Chapter 7

Industrial Agglomeration, Production Networks, and Foreign Direct Investment Promotion: Cambodia's Experience

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Industrial Agglomeration, Production Networks, and Foreign Direct Investment Promotion: Cambodia's Experience

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Abstract

The key strategy of the Royal Government of Cambodia (RGC) with its industry policies is to expand the economic linkages between agriculture and industry to improve the industrial sector and to lessen its dependence on the textile industry. The Royal Government continues to provide the necessary physical infrastructure and highly qualified support services to enhance the investment climate, promote transfer of technology, increase professional training, and establish industrial zones. The legal framework is also being strengthened to ensure efficiency and transparency in the implementation of laws and regulations.

The major issues that industries in Cambodia have to contend with are the high compliance costs, weak legal framework, and business environment. Such conditions have produced uncertainties and risks, which have resulted in high barriers to entry, limited access to finance, poor access to market infrastructure and information, and outright lack of market information. All of these hinder manufacturers' access to markets.

The government has developed a plan of action aimed at reducing the cost of doing business in Cambodia, attracting foreign direct investment (FDI), and developing infrastructure and the industrial sector. The garment industry plays a major role in poverty reduction by providing employment and producing export products with a comparative advantage in the international market. However, the industry seriously lacks backward linkages and associated support industries.

Creating linkages is an important way to improve industry competitiveness. It enhances specialization and helps overcome the disadvantages of being small. Developing clusters, business associations, and value chains are key ways for industries to foster business linkages and increase market access.

To promote industrial development, the following measures are recommended:

- Overcome negative issues that existing investors and manufacturers have to contend with;
- Diversify markets by expanding export markets to Japan, Russia, the Middle East, and other Asian countries;
- Enhance the quality of labor with a view to increasing productivity;
- Simplify import-export procedures;
- Establish human resource development (HRD) and develop technical training; and,
- Build linkage-capacity programs (training courses, workshops)

INTRODUCTION

Cambodia's economy has undergone dramatic changes over the past two decades, the most significant of which is the shift from central planning to a market economy. In 1989, private property rights were reintroduced, price control was abolished, state-owned enterprises were privatized, and investments were liberalized. The Paris Peace Agreement in 1991 led to UN-sponsored elections in 1993 and the establishment of the Royal Government of Cambodia (RGC) in September 1993.

From 1994 to 2006, annual growth rate of gross domestic product (GDP) averaged 8.4 percent per annum (World Bank 2007:1). Growth continues to be driven by garment exports, tourism, construction, and agriculture expansion. In the meantime, industrial development faces numerous challenges. Cambodia's industrial base is narrow, relying on a small set of products (mainly garments and footwear) and markets. At the same time, there are significant constraints that hinder private investments, both domestic and foreign. These include weak infrastructure, lack of transparency and accountability in the legal and regulatory framework, limited financing resources, lack of industrial and managerial skills, and poor support infrastructure (road and port infrastructure, electricity, water and telecommunications).

A joint research case study with the Japan External Trade Organization (JETRO) titled "Analysis of Industrial Agglomeration, Production Networks and FDI Promotion: Developing Practical Strategies for Industrial Clustering in Cambodian Context" offers a clearer insight into the current status of Cambodia's industry and government policies on industrial development. The study also identifies the critical issues and constraints that Cambodia needs to overcome for its further development. The study was based on previous studies of many institutions, including government and private, national and international, as well as individual and collective studies.

This report consists of three sections: (1) policy overview, which examines RGC's industrial policies, regulatory framework for business operations, support infrastructure, incentive policy to promote FDI, trade and customs and investment, and special economic zones; (2) description of the garment industry in terms of its current status of development, productivity, management, and competitiveness; and (3) policy implications and recommendations for an action plan to promote FDI and accelerate industrial development in Cambodia.

1. OVERVIEW OF POLICIES

1.1. Industrial Policies

Cambodia's political situation and the economic condition changed for the worse before November 1993. Operations of nearly all existing factories and enterprises were paralyzed. Production efficiency was affected, and manufacturers produced low-quality, high-priced goods that could not compete with foreign products. Thus, they were forced to close shop and temporarily stop production.

Fortunately, the establishment of the RGC in November 1993 broughtpolitical stability, generating full support from the United Nations and the international community.

This development encouraged the Ministry of Industry, Mines and Energy (MIME) to set up a two-year plan (1994 to 1995) to increase local production which would improve employment opportunities and raise Cambodians' standard of living. Out of the 79 existing factories in Cambodia, 66 state-owned factories have already been privatized.

To meet the objectives of the two-year plan, MIME has endorsed the following well-defined and clear-cut policies:

- Privatize all remaining factories that are unable to apply the autonomy policy
- Enhance the operations, management, and control of the remaining factories and enterprises
- Encourage the development of private industry in the city provinces by providing infrastructure and bureaucratic efficiency especially for industries that:

  a) produce goods for export or import-substitution goods;

  b) provide services that can promote income in foreign exchange;

  c) construct infrastructure, e.g., public facilities, hydroelectric stations;

  d) utilize raw materials and natural resources existing in the country; and

  e) absorb labor

Moreover, the Royal Government has set up the Industrial Development Action Plan,[i] 1998-2003, which focuses on two goals. The first goal is to prioritize the development of export-oriented industry; the second is to prioritize the development of import-substituting production of selected consumer goods. Seven subsidiary objectives have also been identified:

- promotion of labor-intensive industry
- promotion of nature resource-based industry
- promotion of small-scale industry and handicrafts
- promotion of agro-industry
- promotion of technology transfer and upgrading the quality of industrial products
- promotion of the establishment of industrial zones
- promotion of import-substitution of selected consumer goods industries

The outward-oriented industrial development strategy is given first priority for four reasons. First, the small size of the domestic market in terms of population and purchasing power limits the opportunities for efficient production. Second, Cambodia does not have sufficient financial resources or managerial expertise to fully utilize its natural resource base. Third, access to technological innovations that underpin increased efficiency and wider consumer choice can only come from integration with regional and global economies. Fourth, no country has a comparative advantage in producing everything, and all countries can therefore benefit from cooperating and trading with others.

The promotion of labor-intensive manufacturing will continue to focus on the textile and garment sectors where the ready supply of mostly female workers supports cost-competitiveness. However, the Royal Government recognizes that retaining and increasing market share in an increasingly competitive international environment requires upgrading product quality and increasing productivity through improvements in technology and management. It is essential that better industrial relations within the established legal framework are developed and ways of increasing the multiplier effect of garment manufacturing are investigated. Currently, most garment manufacturers operate on cut, manufacture, and tailor basis. They import fabric and accessories (e.g., zippers, buttons, thread) and avail themselves of local services such as transportation and freight clearing, construction, and utility-type services to run and build factories.

The promotion of natural resource-based industry will focus on identifying and exploiting opportunities in processing natural resources, including nonmetallic mineral resources, timber, and fisheries. The development of animal- and fish-breeding facilities may permit their supply as a raw material for reprocessing factories.

With regard to small-scale industries and handicraft production, the Royal Government will prioritize the promotion of traditional arts and crafts for the tourist market in both rural and urban areas. Again, it will be important to ensure sustained product quality. In addition, a microfinance scheme will be set up for small-scale businesses that have little access to credit agencies.

The core strategy for agro-industry development is to grant concessional lands to both domestic and foreign companies on a long-term basis and to encourage contract growing by smallholders who supply raw materials to a processing factory constructed on-site. The main companies identified include:

- textile factories created for the purpose of dying traditional cloth or silk (to increase the above-mentioned multiplier effect of garment production);
- jute factories based on jute growing near the Tonle Sap River;
- sugar factories in Battambang and Kampong Speu, which raise two to three crops of sugar cane a year. Waste sugar from milling will be used for power generation, fertilizer production, molasses production, and alcohol production;
- palm oil refineries;
- cashew nut-processing factories that draw supplies from concessional and other lands;
- rubber-processing factories (involving incorporation and privatization of state-owned rubber farms and processing factories); and,
- other factories producing tapioca starch, flour, and fruit products (juice, canned fruit, dried fruits).

These agro-industry initiatives require close coordination between the ministries of industry, mines and energy, agriculture, fisheries and forestry as well as the local authorities. These also entail technical assistance in the full assessment of development potential. Strengthening the economic linkage between agriculture and industry within the context of sound environmental management is seen as essential to the creation of income and employment.

The promotion of technology transfer and the upgrading of products will require the Ministry of Industry to design and implement a quality control system for export products that sets internationally accepted standards and includes laboratory control. In addition, the transfer of technology must be encouraged by establishing an appropriate legal and regulatory framework covering copyright, trademarks, and so on.

The creation of industrial zones is aimed at facilitating export development and creating employment by providing the high-quality infrastructure and utilities needed to encourage investment. Zones in suburban Phnom Penh and Sihanoukville would provide transport and communications, power and water, waste management, education and health facilities, and shopping complexes along with minimal customs formalities and duty-free importation of business inputs.

The promotion of import-substitution of selected consumer goods must be undertaken on the basis of carefully prepared feasibility studies, which establish whether or not there is a genuine prospect of a proposed industry becoming internationally competitive.

Areas proposed for such investigation are the following:

- development of the paper industry through the use of specific domestic raw materials (bamboo in Kratie; paper mulberry in the northeast and northwest; old rubber trees in Kampong Cham; hay, and waste from sugar mills)
- development of chemical industry producing fertilizer, caustic soda, sulphuric acid, and aluminum sulphate
- production of a range of consumer goods, including soap products, toothpaste, paints, plastic ware, and electrical accessories
- development of metal processing starting with the assembly-line production of vehicles, water pumps, motor aggregates, and agricultural equipment. This will eventually evolve into a small and medium enterprise (SME) production of spare parts for bicycles, motorcycles, boats, ferries, and tractors

In general, the government will support broad-based industrial development by:

- encouraging the expansion of the SME sector, especially by providing microfinance schemes;
- improving the performance of state-owned enterprises through incorporation and privatization;
- stemming the flow of illegally imported products;
- reducing barriers to export such as export taxes and inefficient provision of trade facilitation services (e.g., licensing);
- reducing barriers to importation of business inputs;
- providing infant-industry protection in carefully selected cases;
- establishing a national laboratory with technical capacity to undertake physical, chemical, microbiological, and mechanical analyses to help establish product quality and specifications;

- establishing an industrial property rights bureau that would protect new products, designs, and technologies from copyright infringement;
- promoting vocational training locally and overseas;
- upgrading the legal framework in the areas of factory law, industrial zone law, patent and industrial design law, weights and measures, and industrial safety; and,
- encouraging the involvement of private sector organizations in identifying industrial development opportunities and constraints, participating in the policy formulation and monitoring processes, and promoting domestic and foreign private investment.

However, in order to improve the industrial structure, the key strategy of the industry policy of the Royal Government is to expand the economic linkages between agriculture and industry via the promotion of agro-industry as the core industry. This will wean the country from overdependence on the textile subsector (Office of the Council of Ministers 2004:29).

1.1.1. Regulatory Framework Relating to the Business Operation

The RGC has been updating laws and regulations and introducing new laws and regulations in the field of investment, trade, and business. This is being undertaken to improve the business and investment climate in Cambodia in compliance with the regulations of the World Trade Organization (WTO) and to keep the promises Cambodia made upon accession to the WTO.

Such essential laws and regulations as shown in Table 1 were enacted in the last five years.

Table 1: Recently Enacted Laws and Regulations Relevant to Trade and Investment

- Sub-Decree No. 84 on Creation of Anti-Corruption Entity (2006)
- Civil Procedure Code (2006)
- Sub-Decree on Risk Management (2006)
- Law on Commercial Arbitration (2006)
- Law on Management of Factories and Handicrafts (2006)
- Sub-Decree No.148 on the Establishment and Management of the Special Economic Zone (2005)
- Law on Negotiable Instruments and Payment Transactions (2005)
- Sub-Decree No.111 on the Implementation of The Amendment to the Law on Investment (2005)
- Law on Commercial Enterprises (2005)
- Law on WTO Accession (2004)
- Law on the Patents, Utility Model Certificates, and Industrial Design (2003)
- Law on the Copyright and Related Rights (2003)
- Law on the Amendment to the Law on Investment (2003)
- Law on the Amendment to the Law on Investment (2003)
- Law on the Amendment to the Law on Taxation (2003)
- Law on Marks, Trade Names and Acts of Unfair Competition (2002)
- Law on Land (2001)

Source: CDC (2007), p.10.

Nevertheless, there are still some vital laws that have yet to be enacted in the area of business laws. These include, but are not limited to, the following:

- Law on Commercial Contracts
- Law on Secure Transactions
- Law on Insolvency (Bankruptcy)
- Law on Antidumping, Countervailing Duties, and Safeguards
- Customs Code
- Law on Industrial Standards
- Law on Anticorruption

a) Taxation

The assessment of the tax on profit shall be made according to the taxation system of the real regime, simplified regime, or estimated regime. The taxpayers' regime shall be determined according to the form of the company, type of business activities, and the level of turnover (Article 4, Law on Taxation).

b) Labor

Cambodian labor relations, employment and work terms, and other labor-related matters are basically regulated by the Constitution and the 1997 Labor Law. The 1997 Labor Law, which was enacted in March 1997 and which brought significant modification to the socialistic 1992 Labor Law, is quite liberal and considerably protects the rights of laborers and unions.

c) Land

Land Law was first promulgated in 1992 and amended in August 2001 (2001 Land Law). The 2001 Amendment to the Land Law is especially aimed at determining the regime of ownership for immovable properties in Cambodia for the purpose of guaranteeing the rights of ownership and other rights related to immovable properties. It also intends to establish a modern system of land registration that guarantees the rights of people to own land.

d) Environment Protection

In 1996, the Law on Environment Protection and Natural Resource Management (LEPNRM) was enacted, followed by the Sub-Decree on Management of Solid Waste (1999), the Sub-Decree on the Water Pollution Control (1999), and the Sub-Decree on the Control of Air Pollution and Noise Disturbance (2000). Numerical standards for environmental quality are set in each subdecree but they are said to be very strict compared to those in neighboring countries.

e) Intellectual Property Rights (IPR)

Although Cambodia became a member of the World Intellectual Property Organization (WIPO) in 1995 and joined the Paris Convention in 1998, it had a weak regulatory framework for protecting IPR. But since the turn of the century, the Cambodian government has passed a series of laws and crafted a regulatory framework to protect IPRs in the country. It has made progress in protecting IPRs and has so far been able to comply with its WTO obligations. The laws that have been enacted recently include the following:

- Law on Marks, Trade Names, and Acts of Unfair Competition (2002)
- Law on the Copyright and Related Rights (2003)
- Law on the Patents, Utility Model Certificates, and Industrial Design (2003)

Furthermore, the Royal Government is now working on the enactment of the following laws:

- Law on the Protection of Undisclosed Information and Trade Secret
- Law on the Protection of Layout Design of IC
- Law on the Protection of Geographical Indications
- Law on Breeder Rights and Plant Varieties Protection.

f) Dispute Settlement

The Draft Law on Commercial Arbitration, about four-fifths of which was extracted from the Model Law of the United Nations Commission on International Trade Law (UNCITRAL), was adopted in 2003 and enacted into law in May 2006. The purpose of the law is to facilitate the impartial and prompt resolution of economic disputes, to safeguard the legal rights and interests of the parties, and to promote sound economic development.

1.1.2. Infrastructure

a) Electricity

The Electricity Law was promulgated in February 2001 with the view to regulating the power sector. The Electricity Authority of Cambodia (EAC) was established as a legal public entity to act as the regulator and the arbitrator of business activities in the power sector. In Cambodia, electricity is generated and/or distributed by the following entities:

- Electricite Du Cambodge (EDC), a government enterprise
- private entities, including independent power producers (IPP) in the provincial towns
- licensees in smaller towns.
- rural electricity enterprises (REEs) in the rural areas

The electricity supply still does not meet the basic demand for electricity, especially in rural areas where a 24-hour supply of electricity is not assured, and the quality of electricity is not reliable. There can only be reliable supply of electricity when the construction of transmission infrastructure and the Kamchay hydropower plants, which have a capacity of 193.2 MW, are completed. For the meantime, Cambodia will have to rely on the electricity supplied by neighboring countries, mainly Thailand and Viet Nam, and later Laos, to meet its increasing demand for electricity in the future.

During its midterm planning, the RGC came up with a master plan to develop all the potential hydropower plants and diversify the source of energy by establishing bigger coal- and gas-powered plants, which are expected to reduce dependency on expensive oil and the cost of electricity.

b) Telecommunications

Cambodia's Ministry of Posts and Telecommunications (MPTC) is a policymaking and regulating body in the field of telecommunications. The MPTC used to operate a fixed-line network. However, in January 2006, it spun off its telecom operations arm and established a new public enterprise called Telecom Cambodia. It provided its own assets equivalent to US$40.3 million and 700 staff members to provide fixed-line service with the 023 prefix. Telecom Cambodia will be privatized in 2008.

Although the telephone density in Cambodia has tripled in the last five years, the fixed-line subscriber base has been experiencing slow growth. Cambodia is the first country in the world where the number of mobile phone subscribers exceeds the number of fixed-line subscribers. This is simply because there is a continuous shortage in fixed-line telephone service.

c) Water Resource

The Ministry of Water Resources and Meteorology is responsible for developing and managing water resources in Cambodia. In Phnom Penh, the Phnom Penh Water Supply Authority (PPWSA), a public enterprise, is responsible for providing water since 1996. Its network expands to some 320 km but needs rehabilitation work. In other parts of the country, the Ministry of Water Resources and Meteorology is primarily responsible for urban water supply but in many cases, it provides private companies with a license to supply water on a commercial basis. In Sihanoukville, the Sihanoukville Water Supply Authority supplies water to the city, but in rural areas, people mostly depend on groundwater, river water, and/or rainwater.

Although Cambodia's annual average precipitation is around 4,000 mm, the difference between the rainy season and the dry season is big. On top of that, the irrigation system is incomplete, which makes it difficult to secure stable water supply for agriculture.

d) Aviation

The number of airlines flying into Cambodia has steadily increased in recent years, thanks to the government's open air policy. Nonstop international flights to nine destinations in eight countries/regions are currently being operated at the Phnom Penh International Airport. Siem Reap Airport also operates some international flights.

These two major operating airports are managed and operated by Cambodia Airport Services Ltd. (CAMS), a France-Malaysian joint-venture company, on behalf of another French-Malaysian joint venture named SCA. The latter is a concessionary company that invested in a 25-year Build-Operate-Transfer (BOT) project to develop the Phnom Penh International Airport.

e) Roads

The road network in Cambodia covers a total area of approximately 30,268 km. This consists of 4,695 km of national roads, 6,615 km of provincial roads, and about 18,958 km of rural roads. There is currently no divided expressway in Cambodia although there are plans to construct three international highways that will traverse the country: the Asian Highway, the ASEAN (Association of Southeast Asian Nations) Highway, and the Great Mekong Subregion Roads. Twenty percent of the total length of these three highways will be asphalt or cement-paved two-lane roads. About half of the total length will be narrow double bituminous coal-paved two-lane roads, and the remaining 30 percent will be on inferior quality.

f) Railways

Cambodia has two railway systems in operation, namely, the Northern Line (386 km) and the Southern Line (264 km), both of which start from Phnom Penh. The trains carry mainly fuel for generators, cement, and rice on their inbound service to Phnom Penh and wood and stones on their outbound service to Sihanoukville.

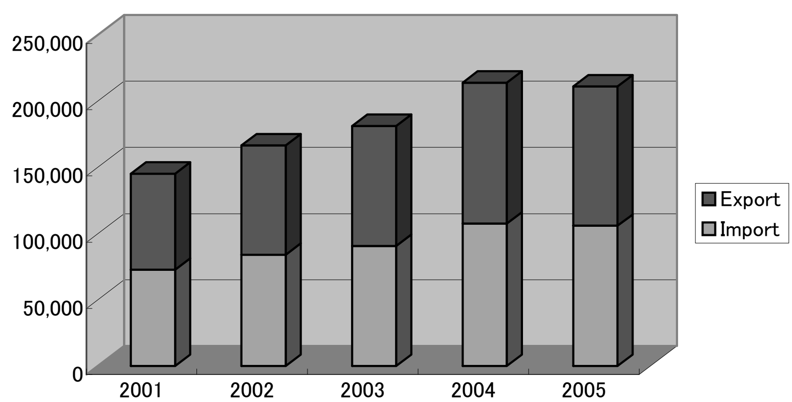
To improve the railway systems, the Asian Development Bank (ADB) is now implementing a $20-million project called the “Study for the Rehabilitation of the Railway in Cambodia.” This project will upgrade the railway system within three years, increasing the maximum service speed to 50 kilometers per hour (kph).

g) Seaport

There is only one deep-water port in Cambodia, which is in Sihanoukville. Phase I expansion of the port’s container yard, which measures 240 m, is already completed. It is now implementing the second-phase expansion of its 160 m berth. Statistics from the Port Authority of Sihanoukville (PAS) show that the throughput volume of containers at the port increased continuously from 2001 to 2005.

Due to the open-sea policies of the Cambodian government, another small port was opened at the nearby Sihanoukville Port. This small port absorbs a considerable volume of cargo delivered by smaller vessels. It also offers lower port charges, easier customs clearance, and lower duties because unofficial fees occasionally substitute for duties.

Figure: 1 Volume of Container Throughput in Sihanoukville Port (TEU)



Source: CDC (2007): p.28.

Information from the PAS) show that the current maritime routes connect Sihanoukville Port with the United States, the European Union (EU), China, Hong Kong, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, Thailand, and Viet Nam, although much of the cargo carried on these routes is transshipped in Singapore.

(h) Inland Water Transportation

The Cambodian inland water network consists mainly of the Mekong River, Tonle Sap River, and Bassac River. The total length of this water network is approximately 1,750 km during the rainy season and may decrease to 580 km during the dry season when navigation is limited.

There are seven major river ports in Cambodia:

- Phnom Penh Port
- Kampong Cham Port, on the mainstream of the Mekong 105 km up from Phnom Penh
- Kratie Port, on the mainstream of the Mekong 115 km up from Kampong Chham Port
- Stung Treng Port, on the mainstream of the Mekong 150 km up from Kratie Port
- Neak Loeang Port, on the mainstream of the Mekong 60 km down from Phnom Penh Port
- Kampong Chnang Port, on Tonle Sap River 90 km up from Phnom Penh
- Chong Khneas (Siem Reap) Port, on Tonle Sap River

1.1.3. Institutional Capacity

Many institutions in Cambodia were barely functioning when the government began its first mandate in 1993. Although Cambodia has made important progress in rebuilding institutions, the country continues to operate far below its economic and social potential due to weak governance (World Bank 2005:6). Key areas of governance requiring reforms include addressing corruption, the legal and judicial system, public financial management, public administration, and local governance. The government is well aware of these challenges and has proposed reforms in key policy documents. Such reforms include the Government Action Plan (GAP), the Socioeconomic Development Plan (SEDP) II, the National Poverty Reduction Strategy (NPRS), and the Rectangular Strategy (RS).

However, despite much effort devoted to policy formulation, the implementation of reforms has been slow. There is also a need for an enhanced participation of ordinary citizens in public decision making so as to improve accountability and reduce corruption.

1.2. Trade and Customs and Investment

1.2.1. Trade and Customs

To simplify and improve trade-related procedures, the Trade Facilitation Program is now being implemented. The core of the program consists of the implementation of the Single Administrative Document (SAD) based on Automated System for Customs Data (ASYCUDA), a comprehensive electronic customs clearance system, and the Risk Management System for trade-related applications, customs clearance, and audits. For this purpose, a Sub-Decree on Risk Management and Ministerial Order #607 (MEF) on Establishment and Putting into Operation the Office of Risk Management and Audit of Customs and Excise were issued in 2006. The Law on Customs and the Law on the Rule of Origin are also due to be enacted soon.

a) Export and Import Procedures

The Ministry of Commerce grants export approval and the permission for duty-free imports for Qualified Investment Projects. These processes are administered by the Cambodian Investment Board (CIB) of the Council for Development of Cambodia (CDC). No license is required for the usual imports.

Inspection of exports and imports is carried out by the Customs and Excise Department (CED) of MEF and the Cambodia Import Export Inspection and Fraud Repression Department (CAMCONTROL) of the Ministry of Commerce (MOC).

Inspections are conducted at the factory and the export port for exports and the import port for imports. At present, all inbound and outbound cargo are examined in Cambodia. The Royal Government's plan was to reduce the ratio to 50 percent by the end of 2006 and to 25 percent by the end of 2007. By the end of 2010, the Royal Government expects to have this ratio reduced to 5 percent. A nonintrusive examination method using X-ray detection equipment will be installed in customs areas at Sihanoukville Harbor.

Preshipment inspection (PSI) is required for imports of goods with a value of $5,000 or more in the original exporting country. PSI was introduced in October 2000 by virtue of Prakas (Ministerial Order) of MEF No. 500 on the Implementation of the Preshipment Inspection Service with the aim of implementing the rational valuation of duties and taxes on imported commodities. BV（Bureau Veritas）now carries out the inspection.

More than 20 kinds of documents are currently required and two days to one week are needed to complete the export and import processes. However, with the introduction of a single-window mechanism in which only a SAD will be used, the Royal Government expects to reduce the number of documents and days required to only one.

b) Export Privileges as a Least Developed Country

Cambodia has been granted Most Favored Nation (MFN) status by the U.S., the EU, and other developed countries. As a least developed country (LDC), Cambodia approved and put in effect in February 2001 a tariff- and quota-free access under the Everything-But-Arms Initiative (EBA), which is part of the EU's Generalized System of Preferences (GSP) program for LDCs. Cambodia is also entitled to privileges under the U.S. and Japan GSP programs.

c) Local Content for Exports and the Rules of Origin (ROO)

There is currently no local content requirement in Cambodia. That means there is no restriction on the use of imported materials, parts, and components unless they are harmful to the health, the environment, or society. However, Cambodian exporters should take into account the rules of origin requirements (ROO) for the GSP, including the EBA scheme for exports to the EU market. The EBA provides special arrangement for LDCs, including Cambodia. Practically all products (except arms and ammunition) covered by the EBA are granted duty-free access (zero duty rate) to the EU market if they fulfill the ROO requirements.

d) Incentives, Limitations, and Taxation on Exports

Under the Amended Law on Investment, Export Qualified Investment Projects (Export QIPs) can import production equipment, construction materials, and production materials free from customs duty, unless Export QIPs operate under the customs bonded warehouse mechanism. Export QIPs are also granted a tax holiday or special depreciation scheme. For exports, value-added tax (VAT) is refunded or credited to the materials for exported products.

Several items are prohibited or strictly restricted for export. These include antiques, narcotics, toxic materials, logs, precious metals and stones, and weapons. An export tax of 10 percent is required for products such as semiprocessed or processed woods, rubber, raw or processed leather, fish (fresh, chilled, or fillet), and live animals.

e) Duty-exempt Imports

Qualified Investment Projects (QIPs) under the Amended Law on Investment are granted the privilege to import production equipment, construction materials, raw materials, intermediate goods and/or production input accessories free of duty, depending on the category under which the project is classified. In order to obtain approval for duty-free importation for the production of raw materials, the importing companies have to submit annually to the Cambodian Investment Board (CIB) a master list containing the volume, kinds, and value of the imported materials. The processing time for an import application or the amendment of an import plan is around three working days.

f) General Tariff Rates

Import duties are levied on all imported goods at the point of entry in Cambodia, unless the imported goods are subject to duties exemption treatment under the Law on Investment or other special regulations. Tariffs on imports to Cambodia principally consist of the following four rates: 0 percent, 7 percent, 15 percent, and 35 percent.

g) Preferential Tariff Rates under the AFTA

Under the Common Effective Preferential Tariff (CEPT) scheme for the ASEAN Free Trade Agreement (AFTA), lower tariff rates can be applied to imported products from other ASEAN countries.

h) Free Trade Agreements of the ASEAN

As a member of the ASEAN, Cambodia is, and will continue to be, subject to tariff reductions set in the free trade agreements (FTAs) between the ASEAN and other countries. As of June 2006, two FTAs (with China and South Korea) took effect. Three more FTAs are under negotiation and will bring about trade liberalization.

i) Improvement on Customs Control

The World Customs Organization (WCO) adopted a Protocol of Amendment (Revised Kyoto Convention) in June 1999, which was enforced on February 3, 2006. The key governing principle of the Revised Kyoto Convention is the commitment by Customs administrations to provide transparency and predictability for all those involved in international trade. To realize simple, efficient, transparent, and predictable customs administration, the Revised Kyoto Convention adopted such principles as follows:

- Apply minimum controls necessary to ensure compliance. Customs control shall be limited to that necessary to ensure compliance with the Customs law; and,
- Use risk management in the application of Customs control.

1.2.2. Foreign Direct Investment

a) Policies toward FDI

As stated in the Second Socio-Economic Development Plan 2001-2005, the RGC regards foreign direct investment (FDI) as a major engine for economic growth. From the viewpoint of Cambodia's legal framework, laws and regulations governing FDI in the country are basically designed to encourage investments. As the Law on Investment stipulates, FDIs are treated in a nondiscriminatory manner except for land ownership. Also, investments are allowed in many areas. Under the current Law on Investment, the investors who are given Final Registration Certificates are entitled to various incentives.

The Royal Government has been improving investment facilitation services. For example, it decided in 2005 to establish the Cambodian Special Economic Zone Board (CSEZB) under the Council for the Development of Cambodia (CDC) to promote the special economic zone (SEZ) scheme. Administered by the CSEZB, the Special Economic Zone Administration will be established in authorized SEZs and provide one-stop services (OSS) to zone investors, from the registration of investment projects to routine export-import approvals.

b) Regulatory Framework for Investment

In Cambodia, FDIs can be freely implemented, except in areas prohibited to or restricted for foreign investors. In this case, foreign investors have to register with the Ministry of Commerce and obtain relevant operating permits. However, if foreign investors seek investment incentives, they have to apply for investment registration, which can be obtained through the CDC or the Provincial-Municipal Investment Sub-Committee (PMIS). The application for the investment registration can be made either before or after the incorporation (or a registration within the Ministry of Commerce).

The investment license scheme was originally regulated by the Law on Investment, which was promulgated in August 1994. In March 2003, in order to make the licensing schemes simpler and more transparent, predictable, automatic, and nondiscretional, the original Law on Investment was amended by the Law on the Amendment to the Law on Investment. In addition, the Sub-Decree on the Establishment of the Sub-Committee on Investment of the Provinces-Municipalities of the Kingdom of Cambodia was issued in February 2005 to regulate the licensing scheme for investments of less than US$2 million. The Sub-Decree No. 111 on the Implementation of the Law on the Amendment to the Law on Investment was also issued in September 2005.

c) Outline of Investment Licensing Scheme

- The Law on the Amendment to the Law on Investment of 2003 was made in order to facilitate the automatic approval system of investment projects.

Approval must be completed within 31 working days of the CDC's or PMIS' receipt of the investment application, unless the projects fall under the list of prohibited projects or those that may compromise national interest or are environmentally sensitive in nature.

- An investment license or approval will be issued not to an investor or investing enterprise but to a project. A project that receives the investment license is called a Qualified Investment Project or QIP.
- The Law on the Amendment to the Law on Investment of 2003 governs all Qualified Investment Projects (QIPs) and defines the procedures by which any person establishes a QIP.
- Investment incentives are granted automatically.
- The CDC is expected to serve as a one-stop shop and obtain all the necessary licenses required from relevant ministries listed in the conditional registration certificate (CRC) for investment on behalf of the investment applicant.
- A QIP may be in the form of a joint venture. A joint venture may be formed between Cambodian entities, between Cambodian entities and foreign entities, or between foreign entities. There is no limitation based on nationality or the shareholding proportion of each shareholder, except if a joint venture owns or intends to own land or an interest in land in Cambodia. In such case, the maximum combined shareholding of all foreign parties must not exceed 49 percent.

d) Responsible Organization

The CDC is the sole and one-stop service organization responsible for the rehabilitation, development, and oversight of investment activities. It is responsible for the evaluation of, and all decision making related to, rehabilitation, development, and investment project activities.

However, the CDC shall seek the approval of the Council of Ministers (COM) for any of the following types of investment projects:

- Projects with a capital investment of $US50 million and above
- Projects involving politically sensitive issues

- Projects involving the exploration and exploitation of mineral and natural resources
- Projects with a possible negative impact on the environment
- Project with a long-term development strategy
- Infrastructure projects such as Build-Own-Transfer (BOT), Build-Own-Operate-Transfer (BOOT), Build-Own-Operate (BOO), or Build-Lease-Transfer (BLT) projects

e) Qualified Investment Projects

To be admitted as a QIP, the investor has to register the investment project with the CDC or PMIS and receive a Final Registration Certificate (FRC) under the Law on Investment.

f) Investment Incentive

1) Investment Incentives Granted to QIPs

QIPs are entitled to the following investment incentives:

- Profit tax exemption or special depreciation. QIPs may choose to receive one of these two incentives.
- Profit tax exemption (selective). A tax holiday period is composed of a "Trigger Period" + three years + Priority Period
  - Maximum Trigger Period is either the first year of profit or three years after the QIP has earned its first revenue, whichever is sooner
  - Priority Period will be determined by the Financial Management Law
- Profit tax exemption. To get this incentive, the QIP has to obtain an annual Certificate of Obligation Satisfaction.
- A QIP shall be subject to a profit tax rate after its tax exemption period, as determined in the Law on Taxation.
- Special depreciation (Selective): 40 percent special depreciation allowance on the value of new or used tangible properties used in production or processing
- Duty-free importation of production equipment, construction materials, etc.
- A QIP located in a designated SPZ or export processing zone (EPZ) is entitled

to the same incentives and privileges granted to other QIPs as stipulated in the Amendment to the LOI.

- A QIP shall be entitled to 100 percent exemption from export tax, except for activities stipulated in laws in effect
- The rights, privileges, and entitlements of a QIP can be transferred or assigned to a person who has acquired or merged a QIP subject, with the approval of the CDC or PMIS.

2) Projects Eligible for Incentives

The minimum amount and other conditions of investment in various fields, which are required for the provision of the incentives, are listed in Table 2.

Table 2: Minimum Conditions Required for the Provision of Incentives

Field of Investment	**Requirement for Investment (in US Dollars)**
Support industry, which has its entire production (100%) supplied to export industry	$100,000 or more
Production of animal feeds	$200,000 or more
Production of leather products and related products Production of all kinds of metal products Production of electrical and electronic appliances and office materials Production of toys and sporting goods Production of motor vehicles, parts, and accessories Production of ceramic products	$300,000 or more
Production of food products and beverages Production of products for textile industry Production of garments, textiles, footwear, and hats Production of furniture and fixtures that do not use natural wood Production of paper and paper products Production of rubber products and plastic product Clean water supplies Production of traditional medicines Freezing and processing of aquatic products for export Processing of any kind of cereals and crop products for export	$500, 000 or more
Production of chemicals, cement, fertilizer, and petrochemicals Production of modern medicines	$1,000,000 or more
Construction of modern market or trade center	$2,000,000 or more More than 10,000 square meters Adequate space for car park
Training and educational institutes that provide training for skill development, technology, or polytechnology that serves industries, agriculture, tourism, infrastructure, environment, engineering, sciences, and other services	$4,000,000 or more
International trade exhibition center and convention halls	$8,000,000 or more

Source: CDC (2007), p.32.

1.3. The Special Economic Zones

1.3.1. Legal Frame for the Special Economic Zone (SEZ) Scheme

Scrutiny of the concept of having economically promoted zones/areas in Cambodia started back in the 1960s. The SEZ scheme finally introduced for the first time in December 2005 (CDC 2007:34). Sub-Decree No.147 on the Organization and Functioning of the CDC was issued on December 29, 2005 to restructure the organization of the CDC. A new wing of the CDC, called the Cambodian Special Economic Zone Board (CSEZB), was set up to manage the SEZ scheme. To govern the SEZ scheme, Sub-Decree No. 148 on the Establishment and Management of the Special Economic Zone (The SEZ Sub-Decree) was issued on December 29, 2005.

1.3.2. Basic Concept and Conditions for the SEZ

The basic concept and conditions for the SEZ are defined in the SEZ Sub-decree.

- SEZ refers to a special area for the development of the economic sectors, which brings together all industrial and other related activities and may include General Industrial Zones and/or Export Processing Zones. Each SEZ shall have a production area which may include Free Trade Area, Service Area, Residential Area, and Tourist Area.
- It must occupy a lot measuring more than 50 hectares, with precise location and geographic boundaries.
- It must have a surrounding fence (for Export Processing Zone, the Free Trade Area, and for the premises of each investor in each zone).
- It must have a management office building and zone administration offices. All the necessary infrastructure must be provided.
- It must have water sewage network, wastewater treatment network, location for storage and management of solid waste, environment-protection measures, and other related infrastructures as deemed necessary.

1.3.3. Approved and Planned SEZs

The Cambodian government has so far officially approved six SEZs (Stung Hao, Manhattan, Chhay Chhay O'Neang, Doung Chhiv Phnom Den, Phnom Penh, and

Sihanoukville) by the SEZ Sub-Decree. Five other SEZs have been licensed by the CSEZB. Tai Seng Bavet SEZ, Oknha Mong SEZ, and Goldfame Pak Shun SEZ have also applied for CSEZB approval.

Among the SEZs, the Phnom Penh SEZ began project implementation on July 6, 2006. The first phase of the project was expected to be completed by the end of 2007. Although the Manhattan SEZ has not received the SEZ Sub-Decree, it already has three investors operating in the zone. Sub-Decree # 135 on the Establishment of MANHATTAN (Svay Rieng) Special Economic Zone was issued on November 29, 2006.

2. CURRENT SITUATION OF THE GARMENT INDUSTRY AS SELECTED INDUSTRY

2.1. General Overview

The private sector accounts for 90 percent of employment in Cambodia. The agricultural sector has the largest share of this percentage, providing 70 percent of total employment. It is followed by the services sector at 15 percent and the industrial sector at 8 percent. However, the agricultural sector accounts for only 35 percent of total GDP, while the services sector and the industrial sector account for 35 percent and 20 percent, respectively.

The Cambodian economy has demonstrated a comparative advantage in the production of labor-intensive goods for export, and there is a big potential for further growth. The pool of relatively cheap, unskilled labor will continue to grow rapidly, underpinning the country's wage cost advantage. In the case of the textile and garments industry, there are opportunities to diversify into nonquota markets, and for the promotion of upstream activities such as textile production. Other labor-intensive activities, such as toy and footwear production and the assembly of consumer and industrial electrical and electronic products, are also potential growth areas. In the agro-processing sector, there may also be opportunities for developing rubber products and furniture. Likewise, there may be opportunities for import-substitution, although experience has shown that caution must be exercised in order to avoid the development of chronically inefficient, and therefore costly, production.

There are about 27,000 small companies with less than 50 employees in the industrial sector; in the medium and large enterprises, about 300. Approximately 80 percent of large companies are into the textile and apparel business.

2.2. Garment Industry

Cambodia's garment industry, the country's largest industry, accounts for almost 80 percent of Cambodia's total exports. It was the leading export revenue earner in 2006, generating a total of US$2.5 billion in garment exports and employing 330,000 workers in the same year. Majority of these workers are poor women from the rural areas who support extended families.

In total, about 1.7 million people depend on the garment industry directly and indirectly.[ii] According to the report "Export Diversification and Value Addition for Human Development" published by the Economic Institute of Cambodia (EIC) in June 2007, garment industry workers receive an average of $73 per month, 29 percent of which comes from overtime work.

The garment sector is crucial to Cambodia's economy. However, increasing global competition makes the industry vulnerable. A variety of approaches are needed to help the industry sustain itself.

The garment-manufacturing industry covers a broad range of products, including clothing, footwear, socks, gloves, hats and caps, pillow cases, cushions, towels, bed sheets, curtains, hand towels, tents, bags, carpets, and fishing nets. Cambodia does not have state-owned garment companies, and indigenous garment makers cannot produce the required volume for export. Thus, the operations of wholly owned subsidiaries of foreign companies were allowed, which resulted in foreign companies producing and exporting garment products.

2.2.1. Firms' Location

The list of firms maintained by the CDC and Garment Manufacturers Association in Cambodia (GMAC) shows that most of the export-oriented garment companies are located in Phnom Penh Municipality and Kandal Province. Companies located in other areas, such as Sihanoukville, account for not more than 10 percent of the total. A significant concentration of export-oriented garment firms can be found in four subregions in Phnom Penh Municipality-Kandal Province area: the area along Road No. 5, the Toulkkork area and along Road No. 4, the Steung Mean Chey area and along Veng Sreng Street, and the area along Road No.2. Almost an equal number of firms are located in each of the four subregions.

2.2.2. Management

Most of the top managers in export-oriented garment companies in Cambodia are foreign nationals. The Chinese nationals account for the largest number of top managers. Thirty percent of top managers are from mainland China, while 15 percent and 21 percent are from Hong Kong and Taiwan, respectively. The rest are from South Korea, Singapore, Malaysia, and the United States, in that order. Only 8 percent of top managers are Cambodians (Yamagata 2006:8).

More than 90 percent of top managers obtained education beyond high school. More than a quarter obtained a master's degree, including Masters in Business Administration.

As to work experience, more than a quarter of these top managers have worked for textile-related firms, but majority of them have not worked for any other firms before.

Majority of these foreign-owned companies have contributed substantially to Cambodia's export-oriented garment industry. Foreign garment makers in Cambodia maximize profits through the mass production of low-margin basic items, against the backdrop of abundant, cheap labor. Since small-lot orders are not conducive to profit maximization despite the fact that they require more work, foreign garment makers in Cambodia do not aim for small-lot production of high-margin luxury items.

The degree of technological advancement and managerial sophistication among garment companies in Cambodia varies widely. Although some companies have shown technical improvements, majority of garment factories still require both technical and managerial training.

2.2.3. Production

A major feature of the export-oriented garment industry in Cambodia is that most companies do not produce fabrics but instead specialize in producing garments using imported fabrics. Most companies only sew fabrics and produce finished products.

Such feature contrasts markedly with outstanding garment exporters in other LDCs. In order to receive a preferential tariff exemption from the EU in accordance with the GSP, garment exporters in other LDCs have been adopting vertical integration since the middle of the 1990s. Although a similar system has been applied to Cambodia as an LDC and considering that knitwear is a major category of garment export, Cambodia has not undertaken the same action that other LDCs have.

Cambodia's garment makers focus mainly on knitted products. These do not require large investments, and shipping cost is low due to their light weight. Additionally, production efficiency in knitted products can improve quickly, even though production does not require high-level skills. Generally, the production efficiency of knitted products is approximately 10 percent higher than that of woven-fabric products. In 2005, exports of woven-fabric products accounted for a mere 30 percent of garment exports.

Cambodia's garment products are classified into three categories: outer garments (uniforms, training wear, jackets, blouses, trousers, and skirts), middle garments (pajamas, T-shirts, white shirts, and sweaters), and undergarments (underwear). The country started with the manufacture of undergarments, which are easy to produce and and for which quality standards are not very rigorous. It has gradually been shifting to middle garments and outer garments. However, as Cambodia has not acquired sufficient skills for the manufacture of business wear, factories have focused their specialization in the manufacture of undergarments and middle garments.

Cambodia is highly dependent on imports for all of its raw materials, accessories, and auxiliary material needs, because of the absence of the upstream sector (which produces yarn and fabrics) and supporting industries (which produce accessories and auxiliary materials) within the country. As a result, although production in Cambodia has the benefit of comparative low wages, the shipping cost of imported materials, accessories, and auxiliary materials is a demerit. Taking these factors into consideration, the garment industry can only rely on production efficiency for its profits.

Due to the difficulty in purchasing materials and inability to respond quickly to market needs, operations in Cambodia are devoted primarily to sewing commissions for U.S. brand items. As a result, there are not very many businesses operating under the develop-and-export scheme, under which companies purchase materials at their discretion, develop markets for their own brands, and offer diverse fashions of their own.

2.2.4. Employment and Wages

The export-oriented garment companies in Cambodia tend to specialize in the final production process of apparel. The composition of the workforce reflects this tendency, with most of the total workforce in garment firms allocated to the garment section where garments are made from imported fabrics, or sweaters and socks are knitted from imported yarn. There are relatively fewer workers engaged in other production sections such as knitting, weaving, dying, and finishing.

A significant feature of the export-oriented garment industry in Cambodia is the very high ratio of female workers employed. This high reliance on female labor reflects the same situation the garment industry in other Southeast Asian countries had been into two or three decades ago. The development of the industry empowers women economically by providing them with large-scale employment opportunities that also pay remarkably high wages. One notable concern is the high number of female supervisors. To a certain extent, this is due to the immigration of Chinese female supervisors from subsidiaries located in other countries. Many supervisors are female Chinese who have had long experience in the garment industry before they came to Cambodia. Thus the large number of Chinese female supervisors offers a slim chance for the Cambodian female operators and quality controllers to be readily promoted to supervisory positions.

In general, garment workers in Cambodia earn relatively high wages. The average wages are far higher than those of garment workers in Bangladesh, where per capita income is higher than Cambodia's. The wage rate for an entry-level garment worker is around twice as high as that in Bangladesh.

Entry barriers in terms of educational attainment for people seeking employment in garment companies are not high. Employers do not require a high level of education from factory-floor garment workers.

In sum, female workers in Cambodia can get a high-paying job in a garment factory even without a high level of education.

(a) Technology and Human Resource Training

Technical training is lacking at all personnel levels: senior managers, middle managers, technicians, supervisors, sewing operators, cutting-room personnel, and pressing, folding, and packing operators. Although sewing machine mechanics usually receive some basic training, this training needs to be supplemented to ensure effectiveness and competitiveness.

Some local training options already exist. For example, there is the Cambodia Garment Training Center, which is operated by GMAC. Small, private training institutes for basic sewing skills are also in place. However, these training centers have been ineffective in attracting middle management trainees or turning out industrially competent supervisors and operators.

Supervisors, the first level of management, ensure that a production plan is successfully executed. They are, therefore, at the nucleus of a company's success. Supervisors are responsible for making things happen and seeing to it that things are done correctly in terms of quality, cost, and timeliness. Very few companies have trained their supervisors. Rather, it is the section and line supervisors and experienced operators with little formal education that are usually trusted.

In the middle management level, Cambodian factories lack trained administrators, production planners, and method engineers. Accurate costing, good planning and programming, and realistic time standards are key to any productive garment business. Few companies have an industrial engineer. Industrial engineering is vital to the progress of the Cambodian garment industry.

2.2.5. Productivity and Price Competitiveness

From 1995 to 2003, productivity of Cambodia's garment industry significantly increased. On average, the productivity of worker in US dollars rose by 14 percent per year during these periods.

a) Efficiency and Competitiveness for the Production of Major Garment Items by Country

Category 341 (W/G Cotton Blouse) is one of the most exported Cambodian products to U.S. markets. Thus, it is beneficial to analyze the comparison of Cambodian and other countries' cotton blouses in the U.S. market in terms of cost competitiveness. It should be noticed that comparing by purchasing prices in consuming countries is more significant than comparing by FOB (free-on-board) price in producing countries, because it is important to compare the competitiveness in the end retail market of export destination for evaluating export competitiveness. From this viewpoint, the FOB prices in Cambodia are strongly competitive compared to those in other countries. However, the purchasing prices of U.S. retailers for Cambodian goods are not significantly competitive, compared to the prices given to same items exported by other countries (JICA 2007:5-17).

Table 3: Cost Competitiveness of Imported W/G Cotton Blouse in US Market in 2005 (US$/piece)

Exporting Country	Cambodia	Thailand	China	Viet Nam	Myanmar
Raw materials (including transportation)	2.7	2.2	2	2.5	2.7
Labor cost	0.6	1.4	1.3	0.8	0.3
Subtotal	3.3	3.6	3.3	3.3	3
Power charges	0.5	0.3	0.3	0.3	0.4
Depreciation	0.4	0.5	0.5	0.5	0.4
Overhead cost	0.4	0.7	0.6	0.6	0.4
Total production costs	4.7	5.1	4.7	4.7	4.2
Profits	0.3	0.5	0.4	0.5	0.3
FOB price	4.9	5.6	5.1	5.2	4.5
Shipping cost	2.7	2.2	2.1	2.2	2.6
Import tariff	0.2	0.4	0.4	0.4	0.4
Purchasing price	7.8	8.2	7.6	7.8	7.5
Sales price	15	15	15	15	15
Profit on sales	7.2	6.8	7.4	7.2	7.4

Source: Compiled by JICA Study Team from various sources

The average FOB prices between Cambodian and Chinese products are more or less the same, having a difference of only 20 cents. However, there is a significant difference in the FOB prices of Cambodian products and those from other countries such as Thailand and Myanmar. Such difference is mainly due to the costs associated with raw material imports and labor costs, which take up a major portion of production costs. Raw material costs take up about 60 percent of FOB price in Cambodia as these raw materials are imported from various countries, especially China, Taiwan, Korea, Indonesia, Malaysia, etc. In comparison, the inexpensive raw materials used by Chinese garment manufacturers, which take up only 40 percent of FOB price, are locally available in China since domestic backward linkage is already developed in this country.

Power charges, unless the air-conditioning units are turned off, take up only 3 percent of FOB price.

Looking at the labor cost in order to analyze productivity (see Table 4), it will be noted that Cambodia's monthly average labor cost is lower than Viet Nam's, China's, and Thailand's. However, the average productivity of Cambodian workers is lower than that of Viet Nam, Thailand, and China, leading to a situation where labor cost per piece does not make much difference with that of Viet Nam, after the inexpensive labor cost in Cambodia has been taken into consideration. However, the largest problem for foreign-invested companies is that jobs in garment companies in Viet Nam, China, and Thailand do not appeal to skilled workers anymore. As such, in the medium to long term, Cambodia has the potential for development because its garment industry only has a small labor-force bottleneck (JICA 2007:5-18).

Table 4: Labor Cost Performance Comparison of One-Piece W/G Cotton Blouse in 2005

	Myanmar	Viet Nam	Thailand	China (Shanghai)	Cambodia
Production Pieces/ Per one person day (one day=9 hours)	6 pieces	9 pieces	9 pieces	10 pieces	7 pieces
Labor Cost/ month (in US dollars)	$35	$100	$200	$180	$70
Labor Cost Performance (in US dollars; labor cost/piece)	$0.23	$0.44	$0.88	$0.72	$0.40

Source: Compiled by JICA Study Team from data from various factories

(b) An Analysis of Select Items in which Cambodia has Export Competitiveness

The selection of the items which are suitable for production in Cambodia is a critical prerequisite for the development of projects, as it is impossible for Japanese garment makers to make a business plan (sewing-on-commission, develop and export, investment projects, etc.) unless items suitable for production are identified. Companies will start operations in Cambodia only if such selection has been done.

Cambodian factories can also address competitiveness through management decisions. However, they must do this without lowering wages, restricting benefits, or negatively affecting the working environment. Any of these three may result to worker strikes and reduced product quality as well as deter foreign investments.

The central challenge to Cambodian producers' continued success and competitiveness is to remain socially responsible manufacturers while improving productivity and efficiency. In the postquota environment, however, filling the social responsibility niche cannot compensate for lack of competitiveness on other fronts. To remain in the pool of acceptable suppliers, Cambodian factories must remain competitive and work with authorities to address red tape and corruption. Toward this end, Cambodia is committed to improving the investment climate by introducing streamlined trade facilitation procedures.

2.2.6. Garment Export

All garment products are exported. Most favored destinations are the U.S., which buys roughly two-thirds of Cambodia's exports and the EU, which buys most of the rest.

Cambodia began exporting garments in 1995. As the country has kept its promise to the U.S. to abide by the standards of the International Labor Organization (ILO), it has enjoyed one of the highest export growth rates in the world in the past 10 years. Its technical skills, though, may not be as advanced as Viet Nam's and Bangladesh's. This has allowed the good performance of the knitwear garment industry over the years because the machines required are less expensive and the process employed is simpler than that used in woven garments.

The 1999 U.S.-Cambodia Bilateral Textile Agreement links quota access in the U.S. market to factories' compliance with international labor standards, as monitored by the ILO. Cambodia has earned a reputation among buyers as having a socially responsible manufacturing platform, an ideal setup for sourcing garments.

Cambodia's textile exports grew rapidly from 1990 to 2005 due mainly to Cambodia's MFN and GSP status offered by the U.S. and the E.C. Along with that, ministries and institutions took measures to streamline trade facilitation processes, including overlaps in papers requirements and inspections carried out by authorities; reduced clearing times; increased official revenues; and automated some processes.

However, Cambodia's exports in terms of value and quantity remain small compared to the other countries in the region, except Laos. Moreover, Cambodian workers contribute only a small fraction of value-added taxes, as most of the inputs used to produce garment products are imported. Cambodia imports almost everything, including semifinished products (panels) that simply need stitching together before being re-exported.

2.2.7. Investment Climate

In order to promote textile manufacturing (including weaving and the manufacture of other garment products) and footwear exports, export-oriented companies are given incentives. These include an annual duty exemption on the importation of machineries and inputs, such as raw materials and accessories directly used in production.

The garment manufacturing business is a leading exporting industry in Cambodia. In the near future, the Cambodian Investment Board-Council for the Development of Cambodia (CIB/CDC), with support from FIAS/World Bank, will put in place the Duty Suspension Scheme (DSS), an automation system for import-duty exemption of production inputs. The scheme will tremendously shorten the time spent in administration procedures and will facilitate investors' online application for a master list of imported items.

The government has endeavored to carry out export-promotion policies similar to those adopted by most developing countries, such as tax deductions on export earnings and tariff exemptions on imported machinery. Cambodian garment manufacturers enjoy tax-deduction schemes for exports and tariff exemptions on imported machinery.

In general, the investment climate in Cambodia is viewed as being not particularly favorable even though the Royal Government has been able to attract FDIs in the garment industry. There are a number of constraints yet to be addressed—inconsistent taxes and regulations, immature financial market, political instability, corruption, high crime rates, and poor infrastructure (Yamagata 2006:14). Cambodia's physical and institutional infrastructures are poorly developed. The problem of governance still creates serious challenges in many areas of development activities.

2.3. Related and Supporting Industry

It is argued that Cambodia is significantly weak in terms of building up a support industry for its local businesses. The role of related and supporting industries in improving competitiveness is largely nonexistent in Cambodia. Local supplies are perceived as very limited in terms of quantity and quality. More than 85 percent of firms acknowledge that processing equipment and machinery for their business are almost always imported, while 63 percent of firms argue that specialized research and training services are somewhat unavailable in Cambodia.

Some would still argue that quality and quantity issues among local suppliers are the most comparative disadvantages of Cambodia compared to the other five benchmarked countries (EIC 2005:39).

2.4. Linkages

Creating linkage is an important way to improve industry competitiveness. This will improve areas of specialization and help in overcoming the disadvantages of being small. Developing clusters, business associations, and a value chains are key ways for industry to foster business linkages and increase market access.

Cluster development is in place in Cambodia, with the help of business associations. The United Nations Industrial Development Organization (UNIDO) has begun taking stock of the existing SME clusters in Cambodia and is eyeing to develop a program to further assist the development of SMEs. Initial stocktaking by UNIDO in selected provinces has identified three potential clusters for which it proposes to provide technical assistance. These are:

1. Rice milling cluster spread in nine districts of Battambang Province;
2. Thbong Khmom Cassava Processing Cluster in Kampong Cham Province; and,
3. Handloom weaving cluster (textiles handlooms) spread in three districts in Takeo Province (SME Secretariat 2006:22).

The proposed project places a special focus on women in these clusters. For example, in those clusters where the concentration of women is higher (e.g., handloom and cassava), women's self-help group will be formed and/or strengthened as part of the cluster strategy. The project also proposes to offer assistance for the dialogue process among the cluster actors to improve the exchange of information and identify common strategic objectives.

While the proposed project provides a good starting point for cluster development in Cambodia, additional work is needed to identify more clusters with the potential to support industry and provide necessary assistance to enable their development.

Strengthening business associations also has a great potential for creating business linkages. The associations provide a wide range of information services to members and all other industries in Cambodia, including information on business contacts for buying and selling products or services and sector-specific statistical information from the public sector such as taxation, customs regulations, and business registration procedures.

Improving value chains is another way to improve linkages for industry and small and medium enterprise development. The project is working to improve the bankability of micro, small, and medium enterprises to improve their access to finance and to link them with appropriate financial institutions. The project is also working to strengthen local business associations in the areas of policy advocacy as well as to make these associations a stronger force in building business linkages.

Business linkages can be promoted through the development of high-quality, updated business directories where industries are able to find the partners both inside and outside Cambodia. Assisting private-sector providers of such business information is an ideal way to help industry build business linkages.

3. POLICY IMPLICATION FOR INDUSTRIAL AGGLOMERATION AND NETWORKING

Several problems in business and industrial development have been identified. Some of these problems and the government countermeasures and improvement efforts are shown in Table 5.

Table 5: Issues Challenged in Doing Business in Cambodia

Business Issue	Improvement
Trade procedures are complicated and take more time than in Viet Nam. (Shoe manufacturer)	Trade facilitation projects supported by the World Bank have been implemented.
Cambodia's domestic market is very small. (Shoe manufacturer)	In line with the ASEAN Common Effective Preferential Tariff (CEPT) scheme, a company in Cambodia can regard the ASEAN-wide market as a "domestic market."
Corruptive behavior of tax offices and smuggling are rampant. (Shoe manufacturer, transport equipment manufacturer)	The Cambodian government has tightened control over smuggling.
Industrial infrastructures are underdeveloped. (Various industries)	Development projects have been and will be implemented through the support of various international donors. (e.g., Sihanoukville Port and SEZ)
Incentives for small and medium enterprises are not the same as those for large enterprises. (Electrical equipment manufacturer)	SME development is regarded as an important component of national economic development strategies. It will be materialized through projects in the future.
Labor disputes frequently occur. (Industrial association)	Unchanged
Level of skills and knowledge of workers is low. (Industrial association)	At the SEZ, zone developers have to provide the workers with vocational training.
Due to the lack of protection for design rights, imitation products flow into the Cambodian market. (Transport equipment manufacturer)	The National Assembly has passed the Law on the Protection of Patents and Industrial Design.
A company in Cambodia has to pay corporate tax in advance but the refund is sometimes delayed or not made. (Apparel manufacturer)	Unchanged

Source: CDC (2007) p.38.

Several studies have been carried out to identify and diagnose the major issues facing the industry in Cambodia. High costs and uncertain business environment can be separated into the following key issues:

(i) High regular compliance costs: Cambodian industries face a weak legal and business environment that create uncertainties and risks, resulting in the development of high barriers to entry.

(ii) Lack of clear and market-oriented framework for industry development: While it recognizes that the industrial sector remains one of the core engines of growth, the government has been unable to come up with a framework for its development.

(iii) Limited access to finance: Local commercial banks provide only 1 percent of working capital and 1.7 percent of investment capital overall. Despite the high liquidity of the banking system, banks do not easily give access to loans due to the weak financial infrastructure, which makes enforcing loan agreements and liquidating collateral very uncertain.

(iv) Poor market access infrastructure and information: A lack of market information inhibits local manufacturers from gaining access to markets. It is difficult for local producers to meet both domestic and foreign market demands due to poor road conditions, limited access to the Internet and other telecommunication services, and lack of groups to assist in gathering information about quality and design requirements (SME Secretariat 2006:7).

4. CONCLUSION

Having recognized some of the factors that deter industry growth, the Royal Government started to take steps and develop a plan of action aimed at reducing the cost of doing business in Cambodia and made some improvements, particularly industrial and infrastructural development, to attract FDIs.

The areas in the manufacturing business being developed in Cambodia are extremely limited. The garment industry plays a major role in contributing to poverty reduction by providing employment for the poor and undereducated people and offering high-wage schemes for entry-level workers.

Cambodia has been able to maintain its comparative advantage in the international export market for garment products, but it seriously lacks backward linkages and associated supporting industries. Creating linkages is an important way to improve industry competitiveness by improving specialization and overcoming the disadvantages of being small. Developing clusters, business associations, and a value chains are key ways for industry to foster business linkages and increase market access.

<u>Recommendations to Promote Industrial Development</u>

To promote industrial development, the following are thus recommended:

- Overcome negative issues that existing investors and manufacturers have to contend with;

- Diversify market by expanding Cambodia's export market to Japan, Russia, the Middle East, and other Asian countries. There should be a training course on quality control in CGTC, which should be particularly designed to enhance export competitiveness in the U.S. and the EU, and ultimately, Japan.
- Enhance the quality of labor with a view to increasing productivity. Ensure that guidance, mainly in production process analyses and standardization, is provided to guarantee the optimum arrangement of machinery and productivity management and realize improvements on productivity;
- Put in place a system for inventory financing and plant and equipment financing. These are prerequisites for accelerating the transition from sewing-on-commission to develop-and-export;
- Simplify import-export procedures;
- Introduce additional measures to cut lead time with a view to enhancing Cambodian competitiveness vis-à-vis its neighboring countries;
- Encourage both foreign and domestic investments for the development of backward linkages and supporting industries. This will further shorten the lead time and will result in a higher level of competitiveness;
- The SEZ will have to clearly establish the standard for EPZ functions and other elements of the management scheme as well as industrial infrastructural elements, such as electrical power, water, and wastewater treatment;
- Provide the major infrastructure required for industrial development and FDI promotion, including development of SEZs, electricity, telecommunications, roads, aviation, railways, seaports and water resource infrastructure; and,
- Develop and carry out Human Resource Development (HRD) and technical training.

Recommendations for Regional Support

- Build Linkages-Capacity Programs (training courses, workshops, etc.) in late-coming countries such as Viet Nam, Laos, Cambodia, and Myanmar
- Evaluate geographical cluster establishment based on the cluster schemes in developed countries, in order to experience sharing

- Continued survey of emerging industries in order to establish cooperation or create linkages in the ASEAN area
- Build Linkages-Capacity Programs (trainings, workshops)

NOTES

[i] Second Five year Socioeconomic Development Plan 2001-2005, RGC, Phnom Penh, Page 192.

[ii] World Bank "Garment Sector Competes and Thrives in Cambodia." Phnom Penh, August 5, 2007. www.worldbank.org/kh (accessed February 5, 2008).

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