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CONSTRAINTS TO THE COMPETITIVENESS OF CAMBODIA'S PRIVATE SECTOR

The government of Cambodia has identified growth of the private sector as critical for developing the economy in order to alleviate the country's high levels of poverty. However, it is widely recognized that Cambodia's private sector is largely uncompetitive, both domestically and internationally. Various studies attribute the lack of competitiveness to a number of constraints that greatly add to the cost of doing business. As part of MPDF's ongoing commitment to improving the business environment, this issue of the Business Issues Bulletin discusses constraints facing the producers of a number of agricultural and manufacturing products, drawing on a recent World Bank study that used value chain analysis.¹

What is a Value Chain?

It is the alliance of enterprises working in a coordinated manner to increase the value of a product or service to final buyers. An increasing share of world trade occurs through local and global value chains.² Value chain analysis is useful because it can identify obstacles at any stage in the process that could make products uncompetitive by reducing quality, causing delays and/or raising costs. Value chain analysis can be used to help identify problems with regard to suppliers, services, inspections etc. that, if resolved, would raise the productivity of the entire chain or network.

Key Sectors with potential for growth

Cambodia has a large and vibrant garment manufacturing sector which is based on being able to sell to markets in Europe and North America with low or no duties being charged on its quota of products. When the Multifiber Agreement (MFA) ends on 31 December 2004, Cambodia's garment sector will have a better chance of competing if it was integrated with competitive textile manufacturing.³ Historically, Cambodia was a significant cotton producer and could be again if the costs of imported inputs were not so high and cotton farmers had additional support.

Motorcycle assembly and production of related spare parts is another sector with potential. Every year some 20,000 new motorcycles and some 100,000 used motorcycles are sold locally, and research shows that the cost of assembly in Cambodia is 1.3 to 1.5 times lower than in Vietnam. Were Cambodia to develop companies with the skills and equipment to assemble motorcycles and produce spare parts,

¹ To better understand the challenges limiting the private sector in Cambodia, a World Bank consultant conducted a channel mapping exercise. This traces product flow through the entire channel from product concept to the point of consumption and in doing so, has identified areas where policy and administrative reforms would have the greatest impact. The study also compared costs in similar enterprises in other countries. *Towards a Private Sector-led Growth Strategy for Cambodia*, Volume 1: Value Chain Analysis, Yasuo Konishi, World Bank, June 2003.

² See *East Asia Integrates*, World Bank 2003.

³ The Multifiber Agreement (MFA) is a framework agreement that governs the trade in textiles and clothing. Under the agreement, each developed country negotiates bilateral tariff rates and quotas with every developing country seeking to access their respective market.



The "Business Issues Bulletin" provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Cambodia, and exposure to different opinions held by various stakeholders on the topic.

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related opportunities in the auto industry might develop. For example, Thailand might contract the production of spare parts for its auto industry now that Thai labor costs make such work unprofitable. This could, in turn, stimulate growth in other forms of light manufacturing.

Like motorcycles, increasing local demand for canned milk makes this a business with potential.⁴ Rice farming is another sector that could expand. At present, however, the rice milling industry in Cambodia is limited, so paddy is smuggled to Vietnam and Thailand where it is milled and sold as ‘Thai Jasmine Rice’.

Although there is potential for growth in all these areas, there are also significant barriers constraining production. While these products and commodities represent only a segment of the Cambodian economy, they suggest challenges that producers in other sectors likely face as well. This *Bulletin* focuses on the four challenges most often cited in everyday discussion: customs clearance, red tape and bribery, smuggling and high energy costs.

High costs for customs clearance

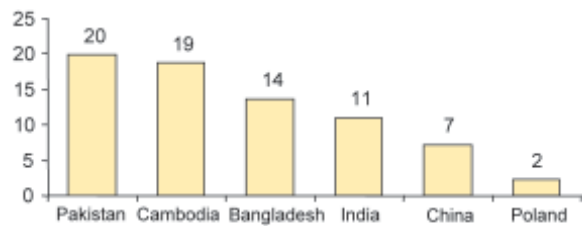
All of the sectors investigated face high official charges in importing raw materials. The garment sector, which provides an estimated 220,000 jobs and 77% of Cambodia’s exports, is entirely dependent on imported material, which accounts for 63% of the cost of production. The combined **costs** for transport and imports through customs in Cambodia are nearly three times higher than in Malaysia and 55% higher than in Hong Kong. The transport and export clearance **times** are also uncompetitive. Garment exports can take as long as 19 days to clear the numerous steps and 45 documents are required. Delays in Cambodia are three times worse than the longest delays in China.

Regarding the potential for growing cotton mentioned earlier, the costs of importing fertilizer and seeds are among hindrances that prevent cotton from once again achieving commercial scale.

With rice, Cambodia has the potential to regain its 1960s stature as a rice exporting country if the costs of importing inputs (seeds and fertilizer) and exporting were reduced. Due to high import costs, fertilizer

⁴ As explained later, Nestlé was canning milk in Cambodia but had to close the plant due to competition with smuggled products. In a better regulatory environment, canning of milk could again be undertaken locally.

No. of days for exports to clear customs: Garment Sector



Source: Cambodia Productivity and Investment Climate Survey, 2003

accounts for 29% of total production costs, compared to only 7% in Thailand. Importing and exporting charges constitute 10.6% of the total cost of producing rice.

Informal fees substantially increase my production costs. I cannot import the bottles and cans I need without paying bribes. The delivered price of new empty bottles from Vietnam and Taiwan is US\$0.09 per bottle at the port of Sihanoukville. After adding customs and land transportation, the cost rises to US\$0.13 per bottle. Similarly, the Sihanoukville delivery price of an empty can is US\$0.07, but when it reaches my factory, the cost has gone up to US\$0.12. I use, for instance, 1 million new bottles and 1 million new cans every year, so annually my costs increase by US\$90,000 (\$40,000 for bottles and \$50,000 for cans). To improve export procedures, the government should publish and widely distribute an itemized table that lays down the rates for various products.

Mr. Heng Heang, President of Phnom Penh Small & Medium Industry Association (PSMLA) and Producer of Fish Sauce

While the constraints identified in the value chain study just confirm what we’ve known all along, it gives us direction on what to do to increase competitiveness. We need to develop better linkages by looking at domestically grown cotton. However, these inputs are not regularly supplied. While there are some positive changes within the Customs Department due to lower fees, fees are still too high and the numbers of signatures and amount of paperwork required haven’t improved. Similarly, we did manage to get the time needed to process an application for certificate of origin (C/O) reduced, but we were less successful in getting the government to computerize the process. Streamlining customs clearance through computerization will reduce the number of people that we have to deal with.

Mr. Ken Loo, PhD., Secretary General of the Garment Manufacturers Association in Cambodia

Red tape and bribery

The cumbersome procedures for customs clearance are not only time consuming; they also provide an opportunity for officials to extract bribes from those who want faster clearance. As stated previously, customs clearance for both importing and exporting garment industry materials can require completion of as many as 45 separate documents and numerous signatures, each of which requires a fee. Likewise, the tobacco industry is required to have 22 separate documents signed and stamped in order to import production inputs. Completing such documents is widely known to happen faster if bribes are paid.

The increase in fuel prices has affected my business rather substantially as well as those of others. I almost cannot bear the operating costs these days. On average I lose between 30% to 40% of my total revenue due to high costs for fuel, toll fees, traffic around Phnom Penh and customs procedures. The government should publish all the fees related to import and export of goods, and it should institutionalize receipts for all payments so that “under the table payments” can be suppressed. They should also reduce paperwork for import and export of goods. I believe that three signatures are enough for import and export.

Mr. Chhim Sokan, Director of Sokehan Transport Co., Ltd.

There are too many regulations within the Customs Department and they always come up with new ones. Sometimes when a Customs Officer does not know what rate to charge, he will arbitrarily pick a figure out of the blue. Publishing tariff rates is not enough because Customs can still increase our costs by delaying the clearance time. Maybe we should consider having a commission to look into the complaints of importers and exporters and take action on them. Such a commission must be required to respond to a complaint within two days and have full authority to make decisions. Another option could be to have an independent third party monitor custom clearance. But unless customs officers are appropriately paid, nothing will change. These two options should be accompanied by a reduction in the paperwork and signatures required.

Mr. Frankie Yee, Country Manager, Goodhill Enterprise (Cambodia) Ltd.

“Under-the-table” fees have gone down by 20% to 30% compared to 2003, however, CAMCONTROL has not changed. Even if there is a single typo in a document, they won't accept it. They won't allow the use of correction fluid and require

us to prepare the document again. If CAMCONTROL could be more flexible, conditions would improve. To reduce under-the-table payments, the number of documents and signatures required and consequently the number of people involved needs to be reduced. This will not only reduce money paid informally, but also the time involved.

Mr. Keo Sokun, General Manager of First Trans Co. Ltd.

Smuggling

The high cost of importing inputs affects the competitiveness of businesses producing goods for the domestic market. For example, with VAT and import charges adding 50% to the price of a 100cc motorcycle, and even more for larger models, there is a strong incentive to smuggle motorcycles. This in turn discourages entrepreneurs from setting up businesses to assemble motorcycles and make related spare parts.

According to Nestlé-Cambodia, smuggling forced the company to close its canned milk producing facility and instead import its products from its factory in Thailand. Yet it still lost an estimated \$500,000 per month in potential sales through competition with smuggled Nestlé products. This widespread smuggling has not only forced Nestlé to stop local production, but has also discouraged local investments in packaging, labeling, and other support industries.

High energy costs

The high government tax on fuel results in the price being 30-40% higher in Cambodia than in other countries in the region. This higher price increases both the costs of transporting goods and the cost of generating electricity in Cambodia. In the textile industry, energy costs put Cambodian enterprises at a 128% comparative disadvantage with competing with producers in China.

The rising cost of fuel has increased production costs and the price of our rice. The sudden increase in the price of fuel from around Riels 2,000 to almost Riels 3,000 has reduced our profit margin by US\$2.50 per ton. There are around 300 rice mills in our federation and, on average, we mill around 500 tons per year. Hence the forgone profits for our members, resulting from higher fuels costs, is an estimated US\$375,000.

Mr. Phou Puy, President of Rice Millers Federation

Impact on the economy

As indicated in Table 1 below, the forgone potential public sector revenue totals an estimated \$27.93 million and potential losses in GDP total \$226 million for the few products included in the Value Chain Analysis.⁵ Again, these products and commodities are only part of the Cambodian economy, and similar constraints to competitiveness are likely to be found elsewhere. The lack of regulatory enforcement is not only reducing public sector revenue flows from legitimate business transactions, but more importantly, discouraging private sector investments in the economy. In the absence of good governance, investments that deepen the supply chain as well as stimulate horizontal integration are unlikely to take place.

Potential Losses in Annual GDP Contribution and Public Sector Revenue

| | GDP Contribution | Public Sector Revenue |
|---------------------|----------------------------|------------------------|
| Rice | \$69.7million ¹ | \$4.8 million |
| Tobacco | \$60 million ² | \$9 million |
| Garments (trousers) | \$3.8 million* | \$0.73 million |
| Motorcycle | \$62.5 million | \$10.4 million |
| Canned Milk | \$30 million | \$3 million |
| Cotton | NA | NA |
| TOTAL | \$226 million | \$27.93 million |

* in the form of GSP quota

Source: *Towards a Private Sector-led Growth Strategy for Cambodia*, Volume 1: Value Chain Analysis.

Positive Signs of Reform

The good news is that the Cambodian Government is now addressing some of the key impediments. In March, the Prime Minister issued Decision No. 12/2004 creating a Special Inter-ministerial Task Force (SITF) for Improving the Investment Climate and Trade Facilitation. This task force is responsible for proposing immediate measures to reduce trade facilitation costs. These include reducing duplication, simplifying processes, reducing the time required, and increasing official Government revenue.

⁵ These figures are rough estimates based on assumptions made in the World Bank's Value Chain study. Some suggest that trade facilitation problems in the garment sector make the government's losses many times higher than the \$3.8 million listed in the table above.

The World Bank Group met with the SITF on March 25, 2004 and shared many of the findings reflected in this *Bulletin*. The Task Force worked for two months and produced a program of 12 initial reforms to be undertaken over an 18-month period from June 2004 to December 2005, including reducing the number of documents, inspections, time and cost required to import, export and register companies. The World Bank, European Commission, IFC, MPDF, AusAID, GTZ and other donors will support the Government's policies to create a more viable environment for private value chains.

The issues discussed here are not relevant to my business. However, there have been some improvements with export procedures as inspections and paperwork involving the Ministry of Industry, Mine and Energy and the Ministry of Commerce have decreased by 50%. Likewise, the cost of clearing Customs and CAMCONTROL is 50% lower. I attribute this to the success of the Private Sector Forum held with Samdech Prime Minister.

Okenha So Nguon, Director, So Nguon Transportation & Service Import Export Co., Ltd.

In order to reduce or eliminate these constraints the government, civil servants, and ordinary people have to respect the law. The government should establish a Commercial Court while improving border control. In the meantime, the "mobile units" of the Customs Department should increase their inspections to reduce smuggling. The government should also reduce customs rules and procedures to ease the importation of merchandize, especially raw materials.

Okenha Te Tain Por, President of LTP Lien Phong International Investment Co., Ltd.

Conclusions

There is clearly an urgent need to resolve the existing constraints to competitiveness if Cambodia is to become attractive to foreign and domestic investors and be able to compete domestically and internationally. The Government is taking some important steps that need to be supported until final implementation. Meanwhile, the private sector should take a number of concrete steps themselves to build linkages between firms so that Cambodia can leverage the power of value chains.