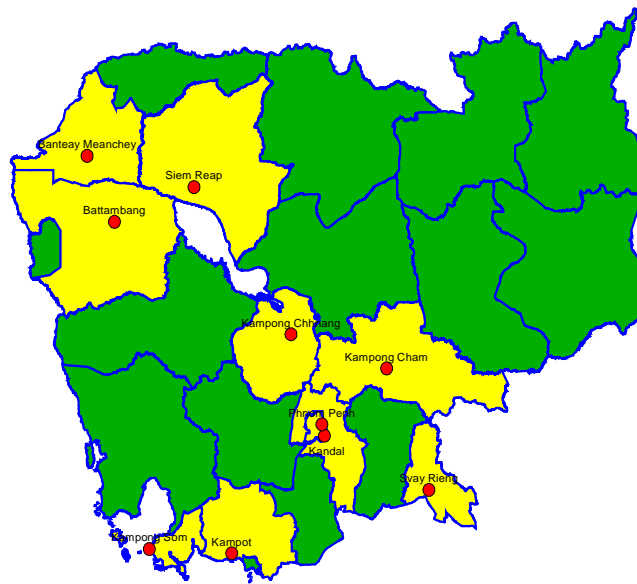


Reforming Business Environment Bottom-up: Provincial Business Environment Scorecard in Cambodia



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Executive Summary

This paper presents the approach to reforming the business environment in Cambodia by working to lessen the burden of regulatory compliance at the sub-national level, taken by the International Finance Corporation (IFC) – Mekong Private Sector Development Facility (MPDF). This project builds on the IFC’s global experiences of reforming sub-national business environment, particularly those in Latin America and Vietnam.

In line with the conference theme 2, *Managing Successful Business Environment Reforms in Asia*, and hot topic 5, *Sub-national business environment reform*, this paper summarizes the IFC-MPDF technical assistance project that a) starts with a diagnostic study to evaluate the business environment at the provincial level from the perspective of economic governance and regulatory policy and benchmarks the provinces against each other; and b) assists provincial authorities to design and implement reform agendas to simplify business regulations in the provinces.

Background

Cambodia’s economy has grown at an average rate of 7.1% from 1994 to 2004, despite having just emerged from three decades of war. Economic performance in 2005 was also impressive, with a growth rate of 13.4%. Another year of strong growth is expected for 2006, with the World Bank projecting the growth rate to be almost 9%. This growth has brought about much needed poverty reduction. Between 1994 to 2004 poverty was reduced by 12%, from 47% in 1994 to 35% in 2004.¹ The growth, however, has been narrowly based and geographically concentrated in urban areas, and as a consequence, reduction in poverty has not been evenly distributed. The majority of the poor (91%) live in rural areas.

Economic growth has to be broad-based to ensure that its benefits are felt by all. This requires pro-poor and rural-focused growth since over 80% of the population lives in rural areas. It is imperative, therefore, to have a good understanding of the business environment in rural areas so that appropriate interventions could be designed to unleash the potential of broad-based growth in Cambodia. Within the Cambodian context, this means reviewing the business environment in the provinces; as in many instances, interactions between businesses and the government occur at provincial/municipal level.

¹ Poverty line is \$0.45 per person per day. World Bank (2006). Cambodia: Halving poverty by 2015? Poverty Assessment



The IFC-MPDF Business Enabling Environment Program in Cambodia

The IFC-MPDF BEE program works at the macro level to advocate for a better business environment. BEE program activities include: research to identify private sector problems and practical solutions; wide dissemination of research findings through a variety of means including mass media and IFC-MPDF's own publications; providing analytical inputs in dialogue between the private sector, government and other stakeholders; and promoting corporate citizenship.

The BEE program in Cambodia over the next five years will evolve from providing diagnostic studies and solution designs to assist the government to implement reform agendas to ensure that the regulatory environment is business friendly. This will entail designing projects to reduce regulatory burdens on business operations at both national and provincial levels and help establishing a reliable and fair mechanism for contract enforcement.

The IFC-MPDF approach to sub-national level reform

As worldwide experience shows, national policy and actual implementation at the local level can differ significantly. Building on this knowledge and its experience in Vietnam, IFC-MPDF in Cambodia has begun a process to simplify business regulations in the provinces.

The initiative is being carried out in two stages:

First, in collaboration with The Asia Foundation and building on the IFC's *Doing Business* experience, IFC-MPDF is developing a Provincial Business Environment Scorecard (PBES) that benchmarks province's economic governance and scores them against one another. Some of the main indicators include provincial business regulations and administration. The result of the PBES disseminated on October 26, 2006 and was widely covered by the media.

In the second stage, IFC-MPDF will work with select provinces to simplify a number of procedures for businesses at the provincial level, including registration, licensing, permits, etc. depending on the needs of the provinces. This work is scheduled to begin in late 2006, following the launch of the PBES.

Reforming Business Environment Bottom-up: Provincial Business Environment Scorecard in Cambodia

I. Background

Considering that the country has just emerged from over three decades of war, Cambodia's economic performance over the past decade or so has been very strong, growing at an average of 7.1% annually between 1994 and 2004.² The economy continued its strong performance with real GDP growth of 13.4% in 2005.³ The World Bank's projection expects another year of strong performance with 8.9% growth in 2006.

This growth, however, has been narrowly based; with garment manufacturing and tourism as the main drivers. While the agricultural share of GDP (in 2000 constant price) decreased from 46% in 1994 to 31% in 2004, it continues to support more than 70% of the Cambodian labor force. On the other hand, the industrial sector supports only 8% of the labor force despite doubling its share of GDP over the past decade (from 14% in 1994 to 29% in 2004).⁴ There is no substantial change in the service industry's (inclusive of trade and tourism) share of GDP, remaining at around one-third; it employs about 21% of the work force.

The growth phenomenon in Cambodia has been geographically concentrated in urban areas—specifically Phnom Penh (for garment sub-sector) and Siem Reap town, where the Angkor ruins stand responsible for growth in the tourism sector. The impacts of growth on poverty reduction, consequently, reflect the country's growth patterns, i.e. although in aggregate this growth has helped reduce poverty from 47% in 1994 to 35% in 2004, it has been the urban areas that have benefited the most. In 2004, only 5% of the people living in Phnom Penh, the capital, lived under poverty line.⁵ By comparison, the poverty rate was 21% in other urban areas and 34% in rural areas; 91% of the poor live in rural areas. As such, more pro-poor and rural-focused growth is imperative to accelerate poverty eradication and ensure sustainable growth. To that end, promoting the growth of enterprises outside the urban centers is crucial.

² The World Bank (2006). Cambodia: Halving poverty by 2015? Poverty Assessment. Phnom Penh. Page 16.

³ The World Bank, in its quarterly update in early 2005, reported a growth rate of 7.7%. The IMF's estimate at the time was within this range. In its latest update in early 2006, the Fund recalculated and reported a growth rate of 10% for 2004.

⁴ Ibid.

⁵ According to the World Bank's Poverty Assessment (2006), Cambodian poverty line is approximately \$0.45/day/person.



II. The IFC-MPDF BEE program in Cambodia

The IFC-MPDF BEE program works at the macro level to advocate for a better business environment. As worldwide research shows, the quality and implementation of business related laws and regulations are critical factors in private sector success. BEE program activities, which are planned and often carried out in collaboration with government and business associations include: research to identify private sector problems and practical solutions; wide dissemination of research findings through meetings, the mass media and IFC-MPDF's own *Private Sector Discussion Papers* and *Business Issues Bulletins*; providing analytical inputs in dialogue between the private sector, government and other stakeholders; and promoting corporate citizenship.

The BEE program in Cambodia over the next five years will evolve from undertaking diagnostic studies and solution design to assisting the government, in close consultation and cooperation with the private sector, to implement reform agendas at both the national and sub-national level to ensure that the regulatory environment is business friendly. This will entail designing projects to reduce regulatory burdens on business operations and helping to establish a reliable and fair mechanism for contract enforcement. The former involves streamlining business registration, licensing, permits, and inspection procedures to ensure that informal charges are eliminated (or at least minimized), access to regulatory information is guaranteed and property rights are upheld. The latter involves providing technical assistance to help setting up an alternative dispute resolution (ADR) mechanism in Cambodia.

III. The IFC-MPDF approach to sub-national level reform

While many studies and reports have documented informal charges sought by public officials, lack of access to regulatory information by enterprises and weak property rights at the central level, there is less information about the variations of these issues between provinces. Worldwide experience shows that national policy and actual implementation at the local level can differ significantly. Building on this knowledge and its experience in Vietnam, IFC-MPDF, with the government and The Asia Foundation, has completed the first Provincial Business Environment Scorecard (PBES) to better understand economic governance and its differences across provinces in Cambodia, and to generate a feeling of competition among provinces as they seek to increase investment (building on the IFC/World Bank *Doing Business* model). What has been learned in the research at the sub-national level will feed back up to national policymakers through IFC-MPDF's established dialogue and advocacy channels. In addition, the scorecard will serve as the foundation for IFC-MPDF's ongoing work in selected provinces to implement regulatory reforms, specifically in simplifying procedures and regulations for the business community. The ultimate goal is to lower the time and costs associated with complying with business regulations.

There is significant IFC experience in sub-national simplification from other parts of the world to build upon, including Bolivia, Peru and Indonesia. While it is premature to offer an overall assessment of success of these initiatives globally, anecdotal evidence from IFC's Latin America facility shows impressive results. After one year of implementing simplified procedures in the municipality of La Paz in Bolivia, the number of newly registered



businesses increased by 20% while the time to obtain a general activity business license was reduced by 13 times.⁶

a) The Provincial Business Environment Scorecard (PBES)

The first major component of the IFC-MPDF provincial simplification project in Cambodia is the PBES, designed to generate competition between provinces and provide baseline information on specific provinces for further support. In this first year, the survey was administered in 10 of Cambodia's 24 provinces, and will be expanded in subsequent years. Carried out in collaboration with The Asia Foundation and with the full support of the Ministry of Industry, Mining and Energy (MIME) and the Ministry of Commerce (MOC), generating support at the sub-national level was still a particular challenge. The survey has been completed and the scorecard was launched on October 26, 2006. The results will enable provincial administrations to reflect on the complexity of the actual implementation of regulations in their provinces. The analysis will also help IFC-MPDF and provincial administrations to identify areas where reforms could have the highest potential impacts in terms of expanding private sector growth and job creation. The PBES has already identified a number of priority areas for reform that could significantly promote economic growth; the Executive Summary of the Provincial Business Environment Scorecard below offers brief overview of the findings of the survey.

b) Implementing Simplification of Business Regulatory Procedures at the provincial level

The second, bigger phase of the project will build upon the experience of IFC-MPDF in Vietnam and on IFC's experience elsewhere in the world in helping provincial authorities to actually implement reforms and new procedures. This phase is scheduled to begin in late 2006, once the results of the scorecard have been made public. It is anticipated that at that point in time, a number of the more reform-minded provinces will seek outside assistance to improve their local business environments, as was the case in Vietnam.

IFC-MPDF has begun the process of building stakeholder buy-in among central and provincial government authorities on both the results of the PBES and potential benefits of simplifying business regulations in the provinces. Following these consultations, IFC-MPDF will select two or three provinces to work with and together select key priority areas in which to pilot reforms of business procedures. The project will likely consist of detailed mapping of existing procedures, identifying redundant steps/procedures, agreeing together on steps to be eliminated, and implementing the new procedures. IFC-MPDF will provide the necessary technical assistance to put new procedures and reforms in place, provide training and capacity building to staff and implementing a public awareness campaign about the new procedures.

⁶ BEENet – Business Enabling Environment Network – an IFC online knowledge bank.
http://ifcgp.ifc.org/quickplace/beenet/Main.nsf/h_FA6535DB484CAA4985256FC800742DAA/47D2C983F6FC7D6E85256FC800746A1E/%3fOpenDocument



IV. Outcomes and Impacts

As this project is still in very early stages of implementation, it is not yet possible to determine outcomes and impacts. The launch of the PBES results on October 26, 2006 generated wide media coverage. Ultimately, the intended impact of the project is to lower the time and cost of complying with regulations that businesses have to face.

Summary Report of

The Cambodian Provincial Business Environment Scorecard

A Measure of Economic Governance and Regulatory Policy⁷

⁷ The Provincial Business Environment Scorecard (PBES) is a partnership between the International Finance Corporation's Mekong Private Sector Development (IFC-MPDF) and The Asia Foundation, with funding support from the Australian Agency for International Development (AusAid). The lead consultant was Edmund Malesky, Assistant Professor at the University of California, San Diego. The field research was carried out by Indochina Research Limited, based in Cambodia.

Common Abbreviations

Asian Development Bank (ADB)

Australian Agency for International Development (AusAID)

Department of Industry, Mines, and Energy (DIME)

Department of Commerce (DOC)

Department of Tourism (DOT)

World Bank's Investment Climate Analysis (ICA)

Ministry of Industry, Mines, and Energy (MIME)

Mekong Private Sector Development Facility (MPDF)

Ministry of Commerce (MOC)

Ministry of Tourism (MOT)

Provincial Business Environment Scorecard (PBES)

The Asia Foundation (TAF)

Value Added Tax (VAT)

World Bank (WB)

Executive Summary

A flurry of excellent work on the development of the Cambodian private sector has highlighted four important and interconnected findings.⁸

First, the private sector is the major source of employment in the economy (accounting for 92% total jobs) and will continue to be the dominant source of job creation and poverty reduction for the foreseeable future.

Nevertheless, relative to its peers in other Southeast Asian economies, the Cambodian private sector has been inhibited in its ability to grow and create jobs because of a wide spectrum of institutional barriers and constraints to its development.

As a result of these institutional barriers, the vast majority of private enterprises have avoided the full formalization of their activities (as measured by whether an enterprise has registered with the Ministry of Commerce).

For all unregistered enterprises and most of the registered enterprises as well, the immediate interface with governing institutions is at the local (specifically the provincial/municipal) level.

And yet, researchers and those in the donor community understand very little about these interactions, how they affect private sector performance and the choice to formalize, and finally how provincial governance differs across Cambodia. The missing key to our understanding of how to promote the growth and dynamism of the private sector in Cambodia and thereby assist job creation and poverty alleviation lies in a thorough understanding of the impact of local institutions on private sector performance.

This report attempts to begin the process of filling in these gaps with what we are calling, “The Provincial Business Environment Scorecard (PBES).” The PBES is a thorough diagnosis of the comparative economic governance of 10 provinces according to 10 basic criteria (sub-indices). The ultimate goal of the project is to identify the provinces that have excelled at various aspects of provincial governance and communicate the successful

⁸ Development Consulting International, 2003. “Private Sector Assessment for the Kingdom of Cambodia,” *TA Report for the Asian Development Bank and Ministry of Industry Mines and Energy*. Asian Development Bank: Phnom Penh, December; World Bank Group, 2004a. “Cambodia: Economy Profile,” *Doing Business in 2005: Removing Obstacles to Growth*. World Bank: Washington, D.C.; World Bank Group, 2004b. *Cambodia Seizing the Global Opportunity: Investment Climate Assessment and Reform Strategy for Cambodia*. World Bank: Phnom Penh; Dapice, David. 2005. “Reducing Poverty by Creating a Normal Country,” Memorandum to Government of Cambodia; Chandarrot, Kang, 2006. *The Enabling Environment for Micro, Small, and Medium Enterprises in Cambodia*. Phnom Penh: The Asia Foundation and Cambodian Development Resource Institute. Chandarrot, Kang, Salze-Lozac’h, Veronique, and Liv Dannet, 2006. *Streamlining Local Licensing Procedures in Cambodia*. Phnom Penh: The Asia Foundation and Cambodian Institute of Development Study.

practices to struggling provinces.

I. The Sub-Indices

More detail is provided in the final report about how these sub-indices were measured, but briefly the sub-indices include:

1. *Entry Costs*: A measure of the time it takes firms to register and receive all the necessary licenses to start business, the number of licenses required, and the official costs of obtaining all licenses/permits.
2. *Property Rights*: A measure of the formal rights to business premises and the security of tenure once land is properly acquired and titled.
3. *Transparency and Access to information*: A measure of whether firms have access to the proper planning and legal documents necessary to run their business, whether those documents are equitably available, and whether new policies and laws are communicated to firms and predictably implemented.
4. *Participation*: The flip-side of Transparency, measuring whether firms are consulted in the creation of provincial policy and whether their interests are represented in policy discussions by business associations or other interest groups.
5. *Time Costs of Regulatory Compliance*: A measure of how much time firms waste on bureaucratic compliance and waiting periods, as well as how often firms must endure inspections by local regulatory agencies.
6. *Informal Charges*: A measure of how much firms pay in informal charges, how much of an obstacle those extra fees pose for their business operations, and whether payment of those extra fees are predictable and result in the expected results or “services.”
7. *Crime Prevention*: A measure of how much firms pay in explicit costs as a result of crime due to property that is lost or stolen, as well as the implicit costs of preventing crime through security and protection money.
8. *Tax*: A gauge of both the administrative and fiscal burden imposed by tax regulation in the province.
9. *Proactivity of Provincial Leadership*: A measure of the creativity and willingness of provinces in both implementing central policy, designing their own initiatives for private sector development, and working within the often unclear national regulatory framework to assist and interpret in favor of local private firms.
10. *Dispute Resolution*: A measure of the satisfaction firms have in the outcomes of formal and informal modes of dispute resolution in the province.

II. Methodological Innovation

Two general types of data were used to construct the sub-indices. The first is perceptions data drawn from a face-to-face survey of 500 private firms in 10 provinces. This perceptions or “soft” data was combined with objective or “hard” data gathered from published sources, such as statistical yearbooks, the annual provincial budget, first-person collection and interviews with third-parties like state owned banks and real estate firms.⁹

It is important to highlight that while the PBES analysis studies similar issues as previous assessments of the private sector in Cambodia, its methodology differs in two critical ways. First, the PBES research team did not limit its analysis to the formal sector; the explicit goal of the research was to assess the private sector generally and this meant focusing on economic governance toward unregistered firms as well. 58% of the firms in our sample are not registered with the Ministry of Commerce or even possess the less formal distinction of one-year registration through Municipal/Provincial Department of Commerce. Nevertheless, calling them informal is a misnomer, as 73% have documented their business activities by paying a one-year Patent Tax with the local tax authority. Local officials are aware of their business activities and benefiting from them.

The decision to sample from the entire population of enterprises arose from two problems faced in the early stages of the research – one methodological and one theoretical. Methodologically, the research team found it impossible to obtain similar lists of registered enterprises (or enterprises with one-year operating licenses) in different provinces. Data quality and coverage differed dramatically (if lists existed at all), raising severe concerns about selection bias in the comparison of provincial environments. A random sample from a well-documented census of all enterprises in the research area would yield far more realistic results than a list haphazardly slapped together by a local official at the Department of Commerce. Theoretically, the ultimate goal of the research was to understand the environment for private sector activity at the provincial level – this simply could not be done if 75% of the active private sector was omitted because it was considered informal, as would have been the case in Banteay Meanchey. Furthermore, as important as it is to understand the constraints faced by the registered sector, it is equally important to understand why such a large portion of private firms (accounting for 80% of GDP and 95% of employment¹⁰) choose not to take the next steps in the formalization of their activities. Certainly, this will be best done in a panel setting with yearly surveys of the same enterprises, but it cannot be done at all if they are eliminated from the study at the outset.

The second major difference between the PBES and earlier work on private sector activity in Cambodia is that rather than extrapolating a few provincial-level results from a national-level sample, the research team drew 10 different provincial-level samples, so that it had as accurate a picture as possible of the private sector. To do this, the team performed a detailed

⁹ See Appendix 1 for a list of the full set of indicators.

¹⁰ Development Consulting International, 2003, p. 10.

census of private sector operation in the capital and the three other major population centers of all the provinces and municipalities. First, the 10 most economically important provinces were selected, including, arguably, all of Cambodia's main economic centers. Collectively, these provinces represent 75% of GDP and 64% of the Cambodian population.¹¹ While the goal is to eventually extend the PBES analysis to all provinces; in this inaugural year, the research team found it appropriate to concentrate on provinces with relatively robust economies. Next, PBES researchers traveled to each of the 10 provinces for a complete census of business activity. Every business operation in a fixed location with at least one employee in addition to the owner was considered an active enterprise for our analysis. In total, 41,775 business operations were identified. Later, the research team drew a stratified random sample from the lists generated by the census. Strata were defined by the number of employees (five different categories) and the sector in which the firms operate (services, manufacturing and construction, and commerce) for a total of 15 different strata. Random selection within these strata ensured that the sample would be reliable representation of the provincial populations. The result of these methodological choices is a far more accurate representation of provincial-level business activity than has been put together thus far in Cambodia.

III. The Provincial Business Environment Scorecard

The final results of the PBES can be seen in Figure 1 below. Interestingly, the Eastern border provinces of Kampong Cham and Svay Rieng are on the top the list, followed by Kampong Chhnang and Kampot. Kandal, a province encircling Phnom Penh, along with Banteay Meanchey and Battambang in the Northwest along the Thai border, rank sixth and seventh respectively. The poorest governed provinces are the capital city of Phnom Penh, Siem Reap, the home of the extraordinary Angkor Wat temple complex and a thriving tourist destination, the port province of Sihanoukville. Individual scores can also be seen in Table 1 below.

Siem Reap's placement near the bottom of the list may come as a surprise to some who are familiar with the large investment and growth in the hotel and tourist industry in the province. Those who have worked there, however, may be less surprised by Siem Reap's especially low scores on Entry Costs, Transparency, Crime Prevention, Proactivity, and Taxes. Like natural resource rich economies who suffer from the well-known "*resource curse*," where heavy rent-seeking for access to oil, lumber, and minerals leads to corruption and officials with a little incentive to improve governance,¹² Siem Reap may suffer from an analogous issue related to its tourist potential. Siem Reap's government officials do not have to try as hard as their peers from other provinces to improve their economic situation. Due to the historical accident that placed one of the world's ancient wonders in their borders, they are virtually guaranteed a greater flow of tourist dollars and service activity than their neighbors.

¹¹ Author's own calculation based on Cambodian Statistical Yearbook 2004.

¹²Ross, Michael, 2001a. *Timber Booms and Institutional Breakdown in Southeast Asia*. New York; Cambridge University Press. Ross, Michael, 2001b. "Does oil hinder democracy?" *World Politics* 53: 325-361. Sachs, Jeffrey and Andrew Warner, 1995. "Natural resource abundance and economic growth." *National Bureau of Economic Research Working Paper No.* 5398.

Indeed, Siem Riep has the highest GDP per capita outside of Phnom Penh and the PBES survey revealed that its firms enjoyed the highest growth in labor and investment over the past year, while ranking second only to Kampong Cham in willingness of entrepreneurs to expand their business. Nevertheless, it is not at all difficult to imagine that with just a modicum of improved governance to complement its enormous tourist potential, Siem Riep would be growing even faster!

Figure 1: The Provincial Business Environment Scorecard (PBES)

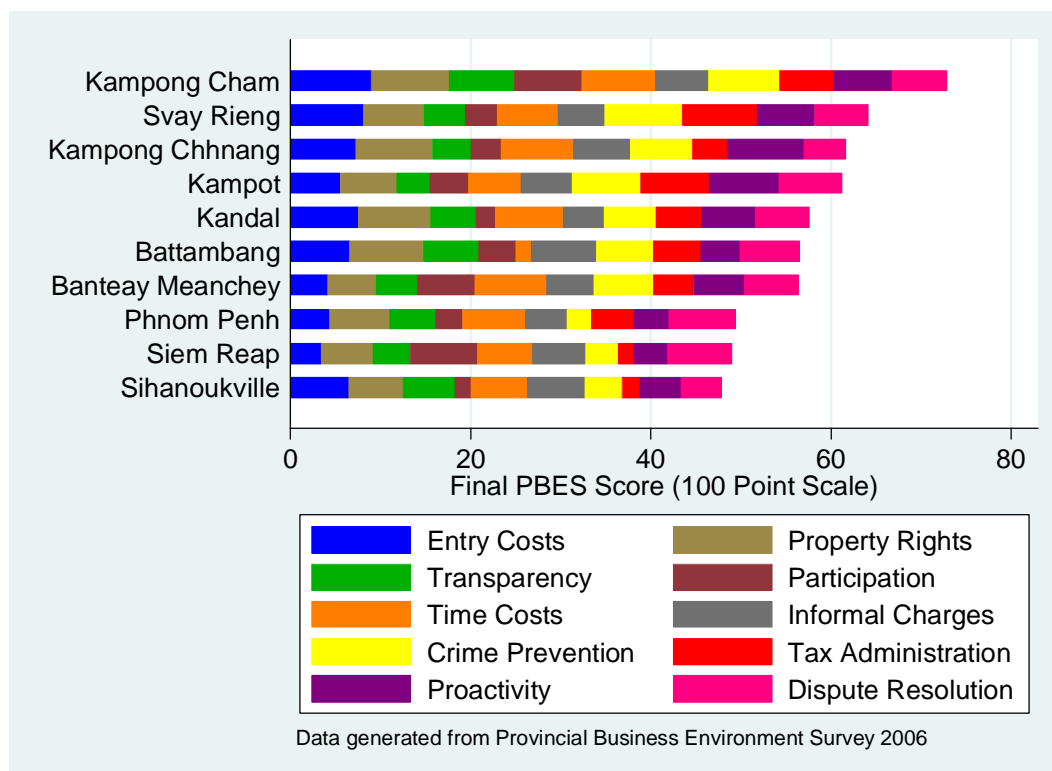


Table 1: Final Provincial Business Environment Scorecard

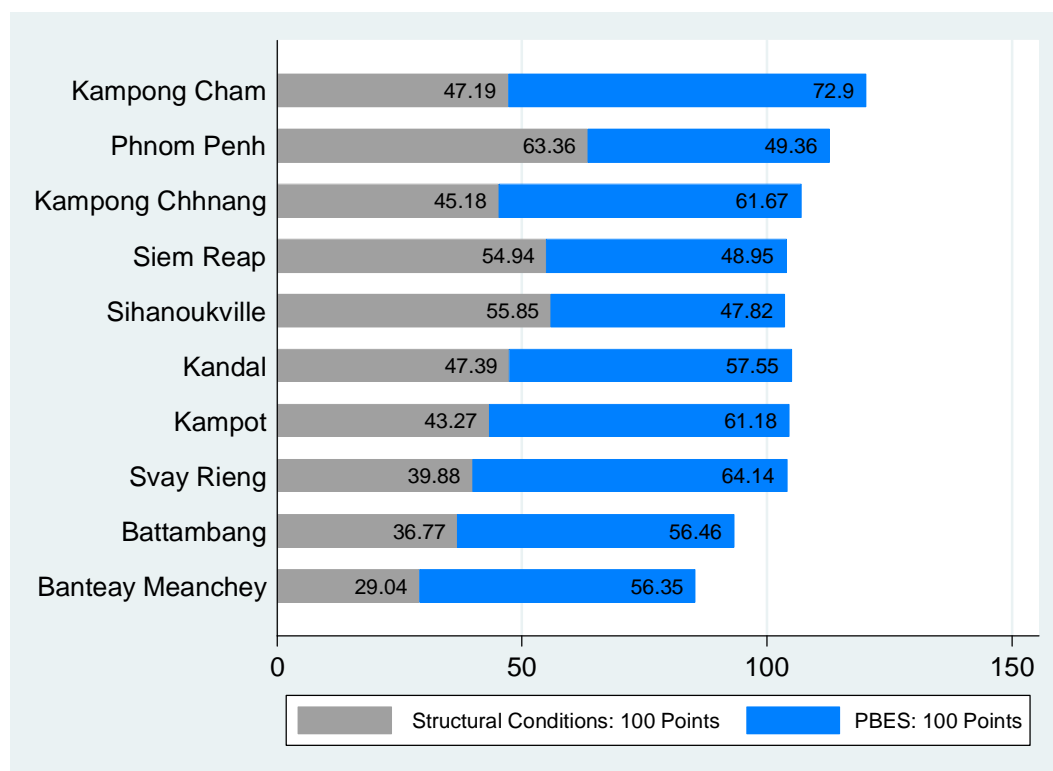
<i>Province</i>	<i>Entry Costs</i>	<i>Property Rights</i>	<i>Transparency</i>	<i>Participation</i>	<i>Time Costs</i>	
Kampong Cham	8.95	8.62	7.29	7.48	8.18	
Svay Rieng	8.08	6.74	4.56	3.56	6.72	
Kampong Chhnang	7.20	8.52	4.32	3.28	8.10	
Kampot	5.49	6.31	3.68	4.24	5.86	
Kandal	7.49	8.04	5.08	2.08	7.57	
Banteay Meanchey	6.50	8.23	6.16	4.12	1.67	
Battambang	4.13	5.40	4.50	6.40	8.00	
Phnom Penh	4.33	6.65	5.13	2.95	7.02	
Siem Reap	3.40	5.73	4.16	7.46	6.10	
Sihanoukville	6.41	6.08	5.72	1.84	6.25	
<i>Province</i>	<i>Informal Charges</i>	<i>Crime Prevention</i>	<i>Tax</i>	<i>Proactivity</i>	<i>Dispute Resolution</i>	<i>PBES</i>
Kampong Cham	5.86	7.89	6.57	5.96	6.11	72.90
Svay Rieng	5.22	8.59	6.38	8.33	5.96	64.14
Kampong Chhnang	6.30	6.87	8.43	3.92	4.73	61.67
Kampot	5.66	7.64	7.77	7.58	6.94	61.18
Kandal	4.54	5.75	6.01	5.02	5.98	57.55
Banteay Meanchey	7.30	6.29	4.34	5.23	6.62	56.46
Battambang	5.23	6.62	5.71	4.39	5.97	56.35
Phnom Penh	4.58	2.70	3.88	4.77	7.36	49.36
Siem Reap	5.87	3.65	3.74	1.70	7.11	48.95
Sihanoukville	6.40	4.09	4.60	1.96	4.46	47.82

It is important to note that the PBES is solely a measure of economic governance and regulatory policy. It should not be confused with a measure of Total Investment Environment that includes both governance and measures of initial endowments, which are sometimes referred to as structural conditions. Using proxy measures for structural factors of the economy to generate an index of structural conditions, it is possible to generate just such a measure. To calculate this measure we use data from secondary sources to generate four determinants of structural conditions: Infrastructure¹³, Human Capital¹⁴, Proximity to

¹³ A composite measure of road coverage per square kilometer of surface area, road quality from a 2004 Japanese Investment Corporation Survey of the types of road surfaces in each province, the price of energy in the province from the Ministry of

Markets¹⁵, and Tourist Potential¹⁶. It should be immediately obvious that rankings differ dramatically with Phnom Penh, Sihanoukville, and Siem Reap rising dramatically in the rankings. Yet such a total investment environment is uninteresting analytically. Provinces with relatively poor initial endowments such as Banteay Meanchey can do little to improve endowments in the short term. Far more useful is the impact in business development than can come from improving the economic governance (measured by the PBES) in the short term.

Figure 2: Total Investment Environment



Indeed, all provinces have a great deal of work to do on improving economic governance in particular arenas. The star chart in Figure 3 helpfully demonstrates the weakness and strengths of every province relative to the perfect score. No province excels in all areas.

Industry, Mines, and Energy 2006, and average annual electricity and water interruptions from the PBES survey. Please see Appendix 4 for details.

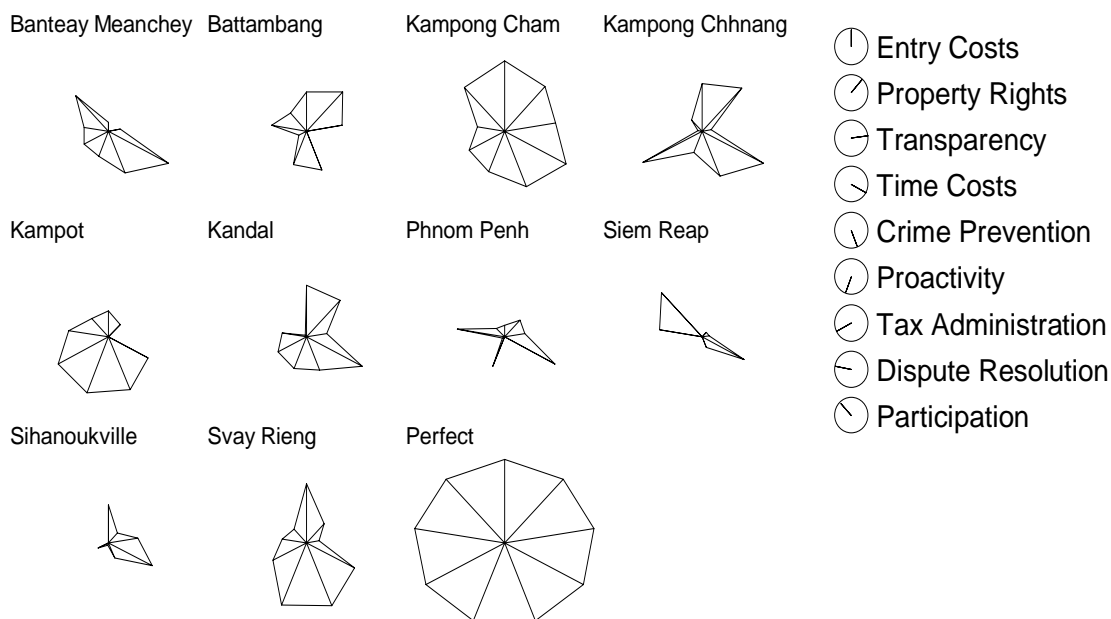
¹⁴ A composite measure of provincial literacy rates, secondary school graduates, and teachers per 1000 citizens obtained from the 2005 Cambodia Socio-Economic Survey.

¹⁵ A gauge of the potential market for goods and services as measured by the province's distance from Phnom Penh, the port in Sihanoukville, and percentage of citizens living in urban areas.

¹⁶ Though tourist records are only officially recorded at points of entry such as airports, ports, and border crossing, it is possible to proxy the importance of tourism to the economy by the number of provincial officials working in the local Department of Tourism (for example, Siem Riep employs 92 people to Phnom Penh's 21). This number is a helpful measure to control for the enormous distortion caused in firm employment by the presence of Angkor Wat.

Even top-ranked Kampong Cham scores poorly on the Informal Charges, Proactivity, and Dispute Resolution Sub-Indices. Provinces such as Battambang and Kampong Chhnang show highly skewed governance scores with some excellent marks and other areas in need of tremendous improvement. The lowest scoring provinces have room for improvement on every sub-index.

Figure 3: Star Chart of Provincial Scores on Each Sub-Index



IV. The Impact of Provincial Business Environment

While some of these changes may be time consuming and perhaps politically difficult to accomplish, improved governance will almost certainly have an immediate effect on the business development in the region. Statistical analysis of the PBES indicators bears this out. Controlling for firm-level variable such as age, sector, size, and costs, and the provincial-level factors of infrastructure and tourist attraction potential, it can be shown that a one point improvement on the PBES index from the mean score of 56.3 would lead to a 1.2% increase in the probability of firm expansion. Thus, a one standard deviation improvement (7.27 points) from the mean would generate a predicted 8.2% increase in the probability that

existing firms will expand their businesses over the next two years.¹⁷ To make this more tangible, if Battambang (given its existing infrastructure, tourist potential, and human capital) were to improve from its present PBES score (56.46) to the level of Kampong Cham (72.9), it could expect nearly a 17% improvement in the willingness of existing firms to expand their businesses in the future.

Table 2 takes this relationship one-step further by looking at the relationship between governance and willingness to expand in the manufacturing sector – thought to be a future source of growth in Cambodia due to its labor cost advantages.¹⁸ On average, there is statistically no difference between the willingness of firms engaged in manufacturing (63.6% of firms) and construction to expand their business than firms in other industries (62.5%). This relationship changes drastically, however, if we look at the options for manufacturing firms in well-governed provinces (defined as provinces with a total PBES score of 59 points or above). Here, we find that in provinces with low PBES scores, manufacturing firms are more reluctant to expand their businesses than firms in other industries (53% to 58%). In provinces with high PBES scores, however, both types of firms envision significant expansion over the next two years with manufacturing far more likely than their peers in commerce or services (73% to 67%). The results are quite striking, the predicted impact of manufacturing expansion will be most pronounced in well-governed regions.

Table 2: Predicted Probability of Expansion in Next Two Years (By Provincial Business Environment Score and Sector)		
	<i>Low PBES</i>	<i>High PBES</i>
<i>Non-Manufacturing Firms</i>	0.58	0.67
<i>Manufacturing Firms</i>	0.53	0.73

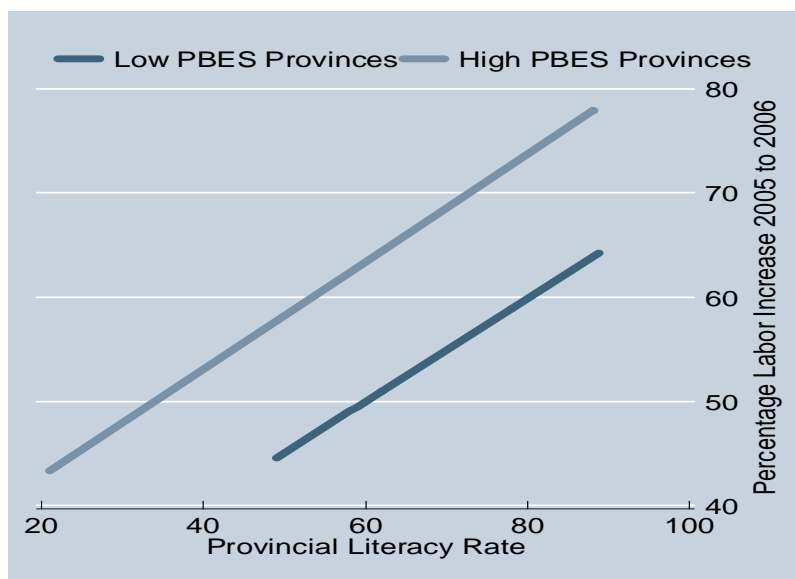
Of course a simple willingness to expand can be misleading due the irrational exuberance of many entrepreneurs. Maybe a more realistic measure of the impact of governance on firm expansion is the actual percentage of employees each firm has added to the labor force over the past year. Once again, we find that the governance is quite influential. A one point increase in PBES from the mean score would likely yield a 2.39% increase in average firm

¹⁷ Derived from a firm-level regression with standard errors clustered at the provincial level using Survey Question B_8, “Which statement best characterizes your firm’s investment plans over the next 2 years?” Please see Appendix 2A for more details on regression and robustness analysis.

¹⁸ World Bank 2004b; Mohan, T. 2005. “SMEs can be the Drivers of Competitiveness in Cambodia.” *Cambodian Review*, August, p. 10.

employment.¹⁹ Thus, if Banteay Meanchey were to improve its existing PBES score of 56.35 to the level of Kampong Chhnang (61.67) without changing its infrastructure or human capital, it could expect firms within its border to increase their employment by 12.7% on average. Indeed, such an improvement would be a much easier short-term goal to accomplish than Banteay Meanchey raising its provincial literacy rate from 62% to the Kampong Chhnang level of 88%, which would yield a predicted 9.36% increase in labor growth per firm. Figure 4 demonstrates the results of the interaction between governance and literacy on net firm hires, controlling for other firm and provincial-level factors. Additional hiring in firms is strongly related to improvements in literacy in both high and low governed provinces. Indeed, the slopes of the two lines are roughly the same indicating that a 10 point improvement in literacy would have about the same 5% increase in labor growth in both types of provinces. But if we take literacy as given, we can see that at each literacy level, firms in well-governed provinces hired more workers on average than those in lower performing regions, controlling for other factors. At the 60% literacy rate, for example, a province with a low PBES score would have experienced a 50% increase in employment on average, whereas a well-governed province about a 62% increase in employment.

Figure 4: PBES and Literacy Rates on Firm Labor Growth



For provincial officials wishing to prioritize their reform interventions, Table 3 demonstrates that improvements in Entry Costs, Property Rights, Transparency (specifically access to regulatory information), Participation, Informal Charges, and Crime Prevention play the largest role in explaining labor growth. Provincial officials are advised to concentrate on policies that will improve these indicators first before concentrating on the others. Increasing

¹⁹ Derived from a firm-level regression with standard errors clustered at the provincial level using three survey questions: $[Q7_7a \text{ (Number of Permanent Employees Hired 2006)} - Q7_7b \text{ (Number of Permanent Employees Fired 2006)}] / Q6a_b \text{ (Number of Permanent Employees in 2005)}$. Please see Appendix 2B for more details on regression and robustness analysis.

performance on informal charges alone will yield a potential 21% increase in firm labor for every one point improvement. Simply improving the availability of information on registration and licensing would generate a potential 8% average growth in firm level employment.

Table 3: Predicted Impact of Sub-Indices on Labor Growth 2005-2006

<i>Sub-Index</i>	<i>Impact of a 1 Point Increase in the Sub-Index on Labor Growth</i>
Entry Costs	10.25%*
Property Rights	17.44%**
Transparency	10.94%
Dimension 1: Access to Regulatory Information	8.8%***
Participation	8.0%*
Informal Charges	20.9%**
Crime Prevention	12.7%**
*** p<0.01, ** p<0.05, * p<0.1	

VI. Conclusions

This summary has endeavored to demonstrate three critical points. First, provincial governance as measured by the PBES differs drastically across the different regions of Cambodia. Secondly, all provinces no matter how high their scores have room for improvement. And finally, any governance improvements will likely generate a large impact on provincial business expansion and employment, but a few key areas will yield enormous returns.

Appendix 1: Sub-Indices of the PBES

Appendix 1: Detailed Descriptions of Sub-Indices and Components Indicators	
<p>1 Entry Costs</p> <ul style="list-style-type: none"> % of firms registered with the Ministry of Commerce or Municipal Commerce Division Total number of registrations, licenses and permits a firm needs to operate Official fee for One-Year Operating License Waiting period for Registration Certificate from Municipal Commerce Division Official fee for Registration Certificate from Municipal Commerce Division Waiting period for One-Year Operating License Official fee for One-Year Operating License Waiting period for Patent Tax from Local Tax Authority** Official Patent Tax Fee from Local Tax Authority** 	<p>6 Informal Charges</p> <ul style="list-style-type: none"> Giving gifts to public officials is sometimes required to pass customs, obtain licenses, receive public services, or meet tax requirements % of firms that paid informal charges in application for Patent Tax Firm's assessment of corruption in province Information regarding available public procurement contracts is transparent Importance of government connections for winning public procurement contracts % of firms who believe firms in their industry often pay commissions when doing business with government % of firms that believe government agencies assess additional fees based on what their counterparts are able to acquire Firms usually know how much additional payment is required in their industry Regularity that services are delivered as expected when a firm pays the required additional payment
<p>2 Land Access and Property Rights</p> <ul style="list-style-type: none"> % of firms with land documentation % of firms with Solid title to land % of firms who feel expropriation is a risk % of firms renting land from government % of firms who deem rental changes a risk Effective land prices (adjusted for differences in supply and demand)** Rental Revenue per Firm* 	<p>7 Crime</p> <ul style="list-style-type: none"> % of firms that experienced losses due to theft, robbery, vandalism, or arson in last year Monetary Value of firm's losses caused by crime % of firms who believe firms in their sector make protection payments to the police % of firms that know firms who have made protection payments in the past
<p>3 Transparency</p> <ul style="list-style-type: none"> Transparency of - and access to - local planning and decrees/decisions Firm's access to provincial budget % of time that a relationship with a provincial official is necessary for receiving access to land or property documents Favoritism toward firms with political connections is an obstacle to business. Regularity that representatives from the provincial governor's office meet with firms to discuss changes in laws or policies Degree that firms are informed about new economic and finance regulations that affect their business Regularity that a firm receives advance notice about new or changing central government laws Request to Department of Commerce** Request to Departments of Industry Mine, and Energy** 	<p>8 Proactivity</p> <ul style="list-style-type: none"> Provincial government officials' attitude toward private business Attitude of the provincial government toward private business is improving Provincial government interprets law in favor of local firm if certain government regulations are unclear Provincial departments of line ministries tend to interpret in firms favor when central regulation lacks clarity Provincial government is good at working within central laws to create a profitable business environment Provincial government is creative and clever about solving new business problems. Provincial government willingly risks punishment from the central government to pass decisions to aid local businesses There are no initiatives at the provincial level
<p>4 Participation</p> <ul style="list-style-type: none"> Provincial government solicits advice from affected firms on new laws, rules, regulations or decrees 	<p>9 Tax Burden</p> <ul style="list-style-type: none"> % of Firms that believe bribes to public officials to avoid taxes and regulations are a significant business obstacle % of firms that pay taxes Rate that a firm makes extra payments to expedite tax process % of firms that believe negotiating with tax authority is part of business Tax rates as obstacle (mean)



<p>There are business associations or clubs in the province</p> <p>Firm membership in any business associations or clubs in the province</p> <p>Number of business associations per 10,000 firms in province**</p>	<p># Legal Institutions</p> <p>% of firms who are confident that the legal system will uphold contracts and property rights in disputes</p> <p>Firms ability to go to another official to successfully dispute unjust charges</p> <p>% of monthly total sales in 2005 that were not paid within the agreed time</p> <p>% of monthly sales never repaid in 2005?</p> <p>Firm satisfaction with government dispute resolution</p> <p>Firm's success at recovering money owed to it</p> <p>% of firms in province that believe there is a fair process to dispute changes in rent contracts</p>
<p>5 Time Costs</p> <p>% of management time spent dealing with requirements imposed by government regulations</p> <p>Total number of inspections per year</p> <p>Time it took a firm to receive their land title</p>	
<p>Notes: *Denotes component uses both hard and soft data; **Denotes component uses only hard data; All other indicators are derived from perceptions data; #Derived from factor analysis; In all sub-Indices each primary component is given equal weight (i.e. Entry Costs has four primary components each worth 25%).</p>	



Appendix 2

Program Description - Mekong Private Sector Development Facility

IFC-MPDF is a multi-donor funded initiative set up by the International Finance Corporation in Vietnam, Cambodia, and Lao PDR, to reduce poverty through sustainable private sector development. Our goal is to help small and medium-sized enterprises to solve common operational and management problems and compete more successfully in the global economy. We work through six interrelated programs that seek to improve the business environment; develop the financial sector; improve managerial capacity; and increase sustainable business practices in three sectors that are central to economic growth and poverty reduction – tourism, agribusiness, and garments.

Business Enabling Environment Program

Our BEE program works at the macro level to advocate for a better business environment. As worldwide research shows, the quality and implementation of business related laws and regulations are critical factors in private sector success. BEE program activities, which are planned and often carried out in collaboration with government and business associations include: research to identify private sector problems and practical solutions; wide dissemination of research findings through meetings, the mass media and IFC-MPDF's own *Private Sector Discussion Papers* and *Business Issues Bulletins*; technical assistance to governments to aid in developing and implementing best practice business laws; facilitating dialogue between the private sector, government and other stakeholders; addressing gender issues in business; and promoting corporate citizenship. The BEE program also facilitates donor coordination by identifying gaps and overlaps in private sector assistance, and maintaining a database of donor programs on IFC-MPDF's website.

Financial Markets Development Program

Our FMD team works with the financial sector to strengthen financial institutions, deepen financial intermediation and increase access to finance. Research shows that the development of the financial sector reduces income inequality by disproportionately boosting incomes of the poor. In Vietnam and Cambodia, the FMD program continues to support the bank training institutes that IFC-MPDF helped establish. Most recently, the program has been advising the State Bank of Vietnam on how to develop a private credit bureau that will enable banks to improve credit decision-making and reduce reliance on collateral. FMD is also encouraging Vietnamese banks to consider environmental and social risks and opportunities, and improve corporate governance. In Cambodia, the Facility helps banks and microfinance institutions to improve their operations and attract longer term financing from international finance institutions. Assistance from IFC-MPDF and other donors has helped Cambodia's commercial microfinance sector to



become exemplary, and the FMD program is supporting the new Cambodia Microfinance Association.

***Business Edge* Management Training Program**

Based on feedback from business owners, who rated development of managerial skills as their second highest need after financing, our *Business Edge* program has developed a suite of affordable, locally tailored management training resources to improve individual and company performance. These include 1-2 day seminars, workbooks for self-study, a rigorous competency-based ‘Train the Trainer’ certification process, and *Business Edge TV*, a weekly business information program in Cambodia. To ensure sustainability, *Business Edge* collaborates closely with local partners. Workbooks are printed and sold by local publishers, and seminars are delivered by local training companies. To meet growing demand for qualifications, the BE program is piloting an initiative in Vietnam that enables middle managers to earn an internationally-recognized certificate of applied business skills. Based on success in the Mekong Region, IFC-MPDF is helping other IFC Facilities in Asia and Africa to adapt *Business Edge* resources for their own needs.

Tourism Sector Program

Our Tourism Sector program focuses on small and medium-sized accommodation providers. We target tourism because it is of great importance to economies in the Mekong region, and has strong potential to grow. But unless tourism assets are developed and managed carefully, damage to the environment, historic sites and local communities could be serious and irreversible. The current Tourism program is built on IFC-MPDF’s pioneering web portals that have enabled some 400 hotels and guest houses in 20 cities to market over the Internet. Support for these web portals and booking offices will continue, and the program will roll out two new initiatives—a traveler feedback system to improve customer service, and a rating system to recognize sustainable practices. Initiatives include an industry conference and workshops, and destination-specific technical assistance in areas such as saving energy and eco-tourism. In partnership with hotel associations and other national actors, we will also advise on destination marketing.

Garment and Handicraft Sector Program

Our Garment and Handicraft Sector program builds managerial capacity in four key areas: production management, marketing and merchandising, human resources management and sustainability (good labor, environmental and social practices). We target the garment sector because it is the top export industry in Cambodia and ranks second in Vietnam. The program focuses on middle managers and supervisors because they are an important link between management and labor, and they are in a position to effect change both within the factory and in the industry as a whole. In Vietnam, our partner is the International Garment Training Center, which we helped establish with a consortium of



local manufacturers. In Cambodia, we are collaborating with the multinational clothing retailer Gap Inc. and currently training hundreds of factory supervisors in human relations skills. We also advise Craftnetwork-Cambodia, a new initiative set up to help local handicraft producers improve production, connect with international buyers and meet buyers' requirements for quality and timely delivery.

Agri-sector Program

Our Agri-sector program is improving supply chains and sustainable practices, initially with companies manufacturing wood, bamboo and rattan furniture. We target the agri-sector because of its importance in all three countries in creating jobs and improving rural incomes. In Vietnam, in partnership with the Asian Development Bank and others, we are developing a supply chain linking hundreds of subsistence farmers with a company manufacturing bamboo flooring for IKEA. This is helping farmers increase yields in an environmentally-friendly way. Similar linkages with bamboo harvesters are also being investigated in Lao PDR and Cambodia. In Vietnam, we have initiated work with clusters of companies manufacturing wooden furniture.

IFC-MPDF Donors: Asian Development Bank, Australia, Canada, Finland, IFC, Japan, New Zealand, the Netherlands, Norway, Sweden, Switzerland and the United Kingdom.