

Removing Trade Constraints To Improve Competitiveness and Reduce Poverty

If trade constraints are reduced, business operating costs will drop, leading to improving competitiveness and standard of living, especially in rural Cambodia

It seems trade has recently become a factor that may enhance the Cambodian standard of living as rural Cambodia seemingly has moved away from subsistence to surplus activities. The trade activities are becoming significant to Cambodia's economy. Though official statistics are scarce and mostly unreliable, it may be estimated that the trade activities currently involve at least 300,000 workers across the country, representing approximately 6 percent of labour force. The value added of trade is estimated to be about 10 percent of the Cambodia's GDP in 2003.

Over the last several years, the Cambodian government has indeed tried to develop and implement trade reform policies in an effort to cut down poverty. However, based on recent human development and poverty indicators released by the United Nations, positive outcomes of those policies seem rather limited. There are of course a number of reasons for the disappointment, and perhaps the most significant ones are constraints relating to trade activities.

These trade constraints may become even more troublesome in the advent of the country's membership in the World Trade Organization (WTO). The WTO accession means that Cambodia has to face fierce competition with other country members.

One of the trade constraints Cambodia has to deal with rather quickly is an unofficial payment to government officials, or better known as bribe tax, that has become a real cost to businesses operating in the country. According to a World Bank's Investment Climate Assessment (ICA) that surveys 500 companies throughout Cambodia, corruption and informal practices are significant constraints. The survey shows that bribe tax is very widespread affecting the whole business system of Cambodia. The bribe amount ranges from 1.3 percent of business revenue for rural non-farm to 6.9 percent for foreign companies (Figure 1). It seems the larger

the business the higher the bribe tax is. And the overall impact is that, everything being equal, such bribe tax inevitably encourages a growing informal trade, and stifles competitiveness.

Based on this survey, the bribe tax should amount to hundreds of millions of US dollars per year. A likely implication is that if such trade constraint were to reduce to some extent then business operating costs would substantially decrease, making them more competitive and encouraging further investments. The multiplier effect would be more jobs and better standard of living for workers. Farmers would get a higher farmgate price for their produce, if the bribe tax within the trading system were kept under control.

In order to contribute to a continuing debate on how to improve Cambodia's competitiveness, this article will discuss trade constraints in three key industries - rice, fishery, and garment.

Trade Mechanism

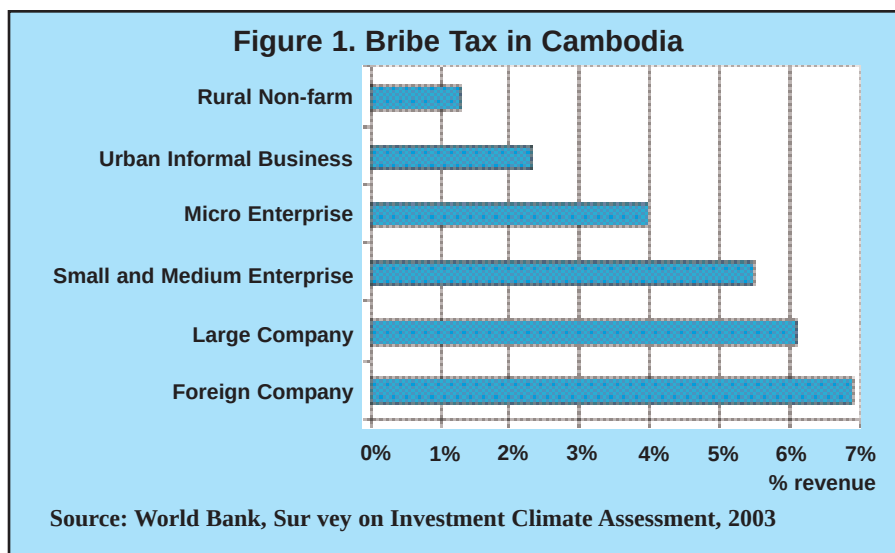
In the rice industry, farmers sell their paddy to either traders or rice millers who will then sell it to wholesalers or exporters. Some medium and large rice millers buy paddy from farmers for milling before exporting it directly to neighbouring countries. According

to some rice miller associations, a large proportion of Cambodian rice export is in form of paddy rice, depriving the country of the benefit of value added. Large-scale operators in rice milling and exporting play a vital role in virtually determining the farmers income. It is a common practice for large rice millers to buy, store, and export the products throughout the year.

The rice export is made in the form of either official or unofficial operation, and a large proportion is exported illegally. It is estimated that of the total annual rice export of 300,000 tons, only about 15 percent are recorded officially.

There are four main players in the fishing industry: fishermen, fish merchants, wholesalers, and exporters. The large fishing operators may sell their daily catches directly to wholesalers or exporters. In general, however, the fishermen sell their stocks to fish merchants at their landing sites. The merchants will then forward their purchases to wholesalers who will eventually resell them to exporters. Most of exports of fish are unofficial to evade the high total fees.

Trade mechanism for the garment industry is quite different from the above two industries. Garment investors in Cambodia have formed a powerful association, well known as the Garment Manufacturers Association of Cambodia



(GMAC), which directly facilitates trading activities of the industry. The garment industry imports raw materials, mostly as semi-finished products, then manufacture garment products for the purpose of exporting them to US and EU markets. Some garment exporters buy quota from the Ministry of Commerce to export their products to the US. Therefore, the garment export is totally formal.

Cost Structure

The cost structures in Figure 2 show that, for the three industries, the weight of trade cost is rather heavy, especially for rice and the fishing industries. The trade cost is defined to include cost of transportation, bribe tax, and trading margin. The costs of trade, labour, and production make up total business operation expenditure, which is equal to gross revenue.

The trade cost is a major cost item for the rice industry. It amounts to 44 percent of the total cost. A possible explanation is that in general, there are many layers of the middlemen between the primary producers to the exporters.

Regarding the fishing industry, the trade cost accounts for more 55 percent of the total cost. Unofficial payment and corruption from the production process to export market make up a large proportion of the total cost, which tends to reduce industry cost competitiveness.

For the garment industry, costs of importing raw materials have kept the cost of production up. Labour cost represents a smaller proportion of the total production cost. According to GMAC, an unofficial payment in the industry amounts to about 7 percent of the total export sales per year.

Trade Constraints

In the above discussion of the industry cost structures, it seems there are certain trade constraints that relate to the issues of governance, institution and environment, product quality, financial credit, and market access.

Governance

The three major industries

under examination are not really competitive due to their trade cost component, which raises serious questions on governance in the country. The unflattering experience of the rice and the fishing industries at a point of export indicates the issue of governance needs addressing. At border checkpoints for rice and fish exports, there are a number of payments, both unofficial and official, to be made to custom officers, Camcontrol, phytosanitary inspectors, economic police, and border police etc. Specifically to the fishing industry, unofficial payments are still required even though the exporters hold legitimate export license. The exporters, after paying for the license, are forced to pay another sum unofficially to the officials to "facilitate" a movement of goods.

For the garment industry, a similar problem arises when there are a large number of officials authorised to control the exporting process. According to GMAC, the number of custom inspections in Cambodia is higher than the other countries, including China and Bangladesh, resulting in a higher cost paid by the manufacturers. Bureaucracy remains another critical issue for garment factories. When the products of factories are exported or imported, it takes a long time to deal with paperwork. The length of time spent on bureaucratic matters has been described to be longer than that of the other countries in the region. A World Bank study shows that 16.4 percent of the management time in Cambodia is spent on bureaucratic mat-

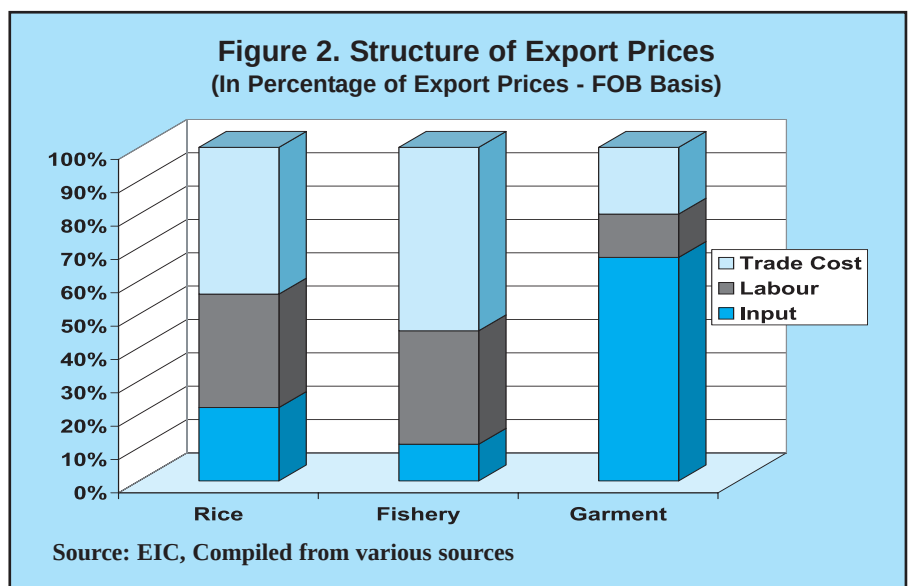
ters, while Bangladesh requires only 4.2 percent, and China 12.3 percent.

Investors have generally concluded that corruption in Cambodia is a kind of risk related to their business operation. According to the Investment Climate Assessment Survey by the World Bank in 2003, about 75 percent of the 500 companies surveyed indicate that corruption is the main constraint to private enterprise operation and growth. Almost 65 percent of the respondents nominate anti-competitive or informal practices as another main constraint. And over 50 percent of them indicate the uncertainty in regulatory policy and the legal system are also the problems. The survey also suggests that the unofficial costs range between 54 to 64 percent of the total cost.

Institution and Business Environment

The trade constraints are also in the form of institution and business environment. For the rice industry, the Cambodian farmers are generally put at disadvantage when pricing their products due to the lack of updated market information, and the consumers' product preference for quality rice and other factors, which have effectively encouraged unofficial trade at the borders.

The high trade cost in the rice industry necessarily forces the price of Cambodian products up, making it impossible to compete for a secured share of the export market. The obvious impact of this crippling trade cost is that



the rural Cambodia has continued to generate only meagre income, not sufficient to get it out of the poverty trap.

Because they are not well informed about market conditions, and lack bargaining skill, Cambodian rice farmers are not in position to negotiate a better farmgate price for their paddy. They tend to settle for a fixed price even though the market price for their paddy has increased, or is expected to rise. Another pressure for the farmgate price to remain stagnate or drop at the expenses of the primary producers is a large number of layers of middlemen in the rice supply chain, especially when compared to those in Thailand and Vietnam.

Rice consumers in Cambodia have a strong preference for certain type of rice, namely the high quality Phkar Knhey or Neang Minh, rather than a high-yielding but low quality rice, widely known as IR variety. The lack of demand and an abundance of the high-yielding rice necessarily force or keep the farmgate and market price down. It encourages middlemen from Vietnam to stock the high-yielding rice during harvesting season, and later import it back into Cambodia for a higher market price just before the next harvesting season when the rice stocks in the country are generally depleting. Most of these trading activities across the border are carried out informally.

As for the garment industry, customs clearance has been a major difficulty for factories. Salaries of government officials in Cambodia are relatively low and inadequate for a decent living, making unofficial payments to customs officials for goods clearance almost necessary trade constraints. In the process of controlling goods, consignments are checked individually rather than using state-of-the-art risk assessment methods, raising time consuming problems for exporters. The costs of goods clearance are inevitably high.

The main competitors for the Cambodian garment industry are China, Bangladesh, and Vietnam. Despite the fact that China, a WTO member, has a wage rate (US\$ 1.14) higher than that of Cambodia (US\$ 0.29), corruption in Cambodia is generally accepted to be three times worse than in China.

Transportation

Transportation is considered to be a major problem for primary producers - farmers and fishermen. Farmers have to sell their produce at low price at the "farmgate" to traders because it is neither economical nor cost effective for them to incur transportation cost. For fishermen, the transportation costs associated with substandard infrastructure and transport mode also encourage them to dispose of their catch at landing sites. For the very same reason, the transportation cost is also a constraint for the middlemen at each layer of the trading transactions in the industry.

The World Bank 2003 Investment Climate Assessment Survey indicates that the Cambodian transport and import clearance charges on a standard 40 foot container is one of the highest. They cost US\$ 858 in Cambodia, Hong Kong US\$ 555, Sri Lanka US\$ 484, Madagascar US\$ 367, and Malaysia US\$ 309. Compared Cambodia's to the lowest in the list, it costs almost three times as much for transport and customs clearance in Cambodia.

Product Quality

Besides the low cost factor, high quality is another one of the major factors that can help secure competitive advantage. Cambodian rice is generally classified as low quality product due to a high mixture of broken grade of rice, which appears to be three times higher than that of Vietnam. The high mixture is due to

inadequate selection of seeds that allows impurities, and milling process. This low product quality is indeed a trade constraint that needs addressing.

It seems there exists no financial incentive for farmers and rice millers to reduce the mixture so as to raise the product quality. The first and well known large rice miller, Ankor Kaksekam Rong Roeung, argues that it can of course produce the rice with only 5 percent, in lieu of the current 15 percent, by a filtering method; but the current market price for the high quality will not justify the extra filtering cost.

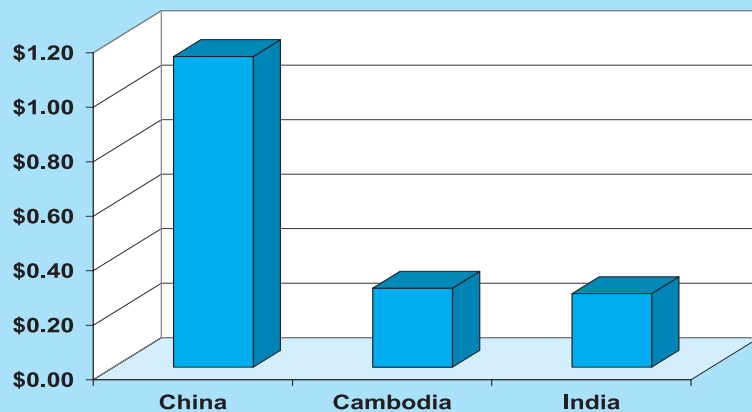
There is no clear indication of the quality of the current fish export. It carries neither quality guarantee nor health certificates.

Another possible trade constraint for the garment industry is the product quality after the lifting of the quota system from 1995 when it will face tough competition from China. The Cambodian garment industry is relatively younger, and it has yet to have skilled labour to improve its product quality and productivities.

Financial Credit

The lack of available credits at a reasonable rates hampers free trading activities for the local players in the three main industries. For most rice farmers, a need for cash during an emergency tends to leave them with only two options - disposal of their rice stocks at a fire-sale price, or obtaining loan credit with a crippling interest rate ranging from 24

Figure 3. Labour Cost Competitiveness (US\$/hour)



Source: Garment Manufacturers Association in Cambodia

percent to well over 100 percent per annum. For the middlemen and millers, the interest rate of 18 percent per year charged by commercial banks on business loan is hardly an incentive for vibrant economic activities, especially when the international market rate is less than 5 percent. In the fishing industry, fishermen, merchants, and even wholesalers are all in the same boat. They do not have many options besides loans with high interest rates that make their business operations costly and less competitive in the world market.

Market Access

Market access is another trade constraint issue. The Cambodian rice export is limited to a few neighbouring countries: Vietnam, Thailand, and Singapore. Only a small portion of the rice surplus is legally exported from Cambodia, and most of it to Singapore. The fish export concentrates in the South East Asian region, but the quantity is still limited due to a lack of standard quality of agro-processing and the trade constraints in Cambodia. The garment industry, however, has enjoyed a tremendous market access to the US and European markets for the last few years.

At the advent of the WTO membership, Cambodian industries will be exposed to a greater world market; and only their competitiveness will determine the degree of their success in terms of securing the world market shares for their exports.

Concluding Remarks

The Cambodian rice industry is not as competitive as Thailand's due to its trade cost. Figure 4 shows that though the farmgate price of the Cambodian rice industry is fairly comparable to that of Thailand, their trade costs are not. While the trade cost for the Cambodian rice industry amounts to US\$ 127 per ton, the one for Thailand is a mere US\$ 45 per ton. One plausible explanation is that there is not sufficient competition within the industry to keep the trade cost down.

To compete favourably with Thailand, the trade cost associated with the Cambodian rice industry needs to be

lowered. This can be done with a number of measures. First, information on market conditions should be made readily available to the primary producers to improve their negotiation position in pricing their produce. There should be on-going training for the rice farmers to appreciate the usefulness of, and to use, the market information, and the selection quality of rice to best satisfy the market demand. Currently, the export markets seems to require rice that has low impurities. Second, competition among the middlemen and the exporters within the industry is absolutely crucial to control the trade cost. Third, making finance available to the industry at reasonable rates would assist in forcing the trade cost down.

It is crucial the total trade cost for the fishing industry be lower. The so many fees, official and unofficial, in the fishing industry need to be rationalised; they are simply creating a severe bottleneck for export. Some official fees, including licences for export, not only encourage corruption in fishery authorities but also push up the informal export as the exporters will attempt to evade those fees as much as possible. Hence, an elimination of the licence requirement would be the first step to encourage exporting, and help reduce informal exports. The current market of fishing industry is limited to some Asian countries; it should and could be extended to EU and other markets. A high standard of agro-processed products may help secure a larger export market share.

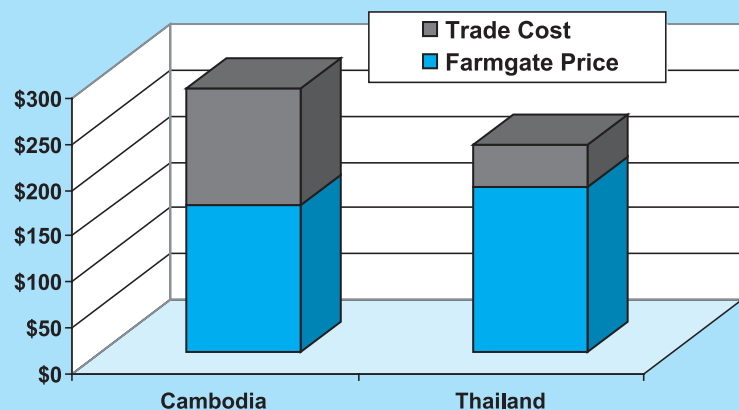
For the garment industry, the issue of red tape needs addressing urgently as the protective system of export quotas it has enjoyed in the past few years is due to end by December 2004. Cambodia's garment industry is competitive in terms of labour cost compared to that of China (Figure 3). Yet, Cambodia's garment is not competitive due to higher level of widespread corruption in the industry.

The customs system today is described as an obstacle for investors in the import and export of products, incurring unnecessary trade costs, which lowers the country's level of competitiveness. Customs officials deliberately try to delay the goods clearance awaiting unofficial payments. The customs system needs to function effectively and efficiently without imposing additional unjustifiable trade cost in terms of time and money.

Overall, the above analysis shows that corruption has increased the business operating expenses to the extent that the main three industries find it most difficult to compete in the market places. There needs to be an overall review and reform of the existing governance to discourage and lower the bribe tax that adversely affect the country's economic and business activities. Other important issues relate to availability and usage of market information, and training of workforce to produce quality products that would best satisfy the market needs.

By Touk Khy

Figure 4. Comparison of Export Prices of First Quality Rice (US\$/ton - FOB Basis)



Source: EIC, compiled from various sources