



Assessing the impacts of trade liberalization on growth, employment and poverty in Cambodia

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In 2012, with the support of UK Department for international Development (DfID or UK Aid) and the International Development Research Centre (IDRC) of Canada, PEP launched a new program to support and build capacities for "Policy Analyses on Growth and Employment" (PAGE) in developing countries.

This brief summarizes the main features and outcomes of one of the projects selected for support under the 1st round of PAGE funding (2013-2014).

In this project, a team of local researchers in Cambodia aim to assess the impacts of trade liberalization, and related changes in fiscal policy, on growth, employment and poverty in the country.

Trade liberalization in Cambodia

Since transitioning to a market economy in 1993, Cambodia has embraced a series of trade liberalization measures to fulfill its commitment for freer trade in accordance with AFTA, WTO, and other regional trade agreements. Amid strong economic growth, averaging 8% between 1994 and 2011, there is a concern that benefits of international trade have exacerbated the inequality in the country.

As it prepares for the establishment of the Association of Southeast Asian Nations (ASEAN) Economic Community (AEC), by the end of 2015, trade liberalization and economic integration (both regional and international) have become top policy priorities for the Royal Government of Cambodia in recent years.

This strategy has been elaborated in a number of national policy frameworks, with the stated objectives to create jobs, enhance economic growth and reduce poverty. And yet, as of 2013, no evidence from any in-depth analysis had been produced to support this trend, i.e. no analysis measuring the potential costs and benefits of increased trade liberalization for the Cambodian economy.

In view of this important knowledge gap, a team of local researchers sought PEP support to produce a rigorous assessment of the impacts of Cambodia's trade liberalization - and related changes in fiscal policy - on growth, employment and poverty in the country.

Methodology

In order to produce such evidence, the team first had to build a computable general equilibrium (CGE) model of Cambodia's national economy (structure, features, constraints, etc.). CGE models are meant to serve as a laboratory to conduct simulations of macro shocks/policies, and assess their impacts on a variety of outcomes in a given country.

A priori, and as a prerequisite of such methodology, the researchers also had to build the first Social Accounting Matrix (SAM) of Cambodia

Through the conduct of macro-micro policy simulations using these new analytical tools, the researchers seek to identify the policy options that would help maximize the benefits and minimize the costs, while preparing the country for full trade liberalization.

Key findings

Using the CGE model they have built of the Cambodian national economy, the researchers conducted two distinct simulations of complete tariff removal (trade liberalization). In the second simulation, they included an increase in indirect tax rates imposed on commodities (VAT tax), which is meant to compensate tariff revenue loss and in accordance to current government policy.

At the macro level (see table to the right), the results show that, overall, tariff elimination leads to an expansion in production outputs and an increase in export/import volumes. A government policy for indirect tax-led revenue compensation results in the change of structural production output, favoring the manufacturing industry over the agriculture and service sectors.

Those “favoured” manufacturing industries include textiles, raw metals, fabricated metals, and office and computing machinery. The effects of tariff removal favour the textiles industry as it is presently less protected and consumes a large proportion of now cheaper intermediate inputs. This industry will continue to be the backbone for growth and employment over the short and medium term. In terms of effects on labor market, low-skilled labourers see relatively less benefit from tariff elimination.

At the micro level, the impacts on households’ income and consumption are almost the same. Those living in Phnom Penh are less affected by the indirect tax increase and, overall, welfare gains for the majority of households are positive, but small. The exceptions are those populations living in remote provinces – e.g. Kratie, Preah Vihear, Rattanakiri, Stung Treng - who experience a negative welfare effect from the simulations of tariff removal.

	SIM 1	SIM 2
Output	0.04	0.11
Real GDP	-0.19	0.26
Exports	0.94	0.97
Imports	1.34	1.50
Investment	-6.29	3.26
Consumption	1.15	-0.44
Consumer price	-0.74	-0.61

Table: **Effect of simulated trade and fiscal policy changes on macro variables**

Policy implications

Based on these results, the research team suggests the following policy measures to address the negative side effects of tariff removal:

- As the agricultural sector is negatively affected by an indirect tax increase, effort should be made to aid the sector, e.g., infrastructure development and tax exemption support.
- Government can help low-skilled workers by providing training programs and not imposing further burdens on them through its tax policy.
- Households of remote areas, such as Kratie, Rattanakiri, Preah Vihear and Stung Treng, should be prioritized in government complementary policy interventions (e.g. via social protection policies).

Cambodia should also take serious consideration into tariff structure to encourage more economic activities and productivity growth in agriculture, which is employing half of the labor force.

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To find out more about the research methods and findings, read the [PEP working paper 2015-08](#)