

Chapter 2

CAMBODIA'S INVESTMENT CLIMATE: MACROECONOMIC ENVIRONMENT AND PERCEPTION OF MANUFACTURING FIRMS

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Abstract

Cambodia does provide some potentially rewarding options for investment from Japanese or other foreign companies. Although the domestic market is small and relatively poor, investment may, to some extent, be justified by Cambodia's location in the center of a large and growing regional market. The key benefit to foreign direct investment, however, is the opportunity to gain access to resources, chiefly cheap labor and agricultural land. With proper management techniques and technology, output of primary production and related manufactured goods could be significantly increased in a number of areas. Any business considering a long term investment in Cambodia, however, needs to be aware of constraints to doing business, which include very high electricity costs, the 'time tax' of complying with Government regulations, corruption, and under-developed infrastructure.

INTRODUCTION

There are opportunities for Japanese and other foreign firms to generate favourable returns on Cambodian investments. Although the domestic market is relatively poor investing in Cambodia could provide easier access to the regional ASEAN market. Some key inputs to production, namely labor and agricultural land, are relatively cheap in Cambodia, suggesting investing to access such resources could provide the investing company with a comparative advantage. The Cambodian Government, in recognition of the importance of investment for growth, has introduced policy to improve the attractiveness of Cambodia as a destination for Foreign Direct Investment (FDI).

Foreign companies, however, have good reason to be wary about investing in Cambodia. There is a significant amount of risk associated with generating returns on Cambodian investments. For 2009 the World Bank ranked Cambodia 135 from 181 countries for ease of doing business, taking into account such factors as business regulations and property rights.¹ Corruption is rife, as reported by the World Bank and other researchers. And while the cost of labor is low, many people have only a very basic education limiting their ability to perform more complicated manufacturing tasks without additional training. Infrastructure, not included in the WB's doing business rating, is still under-developed in Cambodia and some inputs, particularly electricity, are expensive by regional and international standards.

The following is a brief review of the main factors impacting on investment in Cambodia's manufacturing sector. This report affords some insight to investing in Cambodian, largely through the use of primary data, but summarises rather than explores in detail the key features of the Cambodian investment climate.

Section 1 outlines our approach to examining investment. The second section provides a brief overview of investment in Cambodia and how it has changed since the early 1990s. The third section of the report summarises the key macro-economic or economy-wide variables determining investment. The fourth section discusses the main

¹ The World Bank 2008. *Doing Business 2009, Country Profile for Cambodia*. It should be noted that this is an improvement of 15 places from 2007.

firm-level factors which firms consider as important determinants of investment. The last section summarises the report's key messages for FDI.

1. FRAMEWORK FOR EXAMINING THE CAMBODIAN INVESTMENT CLIMATE

We summarise the Cambodian investment climate by discussing the main economy-level and firm-level variables determining or constraining investment.

At the level of the economy we examine the variables indicating Cambodia's attractiveness as a destination for FDI. This section considers FDI in the context of the comparative advantage provided by FDI, in accessing the Cambodian market, 'market seeking' investment, and through accessing resources for production, 'efficiency seeking' investment.² The motivation for domestic market seeking investment is examined by considering the changing wealth of Cambodia, as indicated by GDP growth. Cambodian efficiency seeking investment incentives are considered by looking at the cost and quality of labor and land. Also discussed is asset price stability as indicated by inflation and Cambodian Government policy to attract FDI.

At the level of the firm we consider the main constraints to firm growth as identified by Cambodian business owners and managers. Key factors identified and discussed include the cost and supply of inputs to production, particularly electricity, the cost and availability of finance and the impact of corruption on business activity. Our choice of constraints is based on World Bank Cambodian investment climate surveys.³ Evidence of the significance of these constraints is provided from a BRC and NZIER February 2009 survey of 36 manufacturing firms in Phnom Penh Cambodia.

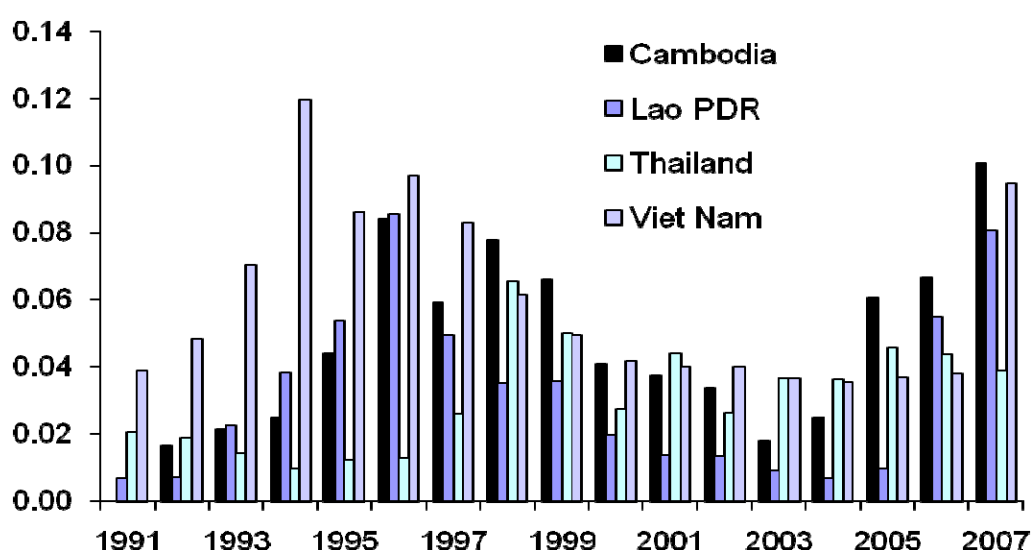
² Resource seeking, investment to gain access to resources, could be added as a third category, although it is, strictly speaking, a form of efficiency seeking.

³ The World Bank surveyed 26,000 firms in 53 countries, one of which was Cambodia. Findings for each country are reported separately.

2. CAMBODIAN INWARDS FDI AT A GLANCE

Figure 1 shows FDI inflow to Cambodia, as a share of GDP, relative to other South East Asian nations.

Figure 1: Inwards FDI flows (As percent of GDP selected Asian economies)



Source: ADB Key Indicators for Asia and the Pacific 2008. UNCTAD FDI database. NZIER calculations

The growth in FDI to Cambodia from the early 1990s was motivated by the country's shift towards a market economy, lessening violence and growing macro-economic stability. From 1989 international and domestic efforts to encourage peace in Cambodia intensified, and in 1993 the country had its first election following the 1970's civil war. In 1994, in recognition of the benefits of inwards FDI, the Cambodian Government introduced *Laws and Regulations on Investment in the Kingdom of Cambodia*, with generous incentives offered to foreign investors, including a tax holiday of up to 8 years.⁴

⁴ ADB Institute 2006 *the Mekong Region Foreign Direct Investment*.

A considerable amount of early inwards FDI was into the manufacturing sector, particularly into apparel factories. From 1995 to 2003 approximately 30 percent of total Cambodian inwards FDI, and about 90 percent of manufacturing inwards FDI, was in apparel factories.⁵

Inwards FDI was largely motivated by ‘market seeking’ behaviour of apparel firms. Garment companies exporting from Cambodia were provided preferential access to American and European markets. Investing in Cambodia, therefore, enabled firms, regardless of their origin, to circumnavigate trade barriers to lucrative markets. To a lesser extent FDI was ‘efficiency seeking’, motivated by the availability of cheap labor in Cambodia. Also playing a role were the incentives provided by the Cambodian Government to investing firms under *Laws and Regulations on Investment in the Kingdom of Cambodia* mentioned above.

The marked decrease in inwards FDI from the late 1990s, as shown in Figure 1, was a feature of the initial surge in investment to benefit from policy reforms and new investment opportunities. Following the first round of investments opportunities for gain dissipated somewhat reducing significantly the amount of inwards-FDI.⁶ As can be seen in Figure 1 this was a common pattern across the later developing economies of South East Asia.

The East Asian financial crisis also played a role in slowing inwards FDI to Cambodia, primarily due to investment source countries being at the centre of the crisis. About 80 percent of the approved inwards foreign investment to Cambodia in the 1990s came from other Asian nations, chiefly Malaysia, Taiwan and Korea.⁷ The investing activities of these firms fell considerably due to lower company incomes and a greater degree of uncertainty.

A similar share of Cambodian investment still originates from recently industrialised Asian nations, with China recently emerging as another key source country. Part of the reason for the majority of investment coming from such countries

⁵ By value, UNCTAD, Cambodian Development Resource Institute 2005 and NZIER calculations.

⁶ Asian Development Bank Institute 2006 *The Mekong Region Foreign Direct Investment*.

⁷ The council for the Development of Cambodia 2007 *Cambodia Investment Guidebook*.

could be that investors from these nations have faced similar investment climates in their own economies as exist in Cambodia. They are familiar with and better able to deal with constraints such as poor infrastructure and corruption.⁸

The observed growth in inwards FDI from 2003 has largely been due to investment in services, particularly tourism and construction. Over 70 percent of investment in the two years to the last quarter of 2008 was in the service sector.⁹

Within manufacturing, there have been some recent investments into food processing and construction related manufacturing, although values are low compared to previous capital flows into the apparel sector. Investment into garment factories appears to have slowed significantly in 2008. The Garment Manufacturers Association of Cambodia claims that 30 factories, about 10 percent of the total, closed last year.¹⁰ Although there is some debate as to the reasons behind the closures the key factor is probably slowing demand from the country's main markets due to the recessions in the US and EU countries.

2.1. Future inwards FDI

The significance of market demand from the US and EU for Cambodian garment exports suggests that as these economies start expanding again so too will investment in Cambodian apparel factories. This may not be the case, however.

Investment in Cambodian garment factories was largely driven by the nation's preferential access to the US and EU markets. The initial preferential access accord, the Agreement on Textile and Clothing, was replaced in 2005 with an arrangement constraining Chinese apparel exports. This agreement in turn expired at the end of 2008. A further factor increasing competition for apparel market share in the US and EU is Vietnam's entrance to the WTO in 2007.

A further factor possibly decreasing further inward FDI is the change in the laws around foreign investment. These include an increase in the tax rate faced by new and existing

⁸ Asian Development Bank Institute 2006 *the Mekong Region Foreign Direct Investment*.

⁹ The Council for the Development of Cambodia (CDC).

¹⁰ Van Sou Ieng, president of the Garment Manufacturers Association of Cambodia (GMAC) quoted in the Phnom Penh Post 9 December 2008.

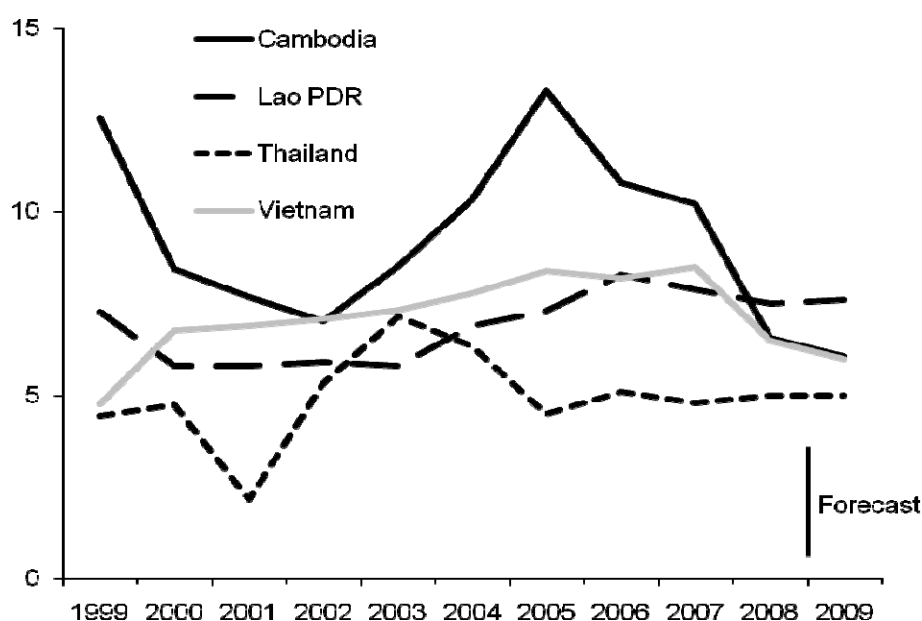
investors, and eliminating tax free reinvestment of profits.¹¹ The new law covering foreign investment in Cambodia is outlined in the following section.

3. ECONOMY-LEVEL INVESTMENT DETERMINANTS

3.1. Market seeking investment: a growing market?

Although Cambodia experienced strong GDP growth through the 1990s, income per capita remains low. Cambodia's GDP per capita is unlikely to converge significantly towards the income levels of other developing Asian nations over the next few years. See figure 2. A relatively poor domestic market limits the incentive for market seeking investment.

Figure 2: GDP Growth (Annual percent change selected South East Asian nations).



Source: Asian Development Bank Key Indicators Country Tables and Asian Development Outlook 2008

¹¹ Cambodia sectoral developments

Strong GDP growth since the mid 1990s was largely driven by rapid expansion in garments, tourism, and, particularly over the last few years, construction. Agricultural output has also shown a steady increase since a 2004 drought.

Garments, tourism and construction, however, are unlikely to be able to sustain the recently experienced high levels of GDP growth. Growth in garment export values, although still positive, slowed in 2007 and during the first half of 2008.¹² In the short term growth in income from tourism may slow as many of the world's economies continue in recessions. On top of this, anecdotal evidence suggests construction activity has already diminished as the economy slows and land prices decline.¹³ On a positive note, last year provided plenty of rain and agricultural output is expected to have increased by 5.5 percent in 2008.¹⁴

The size and exploitability of off-shore oil and gas deposits discovered in Cambodian territory remains uncertain and are unlikely to have much impact on GDP over the next few years. The Government does not expect revenue from commercial exploitation until 2011.¹⁵

Overall Cambodia's GDP growth will probably remain positive for the foreseeable future, although it seems unlikely that the economy will grow at the double digit rates experienced over the last few years. Bearing in mind the small population of about 14.5 million; per capita GDP of about US \$750;¹⁶ and an urbanisation rate of less than 20%;¹⁷ investment in Cambodia does not provide, and is not likely to provide anytime soon, access to a large or wealthy domestic market.

Investing in Cambodia, however, could provide access to a fast growing regional market. Barriers to ASEAN intra-regional trade in manufactured products have been decreasing as trade barriers are reduced or removed and the area's transportation network is developed. These factors provide the potential for both gains and losses to the Cambodian people. If barriers to doing business in Cambodia are low enough and

¹² Economic Institute of Cambodia October 2008 *Cambodia Economic watch*

¹³ Economic Institute of Cambodia *ibid*

¹⁴ Economic Institute of Cambodia 2008 *ibid*

¹⁵ Economic Institute of Cambodia *ibid*

¹⁶ International Monetary Fund estimate

¹⁷ Asian Development Bank Key Indicators 2008

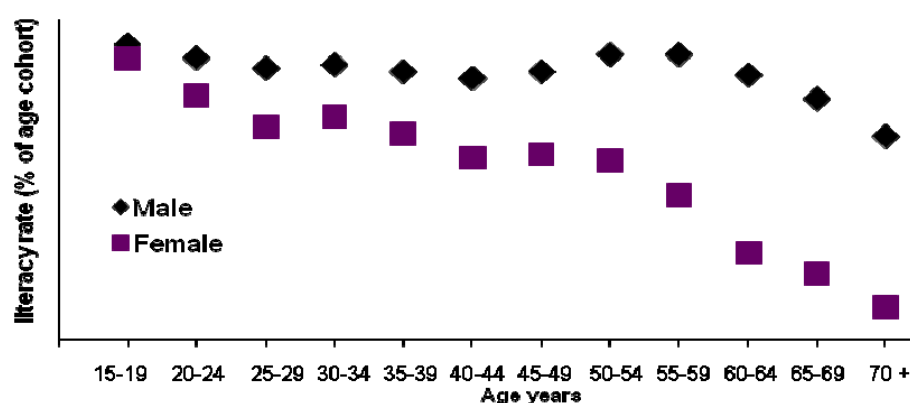
the return on resource seeking investment is high enough then the nation will attract inwards FDI. If, however, these factors are not as good as or better than in neighbouring countries, then companies will instead invest elsewhere in Asia and simply export products to Cambodia.

3.2. Resource seeking investment: abundant and cheap?

3.2.1. labor

Generally Cambodian labor remains abundant and wages remain low. The Economic Institute of Cambodia estimated a labour force of about 6.5 million in 2005, growing by around 250,000 per year.¹⁸ The effective wage rate in Cambodia is lower than in most other Asian countries, including China and Vietnam,¹⁹ although recently there have been wage increases in the garment sector, possibly eroding some of the comparative advantage provided by resource seeking FDI in Cambodian apparel manufacturing.²⁰

Figure 3: Cambodian male and female literacy rates (by age)



Source: Cambodia Socio-Economic Survey 2004

¹⁸ Economic Institute of Cambodia 2007 *Export diversification and Value Added*

¹⁹ Economic Institute of Cambodia 2007 *ibid*

²⁰ The World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

The general level of education has been improving, as can be seen in figure 3, this, however, is coming from a very low level and gross secondary school enrolment is still significantly lower than in many other developing countries.²¹ The low level of education obtained by the majority of Cambodian workers is likely to constrain the use of modern technology or a shift to higher value added manufacturing.

3.2.2. *Land*

Compared to many other Asian nations Cambodia is abundant in land available for agricultural production. The World Bank calculates that there are approximately 10 million hectares of land on which output could be significantly improved with better management, the use of more efficient technologies and improved infrastructure.²²

Japanese or other foreign companies, with expertise in crop production management and technology, may benefit from investing in Cambodian agricultural production. Two of the key constraints hampering agricultural output in Cambodia are a lack of fertilizer use and limited irrigation. Both of these issues could be reasonable easily addressed, in many areas, with adequate investment and management.

The potential benefit from agricultural investment, however, needs to be balanced against the costs imposed by typically very poor rural infrastructure and uncertainty over land ownership in many rural regions. The Economic Institute of Cambodia reports that the cost of transportation of agricultural products in Cambodia (per ton per 100 km) is twice as high in Vietnam and is nearly 4 times higher than in Thailand. The Economic Land Concession process is considered non-transparent and risky for foreign investors.²³ It is illegal for foreigners to own land, although the Government is considering allowing foreigners to own buildings.

²¹ The World Bank 2009 *ibid*

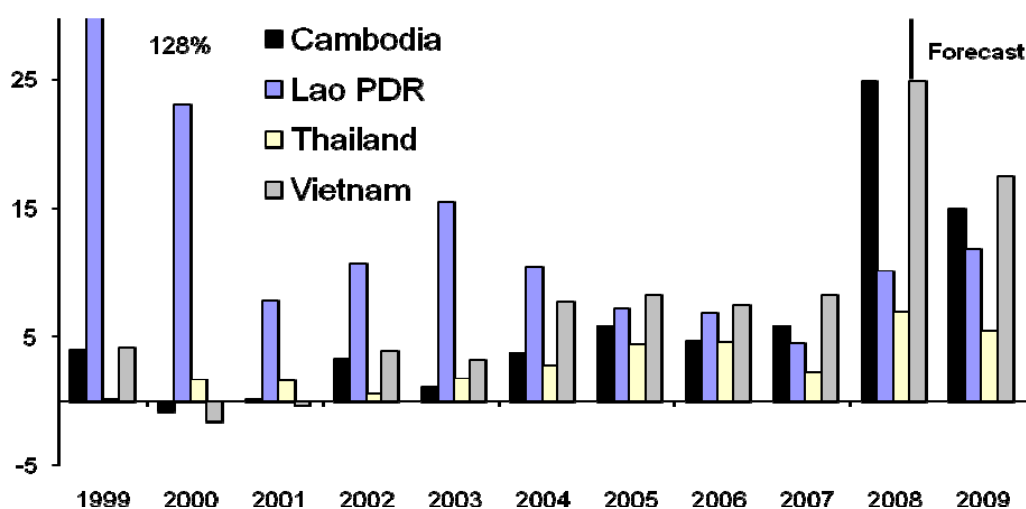
²² The World Bank 2009 *ibid*

²³ Economic Institute of Cambodia and reported in The World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

3.3. Inflation

The rate of inflation in Cambodia, although largely stable and relatively low since the late 1990s, increased rapidly from the end of 2007. Data from the National Institute of Statistics shows inflation at 22.6 percent in the eight months to August 2008.²⁴ The two main inflationary drivers were significantly higher prices for food and oil.

Figure 4: Inflation (annual percent change selected South East Asian nations)



Source: Same as in Figure 2

Although the growth in inflation was largely due to external factors it highlights two potential problems with investing in Cambodia. First, due to the high degree of dollarization of the economy, Cambodia has little flexibility in using monetary policy to control domestic inflation. Second, the Cambodian Government has shown a willingness to intervene in the market preventing Cambodian businesses from exporting produce. In March 2008 in an effort to control domestic prices the Government placed a two month ban on exporting rice.²⁵ The Government’s intervention in the market is a

²⁴ Cambodian National Institute of Statistics in Economic Institute of Cambodia October 2008 *Cambodia Economic Watch*

²⁵ International Herald Tribune May 27 2008, Cambodia lifts ban on rice exports, accessed at <http://www.ihf.com/articles/2008/05/26/business/rice.php> March 2009.

reason for concern for companies considering investment in Cambodia, particularly in agricultural production.

3.4. The law on Investment

In 2005 a revised law on investment came into force. This was done in an attempt to provide similar incentives to both foreign and domestic investors, to encourage transparency and to minimise the discretion of policy makers for delaying or distorting investments. The change in law has reduced the Government provided incentives to invest in Cambodia. The key features of the law relative to previous requirements are outlined below:²⁶

- Investors are required to pay tax after 3 years whereas previously they were eligible for an 8 year tax holiday (although a longer tax holiday can be achieved conditional on compliance with general tax administration requirements).
- All investment projects are subject to standard corporate tax rates following the tax holiday, whereas the previous law provided for a corporate tax rate 11% below the standard rate for investment projects (9% verses 20%).
- Repatriated profit is subject to a 1% withholding tax, verses no tax on repatriated profits previously.

As part of the reforms to foreign investment a fast track procedure has been introduced to enable approval of applications within 14 days.

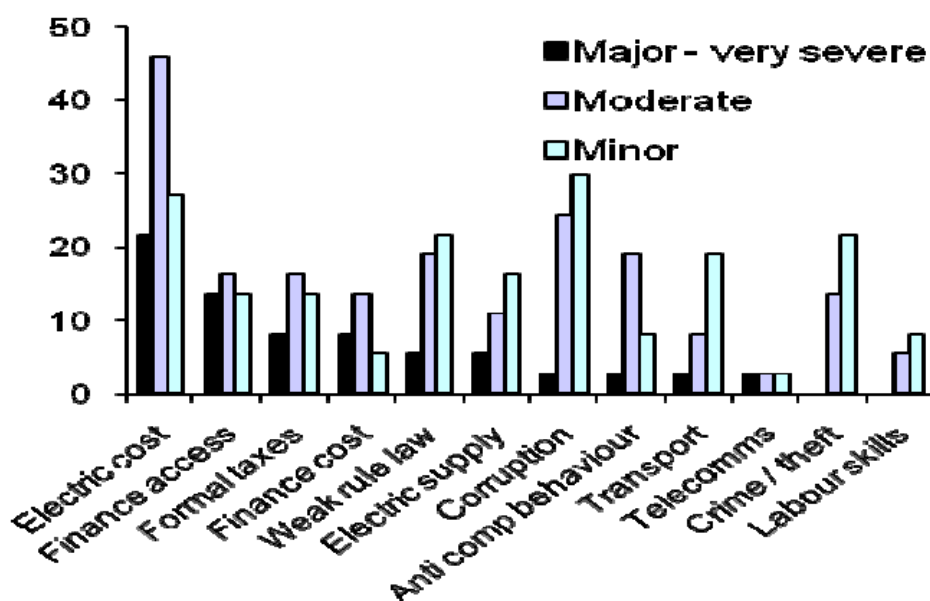
In theory we would expect the law to decrease the flow and possibly stock of FDI, particularly in the period following the tax requirements coming into force (from 2008). There are other probably more significant factors influencing FDI flows, however, as outlined above in section 2.1. The impact of the change in law will be difficult to determine without robust data and empirical analysis.

²⁶ Asian Development Bank Institute 2006 *the Mekong Region Foreign Direct Investment*.

4. FIRM-LEVEL INVESTMENT DETERMINANTS: SURVEY RESULTS

In February 2009, Seng Piseth and Peter Bailey from the NZIER visited 36 manufacturing firms in and around Phnom Penh on behalf of the BRC. The survey questionnaire was based largely on an earlier World Bank investment climate survey²⁷ and sought to find the key motivations and barriers encouraging, enabling and preventing investment by Cambodian manufacturing firms. As well as asking about previous and planned investment, company owners and managers were asked to rank 14 barriers according to the severity of each constraint in preventing firm development and investment. The 12 most commonly mentioned constraints, by order of severity, are displayed in Figure 5.

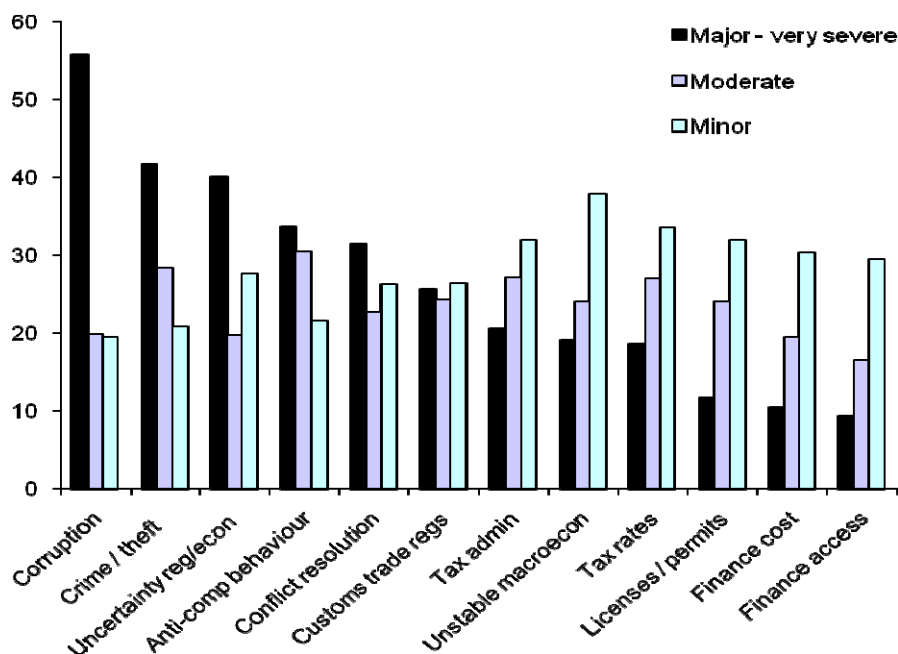
Figure 5: Main constraints to Cambodian manufacturing firm growth (BRC and NZIER survey)



Source: BRC and NZIER 2009

²⁷ The World Bank 2004, *Cambodia Seizing the global Opportunity: Investment Climate Assessment and Reform Strategy*.

Figure 6: Main constraint to Cambodian firm growth (World Bank investment climate survey)



Source: World Bank World Development Report 2005

Results from the 2004 World Bank Cambodian investment climate survey on the key constraints facing firms are displayed in Figure 6.

4.1. Manufacturing firms only provide different results

As is clear when comparing Figures 5 and Figure 6, our survey, although using similar questions, produced quite different results than the World Bank survey. The different results are likely to do with us sampling manufacturing firms only, whereas World Bank results are reported for firms from all sectors. Other factors which possibly contribute to the different results include: the small size of our sample; different sampling techniques; and changes in business owners' and managers' perceptions on constraints to growth in the 4 to 5 years between surveys. Anecdotal evidence suggests that the business environment in Cambodia has been improving over the last few years.

4.2. Caveats

It should be noted that the above results report the perceptions of the firm to different constraints. This can provide somewhat misleading results as people often focus on factors which are fresh in their minds. If, for example, we asked about key constraints immediately following the uncovering and wide-spread reporting of corruption in the police, then corruption would possibly be ranked more highly as a constraint than otherwise. In spite of this, survey data from even a small sample can provide insight not available when looking at macroeconomic variables as we have above.

One last point is in regard to the timing of our survey. In February 2009, when the survey was done, many of the world's more developed economies were in recession. The flow-on effects from the 2008 financial crisis had lowered demand around the world, including in Cambodia. This was apparent in survey responses with the majority of firms reporting lower demand and a resulting spare production capacity, and an expectation of lower demand in the future. That is, the constraints to investment were often demand, as well as supply driven.

4.3. Different results for different subsectors

We surveyed 36 manufacturing firms in four different subsectors as shown in table 1.

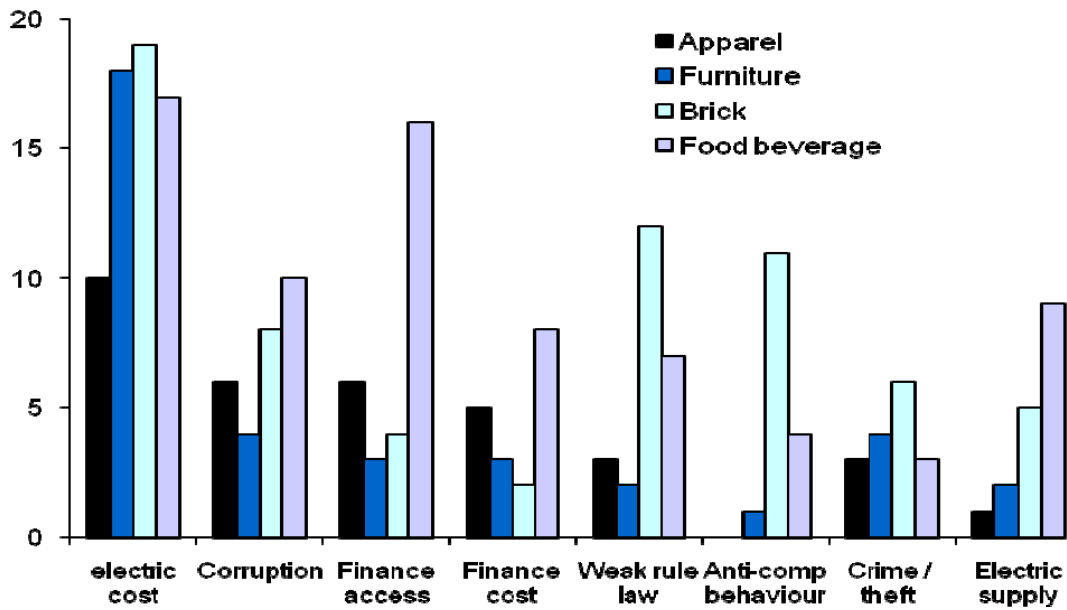
There was a certain amount of consensus between the different sectors regarding the key constraints, although there was also some variation. Figure 7 displays the same results as in Figure 5, but with a single total value attached to each constraint (rather than separated into severity of constraint as above) and results displayed by subsector for the eight highest ranking constraints.

Table 1: Firms survey by BRC and NZIER.

Sector	Firm name
Apparel	1 Great Union
	2 New Orient
	3 Hambo Enterprises
	4 Chan Kok Wing
	5 Lim Tay Meng
Furniture / doors / windows	6 Sok Vandy
	7 Kim loun
	8 Heng de
	9 Chhuon Seung
	10 Hong Kong door and window
	11 Khun Bunlang
	12 Sok Lim
	13 Heng Leap
	14 Boeung Tra Bek
	15 Thnot
Construction brick	16 Deum thnot
	17 Pun Lea Preas Atith
	18 Long Vanny
	19 Kdey Chas
	20 Hok Seng
	21 Lucky
	22 Cheahuy
	23 Yim Meng Keat
	24 Chhun Thaung
	25 Heng Samnang
Food and beverage	26 Kampot pepper
	27 Black Jelly
	28 Meng You Salt
	29 Rice Wine
	30 Alpine
	31 Ly Ly
	32 Kheang Kheang
	33 5 Star Noodle
	34 Angkor Coffee
	35 Hagar Soy
Other (packaging)	36 Union Packaging

Source: BRC and NZIER

Figure 7: Survey results for different subsectors



Source: BRC and NZIER

The key constraints to business growth and investment identified in the BRC NZIER survey, as displayed in Figure 5 and Figure 7, are discussed further below. Although the World Bank survey reports results for all sectors, rather than only manufacturing, some of the key findings are relevant and are referred to in the following discussion.

4.4. Production inputs: Electricity

4.4.1. Electricity costs

The most constraining factor to manufacturing firm development, as determined in our survey, was the cost of electricity. Many of the owners and managers we spoke with considered the high cost of electricity to be a function of Government and infrastructure inefficiency. Generally business people were aware of the comparable prices paid for power in neighbouring countries and at the boarder where electricity was imported to

Cambodia (almost half the price paid in Phnom Penh). A significant share of the electricity used in Phnom Penh, about 95 percent in 2007, is generated from diesel power plants. There is no national grid or high voltage transmission system which leads to large losses during transmission and distribution.²⁸

Supporting the claim that electricity costs constrain business development in Cambodia is the high use of generator electricity and the lack of electricity-intensive industry in the country. According to the World Bank, 36.2 percent of electricity in the manufacturing sector comes from generators.²⁹ We found similar results for the manufacturing firms we sampled, of the 36 firms we interviewed 12 had electricity generators.

4.4.2. Electricity supply

Many of the business people we surveyed said that the supply of electricity had improved considerably over the last 12 months. This probably reflects recent Government efforts to increase domestic generation capacity and to secure more supply from neighbouring exporters.³⁰ Further Government efforts to increase supply may result in a reduction of the cost of power to Phnom Penh businesses over the next 2 to 5 years.

Three hydro-power plants are being built in Cambodia, power transmission capacity is being up-graded and a contract has been signed to build an additional domestic coal-fired-power plant. The combined increase in supply, including through new power lines from Vietnam and Lao PDR, will be close to 1,000 MW, with 536 MW coming from the three domestic hydro-power plants. This compares with current supply of 350 MW and a supply short-fall of about 100 MW.³¹

4.4.3. Future electricity demand and supply

These efforts should meet growing demand from Cambodian businesses and, if managed properly, reduce electricity costs. Lower generation costs should transpire and,

²⁸ The World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

²⁹ The World Bank 2009 *ibid*

³⁰ The council for the Development of Cambodia 2007

³¹ World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

if there are improvements in power utility and grid management, including provision of limited opportunities for rent seeking behaviour by officials, then these lower costs should be passed onto end users.

Better supply and lower cost of electricity may open the door for investment in energy intensive manufacturing sectors. A wait and see approach is recommended, however, until the above mention projects are completed and changes to electricity supply and cost are evident.

4.5. Access to finance

Access to finance was ranked as the second most severe constraint in our survey and as a minor or moderate constraint to many companies surveyed by the World Bank. To some extent these responses may have had something to do with timing. Our survey took place following the international financial crisis at a time when credit was becoming harder to find for many companies. This is unlikely to be a major factor thought, as many smaller firms in Cambodia rely solely on informal sources for credit.

Figure 7 shows that food and beverage manufacturing firms consider access to credit a larger constraint than any other type of firm, and almost as much of a constraint as electricity costs. This is quite probably a consequence of their size and domestic origins. A number of the food and beverage firms we interviewed were of a size where they could no longer rely on traditional, generally informal, sources of credit for expansion. Hagar Soya, for example, reported that they had been seeking a US\$ 3 million loan for investing in a new plant, considerably more than was available through previous sources.³² Ly Ly, with 80 staff, reported difficulty borrowing from informal or formal lenders due to the relatively large amounts of capital they required for investments.³³ Garment manufacturing firms, on the other hand, were generally provided capital for operating and expansion from their parent companies. The brick and furniture and door manufacturers we questioned were considerably smaller than the

³² Graham Taylor business advisor to Hagar Soya. Personal communications February 2009.

³³ Manager of Ly Ly food and drink manufacturer. Personal communications February 2009.

larger food and beverage companies surveyed. As such, finance from family and friends was usually enough to fund their investments.

Although bank credit has been growing rapidly in Cambodia the financial sector is still under-developed. The current financial crisis will possibly limit further the ability of firms to borrow to invest in physical capital, particularly as Cambodia, with low levels of domestic savings, is very dependent on foreign financial capital.

Potential foreign investors should be aware of the difficulty involved with accessing credit domestically: demand is generally greater than supply; the cost of credit is relatively high; financial services are relatively under-developed; and it may be difficult to use land as collateral. On the other hand, Cambodian law was changed in 2007 to allow banks to use moveable and intangible assets as collateral and financial markets have been developing quickly with the presence of a number of new international banks.

4.6. Formal taxes

Formal taxes were usually rated as a moderate or minor constraint, rather than major or very severe. A reasonable number of respondents did rank formal taxes as a constraint, however, suggesting that they may be posing somewhat of a barrier to firm development.

The issue appears to be not so much in the monetary costs of formal taxes, but rather, in high compliance costs, particularly in regard to exports. Kampot pepper reported that they needed to make monthly reports on the amount of product they had sold and, with regards to overseas sales, who they had made the sale to.³⁴ There was no direct financial cost but the requirements were very time consuming. Angkor Coffee reports that domestic market tax was no problem, but when they exported they needed to go through a large number of processes, with each process adding costs in terms of time and money.³⁵ In its 2004 report on the Cambodian investment climate the World

³⁴ Manager Kampot Pepper. Personal communications February 2009.

³⁵ Manager of Angkor Coffee. Personal communications February 2009.

Bank noted that there was a high “time tax” on businesses when official inspections were required.³⁶

Garment manufacturers do not appear to have the same requirements or costs to exporting as other sectors of the economy. The World Bank reports that the cost of exporting garments decreased, by 41 percent, between 2003 and 2007. Over the same period the cost of exporting rice increased by 39 percent.³⁷ This is quite possibly a consequence of the lobbying power of the Garment Manufacturers Association in Cambodia, discussed further below in the section on corruption.

4.7. Corruption

Although few firms in our survey ranked corruption as a major or very severe constraint to growth, about 60 percent of the firms we interviewed said that it did hamper their development to some degree. Most firms were required to regularly pay ‘coffee money’ to police or other Government officials in order to trade. Often the amount paid, however, was a small share of total revenue and was considered in a similar manner to how many firms in less corrupt societies consider formal taxes – a necessary cost of doing business.

While this lack of concern with corruption may suggest it does little harm, other evidence suggests this is not the case. The World Bank has identified corruption as the single biggest constraint facing most Cambodian firms.³⁸

Corruption impacts on a firm’s development through a number of direct and indirect channels. Some of these channels may not impact on the firms we surveyed, due to their size and area of operations, perhaps leading to their impression that corruption is only a moderate or minor constraint. Possibly the most obvious form of corruption is the paying of bribes in order to collect state services (or not to attract Government scrutiny), as noted above. Other forms of corruption include the

³⁶ The World Bank 2004, *Cambodia Seizing the global Opportunity: Investment Climate Assessment and Reform Strategy*

³⁷ The World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

³⁸ The World Bank 2009 *ibid*

requirement that money is paid to officials in order to secure Government contracts, and that some members of the judiciary may be influenced by unofficial payments. Further, corruption can deter investment by discouraging firms from entering the market.

A feature of corruption is its opaqueness. In a corrupt economy it is considerably harder to find out the true cost of doing business. Corruption costs are often unknown prior to investment, and will vary over time and depending of factors such as company size and activity and owners' connections. The size and shape of corruption costs would generally be expected to be more uncertain for new foreign as opposed to domestic investors. Locals will have a better awareness of how the system works and what they need to pay to whom, whereas foreign firms are unlikely to be privy to this information.

As a consequence we would expect to see foreign investment only when the probable return is significantly high to compensate for these cost uncertainties. With regard to garment manufacturers this does appear to have been the case. Given that the opportunity for high returns through preferential market access have decreased, greater emphasis now rests on lowering costs and barriers to doing business so as to attract inwards FDI.

4.7.1. The Garment Manufacturing Association in Cambodia

Figure 7 shows that apparel firms report having fewer constraints to growing their business imposed by corruption relative to domestically owned food and beverage and brick manufacturing companies. A possible reason may be the representation of garment manufacturers by the Garment Manufacturers Association in Cambodia (GMAC). GMAC have become a reasonably powerful organisation able to secure benefits for all of their members in close negotiations with Government. These benefits appear to include a lower cost of corruption, as well as provision of improved infrastructure and reduced export compliance expenses. As noted above garment sector export expense decreased at a time when export costs were increasing for other Cambodia non-garment manufacturing companies.³⁹

³⁹ The World Bank 2009 *Sustaining Rapid Growth in a Challenging Environment*

4.8. Summary: why invest in Cambodia?

4.8.1. Market access

Incomes in the small Cambodian domestic market are unlikely to converge much towards those of other ASEAN countries over the next few years, suggesting the country will provide lower returns to domestic market seeking FDI relative to Asian nations. On the other hand, lower costs and barriers to intra-regional trade within ASEAN suggest that by investing in Cambodia a company would have access to a large and growing regional market. FDI in Cambodia could still therefore provide relatively good returns – provided other features of the domestic economy, such as the costs of doing business and production resources, are at least as investment friendly as in other developing ASEAN nations.

Currently, however, the costs and barriers to doing business in Cambodia are higher than in many other ASEAN developing economies. While some of these factors, such as electricity supply, are being targeted by the Cambodian Government, others, such as corruption, are being addressed half-heartedly. The key benefit to investing in Cambodia may be the comparative advantage afforded in accessing resources.

4.8.2. Resource seeking

As discussed above the two key resources that could potentially reward inwards FDI are labor and land. Labor remains relatively abundant and cheap, although the standard of education is generally low. The price and availability of agricultural land in Cambodia may provide an investing company with a comparative advantage in agricultural manufacturing and a healthy return to investment.

Agricultural output could be dramatically improved in many places with the use of good crop production management and technology. The option exists for an investing firm to utilise both available land and cheap labor to produce and add value to agricultural produce.

On the other hand, other inputs to production, namely power, is expensive, rural infrastructure is poorly developed and corruption is wide-spread. A further potential issue is Government willingness to control trade, as during the large rises in rice prices in 2008.

4.8.3. *A lesson from apparel manufacturers*

A lesson from the Garment Manufacturers Association in Cambodia is that support from the Cambodian Government can significantly lower the costs of doing business. At the level of the economy this suggests that strong governance can improve the business environment. At the level of the firm it implies that investing firms should position themselves to be able to negotiate closely with government from a position of strength.

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