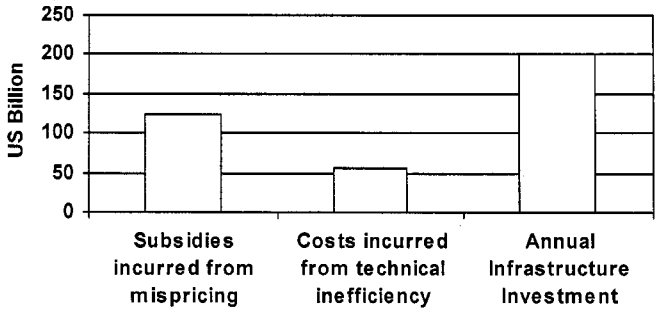
[66] The World Bank and Asian Development Bank (2003), *Cambodia - Enhancing Service Delivery through Improved Resource Allocation and Institutional Reform: Integrated Fiduciary Assessment and Public Expenditure Review.*

interventions have largely been unsuccessful.[67] In fact, studies of global experience comparing public to private provision of infrastructure services have revealed that, by the early 1990s, the annual losses from inefficiencies and unsustainable pricing policies associated with public provision of infrastructure were estimated to be nearly equal to annual investment (see figure below).[68]

Increased private participation in infrastructure (PPI) in Cambodia, under an appropriate institutional and regulatory framework, is likely to provide opportunities for augmenting budget resources and for improving efficiency. The benefits of the latter can be substantial, particularly when accompanied by pro-competitive reforms (or even monopolistic activities operating under an appropriate regulatory framework). The most thorough studies of the impacts of privatization have shown that well-designed schemes can bring about substantial increases in overall welfare. For example, private participation in water and sanitation lead to overall domestic welfare benefits of $1.4 billion in Buenos Aires and $23 million in Guinea.[69] Six cases of private participation studied in detail in the telecom, power, and ports sectors also showed substantial welfare gains to the government, consumers, investors, and, often, workers. These studies have found that the main sources of benefits were increased investment to bring service to new consumers, lower prices, and improved productivity and efficiency.[70]

FIGURE 4.1

Global Public infrastructure Provision In early 1990s



Source: The World Bank, *World Development Report. Infrastructure for Development.* 1994.

4.2 Relevance of PPI to Cambodia's PSD Strategy

Governments have long recognized that infrastructure has a vital role to play in supporting a country's growth and development as well as in directly addressing poverty. Improving access to efficient and affordable water, electricity, transport, and telecommunication services can have major impacts on the living standards of individual households. Efficient infrastructure is also essential to sustain broader economic growth and industrial competitiveness.

[67] The World Bank (1995), *Bureaucrats in Business: The Economics and Politics of Government Ownership,* World Bank Policy Research Report.
[68] The World Bank (1994), *World Development Report. Infrastructure for Development.*
[69] Shirley (ed.) (2002), *Thirsting for Efficiency: the Economics and Politics of Urban Water System Reform.*
[70] Newbery and Pollitt (1997), "The Restructuring and Privatization of the U.K. Electricity Supply – Was It Worth It?," World Bank Viewpoint Note No. 124; Galal, Jones, Tandon, and Vogelsang (1994), *Welfare Consequences of Selling Public Enterprises.*

Given this widely held view, and the description of Cambodia's infrastructure "endowment" in Chapter 2 and above, it is somewhat surprising that infrastructure does not appear to rank highly among the key constraints identified by the 2003 investment climate survey sample. It would be misleading to derive from this that a lack of access to reliable, efficient, and low-cost infrastructure and public services is simply not constraining in the Cambodian context. On the contrary, poor-quality, unreliable, and expensive infrastructure is a serious impediment to economic growth in Cambodia, and there are a number of likely explanations for the supposedly low ranking of infrastructure among the key constraints. These include the following:

- **Attribution.** First, the infrastructure constraint may be associated with (and therefore "hidden" by) other constraints. For example, port inefficiencies may be attributed to corruption and customs delays, rather than to inefficient terminal operations. Corruption may also be perceived to be at the root of other infrastructure failures. For example, the survey finds that 100 percent of respondents indicated that an unofficial payment is required for a mainline telephone and electrical connection. Similarly, the non-transparent and uncompetitive award of long term concession contracts may be described as "corruption" or "anti-competitive or informal practices" (from the perspective of utility firms), even though the consequences (high tariffs, inefficient services, etc.) are clearly "infrastructure" constraints.

- **Self-Selection.** Second, the sample of existing firms is self-selecting, in the sense that businesses that are intensive users of infrastructure services may simply be unprofitable in Cambodia, and so do not form a significant part of the population. For example, the absence of a substantial agro-processing industry may be attributed in part to inadequate roads, limited storage and warehousing facilities, and a very inefficient port. Similarly, manufacturing diversification and expansion may be inhibited by expensive power and unreliable water supply resources. It is worthwhile to note that the value chain analysis for six distinct commodities – rice, garments, cotton/textiles, motorcycles, tobacco, and canned milk – found high electricity and transport costs to be consistent impediments to competitiveness.[71]

- **Relative Improvement.** Third, major investments in infrastructure may make conditions appear much better by comparison than at any time in recent memory. For example, the availability of mobile phones has substantially reduced the constraint imposed by the fixed line system. Cambodia is the only country in the world with mobile penetration rates more than double that of fixed line penetration. However, this perception may be short term, in the sense that there are real limits to the extent to which mobile services can substitute for basic telephony. Similarly, visible improvements to the airport terminals at Phnom Penh and Siem Reap do not necessarily mean that the government, airline companies, or passengers are getting good value for money from the concession arrangement.

- **Substitution.** A final reason infrastructure may not appear to be more constraining lies in the extensive investments firms make to substitute for weak public systems. As noted above, 39 percent of all firms (and 63 percent of large firms) own their own generator, and 44 percent of all firms have their own well. Weak public systems appear to be particularly constraining for the garment sector, in which 67 percent of firms auto-generate, and the agro-processing sector, in which 91 percent of firms have their own water supply. While this substitution of public for private utility systems may assure a reliable supply, these expensive investments constrain financing available for expansion and upgrading.

[71] The World Bank (2003c), *Towards A Private Sector -Led Growth Strategy for Cambodia - Volume 1: Value Chain Analysis.*

It is thus reasonable to conclude that infrastructure service delivery is a critical feature of the investment climate. Encouragingly, there appears to be strong recognition of the benefits of private provision of infrastructure in Cambodia, which unlike other countries at similar levels of development, has significant experience with PPI, across all sectors – in urban electricity generation and rural electricity generation and distribution; provision of rural water supplies; international, mobile, fixed line, and internet telecommunication services; highways and airports; and municipal waste collection and disposal services. Figure 4.1 summarizes the main PPI contracts to date in Cambodia, grouping them by sector; indicating the public entities (ministries, departments, and regulatory agencies) that are officially responsible for administration and approvals for each sector and those that were actually involved with each PPI contract; describing the form of PPI contract deployed in each case; and where known, the capital value of the project.

On the face of it, this is good news for Cambodia. There appears to be strong and widespread political will to entertain PPI. The value of this should not be underestimated, as this is often a serious impediment to sustained PPI in developing countries. Moreover, there appears too to be a good understanding of the constraints, risks and opportunities from PPI contracts among some senior government officials.

Infrastructure service delivery through PPI is also an important source of growth for providers. A number of international firms have already made substantial investments in Cambodian infrastructure, notably in electricity generation, telecommunication services, road transport, and airports. Moreover, the local private sector is entrepreneurial and innovating, and seemingly willing to take risks, for example, by contributing their own equity into PPI projects. Local participation is spread across almost all sectors, suggesting that there is a local market to respond at least to some of the PPI opportunities. In the power sector, for example, there is local ownership in one of the independent power producers (Jupiter Power – minority Cambodian shareholding), and among the small-scale power producers that provide about 60 MW of capacity, largely financed from their own funds. In the water sector, all the small-scale service providers in provincial and district towns and rural areas (16 in total) are locally owned and primarily internally financed. In telecom, one of the four mobile companies is partly owned by the Royal Group, a large Cambodian company. Lastly, in the transport sector, a Cambodian company, Meng Steang, is in a joint venture with a Malaysian company to manage and operate two toll roads around Phnom Penh, while a second company, AZ Group, has the concession rights for tolling along National Road 4, the 220-km divided highway connecting Sihanoukville and Phnom Penh.

Cambodia also has a small but developing expertise in local private PPI advisory services, and a number of local companies (particularly legal firms) have acted on behalf of private service providers in negotiating PPI contracts with the RGC. Moreover, Cambodia has a tradition of public-private dialogue. These characteristics suggest that Cambodia has some of the ingredients necessary for a successful PPI program.

The practice of PPI, however, does not reflect many of these apparent advantages, and in the absence of an appropriate legal, institutional, and regulatory framework, many of the benefits frequently associated with PPI have not been secured. Each and every contract listed in Table 4.1 has been directly negotiated with the private contractor, without competitive bidding, in line with the procurement method under Sub-decree 60, governing public procurement. In the power sector, for example, independent power producers have all negotiated power purchase agreements directly, and this has meant that projects were not necessarily commissioned on a least-cost basis nor met technical criteria that would limit the likelihood of delivery failure.

Table 4.1. PPI Experience in Cambodia

Sector **Project**	**Public Entities**	**Form of PPI contract /**	**Value** **US$**
Municipal Services			
Waste management	APSARA Authority	**Concession** for Angkor Wat garbage collection with a private sector firm	N/A
	PP Municipality	**Concession** for Phnom Penh garbage collection with a Cintri Company	n/a
Water	Various agencies		
Rural	MIME, MRD, MOWRAM, MPWT	Ten rural systems privately **negotiated** MIME Six rural systems directly **negotiated** with MRD-MIME-PGs	< 250k < 100k
Transport	MPWT, PGs		
Roads	MPWT	National Route 4 **negotiated** with CoM	n/a
	Provinces	Rural **concessions** negotiated with provincial governors	n/a
Ports	MPWT	Oil terminal and dry ports negotiated with CoM	n/a
Airports	CoM, SSCA	**Concession** with Vinci subsidiary SCA for development of Pochentong Airport, Phnom Penh (PNH) negotiated with CoM	30m
	CoM, SSCA, MPWT	**Concession** with Vinci subsidiary SCA extended to include Siem Reap International Airport, based on international exclusivity clause in PNH concession	n/a
	SSCA	Air navigation services negotiated with CoM	23m
Electricity	MIME, CoM, EDC, EAC		
Urban	MIME	**Power Purchase Agreements** for IPPs negotiated with MIME in cooperation with CoM in the presence of EdC as offtaker	n/a
Rural	MIME, EDC EAC (regulator)	Battambang and Siem Riep negotiated with MIME-EdC **Licensing** of (existing) small rural electricity providers >50kW	n/a 12m
Telecoms	MPTC		
Inter-national gateway	MPTC	**Joint venture** agreement with RTI	n/a
2nd fixed line network	MPTC	**Joint venture** agreement with Indosat for Camintel	n/a
Mobile Services	MPTC	**Joint venture** agreements with 4 operators: Mobitel, Samart, Camtel, Shiniwatra negotiated with MPTC/CoM	n/a
VOIP	CoM, MPTC	**One Licence** for Voice-Over-Internet Protocol (VOIP) granted to BCC, negotiated with CoM	n/a
Internet	MPTC	**Licences** to Internet Service Providers	n/a

Cambodia has similarly failed to reap all the benefits of competition and private involvement in service provision in the telecommunications sector. The key reason for this is that each private license that has been awarded or cooperation agreement entered into has been in the form of a joint-venture between the operator and the Ministry of Post and Telecommunications (MPTC) itself. The Ministry thus shares in the ownership of all mobile services, the fixed line network, and the international gateways. It also sets telecommunications policy and acts as the regulatory agency. The sector is characterized by a lack of transparency in the process for awarding licenses, forced large-scale revenue sharing between private operators and the MPTC, and very little price competition between service providers. In the transport sector too, it is difficult to determine whether the RGC and/or users are getting value for money from the airports, toll roads, and air traffic control concessions, since all the contracts were directly negotiated and the details regarding performance obligations and risk allocation are not publicly available.

4.3 The Overall Regulatory Environment for PPI – Enabling or Constraining?

It is clear, therefore, that Cambodia's PSD strategy must consider infrastructure service delivery both as a feature of the investment climate, and as an important source of growth for providers. To support this effort, the World Bank is overseeing a project on behalf of the Royal Government of Cambodia's Ministry of Commerce, funded by the Public-Private Infrastructure Advisory Facility (PPIAF)[72], to strengthen the regulatory, procedural and institutional framework for managing PPI transactions in Cambodia (in short, PPI Governance). The study will deliver a set of practical tools (draft law, policies, and supporting regulations and guidelines) that together assist in strengthening PPI governance in Cambodia, thereby increasing the country's attractiveness to private infrastructure investors, both international and local. Enhancing the role of the private sector in infrastructure and public service delivery represents Cambodia's best option for addressing the substantial infrastructure backlogs and will play an important role in facilitating private sector growth and development.

The PPI Governance Study was initiated with a "regulatory and institutional gap analysis", which entailed a review of policy, legislation, and other relevant documentation; a review of best practice and experience elsewhere; as well as a series of in-depth meetings with senior government officials, private sector providers, and other key stakeholders.

In comparison to practice and experience in other countries, the gap analysis identified several major issues in relation to the regulatory environment for PPI in Cambodia. First, there is a general lack of transparency in the handling of dealings between the public and private sectors, specifically in the negotiation and management of specific contracts between government and investors, from the initiation of a potential project through to implementation. Few if any concession agreements or negotiated contracts have been made available for review, publication, audit, or public scrutiny. Second, there are significant gaps in the legal framework in a number of sectors, with over-arching sector laws still in draft for telecommunications, water supply, and transport (inland and water as well as civil aviation). Even where there are no gaps in the legal framework, there is persistent bypassing of laws and administrative process and rules. Third, scant respect is paid to examining and documenting contingent and ongoing liabilities taken on by the public sector via contracts negotiated by government with private sector parties for infrastructure projects. Fourth, planning processes across sectors are generally inadequate, and as a result private firms frequently present unsolicited offers independent of sector plans or in conflict with previously negotiated concessions. Fifth, there appears to be little auditing of concessions prior to or after implementation. The 2004 work plan of the Auditor General has already been set and audits for concession agreements are not in the plan.

[72] The PPIAF is a multi-donor technical assistance facility aimed at helping developing countries improve the quality of their infrastructure through private sector involvement.

Finally, and equally importantly, there is considerable institutional muddle, including cases where the allocation of roles and responsibilities between institutions is unclear. In several sectors there are multiple agencies providing oversight, licenses, and permissions to operate, but there is no or limited coordination between them. Government agencies tend to compete with each other to enter into concession negotiations with private sector investors. In some instances officially designated roles and responsibilities have been over-ridden by more senior individuals, departments, and ministries in government. On the other hand, different investors have taken different points of entry and different negotiation and approval paths (e.g. individual line ministries, the CDC, and the CoM) for similar projects that should be handled identically.

The consequences of these problems include:

- **non-bankable projects**, with investors to date completely unable to secure limited recourse or non-recourse project financing for infrastructure projects in Cambodia – all investments have been fully equity financed, which drives up required returns and hence the prices to consumers;
- **higher than necessary prices** to consumers in the Cambodian economy due to the costs of administrative inefficiency to investors and the extraction of bribes by individuals and government agencies involved in approval, permitting, licensing, and concession processes;
- **unavailability of information** on the value-for-money received by the public from infrastructure projects due to the inability of the public or third parties such as international development banks and agencies to assess the full value set of risk and the distribution of revenues and profits in concessions.
- **limited protection of the public interest** – the lack of transparent, predictable, and enforceable laws and administrative procedures contributes to an environment where decisions can be made in an arbitrary or improper manner without due regard to the economy, efficiency, the long term sustainability of the project, or the interests of consumers and the wider public.

4.3.1 Weaknesses in the Legal Framework

There are substantial gaps in the wider legal framework for PPI. Cambodia's legal framework is still in the course of development with many new laws being drafted, examined, and adopted. Over 50 laws are due to be adopted within the next 4 to 5 years as a requirement to Cambodia joining the WTO. Many areas are not yet covered by any laws or regulations. The backlog of laws to be implemented and the slow speed with which new laws are adopted also has implications for the extent to which the framework for managing PPI can be reformed by changes to laws or regulations.

Gaps in the wider legal framework in Cambodia adversely affect the bank ability of infrastructure projects with private participation. Gaps include the lack of a security law (and, more specifically, laws clarifying the ability of lenders to take security over infrastructure assets, income streams, and contractual rights), bankruptcy laws, commercial contract laws, a business law, and the absence of developed anti-competition laws.

Even where laws have been enacted, those laws and regulations are not fully applied or are difficult to implement. This reflects a lack of clear enforcement mechanisms in the applicable laws and shortcomings in the legal mechanisms for enforcing laws generally, notably because the court system is unreliable. As Chapter 2 reveals, the courts are not only regarded by private firms as the least honest public body, but this perception appears to have worsened over time (when comparing the 2003 ratings to a parallel question in the 1999/2000 enterprise survey, a higher percentage of firms rate the judiciary as corrupt).

The deficiencies in the wider legal framework are reinforced by problems in legislation that

have specific relevance to various stages of a typical PPI project cycle. These include the following:

- ***Policy-making, planning and project identification.*** Current laws and regulations do not provide for any effective, coordinated process for agreeing policy on development of PPI, nor for setting priorities across projects or sectors. The general legal framework provides for planning processes to be dealt with on a sectoral basis. However, it does not contain clear requirements to carry out such planning, so that even within sectors there is, in practice, little or no planning and pre-approved plans are often changed when unsolicited proposals are received. In addition, no detailed policy planning is provided for in sectoral laws and regulations and such planning (if done) is performed under the general duties provided in the laws or regulations establishing each ministry or government entity. The draft Sub-decree on Power Projects has sought to address this problem, for example, by detailing the policy planning process and forbidding unsolicited proposals.

- ***The approval process prior to award.*** Once individual projects have been identified, the 1993 Financial Budgetary Law requires all PPI contracts, regardless of the sector, to be approved by the Ministry of Economy and Finance (MEF) prior to signing. However, this legal requirement is generally not followed and it is not clear that MEF has the capacity to carry out this function.[73] The laws and regulations leave it unclear whether certain minimum risks, such as legal and regulatory risk, will (or may) be borne by the Government (as will usually be required by private investors), reflecting the lack of understanding within the RGC of the importance of the allocation of risks in PPI projects. The legal framework also fails to provide clear guidelines, conditions, and procedures for the approval of governmental support to a project, particularly financial or performance guarantees. While the law requires guarantees to be approved by the National Assembly (either in an annual Financial Law or by a separate law), the procedure for taking a guarantee to National Assembly for approval and the criteria for approval are not set out in law.

- ***Negotiation and award of projects.*** A number of cross-sectoral laws reflect the principle that contracts with the private sector should generally be awarded by competitive tender. However, these laws either have limited application to PPIs or are simply not followed. To date, most PPI contracts in Cambodia have been awarded without a formal bidding process. The sectoral laws also do not set out clear procedures for awarding and negotiating PPI projects. Furthermore, these sectoral laws or regulations do not address the applicability of cross-sectoral laws and regulations (such as Sub-decree No.11 concerning BOT projects) to PPI projects in each sector, particularly where conflict exists between these. The developing legal frameworks for most sectors (electricity sector excluded) also do not appear to address this issue. Finally, the existing laws do not clearly identify which governmental entity has the power to enter into negotiations and take decisions on all types of infrastructure projects, notably with confusion existing between the powers of the Council for the Development of Cambodia (CDC), line ministries, the MEF, and the Council of Ministers (CoM), and between these of the central government, the provinces, and the communes.[74]
- ***Project implementation.*** Once agreement has been reached with the Government on award of a project, private investors must begin the burdensome task of requesting all necessary approvals, permits, consents, licenses, and authorizations from multiple governmental entities, including the Ministries of Environment, Social Affairs, Labor, Vocation and Youth Rehabilitation, and the Tax

[73] It should be noted, however, that there appears to be at least one recent instance in which the Minister of Finance used the provisions of the 1993 Law to refuse to sign an implementation agreement for a power generation, transmission, and distribution contract, until such time as his Ministry has had the time to review the draft contract in more detail.

[74] The Law on Investment (LOI, 1994) established the Council for the Development of Cambodia (CDC) as the 'one-stop' service organization for investors and supposedly the sole responsible organization for evaluating and making decisions on all investment projects, both rehabilitation and new. However, numerous contracts, including the National Route 4 Highway; the oil terminal and dry ports; and the airport concession were each negotiated directly with the CoM. Similarly, power purchase agreements with independent power producers in Phnom Penh and electricity projects in Battambang and Siem Riep were each negotiated with the Ministry of Mines and Energy (MIME) and the CoM in the presence of Electricté de Cambodge (EdC).

Department. Although the Law on Investment of 1994 sets out a process for identifying the required consents and streamlining the approval process, these procedures in practice are not followed. This largely reflects gaps in the scope of the law and the absence of suitable enforcement mechanisms. Given the lack of institutional capacity, the scope for legal solutions to these problems may be limited.

- ***Management of PPI contracts.*** The legal framework does not make provision for post award management of PPI contracts. In particular, the law does not clearly identify the public authority responsible for monitoring construction and operation of the project, or for enforcing the terms of the PPI contract. Issues such as principles for managing changes in tariffs project costs, auditing government spending under the contract and for extending the PPI contract on completion of its term are not dealt with in relevant laws or regulations. In practice, there is little evidence of effective project monitoring or management.

- ***Regulation of infrastructure projects.*** In many sectors, the law is unclear as to which entity has the power to regulate projects of the kind contemplated by the particular PPI contract. In most sectors, the laws establishing the line ministries provide generally that regulation of the sector is the responsibility of that ministry. There is, therefore, no separation between the authority approving and awarding the contract on the one hand and the entity responsible for regulating the project on the other, creating potential conflicts of interest and confusion where a project falls within the scope of more than one 'sector' (under different line ministers). A further problem is the lack of clear distinction between the government party to a concession or other type of PPI contract and the body that would regulate or resolves disputes arising under the contract on the other hand. In certain sectors (namely power and aviation), separate regulators have been established, though in the case of civil aviation the regulator is not independent. The procedures for making regulatory decisions are not set out in law or regulation, and there is no requirement to make decisions available to affected persons or for those decisions to be challenged.

4.3.2 Institutional Weaknesses

In Cambodia, the unstructured and informal nature of the PPI project process makes the construction of an institutional 'road map' especially difficult, and largely irrelevant. It would appear from the gap analysis that none of the successful concession agreements began with a line ministry and followed a clearly documented prescribed path to approval that involved the assigned line ministry, except as an implementing agency. It is therefore not possible to describe a general approval path followed in practice by many or most PPI transactions.

Several cross-sectoral institutions have key if not clear roles in the PPI process. These include the following:

The Council for the Development of Cambodia was established as a 'one-stop shop' service organization for all investment in the country. After receiving a registration certificate from CDC, investors should be eligible for investment guarantees, tax incentives, and import duty incentives. CDC should also provide a conciliation service for disputes. The CDC automatically refers large projects with a value of over US$50 million to the Council of Ministers, but even smaller projects have bypassed the CDC.[75] The amendment to the LOI (2002) makes the granting of a registration

[75] While the CDC has devised an 'official' process for an investor to bring a project to the RGC through its various internal departments and ultimately to the CoM, more common routes entail projects being brought either directly to the Council of Ministers or indirectly to the Council of Ministers through a 'relationship broker'.

certificate automatic, subject to investors meeting set criteria rather than the discretionary basis in the past.[76] The amendment also makes the CDC responsible for obtaining on behalf of the applicant all of the licenses required from the relevant ministries/entities, and requires that the latter issue the documents within 28 days.

- **The Ministry of Economy and Finance** has, in theory, a fairly comprehensive role in the oversight and approval of key aspects of the leasing or concession process. According to Order N° 30BB on Management of State Property, MEF has a central role in the management, sale, and letting of state property that is under the management of ministries, provinces, municipalities, state, and public enterprises (called Trustee Authorities). As mentioned above, the 1993 Financial Budgetary Law requires all PPI contracts to be approved by the MEF prior to signing. In addition, while the MEF has a dedicated department to play this latter role, it lacks the capacity to do so effectively, or it is simply bypassed.

- **The Office of Public Procurement,** established under the MEF, should theoretically review all public-private partnerships. However, it can be and is frequently bypassed if the proposed project does not require budget transfers or can be justified as an emergency.

- **The Audit Authority**, established in terms of the Law of Audit 2000, is empowered to undertake audits on all state and government institutions, using its powers to gather information, enter premises, inspect records, and impose penalties on individuals. To date, the Authority has not undertaken an audit of any of the existing concession contracts, and has not planned to do so in financial year 2004.

Sectoral institutions similarly lack capacity and clear institutional roles and responsibilities, although this is uneven across the sectors. The institutional framework is quite advanced in the electricity sector, for example, both in the existence and roles of organizations and in the ongoing proposals in the recently developed draft policy. Roles have been substantially clarified, with MIME as policy-maker, the newly formed Electricity Authority of Cambodia (EAC) performing the regulatory function, and the main utility EdC being the off taker for power purchase agreements and the major transmission and distribution player serving Phnom Penh and a number of other urban areas in Cambodia.

The institutional framework is less advanced in the other sectors. The Ministry of Post and Telecommunications (MPTC) is both the line ministry with policy responsibility and in effect the sector regulator, responsible for issuing licenses for telecommunications operators. There is a draft law which may establish the Telecom Authority as independent regulator. An independent water regulator is proposed in the draft Water Supply Law. Overall, the institutional framework for transport is unclear and weak, with no clear legal framework and a tendency for sector projects to bypass the line ministry, the Ministry of Public Works and Transport.

[76] The amendment has also reduced the size and scope of some of the incentives.

Box 4.1. Permits, licenses, and consents required for a typical power project

Establishment

- Investment license and Investment Incentives (CDC)
- Registration of the Company (Ministry of Commerce)

Tax

- Master list import exemption (CDC/MEF)

Licenses

- Consolidated License according to the Electricity Law
- RGC to provide a Policy Directive to EAC for the grant of the appropriate distribution and retailing licenses to the Company in relevant Provincial Towns
- RGC to provide the principles and conditions for the grant of the appropriate Special Purpose Transmission Licenses to the Company

Construction

- Construction permit for facility (Ministry of Land Management, Urban Planning, and Construction)
- Construction permit for smaller works (Ministry of Land Management, Urban Planning, and Construction)
- Permit for water intakes (Ministry of Water Resources and Meteorology)
- Permit to build pontoon structure on river where applicable (Ministry of Water Resources and Meteorology)
- Street excavation and use license for water/fuel piping and electrical (Ministry of Water Resources and Meteorology, Ministry of Culture and Fine Arts, Cambodian National Petroleum Authority, Ministry of Transport and Public Works)
- Waste water and storm water discharge permit (Ministry of Water Resources and Meteorology)
- Right to extract water for use at the facility

Transportation

- Permit for off loading of fuel at Port (Ministry of Transport and Public Works)

Environment

- Agreement with Ministry of Environment (MOE'') to regulate the Company's compliance with environmental regulations in a form and substance satisfactory to the Company
- Site assessment approval (MOE)
- Environmental Impact Assessment Report approval (MOE)
- Exportation of hazardous waste (MOE, Ministry of Commerce and Importing Country Permit)
- Transportation of hazardous waste (MOE)
- Discharge or transportation of wastewater (MOE Permit)
- Investment of the treatment or incineration of hazardous waste (MOE)

Immovable Property

- Registration of title transfer (if applicable)
- Registration of easement (Ministry of Land Management, Urban Planning, and Construction)
- Registration of lease (Ministry of Land Management, Urban Planning, and Construction)
- Registration of security interest in land (Ministry of Land Management, Urban Planning, and Construction)
- Registration of security interest in i) improvements and ii) easement (Ministry of Land Management, Urban Planning, and Construction)

4.4 Improving the PPI Framework – Key Drivers for Change

WTO Accession. Cambodia has recently obtained agreement for WTO accession. In joining the WTO Cambodia will be required to adopt and implement a range of legislation and practices, which will promote better governance. Key among these will be government procurement practices that promote competition, accountability, and transparency. The pressure to adopt a multitude of reforms is likely to impact the institutional and regulatory environment for PPI in Cambodia directly, and there is already evidence of this in the telecommunication sector, which is in the process of drafting a new Telecommunications Act. The Act will separate policy-making powers from regulatory and operational ones, which will have a profound effect on the current structure of the sector, in which the Ministry has a role in all three functions. Similar reforms are anticipated for the water sector.

The Changed PPI Environment. Globally, the PPI environment has changed dramatically in the past few years. The optimism of the mid-1990s has now been replaced by widespread pessimism. Annual investment flows to private infrastructure projects in developing countries, which peaked at nearly $130 billion in 1997, are down (and by 2001 were only 44 percent of the levels seen at their peak). Projects have been renegotiated and some have been re-nationalized or cancelled. Investor interest in private infrastructure projects in developing countries is also subdued, and the appetite for risk severely diminished. Many of the traditional players are even trying to disinvest from countries in which the political and regulatory risks are considered to be extremely high.

The Royal Government of Cambodia will need to respond to this changed environment in a number of important ways, such as by:

- Making immediate and fundamental changes to the current regulatory and institutional environment for PPI – focusing on transparency, predictability, competition, and accountability – to mitigate political and regulatory risk;
- Reinforcing government performance risk by using political risk guarantee instruments to protect foreign investors and lenders not only against war, currency transfer, and expropriation, but also against government breach of contract risks;
- Using transition subsidies to full cost recovering tariffs and connection subsidies to connect some of the poorest households, employing private partners to ensure effective delivery of subsidies; and
- Recognizing that at least some of the investment to achieve build-out targets may need to be kick-started by public finance.

This new reality has implications for both the RGC and for the international donor community. For the Government of Cambodia, it means that failure to introduce early and meaningful reforms will severely restrict the number of private operators and investors willing to participate in the PPI market in the country, and may induce existing concessionaires to seek to renegotiate their contracts.

For the donor community, it provides considerably more leverage to attach funding conditions for improved PPI governance to the projects with which they are associated, thereby increasing transparency in project award. There is already evidence that the donor community has begun to "flex its muscles" in this regard. In two recently signed infrastructure loans provided by the World Bank, for example, one for road transport and a second for rural electrification, the World Bank has incorporated conditions that require the Cambodian Government to publicly disclose (on appropriate government websites) relevant project information, including the name of the awarded party; the value of the contract; its location; duration; financing arrangements, and other non-proprietary commercial information. In a separate project, the Korean Government has publicly announced its intention to retract a commitment to fund a road transport project, based on its assessment that the procurement and selection process was fraudulent.

Box 4.2 The Importance of Transparency

Citizens, service providers, and governments would all gain from increased accountability and transparency. With easy access to published concession contracts, citizens would be better able to determine which party has responsibilities for a particular aspect of the project, such as maintaining service quality, improving infrastructure, collecting fees, connecting and disconnecting service, and a variety of other daily operations. This would enhance the accountability of both service providers and governments to respond to citizens' issues and concerns. In many cases of troubled projects, governments and concessionaires simply exchange accusations without allowing citizens to directly establish liability.

Transparency reduces the chances for, and perception of, of corruption. In Cambodia, many projects that were negotiated through closed, non-transparent concessions are the subject of frequent allegations of corruption, and are also often the subject of calls for renegotiation of tariffs paid by users. A norm of publication could reduce the suspicions that sometimes surround the awarding of contracts. This would be very valuable when projects are unsolicited and/or contracts are directly negotiated. With this in mind, the Mexican Government recently passed a Transparency and Access to Public Government Information Law making government contracts available to requesting citizens within 20 days. The new Mexican law also dictates that federal agencies must place contracts on government websites by mid-2003. Although transparency laws like Mexico's will not prevent all corruption, both government officials and companies would be less likely to engage in unethical behavior during the awarding phase if they know that their contracts will eventually be made publicly available.

Transparency helps markets work better. Publication of contracts could facilitate the evolution of standards in infrastructure transactions. Governments could obviously benefit from access to privatization agreements from other municipalities, agencies, and countries. Widespread availability of contracts would also make it easier for consumers to benchmark tariffs and other service obligations with similar systems in other jurisdictions. Overtime, contracts for services in similar environments would become more in line with one another, thus lowering the number of "sweetheart" deals. Published contractual information could facilitate easier and quicker market access to new entrants as well. If previous agreements are widely available as benchmarks, prior to bidding a potential concessionaire would have a much better idea of what terms to expect from a particular government.

Transparency is consistent with WTO. In Cambodia's WTO Working Party Report Para 217, the Council of Ministers has committed to establish or designate an Official Journal dedicated to the publication of regulations affecting trade. Furthermore, moving forward on an agenda of transparent, competitive PPI indicates that Cambodia is on the way to implementing one of the so-called "Singapore Issues" on public procurement.

Is contractual information confidential? Private providers will often dispute that certain information in a contract is property of the company and should not be publicly disclosed. For example, private operators may argue that concession agreements contain confidential information about technologies used, cost of capital, national security, or parent company finances. This type of information, however, rarely is central to the consumers and does not necessarily need to be in the concession contract. A key would be to accurately separate true confidential information from publicly acceptable information. The US Freedom of Information Act does allow for certain information to remain confidential, especially if it is relevant to national security. Governments may fear that companies will not participate in bidding processes if contracts are made public. If the terms that companies are willing to accept are so bad that they must be hidden from citizens, however, then the concession arrangement was probably not best for the community in the first place. In the long-term, governments may even adapt policies of circulating concession agreements for public comments before signing, which is often the case for laws

4.5 Conclusion

In summary, the opportunities for realizing significant efficiency gains from current and future PPI transactions in Cambodia are severely constrained, for a number of reasons. These include the fact that the vast majority of deals are done at very high levels of government, circumvent the institutional and

regulatory framework, undermine the ability of line ministries to develop credible policy, and weaken the accountability of ministries. Finally, because the terms of these contracts are not released to either Parliament or the public, there is no way for citizens to know if terms are providing good value for their money nor a means for them to pressure for terms which are more favorable. In other words, these practices violate three basic principles: competition, accountability, and transparency. Since the service providers are granted long-term rights to manage monopoly assets, the only opportunity for obtaining the benefits of competition comes during the initial transactions. The lack of regulatory institutions that could bring a proxy for competition benefits to bear on tariffs and performance obligations also highlight the need for competition at the point of transaction.

The PPI Governance Study is nearing completion and draft proposals have already been submitted to key Cambodian government officials and political leaders for consideration. Final proposals, to be reflected in a limited number of key instruments (policies, legislation, and supporting regulations and guidelines), will be delivered by August 2004. The outlines of a reform program for PPI are discussed briefly in Chapter 5 below.

CHAPTER 5: A PROGRAM OF REFORM

Strategic objective. The objective, as defined in the NPRP and through the public pronouncements of the Government, is to enable broad-based private sector growth as a sustainable means of poverty reduction. Given the limited public sector resources to develop, implement, finance, and monitor policies, question of strategy is about making best use of limited resources in a way that has the greatest impact on the strategic objective. The core of the strategy is about removing administrative obstacles, strengthening essential trade-enabling institutions, and improving the enabling environment for the private sector's contribution to service delivery. The analysis informs a set of principles that may help Government, Donors, and the private sector in prioritizing actions and reforms.

Guiding principles

Ease the burden on business: a shift from a culture of control to a culture of facilitation. Streamline institutional overlaps, particularly in trade facilitation, and reduce the large number of inspections and licensing requirements, particularly those related to ensuring quality.

Empower markets and competition. The healthy development of the private sector depends on removing policy distortions that prevent market signals from reaching the private sector and helping shape economic decisions. This includes elimination of exclusive dealing arrangements.

Do not go beyond the limited capacity of public institutions. Given capacity constraints, it is necessary to focus on non-state roles and streamline the role of the public sector. The strategy should reposition the state to provide effective governance, accountable to the public, and focus where possible on enabling private service delivery.

Focus on reforms that are empirically shown to relate to improving competitiveness and productivity. There is a range of institutions and reforms that can help the private sector, but in consideration of the survey and value chain analysis, few that impact productivity. Increasing labor productivity is the most sustainable way to increase job growth.

Use private institutions to integrate rural and informal sectors. Integration means removing policy-related impediments, both formal and informal, that raise the cost of doing business for firms that are now limited to either informal or small-scale, local trade. This will be achieved by (1) reducing policy-based impediments, particularly in such areas as trade facilitation and business inspections and (2) reducing entry barriers, such as unnecessary licenses and the high cost of registering businesses.

Focus on institutions that reduce risk and transaction costs. While specific, sectoral interventions may be needed, institutions that reduce the risk and uncertainty of trade are needed across all sectors. Where feasible, these should include sustainable alternatives to state or donor-funded measurement systems.

Focus on institutional learning, given the early stage of private sector development. Explore the role of local business organizations, scaling up pilot work with rice millers and REEs.

Introducing greater accountability in policy formulation and performance. No strategy or economic policy can have impact unless it is monitored and there are consequences for objectives and milestones that are not achieved. In Cambodia, donors currently provide a monitoring role. This is inconsistent with a program designed to achieve sustainability. The strategy should strengthen private sector monitoring of public performance (including corruption) and capability to participate in policy dialogue – both to support Government-Private Sector Forum and rural areas.

Reform Priorities

Private sector development is an evolving process, and successful reform can only emerge from continual effort to improve the investment climate. Based on the analyses conducted to date, the following eight reforms emerge as initial priorities supporting existing reforms under WTO commitments.

5.1. Streamline Trade Facilitation

As part of WTO accession, Cambodia has committed to a new Customs Law.[77] However, extending the benefits of WTO accession to the rural economy requires not just Customs Reform but comprehensive trade facilitation reform. For this reason, we have provided a detailed outline of a reform program that address several key requirements:

- The solution should comprehensively address all stakeholders rather than Customs alone;
- Decrease the import and export transaction costs to the private sector;
- Increase formal revenue flow to the RGC;
- Decrease unnecessary and redundant operational costs to the RGC to manage the trade process;
- Decrease the overall time it takes to import and export products;
- Increase the visibility and predictability of the process with respect to both time and cost; and
- Comply with international commitments – most importantly WTO, but also APEC, AFTA and GMS.

Reform Actions.

Reform must start from a cross-agency perspective– rather than in agency silos. Currently, each agency pursues mandates independently and communication across agencies is insufficient. Since the CED and CamControl have overlapping approximately the same powers and responsibilities, their activities should be better integrated or possibly merged over time.

Adopt a challenging, aggressive, and achievable trade facilitation mission statement that is supported by the senior members of the RGC in order to provide the framework and motivation for significant reform. The mission statement should (1) set the broad goals for the trade facilitation function, (2) establish Cambodia's performance objectives with respect to its competitors, (3) acknowledge the importance of trade facilitation within the larger societal/economic goals of the country, and (4) set a timeline for achievement of stated goals.

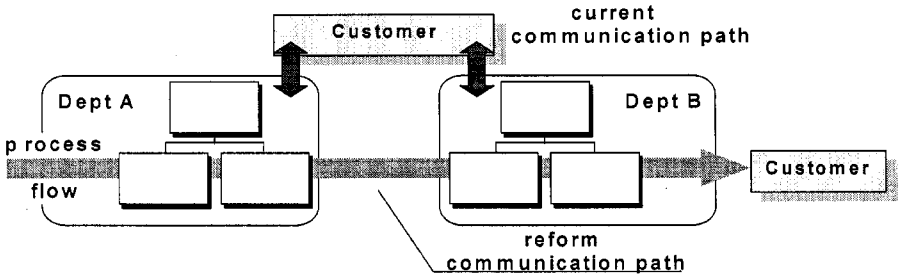
Set quantifiable performance goals – and measure progress. Agreement on a set of regularly tracked metrics is proposed, to (1) assess overall performance, (2) compare efficiency across departments and against competitors, (3) assess staff performance, (4) guide staffing and policy decisions by management, and (5) improve public relations with respect to process improvement.

[77] Working Party Report, Para 84 and 93.

- **Reengineer the Facilitation Process while Introducing a Single Administrative Document.** The current "real" trade facilitation process contains numerous steps that provide little or no value in facilitating trade and significant opportunities for rent seeking among government agents. As such, basic process streamlining is required to drive cost and unnecessary processing time out of the system by eliminating "non valued-added" steps. The reengineering is designed to support the move from independent dealing by each concerned agency with a single, rationalized process facing the customer, which is the private sector export or importer. Such a process, based on improved information sharing across agencies, could usefully start with the replacement of the current multiple documents with Single Administrative Document shared by all agencies. Initially, streamlining should focus on improving the manual processes, but at the same time it will pave the way to automation.[78] WTO entry requirements (valuation standards and the Harmonization System) should be incorporated.

- **Rationalize Roles and Responsibilities Across RGC Agencies under a Single Window with Flat Fee for Service and SLAs.** To increase efficiency and accountability, trade facilitation processes should be consolidated into a Single Window. The implementation of a Single Window is a core step to improving overall customer service, reducing opportunities for rent-seeking and addressing the needs of the legitimate private sector. The Single Window should consolidate all documentation and payment processing into a single customer interface for importers and exporters operating in Cambodia.

- **Introduce a Risk Management System to Reduce the Inspection Rate per Container**. Current discretionary inspections should be replaced by a system by which inspections are selectively inspected based on risk parameters. The development of risk parameters would take into consideration historical



performance, and the perspective of the various agencies involved in the TF process.

- **Automate the Process.** To support the successful implementation of other streamlining initiatives and to achieve the vast process efficiency improvements the technology has demonstrated, a comprehensive automation system should be deployed. An overall architecture across key agencies should be developed, followed by a phased implementation plan.

- **HR Management Reform.** Although it is unlikely that official salaries will ever match the full compensation that customs agents are currently making through official and unofficial payments, it is important to increase compensation to reasonable levels. An effective, comprehensive compensation program requires restructuring of salary scales to increase formal base compensation, restructure positions/grades to provide additional promotion opportunities and development of a system of tangible performance goals. To pilot new processes and automation within the trade facilitation process and to increase customer service, an "elite unit" within Customs should be established.

[78] The foundation for manual process streamlining has already been developed by the CED/IMF. Initial focus should be on driving the implementation of those initiatives.

- **Review support functions.** While KAMSAB has improved the overall process for coordination of shipping activities within Cambodia since its inception, the introduction of commercial shipping agents in the market eliminates the need for an official government shipping agent. While the current outsourced PSI program is not operating at an optimal level, immediate transition of PSI responsibilities to customs is not advisable in the near-term. Over time, however, placing all inspection responsibilities under an institutionally-strengthened Customs agency will reduce cost and processing time.[79] To provide the RGC with additional funds and to introduce competition within the shipping agent industry, the privatization of KAMSAB should be evaluated.

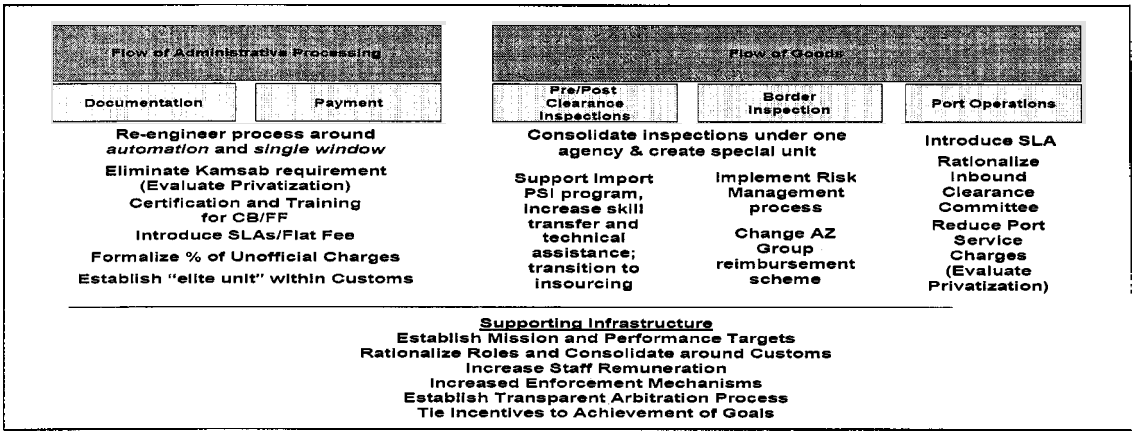
- **Increase Enforcement to Deter Government Agent Malfeasance.** To support other initiatives to reduce petty corruption among agents, an aggressive enforcement program should be adopted that attacks the problem of agent malfeasance at multiple levels. The core components of this enforcement program include the creation of an independent arbitration panel to review cases of agent malfeasance, enforcement of a "zero-tolerance" policy against petty corruption, and formalization of post-reconciliation audit to locate and punish fraud and increased penalties.

- **Introduce Stronger Anti-Smuggling Enforcement Mechanisms.** A systematic review, evaluation and refinement of current enforcement mechanisms should be conducted. The role of and capabilities of the Intelligence unit within Customs Administration must be strengthened and cooperation between enforcement agencies increased.[80]

- **Focus also on private sector ethics.** While in the short-run, more enforcement is needed, over the long term, a culture of trade facilitation by the public sector must be matched by a culture of compliance by the private sector based on ethics.

- **Establish a trusted, transparent, dispute settlement mechanism.** Cambodia has committed to establishing a dispute settlement mechanism within its WTO commitments.[81] The mechanism should be independent, autonomous, and to the extent possible, include private sector participation. It should focus on specific technical issues such as nomenclature and valuation rulings, which have as their base, publicly disseminated information.

FIGURE 5.1. SUMMARY OVERVIEW OF REFORM INITIATIVES



[79] Working Party Report, Para 93, 105.
[80] Working Party Report Para 98.
[81] Working Party Report Para 99.

5.2. Remove Impediments to Diversification

Value-Chain Focus on Removing Impediments. The value chain analysis indicates that in order to improve the competitiveness of locally produced products, particularly those targeted for the export market, a number of policy and market based reforms must be undertaken simultaneously. Isolated action by the government or the private sector to address either policy or market reform issues is likely to have a limited impact on the overall competitiveness of the Cambodian economy, particularly as many of the critical barriers to competitiveness are cross-cutting issues that can only be tackled through a strong public-private partnership. No one Ministry has within its ambit the broad range of strategic reforms required to remove these constraints. We therefore suggest forming pilot inter-ministerial task forces around key value chains, beginning with rice and cotton as pilot products. The composition of these task forces should be determined by where the key constraints lie and who has authority to address them. The effort should be guided by market demand, and the task forces should also be informed by direct consultation with the private sector. Private sector input should be broadly coordinated by the Government-Private Sector Forum, but should incorporate the input of the relevant business association. The support of MPDF, SME Cambodia, CDRI, and other technically competent organizations should be leveraged, possibly on a competitive basis. For example, looking at the rice value chain, key agenda items would include:

- Addressing high fertilizer import costs and dilution of fertilizer through opening trade;[82]
- Strengthen access to rural financing by removing impediments to rural branch banking, improved land titling, and strengthening legal institutions for collateral and contract enforcement;
- Address low productivity in planting through agricultural extension and improved rural education;
- Improve export competitiveness of domestic mills through power sector reforms, competitive contracting of private roads, combating illegal roadblocks, and trade facilitation.

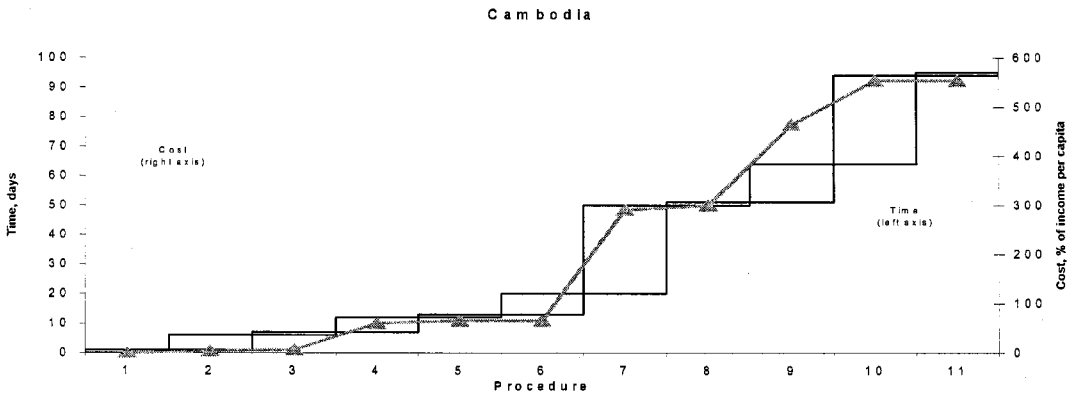
Streamline business registration. As noted in Chapters 2 and 3, competition and economic dynamism in Cambodia are constrained by barriers to entry and a variety of administrative and regulatory impediments to formal operation. This begins with business registration, a long and costly process estimated by the Doing Business evaluation to take 94 days and cost over 550 percent of GNI per capita in 2002 ($280). A further minimum capital requirement requires a deposit of over 18 times per capita GDP. Experience of other countries has shown that business registration can be substantially expedited even without any fundamental technological changes relating to the process. For example, the VAT can pre-approve registration numbers, which are then assigned by the Ministry of Commerce upon the incorporation of the firm in the commercial registry. Low-income countries often achieve registration within 30 days (e.g. Bangladesh, Ghana and India).[83]

- Reduce the cost and time required to register the incorporation with the Commercial Register, which is maintained at the Office of the Clerk of the Commercial Court, and costs an average of $630 and 30 days. Registration as a corporate entity should be an administrative procedure and information should be conveyed from the Ministry of Commerce to the Commercial Register automatically;
- Remove the requirement to send a notification of the Ministry of Labor to start hiring employees, costs $250 and 30 days to complete;
- Automatically register the company for the VAT using the same form; and
- Waive the minimum capital requirement, which can be eliminated as it does not, in practice, serve any function other than to make entry more expensive.

[82] Working Party Report Para 77 requires removal of Quantitative Restrictions (QRs) and establishment of WTO-consistent methods for registration and review.

[83] See, for example Djankov et al., "The Regulation of Entry", *Quarterly Journal of Economics*, 117, 1-37, February 2003.

FIGURE 5.2.



Number of procedures	**11 procedures**
Time (days)	**94 days**
Cost (% of income per capita)	**553.8 %**
Min. capital (% of income per capita)	**1825.8 %**

Source: The World Bank, Doing Business Database 2003

Step 1: Deposit the legally required initial capital in a bank
Step 2: Check the uniqueness of the company name
Step 3: Pick up a company registration form
Step 4: File the office registration with the Municipal Government
Step 5: Make a company seal
Step 6: Publish formation notice
Step 7: Incorporate the company with the Commercial Register
Step 8: Have registration documents stamped
Step 9: Register the company for VAT
Step 10: Notify the Ministry of Labor
Step 11: Receive Inspection from Labor Inspector

Streamlining Bureaucracy

Removal of obsolete licenses. Many licensing requirements currently serve little purpose, and are frequently ignored. For all products for which there has been no request for a new license in 24 months, the licensing requirement should be eliminated except in cases of extremely risky business lines.

Automatic Approval. All requests for Government approval of a license will be considered positive if there is no response within 30 days of an acknowledged acceptance of the request. If circumstances dictate a more lengthy review (such as a mining or natural resource investment with significant socio-economic impact), then the Government should respond within 30 days with a clear process and timetable.

Flat fee for all sector licenses. To avoid artificial incentives, fees to obtain licenses should be waived or set at a minimal level that is equal for all products and sectors.

Place the burden on the Government to share information. Multiple forms should be replaced by Single Administrative Documents that serve multiple agencies wherever possible. Agencies should be prohibited from requesting information that has already been provided to another institution during the same process.

5.3. Strengthen Rule of Law

Businesses identify the weak rule of law as critically and increasingly constraining to their operation and growth. Weak rule of law adds to business costs and heightens the risk associated with investment. Cambodia has embarked on a strategy to complete its legal framework and strengthen its judiciary. In addition, Cambodia has committed to a substantial program of law development within the context of WTO accession, including the passage of a law establishing the Commercial Court.[84] The underlying substance of the reform program is currently being reviewed by a number of donors including the World Bank Group, and a Legal and Judicial Reform Assessment is being prepared by the Bank with a donor working group, as well as the Law, Tax, and Governance working group of the Government-Private Sector Forum.

Yet it is clear that certain key elements will characterize any approach to strengthening the rule of law. One is to complete the legal framework for markets, by putting into place the basic laws that together comprise a commercial code, starting with the Law on Business Enterprises.[85] Another is to make certain that laws and regulations are widely available, not only to judges and lawyers, but also to citizens and businesses, so that they better understand their legal rights and responsibilities. A third is to improve the functioning of the courts, potentially through technical assistance, training and administrative reforms, so that impartial and legally-based judicial decisions can underpin contracting and backstop alternative dispute resolution. Since establishing the legal framework, implementation capacity, and awareness among stakeholders will take considerable time; early and sustained progress is essential to building investor confidence. Meanwhile, as complements to the formal rule of law, it is important to note that stakeholders to the legal and judicial reform program can be empowered to actively promote rule of law and "demand side" reforms. This will involve both mainstream public education and outreach to the rural and informal private sector regarding legal rights and fair mechanisms to resolve business disputes.

5.4. Leverage Private Sector Value Chains to Develop Suppliers

Encourage both FDI and supplier development programs. A key lesson from recent experience with globalization is that the value chain concept is important because it represents a way the private sector can organize itself to deliver value. An increasing share of world trade occurs through global value chains, or international production networks. In these value chains and networks, suppliers benefit from the technical and marketing expertise of large buyers who set market standards for quality, cost, delivery and even responsible labor and environmental practices. This requires attracting foreign investors and leveraging the interest of both investors and suppliers in creating productive value chains.

The key lesson from the TOPS and other value chain programs around the world is that private value chain participants, formally or informally, can address a number of institutional and incentive problems without relying heavily on public sector capacity. Private value chains are an effective complement legal and institutional reforms to support efficient markets. While legal institutions to support transparent, low-cost transactions are maturing, and while institutional support infrastructure is evolving in ways more responsive to the needs of the private sector, private value chains can play complementary role.

There are a number of donors involved in agro-industry, including ADB's Agricultural Sector Development Program, AusAID's AQIP, the Cambodian Australian Agricultural Extension Project, GTZ, French bilateral projects targeting a number of specific products, the World Bank, and FAO projects on the

[84] Working Party Report Para 35.
[85] Working Party Report Annex I. Attachment.

empowerment of women and support to the Ministry of Agriculture, Fisheries, and Forestry (MAFF).[86] To build on these, we recommend a complementary approach of developing private supply chains through:

- **Removing Impediments.** To attract investment in the critical transport, distribution food processing and market-making functions that are necessary for supply chains to function, sector-specific restrictions on investment should be eliminated, with regulatory processes focused on public goods such as environmental safety, rather than on controlling the market. Research in many countries around the world indicate that the regulations to protect traditional retail industry, for example, end up preventing the emergence of efficient supply chains by limiting investment in modern logistic and distribution. This ultimately reduces the productivity and income of farmers and other suppliers.

- **Attracting investment.** Creating an enabling environment where FDI that is supply-chain sensitive – particularly modern-format retail and agro-industrial processors – is interested in Cambodia. This means understanding sector-specific constraints of the investment climate most relevant to modern-format retail and addressing those impediments (including excessive licensing, inspections and registration). One such area is efficient trade facilitation and logistics.

- **Building capacity of suppliers.** Where FDI has located in Cambodia, the Government-Private Sector Forum can be used to encourage creative partnerships between NGOs, foreign investors, and donors working on rural development, and local educational institutions in order to expand the supplier base. The TOPS experience, a creative partnership between local and international institutions, provides an effective model. MPDF is moving in this direction, and other donors should be encouraged to do so under the guidance of willing and capable investors. Aligning donor and civil society resources to scale up vendor development technical assistance to the private sector can address the "content" side of capacity building on buyer's technical standards; it also addresses the scaling problem through a public-private partnerships; and addresses the "incentive" problem by ensuring that firms who successfully complete capacity building have a potential market.

5.5. Strategic Review of CamControl

Shift to market-driven reporting, standards assurance, and prevention. CamControl has both a mandatory and a voluntary role in support of its mission, but focuses a significant effort on mandatory inspection. While this is a legitimate public interest, the law that provides for 100 percent inspections of commercialized products is obsolete and contributes substantially to the problems with Cambodia's investment climate described in Chapter 2. In the past, Cambodia was used as a market for expired goods by unscrupulous traders. CamControl's mandate, prepared during the Socialist period, enables the firm to inspect any traded good. However, the way this mandate is carried out places a high burden on firms with limited results. CamControl can more effectively achieve its objectives by formulating and implementing an import inspection program based on risk management and by upgrading and facilitating market and consumer reporting, providing a resource for adherence to international norms and standards, and promoting awareness and knowledge both among consumers and producers of those norms. This will transform CamControl into a valuable asset both to the private sector and to consumers. The creation of consumer associations would complement the facilitation of the exercise.

WTO accession means that domestic firms will now be exposed to international competition both in Cambodia and in foreign markets. As described in Chapter 3, the lack of non-garment exports is

[86] Gummert, Martin, Consultant to MAFF PRASAC II, "Assessment of the Agro-Industrial Situation in Cambodia." February 2003, along with several interviews in which these projects were described.

related to a lack of institutions to establish trust in Cambodia's ability to produce at agreed quality and price. The voluntary adherence of firms to international standards and norms in labor, quality, product labeling, and environment can help bridge that trust gap and help open up new market avenues in industrialized countries where compliance to international standards and norms are a must. CamControl, both with laboratory assets and a number of employees who are familiar with ISO, HAACP, GMP and a number of other international standards frameworks, can help build local compliance capacity. Without this, standards will act effectively as technical barriers to trade (TBT). Adoption of international norms can also facilitate investment and establishment of joint ventures with firms that already adhere to those standards. A clear example is the introduction, by 2005, of EUROGAP standards on all agricultural imports into the EU. Compliance to such standards will demand that Cambodian farmers adhere to the use of prescribed and registered agrochemicals.

The elements of a modern quality assurance system –Metrology, Testing, Standards, and Quality assurance, are only partially in place. The Ministry of Industry is establishing an Office of Metrology with UNIDO support.[87] The Ministry of Agriculture and Forestry (MAFF) also implements a sub-decree on material standards. Other institutions are needed along side the Office of Metrology in order for standards to have an impact in the economy, including testing and calibration laboratories and training centers. In Thailand, for example, the Thai Productivity Institute, a public-private partnership, plays an important role in raising awareness and adherence to quality processes both through training and consulting. While it is important that CamControl not assume the role being played by the Office of Metrology, CamControl's laboratory assets could be put to good use as voluntary testing facilities for private companies wishing to meet international product standards. The Ministry of Commerce is, with EU support, developing National and International Trade Enquiry Points.

Sharing of Information on Product Standards and Norms: CamControl may be effectively positioned to develop a database accessible by both suppliers and buyers on international standards. Reverting back to an earlier example of problems faced by farmers with diluted fertilizers, the proposed database on international standards and norms would give farmers leverage over fraudulent wholesale and retail agents, while at the same time place suppliers in a stronger negotiating position with buyers based not only on the quantity of goods and services delivered, but also on its quality. Information on standards is crucial for improving market transparency and competitiveness, but without support for compliance training, the proposed actions may have a negative rather than a positive impact on rural farmers and SMEs.

Cross-Recognition of Quality Standards. One of the Government's more immediate tasks will be to cross-recognize quality standards from countries that invest in or trade with Cambodia, starting with ASEAN and then extending to all WTO members as agreed in the Working Party. There is no reason for Cambodia to focus its standards development process on products in which a regional ASEAN standard might be developed, or that have been certified by competent authorities in key trading partners.[88] In most cases, quality is a market judgment and the public sector's role should be focused on public safety.

Other potential roles for CamControl include potential conversion to a Food and Drug Administration or similar agency.

[87] Consistent with WTO commitments, the Ministry of Industry Mines and Energy is also drafting a law on Industrial Standards and implementing regulations. Working Party Report, Table 10, para. 131.
[88] Working Party Report, para. 127.

5.6. Strengthen Governance for Increased Private Participation in Infrastructure

The key objective underlying the PPI Governance Study is to create an enabling framework for PPI that is sufficiently flexible to allow for unique sectoral requirements in contracting. At the same time, the regulatory, procedural, and institutional framework should be sufficiently robust and inclusive to ensure that all PPI transactions – regardless of the sector, source of funding, or size of the transaction – are conducted fairly, transparently, competitively, and in the public interest. Strengthening governance for increased private participation in infrastructure and public service delivery rests on four principles that are cornerstones of a sound, enabling environment for PPI:

- improving predictability via improvements to the legal and institutional *framework;*
- assigning clear lines of responsibility within *institutions;*
- ensuring accountability of those institutions responsible for applying the procurement *processes* according to the legal *framework*; and
- improving the transparency and openness of government procurement *processes.*

Based on these principles and on the institutional and regulatory gap analysis described in Chapter 4, PPI governance reforms will need to revolve around six themes (i.e. a convenient and rational grouping of measures/interventions that reflect common elements in the identified problems, such as the stage in the project cycle, the institutions involved, or the solution instruments) that provide answers to three primary questions, namely:

- **What** approvals are required;
- **Who** contracts and monitors; and
- **How** will government capacity be developed?

The relationship between the various programs, the main focus of the program components, and the primary questions they address are presented in the summary table below.

Program	Addresses	Substance
1. Clarify responsibility for **primary approvals**	**What** approvals are required?	The decisions on project go-ahead (can terminate a project)
2. Clarify and streamline **secondary approvals**		The decisions on project details (has the potential to delay a project)
3. Establish responsibility for **granting contracts**	**Who** contracts and monitors?	Clarifies which government entity should contract with the investor
4. Establish authority for **contract management and monitoring**		Clarifies which government entities manage and monitor the PPI contract
5. Build PPI capacity in **functional ministries**	**How** will government capacity be developed?	Strengthens central ministries on PPI project transactions
6. Build PPI capacity in **sector ministries**		Strengthens sector ministries to manage PPI projects

Key objectives for each theme are as follow:

Theme 1 – Primary Approvals. The first step will be to clarify which cross-sectoral and sector - specific laws or sub-decrees apply to a particular type of project and to recommend specific changes to legislation and regulations to ensure the primary approvals required for any particular project are clearly set out in the applicable legislation, while removing any overlap in types of projects/approvals required or conflicts between legal instruments. The second step will be to develop appropriate criteria for determining when a particular project requires a specific approval, and to ensure the process reflects real public policy concerns. The third step is to clarify the timing of various approvals through the various stages. It will also be necessary to ensure that the cross-sectoral rules reflect approaches being developed in the various sectors (and particularly in the electricity sector) so that there is no conflict.

Theme 2 – Secondary Approvals. The first step will be to clarify the legislation pertaining to the secondary approvals, removing ambiguities, and simplifying wherever possible. The role of CDC as the 'one-stop shop' for secondary approvals will be reinforced. The second step will be to support CDC, as part of its role as an investment promotion agency (IPA), to prepare guidelines for investors, so that investors will understand what the specific requirements might be regarding both primary and secondary approvals.

Theme 3 – Responsibility for Granting Contracts. The objective here will be to clarify the legal capacity of different levels of government and government-owned entities to tender for, and act as contracting party to, a PPI project (including the relevant person authorized to bind that government or public entity). Where appropriate, changes to the legal capacity of different government entities will be proposed, so as to enable, for example, provincial and commune levels of government to act as purchasing authorities.

Theme 4 – Contract Management and Monitoring. The key objective here is to establish the legal responsibility for monitoring and regulatory roles, which will require new legislation. Key among these will be amendments to the Financial Budgetary Law and the Annual Financial Laws via additional provisions that make them sufficiently detailed with clear obligations on line ministries to comply with fiduciary requirements. It will also be important to define in law, with coverage of all sectors, a regulatory role separate from the policy-making and PPI contracting roles in all sectors. Independent regulation will be supported by relevant legislation specific to the sectors in which the private sector participates. This including electricity, civil aviation, telecommunications, water and social sectors such as education.

Theme 5 – Build Capacities of Functional Ministries. This will focus in particular on developing the capacities of 3 functional ministries, namely the Council for the Development of Cambodia, the Ministry of Economy and Finance, and the National Auditing Authority. Whereas developing CDC's role as an efficient investment promotion agency is an important aim in the long term, in the short term the program aims to improve its efficiency and effectiveness as a 'one stop shop' as regards to acquiring secondary approvals for Cambodia's PPI investors. The primary support for MEF will be to perform its financial appraisal and monitoring role on PPI projects and to ensure that budgetary considerations are incorporated in all stages of PPI project development. Support to NAA will primarily be in the form of the development of tools and methodologies that facilitate auditing of PPI projects to ensure compliance with contract terms, assess value for money and to analyze contingent government liabilities.

Theme 6 – Build Capacities of Sector Ministries. The primary objective of this theme is to ensure that the technical, economic, and financial skills exist within the line ministries to develop appropriate PPI sector strategies in terms of the technical solutions utilized, taking into account project costs and financing barriers. This would focus on developing (i) strategy/planning skills, (ii) project appraisal skills, and (iii) understanding concepts of risk allocation and optimal project design within target line ministries. The benefit of the effort would be to reduce the reliance on unsolicited PPI proposals and promote competitive tendering practices.

It is important to understand that the themes represent the package of critical reforms that will be required to create an enabling environment for PPI in Cambodia. However, it is not reasonable to presume that all the reforms can be introduced in a short time period. Nor will it be necessary. While private investors will require certain fundamental reforms to be in place, particularly in the current environment for PPI, and to see visible and demonstrable evidence of a clear commitment to reform, experience elsewhere suggests that private investors are willing to invest in relatively risky markets, as long as the rewards are commensurate to the risks, and political risk mitigation instruments are available. In confronting the more urgent areas of reform required in the immediate term, the World Bank team has developed, with the Government, a set of practical proposals in the form of policy and legislation:

- **PPI Policy**. The PPI Policy sets out the roles and responsibilities of the various parts of government with respect to PPI projects, as well as specific policy proposals for managing the PPI process throughout the typical PPI project cycle, with various aims to address *inter alia* several serious concerns with respect to: the lack of transparency in the handling of dealings between the public and private sectors particularly in the selection, negotiation and management of specific contracts between government and investors; more systematic control over the contingent and ongoing liabilities taken on by the public sector under PPI contracts; and improvements to supervision of the performance of PPI concessions during project implementation and operation.

- **Concession Law and Sub-decree on Concessions**. These pieces of draft legislation embed the key policy recommendations underlying the draft PPI Policy in the law. Prior to the World Bank-managed PPI Governance Study, UNIDO was commissioned to assist RGC to develop a Law on Concessions, the intention of which is to replace the BOT Sub-Decree and to supersede the relevant provisions of Order 30BB on the Management of State Properties. Te RGC asked the World Bank team to work with UNIDO to ensure overall consistency with the approach being proposed in the draft PPI Policy. The World Bank team has also drafted a Sub-decree on Concessions, which expands on the key provisions in the Law in greater detail.

- **Policy Guideline Documents**, dealing with:

    - **Financial Management of PPI Projects** – setting out a range of policy options and guidelines for managing government's fiscal exposure through PPP projects;
    - **Policy for Dealing with Unsolicited Bids** – setting out guidelines and suggestions for managing the trade-offs involved in balancing the advantages of encouraging private sector initiative to come forward with sensible project ideas with the potential loss in transparency and efficiency gains of a well-conceived competitive tender process;
    - **Contract Design Issues** – setting out some recommendations for ensuring that contract design is consistent with encouraging private sector participation; the parties responsible for management and monitoring are involved in contract negotiation; and that contracts transfer the appropriate risks to the private sector, while being flexible enough to deal with material changes to the context in which to operate;
    - **Policy for Contract Publication** – setting out some recommendations on how best to make public the contractual terms for PPI projects, to maximize transparency and enhance public confidence and trust in the integrity of the procurement process;
    - **Policy on Decentralization of PPI Project Governance** – setting out some guidance notes on how to ensure that initiatives to improve the PPI governance that are appropriate to the requirements of large national or large provincial-level projects do not have the undesirable side-effect of suffocating small scale infrastructure development.

Capacity building program to support implementation.

5.7. Strengthen Institutional Learning through Business Associations

Increasing the effectiveness of institutional learning. Since Cambodia is at early stage of formalization and specialization the most important consideration may be the ability of local institutions to learn – to acquire information and experience that is an essential part of the process of technology adoption. Cambodia does not have the benefit of a national innovation or deep extension system. Yet there have been good experiences in building the skills of, for example, the Rice Millers' Association through a visit to Thailand and exposure to different milling techniques.[89] While this particular bilateral intervention was highly productive, this can be costly and its impact is limited to one sector.

First, it is important that the range and depth of business membership organizations be expanded, and more producers become organized through them. Secondly, the capacity building process needs to be made more scalable. This could be achieved through research and apprenticeship partnerships – both bilaterally and with international organizations – focused on exposure to the particular sectors. ICT is particularly well suited for this task, and an increasing number of telecenter projects are emerging, which may provide sustainable access to communication throughout the country. Given high illiteracy rates, it is inevitable that learning will also involve demonstration on site. But the targeting of learning would be more cost effective when combined with research partnerships that draw on the resources of, for example, international textile research institutions or textile producer associations in other countries. It is important that these research partnerships be focused in the private sector; a public institution-centered approach allows public organizations to become the center of technological learning but diffusion to the private sector is absent. Furthermore, it is important that these activities take place through industry groups to strengthen trust and stimulate innovation in the sector.

Increase Access to Market Information. The value chain analysis suggests at least three types of information are critical for improving the bargaining power of suppliers, reducing monopolistic market behavior, and improving the overall competitiveness of enterprises operating in Cambodia: legal and regulatory information; information on prevailing market price of goods and services; and information on requirements to meet and comply with international standards and norms. As real time data and information is paramount for improving market transparency, the introduction of an IT strategy with accessibility even to rural farming communities could play a significant role in improving competitiveness of enterprises operating in Cambodia. It is anticipated that the Government-Private Sector Forum and more specifically the industry working groups would serve as a platform for establishing various public-private partnerships to develop and manage information access points (or "access nodes") for their respective constituents.

Building private sector policy monitoring and advocacy capacity. No party has a larger stake in a successful reform than the private sector, which is directly affected by the quality of the investment climate. As such, building local capacity to monitor reform is more likely to be sustainable, and more consistent with a strategy that calls for maximum use of private, non-state resources. To enable long-term private sector monitoring and evaluation, the Bank Group (IDA, MPDF, IFC) can identify one or more private institutions to monitor reform and build capacity through the following actions.

- Agree on a common set of benchmarks to monitor, relevant to each portion of the strategy.
- Build capacity with regard to the underlying analytical techniques and content areas (investment climate, value chain analysis, trade facilitation, private participation in infrastructure).
- Support preparation, World Bank review, and an annual monitoring report ("The *Cambodia Competitiveness Report")* on the reform program in each of these areas.
- Support the Government-Private Sector Forum, to disseminate the monitoring report.

[89] Tony Knowles, SME Cambodia, interview.

5.8. Accelerate Leasing and Access to Finance

Demand for formal credit appears to be low, but this would likely change quickly if other impediments are removed. Because of long and detailed work required to build a sound financial system and credit culture, early action needs to be taken to be prepared for an expected increase in demand. As a cash-based economy, the scope of potential private sector transactions is severely limited. Cambodia has committed to a number of actions in the financial area through the WTO process[90] and through the Government's financial sector blueprint prepared by ADB.[91] Until these are established and enforced, the risk of secured lending will make costs to the private sector very high. [92]

There is no shortcut around the difficult and detailed work required to build the policies, laws, institutions and skills that a modern financial sector demands – particularly for term finance. Cambodia has committed to legal reforms including a Secured Transactions Law, a Leasing Law, and a legal framework for insolvency. These will be particularly important for private sector firms that require capital equipment and other long-term assets. While the foundation for basic credit delivery is being developed, the analysis suggests two focal areas may produce more rapid results.

Lease transactions, because they do not require a change in title, are less dependent on a robust legal framework for secured lending and in fact do not require borrowers to secure loans with collateral. Leasing companies retain title, and in case of default on lease payments by the user of the equipment (lessor), the leasing company typically does not need a legal judgment to repossess the equipment. Furthermore, the rights and obligations under a leasing contract are relatively easy to transfer to third parties. In a default situation, often the leasing company and the lessor can find another user for the equipment who is willing to take over the equipment and the lease, which keeps the equipment in productive use. Representatives from Cambodian industry associations said that the associations would both encourage repayment and would assist with locating another member who would take over the equipment and lease in case of default.

Basic differences between a bank loan and lease are as follow:

	BANK LOAN	FINANCIAL LEASE
Ownership during lease term	Borrower	Lessor (Leasing Company)
Ownership after lease term	Borrower	Lessee (User of Equipment)
Mortgage and collateral needed?	Yes	No
Default remedies	Uncertain, multi-year process to foreclose on collateral	Various options, including finding another user to take over use of equipment and rights and obligations under original lease agreement
Term of financing	6 months to 1 year in Cambodia	3-5 years. Depends on: Useful life of equipment Credit risk of lessee Cash flow of lessee Whether equipment is multipurpose
Underwriting	Collateral value	Value and importance of equipment to business
Type of collateral	In Cambodia, only property is acceptable collateral for a bank loan.	Leased equipment such as: harbor operations (cranes) transport/logistics (trucks) fishing boats textiles (spinning, weaving, dying, printing) garments (stitching) rice milling

[90] Working Party Report Services Schedule: Financial Services.
[91] Chun, Zhang, et. Al (2001), *Financial Sector Blueprint for 2001-2010.*
[92] Working Party Report Annex I includes commitments on Insolvency, Secured Transactions, and Leasing.

5.9. Moving Forward

Progress in private sector development is closely tied to further progress on public sector reform. Improvements in tax collection, streamlining the civil service, introducing performance-based competitive wages, and building public sector capacity would significantly increase the success of the reform program cited above and the likelihood of building a diversified, productive private sector. Again, many of the required reforms fall outside the scope of this study, with the exception of the trade and investment-supporting agency reforms described.

Completing the transition of the Council for Development of Cambodia's FDI function to an effective Investment Promotion Agency (IPA). Recommendations 2 and 3 above on leveraging private sector mechanisms to build a responsive supplier base would be significantly facilitated by new foreign investment. While international experience suggests that foreign investment is responsive to improvements in the investment climate by addressing the very problems identified in the investment climate review, many countries actively promote foreign investment through investment promotion agencies. The Council for Development of Cambodia (CDC)'s Cambodian Investment Board (CIB) currently serves a number of administrative and regulatory functions that are affected by the Amendment to the Law on Investment, which was approved by the National Assembly in February 2003. The Amended Law on Investment explicitly moves the CIB toward serving as a facilitative and promotional agency, with many evaluative and regulatory functions replaced by automatic systems. This new role will create a need for a corporate strategy to be developed, defining the new agency's goals and objectives, the strategies and resources it will use to achieve these and the performance measurements by which it will assess its progress and success. The planning process can also be expected to yield an action plan and help to define the organizational structure that the agency would need to implement the strategies and actions chosen. FIAS has recommended a strategic review of the functions and structures of the Cambodian Investment Board to address their appropriateness in the light of the explicit amendment in the Law on Investment designed to move the Board from a regulatory agency to a facilitative and promotion agency and the problems in the overall investment environment and emerging changes in the global competitive environment.

More analytical work will need to be done at (a) the interface of the enabling environment for private sector development and agriculture; (b) a deeper understanding of the role of social capital, particularly trust, in building trade-supporting institutions; and (c) more work and possibly action research on formalizing or scaling up traditional or informal institutions, including dispute resolution. As this second generation set of reforms is set in motion, Cambodia will quickly need to move to a third-generation of reforms –those that focus on higher quality skills and a more competitive financial sector.

Strategy development is a continual process, and private sector development strategy is in its early phases. Since many of the reforms are questions of political will, it is hoped that this analysis contributed to a frank and factual dialogue between the Government, private sector, and development partners.

Chapter 6: Government Actions and Commitments

The Government has recognized that combating poverty requires fundamental improvements in governance. This will ultimately require a change in mindset from one focusing on short-term gain to a focus on long-term development based on a strong moral foundation and work ethic. Better regulation can contribute toward realization of this vision by improving the reward for legitimate entrepreneurship. By taking on the more difficult challenges of the investment climate, the Government demonstrates its commitment to realization of this new vision.

6.1 Special Inter-ministerial Task Force on Trade Facilitation & Investment Climate

The investment climate survey findings were presented to the Government in February 2004, and were discussed in a series of Cabinet-level meetings. These Cabinet level discussions resulted in Prime Minister's Decision No. 12/2004, to form a Special Inter-Ministerial Task Force on Trade Facilitation and Investment Climate, Chaired by the Minister of Economy and Finance and Vice-Chaired by the Minister of Commerce.

KINGDOM OF CAMBODIA
Nation Religion King

No.: 12 SSR
DECISION
ON

The Establishment of Inter-ministerial Special Task Force for Investment Climate Improvement and Trade Facilitation

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The Royal Government of Cambodia

- Having seen the Constitution of the Kingdom of Cambodia
- Having seen the Royal Decree No. NS/RKT/1198/72 dated November 30, 1998 on the Organization of the Royal Government of Cambodia
- Having seen the Royal Kram No. 02/NS/94 dated July 20, 1994 that stipulates the use of the Law on the Organization and Functioning of the Council of Ministers
- Having seen the Royal Kram No. 03/NS/94 dated August 05, 1994 that stipulates the use of the Law on Investment of the Kingdom of Cambodia and the Royal Kram NS/RKM/0303/009 dated March 24, 2003 that stipulates the Law on the Amendment of the Law on Investment of the Kingdom of Cambodia
- Having seen the Sub-decree No. 70 ANKr/BK dated July 27, 2001 on the Organization and Functioning of the Council for Development of Cambodia
- Having seen the Decisions No. 44 SSR dated August 03, 2001 and No. 41 SSR dated August 12, 2001 on the Formation of Sectoral Working Group
- Based on the spirit of the plenary meeting of the Council of Ministers dated February 27, 2004 on Implementation Program to carry out Cambodia's Obligations within the Framework of the World Trade Organization
- Based on the spirit of the Inter-ministerial plenary meeting on March 18, 2004

DECIDES

Article 1: Form a Special Inter-ministerial Task Force (SITF) to improve investment climate and trade facilitation. SITF is comprised of:

H.E. Keat Chhon	Senior Minister, Minister of Economy and Finance	Chairman
H.E. Cham Prasidh	Minister of Ministry of Commerce	Vice Chairman
H.E. Suy Sem	Minister of Ministry of Industry, Mines, and Energy	Member
H.E. Chan Sarun	Minister of Ministry of Agriculture, Forestry, and Fisheries	Member
H.E. Proum Sokha	State Secretary of Ministry of Interior	Member
H.E. Pen Siman	Delegate of RGC in charge of Customs and Excises Department	Member
H.E. Lou Kim Chhun	Director General of Sihanoukville Port	Member
Mr. Hong Tha	Director of Tax Department	Member
Mr. Suth Dara	Director of Camcontrol Department	Member
Mr. Seang Bun Leang	First Deputy Director of Economic Police	Member
H.E. Sok Chenda	Secretary General of the Council for Development of Cambodia	Secretary

Article 2: To improve investment climate and trade facilitation, SITF shall have immediate responsibilities as follows:

First- Raise and implement measures to reduce cash payments on intermediaries related to export-import

Second- Raise and put into implementation measures to reduce procedures or cancel duplicating procedures in the management of trade process.

Third- Raise and put into implementation measures to reduce time delays for goods export and import.

Fourth- Raise and put into implementation all measures that would increase national budget.

All the measures of the above responsibilities one, two, and three are only part of Cambodia's obligations being member of the World Trade Organization that the Ministry of Commerce has been leading and complying with a decision made by the Council of Ministers dated February 27, 2004.

Article 3: The above responsibilities have to be achieved and computable in digit term.

Article 4: SITF shall regularly report to the Head of RGC all the measures initiated by itself. In case where some measures are beyond its capacity, SITF shall report and request for guidance and decision from the Head of RGC.

Article 5: The Chairman of SITF may invite the Leaders of line ministries/institutions to participate in conducting the work. During the absence of the Chairman, SITF can conduct meetings led by Vice Chairman or Representative based on delegating power of the Chairman.

Article 6: If deems necessary, SITF may collaborate with donors and/or private stakeholders in order to efficiently achieve the above responsibilities.

Article 7: SITF shall have the right to use the stamp of the Council for Development of Cambodia.

Article 8: The mandate of SITF will be ended when the mechanism of RGC on the implementation of strategy to develop private sector and the program to improve investment climate in Cambodia is determined. In this context, SITF shall shortly submit its proposals to the Head of RGC upon the mechanism.

Article 9: The Minister in charge of the Council of Ministers, Minister of Ministry of Economy and Finance, Minister of Ministry of Industry, Mines and Energy, Minister of Ministry of Agriculture, Forestry, and Fisheries, Co-Ministers, Ministers, State Secretaries of line ministries and those as stated in Article 1 shall implement efficiently this Decision from the date of signature.

Phnom Penh, March 22, 2004

Prime Minister

Signed and sealed

HUN SEN

Cc:

- *The Ministry of Royal Palace*
- *General Secretariat of the Senate*
- *General Secretariat of the National Assembly*
- *The Cabinet of the Prime Minister*
- *Similar to Article 9*
- *Archives*

6.2 Twelve Point Plan: Government Commitments to Improve the Investment Climate and Trade Facilitation

The Special Task Force as defined in 6.1 has defined, and discussed with the Bank, an integrated program of reform to address the most urgent impediments in trade facilitation raised in the document *Towards a PSD Strategy*. At its June 7, 2004 meeting, the Task Force (TF) discussed these steps and agreed upon a number of actions to be taken as described below.

The reform measures agreed – establishing a cross-agency reform team, consolidating inspection mandates across agencies and introducing selective inspections based on risk, implementing a Single Administrative Document and Single Window process, automating information flows across agencies, streamlining business registration procedures and recognizing ethical behavior in the private sector – will be initiated in July 2004 be implemented on an urgent basis by December 2005. These reforms address some of the key causes of high costs and delay and strongly complement Cambodia's entry into the World Trade Organization.

Actions Agreed by Special Inter-Ministerial Task Force (SITF) on Investment Climate & Trade Facilitation	WTO Working Party Report Reference	Actions Agreed by WB
1. Establish a Cross-Agency Trade Facilitation/Investment Climate Reform Team		
The TF agreed to form a team consisting of eight to ten members representing the Ministries of Economy and Finance, Commerce, Agriculture, Labor and Social Welfare, Interior, Industry, the CDC, and the Port Authority of Sihanoukville to oversee the change measures in trade facilitation. This team will make reform recommendations to the SITF and support operational work toward on the reform. The SITF assigned CDC to identify the members, prepare the TOR and initiate the team by July 1, 2004.	Working Party Report Para 39 defines inter-ministerial coordinating committee.	The Bank agreed to work with the CDC to develop TORs for the change management team.
2. Establish A System Of Transparent Performance Measurement including Private Sector Monitoring		
The SITF agreed to establish a performance monitoring system to monitor progress accurately, engender trust of all stakeholders in the reform, and to report progress to the public. This system will report the time and cost of importing and exporting product, and include monitors from the private sector. The first "baseline" measurements of the current process will begin in July 2004 and continued each month. The SITF asked the Bank and CDC to work together to develop a TOR on the details of establishing the system and the modalities and extent of private sector involvement. This should include the Chamber of Commerce.		The Bank is already working on a methodology for performance measurement, to be introduced as for the consideration of the reform team July 1. The Bank further agreed to work with the CDC on developing TORs and coordinating with related initiatives as appropriate.

3. **The trade facilitation process, including all licenses, procedures and documents, will be reviewed to remove overlaps and unnecessary approvals. Following the reengineering, a Single Administrative Document will be implemented and other documents progressively eliminated.**

Currently over 45 documents are required to export a shipment, each of which adds time and cost to the trade facilitation process. To enhance sharing of information, to reduce cost and to pave the way for automation, Cambodia will implement a Single Administrative Document by December 1, 2004. All other documents currently in use to support trade facilitation will be progressively eliminated. The SITF agreed that the reengineering process should occur on an accelerated basis so that it can precede the Single Administrative Document.	Working Party Report Table 7 Paragraph 93. Single Administrative Document is a step toward automated customs processing as described in Working Party Report Table 7.	The Bank agreed to coordinate with the efforts already underway, including within ASEAN and GMS. The Bank will contact other members of the donor community, which are currently considering a potential Sector Wide Approach (SWAp) to coordinate assistance.

4. **Introduce an overall risk management strategy to consolidate and rationalize all examination requirements of the different control agencies.**

The TF agreed a risk management strategy was necessary and asked for the Bank's help in developing a TOR for this work. A matrix of inspection requirements by categories of goods will be drawn by all the relevant agencies, and will be progressively applied to shipments, with a view to consolidate all inspections under one session.		The Bank agreed to help develop TORs.

5. **A strategic review of the role of CamControl will be launched to more productively deploy the organization's unique knowledge of quality control processes and make optimized use of inputs and resources from other agencies, such as the CED.**

The SITF recognizes that the role of CamControl may need to be modernized and updated in light of the maturity of the economy, the private sector's ability to determine quality and its trading relations. The Government will conduct the strategic review of CamControl including several options: retaining the existing profile, merger with CED (following cross-training) or establishment of a new entity such as a Food and Drug Administration.		The Bank agreed to discuss possibilities for such support with other donors involved in the PSD SWAp discussions, and respond to the TF's request as soon as possible.

6. **A Single Window process to manage trade facilitation will be piloted in the Port of Sihanoukville by December 2005. The Trade Facilitation process, once streamlined, will be automated by December 2005.**

The TF agreed to these timelines, and said that every attempt would be made to complete this work by end 2005. The TF also agreed that the Government will initiate a comprehensive automation project by October 2004. The process will start, as soon as possible, with the design of an overall architecture that incorporates all agencies into a seamless network. Within this overall architecture, implementation will be undertaken in phases. The TF asked if the Bank could provide grant support for the hardware required for automation as well as provide a flowchart of the	Working Party Report Table 7 Paragraph 93	The Bank agreed to provide the flowchart but noted that grant assistance had to be discussed within the context of the upcoming CAS discussions.

automation process.

7. **The Government will introduce a WTO compatible flat fee for service, and the service will be defined by a service-level agreement. The fee structure will be public.**

The TF agreed that the Single Window should be implemented in conjunction with a flat fee-for-service compensation mechanism that enables the private sector to pay once for all customs clearance processing. They also agreed that this fee should be tied to publicly stated and enforced SLAs that clearly outline the level of service provided to the customer in exchange for the fee paid, and a refund should be allocated to the customer should the agency fail to provide service within the terms outlined in the SLA. The Trade Facilitation Reform team will determine the appropriate fee structure.

The SITF asked the World Bank to provide technical inputs to the TFRT. The Bank agreed to do so.

Licensing and Registration

8. **Streamline the process and reduce the cost of incorporating with the Commercial Register, which is maintained at the Office of the Clerk of the Commercial Court, and costs an average of $630 and 30 days.**

9. **Streamline the process notification of the Ministry of Labor to start hiring employees, which costs $250 and 30 days to complete.**

10. **Harmonize registration for VAT, income tax and company registration using the same form and resulting in the same number. This would enable a unique identifier and facilitate information sharing across agencies.**

The SITF endorsed the goal of streamlining licensing and registration to decrease the share of companies that operate informally by making formal registration and hiring workers as easy and inexpensive as possible. The SITF noted that the changes proposed in Item 12 may require changing existing legislation and agreed that reform team would present proposals after taking into consideration ongoing reform efforts. In one such effort, the Ministry of Commerce is in the process of decreasing incorporation fees to $295 and the number of days to 10 days.

The Bank agreed to consult with other donors such as the Asian Development Bank, MPDF and FIAS.

Private Sector Governance

11. **Implement a national award to promote good corporate citizenship and governance in the private sector.**

Improving governance cannot rest on public action alone. Any strategy to fight corruption, build better institutions, introduce transparency in public contracting must also rest on efforts to strengthen codes of ethics and standards of governance that are developed and enforced by the private sector

The Bank agreed to work with IFC, MPDF and other donors to design and possibly fund such a program.

itself. The TF agreed that the Government will encourage, through the Government-Private Sector Forum, adoption of a Code of Ethics by the private sector. The Government also will try to introduce a national award for corporate governance, which will depend on an assessment against objective governance criteria. Publicizing the criteria is expected to raise awareness of corporate governance.		
12. Monitoring and Reporting		
The TF agreed that the private sector, through business associations, will monitor and evaluate progress toward reform objectives. Progress reports will be provided to the Government-Private Sector Forum.	Working Party Report Paragraph 217 requires transparency on trade-related regulation.	IFC, AusAID

6.3 The Government's Track Record of Reform in Private Sector Development

While the reforms required to facilitate private sector development are substantial, the Government has not been complacent in the past. The following is a compendium of reforms introduced by the Government in five areas: trade policy and integration, private sector development policy, banking and finance, tax and customs. It is clear that the government has engaged heavily in policy reform. Implementation of these reforms will continue to be deepened over time, complemented by the new commitments cited above.

6.3.1 Integration into the World Economy and Trade Policy Development, 2001-2003

2001

- Government reduced maximum tariff rates from 120 percent to 35 percent and reduced the number of tariff bands from 12 to 4. Structure of the 4 tariff bands are 0%, 7%, 15% and 35%, of which about 95 percent of the tariff lines are under three bands: 7%, 15% and 35%.
- Average un-weighted tariff rates were lowered to 16.5 percent from 17.3 percent in 2000 and 18.4 percent in 1997.
- The Government imposed an absolute ban on exports of logs and an export quota on rice. Five items are subject to export licensing requirement: (i) processed wood products, (ii) garments, (iii) weapons, (iv) all vehicles and machinery for military purposes and, (v) pharmaceuticals and medical materials.
- Most non-trade barriers were eliminated.

2002

- The Government is moving forward with its tariff restructuring program by planning to reduce the un-weighted average tariff rate to below 15% in 2002-2003.
- The Government initiated a Triangle Economic Cooperation strategy between Cambodia, Vietnam and Lao PDR, focusing on (i) Commerce, (ii) Industry, (iii) Public works and Transportation, (iv) Tourism.

2003

- The Prime Minister asked the Ministry of Commerce, Ministry of Public Works and Transport and other concerned institutes to conduct a detailed feasibility study on the promotion of sea ports mainly in areas of Koh Kong, Sre Ambel, Keo Phus, Kampot and Keb into international seaports.
- Cambodia become 147th WTO member at Cancun 5Th WTO Ministerial Conference following

successful five rounds of working party negotiations with its multilateral and bilateral market partners.

- Failed ratify its WTO membership by deadline March 31, 2004. A formal extension request was send to WTO secretariat and new ratification deadline is extended to September 30, 2004.
- Under the ASEAN-China Free Trade Area's Early Harvest scheme signed in July 2003, China has granted to Cambodia, effective from January 1, 2004, a special preferential tariff (SPT) treatment for 297 agricultural products at zero percent tariff rates.
- Under the ASEAN Integrate Special Preferential (AISP), Thailand has agreed to provide Cambodia a special and preferential tariff treatment for 249 products, Lao PDR 150 products and Myanmar from 300-400 products, effective from this year in 2004.
- Cambodia-Canada Memorandum Of Understanding signed by the two countries in March 2003 has given Cambodia, along with other least developed countries, a quota and duty free access to all its markets except banana. Its exported goods must meet the rule of origin which is contained at 25% Cambodia's added value. Under the ASEAN agreement, raw materials importing from ASEAN countries are also considered local origin.
- Meanwhile, Japan expanded its duty and quota free treatment for LDCs to 496 agricultural and fishery products in 2003 and Cambodia is also eligible for this treatment as an LDC.
- Japan-ASEAN Comprehensive Economic Partnership signed in 2003 has provided Cambodia a broad-based liberalization of trade and investment promotion. The Japan-ASEAN Comprehensive Economic Partnership has focused on regional trade and investment promotion with other facilitation measures, including, customs procedures, standards and conformance, financial services, information and communications technology, science and technology, human resource development, small and medium enterprises, tourism, transport, energy and food security.
- Summit for Economic Cooperation Strategy between Cambodia, Lao PDR, Myanmar and Thailand that was held on November, 2003 in Bagan—Myanmar. The Bagan Declaration for Economic Cooperation Strategy[93] among the four countries has a 10-year timeframe from 2003-2012 with focused areas on Trade and Investment Facilitation, Agricultural and Industrial Cooperation, Transport Linkages, Tourism Cooperation and HR Development.

Sources: Reports of Cambodian Authorities.

6.3.2 Reform Progress Made in Private Sector Development Policy, 2000-2003

2000

- Established seven public/private sector consultative working groups: (i) Banking & Finance Working Group, (ii) Export Processing & Trade Facilitation Working Group, (iii) Manufacturing & SME Working Group, (iv) Agriculture & Agro-business Working Group, (v) Energy & Infrastructure Working Group, (vi) Law, Tax & Good Governance Working Group, (vii) Tourism Working Group.
- Held seven public forums chaired by the Prime Minister in the past two years to discuss issues raised at the working groups;
- Removed most import and export licensing requirements;
- Removed the monopoly of CAMINCO and introduced new legislation facilitating the entry of foreign insurers. To date (June 2003), four fully licensed insurance companies are under operation (one is state-owned);
- Entered into a new two year agreement in October 2000 with SGS to conduct Pre-Shipment Inspections on goods imported into Cambodia;
- Required agencies operating at border checkpoints to co-ordinate their activities and subject traders

[93] The Bagan Declaration was later called "Arrewady, Chaopraya, Mekong Economic Cooperation Strategy" (ACMECS).

to only one inspection;
- Attempted to streamline procedures for issuing Certificates of Origin to garment exporters;
- Established visa-issuing facilities to individuals entering Cambodia at the major land border checkpoints.

2002
- The Ministry of Commerce set its mission statement as " Year of Decentralization and Deregulation" to mainly reduce paperwork procedures in dealing with their export activities and introduced computerized system in coordination with the US Customs Department for monitoring garment exports.
- Law on Commercial Enterprises was submitted to the National Assembly for Approval;
- Law on Patents, Inventions and Industrial Design was adopted;
- Law on Trademarks and Dishonest Competition was adopted;

2003
- Amended Law on Investment was adopted (February) to make the investment climate more conducive to growth.
- Law on Copy Rights was adopted (January);
- Draft Law on Industry Management was sent to the National Assembly for approval;
- Draft Law on Industrial and Export Processing Zones was sent to the National Assembly for approval.

Sources: Cambodian Authorities

6.3.3 Reform Progress Made in Monetary and Banking Policies 2001-2003

- National Bank of Cambodia (NBC) established a clearinghouse for dollar-denominated checks.
- NBC Adopted a financial blueprint for the next ten year so called "Vision and Financial Sector Development Plan for 2001-2010".

2002
- The Government completed the re-licensing programs under the LBFI (in April), 15 banks were closed due to inability to meet the new minimum capital requirement set at US$13 million. As of December 2002, Cambodia's banking system consists of 17 banks: one state-owned, three foreign bank branches, nine locally incorporated commercial banks and four specialized banks.
- Draft law on Negotiable Instruments and Payments Transactions was submitted to the Council of Ministers and expected to submit to the National Assembly in 2003. The law aims to improve payment transactions, eliminate legal uncertainties and reduce payment system risk.
- The Government pursued a flexible market-based exchange rate policy with the spread between official exchange and market rates limited to 1%.
- NBC (in September) lowered commercial banks liquidity ratio requirement from 100 percent to 80 percent in response to appeals from banking community.

2003
- Announced policy to privatize and seek potential investors to run the state-owned FTB.
- A uniform Chart of Accounts (COA) was made available to all commercial banks.
- This international based Uniform Chart of Account is expected to be fully completed by the end of 2004 for all commercial and specialized banks.
- Draft Law of Negotiable Instrument and Payment System was passed by the Council of Ministers and submitted to the National Assembly for approval.
- Issued complete procedures on off-site surveillance and on-site inspection.
- Completion of on-site inspection for six commercial banks.
- NBC expanded two additional provincial branches to a total of 20 provincial branches covering major cities throughout the country.

- Adoption of a Prompt Corrective Action system (PCA) for commercial banks to ensure that central bank can effectively deal with problems at an early stage.
- Issued Prakas on Procedure for Identification of Money Laundering.
- Established Committee for International Reserve Investment. The Committee would be in charge of formulating the international reserve investment policy.
- By the end of 2003, 5 licenses was issued for Micro-finance Institutions.
- ACLEDA Specialized Bank was licensed to become a commercial bank effective December, 2003.
- The central bank with support from the Asian Development Bank prepared an IT development plan with objective to automate key operations.
- Introduce CAMELS ratings to access and boost public confidence on commercial banks.
- Draft of Bankruptcy Law was reviewed among the concerned line ministries.
- Law on Secured Transaction has been drafted for consultations.

Source: National Bank of Cambodia.

6.3.4 Reform Progress Made by the Ministry of Economy and Finance in Tax Policies

2001

- Treatment of diesel sales as final sales for VAT purposes;
- Introduced visa sticker to avoid tax loss from visa revenues;
- Introduced stamp system for tax collection on cigarettes;
- Expanding VAT on real regime (self-assessment system) to additional 150 firms (following the 2000 expansion by 500 companies);
- Introduced 10% excise tax to be levied on entertainment services;
- The minimum profit tax of one percent was eliminated on investment project;
- Established large taxpayer unit to cover about 500 large taxpayers;
- Strengthening tax audit.

2002

- Improving exchange information with department of MEF and other government agencies to support tax audit program such as: Custom Department, Treasury Department, Procurement Department, CDC, Ministry of Commerce, etc.
- Raised additional tax on petroleum products, 2 cents per litre for gasoline and 4 cents per litre for diesel.
- Expanding real tax regime (real tax regime means taxation is based on accounting statement) to cover additional 5 provinces (it was previously applied to 5 provinces only)[94].
- Raising excise tax on beer from 10% to 20%.
- Law on Corporate Accounting, Audit and the Accounting Profession was promulgated (in July).
- Applied a 15% withholding tax on interest earned by bank depositors.
- Submitted a new Customs Code to the Council of Ministers (in July 2002). It is subjected to be in line with the WTO.
- Reviewing the contract of ticket sales to Angkor Wat complex (Siem Reap province) with Sokha company, to increase revenue sharing to state coffer and collect VAT.
- The share of garment export quotas to be auctioned was increased from 10% to 20%.

[94] The real regime tax system was expanded in 2000 to five provinces: Sihanoukville, Koh Kong, Siem Reap, Kompong Cham and Battambang. In 2002, the real regime system has been expanded to another five provinces: Kandal, Svay Rieng, Kampot, Kompong Speu and Kompong Chhnang.

- An Inter-Ministerial Commission (Intelligence Unit) on anti-smuggling was established and regular reports will be submitted to the Council of Ministers.
- Strengthening the pre-shipment inspection program for imports by using reconciliation procedures to resolve valuation differences, and reducing to no more than 10% the number of sealed containers subject to re-inspection by any government agency based on principles of risk management. Penalties for firms that by-pass the pre-shipment inspection (pre-shipment inspection of imports introduced in October 2000).
- Introduced Medium Term Expenditure Framework 2003-05.
- Streamlining the system for controlling refunds and develop risk management techniques for the verification and approval of VAT refund claims.
- Development and implementation of streamlined customs clearance procedures to enhance trade facilities and improve effectiveness of operations.
- Establish a single operational structure of government bank account in the National Bank of Cambodia under government control.
- Establish a structure for a Chart of Accounts (COAs) at the national treasury.
- Introduced direct payment of large taxpayers to the National Bank of Cambodia.
- Strengthening collection enforcement measures to taxpayers who had tax arrears, for example: froze bank account, stopped import-export; CDC not to permit import materials, treasury department to freeze account, .etc.

2003

- Applied the VAT on imported and domestically produced agricultural product equally.
- Issued Treasury Bill for an amount of 50 billion riels.
- Amended Law on Taxation was discussed many times between government and private sectors and then adopted by the National Assembly (Feb.) in responding to the five main thrusts of the tax law reform initiative: (i) systematic reform which links the respective amendments to the Law on Investment and Taxation, (ii) Increase revenues to support increasing expenditures, (iii) simplify and clarify Cambodia tax system, (iv) align the tax system with international tax standards in order to attract foreign investors and (v) strengthening provisions aimed at collection tax arrears.
  The main points of these amendments are as follow:
  - Change exemption period
  - Introduce 40% special depreciation for Qualify Investment Project (QIP) that not elect to use exemption period
  - Introduce new depreciation schedules (declining balance method).
  - Introduce additional profit tax on dividend distribution
  - Reduced withholding tax on payment to non-resident from 15% to 14%
  - Reduced withholding tax on interest payment from bank to resident taxpayers from 15% to 6% and from 5% to 4%.
  - Increased rate of salary tax for non-resident taxpayer from 15% to 20%
  - Eliminate 1% of turnover of minimum tax and pre-payment of profit tax on QIP
  - Strengthening collection enforcement
- Applied decree on Public Procurement to all ministries on budget expenditures chap. 11 and 13, except Defense and Interior ministries and the Royal Palace.
- A new agreement signed with the Sokha Company on new formula for the sharing of revenues from entry fees into the Angkor Complex and VAT payment.
- Expansion the coverage of Medium Term Expenditure Framework (MTEF) to (i) Ministry of Agriculture, Forestry and Fisheries, (ii) Ministry of Rural Development, (iii) Ministry of Public Works and Transport and possibly to (iv) Ministry of Justice and (v) Ministry of Women's and Veterans' Affairs.
- The Prime Minister's circular, orders the Ministry of Economy and Finance not to sign new payment orders without sufficient cash in the national treasury. The payment orders must not accumulate in the national treasury over a total value of one twelfth of annual current revenue and

as the total value reaches threshold, the Ministry of Economy and Finance shall temporarily suspend issuance of new payment orders until the cash flow is settled.

- Penalty charge was applied for delay or non-payment on leases of state assets.
- Completed review of telecommunication operations was done to ensure funds are transferred properly to state budget.
- Completed inventory process at ministry level on leases of state assets.
- New restructured tariff with an un-weighted rate of less than 15% is applied from January 1, 2004.
- MEF financial controllers were transferred to Ministry of Education and Ministry of Health with clear TORs and responsibilities.
- Established Kampuchea Institute of Certified Public Accountants and Auditors (KICPAA) to ensure promotion of the accountancy and auditing professions.
- The government would approve the ASYCUDA system to automate the customs-related services to reduce risk of leakages of revenues.
- The government reviewed and reduced tax exemption provided under the amended Law on Investment.
- Increased excise tax rate on beer from 20% to 30%. Increased excise tax on service: air transportation and telecommunication from 2% to 10% and broadening tax base to cover both domestic and international and introduced some new excise taxes. These above excise taxes were implemented in 01 January 2004.

2004

- The Ministry of Economy and Finance put stiffer pressure on government's private debtors and set January 31, 2004 deadline to all vehicle owners to pay tax or confiscated.
- The government reduced import tax on luxury vehicles from 230% to 50% beginning January 1, 2004 with expectation that the reduction in tax would prompt and encourage people to pay it.
- The government, in February 9, 2004 issued an order to all owners of their unused land in Phnom Penh city to pay tax by March 10, 2004 or be confiscated as state property. The government has put a squeeze on its tax debtors in response to the concerns of widening budget shortage.
- Set up a working group to take action on collection non-tax revenues and arrears particularly in telecommunication services and leases of state assets.

Sources: Cambodian Authorities.

Linking Private Sector Development to the CAS and NPRP

Longer-Term Development Agenda		*CAS Outcomes*		*Bank Interventions*	*Partner Interventions*
Strategic and Longer Term / Higher Order Country Outcomes	**Governance Issues that need to be addressed to Achieve the Higher Order Outcomes**	**CAS Outcome(s), Indicators Bank expects to influence**	**Intermediate indicators of progress towards CAS outcome**	**IDA interventions to support outcomes**	**Partner interventions**
➢ **Private-led Growth** "The central objective of the Royal Government's policy is to promote broad-based sustainable economic growth with equity, with the private sector playing the leading role... RGC aims to achieve a sustainable real rate of inclusive broad based economic growth of 6 to 7 % per year." - NPRP, p. iv.	To achieve 6-7% real growth, Cambodia needs to reduce corruption, strengthen legal and regulatory frameworks and build institutions that enable enterprises to flourish. While doing so, it needs to increase accountability and the voice of the private sector, particularly rural enterprise.			Lending FY05-07 • Trade Facilitation & Competitiveness • Pov Reduction Support Credit • Logistics/e-gov't (EASTR) Transparency requirements in all infrastructure lending. Supervision FY05-07 • Cambodia Provincial & Peri-Urban Water Project • Cambodia Rural Electrification and Transmission (KHRET) • Cambodia Provincial and Rural Infrastructure Project Analytical & Advisory Work • WB Value Chain (2003) • WB Seizing the Global Opportunity / ICA (2004) • WB Sources of Growth • WB Transport Sector Strategy • WB PSIA on WTO • WB Rural Sector Strategy • WB Analysis of Local Dispute Resolution • FIAS Corporate Social Responsibility • FIAS Support to the Cambodia Investment Board	IMF TCAP ADB PSD credit / TA European Union MUPLTRAP AUSAID CETEF AFD Program GTZSME development program Danida Supply Chain program **Infrastructure Portfolio:**
➢ **Export-led Growth** To increase exports of goods and services, thereby creating jobs and contributing to poverty reduction.	While Cambodia's WTO accession will enhance market access, poor regulation exposes exporters to complex, costly trade facilitation practices that limit competitiveness. Symptoms: • Multiple, overlapping agency roles, approvals and inspections; • Excess cost & time to clear imports /exports. • Smuggling is widespread and efficient.	1a. Cost, time effort required to clear shipments are reduced, as measured by: • The number of steps required to import products is reduced from 45 to less than 20; • Share of export shipments physically inspected reduced to less than 40%; • A 35% reduction in time to clear export shipments by June 2006. • Number of exporters using export duty exemption scheme increases. 1b. Cambodia's ratings of compliance with Corporate Social Responsibility (CSR) continues to improve in line with ILO framework or global CSR standard applied by an independent agency.	***Facilitating Trade*** • Agencies with the authority and mandate to conduct routine inspections of shipments reduced from six to two; • Selective inspections based on risk management introduced by June 2005; • The Single Administrative Document implemented by June 2005; • Single window process fully implemented and substantially automated by December 2006. • FIAS recommendations on export duty exemption scheme in place by Dec 2005. 1b. ***Corporate Social Responsibility*** • Framework for CSR in place and agreed by key stakeholders.		
➢ **Diversifying the sources of growth** " Reduce Cambodia's dependence on GSP		2. Investors perceive Cambodia to have a more hospitable investment climate as measured thorough follow-up ICA (2006-2007).	***Integration of new sectors into economy*** 2a.Removing Barriers to formalization • Policy to streamline business registration formally endorsed.		

exports and leverage market access opportunities of WTO to diversify range of exported commodities" – NPRS Increased investment in non-garment sectors	Agro-industry provides a strong case for diversification, but firms are small, informal, limited to local markets. Growth is constrained by a lack of institutions to integrate markets, reduce risks and enable commercial transactions. Since diversification is at an early stage, institutional learning is important. But producers are not well organized, are isolated from policy development and lack awareness of standards, trade norms and corporate governance. The development impact of such investment is therefore limited .	2a. Barriers to formalization reduced: • Steps to register limited liability co reduced from 11 to less than 9. • Cost reduced from $630 to < $450 2b. Trade institutions strengthened: • Informal / alternative dispute resolution mechanism in commercial use; • Firms using trade support network • Domestic trade network to be better supported by improvements in provincial Governance. 2c. Standards and practices improved: • Awareness of corporate governance increased • Linkages between new sectors and local suppliers strengthened 2d. Institutional learning, voice of the private sector supported by: • Policy dialogue better reflects local / rural business issues.	2b. ***Building Trade- supporting institutions*** • Strategy to support resolution of disputes at local level developed • Domestic trade networks broadened to encourage diversification and access to markets. 2c. ***Catalytic investment in new sectors*** • IFC investments in tourism, agro-industry and non-garment sectors in line with investment climate improvement • MPDF linkage program and corporate governance award in place 2d. ***Building Private sector voice*** • Existing institution (s) identified and trained in (a) monitoring policy relevant to PSD (b) policy advocacy. (MPDF) • Government Private Sector Forum (PSF) incorporated into donor PSD dialogue.	• FIAS Exporters Duty Suspension Scheme • IFC support to Government-Private Sector Forum • MPDF Business Associations support • MPDF Linkage Program • PPIAF PPI Governance • PPIAF Electricity Sector • PPIAF Water • PPIAF Telecom IFC Sector Strategy Possible Sector Wide Approach	Transparency/ Governance requirements introduced into other donor portfolios.
➢ **Private sector delivery of public services** "A substantial role for the private sector in delivering public services, including infrastructure, health and education -- NPRS	Effective PPI creates efficiency gains from competition. Citizens not realizing gains due to: • Unclear legal and institutional framework; • frequent closed concessions; • Lack of regulatory capacity; • Lack of coordination between public investment, sector strategy, and PPI projects.	3. Private investment in infrastructure in Cambodia increases: • Investment regime for PPI perceived as fair and competitive as measured through follow-up ICS in 2006. • All PPI transactions water, road transport and electricity are subject to competition no later than December 2006. • Framework for regulated, competitive contracting expanded in water beyond MIME pilot.	***3. Transparency & Accountability of PPI*** • PPI Policy issued by RCG by Dec 2004; • BOT Anukret replaced with Concessions Law and Subdecree, relevant to all forms of PPI, by June 2005; • Regulatory frameworks for private provision of electricity, water, telecom, transport and education issued; • Key terms of contracts with the private sector to deliver public services will be disclosed by website by June 2005. • Framework for regulated competitive contracting of water services agreed.		

Bank Performance Measures

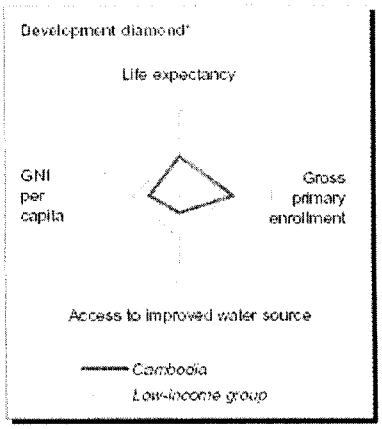
- Cross-organizational multi-disciplinary team maintained, including IFC, MPDF, FIAS and other sector units (PS anchor, rural, public sector).
- Increase in donor alignment on key recommendations; joint tasks undertaken with each partner.

Risks

- **Trade facilitation.** Key risks are (a) high unofficial fees generated within the trade facilitation area by a number of agencies, which provides a strong incentive to retain existing practices, (b) possible narrow reform approaches which will allow leakages to be carried to other parts of process, (c) vested interests who use weak port processes to enable illegal activity, such as drug smuggling; (d) some key officials in process are politically powerful and somewhat autonomous and (e) cross-Ministerial coordination. To mitigate, PM-level buy-in and public monitoring accountability is critical, plus exposure of staff to similar experiences elsewhere that have successfully addressed similar problems.
- **Integration.** Lack of integration is caused by both a lack of trade-supporting institutions (contractual law) and policy-based impediments that add cost and uncertainty, and monopolistic practices. Key risk is that some marketing and distribution channels are controlled by powerful, well-connected business groups, who will use connections to public sector to maintain dominant market position and threaten entry of alternatives.
- **Formalization.** WTO requires reform of import licensing requirements, particularly in agricultural inputs and pharmaceuticals. Constituency for reform loosely organized, with exception of garment sector.
- **PPI Governance.** Key risk is the large transaction sizes which are a substantial incentive to undertake closed, non-transparent concessions and non-competitive transactions, as well as the frequency of closed transactions being undertaken by well-connected business groups. Risk of bid-rigging, or competitive tender processes being undermined by "low-balling" submitting excessively low cost proposals which are implemented by reducing cost of materials or quality, or renegotiated early in the contract period. Many large concessions where opportunities to increase value have already been executed – airports, telecom – but risk involved in reopening.

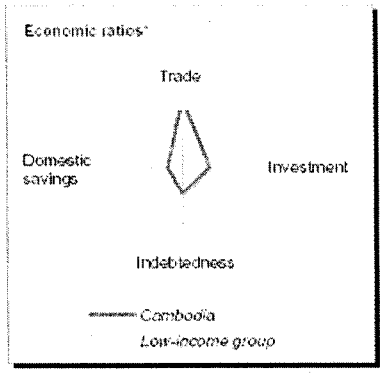
Annex I: Cambodia at a Glance

POVERTY and SOCIAL	Cambodia	East Asia & Pacific	Low-income
2002			
Population, mid-year *(millions)*	12.5	1,838	2,495
GNI per capita *(Atlas method, US$)*	280	950	430
GNI *(Atlas method, US$ billions)*	3.5	1,740	1,072
Average annual growth, 1996-02			
Population *(%)*	2.2	1.0	1.9
Labor force *(%)*	2.6	1.2	2.3
Most recent estimate (latest year available, 1996-02)			
Poverty *(% of population below national poverty line)*	36	..	..
Urban population *(% of total population)*	18	38	30
Life expectancy at birth *(years)*	54	69	59
Infant mortality *(per 1,000 live births)*	90	33	81
Child malnutrition *(% of children under 5)*	45	15	..
Access to an improved water source *(% of population)*	30	76	76
Illiteracy *(% of population age 15+)*	31	13	37
Gross primary enrollment *(% of school-age population)*	110	106	95
Male	117	105	103
Female	103	106	87

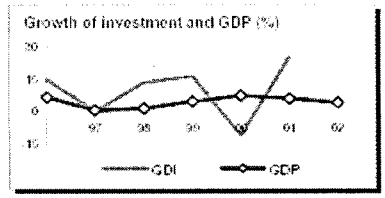


KEY ECONOMIC RATIOS and LONG-TERM TRENDS	1982	1992	2001	2002
GDP *(US$ billions)*	..	2.0	3.4	3.7
Gross domestic investment/GDP	..	9.8	17.9	..
Exports of goods and services/GDP	..	15.7	53.2	..
Gross domestic savings/GDP	..	6.9	9.8	..
Gross national savings/GDP	..	7.6	..	..
Current account balance/GDP	..	-4.7	-3.1	..
Interest payments/GDP	..	0.0	0.1	0.2
Total debt/GDP	..	92.4	79.3	79.1
Total debt service/exports	..	..	1.2	..
Present value of debt/GDP	..	..	67.5	..
Present value of debt/exports	..	..	133.8	..

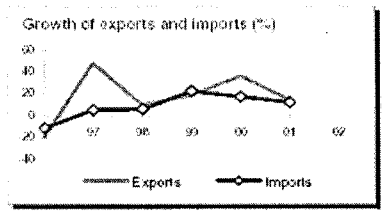
	1982-92	1992-02	2001	2002	2002-06
(average annual growth)					
GDP	5.5	4.8	6.3	4.5	..
GDP per capita	2.2	2.2	4.2	2.6	..
Exports of goods and services	..	19.0	14.6	..	..



STRUCTURE of the ECONOMY	1982	1992	2001	2002
(% of GDP)				
Agriculture	..	47.8	36.9	..
Industry	..	13.2	21.9	..
Manufacturing	..	5.1	..	..
Services	..	39.1	41.2	..
Private consumption	..	83.6	84.2	..
General government consumption	..	9.5	6.0	..
Imports of goods and services	..	18.6	61.3	..



	1982-92	1992-02	2001	2002
(average annual growth)				
Agriculture	5.1	1.7	3.9	..
Industry	6.0	9.8	15.5	..
Manufacturing	6.1	9.2	..	..
Services	5.8	5.4	2.5	..
Private consumption	..	1.7	2.2	..
General government consumption	..	3.1	13.1	..
Gross domestic investment	..	10.5	25.5	..
Imports of goods and services	..	12.2	12.6	..



Note: 2002 data are preliminary estimates.

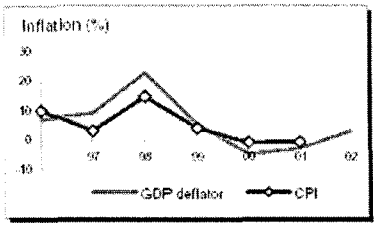
This table was produced from the Development Economics central database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Cambodia

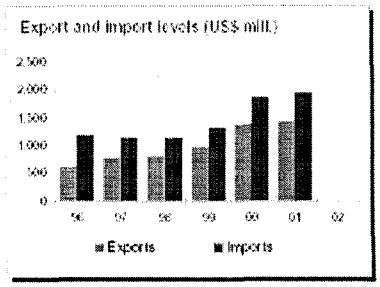
PRICES and GOVERNMENT FINANCE

	1982	1992	2001	2002
Domestic prices				
(% change)				
Consumer prices	..	..	-0.6	..
Implicit GDP deflator	..	75.4	-2.8	3.1
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	6.5	12.2	..
Current budget balance	..	-3.0	1.5	..
Overall surplus/deficit	..	-3.3	-6.0	..



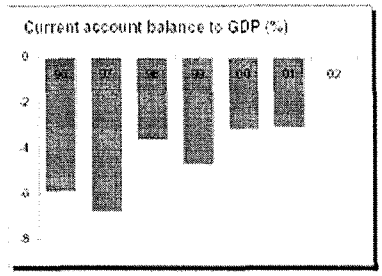
TRADE

	1982	1992	2001	2002
(US$ millions)				
Total exports (fob)	..	265	1,451	..
Rubber	..	12	..	..
Logs and sawn timber	..	25	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	351	1,950	..
Food	..	..	..	..
Fuel and energy	..	..	..	..
Capital goods	..	..	..	..
Export price index *(1995=100)*	..	..	..	..
Import price index *(1995=100)*	..	..	..	..
Terms of trade *(1995=100)*	..	..	..	..



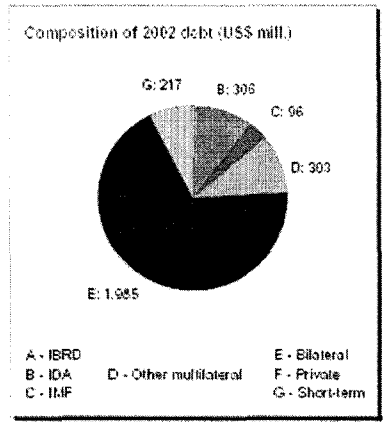
BALANCE of PAYMENTS

	1982	1992	2001	2002
(US$ millions)				
Exports of goods and services	..	314	1,681	..
Imports of goods and services	..	373	2,006	..
Resource balance	..	-59	-325	..
Net income	..	0	-118	..
Net current transfers	..	14	..	..
Current account balance	..	-93	-105	..
Financing items (net)	..	..	171	..
Changes in net reserves	..	..	-66	..
Memo:				
Reserves including gold *(US$ millions)*	..	..	..	..
Conversion rate *(DEC, local/US$)*	..	1,266.6	3,916.3	3,912.1



EXTERNAL DEBT and RESOURCE FLOWS

	1982	1992	2001	2002
(US$ millions)				
Total debt outstanding and disbursed	9	1,831	2,703	2,907
IBRD	0	0	0	0
IDA	0	0	238	306
Total debt service	0	13	21	21
IBRD	0	0	0	0
IDA	0	0	1	2
Composition of net resource flows				
Official grants	21	99	186	..
Official creditors	0	0	91	146
Private creditors	0	0	0	0
Foreign direct investment	0	33	113	..
Portfolio equity	0	0	0	..
World Bank program				
Commitments	0	0	63	30
Disbursements	0	0	40	47
Principal repayments	0	0	0	0
Net flows	0	0	40	47
Interest payments	0	0	1	2
Net transfers	0	0	38	45



The World Bank Group: http://www.worldbank.org/data/ 8/20/03

Annex II: Worker Skills and the Cambodian Economy

Background Cambodia has made significant progress over the last decade in expanding educational opportunities, particularly since 1999, which coincides with the scaling up of the government's Education Sector Support Program (ESSP)/Priority Action Program (PAP). Yet despite the improvement across generations, standard educational attainment indicators for Cambodia are among the lowest in the region. The mean years of schooling of the adult population aged 25 and over in 2001 was only 3.8 years.[95] Child labor interferes with schooling and as such jeopardizes the future supply of skills. The labor force participation rate of children aged 10-14 is significant (21.2 percent), and children comprise 5.5 percent of the labor force.

Figure 1: Literacy and illiteracy rates, 15+ age group, by sex, 1999

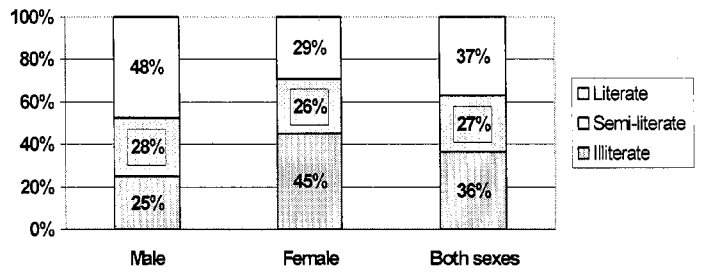
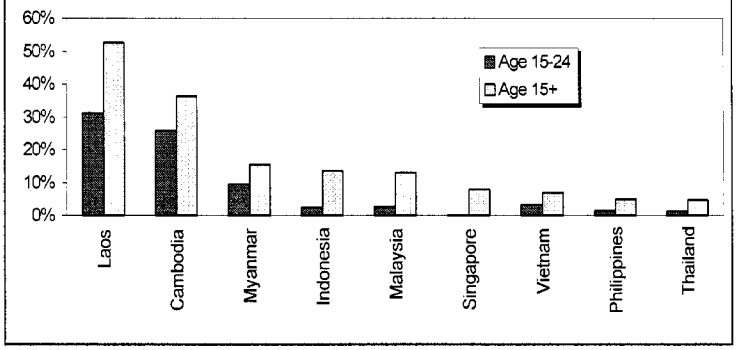


Figure 2: Illiteracy rates, ASEAN countries, age 15-24 & 15+, 1999



Government expenditure in education has increased significantly in recent times, both in absolute terms and as a percentage of the GDP and total public expenditures. Illiteracy rates in Cambodia are far higher, both for the 15-and-over population as a whole and for the 15-24 age group, than in all of its ASEAN neighbors (UNDP 2001) except Laos (Figure 2).

There has been a remarkable improvement in enrollment rates in recent years. However, coverage remains low, particularly in post-primary education. Repetition and dropout rates in primary school remain very high. Although teacher quality has improved, the shortage of teachers and classroom has recently become more acute.

The labor force participation rate increased between 1993/4 and 2001 as Cambodia was making the

[95] This information is based on the most recent Labor Force Survey (LFS 2001), which covered 500 sample villages or a total of 5000 sample households nationwide.

transition to a market economy, from 58 percent to 72 percent. The current demand for skilled and educated workers in the labor market is low, which results in an overall adequacy of skills supplied and skills demanded. Unpaid family labor is still the largest single category of employment status (42.8 percent) which, along with the low proportion of paid workers in wage employment (28.4 percent), indicates the relatively early stage of development of the Cambodian labor market. Women have a significantly higher incidence of unpaid family work than men.

Table A3.1. Sector of primary employment (%)

	Total employment	Self-employment	Wage employment
Agriculture, hunting, forestry	66.04	63.11	20.01
Fishing	4.18	6.04	2.68
Mining, quarrying	0.22	0.09	0.95
Manufacturing	8.73	7.77	26.44
Electricity, gas, water	0.06	0.00	0.37
Construction	1.51	0.61	7.55
Wholesale/ retail trade	10.32	16.72	2.28
Hotels, restaurants	0.17	0.09	0.78
Transport, storage, communications	2.71	3.91	6.65
Financial services	0.10	0.05	0.45
Real estate, renting, business act.	0.26	0.21	0.84
Public administration, defense	2.39	0.04	14.56
Education	1.42	0.03	8.63
Health, social work	0.40	0.17	1.96
Other services	0.89	1.09	2.22
Private households	0.44	0.06	2.59
International organizations	0.16	0.00	1.01
Total	100.0	100.0	100.0

Source: Labor Force Survey

In spite of the limited demand, there are positive, sizable and increasing returns to schooling in the labor market both in terms of wages/earnings and employment-related outcomes. A probit analysis of the 2001 Labor Force Survey data indicates that the returns to schooling in terms of paid employment are very sizable. Having primary school completed increase the chances of working for pay by 12 percent with respect to no school level completed. Wage returns to schooling increase with school level, but this is more accentuated at the lower and upper ends of the wage distribution. These returns reflect shortages in the supply of educated workers and reflect, at least in part, differences in productivity. There is some evidence that labor rigidities may restrict the returns to schooling in such sectors as garments and public administration.

Although the current supply of skills does not pose a serious constraint to the current economic model in Cambodia, the development of new sources of economic growth will. The development of a modern and diversified agricultural sector and industrial development strategy. While the most cost-effective way to improve the stock and quality of human capital in the long run is through the school system, the low rates of literacy and numeracy in the adult population also call for a more short run type of approach based on adult education and formal job training.

Overall, only 6.57 percent of firms report the supply of skilled and educated workers as a major or severe constraint to the operation and growth of their business, while the majority of firms (37.17) do not deem as a constraint at all (Table 18). The garment industry, which accounts for 42.5 percent of workers in

the ICS sample, appears to be the most affected by the skills constraint. Yet even here the percentage of firms reporting major or severe constraint is only around 13 percent. Hence, most firms in the survey deem the skill and education composition of their workforce as adequate for their business.

While the impact of rigid pay policies in adjusting to the observed supply shortage of educated workers in general, but we know that at least labor market rigidities do not prevent more educated workers from earning more than less educated workers. In an attempt to examine how pay policies distort the price of schooling, we estimated wage returns to schooling for 4 major sectors separately: agriculture, manufacturing, construction and public administration and defense.[96] The highest returns to schooling correspond to the construction sector, followed by manufacturing, agriculture and public administration. Civil servants get paid less formally than equally educated workers in other sectors. On the other hand, we saw previously that the average educational attainment in the public administration is actually higher than in the other 3 sectors, and wages are lower. First, it appears that public pay policies distort the price of schooling and thus generate inefficiencies. Furthermore, it is well documented that widespread corruption augments formal compensation for many of these public sector workers.

Although survey responses indicate that labor regulations are a major institutional constraint for only a small percentage of, a closer look at the data is revealing. Only 5.94 percent of firms in the sample deem the constraint from labor regulations as major or severe obstacle, yet these firms represent 42.5 percent of the workers in the sample. However, most of these firms are in the garment sector (57.14 percent), which is the biggest employer in the sample and includes the biggest firms (an average of 1297 workers per firm in contrast with an average of 22 workers per firm in the other sectors).

Finally, the difference in the returns to schooling between construction and manufacturing may also be due in part to the difference in the intensity of labor regulations. In particular, data from the enterprise survey shows that 25.81 percent of firms in the garment sector deem the constraint from labor regulations as major or severe, while only 2.8 percent of firms in the construction sector do. Furthermore, while the average percentage affiliation of workers to trade unions is 82.89 percent, this figure is only 0.40 percent for construction firms. This evidence indicates, again, that labor rigidities may distort the price of schooling in some sectors of the economy.

Do differences in wages by school level reflect differences in productivity or is education simply used as a credential or signaling device? To this end, we estimated the relationship between productivity per worker at the firm level and the proportion of workers with upper secondary school.[97] The results show that the higher the percentage of workers with upper secondary education, the higher the productivity per worker.

Is the current supply of skills a constraint to the development of new sources of growth (as opposed to current sources of growth)? The current sources of dynamism in the economy, garment and tourism, are likely to do little to increase the overall demand for skilled workers in the labor market. Godfrey (2002) argues that Cambodia enjoys a current comparative advantage in natural-resource-based production, initially involving relatively unskilled labor, rather than in the non-agricultural labor-intensive activities for which countries like the Philippines and Vietnam, with high skill levels and labor/land ratios, are better suited. A key constraint to the development of an increasingly modern and diversified agriculture sector is the low proportion of arable land under irrigation, both in comparison with other ASEAN countries and in relation to its potential.[98] Even if the economy adopts the path dictated by its underlying comparative

[96] These results are available upon request.
[97] The model was estimated by OLS and also included the proportion of skilled workers as well the variables in Table 17, geographical area dummies, and sector dummies. The data used for the analysis come from the enterprise survey described earlier. These results are available upon request.
[98] Another key constraint is the poor state of the road network, which also applies to other sectors.

advantage, the supply of skills is likely to be a constraint as the use of irrigation and modern farming technologies require skilled workers. This strategy is certainly at the core of the government's Economic Action Agenda for 2003-2008.

However, the current supply of skills is inadequate to these proposed developments, so to be able to follow this path successfully the stock and quality of education must be improved. School coverage remains low, particularly in post-primary education, repetition and dropout rates in primary school remain very high, and the shortage of teachers and classroom has become more accentuated. In response, two new programs were introduced since 1999. The Education Quality Improvement Project (EQIP) has been providing grants to primary schools for quality improvements, while emphasizing and supporting school management and teacher training. A new wave of educational reforms at the primary school level, known generically under the name PAP (Priority Action Program), started in 2000. These included school grants for routine operating expenses, the abolition of school fees, village-based remediation programs. The resulting improvements in enrolment and flow rates in primary school will pose a serious pressure to the supply of secondary school facilities and teachers in the near future unless actions are taken in that respect. In response to this concern, the government's Education Sector Support Program Plan (ESSP) is considering an integrated approach of demand and supply side interventions at the secondary school level: (1) Targeted school construction; (2) Improved utilization of existing facilities through double shifting of teachers; and (3) Scholarships for girls and the poor.

However, even if all these recent and planned education programs and reforms point in the right direction, increasing the stock and quality of education in the labor market does not create demand for skilled workers. If the labor market and the economy does not keep up in terms of generating enough economic opportunities for educated workers, two problems may emerge. First, the observed returns to schooling in the labor market would be reduced. Second, there would be skill mismatch in the labor market. The two key demand-side distortions that may be subject to public policy reform appear to be:

1) At present, in part due to international agreements designed to quality Cambodia for import quotas in the US market, wage rates are artificially high in the garments sector. With WTO, the incentive for this policy will diminish. The challenge will be either to find higher value-added activities that can maintain high wages for organized workers in this sector, or to address workers' potential disappointment and need to flexibly respond to changing demand.
2) It is clear corruption revenues in the public sector are attracting some higher-skilled workers to public service for the wrong reasons. On the one hand, civil service reform should address the wage distortions that create the mismatch between public employee skills and formal compensation. On the other hand, a serious and well-enforced anti-corruption program is required, so that Cambodia's most skilled workers are channeled by markets to productive activities, rather than diverted to rent-seeking.

Annex III: Methodology: Productivity and Investment Climate Survey

Survey Rationale

Investment climate assessments represent a World Bank Group global initiative to systematically analyze conditions for private investment and enterprise growth. Improving the investment climate is recognized as a key pillar of World Bank Group work to promote economic growth and reduce poverty in developing countries.

Investment climate assessments are envisioned in the World Bank Group's Private Sector Development Strategy as a systematic means to allow:

- Better identification of the features of the investment climate that matter most for productivity and hence income growth,
- Tracking of changes in the investment climate within a country, and
- Comparison of countries and regions within countries

ICAs provide a standardized way of measuring and comparing investment climate conditions in a country, replacing a number of varying methodologies of the past. These assessments highlight the microeconomic and institutional conditions inhibiting constraining productive investment. They identify priority problems whose improvement would yield the greatest and most immediate gains. To this end, ICAs look in detail at impediments (including policy , regulatory and institutional factors) that constrain the effective functioning of product markets, financial and non-financial factor markets, and infrastructure services.

ICAs utilize a set of tools and analytical framework to identify reform priorities in a country's investment climate, by linking constraints to firm-level costs and productivity. Underpinning all ICAs is a **standard core investment climate survey** instrument covering a variety of topics including financing, regulation, supplies and marketing, labor relations, technology and training, conflict resolution and governance. Surveys provide unique, micro-level information on the constraints and performance of firms as experienced by enterprise managers in a local context. Using a standard survey and consistent methodology facilitates comparability among countries. Integrating the survey with other information sources balances the private perspective of businesses with broader policy concerns. Implementing ICAs in partnership with local partners and other donors deepens capacity and ownership.

Survey Execution

The survey was contracted to Indochina Research Ltd., a leading Cambodian Market Research company. It followed the following steps in survey implementation.

Sample Coverage. The sampling was drawn from a wide range of commercial sectors (as agreed with WBG) that were considered to be representative of Cambodian economy and market in terms of sector activity in each survey location: Phnom Penh, Siem Reap, Kampong Cham, Battambang and Sihanoukville.

Selection Process. Respondents were randomly selected from IRL's company and SME database, business association membership lists and the WBG in the case of electric power providers' list. IRL staff also made field visits when contact lists were depleted / insufficient to gain the required number of respondents. This occurred most for gaining contacts in the construction materials and services and agro-processing sectors. Respondents contacted to arrange interview time and place. First contact was made by phone and repeated on average four times before a successful interview appointment was made.

Pilot Interviews. The content and form of the questionnaire was tested using a "pilot" survey using experienced interviewers to conduct face-to-face interviews with 5 randomly chosen SMEs. This pilot survey ensured that the final questionnaire used in the actual survey was as accurate and efficient as possible.

Quality Control. In order to ensure the best quality data collection possible, experienced supervisors managing the fieldwork carried out quality control of the survey results. These staff are experienced in a range of survey methodologies, quality control and procedural aspects of such research projects and will work closely with IRL management, to monitor the performance of interviewers.

Productivity and Investment Climate Dataset and its Purpose

The PICS productivity dataset brings together survey data on firm-level performance by combining and *processing* key productivity questions of World Bank surveys carried out in different countries during the past years. Its main purpose is to support the work of the Investment Climate Unit by making comparative productivity information readily available to colleagues participating in the elaboration of Investment Climate Assessments.

Rather than being a comprehensive gathering of Survey questions, this database builds upon a few key questions by (i) adding extra information crucial for cross-country comparisons and (ii) harmonizing questions across surveys from a "productivity" perspective. The dataset also contains a group of "derived concepts" so that the user can work directly with central variables like labor productivity, capital intensity, unit labor cost, investment ratios, weighted growth rates, and others. Additionally, unique firm identifiers are included so that the user can link other datasets to this one.

The sections below describe the structure of the dataset and discuss some issues related to firm-performance assessment using the dataset.

Structure of the Dataset

The dataset has a three-part structure as indicated below:

Part 1: Firm-level variables

Part 2: Economy-level variables

Part 3: Derived-concept variables

The dataset contains information on multiple years (3, 2, or 1 depending on the survey). The structure of the data is such that different years of a same variable are counted as different variables, where the suffix "_lag#" in the variable name was introduced to denote "# years ago". Naturally, one can always reshape the dataset to stack different years of a sane variable into one single variable indexed by time.

The first part contains firm-level information directly extracted from the original surveys. Unique variable names (e.g. Sales, Fuels, etc) were assigned to common questions across surveys and the information was stacked producing one column for each variable spanning all firms and countries in the sample. At this stage, no outliers were removed.

All "value" questions of block 1 are in local currency units (Cambodia is the only exception since the survey is already in Dollars) and they are normalized so that the numbers indicate thousands of LCU. Sectoral breakdowns are kept as they come in the original survey. This issue is further discussed on the sectoral alignment section ahead.

Missing observations in the dataset indicate that a certain variable was not available in the respective survey. This is a problem for indirect cost and inventory variables in some countries, directly affecting value-added calculations. This issue is further discussed in the conceptual adherence versus sample validation section.

The second part contains country-specific variables that are useful for conducting international level productivity comparisons. As of now, only nominal exchange rates (average of the period) and expenditure-based PPP are reported. These are used to convert LCU to a common currency. In the near future, real and nominal GDP figures will also be included so that the implicit GDP deflator can be calculated and used for inter-temporal comparisons. The issue of whether to use nominal exchange rates or PPP when comparing international productivity levels is further discussed in a separate section below.

The third part contains key productivity concepts derived from Parts 1 and 2 (for instance, partial factor productivity, capital intensity, and unit labor costs).

Estimating Productivity Gaps Across Countries

The calculation of productivity gaps was based on the estimation of a production function pooled across countries (China, India, Bangladesh, Pakistan, Poland, and Cambodia) and sectors (Garment, Food Processing, and IT Electronics) where ordinary least squares combined with White correction for heteroskedascity were used to fit an augmented Cobb-Douglas technology. The specification used was:

$$\ln(Output_i) = cons + \beta_m \ln(Material_i) + \beta_l \ln(Labor_i) + \beta_c \ln(Capital_i) + SectorDumies + \sum_{n=1}^{J-1} \beta_n D_n + \varepsilon_i \quad (1)$$

Where i indexes the firm, n the country where the firm is located, and J denotes the number of countries. India and Food Processing, respectively, were chosen as bases for country and sector dummies. Productivity gaps expressed in relative percentage terms were retrieved from the estimated coefficients on the country dummies as follows:

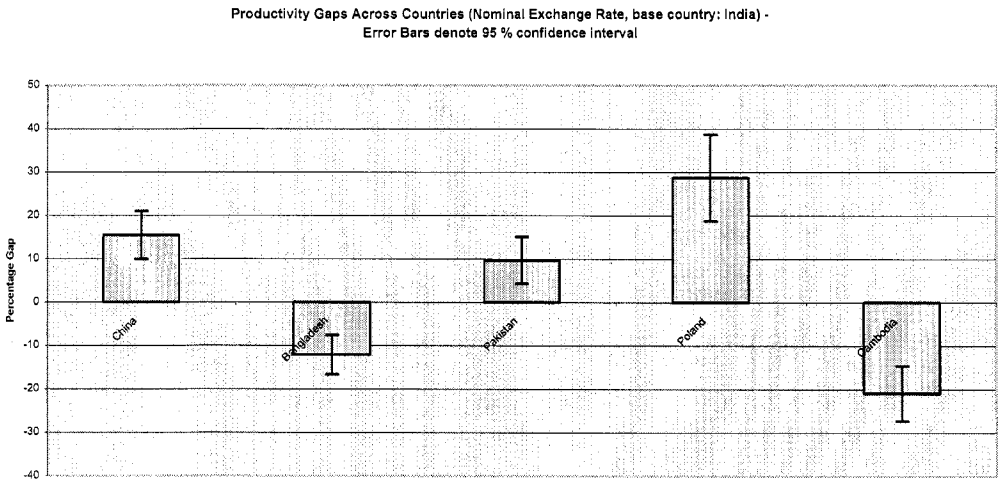
Productivity Gap for country n = [exp (β_n) – 1] * 100, for any country n other than India (2)

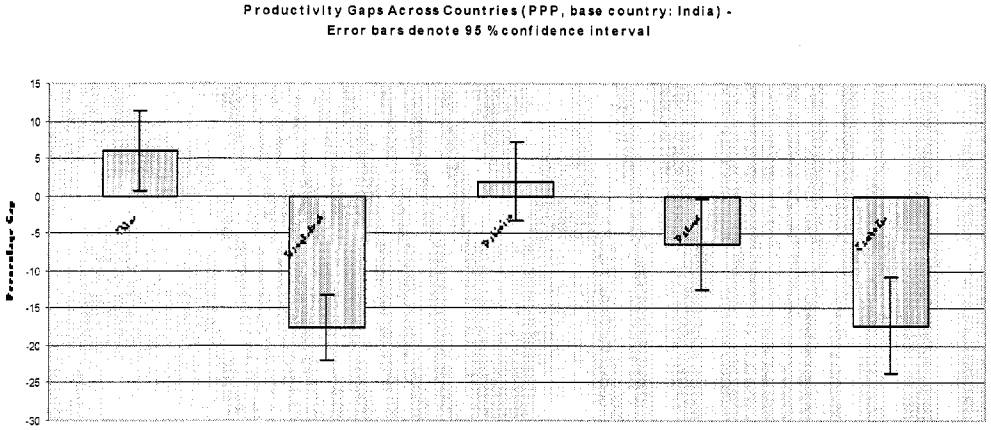
The tables below report estimation results for equation (1) and country productivity gaps as calculated in expression (2).

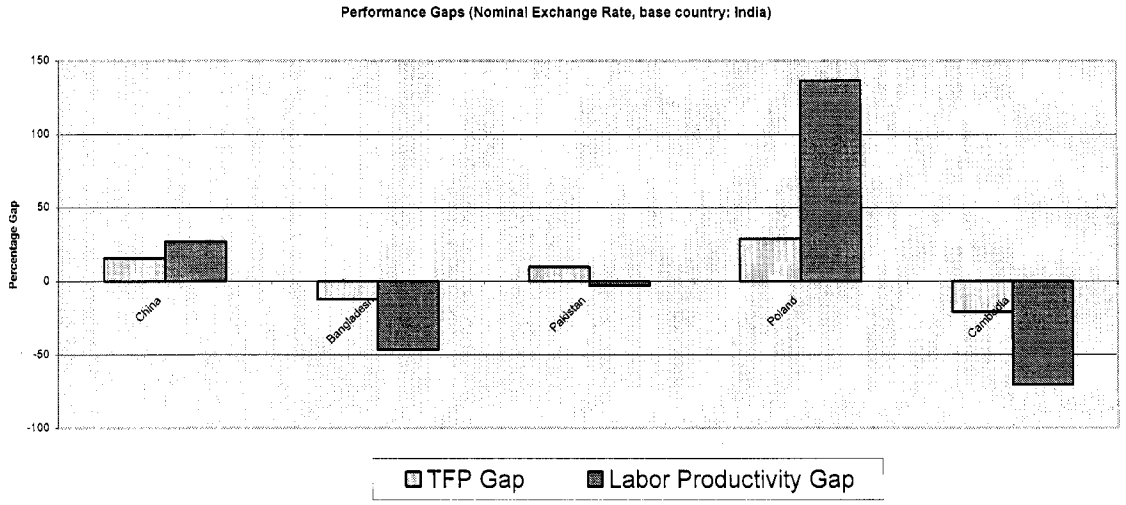
Productivity Gaps – India as Base Country for Productivity Gap

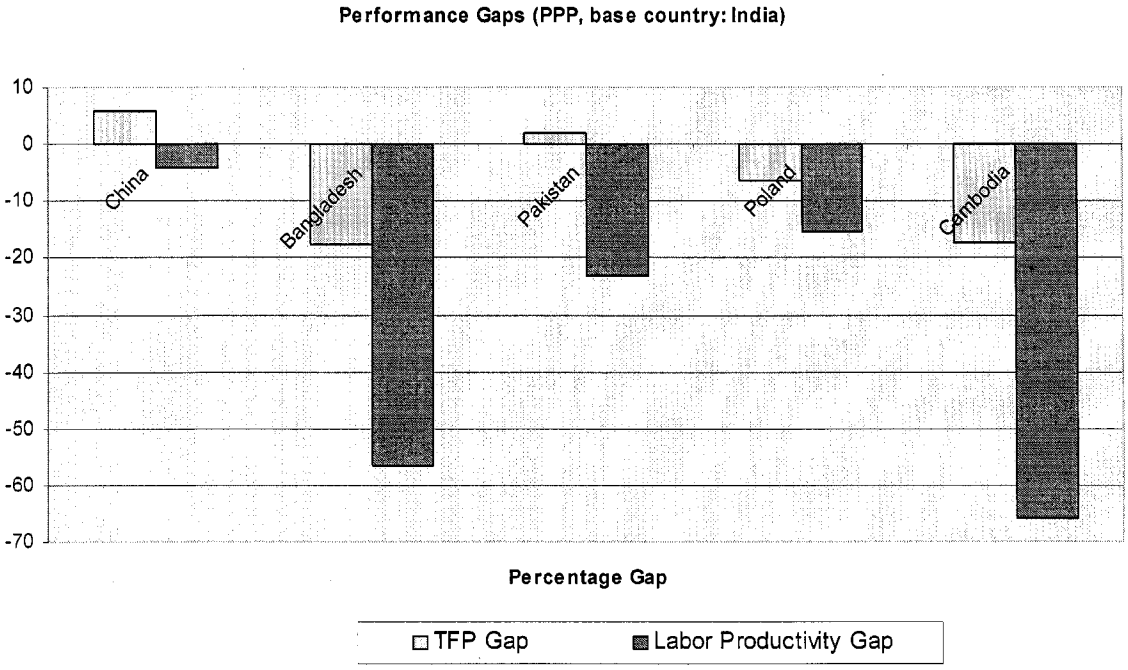
	Nominal Exchange Rate			***PPP***		
ln (Output)	*Coeff*	*Std. Error*	*Productivity Gap (%)*	*Coeff*	*Std. Error*	*Productivity Gap (%)*
Ln (Capital)	0.07[1]	0.009746	NA	0.07[1]	0.009746	NA
ln (Labor)	0.32[1]	0.018611	NA	0.32[1]	0.018611	NA
ln (Material)	0.61[1]	0.015583	NA	0.61[1]	0.015583	NA
China	0.14[1]	0.018949	15	0.06[5]	0.020282	6
Bangladesh	-0.12[1]	0.020889	-12	-0.19[1]	0.021161	-17
Pakistan	0.09[1]	0.019753	10	0.02[N]	0.020506	2
Poland	0.25[1]	0.031372	28	-0.07[5]	0.025866	-6
Cambodia	-0.23[1]	0.032417	-21	-0.19[1]	0.031587	-17
Garment	-0.12[5]	0.034892	NA	-0.12[5]	0.034892	NA
IT	0.09[13]	0.053418	NA	0.09[13]	0.053418	NA

[1] Significant at 1%; [5] Significant at 5%; [10] Significant at 10%; [13] Significant at 13%; [N] Not significant









Probit Analysis of Impact of Investment Climate improvements on probability of firms creating employment.

In order to better understand how investment climate variables relate to firm level performance, several econometric models and specifications were tried. Due to imperfections in data and comparability across countries, the strongest indicator of firm performance for which data was broadly available was determined to be employment growth. This indicator is a satisfying one, in that Cambodia faces a

fundamental challenge of creating employment for its rapidly growing labor force, and employment growth links intuitively to poverty alleviation. A number of indicator variables were identified in parallel for several countries, defined as follows:

Variable description:

LaborGD: Stands for Labor Growth Dummy. It assumes the value one when there was positive labor growth, and zero otherwise. This is the dependent variable of the Probit.

(Regressors)

Labor_lag1: Measures the employment level at the base period. The significant indicates that the likelihood of observing firm growth increases with the labor force.

Age: How many years of existence the firm had at the time of the survey.

ForOwn: Percentage of the firm that is foreign owned.

Export: Percentage of firm's sales that is directly or indirectly exported

MIC_Number~n: Investment climate variable measured as the number of inspections averaged by country.

MIC_BribeTax: Investment climate variable measured as the percentage of sales made in illegal payments averaged by country

MIC_Access~n: Investment climate variable measured as the proportion (within country) of firms saying that Access to financing is a major or severe obstacle to the operation and growth of their business.

MIC_LegalS~m: Investment climate variable measured as the proportion (within country) of firms answering that they tend to agree with the statement that "they are confident that the judicial system will enforce contractual and property rights"

A probit model was specified to determine the influence of changes in each indicator variable on the probability that a firm's employment had grown in the previous year. Below are the results of the model employed.

(standard errors adjusted for clustering on Country Name)

LaborGD	Coef.	Robust Std. Err.	z	P>|z|	[95% Conf.	Interval]
Labor_lag1	.0005907	.0002878	2.05	0.040	.0000265	.0011549
Age	-.0024903	.0069629	-0.36	0.721	-.0161374	.0111568
ForOwn	.0075472	.0020239	3.73	0.000	.0035804	.0115139
ExportP	-.0003331	.0009328	-0.36	0.721	-.0021614	.0014952
MIC_Number~n	-.0160261	.0021671	-7.40	0.000	-.0202734	-.0117787
MIC_BribeTax	-.0750523	.0123989	-6.05	0.000	-.0993537	-.0507509
MIC_Access~n	.6458396	.4129204	1.56	0.118	-.1634695	1.455149
MIC_LegalS~m	.2466293	.070277	3.51	0.000	.1088889	.3843697
_cons	-.3919604	.0586045	-6.69	0.000	-.506823	-.2770977

When interpreting the magnitudes of the coefficients, it is usually a good idea to implement a transformation mapping the slope coefficients above (which capture effects over the quintiles of a normal

distribution) into probability changes (normally evaluated at the mean point of the data). Using a STATA software transformation designed for this purpose yields the table below:

LaborGD	dF/dx	Robust Std. Err.	z	P>|z|	x-bar	[95% C.I.]	
Labor_~1	.0002102	.0001025	2.05	0.040	179.744	9.3e-06	.000411
Age	-.000886	.0024766	-0.36	0.721	11.9332	-.00574	.003968
ForOwn	.002685	.0007186	3.73	0.000	8.67791	.001277	.004093
ExportP	-.0001185	.0003319	-0.36	0.721	33.3197	-.000769	.000532
MIC_Nu~n	-.0057015	.0007686	-7.40	0.000	24.0977	-.007208	-.004195
MIC_Br~x	-.0267009	.0044286	-6.05	0.000	2.64616	-.035381	-.018021
MIC_Ac~n	.2297664	.1467374	1.56	0.118	.337227	-.057834	.517366
MIC_Le~m	.0877418	.0250584	3.51	0.000	.606019	.038628	.136855

This table brings the same model as the first one, but it reports the change in probability for a infinitesimal change in each independent variable (that is, it carries out the transformation I alluded to above). For example, choosing the Bribe Tax, one would interpret the coefficient -.0267009 as indicating that on average, a 1 point worsening of the BribeTax IC measure will reduce the probability of job creation by approximately 2.6 percent. On the other hand, the worsening of the IC inspection measure is 0.57 percent. The IC measures for Credit Access and Legal System are categorical, and must be interpreted accordingly. That is, for example, if the average expressed view of the judicial system enforcing contractual and property rights shifts from "tend to disagree" to "tend to agree", this should be associated with an average increase in the probability of a firm creating jobs of almost 9 percent.

Descriptive Statistics

Table A4.1: Globalization of Markets and Inputs										
	Cambodia	*Micro*	*Small*	*Large*	*Foreign-Invested*	*Domestic*	*Exporter*	*Non-Exporter*	*Low Capacity*	*High Capacity*
Percent of Sales:										
Sold Domestically	86.40	97.76	95.08	32.49	41.74	96.52	13.38	100.00	93.49	76.16
Exported Directly	10.80	2.11	3.93	53.58	49.33	2.06	68.77	0.00	5.38	18.39
Exported Indirectly	2.80	0.13	0.98	13.92	8.92	1.41	17.85	0.00	1.13	5.45
Percent of Inputs/Supplies										
Purchased from Domestic Sources	71.84	86.24	76.09	22.76	36.22	79.92	19.97	81.50	73.92	67.08
Imported Directly	20.83	8.52	17.61	63.70	52.01	13.76	64.71	12.65	20.17	23.80
Imported Indirectly	7.33	5.24	6.30	13.54	11.77	6.32	15.32	5.84	5.90	9.12

	Table A4.2: Competitors and Suppliers										
		Cambodia	*Micro*	*Small*	*Large*	*Foreign-Invested*	*Domestic*	*Exporter*	*Non-Exporter*	*Low Capacity*	*High Capacity*
Average Number of Competitors	Domestic Private Firms	65.12	57.64	70.02	78.68	77.54	62.94	80.23	63.03	67.85	60.90
	State Owned Firms	11.19	1.50	9.89	37.75	32.50	5.76	44.70	5.51	9.86	17.30
	Foreign Owned Firms	37.34	20.73	26.93	63.91	54.34	27.38	60.69	27.06	25.14	58.93
Average Number of Suppliers	Domestic Private Firms	16.86	20.73	16.08	3.16	5.92	18.57	16.15	16.94	18.60	20.56
	State Owned Firms	1.90	1.00	2.60	10.00	2.00	1.89	NA	1.90	1.33	1.71
	Foreign Owned Firms	8.28	4.68	3.32	16.00	13.87	4.20	15.75	4.06	5.92	12.16
Average Number of Customers	Domestic Private Firms	51.92	59.21	53.60	20.58	45.06	53.11	18.84	56.88	49.17	54.49
	State Owned Firms	23.02	34.81	17.57	8.78	9.83	25.85	13.57	23.72	21.14	26.23
	Foreign Owned Firms	23.17	30.97	29.69	9.65	9.96	31.98	6.62	33.25	23.59	18.37

Table A4.3: Respondents' Evaluation to General Constraints to operation										
% of firms evaluating constraint as "major"										
	Cambodia	*Micro*	*Small*	*Large*	*Foreign-Invested*	*Domestic*	*Exporter*	*Non-Exporter*	*Low Capacity*	*High Capacity*
A.Telecommunications	3.21	2.22	3.30	6.33	4.30	2.96	6.33	2.62	3.85	3.14
B.Electricity	12.70	7.52	15.64	19.23	16.13	11.91	16.46	11.99	10.78	15.18
C.Transportation	7.84	9.77	4.47	10.13	3.30	8.88	10.13	7.39	5.80	13.16
D. Access to Land	3.21	1.42	4.02	7.25	5.00	2.84	7.35	2.51	2.68	3.98
E. Tax rates	18.62	15.02	19.43	25.97	23.33	17.53	27.63	16.92	19.03	21.31
F. Tax administration	20.67	17.14	18.08	34.18	29.03	18.65	34.18	18.00	20.00	26.63
G. Customs and Trade Regulations	25.61	27.68	21.09	30.26	31.40	24.07	33.77	23.72	18.97	37.28
H. Labor Regulations	5.94	1.88	5.36	19.23	18.48	2.90	20.51	3.05	3.72	9.34
I. Skills and Education of Available Workers	6.57	5.91	6.21	8.97	5.49	6.82	11.69	5.61	5.70	8.56
J. Business Licensing and Operating Permits	11.73	9.90	11.17	18.42	15.73	10.79	15.58	10.97	10.50	16.67
K.Access to Financing (e.g. collateral)	9.39	12.07	6.38	9.09	7.69	9.81	9.23	9.42	8.42	11.88
L. Cost of Financing (e.g. interest rates)	10.46	14.12	8.55	7.14	7.79	11.08	7.69	10.98	7.37	15.06
M.Regulatory Policy Uncertainty	40.13	44.55	40.35	29.49	37.78	40.68	35.06	41.12	38.07	46.45
N.Macroeconomic Instability (inflation, exchange rate)	19.07	21.90	20.69	8.00	14.94	20.00	10.81	20.60	21.27	18.33
O. Corruption	55.89	59.73	52.22	55.13	60.00	54.98	60.53	55.05	54.31	64.02
P.Crime, theft and disorder	41.70	46.15	41.44	30.38	33.70	43.53	34.62	43.03	40.52	50.26
Q. Anti-competitive or informal practices	33.74	41.15	29.61	22.08	23.60	35.96	26.32	35.08	28.76	42.02
R. Legal system/conflict resolution	31.44	35.61	27.27	28.95	32.22	31.25	36.49	30.47	29.49	35.91

Table A4.4: Infrastructure Indicators

	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Freq of power outages(Days last yr)	5.65	5.76	5.52	5.49	4.92	5.81	4.86	5.78	5.92	5.19
% of production lost due to power outages	2.86	2.59	2.82	2.87	3.58	2.71	3.42	2.77	3.50	2.58
Have own generator (%)	38.97	27.63	43.72	63.29	48.39	36.83	54.43	36.08	34.45	46.60
Have own well (%)	44.14	50.88	45.36	29.11	25.81	48.29	16.46	49.29	39.50	47.12
% of production lost in shipment	1.35	1.04	1.86	1.29	2.03	1.20	2.96	1.07	1.17	1.97
No. of days to obtain a telephone connection	4.15	4.13	4.54	3.88	2.16	5.30	3.04	4.83	3.69	3.69
No. of days to obtain an electricity connection	7.57	7.89	8.74	4.92	4.27	8.91	4.84	8.62	8.88	6.19
No. of days to obtain a water connection	5.59	6.81	5.37	5.19	4.56	6.16	4.42	6.20	4.97	6.19

Table A4.5: Credits, Loans and Liabililities

	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Share with overdraft or line of credit:	6.96	3.07	7.10	17.72	15.05	5.12	17.72	4.95	5.88	7.85
Percent of credit that is currently unused:	34.62	35.00	36.00	33.91	35.50	34.06	28.33	40.00	23.50	35.18
Share with a term loan from a bank or financial institution:	10.14	4.82	12.57	21.52	20.43	7.80	24.05	7.55	9.24	13.09
For the most recent loan or overdraft:										
Share that require collateral:	61.54	0.00	100.00	42.86	66.67	57.14	60.00	62.50	66.67	50.00
Average value of collateral required (as % of the loan):	46.67	NA	52.50	40.00	66.67	26.67	40.00	53.33	45.00	50.00
Average interest rate on loan:	13.44	NA	18.13	5.00	15.40	10.17	17.50	9.38	10.63	20.00
Average duration of the loan: (mns)	7.20	6.00	7.00	7.60	11.67	5.29	10.00	5.33	6.75	10.25
Share of your total borrowing denominated in foreign currency:	78.78	83.86	70.00	84.00	80.00	77.94	80.70	77.65	76.70	79.17
Share of long-term liabilities (1 year or more) in total liabilities:	23.98	14.55	33.18	15.19	7.11	29.61	18.37	24.79	29.41	12.05
Share of short-term liabilities in total liabilities:	11.45	12.16	11.20	10.88	10.23	11.88	7.73	11.80	10.82	12.70
Share of equity earnings (or share capital) and retained in total liabilities	85.53	91.77	83.56	75.57	76.11	87.30	72.95	87.01	87.07	79.97

Table A4.6: Financial Sector -- Auditing, Transaction Costs, and Property Rights	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Share of firms whose financial statements are audited by outside auditors:	13.33	3.05	10.71	45.33	42.05	6.35	45.33	6.93	10.58	17.06
Days to clear the following payments through your financial institution										
check (days)	6.62	8.45	6.16	5.36	5.45	7.28	6.09	6.83	7.04	6.29
a domestic currency wire (days)	6.85	8.95	6.45	5.07	6.78	6.89	9.54	5.76	9.81	4.11
a foreign currency wire (days)	10.97	12.24	11.71	8.79	12.63	9.98	11.94	10.56	12.59	10.57
Share of land that is:										
owned	54.217	56.738	64.12	26.42	11.11	64.31	21.57	60.14	58.44	48.44
leased or rented	40.361	34.043	32.06	73.58	87.30	29.37	78.43	33.45	35.71	46.09
Share of buildings that are:										
owned	53.165	57.407	58.72	26.03	13.48	62.34	20.27	59.25	54.67	50.28
leased or rented	42.405	36.574	37.21	72.60	85.39	32.47	78.38	35.75	41.33	44.69

Table A4.7: Regulatory Burden and Administrative Delays by Country Dimension	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Interpretations of regulations consistent, predictable (% disagreeing)	44.35	42.92	42.44	51.35	53.93	42.16	52.11	43.00	43.75	48.90
% senior management's time spent dealing with regulations	11.12	6.31	15.98	12.81	13.73	10.53	14.66	10.47	10.73	9.07
% revenues typically paid to officials to "get things done"	5.18	3.95	5.49	6.14	6.86	4.82	7.59	4.73	6.06	4.42
% total firm revenues typically reported for tax purposes	48.00	39.74	53.47	60.74	61.12	45.22	60.38	45.92	45.30	50.09
Total wait in days for business registration (days)	17.65	15.11	21.36	14.68	21.43	15.62	14.42	19.04	18.49	11.56
Inspections										
a) Total days spent in inspections or required meetings with officials (days)	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
b) % of meetings/inspections by Local Authorities	28.89	44.91	21.08	20.48	19.87	31.65	27.11	29.32	30.32	32.96
c) Total cost of fines or seized goods (% Sales)	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
d) % of interactions in which informal payment requested	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
e) If yes, value? (Dollars)	312.50	107.71	213.28	881.17	864.00	173.11	1002.10	165.78	161.24	480.83
Imports										
Avg. days to clear customs (days)	6.45	7.75	4.79	7.03	6.22	6.72	6.68	6.16	6.42	4.82
Longest delay to clear customs (days)	11.29	12.44	11.60	9.83	10.13	12.43	9.64	13.27	11.72	12.05
Exports										
Avg. days to clear customs (days)	4.53	2.00	2.14	5.23	4.35	5.38	4.60	3.00	2.20	4.77
Longest delay to clear customs (days)	15.07	5.67	4.63	17.67	12.42	24.58	13.35	45.00	5.23	17.37

Table A4.8: Governance -- Uncertainty and Corruption

	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Uncertainty										
How consistent/predictable are government interpretations of regulations?	55.65	57.08	57.56	48.65	46.07	57.84	47.89	57.00	56.25	51.10
Share of profits reinvested in the firm?	72.67	79.60	71.41	56.41	61.45	75.15	56.96	75.43	80.45	64.22
Confidence in the judiciary.	38.97	38.16	42.08	34.18	31.18	40.73	35.44	39.62	40.76	32.46
Percent of payment disputes resolved in the courts	0.21	0.03	0.21	0.74	0.58	0.12	0.74	0.11	0.35	0.10
Planning Horizon for Investments (months)	12.32	12.33	12.50	12.33	12.45	12.29	11.71	12.44	11.15	13.75
Corruption										
Percent of revenues that are needed for informal payments?	5.18	3.95	5.49	6.14	6.86	4.82	7.59	4.73	6.06	4.42
% Saying Gift/Payment Required for:										
a) A mainline telephone connection	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
b) An electrical connection	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
c) A construction permit	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
d) An import license	91.76	66.67	95.65	95.83	95.74	86.84	96.15	84.85	90.63	90.24
e) Operating license	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
% of Revenue Reported by Typical Establishment for Tax Purposes	48.00	39.74	53.47	60.74	61.12	45.22	60.38	45.92	45.30	50.09

Table A4.9: Labor and Training in International Comparis on and by Firm Characteristic										
	Cambodia	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Labor composition										
Share of workers that are permanent	94.94	98.34	93.25	89.06	95.19	94.88	94.71	94.99	96.91	94.46
Share of permanent workers that are female	30.60	22.65	30.08	57.80	54.52	25.25	62.49	24.77	28.37	33.67
Share of temporary workers that are female	7.24	0.42	2.85	38.52	28.50	2.32	35.08	2.073.23		11.50
Share of permanent skilled workers that are foreign nationals	2.16	0.77	1.458.03		9.39	0.528.43		0.991.02		3.17
Labor turnover										
New employees as share of total	28.37	1.79	4.24	67.13	62.58	7.76	66.91	3.72	14.44	50.07
Employees that left as share of total	13.62	NA	42.67	8.78	8.45	35.61	8.78	29.10	28.56	7.18
Average time to fill for skilled technician vacancy (Weeks)	4.25	3.67	3.824.90		3.64	5.104.80		3.863.56		4.85
Average time to fill production/service worker vacancy (Weeks)	4.90	3.50	7.204.08		3.00	8.003.42		5.942.89		5.67
Excess workforce due to regulatory restrictions	19.32	11.95	26.11	23.08	22.22	18.67	28.21	17.66	20.76	18.42
Training and education										
Share of workforce with less than 6 years schooling	20.76	15.73	23.09	32.03	21.04	20.69	25.61	19.85	22.16	21.91
Share of workforce with more than 12 years schooling	16.35	13.93	20.86	11.78	25.86	14.19	19.51	15.76	18.32	12.18
Share of firms offering formal training	22.47	10.96	27.32	43.04	47.31	16.83	44.30	18.40	22.27	24.61
Share of permanent skilled workers receiving training	60.24	73.60	65.96	42.18	48.84	67.51	52.17	63.86	59.49	62.32
Labor Unrest										
Total days lost to labor disputes or civil unrest	8.13	6.60	11.29	6.92	6.91	9.157.50		8.576.50		7.92

Doingbusiness

Annex IV: Doing Business in 2004 - Cambodia Country Profile

Monitoring, Analysis and Policy Unit
Investment Climate Department
World Bank Group

http://rru.worldbank.org/doing business

Introduction

A vibrant private sector—with firms investing, creating jobs, and improving productivity—promotes growth and expands opportunities for poor people. That is why governments around the world have implemented wide-ranging reforms, including macro-stabilization programs, price liberalization, privatization, and opening to foreign trade. In many countries, however, entrepreneurial activity remains limited, poverty high, and growth stagnant. And other countries have spurned orthodox macro reforms and done well. How so?

Although macro policies are unquestionably important, there is a growing consensus that the quality of government regulation of business and the institutions that enforce this regulation are a major determinant of prosperity. Hong Kong (China)'s economic success, Botswana's stellar growth performance, and Hungary's smooth transition experience have all been stimulated by a good regulatory environment. But there is little work measuring specific aspects of regulation and analyzing their impact on economic outcomes, such as productivity, investment, informality, corruption, unemployment, and poverty. The lack of systematic knowledge prevents policymakers from assessing how good their legal and regulatory systems are and how to design and sequence reforms.

Doing Business in 2004: Understanding Regulation is the first in a series of annual reports investigating the scope and manner of regulations that enhance business activity and those that constrain it. New quantitative indicators on business regulations and their enforcement can be compared across more than 130 countries—from Albania to Zimbabwe—and over time. The indicators are used to analyze economic outcomes and identify what reforms have worked, where, and why.

The indicators presented and analyzed in Doing Business emphasize domestic, small and medium sized companies, which comprise the vast majority of firms, investment and employment in developing countries. Two types of indicators are constructed. First, measures of actual regulations—for example the number of procedures to register a business or an index of employment law rigidity. Second, measures of regulatory outcomes, such as the time and cost to register a business, enforce a contract, or go through bankruptcy.

The methodology is based on detailed assessments of laws and regulations, and surveys of in-country government officials, lawyers, legal consultants, and other professionals involved in administering, or advising on, legal and regulatory requirements. This methodology offers several advantages. It is based on factual information. The data collection process is transparent and easily replicable. It allows multiple interactions with the local respondents, ensuring accuracy by clarifying possible misinterpretations of the survey questions. It is relatively inexpensive to administer and as a result the data can be produced for a large sample of countries. And because the same standard assumptions are applied in collection, the data enable valid cross country comparisons and benchmarking.

Most importantly, the analysis has direct relevance for policy reform. Two features facilitate this. First, Doing Business studies the effects of the indicators on economic and social outcomes. This enables policy makers to understand better how particular laws and regulations affect employment, access to credit, the size of the informal economy, entry of new firms, corruption,

and poverty.

Second, beyond highlighting the areas for policy reform, the analysis provides guidance on the specific design of reforms. The data provide a wealth of detail on which specific regulations and institutions enhance or hinder business activity, what the biggest bottlenecks causing bureaucratic delay are, and how costly compliance with regulation is. Each indicator set is supported by a library of current laws, and a file specifying what regulatory reforms are underway. After reviewing their country's Doing Business indicators, governments can identify where they lag behind and understand what to reform.

The initial data covered in the database and included in this country profile are:

- Starting a Business: Entry Regulations
- Hiring and Firing Workers: Employment Regulations
- Enforcing a Contract: Court Efficiency
- Getting Credit: Creditor Rights and Credit Information
- Closing a Business: Bankruptcy

A full set of topics will be built over a period of three years. New topics will include business licensing and inspections, corporate governance, property rights, taxation and law and order. Once published, each topic will be updated annually. The initial data are benchmarked to January 2003.

The data set covers over 130 economies. The sample includes up to 22 high-income OECD economies as benchmarks, 34 from Africa, 13 from East Asia and the Pacific region, 27 economies from Europe and Central Asia, 21 from Latin America, 17 from the Middle East and North Africa and 6 from South Asia. The sample covers every economy with a population greater than 1.5 million, except for six economies that are not members of the World Bank or are inactive International Development Association borrowers. Inclusion of economies with less than 1.5 million population may be considered on a case by case basis upon request by Governments or World Bank departments.

The following pages present the summary Doing Business indicators for Cambodia. Further information is available in a new annual report entitled Doing Business, which presents the indicators, analyses their relationships with economic outcomes and recommends reforms. The first report Doing Business in 2004: Understanding Regulation, published by the World Bank and Oxford University Press, will be launched in Fall 2003. The data is also available online at http://rru.worldbank.org/doingbusiness and will be published in an annual report.

Summary of Indicators

CAMBODIA		REGION: East Asia & Pacific	
Economic Characteristics		Entry Regulations	
Income per capita	280	Number of procedures	11
Legal origin	French	Time (days)	94
Informal economy (% of income)	..	**Cost (% of income per capita)**	553.8
Population	12,265,220	**Min. capital (% of income per capita)**	1825.8
Labor Regulations		Contract Enforcement	
Flexibility of hiring index	33	Number of procedures	20
Conditions of employment index	81	Time (days)	210
Flexibility of firing index	49	Cost (% of income per capita)	268.5
Employment laws index	54	**Procedural complexity index**	78
Credit Markets		**Bankruptcy**	
Public credit registry operates?	No	Time (in years)	no practice
Public registry coverage (borrowers/1000 capita)	**n. a.**	**Cost (% of estate)**	no practice
Public registry index	**0**	**Absolute priority preserved index**	100
Private credit information bureau operates?	**No**	**Efficient outcome achieved index**	0
Private bureau coverage (borrowers/1000 capita)	**n. a.**	**Goals-of-insolvency index**	25
Creditor rights index	**0**	**Court-powers index**	67

Notes

Employment Regulations

Indices are scored between 0 and 100, with 100 representing the highest level of regulation. The employment regulation index is the average of the flexibility of hiring, conditions of employment and flexibility of firing indices.

Contract Enforcement

The procedural complexity index is constructed by averaging six sub-indices. It varies between 0 and 100, where higher values indicate more complexity in contract enforcement procedures.

Credit Markets

The creditor rights index is calculated by assigning a value of 1 for a "yes" response on each of four types of creditor rights and summing the total score across all four variables. A minimum score of 0 represents weak creditor rights and the maximum score of 4 represents strong creditor rights.

The public registry index measures how well the public credit registry rules are designed to support credit transactions. This index is a simple average of four sub-indices (collection, distribution, access and quality) and its values can range from 0 to 100, where higher values indicate a more extensive registry.

Bankruptcy

Absolute priority preserved index measures the order in which claims are paid in the bankruptcy process. Scores range from 0 to 100. Higher values imply stricter observance of priority for secured lenders. A 100 on Absolute Priority Preserved means that secured creditors are paid before court costs, labor claims and tax claims. A 67 means that secured creditors get paid second, and 33 means they get paid third. A 0 on Absolute Priority Preserved means that secured creditors get paid after all court costs, labor claims, and tax claims are satisfied.

Efficient outcome achieved index measures the success of the bankruptcy regime in reaching the economically-efficient outcome. A score of 1 indicates the efficient outcome is achieved 0 otherwise.

Goals-of-insolvency index is calculated as the simple average of the cost of bankruptcy (rescaled from 0-100 where higher scores indicate less cost), time of bankruptcy (rescaled from 0 to 100, where higher scores indicate less time), the observance of absolute priority of claims, and the efficient outcome achieved. The total goals-of-insolvency index ranges from 0 to 100, with higher values indicating more efficiency.

Court-powers index measures the degree to which the court drives bankruptcy proceedings. Scores range from 0 to 100, with higher values indicating more court-powers.

Starting a Business: Entry Regulations

When an entrepreneur draws up a business plan and tries to get underway, the first hurdles that need to be overcome are the bureaucratic and legal procedures to incorporate and register the new firm.

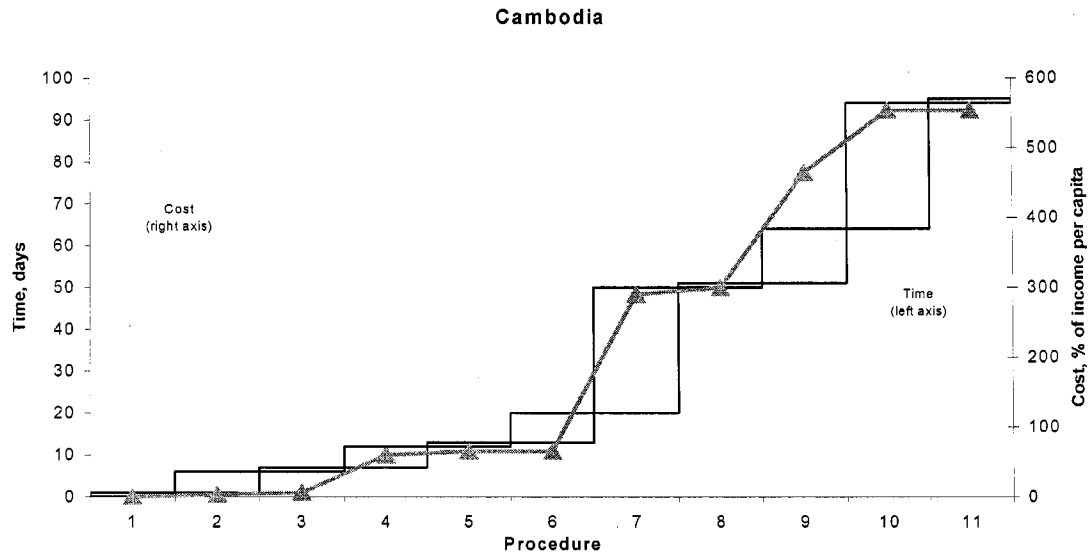
Economies differ significantly in the way in which they regulate the entry of new businesses. In some economies the process is straightforward and affordable. In others, the procedures are so burdensome that entrepreneurs have to bribe officials to speed up the process or they would rather run their business informally.

The entry data is based on a survey in 133 economies, which investigates the required procedures that an average small-medium sized company needs to go through before starting operation legally. This includes obtaining all necessary permits and licenses, and completing all the required inscriptions, verifications and notifications with all requisite authorities to enable the company to start operation. The survey calculates the costs and time necessary for fulfilling each procedure under normal circumstances, as well as the minimum capital requirements to operate. The assumption is that information is readily available to the entrepreneur and that all government and non-government entities involved in the process function efficiently and without corruption.

To make the data comparable across countries, the indicators track the procedures for a standardized, hypothetical company to register a business formally. Detailed assumptions about the type of business are applied. Among these, it is assumed that the business: is a limited liability company conducting general commercial activities in the capital city; that it is 100 percent domestically owned, with start up capital of 10 times income per capita, turnover of 100 times income per capita and between 5 and 50 employees; and that it does not qualify for any special benefits nor dos it own real estate. Similarly detailed assumptions about the type of procedures are made, including that: procedures are only recorded where interaction is required with an external party; the founders complete all procedures themselves; voluntary procedures are not measured by mandatory shortcuts are; and that industry specific requirements and utility hook-ups are not measured.

Across countries, cumbersome entry procedures are associated with more corruption, particularly in developing countries. Each procedure is a point of contact—an opportunity to extract a bribe. Empirical analysis shows that burdensome entry regulations do not increase the quality of products, make work safer, or reduce pollution. They hold back private investment, push more people into the informal economy, increase consumer prices and fuel corruption.

CAMBODIA	
Entry Regulations	
Number of procedures	**11**
Time (days)	**94**
Cost (% of income per capita)	**553.8**
Min. capital (% of income per capita)	**1825.8**

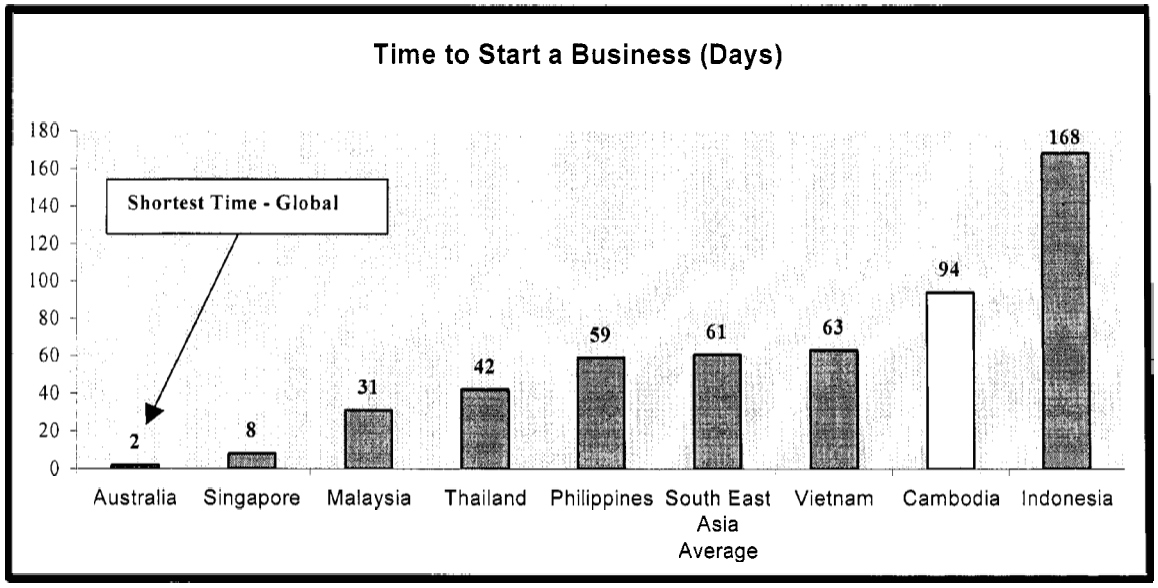


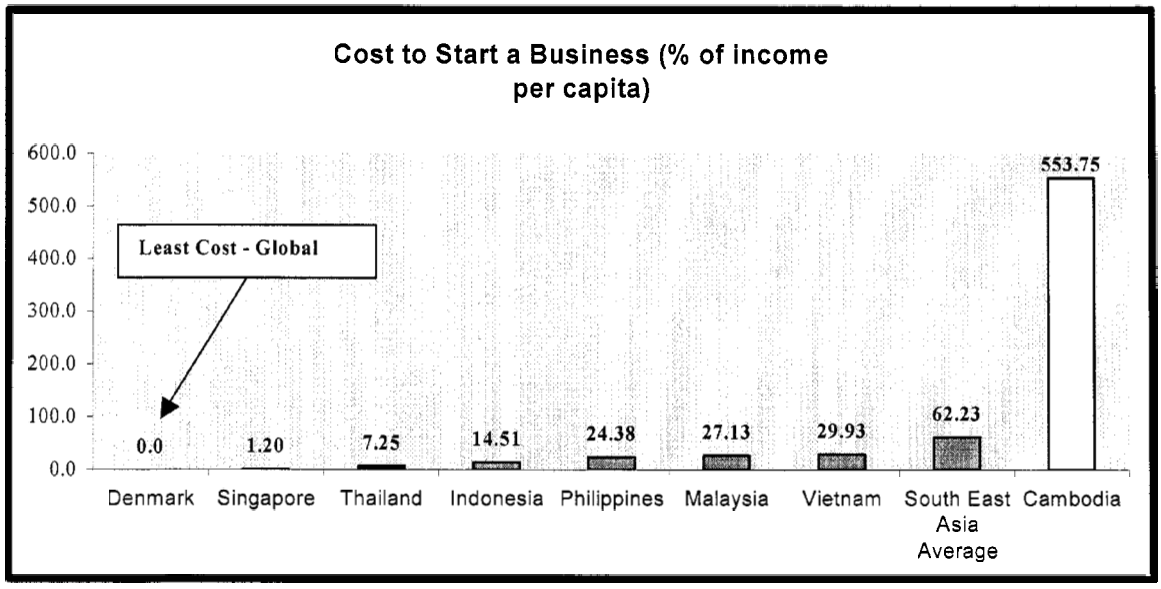
Deposit the legally required initial capital in a bank
Check the uniqueness of the company name
Pick up a company registration form
File the office registration with the Municipal Government
Make a company seal
Publish formation notice
Incorporate the company with the Commercial Register
Have registration documents stamped
Register the company for VAT
Notify the Ministry of Labor
Receive Inspection from Labor Inspector

Source: Doing Business Database.

Benchmarking—Entry Regulation

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries





Source: Doing Business Database.

Hiring and Firing Workers: Employment Regulation

Every economy has established a complex system of laws and institutions intended to protect the interests of workers and to guarantee a minimum standard of living for its population. This system encompasses four bodies of law: employment laws, industrial relations laws, occupational health and safety laws, and social security laws. Doing Business examines government regulation in the areas of employment laws.

An employment regulation index is an average of three sub-indices: flexibility of hiring, conditions of employment, and flexibility of firing. Each index takes values between 0 and 100, with higher values implying more rigid regulation. Flexibility of hiring covers the availability of part-time, fixed-term, and family members' contracts. Conditions of employment cover working time requirements, including mandatory minimum daily rest, maximum number of hours in a normal workweek, premium for overtime work, and restrictions on weekly holiday; mandatory payment for non-working days, which includes days of annual leave with pay and paid time off for holidays; and minimum wage legislation. Flexibility of firing covers workers' legal protections against dismissal, including the grounds for dismissal, procedures for dismissal (individual and collective), notice period, and severance payment.

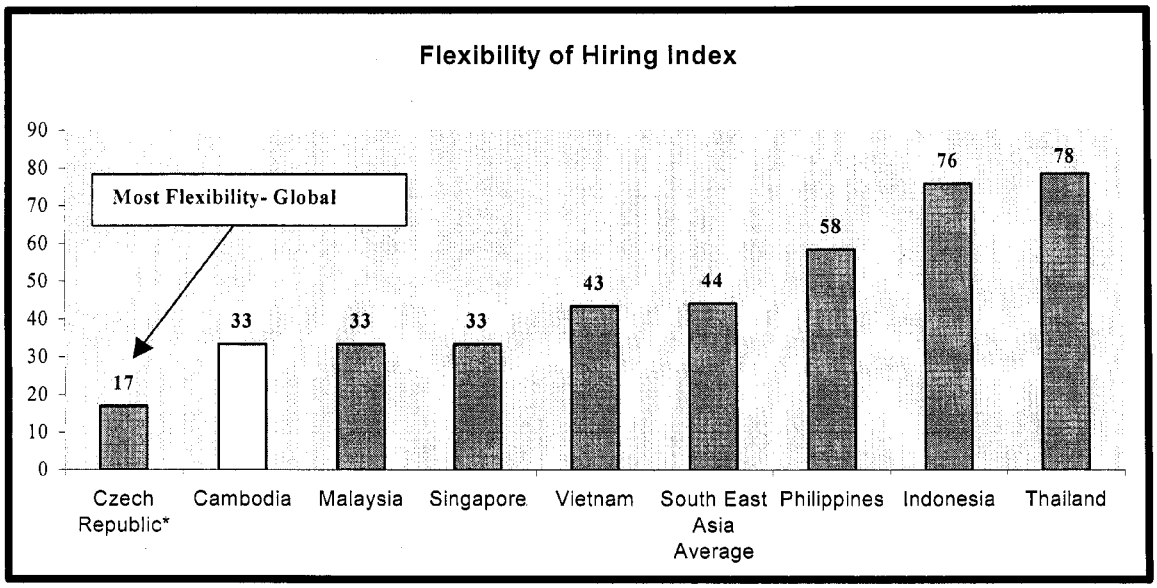
The indicators on employment regulations are based upon a detailed study of employment laws and industrial relations laws. Data are also gathered on the specific constitutional provisions governing these two areas. In most cases both the actual laws and a secondary source were used to ensure accuracy.

To make the data comparable across countries, a range of assumptions about the worker and the company are applied. Among others, assumptions on the worker include that he is a non-executive full-time employee in the same company for 20 years, has a non-working wife and two children and is not a member of the labor union (unless membership is mandatory). It is assumed that the company is a limited liability manufacturing corporation that operates country's most populous city. It is 100 percent domestically-owned, and has 201 employees.

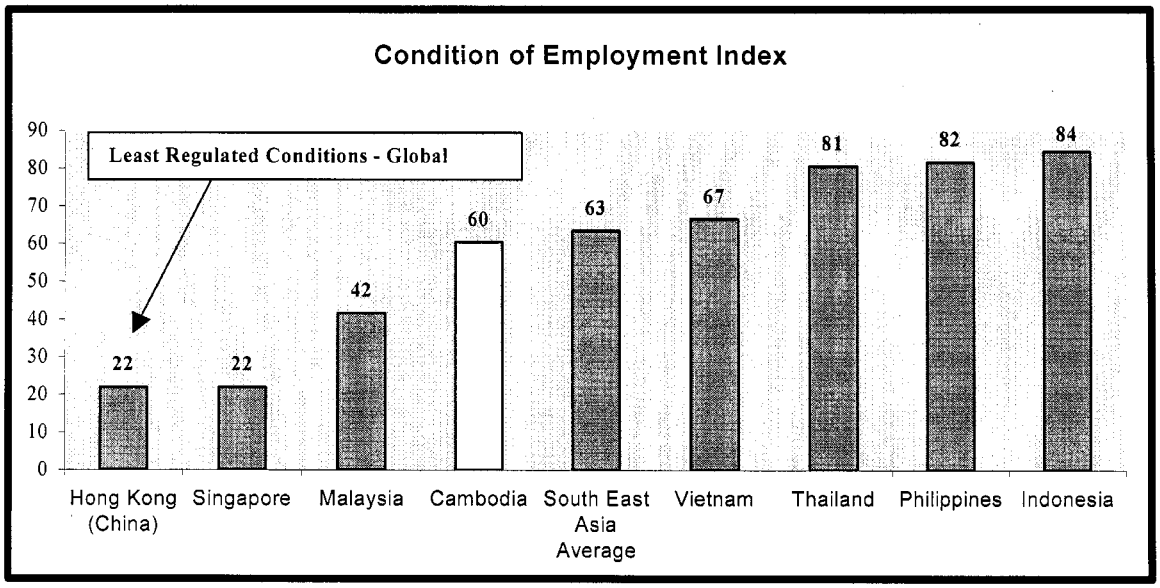
Although most employment regulations are enacted in responses to market failures, it does not mean that today's regulations are optimal. Analysis of the indicators across countries shows that while employment regulation generally increases the tenure and wages of incumbent workers, strict regulatory intervention has many undesirable side-effects, including less job creation, longer unemployment spells and the related skill obsolescence of workers, less R&D investment and smaller company size—all of which may reduce productivity growth. And with fewer job opportunities in the formal economy, the expansion of an unofficial sector becomes inevitable.

Benchmarking—Employment Regulation

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries



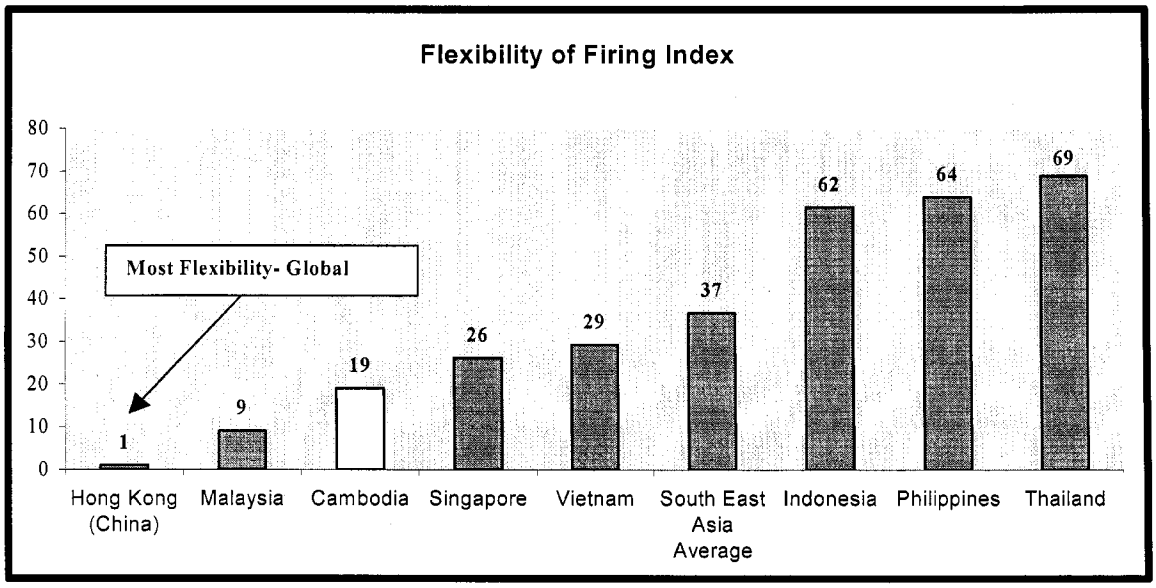
**Other countries which offer the most flexibility globally include Nigeria, Papua New Guinea and China.*

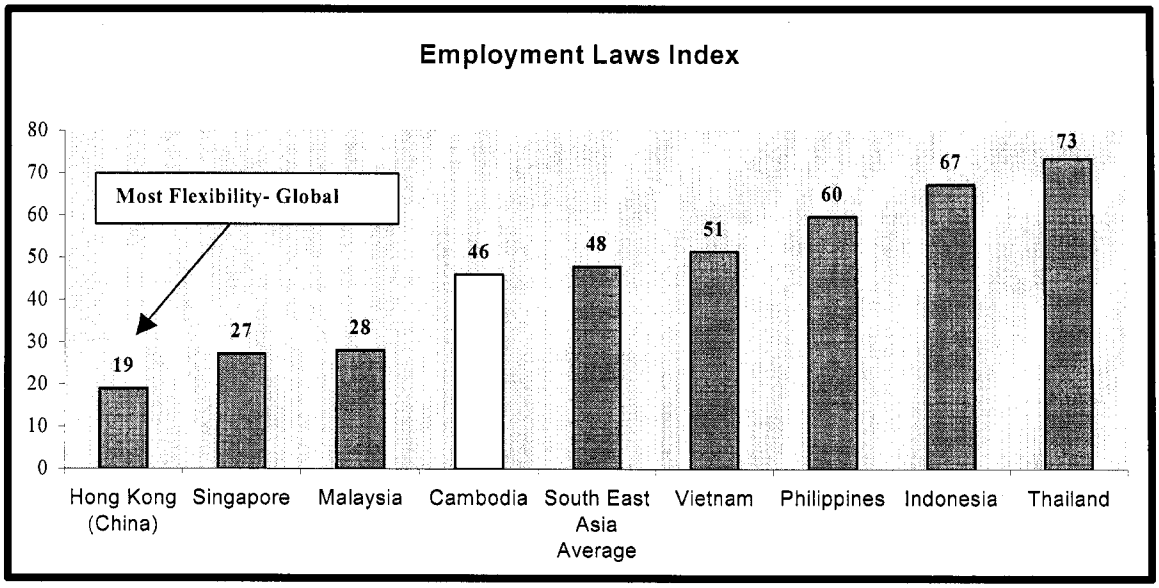


Source: Doing Business Database.

Benchmarking—Employment Regulation

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries





Source: Doing Business Database.

Enforcing a Contract: Court Efficiency

Contract enforcement is critical for businesses to engage with new borrowers or customers. The institution that enforces contracts between debtors and creditors, suppliers and customers is the courts. In many countries around the world, courts are slow, inefficient, and even corrupt. The evidence here tracks the differences in the efficiency of contract enforcement, looking at simple transactions of relevance to the average business in everyday business activity.

The indicators on contract enforcement are constructed assuming a hypothetical case of a payment dispute over 50 percent of income per capita in the country's most populous city. The data track the procedures to recover the debt through the courts. It is assumed that the plaintiff has fully complied with the contract (plaintiff is 100 percent right) and files a lawsuit to recover the debt. The debtor attempts to delay and raises opposition to the complaint. The judge decides every motion for the plaintiff. There are no appeals or post-judgment motions. The data are derived from reading of the Codes of Civil Procedures and other court regulations, as well as administering surveys to local litigation attorneys. The respondents are members of the Lex Mundi or Lex Africa association of law firms, with at least two lawyers participating in each country.

Based upon the survey responses, four indicators of the efficiency of enforcement of commercial contracts are developed. The first indicator is the number of procedures, mandated by law or court regulation, that demand interaction between the parties or between them and the judge or court officer. The second indicator of efficiency is the time—in calendar days—of dispute resolution. Time is measured as the number of days counted from the moment the plaintiff files the lawsuit in court, until the moment of settlement or, when appropriate, payment. This measure includes both the days where actions take place and waiting periods between actions. The third indicator is the official cost of going through court procedures. The cost includes court costs and attorney fees. Finally, an index of the procedural complexity of contract enforcement is built by scoring countries on how heavily regulated the dispute resolution process is.

Companies that have little or no access to efficient courts must rely on other mechanisms—both formal and informal, such as credit bureaus, trade associations, social networks, or private information channels—to decide whom to do business with and under what conditions. Companies may also adopt conservative business practices and deal only with repeat customers. Transactions are then structured to forestall disputes. Whichever alternative is chosen, economic and social value may be lost. The main reason to regulate procedures in commercial dispute resolution is that informal justice is vulnerable to subversion by the rich and powerful. But heavy regulation of dispute resolution has negative consequences. Across countries, the more procedures it takes to enforce a contract, the longer the delays and the higher the cost. Moreover, higher levels of complexity in the procedures to enforce a contract are associated perceived unfairness, corruption, inconsistency and dishonesty in the judiciary.

The indicators make clear that contract enforcement in Cambodia is very expensive in comparison to many other countries in the region, and five times the regional average as measured by percent of per capita income. In terms of time, contract enforcement appears on a par with Thailand and below the regional average. However, other nearby countries, including Singapore and Vietnam, resolve conflicts in much less time.

Doingbusiness

Contract Enforcement

This table provides a summary list of four indicators of performance on contract enforcement: number of procedures, duration, cost, and a procedural complexity index (including its six sub-indices and their components).

Top of Form

Cambodia

Bottom of Form

Contract Information	Indicator
Number of procedures	**20**
Duration (days)	**210**
Cost (% income per capita)	**268.5**
Procedural Complexity Index	**78**
Professionals or Laymen	0.67
Written or Oral	1.00
Legal Justification	0.67
Statutory Regulation of Evidence	0.38
Control of Superior Review	1.00
Other Statutory Interventions	1.00

Top of Form
Bottom of Form

Notes: Sub-index components are scored between 0 and 1, with 1 representing the highest level of complexity. The procedural complexity index is constructed by averaging the six sub-indices and multiplying by 100. It varies between 0 and 100, with higher values indicating more complexity in contract enforcement procedures.

Sub-indexes:

Professionals or laymen index measures the required legal expertise of the person settling the dispute.

Written or oral index measures whether the stages of the process are normally carried out orally or in written form.

Legal justification index measures the level of legal formalism of the documentation filed during the enforcement process.

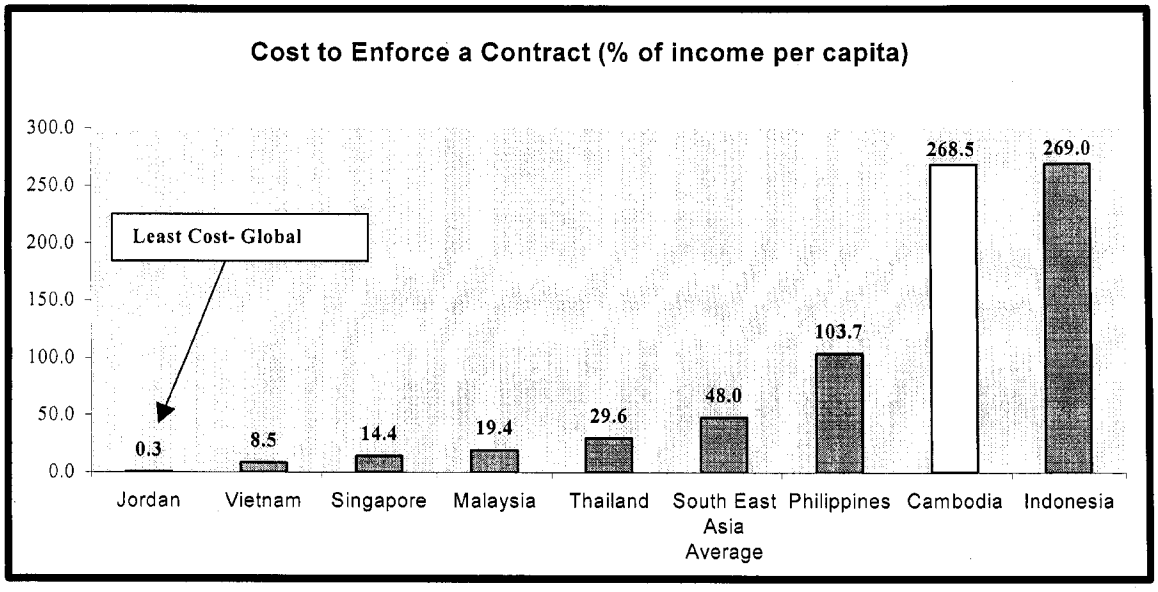
Statutory regulation of evidence index measures the levels of formality when introducing evidence during the enforcement process.

Control of superior review index measures how the enforcement process is affected by appeal proceedings.

Other statutory interventions index measures the review role exercised by the courts during the judicial process.

Benchmarking—Contract Enforcement

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries



Source: Doing Business Database.

Getting Credit: Creditor Rights & Credit Information

Access to credit is consistently rated by firms as one of the greatest barriers to operation and growth. Two sets of issues, credit information registries and creditor rights, are covered by the database.

Access to credit may be expanded significantly by credit registries - institutions that gather and disseminate information on credit histories. The information sharing role of credit registries helps creditors to assess risk and allocate credit more efficiently, which means that entrepreneurs don't need to rely on only personal relations when trying to obtain credit. The indicators report whether public credit registries or private credit bureaus operate in surveyed countries and the amount of credit information they cover. An index of the extent to which the rules of credit information registries facilitate lending is constructed on the basis of: scope of information collected; scope of information distributed; ease of access to information and quality of information. The data were obtained from surveys of public and private credit registries.

Effective regulations on secured lending - or collateral - are another institutional solution to credit constraints. With collateral, a lender can seize and sell the borrower's secured assets upon default of a loan, which limits the potential losses of a lender and acts as a screening device of borrowers. Therefore with effective collateral law, systems and enforcement, one may expect increased access

to credit and better allocation of credit. Doing Business reports an indicator of creditor rights, which measures the powers of secured lenders in bankruptcy.

The creditor rights indicator is an index that measures four powers of secured creditors in liquidation and reorganization laws. First, whether there are restrictions, such as creditor consent, on entering into reorganization proceedings. Second, whether there is no automatic stay (or 'asset freeze') on realizing collateral upon bankruptcy. Third, whether secured creditors are satisfied first upon liquidation, and finally whether management is replaced by a court or creditor appointed receiver in reorganization. Data for the variables were obtained from an examination of bankruptcy laws and legal summaries, verified through a survey of bankruptcy lawyers and cross checked with data gathered for the Doing Business bankruptcy project.

These two measures are important indicators of well functioning credit markets. Across countries, stronger creditor rights and more information sharing are associated with deeper credit markets and lower default rates. The presence of credit registries is also associated with a lower spread between lending and deposit rates. Firms in countries with information sharing are less likely to report obstacles to obtaining finance and evidence of credit constraints. Countries with stronger legal creditor protections have larger debt markets, and higher rates of capital investment and productivity growth.

Evident in the tables below, Cambodia clearly lacks essential structure in both fields- creditor rights and information sharing. There is neither a debtor-oriented rehabilitation procedure in Cambodia nor institutions that assure credit information sharing. The decision to rehabilitate is made by a creditor meeting, once insolvency proceedings have commenced and foreclosure is stayed throughout this process. Direct liquidation is the most likely procedure to be used in the case of insolvent debtor firms.

Doingbusiness

Getting Credit: Creditor Rights & Credit Information

This table shows two measures: indicators of the presence and structure of public and private registries, and a creditor rights index measuring the powers of secured lenders. To relate these indicators to outcomes the table lists three credit market outcomes.

Top of Form

Cambodia

Bottom of Form

Credit Information	Indicator
Public credit registry (PCR) operates	No
Year of PCR establishment	n. a.
PCR coverage (borrowers per 1000 capita)	n. a.
PCR Access Index	0
PCR Collection Index	0
PCR Distribution Index	0
PCR Quality Index	0
PCR Index	**0**
Private credit bureau operates	No
Private credit bureau coverage (borrowers per 1000 capita)	n. a.

Creditor Rights	Indicator
Restrictions on entering reorganization	No
No automatic stay on enforcing security	No
Secured Creditors are paid first	No
Management does not stay during reorganization	No
Creditor Rights Index	**0**

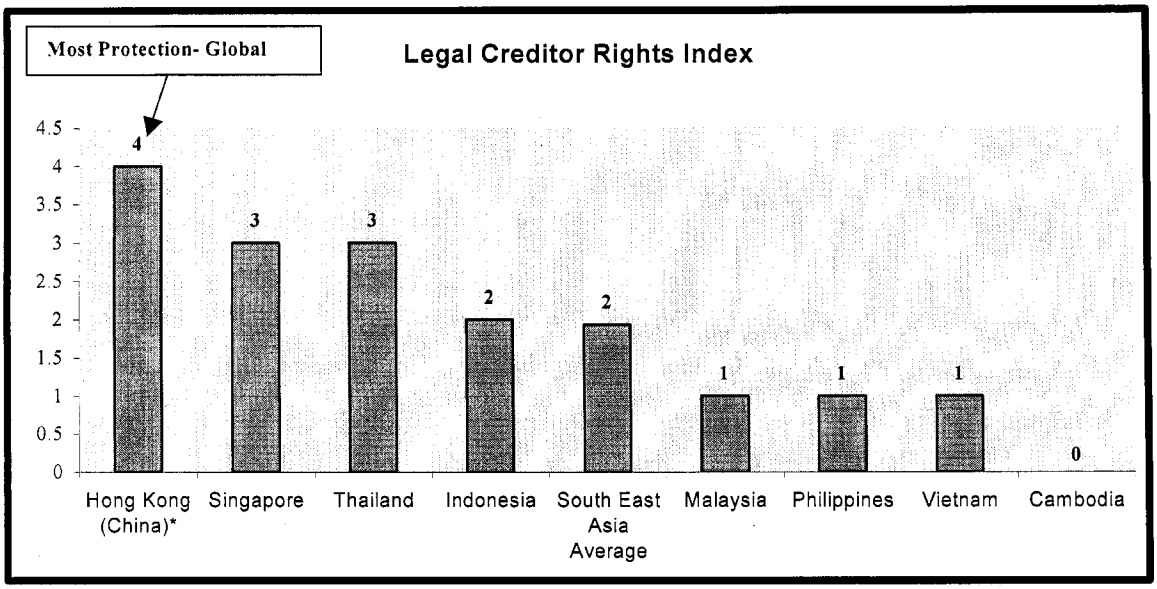
Credit Market Outcome Variables	Indicator
Private credit (% GDP)	0.1
Five bank concentration ratio (%)	..
Interest rate spread (%)	10.8

Note: Scores for each of the public credit registry indices on collection, distribution, access, quality can range from 0 to 100. The total public credit registry index is the simple average of the collection, distribution, access and quality indices, and ranges from 0 to 100. Higher values indicate that the rules of the public credit registry on collection, distribution, access and quality are better designed to support credit transactions. The creditor rights index is calculated following the methodology of La Porta et. al (1998) by first assigning a value of 1 for a "yes" response on each of the four types of creditor rights and then summing the total score across all four variables. A minimum score of 0 represents weak creditor rights and the maximum score of 4 represents strong creditor rights.

Source: Doing Business Database.

Benchmarking—Creditor Rights Indicator

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries



** Other countries which offer the most protection globally include Kenya, Lebanon, New Zealand, Nicaragua, Nigeria, Panama, Zimbabwe, and the UK.*

Source: Doing Business Database.

Benchmarking - Credit Information Indicators

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries

The table shows the coverage of credit registries in Cambodia and selected benchmarks with indicators on the number of registered borrowers per 1000 inhabitants.

Country	Coverage Public Registry (borrowers / 1000cap.)	Coverage Private Bureau (borrowers / 1000cap.)
Portugal	496 (highest coverage)	24
Norway	0	945 (highest coverage)
Malaysia	105	no data
South East Asia Average	9	24
Indonesia	3	0
Singapore	2	0
Vietnam	2	0
Thailand	0	98
Philippines	0	22
Cambodia	0	0

Source: Doing Business Database.

Closing a Business: Bankruptcy

Recent economic crises in emerging markets, from East Asia, to Latin America, to Russia and Turkey, have raised concerns about the design of bankruptcy systems and the ability of such systems to help reorganize viable companies and close down unviable ones. In countries where bankruptcy is inefficient, unviable businesses linger around for years, not allowing assets and human capital to be reallocated to more productive uses. Most often, the bottlenecks in bankruptcy are associated with the inefficient judicial process, and hence the unwillingness of banks and other lenders to push for a formal bankruptcy resolution.

In this set of indicators, the focus is on identifying weaknesses in the existing law, as well as the main procedural and administrative bottlenecks in the bankruptcy process. In many developing countries, bankruptcy is so inefficient that creditors hardly ever use it. In such countries, policy reform would best focus on improving contract enforcement outside of bankruptcy.

The indicators are derived from questionnaires answered by attorneys at private law firms and bankruptcy judges. Most respondents are members of the International Bar Association.

The data track the step by step procedures for a hypothetical company to go through the bankruptcy process. It is assumed that the company is a domestically owned limited liability corporation, operating a hotel in the most populous city. The company has 201 employees, 1 main secured creditor and 50 unsecured creditors. Detailed assumptions about the debt structure and future cash flows are made. It is assumed that the company becomes insolvent on January 1. The case is designed so that the company has a higher value as a going concern—that is, the efficient outcome is either reorganization or sale as a going concern but not piecemeal liquidation.

Six indicators were constructed from the survey responses: the time and cost to go through the bankruptcy process, a measure of whether absolute priority for secured lenders is preserved throughout the process, a measure of whether the efficient outcome is achieved in the hypothetical case. An aggregate "goals of insolvency" measure was built by averaging the scores on time, cost, priority, and whether the efficient outcome is achieved. Finally, an indicator of court powers in the bankruptcy process was constructed.

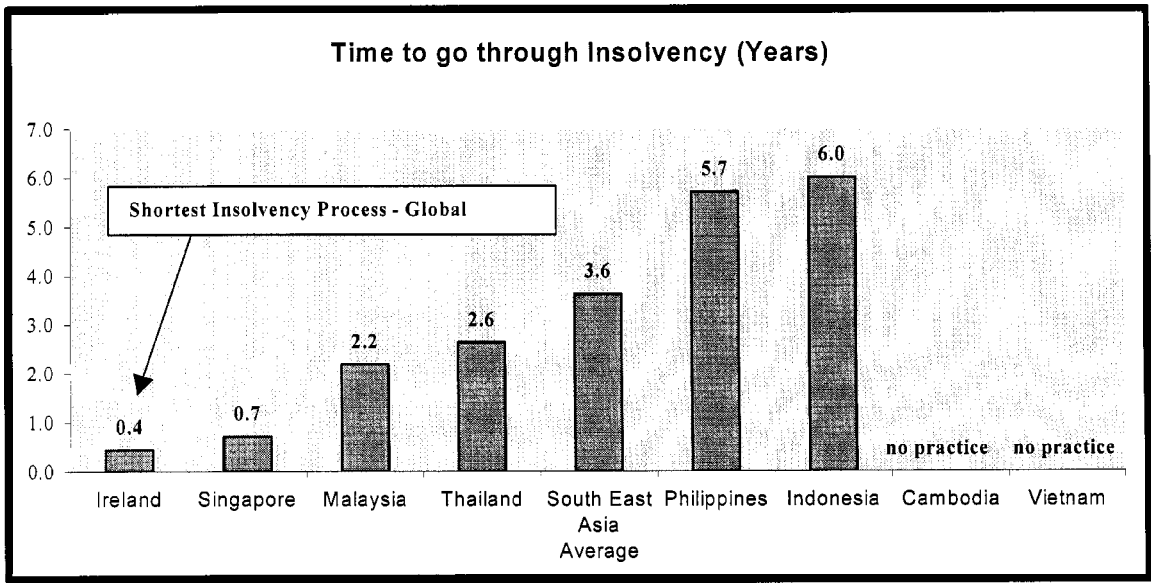
Countries with ill-functioning judiciaries are better off without sophisticated bankruptcy systems. There is a general misperception that bankruptcy laws are needed to enforce creditor rights. In practice, the laws usually exacerbate legal uncertainty and delays in developing countries. Private negotiations of debt restructuring under contract law, the efficient enforcement of secured debt contracts outside insolvency under collateral law, through summary judgments and private enforcement will do better. Bankruptcy law is often oriented to closing down unviable companies. But sometimes the bias toward discontinuing the business may lead to the premature liquidation of companies in temporary distress—and a loss of value to society.

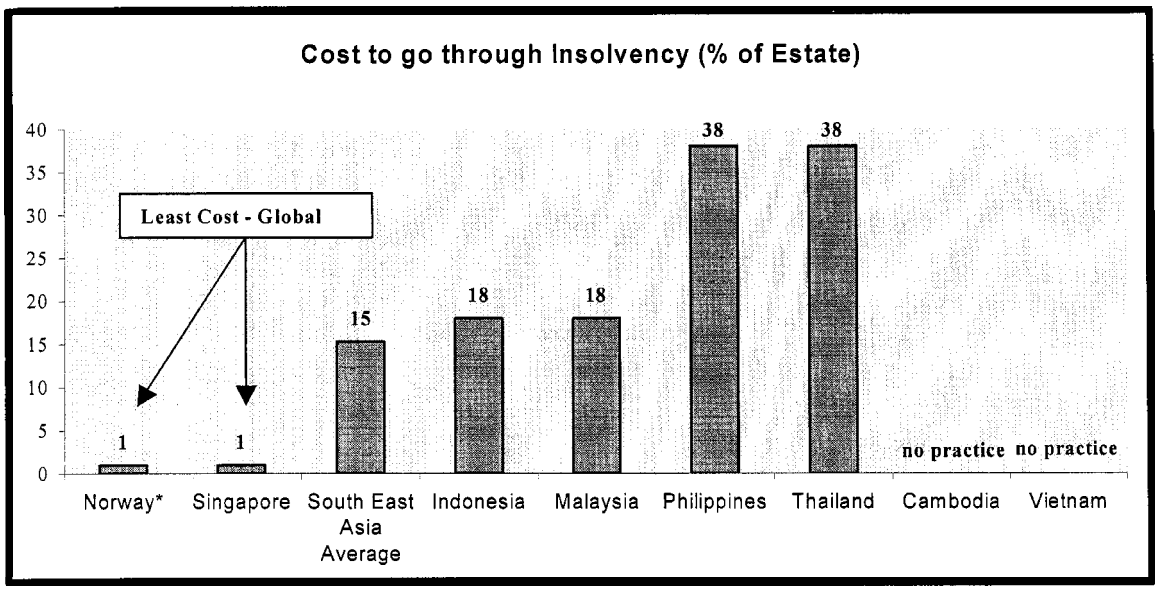
There is no law on insolvency or liquidation in Cambodia. The Draft Law on Insolvency, introduced in July 2002, has not been enforced yet, but is the most likely basis for future practice. If fact, in those areas of business where the only legislation is draft legislation, the governmental authorities and the courts tend to use such draft legislation as practical guidance pending the enactment of the legislation. Given its recent nature, the Draft Law on Insolvency has not been in

existence long enough to provide reliable statements about the development of practices and procedures guided by the draft law itself. The court with bankruptcy jurisdiction, TOLAKA KHET/ KRUNG, Is plagued by work overload. Further, the lack of civil procedure legislation make the use of delaying litigation extremely easy for parties wishing to do so.

Benchmarking—Bankruptcy

Cambodia—Compared to Global Best / South East Asia Average / Selected Other Countries





**Finland and Colombia also have cost equal to 1% of estate value.*

Source: Doing Business Database.

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