Conference on Foreign Direct Investment:
Opportunities and Challenges for Cambodia, Lao P.D.R. and Vietnam,

Co-hosted by the International Monetary Fund and the State Bank of Vietnam,

Comments made by Robert P. Hagemann
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On

Cambodia's Foreign Direct Investment: Situation and Strategy
by Dr. Hing Thoraxy (Council for the Development of Cambodia)

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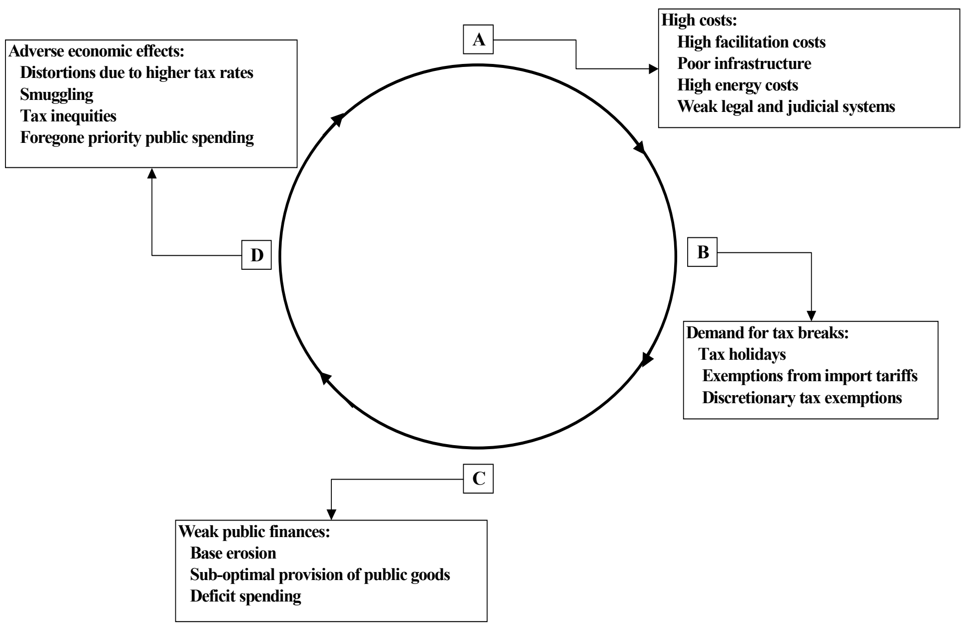
Dr. Hing Thoraxy has provided a relatively complete overview of the elements of the government's approach to redressing the economy and attracting investment, be it domestic or foreign in origin. There is little I can add to his paper in terms of the gamut of the government's policies. In my brief remarks, I want to give some structure to those elements so that the overall strategy is more obvious. I will do this by taking refuge behind the old adage that a picture paints a thousand words, and call upon a simple geometric figure to illustrate both the dilemma confronting the Royal Government of Cambodia and the logic of the government's strategy.

Let us start with a simple circle, and label one point "High Costs", as at point **A** in Figure 1. It is widely recognized that operating costs in Cambodia can be high, harming the country's competitiveness. Sources of high operating costs include:

- High facilitation fees, ranging from inefficient administrative processes (e.g. customs clearance, application for licenses, registration, etc.) to nuisance fees and, more serious, bribery payments;
- Poor infrastructure which raises transportation costs and slows production;
- High energy costs due importantly to under-investment in power generation;
- Investment risks associated with the weak legal framework and judicial system.

Figure 1



As a partial offset to these higher costs, investors demand tax breaks of various sorts (point **B** in Figure 1) in order to bring the after-tax rate of return to levels that prospectively make the after-tax rate of return attractive compared to alternatives elsewhere. Tax breaks can and do take a variety of forms in Cambodia, including: tax holidays, exemptions from various indirect taxes and import tariffs, selected exclusions provided on a discretionary basis to individual investors, etc.

While the aim of such tax breaks is to make investment attractive, including to foreigners, there is little evidence that they are either effective or have lasting desirable economic impacts, as we have seen from the discussion thus far during this conference. In any event, they have clear immediate adverse impacts on the country's public finances (point **C** in Figure 1). By lowering revenue below levels that might otherwise be reached, the government is obliged to either cut spending—including on goods and services that could reduce the costs that give rise to the initial demands for tax breaks. At the same time, tax rates on the narrower base have to be higher than otherwise, which then undermines both economic performance and, in turn, the budget (point **D** in Figure 1). A well-known dictum in public finance is that the welfare costs of taxes increase more than in proportion to the increase in the tax rate; hence, the granting of tax breaks, other things equal, has increasingly destructive effects. Higher tax rates on the remaining tax base also lead to tax evasion, through smuggling for instance, or by motivating taxpayers to migrate to the informal sector. As we see, we are rapidly back to where we started, and the vicious cycle continues.

The government's strategy is to break this vicious cycle and to reverse the causation. We can debate where in the circle a government is best advised to break in. But the strategy of the Royal Government of Cambodia can be seen as consisting of breaking in somewhere around point **C**, by improving public finances in particular, and governance more generally. Thus, the government is concentrating on, for instance:

- Broadening the tax base by: improving tax administration, closing loopholes, building a tax compliance consciousness in Cambodia.
- Improving governance by:
  - reforming civil administration;
  - modernizing the budget management and treasury systems;
  - tightening up on government contracts with the private sector;
  - accelerating and deepening legal and judicial reform.

The strategy should thus be seen as holistic, designed to improve what Nick Freeman earlier referred to as addressing the business environment as a whole. This is precisely what Cambodia needs to do if it is to reverse the recent weakness of foreign direct investment and durably improve the outlook for poverty reduction in the country.