The Impacts of International Integration on MSME Development: The Case of Cambodia

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Introduction

Micro, small and medium enterprises (MSMEs) play an important role in job creation and income generation, directly contributing to poverty alleviation. As a result of the integration of the Cambodian economy into regional and world economies (ASEAN and WTO), MSMEs appear to face strong competitive pressure. No studies appear to have been conducted on this subject for Cambodia, so the effects of international integration on MSME development remain unclear.

The main purpose of the present study is to provide an overview of MSME development in the context of globalisation at three different levels: (a) national—the linkage between exports/imports and MSMEs, mainly focusing on three main commodities (garments, rice and fish), the business environment and financial services; (b) industry—business associations and marketing linkages, in particular the use of contract farming; and (c) enterprise—skills training and entrepreneurship development. The conclusions of the study cannot be generalised, since the case studies used are unable to present an overall picture of the MSME sector in either rural or urban areas. However, it is hoped that this paper will give some background and guidance on future research into this topic.

Current Situation of Micro, Small and Medium Enterprises in Cambodia

The growth rate of Cambodia's gross domestic product during the period 1990–1996 was around 7 percent per year, and an average of 5.4 percent during 1997–2003. The slower growth in 1997–2003 was largely a reflection of the Asian financial crisis, political conflict in Cambodia in 1997, the terrorist attacks in the United States on 11 September 2001, the anti-Thai riots in Phnom Penh in early 2003 and the outbreak of SARS across the region. Along with the economic deceleration in recent years, the main components of GDP have been altered significantly, except for the service sector remaining constant at around 35–36 percent of GDP during this period. Thus, agriculture accounted for 37.2 percent of GDP in 2003, down from 47.1 percent in 1998. The industrial sector has grown from 17.9 percent of GDP in 1998 to 26.8 percent in 2003. Of this, manufacturing, which accounted for 13.8 percent of GDP in 1998, rose to 19.3 percent in 2003. The total number of micro, small and medium enterprises in 2001 was 27,201 while there were only 274 large enterprises. The share of MSMEs in GDP is approximately 8.3 percent, far lower than in other countries of the region, where they account for 20–25 percent (Hing, 2003).

Trade Liberalisation

In the late 1980s, Cambodia began market-oriented liberalisation. As a result, the state monopoly on foreign trade was abolished in 1987, and a foreign investment law was promulgated in 1989 enabling private companies to engage in foreign trade. In the early 1990s, trade policies were greatly liberalised and most quantitative restrictions and licensing requirements eliminated. In the late 1990s, Cambodia moved towards a highly liberal trade regime by integrating into both regional and global economies.

Since it became the 10th member of ASEAN in April 1999, Cambodia has committed to gradually reducing most tariff rates on goods from other ASEAN members to below 5 percent by 2010, and the remaining tariff lines (which are mostly sensitive agricultural products) by 2015, within the framework of the Common Effective Preferential Tariff (CEPT) agreement. The CEPT covers a broad range of items, including manufactured and agricultural goods, i.e. finished goods, intermediate goods and raw materials. As a result of the tariff reform, the number of tariff bands was reduced from 12 to four, with the maximum tariff rate falling from 120 percent to 35 percent in April 2001. Further tariff reductions will be implemented following Cambodia's full membership of the World Trade Organisation (WTO).

National Level

Linkage between Exports and MSMEs

In line with a jump in the export-GDP ratio (17.8 percent in 1994 to 47.8 percent in 2003), the export structure also changed remarkably during the period 1994–2001. The proportion of domestic exports in total exports rose[1] significantly, from 53.5 percent in 1994 to 87.2 percent in 2001. In contrast, the share of re-exports dropped from 46.5 percent to 12.8 percent during the same period. After 1995 there was significant growth in the garment sector, due mainly to most favored nation (MFN) status and the generalized system of preferences (GSP) agreement. Consequently, the share of garments in total exports increased sharply, from 0.4 percent in 1994 to 83 percent in 2001.

The value added in Cambodian exports is very low. In the case of the garment sector, Sok *et al.* (2001) indicate that for every $100 worth of garment exports, $76 is spent on imported raw materials and $4 on utilities and other domestic inputs. Moreover, a study conducted by the Mekong Private Sector Development Facility (MPDF) also showed that garment companies usually

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obtain inputs from their customers, most of them operating on a cut, make, trim (CMT) arrangement. Unlike free on board (f.o.b.) producers,[2] CMT producers receive all major inputs and specifications from the buyers, who then buy 100 percent of the final product (MPDF 2000, p. 23).

There is also little value added in other products such as rice, which accounts for the largest share of agricultural production (33 percent in 1999). It has been noted that rice production reached a sustainable level of surplus at the national level in 1997, and the highest level in 1999/2000, with more than 4 million tonnes of paddy. To encourage the export of surplus rice, the government has eliminated barriers. However, to ensure national food security, the government requires exporters to obtain a permit. Despite the government's efforts to encourage rice exports, only a very small proportion of exports are milled rice (3,110 tonnes in 1999), and most are unprocessed paddy (470,594 tonnes in 1999).[3] A recent study conducted by the World Bank found that "in Battambang, which included a large number of rice millers, 70% of output is sold directly to consumers and the rest to small local businesses." (World Bank 2004, p. 43).

Similarly, the fish-processing sector in Cambodia is minuscule. On average, Cambodia produced 347,606 tonnes of fish annually in the period of 1998–2002, of which only 32,020 tonnes (9.2 percent) were processed and 43,760 tonnes (12.6 percent) were exported. Of total exports, it is estimated that about 75 percent are delivered to Thailand as fresh fish, iced fish and seafood, and another 15 percent to Vietnam (World Bank 2002). The study by Acharya *et al.* (2003) of 60 self-employed persons and enterprises engaged in fishing and 60 fish processing businesses also reflects this reality, pointing out that most fish is marketed fresh, and a relatively small portion is smoked, dried or salted. Fresh fish is mainly transported either to Phnom Penh or to the border at Poipet for export to Thailand.

Linkage between Imports and MSMEs

It is often argued that a low tariff rate on all imported capital goods and raw materials will allow local producers (including MSMEs) to obtain raw materials at world prices and ensure that local producers will not be at a disadvantage in competing with imported goods. In particular, a lower tariff rate on capital goods, raw materials and finished goods obviously discourages smuggling of imports. By contrast, a lower tariff rate on finished goods has an adverse effect on local producers. For instance, a cement factory in Chakkrei Ting, Kampot, was closed because it could not compete with imported goods, some of which are smuggled (Hing 2003). Cheap synthetic fabric with similar designs and patterns imported from Thailand increased slowly from a base of 100 in 1998 to 111 in 2002 (Acharya *et al.* 2003), and have reduced the sales of locally produced silk.

Although tariff rates will be reduced to below 5 percent by 2010, the government has increased excise rates on major import categories as a compensatory revenue measure. Excise taxes were raised on beverages, tobacco, passenger vehicles, motorcycles and petroleum products. In particular, the excise tax on petroleum products, which is the highest rate in the region (World Bank 2002, part C), has a big impact on manufacturers by increasing the cost of transportation and electricity and pushing down farm-gate prices, and as a result discourages production. This has seriously reduced Cambodia's competitiveness.

In addition, there are many unofficial fees levied on imports, reflected in the regulatory framework that allows many agencies to be represented at international checkpoints, with at least three different agents (World Bank 2002 states at least five) always present. The agencies involved in processing and inspecting imports include CamControl, the Customs and Excise Department, the Ministry of Health, the Ministry of Agriculture, Forestry and Fisheries, the Police Frontier Defence Department and the Economic Police from the Ministry of Industry and provincial/municipal authorities. CamControl, the Police Frontier Defence Department and the Customs and Excise Department are to be represented at every border checkpoint. The duplication in import processing has raised uncertainties, costs and the time needed to import production inputs.

As a result, the high costs of inputs and equipment resulting from excise taxes and formal and informal fees remain a major constraint for local manufacturers in competing with legally imported or smuggled goods.

Business Environment

Legal Basis of the MSME Sector

Since there is no commercial enterprise law, firm registration and corporate governance are stipulated under the 1995 Law on Commercial Rules and Registration and its 1999 amendments and in the Ministry of Commerce (MoC) Instructional Circular on Commercial Registration. The Law on Commercial Rules and Registration and its amendments cover mainly the requirements for commercial registration and the maintenance of the commercial registry (ADB 2003).

However, the government has recently improved the legal framework for commerce, with new financial sector laws helping to strengthen the banking system and the insurance industry, for example. The land law has created the framework for ownership of immovable property, the mortgaging of land and the issuance of land titles. The Law on Investment (LoI) amendment in 2003 simplified investment licensing and modified the tax incentives for investment projects. Moreover, the government is currently drafting laws on commercial enterprises, commercial contracts, commercial arbitration, negotiation instruments and payment transactions, factory management, insolvency, secured transactions and industrial zones.

Business Regulation

Under the Law on Commercial Rules and Registration, only companies with more than 6 million riel ($1,500) in annual profit are required to pay profit tax and to register, and therefore most MSMEs are not subject. In practice, an enterprise tends to register for specific reasons, such as borrowing from a bank, obtaining an export or import licence, applying for government procurement projects or entering into contracts with large enterprises. Moreover, the registration process is very complicated. Because of this, enterprises usually count on formal or informal facilitators, who charge fees to manage all the application forms. Although the process is significantly simplified, the overall cost of registration is increased, from 300,000 riel (about $75) under the law, to an average of 8,000,000 riel (about $2,000).

The government made plans to simplify and streamline registration in its first planning stage during 2004–2006 by: (a) allowing enterprises to authorise representatives to carry out tasks such as providing signatures and making presentations at the MoC; and (b) establishing one-stop services for enterprise registration (ADB 2003).

Investment Incentives

Sub-decree 88 of 1997, on implementation of the LoI, provides a list of sectors, sizes of investment and tax-paying status for which incentives apply and the size of qualifying projects. In most cases, the investment requirements are too large for most Cambodian MSMEs to participate. For example, in manufacturing sectors the minimum investment to be a qualified investor is $500,000. In other sectors, such as textile mills or paper and paper products, the size of investment amounts to at least $1 million. In addition, only enterprises registered with the MoC and completing financial statements under the profit tax system are qualified to participate in the incentive system. Therefore, MSME investors are unable to use investment incentives.

Credit Access

To some extent the bank re-licensing program seems to be successful, because public confidence in the banking system appears to be gradually improving. However, lending continues to stagnate, and most loans are still short term, mainly providing import/export financing and working capital to the wholesale and retail trade and the service sector (such as tourism, hotels). The study conducted by MPDF in 12 out of the total 17 banks found that: (a) 70 percent of loans to MSMEs in Cambodia were for one year or less; (b) 29 percent of loans were for one to two years; and (c) only 1 percent of loans were for over two years.

In addition to the banks' reluctance to make long-term loans, limited access to financial institutions is also a major issue facing enterprises in Cambodia. It has been noted that approximately 80 percent of the population is unable to access banking services. On the other hand, there are approximately 80 NGOs (both local and international) operating as semi-formal micro-finance institutes in rural areas and providing small loans to farmers and small businesses, which, however, cannot meet the whole demand for borrowing. Only 20 percent of the annual rural finance demand of $120–130 million is met from institutional sources. One third of this demand is for micro-credit, ranging from $50 to $300 (ADB 2003).

Industrial Level

Business Associations

Business associations are expected to play an important role in developing markets by providing market research, information on consumer preferences and assistance in distribution. It is known that rice miller associations have helped to improve quality through training of millers in seed and milling technology. They have also instructed rice millers on market trends and educated them on how to meet market demands. Despite this, the recent study by MPDF of 68 firms showed that only 18 of the sample were members of an association or chamber of commerce. The 18 members of associations are larger firms with a mean turnover of $625,000 per year, compared to a mean turnover of $150,000 for the sample as a whole and $120,000 for non-members of associations. In addition, most members expressed disappointment with the benefits received from their associations (MPDF 2000, p. 21).

Subcontracting

It is well known that contract farming schemes provide more opportunities for local businesses to create an environment that fosters market growth, specialisation and adherence to international quality standards (World Bank 2004). However, a study of four major cash crops (soybeans, maize, cassava and cashews) focusing mainly on production, marketing, exports and processing revealed that such schemes are difficult to establish in the current context of Cambodia, which is characterised by severe poverty and a lack of effective enforcement of contracts (Chan 2003). However, there are several cases of firms successfully establishing contract-farming schemes in recent years, such as Angkor Kasekam Roongroeung, a Cambodian investment firm established in 1999, specialising in rice processing and exports, and hand made garment items.

Srey and Lay's study (2004) of Angkor Kasekam Roongroeung found that farmers' annual incomes had doubled from 800,000 riel per ha to 1.6 million riel per ha due to the use of a contract farming scheme, and the company's rice exports had doubled from 4,000 tonnes in 2002 to 8,000 tonnes in 2004. A study of cross-border trade by Murshid and Sokphally (2004) in the Poipet area also found that the subcontracting system for garment items (e.g. hats, shorts or trousers) is rapidly expanding from the border area to deep inside Cambodia.

Enterprise Level

Skills training

A number of technical centres and schools have been set up by the government and NGOs in both rural and urban areas in Cambodia. These centres provide only short training courses of a few weeks or months, so it is difficult to transform trainees with few assets and low education into entrepreneurs. Furthermore, the vast majority of workers learned skills from their families, and in some cases from NGO experts, although it is not clear whether this was important for workers in their present jobs (Acharya *et al*. 2003).

Entrepreneurship Development

Currently, there are few business development services in Cambodia. Organisations such as the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), MPDF, SME Cambodia and the Association of Cambodian Local Economic Development Agencies (ACLEDA) have provided business training for many years (ACLEDA abandoned its training programmes in mid–1998 due to low demand).

In its operations in Cambodia, MPDF has offered training in marketing, human resources, production and operations management, finance, accounting and so on. MPDF has also supported Cambodia's motivated rice millers to create a business association. To strengthen the associations' abilities, MPDF collaborated with SME Cambodia and Khmer Internet Development Service (KIDS) to launch RICENET—a website dedicated to providing more effective dissemination of industry information and facilitating communication between suppliers and buyers. It also seeks to support and build the capacity of local intermediary organisations that deliver essential services to MSMEs as well as to improve the business environment for MSMEs. However, out of the 87 company advisory assistance projects completed by MPDF in the region (Cambodia, Lao PDR and Vietnam), only seven were in Cambodia.

Conclusion

Findings indicate that the impacts of trade liberalisation on MSMEs in Cambodia have so far been relatively limited at each of the three levels examined (national, industrial and enterprise). Although the business environment seems to have gradually improved over the past few years in terms of legal status and business registration and licensing procedures, there remain serious issues for other policies, including excise taxes levied on major imported commodities (in particular petroleum products), higher formal and informal fees on imports, lack of access to investment incentives, lack of financing and poor physical infrastructure. In addition, business associations for the MSME sector have developed slowly despite some attempts to accelerate them, and members generally report low involvement and limited use. The study findings also confirm that very few MSMEs have been directly influenced by economic integration, through direct contact with foreign firms or direct exports, because there is extremely limited forward and backward linkage between foreign-owned or large Cambodian enterprises and MSMEs, and because of low or no value added in Cambodian exports. More interestingly, the study has identified the potential use of contract-farming schemes in both agricultural and industrial products.

Endnotes

1. Total exports are the sum of domestic exports and re-exports. Domestic exports include logs, sawn timber, fish products, rubber, garment exports, agricultural products etc.
2. F.o.b. producers are responsible for inputs and have more flexibility to search for both multiple suppliers of inputs and diversified buyers. The tradeoff between higher value addition and profits of f.o.b. production is the greater investment required and greater risk assumed by the producer.
3. In addition to the lack of access to working capital, insufficient milling capacity is also part of the reason for exporting unprocessed paddy. Cambodia produces nearly 4.12 million tonnes of paddy each year, but milling capacity is only 1.31 million tonnes (World Bank 2004).

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