

Chapter 3

Extent of Corruption and Its Implications

There have been many complaints about nationwide corruption and particularly corruption in the private sector. This chapter will illustrate the seriousness of the unofficial payments, and provide further knowledge of how much corruption there is in the private sector, based on the EIC modeling system.

3.1. Seriousness of Unofficial Payments

All enterprises were asked to rate the seriousness of unofficial payments in Cambodia.¹¹ The seriousness of unofficial payments was defined as the high degree of unofficial fees that the public need to pay to civil servants. Each respondent mainly determined ‘seriousness’ based on their affordability and revenues. The three types of enterprises had different perceptions on this matter. While micro and large enterprises viewed that unofficial payments in Cambodia were relatively high, the answers provided by SMEs were less negative (table 3.1).

Table 3.1: Seriousness of Unofficial Payments
(1 = not serious, 7 = very serious)

	Micro-enterprises	SME	Large enterprises
Prey Veng	4.08	4.33	-
Sihanoukville	4.10	4.50	-
Kampong Cham	4.27	3.52	-
Kandal	4.35	4.34	-
Phnom Penh	4.53	4.22	4.98
Banteay Meanchey	4.61	3.73	-
Battambang	4.65	3.57	-
Siem Reap	4.88	3.21	-
Kampot	5.29	4.11	-
Average	4.53	3.95	4.98

Source: EIC, CAPS survey, April 2006

Respondents (Micro-enterprises = 810; SMEs = 236; Large enterprises = 44)

¹¹ When asked this question, respondents tend to express their opinion about overall corruption in Cambodia rather than in the private sector. Thus, this perception is about overall corruption in Cambodia rather than their individual firms.

The perceived degree of seriousness of the unofficial payments varied across the provinces. Micro-enterprises that viewed unofficial payments as the most serious were those located in Kampot, followed by Siem Reap, Battambang, Banteay Meanchey and Phnom Penh. Micro-enterprises in Prey Veng and Sihanoukville perceived unofficial payments to be the least serious. Conversely, SMEs in Sihanoukville perceived the unofficial payments as the most serious, followed by those in Kandal, Prey Veng and Phnom Penh. The differences in degree of seriousness of unofficial payments from province to province are strongly linked to the public administration in each province that enterprises deal with, and the economic activities of those provinces and municipalities.

However, unofficial payments for individual firms that participated in the FGDs were reportedly not that serious. This answer is different from the quantitative survey result, because when answering the quantitative question, they refer to overall corruption in Cambodia rather than their individual firm. An overwhelming majority of participants in the FGDs in nearly all provinces and municipalities confirmed that payments of unofficial fees do not seriously affect their business because they can afford it. *“Unofficial fees are not so serious for small companies but are serious for large companies,”* explained an entrepreneur from a small enterprise. Small businesses pay less than large ones due to their scale and activities. A minority of respondents complained about the seriousness of unofficial fees.

In fact, the seriousness of unofficial fees depends on types, location of business, revenues of enterprises as well as the public authorities that the business deals with. A rice miller in Neak Loeung, Prey Veng province, complained: *“Public officials think we are rich and earn a lot of money, so they demand unofficial fees higher than other businesses”*.

If business types are illegal, such as trading in fine woods from banned forests, unofficial fees are increasingly high. The informality or formality of an enterprise is another pre-condition related to the seriousness of unofficial fees. Participants also pointed out that manufacturing enterprises pay more bribes than other types of enterprises as they need to deal with different public officials for different production stages.

A vast majority of participants in the FGDs agreed that even though unofficial fees do not pose a serious threat to them, they feel bored and nervous by frequent inspections by public officials. Many entrepreneurs need to spend time with these public officials, with some entrepreneurs complaining about this time spent being a disturbance to their business.

Another critical point concerning unequal treatment and payment, was also raised by participants in the FGDs. Due to networking, the amounts of unofficial fees are diverse depending on individual enterprises regardless of business similarities. Enterprises that pay more in unofficial fees cannot compete. This provokes an unjust and unfair situation among competitors.

Enterprises acknowledged, nonetheless, that corruption has improved over the last three to four years. This improvement is due to a better business environment; many enterprises agreed that there has been a reduction in both the number public institutions and public officials who visit their enterprises for unofficial fees. An SME entrepreneur mentioned, *“Since 2000, unofficial payments have been reduced. It is not as serious as before, but I still feel fed up with them.”*

3.2. How Much Corruption is there in the Private Sector?

The private sector pays on average 3.9 percent of their annual turnover¹² in official and unofficial fees. About 28 percent of the amount (or 1.1 percent of turnover) is in the form of official fees¹³, while another 72 percent is unofficial fees paid by the private sector to various government officials. According to the entrepreneurs interviewed, these officials include tax agents, police, local authorities, fire and building safety officials, environment officials, etc.

Unarguably, the larger the firm, the more payments are required by government officials. Results from the survey suggest that large enterprises pay an average of 5 percent of their annual turnover, whilst micro-enterprises and SMEs pay only 3.1 percent and 3.6 percent respectively (Table 3.2).

**Table 3.2: Payments to Public Officials
(as Percentage of Turnover)**

	Micro	SME	Large	Average
Total Payment	3.1%	3.6%	5.0%	3.9%
Official Payment	1.3%	1.1%	0.9%	1.1%
Unofficial Payment	1.8%	2.5%	4.1%	2.8%

Source: EIC's Projection based on the CAPS Survey, April 2006

Interestingly, the official fees payment or effective tax payment seems to place more burden on micro-enterprises than on SMEs and large enterprises. The effective tax rate is reduced from 1.3 percent for micro-enterprises to 1.1 percent for SMEs and 0.9 percent for large enterprises. One possible explanation for this

¹² The term 'annual turnover' refers to the total amount of goods or services sold by an enterprise during 12 months

¹³ Official fees constitute almost only effective tax paid by the private sector. Generally, tax receipts are provided.

phenomenon is that SMEs or large enterprises have more bargaining power to negotiate for a lower rate with public officials. In addition, many large enterprises in particular benefit from tax exemptions, the result of Government policies to attract foreign investment.

Noticeably, small gaps in effective tax rates paid by different enterprises mean there is a strong correlation between total payment and unofficial payment. The low official fees paid by large enterprises are compensated by the high rate of unofficial payments which represent almost 4.1 percent of their annual turnover. The unofficial fees paid by micro-enterprises and SMEs account for only 1.8 percent and 2.5 percent of sales, respectively. On average, unofficial payments represent about 2.8 percent of turnover.

It is interesting to note, that the extent of corruption in the private sector seems to be significantly reduced if compared to the actual survey results undertaken by the World Bank in 2004 (about 5 to 7 percent of turnover)¹⁴.

Box 3.1: How are Unofficial Fees Paid by the Private Sector Determined?

Determining unofficial fees in the private sector is quite a difficult task because usually entrepreneurs do not know how much they are supposed to pay in official fees. It could be inferred from the literature review of various documents that tax is the only payment obligation that private enterprises have to meet for their yearly operations. Other official fees, rather than tax, may also be required by Government agencies but the amount due is however very little and negligible. It is therefore not that relevant to spend time distinguishing whether they are official or unofficial. Therefore, all non-tax payments to government officials are considered here as unofficial fees paid by the private sector.

To evaluate the extent of payment by the private sector to all public officials, two different methods have been used. The first, called the calculation method, divides the total payment by annual turnover. The second method seeks an estimation of total payment as a percentage of annual turnover. The two methods provide different results, making it hard to choose the appropriate method to apply. However, following the ad-hoc advisory meeting in May 2005, the second method is preferred, assuming that entrepreneurs interviewed may not list all items of their payment, especially the unofficial payment.

Furthermore, for data consistency and reliability, only part of the sample is used to evaluate the extent of corruption. The sample selected for this purpose is based on the reliability of three main items declared by the enterprises. These are the annual turnover, the total payment to public officials and finally the estimation of total payment to public officials as a percentage of annual turnover. The enterprises which did not provide any of the above three pieces of information were not considered for the calculation of the extent of corruption.

Source: *EIC, CAPS Survey, April 2006*

¹⁴ It is important to note that the surveys conducted by EIC and the World Bank use different methodologies. EIC's survey concentrated more on the provinces, where corruption is perceived to be lower than in Phnom Penh.

Based on the amount of turnovers estimated by EIC,¹⁵ the unofficial fees paid by the private sector reach US\$330 million, representing an amount 2.5 times higher than that of official payment. This amount represented also about 50 percent of the total government budget revenue in 2005. One must note that this amount does not include unofficial fees paid by import-export companies to custom officers or other public officials during goods clearance, nor by companies who have received government contracts.

Table 3.3: Payments to Public Officials (Million US\$)

	Micro	SME	Large	Total
Total Payment	120	150	190	460
Official payment	50	46	34	130
Unofficial Payment	70	104	156	330
<i>Memorandum Items</i>				
Turnovers(*)	3,885	4,154	3,805	11,844

Source: EIC's Projection based on the CAPS Survey, April 2006

(*) Excluding the agriculture and public administration that do not pay tax

3.3. Impact of Corruption on the National Budget

The high level of unofficial fees also seems to have an impact on the effectiveness of government revenue collection. Results from the survey highlight that the official tax rate¹⁶ on private enterprises is much higher than the effective tax rate actually paid. The calculation shows that the potential tax rate should be as high as 3.7 percent of turnover for micro-enterprises, 5.8 percent for SMEs, and 3.8 percent for large enterprises (Table 3.4).

It should be noted that large enterprises have paid official tax rates that are broadly the same as that of micro-enterprises, and significantly lower than that of SMEs. One possible explanation is that many large enterprises, including garment factories, benefit from tax exemptions, which are the result of Government policies to attract foreign investment.¹⁷

¹⁵ There are no official statistics on the turnover of micro, small and medium, and large enterprises in Cambodia. However, commissioned by the International Labor Organization (ILO), estimations on the labor force and value added of formal and informal enterprises have been made in 2005 by EIC and the National Institute of Statistics (NIS). Based on this experience, EIC compiled the turnovers of micro, small and medium, and large enterprises from the newly-released NIS national accounts by using its CGE and I/O (Input-Output) models.

¹⁶ Official tax refers to the amount of tax an enterprise should have paid according to the official rates.

¹⁷ Without tax exemptions, potential tax rate for the large enterprises should reach 6.4 percent of turnover.

During the last ten years, the Tax Department made significant progress in collecting domestic tax revenue.¹⁸ Nevertheless, the efficiency of the current tax system still seems to be relatively weak. Only about 25 percent of the potential tax was collected from the private sector in 2005, which means that the Government might lose about 75 percent of its potential income.¹⁹ The Government's potential loss in tax evasion represented thus about US\$400 million in 2005.

**Table 3.4: Effective vs. Official Tax Rate
and Potential Tax Evasion**

	Micro	SME	Large	Average
(As Percentage of Turnover)				
Effective Tax Rate	1.3%	1.1%	0.9%	1.1%
Official Tax Rate	3.7%	5.8%	3.8%	4.4%
Potential Tax Evasion	2.4%	4.7%	2.9%	3.3%
(Million US\$)				
Effective Tax Paid	50	46	34	130
Official Tax Amount	144	240	146	530
Potential Tax Evasion	94	194	112	400
<i>Memorandum Items</i>				
Turnovers	3,885	4,154	3,805	11,844

Source: EIC's projection based on the CAPS Survey, April 2006

Although the Government has made significant efforts to improve the tax collection system, entrepreneurs interviewed still perceived that the tax collection problem is partly linked to the complexity and lack of transparency of the current tax system. A more simple and transparent taxation of the private sector should be set up so that entrepreneurs could easily understand their obligation to pay tax. Basic ideas for entrepreneurs on how to calculate tax obligations for their individual enterprise should also be provided. Furthermore, the current official tax rate, especially for SMEs, should be reduced to a more realistic level so that they could be able to pay the required amount.

¹⁸ In 2005, total tax revenue collected by the Tax Department reached CR644 billion, against CR270 billion in 2000, and CR47 billion in 1995.

¹⁹ The problem of tax evasion is worldwide. Nevertheless, in a country where the tax system is simple and transparent, and the tax administration is strong, the amount of tax effectively collected should reach 70 to 80 percent of the potential tax to be paid.

Box 3.2: Real Regime vs. Estimated Regime of Taxation

At present, two tax regimes, the real regime and estimated regime, are applied in Cambodia. Whether an enterprise falls under the real tax regime or not depends on (a) the legal form of the enterprise, or (b) the level of turnover, or (c) the type of business activity. In general a sole proprietorship is taxable under the estimated regime if its annual turnover is less than CR 500 million (about US\$125,000) in the case of the supply of goods or mixed supply, or less than CR 250 million (about US\$62,500) in the case of the supply of service, or less than CR 125 million (about US\$31,250) in the case of the government contract. In this exercise, it was estimated that tax regime is applied for MSMEs, while large enterprises come under the real tax regime.

In the estimated tax regime, where the accounting system is not compulsory, not many entrepreneurs understand the base for tax calculation. MSMEs entrepreneurs usually pay tax according to the tax officer and their bargaining power to ask for a smaller tax payment. Indeed, three main tax components, including patent tax, estimated tax on turnover and tax on estimated profit, should be paid by enterprises in the estimated regime. The patent tax is determined based on business activity and the level of turnover, while tax on turnover is fixed at 2 percent of the enterprise's estimated turnover. As for tax on estimated profit, the calculation varies from enterprise to enterprise and different rates are applied according to the business activity and the level of profit estimated by tax officers.

Source: *Law on Taxation 1997, Prakas on the Profit Tax 2004 and Interview with tax officer*

3.4. Impacts of Corruption on the Economy

Although unofficial fees sustained by Cambodia's private sector seem to have been significantly reduced (from 5-7 percent in 2004 to 2-4 percent of sale in 2006), its amount, US\$330 million, remains considerably high in comparison to the size of the Cambodian economy. The amount of unofficial fees represents about 6 percent of the country's GDP, or about 50 percent of government domestic revenue (excluding foreign aid).

This amount could be used for a more productive and transparent development. This could include strengthening the current dilapidated public administration by raising the salaries of civil servants, developing an adequate irrigation system to drastically reduce poverty in rural areas, or putting in place a relevant education system so that Cambodian workers become more competitive in today's knowledge-based global economic system.

To assess the impacts of unofficial fees on the economy, some exercises will be illustrated:

i- Raising the Salary of Civil Servants

The amount of unofficial fees paid by the private sector is more than enough for the Government to raise the salaries of its civil 300,000 servants (including teachers, nurses, policemen, soldiers, etc.) to a decent level of US\$130 to US\$150 a month on average.

The surveyed private sector highlighted that the low salaries of civil servants is one of the most important causes of corruption. In addition, the World Economic Forum and EIC *Competitiveness Report for 2005-2006*²⁰ clearly showed that Cambodia is amongst the least competitive countries in the world, because of the high levels of corruption. Therefore, raising the salaries of civil servants to a decent level will help the Cambodian economy be more competitive, generate more employment, and thus reduce poverty more significantly.

ii- Developing an Irrigation System

With the estimated amount of unofficial fees paid by Cambodia's private sector, the Government could develop an irrigation system that could supply about 500,000 ha of cultivated land. Over a few years, Cambodia's cultivated areas could become one of the most irrigated in the region. The country could thus become one of the main exporters of rice in the world as it was 40 years ago. The incomes of rural households could double or even triple. Again, poverty in rural areas will no longer be visible.

iii- Putting in Place a Suitable Education System

The education system in Cambodia is known to be of a very low standard. In addition, the current education system is not compatible with the needs of the private sector. Consequently, investors always complain about a lack of human resources in Cambodia.

The 2005 national budget for education totaled around US\$85 million. Consequently, the amount of unofficial fees paid by the private sector represents about three times the national budget for education. With strong political will, the Government could improve the education system in Cambodia, by re-allocating the money from corruption to the education of Cambodia's youth. In doing so, the Cambodian economy will be more competitive, through the improvement of human resource capacity.

Finally, one must consider the fact that Cambodia is just as plentiful in resources as its neighboring countries. Nevertheless, they have been more successful in developing their economies due to the better management of available resources. By fighting corruption within their administration, they mobilized their available resources to ensure productive development, such as education and irrigation.

²⁰ Vuthy Chan and Klara Sok, *Cambodia Competitiveness Report 2005-2006*, 2005, EIC