Informality, Tax Evasion and Constraints to Development in Cambodia

Chea Leakhena

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1- Introduction

Informality means different things to different people. Sometimes the term is used to refer to tax evasion, and sometimes to other forms of regulatory evasion, such as noncompliance with labor and product standards. Whichever definition is used, informality is a serious problem in many developing countries (Sugata, Sudeep and Amit, 2006). It is a particular problem in Cambodia. According to an authoritative measure developed by Friedrich Schneider (2005), a professor at the University of Linz, informal activity accounted for 42 percent of Cambodia’s output in 2002–03, compared with 16 percent of China’s, 26 percent of India’s, and 33 percent of Mexico’s. Tax evasion is not the only reason so many Cambodian firms remain informal- corruption, business registration, anti-competitive and capital market are large part of the story—but it is an important one. According to the World Bank’s Doing Business survey for 2006, firms in Cambodia must spend more time to comply with tax requirements than those in any other countries. Cambodian firms are also more likely to cite tax administration as a severe constraint on their operations than their counterparts elsewhere. Tax evasion is also an area in which the Cambodian government has begun to make some progress, and its experience offers some lessons for policymakers in other developing countries.
2- Informality and Productivity Growth

Informality matters for several reasons. Probably the most serious one is that it stifles investment and undermines the overall competitiveness of the economy, because many informal enterprises are stuck in a low productivity trap (Palmade and Anayiotos 2005). Being outside the regulatory and tax umbrella means that these enterprises can afford to be less productive than their competitors in the formal sector. But it also means that they are locked out of markets for finance, technology, and other resources that would enable them to close the gap (Era, Mark and Gabriela, 2006). As a recent Cambodian government report puts it, “the informal economy . . . undermines the evaluation of credit risk by banks, raises the cost of borrowing and curtails the use of capital market instruments, where transparency is a necessary condition for efficiency” (Rocca 2004, p. 24). The effects of informality on firm behavior emerge very clearly from the results of the World Bank’s Investment Climate Survey in Cambodia. The 2003 survey covered more than 800 firms in a broad range of manufacturing activities. Because obtaining direct information about tax evasion is almost impossible (respondents are usually unwilling to acknowledge it), the survey asked firms what fraction of sales “a typical establishment in their area of activity” would report for tax purposes. This indicator serves as a proxy for a firm’s own level of compliance. The resulting data set provides the first hard evidence for Cambodia on the extent of tax evasion and its costs: Tax evasion is not limited to small and medium-size enterprises, as is commonly believed. Even large and very large firms, those employing more than 100 workers, reported only moderate compliance. Less than a third said that typical firms declared all their sales for tax purposes. Evasion is also a matter of degree—there are few outright saints or sinners. On average, respondents said that typical firms reported about two-thirds of their sales to the authorities. Compliance is higher in capital-intensive industries like chemicals and electronics than in labor-intensive ones like clothing and food processing. Firms that reported high levels of tax evasion also find it harder to access external finance and are less likely to be publicly listed. This is because selling shares to outside investors requires an external audit. Many of these firms are unwilling to publish accurate information about their sales and profitability for fear of alerting the tax authorities. Firms reporting high levels of tax evasion are less productive than their formal competitors, even when size, ownership type, and other factors are controlled for. According to a recent World Bank study, a 1 percent increase in the share of informal full-time employees among Cambodian firms is associated with a 0.3 percent decrease in total factor productivity, with other factors constant.
Productivity is the single most important factor in explaining national income differences among nations. Hall and Jones’ review of international evidence suggests that over two thirds of country differences in national income can be accounted for by productivity, rather than the contribution of physical or human capital. This suggests the central role productivity is playing in economic growth. Other work has clearly shown that the income of the poor rises in rough proportion to overall economic growth, indicating that a growing economy is the single best anti-poverty strategy. The effects of growth for poverty alleviation can be strengthened through appropriate investments in people.

Evidence on productivity indicates that Cambodian firms and workers are generally less productive than those in a variety of countries in the world, including major producers such as China, India, Pakistan, Poland and Bangladesh. Whether in nominal or purchasing power parity (PPP) terms, Cambodian firms are not as productive as firms in these comparator countries. Total factor productivity is some 18 percentage points below India, 24 points below China, while roughly even with Bangladesh. However, the labor productivity is roughly 65 percentage points behind India, 62 percentage points behind China, and about 10 percentage points below Bangladesh. Comparative data suggests that Cambodia’s low labor costs do not wholly compensate for the lower productivity of its workers.

**Figure 1:** Performance Gaps (Nominal Exchange Rate, base country: India)

Source: The World Bank, *Cambodia PICS*, 2003, p. 89
3- Constraints to Development

The top priorities of firms focused on governance, rule of law and regulation. Cambodia firms identify corruption as their leading constraint to the operation and growth of Cambodia, followed by crime and anti-competitive practices and/or informal competition. A number of regulatory concerns rank in the top 10 constraints, including regulatory policy uncertainty, customs and trade regulations, taxes and tax administration, and business licensing and operating permits. The fifth-ranking constraint, however, relates to the legal system and formal conflict resolution. The ninth-leading constraint concerns macroeconomic instability. Somewhat surprisingly, neither financing nor infrastructure placed among the top 10 obstacles as rated by the 2003 sample.

Figure 2: Cambodia: Top 10 General constraints to Private Enterprise Operation and Growth

Source: The World Bank, Cambodia PICS, 2003, p. 45

3.1 Corruption

The governance problem is reportedly pervasive, and most firms acknowledge that payments to public officials are frequently, mostly, or always required to “get things done”. Of the 447 firms that answered the question on bribe payments 82 percent (368 firms) reported a positive level of bribe payments. Some 71 percent of large firms suggest such payments are frequent. The private sector estimates that the magnitude of
payments exceeds 5 percent of annual sales revenue, on average, but increases with firm size and formality, exceeding 6 percent of total sales value for large firms in the main sample. Firms’ financial data suggests that unofficial payments are a large component of the cost of doing business.

Figure 3: Percent of Sales Value Paid Informally to Public Officials

Source: Cambodia Selected Issues, IMF 2005, p. 81

The share of revenue consumed by unofficial payments is more than double that found in a parallel survey in Bangladesh, Pakistan or China. Clearly, some types of firms pay more than others, and the international comparison for the garment sector paints a particularly poor picture of the relative costs of corruption in Cambodia. The implications either for the total cost to business or foregone revenue to government are substantial. Yet unofficial payments are not the only form of corruption – firms also acknowledge than an average of 5 percent of contract value must be paid to secure business with public agencies.

In many countries, unofficial payments are seen as a mechanism to expedite delivery of services (Jeff Everett, Dean Neu, and Abu Shiraz Rahaman). In Cambodia, this does not appear to be true. Larger firms tend to be more “formal” as measured by the share of income reported for tax purposes. Large firms report over 60 percent, micro-enterprises report 33 percent, and firms in the urban informal sample, less than 2 percent. The larger and more “formal” the enterprise, the higher the bribes as a share of sales. Firms of all sizes acknowledge paying bribes. Statistical analysis of bribe data suggests that it is rent-seeking, with bribe revenue disproportionately extracted from firms with higher profitability, more workers, and capital.

The “efficiency grease” theory of corruption – that bribes expedite service – does not appear to hold true.
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Firms note that bribes are routinely required for connection to public services, including power and telephones. There is no statistical difference between the speed of administrative procedures for firms reporting higher versus lower ratios of bribes as a share of sales for essential services such as utility connections.

Overall, business’s view of agency integrity is alarmingly negative, with the Judiciary and Customs viewed the most negatively. Over 80 percent of firms perceive the judiciary and customs negatively. More than 60 percent of firms gave negative ratings to the Ministry of Commerce office dealing with trade, the military, and central government leadership. Finally, more than half of all respondents negatively rated pre-shipment inspection services and then national assembly. Taken in total, these reviews suggest a widely-held view that government corruption is pervasive.

Firms perceive influence to be concentrated among certain privileged groups. Over 70 percent of respondents view “dominant firms or conglomerates in key sectors” and two-thirds see individual or firms with close personal ties to political leaders as wielding substantial influence over national laws and regulations affecting firms. Foreign firms, organized crime, and international development agencies and foreign governments round out the groups perceived by the majority of respondents as wielding at least moderate influence over national decisions.

**Figure 4**: How much influence do these groups have over recent national laws, regulations relevant to your business?

Source: Selected Issues in Cambodia, IMF 2004, p. 98
3.2 Business Registration

The business registration process - one of the slowest and least affordable systems for business entry in the East Asia region –is being reformed. According to the 2003 Doing Business study, it takes 94 days to start a business in Cambodia - 30 days longer to start than in Vietnam, and 52 days longer than in Thailand. Especially slow steps include incorporation in the commercial register, VAT registration, and Ministry of Labor notification. Doing Business measures entry costs in terms of per capita GDP, and by this standard, Cambodia has the least affordable costs in the region at 554 percent of per capita GDP. This compares to a cost of 30 percent of per capita GDP in Vietnam and 7 percent in Thailand. The Minister of Commerce has undertaken rapid measures to both reduce the time and cost of registration. He has committed to reducing the incorporation cost component from $650 to $280 or less, with a ten-day turnaround time.

![Figure 5: Time to start a Business (Days)](image)


3.3 Tax administration

There was an improvement in the perception of the private sector on tax administration since the 1999/2000 business environment survey, but it still appears to impose substantial costs, both formal and informal. The Tax Department has, with IMF support, undertaken a range of reforms to increase revenue and the results of this work have been impressive. However, there is a gap between stated policies of the Tax Administration and results reported by the private sector. For example, roughly a third of firms should receive a tax audit each year according to policy. But of firms subject to tax inspections, the average number reported per firm in the last year was just over 7. The average inspection lasted 2 days, generally involved fines, and
also involved informal payments in many cases.

3.4 Anti-Competitive Practices

A majority of firms identified unfair or informal competition as at least a moderate problem. Firms gave a number of indications of the ways in which they viewed the economic playing field as uneven. Of a variety of potential practices of competitors evaluated, over a third of firms suggested that competitors conspiring to limit their access to markets and suppliers was a major or very severe problem. This suggests that dominant firms can act with some impunity to prevent entry of potential rivals. 32 percent of respondents identify the issue of competitors subsidies or toleration of arrears as at least a major problem, suggesting the perception that government does not treat all firms equally. 31 percent suggested that violation of intellectual property rights posed at least a major constraint. Interviews suggest that part of this problem lies in the prevalence of fake or fraudulent products, which can undermine retailers’ relationships with increasingly quality-conscious consumers. Exporters, who are generally larger, are more likely to have foreign ownership, are subject to more regulatory scrutiny, and are dramatically more likely than non-exports to identify unfair or informal competition as a major or very severe constraint. This difference is especially striking with regard to competitors’ violation of intellectual property rights, failure to pay duties or observe trade regulations, avoidance of taxes, and avoidance of labor regulations and taxes.

<table>
<thead>
<tr>
<th>Practices of Unfair or Informal Competition</th>
<th>All</th>
<th>Micro</th>
<th>SME</th>
<th>Large</th>
<th>Exporter</th>
<th>Non-exporter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conspire to limit my access to market/suppliers</td>
<td>34.39</td>
<td>34.12</td>
<td>34.43</td>
<td>36.71</td>
<td>41.77</td>
<td>33.02</td>
</tr>
<tr>
<td>Receive subsidies (including toleration of arrears)</td>
<td>31.81</td>
<td>31.58</td>
<td>31.15</td>
<td>34.18</td>
<td>37.97</td>
<td>30.66</td>
</tr>
<tr>
<td>Violate copyrights, patents or trademarks)</td>
<td>31.41</td>
<td>31.58</td>
<td>29.51</td>
<td>37.97</td>
<td>40.51</td>
<td>29.72</td>
</tr>
<tr>
<td>Don’t pay duties or observe trade regulations</td>
<td>25.05</td>
<td>22.81</td>
<td>25.14</td>
<td>34.18</td>
<td>40.51</td>
<td>22.17</td>
</tr>
<tr>
<td>Avoid sales tax, VAT or others taxes</td>
<td>22.47</td>
<td>16.23</td>
<td>25.68</td>
<td>35.44</td>
<td>40.51</td>
<td>19.1</td>
</tr>
<tr>
<td>Avoid labor taxes/regulations</td>
<td>20.68</td>
<td>14.04</td>
<td>26.23</td>
<td>30.38</td>
<td>40.51</td>
<td>16.98</td>
</tr>
</tbody>
</table>

3.5 Access to Capital

Cambodian firms receive little external finance, except through informal networks of family and friends. Cambodia is a cash-based economy, and local commercial banks provide only 1 percent of working capital overall and a similar share of investment capital (foreign banks provide slightly more). Within Cambodia, by sector, loans are much more common among manufacturing firms, where 21 percent have a bank loan, compared to only 4 percent of trade firms and 6 percent of service firms. Large firms and foreign firms are more likely to have bank credit than small firms: 22 percent of large firms versus 5 percent of micro firms have bank loans.

Demand for formal financing is limited, especially among smaller firms. The survey reveals that less than 4 percent of the firms who do not have a loan have actually applied and been rejected. Conversely, more than 94 percent of the Cambodian firms who do not have a loan have never applied for one. When asked why, about 83 percent of these firms responded that they did not need a loan.

Cambodia is a cash economy. One important explanation is the large amount of cash kept outside of the banking system. Family and friends provide an unusual amount of finance (roughly one-fourth all finance overall). These personal networks appear to be preferred to the formal financial system, which requires disclosure of closely-guarded financial information and may carry a certain stigma among the more traditional firms. For the generally very small enterprises in both the rural non-farm and urban informal samples, family and friends provided close to 50 percent of overall financing. Growth in Cambodia is financed through the use principal (borrowing cash from friends and family) rather than leveraging principal to gain access to debt instruments. In the absence of debt as a growth tool, the rate of economic growth is limited by the availability of cash.

The enabling environment is not conducive to secured lending. Bankers note high reserve requirements contribute to higher interest rates. Limited competition, poor information and high risk contribute to a general reluctance of banks to lend to all but well-known and trusted firms. Specifically, in Cambodia much of the land and capital that might serve as collateral is unregistered, enterprise financial records are generally weak and unreliable, and enforcement through the court system is difficult. Efforts to foreclose on collateral generally yield lengthy court procedures with multiple appeals, and the outcomes are seen as determined by the “highest bidder”. Accounting practice is poor, making client evaluation more costly. Furthermore, there is
no credit bureau and sharing of credit records between banks has been discouraged by privacy regulations. In addition to these business climate factors, credit skills in the banking sector are weak and in need of development.

**Figure 6:** Legal Creditor Rights Index

Source: *Cambodia Selected Issues, World Bank 2003*, p. 56

### 3.6 Rural, Urban, and Informal Investment Climate

In the context of understanding the possibility of diversification, it is important to understand how the investment climate may be different outside of the capital. It is clear that the investment climate in Battambang and Kampong Cham, two important areas for agro-industry, needs particular attention. While investors/enterprises in Kampong Cham appear extremely displeased across all categories, investors in Battambang appear particularly concerned about anti-competitive practices by other firms and corruption. Firms in Sihanoukville and Siem Reap appear to be the least constrained, perhaps indicating a favorable environment for investment in tourism.

The national government is viewed unfavorably by those outside of Phnom Penh, and this appears associated with degree of formalization. In light of the problems firms encounter with corruption and regulation, it is understandable that 60 percent of firms, and fully 67 percent of micro enterprises, regard national government as unhelpful. Local government is held in higher regard – only 36 percent of firms regard provincial government as unhelpful, while 33 percent view municipal government as unhelpful. Perspectives on
government helpfulness varied substantially by location, with the most favorable views generally prevailing in Phnom Penh and Battambang, and the least favorable in Kampong Cham. It is worthwhile to note that the three cities with the lowest rating on national government helpfulness are also characterized by the lowest firm estimates for how much of firm’s income is reported for tax purposes.

A supplemental survey of 200 rural non-farm enterprises in 4 locations was conducted to understand the similarities and differences between urban and rural non-farm enterprises. These firms were found to be mostly very small – 90 percent classified as micro-enterprises (fewer than 10 employees) and 10 percent classified as SMEs (10 to 100 employees). A second supplemental survey was administered to 100 urban informal enterprises – of which 95 percent were micro-enterprises and 5 percent were SMEs. Virtually all firms were unregistered with the central government, although over a quarter of the rural firms had licenses from local governments. The rural non-farm sector is principally run by sole proprietors: 95 percent of businesses are run by one principle owner, while the rest hire external individuals to manage their businesses. Within the urban informal sector, either sole entrepreneurs or their families own 90 percent of businesses, while 10 percent of the businesses take the forms of partnerships. Almost 10 percent of both samples are registered with local authorities.

Being informal pays - a comparison of formal vs. informal firms shows systematic advantages to informality. It also shows that formality is a continuum, and even large and foreign-owned firms are not wholly formal. First, urban informal firms report themselves to be systematically less constrained than urban formal firms. They suffer less impact from corruption, weakness of the legal system, tax administration, and every other manifestation of public control of the economy. Labor regulations, trade regulations and tax rates were not rated as a major or greater constraint by any urban informal firms, showing the great advantage of informality in avoiding regulatory and tax burden.
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**Figure 7**: Leading General Constraints, by location

Source: The World Bank, *Cambodia PICS BIS*, 2003, p.21

**Figure 8**: Cambodia: Constraints to Urban Formal and Informal Firms

Source: The World Bank, *Cambodia PICS BIS* 2003, p. 34

Overall, while rural non-farm enterprises generally reported themselves less constrained than urban formal firms, they rated three factors as more constraining than did the main group: macro-instability, infrastructure
(power, transport), and the cost of finance. Macroeconomic stability is a concern despite relatively stable exchange rates and low inflation. While agreeing on corruption, crime, and economic and regulatory policy uncertainty as their top three constraints, they placed macroeconomic instability next on their list. Like the urban sample, anti-competitive and informal practices were among their top 5 constraints.

**Table 2:** Top Constraints: Main Sample, Informal, and Rural Non-Farm

<table>
<thead>
<tr>
<th>Urban – Main Sample</th>
<th>Urban – Informal</th>
<th>Rural Non-farm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corruption</td>
<td>Crime, theft and disorder</td>
<td>Corruption</td>
</tr>
<tr>
<td>Crime, theft and disorder</td>
<td>Corruption</td>
<td>Crime, theft and disorder</td>
</tr>
<tr>
<td>Economic/Regulatory Policy</td>
<td>Economic/Regulatory Policy</td>
<td>Economic/Regulatory Policy</td>
</tr>
<tr>
<td>Uncertainty</td>
<td>Uncertainty</td>
<td>Uncertainty</td>
</tr>
<tr>
<td>Anti-competitive/unfair practices</td>
<td>Anti-competitive/unfair practices</td>
<td>Macroeconomic Instability</td>
</tr>
<tr>
<td>Legal system/conflict resolution</td>
<td>Legal system/conflict resolution</td>
<td>Anti-competitive/unfair practices</td>
</tr>
<tr>
<td>Customs and Trade regulations</td>
<td>Macroeconomic Instability (inflation,….)</td>
<td>Cost of Financing (e.g. interest rates)</td>
</tr>
<tr>
<td>Tax Administration</td>
<td>Electricity</td>
<td>Legal system/conflict resolution</td>
</tr>
<tr>
<td>Macroeconomic Instability)</td>
<td>Transportation</td>
<td>Electricity</td>
</tr>
<tr>
<td>Tax Rates</td>
<td>Tax Administration</td>
<td>Transportation</td>
</tr>
<tr>
<td>Electricity</td>
<td>Skills &amp; Education of available workers</td>
<td>Tax Rates</td>
</tr>
</tbody>
</table>


Second, all measured costs imposed by the formal economy are substantially less for both urban informal and rural firms. Along a number of regulatory dimensions, both informal and rural firms benefit from being somewhat “under the radar screen” of public officials. Urban informal firms regard bureaucratic behavior as equally arbitrary as do formal firms, and rural firms have an even more negative view than urban firms of the consistency of regulatory enforcement. However, both rural and informal firms are subject to far lower
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compliance costs, due to their greater informality and smaller average size.

They spend much less time dealing with regulations and inspections, report paying fewer unofficial payments, and typically report far less of their income for tax purposes, and hence, pay very little in revenue-based taxes. Formal firms’ visibility not only requires higher formal payments to government, but also appears to invite greater attention and harassment from public officials.

**Table 3: Business-Government Relations**

<table>
<thead>
<tr>
<th>Main Sample</th>
<th>Rural Area</th>
<th>Urban Informal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpretations of regulations consistent, predictable (% disagreeing)</td>
<td>44.35</td>
<td>53.62</td>
</tr>
<tr>
<td>% senior management's time spent dealing with regulations</td>
<td>11.12</td>
<td>2.37</td>
</tr>
<tr>
<td>Total days spent in inspections or required meetings with officials (days)</td>
<td>22.7</td>
<td>11.8</td>
</tr>
<tr>
<td>% revenues typically paid to officials to &quot;get things done&quot;</td>
<td>5.18</td>
<td>1.27</td>
</tr>
<tr>
<td>% total firm revenues typically reported for tax purposes</td>
<td>48</td>
<td>4.95</td>
</tr>
</tbody>
</table>


On the other hand, the main survey makes clear that formal participation in the economy brings relatively few of the traditional benefits that it might be expected to bring in a better-developed economy. The legal system is held in low regard and protection of property and contractual rights is poorly rated. Formal firms have extremely limited access to finance, with banks supplying only 2 percent of their needs. Anecdote and the value chain study also suggest that informal markets may in some respects function more efficiently than formal ones – for example, smuggling is highly developed, quick, and relatively inexpensive, while formal border logistics are weak, slow, and costly.

4- Lessons from Cambodia

All the above-mentioned factors give way to widespread informality in Cambodia. Informality matters because it deters investment and productivity growth. However, governments often worsen the
situation by adding to the tax and regulatory burden to compensate for poor enforcement. This simply drives more firms underground. Breaking the cycle requires a careful approach that induces firms to comply with their obligations yet avoids driving them out of business. Moreover, policymakers need to recognize that eliminating informality can carry a high short-term cost. Simply closing down informal firms will throw many unskilled and poorly paid employees out of work, most of them beyond the reach of social safety nets (Robert, 2007). The best approach is to balance the carrot of participation in formal institutions with the stick of stiffer penalties for persistent noncompliance.

In 2004 the Cambodian government put tax reform high on its political agenda. At the same time an influential study appeared that emphasized the role of unfair competition in undermining productivity and investment (McKinsey & Company 2004). This led policymakers to realize that tackling informality and extending the tax base were necessary to stimulate growth and improve the efficiency of the economy. The Cambodian case provides some concrete examples of what can be done.

Most important, policymakers need to convince firms that it is in their interests to go formal. Not only are informal firms shut out from markets for finance and technology; they also are more at risk from predation by public officials and less likely to participate in other formal institutions such as the courts. The Investment Climate Survey data for Cambodia show that informal firms have less confidence. Therefore, the judicial system will uphold their property rights in the event of a dispute, have less influence over the content of government regulations which affect their business, and are more likely to suffer from demands for bribes by corrupt officials. (Again, these findings hold even with firm size and ownership type controlled for.) Policymakers should publicize these facts. The Cambodian government has done less along these lines than it might. Most examples of best practice come from other parts of the world, including industrial countries. The Peruvian Institute for Liberty and Democracy has elaborated guidelines for communicating with firms in the informal economy, understanding the barriers to formalization, and emphasizing the benefits of compliance. Business associations and similar representative groups can play a useful role in this communication effort, as they have in parts of northern Italy. Another possibility is to put in place transitional measures to encourage firms to come in from the cold. At the very least, newly compliant firms should be exempt from retroactive taxation. Policymakers also need to reduce the burden of regulation. They should remember that tax compliance is not the only reason that firms remain informal. Registration and other procedural costs also
matter, as do excessively rigid labor laws. Some countries, like the Russian Federation and Ukraine, have reduced informality by setting up one-stop shops for a range of government administrative requirements. Even so, reducing corporate tax rates and simplifying the paperwork for tax compliance certainly help.

Tackling informality also requires governments to pay more attention to enforcement. This means stiffer penalties for noncompliance. In industrial countries fines for tax evasion are usually two or three times the taxes owed; in Cambodia they are much lower (Farrell 2004). Detecting and punishing evaders also requires more resources. Cambodia still spends only a small fraction of what most industrial countries spend on tax collection; it also lacks lawyers and judges with tax expertise (McKinsey & Company 2004). Remedying this will take many years. Another requirement for improving tax enforcement is to change attitudes among businesspeople and the public (Richard and Robert, 2006). Here the Cambodian government has made some progress, delivering a short, sharp shock by jailing several prominent offenders. Policymakers also need to target firms that are using informality to gain a competitive edge. In Cambodia some industries, like banking, telecommunications, and steel production, are well integrated into the formal economy; others, such as construction, retailing, and many other labor-intensive services, are not (McKinsey & Company 2004). The poorly integrated sectors are also dominated by smaller firms. These firms require a very different compliance strategy than larger ones—which is why many industrial countries have separate tax administration units for small and large firms. The Cambodian government has made an effort to identify the types of small business activity most prone to evasion, like gasoline and cigarette retailing. This information can help policymakers devise appropriate responses, since any strategy needs to be tailored to the characteristics of the industry it addresses. In Cambodia, for example, the government was able to crack down on beer manufacturers by installing devices that measure the flow of liquid through the production line and report output levels electronically to the Internal Revenue. Finally, detecting evaders requires great coordination and information sharing among government departments, particularly the tax authorities and police. It also calls for close collaboration between the government and the legitimate private businesses that suffer from the effects of unfair competition. This is important because tax evasion is less visible and harder to track than many other types of crime.
5- Conclusion

Informality impedes private sector development by undermining investment and productivity growth. Contrary to what many people have argued, informal firms do not always “grow up” and join the formal sector. Instead, they can remain stuck in an informality trap, excluded from markets for finance and forced to evade taxes and other regulations to compete with their more productive rivals. The solution lies in a mix of stronger incentives for compliance and stiffer penalties for noncompliance if Cambodia is to induce underground economy to formal state. Governance issues need urgent attention to deal with corruption, business registration and create favorable environment for market competition.

References


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