REPORT

MINISTRY OF COMMERCE, CAMBODIA

Integration and competitiveness study — Part D

Review of the Law on Investment

A pilot study prepared under the Integrated Framework for Trade Related Technical Assistance

26 November 2001

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Preface

IN AUGUST 2001, a team of consultants worked with Ministry of Commerce (MOC) officials in Cambodia conduct a diagnostic study of Cambodia's trade policy issues and technical assistance needs. The terms of reference for this study were designed to support the Royal Government of Cambodia (RGC) in developing its Pro-Poor Trade Policy Strategy. Ministry of Commerce officials involved were H.E. Sok Siphana, Secretary of State; In Vothana, Bureau Chief; Ung Sovithiea, Deputy Bureau Chief; Keomuny Kong, Deputy Bureau Chief; Sophann Tauch, Director; and Oeur Samrith, Assistant Director. The team members were Kelly Bird, Consultant — Trade Policy; Sandy Cuthbertson, Consultant, Centre for International Economics (CIE) —Team leader; Martin Desautels, Consultant, Gide Loyrette Noel (GLN) — WTO Accession; Curtis Hundley, Consultant — sector studies on tourism and fisheries; Hiau Looi Kee, World Bank — market access survey and analysis; Ray Mallon, Consultant — sector studies on rice and labour services; Philippe Marciniak, IMF — macroeconomic assessment; Andrew McNaughton, Consultant — sector studies on diversified agriculture and handicrafts; Maika Oshikawa, WTO — trade policy, Sopanha SA, IMF — macroeconomic assessment; Isidro Soloaga, Consultant — poverty assessment; Ieng Sovanarra, Consultant — sector study on garments; and Geoff Wright, Consultant — trade facilitation. A review of investment regulation was carried out by Ross Chapman and Lee Davis of the CIE as a parallel study working directly to the Government. The World Bank Task Manager was Ataman Aksoy.

Following this fieldwork, team members prepared drafts of the following reports.

- Part A: Overview.
- Part B: Component reports — macro assessment, trade policy, trade facilitation, poverty analysis.
- Part C: Sector studies — rice, diversified agriculture, handicrafts, fisheries, garments, tourism, labour services.
- Part D: Review of the Law on Investment.

These drafts were discussed at a workshop held in Cambodia on 19 and 20 November 2001. Following that workshop the draft report was finalized particularly taking into account participants' suggestions for technical assistance.

1 The need for LOI reform

Cambodia's Law on Investment (LOI) contains a range of taxation concessions for approved investment activities. These provisions include tax holidays, special corporate taxation rates, tax free reinvestment of profits and tax free repatriation of earnings.

Reviews of the LOI had concluded that it suffered in several respects (FIAS 2000, FIAS 2001). Amongst other things, the LOI was regarded as being subject to too much discretion in its application, leaving unnecessary investor uncertainty and potential for manipulation and governance concerns. Furthermore, tax-reducing provisions available under the LOI were considered to be too generous, potentially hampering revenue mobilisation by the Royal Government of Cambodia (RGC) and causing distortions to the overall tax policy framework. Both the World Bank and the International Monetary Fund shared these concerns and in early 2001 both agencies suggested a number of reforms to the LOI as part of negotiations in the context of a Structural Adjustment Credit (SAC).

From late 1999, there was a sharp deterioration in the regional investment climate, reflected in falling net flow of funds and FDI into ASEAN countries. In this environment there was concern among government ministers and within the business community that Cambodia not do anything that would reduce its prospects of either attracting investment or make it more difficult to retain what it has attracted to date. As a result emphasis was placed on the need for gradual and long term changes in any tightening of privileges under LOI reform.

In mid 2001 the RGC identified and set in train certain procedural reforms within the Cambodian Board of Investment designed to speed up and render less bureaucratic the registrations and approval process for those investors seeking to access privileges under the LOI. Other reforms require changes to the Law itself.

To assist the RGC to assess reform options, the Government commissioned the Centre for International Economics (CIE) to conduct consultations with government and the business community and to subsequently develop and analyse some possible options regarding the specific parameter settings of

four proposed reforms. This study reports on identified shortcomings of the LOI, gathers stakeholder views together, develops some reform options and spells out the likely stakeholder impacts of each alternative. Stakeholders include

- the government as custodian of policies for economic development and employment growth, as revenue raiser with responsibilities for fiscal integrity, and as administrator of both Customs and the investment incentives authority — the Cambodian Development Commission;
- exporters, currently dominated by the garment and footwear sector;
- import competing industries established by foreign investors; and
- other domestic market oriented investors.

In setting out possible interpretations of the proposed reforms, the paper provides discussion points for Government to lead to a determination on the reforms. The study builds on consultations already held with the government, with private sector investors and with international financial institutions.

Discretionary and unpredictable investment regime

Since the first Foreign Investment Advisory Service (FIAS) review in 1997 of investment incentives offered, the RGC has made a number of changes to the Cambodian investment environment. These changes introduced greater transparency to the granting of investment incentives, limiting the ability of ministers/ministries to exercise discretion and expanding investment monitoring capacity and customs governance.

However, despite these changes, FIAS in 2000 noted that:

> 'Despite these changes, Cambodia's investment regime remains heavily discretionary, selective, complex and open to unnecessary revenue sacrifice and abuse… (FIAS p. i, 2000)'

As discussed in chapter 2, the RGC does not appear to currently possess the governance and administrative capacity to implement the current investment incentive regime as intended. Furthermore, the complexity of the regime places an excessive administration burden on the RGC, thereby putting pressure on limited RGC resources.

From the viewpoint of private sector stakeholders, the discretionary nature of the current regime — giving rise to 'hidden' bureaucracy costs, uncertainty and sovereign risks — increases operating costs. Excessive

layers of bureaucracy and discretion have also been cited as the reason why entitlements under the current incentive regime have not been received.

Revenue mobilisation

When the Law on Investment reform process began in 1997, revenue mobilisation was not a central consideration. However, revenue mobilisation is a priority of the RGC and reform of the LOI must be seen in that broader context.

The International Monetary Fund (IMF) has recommended, and the RGC agreed to, increasing Cambodia's tax revenue from 8.6 per cent of GDP in 2000 to 9.7 per cent in 2002, an increase of 1.1 per cent, equivalent to around CR 150 billion (IMF p. 7, 2001). Increasing tax revenue to 9.7 per cent will mean that current expenditure by the RGC — estimated to be 9.7 per cent of GDP in 2000 — will be financed entirely by tax revenues, thereby putting public finance on a more sustainable basis. The extent to which reform of the current investment regime will lead to net revenue mobilisation will be of obvious assistance to the RGC as it pursues fiscal self-reliance.

Objectives of LOI reform

In recognition of the problems associated with the current investment incentive regime, a number of changes to the LOI have been formulated. Broadly speaking, changes to the LOI seek to rationalise the investment regime so as to limit discretion, improve transparency and reduce the administrative burden of the current LOI. In drafting guidelines for amendments to the LOI, FIAS noted that the purpose of the guidelines is to:

> …assist in creating a regime more conducive to the encouragement of private investment in Cambodia through:
>
> - transparency, simplicity and predictability in both the approval process of private investments and the provision of fiscal incentives to such private investments; and
> - the provision of investment guarantees (FIAS p. i, 2001a).

Proposed changes to the LOI as discussed by FIAS

To meet the above objectives, the proposed changes to the LOI address 4 areas — concessionary rate of profit taxation, tax holiday provisions, taxation on reinvestment of profits and taxation of distributed profits. The

changes proposed by FIAS were conditionalities of a Structural Adjustment Credit (SAC) being negotiated during 2001. The proposed changes comprised:

- elimination of the special 9 percent corporate tax rate for all new investment and phasing the 9 percent rate out to the standard 20 percent under the Law on Taxation for the next 5 years for existing and operational projects;
- repeal of the current tax holiday provisions and the introduction of a three year tax holiday, conditional on annual certification of compliance, to all qualifying new investment, without evaluation; the use of a tax holiday will deny the tax payer any benefits available under the Law on Taxation during the tax holiday including initial investment allowance as well as accelerated depreciation allowance; all current tax holidays provided under the Law on Investment will be grandfathered;
- elimination of the tax free reinvestment of profits and introduction of an appropriate investment allowance in the Law on Taxation at a rate to be determined, satisfactory to the World Bank, and applicable to all qualifying investment, new or expansion, irrespective of source of finance, without evaluation; and
- elimination of the right to the tax-free repatriation of earnings and other incomes by approved enterprises.

Changes to the LOI as discussed by FIAS will obviously contribute to revenue mobilisation. However, revenue mobilisation is not a direct objective of the proposed changes. Indeed, in putting forward a range of options with which to raise an additional CR 150 billion, the IMF does not consider any additional revenue raised by way of the proposed changes to the LOI. Broadly speaking, there is stakeholder confusion as to the relationship between proposed changes to the LOI as discussed by FIAS, and revenue raising measures put forward by the IMF. Specifically, stakeholders typically see the IMF option of a minimum import duty as being a FIAS proposal. For those export orientated firms operating under the LOI, the ability to get production inputs at world prices is a key determinant in their ability to be internationally competitive. For these firms import duties are likely to be given greater consideration than LOI reform as discussed by FIAS. Indeed, the RGC may need to resolve the issue of minimum import duties before progress can be made in advancing the LOI reforms as discussed by FIAS and key conditions of SAC release. This issue is discussed further in chapter 3.

2 Stakeholder interpretations and views

A wide range of stakeholders — encompassing representatives of the RGC, private sector and IFIs — were consulted for the purpose of seeking views and opinions as to the need, if any, to reform the current LOI and the form that any proposed changes should take. The stakeholders consulted are reported in table 2.1. Stakeholder views, opinions, attitudes and arguments are presented here.

Royal Government of Cambodia

Under current arrangements the Cambodian Development Council, the Department of Taxation and the Customs Department all have significant roles to play in delivering incentives to investors. These roles would change somewhat with the adoption of the LOI reforms as discussed by FIAS. The private sector has issues with their treatment by each of these institutions. Should government decide *not* to implement the reforms it would still need to decide whether the current system is capable of administering the investment law *as it stands*.

The advisory team met with all three organisations to form a view on this.

Cambodian Development Council

The Secretary General outlined the functions and role of the two arms of the CDC — the Cambodian Investment Board (CIB) and the Cambodian Rehabilitation and Development Board (CRDB).

After an introductory meeting with the Secretary General, and senior staff of CDC, the consultants met individually with Department Directors from the Cambodian Investment Board to gather views from within on the information and promotion, evaluation and monitoring activities of the CDC. All of these areas would experience some change under implementation of the proposed reforms.

Information and promotion activities

The consultants were provided with the standard information pack available to prospective investors. It gives an outline of the obligations of investors seeking incentives, the entitlements of those firms whose applications are approved and the commitments that the CIB must meet (for example, a 28 working day turnaround after all required documentation is submitted for evaluation.) The consultants formed the view that information, rather than investment promotion, was the function of this Department under current arrangements. Because of the maize of unofficial as well as official charges that face the incoming investor, even the task of providing a truly informative backgrounding of prospective investors would be a formidable one. Examples are provided by the ad hoc *prakas* powers exercised by individual ministries in levying taxes and charges which do not flow to consolidated revenue but are retained by the ministry itself and the array of charges that attach to clearing a container through customs.

Evaluation activities

The advisory team met with the Director and staff of the Evaluation Department to explore the procedures followed in awarding incentives to new developments or expansions. An issue for government in responding to the views of the Cambodian investment community is whether the current arrangements are actually *delivering* incentives which are attractive by regional standards and doing so in an even handed and efficient manner, with minimal bureaucratic discretion. The recommendations of the FIAS report and the SAC conditionality on tax holidays and tax rates both point to judgements that in some respects the regime is overly generous but also failing to provide a transparent, consistent and equitable access path to those incentives. The current evaluation process has been called into question.

The use of ‘points’ awarded against an evaluation matrix to establish a prospective investor’s tax holiday entitlements is an integral part of the present evaluation system. It has so far provided relatively few holidays and none of the *maximum* length of 8 years provided for in the law.

The distinction in the application evaluation process between the treatment of garment manufacturers and other investors was pointed out, whereby the ‘one stop shop’ approach applying to the latter is replaced with a directing of garment manufacturers’ applications through for Prime Ministerial consideration. (The one stop shop treatment provides for the CIB to be the focal point for gathering all relevant documentation required

by other ministries to issue approvals and licences for which they are responsible. However, these clearances occur within the ministries and not at CDC.)

The obligations of the Evaluation Department at present require, inter alia, consideration of feasibility studies submitted by firms as part of the approval process and the application of 'reasonableness tests'. The reasonableness tests consider for instance the realism of the implied ratios of stated capital equipment (numbers of machines) to stated employment, size of factory and proposed employment levels to land area and the like. These are used as rough checks against bogus applications. The Department continues to uncover applications by business brokers on behalf of their clients that are fraudulent — copies of planned operations details for factories that have already been considered by the Department.

The advisory team has yet to resolve why such evaluations, where they are warranted at all, would not be subsumed in the duties of the individual ministries in the granting of operating or business licences and the like.

The powers of the Evaluation Department in granting initial approvals appear to be limited in reality by the scope for their recommendations to be overridden.

Approved investors requiring import duty exemption submit to the CDC a list — detailing the quantity and value — of production inputs required over the next 12 months. The CDC may vary elements of the list, producing a Master List of allowable imports. As the master List is valid for 12 months, investors must provide periodic evidence to CDC for the purpose of updating import requirements.

Monitoring

The Monitoring Department, which also acts as the primary database for CDC, functions in a limited way at present, handicapped by computer software problems and resulting data capture problems. For instance, whilst those investment firms which are monitored will shortly be required to complete a relatively demanding questionnaire on their activities, simple numbers of firms accessing duty exemptions are not available. Nor is any data available as a database on the firms' *actual* investments as distinct from approved stated values. Monitoring activity at present is largely restricted to establishing that firms who have accessed (mainly duty exemption) privileges are indeed operational. At the instigation of the CDC Secretary General, firms are being required to produce evidence on what they exported to claim duty exemption and 'government paid' VAT status

on imported inputs. (Customs verification of these entitlements is reportedly itself being charged for.) At present the CDC does not capture this information.

The Monitoring Department is not at present able to readily generate data on the number of firms accessing duty privileges in any one-year or a summary of the status of firms with respect to their tax holidays.

The Monitoring Department distinguishes between 'active', 'non active' 'deleted' and 'non-monitored' firms. Active firms are monitored and established as being in business. There are some 335 non-monitored firms, a small minority of which, according to the Department are likely to be active and accessing privileges. Despite the fact that there were some 382 active firms in 2000, only 270 of these were registered with the Department of Taxation according to figures provided by the latter. The answer to the divergence between active and registered with the Taxation Department appears to lie in the fact that whilst co-operation between Taxation and CDC has improved since 2000, information flows were poorer in earlier years.

This gap raises questions for government as to why a substantial number of firms (export or domestic orientation unknown) which would seem to be accessing duty exemptions are not registered as investment firms for tax purposes. The review team were also advised that, were monitoring to reveal investor firms in breach of their obligations, it was unlikely that action would be taken to delete them in the present climate. Fear of sending signals that would be interpreted as 'investor unfriendly' may be contributing to this reluctance.

So whilst CDC is making steady progress in reducing the number of 'non-monitored' firms, the benefits of monitoring in its present form are questionable if enforcement is absent or sporadic. For CDC to fulfil its currently assigned role as monitor of firms enjoying tax and duty privileges, it appears to need clearer signs of government endorsement of that role.

Implementation of the proposed reforms would involve significant changes to both evaluation and monitoring activity, involving automatic conditional registration of applicants, entitlement to standardised tax holidays after receiving operating approval by the relevant ministries, and annual renewal of duty exemption entitlements on production of tax compliance evidence at CDC. (It is noted that the latter is an issue that importers have concerns about given the current interpretations of requirements on pre-payments of profit tax.)

Tax Department

The predominant role of border taxes (78 percent of tax revenue at present) and the medium term requirements to meet AFTA tariff rate reduction goals has caused the authorities to move towards both broadening the tax base across taxpayers and to redistribute the proportion of tax collected by the different tax instruments (principally profit tax or minimum tax on turnover, VAT, import duties and excise). In its role as assessor the Tax Department has made efforts to bring an increasing number of firms under the 'real sector' category where VAT payments are mandated.

In the 2000 tax year a further 500 entities were brought into the real sector category. There are now some 2700 entities in the real regime, around 300 of which would come under the proposed Large Taxpayer Unit recommended by the IMF. An additional 5 provinces were added to those already operating under the real regime.

These measures are consistent with previously published suggestions by the International Business Club (many of whom equate the LOI reform proposals with the single purpose of collecting more tax revenue from foreign investor firms) to broaden the tax base.

Calculations provided by the private sector as a response to the FIAS report purport to show how an additional US$47 million annually could readily be raised based on apparent numbers of firms registered with the Ministry of Commerce (MOC). These claims have been rebutted by the IMF and by a consultant to the World Bank, Thomas Hart, who notes 'There is a large difference between being registered with the Ministry of Commerce and being active…there is absolutely no data to support the fact that there are 5000 registrations that do not pay tax.'

These issues have yet to be worked through with the private sector representatives. Nevertheless, a combination of the requirements of the existing Law on Investment and Law on Taxation (LOT), recent changes to replace minimum tax requirements with prepayment of profit tax, and the current practices of both CDC and the Tax Department have left elements of the international business community highly critical of current tax procedures, as discussion below reveals.

For its part, the Tax Department rejects suggestions of a parallel tax regime that allows significant numbers of domestic firms to go unchallenged on their tax status. Whilst admitting that evasion and under reporting of turnover and profit is widespread, officials deny that there are significant numbers of firms that enjoy a tax-free status to which they are not entitled.

However, the auditing strength of the Department, while growing, is limited. Very few firms maintain auditable accounts that would meet international standards and the continued lack of an accounting law allows even larger firms to present income tax statements that prove difficult to verify.

This is contributing to an outcome where, for the CDC approved investor non-tax or 'outside' sources of information (for example, from Customs, outcomes of garment quota auctions etc) are required to establish under reporting of tax. Reassessment of 71 firms in 1999 resulted in additional tax payable of CR 18.1 billion. But the advisory team understands that these were export firms and the capacity to deal with offending domestic oriented firms remains questionable.

That revenue from investor firms which is collected as profit tax or its equivalent is collected in the form of monthly *prepayments* from 175 firms which are loss making and a further 36 whose profits are less than the 1 percent threshold. The remainder, 20 firms in 2000, prepaid profit tax monthly in to be credited against their 9 percent profit tax liability. The first type of firm includes firms that have qualified for tax holidays. However the Tax Department takes the view that the LOI currently offers tax holidays from the first year of profit making, not the first year of operations so prepayments are required. These two categories together yielded CR 42.3 billion, while profit taxes from the remainder paying 9 per cent yielded CR 21.7 billion.

The apparently conflicting provisions of the Law on Investment, which allows for tax holidays to commence when profit is first earned and the Tax Department's interpretation that prepayments are due from all other taxpayers is an issue that will have to be resolved in the course of reaching a decision on the proposed reforms. It is highly contentious with the private sector.

Customs

Meetings with senior customs officials and the IMF consultant managing the Customs Reform Workplan touched on procedures within Customs, progress with reform and the interface between Customs responsibilities and practices and the delivery of investment incentives through duty exemption arrangements.

Smuggling

There is recognition within Customs that irregular practices and under the counter charges are raising the cost of trade transactions and contributing to competition problems for local industry. Low pay for officials was cited as a fundamental cause and a contributory factor in official smuggling — where dutiable imports come through customs points duty free in return for payments to customs officers. Steps to address this through officer rotation and the formation of a smuggling task force and audit teams were outlined.

Some Customs officials believe quantities of goods are smuggled in containers that bypass the pre-shipment inspection (PSI) system (garment inputs). Customs are developing a record set on volumes and weights of imports and re-exports of individual producers as a means of identifying offenders.

There are also reported concerns with the PSI system itself, with one estimate suggesting more than 50 per cent of containers entering under that system are entering unsealed or with broken seals, suggesting a further contributory factor in the smuggling problem.

Customs interface with CDC

Customs officials have a role to play at CDC in the establishment of Master Lists for importers but suggest that negotiated outcomes are reached between manufacturers and CDC before Customs is involved. They question why a set of norms is not established and adhered to, avoiding repeated negotiation.

However, no clear position emerged on questions concerning Customs own valuation procedures. Arbitrary undervaluation of some imports is admitted to as a disincentive to smuggling. Adherence to valuation codes would have some costs in this respect and these would need to be recognised in advance.

Customs clearance charges

Discussions with the private sector revealed widespread dissatisfaction with elements in the total bill for clearance of a container that cannot be traced to any service, tax or duty. This arbitrary cost-raising element is one of the main complaints brought against Customs and it is not clear what definitive steps are planned to tackle the problem. These charges typify one

of the areas where change is needed if investors' competitiveness is to rely on other than compensating taxation privileges.

Views of government ministries and government members of the Working Groups

The advisory team sought views on the proposed reforms, and impediments to their implementation, from the Ministries of Agriculture, Forestry and Fisheries; Commerce; Economy and Finance; Industry, Mines and Energy; Public Works and Transport; and from the National Bank of Cambodia.

In principle support for LOI reform but questioning of priorities

The consensus that could be found among this group was confined to in principle support for implementation of the proposed reforms under a generous timetable and with reservations about some of the FIAS recommendations. The lack of specific detailed criticism of these, not all of which are part of the reforms, suggested to the advisory team that not all ministries have had the incentive or opportunity to study either the FIAS report or the proposed reforms in fine detail.

Some ministries were of the view that reform of the LOI along the lines indicated was a second order issue. There was concern on the part of some that whilst current incentives were adequate or even generous by regional comparison, they did little to offset the primary cost, risk and competitiveness problems generated by:

- insecure land tenure (with illegal invasions in rural districts);
- poor infrastructure, high transport costs and high utilities charges;
- lack of laws on commercial agency, contracts, property leasing, secured transactions and accounting, an inadequate penal code for enforcing those laws that are operative;
- high and hidden (corruption) costs of bureaucracy;
- smuggling;
- relatively small scale production compared to regional neighbours such as Vietnam and Thailand, especially in agriculture;
- low workforce productivity; and
- mistrust of the banking sector following bank closures and re-licensing.

LOI privileges however only compensate a select few firms for the costs imposed by such impediments. An alternative policy may be to

compensate all firms through a generous tax code that would assist all 2700 firms within the real regime to overcome cost impediments.

Equating of reforms with reduced profit margins and reduced investment flows

Several ministers had formed the impression that the primary (and perhaps sole) aim of the reforms was revenue raising and were of the view that this would inevitably mean further loss of competitiveness of existing investors, an extinguishment of attraction to new investors and the risk of departure of garment and footwear firms. There was some support for the view that these measures should wait until a number of the 'primary' problems listed above could be addressed even though these were conceded to be long term problems.

There was a frequently encountered view that the SAC reforms to the investment incentives available to firms through CDC would inevitably cut after tax profit margins across the board. This would endanger the growth sector — garments and footwear — which operates on very fine margins. There was little focus on the cost cutting potential of the bureaucratic streamlining of incentive administration and delivery contained in the SAC reforms. But there was recognition of an 'in parallel' need to address bureaucratic slowness and illicit charges that were burdening exporters and firms competing with smuggled goods alike.

It was apparent to the advisory team that, despite the creation of the Working Groups that had improved government–industry contacts, ministry to ministry communications were not optimal for reducing bureaucratic costs. One instance was given of a 3-month delay in gaining export approval for export of a manufactured food product, with subsequent loss of market in Malaysia.

Tightening existing tax collection as alternative to SAC reform

There was also a questioning of the adequacy of existing tax collection procedures with the implication that there might be significant scope for revenue raising without going from 'lax' to 'strict' investment incentives. (Some ministries had interpreted the abolition of discretionary 8 year holidays — *which no one has to date been awarded* — with 'automatic' 3 year holidays for all qualified firms as an indicator of this.) One Minister suggested that the consultants do a survey of stall holders in Phnom Penh to establish what tax they pay.

In focussing on the revenue raising or saving capacities of the reforms there was some discussion about the fact that these were, as one Minister pointed out, long-term reforms. The implication was that there would be short-term pain for investors and the economy would only benefit, if at all, in the longer term. The fact that 'grandfathering' of existing privileges for investors already here is a significant part of the proposals has possibly been overlooked by some, as has the fact that efficiency gains to incoming investors would be almost immediate

There was widespread reference to the vulnerability of the economy to the garment sector with its 170 000 employees and the fact that 30 factories had reportedly closed this year. An issue for discussion was the extent to which changes to incentives would adversely impact on this sector and what role incentives would play in the run up to the uncertain world trade regime following the expiry of the Multi Fibre Agreement (MFA) in 2005. It was suggested that there was a need to work through the likely impact of the reforms for these firms but recognition that actual cost data would be difficult to obtain.

The need for diversifying the economy to reduce its vulnerability to the garment sector was raised. With this in mind, and the possibilities for manufacturing enclaves on the Thai–Cambodian border, it was suggested that the consultants revisit the incentives available there and compare them with those that would be available under the SAC reforms.

The minimum duty issue

It was evident that some ministries were not clear on the point that, though related through revenue strengthening and ESAF requirements and the government's commitment to raising a further 1.1 percentage points of GDP through taxation, a measure to introduce a minimum tariff was not one of the four SAC conditionalities.

One Minister suggested that it was important to uncover what other countries did by way of imposing a minimum duty. There were also calls for further analysis to demonstrate the possible impact on firms' financial position. This suggests that not all ministries have had the opportunity to study the impact analysis provided by FIAS in June 2001 in response to requests for such an exercise.

Private sector

Two meetings were held with the private sector. The first meeting was held with members of the International Business Club (IBC), who represented the interests of the garment, manufacturing and professional services sectors. The second meeting was with the Garment Manufacturers Association in Cambodia (GMAC) who put forward the views and opinions of Cambodia's textiles, clothing and footwear sectors.

International Business Club

The private foreign investment sector, as represented by the IBC, considers (unanimously) that the business environment in Cambodia is not conducive to making an acceptable return to invested capital. Depending on type of economic activity and focus (export or domestic market), businesses place different weighting on the range of problems reported to exist in Cambodia. However, typically cited problems include:

- high operating costs, in part brought about by poor infrastructure and overpriced utility services;
- excessive layers of bureaucracy that add to production costs and introduce uncertainty and sovereign risk;
- 'hidden' transaction costs and smuggling; and
- a lack of good governance (transparency, accountability and responsibility).

Given these 'real world' considerations, investment incentives as granted under the LOI are claimed to be an important consideration when deciding whether to invest in, or to continue to operate in, Cambodia. The point was stressed that if the business environment in Cambodia was perfect and the above listed problems did not exist, then investment incentives would only be of marginal importance. However, as this is not the situation, investment incentives are important, in contrast to the FIAS assertion that they are not a *primary* consideration.

Areas of confusion

Broadly speaking, private sector foreign investors (as represented by the IBC) consider the primary, and indeed only, objective of the LOI reform package, as discussed by FIAS, to be revenue raising. This is, according to the private sector, exemplified by raising profit tax to 20 per cent and the minimum import duty of 5 per cent. (We note that there is apparent confusion here as the issue of a minimum tariff was not a FIAS

recommendation. Indeed the FIAS report circulated prior to the March workshop contained no recommendations as such.) The private sector does not distinguish between the proposed reforms (which largely address rationalisation of the investment regime) and the minimum import duty (which is a revenue raising measure).

Furthermore, while the proposed reforms seek to rationalise the investment regime so as to limit discretion, improve transparency and reduce the current administrative burden of the current LOI, the private sector is not aware of, or giving any weight to, these objectives. It did not feel that these objectives were adequately addressed in the FIAS report. Quite simply, the private sector did not, for example, equate a guaranteed 3-year tax holiday with improved predicability and heightened transparency.

It was quite evident that the private sector had either chosen to over look the elements of the FIAS package targeting good governance or had not realised/been made aware as to how achieving these objectives could improve the business environment in Cambodia and promote competition and further investment. It was noted that limiting discretion and providing certainty were good objectives, but it was felt that the FIAS report did not highlight this or indicate how the proposed reforms mapped to these objectives.

Further discussions with a subset of the private sector made it clear that people were not aware that some elements of the proposed reforms were open for potential further discussion, such as the parameters of the investment allowance; the manner in which the profit tax is to be increased from 9 to 20 per cent; and the trigger point /starting date of the 3-year tax holiday.

Problems associated with the current LOI regime

Many examples were provided of problems/difficulties associated with the current LOI privilege regime. However, there was broadly unanimous support for the current regime (that is, it should not change). This led the consultants to doubt whether the ‘benefits’ of current LOI regime had been accurately evaluated and compared against the proposed reforms. Some cited examples of difficulties with the current regime follow.

- Failure to get CDC approval for import duty exemption in the first year of operation for domestically orientated LOI approved firms.
- Failure of the vast majority of LOI approved firms to be granted tax holidays.

- Discretionary nature of decision-making and its contribution to 'hidden' transaction costs.
- Ability of government to alter the 'rules of the game' and impose additional costs on businesses through issuing a prakas.
- Excessive layers of bureaucracy, hampering expediency in problem resolution and leading to additional transaction costs.

From these examples it is apparent that the current LOI regime is significantly flawed — there are costs associated with bureaucracy, lack of transparency, uncertainty, unpredictability and sovereign risk. However, these are exactly (with the exception of sovereign risk) the types of problems that the reforms are trying to address. Given this, the consultants question whether the private sector has critically evaluated what advantages they currently receive, and what adopting the proposed LOI reforms would mean in terms of costs and benefits.

The primary concern with reforming the current LOI

Putting aside for the moment the issue of when LOI reforms would take effect and what the reforms actually embody, the private sector feels that implementation of the LOI reforms contained in the FIAS report would impose *immediate* costs on firms currently operating under LOI privileges. However, any benefits arriving from the reforms — should they ever eventuate — such as improved governance and infrastructure, and a broadening of the tax base, will not be felt for many years to come. In the intervening period between immediate costs and future benefits, firms enjoying the current LOI privileges will go out of business.

This raises the issue of whether LOI reforms are a matter of timing — does an opportunity exist to link reforms to cost reducing improvements elsewhere in the economy?

An issue of timing?

While differing in focus, a continual theme of discussions with the private sector was that due to inherent problems facing businesses in Cambodia, assistance via way of LOI privileges was critical to current investors and central to attracting new investors. However, should the above mentioned problems be addressed, then this questions the need for the level of privileges currently offered under the LOI.

However, when questioned about appropriate triggers, it appeared that the private sector had not given much thought to what triggers would be

required for them to support the LOI reform requirements as currently specified in the proposed reforms. It was stated that it was not up to the private sector to detail a credible timetable of triggers — it is a RGC responsibility. For some (particularly import competing producers) this reflects an apparently entrenched position that *existing* privileges are inadequate and there is an unwillingness to consider *any* of the reform elements. For others there is an interest in finding out what is negotiable.

Developing a set of time bound actions with which to gain support for and advance LOI reform will require the RGC to develop and set out a credible portfolio of achievable triggers. However, the private sector noted potential difficulties with such an approach — in their eyes the RGC is not seen as credible, it has not established a good track record and does not have the political will for reform. This culminates in the private sector placing little, if any, confidence in a government promise of 'it will be good for you in the long run'.

What the IBC would like to see

Assuming the IBC 'line' accurately represents the wishes of *all* members of the group, then the IBC would like greater assistance rather than less. This is obviously a wish of all businesses around the world, irrespective of the country in which they operate. The IBC wish is premised on the view that the reforms do not offer any additional benefits relative to the current regime.

For example, the IBC would like to see not only export-orientated firms exempt from import duties on production inputs, but domestically oriented firms as well. The IBC has given no explicit consideration to what this would mean for government revenues. Duty exemption was seen as necessary so that domestically oriented firms could compete with (cheaper) smuggled goods. On the issue of smuggling, IBC members suggested that for some commodities they could provide details on 'who', 'how much', and 'when' — but no such data was made available during the meeting. This remains a matter for further exploration with the private sector.

Garment Manufacturers Association in Cambodia

GMAC welcomed the consultation process as a major step forward in improved mutual understanding between the private sector and government. They were grateful for the opportunity to discuss their concerns frankly with an independent group in a non-adversarial atmosphere.

However, as with the IBC, GMAC members were not aware that the minimum import duty — the source of their greatest concern — was not part of the proposed reforms. Furthermore, on clarification of what the reforms actually embody, and the scope for potential negotiation on some of the details and transitional arrangements, GMAC members appeared willing to engage in further the dialogue and consider the reforms put forward.

To facilitate further dialogue, GMAC suggested the following steps be taken.

- Clarification on what the proposed reforms actually mean in practice. For example, clarification of the reasons why elimination of tax-free repatriation of profits does not equate to double taxation.
- Quantitative (that is, spreadsheet) examples of the effects of differing investment allowances and dividend taxation.
- To view any impact analysis/marginal effective rate of taxation studies that might be available (FIAS has undertaken such analysis and provided it as part of its impact analysis).

Problems associated with the current LOI regime

Problems arising from the current LOI arrangement stem form an apparent conflict between the Law of Investment and the Law of Taxation. Under the current LOI, the tax holiday of CDC approved firms commences once the firm makes a profit. However, prior to profit, LOI firms are required, under the Tax Department's interpretation of the LOT, to make profit tax prepayment (equivalent to 1 per cent of turnover). GMAC make two comments about this current arrangement.

- It is unclear to GMAC members whether the profit tax prepayment is to be seen as a tax credit, or is it revenue forgone? From conversations with the Tax Department, it is seems that profit prepayment is to act as a tax credit. However, GMAC report that continued inquiries about the status of their tax prepayment have gone unanswered.
- Conflict between the LOI and LOT arises as once a tax holiday is enacted (that is, the firm makes a profit), under the LOI the firm is not required to make profit tax prepayments. Rather, the firm submits a monthly tax declaration to the Tax Department. However, under the LOT, monthly prepayments are required. Hence due to the absence of tax prepayments, CDC approved firms are not tax compliant and hence cannot get import duty exemptions from CDC as tax compliance is a requirement for exemption. This raises the prospect that CDC

approved firms need to pay the tax prepayment — even though they are exempt from it under the LOI — in order to get import duty exemptions.

Other problems raised by GMAC are consistent with those raised by the IBC — hidden bureaucracy costs, slow turnaround time of CDC to amend the Master List, excessive bureaucratic burden associated with undertaking business, and ability of Ministries to exercise discretion and issue prakas that impose additional costs on firms. Examples of these types of problems follow.

- GMAC estimates that between 40–50 per cent of the cost of clearing a 40-foot container through customs can be attributed to unofficial payments.
- It takes around 2 weeks for CDC to amend the Master List for imports. Depending on the price discrepancy, it may not be worth amending the list due to the time taken.
- Ministry of Commerce and Ministry of Labour respectively issuing decrees requiring quality inspection charges for imports and apprenticeship programs for enterprises with more than 60 personnel.

It is the consultants' opinion that GMAC's concerns with minimum tariff are of higher order than reforms to the LOI as embodied in the proposed reforms.

International Financial Institutions

World Bank

The consultants had an opening briefing from the Country Chief of Office. The history of the debate on LOI reforms was reviewed and the Chief of Office gave an account of the government's concerns as understood by the Bank. The timing constraints facing the Bank and the RGC were outlined.

International Monetary Fund

The IMF Resident Representative pointed out that when the LOI reform process began in 1997, revenue raising was not a central consideration. The current LOI is seen as costly, unpredictable, slow and not implemented.

Given the lack of international accounting standards and the apparent continued inability of LOI approved firms to make a profit, the IMF

consider a minimum import duty of 1–3 per cent and prepayment of profit tax as possibly the only means by which tax can be raised from them.

The Draft Accounting Law is about to go before the National Assembly, the Secure Contracts Law will be drafted by October 2001, and the Bankruptcy Law is scheduled to be completed by early 2002. Before such laws are enacted — especially Accounting Law — there is an issue of whether revenue mobilisation can be achieved without placing greater emphasis on border taxes.

Consultation with an IMF Customs Adviser was also undertaken. Consistent with private sector wishes, the Customs reform package is focusing on reducing opportunities for discretion. This is to be achieved through automation and simplification of the customs process. However, the reform Customs package is a long-term process — significant changes in capacity and governance are not expected for at least 12 months.

2.1 Stakeholders consulted

Department/Institution	***Person***	***Title***
Royal Government of Cambodia		
Ministry of Economy and Finance	H.E. Keat Chhon	Senior Minister
	Dr Aun Porn Moniroth	Secretary General
Council for Development of Cambodia	H.E Sok Chenda Sophea	Secretary General
Cambodian Investment Board	Chea Vuthy	Director, Public Relations and Promotion
	Dr Hing Thoraxy	Director, Project Monitoring Department
	Poth Narin	Director, Project Evaluation
Tax Department	Hong Tha	Director
(Ministry of Economy and Finance)	Um Seiha	First Deputy Director
	Pan Bun Thoeurn	Chief of Real Regime Tax Office
Customs and Excise Department	Pen Sam Ath	Chief of Secretariat
(Ministry of Economy and Finance)		
Ministry of Agriculture, Forestry & Fisheries	Chan Tong Yves	Acting Minister

(Continued on next page)

2.1 **Stakeholders consulted** (continued)

Department/Institution	***Person***	***Title***
Ministry of Industry, Mines and Energy	H.E. Suy Sem	Minister
	Hul Lim	Under Secretary of State
Ministry of Public Works and Transport	H.E. Khy Taing Lim	Minister
Ministry of Commerce	H.E. Cham Prasidh	Minister
	H.E. Sok Siphana	Secretary of State
National Bank of Cambodia	Tal Nay Im	Director General
International Financial Institutions		
The World Bank	Bonaventure Mbida-Essama	Chief, Cambodia Country Office
International Monetary Fund	Mario de Zamaroczy	Resident Representative
	William LeDrew	IMF Customs Advisor
Private Sector		
International Business Club		
Cambodia Beverage Company	Denis Lauwens	General Manager & Chairwomen IBC
Tilleke & Gibbins and Associates Ltd.	Bretton G. Sciaroni	Partner
Dirsken Flipse Doran & Le	David D. Doran	
British Business Council	Senaka Fernando	Chairman
Malaysian Business Council of Cambodia	Teh Sing	President
Garment Manufacturers Association Cambodia	Van Sou Ieng	Chairman
Tack Fat Garment (Cambodia) Ltd.	Ray Chew	Administration manager
June Textiles Limited (cambodia)	William Ong	General Manager
Manhattan textile & Garment Corp.	Larry Kao	General Manager
Suntex	Albert Tan	General Manager
Cambodia Shoes Industry Association	Wang Hsin	President
China Hong Kong & Macau Business Association of Cambodia	Jacky Mau	President
Tourism Working Group	Pascal Brandt	Chairman

3 The way forward

The proposed alterations to the existing Law on Investment will impact on four main groups within Cambodia. These are:

- the Royal Government of Cambodia itself;
- exporters who derive benefits from the provisions of the law, and who at present largely consist of garment and footwear manufacturers, and who are largely foreign investors;
- import competing industries which have also been established by foreign investors; and
- other, largely Cambodian, domestic oriented investors.

The Royal Government of Cambodia

Revenue interests

The cost to revenue of the existing LOI, as implemented, cannot be readily estimated. The low incidence of tax holidays mean that there is little cost to revenue at present (but presumably little attractive power either for any serious potential investors who check on the likelihood of being granted a holiday). However, the discretionary nature of the current scheme means there is a chance that many of the existing LOI firms who have been conditionally 'approved' for tax holiday status, could eventually be granted such holidays with the timing and magnitude of the cost to revenue remaining uncertain.

To the extent that income statements submitted to the Tax Department reflect true profitability and tax obligations of LOI firms, application of a concessional 9 percent profit tax rate rather than a standard 20 percent will have revenue consequences only in the longer term. Even if the standard tax rate were applied without a phase in period, calculations suggest that if profit margins on sales (expressed as earnings before interest and tax to turnover) are generally less than 5 percent, as claimed for the garment sector at least, then levying 1 per cent of turnover as a pre paid profit tax would continue to yield more revenue than a 20 per cent profit tax. So

while profit margins remain slim, so will the tax revenue enhancement effect of moving to 20 per cent. The tax currently collected at the 9 per cent rate is only CR 698 million, so moving those few firms currently making profits onto a 20 per cent rate will have little impact on revenue.

Nevertheless, in its need to strengthen the fiscal base, the RGC has little interest in retaining a system that injects unnecessary uncertainty into its revenue flows and preserves a *permanent* wedge between the profit tax rate for domestic and foreign investors. (In Thailand for instance, the concessional tax rate that follows a tax holiday for firms ceases after 5 years). And in the longer term the prospect of taxing profitable firms at a higher rate than 9 per cent offers scope for gradually reducing dependence on border taxes.

Should the government decide to adopt an investment allowance as an alternative to tax holiday arrangements and as a replacement for the current exemption from tax of reinvested current profits it will not be giving up any revenue from such a move. It will simply be changing timing of tax receipts from those who choose this option.

Growth and development interests of the RGC

The SAC conditionality reforms to the LOI have, at their core, proposals to make a currently highly discretionary, opaque and uncertain scheme more transparent, predictable and automatic. *Existing* beneficiaries opposed to the reforms do not concede that these features will compensate for phasing out of the 9 per cent tax rate, abolition of tax on dividend remittances and on re-investments out of current earnings. The government, in seeking a way forward that is both fiscally responsible and growth enhancing, must consider the views of both incumbent firms with choices to expand, contract, or leave, and the likely responses of potential new investors.

In weighing up the likely responses of *incumbent* firms it must be remembered that, for the vast majority, the current benefits are dominated by the duty concessions, given their apparent low levels of profitability. There were only 56 profitable LOI firms (based on Tax Department records) in 2000 (with average profits of around CR2100 million per firm) and only 5 enjoying tax holidays (but, for some unknown reason, still paying tax). To the extent that, ultimately, profitable firms would be faced with higher rates of profit tax under the reforms, this may act as some disincentive to expansion investment by incumbents.

A good deal will depend however on the timing of any such increased liability. An analysis of one possible reform option considered below shows

that a firm considering reinvesting profits next year with a 10-year time horizon would only be affected by proposed alterations to the profit tax 8 years into the future.

New investors and rival packages

In looking to the investment and employment growth implications of any change to investment incentives the RGC will be mindful of the likely impacts on prospective *new* investors as well as existing firms. While it is important to retain the presence of those already established, and to facilitate their expansion by removing impediments to growth, there is recognition that the export industrial base is narrow, leaving Cambodia vulnerable to any change in market conditions or rates of return in the garment sector.

The factors that will continue to attract garment manufacturers to Cambodia are changing and post 2005 — when the MFA ends — prospects are uncertain. The government, in trying to attract diversified investment in industries that can benefit from Cambodia's labour cost advantages, is conscious of the incentive packages available in neighbouring economies. As a stakeholder trying to assess the merits of retaining the status quo, it is tempting for the RGC to refer to the apparent generosity of length of tax holiday (8 years for selected industries) and other profit tax privileges available in, for instance, Zone 3 in Thailand (which includes many of the rural provinces bordering Cambodia.)

The relevance of this kind of comparison requires that the government consider the package as a whole and its success record. For instance, a tax holiday commencing from the first date of production or sales is much less generous than one commencing with the first date of recorded profit. (Where companies make losses in the first few years a tax holiday is irrelevant in that period.) A nominally longer tax holiday for exporters who only get limited period access to duty exemptions on essential materials may well be less attractive than a shorter tax holiday or generous investment allowance applying from date of first profit and with unlimited access to material inputs at world prices.

What information is available points to very limited success from the apparently generous incentives package available to qualifying investors in Thailand's Zone 3, particularly when it comes to attracting FDI. One area of light manufacturing which has attracted RGC attention as a possible area of diversification is the manufacture of toys, artificial flowers, souvenirs etc. Since 1997, when Thailand further liberalised its incentive regime, the Thai Board of Investment has listed 32 companies (on its published database) as

approved for incentives in these product areas. Of these, only 14 were majority foreign owned. The approved companies indicated total capital investment of only US$1.85 million and plans to employ 8334 nationals with only 37 percent of this employment generated by majority foreign owned enterprises.

Administrative interests of the RGC

Just as potential and existing investors have an interest in seeing the administration of incentives delivered with maximum efficiency, so does the government have an interest in reforms that would deliver this. If the current approval mechanism (both for initial approved investor status and for periodic ongoing access to duty exemptions) is retained, rather than the mechanism of automatic registration and compliance based privileges as set out in the proposed reforms, the government needs to clearly establish what, if any, advantages flow from this.

Exporters who are largely foreign investors

This group will (ultimately) be affected by the proposal to abolish the 9 per cent profit tax rate, the advance tax (or equivalent) on dividends during any tax holiday where none currently applies, and abolition of the tax-free reinvestment provision. A possibly bigger issue than any of these proposed reforms, however, is the separate but related proposal to impose a minimum duty on all imports.

Currently this group remains largely unprofitable according to tax data, making up the majority of LOI firms (those recognised by the Tax Department as registered with the CDC). Only 20 LOI firms are paying profit tax, with a further 36 paying an advance profit tax at a rate of 1 per cent on turnover because this is larger than 9 per cent of their positive (but relatively small) profits. See table 3.1.

In the short term at least, moves to raise the profit tax rate or to tax reinvested profits will have little impact on (apparently) loss making firms. The impact will be in the medium to longer term when these firms become profitable. However, impacts may come sooner rather than later if the eminent introduction of the Accounting Law (which is currently being drafted) causes large numbers of firms to re-assess their true profitability for reporting purposes.

3.1 **Real regime tax revenue, 2000 financial year**

Real regime firms	*Paying prepayment tax*[a]		*Paying profit tax*		*Total*	
	Enterprises	*Tax paid*	*Enterprises*	*Tax paid*	*Enterprises*	*Tax paid*
	Number	CR million	Number	CR million	Number	CR million
LOI approved firms						
Paying 0% profit tax	4	500	1	2 000	5	2 500
Paying 9% profit tax	201	31 902	15	698	216	32 600
Paying 20% profit tax	6	9 899	4	14 099	10	23 998
Total	211	42 301	20	16 797	231	59 098
Other real regime firms						
Paying 20% profit tax	1 277	12 633	226	23 486	1 503	36 119
Total	***1 488***	***54 934***	***246***	***40 283***	***1 734***	***95 217***

[a] Enterprises in this classification comprise those making losses and hence paying the 1 per cent profit tax prepayment (175 enterprises); and those enterprises making profits sufficiently small such that tax liability is dominated by the 1 per cent profit tax prepayment (36 enterprises).

Source: RGC Tax Department, personal communication.

This group is dominated by garment exporters who, according to a recent survey conducted by the Cambodian Development Research Institute, operate on profit margins (on turnover) of less than 5 per cent. Their costs are dominated by imported materials inputs, which make up 63 per cent of their costs. Those (almost all) who export 80 percent or more of their output enjoy ongoing import duty exemption under current arrangements.

Even a 2 per cent duty on imported material inputs — as has been floated by some IFIs — for this group would cut profit margins by 25 per cent (since competitive world markets will prevent them passing on the cost to buyers). This additional cost impost means that the capacity to bid for quota auctioned by the government will be correspondingly reduced with implications for government revenue from that source.

This group have an interest in the suggested reforms to the CDC process of renewing privileges to import inputs duty free. The current system is problematic for them. Streamlining this process will reduce their costs. Beyond the LOI reform issues they also have an interest in any changes that will reduce existing customs clearance costs which are currently non-transparent and arbitrary.

Import competing firms established through FDI

These firms include large multinational food and beverage manufacturers currently operating in Cambodia. They have argued for rejection of the SAC conditionality based reforms on the grounds that they represent a tightening of existing investment privileges which are themselves

inadequate to compensate for investment deterring effects, which come from:

- effects on costs from poor infrastructure, high utility charges, low labour productivity; and critically
- unfair competition created through a serious smuggling problem.

Whilst the law does not provide for *ongoing* duty free access to imported inputs for this group (only exporters enjoy this), these producers argue for an amendment which would give them this status. (According to reports they are currently enjoying this treatment as a result of ad hoc extensions of their *initial* one-year duty free access granted under the existing LOI.) This is justified in their view as partial compensation for the effects on their markets from smuggling.

While these firms continue to struggle to make a profit, any change to the rate of tax on profits or to the tax treatment of remitted dividends would seem to have consequences for them only in the medium to longer term.

Being typically more capital intensive than garment manufacturers, any expansion investment or greenfields investment by enterprises of this type stand to be relatively bigger beneficiaries from the introduction of an investment allowance. However, such an investment allowance would be less attractive than the possibility of an indefinitely postponable tax holiday that is theoretically available under the current system. For this reason, such firms are likely to oppose such a change, despite the fact that actual granting of tax holidays has been negligible.

Domestic investors

The interests of domestic investors are affected by any decision to retain the current tax privileges of foreign investors since these affect other required rates of taxation and the capacity of the government to generate revenues that finance infrastructure, both social and physical.

The RGC's need to balance revenue considerations and a long-term growth in foreign direct investment (FDI) means that the last of these groups is at risk of being overlooked in the reform debate. Whilst they have been singled out for attention by some critics of the proposed reforms, this attention has largely focussed on them as an as yet under taxed group. It has been argued that by more vigorously pursuing tax revenues from these businesses there would be scope for leaving the existing investment incentives in place.

Effects on domestic investors of retaining current incentive arrangements

One interpretation of this option is for a *permanent* 11 percentage point profit tax differential in favour of foreign investors. In weighing up the option of retaining a permanent wedge between foreign and domestic tax rates, the RGC needs to consider whether foreign investors face permanently higher risks than domestic investors — risks that persist long after an initial investment has been made — or whether risks are such that they can be compensated for through temporary tax privileges.

A consequence of leaving the law unchanged would be that a foreign based investor who makes an *expansion* investment after a possibly lengthy presence in Cambodia would be treated more favourably than a domestic investor setting up business for the first time.

Among the options the Government to consider is an interpretation of the reforms that leaves the concessional 9 per cent tax rate in place for *existing* foreign investors but faces all newcomers with a phasing out of the differential.

Supporters of a permanent differential tax regime (one rate for foreign investors and another higher rate for domestic ones) argue that the growth impetus provided through enhanced foreign investment will grow the whole tax base, therefore allowing other taxes to remain lower than they might otherwise be. This would include profit taxes on domestic investors.

There are challengeable assumptions underlying these kinds of arguments for the status quo. One such assumption is that long term foreign investment flows into Cambodia will be significantly higher at a 9 per cent tax rate than at a 20 per cent rate and that the difference will be great enough to produce a higher aggregate investment rate than the impact of say a lower uniform rate (say 15 per cent) for *all* investors. This higher investment rate will, it is argued, eventually translate into a broader overall tax base and the bigger base will offset the lower rate for foreign investors. (An alternative but similar interpretation is that the existing incentives are insufficient to sustain a significant FDI flow in difficult world conditions but the outcome would be even worse under a uniform tax rate higher than 9 per cent.)

Corporate tax rate

The SAC conditionality requires elimination of the special 9 percent corporate tax rate for all new investment and phasing the 9 percent rate out

to the standard 20 percent under the Law on Taxation for the next 5 years for existing and operational projects.

Possible interpretations and options

The key interpretations of the conditionality concern what is the trigger for the corporate profit tax rate to increase, and what should the transitional arrangements be? Importantly, these questions are only relevant for existing LOI approved firms — new investments will attract the 20 per cent profit tax immediately (ignoring any tax holiday period).

As read, there is a 5-year grace period before the rate is to be 20 per cent. However, we don't know from when the 5-year period begins. Balancing the need to provide firms with an adequate adjustment period and the need to prevent revenue leakage, several options are immediately apparent:

- if firms have already exercised any tax holiday and it has expired at the date of promulgation of the revised LOI, then those firms will have 5 years from the date of LOI promulgation before facing a 20 per cent corporate profit tax rate; or
- 5 years after completion of any tax holiday, or 8 years after promulgation of the revised LOI, whichever is the sooner.

With respect to the transitional arrangements — that is, the process by which the tax rate is increased from 9 to 20 per cent — there are a multitude of options. For example, the rate could remain at 9 per cent and then increase to 20 per cent when applicable, or gradually 'ramp-up' over the relevant adjustment period.

Discussion

The options for triggering the 20 per cent corporate profit tax rate presented above will mean that existing LOI approved firms will have between 5 and 8 years before facing the higher tax rate. Given that LOI approved firms will receive an automatic 3-year tax holiday under the revised LOI, the vast majority of existing LOI approved firms will not face the higher tax rate for a period of 8 years.

The private sector will obviously favour a transitional arrangement that sees profit taxes kept as low as possible for as long as possible. Hence this would see a preference for maintaining the 9 per cent rate until such time as the 20 per cent profit rate becomes applicable.

While the SAC conditionality explicitly notes that the corporate profit tax rate is to increase to 20 per cent, stakeholders may wish to consider the possibility of an interim arrangement that sees the tax rate increasing to say a rate of 15 per cent. However, such a step should not last indefinitely — there is little justification over the longer term for taxing LOI firms at 15 per cent and non-LOI approved firms at 20 per cent. To do so would require evidence that LOI firms face ongoing higher risks and/or costs than other firms operating in Cambodia. As the RGC passes legislation such as Secure Contracts Law, Bankruptcy Law, Accounting Law, Land Law and advances the business environment in Cambodia, there can be little justification for an indefinite two tiered tax regime.

Tax holiday provisions

The SAC conditionality requires repeal of the current tax holiday provisions and the introduction of a 3-year tax holiday, conditional on annual certification of compliance, to all qualifying new investment, without evaluation. The use of a tax holiday will deny the tax payer any benefits available under the Law on Taxation during the tax holiday including initial investment allowance as well as accelerated depreciation allowance; all current tax holidays provided under the Law on Investment will be grand fathered.

Possible interpretations and options

It is proposed that the current tax holiday provisions are replaced with an automatic 3 year tax holiday granted to all firms (conditional on annual certification of compliance — see below). Firms that have been granted tax holidays longer than 3 years under the current LOI will have that benefit carried over to the new regime.

The length of the tax holiday under the proposed LOI reform is not negotiable. However, for existing LOI approved firms, what is open to interpretation is when does the tax holiday begin. There are 3 options for the tax holiday trigger, namely:

- the tax holiday begins once the firm begins production;
- the tax holiday begins when the firm makes a profit; or
- the tax holiday begins when the firm returns a profit, or a certain number of years after promulgation of the LOI, whichever is the sooner.

The third option is a compromise between the first two options. With respect to the third option, the number of years after which the tax holiday begins following promulgation of the law has not been defined. Three years would seem an appropriate starting point for discussion.

Compliance certification

The 3-year tax holiday is conditional on annual certification of compliance. Compliance certification could require such things as provision of a tax number, proof that the firm is not in arrears with the Tax Department or other RGC departments if applicable, compliance with licences and so forth.

However, what is required by way of annual compliance certification has not been defined, nor has it been established who will provide the compliance certificate. It could reasonably be expected that at a minimum, certification would require provision of the firm's tax number and proof that the firm is not in arrears with the Tax Department.

Discussion

Given the prevalence of losses in the first few years of operation — the IBC notes that most investors will make losses during the first 3 years of operation — the value of a 3-year tax holiday beginning from the date of first production is questionable at best (IBC p. 4, 2001). Furthermore, with the five-year loss carry forward, there is potential that firms will get no effective benefit from the tax holiday if it begins when the firm starts production. Even though only a handful of firms have received tax holidays of typically between 2–4 years under the current regime, it would be difficult to see support for an automatic 3-year tax holiday which begins from the date of first production.

From the government's point of view, a tax holiday that begins when the firm makes a profit may translate into an open-ended tax holiday, as noted by the IMF (IMF p. 78, 2001). Such a situation would obviously hamper the RGC in its attempts to mobilise taxation revenue.

A compromise would see firms granted a period to earn profits — say 3 years after promulgation of the LOI — with the tax holidays beginning *automatically* after that period. If profits were earned *prior* to the 3-year period expiring then that would be the trigger for the tax holiday. Under this option, the RGC would know with certainty the maximum time that could elapse before any granted tax holiday would expire. This has

advantages in forecasting likely tax revenue impacts of concessions. Furthermore, existing investors have an additional 3 years after LOI promulgation to return a profit. The number of years after which the tax holiday begins following promulgation of the LOI would need to be decided by the RGC in consultation with the private sector.

With respect to compliance certification, it is noted that some private sector investors believe that a conflict of interest may exist if the Tax Department is responsible for issuing compliance certificates. With responsibility for issuing compliance certificates, some in the private sector believe that it may be in the interests of the Tax Department not to issue compliance certificates — even though the firm is compliant with all requirements — so as to deny the tax holiday and generate revenue. Current confusion between tax holiday entitlements under the LOI and profit prepayment requirements under the LOT would lend weight to this concern.

One option for resolving the impartiality issue would be to allow the CDC to delegate Certified Practicing Accounts (CPAs) for the purpose of certifying compliance. As the Cambodian economy is opened to foreign accounting firms the workability of this option increases, and it also removes some of the administrative burden from government (with the exception of requiring CDC to delegate suitable CPAs).

Reinvestment of profits

In its attempts to simultaneously provide an investment climate favourable to foreign investors and one that stimulates expansion investment, the current LOI creates tensions. The tax exemption on dividends is 'balanced' with an incentive to reinvest *current* profits.

The SAC conditionality requires elimination of the tax free reinvestment of profits and introduction of an appropriate investment allowance in the Law on Taxation at a rate to be determined, satisfactory to the World Bank, and applicable to all qualifying investment, new or expansion, irrespective of source of finance, without evaluation.

Possible interpretations and options

While this SAC conditionality is straight forward, it does not establish:

- the investment allowance rate (for example, greater than or less than 100 per cent);

- whether the investment allowance acts to reduce the tax base or tax due; or
- whether and how other instruments made available under the Law on Taxation — such as accelerated depreciation — could be used to encourage investment. The period of time over which capital (with the exception of structures) can be written off is yet to be defined, but four years could be a starting point for discussions.

It is important to note that under the proposed reforms to the LOI, firms making use of the tax holiday will be denied access to benefits available under the Law of Taxation such as investment allowances and accelerated depreciation. In practice, industries with low capital costs would probably continue to opt for the tax holiday route. However, the choice means that the more capital intensive enterprises could find the straightforward investment allowance/accelerated depreciation option more favourable.

Discussion

The current tax exemption provided to reinvested profits amounts to providing a 100 per cent investment allowance up to an amount equal to taxable income. However, the tax exemption benefits only those investments financed out of current earnings. That is, it does not apply to investments financed from past profits. Hence those investments financed from past earnings or debt are denied any benefit. The proposed elimination of the tax-free reinvestment of profits and introduction of an appropriate investment allowance seeks to address this bias.

If the investment allowance were set at 100 per cent, then it would differ from the status quo only in that *all* investment, irrespective of how it is financed, would benefit by way of tax exemption. An investment allowance of 100 per cent provides an obvious starting point for consideration. Combined with a 4-year assumed economic life of (non-structural) assets for tax purposes, this is an option that deserves serious consideration by investors.

Repatriation of earnings

The SAC conditionality requires elimination of the right to the tax-free repatriation of earnings and other incomes by approved enterprises.

Possible interpretations and options

The main issue here is whether taxation of redistributed earnings should be collected via an advanced tax on dividends (ATD) or a deferred profit tax (DPT). For consistency, the rate of taxation of distributed earnings will need to be the same as the rate of corporate profit taxation (that is, 20 per cent).

A deferred profit tax would differ from an advanced tax on dividends only in that ATD is creditable against profit tax, while in the case of a DPT any profit tax is creditable against the deferred profit tax. Both the ATD and DPT would require largely identical administrative practices and both would require the RGC (or agent thereof) to monitor distributions.

Discussion

At present, under the LOT provides for an ATD at the rate of profit tax specific to that income and to be credited against the taxpayer's obligation for profit tax. In the case of income earned during a tax holiday, the applicable rate of ATD is 0 per cent while for post tax holiday income it is 9 per cent. When investors repatriate income to their country of residence, the income earned is typically subject to the standard corporate tax rate in the home country with a tax credit provided for any tax paid in Cambodia. However, as considerably less — potentially zero — tax has been collected in Cambodia the tax credits will be small. The end result being that once tax preferred earnings are distributed abroad, the tax revenue that was forgone in Cambodia is collected by the investor's home country (FIAS p. 39, 2000).

Neither the ATD nor DPT can alter the net revenue collected from taxation of distributed earnings. The corporate tax rate determines the revenue collected, and it has been proposed that this rate increase from 9 to 20 per cent (see above SAC conditionality). However, the ATD and DPT can influence *when* the RGC can access the tax revenue from LOI approved firms.

Under the proposal, all distributions would be subject to the ATD at a rate of 20 per cent, including those firms enjoying tax holidays or lower corporate profit tax rates. However, the ATD would be creditable against future obligations for profit taxation. The ATD in effect brings forward tax payments, and lowers future profit tax obligations due to the tax crediting.

In terms of the overall taxation paid by LOI approved firms and despite the fact that dividends of LOI firms are currently tax exempt in Cambodia, the ATD will actually *lower* the tax burden of foreign owned firms. This will

occur as during a tax holiday or period of lower than 20 per cent profit tax, any ATD paid will act as a credit against future profit tax obligations in Cambodia, and will also act as a credit in the (home country) to which profits are distributed. Under the current arrangement, profits distributed abroad during the tax holiday period will be taxed in the home country, but no credits will be received to count against future profit tax obligation in Cambodia.

While the ATD (or DPT) will act to lower overall tax burden, it will also impose some cost on firms. Firms will be required to pay more tax today and less in the future, but this is not a cost-neutral proposition. Time preference — the tendency to prefer benefits now rather than later and costs later rather than now — means that firms will cost the additional tax payments today *greater* than the tax credits generated but to be 'enjoyed' some time in the future. However, in a country with such limited fiscal resources as Cambodia, the ability of government to access taxation revenue today may be seen as more important than any non-neutrality issues. Furthermore, the overall decline in taxation burden may well offset any costs associated with time preference of money.

4 Impact of proposed LOI reforms: conditioning factors

Various options with respect to each of the proposed reforms have been sketched out above. Their impact on each of the identified stakeholders, and their acceptability, will, however, depend on a number of conditioning factors that also require policy decisions. Two critical factors are:

- the method of allowing access to duty exemptions on imported inputs and the scope of such concessions; and
- reforms to the customs service and mechanisms for dealing with smuggling.

The duty exemption issue.

There is a forceful case on efficiency grounds for giving all exporters access to essential materials imports at world prices. The preferred way of administering such access is through a duty suspension scheme as outlined in Volume 1 of the FIAS report of October 2000.

However, given that the Customs and Excise Department is in the early stages of a restructuring program, with automation perhaps four years away, it would not seem to have the capacity at present effectively administer a duty suspension (or drawback) scheme for all importers approved for such benefits by the CDC.

The restructuring of tariffs and the adoption of four tariff bands will reduce complexity and facilitate other reforms. Where this broad banding reduces some existing rates it will also reduce unwanted incentives to underdeclare value and to smuggle.

But major difficulties remain in achieving effective access to duty free inputs. At present some exporters face costly delays in getting reapproval for import volumes and some domestic oriented investors continue to enjoy duty exemption on inputs beyond the first year of operation, which is not intended under the LOI. The current practice of allowing duty free access to all imports by those who export 80 per cent or more invites abuse and

according to some importers, leads to disputes with CDC over eligible values for duty exemption at each shipment date.

A minimum duty with VAT paid by government scheme

One option, which is the subject of some informal discussion within the Customs and Excise Department, is to subject all imports used in garment production to a duty of 7 per cent (consistent with the restructured tariff bands), but exempt those firms from paying VAT. The tariff schedule would be amended so that for firms opting to pay the import duty, VAT would be treated as 'paid by government'. (This is a serious issue for exporters at the moment who complain that they pay VAT on imported inputs but have difficulty getting it refunded when the goods are transformed and re-exported.) Firms electing the minimum import duty option would by pass the CDC system. Informal discussions with the garment sector lead the Department to believe that 40–50 per cent of garment exporters would be happy to this duty rather than deal with the CDC. Alternatively, firms could elect to use the CDC system and in so doing, avoid the import duty.

This would be combined with allowing any exporter to receive duty exemption on a proportion of imported inputs — the proportion determined by the amount of production exported. The only monitoring involved would relate to verification of the export to output ratio.

Whilst it would not provide duty free access it would, according to its supporters, lower the actual costs of many importers. This proposal is a variation of that raised by FIAS — whereby reform is introduced through the tariff schedule. The only difference is the proposed rate, with FIAS suggesting zero per cent and Customs and Excise suggesting 7 per cent. The 7 per cent duty rate provides a possible starting point for negotiations. It raises questions of what would be an appropriate rescheduled tariff rate?

A tailoring of the tariff schedule with gradual introduction of duty suspension

An alternative would be to use the restructured tariff schedule as canvassed by FIAS (2001b). This involves moving to a zero tariff as the minimum duty on those tariff items almost exclusively used as inputs by exporters. FIAS estimate that compared to the current situation only approximately US$1 million tariff revenue would be put at risk. The VAT problems of the current scheme could be addressed under this option by suspending VAT liability until the importer could simultaneously claim credit for it on the next monthly return, cancelling the liability.

If, as FIAS suggest, new export industries were to emerge and be the first to be enrolled in a duty suspension scheme, this would allow Customs and Excise to build up its capacity to administer such a scheme without overtaxing its resources with a suspension scheme that applied to *all* exporters. The duty suspension scheme for new export industries could be simply be of the type where, on establishing the ratio of value of imports to value of exports, (say 40 per cent for example) imports up to the value of 40 per cent of exports could be imported duty free for that business.

This suggestion has several drawbacks. Ideally, duties on individual items should not be determined solely by the proportion of them used by exporters and this ad hoc adjustment to the tariff schedule has this effect. If over time an item changes in use to become an increasing part of general imports, this approach sacrifices revenue. It is not the best approach if a viable and comprehensive duty drawback or suspension scheme could be implemented. But this is some time away in Cambodia. It therefore deserves serious consideration.

The real choice then is between retaining the current system with the inevitable leakages and costs to importers that it entails, or an admittedly imperfect system described immediately above, or some form of (positive) minimum duty scheme such as that discussed by Customs and Excise.

A level playing field for domestically oriented firms

None of these options addresses the key complaints of domestically oriented investors. These investors import large quantities of raw materials and production inputs and would be faced with minimum duty of 7 per cent on these under the new tariff structure, and under adherence to the LOI which restricts ongoing duty exemptions on raw materials and production inputs to exporters. Unless a strong independent case can be made for making certain inputs imported by these investors available to the whole of the economy at a tariff rate of zero, then this group will be disadvantaged by the reforms. But it should be recalled that this particular reform would be nothing more than an enforcement of provisions made available under the current law. Firms make investments presumably on the expectation that the law will be enforced and can hardly complain when it is.

Specific reforms to address smuggling

Import competing firms in particular are arguing that continuing access to duty free inputs for them is a necessity if nothing is done to address the

unfair competition from smuggled finished goods and inputs. Smuggled finished goods pay neither duty nor VAT and drive down price and market share for legitimate operators. But FIAS has already demonstrated that general access to duty free inputs would come at an unacceptable cost to revenue, while restricting such access to LOI investor firms would be inequitable and could create an increasing revenue weakness over time.

Government will need to consider announcing a detailed package in tandem with any reform to the LOI that addresses the smuggling issue if government is to enjoy any credibility with this group and reduce their grounds for complaint.

Apart from detailing the reforms to Customs and Excise administration and the time lines for specific goals, government may wish to cost and announce specific measures, perhaps including a restructuring of customs officials' pay scales.

The government may also wish to consider announcing hypothecation of a proportion of customs revenue raised from terminating duty exemptions which do not conform with the LOI to fund specific budget increments for pay reform and to fund the anti smuggling task force.

The 'hidden taxes' that make up the totality of customs clearance charges need addressing. There is a need to stop having the cost of clearing a forty foot container vary from importer to importer in a highly arbitrary way with large and variable components of the total charge unaccounted for. Importers can legitimately complain about these hidden cost elements. Government may wish to consider reviewing customs clearance and related charges within a 3-month period and announcing a new structure that builds in scope for increased employee wages.

Utility charges

As part of a reform package that recognises that not all stakeholders can be winners from reforms that are restricted to the LOI, the government should consider announcing a time bound review of utilities pricing with a particular emphasis on electricity. Prices (and take or pay packages) are such that they are maximising incentives for users to seek self-generation alternatives. There are suggestions that government is inflating diesel prices as one means of deterring substitution of this kind. But this is further encouraging smuggling of diesel.

In a country where there is a perception that many essential inputs are relatively highly priced and/or only available as imports, it is important

that the government not try to create and exploit captive markets for services. This can have a greater adverse effect on investors than abandoning an attempt to present as the most generous provider of investment incentives in the region, as the effects directly feed into firms' probability of making long run profits. And this remains one of the major determinants of investment.

5 Next steps

Significant steps have been taken in canvassing attitudes and arguments of stakeholders in the LOI reform process. It seems that there is further explanatory work to be done with some government ministries and the private sector in working through each of the individual elements of the proposed reforms and what change they imply from the status quo.

The consultants have provided the private sector with some materials for evaluating reform impacts. This should enable a rapid identification of specific palatable tradeoffs acceptable to key private sector stakeholders. Information on these acceptable trade offs is critical when government is framing options.

An early agreement on government's interpretation of areas of flexibility that nevertheless are consistent with the reforms is required before the second phase consultations with the private sector can begin. This could include the trigger points for new tax holiday arrangements, timing and scaling of transition to a 20 per cent tax rate, the desirable level of any investment allowance and the like.

To this end, the following steps are suggested.

1. Discussion within the RGC as to what the proposed changes to the LOI as discussed by FIAS actually entail and the implications of those changes for the various stakeholders. Dissemination of all material produced by FIAS would facilitate this process.

2. Resolution of the minimum import duty issue. A satisfactory outcome from the viewpoint of export orientated firms will be critical to progressing LOI reform.

3. Agreement within government and between the RGC, World Bank and IMF on areas of 'flexibility' in the proposed reforms (with options being nevertheless broadly consistent with reforms).

4. Formatting reform options and putting these 'on the table' so as to initiate discussions with the private sector and to provide something for

the private sector to respond to. Potential options were raised in chapter 3.

5. Provide a well articulated and comprehensive package, including credible time lines and milestones, of funded reforms addressing other identified problem areas such corruption, smuggling, narrow tax base, lack of governance, inadequate infrastructure and absence of laws needed to conduct business (such as Secure Contracts and Bankruptcy law).

A credible package of reforms addressing other problems which currently detract from the Cambodian business environment will be an important step in overcoming objections to LOI reform, especially those put forward by firms supplying the domestic market. Investors will want to know 'what they are getting' for their money — how will any additional taxation revenue raised be used to improve the business environment?

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