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UNDERSTANDING THE PATHS TO FORMALIZATION IN CAMBODIA: An Integrated Vision

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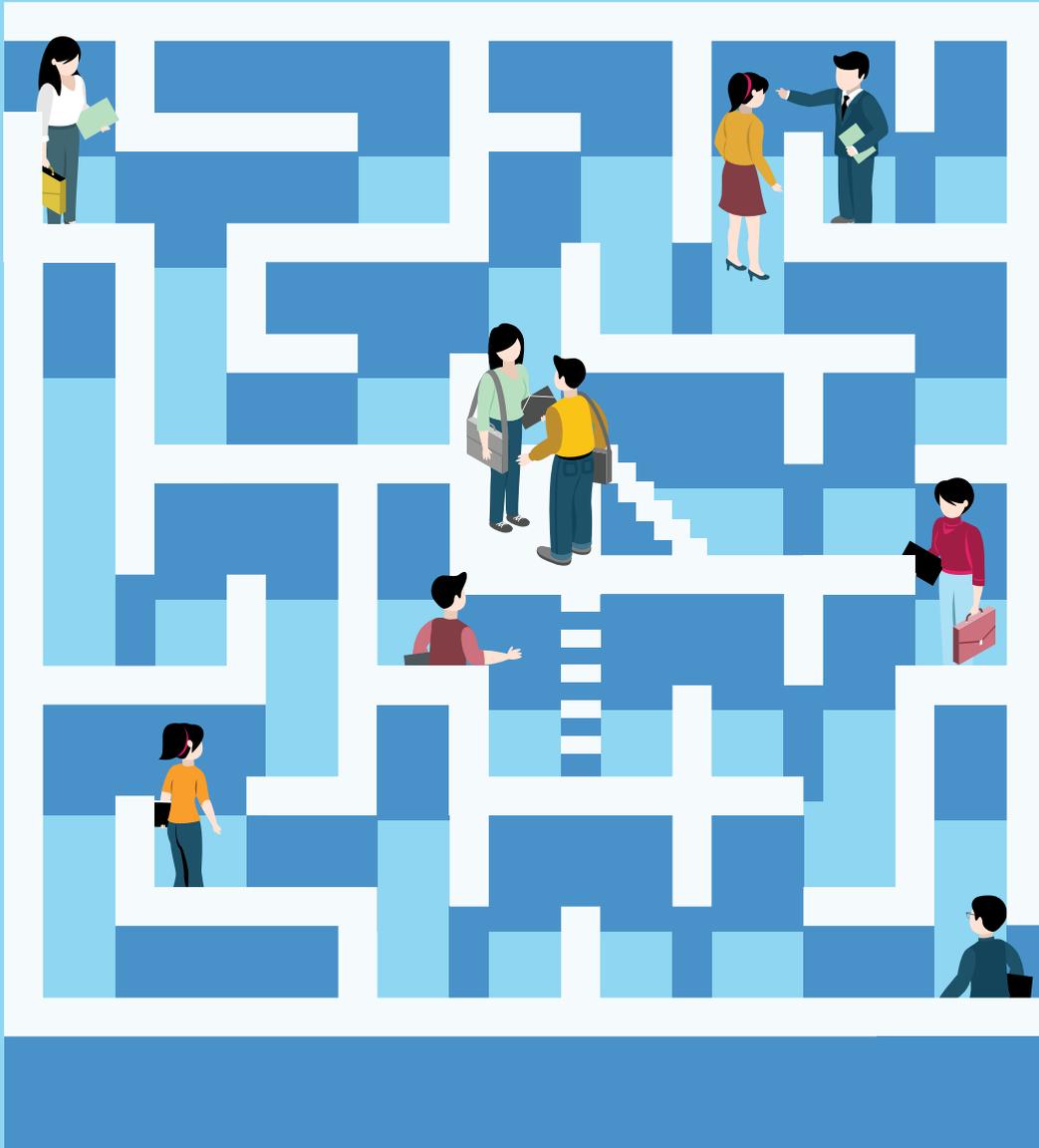
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Understanding The Paths To Formalization In Cambodia:

An Integrated Vision

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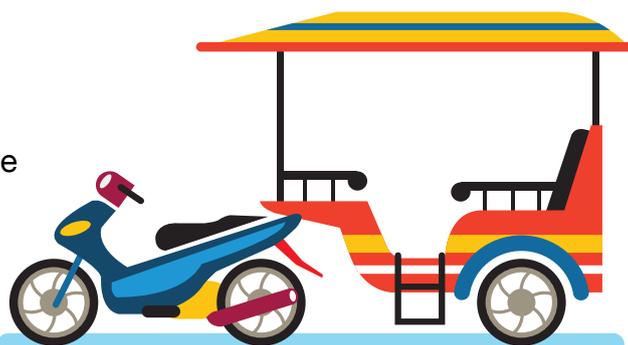


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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BDS	Business Development Services
CIT	Commercial Income Tax
CSES	Cambodian Socioeconomic Survey
ORS	Occupational Risk Scheme
ESAF	Evangelical Social Action Forum
GDP	Gross Domestic Product
GDT	General Department of Taxation
GS-NSPC	General Secretariat for the National Social Protection Council
HHE	Household Enterprise
HCS	Health Care Scheme
ILO	International Labour Organization
ISIC	International Standard Industrial Classification of All Economic Activities
KHR	Cambodian Riel
LFS	Labour Force Survey
MEF	Ministry of Economy and Finance
MEI	Micro Entrepreneur Individual
MISTI	Ministry of Industry, Science, Technology and Innovation
MoC	Ministry of Commerce
MoH	Ministry of Health
MoI	Ministry of Interior
MoLVT	Ministry of Labour and Vocational Training
MoPT	Ministry of Post and Telecommunications
MoT	Ministry of Tourism
MSE	Micro and Small Enterprise
MSME	Micro, Small and Medium Enterprise
NIS	National Institute of Statistics
NSSF	National Social Security Fund
OWS	One Window Service
PIT	Personal Income Tax
SEZ	Special Economic Zone
SME	Small and Medium Enterprise
UNDP	United Nations Development Programme
USD	US Dollar
VAT	Value Added Tax
ZAR	South African Rand



Exchange rate used in this report (market rate at time of authorship): USD 1 = KHR 4,052

EXECUTIVE SUMMARY

The formalization of jobs and enterprises is integral for building resilience and setting the foundations for long-term socioeconomic development. The emergence of non-standard forms of employment, including through the rise in digital platforms, has pushed the boundaries of the informal economy around the globe. The COVID-19 crisis has thoroughly exposed the vulnerabilities of the informal economy. It has highlighted the need for enhanced, gender-responsive policy efforts to both protect and empower informal workers and enterprises, while facilitating their gradual transitions to formality to foster job creation and decent work, avoid a deepening of poverty and inequality, and build forward better.¹

Informality is common in Cambodia: 88.3 percent of workers are engaged in informal employment (of these, 87.6 percent are women) and 87.6 percent of establishments are informal. Addressing informality is challenging, in part because it is pervasive and long established. This report examines the context and challenges associated with formalizing enterprises and employment in Cambodia, and provides a range of policy options that can be included in an integrated strategy for formalization. It focuses in particular on micro enterprises and their employees, as they are more likely to be informal than other enterprises or workers.



INTERNATIONAL EXPERIENCES WITH INFORMALITY

The International Labour Organization (ILO) has defined the term “informal economy” as “all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.”² The informal economy includes informal employment as well as informal economic units. Informality presents a range of challenges for workers, businesses, governments and society, but perhaps none are as important as the associated decent work deficits. Informal workers have lower incomes and less access to labour rights protections and social security. For enterprises, informality is associated with lower productivity, as well as challenges such as limited access to finance and markets, and restricted assistance in times of crisis to governmental business support schemes and stimulus measures.



1. UNDP, Informal Economy Data Explorer, <https://data.undp.org/informal-economy/> [accessed July 12, 2022].

2. ILO, Recommendation 204 concerning the Transition from the Informal to the Formal Economy, 2015, https://www.ilo.org/ilc/ILCSessions/previous-sessions/104/texts-adopted/WCMS_377774/lang--en/index.htm [accessed July 13, 2022].

Informality is a complex challenge, and addressing it often requires numerous actions, which in some contexts have been coordinated in an integrated strategy to address informality. Globally, one of the most common actions to address informality is to remove barriers to formalization for enterprises and workers. This can include reducing fees, eliminating minimum capital requirements, eliminating or reducing procedures, and making licensing or registration automatic. Taxes are common reasons that enterprises remain informal, and tax incentives have sometimes been an effective intervention to encourage formalization. Preferential tax regimes are a commonly used tool to encourage formalization. Other types of incentives have also been used to drive formalization, including monetary incentives and improved access to social security schemes, public procurement, financial services, new markets or new clients. Other approaches to addressing informality include business environment reforms, reducing information gaps, building micro, small and medium enterprise (MSME) capacity for fulfilling the requirements of formalization, enhancing access or assistance to formalize, increasing enforcement and using technology to drive formalization.



An integrated approach can often result in improved outcomes in comparison to siloed actions to address formalization. ILO Recommendation 204 concerning the Transition from the Informal to the Formal Economy outlines factors to be considered in an integrated approach, and highlights that the transition to formality includes the creation of new formal enterprises and decent jobs, the transition of informal workers and enterprises to the formal sector, and the prevention of the informalization of formal jobs. It also emphasizes the need for coordination across government.

THE SOCIOECONOMIC LANDSCAPE IN CAMBODIA

Over the last decade, Cambodia has made significant strides in developing its economy and reducing poverty. Consumption and disposable household incomes increased substantially in the 2010s. According to recent labour force surveys, average incomes increased from US\$117.70 per month in 2012 to \$263.20 per month in 2019. This coincided with a shift in workers away from contributing family work and towards own-account and wage and salaried work. There has also been a sectoral shift in work, away from agriculture and towards both services and industry. The COVID-19 pandemic further affected Cambodia's labour

market, increasing the unemployment rate to 4.3 percent in 2020 and disproportionately impacting women workers, although the country's economy recovered in 2021 and 2022.

The overall trend of informality in Cambodia is declining, excluding any temporary effects of the COVID pandemic. In 2019, labour force survey data showed that 88 percent of Cambodia's workforce was engaged in informal employment, down from an estimated 93 percent in 2012. While these surveys are not easily comparable, other data also suggests the same overall trend of declining informality. For example, the share of the labour force in the highly informal agricultural sector has declined, while the share in the more formal industrial and services sectors has increased. At the same time, the share of formal employment in both industry and services has also increased. Despite the trends, however, informality remains pervasive in Cambodia.

Cambodia's private sector has grown significantly in the last decade, and MSMEs continue to play an important economic role, providing incomes for millions of Cambodians. There were 735,456 non-agricultural establishments according to the 2022 economic census, excluding agricultural businesses involved in production. Approximately 99.8 percent of these are MSMEs, which are collectively responsible for 58 percent of employment and 58 percent of gross domestic product (GDP). However, many enterprises – especially smaller ones – remain informal. The vast majority of establishments (87.6 percent) are not registered, which is a key trait of informality. All establishments with 100 or more workers and 89 percent of establishments with 5 or more workers were registered. However, only 6.5 percent, or 45,793 micro establishments were registered. According to a UNDP longitudinal survey, when COVID-19 hit in mid-2020, both informal and formal MSMEs were severely affected in demand and profit, but loan access was much more difficult among informal MSMEs (56 percent) compared to formal MSMEs (19 percent).³



THE LEGAL AND POLICY LANDSCAPE

The regulatory framework in Cambodia governs enterprise entry, as well as many aspects of operations. However, it differs significantly based on enterprise size, with micro enterprises facing far fewer

3. UNDP, Informal workers and MSME survey, <https://www.dataforcambodia.org/msme-profit> [accessed July 14, 2022].

legal requirements. Many enterprises are required to complete a registration, license, permit or declaration. The Ministry of Commerce (MoC) registers companies according to the Law on Commercial Rules and Register, which requires merchants and commercial companies to register unless they are exempted from profit taxes. Enterprise registration, licensing and permitting are also provided by numerous sectoral ministries, including but not limited to the Ministries of Labour and Vocational Training; Culture and Fine Arts; Education, Youth and Sports; Tourism; Industry, Science, Technology and Innovation; Mines and Energy; Health; Agriculture, Forestry and Fisheries; and Land Management, Urban Planning and Construction.

Small, medium and large enterprises also have greater taxation obligations. Cambodia's taxation system classifies taxpayers into four groups: general (which includes micro enterprises that fall below the small taxpayer threshold), small, medium and large taxpayers. While all taxpayers are required to register with the General Department of Taxation (GDT), only those who meet the minimum requirements of a small taxpayer are required to pay income tax or a minimum tax on turnover – whichever is larger. They also collect and remit value added tax (VAT), pay patent and withholding taxes, and pay a range of fees. Micro enterprises that are considered general taxpayers do not pay or administer many of the taxes faced by other enterprises.

Enterprises in Cambodia must comply with a range of laws and regulations regarding labour and social security. Any business with at least one employee (whether part-time or full-time, on a salary or commission basis) is required to file a declaration with the Ministry of Labour and Vocational Training (MoLVT) when starting operations, among other requirements. Enterprises with at least one employee must also register with the National Social Security Fund (NSSF), make monthly contributions to the occupational risk scheme (ORS) and health care scheme (HCS) and, starting in July 2022, the pension scheme.

Business registration, licensing and permitting can be done through a few channels, depending on the process and characteristics of the enterprise. Small, medium and large enterprises can register online with the MoC, GDT and MoLVT via the CamDX portal. Micro enterprises and enterprises needing various licenses can often apply in-person at the one window service (OWS) – a single point for interaction between government and individuals or enterprises.





Some functions can only be completed at the relevant ministry, for example registration with the NSSF by enterprises.

Companies also face numerous requirements when exiting the market. These include deregistration with the GDT, MoC and Council for the Development of Cambodia (if applicable). However, the time needed for creditors to recover debts can still be numerous years, and there are significant costs associated with the insolvency process.

DRIVERS OF INFORMALITY IN CAMBODIA

Informality is complex and lacks a single key driver. Some challenges are specific to micro enterprises, others to SMEs, and still others are cross-cutting, affecting workers and enterprises of all sizes. For micro enterprises, the primary reason that many are informal is because the legal and regulatory framework does not require them to fulfill some of the steps associated with formality. Practically, micro enterprises are not required to register with the MoC, nor pay commercial income tax (CIT) or charge and collect VAT from customers, although they can register with the NSSF if they have a permit or license from the OWS. The CamDX registration portal, a primary avenue through which enterprises formalize, is not yet compatible with the registration needs of micro enterprises. According to a recent UNDP study, 84 percent of MSMEs that were not registered with NSSF cited the complicated and time consuming registration process as a reason, followed by the cost of compliance (34 percent).⁴

Though both the MoLVT and NSSF have mandatory registration and legal requirements for micro enterprises, compliance rates are not high. Micro enterprises face a steep increase in costs and legal and regulatory burdens if they hope to formalize. This is in part due to the very low taxation and regulatory burden for individuals and enterprises that fall below the small taxpayer or other legal and regulatory thresholds.

For small and medium enterprises (SMEs), the drivers of informality are more complex. There are numerous types of financial and time costs associated not just with formalizing, but with remaining formal, and these shape enterprise decisions about formality. The time and financial costs of taxes are one example. However, it is not

4. UNDP, Fifth round of informal sector and MSME surveys, 2022.



only the cost of paying taxes that must be taken into account, but also the tax-related risks and uncertainty. The GDT has significant authority to assess back taxes, and charge penalties and interest at a rate of 1.5 percent per month. This is compounded by an incentive structure for tax officials in which they can be rewarded for large penalties, creating an incentive for them to “go after” companies. The financial costs of formalizing are also comparatively high. For sole proprietors who are small taxpayers, the one-time costs to register via the CamDX are about \$135, although this excludes further business start-up, registration and licensing costs at other ministries or subnational administrations. For medium enterprises, the costs could rise to \$754, and for large enterprises costs would be even higher.

Another driver of informality is the lack of enforcement, which reduces the risks associated with non-compliance, thereby making informality relatively more appealing. Both the NSSF and MoLVT face human resource constraints, as the growth in the number of inspectors has not kept pace with the growth in the number of enterprises. MoLVT and the NSSF also face practical difficulties enforcing the law against non-compliant enterprises. Enhanced information sharing between ministries could help reduce some enforcement gaps. Other drivers of informality include:

- A taxation system that taxes salaries at graduated rates from 0 percent to 20 percent but does not yet enforce personal income taxes for own-account workers in the same line of work. This creates a clear disincentive to formalize employment.
- Quality issues, or perceptions around quality and value for money that may dissuade enterprises from participating in the NSSF, increasing the share of informal enterprises.
- Corruption, which can increase the costs associated with formalizing or remaining formal.
- The challenges associated with quantifying the benefits of formality, which may contribute to a perception that it provides little perceived value added.
- The perception among some enterprises that formalization attracts unwanted attention, which can increase both formal and informal costs.
- Issues in the legal and regulatory framework design that can sometimes make compliance difficult, costly or even impossible.



THE BUSINESS CASE FOR AN INTEGRATED APPROACH TO FORMALIZATION

Formalization is important for fostering an economy and labour market that creates more and better jobs, thereby reducing poverty and alleviating some of the most serious decent work deficits. One of the avenues through which this takes place is participation in social security systems. The expansion of social protection is a stated goal of the Royal Government of Cambodia, noted among other places in the National Social Protection Policy Framework 2016-2025. However, the business case for formalization is not straightforward nor simple – it comes with benefits, costs and risks for different groups such as government, enterprises and workers.

THE BUSINESS CASE FOR AN INTEGRATED APPROACH TO FORMALIZATION	
Benefits of formalization for government, enterprises and workers	
For government	Increases tax revenue
	Improves data on enterprises, the economy and labour market
	Increases capacity to roll out emergency assistance
For enterprises	Creates a more level playing field
	Increases opportunities to access capital, new markets and business development services
For workers	Provides greater protection from unexpected declines in income through social protection
	Increases labour mobility
Costs of formalization for government, enterprises and workers	
For government	Requires more resources that are used simultaneously
For enterprises	Raises the direct ongoing costs of doing business, including taxes and social security contributions
	Increases the time and cost needed for ongoing compliance and legal obligations
For workers	Reduces take-home earnings for own-account workers and, to a lesser extent, employees
	Increases the time and financial costs of compliance for own-account workers
Risks of formalization for government, enterprises and workers	
For government	Poorly designed or implemented approaches to formalization could fail and contribute to enterprise perceptions that formalization is not beneficial
For enterprises	Unexpected past tax liabilities
	Increases attention from government officials moving forward
For workers	Workers may miss out on social protection benefits if they lack awareness or if bureaucratic systems are not working well



STRATEGIES FOR ADDRESSING INFORMALITY IN CAMBODIA

There are numerous possible policy options in Cambodia that could form part of an integrated approach to encourage micro and small enterprise formalization and increase NSSF coverage. One of the first steps to developing an integrated approach is to agree on a shared concept of formality, which is an important foundation for government-wide collaboration. This shared understanding of formality should focus on the behaviour and status of the enterprise, not its size. Furthermore, it should not require that every single enterprise – whether it be a two-person operation or the country’s largest business – face the same requirements and regulatory burden.

For the purposes of Cambodia’s government administration, formality could be thought of in the following way for different groups:

- Small, medium and large enterprises: registered with the MoC, GDT and NSSF; opening declaration with the MoLVT.
- Micro enterprises (including own-account workers): registered, licensed or permitted by a competent ministry or institution (if applicable) or the OWS office; opening declaration with the MoLVT (if applicable) and registered with the NSSF.
- Employees (and other workers that are not self-employed): registered with the NSSF directly or through their employing enterprise.

Informality should be viewed as any worker or enterprise that does not fall within, or is inadequately covered by, the formal legal framework outlined above.

A simple and well-conceived strategy that incentivizes micro enterprises to become and remain formal is essential for bringing these enterprises and their workers into the legal fold. This could be accomplished by modifying the existing legal and regulatory framework to allow easier access to the NSSF for micro enterprises and workers, or by creating a monotax regime for micro enterprises that includes the NSSF. While a monotax regime would provide an important step towards formality for many micro enterprises, they would still face greater costs and compliance requirements. To encourage enterprises to make this transition, an assistance programme could be adopted, and may include:

- Trainings/capacity building on the compliance requirements associated with becoming a small enterprise.
- A phase-in of the costs and compliance requirements facing these enterprises.



- A limitation on the potential tax liabilities associated with formalizing.

These could be complemented by increased communications efforts or a formalization campaign.

While a monotax for micro enterprises and procedural reforms for SMEs both make formalization easier, a significant share of MSMEs may still face affordability challenges related to formalization. There are multiple ways to address these challenges, which could include one or more of the following:

- Phase-out of subsidies or preferential rates.
- Semi-targeted subsidies or preferential rates.
- Means-tested subsidies or preferential rates.
- A limited-time offer of incentives to formalize.



Affordability challenges could also be addressed by new efforts to help formalizing enterprises boost profits and productivity, enhancing their capacity to meet these new obligations. This could include:

- Reinforced efforts to make credit available to MSMEs through public or private channels (e.g., access to credit guarantee schemes).
- Enhanced business development or product development services.
- Increased workforce skills training, targeted especially at employees of micro and small enterprises (MSEs).

Additional changes to processes and procedures that could help to make it easier for enterprises to become and remain formal include: (1) combining multiple monthly payments (the GDT and NSSF) into a single payment; (2) allowing acceptance of scanned or digital copies of IDs and other documents; (3) permitting document validation and biometric identification for employers or workers to take place after registration, but before benefits are disbursed; and (4) adopting regulations that allow workers to remain on the NSSF rolls for up to three months in case of an error by the employer or the NSSF.

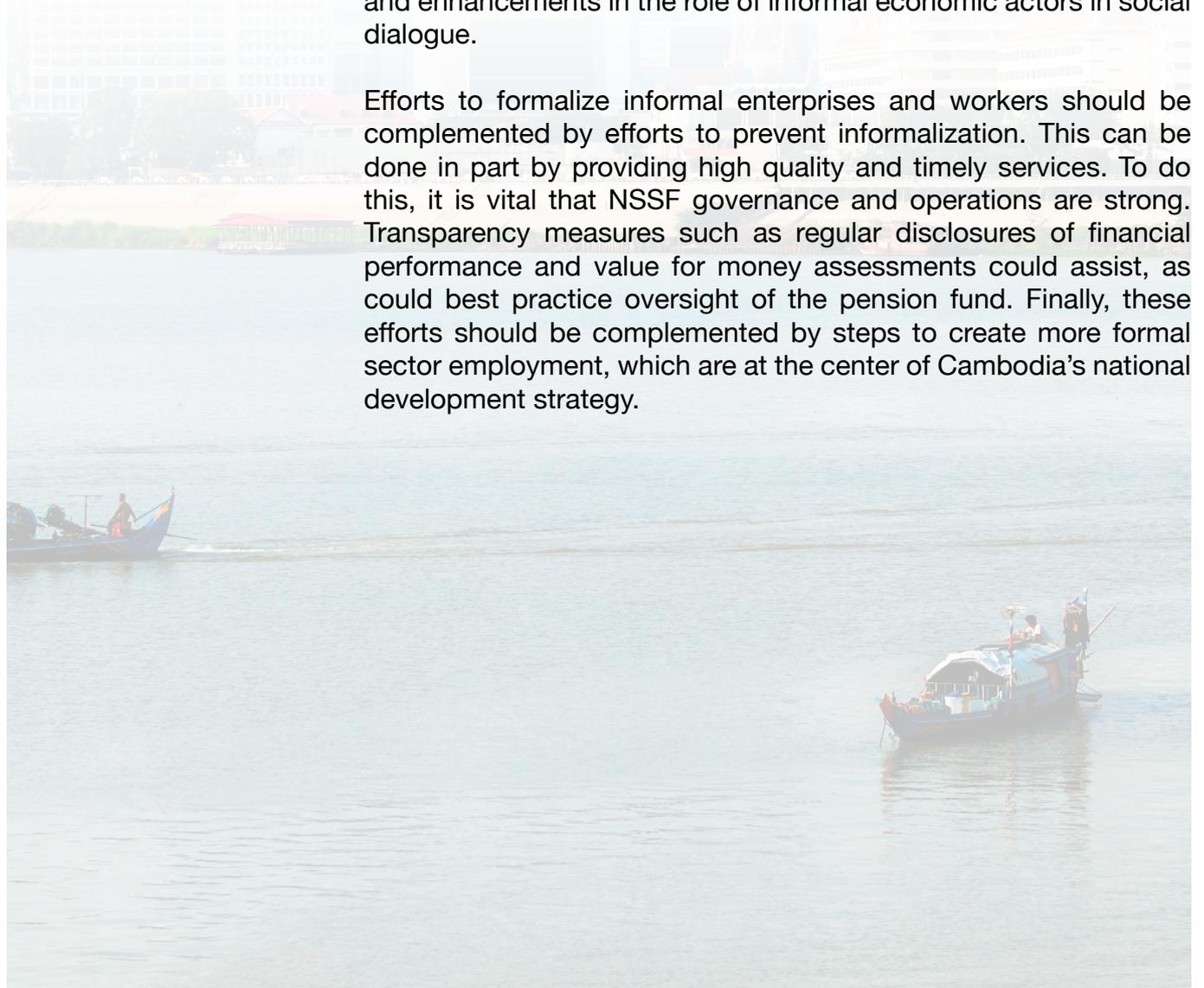


Enforcement is an essential component of any integrated strategy to address informality, because it incentivizes compliance with the law. However, given differences in enterprise characteristics, a one-size-fits-all approach to enforcement is not appropriate. Large enterprises have greater financial and human resources needed to

comply with the law, so a more traditional enforcement approach is probably appropriate. However, some micro enterprises do not even have a clear formalization framework, and as such need a much different enforcement approach. For them, enforcement should follow clarifications to the legal framework, and start with a more remedial and education-focused approach before moving to a system that relies on increased penalties for repeat or egregious violations.

These efforts could be complemented by other strategies to address the transition to formality, including enhanced inter-ministry cooperation and information sharing. Specifically, this could include greater sharing about registration, licensing and permitting (especially of micro enterprises) between the OWS and other government entities such as the MoLVT and NSSF. Enhanced coordination with the MoC and GDT may also be beneficial. These efforts could be accompanied by improving public awareness about formality generally, and the NSSF specifically. Government efforts to encourage formalization could be aided by partnerships with business and worker unions and associations, assistance to help own-account workers develop representative organizations, and enhancements in the role of informal economic actors in social dialogue.

Efforts to formalize informal enterprises and workers should be complemented by efforts to prevent informalization. This can be done in part by providing high quality and timely services. To do this, it is vital that NSSF governance and operations are strong. Transparency measures such as regular disclosures of financial performance and value for money assessments could assist, as could best practice oversight of the pension fund. Finally, these efforts should be complemented by steps to create more formal sector employment, which are at the center of Cambodia's national development strategy.





INTRODUCTION

The formalization of jobs and enterprises is an integral part of Cambodia's socioeconomic development. Formalization can help workers access legal protections and social security, which reduces vulnerability and inequality and helps improve their access to decent work opportunities. It can also enhance enterprises' resilience and job creation by facilitating access to new markets and services, providing greater predictability and enhancing workforce stability. Informality, on the other hand, is characterized by lower productivity, higher poverty and decent work deficits. Furthermore, informal enterprises and workers do not contribute to public revenues, and sometimes engage in unfair competition with formal enterprises.⁵

Informality is a major challenge in Cambodia. About 88 percent of the workforce is engaged in informal employment. Many enterprises are informal. The 2022 economic census found that 87.6 percent of establishments are not registered with the government, which is a key trait of informality. The challenges associated with informality were brought to the forefront by the COVID-19 pandemic, which showed how a lack of social protection and financial relief created major problems for workers and enterprises. This led policymakers to include strengthening social protection and increasing formalization as important components of the Strategic Framework and Programs for Economic Recovery in the Context of Living with COVID-19 in a New Normal 2021-2023, which outlines the post-COVID-19 recovery landscape for the country.

Formalizing workers and enterprises will be a challenge in Cambodia, whose economy has long been heavily informal. For most micro enterprises and own-account workers, the legal and regulatory framework does not require them to register a company or pay income taxes, which are characteristics often associated with formality. Enterprises with at least one employee should register with the Ministry of Labour and Vocational Training (MoLVT) and the National Social Security Fund (NSSF), but compliance is low. Own-account workers can access some social security schemes, but participation is voluntary and not common. Expanding the current requirements for small, medium and large enterprises (SMLEs) to micro enterprises is an option. However, relative costs could be high, and capacity constraints could limit the ability and willingness of micro enterprises to formalize. These challenges are compounded by the generally lower productivity levels of micro

5. ILO, Enterprise Formalization, 2022, <https://www.ilo.org/empent/areas/ef/lang--en/index.htm> [accessed July 13, 2022].

enterprises. Small and medium enterprises (SMEs) face a different legal and regulatory framework than micro enterprises, one with higher compliance burdens and greater and more uncertain costs. While SMEs also face capacity and financial constraints, some sources suggest that they perceive formalization as risky, given the uncertainty and potential costs associated with formalization.

This report provides a guide to formalizing enterprises and employment in Cambodia, including a range of policy options that can be included in an overall strategy for formalization. While the report covers topics relevant to all micro, small and medium enterprises (MSMEs), it focuses on micro enterprises as they are much more likely to be informal than SMEs. Similarly, while topics relevant to all employees are included, the report focuses on own-account workers and micro enterprise employees, who are more likely to be engaged in informal employment.



2.

RESEARCH APPROACH

The research approach for this study combined several different methodologies, including a literature review, a review of Cambodia's legal and regulatory framework, interviews with key stakeholders, a review of quantitative data, and consultative workshops with key stakeholders and parts of the government. The literature review covered the regional and global literature on formalization, which is the basis for the section on international experiences in the report, as well as for the context and past efforts related to formalization in Cambodia. This included a number of background studies completed by the United Nations Development Programme (UNDP) and International Labour Organization (ILO) on subjects related to formalization, including the expansion of social security to informal workers and the country's business registration systems. The country review also covered practices in the implementation of the legal and regulatory framework and reviewed publicly available quantitative data. It further covered the legal and regulatory framework in key areas related to formalization such as enterprise registration, taxation, social security and labour regulations. Lastly, the review covered the authorities and systems responsible for implementing key aspects of the legal and regulatory framework.

To complement the desk review, stakeholder interviews were held with government ministries and other organizations, private enterprises, labour organizations and stakeholders. These interviews covered many of the same topics as the literature review. Most interviews were conducted in May and June 2022, with follow-up meetings held in October 2022. In order to encourage respondents to provide honest views, a full list of interviewees is not included in the report, and many quotes are not attributed to individuals, enterprises or government ministries.

This work, which has been supported by the UNDP and ILO, was developed and implemented in close coordination with the Cambodian government, especially the General Secretariat for the National Social Protection Council (GS-NSPC). The GS-NSPC has been involved throughout the process of writing the report, including in the initial consultation, review of the inception report, review of an early draft of the report, and workshops and stakeholder consultations held in October 2022.



3.

**INFORMALITY:
INTERNATIONAL EXPERIENCES**

Two billion people aged 15 and over work informally, which accounts for some 61.2 percent of global employment. In Southeast Asia, the share is even higher at 78 percent – a percentage that is almost the same for both women and men.⁶ Early thinking on the informal economy often assumed that this traditional part of the economy would, with the right policies and support, be absorbed into the more modern, dynamic part of the economy.⁷ However, as economies developed, informality did not disappear. Instead, it grew alongside the formal economy. Over time, governments began to see informality as “a permanent, not a short-term, phenomenon,” and one that was “associated with both growth and global integration.”⁸

The reasons why individuals and enterprises are informal can vary. Some experts like economist Hernando de Soto argue that the informal economy is full of people that “already possess the entrepreneurial spirit and the capital they need to thrive” but often lack the formal property rights needed to succeed.⁹ These entrepreneurs, many of whom are from developing countries, “do not so much break the law as the law breaks them, and they opt out of the system.”¹⁰ Others have argued that informality is a strategic choice of enterprises and workers who purposefully remain informal to avoid taxes and regulations.¹¹ In practice, there a range of reasons that explain why workers and enterprises are in the informal economy. Despite the motivation, many informal enterprises would welcome lower costs and barriers to formality, and most informal workers would welcome stable jobs and improved workers’ rights associated with formality.¹²

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6. ILO, *Women and Men in the Informal Economy: A Statistical Picture* (third edition), Geneva, 2018, https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_626831.pdf [accessed July 13, 2022].
 7. *Women in Informal Employment, Globalizing and Organizing, History & Debates*, 2022, <https://www.wiego.org/informal-economy/history-debates> [accessed May 22, 2022].
 8. M A Chen, *Rethinking the Informal Economy: Linkages with the Formal Economy and the Formal Regulatory Environment*, UN DESA, Working Paper No. 46, 2007, pg. 2, https://www.un.org/esa/desa/papers/2007/wp46_2007.pdf [accessed May 20, 2022].
 9. G Healy, “Dangerous Minds: Hernando de Soto”, *CatoInstitute.org*, April 14, 2004, <https://www.cato.org/commentary/dangerous-minds-hernando-de-soto> [accessed July 13, 2022].
 10. H De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, 2000, pg. 21.
 11. S Levy, *Good Intentions, Bad Outcomes: Social Policy, Informality, and Economic Growth in Mexico*, 2008, Washington, Brookings Institution Press.
 12. M A Chen, 2007.

3.1 WHAT IS INFORMALITY?

Informality is complex. It includes subsistence work, but also dynamic enterprises. It includes work in traditional sectors such as construction and agriculture, as well as temporary work through digital labour platforms. It includes non-standard wage workers, entrepreneurs and own-account workers. It is not just the part of the traditional economy that consists of low productivity enterprises and subsistence labour. In some cases, informality refers to workers outside of the formal sector. In others, it refers to enterprises that are not, or are not yet, fully formal. Sometimes it is used in reference to a part of the overall economy – such as the “informal economy” or “informal sector”. These varying conceptions are not surprising – informality is a diverse concept that can cover many different types of actors and can have multiple different motivations. This section reviews the many closely related concepts around informality and provides guidance on how they will be used in this report.

The ILO has defined the term “informal economy” as “all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.”¹³ While this definition covers a significant share of the economy, it purposefully excludes illicit activities, including but not limited to

Informal economy: “all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements.”

International Labour Organization

goods forbidden by law, illicit production and trafficking of drugs, illicit manufacturing and trafficking of firearms, trafficking in person and money laundering. The above definition introduces the concept of “economic units”, which includes (1) units that employ hired labour; (2) units that are owned by individuals working on their own account, either alone or with the help of contributing family workers;

13. ILO, Recommendation 204 concerning the Transition from the Informal to the Formal Economy, 2015, https://www.ilo.org/ilc/ILCSessions/previous-sessions/104/texts-adopted/WCMS_377774/lang--en/index.htm [accessed July 13, 2022].

and (3) cooperatives and social and solidarity economy units.¹⁴ Informal employment is defined as the “total number of informal jobs, whether carried out in formal sector enterprises, informal sector enterprises, or households; including employees holding informal jobs; employers and own-account workers employed in their own informal sector enterprises; members of informal producers’ cooperatives; contributing family workers in formal or informal sector enterprises; and own-account workers engaged in the production of goods for own end use by their household.”¹⁵

3.2 THE CHALLENGES OF INFORMALITY

Informality presents a range of challenges for workers, businesses, governments and society, but perhaps none is as important as the decent work deficits associated with informality. On average, workers in the formal sector earn 19 percent more than workers in

There is a clear link between informality and poverty, with many working poor being employed in the informal sector. This highlights the need for inclusion and investment in education and skills, especially for the poor.

the informal economy, and in some countries this can be greater.¹⁶ There are a number of reasons why informal workers earn less, including segmented labour markets, self-selection into informality, and characteristics of informal workers such as a generally lower level of skills compared to formal workers.¹⁷ Notably, some studies have found that the differences between formal and informal sector incomes are largely due to workforce characteristics (e.g.,

14. ILO, *Measuring Informality: A statistical manual on the informal sector and informal employment*, 2013, Geneva, https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_222979.pdf [accessed July 13, 2022].

15. ILO, *Measuring Informality: A statistical manual on the informal sector and informal employment*, 2013, Geneva, pg. 37-38, https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_222979.pdf [accessed May 22, 2022].

16. E El Badaoui, E Strobl and F Walsh, 'Is There an Informal Employment Wage Penalty? Evidence from South Africa,' 2008, *Economic Development and Cultural Change*, University of Chicago Press, vol. 56(3), pg. 683-710, April 2008.

17. N Loayza, 'Informality: Why Is It So Widespread and How Can It Be Reduced?', 2018, *Research & Policy Brief 20*, World Bank, Kuala Lumpur, Malaysia; G E Perry et al. *Informality: Exit and Exclusion*, 2007, Washington, DC: World Bank; and F Ohnsorge and S Yu, eds. *The Long Shadow of Informality: Challenges and Policies*, 2019, Washington: World Bank.

education, skills, etc.) and not an earnings penalty for working informality.¹⁸ There is a clear link between informality and poverty, with many working poor being employed in the informal sector.¹⁹

The decent work deficits in the informal sector are not just limited to lower incomes but are also evident in other areas. Workers in the informal economy are less likely to enjoy labour rights or access to social security. The ILO has previously noted this, stating that “gaps in social protection coverage are often associated with high levels of informality that hold back decent work and socio-economic development.”²⁰ They also tend to face worse working conditions. Informal workers are more likely to be exposed to noise, dust, fumes or vibrations.²¹ Job satisfaction data, which is often used to assess vulnerability at work, from a small number of countries points to a satisfaction gap of five to 27 percent between formal and informal workers.²² Women in the informal economy are often particularly vulnerable not just to poor working conditions, but also to discrimination.

Informality presents a range of challenges for workers, businesses, governments and society, but perhaps none of those challenges is as important as the decent work deficits that are closely associated with informality.

Informality is not just a challenge for workers, however. It can also present challenges for enterprises. Wages and productivity share a close link, so it is not surprising that the productivity of informal enterprises is lower than that of formal enterprises. The productivity gap varies by country, but a literature review found that it ranges

18. World Bank, *Global Economic Prospects: Darkening Skies*, 2019, Washington, DC: World Bank.

19. ILO, *Women and Men in the Informal Economy: A Statistical Picture* (third edition), 2018, Geneva, https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_626831.pdf [accessed July 13, 2022].

20. ILO, *World Social Protection Report 2020-22: Social protection at the crossroads – in pursuit of a better future*, 2021, Geneva, pg. 49, https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/@publ/documents/publication/wcms_817572.pdf [accessed May 21, 2022].

21. OECD and ILO, *Tackling Vulnerability in the Informal Economy*, 2019, pg. 76, <https://doi.org/10.1787/939b7bcd-en> [accessed July 13, 2022].

22. Ibid.

from between 30 to 216 percent.²³ Another study found that “labor productivity at the average informal firm in emerging market and developing economies is only one-quarter of that of the average firm operating in the formal sector.”²⁴ There are numerous reasons for this, including the fact that informal enterprises:

- Use less advanced technologies;
- Rely more on unskilled labour;
- Have limited economies of scale; and
- Have less access to services, markets and funding.²⁵

Besides productivity, enterprises in the informal economy also face a number of other challenges, including a lack of legal protection, limited access to financial and business development services, limited relief support from government, and limited access to business opportunities in the formal economy.

Informality presents additional challenges for decent job creation, sustainable economic development and government revenues. Informal enterprises tend to pay very little, if any, direct taxes, thereby depriving the government of revenues. Government revenues in emerging markets and developing economies with higher informality were five to 12 percentage points of GDP less than those with lower informality.²⁶ The types of taxes also differed. Economies with higher levels of informality relied more on trade taxes, which are less progressive but easier to collect. The lack of revenues also inhibits the development of institutions and access to relevant services for the wider public.

Another major challenge of informality is that it creates unfair competition between enterprises in the formal and informal sector. Some informal enterprises can gain an unfair advantage by avoiding their legal obligations, gaining market share and harming formal enterprises that abide by the law. This phenomenon can be seen in enterprise survey data which shows that the growth rate of

23. F Ohnsorge and S Yu, eds. 2021.

24. Ibid, pg. 137.

25. Ibid.

26. Ibid.

employment in formal firms declines significantly as competition from informal firms intensifies.²⁷ Notably, the negative impact on employment growth at formal enterprises is “much larger when the business environment is less conducive to operating formally versus informally due to factors such high corruption, weak rule of law, more burdensome regulations, and high profit tax rate.”²⁸ This can have a negative impact on the development of sustainable, resilient and compliant enterprises.

3.3 ADDRESSING INFORMALITY: INTERNATIONAL EXPERIENCES

Because informality is a complex challenge, addressing it requires a broad range of integrated actions implemented over many years. While the specific steps and priorities vary according to local circumstances, there is a growing consensus that “supporting informal enterprises and improving informal jobs are [...] key pathways to promoting growth and reducing poverty.”²⁹

At the country level, informality is associated with a number of negative characteristics. Informal employment has been shown to have a negative association with gross domestic product, the Human Development Index and labour productivity and a positive association with poverty.³⁰ However, the relationship between formality and the performance of individual enterprises is not always as clear. Some studies have found that formality is associated with higher worker pay and improved firm performance. Several experimental studies have shown that registering and becoming formal can have a small effect on performance,³¹ while many non-experimental studies have found positive effects.³² A study conducted in Vietnam

27. M Amin, Does Competition from Informal Firms Hurt Job Creation by Formal Firms? Evidence Using Firm-Level Survey Data, Policy Research Working Paper No. 9515, 2021, World Bank, Washington, DC, Abstract, <https://openknowledge.worldbank.org/handle/10986/35029> [accessed May 18, 2022].

28. Ibid.

29. M A Chen, 2007, pg. 1.

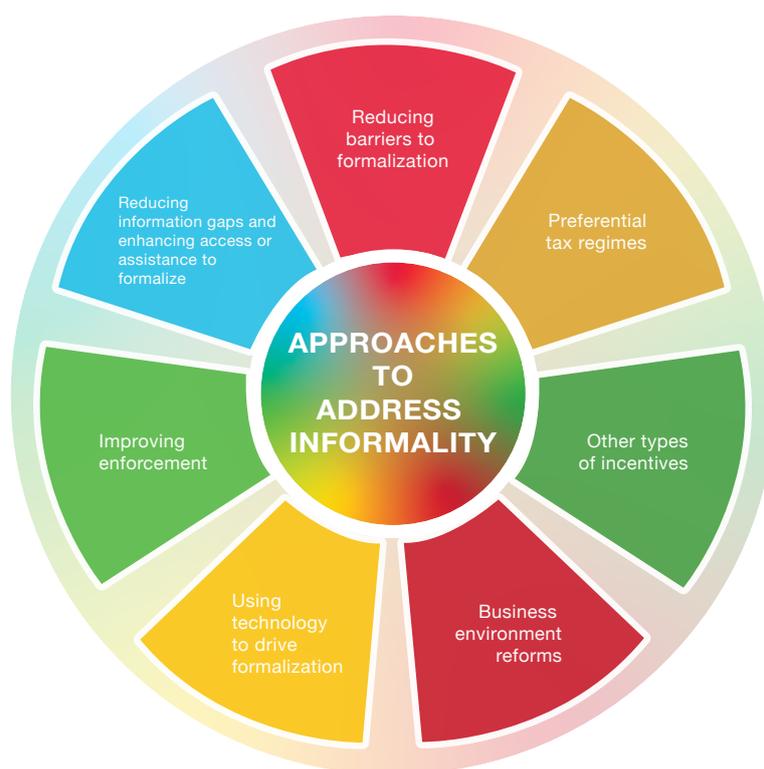
30. OECD/ILO, Tackling Vulnerability in the Informal Economy, Development Centre Studies, 2019, OECD Publishing, Paris, <https://doi.org/10.1787/939b7bcd-en> [accessed July 18, 2022].

31. S De Mel, D McKenzie and C Woodruff, ‘The Demand for, and Consequences of, Formalization Among Informal Firms in Sri Lanka,’ National Bureau of Economic Research, Working Paper No. 18019, 2012, https://www.nber.org/system/files/working_papers/w18019/w18019.pdf [accessed July 17, 2022]; G De Giorgi and A Rahman: ‘SME’s registration: evidence from an RCT in Bangladesh,’ *Econ. Letters* Vol. 120(3), 2013, pg. 573–578; and N Benhassine et al., ‘Does Inducing Informal Firms to Formalize Make Sense? Experimental Evidence from Benin,’ *Journal of Public Economics* 157 (1), 2018, pg. 1-14.

32. See, for example: D McKenzie and Y Sakho, ‘Does it pay firms to register for taxes? The impact of formality on firm profitability,’ *Journal of Development Economics* Vol. (1), 2010, pg. 15–24; and P Fajnzylber, W F Maloney, and G W Montes-Rojas, ‘Does Formality Improve Micro-Firm Performance? Evidence from the Brazilian SIMPLES Program,’ *Journal of Development Economics*, Vol. 94, 2011, pg. 262-276.

demonstrated that an increase in social security coverage resulted in increased revenues per worker and increased profits.³³ A similar finding emerged from a study in Indonesia, where the provision of social security had a positive effect on SMEs' performance. Here, a 10 percent increase in social security contributions increased per worker revenue by two percent.³⁴ However, other studies have found no evidence of formalization benefits, for example for household businesses in Vietnam.³⁵ A literature review by the World Bank argued that “most informal firms appear not to benefit on net from formalizing.”³⁶

Figure 1. Potential areas for reform to address informality



33. S Lee, and N Torm, 'Social Security and Firm Performance: The Case of Vietnamese SMEs'. *International Labour Review* 156 (2), 2017, pg. 185–212, <https://doi.org/10.1111/j.1564-913X.2015.00054.x> [accessed July 18, 2022].
34. N Torm, 'To What Extent Is Social Security Spending Associated with Enhanced Firm-Level Performance? A Case Study of SMEs in Indonesia,' *International Labour Review* 159 (3), 2020, pg. 339–66, <https://doi.org/10.1111/ilr.12155> [accessed July 18, 2022].
35. B McCaig, and J Nanowski, Business formalisation in Vietnam. *Journal of Development Studies*, 55(5), 2019, pg. 805-821.
36. M Brunh and D McKenzie, 'Entry Regulation and Formalization of Microenterprises in Developing Countries', World Bank Policy Research Working Paper N. 6507, 2013, Abstract, <https://openknowledge.worldbank.org/bitstream/handle/10986/15866/WPS6507.pdf?sequence=1&isAllowed=y> [accessed July 15, 2022].

3.3.1. Reducing barriers to formalization

One of the most common approaches to addressing informality is to remove barriers that make it more difficult for enterprises and workers to formalize. These steps, often referred to as “cutting red tape”, aim to eliminate unnecessary or redundant documentation and procedures, reducing the time and financial costs of starting a formal enterprise and remaining compliant while operating.³⁷ For example, Benin was one of the first countries in West Africa to introduce a new status called the *entrepreneur*, which was designed for micro and small enterprises (MSEs).³⁸ The registration process is easy, free of charge and takes only one business day. It also registers the MSEs for taxes.³⁹ Numerous studies have been conducted on whether reducing barriers increases formalization. Studies have found that they can, but that individual reforms aiming to increase registrations need to reduce registration costs by at least half to significantly increase the number of registered businesses.⁴⁰ In some cases, such as in Indonesia, major programmes to reduce registration costs have not had any effect on informality.⁴¹

37. E Gaarder and J van Doorn, *Enterprise Formalization: Simplifying and facilitating business start-up and compliance*, Thematic Brief 2/2021, Geneva: ILO, 2021, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_767328.pdf [accessed July 14, 2022].

38. World Bank, ‘Promoting Business Registration with Entrepreneur Status in Benin,’ 2019, <https://www.worldbank.org/en/programs/competitiveness-policy-impact-evaluation-lab/brief/benin-impact-evaluation-of-the-entrepreneur-status> [accessed July 18, 2022].

39. D McKenzie, *Targeting which informal firms might formalize and bringing them into the tax system*, World Bank Development Impact Blog, February 6, 2017, <https://blogs.worldbank.org/impactevaluations/targeting-which-informal-firms-might-formalize-and-bringing-them-tax-system> [accessed July 15, 2022].

40. K Van Elk and J de Kok, ‘Enterprise formalization: Fact or fiction? A quest for case studies,’ 2014, Geneva: International Labour Office and Deutsche Gesellschaft für Internationale Zusammenarbeit.

41. A D Rothenberg et al., ‘Rethinking Indonesia’s Informal Sector,’ 2016, *World Development*, Volume 80, pp. 96-113, <https://doi.org/10.1016/j.worlddev.2015.11.005> [accessed July 17, 2022].

Box 1. One-stop shops

A one-stop shop is an “organization that (a) receives documents for business registration and (b) also carries out at least one other function related to business start-up.” The most common other function carried out at one-stop shops is tax registration. Sometimes, as is the case in Finland, both of these processes can be done by using a single form. Some one-stop shops are physical, while others are online. The purpose of a one-stop shop is to make it more convenient for enterprises to get started. International evidence suggests that there is a relationship between one-stop shops and the ease of starting a business. Countries with one-stop shops on average had 6.1 procedures that took 19 days, while countries without one-stop shops on average had 9.3 procedures that took 46 days. The implementation of one-stop shops can help encourage enterprise formalization. In Mexico, the start of one-stop shops increased registration among enterprises with characteristics similar to those of formal businesses by 15 percent.

Source: IFC, ‘How Many Stops in a One-Stop Shop? A Review of Recent Developments in Business Registration,’ 2009, Washington: World Bank Group, pg. 1, <https://openknowledge.worldbank.org/bitstream/handle/10986/27886/587870WP0Howma10BOX353819B01PUBLIC1.pdf?sequence=1&isAllowed=y> [accessed July 18, 2022]; and M Brunh and D McKenzie, 2013.

Reducing barriers to formalization is a multi-step process, which starts with documenting the procedures, making this information public, identifying bottlenecks and then creating a reform agenda with identified priorities.⁴² Common inefficiencies that have been identified in these processes include: prospective enterprises having to provide the same information on multiple documents to multiple different government agencies; unclear procedures that force enterprises to waste time trying to determine what is required; and government departments or officials that are not aware of the requirements or processes of other departments and the interaction between these requirements which can compound the challenges of formalization.⁴³ Many countries have taken steps to improve start-up processes including:

- Eliminating minimum capital requirements;
- Eliminating or combining procedures;
- Reducing the formal fees charged by government for starting a business;

42. E Gaarder and J van Doorn, 2021.

43. Ibid.

- Making licensing automatic, with verification of eligibility and compliance taking place afterwards; and
- Improving intra-governmental coordination in the start-up process, including through combining procedures or the use of one-stop shops (see Box 1).⁴⁴

3.3.2. Preferential tax regimes

Taxes are often one of the primary reasons that firms remain in the informal economy. Enterprises often struggle to comply with the tax system if “it is too complex, expensive, opaque, or perceived to be unfair.”⁴⁵ Reducing the tax burden on small enterprises can increase the number of firms registering for taxation.⁴⁶ Similarly, reforms to streamline and improve tax administration have made it more likely for firms to register for taxation.⁴⁷ Tax reforms should include the full breadth of taxes, not just those on income. In some countries, other types of taxes have been cited as the most challenging and costly for enterprises, such as the value added tax (VAT) in South Africa, which enterprises perceived as the most excessive cost they faced in tax compliance.⁴⁸

Tax incentives have previously been shown to be a particularly effective type of intervention.⁴⁹ Often, tax-related incentives take the shape of a special tax regime, adopted to help encourage entrepreneurs and MSMEs to formalize. These regimes can potentially cover the costs of formalization. Some but not all preferential tax regimes include a social security component through which enterprise owners and workers gain access to social protection based on the payment of social security contributions that are tailored to their payment capacities.⁵⁰ Different types of

44. Ibid.

45. W Nielsen and S White, 'Dealing with Firm Informality,' Donor Committee for Economic Development, November 2021, pg. ii, <https://www.enterprise-development.org/wp-content/uploads/DCED-BEWG-Dealing-With-Firm-Informality-Final.pdf> [accessed July 17, 2022].

46. P Fajnzylber, W F Maloney, and G W Montes-Rojas, 2011.

47. S White and P Fortune, Business Environment Reform and Poverty: Rapid Evidence Assessment, 2015, London: Coffey International Development.

48. Y Naicker and R Rajaram, 'Factors that Influence Tax Compliance of SMEs in South Africa,' April 2019, https://www.researchgate.net/publication/332318084_Factors_that_Influence_Tax_Compliance_of_SMEs_in_South_Africa [accessed July 17, 2022].

49. J Jessen and J Kluge, 'The effectiveness of interventions to reduce informality in low- and middle-income countries,' World Development, Elsevier, vol. 138(C), 2021, <https://ideas.repec.org/a/eee/wdevel/v138y2021ics0305750x20303831.html> [accessed July 17, 2022].

50. List adapted from M Marchese, 'Preferential Tax Regimes for MSMEs: Operational aspects, impact evidence, and policy implications,' 2021, Geneva: ILO, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_803925.pdf [accessed July 17, 2022].

preferential tax regimes have been adopted in Asia, Africa and especially Latin America. While each tax regime is unique, there are some characteristics that are shared by multiple systems, which include:

- (1) Allowing businesses to calculate their tax liability without having a complete set of accounts. Instead, they use another, easy-to-observe factor such as turnover or number of employees as the basis for determining tax owed. This type of system is often targeted at micro enterprises or entrepreneurs, with the goal of encouraging them to formalize.⁵¹
- (2) Giving businesses a discount on statutory tax rates. This type of system normally applies to businesses that are registered as a separate legal entity.
- (3) Allowing some types of businesses and individuals to pay a lump-sum tax.
- (4) Having more simple compliance requirements, such as rolling multiple payments or compliance forms into one, or allowing businesses to file and pay taxes less frequently.
- (5) Providing exemptions from paying other types of taxes, such as local taxes or excise taxes.

51. Ibid.; note that “turnover-based presumptive regimes are often confined to similar business activities (e.g., personal services), while when they apply to the whole economy, sector coefficients should be used to take into consideration different average profitability ratios across different sectors.”

Box 2. Examples of preferential tax regimes for micro and small enterprises

Preferential regimes with a social security component:

Brazil: The Simples Nacional regime was introduced in 2006 and simplified the administrative and tax burdens of MSEs. It is only open to enterprises conducting certain economic activities, assuming they do not exceed the turnover threshold. It allows MSEs to file a single annual simplified tax declaration, and pay a monthly monotax with variable rates, based on total turnover. It also exempts them from paying additional federal social security contributions and reduces some other fiscal obligations. It further allows MSEs to enjoy simplified registration procedures and regulations (in some areas).

Self-employed people or employers with no more than one employee who earn less than approximately \$15,000 a year (81,000 Brazilian real) can participate in the Micro Empreendedor Individual (MEI) scheme. The MEI is a special scheme within the Simples Nacional regime. The MEI scheme combines many different payments into a single, lower monthly payment, which can be done online. The goal is to help micro entrepreneurs formalize, and comes with tax benefits including:

- A fixed monthly payment for state and municipal taxes (not variable rates);
- Exemptions from federal taxes; and
- Social security contributions, set at five percent of the minimum wage.

In 2020, 11 million enterprises in Brazil operated under this tax system.

Mexico: *Régimen de Incorporación Fiscal* is a tax system for small businesses that do not employ any college graduates and whose annual income is less than \$100,000. The main advantage is that enterprises receive a discount on taxes that decreases over time. In the first year, they receive a 100 percent discount on income taxes and VAT and a 50 percent discount on social security payments. The discount on income taxes and VAT decreases by 10 percent per year, while the discount on social security contributions decreases by 10 percent every other year. After ten years, both discounts decline to zero. Enterprises under this system also get a simplified schedule of VAT rates and can fill out tax returns every other month, instead of every month. They can additionally receive preferential access to subsidized credit and training programmes.

Uruguay: Eligible small businesses can choose between paying a monotax on their revenues or paying the ordinary taxes and social security contributions. Enterprises that elect the monotax regime make payments to the Uruguayan Social Security Institute, which then transfers the tax share of the contributions to the tax authorities while retaining the social security share of the payment.

Preferential regimes without a social security component:

Zambia: A turnover-based tax, with a three percent rate, is used for individuals and small enterprises with annual turnover of up to \$50,000 (200 million Zambian kwacha).

Ghana: The country has a lump-sum tax that applies to vehicle operators, such as informal taxi drivers. The tax is based on the type and size of vehicle, and ranges from \$1 to \$20 per month. The tax is collected every three months. It has a high compliance rate of 85.5 percent.

Vietnam: The 2018 SME Support Law sets the commercial income tax rate at 15 percent for micro enterprises and 17 percent for SMEs, which is lower than the general rate of 20 percent.

Malaysia: SMEs with paid-up capital of less than 2.5 million Malaysian ringgits (approximately US \$563,000) pay a corporate income tax rate of 17 percent, in comparison with 18 percent for other enterprises. New SMEs are exempt from estimated tax payments for two years.

Source: OECD, SME and Entrepreneurship Policy in Viet Nam, OECD Studies on SMEs and Entrepreneurship, 2021, OECD Publishing, Paris, <https://doi.org/10.1787/30c79519-en> & Malaysia's SMEs Tax Rate (<https://www.paulhy-pepage.my/guide-faq/malaysia-smes-tax-rate-2021/>); ILO, 'Simples Nacional: Monotax Regime for Own-Account Workers, Micro and Small Enterprises: Experiences from Brazil,' 2019, Geneva, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_715864.pdf; and E Gaarder et al., 'Enterprise formalization: Tailored registration, tax, and social security requirements for MSEs,' 2021, ILO, Thematic Brief 3/2021, pg. 9, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_767329.pdf [accessed July 18, 2022]

In many countries, there is evidence that preferential tax regimes encourage formalization. Of course, the experiences of each country are different, and the success or failure of the regime depends on both its design and the local context. Key general and country-specific findings include:

- The benefit of a preferential tax regime can sometimes be a one-off, as the “increased number of enterprise registrations or business tax payments stabilizes after a relatively short period of time from the introduction of the policy.”⁵² In Brazil, enrollment in the MEI tax regime increased the number of formal firms by 4.3 percent from 2009 to 2012, but almost all of these gains came in the first six months that the policy was introduced.⁵³
- When preferential tax regimes include access to social security, it can provide an important incentive to formalize. For example, nearly one third of enterprises in Brazil stated that “social security” was the reason that they registered under the MEI scheme.⁵⁴
- Many enterprises that formalized through a preferential tax regime had business practices that close to those of enterprises in the formal economy.⁵⁵ As such, these preferential regimes may be less effective among informal enterprises that operate at the subsistence level.
- Some preferential tax regimes showed sustained participation over time. In Brazil, the total number of enterprises participating in the MEI scheme increased from 5.5 million in 2005 to 11.3 billion in 2020, and 60 percent of informal entrepreneurs that started participating remained enrolled four years after initial registration.
- There is mixed evidence that businesses avoid growing to remain eligible for preferential tax systems. There is very little sign of this among programmes aimed at self-employed and micro entrepreneurs, though these effects are more evident in regimes that have a larger difference between the preferential and mainstream tax rates, as well as those with size-contingent labour regulations.⁵⁶

52. M Marchese, 2021, pg. 19.

53. M Marchese, 2021, pg. 14.

54. E Gaarder et al., ‘Enterprise formalization: Tailored registration, tax, and social security requirements for MSEs,’ 2021, ILO, Thematic Brief 3/2021, pg. 9, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_767329.pdf [accessed July 18, 2022].

55. M Marchese, 2021.

56. M Marchese, 2021.

- Preferential tax regimes gain higher participation if they offer a more attractive fiscal package compared to the mainstream tax regime.

Overall, international experience shows that while preferential tax regimes can help encourage the formalization of some enterprises, they are not meant to be a universal solution. Instead, they can be used as one policy among many in an integrated framework. They should be included in the broader set of institutional policies that, along with structural changes in the economy, are needed to make major advances in formalization.⁵⁷ They can also potentially have a negative effect on tax equity and government revenues, so it is vital that preferential tax regimes are carefully designed given existing systems and local circumstances.

3.3.3. Other types of incentives

According to evidence from international experience, other incentives, including but not limited to government services, can help improve the prospects of enterprise formalization. In this section, these incentives are more narrowly defined as rewards that businesses receive. Unfortunately for enterprises, formalization in developing countries often does not result in more government services such as improved infrastructure, more stable electricity or enhanced waste management.⁵⁸ However, there are numerous examples of incentives from international experience, such as:

- **Incentives to conduct business with formal enterprises:** Registered enterprises in some countries are provided with an incentive to encourage them to trade with other formal enterprises. These enterprises are allowed to write off the costs of inputs from formal enterprises for the purposes of VAT, whereas they cannot do this with informal enterprises. This provides an incentive for them to conduct business with newly formalized enterprises. Cambodia and almost all other countries with a VAT have this type of incentive in their taxation structure.

57. J Chacaltana and V Leung, 'Pathways to formality: Comparing policy approaches in Africa, Asia and Latin America', in D Kucera and D Schmidt-Klau (eds.), *Global Employment Policy Review 2020: Employment Policies for Inclusive Structural Transformation, 2020*, International Labour Office, Geneva, https://www.ilo.org/employment/Whatwedo/Publications/WCMS_734489/lang--en/index.htm [accessed December 5, 2022].

58. ILO, 'Policies, Strategies and Practices for the Formalization of Micro and Small Enterprises,' 2016, Geneva, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_533204.pdf [accessed July 17, 2022].

- **Monetary incentives:** Direct financial incentives to register can sometimes encourage formalization, although evidence is mixed and depends on the context and incentive size. In Sri Lanka, one study on registration incentives found that an incentive equal to the direct costs of registration did not have any effect on registration rates.⁵⁹ However, when offered payments, the share of enterprises that registered increased. When offered an incentive equal to about half a month of the enterprise's median profit, 17 per cent of eligible firms register. This jumps to 48 per cent when offered two months of median profits. Similarly, other studies testing an incentive equal to the cost of registration for informal enterprises in Brazil found no negative impacts on rates of registration.⁶⁰ As such, "the evidence is cautious around the extent incentives boost registration" and therefore formalization.⁶¹
- **Access to public procurement:** Informal enterprises are often ineligible to participate in public procurement, as is the case in Indonesia and many other countries.⁶² Making public procurement systems easily accessible to newly formalized businesses could encourage formalization. This can be done through simplified procedures, smaller lots, quotas, payment deadlines and capacity building for government officials, among other measures.⁶³ In Colombia, for example, MSMEs receive support and some preferences in public procurement, including a tie-breaker that awards the tender to a MSME in the event of a tie. Colombia has also made special efforts to invite MSMEs to participate in tenders, as well as efforts to disseminate regulations and support MSMEs in the tendering process. They have a public procurement handbook for MSMEs and have conducted workshops on it throughout the country.⁶⁴

59. S De Mel, D McKenzie and C Woodruff, 'The Demand for, and Consequences of, Formalization Among Informal Firms in Sri Lanka,' National Bureau of Economic Research, Working Paper No. 18019, 2012, https://www.nber.org/system/files/working_papers/w18019/w18019.pdf [accessed July 17, 2022].

60. G Henrique de Andrade, M Bruhn and D McKenzie, 'A helping hand or the long arm of the law? Experimental evidence on what governments can do to formalize firms,' World Bank Economic Review Vol. 30 (1), 2013, pp. 24–54.

61. W Nielsen and S White, 2021, pp. 24.

62. N McCulloch, G Schulze, and J Voss, 'What Determines Firms' Formalization Decisions: Empirical Evidence from Rural Indonesia,' 2009, https://www.econstor.eu/bitstream/10419/39920/1/32_schulze.pdf [accessed July 17, 2022].

63. ILO, 'Enterprise Formalization,' January 2017, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_544828.pdf [accessed July 17, 2022].

64. ILO, 'Policies for the formalization of micro and small enterprises in Colombia,' 2014, https://www.ilo.org/wcmsp5/groups/public/---americas/---ro-lima/documents/publication/wcms_318211.pdf [accessed July 17, 2022]

- **Access to financial services:** The lack of access to financial services, especially credit, is one of the most common challenges for informal enterprises. Globally, 70 to 80 percent of informal MSMEs have no access to credit but need credit.⁶⁵ Banks and other formal financial service providers typically require proof of business registration, as do most government-led financing schemes. Preferential loan programmes for MSEs could provide an additional incentive for formalization. It is important that these programmes are both accessible and highly competitive with other sources of credit. In Chile, the state-owned bank BancoEstado Microempresas supported customers to formalize their businesses by providing information and training on the respective procedures. Depending on the type of training support attended, informal enterprises could become eligible to receive financing. Whether they could access a second loan, increase an existing loan or obtain other financial products was conditional upon progress in the formalization process.⁶⁶ Guarantees may increase accessibility and reduce the risk of indebtedness among clients.
- **Access to new markets or clients:** Large enterprises typically require some degree of formality from their suppliers. Creating business linkages between smaller and larger enterprises may help facilitate formalization and business growth among MSEs. Public and private sector-led initiatives may be considered in this regard. In Georgia, certification and access to business opportunities in the private sector incentivized small businesses to formalize. These certifications helped increase the benefits of formality by improving market access and attracting new, formal sector clients.⁶⁷ In Chile, the direct involvement of larger enterprises in providing market access can be a strong formalization incentive for smaller enterprises. In the context of a public private partnership, a multinational company established a supplier development programme which focused on improving the competitiveness and

65. ILO, 'Role of Finance in Driving Formalization of Informal Enterprises,' Thematic Policy Brief – Enterprise Formalization, 2016 https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_533200.pdf [accessed July 17, 2022].

66. ILO, 'Progressive Access to Finance and Support to Encourage Enterprise Formalization: Experiences from Egypt and Chile,' Case Study 1/2021, 2021, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_821977.pdf [accessed July 18, 2022].

67. ILO, 'Certification and access to markets as an incentive to formalize: Experiences from Georgian dairy producers and farmers,' Case Study 3/2021, 2021, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_824828.pdf [accessed July 17, 2022].

professionalism of SMEs, enabling selected firms to become its suppliers. After a year, participating SMEs improved their level of compliance by 25 percent on average.⁶⁸

- **Access to business services:** Some government and non-government business development services are only available to formal enterprises. These services can include training, consulting, advising, coaching and guidance on business decisions, among other services. In India, one study found that these services are linked to an increase in formalization as well as improved business practices in areas such as accounting and market and business expansion.⁶⁹ As such, providing access to these services for formal enterprises may incentivize formalization.

3.3.4. Business environment reforms

Business registration and taxation reforms are some of the most common approaches to address informality, but other types of business environment reforms can also influence an enterprise's decision to formalize. One such area is the labour law framework, where reforms have been shown to have a connection to the formality of employment and enterprises. Depending on the country's existing legal and regulatory framework, labour laws can be a challenge for enterprises – though this depends on the degree of implementation and levels of compliance and productivity. In some countries and sectors, enterprises have noted that labour laws are a major challenge.⁷⁰

The costs and burdens associated with complying with labour laws and regulations can limit employment growth in certain conditions, and their reduction can sometimes benefit enterprises and encourage employment growth. As such, the overarching goal for reforms to labour laws and regulations should be to increase the protections enjoyed by workers, while at the same time encouraging informal firms to adopt formal employment practices

68. ILO, 'Promoting Business Linkages with Small Enterprises as an Incentive to Formalize: Experiences from Chile,' Case Study 2/2021, 2021, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_824823.pdf [accessed July 18, 2022].

69. ILO, 'Microfinance and Enterprises' Formalisation: An impact study from ESAF's (India) microfinance innovation,' Microfinance for Decent Work, Working Paper No. 59, 2014, <https://www.ilo.org/public/libdoc/ilo/2014/489495.pdf> [accessed December 3, 2022].

70. G Hampway and S Jeppesen, 'The role of state-business relations in the performance of Zambia's food processing sub-sector,' December 2014, https://www.bulletinofgeography.umk.pl/26_2014/06_Hampwaye.pdf [accessed July 17, 2022]

and eventually formalize.⁷¹ The general trend in developing countries is towards the expansion of social security for workers, including informal and own-account workers, regardless of enterprise size.⁷² These strengthened safety nets, alongside well-designed worker protections and worker representation, should be combined with the flexibility enterprises need to be competitive (such as retrenchment or minimum wage laws that are dissuasive but not punitive). This balance, if struck, can help expand formal employment.⁷³ This can help address the role that labour regulations play in influencing firm's decisions about formalization, as has been seen in Latin America.⁷⁴

Other areas of reform sometimes associated with formalization include property rights and access to land. This is connected to the ability of informal enterprises to use land titles and other assets to access finance. However, these reforms can be challenging and costly and the impact on formalization is both indirect and unclear.⁷⁵ Lastly, reforms that improve the enabling environment for digitalization may also help facilitate formalization if they can help enterprises improve their productivity.

3.3.5. Reducing information gaps and enhancing access or assistance to formalize

Informal enterprises often have limited knowledge or misconceptions about the formalization process and the costs and benefits associated with it. A survey of informal enterprises by the World Bank found that 29 percent of small firms cited the lack of information on registration requirements and procedures as the primary reason for not registering.⁷⁶ Studies on the effects of information sharing on formalization have shown mixed results. A study in Sri Lanka found that sharing information about the registration process did not have a direct effect on formalization, even if the registration costs were

71. W Nielsen and S White, 2021.

72. A M Vargas, 'Applying Labour Law to Micro, Small and Medium-Sized Enterprises: A comparative study of 16 countries,' ILO Working Paper 9, October 2020, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_757271.pdf, [accessed July 19, 2020].

73. G Perry et al., *Informality: Exit and Exclusion*, Washington: World Bank, 2007, pg. 15, [https://openknowledge.worldbank.org/bitstream/handle/10986/6730/400080Informal 101OFFICIAL0USE0ONLY1.pdf?sequence=1&isAllowed=y](https://openknowledge.worldbank.org/bitstream/handle/10986/6730/400080Informal%20101OFFICIAL0USE0ONLY1.pdf?sequence=1&isAllowed=y) [accessed July 17, 2022].

74. Ibid.

75. S White and D Alyward, 'Formalization of smallholder agriculture and agri-business,' Department for International Development, Discussion Paper, 2016, <https://www.gov.uk/research-for-development-outputs/formalisation-of-smallholder-agriculture-and-agri-business> [accessed July 18, 2022].

76. ILO, 2016.

reimbursed.⁷⁷ Another study in Colombia found that information on registration only had a short-run impact on formalization, with many enterprises letting their registration lapse.⁷⁸ These findings have been echoed in other studies.⁷⁹ However, some studies have found that information conveyed by trained staff in person is more effective than just sharing written material.⁸⁰ Promoting knowledge and raising awareness are an important part of a broader approach to addressing informality.⁸¹ Given this information deficit, efforts to simplify the requirements and processes, including but not limited to one-stop shops, may help facilitate enterprise registration.⁸²

Promoting knowledge and raising awareness are an important part of a broader approach to addressing informality, and an “important component to combine with other interventions.”

Another type of intervention, closely related to information sharing, is to directly assist firms in the process of registration and formalization. A number of studies have shown that this direct assistance can help to increase formalization. For example, in Benin, a study compared different types of assistance in the registration process:

1. Package A involved advisers visiting informal enterprises, sharing information on the benefits of formalizing through a special micro enterprise programme and providing three leaflets on registration and tax. The advisors would also help entrepreneurs with the formalization process, by assisting

77. S De Mel, D McKenzie, and C Woodruff, 2012.

78. S Galiani, M Meléndez and C Navajas, 'On the effect of the costs of operating formally: new experimental evidence,' *Labour Economics* Vol. 45, 2017, pg. 143–157.

79. M Bruhn and D McKenzie, 2018; Fajnzylber and Montes-Rojas, 2011; M Bruhn, 'License to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico,' *The Review of Economics and Statistics* 93 (1), 2011, pg. 382-86; S De Mel, D McKenzie, and C Woodruff, 2012; and D S Kaplan, E Piedra and E Seira, 'Entry Regulation and Business Start-Ups: Evidence from Mexico,' *Journal of Public Economics* 95 (11-12): 2011, pg. 1501-15.

80. G Henrique de Andrade, M Bruhn and D McKenzie, 2013; S De Mel et al., 2013; Benhassine et al., 2018.

81. J Jessen and J Kluge, 2021.

82. L Deelen (ed.), 'Políticas para la formalización de las micro y pequeñas empresas en América Latina,' 2015, Santiago: International Labour Office.

them with filling in declarations and preparing all required documents.

2. Package B included the services in Package A, as well as training courses at the enterprise and additional, optional courses on accounting, management and other areas. These enterprises were also supported to open a bank account and advised on how to use it.
3. Package C included assistance in preparing tax forms and offered mediation services for any future tax disputes.⁸³

The study found that all of these interventions were effective, increasing formalization by 9.6 percent, 13.0 percent and 16.3 percent respectively. However, the costs to formalize a business using these interventions ranged from \$1,237 to \$2,217, raising questions about whether these interventions are efficient and scalable.

3.3.6. Improving enforcement

While many of the other intervention types designed to encourage formalization focus on providing “carrots”, it is also important that they be complemented with “sticks” – the enforcement of appropriate laws, rules and regulations. Because there are many parts of government that are responsible for some aspect of formalization, enforcement is undertaken by a range of authorities, including tax officials, labour inspectors and business registration authorities.

There is strong evidence that improved enforcement can help increase formalization, especially when the legal and regulatory framework is appropriate and the enforcement is targeted at enterprises with the means to comply. A macro-level study found that labour inspections can generate significant impacts on the decisions of enterprises to formalize.⁸⁴ This is supported by numerous country-level studies. In Brazil, for example, increased enforcement raised wages and output by improving the allocation of workers between the formal and informal sectors.⁸⁵ Another study from Brazil found

⁸³. N. Benhassine et al., 2018.

⁸⁴. J Jessen and J Kluge, 2021.

⁸⁵. C Meghir, R Narita and J Robin, ‘Wages and Informality in Developing Countries,’ *American Economic Review*, Vol. 105 (4), 2015, pg. 1509-46.

There is strong evidence to suggest that improved enforcement can help increase formalization.

that labour inspections drove both informal workers and enterprises to formalize.⁸⁶ A third study, also from Brazil, found that inspections were a more important reason for enterprises to formalize than were incentives.⁸⁷ Another study in Colombia tracked the effects of a dramatic increase in the number of labour inspectors, and found it was linked with a small but statistically significant increase in formal employment.⁸⁸

Besides increasing the number of labour inspectors, other interventions could include expanding labour inspection to all workplaces (even those in the informal economy), enhancing inspector capacity and providing new guidelines on enforcing working conditions in the informal economy. The ILO recommends the following interventions to help improve the capacity of labour inspectors to promote formalization:

- “Strengthen the legal framework for labour inspection interventions in the informal economy, especially by attempting to include all workers under its mandate.
- Enhance the human, material and financial resources of labour inspectorates. This should include improved planning of inspection activities, and collaborating with other institutions in order to achieve, in both cases, not only a more effective use of allocated resources, but also a greater impact of inspections.
- Provide labour inspectors and the labour inspection management with specific training on strategies for promoting the transition from the informal to the formal economy.”⁸⁹

⁸⁶. R Almeida and P Carneiro, ‘Enforcement of Labor Regulation and Informality,’ *American Economic Journal: Applied Economics*, Vol. 4 (3), 2012, pg. 64-89.

⁸⁷. G Henrique de Andrade, M Bruhn and D McKenzie, 2013.

⁸⁸. J Jessen and J Kluge, 2021.

⁸⁹. ILO, ‘A Guide on Labor Inspection Intervention in the Informal Economy: A Participatory Method,’ 2018, pg. 7, https://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---lab_admin/documents/publication/wcms_626573.pdf [accessed July 18, 2022].

There are also benefits associated with improved enforcement of tax regulations, which can take the form of on-site inspections, auditing and monitoring. Improved enforcement has been shown to discourage informality.⁹⁰ Similarly, more efficient auditing or improved levels of financial development can also help to make enforcement of tax compliance easier, and thereby discourage informal activity.⁹¹ Beyond the areas of labour and taxation, improved rule of law and law enforcement in other areas of the business environment can improve the appeal of formalization. For example, strengthening formal enforcement systems for financial contracts can lower credit costs in the formal sector, providing an incentive to formalize.⁹²

3.3.7. Using technology to drive formalization

While technology is driving widespread changes to the world of work, it is also providing governments with new tools to facilitate the transition to formality. These technological tools are changing not just how policy works but also how we define and understand the formality of enterprises or workers. Technologies can be used to drive formalization by:

- Helping institutions in different parts of government to coordinate, which can be especially useful when agencies in charge of enterprise formalization (e.g., registration and tax authorities) coordinate closely with agencies in charge of worker formalization (e.g., labour and social security authorities). For example, in 2007 Brazil launched eSocial, which unified employer and employee data transmission to government.
- Reducing the time and financial costs associated with formality by combining multiple payments – including social security – into a single payment.
- Providing tools that benefit both enterprises and government authorities in charge of formalization. For example, automatic

90. E. Ilzetzi and D. Lagakos: “The Macroeconomic Benefits of Tax Enforcement in Pakistan,” International Growth Centre, Report F-37405-PAK-1, 2017, <https://www.theigc.org/wp-content/uploads/2017/09/Ilzetzi-Lagakos-2017-Final-report-2.pdf> [accessed July 18, 2022]

91. J Guo and F Hung, ‘Tax evasion and financial development under asymmetric information in credit markets,’ *Journal of Development Economics*, vol. 145, issue C, 2020.

92. See for example: A Antunes and T Cavalcanti, ‘Start up costs, limited enforcement, and the hidden economy,’ *European Economic Review* Vol. 51, Issue 1, 2007, pg. 203-224.

transaction reporting in Hungary and Belgium sends data to tax and social security authorities, eliminating the time burden on enterprises to do this.

- Providing real-time information to speed up inspections and compliance. For example, in Argentina, the online worker registration database was made available to labour inspectors who can verify during the inspection, in real time, whether all workers at the facility are properly registered and the enterprise is up to date with contributions. This has reduced the inspection time from 40 days to a single day.⁹³

3.4. INTEGRATED FRAMEWORKS

Because informality is a complex challenge involving both enterprises and jobs, and covering a wide range of governmental responsibilities, an integrated approach to formalization is preferred in comparison to siloed responses. This type of approach is likely to result in improved outcomes. Research from the ILO has shown that a broad set of institutional policies, along with structural economic change, are important for making significant advances in formalization.⁹⁴ This has been seen especially in research from Latin America, where countries often separated economic policies and institutional responses on formality. Studies found that “when experiences were specific or prioritized only one aspect of the problem, results were generally limited. By contrast, when a set of policies was applied that addressed <multiple> interventions identified in the studies [...] the impact was more complete and effective.”⁹⁵

An integrated approach to formalization is preferred in comparison to siloed responses, because it is likely to result in improved outcomes.

93. J Chacaltana, V Leung and M Lee, ‘New technologies and the transition to formality: The trend towards e-formality,’ Employment Working Paper No. 247, 2018, Geneva: ILO, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_policy/documents/publication/wcms_635996.pdf [accessed July 20, 2022].

94. M Marchese, 2021.

95. ILO, ‘Recent Experiences of Formalization in Latin America and the Caribbean,’ 2014, pg. 13, https://www.ilo.org/wcmsp5/groups/public/---americas/---ro-lima/documents/publication/wcms_245882.pdf [accessed July 17, 2022].

ILO Recommendation 204 on the Transition from the Informal to the Formal Economy, is the international labour standard regarding the transition to formality. Adopted in 2015, it provides guidance to ILO members to:

- “(a) facilitate the transition of workers and economic units from the informal to the formal economy, while respecting workers’ fundamental rights and ensuring opportunities for income security, livelihoods and entrepreneurship;
- (b) promote the creation, preservation and sustainability of enterprises and decent jobs in the formal economy and the coherence of macroeconomic, employment, social protection and other social policies; and
- (c) prevent the informalization of formal economy jobs.”⁹⁶

Formalization is not simply the process of transition by an enterprise or worker from the informal to formal economy. It is a broader, economy-wide transition that includes the creation of new formal enterprises and decent jobs, the transition of informal workers and enterprises to the formal sector and the prevention of the informalization of formal jobs. Recommendation 204 calls for members to develop an integrated strategy to facilitate the transition to the formal economy, noting the need to consider the diversity of characteristics and circumstances that affect workers and economic units in the informal economy, as well as the specific national circumstances that would shape the transition to formality. It also lays out a wide array of factors that should be addressed by an integrated approach (see Box 3).

96. ILO, Recommendation 204, 2015.

Box 3. ILO Recommendation 204 – Transition from the Informal to the Formal Economy

ILO Recommendation 204 outlines a range of areas to be addressed in an integrated strategy, including:

- (a) the promotion of strategies for sustainable development, poverty eradication and inclusive growth, and the generation of decent jobs in the formal economy;
- (b) the establishment of an appropriate legislative and regulatory framework;
- (c) the promotion of a conducive business and investment environment;
- (d) respect for and promotion and realization of the fundamental principles and rights at work;
- (e) the organization and representation of employers and workers to promote social dialogue;
- (f) the promotion of equality and the elimination of all forms of discrimination and violence, including gender-based violence, at the workplace;
- (g) the promotion of entrepreneurship, micro, small and medium-sized enterprises, and other forms of business models and economic units, such as cooperatives and other social and solidarity economy units;
- (h) access to education, lifelong learning and skills development;
- (i) access to financial services, including through a regulatory framework promoting an inclusive financial sector;
- (j) access to business services;
- (k) access to markets;
- (l) access to infrastructure and technology;
- (m) the promotion of sectoral policies;
- (n) the establishment of social protection floors, where they do not exist, and the extension of social security coverage;
- (o) the promotion of local development strategies, both rural and urban, including regulated access for use of public space and regulated access to public natural resources for subsistence livelihoods;
- (p) effective occupational safety and health policies;
- (q) efficient and effective labour inspections;
- (r) income security, including appropriately designed minimum wage policies;
- (s) effective access to justice; and
- (t) international cooperation mechanisms.

Recommendation 204 also calls for coordination across different levels of government and between different ministries and authorities. It notes that countries should, both in law and practice, work to progressively extend social security, maternity protections, decent working conditions and a minimum wage to all workers in the informal economy.

Although ILO Recommendation 204 provides a comprehensive list of areas for an integrated formalization strategy, many countries that have successfully reduced informality have done so by addressing many, but not all, of these areas. Formalization efforts have sometimes focused on business environment reforms to promote stability and growth while raising the capacity of economic units to comply with standards. These efforts have been complemented by capacity building efforts, especially for government institutions.⁹⁷ At least eight countries have designed and implemented integrated formalization strategies.⁹⁸ Many of them have a timeframe of four to six years, with the shortest being a three-year strategy and the longest a 10-year strategy. To develop the strategies, countries took preparatory steps including:

- conducting public workshops;
- conducting background studies;
- developing studies on the causes, consequences and characteristics of informality;
- holding tripartite workshops or roundtables; and
- holding workshops and interviews with informal actors.⁹⁹

Countries often establish targets and measures to track their progress on formalization. Among the targets adopted in these eight countries were improvements in the World Bank's now discontinued Doing Business indicators, improvements in the labour formality rate, a decline in the share of informal employment, an increase in

97. ILO, 'Thematic Labour Overview: Transition to Formality in Latin America and the Caribbean,' Lima: ILO, Regional Office for Latin America and the Caribbean, 2014, https://www.ilo.org/wcmsp5/groups/public/---americas/---ro-lima/documents/publication/wcms_314469.pdf [accessed July 17, 2022].

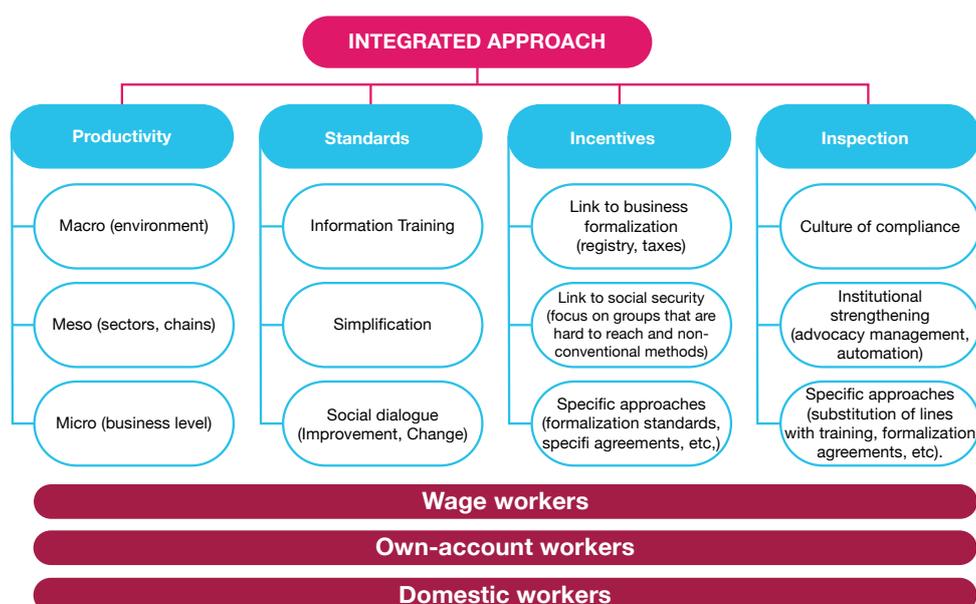
98. V Leung, 'Policy Frameworks for Transition to Formality: Formalization Strategy and Plan and National Employment Policy,' ILO Global Employment Policy Review Background Paper No. 3, 2020, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/documents/publication/wcms_792080.pdf [accessed July 18, 2022].

99. Ibid.

the registration rate, and an increase in social security participation and the share of the informal economy in GDP.¹⁰⁰ Of the 20 different policy areas noted in Recommendation 204, integrated strategies from across the world have included aspects covering 17 of the areas. However, *the most commonly addressed areas, in order of frequency, were: the establishment of an appropriate legislative and regulatory framework; the promotion of a conducive business and investment environment; and efficient and effective labour inspections.*

Recommendation 204 provides a list of areas to be included in an integrated policy framework. However, because some of these areas share similarities with others, and because integrated frameworks in practice have focused on some aspects more than others, several sources provide more concise examples of what an integrated framework should look like. One example from the ILO in Latin America notes that an integrated approach should cover four areas: productivity, standards, incentives and inspection (see Figure 2).

Figure 2. Public policies for the transition to formality in Latin America and the Caribbean



Source: ILO, 'Thematic Labour Overview: Transition to Formality in Latin America and the Caribbean,' 2014, pg. 20.

¹⁰⁰.Ibid.

Other efforts to provide a simplified schematic of integrated approaches to formality are similar in their main pillars. For example, a 2021 report on enterprise formalization (see Figure 3) identified four interlinked areas of work that are fundamental to an integrated approach: simplifying laws and procedures, incentives, productivity enhancement, and enforcement and compliance. This approach provides a clear yet simple picture of the key components of a formalization strategy. However, some important areas that are covered in this work, such as preventing the informalization of jobs, do not strictly fall under this “enterprise formalization” structure. There is a significant amount of overlap in the enforcement and compliance work that will contribute to enterprise formalization and that which will contribute to preventing informalization of jobs. As such, the general structure remains suitable for much of this analysis.

Figure 3. Approach to enterprise formalization



Source: ILO, 'Enterprise Formalization: Tailored registration, tax and social security requirements for MSEs,' Brief 1/2021, 2021.

3.5. CROSS-CUTTING STRATEGIES TO BETTER ADDRESS INFORMALITY

Addressing informality requires not just the right mix of policies, but also a strategy that includes the right stakeholders and the right focus. These can have a significant effect on the overall success and the efficiency of integrated frameworks to address informality.

3.5.1. Segmentation of different target groups

The challenges associated with formalizing and remaining formal are not the same for all enterprises. The literature shows that the challenges can be much greater for MSEs. One reason for this is simply that there are fixed costs associated with compliance. On a per-person basis, these costs are greater for MSEs than larger companies. For example, in South Africa, one study found that companies with an annual turnover of ZAR 245,000 (approximately US \$13,300) or less pay an average of 4.7 percent of their sales to hire a professional to manage their taxes, and 3.1 percent of their sales to hire a professional to manage their payroll. However, for businesses with turnover of between ZAR 245,000 and ZAR 525,000 (approximately \$13,300 and US \$28,500), the costs fall to 1.4 and 1.9 percent of sales to outsource tax and payroll management, respectively. For companies with sales of more than ZAR 3 million (approximately US \$163,000), these figures are 0.3 and 0.1 percent of total sales.¹⁰¹ Formalization often creates a more significant increase in fixed costs as a proportion of overall costs for MSEs. This can directly lead to a decrease in net profits, which at the margins can mean that a small share of MSEs become unviable. Another challenge is that MSEs may have unstable revenues or engage in seasonal activities, which affects their capacity to comply with the required payments over time.

For this reason, efforts to formalize enterprises are generally more effective when they segment different categories of enterprises and apply tailored approaches for each of them. This includes tailored approaches for firms that already share a number of characteristics with formal firms. These enterprises often have less work to do to become formal. They are closer to the “margin”. This was found in a study on Benin, where the rate of formalization doubled by focusing on these firms.¹⁰² The characteristics associated with formal enterprises included more educated owners, operating outside of the main market, and operating in sectors other than retail, among others.¹⁰³ While targeting enterprises closer to the frontier may be a useful strategy for some interventions, it may not reach the most vulnerable who are most in need of social security protections. It may also risk reinforcing socially undesirable

¹⁰¹. Smulders et al., 2012 in M Marchese, 2021.

¹⁰². N Benhassine et al., 2018.

¹⁰³. Ibid.

goals, such as socioeconomic or gender differences. Therefore, it is recommended to tailor interventions to specific segments of economic units. Criteria for segmentation may relate to the size of the economic unit (e.g., own-account workers vs. micro and small enterprises), the sector of operation, the background and degree of vulnerability of the entrepreneur and workers (e.g., women, youth, etc.) and the actors that engage in subsistence economic activities.

3.5.2. Partners in formalization

While governments have an important role to play in addressing informality directly, international experience shows that non-governmental organizations (NGOs), civil society organizations, intergovernmental organizations, labor unions and associations also play a role. Sometimes this is in partnership with government, and other times it is on their own. In India, for example, the Evangelical Social Action Forum (ESAF) Microfinance and Investments, a non-bank financial institution, launched an initiative to increase business registrations among its client base. ESAF launched a range of business development services (BDS) and awareness raising activities about the benefits of formalization. They launched trainings for informal enterprises, which included information on the formalization process and business expansion. They also had individual client visits, which included briefing sessions on marketing and accounting.¹⁰⁴ These steps helped increase registrations among targeted clients by 70 percent.¹⁰⁵

Employers' and workers' organizations have played a role in assisting governments to address informality.

In other countries, employers' and workers' organizations have played a role in assisting governments to address informality. In Australia, Hungary, Belgium and Sweden, business groups have worked with government to address high tax non-compliance.¹⁰⁶ Other governments have partnered with employers' organizations to help them offer information and counseling on business expansion

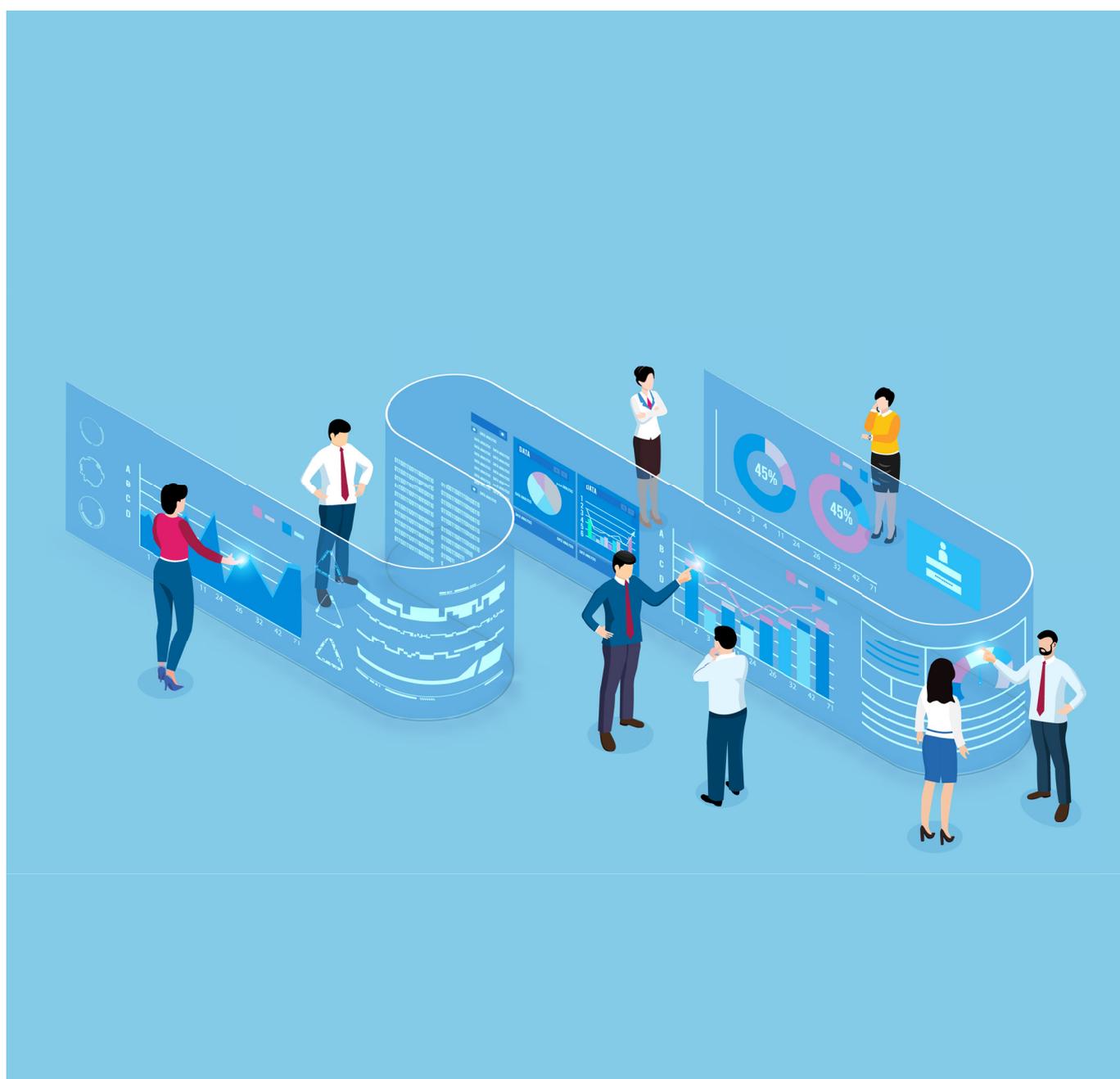
104. Q A Nguyen and N M S da Cunha, 'Extension of Social Security to workers in the informal economy in the ASEAN region,' 2019, ILO, https://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_344839.pdf [accessed July 17, 2022].

105. ILO, 2016.

106. G Perry et al., 2007.

and formalization. In the Dominican Republic, the Autonomous Confederation of Workers' Unions launched the Mutual Association of Solidarity Services to serve as an interface between the social security institution and workers. It encouraged affiliated micro businesses to formalize through awareness raising and support for the administrative procedures to register. The association also handles ongoing interactions with the social security administration in exchange for an administrative fee of one percent.¹⁰⁷

107. Q A Nguyen and N M S da Cunha, 2019, pg. 73.





4.

THE SOCIOECONOMIC LANDSCAPE IN CAMBODIA

Over the last decade, Cambodia has made significant strides in developing its economy and reducing poverty. Household consumption has increased substantially, as have disposable incomes, which rose by 59 percent from 2014 to 2019.¹⁰⁸ These improvements have been accompanied by a shift away from self-employment and towards wage and salary work. Income from wages and salaries accounted for about 55 percent of disposable income in 2019, up from 45 percent in 2014. At the same time, income from self-employment accounted for 36 percent of disposable income in 2019, down from 51 percent in 2014.¹⁰⁹

Despite these impressive gains, Cambodia's economy remains vulnerable to external shocks due to its dependence on a few key growth drivers such as tourism, construction and manufacturing exports. Many people remain vulnerable to falling back into poverty, in large part due to the high number of near-poor households. These vulnerabilities were evident following the onset of the COVID-19 pandemic, which hit informal workers and MSMEs especially hard. The Russia-Ukraine war also had an impact, by increasing the costs of food and other products. This section reviews Cambodia's economic, labour market and social landscape, in which formal and informal enterprises and workers are situated. It also provides a review of the current understanding and context of informality in the country.

4.1. SOCIAL AND ECONOMIC OVERVIEW

From 2010 until the onset of the COVID-19 pandemic, Cambodia experienced strong economic growth and falling poverty rates. GDP growth rates from 2010 to 2020 were seven percent or greater every year except for one, helping the country more than double its nominal GDP. This growth was accompanied by a significant rise in incomes, from a monthly average of \$117.70 in 2012 to \$263.20 in 2019.¹¹⁰ Consumption by Cambodian households increased significantly as well, up 49 percent between 2014 and 2019/2020 from Khmer Riel (KHR) 1.53 million to KHR 2.28 million (US \$378 to US \$563) per month.¹¹¹ The dramatic growth in incomes and

108. National Institute of Statistics, Report of Cambodia Socio-Economic Survey 2019/20, Kingdom of Cambodia, Phnom Penh, December 2020, http://nis.gov.kh/nis/CSSES/Final%20Report%20of%20Cambodia%20Socio-Economic%20Survey%202019-20_EN.pdf [accessed July 17, 2022].

109. National Institute of Statistics, 2020.

110. National Institute of Statistics, 2020 and National Institute of Statistics, Cambodia Labour Force and Child Labour Survey 2012: Labour Force Report, November 2013, https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---sro-bangkok/documents/publication/wcms_230721.pdf [accessed July 17, 2022].

111. National Institute of Statistics, 2020, pg. 127.

GDP contributed to a large decline in poverty. According to official estimates, the poverty rate fell from 48 percent in 2007 to 18 percent in 2019. However, non-monetary measures suggest that poverty has fallen less quickly.

The COVID-19 pandemic created significant challenges for the Cambodian economy. After a decade of strong economic growth, GDP in 2020 declined by approximately three percent, although it rebounded by three percent and 5.1 percent in 2021 and 2022, respectively.¹¹² Poverty increased, with models suggesting that it could rise to 17.6 percent – an increase of around eight percentage points compared to pre-COVID-19 levels.¹¹³ This would undo years of poverty reduction efforts. Even those who remained above the poverty line would face significantly greater economic stress.¹¹⁴ The pandemic had substantial negative effects on non-farm family businesses. Nearly half of all households saw their incomes decline from December 2020 to March 2021.¹¹⁵ Despite the significant fall in poverty, Cambodia’s social security net still has limited reach. Only six percent of households reported having an IDPoor card as of October 2020.¹¹⁶ This limited the government’s ability to use social protection mechanisms to assist the poor during the pandemic.

4.2. THE ENTERPRISE LANDSCAPE IN CAMBODIA

Cambodia’s economy has grown significantly in the last decade, with MSMEs playing an important economic role, providing incomes for millions of people. MSMEs are hugely diverse and operate in all sectors of the economy. They engage with a wide range of government authorities. This diverse engagement produces a significant amount of administrative data about enterprises, yet this data is often shaped by the legal and regulatory framework that governs how and why it was collected.

112. IMF, ‘Cambodia,’ <https://www.imf.org/en/Countries/KHM#countrydata> [accessed November 20, 2022].

113. UNDP and Ministry of Economy and Finance, ‘COVID-19 Economic and Social Impact Assessment in Cambodia: CGE & GTAP Simulation Exercises,’ October 2020, https://www.undp.org/sites/g/files/zskgke326/files/migration/kh/UNDK_KH_POLICY_BRIEF_first.pdf [accessed July 19, 2022].

114. World Bank, Living with COVID: Special Focus The Impact of the COVID-19 Pandemic on Learning and Earning in Cambodia, December 2021, <https://documents1.worldbank.org/curated/en/099350012062137172/pdf/P1773400f35a770af0b4fa0781dffcd517e.pdf> [accessed July 17, 2022].

115. World Bank, 2021.

116. Currently, around 750,000 beneficiary households are eligible and carry an active IDPoor Equity Card which entitles them to access various social and pro-poor services such as discounted or free medical services, cash transfer services or scholarships.

Table 1. Number of establishments by size

1 person	367,221
2-4 people	332,725
5-49 people	50,205
50-99 people	1,649
100 or more people	1,870

Source: National Institute of Statistics, 2022

Though enterprise and establishment sound similar, the terms have different meanings.

- **An establishment is an economic unit performing services or selling goods in a single place under a single manager.**
- **An enterprise is a single establishment with any type of ownership or group of establishments with common corporate-form ownership. The vast majority of Cambodia's establishments are single-unit enterprises.**

Cambodia had 735,456 non-agricultural establishments according to the 2022 economic census, excluding agricultural businesses involved in production (ISIC Rev. 4 Section A, which includes farmers who work on their own account) as these were not covered by the survey.¹¹⁷ Approximately 99.8 percent of these were MSMEs, which were collectively responsible for 58 percent of employment and, according to a different source, 58 percent of GDP.¹¹⁸ The vast majority – almost 699,946 or 93 percent – were micro establishments (enterprises and establishments are different – see callout box). Over 99 percent of micro establishments were Cambodian-owned, while 71 percent were owned by women. The economic census

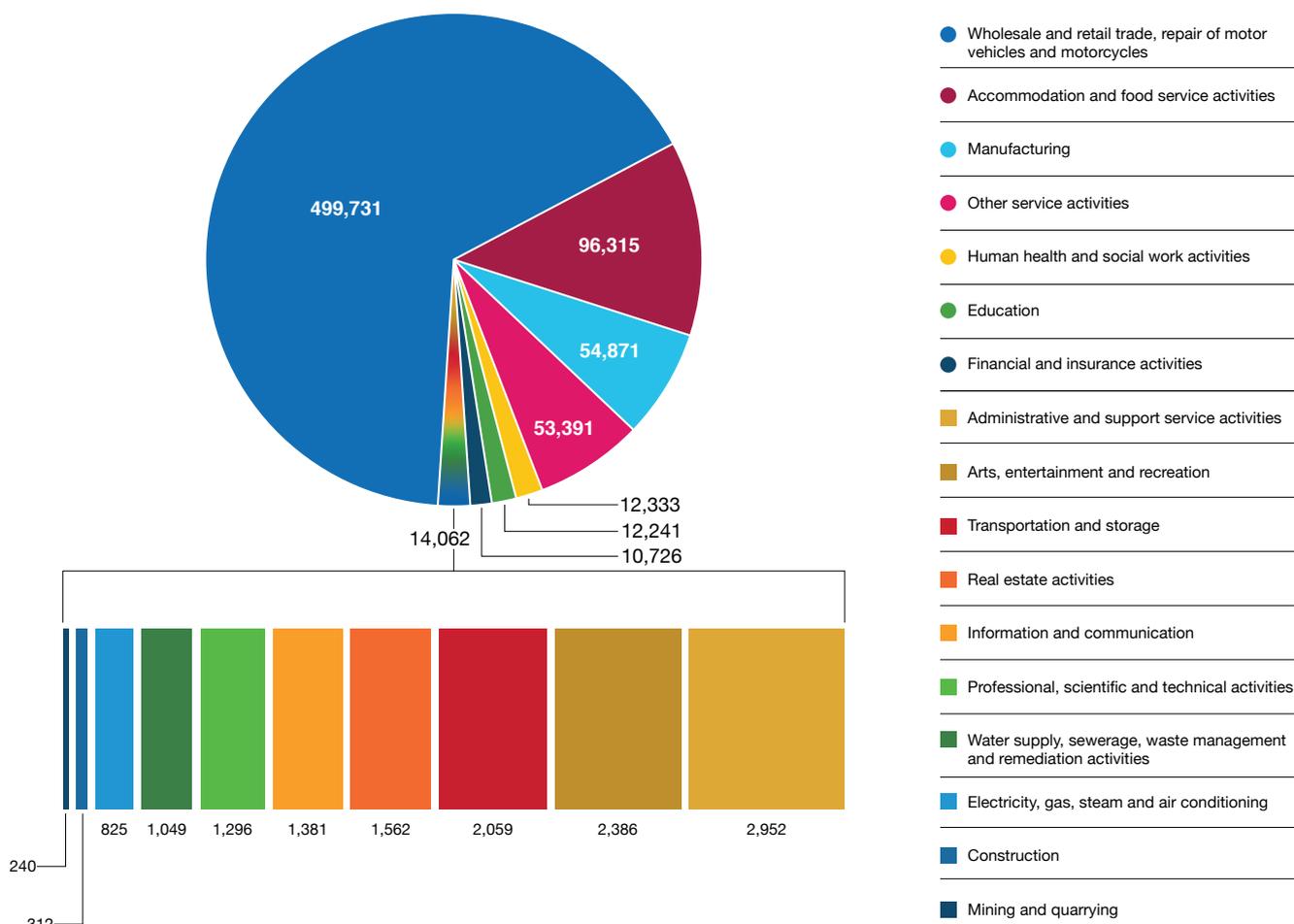
117. National Institute of Statistics, 'Economic Census of Cambodia 2022: Preliminary Results,' Ministry of Planning, Government of the Kingdom of Cambodia, December 2022, <https://www.nis.gov.kh/nis/EC2022/Preliminary%20Results%20of%20Economic%20Census%202022.pdf> [accessed May 6, 2023].

118. National Institute of Statistics, 2022; Ministry of Industry and Handicrafts, 'The Current Situation of SME in Cambodia- MSME Financing,' 2019, <https://www.unescap.org/sites/default/files/SME%20Financing-Chapter%20Layhy%202019.pdf> [accessed July 19, 2022].

found 53,724 establishments with 5 or more people, and 1,870 with 100 or more people. The ownership of small, medium and large establishments was male-dominated at 60.8 percent.

Establishments are heavily concentrated in the wholesale and retail trade sector, which has 66 percent of all establishments. The vast majority of these are micro establishments. On the other hand, SMEs were distributed across a much broader range of sectors, and previous data suggests that large establishments were heavily concentrated in the manufacturing sector. This is not a surprise, given that manufacturing is often labour intensive, and Cambodia has a significant number of labour-intensive apparel factories.

Figure 4. Share of establishments by sector and size



Source: National Institute of Statistics, 2022

The vast majority of establishments in Cambodia (87.6 percent) were not registered. Unsurprisingly, this is not the same across establishments of different sizes. All establishments with 100 or more workers and 89 percent of establishments with 5 or more workers were registered. However, only 6.5 percent, or 45,793 micro establishments were registered.¹¹⁹ The majority of micro establishments in Cambodia (87.4 percent) were unregistered individual proprietorships, which are owned by a single person and do not have any legal separation between the business and the person. The individual owner receives all of the profits and is responsible for all of the losses of the establishment. Another 3.7 percent were registered individual proprietorships.¹²⁰

Another survey, by the World Bank, found 1.4 million non-farm household enterprises – a higher number than in official statistics, although this difference could be due to the World Bank study’s inclusion of mobile and street businesses, of which there are many. These household enterprises have average assets of just \$1,000, and half employ just a single household member. Only four percent were registered – with three in four unregistered household enterprises stating that they are not required to register because they are so small. The majority of household enterprise owners prefer to own their business. 90 percent of them said that if given a choice between running a business, working in a manufacturing job, working in a non-manufacturing job and migrating abroad, they would prefer running a business.¹²¹ However, a significant share – 23 percent of men and 33 percent of women – said they worked in a household enterprise because they did not have a job. The average household enterprise earns a monthly profit of \$260, while average monthly per worker profits are lower, at \$155. Despite this, most household enterprise owners are not viewed as poor, and therefore not many are beneficiaries of government support through the IDPoor programme.¹²²

119. National Institute of Statistics, 2022

120. Ibid

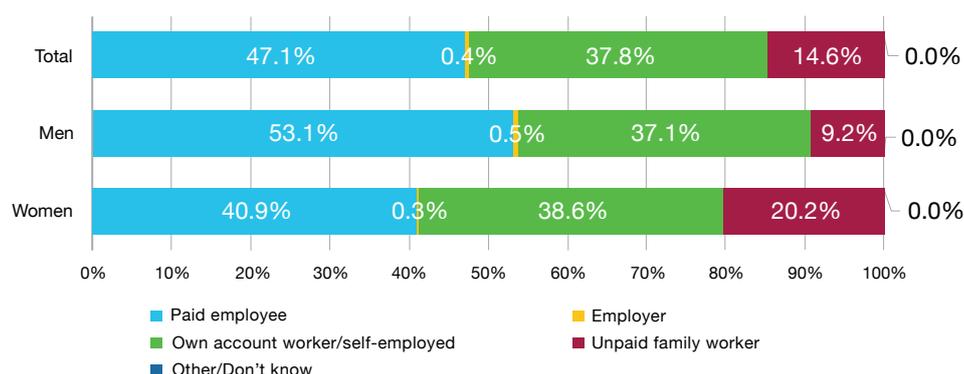
121. W Cunningham and M Shrestha, 'Non-Farm Household Enterprises in Cambodia- Moving out of the Policy Shadows,' World Bank, undated, <https://documents1.worldbank.org/curated/en/694681624625104267/pdf/Non-Farm-Household-Enterprises-in-Cambodia-Moving-Out-of-the-Policy-Shadow.pdf> [accessed July 17, 2022].

122. Ibid.

4.3. THE LABOUR MARKET IN CAMBODIA

Cambodia’s working age population comprises approximately 11.5 million people (73.2 percent of the total population), of whom 69.3 percent participate in the labour force, according to the most recent Labour Force Survey (LFS). Participation rates were higher for men (77.2 percent) than women (62.4 percent), with unemployment at a low 1.2 percent – a rate that was the same for both men and women. One recent socioeconomic survey found even higher labour force participation, at 87.4 percent, as well as a higher unemployment rate of 2.4 percent.¹²³ Both surveys provide evidence of strong labour force participation in Cambodia.

Figure 5. Employment status, main occupation by sex



Source: National Institute of Statistics, 2020.

In recent years, Cambodia’s labour force has experienced significant growth in wages. The average monthly wage of paid employees at their primary job was approximately KHR 1.079 million (\$269.90) per month in 2019. The median monthly wage was KHR 910,000 (\$227.50). Notably, both average and median monthly wages for men and women workers did not differ significantly in any occupation.¹²⁴ Wages in the Cambodian labour market have grown significantly since 2012, when the average monthly income of paid employees was KHR 477,517 (\$119.00).¹²⁵ The growth in wages has been accompanied by a shift from self-employment to wage and salary work. The share of household income from wages and salaries

123. National Institute of Statistics, 2020.

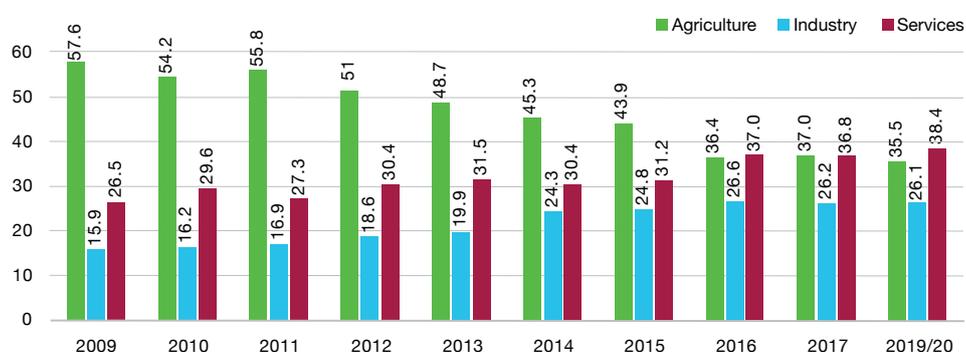
124. National Institute of Statistics, Report on the Cambodian Labour Force Survey 2019, Kingdom of Cambodia, 2021, pg. xi, http://nis.gov.kh/nis/CLFS/CLFS19_Final_Full%20Report_EN.pdf [accessed July 17, 2022].

125. National Institute of Statistics, 2013.

increased from 45 to 55 percent between 2014 and 2019/2020, while the income from self-employment fell from 51 to 36 percent over the same time period.¹²⁶ For the first time, Cambodia’s most recent LFS showed that a greater number of workers in the country are classified as a “paid employees” than as “own account workers/self-employed.” About 47 percent of the country’s workforce was classified as “paid employees” in 2019, while 38 percent was classified as “own account workers/self-employed”.

In the last decade, there has also been a transformation in the sectors in which Cambodians work. Most notably, there has been a marked shift away from agriculture. From 2009 to 2019/2020, the share of the employed population in agriculture declined from 57.6 percent to 35.5 percent. The share of employment in both services and industry has grown, but that growth has been mostly concentrated in the services sector, which increased from 26.5 to 38.4 percent of employment.

Figure 6. Employment of population aged 15-64 by sector, 2009-2019/2020, in percent



Source: Cambodia Socio-Economic Survey (CSES), 2019/2020

The COVID-19 pandemic had a notable effect on Cambodia’s labour market. In 2020, the estimated unemployment rate jumped to 4.3 percent, significantly higher than the rate of unemployment in 2019. Women workers were disproportionately affected by the COVID-19 crisis due to their higher rates of participation in industries such as apparel and tourism, both of which were heavily affected.¹²⁷ Surveys from the World Bank echo these findings about the COVID-

¹²⁶. National Institute of Statistics, 2020.

¹²⁷. UNDP Cambodia, ‘2021 COVID-19 Economic and Social Impact Assessment in Cambodia,’ September 2021.

19-related contraction in the labour force. A survey implemented in March 2021 found that 69 percent of respondents were working, a similar level to a few months earlier but below pre-pandemic levels of 82 percent.¹²⁸

4.4. INFORMALITY IN CAMBODIA

4.4.1. Definition of informality

Though informality is common in Cambodia, there is not yet a shared conception among government ministries and other stakeholders of exactly what defines informality. Some parts of government, such as the GDT, do not formally define informality but practically approach it as any enterprise that is not registered for tax, including all micro enterprises as they fall below the small taxpayer threshold. Joint Prakas 404, issued in 2017 by the MoLVT, Ministry of Economy and Finance (MEF) and Ministry of Health (MoH) provides a definition of an “informal worker” for the purposes of the Health Equity Fund – although it excludes many workers that would be considered informal under global definitions. “Formal workers” and “informal workers” are also defined in the annex of Cambodia’s social security law.

Statistics on informality from major surveys approach informality in a different way than these parts of Cambodia’s government. For example, the 2019 LFS defines the “formal sector”, “informal sector” and “formal employment” as the following:

“The formal sector comprises all workers in the government, state-owned enterprises, international organizations, and in foreign embassies; as well as in limited companies, trading partnerships, limited partnerships, and enterprises that are registered with the relevant authorities and/or keep a complete set of accounts for reporting to the national government, including an accurate balance sheet of assets, income, and expenditures.”¹²⁹

128. W Karamba, I Salcher and K Tong, ‘The Socioeconomic Impacts of COVID-19 on Households in Cambodia: Results from the High-Frequency Phone Survey of Households Round 5 (1-21 March 2021),’ June 2021, World Bank Group, Report No. 5, <https://documents1.worldbank.org/curated/en/833701624563697124/pdf/Main-Report.pdf> [accessed July 17, 2022].

129. Note that the “formal sector” usually corresponds to the economic units and not all workers. As such, this definition, which is taken from the 2019 Labour Force Survey, more closely resembles a definition of workers in the formal sector. This same note also applies to the definition of the informal sector, which more closely resembles a definition of workers in the informal sector.

“The informal sector comprises all workers in enterprises that are not registered with the relevant authorities, and do not keep a complete set of accounts. It excludes households that produce exclusively for own final use, subsistence agriculture, the construction of own dwellings, etc.”

“Formal employment includes persons who work in their own businesses in the formal sector or who are employees, apprentices, interns of an employer who makes contributions to a national pension fund, health, and/or unemployment insurance fund, or who provides paid annual leave and sick leave in cases of illness or injury.”¹³⁰

Earlier surveys, such as the 2012 LFS, provide somewhat different definitions of informality. For example, the definition of “informal sector” was much more focused on the establishment of a separate legal identity for the enterprise. The 2012 definition of “informal sector” was that:

“The informal sector consists of unregistered and/or small unincorporated private enterprises engaged in the production of goods or services for sale or barter. The enterprises typically operate on a small scale at a low level of organization, with little or no division between labour and capital as factors of production. Labour relations are based mostly on casual employment, kinship or personal and social relations. The fixed and other assets do not belong to the production units as such but to their owners, and the units cannot engage in transactions or enter into contracts with other units nor incur liabilities on their own behalf. An unincorporated enterprise is a production unit that is not constituted as a separate legal entity independently of the individual (or group of individuals) who owns it and for which no complete set of accounts is kept.”

While various parts of government and surveys make a clear separation between formal and informal, and discuss them as a dichotomy, in practice, workers and economic units often exist in a gray area, exhibiting some traits of formality but not others. This is important because it suggests that for some workers and economic

¹³⁰. National Institute of Statistics, 2021, pg 7; Note that in practice, Cambodia only has an operational HCS as of the middle of 2022, so the inclusion of references to pension and unemployment funds are largely irrelevant in the country context.

units – especially those that already exhibit some traits of formality – the journey to being fully covered by formal arrangements may be easier than for other workers or economic units.

4.4.2. Recent trends in informality

Determining trends in informality in Cambodia is complicated but most data show that informality in the country is declining. The 2019 LFS showed that about 88 percent of the workforce in Cambodia was engaged in informal employment while just 12 percent of the country's employed persons (923,046 out of 7.9 million) were in formal employment. In comparison, the 2012 LFS showed that 6.5 percent of employed persons were in formal employment (467,882 out of 7.2 million), while 60.2 percent were in informal employment and 33.3 percent in agriculture.¹³¹ The two labour force surveys are not easily comparable for numerous reasons, including exclusion of agricultural workers from the calculation on informal employment in the 2012 LFS. However, if we assume that the share of informal employment in agriculture was constant from 2012 to 2019 at 98.6 percent, we estimate that 93 percent of Cambodia's employed persons were in informal employment in 2012.¹³²

Other data also suggests that Cambodia's labour force may be moving towards greater formality. Data on household incomes, which the LFSs show have more than doubled in the last decade, suggest this. This is notable because increases in individual incomes are often associated with declining informality.¹³³ It is unusual to see an increase in informality accompanied by a significant increase in incomes over a long period of time.

Beyond increasing incomes, Cambodia has also experienced a transformation in the sectors of employment over the last decade. There has been a move away from the (highly informal) agriculture sector and towards the (more formal) industry and services sectors. This shift is notable in part because formal employment as a share of total employment has increased in industry and services over the

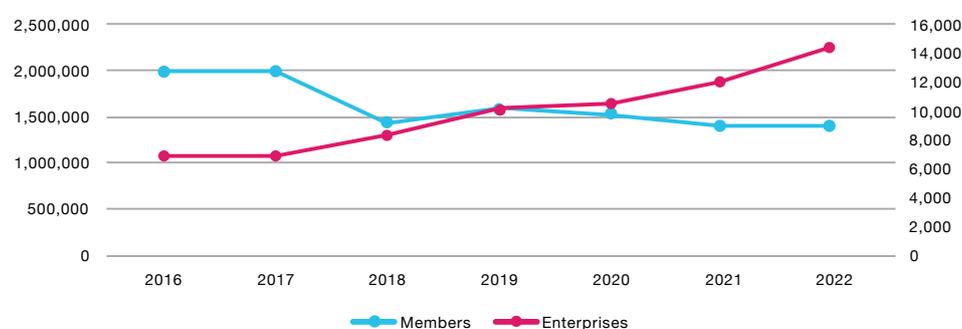
131. National Institute of Statistics, 2013.

132. The 2012 and 2019 LFS are not easily comparable for numerous reasons. First, there were changes in the definitions of employment and criteria to identify informality. Second, Cambodia adopted a HCS between the survey periods, and participation in the scheme is now considered a characteristic of formality. As such, the legal requirements associated with being formal changed between the survey periods. And lastly, the 2012 LFS did not include agricultural employment in its calculation of formal or informal employment, whereas the 2019 survey did, making comparison more difficult.

133. ILO, 2014.

last decade. For example, in manufacturing, which is the largest industrial subsector, the share of workers in formal employment increased from 2.3 percent to 30.0 percent from 2012 to 2019.¹³⁴ Other important subsectors with large numbers of workers have also seen an increase in the share of formal employment over this time period. Sectors that became more formal include wholesale and retail trade, transportation and storage, accommodation and food services, and even construction.

Figure 7. Number of workers and enterprises enrolled in the NSSF



Sources: National Social Security Fund, 'Report on Annual Achievements 2022 and Action Plans,' 2023, Government of Cambodia, <https://www.nssf.gov.kh/wp-content/uploads/2023/04/NSSF-Annual-Report-2022.pdf> [accessed May 6, 2023]; ILO Forthcoming 2022 (Meertens et al).

Lastly, administrative data from the NSSF suggests a mixed picture in regard to enrollment over time. The enrollment of workers has decreased since 2016 and 2017, although data from 2022 shows a slight rebound in members when compared to 2021. However, the number of enrolled enterprises has consistently increased from 2016 to 2022, more than doubling over this same time period. This is surprising, given the lack of other data or plausible explanations that would explain a decline in the average size of participating enterprises. As such, the implied decline in enterprise size may actually be due to improved recordkeeping by NSSF. Other data from the NSSF suggests consistent growth in the number of participating workers and enterprises, as well as year-on-year growth in the total value of premiums collected, since the inception of the programme in 2008.¹³⁵

¹³⁴. National Institute of Statistics, 2013, pg. 47; National Institute of Statistics, 2021, pg. 38.

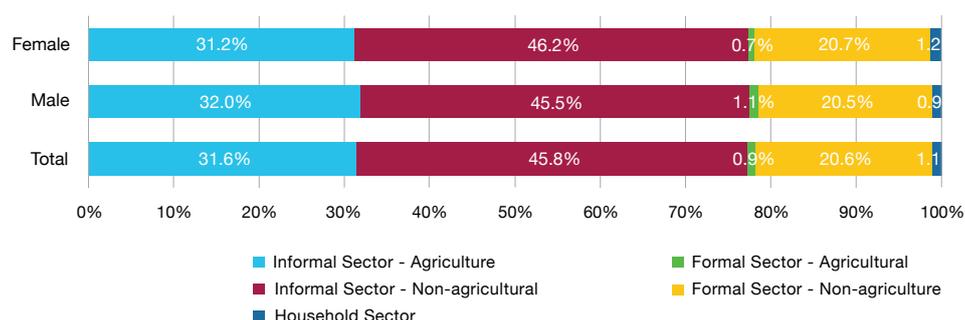
¹³⁵. National Social Security Fund, 'Report on Ten-Year Achievements 2008-17 and Action Plans 2018,' 2018, Government of Cambodia, <http://www.nssf.gov.kh/default/wp-content/uploads/2018/04/Binder1.pdf> [accessed July 17, 2022].

4.4.3. The current context of informality

Despite contradictory information on trends in formality, there is strong evidence showing that informality has been, and remains, pervasive in Cambodia. This is despite the country’s success in poverty reduction, growth in per capita incomes, and increases in wage and salaried work. The majority of Cambodians (77.4 percent) still work in the informal sector, including almost equal numbers of men and women workers. Almost all of the employed population in agriculture is in the informal sector, whereas the vast majority in the formal sector are in non-agricultural enterprises.

Informal employment – including both employment in the informal sector as well as informal employment in the formal sector – was even more pervasive at 88.3 percent of Cambodian workers. Informal employment was somewhat more common in rural areas but even then, 85 percent of the urban population was engaged in informal employment.¹³⁶ In rural areas, 90 percent of the population was engaged in informal employment. While both men and women workers were much more likely to work in informal employment, the share of men in informal employment was modestly higher than women – at 89.0 percent versus 87.6 percent.

Figure 8. Share of employed population in the formal and informal sector



Source: National Institute of Statistics, 2021, https://nis.gov.kh/nis/CLFS/CLFS19_Final_Full%20Report_EN.pdf [accessed December 6, 2022]

The majority of employment is informal in all sectors of the economy, including traditionally formal sectors such as public administration and the activities of extraterritorial bodies and organizations. Formal employment is most common in sectors with a significant public sector presence, although manufacturing (a sector dominated

136. National Institute of Statistics, 2021.

by private enterprises) also compares relatively well. Informal employment is much more pervasive in sectors such as agriculture and construction. In the country's largest sector (agriculture), 98.6 percent of workers are in informal employment, making it nearly universal.

Table 2. Formal and informal employed population

	Both Male and Female	Male	Female
Informal employment	88.3%	89.0%	87.6%
Formal Employment	11.7%	11.0%	12.4%

Source: National Institute of Statistics, 2021.

Informality presents challenges for many workers and enterprises. For enterprises, operating in the informal sector can bring a range of operations-related challenges. For example, it can negatively affect access to finance from formal financial institutions, forcing them to rely on personal savings and informal finance. Informal enterprises also face risks, including fines and business closure. They further present a challenge to formal enterprises, who spend both money and time to comply with the legal framework. The majority of formal enterprises (78 percent) reported that they competed against informal firms.¹³⁷ A recent World Bank study on the business environment found that of 15 different aspects of the business environment, 28 percent of formal firms said that informal competitors were the biggest obstacle to their daily operations.¹³⁸

For workers, informality is associated with decent work deficits – such as the denial of rights at work, the absence of sufficient opportunities for quality employment, inadequate social protection, the use of short-term fixed duration contracts and the absence of social dialogue.¹³⁹ It is also associated with greater challenges

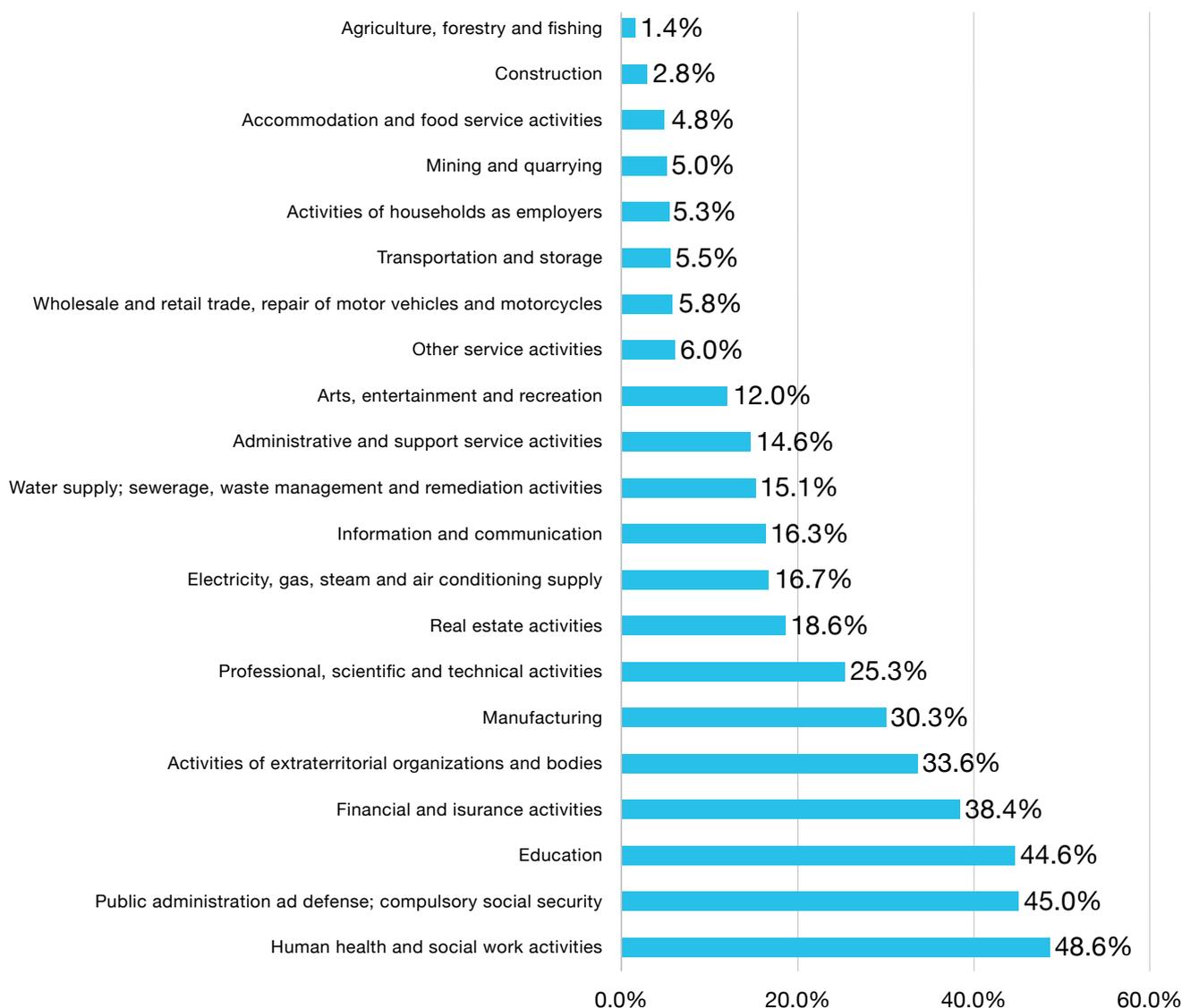
137. World Bank, 'Cambodia,' 2016, <https://www.enterprisesurveys.org/en/data/exploreconomies/2016/cambodia#informality> [accessed July 17, 2022].

138. World Bank, 'Cambodia 2016: Country Highlights,' 2016, <https://www.enterprisesurveys.org/content/dam/enterprisesurveys/documents/country-highlights/Cambodia-2016.pdf> [accessed July 17, 2022].

139. ILO, Recommendation 204, 2015.

meeting basic needs. For example, a recent UNDP survey found that 69 percent of informal workers struggle to meet their needs in comparison to 53 percent of formal workers.¹⁴⁰

Figure 9. Formal employment, by sector, in percent



Source: National Institute of Statistics, 2020.

140. UNDP & Angkor Research and Consulting Ltd., 'Tracking of Socioeconomic Impacts Survey: Round 4,' December 17, 2021.

Box 4. A profile of informal workers in Cambodia

Informal employment is pervasive in Cambodia. A forthcoming study from the ILO and UNDP, entitled “Expanding social protection for those of active age in Cambodia: A study to understand the characteristics of workers and enterprises in the informal economy,” conducts a thorough examination of workers in informal employment in Cambodia. It finds that 90 percent of the non-civil service workforce are in the informal sector, according to data from the 2019 LFS. About 56 percent of the non-civil service workforce is comprised of non-wage earners. Most of these – 2.9 million – are own-account workers and another 900,000 are contributing family workers. These two groups of workers, which together are considered “vulnerable forms of employment”, represent more than half of the non-civil service workforce. The vast majority of own-account workers (96 percent), as well as all contributing family workers, are in the informal sector.

Vulnerable employment is not evenly spread across the economy, but instead is concentrated in particular sectors. It is particularly common in agriculture, where 80 percent of workers were in vulnerable employment, and wholesale and retail trade, where 83 percent were in vulnerable employment. However, it was rare in other sectors. In construction, 95 percent of workers were employees. In manufacturing, 92 percent of workers were employees, while the figure was 75 percent for other services.

High levels of vulnerable employment are closely related to informality and mean that the vast majority of workers in sectors such as agriculture or wholesale and retail trade are not covered by key labour rights or social security. These workers are exposed to both economic and life cycle risks which can affect their incomes and well-being.

Workforce coverage by Cambodia’s social security system, the NSSF, is somewhere between 11 and 22 percent of the non-civil service workforce. NSSF administrative data, which covers the total number of workers in the ORS since the programme started, suggests 22 percent are covered. Data from the 2019 LFS, which asks only about health insurance, suggests that 11 percent are covered. However, regardless of the estimate, there is a significant share of workers not covered by the NSSF, even in the formal sector, where LFS data suggests that 68 percent remain uncovered. This could suggest a high level of non-compliance among formal enterprises, especially in the manufacturing, other services and construction sectors.

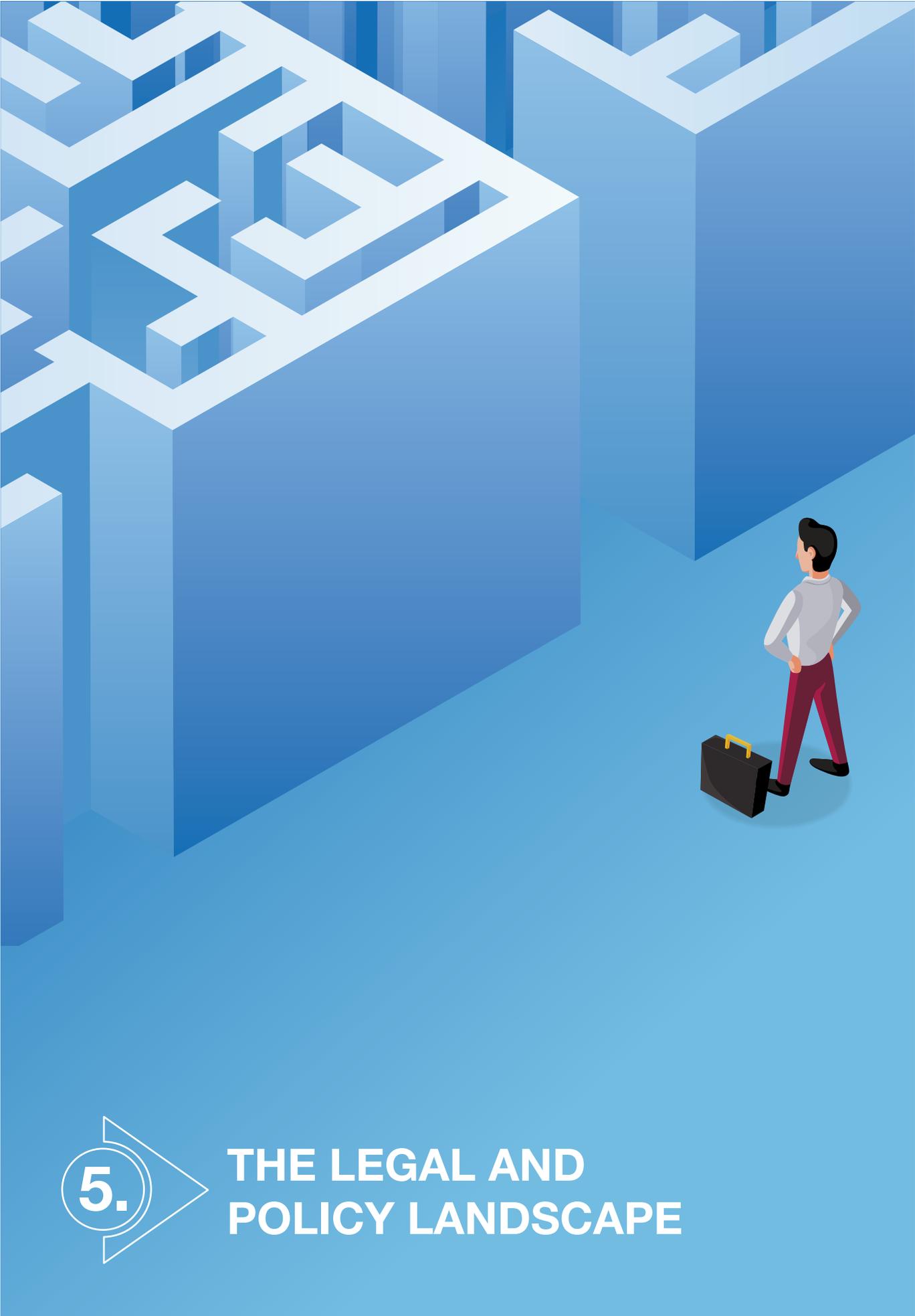
The level of NSSF coverage varied by sector, with the share of workers that were uninsured in the agriculture, wholesale and retail trade and construction sectors reaching 99.9 percent, 99.0 percent and 98.0 percent respectively. The sectors with the highest share of insured workers were garment manufacturing (48 percent), other services (38 percent) and the non-garment industry (35 percent). The level of coverage also differed based on a number of characteristics of the individual worker, including:

- **Age:** younger workers are more likely to be covered than older workers.
- **Income:** lower income workers are less likely to be covered than higher income workers. According to the LFS, 99.5 percent of workers in the bottom income quintile are uninsured, compared to 85 percent in each of the three highest income quintiles.
- **Education:** workers with lower levels of education are less likely to be insured. Seventy percent of insured workers had a secondary education or higher, while only 44 percent of uninsured workers had a secondary education or higher.
- **Gender:** 95 percent of men workers were uninsured compared to 92 percent of women workers – a phenomenon largely driven by the dominance of women workers in the garment subsector, which had higher than normal levels of insured workers.

There are both financial and non-financial barriers that prevent workers from accessing social security coverage. Nearly 48 percent of employees may struggle to make their full contribution to their NSSF pension when contribution rates hit their full level in ten years. Workers in construction and manufacturing were most capable of meeting these obligations, while domestic workers and people working in agriculture and wholesale and retail trade were the least capable of making these contributions. However, the capacity of workers to contribute depends on many factors, including household debt levels, which have increased during the COVID-19 pandemic. Non-financial barriers to accessing social security include a lack of knowledge and awareness about benefits and processes. Nearly two in three workers were not aware of the NSSF at all, though the NSSF notes that they have cooperated with employers and enterprises to raise awareness, including through social media. A lack of trust is another challenge.

Source: F Mertens, W Habib and U Naeem, 'Expanding social protection for those of active age in Cambodia: A study to understand the characteristics of workers and enterprises in the informal economy,' Oxford Policy Management, forthcoming (2022).





5.

**THE LEGAL AND
POLICY LANDSCAPE**

The regulatory framework for enterprises in Cambodia governs their entry, exit and many aspects of their operations. However, the legal and regulatory framework differs based on enterprise characteristics including, but not limited to, the sector of operation, the number of employees, the annual turnover, the legal structure of ownership and the assets held by the enterprise. Similarly, the incentives available to enterprises are also shaped by these characteristics.

One important determinant of the regulatory framework faced by enterprises is whether the enterprise is classified as a micro, small, medium or large enterprise. The definitions of small and medium enterprises are outlined in Table 3, and vary somewhat between the agriculture, industry and services and trade sectors. Micro enterprises are those that fall below the minimum requirements to be classified as a small enterprise. Large enterprises are those that exceed the maximum levels for a medium enterprise. The size classification affects a number of different aspects of the regulatory framework, such as taxation.

Table 3. Criteria for small and medium enterprises in agriculture, industry and services and trade

Sector	No. of Employees			Annual Turnover (USD)			Assets (USD)	
	Small	Medium		Small	Medium		Small	Medium
Agriculture	5-49	50-199	And	62,250 – 250,000	250,001 – 1,000,000	Or	50,000 – 250,000	250,000 – 500,000
Industry	5-49	50-199		62,500 – 400,000	400,001 – 2,000,000		50,000 – 500,000	500,001 – 1,000,000
Services & Trade	5-49	50-99		62,500 – 250,000	250,001 – 1,500,000		50,000 – 250,000	250,001 – 500,000

Note: Turnover or assets condition to be chosen, whichever is higher.

Source: MISTI, CoM Office Letter # 36, dated January 21, 2021

5.1 ENTERPRISE REGISTRATION, LICENSING AND PERMITTING

Enterprise start-up is governed by a range of registration, licensing, permitting and declaration requirements implemented by many government ministries or institutions. Registrations, licenses and permits are conceptually different. A registration provides relevant information to the government about an enterprise. It is an administrative requirement and generally does not involve an

approval (though it does require appropriate paperwork to be submitted). A license is needed to gain government consent before the enterprise starts operation, and generally requires an approval. Licenses are often sector specific. Permits, like licenses, are sector specific but generally involve an inspection in order to verify business compliance with public health and safety requirements. A declaration is similar to a registration, although generally it is a one-way transmission of information as opposed to a registration, in which an enterprise receives something in response, such as a business or tax ID number. Because registration, licenses, permits and declarations serve different purposes, enterprises may need to complete more than one process to be fully compliant with the legal and regulatory framework.

5.1.1. Enterprise registration at the Ministry of Commerce

The Ministry of Commerce (MoC) is one of the key institutions responsible for enterprise registration. Its primary focus is the registration of companies. A company is a legal entity formed by, but legally distinct from, an individual or group of individuals, whereas an enterprise is a business organization that may or may not be registered as a company. Company registration in Cambodia is governed by the Law on Commercial Rules and Register, which requires all merchants and commercial companies whose principal establishment, branch office or agency is in Cambodia to register, unless they are exempted from taxation of profits.¹⁴¹ This means that all enterprises other than agricultural cooperatives with annual turnover of at least \$62,500 are required to register with MoC. Enterprises with annual turnover of less than \$62,500 that do not meet any other criteria of a small taxpayer may not be required to register with MoC, although may do so if they so choose.

MoC registers a number of different types of business structures. The first two types – a company and a foreign company – are separate legal entities from their owner or owners. The third category, sole proprietorship, is not a separate legal entity from the owner. This registration type is for individuals who exceed the minimum threshold for a small taxpayer but who do not want a separate legal entity. Sole proprietor registration with a national ministry of commerce is not present in all countries. The last type of registration is a partnership, which includes both general and limited partnerships.

¹⁴¹. Law on Commercial Rules and Register, Article 12.

Table 4. Forms and number of enterprise registrations with the Ministry of Commerce

Type of Enterprise Registration		Number
Company	Private limited company	38,885
	Public limited company	
Foreign Company	Foreign branch office	
	Commercial representative office	
	Subsidiary	
Sole Proprietorship		
Partnership	General partnership company	3
	Limited partnership company	

Note: Data current as of May 23, 2022

Source: Ministry of Commerce, 2020, <https://www.registrationservices.gov.kh/wp-content/uploads/2020/06/User-Guide-Eng-1.pdf> [accessed June 3, 2022]

According to data from the MoC in 2022, the total number of enterprises registered with the ministry is 54,384. Of these, the majority – some 38,885 – are companies or foreign companies. The remainder are almost exclusively sole proprietors. Though MoC offers registration for partnership companies, only three have registered. The current number of enterprises registered according to MoC data is lower than the number reported in the 2022 Economic Census, which found 41,835 registered sole proprietors as well as 7051 private businesses, 12,778 public or state enterprises (or state joint ventures), and 2,059 subsidiaries, branches or offices of foreign companies. However, MoC registration is not mandatory for micro enterprises, so it should not be used as a standalone measure of formality. MoC also requires enterprises to take some ongoing steps to remain compliant, such as filing an annual status declaration. Enterprises that are registered with MoC must also make filings when changing their commercial registrations, creating or changing their branches, and upon closure or dissolution of commercial entities. Separate from its role as the commercial registrar, MoC also oversees the licensing of e-commerce businesses, which it started in 2021.

5.1.2. Registration, licensing and permitting at sectoral ministries

A number of ministries in Cambodia engage in business registration, licensing and permitting, including but not limited to the Ministries of Labour and Vocational Training; Culture and Fine Arts; Education, Youth and Sports; Tourism; Industry, Science, Technology and Innovation; Mines and Energy; Health; Agriculture, Forestry and Fisheries; and Land Management, Urban Planning

and Construction. The Ministry of Commerce also issues a permit/license for commercial service businesses. Many enterprises that are not registered with MoC obtain a registration, license or permit from one or more of these sectoral ministries, sometimes through the OWS. There are hundreds of different types of registrations, licenses and permits that enterprises may be required to obtain, generally depending on the sector of their operations. A full review of these is beyond the scope of this report, however more details can be found in the recent UNDP Cambodia report entitled, “Background Research on Administrative Barriers to Formalization of Business Enterprises in Cambodia”.

Table 5. Number and workforce of industrial enterprises registered with MISTI, by sector

Industrial Subsectors		2022	
ISIC Codes	Description	No. of Bases	Labour
10-12	Food, beverages and cigarettes	28,355	164,656
13-15	Garments, textiles, handbags and shoes	3,340	193,686
16	Wood industry and wood products (except furniture)	283	2,075
17-18	Paper and printing (except clothing)	194	4,410
19-22	Chemical, rubber and plastic industries	1,308	12,179
23	Non-metal mineral industry	2,109	30,374
24-30	Metal processing industry	5,382	20,569
31	Furniture	897	4,598
32	Other industries	1,515	5,645
Grand Total		43,383	438,192

Note: Does not include non-industrial enterprises registered with MISTI. Data current as of May 2022.

Source: Ministry of Industry, Science, Technology and Innovation

One example of a sectoral ministry with an important role in enterprise registration, licensing and permitting is the Ministry of Industry, Science, Technology and Innovation (MISTI). According to data from the ministry in 2022, there were 43,383 industrial enterprises registered. The majority of these – 28,355 – were in the food, beverage and cigarette manufacturing sub-sectors. This suggests a moderate decline, perhaps due to the COVID-19 pandemic, in the number of registered enterprises, which in 2019 was 49,949.¹⁴² MISTI oversees a range of registrations, permits and certificates, from the registration of handicraft workshops and factories to permits for using a standard product logo. Other ministries also register, permit and license enterprises and collect data on them. The regulatory requirements of each ministry

¹⁴² National Institute of Statistics, ‘Statistical Yearbook of Cambodia 2021,’ Ministry of Planning, 2022, <https://nis.gov.kh/nis/yearbooks/StatisticalYearbookofCambodia2021.pdf> [accessed July 18, 2022].

vary, making it difficult to summarize. Despite the disaggregated nature of registration, licensing and permitting in Cambodia, there is not yet a comprehensive statistical business register hosted by the National Institute of Statistics (NIS) or any other government entity. This makes it difficult to provide information on the entire landscape of enterprises. However, in December 2022, Cambodia released initial findings from the 2022 economic census, which provides useful updated data on the entire sphere of enterprises in Cambodia.

5.2. TAXATION SYSTEM

Cambodia's tax system focuses heavily on taxation of and through enterprises. Its reliance on indirect taxes – the types of taxes charged to one entity like a business but passed onto another entity such as a consumer – is significantly greater than the average in the Association of Southeast Asian Nations (ASEAN).¹⁴³ Cambodia's taxation system classifies taxpayers into four groups: general, small, medium and large taxpayers. All taxpayers (including individuals) are required to register with the GDT or a local tax branch within 15 working days after starting their activities, however only taxpayers who meet the minimum requirements of a small taxpayer are required to pay most taxes.¹⁴⁴ Enterprises that are registered as a separate legal entity (such as a limited liability company) are required to register as a medium or large taxpayer. While Cambodia's system is a self-assessment regime where enterprises declare the taxpayer level they qualify under, the GDT can re-classify taxpayers if the declared turnover does not reflect actual turnover. This is done based on the assets of the enterprise.

Large taxpayers are responsible for the majority of taxes collected in Cambodia. In 2017, there were 3,744 active large taxpayers accounts in Cambodia that were responsible for 73 percent of total tax collections.¹⁴⁵ A total of 32,364 taxpayers have been verified as complete and transferred to the central taxation database, a population that “continues to appear very small in relation to the visible economic development in Cambodia,” according to the IMF.¹⁴⁶

143. Cambodia's tax mix ratio is 23% in 2019, compared to 40% across ASEAN. See A Chongvilaivan and A Chooi, 'A Comprehensive Assessment of Tax Capacity in Southeast Asia,' December 2021, ADB.

144. DFDL, 'Cambodia: Revision of Taxpayer Classification,' February 2021, <https://www.dfdl.com/resources/legal-and-tax-updates/cambodia-revision-of-taxpayer-classification/> [accessed July 17, 2022].

145. IMF, 'Cambodia: Technical Assistance Report-Tax Modernization Priorities 2019-23,' November 2018, <https://www.elibrary.imf.org/view/journals/002/2018/305/article-A001-en.xml> [accessed July 17, 2022].

146. Ibid.

All small, medium and large taxpayers pay a number of different taxes every year (a full breakdown is provided in Table 5. They pay commercial income tax (CIT) on profits, or alternatively a one percent minimum tax on the total value of annual turnover – whichever is larger. They also collect VAT, although they are able to deduct inputs from registered enterprises with a proper invoice. They pay patent tax, collect and pay monthly withholding tax, and are subject to fees for taxpayer identification registration (one time only) and tax updates (per filing). Enterprises file both monthly and annual tax declarations. Small taxpayers receive some benefits in comparison to medium and large enterprises. They face lower fees in a number of areas, such as for tax registration. They can also use simplified accounting obligations, a minimum VAT input credit threshold and withholding tax exemptions.¹⁴⁷

General taxpayers, which includes all micro enterprises, property owners and own-account workers that fall below the small taxpayer threshold, are not required to pay many of the taxes faced by other taxpayers, although they are still subject to other types of taxes, depending on their activities. These taxes include property tax, tax on property rental, tax on means of transportation, unused land tax and tax on registration, among others. Small, medium and large taxpayers may also be liable for these taxes, although they are applicable only if the enterprise has assets or engages in a relevant activity. According to the 2003 Law on Taxation, all employees are liable to pay salary tax on their employment activities, with their employers being obligated to deduct, withhold and pay the salary tax obligations of employees to the tax administration.¹⁴⁸ For monthly salaries up to KHR 1,200,000 (US \$296), the tax rate is zero percent.¹⁴⁹



147. DFDL, 2021.

148. National Assembly of the Kingdom of Cambodia, 'Law on Taxation,' Article 42, 2003.

149. National Assembly of the Kingdom of Cambodia, 'Law on Financial Management,' Article 47, 2018.

Table 6. Taxpayer classifications under the self-assessment regime

Small Taxpayer	Medium Taxpayer	Large Taxpayer
Any sole proprietorship or partnership that has:	Any enterprise incorporated as a legal entity or a representative office, or any sole proprietorship or partnership that has:	Any branch of foreign companies; subsidiary of multinational companies; and enterprise registered as a Qualified Investment Project (QIP); as well as any sole proprietorship, partnership or legal entity that has:
<ul style="list-style-type: none"> • Annual turnover* from KHR 250 million (\$62,500) to KHR 1,000 million (\$250,000) for agricultural, service and commercial sectors; • Annual turnover from KHR 250 million (\$62,500) to KHR 1,600 million (\$400,000) for the industrial sector; • Or expects to have turnover in any period of three consecutive calendar months** exceeding KHR 60 million (\$15,000). 	<ul style="list-style-type: none"> • Annual turnover from KHR 1,000 million (\$250,000) to KHR 4 billion (\$1,000,000) for taxpayers in the agricultural sector; • Annual turnover from KHR 1,000 million (\$250,000) to KHR 6,000 million (\$1,500,000) for taxpayers in the service and commercial sectors; and • Annual turnover from KHR 1,600 million (\$400,000) to KHR 8,000 (\$2,000,000) in the industrial sector. 	<ul style="list-style-type: none"> • Annual turnover above KHR 4,000 million (\$250,000) for taxpayers in the agricultural sector; (companies/sole proprietorship/partnership); • Annual turnover 6,000 million (\$1,500,000) for taxpayers in the service and commercial sectors; and • Annual turnover above KHR 8,000 (\$2,000,000) in the industrial sector.

Notes: *The term “turnover” refers to the level of a taxable supply of goods and services related to a taxpayers business activities. **Calendar months: Within the same tax year

Source: DFDL, Revision of Taxpayer Classification, February 2, 2021, <https://www.dfdl.com/resources/legal-and-tax-updates/cambodia-revision-of-taxpayer-classification/> [accessed December 6, 2022]

Cambodia’s taxation system also has a number of fees that appear to focus on revenue generation but are not necessarily linked to the performance or profitability of the enterprise. The patent tax is one example. It is charged by the GDT, and functions largely as an annual business registration tax. Beyond fees, the GDT also assesses interest on unpaid taxes at a rate of 1.5 percent per month. This is high both in comparison to other countries in the region, as well as in comparison to market interest rates and Central Bank-issued rates in Cambodia. In addition, the GDT can enforce penalty tax for violations on top of charging interest on unpaid taxes.

Table 7. Tax and tax-related reporting and compliance obligations in Cambodia

Taxpayer type	General	Small	Medium	Large
Tax				
Commercial income tax*		20% of profit	20% of profit	20% of profit
		or	or	or
Minimum tax		1% of turnover	1% of turnover	1% of turnover
Value added tax		10%	10%	10%
Patent tax (per business activity)		USD 100	USD 300	USD 500 or USD 1,250
Withholding tax (on rentals, independent services, royalties, and interest)**	4% - 15%	4% - 15%	4% - 15%	4% - 15%
Tax registrations		KHR 20,000 (US \$4.93)	KHR 400,000 (US \$98.72)	KHR 400,000 (US \$98.72)
Tax updates		KHR 10,000 (US \$2.47)	KHR 200,000 (US \$49.36)	KHR 200,000 (US \$49.36)
Tax reporting and other tax compliance requirements				
Monthly tax declaration		x	x	x
Annual tax declaration		x	x	x
Salary tax deductions for employees	x	x	x	x
Mandatory audits		All public enterprises, public limited enterprises and investment projects; all enterprises that meet two of the following conditions: revenue of KHR 4 billion or \$1 million; total assets of KHR 3 billion or \$750,000; and at least 100 employees		
Submission of unaudited financial statements		All enterprises not subject to mandatory audits		
* Limited exceptions and variations				
** 15% withholding on services is not applicable for payments to a registered taxpayer, when supported by a proper invoice				

Sources: MEF Prakas 562, MEF Notification No. 002 NK Sor. Sor Chor Nor, https://www.taxesforexpats.com/country_guides/cambodia/us-tax-preparation-in-cambodia.html, <https://assets.kpmg/content/dam/kpmg/kh/pdf/technical-update/2020/tax-registration-and-update-of-taxpayer%27s-information-tax-update-kpmg-kh.pdf>, <https://www.grantthornton.com.kh/en/insights2/articles-and-publications/prakas-no.-563-mef.prk/>

Property tax: <https://www.tax.gov.kh/en/content-detail/64yR97142168697947>

Cambodia has about 7,800 citizens per tax officer, which is on the higher end for Asia and the Pacific, suggesting that the GDT may not be understaffed. Cambodia established an e-filing system for taxes recently, in 2021.¹⁵⁰ It also offers tax incentives for newly registered SMEs in targeted sectors. The incentives include a three to five-year income tax exemption, an exemption from tax prepayments and the annual minimum tax, and increased deductions for IT-based accounting software, some types of staff training and productivity-enhancing equipment or technology.¹⁵¹ In practice, GDT accepts businesses registrations, licenses and permits from a range of authorities for the purposes of registering for taxes, suggesting that MoC registration is not and does not need to be a prerequisite for tax compliance.¹⁵² It also suggests that back-office coordination between ministries and subnational administrations could help further reduce the multi-step registration and licensing process, though important initiatives that could address this are already underway – notably the CamDX portal.

5.3. LABOR AND SOCIAL SECURITY REGULATIONS

Enterprises in Cambodia must comply with a range of laws and regulations regarding labour and social security. Any business with at least one employee (whether part-time or full-time, on a salary or commission basis) is required to file a declaration of enterprise opening with the MoLVT prior to or within 30 days of starting operations.¹⁵³ For enterprises that register online using the CamDX system, the enterprise opening announcement can be done as part of the online process. The cost for this declaration via the CamDX is KHR 120,000 (about \$30). However, micro enterprises cannot yet use the CamDX system solely for this purpose, unless they also register with MoC and GDT. Instead, micro enterprises must file the announcement directly with the MoLVT where the formal cost is also KHR 120,000 (about \$30).

150. KPMG, 'Cambodia: System for e-filing income tax returns; tax relief (COVID-19),' February 5, 2021, <https://home.kpmg/us/en/home/insights/2021/02/tnf-cambodia-system-for-e-filing-income-tax-returns-tax-relief-covid-19.html> [accessed July 17, 2022].

151. DFDL, 'Cambodia Tax Update: SME Tax Incentives Announced,' 2018, <https://www.dfdl.com/resources/legal-and-tax-updates/cambodia-tax-update-sme-tax-incentives-announced/> [accessed July 17, 2022].

152. General Department of Taxation, "Tax Registration and Updating of Tax Information," Prakas No. 701 (2020) of the Ministry of Economy and Finance, <https://www.tax.gov.kh/u6rhf7ogbi6/gdtstream/60d6b8e5-b734-4879-aed6-cf51c10f636d> [accessed July 17, 2022].

153. National Assembly of Cambodia, 'Labour Code,' Article 17, March 13, 1997; and Prakas No. 288 (2001) of Ministry of Social Affairs, Labour, Vocational Training and Youth.

In addition, business owners/employers must also file a request for an enterprise logbook and payroll ledger.¹⁵⁴ Enterprises must register workers under the age of 18, obtain certificates for apprenticeship and register staff movements, among other ongoing requirements. Enterprises need to register all employees within three days of the commencement of employment. Many enterprises are subject to annual labour inspections and compliance with a range of labour-related rules and regulations including but not limited to requirements on wages, working conditions, workplace safety, overtime, leave, termination and other areas. The estimated time needed to comply with these requirements is 84 hours per year, or seven hours per month – somewhat higher than the Asia and the Pacific average of 60 hours per year.¹⁵⁵ However, this time estimate was prior to the introduction of the online registration system by the MoLVT, which may have affected the time needed for compliance.

Businesses may also request other services from the MoLVT. Enterprises with one to seven employees, and most enterprises with eight to 100 employees, report to the provincial departments of the MoLVT. Enterprises with more than 100 employees, as well as some specific types of enterprises (e.g., casinos, airlines, etc.) report only to the national-level MoLVT office.¹⁵⁶ The smallest enterprises are exempt from some compliance requirements, such as registering their internal work rules or regular labour inspections. Compliance standards are highest for enterprises reporting directly to the national-level MoLVT. Lastly, enterprises are required to file a declaration within 30 days of suspending or closing an enterprise.¹⁵⁷

Enterprises that are subject to the provisions of the labour law (e.g., those with at least one employee) are required to register with and make regular contributions to the NSSF. This includes households that hire a housemaid or domestic worker. According to the 2022 NSSF Annual Report, some 17,821 enterprises with nearly 2.6 million employees were registered with the NSSF HCS, though this figure includes 843 CSOs with just over 27,000 workers.¹⁵⁸

154. National Assembly of Cambodia, 'Labour Code,' Article 29 & 30, March 13, 1997.

155. OECD and Economic Research Institute for ASEAN and East Asia, SME Policy Index: ASEAN 2018: Boosting Competitiveness and Inclusive Growth, 2018, OECD Publishing, Paris/Economic Research Institute for ASEAN and East Asia, Jakarta, <https://doi.org/10.1787/9789264305328-en> [accessed July 17, 2022].

156. DFDL, 'Cambodia Labour Update – August 2020,' September 2, 2020, <https://www.dfdl.com/resources/legal-and-tax-updates/cambodia-labour-august-2020/> [accessed July 17, 2022].

157. DFDL: "Cambodia Labour Update – August 2020," September 2, 2020, <https://www.dfdl.com/resources/legal-and-tax-updates/cambodia-labour-august-2020/> [accessed July 17, 2022]

158. National Assembly of Cambodia, "Labour Code," Article 18, March 13, 1997; and Prakas No. 288 (2001) of Ministry of Social Affairs, Labour, Vocational Training and Youth.

However, of this total, only 11,623 of these enterprises (with just under 1.4 million employees) made timely contributions. Almost all enterprises registered with the NSSF are also registered with the MoC and GDT. Unlike the taxation system, which exempts many micro enterprises, registration and contribution payments to the NSSF are required for all enterprises that have at least one employee.¹⁵⁹

Table 8. Mandatory NSSF contributions for employers and workers

		Contribution Rates		Monthly cap (per employee)
		Employer	Employee	
Occupational risk scheme		0.8%	0.0%	\$2.40
Health care scheme		2.6%	0.0%	\$7.80
Compulsory pension scheme*	Years 0-5	2.0%	2.0%	
	Years 6-10	4.0%	4.0%	
	Years 11-20	5.375%	5.375%	

* The compulsory pension scheme launched as of July 2022, with contributions starting October 2022.

Source: Mairead Barron, Cambodia, The Social Security Pension Scheme, April 12, 2021, <https://immedis.com/country-updates/cambodia-the-social-security-pension-scheme/> [accessed December 6, 2022]

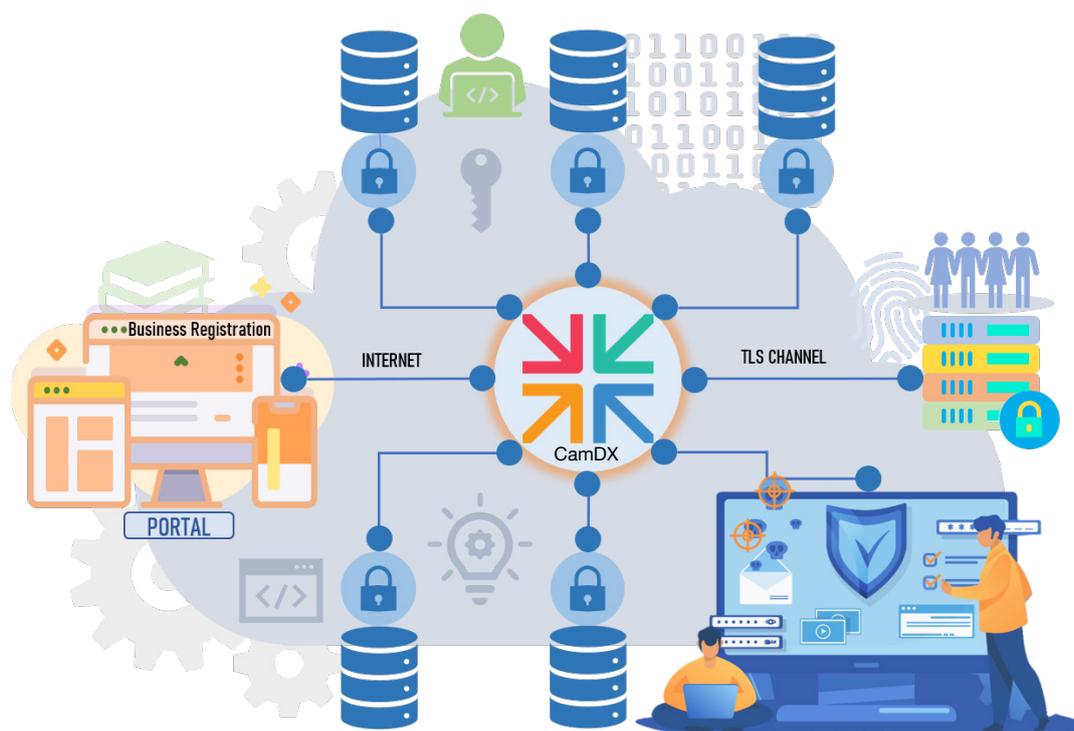
Enterprises are required to make monthly payments to the NSSF for the ORS and HCS. The cost of these schemes, which are both paid fully by the employer, are 0.8 percent and 2.6 percent of the average wages per employee, respectively. Both of these contributions also have a maximum level. In 2021, a sub-decree was issued by the Royal Government of Cambodia providing details on the pension scheme, which consists of four components: an old-age pension, a disability pension, a survivor's pension and a funeral allowance. The pension scheme, which started collecting mandatory contributions in October 2022, has a two percent employee contribution and two percent employer contribution for the first five years of the scheme, with increases later. Enterprises that are not already registered under the NSSF for the other schemes are required to register within 30 days of the issuance of the sub-decree. Under this sub-decree, enterprises will make monthly pension contributions alongside their existing NSSF contributions, as well as report on the number of workers monthly to the NSSF.

159. Ministry of Labour and Vocational Training, 'Notification on Registration of the Informal Workers in the National Social Security Fund in Order to Access Health Care Scheme Through the Health Equity Fund System and the Additional Allowance for the Female Workers When Delivery,' Kingdom of Cambodia, No. 307 LV/N.NSSF, <http://www.nssf.gov.kh/default/wp-content/uploads/2017/12/307.pdf> [accessed July 17, 2022].

5.4. AVENUES FOR FORMALIZING AND REMAINING FORMAL

Business registration, licensing and permitting can be done through multiple channels, depending on the types of registrations, licenses and permits that an enterprise needs to obtain. Channels include:

- **Online through the CamDX portal.** This portal allows enterprises that want to establish a company, register as a small/medium/large taxpayer and declare their opening to the MoLVT to complete all these processes through a single, digital portal (note that NSSF registration is separate from the MoLVT declaration and not included in the CamDX process as of July 2022). Presently, the CamDX caters to enterprises that need to complete all of these processes. This limits its usefulness for enterprises that do not need all of these registrations. The portal also allows enterprises to apply for some specialized licenses with ministries including the MISTI, Ministry of Tourism (MoT), Ministry of Post and Telecommunications (MoPT) and the Real Estate and Pawn Regulatory of Non-Bank Financial Services. Fees when registering via the portal start at \$136.25.



Source: camdx.gov.kh

Table 9. Service fees of selected ministries in the CamDX portal, by enterprise type

Ministry of Commerce				
	Company	Foreign Company	Sole Proprietorship	Partnership
Reservation of a company / enterprise's name	KHR 25,000 (US \$6.17)	KHR 25,000 (US \$6.17)	KHR 25,000 (US \$6.17)	KHR 25,000 (US \$6.17)
Business registration	KHR 1,010,000 (US \$249.26)	KHR 1,010,000 (US \$249.26)	KHR 180,000 (US \$44.42)	KHR 1,010,000 (US \$249.26)
Total	KHR 1,035,000 (US \$255.43)	KHR 1,035,000 (US \$255.43)	KHR 205,000 (US \$50.59)	KHR 1,035,000 (US \$255.43)
General Department of Taxation				
	Small Taxpayer	Medium Taxpayer	400 million riels (US \$98,700) < Turnover < 10,000 million riels (US \$2,468,000)	Turnover > 10,000 million riels (US \$2,468,000)
Tax registration	KHR 20,000 (US \$4.94)	KHR 400,000 (US \$98.72)	KHR 400,000 (US \$98.72)	KHR 400,000 (US \$98.72)
Patent tax per business activity	KHR 200,000 (US \$49.39)	KHR 600,000 (US \$148.08)	KHR 1,500,000 (US \$370.19)	KHR 2,500,000 (US \$616.98)
Total	KHR 220,000 (US \$54.29)	KHR 1,000,000 (US \$246.79)	KHR 1,900,000 (US \$468.90)	KHR 2,900,000 (US \$715.70)
Ministry of Labour and Vocational Training				
	All Forms of Enterprises			
Notice for Enterprise Opening	KHR 120,000 (US \$29.62)			
Total	KHR 120,000 (US \$29.62)			

- **In-person at the subnational administration one window service (OWS).** The OWS is a single point of engagement for individuals and enterprises to streamline their government interactions. Nearly 200 delegated administrative functions from a range of ministries can be completed at the OWS. This includes personal services such as certifying an educational certificate, as well as enterprise services such as obtaining a license and permit.¹⁶⁰ Many of the licenses and permits are for micro

160. More information on the OWS is available at: <https://www.service.gov.kh/ministry/37>.

enterprises or own-account workers. Examples range from bookstore permits to permits for guesthouses with less than eight rooms to permits for noodle shops. Cambodia's government has noted that the OWS has been a useful tool in combatting corruption.¹⁶¹ The recent expansion in 2021 and 2022 of the OWS to all municipalities, khans and districts suggests that the government sees this as a complementary channel to the CamDX for engaging enterprises. Service fees vary, and many are publicly listed on the Ministry of Interior's OWS Office website.¹⁶²

- **At the relevant ministry.** Some functions can only be completed directly with the relevant ministry or other institution, for example enterprise registration with the NSSF. Enterprises submit a hard copy application, often accompanied with a photo, original thumb print, signature and original or certified copies of supporting documents to complete the registration.

5.5. INCENTIVES

Cambodia has a range of incentives to encourage enterprises to formalize – though at present they are targeted at SMEs. Existing incentives include a three-year income tax exemption for new SME tax registrations in certain sectors, and for all SMEs located in SME clusters. Some SMEs in selected sectors can obtain five-year exemptions when meeting certain employment and local input thresholds. These tax incentives are detailed in Sub-Decree No. 124 ANKr.BK.¹⁶³ These incentives also allow accounting systems and some types of staff training to be offset on tax returns at 200 percent of their cost (e.g., deducting twice the cost of the training from the tax returns), and investments in productivity-enhancing capital to be offset at 150 percent. Prior to this, in 2017, the government issued Sub-Decree No. 17 ANKr.BK which declared that SMEs registering voluntarily with the GDT would receive a two-year exemption from tax on business profits and an exemption from the annual one percent minimum tax (and monthly pre-payments).

161. S David, 'One Window Service Offices are a success,' Khmer Times, November 30, 2021, <https://www.khmertimeskh.com/50979454/one-window-service-offices-are-a-success/> [accessed July 18, 2022].

162. Ministry of Interior, One Window Service Office, <https://www.service.gov.kh/ministry/37> [accessed May 22, 2022].

163. APV Certified Public Accounts, 'Cambodia Investment & Tax Booklet 2020,' 2020, <https://www.mgiworld.com/media/2123433/apv-investment-tax-booklet-copy-2.pdf> [accessed July 18, 2022]

Cambodia's government also launched a Business Recovery Guarantee Scheme in 2021, to help businesses recover from the COVID-19 pandemic. To participate, enterprises must either be registered, complete registration after they receive the guarantee, or pay an additional fee of 0.5 percent per year.¹⁶⁴ Cambodia additionally has an Entrepreneurship Development Fund and the Skills Development Fund, which are mainly for registered MSMEs.¹⁶⁵ The country offers a range of investment incentives for Qualified Investment Projects (QIPs), as well as for Expanded QIPs for existing investment projects.¹⁶⁶ However, these incentives target medium and larger investments and are not further covered here given the report's focus on micro and small enterprises.

These incentives have been met with mixed reviews. SMEs initially took advantage of the tax exemptions launched in 2017, however registrations slowed as it was unclear what was meant by "voluntary registration". Moreover, tax officers required proof that a SME had registered voluntarily, and often the SME was still required to pay tax, pending clarification from the GDT. SMEs were also worried that if they registered, they would be required to pay penalties and back taxes. Some SMEs remain reluctant of the tax incentive, as they see it as burdensome and fear that they will have to pay penalties.¹⁶⁷



164. Credit Guarantee Corporation of Cambodia, 'Business Recovery Guarantee Scheme,' <https://www.cgcc.com.kh/en/brgs/> [accessed July 18, 2022].

165. United Nations Department of Economic and Social Affairs, 'Supporting Micro-, Small and Medium-sized Enterprises (MSMEs) to Achieve the Sustainable Development Goals (SDGs) in Cambodia through Streamlining Business Registration Policies,' 2020, pg. 8, https://sdgs.un.org/sites/default/files/2020-07/Supporting_MSMEs_to_Achieve_SDGs_in_Cambodia.pdf [accessed July 18, 2022].

166. World Bank, 2021.

167. IFC and Umbrella Facility for Gender Equality, 'Exploring the Opportunities for Women-owned SMEs in Cambodia,' 2019, pg. 19, https://www.ifc.org/wps/wcm/connect/9e469291-d3f5-43a5-bea2-2558313995ab/Market+Research+Report+on+Women_owed+SMEs+in+Cambodia.pdf?MOD=AJPERES&CVID=mOU6fpx [accessed July 18, 2022].



6.

**DRIVERS OF INFORMALITY
IN CAMBODIA**

Informality is complex and lacks a single key driver. Some challenges are cross-cutting and affect micro enterprises as well as SMEs. Others are specific to some sub-groups of MSMEs and have little if any implications for other enterprises. Drivers can differ based on the characteristics of the enterprise and the experiences and views of the owner, though there is a notable divide between micro and small enterprises. This is partly because these groups face different legal and regulatory requirements that shape whether formalization is beneficial, needed or even possible. This section reviews the key drivers of informality, starting with micro enterprises and SMEs and then turning to cross-cutting drivers.

6.1. THE ABSENCE OF A FRAMEWORK FOR MICRO ENTERPRISE FORMALIZATION

The primary reason that numerous micro enterprises are informal is because the legal and regulatory framework does not require them to fulfill many steps associated with formality. This is evident both in the legal and regulatory framework review as well as from interviews with micro enterprises. According to a 2019 World Bank survey of non-farm household enterprises – a group of enterprises that significantly overlaps with micro enterprises – 75 percent said they are not required to register because they are so small. On the other hand, less than one percent said that the direct costs, e.g. its expense, or the indirect costs, such as a difficult process or risk of tax problems, are a deterrent to registration.¹⁶⁸

For micro enterprises, the primary reason that many are informal is because the legal and regulatory framework does not require them to fulfill many steps associated with formality.

The policy framework often either excludes or does not require micro enterprises to participate, but it also does not have a clear and separate pathway for them to formalize. They are not required to register with the MoC. They are also not forced to pay commercial income tax (CIT) or personal income tax (PIT), nor to charge VAT to customers. Some micro enterprises that buy goods for resale from a formal supplier may indirectly pay VAT, however micro enterprises buying goods or services from informal suppliers or agricultural

168. W Cunningham and M Shrestha, undated.

producers (which are almost exclusively informal) would not. As such, the vast majority of micro enterprises do not keep a full record of accounts for the tax authorities, because tax authorities do not require them to do so. They have little incentive to keep a full record of accounts. Cambodia's CamDX registration system, which allows enterprises to register with the MoC, GDT and MoLVT in a single process, is also not aimed at micro enterprises and does not have a clear path for micro enterprises to use it for only the registration that they need. Many micro enterprises do obtain some type of license or permit, often via the OWS.

The MoLVT does have mandatory requirements that apply to micro enterprises. The 1997 Labour Law applies to all enterprises that employ at least one worker, even discontinuously, although the law also contains mention of artisans as a special status applying to some micro enterprises with no more than seven employees. However, labour laws still apply to a significantly greater number of micro enterprises than either MoC or GDT registration requirements. Similarly, NSSF registration is required by the Law on Social Security Schemes and is specifically outlined in a Prakas, which requires all employers that employ one worker or more (whether regular or casual) to register within 30 days of the enterprise opening.¹⁶⁹ However, non-compliance with declaration requirements and labour laws is high. Despite this, the overall micro enterprise framework still allows many micro enterprises to be either partially or even fully compliant but to appear informal given their lack of MoC registration and tax payments.

6.1.1. Affordability and formalization costs for micro enterprises

While micro enterprises could formalize under the current framework for small enterprises, there are significant financial and other disincentives to do so. Micro enterprises could register as a company or sole proprietor with the MoC, however this step is unnecessary, incurs additional direct costs and automatically creates tax and record keeping obligations that they would not otherwise have. While there are some advantages to becoming formal, the fact that few micro enterprises have formalized under the small enterprise framework suggests that the costs outweigh the benefits. This is not surprising, given the framework was not designed with micro enterprises in mind.

Some micro enterprises could struggle to pay for the costs associated with formalizing under the framework for small enterprises. The

¹⁶⁹. NSSF, 'Prakas on Registration of Enterprises/Establishments and Workers in the National Social Security Fund (NSSF) for Persons Defined by the Provisions of the Labour Law,' Prakas 448 LV/PRK.NSSF, March 7, 2017.

lowest possible cost under the current CamDX registration system is \$135 – more than half the monthly profit of \$260 for an average micro enterprise.¹⁷⁰ This does not include other one-time or ongoing costs, nor the additional compliance burden these micro enterprises would face. This speaks directly to the need for a more affordable and simple formalization process for micro enterprises, while also showing the need for higher productivity among micro enterprises which would increase the share that have the capacity to formalize.

6.1.2. From micro to small enterprise: a major leap

Micro enterprises face a steep increase in costs and legal and regulatory burdens if they transition to the status of a small enterprise. One of the most striking features of Cambodia's tax system is the low tax burden for individuals and enterprises that fall below the small taxpayer threshold. The GDT does not enforce taxes against most micro enterprises in any meaningful way. These “general taxpayers” are not required to pay the CIT nor to collect VAT from customers. Further, Cambodia does not yet enforce PIT, so individuals who work on their own account and do not meet the minimum income to register as a small taxpayer do not pay PIT on their earnings. Employees of micro enterprises are subject to salary tax, although the levels of compliance are not clear, and many employees fall into the zero percent tax bracket. Because they do not pay any of these major taxes, individuals and enterprises under the small taxpayer threshold are also not subject to tax audits.¹⁷¹

Micro enterprises face a steep increase in costs and legal and regulatory burdens if they hope to transition to the status of a small enterprise.

This approach, though beneficial for micro enterprise owners, creates disincentives to formalization by making the jump from micro enterprise to small taxpayer significant. It includes registering with the MoC and GDT, as well as paying CIT, keeping formal financial records and administering VAT. It also includes filing monthly and annual tax returns. The increase in administrative requirements and costs means that micro enterprises require significant money, time and expertise to move up to a small enterprise.

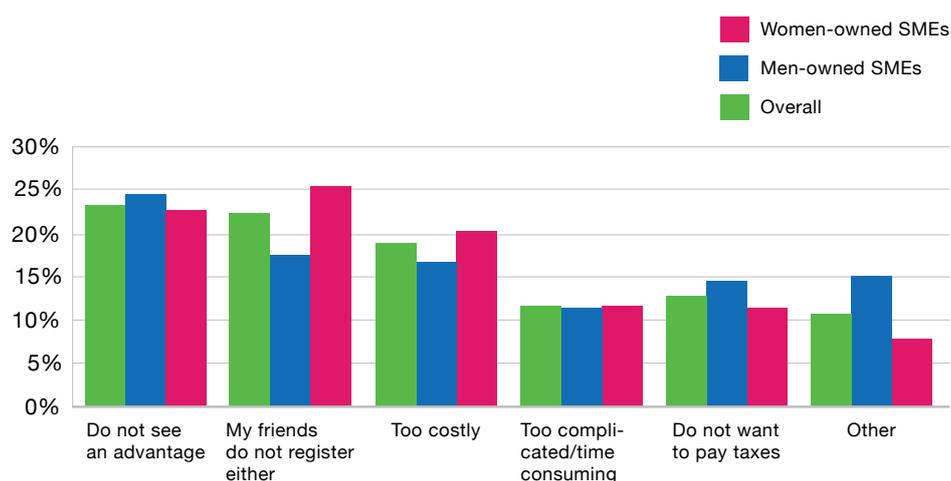
170. W Cunningham and M Shrestha, undated.

171. Transparency International Cambodia, 'Case Study: Tax System in Cambodia,' 2016, http://ticambodia.org/library/wp-content/files_mf/1536811560Final_Eng_CaseStudyonTaxSystem.pdf [accessed July 18, 2022].

6.2. THE DRIVERS OF INFORMALITY AMONG SMALL AND MEDIUM ENTERPRISES

For SMEs, the drivers of informality are somewhat different than for micro enterprises. Cambodia’s legal and regulatory framework requires enterprises to register with the MoC if they meet the small taxpayer threshold – which by definition creates a requirement for all SMEs to register. They must also register with the GDT as a small or medium taxpayer and file a declaration of opening with the MoLVT. While the majority of SMEs will meet the requirements to make a declaration to the MoLVT, it is possible that a sole proprietor or company will not have any employees and will not be required to make a declaration of opening to the MoLVT.

Figure 10. Reasons for not registering businesses, by gender



Source: IFC and Umbrella Facility for Gender Equality, ‘Exploring the Opportunities for Women-owned SMEs in Cambodia,’ 2019, pg. 30, https://www.ifc.org/wps/wcm/connect/9e469291-d3f5-43a5-bea2-2558313995ab/Market+Research+Report+on+Women_+owned+SMEs+in+Cambodia.pdf?MOD=AJPERES&CVID=mOU6fpx [accessed July 18, 2022]

The legal and regulatory framework for SMEs creates both a requirement and path to formalization, yet many SMEs remain informal. When asked about this, one interviewee noted simply that “formalization takes time. It is costly. Informality is low cost.” Survey data shows that there are a range of reasons – many related to financial or time costs – why enterprises do not formalize. The most commonly cited reason was that they “do not see an advantage” to registering. This suggests that current incentives may not be appealing or may not address longer-term issues that affect enterprises’ decision making. Another commonly cited reason was that their friends did not register, suggesting that in a highly competitive environment, enterprises may be afraid that

paying higher taxes will put them at a competitive disadvantage.¹⁷² A significant share of enterprises also noted challenges in the registration process – with about 30 percent saying that their reason for not registering was because the process was too costly or too complicated/time consuming. Notably, women entrepreneurs were more likely to have a third party complete their registration process. This increases the registration costs for women entrepreneurs and may act as a deterrent to registration.

6.2.1. Challenges in the formalization process for SMEs

Challenges in the formalization process are one of the barriers to formalization cited by SMEs. One challenge is simply the number of steps needed to become fully formal. Formalization is a multi-step process, initially requiring registration and payment to the MoC, GDT and MoLVT, and perhaps other sectoral ministries. As of 2019, the World Bank noted that starting a business in Cambodia required nine steps, took 99 days and cost 53.4 percent of income per capita.¹⁷³ The launch of the CamDX web portal in 2020 and the expansion of OWS offices may help alleviate some of these costs and challenges, though more updated data is not available.

The official financial costs of formalizing can be a challenge for some enterprises. For sole proprietors who are small taxpayers, one-time registration costs via the CamDX are \$135, although this excludes other one-time start-up costs, including registration and licensing at other ministries or/and subnational administrations. For some medium enterprises, costs could rise to \$754, and for large enterprises costs would be even higher. These figures do not include other costs, such as document preparation, broker fees or informal costs. While costs have been reduced in recent years, they remain high in comparison to other countries. For example, the World Bank recently noted that there is “still scope for further reductions” and noted that in many countries, business registration is free.¹⁷⁴ The timing of costs, most of which come before operations have started and revenue is flowing, can also present a challenge for SMEs.

172. IFC and Umbrella Facility for Gender Equality, 2019.

173. World Bank, ‘Doing Business 2020: Economy Profile Cambodia,’ 2020, <https://www.doingbusiness.org/content/dam/doingBusiness/country/c/cambodia/KHM.pdf> [accessed July 17, 2022].

174. World Bank, Resilient Development: A Strategy to Diversify Cambodia’ Growth Model, Cambodia Country Economic Memorandum, 2021, pg. 14, <https://documents1.worldbank.org/curated/en/099925001262213662/pdf/P1719580f183f60bb0ac1e01e64a9c905ea.pdf> [accessed July 18, 2022].

6.2.2. Taxation challenges for SMEs

SMEs classified as either small or medium taxpayers are required to pay taxes including CIT, patent tax and withholding tax, while also collecting VAT from customers and salary tax on wages paid to employees. This creates both a financial burden, as well as a time-related burden to ensure compliance. Interviewees noted, simply, that if enterprises fully comply “they have to pay more” than if they do not fully comply. Another said, “if you comply, you pay a lot.” These costs compound with other challenges SMEs often face, such as irregular or low cashflow or access to financial services that can make complying with taxes in a timely fashion challenging.¹⁷⁵ Some taxes, such as the patent tax, are redundant and create unnecessary additional steps and payments.

Taxes are an important reason why SMEs do not register.

Taxes are an important reason why enterprises do not register, as cited by one in eight enterprises (see Figure 10). This suggests that taxes are not only an important determinant of formality, but also that SMEs consider both the one-time costs of formalizing and the ongoing costs of remaining formal when making formalization decisions. Private sector interviewees also noted that formalizing creates uncertainty and risk associated with both past and future tax obligations. The GDT has the ability to reclassify taxpayers and overrule self-assessments, which could lead to tax assessments that are significantly larger than expected. For example, one enterprise interviewed noted that when assessing their tax situation, the GDT stated that profit levels in the construction sector were 30 percent and charged tax on this basis, including interest and penalties.¹⁷⁶ The country’s tax system also lacks a truly independent authority to review GDT rulings, compounding tax-related risks.

The tax-related risks and uncertainty that enterprises face is exacerbated by other factors. Interest on past-due taxes is charged at a rate of 1.5 percent monthly. This is significantly higher than the rate of inflation or lending rates from Cambodia’s commercial lenders. It can lead to the interest on tax obligations being higher than the initial obligations themselves.¹⁷⁷ In addition, the GDT can

¹⁷⁵. Transparency International Cambodia, 2016.

¹⁷⁶. Interview with stakeholder.

¹⁷⁷. See for example: C Niem and A Baliga, ‘After Cambodia Daily’s \$6M bill, tax authority targets RFA, VOA,’ Phnom Penh Post, August 14, 2017, <https://opendevelopmentcambodia.net/news/after-cambodia-dailys-6m-bill-tax-authority-targets-rfa-voa/#!/story=post-108143> [accessed July 19, 2022].

impose penalty tax on top of unpaid taxes and interest. This is compounded by an incentive structure for tax officials in which they can be personally rewarded for large penalties. Tax officials at various levels in the GDT may receive a reward of up to 10 percent of the fines, creating “an incentive to go after companies and fine them. This scares companies.”¹⁷⁸ One interviewee shared their perception that some regulators try to find mistakes just so they can penalize enterprises. Collectively, high interest rates combined with the discretion and incentives of tax collectors create an environment in which tax obligations are highly uncertain and punitive. This directly shapes the formalization decisions of enterprises and has been “identified as a disincentive for firms to register with the NSSF.”¹⁷⁹

Cambodia’s taxation system has been undergoing numerous changes in recent years, including the creation of different taxpayer groups and the elimination of the estimated regime. According to the GDT’s Revenue Mobilization Strategy 2019-2023, other changes are likely. While some changes may improve tax system design, the pace of reforms may create compliance challenges for smaller enterprises that do not have the time or capacity to regularly monitor and learn about updates to the taxation system.

6.3. Enforcement-related issues

Enforcement can incentivize formality among enterprises by raising the potential costs of non-compliance and the likelihood of being caught, thereby making formality relatively more appealing. Many ministries are involved in enforcement. The GDT enforces tax laws, while the MoLVT enforces labour laws. The NSSF is responsible for enforcement of compliance with the Law on Social Security Schemes. These authorities conduct enforcement through a number of methods. For example, if an enterprise starts operating but does not declare its opening to the MoLVT or register with the NSSF, they may conduct a search for it and ask them to register. The NSSF noted that sometimes they are informed by local authorities when an enterprise is not compliant. There is a procedure for bringing enterprises into compliance, which can include fines or criminal charges, if corrective action is not taken.

178. Stakeholder interview; MEF circular No. 001 SHV/ChMP, Feb 26, 2013, on Principles and Procedure for Granting Incentives on Public Services Delivery; The circular supports a Joint-Prakas or MEF Prakas on Granting Incentives to the respective ministry/institution as mentioned above. For example, for the MLMUPC it is Joint-Prakas 996 SHV.BrK, Dec 28, 2012, and Joint-Prakas 1369 SHV.BrK, Nov 23, 2016. Prakas 1147 SHV.BrK, dated Sept 15, 2015, on Granting of Incentives for collection of revenue from public services of GDT of MEF.

179. Q A Nguyen and N M S da Cunha, 2019, pg. 25.

Both the NSSF and MoLVT face constraints on human resources. The MoLVT specifically noted that while the number of enterprises has grown, the number of inspectors has not. This has forced them to take a more risk-based approach to inspections.¹⁸⁰ Similarly, the NSSF also lacks the “human resources to enforce the rules.”¹⁸¹ Even though some employers are willing and able to pay contributions, one of the reasons they do not is the lack of enforcement by the NSSF and MoLVT.¹⁸² Both authorities also noted that even though they are charged with enforcement, practically it can still be difficult to properly enforce the law against non-compliant enterprises, due to broader rule of law issues.

Enforcement can be challenging and time-consuming, however information sharing between ministries can help reduce the time burden and other challenges associated with enforcement. The CamDX system is a good step in addressing this, but it does not yet address some of the information needs of the MoLVT and NSSF to ensure compliance – namely information sharing from sectoral ministries that license and permit enterprises. If this information was provided directly to the MoLVT and NSSF, it could help them target enforcement efforts. Similarly, there is no national statistical business register. If this was developed, the MoLVT and NSSF could cross-reference their administrative records with the statistical business register to help improve targeting of enforcement efforts.

Given these challenges, the MoLVT and NSSF have taken a more remedial approach to enforcement. Instead of pressuring enterprises, they have tried to educate them about compliance with labour laws and other regulations, and to assist them to come into compliance.¹⁸³ While this approach has benefits, such as improved employer awareness, it creates a disincentive to comply if employers know they will be given a chance to correct problems without penalty. Enforcement challenges are further compounded by the lack of knowledge among workers about the protections and benefits to which they are entitled. As such, they are less likely to flag non-compliance to government. Workers who are aware of their entitlements are also sometimes not willing to take the risk to report it to the authorities.

180. Interview with stakeholder.

181. Interview with stakeholder.

182. F Mertens, W Habib and U Naeem, ‘Expanding social protection for those of active age in Cambodia: A study to understand the characteristics of workers and enterprises in the informal economy,’ Oxford Policy Management, forthcoming (2022), pg. 30.

183. Interview with stakeholder.

While improvements in capacity, inter-ministerial coordination and the rule of law are important for improving enforcement, it is also essential that the legal and regulatory framework provides appropriate sanctions. The sanctions should be strong enough to serve as a deterrent, but not so punitive that they threaten the sustainability of jobs or enterprises. The Social Security Law provides examples of penalties, such as requiring employers to pay a penalty of 10 to 30 times the daily base wage for each worker whose contribution is not made, or 120 to 360 times the daily base wage and one month to one year in prison for deductions from workers' wages that should be paid by the employer.¹⁸⁴ Social dialogue can help stakeholders determine if penalties are appropriate. Similarly, enforcement should not be arbitrary or unfair, for example by charging employers interest and penalties on tax filing delays caused by the GDT.

6.4. Other drivers of informality

Beyond drivers that affect only SMEs or micro enterprises, there are some drivers of informality that are common among all enterprises or workers. These drivers include the following:

6.4.1. Unequal treatment of formal labour

The Cambodian taxation system, as currently designed and implemented, has a feature that can incentivize informality: the salary tax. This tax covers Cambodia and foreign-source salary for Cambodian tax residents, with graduated rates from 0 to 20 percent. However, Cambodia does not currently enforce a PIT that would create a similar tax obligation for the non-salary income of individuals in the informal sector. Individuals working as contractors for enterprises may be subject to withholding tax, but others selling services to the general public may not have a tax obligation. As noted earlier, Cambodia's tax system is dynamic, and this disparity is likely to change in the near future. The GDT may begin implementing a PIT in the future, which would reduce this distortion.¹⁸⁵ However, at present this structure creates a clear disincentive to work with formal enterprises among some types of workers.

6.4.2. Quality challenges and barriers to accessing the NSSF

Quality or value for money issues (or perceptions thereof) may dissuade enterprises from participating in the NSSF. Quality-related challenges cited elsewhere include the "low effectiveness and efficiency within the system due to high costs and inconsistency of

¹⁸⁴. National Assembly, 'Law on Social Security Schemes,' Article 98, October 2019.

¹⁸⁵. IMF, 2018.

benefits across schemes,” as well as underdeveloped systems for monitoring policy.¹⁸⁶ There may also be barriers to accessing the NSSF for enterprises and workers. The MoLVT Prakas No.168/22 KB.BrK. NSSF, issued on July 5, 2022, outlines requirements for NSSF registration, which include a completed copy of Form 1.01, and for employers or enterprise owners, a MoC registration certificate or other equivalent legal document, and the Khmer ID card or passport of the employer or their representative. For employers of domestic workers, a residence book or other equivalent legal documents and a Khmer ID card or passport are required. While the Prakas provides more clarity than in the past, it lacks clarity on exactly which equivalent legal documents are acceptable.

Informal workers may face some specific challenges when attempting to access the NSSF, with stakeholders suggesting that there were procedural and other challenges that made it difficult to register. Joint Prakas 404, which provides a definition of an informal worker for the limited purpose of extending the Health Equity Fund, unintentionally excludes some informal workers. The Prakas defined an informal worker as a worker that “signs an employment contract, which is not more than 8 (eight) hours a week, intermittent work, casual work, or seasonal work, and has been registered in the National Social Security Fund.”¹⁸⁷ However, this definition excluded workers who were informal but did not have an employment contract, worked more than eight hours per week, etc. There are also steps associated with validating the status of informal workers. The result was that some informal workers, like tuk-tuk drivers, who wanted to participate in the NSSF were unable to do so. However, in 2023, the NSSF announced a pilot project to study the feasibility of expanding the HCS to also cover self-employed workers.

6.4.3. Governance-related issue

Governance-related issue can serve as a significant deterrent to enterprise formalization. According to the World Bank’s enterprise survey, approximately 60% of public transactions in Cambodia in 2016 involved an unofficial payment, more than double the Asia Pacific average of 24 percent. Nearly 65 percent of Cambodian firms reported experiencing at least one facilitation payment request, again more than double the regional average of 30 percent.¹⁸⁸

186. F Merttens, W Habib and U Naeem, forthcoming (2022).

187. MoLVT, MEF and MoH, ‘Inter-Ministerial Prakas on Implementation of Health Care Scheme Through Health Equity Fund System for Informal Workers and Provision of Additional Allowances for Female Workers when Delivery,’ Joint Prakas No. 404 LV/PrK. NSSF, Oct 11, 2017, <http://www.nssf.gov.kh/default/wp-content/uploads/2019/01/404.17.pdf> [accessed July 18, 2022].

188. World Bank, Resilient Development, 2021,

There is a perception among at least some enterprises that formalization attracts unwanted attention, which can lead to an increase in formal and informal costs. Business size similarly seems to attract attention. It also is found that formally medium-sized to large-sized enterprises draw a lot of inspections, which could lead to more potential for informal facilitation.¹⁸⁹ Despite the fact that small enterprises generally have less capacity to request informal facilitation than larger enterprises, they still encountered regulatory burden. For example, small enterprises reported that an informal payment was expected in 62 percent of public transactions, higher than the shares reported by either medium or large enterprises.¹⁹⁰ This has led the International Finance Corporation (IFC) to note that “the smaller the enterprise, the more the respondents complained about informal payments, high costs, and applicable taxes.”¹⁹¹ Together, these dynamics have a direct implication on the decision making of enterprises, some of whom opt for informality to “fly below the radar”.

6.4.4. Rigid legal framework

Shortcomings in the design of the legal and regulatory framework can make compliance unnecessarily difficult or costly, and sometimes even impossible. This can dissuade enterprises from formalizing. For example, the NSSF is largely geared towards formal workers in employment relationships. However, many other workers need, and would benefit from, social security. And many enterprises – both formal and informal – employ workers in modalities that are not full-time, such as seasonal workers. While the 2019 Law on Social Security Schemes covers many types of employment arrangements, the implementing regulations are unclear, so these workers are not yet able to access the NSSF. Thus the regulatory framework can unintentionally contribute to informality among some workers.

6.4.5. Challenges quantifying some benefits of formality

The costs of formalizing, such as the additional taxes or costs of completing the registration process, are often clear and measurable. The benefits of formalizing can also be measured in some cases, such as when formalizing allows an enterprise to increase sales to a new client. However, other benefits of formalizing are less simple to measure. Examples of this include the increased ability of the enterprise to attract and retain staff who value the ORS or HCS

189. World Bank, Resilient Development, 2021,

190. World Bank, ‘Cambodia: Corruption,’ 2016, <https://www.enterprisesurveys.org/en/data/exploreconomi es/2016/cambodia#corruption> [accessed July 19, 2022].

191. IFC and Umbrella Facility for Gender Equality, 2019, pg. 30.

benefits from the NSSF, or the increased productivity of a happier, healthier workforce. Capturing this information within an enterprise can be challenging if not impossible, and there is currently limited public information and communication efforts to help educate enterprises about the benefits of formalization.

6.4.6. The additional challenges of being small

The costs of compliance are another challenge and are especially acute for MSEs and own-account workers. Compliance often entails steps such as maintaining formal accounts, submitting documentation to ministries, or renewing registrations and licenses. MSEs often have just one or a very small number of workers, and they lack the scale to hire a dedicated human resources or compliance officer but also do not have the time to develop specialized compliance skills. Despite this, the costs and compliance requirements of social security are often the same for all enterprises, including MSEs. Maintaining accounts could be a major challenge in Cambodia, with existing data showing that only a small share of household enterprises keep written business records. Data shows that only 22 percent of men owners and 12 percent of women owners engage in this practice, with even fewer keeping a record of each purchase and sale.¹⁹² Formalization is an integral part of fostering an economy and

192. W Cunningham and M Shrestha, undated.





7.

**THE BUSINESS CASE FOR
AN INTEGRATED APPROACH
TO FORMALIZATION**

labour market that creates more and better jobs, reduces poverty and alleviates some of the most serious decent work deficits. Formalization of enterprises “goes hand in hand with a conducive business environment, economic growth and better working conditions,” while also increasing tax revenues to fund public goods and services.¹⁹³ Formalization is generally accompanied by the extension, in law and in practice, of social security, maternity protection, decent working conditions and a minimum wage to all workers in the informal economy – taking into account the contributory capacity of those in the informal economy.

A common characteristic of formality is participation in social security, which is part of the broader social protection framework supported by both direct contributions and, indirectly, the taxes paid by workers and employers. A robust social protection system is not just an economic and social necessity but also a universal human right. It ensures that all people have access to healthcare and income security throughout their life cycle, especially when they are affected by unexpected events such as illness, unemployment or injury.

The expansion of social protection is a stated goal of the Royal Government of Cambodia. It is a component of Cambodia’s Strategic Framework and Programs for Economic Recovery in the Context of Living with COVID-19 in a New Normal 2021-2023, as well as the country’s Rectangular Strategy for Growth, Employment, Equity and Efficiency: Phase 4. In its National Social Protection Policy Framework 2016-2025, the government defines its long-term vision for the development of social protection, which is “the construction of a social protection system based on inclusiveness, effectiveness and financial sustainability as a tool to reduce and prevent poverty, vulnerability and inequality and which will contribute to the development and protection of human resources and stimulate economic growth.”¹⁹⁴ The government’s commitment towards expanding social protection was also evidenced in its support for the ASEAN Declaration on Strengthening Social Protection in 2013. In this, the government committed itself to a number of important principles including:

- The entitlement of all people to equitable access to

¹⁹³. ILO, Recommendation 204, 2015.

¹⁹⁴. Royal Government of Cambodia, National Social Protection Policy Framework 2016-2025, 2017, Phnom Penh, https://nspc.gov.kh/Images/SPFF_English_2019_10_28_12_10_56.pdf [accessed July 14, 2022].

social protection as a basic human right;

- The gradual extension of coverage;
- A coordinated and holistic approach to implementing social protection, involving governments, private sectors, development partners, civil society, service providers and other stakeholders; and
- The support for social protection with adequate resources.¹⁹⁵

The formalization of enterprises and employment is an integral part of Cambodia’s broader social protection efforts. However, formalization is neither straightforward nor simple – it comes with benefits, costs and risks for different groups including government, enterprises and workers. Understanding these different benefits, costs and risks is a vital part of the overall business case for formalization, and a prerequisite for examining policy options and selecting policy solutions.

7.1. BENEFITS OF FORMALIZATION

Table 10. Benefits of formalization for government, enterprises and workers

For Government	Increases tax revenues	Growth in the number of workers and enterprises in the formal sector increases total tax revenues. This should enhance government capacity to properly resource important public goods and services, while increasing human resources dedicated to enforcement and remediation.
	Improves data on enterprises, the economy and labour market	Increases in formalization lead to more enterprises and workers interacting with government in registration, tax and social security. This provides government with better data about economic and labour market trends, which could contribute to improved policymaking. It could also help improve transparency and strengthen the effectiveness of law enforcement and compliance.
	Increases capacity to roll out emergency and non-emergency social protection	Greater levels of formalization, especially among own-account workers and other vulnerable segments of the labour market, improves the ability of government to target vulnerable groups and provide emergency assistance in situations like those faced during the COVID-19 pandemic.

195. ASEAN, ASEAN Declaration on Strengthening Social Protection, 2013, https://www.asean.org/wp-content/uploads/images/archive/23rdASEANSummit/5.%20asean%20declaration%20on%20social%20protection_final.pdf [accessed July 19, 2022].

For Enterprises	Creates a more level playing field for enterprises	Formalizing informal enterprises could lead to a more level playing field among enterprises by reducing the competition that formal and compliant enterprises face from informal, non-compliant enterprises.
	Increases opportunities to access capital and new markets	Formalization increases access to finance from the formal financial system, especially when formalized enterprises improve their accounting standards. It also allows enterprises to access new markets, especially export markets, which require registration to obtain documents needed to export.
	Increases access to some government services, such as business development services (BDS)	If government offers BDS that are only available to formal enterprises, formalization could increase the enterprise's access to those services.
	Makes labour market liberalization more likely	Strong social protection systems to protect workers can give government the leeway to reduce labour market rigidities. This allows workers to move between jobs more easily while protecting their well-being. This could also help employers improve their productivity and competitiveness.
	Raises the overall capacity of enterprises	Enterprises that are pushed to formalize may also undertake other steps to build capacity, such as learning how to maintain financial accounts. This could provide the enterprise with a better understanding of their operations, helping them improve business management and creating positive spillovers in other areas.
For Workers	Provides greater protection during income shortfalls	A more robust social protection system will help workers during times of unexpected income shortfalls, such as during pregnancy, old age, health issues, unemployment and work-related disability. This could contribute to overall welfare improvements, including a reduction in poverty and improved health outcomes, and help to smooth aggregate demand in times of economic challenge.
	Increases labour mobility	Improved social protection could help increase labour mobility by reducing the negative effects of temporary unemployment.
	Requires forced savings for old age	The pension scheme requires workers, with matching contributions from employers, to save for old age. This could have a significantly positive effect by reducing the likelihood of income shortfalls when older, thereby reducing old age poverty.
	Provides greater predictability about health spending	The HCS entitles workers to receive healthcare services without additional costs, thereby increasing the predictability of their costs. This could reduce the likelihood that workers or their families have to take on health-related debts during an emergency.

7.2. COSTS OF FORMALIZATION

Table 11. Costs of formalization for government, enterprises and workers

For Government	Requires more resources used simultaneously	Efforts to formalize could increase costs by requiring multiple simultaneous measures that can collectively require larger budget outlays and human capital.
For Enterprises	Raises the direct ongoing costs of doing business	Enterprises that formalize will incur additional expenses including taxes, registration costs and contributions to the NSSF. They may also have to pay additional costs to comply with requirements of formality, such as hiring an accounting firm to keep financial records.
	Increases the time needed for ongoing compliance	Enterprises that formalize have to spend more time on compliance, including maintaining financial accounts (if they do this themselves), filing and paying taxes, administering VAT, filing employee updates with the MoLVT and making regular reports and payments to the NSSF.
	Creates one-time challenges associated with becoming and remaining compliant	Any enterprise that wants to formalize has to spend time learning how to formalize and how to remain compliant once they are formal. This creates one-time financial and/or time costs for enterprises.
	May force some enterprises to leave the market	The costs and challenges of formalization could be especially problematic for enterprises with lower productivity or margins. A push to formalize may force some of them to close if they cannot remain competitive with a higher cost structure.
For Workers	Reduces take-home earnings for own-account workers and, to a lesser extent, employees	The most direct cost to workers is the financial cost of contributions. If laws require participation and force own-account workers to pay both employer and employee contributions, it would reduce earnings significantly. Employees, on the other hand, are only responsible for their share of pension contributions.
	Increases costs of compliance for own-account workers	Own-account workers are responsible for the time and financial costs of compliance, such as the time costs of filing monthly contributions and associated financial costs like hiring an accountant or using accounting software.

7.3. RISKS OF FORMALIZATION

Table 12. Risks of formalization for government, enterprises and workers

For Government	Poorly designed or implemented approaches could fail or be counterproductive	Without careful design and thoughtful integration, attempts to encourage informal enterprises to formalize could fail, and create or further perceptions that formalization is not in the interests of enterprises, or is a “trap”.
	Schemes may struggle with administrative capacity or service provision with large increases in users	An increase in the number of enterprises and workers participating in the NSSF could increase demands on the fund’s administrative capacity and on affiliated service providers, such as in the healthcare sector. If enrollees increase faster than administrative capacity, service quality could lag, creating a risk of negative user perceptions.
	Negative fiscal shocks may affect the government’s formalization plans	Formalizing informal enterprises requires significant investments by the government. Shocks that negatively impact fiscal space, such as pandemics and recessions, could affect government’s fiscal capacity to deliver on some benefits, which could alter the perception of enterprises that have or are considering formalizing.
For Enterprises	Unexpected past tax liabilities	Formalizing creates a risk that enterprises may be required to pay a significant amount of past tax liabilities. With limited options for appeal, the risk of tax liabilities is a major concern for enterprises.
	Increased undue attention from government officials moving forward	Formalizing may increase the risk that enterprises experience greater demands from government officials moving forward, either for compliance with the legal framework or for informal payments.
	Competitive disadvantage if other enterprises remain informal	Enterprises that choose to formalize may fear being put at a competitive disadvantage in the future if other firms do not formalize.
For Workers	User views on services are not clear	Users may view services as poor value for money or difficult to understand.
	Workers may miss out on potential benefits	It may take time to educate workers and ensure bureaucracy is working well, and as such, workers may miss out on some benefits available through the social security system, even if they are paying for them. This could contribute to negative perceptions of the system.

7.4. AN INTEGRATED APPROACH: BENEFITS, COSTS AND RISKS

Formalization has a host of benefits, costs and risks for government, employers and workers. An integrated approach to formalization presents some unique benefits, costs and risks that would not apply to piecemeal formalization efforts, including:

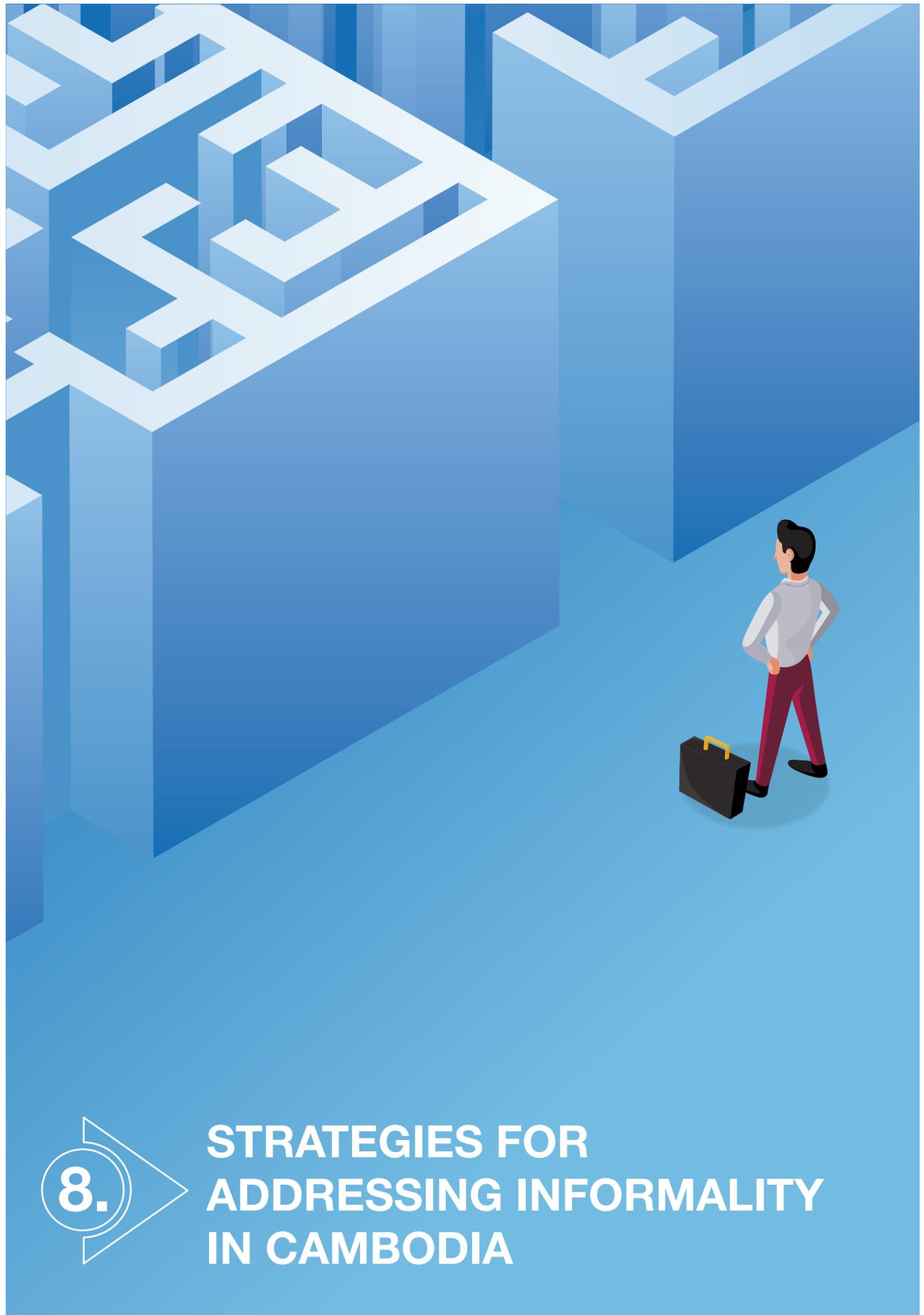
- **Benefit: has a greater likelihood of success.** An integrated approach is more likely to achieve the end goal of greater formalization. It may also provide better value for money for government spending and reduce revenue lost via incentives (such as tax incentives) that do not produce the desired outcomes.
- **Cost: increases the time and financial costs of interventions.** The increased time and costs are largely due to the more complex planning and greater inter-ministerial coordination required for the more complex integrated strategy.
- **Cost: makes it more difficult to isolate unneeded spending or effort.** In an integrated approach, multiple interventions are happening concurrently. While many of these could contribute to changes in the overall outcome, it may be challenging to disaggregate information to identify the effects of each individual component of the integrated approach (e.g., it could be difficult to determine if a particular part of the integrated approach is not very effective but comes at a high financial or time cost). This could make it more challenging to reduce unnecessary expenditure or effort. Monitoring and evaluation, including data collection from enterprises to understand their motives for formalizing, may help identify which interventions are most effective. Combining this user experience data with cost data from government could help reduce ineffective spending.
- **Risk: lack of coordination results in an approach that is integrated in theory but not in practice.** Large-scale coordination is challenging. Effective-high level oversight is needed to ensure that it happens in practice, and that ministries engage constructively.

7.5. MONITORING FORMALIZATION

The effort to formalize both enterprises and workers can have many benefits but also presents costs and risks. It is essential that the government monitors progress towards the goal of greater formalization, using metrics that reflect the end goals of the formalization process. Among the measures that could be used to monitor progress towards formalization include:

- Number of enterprises with at least one employee registering under the NSSF micro enterprise social security scheme;
- Number of own-account or domestic workers registering with the NSSF;
- Satisfaction scores among registered enterprises and workers;
- Total number of active individuals covered by the NSSF; and
- Retention rate for enterprises, own-account and domestic workers.





8.

**STRATEGIES FOR
ADDRESSING INFORMALITY
IN CAMBODIA**

Addressing informality is a complex challenge that requires a nuanced strategy with different approaches for different groups. Formality among large enterprises in Cambodia is high, but among SMEs it is significantly lower. Encouraging SMEs formalize can be difficult as they are “harder to reach, harder to tax, less capable of meeting basic compliance requirements, and yield less revenue” in comparison to large enterprises, according to the IMF.¹⁹⁶ Micro enterprises are even more challenging to formalize, given their large numbers, small size and limited resources and capacity. Numerous efforts have been recommended to help increase formalization in Cambodia, including: improving the registration of businesses through simplifying the procedures and establishing one-stop shops, simplifying the taxation system, reducing the burden of tax declarations and social security contributions payment by simplifying the declaration and payment procedures, increasing awareness of labour regulations, and using technological innovations and electronic services to facilitate the performance of economic activities.¹⁹⁷ The Cambodian government has already, or is in the process of implementing, numerous of these and other steps to increase formalization. This section outlines strategies that, when integrated, may help to further increase formality and the NSSF participation of MSEs and their workers.

8.1. DEVELOPING A SHARED UNDERSTANDING OF FORMALITY AND INFORMALITY

While stakeholders in Cambodia are widely familiar with the concept of formality, they often define it differently. Developing a shared understanding of formality is important because it provides the foundation for government-wide collaboration on legal and regulatory reform. This shared understanding of formality should be characterized by the following:

- **Formality should not be defined by enterprise size, but instead by enterprise behaviour.** Some parts of government equated an “informal enterprise” with a micro enterprise and/or own-account workers. Though this view reflects the current correlation between these, it also normalizes the idea that micro enterprises do not or cannot operate formally. It also suggests that the lack of legal protections is natural or normal.

¹⁹⁶. IMF, 2018.

¹⁹⁷. V Leung, 2020, pg. 11.

Instead, formality should be understood as relating to compliance and participation, not enterprise size.

- Formality should not require that every single enterprise – whether it be a two-person operation or the country’s largest business – face the same requirements and regulatory burden. Strong consideration should be given to how to handle enterprises with limited or no capacity to pay additional costs associated with formalization.

For the purposes of Cambodia’s government administration, formality could be conceived of in the following way for different groups within the economy:

- Small, medium and large enterprises: registered with the MoC, GDT and NSSF; opening declaration with the MoLVT.
- Micro enterprises (including own-account workers): registered, licensed or permitted by a competent ministry or institution (if applicable) or OWS office; opening declaration with the MoLVT (if applicable) and registered with the NSSF.
- Employees (and other workers that are not self-employed): registered with the NSSF directly or through their employing enterprise.

Informality should be viewed as any worker or enterprise that does not fall, or is inadequately covered, within the formal legal framework. Once a new approach to formality is established and defined in law, perhaps in the draft Social Protection Law, the current Joint Prakas No. 404 LV/PrK NSSF from 2017 that defines informal workers for the purposes of the Health Equity Fund could be terminated.

8.2. TRANSITIONING FROM INFORMAL TO FORMAL

8.2.1. A formalization framework for micro enterprises

A simple and well-conceived strategy that incentivizes micro enterprises to become and remain formal is essential for bringing them into the legal fold. However, the existing formalization framework

for micro enterprises is somewhat neglected and unclear, so near-term efforts to encourage their formalization could focus on the development of this formalization framework. This framework should not only provide a simple avenue through which to become formal and access NSSF benefits. It should also deliver value beyond this, including by offering micro enterprises greater predictability about their obligations to government and helping them reduce informal costs – for example, providing a shield against petty corruption. The framework should not focus on one-time incentives, given the targeting challenges, but perhaps more robust incentives could be adopted at a later stage. Similarly, enforcement should not yet play a major role in driving micro enterprise formalization, although this could feature more prominently in the future.

While micro enterprises are diverse, the vast majority are very small: made up of a single establishment and having an average of 2.2 people working for them, including the owner (and often family members). Many of these enterprises are not highly productive, nor will they grow significantly in the years to come. They have limited capacity to pay taxes and NSSF contributions, as well as limited capacity to comply with a complex legal and regulatory framework or requirements for numerous and regular filings with government. There are a number of design options for a formalization framework for micro enterprises, including the following:

8.2.1.1. Option 1: Modify the existing legal framework to allow easier NSSF registration for micro enterprises

Under the current framework, micro enterprises lack some documents that larger enterprises use to demonstrate formality. However, these documents, which are not legally required, should not be a barrier to NSSF participation. To address this, MoLVT Prakas No. 168/22 KB.BrK.NSSF could be changed to note that the NSSF should accept the widest possible range of business registrations, licenses and permits in lieu of MoC registration or a patent tax certificate. For any economic activity that does not require a registration, license or permit, a national ID could be accepted instead.

However, numerous challenges to NSSF participation would remain. Many micro enterprises do not keep formal accounts, and therefore may not have a clear understanding of turnover, profits or wages, the latter of which serves as the basis of NSSF contributions. Using total turnover to calculate NSSF contributions could result

in obligations that are too high, as turnover would include returns from both capital and labour. These concerns could be partially or fully addressed by modifying the NSSF legal framework so that:

- Enterprises with formal accounts would base NSSF contributions on net earnings, or share of net earnings, derived from labour.
- Enterprises without formal accounts would base NSSF contributions on a percentage of total turnover that is estimated to correspond to the labour share of income for that sector. This is done in a number of countries, such as Portugal, where the contribution base is 70 percent of the value of services or 20 percent of the sale of goods.
- An exemption on contributions is provided for those that fall below a certain threshold.

Table 13. Advantages and disadvantages of extending the current framework to micro enterprises

Advantages	Disadvantages
<ul style="list-style-type: none"> • It would require little additional work • It would not require a government subsidy 	<ul style="list-style-type: none"> • It may do little to attract micro enterprises • Micro enterprises could still be required to complete multiple forms and engage with multiple ministries • It may overtax micro enterprises if NSSF rates are based on total earnings, not wages • Enterprises would have an incentive to understate turnover

Table 14. Micro enterprise cost estimates for NSSF contributions

NSSF cost estimates for single employee micro enterprises (includes ORS, HCS and pension; employer and employee side, 7.4% of monthly contributory wage)		
	HHE per-person earnings	LFS per-person sectoral wages
Industry	\$11.47	\$18.40
Services		\$20.07
Trade and services		\$20.07

Note: Current unsubsidized cost includes 0.8% for ORS, 2.6% for HCS and 4% for pension. Wages for the “services” sector include those from “trade” because of the data aggregation used. Based on average monthly wages from the 2019 LFS.

8.2.1.2. Option 2: An unsubsidized monotax regime for micro enterprises

A well-designed monotax system could create a path to formality for hundreds of thousands of Cambodian micro enterprises. A monotax system could be applied to a majority of micro enterprises, however it would not be appropriate for all individuals and enterprises under the small taxpayer threshold, as some are high-earning individuals. To ensure the monotax regime is well-targeted, criteria for participation could be established, such as:

- An income that falls below the minimum threshold for a small taxpayer (as set out by the GDT);
- Cannot be a partner, administrator, owner or part-owner of another business;
- Operating in sectors approved by the government (e.g., retail and food services, but not including enterprises like small law firms or doctors’ offices);
- No more than four employees (including salaried self-employed owners or partners); and
- Cannot have an average employee salary of more than three times the minimum wage for the garment sector (to prevent small professional firms from using the monotax scheme).

The monotax design should be thoroughly researched, well-consulted and reviewed carefully before being implemented. Possible design characteristics could include:

- **A single payment.** All major taxes and fees should be combined into the monotax and paid through a single payment to one ministry or department (for example, to the GDT or NSSF) that then disburses funds to other ministries. The payment could be monthly, quarterly or annually. The annual payment option could be designed to fall at the end of December, which is when the fewest individuals reported shortfalls in their income.¹⁹⁸ The single payment could cover:
 - One annual license or permit (or renewal) from a municipal, khan or district OWS office or sectoral ministry for the main business activity;
 - All national taxes (which are anyways not applicable to micro enterprises);
 - ORS;
 - HCS;
 - Pension; and
 - Skills development/vocational training levy (if any).
- **Mandatory participation.** While voluntary participation may be easier to enforce, participants are likely to be self-selecting, creating financial strain for the NSSF. Further, examples from other countries such as Thailand, Vietnam and Laos have found that voluntary participation in social security schemes has only led to limited expansion of coverage.¹⁹⁹ Making the scheme mandatory may require changes to Article 82 of the Law on Social Security Schemes to remove “the self-employed shall contribute voluntarily to Health Care and Pension Schemes.”²⁰⁰ Notably, some stakeholders in Cambodia, including representatives of labour, note

198. Oxfam, ‘Contributory Capacity of Informal Economy Workers to NSSF,’ pg. 36.

199. ILO, World Social Protection Report 2017–19: Universal social protection to achieve the Sustainable Development Goals, International Labour Office – Geneva, 2017, pg. 37, <https://www.social-protection.org/gimi/gess/RessourcePDF.action?id=54887> [accessed July 19, 2022].

200. National Assembly, 2019.

that NSSF participation should continue to be voluntary, highlighting the need for extensive consultation on design.

- **Easily understood principles, prices and levels.** For example, “\$5 a month for you, and \$3 a month for each of your employees.” Alternatively, there could be a sliding scale, as in the case of Brazil’s *Simples Nacional*.
- **Multiple payment channels**, including at the district, Khan or municipal OWS, NSSF branches or through an online application and electronic transfer.
- **A simplified application and compliance scheme** which requires only:
 - A single application form to enroll in the scheme, which should include relevant information for the registering ministry, the MoLVT (including the NSSF) and GDT. This form could automatically feed into a shared, multi-ministry database.
 - A single electronic or hard copy form to add or remove employees, which also changes the NSSF contribution levels (and therefore monotax level) of the micro enterprise. There should be no filing fee to add or remove employees.

In an unsubsidized scheme, micro enterprises and own-account workers would be responsible for both employer and employee contributions, resulting in a rate of 7.4 percent just for NSSF contributions. This would increase as pension costs rise, which should happen in 2027. If the average micro enterprise employee earns \$155.00 per month, the contribution would start at an estimated level of \$11.47 per month for only the NSSF. This puts the contribution rate above the range that most own-account workers and micro enterprises have stated is affordable.²⁰¹ This is one of the biggest challenges of the unsubsidized monotax – the high costs may lead to reduced participation as informality persists.²⁰²

201. Note that this payment size is close to the fees paid by some enterprise types under the Brazilian MEI scheme, though that fee can apply for up to two persons (one employee and one owner).

202. A monotax system targeted at micro enterprises should not be significantly affected by the launch of a PIT. Earnings and wages at most micro enterprises fall below the current minimum threshold at which salary taxes first apply, which is a rate of 5% starting at KHR 1.3 million. However, the interaction between the PIT and monotax should be considered in the design phase so as to not negatively affect affordability.

Table 15. Advantages and disadvantages of an unsubsidized monotax for micro enterprises

Advantages	Disadvantages
<ul style="list-style-type: none"> It would be financially advantageous for the government if new revenues raised exceed costs It could deter corrupt officials from asking for additional tax payments, threatening penalty taxes or requesting informal payments 	<ul style="list-style-type: none"> Some micro enterprises could struggle with the unsubsidized costs of participation, which could result in lower participation rates Enterprises would have a strong incentive to understate earnings/wages It may overtax micro enterprises if NSSF rates are based on total earnings, not wage-equivalents

Table 16. Micro enterprise cost estimates for unsubsidized monotax regime, in USD

	NSSF estimates (includes EIS, HIS and pension; employer and employee side, 7.4% of average sector wages)		Business permit/ license cost estimates (from OWS, most common type)	Average monthly cost estimates	
	HHE per-person earnings	LFS per-person sectoral wages		Owner/employee	Each additional employee
Industry	\$11.47	\$18.40	KHR 50,000 (US \$12.34) (annual handicrafts workshop registration)	\$12.50 – 19.43	\$8.37 – 13.43
Services		\$20.07	KHR 25,000 (US \$6.17) (annual commercial services registration)	\$11.98 – 20.58	\$8.37 – 14.65
Trade and services		\$20.07			

Note: Current unsubsidized cost for owner/employee includes 0.8% for ORS, 2.6% for HCS and 4% for pension. Current unsubsidized costs for additional employees includes 0.8% for ORS, 2.6% for HCS and 2% for pension. Wages for the “services” sector include those from “trade” because of the data aggregation used. Annual permit/licensing costs from OWS are evenly spread across monthly payments.

8.2.1.3. Option 3: A fixed fee monotax regime for micro enterprises

A fixed fee monotax regime would work much like the unsubsidized monotax regime in Option 2, except the fees would not be dependent on the wages or earnings of the micro enterprise. A fixed fee regime could be easier to administer, because it would not require verification of the wages or earnings of each micro enterprise. However, it would require the government to set reasonable fee levels by sector, which would require some research and data collection to match these with average earnings of each sector. The fixed fee monotax regime could otherwise be similar to the monotax regime in Option 2, with a single payment, application form and monthly form. It should also have the same simplicity and multiple filing and fee payment channels outlined in Option 2. Cost estimates are the same as in Option 2, but would be fixed by the government instead of variable depending on the earnings/wages of the enterprise.

Box 5. Advantages and disadvantages of an unsubsidized monotax for micro enterprises

Advantages	Disadvantages
<ul style="list-style-type: none"> • It would be financially advantageous for the government if new revenues raised exceed costs • It could deter corrupt officials from asking for additional tax payments, threatening penalty taxes or requesting informal payments. There would be less room for corruption as verifying individual enterprise earnings/wages would not be needed • It could give enterprises greater certainty about their tax burden if they formalize 	<ul style="list-style-type: none"> • Some micro enterprises could struggle with the unsubsidized costs of participation, which could result in lower participation rates • It could be more challenging for micro enterprises with lower earnings/wages

8.2.1.4. Publicizing the monotax

For marketing purposes, the monotax should be publicly presented as an avenue to formality and social security benefits but should not be advertised as a tax. Micro enterprises currently face a very low tax burden and referring to the monotax as a “tax” – especially if the majority of the revenues raised are going to social security purposes – may deter participation. The public presentation of the monotax could focus on social security access and administrative simplification, and be branded as “Social Protection Participation”, “Micropay”, or some other similar name, as is suitable in the Khmer language.

The monotax should be designed to limit contact with government officials, thereby reducing time costs for enterprises and corruption opportunities for government officials. Advertising and internal regulations should support this objective. Using the monotax to reduce the number and frequency of interactions with officials will deliver value to enterprises at limited cost to government. A public advertising campaign could be developed and implemented that tells micro entrepreneurs that they should not make any payments to inspectors and could be accompanied by an independent hotline for complaints. This may also have the effect of reducing the frequency with which government officials ask for informal payments.

Public branding could accompany the monotax – a sticker or placard that enterprises could display. For enterprises, displaying the sticker could be required as part of participation in the programme. Policies could be developed to limit the powers of tax inspectors over micro enterprises with the sticker or placard displayed. It could also serve other important purposes. Customers and competitors would be able to observe the sticker (or lack thereof), and report incidents where they think an enterprise is misclassifying themselves in the monotax programme or does not have a sticker displayed. It could provide a public messaging effect that the micro enterprise is legitimate and complying with the law. The public advertising campaign could encourage people to patronize micro enterprises that participate in the programme.

For all of the above approaches, enterprises should have both an analog and digital option for formalizing and remaining formal. Forcing all enterprises to use a digital path to formality, such as the CamDX, is not currently appropriate for some micro enterprises. A significant share of the population – 70 percent, according to the government – is not yet digitally literate, and that level of

proficiency is needed to complete fully-online registration and compliance processes. Instead, micro enterprise registration could use the existing OWS or NSSF offices for in-person interactions, complemented with a digital option.

8.2.2. Easing the transition from micro to small enterprise

Although a monotax regime would provide an important step towards formality, these micro enterprises would still face a significant increase in costs and compliance requirements when transitioning to the small enterprise regime. To encourage enterprises to make this transition, a transition programme could be adopted and include the following components:

- Trainings/capacity building on the compliance requirements for small enterprises (which could be implemented either by government, associations or a public-private partnership) covering:
 - How to implement the VAT;
 - How to conduct basic accounting and calculate CIT;
 - How to file tax returns;
 - How to comply with labour law and NSSF requirements; and
 - How to register and obtain licenses and permits.
- Phase-in of the costs and compliance requirements facing small enterprises, including a phase-in of taxes that aligns with the current tax incentives offered to SMEs.
- A limitation on the potential tax liabilities (e.g., from taxes, interest and penalties) associated with formalizing, so as to de-risk the transition from micro to small enterprise.
- No minimum or maximum time period that an enterprise has to be enrolled in the monotax scheme before transitioning to the small enterprise scheme, so as not to deter high-growth firms.

8.2.3. Increasing productivity

Enterprise formalization should be accompanied by efforts to help enterprises boost profits and productivity, which could help enhance their capacity to meet new obligations. This could include:

- Reinforced efforts to make credit available to MSMEs through public or private channels. This could focus on longer-term financial products that these enterprises need to invest in capital-enhancing equipment. It may include concessionary rates or terms, as well as financial management advisory and assistance services to help micro enterprises borrow responsibly.
- Enhanced business development or product development services. These services should be designed to help enterprises generate greater revenues through accessing new markets, improving management practices, improving financial management and other productivity improvements. These could help offset higher costs associated with formality.
- Increased workforce skills training aligned with the needs of private sector and targeted at employees of MSEs. This could include improvements in the size or quality of skills development programmes, and reforms to skills infrastructure to make it more efficient.
- Efforts to link formalization with the digital and green economy transitions, which are also priorities of Cambodia's government.

8.2.4. Addressing affordability challenges for MSMEs

Many MSMEs may face affordability challenges related to formalization. A survey of informal economy workers – some of whom are self-employed individuals leading household micro enterprises – found that 85 percent of respondents said that they could contribute up to \$2.00 per month to the NSSF.²⁰³ This is lower than the per-worker costs outlined by NSSF regulations. Another study on employees (not self-employed) found that 52 percent could afford to contribute 6.75 percent of their incomes to

203. Oxfam, 'Contributory Capacity of Informal Economy Workers to NSSF,' December 2021, pg. 37.

the social security scheme on pension.²⁰⁴ Although this does not explicitly cover own-account workers, it raises questions about affordability for own-account workers and for micro enterprises and their workers, given that wages in the informal economy tend to be lower and that micro enterprises would be responsible for both employee and employer contributions. Similarly, contribution levels for micro enterprise monotaxes in other countries such as Brazil are significantly lower than in Cambodia, when measured as a share of total earnings. This suggests (but certainly does not prove) that micro enterprises and informal economy workers may face affordability challenges given the current NSSF rates and other taxes.

There are multiple ways to address the affordability challenges that MSMEs and their workers could experience. However, the exact approach depends on the costs and policy objectives. Subsidies or preferential tax rates could be structured in the following ways, or could combine two or more of these types of subsidies or preferential rates:

Box 6. Four strategies to make formalization more affordable for MSMEs

1. Phase-out of subsidies or preferential rates
2. Semi-targeted subsidies or preferential rates
3. Means-tested subsidies or preferential rates
4. A limited-time offer of incentives to formalize

8.2.4.1. Phase-out of subsidies or preferential rates

The government could offer an introductory scheme with lower rates or a cost-sharing contribution for all enterprises for a period of time, perhaps three years, after enrolling in the NSSF (this time period aligns with the GDT tax incentive schedule). The three-year programme could also be graduated, with a government/employer contribution ratio of 75/25 percent in the first year, 50/50 percent in the second year and 25/75 percent in the third year.²⁰⁵ This may help to avoid a significant jump in costs due to both NSSF contributions and CIT obligations that would start after three years. This approach, which is the least targeted, would give subsidies

²⁰⁴. F Merttens, W Habib and U Naeem, forthcoming (2022), pg. 39.

²⁰⁵. N Both et al., 'Practical Options for the Extension of Social Protection to Workers in the Informal Economy in Cambodia,' ILO and NSSF, 2018, pg. 40.

to all enterprises. However, temporary subsidies or preferential rates may not adequately address the long-running affordability challenges and risks of formalization faced by MSEs.

8.2.4.2. Semi-targeted subsidies or preferential rates

A more targeted approach could provide permanently lower rates or subsidies to certain types of enterprises. This approach could use broad and easily verified criteria to apply subsidies or lower rates – not characteristics of the individual enterprise or worker. Examples of targeting criteria include:

- All micro and small enterprises;
- Enterprises in lower-productivity sectors, such as retail and wholesale trade or agriculture; or
- Enterprises in certain parts of the country (for example, more economically disadvantaged provinces).

The exact size of subsidies or lower levels of rates could be determined after an approach has been determined using existing data.

8.2.4.3. Means-tested subsidies or preferential rates

Another type of targeted approach could provide subsidies and preferential rates to enterprises or workers with specific characteristics, aiming to target the most disadvantaged. This approach recognizes that there are significant earnings gaps within the informal economy. On the whole, “employers have the highest earnings; followed by their employees and other more “regular” informal wage workers; own account operators; “casual” informal wage workers; and industrial outworkers.”²⁰⁶ Beyond this, men are over-represented in higher earning groups, and women are over-represented near the bottom of the earnings distribution.²⁰⁷ Examples of potential targeting mechanisms include:

- Subsidies for all workers who earn less than \$200 a month;

²⁰⁶. M A Chen. 2007, pg. 3.

²⁰⁷. Ibid.

- Subsidies for all micro enterprises with annual turnover of \$0 to \$16,000;
- Subsidies for enterprises with larger numbers of women workers; or
- Subsidies targeting low-earning groups such as cyclo drivers or industrial outworkers.

While this approach would involve a more targeted use of subsidies and preferential rates, it would also require government to obtain verifiable information on the situations of enterprises and workers – no small task given the circumstances. This would mean a significant burden on government to monitor and enforce. It would also create incentives for enterprises to understate wages or turnover and create a need to ensure that enterprises are not manipulating the system.

8.2.4.4. A limited-time offer of incentives to formalize

A final approach could offer a set of incentives, such as a subsidy, only for enterprises that enroll within a specific window of time (for example, any time in a specified calendar year). This could be joined with a promise for enhanced enforcement after the time window expires, as a tool to make a “big push” towards formalization. This limited-time offer could use any of the targeting mechanisms detailed above. However, it may also be offered only to enterprises that have only been registered for a certain period of time (this could be as low as one day, or up to a number of years). This could eliminate financial losses associated with incentives flowing to new businesses that would likely have registered for the NSSF anyways.

8.2.5. Reforms to processes and procedures

To improve the experiences of enterprises, the Cambodian government has already made numerous changes to processes and procedures, including the introduction of the CamDX web portal for SMLE registrations and the OWS for, among other things, enterprise licensing and permitting. Further changes are also ongoing, including the integration of additional ministries into the CamDX platform. Some additional changes that could help to make it easier for enterprises to become and remain formal include:

- Combining multiple monthly payments (such as taxes and social security contributions) into a single monthly

payment made on a single form at a single location, eliminating the need for multiple payments and forms. Consider requiring businesses to pay social security contributions to the GDT, which would then distribute funds to the NSSF, or vice versa.

- Allowing the acceptance of scanned or uncertified copies of identification cards or passports and other supporting documents.²⁰⁸
- Removing any requirements for employers or workers to visit the NSSF to validate documents or undertake biometric identification. Instead, NSSF inspectors or OWS officials could do this during their first visit to the enterprise – a step that could also be integrated into awareness-raising campaigns at unregistered enterprises.²⁰⁹
- Regulations allowing workers to remain on the NSSF rolls for a period of time in case of an error by the employer or the NSSF. This grace period could help keep workers covered and be paid for by a marginal adjustment to the overall rates or a government subsidy. Over time, as employers become more familiar with the NSSF system, compliance should increase and lapses (and their associated cost) should decline.

8.2.6. Changes to enforcement

Enforcement is an essential component of the strategy to address informality and is necessary to influence enterprise behavior and ensure compliance. However, given the differences in enterprise characteristics, a one-size-fits-all approach to enforcement is not appropriate. Large enterprises, for example, should have the financial and human resources needed to fully comply with the formalization framework, including paying taxes, fees and NSSF contributions. Micro enterprises, on the other hand, do not even have a clear formalization framework, and as such need a different enforcement approach. Once a framework for micro enterprises is implemented, the enforcement approach should focus on remedial actions and education first, not punitive enforcement – as this could

208. S Koemsoeun, 'Cambodia Soon to Transit into Digital Identification Milestone,' Khmer Times, February 11, 2022, <https://www.khmertimeskh.com/501023022/cambodia-soon-to-transit-into-digital-identification-milestone/> [accessed July 19, 2022].

209. N Both et al., 2018, pg. 39.

deter enterprises from participating and push them further into the shadows. The initial goal should be to educate and solve problems.

Table 17. Example of a phased approach to enforcement

	Near-term (next 3 years)	Medium-term (next 4-6 years)	Long-term (next 7+ years)
Large enterprises	Multi-step approach to penalties; education	Full enforcement	Full enforcement
SMEs	Education; remedial actions	Escalating penalties	Full enforcement
Micro enterprises	Design and launch simplified formalization framework	Education; remedial actions	Escalating penalties

This approach should consider the formalization framework and enterprise characteristics and incorporate numerous different approaches to enforcement, including:

- A focus on education and remedial action, where interactions with regulators are largely focused on teaching enterprises about how and why to formalize, and assisting them to do so.
- An enforcement approach that relies on escalating penalties. This approach should target repeat or egregious violations with strong enforcement action, while approaching first-time or minor offenders with no or modest punishments. An example of this approach could be:
 - First error: notice of error, official from the GDT or NSSF assigned to help remediate error;
 - Second error: notice of second error, official from the NSSF assigned to help remediate error; and
 - Third error: notice of error, minor penalty, employer asked to remedy error on their own.

Other approaches that could help improve enforcement include:

- Establishing an anonymized complaints mechanism where workers could file complaints about enterprises that are non-compliant on social security contributions: This complaints system should be used in conjunction with the overall approach above, with a mix of education, remedial actions and enforcement, depending on the enterprise size and number of infractions.²¹⁰
- Sequencing of enforcement: Not all enterprises have equal capacity to pay contributions. Given this, enforcement may target enterprises in high wage, high productivity sectors first (e.g., professional services), and eventually move to low wage, low productivity sectors (e.g., agriculture, retail, etc.).
- Targeting of enforcement. Using economic census data, characteristics of formal firms could be identified. Then, other data could be used to identify informal firms that share characteristics of formal firms. This type of targeting approach would result in a significantly higher increase in formalization versus an approach that broadly targets all businesses.²¹¹
- Data collection to improve enforcement: Some parts of the Cambodian government have previously conducted national street surveys to identify unregistered businesses.²¹² This information could feed back into remediation and enforcement efforts.

210. N Both et al., 2018, pg. 41.

211. This type of approach should be further evaluated for feasibility. Data can be obtained from the economic census. Given that an economic census was recently completed, this could be done using updated data. However, it is also contingent on the laws and regulations around the use of census data, and the lack of prohibitions on data use for a purpose such as this. Consideration should be given to the drawbacks of using census data for this purpose, as it may dissuade participation in the census. A list of questions contained in the census is available here: <https://nada.nis.gov.kh/index.php/catalog/23#metadata-questionnaires>

212. IMF, 2018.

8.2.7. Other strategies to address the transition to formality

8.2.7.1. Enhanced inter-ministerial cooperation and information sharing

Enhancing inter-ministerial cooperation and information sharing can simplify procedures for enterprises and workers and provide additional data for enforcement. The CamDX is an excellent example of this. Shared databases across ministries and government agencies to promote information sharing can aid in the extension of social security by allowing for cross-validation of information to identify non-compliant enterprises and workers and to prevent fraud.²¹³ However, additional integration is needed to cover micro enterprises that are not using and will not use the CamDX to register. Areas where additional information sharing and integration could be considered include:

- Information sharing on enterprise registration, licensing and permitting (especially of micro enterprises) from the Ministry of Interior (Mol), which administers the OWS, to ministries such as the MoLVT and NSSF. This could include sharing existing data or changing procedures to collect and share important information.
 - For example, for the handicraft workshop registration implemented at the OWS on behalf of the MISTI, a “Report on Labour and Equipment” is already collected as part of the permit application. The MoLVT should work with the Mol and MISTI to create a channel for it to receive copies of this report from each handicraft workshop that receives a permit.
- Enhance coordination between the MoC and GDT. The GDT already has a “centralized database of businesses and individuals required by law to register [which] is compiled and maintained that includes business and individual taxpayers, as well as others such as employers with withholding responsibilities.”²¹⁴ This could be shared, if not already done so, through the CamDX portal.

²¹³. N Both et al., 2018, pg. 52.

²¹⁴. IMF, 2018.

- Automate information flows from the GDT and MoI to the MoLVT and NSSF, so that enterprises do not have to register with the MoLVT and NSSF. This would eliminate opportunities for non-compliance and reduce the administrative burden on enterprises.
- Conduct further consultation with private sector and tax officials to gather views on whether the GDT should use VAT non-compliant supplier information from large enterprise tax returns to identify informal suppliers. This could provide data for a targeted formalization campaign.
- Sharing registration information that predates the CamDX portal with relevant ministries.

8.2.7.2. Improved public awareness

Improving public awareness about formality generally, and the NSSF specifically, could also help enterprise formalization. Examples of information-sharing approaches that could be beneficial include:

- Running public campaigns to educate workers and enterprises on how to comply with NSSF requirements and claim benefits. At present, 80 percent of informal workers lack knowledge on accessing entitlements. Education in this area could improve formalization rates.
- Cross-referencing MoLVT and NSSF registration requirements in information about licensing and permitting. For example, a men's hair cutting shop with two to four chairs requires a license, and the procedure is publicly available (see <https://www.service.gov.kh/service/101403>), yet no mention of the need to formalize with the MoLVT or NSSF is included.
- Developing a simple online tool to allow all enterprises to search (by type of business, sector, ministry or ISIC code) and find the registrations, licenses, permits and declarations they need.

8.2.7.3. Developing partnerships for formalization

The government's efforts to encourage enterprise formalization can be assisted by partnerships with key stakeholders. Examples include:

- Developing partnerships with business associations, perhaps also supported by a financial grant for a period of time, to help them extend their service offerings to target the informal sector. In other contexts, a significant share of target enterprises have engaged with a business association and often benefited from these connections, for example by having easier access to information on government COVID-19-related assistance programmes for SMEs.²¹⁵ Examples of partnerships include:
 - A business service desk for micro enterprises.
 - A programme for selected business associations to help them acquire members and ensure their suppliers are registered and fully compliant.
- Providing assistance to organizations working with own-account and other informal workers to raise awareness or facilitate registration, in a similar way to partnerships with business associations.
- Providing assistance to help own-account workers develop organizations. Local governments can provide subsidies to help establish new organizations that can provide a voice for informal economic actors or expand the training offerings of MSME-focused training organizations.²¹⁶
- Enhancing the role of informal economic actors in the social dialogue process.²¹⁷

215. International Trade Centre, *SME Competitiveness Outlook 2021: Empowering the Green Recovery*, Geneva, 2021.

216. V Leung, 2020.

217. ILO, 'Formalizing the Informal Economy Country Brief: Costa Rica,' *Social Dialogue to Achieve the Sustainable Development Goals*, 2018, https://www.ituc-csi.org/IMG/pdf/costa_rica_-_reader_friendly_-_en.pdf [accessed July 19, 2022].

- Providing incentives for private-sector small business service providers to offer new or improved services. For example, run a challenge competition to have private Cambodian companies develop or enhance payroll and accounting programmes that can auto-generate and auto-send forms that are in compliance with GDT and NSSF requirements, eliminating the need for owners to do this.
- Developing partnerships with private sector and financial institutions to help facilitate NSSF contributions. There are numerous examples of this in other countries, such as the partnership between the Indonesian government, Bank Mandiri and the digital platform GoJek to help drivers register and make social security contributions.

8.2.7.4. Phased implementation

Much like the phased approach to enforcement outlined above, a phased approach to the implementation of the monotax or other aspects of the integrated approach could be used. Phased implementation has a number of advantages. It could start with a focus on sectors that have the highest capacity to pay. It could also trial the overall scheme and collect lessons about what worked and what did not. This would allow for adjustments to be made before it is rolled out widely, including to those with less capacity to pay.

8.2.8. Incentives and their limits

Incentives and subsidies can help improve compliance and in the long run, may generate revenues for government if enterprises remain formal. However, they also come at a sometimes significant short-term financial cost. Given this, financial incentives should be well-designed and used frugally, with a focus on changing behaviour at the margins. They should target, as much as is possible, only enterprises that would not formalize without the financial incentive – such as those that otherwise may not register or be able to regularly pay contributions. Incentives should not be targeted at businesses that would register anyways or have the financial capacity to pay. Of course, this targeting is not straightforward and the government may decide it is too complex to be worthwhile. However, approaches that could be considered include linking it to payment capacity or enterprise characteristics. Non-financial incentives should also be used whenever possible, for example by providing public announcements about newly formalized SMEs that other formal enterprises can patronize and receive VAT deductions when doing business with.

The limitations of incentives should also be recognized. They do not offset the uncertainty and risks that can come with formalization. As such, “existing incentives – including the fact that NSSF contributions are tax deductible – are unlikely to have an impact on promoting enrolment.”²¹⁸ These challenges highlight the importance of an integrated approach that also addresses other drivers of informality, including legal and regulatory challenges, the practically complicated formalization processes and the threat of back taxes and punitive interest. Incentives must also be viewed in context. Micro enterprises currently do not pay or collect CIT, VAT or PIT, and therefore have very low tax burdens. Incentive programmes will probably not encourage them to formalize, as they cannot improve their current situation.

Further study should also be undertaken, using NSSF administrative data on missed payments or other items, to learn about the enterprises and workers that move into and out of compliance. This could help identify characteristics of marginal enterprises and workers, including size and sector. This could facilitate additional research on these target groups to learn more about the drivers of their movement into and out of compliance, and identify ways to help them address these challenges and remain compliant more often.

Lastly, incentives should be contingent on legal and regulatory compliance. Existing tax and potential NSSF incentives could be changed so that they are explicitly linked to ongoing compliance with all aspects of formality, including maintaining a current business registration, license or permit and staying updated on taxes and NSSF contributions.

8.3. PREVENTING INFORMALIZATION OF EMPLOYMENT

Another prong of efforts to formalize the economy is preventing the informalization of formal enterprises. Ensuring that enterprises stay formal requires a balance of having an efficient and effective system that delivers for enterprises and workers, as well as appropriate enforcement. Funds that employers and workers pay into the NSSF system, and into public coffers more broadly, need to deliver value for money. This is especially true for informal workers and micro enterprises, who generally have little excess capital and are more challenging when it comes to enforcement. If perceptions spread that enforcement is weak or services are poor value for money, it could increase informalization of enterprises and workers.

²¹⁸. N Both et al., 2018, pg. 25.

8.3.1. Governance and operations of the NSSF

Providing high quality and timely services is essential to ensuring that individuals and enterprises remain enrolled in the NSSF. This is a complex challenge and includes the need for effective services both for enterprises that pay into the fund, as well as for users of health services. The NSSF has taken some steps to improve the quality of healthcare provided to NSSF cardholders, including a programme in which a patient checklist is cross-referenced with health facility invoices to the fund. Expansion of this programme, or additional audits including random or targeted audits, could further improve healthcare quality for NSSF cardholders.²¹⁹

Efforts to ensure quality healthcare services must be complemented by steps to ensure good governance and effective operations of the funds used for healthcare services. Examples of ways to promote good governance of the funds include to:

- **Require regular disclosures of financial performance** through annual reports, released in a timely manner, that review the fund's performance, financial situation and user feedback.
 - For the HCS and ORS, adopt administrative rules that automatically reduce contribution levels if the accumulated balance exceeds a certain level. This will ensure that the NSSF does not continue to accumulate money indefinitely.
- **Take steps to ensure that HCS and other social security programmes deliver value for money.** The majority of NSSF funds should be used to make payments to beneficiaries. Overhead expenses are necessary to do this. However, social security funds in some countries struggle with high overheads in comparison to the funds delivered to beneficiaries. The government should work to maximize the value of benefits received by fund participants by considering a limit on the share of funds that can be used for administrative expenses, a minimum share of funds going to benefits, key benchmarks for service delivery (e.g., responding to all claims within 10 days) and the integration of user feedback data into fund performance

219. N Both et al., 2018, pg. 43.

measures. This information should be readily available from the fund(s) to build confidence among enterprises and workers.

The success of the NSSF depends in part on aligning the incentives of key stakeholders to ensure that they all have a vested interest in the good governance of HCS funds. To do this, one option that could be considered is the **reintroduction of small worker co-payments for the HCS**. The initial design of the HCS included employer and employee payments, though employee contributions were dropped in 2018. Because of this, some workers may view the HCS as “free”. While it is important to keep employee costs low, workers who receive coverage for “free” may have less interest in making sure the system is operating efficiently and providing quality services. Restructuring HCS contributions to require a small worker contribution could ensure they are invested in the quality of outcomes from the NSSF, transforming them from passive recipients to active participants in fund governance. The topic of co-payments is a complex one which must involve technical analysis and thorough consultation. Further study could help better identify the ideal balance between low worker costs but sufficient worker interest in oversight of the quality of healthcare services and fund finances.

8.3.2. Pension fund oversight

Strong oversight of the NSSF pension fund is integral to the continued participation of workers and employers in the system and therefore in the formal economy. The NSSF, which has overall responsibility for the pension fund, has a tripartite governing body which includes four government representatives, two employer representatives and two worker representatives. This same tripartite structure could also provide effective governance of the pension fund and is common in many pension systems. Tripartite stakeholders have a clear role in pension scheme management or, at a minimum, in consultation about the pension scheme.²²⁰ This is “particularly important given that workers and employers finance these schemes and therefore should have their say in determining how the schemes operate.”²²¹ Given this, deeper worker and employer engagement in pension oversight, perhaps beyond the high-level tripartite oversight of the NSSF, may be merited. The governing body of the pension

220. ILO, ‘Tripartite Round Table on Pension Trends and Reforms (30 November-2 December and 4 December 2020): Record of proceedings,’ Geneva, 2021, https://www.ilo.org/wcmsp5/groups/public/@ed_protect/@soc_sec/documents/publication/wcms_789672.pdf [accessed July 19, 2022].

221. ILO, ‘Tripartite Round Table,’ 2021, pg. 9.

fund should also be accountable to pension fund members and beneficiaries as well as to relevant authorities, and professional auditors and actuaries should ensure the functioning of the system and provide reporting information.²²²

8.3.3. Ensuring fair competition

Beyond the governance of social security contributions, it is also important that the government continues to pursue fair competition in the economy, ensuring that enterprises outside the legal and regulatory framework do not gain an unfair advantage over formal enterprises. For example, this includes ensuring fair competition between digital platforms and formal enterprises when they provide the same or similar goods and services. Some platforms operate in markets that have traditionally been informal, and could be partners in promoting formality and compliance. Other types of digital platforms operate in markets that are more formal and compete directly against formal enterprises and could gain a competitive advantage by using informal workers or partnering with informal businesses. It is vital for the government to develop and implement regulations that prevent unfair competition while also incentivizing formality.

8.4. CREATING MORE FORMAL SECTOR EMPLOYMENT

The final prong of efforts to formalize the economy is creating more formal sector employment. These efforts are at the center of Cambodia's national development strategy. There are a number of parts of government, such as the country's investment promotion agency, the Council for the Development of Cambodia, whose focus is on private sector development and included in that, formal sector employment growth.²²³ The efforts of these parts of government are complemented by a number of changes to the legal and regulatory framework to attract investment and jobs. This includes the QIP framework, an investment scheme that has "some of the most attractive incentives in the region."²²⁴ The QIP framework includes a tax holiday on profits that can last up to nine years for qualifying investments. More attractive investment schemes and

222. OECD, OECD Guidelines for Pension Fund Governance, 2009, <https://www.oecd.org/finance/private-pensions/34799965.pdf> [accessed July 19, 2022].

223. Council for the Development of Cambodia, Who We Are, 2022, <https://cdc.gov.kh/who-we-are/> [accessed July 19, 2022].

224. Tilleke & Gibbons, 'Qualified Investment Projects in Cambodia,' November 25, 2016, <https://www.tilleke.com/insights/qualified-investment-projects-cambodia/> [accessed July 19, 2022].

incentives are being provided in the new 2021 Law on Investment, the implementation of which is awaiting adoption of a sub-decree on implementation of the new law.

Other efforts – both direct and indirect – to increase formal sector employment are detailed in the country's overall economic development strategies, including but not limited to the Rectangular Strategy Phase IV. These include:

- Further implementing the country's industrial development policy and the development of the Sihanoukville special economic zone (SEZ).
- Developing and improving SEZ operations to attract investments and develop industrial bases in agro-processing, assembly, furniture manufacturing and household appliances, as well as souvenir products for the tourism sector.
- Preparing and implementing a plan for diversification in tourism.
- Promoting development of entertainment services and creative arts.
- Preparing for the digital economy and Fourth Industrial Revolution.
- Establishing a SME Bank, National Entrepreneurship Fund and Entrepreneurship Development
- Center to further support the development of SMEs and entrepreneurship.



9.

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