

EXECUTIVE SUMMARY

The signing of the Paris Peace Accord in 1991 ended the years of violence and civil war and allowed Cambodia to begin to rebuild through the development of a market economy. Privatization and liquidation of state-owned enterprises (SOE) occurred rapidly in the 1990s to the point that only a few now remain. The Royal Government of Cambodia (RGC) has also embarked on a series of macroeconomic and structural reforms, which have succeeded in stabilizing the economy and establishing the foundation of a market economy. These reforms included the restructuring of the financial sector, enactment of investment and tax laws, the establishment of a land titling regime and progress toward adopting improved accounting and auditing standards. While these reforms are far reaching, additional reforms such as the adoption of a commercial code to improve contract enforcement, strengthening of the judiciary and improved governance are necessary to create an effective enabling environment for the private sector. In particular, reforms of registration and licensing procedures would go a long way to relieve the pervasive informality of the private sector by bringing more enterprises into the formal sector where they would have better access to financing, markets and training.

The RGC with the support of the donor community has also made strides toward improving basic education while the number of vocational schools, mostly operated by the private sector, has increased significantly since the mid 1990s. Steps are still needed to improve the quality of education and assure that vocational training addresses the practical demands of the economy and results in a better qualified workforce. Strides have also been made in developing the physical infrastructure of the country including the development of the road network and improvements in the provision of electricity. The private sector identifies the poor condition of the road network as a major constraint to growth. At the same time, electricity prices in Cambodia are amongst the highest in the world and have a significant impact on the cost competitiveness of Cambodian businesses. Because of high energy prices many enterprises are forced to commit limited capital resources to purchase and maintain their own power generators. Continued support from the RGC and the donor community will be necessary to further improve education and training capabilities and develop the physical infrastructure necessary to make Cambodia a more efficient and cost effective place to do business.

The PSA outlines the role of the private sector in Cambodia and identifies major constraints facing the development of the private sector. The major constraints focus on the legal and regulatory environment, weaknesses in human capacity caused by insufficient education and training and the need to further develop the physical infrastructure of the country, including transportation, electricity and water. The PSA also provides a long-term vision and phased action plan for addressing the major constraints. The action plan provides a sequenced set of recommendations for the RGC over the next ten years focusing on policy, regulatory and institutional reforms, which are targeted at establishing a business environment conducive to private sector development.

The Private Sector in the Macroeconomic Environment

Overview

After almost 30 years of civil war, Cambodia began to rebuild its economy in the early 1990s with the support of the International Monetary Fund's (IMF) Enhanced Structural Adjustment Facility. Political stability and macroeconomic reforms led to a rapid increase in economic growth combined with a stabilization of prices. The RGC has improved its revenue

collection, which reached 11.2% of GDP in 2002. While still low, this ratio marks a major improvement over revenue collection rates of the 1990s. Unfortunately, with increased Government spending the overall fiscal deficit has actually increased since the late 1990s and is a source of concern in the long-term.

Private Sector Profile

Agriculture is the largest sector of the economy accounting for 77% of employment and 33.4% of GDP. While the ratio of agriculture employment has remained relatively stable, agriculture has declined significantly as a percentage of GDP down from 46% in 1997. The cause for this decline is the rise of the industrial sector, which accounted for 26.3% of GDP in 2002 up from 15.2% in 1997. Most of this growth can be attributed to the garment sector, which accounts for almost half of all industrial employment. The service sector accounts for 34.2% of GDP and 15% of employment. In the service sector, tourism has great potential for contributing to economic and employment growth although a temporary setback in 2003 caused by international events and the outbreak of severe acute respiratory syndrome (SARS) may reduce the potential of this sub-sector in the short-term.

The informal sector is prevalent in Cambodia comprising over 80% of GDP and 95% of employment. The informal sector is made up mostly of unregistered farmers and agricultural enterprises. The informal industrial sector is composed of over 27,000 small enterprises, which are not registered with the Ministry of Commerce (MoC). Only half of these enterprises have operating licenses from the Ministry of Industry, Mines and Energy (MIME). The informal industrial sector accounts for almost half of total industrial output and supplies mainly the domestic market. Registered private enterprises constitute what is referred to as the formal private sector and number approximately 9,000. These enterprises acquire legal status as commercial enterprises through registration with the MoC and are required to pay profit tax based on the real regime calculation method, which relies on the submission of financial statements. Their legal status as commercial enterprises allows them to apply for import and export licenses and improves their access to the formal financial sector. It also gives them access to investment incentives through the Law on Investment (LOI).

The foreign sector, especially the garment industry, plays an important role in the Cambodian economy and is the main source of exports. Foreign investment has declined significantly since the late 1990's. Not only have the effects of the Asian financial crisis impacted foreign investment, but the fact that Cambodia will have to compete in US and EU garment markets without the benefit of export quotas from the end of 2004 means that investment in the garment sector has slowed significantly. While the garment sector currently accounts for approximately three-fourths of all exports, its future is uncertain once garment exporters have to compete on price, quality and delivery from the beginning of 2005 when preferential access to major markets ends with the expiration of the Multi-fiber Agreement. Other important foreign investment includes hotels, tourism and telecommunications.

Private Sector Contribution to Cambodian Economy

The private sector in Cambodia is the primary employer in the country accounting for approximately 92% of total employment. Since the agriculture sector employs the largest number of people, it will continue to be an important source of jobs for new entrants. However, with the low productivity of the sector and the reduced amount of land available to workers, the role of the industrial and service sectors will continue to grow as a source of new employment. High growth sectors such as manufacturing and construction will contribute to job growth and

productivity improvements. Continued growth in manufacturing will depend on the ability of the private sector to diversify into new areas to reduce the sector's dependency on the garment sector. In particular agro-processing has potential to contribute to the growth of the economy. In the service sector tourism and trade have great potential to generate economic growth and employment.

PSD Role in Poverty Reduction in Cambodia

Approximately 36% of the Cambodian population lives below the poverty line with about 90% of the poor living in rural areas. The high level of poverty in rural areas is putting pressure on urban areas, which are attracting more and more migrants. High fertility rates result in an estimated annual population growth of 2.5% with urban populations growing at an even faster pace of around 3.4%. Because of the young population the growth rate of new job entrants is high at approximately 3.2% per year with about 228,000 annual new entrants expected through 2005. With so many people to employ in the coming years, the country will need to rely on the private sector to generate growth and employment. Unfortunately, private sector investment has been on the decline since 1997 in nominal terms and as a percentage of total investment. Public investment has increased since 1997 mainly as a result of the \$190 million received from foreign donors. To reverse this trend in private investment the RGC needs to promote the development of labor-intensive industries by improving the legal and regulatory environment and reducing administrative costs and uncertainties for investors. By simplifying licensing and registration procedures and streamlining import and export procedures to improve access to inputs and markets the RGC can encourage the private sector to increase investment resulting in an increase in employment and a reduction of poverty. A sound poverty reduction strategy should include supporting small and medium enterprises (SMEs) by improving their access to financing and strengthening their production, management and accounting skills.

Methodology and Framework of Private Sector Assessment

The PSA uses a conceptual framework and methodology for analyzing the constraints facing the private sector by looking at enterprises at each stage of development namely: 1) start-up; 2) quasi formal; 3) formalization and expansion; and 4) exporters. Since enterprises at the different development stages face their own set of constraints, it is important that the analysis recognize the unique characteristics of each stage.

At the start-up stage enterprises are typically self-financed or obtain financing from family or friends. These are informal enterprises operating in very local markets without registration and are often unlicensed. Their tax obligations are very small, if any at all. At the quasi-formal stage enterprises are unregistered and are not considered legal entities. However, they do have operating licenses and usually pay some form of lump-sum estimated tax to the local authorities. These enterprises operate in a wider market and face more concerns related to market access and inputs of raw materials. These enterprises are unable to obtain financing from the formal financial sector.

At the formalization and expansion stage enterprises are growing and see the need to become registered as legal entities in order to obtain export licenses, access bank financing and markets and obtain investment incentives. These enterprises face competition from imported (smuggled) products and must compete in wider markets to be successful. They will face government intervention in terms of inspections as well as tax collection, which is based on submission of financial statements to the Tax Department. These enterprises may join business associations in order to expand information networks, build capacity and dialogue with the

government. Exporters are the most developed enterprises in the country and are often foreign owned. For these enterprises access to import and export markets is vital. Government intervention in import and export processing is a major concern due to the administrative costs and impact on lead-times. These enterprises are affected more than others by labor relations because of potential strikes. These firms require a higher level of skill than at other development stages because of quality demands in foreign markets and the necessity to be cost competitive. Vocational training is important for them to improve skill levels.

Enabling Environment

Major Private Sector Development Policies

The RGC has issued several strategy papers in recent years in support of the private sector. The RGC's Second Socio-Economic Development Plan 2001-2005 and National Poverty Reduction Strategy recognize that the private sector is the engine for economic growth and poverty alleviation. These plans emphasize that private sector growth requires improved infrastructure and legal and regulatory reform to encourage investment. The RGC has taken measures to strengthen the financial sector by adopting the Financial Sector Blueprint 2001-2010 to support the development of banking sector as well as for non-bank financial services such as insurance and leasing. With its plan to join the World Trade Organization, the RGC recognizes the need to develop trade policy to reduce tariff and non-tariff barriers and improve export facilitation through the Integrated Framework process. Through its support of the Private Sector Forum the RGC aims to improve the understanding between the Government and the private sector. The RGC's Governance Action Plan focuses on the need to carry out judicial and legal reforms, improve public administration and finance, combat corruption and improve gender equity.

Rule of Law

In recent years the Royal Government of Cambodia (RGC) has made progress in creating the legal framework for private sector activities by establishing a contract law and a law on commercial registration. However the existing legal framework for commercial activities is very weak with many necessary laws currently in the drafting process, including the commercial enterprise, insolvency, secured transactions and commercial arbitration laws. The RGC has established investment incentives through the LOI and has enacted a Tax Law to reform the tax system and a Land Law to secure land and property rights. To strengthen the financial sector the RGC has enacted banking and insurance laws as well as legislation to develop accounting and auditing standards for private enterprises. A Labor Law has been enacted to strengthen workers' rights and safety, and the RGC is drafting laws on factory management and industrial zones to regulate the industrial sector.

Conclusions

Through its various strategies and plans, the RGC has repeatedly emphasized the importance of the private sector in poverty reduction. The RGC is relying on the private sector to act as the engine of growth for the economy by generating jobs and creating investment opportunities. For its part, the RGC recognizes that it must assist the private sector to create an appropriate business environment, including improving public sector governance and reducing corruption, providing physical infrastructure and helping to develop the capabilities of the private sector through education and training. The RGC recognizes the importance of implementing legal and regulatory reforms and must focus on improving the commercial law framework and

removing market constraints, which are obstacles to private sector development. Throughout the course of this PSA we will identify areas where the RGC needs to improve implementation of reforms to improve the business environment. While the RGC has been active in updating the legal framework to meet the needs of the private sector, successful implementation of the legal framework will require a commitment to implement necessary sub-decrees, carry out training and enforce penalties for non-compliance.

Major Issues and Constraints

Major Constraints in Business Regulation

The private sector faces many legal and regulatory constraints related to business operations. One hurdle to starting or entering a new business is commercial registration and licensing. Completing commercial registration and obtaining the necessary operating licenses is complicated for start-up enterprises and involves both official and unofficial fees, which according to a survey of newly registered enterprises amounts to an average of \$2,000. Because of the high cost, enterprises have an incentive to remain informal to avoid these costs, as well as the potential for increased government intervention in their operations resulting from inspections. An enterprise may delay registration until it needs the business license to borrow money from a bank, obtain import or export licenses, apply for Government procurement projects or enter into contracts with large enterprises. As long as the cost of formalizing a business remains high and the process complicated there will be little incentive for SMEs to register. Licensing also remains a problem for enterprises. Enterprises often require many licenses to operate from many different ministries. It can be a lengthy process to obtain all necessary licenses some of which have duplicating functions. Along with the licensing come many inspections from relevant authorities, which require additional unofficial fees and interfere with operations. Clear criteria for inspections are often lacking and the rights of the enterprise operator are not guaranteed.

To improve business regulation governance reforms are necessary to ensure that laws and regulations are properly implemented. The RGC has been taking steps toward governance reform through the Governance Action Plan issued in 2001. Although the Council of Ministers adopted an anti-corruption law in June of 2003, which it sent to the National Assembly, more progress is needed including judicial reforms to strengthen enforcement of laws and increased efforts to curb corruption. Public administration reforms are still needed to improve the efficiency and service delivery of public institutions. Continued efforts are also needed to implement decentralization of decision making to provincial and local government levels.

Major Constraints in Access to Financial Capital

Access to financing remains an important obstacle to the development of the private sector. While the banking sector has been strengthened through the bank relicensing program, which raised the minimum capital requirements for banks, high liquidity requirements combined with the risky lending environment result in high interest spreads and a prevalence of short-term maturities. The legal framework for secured transactions and insolvency are currently being prepared, which will make it possible to improve cash-flow based lending. Efforts are still needed to establish accounting standards and improve credit information sharing among banks. Continued training to strengthen the skills of bankers in the area of loan appraisal is also necessary. Micro-finance institutions need to expand their reach in rural areas and improve their ability to mobilize savings. In the insurance sector implementation of compulsory insurance is

necessary to create demand for insurance and increase the awareness of its importance to mitigate some investment risks.

Tax incentives play an important role in the financial planning of enterprises. With the amendments to the LOI, which were passed in 2003, special corporate tax rates have been phased out, new tax holiday provisions have been introduced and tax-free repatriation of earnings has been eliminated in order to rationalize tax incentives for qualified investment projects (QIPs). The LOI establishes a set number of days in which the Council for the Development of Cambodia (CDC) should issue the QIP certificate, in order to ensure that approvals are processed in a timely fashion. It remains to be seen whether the CDC and the relevant ministries involved in licensing QIPs will be able to meet the specific deadlines for approving investor applications. Since the tax incentives under the LOI, including duty exemptions on equipment and raw materials, apply only to large investors, SMEs are unable to receive duty or profit tax incentives.

The Tax Law provides for two methods of calculating profit tax. Under the real regime method the enterprise makes a self-assessment of profits and submits monthly income statements to the Tax Department. Under the estimated regime, enterprises are assessed a lump-sum tax based on a negotiation process with provincial-municipal tax officials. In most cases the tax burden under the estimated regime is lower since no income statements are provided to tax authorities, and it is difficult to estimate the true tax burden. While the RGC is making significant strides to improve tax policy and administration, it must continue to work to expand the tax base and remove the discretion in calculating profit tax. By strengthening enforcement of the tax system and developing Cambodian accounting standards it will be easier to assure transparency in calculating profit tax and reduce the role of negotiation in the process.

Major Constraints in Access to Social Infrastructure

Cambodia's current human resource base was devastated by almost two decades of war and isolation and is negatively affected by the low level of public expenditure on education, which is less than 2% of GDP. Although primary and secondary schooling is officially free of charge, the education system is heavily reliant on households' private contributions for unofficial school fees and other expenses such as books and uniforms. Financial constraints are a major cause for the low completion rate for primary and secondary education. The quality of education is also a major problem caused by shortage of qualified teachers, adequate education materials and relevant curriculum.

Vocational training has become a more important aspect of human resource development in recent years with the establishment of many private sector and NGO managed programs. Issues remain concerning the development of training standards and the access to training due to its high cost and limited availability in rural areas. Firm based skills and management training is also needed. So far the RGC has been unable to provide firm-based training.

Utilization of public health care services is very low and the private sector is the predominant source of medical care for the majority of the population. Many doctors working in public hospitals also run private clinics and hospitals. Improving access to health services is a major challenge. Since public facilities are often located far from rural villages, most of the rural population prefers to utilize locally available private services. Unfortunately, rural households can not easily afford the out-of-pocket payments for health care, which account for 6%-10% of total household consumption. For poor Cambodians health care expenses often result in

indebtedness and landlessness since there is no public health insurance available. To assist the poor to access health care some NGOs have piloted “equity funds” to pay for public health facilities used by the poor. The RGC is also experimenting with contracting out public health care services to NGOs to improve cost effectiveness and increase the accessibility of these services to those in need.

Major Constraints in Access to Physical Capital

Access to physical capital, including land, roads and transportation, and electricity is often a major constraint to private sector development. Land tenure continues to be a problem for the private sector due to the low level of land titling in the country. While the Land Law provides the legal framework for land tenure, land titling needs further implementation as do mechanisms for enforcing the law, reducing land conflicts and facilitating land management.

The shortage of physical infrastructure increases the cost of doing business in Cambodia. The high cost of electricity affects production costs, while expensive fuel and inadequate road infrastructure increase the cost of transportation. Due to the high cost of diesel oil, which is the main fuel for power generation, and the limited generating capacity in the country, electricity prices in Cambodia are significantly higher than in neighboring countries. The RGC has adopted a Power Sector Strategy to reduce the cost of electricity, which involves constructing a high-voltage grid to allow the import of power from Vietnam and Thailand at much lower prices. The strategy also includes the construction of new power plants using hydropower and other renewable energy sources. A major constraint to the development of Cambodia’s energy infrastructure includes the high cost of the power programs and the need for greater private sector participation in energy distribution, particularly in rural areas.

After nearly 30 years of war, Cambodia’s road infrastructure was left in ruins. Less than 10% of all roads are all weather with much of the system impassable during the rainy season. Poor road conditions increase the time needed to deliver products to markets and result in product spoilage and damage. Although the ADB has provided loans totaling \$158 million to rehabilitate roads and other donors have contributed handsomely, full reconstruction of the road network will require much more financial assistance and is expected to take as long as two decades to complete.

Major Constraints in Access to Competitive Markets

Local manufacturers face much competition in domestic markets from imported products and particularly from smuggled goods, which enter without import, excise and VAT taxes. Smuggling is identified by local manufacturers as one of the major problems in accessing local markets. Poor road and communication infrastructure and the lack of business associations result in limited market information concerning, quality and design requirements. For exporters, accessing foreign markets is complicated by the burden of export processing, which adds significant administrative costs.

Accessing imports at global prices is necessary for local manufacturers to compete in local and foreign markets. Since many enterprises are dependant on the import of necessary equipment and raw materials, the high cost of port facilities and import administration combined with duty, excise and VAT taxes, make it impossible for firms to access inputs at global prices. The high cost of inputs severely affects the competitiveness of Cambodian products in both domestic and foreign markets.

Major Sub-sector Constraints

The sub-sectors in Cambodia defined in this report as agriculture, household non-agriculture, domestic formal enterprises and foreign-invested enterprises face both common and unique constraints in their development. The agriculture sector faces issues regarding access to land, weak infrastructure, limited access to markets and a lack of processing capacity to add value to farm and fishery production. The non-farm household sector operates informally, and its main concerns revolve around operational issues such as financing and access to markets. These enterprises have limited access to market information as well as to information regarding technical and quality standards.

The domestic formal sector is concerned with issues regarding formalization such as commercial registration, licensing and compliance to taxation requirements. Domestic formal enterprises face competitive concerns, which increase the risk of investment due to the smuggling of cheaper foreign finished products and the high cost of importing inputs of raw materials and equipment. Tariffs and bureaucratic import procedures are a major cause of this high cost and increase the uncertainty of the supply chain through unnecessary delays.

The foreign invested sector is focused on garment manufacturing and is reliant on a cheap supply of labor. The sector is affected by Government intervention related to the supply of imported raw materials, factory inspections and the processing of exports. The foreign sector is also sensitive to high energy, input and labor costs and carries a disproportionate amount of the tax burden. While the garment industry has selected Cambodia as a manufacturing base due to preferential market access in the U.S. and European Union, the high cost of doing business explains why other labor-intensive industries are not well represented in the economy.

Long-term Vision and Action Plan for Private Sector Development

Overview

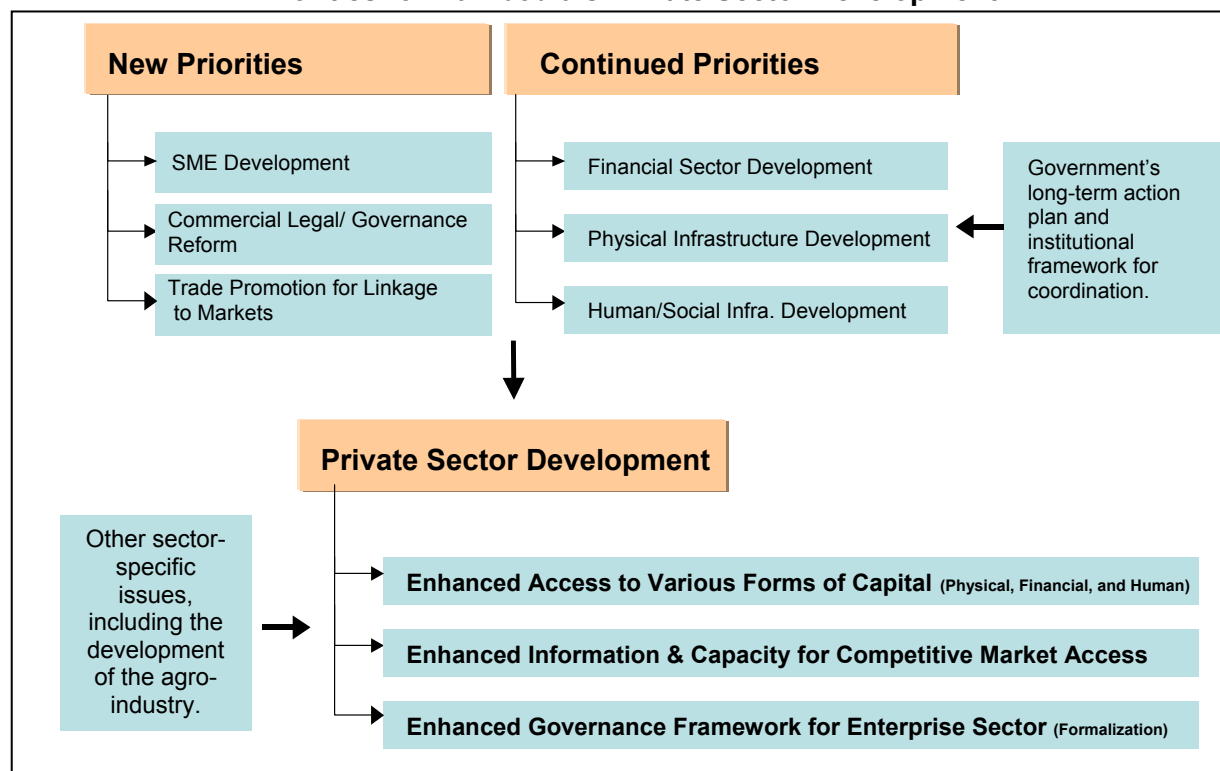
Macroeconomic stability and government reforms have had a positive impact on private sector growth in Cambodia. However, the RGC needs to develop a long-term vision and action plan for private sector development, which will establish an enabling environment for business and strengthen the governance framework.

The RGC also needs to assist private enterprises through the provision of market information and trade promotion services as well as through firm-based training. Continued implementation of legal reforms in the financial sector will improve access to financing as will the establishment of a credit bureau and improved accounting standards.

The high cost of inputs, including infrastructure, raw materials, labor and capital must be addressed by the RGC. Competitiveness of local manufacturers can be strengthened through an improved business environment, which reduces the cost and uncertainty of doing business. The action plan for private sector development provided in the PSA addresses these challenges and provides phased recommendations for the RGC over the next ten years.

The action plan recognizes the importance of not only creating the necessary legal and regulatory framework, but also the need to focus on implementation through improved governance and support by the RGC. The overall vision as recommended in this PSA is illustrated as below and further explained below.

Priorities for Cambodia's Private Sector Development



Formalization

By improving the enterprise registration system, the RGC can reduce the pervasive informality of the private sector. When informal, the enterprises lack effective access to various forms of capital and other resources to become competitive. They are also unable to be protected under the law by corruptive and illegal activities of others. A simplified and transparent registration system should encourage more enterprises to formalize their operations by speeding up the process and reducing the cost. Increased formalization will give enterprises greater access to markets, financing and investment incentives. The RGC would also benefit by being able to obtain more information through an effective enterprise registry and provide opportunities to match large buyers with local suppliers. The RGC should streamline the registration process by reducing the paperwork needed and establishing a convenient one-door process for enterprises to submit all documents and obtain necessary information. The RGC should establish a computerized database of registered enterprises to provide information to policymakers and improve dissemination of information to the public. The requirement for registration should be expanded to a greater number of enterprises and incentives should be provided to make registration more attractive.

To improve licensing and inspection, the RGC needs to establish transparent regulations and procedures and clarify the roles and responsibilities of ministries and local government bodies to remove overlapping authorities. By simplifying licensing and inspection the cost of compliance would be reduced and uncertainties facing a new business would be lessened. The PSA recommends that the RGC establish an inter-ministerial task force under the Supreme National Economic Council (SNEC) to review all business licenses and inspection requirements

and develop an action plan for streamlining procedures and improving transparency. In later phases of the PSD action plan the RGC should issue specific decrees on simplifying licensing procedures and removing unnecessary licenses. As part of this process the RGC should also strengthen the rights of businesses regarding inspections by creating clearer guidelines for what inspectors are allowed to do and by providing enterprises an opportunity to register grievances concerning the actions of government officials and inspectors.

Enforcement of Legal Framework

Enhancing the rule of law by improving dissemination of legal and regulatory information, strengthening the judiciary and reducing the need for long and expensive court proceedings to resolve commercial disputes would have a significant impact on private sector investment by providing a more predictable business environment. Implementation of anti-corruption legislation, civil service reforms and the strengthening of the National Audit Authority would also have a positive impact on private sector investment. The PSD action plan recommends the RGC to increase distribution of the legal gazette to make legal and regulatory information more widely available. It also recommends the establishment of a specialized commercial court and a commercial arbitration panel to improve resolution of commercial disputes and create a more professional judiciary in the area of business law. The action plan also recommends the enactment of an anti-corruption law, which requires accountability and a code of conduct for public officials and establishes an anti-corruption commission to investigate corruption charges. The RGC should also strengthen the capacity of Ministry General Departments of Inspection for internal audit and the National Audit Authority for external audit.

Market Access and Information

Improving market access through the strengthening of RGC trade promotion activities, reforming customs, strengthening the role of business associations and developing export promotion strategies is vital for the development of the private sector. The PSD action plan recommends the RGC to publish a business directory of registered enterprises to help match buyers and sellers. The RGC should also establish a trade promotion center, which would organize trade fairs and provide market information services to the private sector. The RGC should also develop a website to promote local products and enterprises, which could be linked with foreign chambers of commerce and trade promotion agencies. The RGC should also initiate a “buy Cambodia” campaign, which is coordinated with tourism promotion efforts, to promote local products.

To improve market access the RGC needs to take serious measures to combat smuggling through the enhanced efforts of the anti-smuggling task force to control illegal trade at the borders and at markets and stores. The RGC should also reduce the cost of official imports by lowering customs duties and streamlining import processing procedures. With the assistance of the IMF and other donors the RGC should strengthen the capacity of the Customs and Excise Department by developing a human resources plan, training programs to strengthen management skills, a code of ethics to control behavior and a computerized system to automate customs clearance and improve statistics gathering.

Business associations will play an important role in supporting market access and information through trade promotion, capacity building and technological development. The RGC should support the development of business associations through assistance with facilities and organizational capacity building. Business associations should be encouraged to set up cooperatives to carry out business activities, develop capacity building programs and in the

longer-term to establish credit cooperatives to mobilize savings and provide financing to members. While the private sector must take the lead in forming effective business associations, the RGC and donors should provide encouragement and support.

Since the domestic market is small an effective export development strategy is needed to promote private sector growth. Specific actions to promote exports such as the establishment of an export marketing fund to provide grants to exporters, particularly SMEs, to participate in overseas trade fairs and exhibitions would assist in increasing access to markets and information. The RGC should also organize international trade fairs and exhibitions to promote local producers. In the long-term the RGC should establish an export promotion agency to formulate export policies, provide information services, establish a website with e-commerce capabilities, and provide newsletters and buyers guides for Cambodian products. The agency could also sponsor overseas market research and carry out workshops and training. Further necessary actions to increase access to export markets include the reduction of trade facilitation costs resulting from complicated import and export processing procedures. One method of improving trade facilitation is to establish export processing zones, which would simplify customs clearance, while at the same time creating high-quality infrastructure and fiscal incentives for companies moving to the zone.

Access to Finance

To improve access to financing it is necessary for the RGC to develop a sound legal framework to protect property rights and enforce contracts. Improved credit information sharing between banks and the development of accounting standards would allow financial institutions to make well-informed credit decisions. The development of non-bank financial services such as insurance, leasing and capital markets would increase financing options and promote new investment.

The PSD action plan recommends the RGC to establish the key commercial infrastructure to underpin financial sector development, including enactment of the laws on commercial enterprises, insolvency and secured transactions. The establishment of a commercial court would have a positive impact on dispute resolution. A public secured transactions registry should be established. In addition, efforts to complete land titling should be intensified by improving dispute resolution mechanisms and reducing the land titling fees.

To improve credit information the RGC should establish and enforce accounting and auditing standards through the recently established National Accounting Council. The Institute of Khmer Auditors and Accountants should be strengthened to establish professional accounting standards, training and the development of a code of ethics. Banks should do their part to enhance credit information by establishing mechanisms to share credit information. The RGC needs to create a regulatory framework governing the sharing of credit information between banks. With the assistance of the National Bank of Cambodia (NBC) the bankers association should establish a full credit bureau by determining membership, fee structures and information sharing mechanisms.

The expansion of non-bank financial services and insurance is critical to the development of the private sector. Although the Banking Law permits leasing, the NBC needs to develop implementing regulations before banks are willing to enter the market. Effective measures for supervising the leasing industry are also needed as are appropriate fiscal incentives to attract investment. In the longer term the RGC should establish capital markets by creating the necessary regulatory body, establishing a securities exchange and developing the

capacity of capital market participants such as securities brokers and associations. The development of the insurance industry has been stalled by the weak implementation of compulsory insurance regulations. The RGC needs to strengthen the implementation of compulsory insurance by increasing inter-ministerial coordination to create enforcement and monitoring mechanisms. Promoting public confidence in the insurance industry through improved regulatory supervision and encouraging more companies to enter the market is another key to developing the industry.

To assist banks in managing liquidity, the RGC needs to establish the foundation of a short-term interbank market by establishing the regulatory framework for T-bills and other liquid money market instruments, in particular the adoption of a negotiable instruments law. After establishing the regulatory framework, the RGC should begin issuing T-bills and other government securities to facilitate bank liquidity management. The RGC also needs to develop a primary dealer system for issuing securities. In the longer-term the RGC should establish the regulatory framework for the issuance of commercial paper and trade bills by non-financial institutions as well as the development of private bond markets.

Sub-sectors

1) Agriculture

The agriculture sector will continue to be a major engine of the Cambodian economy. Increased crop diversification from rice to other higher-value added products with export potential is necessary to increase the returns of the sector. To enhance the diversification of agricultural products the RGC needs to encourage investment in agro-industry by establishing land tenure through land concessions. It is important that government large-scale concessions are transparent and will contribute to the export potential of the country by cultivating high-value produce. Supporting smallholders is also vital for the development of the agriculture sector. This can be achieved by assisting to integrate them with agro-enterprises to provide stable markets for farmers. The RGC should assist this integration by improving access of smallholders to land, finance and other inputs. The development of contract farming would also assure smallholders of markets for their diversified produce and would encourage them to invest in new products. The RGC can assist in developing the potential of agro-enterprises through capacity building programs to improve packaging and quality, supporting the development of associations and assisting in trade promotion. Continued rehabilitation of irrigation systems and strengthening of water management capabilities is also necessary.

To strengthen support for the development of fisheries, the RGC needs to establish the legal framework for fisheries management by enacting the draft fisheries law and sub-decree on community fisheries and strengthening local management of fisheries. The formation of private business associations would help to strengthen the capacity of fishery enterprises and would generate financing opportunities through credit unions. Associations would also help to raise the value-added of the sector by providing more marketing opportunities and improving transportation and storage. The RGC should support aquaculture development by assisting the private sector to arrange technical and financial support from the donor community and by providing extension services and training to farmers to develop fishponds and assisting in the development of localized aquaculture management plans.

2) Households

Household enterprises need to improve their access to markets. The development of commune-based associations would improve access to market information such as pricing, quality and design requirements and help build capacity in production and marketing. The RGC should assist household enterprises to formalize their businesses to become a part of the acknowledged business community. To encourage formalization through registration and licensing, the RGC should provide incentives to household enterprises such as a simplified tax structure, access to investment incentives, opportunities to obtain government procurement contracts and access to financing, marketing and capacity building programs.

3) Formal Domestic Sector

The domestic formal sector has great potential for growth through labor-intensive industries. The key to developing this sector is to create a competitive business environment where fair competition, good governance and a low cost structure make the risks of investment commensurate with the returns. To promote this sector the RGC should strengthen anti-smuggling efforts, streamline import processing to improve access to necessary inputs and create a more equitable tax structure, in particular the replacement of the minimum profit tax with another form of quarterly tax payments based on actual profits. The RGC should develop industrial standards to help increase product quality and improve consumer confidence. Public awareness of the importance of industrial standards should be increased to give producers a greater incentive to obtain relevant certifications. The RGC should also continue with efforts to improve the cost competitiveness of Cambodia through physical infrastructure improvements to reduce the cost of transportation and electricity.

4) Foreign Invested

Since the foreign invested sector is the main contributor to Cambodia's export base, foreign investment should be widely encouraged by the RGC. The RGC should enact legislation to guarantee access to land for agro-industry and other labor intensive industries. It should also consider reforming labor policies, which result in higher wages than in neighboring countries, such as generous overtime and night pay. The RGC should also improve arbitration and other dispute resolution mechanisms to reduce the risk of poor labor-management relations disrupting business operations. The RGC should concentrate efforts on making Cambodia a globally competitive investment environment by improving physical infrastructure, including establishment of industrial zones, strengthening governance to reduce administrative costs and establishing policies to develop supporting industries to act as suppliers for foreign-invested manufacturers.

5) SME Sector

Since the SME sector is the backbone of the economy, it is necessary to formulate policies to create an enabling environment for SMEs. The first step is for the RGC to develop the legal framework for SME promotion, which is currently absent. Such legislation is necessary to establish incentive and support programs for SMEs. An SME policy framework, including a long-term SME development strategy and action plan, is also necessary. The strategy and action plan should focus on developing an SME support framework, including incentives, financing and capacity building programs. The SME policy should also determine the government institutional framework for SME development, including the establishment of an inter-ministerial SME Committee to coordinate policies and programs. The committee should be

supported by an SME policy office acting as the secretariat and located under SNEC or as an independent agency. The SME Committee should define the roles of each ministry in SME development and coordinate their activities.

The RGC's SME promotion activities should be designed to improve SME access to financing and the delivery of business development services. While continuing with financial sector reforms to strengthen the legal framework and credit information, the RGC should examine the feasibility of establishing a scheme to finance SMEs through lending programs or credit guarantees. To enhance private sector lending to SMEs, capacity building in the area of loan appraisal, credit administration and credit scoring is necessary to improve the efficiency of lending. Increased use of cash-flow based lending methodologies will be required. To increase the reach of SME financing in rural areas, the RGC should encourage the development of credit unions and cooperatives affiliated with business associations.

To build capacity of SMEs the RGC should focus on firm-level training to strengthen SME management, production and marketing skills. The RGC should establish a training institute to support SME development and a trade promotion center to act as a one-stop shop for trade promotion and information services. The trade promotion center should develop an internet portal site to facilitate access to information and enhance trade promotion and business linkages. The RGC should establish these institutions with the intention of creating public-private partnerships to eventually manage their operations. The RGC should also establish a design and innovation center to build SME capacity in product, labeling and packaging design. The establishment of SME business associations should also be promoted nationwide to build business linkages and support capacity building efforts.

Priorities for Private Sector Development in Cambodia

The vision and action plan for private sector development cover a wide range of issues, which require prioritization. The six points below are considered the main priority areas the RGC and donor community should target by implementing necessary reforms and capacity building measures as well as for developing necessary programs and projects. These points are selected from the many recommendations provided in this report and in the action plan provided in appendix 1.

1) Support SME Development

SME development should be a priority of private sector programs in Cambodia. Reforming registration and licensing procedures for SMEs is the key to improving formalization and making it possible to support SMEs through better access to financing and business development services. The RGC should carryout thorough reviews of the registration and licensing procedures and carry out reforms to streamline processes. As a priority to private sector development the RGC should also establish a legal, policy and institutional framework for SME development and prepare an SME development strategy and action plan.

2) Governance Reform to Improve Enforcement of Laws

The RGC should strengthen its governance reform efforts by improving enforcement of laws. Judicial reform and capacity building in the area of commercial law is needed to improve dispute resolution mechanisms and improve the performance of the courts. Since many new commercial laws will be enacted soon, it is necessary to develop the capacity of the judiciary for implementation. Since governance impacts so many aspects of the business enabling

environment, it is vital that reforms assure that the legal framework is effectively implemented and measures to combat corruption are supported.

3) Continue Support for Financial Sector Reforms

Since access to financing is a fundamental aspect of private sector development, efforts to reform the financial sector should continue to be a major priority of the RGC and the ADB through the development of a secured transactions system, credit bureau and to support the efforts of the bankers association to train bankers. Development of leasing would provide alternatives to long-term bank financing and the strengthening of the insurance industry is necessary to reduce risks in business operations. Measures to improve liquidity management such as interbank markets and the issuance of T-bills are vital for improving financial intermediation and strengthening the potential of term lending.

4) Develop RGC's Capacity to Provide Assistance to the Private Sector

The RGC has limited capacity to provide trade promotion, training and other business development services to the private sector. These are important functions, which should be developed in the long-term. Donor support should focus on developing mechanisms for assisting the private sector by strengthening the capacity of the RGC and supporting public-private partnerships to deliver private sector services. The RGC requires much assistance to develop the ability to support the private sector. By assisting the RGC to provide support services, the donor community would help to stimulate the private sector by expanding market opportunities and trade potential.

5) Continue Infrastructure Development

Infrastructure development will continue to be a key to private sector development. Continued donor support will be necessary to finance road construction and rehabilitation, the development of the power infrastructure, improvement of irrigation systems and renovation of port facilities. In addition to supporting the development of the physical infrastructure, it should also be a priority of the RGC and donor community to develop capacity in road, electricity, irrigation and port management to assure the sustainability and maintenance of infrastructure improvements.

6) Strengthen Capacity Building

A well educated and trained workforce is the key to private sector competitiveness and improving the quality of life of the population. The support of basic education should continue to be a major priority of the RGC and donor community. Efforts to reduce the financial constraints in accessing education are necessary as are programs to improve the quality, especially in rural areas. With the diversification of the Cambodian economy from agriculture to industry and services, it is increasingly important to strengthen vocational training. Although, the private sector and NGOs should continue to be the main providers of vocational training, government support for improving the access and quality of training programs is necessary. Firm-level training should also be encouraged through business associations and chambers of commerce.