Narrowing the Development Divide in ASEAN: The Role of Policy

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Abstract
ASEAN is divided. The most striking is the development divide that separates the newer members (the CLMV countries) from the original ones (ASEAN6). More rapid growth in the CLV since the 1990s, driven by trade, investment and other market reforms, have reduced these income differences. While the development divide has narrowed, huge gaps remain. Further narrowing of these gaps will require an increase in the speed and the breadth of policy reforms. A gaping hole in the policy landscape in ASEAN is the failure to address labor mobility adequately. On-going demographic transitions will result in greater labor outflow. The current policy void on labor migration not only limits the benefits from trade and investment liberalization, but increases the cost of structural adjustment. Although rapid growth has resulted in convergence, it has also increased polarization within countries. This can threaten social cohesion, as well as the sustainability of future growth. In order to make growth more inclusive, there is a need to invest more in education and health, and to institute land reform. Apart from directly reducing social and asset inequities, it will produce a workforce more able to actively participate in the growth process and adapt to structural change.

Keywords: ASEAN; development divide; convergence; inequality; transition economies; labor mobility

JEL Classification: F15, O24
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1. Introduction

Arguably the most striking characteristic of the ASEAN region is its great diversity, probably more so than any other grouping in the world. Indeed, its economic, political, cultural and linguistic diversity is greater than even that of the European Union (see Hill and Menon, 2012). Partly as a reflection of the wide range of differences that exist, economic diversity within the region is also vast. Not only is it the most conspicuous, especially following the inclusion of Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) as its newest members, it is also the most worrisome. ASEAN includes two high income countries (Brunei and Singapore), one upper middle-income country (Malaysia), five lower middle-income countries (Indonesia, Lao PDR, Thailand, Philippines, and Vietnam) and two low-income countries (Cambodia and Myanmar). In 2011, the per capita income of Singapore was some 50 times that of Cambodia, 40 times that of Lao PDR, and more than 35 times that of Vietnam’s (Table 1). The average for the CLMV was less than a third of ASEAN's average. Although these differences are less striking when measured in purchasing power parity (PPP) terms, they remain large (Table 2). These economic differences have come to be known as the “development divide”.

(Table 1 here)

(Table 2 here)

Members have committed to realizing an ASEAN Economic Community (AEC) by 2015. The third pillar of the AEC Blueprint is on Equitable Economic Development, which aims to "address the development divide and accelerate integration of Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) through the Initiative for ASEAN Integration (IAI) and other regional initiatives." (para 7). The reality is that neither the IAI nor other regional initiatives will have the resources, or the ability, to address the development divide. While aid can play a part, the solution must come from within the countries itself. This will necessarily involve the adoption of policies that promote rapid economic development, and economic convergence.

There is evidence to suggest that the process of convergence has started taking place within ASEAN, as the newer members begin to catch-up to the economic conditions prevailing in the original member countries. Strong rates of economic growth since the 1990s, driven by trade, investment and other market reforms, have reduced differences in per capita incomes. This rapid growth has also been associated with dramatic reductions in poverty. Notwithstanding these achievements, there is still a long way to go however, and much more needs to be done before the development divide is substantially narrowed.

Furthermore, while rapid growth in the CLMV has reduced per-capita income differentials with the other ASEAN members, the distribution of these gains have been uneven and income inequality within these countries has worsened. It would appear that inter-country differences in economic conditions are being narrowed at the same time that intra-country differences are being increased. All kinds of within-country inequities have remained stubbornly high or have increased, including across geographical regions (rural-urban),

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2 This World Bank classification masks significant variation within the groupings; for instance, Lao PDR crept in to lower middle-income status in 2010, while Vietnam did so in 2008, and both these countries are situated at the lower end of this scale compared to the others.

3 This multiple would be highest for Myanmar, perhaps 60 or more, but data is particularly sketchy. Continuing with Singapore as a reference, per capita income was five times Malaysia’s, while Malaysia’s was four times that of the Philippines, while Philippines’ was about twice or more of that of the CLMV countries.

4 While we try and cover all four countries of the CLMV grouping as much as possible, we are sometimes faced to omit Myanmar and focus on the CLV when the data are either incomplete or unusually inconsistent.
along ethnic lines and across gender. What is alarming is the increase in polarization, both economic and social, in these countries. These factors can threaten cohesion, and pose major risks to social stability. High and/or rising income inequality can also threaten growth itself, as well as the poverty elasticity of growth.

This paper examines the extent to which economic convergence within ASEAN is occurring and the factors that are driving it. In analyzing the determinants of convergence, we look closely at the role that policy has played in the process. In particular, what are the gaps in policy that need to be filled, and the new areas that need to be addressed, to ensure that convergence continues? Finally, we look at whether the rapid growth required for catch-up by the CLMV can occur without further polarization within their countries. We begin in Section 2 with some theory, examining the conditions under which we can expect convergence to occur. Section 3 examines the policy and the experience relating to trade, investment and labor flows. We document the rapid growth in trade and investment, and how they have contributed to rapid growth, and the policies that have delivered these outcomes. The extent to which this growth has contributed to convergence, or the narrowing of per capita incomes, is examined in Section 4. Since the development divide is multi-faceted, we also examine outcomes in relation to a host of other social indicators in comparative perspective. In Section 5, we identify gaps in the reform agenda that still require attention, and how future growth can be made more inclusive and therefore less threatening to social harmony. A final section concludes.

2. The Theory Underpinning Economic Convergence
A long standing debate in economics centers on the question of whether integrating economies necessarily converge in terms of per capita income, productivity and technology. Some even trace this debate back to the Scottish Enlightenment and the publication of an essay by David Hume in 1742 (Elmslie, 1995). Whatever its origin, and whenever it started, what is clear is that the debate continues to rage and remains largely unresolved. Theory offers some insights. One reason to expect convergence or catch-up is the difference in the marginal efficiency of capital between poor and richer countries. With little access to capital, workers in poor countries have relatively low levels of productivity that can be raised substantially by increasing the amount of capital available to them by even small amounts. Unlike countries with higher capital-labor ratios, they have a longer way to go with capital accumulation before diminishing returns sets in.

There is also the latecomer's advantage hypothesis, where it is postulated that late adopters of technology may be better positioned, because they can avoid the mistakes, and learn and borrow in adapting technologies in a way that benefits them more than early adopters, assuming that the technology is available for purchase or is easily diffused. This was noted as far back as Veblen (1915), although modernized by Gershenkron (1952) as “the advantage of relative backwardness”. In certain instances, they are even able to leapfrog early movers, further consolidating their advantage (for example, avoiding costly investments in telephone lines and focusing instead on mobile telephone infrastructure).

There is both anecdotal and empirical evidence to support these views on convergence. It is likely that difference in the productivity of capital accounted for some of the catch-up observed in the so-called newly Industrializing Economies (NIEs) of East Asia—Hong Kong, Korea, Singapore, Taiwan—and when their incomes per capita rapidly converged to those of developed countries during the 1980s and most of the 1990s. Another oft-cited example is the rapid growth of Japan and Germany during the reconstruction period after the Second World War, compared with the United States and the UK, for instance.

Elmslie (1995) claims that the ensuing 'rich country-poor country' debate—between David Hume on the convergence side and Josiah Tucker on the nonconvergence side—represents one of the first major doctrinal debates in economics.
A common element across all of these countries is a policy framework that was open and outward-oriented. Indeed, there is a vast body of cross-national statistical evidence linking trade and growth, and a positive association between economic openness and growth or convergence (Dollar, 1992; Edwards, 1998; Sachs and Warner, 1995; Rodriguez and Rodrik, 2001; Bhagwati and Srinivasan, 2001; Rodriguez, 2007). Greater openness appears to have played a huge role in this growth story of convergence.

3. Trade, Investment and Labor in the CLMV: Policy and Experience

The opening up of Cambodia, the Lao PDR, and Viet Nam to trade and investment occurred almost concurrently in the late 1980s. Cambodia’s government was the first to embark on a market-oriented reform process in 1985. In the Lao PDR, the process of transition to a market-oriented economy began in 1986 with the implementation of the New Economic Mechanism, a major program of economic reforms. The opening of Viet Nam’s economy to trade and FDI was part of doi moi (renovation) reforms initiated in 1986.

3.1 Trade Policy and Experience

Trade Policy

Although unilateral policy actions drove the reforms in the early stages, greater economic cooperation through the GMS Program and then later through membership of the Association of Southeast Asian Nations (ASEAN) and its Free Trade Agreement (AFTA) also played an important role. While the GMS program focused on the provision of much needed physical infrastructure, membership of AFTA committed these countries to an ambitious program of tariff reduction on trade with ASEAN members. Cambodia and Viet Nam became members of the WTO in 2004 and 2007, respectively, while, the Lao PDR is at an advanced stage in negotiations for WTO accession. The most important contributions of WTO membership were to enshrine the principles of Most-Favored-Nation (MFN) and National treatment (NT), and to bind the reductions in tariff rates.

In all three countries, the trade reforms focused on reducing technical barriers, mainly in the form of tariffs, and converting quantitative restrictions into tariff-equivalents (see Menon and Melendez, 2011, for details). Although some progress has also been made in reducing trade costs through trade facilitation, this is where most of the remaining barriers to trade exist.

Trade facilitation activities are taking place under the auspices of the GMS Program and ASEAN, in addition to unilateral and bilateral initiatives. Apart from hardware in the form of physical infrastructure, which increases connectivity and reduces transport costs, the GMS program has also tried to address complementary software issues by improving trade facilitation. A key initiative towards this end is the Cross-Border Transport Agreement (CBTA), a comprehensive multilateral instrument that supports a range of measures to facilitate trade, which in turn promotes integration. These include: one-stop customs inspection; cross-border movement of persons (e.g., visas for persons engaged in transport operations); transit traffic regimes, including exemptions from physical customs inspection, bond deposit, escort, and phytosanitary and veterinary inspection; eligibility requirements for road vehicle cross-border traffic; exchange of commercial traffic rights; and infrastructure, including road and bridge design standards, road signs, and signals (ADB, 2009).

Majority of the transport-related Annexes and Protocols to the CBTA were agreed and signed by 2004/2005, and Annex 6 on Customs Arrangements was agreed and signed in 2007. Most of the GMS countries have also ratified the annexes and protocols (Thailand has ratified 14 out of the 20 annexes and protocols, while Myanmar has yet to ratify any of the annexes and protocols).
Initial implementation of the CBTA has been achieved at various border crossing points, and an additional agreement has been adopted on additional border crossings for CBTA implementation, between the PRC and Lao PDR along the North-South Corridor, and between Cambodia and Viet Nam along the Southern Economic Corridor (SEC). Agreement has been reached on harmonized customs transit system (CTS), a core component of the CBTA. Implementation of the CTS will be undertaken by a public-private partnership (particularly guarantees by private sector organizations to customs in transit countries). A CTS pilot project was established across the East–West corridor from Viet Nam to Thailand, through Lao PDR, in mid-2009. Agreement has also been reached on a GMS road transport permit system.

Apart from the CBTA, the Strategic Framework for Action on Trade Facilitation and Investment (SFA-TFI), endorsed at the second GMS Summit in Kunming in July 2005, likewise addresses issues in customs, sanitary and phytosanitary (SPS) regulations and other border management concerns, and logistics development.

ASEAN has embarked on its own set of initiatives to improve transport and trade facilitation in the subregion. In 1998, ASEAN established the ASEAN Framework Agreement on Facilitation of Goods in Transit (AFAFGT), which is similar to the CBTA in intent and content. However, very little progress had been made in implementing trade facilitation reforms up until the adoption of the ASEAN Economic Blueprint in 2007. Included in the Blueprint are several aspects of transport and trade facilitation, including the harmonization and standardization of trade and customs procedures, customs modernization, integration of national single windows into an ASEAN single window (ASW), and harmonization of standards, technical regulations and conformity assessment procedures. Complementing these initiatives are the ASEAN Framework Agreement on the Facilitation of Inter-State Transport, the ASEAN Framework Agreement on Multimodal Transport, and the Master Plan on ASEAN Connectivity, which aim to reduce the cost of moving goods across ASEAN's borders.

At their 39th meeting held in August 2007, the ASEAN Economic Ministers agreed to transform the Common Effective Preferential Tariff (CEPT) for the ASEAN Free Trade Agreement (AFTA) into a more comprehensive instrument and integrate ASEAN’s various trade-in-goods initiatives under a single umbrella. This led to the signing of the ASEAN Trade in Goods Agreement (ATIGA) in February 2009. ATIGA addresses trade facilitation reforms by including the ASEAN Framework on Trade Facilitation. Subsequently, ASEAN has developed the Trade Facilitation Work Programme for 2009-2015.

These recent initiatives have provided the necessary impetus for trade facilitation reforms to move forward. The implementation of the AFAFGT and an ASEAN Customs Transit System (ACTS) has become a top priority and work has since picked up speed. The Protocol to the AFAFGT has been completed, feasibility studies have been carried out, a costing has been prepared and a management environment has been proposed to which the Member States will contribute staff. Nevertheless, the real test lies with actual implementation, and ASEAN's record is not generally good in this area.

Apart from these initiatives under the GMS and ASEAN, CLMV countries have also been pursuing a number of transport and trade facilitation reforms as part of their accession to the World Trade Organization (WTO), or as parties to FTAs signed by the ASEAN. These FTAs incorporate trade facilitation provisions and principles which go beyond customs procedures, to include areas such as the use of ICT, adoption of international standards, and risk management, with some agreements containing completely separate chapters or frameworks for trade facilitation (Duval, 2011). In addition, a number of bilateral road transport agreements have also been adopted by neighboring countries in the sub region (ADB, 2010). The different modalities being pursued runs the risk of duplication,
inconsistencies and puts pressure on limited human resources. There is a need to focus on completing the multilateral framework, which should hopefully encompass and supersede all these other initiatives.

**Growth in Trade and Trade Openness**

Although trade growth contracted in 2008 and 2009 as a result of the Global Financial Crisis (GFC), in general, unilateral policy reforms and greater economic cooperation have led to positive trade growth in the GMS. With the exception of Myanmar, trade openness has increased throughout the region, with trade as a percentage of GDP above 100% in Thailand and Viet Nam. Cambodia’s trade openness fell sharply after the GFC, but recent data would show a marked but slow recovery (Figure 1).

(Figure 1 here)

The direction of trade over the past two decades suggests an expansion in GMS’ countries trade not only with the world, but especially among themselves (Figure 2). Cambodia’s direction of trade may be the only exception to this general trend. In the 1990s, Cambodia’s trade with the subregion accounted for about one-third of its total trade, on account of log and timber exports. However, this share has since declined, largely as a result of a ban on log exports and the growing importance of the United States (US) and European Union (EU) as export destinations. The PRC is also fast emerging as a major source of imports. The increase in Cambodia’s intra-GMS trade in the latter part of the 2000s could have been mainly the result of falling demand for Cambodian exports in the US and the EU, as a result of the GFC.

The larger GMS countries, Thailand and Viet Nam, have shown modest increases in subregional trade. As might be expected, these countries trade predominantly with the rest of the world and therefore have more diversified partners. Japan continues to be Thailand’s biggest trading partner, although Japan’s share has been steadily declining in recent years and is likely to soon be overtaken by the PRC. The PRC is already Viet Nam’s leading trading partner, accounting for roughly 18% of its trade in 2010.

The share of intra-GMS trade in total trade has traditionally been higher for the subregion’s smaller countries—the Lao PDR and Myanmar—reflecting both transshipment arrangements and limited commercial penetration beyond the immediate neighborhood.

(Figure 2 here)

Changing demand for export products has helped transform the structure of exports from the subregion. In Cambodia, Thailand, and Viet Nam, there is a clear shift in the export base away from primary commodities into manufactured goods. In Cambodia, this has been driven by garments exports, which account for the bulk of Cambodia’s exports. In Thailand and Viet Nam, production fragmentation trade has become a critical part of export dynamism, with the share of machinery and equipment rising as a proportion of total exports.

However, while this shift towards manufactured goods has also led to a movement up the value chain in Thailand and Viet Nam, this has not been the case for Cambodia, where the garments sector remains predominantly low-skilled and labor-intensive. Manufactured exports from Lao PDR and Myanmar likewise remain predominantly labor-intensive and resource-based (Table 3).

(Table 3 here)

**3.2 FDI Policy and Experience**
**FDI Policy**
Prior to the reforms in the late 1980s, all three countries shared a common distrust of FDI. This perception has changed radically and all three are highly receptive to FDI. Today, 100% ownership is allowed in most sectors, although each country retains an exemption list that covers sensitive sectors. Procedures governing the approval of investment projects have been streamlined and all three countries provide attractive investment incentives (see Menon and Melendez, 2011, for details).

**Growth in Foreign Direct Investment**
Along with trade, foreign direct investment (FDI) to the subregion has also risen over the last two decades. In 2010, total FDI stock amounted to $209 billion. Cambodia and Viet Nam have FDI stock-to-GDP ratios well above the subregional average. In contrast, Myanmar’s openness to FDI has declined since 1998. Historically, Thailand has been the largest FDI recipient in the region, but Viet Nam has been catching up in the last several years (Figure 3).

(Figure 3 here)

The source country composition of FDI is characterized by a clear, intra-ASEAN bias for the smaller GMS countries (Figure 4). Thailand has traditionally accounted for the bulk of these inflows.

(Figure 4 here)

That trade and investment are growing hand-in-hand in the subregion is no coincidence. Early signs of a trade-investment nexus are emerging whereby trade not only encourages investment, but investment, in turn, encourages trade—for instance, in Lao PDR, FDI in agriculture and forestry and in mining and hydropower projects have contributed significantly to export growth. This is a virtuous circle that links back to economic growth.

### 3.3 Labor Migration Policy and Experience

**Labor Migration Policy**
Unlike the reforms relating to trade and investment, policy relating to labor flows remains piece-meal or non-existent. Although regional labor markets are becoming increasingly integrated, policy relating to cross-border movements continues to lag behind. The gaps in policy relating to labor flows exist in both sending and receiving countries, and both need to be addressed. Therefore, the challenges for policy relate to the governance of labor migration, the protection of migrant workers, and the harnessing of labor migration for economic development.

Here too ASEAN has signed several formal accords since 2000, including the January 2007 ASEAN Declaration on the Protection and Promotion of the Rights of Migrant Workers, but implementation has been lackluster, to say the least (Hill and Menon, 2012). However, intra-ASEAN labor flows occur independently of these arrangements, and are largely market-driven, dictated by large inter-country wage differentials and porous borders.

**Labor Flows**
Although subregional labor migration has been occurring in the GMS for centuries, this trend has increased markedly in recent years (Tables 4 and 5). It should be noted at the outset that there appears to be significant amounts of informal flows within the region, and that reported flows are likely to seriously underestimate the actual numbers. As expected, Thailand accounts for the bulk of total cross-border flows within the region, spurred by Thailand’s growing need for low-skilled workers.

(Tables 4 and 5 here)
Migrant workers are fast becoming an important resource in Thailand, with most studies concluding that they contribute approximately one percent to GDP (International Migration Office Thailand, 2011). Again, given apparently large but uncertain numbers of unregistered flows, this contribution is also likely to be an underestimate. This trend is expected to increase over time, although it is unclear what impact the establishment of the ASEAN Economic Community (AEC) by 2015 will have on these flows as the AEC only deals with movement of skilled labor.

In December 2009, there were 1.3 million registered migrants in Thailand from Cambodia, Lao PDR and Myanmar, accounting for roughly 42% of the total migrant population in Thailand. The majority of these migrants are male (55%) and employed in agriculture (17%), construction (17%), seafood processing (10%), and household work (10%) (Figures 5 and 6).

(Figures 5 and 6 here)

4. Economic Convergence and the Development Divide in the CLMV

What is the experience in the CLMV with regard to catch-up or economic convergence and narrowing of the development divide? Much higher rates of economic growth in the CLV compared to the rest of ASEAN since the early 1990s has reduced gaps in real per capita incomes in PPP terms (Table 2). Greater openness to trade and investment flows has played a huge role in this growth story.

As Figure 7 shows, the growth in per capita incomes in the CLMV countries has been amongst the highest in ASEAN. In 2000, the average real per capita income of the CLMV was about a third of the average of the ASEAN6, while today it is almost half. From Figure 8, using Thailand as a reference point, we can see that real per capita income growth in the CLV has been consistently higher than that of Thailand in the 2000s. As a share of Thailand’s real GDP per capita, we can see from Figure 9 that there has been significant catch-up between 2000 and 2010. These data present clear evidence of economic convergence between the CLMV and the rest of ASEAN. Despite these notable achievements in narrowing per capita income differences, the gaps themselves still remain quite large. In 2010, real per capita incomes in the CLMV as a share of Thailand’s real per capita income still ranged from around only 23% to 37%.

(Figures 7-9 here)

The rapid growth has also translated into dramatic reductions in poverty. Irrespective of the measure of poverty, there have been dramatic reductions across the board (Table 6). Nevertheless, the level of poverty remains a concern in the CLMV when it has been reduced to below 10% in the other ASEAN countries except for the Philippines and Indonesia. In all countries except Viet Nam, most of the reductions in poverty have taken place in the urban sector. By and large, the poverty challenge is one rooted in the rural sector.

(Table 6 here)

As noted earlier, the development divide is not confined to income differentials; it covers a host of human development and social indicators. Table 7 presents data on the human development index for about the last decade, while Table 8 covers a range of health and education indicators, for ASEAN countries. Again, there have been improvements in all indicators over this period in the CLMV, and the changes have been more dramatic than in other ASEAN countries. As with the income measures however, and despite these dramatic improvements, differences in levels between the CLMV and most other ASEAN countries remain stark. For instance, despite large improvements, maternal mortality rates of close to 600 and 300 (per 100,000 live births) in Lao PDR and Cambodia, respectively, in 2008
remain a serious concern. Similarly, while literacy rates are above 90% in almost all ASEAN countries, they remain below 80% in Cambodia and Lao PDR. In sum, while marked improvements in living standards and human development outcomes in the CLMV particularly over the last decade have been impressive, there is a lot of room for improvement and challenges remain.

(Tables 7 and 8 here)

Various forms of inequality also characterize the CLMV, as well as the other ASEAN countries (see Menon et al., 2011; ADO, 2012). From Table 9, we find that income inequality as measured by the Gini coefficient rose in the 2000s in Cambodia and Lao PDR, but fell slightly in Viet Nam. The Gini coefficient in Cambodia has remained above 40% throughout the 2000s, a threshold level considered to signify a highly unequal distribution. The same is true for Malaysia, Philippines and Thailand. Both Lao PDR and Viet Nam are not far behind, with Gini coefficients above 35%. The same pattern can be observed for the income share held by the top 20% of the population, with Cambodia recording the highest share in ASEAN at almost 52% of income. The income share held by the lowest 20% fell in all three countries in the 2000s, further accentuating polarization within these countries. The most recent data for these countries point to the bottoms 40% of the population having between only 16% to 19% of income.

(Table 9 here)

5. Remaining Policy Challenges to Narrowing the Development Divide

It is worth reiterating that the challenge of narrowing the development divide in ASEAN cannot be met by relying on programs of assistance alone, such as the IAI or other regional efforts. In this regard, the recent proposal to enlarge the ASEAN Development Fund by creating an ASEAN Convergence Fund (see ADBI 2012), still to be financed by voluntary contributions of members but managed by so-called professionals may help but is unlikely to make a significant or lasting difference. One reason is that unlike Europe, the better-off members of ASEAN, from which most of the funds would presumably have to come from, are either very small (Singapore and Brunei) or relatively small (Malaysia). The richest country in ASEAN, Singapore, does not even have a formal aid program. Although the CLV have received quite substantial amounts of aid (grants and concessional lending) from both external bilateral donors and multilateral agencies, these will begin to taper-off as they converge anyway. In this sense, these countries are likely to be victims of their own success, going forward. Therefore, any discernable and sustainable narrowing of the vast gaps that continue to divide will have to come from more rapid growth in these countries themselves.

In order to grow at a rate that allows catch-up further policy reforms will be required. These relate to trade, investment and labor, and each is discussed in turn, below. Finally, in order to retain social cohesion, and ensure that future growth is sustainable, policies that ensure greater inclusiveness need to be pursued.

Trade Policy

In relation to trade policy, there are two key outstanding issues that need to be addressed. The first relates to ensuring consistency in the tariff regime, while the other refers to the need to hasten trade facilitation efforts in order to reduce trade costs. Since the first challenge has been discussed in detail in Menon (2011) and Menon and Melendez (2011), we discuss it only briefly here and focus on the second.

The CLMV countries, unlike ASEAN’s original members, have chosen to implement their AFTA tariff reduction commitments on a minimalist basis, resulting in a two-tier tariff system in each country with a different preferential and MFN rate for each tariff line. In other words,
they have chosen not to multilateralize their AFTA preferences, and not to offer them to non-members on a non-discriminatory basis. This not only reduces the benefits while increasing the potential for trade diversion, it also increases the burden on a weak and overstretched trade and customs bureaucracy. As members of ASEAN, they are also party to at least 6 ASEAN+1 FTAs so far, with more surely to come. It is simply fantastic to expect these countries to effectively implement a system whereby seven or more tariff rates can apply to each tariff line, depending on rules of origin that can also differ by source. Therefore, the CLMV countries should follow the original ASEAN members and multilateralize their AFTA and various ASEAN+1 preferential tariffs and the sooner the better.

Next we turn to the main challenge on the trade policy front, that of trade facilitation. Despite the achievements on this front described in Section 3.1, a number of critical challenges continue to limit the subregion’s potential for reaping further gains from trade. Data on trade costs and logistics reveal considerable variation in trade facilitation and logistical performance across the GMS countries, with Thailand and Viet Nam performing better than the CLM countries, highlighting the need for the latter to catch up with their neighbors (Tables 10 and 11).

(Tables 10 and 11 here)

The implementation of the CBTA and other such reforms continue to face a number of challenges, such as slow progress in the exchange of traffic rights; weak procedures for border clearance and insufficient investments in border infrastructure for goods processing; and weak institutional mechanisms for supporting transport and trade facilitation. Setbacks in implementing the CTS, in particular, have been cited as an impediment to implementation of CBTA in every country (ADB, 2010).

The need to strengthen implementation of the CBTA and other trade facilitation reforms was highlighted at the Third GMS Summit in March 2008, where leaders called for greater focus on “softer” aspects of regional cooperation in GMS. More concretely, in 2010, the 16th GMS Ministerial Conference endorsed a comprehensive medium-term Program of Actions for Transport and Trade Facilitation (TTF), encompassing both (i) transport facilitation, by enhancing exchange and implementation of traffic rights, improving custom transit systems, and strengthening the road transport industry; and (ii) trade facilitation, by enhancing coordinated border management, strengthening sanitary and phytosanitary standards, and developing the logistics sector.

Foreign Investment and Labor Migration Policy with Shifting Demographics

Over a longer run the benefits from trade liberalization will be considerably larger if accompanied by reforms in other sectors. For instance, if the movement of factors of production such as capital and labor is also freed up, the gains from trade liberalization will be magnified. This will occur as investors respond to the changed structure of incentives with new capital investments and entirely new industries develop in response to new opportunities (see Warr et al, 2010).

The importance of factor mobility takes on an additional dimension in ASEAN when we consider differences in demographic profiles. ASEAN countries are comprised of populations that can be described as either ageing or youthful, especially given shifts expected to occur over the next decade or so. With countries facing an ageing population, there will be a decrease in labor supply going forward as a result of a ‘shrinking’ labor force, while countries with a relatively young population will experience an opposite phenomenon with a ‘bulging’ labor force. Over the next decade or so, the CLV countries will experience bulging labor forces, as will Brunei and the Philippines, while the other ASEAN countries will likely experience shrinking ones. The ageing phenomenon will also characterize the labor forces of the East Asian countries of China, Japan and Korea (see Menon and Melendez, 2010).
Many of the countries facing the ‘ageing’ phenomenon are also countries that run sizable current account surpluses, reflecting the fact that domestic savings are much higher than domestic investment. Many of the countries facing the opposite phenomenon of an impending bulging of working age populations are also countries that run sizable current account deficits, where domestic savings are insufficient to meet domestic investment requirements.

There are benefits to countries with both relatively high and low capital-labor ratios in encouraging cross-border movement of factors that tend to equalize their relative prices. Through FDI flow for instance, capital-labor ratios across so-called ‘shrinking’ and ‘bulging’ countries will adjust, as factor prices tend towards being equalized and, in the process, promote growth in both investing and recipient countries. It will help overcome the labor shortage problem in ‘ageing’ countries and at the same time help in absorbing the surplus labor in ‘bulging’ countries. This is already happening, but the demographic changes expected over the next decade suggests that the role that FDI could, or indeed should, play will be significantly more important in addressing imbalances in labor markets.

As described in Section 3.2, the CLV countries have been receiving quite substantial amounts of FDI as their investment climates improved and their reform programs matured. There is considerable amount of capital mobility in ASEAN already, mostly in the form of inflow from outside the region, but both intra-regional flows and outflows have also been growing, *albeit from* a small base. The AEC also aims to further liberalize these flows in its pursuit of a single production base. Further increases in FDI flow will probably require significant improvements in the investment climate of the CLMV countries from here on, further improvements will involve addressing structural and institutional issues, such as strengthening of legal and regulatory frameworks, improvements in governance and the protection of property rights, deepening of financial markets, and political and macroeconomic stability. These are long-term challenges and although the pay-off is likely to be high, they will take time.

In the interim, it would be equally beneficial if labor could move more freely to equalize these differences between countries with shrinking and bulging labor forces. Greater labor mobility, if properly regulated and controlled, can be to the benefit of both sending and receiving countries. Arguably the biggest disappointment of the AEC blueprint is its failure to deal adequately with labor mobility. National governments also lack an adequate legal and policy framework when it comes to governing labor flows. As a World Bank (2006) study notes, the CLMV countries lack the capacity to effectively manage the mass export of labor and to protect the rights of their migrant-nationals abroad. Similarly, receiving countries in other parts of ASEAN, Malaysia and Thailand in particular, have fairly weak migration policy frameworks when it comes to governing labor flows. As a World Bank (2006) study notes, the CLMV countries lack the capacity to effectively manage the mass export of labor and to protect the rights of their migrant-nationals abroad. Similarly, receiving countries in other parts of ASEAN, Malaysia and Thailand in particular, have fairly weak migration policy frameworks, which often have been implemented hastily as an ‘after-the-fact’ response to the arrival of large numbers of migrants. ASEAN governments in both sending and receiving countries face an urgent need to adopt policies that can help manage the increased flows in an efficient but equitable way. Therefore, improving policy frameworks relating to labor movement, whether transitory or migratory, is in the interest of both exporting and importing countries, and can raise the benefits to both while protecting the rights of foreign workers and reducing the security risks associated with unrecorded inflows of labor.

As noted, the focus of the AEC is on liberalizing flows of skilled labor, and even here there are difficulties in interpreting what this is likely to amount to in practice. But most of the labor in most of ASEAN is low- or semi-skilled, and this population has been ignored in the reform agenda. In fact, the overwhelming share of both recorded and unrecorded labor flows within ASEAN is in low-skilled labor (Section 3.3). This extends from domestic helpers in Malaysia and Singapore (from the Philippines and Indonesia), to agricultural labor in Malaysia (from
Indonesia) and Thailand (from CLM) to various service sectors such as construction in Malaysia and Singapore and food processing in Thailand.

Further liberalization of official flows, combined with efforts to control informal flows and bring them into the formal arena, can yield substantial mutual benefits. Not only can increased labor mobility substantially increase the benefits that can be expected to accrue from trade liberalization, it can also reduce adjustment costs in sectors that are negatively affected by such reforms. Restrictions on labor mobility during period of structural adjustment or reform tend to make individual regions\countries income per capita more divergent. As World Bank (2011, p.48) puts it, “(i)mpediments to migration, whether ethnic, social, economic, regulatory, or geographic, will only accentuate inequality”.

There is another aspect to the facilitating role that labor mobility can play in the adjustment process in the CLMV. The CLMV countries face nominal rigidities to varying degrees when it comes to having an exchange rate that can operate as an adjustment mechanism. This is a result of dollarization and the multiple currency systems that prevails, to varying degrees, in these countries (see Menon, 2010). While Cambodia is almost completely dollarized, Lao PDR is probably only half so but both baht and dollars are used in addition to the locally-issued kip. Vietnam has the lowest share of dollarization but exchange rate uncertainty resulting from macroeconomic instability has resulted in a switch to gold as a store of wealth. In Myanmar, the government is trying to unify a multiple rate system and the first steps towards a managed float have been implemented.

In this context, the nominal exchange rate of these countries may not adjust fully, or quickly, to economic disturbances or shocks. The real exchange rate movements required to move the economy back toward equilibrium following an economic shock will have to be induced by price changes rather than nominal exchange rate changes. This will have to involve changes in the rewards paid to factors of production, and it is most likely that wages will have to bear the brunt of this adjustment (Menon, 2008).

But nominal wages may be sticky downwards. If nominal wages are initially close to subsistence levels, then any downward adjustment in response to an external shock will be difficult. Thus, the adjustment mechanism that requires changes in wages instead of changes in nominal exchange rates is a relatively inefficient instrument. It could result in social costs involving increased unemployment of resources such as labor and capital.

Given this situation, it is even more important that there is sufficient amount of labor mobility in order to reduce the adjustment pressures and minimize economic and social costs. This is not to deny that labor migrant does not involve social costs or disruption to the sending countries. The dislocation and related costs associated with out-migration, while not insignificant, is likely to be a lot lower than that of rising unemployment at home.

**Is convergence with cohesion possible?**

While the benefits from freeing up labor movements can be substantial, this is not a panacea and needs to be considered as part of a broader development program. Increasing labor mobility alone is also unlikely to significantly reduce disparities within or between countries, and needs to be accompanied by other policy interventions. In this regard, we, turn finally to examining how future growth in the CLMV can be made more inclusive. As noted in the Introduction and described in Section 4, while rapid growth in the CLMV has reduced gaps in per-capita income in ASEAN, the distribution of these gains have been uneven and many forms of within-country inequality have remained stubbornly high or have worsened. What is more disturbing is the increase in polarization in these countries, both economic and social. High and/or rising inequality and polarization poses risks to social stability. They can also threaten growth itself, as well as the poverty elasticity of growth. How can these consequences of rapid growth be avoided, or at least minimized?
A good starting point in trying to answer this question would be to identify the factors driving the inequality in these countries. Many of the factors driving rapid growth in the CLMV can also be linked to those driving inequality. The literature on growth and inequality identifies three key elements that tie growth and inequality together. These are the processes of technological change, globalization, and market-oriented reforms. The link between inequality and growth is derived from the fact that all three are also considered as the primary drivers of growth. ADB (2012) examines inequality in Asia in detail, and identify these three processes as the key drivers for the rising inequality in developing Asia. They note that these forces have tended to favor owners of capital over labor; high-skilled over low-skilled workers, and urban and coastal areas over rural and inland regions. All three factors are present in the CLMV, although globalization and market oriented reforms are the dominant ones.

Reducing growth in order to reduce inequality is not a sensible policy option. Similarly, reversing the trend towards greater openness and market orientation is not the way to go in order to redress inequality, if these factors are the main ones driving it. If convergence at the expense of internal cohesion is seen as a hollow victory, then so too must the preservation of internal cohesion at the expense of convergence. How can we strike a balance between the two, where convergence can continue without further threatening internal cohesion? In order to answer this question, it is useful to examine the experience of some of the NIEs, Korea and Taiwan in particular, from the 1960s, when they underwent a dramatic transition. The switch from highly interventionist import-substitution programs to more market-friendly export-oriented reforms is a conversion that bears a lot of resemblance to that being undertaken by the CLV countries in their transition towards market economies. Their experience highlights what can work rather than what cannot, since a distinguishing characteristic of the economic performance of the NIEs is the relatively equitable distribution of gains from rapid economic growth. The rapid and sustained growth in these economies since the late 1960s has been accompanied not only by sharp reductions in poverty but across-the-board improvements in living standards that significantly raised the welfare of the majority. Income distribution has remained more equal than in other countries at a comparable stage of development. It is widely recognized that income inequalities remain low in the NIEs (see, for instance, Balassa and Williamson, 1987; Fei et al., 1979; Wood, 1999).

What are the factors that have produced these outcomes in the NIEs, and what lessons do they hold for the CLMV countries? A number of key features and policies stand out. The first distinguishing feature of these NIEs is the initial conditions relating to a host of social indicators, particularly education but also health. The initial endowment of human capital is a critical factor in determining the ability of the workforce to fully participate in the economy, and thereby share in the benefits of growth. Although initial educational and skill levels in the NIEs were not exceedingly high, near universal access to quality primary and secondary education, combined with effective vocational and on-the-job training facilities, resulted in a productive workforce. With this they were able to avoid the skills shortage or mismatch that currently exists in the CLMV, and other countries trapped in middle-income status. Therefore, an important barrier to be overcome in the CLMV is the quality of primary and secondary education, and vocational training. Increasing access to health care services must complement these changes.

This feature of the labor force, when combined with a conducive investment climate and sound macroeconomic fundamentals, accounts for the next determining factor. In this environment, these countries could exploit their comparative advantage, and benefit from opportunities arising from labor-intensive light manufacturing activities. Given the fact that labor is the most widely distributed factor of production in the economy, employment
expansion and the subsequent increase in real wages contributed to reductions in both poverty and income inequality as the NIEs developed (Balassa and Williamson, 1987; Fei et al., 1979; Athukorala and Menon, 1997). As noted earlier in discussing FDI flows however, the longer-term institutional and structural constraints need to be addressed in order to improve the investment climate, and thereby allow the forces of comparative advantage to absorb the burgeoning pool of low skilled labor.

The third factor relates to distribution of land ownership and asset inequality. Deininger and Squire (1998) show that asset inequality, more than income inequality, can undermine not only growth but the effectiveness of pro-poor policies. Korea, Taiwan and Japan had instituted significant land reforms which resulted in a fairer distribution of this critical asset, especially for low income agricultural households, before their liberalization programs began. Indeed, this was a crucial factor that facilitated the transfer of labor from agriculture to manufacturing during the ensuing structural transformation. This is not the case in the CLMV countries, and land reform remains an unfinished item on the policy agenda of these countries until today. Cambodia presents a useful example that illustrates this general problem. The lack of land titling has resulted in widespread deforestation as well as ‘land-grabbing’. In an ironic twist, rather than enjoying in the benefits from the land price boom, it has often made some of the most vulnerable worse off. Without clear or proper titles to prove ownership, many of the poor have been evicted or forced off their land.

The experience from the NIEs, especially Korea and Taiwan, suggests that all of these conditions or policies need to be in place before convergence with cohesion may be possible. It would appear that a sub-set of the above, rather than a full complement, is unlikely to work to produce the desired outcome. Therefore, it is important that the CLMV pursue all of these policies in a comprehensive and simultaneous manner if it is to achieve growth with equity. These are necessary conditions, and other elements of inclusive growth (see Menon et al., 2011) would also need to be incorporated in the reform program to ensure the desired outcome.

In summary, the experience from the NIEs suggest that the rapid growth required for catch-up by the CLMV can only occur without further polarization within their countries if a number of necessary conditions are simultaneously met. The first relates to the need to invest in social infrastructure, especially education but also health, in order to produce a workforce more able to participate in the growth process. Second is the need to improve the investment climate, to increase capital inflow and labor absorption, along comparative advantage lines. Third is the need for land reform, to directly redress asset inequality, and to enhance incentives and productivity in agriculture, and facilitate factor transfer following structural adjustment. These necessary conditions need to be complemented with the other elements of an inclusive growth strategy in order to ensure convergence with cohesion.

6. Conclusion

ASEAN is divided. The most striking is the development divide that separates the newer members (the CLMV countries) from the original ones (ASEAN6). Although the development divide is multi-faceted, its most conspicuous manifestation lies in differences in per capita incomes. More rapid rates of economic growth in the CLV since the 1990s, driven by trade, investment and other market reforms, have reduced these income differences, while dramatically reducing poverty. While the development divide has narrowed, huge gaps remain.

Further narrowing of these gaps will require an increase in the speed and breadth of policy reforms. With trade, the focus needs to shift to behind-the-borders measures that reduce trade costs through transport and trade facilitation. A gaping hole in the policy landscape in ASEAN is the failure to address labor migration adequately. Furthermore, on-going demographic transitions will require greater capital inflow or labor outflow if massive
unemployment is to be avoided. Capital inflows will only increase if there are substantial improvements in the investment climate. These changes will take time and since absorptive capacity is currently nearing its limit, it is an issue for the long run. Greater labor mobility will occur in the interim, but will require effective policy frameworks to be developed in both sending and receiving countries, if it is to be regulated. It would also help if a regional agreement that also deals with low skilled labor could be struck. The current policy void on labor migration not only limits the benefits from trade and investment liberalization, but increases the cost of structural adjustment. For the CLMV, the absence of a functioning exchange rate mechanism due to varying degrees of dollarization increases the importance of labor mobility in adjusting to economic disturbances or other shocks.

Addressing labor mobility needs to be accompanied by other reforms. Although rapid growth has resulted in convergence, it has also increased polarization within countries. This can threaten social cohesion, as well as the sustainability of future growth. If convergence at the expense of internal cohesion is seen as a hollow victory, then so too must the preservation of internal cohesion at the expense of convergence. How can we strike a balance between the two, where convergence can continue without further threatening internal cohesion? In other words, how do we make growth more inclusive? In order to do this, there is a need to invest heavily in social infrastructure, especially education but also health. Apart from directly reducing social inequities in these areas, such investment will produce a workforce more able to actively participate in the growth process. More than income inequality, asset inequality creates wide and versatile divisions within these countries. Land reform is a critical step in addressing these divisions, increasing agricultural productivity, and enhancing labor market flexibility during periods of structural transition.
References


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