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Country Economic Report 2006:2

Employment and Growth in Cambodia

– An Integrated Economic Analysis

Foreword

This country economic report the explores the opportunities and binding constraints for enhancing employment and labour productivity in Cambodia against the backdrop of the country's rapidly growing human resource base. Starting from the assumption that improved employment and income opportunities for the poor provide the main avenue for reducing material poverty, the study applies an integrated approach to economic analysis by linking employment analysis with analyses of the business environment and of the macro-economic situation. A main conclusion drawn in the study is that high priority must be given to an intensification of agriculture in order to permit this sector to resume the role as a main contributor to employment and income generation, at least in the short to medium term. The present trend of agricultural stagnation is not only a cause of widening income and asset inequality and an immediate obstacle to poverty reduction, but is also a main constraint to a sustainable and broad-based development of the non-farm sectors of the economy. Corruption presents another acute constraint to pro-poor growth, while the lack of a skilled and well-educated labour force and the poorly developed financial sectors seem likely to emerge as increasingly important constraints. The present study is part of an on-going methodological work within Sida (a cooperation between the Department for Infrastructure and Economic Cooperation and the Department for Policy and Methodology) aimed at achieving a sharper poverty focus in economic analysis.

The study is part of a series of country studies, undertaken by Sida itself and by various Swedish universities and research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. It is also hoped that they will have a broader academic interest and that the collaboration will serve to strengthen the Swedish academic resource base in the field of development economics.

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1. Challenges for Poverty Reduction in Cambodia

The past decade has been the most fortunate in Cambodia's modern history. Not only has peace and security been re-installed but there has been economic development and reductions in poverty rates. However, when seen from different perspectives the achievement is somewhat less impressive. From a regional perspective the growth rates have been modest. The Cambodian economy has grown at a slower rate than its main neighbours over the past 15 years implying that rather than catching up, the country is falling further behind. The rate of growth has also been considerably lower than that of other countries in the region during similar phases of development. Moreover, the economic gains can probably to a large extent be explained by a peace dividend and more recently by a favourable demographic development leading to an improved dependency ratio, rather than to any well-conceived development strategy. Hence, the achievements of the recent past offer no guarantees of future successes. Cambodia faces several major challenges, which need to be addressed.

1.1 The Rapidly Growing Human Resource Base

Cambodia has one of the fastest growing and youngest populations in the world.[1] The population has increased from an estimated 6.5 million in 1980, to 10.7 million people in 1993 to 13.1 million in 2004 and is expected to reach 15 million by 2010 (Table 1.1). The relative peace and security that was reinstalled after the fall of the Khmer Rouge resulted in dramatically increased fertility and birth rates in the 1980s. Fertility rates peaked at over 6 in the 1980s, but have fallen rapidly in the past ten years to 4.0 in 1998, to 3.3 in 2004. The decline in birth rates is taking place with a considerable time lag and is much more modest as the large population cohorts of girls born in the 1980's enter the child bearing ages. Put differently, the youthfulness of the population implies continued high rates of population increase also in the coming decade. This development is further underscored by an increased life expectancy resulting from falling infant and child mortality.

[1] Socio-economic survey 2004 (2005a:2).

Table 1.1 Population development.

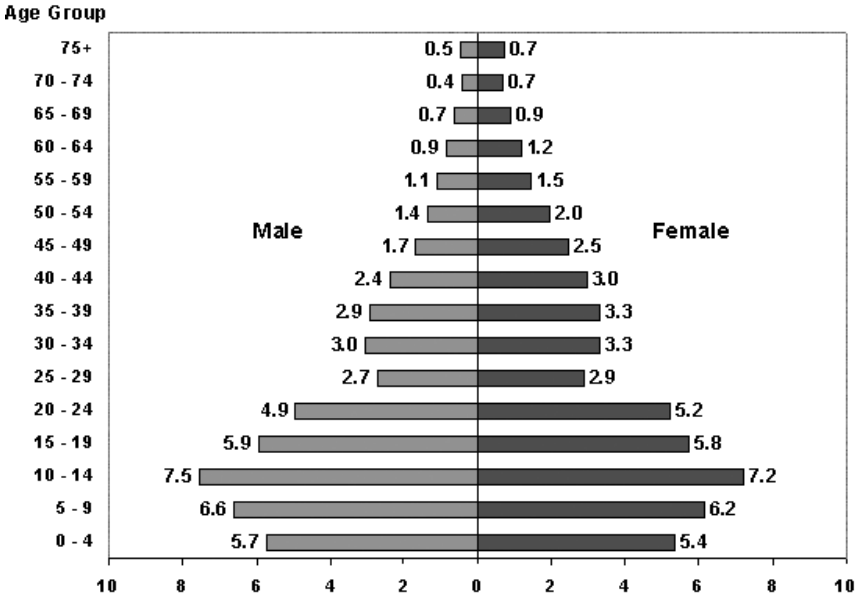
Year	Total (1,000)
1993	10,660
1998	11,438
2004	13,091
2006	*13,996*
2010	*15,034*

Sources: Census 1998, Inter-censal Population Survey 2004 (2004:table 1); Socio-economic Survey 2004 (2005a:20).

Remark: Population projections have gradually been revised downwards over time, suggesting that the fertility is declining and birth rates are falling considerably faster than anticipated, in particular as death rates have fallen substantially as well. The estimate for 2006 and 2010 are based on the lower estimate in Socio-economic Survey 2004a). Fertility has declined from over 6 in the early 1980s to 4.0 in 1998 to 3.3 in 2003 (Socio-economic Survey 2004 [2005a:2]).

As a result of its turbulent past – the extreme human suffering and human losses during the Khmer Rouge period followed by a very pronounced baby boom – Cambodia has a skewed and exceptionally broad-based population pyramid (Figure 1).

Figure 1. Population Pyramid, Cambodia, 2004



Source: http://www.nis.gov.kh/SURVEYS/cips2004/p_pyramid.htm

The high and increasing proportion of children in the population in the 1980's and early 1990's implied a rapidly worsening dependency ratio. In other words, each income earner had to support an increasing number of independents. This had a generally depressing effect on per capita incomes during this period and made mitigation of income poverty very difficult.

As the large population cohorts born in the 1980's began to enter the working age in the mid 1990's the demographic development challenge

has changed dramatically. As very large numbers of young people began entering the labour force resulting in an extremely high rate of growth of the labour force, the economy came under enormous pressure to generate productive employment opportunities for the large numbers of new entrants into the labour force. Projections based on data from the socio-economic survey of 2004 and using the age-specific participation rates of 2004 as a basis suggest that the labour force increased by 221,000 people, or 3.6 per cent, per year between 1998 and 2004, and that it will continue to increase at the same absolute pace between 2004 and 2010 (Table 1.2).[2]

Table 1.2 Development of Population and Labour Force (LF) 1998–2010.

Age	*Pop 98*	*LF 98*	Pop 2004	Labour force	Participation rate%	*Pop 2010*	*LF 2010*
0–4	*1926,4*	*0,0*	1531,4	0,0	0,0	*1798,8*	*0,0*
5–9	*1821,2*	*0,0*	1779,5	0,0	0,0	*1507,8*	*0,0*
10–14	*1703,5*	*819,4*	1817,9	874,4	48,1	*1651,7*	*794,5*
15–19	*1381,0*	*1005,4*	1705,3	1241,5	72,8	*1848,7*	*1345,9*
20–24	*766,0*	*640,4*	1443,3	1206,6	83,6	*1697,9*	*1419,4*
25–29	*912,8*	*794,1*	815,3	709,3	87,0	*1488,6*	*1295,1*
30–34	*804,1*	*710,8*	851,8	753,0	88,4	*911,8*	*806,0*
35–39	*714,9*	*637,0*	801,6	714,2	89,1	*779,8*	*694,8*
40–44	*510,6*	*452,9*	710,3	630,0	88,7	*810,0*	*718,5*
45–49	*427,3*	*375,2*	519,9	456,5	87,8	*700,7*	*615,2*
50–54	*321,0*	*268,0*	416,5	347,8	83,5	*535,1*	*446,8*
55–59	*263,9*	*204,0*	313,4	242,3	77,3	*401,9*	*310,7*
60–64	*210,6*	*140,5*	244,7	163,2	66,7	*305,1*	*203,5*
65–	*406,2*	*175,5*	488,3	210,9	43,2	*596,3*	*257,6*
All ages	*12169,5*	*6223,1*	13439,2	7549,7		*15034,2*	*8907,9*

Sources: Socio-economic survey 2004 (2005a) (2005b).

Remark: Backward and forward projections of labour force based on age specific participation rates as of 2004, Population projections based on Socio-economic survey 2004 (2004a).

Cambodia's main riches are its human resources. Hence, the rapidly expanding human resource base, through the increase of economically active age groups, combined with a steady improvement in the dependency ratio, which implies that each economically active person has fewer mouths to feed, should be perceived as an important development potential for Cambodia. At the same time, the country faces several challenges: (i) to equip the human resources with education, health care and other qualitative attributes that enhances their productive capacity, employability and ability to lift themselves out of poverty, (ii) to create an economic, political and social environment that enables the economy to generate productive employment opportunities for the rapidly increasing labour force, and to (iii) as far as possible ensure equal access to produc-

[2] Implying a slightly lower but still very high rate of growth, i.e. 3.0 per cent per year

tive employment for all to make the poor full and equal contributors to the development and beneficiaries of the fruits of development.

The economic analysis that follows has these challenges in the focus.

1.2 A Late Starter in a Dynamic and Competitive Region

In terms of economic, political and economic development Cambodia is a late starter and a laggard in perhaps the most dynamic and rapidly integrating region in the world. It is bordered by Thailand and Vietnam, both of which are economically very dynamic and in the case of Thailand also a very much more economically developed. Cambodia is a small and open, but still very much underdeveloped, economy in the process of rapid regional integration resulting from membership in ASEAN and WTO. This presents a challenge with both opportunities and threats and puts a very strong emphasis on the need for competitiveness. It offers unique possibilities of benefiting from the dynamism of the neighbouring countries in terms of markets for export and import of technology, capital and foreign direct investment. But it also implies that virtually all spheres of the Cambodian economy are exposed to fierce international competition from the outset. It does not have the option of protecting the different sectors of the economy, be it agriculture or manufacturing, from outside competition in their early stages of development until they are strong and developed enough to compete.

The dollarisation of the Cambodian economy further underscores this challenge, as it virtually precludes the use of exchange rate policies in particular, but also arguably monetary policies more generally, as an instrument for enhancing the competitiveness of the domestic economy or protecting it against external competition. Competitiveness is therefore crucial for making full use of the potential for development and poverty reduction offered by the rapidly growing human resource base.

1.3 The Purpose of the Study

The rapidly growing human resource base together with the need for sustained reduction of income poverty in the context of a highly competitive external environment, underscores the need for a focus on both employment and productivity. The present study applies an integrated economic approach to the analysis of poverty, economic growth and the distributional aspects of growth. Starting from the assumption that improved employment and income opportunities for the poor provide the main avenue for reducing material poverty, it links analysis of employment with analyses of the climate for business (investments and entrepreneurship) and of the macroeconomic situation. Due to the very limited scope for independent macroeconomic policies in Cambodia, this part of the analysis is dealt with rather fleetingly. Instead, the main thrust is put on the analysis of the business climate and on structural factors. Hence, the study is inevitably broad in scope. The aim of this integrated economic analysis approach is to find the underlying bottlenecks of poverty reducing economic growth.

2. Methodology

This study is based on the assumption that improved employment and income opportunities for the poor is the main way to reduce material poverty, i.e. that poor people gets a chance to participate fully and on an equal footing in economic activities and to derive the full benefits from this participation. It is crucial for a pro-poor analysis to consider the poor not only as consumers who should recieve a share of the country's growth, but also as workers, which makes an employment analysis necessary, and as producers, which makes a business climate analysis necessary. It is also important to analyse the macro economic environment that to a large extent determines the parameters for economic development and policies, but also mirrors strengths and weaknesses in the economy. With this view on pro-poor growth, an integrated economic analysis becomes necessary in order to find the bottlenecks for improving incomes and reducing material poverty.

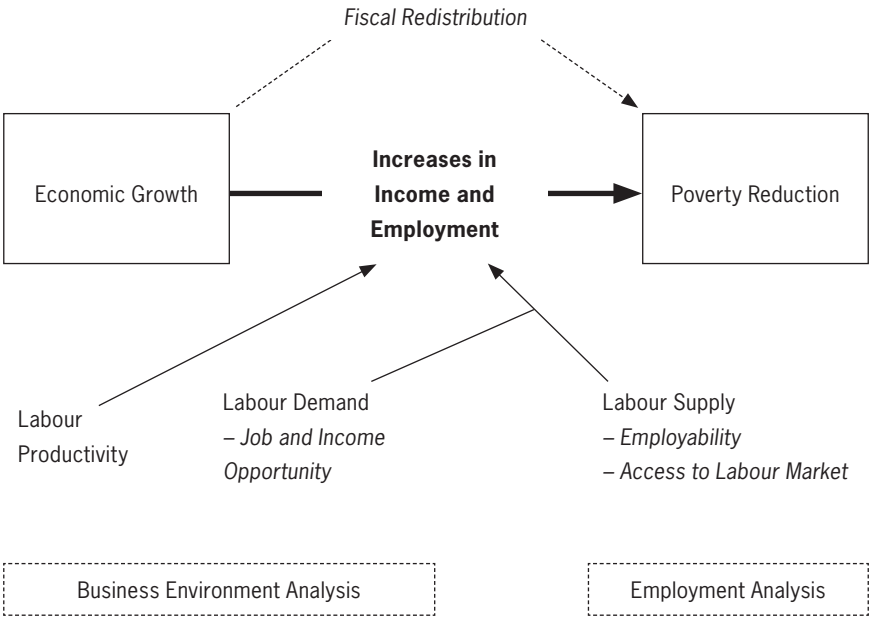
It is similarly important to have a dynamic view on employment in order to capture occupational and geographic mobility and the role of returns to labour and wages as instruments for guiding labour to where their contribution to growth will be highest. This determines the possibilities for structural changes and hence the extent to which pro-poor growth policies need to focus on specific sectors or areas, or if the most efficient link to the poor is by improving the functioning of the labour market and business environment.

Figure 2 describes how the business environment and the labour market are affecting economic growth as well as the poverty elasticity of growth through changes in employment, productivity and incomes. Employment and the remuneration derived from employment are determined by the supply and demand for labour. An employment analysis casts light on the supply side of labour and the functioning of the labour market, while a business environment analysis gives insights on the level of, potentials for and constraints to economic activities and the resulting demand for labour and, through productivity, returns to labour.

The size of the population and the age structure, which combined give the working-age population, set the outer limits for the size of the labour force. The working-age population (typically comprising the 15 – 65 age brackets, although variations exist) can be divided into the economically active – the labour force – and the economically non-active.[3]

[3] Among the many reasons for not participating in the labour force can be mentioned school attendance, disabilities or illness and household duties. The participation rate in the labour force tends to be lower for women than for men as a result of a situation where women have to bear the brunt of the burden of child-rearing and household work and thus have little time left for economic activities. Outright gender discrimination – women's lives should focus on 'kinder, kirche und küche' – can also reduce the scope for women to participate in the labour force. Another important reason for not being part of the labour force is often also sheer resignation; a perception that there simply is no work available.

Figure 2. Interaction between the business environment analysis and the employment analysis for pro-poor growth



The labour force is subdivided into two categories: the employed and the unemployed, the latter consist of those who are without work but available for work and seeking work. Under-employed is often added as a subcategory of the employed. Under-employed are those who lack sufficient work or, more commonly, are trapped in employment of such low productivity that it – despite long, hard hours – pays too little to enable them to escape poverty.

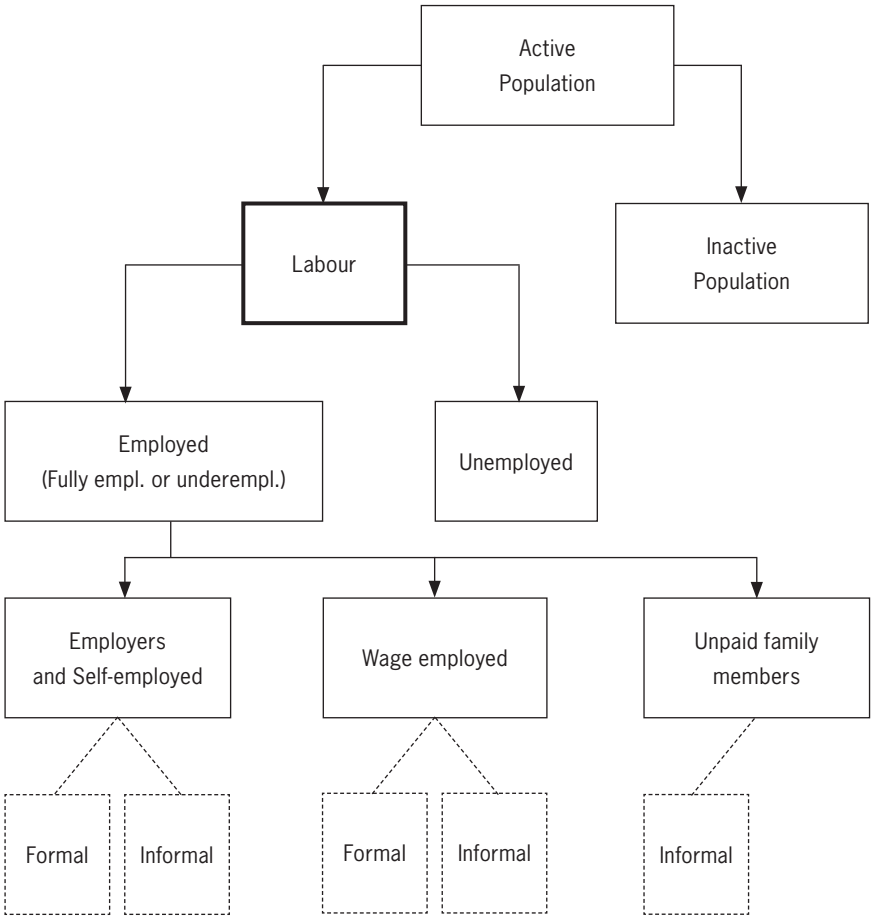
The employed can be sub-divided into three types according to their employment status: employers (self-employed and owners of firms with employees), wage employed (employees) and unpaid family helpers. It should be noted that while the income of wage employed is a result of negotiations and at times legislation, the income of employers and self-employed is essentially determined by the profitability of their own businesses.[4] The income of employers and self-employed is dependent not only on the quantity and quality of the supply of their labour but also, crucially, on their ability to market the goods and services they produce, that is their ability to create a demand for their own labour. Hence, a business environment analysis becomes essential for understanding the employment and income opportunities for this category of labour, as well as indirectly and more generally for all types of labour.

The employed can also be sub-divided into a formal and an informal labour force. The former consist of wage-workers in regular, contract-based employment and employers and self-employed in registered, formal sector enterprises. The latter consists of the rest of the labour force, who are not at all or only poorly covered by any legislative or regulative framework. The division of the labour force into with formal/informal employment is a direct reflection of the division of the economy into formal and non-formal parts, which in its turn is very much in the

[4] The only difference between the two categories is that foreign investors and domestic investors/entrepreneurs who do not derive any income from own labour is included in the latter, but not the former.

focus of a business environment analysis. Hence, a business environment analysis is indirectly an analysis of how to formalise the informal economy and hence an analysis of the possibilities for the poor to gain, usually qualitatively superior, employment in the formal economy.

Figure 3. "The Employment Tree"



Hence, the business environment in a country and the level and type of employment is closely linked. Note that the definition of business includes small and large businesses, business dealing with services, agriculture or manufacturing, and businesses in the rural as well as the urban area. An investor that wants to start a business may soon find out that the investment environment is quite hostile – it costs a lot just to start a business as well as running a business. For a large foreign investor it may be possible to negotiate a special deal offering privileges and a better investment climate and hence a possibility to escape some of the distortions in the regular formal sector. An investment following from such a deal will create some employment opportunities, but also distort domestic competition. A potential domestic investor has three options; (1) to refrain from starting any business and hence create no employment opportunities. (2) To start a business without informing the authorities in order to escape some parts of the bad investment climate, but at the expense of losing the benefits of being formal. This will create some informal employment opportunities but those employed will not be protected by formal labour or wage regulations. Or (3) you start a formal business, but are forced to

operate below its potential due to the inimical business environment and at a disadvantage vis-à-vis other competing firms (firms abroad or FDIs). This will generate some employment opportunities, but less than there could have been. Hence, a bad business environment does not only lower the level of employment, but the type of employment created will also be of lower equality – both this mechanisms mainly affect the poor.

The business environment analysis builds on the methodology developed by Hausmann, et. al. (2005) called "Growth Diagnostics". Investments and entrepreneurial activities are determined by the relation between the private returns to and costs of accumulation. The private returns are a function of the social returns (interpreted in a broad sense as the return to accumulation of physical capital, human capital, entrepreneurship, technology, etc) and the private appropriability of these returns, i.e. even if the underlying productivity is high private investors may not be able to profit from their investments due to market or government failures. The cost of accumulation is determined by the access to and price of capital.

The conclusions from the integrated economic analysis build on the principle of binding constraint also developed by Hausmann, et. al. (2005). They describe a binding constraint as the constraint that, if it is relaxed, will boost economic growth. Hence, this approach will not necessarily identify the most distortive constraint as the most important since relaxing that constraint may have little impact on growth. However, the present study focuses on poverty reduction; on achieving pro-poor growth through increased employment and income opportunities rather than on growth *per se*. As discussed below, it also reasons in terms of bundles of binding constraints rather than on identifying a single binding constraint.

The binding constraint methodology developed by Hausmann et al (2005) focuses on a business environment analysis, while taking other aspects of the economy such as the supply side of labour or the macroeconomic setting as largely given and external to the analysis. The IEA analysis for pro-poor growth takes a broader approach by integrating employment and macroeconomic analysis with the business environment analysis. This makes it possible to analyse the dynamics and interplay between these three realms for the identification of binding constraints to increasing employment and productivity.

The "Growth Diagnostics" approach efficiently captures growth constraints due to low productivity (technology, institutions, risk, etc) or low levels of input of production factors (land, labour, capital). These aspects are included in the business environment analysis. However, growth can also be a result of *structural changes* where labour is moving to a sector of higher productivity (for example from agriculture to industry, or from low productivity manufacturing to high productivity manufacturing), or from deploying previously unutilised productive resources. Such sources of growth also need to be brought into the picture, as indeed the conclusions of the present study underscore.

In its most stylised form the "Growth Diagnostics" approach sets as the objective to identify a single binding constraint. However, it is important to look at *the bundle of constraints* that can realistically be addressed within a specific period of time, such as the period covered by a PRS. Focusing on only one constraint at the time may be sub-optimal. Firstly, as there may be interlinkages between different constraints making it necessary to address several constraints jointly (which does not diminish the importance of sequencing). Secondly, over a slightly longer period of

time the optimal direction of reforms may differ from what a very short term perspective and the identification of the single, most acute, binding constraint would suggest. Thirdly, extending the analysis to include more than one binding constraint reduces the risk of missing important constraints, which is especially serious when donors harmonise around a single development strategy.

There may also be *time lags* from policy change to a changed economic environment, for example in the case of human capital formation or in addressing environmental concerns. This means that some up-coming binding constraint must be addressed today, even though they are not binding at present.

Still, given financial and capacity constraints in developing countries, as well as the difficulties in identifying all necessary reforms and their optimal sequence, the principle of the binding constraint approach is a productive approach to prioritization of public investments and reforms.

3. Development Dynamics

3.1 The Economic and Employment Dynamics

3.1.1 The 1990s

The labour force almost doubled in the course of a decade, between 1993/94 and 2004. Between 1996 and 2004, a period for which data are more comparable,[5] the labour force increased by 64 per cent, that is over 6 per cent per year, from 4.9 million to 7.5 million. The increase was matched by an economic growth of 73 per cent over the period resulting in a positive, though modest, overall increase in labour productivity by some 12 per cent (Table 3.1). This has in its turn been translated into improved incomes and reduced income poverty at the aggregate, overall level. Headcount poverty fell by some 12 percentage units between 1993/94 and 2004.[6] This is by any means quite an impressive performance.

However, a more detailed analysis over time and across sectors and population groups results in a more mixed and, during recent years, more worrisome picture. During the early 1990s growth not only failed to keep up with the pace of increase of the labour force, resulting in an overall fall in productivity of approximately 5 per cent between 1993/94 and 1996.[7] More importantly, growth was geographically concentrated to Phnom Penh and largely confined to the service sector, being spearheaded by hotels and restaurants and financial and real estate services. Sectors where this marginal employment that was created was by and large out of reach for the poor. Thus, agriculture, which provided the main source of livelihood for three quarters of the population, was forced to serve as an employment buffer, absorbing an unproportionate share of the increase in the labour force. Indeed, it would seem that agricultural labour force not only increased in absolute terms, but also in relative terms, from 75 to 78 per cent of the labour force during this period (Table 3.2).[8] The result was a sharp fall in the already dismally low levels of labour productivity and incomes in agriculture between 1993/94 and 1996.[9]

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[5] Comparisons with data from 1993/94 should be made with caution as the geographic coverage of this survey was incomplete.

[6] World Bank (2006:i),

[7] Chan et. al. (1998:4).

[8] The figures should be interpreted with caution as data from the two surveys are not entirely comparable.

[9] It has been estimated that labour productivity in agriculture over this three year period fell by some 16 per cent (Chan et. al [1998:16]). The figure is a rough estimation as data form the 1993/94 and 1996 socio-economic surveys are not entirely compatible.

Table 3.1 Production, labour and labour productivity by sectors 1996 – 1999 and 1999–2004. Index: 1996 = 100. Constant prices.

	GDP		Employment		Labour productivity	
	1999	**2004**	**1999**	**2004**	**1999**	**2004**
Agricultural sector	114.9	124.8	111.0	119.0	103.5	104.9
– Agriculture	128.6	135.1	111.2	112.6	115.6	120.0
Industrial sector	150.3	334.4	153.2	400.7	98.1	83.5
– Manufacturing	175.8	400.0	140.7	387.0	124.9	103.4
Service sector	123.8	159.8	112.7	232.6	109.8	68.7
– Trade	111.8	129.7	93.5	242.3	119.6	53.4
All sectors	124.8	173.2	113.4	154.3	110.1	112.2

Sources: National Accounts 1993–2004 (2005), Chan Sophal et al (1998:16), Socio-economic survey 1999 (1999 :32), Socio-economic survey 2004 (2005b).

Table 3.2 Employment by industry 1993/94, 1996, 1999 and 2004. Percentages.

	1993/94	**1996**	**1999**	**2004**
Agricultural sector	75.0	78.2	76.5	60.3
– Agriculture	73.7	76.1	74.6	55.5
Industrial sector	4.5	5.7	6.4	12.3
– Manufacturing	3.4	3.8	4.7	9.5
Services sector	20.5	16.9	16.8	25.5
– Trade	9.8	8.8	7.3	13.9
– Transport & com.	3.1	1.5	2.2	2.6
– Public administration	3.8	3.2	3.4	2.4
All sectors	100.0	100.0	100.0	100.0
Labour force (1,000)	3,939.8	4,858.8	5.508,0	7,495.6

Sources: Chan et.al (1998:16), Socio-economic Survey 1999 (1999:32), Socio-economic survey 2004 (2005b:14).

Despite the political and economic crisis in 1998, the 1996–1999 period, must be considered quite successful in terms of economic development, employment and income generation and reduction of income poverty. This overall positive development can by and large be ascribed to two main factors: growth in agriculture and the rapid development of a garment industry more or less from scratch. Out of a total increase of the labour force of some 649 thousand over the three year period, slightly less than two thirds were absorbed in agriculture while the rest found employment in the non-farm sectors (Table 3.3). Thanks to the nascent garment industry manufacturing generated employment for some 75 thousand people, or 11.5 per cent of the increment of the labour force, over the period, increasing its share of the labour force from 3.8 to 4.7 per cent (Table 3.2).

More importantly, a rapid growth of agriculture contributed not only to an overall high rate of economic growth but also led to a much more

broad-based growth than during the first half of the 1990s. The primary/agricultural sector[10] grew by 5 per cent per year, while agricultural production alone leaped by some 29 per cent or almost 10 per cent per year (Table 3.1). Manufacturing, i.e. primarily the garment industry, registered by far the most impressive growth (some 75 per cent over the period), but from a very low base. As a result, overall labour productivity increased by some 10 per cent, or over 3 per cent per year. The increase was broad based and included agriculture. Thus, not only employment, but also average incomes increased in both rural and urban areas.

3.1.2 A Trend Break

While overall economic growth has remained fairly high, at more than 5 per cent per year, since 1999, the pattern of growth and of employment and income creation in this more recent period presents a strikingly different pattern compared to the period up to 1999.

Table 3.3 Distribution of incremental labour force by industrial sectors 1996–1999 and 1999–2004.

	Thousands		% of total increment	
	1996–1999	**1999–2004**	**1996–1999**	**1999–2004**
Agricultural sector	416.3	306.2	64.1	15.4
– Agriculture	413.9	51.1	63.8	2.6
Industrial sector	122.4	569.5	18.9	28.7
– Manufacturing	74.9	453.2	11.5	22.8
Service sectors	104.2	985.5	16.1	49.6
– Trade	- 27.9	639.8	- 4.3	32.2
– Transport & communication	50.0	73.6	7.7	3.7
– Public administration	31.1	- 7.4	4.8	- 0.4
All sectors	649.2	1,987.6	100.0	100.0

Sources: Chan et.al (1998:16), Socio-economic Survey 1999 (1999:32), Socio-economic survey 2004 (2005b:14).

Remark: The participation rate in the labour force among the 10+ age groups increased from 66.1 per cent in 199 to 74.6 per cent in 2004, based on a one-year reference period for both years. The increase in the participation rate was highest in the 10–14 age group (from 11.1 to 48.1 per cent and the 15–19 age group (from 59.8 to 72.8 per cent and for the 65+ age group (from 26.8 to 43.2 per cent).

Manufacturing, i.e. essentially the garment industry, became a virtual growth engine and a major source of employment creation. The value added produced in manufacturing increased by some 125 per cent over the five year period (1999 – 2004), increasing its share of GDP from 14.1 per cent in 1999 to 21.7 per cent in 2004.[11] Growth in agriculture, though still positive, slowed down considerably to an average of less than two per cent per year over the period (Table 3.3). The services sectors grew by slightly over five per cent per year, that is at approximately the same rate as the economy as a whole.

[10] That is agriculture, forestry, hunting and fishing combined.

[11] National Accounts of Cambodia 1993–2004 (2005).

The economically active population increased at an unprecedented rate of over six per cent per year, from 4.9 million in 1999 to 7.5 million in 2004 (Table 3.2). This extremely rapid increase was primarily due to an increase of the population in the economically active age groups, as the large cohorts born in the 1980s reached working age, but also to a sharp increase of the participation rate of the those in the economically active age groups in the labour force; from 66.1 per cent in 1999 to 74.6 per cent in 2004. At the same time, the traditional role of agriculture as the main source of additional employment opportunities came to an abrupt end. A mere 2.6 per cent (or some 51,000 people) of the increase in the labour force was absorbed in agriculture between 1999 and 2004, as against 64 per cent between 1996 and 1999 (Table 3.3).

Thus, not only did agricultural production grow at a sluggish pace, but it generated virtually no additional employment opportunities, at a time when the labour force grew at an unprecedented high rate. The role of the garment industry as a source of employment and income generation thus became crucial. Indeed, the manufacturing sector absorbed almost a fourth of the increase in the labour force between 1999 and 2004, or some 453 thousand people. In terms of income generation and poverty reduction the role of the growing garment industry was even more important. Not only did it create employment opportunities for young females, who typically would be among the most vulnerable and weakest on the labour market, but it also provided a source of much needed additional cash income for hundred of thousands of primarily rural households, as the young women working in the garment industries sent part of their wages back home to their families as remittances. Labour productivity and incomes in the garment industry, though low by international standards, were also considerable higher than those in agriculture.

Still, the rapid expansion of employment generation in the manufacturing sector could not make up for absence of employment generation in agriculture. As a result, labour was pushed out of agriculture and the lower end of the services sector, primarily (petty) trade assumed the role of employment buffer, that traditionally had been held by agriculture. Thus, employment in trade increased by some 640 thousand, representing almost a third of the increment of the labour force, increasing the share of trade in total employment from seven to thirteen per cent between 1999 and 2004. Push rather than pull factors were responsible for the rapid growth of employment in services in general and in trade in particular. Indeed, at a mere three per cent per year, the growth of trade in economic terms was considerably lower than that of the economy as a whole. As a consequence, labour productivity in services fell by more than half over the five year period.

The growth of employment in trade and other services can only be interpreted as a distress phenomenon, as a last resort for employment and incomes when no other options are available and as a diversification strategy to mitigate the high vulnerability that dependence on rainfed agriculture while having no economic margins imply. Thus, the economy clearly failed to provide adequate employment and income opportunities to the growing labour force (in contrast to the situation in the second half of the 90s), let alone to turn the rapidly increasing human resource base into an advantage and source of development. This conclusion is forcefully underscored by the fact that employment increased sharply among age groups that normally are not found, nor should be found, in the labour force. The incidence of child labour increased dramatically. According to the socio-economic survey of 2004, by 2004 almost half (48 per cent) of the children

aged 10 – 14, or some 875,000, were working, as against 11 per cent in 1999.[12] There was a similar, though less dramatic, increase in the share of the 15–19 year old who were working – from 60 per cent in 1999 to 73 per cent in 2004, and among those over the age of 64; from 36 per cent to 43 per cent.[13] These figures should however be interpreted by some caution. A labour force survey in 2001, i.e. half way between 1999 and 2004 reported that 21.2 per cent of those aged 10–14, 67.2 per cent of the 15–19 and 52.1 per cent of those over the age of 65 were in the labour force.[14] However, even the data are interpreted with a margin of error, it seems clear that there was a sharp increase in the number of households that had to resort to the labour of children and elderly in order to make ends meet.

3.1.3 Agriculture: The Weak Heart of the Economy

At the heart of the matter was the complete and sudden failure of agriculture to generate additional employment and income opportunities. A failure that only to a limited extent can be attributed to the reduced rate of growth of agricultural production. Other factors, pertaining to the distribution of and access to land would seem to have been at play.

Despite modest improvements in the second half of the 1990s, most farm households eked out a precarious living. Lack of predictable markets for outputs and inputs, the risks of crop failure inherent in weather-dependant rainfed rice cultivation and the inability to assume calculated risks implied by not having any economic margins effectively prevented most farm households from making the cash investments necessary to intensify production and increase the returns from farming. At the same time rapid population pressure resulted in an increasing population pressure on land creating a vicious circle that made escape from poverty very difficult indeed. As a consequence, there was a process of increasing differentiation in access to land where some people were able to expand their holdings by buying up more land while others had to sell their land and as a result, became landless or near landless. A number of surveys in the mid-1990s provided a uniform picture of unequal and for many inadequate access to land.[15] It would seem that by the mid 1990s approximately a third of the rural households held less than half a hectare of agricultural land, that is clearly inadequate to make a living from farming, yet over 80 per cent of these households depended on agriculture as a main source of living. An additional 10 – 20 per cent was landless; a heterogeneous group comprising destitute people as well as comparatively well-off wage earners. No more than a quarter of the rural households held more than one hectare of land.[16]

The process of pauperisation of a large part of the agricultural population was driven by several factors. The rapid population growth with a resulting fragmentation of already small holdings as land was shared to assist young family members when they married and set up their own households, combined with a poorly implemented land distribution at the outset, was probably the most significant factor.[17] Distress sales, often brought about by illness, accidents or crop failure, and sheer land grab-

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[12] The figures refer to those working during the week preceding the survey. It does not necessarily imply that they worked full time.

[13] Socio-economic survey 2004 (2005b:5), Socio-economic survey 1999 (1999:28).

[14] Statistical Yearbook 2005 (2005:62)

[15] Ramamurthy, Sik and Ronnås (2001).

[16] Ramamurthy, Sik and Ronnås (2001:45–53).

[17] Ramamurthy, Sik and Ronnås (2001:63).

bing were other important factors. Poor education and lack of access to information was quoted as another important factor.[18]

The process of land concentration would seem to have increased quite dramatically in recent years. Recent household surveys suggest that the share of land held by the bottom 40 per cent of the households declined from 8.4 to 5.4 per cent between 1999 to 2003, while the share held by the top 10 per cent increased from 45 to 64 per cent (Table 3.4). While the exactness of these figures may be questioned, there seems to be little doubt that they reflect an increasingly rapid process of land concentration and an ensuing pauperisation of a large stratum of the rural population.[19] Indeed such a development is consistent with and corroborated by the sharp increase of distress employment in the non-farm sectors (not least trade) discussed above.

Table 3.4 Land ownership in Cambodia. Share of land owned by size groups of holdings. Percentages.

	1999	2003
Bottom 40%	8.4	5.4
Middle 20% (40–60)	11.0	8.6
Next 20% (60–80)	21.6	16.0
Top 20%	59.0	70.0
Of which: top 10%	44.6	64.4

Source: Dapice (2006).

The process of land concentration takes several forms; ranging from outright land grabbing to regular transactions, albeit often through distress sales. It would also seem that most transactions are no longer intra-village, but that land is increasingly amassed in the hands of urban elites. Land prices have also increased sharply, particularly in areas with easy road access to the major urban centres. This development has severe implications. First, the rural poor are deprived of their main productive asset, apart from labour, making escape from poverty much more difficult. Second, as the land purchases by the urban elite seem to be done primarily for speculative purposes they result in little if any investments in the land. On the contrary, the land bought is often taken out of agricultural production rather than leased out to farmers to reduce the risk that any tenant might claim right to the land in the future.

3.1.4 A Need to Reconsider the Development Strategy

At the same time the role of agriculture as a main provider of employment and livelihood is being undermined by land concentration, the role of the garment industry as an engine of growth and employment creation has been seriously put in question by the abolition of the Multi-Fiber Agreement. While the indications so far suggest that the garment industry in Cambodia may survive the sudden onslaught of fierce international competition, notably from China, there is little reason to believe that the rapid development of the industry in the past decade can continue unabated. Combined, this amounts to a worrisome picture. Concerted action is called for to reverse the negative developments in the agricul-

[18] Kato (1999b).

[19] It would seem the figures include land given in concessions as well as 'traditional' agricultural land.

tural sector at the same time as the need for a more broad-based and forceful development of the non-farm sectors of the economy has become an urgent imperative.

3.2 Dynamics of Poverty and Inequality

Poverty has decreased by a respectable 12 percentage units, from 47 to 35 per cent of the population, between 1993/94 and 2004. However, the actual achievements in terms of reducing poverty are less impressive than a first glance at the aggregate data suggests. First, poverty reduction has been highly uneven. The decline has been sharpest in Phnom Penh and in other urban areas, where the rates of poverty were the lowest to start with, resulting in rural – urban differences in poverty (Table 3.5). Indeed, by 2004 over 90 per cent of the poor lived in rural areas.

Table 3.5 Changes in headcount poverty 1994 – 2004. Percentages.

	Poverty line		Food poverty line	
	1994	**2004**	**1994**	**2004**
Phnom Penh	11	5	6	3
Other urban areas	37	21	20	13
Rural areas	43	34	22	17

Source: World Bank (2006:21).

Remark: Figures refer to only to areas covered by both surveys.

Table 3.6 Trends in income inequality by areas. Gini coefficient.

	Rural	Other urban	Phnom Penh	All areas
1993/94	0.27	0.44	0.39	0.35
2004	0.33	0.44	0.37	0.40

Source: World Bank (2006:27).

Remark: The figures refer to the parts of Cambodia covered by both surveys. Data for the whole of the country are not available for 1993/94. By 2004 the Gini coefficient of income for the whole of Cambodia was 0.42

Second, income inequality has increased quite sharply (Table 3.6). By 2004, the Gini coefficient had reached 0.42, making Cambodia one of the most unequal countries in the region.[20] In other words, growth has not been particularly pro-poor, and the high and increased economic inequality will make it increasingly difficult to achieve pro-poor growth in the future. The increase in income inequality was to a certain degree due to the widening rural – urban gap. However, the sharpest increase in inequality was within the rural areas. Indeed, 86 per cent of the total increase in inequality was attributable to increased inequality within the rural region.[21] It can be expected that this increased inequality took two forms: (i) Increased inter-village differences as some villages benefited from investments in physical infrastructure, such as roads, and from improved market access, while others did not, and (ii) increased intra-village differences in incomes resulting from increasingly unequal access to land.

[20] The Gini coefficient is a measurement of inequality, where 0 denotes perfect equality and 1 absolute inequality.

[21] World Bank (2006:25).

Third, the demographic composition of the household and the dependency ratio, i.e. the relation between the number of economically active and number of dependents, has a strong bearing on poverty. With an improved, lower, dependency ratio the exposure to poverty falls. This relationship is very strong. The 20 per cent poorest households in Cambodia had a dependency ratio of 0.97 in 2004, as against only 0.54 among the richest 20 per cent of the households (Table 3.7). Sharply falling fertility rates combined with the entry of the large population cohorts born in the 1980s' into the labour force is resulting in a quite rapid improvement (fall) in the dependency ratio since the mid-1990s. This factor, by itself explains a large, if not the main, part of the reduction of poverty in the past decade.

Fourth, the average figures for the period as a whole are likely to mask substantial differences in the performance during different periods. The sharp differences in the performance in terms of generating employment and increasing labour productivity prior to and after 1999, discussed in Chapter Four, suggest that growth has become considerably less pro-poor since 1999 that is, the efficiency by which growth has reduced poverty has gone down, at the same time as it seems probable (although data are inadequate to confirm this) that worsening of the income distribution moved into a higher gear. During the past years, the industrial and occupational diversification of the labour force, i.e. the move from agriculture to other sectors, has clearly increasingly been the result of push rather than pull factors.[22]

Table 3.7 Key factors related to rural income distribution. Percentages.

	Income group, Quintiles				
	Poorest 20%	**20–40%**	**40–60%**	**60–80%**	**Richest 20%**
Owned agricultural land secured by title,%	15.6	21.6	24.5	25.3	28.6
Distance to all-weather road, km	5.2	3.7	3.3	3.1	1.9
Distance to permanent market, km	10–8	9.6	8.1	7.1	4.2
Dry season irrigation,%	6	10	12	13	12
Dependency ratio	96.5	84.5	76.6	64.9	54.3
Education, avg. years of school of hh	2.8	3.5	3.9	4.6	6.3

Source: World Bank (2006:vi).

Apart from access to land and the demographic composition of the household, a number of other factors are also clearly related to rural poverty (Table 3.7). Secure ownership of land, roads and access to markets and irrigation are all associated with higher household incomes and thus lower rates of poverty. Similarly, education is associated with higher incomes and reduced exposure to poverty. These are all areas where public interventions and policies can play a major role.

[22] As evidenced by the sharp increase in employment in trade at the price of rapidly falling labour productivity.

4. Employment and Labour Market Analysis

4.1 The Supply Side

Between 2004 and 2010 the labour force can be estimated to increase at an annual rate over 3 per cent by about 1.4 million people, or by some 230 – 240 thousand people per year. This is at approximately the same pace in absolute numbers as during the previous six year period.[23] In order to generate sufficient employment opportunities at adequate and increasing levels of productivity, economic growth will need to be sustained at a high rate, sectorally and geographically broad based, labour intensive and pro-poor in the sense that it opens up employment opportunities that are accessible to the poor and those at risk of falling into poverty. At the same time, and as importantly, labour productivity needs to increase considerably, in particular in agriculture.

As a result of the demographic structure, the labour force is very young (Table 4.1). By 2004 more than half, 53 per cent, of the labour force was below the age of 30, a share that can be expected to remain more or less the same by 2010.

Table 4.1 Labour force by age groups in 2004.

Age group	No (1,000)	Per cent	Males	Females
10–14	874.6	11.6	12.0	11.3
15–19	1,241.2	16.4	16.5	16.2
20–24	1,206.6	16.0	16.2	15.5
24–29	709.0	9.4	9.6	9.1
30–39	1,467.9	19.4	19.7	19.1
40–	2,058.3	27.2	28.1	28.8
All ages	7,557.6	100.0	100.0	100.0

Source: Socio-economic survey 2004 (2004b:5); Statistical Yearbook 2005 (2005:99).

Remark: Figures refer to economically active during week prior to survey.

Participation rates in the labour force are high. Among those aged 10 years or more, some 75 per cent were economically active in 2004 (Table

[23] Excluding child labour in the 10–14 age group.

4.2). As might be expected, the participation rates were higher in rural than in urban areas, reflecting high rates of labour force participation in farm households. Participation rates are somewhat lower for women than for men in both rural and urban areas, but at 71 per cent, it must still be considered high.

At less than one per cent, open unemployment is very low. However, in a situation where there are no unemployment benefits and little other social protection, unemployment is simply no option to the vast majority of the population, who have to earn a living by working to subsist.

Table 4.2 Labour force participation by sex and rural/urban (12 months data).

Sex	Phnom Penh	Urban	Rural	All areas
Both sexes	60.8	69.5	77.0	74.6
Male	65.1	73.1	81.4	78.9
Female	56.7	66.0	73.0	70.7

Source: Socio-economic survey 2004 (2005b:4)

Remark: Based on population aged 10 years and above, 12 months data. Total population in the economically active age groups was 10,128,000, of which 7,557,600 or 74.6 per cent were in the labour force.

Of total population in labour force 99.2 per cent were employed and 0.9 per cent unemployed.

Underemployment can take two forms; (i) working less hours than one would want or (ii) working long hours at such low levels of productivity that the incomes earned from work, whether in cash or kind, do not suffice to escape from poverty. In practice, the distinction between these categories is often blurred, as those who have access to too little work at adequate levels of productivity and income often are forced to complement this work with additional work at very low levels of productivity elsewhere in order to make ends meet. Rainfed agriculture is often a case in point, as it provides spells of intensive work at high productivity during the peak agricultural season, followed by long periods of little need for labour during which poor farmers often have to resort to other sources of employment, such as petty trade, at typically very low levels of income.

Table 4.3 Distribution of the employed population by average number of hours worked per week.

Hours	Both sexes	Men	Females	% of category available for additional work
1–14	5.5	5.2	5.8	17.5
15–29	16.0	15.6	16.2	23.5
30–44	20.3	18.1	22.5	33.2
45–49	15.2	15.7	14.8	29.6
50–54	7.9	7.3	8.5	37.7
55–59	24.9	27.4	22.5	32.3
60<	10.2	10.7	9.8	25.7

Source: Statistical Yearbook 2005 (2005:89).

As can be seen from Table 4.3 most Cambodians, both women and men, work long hours. According to the 2001 labour force survey, close to 60 per cent of the labour force worked 45 hours or more per week. A quarter of the labour force worked more than 59 hours, while slightly more than a fifth worked no more than 29 hours per week. Low productivity, rather than absolute shortage of work would seem to be main cause of inadequate income from work and the main form of underemployment. This is further underscored by the fact that not only those working few hours, but also those working full time and more expressed a wish to take on additional work (Table 4.3). The fact that about a third of those working 50 hours or more per week wished to take on additional work is a clear indication of extremely low level of labour productivity and earnings per hour worked. This further underscores that it is imperative that a focus on creating sufficient employment opportunities for the rapidly expanding labour force must be combined with an equal focus on raising labour productivity and earnings.

Table 4.4 Earnings by location and work status, 2001.

1,000 Riels /month	Employers and own account workers				Employees			
	All areas	Phnom Penh	Other urban	Rural	All areas	Phnom Penh	Other urban	Rural
>50	22.7	5.8	15.7	24.7	12.7	10.2	11.8	13.8
50–99	32.8	12.6	25.0	34.2	30.2	23.9	29.3	30.2
100–149	15.4	15.0	14.7	16.1	17.5	22.5	18.2	18.2
150–199	13.8	25.3	18.1	13.1	18.8	18.2	16.5	20.4
200–299	6.9	16.9	12.5	6.1	12.3	6.6	12.6	12.6
300–499	6.4	17.9	9.2	4.6	6.6	8.3	8.7	0.4
500<	2.0	6.5	4.8	1.2	2.0	9.3	2.9	0.7

Source: Labour Force Survey (2001).

Remark: 1 USD = 3.800 Riel

Indeed, as can be seen from Table 4.4, the incomes from long hours of work are for most Cambodians very low, although there are pronounced differences between areas and depending on the employment status. Wage workers generally earn better than own account workers[24].

By 2004 a mere 20 per cent of the labour force was employed for wages, while the remaining four fifth were self-employed in one form or another (Table 4.5). As might be expected, there were large differences between rural and urban areas. While about half of the labour force in Phnom Penh was employed for wages, a mere quarter of those living in other towns and 17 per cent of the rural labour force were wage-workers. The very high share of self-employed in the labour force is partly a result of the importance of agriculture in the economy, but also reflects a large small-scale, predominantly informal, sector in the urban areas. Furthermore, the high share of own account workers in urban areas can no doubt also be ascribed to the increasing

[24] Including self-employed, unpaid family helpers and employers.

Table 4.5: Labour force by gender, location and employment status 2004. Percentages.

	Employees	Employers	Own account workers	Unpaid family helpers	Others	Total
Cambodia						
– Both sexes	20.0	0.1	34.4	43.3	2.3	100.0
– Male	23.3	0.1	39.7	34.8	1.2	100.0
– Female	16.6	0.1	28.8	52.0	2.5	100.0
Phnom Penh						
– Both sexes	48.0	0.1	27.1	22.9	1.9	100.0
– Male	56.3	0.0	23.5	18.7	2.4	100.0
– Female	39.1	0.1	31.0	27.4	2.4	100.0
Other urban						
– Both sexes	26.3	0.2	34.5	36.5	2.6	100.0
– Male	32.6	0.3	36.3	28.8	2.1	100.0
– Female	19.5	0.0	32.6	44.7	3.1	100.0
Rural						
– Both sexes	16.7	0.1	35.0	46.0	2.3	100.0
– Male	19.1	0.1	41.7	37.1	2.0	100.0
– Female	14.3	0.1	28.2	55.0	2.4	100.0

Source: Socio-economic survey 2004 (2005b:11)

Remark: The figures refer to the employed labour force only, i.e. they exclude the unemployed.

trend of distress migration from agriculture to the informal services sector in urban areas, and to a strategy of risk mitigation at the household level, not least among farm households, through diversification of sources of income.

The high share of self-employed also implies that for four fifth of the labour force, the availability of work and the level of earnings depends on their ability make profitable use of their own productive resources, which in its turn is highly dependent on the overall business environment, in particular for small enterprises and entrepreneurs. This key aspect of the demand for labour is discussed in some detail below.

As can be seen from Table 4.5, access to wage employment is much poorer for women than for men. Almost seven percentage units more men than women are wage workers, not withstanding the fact that the garment industry predominantly employs women. The gender gap in access to wage employment is more pronounced in the urban areas than in the rural areas. Combined with the fact that self-employed are much more likely to suffer from extremely low earnings than wage workers are (Table 4.4), it is clear that women are considerably over-represented at the lower end of the labour market. This picture is further underscored by the fact that women predominate among the unpaid family helpers, who arguably make up the bottom – in terms of both income and status – of the labour market.

Table 4.6 Labour force by level of education and age groups.

Age group	None	1–5 years	6–8 years	9–11 years	Total
15–19	13.4	42.2	34.5	10.0	100.0
20–24	18.9	36.2	25.4	19.3	100.0
25–29	23.7	37.0	22.4	17.0	100.0
30–39	24.2	35.7	24.4	15.7	100.0
40–	37.3	37.4	15.0	10.3	100.0
All ages	23.7	42.4	21.8	12.1	100.0

Source: Socio-economic survey 2004 (2005b:6).

Remark: Totals refer to labour force aged 10+.

Table 4.7 Labour force by level of education and gender, 2001.

	None	1–5	6–8	9–	Total
Both sexes	18.6	49.1	21.1	11.2	100.0
Males	13.4	46.2	25.3	15.1	100.0
Females	23.4	51.8	17.4	7.4	100.0

Source: Labour force survey 2001 (2001).

Generally speaking the labour force suffers from poor levels of education, both when seen against the requirements that will follow from an increasingly developed and sophisticated economy in years to come, and when seen in a regional perspective, i.e. from the perspective of external competitiveness. By 2004 almost a quarter of the labour force had had no formal education at all and an additional 42 per cent had no more than five years of schooling, while a mere 12 per cent had nine years of formal education or more (Table 4.6). From an overall perspective, this imposes a constraint on both the sustainability and structure of future economic development. At the individual level it implies that a very large share of the labour force has very limited access to employment at the upper, more highly remunerated end, of the labour market and to wage employment more generally. The gender gap in educational level of the labour force is very pronounced (Table 4.7). Less than a quarter of the female labour force had more than five years of education in 2001, as against 40 per cent of the men.

Fortunately, this rather dismal picture is changing as a result of large investments in education in the past decade. Thus, as can be seen from Table 4.6, the educational status of the young entrants into the labour force is considerably higher than among their older peers. By 2004 some 45 per cent of the age group 15–19 in the labour force had more than five years of formal education as against 34 per cent of the labour force as a whole. Similarly, it is clear that the gender gap in education is much lower among the young. Net enrolment rates in primary education were by 2004 almost equal for boys and girls, at slightly over 80 per cent, and the rural – urban gap was also clearly diminishing.[25]

Hence, the situation is improving, albeit from a very low level, and just as investments in education in the past decade now have the poten-

[25] World Bank (2006:95).

tial of yielding returns resulting from a better education force, present and future investments in education will ensure continuously improving levels of education of the labour force in the future, though with a time lag of up to ten years. However, a caveat needs to be introduced at this point, as the rising incidence of child labour (see Chapter Three) may well exert a negative influence on school attendance.

There are some indications of labour market restrictions resulting in reduced and/or discriminatory access to the labour market. Case studies have revealed that a (rural) girl aiming to get a job at a garment factory faces an initial cost of between 50 – 75 USD in bribes and transport fares. While this may prevent young women from the very poorest households to access such employment, the cost is still modest when set against a subsequent monthly wage income of 30 – 80 USD. IMF has suggested that the minimum wage legislation (of 45 USD per month in the formal sector) and at times numerous fringe benefits are an obstacle to formal sector employment generation.[26] However, this is a conclusion that does not seem to be echoed by others.

All in all it seems safe to conclude that a quantitative mismatch between the supply and demand for labour, at both the aggregate and the sectoral level, and still poor employability in terms not least of education, rather than labour market impediments restricting access to the labour market are the main challenges that need to be addressed in order to enhance employment and income opportunities and reduce income poverty in the short as well as the more long run.

4.2 The Demand Side

A rough calculation clearly shows that the non-farm agricultural sectors will not be able to absorb the increase in the labour force in the coming years if current levels of productivity and incomes in these sectors are at least to be maintained. Both the industrial or secondary sector[27] as a whole and the manufacturing sector are expected to grow by an average of 7.5 – 8 per cent per year in the 2005–2010 period according to the new Strategic Development Plan for Cambodia (NSDP).[28] This is a very ambitious target indeed, not least considering that it will not be possible to depend on the garment industry as a main engine for growth and employment and income generation, as has been the case in the past few years. These growth targets must by any standard be considered to be on the optimistic side. Even so, and assuming an employment elasticity of one, i.e. constant labour productivity, it can be seen that the sector as a whole would under the best of circumstances only absorb some 560,000 or 40 per cent of the increase in the labour force. Of this, the manufacturing sector would at best create employment for some additional 415,000 between 2004 and 2010 that is approximately 30 per cent of the projected increase in the labour force.

The services sector is expected in the NSDP to grow by some 47 per cent over the period. However, as discussed above, in the past few years the services sector in general and trade in particular has assumed the role of an employment buffer for labour pushed out of agriculture, with sharply falling levels of productivity as a result. If previous levels of productivity are to be restored and the under-employment in this sector reduced, the ability of this sector to generate additional employment

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[26] IMF (2004a:19).

[27] Interpreted to include mining, manufacturing, construction and energy production.

[28] NSDP (2005:87)

opportunities at adequately high levels of income will be substantially lower than the forecasts for the GDP growth in the sector suggest.

The bottom line is that agriculture will have to generate substantial additional employment during the coming five years at the same time as labour productivity needs to be increased considerably in order to reduce the widespread income poverty in agriculture. Against this backdrop, the rather modest development forecasts for the agricultural sector, with a growth prognosis of less than 4 per cent per year on average 2005–2010, is worrisome. The trend of the past five years where the role of agriculture as a main generator of additional employment and income opportunities has been virtually zero needs to be broken. In particular incomes, but also employment opportunities need to be substantially increased in agriculture, at least in a five to ten year perspective, if the challenge to create sufficient jobs at increasing levels of productivity for the rapidly expanding human resource base is to be met.

The need to reduce poverty – which indeed is the core objective of the National Strategic Development Plan – and to halt and if possible reverse the secular trend over the past decade of increasing income inequality underscores the importance of a growth that is firmly based on two pillars: intensification of agriculture with a focus on small-scale farmers and a broad-based and rapid development of the non-farm sectors.

As discussed above (Chapter Three) the majority of the farm population are caught in a poverty trap, where increasing population pressure on land combined with stagnant or very slow growing levels of production and yields, at a low level of production, results in rapidly decreasing returns to labour and labour productivity and stagnant or falling farm incomes. The less fortunate are pushed downwards in a vicious circle until they reach a point where work on the farm no longer suffice to make ends meet and they have to resort to distress migration into the lowest end of the non-farm sectors and/or sell their land. Others, somewhat more fortunate manage to muddle through, but with little or no improvement in incomes and standard of living. A small minority, manage to escape from poverty by acquiring more land and/or by finding means to intensify farming, gradually moving from subsistence to market oriented farming.

Access to more productive non-farm employment, in the form of wage employment or successful non-farm entrepreneurship, can (and must) play a crucial role to break out of agricultural poverty, as the success story of the garment industry clearly shows. Not only have hundred of thousands of, primarily young women, managed to lift themselves out of poverty through employment in this sector, but large numbers of farm households have received a much needed boost in household incomes, as the garment workers remit much of their earnings to their families back home. According to the 2004 socio-economic survey about 13 per cent of the rural households received some remittances from family members working in towns and cities, although the amounts received tended to be modest.[29] However, as argued above, this source of creation of employment and income generation will, at least in the short to medium term, be inadequate to absorb the rapid increases in the labour force while at the same time increasing overall labour productivity and reducing income poverty. It needs to be complemented and supported by an intensification of agriculture, with a focus on small holdings, that is forceful enough to break the vicious circle of falling labour productivity and distress migration out of agriculture through sharply increased yields

[29] World Bank (2006:63). The average amounts received were 327,000 Riel (83 USD) per year.

and returns to land, which in its turn would translate into a higher labour absorptive capacity and increased labour productivity in farming.

The potential gains from such a development could be quite large. Agriculture remains very extensive, in terms of use and returns to land (which is the binding constraint in terms of production factors), and the scope for increasing production and returns to land is still considerable. Paddy yields averaged a mere 2.0 tonnes per hectare between 2002 and 2004, as against 4.7 tonnes in neighbouring Vietnam and in Indonesia and 6.2 tonnes in China.[30] Not only was Cambodia, because of its turbulent past, left out of the Green Revolution, but by and large agricultural development has been lack-lustre also since the restoration of peace. The agricultural sector grew at an annual rate of 3.3 per cent between 1993 and 2003, that is at a rate much below that achieved by other countries in the region during comparable periods of development (China over 6 per cent in the 1980s – 1990s, Thailand 5 per cent per years 1965–75 or Vietnam more than 4 per cent 1990–2000.)[31]

Development of irrigation, which together with market access, arguably an indispensable main pillar for intensification of agriculture in monsoon economies, remains sorely underdeveloped, as a mere 7 per cent of the agricultural land is irrigated. By contrast, the share of irrigated land in neighbouring Vietnam and Thailand stands at 45 and 31 per cent, respectively.[32]

As there are presently no economies of scale (in terms of returns to land) in agriculture in Cambodia, and the economic returns to intensification of agriculture are by and large neutral to scale, a strategy for intensification of agriculture can and should have the small holder agriculture at its focus. However, intensification of agriculture will only be pro-poor as long as the distribution of land is reasonably even. The degree to which farm households can and will benefit from such an intensification hinges crucially on their access to land. For the near landless it may often not suffice to bring them out of poverty, while for the landless it offers no direct reprieve at all. The rapidly increasing inequality in access to land in rural areas will, unless it is reverted, undermine the effectiveness by which an intensification of agriculture can increase employment and income opportunities among the rural poor.

An intensification of agriculture would also greatly enhance the prospects for a sustainable and rapid development of the non-farm sectors. At present the economy, and employment, outside Phnom Penh is very poorly diversified. Industrial sector employment and production is largely confined to Phnom Penh. Indeed, with no more than 11 per cent of the labour force in the industrial sector, and 7 per cent in manufacturing, in the other urban areas than Phnom Penh, while 46 per cent are employed in services and an additional 41 per cent agriculture, most towns are little more than market centres that have retained a strong agricultural component (Table 4.8). Industrialisation has yet to commence in earnest outside Phnom Penh. The function of most urban centres as little more than market centres with their main economic linkages to the surrounding countryside, implies that their economic development is severely constrained by the lack-lustre growth of agricultural production and incomes. An improvement of agricultural production and incomes resulting from intensification would, through increased local demand, release this growth constraint on the towns, result-

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[30] http://www.faostat.fao.org

[31] World Bank (2006:54–56).

[32] World Bank (2006:56).

ing in enhanced non-farm employment and income opportunities, which in its turn would create more attractive exit opportunities for labour from agriculture, leading to higher incomes for those remaining on the farm. A beneficial circle, based on pull rather than push factors shifting labour out of agriculture could result, as evidence from elsewhere in the region clearly has shown. In order to be sustainable and sufficiently forceful, such a development would need to be supplemented by a much more broad based – branch-wise as well as geographically – industrialisation, creating a manufacturing base in towns outside Phnom Penh, as well as stronger economic linkages between these towns and the rest of the country.

Table 4.8: Employment by industry and location. Percentages.

Industry	Cambodia	Phnom Penh	Other urban	Rural
Agricultural sector	60.3	2.6	40.5	68.0
– agriculture, forestry	55.5	2.5	34.0	63.0
– fishing	4.8	0.1	6.5	5.0
Industrial sector	12.3	19.7	10.6	11.9
– Manufacturing	9.5	15.5	6.9	9.3
Service sector	25.5	75.4	45.7	18.4
– Trade	13.9	35.8	24.5	10.5
– Hotel & restaurants	0.4	2.1	1.0	0.2
– Transport & Communication	2.6	6.6	5.3	1.9
– Public administration	2.4	12.5	4.7	1.2
All sectors	100.0	100.0	100.0	100.0

Source: Socio-economic survey 2004 (2005b:14).

At present, much of the non-farm employment in rural areas and in towns outside Phnom Penh is seasonal. Due to the highly seasonal demand for labour in rainfed agriculture, labour tends to move between the farm and non-farm activities following the agricultural seasons. The economic diversification that these seasonal movements result in is not sustainable and cannot provide a basis of a broad-based economic development. Large seasonal fluctuations in the level of production are only possible in small enterprises with little capital and, as a result, typically low labour productivity. Furthermore, it imposes a binding constraint on the growth potential of these enterprises, as growth and sustained competitiveness requires investments in capital, that must be utilised throughout the year in order to be profitable, and as enterprises cannot afford not to seek markets and meet demand on a continuous business in an increasingly competitive environment. Intensification of agriculture and, in particular, investments in irrigation greatly enhances the scope for full time employment in agriculture, with much reduced seasonal variations, thus permitting a specialisation of labour whereby the agricultural labour force increasingly have farming as a full time occupation, while those who leave for the non-farm sectors do so on a permanent basis, permitting a detachment of the operation of non-farm enterprises from the seasonal variations in demand in agriculture and thus paving the way for a development of non-farm enterprises operating on a permanent basis providing full employment throughout the year for those employed.

5. Macroeconomic Analysis

It is generally agreed that by and large Cambodia has succeeded in maintaining macroeconomic stability. Indeed, being a small open and almost entirely dollarised economy, Cambodia has little scope for pursuing independent macroeconomic policies and cannot afford any major imbalances. As mentioned, due to the very limited scope for independent macroeconomic policies in Cambodia, this part of the analysis is dealt with rather fleetingly.

Vulnerability, rather than instability is the main concern with regard to the external sector. Garments dominate exports entirely. The abolition of the multi-fiber agreement has put the future of this export in question, even though the industry so far seems to have weathered the storm well. The small export base is a reflection of the narrow base of the economy as a whole. The vulnerability that results from the export dependence on garments pertains not only to uncertainty about the ability of this industry to survive in the face of unfettered international competition, but also to the exposure to terms of trade shocks. More generally, the heavy reliance of the country's growth on foreign demand implies that any changes in this demand will have a direct and unmitigated impact on growth.

Cambodia has for many years had a high but rather stable trade deficit. Despite the importance of the tourist sector, the service balance has fluctuated between a small surplus and a small deficit. In recent years the private transfers, presumably mainly as remittances from Cambodians abroad, have increased considerably. The inflow of capital through FDI has shown a less dynamic development. The current account has for a number of years shown a deficit equal to about ten per cent of GDP. Most of this deficit has been covered by ODA, thus reducing the total deficit to manageable proportions, while at the same time highlighting the dependency on ODA for maintaining a balance in the external account.

The dollarisation of the economy implies that there are effectively two inflation rates, one for dollar denominated prices and one for riel denominated prices The ambitions to control inflation have been achieved both with regard to the overall levels of inflation, which have been no higher than in neighbouring countries, and with regard keeping the dollar – riel inflation spread small and the value of the riel stable vis-à-vis the US dollar.

The interest rates on deposits as well as on lending, in both Riel and USD, have been high. The interest rate spread has also been significant and was in 2004 12 per cent for Riel and 13 percent for USD. Both the

Table 5.1 Basic macro-economic data, 2000–2004.

	2000	2001	2002	2003	2004
GDP, current prices (millions of Riel)	14,089	14,860	15,995	17,311	19,630
Total Investments (% of GDP)	16.5	16.6	16.9	17.4	17.1
– Private	9.8	10.0	9.4	10.6	11.0
– Public	6.7	6.6	7.5	6.8	6.1
Inflation, Riel	-0.7	-0.9	0.0	1.0	3.9
Inflation, USD	-1.8	-2.5	0.1	-0.3	2.9
Interest rates					
– Deposits, Riel	7.2	8.3	7.2	7.0	6.6
– Deposits, USD	6.0	4.8	4.2	4.0	3.7
– Lending, Riel	18.9	21.3	21.0	21.1	18.7
– Lending, USD	16.7	16.5	18.2	17.3	16.7
Govt. Revenue (% of GDP)	10.1	10.3	10.9	10.2	10.8
Govt. Expenditure (% of GDP)	14.4	16.6	18.4	15.9	15.2
Overall budget balance, excl grants and loans (% of GDP)	-4.3	-6.3	-7.5	-5.7	-4.4
Exports of goods (% of GDP)	38	41	43	47	49
Imports of goods (% of GDP)	53	55	63	59	62
Current account balance, excl official transfers (% of GDP)	-11	-9	-9	-10	-12
Exchange rate (riel per US dollar)	3,859	3,924	3,921	3,980	4,025

Source: CDRI (2005) and EIC (2005a).

deposit and the lending rate in Riel have been higher than in USD due to the risk of depreciation. The spread between deposit and lending rates rather than any overall high cost of capital is the main reason behind the very high real lending rates.

Cambodia's primary fiscal balance has shown a steady improvement over the past few years and fell to 4.4 per cent of GDP in 2004. The deficit is almost entirely funded from foreign sources, mainly through project support.[33] Total domestic public revenue has remained at a constant level of 10 to 11 per cent of GDP during the 2000 – 2004 period. Public expenditure averaged 16.5 per cent of GDP over the same period. Current expenditures averaged about 10 per cent of GDP, the remainder being made up by capital expenditures. Hence, domestic public revenue has sufficed to cover current public expenditures, but little if any of the capital expenditures, which have covered by development assistance.

The total external debt amounted in 2003 to three billion USD, or 70 per cent of GDP. About two thirds of the debt is bilateral, while one third is owed to multilateral institutions, primarily the Asian Development Bank and the World Bank. A rescheduling of the bilateral debt through

[33] CDRI (2005:57).

the Paris Club is in the pipeline, but is being delayed by debt disputes with Russia and the United States. Successful Paris Club negotiations are expected to reduce the external debt to about 40 per cent of GDP. As most of the debt is on concessional terms, debt servicing imposes no major strain on either the external or the fiscal balance. With a debt rescheduling this burden would be even further reduced.

From the perspective of the present study, a review of the macro economic picture results in two main conclusions. First, vulnerability rather than acute imbalances is the main worry. Second, the scope for using macroeconomic policy instruments, such as exchange rate and monetary policies, to enhance international competitiveness and in support of economic growth is very limited indeed. Hence, the main avenue available to further these ends must be a focus on creating an enabling business environment. The problem of macroeconomic vulnerability, in its turn, can only be dealt with through a more robust and broad-based economic development, which again puts a focus on the business environment.

6. Business Environment Analysis

The business environment analysis will present several constraints for growth in Cambodia. Note that the definition of a business includes large or small businesses, businesses dealing with services, agriculture (such as farms) or manufacturing and can be rural or urban based. The importance of differentiating between the types of businesses when identifying the binding constraints depends on the development dynamics. In the conclusions in Chapter Seven the *binding* constraints are identified, given the whole integrated economic analysis (i.e. not only the business environment analysis).

The data in the business environment analysis is mainly based on the World Bank's investment climate assessment (ICA),[34] the assessment by the World Bank Forum (WEF) as presented by the Economic Institute of Cambodia[35], and a Micro, Small and Medium Enterprise (MSME) environment assessment supported by Cambodia Development Resource Institute and the Asia Foundation[36]. Information on respondents' perception of the overall business climate and important reforms are presented in Figure 5–7 and Table 6.1 below. Note that the respondents in the assessment by the WEF (Figure 5 and 7) are mainly executives of larger businesses in Phnom Penh, while the study by Kang (Figure 6) concentrates on MSMEs outside Phnom Penh, but still in urban areas. The ICA (Table 6.1) includes several types of businesses and areas, as does the Doing Business study.

6.1 Private Returns to Accumulation

6.1.1 Private Appropriability

Macro Risks

As mentioned in Chapter Five, the macro economic situation in Cambodia when looking at *monetary and exchange rate* indicators seems stable, largely due to the dollarised economy. The *fiscal balance* has also been stable even though there are some concerns about a potentially severe debt situation and aid dependency, and concerns about an unstable *trade balance* due to a non-diversified export industry.

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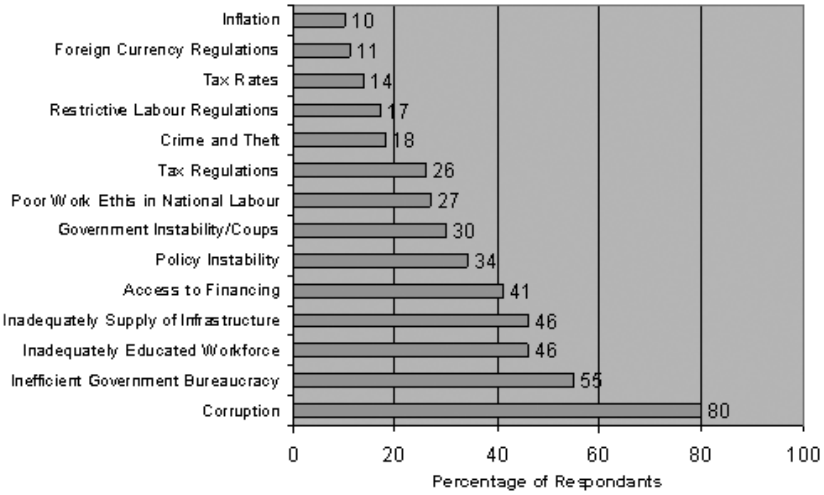
[34] World Bank (2004a).

[35] EIC (2005b)(2005c).

[36] Kang (2005).

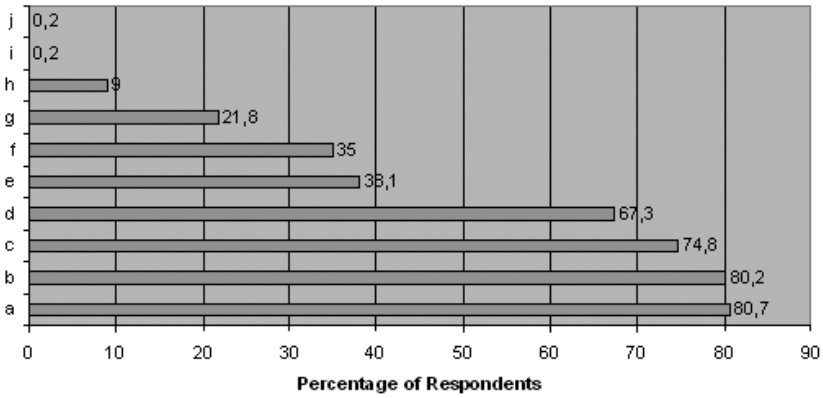
Figure 5 The most problematic factors for doing business in Cambodia.



Source: EIC (2005b)(2005c).

Remark: From a list of 14 factors, respondents where asked to select the five most problematic factors for doing business in Cambodia. Most respondents are executives of larger enterprises in Phnom Penh.

Figure 6: Why do you feel that more people do not own businesses?



Source: Kang (2005).

Remark: a. “Potential market too small”, b. “High start-up costs”, c. “Risk-averse”, d. “Do not know how to start a business”, e. “Difficulty getting licence, permits, registration”, f. “Waged employment offers greater security”, g. “Gender reasons”, h. “Cultural reasons”, i. “Low educations”, j. “High tax/many taxes”

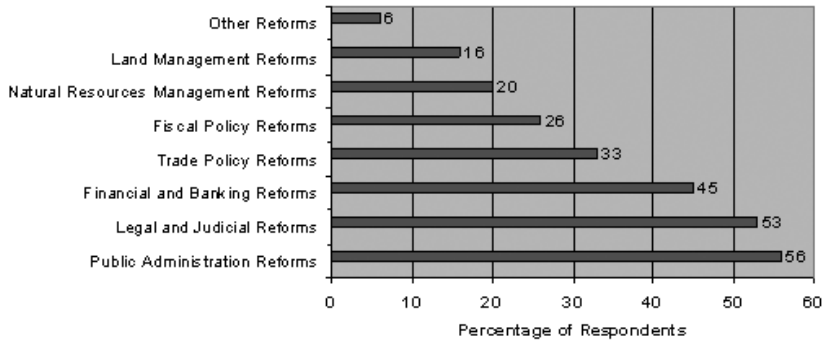
Table 6.1 Respondents' evaluation to general constraints to operation (the rank of the% of firms evaluating constraint as 'major').

	All	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Corruption	*1*	1	1	1	1	1	1	1	1	1
Crime, Theft and Disorder	*2*	2	2	3	3	2	4	2	2	2
Regulatory Policy Uncertainty	*3*	3	3	5	2	3	3	3	3	3
Anti-Competitive or Informal Practices	*4*	4	4	8	7	4	8	4	5	4
Legal System/ Conflict resolution	*5*	5	5	6	4	5	2	5	4	6
Customs and Trade Regulations	*6*	6	6	4	5	6	6	6	9	5
Tax Administration	*7*	8	9	2	6	8	5	8	7	7
Macroeconomic Instability (inflation, exchange rate)	*8*	7	7	15	12	7	13	7	6	9
Tax Rates	*9*	9	8	7	8	9	7	9	8	8
Electricity	*10*	15	10	9	10	10	10	10	10	11
Business Licensing and Operating Permits	*11*	12	11	11	11	12	11	12	11	10
Cost of Financing (e.g. interest rate)	*12*	10	12	17	13	11	16	11	13	12
Access to Financing (e.g. collateral)	*13*	11	13	13	14	13	15	13	12	14
Transportation	*14*	13	16	12	18	14	14	14	14	13
Skills and Education of Available Workers	*15*	14	14	14	15	15	12	15	15	16
Labour Regulations	*16*	17	15	10	9	17	9	16	17	15
Telecommunications	*17*	16	18	18	17	16	18	17	16	18
Access to Land	*18*	18	17	16	16	18	17	18	18	17

Source: World Bank (2004).

Out of 14 business constraint indicators, "foreign currency regulations" and "inflation" are least often mentioned as a major constraint in Cambodia (Figure 5). However, even though the macroeconomic stability picture is stable, "policy instability" is ranked as the sixth major constraint. This macro risk is also reflected in Table 6.1 where "regulatory policy uncertainty" is the third major constraint to doing business out of 18 indicators. In the case of Cambodia this probably reflects an uncertainty about up-coming reforms or policies of the

Figure 7 Critical reforms for business in Cambodia.



Source: EIC (2005b) (2005c).

Remark: From a list of eight factors, respondents were asked to select the three most critical reforms for doing business in Cambodia. Most respondents are executives of larger enterprises in Phnom Penh.

government rather than that the political situation is unstable ("government instability/coups" is the seventh most severe constraint in Figure 6).

Micro Risks

Corruption is the single most important constraint for doing business in Cambodia (see Figure 5 and Table 6.1). In the WEF assessment 80 per cent of respondents mention corruption as one of the most problematic factor. Cambodia has been identified as the third most corrupt country out of 117 and corruption is perceived to be most severe in connection to import and export permits, tax collection, awarding of public contracts and obtaining favourable judicial decisions.[37] Table 6.2 gives a convincing picture of how corruption is affecting more or less all formal activities and all types of businesses. Cambodian businesses pay bribes to a value of 5.2 per cent of sales revenues and have an average of 16 inspections per year, which is an unusually high number.[38] Another illustration of the problem with corruption is that 69 per cent of the MSMEs in urban areas gave the reason "too many fees" when asked why they could not buy inputs from other markets beside the current. Corruption has an impact on growth not only by increasing the level and unpredictability of transaction costs, but also by preventing small enterprises from growing at all. When small businesses grow to a certain level, the owner often chose to start another small business, rather than expanding the current one, in order to stay less visible. Hence, corruption is preserving a large informal sector which can hardly provide the basis for a development of a modern economy.

[37] EIC (2005c).

[38] World Bank (2004).

Table 6.2 Incidence and scale of corruption.

	All	Micro	Small	Large	Foreign-Invested	Domestic	Exporter	Non-Exporter	Low Capacity	High Capacity
Percent of revenues that are needed for informal payments	*5.2*	3.9	5.5	6.1	6.9	4.8	7.6	4.7	6.1	4.4
Percent saying gift/payment required for:										
A mainline telephone connection	*100*	100	100	100	100	100	100	100	100	100
An electrical connection	*100*	100	100	100	100	100	100	100	100	100
A construction permit	*100*	100	100	100	100	100	100	100	100	100
An import license	*91.8*	66.7	95.6	95.8	95.7	86.8	96.1	84.8	90.6	90.2
Operating license	*100*	100	100	100	100	100	100	100	100	100
Percent of revenue reported by typical establishment for tax purposes	*48.0*	39.7	53.5	60.7	61.1	45.2	60.4	45.9	45.3	50.1

Source: World Bank (2004).

One explanation for the level of corruption may be the low salaries paid to public officials. However, this is most probably only part of the problem, since the system is well rooted at the top and there seem to be a general climate of tolerance of corruption, as little efforts are made by corrupt public servants to hide the benefits they have received.

The problem of corruption is reinforced by weak *governance.* Public administration reform is ranked as the most critically needed reform for doing business in Cambodia (Figure 7). World Bank (2004) argues that "The governance findings are so acute that they overwhelm visible deficiencies such as finance, infrastructure, and human skills". One aspect of governance is the availability, or lack thereof, of realistic and well-founded government strategies that are in coherence with an overall strategy, i.e. the NSDP. This is particularly acute in the agricultural sector where the lack of development projects often is referred to as a consequence of lack of a strategy. This is partly explained by the emphasis on the social sectors (health and education) by the donor community.[39] Moreover, there are several ministries that all deal with issues related to the agricultural sector and they do not seem have a common idea on the best way to develop the sector. This lack of strategy, or lack of transparency if there exist an implicit agricultural strategy known to the government officials, is creating unequal access to information on public investments and hence on the value of agricultural land. This in turn will affect land concentration since the small land owner will not be informed about the future value of their land.

A functioning and transparent public financial system, including the public procurement system, is another aspect of governance. The public financial system has been improved substantially in Cambodia, but is still developing. There are major shortcomings in the procurement system as fair competition is lacking and the decision making process allocating public contracts is far from transparent.

[39] Beresford et.al. (2004).

Property rights and their enforcement by a stable legal system is a major concern in all of Cambodia and for all types of assets, but it is an especially severe problem when it comes to agricultural land, i.e. the main asset of the poor. As long as there remain uncertainties about land property rights there will be very limited investments in agriculture. The problem starts by lack of formal titling, which is a prerequisite for enforcement by law. At present, the major land titling conflicts are concentrated to the "new land areas", i.e. the former war zones. The principles of land distribution are far from transparent and a major part of this valuable land has been allocated to military officers.

It may seem astonishing that land reform is not identified as a critical reform for doing business in Cambodia (Figure 7). However, this is probably a reflection of the fact that many private actors are still profiting from the possibilities of land grabbing and/or cheap land, since they have better information of the future value of the land, or since they take advantage of poor people in a distress situation of extreme poverty. Note also that the respondents in the WEF assessment were mainly large enterprises in Phnom Penh. However, once this process has reached a certain level, the demand for land titling will no doubt be requested by the large land owners who will want to protect their new assets. Cambodia will then, given the present trends, have strong titles to highly concentrated land.

However, even in cases where formal land titling exists there are few cases where disputes have been resolved through the *legal system*. The capacity of the judiciary system is extremely low, illustrated by the fact that there are only 425 lawyers on a population of 13 million. This lack of lawyers creates a monopoly situation where only the cases through which the lawyers can make significant profits will be addressed. Without a stable and trusted legal system where all asset and contract disputes can be settled, there will be no investments or commercial activities at a scale needed for sustained economic development. Hence, this is a binding constraint and is mentioned as the second most critical reform for doing business in Cambodia (see Figure 7). Such a change will demand a lot of effort since the legal system is also severely affected by corruption.

Another factor that affects the private appropriability to accumulation is *taxes*. However, at present neither the tax rates (ranked 12 in Figure 5 and 9 in Table 6.1), tax regulations (ranked 9 in Figure 5) nor tax administration (ranked 7 in Table 6.1) seem to be major constraints to business expansion. However, this opinion may well reflect the ease with which taxes can be avoided or negotiated and not a satisfaction with *de jure* tax rates. Still, for the time being it is not taxes but rather the informal fees associated with tax collection that is the constraint to growth.

It is interesting to notice that *crimes, violence and thefts* were the second most often mentioned major constraint in Table 6.1 including businesses from the whole country but only ranked 10th in Figure 5 including mainly large businesses in Phnom Penh. This is probably due to higher level of public protection in Phnom Penh than in the rest of Cambodia and/or more private investment in security in large enterprises.

6.1.2 Total Factor Productivity

Total factor productivity can be increased by new technologies or organisational structures and is affected by factors such as research and development, entrepreneurial profits, etc. In the case of a developing country in the process of catching up with other more developed countries, it is

usually a matter of diffusion of technology and organisational structure rather than new innovations. Production processes in Cambodia are in general labour-intensive and often based on obsolete technology. Cambodia needs to catch up, not only compared to developed countries but also compared to neighbouring countries and competitors such as Vietnam and Thailand. The diffusion of technology is hindered by the limited number of scientists and engineers within the country, the almost non-existing scientific research institutions, limited financing for new ideas, etc, and the main channel for technological transfer is through foreign direct investments (FDI)[40]. There is clearly a need for more technical training but also for training on how to start and run a business. "Do not know how to start a business" is mentioned as the reason for why there are not more businesses by as many as 67 per cent of the respondents in the MSME survey (Figure 6).

Apart from increased human capital, there is a need for a more diversified production with increased backward and forward linkages – and less fragmented markets – for new technology to spread throughout the economy. An important factor, already mentioned, affecting the possibilities for diffusion is the one-season-based agriculture. A modern industry with dynamic technology can hardly develop in a society where new investments will be under-used during much of the year due to large seasonal variations in the supply of labour

6.1.3 Aggregate Capital Stock

The aggregated capital stock in Cambodia as a whole, but also in the local community, will affect the potential returns for the individual economic actor. One reason is the low demand due to a low level of economic activity, i.e. expansion is difficult due to *small markets*. Given an average GDP per capita of about 360 USD the domestic demand in Cambodia is very small and limits the expansion of non-export goods and services. The limited size of the potential market is identified as a main reason for why not more businesses are started in the survey of micro-, small- and medium sized enterprises (Figure 6). However, given the level of openness of the Cambodian economy and the proximity to large external markets, small markets should not be a binding constraint for Cambodia at an aggregated level and for export goods.

Another effect of a low aggregate capital stock is the presence of *fragmented markets* or coordination failures. In Cambodia this problem is aggravated by the absence of institutions that could reduce the risks and costs of formal transactions and by extensive corruption that serve to increase these costs, as well as a lack of government strategies in some sectors such as the agricultural sector. There may be a geographical fragmentation of the economy with lack of connections between local markets that prevent further commercialisation. In Cambodia this is partly due to the level and quality of infrastructure (see 6.1.5 below.) and the shortage of business development services, but also to lack of business associations and middlemen as a consequence of the limited amount of trade compared to the costs (including informal fees). Kang (2002) argues that the main factors dampening profit expectations for MSMEs in Cambodia are, apart from competition from abroad, low purchasing power (i.e. small markets) and lack of middlemen.

There may also be a vertical fragmentation of markets where inputs needed in the production are either not available at all domestically or

[40] EIC (2005b)

available only in limited quantity and quality and therefore need to be procured from outside the country. An obvious case in point is the garment industry, which has a very high import content and as a consequence a limited domestically produced value added. This type of fragmentation has severe negative implications on the country's growth since the multiplier effect from expansion in one sector becomes very weak in the rest of the economy.

6.1.4 Labour Input

Cambodia's labour input in terms of employability and access, as well as the rigidity of the labour market, has been discussed in section 4.1 on the supply of labour. The main messages are that the labour force is growing extremely fast, but that it suffers from inadequate education and skills. Moreover, the agricultural labour force, which makes up the majority, is for most part only available for non-farm employment on a seasonal basis.

The importance of the labour input was also covered in some of the business climate surveys. Neither "skills and education of the labour force" nor "labour regulations" were identified as major constraints in the survey including Cambodia as a whole (ranked as low as15th and 16th in Table 6.1). "Restrictive labour regulations" and "poor work ethics in national labour" were two labour input aspects that were ranked low in the survey mainly including larger enterprises in Phnom Penh (ranked 11th and 8th respectively in Figure 5). However, in the same survey "inadequately educated work force" was considered to be the third most severe constraint to do business. There are good grounds to expect that shortcomings in education and skills will become an increasingly important restriction to growth in Cambodia as businesses grow in size and sophistication. Hence, even if shortfalls in education and skills do not constitute a binding constraint for growth today, the issue needs to be addressed due to the time lag between action and results in the educational sector.

6.1.5 Public Infrastructure

High *transportation costs,* mainly due to the poor quality of roads, have been a major problem for commercialisation of the agricultural sector as well as industrialisation outside Phnom Penh. However, there have been major improvements in the inter-urban road network during the past years so this is no longer a binding constraint in the main cities. In the MSME study people were asked why they cannot buy inputs from other markets beside the current markets and 69 per cent said that the reason was too many fees, 28 per cent stated lack of transportation and only a few percent mentioned lack of roads.[41] Moreover, "transportation" was only ranked 14th of 18 major constraints to doing business (Table 6.1).

However, even though this constraint has been relaxed for the urban areas that are connected to the primary road network, it is still one of the binding constraints for the rural areas. Relaxing this constraint for the rural area is crucial for growth and poverty reduction. If other types of improvements in the rural business environment are not complemented by improved access to markets, the poverty reducing effect of expansion will be marginal since increased production will only lead to decreased prices on the local market.

"Electricity" was ranked high as a constraint in Table 6.1 which may explain why the aggregated indicator "inadequate *supply of infrastructure*"

[41] Kang (2005).

turns out as the forth major constraint for doing business in Figure 5. The cost of commercial electricity ranges from 12.5 to 24 US cents per kWh, which can be compared to 5.1 to 14.5 US cents per kWh in Vietnam.[42] Some 39 per cent of the enterprises have generators to produce their own electricity since this, still expensive, source of electricity is cheaper than using the public grid.[43] The possibility for Cambodia to decrease electricity costs, either by new sources of energy or by importing cheaper energy will be crucial for the international competitiveness of the industry sector as well as for the possibilities for rural industrialisation.

Another type of infrastructure that is extremely expensive and of low quality in Cambodia is telephone and internet communications. This is mainly due to oligopoly markets and should be addressed by regulatory interventions aimed at increasing competition.[44] However, this is not identified as a binding constraint (for example ranked 17th in Table 6.1) and competition is likely to increase as the economy develops, i.e. the market increases to allow for more actors, with a fall in prices as a result.

Irrigation is a type of infrastructure that needs special attention in Cambodia. The productivity of agriculture as well as the rest of the economy would be affected by a public decision to invest in irrigation. Irrigation may open up for two to three harvests per year, making it possible for farmers to use their land more efficiently, diversify production and further invest in their land since it can be used more efficiently throughout the year. Moreover, the one-yield-a-year production of rice means that there is a very labour-intensive peak each year which ties a large proportion of the labour force to agriculture that during the rest of the year is left to low-productivity activities. Hence, irrigation is not just an investment needed for increased agricultural production, but also for an increased production in the rest of the economy.

6.2 Cost of Financing Accumulation: The Cost of Borrowing

6.2.1 Local Finance

The cost of local finance will be a binding constraint if there is a demand for business expansion, but the price or access of capital is too high. However, it might be the case that the enabling environment for doing business is so bad that the willingness to invest, i.e. the demand for finance, is low. Moreover, a bad investment climate increases the probability of unsuccessful investments, which pushes up the interest rate demanded by the banks as they need to compensate for increased risk exposure. Since the opportunities for successful investments are limited this will also affect the quantitative supply of financial services as well as the diversity. This lack of competition might be another reason for a high price of capital. However, once the enabling environment for business improves the acceptable level of interest rate will increase for the private sector and decrease for the banking sector, given that the larger market will lead to increased competition.

The interest rate spread in Cambodia is very large, as discussed in the macroeconomic analysis in Chapter Five. An important question is how

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[42] Dapice (2006).

[43] World Bank (2004).

[44] EIC (2005b).

much of the interest spread that is due to a natural response to the investment climate, and how much that is due to market failures in the banking sector (lack of competition, lack of information, lack of general trust in the sector, etc.) and hence in a need for some sort of intervention.

It is clear from the analysis above that there are restrictions in the business environment outside the credit market, i.e. the expected private returns to investments tend to be low. Hence, the demand for investment financing can be assumed to be relatively small, especially in the rural area. However, the figures and tables presenting the general business constraints show a mixed picture. When asking executives from larger enterprises in the urban areas, access to finance is presented as the fourth major constraint (Figure 5). Moreover, financial and bank reforms are presented as the fourth most important reform for doing business (Figure 7). However, looking at Cambodia as a whole there seems to be other more urgent constraints since "cost of finance" and "access to finance" are only ranked 12th and 13th (Table 6.1).

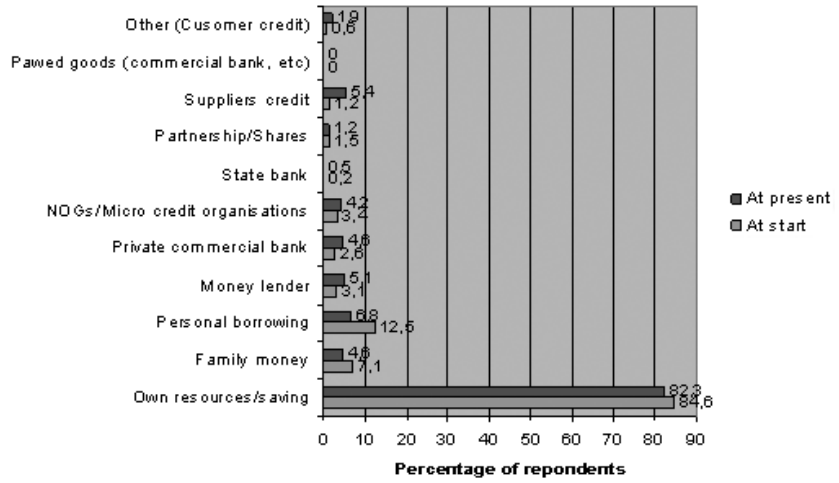
Figure 8 clearly shows that the major source of finance for MSMEs outside Phnom Penh is own resources and savings (which in turn can be assumed to be small amounts). Even though borrowing from formal credit institutions increases after start-up, it is still not common. The reasons for not seeking a bank loan are presented in Figure 9. The most frequently given reason (mentioned by 72 per cent of the respondents) was "because the profit from expansion would not be higher than the interest rate". As emphasised by Kang (2005), this is different from the usual assumption that the absolute level of the interest is too high. It is the relative cost of capital, when set against expected profits, that is too high, suggesting that it may well be the business environment that is the binding constraint.[45] However, there are also other important reasons for not seeking a loan that are connected to lack of information on bank procedures and the cumbersomeness and time needed to obtain a loan.

The two most common reasons for being refused a bank loan (52 per cent of the applicants were refused) were insufficient collateral and outstanding loans. These factors can be a natural consequence of a high risk investment climate and are not necessarily indications of failures in the financial market. When asking people why they do not think more businesses are started they mention high start-up costs on second place but lack of market demand and risk aversion on first and third place (Figure 6).

Even if the poorly developed financial system is not identified as a binding constraint at the present, it is likely that it will become one in the future. It takes time to develop a well-functioning financial system since it depends on a robust institutional framework as well as on a high level of trust. Hence, a free market development of the financial sector needs to be intertwined with and supported by regulatory work and institution-building, implying a need for an active role by Government today as well as in the future.

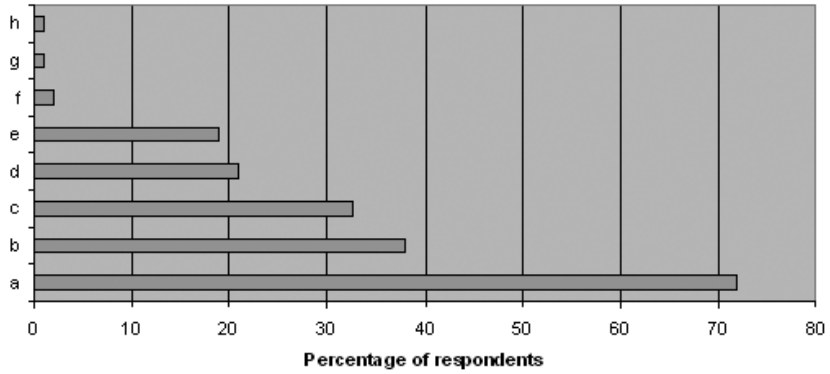
[45] The enterprises were also asked about their market expectations and 75% answered that "Demand for my product/service is insufficient to warrant expansion", 56% "The profit from expansion would not be higher than the interest rate" and 52% that "It is too risky to explore new expanded business" (Kang, 2005).

Figure 8 Sources of finance at start-up and at present (percentage of enterprise involved).



Source: Kang (2005).

Figure 9 Reasons for not seeking bank loan.



Source: Kang (2005).

Remark: a. "Because the profit from expansion would not be higher than the interest rate"

b. "Because I am uninformed regarding banking/loan procedures"

c. "Because collateral requirements of bank make it impossible for me to take out a loan"

d. "Because bank procedures are too time consuming"

e. "Because getting a loan requires informal payments"

f. "Because I have my own funds"

g. "Because I have enough funds"

h. "Because I am currently in debt"

6.2.2 International Finance

The response from FDIs to the first wave of reforms in 1993 was very positive. However, FDI has fallen consistently since 1999 due to a combination of factors such as domestic political instability and the regional crises in 1997–1998.[46] The problem of attracting FDIs to Cambodia is not trade openness, but the business environment. In order to turn the trend of declining FDI around the Government plans to develop special export zones with favourable conditions for foreign businesses. However this can hardly be a substitute for creating an environment conducive to sustainable broad-based growth in general. Indeed, improving the overall business climate and reducing the perceived general 'country risk' will be crucial to attract international finance and FDIs in the longer run.

[46] World Bank (2004).

7. Conclusions on Binding Constraint to Pro-Poor Growth

Despite respectable rates of economic growth in the past decade, Cambodia remains one of the poorest countries in Asia. Sustained and high rates of increase of labour productivity will be crucial for reducing poverty. Cambodia's location in a highly dynamic region and its rapidly growing human resource base offers opportunities, but also major challenges. The foremost challenge is to create conditions for sufficiently fast and broad-based economic development in order to provide employment for the rapidly increasing labour force and permit increasing labour productivity to enable escape from income poverty, while ensuring international competitiveness.

Against this backdrop, the development of the past half decade displays some worrisome features:

- The ability of the *current agricultural system* to serve as a generator of additional employment has apparently come to an end. Between 1999 and 2004 a mere 2.6 per cent of the increment of the labour force was absorbed in agriculture.
- Manufacturing remains a potentially important, though insufficient engine of employment and income generation. As a consequence *distress migration* from agriculture has increased sharply. The service sectors, mainly trade, appear to have taken on the role of employment buffer. A more than doubling of employment in trade has not been met with any commensurate growth in value added in this sector resulting in sharply falling levels of productivity and incomes.
- Despite spectacular growth of *manufacturing* in past years, the base will remain too small to absorb but a minor part of the labour force increase in coming years. Furthermore, the period of very rapid growth of the garment industry has probably come to and end and expansion of employment opportunities in manufacturing can by no means be taken for certain.
- The fall in overall income poverty in the past decade has taken place along with an increase in income *inequality*, due partly to an increasing rural – urban gap, but, more importantly, to increasing income inequality within the rural areas. The increased income inequality in the rural areas is to a large extent a consequence of accelerating land concentration and unequal access to land.

A continuation of the growth pattern of the past years would not, even if it were to be possible, be able to address the dual challenge of raising

labour productivity and accommodating the rapidly growing labour force and would in all likelihood result in further increases in income inequality from an already high level. Growth seems to have become less efficient as a vehicle for poverty reduction. This trend calls for a revisit of the strategic development options.

A faster and more broad-based development of the non-farm sectors is a necessary, but by itself insufficient, component for sustainable economic development and poverty reduction. Agriculture will have to resume its role as a main contributor to employment and income generation, at least in the short to medium term. This can only be achieved through an intensification of agriculture, i.e. higher and more predictable returns to land, with a focus on small scale farming. There are several reasons for this conclusion:

- Conditions need to be created that permits agriculture to absorb a substantial part of the *rapidly growing labour force* without falls in labour productivity from already very low levels.
- The highly seasonal nature of employment in agriculture has resulted in a pattern of *counter-cyclical employment* in small-scale non-farm activities. This does not provide a basis for sustainable overall growth. Instead, an ability to operate on a continuous basis and to adjust the level of operation to demand rather than to seasonal supply of labour is needed in all sectors. This in its turn requires opportunities for full time employment in agriculture brought about by intensification, including irrigation.
- Sustainable growth needs to be based on domestic as well as export *demand*. With the bulk of the population remaining dependent on agriculture for their living, increased incomes in agriculture must be an indispensable part of such a development.
- Similarly, a more broad-based pattern of economic growth is necessary to increase *multiplier effects* in the economy, which is needed to enhance the robustness as well as the rate of growth.
- Increased returns to land, with a focus on small-scale farming, is an absolute prerequisite for breaking the present rapid *concentration of land*. At the same time the benefits of intensification will only benefit the poor to the extent that they have access to land. Hence, it is an issue of considerable urgency.

To achieve sustainable pro-poor growth several constraints need to be addressed. Focus must be put on removing binding constraints in three areas: Agriculture, the non-farm sectors and for structural change.

The binding constraints to intensification of agriculture are arguably: (i) Secure and clear property rights (land titles, rule of law and policy transparency); (ii) access to markets and (iii) irrigation combined with extension services. Irrigation is an indispensable basis for agricultural intensification, both by opening up for sharply increased returns to land and by reducing the risks and uncertainties implied by weather-dependent, rain-fed agriculture. Such a development, in its turn must be preceded by increased access to markets in order to provide incentives to invest in intensification and to avoid local price collapses due to lack of demand. However, investments in land improvement will only take place if land ownership is secure. Moreover, land titling should ideally precede improvements in market access and irrigation infrastructure, as secure ownership becomes crucial to protect small holders against the risk of arbitrary expropriation or theft of the land as its value increases. In

addition, policy transparency is needed for small scale farmers to be able to make realistic assessments of the present and future production potential and value of their land.

The two main binding constraints for the industrial sector are (i) corruption and (ii) the cost of energy. Corruption stands out as the single most severe binding constraint. Closely related to this are problems with a dysfunctional legal system and poor governance. They hinder enterprise development and growth generally through increased cost and through the creation of unequal playing field. The latter also results in discrimination, in particular, against small and weak economic actors. The second main binding constraint is arguably the exceedingly high cost of energy, in particular electricity, which puts Cambodian manufacturing at a distinct competitive disadvantage compared to that in the neighbouring countries.

The transformation of the Cambodian economy from one dependent on primitive agriculture and a single industrial branch to one that is more sophisticated and broad-based requires major structural changes. The most acute binding constraint to such structural change is the failure to move from subsistence-based agriculture with low and uncertain returns to land towards a more intensive and market-oriented agricultural sector. In a slightly longer perspective, the lack of a skilled and well-educated labour force and the poorly developed financial sector seem likely to emerge as binding constraints. As these shortcomings take a long time to overcome they need to be addressed long before there impact becomes acute.

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