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Trade liberalisation: a Cambodian perspective

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Key to symbols used in tables

n.a.	not applicable
..	not available
-	zero
.	insignificant

Abbreviations

ACP	African, Caribbean and Pacific
AIA	ASEAN Investment Area
AICO	ASEAN Industrial Economic Cooperation
ASEAN	Association of Southeast Asian Nations
CDC	Council for Development of Cambodia
CEPT	Common Effective Preferential Trade Area
CR	Cambodian riel
EBA	Everything But Arms
FMV	fair market value
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GSP	Generalized System of Preferences
JICA	Japanese International Cooperation Agency
ILO	International Labor Organisation
LDC	least developed country
MEF	Ministry of Economy and Finance
MFN	most-favoured nation
MIME	Ministry of Industry, Mines and Energy
MOC	Ministry of Commerce
MPDF	Mekong Project Development Facility
NTB	non-tariff barrier
PSI	pre-shipment inspection
RGC	Royal Government of Cambodia
SAARC	South Asian Association for Regional Cooperation
SEDP	Socioeconomic Development Plan
SGS	Société Générale de Surveillance
SME	state marketing enterprise
SPS	sanitary and phytosanitary
VAT	value added tax

Trade liberalisation: a Cambodian perspective

Since the late 1980s, Cambodia has made considerable progress in establishing a modern trade regime. During the 1960s the country was an exporter of agricultural products (mainly rice, rubber and corn), and in the early 1980s it adopted a trading system that effectively controlled the level and composition of trade through quantitative restrictions and state trading enterprises. During this period, tariffs and trade taxes played little or no role other than as means of revenue collection.

This changed, however, with the move to a market economy and the related implementation of a wide range of reforms in the late 1980s. The state monopoly of foreign trade was abolished in 1987 and the foreign investment law was promulgated in 1989, allowing private companies to engage in foreign trade.

Since the early 1990s, Cambodia has undergone a period of accelerated transformation, restructuring and adjustment. The Royal Government of Cambodia has made great strides in implementing its wide-ranging reform agenda. It has made fiscal, administrative and judicial reforms, begun military demobilisation, undertaken sound management of natural resources and state assets, and improved governance and combated corruption. In 1993, trade policies were greatly liberalised. Most of the restrictions on firms and individuals' engagement in international trade were removed. Now there are few binding quantitative restrictions and the rates of taxes on imports and exports are for the most part not prohibitive. Nonetheless, tariff rates and other trade taxes are still high and variable, and the current structure of duties taxes some activities while benefiting others, creates obstacles to the growth of efficient industries, gives rise to pressures for exemptions, hurts revenue and compounds customs administration problems.

Progress was also made in structural reform: a two-tier banking system is being established and new large-denomination banknotes have been introduced to promote 'de-dollarisation'; most non-tariff barriers have been eliminated; the tariff structure has been streamlined; and a liberal foreign investment law has been adopted. Since then, Cambodia has made impressive strides in re-establishing political and economic stability and re-integrating itself into the international community.

Overview of the economy

Cambodia is an agrarian economy with 80 per cent of the workforce employed in the agricultural sector. Rice production, for household consumption and trade, is the major economic activity for most of the 84 per cent of households located in rural areas. Households supplement rice production with fishing, production of vegetables, fruit and other cash crops, the gathering of forest products, and off-farm employment.

Some household members also earn money from the domestic private enterprise sector, which consists mainly of informal small enterprises, and recently also a number of medium-size enterprises; from foreign-funded private enterprises engaged primarily in garment production, other light industries, tourism, and other services; and from the public sector, including a (declining) state enterprise sector.

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In 2001, Cambodia's population was approximately 12 million people (51.8 per cent female), living in 2.2 million households, some 26 per cent of which are headed by women. The population is very young, with 42.9 per cent aged 0–14 years, and fertility rates are high, with an estimated annual population growth rate of 2.5 per cent. The workforce is growing by 3.2 per cent per annum, with 228,000 new entrants in the workforce each year.

After tepid growth of 3.7 per cent and 1.5 per cent in 1997 and 1998 respectively, real GDP growth bounced back to 6.9 per cent in 1999 but slowed down to 5.4 per cent in 2000 because of severe flooding. In 2001, economic growth was estimated to be 5.3 per cent, reflecting the global economic slowdown. Manufacturing and tourism have been the main engines driving output growth, with growth and investment in export-oriented industries such as garments and footwear particularly strong.

Cambodia has pursued a flexible market-based exchange rate policy. Given low inflation, the exchange rate has remained stable, and there has been a further buildup of international reserves to retain import coverage for about 3 months of imports. The government's policy is to unite the official exchange rate and the market rate by keeping the spread below one per cent.

Agriculture

In 2001, Cambodia's agricultural sector (including fishing and forestry) accounted for about 36 per cent of its GDP, compared with 46 per cent of GDP in 1995. About 80 per cent of all workers are engaged in crop production, livestock production, fishing, hunting and forestry, for subsistence and/or trade, and mostly as part of household production units.

In 2000, crop production accounted for 50 per cent of agricultural sector value added. Rice is planted on 90 per cent of the total area currently cultivated with annual crops, however the total area planted with rice today is only 80 per cent of the area planted with rice in the early 1970s. Despite recent improvements, Cambodia's rice yields per hectare are amongst the lowest in Southeast Asia. Economic returns to labour from rice production are as low as US$0.64 per day, or less than half the returns from the production of other agricultural products such as vegetables, soybeans, mung beans, cassava, sweet potato, tobacco and cotton. The Government aims to increase the production of annual crops by utilising some of the 1.2 million hectares of agricultural land that is currently unused. It also envisages a major expansion of rubber plantations, and other industrial crops such as coffee, cashews, palm oil, coconuts, sugar cane, and horticultural crops.

Besides accounting for 90 per cent of the total area currently cultivated with annual crops, rice production also accounts for 29 per cent of value added in the agricultural sector. The majority of Cambodian households are engaged in rice production, and rice represents the major staple in household consumption. Since 1990, there have been gradual improvements in productivity and increases in cultivated area, and Cambodia has shifted from net rice importer to net rice exporter (JICA 2001). Most exports, however, are unofficial. Despite being a net exporter, Cambodia still experiences food shortages in some areas because of lack of infrastructure, poor trading arrangements, weak rural

finance, lack of information and low incomes. The prospects for future increases in production are still largely unknown. They depend on factors like relative prices of alternative crops and inputs, alternative employment opportunities, technical developments, infrastructure, and technical limits related to the natural resource base. A recent study conducted by the Japanese International Cooperation Agency (JICA) presents a wide range of scenarios for future rice exports, from negligible levels to 750,000 tons by 2010 (JICA 2001). Regardless of export levels, improved post-harvest practices and more consistent quality could help reduce product losses and increase farm gate prices and incomes. Attempts to increase farmer returns will need to focus on quality improvements and reduction of post-harvest losses, and guard against the negative impacts of any increased use of chemical inputs.

Freshwater fish production represents a major source of dietary protein and cash income for many rural households, and accounts for about 27 per cent of measured value added in the agricultural sector. The Tonle Sap, the Mekong River and its flood plains are important fishery resources. Unfortunately, however, the Tonle Sap—which also has significance as the major breeding ground for fishing stock in the Mekong River and its tributaries—is under ecological threat from destructive fishing practices, agro-chemical pollution, and the degradation of surrounding swamps.

Livestock and poultry production accounts for 17 per cent of value added in the agricultural sector. There is potential to increase livestock production (including eggs, poultry and pig meat) for export and domestic markets, and increase household protein supply, by reducing the above-mentioned barriers to production and developing village-based systems of disease reduction and animal health improvement. This would have a direct positive impact on rural incomes and food security, and provide a growing domestic market for animal feeds produced from corn, cassava and other agricultural products. Given that many farm households use livestock as a bank or form of insurance (selling animals in case of unexpected need for cash), improved animal health could also help reduce the risk of poverty.

In 2000, forestry and logging accounted for 7 per cent of measured value added in the agricultural sector, compared with about 20 per cent in 1994. During the 1990s, log exports were Cambodia's major source of export earnings, but forests were decimated by logging levels that Government estimates put at four times the sustainable level. There is now a temporary ban on log exports, but illegal log exports continue. Improved forest management is considered a high priority, with the Government's medium-term strategy being to introduce and enforce sustainable forest management practices in order to support wood products, wood-processing industries, and tourism. Local community participation in forest management is seen to play an important role in the safeguarding of forest resources and national parks. This, in turn, will be critical in increasing returns from forest areas while protecting watersheds and tourism development opportunities.

Government priorities for agricultural sector development include

- improving food security by expanding production of rice and other food crops
- adding value to crop and livestock production by developing agro-processing industries

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- increasing income opportunities for farm households, particularly those headed by women, by diversifying crop production
- strengthening participatory processes in rural communities
- ensuring sustainable agricultural production through improved management of natural resources and
- increasing the availability of rural financial services.

The relevance of these priorities needs to be reviewed on an ongoing basis. Given that food self-sufficiency has been achieved and income-earning opportunities now provide alternative ways of achieving food security, the need to focus on expanding rice production can be reviewed.

Industry

Since the mid 1990s, Cambodian industry has grown rapidly from a low base, with the share of industrial output (manufacturing, mining, construction, and energy and water supply) in GDP increasing from 13.9 per cent to 35.6 per cent between 1995 and 2000. The share of manufacturing output in GDP increased from 8.3 per cent to 18.4 per cent, largely because of rapid growth in textiles and garments (from 1.9 per cent to 12.4 per cent of GDP between 1995 and 2000). Garment manufacturing has been a major source of growth in paid employment in recent years. Meanwhile, since 1999, the share of construction in GDP has increased, following a decline during 1997 and 1998.

Services

Between 1995 and 2000, the share of services in GDP declined from 39.9 per cent to 35.0 per cent, mainly because of a decline in the share of trade from 13.4 per cent of GDP in 1995 to 10.2 per cent in 2000, and a smaller decline in the share of transport and communications. Given the rapid opening up of the Cambodian economy since 1995, the reported decline in the share of trade, transport and communications in both GDP and value added in the service sector is somewhat surprising. While the decline in share in GDP may be partly due to the rapid expansion in garments, it may also reflect relatively stronger growth in informal service sector activities because of economic distortions and administrative weaknesses that encourage considerable informal trade and widespread smuggling. The shares in output of hotels and restaurants, finance and real estate remained largely unchanged between 1995 and 2000. Government development strategies emphasise service sector development, especially tourism development, as an important source of growth in paid employment.

External trade

Trade liberalisation, particularly within ASEAN, could have significant benefits for Cambodia, since its preferential access can be used to generate export growth and investment from other countries. In the medium term, tariff reforms and rationalisation will allow for a more rational allocation of resources by avoiding costly domestic

protection. In this context, the government is currently formulating a trade strategy linked to objectives of poverty reduction. This strategy is expected to focus on a number of sectoral action plans for key export products and services, and to identify needs and gaps in existing institutional capacity.

A combination of factors—including increased garment exports, higher petroleum product prices and expanded tourist activities—affected the external trade sector in 2000. Booming exports underpinned a stronger external position, with domestic exports growing by 35 per cent to US$1.091 billion, of which garment exports accounted for an estimated US$965 million. Retained imports also grew quickly, by 36 per cent to US$1.3 billion, reflecting increased inputs to support the growth of manufacturing exports and the impact of increased world oil prices. Meanwhile, the current account deficit (excluding official transfers) declined to 8.0 per cent of GDP.

Cambodia's major export items are textiles and apparel, footwear, wood and wood articles, plastics, gems, live animals and rubber. Garments and footwear are the dominant exports, accounting for 87 per cent of total exports.

Major import items are textiles and fabric for garment factories (35 per cent of total imports), oil products (15 per cent), machinery and electrical appliances (11 per cent), foodstuffs (8 per cent), pharmaceutical products (6 per cent), motor vehicles (5 per cent), pulp and paper (3 per cent) and plastics (2 per cent).

Cambodia's merchandise trade has not diversified, and a significant portion of imports remains concentrated in a few markets. Cambodia's major export partners are the United States, the European Union, Hong Kong, Singapore, Thailand and Vietnam. The United States is Cambodia's main export market for garment products. Only about 6 per cent of Cambodia's exports went to ASEAN.

Imports, however, come mainly from Asian countries, including Hong Kong (18 per cent of all imports), Thailand (15 per cent), Taiwan (12 per cent), China (8 per cent), Singapore (7 per cent) and Vietnam (6 per cent). Imports from ASEAN countries represent 39 per cent of all imports, making ASEAN countries Cambodia's main import partners. Meanwhile, 6 per cent of Cambodia's imports come from the European Union and 2 per cent from the United States.

Re-exports presently account for a sizeable portion of Cambodia's merchandise trade and are an important source of revenue. However, their importance has gradually declined since 1996, when their value was US$350 million—33 per cent of total import value or half the value of retained imports and the same value as domestic exports. In 2000, re-exports declined by 12 per cent to US$236 million. Most of Cambodia's re-exports go to Vietnam, and they mainly consist of cigarettes, gold, pulp and paper, alcohol, soft drinks, and motor cycles, electrical appliances and motor vehicles.

Garments as a pillar for Cambodia's exports

In the late 1990s, Cambodia's exports performed remarkably well, with total exports rising from a negligible US$51.3 million in 1992 to US$1.1 billion by 2000. Garment exports explain most of this growth. Up until 1995, garment exports were almost non-existent, however with increased stability, relatively low wages and no quantitative restrictions to

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the European Union and United States markets, and because neighbouring countries were close to using up all their quota, foreign investors began engaging in production in Cambodia. Consequently, garment exports jumped from US$24.2 million in 1995 to US$79.4 million in 1996, tripled to US$227 million in 1997 and by 2000 had reached US$965 million, or 87 per cent of total export value in that year. While the growth has been unusually rapid, the pattern of manufacturing exports—dominated by labour-intensive products such as garments—is typical of a labour-abundant economy like Cambodia's.

In developing economies like Cambodia where labour is abundant and concentrated in the rural areas, labour-intensive modern sectors need to be expanded in order to absorb unskilled workers during the earlier stages of industrialisation. Judging by the experiences of other Asian economies, it can be said that as incomes increase, employment in agriculture tends to decline. Also, technologies used in traditional industries tend to change as costs of labour rise and technological advances are made, encouraging the adoption of new methods. Typically, job opportunities in services and industry increase, as employment in agriculture and the informal sectors declines and workers move to urban areas and the formal sectors. Given the large supply of unskilled workers in Cambodia, this process is likely to continue for many more years.

Since 1995, the main engines of economic growth and largest generators of employment in the formal sector have been the garment and footwear and tourism sectors. In 2000, there were about 200 garment factories in Phnom Penh employing more than 120,000 workers, most of them young women.

The main markets for Cambodia's apparel exports are the United States and the European Union. The United States imported more than 67 per cent of Cambodia's apparel exports in 1999 and 76 per cent in 2000, while the European Union imported 23 per cent of apparel products in Cambodia's top 50 export commodities in 1999 and 23 per cent of its total garment exports in 2000. The main export markets for Cambodian footwear are the European Union (60 per cent) and Japan (35 per cent). Exports from Cambodia to the United States took off in 1997, and experienced an average annual growth rate of nearly 70 per cent between 1997 and 2000. Apparel products make up more than 97 per cent of Cambodian exports to the United States. The surge in garment exports (especially of woven trousers and knitted shirts) to the United States moved the US Government in 1999 to impose volume restrictions on 12 categories of Cambodian exports for a period of three years, on the grounds that Cambodian exports were disrupting the US garment market. The US trade representative has chosen to treat garment products as 'sensitive' import items and thus exclude them from the generalised system of preferences (GSP). Thus, those of Cambodia's export commodities that could be competitive on US markets do not receive tariff-free access, and in fact the current average most-favoured nation (MFN) tariff rate for US apparel imports is 17.6 per cent.

Cambodia has duty-free quota-free access to the EU market under the 'Everything But Arms (EBA)' initiative because of its status as a least developed country (LDC). Under the EBA initiative, part of the European Union's GSP, which came into effect in February 2001, all products from all 48 least developed countries receive duty-free quota-free access

to the EU market, provided they conform to rules of origin. In the past, Cambodia's garment exports to the EU were guided by the three-year Cambodia–EU bilateral textiles agreement, signed by the two Governments in May 2000, which eliminates quantitative restrictions on Cambodian garment exports to the EU, subject to market share considerations and rules of origin. A product will be considered to be of Cambodian origin if it has no less than 40 per cent local content, and in addition, under the EU program, Cambodia is allowed to have cumulative origin with ASEAN and the European Union—that is, materials imported from ASEAN or EU countries can be counted as Cambodian local content. Also, until the end of 2001, under the special waivers granted to Cambodia and three other least developed countries, certain textile products from Cambodia are allowed to have cumulative origin with ASEAN countries, as well as member countries of the South Asian Association for Regional Cooperation (SAARC) and African, Caribbean and Pacific (ACP) countries, up to a certain quantitative limit. However, given that most of the material inputs of Cambodia's garment industry are from Hong Kong and China, most Cambodian garment exports to the European Union do not conform to the rules of origin and thus do not receive duty-free access to EU markets.

Additional easing of quantitative restrictions on Cambodian exports is linked to progress made in labour standards. According to this agreement, a quota increase of up to 14 per cent quota is possible if Cambodia 'substantially complies with labour standards', including those set out in Cambodia's labour laws and the four core International Labor Organization (ILO) conventions. The ILO's definition of internationally recognised core labour standards has four parts

- freedom of association and the effective recognition of the right to collective bargaining
- the elimination of all forms of forced or compulsory labour
- the effective abolition of child labour
- the elimination of discrimination in respect of employment and occupation.

In 2001, following an assessment of Cambodia's labour standards, the US Government eased restrictions by 9 per cent. It did not commit to the full increase on the basis that Cambodia had not made substantial progress in respect to freedom of association and the right to recognise and bargain collectively. The basis of this decision is not well documented, however, and the condition 'substantial compliance' with labour standards is vague and open to non-transparent assessments.

An argument often used to allay concerns about least developed countries' lack of market access to developed country markets is that garment quota arrangements and GSPs are specially designed to help these countries sell their products in industrial economy markets. There is evidence, however, that the US garment quota arrangement has restricted the growth of Cambodia's exports to the United States. Two important points can be made in this respect. First, while the United States has supposedly made Cambodia a beneficiary of its GSP, the system specifically excludes textiles and garments from the list of goods subject to low or zero tariff rates. Thus, Cambodian garments (both quota and non-quota garments) are subject to high most-favoured nation tariff rates, 17 per cent on average.

Second, the annual easing of quota restrictions by up to 20 per cent during the agreement period is less liberal than it first appears. In fact, the largest easing of quota restrictions so far has only been 15 per cent, in 2001—the guaranteed 6 per cent annual increase and a 9 per cent increase for progress on labour standards.

The growth of Cambodia's garment industry has been remarkable and is well known. Industrial growth from virtually zero activity to some 200 factories and 150,000 jobs in just five years would be spectacular in any country, let alone one experiencing political upheaval and hampered by rundown infrastructure, poor administration and a poorly educated labour force, as Cambodia was during the period in question.

Paddy production and the rice trading system

The Cambodian rural economy is composed predominantly of semi-subsistence rice farms, and household and small enterprises employing less than 10 people. There exists a wide range of opportunities to build on this base, that is to diversify and expand agricultural production and value-added processing activity, with an orientation toward domestic and international markets. However, there also exist constraints.

- Systemic constraints, including poor infrastructure, governance issues (especially informal taxes and transaction costs), access to information, and access to capital.
- Specific constraints, most importantly the lack of effective support of small-scale private producers and processors, in particular extension services for non-rice production and business development services for agro-processing entrepreneurs.

The government's poverty alleviation objectives can be addressed through employment generation, especially in rural areas. The suggested means to generate employment is to encourage the existing small-scale private sector to diversify agricultural production and expand and develop agro-processing enterprises. A number of specific approaches have been described, and the proposed Incubator Project could provide a mechanism for a more in-depth analysis of the sector, and the identification and nurturing of some initial successes.

Most rice in Cambodia is produced by rural household units, using low-input technology and with little contact with the market. The main inputs for most rice production systems are land and labour, and output per unit of land and labour are amongst the lowest in Asia. Many farmers are illiterate and have limited access to information and agricultural support services. Rice seed is often self-grown, or obtained from other farmers, thus seed quality is variable and adoption of new varieties slow. Seed varieties are often mixed, making it difficult to obtain quality consistency and difficult to achieve management practices suited to external markets. Practices that may have been appropriate for subsistence production are proving less appropriate to production for higher-income urban and export markets. Post-harvest losses are high, while opportunities to reduce losses and improve quality exist at all stages, from husking, drying, transport, storage, milling and polishing to final marketing. The overcoming of these deficiencies could bring substantial gains in terms of increased household incomes, poverty reduction, and increased export opportunities.

Small family mills are found in most rice-producing villages, and they generally mill rice for local farmers in return for the bran, or for a cash fee. They also sometimes act as buyers for larger mills, which are located in the major rice surplus areas and in Phnom Penh. Most of these mills purchase paddy, mill it and than sell it to wholesalers and retailers, however a few larger mills have their own wholesale and/or retail outlets. A Federation of Rice Millers was recently established to represent the interests of Cambodian millers, and to increase valued added in domestic rice processing. The Federation recognises that the interests of rice millers are best served by assisting farmers to produce quality rice to meet consumer needs, and has thus been studying ways of enabling farmers to supply better rice.

Cambodian farm gate prices are squeezed by high transportation costs due to poorly developed infrastructure, weaknesses in transport services, informal tax collections on roads and other transaction points, and high shipping costs. Weaknesses in post-harvest practices and rice milling result in the export of substantial quantities of unmilled paddy to Vietnam and Thailand. Limited domestic milling capacity adds to marketing costs and further reduces the prices paid to farmers. These are deadweight losses to the economy. Given the relatively small economies of scale in rice milling, there should be strong profit incentives to invest in improved post-harvest processing and avoid these costs, however past instability and financing problems have been cited as reasons for limited investment to date.

The economic gains from reduced inefficiency in agricultural production and trade would be substantial, with expansion of trade in rice and other agricultural commodities contributing significantly to poverty reduction. In Cambodia, most efficiency gains can be realised from reform of domestic production, processing and trade systems, rather than reform at the border. The resulting reductions in intermediation costs would benefit both producers and consumers. Although Cambodia is a net exporter of rice, and domestic rice generally reflects export parity prices, there is some market segmentation. Higher-quality paddy is exported, while high-quality milled rice is imported. Improving the quality of local rice would reduce the need to import high-quality rice and, by reducing transport costs, would result in lower prices for high-quality rice in urban areas in Cambodia. Also, increased domestic production of higher-quality rice, in the absence of other efficiency gains, could result in reduced supplies and increased prices for lower-quality rice.

In localised areas where no opportunities currently exist to access other domestic and international markets, increased trade opportunities would result in increased local rice prices. This would benefit those with sufficient resources to produce surplus rice but increase the cost of purchasing rice for those without the resources to fulfil household requirements. On the other hand, improved access to trade and higher farm gate prices would boost incentives to increase investment in production, in turn generating increased employment. Thus households with rice surpluses would benefit, while potential net effects on rice consumers remain unclear.

In addition to rice production at the household level, the government's agricultural development approach is also significantly concerned with the expansion of plantation crop production for export in raw or primary processed form. Rubber has been an

important export crop since colonial times, and, in the current stage of transition from a command economy to a market-driven economy, the model of granting large tracts of land to individual management units (state-owned, quasi-private and private enterprises) for production purposes remains attractive to policymakers.

Agricultural processing and marketing are largely informal; the processing and marketing of the larger rice millers and the rubber and other plantation enterprises are exceptions to this. Since storage and processing infrastructure is minimal, agricultural products flow from small producers to consumers quickly, through short channels. Producers either bring commodities directly to local markets themselves or sell to collectors (middlemen), who deliver to retailers in larger market centres, especially Phnom Penh. Some wholesale enterprises exist, especially for commodities that may be transported to other provinces or exported to Thailand and Vietnam, but even these are informal enterprises, often without fixed operating locations or storage space.

Agricultural products are traded within and between provinces where local surpluses and deficits of rice, fruit, fish or other staples exist. Commodity supplies and requirements are often seasonal, with many non-rice crops being produced in the wet season. Net flows may reverse from season to season, as for example imports of oranges to Phnom Penh in February and exports of oranges from Battambang to Thailand at other times of the year. Many commodities will be in glut for a short time, then disappear to be replaced by others in season.

Cambodian markets display a broad range of locally processed agricultural products, for example milled rice; smoked, dried, fermented or salted fish; fermented cabbage and pickled vegetables; noodles; baked goods; and dried fruit. Much of this material comes from household and micro-enterprises, although a few larger processing operations do exist, in addition to the large rice mills. A recent study of large manufacturing enterprises in Phnom Penh found 20 per cent of the sample to be food processors, such as noodle manufacturers, small canneries and bottling plants (Webster and Boring 2000). Unfortunately, the study was essentially confined to Phnom Penh, and the analysis did not provide a disaggregated description of the operations in question. More detailed field studies are required to identify and describe household-level and larger operations in other centres, especially in rural communities.

Trade liberalisation

Recent changes in tariff policy

The main objectives of Cambodia's foreign economic policy are to expand and strengthen economic ties with the rest of the world through the integration of the Cambodian economy into the regional and world economies, and to utilise the advantages of the international division of labour to promote economic development and improve the welfare of the population.

Since the late 1980s and especially in the early 1990s, Cambodia has undertaken trade liberalisation and integration of the country's economy into the regional and world economies. The private sector was freed to establish trading companies with a maximum foreign participation of 49 per cent. Most non-tariff barriers were eliminated, and in 1993

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Table 1 **Cambodia's tariff rate structure**

Tariff band	1997		2000		2001	
	Number	Share (per cent)	Number	Share (per cent)	Number	Share (per cent)
0	107	2.1	290	4.3	297	4.4
0.3	7	0.1	9	0.1	n.a.	n.a.
7	2,112	40.7	2,731	40.0	2,758	40.4
10	14	0.3	14	0.2	n.a.	n.a.
15	1,184	22.8	1,861	27.3	1,936	28.4
20	46	0.9	68	1.0	n.a.	n.a.
30	n.a.	n.a.	4	0.1	n.a.	n.a.
35	1,575	30.4	1,569	23.0	1,832	26.9
40	n.a.	n.a.	8	0.1	n.a.	n.a.
50	133	2.6	256	3.8	n.a.	n.a.
90	n.a.	n.a.	6	0.1	n.a.	n.a.
120	n.a.	n.a.	6	0.1	n.a.	n.a.
Total	5,186	100.0	6,823	100.0	6,823	100.0
Average tariff						
Unweighted average tariff rate		18.4		17.3		16.5
				(13.6)		(11.9)
Import-weighted average tariff rate		15.9		15.4		14.2
Effective tariff rate		n.a.		10.8		n.a.
				(12.4)		

Note: Figures in parenthesis are standard deviations, which measure the dispersion of tariff rates. Effective tariff rate is the ratio of revenue from tariffs over the value of imports. Import-weighted average tariff rate for 2001 has been calculated using import data from 2000.
Sources: Customs Department and Ministry of Economy and Finance.

the general licensing requirement was eliminated for most goods in which trade is undertaken by registered companies. Some non-tariff barriers still exist, including temporary export restrictions on rice and import licensing for pharmaceuticals. Exports of wood products are subject to annual export quotas and non-automatic licensing. In addition, owing to its low customs duties, Cambodia has become a hub for transit trade in the region, especially with Vietnam. Since 1996, however, re-exports to Vietnam have experienced a gradual decline, since Vietnam has begun opening up to rest of the region and the rest of the world.

The Cambodian Government continues to reform its tariff rate system. In April 2001, the number of tariff bands was reduced from 12 to 4, with the maximum tariff rate falling from 120 to 35 per cent (Table 1). Tariff rate reductions covered several major finished goods as well as some intermediate goods and raw materials. One of the major tariff cuts in this reform package covered finished passenger cars (from 40–120 per cent to 35 per cent) and spare parts (from 50 to 35 per cent); tobacco products (from 50 to 35 per cent); and alcoholic beverages such as wines and distilled beverages (from 50 to 35 per cent). However, these changes have had just a minor impact on the overall tariff structure, since only a small percentage (3.8 per cent) of tariff lines had rates above 35 per cent in 2000. For example, the percentage of tariff lines that were duty free or subject to the minimum 7

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per cent tariff rate only increased from 44.3 per cent in 2000 to 44.8 per cent in 2001, and the percentage of tariff lines with tariff rates of 15 per cent or less only increased from 71.6 per cent to 73.2 per cent. Consequently, the average tariff rate fell only slightly, from 17.3 per cent to 16.5 per cent, indicating that tariffs, on average, still remain high. A standard deviation of 11.9 per cent indicates that there is still a large dispersion of tariff rates.The government intends to reduce the unweighted average tariff rate to 14 per cent by 2002. While low average tariff rates are useful indicators of tariff reform progress, the picture they give is incomplete. Indeed, it would be possible to reduce the average tariff rate yet leave pockets of highly protected industries. As a rule of thumb, the lower the number of rates, the narrower the range of rates and the lower the average rate, the less costly the tariff structure will be to the economy in terms of misallocation of resources.

Almost half of Cambodia's total tax revenue comes from border taxes. Tariff rate reductions on the many high-revenue yielding imported excisable goods (petroleum and petroleum products, autos, motorcycles, beverages and cigarettes) raised concerns that the tariff changes would result in a drop in revenues. As a revenue-compensatory measure for the tariff changes, the government increased excise tax rates on the products in question (see Annex B for details). As result of these tax increases, the average applied rate of taxes on imports (import duty plus excise tax) remained virtually unchanged at 18 per cent from 2000 to 2001. The advantage of this shift away from tariffs to excise taxes as a revenue-raising measure is that it avoids the negative effects of high tariffs on domestic resource allocation, since an excise tax applies equally to domestically produced goods and imports.

It is striking that the shares of imports by tariff band are similar to the distribution of tariff lines (Table 2). Still, a fifth of all imports are subject to the highest tariff rate of 35 per cent. The tariff peaks (tariff rate of 35 per cent) protect several semi-processed goods and consumer goods such as processed meat and dairy products; processed vegetables and fruits, wheat flour; beverages and tobacco; garments and footwear; plywood; and jewelry. For revenue-raising purposes, all major excisable goods are included in this band. On the basis of import data for 2000, the import-weighted average tariff rate fell from 15.4 per cent in 2000 to 14.2 per cent in 2001. These statistics do not take into account the extensive use of tariff concessions in connection with investment and export incentive schemes.

Almost 80 per cent of Cambodia's total tax revenue comes from taxes on imports. In addition to customs duty, two indirect taxes are levied on imports: excise tax and value added tax (VAT). In 2000, excise tax and VAT represented approximately 51 per cent of total taxes on imports. Excise taxes are levied on five product groups: beverages (including

Table 2 **Tariff rate structure**

Tariff band	Tariff lines per cent	Imports per cent
0	4.4	8.1
7	40.4	45.6
15	28.4	25.9
35	26.9	20.4

Source: Ministry of Economy and Finance.

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mineral water), tobacco, passenger vehicles, motorcycles and petroleum products. The VAT is a uniform 10 per cent rate. With few exceptions, both taxes are levied on imports at the same rates and with the same conditions as domestic traded goods. For imported materials used to produce exportable goods, exporters receive VAT zero rating.

To certain types of importers, import duty concessions and exemptions are available. Items imported for the purpose of re-exporting (for example, cigarettes) are charged a concessionary duty rate. Imports of goods by international donors, NGOs and the Cambodian Government are all exempt from import duties. Under the Investment Law, investors who export more than 80 per cent of their product are entitled to duty exemption on capital goods, raw materials and intermediate inputs. Other investors approved by the Council for Development of Cambodia (CDC) are entitled under the Investment Law to duty exemptions on imported goods, normally for one year, although a one-year extension of duty exemptions is possible. In 2000, about half of all imports were exempt from duty and tax, and forgone tax revenue was estimated at US$207 million. In the first semester of 2001, forgone revenue amounted to US$128 million (CR501 billion), compared with customs collection of US$112 million (CR436 billion). Almost 80 per cent of trade tax exemptions are connected with from imports of raw materials (mainly fabrics) and capital goods used by garment producers.

Given the widespread availability of import duty exemptions, nominal tariff rates applied in practice are quite different from listed tariff rates. Moreover, certain other trade taxes tend to be less visible but are often no less important. As a result, the average burden of tariffs on traded goods will be quite different from the listed tariff rates.

Of course, there are sound economic reasons to have a low effective tariff rate on most imported goods, but an *ad hoc*, unsystematic tax exemption scheme is not an effective means of achieving this goal. In particular, differential tariff treatment creates unpredictability and non-transparency for importers and investors, while the elaborate system of administration it requires tends to cause both the Government and investors losses in time and money.

Examining the effective tariff rates on imports, we see a heavy reliance on a relatively narrow base of imports. The traditional excisable goods—petroleum, alcoholic beverages, tobacco and autos—account for more than 60 per cent of customs tariff revenue. According to customs data, the ratio of total collected tariff revenue to total value of imports is 6.7 per cent. The fact that this ratio includes a large proportion of tariff revenue on a small number of excisable goods means that the average burden of tariffs is in fact much less. If the major excisable goods are eliminated, the ratio is 3 per cent.

Reflecting in part the various exemptions along with preferential rates applied under the Common Effective Preferential Tariff Agreement (CEPT), the average effective tariff rate for all imports is 10.8 per cent, much lower than the average listed nominal rate of 16.5 per cent. Nonetheless, the *ad hoc* nature of the various exemption schemes has created as much variability or distortion in the tariff structure as the listed nominal rates imply, as indicated by the fact that the dispersion of effective tariff rates (measured by the standard deviation of 12.8 per cent) is not much smaller than the dispersion of listed rates (13.4 per cent).

Table 3 **Average effective trade tax on exports, 2-digit HS**

HS	Product group	Export tax per cent
01	Live animals	10.0
44	Wood products	9.9
03	Fish	9.8
40	Rubber	3.2

Source: Customs Department, Ministry of Economy and Finance.

As indicated above, officially recorded trade taxation of exports (that is, through customs) is relatively limited. The average effective trade tax for exports was 5.7 per cent, while the primary goods burdened with significant export taxes are wood, rubber and fish (Table3). There is, however, anecdotal evidence of cases where the effective tax rate is less than the listed nominal tariff rate. The effective tax rate for imports of fabrics, for example, is much less than the nominal tariff rate of 7 per cent, no doubt reflecting significant exemptions from duty granted to manufacturers of garment exports.

There is a strong economic case for retaining duty exemptions on materials required by exporters. Exporters need to be able to source materials at international prices if they are to remain competitive. Garment manufacturers now account for about 80 per cent of the total value of duty exemptions. One approach for the garment industry would be to reduce tariff rates on imported materials and accessories—for most of which the current tariff rate is 7 per cent—to zero. This would have little impact on customs revenue, since most imported fabrics and accessories are already exempted from duties. Garment exporters would not have to maintain a Master List for imports of materials at CDC, as they are currently required to do under the duty exemption scheme, and they would be able to reduce administration costs for both the garment industry and the Government.

A zero tariff policy for garment inputs would also help develop a competitive domestically oriented garment industry, since Cambodian firms would also be able to source materials at international prices. To avoid a distorted incentive regime, however, tariffs on finished garments (currently 35 per cent) would also have to be set to zero. This would only be viable for exporters operating in the garment (and also footwear) sector, where it is possible to identify required imported inputs for which their demand dominates the demand of importers in general. Rather than zero tariff, a low rate of 2–3 per cent combined with streamlined procedures would bring greater benefits to exporters (lower costs overall) and the Government (more revenue), though perhaps not to people relying on bureaucratic costs.

There are several good reasons to limit exemptions to trade taxes for non-exporters and on capital imports. First, exemptions are always difficult to administer, exemptions to government, donors, international organisations and NGOs not excepted. Officials are inevitably pressured to widen the range of exemption-receiving imports or be flexible in applying regulations. Second, duty exemptions can distort purchasing decisions. It may actually be more efficient to purchase a good locally but appear less expensive to import it duty free. While it is often difficult to reduce exemptions for imports by aid and donor

agencies, it is straightforward to do so for government imports. This reduces distortions in the allocation of government resources, setting a good example for the private sector. Moreover, as the overall tariff structure moves towards a low uniform rate, the need for duty exemptions on imports by non-exporters will diminish. Finally, in moving towards a low uniform tariff rate, surcharges implicit in the administered minimum dutiable value system will need to be removed, perhaps by abolishment of the system itself.

A final issue relates to the adjustment costs of tariff policy reform. Countries that have liberalised their trade policy regimes have experienced short-term adjustment costs to varying degrees. In particular, countries that made extensive use of tariffs and non-tariff barriers to protect inefficient industrial bases in the past have typically experienced the greatest adjustment costs. One of the common costs is temporary but high unemployment, as inefficient sectors restructure and resources move to more productive uses. Cambodia, however, is unlikely to face the same short-term adjustment costs as many other countries, for the reason that, despite the inherent distortions in its tariff structure, Cambodia does not have an inefficient industrial sector protected by high tariffs. For many activities, the remaining high tariff rates are redundant, either because little domestic activity is undertaken in the related sectors or because smuggling keeps domestic prices close to world prices.

Most of the recent rapid growth in Cambodia's industrial sector has been driven by export-oriented sectors, notably garments and more recently footwear. As a consequence, further tariff reform will bring great benefits in the medium term. A low, uniform rate will signal to investors that Cambodia wishes to be a platform for investment in activities where it has a comparative advantage, and this should attract sufficient new FDI in the relevant sectors. A low, uniform tariff rate will allow investors to source raw materials at world prices (or close to world prices), ensuring that producers supplying the domestic market (including state marketing enterprises) will not be disadvantaged in relation to imports, and this in turn will encourage the development of import-competing industries.

Valuation of imports

Cambodian Customs operates two valuation schemes for the purpose of calculating dutiable values for imports and exports. The first is a fair market value (FMV) scheme, whereby the valuator (Société Générale de Surveillance (SGS) under the Pre-Shipment Inspection agreement) uses international prices to determine dutiable values. In the second scheme, the Ministry of Economy and Finance (MEF) sets predetermined, minimum or fixed dutiable values for certain products to be used by SGS and customs. Customs duty, excise tax and VAT are calculated from the administered prices. For some of these products, SGS is required to use the pre-determined minimum values in cases where the pre-determined values are greater than actual SGS valuations based on the FMV or c.i.f. value of imports. For a small number of other products (petroleum, for example), fixed dutiable values are used irrespective of c.i.f. value of imports. The stated purpose of this scheme is to circumvent under-valuation of imported items and thus ensure stability in customs revenue collection. In cases where the predetermined minimum value is higher than the FMV, the customs duty will increase, indicating a specific duty, thus the implicit *ad valorem* tariff rate will be higher than the applied tariff rate. Where minimum values

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are set by brand (motorcycles, cigarettes) or source country (for example, passenger automobiles), the implicit *ad valorem* tariff rate will often vary among brands and countries. This system gives rise to non-transparent duties increased protection, especially when international prices fall below the administered minimum dutiable import values.

More then 400 items made in Thailand and Vietnam are also subject to administered minimum dutiable values. While it is impractical to compare the values of all items subject to administered dutiable values with their corresponding c.i.f. values or FMV, selected examples demonstrate the extent to which these prices deviate. For some products, current administered prices are roughly in line with international prices—for example, gasoline (US$320/tonne). These prices will deviate, however, if international oil prices suddenly change. For other products, the c.i.f. value or FMV of imports is lower the administered price. For example, the FMV of ordinary Portland cement, exported to Cambodia between May and July of 2001, ranged between US$32/tonne and US$34/tonne, compared to the minimum administered price of US$40. With a tariff rate of 10 per cent applied to the administered price of US$40, the implicit *ad valorem* tariff rate on imported cement was approximately 12.5 per cent.

Administered dutiable values for used automobiles are generally set above the c.i.f. value of imports. For example, in 2001, an imported used 1999 Toyota Camry (2000cc) was subject to an administered price of US$8,500, whereas its FMV was estimated at US$4,634, meaning its implicit *ad valorem* tariff rate was 64 per cent and not the applied tariff rate of 35 per cent. A recent Ministry of Economics and Finance letter instructs SGS to use FMV for Mercedes passenger cars and trucks made in Korea, thus no implicit surcharge is imposed on Mercedes models produced in Korea and exported to Cambodia. Smuggling of automobiles into Cambodia, however, is prevalent, and this activity undermines customs duties collection.

For some products, the fixed dutiable value is deliberately set below the c.i.f. value of imports. Two examples are cigarettes and used motorcycle parts. Cigarettes are a major re-export product, with up to 80 per cent of imports informally re-exported, mainly to Vietnam. To encourage this activity, and to capture some customs revenue from it, Customs applies the normal tariff and excise rate to cigarette imports at a dutiable value set below the c.i.f. value of imports. Similarly, for used motorcycle parts the Government sets a dutiable value below market value according to an import substitution strategy, since three or four firms assemble these components locally.

Overall, this minimum dutiable valuation regime can be said to create uncertainty in the tariff structure, since it creates ‘hidden’ specific duties or concessions not explicitly included in the tariff schedule. Valuation regimes and the resulting specific taxes lead to increased protection and protection increases whenever international prices fall below administered prices. Such regimes are also often used as ‘backdoor’ ways of protecting certain domestic or foreign producers from competitive imports. The implicit specific duty regime is also discriminatory, as it treats products differently according to brand or country of origin. Another problem is that import (c.i.f. or FMV) prices often deviate from administered prices, especially if the latter are not updated (as of December 2000, many administered prices had not been updated for two years). In some cases the fixed

administered prices fall below the market price, in which case the government forgoes revenue. Finally, like high tariffs, implicit specific duties encourage smuggling.

Ad valorem tariff rates are preferable to specific taxes as tariff instruments, because whenever international prices of imports change they create less variability in domestic prices and are thus less costly to the economy in terms of resource misallocation.

Import restrictions and controls

In 1994, with a few exceptions, all official quantitative restrictions on imports were eliminated as part of comprehensive trade reforms. The import license system was also eliminated in 1994, for all items except pharmaceutical products, gold and silver, armaments and ammunitions, and various cultural and medical products. Ministerial authorisation is required for imports of these items. A few bans on imported goods remain. Recent examples of import prohibitions include pig meat, used motorbike tires, right-hand drive automobiles, and used footwear. Otherwise, importers face no restrictions as long as they are registered firms incorporated under Cambodian law. Foreign trading companies are free to operate in Cambodia, as long as they are incorporated under Cambodian law and registered with the Ministry of Commerce. While a few state trading companies continue to operate, for the most part they compete with private trading companies in the same markets.Table 4 shows selected products subject to import licensing and prohibitions.

Developments in export policy

Export prohibitions, quotas and charges. For certain exported goods, licensing is used to administer quotas, conditional prohibitions, and absolute prohibitions. These measures are typically put in place for public health and security reasons as well as to fulfil agreements with trading partners, notably in the case of textiles and clothing exports to the

Table 4 **Selected products subject to import licensing and prohibitions**

Commodity	Rationale	Measures	Responsible agency
Live pigs and pig meat	Public health	Prohibited	Ministry of Agriculture
Armaments and ammunitions	National security	Prohibited, except for military procurement	Ministry of Defence/ Internal Affairs
Illicit drugs	Public health	Prohibited	
Firecrackers	Public safety	Prohibited, except for special occasions	Ministry of Defence? Internal Affairs
Printing material	Public morality	Prohibited if deemed to have negative impact on society	Ministry of Education/ Ministry of Culture
Gold bars	Monetary policy	License	Central Bank of Cambodia
Cultural items	Protection of culture	License	Ministry of Culture
	Monetary policy	Automatic license as long as declared items above US$10,000	Central Bank of Cambodia
Pharmaceuticals	Public health	License	Ministry of Health
Artificial sweeteners	Public health	License	Ministry of Health
Right-hand drive vehicles	Public safety	Prohibited	n.a.
Used motorcycle tires	Environment	Prohibited	Ministry of Environment
Used footwear and leather bags	Environment	Prohibited	Ministry of Environment

Source: Customs Department, Ministry of Economy and Finance.

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United States and European Union. Cambodia currently has an absolute ban on exports of logs, an export quota on rice, and garment quotas. Five items are subject to export licensing: processed wood products (furniture, wooden handicrafts and so on), garments, weapons, all vehicles and machinery for military purposes, pharmaceuticals and medical materials. Ministerial authorisation is required for export of these items. A state-owned enterprise, KAMFIMEX, has a monopoly on fish exports. In 1996, an export quota was placed on rice, replacing a previous ban on rice exports. The export quota is an element of the government's food security program. Evidently, the quota on rice exports is not binding, since the actual recorded export volume has never reached the ceiling set by the quota. A special inter-ministerial working group decides on the annual ceiling for the quota. Individual shipments, which should not exceed 3,000 tonnes, are granted an Export License from the Ministry of Commerce after approval is obtained from the Ministry of Agriculture, however unofficial (non-quota) exports of rice and also unmilled paddy are apparently substantial, though estimates are not currently available.

Since May 1995, an export ban has been imposed on logs and sawn logs. In the early 1990s, strong economic growth recorded in the Asian countries created a substantial increase in the demand for logs. Meanwhile, neighbouring countries such as Malaysia and Thailand strengthened their control on log exports, hence log prices increased significantly. These elements, together with limited institutional capacity for proper forestry management, were conducive to illegal log exports from Cambodia. The 1995 ban, combined with export taxes on semi-processed wood, is considered by many observers to be inefficient, since it encourages excessive and costly domestic processing of plywood and veneer sheets. The government intends to review the ban and bring it into line with ongoing improvements in overall forestry management.

In 1999, an export quota was placed on garment exports to the United States, in response to a surge in Cambodian garment exports. Quota restrictions were imposed on 12 broad categories of garments, initially for three years, up until December 2001. Under the current arrangement, the quota restriction will be eased by 6 per cent per annum. An additional easing of up to 14 per cent of the quota will be allowed if Cambodia 'substantially complies with labour standards', including those set out in Cambodia's labour laws and the four core ILO conventions. Following an assessment of Cambodia's labour standards, the US Government has granted Cambodian garment imports a 9 per cent quota increase. The Cambodian Government has implemented a flexible quota system whereby about 80 per cent of the quota is allocated to firms operating in Cambodia in 1998, on the basis of past export performance and production capacity. Up to 10 per cent can be allocated to exporters as a reward for current export performance and compliance with the country's labour laws, and the remaining 10 per cent is sold to garment producers through auction. For garments sold under quota to the United States and garments exports to the European Union, the government charges a specified fee (known as visa fees) per dozen.

The garment quota arrangement raises several important issues relating to long-term competitiveness. First, institutional labour arrangements—such as relatively high minimum wages and restrictions on work shifts, as well as the costs of compliance with

such standards—are raising overall garment sector costs. While these arrangements may benefit current workers in the short term, they put expanded employment in the industry at risk by creating a cost structure only viable with preferences and not viable if preferred markets cease to exist. Further, they also put the development of other potential export sectors at risk, since they create a relatively high cost structure in labour-intensive sectors where Cambodia has a comparative advantage.

Second, Cambodia's preferential market access to the United States and European Union has led to a costly export facilitation process, which is cumbersome compared to those of many other exporting countries in the region. Much of this process involves ensuring that Cambodian garment exports comply with rules of origin. For example, Cambodian garment exporters require up to 11 documents from three ministries and five departments before their shipments are permitted to leave port. Further, four government agencies are involved in the product inspection process, essentially replicating one another's functions. For example, to export to the United States and European Union, an exporter must obtain a Certificate of Processing from the Ministry of Industry, Mines and Energy (MIME) as proof that the garments are made in Cambodia, and Ministry officials will visit the factory in order to verify this. Then, the exporter must obtain a Certificate of Temporary Authorization to export from the Generalized System of Preferences (GSP) division at the Ministry of Commerce. Officials do not carry out verification of origin at this stage. Both Camcontrol (the Ministry Of Commerce body for the control of product quality) and Customs must then carry out a pre-shipment verification of exports on the factory premises and issue a certificate of inspection before containers are permitted to leave Cambodia. The process is costly and time-consuming, and, because it depends on the physical inspection of shipments by three agencies, is very much open to abuse by petty officials. One of the reasons for this excessive licensing procedure was European Union and United States concerns about third-country garments with fake Cambodian labels arriving at their ports.

As with import duties, export taxes in Cambodia have statutory rates, as stipulated in the Customs Tariff Schedule. In general, the number of products and the level of applied export taxes (except for re-exports) continues to be very low and their contribution to government revenue negligible. Export taxes on live animals and fish (10 per cent), however, place a burden on farmers and fishermen. In addition to the export tax, the Ministry of Agriculture, Forestry and Fisheries has granted a fish export monopoly to the state-owned enterprise KAMFIMEX, which comes under the Ministry's purview. KAMFIMEX does not take physical delivery of fish, but instead licenses five export distributors to purchase fish and transport them across the Thai border. Distributors collect a 4 per cent fee on all fish transported, while the export price is about 35 per cent of the retail price of fish sold in Phnom Penh, indicating that returns to fishermen are relatively low because of KAMFIMEX's distribution monopoly.

Exports of raw hides and skins and semi-processed skins are taxed, reducing the export prices received by farmers and benefiting producers who use these items as inputs in the production of, for example, (tanned) leather and leather-related products. (Cambodia also imposes maximum tariff rates on semi-processed hides and tanned leather imports, and on several leather-based consumer products such as handbags and footwear.)

Other countries' experiences, however, demonstrate that such a strategy can have significant costs. Hides and skins are for the most part byproducts of farmers' primary activity, that is breeding animals for the food industry. An export tax, by reducing the domestic price farmers receive for raw hides, typically takes away the incentive for farmers to take care of hides, thus bringing down the quality of locally-produced tanned leather. Local producers of leather-related goods, especially those who want to compete in the lucrative international market (for example, manufacturers of footwear, handbags, travel cases and so on) require international-quality leather, which the local industry is typically unable to supply. While large exporters of footwear are able to source high-quality leather at international prices through the duty exemption scheme, firms (especially SMEs) supplying the domestic market or wanting to export part of their products are restricted to purchasing low-quality, higher-priced domestically processed leather. This reduces the competitiveness of downstream industries. Other countries such as Indonesia have recognised these negative aspects and recently removed export taxes on local hides and skins, and also reduced tariff rates on imported processed leather.Table 5 shows selected products subject to export licensing and prohibitions.

There is a similar rationale for the export tax on semi-processed wood, veneer sheets and sheets for plywood (there are no corresponding export taxes on finished products such as plywood, veneer panels and other laminated panels). Camcontrol, the Government's health standards and product-quality inspection agency, also imposes a fee of 0.1 per cent on the value of all imported and exported goods.

The ASEAN Free Trade Area Agreement

In April 1999, Cambodia was admitted as the tenth member of ASEAN, and since then the Government has doubled efforts to meet the demands of ASEAN membership—from changing laws to bringing the finance, investment, commerce and trade sectors into alignment with ASEAN standards. Under the ASEAN Free Trade Agreement (AFTA), Cambodia has firmly committed to reducing the majority of tariff lines to below 5 per cent by 2010 and the remaining tariff lines (mainly applicable to sensitive agricultural products) to below 5 per cent by 2015, this within the framework of the CEPT.

The CEPT requires Cambodia to put all tariff lines into one of four lists: the Inclusion List, comprising goods for which CEPT rates will be reduced in either the 'normal' or 'fast' track; the Temporary Exclusion List, made up of goods viewed as too sensitive for immediate rate reductions; the Sensitive List, comprising products declared sensitive and allowed a longer time frame for phasing into the Inclusion List; and the General Exclusion List, made up of a relatively small number of goods for which trade is restricted on the basis of safety or cultural reasons.

The reduction of tariff rates within the framework of the CEPT has two outstanding features. First, the bulk of goods are currently in the Temporary Exclusion List, with only 46 per cent of goods in the Inclusion list and the remaining 2.7 per cent remaining in the restricted lists. Second, tariff rates on goods in the Inclusion List will not be fully reduced to the 0–5 per cent range until 2007. Meanwhile, goods in the Temporary List will be phased into the Inclusion List only between 2005 and 2010, with the commitment that their tariff rates will be reduced to 0–5 per cent by 2010. It is important to note that goods

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Table 5 **Selected products subject to export licensing and prohibitions**

Commodity	Rationale	Measures and conditions	Responsible agency
Prohibitions and licensing			
For public health, security reasons			
Logs and unprocessed timber	Forestry management	Prohibitions	Ministry of Agriculture, Fisheries and Forestry
Sawn timber	Forestry management	Prohibitions	Ministry of Agriculture, Fisheries and Forestry
Articles of processed wood	Forestry management	License	Ministry of Agriculture, Fisheries and Forestry
Cambodian antiques	Protection of culture	Prohibition	Ministry of Culture
Sandalwood	Protection of rare wood	Prohibition	Ministry of Agriculture, Fisheries, Forestry
Weapons	National security	Prohibition	Ministry of Defence/Interior
Vehicles/equipment for military use	National security	Prohibition	Ministry of Defence/Interior
Illicit drugs	Public health	Prohibited	Ministry of Health
Printing materials	Public morality	Prohibited if negative impact on society	Ministry of Education/ Ministry of Culture
Rice	Food security	Quota	Ministry of Agriculture, Fisheries and Forestry
Precious stones, raw gold	Monetary policy	License as long as declare items above $10,000	Central Bank of Cambodia
For economic reasons			
Textiles and garments	Bilateral agreement provisions	Export quota to US	Ministry of Industry/ Commerce
Footwear	Bilateral agreement provisions	Export license to EU	Ministry of Commerce
Pharmaceuticals and medical materials	Public health	Export license	Ministry of Health
Fish		Export monopoly granted to state enterprise	Ministry of Agriculture, Fisheries and Forestry
Live animals	Industry policy	Export license	Ministry of Agriculture, Fisheries and Forestry
Export taxes and other charges			
Garments	Visa fees	Implementation of garment visa system	Ministry of Commerce
Live horses and bovine animals	10 per cent export tax		Ministry of Economy and Finance
Fish, live, fresh, chilled, fillet	10 per cent export tax		Ministry of Economy and Finance
Raw hides, skins and semi-processed skins	10 per cent export tax		Ministry of Economy and Finance
Semi-processed wood	10 per cent export tax		Ministry of Economy and Finance
Veneer sheets and sheets for plywood and veneer panels	10 per cent export tax		Ministry of Economy and Finance
Wood cases, boxes, casks and so on	10 per cent tax		Ministry of Economy and Finance
Used clothing	Unspecified export tax	Terminated in July 2001	Ministry of Economy and Finance
Camcontrol	Charges an inspection fee of 0.1 per cent of value of exports and imports		

Source: Customs Department, Ministry of Economy and Finance.

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on the Temporary Exclusion List would not be eligible for lower CEPT tariff rates if exported to other ASEAN member states. A second point to note is that Cambodia can choose to accelerate its tariff reductions at anytime.

There are good reasons for Cambodia to shift most goods from the Temporary Exclusion List to the Inclusion List immediately and reduce tariffs to 0–5 per cent before 2007. First, accelerated tariff reductions will make Cambodia a viable base for exports to ASEAN, but only for those goods that can be exported to member countries at the lower CEPT tariff rates. For this to happen, goods must be on the Inclusion List and the transitional CEPT rate must be 20 per cent or less. A more effective way to establish Cambodia as a potential investment site would be shift most tariff lines to the Inclusion List immediately, and reduce maximum rates to no more than 20 per cent, preferably less.

A second reason is strong competition from other new ASEAN member states. Investors looking to locate ASEAN-oriented investment in one of the low-wage new members will tend to choose areas of fastest growth and liberalisation. By delaying tariff reductions, Cambodia is forgoing the opportunity to emerge as one of the more attractive sites for ASEAN-oriented investment. It needs then to achieve rapid and comprehensive integration into the AFTA/CEPT framework, a necessary step towards which is the acceleration of tariff reductions.

A third reason for Cambodia to accelerate implementation of CEPT tariff rates is the need to establish predictability in its trade policies. The Government has indicated that most goods will have preferential (CEPT) tariff rates of 0–5 per cent by the year 2010, however nine years is a long time, and the less clearly defined this process is the less confidence investors will have in its eventual success. Stability and transparency are essential characteristics of any effective industrialisation strategy. The CEPT framework entails a large Temporary Exclusion List, which may create significant instability and uncertainty, especially during the next four to nine years when the goods in question are to be phased into the Inclusion List.

It is important to note that in implementing CEPT tariff rates, it would be beneficial for the difference between Cambodia's CEPT preferential tariff rates and its most-favoured nation rates for the rest of the world remained small. The reason for this is that the larger the difference between the two rates the greater the probability that the preferential trade area will divert Cambodia's trade away from the rest of the world to AFTA, rather than create new trade for Cambodia. Recent analyses suggest that if this occurs Cambodia will receive few benefits from joining AFTA. Indeed, an increasing proportion of Cambodia's trade is conducted with partners outside ASEAN, a trend that looks set to continue for many more years. Furthermore, a large margin between CEPT rates and most-favoured nation rates encourages Cambodian firms to source more expensive materials from ASEAN producers. Thus, the Cambodian government should consider ways of reducing most-favoured nation rates in parallel with CEPT rates in order to keep the wedge between the two as small as possible. AFTA permits this.

Cambodia is also committed to promoting other forms of economic cooperation, such as the ASEAN Investment Area (AIA), Liberalization of Trade in Services, and ASEAN Industrial Economic Cooperation (AICO), in the region. With AFTA, Cambodia will be

able to increase its competitiveness against other regional groupings, to increase trade and investment amongst ASEAN members and to third counties, and to achieve greater economic growth. Cambodia also benefits from bilateral trade agreements like the Generalized System of Preferences (GSP) granted by the United States in 1997 and the EU Preferential Rules of Origin for ASEAN members provided by the European Commission in 1999.

WTO accession issues

Existing legislation and new draft legislation and implementation. Cambodia first applied for WTO membership in December 1994, and submitted a Memorandum on its Foreign Trade Regime to the WTO Working Party in June 1999. In May 2001, a Cambodian delegation went to Geneva for the first meeting of the Working Party. The second Working Party is expected to take place in January 2002.

In preparation for WTO accession, the Cambodian Council of Ministers has adopted a draft Legislation Action Plan setting forth the legislative agenda for the years 2001, 2002, 2003 and 2004. Under this draft Legislation Action Plan, around 55 draft laws or regulations have been made in order to complete Cambodia's legal framework. In preparing, drafting, assessing and adopting these new laws and regulations, the ministries are required to ensure full compliance with WTO Agreements. The fields in which WTO Agreements are likely to make the greatest impact on national legislation are customs valuation; intellectual property; technical barriers to trade; and sanitary and phytosanitary (SPS) measures.

Another significant priority area for Cambodia will be the due process requirements under Article X of GATT 1994. Also, upon accession to the WTO, the Government intends to create a sound business environment by preparing and adopting a full range of new laws in order to establish a complete Commercial Code. The National Legislation Program involves the adoption of laws such as the Law on Business Enterprises, the Law Establishing the Commercial Court, the Commercial Contracts Law, the Commercial Arbitration Law and laws on intellectual property. At a later stage, the Government will need to consider detailed rules and regulations governing issues such as rules of origin, anti-dumping and countervailing measures and safeguard measures.

Following further research and in-depth study of the WTO Agreements, the Government will create new laws and regulations to be adopted under the National Legislation Program. In this respect, the Council of Ministers has adopted the Legal and Judicial Reform Strategy for Cambodia, which is aimed making more efficient the adoption of laws and regulations by the National Assembly and the Government. At the heart of any sustained effort at legal reform lies an appreciation of the policies, institutional responsibilities, and legal rights and obligations arising from the adoption of new legislation. When examining the training and retraining needs of government lawyers and legislative officers, one must consider the long and medium-term objective of the administration, that is to have competent personnel equipped to deal with the legal issues confronting the country. Thus, the Government will need to carry out a complete evaluation of the technical skills and knowledge currently available to it both within the

public service and in the wider Cambodian society. Later, once Cambodia's accession to the WTO is complete, permanent governmental entities responsible for monitoring WTO matters will need to be established.

Priorities for implementation. Issues faced by Cambodia in relation to trade policy and strategy for implementing WTO trade rules include: the use of fixed or specific duties to overcome valuation problems; creation of a strategy for binding tariff offers to other WTO member countries; and building institutional capacity to implement WTO rules.

An element of Cambodian trade policy that is clearly inconsistent with WTO rules is the administered minimum or fixed dutiable values from which Customs calculates trade taxes. The WTO agreement on customs valuation provides for customs valuation based on transaction value, that is the price actually paid or payable for goods when sold for export to the country of importation. Cambodia needs to look at ways of phasing out its administered dutiable values, currently used for several product groups.

A second area where Cambodian trade policy is inconsistent with WTO rules is the differential tax treatment between imports and domestically produced goods. The WTO requires that the imported products of any other member country of the WTO shall not be subject to internal taxes (for example, excise and VAT) that exceed those applied to like domestic products. In addition, such taxes should not be applied in order to protect to domestic production.

Another issue is the creation of a strategy for setting binding tariff offers to other WTO member countries. Binding tariffs are the maximum tariff rates a government commits to when joining the WTO. In other words, the government promises other WTO member countries that it will not raise tariff rates above certain bound levels. In practice, most countries set and maintain applied tariff rates lower than these bound rates. There are two approaches to binding rates, the first involving setting initially high rates, the second setting low rates. Each approach has advantages and disadvantages. Setting high bound tariff rates can calm concerns of domestic interest groups opposed to trade liberalisation by assuring them that the government will not give up its capacity to raise tariffs in the future. Setting low binding tariff rates, on the other hand, can signal to the international investment community that the country is committed to an open trade regime and wishes to become a platform for investment. Low binding tariff rates thus imbue a country's trade policy framework with stability and certainty. As noted in the discussion on AFTA, investors like a transparent and predictable policy framework.

A third issue relates to institutional capacity building in order to implement WTO rules. As mentioned, the government has created a very ambitious legislative agenda in order to fulfil its obligations towards the WTO. Examples are intellectual property laws; competition law, bankruptcy law, business enterprises law, commercial contracts law; secured transaction law; rules of origin law and various laws on antidumping and countervailing duties. Most of these laws are complex and require the establishment of separate agencies for implementation. For example, a competition law would require a separate competition commission with its own staff of highly trained economic and legal technical experts. The government also intends to create many other laws and institutions in both economic and non-economic areas relating to WTO accession.

Given this legislative load, the government's administrative capacity will be stretched, indeed it is clear that the government will simply not have the administrative capacity to implement some of these complex laws for several years. While the technical assistance discussed above will help, a strategy for the reprioritisation of legislative efforts must be drawn up. In particular, the implementation of commercial laws that are not fundamental to WTO accession or economic efficiency may have to be postponed. Clearly, some laws are more important than others for improving economic governance and reducing the risk of doing business in Cambodia, for example land law, contracts law and bankruptcy law. Other laws that are also important but may be deferred include laws on antidumping and countervailing duties and competition. A strong argument against introducing laws on antidumping duties is that many countries use them as a disguised form of protection of local industries without regard for the economic costs incurred by end users and consumers. Similarly, it is not clear that a competition law is appropriate at this stage of Cambodia's institutional development. Implementation of such a law would require an independent commission with highly trained economic and legal advisors, since identification of anti-competitive behaviour is data-intensive and requires elaborate economic analysis. It might be more effective to concentrate the limited resources available on implementation of the commercial and economic laws that are key to reducing the risk of doing business in Cambodia.

The interface between trade policies, industrial development and poverty alleviation. A notable feature of Cambodia's tariff structure is that tariff bands broadly correspond to stages in processing from raw materials to finished products. This is known as a 'cascading' tariff structure, since rates cascade downwards, with the highest rates for finished goods and lower rates for intermediate goods and raw materials. Cambodia's cascading tariff structure has changed little since 1997, and several major sectors—food and beverages, textiles and garments, basic metal products—have very distinct cascading tariff structures. This has important implications for the Government's export-led economic development and poverty alleviation strategy. Because of high tariffs on semi-processed and consumer goods, Cambodians are required to pay higher-than-international prices for basic needs, except in cases where smuggling lowers import prices. Locally produced wheat flour, for example, has a tariff of 35 per cent. This duty protects local wheat flour millers from cheaper imports but means that bakers, producers of processed foods, restaurants, home industries and other downstream users of wheat flour must pay a relatively high price for their products' primary ingredient. The higher costs of production are then passed onto consumers through higher retail prices. Since food makes up a large proportion of poor households' expenditure, reduced import tariffs on such primary food products would benefit poor households.

Cambodia's cascading tariff structure is not consistent with the Government's broad-based industrial growth and development strategy. Central goals of both the Government's First Socioeconomic Development Plan of 1996–2000 (SEDP) and its Second of 2001–2006 (SEDP2) are high economic growth, employment and reduced poverty, to be achieved through an export-led development strategy supporting rural and labour-intensive industries. Given the small size of Cambodia's market and its low per capita income, such

a strategy seems highly appropriate. In this context, industrial and trade policies are linked, with trade policies, particularly tariffs, influencing domestic prices and these in turn impacting on investment and production decisions. Industries that do not face import competition because of tariffs, subsidies or quantitative restrictions have an incentive to produce for the domestic market and not to export. It is sometimes argued that a country can protect designated import-competing industries, while at the same time allowing exporters to source imported materials at competitive world prices through various duty exemption schemes, thus achieving the dual objective of promoting exports and import-competing industries.

The Government's economic goals include higher rates of industrial growth and development based on the expansion and diversification of exports and the increased competitiveness of import-competing industries. For these goals to be achieved, resources must be put to their most productive uses. The dominant role of the private sector in allocating resources means that it is essential that policy-based incentives do not distort their assessment of returns to alternative investments. In other words, the large differences in effective rates of protection noted above need to be eliminated, implying a move away from the current cascading tariff structure. Thus the primary policy objective for the tariff system should be the adoption of a low, uniform tariff rate structure, in other words a single tariff rate that applies to all or virtually all imports. The sole purpose of such a tariff system would be to bring in revenue, and the tariff rate would be set so as to achieve the required revenue. A low uniform rate on (virtually) all imported capital goods, raw materials and finished goods would ensure that local producers are not disadvantaged in relation to competing imports. A low uniform tariff rate typically discourages smuggling of imported goods, and a low rate of say 5 per cent with no exemptions would bring in almost as much revenue as the prevailing system but probably with far fewer bureaucratic costs.

Trade facilitation. The Government has taken significant steps forward in trade facilitation in recent years. First, it has established public/private sector consultative working groups and held public forums chaired by the Prime Minister to discuss issues raised at the working groups. Second, it has removed most import and export licensing requirements. Third, it has dissolved the monopoly of Caminco and introduced new legislation facilitating the entry of foreign insurers. Fourth, it has entered into a new two-year agreement with SGS to conduct PSIs on imported goods. Fifth, it has ordered agencies operating at border checkpoints to coordinate their activities with one another and subject traders to only one inspection. Sixth, it has streamlined procedures for issuing Certificates of Origin to garment exporters. Seventh, it has established visa-issuing facilities for the sake of individuals entering Cambodia at major land border crossings.

Despite these achievements, however, significant impediments to trade remain. These impediments reflect three themes that run throughout much of Cambodian administration: procedural interventions by competing government agencies, underpinned by a general acceptance of activities that supplement very low civil service salaries; a lack of transparency and equitable enforcement of the law and a lack of redress from public decision making; and inadequate administration of customs and sporadic enforcement of customs law.

Financial services liberalisation under the ASEAN Framework Agreement on Services

Following the signing of the ASEAN Framework Agreement on Services (AFAS) in 1995, ASEAN has concluded two packages of commitments covering seven priority sectors, including the financial services sector. Also, member countries have agreed to table GATS Plus offers, in other words offers that improve on their existing commitments in the General Agreement on Trade in Services (GATS) or of commitments in new sub-sectors that are not included in GATS. For member countries that have yet to accede to the WTO, however, commitments should be no less favourable than their existing regimes.

The first package (1 January 1996–30 June 1997) included no commitments on financial services, however for the second (1 July 1997–30 June 1998) all ASEAN member countries made commitments in various financial service sub-sectors.

The liberalisation of services will also complement the establishment of the ASEAN Free Trade Area (AFTA), since the competitiveness of ASEAN manufacturers and producers of food and raw materials will be enhanced by strengthened transport, telecommunications and financial systems within the region. Another benefit of the liberalisation of services is the generation of more foreign investment in the services sector, particularly from other ASEAN countries, which in turn would encourage transfers of technology and know-how, and come to play a catalytic role in the development of such critical services areas as finance, telecommunications and transport.

To date, ASEAN has completed two rounds of negotiations on trade liberalisation in seven services sectors: air transport, business services, construction, financial services, maritime transport, telecommunications and tourism. Future services liberalisation under AFAS will have the objective of a 'free flow of services by 2020'. The liberalisation of financial services, however, should be gradual and should take into account the various levels of financial sector development in each member country as well as the need for prudential regulation, effective supervision and capacity building to facilitate its full implementation. Member countries must be allowed to be flexible in scheduling the liberalisation of their financial services sub-sectors and in removing limitations on the four modes of supply under each sub-sector, as guided by the GATS provisions on market access and national treatment and the most-favoured nation principle. In fact, member countries have already set milestones for themselves by scheduling a new round of negotiations every three years until 2020.

ASEAN has identified the common sub-sectors to be liberalised as follows

Insurance and insurance-related services

- Direct insurance (including co-insurance)
  —life
  —non-life
- Reinsurance and retrocession
- Insurance intermediation, such as brokerage and agency
- Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Table 6 **Cambodia: schedule of specific commitments, by mode of supply**

Sector or sub-sector	Limitation on market access	Limitation on national treatment
Financial services. Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction and strategy.	[1] Unbound [2] None [3] Only permitted through licensed financial institutions as banks. [4] As specified in the horizontal	[1] None [2] None [3] Subject to existing laws. [4] As specified in the horizontal commitments. commitments
Financial leasing	[1] None [2] None [3] As specified in the horizontal [4] As specified in the horizontal	[1] None [2] None [3] As specified in the horizontal commitments commitments [4] As specified in the horizontal commitments commitments
Acceptance of deposits and other repayable funds from the public	[1] Commercial presence is required [2] None [3] Only permitted through licensed financial institutions as banks. [4] Subject to the Labor Law, Immigration Law, Law on the Investment of the Kingdom of Cambodia and regulations.	[1] None [2] None [3] As specified in the horizontal commitments [4] As specified in the horizontal commitments.

Note: [1]Cross-border supply; [2]consumption abroad; [3]commercial presence; [4]presence of natural persons.

Table 7 **Cambodia: schedule of horizontal commitments, by mode of supply**

Sector or sub-sector	Limitation on market access	Limitation on national treatment
Horizontal commitments		
All sectors included in this schedule	[1] As indicated in each sector [2] As indicated in each sector [3] Commercial presence of foreign service providers shall be in the following forms: a) Companies or enterprises with 100% foreign equity are allowed b) Branch or representative offices are allowed c) Joint venture enterprises or joint operations in any form are allowed (other than in import–export business, foreign equity participation should be no more than 49%) d) Business cooperation contract [4] Foreign workers shall be subject to Cambodian laws and regulations.	[1] As indicated in each sector [2] As indicated in each sector [3] Foreigners are not allowed to purchase or own land in Cambodia. However, they may lease land for up to 70 years and own buildings. The land leasing is renewable. The commercial presence of a foreign services provider shall be subject to the licensing by the competent government authority. The form and terms of investment and business operation shall be specified in the investment license of each project in accordance with the Investment Law and the Commercial Law. [4] According to the Labor Law and the Immigration Law.

Note: [1]Cross-border supply; [2]consumption abroad; [3]commercial presence; [4]presence of natural persons.

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Banking and other financial services (excluding insurance)

- Acceptance of deposits and other repayable funds from the public
- Lending of all types, including consumer credit, mortgage credit, I factoring and financing of commercial transaction
- Financial leasing
- All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts
- Guarantees and commitments
- Trading for own account or for account of customers, whether on exchange, in an —over-the-counter market or otherwise, the following money market instruments (including cheques, bills, certificates of deposits)
  —foreign exchange
  —exchange rate and interest rate instruments, including products such as swaps
  —forward rate agreements
  —transferable securities
- Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) LJ and provision of services related to such issues
- Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services
- Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring.

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