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► Leveraging foreign investment for decent and productive jobs:

Enabling policies and strategies for linkage development in Cambodia

Deborah Winkler



Leveraging foreign investment for decent and productive jobs:

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► Foreword

The global pandemic had a disruptive impact on employment and economic activities, affecting various types of vulnerable workers. Many firms faced serious interruptions, including those with high demand, as they were cut off from sources of raw materials and intermediate goods.

While firms participating in global value chains (GVCs) have shown faster recovery following the Covid-19 shock, national and local economies can become more resilient to external shocks if they are more diversified and if supply chains are better-integrated through robust linkages among exporting and domestic firms. Critical to this end would be the development of policies and practices that incentivize firms, including foreign direct investments (FDIs), to source more inputs locally while building supplier capacities and domestic value added, thereby translating into productive employment opportunities.

Attracting FDI and mobilizing domestic private investment for industrial development, among others, is the first key strategy formulated in Cambodia's National Industrial Policy (NIP) 2015-25. The country's National Strategic Development Plan (NSDP) 2019-23 also formulated the need to connect small and medium-sized enterprises (SMEs) with FDIs and specifically aims to strengthen domestic production, emphasizing the potential for backward and forward linkages. In this context, several priority sectors have been selected, among them, agribusiness, apparel and tourism. Governments, which include labour, trade and investment agencies, and social partners have a role in advocating for economic diversification and industrial linkage strategies that form sustainable bases for productive employment.

In June 2007, the International Labour Conference (ILC) endorsed the concept of sustainable enterprises where ILO's tripartite constituency of government, employers and workers emphasized the alignment of enterprise development and growth with the creation of productive employment and decent work as well as with achieving sustainable development goals. The strategic framework for creating decent work in sustainable enterprises consists of key pillars, the first of which is the creation of an enabling environment that encourages investments and entrepreneurship in a way that balances the needs and interests of enterprises (both workers and employers) with the broader aspiration of society.

In light of the above, this report aims at strengthening constituents' capacities for advocacy and strategy development towards realizing Cambodia's industrial policy goals. It analyses Cambodia's economic and labour market performance, investment goals and their linkages to the local economy. It identifies FDI spillover potentials that the country may harness and recommends policies and strategies that contribute to local sourcing in Cambodia. Best practices from other countries are detailed.

This report was prepared by Dr Deborah Winkler for the ILO Country Office for Thailand, Cambodia and Lao People's Democratic Republic. Technical backstopping was provided by Makiko Matsumoto, Employment Specialist of the Decent Work for East and South-East Asia and the Pacific, and Sandra Yu, Local Strategies for Decent Work Specialist of the same office and currently SME Enabling Environment Specialist of the Enterprise Department. Tun Sophorn, National Coordinator for Cambodia, provided valuable support especially in organizing the national presentation and validation in Phnom Penh.

It is our hope that this report will contribute to a broader understanding of available policy instruments that can foster greater participation and FDI linkages of Cambodian firms in GVCs, translating into higher domestic value added, productive employment and decent work, reduced informality, and resilient national and local economies.



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► Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BSID	Bureau of Supporting Industries Development (Thailand)
BUILD	Board of Investment Unit for Industrial Linkage Development (Thailand)
CAGR	Compound annual growth rate
DIP	Department of Industrial Promotion (Thailand)
EPZ	Export processing zone
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GSP	Global Suppliers Programme (Malaysia)
GVC	Global value chain
HS	Harmonized System
IDP	Industrial Development Policy (Cambodia)
IFC	International Finance Corporation
ILO	International Labour Organization
ILP	Industrial Linkage Programme (Malaysia)
ISIC	International Standard Industrial Classification
IT	Information technology
LACEX	Labor Content of Exports
LIUP	Local Industry Upgrading Programme (Singapore)
MNC	Multinational company
MSME	Micro small and medium enterprises
NIP	National Implementation Plan (Cambodia)
NEP	National Employment Policy (Cambodia)
NSDP	National Strategic Development Plan (Cambodia)
OECD	Organisation for Economic Co-operation and Development
PSDC	Penang Skills Development Centre
RGC	Royal Government of Cambodia
SEZ	Special economic zone
SME	Small and medium enterprises
SMIDEC	Small and Medium Industries Development Corporation (Malaysia)
TIS	Trade Integration Strategy (Cambodia)
TIVA	Trade in Value Added
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
WITS	World Integrated Trade Solution
WTO	World Trade Organization

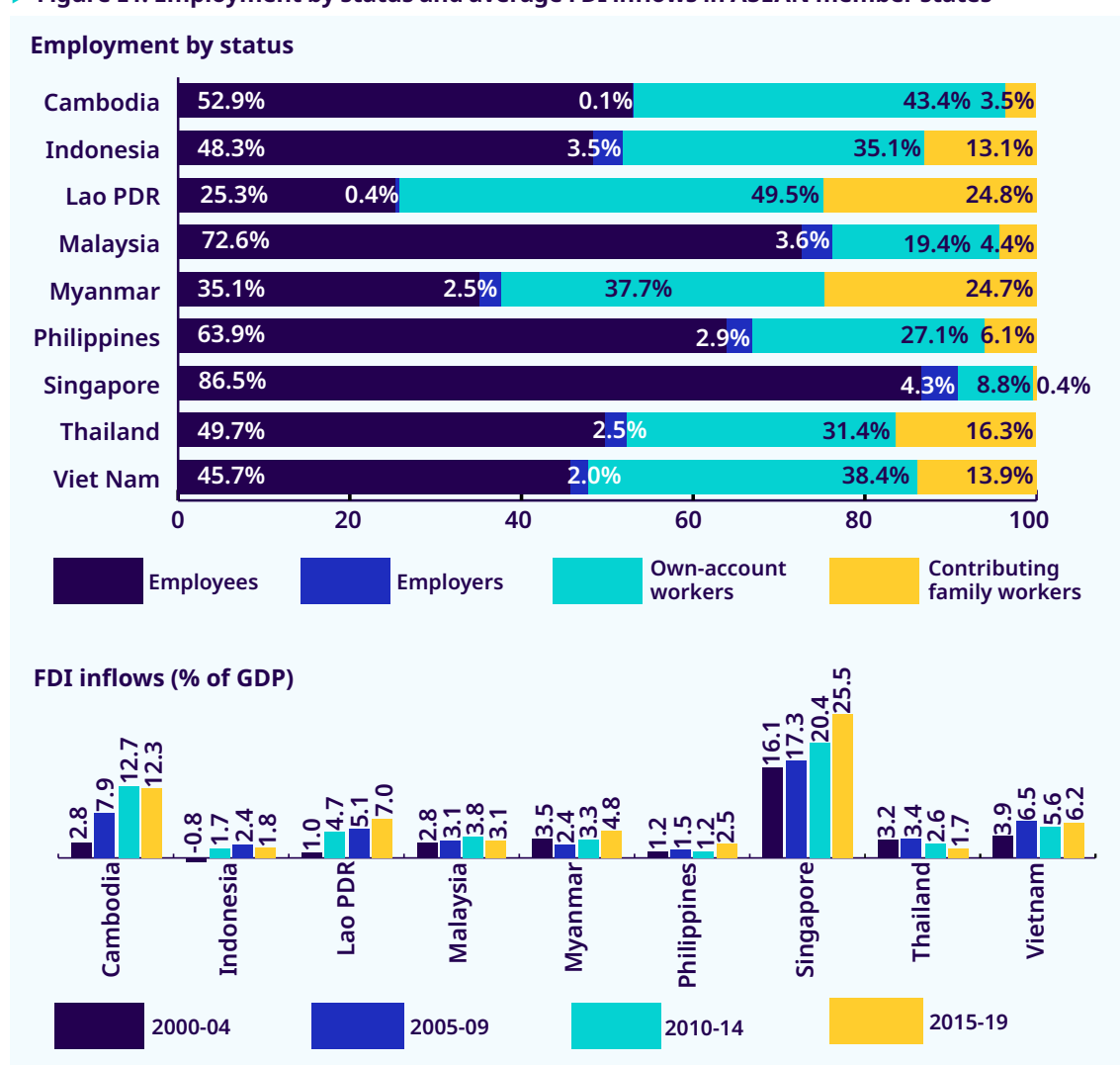


Executive Summary

1. Context and motivation

Cambodia's employment is characterized by high informality despite progress in the past two decades and its early integration into global value chains (GVCs) and successful attraction of foreign investors (Figure 1). Besides high informality which is estimated to affect over three quarters of the workforce (LFS 2019), the country's economic concentration on few low-skill intensive export sectors and products, including in agribusiness (in particular rice), apparel and tourism, has posed a challenge to upgrading through domestic linkages. Upgrading in this context means the increase in domestic value added by linking domestic firms to international activities, including foreign direct investment (FDI) and GVCs.

► Figure E1. Employment by status and average FDI inflows in ASEAN member states



Note: Vulnerable employment is own-account workers and contributing family workers.

Note: FDI inflows as percent of GDP.

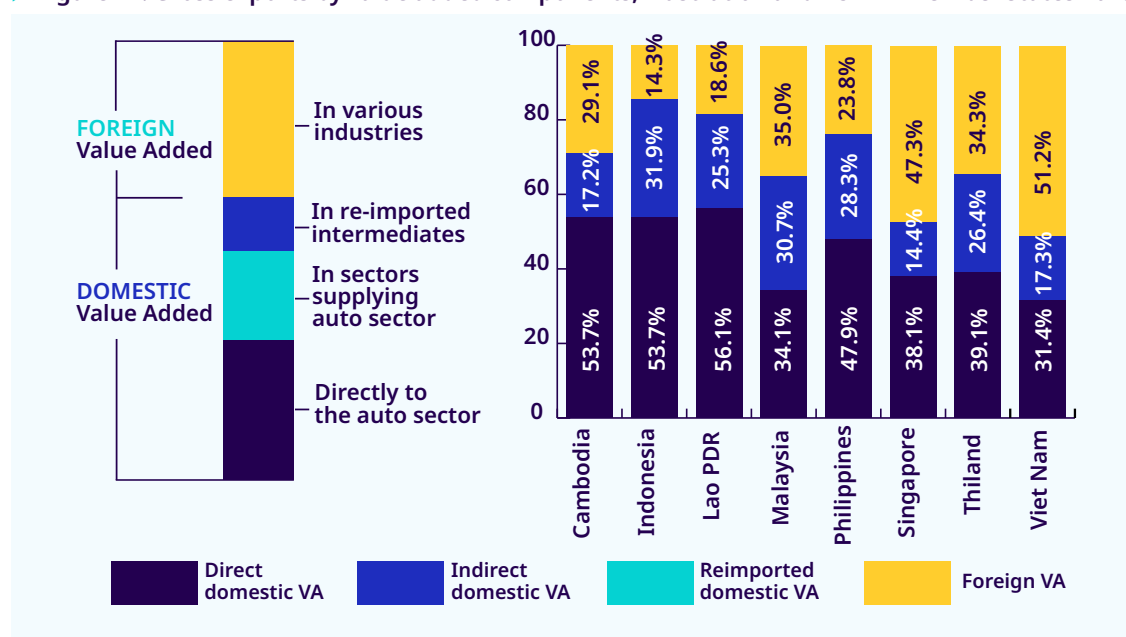
Source: ILO estimates and WDI.

Recent events, such as the Covid-19 shock, highlighted pre-existing vulnerabilities in Cambodia and the need for policies to foster economic diversification and deepen domestic linkages for employment recovery and decent work. The combination of supply and demand shocks during the COVID-19 pandemic severely hit Cambodia's export growth. Cambodia's heavy concentration on the EU and US export markets makes it particularly vulnerable to foreign shocks. The event occurred during an ongoing period of new trends that directly and indirectly affect Cambodia's position in GVCs, including the arrival of new competitors such as Vietnam, the US-China trade war, the trend towards labor-saving automation of production, and sustainability goals (UNCTAD 2021).

2. Assessing domestic linkages and FDI spillover potential in Cambodia

Cambodia's share of indirect domestic value added by supplying sectors embodied in its exports is one of the lowest in ASEAN, indicating low domestic linkages intensity. Trade in value-added data are based on international input-output tables which allow to differentiate between domestic and foreign value added embodied in exports. Figure 2 (left panel) shows the decomposition of gross exports in the automotive sector into (i) the foreign value-added, and (ii) the domestic value-added portions. The latter consists of three components: (i) the direct value-added contribution within the automotive sector, (ii) the indirect contribution of upstream sectors supplying to the automotive sector, and (iii) re-imported intermediates. The right panel shows that Cambodia's share of indirect domestic value added (by supplying sectors) in exports is one of the lowest in the sample (17.2 per cent in 2018) which could be an indication of low local sourcing intensity. It is important to emphasize, however, that these shares are sector-specific. In food exports, for instance, Cambodia's indirect domestic value-added share tends to be higher compared to apparel exports, because it contains domestic agricultural inputs. Nonetheless, Cambodia shows potential for deeper linkages in food exports, with the domestic value-added of upstream sectors accounting for 51 per cent of gross exports compared to 55 per cent in Vietnam.

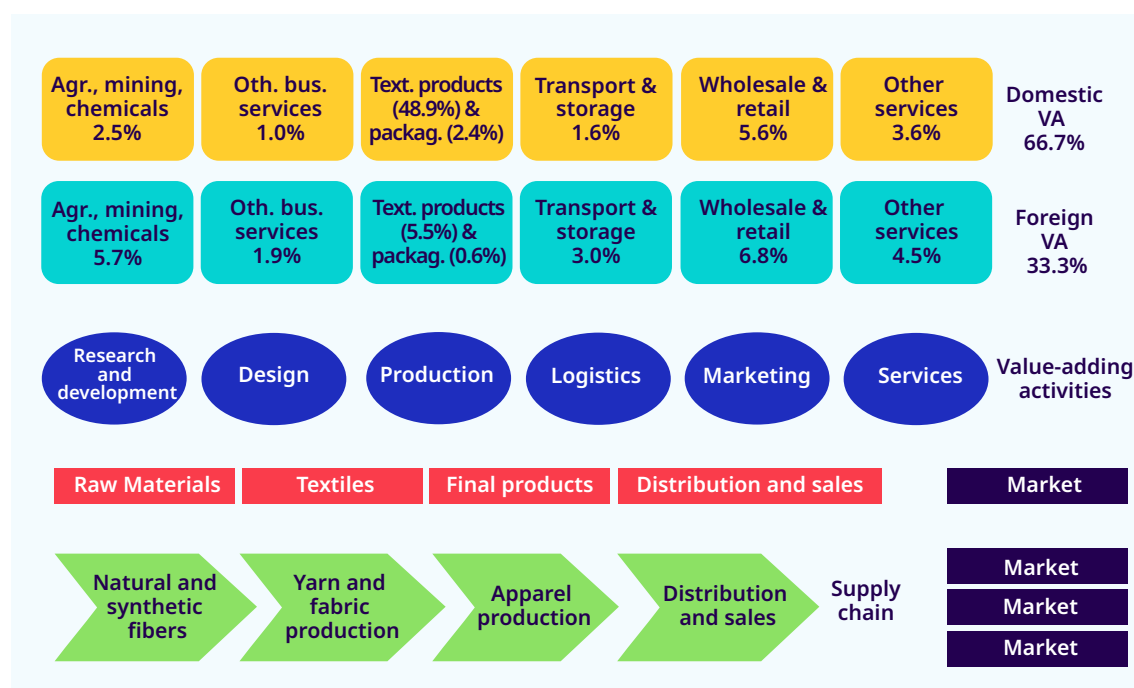
► Figure E2. Gross exports by value added components, illustration and ASEAN member states 2018



Source: Taglioni and Winkler (2016), *Making Global Value Chains Work for Development*, World Bank. Based on Baldwin and Lopez-Gonzales (2013) (left panel) and OECD TIVA 2021 release (right panel).

The decomposition of Cambodia's apparel exports into domestic and foreign value-added sources illustrates the country's potential to increase domestic value-added, especially in services (Figure 3). Domestic value added now makes up almost two thirds of Cambodia's apparel exports. While almost half of the export value comes from domestic value added created within the sector plus packaging, there is also some indirect domestic value added from natural resources-intensive sectors (e.g., agriculture, chemicals) as well as trade, transport/storage, and other services. In contrast, the majority of foreign value added is created in trade, textiles and transport services, Cambodia also depends on natural-resources intensive inputs and other services imports. Overall, Cambodia shows strong potential to increase its domestic services value added embodied, not only in apparel but also other manufacturing exports.

► **Figure E3. Decomposition of Cambodian textile products and footwear by source industry (% of gross exports), 2018**



Source: Own illustration drawing on Stacey and Staritz (2014) and OECD TiVA 2021 release.

Foreign investors in Cambodia seem to have a low linkage and spillover potential, while initial analysis also suggests a low absorptive capacity by domestic firms to internalize FDI spillovers.

The spillover potential of foreign investors is limited not only because of their low sourcing intensity and coverage, but due to their low technology intensity, their strong reliance on investors from East Asia, the low share of local ownership, and the lower coverage of firms offering training to their workers. At the same time, initial analysis suggests that the domestic firms' absorptive capacity is relatively low given their large technology gap and small firm size. However, other factors at the domestic firm level, such as the share of skilled workers, firm location, export behavior, and sector competition (not assessed in this report), could all influence their capability to internalize FDI spillovers.

3. Assessing existing practices to strengthen linkages in Cambodia

The report focuses on existing policy interventions, programmes and projects to strengthen linkages in Cambodia, country examples of successful linkage development and lessons learned, and possible strategies and policy options that can help strengthen linkages in Cambodia. While the government of Cambodia's stimulus measures during Covid-19 mainly aim to provide financial relief to businesses and workers, the policy measures that focus on linkage development and investor attraction in the IDP 2015–25 and further implemented in the NSDP 2019–23 require a more nuanced approach. Several initiatives take into account investment characteristics, in particular with regard to the investors' potential to offer skills building, but also need to assess investment projects in terms of their linkage and spillover potential, as the spillover potential can vary significantly across investors.

In the context of GVCs the foreign investor's global production and sourcing strategy is a key determinant in prospects for local procurement. For instance it would be important to actively target investors that operate in sectors that rely on localized inputs (e.g. food processing), offer complementary technology, knowledge or services (e.g. design services to upgrade apparel GVC), allow for larger domestic participation in its ownership (e.g. through joint ventures), and have experience in establishing and developing local suppliers.

Policy objectives in Cambodia also address many aspects of local actors' absorptive capacity and the institutional capacity, but some areas for improvement remain. Capacity building measures to help SMEs link to multinational firms, for instance, should go beyond the modernization of production chains, and include the building of technical and management skills. Initiatives that target linkages in the context of special economic zones (SEZs) should be extended to non-SEZs given the small size of the Cambodian workforce in SEZs. Finally initiatives that target linkage development could be embedded in a more comprehensive supplier development programme, one that goes beyond the traditional measures of matchmaking or aftercare services.

4. Linkage development and the role of the government, private sector and public-private partnerships

A review of successful linkage development initiatives by the government in other countries highlights that they are more successful if they are part of larger programs and are targeted. Linkage development has shown to be most effective if embedded in a comprehensive supplier development program, such as in Singapore, Malaysia, Chile or Costa Rica. Similarly, policies targeting linkage development as part of other large programs, including industrial or spatial upgrading programs, among others, seemed to be effective, for example in South Africa. Successful programs integrate investors and their specific needs, thus include the demand side as well. At the same time, they also focus on targeting high potential small and medium-sized enterprises (SMEs) as most promising participants and in many cases focus on selected sectors.

Government support needs to go beyond financial assistance, and include help with access to finance, management and technical training, and expansion to new markets. Financing for linkage development programs can also come from donors and foreign investors. More flexible programs, such as Singapore's Local Industry Upgrading Program, seem to be more effective, as they meet the specific needs of all participants. The private sector plays an important part in the training process (e.g., by investors or external private consultants), while foreign investors are sometimes involved in the training process, engage in joint research with local firms, and offer technology transfer or licensing.

The country case studies also offer some important lessons. First, traditional initiatives to build linkages, like matchmaking, information exchange, supplier databases or aftercare services, are important, but only scratch the surface. Second, strict local content regulations are unsuccessful in creating linkages, if suppliers are not up to the task, as the early Vendor Development Program of Malaysia illustrates. Third, excluding foreign suppliers from such programs may be difficult if domestic suppliers are not ready to meet the investors' requirements, which is related to the previous point. Fourth, initiatives that are not embedded in a comprehensive development program tend to be less successful, possibly due to lack of the necessary institutional support, commitment and visibility.

In contrast, linkage development delivered exclusively by the private sector or in public-private partnerships (PPPs) can take a variety of forms. They include supplier development programs by foreign investors, but also less comprehensive training offered by foreign investors to their joint venture partners, suppliers or farmers. Linkage development can also happen through industry associations, private universities, private non-profit organizations or other non-governmental forms, and in some cases also through former employees working at foreign firms that found their own company. The methods being used also vary by sector. In apparel, joint ventures could be a useful channel through which technology can be accessed. In electronics, successful linkage development occurred either through a foreign investor's (Samsung) own Research and Development Center (in combination with financial support for national universities) – or through the creation of a Skills Development Center financed by the government and operated by the private sector (Malaysia).

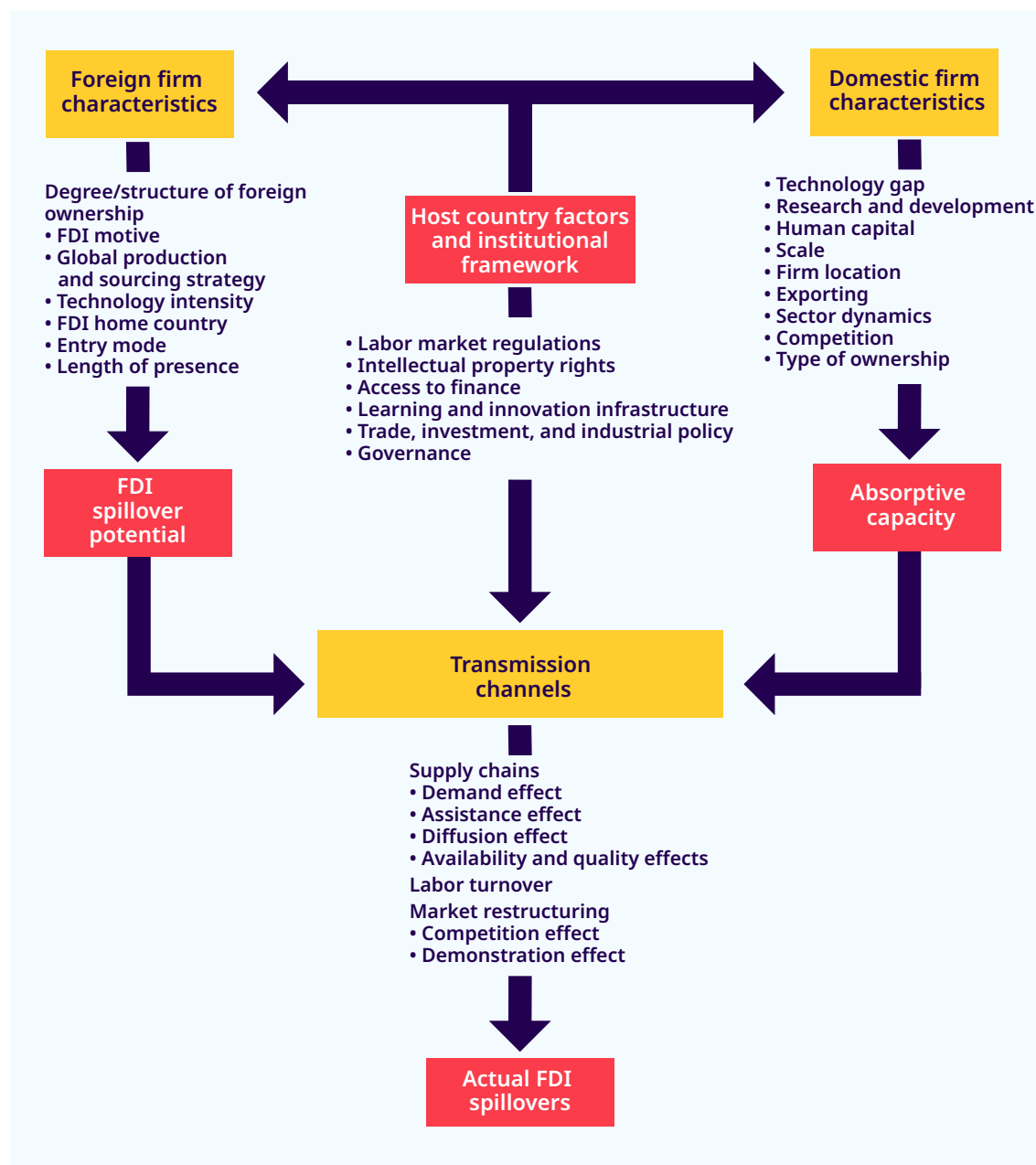
Success factors of comprehensive private development programs include selective targeting, commitment to measurable goals, a strong involvement of the private sector in the actual training, and a holistic approach. More comprehensive supplier development programs, either provided by the foreign investors or delivered in partnership with the host government, are characterized by selective targeting (e.g., of suppliers, farmers, products and provinces) and the formulation of specific goals. In addition, these programs show a strong involvement of the private sector in the actual training. Finally, many of these programs do not only focus on technical training, but include operational, business, and management training, and in some cases encourage innovation.

5. Suitable strategies and policies

This section summarizes suitable strategies and policies for linkage development taking into account the Cambodian context and international best practices. It is based on the premise that linkage development cannot be separated from FDI attraction and efforts to maximize absorptive capacity (Figure 4). Since foreign firm characteristics shape the direction and extent of FDI spillovers and local economy linkages, the first strategy is to prioritize investments with higher linkage potential. This requires to establish a clear policy framework for linkage development. Cambodia can also benefit from policies and regulations that specifically promote local linkages. Finally, the potential for linkage development and spillovers can only be fully exploited if domestic firms have the necessary absorptive capacity.

1. Prioritization of investments with higher linkage potential. Effective interventions can't take a one-size-fits-all approach, but require varied approaches and thus a clear understanding of the value chains. This then allows to explicitly target foreign investors that promise higher linkage potential (e.g. based on their FDI motive and sourcing strategy). It also requires to identify potential sectors/inputs that can increase domestic value added (e.g., services). If certain services cannot be procured domestically, targeting investments in services will be necessary. In an effort to diversify Cambodia's economy, active promotion of sectors with potential for productivity spillovers such as in light electronics is also recommendable. Finally, it is important to ensure that investment incentives, in particular in special economic zones, do not bias against domestic investors (e.g., offering tax holidays to foreign investors while domestic investors need to pay corporate taxes).

► Figure E4. The role of mediating factors for FDI spillovers: a conceptual framework



Source: Farole, Staritz, and Winkler (2014, p. 24).

2. Establishing a clear policy framework for linkage development. This conveys the message that the Cambodian government is committed and can have a positive influence on linkage development. According to case study evidence, introducing legislation or simply discussing its possibility shows the government's commitment to promoting linkages which can encourage a coordinated response from the industry. Here, the focus should be on local value addition rather than only domestic ownership. Foreign investor who sources locally can contribute more value added than a domestic investor who imports all materials. Finally, it is also important to be realistic about the type of local linkages that can be

established in the short term due to supply side constraints. In the medium term, linkage development can be effective if embedded in a clear and comprehensive policy framework.

3. Policies and regulations that promote local linkages. A first necessary step would be to address market failures, such as information asymmetries and contract enforcement between foreign investors and domestic suppliers or coordination problems among domestic suppliers. Building linkage development into investment strategies and incentives e.g., by requiring potential investors to prepare a local linkages strategy as part of their application package to obtain licenses, can be effective, but will rather work for large-scale FDI projects that are likely to deliver substantial long-term rents. Policies can also target (but not force) joint ventures in priority sectors which are especially effective for older technologies which for low-income countries are likely to be most relevant (e.g., Sri Lanka's apparel sector is predominantly operating in joint ventures). However, strategies need to ensure that FDI incentives or requirements do not penalize local sourcing. If foreign investors can source foreign inputs duty-free, but need to pay local taxes on domestically-sourced inputs, this creates additional barriers to linkage development. Finally, designing a specific supplier development program in PPPs which responds to investor demand (rather than merely supply-driven), builds supplier capacity and is embedded in a comprehensive set of policies on linkages government has shown to be effective. The role of the government would be to develop the comprehensive framework for linkage development, while foreign investors should take a lead role in planning and implementing these programs.

4. Strengthening the absorptive capacity of local actors. In Cambodia's case, this includes to reduce the large share of informality of both workers and firms which, in turn, requires capacity building. Those measures need to target firms and workers operating inside and outside of SEZs. Building worker skills requires to invest in the skills of Cambodia's current and future workforce. On the domestic firm side, the emphasis should be on firm capabilities rather than efforts to increase registration rates. While registration is a necessary condition for linkage development, it is not sufficient, and initiatives that increase domestic firms' capacity could incentivize them to register at a later stage. SMEs, in particular, face challenges to comply with international standards. Some SMEs may need to participate in regional value chains first in order to benefit from scale and learning economies before adopting stricter international standards. Finally, the institutional context and business climate also influence absorptive capacity, including the learning and innovation infrastructure, trade policy, business and investment climate, access to finance, labor market regulations.



► 1. Targeting investor linkages to promote decent and productive work

Emerging challenges and opportunities facing Cambodia's global value chain participation

Participation in global value chains (GVCs) has helped Cambodia strengthen its manufacturing sector thus supporting growth, formal employment creation and poverty reduction. Participation in GVCs allowed Cambodia to specialize in low-value added activities, including in apparel, without the need to control the full supply chain, as inputs can be imported from abroad. Over the past decades, Cambodia showed robust growth, supported by its integration in GVCs and strong inflows of foreign direct investment (FDI) which also helped create more formal jobs and therefore reduce poverty. Cambodia's gross domestic product (GDP) increased by over 7 per cent per year on average over the period 2000-19, while exports of goods and services grew at double-digit rates annually.

In recent years, however, external pressures have been challenging Cambodia's participation in GVCs. In 2019, Cambodia faced the partial withdrawal of "Everything but Arms"¹ (EBA) status by the European Union (EU), one of its most dominant export markets, due to human rights concerns². Similarly, the combination of supply and demand shocks during COVID-19 pandemic hit Cambodia's export growth further. Cambodia's heavy concentration on the EU and US export markets makes it particularly vulnerable to foreign shocks. These two events occurred during an ongoing period of new trends that directly and indirectly affect Cambodia's position in GVCs. These new trends included the arrival of new competitors such as Vietnam, the US-China trade war, the trend towards labor-saving automation of production, and sustainability goals (UNCTAD 2021).

While the EBA suspension and Covid-19 have hurt Cambodia's export competitiveness only temporarily, these events highlight deeper structural issues within the country. Such issues include Cambodia's still heavy concentration of exports in certain sectors and the lack of GVC upgrading to higher value-added tasks within existing value chains. While Cambodia has shown efforts of diversification, its exports are still concentrated in agriculture, apparel and tourism which are characterized by mainly low value-added tasks. Similarly, efforts to upgrade its position into higher value-added tasks within existing chains, including in tourism, have not been successful.

These challenges combined with the arrival of new opportunities, such as digital services, require the Government to reassess its type of GVC integration and derive a strategy to foster a more resilient and sustainable development. New opportunities have arisen with respect to GVC participation such as the role of digital services. Research found that, while GVC participation has helped reduce vulnerability resulting from domestic shocks during COVID-19, the negative trade effect is smaller in sectors where a higher share of occupations is performed remotely (Espitia et al. 2020). In order to increase Cambodia's resilience and make its trade-based development sustainable, more strategic diversification efforts are needed in the forthcoming years, both of domestic and export sectors and of worker skills.

1 This EU initiative offers duty-free and quota-free market access to exports (with the exception of arms) from least developed countries, including Cambodia, on the basis that they respect international conventions on human and labour rights among others.

2 European Commission, "[Cambodia loses duty-free access to the EU market over human rights concerns](#)," 12 August 2020.

Given Cambodia's small economic size, its focus on international trade has opened up opportunities to access foreign inputs and sell to foreign markets.

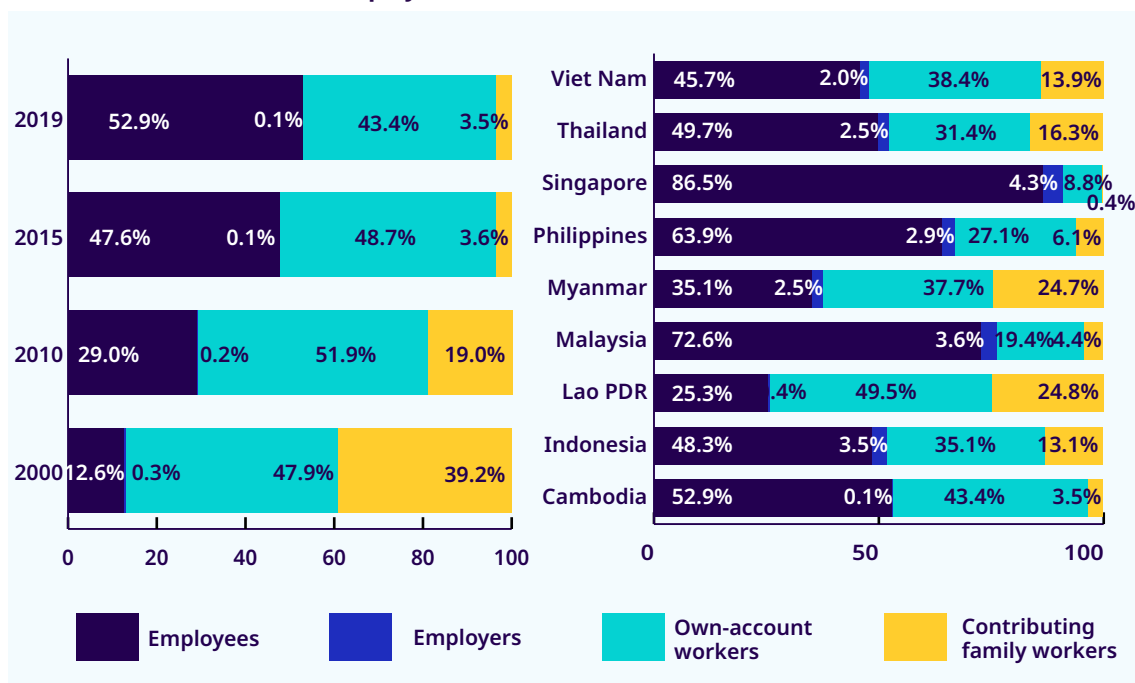
High share of vulnerable employment

The large size of Cambodia's informal economy puts more of its workers at risk of vulnerable employment. Almost half (47 per cent) of the Cambodian workforce still consists of workers in vulnerable employment, as of 2019 (Figure 1).³This percentage remains high even though the country has drastically reduced its share of own-account workers and contributing family workers from 87 per cent since 2000. Cambodia in fact had one of the highest percentages of own-account workers among member states of the Association of Southeast Asian Nations (ASEAN) in 2019. The overwhelming majority, or 97.9 per cent, of all establishments in the country are not registered, according to the Intercensal Economic Survey of 2014.⁴Behind this figure is the fact that micro, small and medium-sized enterprises (MSMEs), with fewer than 100 persons engaged, make up 99.8 per cent of all establishments in Cambodia. Likewise, unregistered MSMEs absorb 65.2 per cent of Cambodia's total workforce, due to the lack of better employment alternatives in the formal sector (National Institute of Statistics Cambodia 2013, ILO and ADB 2015).

3 The Seventeenth International Conference of Labour Statisticians defines informal employment as (i) own-account workers employed in their own informal sector enterprises; (ii) employers employed in their own informal sector enterprises; (iii) contributing family workers, irrespective of whether they work in formal or informal sector enterprises; (iv) members of informal producers' cooperatives; (v) employees holding informal jobs in formal sector enterprises, informal sector enterprises, or as paid domestic workers employed by households; (vi) own-account workers engaged in the production of goods exclusively for own final use by their household. For more information, see ICLS, "[Guidelines concerning a statistical definition of informal employment](#)", (adopted at the 17th International Conference of Labour Statisticians, Geneva, Switzerland, 24 November–3 December, 2003).

4 This report draws on two sources of firm-level data: The Intercensal Economic Survey of 2014 and the 2016 World Bank Enterprise Survey for Cambodia. The Intercensal Economic Survey of 2014 is a sampling survey three years after the 2011 Economic Census and comprises a stratified sample of over 10,000 establishments covering Cambodia's total of 513,759 establishments. As is the case for the Economic Census the data cover all establishments with the exception of establishments in (i) agriculture, forestry and fishing, (ii) public administration and defence; compulsory social security; (iii) activities of households as employers; undifferentiated goods-and services-producing activities of households for own use; and (iv) activities of extraterritorial organizations and bodies. However, the data do not reveal information on certain questions of interest to this guide, such as the extent of local sourcing or selling and are also somewhat older. In certain cases, the guide additionally relies on the 2016 World Bank Enterprise Survey for Cambodia, which consists of a stratified sample (by firm size, sector and region) and covers 337 domestic and 36 foreign firms, making up a total of 373 firms. Since the Enterprise Surveys are available and harmonized for a wide set of countries, this allows for a comparison of Cambodia's performance with its fellow ASEAN member states.

► **Figure 1. Employment by status Cambodia versus other ASEAN member states, 2000, 2010, 2015 and 2019 (% of total employment)**



Note: Vulnerable employment is own-account workers and contributing family workers. Source: ILO estimates.

Formal employment opportunities not only promote decent work but are linked to more productive jobs. Informal workers often face poor working conditions, have no access to health or retirement benefits, and are more likely to be exposed to occupational safety and health hazards as well as extortion, bribery, repression and harassment. The fact that informal workers are less likely to be organized further undermines their vulnerable position. Workers in formal employer-employee relationships typically have higher incomes, more legal and social protection, security, organization membership and a voice, all of which are characteristics of decent work (ILO 2006; ILO 2015). Social security, in particular, is guaranteed mainly to the formal private sector and has limited reach to certain groups of citizens, including informal workers (RGC 2015b). Integrating the informal economy into the legal framework is thus a necessary first step to promote decent work. Nevertheless, legal rights often do not translate into practice while informal employment can occur as well in the formal sector. The development of formal enterprises, in particular small and medium-sized enterprises (SMEs), not only offers formal employment opportunities, but is linked to a large extent to higher productivity and quality because they provide workers better access to technology, education, market information and training (ILO 2006).

Goals of the National Employment Policy and Industrial Development Policy 2015-25

Against this backdrop, the Government of Cambodia developed the National Employment Policy (NEP) 2015-25 to promote decent and productive work, skills and labour market governance, including through the transition of workers into the formal economy. Developed with support from the International Labour Organization (ILO) as part of the ILO-Sida partnership programme, the NEP aims to stimulate the Cambodian economy and labour market toward three goals: (1) increase decent and productive employment opportunities; (2) enhance skills and human resources development; and (3) enhance labour market governance (GC 2015a). The NEP, in Objective 1.3 under the first of the three

goals listed above, recognizes that workers in Cambodia's informal economy constitute the most vulnerable segment of the working population. It thus aims to "promote decent and productive employment by enabling the transition of workers and economic units from the informal to the formal economy, by ensuring the preservation and improvement of the existing livelihood during the transition" (GC 2015a, p. 4). These key goals are also reflected in the National Strategic Development Plan (NSDP) 2019-23 (GC 2019a).

Reducing the size of the informal sector through the formal registration of SMEs is also a major goal of Cambodia's Industrial Development Policy (IDP) 2015-25. The Government's vision is to achieve structural transformation from a labour-intensive to a skills-driven economy by 2025 through participation in regional and GVCs, strengthening the competitiveness, and enhancing the productivity, of domestic industries, and moving toward developing a technology-driven and knowledge-based modern industry. Cambodia's IDP identifies three goals in order to achieve this vision: (1) increase the GDP share of the industrial (manufacturing) sector; (2) promote exports of non-textile products, including agricultural goods; and (3) encourage the formal registration of SMEs (GC 2015b). The NSDP 2019-23 builds on the IDP 2015-25 with regard to these goals.

Fostering global value chain participation to promote formal job opportunities

A complementary route to the transition toward a more formal economy lies in fostering participation in GVCs and their diversification, and creating more local linkages between foreign and domestic investors and the local economy, in order to expand opportunities for formal jobs and formal commercial arrangements. According to the Economic Census of 2011, the share of unregistered firms among large establishments employing more than 100 persons is only 21.1 per cent. Although large firms account for only 0.2 per cent of all establishments in Cambodia, registered large firms employ 24.9 per cent of the total workforce (excluding agriculture, public administration and defence, households as employers and extra-territorial organizations). Among the 781 large firms in Cambodia, around 42 per cent are of foreign origin (National Institute of Statistics Cambodia 2013). While building a business environment that is conducive to productivity and firm growth should certainly be a key priority for policymakers, such policy measures should be accompanied by efforts to foster participation in GVCs and their diversification, and to link foreign and domestic investors to the local economy.

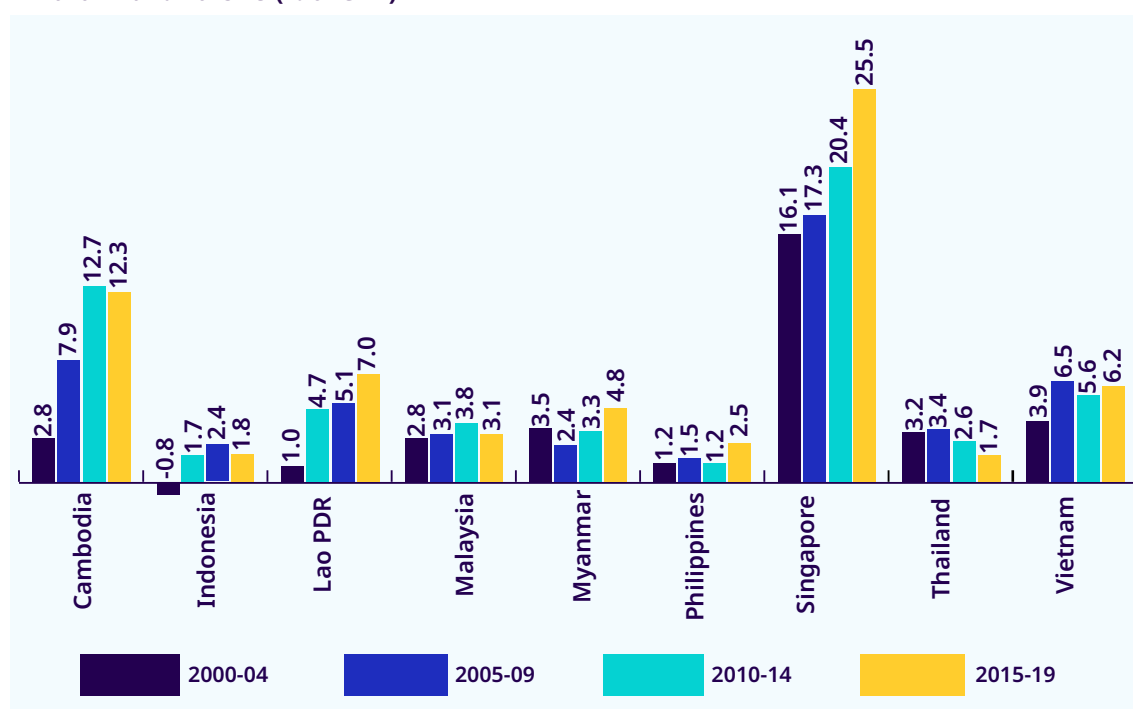
Participation in GVCs provides opportunities for countries to promote structural transformation and advance development, but also brings supply chain risks. In the past, industrialization meant that a country had to build its whole supply chain from scratch. Today, however, countries can enter GVCs, in particular segments of this chain, that correspond to their comparative advantage. The barriers to exports have thus become much lower. In addition, GVC participation helps countries absorb valuable foreign technology and know-how and import inputs that they then process and export in the form of goods, parts, components and services. However, countries also need to be aware of the power relations in GVCs between the lead firm and supplying firms, and the scope for diversifying the risks related to specific supply chains. Because a large part of GVC integration happens through FDI, countries must examine whether FDI leads to positive spillovers for their local actors – especially domestic firms and workers. They also need to know about possible factors at the level of the foreign investor, domestic firm, as well as national and institutional levels, that could – positively or negatively – mediate such benefits (Taglioni and Winkler 2016).

Role of foreign direct investment

Cambodia managed to expand its share of FDI net inflows relative to the size of its economy, especially over the past decade. While Cambodia's average FDI net inflows reached 2.8 per cent of its GDP over the period 2000-04, FDI inflows more than doubled over the period 2005-09 and reached over 12 per cent in the 2010s. Compared to other ASEAN member states, only Singapore shows higher average

inflows of net FDI. Thailand and Malaysia, both of which received a similar share of average FDI inflows in their GDP in 2000-04, only had average FDI net inflows of 1.7 per cent and 3.1 per cent, respectively, one and a half decades later (Figure 2). While the expansion of FDI net inflows could be due to efforts to attract investors, it could also reflect the small size of Cambodia's GDP (see Table 1 below) and its stronger reliance on foreign sources of investment relative to domestic investment (see section 3.1). However, attracting FDI alone is insufficient for reaching the three goals of Cambodia's IDP, because such investments need to be linked to the local workforce and firms.

► **Figure 2. Average FDI net inflows Cambodia versus ASEAN member states, 2001-04, 2005-09, 2010-14 and 2015-19 (% of GDP)**



Source: World Development Indicators.

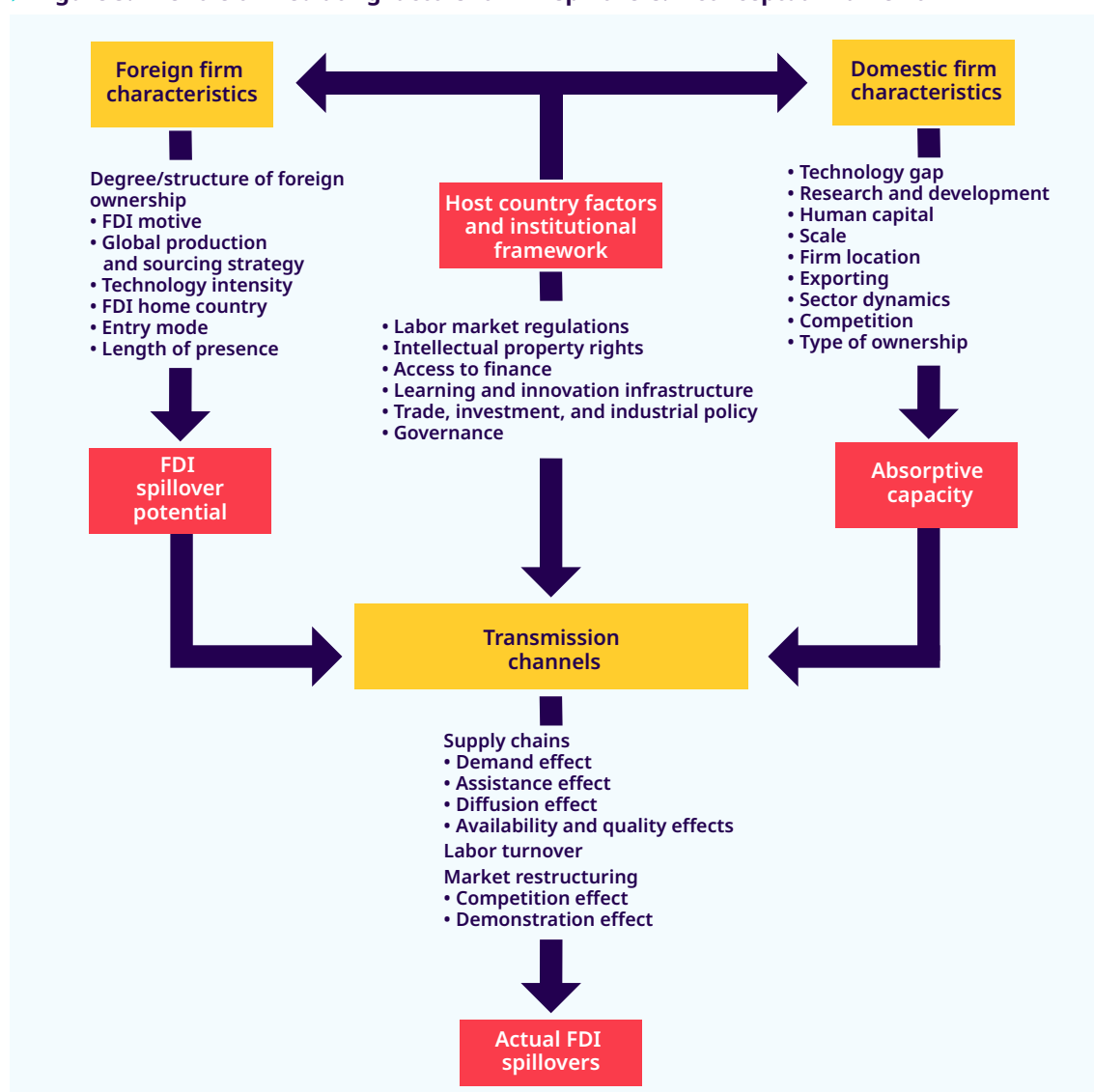
The entry of FDI not only creates formal employment but can provide productivity spillovers to the local economy through three main transmission channels – supply chain linkages, labour turnover and market restructuring. The benefits of FDI to the local economy go beyond direct benefits such as generating domestic investment, employment, foreign exchange earnings and tax revenues, and facilitating trade. Its productivity spillovers, which generally refer to the diffusion of knowledge from foreign investors to domestic firms, include technology and all forms of codified and “tacit” knowledge related to production, including management and organizational practices. Those benefits can extend to local firms within the same industry as the foreign investor (horizontal spillovers), but also to local firms in another industry (vertical spillovers). In the latter case, the presence of foreign investors can increase the productivity of local input or services suppliers (backward spillovers) as well as that of local customers (forward spillovers) (Farole, Staritz and Winkler 2014).

The functioning of the transmission channels as well as various mediating factors at the foreign firm, domestic firm and institutional level determines the extent of FDI spillovers (Figure 3). Conditioning factors at the foreign investor level – including the investor’s degree of foreign ownership, motive, sourcing strategy and technology intensity – influence “FDI spillover potential”. At the domestic firm level, studies

identify its technology gap with foreign investors, its research and development intensity, share of human capital, firm size, export behaviour, firm location, and sectoral competition, as factors that can increase or lower the local firm's "absorptive capacity" to internalize spillovers. Factors at the host country and institutional level can influence foreign and domestic firm characteristics as well as the transmission channels through which knowledge diffuses from multinational firms to local ones. Such factors include a country's income per capita, learning and innovation infrastructure, trade policy, business and investment climate, access to finance, labour market regulations (Farole, Staritz and Winkler 2014).

Such external factors justify interventions that target the development of linkages between foreign investors and the local economy, including supplier development programmes. While impact evaluations of existing linkage development programmes are very rare, a study on Costa Rica's Supplier Development Project for High-Technology Multinational Companies confirms that such interventions have positive effects. Furthermore, the study finds that real average wages, employment and the probability of exporting and export values were significantly higher for those suppliers that participated in this supplier development programme (Monge-González and Rodríguez-Álvarez 2013).

► **Figure 3. The role of mediating factors for FDI spillovers: A conceptual framework**

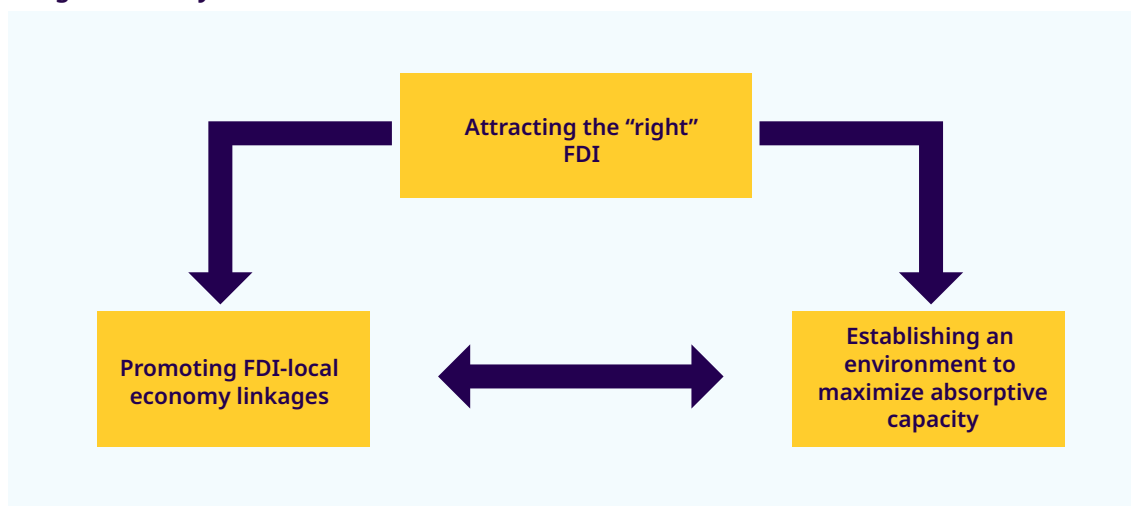


Source: Farole, Staritz and Winkler (2014, p. 24).

Policy framework for linkage development

The policy framework in this guide is based on the premise that linkage development cannot be separated from efforts to attract foreign investments and to maximize absorptive capacity. Since the characteristics of foreign and domestic firms, as well as their institutional context, shape the direction and extent of FDI linkages and spillovers, policies that focus on local sourcing need to be part of a comprehensive strategic framework that emphasizes all three components: (i) attracting the “right” foreign investors, (ii) establishing an environment to maximize the absorptive capacity of local actors and (iii) promoting linkages between FDI and the local economy (Figure 4). However, the ultimate objective is not only to put in place linkage development, but to fully exploit the country’s potential to create value additions, all while promoting decent and productive work.

► Figure 4: Policy framework



Source: Farole and Winkler (2014b, p. 264).

South-East Asian context

Throughout this policy guide, Cambodia’s performance is compared, where possible, with the eight other ASEAN member states (excluding Brunei Darussalam). These are Indonesia, Lao People’s Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. These countries comprise a diverse set of participants in GVCs, ranging from countries specialized in limited manufacturing GVCs such as Indonesia, Lao People’s Democratic Republic and Myanmar, Cambodia and Vietnam, to those specialized in advanced manufacturing and services GVCs such as Malaysia, Philippines and Thailand, and further to countries engaging in innovative GVC activities like Singapore.⁵

5 Based on a taxonomy of GVC integration by the World Bank (World Bank 2019), which classifies countries into four types according to their extent of GVC participation, sectoral specialization and engagement in innovation: commodities, limited manufacturing, advanced manufacturing and services and innovative activities.

ASEAN countries also vary in terms of economic size, income levels and labour market participation (Table 1). Compared to other ASEAN countries, Cambodia has a relatively small population of 16.5 million and had the second smallest GDP behind the Lao People's Democratic Republic in 2019. Although it reached lower middle-income status in 2015, it still has the lowest GDP per capita of US\$1,643 among its fellow ASEAN member states, apart from Myanmar. Cambodia's labour force participation rate of more than 80 per cent is the highest in ASEAN and its 0.1 per cent unemployment rate the lowest, but these mask the high share of informal employment in the country. On the positive side, Cambodia and Vietnam showed the highest annual GDP growth rate of around 7 per cent.

This guide has three main parts. The first part analyses Cambodia's performance with regard to its economic and labour market developments (section 2) as well as investment characteristics and linkages to the local economy (section 3) that help identify the key policy challenges and spillover potential. The second focuses on existing practices of linkage development in Cambodia (section 4) and draws on best practices from other countries (section 5). The third part, based on the previous analysis, suggests strategies and policies to increase local sourcing in Cambodia.

► **Table 1. Economic and labour market Indicators, ASEAN member states (excluding Brunei Darussalam), 2019**

Country	Population, total	GDP per capita (current US\$)	Income status	GDP (US\$ million at current prices)	GDP growth (annual %)	Labour force participation rate*	Unemployment rate **
Cambodia	16 486 542	1 643	LM	27 089	7.1	82.0	0.1
Indonesia	270 625 567	4 135	LM	1 119 091	5.0	68.0	3.6
Lao PDR	7 169 456	2 545	LM	18 246	5.5	78.2	0.6
Malaysia	31 949 789	11 414	UM	364 681	4.3	64.7	3.3
Myanmar	54 045 422	1 477	LM	79 844	1.7	60.4	0.5
Philippines	108 116 622	3 485	LM	376 823	6.1	60.0	2.2
Singapore	5 703 569	65 641	H	374 386	1.3	70.5	3.1
Thailand	69 625 581	7 817	UM	544 264	2.3	66.7	0.7
Vietnam	96 462 108	2 715	LM	261 921	7.0	77.4	2.0

* % of total population ages 15+ modelled ILO estimate.

** % of total labour force modelled ILO estimate.

Source: World Development Indicators. Note: LM = lower-middle, UM = upper-middle, H = high.

► 2. Economic and labour market developments

This section discusses economic and labour market developments in Cambodia. Section 2.1 studies the country's economic diversification in terms of its value added, employment, exports and imports by sector. Section 2.2 analyses Cambodia's GVC participation especially in the agribusiness, apparel and tourism sectors and section 2.3 focuses on the country's main policy challenges with regard to linkage development.

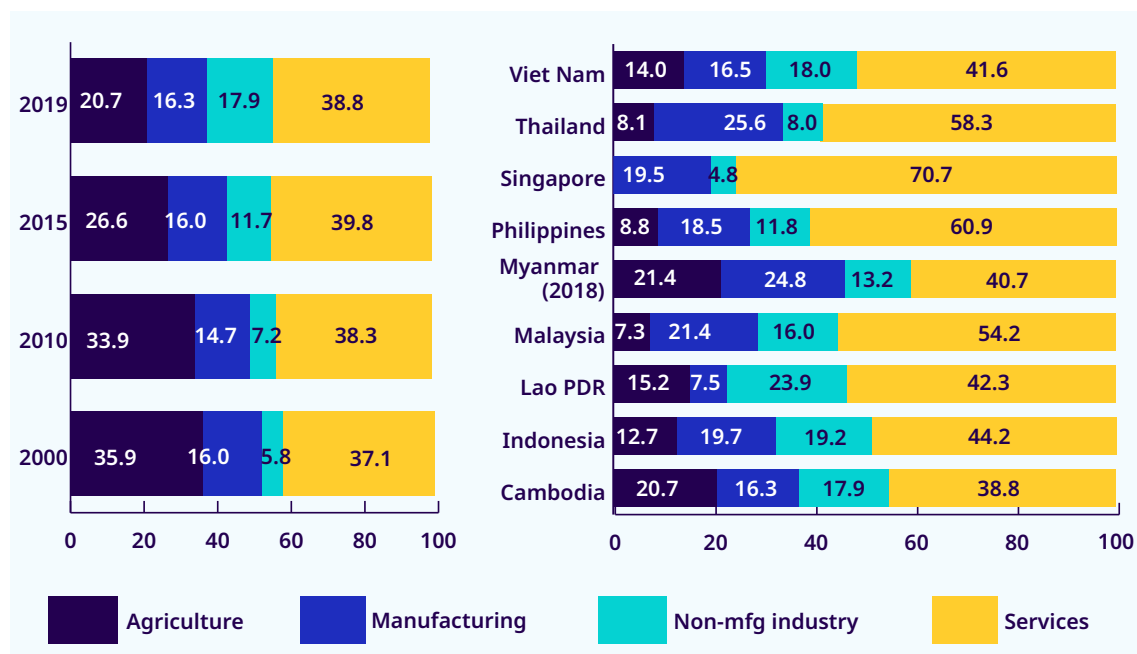
2.1 Economic diversification

Value added and output

While the share of agriculture in Cambodia's GDP has declined considerably over the past years, the share of manufacturing remained constant and the share of non-manufacturing industry showed a robust expansion (driven by construction). The percentage of agriculture (including forestry and fishing) in Cambodia's total value added declined from 35.9 per cent in 2000 to 20.7 per cent in 2019. The share of manufacturing meanwhile remained constant at 16 per cent. The percentage that non-manufacturing industry⁶ accounts for has grown considerably, especially since 2010, to 17.9 per cent in 2019 on account of the expansion of the construction industry and to a lesser extent mining (Table 2). The value-added share of services also grew slightly from 37.1 per cent to 38.8 per cent between 2000 and 2019 (Figure 5 left panel) in Cambodia. By comparison, its manufacturing sector has a small share of GDP, only exceeding the share of Lao People's Democratic Republic but lagging behind all other ASEAN member countries and particularly Thailand. In addition, its value-added share of services is the smallest among its fellow ASEAN member states whereas the share of agriculture in its GDP remains among the highest in the region (Figure 5, right panel).

⁶ Industry corresponds to ISIC divisions 10–45 and includes manufacturing (which is reported separately), mining, construction, electricity, water and gas.

► **Figure 5. Value added by broad sector, Cambodia versus other ASEAN member states, 2000, 2010, 2015 and 2019**



Source: World Development Indicators.

► **Table 2. GDP by sector and compound annual growth rate, Cambodia, 2000 and 2019**

	2000		2019		CAGR 2000-19
	b. riel	%	b. riel	%	
GDP by industrial origin at 2000 market prices	14 174.6	100.0	56 578.1	100.0	7.6%
Agriculture, forestry and fishing	5 058.3	35.7	9 453.9	16.7	3.3%
Mining and quarrying	33.5	0.2	1 009.9	1.8	19.6%
Manufacturing	2 254.8	15.9	13 102.0	23.2	9.7%
Electricity, gas, steam and air-conditioning supply; and water supply, sewerage, waste management and remediation activities	58.1	0.4	386.4	0.7	10.5%
Construction	731.6	5.2	6 237.5	11.0	11.9%
Wholesale and retail trade; repair of motor vehicles and motorcycles	1 512.0	10.7	4 945.4	8.7	6.4%
Accommodation and food service activities	520.9	3.7	2 603.6	4.6	8.8%
Transportation and storage; and Information and communication	930.1	6.6	3 802.5	6.7	7.7%
Financial and insurance activities	175.1	1.2	1 316.0	2.3	11.2%
Other business services*	855.0	6.0	3 957.7	7.0	8.4%
Public administration and defence; compulsory social security	376.6	2.7	585.0	1.0	2.3%

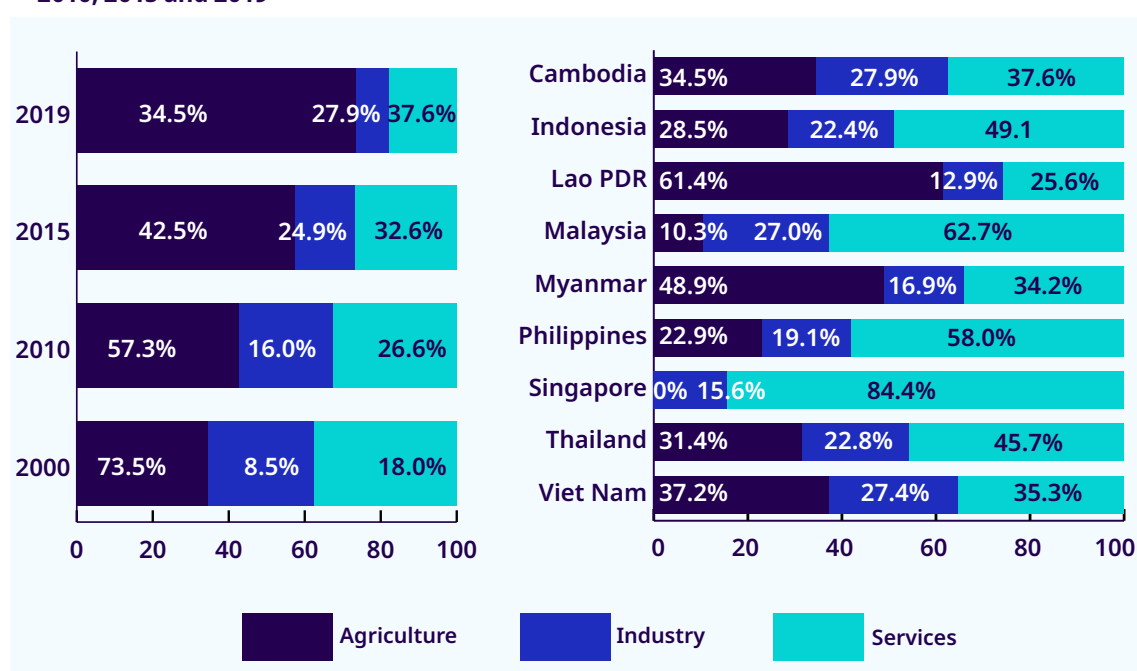
Note: CAGR = Compound annual growth rate.

Source: Asian Development Bank. *Includes real estate activities, professional, scientific and technical activities, and administrative and support service activities.

Employment

The declining role of agriculture in Cambodia's economy is strongly reflected in its figures on the distribution of employment across various sectors, showing the high labour intensity of agriculture while the share of service employment remains relatively low. Almost three-quarters of the Cambodian workforce was absorbed by the agricultural sector in 2000, but this has declined constantly and reached 34 per cent in 2019. The share of services in total employment, by contrast, doubled from 18 per cent to 37 per cent over the same period, while that of industrial employment expanded from 8.5 per cent to 27.9 per cent (Figure 6 left panel). Cambodia's employment distribution is very similar to that of Vietnam. This is because of Vietnam's strong sectoral focus on agriculture, while most of the other ASEAN countries employ a smaller share of their workforce in agriculture (with Lao People's Democratic Republic and Myanmar being the exceptions). Cambodia's employment share in the industrial sector lies in the medium range, while its services sector absorbs a smaller share of the workforce than in most other ASEAN countries except for Vietnam, Myanmar and especially Lao People's Democratic Republic (Figure 6, right panel).

► **Figure 6. Employment by broad sector, Cambodia versus other ASEAN member states, 2000, 2010, 2015 and 2019**

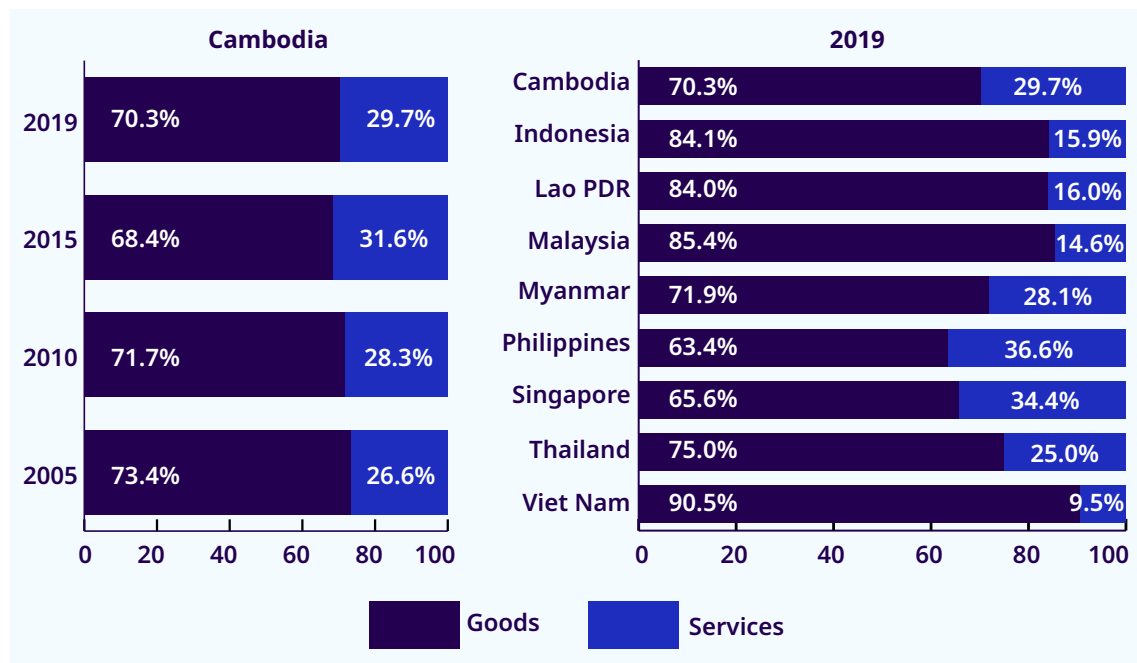


Source: ILO modelled estimates November 2020.

Trade

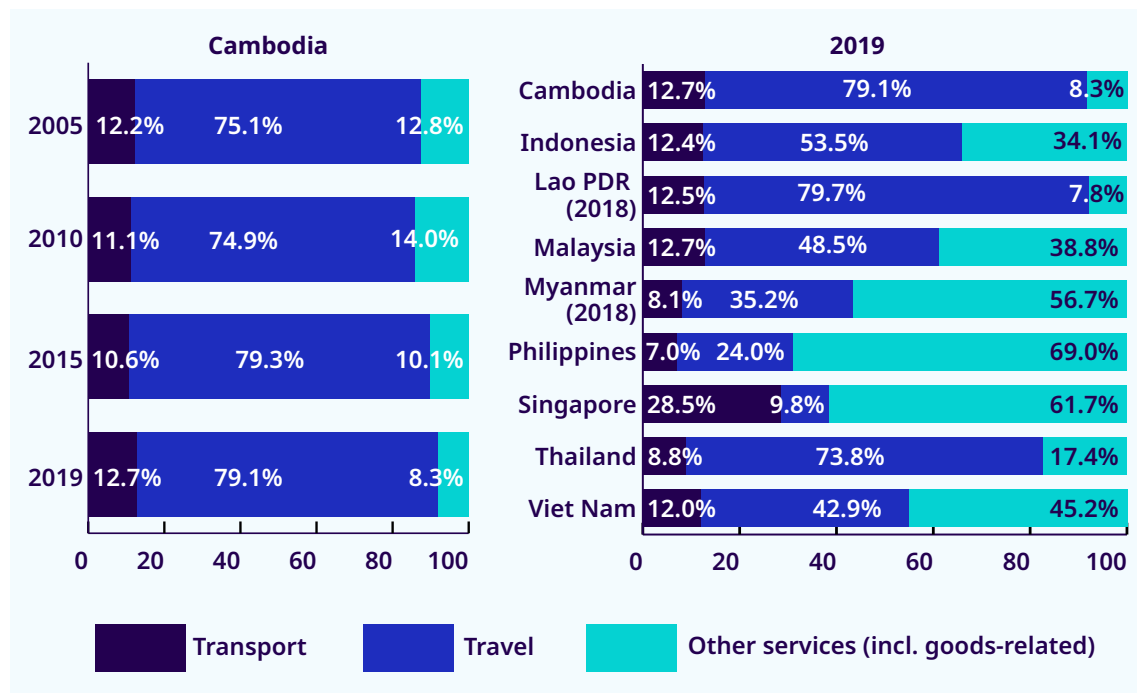
Although services have a small share of total employment, they account for a high share of Cambodia's total exports, reflecting the country's increasing reliance on trade in travel. The share of services in the country's total exports grew from 27.8 per cent in 2005 to 31.6 per cent in 2015 but fell back to 29.7 per cent by 2019. At the same time, the export share of goods reached 70.3 per cent of total exports in 2019 (Figure 7 left panel). The relatively high percentage of services in exports – the third highest after the Philippines and Singapore (Figure 7, right panel) – reflects the country's strong dependence on trade in travel. Travel makes up almost 80 per cent of Cambodia's total service exports (Figure 8, left panel).

► **Figure 7. Goods and services exports, Cambodia versus other ASEAN member states, 2005, 2010, 2015 and 2019**



Source: UNCTAD.

► **Figure 8. Services exports by broad category, Cambodia versus other ASEAN member states, 2005, 2010, 2015 and 2019**



Note: Travel covers goods and services for own use or to give away acquired from an economy by non-residents during visits to that economy.

Source: UNCTAD.

The expansion of the share of travel in Cambodia's service exports came at the expense of other services (including goods-related services). While other services represent almost 70 per cent of all exports of services in the Philippines, 61.7 per cent in Singapore, and more than 30 per cent in Malaysia, Myanmar, Indonesia and Viet Nam in 2019, they account for only 8.3 per cent of such exports in Cambodia (Figure 8 right panel). This is down from their 12.8 per cent share in 2005, a trend largely driven by falling export shares of business services, including telecommunications, computer and information services and other business services. Exports of these business services grew at just single-digit rates, compared with the total exports of services which expanded at an annualized growth rate of 13.1 per cent (Table 3).

► **Table 3. Export of services by detailed category and Compound annual growth rate, Cambodia, 2005 and 2019**

	2005		2019		CAGR 2005-19
	US\$ million	%	US\$ million	%	%
Services	1 118.1	100.0	6 253.8	100.0	13.1
Transport	135.9	12.2	793.2	12.7	13.4
Travel	839.5	75.1	4 944.3	79.1	13.5
Other services	142.7	12.8	516.3	8.3	9.6
<i>Construction</i>	2.0	0.2	29.4	0.5	21.3
<i>Insurance and pension services</i>	0.8	0.1	9.7	0.2	19.5
<i>Financial services</i>	10.6	0.9	30.2	0.5	7.7
<i>Charges for the use of intellectual property n.i.e.</i>	0.4	0.0	7.7	0.1	23.4
<i>Telecommunications, computer and information services</i>	33.9	3.0	95.6	1.5	7.7
<i>Other business services</i>	39.1	3.5	108.2	1.7	7.6
<i>Personal, cultural and recreational services</i>	1.4	0.1	8.8	0.1	14.0
<i>Government goods and services n.i.e.</i>	54.5	4.9	226.8	3.6	10.7

Source: UNCTAD.

Cambodia's export of goods grew at a pace similar to its export of services. This trend is driven to a large extent by the country's low-skill intensive exports of apparel, while it trails behind other ASEAN member states in high-skill intensive exports. Cambodia's compound annual growth rate (CAGR) for the export of goods reached 16.3 per cent between 2000 and 2019. Apparel and footwear exports, representing over 60 per cent of the country's basket of exports of goods in 2019, grew at a similar rate (Table 4). Cambodia's share of labor and resource-intensive exports made up 87.7 per cent of its export basket in 2019. At the same time, its 2.5 per cent share of high-skill intensive exports is the second smallest in the region or less than half the share of that in Myanmar (Figure 9, left panel).

Despite its diversification into more sophisticated export sectors like machinery and electronics, Cambodia still shows a high concentration of exports in a few products. The country has the second highest product concentration of exports after Philippines in 2019, despite having a more diversified

goods export basket since 2000 (Figure 10). This lower concentration index can be explained by the sharp drop in Cambodia's textiles and clothing exports, down from 80 per cent in 2000. At the same time, Cambodia managed to increase its export share of vegetables, hides and skins, footwear, machinery and electronics, and transportation (Table 4).

Cambodia's dependence on apparel exports is also reflected in its basket of imports, which relies heavily on the import of textiles but less on high-skill intensive imports. While the role of textiles in the country's total importation of goods has decreased since 2000, reaching a 26 per cent share of imports by 2019, it remains the largest import sector. This has been followed by the importation of machinery, electronics and transportation goods (Table 5). However, Cambodia's share of the important high-skill intensive products is relatively low at 14.2 per cent. Other ASEAN member nations, including Singapore, Malaysia, Vietnam, the Philippines and Thailand, have a higher reliance on high-skill intensive imports which represent at least 45 per cent of their goods import basket (Figure 9, right panel).

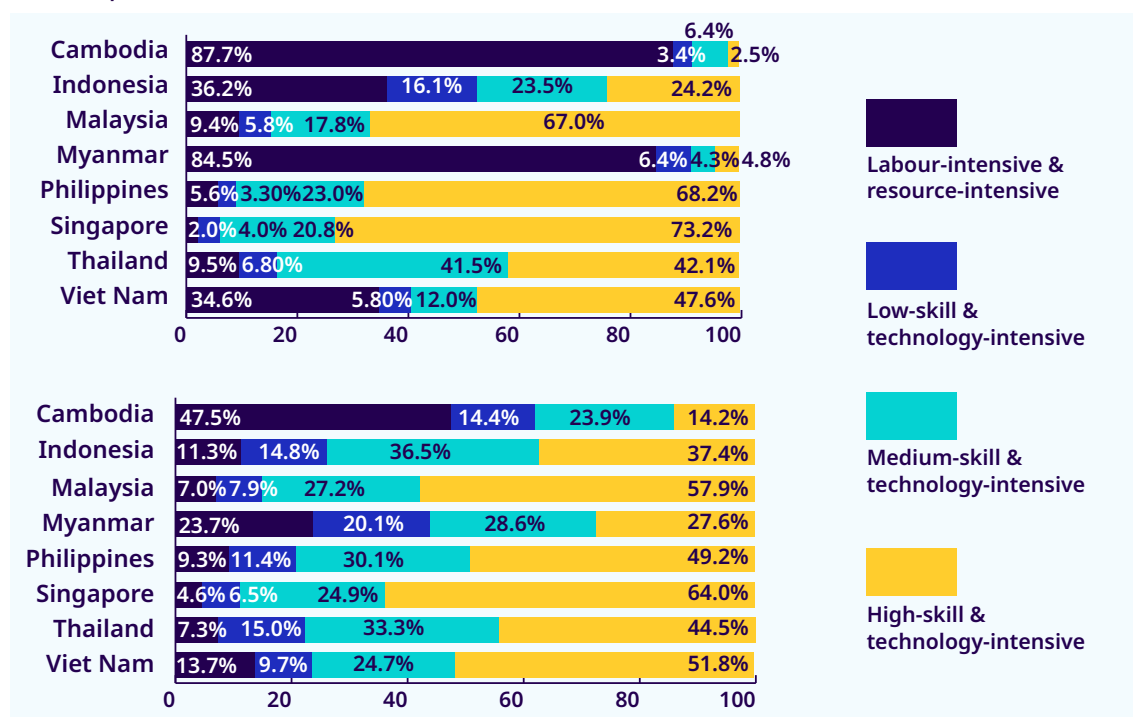
► **Table 4. Export of goods by product category and CAGR, Cambodia, 2000 and 2019**

HS2	Sector	2000			2019			CAGR 2000-19
		US\$ thousand	%	Rank	US\$ thousand	%	Rank	
	Total	1 508 290	100.0		26 409 805	100.0		16.3
1-5	Animal	19 615	1.3	5	60 474	0.2	13	6.1
6-15	Vegetable	4 896	0.3	8	1 317 928	5.0	5	34.2
16-24	Food Products	1 094	0.1	13	143 105	0.5	12	29.2
25-26	Minerals	161	0.0	15	29 916	0.1	15	31.6
27-27	Fuels	40	0.0	16	252	0.0	16	10.1
28-38	Chemicals	472	0.0	14	37 292	0.1	14	25.9
39-40	Plastic and Rubber	50 413	3.3	4	556 600	2.1	8	13.5
41-43	Hides and Skins	3 999	0.3	10	1 878 234	7.1	4	38.2
44-49	Wood	76 149	5.0	3	242 030	0.9	11	6.3
50-63	Textiles and Clothing	1 209 038	80.2	1	13 555 598	51.3	1	13.6
64-67	Footwear	118 610	7.9	2	2 724 110	10.3	3	17.9
68-71	Stone and Glass	3 035	0.2	11	3 613 274	13.7	2	45.2
72-83	Metals	4 523	0.3	9	294 311	1.1	10	24.6
84-85	Machinery and Electronics	5 320	0.4	7	688 799	2.6	7	29.2
86-89	Transportation	1 798	0.1	12	550 612	2.1	9	35.2
90-99	Miscellaneous	9 129	0.6	6	717 269	2.7	6	25.8

HS = Harmonized System 1988/92.

Source: World Bank WITS. Based on UN Comtrade data. Note: Exports based on imported data for the world from Cambodia (mirror data).

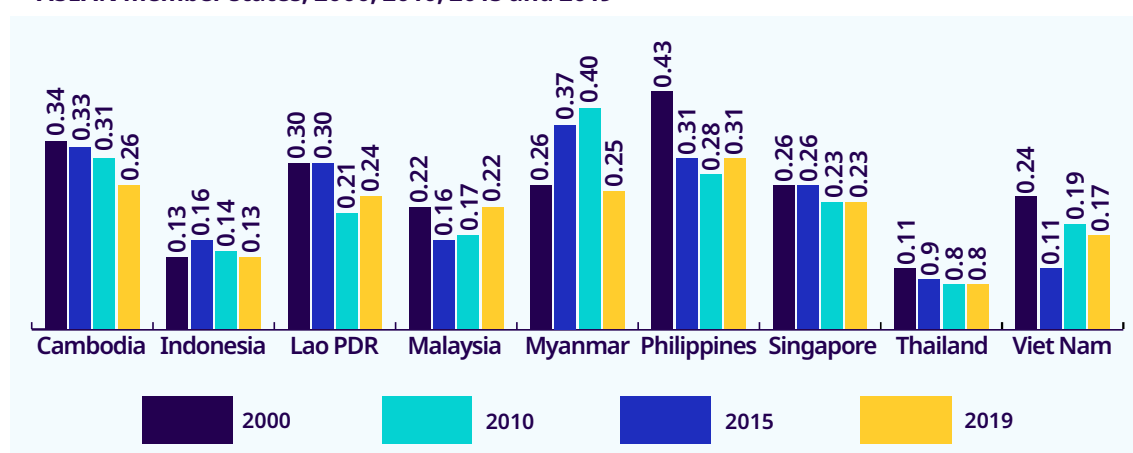
► Figure 9. Export and import of goods by skill intensity, Cambodia versus other ASEAN member states, 2019



Source: UNCTAD.

In sum, Cambodia specializes in three main sectors – agriculture, apparel and tourism. While agriculture plays a major role in the country's employment and value-added creation, agricultural products are still mainly intended for final domestic use rather than for export production. Exports of goods, by contrast, are dominated by apparel, although Cambodia has diversified its basket of export goods in recent years. Travel takes up the lion's share of services exports. The next section focuses on these three value chains in more detail.

► Figure 10. Hirschman-Herfindahl Index of export concentration, Cambodia versus other ASEAN member states, 2000, 2010, 2015 and 2019



Note: The normalized HHI is used in order to obtain values between 0 and 1. An index value closer to 1 indicates that a country's exports or imports are highly concentrated in a few products. On the contrary, values closer to 0 reflect exports or imports are more homogeneously distributed among a series of products.

Source: UNCTAD.

► Table 5. Import of goods by product category and CAGR, Cambodia, 2000 and 2019

HS2	Sector	2000			2019			CAGR 2000-19
		US\$ thousand	%	Rank	US\$ thousand	%	Rank	
	Total	1 438 775	100.0		20 278 818	100.0		14.9
1-5	Animal	3 440	0.2	16	65 545	0.3	16	16.8
6-15	Vegetable	26 086	1.8	13	197 666	1.0	14	11.2
16-24	Food Products	111 286	7.7	4	1 171 935	5.8	6	13.2
25-26	Minerals	31 300	2.2	12	179 857	0.9	15	9.6
27-27	Fuels	182 780	12.7	2	2 368 044	11.7	4	14.4
28-38	Chemicals	87 724	6.1	5	1 012 720	5.0	7	13.7
39-40	Plastic OR Rubber	35 016	2.4	11	951 452	4.7	8	19.0
41-43	Hides and Skins	13 088	0.9	14	604 354	3.0	10	22.3
44-49	Wood	49 400	3.4	9	757 606	3.7	9	15.5
50-63	Textiles and Clothing	501 330	34.8	1	5 277 866	26.0	1	13.2
64-67	Footwear	9 497	0.7	15	197 864	1.0	13	17.3
68-71	Stone and Glass	51 794	3.6	8	508 551	2.5	12	12.8
72-83	Metals	55 963	3.9	7	1 559 425	7.7	5	19.1
84-85	Machinery and Electronics	159 343	11.1	3	2 419 485	11.9	3	15.4
86-89	Transportation	75 582	5.3	6	2 423 967	12.0	2	20.0
90-99	Miscellaneous	45 146	3.1	10	582 482	2.9	11	14.4

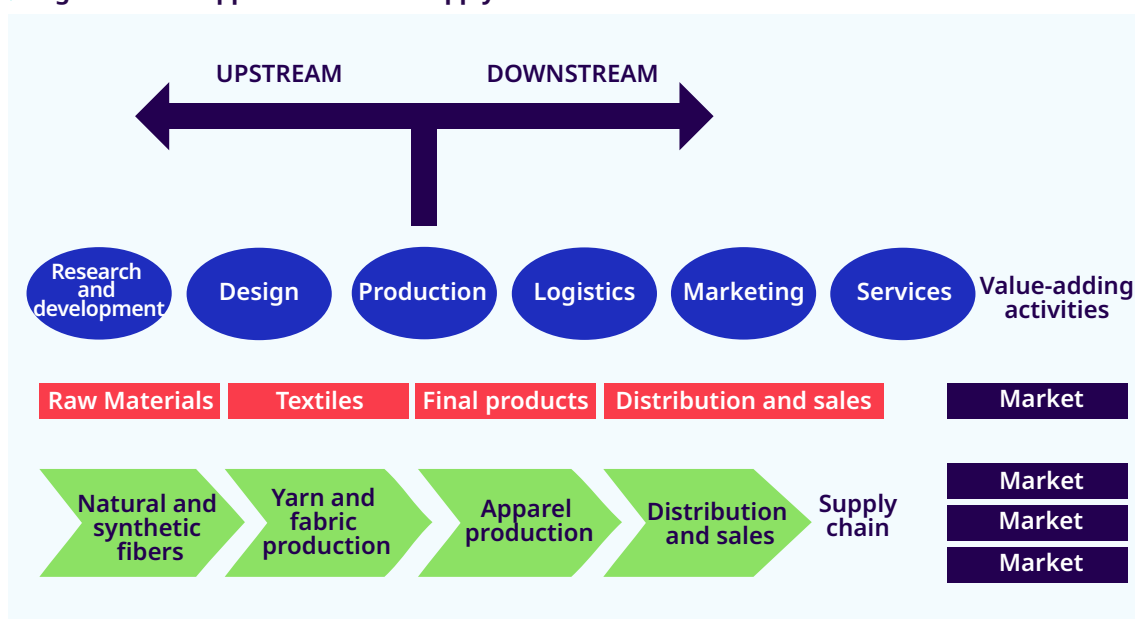
HS = Harmonized System 1988/92 version.

Source: World Bank World Integrated Trade Solution. Based on UN Comtrade data.

2.2 Global value chain participation and potential for deepening economic linkages

This section sheds more light on Cambodia's participation in the agribusiness, apparel, and tourism GVCs. At the outset, it is important to distinguish between supply and value chains. The supply chain focuses on the physical transformation and transportation of raw materials (or inputs) to the final products. A value chain, by contrast, embraces the full range of value adding activities in a supply chain, including research and development, design, input sourcing, processing, marketing, distribution, and customer support. Value added can be defined as the amount by which the value of a good/service is increased at each stage of its supply chain, exclusive of outside purchases. Figure 11 illustrates this difference for the apparel supply and value chain. GVCs have two more features: first, value addition happens across different geographical locations and, second, GVCs are governed by a lead firm that is typically the final producer or buyer but can also include first-tier suppliers.

► Figure 11. The apparel value and supply chain



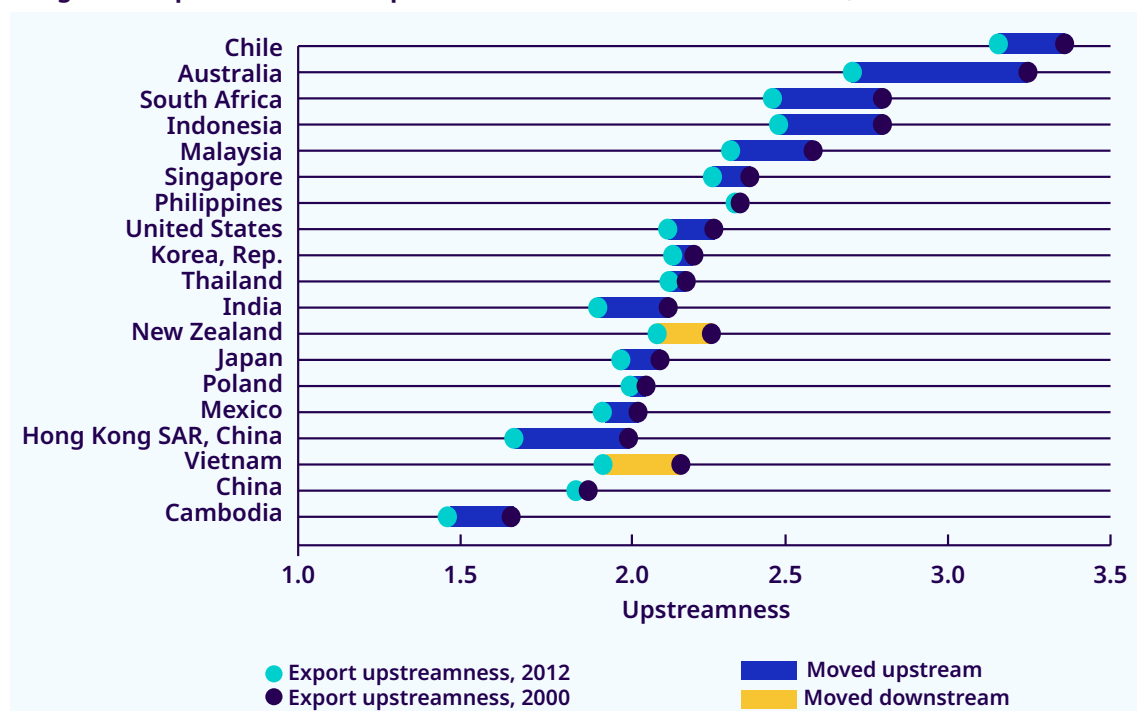
Source: World Bank Group (2015). Modified from Frederick and Staritz (2014) and Frederick (2010).

Distance from final demand

Cambodia's basket of export goods is very close to the final consumer market, which is largely driven by its strong specialization in final apparel exports. This shows potential for sourcing inputs locally. The concept of "upstreamness" measures the position of a country in the value or supply chain in terms of its distance to the final consumer. From the perspective of apparel production in the supply chain, yarn and fabric production, and natural and synthetic fibers, are upstream inputs, while distribution and sales are downstream inputs (Figure 11). Natural-resource intensive exporters, for example, tend to specialize in relatively upstream industries, near the start of the production process and far from final demand, while final goods exporters specialize in downstream industries, closer to where the final consumer is.⁷ Cambodia's basket of exports is very downstream, or close to final market demand, and this is related to its strong focus on apparel production (Figure 12). This points to Cambodia's large potential for sourcing locally (by creating backward linkages) when compared to more natural-resource intensive exporters such as Indonesia or Malaysia. Cambodia's exports moved more upstream over the period 2000-12, possibly due to its diversification into export sectors that require more processing and are further away from the final consumer of these goods (vegetables machinery and electronics transportation, see Table 4).

⁷ Chor (2014) calculates a measure of the production line position, or upstreamness, for 426 industries (279 of which are in manufacturing) using 2002 data from U.S. input-output (I-O) tables. The average position of a country's exports from final demand can then be calculated as the average upstreamness measure for each industry, weighted by the importance of that industry in the country's export basket (Taglioni and Winkler 2016).

► Figure 12. Upstreamness of exports Cambodia versus other countries, 2000 and 2012



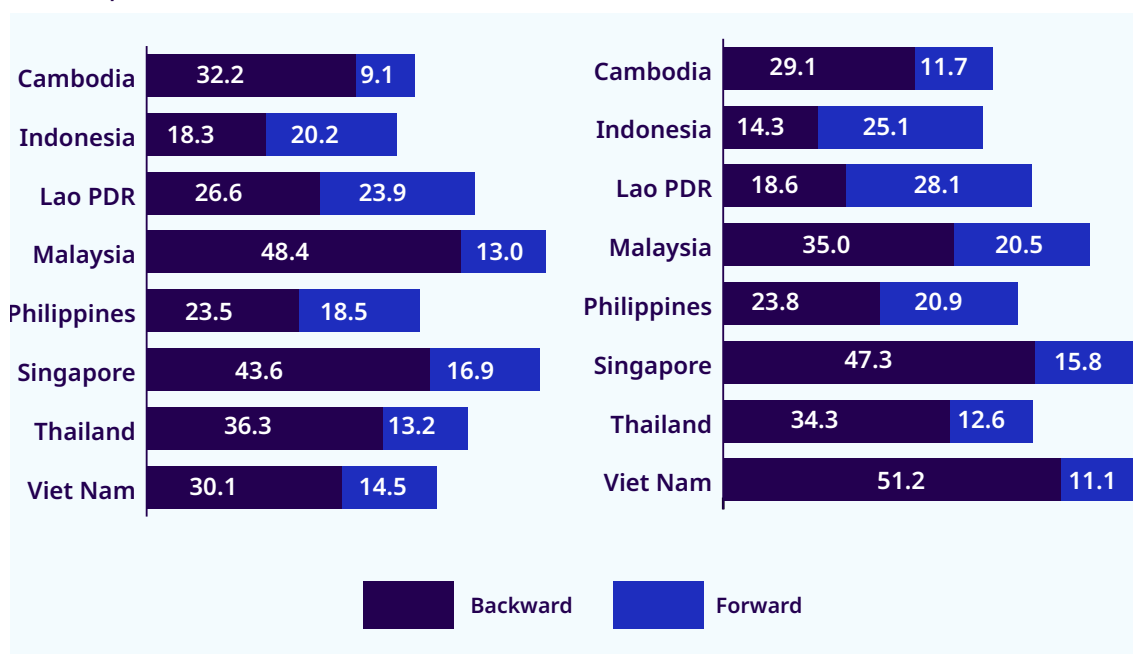
Source: Taglioni and Winker (2016 p. 97). Adapted from Chor (2014) and United Nations Comtrade.

Integration in GVCs

Cambodia's strong reliance on exports of goods and services for final consumption is reflected in its low rate of forward GVC integration. Forward GVC integration is the portion of a country's domestic value added into total exports that are exported to partner countries and used in their re-exports. A higher forward GVC integration rate means that a country is exporting more intermediate goods and services (for re-exports abroad). A lower rate implies that a country's exports consist largely of final consumption goods and services or that intermediates are directly consumed in the partner country. Only 11.7 per cent of Cambodia's exports were embodied in third-country exports in 2018 (Figure 13). This low forward integration into GVCs is linked to the large portion of Cambodia's exports that consists of goods and services for final consumption, such as apparel and footwear, or tourism. This rate's increase from 9.1 per cent in 2000 reflects the country's diversification into sectors characterized by intermediate exports for re-exports, such as vegetables, hides and skins, or inputs of machinery, electronics, and transportation equipment.

In contrast, Cambodia shows high backward integration into GVCs. A country's backward integration into GVCs is measured as the foreign value-added portion embodied in its gross exports as a percentage of total gross exports. Countries whose exports depend strongly on imported inputs that are processed for exporting goods, components or services show a large backward integration. In 2018, Cambodia's backward integration into GVCs was 29.1 per cent. This classifies it as a buyer of foreign value added in GVCs alongside Vietnam, Singapore, Malaysia and Thailand which are countries whose exports consist of an even larger share of foreign value added. Interestingly, the extent of Cambodia's backward integration into GVCs was similarly high in 2000, while that of Vietnam showed a robust increase (and to a lesser extent also that of Singapore although from a much higher level). All other ASEAN countries saw a reduction in the shares of foreign value added in their exports (Figure 13).

► **Figure 13. Backward and forward GVC integration, Cambodia versus other ASEAN member states, 2000 and 2018**



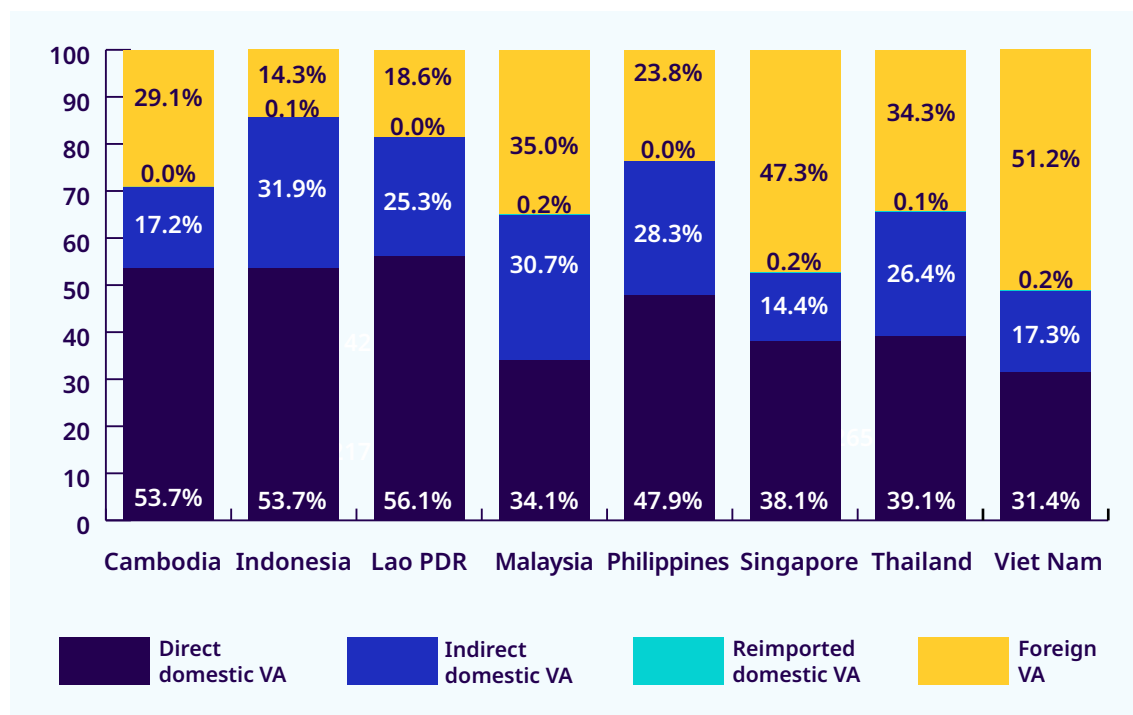
Backward = foreign value added embodied in gross exports (% of gross exports). Forward = domestic value added embodied in third country exports (% of gross exports).

Source: OECD TiVA, 2021 version.

Composition of gross exports

Cambodia's gross exports show low local-sourcing intensity, as implied by a high foreign value-added share in combination with a low domestic value-added share of upstream sectors. A country's gross exports consist of a domestic and a foreign value-added component. Domestic value added can be further broken down into the direct contribution of a sector (e.g. domestic value added created in the automotive sector), the indirect contribution of upstream sectors that supply inputs to that sector (e.g. the domestic value added contained in inputs like steel or rubber, but also research and other business services) and re-imported domestic value added (i.e. domestic value added that has been exported and returns to the country in the form of a processed input or component) (Taglioni and Winkler 2016). Cambodia's domestic value-added contribution of upstream sectors to gross exports stood at only 17.2 per cent in 2018, representing the lowest share among ASEAN countries except for Singapore and Vietnam, most of whose domestic value-added contributions of upstream sectors exceeded 25 per cent their gross exports (Figure 14).

► **Figure 14. Gross exports by value-added components, Cambodia versus other ASEAN member states, 2018**



VA = value added.

Source: OECD TiVA, 2021 version.

Participation in the apparel GVC

Cambodia specializes in the apparel production segment of the supply chain, while sourcing fabrics and other goods and services inputs from abroad. This shows much potential for an increase in its local sourcing of textiles. A look at Cambodia's top ten export products in 2019, representing over a quarter of its goods export basket, shows that it specializes in apparel products for final consumption abroad (Table 6). In fact, only three out of the country's top ten export goods are non-apparel products (gold and handbags). The composition of the top ten products imported into Cambodia in 2019 confirms that the country imports many upstream fabrics used in apparel production (Table 7). This high dependence on imported fabrics is also related to high electricity costs in the country, which prevents Cambodia from growing its own textile sector (Cambodia Industrial Development Policy 2015).

► **Table 6. Top 10 goods exports, Cambodia, 2019**

HS6	Product description	US\$ thousands	%
711291	Waste and scrap of precious metals; of gold, including metal clad with gold but excluding sweepings containing other precious metals	2 425 376	6.8
611020	Jerseys, pullovers, cardigans, waistcoats and similar articles; of cotton, knitted or crocheted	1 121 595	3.1
710812	Metals; gold, non-monetary, unwrought (but not powder)	1 087 393	3.0
611030	Jerseys, pullovers, cardigans, waistcoats and similar articles; of man-made fibres, knitted or crocheted	1 070 398	3.0
620462	Trousers, bib and brace overalls, breeches and shorts; women's or girls', of cotton (not knitted or crocheted)	870 594	2.4
640419	Footwear; (other than sportswear), with outer soles of rubber or plastics and uppers of textile materials	634 199	1.8
610463	Trousers, bib and brace overalls, breeches and shorts; women's or girls', of synthetic fibres, knitted or crocheted	616 686	1.7
610910	T-shirts, singlets and other vests; of cotton, knitted or crocheted	595 631	1.7
610990	T-shirts, singlets and other vests; of textile materials (other than cotton), knitted or crocheted	589 025	1.6
420292	Cases and containers; n.e.c. in heading 4202, with outer surface of sheeting of plastics or of textile materials	583 083	1.6
Top 10 exports		9 593 979	26.9

HS = Harmonized System, 2012.

Source: World Bank World Integrated Trade Solution. Based on UN Comtrade data.

► **Table 7. Top 10 goods imports Cambodia 2019**

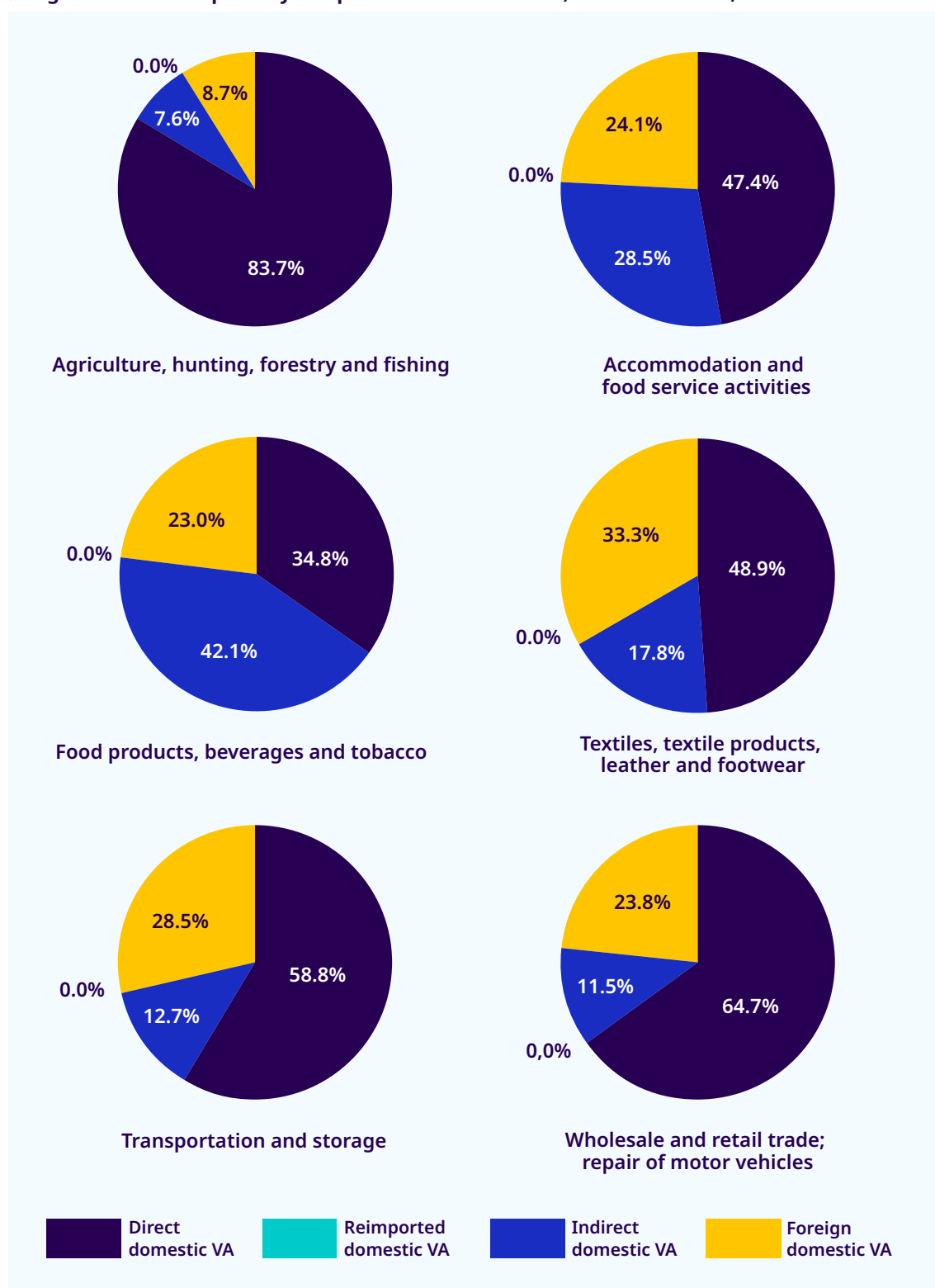
HS6	Product description	2019	%
600490	Fabrics; knitted or crocheted, other than those of heading 60.01, of a width exceeding 30 cm, containing by weight 5% or more of elastomeric yarn or rubber thread,	1 305 036	4.9
600690	Fabrics; knitted or crocheted fabrics, other than those of headings 60.01 to 60.04, and other than those made of wool, fine animal hair, cotton, synthetic or artificial fibres	1 144 702	4.3
271019	Petroleum oils and oils from bituminous minerals, not containing biodiesel, not crude, not waste oils; preparations n.e.c, containing by weight 70% or more of petroleum oils or oils from bituminous minerals; not light oils and preparations	1 111 712	4.2
271012	Petroleum oils and oils from bituminous minerals, not containing biodiesel, not crude, not waste oils; preparations n.e.c, containing by weight 70% or more of petroleum oils or oils from bituminous minerals; light oils and preparations	611 299	2.3
551599	Fabrics, woven; of synthetic staple fibres n.e.c. in chapter 55, mixed mainly or solely with fibres n.e.c. in heading no. 5515	516 889	1.9
270119	Coal; (other than anthracite and bituminous), whether or not pulverised but not agglomerated	403 915	1.5
870421	Vehicles; compression-ignition internal combustion piston engine (diesel or semi-diesel), for transport of goods, (of a GVW not exceeding 5 tonnes), n.e.c. in item no 8704.1	341 021	1.3
871120	Motorcycles (including mopeds) and cycles; fitted with an auxiliary motor, reciprocating internal combustion piston engine, of cylinder capacity exceeding 50cc but not exceeding 250cc, with or without side-cars; side-cars	269 230	1.0
520929	Fabrics, woven; containing 85% or more by weight of cotton, bleached, of weaves n.e.c. in item no. 5209.2, weighing more than 200g/m ²	268 643	1.0
870324	Vehicles; with only spark-ignition internal combustion reciprocating piston engine, cylinder capacity over 3000cc	261 792	1.0
Top 10 imports		6 234 237	23.5

HS = Harmonized System, 2012.

Source: World Bank World Integrated Trade Solution. Based on UN Comtrade data.

The low domestic contribution of upstream sectors to Cambodian exports seems to be driven by the textiles, leather and footwear sector. Figure 15 shows the composition of gross exports for agri-business (agriculture and food products), textiles and footwear and tourism-related sectors (trade, hotels and restaurants, transport and storage). Cambodia's indirect domestic value-added share in textiles, leather and footwear exports reached only 17.8 per cent in 2018, compared to 20 to 35 per cent in other ASEAN countries except for Vietnam. In other words, for every dollar of textiles, leather and footwear products Cambodia exported, 49 cents consisted of domestic value added created within the sector, but only 18 cents consisted of domestic value added created in upstream sectors such as design, chemicals or agriculture (cotton).

► Figure 15. Gross exports by components of value added, selected sectors, Cambodia 2018

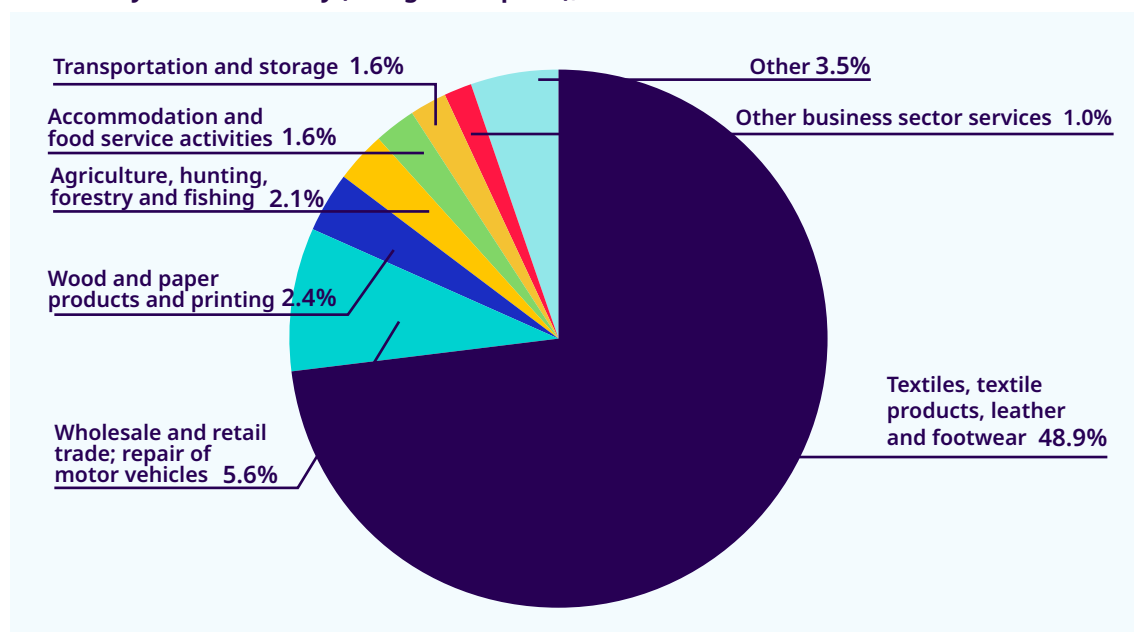


VA = value added.

Source: OECD TiVA, 2021 version.

A further breakdown of the composition of the export value added of Cambodian textiles and footwear, by source industry, reveals that the domestic value-added portion is mainly created within the sector. Figure 16 gives further insights into the share of domestic value added in Cambodian exports of textiles leather and footwear (66.7 per cent of sector's export value) by source industry. Almost 49 per cent of the sector's export value is generated domestically within the textiles leather and footwear sector. But there is likewise evidence of some indirect domestic value added from the trade sector (5.6 per cent of export value) and natural resources-intensive sectors agriculture and wood and paper (over 2 per cent of sector's export value). Other services inputs, including accommodation and food services, transportation and storage, and other business sector services, combined represent over 4 per cent of the textiles leather and footwear export value. This illustrates the huge potential that exists for increasing the share of domestic services in Cambodia's exports of textiles and footwear.

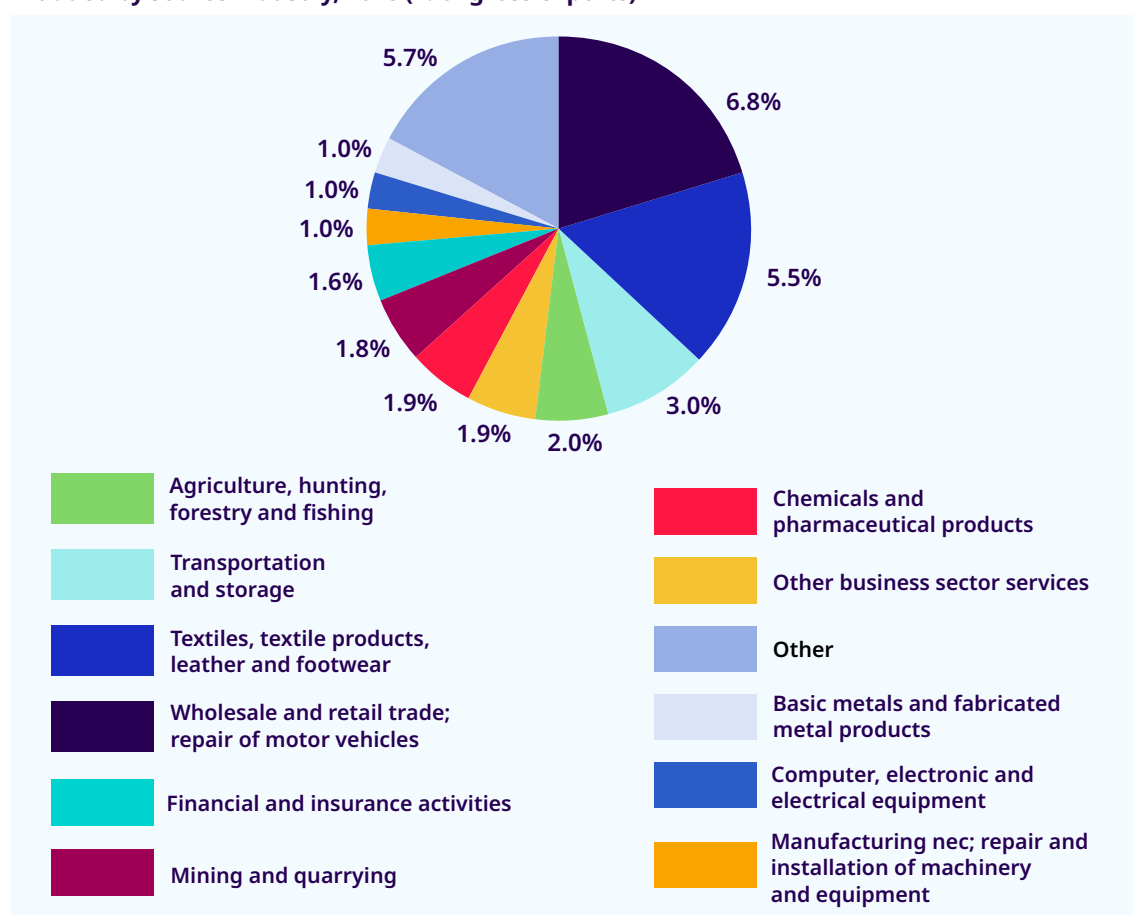
► **Figure 16. Composition of Cambodian textiles leather and footwear exports, domestic value added by source industry (% of gross exports), 2018**



Source: OECD TiVA, 2021 version.

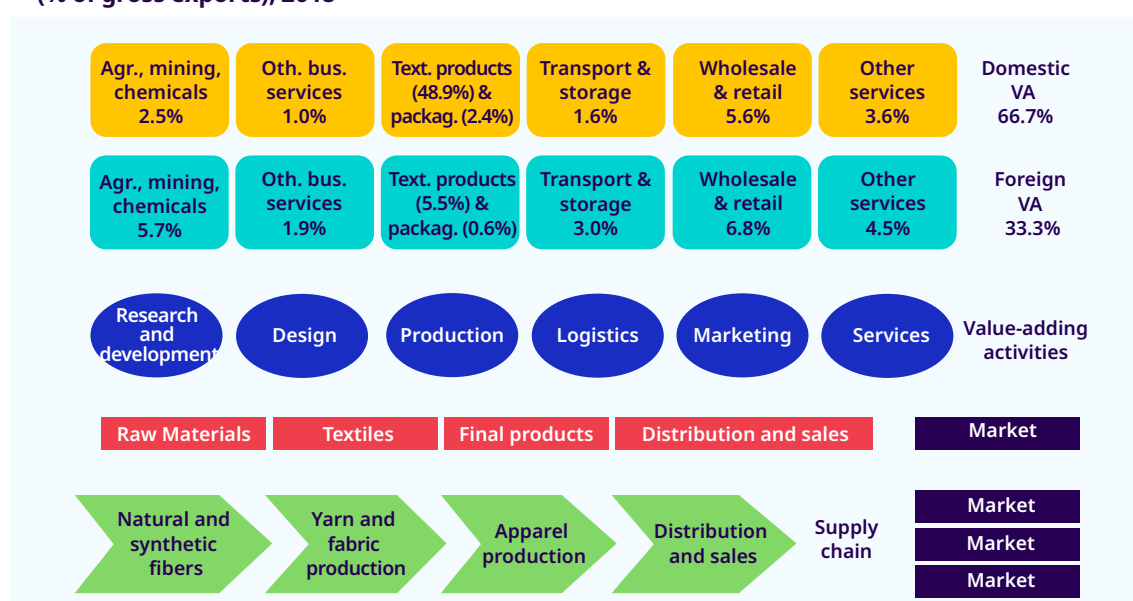
At the same time most of the foreign value added portion in Cambodia's textile, leather and footwear exports is generated in the wholesale and retail trade, followed by textiles and transport and storage. Figure 17 shows the composition of the foreign value-added share in Cambodia's exports of textiles and footwear (33.3 per cent of sector's export value) by source industry. Surprisingly, the foreign value-added share of textiles, leather and footwear (fabrics) is only 5.5 per cent, while the largest share of foreign value added is created in wholesale and retail trade (6.8 per cent of sector's export value). The Cambodian textiles and footwear sector also relies on other foreign business services, including transport and storage, financial intermediation, and other business sector services. In sum, foreign services make up more than 16 per cent of Cambodia's textiles and footwear export value added. The graph also illustrates the sector's reliance on foreign natural-resource intensive inputs, including agriculture, mining and chemicals, which each make up nearly 2 per cent of the sector's export value. Figure 18 combines the data found in Figures 17 and 18 using the the apparel value and supply chain illustration in Figure 11.

► Figure 17. Composition of Cambodian textiles leather and footwear exports, foreign value added by source industry, 2018 (% of gross exports)



Source: OECD TIVA, 2021 version.

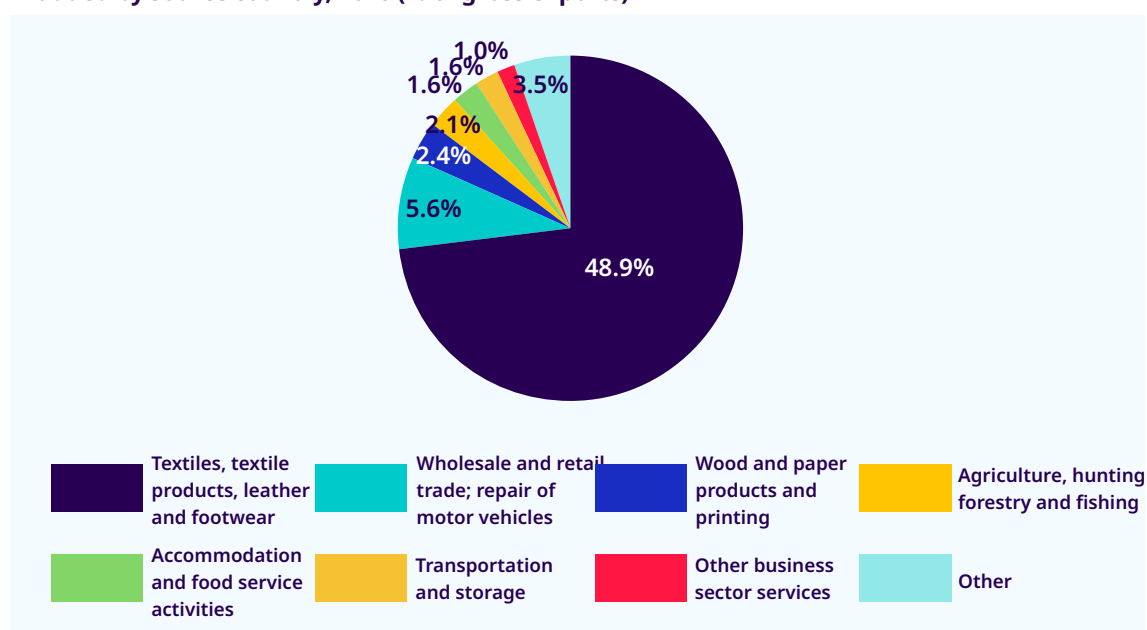
► Figure 18. Decomposition of Cambodian textile products and footwear by source industry (% of gross exports), 2018



Source: Own illustration drawing on Stacey and Staritz (2014) and OECD TIVA 2021 release.
This illustration summarizes the data presented in Figures 16 and 17.

Going by source country, China, Chinese Taipei and Hong Kong China capture almost one fifth of the value added of Cambodia's textile and footwear sector. Figure 19 focuses on the source countries of the value added in exports of Cambodian textiles leather and footwear. An analysis of the data reveals that while Cambodia itself accounts for the majority of the export value added (two thirds), China (15.5 per cent), Hong Kong (2.7 per cent) and Chinese Taipei (1.3 per cent) capture almost one fifth of the value added in the country's apparel exports. With the exception of the United States, the largest source countries are mainly Asian, including Thailand, Vietnam and Japan. The category "Other" covers countries with individual value added shares of less than 1 per cent.

► **Figure 19. Composition of Cambodian textiles apparel leather and footwear exports, value added by source country, 2018 (% of gross exports)**

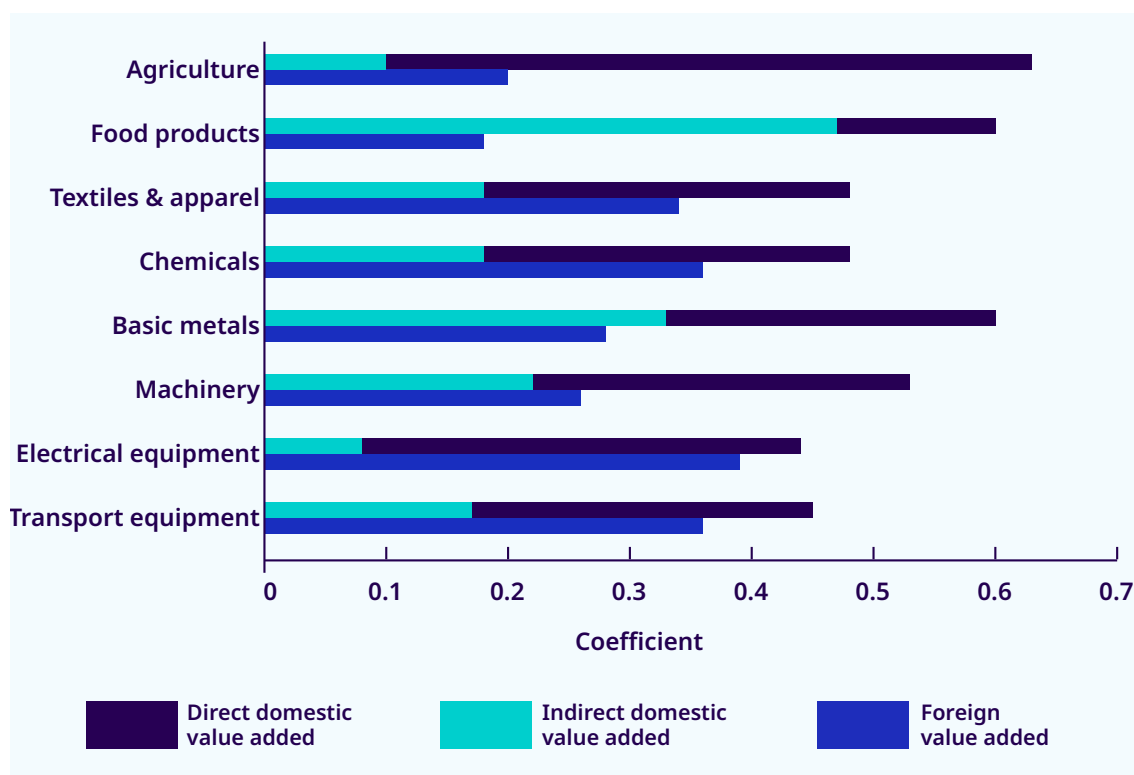


Source: OECD TIVA, 2021 version

Participation in the agribusiness GVC

The export of agricultural and food products offers larger opportunities for the growth of domestic value added, when compared to other manufacturing sectors. Regression analysis across a sample of 57 countries for the years 1995, 2000, 2005, 2008 and 2009 suggests that a direct value-added growth of 1 per cent in agriculture is associated with 0.53 per cent growth in exports. In food manufacturing, by contrast, an indirect domestic value-added growth in upstream sectors of 1 per cent is associated with export growth of 0.47 per cent. Agriculture emerges as the highest within-sector contribution to sectoral export growth, while food manufacturing shows the highest contribution of upstream sectors. In other manufacturing sectors, foreign value added contributes more to sectoral export growth, including in electrical and transport equipment, chemicals and textiles and apparel (Taglioni and Winkler 2016, and Figure 20).

► Figure 20. Value-added contribution to gross export growth by sector 57 countries



Note: Regression coefficients based on Trade in Value Added data from OECD-WTO (May 2013 version), which covers 57 OECD and non-OECD countries and the years 1995, 2000, 2005, 2008 and 2009.

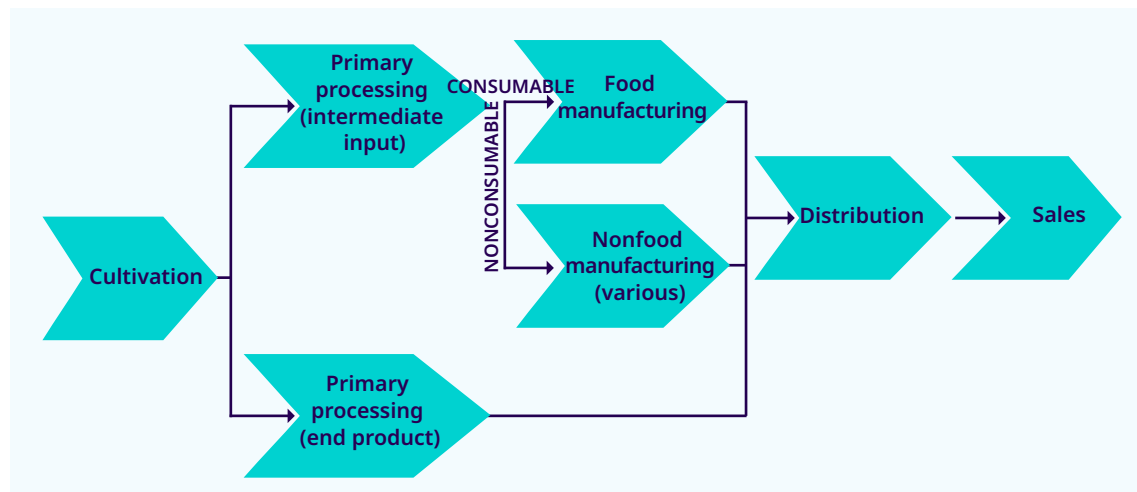
Source: Taglioni and Winkler (2016, p. 40).

Cambodia's food sector, as well as its hotels and restaurants, depends significantly on domestic upstream sectors. This shows potential for strengthening the linkages between agriculture, food processing, and the hospitality industry in the country. The domestic value added of upstream sectors accounts for 51 per cent of gross exports in Cambodia's food industry compared to 55 per cent in Vietnam. This reflects the large contribution of agriculture to food processing. Cambodian exports of agriculture, by contrast, virtually consist only of domestic value added that is generated within the sector (98 per cent), while upstream sectors – both foreign and domestic – contribute only 1 per cent each. Similarly, the domestic value added of upstream sectors represents 43 per cent of gross exports in Cambodia's hotel and restaurants sector, compared to only 32 per cent in Vietnam (Figure 15). Strengthening domestic sectors that make use of domestic agricultural inputs, such as food processing and possibly hotels and restaurants, seems to be a channel for increasing local sourcing.

However, Cambodia's participation in the agricultural value chain is characterized by the cultivation of primary agricultural products and a limited degree of domestic processing. The different stages of the agricultural value chain include cultivation, primary processing, secondary processing for food and non-food manufacturing, distribution and sales (Figure 21). Smallholders are mainly involved in the cultivation stage, which comprises tasks such as input supply, cultivation, harvesting and transportation. Commercial farms and farmer cooperatives, for their part, can be involved in both cultivation and primary processing, while multinationals are more involved in the non-cultivation stages (Kaiser Associates Economic Development Partners 2014a). Cambodia's top agribusiness export product is rice, which accounted for 1.2 per cent of the country's export of goods in 2019 (Table 8). Rice production

requires only one stage of low-technology processing (Table 9). However, Cambodia's top ten exports also include some vegetables (vegetable roots, nuts, fruit, oils and starch) and processed products (like dog or cat food, sugar and cigarettes) (Table 8). Such processed products typically require two stages of processing and are characterized by more complex product transformation (Table 9), but their role in total goods exports remains very small.

► **Figure 21. Agricultural value chains**



Source: Kaiser Associates Economic Development Partners (2014a, p. 165) in Farole and Winkler (2014).

► **Table 8. Top ten agribusiness exports, Cambodia 2019**

HS6	Product description	US\$ thousands	%
100630	Cereals; rice, semi-milled or wholly milled, whether or not polished or glazed	417 013	1.2
71410	Vegetable roots and tubers; manioc (cassava), with high starch or inulin content, fresh, chilled, frozen or dried, whether or not sliced or in the form of pellets	363 572	1.0
80131	Nuts, edible; cashew nuts, fresh or dried, in shell	309 306	0.9
80390	Fruit, edible; bananas, other than plantains, fresh or dried	51 478	0.1
10611	Mammals; live, primates	33 920	0.1
151110	Vegetable oils; palm oil and its fractions, crude, not chemically modified	30 115	0.1
230910	Dog or cat food; put up for retail sale, used in animal feeding	23 679	0.1
110814	Starch; manioc (cassava)	22 601	0.1
170114	Sugars; cane sugar, raw, in solid form, other than as specified in Subheading Note 2 to this chapter, not containing added flavouring or colouring matter	18 200	0.1
240220	Cigarettes; containing tobacco	17 725	0.0
Top 10 products		1 287 609	3.6

Source: World Bank WITS. Based on UN Comtrade data. HS = Harmonized System, 2012.

► **Table 9. Types of agribusiness value chains**

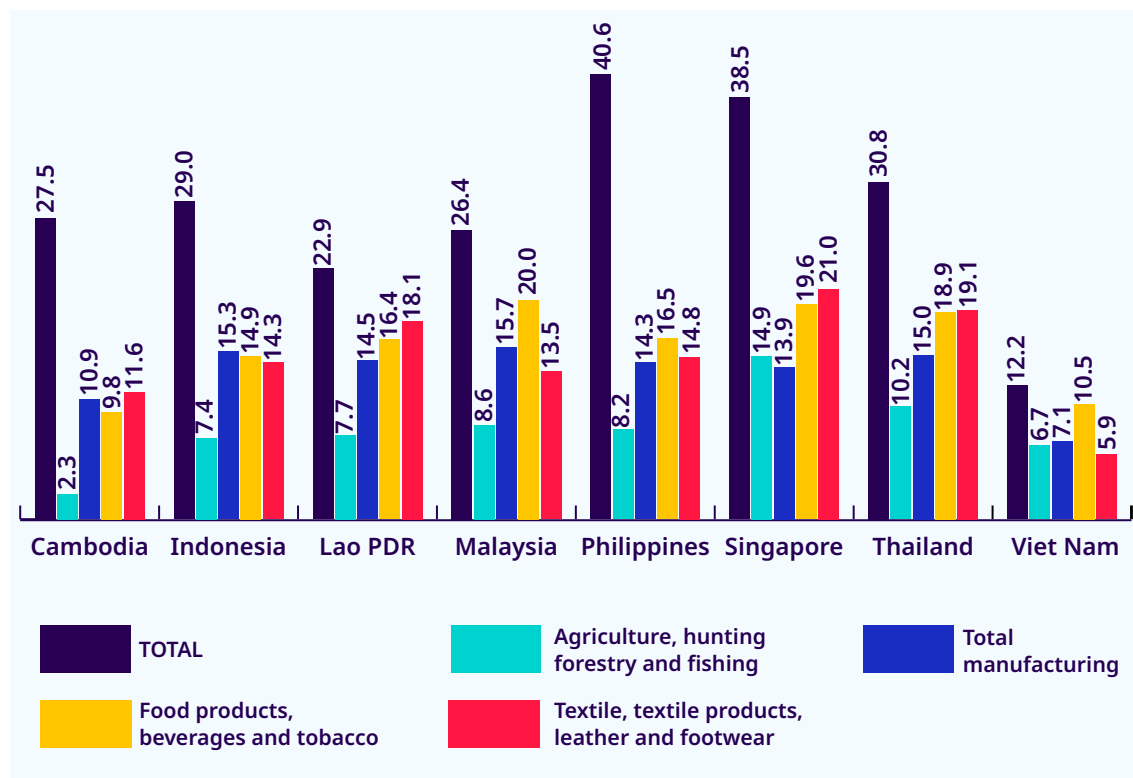
Type of value chain	Examples	Characteristics
Primary agricultural products (consumable)	► Fresh fruit and vegetables ► Staple food products (maize, rice) ► Meat ► Nuts ► Tea	► One stage of “processing” – typically low technology processing (for example, packaging, cutting) ► Limited product transformation before end-consumer
Processed agricultural products (consumable)	► Confectionary ► Biscuits ► Beverages ► Dairy products ► Coffee ► Chocolate	► Two stages of processing – although can be vertically integrated ► Substantial and complex product transformation ► Branded/differentiated products
Processed agricultural products (nonconsumable)	► Textiles (cotton, leather) ► Animal feed (maize) ► Biofuels (feedstock) ► Pharmaceuticals (palm oil, extracts) ► Industrial use (rubber, various byproducts)	► Two stages of processing – although can be vertically integrated ► Substantial product transformation ► Often linked to waste products from consumable agricultural products (for example biofuels, animal feed) ► End-use in nonconsumable/nonfood products

Source: Kaiser Associates Economic Development Partners (2014a, p. 164) in Farole and Winkler (2014).

Domestic services in exports

Despite improvements in recent years, Cambodia trails behind fellow ASEAN member states in offering domestic services for the apparel and agribusiness GVCs. The country’s specialization in lower-skilled, low-value added segments of the apparel and agribusiness GVCs has potential for creating backward linkages by sourcing local inputs such as textiles and agricultural inputs, and forward linkages by strengthening and adding downstream tasks such as food processing and packaging (Cambodia Industrial Development Policy 2015). Cambodia should also use opportunities to develop domestic services for the apparel and agribusiness GVCs, which can be applied as well to a wider range of GVCs, such as transportation, logistics, catering, information technology, construction, cleaning, security, human resources and training. Cambodia’s value-added share in domestic services used for its agricultural exports is only 2.3 per cent compared to the share in other ASEAN countries ranging from 6.7 per cent to 14.9 per cent. Similarly, this share stands at only 9.8 per cent in food products but is 50 to 100 per cent higher in most other ASEAN member states except for Vietnam. Cambodia is also lagging in textiles, apparel, leather and footwear, where the value-added share of Cambodia’s services is 11.6 per cent in exports compared to a range of 13.5 per cent to 21 per cent in other ASEAN countries with the exception of Vietnam (Figure 22).

► Figure 22. Domestic services value added in exports (%), by export category, Cambodia versus other ASEAN member states, 2018

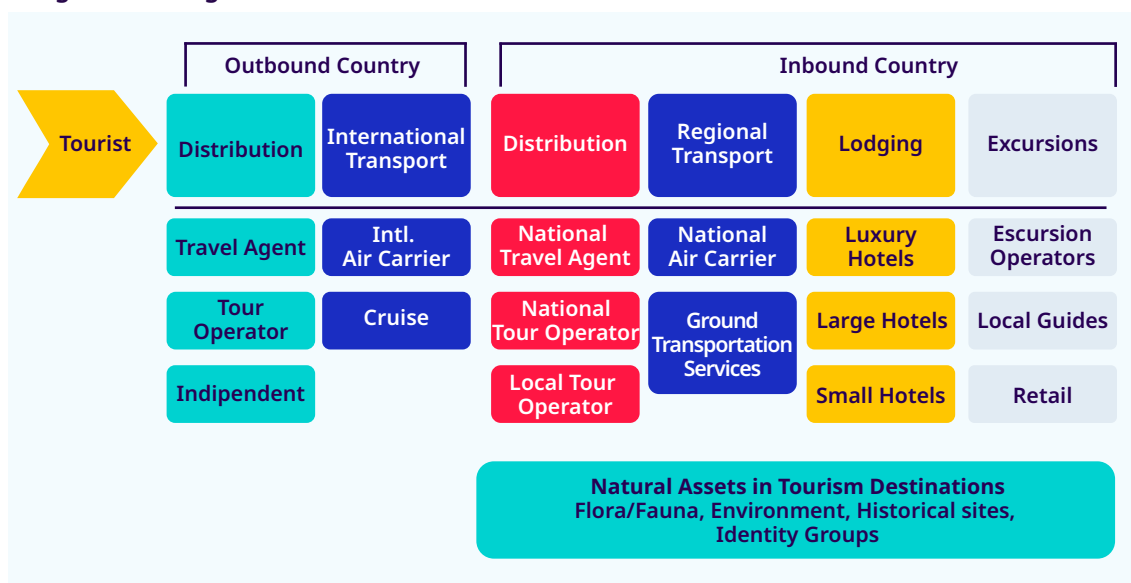


Source: OECD TiVA, 2021 version.

Participation in the tourism GVC

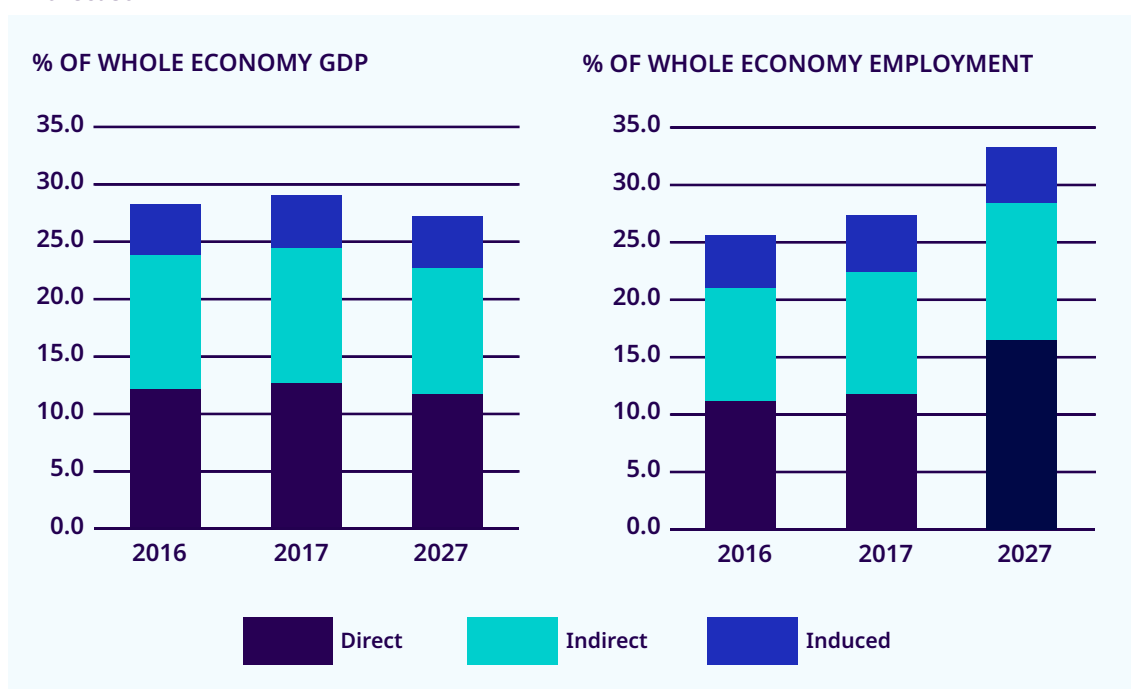
Services related to tourism show a large share of direct domestic value-added contribution, in particular in trade and transportation, as well as a significant indirect and induced contribution to GDP and employment. Tourism-related services in inbound countries range from distribution to regional transportation, lodging and excursions (Figure 23). The direct contribution of domestic value added in exports of wholesale and retail trade, as well as transport and storage, is 60 per cent and 53 per cent, respectively (Figure 15). Travel and tourism do not only contribute directly to GDP and employment, but indirectly through investment or government spending (Appendix I). In addition, the amount of money spent by employees working in travel and tourism-related industries adds to GDP and employment (induced contribution). Travel and tourism accounted for around 28 per cent of Cambodia's GDP and 26 per cent of employment in 2016. Employment in travel and tourism is expected to continue growing in the near future.

► Figure 23. The global value chain in tourism



Source: Christian (2010), taken from Christian, Fernandez-Stark, Ahmed and Gereffi (2011).

► Figure 24. Contribution of travel and tourism to GDP and employment, Cambodia, 2016 and forecast



Note: See Appendix I for definitions.

Source: World Travel and Tourism Council (2017, pp. 3-4).

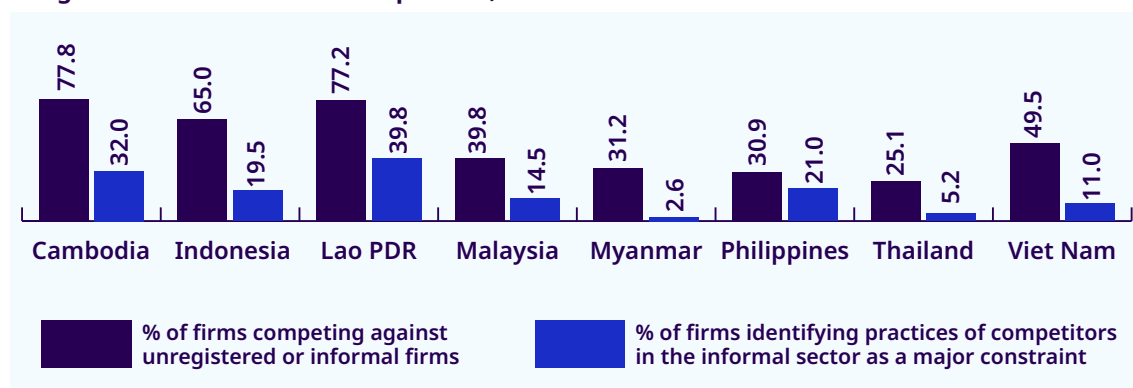
2.3 Key policy challenges

Informality and the business climate

This section discusses some key policy challenges in Cambodia that affect the potential for FDI linkages and spillovers, including practices in the informal economy that do not only cause problems for workers but constitute major constraints for formal businesses. Firms operating in the formal economy have to comply with the rules and regulations in a country, while informal firms can engage in practices that may give them an unfair advantage over formal ones.⁸ Informality can have a negative impact on the transmission channel through which FDI increases the productivity of firms and their workers (Figure 3). While foreign investment increases competition for scarce resources and is expected to raise aggregate productivity in the medium term, a high proportion of firms engaging in informal practices could crowd out formal firms that tend to be more productive than informal firms – and offset this positive competition effect.

Formal enterprises in Cambodia found competition from the informal sector to be the top business obstacle, and the same challenge has been encountered by other ASEAN countries (World Bank Group 2016). According to the World Bank Enterprise Surveys, 77.8 per cent of all surveyed firms in Cambodia are competing against the practices of the informal sector. This percentage is on par with Lao People's Democratic Republic, but is much higher than in most other ASEAN countries, in particular, Thailand, Philippines, Myanmar and Malaysia. As a result, almost a third (32 per cent) of firms in Cambodia consider a major constraint the practices of competitors in the informal sector. This percentage is the second highest in the region after Lao People's Democratic Republic's 39.8 per cent (Figure 25).

► Figure 25. Informal sector competition, Cambodia versus other ASEAN member states



Note: Foreign firms have a foreign ownership share of at least 10 per cent.

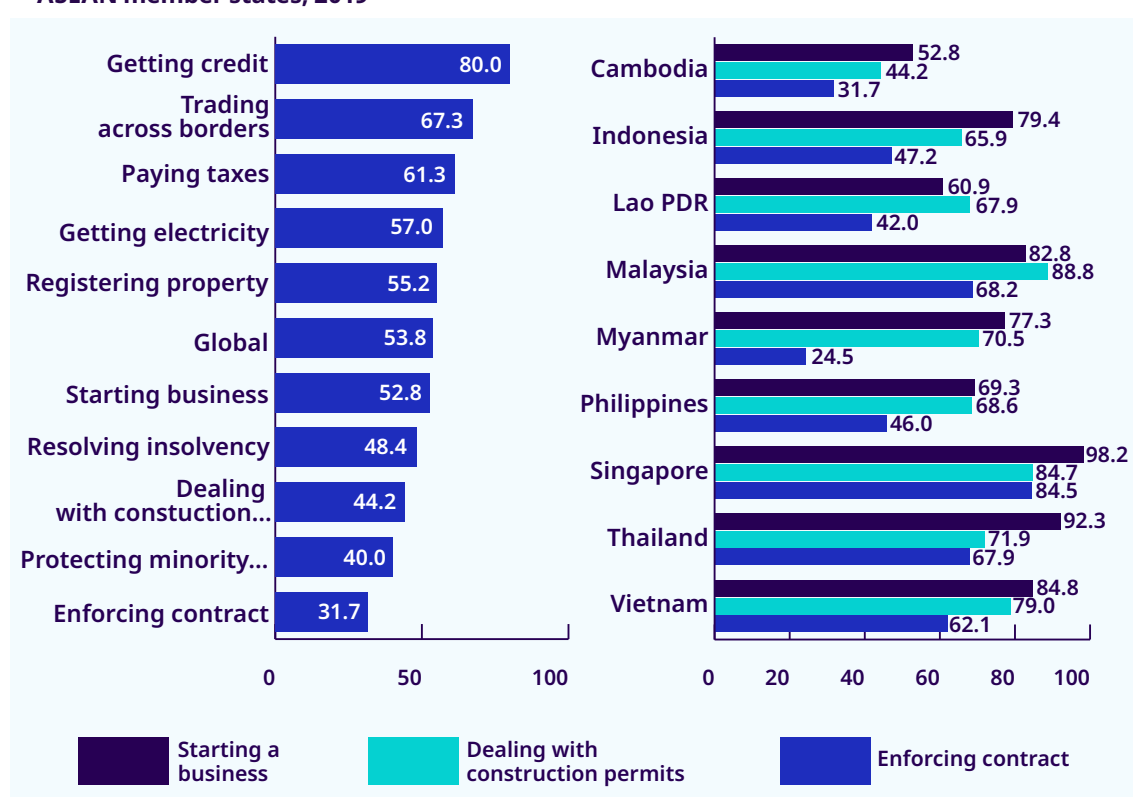
Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines and Vietnam; and 2014 data for Myanmar.

There are serious policy constraints in Cambodia when it comes to the registration processes for formal firms, in particular, those related to starting a business. In the World Bank's 2019 Doing

⁸ Firms in the informal sector can engage in anti-competitive practices (e.g. price collusion, product adulteration). A large informal economy thus can crowd out formal firms in certain sectors (e.g. agribusiness) and result in a smaller number of formal firms with larger market power-reducing competition (Yadav and Mitra 2009).

Business indicators, Cambodia performs poorly relative to the leading country for a certain indicator (distance to frontier score) in contract enforcement, protecting minority investors, dealing with construction permits, resolving insolvency and starting a business. However, the country does well in the areas of getting credit, trading across borders or paying taxes (Figure 26, left panel). In the particular indicator that measures the ease of starting a business, Cambodia is behind other ASEAN countries (Figure 26, right panel and Appendix II). The process for starting a formal business in the country requires nine procedures, takes 99 days, and costs 47.4 per cent of income per capita. This is a serious constraint especially for unregistered MSMEs.

► **Figure 26. Doing Business indicators (distance to frontier score), Cambodia versus other ASEAN member states, 2019**



Note: See Appendix IV for all indicators. An economy's distance to frontier score is indicated on a scale from 0 to 100, where 0 represents the worst performance and 100 the frontier.

Source: World Bank Doing Business Indicators.

Other challenges related to doing business in Cambodia include the degree of ease in contract enforcement and obtaining construction permits. Contract enforcement is related to informality. The lack of contract enforcement with informal firms can reduce a foreign investor's willingness to offer assistance if the informal enterprise starts side-selling products to other clients and thus negatively affects the FDI spillover potential (Figure 3). Compared to its ASEAN neighbours, Cambodia clearly underperforms in the area of contract enforcement; only Myanmar has a lower distance to frontier score. Contract enforcement in Cambodia takes 483 days and costs 103.4 per cent of the value of the claim. Similarly, Cambodia's system for processing construction permits, which requires 20 procedures and takes 652 days falls behind those of ASEAN countries (Figure 26, right panel, and Appendix II).

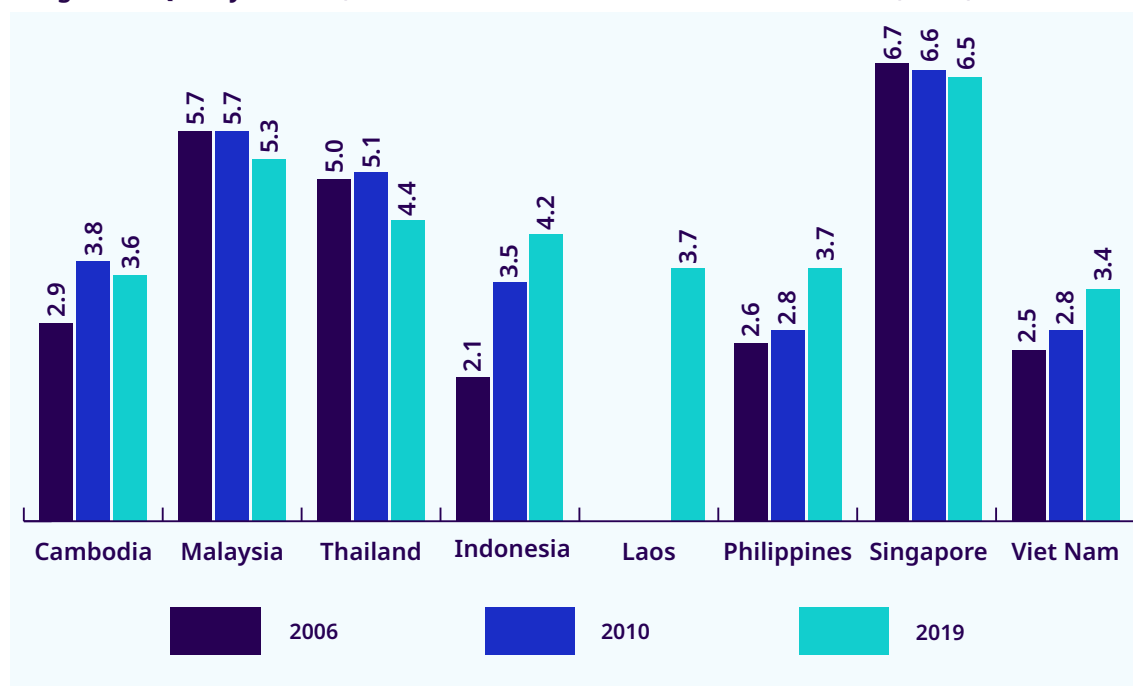
Infrastructure

The lower quality and density of infrastructure in Cambodia can have a negative effect on the creation of supply-chain linkages. This can affect the transmission channels through which FDI increases productivity, in particular the creation of supply-chain linkages (Figure 3). Linkage development in the context of GVCs needs to ensure not only connectivity at borders with other countries, but also to integrate domestic value chains (Taglioni and Winkler 2016). According to a study on the competitiveness and linkages of Cambodia's manufacturing sector, key challenges to these include the lack of proper infrastructure support, difficulties with energy supply and disruptions, as well as internet connections (UNDP 2014).

Cambodia's infrastructure requires improvements with regard to road quality, energy costs and internet connectivity. While the quality of the country's roads has improved since the mid-2000s, executives still gave Cambodia a lower rating than most of its neighbouring countries in ASEAN, especially Singapore, Malaysia and Thailand. Even Indonesia and the Philippines which were ranked lower in 2006 made more progress in road quality, with only Vietnam lagging behind in 2019 (Figure 27). Cambodia's electricity costs 18.2 US cents per kWh, which was the highest among other ASEAN countries in 2020 (Figure 28).⁹ This poses challenges for the country's efforts to build up its own textiles industry, which relies heavily on electricity. In the medium term, Cambodia also needs to continue to invest in its internet infrastructure. In 2016, there were only around 20 secure internet servers per one million people in Cambodia, but the country increased its internet density by 2020 relative to Lao PDR, Myanmar and even the Philippines. However, Vietnam, Thailand and Indonesia achieved faster expansion than Cambodia (Figure 29). This is important not only for building skills, but for expanding the low base for domestic services that is used to produce Cambodian exports (Figure 22).

9 Singapore's low energy costs for producers seem surprising and could be related to a combination of two factors: (i) introduction of competition through privatization and (ii) switching from oil-fired steam plants to most cost-efficient ways of generating electricity such as gas-fired combined cycle gas turbines. Singapore does not subsidize energy producers, as this creates disincentives to investing in more innovative cleaner technologies.

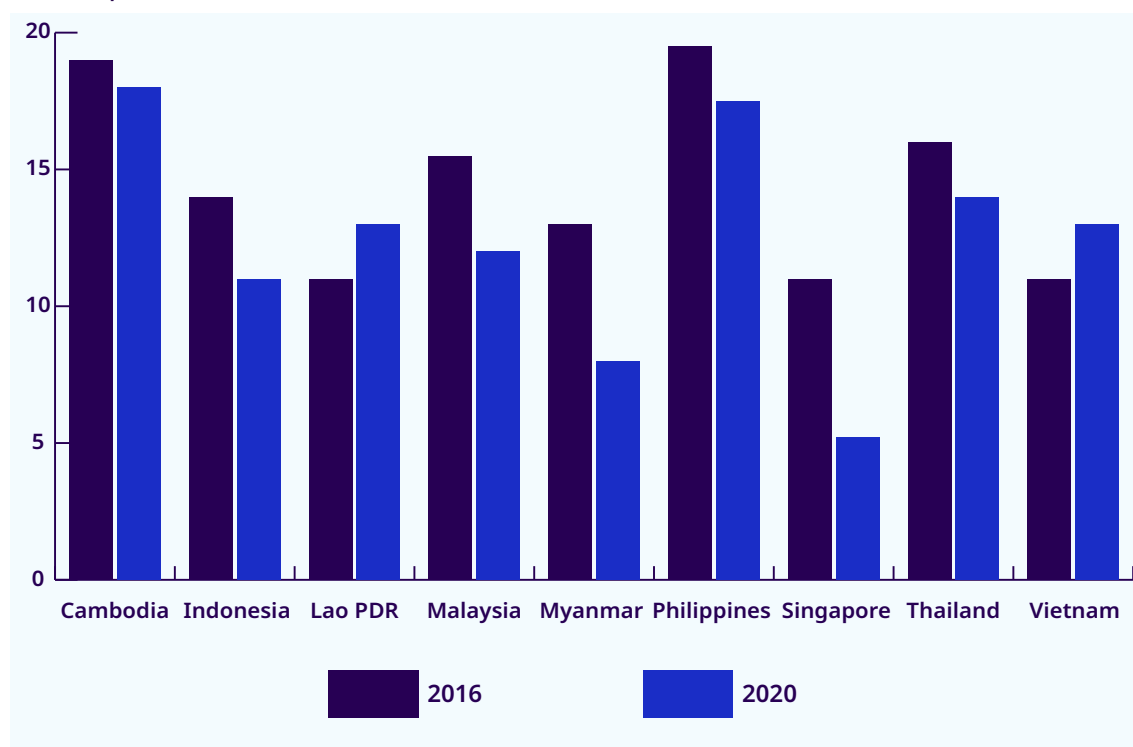
► Figure 27. Quality of roads, Cambodia versus other ASEAN member states, 2006, 2010 and 2019



Note: The index ranges from 1 to 7. The number 7 represents the highest quality of roads.

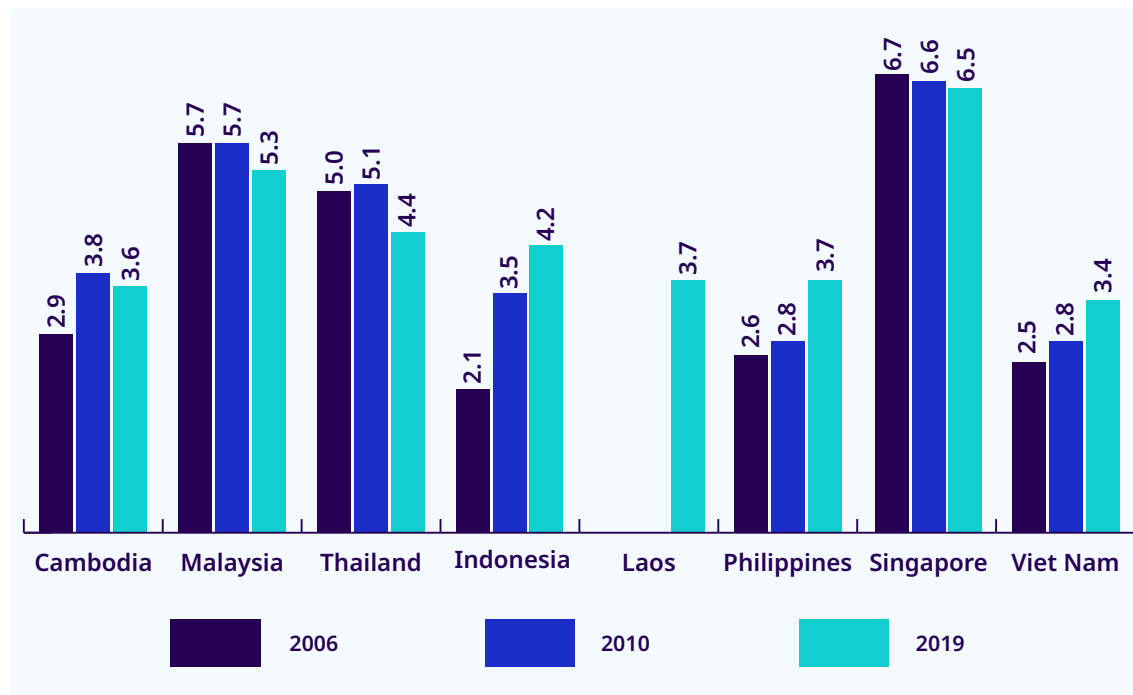
Source: World Economic Forum, Global Competitiveness Index.

► Figure 28. Cost of electricity (US cents per kWh), Cambodia versus other ASEAN member states, 2016 and 2020



Source: World Bank Doing Business Indicators.

► Figure 29. Secure internet servers (per 1 million people), Cambodia versus other ASEAN member states, 2016, 2018 and 2020



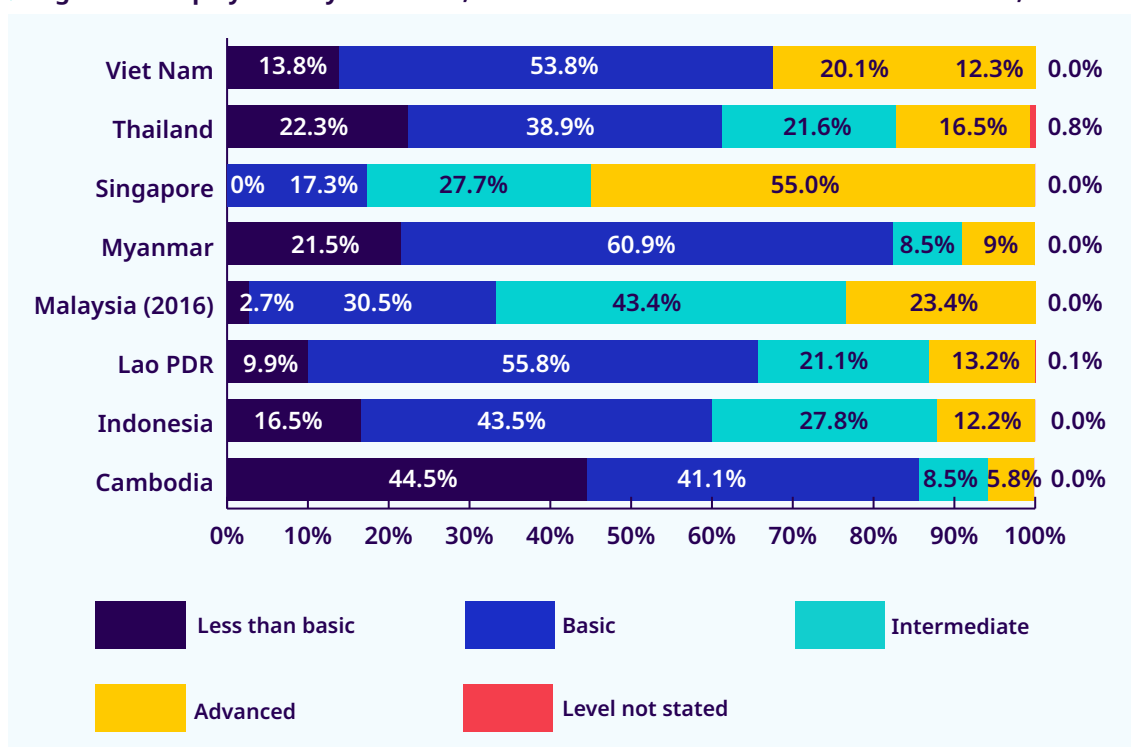
Note: Singapore and Malaysia are excluded due to their high internet density.

Source: World Development Indicators.

Skills

The bulk of Cambodia's workforce consists of low-skilled workers with basic or less than basic skills, and the country lacks workers with advanced education. In fact, Cambodia has the largest share of workers with less than basic education (44.5 per cent) among ASEAN countries. This is partially related to the large share that agriculture accounts for in Cambodia's total employment. Although agriculture accounts for a similarly high share of employment in Vietnam (Figure 6), its workforce fares better in basic education (53.8 per cent compared to 41.1 per cent in Cambodia). As a result, Cambodia's proportion of employees with intermediate (8.5 per cent) and especially advanced (5.8 per cent) education is among the lowest among ASEAN member states (Figure 30). This poses a problem for linkage development because foreign investors are looking for domestic workers and suppliers that are up to the task.

► Figure 30. Employment by education, Cambodia versus other ASEAN member states, 2017*



Note: Educational groups are based on the International Standard Classification of Education (ISCED).

*Latest available data for Malaysia for 2016.

Source: ILO, based on Labour Force Surveys.

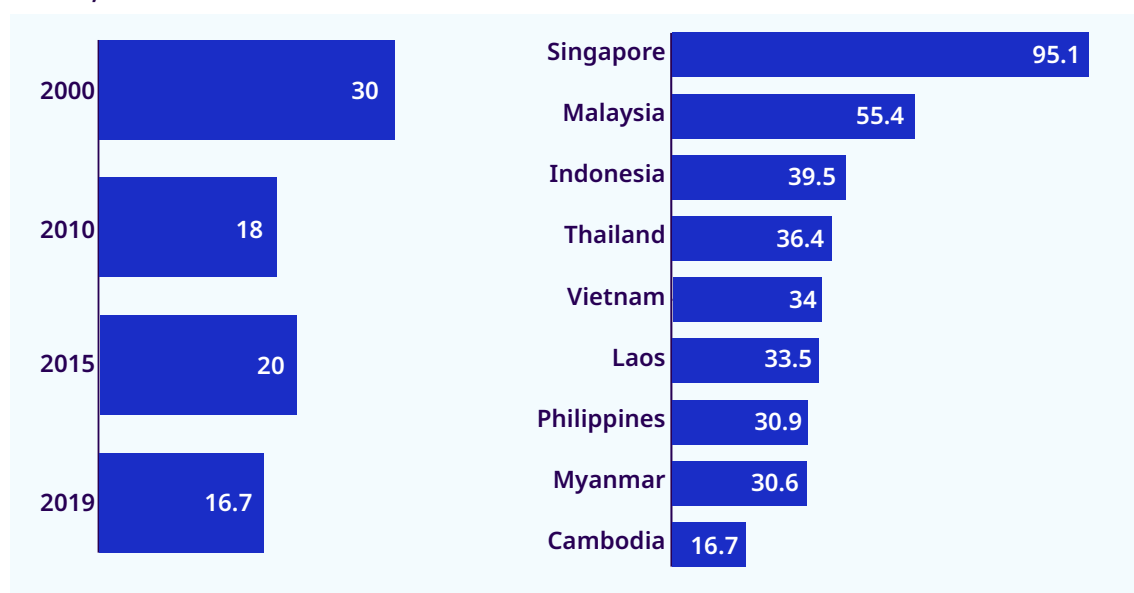
The quality and skills of Cambodian workers also influence their country's attractiveness to foreign investors and domestic actors' capacity to internalize productivity spillovers (Figure 3). While in most cases, those investors train their workforce in necessary skills, this is only possible if the workforce has a minimum level of skills. This influences not only a country's capacity to create linkages, but to absorb foreign technology spillovers. As local firms are exposed to foreign firms' products, marketing strategies and production processes, knowledge spillovers from direct imitation or reverse-engineering might accrue – which is more likely for firms with a more educated workforce. In addition, foreign investors may expect high international standards from local input and service suppliers, such as in product quality and delivery time, and technological efficiency that increases overall productivity. Local firms with a more skilled workforce are more likely to be able to meet these standards (Farole, Staritz and Winkler 2014). Blalock and Gertler (2009), for example, find that the proportion of employees with college degrees significantly increases domestic firms' productivity gains from FDI in Indonesia's manufacturing sector.

Governance

Governance in Cambodia seems to have deteriorated since 2000, limiting the country's attractiveness to foreign investors and domestic firms' absorptive capacity. Weak institutions – including corruption, red tape or other inefficiencies or burdensome regulations – may hold foreign as well as local investors back from fully exploiting their competitive advantages. This may likewise influence the type of FDI the country attracts in the first place, as well as the domestic firms' absorptive capacities for such investments (Farole, Staritz and Winkler 2014) (Figure 3). According to the government integrity index by the Heritage Foundation, Cambodia's performance continued to decline in 2019, from already low

levels in 2000, 2010 and 2015 (Figure 31, left panel). The index consists of six sub-indicators with equal weights, namely public trust in politicians, irregular payments and bribes, transparency of government policymaking, absence of corruption, perceptions of corruption, and transparency in the government and civil service. By these parameters, Cambodia is far behind Malaysia, Indonesia and Thailand (Figure 31, right panel).

► **Figure 31. Government integrity index, Cambodia versus other ASEAN member states, 2000, 2010, 2015 and 2019**



Note: The Heritage score ranges from 0 to 100 = highest. Government integrity is composed of six sub-indicators (with equal weights): public trust in politicians, irregular payments and bribes, transparency of government policymaking, absence of corruption, perceptions of corruption, and governmental and civil service transparency.

Source: Heritage Foundation.

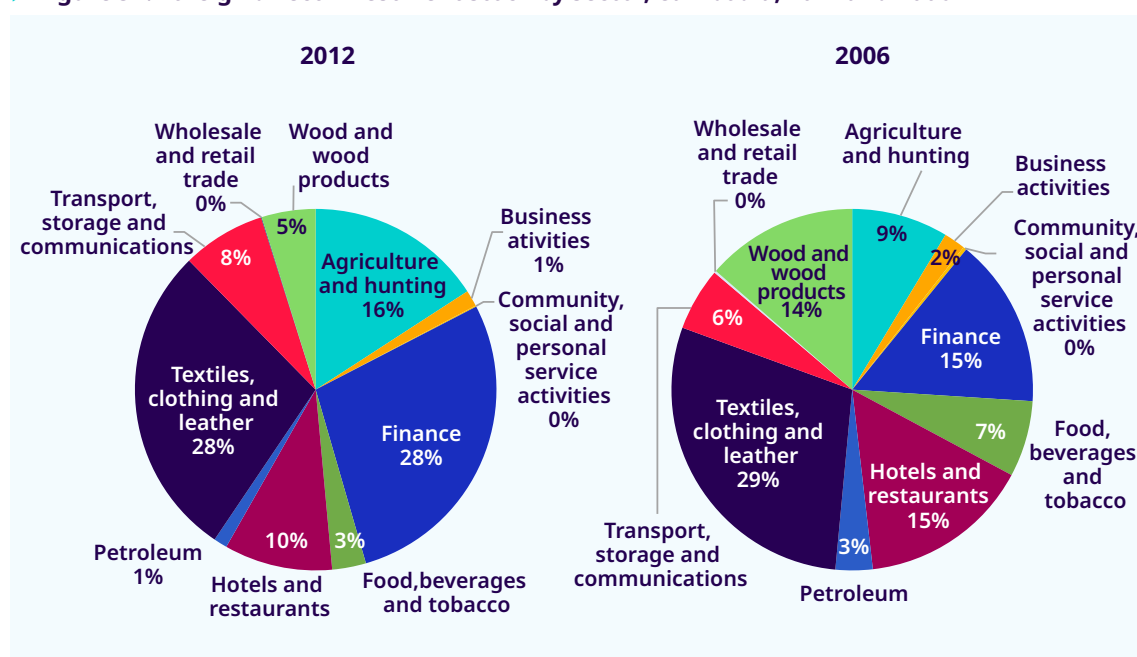
► 3. Foreign and domestic investment and linkages to the local economy

This section analyses the characteristics of foreign and domestic investments in Cambodia and their linkages to the local economy. Section 3.1 assesses the sectoral concentration of these investments, source countries and the share of foreign firms' sectoral output. Sections 3.2 and 3.3 quantify the extent of Cambodia's linkages on the sourcing and selling sides, and section 3.4 focuses on the extent of labour market linkages. The final section assesses the country's spillover potential and domestic absorptive capacity.

3.1 Characteristics of foreign and domestic investment

Cambodia's total FDI stock in 2012 showed a concentration in apparel, finance and agriculture. These three sectors received 63 per cent of all FDI inflows over the period 2007 to 2012 (24.8 per cent in finance, 21.8 per cent in apparel and 16.5 per cent in agriculture). As a result, the sector comprising textiles, clothing and leather represented 28 per cent of total FDI stock in 2012, reflecting little change from 2006 figures. The percentage of total FDI stock from finance, however, rose from 15 per cent in 2006 to 28 per cent in 2012. Agriculture also attracted more FDI, representing 16 per cent of total FDI stock in 2012 compared to 9 per cent in 2006. In contrast, the share of wood and wood products in total FDI stock went down from 14 per cent to 5 per cent over the same period, that of hotels and restaurants from 15 per cent to 10 per cent and that of food, beverages and tobacco from 7 per cent to 3 per cent (Figure 32). But while these sectors' shares in total FDI stock contracted, absolute FDI stock in them still grew, especially in hotels and restaurants.

► Figure 32. Foreign direct investment stock by sector, Cambodia, 2012 and 2006



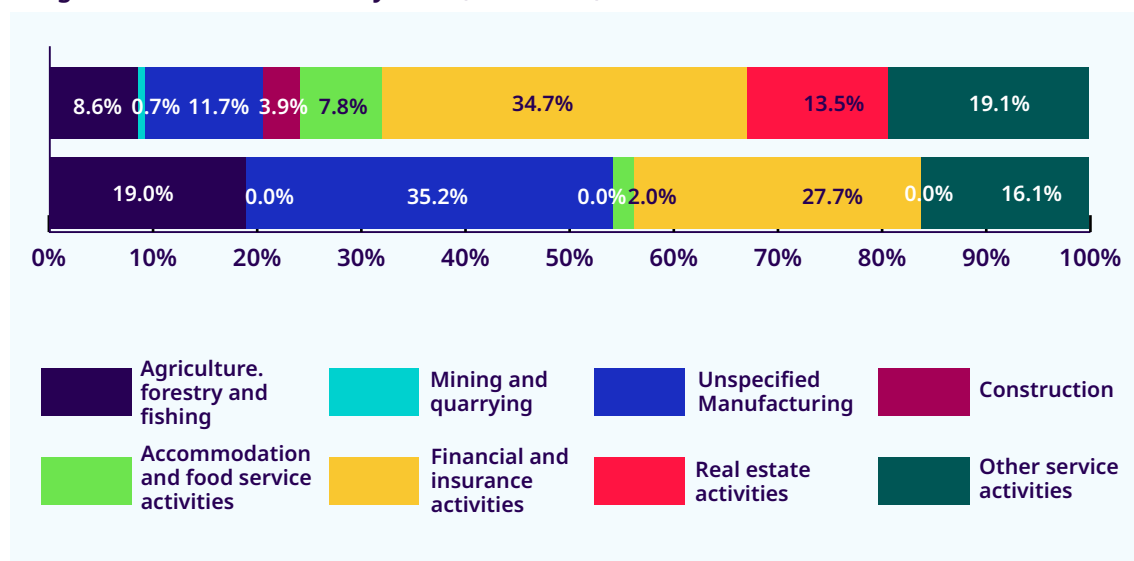
Source: International Trade Centre, Investment Map.

Looking at more recent FDI inflows by sector reveals a change between 2012 and 2017 in Cambodia.

While a total of 35.2 per cent of FDI inflows targets manufacturing in 2012, this share had declined to 11.7 percent five years later. Similarly, the share of FDI inflows in agriculture, forestry and fishing more than halved from 19 per cent to 8.6 per cent over this period. Meanwhile, FDI inflows in services sectors strongly expanded, including in accommodation and food services, finance and insurance, real estate and construction (Figure 33).

Total FDI inflows by the top ten foreign investors over the period 2014-18 totalled around US\$ 9.58 billion. Asian investors, in particular China, were important source countries of foreign investment inflows. China's total investments over the period 2014-18 accounted for 26.1 per cent of total FDI inflows. Hong Kong, China, is the second largest foreign investor in Cambodia, with its total FDI making up 10.6 per cent of the total investments in the country over the period 2014-18. It is followed by Vietnam, Japan, the Republic of Korea and Singapore with shares of between 6 to 7 per cent. Malaysia, Thailand, Chinese Taipei and the United Kingdom also are among the top ten foreign investors during this period (Figure 34). The foreign investor's home country may influence spillover potential through the choice of production strategy and technologies. It also influences managerial practices and cultures, which are related to differences in the engagement of expatriate workers, attitudes and strategies concerning the training of local workers, and general skills development.¹⁰

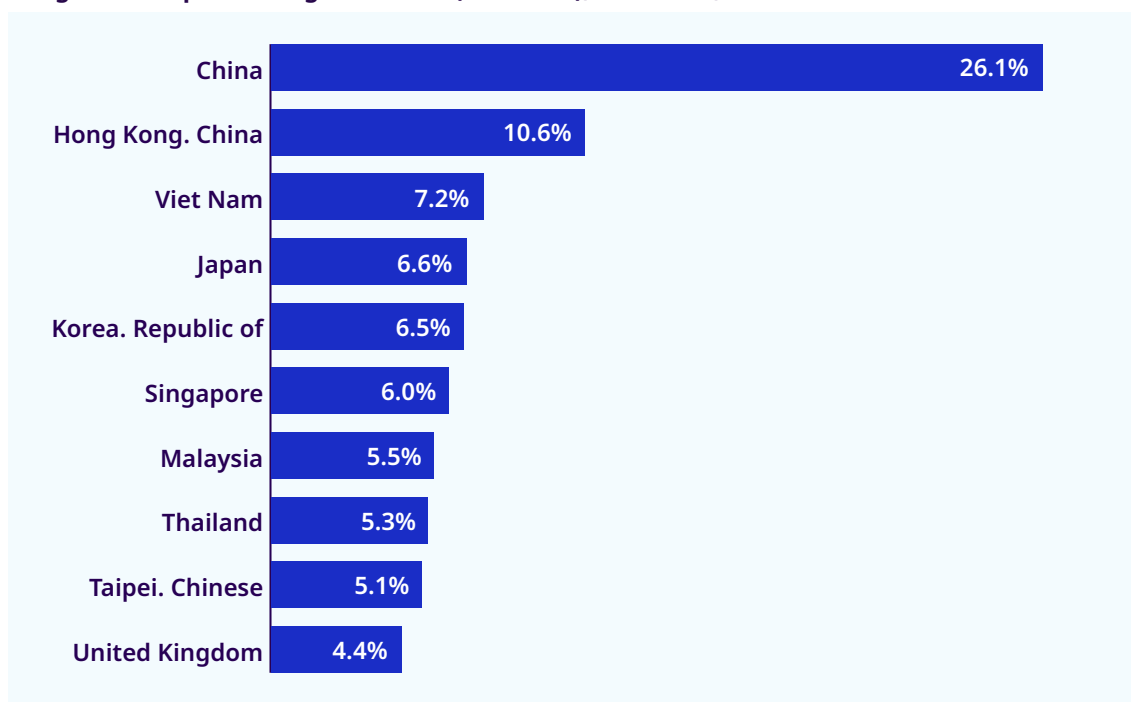
► **Figure 33. Total FDI inflows by sector, Cambodia, 2012 and 2017**



Source: International Trade Centre, Investment Map.

¹⁰ In the apparel sector, for example, European-owned firms in Mauritius and Madagascar largely export to Europe, whereas Asian-owned firms serve the US market; in Lesotho, Asian-owned firms export to the United States while South African-owned firms export to South Africa (Gibbon 2003; Staritz and Morris 2012, 2013). These patterns impact on spillover potential, as buyer sourcing requirements and practices can vary considerably by market (Farole, Staritz and Winkler 2014).

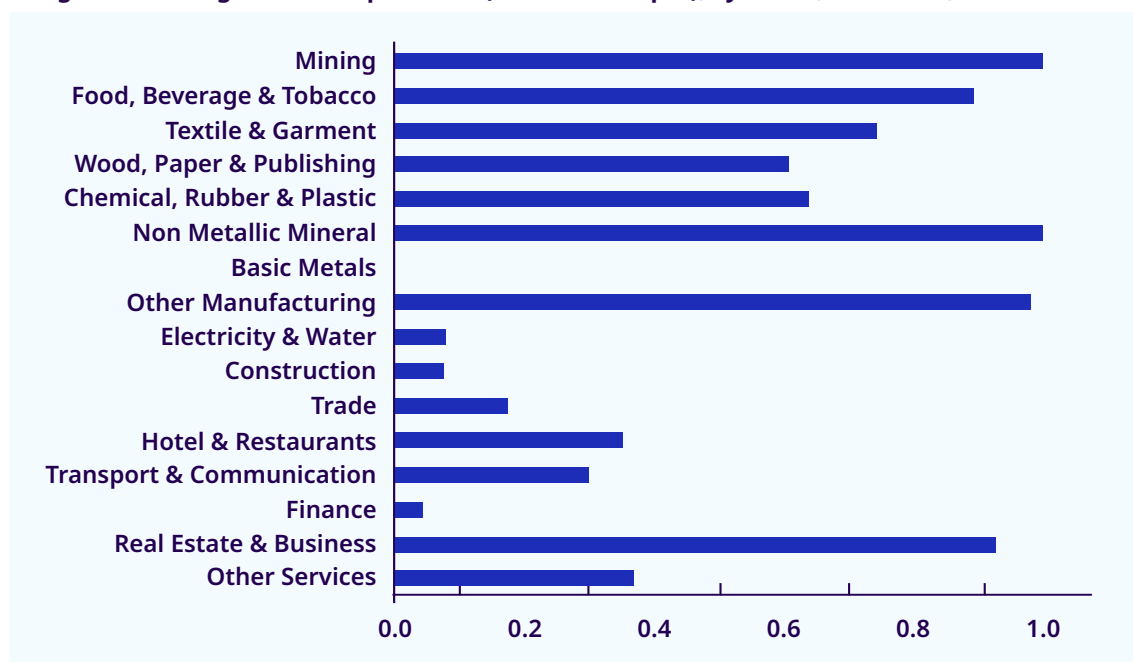
► Figure 34. Top ten foreign investors (% of total), Cambodia, 2014-18 total FDI inflows



Source: International Trade Centre, Investment Map.

The large share of foreign output in the total output of the apparel and food processing sectors points to a smaller domestic supply base in these sectors. In contrast, the share of foreign output is much lower in tourism-related industries. The presence of foreign firms in a sector can increase the productivity of domestic firms in the same sector through several transmission channels, including through the creation of competition for scarce resources (labour, capital, inputs) and the knowledge that local workers who have been trained previously by foreign firms can bring to domestic ones (labour turnover) (Figure 3). Horizontal linkages in the literature on FDI spillovers are measured by the share of foreign output in a sector's total output. While the presence, and subsequently output share, of foreign investors is traditionally higher in capital-intensive, resource-seeking FDI such as mining and minerals, the large share of foreign output in textiles and garments as well as food, beverages, and tobacco in Cambodia could point to a smaller domestic basis in these sectors. With the exception of real estate and business, service industries, including those related to tourism, are characterized by lower horizontal linkages (Figure 35).

► Figure 35. Foreign firms' output share (% of total output), by sector, Cambodia, 2011



Note: In the Economic Census 2011, ownership status is determined based on the nationality of the owner of the establishment and, in the case of joint ownership, the largest shareholder. In case of equal shares between a Cambodian and foreign shareholder, the firm is classified as Cambodian.

Source: Economic Census of Cambodia 2011. Taken from UNDP (2014, p. 13).

3.2 Extent of linkages on the sourcing side

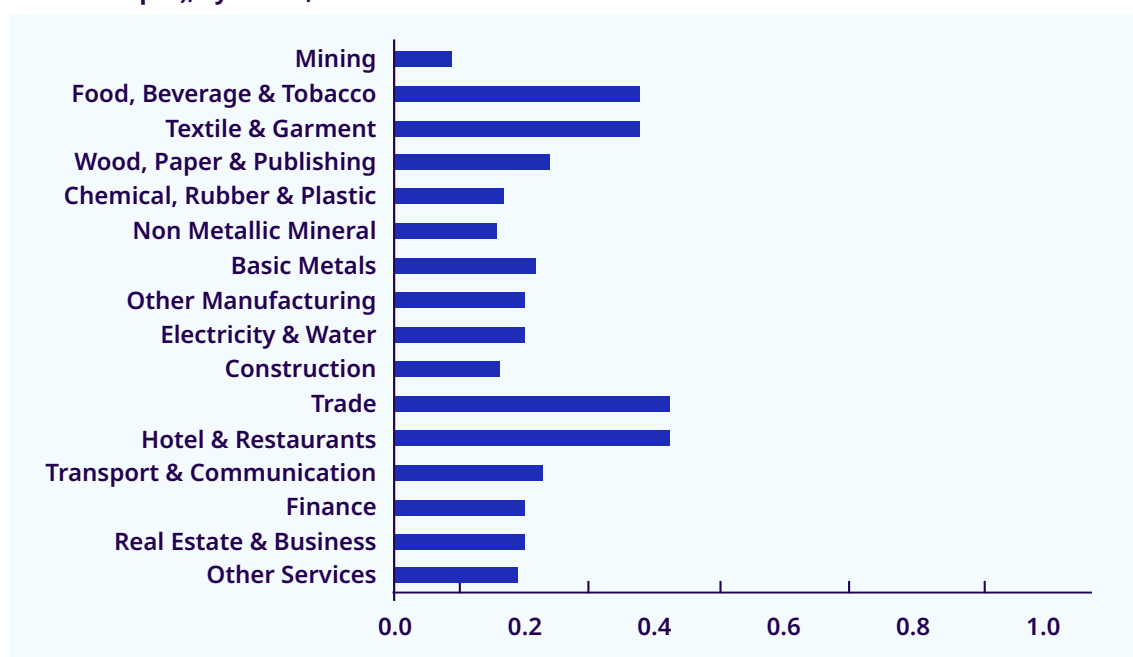
Investment in the manufacturing sector can lead to positive spillovers, especially in labour-intensive sectors, but co-sourcing and co-location strategies of lead firms in GVCs such as in apparel reduce the potential for domestic linkages. Manufacturing investment that is more labour-intensive has greater requirements for a broad range of goods and services inputs, and has lower barriers to domestic links. It is a strong candidate for generating spillovers (Farole, Staritz and Winkler 2014). But co-sourcing strategies, such as lead firms/foreign investors sourcing inputs from established suppliers abroad, or co-location strategies where they require established foreign input suppliers to enter the host country, could make the entrance of new local suppliers more difficult. This is a particularly common situation for foreign investors in the clothing, footwear, electronics and automotive sectors (Paus and Gallagher 2008, see also Figure 3).

The sectors of specialization in Cambodia – apparel, food processing and tourism-related sectors – show larger backward linkages between foreign investors and domestic suppliers, suggesting that linkages are existent. Backward linkages are defined as the share of a sector's output supplied to foreign firms (percentage of total output) that are located within the country and operate in downstream sectors that use this output for their production. These linkages are highest in trade and tourism and hotels, followed by food processing and apparel.¹¹ This implies the existence of an industrial base in

¹¹ This measure takes the perspective of the supplying sectors.

upstream sectors for the purpose of serving foreign investors. In food processing and hotels and restaurants, foreign investments are more likely to be linked to agriculture. Despite the smaller role of the domestic textiles industry in Cambodia, the output share of domestic upstream industries to foreign investors in apparel still exceeds 40 per cent. The high share of output to foreign investors in the domestic retail and wholesale trade sector also stands out (Figure 36), emphasizing the role that business services play in a country's exports (see Figure 22).

► **Figure 36. Output supplied to foreign firms operating in downstream sectors in country (% of total output), by sector, Cambodia 2011**

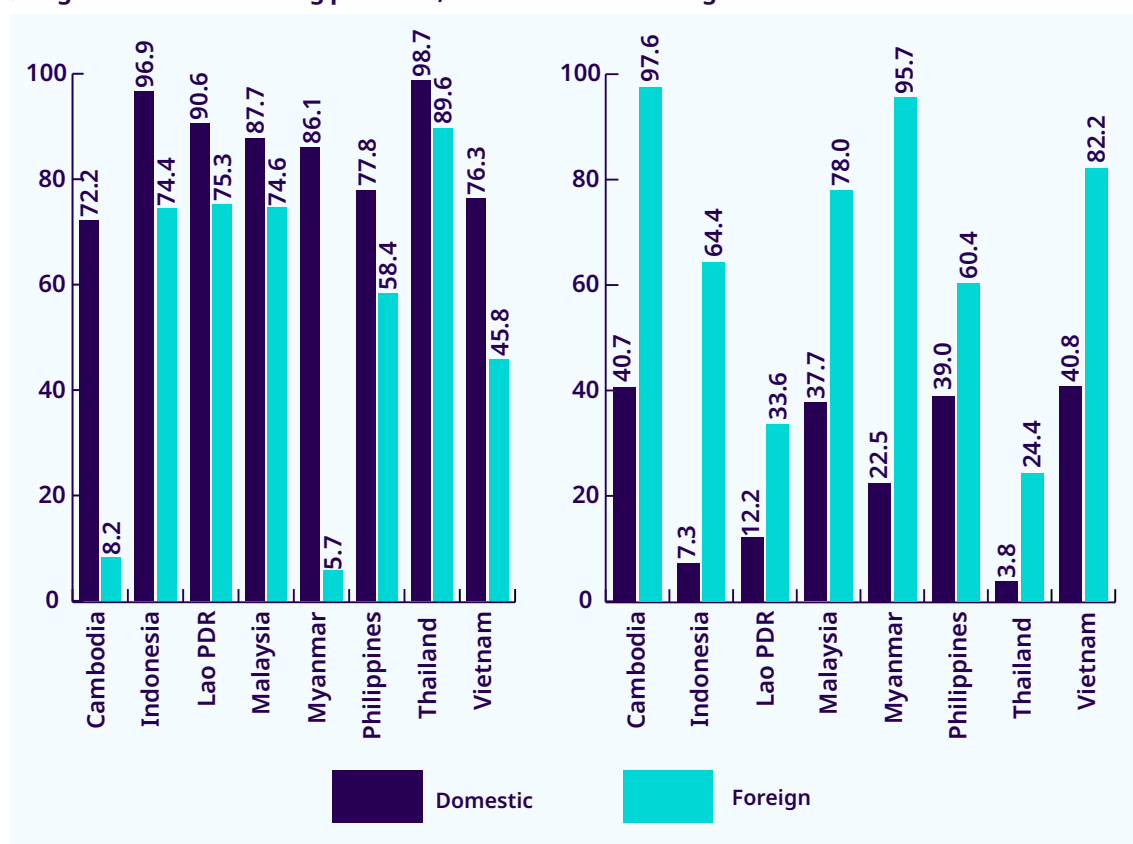


Note: In the Economic Census 2011 ownership status is determined based on the nationality of the person owning the establishment and, in the case of joint ownership, the largest shareholder. In case of equal shares between a Cambodian and foreign shareholder, the firm is classified as Cambodian.

Source: Economic Census of Cambodia 2011. Taken from UNDP (2014, p. 13).

While linkages exist, Cambodia's domestic and foreign firms are characterized by a low intensity of local sourcing. According to the World Bank Enterprise Surveys, local sourcing intensity, measured as the percentage of total inputs sourced domestically, is 72.2 per cent for domestic firms in Cambodia – the lowest across ASEAN countries. By contrast, domestic firms in Thailand, Indonesia and Lao People's Democratic Republic source more than 90 per cent of their inputs locally. Local sourcing intensities in Cambodia are also among the lowest for foreign firms, reaching only 8.2 per cent. Only Myanmar shows a lower intensity, while foreign firms in the Lao People's Democratic Republic, Malaysia and Indonesia source around three-quarters of their inputs domestically (Figure 37, left panel).

► Figure 37. Local sourcing practices, domestic versus foreign firms



Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines and Vietnam; and 2014 data for Myanmar.

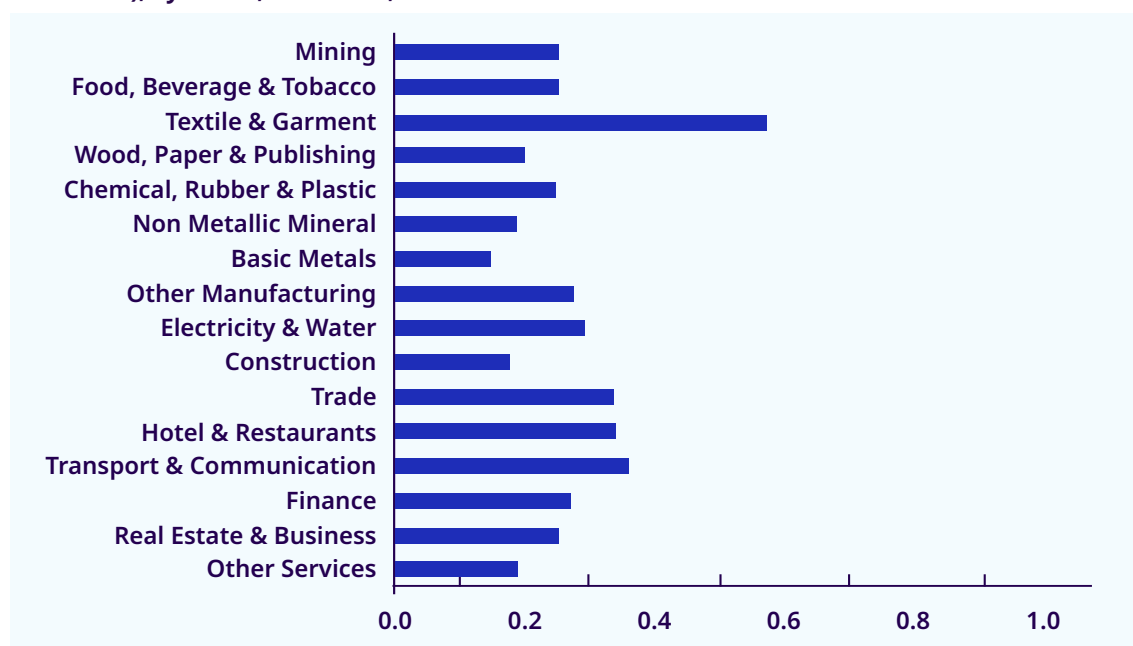
At the same time, the share of manufacturing firms in Cambodia that use inputs of foreign origin is the highest among fellow ASEAN countries, for both domestic and foreign firms. More than 40 per cent of domestic manufacturing firms in Cambodia source inputs internationally a percentage that is on par with Vietnam, the Philippines and Malaysia. This share was much lower in Thailand (4 per cent), Indonesia (7 per cent) and the Lao People's Democratic Republic (12 per cent). Among foreign manufacturing firms in Cambodia, 97.6 per cent source inputs from abroad. This figure is comparable to that of Myanmar's but much higher than Thailand and the Lao People's Democratic Republic, where only one quarter and one third, respectively, of foreign firms rely on inputs of foreign origin. The percentage of manufacturing firms that source inputs internationally is 64 per cent in Indonesia and 82 per cent in Vietnam (Figure 37, right panel).

3.3 Extent of linkages on the selling side

Forward linkages between foreign suppliers and domestic buyers in Cambodia are highest in the apparel and tourism-related sectors, implying that foreign suppliers capture a high share of value added in the supplying sectors of the apparel and tourism value chains. Forward linkages are measured by a sector's share of inputs sourced from foreign firms (percentage of total inputs sourced) that are located in the country and operate in upstream sectors, that is, the measure focuses on the role of

multinational suppliers in the country.¹² The foreign input share reaches around 60 per cent in the textiles and garment sector, and between 30 per cent and 40 per cent in transport and communication, hotel and restaurants, and trade. The large foreign presence in business services could point to a less developed services sector in Cambodia, which has a low share of domestic services value added in its exports (Figure 38). Interestingly, forward linkages are lower in food, beverages and tobacco, suggesting that domestic suppliers capture a higher value-added share in the food-processing value chain. This is also supported by the analysis in section 2.2 (Figure 15).

► **Figure 38. Inputs sourced from foreign firms operating in upstream sectors (% of total inputs sourced), by sector, Cambodia, 2011**



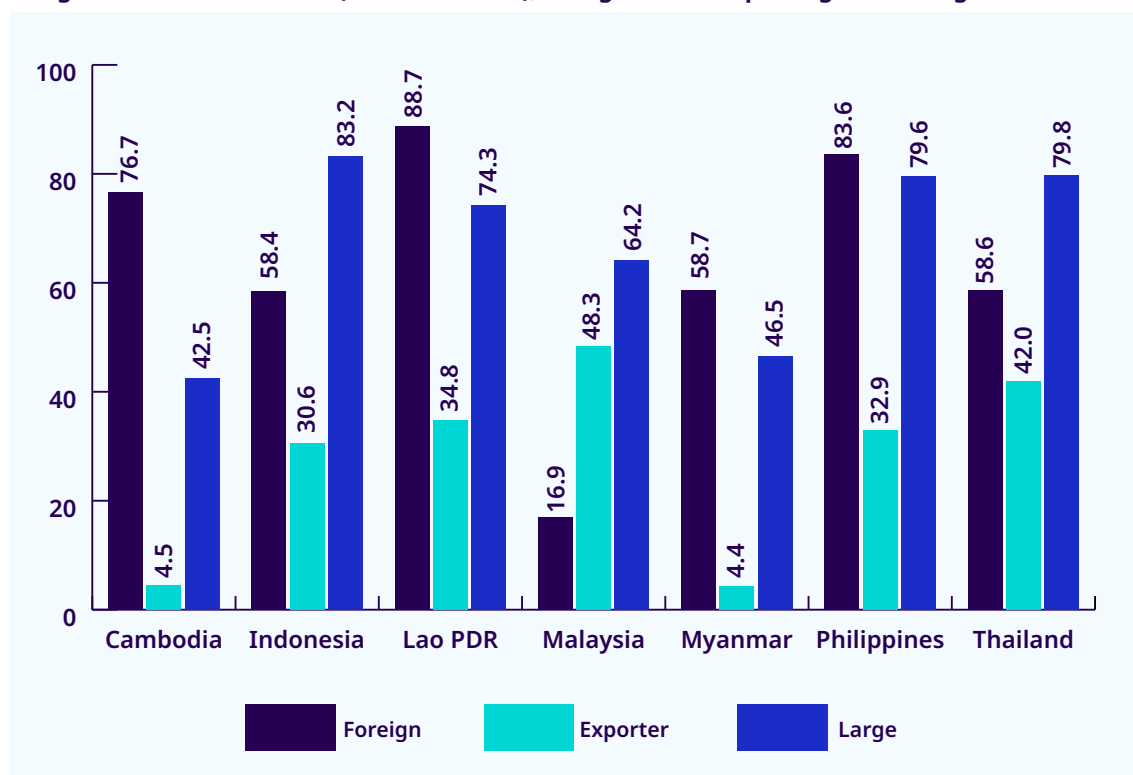
Note: In the Economic Census 2011, ownership status is determined based on the nationality of the owner of the establishment and, in the case of joint ownership, its largest shareholder. In case of equal shares between a Cambodian and foreign shareholder, the firm is classified as Cambodian.

Source: Economic Census of Cambodia 2011. Taken from UNDP (2014, p. 14).

Nevertheless, exporting firms as well as large firms in Cambodia sell a smaller share of output to the local market than they do in other ASEAN countries, reflecting a trend toward efficiency-seeking investment. According to the Enterprise Surveys, more than three quarters of foreign investors' sales in Cambodia are destined for the local market. This share seems surprisingly high and could be related to specific sectors such as construction or wholesale and retail trade. A different look at the data reveals that, among exporting firms in Cambodia (both foreign and domestic), such as firms with a direct export share of 10 per cent or more in total sales, the share of domestic sales is only 4.5 per cent. This is the lowest among ASEAN countries. Taking into account firm size, the data shows that large firms with at least 100 employees in Cambodia sell only 42.5 per cent of their output to the local market. Large firms account for significantly higher sales targeted at local markets in Indonesia, the Philippines, Thailand and Lao People's Democratic Republic (Figure 39). These numbers suggest that investments in Cambodia tend to be more efficiency-seeking (that is, "extracting" low-wage labour rather than broader capabilities of local firms) than market-seeking. This trend is likely driven by Cambodia's apparel sector.

¹² This measure takes the perspective of the buying sectors.

► Figure 39. Domestic sales (% of total sales), foreign versus exporting versus large firms



Note: Foreign firms have a foreign ownership share of at least 10%. Exporters have a direct export share of 10% or more. Large firms have at least 100 employees.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia and Philippines; and 2014 data for Myanmar. Measure unavailable for Vietnam.

3.4 Extent of labour market linkages

Investment by multinationals in their workforce provides workers with knowledge and skills that may spill over to local firms through labour turnover in the medium to long term. The knowledge that workers gain in multinational firms may move from multinational to local firms – either to existing local firms or when workers start their own firms (Fosfuri, Motta and Ronde 2001; Glass and Saggi 2002; Crespo and Fontoura 2007). Studies evaluated the existence of labour turnover as a channel for productivity spillovers from FDI.¹³ However, spillovers through labour are more likely to be realized in the medium to long term, as knowledge first needs to be absorbed by the local workforce. In the short term, it is more likely that foreign firms will bid away high-quality labour from domestic firms by offering higher wages and benefits, resulting in potentially negative spillover effects (Sinani and Meyer 2004; Hoekman and Javorcik 2006; Crespo and Fontoura 2007). The loss of skilled labour also affects the domestic firms' capacity to internalize FDI spillovers.¹⁴

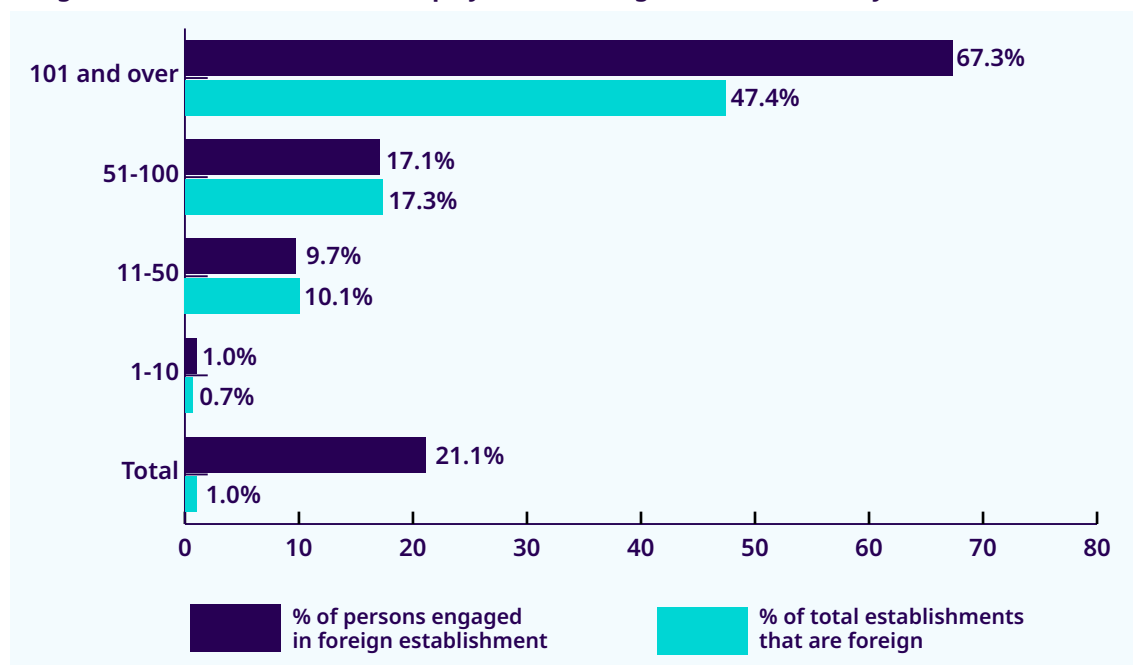
¹³ Balsvik (2011) for manufacturing firms in Norway and Görg and Strobl (2005) for manufacturing firms in Ghana.

¹⁴ Drawn from Farole, Staritz and Winkler (2014).

The Intercensal Economic Survey of 2014¹⁵ shows that, while only 1 per cent of all Cambodian establishments have foreign ownership status, these firms absorb 21.1 per cent of the total workforce (excluding agriculture, public administration and defense, households as employers, and extra-territorial organizations). This percentage increases drastically with firm size. While over 47 per cent of large firms (that is, establishments employing more than 100 workers) are foreign, they employ more than two thirds of persons working in large establishments (Figure 40). Firms of Chinese origin alone employ 9.9 per cent of the total non-agricultural workforce in Cambodia and 34.4 per cent of the workforce in large establishments (Appendix III). In addition, foreign firms tend to create manufacturing jobs. Among all persons engaged in foreign firms, more than 81 per cent end up in manufacturing jobs (Table 10).

This is driven by the large size of manufacturing firms that rely more on unskilled production workers than in many other ASEAN countries, reflecting Cambodia's specialization in lower-skill manufacturing production. According to the Enterprise Surveys, Cambodia's foreign manufacturing firms employ on average around 950 permanent production workers, exceeding the number among its fellow ASEAN member countries (Figure 41). However, foreign manufacturing firms in Cambodia rely more heavily on unskilled production workers than other ASEAN countries. Only foreign firms in Vietnam and especially Myanmar show a higher share of unskilled permanent manufacturing workers (Figure 42). This reflects Cambodia's specialization in lower-skill manufacturing production, which is further confirmed by the percentage of unskilled labour contribution in the total labour value added in the country's exports. Unskilled labour represents almost 85 per cent of Cambodia's total labour value added in exports, the highest share across ASEAN countries (Figure 43). This is driven by apparel, agriculture, and trade and transport services (see Appendix IV).

► Figure 40. Establishments and employment in foreign firms, total and by firm size, Cambodia



Source: Intercensal Economic Survey of Cambodia (2014).

15 While the Intercensal Economic Survey data of 2014 are older, they have the advantage of being representative and cover over 513,000 establishments in Cambodia. To date, they are the only reliable data source that allows us to obtain information on the share of the local non-agricultural workforce that is employed by foreign companies.

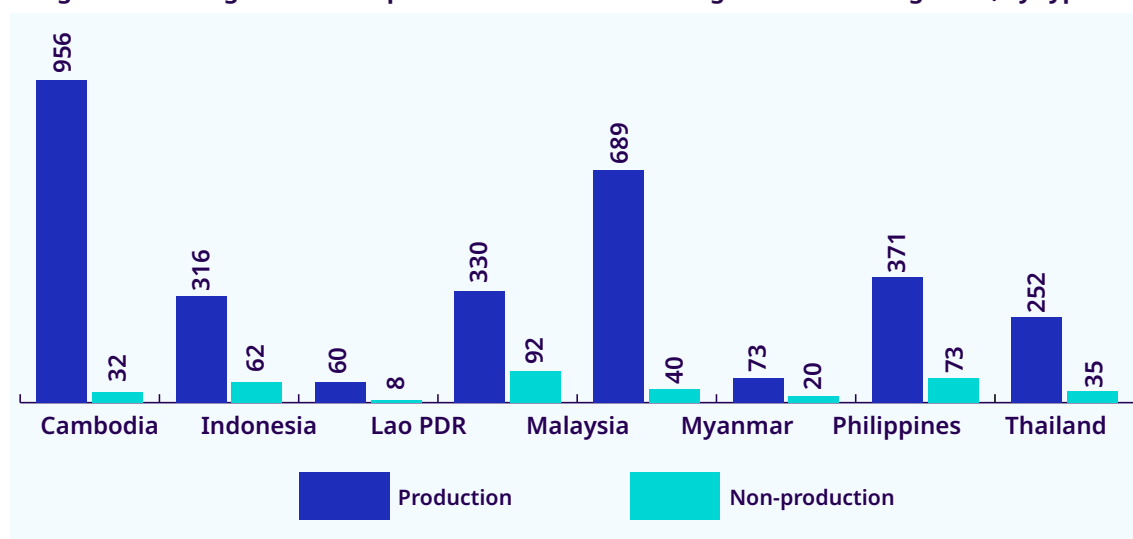
► **Table 10. Persons engaged in foreign firms by sector**

ISIC Rev.4	Persons engaged in foreign firms	%
Total	394 760	100.0
Manufacturing	320 636	81.2
Wholesale and retail trade; repair of motor vehicles and motorcycles	14 034	3.6
Accommodation and food service activities	10 675	2.7
Education	1 181	0.3
Human health and social work activities	1 859	0.5
Other service activities	17 720	4.5
Others	28 655	7.3

Note: ISIC Rev.4 stands for International Standard Industrial Classification Revision 4 (2008).

Source: Intercensal Economic Survey of Cambodia (2014).

► **Figure 41. Average number of permanent workers in foreign manufacturing firms, by type**



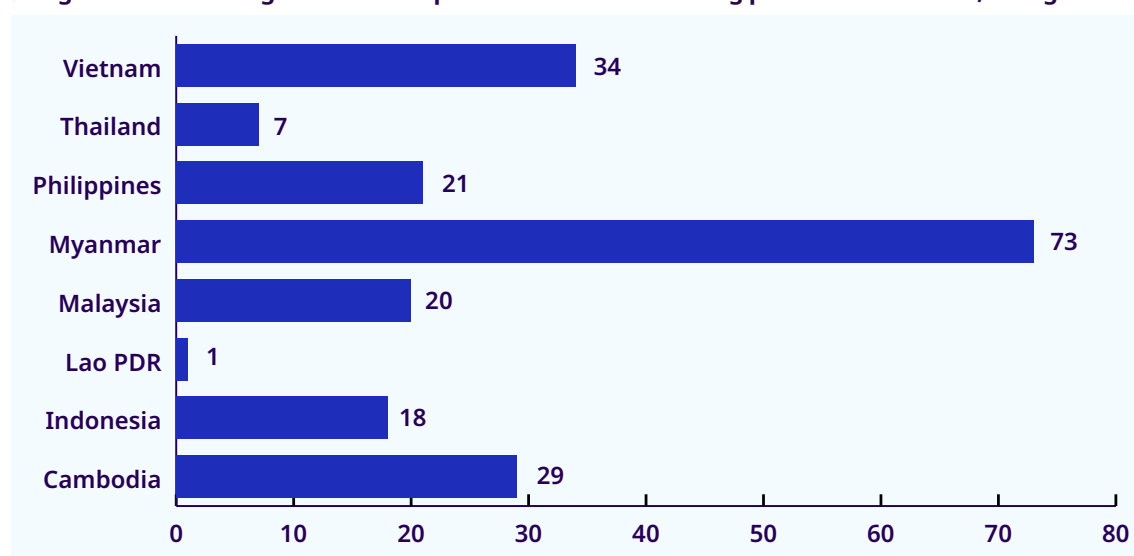
Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines, and Vietnam; and 2014 data for Myanmar.

Spillovers through labour turnover depend on domestic firms' ability to attract workers that previously worked in foreign firms, but the large share of informal MSMEs and lengthy procedures to start a business present major challenges in Cambodia. Competitive wages are likely to be the most important driver for attracting the local workforce, which is also related to firm size, technology intensity and openness to trade. Spillovers also depend on the ease of and support for establishing new local firms, which is affected at the host-country level by investment policies, access to finance and

SME development policies. Cambodia's large share of MSMEs that are mainly informal as well as the cumbersome procedures for starting a business (Figure 26) are a major challenge for domestic firms in internalizing spillovers through labour turnover.

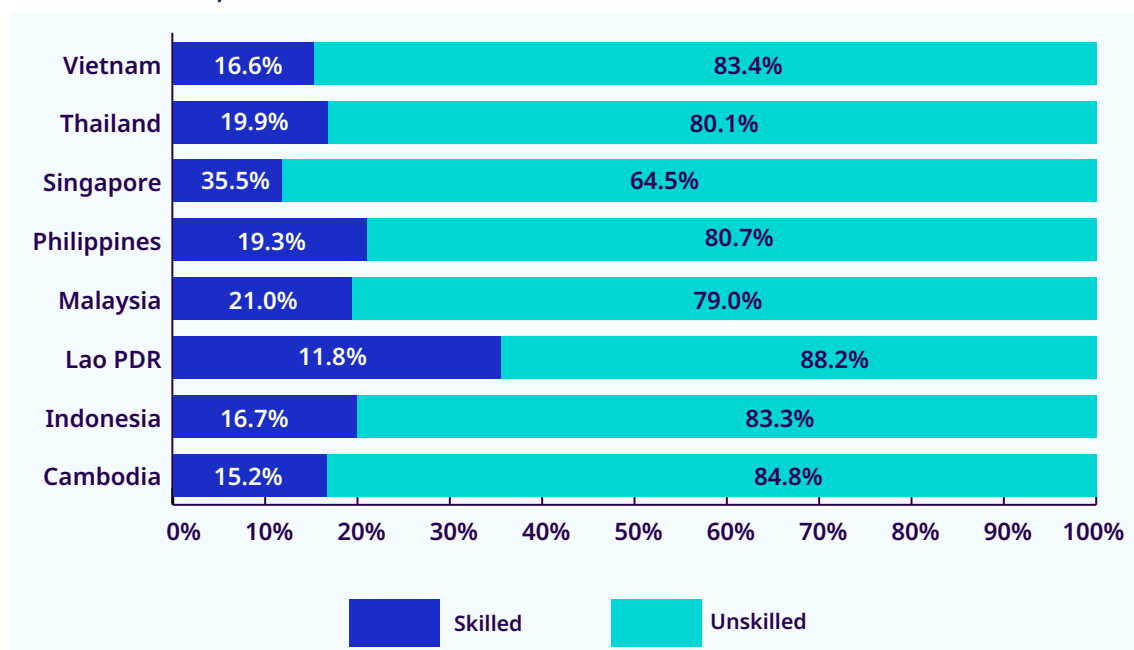
► **Figure 42. Percentage of unskilled permanent manufacturing production workers, foreign firms**



Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines, and Vietnam; and 2014 data for Myanmar.

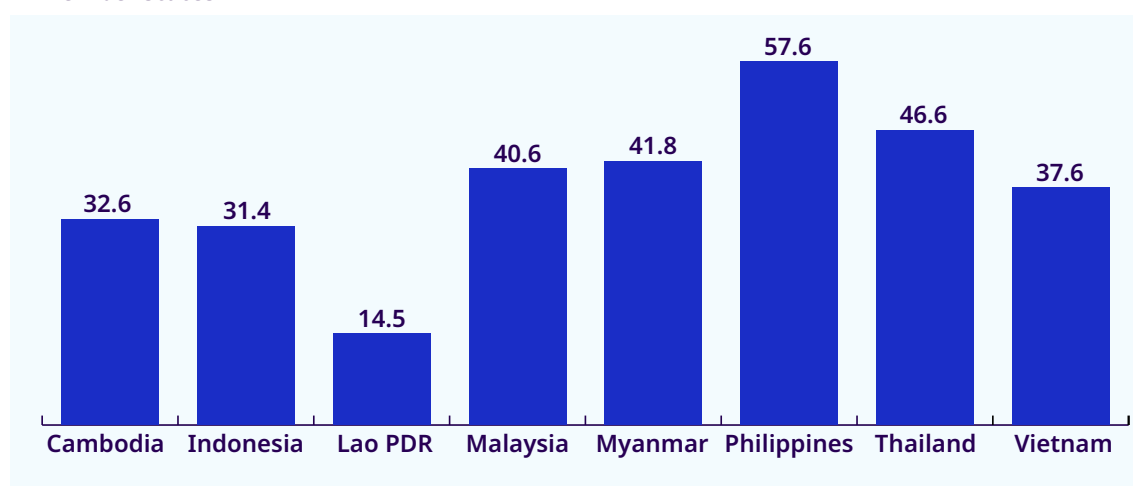
► **Figure 43. Labour value added in exports (% by skill level), Cambodia and other ASEAN member states, 2011**



Source: World Bank LACEX database.

The extent of spillovers also depends on the amount of training and knowledge local workers receive in foreign firms, the share of local workers in skill-intensive technical, supervisor or management positions; and the proximity to and interactions with local firms. The home country of the foreign investor influences the spillover potential through its managerial practices and culture around the employment of foreign workers, attitudes toward training local workers, and skills development. This also affects domestic firms' absorptive capacity, because workers in domestic firms observe and adopt technologies, management practices, and cultural values (Zhang, et al. 2010). Only 32 per cent of firms surveyed in Cambodia offer training initiatives, compared to more than 40 per cent in Malaysia, Myanmar and Thailand, and more than 50 per cent in the Philippines (Figure 44).

► **Figure 44. Percentage of foreign firms offering formal training, Cambodia and other ASEAN member states**



Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines, and Vietnam; and 2014 data for Myanmar.

At the host-country level, the extent of labour market rigidity determines not only whether labour can flow freely between firms, but how long workers stay with a firm, which is an important factor for knowledge absorption and diffusion (Farole, Staritz and Winkler 2014). Cambodia does not have an excess supply of agricultural workers, unlike Bangladesh, China or Vietnam. As a result, up to 20 per cent of apparel industry workers migrate back to their hometowns during peak farming seasons (ADB-ILO 2015). This undercuts workers' capability to absorb new knowledge. Interviews with government representatives confirmed that this is an issue, and plans are underway to offer affordable housing options in the form of subsidies to garment workers.

3.5 Assessing spillover potential and domestic absorptive capacity

There is little empirical evidence, and conflicting ones at that, on the correlation between foreign investment and domestic firm productivity within the same sector in Cambodia. Using firm-level cross-sectional data from the Survey of Industry Establishments for the year 2000, Cuyvers et al. (2008) find evidence for positive horizontal spillovers into domestic firms' labour productivity within the same sector, but those were relatively small compared to other studies. Such positive productivity gains for

domestic firms within the same sector as the foreign investor may occur due to stronger competition for limited resources, but also labour turnover from foreign to domestic firms. Cheng (2012) also studies horizontal spillover effects in Cambodia, but finds no evidence of spillovers when domestic firms' absorptive capacity is not being controlled for. The study is based on Enterprise Surveys for 2005 and 2006. By contrast, a 2014 study by UNDP uses the Economic Census data for 2011 and finds a negative and significant correlation between FDI and domestic firms' labour productivity within the same sector for the full sample, and also for the service sectors only.

Empirical evidence suggests a positive correlation between FDI and firm productivity in upstream sectors (backward spillovers) in Cambodia, while the correlation in downstream sectors (forward spillovers) is negative. The positive backward spillovers, however, are only confirmed in the full sample and for the service sectors, but not for the manufacturing sectors alone. This seems to be symptomatic of the lack of linkages to suppliers in Cambodia's manufacturing sector, in particular in apparel. Forward spillovers are negative in the manufacturing data sample, suggesting that foreign presence in a sector does not benefit firms in downstream industries in terms of productivity gains (UNDP 2014). This finding is surprising, as one would expect positive productivity spillovers through the availability and higher quality of inputs produced by foreign firms (see transmission channels, Figure 3). Forward linkages between foreign investors and domestic buyers are highest in apparel and tourism-related sectors. One possible explanation could be that foreign presence lowers the productivity of existing domestic firms in these sectors through increased competition, which could in turn weaken productivity in their respective domestic value chains.

Technology gap between foreign and domestic firms

The technology gap between foreign and domestic firms affects FDI spillovers, including in Cambodia. In fact, such a gap has been identified as one among the most important factors for FDI spillovers (Kokko, Tansini and Zejan 1996; Grünfeld 2006). A large gap can be beneficial for local firms because their catching-up potential increases, but local firms might not be able to absorb positive FDI spillovers if the gap is too big or too small (Smeets 2008; Jordaan 2011). If the efficiency and modernity of equipment and production processes employed by local and foreign firms differ considerably, the local workforce may not be able to benefit from the technology provided by the multinational firm. If, however, they are too similar, the potential for spillovers is smaller. Empirical studies suggest that spillover effects from FDI in Cambodia are influenced by the technology gap. Cheng (2012) also takes into account the role of the technology gap when studying horizontal FDI spillovers, including such a gap in domestic firms relative to foreign firms in the sector, and finds that a larger technology gap has a positive effect on horizontal FDI spillovers. By contrast, UNDP (2014) finds that a larger technology gap between local and foreign firms reduces the FDI-induced productivity gains for domestic firms within the same sector. This same study finds that a larger technology gap increases the FDI-induced productivity gains for domestic suppliers via backward spillovers. One explanation may be that foreign investors extend training assistance and other development initiatives to their suppliers, in particular, if they have a large technology gap.

Within Cambodia's important GVCs, the technology gap of domestic firms relative to foreign firms is big in the food and transportation sectors, but quite small in the apparel sector. The technology gap in a sector is measured as the average productivity of foreign firms minus a domestic firm's specific productivity divided by the average sectoral productivity of foreign firms. Domestic firms with lower productivity levels compared to the average of foreign firms in the sector show a positive gap, while those with higher productivity levels have a negative gap. Cambodian apparel firms are more productive than foreign ones, implying that foreign investment in that sector is largely driven by efficiency-seeking, low-productive FDI that targets low-skilled labour. Therefore, it makes sense to target higher-productivity investors in the apparel sector order to increase FDI spillover potential there. The sizable technology gap in the food and transportation sector points to the country's need to increase productivity in these two sectors (Table 11).

► Table 11. Domestic firms' technology gap, by sector, Cambodia, 2011

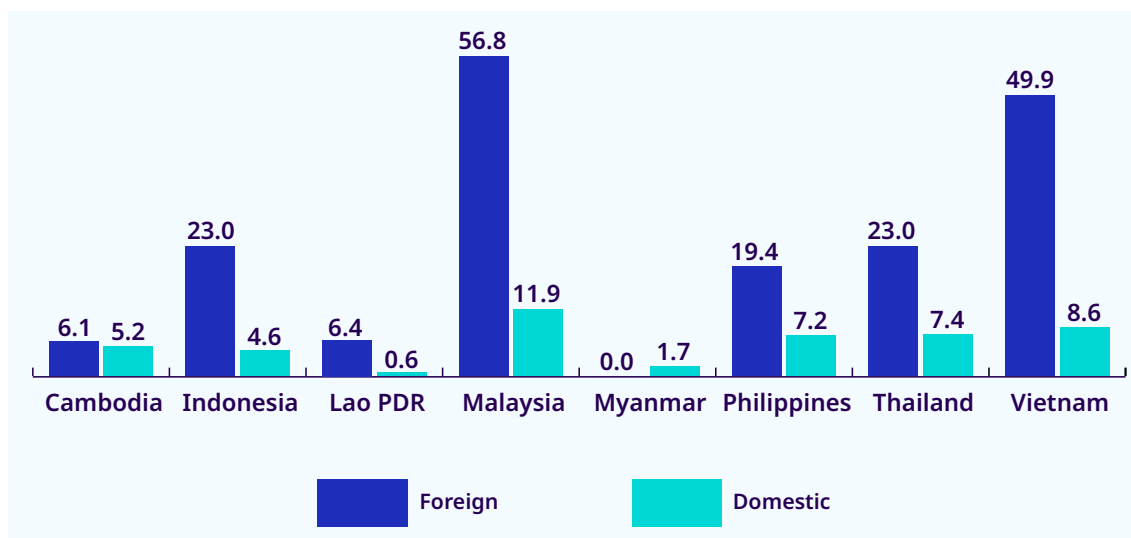
Sector	Technology gap
Real estate & business	0.871
Other services	0.752
Chemical, rubber & plastic	0.746
Food, beverage & tobacco	0.714
Electricity & water	0.692
Transport & communication	0.426
Other manufacturing	0.281
Hotels & restaurants	0.096
Wood, paper & publishing	-0.436
Trade	-0.507
Construction	-0.629
Textile & garment	-1.651
Finance	-2.789

Note: Technology gap = (average productivity of foreign firms in sector - domestic firm's specific productivity) / (average productivity of foreign firms in sector).

Source: UNDP (2014, p. 25).

Spillover potential depends not only on technology gap, but on the technology intensity of the foreign investor's goods produced in the host country. Cambodia's portion of domestic firms with internationally recognized quality certification lies in the medium range when compared to other ASEAN countries, but the proportion of foreign firms with certification is low compared to other ASEAN countries (Figure 45). The level of technology intensity of foreign investors also determines if spillovers occur. Products characterized by greater technology generally contain a greater element of knowledge and involve a broader set of skills. Using the percentage of foreign firms with an internationally-recognized quality certification as a proxy for its technology intensity suggests that foreign investors in Cambodia are less technology intensive (Figure 45). This trend is reflected in the high share of low-skill intensive exports from Cambodia (Figure 10).

► **Figure 45. Percentage of firms with internationally recognized quality certification, foreign versus domestic**



Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines and Vietnam; and 2014 data for Myanmar.

Country of origin of foreign investors

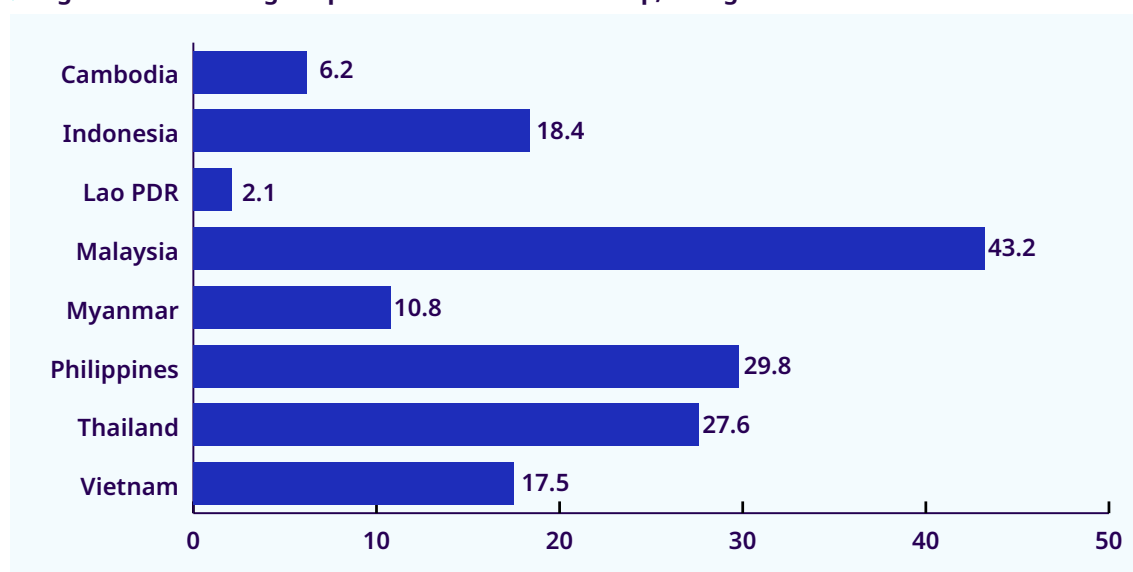
Although having more remote source countries of foreign investors and the non-existence of preferential trade agreements with the host country could act as an incentive for increased local sourcing, Cambodia's FDI structure shows a strong reliance on investors from East Asia, including ASEAN. The share of intermediates sourced locally by foreign investors is likely to increase with the distance between the host and the source economy. This is because the cost of communication and coordination increases with distance (Rodriguez-Clare 1996). The share of local intermediates is also likely to be larger for multinationals based in countries that are outside the country's preferential trade agreements, because such agreements make imports from the home country less attractive as these do not benefit from duty-free or reduced tariffs (Javorcik and Spatareanu 2011, see also Figure 5). This rationale plays an important role for special economic zones (SEZs) that often offer investors preferential treatment in terms of taxes and import duties. However, the largest investors in Cambodia are from countries in the East Asian region, including ASEAN (Figure 31), a fact that could limit efforts to increase local sourcing.

Share of foreign ownership

Levels of domestic ownership of foreign firms are very low in Cambodia, and this may lower the FDI spillover potential given the country's specialization in lower technology sectors. The average share of private domestic ownership among foreign firms in Cambodia is only 6.2 per cent – only Lao People's Democratic Republic has an even lower rate among ASEAN countries. The share of domestic ownership is particularly high for manufacturing buyers, reaching 43 per cent in Malaysia, 30 per cent in the Philippines and 27.6 per cent in Thailand (Figure 46). A larger domestic ownership share could be beneficial for local firms because the foreign investor's interests are less well protected and could make technology leakages more likely. It might also increase the likelihood of relying on domestic suppliers (Crespo and Fontoura 2007). Empirical studies controlling for different structures of foreign ownership

tend to support the more positive spillover effects of joint ventures (Abraham, Konings and Sloodmaekers 2010). A higher share of foreign ownership – and thus larger control over management and lower potential for knowledge leakages – correlates positively with the parent firm’s incentive to transfer knowledge and technology (Takii 2005). However, the spillover potential is likely to be smaller in Cambodia given its specialization in lower-technology sectors like apparel or agribusiness.

► **Figure 46. Percentage of private domestic ownership, foreign firms**



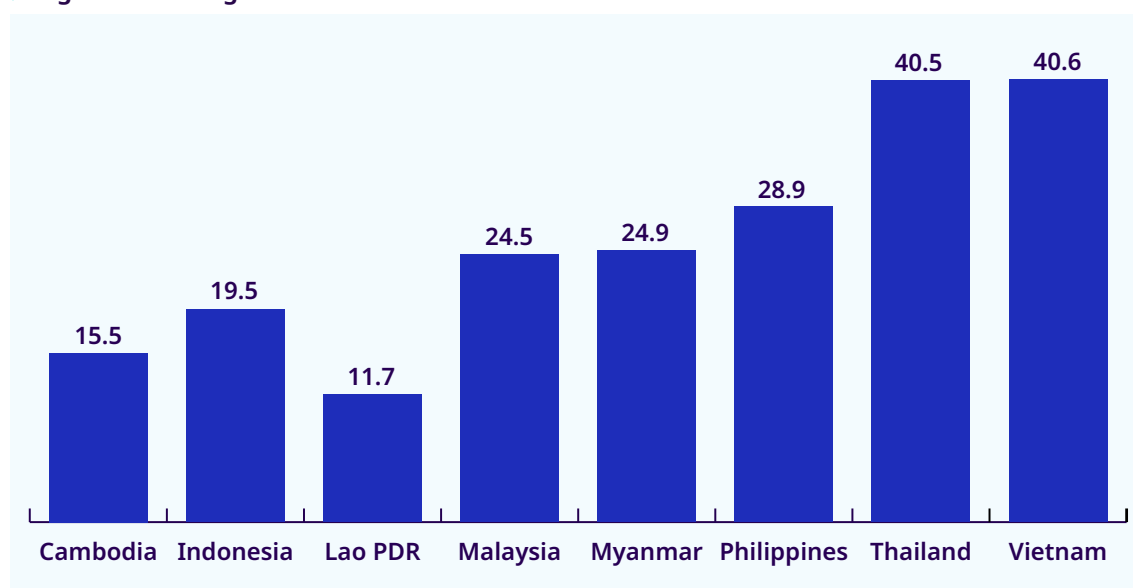
Note: Foreign firms have a foreign ownership share of at least 10 per cent.

Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines and Vietnam; and 2014 data for Myanmar.

Size of domestic firms

The smaller size of Cambodia’s domestically-owned firms could reduce absorptive capacity to internalize spillovers from FDI. Firm size has been positively related to a domestic firm’s capacity to absorb FDI spillovers (Jordaan 2011; Farole and Winkler 2014a). Larger firms may (1) be in a better position to compete with multinationals and adopt their tools (Crespo and Fontura 2007); (2) pay better wages and therefore find it easier to attract workers who have been employed by multinational firms; and (3) be more visible, perhaps organized in associations, and thus more likely to be selected as local suppliers by foreign firms (Farole, Staritz and Winkler 2014). According to the Enterprise Surveys, Cambodian-owned firms employ on average 15 full-time workers, a figure that is among the lowest in ASEAN and in sharp contrast to Vietnam and Thailand, where domestic firms employ on average 40 people (Figure 47).

► Figure 47. Average number of full-time workers in domestic firms



Source: World Bank Enterprise Surveys. 2016 data for Cambodia, Lao People's Democratic Republic and Thailand; 2015 data for Indonesia, Malaysia, Philippines and Vietnam; and 2014 data for Myanmar.

Assessment

In summary, foreign investors in Cambodia seem to have a low linkage and spillover potential, while initial analysis also suggests a low absorptive capacity by domestic firms to internalize FDI spillovers. The spillover potential of foreign investors is limited not only because of their low sourcing intensity and coverage, but due to their low technology intensity, their countries of origin, the low share of local ownership, and the lower coverage of firms offering training to their workers. Initial analysis suggests that the domestic firms' absorptive capacity is relatively low given their large technology gap and small firm size. It is too early to assess the domestic firms' absorptive capacity, as other factors at the domestic firm level, such as the share of skilled workers, firm location, export behaviour, and sector competition, could all influence their capability to internalize FDI spillovers. In view of the reduced spillover potential of FDI and low absorptive capacity of domestic firms, the next sections focus on existing policy interventions, programmes and projects to strengthen linkages in Cambodia (section 4), country examples of successful linkage development and lessons learned (section 5), and possible strategies and policy options that can help strengthen linkages in Cambodia (section 6).



ព្រឹត្តិបត្រកម្ពុជា



ក្រុមបាល់ទាត់ស្រីសាលាប្រឹក្សាភិបាលក្រុងភ្នំពេញ



ក្រុមបាល់ទាត់ស្រីសាលាប្រឹក្សាភិបាលក្រុងភ្នំពេញ



ក្រុមបាល់ទាត់ស្រីសាលាប្រឹក្សាភិបាលក្រុងភ្នំពេញ



ក្រុមបាល់ទាត់ស្រីសាលាប្រឹក្សាភិបាលក្រុងភ្នំពេញ

► 4. Existing practices to strengthen linkages in Cambodia

This section reviews existing practices for strengthening foreign and domestic investor linkages in Cambodia. As many of these practices in Cambodia do not explicitly target investor linkages, this review also focuses on practices that are aimed at attracting foreign investors and strengthening the absorptive capacity of local firms which are, in turn, prerequisites for successful linkage development. Section 4.1 focuses on policy interventions, in particular, Cambodia's IDP 2015-25, the NSDP 2019-23 (GC 2019a) and the Trade Integration Strategy (TIS) 2019-23 (GC 2019b), followed by a review of select programmes and projects that have been initiated by development agencies in section 4.2.

In response to Covid-19 and the partial withdrawal of “Everything but Arms” (EBA) status by the European Union (EU) due to human rights concerns, Cambodia’s government issued several measures to support the economy. While some measures such as the consumer protection law¹⁶ and direct financial aid to workers are intended for Cambodian consumers and workers, others aim to mitigate the negative impact of Covid-19 on businesses, mainly in the form of tax exemptions or delays. They will be discussed as part of the different types of policy measures below.¹⁷

4.1 Policy interventions

Current investment policies

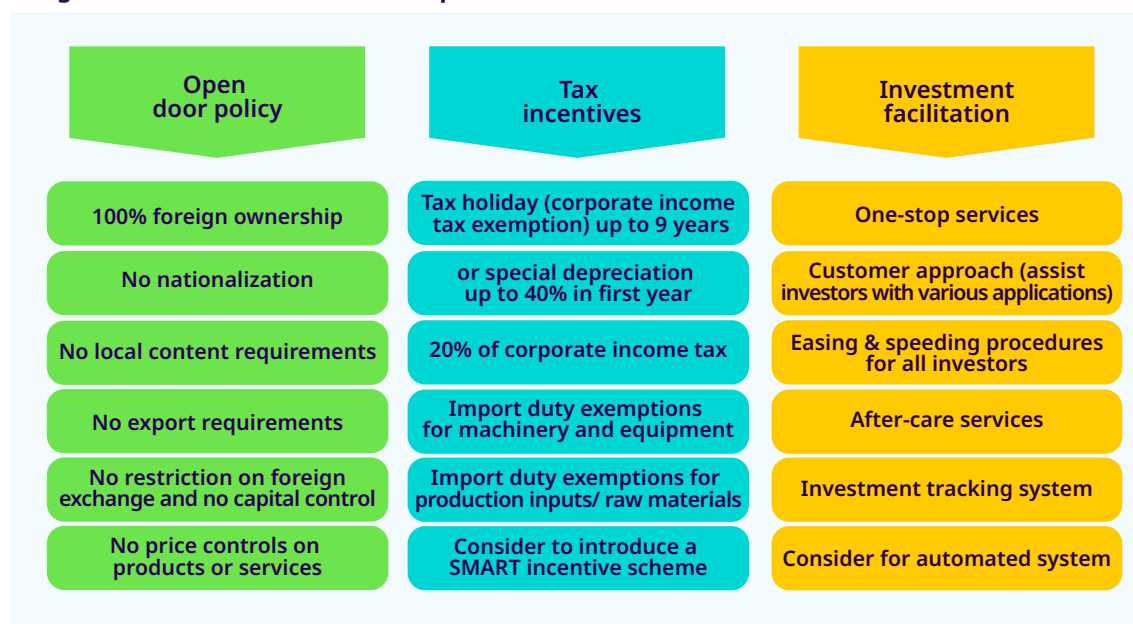
Cambodia’s investment policies show a strong focus on promoting foreign investment but have not integrated linkage development as a priority. Investor attraction is based on three pillars: an open-door policy, tax incentives and investment facilitation. The open-door policy does not impose restrictions on the extent of foreign ownership, country of origin, local content, and export status, among others. Tax incentives include tax holidays or special depreciation, low corporate income tax, exemptions from import duty taxes on machinery and equipment and inputs and raw materials. Finally, investment facilitation focuses on easing and speeding procedures, including offering One-Stop Services and assisting customers with several applications (Customer Approach), but also aftercare services and an investment tracking system (Vuthy 2016). The FDI policy framework, however, does not include policies that target linkage development (Figure 48).¹⁸

16 The consumer protection law excludes goods and services received for the use in production chains and thus does not directly affect linkage development. A translated copy of the law which was passed by the National Assembly of Cambodia on 08 October 2018 can be accessed [here](#).

17 See US Department of State, “2021 Investment Climate Statements: Cambodia,” 2021.

18 More detailed information on investment incentives can be found in the website, [Council for the Development of Cambodia](#).

► Figure 48. Cambodia's investment policies



Source: Vuthy (2016, slide 4).

Policy measures to develop linkages and support priority sectors

Cambodia's IDP 2015-25 has formulated several policy measures and action plans to attract foreign investors, some of which specifically address linkage development. Attracting FDI and mobilizing domestic private investment for industrial development, development and expansion of the export market, and promotion of technology development and transfer, is the first key strategy formulated in the NIP 2015-25. The NSDP 2019-23 formulates the need to connect SMEs with FDI and specifically aims to substitute imports with domestic production. One action plan to promote linkage development is to organize cross-sector meetings between producers, suppliers and marketers and requiring the participation of the public sector (ministries and agencies) and private sector (Chamber of Commerce, Chamber of Employment, associations, unions and enterprises).

Measures for FDI attraction aim to generate domestic value addition and positive externalities for the development and attraction of new industries. Acknowledging that spillovers are dependent on both foreign investor and domestic firm characteristics, the IDP 2015-25 targets specific source countries, priority sectors, as well as high-potential SMEs, which could include investment support to modernize their production chains to enable linkages to MNEs. Action plans also include improving investment-related services such as access to information and aftercare services, cooperating with foreign investors (e.g. from Japan, Republic of Korea and Singapore) to create joint skills training centres, considering the provision of additional incentives for investment projects that focus on skills training, research and development, innovation, and reassessing the incentives given to foreign versus domestic firms in SEZs. In addition, the Government of Cambodia assesses whether the creation of industrial parks for SMEs could promote linkages between foreign and domestic firms. The NSDP 2019-23 plans to engage in consultations and study tours to explore the design of such industrial parks for SMEs, in particular, in the context of regional integration with Thailand or Vietnam.

Cambodia has identified several priority sectors with high linkage potential, including agribusiness, apparel and tourism. The Government defines its role as a facilitator to provide overall

coordination and guidance based on the country's competitive advantage, and to encourage use of the full potential of available resources. In this context, several priority sectors have been selected, including agribusiness, apparel and tourism. The agribusiness sector, in particular, is considered a channel through which SMEs can be developed and modernized. The IDP 2015-25 addresses the need to increase backward linkages in the apparel sector (that is, more local sourcing), but also emphasizes the potential of forward linkages in these three sectors.¹⁹

More recently, the TIS 2019-23 suggested to promote light manufacturing sectors outside of apparel and agribusiness such as bicycles, toys, sports goods, electrical and electronic components, machinery and fabricated parts and packaging materials. The TIS specifically suggests the promotion of SEZ-SME supplier linkages by establishing a sub contract exchange between buyers (such as foreign investors) and domestic suppliers. To ensure the required technical SME capacity, a trusted third party (such as an industry association or an SME promotion agency) could be responsible for the profiling of SMEs and matchmaking with potential buyers.

During the Covid-19 pandemic, the Government acted quickly and put in place stimulus measures in February 2020 to support businesses operating in Cambodia's key sectors. The planned implementation of a capital gains tax of 20 per cent was postponed from January 2021 to January 2022.²⁰ Apparel and footwear firms were granted a tax holiday for up to one year, as they were hit particularly hard through input supply shortages and the partial EBA suspension by the EU. In addition, the rules to import inputs and components for apparel production were to become easier. In the tourism sector, hotels and guesthouses in the Siem Reap province were granted a tax break due to the lower inflow of tourists. To relieve the agribusiness sector, the Government allocated funds that SMEs could access in the form of low-interest loans.²¹ As of June 2021, eight additional stimulus measures have followed and continued to focus predominantly on the apparel and tourism sectors. They included extensions of tax holidays to hotels and guesthouses in more provinces, financial aid to workers in tourism and apparel, and financial support to related industries (aviation, transportation, logistics).²²

Policy measures to attract investors

The majority of policy measures to attract foreign investors to Cambodia aims to improve the country's investment climate. FDI promotion is to be achieved through a focus on (i) improving the investment climate and (ii) developing competitive spaces (SEZs, industrial zones, among others). Several action plans have been formulated in the IDP 2015-25 and the NSDP 2019-23 plans to further implement them. However, other areas that could maximize the potential benefits of FDI, including the characteristics of foreign investors or the absorptive capacity of domestic actors, are not adequately addressed. The TIS 2019-23 nevertheless recognizes the need to promote investments in light manufacturing spillover potential by taking into account specific criteria to select quick investment projects, in particular their potential to create value addition and SME linkages. The investment climate will be targeted by reviewing and amending existing regulations, improving the regulatory framework to strengthen the governance

19 In addition, the IDP 2015-25 targets (i) new industries or manufacturing that have the potential to penetrate markets, contribute high value added, are innovative and highly competitive; (ii) SMEs across all sectors, (iii) agricultural production for both export and domestic markets and (iv) support industries to regional value chains and strategic industries such as information technology and telecommunication, energy, heavy industries, handicraft and green technology.

20 Thou Vireak, ["Capital gains tax postponed until January 1, 2022,"](#) *The Phnom Penh Post*, 22 October 2020.

21 Ayman Falak Medina, ["Cambodia Issues Regulations for Business Impacted by COVID-19 and EBA,"](#) *ASEAN Briefing*, 11 March 2020.

22 Ayman Falak Medina, ["Cambodia issues ninth round of stimulus measures,"](#) *ASEAN Briefing*, 7 July 2021.

and effectiveness of relevant public institutions, strengthening institutional capacity, and establishing and developing industrial infrastructure.

Besides helping improve the investment climate, the development of competitive spaces like SEZs and industrial zones is a key component of efforts to attract investors. As of April 2021, Cambodia had 23 SEZs.²³ Besides SEZs and industrial zones, the Government targets economic corridors and industrial parks, industrial clusters, industrial information technology clusters, agro-industrial clusters, and manufactured/handicraft clusters. The goal is to develop SEZs that meet international standards – in terms of the necessary physical infrastructure and management systems to facilitate the supply of raw materials and other inputs and to enable trade – and large industrial parks that ensure adequate clustering, economic linkages, efficient transport and logistics services, electricity supply and other supporting infrastructure.

Measures to develop competitive spaces focus on strengthening their physical infrastructure, including through more active participation by private investors, their administrative capacity as well as environmental and safety standards. These include the supply of water and electricity, and transportation and telecommunication systems and services, especially in SEZs. In addition, the Government aims to encourage private investors to contribute to investments in physical infrastructure, develop large high-standard SEZs through public-private partnerships, and ensure fair competition and common sector interests. A related measure is to strengthen and streamline the administrative capacity for managing the operations of SEZs. Finally, those measures target clear environmental and safety standards for investment projects located in SEZs and other industrial zones that could also be achieved by encouraging more competition among SEZs in promoting best practices.

The IDP 2015-25 also has measures to improve the regulatory environment and enhance competitiveness, which should increase Cambodia's attractiveness to foreign investors and its potential for linkage development. Improving the legal environment to enhance competitiveness, as a key strategy of IDP 2015-25, is to be achieved through improving the investment climate and promoting trade facilitation, providing market information, and reducing business-related transaction costs, which also includes better cooperation and broader coordination among relevant authorities. Measures to improve the regulatory environment centre around (i) trade facilitation and export promotion, (ii) industrial standards and property rights, (iii) facilitation for payment of tax and excise, and (iv) labour market development and industrial relations. All of these areas, in particular trade facilitation, can be expected to improve Cambodia's attractiveness to foreign investors, while export promotion and standards compliance increase the potential for linkages between foreign investors and competitive domestic firms.

Facilitating trade and promoting exports, in particular, are important measures for attracting investors in the context of GVCs. Suggested trade facilitation measures include the implementation of the trade facilitation reform plan and the utilization of the National Single Window Service at all international border checkpoints and its integration with the ASEAN Single Window Service, as well as the implementation of the Cross-Border Transport Agreement by the countries of the Greater Mekong Subregion (Cambodia, China, Lao People's Democratic Republic, Myanmar, Thailand and Vietnam). They also include the establishment of trade information centres, improvement of customs clearance procedures for tax-exempt goods, reduction and abolition of repetitive and non-transparent procedures, and improvement of the efficiency of the national and regional logistics system. Proposed export promotion measures focus on building the necessary national institutional capacity (e.g. for the General Department of Trade Promotion of the Ministry of Commerce to function as an export promotion agency), offering access to information and knowledge sharing as well as access to finance and providing reward programmes to exporters particularly in priority industries (IDP 2015-25).

23 US Department of State, [“2021 Investment Climate Statements: Cambodia,”](#) 2021.

Policy measures to strengthen absorptive capacity

Apart from attracting foreign investors, several action plans in the IDP 2015-25 are aimed at strengthening the absorptive capacity of domestic firms, in particular SMEs. A key strategy of the IDP 2015-25 is to develop and modernize SMEs. Several objectives have been identified, including expanding and strengthening the manufacturing base, modernizing and officially registering enterprises, promoting technology development and transfer, and strengthening industrial linkages between domestic and foreign enterprises specifically in the agro-industrial sector. The NSDP 2019-23 aims to build on these efforts to promote SMEs and to prepare a SMEs Development Policy and a five-year implementation plan.

SME financing and formal registration are necessary, but insufficient, conditions for domestic firms to create linkages to investors. In 2020, Cambodia established its SME bank aiming to support the growth of local SMEs which was also formulated as part of the NSDP 2019-23. SMEs of a minimum size or income can access low-interest loans for both working and investment capital.²⁴ The SME Bank targets sectors that are consistent with the IDP 2015-25 sector prioritization. Similarly, the IDP 2015-25 includes action plans to facilitate the formal registration of Cambodian enterprises, in particular, SMEs, and to build entrepreneurial capacity. However, other policy measures that strengthen domestic firms' capacity to link to investors and internalize spillovers, including promoting technology development and transfer, developing skills and enabling knowledge sharing, and improving industrial standards and property rights, are key to promote linkages.

Technological development and skills building are at the forefront of the Government of Cambodia's supporting policy measures and are also in line with Goal 2 of the NEP 2015-25. This goal seeks to "enhance skills and human resource development", which is to be achieved through the development of soft skills, better access to and quality of education and training (including technical and vocational), and better matching of education and training to the actual needs of the labour market (GC 2015a).

Technology development and transfer hinge on the existence of high-education institutions to absorb knowledge and promote market-driven technological innovation. The IDP 2015-25 targets capacity building in subjects such as science, technology, engineering and mathematics and those linked to the target sectors. Other policy measures to increase technological innovation include field visits, tapping into foreign technology, creating awards for technology innovation, and exploring the creation of science and technology parks. The TIS 2019-23 suggests fostering innovation linkages between light manufacturing firms and local universities and research centres.

Several regulations already target linkages to the local workforce and vocational training in the context of SEZs, but cover a tiny fraction of the Cambodian workforce. Cambodia's SEZs are almost exclusively privately owned and managed. Article 11 of the SEZ Sub-Decree limits the percentage of foreign managers, technicians or experts in SEZs (to 10 per cent). In addition, Article 12 requires zone developers to cooperate with the Ministry of Labour and Vocational Training to facilitate the training of Cambodian workers and employees and to promote new knowledge and skills through specific and effective programmes (Warr and Menon 2015). Both articles seem to target linkages to the local workforce and vocational training. However, SEZs in Cambodia account for less than 1 per cent of total employment and only 3.7 per cent of industry employment, going by 2014 data. By contrast, Cambodia's apparel sector, mostly outside the SEZs, takes up 38 per cent of industry employment (Warr and Menon 2015).

In addition, the IDP 2015-25 formulates several action plans to build skills and enable knowledge sharing that go beyond SEZs. The building of skills of the current workforce is to be achieved through a combination of training initiatives, including on-site technical and vocational training of factory workers,

24 Thou Vireak, ["SME Bank Officially Launched,"](#) *The Phnom Penh Post*, 5 April 2020.

promotion of trilateral training “government-training institutions-companies/factories”, and training scholarships. The future workforce can benefit from technical skills training through secondary and higher education as well as through apprenticeship schemes. In addition, knowledge and information sharing is promoted through the formation of sub-sectoral associations.

Technological and skills development, along with the capacity building of standard-setting national institutions, helps implement industrial standards and property rights which, in turn, strengthens the domestic firm’s competitiveness and fosters linkage development. Standards implementation, in particular with regard to quantity, quality, safety, service, environment and management, can serve as a tool for promoting competitiveness and attracting the interest of entrepreneurs, including foreign investors, and ultimately foster linkage development. This also requires improving the capacity, competency, and international recognition of key national institutions such as the Institute of Standards of Cambodia and National Metrology Centre. It also requires developing the necessary institutional and regulatory framework.

Assessment

While the government’s stimulus measures during Covid-19 mainly aim to provide financial relief to businesses and workers, the policy measures that focus on linkage development and investor attraction in the IDP 2015-25 and further implemented in the NSDP 2019-23 require a more nuanced approach. Several initiatives take into account investment characteristics, in particular with regard to the investors’ potential to offer skills building. However, a more nuanced approach is needed to assess investment projects in terms of their linkage and spillover potential, as the spillover potential can vary significantly across investors (Figure 3). The TIS 2019-23 recognizes this need in its recommendations to select investment projects in terms of their linkage and spillover potential for light manufacturing sectors.

In the context of GVCs, the foreign investor’s global production and sourcing strategy is a key determinant in prospects for local procurement. In terms of investor attraction, Cambodia’s IDP 2015-25 considers to provide additional incentives for investment projects that focus on skills training, research and development, and innovation – but incentives could also be offered for other types of spillovers, especially local procurement. For instance, it would be important to actively target investors that operate in sectors that rely on localized inputs (e.g. food processing), offer complementary technology, knowledge or services (e.g. design services to upgrade apparel GVC), allow for larger domestic participation in its ownership (e.g. through joint ventures), and have experience in establishing and developing local suppliers (see more detailed discussion in section 6).

Policy objectives identified in the IDP 2015-25 also address many aspects of local actors’ absorptive capacity and the institutional capacity, but some areas for improvement remain. Measures to strengthen the absorptive capacity specifically target SMEs and include the establishment of a SME Bank, the facilitation of formal registration, the promotion of technology development and transfer, the development of skills and enabling knowledge sharing, and the improvement of industrial standards and property rights. Capacity building measures to help SMEs link to foreign firms, for instance, should go beyond the modernization of production chains, and include the building of technical and management skills. Initiatives that target linkages in the context of SEZs should be extended to non-SEZs given the small size of the Cambodian workforce in SEZs. Finally, initiatives that target linkage development could be embedded in a more comprehensive supplier development programme, one that goes beyond the traditional measures of matchmaking or aftercare services (see more detailed discussion in section 6).²⁵

²⁵ While the implementation of some parts of the IDP 2015–25 is delayed, the Government of Cambodia could review and, if necessary, revise the objectives specifically with regard to linkage development.

4.2 Programmes and projects

This section illustrates a number of programmes and projects in Cambodia that focus on building the capacity of domestic firms, farmers and workers, and in a few cases, of linkage development to international markets. These examples, which serve illustrative purposes and are by no means representative, include numerous initiatives in upstream activities such as in agribusiness, where Cambodia has strong value-adding potential. They also capture initiatives that focus on the production segment of the apparel value chain, such as the Better Factories Cambodia programme. Some initiatives can be found in downstream activities that are closer to final demand, including training programmes in tourism that link the informal and formal tourism sector, but also initiatives that help domestic firms access export markets. The highest number of initiatives can be found in the agribusiness sector. The Lower Mekong Food Security database by the Mekong Institute lists 66 agricultural market and trade sector projects in Cambodia alone, compared with 53 in Vietnam, 34 in Lao People's Democratic Republic, 22 in Myanmar and 7 in Thailand, most of which have been completed.²⁶

Facilitating exports

The Export Market Access Fund was a technical assistance-matching grant facility aimed at encouraging small firms to become exporters. It was implemented in 2005 by the Ministry of Commerce and funded by the World Bank until 2009 as part of its Trade Facilitation and Competitiveness Project. The fund did not target specific sectors, but offered grants in response to private sector demand on a non-discriminatory and a first-come, first-served basis. The majority of small firms were from agriculture and food processing (41 per cent) and fashion and handicrafts (24 per cent). The grants covered 50 per cent of the cost of achieving market standards or evidence of compliance with those standards. Supported activities included research on new markets and products, attendance at trade shows, and obtaining certifications to access new export markets. While the number of new exporters created fell way below the target, the Export Market Access Fund was successful in opening new markets and encouraging new exporters. The number of firms preparing export development plans, in particular, exceeded the targets (Table 12).²⁷ This finding is important because exports have been shown to strengthen a domestic firm's absorptive capacity to benefit from FDI spillovers (Figure 3).

To overcome the constraints on small businesses caused by Covid-19, the United Nations Development Programme (UNDP), supported by the Australian Government, has initiated the "E-commerce Acceleration Programme" with the goal to accelerate Cambodia's e-commerce and access larger markets within and across borders. This programme supports 1,000 MSMEs in different sectors such as food, consumer products and transportation, to sell their goods and services on e-commerce platforms and offers training to build their digital skills. The programme also targets 1,200 small household farmers by facilitating their access to supplies, technical information and trade credit through an agri-tech platform.²⁸

26 Mekong Institute, "[Market and Trade Sector Projects in Cambodia](#)," Lower Mekong Food Security Database, accessed 15 July 2017.

27 Emerging Markets Consulting, "[Export Access Market Fund](#)," 21 February 2014.

28 United Nations Development Programme, "[E-commerce acceleration and formalization of MSMEs](#)."

4.3 Agribusiness

A large number of initiatives in Cambodia's agribusiness sector helps strengthen farmers and firms and link them to international firms and markets. The majority of programmes or projects focus on capacity building in selected target sectors and many are funded by development agencies in industrialized countries. In some cases, the programmes or projects are implemented by the Government of Cambodia. The ASEAN Sustainable Agrifood Systems, for example, aims to provide solutions for long-term food security in the region and to promote cross-border value chains.²⁹ The Cambodia Agricultural Value Chain Programme focuses on improving farmers' incomes by increasing the value of agricultural production.³⁰ Cambodia's Agribusiness Development Facility, by contrast, focuses on sustainable improvement of non-rice value chains such as commercial horticulture farmers and pig raisers.³¹ The Rice Sector Support Project aims to help farmers access higher-value seed varieties and increase the efficiency and yield of their farms (Table 12).³²

Apparel

A well-known programme in the apparel sector is Better Factories Cambodia, one of the first Better Work Programmes. Designed and implemented by the International Labour Office in 2001, it was expanded three years later in cooperation with the International Finance Corporation. The huge programme currently includes 59 global brands and retailers, 557 factories and over 600 000 workers. Linkage development happens through three main channels: (i) advisory factory visits that include one-on-one meetings with factory managers to identify compliance and other issues and establish the means of improvement, (ii) training courses for factory managers, supervisors and workers, including detailed instructions on problem solving to create safer and better working environments, constructive workplace relations, and effective systems, and (iii) comprehensive assessment of a factory's progress in complying with international labour standards and national labour laws, which is a legal requirement for apparel-exporting factories in Cambodia (Table 12).³³

Tourism

The High-Impact Tourism Training offers formal training programmes to the informal tourism sector and strengthens links to formal sectors. Established in 2005 by the SNV Netherlands Development Organisation, it aims to offer formal training to the informal tourism sector and strengthen links to formal sectors. After extensive market research and analysis, two target groups were selected, namely (i) food and beverage service attendants due to their high turnover rates and underpayment, and (ii) room attendants due to a high skills gap. High-Impact Tourism Training offers vocational training courses to teach cleaning, greeting, soft skills, bed preparation and basic English. The course consists of two core modules on excellence in services and professional hospitality, as well as specific modules for the target groups (Table 12).

29 Sector Network Natural Resources and Rural Development Asia and the Pacific, ["ASEAN Sustainable Agrifood Systems \(ASEAN SAS\)."](#)

30 CARDNO, ["Cambodia Agricultural Value Chain Program \(CAVAC\)."](#)

31 IDE, ["Farming is a Business."](#)

32 International Finance Corporation, ["Transforming the Rice Industry and Building Export Capacity in Cambodia."](#)

33 Better Work, ["Better Factories Cambodia: Our Services."](#)

► Table 12. Select programmes and projects in Cambodia to build capacity and promote linkages

Name	Organization	Date	Sector	Goal	Capacity building /linkage development	Coverage	Actual and expected impacts
Export Market Access Fund	Implemented by the Ministry of Commerce and funded by the World Bank (Trade Facilitation and Competitiveness Project)	2005-09	agriculture & food processing (41%), fashion & handicrafts (24%), tourism (9%), IT (9%), and healthcare & beauty (6%)	encourage small firms to become exporters through the provision of technical assistance and matching grants to promote products overseas	grant covering 50% of the cost of achieving market standards or evidence of compliance with those standards, e.g. through research on new markets and products, attendance at trade shows, and obtaining certifications to access new export markets	75 firms and business associations, 65% were Cambodian owned	successful in opening new markets and encouraging new exporters, with the number of firms preparing export development plans exceeding the targets
E-commerce Acceleration Programme	United Nations Development Programme (UNDP) and supported by the Australian Government	2019-13	different sectors such as food, consumer goods and transportation	accelerate Cambodia's e-commerce, access larger markets (within and across borders) for inputs and sales, access information	e-commerce training workshops have been developed to build the digital capacity of small businesses	1,000 MSMEs, 1,200 small rice and vegetable farmers in five provinces	on-boarding MSMEs and farmers to digital platforms to sell products and services online, purchase inputs and access information
Better Work Programme / Better Factories Cambodia	ILO and International Finance Corporation	2001	apparel	strengthen labour and safety standards and boost profitability	advisory factory visits, training courses for factory representatives, and industry seminars	covers 49 global retailers, 557 factories and almost 550 000 workers	increased compliance with ILO core labour standards and national labour law, more income for households with apparel workers, reduction of gender wage gap

Name	Organization	Date	Sector	Goal	Capacity building /linkage development	Coverage	Actual and expected impacts
ASEAN Sustainable Agrifood Systems	German International Cooperation	2013-17	agribusiness	provide solutions for long-term food security in the region and promote cross-border value chains	technical support for the (i) development of regionally-coordinated policies and strategies for sustainable agriculture, (ii) resource-saving and environmentally-friendly production technologies, and (iii) practices and promotion of cross-border value chains in collaboration with public decision-makers, agricultural enterprises as well as farmers and private associations	n/a	n/a
Cambodia Agribusiness Development Facility	managed by International Development Enterprises (IDE) and funded by New Zealand Aid Program	2010-13	agribusiness (vegetables, swine, sericulture, fruit trees)	sustainable improvement of non-rice value chains	improving access to technical assistance, market information, quality inputs, and new technologies to strengthen the value chain that links all of the agricultural market players together	commercial horticulture farmers and pig raisers in two provinces	5 158 (1 832) total commercial horticulture, farmers (pig raisers) reached and US\$754 (US\$1 066) average increase in net annual income from horticulture (pigs)
Cambodia Agricultural Value Chain Program	Australian government working with Cambodian ministries	2007-15	agribusiness (rice, fruit and vegetable value chains in three provinces)	improve farmers' incomes by increasing the value of agricultural production	strengthening market connections, promoting greater investment and adding value along specific product value chains that link suppliers, farmers and consumers	smallholder farmers in three provinces	constructed 20 irrigation schemes that now deliver year-round water to over 19 000 households; work with firms to help disseminate up-to-date advice on the use of fertilizer and help 10 000 farmers access modern technologies

Name	Organization	Date	Sector	Goal	Capacity building /linkage development	Coverage	Actual and expected impacts
Rice Sector Support Project	Implemented by International Finance Corporation, co-funded by the European Union and Enhanced Integrated Framework	2012-16	rice	work with and through local millers to help farmers access higher-value seed varieties and increase the efficiency and yield of their farms	(i) advising rice millers on equipment and technology upgrades to improve efficiency and quality, introducing food safety management systems and certification, strengthening management through the use of mill software and financial literacy training; (ii) developing and implementing a strategy to increase rice exports, especially for high value, aromatic rice products, supporting rice industry associations in building capacity of exporters, strengthening brand identity of Cambodian rice on the international market by participating in international rice events	100 medium-sized and large rice millers and exporters in eight provinces	built the capacity of Cambodian rice millers and exporters to participate in international trade fairs and market their products successfully; improved the international perception of Cambodia's rice, resulting in the country's premium jasmine rice winning the "World's Best Rice" award in 2012-2014; significantly increased high-quality rice exports; certified 11 rice millers
High Impact Tourism Training	Established by SNV Netherlands Development Organisation, funded by European Commission	2005	tourism	offer formal training programs to the informal tourism sector and strengthen links to formal sectors	vocational training course to teach cleaning, greeting, soft skills, bed preparation and basic English	food & beverage service attendants, room attendants	workers will be able to access higher wages, valid contracts and workers' rights

Source: Own compilation. See footnotes of section 4.2 for underlying sources.



► 5. Country examples of successful linkage development

This section gives country examples of successful linkage development. Section 5.1 reviews successful government initiatives that promote linkages between foreign investors and local suppliers, which either take the form of targeted supplier development programmes or aim to increase the competitiveness of local suppliers in the context of broader programmes for industrial upgrading. Section 5.2 illustrates several private-sector initiatives that focus on linkage development and building the absorptive capacity of local suppliers, e.g. through training, as well as initiatives by public-private partnerships. The distinction between public and private initiatives is sometimes blurry, as government programmes often integrate with the private sector to various degrees. This section aims to identify the driving forces behind these initiatives.

5.1 Government initiatives

Given that there are many government initiatives promoting linkages, this section narrows the focus to regional partners and successful examples outside ASEAN that are relevant to Cambodia's context. The following examples focus on initiatives that target the development of linkages between foreign investors and SMEs, but may also include successful programmes that focus on strengthening the capabilities of SMEs. They cover examples from Malaysia, Singapore, and Thailand, as well as from countries like Brazil, Chile, Costa Rica, Mexico, South Africa, Sri Lanka, and Uganda. This section excludes policy measures aimed at attracting FDI, as these are typically similar across countries and encompass fiscal incentives³⁴, the development of competitive spaces (e.g. SEZs or clusters), and an improvement of the investment climate (e.g. infrastructure).

Traditional initiatives focus on matchmaking, information exchange, supplier databases or after-care services. Matching services by investment promotion bodies, as illustrated in the following country cases, play an important role for potential linkage development – even in the pre-investment phase. These include databases and directories that contain detailed information on available domestic SMEs and their capabilities. In some cases, specific government programmes can assist in foreign investors' research efforts to identify local suppliers and provide them with more detailed evaluations of their capabilities (UNCTAD 2011). Aftercare services are also important as reinvestment plays a large role, and include, collecting feedback from existing investors to help ensure investor satisfaction (Tuomi 2012). The following examples show that those countries that went beyond traditional initiatives were more successful in creating linkages to foreign investors.

Singapore

Combined government efforts to strengthen the competitiveness of SMEs and skills building helped Singapore develop linkages to foreign investors in a natural way, although the government also specifically implemented programmes on linkage development. Singapore's focus on

³⁴ Fiscal incentives include reduced corporate tax rates – overall or for certain sectors or regions – tax holidays, investment tax allowances/credits, accelerated depreciation, input sales tax credit, loss carry forward, export/import incentives and subsidies/grants (Tuomi 2012).

strengthening SMEs through financial support and capability development programmes since the late 1970s has enabled the development of natural linkages between foreign investors and SMEs in various sectors. This was supported by government programmes to build skills and strengthen the domestic SMEs' absorptive capacity to internalize FDI spillovers. In an effort to maximize spillovers, the Government of Singapore implemented linkage development programmes such as the Local Industry Upgrading Program of 1986 (UNCTAD 2011).

Singapore's Local Industry Upgrading Programme enabled FDI spillovers to SMEs through technology transfer and knowledge sharing. Foreign investors are encouraged to buy from local suppliers, a process that involves the government's provision of incentives through financial and organizational support to both these participants. The programme has three phases: phase 1 focuses on improving the overall operational efficiency of SMEs, phase 2 on transferring new products or processes to SMEs, and phase 3 on joint product, process research and development with the foreign partner (Table 13). The Local Industry Upgrading Programme has helped SMEs establish many linkages to foreign investors, upgrade their capabilities through technology transfer and knowledge sharing (e.g. related to marketing practices and business processes), and generate productivity gains. Hewlett Packard, for example, helped FJ Industrial build production sites with the necessary equipment for process control and sanitized rooms to manufacture switches and circuits for HP's calculators and computers, as well as trained FJ Industrial's manager and engineer at a factory in Los Angeles, United States (UNCTAD 2011).

The Government of Singapore's flexible approach in terms of its support system and sector focus allows the programme to target the specific needs of all participants. The Local Industry Upgrading Programme (LIUP) offers a variety of organizational and financial support measures for upgrading supplier relationships, such as government contributions to the salaries of foreign-affiliate representatives seconded to local suppliers (Table 13). Local suppliers are also encouraged to follow their multinational customers to other locations, especially in South-East Asia. Although it initially focused on the electronics sector, the programme later expanded to cover other sectors, including information technology and aerospace (UNCTAD 2011).

► **Table 13. Singapore's Local Industry Upgrading Programme**

Objectives	► Upgrade, strengthen and expand the pool of local suppliers to foreign affiliates by enhancing their "efficiency, reliability and international competitiveness" ► Provide support for local suppliers to upgrade through collaboration with MNCs ► Encourage local suppliers to expand internationally
How it works	The LIUP has three phases of implementation: ► Phase 1: Improvement of overall operational efficiency, such as production planning and inventory control, plant layout, financial and management control techniques ► Phase 2: Introduction and transfer of new products or processes to local enterprises ► Phase 3: Undertaking of joint product and process research and development with foreign affiliates' partners
Incentives for investors	► A variety of measures around organizational and financial support for upgrading vendor relationships (e.g. contributions to salaries of foreign-affiliate representatives seconded to local suppliers).

Source: UNCTAD (2011, p. 49).

Malaysia

To boost the capacity of SMEs in the manufacturing sector, the Government of Malaysia initiated several linkage development programmes in the late 1980s, including the early Subcontractor Exchange Programme and Vendor Development Programme. These aimed to encourage investors to source from local suppliers. While the Subcontractor Exchange Programme focused on export-oriented investors, the Vendor Development Programme targeted the Malaysian carmaker Proton. The Vendor Development Programme gave local suppliers preferential rights to supply parts, components and inputs to Proton, which served as the anchor firm. Its main objective was to provide opportunities for local SMEs to participate in subcontracting arrangements and other joint-venture related activities, and to develop and strengthen SME performance (Table 14). However, Malaysian-owned SMEs supplying Proton lacked the capacity to deliver the required product quality, which subsequently threatened Proton's image as an automotive producer and undermined the success of the automotive sector. This prompted Proton to look for other suppliers, while local SMEs stopped growing due to increased competition in the automotive-supplier sector (UNCTAD 2010, 2011).

Expanding the scope of the original Vendor Development Programme to non-domestic SMEs in the mid-1990s helped the programme improve results. While the original Vendor Development Programme allowed only Malaysian-owned SMEs to participate, changes were introduced in the mid-1990s to allow non-domestic SMEs located in Malaysia to take part in it as well. Several Chinese-owned suppliers in Malaysia have since benefited from the Vendor Development Programme. It also started to target non-automotive sectors, such as electrical and electronics. It remains relevant for linkage development in Malaysia (UNCTAD 2010, 2011), although its emphasis has shifted to the creation of innovative SMEs (Ohno and Ohno 2016).

► **Table 14. Malaysia's Vendor Development Programme**

Objectives	► Provide opportunities for SMEs to participate in subcontracting arrangements and other joint-venture related activities ► Develop and strengthen SME performance as manufacturers and suppliers of components, input materials, machinery, parts and supporting services to large corporations and MNCs
How it works	► Vendors supply components and spare parts to the anchor companies - the large local corporations or MNCs operating in Malaysia. ► In return, the anchor companies are directly involved in the development of the SME, particularly through technology transfer and by providing a stable market. ► This long-term contract will enable the vendors to grow into large corporations and penetrate the international market.
Incentives for SMEs	► The anchor company provides a market for the SME products and technical facilities to the vendors, such as in the areas of training and quality improvement. ► The government provides soft loans and other types of financial support.
Incentives for investors	► Anchors do not receive financial assistance under this program.

Source: UNCTAD (2011, p. 22).

More recent SME-linkage programmes in Malaysia, including the Industrial Linkage Programme and Global Suppliers Programme, were more successful. Besides promoting linkages, the programmes support Malaysian and foreign-owned SMEs in overcoming size and scale constraints, accessing information for business and investment decisions, and benefiting from research and development

– through collaboration with investors in production, marketing, and research and development. While the Industrial Linkage Programme targets SMEs that supply investors in Malaysia (Table 15), the Global Suppliers Programme focuses on developing SMEs so that they become competitive suppliers to multinationals in Malaysia and abroad (Table 16). These do not only include investors in the supplier selection and offer them fiscal incentives, such as the possibility to have expenses deducted from taxable income in the process of developing their suppliers, but offer additional support beyond financial assistance, including access to finance, capacity building and expansion to new markets. For example, Malaysia's Small and Medium Industries Development Corporation promotes linkages between Tesco and food processing SMEs, under the Global Supplier Programme, by offering funding for product, quality and process improvements and certification that enable SMEs to link to Tesco's supplier system (UNCTAD 2010, 2011).

Malaysia's approach to linkage development included 'systematic' programmes, whereas Thailand follows a 'network-based approach' to linkage promotion. The Government of Thailand emphasizes linkage development through a variety of organizations and initiatives, but has not designed a systematic programme (Table 17). The Board of Investment Unit for Industrial Linkage Development (BUILD) offers sourcing services to Thai and foreign buyers that are free of charge, including the specification and volume requirements of potential buyers and the arrangement of one-on-one meetings. BUILD also organizes ASEAN's largest annual industrial subcontracting and business matching event (SUBCON Thailand), manages the ASEAN supporting industry database that it developed and offers free of charge, subsidizes Thai firms' attendance of overseas trade exhibitions through its Vendors-Meet-Customers Programme, and is also involved in partner search such as joint ventures (Ohno and Ohno 2016).

► **Table 15. Malaysia's Industrial Linkage Programme**

Objective	► Develop SMEs into competitive manufacturers and suppliers of parts and components and related services to MNCs and large companies
How it works	► Lead companies can claim as tax deductions the expenses incurred in developing SMEs, including training, factory auditing and technical assistance to ensure the quality of vendors' products.
Incentives for SMEs	► Pioneer status with tax exemption of 100 per cent on statutory income for five years and Investment Tax Allowance of 60 per cent on qualifying capital expenditure incurred within a period of five years are provided to eligible SMEs. ► To qualify for incentives, SMEs must manufacture products or undertake activities in the "List of Promoted Activities and Products" in an ILP. They should also be supplying to TNCs or large companies.
Incentives for investors	► Expenses incurred in developing SMEs – such as training, product development and testing, factory auditing and technical assistance to ensure the quality of vendors' products – will be allowed as deductions in the computation of income tax.

Source: UNCTAD (2011, p. 25).

► **Table 16. Malaysia's Global Suppliers Programme**

Objective	► Help SMEs develop into competitive suppliers of parts and components, not only to MNCs in Malaysia but also their worldwide operations through mentoring activities and the linkage initiative of the GSP.
How it works	► The program involves training in critical skills with MNC input into the curriculum, and SME selection criteria. ► It is implemented in collaboration with local skills development centres. SME Corporation has appointed 42 training providers to undertake skills training for SMEs: e.g. Penang Skills Development Centre.
Incentives for SMEs	► SMEs that send their employees to attend courses at any of the training providers will be eligible for 80 per cent training grants from SMIDEC. Remaining costs may be claimed through the Human Resource Development Fund.

Source: UNCTAD (2011, p. 27).

Thailand

While Thailand's BUILD focuses on promoting linkages, its Bureau of Supporting Industries Development (BSID) targets the absorptive capacity of SMEs. This bureau provides technical support and training to Thai-supporting industries; develops prototype products; promotes subcontracting, *Shindan* (SME diagnosis and advice), and industry associations. Since its inception in 1996, the BSID's role has shifted from directly offering technical and managerial support to firms in supporting industries to (i) establishing and managing thematic forums of supporting industries which developed into 12 privately-run industry associations (e.g. design, metal, machinery, foundry, etc.), to (ii) providing partial subsidies for seminars, training, consultancies, projects, through the industry associations, to (iii) creating a summit organization of the 12 associations (Alliance for Supporting Industries Associations) (Ohno and Ohno 2016).

► **Table 17. Linkage promotion initiatives by the Government of Thailand**

Organization	Status	Functions
BUILD (Board of Investment Unit for Industrial Linkage Development)	One unit of the Board of Investment (central FDI agency); established in 1992	FDI-Thai firm matching (e.g. sourcing services, Vendors Meet Customers program, supplier database, annual subcontracting exhibitions)
DIP (Dept. of Industrial Promotion), Ministry of Industry	Ministry of Industry	Designing policies; monitoring implementation and analysing performance
BSID (Bureau of Supporting Industries Development), DIP/Ministry of Industry	Ministry of Industry; one technical bureau of DIP; established in 1996	Providing technical support and training to Thai supporting industries; developing prototype products; promoting subcontracting, <i>Shindan</i> , and industry associations

Source: Ohno and Ohno (2016).

Chile

Chile's export success in the agribusiness GVC (e.g. salmon, wine, horticulture) since the early 1990s can be attributed to the strong role of its export promotion agency, which is the Chilean Trade Commission or ProChile. Impact evaluation studies have acknowledged ProChile's positive and significant influence on Chilean SMEs' export participation, introduction of new products, and firm-level technological and management improvements. While ProChile's measures focused on building direct export linkages to the US market rather than indirect linkages to foreign investors, valuable lessons can nevertheless be derived from these. In order to improve export capabilities of existing and new SMEs, ProChile developed its Internationalization Plan in 2001, which consisted of two training programmes for agricultural (Interpac) and industrial (Interpyme) SMEs (Taglioni and Winkler 2016, Nathan Associates 2004).

The programmes encompass systematic training on export issues that SMEs face. ProChile covers up to 90 per cent of the training costs if participating SMEs have an exportable product for which international demand exists and if they use labour-intensive production methods. The programmes include training parts on production capabilities, market research, logistics, marketing plans, banking, international law, searching for partners and the export process. Participating SMEs receive individualized, one-on-one counselling by private-sector consultants hired by ProChile. Upon their successful completion of the one-year long programme, participants become eligible for ProChile's co-financing programmes under the condition that they have promising export plans (Taglioni and Winkler 2016, Nathan Associates 2004).

Costa Rica

Costa Rica's case is interesting as it created a successful linkage development programme resulting from its weak backward linkages between foreign investors operating in Export Processing Zones (EPZs) and local suppliers. Following earlier attempts to initiate supplier development programmes by private and public organizations, the Supplier Development Project for High-Technology Multinational Companies was created in 1999. Its core objective was to increase the domestic value added created through high-technology MNCs, by strengthening the SMEs' technological capacity to first become suppliers to multinationals in the country and later exporters. This was necessary due to the Costa Rican SMEs' weak capabilities, including, in the areas of technological sophistication, compliance with standards, productive infrastructure, entrepreneurship or financial resources (Groote 2005, cited in Monge-González and Rodríguez-Álvarez 2013). In addition, Costa Rica invested in aftercare services by establishing a High-Technology Multinational Companies Committee to collect feedback from existing investors to help improve the operating environment and ensure investor satisfaction. This is critical, as reinvestments represent a large share of its FDI (Tuomi 2012).

The supplier development programme targeted those SMEs with higher absorptive capacity in three strategic business areas. These were (i) information and communication technology, electrical and electronics, and metal mechanics, (ii) medical, chemicals, pharmaceuticals, and (iii) agribusiness and textiles. The programme consisted of the following components: (i) a Procurement Pilot Programme, with 45 successful linkages between SMEs and MNCs as the main goal over three years, (ii) an Integrated Information System to manage supply and demand data from SMEs, MNCs and supporting organizations, and (iii) the creation of Costa Rica Provee, a National Supplier Development Office, which identifies the MNCs' requirements and matches demand with local suppliers, and also facilitates small projects between SMEs and multinationals. Over time, local procurement arrangements have become less stringent and now allow, for example, contracts with different suppliers or contract lengths that exceed one year (Monge-González and Rodríguez-Álvarez 2013).

Besides the higher number of linkages in Costa Rica, an impact evaluation study also finds positive effects for labour value added and exports. The number of new backward linkages registered by Costa Rica Provee increased from one in 2001 to 248 in 2011, leading to a total of 1,355 linkages over the entire period. In addition, an impact evaluation study finds that real average wages, employment, and the probability of exporting and export values were significantly higher for those suppliers that participated in the supplier development programme. Nevertheless, only 4 per cent of Costa Rican suppliers to multinationals benefitted from the programme over the period 2001-11, and the value of their sales to multinationals represented just 1 per cent of total local purchases in 2007 (Monge-González and Rodríguez-Álvarez 2013).

Brazil

Another example from Latin America is Brazil, which does not follow a specific linkage policy but has several government measures that promote linkages. This is necessary as Brazilian FDI is primarily market-seeking, catering to the Brazilian or MERCOSUR market. Investment promotion in Brazil is developed by a federal system of institutions, investment promotion agencies, public (state and federal) and private development banks, in addition to non-governmental organizations. Cluster promotion, including locational incentives and incubators for businesses, technical training and regulatory assistance, and matchmaking meetings, is key to linkage development in Brazil. Other initiatives focus on strengthening SME capabilities – such as training to meet standards or to use information technology – providing information on market opportunities, organizing matchmaking events and creating business networks (UNCTAD 2010, Botelho and Bourguignon 2011).

While the government is not the major driver of business linkage programmes in Brazil, some successful programmes can be found at the state level. The Industrial Development Institute of Minas Gerais, together with FIAT, initiated the “Buy in Minas” programme in 1989 to create a network of domestic suppliers in the automotive sector. Involving 90 suppliers, this was very successful in terms of job and local-content creation. Similarly, the Supplier Development Programme in the state of Grão-Pará and Maranhão was established in 1999 in collaboration with the private sector with the goal of improving the technical and management capacity of SMEs in the mining sector, to provide certification, and to organize guided visits to MNCs and benchmark companies as well as roundtables and workshops with MNCs. The number of participating suppliers increased from 78 in 1999 to almost 400 by 2007. At the same time, local procurement by large mining companies went up from 21 per cent to 46 per cent. The programme also offers training courses to 8,700 workers per year (UNCTAD 2010). An analysis of business linkage initiatives in Brazil, Botelho and Bourguignon (2011) show that while the state is not the major driver of business linkages, its involvement can increase the benefits and impacts if it puts in place complementary policies that target education and capacity building, investor attraction, incentives for technology transfer, and development of the business environment.

Mexico

Mexico's efforts to support linkages between foreign investors and SMEs were less successful. In the 1970s, the Mexican government introduced an information exchange system for foreign investors and local suppliers to facilitate matchmaking and promote local subcontracting. While most of these systems that focused only on databases were unsuccessful in establishing linkages, those that managed to offer complementary services, such as the organization of annual sector fairs, matchmaking, subcontracting agreements and supplier development, showed better results. Mexico also created centres called Centros de Articulación Productiva (CAPs) that organize matchmaking events between buyers and suppliers, annual SME meetings, and regular procurement events for specific industries. These were complemented by larger supplier databases that became quickly outdated and were not able to stimulate local sourcing. In addition, the government created nine Design Centres in the late 1990s and designated

private certified counsellors tasked to coordinate linkage development with multinationals, which involved, among others, negotiating and concluding agreements on supplier development. However, only a few MNCs signed agreements although more than 4,500 were contacted (UNCTAD 2010).

South Africa

Linking SMEs to foreign investors has been at the forefront of South Africa's trade and investment policies since the late 1990s, although mainly as an integrated part of other programmes. Following the example of successful linkage developments in Ireland, Singapore, and Malaysia, the Department of Trade and Industry launched several programmes that facilitated linkages. It founded Trade and Investment South Africa to serve as an investment promotion agency, which also supported linkages between local products and producers and foreign buyers and investors in South Africa and SMEs. The annual South African International Trade Exhibition was as an important platform for linking domestic vendors to international buyers and investors. In addition, the Market Access and Business Linkages programme promoted linkages between small business and domestic or foreign firms through the offering consultancy services by Local Business Service Centers. Although successful, the European Union-funded programme ended in 2004. Under the Manufacturing Advisory Programme, several manufacturing advisory centres were created to offer consulting services to MSMEs, including programmes offering MNC mentorship and access to licensed technology. The Manufacturing Advisory Programme also supported initiatives in the technology industry, such as Bandwidth Barn in Cape Town and SmartXchange in Durban and used them to create linkages to large clients, including Microsoft and Siemens (UNCTAD 2010).

Linkage development also played a role under the umbrella of promoting competitive spaces in South Africa. The Department of Trade and Industry launched two other programmes that aimed to create competitive spaces. This included Industrial Development Zones, SEZs that are located near major ports or airports that were founded in the early 1990s and also promote linkages between SEZ firms and potential suppliers outside the SEZ. Established in 1995, the Spatial Development Initiative Programme facilitates economic growth and job creation through private investment in South Africa's competitive industries. One channel through which linkages were to be maximized was cluster key sectors around anchor projects (UNCTAD 2010, Rogerson 2001).

Uganda

Another Sub-Saharan African country promoting linkages is Uganda, whose initiatives focus on facilitating matchmaking capacity. The Uganda Investment Authority provides access to information on potential joint venture partners through a database of projects. Ugandan embassies facilitate business linkages through support for supplier audits and sponsoring trade fairs, exhibitions, investment missions abroad, and networking conferences, and by providing information to potential investors on possible business partners in Uganda. For example, the Danish International Development Agency (DANIDA) Private Sector Development Programme, launched by the Royal Danish Foreign Affairs Ministry, matches Ugandan and Danish joint venture partners in the same sector. A case study of one Ugandan farm participating in the programme found that among the key benefits were the farm's business expansion and higher profits, the introduction of new and efficient production methods and training, long-term cooperation with the Danish joint venture partner, and market access to new large organizations (UNCTAD 2010).

The Government of Uganda also supports business linkage programmes by development agencies. These include UNCTAD's Business Linkage Programme, which has been facilitated by Enterprise Uganda. It offers training and mentoring in close cooperation with the Uganda Investment Authority and receives financial support from the Government of Sweden. The goal is to create sustainable long-term linkages between domestic SMEs and multinationals and support the transfer of technology and know-how, which

makes SMEs more competitive. It does so by identifying suitable SMEs and their capabilities or gaps (e.g. business systems or technical and managerial skills), influencing SMEs' attitude toward the professional conduct of business, and facilitating the implementation of business linkages and mentorships between SMEs and MNCs. As a result of the programme, several agreements have been signed across multiple sectors to support local businesses and farmers. In agriculture, agreements with Uganda Breweries Ltd. and Kinyara Sugar Works Limited were estimated to benefit 3,000 and 2,500 farmers, respectively. The number of suppliers in manufacturing or services that benefited from these agreements, however, seemed to be much lower, ranging from four to 15 SMEs (UNCTAD 2010).

Sri Lanka

Some apparel-exporting countries, like Sri Lanka, have taken measures that link firms located in SEZs to the local economy. Two programmes are particularly important to foster regional industrialization and attract foreign investors. In 1992, Sri Lanka's Board of Investment initiated the 200 Garment Factories Programme and set up 163 factories in rural areas by 1995 (Byiers et al. 2015). In order to give investors incentives to relocate to less developed regions, the 300 Enterprises Programme was launched in 2006. Incentives were extended from EPZ investors (which are mainly foreign investors) to local investors and included exemptions from income and value-added taxes and duties, and the deduction of relocation costs from taxable income (Sivananthiran 2007). The programmes have been successful in promoting regional development and creating jobs, especially for female workers. But despite the creation of a national SME authority and a new SME-focused development bank that promote linkages between large investors and smaller firms, there seems to be no evidence as yet of their impact (Byiers et al. 2015).³⁵

Common characteristics and lessons learned

In summary, successful linkage development initiatives show the following characteristics: (1) Linkage development has shown to be most effective if embedded in a comprehensive supplier development programme, such as in Singapore, Malaysia, Chile or Costa Rica. (2) Similarly, policies targeting linkage development as part of other large programmes, including industrial or spatial upgrading ones, among others, seemed to be effective, for example in South Africa. (3) Successful programmes integrate investors and their specific needs, and thus include the demand side as well. (4) Successful programmes target high potential SMEs as most promising participants, in many cases focusing on selected sectors. (6) Government support needs to go beyond financial assistance, and include helping with access to finance, management and technical training, and expansion to new markets. (7) Financing for linkage development programmes can also come from donors and foreign investors. (8) More flexible programmes, such as Singapore's Local Industry Upgrading Programme, seem to be more effective, as they meet the specific needs of all participants. (9) The private sector plays an important part in the training process (e.g. by investors or external private consultants). (10) Foreign investors are sometimes involved in the training process, engage in joint research with local firms, and offer technology transfer and licensing.

Finally, the country case studies offer some important lessons: (1) Traditional initiatives to build linkages, like matchmaking, information exchange, supplier databases or aftercare services, are important, but only scratch the surface. (2) Strict local content regulations are unsuccessful in creating linkages if suppliers are not up to the task, as illustrated in the case of the early Vendor Development Programme of Malaysia. (3) Excluding foreign suppliers from such programmes may be difficult if domestic suppliers are not ready to meet the investors' requirements. (4) Initiatives that are not embedded in a comprehensive

³⁵ Similarly, Vietnam is keen on increasing backward linkages, but no concrete policy measures have been identified yet.

development programme tend to be less successful, possibly due to lack of the necessary institutional support, commitment and visibility.

5.2 Private sector initiatives and public-private partnerships

Private-sector linkage development initiatives can take several forms, but in most cases, involve training extended by the foreign investor to the local supplier. Some large multinationals implement their own supplier development programmes, such as the car manufacturers Daimler, Fiat, Tata, Toyota or Volkswagen, or technology companies like IBM or Intel. Intel's Smart Approach Supplier Development Programme in Malaysia and Chile's World Class Supplier Development Programme will be used to exemplify how such programmes can look like. In some cases, former employees of foreign firms have acquired the necessary skills and expertise to found their own company. Other private-sector channels include industry associations, private universities, private non-profit organizations or other non-governmental forms. But in most cases, linkage development happens through training offered by foreign investors to their joint venture partners, suppliers or farmers (UNCTAD 2011, Kaiser Associates Economic Development Partners 2014b). This section illustrates selected private-sector training initiatives in agribusiness, mining, apparel and electronics.

Electronics

Intel's Smart Approach Supplier Development Programme demonstrated the investor's commitment to grow Malaysian-based suppliers. Intel targets suppliers that are competitive, capable, stable and resourceful. Its goal for participating suppliers is to become 'best-in-class' technology corporations, to meet stringent health, safety and environmental standards, to respond to multiple and sudden changes, to give 24/7 coverage, to be cost-competitive, and to support a global network and total solutions. Several participants have become successful multinationals on their own account (Box 1).

The Malaysian experience can also be used to illustrate the success of newly created companies set up by the former employees of foreign investors. Besides Intel, Motorola set up successful spin-offs in Malaysia, including Loshta and BCM Electronics, following the Government's call to collaborate with local partners. Thanks to Motorola's technology and knowledge transfer, BCM managed to become a top contract manufacturer and supplier for Motorola components. It also benefitted from operational and business support through the transfer of experienced employees and training. Between its inception in 1993 and 2007, BCM's employee size grew from 50 to 1,200. Over the years, BCM upgraded its role in manufacturing and engineering to quality assurance, planning, purchasing and shipping, and became one of Motorola's top three suppliers with regard to cost, quality and delivery (UNCTAD 2010).

Samsung Vietnam invested in its Mobile Research and Development Centre while simultaneously focusing on reaching out to national universities to attract talent and build capacity. In 2012, the Samsung Vietnam Mobile Research and Development Centre (SVVMC), the company's largest research and development facility in South-East Asia, was established. By 2015, the research centre employed more than 1,500 people, only five of which were foreign nationals, thus reflecting the company's commitment to transfer technology and knowledge to Vietnam. The skills and capacity of the centre's staff are comparable to other Samsung Research and Development Centres in the world, with 90 per cent of engineers attaining Samsung's global standards. However, the quality of education in Vietnam is considered a significant barrier to further skills upgrading.³⁶ As a result, Samsung implemented a university-focused approach and invested US\$2.5 million toward scholarships and grants at the Hanoi University

36 ["Samsung R&D Centre Hitting Stride," Vietnam News](#), 3 December 2015.

of Science and Technology, and agreed to offer US\$1.4 million in scholarships and laboratory equipment to the Posts and Telecommunications Institute of Technology. Despite these efforts, extensive training remains necessary for new recruits (Hollweg, Smith and Taglioni 2017).

Mining

Chile's World Class Supplier Development Programme aims to move Chilean suppliers to the mining industry into higher technological areas by 2020.³⁷ Set up in 2008 by BHP Billiton, the programme has since expanded to other mining companies such as Codelco. It is coordinated by Fundación Chile, a non-profit corporation that aims to support technology transfer and innovation, and increase the competitiveness of Chilean firms, but does not provide funding. Its target is to create 250 world-class suppliers in Chile by 2020, defined as suppliers that are recognized in Chile and abroad, export 30 per cent or more of their services, and provide innovative and technologically advanced services. A review of the existing 3,000 suppliers in 2012 found that 98 per cent were either simple users or adaptors of existing technology, but very few were highly innovative (Kaiser Associates Economic Development Partners 2014b).

Chile's World Class Supplier Development Programme encourages mining companies to detect areas where efficiency across their operations could be improved, and to identify local suppliers who have the capacity to find innovative solutions to problems. A cluster of two to three local suppliers is then created to study the problem and pilot-test innovations. In addition to technical funding and support for the area of innovation, some companies such as BHP also hire external consultants to conduct training on organization and managerial competence and support supplier linkages with local universities. As of 2012, 70 cluster projects were underway from BHP and Codelco, and there is interest from the Peruvian and Colombian mining industries. The selection procedure is rigorous: for example, only 16 per cent of identified projects at Codelco reached the implementation stage. Selection criteria include economic benefit, replicability, urgency of the problem, technological risk, and impact on the operation in the fields of health, safety, and environment (Kaiser Associates Economic Development Partners 2014b).

Agribusiness

In the agribusiness sector, technical support by foreign investors often comes in the form of demonstration plots and farmer training centres, but these only have an impact if implemented at a substantial scale. Foreign investors have taken several initiatives to magnify the delivery of technical assistance and training to farmers, including the (i) use of demonstration plots to promote good farming practices, for example Unilever's plans to establish demonstration farms in Vietnam's tea sector, (ii) establishment of farmer training centres, (iii) formation of groups and "train-the-trainer" approaches, and (iv) use of the media and local languages to reach a wider target audience (Kaiser Associates Economic Development Partners 2014a).

Apparel

In the apparel GVC, joint ventures have emerged as a major driver in establishing and developing Sri Lanka's global competitiveness. Joint ventures represent almost 75 per cent of all garment facilities in the country and helped it significantly upgrade its apparel sector. Joint ventures between a local manufacturer and its global buyer or its global supplier, or all three parties, helped upgrade the

³⁷ The following two paragraphs also draw on Barnett and Bell (2011) and Urzua (2011).

production processes, products, and functions of local manufacturers. This helped Sri Lanka improve its position in the apparel GVC and move from the lower value-added cut, make and trim segment to the manufacturing of original designs. Joint ventures also helped upgrade technical and managerial skills and attract input suppliers to Sri Lanka (Box 2).

Public-private partnerships

In many cases, linkage development was initiated by collaborative efforts between foreign investors and the government or by public-private partnerships, which sometimes resulted in the launch of successful supplier development programmes. For example, the Penang Skills Development Centre in Malaysia was launched to offer training and supplier development services. While it had the identity of a non-profit organization and obtained financial support from the federal and state governments, it was operated and administered by the private sector (see Box 3). This facilitated the launch of its successful Global Supplier Programme (Box 1, see also section 5.1). Another example is the Supplier Development Programme that the Brazilian state of Grão-Pará and Maranhão set up in collaboration with the private sector (see section 5.1). Ten companies, mainly from the mining sector, provided funding for the programme. Among the business development service providers that give technical support is the Brazilian Micro and Small Business Support Service (SEBRAE), which is itself a joint initiative by the public and private sector, between the National Industrial Training Service and Social Service of Industry. One of the strengths of the Supplier Development Programme is the recognition it earned among Brazilian SMEs and multinationals because of its institutional cooperation with the state's Industry Association (UNCTAD 2010).

In Chile's mining sector, for example, private sector initiatives are being complemented by successful public-private partnerships around skills development and training. The Government of Chile has been actively addressing the estimated shortage of 60,000 skilled mining workers such as technicians, supervisors and managers. The Universidad Católica del Norte, for example, established a mining business school in 2009 in collaboration with the regional government, the Chilean Economic Development Agency, mining firms and industry associations as well as the Sustainable Minerals Institute at the University of Queensland in Australia. Participants can achieve a master's degree in mining management or a diploma in mine contract management, and the learning modules are offered by the mining companies. Several other programmes in public-private partnership are underway to reduce the skills shortage in Chile's mining sector (Kaiser Associates Economic Development Partners 2014b).

Vietnam's Public Private Task Force on Sustainable Agriculture was established as a public-private partnership and is part of the global initiative called 'New Vision for Agriculture'. Following the World Economic Forum's 'New Vision for Agriculture' initiative³⁸, the Government of Vietnam (including the Agriculture and Rural Development Ministry, the Finance Ministry and the State Bank of Vietnam) in tandem with 12 global companies (including Unilever, Nestle, Metro Cash & Carry, Syngenta, Cargill, Bunge and PepsiCo) launched a public-private task force to improve food security and agricultural sustainability in the country. Its goals are to raise the productivity and incomes of rural families by 20 per cent per decade and lower emissions by 20 per cent per decade. It coordinates and leverages public and private sector investments in agriculture to increase production and quality, while benefiting farmers and meeting climate targets. Six pilot groups were selected around coffee, tea, vegetables, fisheries, common commodities and finance.

The task force targets improvements across the whole agribusiness value chain and a wide range of focus areas and provinces. In the coffee group, for example, farmers in three Vietnamese provinces were trained in applying new techniques, re-growing techniques and micro-finance, among others, through 50 coffee-garden samples and the participation of extension officers who served as team

38 For a more detailed overview of the initiative, see https://www3.weforum.org/docs/WEF_CO_NVA_Overview.pdf

► **Box 1. Intel's Smart Approach Supplier Development Programme in Penang**

Intel was one of the eight original MNCs (the others being Agilent, AMD, Osram, Bosch, Clarion, Hitachi, Fairchild, Intel) that have been in the Penang Free Trade Zone since the 1970s. Intel's local managers developed the Smart Approach program to demonstrate their commitment to grow Malaysian-based suppliers by continuing to nurture existing and potential new suppliers.

Intel looks for these four qualities in potential suppliers: (i) Competitiveness: safety, quality, delivery, price; (ii) Capability: technical, materials, process; (iii) Stability: vision, finances; (iv) Resourcefulness: management, human resources, training.

It aims for the participants in the smart approach to become "best in class" technology corporations, to meet stringent health, safety and environmental standards, to respond to multiple and sudden changes, to give 24/7 coverage, to be cost-competitive, and to support a global network and total solutions.

A number of the SMEs that participated in the Intel supplier development program have become successful multinationals that are listed in Malaysia's stock exchange (e.g. Eng Teknology, LKT). Other successful firms were launched in the 1990s through Intel's employee welfare-driven program and sold for profit (e.g. Shinca, Shintel, Samatech, Unico and Globetronics).

The following critical success factors emerged from the Intel example:

- Long-term commitment by both government and MNCs
- Existence of a targeted FDI strategy to attract MNCs with a positive corporate philosophy and willingness to delegate to local managers to develop linkages
- Establishment of public-private sector dialogue
- Formation of meso institutions, i.e. skill centres, such as PSDC
- Provision of selective rather than indiscriminate support for SMEs
- Use of systematic supplier development programs versus less structured ones
- Appropriate use of economic incentives

Source: UNCTAD (2006), taken from UNCTAD (2010, p. 90).

leaders and helped with the implementation of the models. The tea group operated in one province and emphasized cooperation and technology transfer, including in harvesting, fertilizing, packaging and market development. The pilot model for the group focusing on vegetables provided training for farmers and conducted impact assessments for new production models, quality and productivity. The fisheries group identified potential fish breeds and direct farmers in one province, focusing on sustainable production and compliance with international food standards. Vietnam's Agriculture and Rural Development Minister Cao Duc Phat attributes to the technology transfer under this programme the average 3 per cent increase in the country's agricultural output and the average 2 per cent reduction in production costs during the first four years between 2011 and 2015.³⁹

Summary and success factors

In summary, linkage development delivered exclusively by the private sector or in public-private partnerships can take a variety of forms. They include supplier development programmes by foreign investors, but also less comprehensive training offered by foreign investors to their joint venture partners, suppliers or farmers. Linkage development can also happen through industry associations, private universities, private non-profit organizations or other non-governmental forms, and in some

39 Somluck Srimalee, "PPP Model Successfully Piloted In Vietnam's Agricultural Sector," in *The Nation*, 27 March 2015, and VIR/Agroberichten Buitenland, "Vietnam: Giving Agriculture a High-tech Boost," in *Hortidaily*, 6 February 2017.

cases through former employees of foreign firms who subsequently founded their own companies. The methods being used also vary by sector. In agribusiness, demonstration plots, samples, and training centres – in the local language – are useful tools to reach a large number of farmers. In apparel, joint ventures could be a useful channel for accessing technology. In electronics, successful linkage development occurred either through a foreign investor's own research and development centre (in combination with financial support for national universities) – or through the creation of a skills development centre financed by the government and operated by the private sector.

The success factors in comprehensive private development programmes include selective targeting, commitment to measurable goals, and strong involvement by the private sector in the actual training. More comprehensive supplier development programmes, either provided by the foreign investors or delivered in partnership with the host government, are characterized by selective targeting (e.g. of suppliers, farmers, products and provinces) and the formulation of specific goals. In addition, these programmes show a strong involvement by the private sector in the actual training. Finally, many of these programmes do not only focus on technical training, but include operational, business and management training and, in some cases, encourage innovation.

► Box 2. The role of joint ventures in upgrading Sri Lanka's apparel sector

Joint ventures upgraded the apparel industry by bringing technology, knowledge, and skills to the largest firms in Sri Lanka.

Parties involved: local manufacturer and its global buyer, or global supplier of upstream textile product and local manufacturer, or three-way joint venture that includes the global supplier, local manufacturer and global buyer

Impacts:

Upgrading of processes, products, and especially functions of local manufacturers. An example is Sri Lanka's intimate apparel product, where local manufacturers, with support from joint venture partners, invested in equipment and human resources for specialized segments like lingerie and swimwear, and became a leading global supplier.

Upgrading of technical and managerial skills through training of local manufacturers. For example, Textured Jersey of the United Kingdom sent ten managers to its affiliate in Sri Lanka to train local counterparts over a period of three to five years. When Textured Jersey was bought by Pacific Textiles of Hong Kong, the latter sent full-time staff in Sri Lanka to share technical knowledge and best practices that helped significantly reduce the share of foreign (mainly Chinese) technical employees.

Global buyers encouraged their textile suppliers to relocate to Sri Lanka. For example, the close relationship between MAS Holdings with Victoria's Secret prompted the latter to request some of its suppliers to set up locations in Sri Lanka.

Source: Staritz and Frederick (2014, p. 227).

► Box 3. Penang Skills Development Centre

In 1989, the Malaysian State government and the Penang Development Corporation started the development of the Penang Skills Development Centre to offer training and supplier development services. While it was established as a non-profit organization, the Federal and State government extended financial support by offering set up and equipment grants as well as subsidies to rent land and infrastructure (building).

The private sector is responsible for the operation and administration of the centre. The management council consisted of 31 members when it was established in 1989 (25 MNCs and six domestic suppliers). By 2005, membership rose to 105 representatives (56 MNCs and 52 domestic suppliers).

The Global Supplier Programme – which later became part of the Industrial Linkage Program of the Federal government – was initiated by the Penang Skills Development Centre (see Table 16).

Source: UNCTAD (2010, p. 89).

► 6. Strategies and policies to promote linkages

This section develops strategies and suitable policies for linkage development, taking into account the Cambodian context and best practices at the international level. It is based on the premise that linkage development cannot be separated from measures to attract foreign investors and efforts to maximize absorptive capacity (Figure 5). Since the characteristics of foreign firms shape the direction and extent of FDI spillovers and local economy linkages, the first strategy is to prioritize investments with higher linkage potential (section 6.1). This requires the establishment of a clear policy framework for linkage development (section 6.2). Cambodia can also benefit from policies and regulations that specifically promote local linkages (section 6.3). Finally, the potential for linkage development and spillovers can only be fully exploited if domestic firms have the necessary absorptive capacity. Another priority to promote linkages is therefore to strengthen the absorptive capacity of local actors (section 6.4).

6.1 Prioritization of investments with higher linkage potential

Agribusiness

Cambodia's agribusiness GVC holds much potential for the creation of domestic value added. The country's participation in the agricultural GVC is characterized by the cultivation of primary agricultural products and a limited level of domestic processing. However, there is much potential for additional value creation in downstream tasks such as food and non-food manufacturing, distribution, and sales (section 2.2). This sector is relevant to the Cambodian economy as it represents many smallholders and informal businesses, and it is one of the priority sectors of the IDP 2015-25. Agriculture alone absorbs 44 per cent of the total workforce and accounts for almost 27 per cent of total GDP (section 2.1), excluding segments like food processing or related services. Encouraging investment in value-added food processing could thus be an important source of backward linkages to agriculture.

The complex and diverse nature of the agribusiness GVC requires highly varied approaches to investor targeting and, thus, a clear understanding of the agribusiness value chain. Not only does the agribusiness value chain encompass all three main sectors of the economy – agriculture, industry, and services – but it contains a diverse set of subsectors and complex stakeholder relationships. Agribusiness activities can range from low-value added commodity production to research and development-intensive production of inputs, such as seeds and fertilizers. Even within commodities, there are products as different as cocoa beans and livestock. This degree of diversity and complexity requires highly varied approaches to investment promotion (World Bank 2014). A clear understanding of the agribusiness value chain is also required if government intervention is to be effective. Box 4 explains a possible method for targeting investors in agribusiness.

Apparel

In its effort to increase backward linkages in the apparel sector, the Government of Cambodia needs to set realistic goals. The previous analysis showed Cambodia's high dependence on imported fabrics, which is in turn related to the high costs of electricity that prevent the faster growth of the country's textile sector. While apparel production is labour intensive, textile production is capital- and energy-intensive and, thus, dependent on specialized workers skilled in the maintenance and repair of machinery and skills to conduct quality assurance tests. In addition, there exist many varieties of fabrics (e.g. cotton, man-made fibres, or blends), so that domestic textile production should match the needs of

the apparel industry in the country (Frederick 2016). While measures to improve electricity supply and lower electricity cost to 12.6 cents per kWh by 2018 are a necessary condition, the Government should be realistic about the results it expects in the short term. Sri Lanka's example has shown that the textile sector grew slowly despite concerted government efforts such as fiscal incentives and the establishment of EPZs.

A feasible approach to developing the Cambodian textile industry would be to rely on foreign investors in the short term. Cambodia still specializes in the lower value-added cut, make and trim segment of the apparel value chain that produces basic products (GC 2015b). In addition, the majority of apparel production operations in Cambodia is foreign-owned. A suitable strategy for building the Cambodian textile industry would thus be to attract FDI in textiles. Some textile and thread producers from Taiwan, China and China started operations in the Phnom Penh SEZ in 2015 (Appendix V). In the medium term, Cambodia could aim to form joint ventures with suitable textile partners from overseas, following the example of Sri Lanka, in order to access the required know-how and technology for the production of fabrics (see section 5.1). But this would also require having more domestic apparel producers that are internationally competitive and are potential joint-venture partners.

At the same time, Cambodia should avoid a narrow focus on growing only its textile production and consider setting up backward and forward linkages to a wide set of supporting industries for apparel. These can include (i) direct raw material inputs (e.g. fabric and yarn); (ii) apparel trim and accessories (e.g. zippers, thread, elastic, labels, and hangers); (iii) non-essential inputs such as packaging (e.g. cartons and poly bags); (iv) capital equipment and machinery parts manufacturers or suppliers; (v) subcontractors that perform a portion of assembly or finishing activities on behalf of another firm (e.g. sewing, embroidering, or screen printing); and (vi) broad services applicable to a range of industries such as transportation, logistics, catering, information technology, construction, cleaning, security, human resources, and training (Staritz and Frederick 2014).

Light manufacturing

Cambodia's diversification to light manufacturing exports such as electronics and automotive should be actively promoted, allowing the country to tap into foreign knowledge and facilitate productivity spillovers. While the domestic value-added contribution to export growth is generally relatively small in electrical and transport equipment (Figure 17), these sectors generally require a notable amount of foreign inputs, increasing the potential to benefit from knowledge and technology spillovers. Much of the recent investments in these sectors have been in industrial zones near the Thai border and are therefore closer to Thailand's customers (as Thailand strongly participates in the automotive GVC). This trend has also been driven by lower labour costs in Cambodia (ASEAN-UNCTAD 2016). However, the Government should not rely only on market-driven investments, but actively promote these sectors following its strategy of focusing on sectors that serve regional production chains linked with either global markets or GVCs (IDP 2015-25).

Services

At the same time, the Government of Cambodia should target investments in services, especially those that are relevant to the apparel and agribusiness GVCs. The previous analysis suggested that Cambodia trails behind its other ASEAN countries in offering domestic services in the apparel and agribusiness GVCs (section 2.2). This points to an underdeveloped domestic services sector, as confirmed by the low export shares of Other Services categories (section 2.1), and strong reliance on the services imports. Besides removing barriers to services trade, it should be of high interest to target investments in services that are applicable to a wider range of GVCs, including transportation, logistics, information technology, and construction.

Investment climate supportive to foreign and local actors

Besides sector targeting, the most important policies to attract GVC-oriented FDI should ensure an attractive general investment climate and policy environment conducive to trade. While political and macroeconomic stability and the general business environment matter strongly for any type of investor – GVC-oriented or not – trade policy and especially trade facilitation has a higher priority for GVC-oriented FDI. Thus, investment promotion agencies may need to put particular emphasis on promoting trade policy reforms (Farole and Winkler 2014b). Among the most pressing issues around Cambodia's investment climate, as identified in this guide, are the large degree of informality of the economy; difficulty of starting a business, enforcing contracts, and obtaining construction permits; low government integrity; low skill levels of the workforce; and underdeveloped infrastructure (roads, electricity, internet). By contrast, Cambodia's trade policy environment is more favourable to GVC-oriented FDI. The initiatives outlined in Cambodia's NIP 2015-25 to improve the regulatory framework, institutional capacity, and industrial infrastructure, and to develop competitive spaces (SEZs and industrial clusters) all aim to improve the investment climate in the country.

Cambodia's investment incentives, in particular in SEZs, should not be biased against domestic investors. This could undermine the overall goal to develop linkages, while more competition among SEZs could support it. Investment promotion incentives need to be supportive of domestic competitors of FDI, potential partners and suppliers. Infrastructure and services are put in place to support the establishment of globally competitive firms – be it foreign or domestic investors. This is particularly relevant to SEZs that are used to primarily attract foreign investors and may put domestic investors at a disadvantage. Levelling the playing field between foreign and domestic firms in terms of investment incentives in Cambodia can support greater FDI integration through physical proximity and networks (Farole and Winkler 2014b). Cambodia's measures to review the incentives given to foreign versus domestic firms in SEZs, as formulated in the IDP 2015-25, should not only focus on SEZs. They should include firms located outside of SEZs, because most firms in Cambodia's SEZs are foreign.

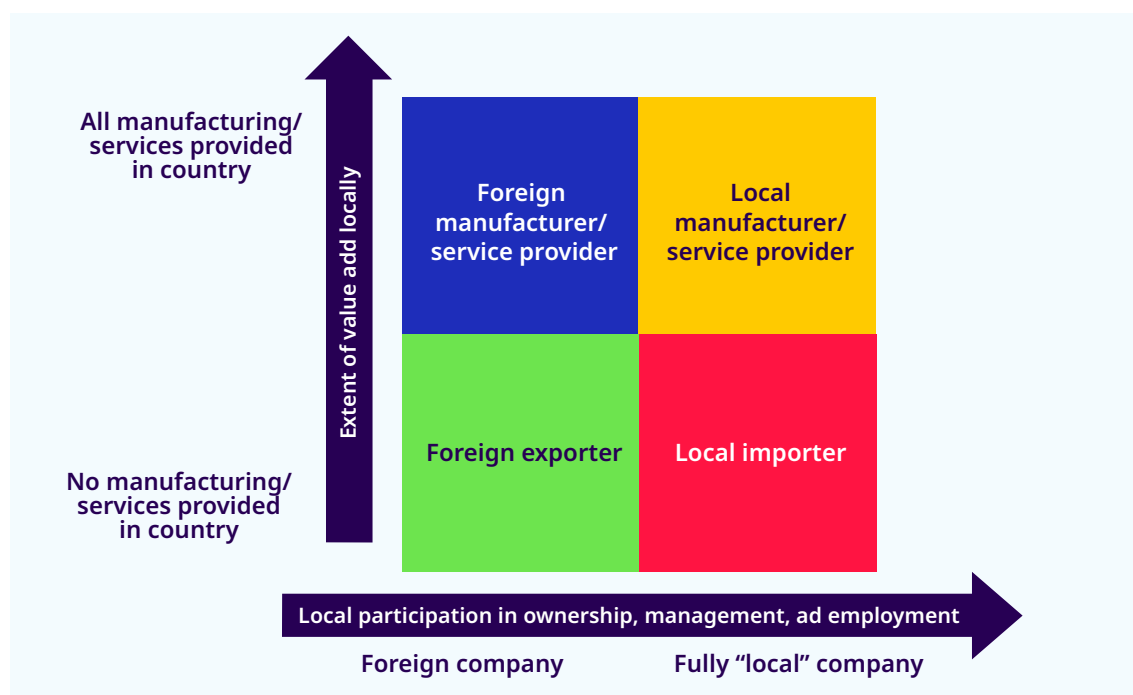
Characteristics of investors

Cambodia's policies for promoting FDI should explicitly account for the characteristics of foreign investors that come from places beyond its target countries, as these shape the extent of linkages and spillovers. Strategies need to recognize that the potential for creating FDI-local economy linkages and productivity spillovers differs by foreign-firm characteristics. These characteristics include FDI motivation, sourcing strategy, technology intensity, share of foreign ownership, country of origin, the amount of training local workers receive, the share of local workers in skills-intensive technical, supervisor, or management positions, and the proximity to and interactions with local firms (Farole and Winkler 2014b). For example, a strengths-weaknesses-opportunities-threats (SWOT) analysis by UNDP (2014) on FDI linkages in Cambodia's manufacturing sector suggests that the effects of SEZs on employment, skills development and linkage creation strongly depend on the foreign consortium that operates and manages the SEZ (UNDP 2014). While Cambodia's IDP 2015-25 lists China, Republic of Korea, Japan, the European Union and the United States as target countries, a more nuanced approach is needed to assess investment projects in terms of their linkage and spillover potential. The Government should actively target investors that operate in sectors that rely on localized inputs (e.g. food processing), offer complementary technology, knowledge or services that Cambodia needs (e.g. design services to upgrade its apparel GVC which currently focuses on the cut, make and trim segment), allow for larger domestic participation in ownership (e.g. through joint ventures), and have experience in establishing and developing local suppliers.

6.2 Establishing a clear policy framework for linkage development

Establishing a clear policy framework for linkage development would convey the Government of Cambodia's commitment to this goal. This, in turn, can have a positive influence on linkage development. According to case-study evidence, introducing legislation or simply discussing its possibility shows a government's commitment to promoting linkages. This can encourage a coordinated response from the industry. It is also important for all stakeholders to have a clear understanding of what the terms 'linkages' and 'local content' encompass. This is relevant for questions such as: Do initiatives that target local SMEs only apply to those that are fully Cambodian-owned, or also to those with foreign participation? Does 'local' refer to the citizenship of the owner or include that of residents? It is also important to clarify how 'content' is defined. Does it refer to the ownership status of the firm or its value addition in the country? The framework for measuring local content (Figure 49) can help define local firms. It shows how local ownership can range from fully foreign-owned to fully domestic-owned while the extent of domestic value added can range from zero to 100 per cent. Combining these two criteria leads to four basic types of firms: (1) foreign exporters with no or low domestic-ownership share that create no or low domestic value added, (2) local importers with high domestic-ownership share, but no or low share in domestic value added, (3) foreign manufacturers/service providers with no or low domestic-ownership share, but a high share of domestic value added, and (4) local manufacturers/service providers with both a high domestic-ownership share and domestic value-added share (Farole and Winkler 2014b).

► **Figure 49. Framework for measuring local content based on local ownership and local value added**



Source: Farole and Winkler (2014, p. 271), based on World Bank (2012).

Setting targets for local content can play a role, but the focus should be on the addition of local value rather than simply greater Cambodian ownership in a firm. Policy options to increase local procurement can include setting targets for local sourcing or for preferential access to local suppliers.

A foreign investor who sources locally can contribute more value added than a domestic investor who imports all materials. In any case, it is important for domestic suppliers to be competitive in quality and price before introducing local content targets. Allowing for some flexibility in setting local content targets can also help with the overall goal of linkage development and would be easier to enforce (Farole and Winkler 2014b). The case of Malaysia has shown that the strict requirements of the Vendor Development

► Box 4. Investor targeting in agribusiness

Investor targeting can encompass these four steps, which are developed in more detail in the Guide on Investor Targeting in Agribusiness by the World Bank (2014):

Step 1 - Scoping: Understanding the context for a targeting campaign

- **Defining viable investment promotion objectives** will have implications for the attractiveness of sub-sectors, for the support provided by stakeholders, and the facilitation of the investment project
- **Understanding the opportunities and challenges of a country's various agribusiness subsectors** (e.g. through a review of existing sector studies, interviews with stakeholders including investors, and original research)
- **Showing full government ownership and leadership is important**, especially when financed by donors, as relationships with investors often outlives a project and investors want to know that the success of their investments does not depend on the involvement of technical assistance providers
- **Knowing stakeholders and their roles**, that is, their interests and most influential decision-makers within each institution, is essential for obtaining the relevant information, assistance, and coordination needed for the targeting campaign
- **Identifying the best government agency to lead the targeting campaign**, which is often the investment promotion agency or Ministry of Agriculture and particularly important when partnering with a development agency/bank
- **Setting realistic timeframes for the implementation of the campaign activities**, as investor targeting in agribusiness usually takes longer than in other sectors, especially when accompanied with parallel reforms in investment climate and/or capacity building in investment promotion (see table below)

Investor targeting steps	Timeframe	Estimated level of effort
1. Scoping	1 month	10-20 days
2. Sector Scan	2 months	25-35 days, depending on scope and depth
3. Campaign Planning	4 months	30-40 days per selected subsector
4. Campaign implementation with reform and / or capacity building	24 months	80-100 days (this ongoing coaching depends on the client's implementation capacity)

- **Identifying the project team that should include an investment promotion specialist**, an agribusiness market specialist, and more junior roles, which might be combined depending on budget and timeline and modified to fit particular modes of investment (such as greenfield, privatization, public-private partnership) by including relevant expertise
- **Efficiently sequencing targeting activities is important** to minimize the overall timeline and produce results within an acceptable timeframe
- **Deciding to proceed or abandon the project depends on information collection for sector scan**, which starts during step 1 and helps determine whether a project can be designed to achieve mutually beneficial objectives within acceptable cost and risk parameters
- **Clearly defining the project and metrics helps to objectively determine project success or failure**, through clear and quantifiable targets for outputs and impacts, baselines for comparison, deadlines for target achievement, and the systems for tracking result indicators

Step 2 - Sector Scanning: Identifying competitive sub-sectors

- **Creating a list of both existing and potential subsectors in the location**, which should be based on existing research and will be the subject of considerable discussion (see table below)

Staple crops	High-value crops	Animal products	Fibres	Beverages	Energy crops	Inputs & others
Rice	Fruits	Livestock	Cotton	Tea	Oilseeds	Seeds
Maize	Vegetables	Dairy	Sisal	Coffee	Sugar	Fertilizers
Wheat	Spices & Nuts	Poultry	Raffia	Cacao		Storage
Pulses	Floriculture	Fisheries				Logistics
Tubers	Rubber					
Sorghum	Sesame					
	Speciality Plants					

Collecting sub-sector information from existing studies and stakeholder interviews, including ministers, other policymakers and advisers, donors, business organization leaders, non-governmental organizations, and representatives of civil society, to take maximum advantage of previous work and local knowledge

- Developing evaluation criteria for the selection of sub-sectors, including on markets, competitive factors, anticipated impact of subsector growth, and investment potential, to ensure that the targeting focus is aligned with everyone's priorities
- Identifying investment climate reforms needed for targeting success, which can be related to land, water, trade logistics, reliable supply, competition policy, and environmental policy

Step 3 - Campaign planning: Preparing for a targeting campaign

- **Developing marketing messages and materials** that should be persuasive and effective and include subsector information, investor needs, location solutions, and proven results
- **Setting targeting campaign parameters**, with face-to-face presentations to high-potential investors, usually at their headquarters abroad, being most effective, although participation in trade shows, business dinners, and press events may also be included
- **Securing cooperation from partners and stakeholders for investment facilitation**, such as business registration, investment approval, land leasing, and importing of capital inputs, among other aspects, and investment climate reforms

Step 4 - Implementing the campaign with reforms and/or capacity building

- **Identifying qualifying investors for the targeting campaign**
- **Sending e-mails and making calls until meetings are confirmed**
- **Conducting in-depth research to tailor messages and screen target companies for suitability to project goals**
- **Preparing customized presentations and promotional materials**
- **Making face-to-face pitches**
- **Following up to get site visits and eventually a decision to invest**

Source: World Bank (2014).

Programme threatened the image of the carmaker Proton and undermined the success of the country's automotive sector.

It is also important to be realistic about the type of local linkages that can be established in the short term due to supply side constraints. Linkage development can focus on the *breadth* of links, that is, the variety of local inputs, and their *depth*, that is, the degree of local value added (Morris, Kaplinsky, and Kaplan 2011). In the short term, lower income countries face supply constraints in terms of suppliers, workers and collaboration within the sector, confining their opportunities for local sourcing to non-core

services activities like security, maintenance, cleaning, catering, and transportation. Targeting this low-hanging fruit immediately can help increase domestic value added in the short term. Establishing local content targets at this stage of development can be counterproductive and weaken the foreign investor's competitiveness (Farole and Winkler 2014b). The Ahafo Linkages Programme in Ghana, for example, was established in 2007 by Newmont Mining and the IFC to support the local sourcing of low value-added products and services, including tools, paints, hospitality services, low-level maintenance and construction, and vehicle rental services. IFC's role ranged from initial business assessment to programme design and coordination, while Newmont customized procedures for local procurement, educated local suppliers on its standards, and provided technical support (Kaiser Associates Economic Development Partners 2014b).

Resources to support supply-side capacity building, however, should target medium-term objectives and be embedded in a comprehensive policy framework. In the medium term, local content targets can be effective if they are part of a clear framework. Capacity building should focus on upgrading the skills of local workers so that they can perform higher value-added tasks, such as technical and managerial roles, and of firms' capabilities to deliver inputs at the required amount, quality and price (Farole and Winkler 2014b). Linkage development has been shown to be most effective if situated in a comprehensive supplier development programme, such as in Singapore, Malaysia, Chile or Costa Rica, or if made an integral part of other industrial upgrading programmes, such as in South Africa.

6.3 Policies and regulations that promote local linkages

Feeding objectives into investment attraction processes

While the realistic range of policy options for investor attraction can be narrower for smaller developing countries like Cambodia, investment targets can be built into their targeting strategies and incentive policies. This includes access to fiscal incentives and privileged land and facilities (e.g. in SEZs) (Farole and Winkler 2014b). The analysis in section 3 has identified a low spillover potential for Cambodia. Moreover, parts of Cambodia's open-door policy can undermine efforts to build linkages, such as the promotion of full foreign ownership or having no local content requirements (Figure 45). While countries like Cambodia can have a more limited range of policy options, the investment targets identified in the previous paragraph can be made part of their targeting strategies and incentive policies.

For large-scale investments, Cambodia should consider feeding linkage and spillover objectives directly into the investment attraction process. For example, the Government could require potential investors to prepare a local linkages and spillover strategy that would become part of the investor's package for applying for licenses. This would work for large-scale FDI projects that are likely to deliver substantial long-term rents. In cases where potential investors are competing for access to a concession, an exploration license, or some other exclusive right, the submission of their local linkages and spillover strategy could be made one component of the evaluation (Farole and Winkler 2014b). In Australia's mining sector, for instance, the implementation of an Industry Participation Plan is required to access tariff concessions offered to investors in the sector. Criteria included in the assessment of an Industry Participation Plan include: employment creation, skills transfer, regional economic development, technology transfer and R&D, and "full, fair and reasonable opportunities" for suppliers to tenders (Kaiser Development Associates 2014b). Cambodia's IDP 2015-25 also considers the provision of additional incentives for investment projects that focus on skills training, research and development, and innovation. While this is a necessary first step, incentives could also be offered for other types of spillovers, especially local procurement.

Incentives to import versus incentives to source locally

The Government of Cambodia also needs to ensure that investment or other incentives as well as rigid requirements by foreign investors do not penalize local procurement. First, investment incentives such as import duties that are waived could disincentive local sourcing, if value-added tax or other taxes still apply for domestic procurement. Other disincentives include restrictions on the flow of goods and labour within and outside SEZs, or barriers for trading between firms located in SEZs with firms that are located outside such zones. Abraham, Konings and Sloommaekers (2010), for example, find that Chinese manufacturing firms located in SEZs experience lower productivity spillovers from FDI than Chinese firms located outside these zones. The reason could be a combination of the export processing focus on the side of the foreign investors, but also the spatial and legal structures governing SEZs that inhibit the integration of domestic actors outside these zones. Second, the Government should encourage foreign investors to use flexible approaches to local sourcing in order to integrate domestic firms, especially SMEs, into their supply chain. Such innovative approaches could include breaking procurement into smaller lots, establishing parameters for contracting with groups of smaller firms, and offering accelerated payment terms and upfront payment (Farole and Winkler 2014b).

Supplier development programmes

Cambodia's public and private sector should design a specific supplier development approach that responds to investor demand, builds SME capacity and is part of a comprehensive set of policies on linkages. The country cases studied in this guide showed that policies fostering linkages as part of systematic supplier development programmes, industrial upgrading programmes, and spatial development programmes that integrated investors and their requirements and emphasized local capacity building were most successful, including in Singapore, Malaysia, Chile, Costa Rica, and South Africa, compared to measures that were merely supply-driven, and not comprehensive or focused enough on active support for the capacity building of SMEs. One issue to consider is scale: many programmes can handle a limited number of suppliers, so that the inclusion of the private sector or putting in place public-private sector partnerships is key. But the case studies also showed that the programmes targeting the most promising suppliers led to the best outcomes. Against this background, the IDP 2015-25's emphasis on identifying SMEs with high potential to link to multinationals is the right approach.

Multinationals should take a lead role in planning and implementing these programmes, while the Government should focus on establishing and supporting the comprehensive framework for linkage development. This parallel approach will help leverage complementary activities and secure additional funding by the private sector. It will also be effective in meeting investor demand. For example, foreign investors could provide operational assistance to suppliers, while government support programmes focus on more general management and technical training. Likewise, multinationals can offer consultancies on quality improvement, while national quality bodies assist with certification. Investors can also offer technical training, while government programmes provide incentives for the use of new technology (Farole and Winkler 2014b).

The role of joint ventures

Joint ventures can be an effective tool for generating linkages and spillovers, especially of older technologies and know-how that are likely to be most relevant for lower-income countries. This does not mean forcing potential investors into a joint venture relationship, an approach that can undermine the foreign investor's willingness to share information (Farole and Winkler 2014b). While export-oriented investors tend to have a preference for full foreign ownership, cases like Sri Lanka's have shown that following a joint venture strategy does not prevent the development of a successful export-oriented apparel industry.

Public-private partnerships for skills building

Capacity building measures to help SMEs link to multinational companies, as proposed in Cambodia's IDP 2015-25, should go beyond the modernization of production chains. While the capacity building of suppliers is vital for linkage development, the IDP 2015-25 only specifically mentions the modernization of production chains through support for investment in machinery parts or production equipment as well as other incentives. SME capacity-building measures supported by the Government of Cambodia aimed at linking SMEs to multinationals, however, should go beyond physical capital and also include the building of technical and management skills.

Cambodia's potential collaboration with targeted foreign investors to establish skills training centres, as proposed in the IDP 2015-25, is thus a promising route for linkages and spillovers. The country aims to target investors from Japan, Republic of Korea and Singapore to achieve this goal. In addition, foreign investors should be offered incentives to collaborate with local universities, research institutes and training institutes. Incentives could target collaboration on research, support for technology licensing and technology transfer, or collaborative activities on skills building with universities and vocational training institutions (e.g. internships, and joint training and curriculum development). Such collaboration would help match FDI research and technology requirements with the programmes and capabilities of local universities and research institutes; it will also facilitate the exchange of information on the specific skills requirements of multinational firms. Incentives could involve the creation of research funds, matching grant programmes or fiscal incentives (Farole and Winkler 2014b).

Improving the institutional framework

One of the clearest roles for the Government to take on is to address information asymmetries on investor needs and local supplier capacity, improve contract enforcement, as well as reduce coordination problems among local suppliers. Information exchange systems address information asymmetries by helping foreign investors identify potential local suppliers and their capabilities, while domestic suppliers are informed about the specific requirements of investors in terms of quantity, quality, certifications, delivery. Possible channels for information exchange include vendor registration, databases, exhibitions, and active supplier matching (Farole and Winkler 2014b). But Cambodia should avoid focusing on information exchange systems or databases alone, as shown by Mexico's unsuccessful case. It should also develop specific programmes for supplier development. Likewise, contract enforcement is a key policy challenge in Cambodia and can pose a serious barrier to the initiation of formal contracting arrangements with local suppliers. For FDI spillovers to materialize, the formation of long-term contractual relationships is a prerequisite. The Government also needs to address the coordination problems between local suppliers by facilitating the development of supplier networks and sectoral learning networks. This could, for example, enable smaller suppliers to jointly bid for large investor contracts. The Government's interest in the potential effect of industrial parks for SMEs on linkages is welcome in this regard. Box 5 summarizes policy recommendations for implementing linkage policy, including targeting, institutional arrangements, coordination, and monitoring.

6.4 Strengthening the absorptive capacity of local actors

Environment that maximizes the absorption potential of local actors

In order to attract investors, develop local economy linkages and benefit from spillovers, Cambodia needs to substantially strengthen the absorptive capacity of its local firms and workers. Initial analysis in this guide suggests that the Cambodian firms' absorptive capacity is relatively low given the large technology gap between them and foreign investors, and small firm size. While other firm-level factors, not analysed here, could also influence domestic firms' capabilities to build linkages and internalize FDI spillovers (e.g. share of skilled workers, firm location, export behaviour, and sector competition), characteristics at the national level, including Cambodia's high share of low-skill workers with only basic or less than basic skills, influence the country's absorptive capacity. This is where the Government has a most important role to play. Besides helping local firms and workers strengthen their absorptive capacity, it is similarly important to help them access opportunities. Several general policy recommendations on establishing an environment that maximizes the absorption potential of local actors are outlined in Box 6.

Maximizing the absorptive capacity of local workers and firms also requires the creation of an institutional context that is conducive to making the best use of the potential for linkage development and spillovers from FDI. Such factors include a country's income per capita, learning and innovation infrastructure, trade policy, business and investment climate, access to finance, labour market regulations, among others (Figure 4). They are important as they can influence foreign and domestic firm characteristics as well as the transmission channels through which knowledge and technology diffuses from multinational to local firms. In the context of GVCs, in particular, open trade and investment policies are especially important. The IDP 2015-25's measures to improve Cambodia's regulatory environment cover these areas. But its success hinges critically on strong leadership, coordination, and effective decision-making, requiring the Government to put priority on overcoming institutional bottlenecks in the short-term so that Cambodia can tackle larger necessary reforms in the medium term.

The Government should prioritize the capacity building of SMEs over efforts to increase their registration rates. It is important to recognize that formal registration is a necessary, but insufficient, condition for domestic firms to link to investors and internalize spillovers, so that Cambodia should prioritize this. If formal SMEs are not competitive, they are unlikely to be selected as suppliers to multinational firms. One could also argue that initiatives that increase the SMEs' competitiveness will encourage them to register formally, as they will be productive enough to comply with prevailing rules and regulations and will no longer need to engage in informal practices. Therefore, the Government should emphasize capacity building rather than formal business registration (an important target in the IDP 2015-25), promoting technology development and transfer, developing skills and enabling knowledge sharing, and improving industrial standards and property rights.

In addition, while SEZs and industrial cluster development contribute strongly to capacity building, including for SMEs, SEZs account for just a small percentage of the Cambodian workforce. SEZs and industrial clusters play key roles in the IDP 2015-25 as part of the Government's efforts to promote FDI, and several regulations target linkages to the local workforce and vocational training in the context of SEZs. As of 2014, SEZs in Cambodia account for less than 1 per cent of total employment and only 3.7 per cent of industry employment (section 4.1). As a consequence, measures to increase absorptive capacity need to go beyond SEZs and reach target firms and workers operating outside these areas, such as many apparel firms in Cambodia, as well as farmers.

Skills building

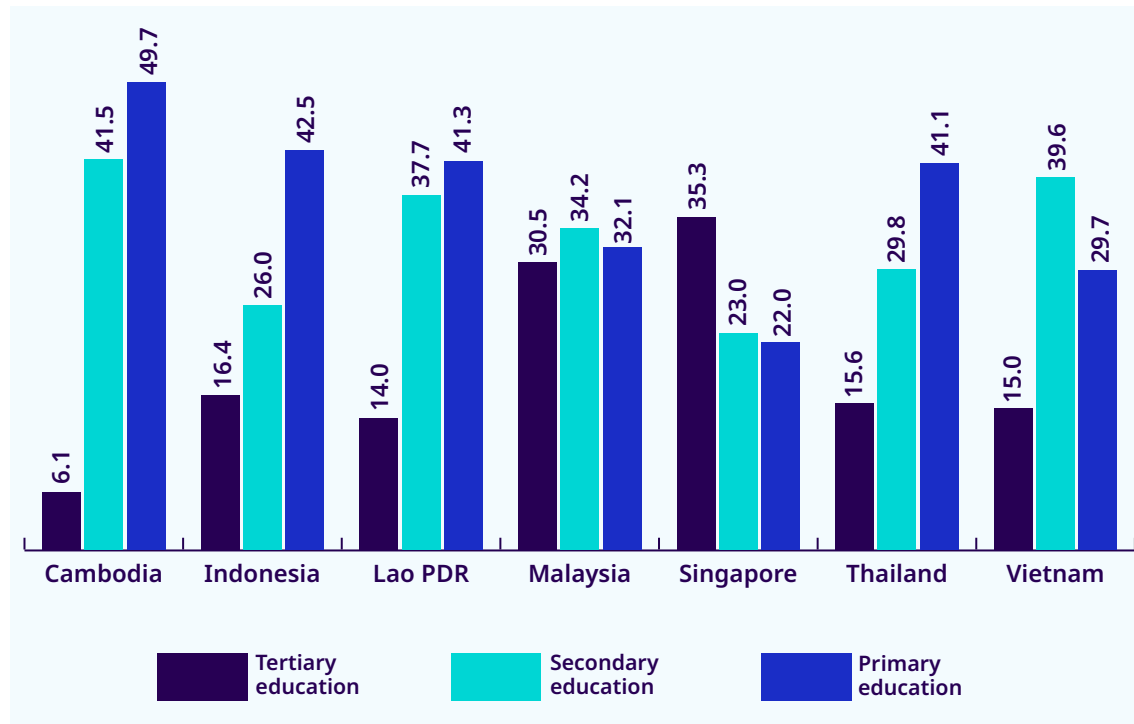
The most pressing issue that the Government needs to tackle is the reduction of the country's large share of informal and unskilled workers. Achieving this would also support the NEP 2015-25's goals to promote decent and productive work, skills and labour market governance. The joint ADB-ILO (2015) publication *Addressing the Skills Gap* finds a mismatch between the skills of Cambodian workers and employers' needs, and identifies as priorities the improvement of the quality of education and access to it. Among the major constraints to skills acquisition and productive employment are: (1) quality problems in education, often due to low-qualified teachers, high student-teacher ratio in primary schools⁴⁰ – especially in underserved areas, and the potential need to reform curricula to emphasize sciences and engineering; (2) inadequate skills of the work force, requiring skills building through re-entry into education or technical and vocational education and training; (3) declining population growth, which leads to a smaller influx of better educated workers (ADB-ILO 2015) into the labour market.

Domestic investment overall, but specifically in tertiary education, needs to be increased. While Cambodia has relied strongly on FDI (Figure 2), total investment represents around 20 per cent of its GDP due to very low domestic investment rates. By comparison, Malaysia and Thailand spent 32 per cent and 34 per cent of their GDP, respectively, on investment during their high-growth periods before the 1997-98 Asian crisis (ADB-ILO 2015).

Low investment also applies to the share of government expenditure spent on education. Cambodia's expenditure has lingered around 8 per cent since the global financial crisis of 2008, reaching 8.8 per cent in 2018, compared to average shares of around 11 per cent during the 2000s prior to the crisis. By comparison, Malaysia's government spent 19.7 per cent, Thailand's 14.5 per cent, and Myanmar's 10.3 per cent of total expenditure on education (World Development Indicators). Expenditure on education by type reveals that half of Cambodian investments are absorbed by primary education, while only 6 per cent target tertiary education. The percentages for tertiary education are 2.5 times higher in the Lao People's Democratic Republic, Thailand, Vietnam and Indonesia, and five to six times higher in Malaysia and Singapore (Figure 50). While it is important to emphasize education from an early age, the country's high student-teacher ratios in primary education suggest that the quality of education needs to improve.

40 Cambodia had on average 46.9 students per teacher in 2013, compared to 18.9 in Vietnam and 16.3 in Thailand (ADB-ILO 2015).

► **Figure 50. Expenditure on education by type (% of government expenditure on education), Cambodia versus other ASEAN member states, 2013**



Source: World Development Indicators. Note: Most recent available data for Cambodia for 2013.

Recognizing the need to prepare Cambodia's workforce that will enter the labour market in the near future, the IDP 2015-25 proposes several measures. It emphasizes the need for capacity building of high-education institutions, in particular in sciences, technology, engineering and mathematics. It also lists the need for technical skills training through secondary and higher education, as well as apprenticeship schemes. This should ideally be complemented with foreign investors' efforts to identify and support talent that is currently enrolled in tertiary education, such as through scholarships (see Samsung Vietnam, section 5.2).

Cambodia should also pursue parallel efforts in upgrading the skills of its current workforce. The goal to build joint training centres with foreign investors from Japan, Republic of Korea and Singapore is definitely a right step in achieving the skills upgrading of Cambodia's current workforce through technology transfer and training. The NIP 2015-25 also proposes a combination of training initiatives, including on-site technical and vocational training of factory workers, promotion of trilateral training "government-training institutions-companies/factories", and training scholarships. Lessons learned from public-private partnerships (section 5.2) should be taken into account to maximize impact; that is, local participants in training programmes should be targeted selectively, and realistic measurable goals formulated. Training should be delivered by the private sector, which will best meet the needs of foreign investors and international buyers, and should not only focus on technical training, but include operational, business, and management training.

► **Box 5. Institutional and implementation arrangements**

These recommendations can be considered when implementing spillovers* policy, including targeting, institutional arrangements, coordination, and monitoring:

1. Spillovers policies should be integrated directly into national industrial policies.
2. Many developing-country governments will need to build capacity in their own institutions in order to implement spillovers policy effectively.
3. Responsibility for delivering the spillovers agenda should be taken at a senior ministerial level rather than as an add-on activity for the investment promotion agency.
4. Given the huge potential base of beneficiaries in the domestic supply sector, targeting will be necessary.
5. Implementing some supply-side interventions through existing industry clusters may be another approach for targeting and efficient delivery.
6. Where technical support is provided to domestic SMEs, include concurrent financing support.
7. Finding sustainable funding for linkage and spillovers programs should be a priority at the outset.
8. Matching grant programs can be another way to develop sustainable funding and can help crowd-in additional financing from foreign investors.
9. Establish sector forums for communication and coordination between government and the private sector around linkages and spillovers.
10. Multi-stakeholder partnerships can be effective in the design and delivery of linkage and spillover programs.
11. Multi-stakeholder dialogues can be effective in the management of expectations.
12. Monitoring is critical both to ensure more effective policy and to encourage transparency and facilitate communication.

* Note: These insights also apply to linkage policies.

Source: Farole and Winkler (2014b), pp. 276-279.

Access to finance

An important aspect of SME development is the facilitation of access to finance, which has been identified as the largest barrier that prevents firms from entering value chains. This is because financing is mainly done at the national level, despite economic participation at the global level through GVCs, and is often fragmented. SMEs, in particular, face larger challenges due their small size and intangibility, while banks tend to rely on tangible performance indicators such as balance sheet data, turnover, and liquidity as predictors of repayment ability. While the preparation of appropriate finance mechanisms for industrial development of SMEs in priority industries is acknowledged in the IDP 2015-25, specific steps need to be taken that take into account intrinsic know-how, talent pool, distribution channels, business relationships, the business model, and access to technology in the valuation of repayment ability. Mechanisms may include engaged, patient (or long-term) equity financing and bank guarantees rather than traditional debt financing (Cusolito, Safadi and Taglioni 2016).

Standards

Similarly important are policy measures that ensure domestic firms' compliance with international standards that are required in GVCs. Once again, SMEs face stronger challenges in complying with product standards and certification requirements which, for example, are very important when entering the food processing segment of the agribusiness GVC. But this applies to quality and safety standards as well as environmental and social sustainability standards. The complexity and heterogeneity of international standards in GVCs increase the costs for firms (Cusolito, Safadi and Taglioni 2016). In any case, adopting standards requires a long-term commitment by the Government as well the necessary incentive schemes. The initiatives to improve industrial standards outlined in the IDP 2015-25 are headed in the right direction, but focus mainly on capacity building of standard-setting national institutions. The IDP

► **Box 6. Establishing an environment that maximizes the absorption potential of local actors**

These policy recommendations can be considered when establishing an environment that maximizes the absorption potential of local actors:

1. Facilitate an incentive regime that is aligned with Cambodia's development priorities.
2. Take into account the heterogeneity of domestic firms and focus on high-potential firms when designing supplier development programmes.
3. Help upgrade technical capacity and, most importantly, achieve quality standards through both general and industry-specific investments.
4. Enable flexible delivery and financing models that allow for sector-specific approaches and collaboration with foreign investors.
5. Facilitate investment financing for local suppliers by teaming up with banks and leveraging FDI supply relationships
6. Provide incentives for the licensing of technology from foreign investors.
7. Ensure that the provision of support goes beyond the technical arena and focuses on basic business and financial management.
8. Promote scaling-up of fragmented local suppliers in order to raise productivity and enable them to engage more effectively with foreign investors.
9. Invest in demonstration pilots which can be efficient to promote spillovers of technical and process know-how.
10. Prioritize both industry-specific and general education policy to achieve spillovers in the long term and reduce the technical and managerial skills gap with foreign investors.
11. Engage universities and research institutes actively to improve spillovers.
12. Promote imports and skilled immigration that may be critical to localization in the long term.

Source: Farole and Winkler (2014b, pp. 273-276).

formulates ambitious goals for SEZ development to meet international standards, not only in terms of the necessary physical infrastructure and management systems, but environmental and safety standards for investment projects located in SEZs. These efforts could be complemented with a sequencing of the introduction of standards. Some SMEs may need to participate in regional value chains first in order to benefit from scale and learning economies before adopting stricter international standards (Cadot and Malouche 2012).

Business services

Finally, business services offer huge untapped potential for domestic value-added creation and structural transformation from a labour-intensive to a skill-driven economy. The share of services in Cambodia's exports is very low, especially in agribusiness and apparel (Figure 20). This points to an underdeveloped services sector. In the World Bank's Services Trade Restrictiveness Index, Cambodia ranks the lowest compared to other ASEAN countries, yet, it is important for firms to access high-quality services from abroad. At the same time, however, relying on foreign services is not enough. In the medium term, Cambodia should develop and strengthen its domestic service sectors, including the infrastructure it requires (e.g. Internet servers, see Figure 26). Between 2005 and 2015, Cambodia's expanding share of travel came at the expense of its "Other Services" exports. This decline was largely driven by falling export shares of business services, including telecommunications, computer, and information services and others (Table 3) which are, in fact, services that need to be strengthened in order to achieve the Government's vision of achieving Cambodia's structural transformation from a labour-intensive to a skills-driven economy by 2025.

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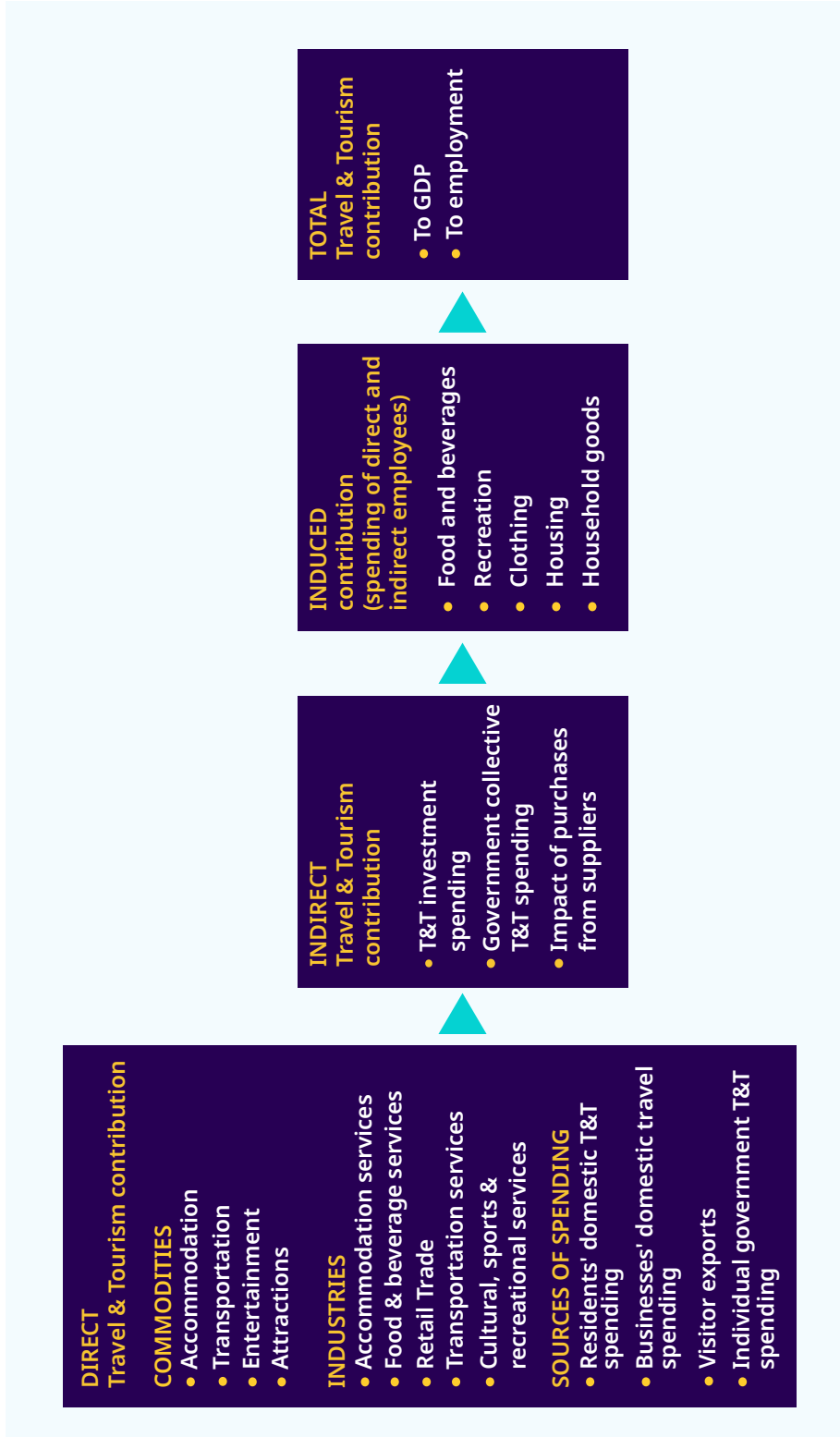
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► Appendices

Appendix I. Economic contribution of travel and tourism



Source: World Travel and Tourism Council (2017, p. 2).

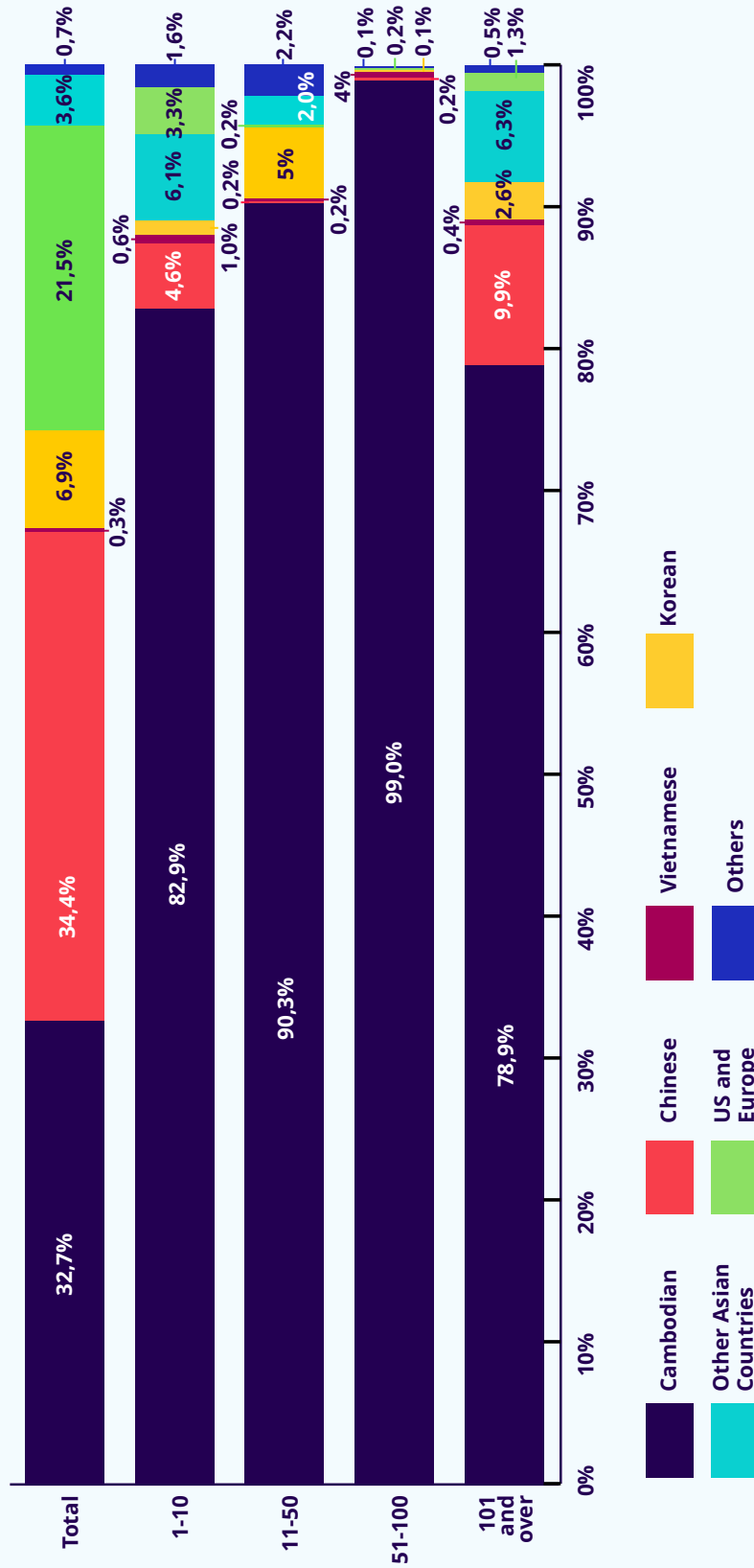
Appendix II. Doing Business indicators (distance to frontier score) Cambodia and other ASEAN member states 2019

	Global	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contract	Resolving insolvency
Cambodia	53.8	52.8	44.2	57.0	55.2	80.0	40.0	61.3	67.3	31.7	48.4
Indonesia	68.2	79.4	65.9	86.4	60.1	70.0	70.0	68.4	66.5	47.2	67.9
Lao PDR	49.8	60.9	67.9	49.6	64.9	60.0	20.0	54.2	78.1	42.0	0.0
Malaysia	81.3	82.8	88.8	99.3	79.5	75.0	88.0	76.1	88.5	68.2	67.2
Myanmar	43.5	77.3	70.5	55.7	52.8	10.0	12.0	63.9	47.7	24.5	20.4
Philippines	60.9	69.3	68.6	87.5	57.6	40.0	44.0	72.2	68.4	46.0	55.2
Singapore	85.8	98.2	84.7	91.3	83.1	75.0	86.0	91.6	89.6	84.5	74.3
Thailand	79.5	92.3	71.9	98.6	69.5	70.0	86.0	77.7	84.6	67.9	76.6
Vietnam	68.6	84.8	79.0	87.9	71.1	75.0	54.0	62.9	70.8	62.1	38.1

Note: Blue = low distance to frontier red = high distance to frontier. An economy's distance to frontier score is indicated on a scale from 0 to 100 where 0 represents the worst performance and 100 the frontier.

Source: World Bank Doing Business Indicators.

Appendix III. Persons engaged in firms (% of total persons engaged) by source country and firm size, Cambodia



Source: Intercensal Economic Survey of Cambodia 2014.

Appendix IV. Labour value added in exports (US\$ million and %) total and by skill level Cambodia, 2011

Sector name	skilled	%	unskilled	%	total	%
Agriculture forestry fisheries	3.4	0.2	340.2	19.3	343.6	19.5
Beverages and tobacco products	0.3	0.0	2.4	0.1	2.7	0.2
Construction	0.5	0.0	2.9	0.2	3.5	0.2
Chemical rubber plastic products	14.7	0.8	68.6	3.9	83.3	4.7
Dwellings	-	0.0	0.0	0.0	0.0	0.0
Electricity gas water	0.4	0.0	0.7	0.0	1.0	0.1
Energy extraction	0.0	0.0	0.1	0.0	0.2	0.0
Metal products	0.1	0.0	0.7	0.0	0.9	0.0
Ferrous metals	0.2	0.0	1.0	0.1	1.2	0.1
Leather products	5.6	0.3	35.5	2.0	41.2	2.3
Wood products	0.2	0.0	1.5	0.1	1.7	0.1
Machinery and equipment n.e.c.	0.4	0.0	2.0	0.1	2.5	0.1
Metals n.e.c.	0.2	0.0	0.9	0.1	1.1	0.1
Mineral products n.e.c.	0.1	0.0	0.8	0.0	1.0	0.1
Manufactures n.e.c.	0.4	0.0	3.3	0.2	3.7	0.2
Minerals n.e.c.	0.2	0.0	1.6	0.1	1.9	0.1
Public Administration/Defence/Health/ Education	18.4	1.0	12.1	0.7	30.6	1.7
Other Private Services	58.7	3.3	83.1	4.7	141.8	8.0
Processed Foods	3.8	0.2	18.1	1.0	21.9	1.2
Paper products publishing	0.1	0.0	0.6	0.0	0.7	0.0
Trade and transport services	68.7	3.9	302.5	17.1	371.1	21.0
Textiles	25.1	1.4	152.9	8.7	178.0	10.1
Transport equipment	0.7	0.0	3.7	0.2	4.4	0.3
Apparel	65.7	3.7	460.2	26.1	525.9	29.8
	268.3	15.2	1 495.6	84.8	1 763.9	100.0

Source: World Bank LACEX database.

Appendix V. Foreign investors starting operations and building factories in the Phnom Penh SEZ, 2014-16 (selected cases)

Company	Nationality	Industry	Market orientation	Start of operation
Taiyo Kogyo	Japan	Flexible container bags	Export	February 2014
Stratco Cambodia	Australia	Metal building materials	Export	February 2014
CH Steel Wire Industries Cambodia	Malaysia	Wire mesh	Domestic	April 2014
Laurelton Diamond	United States	Diamond polish	Export	May 2014
Nikko-Kinzoku Cambodia	Japan	Lost-wax casting	Export	June 2014
Meikodo Cambodia	Japan	Pins	Export	June 2014
Kousei Plastic	Taiwan Province of China	Plastic products	Export, domestic	September 2014
Take off Cambodia	Japan	Stuffed animals	Export	November 2014
Rohto-Mentholatum	Japan	Eye drops	Domestic	December 2014
Heiko Cambodia	Japan	Packaging products	Export, domestic	December 2014
Printe Cambodia	Japan	Electrical parts	Export	January 2015
Shinih Cambodia	Taiwan Province of China	Non-woven fabric	Export	January 2015
Yi Zhixin Non-Woven Shinih Cambodia	Taiwan Province of China	Non-woven fabric	Export	January 2015
Midori Technopark Cambodia	Japan	Automobile interior trim	Export	February 2015
Heng Yang Cotton and Plastic	China	Thread	Export	February 2015
Kanejyu Cambodia	Japan	Garments	Export	May 2015
Artnature	Japan	Hair pieces	Export	May 2015
Rokko Phoenix	Japan	Shoes	Export	June 2015
Ruey Chang Cambodia	Taiwan Province of China	Jewelry carving	Export	June 2015
Nakatora Cambodia	Japan	Garments	Export	August 2015
Betagro Cambodia	Thailand	Animal feed	Domestic	August 2015
Kuipo Cambodia	Japan	Leather bags and wallets	Export	August 2015
Okato Cambodia	Japan	Household production	Export	September 2015

Angkor Dairy Products	Viet Nam, Cambodia	Dairy products	Domestic	October 2015
YHS (Cambodia) Food & Beverage	Singapore	Food and beverage	Export, domestic	Factory construction ongoing
Aprati Foods Cambodia	United States	Candy	Domestic	Factory construction ongoing
Cambodia Beverage	United States	Food and beverage	Domestic	Factory construction ongoing
Yamaha Motor Cambodia	Japan	Motorbike assembly	Domestic	Preparing factory construction
Medipro Cambodia	Japan	Medical garments	Export	Preparing factory construction
Hosiden Cambodia	Japan	Connectors	Export	Preparing factory construction
Winsun Cambodia	Cayman Island	Sanitary production	Export	Preparing factory construction
SVI Public Cambodia	Thailand	Electronics and electrical products and parts	Export	Preparing factory construction
Toyota Cambodia	Japan	Bonded warehouse	Domestic	Preparing factory construction
Masakatsu Kouzai	Japan	Construction material	Export	Processing application registration
Yamato Printing	Japan	Packaging and paper products	Export	Processing application registration
Thai President food	Thailand	Instant noodles	Export	Processing application registration
Wing Corporation	Japan	Dietary supplement	Export	Processing application registration
Sankei Engineering	Japan	Precision parts	Export	Processing application registration

Source: ASEAN-UNCTAD (2016, p. 36) based on information about Phnom Penh SEZ.

