

# BUSINESS ISSUES BULLETIN

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## Informal Charges Hinder Business Growth in Cambodia

*Cambodia relies on its private sector to drive economic growth and job creation, but high levels of informal charges make doing business difficult. Businesses consistently report that informal charges are a major problem that discourages them from expanding. Informal charges, therefore, have a negative effect on the economy by weakening the capacity of the private sector to grow and create jobs.*

*The 2006 Provincial Business Environment Scorecard (PBES)<sup>1</sup> measured informal charges in 10 provinces and found that although they vary from province to province, such charges hurt businesses everywhere. Armed with this information about the level of informal charges in their provinces, local authorities now have an opportunity to take action to improve their economic governance and to monitor their performance on an annual basis. And the good news from the PBES analysis is that reducing informal charges in each province will directly improve the business environment, leading to a stronger private sector and the creation of more jobs.*

*There are practical short term steps that provinces can take to reduce informal charges. In particular, simplifying and improving administrative processes is highly effective because improving transparency and reducing bureaucratic complexity removes opportunities for officials to demand informal charges and eliminates incentives for businesses to pay them. IFC-MPDF is currently working with several provincial governments on administrative simplification projects to help them achieve this.*

*Ultimately everybody benefits when informal charges are reduced. The private sector is better able to grow, leading to more jobs and greater wealth in the community. At the same time, government revenue increases when the private sector grows and businesses expand.*

### What are 'informal charges'?

Informal charges are unofficial extra payments made to government officials to obtain some kind of benefit for an individual or business. The PBES revealed that informal charges exist on two distinct levels in Cambodia: micro level and macro level.

<sup>1</sup> Unless otherwise noted, the information provided in this *Bulletin*, including statistics, conclusions and recommendations, is drawn from *The Provincial Business Environment Scorecard in Cambodia: A Measure of Economic Governance and Regulatory Policy* (PBES). The PBES measured and ranked the economic governance of Cambodia's ten most economically active provinces on ten important indicators, one of which was informal charges. The PBES, published in March 2007, was jointly produced by the International Finance Corporation's Mekong Private Sector Development Facility (IFC-MPDF) and The Asia Foundation (with funding from AusAID - the Australian Agency for International Development).



The *Business Issues Bulletin* provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Cambodia. Also included are opinions on topic from a number of relevant stakeholders.

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The statements and opinions presented here are only meant to provide additional reference material and do not reflect the official opinion of the Mekong Private Sector Development Facility or of IFC.

## Micro- informal Charges

At the micro-level, small bribes are paid to government officials to obtain favorable official decisions, expedite bureaucratic procedures and pass regulatory inspections. Micro-informal charges are the typical ‘unofficial fees’ that almost every business in Cambodia has to pay to achieve favorable outcomes in dealings with government officials.

A number of factors contribute to the high levels of micro-informal charges in Cambodia. In particular, salaries of government officials are low, leading them to sometimes ask for informal payments to perform a specific task in order to supplement their income. In addition, Cambodia’s bureaucratic processes are frequently time consuming and complicated, and consequently there are multiple opportunities for officials to demand informal payments. It frequently seems quicker, cheaper and easier for businesses to pay these charges than to battle with complicated bureaucratic procedures lacking in transparency.

## Macro- informal Charges

At a macro level, bribes are sometimes paid in one-off amounts during the bidding process for public procurement contracts. Such bribes are frequently calculated as a percentage of the value of a procurement contract, and can reach quite large amounts. Only a small number of Cambodian businesses are engaged at this level, as 99% of all enterprises in Cambodia are small and medium enterprises (SMEs)<sup>2</sup> and are simply too small to bid for such procurement contracts.

This Bulletin thus focuses on micro-level informal charges, as they present a direct problem for all businesses, rather than just the largest ones.

## How micro-informal charges hurt business

Informal charges constrain firms’ ability to grow for a number of reasons. Firstly, they reduce business profitability – by their nature, informal charges are additional costs which businesses are not legally required to pay. Secondly, informal charges reduce business predictability which makes doing business harder and more time consuming. The combination of reduced profitability and an unpredictable business environment also hurts business confidence.

<sup>2</sup> Royal Government of Cambodia, Sub-committee on Small & Medium Enterprises (2005), *Small and Medium Enterprise Development Framework*.

<sup>3</sup> The World Bank, and IMF (2004), *Cambodia at the Crossroads*

*Informal charges raise the cost of doing business and make it difficult for most businesses to survive and compete in the international environment. That is why the Cambodian economy remains so dependent on the garment sector and has not been able to diversify into many other manufacturing sectors such as footwear, electronics or food processing. This narrow base makes Cambodia very vulnerable to external shocks and also prevents the economy from creating the better paying jobs that are necessary. This in turn creates high levels of unemployment and frustration amongst young people in Cambodia who would like to find good jobs.*

**Ms. Nisha Agrawal, Country Manager,  
The World Bank, Cambodia**

The combination of frequent informal charges and Cambodia’s complicated bureaucratic processes encourage businesses to remain small and informal. In the short term, the strategy of remaining small and informal makes business sense because it enables firms to avoid onerous bureaucratic obligations and informal charges. But in the long run, it limits firms’ ability to do business, hinders access to credit and discourages growth.<sup>3</sup>

*SMEs are now facing the problem of informal charges when they import raw materials for production. To import raw materials, SMEs have to pay informal charges to customs officers otherwise they tend to delay clearance, which costs SMEs a lot of time.*

**Mr. Heng Heang, President of Phnom Penh  
Small and Medium Industry Association**

*In Siem Reap, informal charges make businesses hesitate to expand their operations because the bigger the business becomes, the more government officials will demand informal charges such as additional tax fees, security fees and others. Production costs increase as a result, making businesses less competitive.*

**Mr. Pheng Kong, President of Siem Reap  
Chamber of Commerce**

*Informal charges negatively affect my business. They increase operation costs as I have to pay informal charges to relevant government officials. Informal charges not only affect the hotel business, but they also impact the tourism sector as a whole. They discourage tourists from coming to Cambodia. I believe that other businesses in the sector, including tour agencies and airlines also pay informal fees. To keep a profit margin, these agents have to increase prices to cover the costs associated with informal fees. Then, the price becomes higher for tourists visiting Cambodia.*

**Mr. Thav Lina, General Manager,  
New York Hotel, Phnom Penh**

**Figure 1: The extent to which micro-informal charges are an obstacle to doing business (by province)**



Source: Compiled from PBES informal charges score

## Levels of micro-informal charges by province in Cambodia

A key finding of the 2006 PBES is that informal charges considered by businesses in Cambodia as an obstacle to doing business. Figure 1 shows that informal charges are higher in provinces with more business activity, including Sihanoukville, Siem Reap, Kandal, and Phnom Penh.

## How to reduce informal charges

Now that the PBES has quantified the extent to which informal charges are a problem in Cambodia's provinces, the challenge is to reduce them in order to make doing business easier for small companies. This is far from easy, but an approach which has worked in other countries is to reduce the incentives for businesses to pay informal charges, and for officials to demand them.

In Cambodia, one of the main reasons that government officials demand payment of informal charges is because they receive low salaries. It is common for officials to say that they extract small bribes because their salaries are inadequate to support their living expenses.<sup>4</sup> To the extent that reducing informal charges encourages greater regulatory compliance, provincial revenues will increase.

*One of the main reasons why government officials tend to solicit bribes is that their salaries are not enough to support their living expenses. So, one solution is to address the issue of salary increase.*

**Mr. Sek Barisoth, Director of Anti-Corruption Program, Pact Cambodia**

One practical short term strategy that provincial governments can use to reduce informal charges is to improve their administrative processes to minimize the opportunity for officials to demand payments by making bureaucratic procedures shorter, simpler and more transparent. More efficient administrative processes mean fewer occasions when officials have the opportunity to demand additional payments. A further benefit is that it leads to faster and better government service delivery. More transparent processes mean better information for firms about their obligations and entitlements and about government fees and services. For example, in La Paz, Bolivia, posting information about process requirements on the municipal websites contributes to making information transparent and more accessible for businesses.<sup>5</sup>

*The Ministry of Commerce has contributed a lot to simplifying business registration procedures and reducing informal charges. For example, we issued Prakas No. 163 which reduces the business registration fee to \$177, and we disseminated this information widely to businesses so they would know how much they are supposed to pay.*

<sup>4</sup> EIC (2006), *Assessment of Corruption in Cambodia's Private Sector*

<sup>5</sup> IFC (2005), *Simplification of Business Regulations at The Sub-National Level*



*from relevant ministries. If business people know the correct fees then they tend not to pay informal fees. Hence, increasing transparency may be a good strategy to reduce informal charges. It also means that information on formal fees and procedural requirements should be more widely disseminated to businesses.*

**H.E. Mao Thora, Undersecretary of State,  
Ministry of Commerce**

In Cambodia, simplifying and improving bureaucratic processes is likely to be a very effective step towards reducing informal charges. At present most Cambodian bureaucratic processes tend to be complicated, burdensome and are rarely transparent. For example, starting a business is a complicated task that requires multiple interactions with a number of different government agencies, multiple bureaucratic procedures, and little written guidance on costs or procedures. At each point different officials are involved and new opportunities arise to demand unofficial payments. Although simplifying and improving the transparency of such administrative procedures does not completely prevent informal charges, it would make a positive difference in Cambodia because officials would have fewer opportunities to demand them, and businesses have less motivation to pay them.

*In 2004, the Government of Cambodia adopted a 12-point reform program for trade facilitation in order to reduce these informal charges. Progress in the implementation of these reforms has been mixed and needs to be accelerated urgently.*

**Ms. Nisha Agrawal, Country Manager,  
The World Bank, Cambodia**

## **The benefits of reducing micro-informal charges**

Reducing informal charges will benefit business, government and Cambodia's economy by improving the business environment. A better business environment will encourage private sector growth and create more jobs. Statistical analysis of the PBES data shows that if provincial governments can reduce informal charges, firms will expand their operations and hire more employees. A more dynamic growth oriented private sector also helps to drive economic growth and reduce poverty.

<sup>6</sup> IFC (2005), *Simplification of Business Regulations at The Sub-National Level*

<sup>7</sup> Ibid

*If provincial governments were to reduce informal charges by just one point on the PBES scale, our statistical analysis reveals that this would likely generate a predicted 21% increase in new jobs, as existing businesses will be encouraged to expand and hire more employees.*

**Professor Edmund Malesky,  
Technical Advisor, the PBES project**

An additional benefit of reducing informal charges is to encourage better regulatory compliance. At present, businesses try to avoid interacting with the government to avoid paying informal charges. Reducing informal charges, therefore, removes a significant disincentive to regulatory compliance and encourages the rule of law.

For the government a direct benefit of reducing informal charges is likely to be an increase in revenue. Simple and transparent administrative procedures encourage more businesses to enter the formal sector resulting in government revenue increases as these businesses start to pay taxes and other administrative fees. In Dagupan City in the Philippines for example, improving business registration processes led to a 13% increase in city revenue.<sup>6</sup> Similarly, in La Paz, Bolivia, simplifying and improving business registration procedures led to a 20% increase in the number of registered businesses, which meant greater revenue for the municipal government.<sup>7</sup>

## **Taking the next step**

Informal charges are a major problem in Cambodia; reducing them is not easy and requires commitment from provincial governments. Ultimately, it is only by addressing all the factors that cause the problem of informal charges that they can be completely eliminated.

In the short term, provincial governments can begin to reduce informal charges by minimizing bureaucratic procedures, simplifying systems and providing better information to businesses. Such steps are realistic and lead to immediate benefits for business, government and the local economy. Moreover, they build confidence in the government and demonstrate a commitment to improving administrative processes.

IFC-MPDF is currently at the stage of identifying areas of cooperation with several provincial governments in order to streamline business start-up procedures, with the goal of reducing informal charges paid by small businesses and improving the environment in which they do business.