CAMBODIA

DIVERSIFYING BEYOND GARMENTS AND TOURISM

COUNTRY DIAGNOSTIC STUDY

Executive Summary

ADB

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EXECUTIVE SUMMARY

During the last 2 decades, Cambodia achieved remarkable economic growth and development—its gross domestic product (GDP) has expanded at an average 7.6% a year since 1995. The country seized growth opportunities from its rich natural resources and the evolving dynamics of the regional and global economy. It effectively leveraged its land and water resources to steadily boost agricultural production, making Cambodia the world's eighth-largest rice producer. Cambodia is also Asia's 10th-largest garment exporter, as it took advantage of the changing global quota regime and buyers' search for new low-cost sites for garment production. A unique cultural heritage also helped Cambodia increasingly make its mark as a tourism destination in Southeast Asia.

Rapid economic expansion brought important gains in national income and poverty reduction. Even so, Cambodia is one of Asia's eight remaining low-income countries and the second-poorest country in Southeast Asia. It also faces considerable challenges in building a modern, sophisticated, and industrialized economy, and to raise living standards to the levels of its more developed neighbors. To sustain its strong economic performance, several growth-supporting factors must be strengthened—infrastructure remains inadequate and unreliable, education attainment and skills are subpar, governance is weak, and savings rates are still low.

This study suggests that Cambodia needs to address these highly interrelated weaknesses to avoid getting trapped in low-wage, low-value-added production, and to maintain a stable political environment conducive to investment and commerce. Moving into higher-value-added production and climbing the global value chain will require sustained improvements in infrastructure, human capital, governance, and other supporting institutions.

Although strong growth is pivotal for improving living standards, creating decent jobs and providing healthy returns for farmers and small businesses will play a critical role in making growth more inclusive. This will require a firm government commitment and well-designed interventions to boost access to economic opportunities and improve social protection. Adequate public investment in education, health, and basic social services to enhance human capacity—

especially for the disadvantaged—is prerequisite. At the same time, market and institutional failures, and social exclusion, must be addressed to broaden access to productive assets, such as infrastructure, credit, and land.

This study identifies the major constraints to inclusive growth in Cambodia, using diagnostics based on the inclusive growth framework developed by the Asian Development Bank. Although the factors affecting economic growth and social development are complex and interrelated, this framework allows a systemic assessment of the key elements for inclusive growth, among them: infrastructure, especially energy and rural transport; skills and education; governance; fiscal spending; decent employment; social infrastructure and services, including education and health care; and access to public services and social protection. These constraints are summarized in the following text.

Human Capital and Decent Employment

Both the low levels of human capital and limited access to decent employment must be addressed before Cambodia will be able to provide higher-value products and services. Human capital development covers "cradle-to-grave" measures that ensure early childhood health and nutrition, education and training, and lifelong learning. Research shows the effects of early childhood development—especially the nutrition a child receives during the 1,000 days from conception through age 2 has significant impact on later life. The prevalence of stunting, wasting, and underweight children in Cambodia is among the highest in Southeast Asia—about 15% of the population was undernourished during 2011–2013, compared with the 11% average for the rest of the region. The country needs a good quality health care system that provides broad and affordable access as a foundation for human development.

Low secondary school completion rates undermine the marked gains in primary education. Parents and young people in Cambodia tend to underestimate the value of education—enrollment is low even in technical and vocational education and training (TVET). Basic learning materials and equipment are scarce, curricula weak, and mathematics scores low.

Increased resources could greatly strengthen human capital development if appropriately used. Government expenditure on education is among the lowest in the region—at less than 2% of GDP during 1995–2013. Although considerable resources have targeted primary education, the emphasis on secondary and tertiary education has declined. A comprehensive education and training plan and strategy would provide clear direction for human capital development and resource allocation. The United Nations Development Programme's recent study, *Human Capital Implications of Future Economic Growth in Cambodia: Elements of a Suggested Roadmap,* could be particularly useful.

The current labor market shows evidence of glaring skill mismatches and other gaps. Upgrading technical skills would benefit all aspects of Cambodia's economy, but is urgently needed in farming, manufacturing, services, and public administration. Training institutions must be better aligned with labor market demand.

Infrastructure: Electricity, Rural Roads, Water, and Sanitation

Reliable infrastructure is essential to support growth and economic inclusion. Despite notable improvements since 1995, more is needed to reduce the costs of doing business and maximize Cambodia's growth potential. The private sector consistently ranks inadequate infrastructure among the top five constraints to doing business.

The lack of long-term power planning during the early stages of Cambodia's reconstruction led to a major deficit in providing electricity. Not only is access to electricity among the lowest in Southeast Asia—serving just 51% of households—but access levels vary widely across provinces. Also, electricity tariffs are among the highest in the region, caused in part by high import, transmission, and distribution costs. These acess and cost factors deter investment in energy-intensive industries.

Current power supply depends heavily on traditional, unsophisticated, and imported energy sources—the latter exposing the country to international energy price volatility. Petroleum accounts for 60% of total electricity generation with oil-fired power plants accounting for 55% of total installed capacity. Because the electricity supply is unreliable, many firms resort to using costly diesel generators to supplement the supply. About 40% of businesses surveyed for the 2012 Investment Climate Assessment cited the unreliability of electricity supply among their top three business concerns.

Transport infrastructure is improving—especially roads—which account for over 90% of passenger and freight traffic. Although the main roads are developed, rural roads—74% of the network—desperately need upgrading. The 2007 Strategic Plan for Rural Roads underscores the link between rural road development, livelihood promotion, economic growth, and poverty reduction. Nearly all rural roads remain unpaved, adding significant cost and time to travel.

Cambodia's rail system is being rehabilitated after the damage incurred by years of conflict and neglect, limited replacement of rolling stock, and insufficient maintenance. Once completed, rail service will compete with road transport, reducing business costs.

Cambodia has the lowest rate of rural access to sanitation facilities in Southeast Asia and the second lowest in rural access to good quality water. Destruction from civil conflict, inadequate budgets, and unclear institutional structures for rehabilitation severely limit water and sanitation infrastructure outside Phnom Penh. About 90% of the population has access to improved water sources in the capital. But this falls to 67% in other cities and 42% in rural areas. The situation is similar for sanitation.

Governance

There has been marked improvement in the rule of law, public administration and finance, and regulation of market activity during the last 2 decades. The improved governance framework enhanced property rights and transaction security, both vital for business. Despite these gains, continuing to strengthen governance will be crucial in speeding the country's economic transition to higher-income status.

The informal payments—often needed to obtain government licenses, permits, and access to basic services—are a major weakness in governance. The business community agrees—the World Economic Forum's Global Competitiveness Report 2013–2014 says corruption and inefficient government bureaucracy are major barriers to doing business in Cambodia. Reforms that combat corruption—such as the enactment of the Anti-Corruption Law in 2010 and measures under the Public Financial Management Reform Program—resulted in a slight decline in perceptions of corruption in recent years. Yet informal payments for government services are still common, raising investment, production, and logistics costs. They can also deter foreign direct investment, especially from countries with strict anticorruption laws.

Fiscal Resources

Cambodia's vast development needs require long-term and recurrent financing for hard and soft infrastructure. However, a narrow tax base and weak tax administration constrain the government's ability to generate revenue in order to advance its development agenda. Revenue collection averaged just 14% of GDP in 2010–2013, predominantly through indirect taxes. On the positive side, Cambodia continues to enjoy a peace dividend after decades of civil conflict ended in the late 1990s, reallocating government spending away from defense toward public services.

The government relies heavily on concessional loans and grants from development partners to meet its expenditure program. Over time, it must reduce this reliance and increase domestic resource mobilization through taxation and other forms of revenue generation, while improving management of existing revenues.

Access to Public Services and Social Protection

As mentioned earlier, marked regional disparities and income inequalities limit social service provision. Poor access to safe water and sanitation often leads to gastroenteric and diarrheal diseases in rural communities, particularly damaging children's health.

Access to social protection is also very limited due to the nascent development of the country's social protection schemes. The government has increased spending on social protection and has attempted to widen coverage, but progress has been slow. As the economy rapidly industrializes and urbanizes, a modern social protection system will be needed to replace the variety of traditional and informal means of providing social protection.

Special Challenge: Diversification and Upgrading

Cambodia faces the special challenge of diversifying and upgrading productive capabilities to improve both economic resilience and growth potential. Currently, economic output rests on four pillars: garments, rice, tourism, and construction. Although this provides some diversity among economic sectors, the mix is nonetheless limited, and exposes the economy to demand disruptions and price shocks. The global financial crisis cut into garment production and exports, exposing vulnerability to its narrow industrial focus. Moreover, about 80% of merchandise exports go to slow-growing markets in Canada, Europe, and the United States; only 15% of merchandise exports go to Asia.

Cambodia's export basket is rudimentary and has not changed much during the last decade. Diversifying into higher-value products and services will help the country avoid being caught in a low-wage, low-technology equilibrium. But it is equally important that diversification and upgrading be developed so they contribute to upgrading skills and creating good quality jobs.

Policy Recommendations

The constraints analysis used in this report leads to a series of key recommendations for policymakers (see Chapter 5 of the full report for the full list).

Human Development

Key Priorities

- Expand health care and encourage improved nutrition.
- Improve the quality of secondary education and raise completion rates.
- Provide an accreditation and certification framework for TVET.

Specific Recommendations

- Increase the number of physicians and other health care professionals and expand health care coverage and access. Ensure effective implementation and financial management of the new health insurance program under the National Social Security Fund.
- Ensure that the first 1,000 days of life are well supported through nutrition and health care. Strengthen prenatal and postnatal care provided by primary health centers and provide support and funding for reproductive, maternal, newborn, and child health services.
- Strengthen public awareness of the importance of good nutrition. Provide adequate resources to expand school-based midday meal programs in poor areas to improve nutrition and encourage parents to send their children to school.
- Decrease the number of students per teacher, which is currently over 40 in many schools, to a maximum of 30 in primary schools and 25 in secondary schools. This will increase the time teachers can devote to each student and improve learning outcomes. Additional teachers will be required to meet these targets.
- Reduce the share of secondary school teachers who have not completed upper secondary education, from the current 20% to 10% by 2017 and to zero by 2022. Provide appropriate in-service and distance learning opportunities for teachers to upgrade their credentials.
- Improve the quality of pre- and in-service teacher training to improve the quality of instruction and learning outcomes. Review the curriculum and pedagogy to ensure that education and skills provided in secondary schools meet the needs of the job market or entry to higher education.
- Improve the quality and relevance of TVET to satisfy labor market demand. The National Employment Agency could provide better and

more detailed information to the National Training Board and employers on current and future skills required.

- Promote private sector involvement in education policy in designing training programs, setting education standards, assessing TVET, and accrediting training institutes. Attract and secure private sector participation and investment in establishing sector-specific centers of excellence.

Infrastructure Development

Key Priorities

- Complete electricity generation expansion and reduce energy imports.
- Strengthen rural electricity enterprises and offer incentives to expand coverage.
- Expand the network of paved rural roads.
- Improve water and sanitation in rural towns and villages.

Specific Recommendations

- Integrate regional grids into a national network—critical in supplying countrywide electricity and distributing generating capacity coming on stream in the next few years.
- Prioritize electricity provision to all villages by 2020 through combined improvement in generation, transmission, and distribution.
- Provide the government support necessary to ensure scheduled power generation capacity is on stream by 2020. This new capacity should reduce imported electricity from its current 64% share to below 30% by 2020 and help satisfy the expected increase in electricity demand.
- With increased generating capacity, a national grid, and improved rural energy supply, tariffs can be lowered and the large gap between rural and urban electricity prices reduced.
- Designate the Rural Electrification Fund as the central coordination agency for pooling funds from development partners for rural electrification. Ensure regular consultations with development partners to plan strategy and implementation. This approach could be modeled on programs where rural electrification has been successful, such as programs of central coordination agencies in Bangladesh and India.
- Ensure the Ministry of Public Works and Transport has sufficient funds for road development projects. Target a significant increase in road density and the share of paved roads from the current 23% to 40% by 2025.

- Finish rehabilitating the railroad to allow a greater share of bulk goods to be transported by rail and thus reduce heavy wear and tear on roads. Ensure rail connectivity with ports in Cambodia and Thailand.
- Upgrade, expand, and maintain urban and rural sewerage and drainage infrastructure outside the capital to fight disease and expand social inclusion.
- Enhance household sewage disposal through improved toilets and connections to sewerage systems and septic tanks. Campaign to reduce open defecation in rural areas from the nearly two-thirds of households today, targeting much lower levels by 2020.

Improved Governance

Key Priorities

- Strengthen the Anti-Corruption Unit and enforce the 2010 Anti-Corruption Law.
- Work with development partners to improve public sector administration and financial management.
- Improve legal capacity to settle commercial disputes.

Specific Recommendations

- Continue strengthening the Anti-Corruption Unit and ensure full implementation of the 2010 Anti-Corruption Law through education on corruption, measures to prevent corruption, and law enforcement. Violators should be prosecuted with sufficient penalties to deter corrupt practices.
- Publicize fees for processing public permits and licenses in offices and on government websites to increase transparency. This should include fees jointly published in late 2012 by the Ministry of Economy and Finance and the Council for the Development of Cambodia, and the fees announced early in 2013 by the Ministry of Commerce. Encourage other ministries to follow.
- Support reforms that combat corruption and strengthen the legal framework, such as the Anti-Corruption Law, the Public Finance System Law, and the Public Financial Management Reform Program. Promote civil society involvement in public contracts by introducing and institutionalizing digitized processes for bidding, procurement, and contract disclosure at both national and local government levels.

- With development partner support, continue to advance the four main reform programs in public sector management—the National Program for Administrative Reform, the Legal and Judicial Reform Program, the Decentralization and Deconcentration Reform Program, and the Public Financial Management Reform Program.

Fiscal Resource Management

Key Priorities

- Enhance revenue mobilization to meet public investment and social service demand.
- Strengthen government tax collection and administration.
- Increase revenue share from direct taxes and explore other sources of revenue generation and savings.

Specific Recommendations

- Prioritize measures to improve revenue generation from the current 15% of GDP to 17% by 2018. Concentrate on taxpayer compliance measures and improve governance of tax collection agencies.
- Target a reduction in tax arrears through a focused strategy and a dedicated arrears collection team. Assess the effectiveness of the profit-tax exemption for attracting new investment to make the incentive less generous and more focused on attracting investment in nontraditional products and services.
- Widen the direct tax base by including more individuals and small firms while continuing the important work of the Large Taxpayers Department. Reduce exemptions on electricity, financial services, and petroleum. Generate additional revenue through broader application and, in some cases, higher rates for excise taxes on tobacco and diesel.
- Improve tax administration productivity through the greater use of information technology and more effective human resource recruitment and management. Offer a broader range of tax payment options through information technology and electronic banking.
- Prepare for increased social services spending and wider coverage of social protection over the medium term—as fiscal constraints have aggravated the dilemma between meeting short-term growth targets and long-run social protection goals. Consolidate ad-hoc social programs and systematically implement social safety nets under a comprehensive national social protection system with sustainable long-term goals and plans.

Cambodia: Diversifying Beyond Garments and Tourism
Country Diagnostic Study
Executive Summary

Cambodia has enjoyed over 2 decades of robust growth, with rising foreign investment and deepening integration into global and regional value chains. The country—once riven by civil war and conflict—is now politically stable and increasingly making its mark as the world's eighth-largest rice producer, Asia's 10th-largest garment exporter, and a rising tourist destination. Yet Cambodia faces considerable challenges. It suffers from major infrastructure deficits; limited skills development and education quality; and weaknesses in governance. Fiscal resources are also stretched. Moreover, for a successful transition to a modern industrialized economy, Cambodia needs to diversify and upgrade its productive capabilities. This publication examines the opportunities and the challenges, and offers recommendations for long-term socioeconomic strategy.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to approximately two-thirds of the world's poor: 1.6 billion people who live on less than $2 a day, with 733 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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