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Preface

by

Masamichi Kono, Deputy Secretary-General, OECD

Cambodia has been one of the world's fastest growing economies, attaining lower middle-income status in 2016. Strong and stable growth has meant that poverty has been substantially reduced. The economy is one of the most open to foreign direct investment both in the region and worldwide, and WTO membership in 2004 further accelerated and consolidated the reforms. Its exports, particularly of garments, have been resilient, in spite of the growing competition from other emerging economies. State-owned enterprises are also far less prominent in Cambodia than in other countries in the region or those at similar levels of development.

This performance has been impressive by any standards, especially for a country with few natural resources, but Cambodia still faces many challenges going forward. Although much of the population has escaped dire poverty, many still remain "near poor". Growth is heavily dependent on garment exports which leaves the economy vulnerable to external shocks such as the erosion of preferential market access. Like other countries in the region, Cambodia is also highly vulnerable to climate change. The government recognises these challenges and has set out an ambitious agenda in successive National Strategic Development Plans and the Industrial Development Policy 2015-25.

Drawing on OECD's *Policy Framework for Investment* (PFI), this first OECD *Investment Policy Review* of Cambodia looks at how improvements in the overall investment climate can contribute to promoting competitiveness, diversification and sustainable and inclusive development. The *Review* is the result of an ever closer co-operation between the Royal Government of Cambodia and the OECD, including most recently Cambodia's participation in the Programme for International Student Assessment (PISA) for Development. It also builds on the OECD's longstanding partnership with the Association of Southeast Asian Nations (ASEAN) on investment policy reform.

We would like to express our gratitude to the Economic Co-operation Support Programme of the ASEAN-Australia-New Zealand Free Trade Area for supporting the *Review*. We hope this report will contribute to creating a favourable investment environment in Cambodia.

Masamichi Kono
Deputy Secretary-General, OECD

Foreword

This first *OECD Investment Policy Review of Cambodia* uses the updated OECD *Policy Framework for Investment* to present an assessment of the investment climate and to discuss the challenges and opportunities faced by the Royal Government of Cambodia in its reform efforts. The *Review* takes a broad approach to investment climate challenges facing Cambodia, with chapters on foreign investment trends and industrial structure, competitiveness and diversification challenges, business regulation, investor protection, investment promotion, good regulatory practices, infrastructure, responsible business conduct, investment in renewable energy, corporate governance, competition policy and the role played by development partners in improving the business climate in Cambodia.

The Council for the Development of Cambodia (CDC) led the process within the Cambodian government and convened meetings of an inter-ministerial taskforce at various stages of the process. A draft version of the *Review* was discussed at a workshop with ministries and government agencies hosted by CDC in Phnom Penh in October 2017, followed by a presentation and discussion in the OECD Investment Committee in Paris.

The *Review* has been prepared by a team comprising Stephen Thomsen, Tihana Bule, Alexandre de Crombrugghe, Victor Duggan, Hélène François, John Hauert,, Fernando Mistura and Martin Wermelinger from the Investment Division, Austin Tyler from the Corporate Governance and Corporate Finance Division and Ruben Maximiano from the Competition Division of the OECD Directorate for Financial and Enterprise Affairs, together with Naeeda Crishna Morgado, Kaori Miyamoto and Emilio Chiofalo of the OECD Development Co-operation Directorate and Winona Bolislis of the OECD Public Governance Directorate. Further inputs were received from Chung-a Park and from Françoise Nicolas, an external consultant. The *Review* was supported by the ASEAN-Australia-New Zealand Free Trade Agreement Economic Cooperation Support Programme.

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Acronyms and abbreviations

AANZFTA	ASEAN Australia New Zealand Free Trade Agreement
ACIA	ASEAN Comprehensive Investment Agreement
ADB	Asian Development Bank
AEC	ASEAN Economic Community
AETR	Average Effective Tax Rate
AFD	Agence Française de Développement
ASEAN	Association of Southeast Asian Nations
BFC	Better Factories Cambodia
BIT	Bilateral Investment Treaty
BUILD	BOI Unit for Industrial Linkage Development
CAGR	Compound Annual Growth Rate
CAMFEBA	Cambodian Federation of Employers and Business Associations
CBA	Cost-Benefit Analysis
CCCA	Cambodia Climate Change Alliance
CDC	Council for the Development of Cambodia
CDRB	Cambodian Rehabilitation and Development Board
CETA	Comprehensive Economic and Trade Agreement
CFPS	Climate Fund for the Private Sector
CIFRS	Cambodian International Financial Reporting Standards
CIT	Corporate Income Tax
CLMV	Cambodia Lao PDR Myanmar Viet Nam
CMT	Cut, Make and Trim
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
CRC	Conditional Registration Certificate
CSR	Corporate Social Responsibility
CSX	Cambodian Stock Exchange
CTIS	Cambodia Trade Integration Strategy
DAC	Development Assistance Committee
EBA	Everything but Arms
ECOSOCC	Economic, Social and Cultural Council
EDC	Electricité de Cambodge
EIA	Environmental Impact Assessment
EU	European Union
FDI	Foreign Direct Investment

FET	Fair and Equitable Treatment
FI	Financial Institution
FiT	Feed-in-tariff
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GIZ	Gesellschaft für Internationale Zusammenarbeit
GMAC	Garment Manufacturers Association in Cambodia
GMS	Greater Mekong Subregion
G-PSF	Government-Private Sector Forum
GSP	Generalised System of Preferences
GVC	Global Value Chain
HRD	Human Resource Development
ICC	International Criminal Court
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information and Communication Technology
IDP	Industrial Development Policy
IFC	International Finance Corporation
IIA	International Investment Agreement
ILO	International Labour Organization
IMF	International Monetary Fund
IP	Intellectual Property
IPP	Independent Power Producer
ISDS	Investor-State Dispute Settlement
ISIC	International Standard Industrial Classification
JETRO	Japanese External Trade Organisation
JICA	Japan International Co-operation Agency
KAMSAB	Kampuchea Shipping Agency and Brokers
KOICA	Korea International Cooperation Agency
KOTRA	Korean Trade and Investment Promotion Agency
LDC	Least Developed Country
MEF	Ministry of Economy and Finance
MFA	Multi-Fibre Arrangement
MFN	Most Favoured Nation
MNE	Multinational Enterprise
MOC	Ministry of Commerce
MOF	Ministry of Finance
MSI	Multi-Stakeholder Initiative
MSME	Micro, Small and Medium-Sized Enterprises
MST	Minimum Standard of Treatment
MW	Megawatt
NAFTA	North American Free Trade Agreement

NAP	National Action Plan
NCP	National Contact Point
NDC	National Determined Contribution
NGO	Non-Governmental Organisation
NSDP	National Strategic Development Plan
OCM	Office of the Council of Ministers
ODA	Overseas Development Assistance
ODF	Overseas Development Finance
OECD	Organisation for Economic Co-operation and Development
ORIA	Office on Regulatory Impact Assessment
PAS	Preliminary Assessment Statement
PFI	Policy Framework for Investment
PISA	Programme for International Student Assessment
PPP	Public-Private Partnership
PPSEZ	Phnom Penh Special Economic Zone
PSD	Private Sector Development
PV	Photo-Voltaic
QIP	Qualified Investor Project
R&D	Research and Development
RBC	Responsible Business Conduct
RE	Renewable Energy
RET	Regulatory Executive Team
RGC	Royal Government of Cambodia
RIA	Regulatory Impact Assessment
RIS	Regulatory Impact Statement
SDG	Sustainable Development Goal
SECC	Securities and Exchange Commission of Cambodia
SEZ	Special Economic Zones
SME	Small and Medium-sized Enterprise
SOE	State-Owned Enterprise
TEU	Twenty-Foot Equivalent Unit
TiVA	Trade in Value-Added
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
TVET	Technical and Vocational Education and Training
TWG	Technical Working Group
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNFCCC	United Nations Framework Convention on Climate Change
UNOHCHR	United Nations Office of the High Commissioner for Human Rights

UNIDO	United Nations Industrial Development Organization
US	United States
USAID	United States Agency for International Development
USD	United States Dollars
VAT	Value Added Tax
WB	World Bank
WEF	World Economic Forum
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Executive summary

Cambodia has demonstrated a strong capacity for rebirth and resilience. The Khmer Rouge period removed a generation of politicians, judges and other civil servants, technical experts and skilled workers, and many others. Land titles were completely destroyed. The civil strife which followed inflicted further damage on whatever infrastructure remained. Starting from the Paris Peace Agreement in 1991, Cambodia has been one of the fastest growing economies worldwide which has made Cambodia one of the best performers in terms of reducing poverty.

Cambodia offers a young workforce and macroeconomic stability. A resource mobilisation strategy has resulted in strong revenue performance, together with a low ratio of debt to GDP. Its tax regime is relatively simple and incentives are not out of line with what is offered elsewhere in the region. Poor quality and insufficient electricity supplies have hampered the investment climate for decades but recent investments have reduced the reliance on imports and altered the energy mix towards cheaper options. As elsewhere in Southeast Asia, special economic zones are slowly starting to diversify sources of foreign investment.

Although still classified as a least developed country (LDC), Cambodia has adopted some policies that are more in line with those of a more developed economy. It is one of the most open economies to foreign investment in Southeast Asia, with very few restrictions except for land ownership. It has privatised most state-owned enterprises and was the second LDC to join the WTO through the full accession process in 2004, which accelerated and consolidated reforms. Starting from a bilateral trade and investment agreement with the United States in 1999, it has also been at the forefront of efforts towards safe sourcing of apparel. It was also the first ASEAN Member State to adopt a green growth roadmap.

Cambodia nevertheless faces several development challenges. Despite rapid economic growth, much of the population remains “near poor” and hence economically vulnerable. Economic growth still depends heavily on exports of garments and footwear, leaving the economy vulnerable to potential declines in competitiveness and the erosion of preferential market access. Overseas development assistance (ODA) is declining steadily as a share of GDP, increasing the importance of private capital, not least for infrastructure. And lastly, as with many other countries in the region, Cambodia is also vulnerable to climate change.

While Cambodia has done remarkably well at attracting investors, notably from East Asia, the investment climate is seen as challenging, as attested by numerous international rankings. The Industrial Development Policy 2015-25 sets out clearly the challenges facing Cambodia in improving its investment climate: the need to diversify the economy towards manufacturing and, within manufacturing, away from over-reliance on garments; the high level of informality; weak entrepreneurship; low value addition and level of technology application; poor human resources and skills; limited financial market development, inadequate infrastructure and weak co-ordination in policy-making.

Attracting further foreign direct investment (FDI) will be essential to offset declines in ODA, expand Cambodia's infrastructure and diversify the economy. With a new *Investment Law* currently being drafted, the government is considering moving towards a system of "smart incentives" which target activities so as to shape outcomes rather than investment per se. This approach has already been adopted elsewhere in the region to varying degrees. It could be less costly and more effective than the current system but must be weighed against the administrative burden it imposes on the government and investors and any potential distortion in capital allocation in the economy.

Special economic zones are often used by governments to facilitate diversification, and in Cambodia they are still a work in progress. If they have not yet delivered on all of their promise, they have also not diverted resources from more general investment climate improvements. They are mostly privately run and investors generally receive the same treatment in terms of incentives as those outside the zones. They have helped the economy to diversify, while providing employment opportunities, often for young women, to enter the formal sector. At the same time, diversification has not fully relieved the precariousness upon which economic growth stands. Most of the activities in the zones involve footloose low wage, low value added activities susceptible to many of the same shocks as the garment sector.

Even if Cambodia can successfully diversify its economy in the long term, the garment sector will need to continue to be an important source of employment and exports for years to come. Beyond much needed productivity improvements in the sector, Cambodia will need to build on its success so far as a location for safe sourcing. Mainstreaming responsible business conduct (RBC) at a government level and clearly communicating RBC priorities and expectations, including to the private sector, would go a long way in overcoming country risk perceptions, maximising the development impact of FDI, attracting quality investment and promoting linkages with multinational enterprises, and creating a level-playing for business (particularly important in light of increasing RBC expectations in supply chains, which can include legal obligations for some investors).

Rapid economic and population growth, coupled with past degradation of infrastructure during the civil conflict as well as subsequent underinvestment, have seen infrastructure bottlenecks emerge as critical constraints to growth and social inclusion. Although investors note a sharp improvement in the quality and supply of infrastructure in recent years, transport and electricity still figure among the top ten constraints – albeit significantly farther down the list in the latest World Bank survey. As rapid economic growth continues, donor financing will further decline in relative importance, underlining the need to mobilise domestic public and private resources, as well as foreign capital, for infrastructure investment. Private investment has so far been limited, largely confined to power generation and international air transport and small-scale projects, but public-private partnerships are becoming increasingly prevalent.

Cambodia should also explore opportunities to mobilise private investment in support of green growth, by improving the quality and sustainability of investment in natural resource sectors and generating new investment in green sectors. Attracting investment in areas such as renewable energy, energy efficiency or waste management could help create jobs and spur growth and development. Just over two-thirds of people still lack access to energy in spite of the strong potential for grid connected and off-grid solar renewable energy generation, particularly small hydro and solar energy. Sustainable natural resource management practices such as better water resource management, eco-tourism and sustainable agricultural practices could promote investment that generates employment, positive environmental benefits as well as growth.

Cutting across all of these challenges is the need to improve public governance, as might be expected given Cambodia's level of development. One manifestation of weak governance is the long delays in drafting and implementing laws. The amendment to the *Investment Law* and the enactment of the *Law of Special Economic Zones* have been debated for several years and are still pending, as is a *Competition Law* which was first mooted as part of WTO accession. Three new laws on the judiciary also took a decade to produce.

Improving pubic governance is a long-term process, involving inter alia capacity-building for officials, simplified procedures and reduced opportunities for corruption such as through electronic filing, together with clear drafting of legislation, regulatory impact assessments and public consultations. Cambodia is moving forward in all of these areas. Good regulatory practices have been promoted for over a decade. Regulatory impact assessments (RIAs) are slowly being introduced but remain voluntary and are followed for only a handful of regulations each year. A key challenge is the lack of skilled staff within implementing agencies able to effectively draft regulatory impact statements and to undertake detailed cost-benefit analysis. As a result, the government has decided to begin progressively while allowing time to further build capacity before fully mandating RIAs for all regulations. Cambodia has also begun to tackle corruption, with an *Anti-Corruption Law* (2010) and an *Asset Declaration Law* (2011).

Public consultations as part of the legal drafting process can also improve the quality of laws. Cambodia presents a mixed picture in this area. Although the Government-Private Sector Forum has not met in recent years, dialogue is generally considered to be more effective at the working group level. Some draft laws are shared widely for consultation, others less so. Overall, according to the business community, the private sector is inconsistently and insufficiently consulted on policies and procedures affecting their operations.

This first *OECD Investment Policy Review of Cambodia* looks at challenges and opportunities from the perspective of the investment climate in light of the *Policy Framework for Investment*. It takes a comprehensive approach to reform priorities. looking not only at the need to increase both domestic and foreign investment but also at ways to increase the development impact from that investment.

Chapter 1. Assessment and Recommendations

This chapter documents the overall development context in Cambodia since the Paris Peace Agreement in 1991, describing how far Cambodia has come since then and describing key challenges going forward. It summarises the key findings in each policy area and provides tailored recommendations.

Cambodia has demonstrated a strong capacity for rebirth and resilience. The Khmer Rouge period removed a generation of politicians, judges and other civil servants, technical experts and skilled workers, and many others. Land titles were completely destroyed. The civil strife which followed inflicted further damage on whatever infrastructure remained. Starting from the Paris Peace Agreement in 1991, Cambodia has been one of the fastest growing economies worldwide which has made Cambodia one of the best performers in terms of reducing poverty.

Although still classified as a least developed country (LDC) by the United Nations, Cambodia has adopted some policies that are more in line with those of a more developed country. It is one of the most open economies in Southeast Asia, with very few restrictions on foreign investment, except for land ownership. It has privatised most state-owned enterprises, and Cambodia was the second least developed country to join the WTO through the full accession process in 2004 which accelerated and consolidated reforms. Starting from a bilateral trade and investment agreement with the United States in 1999, it has also been at the forefront of efforts towards safe sourcing of apparel.

It offers a young workforce (nearly 60% of population under 26 years of age) and macroeconomic stability. A resource mobilisation strategy has resulted in strong revenue performance, together with a low ratio of debt to GDP. In terms of investment incentives, Cambodia combines a relatively simple and not overly generous regime. Poor quality and insufficient electricity supplies have hampered the investment climate for decades but recent investments have reduced the reliance on imports and altered the energy mix towards cheaper options. As elsewhere in Southeast Asia, special economic zones are slowly starting to diversify sources of foreign investment, both by sector and by country.

In spite of these impressive achievements, governance remains a significant challenge – as might be expected given Cambodia's status as an LDC. One manifestation of this is the long delays in drafting and implementing laws. The amendment to the *Investment Law* and the enactment of the *Law of Special Economic Zones* have been debated for several years and are still pending, as is a *Competition Law* which was first mooted as part of WTO accession. Three new laws on the judiciary also took a decade to produce.

Furthermore, and in spite of rapid economic growth, much of the population remains "near poor" and hence economically vulnerable (World Bank, 2015a). Economic growth still depends heavily on exports of garments and footwear, leaving the economy vulnerable to potential declines in competitiveness and the erosion of preferential market access. Overseas development assistance is declining steadily as a share of GDP, increasing the importance of private capital. And lastly, as with many other countries in the region, Cambodia is also vulnerable to climate change.

Attracting further foreign direct investment (FDI) will be essential to offset declines in overseas development assistance, expand Cambodia's infrastructure and diversify the economy. While Cambodia has done remarkably well at attracting FDI, notably from East Asia, the investment climate is seen as challenging, as attested by numerous international rankings. The Industrial Development Policy (IDP) 2015-25 sets out clearly these challenges: the need to diversify the economy towards manufacturing and, within manufacturing, away from over-reliance on garments; the high level of informality; weak entrepreneurship; low value addition and level of technology application; poor human resources and skills; limited financial market development, inadequate infrastructure and weak co-ordination in policy-making. The same discussion has also appeared in different forms in the National Strategic Development Plan 2014-18 and the Rectangular Strategy 2013-18 which, together, provide a roadmap for reforms and their implementation.

This first *OECD Investment Policy Review of Cambodia* looks at challenges and opportunities from the perspective of the investment climate in light of the *Policy Framework for Investment* (Box 1.1). It takes a comprehensive approach to reform. looking not only at the need to increase both domestic and foreign investment but also at ways to increase the development impact from that investment. This review is intended to support Cambodia's ambitious reform agenda and the implementation of the Sustainable Development Goals (SDGs), in particular SDG 8 to promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all.

Box 1.1. The Policy Framework for Investment

The Policy Framework for Investment (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to prosperity and poverty alleviation. It offers a list of key questions to be asked by any government seeking to create a favourable investment climate. The PFI was first developed in 2006 by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. Designed by governments to support international investment policy dialogue, co-operation, and reform, it has been used by 30 countries as well as regional bodies to assess and reform the investment climate. The PFI was updated in 2015 to take this experience and changes in the global economic landscape into account.

The PFI is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in 12 policy areas: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; promoting responsible business conduct; human resource development; infrastructure; financing investment; public governance; and investment in support of green growth. Three principles apply throughout the PFI: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

The value added of the PFI is in bringing together the different policy strands and stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It does not provide ready-made reform agendas but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and for various purposes by different constituencies, including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions.

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising the economic and social returns. Quality matters as much as the quantity as far as investment in concerned. It also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small. The objective of a good investment climate is also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

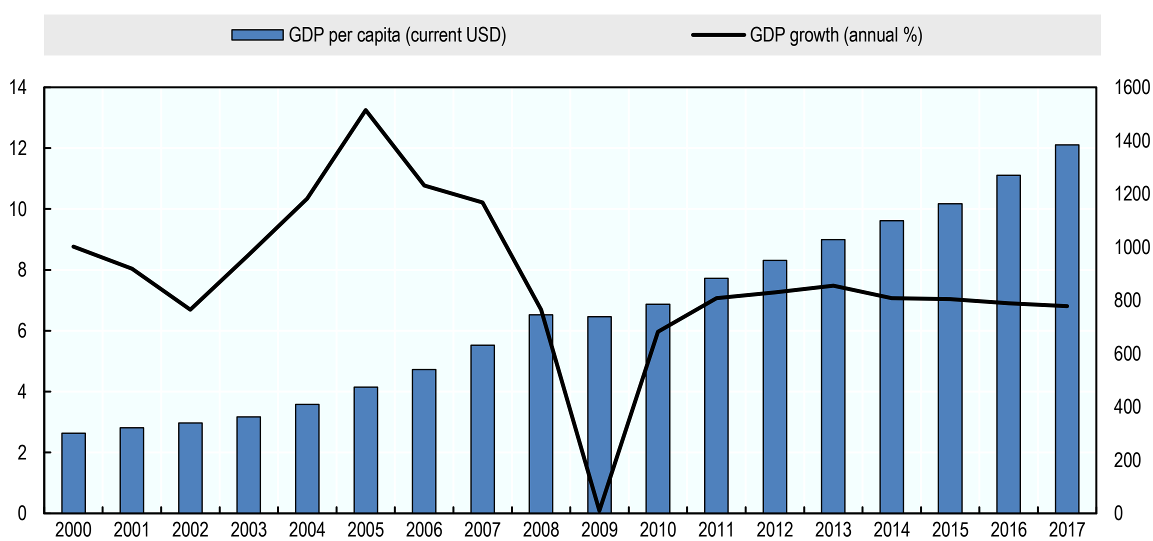
Source: www.oecd.org/investment/pfi.htm

Substantial reforms and strong economic fundamentals

Cambodia has reformed substantially since the Paris Peace Agreement in 1991 to rebuild institutions and transform from a centrally-planned to a market economy. It has rapidly integrated into the world economy, including by joining the Association of Southeast Asian Nations (ASEAN) in 1999 – one of the world's fastest-growing regions – and then by becoming a member of the World Trade Organization (WTO) in 2004, before either Viet Nam or Lao PDR. WTO membership promoted domestic reforms as accession reportedly was partly driven by the desire to protect the fledgling garment sector from the end of the Multi-Fibre Arrangement and required introducing 47 laws and regulations in Cambodia (Chea and Sok, 2008).

The annual growth rate has been strong and relatively stable, with the exception of 2009 when the global financial crisis strongly affected exports – one of the main drivers of growth (Figure 1.1). The economy recovered quickly after 2009 and growth has stayed above 7% since 2011. As a result, GDP per capita has more than doubled in the past 15 years and overall living standards have improved substantially. Cambodia nevertheless remains highly dependent on the broader international economic environment and hence vulnerable to external shocks. Cambodia's strong economic growth has been underpinned by clothing and textile exports, representing two thirds of total exports in 2016. The success of the garment industry in Cambodia results both from preferential market access for Cambodian exports – particularly to the European Union and United States – and from market access developments for competitors in Viet Nam and elsewhere (Table 1.1).

Figure 1.1. Growth in GDP and GDP per capita in Cambodia have been impressive



Source: World Bank.

Attracting FDI is a key government priority

Foreign direct investment has played a crucial role in Cambodia's economic development over the past decade and continues to be a top priority of the government, as evidenced in its national development strategy plans (Box 1.2). It was well-articulated in the overarching Rectangular Strategy for Growth, Employment, Equity and Efficiency, which was launched in 2004 and formed the basis of major government policymaking for the next decade. The more recent IDP 2015-25 (*"Market Orientation and Enabling Environment for Industrial Development"*) takes a step further by putting investment (including FDI) at the heart of its industrialisation strategy to achieve economic diversification, improved competitiveness and higher productivity. This comes on the back of significant donor support which has contributed to institutional strengthening and a vibrant civil society – both of which contribute to an attractive FDI landscape.

Table 1.1. Export performance depends partly on external policy circumstances

	Favourable	Potentially unfavourable
1996	Cambodia granted MFN status by US	
1997	EU grants GSP status	
1990s	Asian garment exporters begin to reach the limits of their quotas Total of 28 countries offer MFN/GSP status	
1999	US-Cambodian Trade Agreement on Textiles and Apparel gives Cambodia improved access in turn for commitments on labour rights Cambodia joins ASEAN	US imposes quotas on 12 categories of Cambodian garment exports
2001	EU grants Everything But Arms treatment ILO Better Factories Cambodia started	China joins WTO, with improved access to key markets
2002	Thailand loses GSP status for certain labour-intensive products EC-Cambodia Trade in Textiles Agreement US extends the Textile Agreement for 3 years.	
2004	Cambodia joins WTO	End of the Multi-Fibre Arrangement
	The US and EU continue to impose restrictive safeguards on Chinese and Vietnamese garment exports (until 2007-08)	
2005	Special Economic Zones allowed The EU imposes anti-dumping duties on imports of bicycles made by Chinese Taipei firms in Viet Nam.	
2006	US-Cambodia Trade and Investment Facilitation Agreement	
2007		Viet Nam joins WTO
2009	ASEAN-Japan Comprehensive Economic Partnership allows Cambodia to import fabrics from ASEAN and still enjoy duty-free access to Japanese market	
2010	EU imposes anti-dumping measures on Chinese exports of leather footwear	
2011	EU relaxes rules of origin requirements for LDC exports to allow for more imported fabrics	Myanmar opens politically and economically
2014	Reforms to EBA mean that many of Cambodia's competitors no longer qualify	
2016		EU-Vietnamese FTA signed, offering improved market access for Vietnamese exports to major markets US commits to remove sanctions on Myanmar and offers GSP status
2019		CPTPP 11 likely to take effect
Future	China+1 and Thailand+1: like other CLMV countries, Cambodia will benefit from the diversification strategies of foreign investors currently in China and Thailand	Potential preference erosion over the long term

As set out in the IDP, Cambodia's industrial structure is characterised by a narrow industrial base (largely dominated by garment production, construction and food/beverage processing), a missing middle of medium-sized firms, widespread informality (with over 98% of microenterprises, 63% of small enterprises and 29% of medium-sized enterprises not formally registered), weak entrepreneurship (especially outside of major cities) and low levels of value addition and technology application in Cambodian industry (which is mostly labour-intensive and focused on unsophisticated production chain segments). The IDP includes four main action pillars:

1. Encourage both foreign and domestic investment, notably through investment climate improvements and the development of special economic zones (SEZs) and industrial parks;
2. Develop the small and medium-sized enterprises (SME) sector to reinforce the manufacturing base and enhance their linkages with foreign firms;
3. Improve the legal framework with a focus on trade, tax and other aspects of the business environment; and
4. Better coordinate supporting policies, such as those related to human resource development, infrastructure and land.

Box 1.2. Articulating and implementing Cambodia's development strategy

Rectangular Strategy for Growth, Employment, Equity, and Efficiency in Cambodia

The government's overarching economic development strategy first launched in 2004 which embedded elements of the Millennium Development Goals, notably the objective to reduce poverty by half in 2015, which was met in 2009 according to World Bank's estimates (CRDB-CDC, 2004; World Bank, 2016b). Since 2013, Cambodia has been rolling out Phase III of the Rectangular Strategy, which sets out the government's development policy agenda for 2013-18. A new Rectangular Strategy is expected to be announced soon.

Socioeconomic Development Plan I (1996-2000) and II (2001-05): Promoting macroeconomic stability, peace, integration into the international community and social and economic development

National Strategic Development Plan 2014-18: A roadmap for implementing the Rectangular Strategy and promoting good governance, macroeconomic balance, and growth and diversification. Provides the overarching framework for implementing development activities and for programming domestic and external resources. The Ministry of Planning was responsible for leading the process of preparing the NSDP.

Industrial Development Policy 2015-25: A guide to promote the country's industrial development that will help maintain sustainable and inclusive high economic growth through economic diversification, strengthening competitiveness and promoting productivity

Cambodia Trade Integration Strategy 2014-18: Strengthening the competitiveness of its leading export sectors while nurturing new ones to support human development

Cambodia Vision 2030: To become an upper-middle income country by 2030 and a high-income country by 2050.

The first pillar includes many aspects that are closely analysed in this OECD *Investment Policy Review of Cambodia* and for which the review provides specific policy recommendations. These include preparing a new *Law on Investment* with a clear vision for the future and enacting the *Law on SEZs*, rationalising and better utilising investment incentives inside and outside the zones, improving governance and efficiency in public institutions, establishing investment facilitation mechanisms, reinforcing public-private sector dialogue, and using SEZs and industrial parks to develop industrial hubs and corridors in strategic areas of the country. Aspects of the IDP included in other pillars are also addressed, including SME development, trade facilitation, infrastructure connectivity and skills development. Effective implementation of the IDP will be critical and will depend in part on the government's capacity to reinforce inter-ministerial dialogue and cooperation.

A need to diversify the economy

Cambodia's economic success is partly the result of the garment sector, employing more than 600 000 workers (mostly women) and representing over half of exports. Although the garment industry has had a strong development impact in the past, Cambodia's narrow production and export base and the lack of technology transfer is a risk to the sustainability of its current pattern of economic growth (ADB, 2014). Over-dependence on one sector has also increased the vulnerability of Cambodia to external shocks, such as the global financial crisis a decade ago.

Tariff preferences have helped to increase exports in many product lines (e.g. travel goods for the US market) and to establish some industries (e.g. bicycle assembly), but Cambodia will eventually cease to be eligible for many tariff preferences as its income rises. Increased competitiveness of countries in the region, including through the recent EU-Viet Nam free trade agreement and other such agreements, might also threaten Cambodia's current competitive advantages in the garment industry.

Diversifying the economy and the manufacturing base and export markets further is, therefore, a critical challenge to reduce exposure to external shocks. Cambodia has been able to exploit its competitiveness and expand market share in traditional export industries in the last decade, gaining market share from economies like China and Viet Nam. But the potential for these industries to continue to propel growth in the future is unclear, with growing competition from other low-cost producing economies such as Myanmar. Garment producers in Cambodia are mostly foreign-owned and generally engaged in low value added, labour-intensive cut-make-trim activities within the value chain, which are potentially more footloose and sensitive to cost pressures. More positively, there are emerging signs of Cambodia expanding into products offering higher export growth opportunities than traditional products (e.g. footwear, unprocessed rice, and some electronics and transport equipment), although they still remain relatively limited compared to the more traditional export basket. Diversification across export destinations is also taking place to some extent but at a much slower pace, as the major export markets remain the US and the EU (Warr and Menon, 2015).

Recent wage developments may weaken Cambodia's cost competitiveness. While recent increases in the real minimum wage for the garment and footwear sector may be warranted from a social policy perspective, notably after years of stagnation in real terms in the 2000s (ILO, 2016), rapid surges in labour costs without productivity improvements put additional pressures on producers. Future adjustments to the sector's minimum wage level will need to better reflect productivity growth. In addition, a more structured planning for wage adjustments as opposed to yearly negotiations would also be helpful. It enables producers to better design their strategic plans in a mid-term horizon, including any investment plans. Maintaining cost competitiveness and further promoting diversification will require a multipronged approach: enhancing trade facilitation efforts; improving infrastructure connectivity and logistics services; upgrading worker skills and facilitating enterprise creation.

Diversification is a challenge faced by many economies, both developed and developing. The IDP contains many concrete measures and targets to achieve this goal.

Diversification involves more than just the export basket or industrial structure. Cambodia needs to diversify geographically in terms of export markets and sources of inward investment. Although OECD-based firms are the most active investors in Southeast Asia as a whole, they are still under-represented – and in some cases totally absent – in Cambodia. As pointed out by Eurocham, for example, while the European Union remains Cambodia's largest export market, European firms account for less than 5% of total foreign investment in Cambodia, in spite of being among the largest investors in ASEAN as a whole (Eurocham, 2016). The same is true for US investors. Much of the existing investment is from Chinese and Korean firms.

Special economic zones in Cambodia have already shown some early signs of diversification, not only in terms of sectors and activities but also by bringing in many investors from countries that had not previously been active in Cambodia, such as Japan and the United States. Building on this early success will require improvements in many areas: skills development, trade facilitation, investment promotion and more targeted incentives. ADB (2014) provides estimates of sectors and activities where exports could be expanded. Further measures to encourage diversification are discussed in Chapter 3.

Even if Cambodia can meet these challenges in the long term, the garment sector will need to continue to be an important source of employment and exports for years to come. Beyond much needed productivity improvements in the sector, Cambodia will need to build on its success so far as a location for safe sourcing, which is widely considered to have supported government efforts to maintain the garment sector beyond the end of the Multi-Fibre Arrangement. The government nevertheless faces certain risks related to poor responsible business conduct (RBC) and unsustainable patterns of natural resource exploitation, which are increasingly hindering the benefits of FDI within the economy. By integrating RBC practices (including robust risk assessment and due diligence) and standards in its economic development strategy and further promoting investment in green sectors, the government has an opportunity to position Cambodia as an attractive destination for responsible and sustainable investments. The experience of the ILO Better Factories Cambodia initiative, which helped not only to improve working conditions in the industry but also to provide a better qualified workforce and enhance workplace productivity, could be replicated in other sectors.

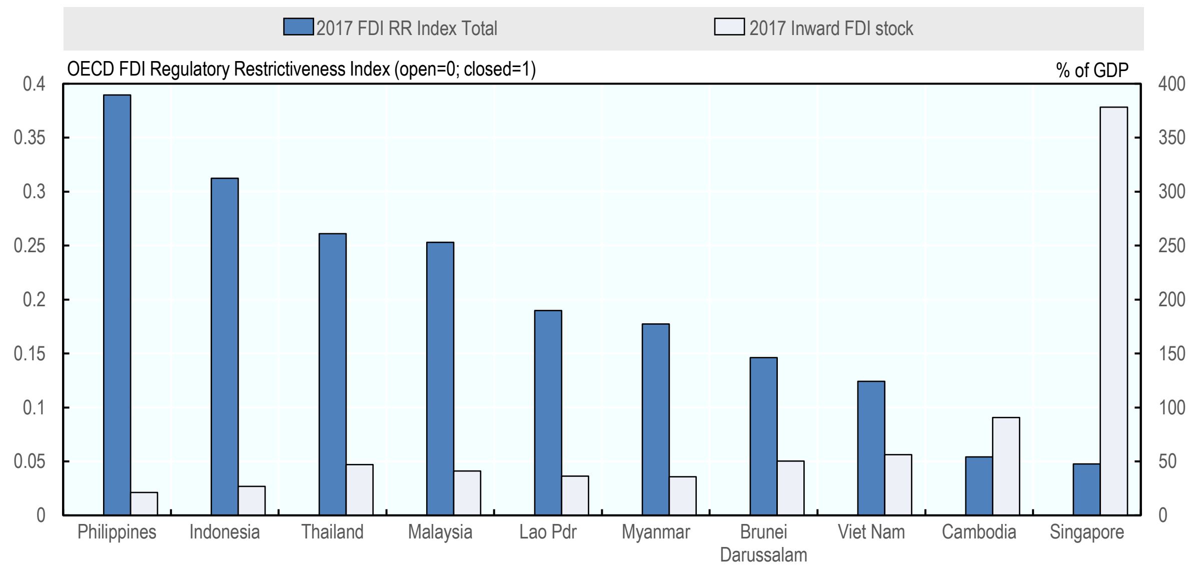
Main findings

Cambodia is one of the most open economies to foreign investment…

In terms of statutory restrictions, Cambodia is second only to Singapore in Southeast Asia in terms of openness to foreign direct investment (Figure 1.2). Indeed Cambodia is more open in statutory terms than the average OECD member. The few restrictions that exist relate to foreign ownership of land and real estate, as is common in the region, and in a few sensitive sectors. This policy stance is remarkable in a least developed economy and clearly sets Cambodia apart from its peers in Southeast and East Asia.

Furthermore, as a result of considerable privatisation, Cambodia does not have a large set of state-owned incumbents against whom private investors must compete – often on unequal terms in many other countries. And in spite of the absence of a competition law, investors do not appear to complain about having to compete against well-established domestic incumbents – a complaint heard in many other countries in the region, such as the Philippines (OECD, 2016).

Figure 1.2. Cambodia has among the fewest FDI restrictions in ASEAN



Source: www.oecd.investment/fdiindex.htm

…but remains a difficult place to do business

Cambodia's performance in many international rankings (Table 1.2), together with high levels of informality, suggests that Cambodia remains a difficult place to do business. This is also attested by investor surveys and interviews conducted as part of this review where concerns were raised about weak public institutions and policy uncertainty. Cambodia is ranked 135th out of 190 countries in 2018 in the World Bank's *Doing Business* indicators, slipping three notches from the previous edition. It ranks 183rd in terms of starting a business.

Without wishing to minimise these findings, which are consistent across many global rankings, the situation on the ground appears to be more complex than these simple measures would suggest. The administrative burden does not usually appear among the top impediments listed by firms in the World Bank Enterprise Surveys, including most recently from 2016 (World Bank, 2018). Interviews conducted with chambers of commerce and investors as part of this review also presented a mixed picture, with some complaining and others downplaying the burden of registering and operating a business. This conflicting picture is discussed in more detail in Chapter 4.

One important way to improve the climate for business in the long run is through public consultations on draft laws. Here too the picture is mixed. Although the Government-Private Sector Forum (G-PSF) has not met in recent years, dialogue is generally considered to be more effective at the Working Group level under the G-PSF. Some draft laws are shared widely for consultation, others less so. Overall, according to the business community, the private sector is inconsistently and insufficiently consulted on policies and procedures affecting their operations.

Table 1.2. Cambodia performs badly in international rankings

Indicator	Rank	Rank in ASEAN	Comment
Doing Business 2019 (World Bank, 2018)	138/190	8/10 (above Lao PDR and Myanmar)	Downgrading from 128 (2016), 131 (2017), 135 (2018)
Starting a business	185		
Obtaining construction permits	179		
Getting electricity	141		
Registering property	124		
Getting credit	22		
Protecting minority investors	110		
Paying taxes	137		
Trading across borders	115		
Enforcing contracts	182		
Resolving insolvency	79		
Global Competitiveness Index 2018 (WEF)	110/140	8/9 (above Lao PDR)	Performs relatively well in terms of labour market efficiency and the macroeconomic environment. The most problematic factors for doing business are innovation capability, skills and institutions.
Global Opportunity Index (Milken Institute)	97/170	8/10 (ahead of Lao PDR and Myanmar)	
Corruption Perceptions Index 2017 (Transparency International)	161/180	10	
Rule of Law Index (World Justice Project)	112/113	8/8 (Lao PDR and Brunei Darussalam not included)	Civil justice (113), open government, regulatory enforcement (112), absence of corruption (111), order and security (81).
Worldwide Governance Indicators	**Percentile rank***		
Voice and accountability	16		
Political stability/absence of terrorism	53		
Government effectiveness	25		
Regulatory quality	32		
Rule of law	13		
Control of corruption	9		

* Percentile ranks indicate the percentage of countries worldwide that rank lower than Cambodia. Higher values indicate better governance scores.

Corruption is being addressed but remains problematic

Corruption is the most problematic factor for doing business according to the *Global Competitiveness Index*. Cambodia also ranks poorly in this area in the *Corruption Perceptions Index* and the composite *Worldwide Governance Indicators* from the World Bank. In the World Bank Enterprise Surveys*,* corruption is rarely ranked as the top constraint, but it is often cited by firms as an impediment to doing business. In 2016, only 7% of firms listed it as a top constraint. In earlier surveys, 30% of registered and unregistered firms mentioned corruption as a major or severe constraint which is high even given Cambodia's level of development. At the same time, the percentage of firms listing corruption as the top constraint fell sharply between 2007 and 2012, and the firms reported that the average amount of informal fees paid has declined as a share of total sales and is now lower than in some neighbouring countries (World Bank 2015b).

Corruption is also present in the judiciary, as judges are reported by stakeholders to lack independence and experience, and judicial rulings are often seen to be inconsistent and unpredictable. Similarly, the ability of civil society to voice concerns and hold the government accountable is not sufficiently strong (ADB, 2014). Some improvements have occurred as a result of a Public Financial Management Reform Program, an *Anti-Corruption Law* in 2010 and an *Asset Declaration Law* in 2011, together with establishing an Anti-Corruption Unit, although this Unit has reportedly suffered from a lack of de jure and de facto independence. Special economic zones have introduced a zero-corruption strategy which, if successful, may help to improve the perception of Cambodia among potential foreign investors (World Bank 2015b).

Investors' property rights are generally well protected…

The protection of property rights, combined with effective enforcement mechanisms, is an important pillar of a sound investment climate. Protecting investors from improper treatment can lower their perception of risk for new investments, and investors who perceive lower risks will generally make capital and resources available at a lower cost and with a longer payback period. At the same time, governments need latitude to regulate investment and to address evolving situations through changes in policy over time. Reconciling these goals involves a challenging balancing act relying on a potentially wide range of policy tools.

Property rights are protected through general laws and procedures and through the constitution, as well as by a range of administrative law doctrines and good administrative practices. Many emerging economies, such as Cambodia with its *Investment Law,* provide for additional protections for all or defined categories of investors or investments. These laws can provide important protections to some or all investors or make protections easier to identify for the relevant investors, and consequently encourage additional investment. At the same time, these laws provide rights for (some) investors that are not available to other constituencies affected by investment and in many cases offer dedicated venues to enforce these rights. This may affect the relative influence of different constituencies on government policy as well as the playing field among different types of investors. Investment treaties between Cambodia and other countries provide additional protection to covered foreign investors.

…but could benefit from greater clarity

Cambodia's legal and policy framework for investment is still a work in progress. Compared to other countries in the region and internationally, Cambodia's *Investment Law*, particularly the section on investment protection, is relatively vague, creating uncertainty for investors and the government as to the protection and obligations it entails. According to public statements, the ongoing revision of the *Investment Law* does not appear to be focused on protection, but rather on investment incentives (*Phnom Penh Post*, 2013). The revision is nevertheless an opportunity to improve the drafting of the investment protection provisions as well. While Cambodia is undertaking certain measures to improve the functioning of the judiciary, most recently with three laws signed in 2014, civil society organisations and the investor community continue to express concerns about the reliability, predictability and independence of the judicial system at all levels.

Likewise, in the protection provided under investment treaties, the results are mixed. Cambodia has signed over 20 bilateral investment treaties as well as a number of multilateral agreements with investment provisions. While some recent treaties have more specific treaty language, specifying government intent and giving direction to arbitrators for their application, the older treaties, which are still in force, often remain vague. Where they provide for arbitration, this gives investment arbitrators broad discretion to interpret and thereby determine the scope of protection they provide.

Policy recommendations on investor protection

- *Continue efforts to improve functioning of the court system.* Despite recent efforts, international rankings and interviews with private sector stakeholders suggest that there is room for further improving mechanisms for contract enforcement in Cambodia to ensure adequate dispute settlement mechanisms for investment and business disputes. The capacity of the courts to deal with private sector cases should be considerably enhanced to boost confidence in the enforcement of contracts.
- *Continue to combat corruption* which, although improved, still acts as a barrier to investment.
- *Consider reviewing existing investment treaties* to assess whether these adequately reflect Cambodia's current approach to investment treaties and are in line with its commitments under ASEAN investment treaties.
- *Specify treaty language to ensure that treaties accurately reflect government intent.* Treaty provisions in most of Cambodia's treaties are relatively broad, leaving arbitrators ample leeway to determine the actual scope of protection they provide. The absence of clear government intent for many of these provisions may pose significant challenges for the government in achieving an adequate balance between investor protection and its own power to regulate.
- *Manage liability risks under investment treaties actively.* While Cambodia has not yet faced investment treaty claims, the authorities should seek to ensure that different government agencies and officials are aware of treaty policy and the obligations it entails. Efforts to improve the management of risks could include training programmes for government officials and the creation of dispute prevention and management mechanisms.

- *Consider the policy rationale for offering different levels of protection to different groups of investors.* While there can be value or a need to provide certain extra incentives to attract specific investors, e.g. foreign investors or investors in certain sectors and projects, Cambodia should seek to guarantee a sound investment climate for all investors and consider whether distortions to efficient investment decisions may occur.

Investment promotion and facilitation is being further refined

Investment promotion and facilitation activities in Cambodia are in the hands of the Council for the Development of Cambodia (CDC) which provides a one-stop service. Investment promotion and facilitation are at the heart of the IDP 2015-25 which seeks to mobilise and attract foreign investments as well as private domestic investments by focusing on large industries, expanding markets and enhancing technology transfer. The government will also revisit the regulatory environment so as to strengthen national competitiveness (investment climate and trade facilitation, market information dissemination and informal fees reduction). To that end, a new *Investment Law* is currently being drafted which would further increase the responsibilities of the CDC.

Over time, the procedures for investors in Cambodia have been simplified. Today the registration and establishment process is on paper easy for both domestic and foreign investors seeking investment guarantees and incentives as "qualified investor projects": it is based on automatic approval and a one-stop service (providing information and processing application approval, customs duty and tax exemption, visa and work permits, and company registration). In December 2015, the registration procedure was further simplified by introducing an on-line business registration system to reduce the number of steps, application forms and number of signatories needed in business registration and permit applications. The new, paperless system enables prospective local and foreign businesses to upload shareholder and board of directors' information and pay the registration fees online, as opposed to the old system where representatives had to go to the ministry to complete registration procedures. In addition to being less time-consuming, the new process is also expected to limit opportunities for corruption.

Special economic zones are beginning to foster diversification

Following the lead of many other countries in the region, Cambodia set up a special economic zone (SEZ) programme in 2005 to facilitate export development and create employment by providing the high-quality infrastructure and utilities needed to encourage investment and to promote some diversification away from traditional activities such as garments. Special economic zones have a mixed record worldwide in promoting development but in the best cases they have been able to jumpstart industrialisation and provide lasting development benefits. The zone programme was intended to support investment attraction by streamlining administrative procedures and tapping the potential for private sector provision of infrastructure and services.

They currently employ over 90 000 workers, mostly women, with much of the employment concentrated in a handful of SEZs either in Phnom Penh or in zones with access to neighbouring or international markets. The zones may be developed by the state, a private enterprise or a joint venture between the state and the private sector. Almost all SEZs so far have been developed and operated by the private sector. Although SEZs are open to domestic and foreign firms alike, almost all firms located in the SEZs are foreign.

…but they are still a work in progress

Special economic zones in Cambodia are a work in progress. If they have not yet delivered on all of their promise, they have also not diverted resources from more general investment climate improvements. They are mostly privately run and investors generally receive the same treatment in terms of incentives as those outside the zones. They have helped the economy to diversify, while providing employment opportunities, often for young women, to enter the formal sector. At the same time, diversification has not fully relieved the precariousness upon which economic growth stands. Most of the activities in the zones involve footloose, low wage, low value added activities susceptible to many of the same shocks as the garment sector.

While manufacturing activity outside the zones is heavily concentrated on the garment industry, SEZs have attracted a much broader spectrum of foreign investors in light manufacturing. They have also been successful at attracting new investors from new countries, particularly Japan, including a large investment from Minebea. While American companies have traditionally tended to shy away from Cambodia, the Phnom Penh Special Economic Zone has recently attracted more than USD 100 million of investments from several large American companies, including Coca-Cola.

At the same time, however, despite one-stop shops and enhanced border clearance procedures, investors complained in the past of burdensome regulation and interference in the SEZs. One-stop shops in the zones were seen to reduce regulatory compliance costs, but without fully satisfying firm managers (Warr and Menon 2015). Corruption and regulatory and policy uncertainty were ranked as major or severe constraints by a substantial percentage (74% and 34% respectively) of firms operating in SEZs in 2012 (World Bank, 2015b). Moreover, SEZ investments have traditionally faced the same constraints as non-SEZ investments (high costs of electricity and transport compared to neighbouring countries, low quality of labour and a general lack of skilled labour).

These critiques are admittedly several years old in what is a fast-changing environment. In the long-term, SEZs are expected to contribute to local development through backward linkages whereby investors purchase materials and services from the local economy, invest in infrastructure built by local companies and bring new technology into the zones that are disseminated to the rest of the economy. Such spillovers are sometimes difficult because of insufficient physical and economic infrastructure for high-technology processes used inside the zones to be adopted elsewhere in the economy. Even if SEZ-firms and non-SEZ firms wanted to trade with each other, they would be inhibited in their ability to do so. Domestic SMEs may not be sufficiently well equipped and the labour force may lack the relevant skills to make co-operation possible. Furthermore, domestic SMEs' sometimes poor record in terms of compliance with certain international standards may deter foreign investors from engaging in business partnerships.

Policy recommendations on investment promotion

- Business linkages between foreign and local companies are one of the channels through which FDI spillovers can arise, but linkages in Cambodia have been elusive so far. Measures to encourage business linkages should primarily focus on alleviating persistent bottlenecks associated with the weak absorptive capacity of the domestic labour force, in particular by bridging the skills gap through a reform of technical and vocational education and training, including consideration of establishing an apprentice system.

- Medium-sized enterprises which typically are the ones most likely to form linkages are scarce in Cambodia. The vast majority of domestic enterprises are informal micro-enterprises serving the local market. To encourage the development of stronger SMEs, policies should aim to promote formalisation, improve technology adoption by SMEs through public-private-academia partnerships, and facilitate SME financing.
- Although mandatory backward linkages may act as a deterrent to foreign investors, softer policy instruments can facilitate and promote cooperation between MNEs and local SMEs, in particular through information provision and matchmaking services. Lessons can be drawn from the experience of neighbouring countries such as Malaysia, Thailand or the Philippines.
- In order to maximise the expected benefits from SEZs, SME participation in zones should be encouraged to enable them to work in clusters, thereby enhancing their productivity, increasing the quality of exports and reducing the reliance on imports. More generally, industrial clustering should be encouraged as well as supplier development by means of fiscal incentives to zone suppliers.

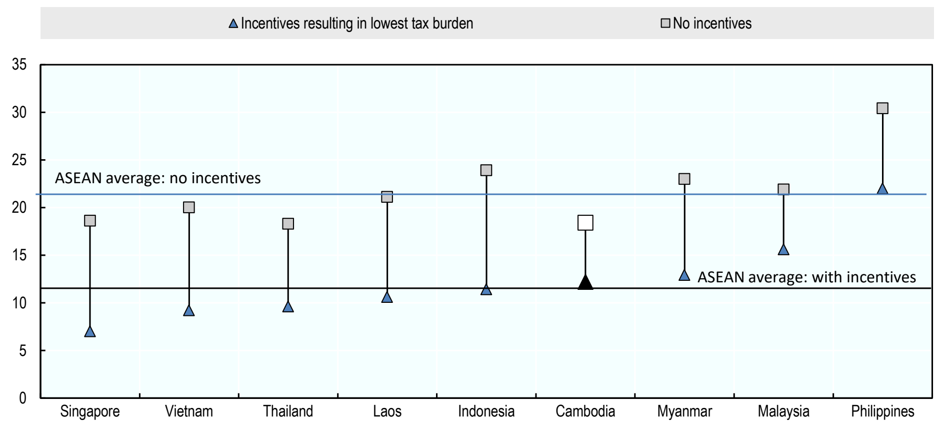
The incentives scheme for investors is being revised

Cambodia has one of the lowest overall rates of corporate taxation in the region. As elsewhere in Southeast Asia, the government offers investment incentives to investors. Tax holidays are provided for up to six years and approved projects are exempt from import duty on machinery and equipment. Investors can repatriate profits freely and reinvestment of earnings is encouraged with special depreciation allowances. Incentives in Cambodia also have the advantage of being relatively simple, although this must be weighed against the fact that they are broad-based and hence likely to represent substantial forgone tax revenue. They also give more weight to tax holidays which, although easy to apply, can be the most costly and least efficient form of incentive. Figure 1.3 provides a comparison of corporate income tax and the forward-looking effective tax rate prevailing after incentives across ASEAN.

A country's tax burden is just one of many, and not usually the most important, factor considered by potential investors when weighing up investment decisions. Empirical evidence suggests that host country taxation and international investment incentives generally play only a limited role in determining the international pattern of FDI, particularly in developing countries, although they can have an influence at the margin. Tax holidays tend to favour mobile activities rather than long-term investment which introduces a bias towards short-term projects with low upfront investment costs and those least likely to generate spillover effects on the wider economy. It has been observed that foreign companies tend to deregister and change names so as to get further tax exemptions as a "new" company to prolong and retain tax incentives[1], although CDC reports that its role is to verify that this does not happen.

Tax incentives in Cambodia are provided by the CDC which grants Qualified Investor Project (QIP) status to most manufacturing projects, as well as to some high-value or large-scale service projects. Unlike in most of Southeast Asia, Cambodia offers essentially no special and differentiated treatment to companies in SEZs, thus avoiding the creation of two distinct regimes which may be a source of complexity. A QIP located in a SEZ is entitled to the same incentives and privileges as other QIPs. Zones are also administered by CDC, which also avoids having a dual strategy for investor attraction within the government, as is found in many other countries.

Figure 1.3. Forward-looking average effective tax rates with and without incentives



Note: A hypothetical investment project is assumed where a firm equally invests in five different assets (including intangibles acquired from third parties, buildings, machinery, financial assets and inventory). Brunei Darussalam is not included in the dataset used for this table.
Source: Based on Wiedemann and Finke (2015).

With a new *Investment Law* currently being drafted, the government is considering moving towards a system of "smart incentives" which target activities so as to shape outcomes rather than investment per se. This approach has already been adopted by other governments in the region to varying degrees. It could be less costly and more effective than the current system but must be weighed against the administrative burden it imposes on the government and investor. And any targeted incentives run the risk of distorting capital allocation and hence the distribution of economic activities in ways in which might run against the natural comparative advantage of the Cambodian economy.

Policy recommendations on incentives

- Consider replacing the tax holiday with a tax deduction or tax credit scheme where investors can deduct expenses on specific activities from their taxable income or subtract the amount of accrued tax credits from the taxes owed, while keeping the option of accelerated depreciation of assets. Import duty exemptions on capital equipment and construction materials as well as export tax exemption could be retained as these schemes lower costs and enhance profitability of investment projects at the margin.
- Consider reducing or removing incentives for sectors that may not be a priority for diversification (including garments), while keeping incentives exclusively in IDP priority sectors. Consider targeting instead well-defined labour-intensive industries that are losing competitiveness due to rising wages in Thailand, in line with Japan's Thailand-plus-one strategy.
- Tax and other financial incentives could also target specific eligible activities/expenses for which investors (of any sector) receive tax deductions or credits. Such activities may include training and skills development, wage expenses on highly skilled management and engineers, exporting, importing of capital goods, R&D, or local sourcing of inputs.
- Although incentives may have helped to attract firms to invest in Cambodia, they need to be used carefully, first because the amount of revenue forgone due to

incentives can be significant, and second because of the potential risk of tax evasion and tax planning by foreign companies. Changing the form of incentives and shifting towards a progressive tax and incentive system that allows for investors to upgrade further along the production value-chain may be preferable so as to retain quality investors in Cambodia.

- The tax authority should regularly prepare tax expenditure statements to measure and monitor the costs of tax incentives. This requires that investors file a tax return even while benefiting from a tax holiday. Audits should also be carried out periodically to ensure that tax incentives are not abused. Proposed conditions attached to incentives require ongoing monitoring.
- Incentive policies should be reviewed periodically to assess their effectiveness in helping meet desired goals. A natural way to introduce periodic assessments of incentive schemes is to make incentive policies temporary rather than permanent. Temporary schemes require regular consideration of whether the incentive should be continued, reformed or repealed. Temporary tax incentives can be used as a counter-cyclical policy: when foreseen to be phased out in the near future, the investment effects of an incentive tend to be bigger than of permanent incentives (US Department of Treasury, 2010).

Implementing good regulatory practice

Cambodia has been actively promoting good regulatory practices in the policymaking process. Since 2008, it has strived to introduce different regulatory management tools, such as regulatory impact assessments (RIAs), to improve the business climate, promote economic growth and attract investment. By the end of 2016, 13 implementing line ministries were actively using RIA, and a Government Decision was recently issued requiring RIA Working Groups to be established in all ministries. Nevertheless, RIA remains a voluntary process followed for only a handful of regulations each year. A key challenge is the lack of skilled staff within implementing agencies able to effectively draft regulatory impact statements. The shortage of economic analytical capacity for more detailed cost-benefit analysis is acute. As a result, the government has decided to promote the RIA concept progressively while allowing time to further build capacity before fully mandating the implementation of RIA for all regulations.

Although clear guidelines exist for drafting RIA statements, this has proved to be challenging in practice. Ministries often find it difficult to find relevant evidence for the problem statement and are predisposed to use assertions. In practice, many regulatory proposals are prepared by consultants whose remit is to draft the proposal, not prepare a wider policy assessment, underpinned by evidence. Furthermore, while there is interest to involve stakeholders in the policymaking process, the scope and breadth remains limited as ministries have continued to find ways to engage with their immediate stakeholders in developing their proposals. Consequently, many consultations still lack the required structure to achieve a formal, effective and productive discussion and engagement.

As Cambodia continues to develop new regulatory frameworks, reducing regulatory burdens can also help improve the overall regulatory policy process by reducing the quantity and complexity of administrative formalities that impose significant costs on citizens and businesses. This can further enhance efforts to improve service delivery and increase Cambodia's competitiveness. Regulatory delivery and compliance can be further improved by benchmarking benefits of RIA on the actual implementation of the regulation. Regulatory improvements can also be carried out effectively by ensuring that these are linked to a long-term plan and are complemented by other regulatory policy management tools.

Policy recommendations on good regulatory practice

Improving capacity and regulatory quality

- *Improve capacity by restarting cross-ministry network meetings for RIA working groups.* Cross-ministry meetings were initially conducted by the four pilot ministries when RIA was first introduced in Cambodia. These meetings were then extended to three additional ministries in 2014, but this posed logistical challenges and the meetings were subsequently discontinued. Furthermore, neither the Economic, Social and Cultural Council (ECOSOCC) nor the Office on RIA (ORIA – now called the Regulatory Executive Team or RET) is mandated to provide oversight to ensure that these meetings are conducted on a regular basis. Therefore, providing ministries with a steady platform to engage and dialogue with their counterparts from the different ministries can give them the opportunity to highlight challenges and best practice in using and implementing RIA.
- *Provide a structure and platform to further engage with stakeholders.* The annual Ministry RIA Action Plans could be used to alert citizens and representative organisations to forthcoming drafts for consultation and preferably early engagement with ministries, through different platforms, such as news or social media. RET can help create a structured process and identify groups, such as business organisations, that can be influential in supporting good policy making and can also consider including them in RIA training and encourage them to seek members' views.

Ensuring effective implementation of RIA

- *Develop frameworks for administrative simplification and burden reduction.* Several initiatives have been introduced to help improve the stock and flow of regulations. RET would need to sustain this momentum by ensuring compliance on the use of RIA and improving the quality of existing ones.
- *Consider consistency of implementation efforts and sanctions vis-a-vis the objectives of the proposed regulations.* The first steps could now be taken towards risk-based inspection and enforcement to introduce consistency across different regulatory frameworks.

Promoting RBC as a strategic choice to enhance attractiveness

Promoting and enabling responsible business conduct (RBC) is vital to attract and retain quality investment and ensure that business activity contributes to broader value creation and sustainable development. RBC principles and standards set out an expectation that all businesses avoid and address negative impacts of their operations, while contributing to sustainable development where they operate.

Cambodia's economic growth has its roots in RBC – improvements in labour conditions in the textiles and garment industry were directly linked with market access under the 1999 United States-Cambodia Trade Agreement on Textiles and Apparel. In light of changing market conditions and external factors that may limit the extent to which Cambodia can continue to rely on traditional sources of growth, taking a broader and more strategic approach to promoting and enabling RBC is warranted. High-profile land disputes, labour unrest, and frayed industrial relations suggest that the benefits of existing investments could be further enhanced. Additionally, despite the fact that Cambodia has one of the most liberal investment regimes in Southeast Asia, together with generous incentives and tax holidays, investor surveys suggest that it may not be attracting as much investment as it could, particularly from investors based in OECD countries. Despite attempts to address some issues, major challenges remain in terms of establishing and enforcing an adequate legal framework that protects the public interest and creates an enabling framework for RBC.

The extent to which Cambodia can attract investment and maximise its benefits without addressing RBC-related risks present in the business environment is unclear, particularly considering the developments on RBC in the rest of the region. Cambodia should meet these trends head on and ambitiously to ensure it is not left behind. Mainstreaming RBC at a government level and clearly communicating RBC priorities and expectations, including to the private sector, would go a long way in overcoming country risk perceptions, maximising the development impact of FDI, attracting quality investment and promoting linkages with MNEs, and creating a level-playing for business (particularly important in light of increasing RBC expectations in supply chains, which can include legal obligations for some investors).

Policy recommendations on RBC

- Clearly communicate responsible investment as an objective in the new *Investment Law* and set out an expectation for investors to adopt an approach consistent with international principles and standards on RBC, such as those contained in the OECD *Guidelines* and UN *Guiding Principles*. Include RBC in "smart" incentives.
- Develop a *National Action Plan on Responsible Business Conduct* in collaboration with stakeholders and in line with international good practice in order to mainstream RBC and prioritise and advance reforms needed to ensure an adequate legal framework that protects the public interest and underpins RBC. The CDC, within its strengthened mandate and responsibilities for implementing the IDP, could take on a leadership role in this regard. Consider establishing a focal point on RBC in the government.
- Establish a procedure at CDC through which affected communities and their representatives can submit reservations and complaints related to RBC in existing investments, including in the special economic zones.
- Strengthen and extend the mandate of the Arbitration Council to cover areas beyond labour issues and to allow for binding decisions and ensure its independence. Promote mediation processes as a step before binding arbitration in order to keep the flexibility and the power of the Council.
- Clarify and strengthen how the effects of proposed investment projects are assessed and increase transparency on environmental and social impact assessments and encourage more public participation; communicate the extent of business responsibilities for protecting the environment at both national and provincial levels. Improve technical capacities of responsible authorities.

- Exercise the government's convening role and bring together stakeholders in order to agree on specific actions to ensure the competitiveness of the garment and footwear sector. Consider the advantages of ambitiously embracing global developments on RBC and the ways in which Cambodia could be the leader in applying the due diligence framework enshrined in the OECD *Guidelines* and the UN *Guiding Principles*.
- Ensure that the application of the legal framework on industrial relations follows international norms and encourage more meaningful stakeholder engagement in this area.
- Communicate RBC expectations to business through the Government and Private Sector Forum. Encourage the establishment of firm-level grievance mechanisms as a complement to existing complaints mechanisms in order to strengthen the capacity of workers to voice concerns. Encourage cross-sectoral learning for addressing RBC risks.

Cambodia's infrastructure still impairs the investment climate

Rapid economic and population growth, coupled with past degradation of infrastructure during the civil conflict and subsequent underinvestment, have seen infrastructure bottlenecks emerge as critical constraints to growth and social inclusion (ADB, 2014a). Although investors note a sharp improvement in the quality and supply of infrastructure in recent years, transport and electricity still figure among the top ten constraints – albeit significantly farther down the list in the latest World Bank Enterprise Survey (World Bank, 2018).

Infrastructure bottlenecks hamper efforts to successfully diversify the economy and to integrate more fully into regional and global value chains (see Chapter 3). Ramping up investment in Cambodia's infrastructure networks will be crucial, not only to sustain robust rates of economic growth, but also for translating this into broad-based improvements in living standards while ensuring long-term climate resilience and environmental sustainability.

As rapid economic growth continues, donor-financing will further decline in relative importance, underlining the need to mobilise domestic public and private resources, as well as foreign capital, for infrastructure investment. Private sector investment has so far been limited, largely confined to power generation and international air transport and small-scale projects, but public-private partnerships (PPPs) are becoming increasingly prevalent.

At the same time, the policy, legal and institutional frameworks governing private investment in infrastructure are ripe for reform. The National Strategic Development Plan 2014-18 sets out short-term priorities for infrastructure. A *Law on Concessions* was promulgated in 2007, but the implementing sub-decree was never approved and accompanying policy and institutional frameworks have not been sufficiently developed. The government has recently made high-level political commitments to adopt necessary reforms. A central PPP unit and risk management unit are to be integrated into the Ministry of Economy and Finance, and a viability gap fund is being considered to subsidise or guarantee investment projects to make them bankable for the private sector.

Aspects of Cambodia's infrastructure challenges are also covered in other chapters. Chapter 3 looks at the role of trade facilitation and logistics in improving competitiveness and promoting diversification. Chapter 8 looks at responsible business conduct, including issues related to resettlement of affected populations from infrastructure projects Chapter 10 considers how to promote further investment in renewable energy, and Chapter 11 looks at how development partners have contributed to private sector development in Cambodia, including through support for infrastructure.

Policy recommendations on infrastructure

- *Improve execution of infrastructure plans*. While long-range infrastructure planning is in evidence to some extent as part of successive National Strategic Development Plans and sectoral Masterplans, much of the execution would appear to be ad hoc, with competitive tendering for infrastructure procurement as the exception rather than the rule, whether delivered as public-private partnerships or through traditional procurement. In either case, no detailed pipeline of forthcoming projects currently exists.
- *Proceed with plans to revamp the legal, policy and institutional framework governing PPPs for infrastructure projects*. Transparency, competition and a focus on value-for-money should be the most critical elements against which the success of the government's ambitious plans to mobilise PPPs for infrastructure should be judged. The procurement of medium- to large-scale infrastructure projects through non-competitive tendering processes should be avoided.
- *Systematically involve end-users, affected communities, private investors and other relevant stakeholders* from the earliest stages of infrastructure projects planning so as to ensure that their needs – as well as social, economic, environmental and governance risks – are correctly assessed and addressed, and adequately reflected in the contractual structures. The revamped policy, legal and institutional frameworks for PPPs should be responsive to affordability constraints and be designed to ensure responsible business conduct in all PPPs.

Mobilise private investment in support of green growth

Green growth implies fostering economic growth and development while ensuring that natural assets continue to provide the resources and environmental services on which our well-being relies. To do this it must catalyse investment and innovation which will underpin sustained growth and give rise to new economic opportunities (OECD 2011). Investment for green growth includes, among other things, investment in infrastructure such as renewable energy, energy efficiency, water purification and distribution systems, transport and housing, the preservation of natural resources and waste management (OECD 2015).

A green investment framework has much in common with a general policy framework for investment, but an investment-friendly policy framework does not necessarily result in direct investment in activities conducive to green growth unless certain elements are also in place. These include: a strong governmental commitment at both the national and international levels to support green growth and to mobilise private investment for green growth; policies and regulations to provide a level playing field for more environment-friendly investments; policies to encourage more environmentally responsible corporate behaviour; an institutional capacity to design, implement and monitor policies to foster green growth objectives; financial mechanisms for green investment; and policies to support private sector involvement in green infrastructure projects (OECD 2015).

Cambodia is facing environmental and development challenges. Much of the population is still highly dependent on natural resources for their livelihoods, and reducing poverty, particularly in rural areas, is a key concern for the government. Unsustainable use of natural resources has resulted in increasing degradation and pollution. These trends are exacerbated by the country's vulnerability to climate change, which threatens progress made towards economic growth and poverty reduction.

These challenges are also opportunities for Cambodia to mobilise private investment in support of green growth, by improving the quality and sustainability of investment in natural resource sectors as well as generating new investment in green sectors. Attracting investment in areas such as renewable energy, energy efficiency or waste management could help create jobs and spur growth and development. Just under 70% of the population still lack access to energy, and at the same time, there is significant potential for renewable energy generation, particularly small hydro and solar energy; these factors highlight the potential for grid connected and off-grid solar solutions, both centralised and decentralised. Sustainable natural resource management practices such as better water resource management, eco-tourism and sustainable agricultural practices could promote investment that generates employment, positive environmental benefits and growth.

Recognising the importance of promoting green growth and environmental sustainability, the government has made much progress in recent years in instituting policies that promote green growth and support the greening of investment flows. The Cambodia Climate Change Strategic Plan (2014-23), supported by the Climate Change Action Plan (2016-18), set out commitments to green growth and climate action. A new Environment Code is being developed that brings together and aligns all previous legislation related to environmental protection issues. The National Council for Sustainable Development is spearheading efforts across ministries to implement climate change actions and undertaking scoping work to understand the potential to engage the private sector in environmental sectors, including renewable energy and sustainable agriculture.

Despite this progress, consistent and robust implementation of policies needs to be strengthened, particularly for environmental protection. For example, capacity to implement environmental safeguards policy at the provincial level is weak and affects enforcement and monitoring. Action at the sector level also needs to be scaled up. Cambodia has a high potential for renewable energy and a fledgling solar industry, spurred in part by donor financed programmes over the past decade. Despite this, no renewable energy policy exists and no incentives are in place to spur the uptake of grid-connected renewables, and power development plans do not reflect the potential for green energy in the country. Similarly, there is no policy framework in place to support energy efficiency.

Policy recommendations for scaling up green investment

- *Include a focus on green investment in the new Investment Law:* Revising the *Investment Law* is an opportunity to include incentives for green investment, in line with efforts by other ASEAN countries such as Viet Nam, Malaysia and Thailand. Viet Nam's investment policy includes incentives for investment in environmentally friendly areas such as renewable energy, afforestation and recycling. Malaysia has instated a major drive to encourage investment in green industrial development, including green technologies (renewable energy, energy efficiency etc.) and waste eco-parks. Malaysian government incentives include tax allowances for green technology projects and income tax exemption for companies providing green technology services. While the current Cambodian *Investment Law* and supporting decrees provide incentives for qualified investment projects, projects that promote environmentally friendly technologies are not included in the list.

- *Develop a policy framework and targets for renewable energy:* Cambodia's power development plan currently includes proposals to scale up power generation from hydropower (large scale), gas and coal, but does not take into account the significant potential of renewable energy sources, despite the decreasing costs of renewable technologies. A recent study shows that renewable energy technologies such as solar could provide power at close to the same price as fossil fuels in Cambodia, and could be cost competitive with additional support, such as through feed-in-tariffs. Developing a policy framework for renewable energy in Cambodia is essential to scale up foreign and domestic private investment in green growth. A clear target and policy for renewable energy is needed and should be reflected clearly in the power development plan.
- *Provide incentives for the roll-out of renewable energy technologies:* While solar technologies have been supported in areas without grid connectivity, there have been fewer efforts to spur the roll out of grid-connected solar as a source of power. In places where houses or companies do have solar installed, they are not actively encouraged or compensated to feed excess energy back into the grid. Despite the lack of incentives, a fledgling solar industry has developed in Cambodia with 11 companies registered with the Solar Energy Association of Cambodia, mostly providing off-grid solutions targeting communities not connected to the grid. With targeted incentives to promote renewable energy, either through feed-in tariffs or net metering, private investment in renewable energy could be scaled up.
- *Use public funding for environment and climate change catalytically to mobilise additional investment:* Development finance has played an important role in supporting Cambodia in addressing environmental issues. Support to government institutions, through multi-donor initiatives such as the Cambodia Climate Change Alliance, have enabled the development and roll-out of important environmental policies including climate change policies and action plans. Going forward, there is a need for environment related development co-operation efforts to focus on catalysing private sector engagement and investment through the use of ODA and other public finance. Programmes that target private sector development and the environment – such as those providing access to finance for green technologies for SMEs and households – could help spur investment in green sectors and mobilise additional investment.
- *Improve access to finance for SMEs and households to promote uptake of green technologies:* The high cost of energy in Cambodia and a dependence on imported energy means there is a clear business case for private actors to invest in energy efficiency. But most industry is characterised by a prevalence of SMEs where a lack of awareness of the potential for cost savings from energy efficiency and a lack of access to finance are cited as major barriers to investment in green technologies. Government and donor programmes to support SMEs to understand the benefits of energy efficiency and increase their access to finance should be encouraged. Some examples of programmes exist already (e.g. UNIDO and Better Factories Cambodia work with SMEs), and these can be further scaled up.

Corporate governance

Corporate governance concerns the structures framing the relationships among a company's executive management, board of directors, shareholders, and stakeholders. From the perspective of modernising legal and regulatory frameworks, effective corporate governance is important because it affects individual firm behaviour as well as broader macroeconomic indicators such as growth and investment. For emerging market economies, improving corporate governance can serve several purposes, including reinforcing property rights, reducing transaction costs, and lowering the cost of capital, which together can improve investor confidence and support capital market development. The Asian financial crisis that began in 1997 acted as a significant catalyst for improving corporate governance frameworks in Asia with the aim of building well-functioning and stable financial markets. While the Cambodian authorities have made progress in recent years in the area of corporate governance, including an updated *Accounting Law* and the adoption of international accounting standards, overall implementation of the corporate governance framework remains challenging.

Policy recommendations to improve corporate governance

- *Enhance the quality of corporate disclosure and ensure that it is made in a timely manner.* The government should ensure the implementation of good practices for financial and non-financial disclosure, in both Khmer and English. Currently, the adoption of Cambodian International Financial Reporting Standards is required for enterprises and non-profit organisations, though an extension has been given to banks and financial institutions until 2019. Implementation has been challenging, however, resulting in delays in the roll-out of mandatory adoption. Progress can be made in terms of the timely publication of financial and non-financial information by firms, especially in English. Managers, board members, and controlling shareholders should especially improve disclosure of the structures that give insiders control disproportionate to their equity ownership.
- *Clarify and ensure effective separation between the state ownership function and regulation.* A clear separation is a prerequisite for ensuring a level-playing field with the private sector and for avoiding competitive distortions. Clear regulations should be developed to protect the independence of regulators, especially vis-à-vis line ministers. Nominal independence is not enough, as operational independence might be jeopardised by a narrowly based fee structure, for example, or by a lack of budget control. In Cambodia, a number of economic activities are performed either within the general government sector or by companies that, while not classified as state-owned enterprises, are closely related to the government.
- *Develop and disclose a state ownership policy.* Although Cambodia has been at the forefront of privatisation in the region, some enterprises remain in government hands. The government has not yet published a policy for state ownership. An ownership policy should define clearly the overall rationale for state ownership and be made public, clarifying the main objectives to which this rationale gives rise. Most importantly, the ownership policy should define how the state should behave as an owner. Clear and published ownership policies provide a framework for prioritising SOE objectives and are instrumental in limiting the dual pitfalls of passive ownership or excessive intervention in SOE management.

Competition policy

Competition is essential for a dynamic business environment in which firms invest (OECD, 2015). Competition not only benefits consumers with greater choice, quality and lower prices but also, drives productivity and innovation, key factors that contribute to economic growth. An effective competition policy usually includes active economy-wide enforcement of antitrust rules designed to deter anticompetitive practices as well as pro-competition sectoral policies. Together, these policies improve both domestic economic performance and international competitiveness.

Creating and maintaining competitive markets requires strong, comprehensive competition legislation which is enforced by a well-trained and resourced competition authority, free from political interference and corruption and that enforces the law. A sound competition regime requires that firms know the rules of the game and respect them and that those rules are applied equally to all firms – private, state-owned, foreign or domestic. It also requires legislation that achieves the legitimate objectives of government but does not create unnecessary barriers to entry of new firms – a crucial element in achieving well-functioning markets.

According to the World Bank Enterprise Survey of 2012, anti-competitive practices are perceived "as a major impediment to doing business in Cambodia"[2]. The authors consider that completing the draft competition law and setting up an independent Competition Agency "would go a long way towards ensuring a level playing field for companies in a country where personal connections are still considered important for business profitability" (World Bank, 2015b). Competition authorities can play an important role in reducing government restrictions on markets that can be an important source in incentivising enterprise registration by helping government bodies identify existing regulations that unnecessarily restrict competition or helping policy makers design new regulations that hinder competition as little as possible yet still achieve their policy goals (OECD, 2009). By failing to comply with various economic rules and regulations, informal firms are often able to undercut and steal business from formal firms, even when they use inefficient production techniques. As a result, formal firms are less able to fully exploit economies of scale, limiting their own growth and productivity.

Currently Cambodia does not have a general competition law in place, even though it has committed to do so within both the context of the ASEAN Economic Community Blueprint (whereby it was meant to have a law by end 2015) and of the WTO accession in 2004 (where it was meant to introduce a competition law by 2006). Discussions have been ongoing for a number of years, but so far have not resulted in a draft being approved or even having initiated the legislative process. Cambodia should adopt the *Competition Law* at the earliest opportunity to benefit from well-functioning markets and a level playing field for both domestic and foreign firms, independent of ownership (private or state). Such rules can help Cambodia benefit from higher productivity gains and continued economic growth. In general terms, the draft law is broadly in line with international best practice. It should be followed quickly with implementing rules on issues such as criteria for remedies and sanctions as well as merger control provisions.

Policy recommendations on competition policy

- Adopt the *Competition Law* and implementing rules on fundamental issues such criteria for remedies and sanctions as well as merger control provisions.

- Ensure more independence of the Competition Commission, including reducing direct government influence in its composition and providing sufficient resources.
- Analyse laws and regulations through a *Competition Assessment Toolkit* or similar tool to ensure that market entry is not unduly restricted by rules and regulations that go beyond what is necessary to meet legitimate policy objectives

Notes

[1] NBC-NIS (2016).

[2] World Bank (2015b).

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Chapter 2. Investment trends and industrial structure in Cambodia

This chapter reviews the investment trends and industrial structure in Cambodia. It describes the relatively strong performance of the Cambodian economy in attracting foreign investment but also the need to further diversify sources of FDI by sector and by country.

Cambodia’s overall economic performance has been impressive, with rapid growth and poverty reduction, but it has been dependent to a large extent on relatively few firms – including many foreign investors – in a handful of sectors. More efforts will be needed to diversify sources and sectors of foreign investment, raise levels of domestic investment, bring the informal sector into the formal economy and allow small firms to grow so as to fill the "missing middle" of medium-sized firms.

Foreign investment has been buoyant in Cambodia, reflecting the longstanding openness towards foreign investors. But while FDI inflows have grown rapidly over time, particularly since WTO accession in 2004, they have not kept pace with overall economic growth. Similarly, recent approvals of foreign investment by the Cambodian Investment Board show no signs of upward movement. The most active investors have been from East Asia, with still relatively little from traditional multinational enterprises (MNEs) located in Europe and North America.

Domestic investment has also been growing, but as a share of GDP is among the lowest in the region and well below that of many other countries at the same level of development. The ratio has fluctuated around 20% for the past 15 years. Allied with this is a high share of informality, with only 2.1% of firms registered with the Ministry of Commerce as of 2014. The practices of the informal sector are by far the most important business environment constraint listed by firms in the latest World Bank Enterprise Survey for Cambodia (World Bank 2018). Most firms are micro enterprises, with 86% having three or fewer employees in 2011. There are very few medium-sized firms, representing only a small share of employment and output. This industrial structure has implications for productivity growth and for the ability of Cambodian firms to benefit from linkages with foreign investors and hence for the long-term development impact of foreign investment. Unlike in many other countries in the region, state-owned enterprises do not play a prominent role within the economy, except in very few sectors.

Domestic trends

The industrial structure is skewed towards micro-enterprises

Micro-enterprises dominate Cambodia’s economy in terms of the number of firms, but they operate almost entirely in the informal sector. Table 2.1 shows the distribution of firms in Cambodia by employment size, as of 2011. Estimates based on a 2014 survey tell much the same story, with firms with 50 or more workers representing only 0.3% of the total universe of firms in Cambodia. In terms of output, the story is very different, with the largest firms representing 42% of total sales or 65% in manufacturing – in other words, 412 firms represent two thirds of total sales in the manufacturing sector. In contrast, firms with 50-99 employees represent only 2% of sales in manufacturing or 2.8% overall.

Investment lags behind much of the region

Cambodia has the lowest ratio of investment to GDP Southeast Asia, with the exception of the Philippines (Figure 2.1). The share of investment in GDP is higher in both Viet Nam and Lao PDR, although the Cambodian share has been rising steadily since 2011 and is now at record levels. It is nevertheless still four percentage points below the average of lower middle-income countries as a group.

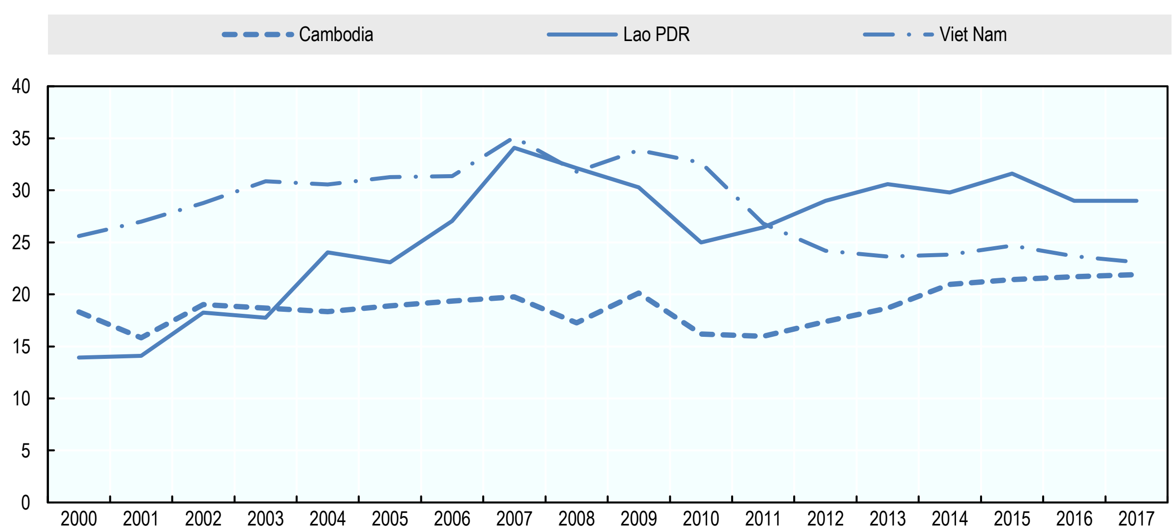
Table 2.1. The "missing middle" of firms in Cambodia, 2011

(size defined by number of employees)

	Micro (1 -9)	Small (10 – 49)	Medium (50-99)	Large (over 100)	Total
All Sectors					
Establishments (number)	491 961	11 513	833	786	505 093
- *Share*	*97.4*	*2.3*	*0.2*	*0.2*	*100*
Employment	960 423	205 307	55 279	452 239	1 673 248
- *Share*	*57.4*	*12.2*	*3.3*	*27.0*	*100*
Sales (USD m.)	5 786	1 242	361	5 290	12 678
- *Share*	*45.6*	*9.8*	*2.8*	*41.7*	*100*
Manufacturing					
Establishments (number)	69 397	1448	159	412	71 416
- *Share*	*97.2*	*2.1*	*0.2*	*0.6*	*100*
Employment	148 824	25 779	10 759	344 979	530 341
- *Share*	*28*	*4.7*	*2.0*	*65.0*	*100*

Source: Economic Census, 2011.

Figure 2.1. Gross fixed capital formation as a share of GDP



Source: World Bank.

Foreign investment trends

Cambodia is doing well in attracting foreign investment

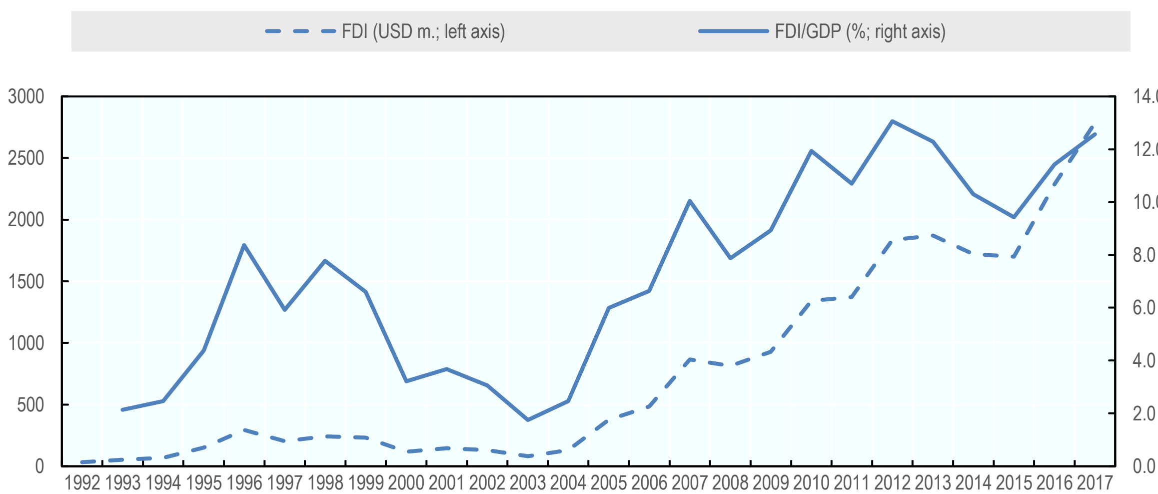
As in many countries in the region, two sources of foreign investment data exist: balance of payments figures for foreign direct investment (FDI) from the National Bank of Cambodia and investment approvals from CDC for QIP-qualifying projects. Approval data typically record investment intentions, which are often inflated. Their usefulness is primarily in giving an idea of investor perceptions at any point in time. The CDC data also exclude certain key sectors such as banking, finance and construction and cover only investment over a certain threshold. The balance of payments data provided by the National Bank of Cambodia. A third source of information is the investment flowing into SEZs which are not captured in other sources. The National Bank of Cambodia and the

National Institute of Statistics developed a survey of foreign investors in 2015 to understand better the economic value that foreign investment brings (NBC-NIS, 2016). It estimated investment into the construction and real estate sectors which are not adequately reflected in the other sources of data. As a result, estimated total FDI inflows into Cambodia were revised substantially upward.

Cambodia has done very well in attracting foreign investors given the small size of its economy, though FDI is still heavily concentrated in only a few sectors, such as garments. As in other countries in the region, FDI inflows took off dramatically after Cambodia joined the WTO in 2004. Although dozens of laws were revised as part of WTO accession, the economy was already relatively open under the 1994 *Investment Law*. The impact of accession on FDI was primarily the result of improved market access for Cambodian exports able to benefit from most-favoured nation treatment.

Figure 2.2. FDI inflows into Cambodia took off after 2003

(USD million)



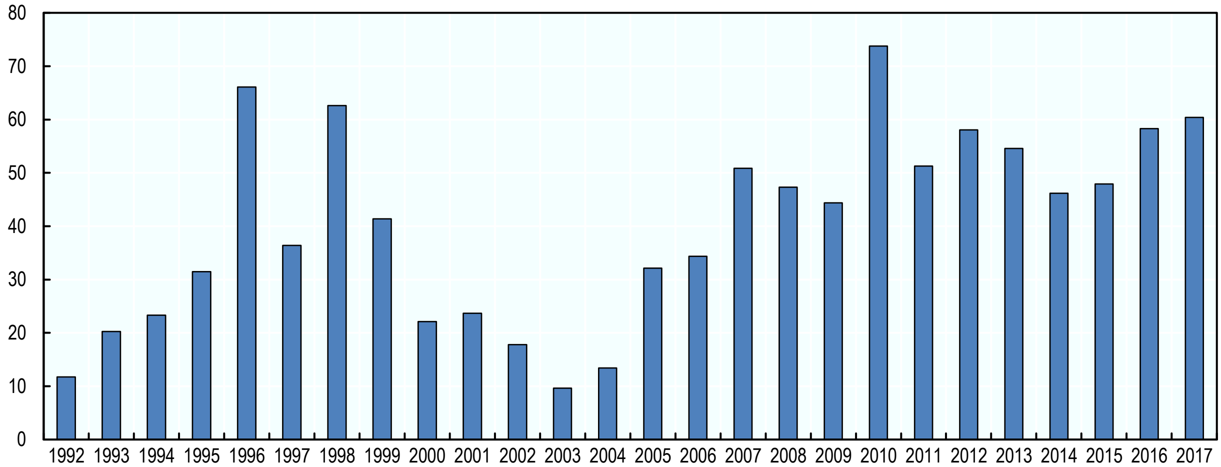
Source: World Bank.

The rapid growth in FDI has led to a rising share for Cambodia in the total stock of FDI in ASEAN. Given the small size of the Cambodian economy, this share is still only 0.9%, but it has been growing at a time when FDI inflows into many other ASEAN member states are also at record levels. As a share of GDP, the stock of FDI in Cambodia, at 93% in 2017, is far higher than in all other ASEAN member states with the exception of Singapore. In recent years, inflows of FDI have accounted for roughly one half of gross fixed capital formation (Figure 2.3) which, as with the stock figures, suggests that foreign investors have a significantly greater role within the Cambodian economy than in much of the rest of ASEAN. Although this is partly a result of the relatively small size of its economy, it is also a function of its longstanding openness to foreign investment.

The revised estimate for the stock of FDI in Cambodia based on the NBC-NIS survey of investors was 50% higher in 2014 than the official figure. This suggests both a better overall performance than what is presented above but also a greater foreign role within the Cambodian economy.

Figure 2.3. FDI inflows relative to gross fixed capital formation

(per cent)



Source: UNCTAD.

…but inflows are now well diversified by sector or by country

While the various official sources of investment data all point to the same overall trends, in terms of the prevalence of Asian investors and the importance of manufacturing projects, the magnitudes differ from one source to another. By balance of payments figures, China has been the largest investor, particularly in recent years, although ASEAN member states as a group have invested more (Table 2.2). Some ASEAN investment may be by multinational enterprises located elsewhere but channelling their investment through affiliates already in the region such as in Singapore. Korea is the largest investor among OECD member countries, as it is often in Viet Nam. According to Korean official statistics, Korean firms have invested USD 2.6 billion in Cambodia or slightly less than Korean investment in either Myanmar or Thailand. While EU and US investors are among the most active in Southeast Asia, they are still under-represented in Cambodia.

Table 2.2. FDI in Cambodia by source country, 2000-17

(USD million)

	2010	2011	2012	2013	2014	2015	2016	2017	2000-17	
Australia	37	20	23	19	33	32	35	32	**322**	2%
Canada	7	6	5	- 7	5	15	26	69	**159**	1%
China	127	180	368	287	554	538	502	618	**3 856**	23%
EU	43	54	126	115	139	180	194	213	**1 277**	8%
Hong Kong (China)	33	48	92	83	136	138	249	347	**1 126**	7%
Japan	6	22	14	39	85	53	199	227	**729**	4%
Korea	47	139	162	178	106	72	140	177	**1 587**	10%
Chinese Taipei	65	109	173	173	122	76	98	169	**985**	6%
USA	16	17	16	34	50	41	53	74	**431**	3%
Intra-ASEAN	349	224	523	299	372	425	636	603	**4 501**	27%
Other	150	230	321	55	124	131	149	202	**2 237**	13%
TOTAL	**783**	**892**	**1 557**	**1 275**	**1 727**	**1 701**	**2 280**	**2 732**	**16 689**	

Source: ASEAN Secretariat.

Approvals data confirm the importance of China and the prevalence of investors from East Asia (Table 2.3). Investment in much of the rest of the region tends to be dominated by OECD-based investors from Japan, Korea, Europe and North America. They are notably less prevalent in Cambodia. According to the more comprehensive data in the NCB-NIS survey, Asia represents 85% of the total stock of FDI as of 2014, with most investment from China (31%), ASEAN (22%) and Korea (15%). Europe represents 7% and the US only 2%.

Table 2.3. Total investment approvals by country, 1994-2015

(USD million)

China	11 104
Korea	5 547
Malaysia	2 825
UK	2 619
Viet Nam	1 664
US	1 366
Chinese Taipei	1 273
Hong Kong, China	1 019
Singapore	992
Thailand	973
Japan	713
Russia	620
Israel	310
France	310
Australia	194
Saudi Arabia	131
Canada	123
India	82

Source: Cambodian Investment Board

Because traditional statistics tended to underestimate FDI in some important sectors, the best source of information by sector is the NBC-NIS survey based on data from 2014 (Table 2.4). Manufacturing, particularly garments, is the most important sector as indicated in other official sources, but agriculture, accommodation, finance, electricity and real estate had all received more than USD 2 billion as of 2014.

Table 2.4. FDI in Cambodia by sector, 2014

(USD million)

	2014
Agriculture, forestry, and fishing	2 715
Mining and quarrying	193
Manufacturing	4 601
Of which: garments	(3 950)
Construction	350
Accommodation and food service activities	2 114
Financial and Insurance activities	2 375
Telecommunication	600
Electricity	2 199
Real estate activities	2 800
Other services activities.	1 290
TOTAL	**19 236**

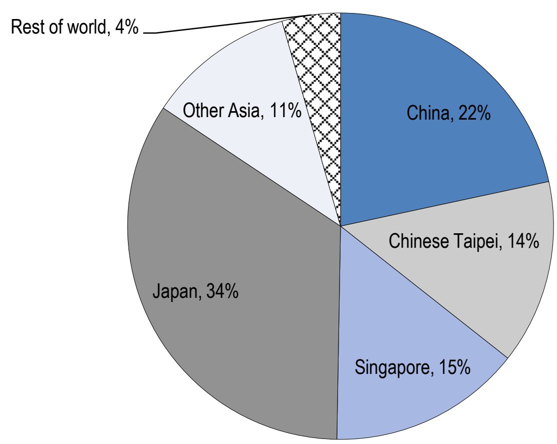
Source: NBC-NIS (2016).

Japanese investors are the most keen to invest in special economic zones, as they sometimes are in other countries such as Myanmar or Lao PDR (Figure 2.4). Almost all existing investors in SEZs have come from the rest of Asia, whether as part of a regional value chain or a global one. Special economic zones have contributed to both geographical (in terms of sources of investment) and industrial diversification. Minebea of Japan became the first motor manufacturer in Cambodia in April 2011 when it started production at the Phnom Penh SEZ.

Of the 76 firms established or starting business in the PPSEZ, 41 are Japanese and another three involve a joint venture with a Japanese firm as one of the partners. The first investor arrived in 2008, but almost half of the investors have established over the past two years and from an increasing range of countries such as the United States, Australia and Turkey. There are at present no European firms in the Phnom Penh SEZ.

Figure 2.4. Japanese investors are the most active in SEZs

(share of total foreign investment in SEZs)



Source: Cambodian Special Economic Zone Board

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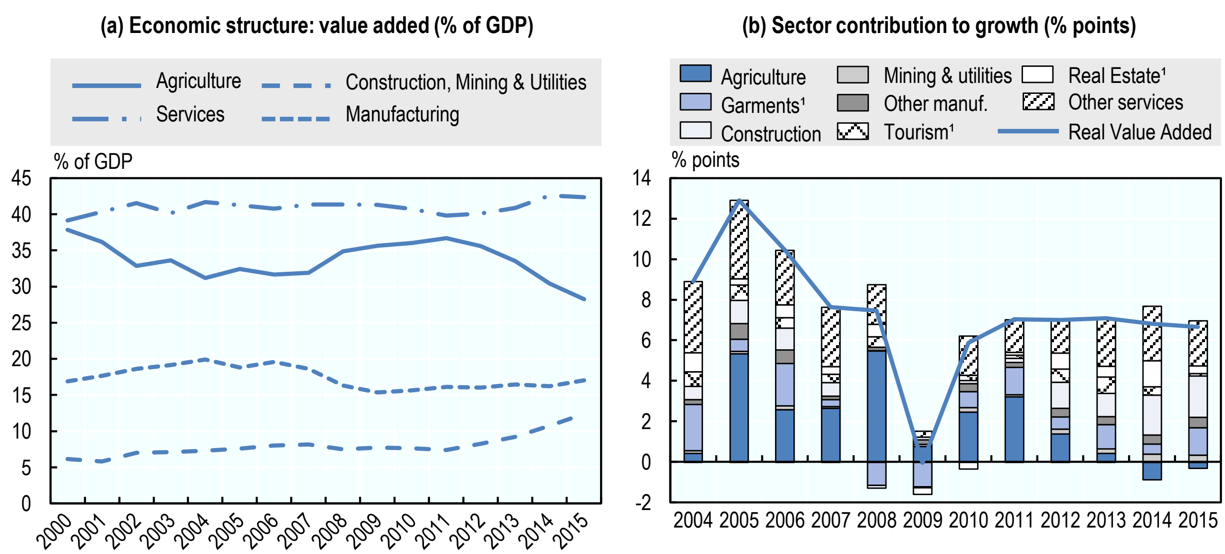
Chapter 3. Competitiveness and diversification in Cambodia: Challenges and opportunities in the manufacturing sector

This chapter looks at the extent of diversification of the Cambodian economy and developments which might erode the competitiveness of the garments sector, which has been central to export-led development over the past two decades. It looks at various measures that can be taken to improve productivity and competitiveness in the manufacturing sector, notably by promoting linkages, strengthening firms' absorptive capacity, addressing skills shortages, enhancing trade facilitation and improving infrastructure connectivity.

Over the past two decades, Cambodia has gone through an important structural transformation away from agriculture, which was only temporarily reversed during the global financial crisis (Figure 3.1a). Services and industry are the leading drivers with respective value added picking up strongly in recent years due to increased tourism, real estate and construction activities (Figure 3.1b). The manufacturing sector remains the key driver behind Cambodia's industrial output – contributing roughly 58% of the industry total value added in 2015 – but it now shares this role with a fast growing construction sector. Since 2000, the share of manufacturing in total value added has been fairly stable, partly reflecting the difficulties in upgrading the industrial base from mostly low value added, export-oriented garment activities towards higher-value added ones. The global financial crisis led to significant backtracking on earlier achievements and, despite the recovery in garment exports since the crisis, manufacturing has seen only a small increase in its share of total value added, enough to return to the levels seen in the early 2000s.

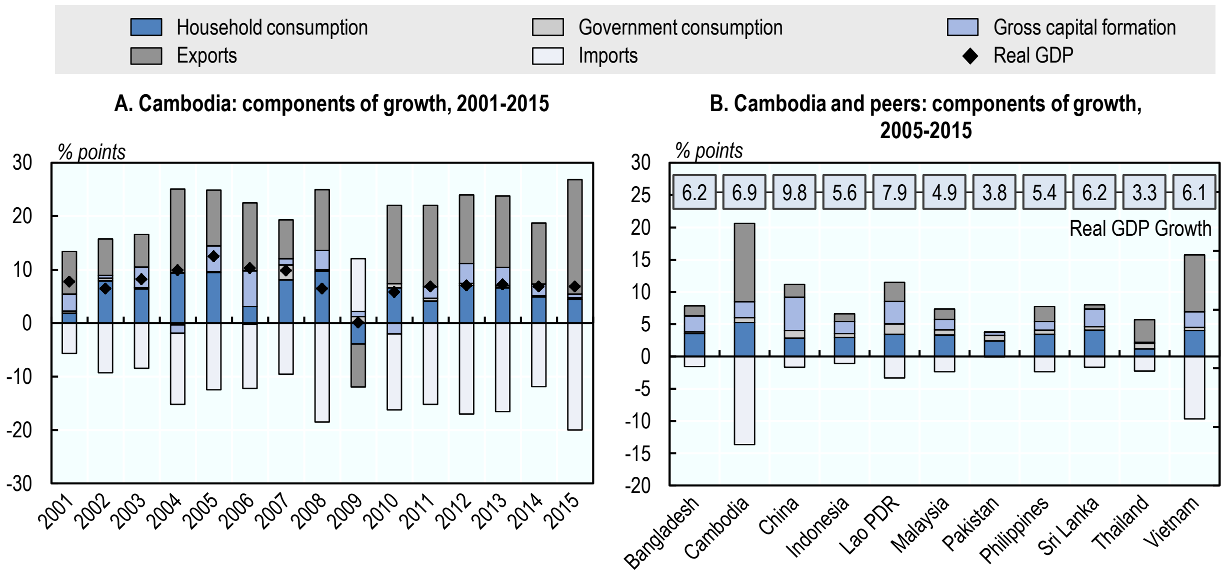
Figure 3.1. Cambodia's economic structure and sector contribution to growth



1. Garments includes textiles and footwear; Real Estate includes business activities and Tourism refers to hotels & restaurants.
Source: Estimates based on World Development Indicators and National Institute of Statistics of Cambodia.

Exports sectors have traditionally driven most of the manufacturing output growth in Cambodia, but these sources of growth remain concentrated in only a few subsectors, notably garments and wood products. These two products accounted for roughly 88% of exports in 2014, with garment exports largely supported by preferential access to the European Union and other developed economies.[1] Data from the National Bank of Cambodia, for instance, point to around 90% of goods exports in 2010-15 related to products covered under a Generalised System of Preferences, with an increasing trend observed.[2] The reform to the EU Everything But Arms programme in force since 2014, focusing support on the most needed developing countries, served to further strengthen the preferential arrangement to which Cambodia is beneficiary. Besides growth of exporting sectors, Cambodia's growth path has also been propelled by private consumption to a large extent (Figure 3.2a), whereas investments have had a more limited role, notably compared to several of its ASEAN peers which have seen a more prominent contribution of investments to growth (Figure 3.2b).

Figure 3.2. Components of growth in Cambodia and selected peers



Source: Estimates based on World Bank Development Indicators.

Diversifying the economy and the manufacturing base and export markets further is, therefore, a critical challenge to reduce vulnerabilities and exposure to external shocks. Cambodia has been able to exploit its competitiveness and expand market share in its traditional export industries in the last decade (Figure 3.3), gaining market share from economies like China and Viet Nam (Box 3.1). But the potential for these industries to continue to propel growth in the future is uncertain, with growing competition from other low-cost producing economies.

Cambodian garment producers are mostly foreign-owned[3] and generally integrated into global value chains at the downstream end of the value chain, through cut, make and trim activities (CMT), where profit margins are low. Investors are thus particularly sensitive to cost-pressures, and foreign ownership makes them potentially more footloose. More positively, there are emerging signs that Cambodia is expanding into products offering higher export growth opportunities than traditional products (e.g. footwear, unprocessed rice, and some electronics and transport equipment), although they still remain relatively limited compared to the more traditional export basket. Diversification across export destinations is also taking place to some extent but at a much slower pace (Warr and Menon, 2015).

Going forward, the challenge lies in identifying and implementing the most appropriate policies to facilitate the emergence of competitive industries that will help the economy to diversify and improve productivity levels, while also finding ways to upgrade the most competitive existing ones. This chapter focuses on the challenges and opportunities for improving Cambodia's manufacturing productivity and strengthening diversification within the sector. Other sectors such as tourism or agriculture, which are not addressed here are also important for Cambodia's development and diversification (Box 3.2).

Box 3.1. Better Factories Cambodia Programme: a source of competitive advantage

Cambodia has successfully improved its competitiveness in the garments industry since the end of the Multi-Fibre Arrangement (MFA) in 2004 led to the reallocation of garment production across countries. It managed to remain competitive and has even experienced significant gains in exports since then. Despite a steep decline in garment exports during the global financial crisis in 2009, which showed the potentially disruptive effects of over reliance on one sector for economic development, its exports rapidly recovered as a result of greater export market diversification. Producers diversified away from the US market by taking advantage of the EU's revised tariffs provisions for Cambodia. As such, the share of exports flowing to the European Union increased considerably (Table 3.1), although exports to the rest of the world also increased significantly.

Table 3.1. Cambodia's top exports by product and market

Top 10 Exports Markets	2005		Top 10 Exports Markets	2010		Top 10 Exports Markets	2014	
United States	1 597 637	52.9%	United States	1 905 612	34.1%	European Union	2 620 741	24.5%
Hong Kong, China	541 694	17.9%	Hong Kong, China	1 386 447	24.8%	Hong Kong, China	2 327 039	21.8%
European Union	516 530	17.1%	European Union	953 108	17.0%	United States	2 000 174	18.7%
Canada	107 145	3.5%	Singapore	429 981	7.7%	Singapore	1 746 908	16.4%
Singapore	69 622	2.3%	Canada	274 421	4.9%	Canada	508 972	4.8%
Japan	62 884	2.1%	Thailand	150 087	2.7%	China	356 595	3.3%
Vietnam	46 106	1.5%	Vietnam	96 146	1.7%	Japan	344 883	3.2%
Thailand	15 218	0.5%	Japan	89 557	1.6%	Malaysia	124 062	1.2%
China	14 257	0.5%	China	65 008	1.2%	Korea, Rep.	123 179	1.2%
Malaysia	8 527	0.3%	Mexico	29 465	0.5%	Vietnam	96 801	0.9%
Total	**3 018 613**	**100%**	**Total**	**5 590 104**	**100%**	**Total**	**10 681 397**	**100%**
Top 10 share	**2 979 619**	**99%**	**Top 10 share**	**5 379 831**	**96%**	**Top 10 share**	**10 249 354**	**96%**

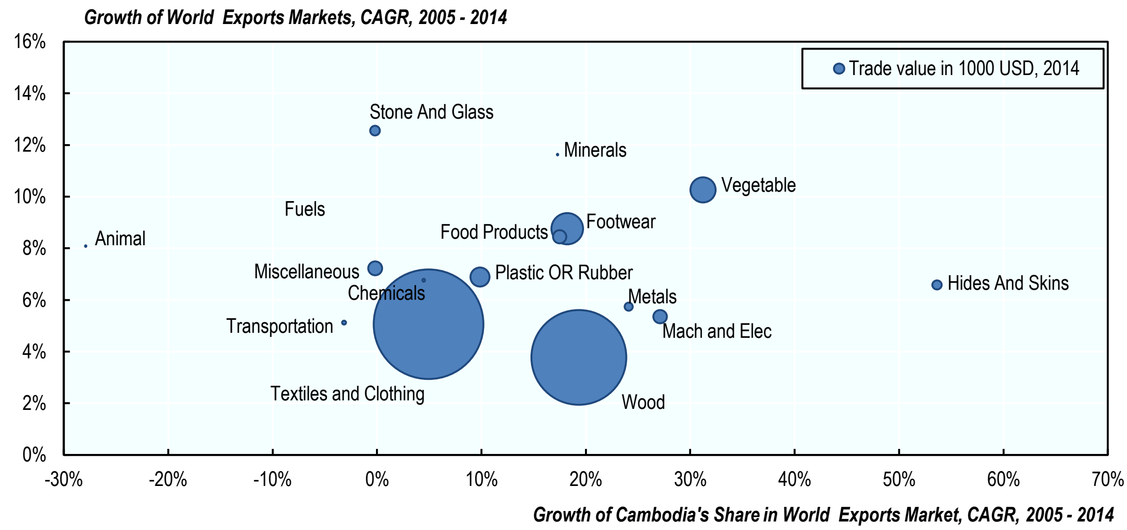
Top 5 Exports Products	2005		Top 5 Exports Products	2010		Top 5 Exports Products	2014	
Textiles and Clothing	2 237 481	74.1%	Textiles and Clothing	3 056 540	54.7%	Textiles and Clothing	5 382 674	50.4%
Wood	591 029	19.6%	Wood	1 816 971	32.5%	Wood	4 048 714	37.9%
Footwear	46 158	1.5%	Footwear	184 086	3.3%	Footwear	443 364	4.2%
Miscellaneous	45 479	1.5%	Mach and Elec	149 342	2.7%	Vegetable	283 092	2.7%
Plastic or Rubber	38 242	1.3%	Transportation	119 796	2.1%	Plastic or Rubber	162 378	1.5%
Total	**3 018 613**	**100%**	**Total**	**5 590 104**	100%	**Total**	**10 681 397**	**100%**
Top 5 share	**2 958 388**	**98%**	**Top 5 share**	**5 326 735**	95%	**Top 5 share**	**10 320 222**	**97%**

Source: UN Comtrade data obtained from the WITS database.

Unlike other countries that also improved or sustained their market share since the end of the MFA (e.g. Bangladesh, Viet Nam, Pakistan, India and Sri Lanka), Cambodia did not pursue a strategy of upgrading or moving up the chain. Instead, it sustained its position in the more downstream CMT activities. Part of its success is sometimes attributed to its efforts to improve responsible business conduct practices in an industry which is largely driven by reputation-sensitive foreign buyers. In 2003, Cambodia, together with the International Labour Organization, implemented the Better Factories programme to improve working conditions in the garment industry by bringing together all stakeholders to commit on such objectives and by monitoring producers' compliance with working condition standards set by the programme, so that Cambodia's international reputation as a source of compliant production was sustained. The evidence seems to point to the success of the Better Factories programme in this respect. Improvements in working conditions were associated with several benefits to employees and producers, including a reduction in the probability of plant closure in some cases.

Source: World Bank (2013)

Figure 3.3. Cambodia's export growth trajectory, 2005-14



Source: UN Comtrade data obtained from the WITS database.

A harsher environment for Cambodia's traditional garment exporters?

Cambodia has greatly benefited over time from the development of global value chains (GVCs) in the textiles and clothing sector. In general, East Asian economies have historically been very successful in linking to lead firms in the apparel industry and moving up the value chain, starting with simple assembly activities and moving on to full-package supply. As wages began to rise in the more traditional export countries, such as Chinese Taipei, Hong Kong (China) and Korea, full-package manufacturers started to further relocate labour intensive activities to less developed countries in the region (Gereffi and Memedovic, 2003). This increased fragmentation of the apparel industry production network allowed Cambodia to host some of the lower value added, labour-intensive CMT activities which were primarily undertaken by the traditional full-package garment producers in the region. Nonetheless, the extent to which Cambodia can continue to rely significantly on traditional garments exports is unclear.

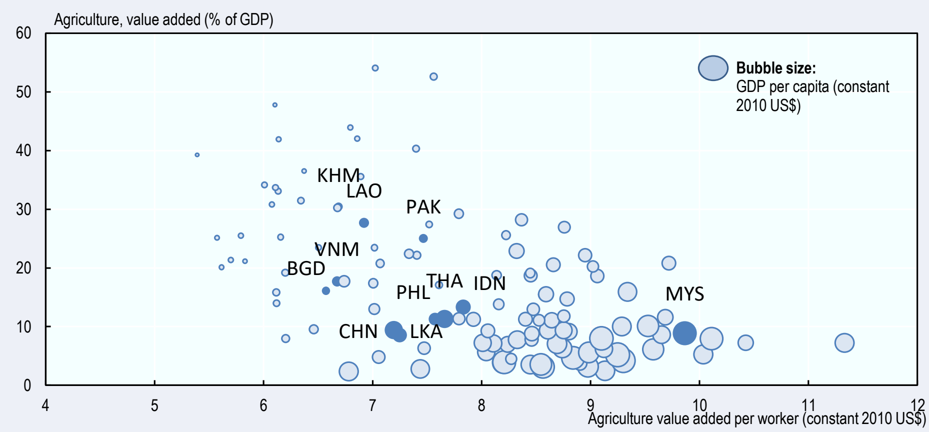
Squeezing margins of garment producers

As observed by UNCTAD (2013), over the past 15 years, the share of domestic value added embodied in Cambodia's garment exports has consistenly declined compared to peer countries in similar positions in the value chain, such as Viet Nam, Sri Lanka and Bangladesh which have also historically specialised in more downstream low value added activities (Gereffi et al., 2010) (Figure 3.5). This seems to result partly from a consistent increase in the unit cost of textile imports and a decline in the unit price of Cambodia's garment exports due to increased competition from abroad since the end of the MFA, consequently squeezing the margins of garment producers (Figure 3.6). In its main exports markets – the United States and Europe – for instance, the average export unit price (per dozen) in 2015 was 29% and 18% lower than in 2005, respectively.

Box 3.2. Raising agricultural productivity remains important

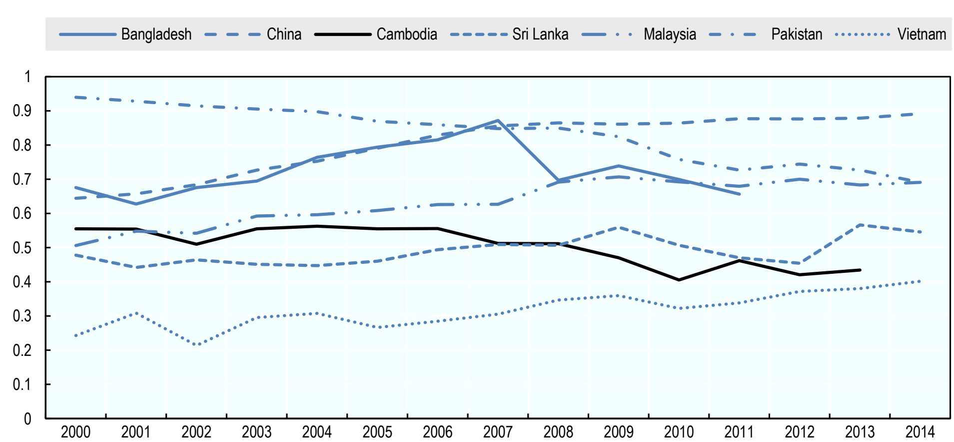
While structural transformation is important to raise productivity and income levels in Cambodia as workers shift out from subsistence agriculture towards more productive activities in services and manufacturing, the agriculture sector remains particularly prominent and efforts to continue improving productivity within the sector remain critical for achieving more inclusive development. The agriculture sector continues to host a large share of the workforce, accounting still for roughly 47% of the total employment in 2015 according to International Labour Organization indicators. But Cambodia's agriculture productivity still lags behind levels observed in most low and middle income countries (Figure 3.4). Agriculture productivity in Cambodia stood at USD 803 (2010 constant dollar prices) in 2014 or about 23% of the median (USD 3 426) for 119 low and middle income economies for which data were available.

Figure 3.4. Agricultural productivity and share in GDP, 2014



Source: World Bank, World Development Indicators.

Figure 3.5. The share of domestic value added in garment exports is low and falling

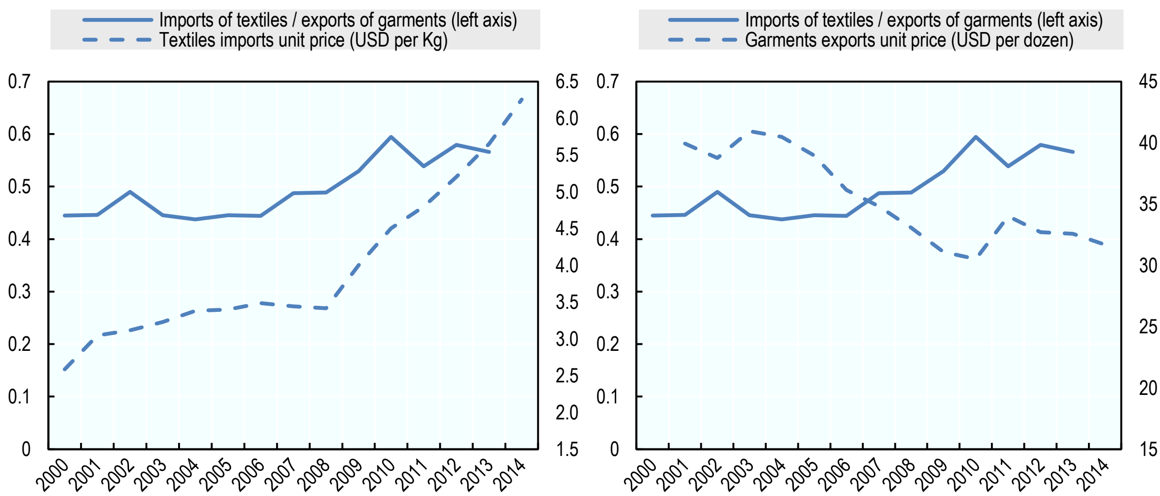


Note: Calculation using SITC Rev 3.1 (4-digit) product codes; domestic value added in garment exports is proxied by the residual share of the ratio of textiles imports to garments exports following UNCTAD (2013).
Source: WITS.

The garment industry is a classic example of a buyer-driven production chain, where the most valuable activities in the chain, such as design, branding and marketing, are undertaken by the lead global retailers and brand owners, and the lower value-added ones, such as manufacturing/assembling, are outsourced through a network of global suppliers (Gereffi and Stacey, 2010). Cambodia sits at this lower value end of the chain and has little leverage to resist or pass on the observed pressures, notably with regards to the increased fabric import prices and competition from other low cost locations.[4]

Figure 3.6. Tougher environment for garment exporters

(Import and export unit prices, 2014)



Notes: Following UNCTAD (2013) approach, we use and extend Asayuna et al. (2012) data on garment export unit prices based on ILO (2015) updated trend data from the Ministry of Commerce. Textile import unit prices, on the other hand, are entirely estimated from the WITS database using SITC Rev 3.1 (4-digit) product codes for textiles (65 and 26 code family). Unit prices are expressed in current 2010 dollar prices.
Source: WITS, SITC Rev. 3.1 (4-digit) data; Asayuna et al. (2012) and ILO report (2015).

Cambodia's participation is made through intermediaries who interact with global clients and co-ordinate manufacturing on their behalf, and not by contracting and receiving orders directly from global buyers/retailers. Cambodian sub-contractors are, thus, mostly specialised in assembling activities and do not provide full-package services (e.g. sourcing, controlling, packaging and shipping). Cambodia also lacks other related industries such as fibre or dyeing in the supply chain (Bafoil et al., 2012). As a result, most raw materials for the garment industry, including textiles and semi-finished garment products[5], have to be imported from other Asian countries.

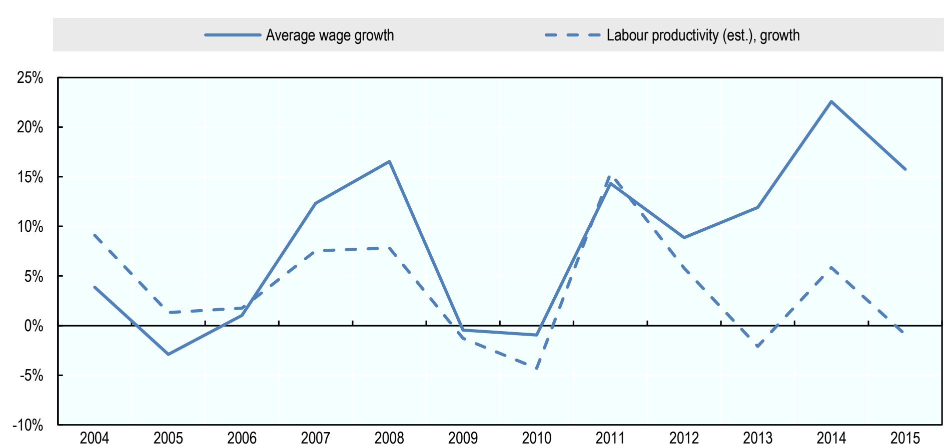
Recent wage rises may weaken Cambodia's cost competitiveness

Cambodia's opportunities in the lower value-added end of the chain may deteriorate if wages continue to rise without accompanying productivity gains (Figure 3.7). While recent increases in the real minimum wage for the garment and footwear sector may be warranted from a social policy perspective, notably after years of stagnation in real terms in the 2000s (ILO, 2016), rapid surges in labour costs without productivity improvements put additional pressures on producers. The extent to which investors are able and willing to absorb them through a reduction in profits or pass them on to international buyers is notably more limited in the current context of margins squeeze and increased competition among producing locations. An unclear pace of wage adjustments may also affect the capacity of producers to plan in a mid-term horizon and therefore will affect investment plans. In that sense, a more structured planning for wage adjustments as opposed to yearly negotiations would be helpful.

Cambodia may find itself in a more vulnerable position if its labour cost competitiveness erodes further and competition from other potential low cost producers such as Myanmar intensifies. Anecdotal evidence from a survey of Japanese-affiliated textile firms in Cambodia seems to suggest that recent wage rises put Cambodia at similar levels to some areas in Viet Nam, where productivity levels are nevertheless higher. In some cases, plans for manufacturing investment expansion have been stopped (JETRO, 2015). There are relatively few barriers to entry in the lower value-added end of the garment production chain, so the threat of new entrants or delocalisation is an important concern.

Cambodia's garment industry is likely more footloose than other countries as it is dominated by foreign-owned producers sourcing most of their inputs from abroad – as Cambodia lacks a domestic textile industry – and sometimes even renting rather than owning their equipment (UNCTAD, 2003). Foreign garment producers may also have less of an incentive to vertically integrate in Cambodia with the textiles industry, because it is relatively capital-intensive and they sometimes source fabrics from their own textile operations abroad (Natsuda et al., 2009) or can easily ship fabrics from competitive textiles markets within Asia offering a wider variety of product. Textiles production also has relatively higher skill requirements than garments manufacturing, which is currently only limitedly available, and is more intense in electricity consumption, which remains relatively expensive in Cambodia. Maintaining labour cost competitiveness is, therefore, particularly important and will require ensuring that future adjustments to the sector's minimum wage level do not consistently exceed productivity growth.

Figure 3.7. Wage and labour productivity growth in the garment sector, 2004-15



Note: Average wage refers to the garment and footwear industry wage bill divided by employment in these sectors. The labour productivity proxy refers to value added of the garments and footwear as per OECD Stan IO tables up to 2011, extended to 2015 based on information on the industry value added from ILO (2015). Data for 2015 are estimated using the previous 3-year average of the industry value added as a share of GDP, applied to the 2015 current GDP obtained from the World Bank's WDI database.
Source: ILO (2015), based on Ministry of Commerce and MoLVT statistics; OECD Stan Input-Output Tables; World Bank World Development Indicators database.

To improve productivity and diversify away from garments

Participation in global value chains is recognised as a vehicle for productivity spillovers to local firms (OECD, 2015). The exposure of local firms to global frontier firms provides them with an opportunity to increase productivity through learning about advanced technologies or good organisational and managerial practices. However, the various potential channels and mechanisms for upgrading are only as useful as local firms' absorptive capacity allows them to be (Saia et al., 2015), and these are to some extent determined by country characteristics (Alfaro, 2014).[6] The prominent role of MNEs in Cambodia's manufacturing sector could suggest a great potential for productivity-enhancing spillovers, if it were not for their circumscribed engagement in the more downstream activities of the garment value chain, which encompasses relatively little interaction with other local firms. In such typical low-skill assembly type of production, there is only limited scope for technology spillovers (Farole and Akinci, 2011). Long-term productivity growth will, therefore, most likely come from greater diversification into higher-value added industries within reach of Cambodia's production capabilities, in addition to upgrading within the garments sector and continued structural transformation away from agriculture.

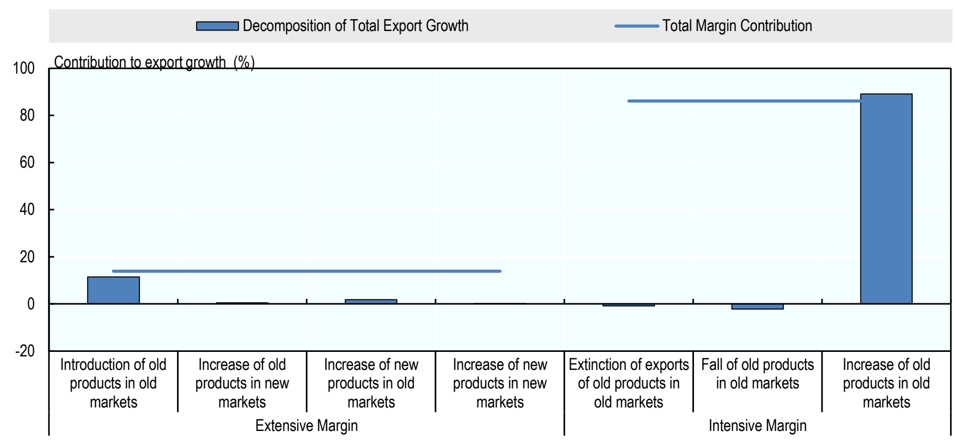
In the case of the garments sector, as previously mentioned, improved productivity is likely to come from incremental value-added associated with more sophisticated tasks within the value chain (functional upgrading), such as pattern making, material sourcing and other niche activities, besides further development of the footwear industry. Much of the basis for upgrading in Hong Kong (China) and Chinese Taipei, for example, came from acquired knowledge of organisational supply chain links, established relationships with international buyers and expertise in efficient sourcing practices (Gereffi, 1999). The knowledge and expertise were learned over several decades and were often assisted by proactive government policies to enhance domestic capital accumulation and strengthen workforce skills. The same process of industrial upgrading will necessarily take time and may not be easily replicated in Cambodia, because the garment industry is foreign dominated with few links to upstream and downstream supply chain activities (Heintz, 2007, p. 29).

Vertical integration into textiles seems less of an option at this stage due to its capital intensity and given the largely foreign-owned nature of the garment industry in Cambodia. Foreign investors are potentially more footloose and may have less of an incentive to invest in vertical integration in Cambodia in the current conditions (e.g. textiles production has relatively higher skill requirements compared to garment manufacturing, which is currently only limitedly available in Cambodia, and is intense in electricity consumption, which remains relatively expensive in Cambodia).

Beyond further upgrading in the textile and garment industry, three other possible avenues can be envisaged for further diversification and upgrading of Cambodia's production: upstream value-added (as with bicycle parts or yarn production), downstream value-added (in particular in agro-industry) and participation in regional production networks (as with car parts production – wire harnessing, or motorcycle ignition for instance). Some diversification is already happening, in particular with the emergence of sub-contracting activities in the electronics sector as well as in car parts production.

Yet, the current business environment poses a challenge for the government's diversification objectives. The decomposition of Cambodia's export growth pattern into its various components reveals the limited diversification that has taken place over the two decades (Figure 3.8). Growth has largely taken place at the intensive margin, e.g. carried within its traditional products and markets, or to a lesser extent with the extensive expansion of traditional products to a great number of traditional partners. Only some diversification has taken place through increases of new products in traditional markets, mostly during 2005-10. Further efforts to diversify exports are necessary. Cambodia's overreliance on garment exports with a relatively concentrated export market base leaves Cambodia vulnerable to sector and external shocks.

Figure 3.8. Cambodia's export growth decomposition, 2000-14



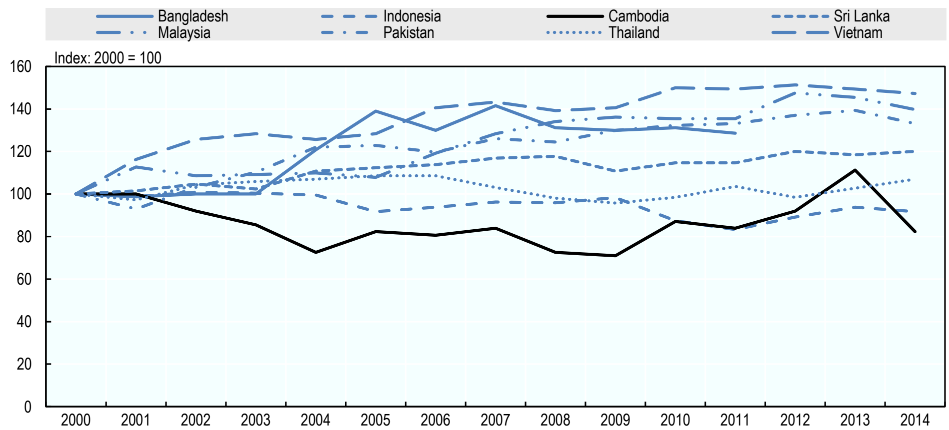
Source: WITS. Notes: Growth decomposition at 4-digit SITC Rev 3.1 product level.

The prospects for further diversification will likely be difficult. Hausmann and Hidalgo (2010) have shown that countries are more likely to diversify into products requiring a relatively similar combination of capabilities (i.e. non-tradable inputs) to traditional exporting products.[7] As such, a country's comparative advantage evolves mostly by moving from traditional goods to those nearby in the "product space". Cambodia has had some difficulty in dynamically expanding its comparative advantage to other products beyond the traditional ones, as can be observed by the trend in the number of products where Cambodia has a revealed comparative advantage (the Balassa Index) (Figure 3.9).[8] After almost a decade and a half, the number of products where Cambodia holds a comparative advantage is just around the levels observed in the early 2000s.

While it may be that exports of products with revealed comparative advantage – although fewer – were also those associated with relatively greater sophistication and potentially higher growth opportunities (Haussman, Hwang and Rodrik, 2005), the observed trend is more likely to reflect the limited density of Cambodia's product space and, therefore, limited scope for diversification (Figure 3.10). Apart from a relatively dense area around the garment and footwear cluster, there is no second cluster of products that has emerged to support further development. Furthermore, the relatively peripheral and sparse position in the product space of the non-garment exports in which Cambodia has a comparative advantage reveals their limited linkages to other products and opportunities for diversification, as well as the difficulty for Cambodia to redeploy resources used in its current exports towards new products in the product space (ADB, 2014).

Figure 3.9. Number of products with revealed comparative advantage, 2000-14

(Index 2000=100)



Notes: Number of products with revealed comparative advantage at 4-digit SITC product level.
Source: WITS.

Despite this, a number of marginal products currently exported are closer to the more dense area of the product space and could become a source of diversification into higher value products in the future. Building capabilities to support these marginal products may be hard and long-term, but the payoffs are potentially higher in terms of diversification. As mentioned above, the accumulation of capabilities offers an exponential capacity to diversify (ADB, 2014; Hausmann and Hidalgo, 2010). These marginal products mostly relate to industries such as the chemical, machinery, paper products, metallurgy, and to a lesser extent to furniture and other manufacturing (ADB, 2014).

Meeting the challenge of competitiveness and diversification will require many complementary policies. Attracting investors in new sectors and activities is discussed in Chapter 6 in the context of investment promotion, special economic zones and targeted incentives. But the government will have to work at the same time to improve the quality of local SMEs and the skills of local workers. It will have to promote more market access opportunities which go beyond the preferential access it currently enjoys, such as through enhancing the potential to supply the regional market. It will also have to improve the hard and soft infrastructure which drives exports. These latter points are discussed below.

Promoting linkages proactively

Although policies mandating backward linkages have had limited success, softer policy instruments may be used in order to facilitate and promote cooperation between MNEs and local SMEs, such as through information provision and matchmaking services. Information provision to foreign investors will also benefit from regional initiatives such as the ASEAN Supplying Industry Database. Although foreign affiliates may have an interest in creating and strengthening local linkages, their willingness to do so may also be influenced and reinforced by government policies with the following objectives:

- Provide information and incentives to encourage MNEs to use local suppliers
- Ensure that linkage programmes address SME capabilities
- Value the many forms of knowledge transfer from foreign affiliates to SMEs
- Expand markets through MNE networks

Figure 3.10. Cambodia's product space

Note: "Classics" refers to products in which Cambodia has a revealed comparative advantage (RCA > 1) in both 1992-95 and 2009-11 periods; "Emerging" refers to products in which it did not have a comparative advantage (RCA < 1) in the first period, but had in the second period observed; "Disappearing" refers to those products where it lost its comparative advantage between the two periods; and "Marginals" are those where in both periods it does not hold a comparative advantage.
Source: ADB (2014).

Several Southeast Asian countries have put in place measures which aim, explicitly or implicitly, to build indigenous capabilities and facilitate business linkages with MNEs. Under the Singapore Local Industry Upgrading programme, MNEs are encouraged to "adopt" SMEs in their value-chain, and government support is provided to both parties through progressive stages of SME development. Malaysia's Industrial Linkages

Programme imposes requirements for joint ventures or limits on expatriate personnel, and uses incentives to encourage linkages between MNEs and local SMEs, such as tax refunds for expenditures on training or factory auditing. The Philippines provides tax credits on domestic capital equipment for import substitution of raw materials used in producing non-traditional exports in order to encourage backward linkages to domestic suppliers. In Thailand, the BOI Unit for Industrial Linkage Development (BUILD) encourages the development of supporting industries and strengthens linkages between final producers and suppliers of intermediate goods or services (Box 3.3).

Although it could be useful to include business linkage development explicitly in the CDC's mandate, environmental factors over which investment promotion agencies have little control are often the major obstacles to implementing a successful business linkages programme. As a result, any linkage development programme will have to be associated with other actions to develop and enhance skills and to promote SMEs. To that end, consultation with the private sector is necessary.

Box 3.3. Thailand and the BOI Unit for Industrial Linkages Development (BUILD)

Of great assistance to Thailand's subcontracting industry was the BOI Unit for Industrial Linkage Development (BUILD), set up in 1991 to promote backward linkages from existing multinationals. The objectives of the programme were i) to encourage the development of supporting industries and promote the deepening of Thailand's industrial structure; ii) to strengthen linkages between final product producers and companies producing parts and components or supplying technical services; iii) to assist small and medium supplying companies in improving efficiency, productivity and quality; iv) to foster cooperation between foreign investors, Thai supplier manufactures, and related government agencies; and v) to remove impediments to subcontracting and improve backward linkage development.

The BUILD has been helping foreign buyers and Thai manufacturers to connect for more than 25 years. It actively promotes and develops Thailand's supporting industries in order to maximise industrial competitiveness. The Unit also serves as an intermediary between manufacturers of readymade products and small- and medium-sized parts producers. The linkages they help to create lead to numerous business contracts and a general transfer of technology within industry.

BUILD provides year-round sourcing service to develop Thailand's business network by steering interested buyers towards potential suppliers. The BUILD unit in Thailand acted as a broker at the macro level, promoting the general environment for market-oriented backward linkages and by removing impediments to such linkages, while at the micro level it acted both as matchmaker (through provision of information) and trouble-shooter.

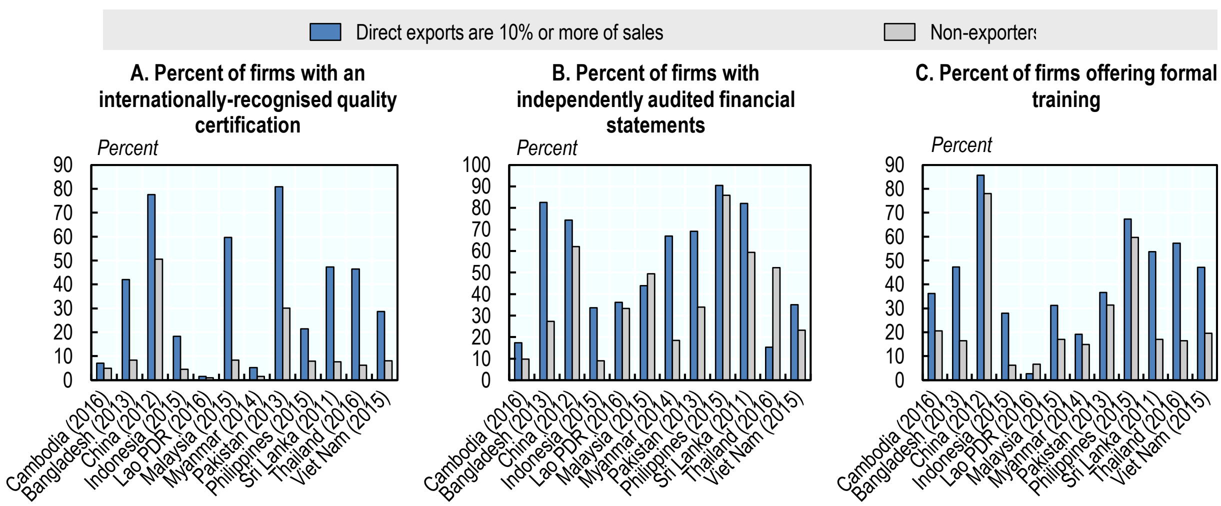
Source : Thailand Board of Investment website and Lauridsen and Narula (2004).

Strengthening firms' absorptive capacity

Foreign investment will likely play a critical role in supporting diversification and productivity growth in other industries, and the extent of its long-term impact will be shaped somewhat by its linkages to the domestic economy and the absorptive capacity of local firms. This may prove a difficult long-term challenge. A range of firm characteristics documented in the 2016 World Bank Enterprise Survey of Cambodia points to potential absorptive capacity weaknesses of firms in Cambodia compared to in other countries in the region (Figure 3.11). For instance, only 7.1% of exporting firms in Cambodia possess an internationally-recognised quality certification, against much higher levels in several of its regional peers.

Similarly, the percentage of exporting firms with independently audited financial statements is only 17.3%, much below the level observed in several of its peers. The percentage of firms offering formal training to the workforce is also lower in Cambodia than most ASEAN countries. While these are not the only determinants of firms' absorptive capacity, these practices may reflect to some extent the level of professionalisation and managerial quality and processes available in the industry. Evidence suggests that quality certification, for instance (as one proxy component of a firm's absorptive capacity), is associated with higher labour productivity and greater FDI spillovers to productivity, thereby increasing firms' catching-up potential (Farole and Winkler, 2012).

Figure 3.11. Cambodia firms have low absorptive capacity potential

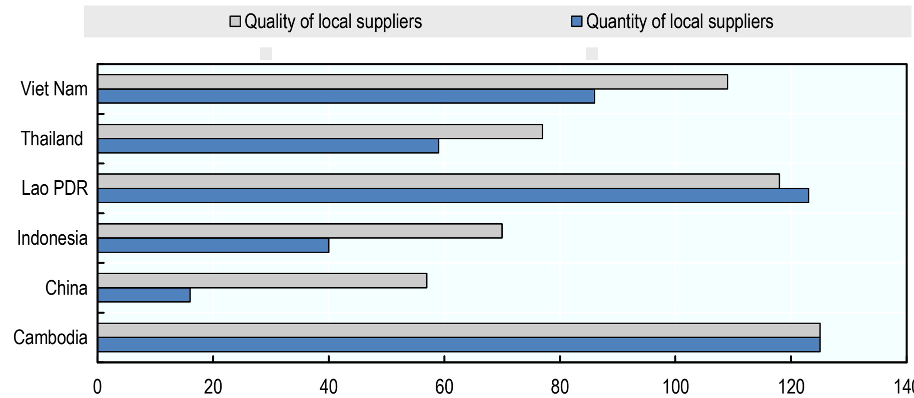


Source: World Bank, Enterprise Surveys, several years.

The inability of Cambodian SMEs to respond to the needs of MNEs is reflected in their difficulty to serve as domestic suppliers. According to the World Economic Forum's *Global Competitiveness Report 2015-16*, Cambodia ranks very poorly for the quantity and quality of local suppliers (Figure 3.12. As such, given their limited capacity, they are not in a position to make use of regional integration (Vannarith et al. 2010). Although this is a common problem in the region, it is particularly acute in Cambodia, which lags behind most countries in the region (except Myanmar).

Diversification efforts can also be strengthened by accompanying reforms to the overall business environment, notably to reduce the burden of starting a business. Empirical evidence suggests that higher domestic business entry costs are also associated with lower export diversification, as well as with lower geographical diversification of exports, albeit to a lesser extent. By one study, a 10% reduction in domestic market entry costs – as measured by the World Bank's *Doing Business* starting a business indicator – is estimated to be associated with a 1% increase in export product diversity (Dennis and Shepherd, 2007). Higher entry costs potentially prevent some firms from entering the market, thus diminishing the potential number of active exporters and export products. Improving the conditions for entry and operation remains therefore critical too.

Figure 3.12. Ranking of local suppliers: Cambodia and selected economies, 2016



Source: World Economic Forum, *Global Competitiveness Report 2015-16*, Geneva

This is particularly an area where Cambodia can do better. Cambodia ranks 185 out of 190 economies in the "starting a business" indicator of the 2019 World Bank's *Doing Business*. It has made some progress in this area, as can be identified by the improvement in the distance to frontier scores (right axis) over time, but it remains relatively costly and burdensome to start a business. It has also backtracked somewhat with the recent reform increasing the time required to register a business and requiring firms to submit evidence of capital deposit after registration (World Bank, 2017). Investors are also subject to a relatively high minimum capital requirement, which adds a further barrier to entrepreneurship, notably to SMEs in less capital-intensive industries (see Chapter 4). Strengthening efforts to facilitate entry and the ease of doing business would provide critical support to achieving greater economic diversification.

Developing SMEs capacity will be instrumental for forging backward linkages. The government recognises that SMEs play a significant role in promoting economic development and creating sustainable employment and income to reduce poverty. As a result, major policy documents such as the Rectangular Strategy (phases I to III) and the National Strategic Development Plan systematically mention SME development. The Cambodian economy remains dominated by a large number of mostly informal very small enterprises (micro-enterprises) and a few large enterprises, while there is a "missing middle" of medium-sized Cambodian firms involved in exports compared with other countries (see Chapter 2).

Micro-enterprises dominate Cambodia's economy in terms of the number of firms, but they operate almost entirely (98.6%) in the informal sector and this hinders their participation in partnerships with foreign investors. The predominance of informal micro-enterprises seems to be associated with excessive regulation-related costs that encourage small firms to remain small and informal[9] – and a dearth of medium-sized firms. Small enterprises are at a disadvantage because of a lack of access to finance and their reliance on old technologies. For the time being, SMEs are also to a large extent informal[10], they tend to be local investment and domestic consumption-oriented, in contrast to large enterprises.

To encourage the development of stronger SMEs, policies should aim to help their formalisation, improve technology adoption by SMEs through public-private as well public-private-academia partnerships, and facilitate SME financing. The weakness of domestic SMEs and the lack of cooperation between local SMEs and foreign investors are acknowledged in the IDP, which envisages a number of measures to address these issues. The single-window mechanism for registering SMEs, for instance, is to be strengthened by way of using SMEs' registration and account ledgers as the basis for evaluating and determining criteria for providing incentives and receiving support from the government. Also a Guidebook is under preparation and should help formalise SMEs.

Addressing skills shortages

Foreign investors also often complain about the low quality of the Cambodian labour force. In the garment industry for instance, due to a lack of appropriate management skills, most managers are foreigners, while only 10% were Cambodians as of 2010 (Hosain 2010). More generally, skills training remains inadequate to service the industrial sector, which partly suffers from low productivity as a result (IDP 2015-25). Overall a widely-held view among foreigners is that there is no systematic effort on the part of the government to remedy the lack of well-trained workers. Despite the existence of vocational training schools, for instance, problems of qualification persist. In particular, provisions of skills are often not in line with economic ambitions or with foreign investors' needs. Numerous initiatives exist in various technical fields but they are said to lack adequate co-ordination. As such, Cambodia ranks very poorly in terms of higher education and training, lagging far behind all its regional partners, with the exception of Myanmar, on indicators of efficiency enhancement and of innovation and sophistication (Table 3.2).

Table 3.2. Selected competitiveness rankings in Southeast Asia and China

	Cambodia	*China*	*IDN*	*LAO*	*MMR*	*THA*	*VNM*
Overall rank (out of 140 countries)	89	28	41	93	131	34	60
Efficiency enhancers	**97**	**30**	**49**	**104**	**131**	**37**	**65**
Higher education and training	124	54	63	106	134	62	83
Quality of the educational system	87	43	39	54	128	67	76
Local availability of research and training services	115	61	49	94	133	93	110
Technological readiness	98	74	91	121	138	63	92
Availability of latest technologies	100	81	73	119	140	70	106
Firm-level technology absorption	99	60	39	105	140	43	78
FDI and technology transfer	53	59	50	90	127	42	83
Innovation and sophistication factors	**118**	**29**	**32**	**93**	**134**	**47**	**84**
Business sophistication	114	34	39	92	135	43	96
Local supplier quantity	125	16	40	123	138	59	86
Local supplier quality	125	57	70	118	138	77	109
Innovation	118	30	31	95	132	54	73
Capacity for innovation	115	45	32	76	137	70	79
Quality of scientific research institutions	123	40	41	102	133	56	98
Company spending on R&D	84	25	26	60	114	46	49
University-industry research collaboration	102	30	28	62	137	41	79
Availability of scientists and engineers	124	30	38	127	122	57	84

Source: World Economic Forum, *Global Competitiveness Report 2016-17*, Geneva.

Skills development and training and workforce retooling are vitally important to absorb technological transfers, to move up the production value chain, to create linkages with MNEs, and to develop new technologies (UNDP, 2014). Having a workforce with the skills that match the needs of the industry is an essential ingredient to improve productivity. It is particularly critical to support the development of a more diversified industrial base, such as the one emerging within Cambodia's SEZs.

Investor surveys suggest that skill shortages are a major impediment for businesses development in Cambodia, and the problem is more acute for firms located within SEZs. About 71% of firms located within zones classify this issue as major or very severe, compared to roughly 37% of the firms outside the zones (World Bank, 2014a). Warr and Menon (2015) report that the average standard of literacy of workers within SEZ firms is not high and that about 30% of new employees have apparently never attended school and cannot read, being only capable of undertaking the most routine manual operations. This gap in the perception of workforce skills between the firms located within the zones – which are more diversified – with those located outside – which are mostly garment producers – indicates that current educational and vocational policies may be failing to support these emerging industries and diversification efforts more broadly.

Firms in SEZs report that workers in Cambodia can reach satisfactory levels of productivity but require higher levels of training and longer periods of adjustment to achieve these levels, as compared to workers in Thailand and Viet Nam (Warr and Menon, 2015). While a challenge, this gap points to potentially important gains from market responsive skills upgrading policies. Despite the potentially high returns from investments in training, firms may be reluctant to do so.[11] The high labour turnover observed in Cambodia may aggravate the incentives to underinvest in training and skills development (BDLINK, 2012; ADB, 2015).

The positive externalities from a qualified workforce would likely justify greater government prioritisation and support in this respect. Among other things, the government would benefit from engaging further with industry associations to improve the quality of training programmes, including through the accreditation of Technical and Vocational Education and Training (TVET) Programmes (UNDP, 2014). Recent surveys suggest that Cambodian employers have been involved to only a limited extent with TVET programmes in the recent past (BDLINK, 2012).

This is also the view reported by the OECD (2016) in its *Economic Outlook for Southeast Asia, China and India* report. Cambodia is reported to lack a robust TVET system that works closely with the private sector, including export sectors, to ensure skill needs of the industry are met. There seems to be a greater emphasis on higher education, despite the critical role of TVET programmes for tapping into more sophisticated manufacturing industries. As such, the development of TVET programme has been slower in Cambodia than in some ASEAN neighbours so far, partly due to inadequate funding and capacity levels and governance skills in management of relevant agencies, and a general lack of enforcement of approved policies and a regulatory TVET framework (OECD, 2016).

The government TVET reform agenda introduced in 2011, nonetheless, provides a good framework for addressing such issues, but its implementation needs to be strengthened. It rightly identifies five critical areas for the success of the TVET programme: i) linking training to market demand; ii) ensuring training quality for enhanced productivity; iii) strengthening public-private partnership; iv) ensuring equity in training; and v) promoting TVET for social-economic development.

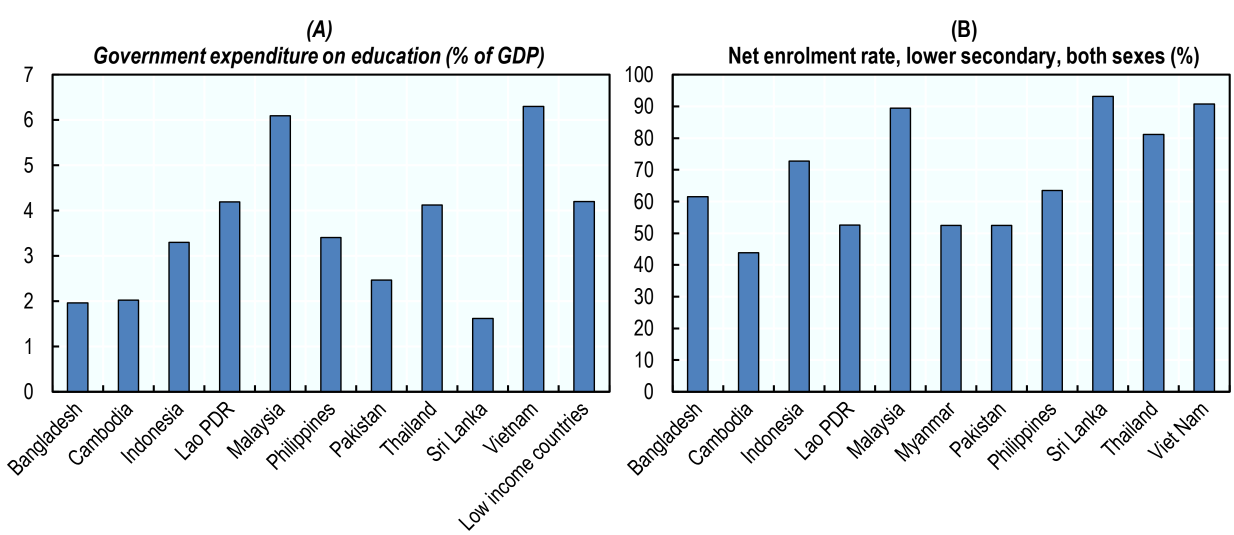
Some progress has already been achieved in recent years, notably in improving the quality and relevance of the TVET system with the development of the Cambodian Qualifications Framework and an initial labour market information and management system, and also by introducing competence-based training. But implementation needs to be strengthened. The Ministry of Labour and Vocational Training has recently developed a TVET Strategic Plan 2014-18 to guide TVET sector development and is receiving assistance from the Asian Development Bank to implement the three policy themes underpinning the plan: (i) equitable access to TVET, (ii) enhanced quality and relevance of TVET, and (iii) strengthened governance and management of TVET (ADB, 2014).

Cooperating with the private sector, particularly foreign investors, is a good way to make sure that the training curriculum is aligned with the needs of the private sector, thereby meeting the quality and skill requirements of companies. The Japanese-Singapore Technical Training Centre and the Vietnamese-Korean Technical Education Centre provide interesting examples of such public-private cooperation (UNDP 2014). It could also be helpful to encourage customised and on-the-job training, and apprenticeships more generally, with close collaboration between the government and the private sector (ADB and ILO 2016).

Other forms of cooperation may go through the development assistance channel. For instance, the Garment Manufacturers' Association of Cambodia in collaboration with Japanese Overseas Development Assistance is currently in the process of establishing a National Garment Training Institute in response to the need for productivity improvement, localisation of the workforce and upgrading of the supply chain. With skilled expatriate-held positions being replaced with a competent local work-force, the local industry's sustainability is expected to increase as a result.

Apart from the challenges in continuing to improve the governance and quality framework of the TVET system, implementing adequately the established framework will require not only a more efficient use of existing resources, but also more investments in general education and training. Cambodia still invests less in education than many of its Asian peers, as well as countries with lower per capita income levels (Figure 3.13a).

Figure 3.13. Cambodia invests less in education than regional peers



Note: Expenditures data for Indonesia and Lao PDR refer to 2014, while for Viet Nam it refers to 2011, and for all others countries data refer to 2013. Net enrolment data refers to 2013 for Bangladesh and Philippines and 2014 for all other countries.

Source: World Development Indicators, World Bank, and UNESCO Statistics.

Greater levels of investment are needed both to strengthen basic literacy and numeracy skills of the young generation entering the job market so to ensure they have the wider competencies needed to sustain more advanced career development, but also to expand the TVET programme in scale and ensure it meets immediate and future job skills requirements (World Bank, 2012). Particular attention is needed to increasing the number of students completing secondary education. While enrolment rates into primary education have improved substantially to above 95% levels in recent years, net enrolment in lower secondary education remains particularly low compared to regional peers (Figure 3.13b), reflecting both a relatively low intake of primary-level students into lower secondary and high dropout rates within the secondary cycle.

Cambodia's participation in the OECD PISA for Development Initiative is also expected to support the government's efforts to improve national education. PISA-D results equips governments to design more effective educational policies by allowing them to better identify priority areas, set policy targets based on measurable goals and learn from good policies and practices of more successful countries (Box 3.4).

Box 3.4. OECD PISA for Development Initiative: Cambodia

Cambodia is one of the eight countries participating in the OECD PISA for Development (PISA-D) Initiative launched in 2013. This initiative aims at making the OECD Programme for International Student Assessment (PISA), which assesses 15-year-olds' proficiency in reading, mathematics and science and measures students' skills in applying what they have learned in school to real-life situations, more relevant and accessible to a wider range of countries.

Through PISA results, policy makers can gauge the knowledge and skills of students in their own countries in comparison with those in other countries, set policy targets against measurable goals achieved in other education systems, and learn from policies and practices of countries which have demonstrated improvement. Since PISA began in 2000, some 80 countries and economies, including 40 middle-income countries and 4 low-income countries, take part every three years in PISA to compare how well their school systems prepare young people for life and work.

While there are undoubtedly high-performing students in Cambodia, based on the experience of the middle-income countries that have participated in PISA, many 15-year-olds can be expected to perform at the lower levels of proficiency. PISA-D's enhanced test instruments will be able to measure these students' performance in a way that ensures that the results are comparable to the main PISA results. The benchmarking should help the Cambodian government to design more targeted and effective educational policies that build on reliable assessments and international good practices.

Source : OECD (2016), PISA for Development Brief – 2016/17.

Further investments to expand TVET in Cambodia may require complementary sources of funds to traditional budgetary resources and aid support from donor agencies. OECD country experiences suggest a number of tools available to stimulate investment in training for skills development. A common practice has been to establish compulsory contributions based on payroll taxes to national training funds administered by employers outside of the government ministry (OECD, 2005). Aside from the possible drawbacks of such an option[12], this may not be the most appropriate instrument for Cambodia at this stage as it could add to labour costs in the short-term. Cambodia's comparative advantage still largely lies within relatively footloose labour-intensive industries and such an instrument could reduce its attraction as an investment destination. In an employer survey in 2009, 86% of employers said they were reluctant to make financial contributions to TVET, although 77% of them were willing to contribute technically to curriculum development (World Bank, 2010).

Instead, the government could consider introducing targeted fiscal incentives for firms investing in training (both external and in-house) (See Chapter 6 for a discussion on incentives). Corporate tax-based schemes (e.g. tax credits, allowances or exemptions of profit or payroll taxes) allowing enterprises to compensate somewhat for the costs of training have proved to be an effective way to stimulate investment in skills development (OECD, 2005). These instruments would have to be designed in a way to also facilitate investments in training by SMEs, for which the associated administrative burden of obtaining such a tax deduction should not constitute a barrier. Fiscal incentives for training would also have to be designed in a way to limit deadweight losses as notably some larger firms would have invested in training even in the absence of such schemes. OECD experience suggests there is no single way to addressing such concerns (OECD, 2005), and hence further attention to exploring the most appropriate modality to implement such schemes in Cambodia would be warranted.

Cambodia and regional integration

Another way for Cambodia to realise the hoped-for shift from light industry to processing assembly industry is through participation in global value chains or regional production networks across East Asia. Due to its strategic location, Cambodia could become a manufacturing hub in ASEAN and be one major beneficiary of the ASEAN Economic Community (AEC), but its poor ranking in cross-border trade indicators suggests that it may not easily integrate in regional and global value-chains, making trade facilitation a priority.

The rise in labour costs in China and the associated shift in China's economic strategy has not necessarily led foreign manufacturers to leave the country, but it has certainly induced them to contemplate other solutions. A growing number of MNEs are pursuing a so-called "China+1" strategy, establishing or expanding their business operation outside China, particularly in other Asian countries where conditions are becoming increasingly attractive in relative terms. The point of this strategy is to mitigate the risks of overdependence on factories in China by looking for alternative production locations.

Cambodia may be one option for unskilled labour-intensive activities. Japanese firms for instance have been seeking to diversify away from China.[13] Other ASEAN economies (such as Indonesia, Viet Nam, or Myanmar) are increasingly perceived as alternative production locations. Following a China+1 strategy, Japanese and Korean firms are investing in ASEAN so as to restrict their vulnerability to fluctuations in China's political and economic conditions. Samsung, for instance, has recently set up shop both in inner Chinese provinces (Xian in Shaanxi province) and in Viet Nam. Moreover, although Asian firms may maintain production units in China to cater to the Chinese market, they are increasingly planning to serve the Chinese market from abroad, particularly from ASEAN.

Moreover, with the rise in wages observed in the most advanced ASEAN countries (such as Thailand), companies which used to take advantage of these cost advantages tend to relocate the most labour-intensive part of their activities in the least advanced economies of the region such as Cambodia, Lao PDR and Myanmar (CLM). In response to the rise in the Thai minimum wage introduced in January 2013 for instance, some Japanese companies, including major manufacturers of automobile parts (such as Yazaki or Denso) and electronic components have started to relocate labour-intensive processes from Thailand to Cambodia and Lao PDR as part of a so-called Thailand+1 strategy (Kobayashi 2013, 2014, Kuroiwa 2016). As a result, CLM countries are gradually integrating into regional production networks as suppliers of unsophisticated intermediate goods.

Despite the competition to attract investors from more mature manufacturing sectors like neighbouring Thailand and Viet Nam, Cambodia is well-positioned to play a major part in the regional supply chain. Major manufacturers take a cluster approach by placing their factories to get the most out of the advantage of their location and their conditions, so they may have parts produced in Thailand, but some produced in Cambodia, some in Viet Nam. This is only the very beginning of a trend, but the opening up of SEZs along the border is certainly a good way to take advantage of this new organisation of production (Cambodia Trade Integration Strategy 2014-18). However, since a regional supply chain survives on moving parts or components in and out of countries cheaply and efficiently, enhancing connectivity is a priority objective, calling for swift implementation of trade facilitation provisions under the AEC scheme.

Enhancing trade-facilitation efforts

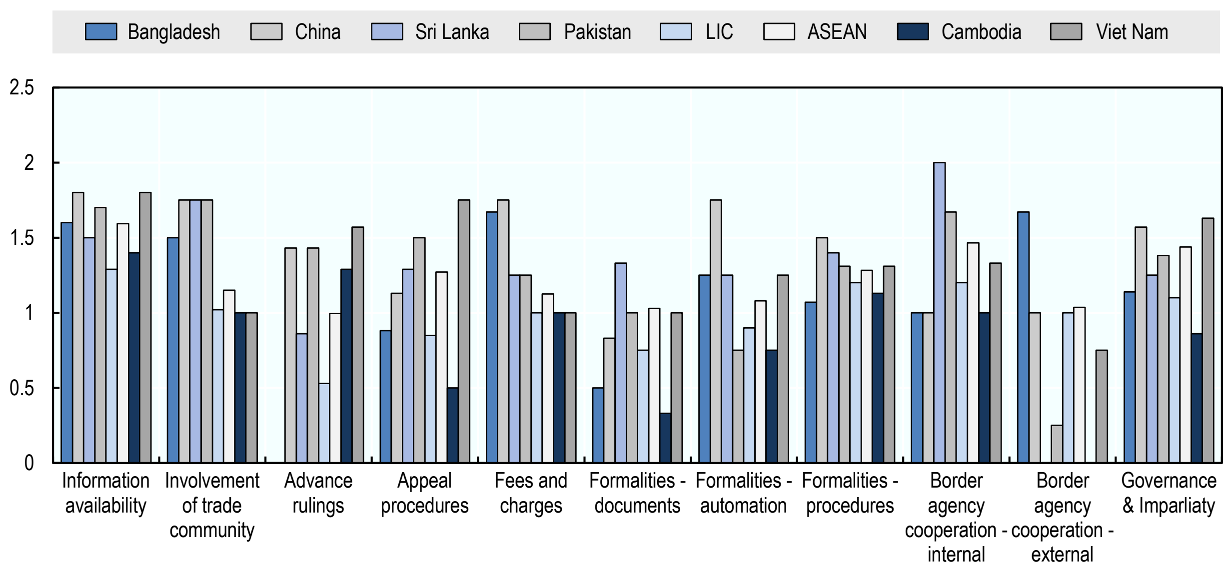
Expanding beyond the garment and footwear cluster requires discovering and facilitating the emergence of new products in which Cambodia can develop comparative advantages. Some prospect for diversification may lie in nurturing further the discovery of new projects and developing current marginal products which demonstrate potentially greater opportunities for diversification and upgrading. In this respect, trade facilitation efforts can contribute significantly to new trade flows and further geographical diversification of existing export products, notably by reducing entry (fixed) costs into export markets (Shepherd, 2009). The author estimated that a 10% improvement in trade facilitation – measured using the World Bank's *Doing Business* data on the cost of exporting – is associated with a 3-4% increase in product diversification and a 5-6% increase in terms of the foreign markets served. Moreover, such benefits seem to accrue more to differentiated products, such as manufacturing goods, than to homogeneous goods, such as agricultural commodities.

Cambodia could, therefore, reap important benefits in terms of trade volumes and costs and diversification from continuing to improve its trade facilitation performance. There have been some important recent improvements in trading across borders, as reported in the World Bank's *Doing Business* database, with the elimination of pre-shipment inspections and a reduction in the time and number of documents required for importing and exporting. Customs clearance time, for instance, fell from 5.9 days in 2010 to 1.4 days in 2014, while consignments selected for inspections fell from 29% to 17% in the same period according to the World Bank's *Logistics Performance Index* database.

Nonetheless, the OECD *Trade Facilitation Indicator* suggests that there is no room for complacency as there are still some cumbersome practices that can be improved (Figure 3.14). While Cambodia fares better or similarly to other low income countries in areas such as information availability, advance rulings and fees and charges, it still generally underperforms compared to the ASEAN average and against selected garment exporter peers in Asia according to the OECD *Trade Facilitation Indicator* (Box 3.5). OECD empirical analysis suggests that improvements in trade facilitation areas such as formalities (documents, automation and procedures) and information availability are those with the greatest impact on increasing bilateral trade flows and lowering trade costs for low income countries such as Cambodia. Other areas such as advance rulings, fees and charges, and governance and impartiality are particularly associated with increases in manufacturing trade levels. In the case of Cambodia, the World Bank (2014a) reports that firms face export costs that are roughly 40% higher than the average of Indonesia, Lao PDR, Philippines and Viet Nam. They report one study finding that if Cambodia were to reduce its export costs to the regional average, the total number of exporters would likely double (Artuso and Reyes, 2014)

Figure 3.14. Cambodia's trade facilitation performance: OECD Indicators 2015

Scale 0 to 2 (best performance)



Source: OECD Trade Facilitation Indicators.

Cambodia is also to benefit from the full implementation of the WTO Trade Facilitation Agreement (ratified in February 2016) and the ASEAN Economic Community Blueprint, which contains important trade facilitation commitments, such as harmonisation, simplification and modernisation of trade and customs processes, customs integration, and the development of the ASEAN Single Window. OECD (2015) estimates that the full implementation of the WTO Trade Facilitation Agreement would reduce Cambodian trade costs by about 18.2% (Figure 3.15). Within ASEAN, trade costs for individual member states could be reduced by between 11.8% and 19.8%, with the greatest benefits accruing from streamlining of procedures (3.8%), automation (3.2%), simplification and harmonisation of trade documents (3%), information availability (2.4%), advance rulings (2.1%), and fees and charges (1.1%). Even a limited implementation of the agreement – where countries implement only the mandatory provisions of the agreement, leaving aside the "best endeavours" discretionary ones which they have not yet implemented – would still significantly reduce trade costs (OECD, 2014).

Box 3.5. Trade facilitation reforms: Potential areas for action

Taking into account the trade flow increase and cost reduction potential of the policy areas highlighted in the OECD Trade Facilitation Indicator, and considering the areas where Cambodia has not yet reached best performance, Cambodia would benefit from continued improvements in the following areas:

Information availability:

- Make forms and documents required for border procedures available online
- Provide an interval between publishing all trade related regulation and entry into force
- Provide necessary information to stakeholders about changes in policies and regulations affecting their activities

Advance rulings

- Improve the availability of information on advance rulings
- Consider increasing the length of time for which advance rulings are valid
- Indicate the reason for refusing to issue or for revoking an advance ruling

Formalities – documents

- Expand the acceptance of copies of documents
- Pursue efforts in view of compliance with international standards conventions [strengthen the implementation of ASEAN e-customs]
- Reduce the number of documents required for import and export and the time necessary to prepare such documents

Formalities – automation

- Improve the capacity of IT systems to exchange data electronically
- Promote the availability of full-time automated processing for Customs
- Improve the quality of telecommunications and IT supporting automation of border processes

Formalities – procedures

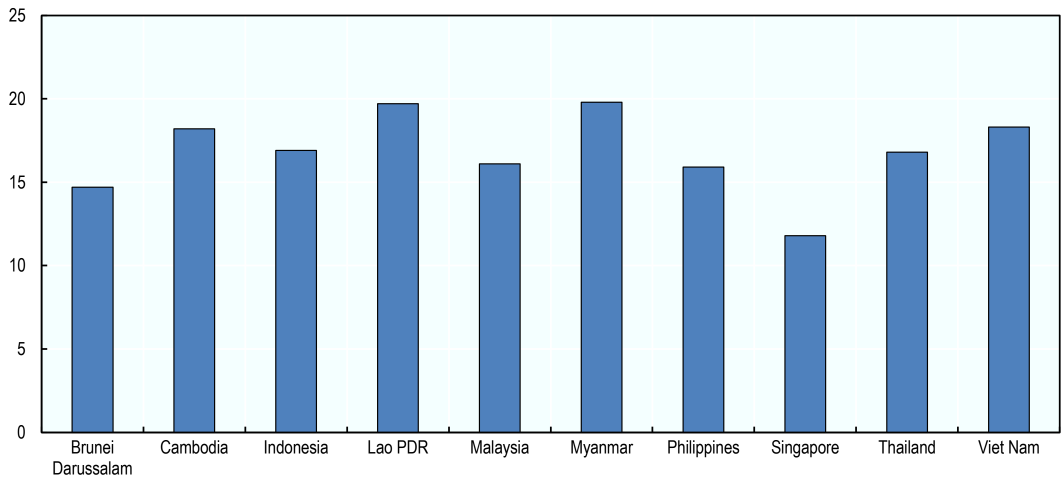
- Pursue the development of a Single Window [and fully implement the ASEAN Single Window]
- Reduce the average clearance time and the percent of physical inspections
- Introduce pre-arrival processing of import documentation
- Provide accelerated controls for perishable goods and preferential treatment concerning the separation of release from clearance
- Further simplify procedures in terms of both associated time and costs

Governance and impartiality

- Promote effective sanctions against misconduct of border officials
- Provide clear provisions for the financing of the Customs administration
- Publish annual Customs activity reports

Source: reproduced from the OECD Trade Facilitation Indicator website, country analysis, www.oecd.org/trade/facilitation/indicators.htm

Figure 3.15. Overall potential trade cost reductions in ASEAN member states (%)



Source: OECD (2015b).

Improving infrastructure connectivity and logistics services

The growing fragmentation of production networks across countries increases the importance of infrastructure connectivity in ensuring efficient and reliable supply-chain networks and in spreading development opportunities beyond traditional centres. Better infrastructure connectivity, therefore, raises countries' capacity to exploit the channels of productivity gains associated with GVCs. Indeed, evidence from on-going OECD work suggests that GVC-related trade is much more sensitive to behind the border infrastructure than overall trade. But hard (physical) infrastructure is only as useful for economic development as the quality of the soft infrastructure surrounding it (e.g. services, regulations, procedures), which may limit or enhance its economic benefits, notably in the case of economic corridors. The close links between infrastructure, trade and investment calls for integrated strategies that align infrastructure policies with overall industrial and development goals.

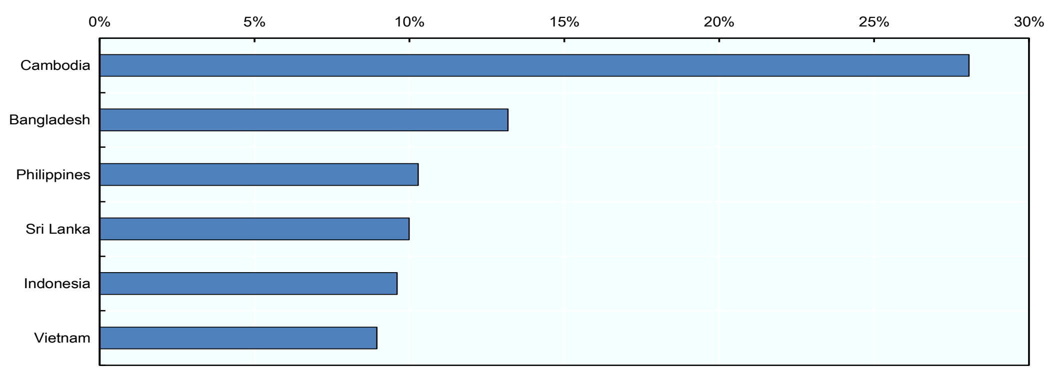
Cambodia is a relatively small economy, deeply integrated into world markets and seeking greater and more diversified participation in GVCs. Infrastructure connectivity is thus critical for attaining this objective, both in the garment industry where the fashion industry requires rapid and reliable garment production turnaround and in some of the newer industries where Cambodia is attracting initial investments, such as those located within the SEZs (e.g. car parts, electronics and electrical products), which are part of sometimes lengthy global value chains. Additional costs and delays at one step of the chain accumulate throughout the entire chain and can undermine GVC integration in such situations. Improved connectivity infrastructure would allow Cambodia to leverage more its beneficial position within reach of key economic centres in neighbouring Thailand (Bangkok) and Viet Nam (Ho Chi Minh City) through waterways and land corridors. Improved infrastructure is also necessary to support the government's objective of increasing agricultural exports, notably to triple rice exports between 2014 and 2019 (World Bank, 2014c).

Inadequate infrastructure has been a constant complaint of investors, including those established within the SEZs (see Chapter 9 on Investing in Cambodia's Infrastructure). This reduces Cambodia's relative competitiveness vis-à-vis other international locations.

SEZs are sometimes perceived as enclaves of superior legal, logistical, and tax arrangements intended to assist countries in attracting investments that would otherwise not happen because of deficiencies in the domestic environment (Warr and Menon, 2015). Hence, if even firms within the zones complain about infrastructure shortcomings, it is likely that outside firms face similar or worse conditions. As more thoroughly discussed in Chapter 9, high electricity costs compared to regional peers are a frequent source of complaint. Additionally, intermittent electricity supply requires manufacturers to rely, more than elsewhere, on expensive generators for their power needs. The World Bank (2014a) reported that not only did Cambodia have the highest rate of electric power transmission and distribution losses among peers (Figure 3.16), but the rate was also rising.

Figure 3.16. Rate of electric power distribution and transmission, 2013

(Per cent of output)



Source: World Bank, World Development Indicators. .

The high logistics costs of getting containers from the factory to the port are also a key concern for investors (Warr and Menon, 2015), although the World Bank's (2017) *Doing Business* indicator of domestic transport costs per distance for Cambodia does not show up as more costly than in other ASEAN countries. The indicator captures the average time and costs associated with transporting cargo from a warehouse in the business city of the economy to the most widely used seaport, airport or land border of the economy. While on average it may not seem as an important impediment, the burden for some investors seems high as indicated by the survey by Warr and Menon (2015). To some extent, the negative perception of investors may reflect the relatively lengthy route to transport a 20-ton container from/to key economic centres in neighbouring countries, notably Bangkok and Ho Chi Minh City (Table 3.3). The route to Viet Nam has likely improved with the completion of the Neak Loeung Bridge over the Mekong in 2015, which eliminated a previously costly and time-consuming ferry crossing (JICA, 2014).

Infrastructure shortcomings are compounded by the incomplete soft infrastructure supporting it according the World Bank (2014c). Short-sighted cross-border transit agreements with neighbouring Thailand and Viet Nam, for instance, weaken Cambodia's land connectivity by allowing only a limited quota of transit licences for trucks to operate across the border, and through a cumbersome and costly process that sometimes discourages truck companies even applying in the first place. Hence, at present, Cambodian trucking companies are not allowed to operate in Thailand and Viet Nam and vice-versa beyond the allowed permit quota, having to trans-load goods in the immediate border area. In the case of Viet Nam, there is one exception to pre-cleared trucks transporting goods to the Manhattan SEZ close to the Vietnamese border which are exempt. Transhipment is thus common. Freight operators claim the cost of obtaining the permits is excessive, preferring to operate only to the border. The lack of a regional third-party liability insurance scheme allowing insurance companies to cover cargo beyond their national borders also adds to this. As such, more than two-thirds of the permits were issued for passenger services according to the World Bank (2014c). This restricts competition and leads to additional delays and freight costs and risks of cargo damage for industrials and consumers. The opacity of regulations and procedures also adds to the challenge as it leads to a high incidence of informal fees charged at checkpoints and weighbridge stations (World Bank, 2014c).

Table 3.3. Time and cost of transporting goods via the Southern Economic Corridor

	Distance	Freight transport (time)	Freight transport (cost, USD)	Cost per kilometre (USD)	Passenger transport (time)
Bangkok to Phnom Penh	666 km	23h55	1 654	2.48	11h30
Phnom Penh to Ho Chi Minh	237 km	14h	593	2.50	5h30

Notes: Freight transport refers to 20-ton containers, excluding pre-shipping document procedures but including border customs.
Source: Mizuho (2014).

Removing transhipment could entice more efficient and competitive logistics and support greater global value chain activities in Cambodia. The transhipment requirement makes these overland international routes more costly than the national corridor between Phnom Penh and Sihanoukville Port or the river corridor to the port of Cai Mep in Viet Nam. The railway network does not offer a viable logistics alternative as it is currently only partially operational and not connected to its trading partners Thailand and Viet Nam. The network is under rehabilitation and there are plans to reconstruct the missing link to Thailand, which could provide some competitive check to existing routes and help to reduce the informal payments practice along trading road routes. Proper implementation of the ASEAN Transport Facilitation Agreements and the GMS Cross-Border Trade Agreement would also go a long way in facilitating cross-border trade in the region (World Bank, 2014c).

Greater efforts to improve air connectivity are also important to support diversification beyond tourism activities and traditional garments, and towards higher-value-to-weight products in electronics and electrical equipment, as well as higher-value garments and footwear products, which are more sensitive to the speed of air freight despite its relatively higher costs. To some extent, the rapid rise in air cargo traffic (11% CAGR in 2010-15)[14] in recent years, as well as the increasing launching of new air freighter services to Phnom Penh[15], reflect Cambodia's emerging diversification and upgrading, although still mostly backed by the garment and footwear industry. The recent opening of the direct flight to Japan may also contribute not only to facilitating tourism and business trips for firms operating in both countries, but potentially to supporting more operations by Japanese firms producing higher-value-to-weight products, such as some electric and electronics components (e.g. audio-visual equipment, semi-conductor devices, wire harnesses) which sometimes rely on air transport (JICA, 2014).

Notes

[1] The relaxation in 2011 by the European Union of the requirements on rules of origin under the Everything But Arms programme supported substantial increases in Cambodia's exports to the EU (World Bank, 2015).

[2] Statistics obtained from the balance of payments database, available at the website of the National Bank of Cambodia.

[3] In Cambodia, only 9% of garment factories were domestically owned in 2010 (Fukunishi et al. 2010).

[4] The example of the cost breakdown of a men's woven cotton shirt sold in the US is reflective of such asymmetric distribution of value along the chain: about only USD 2 or about 6.5% of the final USD 30.7 retail price of a men's cotton shirt in 2004 related to CMT activities (InfoDev, 2008).

[5] Yarns, woven and circular knitted fabrics, accessories, trimmings like threads and almost all packing materials.

[6] The empirical literature on FDI spillovers is relatively more positive regarding vertical spillovers, notably through backward linkages, compared to horizontal spillovers as MNEs would rather are minimise linkages to competitors but may be more willing to improve the productivity of suppliers (Alfaro, 2014).

[7] The authors advance a model that assumes that each product requires a certain number of non-tradable inputs, which they call capabilities, and that countries can make only those products for which they have all the requisite capabilities. As such, products requiring a greater number of capabilities will be produced by a lower number of countries, and, therefore, countries with large capabilities will likely be more diversified. The more capabilities a country acquires, the higher the returns in terms of increased diversification as the capacity to diversify increases exponentially by the possible multiple combinations of any new capability with existing ones (Hausmann and Hidalgo, 2010).

[8] Despite some limitations of the Balassa index (see Leromain and Orefice, 2013), the measure is often used as an indicator of a country's relative trade competitiveness in a particularly product, based on the assumption that trade patterns reflect differences in relative production costs and advantages across countries (Balassa, 1965).

[9] Only about 38 000 of the estimated 530 000 SMEs nationwide are registered with the Ministry of Commerce.

[10] The rate of non-registration is 63% for small enterprises and 29% for medium enterprises.

[11] There are number of market failures that may prevent firms from investing in training despite being in the firms' interest to have a more qualified workforce. An enterprise may underinvest afraid of losing its qualified workforce to competitors. To minimise such risk of poaching, they may also give preference to investments in training related to specific and less transferable tasks and skills to the detriment of broader training options providing employees with the opportunity to upgrade their skills and employability for occupational changes in the long-term. Other reasons can be returns to scale – individual firm training can be costly for smaller firms and could eventually be more efficiently provided by a single training provider – and even liquidity constraints – not only is there the risk that returns on investment in skill development will not be entirely appropriated by the firm making the investment because employees can move away, but such investments may also partly reduce liquidity which cannot be compensated by credit backed by future improvements in labour productivity. Investments in human capital cannot be used as collateral as would investments in physical capital (Kuku et al., 2015).

[12] Possible implications may include "a) deadweight losses; b) administrative complexity and rigid eligibility criteria; c) the possibility that firms shift the tax burden onto wages; d) a lack of incentives for small firms and low-skilled workers to invest or participate in adult learning (OECD, 2005).

[13] According to JETRO overseas business survey (2016), the ratio of firms selecting ASEAN6 countries as an investment destination reached 73.2%, exceeding that of China (53.7%) for four consecutive years.

[14] Data on cargo freight is available at the Cambodia Airports website: [www.cambodia-airports.aero/our-business/traffic-data#anchor], accessed in October 2016.

[15] Cathay Pacific Airways launched its services in late 2014, and Emirates, DHL Express, Raya Airways and AirBridge Cargo Airlines entered the market in 2016.

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Chapter 4. Improving business regulation in Cambodia

This chapter reviews the regulatory framework for starting and operating a business in Cambodia and the quality of implementation in terms of transparency, clarity, predictability and fairness, as well as the extent of corruption. The chapter also discusses the extent of public consultation in Cambodia when laws and regulations are amended. The last section benchmarks the relative openness to foreign investment, an area where Cambodia far exceeds many of its rivals.

Regulation of business establishment and operations is a proper function of government but should be no more cumbersome than necessary to ensure compliance with the law and other policy objectives. When the costs and procedures in establishing and operating a business are unnecessarily high, domestic firms may prefer to remain informal and foreign investors may forgo profitable investment opportunities in favour of other destinations. Uncertainty concerning the procedures and the outcome of any approval process can also deter potential investors. Transparency and accountability are important components of a good business environment.

By some measures, Cambodia is a relatively difficult place to do business

Cambodia's performance in many international rankings, together with a high rate of informality, suggests that it remains a difficult place to do business, particularly when it comes to registering a business. At the same time, surveys of investors, including interviews conducted as part of this review, provide a more nuanced picture, with considerable heterogeneity in how investors experience the investment environment. And the poor performance in "starting a business" rankings has not prevented a significant foreign investor presence which has driven both economic growth and poverty reduction. For a discussion of the *Doing Business* methodology, see Box 4.1.

The rules and regulations governing business operations may be less onerous than they seem on paper, but weak institutions and policy uncertainty have affected investor perceptions. Some uncertainty is inevitable as part of a reform process, but more efforts could be expended on consulting with the private sector on proposed changes and performing regulatory impact analysis which explicitly takes into account the cost of change itself.

Cambodia is beginning to address these challenges, through reforms to the *Investment Law*, automation of government processes and stronger enforcement of existing laws. The Ministry of Commerce recently launched an online registration database for businesses. While the primary objective is to facilitate and accelerate procedures, it may also be seen as a positive step toward reducing corruption and inefficiency. CDC now offers unofficial English language versions of the main legislation affecting investors. The lack of regulatory transparency has been a frequent complaint of investors in the past. Special economic zones have also served to some extent to reduce the regulatory burden on business by having officials on-site.

Cambodia is ranked 138th out of 190 countries in terms of the overall ease of doing business in the World Bank's 2019 *Doing Business* indicators (Figure 4.1), ahead of both Lao PDR (154) and Myanmar (171). The evolving methodology behind *Doing Business* makes it difficult to assess improvements over a long period of time, and the overall ranking will also depend on reforms in other countries. A better measure of change over time is the distance-to-frontier measure which captures the performance of Cambodia relative to the best performer in each category. By this measure, Cambodia has seen an improvement in its performance in each year, although it still lags far behind the best performers, as one would expect given its level of development.

Cambodia's worst performance in *Doing Business* is in the category "starting a business" where is comes in 185th. The number of procedures required to start a business does not seem to be an issue, although it can certainly improve. In Cambodia, an investor needs to complete nine procedures to start a business, compared to a single one in New Zealand, the best performer. But Cambodia's requirements are only slightly greater than some of its ASEAN peers (5 procedures are required in Thailand, and 10 in Lao PDR and

Malaysia) and compare favourably with Indonesia, the Philippines and Viet Nam, which require investors to complete 10, 13 and 8 procedures respectively. Starting a business in Cambodia is relatively costly and lengthy. According to *Doing Business* calculations, it takes about 99 days and costs about 47% of income per capita to complete required procedures, well above the time required and cost in Malaysia, Thailand, Philippines, Indonesia and Viet Nam.

Box 4.1. The World Bank's Doing Business indicators

The Doing Business indicators from the World Bank have had unparalleled success in drawing attention to the regulatory burdens on business, leading to hundreds of reforms worldwide to improve the business environment. These burdens perpetuate informality and can potentially dissuade foreign firms from investing when faced with more welcoming environments elsewhere. At the same time, the indicators have been criticised for the underlying assumption that less regulation is always better, thus ignoring the potential social benefits of regulation. To some extent, Doing Business has also been a victim of its own success by giving the impression that improvements in a country's ranking will automatically have an impact on the ground. An investment climate is a complex organism, requiring interventions in many areas to keep it in good health. Focusing reforms on certain aspects of business regulation because of the worldwide visibility of Doing Business rankings may not always be optimal when facing capacity constraints within government requiring a choice of which reforms to prioritise.

Doing Business looks at the regulatory burden for a local limited liability company operating in the largest business city. The indicators look at the number of procedures, time and cost of starting, operating and closing a business. These include starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Labour market indicators are provided separately and are not included in the ranking. A distance to the frontier measure is also compiled which measures each country's distance from the best performer in terms of good regulatory practice.

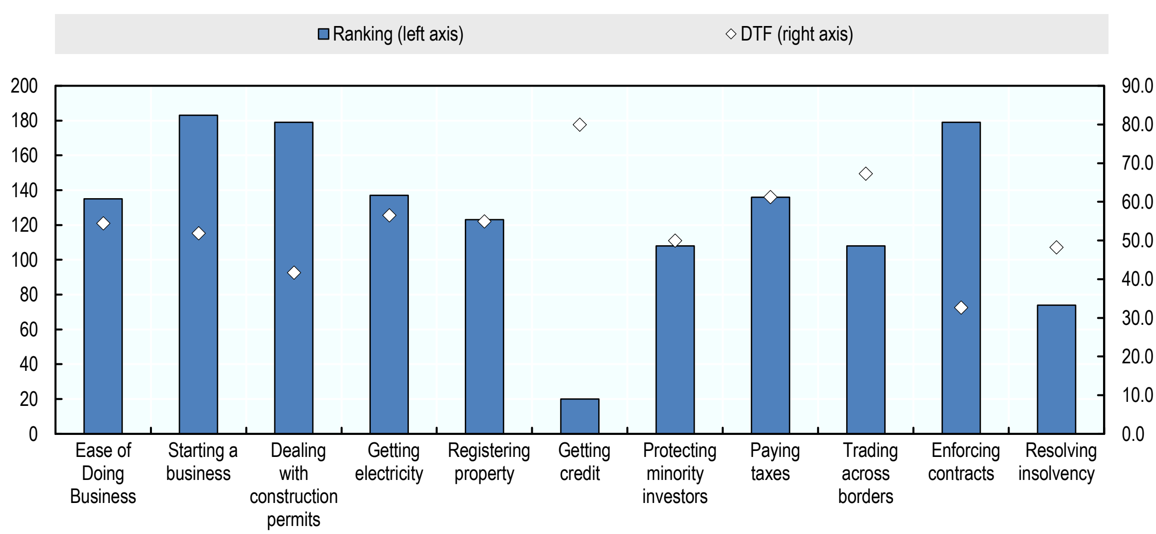
Several studies have used the Doing Business indicators to demonstrate that lower levels of regulation tend to stimulate growth. Eifert (2009) look at specific components of Doing Business and finds that improved contract enforcement stimulates growth. Klapper and Love (2011) find a link between significant reforms and new firm registration and also show that lagging countries are likely to require relatively larger reforms in order to see a significant impact. A World Bank (2013) study estimates that "moving one percentage point closer to the frontier regulatory environment is associated with USD 250-500 million more in annual FDI inflows". Not all studies have found a robust relationship, however, particularly with respect to FDI inflows. Jayasuriya (2011) finds that, "on average, countries that undertake large-scale reforms relative to other countries do not necessarily attract greater [FDI] inflows". For developing countries, he finds an insignificant (albeit positive) relationship.

Critiques of the Doing Business methodology can be found within the World Bank itself. An independent panel review commissioned by the World Bank president in 2013 criticised the data gathering methodology, by relying primarily on legal experts who were likely to have only a certain category of firms as clients and hence a narrow perspective. It also cited potential measurement errors owing to the variation in the number of experts consulted in each country. Doing Business indicators can also lead to "rank seeking" behaviour whereby governments "manipulate the indicators by altering the proxies that are the focus of the rankings, instead of changing the underlying factors that the proxies are attempting to assess" (World Bank, 2013). Furthermore, the titles such as "getting credit" give the impression of being a comprehensive measure of access to credit, instead of being based on "two specific legal structures in credit markets" (World Bank, 2013).

The panel also pointed to the inevitable gap between the regulations and day-to-day practice, as reflected in the discrepancy between the Doing Business rankings and the findings of the World Bank Enterprise Surveys which are based on the experience and perceptions of a broad sample of firms. Hallward-Driemeier and Pritchett (2011) compare the results of the two methodologies and find that firms surveyed generally report actual times for complying with regulations which are much less than what is reported in Doing Business. In fact, they find little correlation between the two measures, even when looking at changes over time. What they find instead is that there is as much variation in treatment of firms within countries as across them. Favoured firms in the worst ranked countries in Doing Business do much better that the disfavoured firms in the best performing countries. Thus, countries looking for best practice might consider the treatment they accord to the most privileged firms and try to replicate it to the extent possible throughout the economy, rather than pursuing the goal of imitating Singapore or New Zealand who are at the top of Doing Business. Furthermore, consistency may matter more than the actual amount of regulation. Hallward-Driemeier et al. (2010) find that firm performance is more a function of the variability in policy implementation than it is of the level of regulation.

The lesson from this experience is that Doing Business is a useful tool but only captures one part of what makes a good investment climate and may in some cases significantly misrepresent the situation on the ground for many investors. At the very least, improvements in a country's ranking can have a potential signalling effect on foreign investors, but the most significant impact of regulatory reforms is likely to be on informality, as smaller firms are the least able to afford the cost and time of registering. Doing Business indicators can point to areas of potential weakness in the regulatory environment and serve as a catalyst for reform, but ultimately, regulatory reforms should be informed by regulatory impact assessments rather than by international rankings.

Figure 4.1. Doing Business in Cambodia, 2018

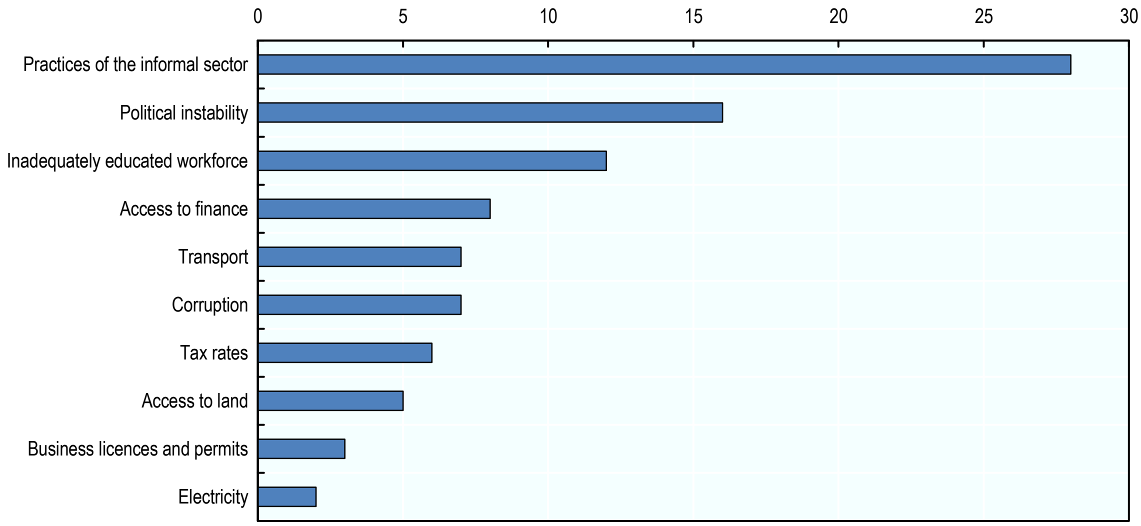


Note: DTF represents the distance to the frontier: the performance relative to the best score in each category.
Source: World Bank Doing Business Indicators, 2019

This poor performance in *Doing Business* is somewhat of a puzzle, especially given that some business surveys suggest that businesses do not see red tape as a major obstacle. According to the World Bank's Enterprise Survey, only 3% of surveyed firms regard licensing and permit gathering as among the top ten constraints (Figure 4.2). This finding is echoed in the World Economic Forum's *Global Competitiveness Index* which finds the burden of government regulation to be no worse – and sometimes considerably better – than in peer countries.

Figure 4.2. Top ten business environment constraints in Cambodia, 2016

(Percentage of firms listing each constraint)



Source: World Bank Enterprise Survey 2016 (World Bank, 2018).

Minimum capital requirements

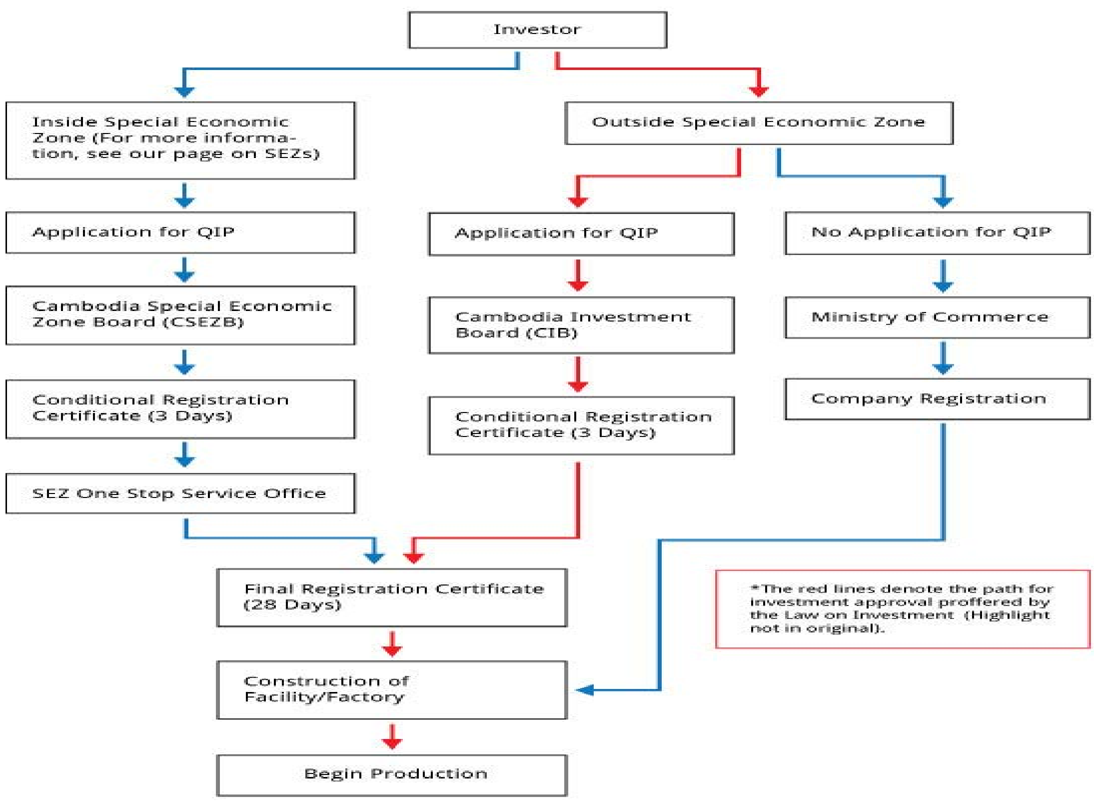
Another particularly burdensome regulation preventing entrepreneurship is the relatively high minimum paid-in capital requirement that applies when of the establishment of a generic business operation – i.e. the standard amount that a foreign or domestic investor is legally required to deposit in a bank or with a notary before registration or up to three months following incorporation. Minimum capital requirements are associated with greater informality, and with firms operating without formal registration for a longer period (World Bank, 2014). For Cambodia, this requirement represents 76.2% of income per capita, against none or close to zero minimum capital requirements in most ASEAN economies. The measure affects particularly the less capital-intensive industries, and notably SMEs. Other industries, such as banking and tourism for instance, are faced with specific capital requirements.

Reforming the registration system

Over time, the procedures for investors in Cambodia have gradually been simplified. The investment licensing scheme (defining the approval process for FDI and providing incentives to potential investors) was originally regulated by the 1994 *Law on Investment* which was criticised for excessive red tape. The *Law on Investment* was amended in 2003 to make the licensing schemes simpler, more transparent, predictable, automatic and non-discretional. An automatic approval system was put in place together with a one-stop service, and a sub-decree was issued in February 2005 to regulate the licensing scheme for investments below USD 2 million.[1] Today the registration and establishment process is on paper easy for both domestic and foreign investors seeking investment guarantees and incentives: it is based on automatic approval and a one-stop service (providing information and processing application approval, customs duty and tax exemption, visa and work permits, and company registration).

Investors may follow two possible tracks depending on the location of their projects: one for SEZ investors and the other one for non-SEZ investors (Figure 4.3). For non-SEZ investors, there are a further two tracks depending on whether investors are asking for incentives. Investors not seeking incentives only have to register at the Ministry of Commerce and obtain operating permits from the relevant line ministries. Investors asking for incentives register their investment as "qualified investor projects" (QIPs) and have to apply for investment registration with the CDC or the provincial/municipal investment sub-committee. The application for the investment registration can be made either before or after incorporation (or registration with the Ministry of Commerce).

Figure 4.3. Investment registration flow



Source: CDC, *Cambodia: FDI and Government Policy* [PowerPoint Slides]. Retrieved from www.adbi.org/files/2012.10.09.cpp.sess3.3.suon.cambodia.fdi.pdf.

As shown in Figure 4.3, the investment application is processed, in theory, within three working days, with the CDC issuing a conditional registration certificate (CRC) to the applicant.[2] As a next step, various ministries (Ministry of Commerce, Ministry of Industry an Energy, Ministry of Land Management, Urban Planning and Construction, Ministry of Economy and Finance as well as local authorities) provide the necessary licences and authorisations so that a final registration certificate is issued by CDC within 28 working days or automatically granted after 31 days if it has not already been issued. The CDC is expected to act as a one-stop shop and obtain all necessary licences from relevant ministries listed in the CRC for investment on behalf of the investment applicant. As is standard for an investment promotion agency, the CDC also provides post-investment services through assistance with registration, customs or work permits, but the quality of the investor facilitation services has reportedly in the past not always deemed to be in line with expectations (Sotharith and Vannarith, 2010).[3]

In December 2015, the registration procedure was further simplified by introducing an on-line business registration system to reduce the number of steps, application forms and number of signatories needed in business registration and permit applications. The new, paperless system enables prospective local and foreign businesses to upload shareholder and board of directors' information and pay the registration fees online, as opposed to the old system where representatives had to physically go to the ministry to complete registration procedures. In addition to being less time-consuming[4], the new process is also expected to limit opportunities for corruption.

In addressing such issues, Cambodia could seek to implement some of the good practices for reducing the costs and length of procedures to start a business that emerged from other countries reform experiences, including inter alia using standard registration and online services, and by limiting registration fees to the actual administrative costs of registration services. According to the *Doing Business* database, Cambodia already made some improvements to its registration system in 2014-15 by, for instance, streamlining procedures for company name checking and approvals at the Single Window bureau of the Department of Business Registration, by unifying tax application forms and by eliminating the requirement for companies to publish abstracts of their incorporation documents in the Official Gazette. An online registration platform was also implemented in 2016, but further reforms to current practices are still needed for the new online interface to deliver on expectations of reduced time and cost for registering a business. The preliminary results after the first few months of operation of the online business registration portal were mixed.

The World Bank (2017) recommends further strengthening the registration system by creating a single window to streamline procedures and costs, removing the obligation to ensure the uniqueness of the company name, and abolishing the requirement to have a company seal. Beyond these measures, the World Bank also recommends establishing a special task force to review, simplify and abolish unnecessary procedures and licences – an approach which has been attempted in many countries, with varying degrees of success.

Beyond regulations, effective implementation is often deficient

Beyond the rules themselves, firms often complain about how they are actually administered. This can be seen in the time taken by investors to comply with regulations. The time spent by senior management dealing with tax regulations, for example, is four times as high in Cambodia as in other lower middle income countries and ten times higher than the average for East Asia and the Pacific (World Bank, 2018). The number of meetings with tax officials each year is also 3.6 times as high.

Transparency, clarity and predictability of regulations

Doing Business focuses on the number of procedures, time and cost involved in registering a business, as well as on other aspects of the regulatory environment. Other issues which are perhaps even more relevant for Cambodia and which arise more often in investor surveys concern the transparency, fairness and predictability of the regulatory regime.

Although there is no pattern of systematic discrimination by the government against foreign investors in Cambodia, numerous issues of transparency in the regulatory regime arise from the lack of legislation and capacity of key institutions (US Department of State

2017). Access to laws and regulations in English can be challenging. According to EuroCham, there is a need to provide easier access to English-language information about *Labour Law* regulations and responsible persons with the Ministry of Labour and Vocational Training (Eurocham, 2016). A business survey by Eurocham (2017) also found that, while transparency processes have improved, the lack of transparency still remains an obstacle. Businesses reported non-transparent practices and unofficial fees as the main obstacle to Cambodia's competitiveness.

Transparency can take many forms. In the first instance, it can mean providing English-language versions of laws and regulations. One in four firms surveyed by Eurocham praised the improvement in the availability of legal information (Eurocham, 2017). CDC now publishes a list of all relevant laws and regulations affecting investor, along with unofficial translations in English.[5] The Official Gazette is also now published on-line. Sometimes the issue is more a lack of clarity in terms of which rules, among conflicting laws and regulations, apply in a particular case. Investors in the Eurocham survey called on the government to continue its efforts in establishing new laws and regulations, while at the same time clarifying some of the existing ones.

Sometimes the rules leave room for discretion which can add considerable uncertainty for investors. For instance, for duty free import of equipment and raw materials under the QIP, the lead time for approval may vary by discretion of the officer in charge at the CDC (such complaints were mentioned by several international investors interviewed by the OECD). According to the WTO (2017, p. 93),

> *"[T]he country faces challenges such as a lack of transparency and predictability in the implementation of regulations, which is impeding full liberalization of many services sectors, even though the legal framework formally adheres to Cambodia's international commitments. Missing information relating to regulatory requirements, inconsistent application and interpretation of regulations across agencies, frequent changes of administrative practices and alleged discretionary applications of rules constitute limitations to an otherwise open regime. In addition, the regulatory infrastructure, human resource capacity and other resources, remain insufficient."*

Corruption

Discretion also offers scope for corruption. Registered firms still view informal payments as a major constraint to doing business. While the amount spent on informal payments may have declined since 2009, the incidence of such payments has risen (World Bank, 2015). According to a World Bank Enterprise Survey, two thirds of Cambodian firms experienced at least one bribe request across six transactions dealing with access to utilities, permits, licences, and taxes in 2016 as compared to 24% in lower middle income economies. Similarly in the recent Eurocham survey, 59% of firms complained of non-transparent practices and unofficial fees. Cambodia also fares badly in Transparency International's *Corruption Perception Index* where it is ranked 161 out of 180 countries, the worst performance in Southeast Asia.

Some improvements have occurred as a result of a Public Financial Management Reform Program, an *Anti-Corruption Law* in 2010 and an *Asset Declaration Law* in 2011, together with establishing an Anti-Corruption Unit, although this Unit has reportedly suffered from a lack of de jure and de facto independence. Its credibility also remains an issue with firms in the Eurocham survey (Eurocham, 2017). Bribery is likely to be a particular constraint for foreign investors from home countries which criminalise such activities throughout the global operations of home-based investors.[6]

The perception of fairness

The variability in treatment from one firm to another seen, for example, in business registration, suggests that rules and regulations are not applied evenly or consistently. This can result from a lack of clarity in the rules themselves, poor capacity of officials to understand or apply the rules, poor compliance by some – often informal – firms, and the possible use by some firms of facilitation payments to expedite procedures. Improving the clarity of rules across the stock of legislation is an ambitious agenda that will require greater attention to regulatory impact analysis (Chapter 7).

Unfair competition was the second largest area of concern for investors in the Eurocham survey (Eurocham, 2017) and first in the World Bank Enterprise Survey (World Bank, 2018). Although it also appeared among the top three constraints in earlier Enterprise Surveys in 2007 and 2012, this was the first time that it ranked first and by such a wide margin (Figure 4.2). Perhaps somewhat paradoxically, the reason why unfair competition has risen as a concern for investors may be related to the strong efforts by the government to improve tax compliance as part of the Resource Mobilisation Strategy (see Chapter 6).

Public consultation is inconsistently applied

Transparency is an essential component of good governance today. More open and inclusive policy-making processes help to ensure that policies will better match the needs and expectations of citizens and businesses. Greater participation of stakeholders in policy design and implementation leads to better targeted and more effective policies. The notion of "open government" is rapidly transforming the way public institutions work, both internally and with citizens, businesses and workers' organisations. Soliciting investor views, along with those of other stakeholders, when developing or revising policies contributes to policy legitimacy and effectiveness. Moreover, policy is more likely to be sound and not produce unintended side effects if it is formed in a structured and transparent way that gathers inputs from all interested parties (OECD, 2015).

According to the business community, the private sector in Cambodia is inconsistently and insufficiently consulted on policies and procedures affecting their operations, with adverse effects on their business. Individual offices and departments within ministries engage in a variety of ways with their immediate stakeholders as they review problems and develop policy proposals. Some engagements are deep and productive, but there is no existing mandate and framework to guide consultations and there are few platforms or processes in which potentially interested individuals and organisations are alerted to the development of new regulations in order to plan ahead and gather information and views from their members. There is opportunity for the government to further engage in substantial and productive discussions with the private sector. These can be achieved through existing mechanisms that aim to strengthen links and develop formal engagements through formal private-public consultation mechanisms such as the Government-Private Sector Forum (G-PSF) (Box 4.2 and below). Furthermore, consultation workshops may benefit from more productive discussions if documents and announcements are announced at an early stage. The government can likewise take advantage of a wider set of expertise by extending the coverage of consultations to other representative organisations.

Box 4.2. The Government-Private Sector Forum (G-PSF)

Established in 1999, Cambodia's Government-Private Sector Forum (G-PSF) was an initiative introduced by the government to further strengthen links between the private and public sector. The G-PSF serves as a joint dialogue mechanism to identify issues and recommend solutions to improve the business environment and stimulate investments. The CDC serves as the secretariat of the G-PSF and facilitates the dialogue between the government and business community through regular meetings with established working groups. There are currently ten working groups focusing on the following: agriculture and agro-industry; tourism; manufacturing and SMEs and services; law, tax and governance; banking and financial services; transport and infrastructure; export processing and trade facilitation; industrial relations; rice; and power and mining resources.

The working group meetings are organised at two levels:

- Private sector-only working group meetings, organised on a monthly basis and serving as a platform for business associations and company representatives to agree on issues to be raised with government counterparts.
- Joint Government-Private Sector Working Group meetings organised at the request of the government or private sector. Each working group is co-chaired by a minister and a private sector representative, with other ministries also invited. Discussions are often based on an agreed agenda related to either law/policy or direct operational impediments faced by the private sector. Unresolved issues within the WG are referred to the Prime Minister, to be resolved during the forum plenary sessions organised twice a year.

The Cambodian Federation of Employers and Business Associations (CAMFEBA) is responsible for coordinating the dialogue between the private and public sector and plays a secretariat role for the Industrial Relations Working Group which is responsible for:

- Considering and settling the demands by workers/employees and employers based on existing laws and regulations;
- Collaborating with the private sector to set up a permanent mechanism of clustered factories to serve the Working Group in developing measures to deal with and to prevent negative incidents in a prompt manner;
- Collaborating and coordinating with the private sector within the framework of existing relevant laws and regulations in order to clearly ensure smooth production operation, and expanding the implementation of the labour standard in Cambodia
- Initiating to develop policies and implementing other necessary tasks that are of interest to all parties concerned within the labour framework

Source: Cambodian Federation of Employers and Business Associations (CAMFEBA), G-PSF, https://www.camfeba.com/en/representative/g-psf.html

Government-Private Sector Forum

The Forum provides a platform for business representatives to offer expertise on a range of policy and regulatory reforms. Successful examples include consultations on the investment, taxation and concession laws, the introduction of private sector monitors at the Ministry of Commerce, and negotiations on cost reductions for scanning operations and toll road fees. The Forum also encourages the business community to adopt a more holistic view toward improving the economy. The performance of the G-PSF has deteriorated over the past few years. The latest plenary session dates back to March 2014 after a hiatus for two consecutive years because of Cambodia's ASEAN chairmanship in 2012 and general election in 2013.

On the whole, foreign investors' assessment of the G-PSF is mixed, with one chamber expressing doubts as to the efficiency of the scheme. Although the government may be in listening mode, it is said to tend to shift part of the responsibility on to the private sector; moreover disagreements between ministries (Economics and Finance, Commerce and CDC) are said to hinder the effectiveness of the dialogue. At the same time, discussions between authorities and some of the working groups recently led to welcome changes, as in the case of changes in tax regulation in April 2016 as a result of months of discussion between the General Department of Taxation and the Tax Working Group and the Working Group on Law, Tax and Governance. Taking stock of this experience, an important objective of the IDP is to further strengthen the Forum mechanism.

Bilateral consultations and investor aftercare

The government is seeking more comprehensive bilateral consultations with targeted high potential investors, especially those from China, Japan, Korea, Thailand and Viet Nam. A Japan-Cambodia Public-Private Sector Joint Meeting has also been organised bi-annually since the two countries signed a bilateral investment treaty in 2007 and co-chaired by the Secretary General of CDC and the Japanese Ambassador. It provides an opportunity for Japanese investors to raise their concerns and requests to the government and forms a critical part of the implementation of the aftercare service. Some of the recent issues include (i) the high cost and unreliable supply of power; (ii) rising wages and low quality of labour (see below); (iii) non-applicability of investment incentives to project expansion; and (iv) non-transparent and complicated administrative procedures including taxes and customs clearance. Nevertheless, the dialogue is not deemed fully satisfactory by Japanese investors, who reportedly complain about the lack of reactivity on the part of the authorities. The 2006 Trade and Investment Framework Agreement also provides a bilateral forum for discussions between the United States and Cambodia.

As a further effort to address investor concerns, a complaints desk has been established at CDC (December 2012) to handle practices not in compliance with standard services, over charged fees, or unjustified delay in documents processing. A special trouble-shooting committee for SEZs oversees any problems that may occur with land rights, exports, imports and the labour market. The prime minister chairs both CDC and the trouble shooting committee. The SEZ Trouble Shooting Committee has the duty to promptly settle all issues occurring in the SEZs, whether pertaining to technical or legal aspects, or issues under the joint jurisdiction of ministries or institutions and beyond the competence of the Special Economic Zone Administration or the Cambodian Special Economic Zones Board. The Committee has the further duty to be a mechanism to receive any complaint, and find solutions to that complaint filed by zone developers as well as by zone investors.

Cambodia is open to foreign direct investment

Investment is a crucial ingredient for economic growth and sustainable development. Domestic investments normally dominate, but foreign direct investment can provide additional advantages beyond its potential contribution to the capital stock. It can serve as a conduit for productivity gains through greater competition and the local diffusion of technology and expertise (OECD, 2015). Therefore, regulatory restrictions on FDI, as with any other policy favouring some firms over others, may involve some important costs to the economy, notably in terms of lower productivity levels (OECD, 2018). The recognition of such potential positive effects partly explains why countries worldwide have in general reduced the number and scope of discriminatory measures affecting foreign investors over time (Kalinova et al., 2010).

FDI restrictions involve land and real estate and a few sensitive sectors

Cambodia is highly open for foreign investment according to the OECD *FDI Regulatory Restrictiveness Index* (Box 4.3), particularly when compared not only to neighbouring ASEAN countries, but also to the OECD average and across sectors (Figure 4.4 and 4.5). Article 8 of the *Law on Investment* as amended in 2003 provides that foreign investors shall not be treated in any discriminatory manner, except in respect of ownership of land as set forth in the 2001 *Land Law* (Article 8). Ownership of land is permitted only to Cambodian citizens and entities, defined in the *Law on Investment* as a company which has a place of business and is registered in Cambodia and in which 51% or more of the shares of the company are held by a person of Cambodian nationality. The legal framework permits foreign investors to hold interests in or over immovable property in Cambodia through leases, land concessions and mortgages. During the land concession or lease period, and subject to the terms of these agreements, investors may mortgage or sub-lease immovable property on the land. Only the transfer or mortgage of concession land which has not yet been exploited is prohibited (DFDL, 2014).

Box 4.3. Calculating the OECD FDI Regulatory Restrictiveness Index

The OECD FDI Regulatory Restrictiveness Index covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial and professional services). Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a weighted average of individual sectoral scores.

For each sector, the scoring is based on the following elements:

- the level of foreign equity ownership permitted,
- the screening and approval procedures applied to inward foreign direct investment;
- restrictions on key foreign personnel; and
- other restrictions such as on land ownership, corporate organisation (e.g. branching).

The measures taken into account by the index are limited to statutory regulatory restrictions on FDI, typically listed in countries' lists of reservations under FTAs or, for OECD countries, under the list of exceptions to national treatment. The FDI Index does not assess actual enforcement and implementation procedures. The discriminatory nature of measures, i.e. when they apply to foreign investors only, is the central criterion for scoring a measure. State ownership and state monopolies, to the extent they are not discriminatory towards foreigners, are not scored. Preferential treatment for special-economic zones and export-oriented investors or for investment from a treaty-covered country is also not factored into the FDI Index score.

Source: For more information on the methodology, see Kalinova, Palerm and Thomsen (2010). For the latest scores, see www.oecd.org/investment/index.

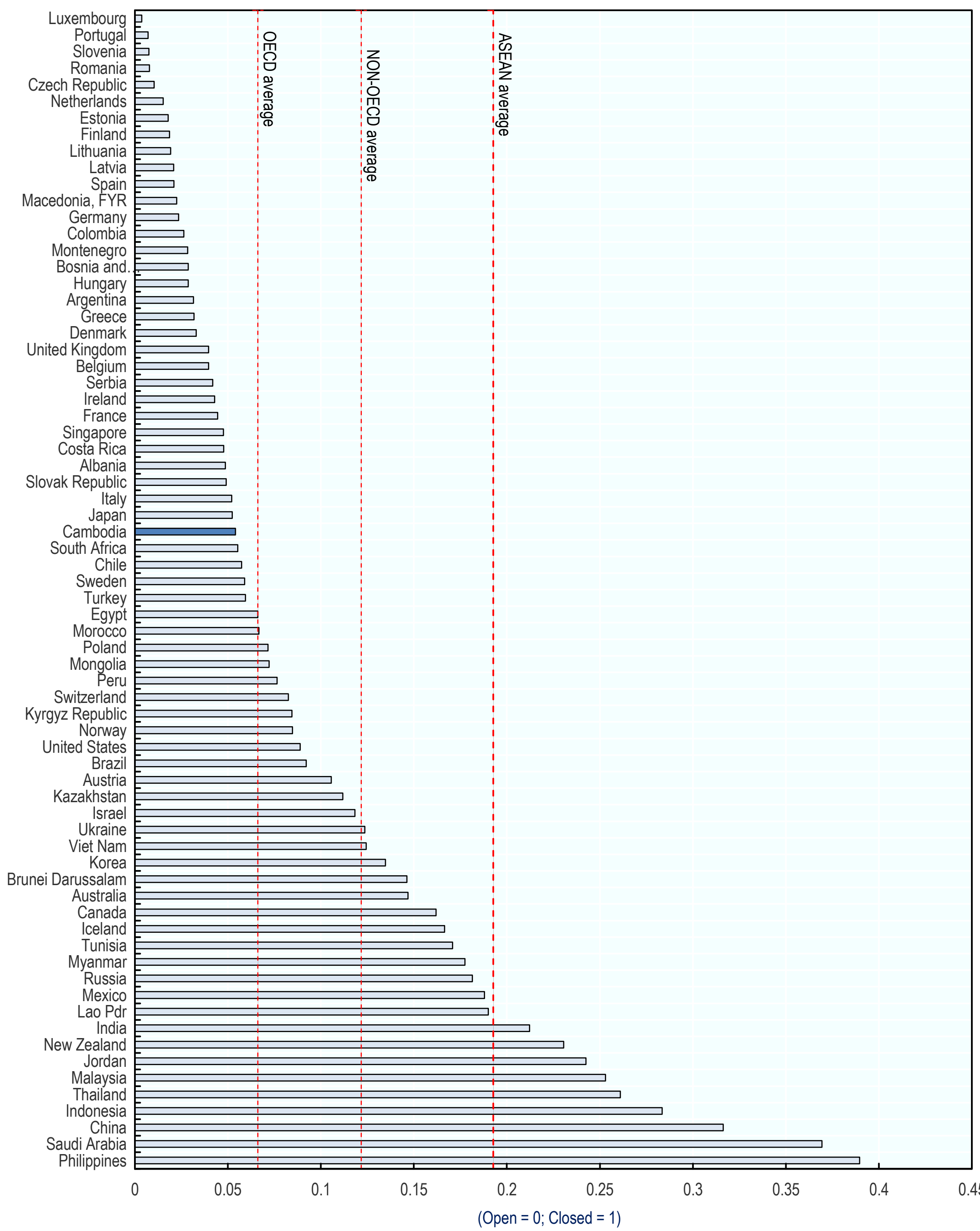
The limitation on foreign ownership of land also implies that a foreign investor – an entity with 50% of more of shares held by foreigners – is not allowed to directly acquire or hold a majority interest in an enterprise owning land in Cambodia. Such an acquisition is possible but requires the prior disposal or transfer of ownership of any land held by the acquired entity to a Cambodian investor, which can then lease back to the new foreign-owned entity. The legal framework is well established in this respect and should not be a particular issue of concern. Practitioners say it is common practice for foreign investors to create special purpose landholding entities owned at least 51% by Cambodian nationals and 49% by the foreign investor for such purposes, and that the available legal instruments (e.g. long-term leases for 15 years or more renewable, the creation of security interests (mortgage), and other contractual arrangements) allows the protection of the interests of the foreign investors in such circumstances (DFDL, 2014).

Foreign ownership of real estate condominium units is also somewhat restricted. Under the 2010 *Condominium Law,* foreign investors can have ownership rights in private units of co-owned buildings only from the first floor up, and the proportion of private units that can be owned by foreigners in a co-owned building is restricted to 70% of the total units. The ground floors and underground floors cannot be owned by foreigners. As is common in other countries, foreign investors are also not authorised to acquire ownership rights in private units of co-owned buildings located within thirty kilometres of the land borders of Cambodia and in other areas determined by the government, except for the co-owned buildings located in special economic zones, in important urban areas and in other areas determined by the government.

Cambodia also maintains a few sectoral restrictions on FDI, such as in radio and TV broadcasting and other printed media, as well as on a few manufacturing sub-sectors and mining activities (see Table 4.1 for a list of regulatory restrictions under the OECD *FDI Regulatory Restrictiveness Index*). For instance, foreign equity is restricted to a maximum of 49% in enterprises engaged in radio and television activities, printing and services related to printing, and other publishing activities.[7] The publishing of newspapers, journals and periodicals, as well as of record media, is subject to authorisation by the Ministry of Information and the Ministry of Culture and Fine Arts. Additionally, the 1995 *Law on the Regime of the Press* (article 18) further requires that the total number of all Khmer language newspapers owned by foreigners not exceed 20% of the total of all Khmer language newspapers that are actually being published in Cambodia. But once a newspaper owned by foreign investors has been authorised, it may not lose its licence due to a decrease in the total number of Khmer language newspapers.

Other sectors facing restrictions on foreign investment are: the manufacturing of cigarettes; the production of alcohol; exploitation of gemstones, manufacturing of clay bricks and tiles, rice mill; wood and stone carving; and silk weaving. Restrictions also apply to foreign-owned legal firms wishing to supply legal services with regard to Cambodian law, which is only allowed in commercial association with Cambodian law firms as per the 1995 *Law on the Bar*. The provision of legal services regarding foreign and international law is not subject to any restriction. A reciprocity condition applies for obtaining an authorisation from the Khmer Bar Council for foreign lawyers to be able to practice the legal profession in Cambodia. The licensing of foreign investors to provide international air transport and banking services is also subject to reciprocity as per the respective sectoral laws.

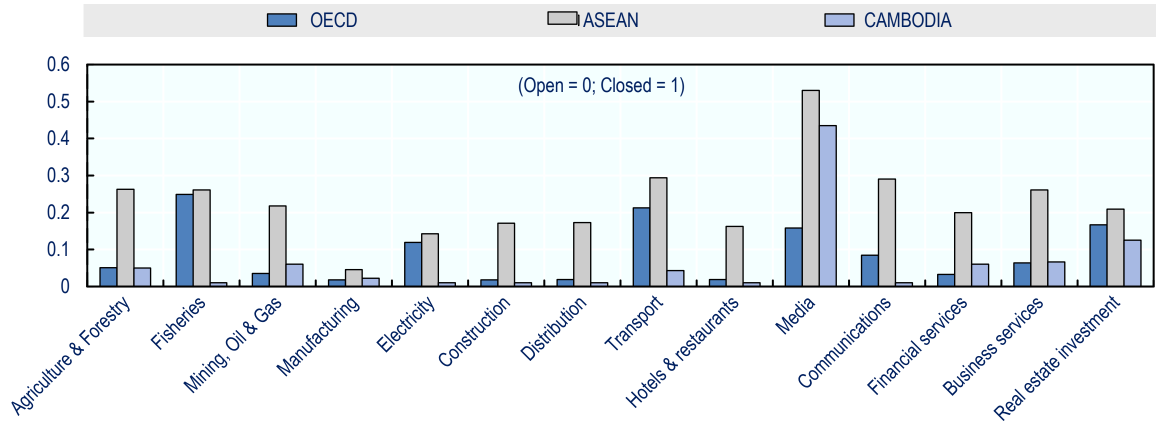
Figure 4.4. OECD FDI Regulatory Restrictiveness Index, country scores



Note: The FDI Index covers only statutory measures discriminating against or more burdensome to foreign investors (e.g. foreign equity limits, screening & approval procedures, restriction on key foreign personnel, and other operational measures). Other aspects of the investment climate are not considered (e.g. the implementation of regulations and state monopolies). Data reflect regulatory restrictions as of end-December 2017.

Source: OECD FDI Regulatory Restrictiveness Index database, www.oecd.org/investment/fdiindex.htm

Figure 4.5. OECD FDI Regulatory Restrictiveness Index, sector comparison



Note: Please refer to figure notes in Figure 4.4.
Source: OECD FDI Regulatory Restrictiveness Index database, www.oecd.org/investment/fdiindex.htm

Table 4.1. Regulatory restrictions on foreign direct investment

Scope/sector	Sub-sectors	Description	Legal authority
Horizontal restrictions			
Land ownership		Ownership of land is reserved to Cambodian citizens and entities (i.e. 51% or more of the shares of the company held by a person of Cambodian nationality)	Law on Investment, 5 August 1994; and Law on the Amendment to the Law on Investment, 24/3/2003; Land Law, 20/7/ 2001
Sectoral restrictions			
Mining & quarrying	Exploitation of Gemstones	subject to local equity participation	Sub-decree 80/ANK/BK on Measures Restricting Certain Investment Sectors, 27 August 1999
Manufacturing	Cigarettes	100% foreign ownership allowed only for export	idem
	Alcohol	subject to prior approval from Minister	idem
	Bricks made of clay (hollow, solid) and tiles	subject to local equity participation	idem
	Rice mill	subject to local equity participation	idem
	Wood and stone carving	subject to local equity participation	idem
	Silk weaving	subject to local equity participation	idem
Media	Publishing of newspaper, journals and periodicals; Publishing of record media;	subject to discussion with Ministry of Information and Ministry of Culture and Fine Arts; the total number of all Khmer language newspapers owned by foreigners shall not exceed 20% of the total of all Khmer language newspapers published	Sub-decree 80/ANK/BK on Measures Restricting Certain Investment Sectors, 27 August 1999; Law on the Press Regime, 18 July 1995
	Other publishing; Printing; Service activities related to printing	Foreign equity is restricted to maximum of 49%	idem
	Radio and television activities	Foreign equity is restricted to maximum of 49%	Law on the Press Regime, 18 July 1995
Transport	Air transport	Licence to conduct international air transportation services is subject to reciprocity	Law on Civil Aviation, 19 January 2008

Scope/sector	Sub-sectors	Description	Legal authority
Financial Services	Banking	Licence is subject to reciprocity	Law on Banking and Financial Institutions, 19 October 1999
	Insurance	A branch of a foreign insurer is not permitted.	Royal Kram No. NS/RKM/0814/021 4 August 2014 on the Promulgation of the Law on Insurance
Business Services	Legal services	Foreign lawyers and law firms are allowed to supply legal services regarding foreign law and international law without restrictions. With regard to Cambodian law, they are only allowed to supply certain legal services in "commercial association" with Cambodian law firms. Foreign lawyers may not directly represent clients in courts. Foreign lawyers may only practice their profession in the territory of the Kingdom of Cambodia with authorisation from the Khmer Bar Council; this authorisation is subject to reciprocity.	Law on the Bar, 15 June 1995;
Real estate investments	Condominium units	Foreign ownership of private units of co-owned buildings allowed only from the first floor up, and up to 70% of the total units of the building	Law on Providing Foreigners With Ownership Rights in Private Units of Co-Owned Buildings, 24 May 2010 ("2010 Condominium Law");

Notes

[1] Sub-Decree on the Establishment of the Sub-Committee on Investment of the Provinces-Municipalities of the Kingdom of Cambodia, February 2005.

[2] The CRC is automatically issued unless the proposal fails to include all the required information or the proposed project is on the list of prohibited activities as defined in Sub-decree No 111 (negative list) or is related to national interest/environmental sensitivity.

[3] This is corroborated by investors' interviews during OECD missions.

[4] The time frame for business registration is expected to be cut from 5-7 days to one hour.

[5] www.cambodiainvestment.gov.kh/why-invest-in-cambodia/laws-regulation.html

[6] Such as the US Foreign Corrupt Practices Act (1977) or the UK Bribery Act (2010).

[7] The sub-decree No. 80/ANK/BK on Measures Restricting Certain Investment Sectors of 27 August 1999 provides for a list of sensitive sectors in which investment shall be restricted on the basis of national security, social welfare, or economic needs. While the sub-decree was issued to support the implementation of the Law on Investment and the sub-decree No. 88/ANK/BK of December 29, 1997 on the Implementation of the Law on Investment of the Kingdom of Cambodia and its amending sub-decree No. 53/ANK/BK of June 11, 1999, which were later abrogated by the sub-decree No. 111/ANK/BK on the Implementation of the Law on the Amendment to the Law on Investment of September 27, 2005, it seems that is still in force. The sub-decree No. 111/ANK/BK did not explicitly abrogate the sub-decree No. 80/ANK/BK and since the provisions of this latter sub-decree are not contrary to the sub-decree No. 111/ANK/BK, it is plausible that it remains valid.

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Chapter 5. Investor protection in Cambodia

This chapter reviews the provisions in both domestic legislation and Cambodia's international investment agreements offering protections for covered investors. It looks first at the domestic regulatory framework in Cambodia, particularly the Investment Law, but also the protection of both intellectual property and land rights. It then discusses the national framework for dispute resolution. The second part looks at the evolving debate about international investment agreements and how Cambodia's approach fits in with emerging trends in other countries.

Summary

The restrictions and conditions faced by foreign investors, both when they establish and in their on-going operations, are only part of the overall investment environment. Transparency and predictability, non-discrimination, and the protection of property rights, combined with effective enforcement mechanisms, are important pillars of a sound investment climate. Investment protection therefore plays a crucial role for the investment climate. The term describes relevant provisions and policies which define the rights of investors, and in particular the level of treatment they may expect in their dealings with the government.

Investment policy involves a balance between investor protection and the government's right to regulate. Protection of investors from improper treatment can lower their perception of risk for new investments, and investors who perceive lower risks will generally make capital and resources available at a lower cost. At the same time, governments need latitude to regulate investment and to address evolving conditions through changes in policy over time. Reconciling these goals involves a challenging balancing act relying on a potentially wide range of policy tools.

The rights and interests of investors can be protected by different legal instruments, such as Cambodia's Constitution and different laws and regulations that apply to all persons. They are also protected by a range of administrative law doctrines as well as by good administrative practices. In many advanced economies, these are the principal protections applicable in practice to most investors under domestic law.

A second level of treatment, under review here, involves laws in Cambodia that apply specifically to some or all investors and investments and that provide more specific protection. Many emerging economies, such as Cambodia with its first *Investment Law* from August 1994, amended in 2003, provide for additional protections for all or defined categories of investors or investments. These laws can provide important protections to some or all investors, make protections easier to identify for the relevant investors, and consequently encourage additional investment. At the same time, they provide rights for (some) investors that are not available to other constituencies affected by investment and in many cases offer dedicated venues to enforce these rights. This may affect the relative influence of different constituencies on government policy as well as the competitive conditions facing different types of investors.

Cambodia had to rebuild its legal system and institutions after the Khmer Rouge. Investment and business specific laws and regulations were introduced and continue to play a central role in the overall legal and policy framework for investment protection. Enforcement mechanisms, like arbitration, that complement the role of the domestic court system, are another important pillar of the investment framework. While the government continues to improve investment specific regulation and dispute settlement mechanisms, it is also working to improve the general legal and judicial framework, as evidenced by recent reforms of the court system.

The assessment of Cambodia's legal and policy framework for investment is still currently mixed. Cambodia's *Investment Law*, particularly the section on investment protection, is relatively vague, creating uncertainty for investors and the government as to the protection and obligations it entails. According to public statements, the ongoing revision of the investment law does not appear to be focused on protection, but rather on investment incentives (*Phnom Penh Post*, 2013). The revision is nevertheless an opportunity to improve the drafting of the investment protection provisions as well. While

Cambodia has undertaken reforms to improve the functioning of the judiciary, most recently with three laws signed in 2014, civil society organisations and the investor community continue to express concerns about the reliability, predictability and independence of the judicial system at all levels.

Cambodia has also signed over 20 bilateral investment treaties as well as a number of multilateral agreements with investment provisions. While some recent treaties have more specific treaty language, specifying government intent and giving direction to arbitrators for their application, the older treaties, which are still in force, often remain vague. Where they provide for arbitration, this gives investment arbitrators broad discretion to interpret and thereby determine the scope of protection they provide.

Policy recommendations

- *Continue efforts to improve functioning of the court system.* Despite recent efforts, there is room for further improving mechanisms for contract enforcement in Cambodia. Continued reform efforts should be undertaken to ensure adequate dispute settlement mechanisms for investment and business disputes. The capacity of the courts to deal with private sector cases should be considerably enhanced to boost confidence in the enforcement of contracts.
- *Review existing investment treaties.* Cambodia might wish to review its existing investment treaties to assess whether these adequately reflect its current approach to investment treaties and are in line with its commitments under the ASEAN investment treaties.
- *Specify treaty language to ensure that treaties accurately reflect government intent.* Treaty provisions in the vast majority of Cambodia's treaties are relatively broad, leaving arbitrators ample leeway to determine the actual scope of protection they provide. The absence of clear government intent for many of these provisions may pose significant challenges for the government in achieving an adequate balance between investor protection and its own power to regulate.
- *Manage liability risks under investment treaties actively.* While Cambodia has not yet faced investment treaty claims, the authorities should seek to ensure that different government agencies and officials are aware of treaty policy and the obligations it entails. Efforts to improve the management of risks could include training programmes for government officials and the creation of dispute prevention and management mechanisms.
- *Consider the policy rationale for offering different levels of protection to different groups of investors.* While there can be value or a need to provide certain extra incentives to attract specific investors, e.g. foreign investors or investors in certain sectors and projects, Cambodia should seek to guarantee a sound investment climate for all investors and consider whether distortions to efficient investment decisions may occur.

The review of Cambodia's Investment Law

Cambodia's *Investment Law* from August 1994 was amended in 2003 and an implementing sub-decree issued in 2005. It is currently under revision which provides a unique opportunity to improve the domestic legal framework for investment protection, including by offering adequate levels of protection to investors, ensuring consistency of approaches within ASEAN to establish an integrated investment region, and by seeking to attract and retain investment that benefits Cambodia and its population. Some countries have chosen to implement very comprehensive investment laws, while many other countries do not have a specific law covering investment.

Embedding the Investment Law in a comprehensive investment strategy

Governments that decide to develop a dedicated domestic legal framework for investors, whether domestic or foreign or both, should ensure that such laws are embedded in a broader strategy to attract and retain investment. Cambodia's *Investment Law* should not be seen in isolation but rather as a complement to the overall legal and policy framework for investment. The review of the law is thus a unique opportunity to complement a strategy that allows society to reap the benefits of investment, in line with the ambitious goals set out in the Industrial Development Policy (IDP). The amended law should foster a sound regulatory environment, with adequate levels of investment protection, while also ensuring that investment actively contributes to social and economic development.

In light of ASEAN's ambition to create an integrated investment region, which is also emphasised in the IDP, the regional dimension of the country's investment strategy should be clearly reflected in the law. This does not require Cambodia to align its law with those of its peers in ASEAN, but it might wish to consider and learn from other ASEAN member states' experience, in designing and implementing their revised investments laws. Experience-sharing on how to set up and manage a whole-of-government approach, that takes into account the views of relevant stakeholders, might be beneficial for all ASEAN members. The recommendations set out in Chapter 7 on Implementing Good Regulatory Practice in Cambodia on law-making generally should be followed in the *Investment Law*'s review process as well.

The scope of the Investment Law

Clearly define "foreign" and "domestic" investment within the law. The definitional section of an investment law is crucial, as it determines the scope of the law, and hence the extent of the obligations, rights and guarantees that it provides. In keeping with what is considered good practice, Art. 1 of the law provides that it applies to both domestic and foreign investors, sending a positive signal that the government treats foreign and domestic investors equally, with an underlying principle of non-discrimination. But when domestic and foreign investments are covered under the same core guarantees, it requires clear definitions of the typology of covered investments. Rules that apply only to foreign investors, such as profit repatriation, are provided together with provisions applying to domestic investors only, such as those applying in sectors that are not open to foreign investment, and with provisions applying to both foreign and domestic investors. The law has to clearly delineate categories of investments to provide investors with greater legal predictability, stability and transparency.

Having a clear typology of investment helps to create an unambiguous and predictable legislative framework for investment. It determines partly under what type of conditions foreign and domestic investors can invest. Some provisions, special benefits or incentives apply exclusively either to domestic or to foreign investors. Specific rights apply to foreign investors, such as access to international investment arbitration, while domestic investors often only have recourse to domestic courts to resolve investor-state disputes. Meanwhile, a few sectors are prohibited for foreign investors.

Specify investment protection provisions to increase predictability for investors and the government

On investment protection, the *Investment Law* is relatively vague. Under chapter 4 on investment guarantees, four provisions are set out: i) a guarantee of national treatment (art. 8); ii) protection against nationalisation (art. 9); iii) a guarantee of non-interference of the government in the price setting of products and services (art. 10); and iv) a guarantee on the purchase of foreign currencies and the remittance of these currencies for specific payments (art. 11). Chapter 8 also contains an important provision for investment protection purposes, governing the settlement of disputes (art. 20). Overall, the language of the investment protection provisions in the law appears to be relatively vague. While this may be due to translation imprecisions in some instances, several clauses are drafted in general terms. Where investment provisions provide for arbitration, as is the case in the investment law, broad language gives investment arbitrators wide discretion to interpret and thereby determine the scope of protection they provide.

Pursuant to article 9, for example, the "Royal Government shall not undertake nationalization policy, which shall adversely affect private properties of investors in the Kingdom of Cambodia". Nationalisation is a narrow term that only covers some forms of expropriation. The authorities might wish to clarify which forms of expropriation fall under art. 9. Myanmar's new investment law from 2016 provides an example of a more comprehensive clause on expropriation. The clause addresses, inter alia, issues such as the calculation of compensation, the distinction between direct and indirect expropriation, and certain forms of regulation that appear not to be precluded by the expropriation provisions. When providing more extensive expropriation language in the law, drafters need to ensure that its implication and scope are well-understood. The experience with similar provisions under investment treaties might inform the drafters in this regard: broader legal and policy questions regarding expropriation provisions that arise in the context of investment treaties are also relevant for similar provisions in domestic laws.

The provision in the current law addressing discrimination might also benefit from clarification in the review process. Art. 8 provides that a "foreign investor shall not be treated in any discriminatory way by reason only of the investor being a foreign investor, except in respect of ownership of land as set forth in the Land Law." This provision appears to provide for national treatment, which provides that a government treat enterprises controlled by the nationals or residents of another country no less favourably than domestic enterprises in like circumstances.

Beyond investor protection: investor obligations in investment laws

The view that investment laws should not merely provide for adequate levels of protection for investment but also play a role in helping society reap the benefits of that investment is gaining traction. Setting out specific obligations for investors in these laws might contribute to that goal. While Cambodia's *Investment Law* already contains investor obligations (see for example the obligation to provide adequate training and to promote local staff to senior positions in art. 18), the government might consider expanding the use of this tool. Some of Cambodia's peers in ASEAN are pursuing a similar path. Lao PDR's investment law from 2016, for example, provides for a wide range of investor obligations, including on social and environmental issues. Myanmar's investment law from 2016 similarly contains a relatively extensive list of obligations. Investor obligations and requirements to comply with domestic law of the host state are also issues under consideration in investment treaty policy.

Protection and enforcement of intellectual property rights

The granting and protection of intellectual property (IP) rights, through patents, trademarks, and their enforcement, are key components of any policy aiming at attracting and retaining investment. IP rights are an important policy area because the protection of IP rights helps foster development and innovation. According to a report by the South East Asia IPR SME Helpdesk, IP rights infringement "is one of the most common concerns for businesses when dealing with South-East Asian countries" (IPR SME Helpdesk, 2017). The protection of IP rights also involves balancing issues: While IP rights provide an incentive to invest in research and development, societies have an interest in having new products priced affordably.[1] High levels of IP protection might impede access to pharmaceutical products at affordable prices, for example.

Cambodia has put in place a relatively extensive legal framework for IP rights protection. The main legislation on the protection of IP dates from 2002-03, including the *Law on Patents, Utility Models and Industrial Designs* (2003), the *Law on Copyright and Related Rights* (2003), and the *Law concerning Marks, Trade Names and Acts of Unfair Competition* (2002). Cambodia joined WIPO in 1995 and subsequently adhered to several international treaties regarding IP rights.[2] A number of these legal initiatives were prompted by Cambodia's accession to the WTO in 2004, but full compliance with WTO standards has not yet been achieved (IPR SME Helpdesk, 2017). While Cambodia's IP laws are more advanced than in some other ASEAN member states, recent reports also suggest that some gaps in protection remain (US State Department, 2016; IPR SME Helpdesk, 2017).

Enforcement of IP rights is challenging for many governments, including in Cambodia. The application, registration and enforcement mechanisms reportedly "remain relatively nascent" in Cambodia, despite some improvement in recent years (DFDL, 2015). Against this background, it is encouraging to see that the IDP recognises the need for further institutional improvements: it sets out the goals to "[i]mprove the effectiveness of the process of registering industrial property rights by way of implementing collaborative procedures to recognize registration agents of partner countries and to facilitate to the registration of IP agents through automation" (IDP: 6.3 B.).

Patent requests are generally registered with Cambodia's Ministry of Industry and Handicraft (MIH); copyrights may be registered with the Ministry of Culture and Fine Arts. A partnership with the Intellectual Property Office of Singapore allows patent owners and applicants in Singapore to register with the MIH. Fast-track procedures were also established with the Japanese IP authorities. Since December 2016, patent protection may also be sought under the framework of the Patent Cooperation treaty (IPR SME Helpdesk, 2017). These initiatives clearly reflect efforts to improve registration processes. Continuing efforts to improve the functioning of the court system, discussed below, would also benefit IP rights holders by facilitating the enforcement of IP rights.

The protection of land rights in Cambodia

Pursuant to the Cambodian Constitution, "All persons, individually or collectively, shall have the right to ownership. Only Khmer legal entities and citizens of Khmer nationality shall have the right to own land."[3] While foreigners are not allowed to own land, they may have a limited number of units in a co-owned building, and they can hold up to 49% of interest in Cambodian corporations (USAID, 2017).

Cambodia's *Land Law* from 2001 is another important pillar of the current legal framework for the protection of land rights. Under the law, full ownership (freehold) is only extended for land peacefully occupied and used before 2001 (GIZ, 2016). The law also establishes a system for the "systematic titling of land and creates a comprehensive dispute-resolution system" (USAID, 2016).

A number of sub-decrees specify the application of the *Land Law*. Sub-Decree No. 146 on Economic Land Concessions from 2005 establishes a framework for the "grant and management of concessions of land for large-scale, market-oriented development, including requirements to conduct public consultations and environmental and social impact assessments (USAID, 2016).

Dispute resolution: the national framework and commercial arbitration

Balancing investor protection and government's power to regulate is also an issue in policies relating to dispute settlement. Well-functioning contract enforcement and dispute settlement mechanisms help increase predictability and certainty in commercial and investment activities. The court system has a fundamental role in enforcing contracts and in settling disputes, both among private actors and between an investor and the state. Businesses may also rely on commercial arbitration and other alternative dispute resolution mechanisms.

The domestic judicial system and courts

In international and regional comparison, the judicial system in Cambodia typically ranks relatively low, partly for historical reasons. Until 1993, Cambodia lacked any laws to guide the judicial system. With the 1993 Constitution, drafted under UN administration, and the first elections in the same year, a new judicial reform impetus emerged. Two laws on the functioning of the legal system and the judiciary were passed in 1993 and 1994 respectively. In 2014, three new laws on the judiciary, whose drafting process had started ten years earlier, were passed to mixed reviews. Overall, additional efforts appear to be required to enhance the quality of the judiciary and court system, not only for investors, but also for Cambodians.

According to the World Bank's *Doing Business* report, contract enforcement and dispute settlement in domestic courts is an area where Cambodia is performing below average, ranking 182 out of 190 economies in the latest report. According to the US State Department (2016), "most investors are generally reluctant to use the Cambodian judicial system to resolve commercial disputes because the courts are perceived as unreliable and susceptible to external political influence or bribery".

Reform efforts to improve the judiciary

Recent reform efforts suggest that the government is taking these concerns seriously. Under the "Rectangular Strategy", it set out an ambitious reform programme, including legal and judicial reform measures to "achieve a credible and stable legal and judicial system that promoted human rights and dignity, strengthened the rule-of-law principle of a liberal democracy, ensured social justice and created a reliable environment for attracting investment" (Rectangular Strategy Phase III, p. 14). For the Fifth Legislature of the National Assembly, which started in 2013 and ends in 2018, the authorities emphasised the role of judicial reform. Seven pillars of the reform efforts are explicitly set out:

> "(1) Further promoting the adoption of key legislations concerning judiciary including the Law on the Statute of Judges and Prosecutors, the Law on Organization and Function of Courts and Prosecution, Amendment to the Law on the Organization and Function of the Supreme Council of Magistracy, as well as the development of new laws required for state governance and Cambodia's membership in the ASEAN Economic Community to be established by 2015 and the World Trade Organization;
>
> (2) Further strengthening of professional capacity and responsibility of judges and prosecutors;
>
> (3) Further promoting the establishment of court administration attached to tribunals at all levels;
>
> (4) Further equipping the tribunals with appropriate means to perform their functions;
>
> (5) Further implementing law dissemination and training programs;
>
> (6) Further extending cooperation and support to the Bar Association of the Kingdom of Cambodia to provide legal assistance to the poor for defending their rights and interests in the court system; and
>
> (7) Further promoting the out-of-court settlement mechanisms."

The three laws, mentioned under the first pillar, were approved by the Senate in 2014 and the Constitutional Council announced that it had no objections shortly thereafter. The laws were signed into effect on 16 July 2014. Overall, these laws have received mixed reviews from civil society organisations.

The *Law on the Courts* reorganised the courts of first instance, with four specialised courts: the Civil, Criminal, Commercial and Labour Courts. The law provides that more specialised courts may be created if necessary. The Commercial Court has competence to hear all commercial cases including insolvency cases, and cases relating to the enforcement of arbitral awards (art. 22). Importantly, the law also provides that a judge hearing cases in the Commercial Court shall be accompanied by two advisors, who are "business men" (art. 23). Where the value of the subject of the dispute is over ca. USD 250 000, three judges, accompanied by two advisors, will hear the case. In smaller claims, where the subject of the dispute is under USD 25 000, the dispute will be heard by a single judge, with the assistance of the advisors. The law suggests that the advisors will only serve on an ad hoc basis, with no permanent affiliation with the court (art. 23). A sub decree is expected to define the role and selection process for the commercial advisors. (US State Department, 2016)

Despite these developments investors reportedly still lack confidence that their disputes will be handled fairly and expeditiously in Cambodian courts. Efforts to improve arbitration as a mechanism to settle disputes have to be seen against this background. While arbitration can supplement domestic courts, it should not be seen as a substitute for a well-functioning national judiciary that is open to all stakeholders and not just businesses and investors.

Commercial arbitration

Cambodia's legal framework for arbitration is largely defined by the *Commercial Arbitration Law* from 2006.[4] The Law provided for the establishment of the National

Arbitration Center, which was eventually established in 2013. The Law follows *UNCITRAL Model Law* and addresses, inter alia, the composition of the arbitral tribunal, the jurisdiction of the tribunal, the conduct of the arbitration proceedings and the making and recognition of the awards.

The state of commercial arbitration in Cambodia has been described as nascent (Norton Rose, 2013). The first case was brought before the Centre in 2015 (Boltenko, 2015). In light of the lack experience in Cambodia with arbitration generally and the Centre in particular, commentators have described a wait-and-see approach, with a preference for international arbitration rules and centres (Malintoppi and Tan, 2017: 82). Commercial arbitration reportedly remains a rarely used tool.[5]

Dispute settlement provisions in domestic legislation

The *Investment Law* contains provisions on dispute settlement and on arbitration. Art. 20 states a preference for amicable dispute settlement but provides investors with access to other remedies if no settlement is reached within two months. The remedies include conciliation before a government body: the Council for the Development of Cambodia; domestic or international arbitration as agreed to by the disputing parties; and domestic courts. Land disputes are excluded from this provision.

For disputing parties it is important to know that decisions and awards of arbitral tribunals will be enforced. Art. 44 of the *Arbitration Law* specifies the limited conditions under which an arbitral award may be set aside. If the subject matter of the dispute is not capable of arbitration under Cambodian law[6], or if the award may be contrary to the public policy of Cambodia,[7] the award may be set aside. An application for setting aside an award may not be made more than 30 days after the party making the application has received the award.[8] The Appeal Court in Phnom Penh appears to be in charge of enforcement matters. Except for the time limit, identical conditions apply to the refusal of the recognition and enforcement of awards (art. 45 and 46, *Arbitration Law*). The court system has thus a crucial role to play in the enforcement process of commercial arbitration awards.

Cambodia is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (also called New York Convention), the leading international treaty applicable to commercial arbitration. It addresses the recognition and enforcement of foreign arbitral awards (i.e., those made in a country other than Cambodia) and of certain awards made in Cambodia.[9] The national courts of contracting parties to the Convention must generally recognise arbitration awards rendered in other contracting parties, subject to narrow exceptions, and enforce the awards in accordance with their rules of procedure. Since Cambodia is a contracting party, investors that have prevailed in arbitral proceedings against Cambodia know the conditions under which the awards will be recognised and enforced in Cambodia. The New York Convention also facilitates the recognition and enforcement of Cambodian awards in third countries that are party to it.

International investment agreements

Investment treaties typically protect existing covered investments against expropriation without compensation and against discrimination, and give covered investors access to investor-state dispute settlement mechanisms (ISDS) to enforce those provisions. Cambodia started signing investment treaties in the 1990s, with an initial focus on Asian countries, particularly in Southeast Asia. In addition to over 20 bilateral investment treaties, Cambodia has also signed a number of multilateral agreements with investment provisions. The most recent bilateral agreements were signed with Belarus (2014), Russia (2015) and Hungary (2016).

As an ASEAN member state, Cambodia's recent investment treaty policy has in many cases been driven by a new regional dynamic: since the conclusion of the intra-ASEAN Comprehensive Investment Agreement (ACIA) in 2009, the group of ASEAN member states has signed agreements with Australia and New Zealand (2009), Korea (2009), China (2009), and India (2014).[10] ASEAN is currently also negotiating the inclusion of an investment chapter for the existing Economic Partnership Agreement with Japan.

The review of the substantive and procedural provisions in Cambodia's investment treaties shows that the language of key treaty provisions has evolved, particularly since the advent of the new regional ASEAN treaty policy in 2009. In recent treaties, Cambodia has specified the meaning of key treaty provisions to clarify government intent. These are treaty policy features, in common with the Philippines (OECD, 2016) and Viet Nam (OECD, 2018). Cambodia might thus wish to consider the consistency of its existing treaties with recent approaches. Dates for renewal or termination of treaties could inform Cambodia's timetable to engage with its existing treaty partners.

Regional and multilateral approaches offer an opportunity to create an integrated investment region in ASEAN and to establish common rules on investment protection and liberalisation. At the same time, additional commitments in agreements covering investment relations already subject to bilateral or other multilateral treaties may jeopardise the consistent implementation of Cambodia's treaty policy: investors may circumvent new treaty policies by invoking the older investment treaty, which does not yet reflect these new policies.

Clearly specify protection provisions to better reflect government intent

International practice shows that investment protection standards in older IIAs have often been relatively vague. This gives investment arbitrators broad discretion to interpret and thereby determine the scope of protection they provide. Many provisions in Cambodia's existing IIAs, in particular older treaties, lack specific language to indicate government intent as to their scope and meaning.

Direct and indirect expropriation

Cambodia's IIAs require host states not to expropriate unless the measures are taken in the public interest, on a non-discriminatory basis and under due process of law, with prompt, adequate and effective compensation. The relevant provisions typically address the determination and modalities of payment of compensation as well. Cambodia's treaties distinguish and cover both direct and indirect expropriation.[11] Direct expropriation generally refers to an actual taking of legal title to property or a physical seizure of property by a government.

Indirect expropriation is a more complex and sensitive issue. Regulatory action or other behaviour by a government can sometimes have a severe effect on an investment, without involving a formal transfer of title or outright seizure. At the same time, provisions on indirect expropriation can affect the host state's policy space because regulatory action can give rise to claims for compensation. Because most policy issues relating to expropriation arise with regard to indirect expropriation, this section focuses on Cambodia's policy in that area.

While Cambodia's IIAs typically cover indirect expropriation, they do not clarify the circumstances under which regulatory measures do not amount to expropriation and where therefore no compensation has to be paid. This gives arbitrators discretion to draw the line between indirect expropriations that entitle the covered investor to compensation and legitimate regulation that may have a significant economic impact on the investor without obliging the government to pay compensation.

Beginning with ACIA in 2009, some treaties to which Cambodia is a party started to include specifications on indirect expropriation to ensure that non-discriminatory measures, designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an expropriation.[12] Such clarifications are also included in the ASEAN agreement with Australia and New Zealand and in the agreement signed with India; they are also referred to in the work programme for the ASEAN agreement with Korea.[13] Including such specifications in its general treaty policy would allow Cambodia to foster the balance between the government's right to regulate and investor protection, and also help increase the predictability of the legal framework for expropriation for both investors and the government.

Fair and equitable treatment and the international minimum standard of treatment of aliens

Fair and equitable treatment (FET) is another standard at the centre of investment treaty claims and treaty policy (Box 5.1). Cambodia's IIAs typically grant FET to covered investors. These treaties often merely state that foreign investors shall be accorded FET without providing further specification. Provisions providing generally for FET have been considered or applied by tribunals in a broad range of claims and there have been widely different interpretations by some arbitral tribunals. Some interpretations of FET are seen as having a significant impact on the right to regulate.

Box 5.1. Two approaches to specifying and limiting the FET provision

Two important approaches to further specifying the scope of fair and equitable treatment have emerged:

- Limit FET to the minimum standard of treatment under customary international law (MST): This approach has been used in a number of major recent treaties in Asia and the Americas. A FET provision limited to MST has been repeatedly interpreted under NAFTA. It has been interpreted more narrowly than FET provisions under other treaties. NAFTA governments have also had much greater success than other governments in defending FET claims (UNCTAD, 2012: 61). In addition to the limitation of FET to MST, the Trans-Pacific Partnership agreement (TPP, now CPTPP) specifies that the mere fact that government action is not consistent with an investor's expectation does not constitute a breach of FET (Art. 9.6(4). Art. 9.6(3) and (5) contain further specifications).
- Define lists of elements of FET: The EU's proposal for the Transatlantic Trade and Investment Partnership (TTIP), the EU-Viet Nam FTA and the CETA agreement made public in 2016, contain a defined list of elements of the FET provision. This approach lists the elements that can constitute a breach of the standard, namely denial of justice, fundamental breach of due process, targeted

discrimination on manifestly wrongful grounds, and abusive treatment of investors. While it is a closed list, this approach is broader than some interpretations of MST. Arbitration tribunals cannot add new elements. Only the Parties may agree to add further elements to the list. The article also provides that the tribunal "may take into account" (or "will take into account", in EU-Viet Nam FTA) specific representations that created legitimate expectations. Other defined list approaches are also used. For example, the ASEAN-China Investment Agreement (2009) limits the application of its FET provision to cases of denial of justice (Art. 7).

Both options are more specific than the broad language of treaties that only refer to "fair and equitable" treatment. This does not mean, however, that issues of interpretation may not arise. The content of the minimum standard of treatment, for example, is subject to debate as are a number of elements in the defined EU lists.

Internationally, there is a growing trend to define FET provisions in treaties to give more direction to arbitrators by clarifying the original intent of the contracting parties. Two approaches to defining FET are outlined in Box 5.2 below. Except for provisions in recent ASEAN treaties, efforts to include more specific language on FET do not appear to be reflected in Cambodia's treaties. Given the centrality of FET to many investor claims and the uncertainty of its meaning, clarification of government intent could improve predictability for both the government and investors. Cambodia might wish to reflect the more specific language found in recent international treaty practice in its own policy.

Most-favoured nation treatment

Most of the investment treaties entered into by Cambodia reviewed for this report contain most-favoured nation (MFN) treatment provisions which guarantee that covered investors will not be treated less favourably than those of third states. Similarly to the other investment treaty provisions reviewed above, Cambodia's IIAs typically use general language to accord MFN treatment to foreign investors. The meaning of general wording in an MFN clause has been subject to different interpretations. The ensuing uncertainty creates costs for governments, some of whom have responded by providing more specific language on the scope of the MFN provision.

With respect to investment protection granted to nationals of third states in investment treaties, one important element is the question of whether the MFN provision only applies to substantive protection provisions – such as the indirect expropriation or FET provisions discussed above – or also to procedural aspects, and notably the ISDS mechanism (Dolzer and Schreuer, 2012). On this particular question, several Cambodian agreements provide more specific language, and some specifically provide that the MFN clause does not apply to ISDS available to investors under IIAs.[14]

Other recent international agreements provide further specifications that Cambodia might wish to consider: for example, some signatories to the Trans-Pacific Partnership (TPP – now CPTPP) have specified that the MFN provision does not cover investment treaties already in force.[15] This may also help to ensure that efforts to specify investment treaty language in new treaties are not circumvented by covered investors by invoking potentially more favourable provisions included in older treaties.

Balancing the right the regulate and investor protection through exceptions

Investment treaty provisions, such as on expropriation and FET discussed above, affect the balance between investor protection and the right to regulate: their design and application by tribunals, determines which government measures may be successfully challenged by investors. There is a growing recognition that some versions of FET and indirect expropriation provisions reduce a government's policy space (Box 5.2).

To seek to protect certain types of regulation from challenge, several Cambodian IIAs have used other tools, often apparently inspired from international trade law, such as general exceptions clauses. While individual bilateral treaties include exception clauses, they are more regularly found in the ASEAN agreements since 2009. The rationale for these clauses is to ensure that the host state will not be prevented from implementing measures that pursue specific regulatory goals providing certain requirements are satisfied. These general exceptions clauses are in a few cases also complemented by more targeted provisions relating to measures addressing security issues, the stability of the financial system, or efforts to safeguard the balance-of-payments.[16]

Box 5.2. Public scrutiny and reform of international investment agreements

IIAs have come under increasing scrutiny by a variety of stakeholders, including civil society and academia, but also by contracting parties to IIAs themselves. Critics argue that international investment agreements unduly restrict governments' right to regulate and that arbitral proceedings are subject to important flaws. In this process, a number of core assumptions have been challenged. Econometric studies, for example, have failed to demonstrate conclusively that IIAs actually lead to increased FDI flows – a policy goal commonly associated with the investment protection regime (Sauvant and Sachs, 2009). Furthermore, while it has been contended that IIAs advance the international rule of law and good governance in host states by providing mechanisms to hold governments accountable, critics argue that opaque legal proceedings and potential conflicts of interest of arbitrators are contrary to rule of law standards (Van Harten, 2008). Moreover, the availability of international investment arbitration to investors has been seen by some as an instrument that could circumvent, and thereby weaken domestic legal and governance institutions instead of strengthening them (Ginsburg, 2005).

Many governments are engaged in reviews of their investment treaty policy and the field has been marked by significant reforms in recent years. Several economies, including India and South Africa, have proposed different approaches to substantive and procedural provisions in investment treaties. Other economies, such as the European Union, have proposed new approaches to ISDS specifically. At the same time, a number of countries continue to conclude investment treaties that do not reflect the recent approaches.

Dispute settlement under investment treaties

Starting in the 1990s, mechanisms for covered investors to bring claims directly against host governments – ISDS mechanisms – for alleged violations of treaty obligations have become a frequent feature of investment treaties. OECD research shows that around 96% of the global IIA stock provides access to ISDS (Pohl et al., 2012). It appears that all of the bilateral investment treaties to which Cambodia is a party – all signed in the 1990s or later – contain ISDS provisions. While it is difficult to establish a precise number and status of investment claims due to the confidentiality of certain ISDS proceedings, there do not appear to have been any claims by foreign investors against Cambodia under investment treaties or claims by Cambodian investors again Cambodia's treaty partners. A claim under an investor-state contract – not an investment treaty – was brought at the International Centre for Settlement of Investment Disputes (ICSID) by a US investor in 2009.[17] Cambodia successfully defended the claim.[18]

ISDS has become controversial in a number of jurisdictions, including those with whom Cambodia has treaties. Some of these jurisdictions are reviewing their ISDS policies and proposing new approaches, some of which Cambodia might also wish to consider adopting.

ISDS provisions in existing treaties almost always provide for investor-state arbitration which generally involves ad hoc arbitration tribunals selected for each case in an approach derived from international commercial arbitration. An assessment based on the OECD investment treaty data base and analysis of selected treaties suggests that Cambodian IIAs also provide only a low level of regulation of investor-state arbitration. For example, few of Cambodia's agreements specify any time limits for claims against the government. In addition to the treaty with Japan[19], the post-2009 ASEAN agreements constitute an exception in this regard by providing that the submission of the investment dispute shall take place within three years of the time at which the investor became aware, or should reasonably have become aware, of a breach of an obligation of the host state under the IIA.[20] As part of the government's drive to foster an enabling investment climate, Cambodia could consider assessing whether this low level of regulation of ISDS proceedings appropriately reflects its treaty policy objectives.

Given evolving approaches to dispute settlement and the low level of regulation of investor-state arbitration in Cambodia's treaties, the government might wish to assess its existing agreements in light of emerging sound practices in recent treaty policy. Review and renegotiation of investment treaties takes time. It may be more easily conducted without the time pressure of either an imminent tacit renewal for an extended period or its denunciation with the attendant publicity. Cambodia should accordingly monitor the temporal validity of its treaties in order to allow it sufficient time to approach treaty partners where appropriate.

Enforcement of awards

The international community has developed specific institutions and rules to enforce arbitration awards. As noted above in the section on commercial arbitration, Cambodia has adhered to the New York Convention. It is also a contracting state to the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) which has over 150 state parties. The ICSID Convention addresses both the arbitral proceedings and the enforcement of awards rendered under these proceedings. The recognition and enforcement of awards is governed by the Convention itself rather than the New York Convention. The ICSID regime is thus more self-contained in this respect, as awards cannot be reviewed by national courts of the country in which their enforcement is sought. In contrast, the New York Convention permits national courts to refuse the enforcement of awards for, inter alia, reasons of public policy.

Notes

[1] See OECD Policy Framework for Investment, 2015: 26.

[2] The main laws and regulations relating to IP rights protection are available at the World Intellectual Property Organization website: www.wipo.int/wipolex/en/profile.jsp?code=KH

[3] Art. 44, Constitution.

[4] For the purpose of this Review, the text available at http://www.cambodiaip.gov.kh/DocResources/372a361b-7a97-44b3-9810-79e5e6ea85f4_c786a043-b88d-4f64-9429-60a330efdc5f-en.pdf was consulted. It is unknown to the authors where any amendment have been made to the law since 2006

[5] EuroCham Presentation, 22 September 2015, available at: www.eurocham-cambodia.org/uploads/36b4c-alex-larkin--dfdl.pptx

[6] Art. 44(2)(b)(i).

[7] Art. 44(2)(b)(i).

[8] Art. 44(3).

[9] Art. I(1), New York Convention.

[10] The dates noted after the treaties indicate their year of signature.

[11] See art. 4(2), Cambodia-Germany IIA (1999; art. 5(2), Cambodia-France IIA (2000).

[12] See ACIA, Annex 2, para. 4.

[13] The Work Programme contains a list of issues that the contracting parties agreed to negotiate upon, including an annex on expropriation, which would typically contain such a clarification.

[14] E.g. ACIA (2009), Art. 6, fn 4; ASEAN-China IIA (2009), Art. 5(4). See also TPP, or the EU-approach.

[15] See for example US Schedule to Annex II list of non-conforming sectors, p. II-US-11 (excluding from MFN any "bilateral or multilateral international agreement in force or signed prior to the date of entry into force"). The US President instructed the United States Trade Representative to withdraw from TPP in January 2017 and the status of the agreement is at this point in time uncertain.

[16] Examples include clauses on security issues (ACIA, Art. 18; ASEAN-India, Art. 22; ASEAN-Korea, Art. 21), the stability of the financial system (e.g. Cambodia-Japan IIA (2007), Art. 20(1)) and – these provisions are widespread in the ASEAN IIAs – measures to safeguard the balance-of-payments (e.g. ACIA, Art. 16; ASEAN-China, Art. 11; ASEAN-India, Art. 12; ASEAN-Korea, Art. 11; AANZFTA, Chapter 15).

[17] For further information see ICSID website at https://icsid.worldbank.org/en/Pages/cases/casedetail.aspx?CaseNo=ARB/09/18

[18] IAReporter, "Cambodia defeats claims over power plant, and wins $5.6 million in costs; arbitrators also ruled on witness immunity and designation of state-entities", 26 April 2013, www.iareporter.com/articles/cambodia-defeats-claims-over-power-plant-and-wins-5-6-million-in-costs-arbitrators-also-ruled-on-witness-immunity-and-designation-of-state-entities/

[19] Art. 17(8), Cambodia-Japan IIA (2007).

[20] For example ACIA, Art. 34(1)(a).

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Chapter 6. Encouraging further investment in Cambodia

This chapter looks at the institutional set up for investment promotion in Cambodia, along with the two central pillars of that platform: special economic zones and investment incentives. It looks at how the government could make better use of both zones and incentives to promote investment, diversify the economy and enhance the benefits to the local economy from that investment.

Summary

Investment promotion and facilitation is at the heart of the Industrial Development Policy 2015-25. In order to achieve its vision, the government will seek to mobilise and attract foreign investments as well as private domestic investments by focusing on large industries, expanding markets and enhancing technology transfer; it will also revisit the regulatory environment so as to strengthen competitiveness (investment climate and trade facilitation, market information dissemination and informal fees reduction). To that end, a new *Investment Law* is currently being drafted. The CDC has been given greater responsibility over time and, in line with the IDP, the new *Investment Law* is expected to give it an even greater role.

As an open economy with a low wage workforce and with preferential access to many of the world's largest markets, Cambodia has a natural appeal to investors. This can be seen in the sustained high FDI inflows relative to the size of its economy. The challenge Cambodia faces is in diversifying those FDI inflows to include a broader range of sectors and countries and in providing a policy environment which maximises the potential benefits from that investment. Beyond removing overt barriers to FDI and reducing the regulatory burden on business, two of the principal tools to achieve these objectives are the creation of special economic zones and the provision of incentives, both of which fall under the responsibility of the CDC.

Following the lead of many other countries in the region, Cambodia set up a special economic zone (SEZ) programme in 2005 to facilitate export development and create employment by providing the high-quality infrastructure and utilities needed to encourage investment and to promote some diversification away from traditional activities such as garments. Special economic zones have a mixed record worldwide in promoting development but in the best cases they have been able to jumpstart industrialisation and provide lasting development benefits. The zone programme was intended to support investment attraction by streamlining administrative procedures and tapping the potential for private sector provision of infrastructure and services.

They currently employ over 90 000 mostly female workers, with most of the employment concentrated in a handful of SEZs either in Phnom Penh or in zones with access to neighbouring or international markets. The zones may be developed by the state, a private enterprise or a joint venture between the state and the private sector. Almost all SEZs so far have been developed and operated by the private sector. They are open to domestic and foreign firms alike, although almost all firms located in the SEZs are foreign.

Special economic zones in Cambodia are a work in progress. If they have not yet delivered on all of their promise, they have also not diverted resources from more general investment climate improvements. They are mostly privately run and investors generally receive the same treatment in terms of incentives as those outside the zones. They have helped the economy to diversify, while providing employment opportunities, often for young women, to enter the formal sector. At the same time, diversification has not fully relieved the precariousness upon which economic growth stands. Most of the activities in the zones involve footloose low wage, low value added activities susceptible to many of the same shocks as the garment sector.

While manufacturing activity outside the zones is heavily concentrated on the garment industry, SEZs have attracted a much broader spectrum of foreign investors in light manufacturing. They have also been successful at attracting new investors from new countries, particularly Japanese ones. While American companies have traditionally

tended to shy away from Cambodia, the Phnom Penh Special Economic Zone has recently attracted more than USD 100 million of investments from several large American companies, including Coca-Cola.

At the same time, however, despite one-stop shops and enhanced border clearance procedures, investors still complain of burdensome regulation and interference in the SEZs. One-stop shops in the zones reduce regulatory compliance costs, but they still do not fully satisfy firm managers (Warr and Menon 2015). Corruption and regulatory and policy uncertainty were ranked in 2012 as major or severe constraints by a substantial percentage (74% and 34% respectively) of firms operating in SEZs (World Bank 2015). Moreover, SEZ investments face the same constraints as non-SEZ investments (high costs of electricity and transport compared to neighbouring countries, low quality of labour and a general lack of skilled labour). This information is admittedly a few years old in what is a rapidly evolving environment.

In the long-term, SEZs are expected to contribute to local development through backward linkages whereby investors purchase materials and services from the local economy, invest in infrastructure built by local companies and bring new technology into the zones that are disseminated to the rest of the economy. Such spillovers are sometimes difficult because of insufficient physical and economic infrastructure for high-technology processes used inside the zones to be adopted elsewhere in the economy. Even if SEZ-firms and non-SEZ firms wanted to trade with each other, they would be inhibited in their ability to do so. Domestic SMEs may not be sufficiently well equipped and the labour force may lack the relevant skills to make co-operation possible. Furthermore, domestic SMEs' sometimes poor record in terms of compliance with certain international standards may deter foreign investors from engaging in business relationships.

The incentives scheme for investors is being revised

Cambodia has one of the lowest overall rates of corporate taxation in the region. As elsewhere in Southeast Asia, the government offers investment incentives to investors. Tax holidays are provided for up to six years following a trigger period and approved projects are exempt from import duty on machinery and equipment. Investors can repatriate profits freely and reinvestment of earnings is encouraged with special depreciation allowances. Incentives in Cambodia also have the advantage of being relatively simple, although this must be weighed against the fact that they are broad-based and hence likely to represent substantial forgone tax revenue. They also give more weight to tax holidays which, although easy to apply, are a rather costly form of incentive.

Direct comparisons of the generosity of incentive schemes across countries are difficult but it does not seem that incentives on offer to investors in Cambodia are overly generous compared to peers. To some extent, the government simply allows firms to defer taxes when profits are reinvested, and withholding taxes of 14% apply when profits are repatriated. Nevertheless, corporate taxes remain a relatively small share of fiscal revenues in Cambodia, and although revenue mobilisation has improved dramatically in recent years, the secular decline in trade taxes and official development assistance (Chapter 11) as a share of total revenue, together with the need to increase social spending, will mean that direct taxes will have to play a greater role in the future.

A country's tax burden is just one of many, and not always the most important, factor considered by potential investors when weighing up investment decisions. Empirical evidence suggests that host country taxation and international investment incentives generally play only a limited role in determining the international pattern of FDI, particularly in developing countries. Tax holidays tend to favour mobile activities rather than long-term investment. This introduces a bias towards short-term projects with low upfront investment costs and those least likely to generate spillover effects on the wider economy. There is also the potential risk of tax evasion and tax planning by foreign companies (IMF-OECD-UN-World Bank, 2015).

The CDC is the only institution providing tax incentives in Cambodia. It grants Qualified Investment Project (QIP) status to most manufacturing projects as well as to some high-value or large-scale service projects and thus practices little targeting of investment projects in specific fields. In contrast to most Southeast Asian economies, Cambodia offers essentially no special and differentiated treatment to companies in SEZs, thereby avoiding the creation of two distinct regimes which may be a source of complexity. A QIP located in a SEZ is entitled to the same incentives and privileges as other QIPs.

With a new *Investment Law* currently being drafted, the government is considering moving towards a system of "smart incentives" which target activities so as to shape outcomes rather than investment per se. This approach has already been adopted by other governments in the region to varying degrees. It could be less costly and more effective than the current system but must be weighed against the administrative burden it imposes on the government and investor. And any targeted incentives for specific sectors run the risk of distorting capital allocation and hence the distribution of economic activities in ways in which might run against the natural comparative advantage of the Cambodian economy.

Although incentives may have helped to attract firms to invest in Cambodia, they need to be used carefully, first because the amount of revenue forgone due to incentives is far from negligible, and second because of the potential risk of tax evasion and tax planning by foreign companies. It has been observed that foreign companies tend to deregister and change names so as to get further tax exemptions as a “new” company to prolong and retain tax incentives[1], although CDC reports that its role is to verify that this does not happen. Changing the form of incentives and shifting towards a progressive tax and incentive system that allows for investors to upgrade further along the production value-chain may be preferable so as to retain quality investors in the Cambodian economy.

Policy recommendations

- Consider replacing the tax holiday scheme with a tax deduction or tax credit scheme where investors can deduct expenses on specific activities from their taxable income or subtract the amount of accrued tax credits from the taxes owed, while keeping the option of accelerated depreciation of assets. Import duty exemptions on capital equipment and construction materials as well as export tax exemption may be retained as these schemes lower costs and enhance profitability of investment projects at the margin
- Consider removing incentives for sectors that may not be a priority for diversification, while keeping incentives exclusively in IDP priority sectors. This could include targeting well-defined labour-intensive industries that are losing competitiveness due to rising wages in Thailand, in line with Japan's Thailand-plus-one strategy. Alternatively, tax and other financial incentives could target specific eligible activities/expenses for which investors (of any sector) can be reimbursed in terms of tax deductions or credits. Such activities may include training and skills development, wage expenses on highly skilled management and engineers, exporting, importing of capital goods, R&D, or local sourcing of inputs.

- The tax authority should regularly prepare tax expenditure statements to measure and monitor the costs of tax incentives. This requires that investors are required to file a tax return even if their benefiting from a tax holiday.
- Incentive policies should be reviewed periodically to assess their effectiveness in helping meet desired goals. A natural way to introduce periodic assessments of incentive schemes is to make incentive policies temporary rather than permanent. Temporary schemes require reconsidering whether the incentive should be continued, reformed or repealed regularly. Additionally, it has been shown that temporary tax incentives can be used as a counter-cyclical policy: when foreseen to be phased out in the near future, the investment effects of an incentive tend to be bigger than of permanent incentives (US Department of Treasury, 2010).
- Eligibility criteria for granting tax incentives should be clearly defined and readily verifiable to avoid discretionary and distortive decisions on incentives. In Cambodia, the priority period in the tax holiday scheme currently lacks transparency as it is left at the discretion of CDC, thus creating unnecessary uncertainty for investors.

The institutional framework: the CDC as the key player

The institutional arrangement for managing and promoting FDI in Cambodia has evolved strongly over time. The *Law on Investment* which was adopted in August 1994 created the Council for Development of Cambodia (CDC), with responsibility for developing and managing external resource inflows into Cambodia, both official development assistance and FDI. The CDC has been reorganised several times and is now an inter-ministerial body under the direct responsibility of the Council of Ministers. Acting as the government's investment promotion agency (IPA), the CDC is the highest decision-making body in defining the framework for investment strategies and accepting or rejecting investment proposals. For foreign investors, CDC is the first point of contact as well as the place to raise and resolve issues. It also serves as the one-stop service for granting authorisations for investment projects in accordance with the *Law on Investment* and oversees matters pertaining to investments as specified in the law.

The CDC can provide approvals to FDI projects including licences, tax exemptions, and a part or full package of incentives (see below), but it is required to consult and obtain the approval of the Council of Ministers for investment projects which involve[2]:

- capital investment of USD 50 million or more;
- politically sensitive issues;
- exploration and the exploitation of mineral and natural resources;
- a possible negative impact on the environment;
- long-term strategy; and
- infrastructure concessions.

In order to facilitate investment to provinces, the government has also established 24 Provincial-Municipal Investment Sub-Committees, although little power is granted to the provincial authorities other than as licensing authorities for investment under USD 2 million. Moreover, all investment promotion and facilitation activity still remains in the hands of the CDC, which coordinates the Sub-Committees. The CDC also acts as the secretariat of the Government-Private Sector Forum (Chapter 4), facilitating dialogue within and among the joint government/private sector Working Groups, and broadly between the government and the business community.

To enhance the effectiveness of the development strategy, the government launched the Industrial Development Policy 2015-25 (IDP) in March 2015 to maintain sustainable and inclusive high economic growth through economic diversification, strengthening competitiveness and promoting productivity. In order to achieve its vision, the government seeks to mobilise foreign and domestic investments by focusing on large industries, expanding markets and enhancing technology transfer. It will also revisit the regulatory environment so as to strengthen competitiveness (investment climate and trade facilitation, market information dissemination and informal fees reduction). As a result, investment promotion and facilitation is at the heart of the IDP.

The IDP strengthens the policy leadership of the CDC in setting directions, endorsing and monitoring the progress of IDP implementation in close coordination with the Committee for Economic and Financial Policy and the Steering Committee for Private Sector Development and other relevant institutions. A challenge in implementing the IDP will be the commonly observed institutional conflicts among ministries, including CDC.

Special economic zones in Cambodia

Special economic zones have a mixed record in promoting development but in the best cases they have been able to jumpstart industrialisation and provide lasting development benefits (Box 6.1). They have been widely used in Southeast Asia as part of export-led development and can sometimes account for a high share of total exports (representing over three quarters of exports in the Philippines, for example), even if they are less important as a share of total employment. From the point of view of investors and compared to the rest of the economy, SEZs can offer any or all of the following: exemptions from sectoral restrictions, specific incentives, dedicated infrastructure, simplified regulations (business licensing and customs) and an environment where corruption can potentially more easily be controlled. In some countries, exporters can receive some of these advantages without being physically located in a zone.

Following the lead of many other countries in the region, Cambodia set up its SEZ programme in 2005, partly to facilitate export development and create employment by providing the infrastructure and utilities needed to encourage investment. It was also seen as a way to mitigate any negative impacts from dismantling the Multi-Fibre Arrangement[3] which was expected to put Cambodia (where the garment industry was set up in response to quota shortages in the rest of the world) under pressure. The SEZs were expected to encourage the diversification away from traditional activities such as garments.

The main legislation covering the definition, procedures and administration of SEZs in Cambodia is the 2005 *Sub-decree on the Establishment and Management of the Special Economic Zone* which aims "to establish and manage the special economic zones and improve the investment climate conducive to the enhancement of productivity, competitiveness, national economic growth, export promotion, employment generation in order to reduce poverty." The zone programme was intended to support investment attraction by streamlining administrative procedures and tapping the potential for private sector provision of infrastructure and services.

Box 6.1. SEZs can promote industrialisation but are not a panacea

Many governments have opted for special economic zones to meet various development objectives, from job creation, increasing export and government earnings, to attracting investment, especially FDI. Common features include a geographically defined area, streamlined procedures – such as for customs, special regulations, tax holidays – which are often governed by a single administrative authority. Over the past few decades they have become a widespread tool to promote economic development. In spite of the frequent emphasis on FDI and exports, it is the more indirect benefits of potential skills upgrading, technology transfer, enhanced trade efficiency of local companies and demonstration effects that can strongly contribute to sustainable industrial development. These benefits are also more difficult to achieve as they rely on a set of framework conditions that can spur industry-driven cluster development, whereas many SEZs stem from a top-down approach with strong government involvement (Zheng, 2011). Experience worldwide suggests that successful SEZ programmes require years of nurturing before they fully bear fruit (Farole and Akinci, 2011).

China, Malaysia and others such as Jamaica and Jordan have effectively used zone-based strategies to test the impact of new policies and measures to improve the investment climate. In China, the Shenzen SEZ was used to test reforms, while Chinese free ports tested financial, legal, labour, and pricing policies before extending these to other parts of the economy (Zheng, 2011). SEZs can thus be used as effective pilot schemes for testing new approaches to boost the investment climate. This could be in the area of building capacity for monitoring the environmental, social and economic impact of the investments in the zones, streamlining registration and licensing procedures (testing the effectiveness of the one-stop services), effectively managing incentive schemes extended to investors, and promoting linkages with local companies to trigger skills upgrading, technology and knowledge transfer.

SEZs traditionally have a policy and an infrastructure rationale: they can be a useful tool as part of an overall economic growth strategy to attract FDI, and to develop and diversify exports but they also allow for more efficient government supervision of enterprises, provision of off-site infrastructure, and environmental controls (Akinci and Crittle, 2008).

Attracting domestic and foreign investors into SEZs is no substitute for improving the general investment climate and tackling fundamental economic development challenges. SEZs often miss broader development goals, creating enclaves with limited connections to the local economy, where foreign companies mainly contribute to export hubs, rather than fostering dynamic industry clusters. Activities in SEZs in some countries have even had negative socio-economic impacts, including exploitation of workers in low wage industries, suppression of overall labour standards and core rights – such as banning rights to assemble or impeding trade unionisation – and low environmental, health and safety standards (Milberg et al., 2008).

Source: OECD (2014)

Cambodian SEZs are designed to offer a one-stop service for imports and exports and have specially-trained public officials stationed on-site to provide administrative services. Applications to establish businesses within SEZs are dealt with on-site, together with company registration and investment licences, work permits and labour books for workers. Investment approvals, customs inspections and import-export procedures are also conducted on-site by representatives of Camcontrol[4] and of various ministries such as labour and commerce). The zones also enjoy higher levels of security, low insurance fees and fewer labour disputes. Other benefits include tax holidays, 0% VAT, full import duty exemption for raw materials, machinery, and equipment, no export tax, permanent visas for families of investors and free repatriation of profits, most of which are also available outside of the zone.[5] There are currently 46 SEZs, of which 27 have been approved by the sub-decree and 16 are operational, mostly located along the border with Thailand and Viet and at Sihanoukville and Phnom Penh (Table 6.1).

Table 6.1. Special Economic Zones in Cambodia (as of June 2017)

Location	*Name*	*Year*	*Projects*	*Investment (USD m.)*	*Empl.*
Phnom Penh	Phnom Penh SEZ	2006	89	555	16 945
	Kerry Worldbridge SEZ	2015	1	21	25
Svay Rieng	Manhattan SEZ	2006	31	128	27 071
	Tai Seng Bavet SEZ	2007	27	154	9 238
	Dragon King SEZ	2012	4	19	1 175
	Shandong Sunshell SEZ	2013	5	15	5 571
	Hi-Park SEZ	2013	1	3	159
	Qi Lu (Jian Pu Zhai) SEZ	2017	1	1	16
Sihanoukville	Sihanoukville SEZ 2	2008	109	313	14 874
	Sihanoukville SEZ 1	2006	3	998	652
	Sihanoukville Port SEZ	2009	3	22	857
Poipet	Poi Pet O'Neang SEZ	2006	5	8	1 612
	Sanco Poi Pet SEZ	2013	10	69	1 298
Koh Kong	Neang Kok Koh Kong SEZ	2007	5	67	7 899
Kandal	Goldfame Paksun SEZ	2007	2	26	4 606
	Suvannaphum	2014	1	1.5	39
TOTAL			**297**	**2 400**	**92 037**

Source: CDC.

The zones may be developed by the state, a private enterprise or a joint venture between the state and the private sector. All SEZs so far have been developed and operated by the private sector (except for the Sihanoukville Port SEZ, which is a public-private joint venture financed by a JICA loan).[6] As stressed by Warr and Menon (2015), this strategy has avoided the large and sometimes wasteful public sector set up costs associated with SEZ establishment in many other countries and introduces greater market disciplines in managing the zones, thereby enhancing their long-term viability.

Despite the attention they attract, SEZs still account for only a marginal share of total investment and employment. According to the CDC, from 2009 to 2014, investment in SEZs never exceeded 15% of total investment (domestic and foreign) and hovered most of the time around 4%. Total employment in all of Cambodia's SEZs as of 2015 was around 68 000, in other words just under 1% of total employment and 3.7% of total secondary industry employment. By comparison, the garment sector, mostly outside the SEZs, accounts for over 700 000 employees, about 38% of total secondary industry employment, or 10 times the size of all SEZs combined (Warr and Menon 2015). While employment in SEZs is still only a small share of total employment in most countries in the region, the figures for Cambodia are even lower than what is observed in most neighbouring countries, suggesting that there is still ample scope for further expansion (Table 6.2). As shown in Table 6.1, the most recent employment figures for SEZs are over 92 000, a 35% increase in under two years.

Table 6.2. Employment in SEZs across selected ASEAN countries, 2015

	Cambodia	Indonesia	Philippines	Thailand	Viet Nam
Number of employees	68 000	4 000 000	735 000	513 000	2 500 000
Share of total workforce	< 1.0 %	2.46%	1.24%	1.09%	2.50%

Source: Authors' calculations based on UNIDO (2015) and World Development Indicators.

Although SEZs are open to domestic and foreign firms alike, almost all firms located in the SEZs are foreign. Out of almost 300 projects, three-quarters are by investors from China (41%), Japan (27%) and Chinese Taipei (8%). In value terms, Japanese investors are the largest investors in SEZs. Although Chinese investors are also prevalent throughout the economy, Japanese investors have a strong preference for locating in SEZs, at least in the early stages of their investment. The same phenomenon has been observed in other countries, such as Myanmar. Almost 60% of the investors in the PPSEZ are Japanese and close to 50% in the Tai Seng Bavet SEZ. The only substantial Japanese investment outside SEZs is the Aeon mall in Phnom Penh. In contrast, Korean investors reportedly tend to shy away from SEZs because fees are deemed too expensive and electricity supply unreliable.

By type of investment project, the most common activities involve garments, footwear and bags (36% of all projects), household and plastic products and packaging (31%) and more recently electronics, wire harnesses, automobile parts and bicycle assembly (18%) – although this latter category is relatively more important in value terms. Total exports from SEZs amounted to USD 1.4 billion or over 13% of total Cambodian exports in 2016. Five SEZs currently account for almost all of these exports, led by the Manhattan SEZ along the Vietnamese border. While SEZs along the border would normally be expected to export to the neighbouring country, the same is true for the Phnom Penh SEZ where over half of exports are to Thailand and Viet Nam and only 12.7% are shipped back to Japan, the home country of many investors in the zone. A World Bank 2012 survey estimated that only one third of output from SEZs was sold in the local market.

The experience with SEZs in Cambodia

There is some evidence of incipient industrial diversification through the development of SEZs in Cambodia. While manufacturing activity outside the zones is heavily concentrated on the garment industry, SEZs have attracted a much broader spectrum of foreign investors in light manufacturing. Several of these are engaged in the production and exports, spanning electronics and electrical products to plastics, food, furniture, and car parts. The location of SEZs along the borders with Thailand and Viet Nam and close to the Gulf of Thailand facilitates their integration into regional and global production chains, as shown by the presence of Japanese car parts producers (such as Denso and Yazaki) acting as suppliers to car-makers located in Thailand.

Related to this industrial diversification, SEZs have also been successful at attracting new investors from new countries, particularly from Japan. While American companies have traditionally tended to shy away from Cambodia, the Phnom Penh Special Economic Zone has recently attracted more than USD 100 million of investments from several large American companies, including Coca-Cola.

On the negative side, however, despite one-stop shops and enhanced border clearance procedures, investors still complain of burdensome regulation and interference in the

SEZs. One-stop shops in the zones reduce regulatory compliance costs, but they still do not fully satisfy firm managers (Warr and Menon 2015). Corruption and regulatory and policy uncertainty are ranked as major or severe constraints by a substantial percentage (74% and 34% respectively) of firms operating in SEZs (based on a 2012 survey in World Bank 2015). Moreover, SEZ investments face the same constraints as non-SEZ investments (high costs of electricity and transport compared to neighbouring countries[7], low quality of labour and a general lack of skilled labour). This information is admittedly a few years old in what is a rapidly evolving environment.

Special economic zones in Cambodia are a work in progress. If they have not yet delivered on all of their promise, they have also not diverted resources from more general investment climate improvements. They are mostly privately run and investors generally receive the same treatment in terms of incentives as those outside the zones. They have helped the economy to diversify, while providing employment opportunities, often for young women, to enter the formal sector. At the same time, diversification has not fully relieved the precariousness upon which economic growth stands. Most of the activities in the zones involve footloose low wage, low value added activities susceptible to many of the same shocks as the garment sector.

Making better use of special economic zones

In spite of this initial success from the SEZs in Cambodia, the typical spillover effects expected from SEZ firms are still a long-term objective, as most of the firms located in the zones source their inputs from abroad and export most of their output (Warr and Menon, 2015). While linkages are limited so far, the zones play a role in generating employment and foreign exchange revenues. And the presence of more diversified type of investments in the zones offers the opportunity for the government to work together with investors to better shape policies aiming at attracting greater levels of investment and increasing scale SEZ activity, as well as ultimately to support the emergence and enhance the capabilities of a potential local supplier base.

In the long term, SEZs are expected to contribute to local development through backward linkages whereby investors purchase materials and services from the local economy, invest in infrastructure built by local companies and bring new technology into the zones that is disseminated to the rest of the economy. Technological spillovers are sometimes difficult in the early stages because countries do not have the physical and economic infrastructure for high-technology processes used inside the zones to be adopted elsewhere in the economy, as is likely the case in Cambodia. Even if SEZ firms and non-SEZ firms wanted to trade with each other, several factors would inhibit their ability to do so. Domestic SMEs may not be sufficiently well equipped and the labour force may lack the relevant skills to make co-operation possible. Furthermore, domestic SMEs' sometimes poor record in terms of compliance with certain international standards may deter foreign investors from engaging in business relationships.

Beyond addressing local capacity issues, further measures need to be taken to maximise the potential benefits of SEZs in the longer term, including broadening the integration of the zones into the local economy. In this respect, one possible option would be to support greater domestic firms' access to SEZ facilities and their investors. For instance, the Federation of Associations for Small and Medium Enterprises of Cambodia is planning to propose that the government set up SEZs for SMEs so that they can work in clusters and benefit from subsidised water, electricity, transport and tax.[8] This could be a way of enhancing their productivity, increasing the quality of their outputs and facilitating linkages with foreign investors and exports markets. More generally, industrial clustering should be encouraged as well as supplier linkage programmes could be designed to stimulate local sourcing.

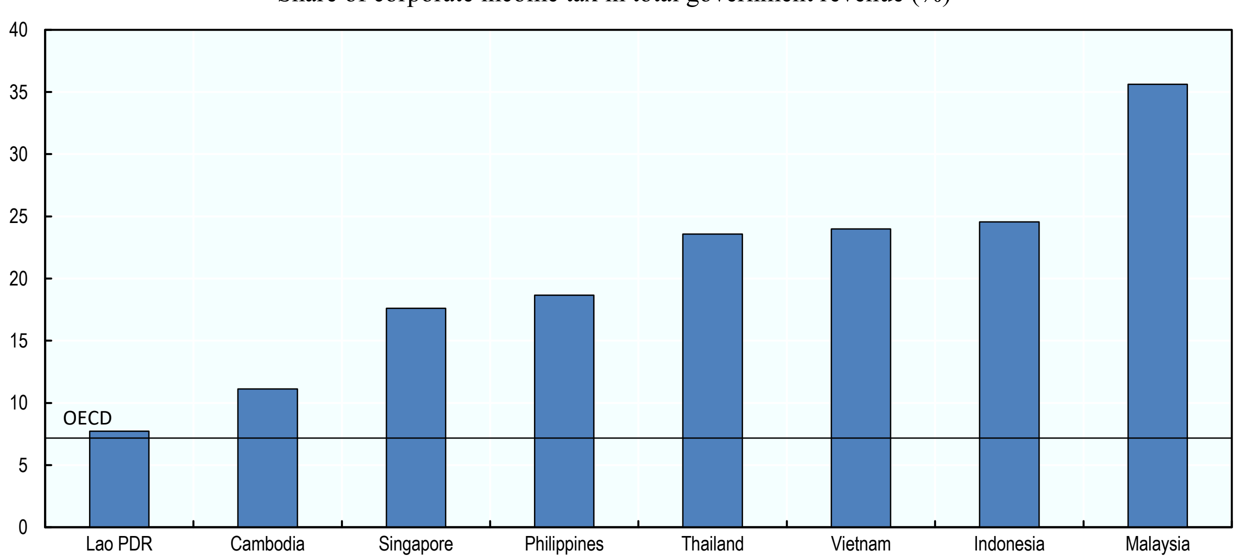
Towards the use of smarter tax incentives for investment

Fiscal and non-fiscal incentives are widely used in ASEAN and worldwide to attract domestic and foreign investment. Incentives are defined as measures to influence the size, location or industry of an investment project, by affecting its relative cost or by altering the risks attached to it (Thomsen, 2004). Incentive policies are among the few remaining tools enabling policymakers in Cambodia and elsewhere to influence investment, in light of significant liberalisation of FDI, particularly in manufacturing (see Chapter 4). With that, incentive schemes have become a popular instrument to promote FDI which supports national development goals. Providing incentives is perceived to be simpler and more immediate than correcting deficiencies in infrastructure and labour skills, for example. Tax incentives are also politically easier to deliver as they are not direct disbursements.

Resource mobilisation in Cambodia is improving. As part of the Revenue Mobilisation Strategy 2014-18 which called for efforts to improve tax compliance, fiscal revenue as a percentage of GDP has risen rapidly and is now among the highest in the region, reaching 19.7% in 2017 (World Bank, 2018). Indirect taxes represent the largest share of the total, while the importance of trade taxes in total revenue is declining and likely to continue to do so with the on-going liberalisation of trade within ASEAN. Cambodia has a relatively small share of direct taxes (on income, profits and capital gains) in total revenue (Figure 6.1), owing in part to the broad incentives offered to many investors.

Figure 6.1. CIT in Cambodia contributes less to public revenue than in most of ASEAN

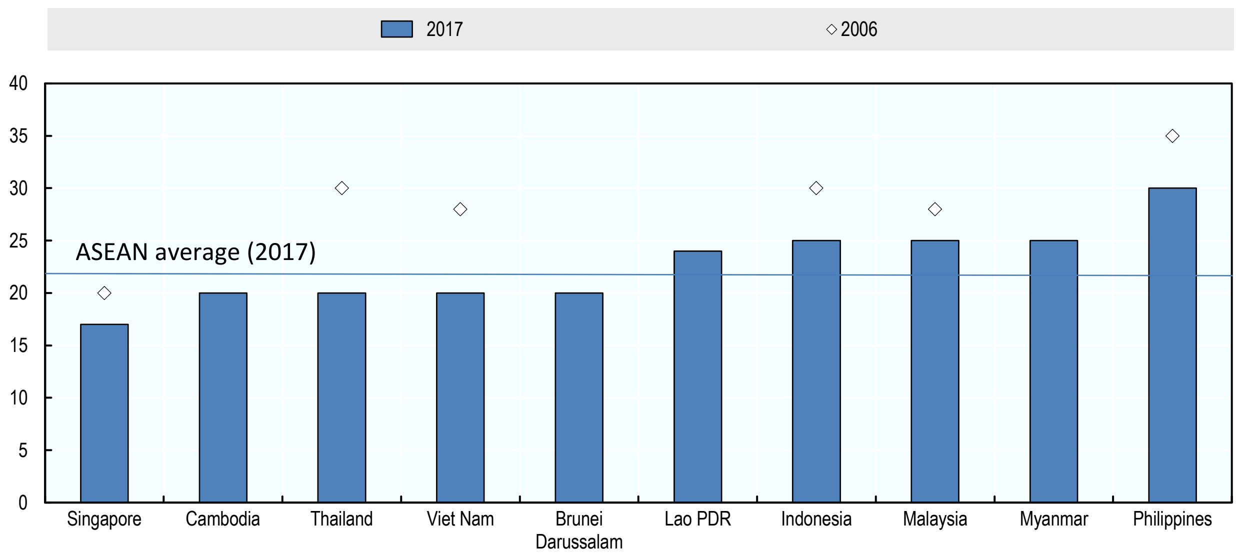
Share of corporate income tax in total government revenue (%)



Note: Data for Brunei Darussalam and Myanmar are not available for this analysis.
Source: OECD (2018a) based on IMF.

The corporate income tax (CIT) rate in Cambodia is among the lowest in the region. Cambodia has a comparatively low statutory CIT rate at 20%, below the Asian and global average (Figure 6.2). Within the region, some other countries such as Thailand and Viet Nam have lowered their CIT rates to the same level Cambodia, down from around 30% a decade ago, but much of the rest of the region retain significantly higher rates of CIT.

Figure 6.2. Corporate income taxes in ASEAN (%)



Source: OECD (2018a), based on KPMG.

Mapping Cambodia's corporate tax and incentive regime

Tax incentives

While investors consider statutory CIT rates as a first reference point when evaluating the tax competitiveness of a jurisdiction, it is the entire tax regime – including various tax incentives – that indicates a tax system's burden on businesses or incentives to invest. The most common types of tax incentives are so-called tax holidays (periods during which an investment is fully exempt from taxation), reduced tax rates, accelerated depreciation, tax credits, and investment allowances.

Cambodia has a relatively simple incentive scheme, including essentially a tax holiday or alternatively a special depreciation allowance for projects granted Qualified Investment Project (QIP) status defined in the *Amended Law on Investment* (2003). The CDC is the only institution providing tax incentives in Cambodia. It grants QIP status to most manufacturing projects as well as to some high-value or large-scale service projects and thus practices little targeting of investment projects in specific fields. An annual certificate of obligation satisfaction has to be obtained by the QIP to be entitled to benefit from the scheme. The incentive scheme includes the following specificities (CDC, 2017):

- ***Tax holiday of up to 6 years:*** The scheme is composed of a trigger period, 3 years of tax holiday, and an additional priority period. The trigger period starts with the issuance of a certificate granting QIP status and ends with the first year of profit or 3 years after the first revenue is made, whichever is sooner. The QIP then benefits at the minimum of 3 years of tax holiday with the option of an additional priority period (additional tax holiday of up to 3 years) as determined by the CDC. According to the *Financial Management Law*, the length of the priority period depends on the type of project and the amount of invested capital. A QIP is subject to the 20% CIT rate after the tax exemption period as determined in the *Law on Taxation*.

- ***40% special depreciation allowance:*** Alternatively, QIPs may opt for a 40% special depreciation allowance on the value of the new or used tangible properties employed in production or processing, which may be particularly attractive for capital-intensive projects.
- ***Import duty exceptions:*** QIPs also benefit from duty-free import of production equipment and construction materials. Commodities to be imported free of duty vary according to the nature of the QIP: a distinction is made between domestically-oriented and export-oriented QIPs and those in supporting industries. Also, agricultural materials used as inputs in export industries may be exempt from VAT.
- ***Other exemptions:*** QIPs are not subject to any restriction on profit repatriation or reinvestment of earnings, and are fully exempted from export taxes.
- ***Special economic zones:*** In contrast to most Southeast Asian economies, Cambodia offers essentially no special and differentiated treatment to companies in SEZs. This avoids the creation of two distinct regimes which may be a source of complexity. A QIP located in a SEZ is entitled to the same incentives and privileges as other QIPs, as stipulated in the *Amended Law on Investment* and the *Law on Taxation*. However, zone developers and investors are eligible for additional incentives (such as further VAT exemptions and special customs procedures). Similarly, QIPs in the agricultural, agro-processing as well as garment and textiles sectors are entitled to additional incentives similar to those in SEZs.

In line with a wide consensus among international organisations and experts to simplify tax systems and to reduce the use of tax incentives, the *Amended Law on Investment* (2003) cut back significantly on generous incentives in the previous *Investment Law* (1994). Key amendments/improvements include the abolishment of a 9% concessionary CIT rate after the tax holiday and the reduction of the maximum length of the tax holiday from 8 to 6 years (Asuyama and Neou, 2012).

The type and level of investment incentives in Cambodia are broadly standard and comparable with those in other countries in the region (see Annex 1.A of this chapter; or ADB, 2012; ASEAN, 2012; and Thomsen, 2004, for a more detailed overview). Cambodia's tax incentive policy is, however, rather unspecific in terms of targeting specific activities, sectors and regions. Most other countries in the region have more targeted tax incentive policies to achieve specific development objectives, such as incentives for R&D (e.g. in Lao PDR, Malaysia, the Philippines and Singapore) or vocational skills development (e.g. in Lao PDR, Malaysia, Philippines and Viet Nam) (Table 6.3).

A rather simple and unspecific policy approach is much clearer for potential investors to understand as compared to schemes that are highly complex and involve significant transaction costs in terms of understanding whether and how a potential investor is eligible to benefit from tax incentives. Thus, simplicity can be an implicit incentive for investment – one that may be more important than tax incentives themselves. On the other hand, very general and non-targeted schemes may be end up supporting almost all investment projects, including those that would almost certainly take action even without incentives and they may provide too much discretion to officials. This puts an important strain on resource mobilisation needs such as for infrastructure and/or skills development (see the following sub-section for good practices in the use of tax incentives). If effectively implemented, targeted incentives may be more likely to support the achievement of specific socio-economic development objectives.

Table 6.3. Targets of tax incentives in ASEAN

	Local sourcing, SME linkages	Employ-ment, training and skills	R&D and other strategic sectors	Green growth	High-tech	Export	Import	Head-quarter	Territorial, SEZs	Infra-structure
Brunei Darussalam		Deduction	Deduction	Deduction	Deduction		Trade tax exemption			
Cambodia						Trade tax exemption	Trade tax exemption		Trade tax exemption	
Indonesia					Tax Holiday		Trade tax exemption		Deduction, trade tax exemption	Tax Holiday
Laos						Trade tax exemption	Trade tax exemption		Tax Holiday	Tax Holiday
Malaysia	Tax holiday, reduction	Deduction	Tax holiday, reduction	Reduction	Tax holiday, reduction	Trade tax exemption	Trade tax exemption	Reduction, trade tax exemption	Reduction	Deduction
Myanmar		Deduction	Deduction			Trade tax exemption	Trade tax exemption		Reduction	
Philippines					Tax Holiday	Trade tax exemption	Trade tax exemption	Reduction	Reduction	Deduction
Singapore		Deduction	Deduction		Tax holiday, deduction		Trade tax exemption	Reduction	Trade tax exemption	
Thailand	Deduction	Deduction	Deduction				Trade tax exemption	Tax Holiday	Tax Holiday	Deduction
Viet Nam		Tax credit	Deduction		Deduction		Trade tax exemption		Tax holiday, reduction, trade tax exemption	Deduction, reduction

Note: Grey shaded cells indicate that a country's tax incentives target specific activities, sectors and regions/zones. Data for Brunei Darussalam is not included in the dataset used for this table.
Source: Based on Wiedemann and Finke (2015).

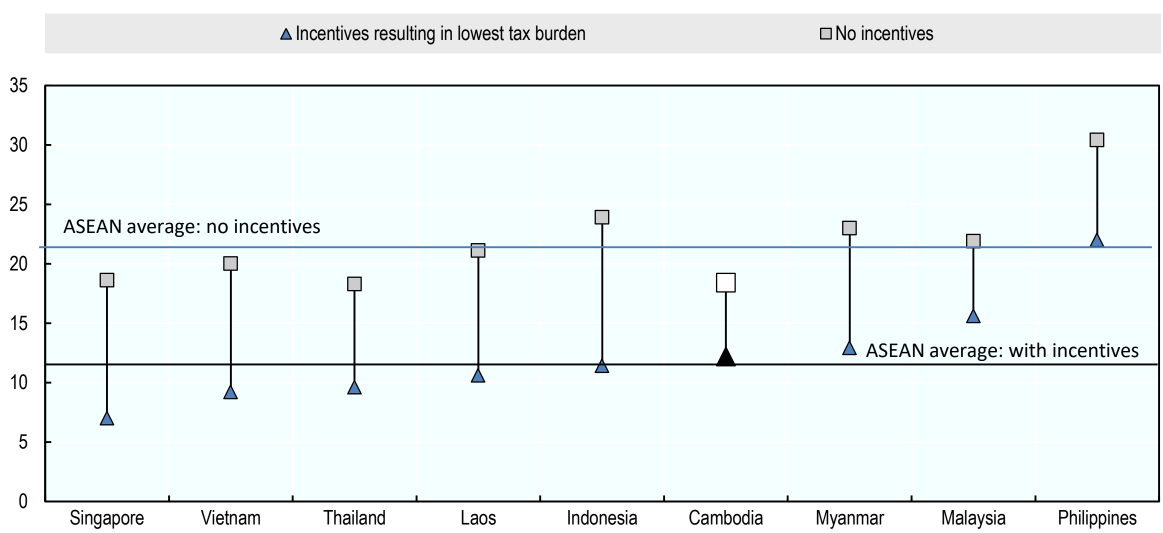
Effective tax rates

Effective tax rates capturing specific provisions of the tax legislation, including tax incentives, are useful indicators to compare sometimes complex tax systems in a single number across countries. In particular, forward-looking average effective tax rates (AETRs) are the net average tax rates of a hypothetical investment project. They correspond to the present value of the estimated tax due divided by the present value of income before taxes. AETRs are used to assess the predicted impact of taxes on discrete investment choices, and in particular MNE decisions of whether and where to locate FDI (location decisions) (IMF-OECD-UN-World Bank, 2015).[9]

Computations of Wiedemann and Finke (2015) allow comparing AETRs with and without incentives for Cambodia and other ASEAN countries. A hypothetical investment project is assumed where a firm equally invests in five different assets (including intangibles acquired from third parties, buildings, machinery, financial assets and inventory). As the focus is to understand tax effects, economic factors such as inflation and real economic depreciation are held constant. The real rate of return on investment is estimated at 20%. The methodology applied is based on and further described in Devereux and Griffith (2003).

Cambodia's AETR for a domestic investor decreases from 18.4% without incentives – slightly below the CIT rate due to general depreciation allowances – to 12.2% including tax incentives (Figure 6.3). Comparatively, the AETR without incentives in Singapore increases from a 17% CIT rate to 18.6%, as the possibility of asset depreciation for tax purposes has been abandoned in Singapore. Incorporating incentives decreases the AETR to just 7% in Singapore, the lowest among ASEAN countries. While CIT rates in Thailand and Viet Nam are at par with Cambodia, highly generous incentive schemes in these countries lower the AETRs to below 10%. Cambodia's AETR without incentives is below the ASEAN average and the equivalent rate with incentives is at par with the ASEAN average. Together with Malaysia, Cambodia reports the lowest wedge between AETRs with and without incentives among ASEAN countries, pointing to a less aggressive incentive system compared to its neighbours. This is also consistent with a comparatively simple system of incentives in Cambodia, as described above.

Figure 6.3. Forward-looking average effective tax rates with and without incentives



Note: A hypothetical investment project is assumed where a firm equally invests in five different assets (including intangibles acquired from third parties, buildings, machinery, financial assets and inventory). Data for Brunei Darussalam is not included in the dataset used for this table.
Source: Based on Wiedemann and Finke (2015).

Despite the low tax wedge and an AETR with incentives at the ASEAN average, the share of revenue from CIT in total tax revenue is at 15% comparatively low in Cambodia (Thanh et al., 2014). Viet Nam currently reports a CIT revenue share at around 20%, although down significantly from a share at above 40% back in 2006 when the statutory CIT rate was at 28% (today the CIT rate in Viet Nam is 20%) (OECD, 2018b). One reason for a relatively low share of tax revenue from CIT may be because almost all investment projects are eligible for tax incentives in Cambodia, which considerably erodes the tax base. Recent OECD and other research concludes that adopting a broad base, low rate approach, that is, recovering potentially lost revenue by applying these tax rates to a broader base is less distortive and would in the case of Cambodia most likely lead to overall higher CIT tax revenues and thus a higher share of corporate income taxes in overall tax revenues (Carter and Matthews, 2012). Currently, Cambodia's revenue is heavily dependent on indirect taxes, including VAT (around 35%) and excise taxes (around 20%).

AETRs often differ for domestic and foreign investors in ASEAN countries due to withholding taxes on income repatriated to the parent companies and due to special treatment of cross-border dividends or interests in the investors' home country. This can significantly affect effective tax rates and thus investors' location decisions. For example, AETRs without incentives for a German outbound investor in Viet Nam are comparable with those of a domestic investor (approximately 20%). This is due to a tax treaty between the two countries exempting dividend payments received by the parent company from taxation in Germany and from withholding taxes in Viet Nam. By contrast, Germany has no tax treaty with Cambodia and those dividend payments are subject to taxation in Germany and to a withholding tax in Cambodia. Thus, the AETR for the German investor increases from 18.4% to almost 30% (Wiedemann and Finke, 2015). For American investors, dividend payments are not exempted from taxation at home but instead taxes paid abroad can be credited against claims by the US tax authorities. Accordingly, incentive schemes in Cambodia and other ASEAN countries might have no effect on effective tax rates for American investors but effectively move tax revenues from host economies (e.g. Cambodia) back to the United States.

Effective and efficient use of tax incentives

Tax incentives and their effects on investment attraction and progress towards socio-economic objectives have been the focus of international organisations and academics for many years. Empirical evidence suggests that host country taxation and international investment incentives generally play only a limited role in determining the international pattern of FDI, particularly in developing countries (e.g. James and Van Parys, 2009; Abbas and Klemm, 2013). For example in Viet Nam and Thailand, recent investor surveys illustrate very high redundancy of tax incentives: in both countries more than 80% of all interviewed firms would have invested even without incentives (James, 2014). Such data are not available for Cambodia, but the Ministry of Economy and Finance reports that forgone revenue due to tax incentives is estimated to amount to almost 6% of GDP in Cambodia, considerably higher than in Viet Nam at 0.7% of GDP. Studies suggest that countries may only benefit from tax incentives, if built upon a strong overarching investment environment (including good infrastructure, availability of skills, macroeconomic stability and clear intellectual property rights) (Kinda, 2014; OECD, 2015; Thomsen, 2004). Thus, a country's tax burden is just one of many, and not always the most important, factor considered by potential investors when weighing up investment decisions.

International organisations and other observers have often advised countries to remove tax incentives or to improve their design, transparency and administration (OECD, 2015; IMF-OECD-UN-World Bank, 2015). Governments are unlikely unilaterally to remove tax incentives given tax competition with neighbouring countries, but Cambodia's incentive regime could nevertheless be made both more effective and more efficient. Tax incentives often lead to increased tax competition and thus a race to the bottom. Thus, the risk is that all countries will lose from using them.

Instrument choice

Cambodia makes use of a whole range of different tax incentives – including CIT, import tariff and VAT exemptions, as well as accelerated depreciation. While for each of these incentives a distinct economic analysis would be required regarding their effectiveness, tax incentives that lower the cost of investment are often to be preferred over profit-based tax incentives:

- ***Cost-based tax incentives*** comprise allowances lowering investment expenses, such as accelerated depreciation schemes, special tax deductions or credits as well as import tariff exemptions on capital goods and other inputs into production. They make investment projects more profitable at the margin and are thus expected to attract new investment that would not otherwise have been made.
- ***Profit-based tax incentives*** reduce the rate applied to profits/income already secured. Tax holidays and reduced CIT rates fall into this category. Profit-based tax incentives directly involve forgone government revenues, make profitable projects even more profitable and are thus less likely to attract new investment.

In Cambodia, tax holidays are provided to investment projects of almost any kind without much targeting in terms of sectors or activities. Tax holidays tend to favour mobile activities rather than long-term investment which introduces a bias towards short-term projects with low upfront investment costs and those least likely to generate spillover effects on the wider economy (IMF-OECD-UN-World Bank, 2015). Box 6.2 describes the advantages and disadvantages of tax holidays. To some extent, comparatively strong investment into the garment industry in Cambodia falls into this category: capital and skill requirements are sufficiently low and – while the employment link of these investments is important – longer term spillovers from investments in the garment sector may be rather indirect.

Cambodia could replace its tax holiday scheme with a tax deduction or credit scheme, where investors can deduct expenses on specific activities from their taxable income or subtract accrued tax credits from taxes owed (see next sub-section on targeting of activities), while keeping the option of accelerated depreciation of assets. Import duty exemptions on capital equipment and construction materials as well as export tax exemption may be retained as these schemes lower costs and enhance profitability of investment projects at the margin. On the other hand, VAT exemptions provided in SEZs in Cambodia may be entirely redundant, since full operation of the tax means that VAT charged on inputs does not stay with the purchaser and can be fully recovered as a credit against VAT charged on sales (IMF-OECD-UN-World Bank, 2015). Thus, if VAT refund procedures are effective in a country – which may be expected in SEZs – exemptions should not have an effect on investment.

Targeting of sectors

Targeting of tax incentives and clearly defining eligibility criteria could, if undertaken properly and with care, offer an effective incentive regime in Cambodia. On the one hand, targeting will help avoid that tax incentives benefit projects that would take place even without incentives, and, on the other hand, it will enable the government to identify and attract those investment projects that are most likely to create social and economic spillovers. Currently, the incentive regime of Cambodia is rather unspecific with some variation on the length of the priority period by sector and size of the investment.

Box 6.2. Advantages and disadvantages of tax holidays

- All returns over the holiday period on investment – including returns covering initial investment costs as well as normal profits – are earned tax-free.
- The most open to tax planning, leading to significant revenue leakages – considerably higher than the revenue that would have been forgone from a legitimate activity. Tax holidays encourage tax avoidance, for instance by using transfer pricing to shift profits into holiday companies. Firms can manipulate the cost of inputs because of the difficulty in establishing the true, "arm's-length" market value of inputs purchased from a related entity. Thus income and deductions can be shifted across entities with different tax treatments either domestically or internationally. As a result, tax revenues can be significantly eroded. Another way to erode profit is through fictitious foreign-ownership (e.g. a domestic company incorporates offshore and reinvests home as if it were foreign-owned).
- Encourage the artificial collapsing and establishment of firm to extend the length of the holiday period. Usually tax holidays are granted to new firms only, so an incentive exists for an old firm to re-establish itself as a new one towards the end of the holiday period to qualify or further benefits.
- Most attractive for footloose industries. "Fly-by-night" or short-term investment is in a favourable situation in a tax holiday environment compared to long-term investment. Since tax holidays benefit the industries that start making profits during the holiday period the tax bias favours for short-term projects and short-term assets.
- Tax holidays (or other favourable corporate tax treatment) targeted at export activities could be inconsistent with WTO rules, except for the lowest income countries.
- The impact of the tax holiday may be diluted once profits are repatriated if the home country operates a worldwide system of taxation. Any reduction in liability in the host country will be offset by increased liability in the home country. In practice, however firms are quite successful in avoiding such payments by delaying repatriation or routing it through third countries. They therefore still benefit from tax holidays.
- Could actually discourage some investment. To maximise depreciation allowances a firm might postpone the investment until later in the holiday period to claim full deductions.

Source: OECD (2014).

Sectoral tax incentive targeting in Cambodia could be based on the Industrial Development Policy (IDP) 2015-25. As set out in the IDP, Cambodia needs to diversify the economy towards manufacturing and, within manufacturing, away from over-reliance on garments and food processing. Furthermore, it needs to foster forward and backward linkages of investment with the local economy. Accordingly, it could be advisable to remove incentives for sectors that may not be a priority for diversification (including garments) and to keep incentives exclusively in IDP priority sectors (e.g. production of equipment such as machinery assembly, mechanic and electric equipment, vehicle assembly; drugs and medical equipment, construction materials, packaging equipment; furniture; business services enabling forward and backward linkages and upgrading in production chains such as logistics, R&D and marketing; ICT, energy and green technology). Alternatively, incentives could be targeted to well-defined labour-intensive industries that are losing competitiveness due to rising wages in Thailand, in line with Japan's Thailand-plus-one strategy (EIC, 2016). However, such incentive targeting would need to be carefully chosen, as it is likely that Cambodia is naturally in the competitive position to absorb such investment from Thailand.

Targeting of specific sectors for tax incentive purposes can be problematic. It puts investments in other economic sectors at a competitive disadvantage and they may under develop despite being more productive. It is of utmost importance that the government is conscious about the choice of priority sectors for incentives and its implication. If this is guaranteed, removing incentives for some sectors usefully increases the tax base if investments in that sector arrive nonetheless (e.g. garments). However, even if less investment in those non-priority sectors can be attracted, it does not negatively affect objectives defined in the industrial policy.

Targeting of activities

Alternatively, tax and other financial incentives could target specific eligible activities/expenses for which investors (of any sector) can be reimbursed in terms of tax deductions or credits. Such activities may include training and skills development, wage expenses on highly skilled management and engineers, exporting, importing of capital goods, R&D, or local sourcing of inputs (also see Chapter 3 on the proposal for fiscal incentives for investment in training). All these activities are designed to foster investment in activities that are likely to enable upgrading within a given sector and to establish linkages with local firms, particularly SMEs. Providing the incentives via cost-based fiscal incentives, i.e. tax deductions or credits, makes projects more profitable at the margin and therefore stimulates more investment involving such activities.

For example, tax and other incentives to foster linkages with SMEs and upgrade their skills have proven effective in various countries around the world (Perera, 2012; UNCTAD, 2011; Christiansen and Thomsen, 2005). Malaysia, for instance, offers various incentives to encourage linkages between foreign investors and local SMEs. Under the Industrial Linkage Programme investors can claim tax deductions for costs involved in providing support to local suppliers, including training, product development and testing, and factory auditing to ensure local supplier quality. Additionally, the Global Supplier Programme offers financial and organisational support to MNEs, if specialists from their foreign affiliates are seconded to local firms (for up to two years) for the purposes of local upgrading. Singapore's Local Industry Upgrading Programme has a similar design.

By providing tax, financing and organisational support, these linkage programme reduce the perceived risks to foreign investors from engaging in capacity building among suppliers. Studies have shown that these programmes have been effective in establishing linkages and have boosted productivity in the SME sector (UNCTAD, 2011). Anecdotally, the programmes in Malaysia have influenced Intel in its decision to develop local SMEs as suppliers. It has developed a model for supporting supplier development and upgrading: potential suppliers were selected based on the quality of their management, human resources, technical, materials and process capabilities and cost competitiveness. They were then provided with training and opportunities to supply the affiliate and ultimately, the global Intel network. Intel estimated benefits worth USD 50 million per year from participating in this programme (Christiansen and Thomsen, 2005).

Monitoring and re-evaluation of incentives

While reforms of Cambodia's incentive scheme along the lines described above are likely to support objectives outlined in the IDP, the proposed adjusted tax incentives will still involve significant costs in terms of forgone fiscal revenue. Therefore, any tax and other incentive programme requires regular monitoring and assessment. This is neglected in many countries (IMF-OECD-UN-World Bank, 2015), or monitoring of eligibility requirements are relaxed over time as found in the case Malaysia, for example (Christiansen and Thomsen, 2005). Cambodia rightly emphasises the need for monitoring and evaluation mechanisms in the IDP. Broader cost-benefit analysis, beyond calculations of forgone tax revenue, is described in Box 6.3.

Box 6.3. Evaluating the costs and benefits of investment incentives

Decision makers should have the capacity to distinguish between beneficial and wasteful tax incentive programmes. Thorough analysis of the effectiveness and cost-efficiency of proposed tax incentives should be conducted both prior to introducing investment-promotion measures as well as systematically ex post, to assess the extent to which, and the cost at which tax incentives meet their intended objectives.

An evaluation of the economic benefits of tax incentives should take into account a) direct impact by the incentives-motivated investment; b) indirect and induced impact due to inter-industry transactions and changes in income and consumption; c) positive externalities, such as technology and know-how transfers by incentives-induced FDI; and d) social and environmental benefits where tax incentives serve to correct market imperfections.

The costs that should be considered when conducting a cost-benefit analysis of a given tax incentives programme include; a) primary revenue forgone due to tax incentives; b) revenue leakages due to unintended and unforeseen tax-planning opportunities; c) costs incurred by taxpayers in order to comply with a given tax incentives regime; d) the administrative costs from running the tax incentives programmes due to the complexity introduced to the legislative and regulatory framework; and e) the costs to the economy of creating an "uneven playing field" where domestic firms are not entitled to the same tax incentives as their foreign competitors.

Source : OECD (2015)

Notes

[1]NBC-NIS (2016).

2 Article 11 of Sub-decree 60 on the organisation and functioning of the CDC.

[3] The MFA is a quota system set up by the US, EU and Canada in 1974 to protect their domestic garment industries. Under the MFA, developing countries were allocated export quotas on specific textiles and garment items. It was illegal for a particular country to export more than its allocated quota. In addition to protecting jobs in the developed world, the MFA system also distributed garment production around the developing world.

[4] Camcontrol is the Cambodia Import-Export Inspection and Fraud Repression Directorate-General.

[5] One minor difference is that VAT exemption is granted on all export-oriented activities in SEZs while it is limited to garments and footwear outside SEZs.

[6] The PPSEZ is managed jointly by Cambodian (78%) and Japanese (22%) capital.

[7] The price of electricity is reported to be twice as much as in Viet Nam and 30-40% higher than in Thailand.

[8] Khmer Times (09/02/2016).

9.Similarly, forward-looking marginal effective tax rates summarise the effect of the legislative tax parameters on an incremental business activity and show how much to invest on the margin given a diminishing expected return on investment due to taxation. They are used to assess how taxes distort the level of investment (scale decisions).

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Annex 6.A. Tax incentives available for manufacturing entities in ASEAN

Cambodia	Tax holiday of 6 years	Qualified investment projects involved in the production and processing of goods.
Indonesia	Tax holiday of 10 years	Companies that operate in one of the 5 designated pioneer industries: basic metals, oil refining and petrochemicals, renewable resources, industrial machinery and telecommunication equipment.
	Accelerated depreciation at double rates for buildings, other tangible and intangible assets, 50% reduction of withholding tax on dividends	Businesses located in economic development zones or hardship areas that lack social and economic infrastructure.
Lao PDR	Tax holiday of 10 years	Investments in zone 1, which is described as remote areas where no economic infrastructure exists and activities specified as level 1. The Investment Promotion Law of 2009 assigns most manufacturing activities to level 1.
Malaysia	Tax holiday of 5 years	Entities with pioneer status, which engage in promoted activities such as high technology or are located in promoted areas.
Myanmar	Tax holiday of 5 years, followed by a 50% reduced tax rate for 5 years plus additional 5 years for reinvested profits	Foreign investments carried out in a SEZ. After the expiry of this incentive additional tax reliefs for exporting enterprises are possible.
Philippines	Tax holiday of 6 years	Newly established pioneer firms that, for example, produce products that are not yet manufactured in the Philippines or enterprises located in less-developed areas.
Singapore	Tax holiday of 15 years	Projects that are considered to have favourable prospects for development and are not yet undertaken at a sufficient scale in Singapore.
Thailand	Tax holiday of 8 years followed by a 50% reduced tax rate for 5 years	Investment in the predefined zone 3 (less industrialised regions of the country) receive a full exemption of 8 years and if the project is also located in one of the special promoted zones the additional reduction is granted.
	Tax holiday of 8 years	For activities that involve high technology or eco-friendly material and products.
Viet Nam	Tax holiday for 4 years and reduced tax rate at 5% for 9 years.	Projects undertaken in areas with extreme socio-economic difficulties, investments located in economic or high technology zones, investments in the high technology sector and enterprises that manufacture software products

Source: Based on Wiedemann and Finke (2015)

Chapter 7. Implementing good regulatory practice in Cambodia

This chapter looks at steps taken by the government to implement good regulatory practice in Cambodia to improve both regulatory quality and government capacity. An important tool in the toolbox for improving governance is regulatory impact analysis (RIA). The chapter describes how the authorities are gradually introducing RIA into the legislative process.

Summary

Regulation is one way for governments to achieve their policy objectives and promote a policy environment that supports investment and well-being. The goal of regulatory policy is to ensure that regulatory measures, processes, and frameworks work effectively to promote public interest. Given their significance in promoting economic and social well-being, it is important that regulations are effectively designed and implemented. A strong regulatory environment is needed to foster business competitiveness, improve citizens' trust in government and curb corruption in public governance. Governments should analyse the effects of policies and regulations before introducing them and rigorously verify their necessity through transparent procedures. In order for regulations to properly support markets, protect the rights and safety of citizens and ensure the delivery of public goods and services, they must be developed through a comprehensive framework in which policy options are assessed by employing sound empirical data (OECD, 2011a). To achieve this goal, the OECD has encouraged countries over the years to integrate regulatory impact assessments (RIA, see Box 7.1) in the early stages of the policy process, particularly when formulating new regulatory proposals (OECD, 2012).

Cambodia has actively promoted good regulatory practices in the policymaking process. Since 2008, it has strived to introduce different regulatory management tools, such as RIA, to improve the business climate, promote economic growth and attract investment. By the end of 2016, 13 implementing line ministries were actively using RIA, and a Government Decision was issued requiring RIA Working Groups to be established in all ministries. Nevertheless, RIA remains a voluntary process followed for only a handful of regulations each year. A key challenge is the lack of skilled staff within implementing agencies able to effectively draft regulatory impact statements. The shortage of economic analytical capacity for more detailed cost benefit analysis (CBA) is acute. As a result, the government has decided to promote the RIA concept progressively, allowing time to build capacity before fully mandating the implementation of RIA for all regulations.

Although clear guidelines exist for drafting RIA statements, this has proved to be challenging in practice. Ministries often find it difficult to find relevant evidence for the problem statement and are predisposed to use assertions. In practice, many regulatory proposals are prepared by consultants whose remit is to draft the proposal, not prepare a wider policy assessment, underpinned by evidence. Furthermore, while there is interest to involve stakeholders in the policymaking process, the scope and breadth remains limited as ministries have continued to find ways to engage with their immediate stakeholders in developing their proposals. Consequently, many consultations still lack the required structure to achieve a formal, effective and productive discussion and engagement.

As Cambodia continues to develop new regulatory frameworks, reducing regulatory burdens can also help improve the overall regulatory policy process by reducing the quantity and complexity of administrative formalities that impose significant costs on citizens and businesses. This can further enhance efforts to improve service delivery and increase Cambodia's competitiveness. Regulatory delivery and compliance can be further improved by benchmarking benefits of RIA on the actual implementation of the regulation. Regulatory improvements can also be carried out effectively by ensuring that these are linked to a long-term plan and are complemented by other regulatory policy management tools.

Policy recommendations

Improving capacity and regulatory quality

- *Improve capacity by restarting cross-ministry network meetings for RIA working groups.* Cross-ministry meetings were initially conducted by the four pilot ministries when RIA was first introduced in Cambodia. These meetings were then extended to three additional ministries in 2014, but this posed logistical challenges and the meetings were subsequently discontinued. Furthermore, neither the Economic, Social and Cultural Council (ECOSOCC) nor the Office on RIA (ORIA – now called the Regulatory Executive Team or RET) is mandated to provide oversight to ensure that these meetings are conducted on a regular basis. Therefore, providing ministries with a steady platform to engage and dialogue with their counterparts from the different ministries can give them the opportunity to highlight challenges and best practice in using and implementing RIA.
- *Provide a structure and platform to further engage with stakeholders.* The annual Ministry RIA Action Plans could be used to alert citizens and representative organisations to forthcoming drafts for consultation and preferably early engagement with ministries, through different platforms, such as news or social media. RET can help create a structured process and identify groups, such as business organisations, that can be influential in supporting good policy making and can also consider including them in RIA training and encourage them to seek members' views.

Ensuring effective implementation of RIA

- *Developing frameworks for administrative simplification and burden reduction.* Cambodia has introduced several initiatives to help improve the stock and flow of regulations. RET would need to sustain this momentum by ensuring compliance on the use of RIA and improving the quality of existing ones.
- *Consider consistency of implementation efforts and sanctions vis-a-vis the objectives of the proposed regulations.* The first steps could now be taken towards risk-based inspection and enforcement to introduce consistency across different regulatory frameworks.

Regulatory impact assessments in Cambodia

The concept of RIA was introduced in Cambodia in 2008 through the ADB Promoting Economic Diversification Programme, focused on regulatory enhancement. RIA was pioneered to promote good governance and supported the goal of creating an attractive investment climate, through competition and diversification. It was brought in as a pilot through the Ministry of Industry, Mines and Energy, responsible for promoting SMEs.

Since 2000, the government has seen SMEs as potential drivers of domestic economic growth and diversification and has subsequently reformed the regulations that affect their performance. Promoting good governance is a central part of a wider agenda of improving economic growth, employment and efficiency, which is underscored in Phase III of Cambodia's Rectangular Strategy (2013-18). The government, through the Office of Council of Ministers, remains proactive in supporting RIA implementation, recognising that it is a powerful tool for policymakers to ensure the effectiveness and efficiency of regulations and to avoid overlaps.

Box 7.1. What is a regulatory impact assessment (RIA)?

Regulatory impact assessment is a cornerstone of evidence-based policy making and one of the most adopted regulatory policy tools by OECD member countries for the past 20 years. RIA is a crucial element of the regulatory governance cycle and is used to develop or strengthen regulatory policy. It is defined as a systematic process to identify and quantify the benefits and costs from different regulatory or non-regulatory options for a policy under consideration and may include benefit-cost analysis, cost-effectiveness analysis or business impact analysis (OECD 2015).

Principle 4 of the Recommendation of the OECD Council on Regulatory Policy and Governance encourages countries to integrate RIA into the early stages of the policy process for formulating new regulatory proposals. It should clearly identify policy goals, evaluate if a regulation is necessary and how it can be most effective and efficient in achieving these goals, consider means other than regulation and identify the trade-offs of different approaches analysed to identify the best approach. More specifically:

1. Adopt ex ante impact assessment practices that are proportional to the significance of the regulation, and include cost benefit analyses that consider the welfare effects of regulation taking into account economic, social, and environmental impacts including the distributional effects over time, identifying who is likely to benefit and who is likely to bear the costs.
2. Ex ante assessment policies should identify a specific policy need, and the objective of the regulation such as the correction of a market failure, or the need to protect citizen's rights that justifies the use of regulation.
3. They should also include a consideration of alternative ways of addressing the public policy objectives, including regulatory and non-regulatory alternatives to identify and select the most appropriate instrument, or mix of instruments to achieve policy goals. The no-action option or baseline scenario should always be considered. Such assessments should in most cases identify approaches likely to deliver the greatest net benefit to society, including complementary approaches such as through a combination of regulation, education and voluntary standards.
4. When regulatory proposals would have significant impacts, ex ante assessment of costs, benefits and risks should be quantitative whenever possible. Regulatory costs include direct costs (administrative, financial and capital costs) as well as indirect costs (opportunity costs) whether borne by businesses, citizens or government. Ex ante assessments should, where relevant, provide qualitative descriptions of those impacts that are difficult or impossible to quantify, such as equity, fairness, and distributional effects.
5. RIA should as far as possible be made publicly available along with regulatory proposals, be prepared in a suitable form and within adequate time for inputs from stakeholders and assist political decision making. It is good practice to use RIA as part of the consultation process.
6. Ex ante assessment policies should indicate that regulation should seek, not deter, competition and consumer welfare, and that to the extent that regulations dictated by public interest benefits may affect the competitive process, authorities should explore ways to limit adverse effects and carefully evaluate them against the claimed benefits of the regulation. This includes exploring whether the regulatory objectives cannot be achieved by less restrictive means.

Source: OECD (2012), OECD (2015).

Cambodia has no existing registry of any of the types of law, nor those under any particular ministry or for any sector, which limits the extent of knowledge of existing and newly proposed regulations. Nonetheless, there is a clear hierarchy of laws (Box 7.2). New laws in Cambodia commonly include the following clause: 'any provision that is in conflict with the provisions of this law shall be abrogated or amended'. In reality, however, laws and regulations still often contradict each other and there remains uncertainty as to which should be followed.

There is an increasing need to ensure that regulations are sufficiently reviewed to avoid any duplication or to prevent any unnecessary burden imposed on businesses and citizens. For example, companies are required to have a seal upon registration although Article 115 of the *Law on Commercial Enterprises* states that 'an instrument or agreement executed on behalf of a company by a director, an officer or an agent of the company is not invalid merely because a corporate seal is not affixed thereto'. Similarly, under Article 261 of the *Labour Law*, 'no foreigner can work in Cambodia unless he possesses a work permit and an employment card issued by the Ministry of Labour and Vocational Training'. However, under the existing system, only an employer may apply for a work permit on behalf of an employee. There are also no existing provisions for individuals who undertake work in Cambodia but do not have a formal employer, such as freelance workers or independent consultants. In practice, these individuals either work without a permit or request that clients provide them with an 'employment contract' in order for them to apply for a work permit. This poses significant challenges for all parties and presents an inaccurate view of the individual's employment status.

Box 7.2. Different types of laws and decrees in Cambodia

- Constitution: The supreme law of the kingdom of Cambodia
- International treaties: The King signs and ratifies international treaties and conventions after their approval by the National Assembly and the Senate. After ratification, international treaties and conventions become laws and may be used as the basis for judicial decisions. (Article 26 of the Constitution)
- Law (Chbab): Laws adopted by the National Parliament
- Royal Decree (Preah Reach Kret): Decrees issued under the name of the King in execution of his constitutional powers
- Sub-Decree (Anukret): Signed by the Prime Minister after adoption by a cabinet meeting. The Prime Minister can use this in execution of his own regulatory powers.
- Ministerial Orders or Proclamations (Prakas): Issued by the Minister in charge of the line ministry in execution of his own regulatory powers.
- Decisions (Sech Kdei Samrach): Individual decision(s) made by the Prime Minister, Minister or Governor, which are made in execution of his own regulatory powers.
- Circular (Sarachor): In general, a circular is issued by the Prime Minister as the head of government, and by a Minister as an official of the relevant ministry either to explain or clarify legal regulatory measures or to provide instructions.
- Provincial Ordinance (Deika): Orders issued by a provincial Governor.

Prior to introducing RIA, the government had already initiated a legislative review process, to ensure effectiveness and demonstrate the effects of laws, which required endorsement from the Council of Ministers or decrees. As a first step, the Economic, Social and Cultural Council (ECOSOCC) and the Jurists' Council reviewed the proposal with the relevant line ministry to ensure effectiveness and check consistency with existing laws and regulations. The revised draft was then sent to the inter-ministerial meeting where it was reviewed by Secretaries of State of all line ministries under either the chairmanship of the Secretary General of the RGC or the minister of the relevant line ministry to finalise the draft law/regulation.

Despite this review process, inconsistencies remained, partly resulting from the lack of knowledge of an existing regulation, particularly where the ministry mandates and scope were changed. In addition, the review process also did not affect regulations from the lower levels of the regulatory hierarchy (Prakas/Edict and below), as there was no entity in charge of overseeing or reviewing these.

Institutions, tools and processes

Institutional responsibilities

The Regulatory Executive Team or RET (formerly ORIA) is established within ECOSOCC at the Office of the Council of Ministers (OCM). It is mandated "to provide advocacy information to line ministries on principles of good practice in the regulation making process, assist with training on RIA methodology, and support line ministries in their implementation of the RIA process".

Regulatory impact assessment fits into the existing legislative review process in Cambodia. It serves as an additional step for ministries, when proposing a regulation, to perform an impact assessment before the regulation in considered by the OCM. It provides the ECOSOCC, which monitors issues and policies that affect the economic, social, and cultural sectors within the OCM, with more detailed economic and social analysis on the merit of a proposed regulation prepared by a line ministry.

Since its introduction in 2008, the RIA process has remained voluntary but has nevertheless gradually been introduced across different ministries through the ADB's Promoting Economic Diversification Programme.[1] Since December 2016, however, under a new Government Decision, all ministries are required to establish a Regulatory Impact Assessment Working Group to work on their respective RIAs. Three more line ministries (justice, national defence and state secretariat of civil aviation), the secretariat of the senate and secretariat of the constitutional council have established RIA Working Groups. While some staff from CDC have been involved in some RIA activities, they have not had a formal role. The support and further engagement of the CDC would be useful to ensure RIA supports national priorities.

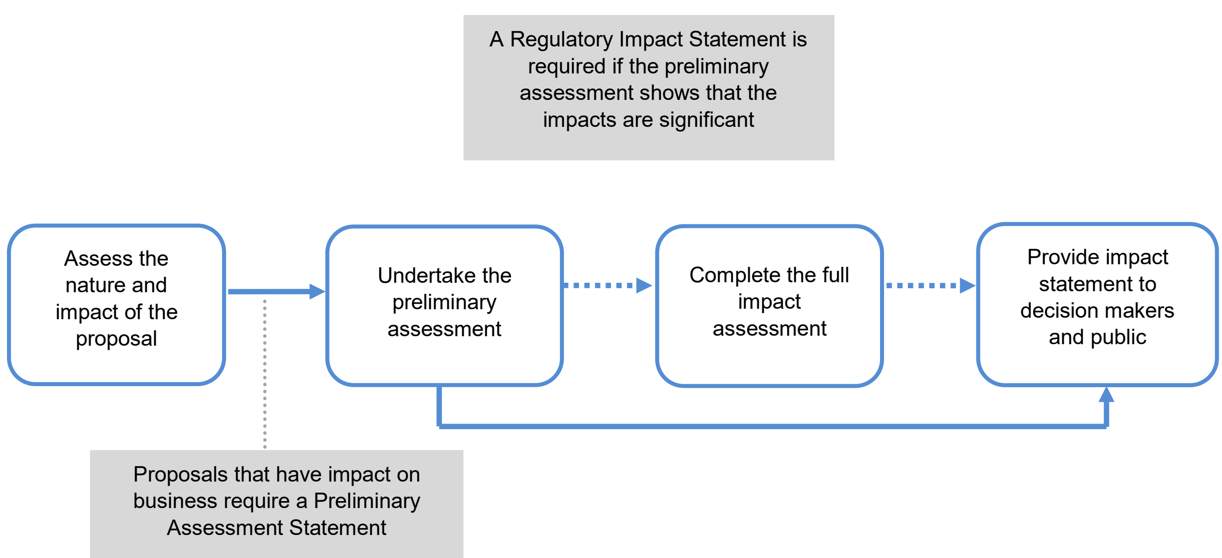
Line ministries are encouraged to agree with their Minister and RET on an annual basis on the draft laws to be assessed and the process it will involve. RET provides full support in the RIA process and also serves as a gatekeeper for regulatory bodies, especially once the concept is widely accepted and ministries have sufficient capacity to undertake the analysis. RET aims to achieve this by gradually embedding RIA in the policymaking process within ministries, as opposed to hurriedly imposing a mandated process that is outsourced to consultants.

Regulatory process management in Cambodia

Regulatory impact assessments in Cambodia follow two stages designed to direct the resources used for impact assessment appropriately by targeting those regulations that have the largest impact on businesses. First a preliminary assessment statement (PAS) rapidly analyses whether a proposal includes a regulatory focus and if it poses significant socio-economic and environmental impacts, especially on businesses. If this reveals that the potential impacts are significant, a regulatory impact statement (RIS) provides a full assessment (Figure 7.1). These assessments consist of the following elements: problem, objective, options, impact analysis, consultation, conclusion and implementation.

The RIS also includes cost-benefit analysis of the proposed regulation using a simplified calculation spreadsheet, rather than any complicated economic formulas, although very few cost-benefit analyses have been completed so far, partly due to the limited economic and statistical capacity and expertise available to undertake the analysis. In many cases, external consultants are engaged to conduct analysis for the RIS, limiting the extent to which ministries claim ownership and are involved in the assessment process. In the initial phases of implementation, focus should be on implementing the principles of RIA into the policy making process rather than sophisticated cost-benefit analysis. This should involve quantification but may start with more fundamental issues such as clarifying the necessity of the new policy (Adelle, et al., 2015).

Figure 7.1. The regulatory impact process in Cambodia



Source: ECOSOCC (2014), *Regulatory Impact Assessment Handbook*, Office of the Council of Ministers.

Each line ministry is responsible for preparing the draft PAS for its proposal. If the proposal is deemed to impose a significant impact, the responsible ministry must seek the approval from its minister to proceed with the draft proposal and prepare a full RIS. Most implementing line ministries should now have more than 10 staff members working on RIA, through an established RIA working group responsible for preparing a PAS and RIS for proposed regulations, using a standard template. This review stage may happen in parallel with review by the Council of Jurists, also based in the Council of Ministers, which conducts a statutory examination of the legal draft of the regulation. Once finalised, the final draft and assessment statements are forwarded to the Technical Meeting for the next stage of legislative review. This process follows similar practices carried out by neighbouring countries such as Malaysia, which has formally established a

RIA system. According to the government, there were a total of 41 PAS and 3 RIS produced during 2012-16.

The established RIA working groups within the ministry may seek advice and assistance from RET to help them complete these statements. The statements are then submitted to RET, with the draft legislation for review. RET then works with line ministry officials to improve the proposal and its assessment. In principle, all assessments are published on the RET website. Comments may be made by the public which RET forwards to the line ministry. In practice, ministries are not always willing to publish the assessments, and, when they are made public, very few comments have been received.

The ADB regulatory enhancement project also proposed that RIA be used to review regulations at the Prakas or Edict level, but ECOSOCC is not currently mandated to review Prakas.

RIA is in the early stages of implementation in Cambodia. Its aim is to improve the information available to decision-makers by providing detailed evidence of the costs and benefits of implementing a particular regulation, and the potential alternatives available to achieve the same objective, so that policy makers are able to make better informed decisions. In order to better facilitate effective consultation and governance, the RIA process in Cambodia has been designed with two key elements in mind:

- *Simplicity* – The approach to RIA is light-handed. Policy makers have recognised that more benefits are likely to be achieved at this stage through good consultation, simple logic, elementary calculations and rigorous testing of assumptions than through complex analysis.
- *Transparency* – The information obtained through RIA is placed on a website, for the public to access. This is a low-cost method of providing transparency in the RIA process. The comprehensive summary of the assessment is available in Khmer and an English version provides a rapid view of the decision accorded in the assessment. At the same time, since some small businesses may not have internet access, an easily accessible hard-copy "public-file" is also available for interested parties to read and access.

Capacity building

Since RIA is still new to Cambodia, current efforts are focused on awareness raising and capacity building activities in order to develop a successful RIA culture. This step-by-step approach provides an opportunity to gradually adapt and integrate the use of evidence-based policymaking though RIA. In order to develop effective RIAs, it is important to strengthen the regulatory analysis capacity of relevant government officials. Furthermore, substantial efforts to raise awareness of the importance of this system through the relevant programmes for education and training can also help mainstream the use of RIA.

As the number of ministries that engage with RET continues to expand, awareness is likewise growing. Some implementing line ministries have even attempted to apply RIA to their respective Prakas, where there is more direct impact on businesses, even if the emphasis has been more at the sub-decree level. Since 2014, the Ministry of Commerce has endeavoured to make a regulatory impact statement for a proposed law on competition, but the proposal has been deferred as RET has recommended to concentrate on lesser regulations and to seek external support for this complex analysis.

The gradual process of introducing RIA means that the positive effect of the improved policy-making on business is slow. At present, each implementing agency is only following the process for a small number of proposals each year and only for those specific proposals where the ministries are able to devote more time. Although there are individual successes, such as the identification of previously unassessed effects on farmers growing tobacco when the tobacco control law was drafted, it is not possible to make any overall assessment of the change in impact on business.

Enabling factors, such as the need to create a database of existing regulation, which RET is attempting to develop, are needed as a way to assess and improve the current stock of regulations before any wider attempt to reduce the burdens on business through newly introduced regulations could be considered. Furthermore, national capacity to implement and enforce regulation must be taken into consideration when deciding to introduce and pass regulations.

Addressing the barriers in implementing RIA

The effective use of impact assessments is demanding in terms of resources and expertise and its success depends on political and bureaucratic factors as well as the management tools used (OECD, 2012). There is a risk of RIA being perceived as a simple formality – performed as a way to comply with administrative processes, especially if the responsible agency or ministry establishing or strengthening regulations lacks specific expert knowledge or experience in analytical techniques or does not fully understand the necessity of an impact analysis. Despite the use of a simple template, ministries find it challenging to undertake cost-benefit analysis. At the same time, the social cost of regulation is difficult to estimate as it is not only connected to a one-off event but to a series of events in the future.

RIA helps the administration decide in favour of more efficient policy options, discarding less efficient alternatives. It becomes part of a broader regulatory management system, by providing a framework to analyse the different policy options, through the use of evidence and by providing the strong basis for the other stages of the policy process by helping policy-makers better design and monitor strategies for implementation and performance indicators (Renda, 2015).

The various costs in Box 7.3 are important when understanding the overall impact of regulations. However, the quantification of the different cost categories becomes challenging when measuring beyond compliance costs, notably in certain categories where there is no widely agreed approach (i.e. indirect costs and macro-economic costs). Most governments that undertake cost-benefit analyses focus on measuring substantive compliance costs, which often represent a substantial portion of costs incurred by citizens, businesses, and governments.

Consequently, there is a risk of preliminary assessments overestimating the benefits or the costs of complying with a proposal. If the process of predicting the economic, social effects and risk of policy and regulation through evidence is done effectively, the government can utilise the regulation as a good means to achieve the policy goal, and also possibly to better cooperate with the regulated when it is implemented.

Box 7.3. Substantive compliance costs

Substantive compliance costs are incremental costs to the target group of complying with a regulation, other than administrative costs. They include only the direct costs borne by those for whom the regulation imposes compliance obligations. Substantive compliance costs include the following broad categories:

Implementation costs are costs regulated entities incur in familiarising themselves with new or amended regulatory compliance obligations, developing compliance strategies and allocating responsibilities for completing compliance-related tasks. They are largely short-term costs, incurred after a new regulatory requirement is adopted, though regulated groups may subsequently decide to revise and update their regulatory compliance strategy and would, in such cases, incur additional implementation costs.

Direct labour costs are the costs of staff time devoted to completing the activities required to achieve regulatory compliance. Only the costs to staff directly involved in undertaking these activities should be included: the costs of the staff supervision/management are included in the overhead costs category. Direct labour costs include two main elements: (1) the costs of wages paid and (2) non-wage labour costs, including pension contributions, sick leave, annual leave, payroll taxes, personal injury insurance, etc.

Overhead costs include the costs of rent, office equipment, utilities and other inputs used by staff engaged in regulatory compliance activities, as well as corporate overheads, such as management inputs, that are attributable to compliance activities.

Equipment costs are items of capital equipment for businesses to comply with many kinds of regulations. This can include both machinery (e.g. equipment to treat the emissions from a production facility to conform to new emissions standards) and software (e.g. programs required to undertake real-time monitoring of actual emissions).

Material costs are incremental costs incurred in changing some of the material inputs used in the production process in order to ensure regulatory compliance (thus, they are sometimes called "input costs"). They are therefore ongoing costs.

External service costs can be defined as the cash cost of payments made to external suppliers providing assistance in achieving regulatory compliance. For example, faced with more stringent emissions controls, a firm may hire consulting engineers to advise on the available means of reaching compliance and their relative costs and benefits.

Source: OECD (2014)

Priority regulations for RIA

The choice of which new legislation to apply RIA has, until now, largely depended on the willingness of the implementing agency, as well as the complexity of the case and the time available. Early adopters should now be able to make an informed selection based on significance to business and the economy. They should also move towards preliminary assessment statements for all new legislation, including Prakas, even if the capacity is still limited for undertaking all the regulatory impact statements it may require. There is a significant opportunity to improve the business environment and further develop support for RIA by the Cambodian approach, which has not overloaded the RIA Working Groups by mandating RIA for all new policies. Existing regulations which are causing an unnecessary burden could be proactively simplified.

The government, with external support, has implemented many improvements since 2000 for business registration and leases, but the current burden of red tape remains a problem. RET could work with representative bodies to identify key areas for possible review and these could be selected and supported through institutions such as the Steering sub-committee on SMEs and the Government Private Sector Forum and its thematic Working Groups. Some representative groups have already identified possible topics.[2]

Cambodia can also learn from Viet Nam's Project 30, which aimed to simplify administrative procedures by 30% between 2007 and 2010. This project was applied in the whole Vietnamese administration, including the 4 levels of government, 10 000 communes, 700 district level units, 1 300 provincial department units, and 400 ministries and agencies. The project also came up with an inventory of all Administrative Procedures, which created more transparency and provided the government with the opportunity to simplify 10 000 sets of procedures to 63 sets at the communal level and 700 sets to 63 sets at the district level (OECD, 2011b).

Developing a community of RIA practitioners

A number of outreach activities have already been conducted in universities, private sector and civil society organisations, as well as in government ministries and institutions to promote awareness of RIA in Cambodia and to develop a community of RIA practitioners. As a result of these activities organised by RET/ORIA, the RIA process has gained significant support from regulation makers and leaders, who recognise the value of RIA in improving the efficiency of the policy-making process. Recently, RET has been introducing the principles and practice of RIA to new implementing agencies.

Regulatory delivery, advice and enforcement

Cambodia is simultaneously developing new regulatory frameworks, for issues ranging from competition to food safety, and seeking to reduce unnecessary burdens on business. There is a risk that the smallest businesses will baulk at having to start to engage with new rules, but there is an opportunity to develop and implement these such that they pose the least possible burden. Being informed of the regulation, understanding what is required and a fair and predictable enforcement approach could make the transition to the formal economy much more acceptable. Regulatory burdens can be minimised and compliant business growth supported by developing an open and constructive relationship between regulators and those they regulate. Professional regulatory bodies, such as the Telecommunications Regulator, can provide skilled involvement in this discussion.

A number of emerging and developing countries have introduced RIA in the context of pursuing reforms related to "ease of doing businesses" in order to improve legislation, especially with regard to business licensing (Renda, 2015). In the case of Cambodia, the role of different parties in advising businesses and enforcing regulations also needs addressing. For example, when a business is applying for a licence, it is also setting up compliance systems. A number of businesses lack the needed guidance to formally set up their businesses and continue to face difficulties in understanding the process. This is therefore a prime opportunity to ensure that businesses understand the requirements of the regulation, rather than having to retrofit activities later; but licensing is currently often seen as an independent, administrative process.

Progress reporting

The 2016 Decision to establish RIA working groups in all ministries mandated ECOSOCC to produce an annual report on RIA to the government. This is a significant opportunity to highlight good practice and problem areas and make substantial recommendations. It can provide a way to gather and promote information on the number of PAS and RIS each line ministry has planned and achieved as a share of all new legislation proposed. Although voluntary, it would highlight the scale of opportunity, as well as examples of effective assessment and consultation and, if possible, drafting improvements. It could include future RIA roll-out priorities in areas such as transparency, RIA practitioner community development or predictable planning. Case studies of how the change would affect an individual business could be very powerful.

Notes

[1] Including the following ministries: Commerce; Environment; Mines & Energy; Tourism; Education, Youth & Sports; Labour & Vocational Training; Health; Agriculture, Forestry & Fisheries; Public Works & Transport; Post & Telecommunications; Land Management, Urban Planning & Construction; Industry & Handicrafts; and Economy & Finance

[2] See the Eurocham 2016 White Book: Trade and Investment policy recommendations.

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Chapter 8. Promoting and enabling responsible business conduct as a strategic choice in Cambodia

This chapter considers how Cambodia could promote and enable responsible business conduct (RBC) as a strategic choice by mainstreaming RBC at a government level and clearly communicating RBC priorities and expectations. The chapter traces Cambodia's success in the garment sector to the steps taken to promote safe sourcing beginning in the 1990s and looks at the growing importance of RBC within global supply chains. It also considers how multi-stakeholder consultations could be expanded and suggests that Cambodia could consider a National Action Plan for RBC.

Summary

Promoting and enabling responsible business conduct (RBC) is of central interest to policy-makers wishing to attract and retain quality investment and to ensure that business activity contributes to broader value creation and sustainable development. RBC principles and standards set out an expectation that all businesses avoid and address negative impacts of their operations, while contributing to sustainable development where they operate.

Cambodia's economic growth has its roots in RBC – improvements in labour conditions in the textiles and garment industry were directly linked with access to the United States market under the 1999 United States-Cambodia Trade Agreement on Textiles and Apparel. In light of changing market conditions and external factors that may limit the extent to which Cambodia can continue to rely on traditional sources of growth, taking a broader and more strategic approach to promoting and enabling RBC is warranted. High-profile land disputes, labour unrest, and frayed industrial relations suggest that the benefits of existing investments could be further enhanced. Additionally, despite the fact that Cambodia has one of the most liberal investment regimes in Southeast Asia, together with generous incentives and tax holidays, investor surveys suggest that it may not be attracting as much investment as it could, especially from investors based in OECD countries. Despite attempts to address some issues, major challenges remain in terms of establishing and enforcing an adequate legal framework that protects the public interest and creates an enabling framework for RBC.

The extent to which Cambodia can attract investment and maximise its benefits without addressing the RBC-related risks present in the business environment is unclear, particularly considering the developments on RBC in ASEAN members. Cambodia should meet these trends head on and ambitiously to ensure it is not left behind. Mainstreaming RBC at a government level and clearly communicating RBC priorities and expectations, including to the private sector would go a long way in overcoming country risk perceptions, maximising the development impact of FDI, attracting quality investment and promoting linkages with MNEs, and creating a level-playing for business (particularly important in light of increasing RBC expectations in supply chains, which can include legal obligations for some investors).

Policy recommendations

- Clearly communicate responsible investment as an objective in the new *Investment Law* and related laws such as the draft Environmental Code. Set out an expectation for investors to adopt an approach consistent with international principles and standards on RBC, such as those contained in the OECD *Guidelines* and UN *Guiding Principles*. Include RBC in "smart" incentives.
- Develop a *National Action Plan on Responsible Business Conduct* in collaboration with stakeholders and in line with international good practice in order to mainstream RBC and prioritise and advance reforms needed to ensure an adequate legal framework that protects the public interest and underpins RBC. The CDC, within its strengthened mandate and responsibilities for implementing the IDP, could take on a leadership role in this regard. Consider establishing a focal point on RBC in the government.
- As a complement to the establishment of an Ombudsman office and consolidation of the trouble-shooting Committee for Special Economic Zones, establish a

procedure at CDC through which affected communities can submit reservations and complaints related to RBC in existing investments, including in the special economic zones.

- Strengthen and extend the mandate of the Arbitration Council to cover areas beyond labour issues and to allow for binding decisions and ensure its independence. Promote mediation processes as a step before binding arbitration in order to keep the flexibility and the power of the Council.
- Clarify and strengthen how the effects of proposed investment projects are assessed and increase transparency on environmental and social impact assessments while encouraging more public participation; communicate the extent of business responsibilities for protecting the environment at both national and provincial levels. Improve technical capacities of responsible authorities.
- Exercise the government's convening role and bring together stakeholders in order to agree on specific actions to ensure the competitiveness of the garment and footwear sector. Consider the advantages of ambitiously embracing global developments on RBC and the ways in which Cambodia could be the leader in applying the due diligence framework enshrined in the OECD *Guidelines* and the UN *Guiding Principles*.
- Ensure that the application of the legal framework on industrial relations follows international norms; encourage more meaningful stakeholder engagement in industrial relations.
- Communicate RBC expectations to business through the Government and Private Sector Forum. Encourage the establishment of firm-level grievance mechanisms as a complement to existing complaints mechanism in order to strengthen the capacity of workers to voice concerns. Encourage cross-sectoral learning for addressing RBC risks.

Scope and importance of responsible business conduct

Promoting and enabling responsible business conduct is of central interest to policy-makers wishing to attract and keep quality investment and ensure that business activity contributes to broader value creation and sustainable development. RBC expectations are prevalent throughout global value chains and are affirmed in the main international instruments on RBC – notably the OECD *Guidelines for Multinational Enterprises* (OECD *Guidelines*), the UN *Guiding Principles for Business and Human Rights* (UN *Guiding Principles*), and the fundamental International Labour Organization (ILO) Conventions – and increasingly in international trade and investment agreements and national development strategies, laws, and regulations. Furthermore, a stronger role for the private sector in the development process was one of the key outcomes of the agreement on the 2030 Agenda for Sustainable Development. A number of Sustainable Development Goals (SDGs) refer to responsible production patterns, inclusive and sustainable economic growth, employment and decent work for all. The Paris Agreement on climate change also underlines the critical role of business in tackling climate change, including through reducing greenhouse gas emissions and improving environmental performance.

RBC principles and standards set out an expectation that all businesses – regardless of their legal status, size, ownership structure or sector – avoid and address negative consequences of their operations, while contributing to sustainable development where they operate. RBC means integrating and considering environmental and social issues within core business activities, including throughout the supply chain and business relationships. Although RBC is sometimes used interchangeably with corporate social responsibility (CSR), it is understood to be more comprehensive and integral to core business than what is traditionally considered CSR (mainly philanthropy).[1] A key element of RBC is risk-based due diligence – a process through which businesses identify, prevent and mitigate their actual and potential negative impacts and account for how those impacts are addressed.

A market in which internationally accepted environmental and social principles and standards are not respected faces an increased risk of being excluded from value chain activity. Many businesses also find that responsible business is good business, beyond ensuring respect for human rights and compliance with relevant laws and regulations. Understanding, addressing, and avoiding risks material to business operations in a more comprehensive way – that is, beyond financial risks – can often lead to a competitive advantage.

Cambodia's economic growth has its roots in responsible business conduct

Relative to other ASEAN countries, RBC is not a new concept in Cambodia, particularly when it comes to employment and industrial relations. Improvements in labour conditions in the textiles and garment industry were directly linked with access to the United States market under the 1999 United States-Cambodia Trade Agreement on Textiles and Apparel.[2] The United States, along with the European Union and Japan, was at the time the top importer of textiles and clothing in the world.[3] Under the agreement, observance of international labour standards in factories, better working conditions, and a commitment to routine monitoring resulted in increased export quotas up until the international quota system was abolished in 2005. This market access gave Cambodia a competitive advantage relative to other major exporting countries.[4]

The Better Factories Cambodia (BFC) project has its origins in this agreement. Established as a third-party monitor, BFC's early successes in improving working conditions at the factory level[5] inspired the ILO Better Work Programme, which has since been implemented in seven other countries. A 2015 World Bank assessment of the programme in the eight countries where it is implemented concluded that participating factories in general do see a positive correlation between investing in better working conditions and profits, productivity and survival rates. On a country level, participation in the programme is associated with significant increases in apparel exports (BFC, 2016a; World Bank, 2015a). BFC has been a major factor for continued sourcing from the Cambodian garment and footwear industry.

Despite these successes, some stakeholders have raised concerns about the actual extent of the impact of BFC on improving conditions considering the ongoing issues observed in Cambodia, such as subcontracting practices, short-term contracts, overtime, compensation, and persistent compliance issues with occupational health and safety standards.[6] The limitations of the programme have been well-covered and recognised both by BFC itself through its annual reports as well as by stakeholders. Nevertheless, BFC presents an early example of collective action to find solutions to the longstanding problems observed in the textiles and garment industry. The initial support provided to the programme by the government – both in terms of funding and the Prakas 108 regulation – demonstrates that an active role of the government in promoting RBC is critical even in the context of low institutional capacity to implement and enforce existing laws.[7] In addition to contributing a part of seed funding, the government ensured participation in the programme (originally voluntary for factories) through Prakas 108 (28 March 2001), a ministerial regulation that tied factory access to the export quota with registration in the programme. Nearly all exporting firms registered for the programme following this decision (World Bank, 2015a; Stanford, 2013).[8]

While several aspects of government involvement in the programme have drawn criticism, particularly with the phasing out of the quota system in 2005, the programme set a precedent for multi-stakeholder engagement in Cambodia that has also helped advance dialogue in other areas of industrial relations. For example, the wage-setting process through the tri-partite Labour Advisory Committee, which advises the Ministry of Labour and Vocational Training on a minimum wage for the garment and footwear sector on yearly basis, is generally viewed as credible. Along the same lines, the Arbitration Council, whose function is to resolve collective labour disputes, has a tripartite structure. While these mechanisms are targeted and a tripartite structure may not be appropriate for all RBC-related issues, experience from the OECD on promoting and enabling RBC shows that cultivating meaningful and effective multi-stakeholder engagement has been a key factor for the successful implementation of the OECD *Guidelines*. The section below discusses this aspect in more detail.

Several other initiatives to promote RBC have also emerged recently. While most are limited in scope and impact so far, they point to a positive trend that RBC is increasingly considered in Cambodia. UN Office of the High Commissioner for Human Rights (UN OHCHR) in Cambodia actively promotes the UN *Guiding Principles*, as well as economic and social rights more broadly. A notable effort since late 2015 has been the support given to local communities in Mondulkiri province in the context of negotiations between indigenous communities affected by an economic land concession and the company to which it had been granted. As yet another testament to how useful multi-stakeholder engagement can be, the negotiation took place in a tripartite committee set up at the initiative of local stakeholders and has yielded concrete and time-bound results,[9] which is not a trivial outcome considering the current political context in Cambodia related to economic land concessions (UN OHCHR, 2016a). Other initiatives include establishing a National CSR Platform in 2015 by a number of civil society organisations and businesses to advocate for adoption of a national CSR framework by 2018 and to promote further adoption of guidelines, tools and principles (CSR Cambodia, 2016). Civil society has also been active beyond this effort; some NGOs, such as the Cambodian Centre for Human Rights and the Cooperation Committee for Cambodia, are running specific programmes to promote due diligence and business respect for human rights, including the OECD Guidelines. The latter published a brochure on RBC, OECD *Guidelines*, and UN *Guiding Principles* in February 2017.[10]

Businesses have also undertaken efforts in this area, although a number of stakeholders consulted by the OECD as part of this review felt that more business involvement is needed. Most activity is undertaken in the garment and footwear sector, where the domestic business association Garment Manufacturers Association in Cambodia (GMAC) participates in BFC. Its parent association, the Cambodian Federation of Employers and Business Associations (CAMFEBA),[11] is a member of the Labour Advisory Committee, the National Training Board, the National Social Security Fund Board, and National Committee on Child Labour. Foreign chambers of commerce have also taken on CSR issues. The European Chamber of Commerce (2016a) launched a CSR Award, administered by the French Foreign Trade Advisors with the support of French Chamber of Commerce, in order to encourage and highlight best practice of Cambodia-based businesses linked with the French foreign trade network. The American Chamber of Commerce (2016) reinvigorated its CSR Committee in 2016, with planned monthly meetings, in recognition of the fact that CSR is an "increasingly important component of all companies activities as a way to demonstrate their commitment to support the community in which they operate, and one which has been demonstrated to serve corporations' overall success". The UN Global Compact Network is not active in Cambodia.

Responsible business conduct as a strategic move

These activities are positive and should be encouraged, but a more strategic approach to RBC by the Cambodian government is warranted. Cambodia's graduation to lower middle-income status in July 2016 testifies to its impressive achievements in poverty reduction and sustained job creation over the past decade. The phase out of trade preferences due to graduation will not be immediate and growth forecasts remain favourable, but, as is the case in other transition countries, the detailed picture is more nuanced. ADB and the World Bank[12] estimate that many Cambodians are near-poor and vulnerable to falling back under the poverty line and the extent to which the economy can continue relying on traditional sources of growth, particularly narrow-based exports, seems limited (Chapter 3). Cambodia's competitive advantages, namely low-wage labour and market access, are increasingly coming under pressure by changing market conditions and external factors.

These challenges have been well-diagnosed and recognised by the government. Phase III Rectangular Strategy, Cambodia's main reform agenda, and the 2015-25 Industrial Development Policy (IDP)[13] cite diversifying the economy, pursuing industrial upgrading, addressing structural issues and attracting investment as strategic objectives. Moving from strategy to implementation has proven to be a challenge for Cambodia. The recommendations in this chapter aim to inform Cambodia's ongoing reform efforts by examining areas where taking a strategic approach to promote and enable RBC based on international principles and standards could help overcome some of the challenges and criticism that the government has faced. The RBC focus on impacts and addressing environmental and social risks of business operations can be a bridge between maximising societal impacts of investment and creating a level playing field for new investors that may perceive the risks of investing as too high due to Cambodia's position in global rankings (see Table 1.2).

Building the investment framework for the future

As noted in Chapter 4, despite the fact that Cambodia has one of the most liberal investment regimes in Southeast Asia, with generous incentives and tax holidays, investor surveys suggest that it may not be attracting as much investment as it could.[14] The extent to which Cambodia can continue to attract investment and expand the range of source countries, while maximising potential benefits, without addressing the RBC-related risks present in the business environment is unclear. Expectations related to RBC are prevalent in global value chains and can also include legal obligations for some investors (Box 8.1). The current elaboration of the new investment law as envisioned by the IDP is an opportunity for the government to position Cambodia as a place to invest and do business responsibly. Doing so would be in line with recent developments in ASEAN recognising that RBC issues are increasingly relevant for the region. Clearly setting out expectations on RBC and integrating RBC in investment promotion and facilitation efforts would ensure that Cambodia is not left behind in light of the strategic signals sent by some of its neighbours on the importance of RBC.

Box 8.1. Global policy developments on RBC

The agreement on Sustainable Development Goals (SDGs) and the historic Paris agreement on climate change have recognised and given renewed attention to the role of the private sector in development. A number of SDGs refer to responsible production patterns, inclusive and sustainable economic growth, employment and decent work for all, while the Paris agreement underlines the critical role of business in tackling climate change, including through reducing greenhouse gas emissions and improving environmental performance. There is much to be gained from promoting and enabling RBC in pursuit of the SDGs. The 2016 Development Co-operation Report: The Sustainable Development Goals as Business Opportunities outlines policy reasons for promoting RBC as a way to mobilise necessary resources for financing the development agenda, while improving access to markets and participation in value chains for domestic industries and increasing accountability and inclusiveness (OECD, 2016c).

RBC has also been included in high-level international commitments, notably by G7 and G20 Leaders. In the June 2015 G7 Leaders Declaration, G7 pledged to lead by example to promote international labour, social and environmental standards in global supply chains; to encourage enterprises active or headquartered in the G7 to implement due diligence; and to strengthen access to remedy (G7, 2015). Specific encouragement was given to international efforts and promulgating industry-wide due diligence standards in the textile and ready-made garment sector. The need to help small and medium-size enterprises (SMEs) develop a common understanding of due diligence and responsible supply chain management was also highlighted. Under the 2016 Chinese G20 Presidency, the G20 recognised in several statements the critical role of RBC in investment and global supply chains. G20 Trade Ministers issued a statement in July reinforcing their determination to "promote inclusive, robust and sustainable trade and investment growth" and agreed on G20 Guiding Principles for Global Investment Policymaking. The Principles state that “investment policies should promote and facilitate the observance by investors of international best practices and applicable instruments of responsible business conduct and corporate governance” (G20, 2016a). Additionally, G20 Leaders acknowledged in their annual Communique “the important role of inclusive business in development” (G20, 2016b). This has been followed by further commitments in 2017 by G20 Leaders to foster “the implementation of labour, social and environmental standards and human rights in line with internationally recognised frameworks”, including the OECD Guidelines (G20, 2017).

More and more countries are also using RBC principles and standards to frame domestic law. In March 2015, the UK enacted the Modern Slavery Act, mandating that commercial organisations prepare an annual statement on slavery and human trafficking and report on their due diligence processes to manage these risks within their operations and supply chains (UK, 2015). France has enacted a similar but broader proposal to mandate supply chain due diligence in accordance with the OECD *Guidelines* requiring all French companies with more than 5000 domestic employees or more than 10 000 international employees to publish a due diligence plan for human rights and environmental and social risks or face fines of up to EUR 10 million.

RBC criteria have also been included in economic instruments. The OECD Recommendation of the Council on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence was revised in April 2016 to strengthen RBC considerations in export credits and to promote policy coherence (OECD, 2016d). Canada has enhanced its strategy Doing Business the Canadian Way: A Strategy to Advance Corporate Social Responsibility in Canada’s Extractive Sector Abroad to allow for withdrawal of government support in foreign markets for companies that do not embody RBC and refuse to participate in the dispute resolution processes available through the Canadian government, including National Contact Points (NCPs) for the OECD Guidelines.

Due diligence requirements for minerals supply chains have been integrated into Section 1502 of the 2010 US Dodd–Frank Wall Street Reform and Consumer Protection Act. More recently, the

Federal Acquisition Regulation was revised in 2015, establishing a number of new safeguards to protect against trafficking in persons in federal contracts (Government of the United States, 2015). Additionally, the 2015 Trade Facilitation and Trade Enforcement Act eliminated the exceptions to the prohibition on import of goods into the United States – it is now illegal to import goods made, wholly or in part, with convict, forced and indentured labour under penal sanctions. In March 2016, US border agents withheld goods tied to forced labour on the basis of the new Act (US Customs and Border Protection, 2016).

In 2014, the EU passed a directive on promoting disclosure of non-financial and diversity information to promote more transparency on environmental and social issues across sectors and companies over a certain size incorporated in EU member states and listed on regulated EU exchanges (EC, 2014). It is currently in the process of being transposed into national law and first reports are expected in early 2018. Recently, an agreement on a framework to stop the financing of armed groups through trade in conflict minerals was reached at an EU level, with the aim that EU companies source tin, tantalum, tungsten and gold responsibly. These minerals are typically used in everyday products such as mobile phones, cars and jewellery (EC, 2016b).

China is also increasingly incorporating RBC into its national initiatives. At the end of 2015, on the basis of OECD RBC instruments, the China Chamber of Commerce Metals, Minerals & Chemicals Importers and Exporters adopted the Chinese Due Diligence Guidelines for Responsible Minerals Supply Chains.

At a regional level, as a response to civil society demands[15] for ASEAN to take more strategic measures to speed up action on RBC and to emphasise company responsibility for economic, social and environmental impacts, CSR references have been included in the ASEAN Socio-Cultural, Economic, and Political-Security Community Blueprints 2025. The Economic Blueprint specifies that enhanced stakeholder engagement is key to promoting transparency and making progress in ASEAN integration and identifies work closely with stakeholders towards promoting CSR activities as a strategic measure (ASEAN, 2016a).

The Socio-Cultural Blueprint also builds on the idea of multi-sectoral and multi-stakeholder engagement and calls for promotion and integration of a Sustainable Consumption and Production strategy and best practices into national and regional policies or as part of CSR activities (ASEAN, 2016b). The Political-Security Blueprint calls on strengthening collaboration with the private sector and other relevant stakeholders to instil CSR (ASEAN, 2016c). More recently, at the 24th ASEAN Labour Ministerial Meeting on 15 May 2016 in Lao PDR, ASEAN Labour Ministers adopted the *Guidelines for Corporate Social Responsibility (CSR) on Labour.* These guidelines provide broad guidance to governments, enterprises/establishments, employer and worker organisations on raising awareness, proactively encouraging engagement, and promoting social dialogue and compliance with core labour standards (ASEAN, 2016d).

Beyond strategic documents at ASEAN level, Cambodia's neighbours are also implementing concrete measures to promote and enable RBC domestically. Viet Nam has consistently stated its objective to deepen its global integration and move up the global value chain – these broad commitments have translated into several specific policies, laws and initiatives to promote better business practices and improve Viet Nam's overall business environment. Notably, the EU Free Trade Agreement (EU FTA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) both include specific language on RBC, CSR and sustainable development, following dominant treaty practice globally in recent years.[16] Specifically, the EU FTA refers to the promotion and co-operation on CSR in the Trade and Sustainable Development chapter (art. 9 and 14), with OECD *Guidelines* specifically mentioned in art. 9 as a relevant international standard. Another chapter that includes provisions related to RBC is the state-owned enterprises (SOEs) chapter (art. 5), underlining co-operation efforts to ensure that SOEs observe internationally recognised standards of corporate governance (EU, 2016). Viet Nam has also committed to specific labour reforms in a separate but related bilateral agreement with the United States, *Plan for Enhancement of Trade and Labour Relations* (USTR, 2015).

Myanmar has established a focal point on RBC and has, as the very first objective in the newly adopted 2016 *Investment Law*, included an explicit reference to responsible investment. The Law states that one objectives is to develop responsible investment businesses which do not cause harm to the natural environment and the society for the benefit of the Union and its citizens;

Development of responsible and accountable businesses is also in the mandate of the Myanmar Investment Commission (Government of Myanmar, 2016). Lao PDR is considering establishing a focal point on RBC within the government and is looking to improve its existing regulatory framework on RBC. The investment law of Lao PDR (art. 69) includes an extensive section that imposes obligations upon investors, which is more detailed than what is commonly encountered in investment laws. In addition to general obligations, art. 70 is fully dedicated to environmental obligations. Specific recommendations were made to both Viet Nam and Lao PDR in the context of the OECD *Investment Policy Reviews* in both countries.

Cambodia should meet these trends head on and ambitiously. While signalling alone cannot be expected to resolve ongoing issues in Cambodia or overcome country risk perceptions, clearly communicating expectations on RBC in the new law can go a long way in sending a message to investors that the government is committed to creating a level-playing for businesses that are responsible. Beyond setting out broad characteristics for responsible investment, this could specifically entail an expectation that investors adopt an approach consistent with international standards on RBC, such as those contained in the OECD *Guidelines* and UN *Guiding Principles*. It could also re-affirm and reiterate expectations enshrined in other laws, such as for example obligations related to impact assessments, taking due account of not duplicating regulation.

Utilising Cambodia's vibrant civil society as a strength

Signalling about the importance of RBC is only a first step and needs to be backed by swift reform to ensure that an adequate legal framework that protects the public interest and underpins RBC exists (some areas that could be prioritised are discussed in the sections below). In light of capacity constraints in implementing existing laws and regulations in the immediate term, the government should consider building on its existing experience with tripartite engagement and cultivating more multi-stakeholder engagement on RBC. The ongoing dialogue and engagement around the draft *Environment and Natural Resources Code*, which seems to be largely inclusive and substantive, is another indicative example. Despite the often tense engagement around human rights, this experience is valuable and should be viewed as a strength by all actors, including the government.

Experience from the countries that participated in the 2015 update of the *Policy Framework for Investment*, on which this review is based, shows that greater participation of stakeholders in policy design and implementation leads to better targeted and more effective policies. Policy is more likely to be sound and not produce unintended side effects if it is formed in a structured and transparent way that gathers input from all interested parties. The experience from OECD work on RBC complements this – a multi-stakeholder approach is one of the best ways to address complex and systemic challenges that may lead to human rights, labour, environmental and other negative impacts of business operations. Getting the buy-in from a variety of actors enables a constructive and problem-solving mind-set and helps move away from finger-pointing toward building a consensus on how best to implement and promote RBC principles and standards.

For example, the revision of the OECD *Guidelines* in 2011 was based on a one-year multi-stakeholder update process which included intensive consultations with a wide range of stakeholders and partners[17] (OECD, 2014). The experience to date from OECD sector projects in minerals, extractives, textiles, and agriculture supply chains suggests the same; the mode of engagement is built into project design. Similarly, 41% of National Contact Points for the OECD *Guidelines* have advisory bodies that are generally multi-stakeholder platforms and can include representatives from trade unions, NGOs, enterprises or academia. Many advisory bodies also include representatives of other government agencies (OECD, 2016a).

The Cambodian government should consider working with stakeholders to develop a national action plan (NAP) on RBC in order to prioritise and advance reforms needed to ensure that an adequate legal framework that protects the public interest and underpins RBC exists. This recommendation is in line with international good practice – many countries are developing or have developed NAPs on business and human rights or RBC[18], including in ASEAN (Table 8.1), following a recommendation by the UN to do so as part of the state responsibility to disseminate and implement the UN *Guiding Principles*. NAPs are useful tools for promoting coherence on RBC within the government, engaging with stakeholders, and demonstrating commitment to RBC. Governments are using NAPs to highlight their policies on RBC and signal the need for future action. The UN Working Group on Business and Human Rights has set up a dedicated webpage to provide easy access to existing plans, as well as key public information and analysis on the various stages of NAP development, implementation and follow up (UN OHCHR, 2017). The Working Group has also produced guidance on developing NAPs.

The process of developing a plan would be a concrete way for the Cambodian government to demonstrate to both its international partners and domestic constituencies that it is committed to promoting and enabling better business practices and improving the overall business environment. The plan should feed into the objectives set out in the IDP and be action-based and time-bound. Particular attention is warranted to ensure that those communities directly affected and which may not always have a seat at a table are included in the process from the outset. This includes civil society more broadly. It would also be worthwhile to examine in this context if the establishment of multi-stakeholder initiatives (Box 8.2) would be appropriate in Cambodia for addressing sector-specific issues, keeping in mind the capacity of the civil society to meaningfully and effectively engage in such initiatives. CDC – within its strengthened mandate and responsibilities for the implementation of the IDP, including engagement with the private sector and streamlined functions for the Cambodia Rehabilitation and Development Board and Cambodia Investment Board – could take on a leadership role in this regard.

Table 8.1. Status of development of National Action Plans in ASEAN Member States

	Malaysia - in the process or committed to it
	Myanmar - in the process or committed to it
	Thailand - in the process or committed to it
	Philippines - promoted by the National Human Rights Institution or civil society
	Indonesia - promoted by the National Human Rights Institution or civil society
X	Viet Nam* - none
X	Lao PDR* - none
X	Cambodia - none
X	Brunei Darussalam - none
X	Singapore - none

Note: *Recommendation to develop an NAP made by the OECD through the Investment Policy Reviews
Source: UN OHCHR, 2017.

Box 8.2. Multi-stakeholder initiatives and responsible business conduct

A large number of multi-stakeholder initiatives (MSIs) have emerged in the past two decades to help business identify and avoid adverse environmental, labour and human rights impacts in global supply chains. MSIs are one way of formalising multi-stakeholder engagement to address specific risks in the sector or to implement specific steps in the due diligence process. While by definition MSIs include the participation of stakeholders, there is a wide variance in their members and objectives. At the 2016 Global Forum on Responsible Business Conduct, experts and participants from national and international MSIs reflected on their experiences to date, and drew broad lessons to help strengthen collaborative engagement on RBC in the future, including helping countries strengthen MSIs and how MSIs can measure their effectiveness and impact. Main takeaways include:

- Governments should lead by example. They can also act as an honest broker to bring groups together, help launch MSIs and cooperate at the international level to scale up initiatives. They should also put into practice what they are advocating, for example by applying recommended standards into public/government procurement.
- MSIs are neither a panacea, nor a means for governments and companies to outsource their responsibility. The scope and purpose of an MSI needs to be clearly articulated. A smart mix of regulatory and voluntary measures is typically most effective.
- The voice of women and communities which MSIs intend to help needs to be built into MSI structures, decision making and activities. Effectiveness can be compromised if representatives do not have a mandate, or expertise.
- MSIs may give civil society a seat at the table and allow them to engage in development decisions. But civil society may be seen as less credible or co-opted by others if MSIs are not effective.
- Many MSIs have internal governance shortcomings, particularly on compliance, enforcement and dispute resolution. On the ground research is needed to see if MSIs are effective from the perspective of the communities they are intended to help. Most

MSIs are not measuring their impact on human rights or on those directly affected by the sector concerned. In the interim, the design frameworks of MSIs can provide a gauge to their effectiveness.

Key takeaways from experts included that MSIs need to have a greater focus on measuring the impact of the initiative on communities and the environment; and need to strengthen internal governance, ensure enforcement / compliance (in the case of standards type MSIs) and be aware of consequences. Those directly affected, particularly under-represented voices from women, the young and indigenous peoples, should be part of the MSI structure and decision-making process.

Source : Adapted from OECD (2016b)

Reframing the conversation around existing investments

Beyond forward-looking strategic actions that the government can take on RBC, there is also a need to speed up action to address the negative impacts of existing investment. High-profile land disputes, labour unrest and frayed industrial relations suggest that the benefits of existing investments are not being maximised. The government has been criticised in the past for its role in these conflicts and, despite attempts to address some issues, major challenges remain in terms of establishing and enforcing an adequate legal framework that protects the public interest and creates an enabling framework for RBC. This is in part due to the highly politicised nature of human rights in Cambodia. While the current political situation in Cambodia is outside of the scope of this review insofar as it does not concern investment, respect for human rights should not be viewed solely as a social or political matter; it is also an economic matter that affects the predictability and stability that investors value in an business environment. As discussed in the section above, enterprises must obey domestic laws and respect human rights wherever they operate even if enforcement of such laws is lacking. Cambodia's continued success in attracting investment could be called into question in the medium-term without due consideration to how social and environmental issues affect the business climate. Even a perfunctory glance at Cambodia’s position in the main international rankings related to RBC, such as the ones on human rights or corruption, may serve as a deterrent for investors, particularly when compared to its neighbours.

Supporting non-judicial grievance mechanisms

Despite recent efforts by the government, including cancelling some economic land concessions and establishing a working group in the Ministry of Land Management and Urban Planning to handle complaints and monitor the disputes (Phnom Penh Post, 2016a), land rights continue to be a major risk for businesses operating in Cambodia even when apparent clarity exists on tenure rights (see for example Section VI of UN (2016a)). These highly controversial cases have gained significant international attention and have been raised in various international fora. The World Bank even instituted a lending freeze to Cambodia in 2011 due to evictions related to a project in Boeung Kak Lake (Reuters, 2011).[19] Complaints have also been considered in the context of the grievance mechanism under the National Contact Points (NCPs) for the OECD *Guidelines*. In 2012, the US National Contact Point considered a complaint related to alleged human rights violations in the sugar industry related to forcible evictions and lack of social or environmental impact assessments and resettlement plans. The NCP offered its good offices to facilitate a discussion between the parties, but the dialogue did not take place in light of the ongoing law suit in UK Commercial Court related to the case (OECD, 2012). Another complaint related to the sugar industry in Cambodia has been submitted to the Australian NCP (OECD Watch, 2014).

Two cases citing land rights and forced evictions, among other issues, are also being considered by the Office of the Compliance Advisor/Ombudsman (CAO), which is the independent recourse mechanism for the IFC and MIGA, the private sector lending arms of the World Bank Group (CAO, 2016). A legal brief alleging that land rights violations amount to crimes against humanity was also submitted to the International Criminal Court (ICC) in 2014 (Global Diligence, 2016; Guardian, 2016). A new policy paper issued in September 2016 by the ICC Office of the Prosecutor (2016) on case selection and prioritisation suggests an increasing space for prosecution of social and environmental issues, citing that particular consideration will be given to prosecuting "crimes that are committed by means of, or that result in, inter alia, the destruction of the environment, the illegal exploitation of natural resources or the illegal dispossession of land." These cases illustrate the highly controversial and political nature of land issues in Cambodia which cannot be ignored or understated. But, as the experience of UN OHCHR shows, introducing practical and problem-solving methods such as negotiation, mediation and arbitration could facilitate resolution of issues in the short term. This should be without prejudice to ongoing efforts to establish accessible, reliable and transparent land administration, secure and well-defined land rights and competent, efficient and independent institutions to resolve land disputes (see Chapter 5 on the Protection of Investors in Cambodia).

CDC's strengthened role and interest in minimising the risks that investors face are an opportunity to help reframe the conversation around the impacts of investments. Engaging with stakeholders to provide meaningful and timely opportunities for them to express their views in relation to planning and decision-making for projects or other activities that may significantly affect them is a key component of RBC (Box 8.3). As a complement to establishing an Ombudsman office and consolidating the trouble-shooting Committee for Special Economic Zones, CDC should establish a procedure through which affected communities can submit reservations and complaints about existing investments, including also in special economic zones.

The process of submitting a reservation or complaint should be easily accessible, with clear and time-bound actions for follow up. This would allow the government to gain a better understanding of the environmental and social impacts of investments. As a possible venue for resolving issues, the government may consider strengthening and extending the mandate of the Arbitration Council to cover issues beyond labour issues and to allow binding decisions. Promoting mediation processes before introducing binding arbitration would be advisable in order to keep both the flexibility and the power of the Council.

CDC is also in a unique position to promote and support an operational-level grievance mechanism and enhanced stakeholder engagement. Both are an integral part of RBC and communicating about these expectations to businesses would be beneficial. One clear venue for doing so is the strengthened Government and Private Sector Forum as envisioned by the IDP (see Chapter 4).

Box 8.3. Land and responsible business conduct

Secure and well-defined land rights encourage new investments and the upkeep of existing investments, as well as sustainable land management. Investors need to be confident that their land rights are properly recognised and protected and that they are protected against forced evictions without compensation. Tenure security does not necessarily require private ownership or a formal title. Simple land use rights, such as lease rights, can provide tenure security if they are clear, of specific duration and the contract cannot be unilaterally broken.

Tenure security is not so much derived from the legal status of the rights held, as from social consensus on the legitimacy of these rights and the reliability of mechanisms for settling disputes should they arise. Acquiring land tenure rights is often a complex and slow process for large investors and measures to facilitate land acquisition can effectively facilitate investment. At the same time, appropriate safeguards should protect existing legitimate tenure rights to ensure, for instance, that land negotiations or transactions do not lead to the displacement, the loss of livelihoods, and more limited access to land for the local population. The legislation can provide for ex ante and ex post environmental and social impact assessments for land acquisitions exceeding a certain area to ensure that land allocation follows a transparent and inclusive process.

The core questions that governments need to consider regarding land tenure concern the existence of an accessible, reliable and transparent land administration. Additional questions on RBC address:

- What measures are in place to ensure transparency and information disclosure related to land-based investments, including transparency of lease/concession contract terms?
- What mechanisms are in place to conduct meaningful, effective and good-faith consultations with land rights holders, in particular indigenous peoples or local communities?
- What measures are in place to minimise the physical and/or economic displacement of legitimate tenure right holders?
- Under what circumstances can the government expropriate land tenure rights holders?
- What measures are in place to ensure prompt, adequate and fair compensation of land tenure rights holders in case of expropriation? How is the value of compensation, including the land value, determined?
- What measures are in place to minimise adverse environmental impacts and promote sustainable land use?
- Additionally, questions related to how the government ensures adequate compensation for land acquisitions and resettlement as part of large-scale investment projects are of relevance.

Source : Adapted from OECD (2015)

Improving how environmental and social impacts are considered and addressed

Chapter 10 describes in detail the extent of Cambodia’s existing measures for protecting the environment and promoting green growth. Taking due account of the need to protect the environment and public health and safety is a pillar of acting responsibly under international RBC principles and standards (see OECD *Guidelines* Chapter V). This entails sound environmental management to control direct and indirect environmental impacts of business activities; establishing and maintaining appropriate environmental management systems; improving environmental performance; being transparent about the environmental impacts and risks, including also reporting and communicating with outside stakeholders; being proactive in avoiding environmental damage; working to improve the level of environmental performance, even where this may not be formally required; and training and education of employees with regard to environmental matters, particularly when it comes to human health and safety.

Environmental damage remains an issue in Cambodia, mainly due to weak enforcement and monitoring, as well as low levels of awareness and compliance with laws and regulations. Cambodia ranks 150 out of 180 on the 2018 Yale *Environmental Performance Index,* which ranks countries' performance on high-priority environmental issues in two areas: protection of human health and protection of ecosystems, suggesting an urgent need to close the enforcement and compliance gaps (Table 8.2), only slightly above Lao PDR, but significantly below Viet Nam and now Myanmar.

Table 8.2. Rank of ASEAN members, 2016 Yale Environmental Performance Index

Rank	Country	2018 Score
49	Singapore	64.2
53	Brunei Darussalam	63.6
75	Malaysia	59.2
82	Philippines	57.7
121	Thailand	49.9
132	Viet Nam	47.0
133	Indonesia	46.9
138	Myanmar	45.3
150	***Cambodia***	***43.2***
153	Lao PDR	42.9

Source: 2018 Yale Environmental Performance Index.

Integrating environmental and social objectives with economic ones is not a matter of either/or for the economy (Box 8.4). Cambodia is among the world's most climate-vulnerable countries, subject to increasingly severe droughts and floods (UNDP, 2016). The current elaboration of a draft environmental code in Cambodia is an opportunity to clarify and strengthen how and when the impacts of proposed investment projects are assessed and to increase transparency on environmental and social impact assessments (ESIAs). Feedback on the draft code has been largely positive; it envisions more power for local communities to manage and protect land, introduces a clear redress structure for violations, and allocates more land for conservation areas (Cambodia Daily, 2016).

These provisions, if reflected in the final law, would be an important step for helping overcome issues related to environmental and social impact assessments in the past, such as, for example, implementation too late in the project development process; underestimation of impacts; lack of coordination among government agencies and clarity with respect to their responsibilities and authority; resource and capacity limitations; insufficient public participation; and a lack of political will to enforce the law (Schulte et al*.*, 2014). In light of these challenges and the issues related to law enforcement in Cambodia, more public participation in such assessments may be warranted. The Regional Technical Working Group on environmental impact assessments, which is comprised of 25 government and non-government members from Cambodia, Lao PDR, Myanmar, Thailand, and Viet Nam, is currently drafting the Regional Guidelines on Public Participation in Environmental Impact Assessment (Mekong Citizen, 2016). Such efforts should be supported and encouraged.

The extent of business responsibilities for protecting the environment should also be communicated at both national and provincial levels. Awareness of community members and stakeholders about good project management practices and environmental protection seems in general quite low.

Box 8.4. Debunking the pollution haven hypothesis

A 2016 OECD report Do environmental policies affect global value chains? A new perspective on the pollution haven hypothesis that examined the impact of environmental policies on global value chains has shown that countries that implement stringent environmental policies do not lose export competitiveness when compared to countries with more moderate regulations. High and low pollution industries and trade in manufactured goods between 23 advanced and six emerging economies from 1990-2009 were examined, and data on the domestic value added in exports from the OECD-WTO Trade in Value Added (TiVA) dataset were included in the analysis.

The findings suggest that emerging economies with strong manufacturing sectors could strengthen and implement environmental laws without denting their overall share in export markets. High-pollution or energy-intensive industries would suffer a small disadvantage, but this would be compensated by growth in exports from less-polluting activities. These results are compelling evidence against the so-called Pollution Haven Hypothesis, which suggests that tightening environmental laws often prompts manufacturers to simply relocate some production stages to countries with lower regulations

Source : Koźluk and Timiliotis, 2016

Better industrial relations can lead to productivity gains

The government has recognised in the IDP that an unskilled labour force and issues with industrial relations are obstacles for further development of the industrial sector. Experience from the garment sector is indicative. The politicised environment around wages and working conditions is directly affecting productivity of the sector in the short term, for example through lost working days, as well as in the long-term by deterring investment in factors needed to ensure that Cambodia remains competitive on a regional or international stage, for example skills and training. This is an issue considering the external factors that will affect the future of the sector and the existing gap between wages and labour productivity (see Chapter 3). The share of domestic value added in exports in Cambodia is lower than in other ASEAN countries. It is important not to draw a negative parallel between improving working conditions and staying competitive – these are not two mutually exclusive goals. Evidence from BFC has shown that garment factories that invest in their workers and better industrial relations are also more productive. This is also true in a broader sense – responsible business is good business (Box 8.5).

Cambodia's garment sector is at a crossroads. Building good industrial relations in the garment sector would introduce predictability and stability, crucial components for future industry growth and upgrading in the value-chain. A clear vision for the future of the sector is needed for industrial upgrading and skills and technology transfer. A plan for the industry was included in the 2014-18 Cambodia's Trade Integration Strategy, but it appears that a more action-oriented plan would be prudent. Already in 2014, the Strategy recognised that a concerted public-private effort would be needed to broaden the scope of productive and value-added activities in the sector. BFC stakeholders in the latest reporting period underlined the same need for a joint strategic vision (BFC, 2016b).

Box 8.5. Responsible business is good business

RBC can contribute to reducing costs and avoiding legal liability. In one study, nearly 20% of the 2 500 sampled companies were found to be subject to sanctions related to their social or environmental performance in 2012-13, amounting to penalties upwards of EUR 96 billion (Vigeo, 2015). Likewise, a recent Harvard University study found that for a mining project with capital expenditure of USD 3-5 billion, the costs attributed to delays from community conflicts can be on average USD 20 million per week due to lost productivity from temporary shutdowns or delays (Davis and Franks, 2014). RBC can also lead to increased returns, lower cost of capital, and higher employee retention. One study found that better business practices have the potential to reduce the cost of debt for companies by 40% or more and increase revenue by up to 20% (Rochlin et al., 2015). More broadly, a cross-sector study tracking performance of companies over 18 years found that high sustainability companies – that is those with strong environmental, social, and governance systems and practices in place – outperform low sustainability companies in stock performance and real accounting terms (Eccles et al, 2011).

Suppliers of multinational enterprises (MNEs) may find that following RBC principles and standards gives them an advantage over businesses that do not, as they are able to respond to and address concerns that may come up in due diligence of the MNE when evaluating supply chain risks. Investors from the 48 countries that adhere to the OECD Guidelines are subject to them wherever they operate, including throughout the supply chain and in relation to business relationships. This means that a large majority of the global supply chain is covered by the OECD Guidelines as these investors account for 75% global foreign direct investment (FDI) outflows and 58% of global FDI inflows between 2010 and 2015, as well as 81% of global FDI outward stock as of end 2014 (OECD/IMF, 2016). Similarly, businesses that want to access markets of these 48 countries are also subject to the OECD Guidelines, and, in some cases, actual regulation related to RBC.

Many businesses have embraced RBC expectations and are actively working toward promoting RBC. For example, the B20, which represents the entire business community in G20 countries, included RBC and Anti-Corruption as an explicit priority for Germany's G20 Presidency in 2017 (B20, 2016).

The government should exercise its convening role and bring together employers, workers, international brands and experts to agree on specific actions to ensure the competitiveness of the sector. In line with the main theme of this chapter to consider RBC as a strategic move, it would be worthwhile to consider the advantages of ambitiously embracing global developments on RBC and discuss ways in which Cambodia could be the leader in applying the due diligence framework enshrined in the OECD *Guidelines* and the UN *Guiding Principles* (Box 8.6). As was recognised in the 2014 Strategy, given that most factories have minimal investments in fixed assets and can easily relocate if local operating costs are no longer competitive, it is imperative that Cambodia safeguards and enhances its reputation as a place to source from responsibly. The government could endorse the OECD *Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector* and consider supporting a pilot project on the application of the guidance in Cambodia. An awareness raising and consultation event on the guidance was hosted by the Ministry of Labour and Vocational Training in December of 2016 in Phnom Penh. Application of the guidance in Cambodia would not be a duplication of efforts. There is a trend in the sector toward more collaboration in addressing common challenges. Due diligence both complements and diverges from existing industry practice and the ongoing government, industry and stakeholder initiatives in Cambodia can be leveraged in order to find a way forward.

Box 8.6. Due diligence framework in the garment and footwear sector

The 2016 OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector clarifies what RBC and due diligence mean in-practice for companies operating in the garment and footwear sector. Due diligence both complements and diverges from existing industry practice. It is a process (rather than a standard) through which businesses identify, prevent and mitigate negative impacts, including those related to human rights, labour, and the environment.

Impacts across the full length of the supply chain are considered, not just in cut-make-trim. The process also includes 'internal due diligence', or the practice by which companies assess their own practices, including purchasing practices, to determine whether their own activities may be contributing to non-compliance with international standards in the supply chain. There is an increased understanding of the role that purchasing practices can play in enabling or hindering improvements in conditions in the garment and footwear supply chain. Poor purchasing practices – including rushed orders, changes to orders and delays in payments – have been said to result in increased overtime and outsourcing to non-certified suppliers. Suppliers often charge that purchasing practices of buyers pose a challenge and a barrier for making financial investments in upgrading factories and acting responsibly.

A key characteristic of due diligence is that it is the responsibility of all actors in the supply chain. All companies, including retailers, brands, manufacturers, buying agents, exporters, and global commodities merchandisers, should carry out due diligence and are encouraged to collaborate where appropriate in order to reduce duplication of efforts and to scale-up effective measures. Additionally, the risk-based nature of due diligence means that companies are encouraged to prioritise the order in which they take action based on the likelihood and severity of the impact and that the extent of efforts should be proportionate to the risk.

More broadly, one area where more focus would be advisable is in resolving existing labour tensions through parallel efforts to enforce the labour laws in a fair manner and to promote better industrial relations. Cambodia's Constitution makes a reference to the Universal Declaration of Human Rights and the related covenants and conventions (art. 31). Cambodia has also ratified eight out of nine core international human rights instruments, including the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights (UN OHCHR, 2016d). The International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families was signed in 2003 but is awaiting ratification. The country has also ratified 13 ILO Conventions, including the eight fundamental Conventions and five Governance Conventions (ILO, 2016a).

Concerns have been voiced by international organisations, some trade partners, and civil society that the recent laws on telecommunications, NGOs and trade unions are overly restrictive and could infringe on the freedoms of association, expression and assembly.[20] ILO (2016b) has in particular noted regarding the *Trade Union Law* that, while it is for its Supervisory Bodies to examine the law in order to assess compliance with ratified ILO Conventions, there is a need for effective tripartite consultations and even advisory mechanisms in order to ensure a common understanding of the law's contents and its application. As already recommended in this review, meaningful stakeholder engagement can be viewed as strength rather than weakness and used as a tool to address perception issues and de-escalate tensions. The ongoing discussion around the draft universal minimum wage law is illustrative. Despite the fact that instituting a minimum wage beyond the garment sector is a proposal not opposed on substance, the way that stakeholder concerns are being addressed has already gained some criticism from trade unions and civil society groups (Phnom Penh Post, 2016b).

Lastly, as the government is thinking through what "smart" incentives could be a part of the new investment law, specific attention should be given to incentives that would encourage RBC and investment in skills. Under international RBC principles and standards, enterprises are expected to encourage local capacity building through close co-operation with the local community and human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees. Considering Cambodia's highly mobile workforce, the incentive structure for enterprises to invest in skills is not currently in place. Communicating to enterprises that contributing to human capital formation (in particular by creating employment opportunities and facilitating training opportunities for employees) is a pillar of RBC – and recognising those that do it – could help overcome the perception problem.

Building on the recommendations from Chapter 3, training on RBC principles and standards, including the OECD *Guidelines* and the UN *Guiding Principles*, should be included in industry-specific training programmes, in collaboration with the business community, educational institutions, civil society and international organisations that are already delivering similar training. This could encompass everything from awareness raising about the obligations in the global supply chain to capacity building exercises supporting cross-sectoral learning efforts (for example, experience from promoting due diligence in the garment sector could be informative for applying due diligence in agriculture, construction or tourism). This type of training and awareness-raising with business leaders could also be useful in promoting a wider understanding and recognition of the importance of RBC.

Notes

[1] Increasingly, CSR is used in a similar way as RBC. For example, the latest strategy of the European Commission A renewed EU strategy 2011-14 for Corporate Social Responsibility uses CSR in broad terms in line with RBC. Many times the difference between the two is an issue of semantics in practice. Both RBC and CSR (if used beyond philanthropy) aim to promote the same idea - that businesses should consider the impact of their activities beyond just the impact on the company itself.

[2] Cambodia's textiles and garment industry has historically benefited from the Multi-fibre Arrangement (MFA) quota system and the WTO Agreement on Textile and Clothing which replaced the MFA in 1994 as a transitional instrument for removal of quotas by 2005. According to GMAC (2016), investors from China, Hong Kong (China), Macau, Malaysia and Singapore started investing in Cambodia in the mid-1990s in order to take advantage of favourable investment conditions, namely the lack of quota restrictions for the US market under the MFA (compared with relatively high restrictions for competitor countries like China and Viet Nam) and later the status of Most-Favoured Nation in the US and access to EU market under the Everything but Arms (EC, 2016a; WTO, 2016a; ODI, 2005).

[3] This remains the case. In 2014, latest year for which data is available, top three importers of textiles and clothing were EU (33% of world total) United States (14%) and Japan (5%). In 2000, the percentages were 38%, 23% and 7% respectively. Source: WTO Statistics Database - Time Series.

[4] USTR (2016); WTO (2016b); ODI (2005).

[5] For example, through increased compliance with safety standards and the labour law.

[6] See as an example reports by the Stanford Law School and Worker Rights Consortium (2013); the Cambodian Centre for Human Rights (2014); and Human Rights Watch (2015).

[7] This issue of institutional capacity has been recognised by the government in several policy documents and is commonly observed both in ASEAN and in comparable lower middle-income economies.

[8] This approach has not come without challenges. The already-mentioned 2015 World Bank assessment looked at the effectiveness of mandatory vs. voluntary subscription in the Better Work programme and has found that mandatory approach does have its drawbacks, for example, subcontracting factories which do not require export permits are not covered and the mandatory subscription does not incentivise factories to use Better Work advisory services (World Bank, 2015a). These issues, however, touch on a more fundamental question about the role of third-party programmes like BFC, particularly around their monitoring vs. advisory and capacity building roles – in other words, BFC should not and does not substitute for the role of formal labour inspectorates.

[9] According to the 2016 OHCHR annual report, as of June 2016, compensation agreements were being finalised related to one sacred site and the company has made clear and time-bound commitments to review all pending land claims (UN OHCHR, 2016a).

[10] Available at ASEAN CSR Network website: http://asean-csr-network.org/c/newsroom/39-our-organisation/resources/1099-responsible-business-conduct-cambodia-booklet-eng-khmer-versions. The ASEAN CSR Network has a presence in Cambodia and supports the CSR Platform and Cooperation Committee for Cambodia.

[11] According to its website (2016), CAMFEBA represents over 2,000 employers, comprising of 11 business associations, 264 individual companies, and 25 non-profit organisations. It is recognised as the sole employers' representative from Cambodia at the International Labour Conference and is a member of the International Organization of Employers, the ASEAN Confederation of Employers and the Confederation of Asia-Pacific Employers.

[12] ADB (2016b) estimates that more than 70% of Cambodians still live on less than $3 a day. A 2014 report by the World Bank notes that a loss of just $0.30 (around 1,200 riel) per day in income would throw an estimated three million Cambodians back into poverty, doubling the poverty rate to 40%.

[13] The Rectangular Strategy reaffirms the government's commitment to sustainable development and cites strengthening corporate governance and CSR as a priority for strengthening the private sector and promoting investment and business while the IDP set out specific policy measures to promote strategic sectors and industrial development, including investment (Government of Cambodia, 2015, 2013).

[14] See, for example, Eurocham Cambodia WhiteBook (2016b), stating "where regulation is lacking, ambiguous, or simply not enforced, this creates opportunities for unfair competition - the single most cited deterrent to expanded European investment in the Kingdom"; US Department of State (2016) Investment Climate Statement, stating "these incentives have not been able to attract significant U.S. capital due to various factors including pervasive corruption, a limited supply of skilled labour, inadequate infrastructure (including high energy costs), and a lack of transparency in government approval processes"; and data from JETRO (2015) investment needs survey.

[15] A 2014 study on CSR and human rights commissioned by the ASEAN Intergovernmental Commission on Human Rights (Thomas & Chandra, 2014) found that RBC is a relatively new subject in ASEAN in general, with a low level of awareness among business leaders and policy

makers. Majority of CSR activities remain philanthropic in nature, although awareness seems to be increasing.

[16] OECD research shows that more than three-fourths of international investment agreements concluded in 2008-13 include language on RBC (mainly free trade agreements with investment protection provisions) and virtually all of the investment treaties concluded in 2012-13 include such language (Gordon et al., 2014). The major functions of such treaty language are, in the order of prevalence: (i) to establish the context and purpose of the treaty and set forth basic responsible business conduct principles through preamble language; (ii) to preserve policy space to enact public policies dealing with responsible business conduct concerns; and (iii) to avoid lowering standards, in particular relaxing environmental and labour standards for the purpose of attracting investment.

[17] For example, all non-adhering G20 countries were invited to participate on an equal footing; they made important contributions, as did participants in the regional consultations in Asia, Africa, Latin America, and the Middle East and North Africa. Business and Industry Advisory Committee to the OECD, Trade Union Advisory Committee, and OECD Watch represented the views of business, worker organisations, and non-governmental organisations. The UN Secretary-General's Special Representative on Business and Human Rights, Professor John Ruggie, also provided extensive input as did the ILO and other international organisations. Multiple OECD committees contributed to the revisions of the relevant specialised chapters: Competition; Consumer Policy; Corporate Governance; Employment, Labour and Social Affairs; Environment Policy; Fiscal Affairs; and, the Working Group on Bribery in International Business Transactions.

[18] A notable example of an NAP on RBC is the draft US National Action Plan on Responsible Business Conduct. Announced by President Obama as one of the core activities under the US Global Anti-corruption Agenda, the US NAP on RBC will be consistent with the OECD Guidelines and the UN Guiding Principles and is expected to address ways in which the US government can promote and encourage established RBC norms related to, but not limited to, human rights, labour rights, land tenure, anti-corruption, and transparency (US Department of State, 2015; White House, 2014).

[19] The World Bank (2016) announced in May 2016 that it is re-engaging with Cambodia, a decision that has not been without criticism, including from the US government and civil society organisations. See US Department of Treasury (2016) and VOA (2016).

[20] See for example statements by the ILO (2016b), UN (2016b), UN OHCHR (2016c); news article and civil society positions, Reuters (2016), Diplomat (2016), CCHR (2016); resolution by the European Parliament (2016); climate statement by US Department of State (2016).

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Chapter 9. Investing in Cambodia's infrastructure

This chapter looks at the improvements in Cambodia's infrastructure over time and the continuing needs for new investment to keep pace with rapid economic growth. It suggests that the policy, legal and institutional frameworks governing private investment in infrastructure are ripe for reform and that, given a decline in donor-financing for infrastructure, private sector involvement will have to be increased from its current low level.

Summary

Rapid economic and population growth, coupled with past degradation of infrastructure during the civil conflict as well as subsequent underinvestment, have seen infrastructure bottlenecks emerge as critical constraints to growth and social inclusion (ADB, 2014a). Although investors note a sharp improvement in the quality and supply of infrastructure in recent years, transport and electricity still figure among the top ten constraints – albeit significantly farther down the list in the latest Enterprise Survey (World Bank, 2018).

Infrastructure bottlenecks hamper efforts to successfully diversify the economy and to integrate more fully into regional and global value chains (see Chapter 3). Ramping up investment in Cambodia's infrastructure networks will be crucial, not only to sustain robust rates of economic growth, but also for translating this into broad-based improvements in living standards while ensuring long-term climate resilience and environmental sustainability.

As rapid economic growth continues, donor-financing will further decline in relative importance, underlining the need to mobilise domestic public and private resources, as well as foreign capital, for infrastructure investment. Private sector investment has so far been limited, largely confined to power generation and international air transport and small-scale projects, but public-private partnerships (PPPs) are becoming increasingly prevalent. At the same time, the policy, legal and institutional frameworks governing private investment in infrastructure are ripe for reform. The National Strategic Development Plan 2014-18 sets out short-term priorities for infrastructure. A *Law on Concessions* was promulgated in 2007, but the implementing sub-decree was never approved and accompanying policy and institutional frameworks have not been sufficiently developed. The government has recently made high-level political commitments to adopt necessary reforms. A central PPP unit and risk management unit are to be integrated into the Ministry of Economy and Finance, and a viability gap fund is being considered to subsidise or guarantee investment projects to make them bankable for the private sector.

Aspects of Cambodia's infrastructure challenges are also covered in other chapters. Chapter 3 looks at the role of trade facilitation and logistics in improving competitiveness and promoting diversification. Chapter 8 looks at responsible business conduct, including issues related to resettlement of affected populations from infrastructure projects Chapter 10 considers how to promote further investment in renewable energy, and Chapter 11 looks at how development partners have contributed to private sector development in Cambodia, including through support for infrastructure.

Policy recommendations

- *Improve execution of infrastructure plans*. While long-range infrastructure planning is in evidence to a certain extent as part of successive National Strategic Development Plans and sectoral Masterplans, much of the execution would appear to be ad hoc, with competitive tendering for infrastructure procurement as the exception rather than the rule, whether delivered as a public-private partnership or through traditional procurement. In either case, no detailed pipeline of forthcoming projects currently exists.

- *Proceed with plans to revamp the legal, policy and institutional framework governing PPPs for infrastructure projects*. Transparency, competition and a focus on value-for-money should be the most critical elements against which the

success of the government's ambitious plans to mobilise PPPs for infrastructure should be judged. The procurement of medium- to large-scale infrastructure projects through non-competitive tendering processes should be avoided.

- *Systematically involve end-users, affected communities, private investors and other relevant stakeholders* from the earliest stages of infrastructure projects planning so as to ensure that their needs – as well as social, economic, environmental and governance risks – are correctly assessed and addressed, and adequately reflected in the contractual structures. The revamped policy, legal and institutional frameworks for PPPs should be responsive to affordability constraints and be designed to ensure responsible business conduct in all PPPs.

Current status of Cambodia's infrastructure

Investors note significant recent progress in infrastructure…

Business surveys consistently attest to improvements in infrastructure provision in Cambodia. In a survey of Eurocham members, 43.5% mentioned infrastructure as an area with significant improvements, the same percentage as in the earlier 2015 survey (Eurocham, 2017). The latest World Bank Enterprise Survey saw electricity fall to tenth place as a constraint on investment, compared to first place in the 2012 survey (World Bank, 2018). Only 2% of respondents felt it was the most important impediment and another 7% listed transport.

…but Cambodia still lags behind most regional peers

Cambodia ranks 106th of 137 countries overall in the World Economic Forum's *Global Competitiveness Report* 2017-18 in terms of the quality of its overall infrastructure (WEF, 2017). Only half of the population has access to electricity, significantly below the rest of ASEAN with the exception of Myanmar (57%). As of 2014, it had the lowest proportion of paved roads as a percentage of total road length of any ASEAN Member State at 11%. While fixed-line telephone and broadband connectivity are among the lowest in the region, a highly competitive mobile technology sector has allowed Cambodia to leapfrog the fixed-line stage of development of its ICT infrastructure networks in recent years, achieving one of the highest rates of mobile cellular subscriptions in the region. Internet usage is still low, but is rapidly increasing, helped in great measure by the spread in mobile technology.

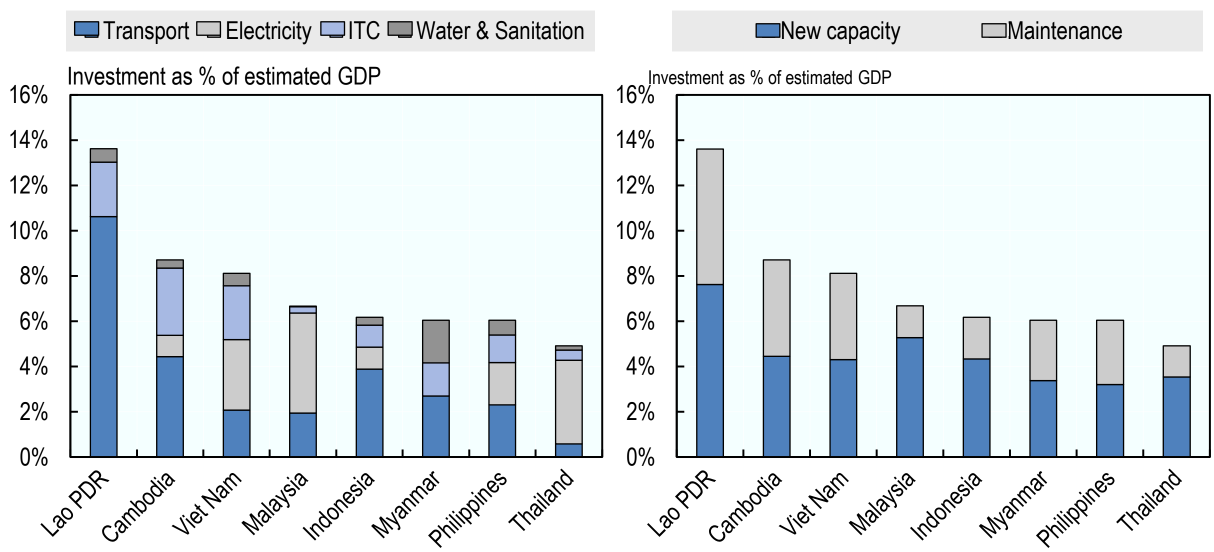
Infrastructure needs will increasingly depend on tax revenues and private capital

The National Strategic Development Plan (NSDP) 2014-18, which aims to maximise the benefits from ASEAN economic integration post-2015 and to achieve upper-middle-income status by 2030, reflects the importance of infrastructure development to economic growth, efficiency, competitiveness and diversification. The Plan identifies four priorities, taking stock of progress and setting out medium-term targets in each: (i) further rehabilitation and construction of transport infrastructure; (ii) water resources and irrigation system management; (iii) development of the energy sector; and (*iv*) the development of information and communication technology (ICT) (RGC, 2014).

Independent estimates of Cambodia's infrastructure investment needs to satisfy consumer and producer demand for infrastructure services have been put at USD 13.4 billion for

2010-20 (Figure 9.1).[1] This is equivalent to 8.7% of estimated GDP for the period, higher than all other countries in the region except Lao PDR. Of these requirements, around 51% would involve investment in the transport sector, 11% in the electricity sector, 34% in ICT, and 4% in water and sanitation. Meanwhile, these investments were estimated to entail roughly half (51%) for building new infrastructure capacity and half (49%) for maintaining existing capacity. Regional infrastructure projects to which Cambodia is a party would require additional investments. More recently, infrastructure investment needs have been conservatively estimated at USD 12-16 billion for 2013-20, equal to approximately 6% of GDP per year (ADB, 2012).

Figure 9.1. Infrastructure investment needs in Southeast Asia



Source: Bhattacharyay (2010).

Adequately addressing acute infrastructure bottlenecks and achieving the targets set out in the NSDP 2014-18 will likely necessitate much greater investment than is currently being undertaken, as well as new sources of financing. Over the past two decades, official development aid has been an important source of capital for infrastructure investment, amounting to nearly USD 1.2bn[2] during 2006-14 (see Chapter 11). But even as the absolute amount of ODA financing for infrastructure has continued to grow in recent years, the development partner-financed capital budget has been shrinking in relative importance, declining from 8.2% of GDP in 2011 to an estimated 5.1% of GDP in 2015, and a budgeted 4.7% in 2016 (World Bank, 2016a). Government-financed capital spending increased from 1.9% of GDP in 2014 to 2.3% of GDP in 2015 and was budgeted to increase by a further 0.5% of GDP in 2016 (World Bank, 2016a), but this has not been enough to plug the gap caused by the steep fall-off in donor financing (relative to GDP), meaning that overall (donor and government-financed) capital spending has continued to decline (relative to GDP) since 2011.

Alternative sources of multilateral and bilateral donor financing and concessional borrowing – notably the China-ASEAN Investment Cooperation Fund, the ASEAN Infrastructure Fund managed by the ADB and the Asian Infrastructure Investment Bank – may become more relevant in the future. Donor-financing is likely to remain an important fixture of Cambodia's infrastructure financing landscape for the foreseeable future, therefore, and it may make sense to utilise this funding source for constructing new infrastructure in remote or mountainous areas where such projects would have a demonstrably positive and significant impact in terms of social inclusion, even though they may be less likely to support alternative, revenue-generating sources of financing. Donor-funding could also be used to establish a standing 'maintenance fund' to prolong the life and improve the quality of infrastructure, while helping ensure maximum value for money, which should remain the over-riding concern.

Private sector investment in Cambodian infrastructure

Private sector investment in Cambodian infrastructure has traditionally been relatively limited, and confined largely to the power generation and international air transport sectors. However, recent years have seen an ad hoc proliferation of private operators across a range of infrastructure sectors, including primary roads, rail services, urban water distribution and mobile telephony as well as further instances in power generation, notably hydropower.

Public-private partnerships (PPPs) are becoming increasingly prevalent in Cambodia, notably in the energy sector but also in other sectors. The government is in the process of developing a policy framework to underpin the legal and institutional frameworks for infrastructure PPPs to move from an ad hoc and opaque approach to a more systematic, coherent, and transparent approach in line with international best practices. Currently, the *Law on Concessions* is the main legislation governing the operation of PPPs, but there is as yet neither dedicated secondary PPP legislation (i.e. a sub-decree to operationalise the *Law* with respect specifically to PPPs) nor an adequate institutional framework that could attract a wider range of private investors, including more foreign providers, through this channel. In fact, Cambodia is one of only 6 of the 82 countries included in the 2017 Benchmarking PPPs Procurement Report (World Bank, 2016b) in which the PPP regulatory framework relies exclusively on a concession law or act.

Judicious prioritisation of public spending – between, for instance, maintenance and construction, and between alternative capital investment projects – will also be important. Further strengthening of the rules and regulations surrounding capital investment projects, as envisaged by a public investment management assessment currently under discussion (World Bank, 2016a), should also allow for more strategic decision-making, and more transparency in procurement.

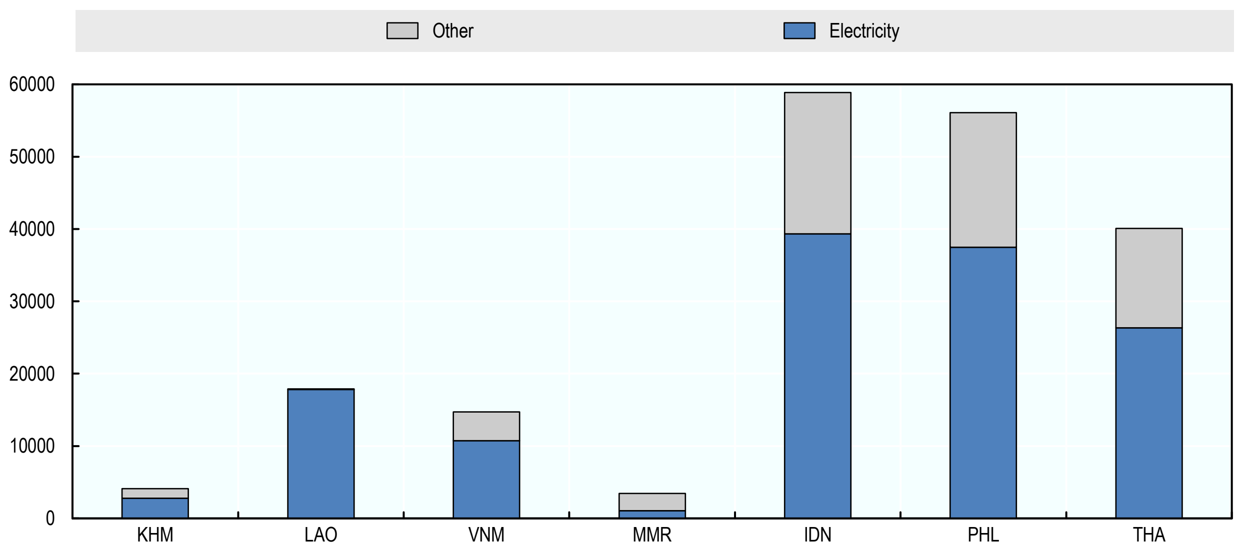
Limited private investments in infrastructure beyond the power sector

Often, a challenge to mobilise private investment in infrastructure is the government's lack of experience with PPPs and consequently its sometimes weak capacity to adequately select and implement projects in partnership with private investors. In general, in developing and emerging economies, such constraints are typically more acute for projects in the transport sector, although it varies across transport segments.[3]

Overall, Cambodia has one of the lowest levels of private sector participation in infrastructure in the region, accounting for just USD 3.6 billion between 2000 and 2014 (Figure 9.2). Some 74% of this investment was accounted for by the power sector, followed by telecoms (21%) and transport (5%). Even in the absence of a clear PPP-dedicated legal framework, the ADB (2012a) notes that there have been an impressive number of PPP projects in Cambodia, but these have traditionally tended to be small in scale and to emerge on an ad hoc basis at the initiative of the private sector rather than being solicited proactively by government contracting agencies or strategically as part of a PPP project pipeline. As a result, bilateral negotiation of contracts has been the norm (ADB, 2012a), contrary to international best practice.

In more recent years, larger scale projects – notably in the hydropower sector – have been initiated, although apparently without a competitive bidding process. Since most of the potential efficiency gains provided by PPPs are expected to occur at the contractual stage, this lack of competition seriously undermines the capacity of government contractors to achieve value-for-money. Direct appointment should therefore be reserved for exceptional cases in the future. The perception a decade ago was that the ad hoc and non-competitive nature of the procurement process gave rise to opportunities for corruption (Sum, 2008).

Figure 9.2. Private participation in infrastructure in Southeast Asia, 1990-2017



Source: World Bank Private Participation in Infrastructure database.

Cambodia's experience with PPPs is most advanced in the power generation sector where a large number of independent power producers supply electricity to Electricité du Cambodge for domestic distribution under the power purchase agreement. To a more limited extent, there have been PPP projects in road transport, such as National Route 4 from Phnom Penh to Sihanoukville, air transport, where a private firm *Cambodia Airports* manages the three international airports (Phnom Penh, Siem Reap and Sihanoukville) under a long-term concession contract, and rail, where *Toll Royal Railway* has long-term concessions to operate the Southern and Northern lines. Outside of these sectors, however, PPPs are limited or non-existent. Most of the foreign investors in PPPs are from China, particularly in the numerous hydropower projects.

Encouraging more systematic private participation in the PPP regime

Promulgated in 2007, the *Law on Concessions* aims to promote and facilitate the implementation of privately financed infrastructure projects under a concession contract (RGC, 2016). As such, it is at present the most important piece of legislation governing PPPs in Cambodia. The implementing sub-decree has never been approved by government, however, while accompanying policy and institutional frameworks have not been sufficiently developed to allow for appropriate project preparation, evaluation and execution. As such, on its own the law "does not address the institutional and capacity issues required for the government to identify, prepare, transact, monitor, and evaluate the contracts, and take appropriate management actions when required" (ADB, 2012a).

Recognising the importance of mobilising private sector investment to achieve its infrastructure targets and of establishing a credible framework for PPPs, the government has made high-level political commitments to adopt the necessary reforms. For example, the Rectangular Strategy phase 3 and the National Strategic Development Plan, 2014–18 envisage "further encouraging participation of the private sector in the development of transportation infrastructure by strengthening and improving the public-private partnership mechanism."

In 2012, the ADB carried out a comprehensive assessment of PPPs in Cambodia, signalling priority areas for reform and has since provided significant capacity building and technical assistance with a view to support the government's PPP reform agenda. In 2014, the ADB published a *Policy Paper on Enabling Public-Private Partnerships (PPP) in Cambodia* (ADB, 2014b), which served as an important input to the government's own draft *Policy Paper on Public-Private Partnerships for Public Investment Project Management, 2016-2020* (RGC, 2016). The draft policy paper aims to "set out policy measures and identify institutional and financial support mechanisms to develop an effective, efficient, transparent, accountable, consistent and interlinked system to manage the investment on public infrastructure through PPPs." It sets out a roadmap for 2016-20, with short and medium term policy measures. As a precursor to adoption by the government of its overarching policy framework on PPPs, steps have already been taken to build institutional capacity.

In the short-term, it is envisaged that an inter-ministerial committee will be established, led by the MEF, and tasked with (i) proposing amendments to the *Law on Concessions* and related laws, (ii) preparing the sub-decree of the *Law on Concessions*, as well as related legal instruments, and (iii) elaborating a list of priority pilot projects to be implemented through PPPs. A Project Development Facility is to be established "to support specialized ministries/institutions in project development from the initial stage of feasibility study to granting the concession contract." There may be scope in the execution of this facility for the ADB and donor organisations and institutions to play a role in terms of capacity building and the sharing of best practice.

To build institutional capacity, a central PPP unit and Risk Management Unit are to be integrated into the existing MEF structures while PPP units are to be established or integrated into different sectoral ministries/institutions, especially the priority sectors. For example, a dedicated PPP unit has already been established in the Office of Private Sector Development Coordination in the MEF. The unit's web portal is also online and provides access to relevant policy and legal documents, as well as capacity building resources. It will also feature the PPP project pipeline once finalised.

Initially, so as to minimise fiscal pressures, it is envisaged that only revenue-based PPP structures will be used, but availability-based and hybrid mechanisms may be explored in the future. Nine sectors are identified as priorities for PPP projects in the initial stages while, over the medium term (2018-20), and based on the implementation of the pilot projects, further infrastructure sectors will be targeted (e.g. petroleum, telecommunications, irrigation and agricultural infrastructure). The roll-out of PPPs to other sectors (e.g. health, education and sports) is foreseen over the longer-term. The build-up of institutional and human resource capacity is also to be continued, while the relevant legal frameworks will be revised as necessary. One important medium-term objective is the possible establishment of a Viability Gap Fund as a means to subsidise or guarantee investment projects to make them bankable for the private sector (RGC, 2016).

Establishing a Viability Gap Fund or similar mechanism would help to increase the range of projects that are bankable for the private sector, but it would be important that the required institutional and human resource capacity is already in place so as to be able to adequately assess the 'viability gap' as well the most appropriate financial or contractual mechanism – if any – to address it. While subsidies or guarantees are in some cases clearly necessary to mobilise private investment, this must be carefully weighed against the value-for-money of the project, the value proposition when compared to other delivery mechanisms, such as traditional procurement, and considerations around perverse incentives arising from non-market-based measures. Moreover, options should be explored for both technical and financial assistance from bilateral and multilateral donors for the operationalisation of the Viability Gap Fund, as well as for blended finance that uses donor-financing to catalyse further private sector investment in infrastructure projects through structured finance mechanisms.

In developing its PPP policy, the government should carefully consider the various challenges identified in the *Recommendation of the OECD Council on Principles for Public Governance of PPPs* (Box 9.1). For instance, while so far the proposed intra-governmental institutional reforms appear to go in the right direction, it would be important to incorporate in the PPP framework a transparent mechanism for engaging with non-governmental stakeholders, including representatives of end-users of infrastructure at project levels. It is also advisable for the government to commit to the highest standards of transparency and communicate clearly the costs and benefits of PPPs. For instance, projects under the new PPP framework could be subject to systematic independent audits to ascertain how they performed in terms of value-for-money, public governance, stakeholder consultation, mitigation of social and environmental risks etc. These and other specific issues could be addressed by means of one or more sub-decrees implementing the *Law on Concessions*, for example.

Box 9.1. OECD Recommendations on Principles for Public Governance of PPPs

By combining private sector innovation and financing, and sharing the risks in innovative ways, PPPs can provide much needed savings for the public sector and a fair deal for the private sector. However, experiences from OECD Member and Partner countries show that it can be difficult to get value for money out of PPPs if government agencies are not equipped to manage them effectively. Moreover, PPPs can obscure real spending and make government actions un-transparent, using off-budget financing. This means PPPs are potentially risky for fiscal sustainability, possibly leading to credit rating downgrades as has happened in some OECD countries. In 2012, the highest governing body of the OECD adopted a Recommendation on Principles for Public Governance of Public-Private Partnerships that can help governments get PPPs right, by providing best practices based on country experiences with what works (and what doesn't). The Recommendation incorporates 12 Principles, organised in three categories:

A. Establish a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities

1. The political leadership should ensure public awareness of the relative costs, benefits and risks of Public-Private Partnerships and conventional procurement. Popular understanding of Public-Private Partnerships requires active consultation and engagement with stakeholders as well as involving end-users in defining the project and subsequently in monitoring service quality.

2. Key institutional roles and responsibilities should be maintained. This requires that procuring authorities, Public-Private Partnerships Units, the Central Budget Authority, the Supreme Audit Institution and sector regulators are entrusted with clear mandates and sufficient resources to ensure a prudent procurement process and clear lines of accountability.

3. Ensure that all significant regulation affecting the operation of Public-Private Partnerships is clear, transparent and enforced. Red tape should be minimised and new and existing regulations should be carefully evaluated.

B. Ground the selection of public-private partnerships in value for money

4. All investment projects should be prioritised at senior political level. As there are many competing investment priorities, it is the responsibility of government to define and pursue strategic goals. The decision to invest should be based on a whole of government perspective and be separate from how to procure and finance the project. There should be no institutional, procedural or accounting bias either in favour of or against Public-Private Partnerships.

5. Carefully investigate which investment method is likely to yield most value for money. Key risk factors and characteristics of specific projects should be evaluated by conducting a procurement option pre-test. A procurement option pre-test should enable the government to decide on whether it is prudent to investigate a Public-Private Partnerships option further.

6. Transfer the risks to those that manage them best. Risk should be defined, identified and measured and carried by the party for whom it costs the least to prevent the risk from realising or for whom realised risk costs the least.

7. The procuring authorities should be prepared for the operational phase of the Public-Private Partnerships. Securing value for money requires vigilance and effort of the same intensity as that necessary during the pre-operational phase. Particular care should be taken when switching to the operational phase of the Public-Private Partnerships, as the actors on the public side are liable to change.

8. Value for money should be maintained when renegotiating. Only if conditions change due to discretionary public policy actions should the government consider compensating the private sector. Any re-negotiation should be made transparently and subject to the ordinary procedures of Public-Private Partnership approval. Clear, predictable and transparent rules for dispute resolution should be in place

9. Government should ensure there is sufficient competition in the market by a competitive tender process and by possibly structuring the Public-Private Partnerships program so that there is an ongoing functional market. Where market operators are few, governments should ensure a level playing field in the tendering process so that non-incumbent operators can enter the market.

C. Use the budgetary process transparently to minimise fiscal risks and ensure the integrity of the procurement process

10. In line with the government’s fiscal policy, the Central Budget Authority should ensure that the project is affordable and the overall investment envelope is sustainable.

11. The project should be treated transparently in the budget process. The budget documentation should disclose all costs and contingent liabilities. Special care should be taken to ensure that budget transparency of Public-Private Partnerships covers the whole public sector.

12. Government should guard against waste and corruption by ensuring the integrity of the procurement process. The necessary procurement skills and powers should be made available to the relevant authorities.

Source: OECD (2012)

Lastly, it would be useful for the centre of government to maintain overall strategic oversight in the prioritisation of infrastructure projects and selection of the appropriate mechanisms for delivery and financing. This could be achieved, for example, through the establishment of an over-arching national infrastructure commission. Such a body would be responsible for elaborating a comprehensive national infrastructure plan, identifying a credible pipeline of infrastructure projects across sectors aligned with development objectives, and communicating priorities and the roles expected from the public and private sector. This can help secure greater policy co-ordination and alignment across levels of government and assure investors of the government's long-term political commitment to infrastructure development.

Fiscal pressures should not be the primary motivation for PPPs

Understandably, with the decline in the relative importance of pivotal donor financing set to continue, and with fiscal resources still somewhat limited despite strong recent growth in tax revenues, the government sees greater reliance on the private sector as an important source of complementary financing through which it can meet its infrastructure needs over the coming years. As yet, there appears to be no explicit targets with respect to the level of resources the government expects to mobilise through PPPs from the private sector but, given the political emphasis that has been placed on these efforts – and the very significant medium-term needs for infrastructure investment – it is likely to be quite significant, in terms of both nominal amounts and the share of total investment.

While the RGC (2016) notes that PPPs can offer "knowledge, knowhow, and modern technology to public sector to develop and manage the operation of public infrastructure investment projects in a more innovative and effective manner", the mobilisation of a "complementary source of financing" would appear to be a major motivation. This impression is reinforced by the rationale – "in order to avoid pressure on the national budget" – offered for the initial focus on projects using revenue-based payments, as opposed to availability payments or hybrid arrangements. Moreover, the Industrial Development Policy 2015-2025 highlights the importance of making use of PPPs to "help reduce the pressure on public investment".

Fiscal pressures should not be the primary motivation for engaging in PPPs. Contrary to conventional wisdom, PPPs do not release government funds, and therefore do not expand the number of projects that the government can undertake. Instead, while the government saves on investment outlays up-front, it renounces future user-fee revenue (if the PPP is financed with user fees) or future tax revenues (if financed with budget payments, e.g. if the PPP is structured using availability payments) which are equivalent to up-front capital investments in present value terms (Engel et al., 2007). In the case of availability-payment PPPs, in which private investors "lend" capital to the state, they will only do so if the state has the ability to repay them, in which case the state is not credit-constrained and public provision is potentially an option. But even in the case of PPPs funded partially or totally by user-fees, if the government can protect the project's revenue stream from other uses, these revenues could likewise be used to repay debt under public provision as well. The perceived financial benefits of PPPs arise largely because accounting rules have allowed PPPs to be counted off the balance sheet, allowing governments to sidestep normal budgetary rules since future obligations associated with PPPs are not required to be recorded in the public accounts (Engel et al., 2007).

The case for a PPP project should rely on its ability to generate greater value for money than the public provision alternative based on its capacity to generate productive, allocative and dynamic efficiency gains (Engel et al., 2007). The use of PPPs as a vehicle for escaping budgetary discipline by hiving financial commitments off public sector balance sheets often leads to problems. Contingent liabilities and other fiscal risks associated with PPPs are often significant. It is internationally recognised that any fiscal implication of infrastructure projects should be reflected in public sector budgets unless all relevant risks truly reside with the private sector. If risks are mitigated by public guarantees, placing them off budget becomes even more questionable (Box 9.1; OECD, 2007, 2012). This would need to be a consideration, for example, in the establishment and operation of the proposed Viability Gap Fund in Cambodia.

Ensuring RBC and managing social and environmental impacts

By connecting firms and people to markets and information, and facilitating access to services that improve people's livelihoods, infrastructure projects can enhance business opportunities, support greater gender equity, and improve the well-being of vulnerable populations (OECD, 2014). Cambodia still has a high proportion of its population living in rural areas. As such, integrating rural populations into infrastructure networks is particularly important for reasons of social inclusion, but this dispersion of the population also highlights inherent challenges in delivering accessible, affordable, high-quality infrastructure to the entire population.

Large-scale infrastructure projects can also give rise to social tensions. Land acquisition, population resettlement, environmental degradation, negative impacts on people's livelihoods and, in extreme cases, even human rights abuses are all risk factors. These are compounded when the legal and institutional frameworks are insufficient or lack clarity.

The key is to ensure comprehensive consultation with stakeholders – including end-users and affected populations – from the earliest possible stage of project planning so that risks can be minimised, avoided or mitigated, and so that adequate and transparent compensation schemes can be put in place. Such consultation exercises could be followed, for example, by conducting an awareness survey which would establish the extent to which the relevant stakeholders and populations are aware of the parameters of the project, the positive and negative impacts, the legal framework and the relevant grievance mechanism (Sum, 2008).

Where there is private sector participation, it is important that the highest standards of corporate governance and responsible business conduct are adhered to, and that all domestic and international labour and environmental standards are respected. Taking such a strategic and pro-active approach can help ensure that infrastructure investments bring the highest possible social and economic benefit, while minimising negative social and environmental externalities.

Concerns have been raised in Cambodia about resettlement programmes instigated to facilitate infrastructure projects (ADB, 2012a). Failing to adequately address such issues at the outset may not only impose negative social and environmental impacts, but can undermine mid-stream the very viability of the projects, leading to delay, increased costs or even abandonment. While affected property owners are constitutionally protected, in the sense that they are due compensation with an agreeable value, there is no clear legislation, regulation or national policy on resettlement or compensation (Sum, 2008), giving rise to significant ambiguities and potential abuses. A related issue is protection for the right of way. While the 2001 *Land Law* prevents new squatters, there is no clear mechanism in place to distinguish between those who have legitimate property rights in need of protection, and those engaged in opportunistic land-grabbing (Sum, 2008).

One concrete example is the Northern rail line, the final sections of which remain uncompleted. The ADB, which has financed much of the country's rail rehabilitation in recent years, decided in 2015 not to provide further funding for the construction of these final sections, but rather to assign funds to the maintenance of those part of the rail network already constructed (The Cambodia Daily, 11 March 2015). In 2014, the ADB published an independent Compliance Review Panel report, which found that a population resettlement plan that, when conceived in 2006, envisaged 2,629 households being affected, was characterised by major design flaws. In particular, it noted inter alia "inadequate requirements for consultation with and participation of [affected households], a lack of provisions for inflation-indexed compensation, no provisions for replacement housing of minimum standard to improve the situation of poor and vulnerable resettled families, inadequate planning for the facilities required at resettlement sites, inadequate grievance redress mechanisms, and a weak program for capacity building for government entities involved in the project."

The government's ambitious plans to boost hydropower generation capacity over the coming years are another source of potential social and environmental risk, particularly given the inherent need large-scale dam projects give rise to in terms of population resettlement. Further issues arise where populations, as for the many in Cambodia living in close proximity to the river system, traditionally depend on fishing to satisfy a large proportion of their nutritional needs. Infrastructure priorities may, in such cases, also come into conflict, between boosting hydropower capacity, on the one hand, and making better use of the main river systems for water transport on the other. Ongoing construction of the Lower Sesan 2 dam plant in Stung Treng province is a case in point. In a positive move in early 2016, the Ministry of Mines and Energy established a committee to address compensation and resettlement issues for families affected by the dam's construction. There is a need for such initiatives to take place much earlier in the planning process, rather than when construction is already well advanced.

Since much of Cambodia's infrastructure networks are at a relatively early stage of development, there is also an opportunity to focus on building in environmental sustainability upfront. The shifting energy mix, towards a heavier reliance on domestically produced hydropower and, to a lesser extent, small-scale off-grid solar power generation have the potential to greatly reduce Cambodia's carbon footprint while reducing dependence on high-cost energy imports and extending access to electricity ultimately to the entire population.

Further rehabilitation of the railway network and increased use of inland water transport for bulky, non-perishable goods has the potential to greatly reduce the number of journeys made by heavy goods vehicles on the road network, thereby enhancing Cambodia's sustainability. Rail and inland water transport can be more efficient, less costly for end-users and entail relatively less carbon emissions per ton of freight transported. This could also help to ease the financial pressure of maintaining roads, potentially freeing up funds to be diverted to road construction and improvement. Of course, increased use of hydropower and inland water transport both need to be considered also in the context of trade-offs with each other, as well as with other aspects of environmental sustainability.

Infrastructure sectors in Cambodia

Electricity

Access to, and affordability of, electricity have been critical constraints on economic growth and social inclusion in Cambodia. The electrification rate in Cambodia is one of the lowest in the region, with households and villages not connected to the grid making use of diesel generators and even car batteries to support electricity usage. This has resulted in a high cost of electricity to end customers, a dependence on imported fuels, as well as an environmental cost in terms of local air pollution.

Despite significant scope to harness renewable power, particularly hydropower, limited generation capacity led to reliance in the past on direct imports of high-cost electricity from neighbouring countries, notably Viet Nam, while domestic power generation was largely oil-based, with a relatively large carbon foot-print and high exposure to volatile prices for oil imports. To address these challenges and cope with annual increases in electricity demand of around 25% (RGC, 2014) the government has ramped up investment in hydropower and coal while improving the distribution network and increasing electrification in rural areas.

Recognising these challenges, improving the electricity situation has remained one the main priorities of the government, and recent years have seen rapid improvements in terms of increased access to electricity, reduced dependence on imports and lower prices. The government has ramped up investment in hydropower and coal while improving the distribution network and increasing electrification in rural areas. In addition to changes in the energy mix, generation capacity has increased which has reduced the dependence on imports, and the number of consumers has grown rapidly and now exceeds two million.

The *National Strategic Development Plan 2014-18* outlines the ambitions of the government with relation to the energy sector: expanded and reliable electricity supply coverage; the supply of adequate energy at affordable rates; and strengthened institutional mechanisms and management. By 2020, 100% of villages[4] and, by 2030, 70% of households are to be electrified. Moreover, the NSDP 2014-18 envisages "further encouraging the private sector to invest in electricity generation, and transmission and distribution infrastructure by focusing on technical and economic efficiency and minimisation of environmental and social impacts." The Plan also recognises the importance both of institutional reform and of developing the legal and regulatory framework to ensure the electricity sector is efficiently managed (RGC, 2015).

While distribution of electricity from the national grid is dominated by the state-owned Électricité du Cambodge (EDC), power generation has been traditionally characterised by a high level of private sector participation, with independent power providers (IPPs) representing 97.5% of energy sent out in 2016. While incentivising private investors to invest in large-scale power generation projects may obviate the need for large up-front public investments, this should be weighed against potential future revenues forgone as well as, where relevant, the impact of locking in relatively high power purchase prices over a concession period spanning several decades.

Domestic generation of energy represented 78% of the total in 2016, with the rest imported from Viet Nam (17%), Thailand (4.7%) and Lao PDR (0.5%). Hydropower constitutes the largest component of the energy mix (55% of capacity and 47% of energy sent out), followed by coal (26% and 44% respectively). New hydro and coal-fired plants were expected to come on line in 2017. Further increasing reliance on domestically generated hydropower has the potential to significantly reduce the cost of electricity, particularly compared to high-cost imports from Viet Nam – reducing both Cambodia's exposure to volatile oil prices and its carbon footprint.

Further efforts to promote energy efficiency and to reduce losses through transmission and distribution can help better match surging demand with constrained supply while contributing to combat climate change. Inefficiencies in the electricity transmission and distribution networks lead to nearly a fifth of electricity being wasted, further adding to the costs of power generation. Not only has the 'loss rate' more than doubled since 2004, it is now the highest in the region (World Bank and ADB, 2015). While the EDC has improved in this regard, there are still, for example, a large number of rural electricity enterprises in operation with electricity losses of up to 40% (RGC, 2013), which is one of the reasons why rural electricity prices tend to be so much higher than urban prices. In 2013, the government introduced a national policy, strategy and action plan on energy efficiency. This framework is consistent with the high-level priorities set out in successive phases of the Rectangular Strategy as well as successive NSDPs.[5] The overarching objective is to slow the rate of growth in energy demand and to reduce it by 20% by 2035.

In spite of this progress, a combination of surging demand and constrained supply contribute to Cambodia having one of the highest electricity costs in the ASEAN region, while prices also vary significantly depending on the location, provider and source of power generation. As with most countries in the region, there are different tariffs for residential, commercial and industrial consumers, while prices are much higher in rural than in urban areas.

Transport

Good transport connectivity is crucial to the smooth flow of goods, services and people. Improving transport infrastructure can reduce firms' operating costs, promote social inclusion, and mitigate the environmental impact of freight and passenger traffic. Better transport connectivity can also support integration into regional and global value chains, and ultimately contribute to the upgrading of economic activity into higher value added sectors. Stone et al., (2010) have shown that Cambodia stands to gain economically the most in the GMS from improvements in transport infrastructure.[6]

To give one example, policy efforts to upgrade Cambodia's activities within the agricultural supply chain by promoting the domestic milling of rice for export would be greatly aided by i) further improving the rural road network, thereby reducing farmers' local transport costs, ii) completing rehabilitation of the northern rail line, connecting the primary rice-growing region Battambang to Phnom Penh and ultimately to Sihanoukville ports by rail freight, iii) improving navigability of the inland water system, and iv) improving the infrastructure for switching freight between these modes of transport. Progress is already being made in this regard, with the reopening of the southern rail line to freight traffic and the expansion of storage and loading facilities for dry bulk goods at Sihanoukville port.

As well as roads, bridges, railways, river and sea-ports – and infrastructure to facilitate inter-modal transport – there will be a need to further develop storage, warehousing, refrigeration and phyto-sanitary infrastructure to support further upgrading in agricultural and fisheries supply chains. Recent improvements in the quantity and quality of 'hard' transport infrastructure have been supplemented by advances in customs and export procedures, as well as increased competition in the trucking sector, which serve to further reduce the cost of, and otherwise facilitate, the export of rice and other goods (World Bank, 2014).

Despite significant investment and improvements in recent years, however, Cambodia's transport infrastructure across all modes – albeit to varying extents – is still inadequate in terms of both quantity and quality, given the increasing demands placed on it by rapid economic growth, as well as level of degradation that occurred during the period of civil conflict and the under-investment during the years that immediately followed. To overcome this important constraint on economic activity, some foreign firms choose to cluster in SEZs which are often strategically located close to key ports, airports, and border crossings, while also being generally well linked into the national primary road network. As a matter of priority, the RGC (2015) is further improving these linkages, better connecting SEZs to each other as well as to the country's main economic hubs. While such infrastructure improvements should help reinforce efforts to attract FDI into SEZs, it will be important also to support inter-modal transport connectivity of SEZs, facilitating for example container freight traffic through their dry ports. More broadly, comprehensive improvements in transport infrastructure networks will be necessary to facilitate backward, forward and horizontal linkages between SEZ-based FDI activities and the rest of the foreign and domestically-owned private sector in Cambodia (see Chapter 6).

The NSDP foresees the design and implementation of a Master Plan for Transport Infrastructure Development to connect all parts of the country and with the neighbouring countries. The Industrial Development Policy 2015-25 envisages creating a new coordinating mechanism for investment in transport infrastructure by linking to targeted industrial areas. This would be an important institutional innovation that could not only strategically support industrial upgrading but also facilitate joined-up, multi-modal networks. Such a coordinating mechanism should also cooperate closely with sub-national governments and the relevant authorities in neighbouring countries so as to ensure Cambodia's efforts to improve its transport infrastructure can also support improved intra-regional connectivity.

Road

Notwithstanding recent progress, the quality of the road network is among the poorest in the region, with only 11% of roads paved, while Cambodia ranks among the lowest in the region for quality of roads according the 2017-18 *Global Competitiveness Survey* (WEF, 2017). While 94% of primary national roads have two lanes, are paved and in good condition, the secondary and rural road network is in a serious state of disrepair. Very few rural roads are paved, meaning that many become impassable in the rainy season (ADB, 2014a). The poor quality of the rural road network is an important contributing factor to high logistics costs, with farm-to-market transport costs double those in Viet Nam and nearly four times the level in Thailand in recent years (World Bank, 2009, in ADB, 2014a).

Not only is the poor quality road network an important constraint on economic development and social inclusion, but the environmental costs, in terms of unnecessary carbon emissions, are significant while the human cost, in terms of fatalities and injuries arising from road accidents, is also considerable. Sustained investment in the construction, repair and maintenance of the road network will therefore be necessary for the foreseeable future. While private sector participation in road infrastructure can alleviate some of the up-front burden on the national budget, as is already happening on some major road arteries, and donor-financing will continue to support construction, there is significantly less scope in this regard for paving and otherwise improving the extensive rural road network. It is important that sufficient resources are made available from the national budget for such upgrade and maintenance, not least because this can be a more cost-effective approach than having to replace existing, but poorly maintained, roads in the future.

The NSDP places high priority on improving the road network, targeting the paving of 300-400km of additional roads per year, while stepping up repair and maintenance efforts as well as enforcing punitive measures against overloading, itself another factor in the continual degradation of the network.[7] The legal framework has improved – notably through the *Law on Roads* and a new *Law on Traffic* – while the policy framework is to be underpinned by both the Masterplan for Transport Infrastructure Development and the Master Plan for Urban Infrastructure Development (RGC, 2014). Meanwhile, the IDP places particular priority on road maintenance and construction, including by exploring the feasibility of converting major national roads into highways, on the main Phnom Penh-Siem Reap and Phnom Penh-Sihanoukville corridors as well as connections to Thailand and Viet Nam.

As urbanisation picks up pace and road vehicle registrations continue to surge, Phnom Penh's roads are becoming increasingly congested. Rapid development of residential projects in suburban areas of the capital has not been preceded in many cases by adequate planning for the necessary road and other infrastructure, which is likely to further add to congestion challenges going forward. Minimising and mitigating congestion can bring economic benefits (through reduced journey times and costs), social benefits (in terms of connectivity and shorter commutes) and environmental benefits (notably reduced carbon emissions).

The blueprint for an Urban Transport Masterplan for Phnom Penh, carried out by JICA (2014), identifies many of the existing and future challenges, formulates traffic projections with a time horizon to 2035, and makes concrete recommendations to improve the road network and traffic management. It also proposes the establishment of an independent Phnom Penh Urban Transport Authority, presaged by a transitional advisory committee to coordinate urban transport projects. Introducing, implementing and financing such a masterplan – as well as an institutional framework to execute it – could greatly help with long-range urban planning, and help Cambodia to avoid some of the problems experienced by other capital cities in the ASEAN region. The annual cost of implementing the Masterplan was estimated at USD 77 million over 2014-16, peaking at USD 232 million in 2017-20, and USD 218 million thereafter until 2035. The extra financing needs above and beyond existing MPWT infrastructure expenditure was estimated to be about USD 100 million per annum, a funding gap for which concessional lending and private sector participation would need to be mobilised (JICA, 2014).

Rail

Ongoing rehabilitation of the railway network has the potential to reduce the pressure of freight traffic on the road system, while passenger services have also begun to reopen after several years of closure. The rail system totals 640km and consists of two main axes: the Northern line, linking Phnom Penh to the Thai border at Poi Pet and crossing Battambang, the main rice-producing region, and the Southern line, which links Phnom Penh to the port of Sihanoukville. The rail service ceased during the period of civil conflict but, despite reopening thereafter, passenger services ended in 2009 amid safety concerns (RGC, 2010). A USD 143m railway rehabilitation initiative was launched in 2009.[8] A private firm, *Toll Royal Railway*, was engaged to operate and maintain both rail lines after their reconstruction and it currently holds a 33-year operating concession. As well as completing the Northern and Southern lines, the rehabilitation programme also includes two branch lines: from Phnom Penh station to the Green Trade Warehouse complex and from Sihanoukville container terminal to the Sihanoukville port (ADB, 2014c).

The Southern line reopened to freight traffic in 2013, mostly for bulky, non-perishable goods such as rice and petroleum. A limited passenger service reopened in 2016. The Northern line is still undergoing rehabilitation, with the 48 km section between Sisophon and Poi Pet still to be completed. In July 2015, the government allocated USD 33m to complete this work by 2017. When rehabilitation of the railways is complete, the number of heavy vehicles using the road network to transport freight could be reduced by up to 50% (ADB, 2014c), reducing freight costs, carbon emissions and degradation to the road network caused by heavy goods vehicles. For precisely this rationale, continued development of the rail network is highlighted as important in the IDP 2015-25. As well as completion of the Northern line, the National Strategic Development Plan 2014-18 also foresees the completion of rail freight terminals at Phnom Penh and Preah Sihanouk.

Air

Cambodia has 3 international airports, 9 local airports and a dozen other airfields. In 1998, Cambodia implemented an 'open sky' policy, leading ultimately to the signature by the State Secretariat of Civil Aviation of air service agreements and memoranda of understanding with 22 countries. In practice, for example, the open skies policy allowed tourists for the first time to fly directly to the international airport at Siem Reap, gateway to the temple complex at Angkor Wat, without first stopping at Phnom Penh (RGC, 2010). As the country became more open and, particularly, as the adverse impact of the 1998 Asian economic crisis receded, this development presaged a significant increase in tourist traffic.[9] The range of overseas destinations served has also been increasing.

International air transport is the infrastructure sector with the most significant and long-standing presence of foreign investors. Since 1995, Phnom Penh international airport has been operated by Cambodia Airports, owned jointly by Vinci airports (70% ownership), a French firm, and Muhibbah Masteron Cambodia (30%), a Malaysian-Cambodian joint venture. Cambodia airports were granted concessions for the other two international airports, Siem Reap and the port and coastal resort of Sihanoukville, in 2001 and 2006 respectively. Concessions for all three international airports were granted on a build-operate-transfer basis (RGC, 2010). While advances in both infrastructure and passenger traffic have been impressive, the government recognises that further improvements are still needed. For example, Cambodia is still ranked second lowest in the region, after Myanmar, for quality of air transport infrastructure according to the 2017-18 *Global Competitiveness Survey*. The most urgent priorities identified in the NSDP include expansion of the international terminal at Phnom Penh and both the domestic and international terminals at Siem Reap, including through PPP projects. The PPP model appears to have served the Cambodian aviation sector well over the past two decades, entailing stable, long-term commitment by a concessionaire, as well as staged and strategic investment in the necessary infrastructure.

Water transport

Cambodia has two international ports and, between the Mekong river and its tributary system, significant potential to utilise inland waterways for freight and passenger traffic. Despite significant investment in upgrading port infrastructure – which sees Cambodia mid-ranked in the ASEAN region in terms of perceived quality of port infrastructure – and efforts to dredge inland waterways, water transport infrastructure is still inadequate to serve the rapidly growing economy. Meanwhile, shipping costs are high by regional standards, reflecting inadequacies in both hard and soft infrastructure, as well as a lack of competition in key shipping services and widespread charging of unofficial fees. A recent cost benchmarking exercise carried out by members of EuroCham Cambodia (2016) suggest that port dues and charges relating to comparable vessels are 3.7 times higher at Sihanoukville than at Cai Mep, Viet Nam.

First constructed in 1956, Sihanoukville Autonomous Port is the only deep-water seaport, accounting for some 70% of imports and exports (ADB, 2014a). It can currently accommodate vessels up to 20 000 deadweight tons and has a loading capacity of around 1 500 TEUs[10] for container vessels.[11] As foreseen in the National Strategic Development Plan 2014-18, work started in 2015 on a new multipurpose terminal which is expected to significantly expand capacity for the storage and export of coal, agricultural products and other dried bulk cargo. This will underpin efforts to expand milled rice exports and will also serve as a logistics base for oil exploration in Cambodian sea territory. In collaboration with JICA, planning is also at an advanced stage for a new container terminal, which will see a significant expansion in the port's overall capacity – to 1-1.2m TEUs per year (Khmer Times, 3 May 2016) – upon its expected completion by 2022. These developments should also support the further development of the port's SEZ, which opened in 2012, as well as industrial development more broadly.

Unlike most countries in the region, Cambodia requires approaching marine cargo vessels to engage the Kampuchea Shipping Agency and Brokers (KAMSAB) as the shipping agent to represent the vessel when dealing with port authorities, while only KAMSAB is authorised to request the port to release containers from its control. This has been highlighted as a contributory factor to high shipping costs and poor quality service (Eurocham Cambodia, 2016). While it is encouraging that the government has pledged to increase the efficiency of KAMSAB (RGC, 2014), consideration should also be given to introducing competition by removing the mandatory requirement.

With some 4m Cambodians living along the inland waterway networks, water transport has been traditionally one of the most reliable and important forms of transport, but inadequate dredging and navigation aids have seen its potential underutilised. Inland waterways measure 1 750km, of which only 580km are navigable during the dry season. River ports are located along the three main inland water arteries: the Mekong, Tonle Sap and Bassac rivers (RGC, 2010). While investment in inland water infrastructure holds great potential, there are a number of natural constraints that will be difficult or impossible to overcome for larger vessels, and therefore for the large-scale use of inland waterways for freight traffic (for example, bends in the Mekong and dry season constraints). At the same time, Cambodia and neighbouring countries are in the process of ramping up hydro-electric power generation capacity, which could impose further constraints on navigability in the future.

Nonetheless, there is still scope to improve both navigability along stretches of the river system and inter-operability with other modes of transport. In particular, there is a need for improved docking, loading and storage facilities in provincial river ports as well as better links to the road and rail networks. As recognised in the IDP 2015-25, such developments have the scope to reduce logistics costs for the transport of dry bulk and agricultural goods, in particular (RGC, 2015). Priorities set out in the National Strategic Development Plan 2014-18 include further dredging and other efforts to improve navigation as well as the elaboration of a Masterplan on inland waterway transport, which should serve to update the 2006 Master Plan on Waterborne Transport in the Mekong River System in Cambodia (RGC, 2010). According to the NSDP, private sector participation is also to be encouraged in both the development of river ports and in inland shipping activities. It will be important that an updated Masterplan incorporate clear strategies to operationalise this.

Both international ports are linked to primary road and rail networks, but there is scope to further improve multi-modality. In this regard, it is welcome that the NSDP 2014-18 foresees the development of a master plan on logistics supply and multi-modal transport to enable trade facilitation. Upgrading existing infrastructure could also improve such multi-modality.

Water and Sanitation

Broad access to potable water and sanitation is a critical component of social inclusion, and an important input for farms and firms of all sizes. At the same time Cambodia faces climate related challenges, which leave it prone to alternating periods of flood and drought, while rainfall can vary significantly from year to year. Cambodia is a signatory (alongside Lao PDR, Thailand and Viet Nam) of the 1995 Mekong Agreement for Sustainable Development of the Mekong River Basin, but financial and human resources remain insufficient for Cambodia to play its full part in these efforts, while the rapid development of hydropower capacity on the river poses new challenges with respect to other public policy goals, such as improving the water and sanitation infrastructure.

Cambodia has made significant progress in broadening access to water and sanitation in recent years, reducing leakages and improving the quality of service, particularly in Phnom Penh, where donor support and a sound institutional framework has played a vital role and where water coverage has surpassed 90%. Ultimately, there is a need to wean the sector off over-dependence on donor-financing (RGC, 2014).

Some of the funding gap could be closed through greater involvement of the private sector. To date, the participation of the private sector in water supply has been relatively limited, as in many other countries. Private operators face particular challenges in accessing finance for expansion and new projects, and in obtaining adequate technical and managerial capacity (World Bank, 2015b). Indeed, these challenges are highlighted in the NSDP, which envisages a bigger role for the private sector going forward. To achieve this, it places a particular focus on improving access to finance through cooperation with development partners, NGOs and other public bodies. Consideration will need to be given to the possible trade-off between promoting more private sector involvement in water distribution and other policy goals, such as improving access to water services and reducing poverty. For example, many water tariffs currently reflect less than full cost-recovery (RGC, 2014). Targeted subsidies, through the *Water for All* programme for example, could be used both to increase access and reduce poverty even in the presence of a private operator implementing a 'cost-recovery plus' pricing strategy.

Likewise, efforts are to be undertaken to improve the policy, legal and regulatory framework governing the sector to promote private sector participation, while private sector incentives are also to be considered (RGC, 2014). Underpinning the new Sector

Development Strategy, there will be a need for a clear legal and regulatory framework, reflected in the on-going development of a comprehensive water supply law, including supporting regulations (RGC, 2014). The establishment of an independent regulatory authority, mirroring the EAC in the electricity sector and the Telecommunication Regulator in the ICT sector, could be an important advance in this regard. An independent and autonomous regulatory body should also serve to reduce any administrative ambiguities arising from the respective responsibilities of different ministries.

Information and communication technologies

ICT and broadband connectivity have become increasingly important enablers of economic activity in global supply chains. This underlines the importance of having the right infrastructure and regulatory frameworks in place, not only for managing the sector itself, but also to support the development of associated sectors, such as e-commerce and mobile banking. Modern ICT has allowed developing and emerging economies to leapfrog the need to install extensive fixed line telephone networks by aggressively promoting mobile alternatives. In turn, this not only allows much greater and better quality interpersonal connectivity, but can also more rapidly extend economic opportunities and promote social inclusion than would otherwise have been the case.

The spread of mobile and internet banking is a prime example and could play an important role in promoting financial inclusion in rural areas, as recognised by the Central Bank of Cambodia. While only 10% of mobile phone users are using mobile banking services, the high rates of mobile cellular penetration highlights the scope for growth if the regulatory, security and other challenges can be overcome (Phnom Penh Post, 16 March, 2016). While Cambodia's ICT sector as a whole has made swift progress in recent years, it is characterised by, on the one hand, a well-developed mobile phone sector with high rates of penetration and, on the other, fixed line and internet connectivity that rank among the weakest performers regionally.

Increased internet usage has allowed Cambodia to make important advances in e-government, and its further development is foreseen in the National Strategic Development Plan 2014-18. The NSDP forecasts that by 2018, the total number of mobile and fixed telephone lines will have reached 21.8 million, up from 19.7 million in 2012, while the number of internet users will have increased from 2.7m to 19.7m over the same period. To achieve these targets, the NSDP has also prioritised inter alia expanding the coverage and strengthening the efficiency of backbone infrastructure and encouraging private sector investment in cutting edge ICT technologies as well as a range of accompanying regulatory and institutional reforms (RGC, 2014). While the initial stages of the necessary infrastructure upgrade are expected to be driven by the RGC itself, private participation through PPPs is envisaged in the second stage. To improve accessibility and 'bridge the digital divide', the RGC intends to support the development of the ICT network in suburban areas, to build and operate 'internet use facilities', and to introduce internet fee subsidisation.

The *Law on Telecommunications* adopted in 2015 defines the respective roles of the Ministry of Posts and Telecommunications and the Telecommunication Regulator of Cambodia, establishes a universal services obligation and clarifies the respective rights of operators and users. Importantly, it also sets the framework for the control and utilisation of infrastructure and networks, covering the aspects of land use, interconnections between operators, equipment standards and service quality requirements. By updating and clarifying the legal framework for the sector, the Law can provide much greater clarity and certainty for existing and potential private sector operators. It will be important to ensure the Regulator is equipped with the institutional, financial and human resource capacity to fulfil its role in what is a dynamic and technologically sophisticated sector. It will also be important that primary and secondary legislation be developed as necessary for associated sectors and initiatives – such as mobile banking and e-government – to ensure the maximum possible social and economic returns from installed infrastructure.

Notes

[1] These estimates build on specific economic and demographic growth rates scenarios to estimate required levels of investment and provide an alternative check to the bottom-up estimations from the government based on the costs to implement identified projects (Battacharaya, 2010). Estimates of investment required have many methodological drawbacks and should be interpreted with caution. Most importantly, they do not represent the level of infrastructure that would maximise growth or socio-economic targets, but rather are based on past observed behaviour of the relationship of income level and infrastructure demand in a sample of countries and extrapolated using predicted income growth (Ruiz-Nuñez and Wei, 2015).

[2] These include only those bilateral and multilateral donors reporting to the OECD's Development Assistance Committee.

[3] In more commercially driven transport sectors, such as ports and airports, greater levels of private participation have been achieved. Road and rail passenger transport projects have had more difficulty in attracting private investors. These projects are characterised by high up-front costs with long payback periods and normally only a limited capacity to extract enough revenue via user fees to cover costs. Their commercial viability is therefore complex, often requiring the government to take part of the responsibility for the commercial risks of the project. Road projects also often face public resistance where tolls are introduced for the first time. As a consequence, investors are typically sensitive to the investment and policy environment concerning such projects. Moreover, while there may be a clear economic rationale for cost-recovery according to the 'consumer-pays principle' – whether or not costs are recovered directly by the private operator – this may come into conflict with other legitimate public policy goals, such as poverty reduction.

[4] The village electrification target involves 14,000 villages with 2.5 million households. It must be noted however that an electrified village is defined as most community facilities and more than 50% of households having access to electricity.

[5] This framework was developed by the EU Energy Initiative Partnership Dialogue Facility and an expert team from Integration Consulting Group, working in close cooperation with the team from the Ministry of Industry, Mines and Energy as well as other contributors.

[6] By exploring the region-wide impact on GDP and the poverty headcount of reduced land transport costs arising from route improvements that were already relatively advanced, Stone et al. (2012) estimated that the gains to GDP could be in the order of 8.3% for Cambodia over the medium term, with increased exports to Viet Nam (USD 272 million) and Thailand (USD 207 million) being important drivers, while the country would also experience the most dramatic reduction in the extreme poverty (<USD 1 per day) headcount. Poorer rural households would stand to benefit.

[7] In total, an improvement of a further 3,500km of the road network is targeted by 2018, with the development of high-speed roads on the main Phnom Penh-Sihanoukville axis a particular priority. Meanwhile, the completion of National Road No. 41, linking National Roads 3 and 4, has improved connectivity in recent years, while the 2018 completion of the 174km National Road No.

58, linking Samrong City to Poipet on the Thai border, will also be an important step (ASEAN and UNCTAD, 2014).

[8] Supported by the Asian Development Bank, the OPEC Fund for International Development and the Malaysian government, with co-financing by the RGC.

[9] The increase in passenger numbers has been particularly marked from 2005 onwards. Between, 1995 and 2013, passenger numbers increased from 600,000 to 2.4m through Phnom Penh, and from 200,000 to 2.7m through Siem Reap. In 2015, passenger numbers reached a record 6.2m, of which 3m through Phnom Penh and 3.2m through Siem Reap, indicating annual growth of 15.5% and 9%, respectively (Phnom Penh Post, 20 January 2016). At such rates of growth, Cambodia is on course to surpass the 7m international tourists expected to visit the country annually by 2020, according to the Tourism Development Strategic Plan 2012-2020.

[10] Twenty Foot Equivalent Unit; the unit of capacity of a container ship.

[11] Website of Sihanoukville Autonomous Port, accessed in June 2015: http://www.pas.gov.kh/en/page/statistics

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Chapter 10. Policy framework for investing in green growth in Cambodia

This chapter describes Cambodia's investment framework in these areas, providing an overview of the elements of the policy framework for green investment that have been instituted. It reviews the policy framework for improving the quality of investments in natural resources, examines in greater depth existing efforts and the potential to engage the private sector to scale up renewable energy and investment in climate friendly agri-business.

Summary

Green growth implies fostering economic growth and development while ensuring that natural assets continue to provide the resources and environmental services on which our well-being relies. To do this it must catalyse investment and innovation to underpin sustained growth and give rise to new economic opportunities (OECD 2011). Investment for green growth includes, among other things, investment in infrastructure such as renewable energy, energy efficiency, water purification and distribution systems, transport and housing, the preservation of natural resources and waste management (OECD 2015).

A green investment framework has much in common with a general policy framework for investment, but an investment-friendly policy framework does not necessarily result in direct investment in activities conducive to green growth unless certain elements are also in place. These include: a strong governmental commitment at both the national and international levels to support green growth and to mobilise private investment for green growth; policies and regulations to provide a level playing field for more environment-friendly investments; policies to encourage more environmentally responsible corporate behaviour; an institutional capacity to design, implement and monitor policies to foster green growth objectives; financial mechanisms for green investment; and policies to support private sector involvement in green infrastructure projects (OECD 2015).

This chapter describes Cambodia's investment framework in these areas, providing an overview of the elements of the policy framework for green investment that have been instituted. It reviews the policy framework for improving the quality of investments in natural resources, examines in greater depth existing efforts and the potential to engage the private sector to scale up renewable energy and investment in climate friendly agri-business. It is structured around the questions on green growth and investment raised in the updated OECD *Policy Framework for Investment* and the OECD *Policy Guidance for Investment in Clean Energy Infrastructure*.

Cambodia is facing environmental and development challenges. Some people in rural areas are still highly dependent on natural resources for their livelihoods, and reducing poverty in these areas is a key concern for the government. Unsustainable use of natural resources has resulted in increasing degradation and pollution. These trends are exacerbated by the country's vulnerability to climate change, which threatens progress made towards economic growth and poverty reduction.

These challenges are also opportunities for Cambodia to mobilise private investment in support of green growth, by improving the quality and sustainability of investment in natural resource sectors as well as generating new investment in green sectors. Attracting investment in areas such as renewable energy, energy efficiency or waste management could help create jobs and spur growth and development. Just over two thirds of people still lack access to energy, and at the same time, the country has significant potential for renewable energy generation, particularly small hydro and solar energy – these factors highlight the potential for grid connected and off-grid solar solutions, both centralised and decentralised. Sustainable natural resource management practices such as better water resource management, eco-tourism and sustainable agricultural practices could promote investment that generates employment, positive environmental benefits as well as growth.

Recognising the importance of promoting green growth and environmental sustainability, the government has made much progress in recent years in instituting policies that promote green growth and support the greening of investment flows. The *Cambodia*

Climate Change Strategic Plan (2014-23), supported by the *Climate Change Action Plan* (2016-18), set out commitments to green growth and climate action. A new *Environment Code* is being developed that brings together and aligns all previous legislation related to environmental protection issues. The National Council for Sustainable Development is spearheading efforts across ministries to implement climate change actions, including, scoping work to understand the potential to engage the private sector in environmental sectors, including renewable energy and sustainable agriculture.

Despite this progress, there is substantial need to strengthen consistent and robust implementation of policies, particularly for environmental protection. For example, capacity to implement environmental safeguards policy at the province level is weak and affects enforcement and monitoring. There is also a greater need to scale up action at the sector level. Cambodia has a high potential for renewable energy and a fledgling solar industry, spurred in part by donor financed programmes over the last decade. Despite this, there is no renewable energy policy and no incentives in place to spur the uptake of grid-connected renewables, and power development plans do not reflect the potential for green energy. Similarly, there is no policy framework in place to support energy efficiency.

Policy recommendations for scaling up green investment in Cambodia

Include a focus on green investment in the new Investment Law: Revising the *Investment Law* is an opportunity to include incentives for green investment, in line with efforts by other ASEAN countries Viet Nam, Malaysia and Thailand. Viet Nam's investment policy includes incentives[1] for investment in environmentally friendly areas such as renewable energy, afforestation and recycling. Malaysia has instated a major drive to encourage investment in 'green industrial development' including green technologies (renewable energy, energy efficiency etc.) and waste-eco parks – Malaysian government incentives include tax allowances for green technology projects and income tax exemption for companies providing green technology services. While the current Cambodian *Investment Law* and supporting decrees provide incentives for qualified investment projects, projects that promote environmentally friendly technologies are not included in the list of QIPs.

Develop a policy framework and targets for renewable energy: Cambodia's power development plan currently includes proposals to scale up power generation from hydropower (large scale), gas and coal, but does not take into account the significant potential of renewable energy sources, despite the decreasing costs of renewable technologies. A recent study shows that renewable energy technologies such as solar could provide power at close to the same price as fossil fuels in Cambodia, and could be cost competitive with additional support, such as through a feed-in-tariff. Developing a policy framework for renewable energy in Cambodia is essential for scaling up foreign and domestic private investment in green growth. There is a need for a clear target and policy for renewable energy and for these to be reflected clearly in the national power development plan.

Provide incentives for the roll-out of renewable energy technologies: While solar technologies have been supported in areas without grid connectivity as part of the government's rural electrification efforts, there have been fewer efforts to spur the roll out of grid-connected solar as a source of power. In places where houses or companies do have solar installed, they are not actively encouraged or compensated to feed excess energy back into the grid. Despite the lack of incentives, a fledgling solar industry has developed in Cambodia with the Solar Energy Association of Cambodia, mostly providing off-grid solutions targeting communities not connected to the grid. With targeted incentives to promote renewable energy – either through feed-in tariffs or net metering, private investment in renewable energy could be scaled up.

Using public funding for environment and climate change catalytically to mobilise additional investment: Development finance has played an important role in supporting Cambodia in addressing environmental issues. Support to government institutions, through multi-donor initiatives such as the Cambodia Climate Change Alliance, have enabled the development and roll-out of important environmental policies including climate change policies and action plans. Going forward, there is a need for environment related development co-operation efforts to focus on catalysing private sector engagement and investment through the use of ODA and other public finance. Programmes that target private sector development and the environment – such as those providing access to finance for green technologies for SMEs and households – could help spur investment in green sectors and mobilise additional investment. In addition, programmes to crowd in private investment can build on financing landscape, such as in the case of the Global Climate Partnership Fund, a blended finance facility that is supporting a microfinance institution to initiate green lending.

Improve access to finance for SMEs and households to promote uptake of green technologies: The high cost of energy in Cambodia and a dependence on imported energy means there is a clear business case for private actors to invest in energy efficiency. Most industry in Cambodia, however, is characterised by a prevalence of SMEs where a lack of awareness of the potential for cost savings from energy efficiency and a lack of access to finance are cited as major barriers to investment in green technologies. Government and donor programmes to support SMEs understand the benefits of energy efficiency and increase access to finance for these should be encouraged. Some examples of such programmes exist already (e.g. UNIDO and Better Factories Cambodia work with SMEs), and these can be further scaled up.

Challenges and opportunities investing in green growth in Cambodia

Cambodia faces several challenges and opportunities on its path to green growth (Box 10.1). Challenges include a high dependence on natural resources for growth, unsustainable use of resources and increasing impacts of climate change; whereas opportunities include the potential to improve energy security and climate resilience through clean energy, and to promote growth and development through sustainable natural resource management. A measured and inclusive approach, based on a sound policy framework that encourages environmentally sustainable investment and promotes investment in green sectors, can help address the challenges and exploit the opportunities in a way that complements a sustainable, climate-resilient development pathway.

Enhancing energy security and sustainability

Significant increases in power generation in the last five years have so far been based on expansion of hydro and coal power generation, both of which are associated with negative social and environmental impacts. For example, in 2015, over 95% of power generated in Cambodia was from these sources, roughly half from each source (coal and hydro). In terms of broader energy use, beyond the power sector, the major source of primary energy, especially for cooking, is still biomass.

Box 10.1. Barriers and opportunities to improving green growth in Cambodia

An OECD case study of green growth in Cambodia reviewed the main factors that either enable or can disable progress on green growth in Cambodia. The study found several important opportunities that can support green growth including:

- Stable political climate which has enabled growth and investment.
- Good economic performance, which has accelerated investment and job opportunities in Cambodia, as well as expansion of microfinance and associated livelihoods improvement.
- Improvements in technical and institutional capacity of the government, which in turn helps to foster inclusive policy making processes, enforcing existing regulations through provision of incentives, and allowing more participatory approaches for public consultation.
- Potential to generate green investment from underexploited natural resources such as bamboo, rattan and silk, as well as small scale energy solutions supported by renewable energy sources.
- Technological improvements have also enabled Cambodia to further explore cost-saving production methods, and which can be further harnessed to promote energy and resource use efficiency.

Barriers to green growth included: a lack of awareness and recognition of the value and opportunities provided by green growth, a lack of institutional coordination, and a lack of a clear investment plan for green areas, including renewable energy.

Source : (Mohammed et al. 2013)

At the same time, Cambodia has the potential to expand its energy consumption from renewable sources beyond large scale hydro, by supporting the scale up of solar, biomass, and to a smaller extent, wind based power generation. Cambodia has favourable conditions and considerable potential for solar power, especially considering the high costs of electricity. At the same time, decentralised off-grid solar power solutions can help it meet its electrification targets. Better utilisation of biomass residues (i.e. by-products from the agriculture sector) and biogas could also support more sustainable use of biomass resources in support of energy consumption. With the demand for electricity increasing rapidly every year, there is a need to increase the share of future electricity that is generated from non-hydro, renewable energy.

Cambodia’s commitment to green growth

A strong government commitment to support green growth objectives and set clear targets to reach such objectives provides encouraging signals to investors. The establishment of national green growth policies or economic development plans which integrate environmental concerns and opportunities, and the allocation of adequate public funds and other resources show the government’s determination to achieve green growth objectives and can help raise investors’ confidence. Setting clear, long term, and legally binding frameworks to mainstream and encourage green growth are also key to attracting private investment.

International commitments in favour of green growth objectives

Cambodia has ratified the three Rio Conventions including the United Nations Framework Convention on Climate Change (UNFCCC) and the United Nations Convention on Biological Diversity in 1995, and the UN Convention on Combatting Desertification in 1997. It also signed the Convention on International Trade in Endangered Species in 1997. On commitments related to climate change, Cambodia ratified the Kyoto Protocol on greenhouse gas emissions in 2002. More recently, the country submitted a Nationally Determined Contribution (NDC) to the UNFCCC in 2015 and signed the Paris Agreement in 2016.

Integration of green growth into national development and industrial policies

The importance of promoting environmental sustainability and green growth are well embedded in the main development policies and plans in Cambodia. Recognising that efforts in addressing climate change cannot be separated from economic development and poverty alleviation goals, Cambodia has made strides in mainstreaming green growth and climate change into national and sub-national planning for socio-economic development.

The first goal of Cambodia's *Rectangular Strategy III 2014-18* is to achieve economic growth (annually 7%) which is 'stable, inclusive and resilient to shocks'. The strategy enumerates a development-focused approach to environmental sustainability, with a focus on four areas: sustainable natural resource management, promoting climate change adaptation, improving institutional and technical capacity for environmental management and reducing environmental pollution and degradation. This is further supported by the *National Strategic Development Plan 2014-18*.

Cambodia's *Industrial Development Policy 2015-25* lays out the framework to improve investment and private sector development. While promoting green growth and investment is not centrally embedded in the IDP, the policy makes important references to various aspects, acknowledging that implementation needs to go hand-in-hand with efforts to reduce or mitigate environmental impacts of industrial development, especially pollution. Within the context of promoting special economic zones, the IDP also strongly promotes green cities, urban development and eco-tourism, with a focus specifically on Sihanoukville in 2018.

National policy framework for green growth and environmental sustainability

Cambodia was the first ASEAN Member State to develop a green growth roadmap in 2009, followed by a strategy and policy in 2013, and, along with Viet Nam, it is one of the only two countries with a green growth strategy in place in the region.

Cambodia's *National Policy on Green Growth 20-2030* and *National Strategic Plan on Green Growth 2013-30* aim to reach middle-income country status by 2030 and propose several actions to promote green growth, including: promoting ecotourism, increasing renewable energy, improving the efficiency of coal-fired power generation, greening the finance sector, and promoting sustainable consumption and production. It is based on an original *National Green Growth Roadmap* developed in 2009 which focussed on access to essential resources for all, including water, land and energy, information and knowledge, mobility, and finance and investments.

In addition to green growth policies, Cambodia has developed its ten-year *Cambodia Climate Change Strategic Plan 2014-23* which outlines measures to promote adaptation and mitigation – the first objective of this plan is to improve climate resilience by promoting food, energy and water security. This is further elaborated by commitments made by Cambodia in its NDC under the Paris Agreement on Climate Change where it identifies rural development and agriculture as key focus areas for adaptation, and renewable energy and energy efficiency as target areas for mitigation, but with no explicit target for renewable energy penetration. As part of the Strategic Plan, line ministries have started to develop sector level strategic plans and action plans. Efforts have also been made to estimate and mobilise financing for these action plans.

Policies to promote green investment in specific sectors

Promoting grid-connected and off-grid renewable energy

The National Strategic Development Plan 2014-2018 states that renewable energy (RE) promotion is a focal issue, and to date, the main area of government support has been to actively promote decentralised, off-grid RE systems as a way of supporting rural electrification while the grid is being expanded. Given its geography, available land area, irradiation, large concentrations of agricultural residues and animal manure, Cambodia has considerable potential for the uptake of solar, biomass, biofuel and biogas options.

Lack of focus on grid-connected renewable energy

Alongside the promotion of off-grid renewables, the government has not followed the path of other ASEAN countries in adopting explicit renewable energy technology targets to promote on-grid renewables and there is no overarching policy framework supporting renewable energy in place. As a result, major investments in the power sector still focus to a vast degree on large-scale hydropower and coal-fired generation as well as grid extension, while decreasing technology costs and prevailing high electricity prices support the business case for grid connected renewable energy generation. Distributed solar has additional benefits regarding the reliability of electricity. These benefits apply to meeting daytime demand peaks and the dry season in general when hydropower output drops significantly. Further, utility-scale solar power installations can be constructed more readily than hydropower or coal-fired generation plants. The example of Cambodia's first utility-scale solar power project is given in Box 10.2.

Box 10.2. Utility-scale solar power for special economic zones

Special economic zones are being strongly promoted by the RGC, but chronic electricity shortages and dependence on energy imports have been a major constraint to SEZ development in the past. In February 2016, the government issued a Request for Proposal for a 10 MW solar PV project in Bavet, Svay Rieng Province, within a special economic zone. The project is the first utility scale solar power plant and the first internationally tendered independent power producer project for renewables in Cambodia. The 20-year power purchase agreement with EDC was awarded in August 2016. The generated energy supply will be equivalent to the demand of 2 600 households or an annual offset of 5 500 tonnes of carbon dioxide equivalents. The project is further supported by the ADB, with the Canadian Climate Fund for the Private Sector in Asia under the Clean Energy Financing Partnership Facility. According to the ADB, the loan was instrumental in assisting sponsors to overcome early mover risks and cost premiums associated with the project.

Source: Hashizume (2017); PV Magazine, (2017)

Impediments to increased renewable energy uptake

Despite Cambodia's significant RE potential, uptake of especially distributed RE has been small-scale to date. While the 10 MW utility-scale solar power plant is a step in the right direction, economically viable RE projects need a clear policy and regulatory framework to attract investments on a larger scale. An enabling environment for RE promotion would include the following elements that are currently missing and thus impeding the uptake of RE on a larger scale:

- An *explicit RE target* as an affirmative and definite signal for private sector investors. RE should also be considered in the power supply projections to avoid mixed signals regarding the seriousness of a national RE target.
- *Financial incentive mechanisms for excess electricity generation* from distributed plants to the grid. Currently, a universal net metering approach – within which electricity consumers are charged for their consumption less excess electricity sent to the grid from their distributed generation plant – is missing. The net metering approach could serve as an intermediary step to the introduction of a feed-in-tariff (FiT) that includes the payment for electricity provided to the grid above the wholesale electricity price. While the net metering mechanism can evolve into the FiT approach, the lack of either in Cambodia does not provide financial incentives to supply daytime electricity in close proximity to actual demand.
- Local *financial institutions providing adequate financial products and services* for implementing RE projects. To date, Cambodian financial institutions (FIs) are hesitant to engage in RE investments other than large hydropower. International development finance institutions can create revolving funds for on-lending at concessional terms for RE projects by Cambodian FIs. Global experience shows that such revolving funds or lines of credit for local FIs help overcome up-front capital barriers and provide initial success stories to stimulate RE market development (IRENA, 2013). Generally, this financial assistance is complemented by technical assistance regarding the development of adequate and demand-driven RE lending products as well as assisting local FIs in improving their business models and bankability. Awareness raising among local businesses, communities and households regarding the benefits of RE solutions is also relevant to stimulate demand for RE financial products and services.

These elements of an RE-conducive environment could be further complemented by exempting solar equipment from VAT as well as general awareness-raising campaigns across government, the private sector and local communities to change the prevailing perception of RE as being too expensive when compared with conventional energy sources as well as too marginal to satisfy electricity demand. By creating a suitable enabling environment, Cambodia could tap international climate funds for low-carbon development.

Promoting climate resilience in the agriculture sector

According to global and regional climate models, Cambodia's agricultural sector will be severely adversely affected by future climate change impacts, jeopardising the government's plans to expand agricultural production and export (WB, 2011). At present, 65% of the Cambodia's population derive their principal income from the agricultural sector that is dominated by rice production (FAO, 2014). The majority of these farmers are smallholders, with 21% of households being landless and a further 45% owning less than one hectare (IFAD, 2013). As Cambodian agriculture depends largely on rainfall, its production for domestic consumption and export will be significantly affected by predicted climate variability and extremes (MoWRM 2012). Experiences from 2002 and 2004 already demonstrated the devastating impact of droughts and floods, which led to a 14% decrease in the national rice yield and a corresponding food shortage for 2 million Cambodians (IFAD, 2013).

Due to low adaptation capacities of smallholder farmers, they will be most severely affected by climate change with immediate and direct effects on their income and resulting food insecurity. To partially avert these impacts, coping strategies likely to be taken up include the selling of assets, increasing debt, reducing expenditures on health care and education as well as a further reduction in food consumption (MoE & UNDP, 2011). Agricultural systems and services as well as institutions and policies that govern them must thus be adapted to meet the needs of householders and farmers as well as manage risks.

To secure and increase rice production as well as exports, the RGC is already focusing on irrigation within national development and poverty reduction policies. Within the National Strategy for Agriculture and Water, introduced in 2007, investments concerning the development and rehabilitation of large-scale irrigation infrastructure are identified to enhance agricultural productivity and improve water resource management. Further, the RGC adopted the Policy on the Promotion of Paddy Production and Rice Rice Export to further support the export of milled rice and transform Cambodia into the world's rice basket. In the short-term, corresponding efforts include inter alia investments in irrigation facilities alongside increased private sector investment in the export of milled rice. In the medium to long-term, competitiveness is to be enhanced via a further focus on infrastructure as well as soil fertility management and production technology.

While paddy production and rice exports did increase significantly in the past, the further consideration of predicted climate change impacts and appropriate adaptation measures in sector strategies and policies is imperative to continue on this trajectory. Demand-oriented, climate-smart agriculture which is already in part implemented in Cambodia could take the following form (Chou, Neang et al, 2012):

- *Climate smart farming systems*: Developing agricultural practices and adaptation strategies for farmers, aimed at achieving optimised use of water, seed and soil in the face of the changing level of precipitation. Further, selection of adapted varieties of different crops as well as improved seed storage and treatment;
- *Climate smart agricultural extension services*: Incorporating insights from the local farming level regarding climate smart farming systems for improved extension services provided by public and private providers;
- *Climate smart policies*: Preparing sector strategies and policies that include, mainstream, climate change adaptation. These strategies and policies would gain significantly from feedback provided from the local level farming systems.

Adjacently, the RGC engages selectively in promoting finance for sustainable energy use in a broader effort to support SME growth and green development. Cambodia's National Biodigester Programme is supported by these measures. In cooperation with Cambodian microfinance institutions, preferential loans and a subsidy for incurred investment of plant installation are provided. While the programme is currently constrained to rural households as beneficiaries, engaged agencies are interested in broadening the target group to include micro and small enterprises in the agricultural sector (adelphi, 2016).

Financing green growth

While there is significant potential to mobilise private investment for green growth – particularly in renewable energy, energy efficiency and sustainable agri-business – many areas are at an initial stage of development. Access to finance to catalyse action in these areas and targeted support for demonstration and awareness raising is an important first step.

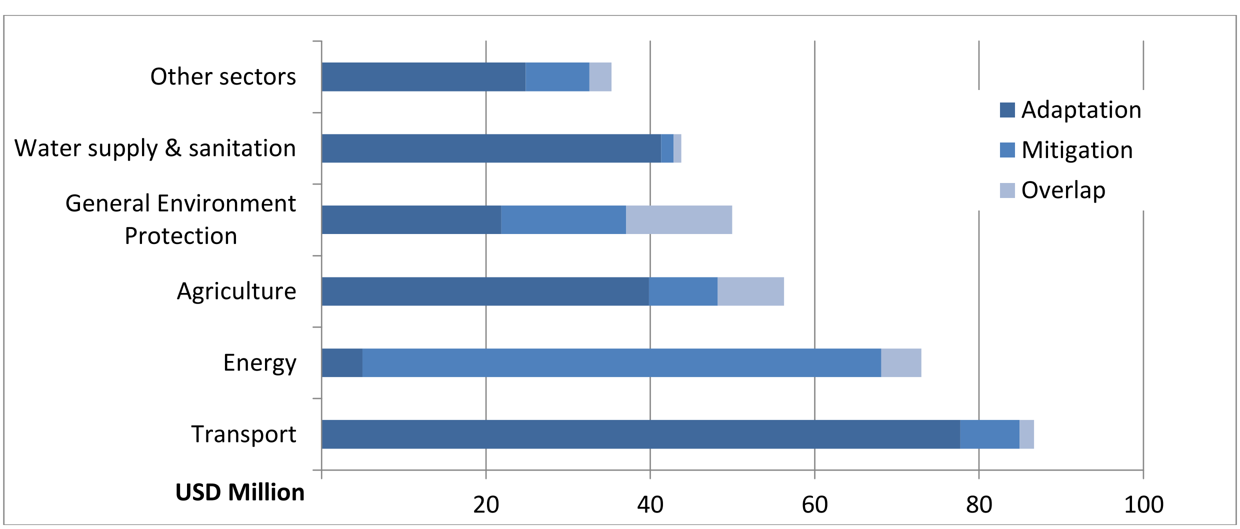
Public climate finance will continue to play an important role

Public finance, both domestic and international, continues to form the main support for climate change and green growth activities, but there are no credible estimates available of private support for these areas. Public expenditure on climate change doubled between 2009 and 2014, rising from 0.9% to 1.3% of GDP in 2014. Roughly a third of public expenditure could be considered climate related in Cambodia in 2014, and around 4% could be considered specific climate finance. Within this, the national budget supported roughly one quarter of this expenditure, while the rest was supported by international public financing.

According to OECD DAC statistics, just over USD 345 million in international development finance commitments went towards climate change projects in Cambodia, in 2013-15, on average (Figure 10.1). Just under two-thirds (61%) focused on climate change mitigation, a third supporting climate change adaptation (30%) and the rest supporting both mitigation and adaptation[2]. The top five development partners in terms of volume of support for climate change in 2013-15 were Japan, the United States, France, Germany and the Climate Investment Funds. Two thirds of this support went towards reducing emissions from and improving the resilience of energy, transport and water infrastructure.

Figure 10.1. Climate-related development finance to Cambodia, 2013-15

(average, current USD commitments)



Source: OECD DAC statistics

As part of its Nationally Determined Contribution under the Paris Agreement, RGC has estimated that USD 1.1 billion will be required between 2014 and 2018 to implement the climate action plans under different line ministries. In support of this, a Climate Change Financing Framework was developed in 2014 to outline the government's plans for mobilising resources to support its NDC. Much of the international climate finance received by Cambodia has focused on providing project level support. The limitations of such approaches include a disaggregation of support across various areas, especially in areas where donor coordination and harmonisation are poor, and reduced alignment with national priorities. An alternative programmatic approach has also been tested. The Cambodia Climate Change Alliance pools funding from the EU, Sweden, Denmark and UNDP and supports pilot projects under areas specified in the climate change action plans of ministries and which are implemented by both government agencies and NGOs.

Scaling up financing for green technologies, especially among small businesses

Access to finance is a critical issue when considering that small businesses make up the bulk of Cambodia's private sector, with over 500,000 or 99.8% of all enterprises in the country being classed as micro, small and medium sized enterprises (MSMEs) in 2014 (ADB, 2015). Many of these work with outdated technologies which result in a high carbon footprint as well as increased costs of production (Schneider et al, 2016). At the same time, small businesses in Cambodia have difficulties in accessing finance more broadly. For example, access to finance is the biggest constraint for agri-business SMEs which make up a third of the SMEs in the country (World Bank, 2013).

These issues are intensified in the case of financing for green technologies or approaches, as exemplified in the case of the road freight/trucking industry in Cambodia (Philipps, 2014). While the freight industry plays an important role in supporting the government's ambitions on agricultural expansion and export, high fuel costs affect the cost of production. The fuel costs are in turn driven by the large share of small and micro trucking companies (including many owner/driver trucks), which use second or third hand vehicles, have low profit margins and almost no access to finance to renew vehicles or invest in driver training etc.

While SME development and access to finance is well recognised by the government, there is a need for government plans in this area to specifically support green financing for SMEs. Specific support for SME focussed credit lines have been put in place in partnership with commercial banks, and could be harnessed to target green lending. For example, ADB and IFC both support ACLEDA bank to roll out SME financing targeting agri-businesses (Eisinger and Cochu, 2016).

The financial sector offers several opportunities to mobilise private finance

The financing landscape in Cambodia can be built on to support future efforts to promote green investment. Several commercial banks operate in the country, though many are foreign owned and target large investments. A new effort – the Cambodian Sustainable Finance Initiative – was initiated in 2016 with support from IFC to increase the awareness of sustainable banking practices among members of the Association of Banks in Cambodia. Working with the National Bank of Cambodia and the Ministry of Environment, this initiative is expected to result in the development of sustainable finance principles which can be adopted and embedded in local banks.

In addition to commercial banks, there is a well-established, flourishing microfinance sector with 33 licenced micro finance institutions MFIs in 2013. Microfinance loans are growing, and the sector has outperformed the banking sector in terms of returns and growth in provision of loans. Cambodian MFIs largely target the agriculture sector, export based businesses and households, and provide short term loans. With established links to small business and households, MFIs could be supported to take on a stronger green lending role. For example, Prasac, the leading MFI in Cambodia, signed an agreement with the Global Climate Partnership Fund in 2016, a donor supported blended finance facility, to initiate lending specifically linked to renewable energy and energy efficiency.

Notes

[1] Incentives include preferential tax rates, import duty exemptions, and reduced land rents.

[2] The OECD Development Assistance Committee (DAC) statistics track development finance from DAC members, non-DAC providers, multilateral development banks and climate funds to developing countries in support of climate change mitigation and adaptation. Bilateral flows are measured using the 'Rio Markers' approach. These statistics include data on Overseas Development Assistance (ODA) (i.e. concessional finance, including grants and concessional loans) and as well as Other Official Flows (OOF) (i.e. non-concessional developmental finance such as loans provided at market rates).

While the OECD DAC statistical system provides the most consistent source of data on climate-related development finance across bilateral and multilateral providers, it is important to note the difference between climate-related development finance and climate finance as reported by parties to the UNFCCC. Whilst party reporting is often based on climate-related development finance statistics, not all climate-related development finance is reported as climate finance as some members may apply additional quantitative methodologies to identify climate finance. Hence the two are not directly comparable.

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Chapter 11. Other areas in the policy framework for investment of relevance to Cambodia

This chapter considers other aspects of the policy framework for investment of relevance to Cambodia, namely corporate governance, competition policy and the role of development partners in promoting private sector development. It documents improvements made recently in the corporate governance framework, as well as the challenges in its overall implementation. On competition policy, it discusses the absence of a general competition law in Cambodia and makes recommendations concerning what should be included in the draft law as it makes its way through the legislative process. And lastly, the chapter reviews what development partners are currently doing to promote private sector development in Cambodia.

Corporate governance

Corporate governance concerns the structures framing the relationships among a company's executive management, board of directors, shareholders, and stakeholders. From the perspective of modernising legal and regulatory frameworks, effective corporate governance is important because it affects individual firm behaviour as well as broader macroeconomic indicators such as growth and investment. For emerging market economies, improving corporate governance can reinforce property rights, reduce transaction costs, and lower the cost of capital, which together can improve investor confidence, including for foreign investors, and support capital market development. The Asian financial crisis in 1997-8 acted as a significant catalyst for improving corporate governance frameworks in Asia to build well-functioning and stable financial markets.

While the Cambodian authorities have made progress in recent years on corporate governance, including updating the *Accounting Law* and adopting international accounting standards, overall implementation of the corporate governance framework remains challenging in terms of access to finance, corporate financial and non-financial disclosure and the perception of corruption. This section evaluates the current and evolving framework for corporate governance in Cambodia, using as a benchmark the *G20/OECD Principles of Corporate Governance* and the *OECD Guidelines on Corporate Governance of State-owned Enterprises* (Box 11.1).[1]

Policy recommendations

- *Enhance the quality of corporate disclosure and ensure that it is made in a timely manner*. The government should ensure the implementation of good practices for financial and non-financial disclosure, in both Khmer and English. Currently, the adoption of Cambodian International Financial Reporting Standards is required for enterprises and non-profit organisations, though an extension has been afforded to banks and financial institutions until 2019, but implementation has been challenging, resulting in delays in the roll-out of mandatory adoption. Progress can be made in terms of the timely publication of financial and non-financial information by firms, especially in English. Managers, board members, and controlling shareholders should especially improve disclosure of the structures that give insiders disproportionate control to their equity ownership.
- *Clarify and ensure effective separation between the state ownership function and regulation*. A clear separation is a prerequisite for ensuring a level-playing field with the private sector and for avoiding competitive distortions. Clear regulations should be developed to protect the independence of regulators, especially vis-à-vis line ministers. Nominal independence is not enough, as operational independence might be jeopardised by a narrowly-based fee structure, for example, or by a lack of budget control. In Cambodia, a number of economic activities are performed either within the general government sector or by companies that, while not classified as state-owned enterprises, are closely related to the government.
- *Develop and disclose a state ownership policy*. The government has not yet published a policy for state ownership. An ownership policy should define clearly the overall rationale for state ownership and be made public, clarifying the main objectives to which this rationale gives rise. Most importantly, the ownership policy should define how the state should behave as an owner. Clear and

published ownership policies provide a framework for prioritising SOE objectives and are instrumental in limiting the dual pitfalls of passive ownership or excessive intervention in SOE management.

Box 11.1. OECD Principles on Corporate Governance

Good corporate governance is not an end in itself. It is a means to create market confidence and business integrity, which in turn is essential for companies that need access to equity capital for long term investment. Access to equity capital is particularly important for future oriented growth companies and to balance any increase in leveraging. The G20/OECD Principles of Corporate Governance therefore support investment as a powerful driver of growth.

The Principles were originally developed by the OECD in 1999 and updated in 2004 and 2015. The latest review was carried out under the auspices of the OECD Corporate Governance Committee with all G20 countries invited to participate in the review on an equal footing with the OECD Member countries. The Principles provide guidance through recommendations and annotations across six chapters:

1. Ensuring the basis for an effective corporate governance framework
2. The rights and equitable treatment of shareholders and key ownership functions
3. Institutional investors, stock markets and other intermediaries
4. The role of stakeholders in corporate governance
5. Disclosure and transparency
6. The responsibilities of the board

Importantly, the Principles have a proven record as the international reference point and as an effective tool for implementation. They have been adopted as one of the Financial Stability Board's Key Standards for Sound Financial Systems. They have also been used by the World Bank Group in more than 60 country reviews worldwide. They serve as the basis for the Guidelines on corporate governance of banks issued by the Basel Committee on Banking Supervision, the OECD Guidelines on Insurer and Pension Fund Governance and as a reference for reform in individual countries.

Complementing the Principles, the OECD Guidelines on Corporate Governance of State-Owned Enterprises are addressed to the state as an owner, providing guidance on how SOEs can operate efficiently, transparently and accountably. They are the internationally agreed standard for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state intervention. The Guidelines were first developed in 2005 and have been updated in 2015 to reflect a decade of experience with their implementation and address new issues that have arisen concerning SOEs in the domestic and international context.

Developing a corporate governance framework

Since 1989, Cambodia has taken important steps in its transition to a market economy. In conjunction with its accession to the WTO in 2004, a number of reforms to establish the legal and regulatory framework for corporate governance have been developed to improve the business environment. Nonetheless, access to finance for firms remains challenging and corporate disclosure is generally weak. To address some of these challenges, the government adopted the National Strategic Development Plan 2014-18, which affirms its intention to "promote the use of international best practices in accounting and corporate governance", as well as an Action Plan for Financial Sector Development for 2016-25, which sets out specific targets for 2025.[2]

The main laws relating to corporate governance in Cambodia are as follows:

- The *Law on Commercial Enterprises* 2005 allows various types of businesses to establish and operate in Cambodia and requires all enterprises to prepare and maintain financial and business records.
- The *Law on Accounting and Auditing*, updated in January 2016, sets out provisions for an annual audit of the financial statements of businesses. The law governs the National Accounting Council, which oversees the adoption of Cambodian International Financial Reporting Standards (CIFRS), which are based on International Financial Reporting Standards.[3]

The *Law on the Issuance and Trading of Non-Government Securities* governs the securities market, including securities issued by public limited companies or other legal entities permitted to publicly issue and trade securities. It outlines the functions of the Securities and Exchange Commission of Cambodia (SECC) as well as those of clearance and settlement facility operations, securities depositories and other operators in the securities market. It also outlines the terms for dispute resolution as well as the penalties that can be issued by the SECC for sanctioning misconduct, including insider trading, market manipulation, false statements, operating without a licence, illegal public offer of securities and non-compliance with SECC instructions.

To complement these legal reforms, a number of regulations (e.g. prakas, sub-decrees) have been passed to provide further details regarding the legal framework for corporate governance (Table 10.2). The *Prakas on Corporate Governance of Listed Companies* (2009) and the *Prakas on Corporate Governance of Listed Public Enterprises* (2010) set out further requirements for listed enterprises and listed SOEs that relate to the composition of the board of directors, disclosure of material information and protection of shareholder rights. An audit committee chaired by an independent director is to review financial reporting; internal control; internal auditing; and external auditing, as well as report committee activities to the board. Listed SOEs above a certain size (approximately USD 50 million in assets) must also establish a risk management committee.

The Listing Rules of the Cambodia Securities Exchange (2015) define the requirements for entering the capital market. The development of a Corporate Governance Code is also currently under consideration by the government. As for the institutional framework for the corporate governance of listed firms, the SECC was established in 2007. The board of the SECC is composed of the Minister of Economy and Finance as Chairman as well as eight other members. Five board members are from government ministries (Ministry of Economy and Finance, National Bank of Cambodia, Ministry of Commerce, Ministry of Justice), one is from the Council of Ministers and two are capital market experts.

Even with these reforms, important gaps in the corporate governance framework remain. In practice, financial and non-financial disclosure remains weak. Many Cambodian firms do not have the capacity to comply with regulations governing disclosure. The existence of a large number of regulations, some of which are more than a decade old, has made awareness by market participants difficult. Additionally, a limited amount of legal safeguards are in place to prevent unwarranted external interference in the activities of private businesses. Challenges to business integrity include the limited implementation of certain laws.

A diminished state-owned sector

Cambodia's SOE sector has diminished significantly over time. Largely during the 1990s, the Cambodian government shifted the economic system from a planned economy to a market-driven system and launched various waves of privatisation of state-owned enterprises (Box 11.2). In 1989, there were 187 fully state-owned enterprises in Cambodia. By the end of 2000, 160 had been privatised, of which 139 were leased to the private sector, 12 transformed into joint ventures, 8 sold and 8 liquidated (UNCTAD, 2003). As of 2007, the remaining 17 fully state-owned enterprises employed 14 251 people, and their total revenue accounted for approximately USD 375 million (Ngov, 2011). By the end of 2016, 10 fully state-owned enterprises remained (Table 11.1).

Table 11.1. Selected state companies and joint ventures in Cambodia

Name of foreign firm	Status	Sector	Total revenue in 2013 (in USD million)	Government equity share as of end 2014
Electricité du Cambodge	State company	Utilities	668.4	100%
Sihanoukville Autonomous Port	State company	Transport	36.5	100%
Telecom Cambodia	State company	Telecom	23.1	100%
Cambodia Shipping Agency	State company	Logistics	5.3	100%
Cambodia Postal Services	State company	Logistics	4.7	100%
Rural Development Bank	State company	Finance	4.4	100%
Green Trade Company	State company	Logistics	3.8	100%
Printing House	State company	Logistics	2.9	100%
Siem Reap Water Supply Authority	State company	Utilities	2.0	100%
Phnom Penh Water Supply Authority	Joint venture	Utilities	40.1	85%
Phnom Penh Autonomous Port	Joint venture	Transport	11.1	80%
Kampcheary Insurance	Joint venture	Finance	3.5	80%
Cambodia Life Insurance	Joint venture	Finance	0.2	51%
Cambodia Securities Exchange	Joint venture	Finance	No data	55%

Source: Ministry of Economy and Finance of Cambodia, General Department of Sub-National Administration Finance, 2015; Cambodia Securities Exchange, 2016.

The *Law on General Statute of Public Enterprises* outlines rules governing SOEs in Cambodia.[4] In accordance with the law, there are two different types of commercial SOEs: (i) a state company in which all of the capital is owned by the state and which has financial autonomy (e.g. Electricité du Cambodge), (ii) a joint-venture in which a majority of capital is owned by the state and a minority by private investors (e.g. Phnom Penh Water Supply Authority). Private enterprises are allowed to compete with state-owned enterprises under de jure equal terms and conditions.

Box 11.2. Cambodia's state-owned enterprises and industrial development

As a result of years of civil war and the pursuit of communist-led policies, the Cambodian economy in the 1970s and 1980s became dominated by agriculture with little or no industry. After the fall of the Khmer Rouge in 1979, the priority of the regime of the People's Republic of Kampuchea became self-sufficiency in an economy where human capital and physical infrastructure had been destroyed. Between 1979 and 1989, state-owned enterprises were re-established, though they frequently sold products at subsidised prices or offered them as rations for government officials. In 1988, the share of state-owned manufacturing output was around two-thirds of all manufacturing output and the total value of industrial production, including handicrafts, was only USD 20 million.

With the collapse of the Soviet Union and the introduction of Viet Nam's economic policy of Doi Moi in 1986, Cambodia launched a gradual process of economic reform. In the mid-1980s, the government introduced private property and began the privatisation of state-owned companies and de-collectivisation of agriculture. These reforms moved Cambodia's political and economic development from a command to a laissez faire capitalist economy and from domestic to export-oriented production. In the 1990s, industrial development was given prominence. According to the Economic Census of 2011, the share of industry in the economy increased from 12.6% in 1993 to around 22.6% in 2011.

Source: Chhair and Ung (2013), Slocomb (2010), National Institute of Statistics (2013)

Each state-owned enterprise in Cambodia operates under the supervision of a line ministry or government institution and is overseen by a board of directors drawn from among senior government officials. The financial reports of SOEs are audited by the appropriate line ministry, the Ministry of Economy and Finance as well as the National Audit Authority – the supreme audit institution in Cambodia – which scrutinises budget implementation in conformity with the *Budget Law*. The National Audit Authority was established in 2000 by the *Law on Audit* and is an independent entity reporting directly to the National Assembly with its own budget funded by the national budget. The government has expressed its commitment to continue to reform the SOE sector. SOEs with sound financial performance are encouraged to list on the stock market or attract private investors. Phnom Penh Water Supply Authority was the first company to list on CSX in 2011 and Cambodia Life Insurance was sold to a private consortium in September 2015, for example. However, efforts to establish separation between ownership and regulation have been limited. A number of economic activities, for example, are either performed within the general government sector or by companies that, while not classified as SOEs, are closely related to the government. There is also currently no clear state ownership policy in Cambodia. The OECD *Guidelines on Corporate Governance of State-Owned Enterprises* provide the government with an internationally-recognised benchmark for evaluating the corporate governance framework pertaining to SOEs and designing reforms.

An underdeveloped capital market

The Cambodia Securities Exchange (CSX) began operations in July 2011 and shares began trading in 2012. The government is aiming to improve access to longer-term and cheaper capital than that provided by banks. CSX currently has four listed companies (Table 11.2), with a combined market capitalisation of USD 193 million as of March 2017. Since its opening, CSX has faced challenges in boosting liquidity and attracting new companies to list. Like the securities exchange of neighbouring Lao PDR, was set up with the support of Korea Exchange (see Box 11.3 for a comparison with other stock exchanges in the region). The two shareholders of CSX are the Royal Government of Cambodia (55%) and Korea Exchange (45%).

Table 11.2. Listed firms on the Cambodian Stock Exchange

Name	Issue name	Sector	IPO	Market capitalisation, March 2017 (USD m.)
Phnom Penh Water Supply Authority	PWSA	Utilities	02/2012	87
Grand Twins International (Cambodia) Plc	GTI	Manufacturing	06/2014	44
Phnom Penh Autonomous Port	PPAP	Transport	12/2015	26
Phnom Penh SEZ Plc	PPSP	SEZ	05/2016	40

Source: CSX, 15 March 2017

Challenges in developing the capital market have included the difficulty in demonstrating the business case for listing to firms. The establishment of institutional investors and other intermediaries in the Cambodian securities market has also been slow. One challenge is the lack of knowledge and financial skills of investors – many are unaware of corporate governance issues and do not have sophisticated accounting skills. Securities companies, which provide financial advice, brokerage services and underwriting for securities issuance, have not yet developed a substantial revenue base. The small size of the market and low level of liquidity are also important factors deterring investors.

In September 2015, the Cambodian authorities announced the creation of a new trading platform to increase participation of SMEs on CSX. Since this decision, SMEs seeking to raise capital have the option of listing on a 'Growth Board' – an addition to the existing 'Main Board'. Though there are not yet any SMEs listed on the Growth Board, this approach aims to increase the number of listings by reducing compliance costs and barriers to entry for local SMEs.

To create a conducive environment for expanding the capital market, the authorities will need to continue to enhance a number of capital market structures, including depositories, clearing and settlement facilities and cash settlement systems. To facilitate market transactions, capacity to undertake asset valuation for securities market transactions also needs to be developed, in particular to align with ASEAN standards. As the market broadens and gains in sophistication, the SECC will need to enhance its IT systems to improve information disclosures and market monitoring and surveillance.

According to the Action Plan for Financial Sector Development 2016-25, the Cambodian authorities aim to continue to develop policies to boost the growth of the capital market. Elements addressed in this plan include: (i) continuing to streamline regulations for SME listing; (ii) encouraging the listing of SOEs; (iii) promoting the creation of exchange traded funds; (iv) reviewing the effectiveness of tax and non-tax incentives for listed companies; and (v) promoting the significant listing of financial institutions. Awareness raising activities with companies and other stakeholders on the benefits of capital market access is also a key component. Lastly, to enhance the relationship with regional and foreign investors, CSX has signed memoranda of understanding with the Stock Exchange of Thailand, Hanoi Stock Exchange, and the Lao Securities Exchange.

Box 11.3. Snapshot of capital markets in Lao PDR, Myanmar and Viet Nam

The Lao Securities Exchange (LSX) has five listed companies and a market capitalisation of USD 1.33 billion, as of March 2017. Electricité du Laos-Generation Public Company is the largest listed company, accounting for over 80% of market capitalisation. According to a recent strategic plan for capital market development, LSX aims to have 25 listed companies by 2020, and 60 listed companies by 2025. The Korea Exchange (KRX) holds a 49% stake in the LSX operating company, while the Bank of the Lao PDR holds 51%. LSX was launched in 2011 with support from both the Stock Exchange of Thailand and the KRX.

In Myanmar, the Yangon Stock Exchange (YSX) opened in December 2015, and has five listed companies and a total market capitalisation of USD 532 million, as of March 2017. A joint venture between the state-owned Myanma Economic Bank (51%), Daiwa Securities Group (32%) and Japan Exchange Group (17%). First Myanmar Investment – a conglomerate with significant real estate holdings – was the first company to list. Companies being considering for listing are among the over 200 public companies in Myanmar, as defined by Myanmar's Special Companies Act.

Viet Nam's two stock exchanges, the Ho Chi Minh Stock Exchange (HOSE) and Hanoi Stock Exchange (HNX), had 324 and 380 listed firms, respectively, as of March 2017. HNX had a market capitalisation of USD 6.89 billion and HOSE a market capitalisation of USD 51.02 billion. HNX also has an alternative market known as the Unlisted Public Company Market with 480 companies as of March 2017. The State Securities Commission, the State Bank of Viet Nam, HNX and HOSE have increased their staff and other resources to keep pace with rapid market expansion.

Source: Websites of LSX, HNX, HOSE and YSX

A challenging environment for disclosure

The *G20/OECD Principles of Corporate Governance* state that "the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company." The disclosure of financial and non-financial information by firms in Cambodia is commonly perceived by investors as being partial and untimely. This is largely a result of the lack of capacity of companies to provide detailed corporate information in English on company websites or through investor relations contacts. Listed firms on CSX are some of the best performers in Cambodia with regards to the disclosure of financial and non-financial information.

The government might consider using the disclosure practices of listed firms on CSX as a good practice example for non-listed firms. Through capacity building and targeted training, regulators can provide assistance to firms in improving their disclosure performance. In this aim, both the human and technical resources of regulators can be improved. To address the lack of skills related to accounting and auditing that are needed to implement and foster a culture of good corporate governance, the government might consider promoting vocational training and continuing education programmes.

Looking ahead

The government has made important steps towards establishing the legal and regulatory framework for corporate governance, but further efforts are needed with regards to the enforcement and implementation of this framework. As discussed, the government might consider placing particular emphasis on improving the disclosure of financial and non-financial information by firms through capacity building seminars and targeted training. With a greater emphasis on disclosure compliance, the authorities will make progress towards the facilitation of regional integration and move towards their expressed ambition of joining the ASEAN Corporate Governance Scorecard.[5]

Competition policy

Competition is essential for a dynamic business environment in which firms invest (OECD, 2015). More competition not only benefits consumers with greater choice, quality and lower prices but also, drives productivity and innovation, key factors that contribute to economic growth. An effective competition policy usually includes active economy-wide enforcement of antitrust rules designed to deter anticompetitive practices as well as pro-competition sectoral policies. Together, these policies improve both domestic economic performance and international competitiveness.

Creating and maintaining competitive markets requires strong, comprehensive competition legislation which is enforced by a well-trained and resourced competition authority, free from political interference and that enforces the law. A sound competition regime requires that firms know the rules of the game and respect them and that those rules are applied equally to all firms – private, state-owned, foreign or domestic. It also requires legislation that achieves the legitimate objectives of government but does not create unnecessary barriers to entry of new firms – a crucial element in achieving well-functioning markets.

Competition policy in Cambodia is considered as an important element of the development of its economy. According to the World Bank Enterprise Survey of 2012, anti-competitive practices are perceived "as a major impediment to doing business in Cambodia". The authors consider that completing the draft competition law and setting up an independent Competition Agency "would go a long way towards ensuring a level playing field for companies in a country where personal connections are still considered important for business profitability" (World Bank, 2015). Competition authorities can play an important role in reducing government restrictions on markets that can be an important source in incentivising enterprise registration by helping government bodies identify existing regulations that unnecessarily restrict competition or helping policy makers design new regulations that hinder competition as little as possible yet still achieve their policy goals (OECD, 2009). By failing to comply with various economic rules and regulations, informal firms are often able to undercut and steal business from formal firms, even when they use inefficient production techniques. As a result, formal firms are less able to fully exploit economies of scale, limiting their own growth and productivity.

Currently Cambodia does not have a general competition law in place, even though it has committed itself to do so with both the context of the ASEAN Economic Community Blueprint (whereby it was meant to have a law by end 2015) and of the WTO accession in

2004 (where it was meant to introduce a competition law by 2006). Discussions have been ongoing for a number of years, but so far have not resulted in a draft being approved or even having initiated the legislative process.

Cambodia should adopt the *Competition Law* at the earliest opportunity to benefit from well-functioning markets and a level playing field for both domestic and foreign firms, independent of ownership (private or state). Such rules can help Cambodia benefit from continued higher productivity gains and economic growth. In general terms, the draft law is to be welcomed as it is broadly in line with international best practice. It should be followed up quickly with the adoption of implementing rules on issues such as criteria for remedies and sanctions as well as merger control provisions.

General recommendations

- Adopt the *Competition Law* and implementing rules on fundamental issues such criteria for remedies and sanctions as well as merger control provisions.
- Ensure more independence of the Competition Commission, including reducing direct government influence in its composition and sufficient resources.
- Analyse laws and regulations through a *Competition Assessment Toolkit* or similar tool to ensure that market entry is not being unduly restricted by rules and regulations beyond what is necessary to attain legitimate policy objectives

Substantive provisions of draft law broadly in line with international practice

The draft Competition Law6 would prohibit (i) unlawful anticompetitive activities, (ii) abuse of a dominant position, and (iii) business combinations that would significantly prevent, restrict or distort competition (merger control). These provisions provide a framework of minimum standards for sound competition law7, are widely applicable8, and are broadly in line with international experience. The rules set out in the draft are of a general nature and would require significant implementation efforts on the part of the Competition Commission, in terms of both implementing regulations and guidelines. Implementing rules would be crucial in determining rights and obligations of parties to a procedure, establishing criteria for remedies and sanctions and implementing a merger control regime establishing the criteria determining those mergers that are subject to a review.

Anti-competitive agreements: Hard core cartels are the most serious violations of competition law. They injure consumers by directly raising prices and restricting supply, thus making goods and services unavailable to some purchasers and unnecessarily expensive for others. The categories of conduct most often defined as hard core cartels are covered in Article 5 and are (i) price fixing, (ii) output restrictions, (iii) market allocation, and (iv) bid rigging.

Abuse of dominance: Dominant firms have the ability to raise prices and restrict output, harming both consumers and economic efficiency. Having a dominant position should not, by itself, be illegal, however, as businesses should not to be penalised for their success when they have attained a dominant position legitimately through greater efficiency than others. To do so would discourage firms from making their best efforts to reduce costs and innovate. At the same time, firms should be deterred from attaining or maintaining dominance by preventing competition. Such cases may have particular importance in transition economies. For example, competition law provisions relating to abuse of dominance may have an important role to play in addressing anticompetitive practices that entrench former state-owned monopoly enterprises (see below). Abuse of dominance provisions are covered in Article 7 of the draft law and are in line with international practices.

Merger control: Almost all jurisdictions with a competition law provide for control of mergers which safeguard against the possibility that firms may acquire market power through mergers and acquisitions. Merger control can help to prevent consumer harm from anticompetitive transactions which likely would reduce competition among rival firms or foreclose competitors[9] and change market structures that lead to adverse competitive effects. Most mergers do not harm competition as they will either have no significant effect (for example, if the merging businesses operate in unrelated markets) or they will generate synergies that can result in lower prices or better products for the consumer. But some mergers can result in very large costs to consumers and to the economy more generally. It is essential that authorities have the power and skills to investigate swiftly and effectively to clear beneficial mergers but also to remedy any potential problems they find, including by blocking the merger. Whilst a general provision regarding business combinations is set out under Section 3 of the draft, it will require significant implementing rules as the provision in the draft merely provides for the legal test for prohibited mergers as well as for the general obligation to notify. In the interests of legal certainty, a number of other provisions would have to be regulated. The criteria for establishing that a business combination which has the effect of significantly preventing, restricting or distorting competition would have to be established, for instance, as would the specific determination of which business combinations would require to be notified.

Inclusion of SOEs: Article 3 states that the law would apply to businesses, including wholly or partly government-owned companies. In many jurisdictions competition regimes apply to any entity carrying out an economic or commercial activity, or a business, including SOEs. Most jurisdictions concur that such activity means the provision of goods or services, regardless of the entity's legal status, ownership or financing structure.[10] The presence of SOEs in the market place is not, in itself, a reason for concern.[11] The OECD's work on competitive neutrality shows clearly that broad and neutral competition law enforcement helps to ensure a level playing field and that competition is not distorted unduly by the presence and actions of SOEs[12]. An example might be where an SOE may enjoy near-monopoly positions in newly liberalised markets, allowing it to hold on to its market position through anti-competitive practices – such as blocking a competitor's access to an essential input. This can raise rivals' costs and create barriers to entry.

Inadequate agency independence and resourcing affects regulatory outcomes

Competitive markets need to be underpinned by a comprehensive competition law enforced by an independent well-trained and adequately financed competition authority. Overall, in order to ensure that the competition law will be applied effectively, the government should ensure the independence of the competition Commission in the *Competition Law* to be approved.[13]

Independence from government and those it regulates increases confidence and trust in the integrity of agency decision-making, while a high level of integrity improves regulatory outcomes[14]. The degree of agency independence also influences legal certainty and the consistent application of rules over time. Voigt (2009) finds that for a developing country, de facto independence of the competition authority will translate into a 17 percentage point reduction in the productivity gap with the United States.[15]

The degree of independence of agencies and the advantage of being removed from politics influences legal certainty and consistency of application of rules over time. Some of the main factors that are generally considered to influence the independence of agencies are (i) who appoints the head of the agency or agencies – whether it be the parliament or the head of government, (ii) whether the agencies are integrated into the government structure or are placed outside that structure (e.g., not part of a ministry), and (iii) budgetary autonomy.

Independence should be safeguarded by competition legislation and several provisions of the draft law suggest a degree of government dependence. The key concern is the composition and broad ministerial discretion to appoint and terminate staff – the Cambodia Competition Commission chairman is the Minister of Commerce (with casting vote) and the majority of members are ministerial appointees who may be replaced at any time by the ministry that appointed them (Chapter III). Such extensive discretionary powers provide for the use or threat of personnel changes to influence the operation of the institution. Furthermore, the Commission has a Director General who shall be responsible for investigating potential violations of the *Competition Law* and who is selected and proposed by the Minister of Commerce to the Prime Minister and then appointed by Royal Decree. The autonomy and independence of the Commission, along with its capacity to perform its functions, is also limited by the role of the minister in determining its budget: its annual budget would be distinct from the Ministry of Commerce but part of the overall budget.

A regulatory framework that supports business friendly environment

Good regulatory practice drives productivity gains by effectively allocating resources, promoting fair and robust competition and minimising the compliance burden on business. Market turnover/churn is as essential to productivity as technological progress and innovation, enabling the entry of innovative firms and the exit of unproductive and unprofitable businesses (Andrews et al., 2015[16]). In the experience of OECD countries, although firms less than five years old (regardless of their size) accounted for less than a fifth of total non-financial business employment, they generated half of all new jobs over 2010-11. Reforms to reduce barriers to firm entry and exit would further support the development of productive entry (generally and for SMEs) and competitive markets. A broader examination of barriers to competition would also be beneficial to identify unnecessary red tape. The OECD *Competition Assessment Toolkit* provides a general methodology for undertaking an assessment of competition barriers, including impediments to the entry and exit of small firms.

How development partners help to improve the investment climate in Cambodia

Development cooperation has played a prominent role in the recovery of Cambodia from the destruction wrought by years of civil strife. In the early years after such cooperation was resumed following the Paris Peace Agreements, multilateral development partners – especially the World Bank, the ADB and the IMF – mainly supported macro-economic reforms through structural adjustment, socio-economic development and public investment programmes (e.g. social and economic infrastructure, health and education). In contrast, bilateral development partners and UN agencies concentrated mostly on healthcare and rural development, while Japan also provided significant amounts to social and economic infrastructure.

Reflecting Cambodia's graduation to lower middle income status according to the World Bank classification as a result of its strong growth and poverty reduction performance, overseas development assistance (ODA) as a share of gross national income has fallen steadily over time – from 11.5% in 2003 to 3.9% in 2016. Net ODA as a share of central government expenses has fallen from 120% to 28% over the same period. At the same time, the development co-operation landscape has evolved in the past decade, with new development partners, such as China and Korea, emerging as large providers of financial and technical assistance, while others, such as the United Kingdom and Denmark, have phased out their assistance.

In 2005-14, China was by far the largest development partner in Cambodia, cumulatively disbursing about USD 2 billion of ODA.[17] Among those that report to the OECD Development Assistance Committee (DAC), the largest providers of overseas development finance (ODF) – which includes both ODA and non-concessional finance – were Japan (USD 1.2 billion), ADB (USD 1 billion), the United States (USD 824 million), World Bank Group (USD 705 million), Australia (USD 624 million), Korea (USD 552 million), Germany[18] (USD 463 million), France[19] (USD 407 million) and the European Union (USD 395 million). By sector, public governance (USD 1.4 billion), health (USD 873 million) and transport (USD 1.9 billion) received the largest amounts by all development parters during the decade. Box 11.4 provides a technical explanation of how ODA and ODF are calculated for the purpose of this analysis.

The focus of assistance is also evolving. Recognising the importance of private sector development, development partners have been increasingly supporting areas related to promoting investment and improving the investment climate. Such assistance can take many forms: while some programmes address the general investment climate, such as public financial management, others engage the private sector directly, mainly micro-finance institutions and companies in productive sectors.

Financial and technical assistance in this area cover the investment climate, productive capacity and physical infrastructure[20]. Development co-operation for the investment climate relates to helping the public sector improve the general framework conditions that could reduce costs, risk and uncertainty for market participants (e.g. business regulations, financial framework, trade policy, and the labour market). Activities for productive capacity, on the other hand, concern enhancing competitiveness of economic sectors and companies by increasing their financial and technical resources in relevant areas through both public and private sectors (e.g. agricultural and industrial policy, value chain development, financial services and business intermediary services). Supporting physical infrastructure (i.e. water and sanitation, transport, energy and communications) contributes to both the investment climate and productive capacity.

By using the above categories, data reported to the DAC for 2005-14[21] and separately to the government show that ODF by bilateral and multilateral development partners to investment-related areas has been increasing sharply in the past decade, both in absolute amounts and as a proportion of total ODF. Investment-related ODF tripled from USD 300 million in 2005 to USD 900 million in 2014 (Figure 11.1). Furthermore, the share of ODF for investment within development partners' portfolios in Cambodia also increased from 42% to 66% in the same period, indicating their growing focus on economic development and private sector-led growth. In contrast, ODF volumes to the health sector, disaster prevention, and post-conflict peacebuilding have proportionally declined.

Box 11.4. Technical note on calculating ODA and ODF totals

Official Development Finance (ODF) consists of Official Development Assistance (ODA), which is concessional, and developmental Other Official Flows (OOF), which are non-concessional. It excludes export credit OOF, as their main objective is not developmental.

Absolute amounts of ODF in this report are generally on a disbursement basis and not in commitments since commitments are recorded in total in the particular year they are signed, i.e. once a commitment has been reported, it will not be repeated again in subsequent years, although it may be disbursed over several years. Furthermore, since disbursement lengths vary across different projects, aggregates of committed amounts would be an accumulation of projects with different number of years of implementation. As such, disbursements are more comparable with annual expenditure figures, for example in national budgets, annual infrastructure spending or gross national income.

Data covered are generally those by the 50 major bilateral and multilateral development partners that report to the DAC at the activity level in the Credit Reporting System (CRS). Development partners' ODF to improve local investment are categorised into three areas: investment climate, productive capacity and infrastructure. The respective CRS purpose codes for each category can be found in Annex 2 OECD working paper: Development Co-operation for Private Sector Development: Analytical Framework and Measuring Official Development Finance

As IFC does not report fully to the DAC's CRS, estimates were obtained for ODF to Cambodia in 2005-14 through its own database. There were 17 projects in Cambodia, of which all was considered as investment-related, amounting to around USD 290 million.

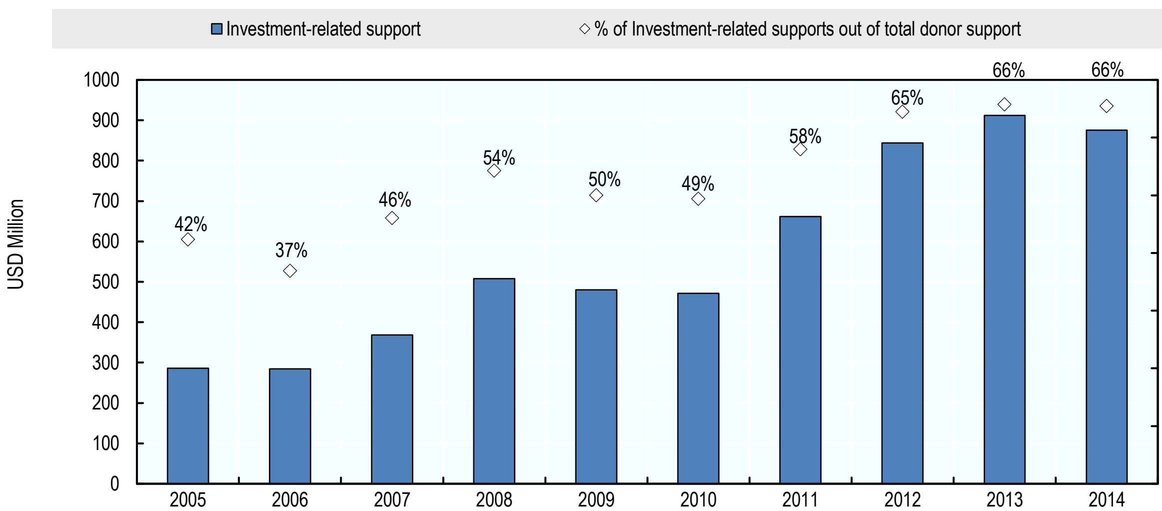
As for ADB, since project level data are not available in the CRS for 2005-09, total ODF for Cambodia was obtained from Tables DAC 2a (ODA) and DAC 2b (OOF) which provide aggregate amounts, totalling approximately USD 1 billion for 2005-14. As for total investment related ODF for 2005-2014, the amount of investment related ODF for 2010-14 from the CRS data was first aggregated, and then its proportion within total ODF for Cambodia for the same period was applied to the total ODF for Cambodia for 2005-09 (which did not have CRS data). These two amounts were added to obtain an estimate of investment related ODF for 2005-2014, which was about USD 812 million.

China does not report to the DAC, but their ODA data are available on the website of the Cambodia Rehabilitation and Development Board (CRDB/CDC). In the period 2005-14, China had 51 development projects in Cambodia, amounting to USD 2 billion of ODA. Among these projects, 37 were investment-related, totalling USD 1.7 billion.

During this period, transport received the largest amount, consisting of more than a third (Figure 11.2). Other areas with significant amounts were public governance (which includes support for public financial management, decentralisation, anti-corruption, etc.), agriculture, and financial services. Water and energy received smaller volumes compared to transport but ODF has increased significantly since 2010 in these sectors.

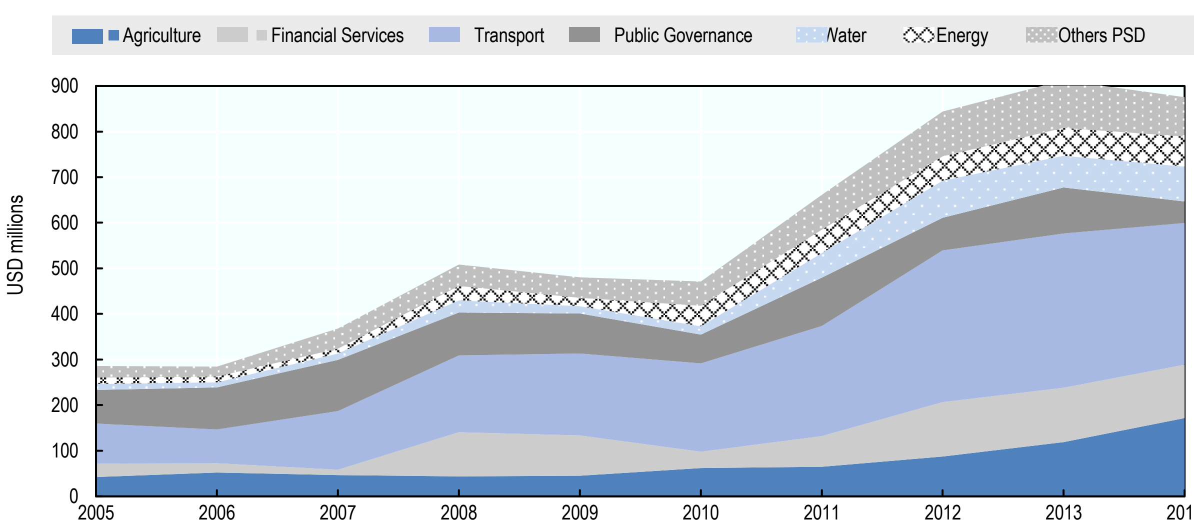
The total volume of ODF relevant to investment by all development partners in 2005-14 amounted to USD 5.2 billion. In terms of specific areas and sectors, Sweden, ADB, Australia, the United States and Japan provided large amounts to activities related to policies and institutions relevant to the investment climate. For productive capacity, the International Finance Corporation (IFC) was by far the main development partner supporting the financial sector – predominantly for microfinance institutions – followed by Germany, Spain, France and Norway. In addition, China, Australia, ADB, Japan, and the US were top development partners for agriculture. The largest financiers for infrastructure were China, Japan, Korea, ADB and the World Bank Group (Figure 11.3).

Figure 11.1. Trends of investment-related ODF by development partners (2005-14)



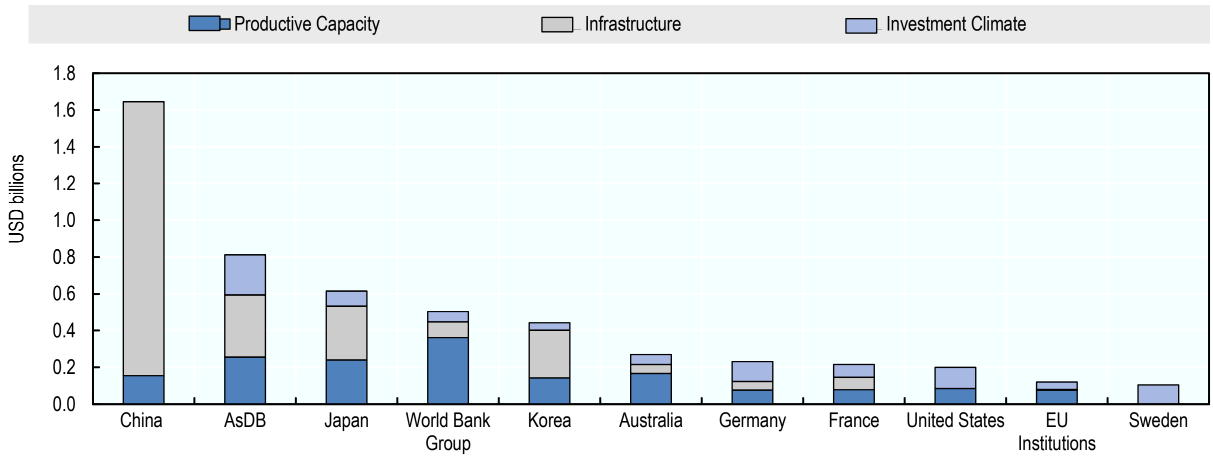
Note: Cumulative disbursements, constant prices (2014). World Bank includes IDA and IFC. Estimated disbursements for ADB, IFC and China.
Source: OECD Creditor Reporting System; ODA Cambodia database; IFC website.

Figure 11.2. Trend of investment-related support by development partners



Note and Source: see Figure 11.1.

Figure 11.3. Largest development partners for investment-related support



Note and Source: see Figure 11.1.

Examples of investment-related support

In the area of the investment climate, European development partners have been providing technical co-operation for public financial management in order to strengthen macro-economic stability and trade policy, with the EU and Sweden providing support for revenue mobilisation, economic statistics, external audit, budget transparency, external oversight through the parliament and anti-corruption. To a large extent, implementation takes place through institutional co-operation between Swedish agencies and their Cambodian counterparts, such as the National Audit Authority, the General Department of Taxation, the National Institute of Statistics, the Parliamentary Institute of Cambodia and Transparency International Cambodia. The EU and Sweden also collaborate with Switzerland on improving public governance and service delivery at the provincial level by strengthening the capacity of district and municipal administrations.

Regarding support for productive capacity, Australia is helping to increase the productivity and incomes of small-scale farmers in milled rice and other crops through improvements in irrigation infrastructure and market linkages. Similarly, Switzerland supports homestead farmers, particularly women, by introducing modern agricultural techniques and promoting market opportunities for processed products. Japan has funded the development of an industrial site within the Sihanoukville Port Special Economic Zone to increase direct investment and generate employment.

Development partners also support the area of responsible business conduct (RBC), particularly in the garment industry, which is the largest contributor to growth in Cambodia. Examples include a programme by Sweden – implemented by the ILO and a Swedish trade union, IF Metall – to improve industrial relations by building capacities of the government, trade unions and factory owners, as well as in ameliorating working conditions in factories. By sharing common interests, Sweden and ILO are particularly active in this area, partly to support H&M’s efforts as an ethical and cost effective investor in Cambodia.

In addition, the Better Factories programme – financed by Agence Française de Développement (AFD), Germany, Netherlands, and the United States, and implemented by the ILO – monitors factories and trains managers and workers. It provides guidance and advice on factory improvements that help enterprises preserve profits while respecting workers' rights. Australia and others also fund Better Work Cambodia, in collaboration with the ILO and IFC, which brings together all levels of the garment industry to improve working conditions and to respect labour rights while boosting the competitiveness of businesses (see Chapter 8 on promoting and enabling RBC).

At a regional level, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) is promoting social and labour standards in the textile and garment sector among Asian countries. Given China's significant role as an investor, GIZ invites Chinese representatives to take part in the implementation of the regional working platforms. At a more global level, Sweden is supporting the Global Deal, which is a multi-stakeholder platform to promote decent work and social dialogue, in collaboration with the OECD and ILO. As Cambodia has signed up to the Global Deal initiative, concrete activities are currently being planned. Workers in the garment industry are relatively well protected compared to other sectors, with an organised trade union and a minimum wage system.

Institutional arrangements to facilitate development co-operation for investment

Development partners positively view the Cambodian government's strategy and institutional framework for investment-related development co-operation, which allow good collaboration in some areas. Specifically, increasing investment is a strategic priority in the Rectangular Strategy Phase III, which is mainstreamed in operational policy documents, such as the NSDP and the IDP. In particular, the four priority sectors for the government – water, energy, other infrastructure, and human resources – are key areas for increasing private investment in the country.

These strategies provide general guidance in the types of activities for development partners, such as: investment promotion; industrial and SME development; human resources development; and banking and financial sector development. In addition, the Development Co-operation and Partnership Strategy (2014-18) identifies four broad priorities which could be supported by development partners to enhance investment, namely: improving the enabling environment for investment; promoting economic competitiveness; developing infrastructure, including through private-public partnerships; and forming direct partnerships with the private sector, either to support public service delivery or to strengthen the business environment. At the same time, the government's dependence on inputs by development partners in developing these strategies, particularly the IDP, may have resulted in a long wish list.

Beyond strategies, the institutional arrangement for investment-related development co-operation builds on a three-level mechanism composed of the Cambodia Development Forum, the Government-Donor Coordination Committee and the Technical Working Groups (TWGs). This mechanism is co-ordinated by the Cambodian Rehabilitation and Development Board (CRDB) – an arm of the Council for the Development of Cambodia (CDC) – in charge of liaising with development partners and NGOs.

As part of its role, the CRDB maintains an ODA database to promote transparency in development co-operation.[22] In this environment, development partners coordinate to carry out a division of labour amongst themselves, such as to avoid the duplication of training programmes for high level officials or designing similar projects in the same provinces, as in the case of the US and Switzerland on rural development. CSOs are also well organised, speaking in one voice and keeping to various deadlines.

Development partners also carry out joint programming and monitoring in areas related to investment, such as infrastructure, HRD, agriculture and rural development. This is particularly the case among the Europeans as the European Development Co-operation Strategy 2014-18 identifies private sector development and employment generation as a core priority (EU et al. 2014) for joint programming. In Cambodia, it involves supporting: policies and related services to reduce the cost of doing business; the banking and financial sector; and skills and HRD. In this regard, AFD is taking a lead role in the support to infrastructure, while the European Commission, Germany, Sweden, and Switzerland collaborate on employment and skills development (see below).

Despite acknowledging the commendable institutional set-up and efforts to promote investment, development partners note the limited capacity of the Cambodian government to carry out co-ordination with numerous actors and to go through the steep learning curve required for PSD. In particular, several TWGs for PSD are currently inactive or ineffective. This may be partly due to the multi-dimensional nature of PSD, which makes operational activities too diverse to co-ordinate adequately. In fact, many of the TWGs have turned into venues for information-sharing rather than platforms for effective division of roles among development partners and collective monitoring. Moreover, China, which is currently the largest development partner in Cambodia, does not actively participate in relevant TWGs, such as on infrastructure and agriculture, partially due to the thin presence of their development co-operation actors on the ground. Some development partners also noted the government's lack of human resource capacity to fulfil the secretariat functions as well as its aid dependence for the financing and maintenance of TWGs. As is common in many LDC, reforms are also largely contingent on the personal efforts of ministers.

Several development partners also mentioned that concrete action plans by the government in relevant areas – from those for education, irrigation, and trade – would be helpful in further directing development co-operation for investment, particularly to support the implementation of the NSDP and the IDP. In particular, while there is an energy sector plan, a more detailed strategy for renewable energy would be essential for Cambodia to realise green growth (see Chapter 10). At the same time, development partners observe that there is lack of capability by sector ministries in preparing concrete action plans. To address these concerns, CDC is currently working with the line ministries in developing sectoral action plans to enable the implementation of the IDP.

Support to human resource development for investment

Given the dissuasive effect of the poor quality of the labour force on potential foreign investors, development partners have been active in HRD, mainly to help improve the skills of Cambodian workers that could suit the interest of investors, which in turn could enhance employment opportunities and reduce poverty. A narrow definition of HRD covers technical and vocational training in agricultural, manufacturing and service sectors through, for instance, enhancing vocational qualification standards that match the demand of the labour market or targeting skills development of specific groups, such as youth, women or poor people in both urban and rural areas.

Examples of development co-operation for HRD include support by Sweden for business development and upgrading of management skills (e.g. drafting of business plan, financial management or networking) among the youth, which is implemented through a twinning arrangement between the Swedish Public Employment Service and Cambodia's National Employment Agency. Sweden is also supporting a multimedia initiative, Klahan9, implemented by United Nations Development Programme (UNDP) and British Broadcasting Corporation Media Action, which packages and spreads information to the youth on inter alia career paths, job application, migration, and sexual harassment at work. One of the recommendations from the UNDP evaluation on the project suggests focusing on influencing the formulation of the government's labour market policies instead of only assisting their implementation.

Switzerland carries out vocational training to boost tourism, hospitality services, and manufacturing in rural areas. It also supports the Ministry of Labour in setting up a technical vocational education and training system as well as a regulatory framework for better inclusion of the poor. AFD is also providing training for tourism in two schools in Phnom Penh while GIZ is assisting tour operators as part of an ASEAN regional integration programme.

At the same time, some development partners see that vocational training alone is not sufficient, as investors are reluctant to hire workers without basic education and discipline, such as keeping time or showing up regularly for work. Furthermore, if workers do not have basic education, it is more difficult for them to learn from various types of training programmes. Educating the workforce is becoming particularly challenging as many youngsters are dropping out of secondary schools to work in construction, entertainment, or domestic labour in neighbouring countries such as Thailand where salaries are relatively higher.

There is a particular shortage of qualified human resources to become mid-level managers in factories or companies, due to the government's lack of priority accorded to education over several decades, as well as the legacy of the Pol Pot regime. Managers are currently mainly expatriates, which can limit knowledge transfer and spillover effects to the local economy. Some partners, such as AFD, are trying to address this by financing a training centre to increase the number of middle managers in the textile industry. Other development partners are supporting primary and secondary education to tackle the long-term needs of HRD, including by helping improve the quality of teachers. More recently, several development partners expressed hope for some changes, as they applauded the education ministry's efforts to clean up the school exam process – often cited as one of the clearest government reforms in recent years.

Focus on impact and sustainability

In order to directly influence the private sector's contribution to development, several development partners are engaging companies more closely. These mainly involve support to financial intermediaries, particularly micro-finance institutions, as well as businesses in productive sectors such as agriculture, manufacturing, and tourism. For instance, AFD and Proparco support the Cambodia Microfinance Association in order to help certify micro-finance institutions and promote transparency and protection of clients, thereby helping to protect the sector from overheating. Norfund has also invested in AMRET, a microfinance institution focusing on the poorest segments of the population, through small scale loans to borrowers in rural areas and medium scale loans to SMEs. Another example is Australia's technical assistance for feasibility studies carried out by a team of engineers and investment managers who analyse tariffs and cash flow to offer efficient 'last mile' grant financing for infrastructure asset investments in remote or low income areas that are unprofitable on solely economic terms. Australia also co-finances the provision of electricity and drinking water with private operators, including through private equity and social impact funds.

A different type of support is Korea International Cooperation Agency (KOICA)'s project in enhancing the technical capacity of the Cambodia Securities Exchange (CSX), which is 51% owned by the Cambodian government and 49% owned by the Korea Exchange. The assistance is built on KOICA's experience in the security exchange of Viet Nam between 1996 and 2002. Activities include training government officials and staff of the CSX and Securities and Exchange Commission of Cambodia in market regulation and operation as well as inviting them to Korea for capacity building.

While supporting the private sector can have a positive impact on promoting investment, the development community emphasises the need to avoid market distortions such as by using ODF to primarily promote national companies. Some development partners advocate for more support towards policy and institutional reforms to improve the investment climate, while others working directly with the private sector claim that it takes too long to achieve concrete improvements in this way. They state that direct support to businesses can have a demonstration effect and help improve the climate by identifying areas that need to be reformed. It can also help accelerate service provision in areas that are under-serviced by public utilities.

JICA's evaluation of its project on enhancing investment-related services of CDC showed that improving the investment climate was more important for attracting investors than boosting investment promotion services and that listening to the view of investors heightened the motivation of CDC to provide better services. JICA also learned from its support to the SEZ that investors demand appropriate infrastructure – particularly a regular supply of electricity – as well as facilities nearby for their expatriate managers and their families, such as schools and hospitals. They also acknowledged the importance of adequate capacity by the government counterpart to liaise with businesses. Although some note that ex post evaluations carried out 3-5 years after project completion frequently show diminished impact, development partners are continuously trying to improve their co-operation for better and enhanced investment.

European partners mentioned that their support to the Cambodian government's capacity building and vocational programmes has contributed to: automating and streamlining the procedures of border agencies; creating a national trade repository on trade and non-tariff measures; increasing the volume of microfinance services; and facilitating the implementation of the government's Technical Education and Training Strategic Plan 2014-18 and the National Employment Policy 2015-25 (EU et al. 2016).

At the same time, some development partners raised concerns about sustainability of investment-related projects. This is particularly important for infrastructure, which requires resources for maintenance of hardware and enforcement of appropriate regulations towards, e.g. prohibition of over-loaded vehicles. The challenge also relates to capacity building provided in public sector reforms or vocational training, as the staff might leave for the private sector that pays better, once they have received the training. In this context, some development partners are trying to build in mechanisms to ensure the sustainability of their projects. For instance, GIZ's ASEAN Integration Project requires counterpart contributions in their support as well as training of trainers in a way that would replicate what they have learned even after the project is completed. KOICA also encourages officials to share knowledge to subordinates through seminars and requires the establishment of a counterpart fund to be used for equipment repairs.

Notes

[1] The *G20/OECD Principles of Corporate Governance* and the *OECD Guidelines on Corporate Governance of State-owned Enterprises* were both revised in 2015, taking in account recent developments in financial markets and the corporate sector. The Principles were endorsed by the G20 in 2015.

[2] The Action Plan for Financial Sector Development 2016-2025 includes short-term, medium-term and long-term goals. The goals related to corporate governance include: (i) facilitate general and targeted training on governance, (ii) conduct an educational campaign on corporate governance for both listed and non-listed companies, including SMEs, with emphasis on the responsibilities of boards of directors, corporate secretaries, and management, (iii) implement the ASEAN corporate governance scorecard for listed Cambodian firms.

[3] According to a Ministry of Economy and Finance proclamation (i.e 'prakas') dated 8 January 2009, the adoption of CIFRS is required for enterprises and not-for-profit organisations in Cambodia after 1 January 2012. For commercial banks and financial institutions, the mandatory adoption of CIFRS was set beginning on 1 January 2016, but this was later delayed to 2019 pursuant to a request made by the National Bank of Cambodia and the Department of Financial Industry of the Ministry of Economy and Finance, considering challenges in implementation.

[4] The board of directors of SOEs must meet at least once every three months and has the following duties: (i) decide on the development projects of the enterprise, (ii) periodically evaluate the result achieved and set forth adjusting measures for implementation, (iii) decide on the proposed budget for the functioning of investment and financing schemes, (iv) adopt the balance and management of various accounts, (v) determine the organisational structure of the enterprise, the statute of the personnel and the salary system, (vi) adopt the public bidding. The agenda of the board meetings must be notified at least 10 days in advance to all members of the Council, State controllers and the responsible ministry or authority. Among the members of the board of directors there must be one seat reserved for the representative of the employees of the public enterprise selected from and by the employees of the public enterprise.

[5] The ASEAN Corporate Governance Scorecard is an assessment undertaken by the Asian Development Bank and ASEAN Capital Markets Forum using a methodology benchmarked against the G20/OECD Principles of Corporate Governance. The Scorecard examines corporate governance standards and practices in six of the ten ASEAN jurisdictions and is used by capital market regulators and other stakeholders as a reference to understand and improve standards across the region.

[6] This assessment of the draft Competition Law which was prepared in March 2016 are based on version 5.5 of the law. As this is only a draft, this section does not purport to make a detailed assessment of its provisions, which may still be subject to significant change

[7] See OECD Clean Gov Biz (2012) - Competition policy: promoting efficiency and sound markets http://www.oecd.org/cleangovbiz/toolkit/50037123.pdf.

[8] They also conform to the ASEAN Regional Guidelines on Competition Policy, Section 3.

[9] The OECD Recommendation on Merger Review (2005).

[10] OECD (2015) Roundtable on Competition Neutrality, p.12.

[11] OECD (2016b).

[12] SOEs and the Principle of Competitive Neutrality (OECD 2009).

[13] According to the OECD Recommendation of the Council on Regulatory Policy and Governance[13], independent regulatory agencies should be considered in situations where "there is

a need for the regulatory agency to be independent in order to maintain public confidence; both the government and private entities are regulated under the same framework and competitive neutrality is therefore required; and the decisions of regulatory agencies can have significant economic impacts on regulated parties and there is a need to protect the agency's impartiality".

[14] OECD (2012).

[15] Voigt (2009).

[16] Andrews et al. (2015).

[17] Source: CRDB/CDC.

[18] Includes amounts by GIZ, BMZ, KfW, DEG, Federal Ministries, Foreign Office, etc. The amount of ODA reported to the Cambodian government may not be the same as that reported to the DAC.

19 Includes amounts by AFD, Ministry of Economy, Ministry of Education, Proparco, etc. The amount of ODA reported to the Cambodian government may not be the same as that reported to the DAC.

[20] Miyamoto and Chiofalo (2017).

[21] In 2015, The DAC changed the way of calculating ODA, particularly for concessional loans.

[22] It captures project-level data and extensive information on aid effectiveness indicators in line with those agreed in the DAC. Most importantly, project data have a thematic marker on PSD which facilitates the identification of relevant projects. The database also includes project-level statistics related to Chinese development co-operation, although they may be estimates that are not reported by the Chinese government.

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