

Long Term Prospects of the Cambodian Economy: A Quantitative Assessment of the WTO Membership

If Cambodian leaders are quick enough to grab opportunities provided by the WTO membership to accelerate some critical reforms, Cambodian people could be freed from poverty in the next 10-15 years.

The light in the tunnel will not be necessarily an oncoming train.

Based on current trends, Cambodia's economic prospects do not seem terribly bright as its private sector is not competitive, corruption is widespread, and governance is weak. The future of its garment industry, which has been a main source of economic growth and job creation during the last ten years, is uncertain in the face of the elimination of the quota system at the end of 2004. The benefit of the tourism industry on local livelihoods has remained limited, since Cambodians do not own high-end assets such as airlines, hotels, and even airports. Furthermore, natural resources such as gems and forests have been largely depleted and have ceased to be a source of substantial income to a large portion of rural Cambodia. As a result, poverty remains very visible, especially in rural areas.

In September 2003, however, Cambodia was accepted to become a member of the World Trade Organisation (WTO). As a less developed country (LDC) member, Cambodia could export most of its products free of tariffs to other WTO members. But these opportunities will turn into benefits only if the Cambodian economy is competitive, requiring prompt and serious domestic reforms. In any case, under the WTO membership agreements, Cambodia must undertake a large number of reforms, especially legal reforms. Will Cambodian government be smart and strong enough to capitalise on the opportunities provided by the WTO membership to accelerate some critical reforms? To what extent will these reforms boost economic development and reduce poverty?

The objective of this article is to identify critical reforms for sustainable development, and tentatively to quantify its impacts on the economy. To evaluate these impacts, EIC will use its modelling system that includes a Computable General Equilibrium Model, a Provincial Projection Model, and a Population Projection Model.

Current Critical Issues

After the formation of its first

coalition government in 1993, Cambodia committed itself to wide economic and political reforms, aiming to transform itself from a socialist country to a liberal democracy. Some emerging industries, such as the garment industry, telecommunications and tourism, have become the engines of economic growth. However, economic development has been largely confined to urban centres. Little has trickled down to rural areas.

Low Productivity

Figure 1 clearly shows a correlation between productivity of worker and the level of stocks of capital. In 2002, stocks of capital in the agriculture sector, which employs more than 70 percent of Cambodia's labour force, were estimated to amount to only US\$ 240 per worker, generating a modest value added of US\$ 275 per worker (about US\$ 0.75 per day). In addition, this productivity has been on the decline since 1995.

Though it started to slow down in 2001, investment in the garment sector has been relatively strong during the past seven years. Productivity of workers in that sector sharply increased, reaching US\$ 2,200 in 2002. However, according to a recent World Bank study on investment climate in the region, Cambodia's productivity remains low compared to other countries, such as China and India. Because the industry faces huge competi-

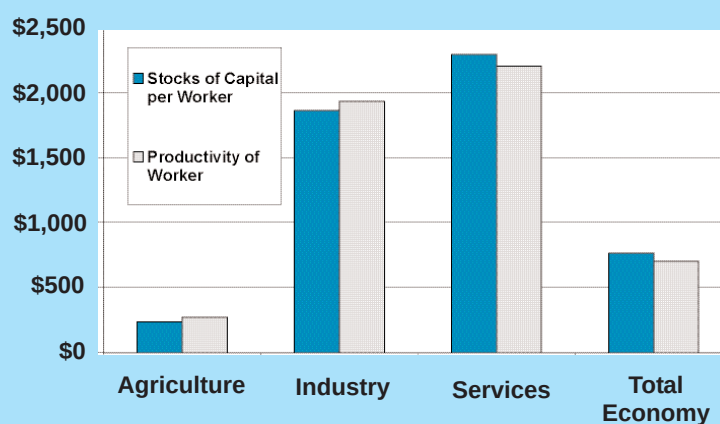
tion when the quota system is eliminated by 2005, this study recommends that Cambodia improve its public governance to support the sector.

Increased Joblessness Among the Young

Cambodia's population figures, devastated during the war years, have been on a huge increase in these years of relative peace. Cambodia's labour force totals have been on an accelerated rate every year since the mid-1990s. This trend will be stabilised only in the next 15 years. Drawing on figures in the 1998 census, it is estimated that 230,000 young people per year will enter the labour market during the early 2000's. However, the number of jobs created during that period by existing industries will not likely exceed 30,000 per year, due to decreases in productive investments. This situation raises great concerns about young unemployment and its implication on social disturbance.

Based on the current level of land and productivity, Cambodian agriculture could efficiently support only about one to two million workers. But currently about 4 million are barely surviving in this sector. In order to provide employment for two or three million of young jobless, investments of between US\$ 400 million to US\$ 600 million would be needed to improve worker jobs and prospects in the rural areas. (see Box 1).

Figure 1. Productivity and Stocks of Capital in 2002



Source: EIC, estimated from various sources

Increased Landlessness

Landlessness is increasingly recognised as a critical development issue in Cambodia. According to Oxfam, the number of landless people in rural areas accelerated during the last few years. In 1984, landless families amounted to about 3 percent of the total population, slightly lower than that of 1969 - about 4 percent. In 1999, however, this ratio jumped to about 12 percent, while landlessness among families headed by single women was even higher - at about 21 percent. Oxfam expects the trend to get worse in the future.

Policies for Future Development

In short, Cambodia has generated some economic growth, but not enough to curb growing under-employment and unemployment. Foreign investment is weak, and Cambodian savings still fly abroad. Fiscal policy is not yet adequately effective to support necessary economic and social development programmes. Landlessness and subsequent migration from rural to urban areas in search of better economic opportunities is ever accelerating. Land disputes are widespread. Poverty alleviation in rural areas is not perceptible. Institutionally, government power-sharing during the last ten years has more resembled a money-sharing scheme. State institutions continue to expand. Corruption is widespread. Civil service reforms move forward very slowly. Demobilisation processes do not remain on track.

Facing these challenges, what should development strategy be? And where do priorities lie?

Restructuring Public Administration

The highest priority is civil service reforms. Economic and social development cannot be achieved without an accountable and efficient public sector. Improving good governance and fighting corruption in public administration are key factors for rapid and sustainable development in Cambodia. The current administration is a legacy of years of war. Since the formation of the first coalition government in 1993, in conformance with the Paris Peace Agreement signed in 1991, administrations from different factions (but mainly from the Cambodian

Peoples' Party and Funcinpec Party) have been merged into a unified administration. In many cases, those staffs have not been selected in accordance with competency criteria, but rather on the basis of party loyalty and nepotism, particularly in the senior ranks. For some lucrative positions, it seems that the selection has been made in a corrupt manner as well. Moreover, the whole public administration is overstaffed, representing almost 7 percent of the total labour force, which is as much as the whole manufacturing sector. Salaries for civil servants are so low that government administration is inevitably inefficient. The government has recognised these weaknesses and for years has pledged to make reforms.

Progress has indeed been made in some sections of the civil service reform, like computerising the registration of civil servants. But the most difficult tasks are yet to be done - assessment of the real staffing needs with appropriate hierarchies and functions, and re-selection of staff. These assessments should be developed urgently with the collaboration of different ministries, and with assistance of donor countries. The selection of

core groups of civil servants will be crucial, and should be made on the basis of competence within the current pool of civil servants; in some cases, such as community and social development, the pool should be expanded to include some non-governmental organisation (NGO) personnel who have demonstrated their abilities. Salaries should be raised for the core group staff to a more liveable level. Staff outside core groups may be transferred to the Ministry of Social Actions, and will continue to receive their existing salary for a certain period.

Military and police reforms should be carried out as vigorously as those for civil service. In times of peace and modern technology, having about 130,000 soldiers and 70,000 policemen is simply too extravagant.

The real challenge for Cambodia is to transform the surplus public administration staff into a productive group. Because the affected personnel are often not well educated, rural economic development zones should be expanded to assist them with strict monitoring on management in regard to land distribution, usage, and cultivation.

Box 1: What workforce size could the Cambodian agriculture sector support by providing the workers an earning at least equal to the poverty line?

To simplify the calculation, we assume:

1. The value added in the agriculture sector represents the income of rural people.
2. Size of household = five persons: two workers -wife and husband- and three dependent children.
3. Poverty line = US\$ 1 income per capita and per day (World Bank definition), making a total of US\$ 5 per household per day, annualised to US\$ 1,825 per household per year.
4. As there are two workers in each family unit, each worker has to generate an income (or value added) of US\$ 912 (= \$1,825/2) per year to reach the poverty line.

VA: Value Added in agriculture (equal to the income of rural Cambodian)

W: Income of worker reaching the poverty line (US\$ 912 per worker per year)

EP: Number of workers earned an income at least equal to the poverty line

$$EP = VA/W$$

According to an EIC estimate, VA in the agriculture sector (excluding rubber and forestry) totalled about US\$ 975 million per year during 2001-2003.

So, $EP = 975,000,000/912$

or $EP = 1,070,000$ workforces (or say, 1 million)

Remark: If we take the Cambodia poverty line definition (US\$ 0.50 per day and per capita or 50 percent lower than that of the World Bank), EP would be roughly two million workforces. However, criticism has been raised against the Cambodian poverty line. Critics say that 50 cents per day per person is an extreme poverty line existence. That amount might buy a minimum to eat and to wear, but would be insufficient for sending children to school or paying for health care when needed.

As a result, Cambodia agriculture could support only about one (or two) million workers, instead of four million currently employed. The rural workforce surplus should be thus between 2 to 3 millions.

Based on various studies on off-farm and non-farm activities, the capital needed creation of one job in Cambodian rural small and medium enterprises (SME) is US\$ 200. The capital required for creating 2 or 3 million productive jobs in the rural areas would thus be US\$ 400 to US\$ 600 million.

Implementing and Enforcing the Laws

Private sector development not only requires laws, but also respect for and enforcement of such laws. Lack of respect for laws and difficulty in enforcing them are not only a matter of political will. They are largely connected to the lack of human and financial resources within the legal system. Legal reforms and human resource development must go hand-in-hand. Cambodia has to improve its educational system for its general population as well as offer specialised education to law enforcement authorities, like police officers and judges.

Re-adjusting Fiscal Policy

Lessons learned from the experiences of previous years show that the government is able to substantially, and in a sustainable manner, raise budget revenues. But first of all, governance reform should be implemented. Corruption and weak governance are harmful to budget revenue collections. According an EIC estimate, smuggling in gasoline alone costs the national budget lost revenue to the tune of one hundred million US dollars per year. To prevent this, the EIC recommends the oil tax policy be readjusted (EIC Economic Review, Issue 1). To improve revenue collection in the non-tax areas, it is strongly recommended that the Ministry of Economy and Finance be the sole authority in charge of monitoring and collecting revenues. The line ministries should only be in charge of technical aspects.

Addressing Credit Issues

The Cambodian economy is characterised by the lack of appropriate credits to the private sector, even though the currency deposit level has dramatically increased. Statistics compiled by the National Bank of Cambodia show those credits from commercial banks to the private sector amount to less than 50 percent of the total deposits. The rest is mostly sent abroad. Such a situation is not acceptable, particularly for Cambodia, where the financing needs for the economy are extremely urgent. Strengthening the supervision system is, at this stage, the most crucial. The monetary authority should also have a clear and active policy on the de-dollarisation of the economy.

Rethinking Foreign Assistance Priority

The amount of foreign assistance to Cambodia has been very substantial, and the envy of some other countries during the past ten years. Many questions, however, have been raised about its impacts on the people's livelihood. Poverty alleviation is yet to be visible. So far, a large amount of foreign aid has been directed to technical assistance. However, it appears that the severe weakness of Cambodian public administration has resulted in foreign assistance having a surprisingly limited effect on structural adjustments and reforms. As stated above, Cambodia's economic development cannot be sustainable without restructuring the public administration and drastically reforming fiscal and monetary systems. For these reasons, it is crucial that foreign assistance focus more on the structural adjustment program. Funds allocated to this program should be strictly earmarked. To increase the effectiveness of the reforms, transparency in managing foreign assistance is needed.

The Economic Prospects

To evaluate the impact of economic reforms in Cambodia, EIC has

developed some simulations using a newly-developed macroeconomic model and database. The simulation includes two hypothetical scenarios: a Reform Scenario and a "*Laissez-Faire*" (or no reform) Scenario. It estimates the impact of reforms by comparing projected outcomes for the two scenarios. It should be noted that the scenarios do not necessarily reflect the entire spectrum of the government's on-going reforms. Only some reform aspects are included, primarily for technical reasons. Also, the assumptions made under each scenario may not precisely match the government's plans for implementation.

Main Assumptions

The Reform Scenario assumes the government vigorously implements reforms in the coming five to seven years (Table 1).

In public finance, revenue-enhancing measures increase the efficiency of tax collection. This enables the government to increase actual revenues from various sources close to their potential levels. The government's reforms of civil administration and military forces comprise many components of programmes. For the simulation, only three compo-

Table 1. Main Reform Assumptions

Policy measures	Reform Scenario	"Laissez-Faire" Scenario
- Raising effectiveness and efficiency of tax collection - Improving public services delivery - Rationalising civil administration - Demobilise soldiers and policemen	- Increasing budget revenue from 10.7% of GDP in 2003 to 17.5% in 2008, and 18.2% in 2013 - Decreasing tax on gasoline and diesel to align their retail prices to those of neighbouring countries - Increasing monthly salary of civil servants from about US\$35 in 2003 to US\$100 in 2008, and adjusting to GDP growth rate from 2008 to 2013 - Increasing locally financed public investment, especially irrigation, schools and health centres in rural area, from 1.5% of GDP in 2003 to 7.6% in 2008, and keep this rate up to 2013 - Increasing education and health spending from 2.4% of GDP in 2003 to 3.6% in 2008, and 4.5% in 2013 - Increasing the number of teachers and health personnel from 103,000 in 2003 to 110,000 in 2008 and 120,000 in 2013 - Reducing the number of other civil servants from 60,000 in 2003 to 40,000 in 2008, and retaining this level until 2013 - Reducing the number of soldiers and policemen from 185,000 in 2003 to 100,000 in 2008, and keeping this level until 2013	- Budget revenue will remain flat around 11% of GDP during 2003-2013 - Keeping tax on gasoline and diesel high - Increasing the monthly salary of civil servants at the same rate as GDP growth during 2003-2013 - No additional local funding for investment - Keeping education and health spending at the same percentage of GDP as in 2003 - Keeping the number of teachers and health personnel unchanged - Keeping the number of other civil servants unchanged - Keeping the number of soldiers and policemen unchanged

nents of reform programmes are selected: (i) the demobilisation of soldiers and security officers; (ii) the rationalisation of civil administration; (iii) an increase of average monthly salaries of public officials.

Judicial and legal reforms and the development of the private sector framework provide businesses with a favourable environment for long-term and large-scale investments. These reforms also create a level playing field for domestic and foreign investors. Foreign direct investment expands rapidly, financial markets are established, and portfolio investment flows in. The strong commitment of the government to reforms sends positive signals to foreign donors and aid agencies. This enables Cambodia to access official grants and loans necessary to carry out various reforms and development programmes.

Under the "*Laissez-Faire*" scenario, the government is assumed to be unable to translate reform programmes into actions. The structural problems of governance continue to prevail over the coming decade.

With regard to the international environment in both scenarios, we assume that the world economy will continue to expand during the simulation period, with a growth rate of 4 percent in the US, 3 percent in Europe and 2 percent in Japan. The Asian economy will continue developing with an average annual growth rate of 6 percent. Owing to these economic growths, crude oil price is assumed to fluctuate in the neighbourhood of \$25 per barrel. Commodity prices in the world markets, such as crops, rubber and timber prices will increase by about 3 percent a year. Meanwhile, prices of manufactured goods will rise more moderately - about 2 percent per year - due to substantial increase in productivities.

Simulation Outcomes

A comparison of outcomes of the two scenarios reveals impact of reforms on Cambodia's economy in the long run. An overall conclusion to be drawn from the scenario work is that the government's reform programmes, if fully implemented, will have a major positive impact on Cambodia's economy in the coming two decades.

If the reform programmes are fully implemented in the coming five to seven years, the real GDP growth rate

will accelerate from 4.5 percent in 2003 to almost 10 percent in the next five years, before slowing down to around 7.5 percent from 2008 to 2013. This contrasts sharply with the "*Laissez-Faire*" scenario in which the growth of real GDP will be hovering around 3 percent per year for the next ten years.

High economic growth stimulated by implemented reforms will have major implications for the level of people's income. Nominal GDP per capita will rise from US\$ 280 in 2003 to US\$ 460 in 2008, and US\$ 680 in 2013. Due to an increase in productive investment in rural area, agricultural production will grow at an annual rate of 5 percent, as compared to a mere 3 percent in the past ten years. This will have dramatic and positive impact on poverty reduction, assuming of course that measures to ensure equitable income distribution - such as rural development and social welfare programmes - are also in place.

By contrast, the picture will be gloomy for a Cambodia without reforms. With modest economic growth, nominal GDP per capita will be US\$ 330 in 2008, and US\$ 400 in 2013. No significant changes will occur in income in real terms, putting on hold any hope for poverty alleviation.

Concluding Remarks

The real determination of Cambodian leaders to move their country forward as a civilized and developed country, with rule of law and a sustainable economic development strategy, is best

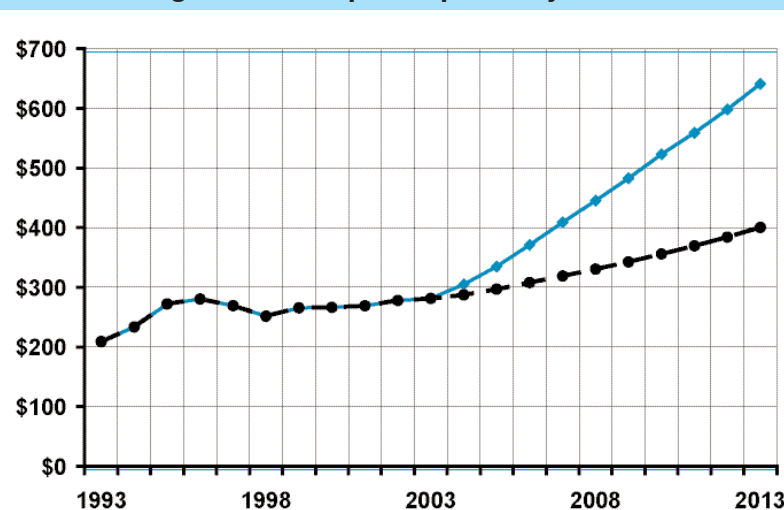
reflected in the outcomes of the "With Reform" Scenario. The rule of law means there is real reform of the judicial system, police force, and the army. A sustainable economic development strategy includes a drastic fiscal and monetary reforms, better natural resource management, and good governance with civil administration reform and decentralization.

By successfully implementing these primary reforms, the Cambodian administration will become more efficient and effective. Cambodia will be able to mobilize what it needs in terms of investments and savings, externally and internally, to develop the country. Economic growth will be strong enough to offer new entrants into the labour market opportunities to be economically productive. Foreign reserves will grow steadily, helping prevent severe volatility in the exchange rates. Inflation rate will remain low, and the Cambodian economy will be increasingly competitive in the world markets.

With the rule of law and strong macro-economic stability, a stock market can be introduced and developed rapidly. The banking and other financial systems that are the main factors in mobilising private savings will thus be revived and strengthened. Long-term private investment will be forthcoming. Income will increase sharply; and basic infrastructures - physical, economic, and social - will be rehabilitated or rebuilt in about 7 to 10 years. The core economic policy aiming at alleviating the poverty of the Cambodian people will be achieved.

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Figure 2. GDP per Capita Projection



Source: EIC Projection