



► Policy Brief

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The paths to formalization in Cambodia An integrated vision*

Key points

- **ILO Recommendation No. 204:** Addressing informality requires coordinated strategies, including removing barriers to formalization, providing incentives, and implementing business environment reforms as outlined in the ILO Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204).
- **Informality in Cambodia:** The country has experienced significant economic growth and poverty reduction over the past decade. However, informal employment has only decreased from 93 per cent in 2012 to 88 per cent in 2019. Informality remains pervasive, particularly among micro and small enterprises, with 87.6 per cent of all establishments not registered with MoC.
- **Registration procedures and compliance:** The regulatory framework varies based on enterprise size. Enterprises must register with the MoC and comply with taxation obligations based on their classification. Labour and social security regulations require businesses with at least one employee to register with the MLVT and the NSSF. Business registration and licensing can be done online or in-person, depending on the enterprise's characteristics, but compliance rates for MSEs remain low.
- **Drivers of informality:** Micro enterprises often remain informal due to lenient legal requirements, unclear registration processes, and compliance costs. For SMEs, challenges include financial and time costs associated with taxes, risks of penalties, and lack of enforcement. Other drivers of informality include taxation system complexities, quality perceptions of social security benefits, corruption, difficulty in quantifying formality benefits, fear of attracting attention, and regulatory framework issues.
- **ILO Recommendations for addressing informality in Cambodia:** An integrated approach to encourage micro and small enterprise formalization and increase NSSF coverage involves defining formality based on behaviour and status rather than size, with varying registration requirements, procedural reforms, enhanced cooperation, and efforts to prevent informalization.
- **The Cambodian National Strategy for Informal Economy Development 2023-2028:** It was launched in October 2023 and aims to promote structural reforms and transition to formality to support economic development, inclusiveness, and resilience to crises.

* This policy brief was prepared by Giulio Bordon (ILO Technical Officer in Cambodia) on the basis of the ILO and UNDP joint publication "*Understanding the Paths to Formalization in Cambodia: An Integrated Vision*". The main report was launched during a 2-day workshop on the integrated formalization for the social protection held on 13-14 December 2023, in Phnom Penh, Cambodia. The report and brief are published within the ILO-EU project "Advancing Social Protection in Cambodia", and the ILO project "Promoting the Transition to Formalization through Integrated Approaches in Cambodia". The contents of the publications are the sole responsibility of the authors and do not necessarily reflect the views of the European Union.

International experience with informality

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.” 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.

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 a common reason 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, 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. The ILO Transition from the Informal to the Formal Economy Recommendation, 2015 (No. 204) 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 2010's. According to recent labour force surveys, average incomes increased from US\$117.70 per month in 2012 to US\$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 affected Cambodia's labour market, increasing unemployment to 4.3 per cent 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-19 pandemic. In 2019, labour force survey data showed that 88 per cent of Cambodia's workforce was engaged in informal employment, down an estimated 93 per cent 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 per cent of these are MSMEs, which are collectively responsible for 58 per cent of employment and 58 per cent of gross domestic product (GDP). However, many enterprises – especially smaller ones – remain informal. The vast majority of establishments (87.6

per cent) are not registered, which is a key trait of informality. All establishments with 100 or more workers and 89 per cent of establishments with 5 or more workers were registered. However, only 6.5 per cent, 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 per cent) compared to formal MSMEs (19 per cent).

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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 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, Forest and Fisheries; and Land Management, Urban Planning and Construction.

Small, medium and large-sized 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, amongst other requirements. Enterprises with at least one employee also must register with the National Social Security Fund (NSSF), make monthly contributions to the employment injury, health insurance, and pension schemes. Though both MoLVT and NSSF have mandatory registration and legal requirements for micro enterprises, compliance rates are not high.

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-sized 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 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 for micro enterprises, others for SMEs, and still others are cross-cutting, affecting workers and enterprises of all size. For micro enterprises, the primary reason that many are informal is because the legal and regulatory framework does not require them to fulfill some steps associated with formality. Practically, micro enterprises are not required to register with MoC, nor pay commercial income tax (CIT), or charge and collect VAT from customers, although they can register with 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 per cent 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 per cent).

For small and medium-sized enterprises (SMEs), the drivers of informality are 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 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 charges penalties and interest at a rate of 1.5 per cent 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 CamDX are about US\$135, although this excludes further business start-up, registration and licensing costs at other ministries or sub-national administrations. For medium enterprises, the costs could rise to US\$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 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 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 per cent to 20 per cent, 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 amongst some enterprises that formalization attracts unwanted attention, which can increase in both formal and informal costs.
- Issues in the legal and regulatory framework design that can sometimes make compliance difficult, costly, or even impossible.

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The business case for an integrated approach to formalization

Formalization is important for fostering an economy and labor 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 amongst other places in the National Social Protection Policy Framework 2016-2025. However, the business case for formalization is not straightforward or simple – it comes with benefits, costs and risks for different groups like 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
	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 used simultaneously
For enterprises	Raises the direct ongoing costs of doing business, including taxes and social security contributions
	Increase the time needed for ongoing compliance
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

Source: Authors' elaboration.

Recommended 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 behavior 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-sized enterprises: registered with 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 MoLVT (if applicable) and registered with NSSF.
- Employees (and other workers that are not self-employed): registered with 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 done by modifying the existing legal and regulatory framework to allow easier access to NSSF for micro enterprises and workers, or by creating a monotax regime for micro enterprises that includes 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 program could be adopted, and could 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 could 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 time-limited 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.
- Enhanced business development or product development services.
- Increased workforce skills training, targeted especially at employees of 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) allow 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 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 complimented 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 MoLVT and NSSF. Enhanced coordination with MoC and GDT may also be beneficial. These efforts could be complemented by improving public awareness about formality generally, and 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.

The National Strategy for Informal Economy Development 2023-2028

In October 2023, the Government of the Kingdom of Cambodia launched the National Strategy for Informal Economy Development 2023-2028 (NSIED). Learning on the lessons drawn during the COVID-19 pandemic, when the Cambodian government found challenges in providing support to the economic units and workers in the informal economy, this strategy recognizes the needs to promote the implementation of structural reforms. Thus, the NSIED recognizes the transition to formality as an untapped potential for contributing to the promotion of the national economic development, as well as an instrument to ensure inclusiveness and resilience to crisis.

In order to tackle the challenges and move towards achieving its vision, goal and objectives, the NSIED identifies five strategic priorities.

1. Identifying, reviewing, and setting up mechanisms to facilitate access to the system.
2. Cutting down the burden of compliance.
3. Offering protection and support to those who have entered the system.
4. Promoting capacity building and support for those who have entered the system to grow and are able to fully participate in the system economy.
5. Strengthening and expanding the dissemination and strategies of the Royal Government and raising awareness of policies and benefits of entering into the system, as well as promoting the engagement of all stakeholders.

As of February 2024, the NSIED has been transferred to the Ministry of Industry, Science, Technology and Innovation (MISTI) in anticipation of its implementation.



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Contact details

International Labour Organization
Joint Programme Office of Cambodia
Phnom Penh Center, Building D, Corner
Street 274 and 3, Phnom Penh
Cambodia

T: +855 23 220 817
E: phnompenh@ilo.org
W: ilo.org/asia/projects/WCMS_908861
ilo.org/asia/projects/WCMS_908610

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