

# EXECUTIVE SUMMARY

*Hadi Soesastro*

## 1. BACKGROUND AND OBJECTIVES

For the last decades, East Asian countries have been exploring and exploiting the potential benefits of regionalization, taking advantage of geographical proximities and diversities. Although intraregional trade has been intensified during the process, the East Asian economy continues to rely heavily on the rest of the world, such as the United States (US) and the European Union (EU). In view of the increasing concerns over the world economy, triggered by soaring crude oil prices and financial instability spreading worldwide from the US, there are reasons to suggest that the region strengthens its self-reliant efforts to address further trade and investment policy arrangements that will be beneficial to the East Asian region as a whole, while continue to adhere to the concept of open regionalism. The proliferation of free trade agreements (FTAs) in East Asia has been seen largely in this context.

This proliferation, however, has failed to provide a seamless regional market and production base that benefits the whole region. In an effort to correct this, ASEAN has moved beyond the ASEAN Free Trade Area (AFTA) to achieve a higher degree of economic integration. It has recently formulated a Blueprint to realize the ASEAN Economic Community (AEC) by 2015. The successful implementation of the AEC Blueprint will give a boost to deepening economic integration in East Asia.

Recognizing the above, this “Deepening Economic Integration” project aims at developing a policy framework to strengthen the AEC and its role in deepening economic integration in the wider East Asian region. The policy framework will be based on further conceptualization of critical issues and is supported by evidence-based analysis and rigorous empirical studies.

## 2. APPROACH

The research project begins with a careful review of the AEC Blueprint. The AEC Blueprint envisages the following four key characteristics: (a) a single market and production base, (b) a highly competitive economic region, (c) a region of equitable economic development, and (d) a region fully integrated into the global economy. It also provides a useful guide to the deepening of economic integration in East Asia as a whole.

The first phase of this research has focused on the following four areas: (i) an in-depth examination of East Asia's development and challenges, (ii) critical issues in implementing the AEC Blueprint, (iii) key investment issues, and (iv) key trade issues.

In the first area, the research identifies the primary factors that have led to the *de facto* economic integration in East Asia. It presents a strategic framework to pursue deepening economic integration that at the same time will contribute to narrowing development gaps by further reinforcing those factors through cooperative, collaborative, and collective efforts. This strategic framework also provides a useful theoretical underpinning that helps structure and prioritize the wide-ranging policy actions stipulated in the AEC Blueprint.

In the second area, the research has focused on several key issues: rules of origin, trade facilitation, services liberalization, investment liberalization and facilitation, competition policy, equitable economic development, and coherent external economic policy. The study is meant to supplement the efforts of the ASEAN Secretariat by providing an analytical framework and further elaboration on as well as potential expansion of the scope of the policy measures. It also gives attention to the important aspects of implementation. Specifically on services liberalization and competition policy, in-depth studies have been undertaken (joint research projects).

In the third area, the key determinants of foreign direct investment (FDI) inflows in East Asia are reviewed by using two types of gravity models. A notable feature of the research is its focus on intra-developing Asian flows of FDI. On the fourth area, the

research evaluates the existing FTAs in the region, focusing on the impact of multiple rules of origin and overlapping FTAs.

### **3. FINDINGS AND CONCLUSIONS**

#### **3.1. Development and challenges**

The remarkable economic growth in East Asia has been accompanied by *de facto* economic integration in the region through the development of international production and distribution networks. International trade statistics vividly illustrate this process. The share of East Asia in world trade has steadily increased from 15.0 percent in 1980 to 23.5 percent in 2006. Intra-regional trade in East Asia has been intensified from 33.3 percent in 1980 to 43.1 percent in 2006, driven particularly by parts and components, the share of which has multiplied from 6.0 percent in 1980 to 28.1 percent in 2005. As a result, intra-regional trade in parts and components in East Asia has exceeded those in the North American Free Trade Agreement group and EU by 2005, in terms of both share and value. Moreover, the share of capital goods in intra-regional trade in East Asia has doubled during the same period from 9.0 percent to 18.9 percent.

FDI flows have been another channel through which East Asian economies integrate with one another. It is noteworthy that intra-Asian FDI flows are no longer a North-South phenomenon but increasingly a South-South one as well, and a substantial portion of FDI from Asia is intra-regional in nature. Developing countries in Asia have been emerging as the sources of FDI outflows as well as the destinations of FDI. As a result, around 35 percent of FDI inflows to Asian developing countries between 1997 and 2005 have come from within the region. Compared to this, intra-ASEAN FDI flows accounted for a relatively small portion, just over 10 percent of FDI flows in Asia between 1997 and 2005.

*De facto* economic integration in East Asia has substantially advanced for some economic elements while being far from complete for other elements. That is, there remains ample room to promote international production and distribution networking through eliminating such gaps by devising a proper policy environment. This is the study's main rationale in developing a framework for deepening economic integration.

In addition, since “narrowing development gaps” is one of the most important regional commitments, policy measures toward deepening economic integration should be closely connected with development initiatives to which regional resources are devoted.

Our strategic framework suggests that the two objectives of deepening economic integration and narrowing development gaps can be pursued at the same time, by effectively utilizing production fragmentation and agglomeration forces. This theoretical claim is supported by our empirical studies. This clearly implies that reduction of service link costs and network set-up costs, coupled with congestion effects in more developed economies, have promoted the shifts of production blocs to less developed economies. The key strategy, therefore, is to reduce service link costs and network set-up costs.

In the context of East Asian economic integration, ASEAN has been gaining its importance as the hub of regional FTA networks as well as the forerunner to deepen economic integration. Therefore, the ASEAN’s initiatives toward the AEC should be supported by the collective action of East Asia as a whole, because deepening economic integration in East Asia largely depends on the successful implementation of the AEC.

## **3.2. Implementing the AEC Blueprint**

### *3.2.1. The AEC Blueprint*

The ASEAN Economic Community (AEC) Blueprint is a very significant development in ASEAN’s efforts toward deepening regional economic integration. The AEC Blueprint is a clear departure from ASEAN’s tradition. With the adoption of the Blueprint, ASEAN has moved from an integration driven by the process to an integration driven by clearly defined end goals and timelines. The AEC Blueprint is also a binding document of commitments by the members.

The Blueprint is organized along the AEC’s four main characteristics, namely: (a) a single market and production base; (b) a highly competitive economic region; (c) a region of equitable economic development; and (d) a region fully integrated into the global economy. The fourth characteristic indicates the “open” nature of ASEAN’s pursuit of regional economic integration (*open regionalism*). The AEC Blueprint,

therefore, provides a useful, operational basis for developing the agenda of deepening economic integration in the wider East Asian region as well.

The Blueprint is comprehensive. It identifies 17 “core elements” of the AEC and delineates 176 priority actions to be undertaken within a strategic schedule of four implementation periods (2008-2009, 2010-2011, 2012-2013, and 2014-2015). It should be noted that some goals in the Blueprint remain vaguely defined and “milestones” are still missing, but these can be rectified in the process, if effective implementation mechanisms are established. Analysis can also make a useful contribution to overcoming this.

### *3.2.2. Rules of origin*

Despite the proliferation of FTAs in East Asia, their potential benefits do not seem to be realized because of the lower-than-expected utilization of FTAs. Our ex post evaluation identified several reasons. First and foremost is the administration cost to satisfy rules of origin (ROOs), as ROOs are a necessary feature of any FTA to prevent “trade deflection” that would tend to erode the trade preference offered by the FTA. Second, due to the so-called “spaghetti-bowl effects”, “proliferation” of FTAs has resulted in additional costs to utilize FTAs by forcing exporters to face various ROOs according to the goods and the destinations. Third, other provisions in FTAs, such as the one on direct shipment, can discourage the utilization of FTAs.

In order to exploit the potentials of existing FTAs, including AFTA, it is necessary to improve ROOs to become less restrictive, simpler, and more flexible. The findings suggest that the change of tariff code (CTC) rule is more business-friendly than the value content (VC) rule, and that less demanding administration such as the self-certificate system may encourage the utilization of FTAs. There is also a need to streamline ROOs in overlapping FTAs. It is most important to keep in mind that FTA provisions should be in line with the multilateral nature of production and distribution networks in East Asia. Finally, it is crucial to conduct ex post evaluation of existing FTAs to pinpoint key bottlenecks and on that basis to draw more detailed prescriptions to eliminate them.

### *3.2.3. Trade facilitation*

International interest in trade facilitation has increased noticeably in the last few years reflecting the progress of trade liberalization and the development of international production and distribution networks. Recent studies suggest that there can be significant economic gains from trade facilitation measures, specifically in areas that increase the overall reliability of the supply chain; overcoming the weakest link in the supply chain; better coordination of border procedures between customs and other agencies; increasing the availability of quality and competitive services such as trucking, custom brokering and warehousing; as well as reforming the logistic service markets.

The AEC Blueprint on trade facilitation, such as the establishment of the ASEAN Single Window and customs integration, is in the right direction. It is important to ensure that current policy intentions are translated by the various governments and agencies into action and implemented. Attention should be given to finding the most effective means to do so, together with monitoring progress in implementation.

#### *3.2.4. Services liberalization*

Equally importantly, services liberalization can generate benefits beyond the service sector itself by facilitating further development of international production and distribution networks through the reduction of service link costs and network set-up costs.

Judging from the importance to facilitate fragmentation through international production and distribution networking, detailed studies on services liberalization in East Asia have been conducted in the following six subsectors: business services, postal/courier services, ports/maritime services, financial services, distribution services, and logistic services. These are important subsectors and compliment the Priority Integration Sectors (PIS) set out in the AEC Blueprint. In the effort to develop subsectoral scorecards, taking all the four modes of services liberalization into consideration, the study has compiled subsectoral “restrictiveness indices” that can eventually be used to conduct quantitative analyses on the impact of services liberalization.

The most important implication from the study is that gains are much larger from reducing nondiscriminatory barriers than from reducing the discriminatory barriers that are typically the focus of trade negotiations. The reason for this is that most of these

barriers are of the cost-raising (i.e., productivity reducing) type rather than the price-raising (or tax) type, although it is not yet clear exactly which type of barriers has which type of effect in all the major services sectors. It is important, therefore, to identify the costs of specific barriers in specific sectors and to clearly spell out the costs of these restrictions to the domestic economy and not just to foreign trading partners.

### *3.2.5. Investment liberalization and facilitation*

FDI has been a key driver of regional economic integration through the emergence of dynamic production networks. Intra-Asian FDI has been far more critical than intra-ASEAN investment in this process. Therefore, it is necessary to re-examine the concept of the ASEAN Investment Area (AIA) to establish the ASEAN Comprehensive Investment Agreement (ACIA) by expanding the scope and measures.

More specifically, the study shows that AIA reform should be accompanied by improvement in the domestic business environment, particularly economic regulations, tax regimes, competition policy, and corporate and labor laws, although some of these have not been well addressed in the AEC Blueprint because they are usually viewed as “behind-the-border” issues. However, it should be stressed that investment liberalization and the accompanying domestic reforms can generate significant positive synergy and the narrowing of development gaps in ASEAN.

The empirical study shows that distance, which is a widely used proxy of service link costs, and wage differentials are significant determinants of intra-Asian FDI flows. This further signifies the importance of investment liberalization and facilitation as one of the main policy pillars of the strategic framework to pursue deepening economic integration and narrowing development gaps.

### *3.2.6. Competition policy*

The AEC Blueprint intends to develop a regional guideline on competition policy by 2010, and the introduction of competition policies in all member countries by 2015. Today, only four ASEAN countries (Indonesia, Philippines, Thailand, and Vietnam) have competition policies, although some others, including Malaysia, have enacted laws and regulations aimed at curbing monopolistic and restrictive business practices.

It is recognized that it would be impractical for ASEAN countries to have a uniform set of competition policies and laws, but the study lends support to the call for some convergence of competition laws. In its absence, there is the danger that the competition law in one country will be challenged under the existing laws in other countries. Conversely, a convergence of competition policy will contribute to the creation of “level playing fields”, where economic resources will be utilized more efficiently.

### *3.2.7. Equitable economic development*

In the era of globalization, the development strategy of each country should be designed to effectively utilize fragmentation and agglomeration forces in production and distribution networking. Along this development path, the key issues to be addressed should begin with devising the strategy to participate in networks, and then move to formulating industrial agglomeration, and subsequently to efforts to upgrading industrial structures.

The AEC Blueprint entrusts ASEAN to address development gaps by enhancing its existing frameworks<sup>1</sup> to achieve equitable economic development. In view of the continuously expanding production and distribution networks, this issue can be addressed more effectively by the collective action in East Asia as a whole.

### *3.2.8. Coherent external economic policy*

The AEC Blueprint stipulates the importance of developing coherent external economic policy by ASEAN because of its critical role in the economic integration of East Asia as a whole. Incoherence can be found in the areas of trade policy, including FTA policy, and investment policy. These incoherences can be detrimental to ASEAN economic integration in particular and to the wider region’s economic integration in general.

As for the trade policy, ASEAN members still maintain wide differences in levels of trade protection in several sectors. They have also concluded a number of FTAs without sufficient consultation with one another. Similarly, in the area of investment policy, not all members have adopted the universal principle of national treatment. They also need to give greater attention to jointly reviewing and revising their domestic



laws and regulations that are critical for promoting investment flows into the region. In establishing a system to enhance regional coordination to formulating coherent external economic policy, it is crucial to address the issue of cooperation and competition among member countries.

ASEAN members should realize that bilateral FTAs are not sufficient to promote the growth of production and distribution networks that are multilateral in nature as well as to strengthen their role in these networks. Moreover, empirical studies continue to bring out the fact that bilateral FTAs are far inferior to unilateral trade liberalization on an MFN (most favored nation) basis.

Therefore, ASEAN members should focus on the timely completion of comprehensive economic partnership agreements (including FTAs) with their main partners in East Asia (China, Japan, Korea, Australia and New Zealand, and India). ASEAN members should have a common template to be used in concluding the above agreements. A common template in the area of investment, competition policy, and intellectual property rights can avoid distortions and deflections that would be detrimental to the further promotion of dynamic production and distribution networks in the region.

### *3.2.9. Implementation issues*

ASEAN member countries must give serious attention to the effective implementation of the Blueprint. In essence, each member country will have to begin this process by preparing more detailed national action plans.

The Blueprint suggests that at the regional level, ASEAN sectoral bodies will be involved in the coordination of the implementation of the Blueprint, but related government agencies are responsible for overseeing the implementation. Partnership arrangements involving government agencies, sectoral bodies, and business associations as well as the civil society will need to be formed to ensure participation of all stakeholders in the preparation of national action plans, as well as in regular consultations on their implementation. The above nongovernment stakeholders need to be identified and clear criteria should be set for their involvement.

The implementation mechanism as envisaged in the Blueprint consists of the following elements: (a) relevant sectoral Ministerial bodies to be responsible for

implementation of the Blueprint and for monitoring of commitments under their respective purview; (b) the ASEAN Economic Ministers (AEM) to be in charge of economic integration in the newly established Council of ASEAN Economic Community (as stipulated in the ASEAN Charter) are also accountable for overall implementation; (c) the High Level Task Force (HLTF) to assist the AEM; (d) regular consultation meetings with stakeholders to be organized by the AEM; (e) a progress report on the implementation of the AEC to be prepared by the ASEAN Secretary General for relevant Ministerial meetings and the Summit; and (f) the ASEAN Secretariat to review and monitor compliance of the implementation of the Blueprint. Of key importance to the successful implementation of the Blueprint is the clear separation between policymaking (HLTF and AEM) and the monitoring of implementation (ASEAN Secretariat). ERIA research will pay particular attention to developing evidence-based analysis that will aid in the meaningful monitoring of the implementation of the Blueprint.

### **3.3. Future research**

#### *3.3.1. Developing ERIA scorecards of services liberalization*

The study has begun to develop analytical scorecards of services liberalization for six subsectors, namely, business services, maritime/port services, courier/postal services, financial services, distribution services, and logistic services. In order to support ASEAN's efforts to achieve "free flow of services", the study will need to be extended to cover other subsectors. What can be called "ERIA scorecards" to assist and supplement similar efforts by the ASEAN Secretariat can be an essential tool to facilitate the implementation of services liberalization in accordance with the AEC Blueprint and its strategic schedule as well as in crafting the services chapter of the various ASEAN agreements with its East Asian partners.

#### *3.3.2. In-depth studies on trade facilitation*

ASEAN already has well-developed proposals on what needs to be done in the area of trade facilitation. However, the motivation to carry out the changes and the most effective means to do so are less clear and it is on these aspects together with

monitoring progress in implementation that research will focus on. This study will also be incorporated into the ERIA scorecards exercise as well. They will also be useful in defining the trade facilitation agenda for the wider East Asian region.

### *3.3.3. Post evaluation of existing FTAs*

In order to optimize the utilization of the existing FTAs in East Asia, the first step is to identify the reasons for their low utilization. A large sample survey can be a useful tool for this purpose. A preliminary survey of responses by the corporate sector has been undertaken in relation to FTAs involving Thailand and Japan. In addition, this exercise can be extended to monitor the implementation of FTAs along with the provisions in the agreements.

### *3.3.4. Enhancing ASEAN's participation in regional production networks*

ASEAN's intention to enhance its participation in "global supply networks" is very much consistent with the strategic framework developed by this study. By incorporating the findings of other ERIA research projects (infrastructure development, industrial clustering, SMEs, and CLMV), a set of practical policy measures to achieve this objective can be elaborated within a comprehensive and unified framework to pursue deepening economic integration and narrowing development gaps at the same time.

## **4. POLICY RECOMMENDATIONS**

The process of deepening economic integration in East Asia will largely depend on the successful implementation of the AEC. The present study has identified crucial policies that will significantly contribute to the establishment of the AEC. Three major aspects are to be given priority.

#### **4.1. Developing AEC scorecards**

AEC scorecards, based on solid analysis of the key obstacles to integration, will assist in tracking the progress of implementing the AEC Blueprint. They will also provide necessary benchmarks, particularly in the areas of trade facilitation and services liberalization. This will enable policymakers to craft more appropriate and effective measures.

#### **4.2. Streamlining ROOs in the Region**

ROOs of the various regional FTAs are inconsistent and cumbersome. This has complicated and limited the use of FTAs, especially by SMEs. ROOs therefore have to be streamlined and AFTA is a useful benchmark on which to establish a common rule of origin for East Asia.

#### **4.3. Re-examining the ASEAN Investment Area Initiative**

Investment has been a key driver of regional economic integration through the emergence of dynamic production networks. Intra-Asian investment has been far more critical than intra-ASEAN investment in this process. Therefore, it is necessary to re-examine the concept of the ASEAN Investment Area (AIA). The study shows, however, that AIA reform should be accompanied by improvement in the domestic business environment, particularly economic regulations, tax regimes, competition policy, and corporate and labor laws. Free investment flows and the accompanying domestic reforms can contribute to narrowing the development gaps in ASEAN.

#### **NOTE**

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1. “The ASEAN Policy Blueprint for SME Development: 2004-2014” for the development of small and medium enterprises (SMEs), and “the Initiative for ASEAN Integration (IAI)” to

narrow development gaps between ASEAN-6 (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand) and CLMV (Cambodia, Laos, Myanmar, Vietnam) countries.

## Chapter 1

# The Strategic Framework for Deepening Integration

*Fukunari Kimura*

## INTRODUCTION

This paper tries to provide a strategic framework for deepening economic integration in East Asia, with special reference to the fragmentation theory and new economic geography. The de facto economic integration in East Asia is “uneven,” and this unevenness actually generates economic dynamism in the formation of international production/distribution networks. We can thus find a way to pursue both deepening economic integration and narrowing development gaps in parallel by utilizing globalizing forces.

To effectively make use of international production/distribution networks, we need to recognize that countries/regions at different development phases face different policy challenges. The fragmentation theory and new economic geography provide useful policy guidance in the framework of two-dimensional fragmentation and agglomeration. This paper argues that more institutionalized economic integration can be a powerful driver for designing and implementing required policy packages. The paper also suggests that the open architecture of free trade agreement (FTA) networking in East Asia may have a benevolent influence on the construction of a new international economic order at the possible conclusion of the Doha Development Agenda.

## **2. CURRENT STATUS AND SPECIAL FEATURES OF ASEAN/EAST ASIA**

### **2.1. *De facto* economic integration and regionalization**

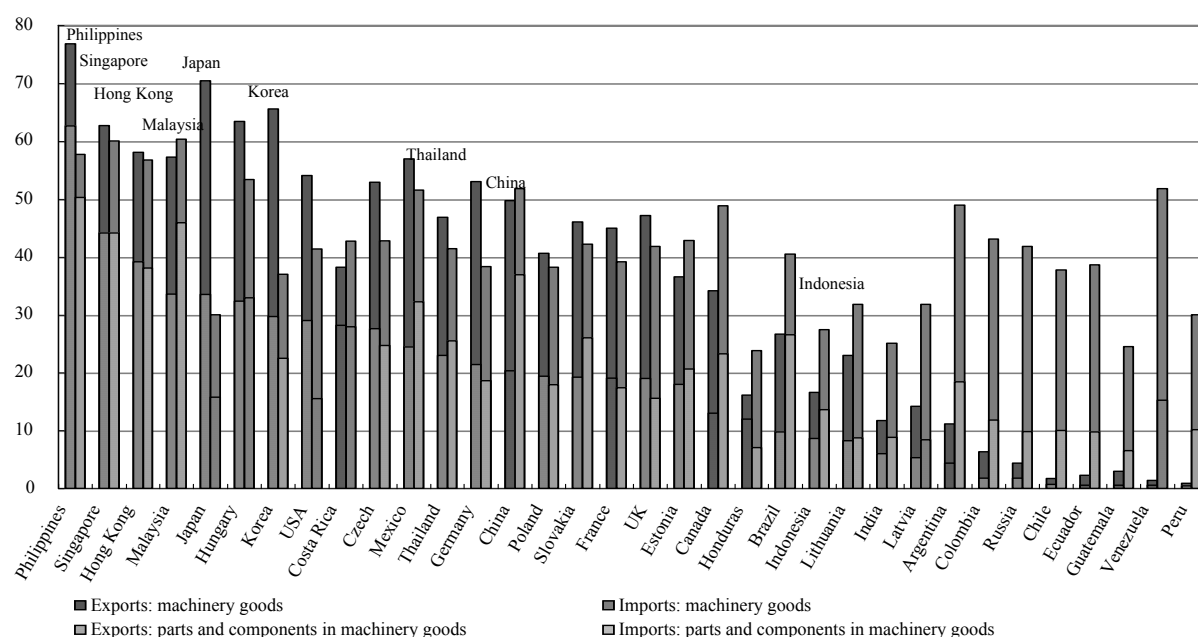
The international trade theory defines the “integrated world economy equilibria” as the extreme of economic integration where the world’s total production and consumption are equivalent to the equilibria in which all economic elements are perfectly mobile or the world economy has zero dimension<sup>1</sup>. Starting from such a pure theoretical concept of economic integration, we can assess the degree of economic integration in two ways: by evaluating the mobility of economic elements and by measuring price convergences. The former method is to check the “process” of economic integration: The diversification of international transaction channels and international mobility of various economic elements such as goods, services, investment flows, human capital, labor, information and technology, and others are to be examined. The latter is to evaluate the “result” of economic integration, judging on how thoroughly arbitrage, where price differences for various economic elements exist, is exploited.

Such assessment vividly reveals the nature and characteristics of economic integration in East Asia, in sharp contrast with the European economic integration. In the case of Europe, particularly the economic integration of core European Union (EU) countries, the high degree of price convergence has been accomplished; for both goods and productive factors, not much room for arbitrage remains. In contrast, East Asia presents an “uneven” pattern of economic integration. For some economic elements, economic integration in East Asia has already been accomplished at a high degree; trade in parts and components and cross-border manufacturing activities are such cases. However, it does still have some economic elements that are far from complete integration: Unskilled labor as well as information and technology are examples.

Domestic and international income/welfare disparity is not at all desirable; so, this certainly should be corrected. However, it is also true that “uneven” characteristics of East Asian economic integration have generated region-specific dynamism through the

formation of international production/distribution networks. In this context, we should be able to pursue both deepening economic integration and narrowing development gaps at the same time.

**Figure 1: Machinery goods trade: Shares in total exports and imports in 2005 (%)**



Source: Ando and Kimura (2008).

Figure 1 presents the importance of machinery/machinery parts and components trade in East Asia in 2005<sup>2</sup>. The ASEAN forerunners, notably the Philippines, Singapore, Malaysia, and Thailand, as well as China were active back-and-forth traders of machinery parts and components. We observe similar trade patterns between the United States and Mexico/Costa Rica, and between Germany and the Czech Republic/Slovakia/Hungary/Poland, but the extensiveness of production networks is distinct in East Asia.

The regionalization of the East Asian economy has obviously advanced, particularly in the context of production networks. Table 1 presents intra- and interregional exports of machinery goods (parts and components, and finished products) in East Asia in 1990 and 2005. The explosive increase in intra-East Asia trade in machinery parts and components presents the regionalization in the formation of



production networks. At the same time, however, we must note that the connection with non-East Asia, particularly for machinery finished products, still maintains its importance. Production/distribution networks are not exclusive to East Asia only but rather have an open-end design to outsiders. Also considering the active operation of non-East Asian multinationals in production/distribution networks in East Asia, the de facto economic integration in East Asia has developed in an open architecture.

**Table 1: Intra- and inter-regional machinery exports in East Asia**

(a) Intra- and inter-regional exports		(millions US\$)				(b) Factors of growth in exports (1990-2005)	
		1990		2005			
	Value	%	Value	%			
<b>Machinery goods: parts and components</b>							
Intra-East Asia	54,336	39.6	399,882	52.6	<b>&lt;Intra-East Asian exports&gt;</b>		
Inter-regional	82,915	60.4	360,823	47.4	(i) Growth in intra-East Asian exports		
(U.S.)	(39,624)	(28.9)	(108,213)	(14.2)	All products		321%
Total	137,251	100.0	760,705	100.0	Machinery goods (total)		522%
					- Machinery final goods		400%
					- Machinery parts and components		636%
<b>Machinery goods: final goods</b>							
Intra-East Asia	50,932	23.2	254,738	35.6	(ii) Contribution to the growth (all products)		
Inter-regional	168,597	76.8	460,832	64.4	Machinery goods (total)		63%
(U.S.)	(70,183)	(32.0)	(188,911)	(26.4)	- Machinery final goods		23%
Total	219,529	100.0	715,570	100.0	- Machinery parts and components		40%
<b>Machinery goods: total</b>							
Intra-East Asia	105,268	29.5	654,620	44.3	<b>&lt;Inter-regional exports&gt;</b>		
Inter-regional	251,512	70.5	821,654	55.7	(i) Growth in inter-regional exports		
(U.S.)	(109,807)	(30.8)	(297,124)	(20.1)	All products		224%
Total	356,780	100.0	1,476,274	100.0	Machinery goods (total)		227%
					- Machinery final goods		173%
					- Machinery parts and components		335%
<b>All products</b>							
Intra-East Asia	270,465	38.5	1,139,821	44.9	(ii) Contribution to the growth (all products)		
Inter-regional	432,736	61.5	1,401,216	55.1	Machinery goods (total)		59%
(U.S.)	(174,978)	(24.9)	(473,093)	(18.6)	- Machinery final goods		30%
Total	703,201	100.0	2,541,037	100.0	- Machinery parts and components		29%

Data source: authors' calculation, based on UN COMTRADE

Note: "East Asia" here includes China, ASEAN4, NIES3, and Japan. Due to lack of data available from UN COMTRADE, (i) Taiwan is not included in East Asia, (ii) data for China in 1992 and Hong Kong in 1993 are used in calculating intra-East Asian exports in 1990, (iii) data for the Philippines are not included in calculating intra-East Asian exports in 1990. Growth rates are in nominal terms.

Source: Ando and Kimura (2008).

## 2.2. Varying approaches for countries at different development phases

Countries at various development phases obviously face different issues in development. Particularly in the context of international production/distribution networks, the variety of location advantages potentially provides economic dynamism, although the proper business environment must be prepared to effectively utilizing globalizing forces. It is important to prescribe proper policy suggestions for countries

that are at different development phases so as to dissolve bottlenecks and take advantage of the mechanism of production/distribution networks.

In the context of utilizing the mechanism of international production/distribution networks, East Asian economies could be categorized into four groups. The first group is about to participating in international production/distribution networks. The issue is how to attract the first wave of production fragmentation from industrial agglomeration nearby. The second group is the phase wherein industrial agglomeration are formulated so as to stabilize the industrial structure. The effective use of positive externalities from industrial agglomeration becomes a crucial issue in this phase. The third group is facing competition from both lower-income and higher income countries. How to upgrade a nation's industrial structure as well as enhance its social welfare up to the level of advanced countries is vital. The fourth group is a major source of foreign direct investment. How to avoid "hollowing out" becomes an important issue for this group.

The benefits from production/distribution networks do not, of course, cover all aspects of economic development. However, the experience of East Asia in the past few decades suggests that the effective use of production/distribution networks is crucial to accelerating economic development. Resolving bottlenecks of production/distribution networks also seems to be helpful in developing other aspects of the economy. Considering the region's successful experience in development so far, it is ideal therefore to design and construct the integration strategy in an "East Asian way".

### **2.3. Keeping optimism in utilizing globalizing forces**

Anti-globalism sentiment has recently proliferated all over the world. In particular, skeptical views on outsourcing and offshoring in North America and Europe have been presented not only in journalistic literature but also among academic intellectuals<sup>3</sup>. However, East Asians have predominantly kept their optimism over welfare-enhancing globalization. Indeed, East Asia has been the region that has most successfully utilized globalizing forces for its economic development. It is extremely important to maintain such optimism for both the region and the world. To do so, the region has to

continuously prove that globalizing forces can work well if the policy is right.

### 3. UTILIZING FORCES OF FRAGMENTATION AND AGGLOMERATION

#### 3.1. Mechanics of international production/distribution networks

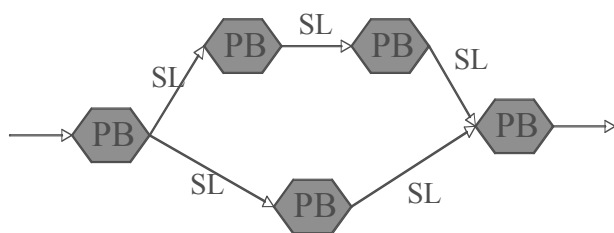
Since the beginning of the 1990s, East Asian economies have experienced an unprecedented development of international production/distribution networks, particularly in machinery industries. The mechanics of international production/distribution networks have recently been analyzed intensively by the fragmentation theory and new economic geography<sup>4</sup>.

**Figure 2: The original concept of fragmentation: An Illustration**

#### Before fragmentation



#### After fragmentation



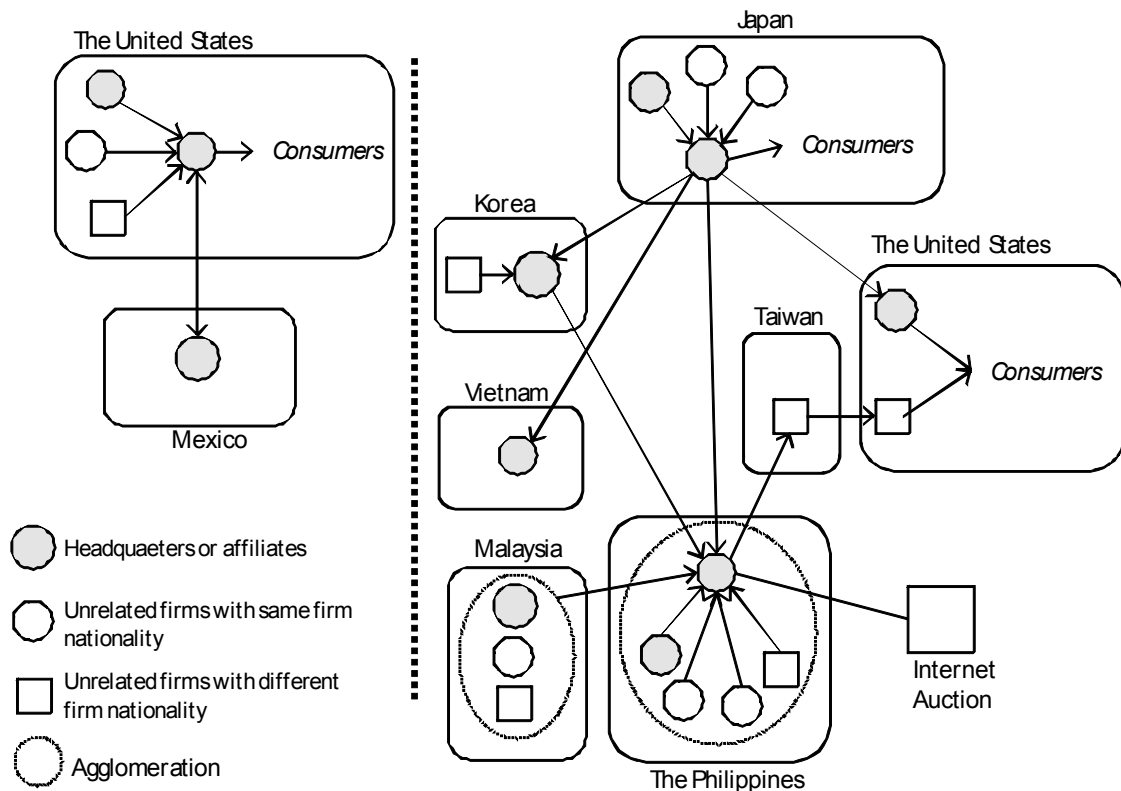
PB: production block  
SL: service link

Source: Kimura (2006).

The fragmentation theory started from the seminal work of Jones and Kierzkowski (1990). Figure 2 illustrates the original idea of fragmentation. Suppose that a large factory producing electric products initially exists in a developed country and covers a long value chain from upstream to downstream. A closer look at the detailed nature of

the production processes might suggest that some operations require intensive monitoring by technicians while others may simply be unskilled labor-intensive. Fragmentation, i.e., locating fragmented production blocks in different locations, becomes cost-saving when the production cost per se drastically falls and the cost of service links for connecting production blocks is low enough.

**Figure 3: Production/Distribution Networks Between the United States and Mexico and in East Asia: An Illustration**

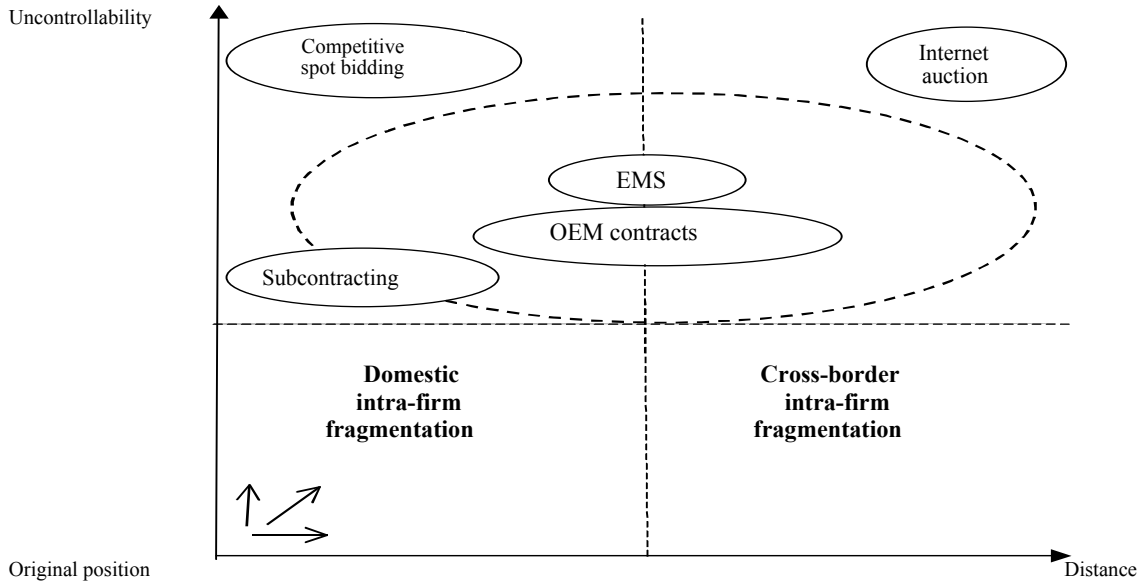


Source: Ando and Kimura (2008).

The original idea of fragmentation primarily deals with a relatively simplistic cross-border production sharing that is, for example, observed between the United States and Mexico. It is a simple back-and-forth production sharing and mostly intra-firm (Figure 3). However, international production/distribution networks in East Asia have developed beyond such a pattern and reached much more complicated forms as illustrated in the right-hand side of Figure 3, including both intra-firm and arm's-length transactions, and some expansion of the analytical framework is inevitably

needed. Kimura and Ando (2005) propose the concept of two-dimensional fragmentation, particularly to analyze the mechanics of networks in East Asia.

**Figure 4: Fragmentation in a two-dimensional space**



Source: Kimura and Ando (2005).

Figure 4 displays various types of fragmentation in a two-dimensional space. The horizontal axis denotes geographical distance. From the original position, located at the origin, a production block can be detached and placed at a geographical distance. The dotted line in the middle is a national border, separating cross-border fragmentation from domestic fragmentation. On the other hand, the vertical axis represents the disintegration or uncontrollability of a firm. A fragmented production process may be conducted by either intra-firm establishments or unrelated firms. The dotted line is the boundary of a firm, separating arm's-length (inter-firm) fragmentation or outsourcing from intra-firm fragmentation.

Fragmentation and agglomeration occur at the same time. The concentration of fragmented production blocks occurs through the following two channels. First, local minimal points of service link costs tend to attract a large number of fragmented production blocks. Moreover, service links are often accompanied by strong economies of scale. Second, the concentration of production blocks may be enhanced because of the close relationship between the service link costs along the disintegration

axis and geographical proximity. Service link costs in arm's-length fragmentation are extremely sensitive to geographical distance. The closer the distance to one's business partners, the smaller the service link cost in searching for potential business partners, consulting detailed specifications of products, controlling product quality and delivery timing, solving disputes over contracts, and monitoring business partners. The latter economic logic, in particular, seems to greatly contribute to the formation of industrial agglomeration in East Asia.

New economic geography links with the fragmentation theory in a consistent manner. New economic geography claims that industrial agglomeration generates both concentration forces and dispersion forces. The logic behind the formation of agglomeration as described by the fragmentation theory is consistent with the mechanism of generating concentration forces in a new economic geography. The dispersion forces, on the other hand, generate another layer of fragmentation from a center to peripheries.

An important aspect of international production/distribution networks is their effective utilization of uneven economic integration. In the fragmentation of production processes, low service link costs as well as the high degree of freedom in cross-border corporate activities are important while differences in location advantages, including wage gaps, provide room for possible cost savings in production blocks. Positive and negative externalities generated by industrial agglomeration also provide development opportunities for both centers and peripheries.

The effective use of arbitrage gaps has been effective in East Asia's economic development. Rather than immediately considering the artificial correction of domestic/international income disparities due to social concerns, we should first try to take advantage of uneven economic integration. To do it, careful policy designs for different development phases are crucial. The fragmentation theory and new economic geography provide a useful framework for identifying bottlenecks and providing policy diagnosis.

### **3.2. Further utilizing fragmentation and agglomeration forces**

In the formation of production networks in East Asia, policy support has certainly

played an important role. However, such policies have largely been the result of passive responses to large and small requests raised by the private sector. Policy environments favorable for international production/distribution networks arose from the accumulation of trouble-shooting solutions, rather than from a well-planned grand strategy. To further activate and extend the utilization of fragmentation and agglomeration forces, we should explicitly evaluate and reorganize the policy environment.

Table 2 presents fragmentation-related policies in a matrix form. Two rows represent two-dimensional fragmentation; i.e., fragmentation along the distance axis and along the disintegration axis. For each type of fragmentation, three kinds of costs are incurred: (1) the set-up cost to develop production/distribution networks; (2) service link cost to connect production blocks; and (3) production cost per se in production blocks. To further activate international production/distribution networks, policies should strategically be geared toward reducing these costs.

Note that the required policy weights in the 2x3 matrix differ across countries at different development phases. At the initial phase of participation in international production/distribution networks, fragmentation along the distance axis has primary importance. A country or a region should invite foreign direct investment by meeting two conditions, according to the fragmentation theory. First, production cost savings in a fragmented production block must be realized. Second, the cost of service links that connects remotely-placed production blocks must not be prohibitively high. Quick improvements of the investment climate in some limited areas would work if the overall improvement for the whole country cannot immediately be implemented. Bottlenecks can be removed by developing industrial estates and reducing service link costs. Once these are in place, some production blocks may be invited through dispersion forces from neighboring industrial agglomeration.

In the next phase, in which the formation of industrial agglomeration is targeted, both types of fragmentation become important. To turn into an industrial power, forming industrial agglomeration with dense vertical and horizontal linkages is essential. To attract a large mass of production blocks, the overall improvements for fragmentation along the distance axis is crucial; such effort includes the development of one-stop services for incoming foreign direct investment, logistics infrastructure,

multiple industrial estates, and stable legal/economic systems. As for fragmentation along the disintegration axis, it is crucial to invite various kinds of firms---including upstream and downstream firms---large and small enterprises, and firms from various nationalities. A package deal of upstream and downstream investment is also effective. In addition, fostering local entrepreneurs/firms becomes important.

**Table 2: Policies for activating two-dimensional fragmentation**

	<b>Reduction in fixed costs to develop production/distribution networks</b>	<b>Reduction in service link costs connecting production blocks</b>	<b>Further cost reduction in production cost per se in production blocks</b>
<b>Fragmentation along the distance axis</b>	<p><i>Various policies to reduce investment costs</i></p> <p><b>Examples:</b>            (i) improvement in stability, transparency, and predictability of investment-related policies;            (ii) investment facilitation in FDI-hosting agencies and industrial estates; and            (iii) liberalization and development in financial services related to capital investment.</p>	<p><i>Various policies to overcome geographical distance and border effects</i></p> <p><b>Examples:</b>            (i) reduction/removal of trade barriers such as tariffs;            (ii) trade facilitation including simplification and improved efficiency in custom clearance/procedures;            (iii) development of transport infrastructure and improved efficiency in transport and distribution services;            (iv) development of telecommunication infrastructure;            (v) improved efficiency in financial services related to operation and capital movements; and            (vi) reduction in costs of coordination between remote places by facilitation of the movement of natural persons.</p>	<p><i>Various policies to strengthen location advantages</i></p> <p><b>Examples:</b>            (i) establishment of educational/occupational institutions for personnel training to secure various types of human resources;            (ii) establishment of stable and elastic labor-related laws and institutions;            (iii) establishment of efficient international and domestic financial services;            (iv) reduction in costs of infrastructure services such as electricity and other energy, industrial estates services;            (v) development of agglomeration to facilitate vertical production chains;            (vi) establishment of economic institutions such as investment rule and intellectual property rights;            and (vii) various trade and investment facilitation.</p>
<b>Fragmentation along the disintegration axis</b>	<p><i>Establishment of economic environment to reduce set-up costs of arm's length transactions</i></p> <p><b>Example:</b>            (i) establishment of economic system to allow co-existence of various business partners as well as making various types of contracts; (ii) various policies to reduce costs of information gathering on potential business partners; (iii) securing fairness, stability, and efficiency in contract; and (iv) establishment of stable and effective institutions to secure intellectual property rights.</p>	<p><i>Development of institutional environment to reduce the cost of implementing arm's length transactions</i></p> <p><b>Examples:</b>            (i) policies to reduce monitoring cost of business partners;            (ii) improvement in legal system and economic institutions to activate dispute settlement mechanism; and (iii) policies to promote technical innovations in modulation to further facilitate outsourcing.</p>	<p><i>Various policies to strengthen competitiveness of potential business partners</i></p> <p><b>Examples:</b>            (i) hosting and fostering various types of business partners including foreign and indigenous firms;            (ii) strengthening supporting industries; and            (iii) various policies to promote the formation of agglomeration.</p>

Source: Kimura (2007).



### **3.3. Utilizing collective effort toward economic integration**

From now on, East Asian countries should utilize the framework of formalized economic integration much more effectively than before. For relatively less developed countries and regions, “narrowing development gaps” is one of the regional commitments; thus, regional resources, both financial and intellectual, can be employed for this purpose.

In this regard, the removal of redundant tariffs is the first task at hand. The ASEAN Free Trade Area (AFTA) is about to see an eventual tariff removal in its six forerunner-countries and extends the free trade regime to latecomers. Such efforts should be continued in the extended East Asia as a whole.

Aside from the simple tariff removal, various efforts of trade/investment facilitation and institutional building for investment climate are required. Some of these policy elements could be incorporated into an economic integration framework that is exemplified in current free trade agreements between Japan and ASEAN countries. The development of economic infrastructure and improvement of capacity building for policy implementation are also of importance. The “development” aspect should be incorporated explicitly in East Asian economic integration efforts.

## **4. A PATH TOWARD FULLY DEVELOPED ECONOMIES**

### **4.1. Relatively less developed services sectors**

At higher development phases, countries inevitably face new challenges. They have already introduced globalizing forces and participated in international production/distribution networks. They have also successfully formulated industrial agglomeration. As the income level goes up, simple labor-intensive activities gradually lose international competitiveness. On the other hand, it is difficult to immediately jump to the level of a fully industrialized society and at the top of the product cycle. Capabilities of domestic firms and entrepreneurs are typically

insufficient for setting up their own business networks and innovation capability without help from multinational enterprises. These countries are facing competition from both lower-income and higher-income countries.

At this phase of development, the piecemeal, responsive, enclave-type policies may not work effectively. Rather, upgrading the whole society, including human resource development and overall business environment, should be accomplished. Since the pattern of economic development in East Asian countries has somewhat been biased toward a part of manufacturing activities, a better-balanced industrial structure should be required at this point in the development path. In particular, some parts of services sectors are prone to being underdeveloped and insulated from foreign competition. It is, however, important to develop competitive services sectors so as to pursue a more advanced industrial structure beyond relatively simple manufacturing operations as well as to pull national welfare up to the level of fully developed economies.

Economic integration initiatives must be fully utilized at this phase. Lessons from other countries' experiences would help. Integration initiatives generate benevolent pressure coming from international commitments.

#### **4.2. Complication in deeper economic integration**

It is, of course, a good thing that people are eager to pursue deeper economic integration beyond simple tariff removals. However, if we proceed to other policy modes such as trade facilitation, services, investment, and movement of natural persons, we have to realize that we are dealing here with issues quite different from simple trade liberalization.

This caveat is not a concern backed by the traditional argument of sequencing and gradualism. Logically, unwarranted claims of "liberalization" would rather yield pain and frustration with incomplete results, and reformers would lose their credibility in the long run. For example, the statement that claims "complete liberalization in services" does not make sense. We academic researchers should guide the liberalization momentum toward a constructive direction.

Once we go beyond simple tariff removal and step into wider policy modes, economic rationale for integration becomes complicated. First, traditional policy for

trade in goods primarily consists of border measures while other policy modes, such as policies on trade in services, are likely to be domestic policies. This means that international commitments step into the realm of domestic politics that may not be accustomed to foreign intervention.

Second, international commitments tend to go beyond the nondiscrimination principles and further incorporate measures for institutional convergence/harmonization, or a commitment on “behind-the-border” issues. The nondiscrimination principle simply calls for the removal of discriminatory practices against foreigners vis-à-vis domestic persons, allowing for international differences in legal systems or economic institutions across countries. However, some of the commitments in trade in services and intellectual property rights protection, for example, tend to include the elements that require one to remove differences across countries.

The nondiscrimination principle has a simple and robust logical background in economics, which claims that the removal of policy distortion is almost always desirable. In the case of institutional convergence/harmonization, on the other hand, the institution itself is justified as a policy tool for canceling out distortions, and thus it is logically difficult to find the first-best situation. In addition, even when convergence/harmonization is desirable, the adjustment cost may be asymmetric across countries. Whether we should go for institutional convergence/harmonization or not must be judged on a case-by-case basis rather than on a simplistic, general principle.

Third, the objective functions of the government may be different in the case of the traditional trade policy and the case of other policy modes. The context of trade policy tends to include “(static and dynamic) efficiency” only. On the other hand, in the discussion of other policy modes, efficiency may not be the only objective of the government. The government would rather like to have a social welfare function with social consideration.

There are caveats. Domestic political economy often uses above logics so as to protect vested interests. What we have to do here is to rely on the momentum of liberalization, to detect the political economy structure, and to promote liberalization and policy reform.

## **5. ARCHITECTURE OF MORE INSTITUTIONALIZED ECONOMIC INTEGRATION**

### **5.1. Can ASEAN continuously lead East Asian integration?**

The ASEAN has played an important role in constructing FTA networks in East Asia. Table 3 presents the current status of FTA conclusions in East Asia and beyond. In terms of tariff removal, ASEAN has led the initiative. That is, with the notable delay in FTA formation among Japan, Korea, and China, ASEAN has taken the driver's seat. ASEAN has also been active in negotiating and concluding FTAs with countries outside ASEAN+3, which have expanded the boundary of East Asia and has constructed an open architecture for East Asian economic integration.

However, going beyond simple tariff removal is not an easy task. Although The Asian Economic Community Blueprint is an important initiative that would lead deeper economic integration in the region, the current format itself may not become a regional model for extended East Asia. To design a convincing format of deeper economic integration, much more sophistication is required.

**Table 3: Status of FTAs in East Asia and Beyond (as of January 2008)**

	Russia	Mongolia	Japan	Korea	China	Philippines	Indonesia	Malaysia	Thailand	Singapore	Brunei	Vietnam	Laos	Cambodia	Myanmar	India	Australia	New Zealand	Chinese Taipei	United States	Canada	Mexico	Peru	Chile	
Russia	■			△												△									
Mongolia		■																							
Japan			■	○	△	◎	◎	◎	◎	◎	◎	○	○	○	○	○	○				△	◎		◎	
Korea	△		○	■	△	◎	◎	◎	○	◎	◎	◎	◎	◎	◎	○	△	△		◎	○	○	△	◎	
China			△	△	■	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	△	○	○						◎	
Philippines			◎	◎	◎	■			◎	◎	◎	◎	◎	◎	◎	○	□	□							
Indonesia			◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	○	□	□							
Malaysia			◎	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	○	○	○		○				○	
Thailand			◎	○	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	◎		○			◎		
Singapore			◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	◎	◎	◎	◎	◎	△	◎	○	○	○	◎	
Brunei			◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	◎	○	□	◎						◎	
Vietnam			○	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	◎	○	□	□							
Laos			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	◎	○	□	□							
Cambodia			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	◎	○	□	□							
Myanmar			○	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	◎	■	○	□	□							
India	△		○	○	△	○	○	○	◎	◎	○	○	○	○	○	■	△	△						△	
Australia			○	△	○	□	□	○	◎	◎	□	□	□	□	□	△	■	◎		◎				○	
New Zealand			△	△	○	□	□	○	◎	◎	◎	□	□	□	□	△	◎	■						◎	
Chinese Taipei										△									■	△					
United States				◎				○	○	◎							◎		△	■	◎	◎	◎	◎	
Canada			△	○						○										◎	■	◎	○	◎	
Mexico			◎	○						○										◎	◎	■	○	◎	
Peru				△					◎	○										◎	○	○	■	◎	
Chile			◎	◎	◎			○		◎	◎					△	○	◎		◎	◎	◎	◎	■	

Note: ◎: Entered into force/signed

○: Under negotiation/agreed to negotiate (bilateral)

□: Under negotiation/agreed to negotiate (plurilateral)

△: Under consideration (G-G base)/feasible study initiated

Source: Author's compilation from the following web-sites. World Trade Organization (<http://www.wto.org>), Organization of American States (<http://www.sice.oas.org/>), Asian Development Bank (<http://aric.adb.org/regionalcooperation/>), Ministry of Foreign Affairs, Japan (in Japanese) (<http://www.mofa.go.jp>), Ministry of Foreign Affairs and Trade, Korea (<http://www.mofat.go.kr>), Ministry of International Trade and Industry, Malaysia (<http://www.miti.gov.my>), Department of Trade Negotiation, Thailand (<http://www.thaifta.com>), Ministry of Trade and Industry, Singapore (<http://app.fta.gov.sg>), Ministry of Commerce and Industry, India (<http://commerce.nic.in>), Department of Foreign Affairs and Trade, Australia (<http://www.dfat.gov.au>), Ministry of Foreign Affairs and Trade, New Zealand (<http://www.mfat.govt.nz>), Office of the United States Trade Representatives (<http://www.ustr.gov>), Foreign Affairs and International Trade Canada (<http://www.dfait-maeci.gc.ca>), Ministry of the Economy, Mexico (<http://www.economia.gob.mx>), Ministerio de Comercio Exterior y Turismo, Peru (in Spanish) (<http://www.mincetur.gob.pe>), Ministry of Foreign Affairs, Chile (<http://www.direcon.cl>).

Source: Kuno and Kimura (2008).

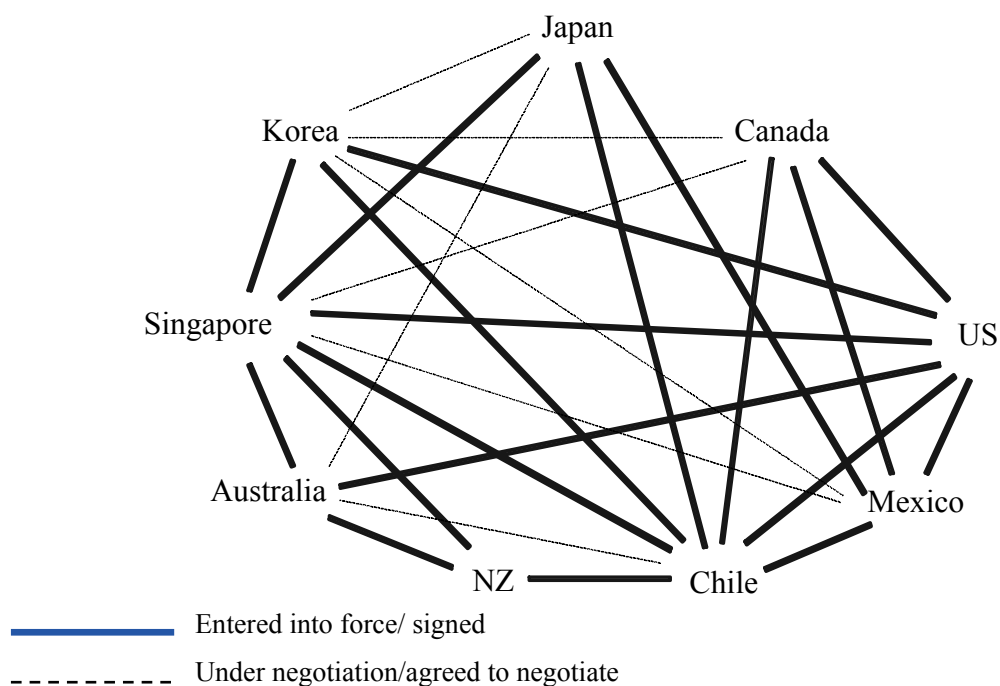
## **5.2. New open regionalism in Asia-Pacific?**

The FTA formation in Asia-Pacific is also in progress. Figure 5 highlights nine Asia-Pacific Economic Cooperation (APEC) participating countries that include seven Organization for Economic Cooperation and Development (OECD) member-countries, Singapore, and Chile. Out of 36 bilateral combinations, 19 have already been connected by FTAs. The idea of an APEC FTA that covers all APEC participating countries may not be realistic, but a path-finder approach with selected countries may be feasible once some of the major countries seriously start taking advantage of the momentum in regionalism. Furthermore, we have to note that some of the FTAs in Asia-Pacific are extremely clean and comprehensive in their liberalization coverage, particularly for trade in goods. Recently concluded FTAs by Australia, Singapore, and the United States, most notably the United States-Korea FTA, commit to an almost 100-percent liberalization for trade in goods within 10 years.

The recent emergence of clean FTAs may become a path-breaking move toward a new international commercial policy regime. To conclude completely clean FTAs with all major trading partners is, from the viewpoint of the country concerned, equivalent to accomplishing open regionalism. Trade economists have long criticized FTAs as a "dirty" policy tool in two aspects: first, FTAs virtually allow some exclusion from trade liberalization; and second, its alleged discriminatory treatment generates trade diversion and other complication such as rules-of-origin issues. However, if one country succeeds to come up with completely clean FTAs with all countries, the mentioned evils will be removed. It does not even have to stick to a geographical concept of "region" anymore; as far as free trade is pursued, any country can be a partner. Such "new open regionalism" shares the spirit of unilateral trade liberalization that trade economists have believed in but is different in that it effectively utilizes pressure against protectionism through the fear of possible isolation. A benevolent domino effect may accelerate trade liberalization in other countries.

Although policymakers are still obsessed with the belief that "FTAs are dirty" and do not intend to actively utilize such a powerful tool, we have to be prepared for the possible emergence of a "new open regionalism."

**Figure 5: Bilateral FTAs Involving Countries in Asia-Pacific(As of August 2007)**



Source: Kimura, Itakura, and Kuno (2007).

### 5.3. Link with the WTO framework

Except for the Information Technology Agreement (ITA) initiative in the latter half of the 1990s and China and Chinese Taipei's accession to the World Trade Organization (WTO) in 2001-2002, WTO has not led much improvement in the trade policy regime in East Asia. In most of the countries in East Asia, the WTO-committed tariff levels are now substantially higher than the actually applied most-favored-nation (MFN) tariff levels; i.e., tariff rate overhang is observed. Majority of East Asian countries are rather passive in using the WTO dispute settlement mechanism and admitted unilateral vehicles such as anti-dumping duties. The WTO has not been successful in incorporating new policy discipline that would reflect novel characteristics of globalization in East Asia.

However, after a possible conclusion of the Doha Development Agenda with a small package, East Asia may need to initiate exploring a new international economic order. East Asia has a number of elements for qualifying for such role. We have a superb economic growth record in effectively utilizing globalizing forces and know

what sort of policy environment is needed. We take more of a functional approach rather than a rigid legalistic approach prone to confrontation. We may lead a “new open regionalism” to accelerate global trade liberalization. In this sense, the East Asian economic integration may also have a profound value to the whole world.

## **6. POLICY RESEARCH AGENDA FOR ERIA**

The integration study group in Economic Research Institute for ASEAN and East Asia (ERIA) has a very important mission in providing intellectual support for economic integration in East Asia. The immediate projects urgently needed include the following:

- (1) Further analysis on the interaction between de facto and de jure economic integration;
- (2) Post-evaluation of integration initiatives (e.g., text and implementation of FTAs);
- (3) Assessment of actual liberalization levels (e.g., scorecards for services);
- (4) Assessment of economic institutions and the necessity for convergence/harmonization (e.g., competition policy); and
- (5) Designing the architecture of economic integration (e.g., inputs for the ASEAN Economic Community and others).

Since these topics are highly policy-oriented, close communication with policymakers in the region is also required.



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## NOTES

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<sup>1</sup> Refer to a standard textbook of international trade theory such as Helpman and Krugman (1985).

<sup>2</sup> “Machinery” includes general machinery, electric machinery, transport equipment, and precision machinery. “Machinery parts and components” are defined at the six-digit level of HS classification. See Ando and Kimura (2005) for the details. Although production networks are observed in various industries such as textiles and garment, chemicals, and software, those in machinery industries are by far quantitatively most important in East Asia.

<sup>3</sup> See, for example, Samuelson (2004) and Blinder (2006).

<sup>4</sup> See Kimura (2006) and Hiratsuka (2006).

## Chapter 2

# **Development of *De Facto* Economic Integration in East Asian Trade**

*Hiromichi Ozeki*

## **INTRODUCTION**

### **1.1. Purpose of study**

East Asia has achieved rapid growth in trade during the world economic expansion in recent decades. Its intraregional trade, most especially, has shown a remarkable performance. This study aims to examine and illustrate characteristics and features of trade in East Asia, and to contribute to the consideration on evolving trade and industrialization pattern. The study serves as a starting point for further discussion into the deepening economic integration as stimulated by political efforts (de jure integration) and into the development and current state of the de facto integration in trade.

### **1.2. Research questions**

This study aims to answer three major questions. First, what pattern (or goods) has caused the rapid expansion of trade in East Asia? To answer the question, long-term trade data classified by production stage are reviewed and insights concerning the nature of goods are derived. Second, is such trade pattern in East Asia different from that of other regions such as the North Americas or the European Union (EU)? The answer to this is important because if the leading trade pattern for de facto integration is different from that of other areas, this would mean the efforts for further integration of East Asia may have different requirements. Finally, can such trade pattern be extended to all countries in spite of the development gap?

### **1.3. Main findings**

Findings show that among all regions, East Asia has expanded the most and achieved remarkable economic integration in trade. Such expansion of East Asia's intraregional trade is led by the manufactured goods, particularly parts and components, as a result of crossborder production sharing in the machinery industry.

The study also shows that the main trade partner of East Asia on parts and components has shifted from the United States to regional members, especially ASEAN and China. This implies that the integration of East Asia has been driven by the production side through parts-and-components trade. Such trade pattern is unique and differentiates East Asia from other areas, especially the EU.

East Asia has a strong tendency as exporter of final goods to nations outside the region, which may make East Asia easily influenced by the world economy. Countries that are into parts-and-components trade (in other words, those participating in cross-border production sharing) have been gradually expanding in the region, which may suggest that these regional members have grown to improve their production capacities needed for international activities. The less developed countries of ASEAN also seem to start engaging in parts and component trade, although their trade amounts are not large at this stage. Based on previous observations, the opening up of a country for international activities such as production sharing seems to offer it a significant chance for economic development. Each member country of East Asia has its own role and contribution to the region, although parts-and-components trade is one of the effective options. Aside from this option, others supply natural and energy resources to member-countries. Still others import final goods, including those produced by such production sharing. Those contributions are not constant all throughout but dynamically changing.

### **1.4. Section organization**

In the next sections, this paper presents an overview of the world trade development then shifts back to the pattern in intraregional trade in East Asia as

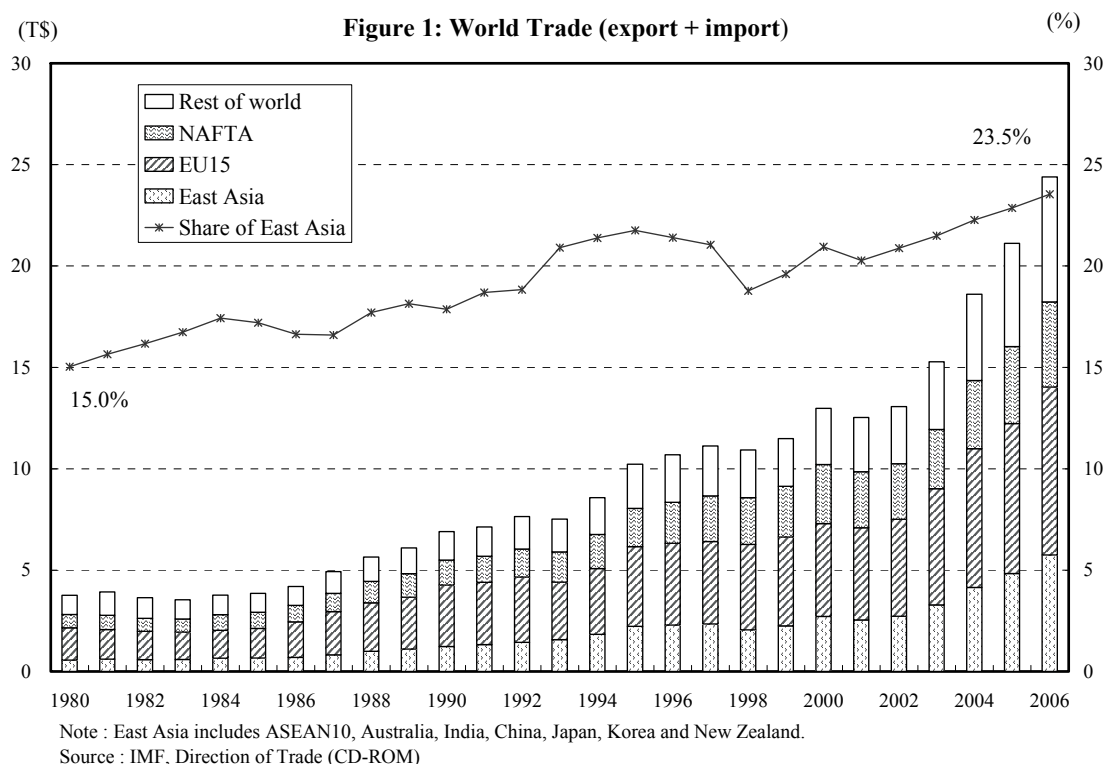
compared with other regions. The trade characteristics of individual countries in East Asia will also be dissected. The final section presents conclusions and policy implications.

## **2. OVERVIEW OF WORLD TRADE**

### **2.1. World trade development**

Figure 1 indicates the total values of world trade together with the regional breakdown. World trade increased from US\$3.8 trillion in 1980 to US\$24.4 trillion in 2006. Therefore, from 1980 to 2006, one sees an expansion of about 6.5 times. The growth, however, was not the same across economic regions. The trade value of East Asia<sup>1</sup> (ASEAN10, Australia, India, China, Japan, Korea and, New Zealand) grew by about 10 times, from US\$0.6 trillion to US\$5.7 trillion during the same period, while that of NAFTA grew 6.5 times, which is similar to the world average. The trade value of EU15 grew by only 5.2 times, which is less than the average. One can therefore say that East Asia is the most active group with the highest growth in trade.

Figure 1 also shows that East Asia's share in world trade increased from 15.0 percent in 1980 to 23.5 percent in 2006 as a result of rapid growth. On the contrary, EU15 decreased its share from 42.5 percent to 34.0 percent while NAFTA remained at almost the same share: from 17.3 percent to 17.2 percent for the same periods.

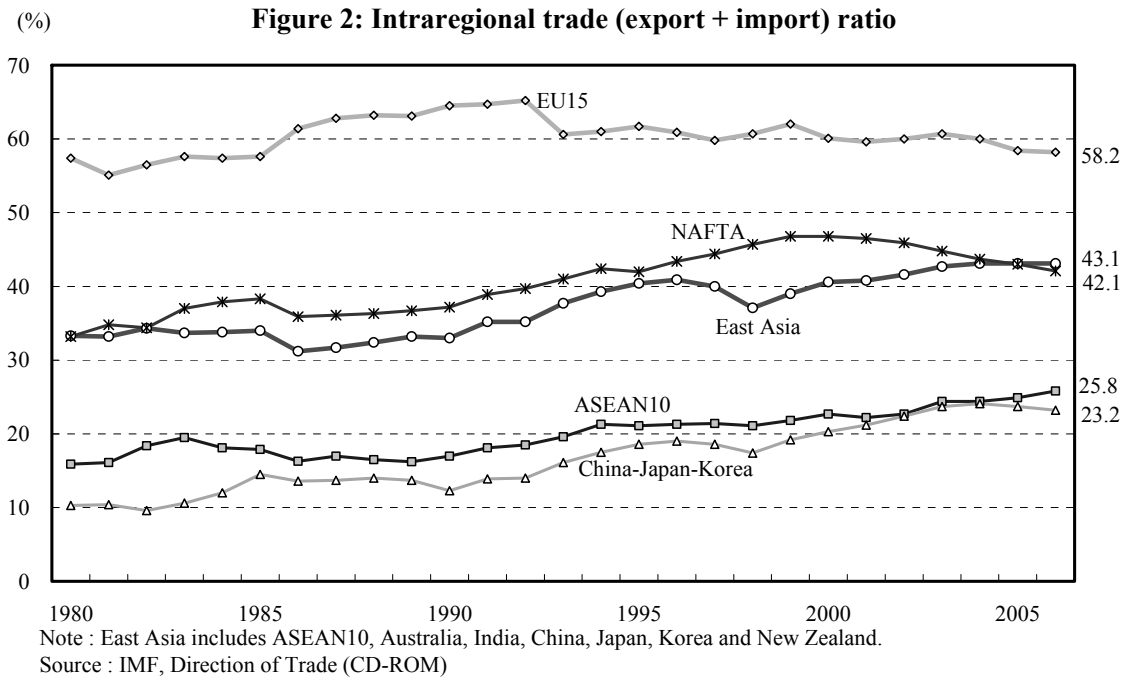


## 2.2. Intra-regional trade of economic regions

After looking at the growth of East Asia's trade, it is now time to examine East Asia's level of integration in terms of trade, in comparison to that of other economic regions such as the EU and NAFTA. For the assessment, the intra-regional trade ratio, one of the major indicators for integration in trade, is used. The aim here is to determine how strong relationship there is among regional trade partners.

Figure 2 shows the historical development of intra-regional trade ratio for several areas. Patterns of ratios are seen to differ among regions during the period involved. The intra-regional ratio of East Asia started increasing in the middle of the 1980s and sustained this in spite of the tentative decline during the Asian financial crisis. The ratios also increased for other groups such as ASEAN10 and China-Japan-Korea although these were much lower than East Asia's. On the contrary, the intra-regional trade ratio of NAFTA increased up to around year 2000, and started declining slowly after that. The ratio of EU15 remained almost at the same level after the mid 1990s. If one is to compare the current level of ratios among major economic regions, East Asia

(43.1) exceeds NAFTA (42.1) although lower than that of the EU (58.2). Based on these observations, one can say that East Asia has been advancing its economic integration in terms of trade.



### 3. CHARACTERISTICS OF TRADE PATTERN INSIDE EAST ASIA

#### 3.1. Change of main trading goods inside East Asia

In terms of trade patterns within East Asia, it is interesting to find out what type of trade pattern or trade goods caused the expansion of intraregional trade. For these, trade data, which indicate the nature of goods classified by production stage, are used for the study.

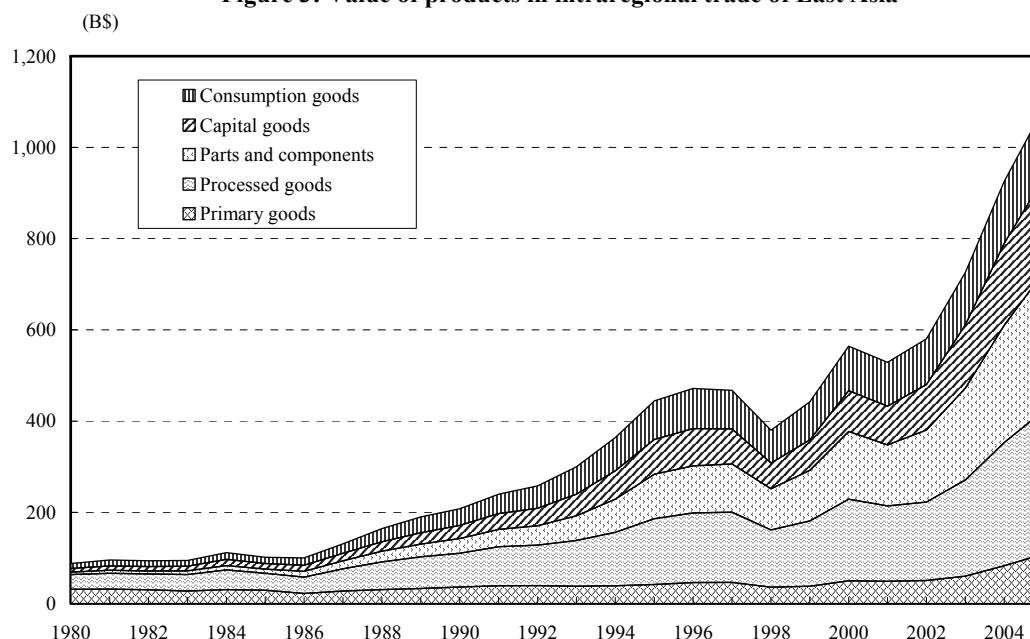
Figure 3 shows the development of intraregional trade values by production stage<sup>2</sup>. Notice that the expansion of intraregional trade is the result of industrialization of East Asia. While the trade value of primary goods remains almost at the same level, those of

the other four types of goods (namely, processed goods, parts and components, capital goods, and consumption goods)---all of which are classified as “manufactured goods”---have expanded tremendously.

Figure 4 indicates the trend in the trade share of five types of goods. A sharp decline in share of primary goods in intraregional trade is coupled by a shift to manufactured goods, although the primary goods shows a small share increase recently partly because of rising prices of commodities.

On the other hand, the expansion is not in the same manner among the four types of manufactured goods. The share of parts and components, which looks like the main driving force for expansion in intraregional trade, has a sharp upward trend. It increased more than 20 points, from 6.0 percent in 1980 to 27.7 percent in 2005. The share of capital goods also increased.

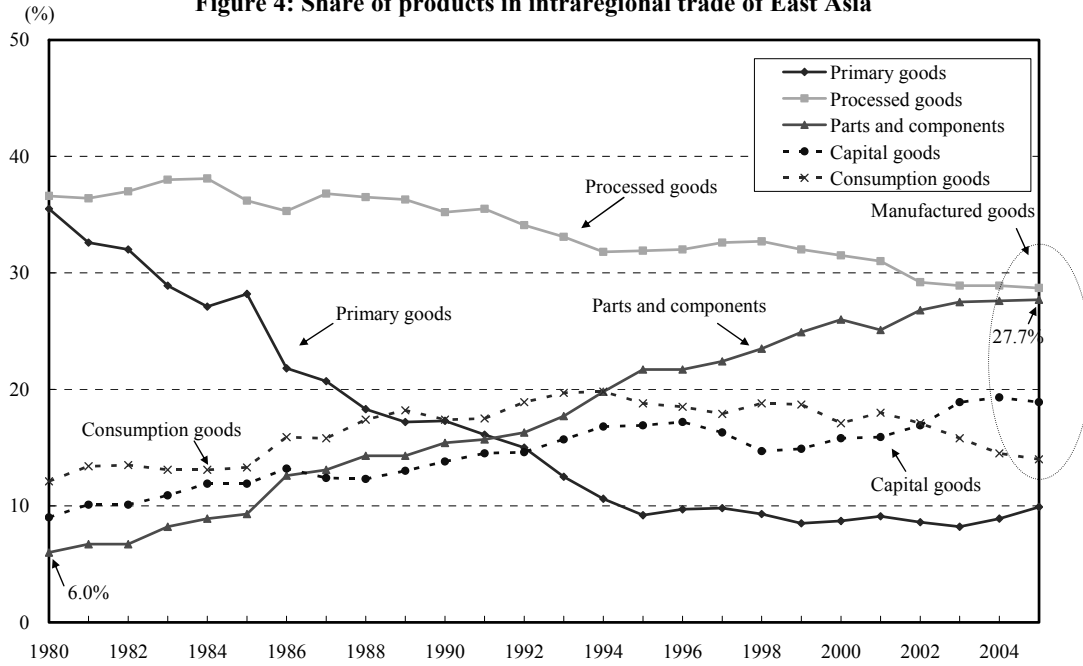
**Figure 3: Value of products in intraregional trade of East Asia**



Note : The values of trade goods are measured by import value on US dollar basis.  
 Source : Original data came from UN Comtrade database. Compiled by IDE.

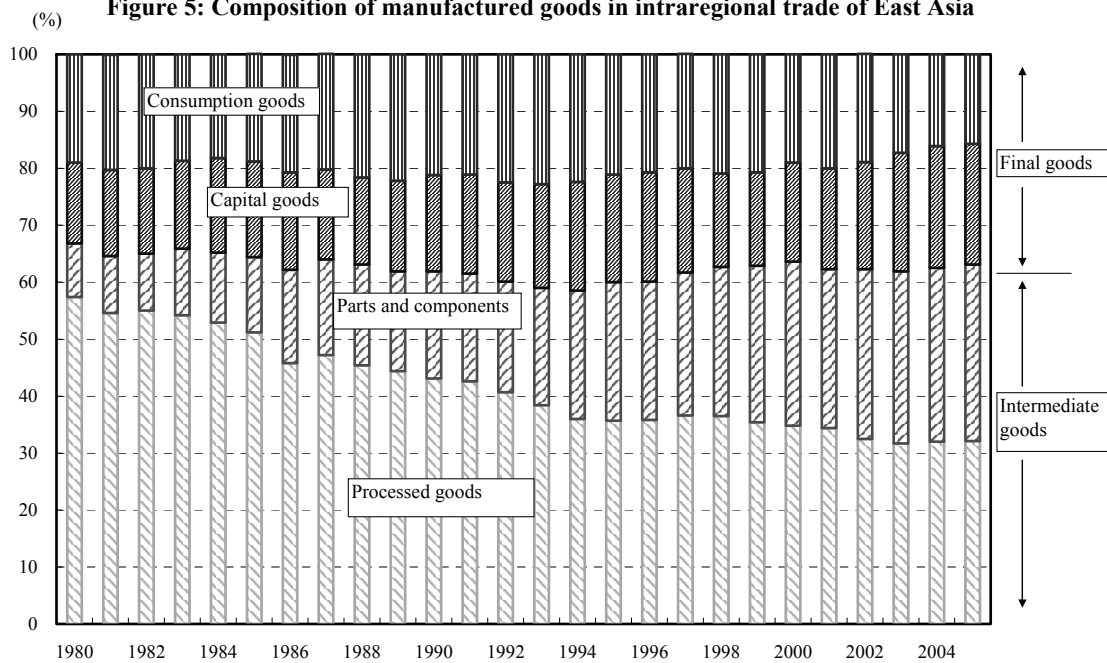


**Figure 4: Share of products in intraregional trade of East Asia**



Note : The values of trade goods are measured by import value on US dollar basis.  
 Source : Original data came from UN Comtrade database. Compiled by IDE.

**Figure 5: Composition of manufactured goods in intraregional trade of East Asia**



Note : The values of trade goods are measured by import value on US dollar basis.  
 Source : Original data came from UN Comtrade database. Compiled by IDE.

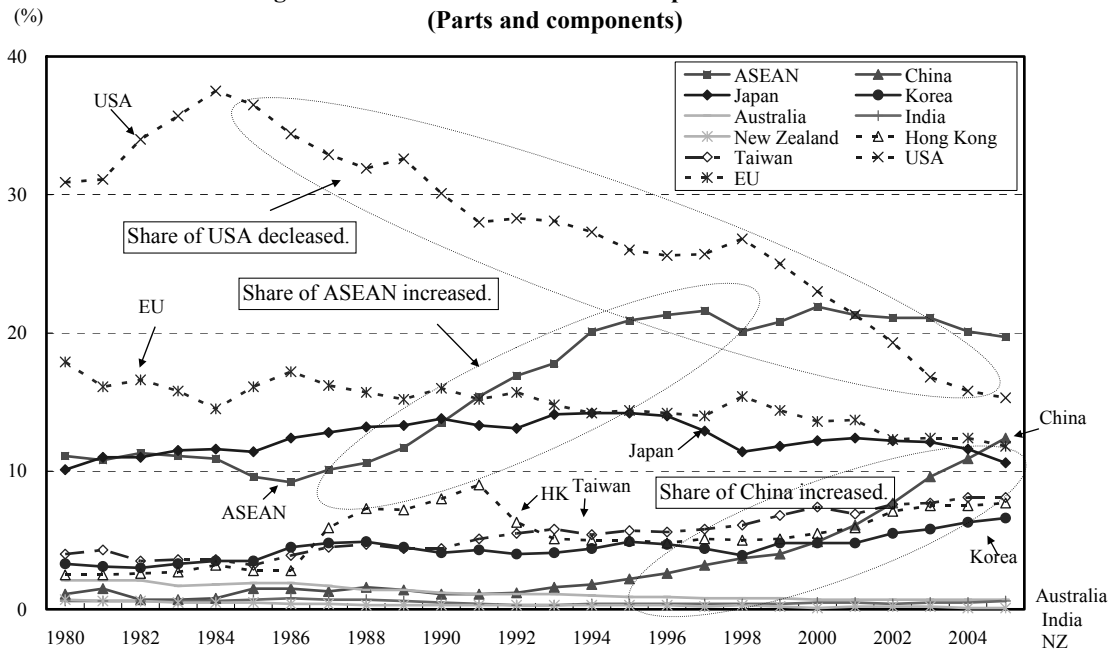
With regard the composition of manufactured goods, Figure 5 illustrates that the share of intermediate goods has not changed much. Again, parts and components has expanded its share, while processed goods has decreased among the intermediate goods. This suggests two possibilities. One possibility is that transactions of machinery have expanded in intraregional trade of East Asia. Another is that the production processes are divided across different locations in various countries, and trade of parts and components surged between those production blocks, along with production sequence. This phenomenon, known as the cross-border production sharing (or fragmentation), occurs when the locations have different advantages (such as different factor prices) for a certain production process and the trade costs between locations are reasonable. The diversity of countries in East Asia, together with trade liberalization, seems to offer a significant chance for development of cross-border production sharing. The increase in share of capital goods and the more striking growth of parts and components than capital goods may support both possibilities.

### **3.2. Trade partner of parts and components**

Now that parts and components has been acknowledged above as the key product category for expansion in intraregional trade, one can continue to ask: Is parts and component the driving force that strengthens integration in trade? The next table focuses specifically on this product category.

Figure 6 showed the share of trade partners with regard to parts and components. Note that the main trade partner shifted drastically from the United States to the neighboring countries in East Asia. The ASEAN increased its share remarkably during latter half of the 1980s and first half of the 1990s. China crept its way in the 1990s. The figure concludes that ASEAN and China got more importance than the United States from the 1980s to 2005. It may also imply that even countries with relatively low income can play an active part in this activity.

**Figur 6: Trade share of East Asia with partner countries  
(Parts and components)**



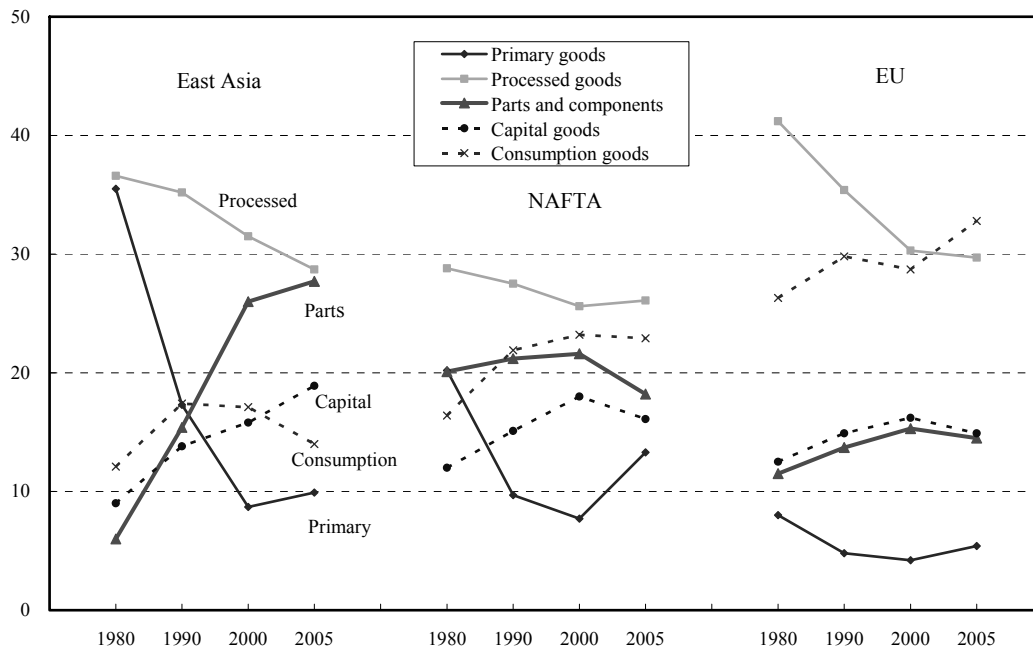
Note : Trade include both export and import.  
Source : Original data came from UN Comtrade database. Compiled by IDE.

### 3.3. Contrast of trade pattern against NAFTA and EU

Next, is such trade pattern in East Asia different from the patterns of other regions such as NAFTA or EU?

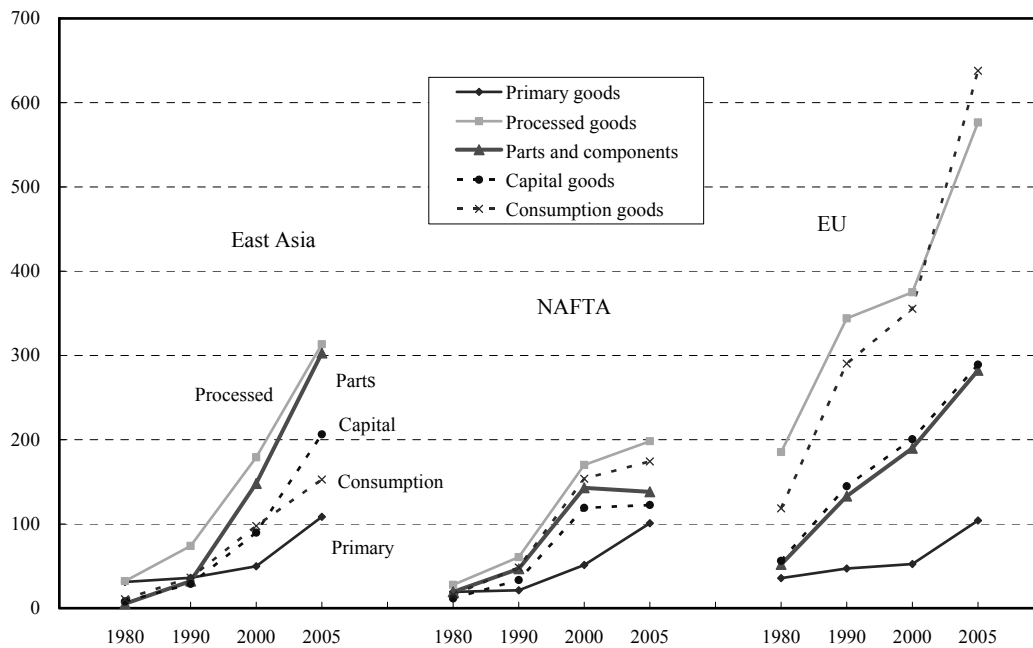
Figure 7 compares the share of parts and components in intraregional trade across three regions. Once more, East Asia has climbed rapidly to a level higher than those of NAFTA or EU. This trade feature of East Asia shows a clear contrast, especially with EU, whose largest share of goods is classified as consumption goods. One can conclude that East Asia is characterized by parts-and-components transactions.

**Figure 7: Share of trade goods in intraregional trade**



Note : The values of trade goods are measured by import value on US dollar basis.  
Source : Original data came from UN Comtrade database. Compiled by IDE.

**Figure 8: Value of trade goods in intraregional trade**



Note : The values of trade goods are measured by import value on US dollar basis.  
Source : Original data came from UN Comtrade database. Compiled by IDE.

Figure 8, meanwhile, indicates that the import value of parts and components of East Asia exceeded NAFTA in 2000 and EU in 2005. This trade pattern is unique when comparing not only with developed regions but with developing regions such as South America as well. For example, the share of parts and components in intraregional trade of MERCOSUR (composed of Argentina, Brazil, Paraguay and Uruguay) is only 12.7 percent as against 27.7 percent of East Asia in 2005.

### 3.4. Trade with those outside the region

After looking into the intraregional trade in East Asia, the next step here is to review the features of East Asia's trade with those outside the region.

Figure 9: Share of trade goods (East Asia → Outside)

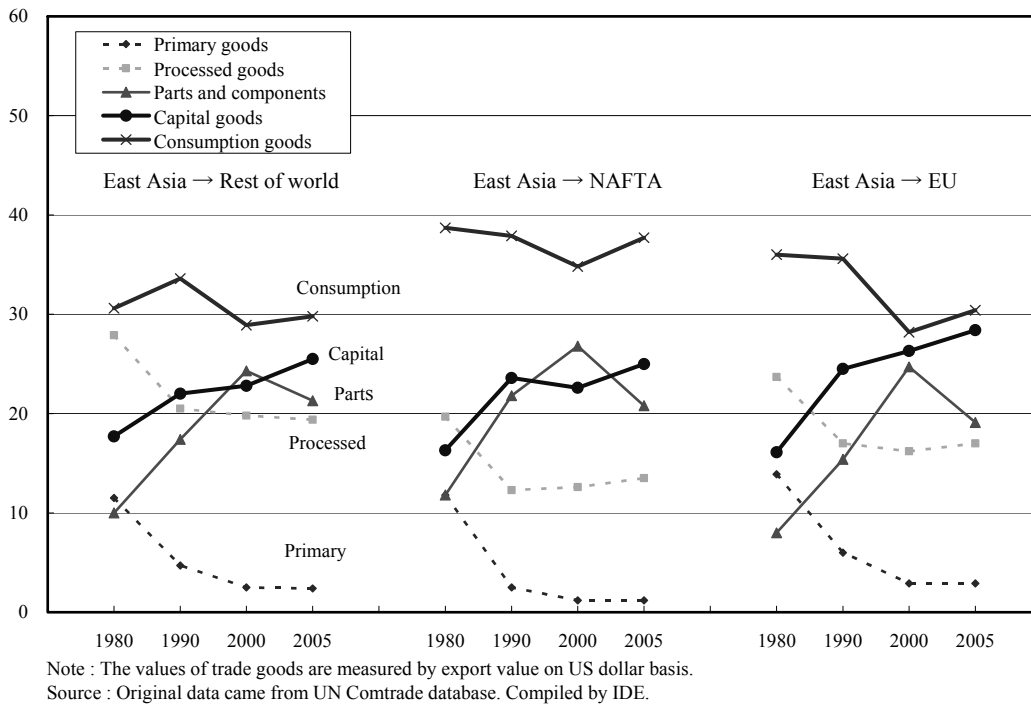


Figure 9 shows the share of East Asia's trade goods exported to the rest of the world. A large portion of export from East Asia to countries outside the region is composed of final goods (i.e., consumption goods and capital goods), which is a stark contrast to the situation in its intraregional trade. In the case of exports to the rest of the

world, the largest category, consumption goods, holds around 30 percent in 2005 and the second, capital goods, is 25 percent and rising. East Asia seems to export final goods, assembled by cross-border production sharing in the region, to outside the region, earning for itself the monicker, “factory of the world”. Around 70 percent to 80 percent of total exports of final goods was sold outside in the 2000s. East Asia may heavily rely on outside countries such as those of NAFTA and the EU for the final demand. This implies how East Asia is easily influenced by the world economy. In this required, East Asia might consider to go the way of self-reliance for the sake of economic stability as well as domestic welfare.

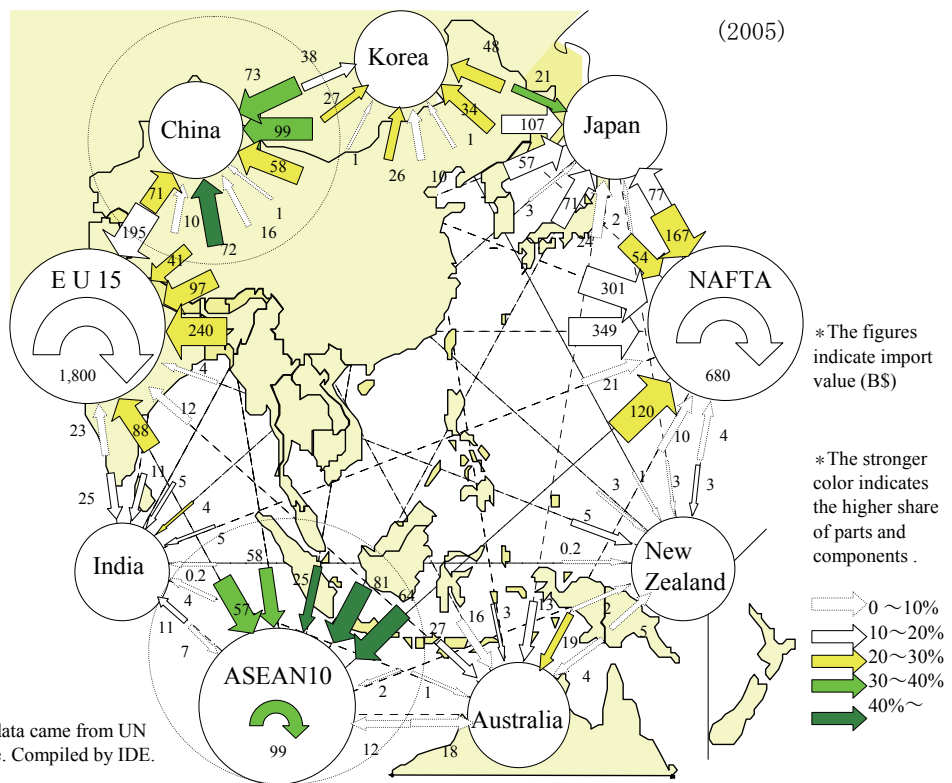
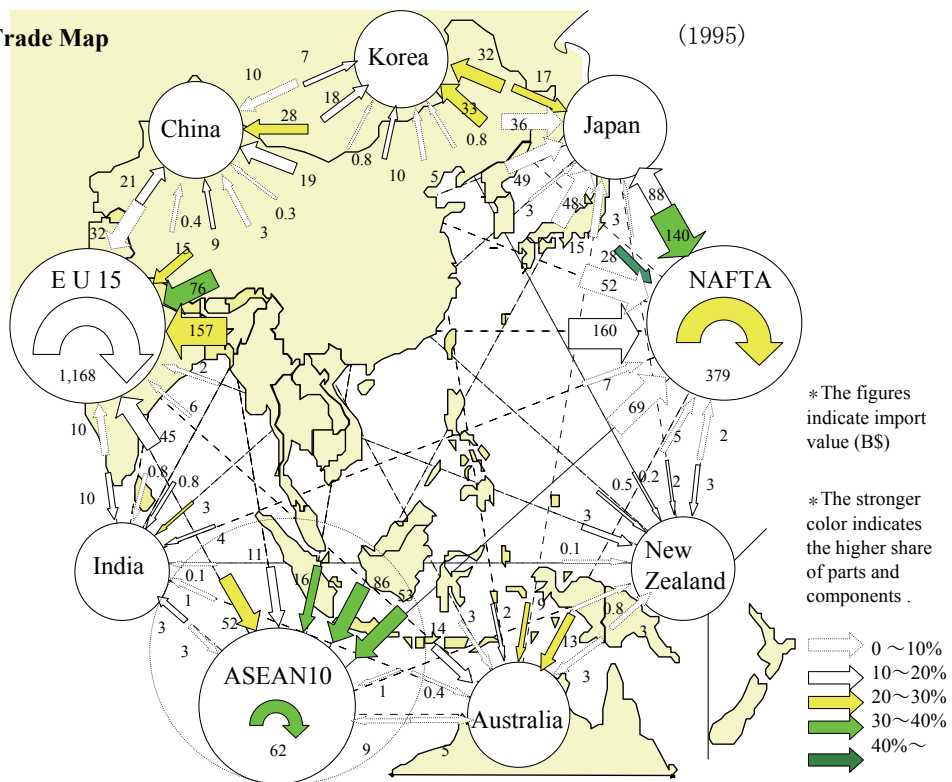
## **4. DEVELOPMENT OF TRADE OF INDIVIDUAL COUNTRY**

### **4.1. Expansion of engaging countries in parts-and-components trade**

The previous sections looked into the trade pattern of East Asia as a region. Now, will findings be the same if one were to examine the case of its member-countries?

Figure 10 shows the sites where parts and components have a large share in trade and how such has expanded in East Asia gradually. At first, ASEAN was engaged in active import of parts and components from Japan and Korea in 1995. Later, China joined the activities and became another center of parts and components business. It got more complicate from hereon. Both ASEAN and China started to export parts and components as well as import. On the other hand, Japan and Korea expanded their parts and component import. It began to look like ASEAN and China started their assembly process as part of production sharing (fragmentation) and more. They expanded production by gathering a wide variety of related factories in their locations as well as expanding production capacity of individual players. Such process of gathering, called *agglomeration*, occurred together with fragmentation. Those countries accumulated both assemblers and parts suppliers. As a result, mutual trade of parts and components expanded in East Asia.

Figure 10: Trade Map



Source : Original data came from UN Comtrade database. Compiled by IDE.

## **4.2. Contribution of individual countries in East Asia**

Parts and component trade is a vital driving force in East Asia's trade expansion and deepening economic integration. As mentioned earlier, its geographic reach had gradually spread around the region. However, some countries are not as active in parts-and-component trade. Does it mean trade integration is not fully achieved? Well, parts and component trade is not the only way toward integration. Each country may have a different role and contribution to intraregional trade.

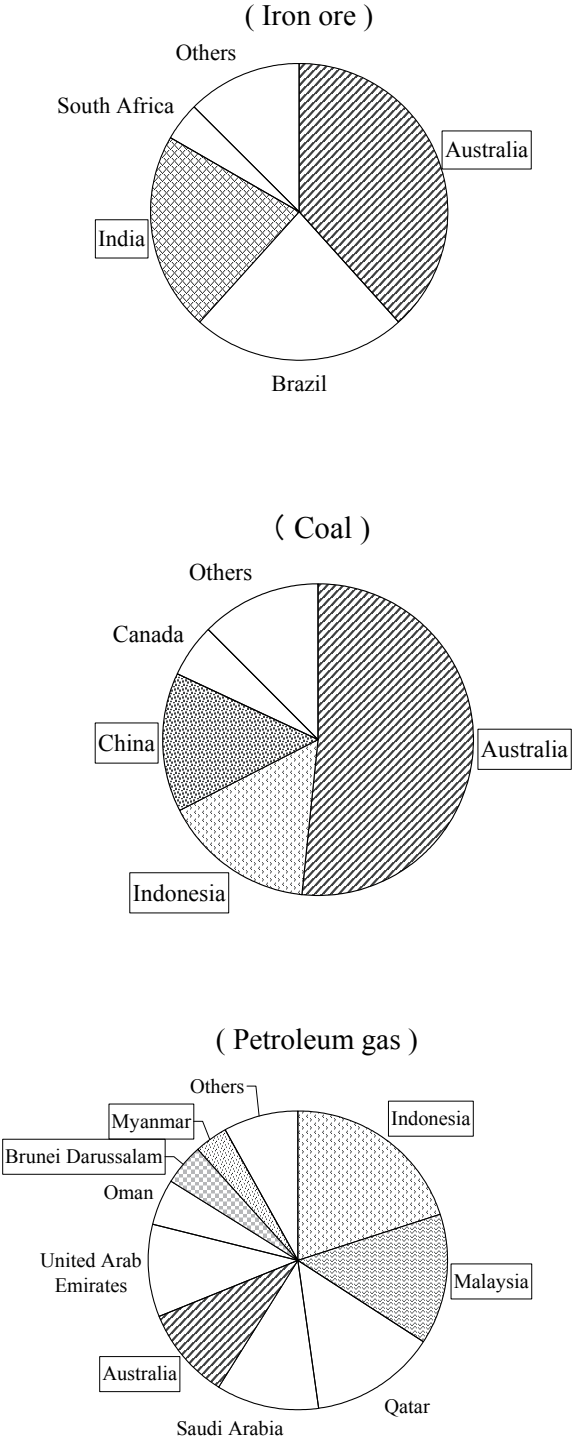
While ASEAN, China, Japan, and Korea are actively engaged in parts-and-components trade, East Asia also heavily engages in export to countries outside the region, which makes East Asia easily influenced by the world economy. How about the demand situation inside the region? Figure 10 also shows that relatively high-income countries such as Japan, Korea, Australia, and New Zealand contribute to intraregional trade as importers of final goods.

The recent rise in oil and other commodity prices is a frequent reminder of how important a stable supply of essential resources is. Figure 11 shows situations where a large portion of East Asian imports for energy and natural resources is supplied by regional members. In the case of iron ore, Australia is the biggest supplier to East Asia, whose share is one-third of total import, followed by Brazil and India. Also, half of total import of coal comes from Australia, followed by Indonesia and China. Around half of the region's petroleum gas is supplied by regional members such as Indonesia, Malaysia, Australia, Brunei Darussalam, and Myanmar.

Note, however, that this export and import relation is far from static; in fact, the situation is dynamically changing.



**Figure 11: Main exporters of energy and resources to East Asia**



Note: Figures are calculated by import values of East Asian countries. Here, East Asia includes Australia, China, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand.  
 Source: Global Trade Information Services Inc., World Trade Atlas database.

### 4.3. Current status inside ASEAN

The ASEAN's share in intraregional trade of parts and components is tremendously high: almost 40 percent in 2005. However, one may ask: Is such level of involvement even among all ASEAN countries, including the less developed members?

Figure 12: Imports of parts and components (2005)

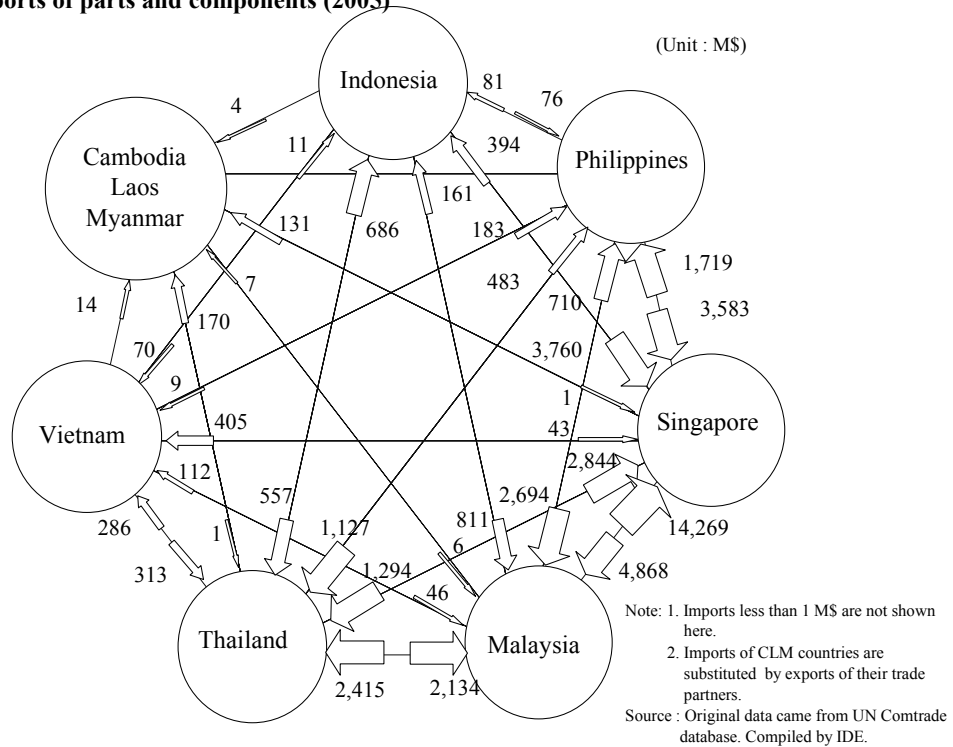


Figure 12 illustrates the import flow of parts and components inside ASEAN. Many ASEAN members such as Indonesia, Malaysia, Philippines, Singapore, and Thailand import large quantity of parts and components mutually, but how about the rest of the region? Vietnam seems to be already involved in the parts-and-components business, which implies that it is already part of the international production network. Meanwhile, Cambodia, Laos, and Myanmar have just started to take part, although their import values are not high at this stage. Nonetheless, opening up a country to international trade allows for economic development.

## **5. CONCLUSIONS AND POLICY IMPLICATIONS**

Transactions on parts and components for the machinery industry have a significant role in intraregional trade, which is reflected by the cross-border production sharing in East Asia. Such is a characteristic unique to East Asia, although the region's heavy dependence on other regions' demand for final goods may be another matter. The expansion of such trade, together with the increase in the number of participating member-countries, has promoted economic integration in East Asia. The less developed countries in East Asia also seem to benefit from the trade, although at a much smaller scale.

What all these show is that participation in and utilization of an international production network can offer a significant chance for economic development as well as integration. The current efforts at trade liberalization should be continued and strengthened.

This study is limited to trade issues and does not yet examine the potential factors that promote or prevent such trade in East Asia. Future research may therefore wish to focus on investment and other related issues aside from trade. Empirical studies may need to look into trade and industrial data such as bilateral trade value (or share) of parts and components, size of economy, level of tariff rate, engagement in free trade agreements, improvement of infrastructure, expansion of supporting industry, and level of factor prices. Such future research may be similar and related to the studies on determinants of FDI flows, especially on influence of policy measures, using the gravity model analysis (Hattari and Rajan (2008), Sasatra Sudsawasd (2008), conducted under ERIA project). It is expected to show how lower trade barriers and better business environments can offer bigger chances of success in international production sharing.

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## **APPENDIX: Data and methodology**

This study used the United Nation's COMTRADE database on Broad Economic Categories (BEC). The BEC data help the analysis focus on the type of trade goods in terms of production process. However, the available time-span of COMTRADE data is short: its data are available on and after 1995 only. The Institute of Developing Economies (IDE) recalculated SITC data to BEC format to get a long-term series (1980-2005).

Analysis is carried out by focusing on five types of trade goods classified by production stage, and using the BEC codes<sup>3</sup>. Table 1 and Table 2 show the relation between five types of trade goods and BEC code.

**Table 1: Classification of Trade Goods by Production Process.**

1. Primary goods
  - 111 Food and beverages, primary, mainly for industry
  - 21 Industrial supplies nes, primary
  - 31 Fuels and lubricants, primary
2. Intermediary goods
  - (1) Processed goods
    - 121 Food and beverages, processed, mainly for industry
    - 22 Industrial supplies nes, processed
    - 32 Fuels and lubricants, processed
  - (2) Parts and components
    - 42 Parts and accessories of capital goods (except transport equipment)
    - 53 Parts and accessories of transport equipment
3. Final Capital goods
  - (1) Capital goods
    - 41 Capital goods (except transport equipment)
    - 521 Transport equipment, other, industrial
  - (2) Consumption goods
    - 112 Food and beverages, primary, mainly for household consumption
    - 122 Food and beverages, processed, mainly for household consumption
    - 51 Transport equipment, passenger motor cars
    - 522 Transport equipment, other, non-industrial
    - 61 Consumption goods nes, durable
    - 62 Consumption goods nes, semi-durable
    - 63 Consumption goods nes, non-durable

**Table 2: BEC code and production process**

BEC Code	Item	Production process				
		Primary goods				
		Processed goods				
		Parts & components				
		Capital goods				
					Consumption goods	
1	Food and beverages					
11	Food and beverages, primary					
111	Food and beverages, primary, mainly for industry	○				
112	Food and beverages, primary, mainly for household consumption					○
12	Food and beverages, processed					
121	Food and beverages, processed, mainly for industry		○			
122	Food and beverages, processed, mainly for household consumption					○
2	Industrial supplies nes					
21	Industrial supplies nes, primary	○				
22	Industrial supplies nes, processed		○			
3	Fuels and lubricants					
31	Fuels and lubricants, primary	○				
32	Fuels and lubricants, processed		○			
321	Fuels and lubricants, processed, motor spirit					
322	Fuels and lubricants, processed (other than motor spirit)					
4	Capital goods (except transport equipment), and parts and accessories thereof					
41	Capital goods (except transport equipment)				○	
42	Parts and accessories of capital goods (except transport equipment)			○		
5	Transport equipment, and parts and accessories thereof					
51	Transport equipment, passenger motor cars					○
52	Transport equipment, other					
521	Transport equipment, other, industrial				○	
522	Transport equipment, other, non-industrial					○
53	Parts and accessories of transport equipment			○		
6	Consumption goods nes					
61	Consumption goods nes, durable					○
62	Consumption goods nes, semi-durable					○
63	Consumption goods nes, non-durable					○
7	Goods nes					

## NOTES

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1. East Asia includes ASEAN10 (Brunei Darussalam, Indonesia, Cambodia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) plus Australia, India, China, Japan, Korea, and New Zealand in this paper unless mentioned otherwise. NAFTA includes Canada, Mexico and United States. The EU includes Austria, Belgium, Denmark, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and United Kingdom (15-country basis). Although the official members of each region (East Asia, ASEAN, NAFTA and EU) may change across periods, the calculation is conducted on the same country basis.
2. Depending on data availability, figures of some countries may be estimated or excluded. For example, the data on China (1980-1983) and Brunei Darussalam (1995, 1996, 1999, 2000, 2004, and 2005) are not included. Data on Laos and Myanmar are substituted by their trade partners'. Data on Cambodia and Vietnam for the years not covered by the COMTRADE database are also substituted by those of their partners. Data are not provided if both the figures for the country in question and that of its partner are both unavailable. Finally, the figures on recent years may be tentative.
3. This transformation method (type of trade goods by production process and BEC code) is used in some literature such as METI (2005), METI (2007), Gaulier, Lemoine and Unal-Kesenci (2006).

## Chapter 3

# **Implementing the ASEAN Economic Community (AEC) Blueprint**

*Hadi Soesastro*

## **INTRODUCTION**

The Association of South East Asian Nation (ASEAN) Vision 2020, adopted in December 1997, envisaged “a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services, investment and freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities” by the year 2020. To realize this, the ASEAN Leaders signed the Declaration of the ASEAN (Bali) Concord II in October 2003 aiming at an ASEAN Economic Community (AEC) as an end goal of its economic integration.

At the 11<sup>th</sup> ASEAN Summit in December 2005, the ASEAN Leaders discussed the acceleration of the AEC implementation from 2020 to 2015 and requested the concerned Ministers and Senior Officials to study its possibilities. Subsequently, the 9<sup>th</sup> High Level Task Force (HLTF) Meeting on ASEAN Economic Integration in Singapore discussed and recommended it to the ASEAN Economic Ministers (AEM). Thus, the ASEAN Secretariat was tasked to develop “a single and coherent blueprint for advancing the AEC, by identifying the characteristics and elements of the AEC by 2015, consistent with the Bali Concord II, with clear targets and timelines for implementing various measures and pre-agreed flexibilities for the interests of the Cambodia, Laos, Myanmar, Vietnam (CLMV) and other concerned Member Countries.” In their August 2006 Meeting, the Ministers recommended the acceleration of AEC implementation. Likewise, they agreed to endorse and propose it during the 12<sup>th</sup> ASEAN Summit in Cebu, Philippines.



Accordingly, the ASEAN Leaders agreed to accelerate AEC establishment to 2015 during the 12<sup>th</sup> Summit in January 2007 and adopted the AEC Blueprint in the following 13<sup>th</sup> Summit in November 2007. It took one full decade for ASEAN to translate its vision into a blueprint.

## **2. SIGNIFICANCE OF THE AEC BLUEPRINT**

The Declaration on the AEC Blueprint stipulates that, “each ASEAN Member Country shall abide by and implement the AEC by 2015.” Concerned Ministers were tasked, with assistance from the ASEAN Secretariat, to implement the AEC Blueprint and report regularly on the progress of its implementation to the Council of the AEC.

The AEC Blueprint is a very significant development milestone in ASEAN, as an organization, in general, and in its specific efforts to deepen regional economic integration. The AEC Blueprint is a clear departure from ASEAN’s tradition since it has never devised a blueprint before to achieving its objectives. The process of regional cooperation and ‘regional community building’ in the past had been left open-ended. It has been driven by the dynamics of the process itself that oftentimes had been dictated by the slowest mover. ASEAN remains a voluntary organization at large, with decisions being mostly non-binding in nature. There is a serious lack of capacity in ASEAN to enforce its decisions either at the regional or at the national level. Many of its past initiatives had been implemented disappointingly slow.

With the adoption of the Blueprint, ASEAN departs from a process-driven integration into that driven by clearly defined goals and timeframes. The AEC Blueprint is a binding declaration of commitments by all Member Countries.

The Blueprint is like a master plan, consisting of the roadmaps that direct the Member Countries on delivering target outcomes, namely the AEC objectives, by managing sets of deliverables or core elements, and carrying-out customized delivery vehicles or actions/measures within a scheduled timeframe.

The Blueprint is organized along the AEC’s four primary objectives (or characteristics), namely: (a) a single market and production base; (b) a highly

competitive economic region; (c) a region of equitable economic development; and, (d) a region fully integrated into the global economy. It is a comprehensive plan, with 17 ‘core elements’ and 176 priority actions, to be undertaken within a *Strategic Schedule* of four implementation periods (2008-2009, 2010-2011, 2012-2013 and, 2014-2015).

Considering the gaps existing amongst Member Countries, the Blueprint is not a detailed agreement with clearly defined targets based on lengthy up-front negotiations unlike that of the North American Free Trade Area (NAFTA). NAFTA is a narrow, yet, a deep integration project and is also not about ‘community building’. In the case of the AEC, there are elements and details that can be realized only when necessary agreement and support have emerged out of greater confidence and comfort in the process and broadening of domestic constituencies. These are accommodated by the Blueprint’s pre-agreed flexibility provisions.

In a sense, the ASEAN process towards realizing the AEC is more like that of the European Union’s (EU) rather than that of NAFTA. The stark and important difference, however, is that the EU’s integration process is driven by its strong regional institutions, of which the ASEAN still needs to build on.

It should be noted that the Blueprint has still some vaguely defined goals and missing milestones. In the process of its implementation, therefore, signposts should be set-up along the road to indicate the progress in achieving the goals. Here is where ‘analytical-based ASEAN Scorecards’ can play a useful, perhaps, a critical role in the successful implementation of the Blueprint<sup>1</sup>.

The Blueprint can also be instrumental in coordinating the many efforts to achieving the objectives and to drive the process of integration. It provides the framework for the development of a set of peer review mechanisms based on systematic regional-national monitoring and tracking systems. It is also the basis for setting-up of meaningful ‘signposts’ to indicate progress (or the lack thereof) towards achieving the four primary objectives of AEC. These processes can facilitate the identification of areas of analysis, policy development and, technical inputs needed along the process.

Having a blueprint also implies opening up the process of regional economic integration to greater public scrutiny. ASEAN has been making progress in publicizing its many initiatives, but it seldom informs the public about their implementation and outcomes. Many observers have been complaining about ASEAN’s lack of

transparency on this aspect, which could be a measure to spare its Member Countries from the embarrassment of failing to implement their commitments. The Association appears to have realized that this lack of transparency could be the cause for its poor performance record.

Hence, efforts towards systematic monitoring, tracking and, publicizing of the implementation will contribute to the successful realization of the Blueprint.

As the Blueprint aimed for the region's full integration in the global economy, it also imparts useful and operational bases for an expanded economic integration agenda to include the wide East Asian region.

### **3. CRITICAL AREAS OF IMPLEMENTATION**

The AEC is an extension of major ASEAN initiatives over the past few years, including the ASEAN Free Trade Area (AFTA), the ASEAN Investment Area (AIA) and, the ASEAN Framework Agreement on Services (AFAS). These can serve as the building blocks of the AEC because they constitute its core elements. As such, the AEC can build on their respective achievements and that of the 2001 Initiative for ASEAN Integration (IAI). However, relevant adjustments pertinent to each of those initiatives may be necessary.

Being comprehensive and in view of the accelerated target date, the AEC and its Blueprint may be ambitious. Defining the outcomes and the required tasks for creating a single market and production base are perhaps the least complicated among the four objectives of the AEC. However, getting this implemented is a different matter.

Essentially, a single market and production base is about providing consumers in the region with a larger market place, where they can satisfy their consumption needs, while offering its producers with an expanded space for their production activities, regardless of existing national (administrative) boundaries within the region. This implies the total removal of all trading barriers in goods, services and, investment. Removal of these barriers still faces many hurdles: physically, technically, economically, politically and culturally.

A Free Trade Area (FTA) in goods is the first step in regional economic integration. Tariffs in manufactured goods can be eliminated readily as compared with that in selected agricultural products. Since many FTAs have set fixed carve-outs on some sensitive sectors. Minimizing those carve-outs is likely to be the cause of the prolonged negotiation processes of FTAs. Beyond this, the agreement must also include a set schedule of tariff reduction and elimination of non-tariff barriers within a reasonable period. AFTA has adopted its own approach. In addition to the general exclusion list (GEL), AFTA has a built-in temporary exclusion list (TEL) and sensitive list (SL). In the process, items in the SL will be progressively moved to TEL while those in TEL will be progressively shortened and ultimately eliminated. GEL is justifiable only if it follows the universal rules. In fact, the AFTA approach of not fixing its carve-outs at the outset can be more liberalizing, but this approach contains an element of uncertainty.

Nevertheless, tariffs in the ASEAN-6 (the six oldest ASEAN members) had been reduced significantly. Most of their products are already in the inclusion list (IL) with about 0-5 percent tariffs. At least 60 percent of those in the IL have zero tariffs already. Above five percent tariffs of recently moved products into the IL will be reduced to 0-5 percent by 1 January 2010.

Despite these developments, the public has yet to consider AFTA seriously. The share of intra-ASEAN trade has not appeared to have been affected by AFTA, although its increase is not a primary gauge of AFTA's success. ASEAN economies are globally oriented and to remain so suggest their success in maintaining their international competitiveness, another key objective of the AEC. Instead of diverting trade from global to regional market, AFTA should watch over more important indicators like its overall trade growth and dynamism. The stable share of intra-ASEAN trade in the total ASEAN trade could signify its success in maintaining trade growth in both the global and ASEAN markets. This is attributed mostly to substantial proportion of manufacturing in ASEAN trade, especially the growing intra-industry trade, in parts and components, which in turn increased the exports of final products to markets outside ASEAN. A fuller picture of the working of regional production networks can be gained by expanding the scope of analysis to the wider East Asian region. The AEC Blueprint also aims at strengthening and deepening the role of ASEAN in these production networks.

In what follows is a provisional list of the critical areas for the implementation of the AEC Blueprint. With regard to the establishment of a single market and production base, the following are the main issues:

- (a) AFTA has brought about significant reduction and elimination of tariffs for goods. The challenge now is how to tackle a host of non-tariff barriers.
- (b) AFAS has not gone that far. The question is whether ASEAN should adopt a new approach in liberalizing trade of services.
- (c) AIA is based on an outdated concept. The task is to develop a new scheme for investment liberalization that can promote the region's dynamic involvement in regional and international production networks.
- (d) Many ASEAN trade and investment facility programs, including capacity building, could be strengthened through synergy with similar programs of wider regional cooperation arrangements (e.g., ASEAN Plus Three, APEC).

Pertaining to the second AEC objective of achieving a competitive economic region, among the key issues are:

- (a) The development of regional guidelines on competition policy;
- (b) The need to conduct a comprehensive review of existing ASEAN Action Plans (e.g., Intellectual Property Rights (IPR), Transport, Energy, among others) and to streamline them according to the *Strategic Schedule* of the AEC Blueprint; and,
- (c) The creation of a Regional Infrastructure Development Fund with the participation of other ASEAN Plus Three (APT) or East Asia Summit (EAS) partners.

With regard to the objective of achieving equitable economic development, key issues include:

- (a) The need to undertake a full review of the ASEAN Policy Blueprint for SME Development to identify real promising actions;
- (b) Serious efforts to translate the concept of "ASEAN (regional) public goods" into practice;

- (c) Development of mechanisms to deliver real and sustained technical assistance to the CLMV countries; and,
- (d) Establishment of an ASEAN Development Fund (ADF).

With the objective of full integration into the global economy, the main challenges are:

- (a) Development of approaches and mechanisms to strengthen ASEAN's role as "hub" in the East Asian integration; and,
- (b) Development of an effective and 'open regionalism' cooperation schemes with other parts of the world (e.g., North America, Europe and, Latin America).

An earlier assessment, based on a series of research, listed the following key questions<sup>2</sup>:

- (a) Whether or not the roadmap to achieve the AEC is realistic, given the relatively short implementation period (timeframe) set to undertake it;
- (b) Whether the progress made in expediting economic integration, particularly the acceleration of integration of the priority sectors, remains on track to achieve its targets and objectives;
- (c) Whether ASEAN has the institutional framework to support such deeper economic integration; and,
- (d) Whether ASEAN would be able to successfully address the economic development divide among its Member Countries.

The assessment also emphasized the following challenges and issues that ASEAN needs to address to achieving the AEC: (a) deal with the barriers to trade; (b) expediting investment and services trade liberalization; (c) strengthening the ASEAN Dispute Settlement Mechanism (DSM); (d) deal with the proliferation of FTAs; and, (e) narrow down the development gap among ASEAN Member Countries.

The issues identified in previous assessments on trade barriers focused on the low utilization of AFTA's preferential tariffs, or the Common Effective Preferential Tariffs (CEPT). Among the possible given reasons were lack of clear and transparent procedures, lack of mutual trust between preference-receiving country and preference-granting country, low margin of tariff preferences between CEPT and most-favored

nation (MFN) rates and, lack of private sector awareness. Apparently, even the rather simple rules of origin (ROO) in AFTA have been fraught with problems during implementation.

Likewise, it was found out that non-tariff measures (NTMs) continue to persist and impede intra-ASEAN trade, particularly in fast-tracking integration of the twelve priority integration sectors (PIS)<sup>3</sup>. The policy of devising the PIS aims to intensify the integration of the respective sectors beyond what AFTA can achieve. AFTA, even when fully completed in 2015 will remain rather shallow. Therefore, it is the deepening of the integration in these priority sectors that is more important than an acceleration of timeframes.

Roadmaps for implementing the PIS were organized along the so-called horizontal measures and sector-specific measures. Greater emphasis should be directed to the sector specific measures, specifically on the real problems that inhibit the integration of the respective sector (i.e., problems of standards and conformance).

Promotion of PIS should encourage the establishment of sectoral groups of stakeholders. Managing these sectoral groups is never easy, especially, if they attract broad interests in all 10 Member Countries. These sectors should not end up as mere industry clubs but function as working groups with a meaningful agenda. Their activities should be based on solid sectoral strategies and policy papers that seem to be nonexistent.

Sector-specific NTMs are a key issue to tackle. Indeed, efforts in the PIS can be directed towards identifying and eliminating NTMs. There are many types of NTMs, some of which seriously interfere with trade, while others become non-tariff barriers (NTBs). ASEAN should now devote more attention in eliminating NTBs. Impact of NTBs are much felt when tariffs fall down. The removing the tariffs can likely lead to the proliferation rather than a standstill of NTBs. It is important that ASEAN could agree on a standstill on NTBs, effective immediately. However, this will be meaningful only if there is capacity in ASEAN to monitor the many types of NTMs. By their very nature, NTBs tend to be non-transparent. There is now an ASEAN Database on NTMs, but it is unclear how well it reflects the reality in the field.

A work program is being developed to eliminate NTBs by 1 January 2010 for ASEAN-6 and 1 January 2015 for CLMV. The complexity and difficulty of dealing

with the issues of NTBs should not be underestimated. It is not clear how soon the NTBs can be eliminated. While tariffs are simple and are handled by one agency (customs office), NTBs take many forms and involve a wide variety of agencies.

There are different approaches to define and eliminate NTBs. ASEAN needs to develop its own practical approach. In the case of NAFTA, a voluminous portion of its agreement relates to the definition of NTBs. The EU, on the other hand, considered any NTM that can be shown to impede trade as a violation of the free movement of goods (free movement axioma). This simple approach works well in EU because a strong legal treaty backs it up.

It may not be practical for ASEAN to come up with a comprehensive assessment of what should constitute the NTBs, instead, the association can focus on what can be called “priority NTBs”. There are two possible approaches to identify them. First is to identify the NTBs that are commonly encountered in the region through a series of studies. The other is to focus its efforts to the PIS and deal with the NTBs in those sectors.

When priority NTBs are already identified, all Member Countries should declare and justify which among them have been applied for protective reasons. Those instituted for protective reasons should be phased out within a certain timeframe, otherwise, they should be dismantled immediately. This approach may have a greater chance of success, however, sufficient time should be given since identification takes time. Similarly, there is no clear reason why the removal of NTBs should take longer in CLMV.

Trade facilitation can be used to overcome many types of NTMs and should be given priority in the implementation of the Blueprint. Several areas deserve special attention. First is the customs modernization. The Vientiane Action Program (VAP) has identified a comprehensive list of actions based on the ASEAN Customs Vision 2020. To ensure that there is free flow of goods and free circulation of goods, priority should be given to the following measures:

- (a) Full implementation of the Strategic Plan for Customs Development 2005-2010.  
This requires Member Countries to overhaul their legal frameworks.
- (b) Modernizing customs techniques should include the implementation of ASEAN Customs Declaration Document for exports, imports and, goods in transit.



- (c) Establish the ASEAN customs systems to facilitate the transit and integration of production and supply chain.
- (d) Expedite the implementation of ASEAN e-Customs and ASEAN Single Window (ASW). National Single Windows (NSW) should be implemented in 2008 and 2012 by the ASEAN-6 and the CLMV, respectively.

Second is standards and conformance. The first principle to minimizing technical barriers to trade is to develop mechanisms that ensure transparency in the development and application of standards, technical regulations and, conformity assessment procedures. It is also important that member countries align their national standards to international standards. The ASEAN Policy on Standards and Conformance provides the guiding principles for joint implementation among Member Countries. Primarily, the principles focus on harmonization of standards, implementation of the relevant conformity assessment schemes, its adoption and, use in technical regulations. Thus, there is also a need to expedite the development of the ASEAN Conformity Mark to facilitate the free movement of goods within the region. More standards need to be harmonized and the focus should be on the PIS.

Under the ASEAN Framework Agreement on Mutual Recognition Arrangements (MRAs), several priority sectors have been identified for the development of sectoral MRAs. Their completion and implementation, likewise, need to be accelerated. This requires an active participation of all member countries, including accreditation of national conformity assessment bodies.

To implement these measures, critical attention on the following should be considered:

- (a) Coordination with other relevant agencies such as customs;
- (b) Improvement of technical infrastructure;
- (c) Changes in legislation; and,
- (d) Post-marketing surveillance.

Indonesian Trade Minister has identified customs modernization, standards and conformance and, infrastructure development as key challenges for the country in the implementation of the AEC Blueprint<sup>4</sup>. In addition, she also emphasized the

importance of establishing institutions or mechanisms in the country to monitor the implementation of commitments. It is likely that other Member Countries share these same concerns.

#### **4. INSTITUTIONAL DEVELOPMENT TO IMPLEMENT THE BLUEPRINT**

ASEAN Member Countries must now focus their attention and organize themselves to implement the Blueprint. In essence, each member country will have to begin this process by preparing more detailed national action plans.

The Blueprint suggests that, at the regional level, ASEAN sectoral bodies will be involved in coordinating the implementation of the Blueprint, while the concerned government agencies are responsible for overseeing and monitoring. Forming partnership arrangements with government agencies, sectoral bodies, business associations and, civil society will ensure the participation of all stakeholders in the preparation of national action plans and in regular consultations on implementation.

The implementation mechanism to be developed consists of the following elements:

- (a) Relevant Sectoral Ministerial Bodies are responsible for implementation of the Blueprint and for monitoring of commitments under their respective domain;
- (b) The ASEAN Economic Ministers (AEM), who are in-charge of the economic integration in the newly established Council of ASEAN Economic Community (in accordance to the ASEAN Charter), are accountable for the overall implementation;
- (c) The AEM is assisted by the High Level Task Force (HLTF);
- (d) The AEM organizes regular consultation meetings with stakeholders;
- (e) ASEAN Secretary General prepares progress report on the implementation of the AEC to relevant Ministerial meetings and the Summit; and,
- (f) The ASEAN Secretariat reviews and monitors the compliance of the implementation of the Blueprint.

The newly established Economic Research Institute for ASEAN and East Asia (ERIA) can provide a useful role in assisting ASEAN on the implementation of the Blueprint. In doing so, ERIA, perhaps through its Deepening Economic Integration (DEI) project, should develop regular consultations with the ASEAN HLTF. This would help ERIA members in understanding and facing the varying challenges of each Member Country. In-country ERIA researchers need to be organized to make an inventory of these key challenges.

The next step for the DEI project (in the next phase) is to provide analytical input to various priority action plans (policy measures) in each of the core elements of the AEC. This analytical input could directly feed into one key task of the ASEAN Secretariat, which is the development of AEC Scorecards to monitor and assess the progress in the implementation of each element of the AEC. In undertaking the analysis, ERIA would be placed in a good position to develop modalities for the implementation of the Blueprint according to the broader challenges of realizing ASEAN commitments under the CEPA (Closer Economic Partnership Agreement) or FTA with its economic partners (such as China, Japan, Korea, Australia, India and, New Zealand). ERIA could also identify areas where these economic partners could provide valuable assistance to ASEAN, especially in capacity building.

## NOTES

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1. 'Analytical-based scorecards' should be distinguished from scorecards based on descriptive statistics of broad socio-economic indicators or those defined by the bureaucratic procedures involved in the implementation (i.e., regulations/policies issued). Analytical-based scorecards consist of evidence-based indicators, factors, or elements, which clearly affect the outcomes (i.e., reduction of transactions or logistics costs).
2. The series of research has been conducted under the ASEAN-Australia Development Cooperation Program of the Regional Economic Policy Support Facility. See Denis Hew, "Conclusion: Towards an ASEAN Economic Community by 2015," in Denis Hew ed., *Brick by Brick: The Building of an ASEAN Economic Community* (Singapore: Institute of Southeast Asian Studies, 2007), pp.209-225.
3. The twelve sectors are: (1) agro-based products; (2) automotive; (3) e-ASEAN; (4) electronics; (5) fisheries; (6) healthcare and healthcare products; (7) textiles and apparel; (8) wood-based products; (9) rubber-based products; (10) tourism; (11) air travel; and, (12) logistics.
4. Presentation by Dr Mari Pangestu, Minister of Trade, at a public seminar at the Centre for Strategic and International Studies (CSIS) in Jakarta (Indonesia) on 2 November 2007.

## Chapter 4

# **Policy Issues for the ASEAN Economic Community: the Rules of Origin**

*Erlinda M. Medalla and Josef T. Yap*\*

## **INTRODUCTION**

Since its inception in 1967, ASEAN has evolved steadily from being a loose forum for exchanging official views to an organization with stronger bonds and a distinct identity underpinned by the unique “ASEAN” way. Despite the limitations of the non-confrontational and “consensual” nature of ASEAN, it has moved forward on many issues, particularly regional security. One benefit of the “ASEAN way” has been the cohesion and solidarity developed among the member countries.

In this context, it is but logical that ASEAN leaders are looking to establish an ASEAN community. Moreover, the role of ASEAN in the process of East Asian economic integration has become more important. And with the continued dynamism provided by its East Asian neighbors, the goal has grown into the vision of an East Asian community.

Nonetheless, a question is often raised whether ASEAN can meet the challenges of the emerging geo-political and economic environment, which are manifested mainly as obstacles to economic integration and the formation of a community. First of all, the proliferation of preferential trading arrangements in the region and around the globe is a hindrance to the process of further economic integration. Second, the complexity of administrative procedures and the consequent transaction costs that govern the ASEAN regulatory framework has impeded the utilization of preferences and the growth of intra-ASEAN trade. Third, the large disparity in economic development and different political systems and structures could hinder closer cooperation and integration. Finally,

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there remains a strong reluctance from individual ASEAN member countries to transfer sovereignty to a supranational authority which is needed to establish a more formal and binding institution that can more effectively support deeper integration.

With all these difficult issues stacked against forging more formal ASEAN integration, not much optimism accompanied the holding of the 12<sup>th</sup> ASEAN Summit held in Cebu in January 2007. However, on the whole, the Summit yielded promising and significant results which were beyond expectations. Arguably the most important outcome is the Cebu Declaration on the Blueprint of the ASEAN Charter. It is an unequivocal commitment to build a stronger institution and to create a more formal regional body, signifying compromise on the part of member countries with regard to transferring sovereignty to a supranational authority.

Much remains to be done and a number of problem areas have been identified. Among the latter is the issue of ASEAN Rules of Origin (ROO). This paper aims to examine the policy issues surrounding the ASEAN ROO regime, with the end in view of contributing to the on-going efforts to achieve best practice in this area. The ROO is at the heart of any free trade agreement (FTA) and in order to achieve its full benefits, the ROO should not only be an instrument to prevent trade deflection. It should be trade facilitating as well.

Striking a balance between trade facilitation and preventing trade deflection is a difficult challenge. ASEAN ROO is already considered as among the simplest in the world and still, in practice, results fall short of expectations. Haddad (2007), for example, has made the following observations about the ASEAN ROO: (1) low AFTA preference utilization rate, (2) difficult compliance even for supposedly simple value-added rule, (3) administrative cost of compliance to prove origin acting as deterrent, (4) low margin of preference for goods traded within ASEAN, and (5) the bulk of intra-ASEAN trade occurring in commodities where preference margins are below the threshold that would justify the cost of compliance.

## **2. ISSUES IN ASEAN ROO**

### **2.1. Cost of compliance and administration**

The problems in ROO are well recognized. ROOs administration and compliance necessarily involve costs, both on the part of administration, and more so in terms of compliance efforts by the intended beneficiaries.

Even without the spaghetti-bowl effect, costs of implementing ROO could be substantial. The JETRO Survey of Japanese Firm's International Operations (JETRO, 2007) shows that of 97 Japanese MNCs using or planning to use FTA preferences in East Asia, about 30 percent find that dealing with different rules of origin increases costs, either from direct compliance with complicated procedures to prove country of origin or from changes to productions processes to achieve the ROO definition.

Estimates of ROO costs vary: 3 percent of the value of goods traded for EFTA countries (Herin 1986), between 4-4.5 percent (Manchin 2006) and 6-8 percent (Cadot et al., 2005) for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimate the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing (2007), using a gravity model, find that for the preferential trade to positively influence trade flows within ASEAN, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance much higher than estimates for EU and NAFTA.

JETRO surveys in ASEAN countries note the time and paperwork involved in obtaining Form D (the official form to prove origin in AFTA). Compliance with ROO involves numerous documentation requirements (including invoices and other evidence for each input used in the final product). These problems are magnified for small firms. In addition, ASEAN requires that Form D should be issued by designated government departments, unlike many other FTAs where private sector associations are allowed to issue certificates of origin.

The type of certification adopted would have direct implication on the trading costs. Some types require involvement by the exporting country government, increasing the burden of the exporters. To reduce this burden, other methods are being adopted such as

the “self-certification” model, which entails certification by a public or a private umbrella entity approved by the government. This would lower administrative costs to exporters and government by transferring the burden of proof of origin to the importers themselves (Estevadeordal and Suominen 2003). However, this method could be too unconventional for most ASEAN countries, making its acceptability a problem. In addition, with a post-audit check and inadequate safeguards against harassment, traders may find it actually less cumbersome and costly to go the route of obtaining government certification.

Another problem is that customs valuations differ across in ASEAN countries and pre-export inspection requirements required by AFTA are cumbersome. In particular, inspection requirements would need face-to-face contact with officials, increasing not only the time input, but the room for graft and corruption. In addition, goods utilizing CEPT are subject to random post-audit checks. Indeed, although a lot of effort in terms of policy reform is done to create “green lanes” to speed up the ROO administration, many firms would still prefer to go through the “red” lane to avoid possible harassment that could arise from the “random” post-audit checks (Manchin and Pelkmans-Balaoing, 2007).

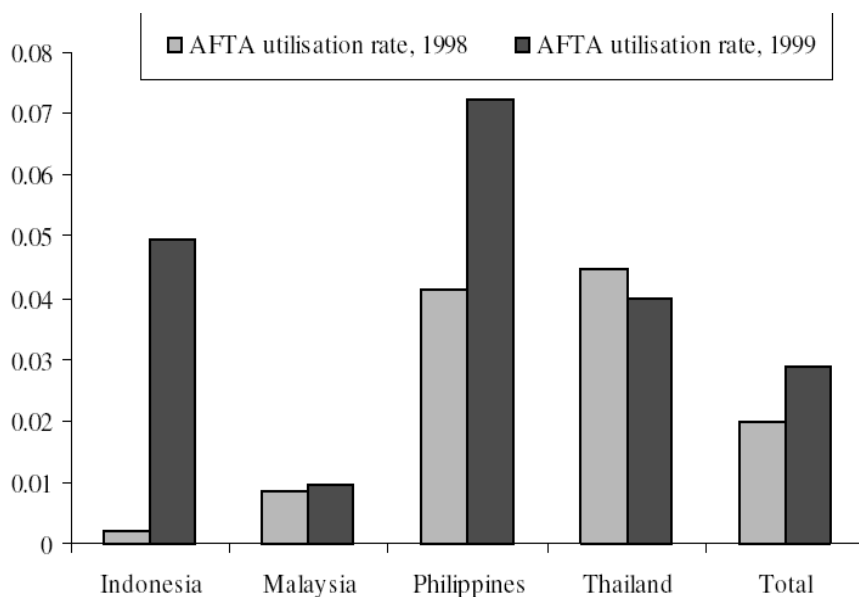
## **2.2. Low AFTA utilization rates**

Compliance costs necessarily dampen the utilization rate of the CEPT preference. Indeed, CEPT utilization rates have been low. Some studies estimate that only 3 percent of intra-ASEAN trade availed of the CEPT rates (Baldwin, 2006). JETRO reports that in 2002, only 11 percent of Thailand’s exports to AFTA and 4.1 percent for Malaysia used the CEPT. This is far below the utilization rates in the EU which are rarely below 50 percent.

In a report on ASEAN’s FTAs and Rules of Origin, JETRO (2004) cites some improvement in the share of CEPT exports. It noted that the share of CEPT exports to total ASEAN exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This encouraging trend indicates better utilization of the CEPT preference but it remains to be seen whether it can be maintained.



**Figure 1: AFTA utilization ratio**



*Source:* PriceWaterhouseCooper (2002) as cited in Baldwin (2006)

### **2.3. Low tariffs in ASEAN for majority of commodities and the nature of ASEAN trade**

Apart from ROO compliance costs, other factors account for the low CEPT utilization rate. An important aspect is that preference margins for products traded within ASEAN are already low for the major intra-ASEAN exports. These are computer/machinery and electrical equipment where the tariffs are nil or very low (around 1.5 percent). In addition, where margins of preference are high, for most ASEAN countries, these are also where non-tariff measures are imposed. A prime example would be the various NTM measures on certain automotive products.

The flipside of this is that the majority of intra-ASEAN trade occurs in commodities with low preference margins—lower than the cost of compliance. Over 90 percent of trade among the ASEAN4—Malaysia, Indonesia, Thailand, Philippines—occurs in commodities where preferences are below 25 percent, the estimated threshold by Manchin and Pelkmans-Balaoing (2007). By any standard, a tariff of 10-25 percent is still substantial; on the other hand, an ROO compliance cost of more than 10 percent is simply too high, making the FTA immaterial.

Not only do ASEAN imports have low preference margins, the import content of key manufacturing sectors is relatively high. The low preference margins and high import content reflect the degree of process fragmentation in highly globalized sectors such as electronics. Moreover, intra-ASEAN trade is only about 25 percent of its total trade, indicating its heavy dependence on outside countries. It would be difficult for any form of ROO or trade preference scheme to overcome structural factors that are a result of decades of economic interaction.

#### **2.4. Further simplification of ROO approach**

Simplifying ROO is a challenging task, often with remedies producing unintended effects. This makes it even more imperative that policy and policy guidelines are as clear and simple as possible. Continuous efforts need to be made by ASEAN to improve ROO administration. There is room for reforms as well in the type of ROO as well. As earlier noted, the ASEAN ROO is among the simplest in the world in theory. AFTA-CEPT ROO provides that:

- (i) A product shall be deemed to be originating from ASEAN Member States, if at least 40 percent of its content originates from any Member States;*
- (ii) Locally-procured materials produced by established licensed manufacturers, in compliance with domestic regulations, will be deemed to have fulfilled the CEPT origin requirement; locally-procured materials from other sources will be subjected to the CEPT test for the purpose of origin determination;*
- (iii) Subject to sub-paragraph (i) above, for the purposes of implementing the provisions of Rule 1 (b), products worked on and processed as a result of which the total value of the materials, parts or produce originating from non-ASEAN countries or of undetermined origin does not exceed 60 percent of the FOB value of the product produced or obtained and the final process of manufacture is performed within the territory of the exporting Member State.*

However, there is still scope for improvement in terms of fine tuning and search for best-practice policy. Practitioners note that when implemented, the RVC rule is difficult to comply with since firms have to measure, disclose and certify input costs. The use of change in tariff classification (CTC) may be easier. The coverage in terms of level, combination, for product list is a further refinement that could be made.

Another example is the use of absorption or Roll Back principle which allows materials that have acquired origin by meeting specific processing requirements to be considered originating when used as input in a subsequent transformation. This is not resorted to in the ASEAN ROO (Kirk, 2007).

### **3. THE ASEAN ECONOMIC COMMUNITY (AEC) BLUEPRINT AND THE ROO: WHAT IS BEING DONE**

ASEAN is fully cognizant that in order to achieve its goal of a single market and production base, progress in eliminating tariffs within ASEAN is not enough. It needs to be accompanied by an enabling ROO regime. Indeed, the AEC Blueprint explicitly provides for instituting reforms in this regard. To wit,

*“Putting in place ROO which are responsive to the dynamic changes in global production processes so as to: facilitate trade and investment among ASEAN Member Countries; promote a regional production network; encourage development of SMEs and the narrowing of development gaps; and promote the increased usage of the AFTA CEPT Scheme.*

*Actions:*

- i. Continuously reform and enhance the CEPT ROO to respond to changes in regional production processes, including making necessary adjustments such as the introduction of advance rulings and improvements to the ROO;*
- ii. Simplify the Operational Certification Procedures for the CEPT ROO and ensure its continuous enhancement, including the introduction of facilitative processes such as the electronic*

*processing of certificates of origin, and harmonisation or alignment of national procedures to the extent possible; and*

*iii. Review all the ROO implemented by ASEAN Member Countries, individually and collectively, and explore possible cumulation mechanisms, where possible.*

Along these lines, there have been efforts to further liberalize and simplify the rules of origin, particularly on the screening and procedural aspect of acquiring certificates of rules of origin. The ASEAN Annual Report 2003-2004 notes the following ASEAN revision in ROO and Operational Certification Procedures:

- standardizing the method of calculating local/ASEAN content,
- adding a set of principles for calculating cost of ASEAN origin and guidelines for costing methodologies,
- treatment of locally-procured materials, and improved verification process including on-site verification

There is agreement that the ROO regime should move towards more simple and unrestrictive ROO. Simpler ROO will help promote regional trade and international competitiveness of member states. Simple rules will reduce compliance costs and administration itself of trade and customs procedures. To minimize the potential for unproductive rent-seeking and corruption, a simple and transparent ROO is important (ADB 2002) .

In practice a simple and less restrictive ROO regime means using a single rule that is the least restrictive. Indeed, this has been the prescription followed by ASEAN even early on, with the use of the Value-added criterion for almost all products. A narrative provided by Manchin and Pelkmans-Balaoing (2007) describes the process in reforming the ASEAN ROO:

“The relatively ample allowance for imports in the AFTA stems from the realization that for many heavily-traded products in the region, like electronics, production processes may be so splintered that the value of local content is often a small percentage of the product’s total value. Very

early on in the formation of AFTA, it was recognized that the 40 percent ASEAN origin rule may often not be met in the case of trade in textile and textile products. In 1995, it was therefore decided that either the percentage value-added or the substantial transformation rule may be used by ASEAN exporters. The AFTA ROO underwent further overhaul, starting in 2003, when operational procedures were further clarified and simplified. In the same year, the decision was reached to adopt a change in tariff heading rule for determining the origin of the product as a general alternative rule “applicable to all products which cannot comply with the 40 percent local/ASEAN content requirement, giving priority to sectors which are the subject of private sector requests and those sectors prioritized by the AEM for accelerated integration. As of last year (2006), the change of tariff heading rule is fully endorsed for four sectors: wheat-flour, wood-based products, aluminum products and iron and steel.”

The reforms in ASEAN ROOs are indeed heading toward the direction of less restriction and simplification. AFTA has started to introduce CTC as a substitute criterion for an increasing number of products. From a product coverage for CTC limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour, aluminum and wood-based products, there are more products now covered by CTC, namely: (i) agro-based products; (ii) automotives; (iii) e-ASEAN; (iv) electronics; (v) fisheries; (vi) healthcare; (vii) rubber-based products; (viii) textiles and apparels; and (ix) wood-based products.

The CTC method is easy for Customs authorities to implement. At the same time, SMEs might also find it easier to comply with, simply needing to show import and export invoices with different classification code. The question is determining the level of disaggregation the member countries would deem to satisfy “substantial” transformation, which would vary across commodities. Here, protectionist tendencies would surface and agreements (especially between developed and developing countries) might be difficult. Nonetheless, the general rule should lean towards less restrictiveness. This implies using a common rule across products, possibly at a 4 to 6-digit level, and if any, with very limited product-specific exemptions.

Another area for reform is using cumulation type ROO more fully. Full cumulation is an important factor allowing for the development of regional production networks. This provides for deeper integration and allows for more advanced countries to outsource labor-intensive production stages to low-wage partners. Coupled with simple ROO, this full cumulation will make it easier for regionally-based firms to exploit the economies of scale (Brenton 2003).

For its part, ASEAN is further refining its cumulation rule and developing a “partial” cumulation approach-- that is, even goods of “partial” origin not having satisfied the 40 percent threshold can be cumulated as part of RVA. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the global production network structure, would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent (Manchin and Pelkmanns-Balaoing, 2007).

Table 1, below summarizes the draft revisions in the AFTA ROO.

**Table 1: Comparison between Draft Revised and Existing CEPT ROO**

	Revised CEPT-ROO <sup>(1)</sup>	Existing CEPT-ROO
Contents	Rule 1 Definitions Rule 2 Origin Criteria Rule 3 Wholly Obtained or Produced Rule 4 Not Wholly Obtained or Produced Rule 5 Accumulation Rule 6 Minimal Operations and Processes Rule 7 Direct Consignment Rule 8 De Minimis Rule 9 Treatment of Packages and Packing Materials Rule 10 Accessories, Spare Parts and Tools Rule 11 Neutral Elements Rule 12 Identical and Interchangeable Materials Rule 13 Certificate of Origin Rule 14 Review and Modification	Rule 1 Originating Products Rule 2 Wholly Produced or Obtained Rule 3 Not Wholly Produced or Obtained Rule 4 Cumulative Rule of Origin Rule 5 Direct Consignment Rule 6 Treatment of Packing Rule 7 Certificate of Origin Rule 8 Review

<p>Specific Provisions Changes: Not Wholly Obtained or Produced</p>	<p>A good shall be deemed to be originating in the Member State where working or processing of the good has taken place:</p> <p>(a) if at least 40 percent of its content (hereinafter referred to as “ASEAN Value Content” or the “Regional Value Content (RVC)”) originates from that Member State or it has undergone a change in tariff classification at four-digit level (change in tariff heading) of the Harmonised System</p> <p>The formula for calculating ASEAN Value Content or RVC is as follows:</p> <p><i>a) Direct Method:</i></p> $RVC = \frac{\text{ASEAN Material Cost} + \text{Direct Labour Cost} + \text{Direct Overhead Cost} + \text{Other Cost} + \text{Profit}}{\text{FOB Price}} \times 100\%$ <p><i>(b) Indirect Method :</i></p> $RVC = \frac{\text{FOB Price} - \text{Non-Originating Materials, Parts or Produce}}{\text{FOB Price}} \times 100\%$	<p>A product shall be deemed to be originating from ASEAN Member States, if at least 40% of its content originates from any Member States.</p> <p>The formula for 40% ASEAN Content is as follows:</p> $\frac{\text{Value of Imported Non-ASEAN Materials, Parts or Produce} + \text{Value of Undermined Origin Materials, Parts or Produce}}{\text{FOB Price}} \times 100\% \leq 60\%$
<p>Cumulation</p>	<p>If the Regional Value Content of the material is less than 40 percent, the qualifying ASEAN Value Content to be cumulated using the RVC criterion shall be in direct proportion to the actual domestic content provided that it is equal to or more than 20 percent. The Implementing Guidelines are set out in <u>Appendix B</u>.</p> <p><i>a) a good shall be deemed to be eligible for partial cumulation, if at least 20 percent of the Regional Value Content (RVC) of the good is originating in the Member State where working or processing of the good has taken place...</i></p>	<p>If the material has less than 40 percent ASEAN content, the qualifying ASEAN national content shall be in direct proportion to the actual domestic content provided that it is equal to or more than the agreed threshold of 20%<sup>(2)</sup></p>
<p><i>De Minimis</i></p>	<p>A good that does not undergo a change in tariff classification shall be considered as originating if the value of all non-originating materials used in its production that do not undergo the required change in tariff classification does not exceed ten (10) percent of the FOB value of the good and the good meets all other applicable criteria set forth in this CEPT-AFTA Agreement for qualifying as an originating good.</p>	
<p><i>Source: Documents from ASEAN Secretariat</i></p>		

Note: (1) As of December 2007, still subject to final confirmation from ASEAN Member countries.

(2) The implementation of this provision would be based on the Implementing Guidelines, which was endorsed by the AEM Retreat, April 2005.

To summarize, the origin criteria in the Draft Revised CEPT-ROO will be as follows:

- 1) goods wholly produced in the country of exportation
- 2) goods satisfying rules on Regional Value Content (40 percent) or Change in Tariff Classification (actual CTC rule) or specific processes
- 3) goods satisfying partial cumulation rule (at least 20 percent of RVC).

#### **4. THE IMPACT OF OTHER EAST ASIAN FTAS**

The proliferation of bilateral and sub-regional FTAs in East Asia has complicated the issue of ROO. The main reason is that FTAs by East Asian countries have a wide spectrum in terms of the stringency of ROO. The likely impact is an increase in administrative cost for traders and production cost for firms. Manchin and Pelkmans-Balaoing (2007) argue that cost of operating in several preferential trade agreements might become so high that producers in the spoke countries might only be able to trade under one single preferential agreement. This is definitely an inferior outcome compared to a liberalized multilateral trading regime under the WTO.

#### **5. CONCLUSIONS AND RECOMMENDATIONS**

From the perspective of ASEAN, creating an economic community would entail increasing intra-regional flow of goods, capital and services. Certainly reforming the ROO can contribute to this goal, but if social and economic development is the primary objective, then the benefits from this measure should be put in proper perspective.

It should be noted that reforming the ROO system is couched in the context of maximizing the effectiveness of FTAs, whether they be bilateral, sub-regional or regional. What should be emphasized, however, is that FTAs have never been an integral part of economic development of countries in the region<sup>1</sup>. Hence, the domestic reform process



should not be constrained by the noodle bowl syndrome and neither should the latter be a major obstacle to social and economic development.

Nevertheless, there are benefits to reforming the ROO in AFTA. Lessons from the EU experience indicate that there are a number of factors which could further lessen the negative effects of restrictive rules of origin schemes. This is related to the wide spectrum of ROO among the various East Asian FTAs. According to Manchin and Pelkmans-Balaoing (2007), the burden of production costs induced by restrictive rules of origin can be somewhat reduced by allowing less restrictive cumulation rules (e.g. diagonal or full cumulation), allowing duty drawback, outsourcing and higher *de minimis* levels. Furthermore, administrative costs can also be reduced by more trader-friendly approaches, such as self-certification methods.

To its credit, ASEAN is fully cognizant of the need to simplify and improve the ROO system. Indeed, the AEC Blueprint explicitly mandates continuous reforms to “*enhance the CEPT ROO to respond to changes in regional production processes, including making necessary adjustments such as the introduction of advance rulings and improvements to the ROO and simplify the Operational Certification Procedures for the CEPT ROO and ensure its continuous enhancement, including the introduction of facilitative processes such as the electronic processing of certificates of origin, and harmonisation or alignment of national procedures to the extent possible.*”

Forging ASEAN in an effective regional economic bloc and eventually an economic community, however, would entail more fundamental structural reforms. The argument by the 2003 McKinsey report that “market fragmentation lies at the heart of ASEAN’s competitiveness challenge” is rather simplistic. Fortunately, the six projects currently being undertaken by the Economic Research Institute for ASEAN and East Asia (ERIA) address these fundamental issues<sup>2</sup>. These studies deal primarily with “supply side constraints” focusing on enhancing the capability of ASEAN member countries to engage with each other and other countries more effectively and meaningfully.

Some of the measures that would arise from these studies are as follows:

- Narrowing the development gap in the region through infrastructure projects and capability building including technology transfer.

- These infrastructure projects and capability building will enable more firms from ASEAN, particularly small and medium enterprises, to participate in global production networks, indirectly through large domestic firms or by directly latching to regional and global supply chains.
- Harmonization of product standards and customs procedures that will facilitate greater trade in goods and services.

In the medium term, ASEAN member countries can push for an East Asia Free Trade Area that will consolidate the various bilateral and sub-regional FTAs and therefore overcome the noodle bowl syndrome. This would be a direct result of harmonizing the various ROO. It goes without saying that the ultimate or long-term objective would be an equitable and efficient multilateral trading system anchored on lower MFN rates under the auspices of the WTO.

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## NOTES

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1. Japan, Korea, Taiwan, China in particular achieved high economic growth without the benefit of any FTA.
2. The projects are as follows: In the area of Deepening Integration, Project No. 1: *Deepening economic integration*; Project No. 2: *International infrastructure development in East Asia: toward effective and balanced regional integration*; and Project No. 3: *Analyses of industrial agglomeration, production networks and FDI promotion. In the area of Narrowing Gaps of Economic Development*: Project No. 4: *Development strategy for CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam) in the age of economic integration*; and Project No. 5: *SMEs in Asia and globalization*. In the area of Sustainable Economic Growth, Project No. 6: Energy security issues such as energy conservation, standardization of biodiesel fuel for vehicles and sustainable utilization of biomass.

## Chapter 5

# **Trade Facilitation: A Study in the Context of the ASEAN Economic Community Blueprint**

*Brent Layton*

## **INTRODUCTION**

The WTO, OECD and APEC all have very similar definitions of trade facilitation. They see it as the simplification and harmonisation of international trade procedures covering the activities, practices and formalities involved in collecting, presenting, communicating and processing data and other information required for the movement of goods in international trade. We will adopt a slightly broader meaning, however, and also consider the time and resources involved in the movement of traded goods across borders and to their destinations within countries. We have adopted a wider perspective because the ASEAN Economic Community (AEC) Blueprint (ASEAN (2007b)) focuses more broadly on improving trade logistics and not just on improving information flows related to traded goods. Moreover, research suggests that policies that cover a wider perspective than customs processing reform are likely to be more successful.

In this section of the report we address:

- the reasons why the interest in trade facilitation among policy advisors and analysts has increased noticeably in recent years;
- the evidence that there is room for improvement in trade facilitation among ASEAN economies;
- the evidence relating to the nature and potential size of the economic gains from trade facilitation;
- the steps currently underway in ASEAN countries to achieve improvements; and
- the creation of a scorecard for measuring improvements in trade facilitation over time and across ASEAN countries

We will conclude by identifying the policy implications for ASEAN and research priorities and opportunities for ERIA.

## **2. INTEREST IN TRADE FACILITATION**

Trade facilitation is one means by which non-tariff barriers to trade are reduced. The focus on it in trade discussions and negotiations has increased appreciably in recent years, including in ASEAN. There are a number of reasons for this.

Firstly, over the past few decades tariff barriers and quota restrictions on trade in goods have been lowered or eliminated. As a result, the economic gains from further changes to such barriers have tended to decline so the focus has naturally shifted to other potential sources of economic efficiency and gains from trade; service liberalisation and trade facilitation are two such potential sources.

Secondly, the reduction in tariff and non-tariff barriers to trade has been followed by significant growth in the volume of trade. Trade has been growing faster than GDP in most economies, including most of those in ASEAN, for several decades. Since the high costs of moving goods across borders affects all trade, the absolute gains to be made from simplification and harmonisation of trade have increased. This has encouraged more effort to capture these potential gains.

Thirdly, experience gained over time has shown that trade facilitation can generate “win-win” opportunities for consumers, legitimate businesses and governments. Greater transparency and much easier auditing and checking of trade for tariff classification and collection and physical and bio-security monitoring usually go along with simplification and harmonisation. This advantages governments whereas speeding up the movement of goods and lowering its costs advantages consumers and businesses. The “win-win” opportunities have helped create a greater willingness among politicians and policy advisors to promote trade facilitation.

Fourthly, a number of studies by international bodies have highlighted the potential high costs of increased trade transaction costs (TTCs), especially to developing economies:

- APEC (2002) estimated there would be an increase in GDP for APEC economies of 0.9% or \$US154 billion following just a 5% reduction in trade transaction costs;
- OECD (2003) based on a Computable General Equilibrium (CGE) model estimated that a 1% reduction in trade transaction costs would bring annual gains of about \$US40 million, with developing economies being the biggest winners in relative terms; and
- Two OECD surveys published in 2002 and 2003 (see OECD (2005)) suggest that studies of the impact of lowering trade transaction costs range between 1 and 15% of the trade transaction value. Most estimates are in the low to middle values of this range but developing economies are more likely to be in the upper end of the range.

Fifthly, the development of just-in-time inventory practices and the fragmentation of the supply chain for many products so that goods and/or their various components are produced in several countries has increased the significance of the costs of border delays and charges and the costs of logistics more generally. This has stimulated greater interest in removing or reducing these costs.

Finally, on the supply side, the increase in capacity and reduction in the costs of information and computer technology (ICT) has made simplifying border procedures and lowering transshipment costs easier and more cost effective to achieve.

### **3. ASEAN'S TRADE TRANSACTION COSTS**

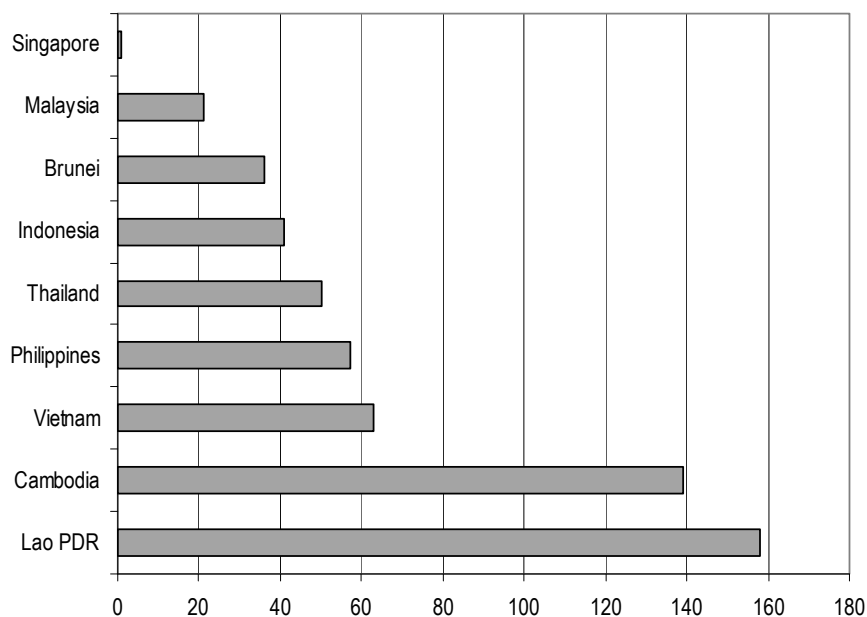
#### **3.1. Ease of doing business: World Bank (2007a)**

The World Bank's 'Ease of Doing Business' rankings include a component relating to trading across borders. This reflects the number of documents necessary to export and import goods, and the time and costs of trade. Higher rankings indicate greater ease of trading across the border. Singapore is ranked number 1 overall among all the 178 countries rated in the survey. At the other end of the scale, Laos is ranked 158 out of 178; there are no data for Myanmar.

The 'Ease of Doing Business' trading across borders data includes details on the

number of documents required to export and import goods. These data show a wide range of requirements among ASEAN countries and that only one, Singapore, requires fewer trade documents per shipment than the OECD countries on average, although Indonesia comes close.

**Figure 1: Ease of doing business – trading across borders**



*Note:* Ranking in '2008' listing out of 178 countries

*Source:* World Bank (2007a).

### **3.2. Connecting to compete: World Bank (2007b)**

#### *3.2.1 Logistics performance index (LPI)*

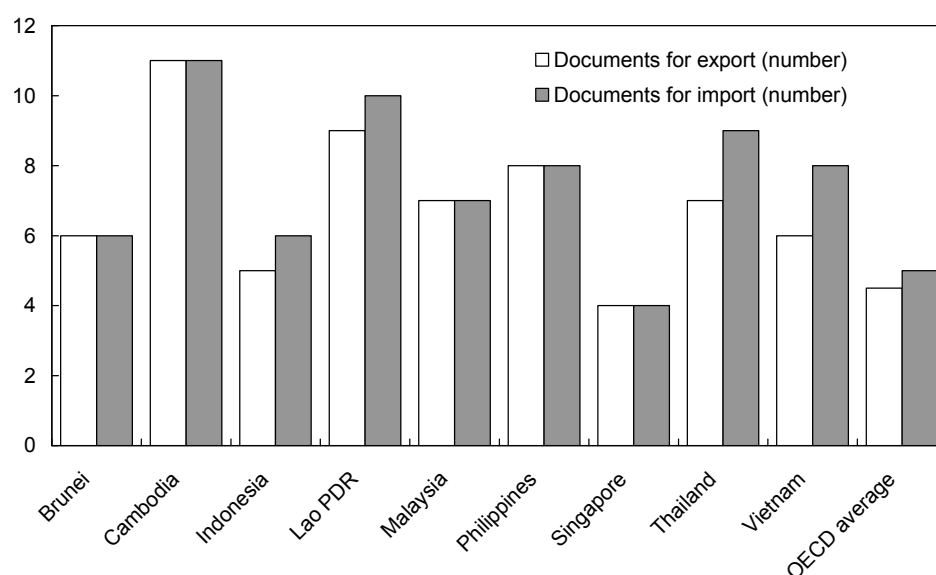
The World Bank has also recently published a more detailed study of the direct and indirect costs related to trade (World Bank (2007b)). This is entitled Connection to Compete: Trade Logistics in the Global Economy. The data are based on 5,000 country evaluations undertaken by 800 freight forwarders and express carriers. Each respondent was asked to rate performance in seven logistics areas for eight countries with which they conduct business. Performance was evaluated using a five-point scale with 1 the lowest score and 5 the highest. The seven areas of performance rated were:



- efficiency of the clearance process by customs and other border agencies;
- quality of transport and information technology infrastructure for logistics;
- ease and affordability of arranging international shipments;
- competence of the local logistics industry;
- ability to track and trace international shipments;
- domestic logistics costs; and
- timeliness of shipments in reaching destinations.

The World Bank used a weighted average of the responses in the seven areas to develop, for each country, an overall Logistics Performance Index (LPI) score. There are no data for Brunei but there are LPI data for all the other ASEAN countries.

**Figure 2: Documents required to export and import**



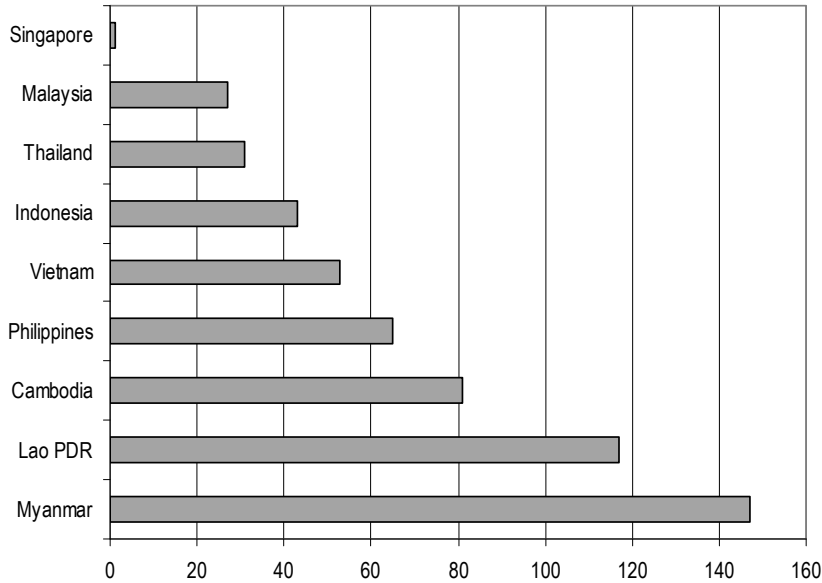
*Note:* Number of documents.

*Source:* World Bank (2007a).

The study covers 150 countries. Once again, Singapore comes out on top among all the countries ranked by the survey. Malaysia also makes it into the top quintile and Thailand into the top quartile. Among ASEAN countries rated, all but Cambodia, Lao PDR and Myanmar are in the top half. The lowest ranked among the ASEAN countries is Myanmar at 147th.

Figure 3 shows the rankings of ASEAN countries according to the LPI and Figure 4 gives their overall scores. Only one country in ASEAN, Singapore, has an LPI score above the OECD average but Malaysia and Thailand are close. The average score for the ASEAN countries is 20.4% below the average score for the OECD countries.

**Figure 3: Logistic performance index (LPI) rankings**

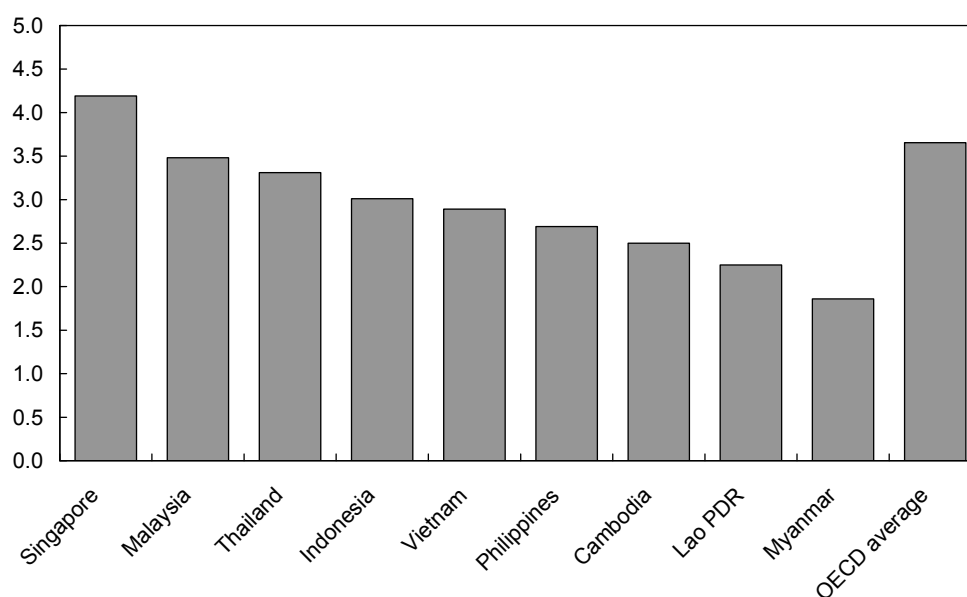


*Note:* Rank out of 150 countries in 2007 study.  
*Source:* World Bank (2007b).

Table 1 summarises the differences in scores on the seven sub-components of the LPI between ASEAN countries and OECD countries and within ASEAN and the OECD. There are two points to note:

- the ASEAN average is below the OECD average by about 20% for the LPI as a whole and also for most of the sub-components. The exception is domestic logistic costs; ASEAN is ahead of the OECD by 13.4% on this measure.
- the variance of the scores between ASEAN countries is much greater than the variability between OECD countries. For three sub-components and the overall LPI, the intra-ASEAN variance is more than three times the intra-OECD variance. Again the exception that stands out is domestic logistic costs; the variance within the two groups of countries is very similar for this component and relatively small for ASEAN.

**Figure 4: Logistic performance index (LPI) scores**



*Note:* Score on a scale of 1 (low) to 5 (high).

*Source:* World Bank (2007b).

**Table 1: ASEAN and OECD logistic performance index scores compared**

	ASEAN Average	OECD Average	OECD-ASEAN Difference	ASEAN Variance	OECD Variance	OECD Variance to ASEAN Variance
Logistical Performance Index	2.91	3.65	-20.39%	0.49	0.15	30.06%
Efficiency of customs & others in clearance	2.77	3.46	-20.01%	0.38	0.18	46.51%
Quality of transport & IT infrastructure	2.70	3.62	-25.21%	0.62	0.25	39.43%
Ease & affordability of international shipment	2.90	3.50	-17.29%	0.43	0.12	27.70%
Competence of local logistical industry	2.89	3.65	-20.81%	0.45	0.17	38.85%
Tracking & tracing ability	2.87	3.71	-22.52%	0.68	0.15	22.38%
Domestic logistics costs	2.97	2.62	13.38%	0.14	0.12	85.14%
Timeliness in reaching destinations	3.33	4.03	-17.36%	0.51	0.11	21.95%

*Source:* Calculated by NZIER from World Bank (2007b).

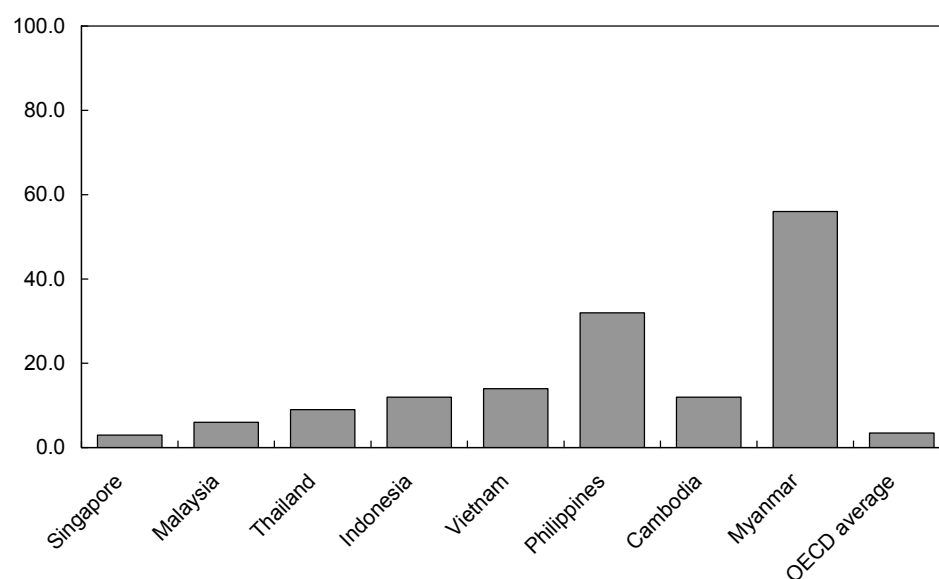
### 3.2.2 Country specific performance data

Each respondent to the survey from which the World Bank developed the LPI was also asked to also evaluate the logistics performance of the country in which they are based and provide time and cost data relating to it. The World Bank has also published the data which cover these aspects of trade (World Bank (2007b) Table A3):

- the percentage rate of physical inspection of containers;
- the number of days for customs clearance;
- the time for exports (median) and imports (best and median) between shipper and port. The best relates to the 10th percentile of shipments and the median to the 50th percentile;
- the number of border agencies for exports and imports;
- the percentage of respondents who consider there is a simple and inexpensive review process available; and
- the typical charge in United States dollars to import and export a 40-foot container or semi-trailer.

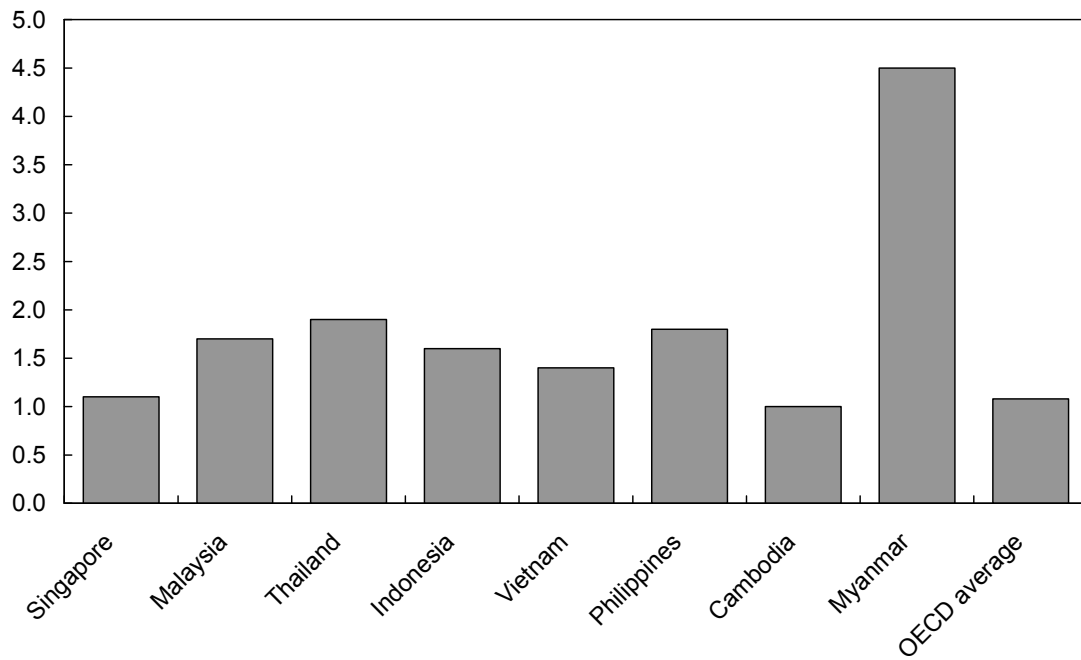
These data are reported in Figures 5-10. There are no data for Brunei or Lao PDR

**Figure 5: Rate of physical inspection of containers (%)**



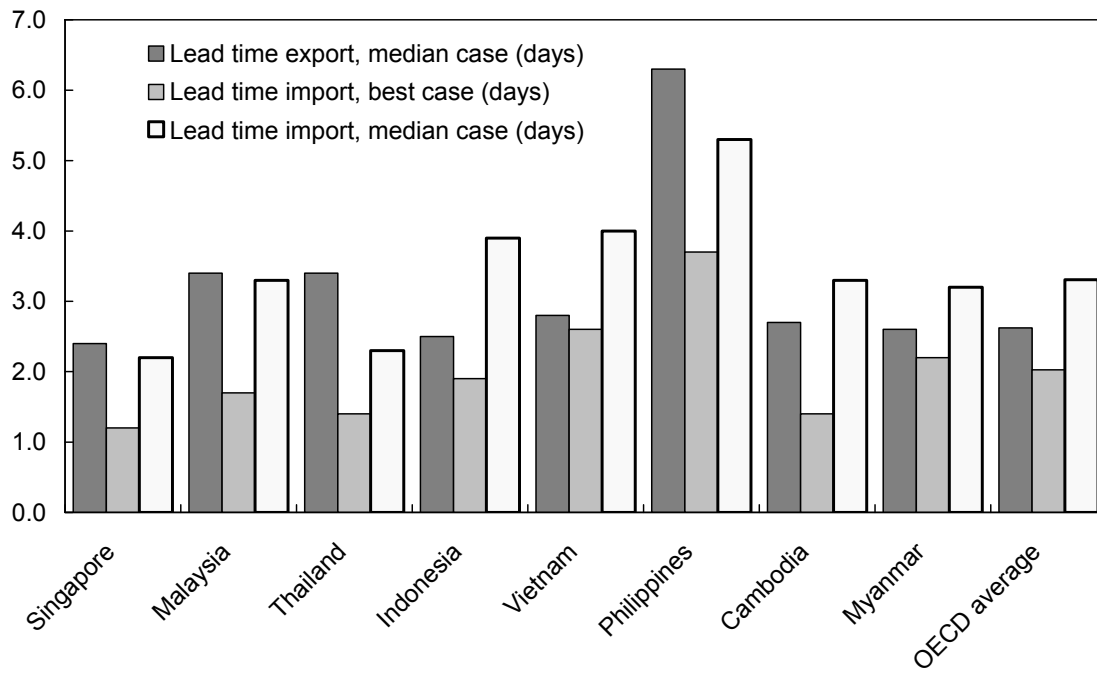
Source: World Bank (2007b).

**Figure 6: Customs clearance time (Number of days)**



Source: World Bank (2007b).

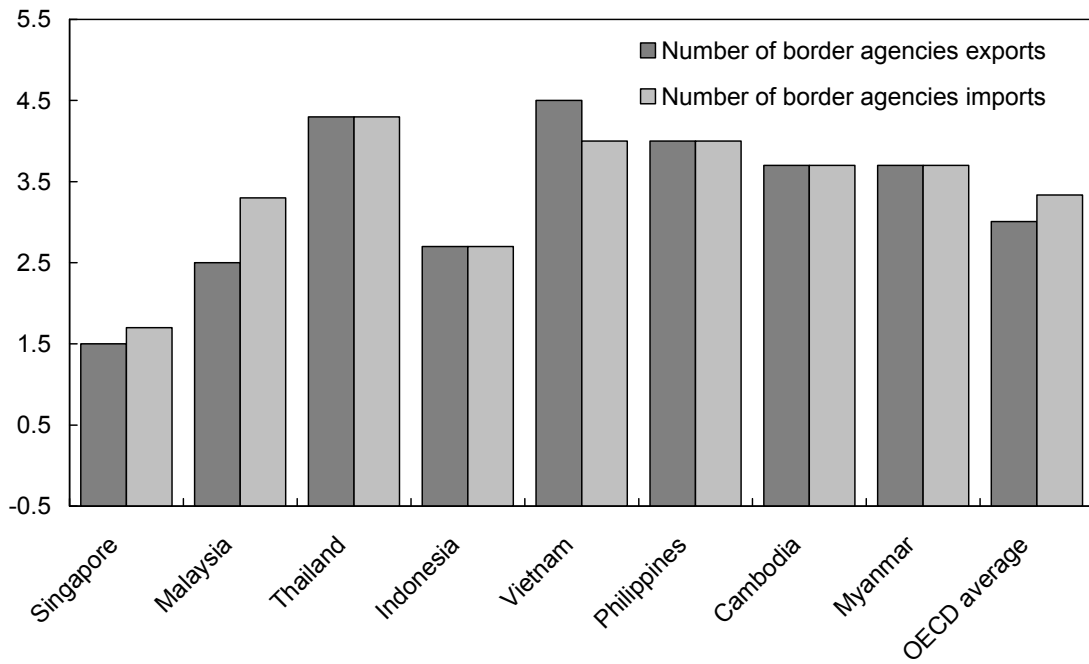
**Figure 7: Time between shipper/consignee and port**



Note: Number of days: median = 50 percentile and best = 10 percentile.

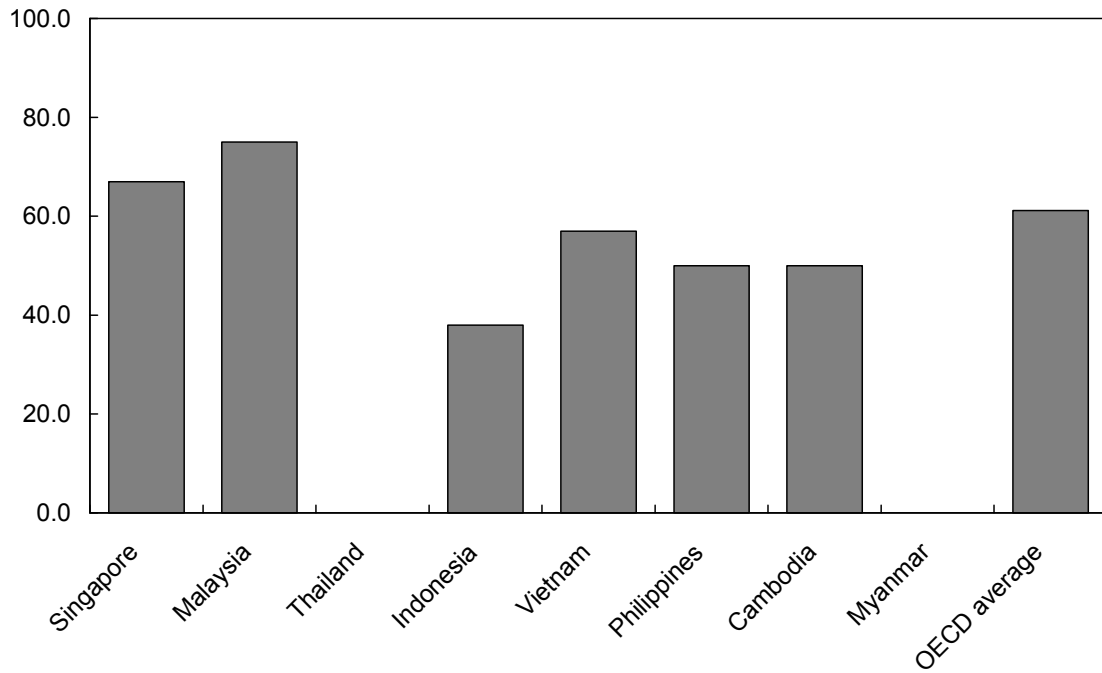
Source: World Bank (2007b).

**Figure 8: Number of border agencies (Average of responses)**



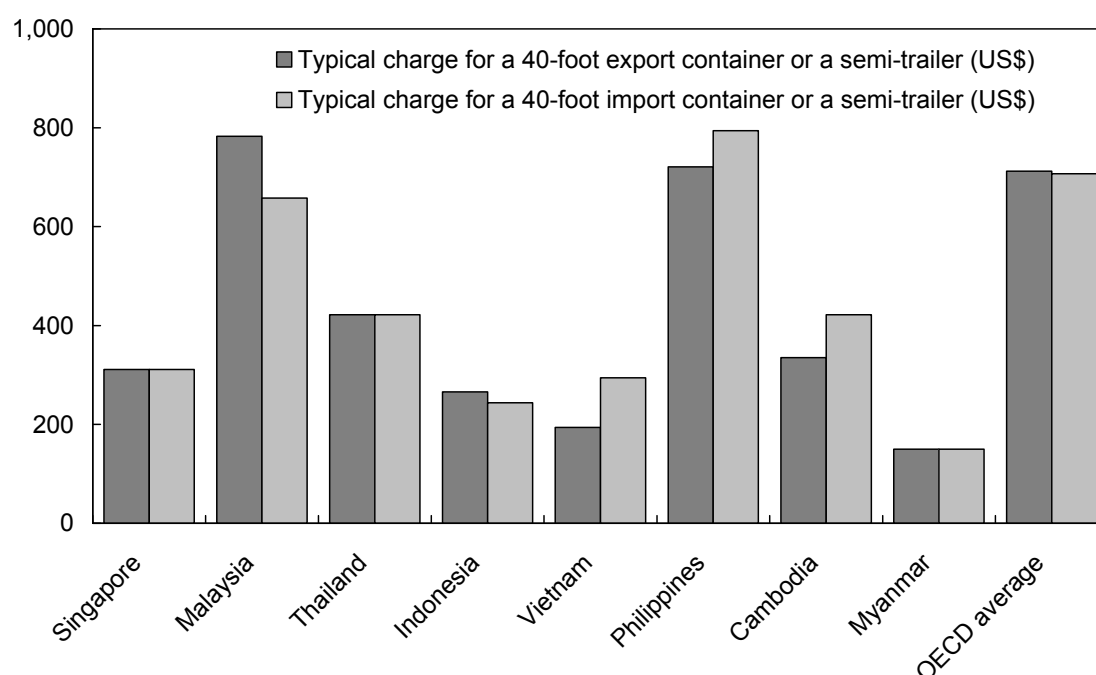
Source: World Bank (2007b).

**Figure 9: Possibility of review procedure**



Note: Percentage of respondents answering a simple and inexpensive review procedure is available.  
Source: World Bank (2007b).

**Figure 10: Typical charge for 40-foot container**



*Note:* \$US per container or semi-trailer.

*Source:* World Bank (2007b).

It is very clear from this data that, according to the professionals surveyed, there are significant differences between ASEAN countries in the extent to which trade is facilitated in practice by logistics, and customs procedures. Moreover, compared with the OECD average, customs inspection rates and clearance times are high and the possibilities of an efficient review, low. On shipping costs, ASEAN generally scores well compared with the OECD; Malaysia and the Philippines are exceptions.

These data show that for most ASEAN countries there is considerable scope to improve performance in regard to trade facilitation as we have broadly defined it. They also show that even the very well performing countries in the region have at least one aspect they could improve.

## **4. THE ECONOMIC IMPACTS OF TRADE FACILITATION**

The economic impacts of trade facilitation fall into three categories:

- the impact on trade flows and hence upon the gains from trade;
- the impact on government revenue; and
- the impact on foreign direct investment.

There has been a considerable amount of research in recent years looking at the first two of these impacts. Quite a lot of this research relates to developing economies and some of it to countries in East Asia. The research on all three aspects was surveyed by an OECD working party in late 2005.

### **4.1. Trade flows**

From its survey of the results of studies using mainly gravity and CGE models, the key conclusions about the relationship between trade facilitation and trade flows drawn by the OECD working party are (OECD (2005) p.15):

- all the studies indicate there is a positive link between trade facilitation and the volume of trade; there is significantly increased trade for even modest reductions in TTCs;
- the studies also indicate that trade in both rich and poor countries stand to gain from trade facilitation; in relative terms the gains are higher for developing economies than developed economies as they usually have more improvements in efficiency to make;
- both the country improving its customs procedures and the countries exporting to this country stand to benefit but the country that improves its border procedures benefits most, so unilateral action pays;
- the potential gains from increased port/transport efficiency are considerably larger than for increasing efficiency of customs procedures; and
- the quantitative results and the results from business surveys are consistent; inefficient movements of goods across borders are a serious impediment to trade



and growth.

The OECD paper notes these key conclusions are supported by the country case studies also surveyed.

The recent World Bank survey of 800 logistics experts has provided some other key insights into the relationship between trade, growth and logistic performance (World Bank, 2007b, p.1):

- while costs and timeliness are of paramount importance, traders are primarily concerned with the overall reliability of the supply chain;
- country performance is largely influenced by the weakest link in the supply chain; poor performance in just one or two areas can have serious repercussions in overall performance;
- modernising customs is usually not enough; the co-ordination of border procedures between customs and other agencies remains an important concern;
- logistic performance is more and more determined by the availability of quality, competitive private sector services such as trucking, customs brokering and warehousing;
- policymakers should look beyond the narrow trade facilitation issues that focus on road infrastructure and information technology in customs to also reform logistic service markets and reduce co-ordination failures across the whole supply chain;
- a focus on improving the whole of the supply chain in parallel as part of a comprehensive approach appears to be more likely to succeed than a piecemeal approach.

#### **4.2. Revenue collection**

Tariff revenue can be important for the governments of developing economies and especially so for some of the least developed economies. This is because trade taxes are sometimes one of the few practicable means of financing public administration available to the government. Consumption and income taxes are difficult or impossible to collect efficiently in many developing economies.

A number of case studies have shown that modernisation of the custom service can significantly increase the actual revenue collected from trade taxes by reducing opportunities for smuggling by using false declarations or bribing officials. The case studies suggest (OECD (2005) pp18-23):

- the benefits of customs modernisation have exceeded the costs by a wide margin;
- even moderate reform can improve custom revenue;
- the financial results may take some time to emerge as the reforms are often implemented in stages over time; and
- the biggest gains are often available to the countries with less capacity to undertake the customs reform programme, so technical assistance in capacity building can be important.

#### **4.3. Foreign direct investment**

One of the key drivers of foreign direct investment is to access the labour resources of developing economies. The efficiency with which inputs can be imported and outputs exported are factors in the investment appraisals supporting the decisions of firms looking to invest in international outsourcing. Case studies have confirmed this to be the case. Since trade facilitation increases the efficiency in this regard it will stimulate higher levels of foreign direct investment with its consequential positive effects on the economy's growth.

There have, however, been very few studies that have empirically examined the importance of trade facilitation to foreign direct investment. One that did, found that customs clearance times were a key determinant of foreign investment (OECD (2005) p.24).

## **5. ASEAN AND TRADE FACILITATION**

### **5.1. Previous initiatives**

A number of the past activities of ASEAN have been aimed at trade facilitation in a general sense. These include (see ASEAN (2003?) and ASEAN (2007a)):

- the introduction in 2004 of a green lane system for common effective preferential tariff (CEPT) goods;
- harmonisation of the customs valuation methods in ASEAN through the adoption of the WTO valuation agreement;
- promotion of harmonisation and transparency in the classification of goods through the implementation of the ASEAN Harmonised Tariff Nomenclature (AHTN) in 2004; and
- development of Strategic Plan of Customs Development 2005-10 (SPCD) to modernise the customs environment.

### **5.2. The ASEAN Economic Community Blueprint**

ASEAN has recently released its Blueprint to establish the ASEAN Economic Community (AEC). The key characteristics of the AEC will be (ASEAN, 2007b):

- a single market and production base for the ten ASEAN countries;
- a highly competitive economic region;
- a region of equitable economic development; and
- a region fully integrated into the global economy.

Trade facilitation, in the broad sense we have defined it, has been identified by ASEAN as key to the development of AEC and, particularly, to the development of a single market and production base by allowing the free flow of goods within the region.

The Blueprint sets out a number of action points to create a free-flow of goods, including ones in the following areas:

- trade facilitation:
  - develop simple, harmonised and standardised trade and customs processes, procedures and related information flows;
- customs integration:
  - integrate customs structures, modernise tariff classification, customs value and origin determination
  - establish ASEAN e-Customs;
  - improve capability and narrow development gaps; and
  - adopt risk based approaches;
- ASEAN single window:
  - develop ten national single windows of individual member countries which enable the single submission of data and information and single decision-making for customs clearance of cargo; and then
  - integrate the national single windows into an ASEAN single window; and
- standards and technical barriers to trade:
  - harmonise standards, technical regulations and conformity assessment procedures through implementation of the ASEAN Policy Guideline on Standards and Conformance.

The AEC Blueprint also identifies that logistics development is important to creating a competitive economic region. To help promote a competitive region the Blueprint lists action points for infrastructure development. Included among these are actions in the following areas:

- transport co-operation:
  - enhance transport facilitation and logistic services;
  - promote multi-modal transport infrastructure linkages and connectivity;
  - facilitate transport and tourism integration; and
  - further liberalise the air and maritime transport sectors;
- land transport:
  - complete the Singapore-Kunming Rail Link; and
  - complete the ASEAN Highway Network;

- maritime and air transport:
  - adopt the general principles and framework for an ASEAN Single Shipping Market; and
  - develop and implement the ASEAN Single Aviation Market;
- information infrastructure:
  - facilitate inter-connectivity and technical inter-operability among ICT systems;
  - leverage national networks into a regional information infrastructure;
  - improve trust and confidence in the use of the internet and security of electronic transactions, payments and settlements; and
  - develop high speed inter-connections among all national information infrastructures.

ASEAN has developed a very detailed timeline for implementation and completion of the various action points under the blueprint and provided that “the ASEAN Secretariat shall review and monitor compliance of implementing the Blueprint.” To assist it with this task, the ASEAN Secretariat is required to develop and maintain a set of statistical indicators and AEC scorecards.

## **6. SCORECARD FOR TRADE FACILITATION**

We have combined the priorities of the AEC Blueprint and the information relating to each country in the two World Bank data sources relating to trade to create a scorecard for measuring trade facilitation in ASEAN. The data used to construct the scorecard come from World Bank (2007a and 2007b) reports and includes information on logistics performance, the time and costs of trading, and customs performance.

The scorecard can be updated annually using the information from the annual World Bank Ease of doing business survey, updates to logistics performance information, through surveying international traders in the various ASEAN countries and incorporating the commitments made to the ASEAN Single Window and conformance with standardised ASEAN customs practises. Annual updates to the scorecard would provide information on and leverage for encouraging improvements to

trade facilitation.

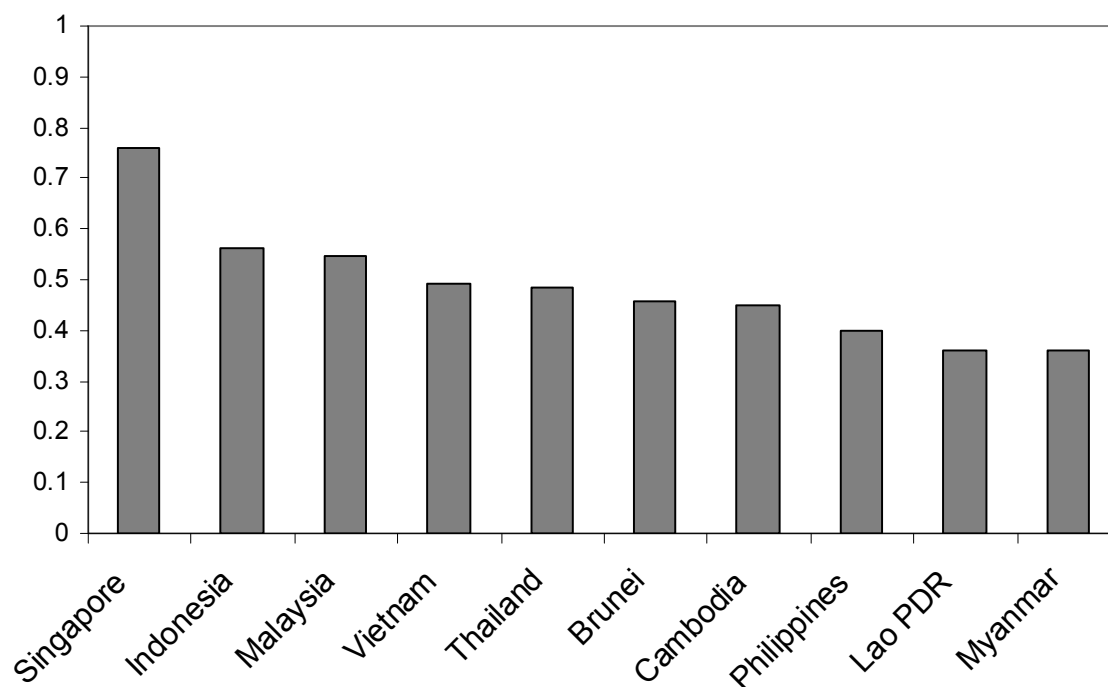
To create the scorecard various indicators of trade facilitation have been weighted into an index based on how closely aligned they are with the priorities set out in the AEC blueprint:

- commitment to the ASEAN Single Window receives a weight of 0.1 reflecting the significance of this separate strategy to economic integration and trade facilitation in the region;
- the Logistics Performance Index (LPI) which includes 7 logistics components as listed in 3.2.1 is given a weight of 0.45; and
- the importance of moving towards conformance with an ASEAN standard as emphasised in the AEC blueprint is reflected in the weighting system by allocating the remaining 0.45 to indicators of customs procedures and the cost and time required for exporting and importing.

Appendix 1 provides the details of the raw data, scores and scoring system, and weights used in the scorecard calculation.

Figure 11 shows the results of the first calculation of trade facilitation scorecard for ASEAN. The scorecard indicates that Singapore is most conducive to trade. Singapore has better quality logistics services, faster customs processing and trading times, and lower costs than the rest of ASEAN. Conversely, the Philippines, Lao PDR and Myanmar have the lowest indexes highlighting the difficulties traders experience in these countries. The initial calculation of the scorecard shows that in 2007 Singapore was the best performer among ASEAN countries in terms of trade facilitation while the Philippines, Lao PDR and Myanmar have substantial room for improvement, particularly in the areas of logistics performance and customs procedures. Singapore scores well because it has higher quality logistics services, faster customs processing and trading times, and lower costs than the rest of ASEAN. The Philippines have higher per unit costs of trade and longer expected trading times, Lao PDR and the Philippines require a large amount of documentation, and Myanmar and Lao PDR have low logistics performance indexes.

**Figure 11: Trade Facilitation Index**



Source: NZIER.

## **7. POLICY IMPLICATIONS**

### **7.1. Limited need to develop policy options**

The research and data we reported at the start of this section lend considerable support to ASEAN’s current policy intentions in relation to trade facilitation as these are set out in the AEC Blueprint and the accompanying detailed timelines. More specifically, they support the following assumptions which are embodied in ASEAN’s current policy and implementation plans:

- there are considerable opportunities within ASEAN to make gains from trade facilitation and so pursuing them should be a priority;
- when planning and implementing reforms in this area it is best to take a broader view of trade facilitation than to consider it is principally customs process reform;

and

- progressing improvements across the whole supply chain in parallel is preferable to piecemeal development of narrow areas in isolation.

Other aspects of ASEAN's current policy are also obviously sound. Examples are, the development of detailed implementation timelines and priorities in advance of actual implementation and the empowering of the ASEAN Secretariat with the role of monitoring and reporting performance relative to these plans and to use statistical indicators and scorecards to assist it do this.

In short, there is nothing in the research and data we reviewed that indicates any need for ASEAN to change policy intentions relating to trade facilitation and supply chain improvement from those in the AEC Blueprint. The key will be to ensure the current policy intentions are translated by the various governments and agencies into action and actually implemented.

## **7.2. Research opportunities**

It is in this aspect that we consider ERIA is able to offer assistance to ASEAN and its Secretariat in two ways:

- ERIA could continue to play a role in developing and refining the statistical indicators and scorecards the ASEAN Secretariat will use to monitor and report on progress. An initial ASEAN scorecard for trade facilitation is reported in Section 6; and
- policy makers and politicians can need good information on the potential gains for the economy as a whole and consumers in order to overcome opposition to reform. One role for ERIA would be to provide the research to establish the benefits and costs of reform and identify their distribution.

While there are typically many who will benefit from trade facilitation reform there are also, in some cases, a few who will suffer significantly because a monopoly rent or source of income they previously enjoyed is taken away. The losers are often employees in the very same public entities which need to develop and implement the reforms.



Reducing the amount of paper work clearly threatens those whose job it is to create and manage it. Reducing the rates of cargo inspection threatens the livelihoods of those who carry out the inspections. Reducing the complexity and unpredictability of customs procedures and increasing the speed of decision making threatens the incomes of those who have earned rents by ensuring the outcomes of the exercise of discretion are favourable and ‘facilitating’ the smooth flow of cargo through approval procedures.

### **7.3. Specific opportunities**

The above suggests the following specific research opportunities for ERIA to assist ASEAN policy makers and politicians in the context of development of the AEC:

- a gravity model study to assess the impact of the costs and time of border procedures among ASEAN countries on trade flows;
- case studies of the likely level of leakage of trade revenue among selected ASEAN countries;
- case studies of the impact of border costs and delays on the investment decisions of potential foreign direct investors in ASEAN;
- development, testing and refinement of scorecards and statistical indicators relating to trade facilitation and logistics development; and
- case studies monitoring the outcomes of trade facilitation reforms in ASEAN countries to see if there are lessons to be learned by other economies.

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## APPENDIX 1. TRADE FACILITATION SCORECARD

**Table A1: Raw data**

	Logistics Performance Index	ASEAN Single Window due date	Customs clearance (days)	Lead time export, median case (days)	Lead time import, median case (days)	Typical charge for a 40-foot export container or a semi-trailer (US\$)	Typical charge for a 40-foot import container or a semi-trailer (US\$)	Number of border agencies exports	Number of border agencies imports	Possibility of a review procedure (%)	Rate of physical inspection (%)	Documents export	Documents Import
Brunei	2.9	2008	6.0	3.3	3.4	398	412	3.4	3.4	42	18	6	6
Cambodia	2.5	2012	1.0	2.7	3.3	335	422	3.7	3.7	50	12	11	11
Indonesia	3.0	2008	1.6	2.5	3.9	266	244	2.7	2.7	38	12	5	6
Lao PDR	2.3	2012	3.0	3.3	3.4	398	412	3.4	3.4	42	18	9	10
Malaysia	3.5	2008	1.7	3.4	3.3	783	658	2.5	3.3	75	6	7	7
Myanmar	1.9	2012	4.5	2.6	3.2	150	150	3.7	3.7	0	56	7	8
Philippines	2.7	2008	1.8	6.3	5.3	721	794	4.0	4.0	50	32	8	8
Singapore	4.2	2008	1.1	2.4	2.2	311	311	1.5	1.7	67	3	4	4
Thailand	3.3	2008	1.9	3.4	2.3	422	422	4.3	4.3	0	9	7	9
Vietnam	2.9	2012	1.4	2.8	4.0	194	294	4.5	4.0	57	14	6	8

*Notes:* (1) imputed ASEAN averages shaded.

*Source:* World Bank (2007a & 2007b).

**Table A2: Scoring system**

<b>Weight</b>	<b>Indicator</b>	<b>Score</b>	<b>Weight</b>	<b>Indicator</b>	<b>Score</b>
	<b>Logistics</b>			<b>Typical charge for a</b>	
<b>0.45</b>	<b>Performance Index</b>		<b>0.04</b>	<b>40-foot import</b>	
	(LPI/5)			0-100	1
				101-200	0.8
				201-300	0.6
<b>0.1</b>	<b>Single window</b>			301-400	0.4
	yes	1		401-500	0.2
	some move	0.5		500+	0
	no	0		<b>0.05 Number of border</b>	
	<b>Customs clearance</b>			1 - 2	1
<b>0.07</b>	<b>(days)</b>			2 - 3	0.75
	0 - 1	1		3 - 4	0.5
	1.1 - 1.5	0.8		4 - 5	0.25
	1.6 - 2	0.6		5+	0
	2.1 - 2.5	0.4		<b>0.05 Number of border</b>	
	2.6 - 3	0.2		1 - 2	1
	3+	0			
	<b>Lead time export,</b>			2 - 3	0.75
<b>0.05</b>	<b>median case (days)</b>			3 - 4	0.5
	0 - 1	1		4 - 5	0.25
	1 - 2	0.8		5+	0
	2+ - 3	0.6		<b>0.05 Possibility of a</b>	
	3+ - 4	0.4		proportion	
	4+ - 5	0.2		<b>Rate of physical</b>	
	5+	0		<b>0.05 inspection (%)</b>	
	<b>Lead time import,</b>			proportion	
<b>0.05</b>	<b>median case (days)</b>			<b>0.04 Documents Export</b>	
	0 - 1	1		0-2	1
	1 - 2	0.8		2-4	0.75
	2+ - 3	0.6		4-6	0.5
	3+ - 4	0.4			
	4+ - 5	0.2		6-8	0.25
	5+	0		8+	0
	<b>Typical charge for a</b>			<b>0.04 Documents Import</b>	
<b>0.04</b>	<b>40-foot export</b>			0-2	1
	<b>container or a semi-</b>			2-4	0.75
	<b>trailer (US\$)</b>			4-6	0.5
	0-100	1		6-8	0.25
	101-200	0.8		8+	0
	201-300	0.6			
	301-400	0.4			
	401-500	0.2			
	500+	0			

Source: NZIER.

**Table A3: Adjusted scores**

	Logistics Performance Index	ASEAN Single Window due date	Customs clearance (days)	Lead time export, median case (days)	Lead time import, median case (days)	Typical charge for a 40-foot export container or a semi-trailer (US\$)	Typical charge for a 40-foot import container or a semi-trailer (US\$)	Number of border agencies exports	Number of border agencies imports	Possibility of a review procedure (%)	Rate of physical inspection (%)	Documents export	Documents Import
Brunei	0.58	0.50	0.00	0.40	0.40	0.40	0.20	0.50	0.50	0.42	0.18	0.50	0.50
Cambodia	0.50	0.00	1.00	0.60	0.40	0.40	0.20	0.50	0.50	0.50	0.12	0.50	0.00
Indonesia	0.60	0.50	0.60	0.60	0.40	0.60	0.60	0.75	0.75	0.38	0.12	0.50	0.50
Lao PDR	0.45	0.00	0.20	0.40	0.40	0.40	0.20	0.50	0.50	0.42	0.18	0.00	0.00
Malaysia	0.70	0.50	0.60	0.40	0.40	0.00	0.00	0.75	0.50	0.75	0.06	0.25	0.25
Myanmar	0.37	0.00	0.00	0.60	0.40	0.80	0.80	0.50	0.50	0.00	0.56	0.25	0.25
Philippines	0.54	0.50	0.60	0.00	0.00	0.00	0.00	0.25	0.25	0.50	0.32	0.25	0.25
Singapore	0.84	1.00	0.80	0.60	0.60	0.40	0.40	1.00	1.00	0.67	0.03	0.75	0.75
Thailand	0.66	0.50	0.60	0.40	0.60	0.20	0.20	0.25	0.25	0.00	0.09	0.25	0.00
Vietnam	0.58	0.00	0.80	0.60	0.40	1.00	0.60	0.25	0.25	0.57	0.14	0.50	0.25

Source: NZIER.

**Table A4: Weighted scores**

	Logistics Performance Index	ASEAN Single Window due date	Customs clearance (days)	Lead time export, median case (days)	Lead time import, median case (days)	Typical charge for a 40-foot export container or a semi-trailer (US\$)	Typical charge for a 40-foot import container or a semi-trailer (US\$)	Number of border agencies exports	Number of border agencies imports	Possibility of a review procedure (%)	Rate of physical inspection (%)	Documents export	Documents Import
Brunei	0.26	0.05	0.00	0.02	0.02	0.02	0.01	0.03	0.03	0.02	0.01	0.02	0.02
Cambodia	0.23	0.00	0.07	0.03	0.02	0.02	0.01	0.03	0.03	0.03	0.01	0.00	0.00
Indonesia	0.27	0.05	0.04	0.03	0.02	0.02	0.02	0.04	0.04	0.02	0.01	0.02	0.02
Lao PDR	0.20	0.00	0.01	0.02	0.02	0.02	0.01	0.03	0.03	0.02	0.01	0.00	0.00
Malaysia	0.31	0.05	0.04	0.02	0.02	0.00	0.00	0.04	0.03	0.04	0.00	0.01	0.01
Myanmar	0.17	0.00	0.00	0.03	0.02	0.03	0.03	0.03	0.03	0.00	0.03	0.01	0.01
Philippines	0.24	0.05	0.04	0.00	0.00	0.00	0.00	0.01	0.01	0.03	0.02	0.01	0.01
Singapore	0.38	0.10	0.06	0.03	0.03	0.02	0.02	0.05	0.05	0.03	0.00	0.03	0.03
Thailand	0.30	0.05	0.04	0.02	0.03	0.01	0.01	0.01	0.01	0.00	0.00	0.01	0.00
Vietnam	0.26	0.00	0.06	0.03	0.02	0.04	0.02	0.01	0.01	0.03	0.01	0.02	0.01

Source: NZIER.

## Chapter 6

# Services Trade Liberalisation in the ASEAN Economic Community and Beyond

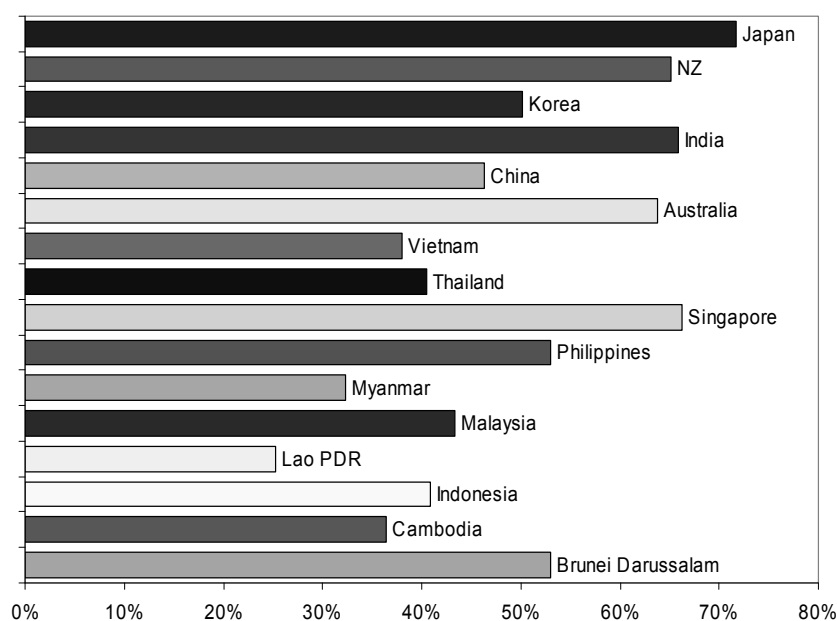
*Jenny Corbett*

## 1. SERVICES IN THE REGION

### 1.1. Services in regional output and employment

Services are a much greater part of both output and employment in all countries of the East Asia region than is usually recognised. Figure 1 and Table 1 show that, even in the least developed economies, services account for nearly 30 to 40 percent of GDP. In most economies they are closer to 60-70 per cent. They account for much higher shares of employment than the manufacturing sectors.

**Figure 1: Service as % of GDP in 2005**



*Source:* UNCTAD website (<http://stats.unctad.org/Handbook/TableViewer/dimView.aspx>), accessed January 9, 2008.

**Table 1: Employment by sector**

	Total	Agriculture	Industry	Service	Year
	In quantity (thousands)				
Australia	10153	356	2155	7614	2006
Cambodia	6561	2609	.	548	2004
China	737400	324870	130480	119010	2002
Indonesia	95177	42323	17106	35748	2006
Japan	63820	2720	17890	42490	2006
Korea	23151	1785	6096	15112	2006
Malaysia	10275	1504	3109	5407	2006
NZ	2117	151	473	1482	2006
Philippines	33188	12166	4898	14494	2006
Singapore	1796			1377	2006
Thailand	36344	4012	6016	18048	2006
Vietnam	42316	24498	7343	10230	2004
	Share of employment by sector (%)				
Australia	100%	3.5%	21.2%	75.0%	2006
Cambodia	100%	39.8%	.	8.4%	2004
China	100%	44.1%	17.7%	16.1%	2002
Indonesia	100%	44.5%	18.0%	37.6%	2006
Japan	100%	4.3%	28.0%	66.6%	2006
Korea	100%	7.7%	26.3%	65.3%	2006
Malaysia	100%	14.6%	30.3%	52.6%	2006
NZ	100%	7.1%	22.3%	70.0%	2006
Philippines	100%	36.7%	14.8%	43.7%	2006
Singapore	100%	.	.	76.7%	2006
Thailand	100%	11.0%	16.6%	49.7%	2006
Vietnam	100%	57.9%	17.4%	24.2%	2004

*Note:* Data not available for India, Brunei, Myanmar, Lao PDR.

*Source:* ILO website (<http://laborsta.ilo.org>), accessed January 8, 2008

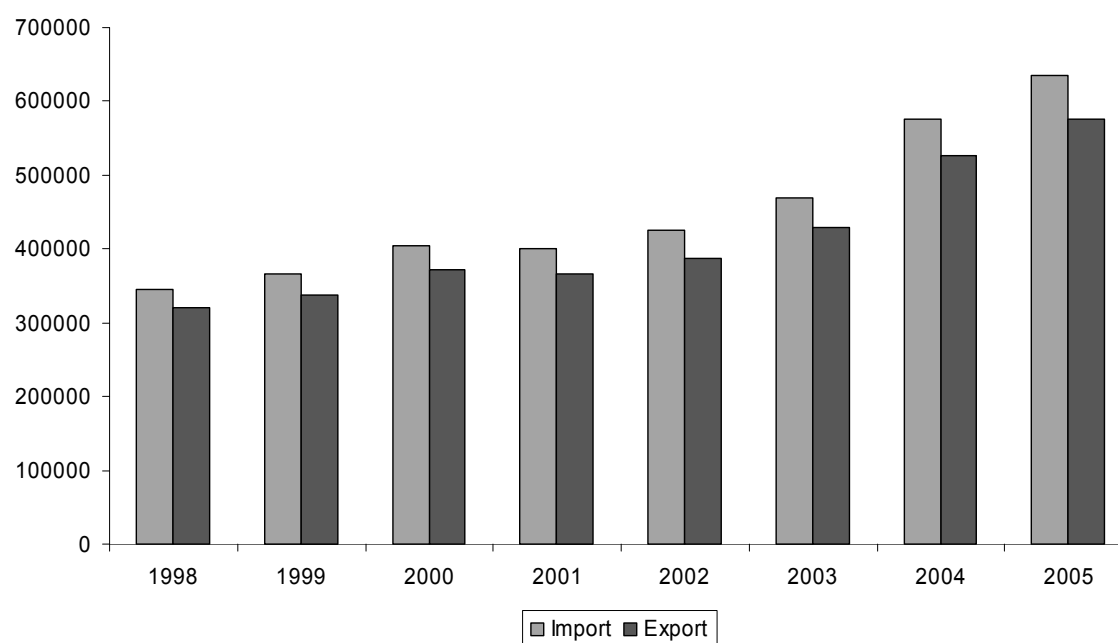
Clearly the services have a very important role to play in all the economies of the region and efficient and competitive service sectors will have a number of beneficial effects. The immediate effect will be seen in growth rates and employment creation but efficient services have even greater effects because of the way in which they are linked to other parts of the economy. Business (including IT and communications) services, transport and financial services are key inputs into almost all other sectors of the economy and, crucially, to the export-oriented manufacturing industries of the region. The now well-documented pattern of production networks can only operate with

efficient transport, freight, logistics, IT and communications services. Inefficiencies and high costs in these sectors therefore become a major source of inefficiency and high cost for the downstream industries that use them as inputs. Any inefficiency in these sectors could contribute as much of a cost burden to manufacturing as the trade facilitation costs that have been a much greater focus of policy attention.

## 1.2. Trade

Although services have traditionally been considered non-tradeable, new technologies and reduced transport costs have changed the picture immeasurably. Trade in services has been growing rapidly throughout the world and trade in the region is no exception. Figure 2 shows the scale and growth of services trade for the regional economies. For some economies in the region (e.g. Singapore) services are their main export.

**Figure 2: ASEAN+6 exports and imports of service, 1998-2005 (Mil.US\$)**



*Note:* Data not available for Brunei and India.

*Source:* UNCTAD website (<http://stats.unctad.org/Handbook>), accessed January 8, 2008.



### **1.3. Services in Trade negotiations**

Services trade is different and more complex than trade in goods. Trade in goods involves exchanges of physical goods across borders and is relatively straightforward to define, record and measure. As a result there are reasonably accurate statistics for the values of cross-border trade. Services, by contrast, are intangible and multi-faceted and may be traded in a variety of ways that make it difficult to track, measure and record their value. Four modes of supply were identified in the 1994 General Agreement on Trade in Services (cross-border trade, consumption abroad, commercial presence and movement of suppliers). Subsequent trade agreements (including the major one in the East Asian region, the ASEAN Framework Agreement on Services, AFAS) have broadly followed the definitions and terminology of the GATS.

The modes of supply are easiest to understand by example. Cross-border trade takes place when neither producer nor consumer move and the service itself is traded. This could take the form of business or financial services provided by mail or telephone or over the internet (for example, the purchase of an insurance contract via the internet when consumer and supplier are in different economies). Consumption abroad occurs when consumers move to the location of the service and the most obvious example is tourism. Both of these modes of supply are quite close to the conventional notion of “trade” and flows of services by these modes are captured (to some degree) in balance of payments statistics. But a considerable part of service provision takes place when producers set up in a host country either via a long-term presence (mode 3; commercial presence) or by a shorter-term movement (e.g. a foreign architect travelling to a site to provide plans and advice for a building project). Neither of these types of service provision is routinely captured in trade statistics but these modes account for a large part of services trade. For these reasons trade statistics are incomplete. Nonetheless, trade negotiations attempt to take account of all modes of supply and schedules of commitments will usually list restrictions according to all modes.

A number of other issues are also more complex in services trade policy than in goods. One is the architecture of the agreements. The GATS uses an approach known as a positive list. This method means that only sectors specifically scheduled in an agreement are subject to liberalising undertakings. There are, however, some

preferential services agreements covering services that use the negative list (so-called NAFTA approach, where liberalising commitments apply to all sectors unless specifically excluded) and some that use a hybrid approach with different strategies on listing restrictions from those used in listing sectors. There is still debate about whether the liberalising effect of one architecture is better than another (see Fink and Molinuevo, 2007). Current research suggests the architecture alone may not be so important: the commitment to real liberalisation is the crucial element and can take place under either architecture. Other complications arise in rules of origin, inconsistent treatment of investment restrictions at the horizontal level and within services, the treatment of movement of persons and recognition of qualifications, government procurement and dispute settlement.

## **2. CURRENT POLICY FOR LIBERALISING SERVICES**

### **2.1. Why liberalise?**

The GATS identifies restrictions to trade in services in terms of whether they restrict *market access* in general or whether they specifically affect foreign service suppliers by not offering *national treatment* to all providers. Liberalising commitments may therefore be in the form of either the removal of general barriers to market access or offering national treatment to foreigners. This distinction has been useful in understanding the costs of barriers to services trade and in making recommendations on how to liberalise.

The economics literature identifies the direct cost of barriers to services trade via their effects on prices of services in the protected market. Barriers will raise the cost of services behind the barrier. It requires some econometric research<sup>1</sup> to establish how much of an effect barriers have but there are a number of studies that now provide estimates (see McGuire, 2003 and Dee, 2005, for surveys of some of that work). The effects are significant. McGuire (2003) cites effects of up to 150 percent increase in prices of some services in developing countries and up to 32 percent for developed.

The mechanisms by which barriers affect prices are also important. Dee and Hounslow (2000) established a now widely-used distinction between measures that raise price margins, thus creating rents for incumbent firms, and those that raise costs for all existing and potential service providers. Both types of barriers create inefficiencies but the rent-creating barriers involve resource transfers from consumers to producers and generally involve smaller economic (welfare) losses than the cost raising barriers. Cost raising regulations create deadweight losses. The former rent-creating barriers are similar to a tax while the latter have been called a “productivity” cost. This distinction has provided a useful theoretical tool for establishing the argument that welfare is likely to be most improved by removing the cost-raising barriers. Removing the rent-increasing barriers, while still valuable, has less economic effect.

It is not clear, however, which types of barriers belong in which category and research is only beginning on how to distinguish them. In general it has been assumed that the main cost-increasing measures are market access barriers (i.e. those that affect all providers) and this is broadly borne out by research to date. The main rent-increasing measures are abrogations from national treatment (which create protection for domestic incumbents against foreign entrants). Some early research arbitrarily assigned measures to one category or another but it is now understood that econometric research is required to accurately determine the direct cost and price effect of different types of barriers, by mode and sector and by whether they are market access or national treatment barriers.

This is not the final word on the economic benefits of services liberalisation. As noted earlier, services are important inputs to other sectors of the economy. Thus barriers to services, both cost and price increasing ones, are in effect a tax on other sectors of the economy as well. To measure the full economic benefits of liberalising services sectors a general equilibrium model estimate is needed. This type of estimate can give an order of magnitude of the benefits to be gained from different types of liberalising packages. A recent estimate for the East Asian region (ASEAN 5 plus CJK and Australia, Dee 2005) shows that the gains from liberalising *non-discriminatory* regulations in services alone far outweigh the gains from a liberalisation package that roughly mirrors the type of liberalising strategy likely under the AEC agenda. Comparing the former package, that only removes non-discriminatory barriers (i.e.

generally behind-the-border, market access barriers that affect domestic as well as foreign providers), with a package that only removes discriminatory, national-treatment type barriers but simultaneously reduces manufacturing and agriculture barriers between regional partners (similar to the AEC Strategies) gives an economic gain *five times* larger.

While the welfare effect is greatest from removing the cost-increasing barriers there may be practical benefits to gradually removing all types of barriers simultaneously. As McGuire (2003, p.68) notes;

“Reducing non-discriminatory restrictions on services suppliers together is a better approach than only reducing discriminatory restrictions on foreign service suppliers. Reducing discriminatory restrictions on foreigners alone can have a negative impact on the level of services supplied by domestic firms. This will result in lower prices and higher total sales, but domestic service suppliers will end up with a smaller share of the service sector. If restrictions that affect foreign and domestic service suppliers equally are reduced, all service suppliers will have the same opportunities to increase the amount of services they supply in an expanding market.”

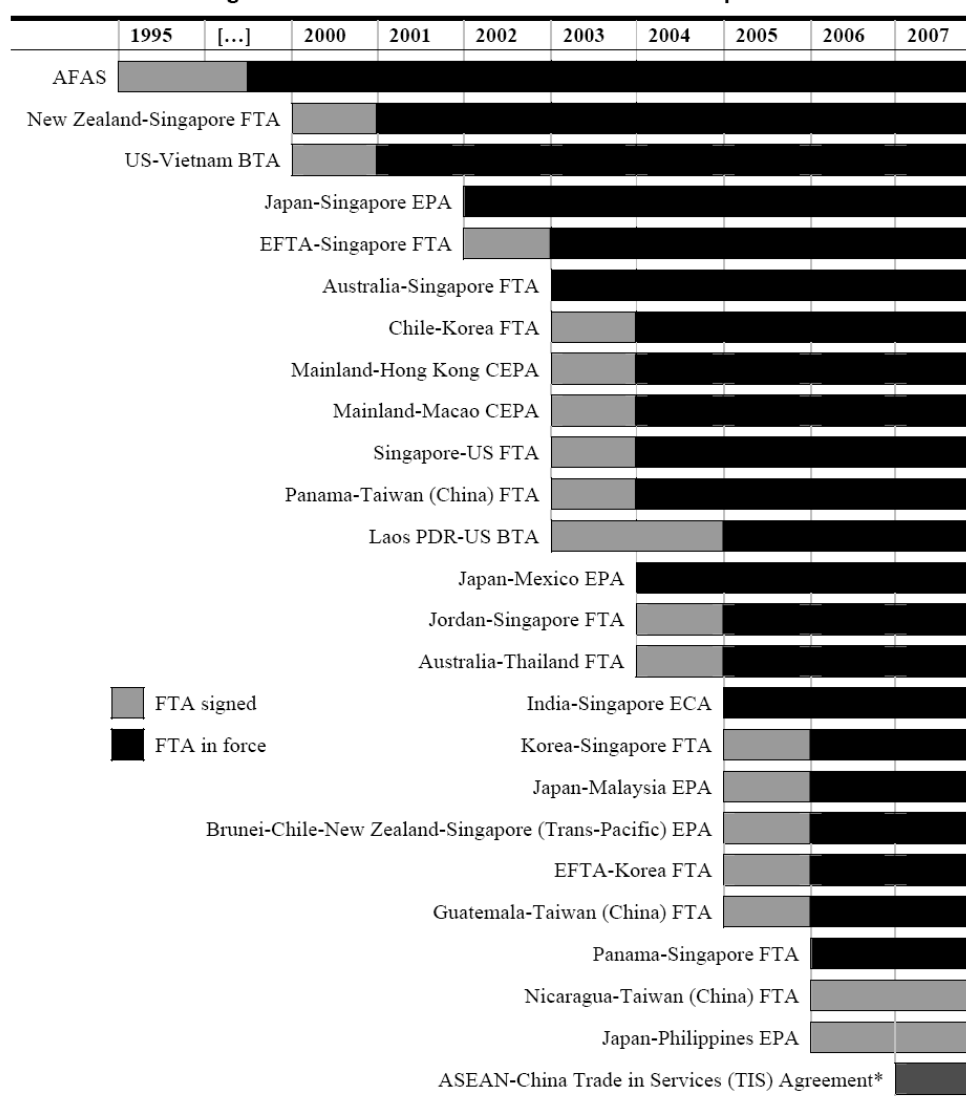
This is an extremely important practical, political-economy message to convey to policy makers. It stresses the benefits of reducing behind-the-border, market access measures which equally affect domestic players (as a rule-of-thumb, until better estimates are available to identify the full range of cost-raising measures) and points out that services liberalisation does not have to advantage foreign providers over domestic.

## **2.2. Agreements in the region**

Because of the importance of services to all economies, and because technology now makes services more easily traded than ever before, they have recently begun to feature heavily in most trade agreements whether bilateral or plurilateral. The AFAS (1995) is an early example of an agreement explicitly focussed on services. More recently, the rate of growth of trade agreements including services components has increased rapidly around the world. 36 preferential agreements have been notified

under the GATS Article V and 29 of these were notified since 2000 when the WTO services negotiations began (12 in 2003-4 and 10 in 2005-6). These figures likely underestimate the number of agreements including services since many agreements are not notified to the WTO. Most agreements covering services sectors involve both developing and developed countries; few agreements between only developed or only developing countries have included services components although the trend may be changing (Roy, Marchetti and Lim, 2006).

**Figure 3: East Asian FTAs with a services component**



Notes: As of January 2007. \* The ASEAN-China TIS Agreement is scheduled to enter into force on July 1, 2007.

Source: Fink and Molinuevo (2007), World Bank, p.2.

East Asia has been slower to engage in preferential agreements than other areas of the world but has recently begun to undertake them. This in part reflects the growing momentum for regional integration but also reflects broader strategic developments in trade policies on the part of some of the larger economies. In 2003 there were only two PTAs per economy in East Asia (Fink and Molinuevo, 2007). Figure 3 shows all PTAs involving at least one economy within the East Asian region that include a services component. They total 25 agreements, including AFAS, and there are several other regional agreements already signed that do not include services. Table 2 shows a number of other agreements currently under negotiation in the region which may or may not include services.

**Table 2: Agreements under negotiation**

Country	FTA partner(s)
ASEAN	Australia & New Zealand, India, Japan
Brunei	Japan
China	Australia, Gulf Cooperation Council, New Zealand, Southern African Customs Union
Indonesia	Japan
Japan	ASEAN, Brunei, Chile, Indonesia, Korea, Thailand, Vietnam
Korea	Canada, India, Japan, Malaysia, United States
Malaysia	Australia, India, Korea, New Zealand, Pakistan, United States
Singapore	Bahrain, Canada, Egypt, Kuwait, Mexico, Pakistan, Peru, Qatar, Sri Lanka, United Arab Emirates
Taiwan	Dominican Republic, El Salvador, Honduras
Thailand	EFTA, Japan, United States
Vietnam	Japan

*Note:* As of January 2007.

*Source:* Fink and Molinuevo (2007), World Bank, p.3.

### 2.3. Services in regional integration

While bilateral or plurilateral agreements are proliferating in the region it is not easy to see how these link to ambitions for the creation of a regional free market in services. At present ASEAN has a clear ambition to create a single market for services amongst ASEAN members but it is less clear how that relates to the policy objectives in the wider EAS region.

ASEAN's plans for regional integration have emphasised the need for liberalisation in services trade since the elaboration of the ASEAN Vision 2020 in 1997. Policy documents regularly refer to the desirability of free trade in both goods and services and services are an explicit element in the plans for the ASEAN Economic Community (first set out in the Bali Concord of 2003). Under the Bali Concord it was agreed to set clear targets and schedules of liberalisation in services and to bring the goal of free trade in services forward from 2020. The Vientiane Action Plan (from the 2004 ASEAN Summit in Vientiane) identified 11 priority sectors for integration, of which 4 are in services (air travel, e-ASEAN, healthcare and tourism). A fifth service sector, logistics, was added in 2005 and the ambition was to see full integration in these priority sectors by 2015 (with flexibility). The recent Blueprint for the ASEAN Economic Community is even more ambitious. It calls for removing substantially all restrictions on trade in services in the first 4 priority sectors by 2010, in logistics by 2013 and in all other services sectors by 2015 (see appendix for the Blueprint plan and the Strategic Schedule) (ASEAN, 2007).

In addition to these steps there have been 5 packages of commitments under the AFAS and separate negotiations on financial services (under the Finance Ministers) and in air transport (under the Transport Ministers). Negotiations on investment liberalisation takes place in the Coordinating Committee on Investment within the framework of the ASEAN Investment Area Agreement (AIA).

Services have also been included in several of the PTAs with ASEAN's dialogue partners (services have been included in the ASEAN-China PTA and are being negotiated with Korea, Australia and NZ) and, as noted above, in the various PTAs of China, Japan, Korea, India, Australia and New Zealand.

#### **2.4. Methods to extend agreements**

To expedite liberalisation of trade in services ASEAN has opted for the "ASEAN minus X" formula where 2 or more members may agree service sector liberalisation without having to extend the concessions to non-participating economies. This may speed up some degree of liberalisation but also runs the risk of removing the pressure on slower moving members to introduce services liberalisation. In addition, it is very far

from an MFN approach and may make it more difficult to extend liberalised treatment to non-ASEAN countries. This raises some issues for the approach that might be applied to a wider regional area such as the CEPEA.

#### **4. HOW TO JUDGE PROGRESS?**

Clearly, to achieve these ambitions on services liberalisation in the region it will be necessary to have a method to measure success. How should the present state of barriers to trade in services and the degree of liberalisation represented by trade agreements and regulatory changes be judged? These questions have only recently become the focus of research and policy thinking so there are still challenges to be faced. The challenges are particularly great within the East Asian region.

Several studies, starting with Hoekman (1995), have measured the restrictiveness of trade and regulatory policy towards services. The main method used to assess the extent of barriers to services trade is to develop indexes of restrictiveness of the regulatory regimes that affect the freedom of entry into the sector and the operations by foreign service-providers. The alternative methodology is to count the frequency with which barriers are applied in sectors or in agreements but these give no indication of the severity of the barriers.

The aim of the index method is to measure the extent to which a service sector is “heavily” restricted relative to some norm. A key question is how to establish a norm. Services are frequently heavily regulated for a number of reasons. By contrast with goods, it is common for countries to have services’ regulations designed to achieve a number of objectives other than market efficiency and lowest cost production. Prudential regulations and safety standards are typical examples but there are many others. Air transport, telecommunications and financial services are all frequently set aside for special treatment in regulation and trade policy because countries have different national policy goals. There is not yet a well-developed economics literature that establishes the optimal amount of regulation in individual industries but a convention is developing. There are now templates that list types of regulatory barriers



based on GATS categories and these provide a reasonable basis for collecting data and building up cross-country comparisons. In effect they provide an implicit benchmark by establishing a list of regulations that go from very little, or no, restrictive effect up to highly restrictive. Dee, 2005, gives an exhaustive compendium of the categories of regulation that are relevant in different services sectors, though other studies still sometimes compile their own lists.

### **BOX 1: The index methodology**

The index methodology proceeds in several steps.

- The first step is to compile data on what restrictions are applied to both establishment and ongoing operations in a sector. The focus is mainly on restrictions that impede trade but since domestic regulations often have a trade effect it is difficult to separate them. The method involves
  - constructing a template of types of restriction that seems most important and appropriate in each sector
  - establishing a score (usually between 0 and 1) for each type of restriction that is imposed
- Data is collected primarily from scheduled commitments in trade agreements but should also be supplemented by information on the actual state of implementation of regulation since commitments often differ from the status quo. Ideally this is done from a deep knowledge of the economy under scrutiny and may be supplemented by questionnaires to business practitioners to identify actual regulations in place rather than just those listed in agreements.
- A score is then calculated from all the restrictions in place, to give an overall restrictiveness index for each sector in each country.

There are obviously a number of elements that are potentially difficult in this exercise:

- Judgement is involved in constructing the initial template of the type of restriction to include
- Judgement is also involved in deciding on the score to be given to each type of restriction
- The final index could be a simple average of the scores for each restriction but is usually some kind of weighted average. This raises questions about how to establish appropriate weights (there are examples of indexes using no weights, using arbitrary, judgement-based weights and using factor-analysis derived weights).
- Data are usually derived from scheduled commitments in trade agreements but

not all countries are signatories to the GATS so other sources need to be found.

- Agreements differ in architecture with some positive list and some negative list approaches. In the case of positive list (GATS type agreements) it is not always clear what situation applies in the sectors not scheduled.
- Actual regulations may be more liberal than trade commitments (which frequently “bind” at a higher level of restriction than is actually in force) so other data are needed if possible to reflect the reality.
- Increasingly countries are signatories to many agreements with different restrictions in a sector (these may be GATS plus but may only apply to the counterparty to the agreement. How should the overall degree of restrictiveness of barriers in a sector be assessed in this case – on the most liberal agreement in force or on the agreement that applies to the majority of trading partners?)
- Even when data are available the process is time consuming. Databases are gradually being built up but they are not always publicly available.

Once developed, the indices give a numerical value for individual restrictions in each sector and for the overall degree of restriction in the sector. The component restrictions can be grouped in a number of informative ways:

- By whether they affect only foreign suppliers (i.e. “national treatment” measures) or also domestic suppliers (similar, though not identical, to “market access” measures)
- By whether they affect the establishment of a business or the ongoing operations (i.e. whether the measures affect those trying to enter or those already in business)
- By whether they affect a specific mode of supply
- Or by whether they are mainly price increasing or cost increasing (see discussion above)

Once these indices are constructed they may be used for a number of purposes:

- To compare countries’ performance in liberalisation against peers and over time
- To discover what types of restrictions are most prevalent
- To show which sectors are most restricted
- To show which modes of supply are most restricted
- To estimate the economic effects of barriers in particular sectors (on the prices, costs and margins in the industries)

- To estimate (in general equilibrium models) the overall economic benefit from removing the barriers.

#### **4.1. Assessments of barriers to services trade: how restricted is the region?**

A number of studies have calculated restrictiveness indicators in some service sectors for countries within the region. There is not space here to describe them or to reproduce their results, and they do not all use consistent methods, but the consensus view can be summarised as:

1. The Asian region is fairly heavily restricted i.e. liberalisation in services has not yet made significant progress
2. There are significant barriers in banking, telecommunications and the professions (Dee, 2005). The barriers in these sectors are generally discriminatory against foreigners and are more rent-creating than cost raising. Barriers in distribution and electricity generation are, on the other hand, more cost raising.
3. In business services ( accountancy, legal services, architectural services, software development and IT services, management consultancy services) barriers are higher in the regulated services than in management consultancy and IT services and the discriminatory element of the barriers is high (REPSEF 05/006, 2007).
4. The most recent set of studies for the region show high levels of restriction still remain in banking, insurance, distribution and logistics with liberalisation only in a few countries (ANU, 2008). There are significant variations across the region in restrictions on business services, maritime and postal services (NZIER, 2008) with restrictions on particular modes more important in some sectors than others.
5. It would be useful to have a more complete set of studies, that used the same methodology and covered more services sectors for the countries in the region and that allowed comparisons with other regional groupings and similar income level countries to make a better assessment of the current position. (Dee 2005, McGuire 2003, REPSEF 2007).

While the ASEAN Secretariat has committed to undertake a Stocktake on services by August 2008 no information is publicly available on how it is to be conducted. The

on-going ERIA project on Services Trade Liberalisation (ANU, 2008 and NZIER, 2008) could provide a basis for such a study and would make the base for a method to judge progress towards the liberalisation goals of the AEC. There have been other suggestions for methods to track progress (see for example Vo and Bartlett, 2003) but they have not been based on the best available methodology, which is a strength of the current ERIA research.

#### **4.2. Assessments of regional agreements**

It is also possible to use a similar methodology to assess how liberalising are recent trade agreements such as AFAS and the various PTAs in the region. The index methodology used in several recent studies (Vo and Bartlett, 2006; Roy et al, 2006; Fink and Molinuevo, 2007; Ochiai et al, 2007) is similar to the method outlined above. The difference is that the template against which the scoring takes place is tailored to the characteristics of trade agreements rather than to the regulations applying to a particular sector. These studies provide a judgement about the liberalising effect of the AFAS and various regional agreements.

The broad conclusion here is that AFAS is not particularly liberalising compared with GATS commitments (Stephenson and Nikomborirak, 2002; Vo and Bartlett, 2006; Roy et al, 2006; Fink and Molinuevo, 2007) and that most regional PTAs do not add significant new liberalising elements over GATS (Ochiai et al, 2007). Since AFAS does not go much beyond the GATS it is, therefore, not providing much impetus to liberalising services trade within ASEAN.

## **5. CONCLUSIONS**

Services are an important part of all economies in the region and an increasingly important part of trade both within the region and between the region and the rest of the world. The nature of services, both within domestic economies and in trade and trade negotiations is complex and different from trade in goods. There are difficulties about

accurately measuring output and trade in services but even within the constraints of existing data it is possible for research to provide a clearer picture than now exists. Policy-focussed research can also help identify the most urgent priorities for the data collection exercise that is necessary.

Because of the complexities of services they have been treated differently in international trade agreements since the GATS. This introduces a lot of new terminology that helps to categorise barriers to trade in services but from an economic point of view these classifications are not the most important ones. Recent research has identified the main economic effects of barriers to services trade depending on whether the restrictive policy measures raise price margins or raise costs. A considerable research effort is needed to identify which measures have which effect but the methods now exist to create indexes of restrictiveness by sector, by type of measure and by mode of supply. All of these are needed to identify the priorities in liberalising regulations in sectors both at the border and behind the border.

Existing approaches to services liberalisation in the region have been limited in effectiveness. The AFAS has been analysed by several researchers and judged not to have delivered much beyond GATS commitments and regional PTAs have a very mixed effect. There is concern that both the architecture and the negotiating methods within the region may actually hinder, rather than help, the extension of the commitments by the early liberalisers to other economies. Within ASEAN, the group that will lead the way in regional liberalisation, services are not treated consistently as a whole sector. Different sectors come under different parts of ASEAN's structure and investment issues are treated separately again.

## 6. POLICY IMPLICATIONS

There are several policy implications that follow from the issues raised in this paper.

1. Gains are much larger from reducing non-discriminatory barriers than from reducing the discriminatory barriers that are typically the focus of trade negotiations. The reason for this is that most if these barriers are of the cost-raising (i.e. productivity reducing) type rather than the price raising (or tax) type though it is not yet clear exactly which type of barriers has which type of effect in all the major services sectors.
2. It is important to increase understanding of this important message and this requires further research that identifies the costs of specific barriers in specific sectors and by clearly spelling out the costs to the *domestic* economy (not just to foreign trading partners) of these restrictions.
3. Commitments to liberalise should be concentrated on the most costly barriers in the most restricted sectors (where the gains are greatest). Further research is needed to identify these sectors. A useful compendium (Dee, 2005b) brings together current studies of sectors and countries but much remains to be done to improve the coverage.
4. Monitoring progress towards the strategic schedule of the Blueprint needs indexes that show the level of restrictiveness by sector and by country. Without a measure of a starting point there is no yardstick for progress.
5. The ASEAN Secretariat's plans for a Services Stocktake may be a useful step but its methodology is not yet public. It is important that there is consultation at an early stage with researchers familiar with the best practice methods for doing such a stocktake<sup>2</sup>. ERIA and its network of research institutes in the region could be a useful structure for compiling the additional information needed to carry out this task.
6. Negotiating strategies and the architecture of regional agreements can be improved to focus on
  - non-discriminatory barriers as well as discriminatory

- strategies that reduce all forms of barriers in a parallel fashion to avoid the potential reduction in quantity of supply of services that could follow reductions of discriminatory barriers alone.
7. It is necessary to establish best practice structures for ASEAN-x agreements and other PTAs so that extension to non-members is straightforward (not clearly the case at present). Index methods should be used to assess the liberalising value of new agreements involving regional economies (most are currently not GATS-plus despite the claims made for them and frequency methods of measuring the breadth and depth of cover are misleading).

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## NOTE

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1. See box below describing the methods used.
2. A relevant research project is underway at the ANU with support from the Productivity Commission and the Australian Research Council.

## Chapter 7

# **Investment Liberalization and Facilitation: Contribution to the ASEAN Economic Community Blueprint**

*Wisarn Pupphavesa*

### **INTRODUCTION**

Investment liberalization and facilitation are integral part of regional economic integration. Investment is instrumental to structural adjustment of the relevant economies and realization of the benefits of dynamic effect of the regional economic integration. Investment is needed to facilitate structural adjustment as well as exploitation of the opportunities emerging from liberalization of trade in goods and services. The structural adjustment and exploitation of the new opportunities may call for industrial relocation from the disadvantage location to a more competitive location, changing and up-grading production technology, enlarging production capacity, provision of supporting services and industries, and new investment. Investment liberalization and facilitation would make capital resource readily available at lower cost and hence enable fuller adjustment and exploitation.

Therefore, to deepen economic integration in ASEAN and East Asia, investment liberalization and facilitation is very vital. This paper reviews and discusses some important features of investment liberalization and facilitation agreement and vision of ASEAN and offers some recommendation on making investment liberalization and facilitation more effective in deepening of ASEAN and East Asian economic integration.

## **2. ASEAN INVESTMENT AREA<sup>1</sup>**

At the fifth ASEAN Summit in Bangkok in December 1995, the ASEAN Leaders decided to establish the ASEAN Investment Area (AIA) to attract FDI from outside as well as within ASEAN region. A Task Force was set up to draft the Framework Agreement on the ASEAN Investment Area. The Framework Agreement was then signed by the ASEAN Economic Ministers on October 7, 1998 and entered into force since April 7, 1999. Cambodia, then joined the accession to the AIA Agreement on April 30, 1999, about 3 weeks after the date of enter into force, so that the AIA extends across all 10 ASEAN countries.

The objectives of the Framework Agreement on AIA are : a) to establish a competitive ASEAN Investment Area with a more liberal and transparent investment environment amongst Member States in order to increase FDI inflows from both ASEAN and Non-ASEAN sources into ASEAN, jointly promote ASEAN as the most attractive investment area, strengthen and increase the competitiveness of ASEAN's economic sectors, and reduce or eliminate regulations and conditions which impede investment flows and the operation of investment projects in ASEAN; and b) to contribute towards free flow of investments by 2020.

Member states are obliged to undertake co-operation and facilitation programme (Schedule I), promotion and awareness programme (Schedule II), and liberalization programme (Schedule III). Under Schedule I, Member States are required to take 1) individual initiatives to increase transparency of its investment rules, regulations, policies and procedures, simplify and expedite procedures for applications and approvals of investment projects, and expand the number of bilateral Double Taxation Avoidance Agreements among ASEAN Member States, and 2) collective initiatives to establish a Database for ASEAN Supporting Industries and ASEAN Technology Supplies and ASEAN database on ASEAN investment and opportunities, promote public-private sector linkages through regular dialogues with the ASEAN business community and other international organizations to identify investment impediments within and outside ASEAN and propose ways to improve the ASEAN investment environment, identify target areas for technical co-operation such as HRD,

infrastructure, supporting industries, SMEs, IT, R&D, etc., review and improve the ASEAN Agreement for the Promotion and Protection of Investment, and examine the possibility of an ASEAN Double Taxation Agreement.

Under Schedule II, Member States agreed to organize joint investment promotion activities, conduct regular consultation among investment agencies of ASEAN on investment promotion matters, organize investment related training programmes for officials of investment agencies of ASEAN, exchange lists of promoted sectors/industries where investment from other Member States could be encouraged and initiate promotional activities, and examine ways to support promotion efforts of other Member States.

Under Schedule III, Member States are required to 1) unilaterally reduce and eliminate restrictive investment measures and liberalize rules, regulations and policies relating to investment, rules on licensing conditions, rules relating to access to domestic finance, and rules to facilitate payment, receipts and repatriation of profits by investors; 2) undertake individual action plans to open up all industries for investment to ASEAN investors by 2010 and to all investors by 2020 and to extend national treatment to all ASEAN investors by 2010 and to all investors by 2020; and 3) promote freer flow of capital, skilled labour, professionals and technology among ASEAN Member States.

Note, however, that Article 7 of the Agreement stipulates that Member States immediately open all their industries for investment and accord national treatment to ASEAN investors subject to exceptions under Temporary Exclusion List (TEL) and Sensitive List (SL). TEL will be reviewed every 2 years and will be progressively phased out by 2010 by all Member States except Vietnam, Lao, and Myanmar. Vietnam will phase out its TEL by 2013 and Lao and Myanmar by 2015. SL would be reviewed by January 1, 2003 and periodically thereafter as decided by the AIA Council.

A Member State is required to extend any preferential treatment under any existing or future agreements to which it is a party to all other Member States on the Most Favoured Nation (MFN) basis.

The Agreement also calls for transparency in the Member State's relevant measures, laws, regulations, and administrative guidelines pertaining to or affecting this agreement and including international agreements pertaining to or affecting investment to which the Member States are also signatory (Article II).

Certain exceptions are provided in the interest of national security and public morals, human, animal or plant life or health, prevention of deceptive and fraudulent practices, protection of privacy of individuals and safety, and equitable or effective imposition or collection of direct taxes in respect of investments or investors of Member States.

In addition, emergency safeguard measures and measures to safeguard the balance of payments are allowed for Member States to prevent or to remedy any serious injury and threat resulting from implementation of the liberalization programme or in the event of serious balance of payments and external financial difficulties or threat.

It could be observed that under the Agreement, Member States unilaterally draw up and implement their own liberalization plans in accordance with the Agreement. The preferential treatment is then extended to other Member States on MFN basis amongst those that meet the requirements in the Agreement. The Member State that is not ready to make the required concessions would have to waive its right to such concessions extended by other Member States unless the counterpart Member State is willing to forego the waiver. This mechanism is the well known ASEAN-X which was employed in AFTA.

Of noteworthy feature of the Agreement is the provision of preferential differential treatment for less developed new members of ASEAN to take 3-5 years longer to achieve the liberalization target but yet might get access to other Member States' MFN concessions.

In order to revive the ASEAN economies from the economic and financial crisis, the ASEAN Leaders agreed at the Sixth ASEAN Summit on December 16, 1998 to adopt Bold Measures whereby TEL for the manufacturing sector would be phased out by all Member States by 2003 except for Cambodia, Lao and Vietnam which would do so no later than 2010. In addition the First AIA Council Meeting on March 5, 1999 agreed to widen and elaborate AIA coverage to include manufacturing, agriculture, fishery, forestry, mining and quarrying and services incidental to these sectors. These were then undertaken by the Protocol to Amend the Framework Agreement on the ASEAN Investment Area agreed in September 2001.

Subsequently, it was reported that the AIA process has made good progress. At the Sixth AIA Ministerial Council Meeting in September 2003, it was reported that Member

States had opened up more industries to foreign investment by phasing in the list of sectors and investment measures in the TEL. Significant achievements had also been made in transferring sectors and measures in the SL to the TEL. Member States also, on individual basis, introduced more favourable measures to improve their investment regime. Several projects on investment promotion and facilitation aiming at strengthening capacity building, improving transparency, and harmonization and improvement of FDI data quality were implemented successfully with support from Dialogue Partners and international organizations such as UNCTAD. To enhance transparency and promote greater awareness of ASEAN investment environment, the Council agreed to publish an update Compendium of Investment Policy Measures and the FDI data set. The Council also agreed to have regular dialogue with ASEAN dialogue partners to spearhead investment cooperation as well as to have more active dialogue with ASEAN and Non-ASEAN business representatives. Recognizing the growing importance of the services sector, the Council agreed to work out the scope of expanding the AIA to include services such as education services, health care, telecommunication, tourism, banking and finance, insurance, trading, e-commerce, distribution and logistics, transportation and warehousing, professional services such as accounting, engineering, and advertising.

In the following year, progress was made in the area of promotion of awareness of development in ASEAN's supporting industries and understanding of transnational corporations' strategies. Some Member Countries have reviewed The TEL and The SL and submitted the revised version. The ASEAN Business Advisory Council (ABAC) in cooperation with the Coordinating Committee on Investments (CCI) successfully organized and concluded the First ASEAN Business and Investment Summit in October 2003 in Bali. The first CCI-Japan Investment Consultation was held in May 2004. Continued progress in the AIA process would be made through enhancing external linkages with Dialogue Partners and joint consultations with private sectors. It was also agreed that ASEAN's investment and trade policies should work in tandem to ensure ASEAN's competitiveness.

Another big step in ASEAN's initiatives in investment cooperation was taken when ASEAN Framework Agreement for the Integration of Priority Sectors was signed on November 29, 2004, to accelerate the integration of priority sectors to realize the end

goal of ASEAN Economic Community that ASEAN Leaders agreed to establish by 2020. The Agreement identified 11 sectors namely agro-based products, air transport, automotives, e-ASEAN, electronics, fisheries, healthcare, rubber-based products, textiles and apparels, tourism, and wood-based products, as the priority sectors. The Agreement provides for liberalization of trade in goods, trade in services, and investment; trade and investment facilitation; and promotion and monitoring in the priority sectors. The Agreement also includes other areas for integration such as intellectual property rights cooperation, industrial complementation promotion, and human resource development among ASEAN Member States.

On liberalization of trade in goods, all CEPT-AFTA tariffs on priority sector products would be eliminated by January 1, 2007 for ASEAN-6 and January 2012 for CLMV (with certain exception). Member States would establish the database of ASEAN NTMs by June 30, 2004, establish criteria to identify NTMs that are barriers to trade by June 30, 2005 and establish a definitive work programme for the removal of NTMs that are trade barriers by December 31, 2005, and adopt the WTO Agreement on Import Licensing Procedures and develop common implementation guidelines appropriate for ASEAN by December 31, 2004. Member States would also endeavour to expand the coverage of the ASEAN Integration System of Preferences (AISP) Scheme by including products in the priority sectors.

As for trade in services, Member States would set clear targets and schedules for progressive liberalization for each round of negotiations toward achieving freer flow of trade in services earlier than 2020, accelerate the service liberalization for the priority sectors by 2010, accelerate the development of Mutual Recognition Arrangements (MRAs) by January 1, 2008 and promote joint ventures and cooperation including third country markets, based on ASEAN-X mechanism.

On investment, Member States would accelerate the opening up of sectors currently in the SL by transferring them to the TEL under the AIA, using ASEAN-X formula and beginning 2004, reduce restrictive investment measures in the SL beginning 2004 and complete the elimination of restrictive investment measures in the TEL by December 31, 2010 for ASEAN-6, 2013 for Vietnam and 2015 for Cambodia, Lao, and Myanmar, identify programme and activities to promote investment in ASEAN by December 31, 2005, promote manufacturing processes in ASEAN to take advantage of their

comparative strengths through establishment of a network of ASEAN free trade zones to facilitate outsourcing beginning 2005 and undertake more efficient joint ASEAN facilitation and promotion measures to promote FDI on ongoing basis, and promote and facilitate joint/cross border investments in manufacturing activities through special incentive where appropriate by CLMV for FDI from ASEAN and special measures by ASEAN-6 to promote and facilitate relocation of investment to CLMV especially for labour intensive manufacturing activities.

Regarding trade and investment facilitation, Member States would improve the CEPT Rules of Origin by making them more transparent, predictable and standardized and adopting substantial transformation as an alternative criteria for origin status; apply the ASEAN Harmonized Tariff Nomenclature (AHTN) for extra-ASEAN trade on an on-going basis; simplify, improve and harmonize custom declaration forms by December 31, 2005; ensure the Green Lane System for CEPT products by December 31, 2004; develop the Single Window approach including the electronic processing of trade documents at national and regional level by December 31, 2005; develop common implementation guidelines by December 2004 to fulfill the obligations of the WTO Agreement on Customs Valuation; take certain steps to accelerate the development of MRAs and harmonize product standards and technical regulations; expedite the development of integrated transport logistics services within ASEAN; and develop ASEAN Agreement and accelerate completion of MRAs to facilitate the movement of business persons, experts, professionals, skilled labour and talents.

On trade and investment promotion, Member States would intensify joint intra-ASEAN and extra-ASEAN trade promotion efforts, assist CLMV in organizing promotional activities, undertake more effective joint ASEAN facilitation and promotion measures, and develop new sources of inward FDI such as China, India and Korea.

The Agreement also provides that Member States expand the scope of ASEAN intellectual property rights cooperation to include cooperation in copyright information exchanges and enforcement; promote industrial complementation among ASEAN manufacturers through identification and development of specialization of production processes, R&D, and testing facilities based on comparative advantage of individual Member States; and development of guidelines on promoting outsourcing arrangements



among Member States, and cooperate to develop and upgrade skills and capacity building.

### **3. ASEAN Comprehensive Investment Agreement (ACIA)**

Subsequent ASEAN Summits accelerated ASEAN economic integration deeper and faster. The Summit in Kuala Lumpur in December 1997 decided to transform ASEAN into a stable, prosperous, and highly competitive region with equitable economic development, and reduced poverty and socio-economic disparities (ASEAN Vision 2020). The Bali Summit in October 2003 declared the goal of ASEAN Community by 2020 including ASEAN Economic Community (AEC), ASEAN Socio-Cultural Community, and ASEAN Security Community. The 12th ASEAN Summit in January 2007 then signed the Cebu Declaration on Acceleration of the Establishment of an ASEAN Community by 2015. Particularly, the ASEAN Leaders agreed to transform ASEAN into a region with free movement of goods, services, investment, skilled labour, and freer flow of capital.

The AEC Blueprint envisaged 4 key characteristics: a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy.

In the AEC Blueprint, free flow of investment and freer flow of capital are two major integral parts. A free and open investment regime is considered to be key to enhancing ASEAN's competitiveness in attracting foreign direct investment (FDI) and intra-ASEAN investment to ensure dynamic development of ASEAN economies. The AEC Blueprint calls for a review of the Framework Agreement on the AIA 1988 and the ASEAN Agreement for the Promotion and Protection of Investment, 1987 or commonly referred to as ASEAN Investment Guarantee Agreement (IGA) with the objective to realize an ASEAN Comprehensive Investment Agreement (ACIA) which would be forward looking, with improved features, provisions and obligations. The ACIA will cover investment protection, facilitation and cooperation, promotion and awareness, and liberalization.

With respect to investment protection, the ACIA will strengthen the provisions on investor-state dispute settlement mechanism, transfer and repatriation of capital, profits, dividends, etc., transparent coverage on the expropriation and compensation, full protection and security, and treatment of compensation for losses resulting from strife.

On facilitation and cooperation, the ACIA will provide for a more transparent, consistent and predictable investment rules, regulations, policies and procedures including harmonizing investment policies; streamlining and simplifying procedures for investment applications and approvals; promoting dissemination of investment information, rules, regulations, policies and procedures; strengthening databases on all forms of investments to facilitate policy formulation; strengthening coordination among government ministries and agencies; consulting with private sectors to facilitate investment; and identifying and working towards ASEAN-wide complementation.

The ACIA will also promote ASEAN as an integrated investment area and production network. The ACIA intends to create the necessary environment to promote all forms of investment and new growth areas into ASEAN; promote intra-ASEAN investments, particularly investments from ASEAN-6 to CLMV; promote the growth and development of SMEs and MNEs; promote industrial complementation and production networks among MNCs in ASEAN; promote joint investment mission focusing on regional clusters and production networks; extend the benefits of ASEAN industrial cooperation initiatives in addition to the AICO Scheme to encourage regional clusters and production networks; and work towards establishing an effective network of bilateral agreements on avoidance of double taxation among ASEAN countries.

Most importantly the ACIA will progressively liberalize ASEAN Member Countries investment regime to achieve free and open investment by 2015. Specifically, the ACIA will extend non-discriminatory treatment, including national treatment and most-favoured nation treatment, to investors in ASEAN with limited exceptions; reduce and where possible, eliminate restrictions to entry for investments in the Priority Integration Sectors covering goods; and reduce and where possible, eliminate restrictive investment measures and other impediments, including performance requirements.

With regard to freer flow of capital, the AEC will strengthen ASEAN capital market development and integration and will allow greater capital mobility. To strengthen ASEAN capital market development and integration, the AEC calls for

greater harmonization in capital market standards in ASEAN in the areas of offering rules for debt securities, disclosure requirements and distribution rules; mutual recognition arrangement or agreement for cross recognition of qualification, education and experience of market professionals; greater flexibility in language and governing law requirements for securities issuance; enhancement of withholding tax structure to promote the broadening of investor base in ASEAN debt issuance; and facilitation of market driven efforts to establish exchange and debt market linkages including cross-border capital raising activities.

In allowing greater capital mobility, the AEC will remove or relax restrictions to facilitate the flows of payments and transfers for current account transactions and remove or relax restrictions on capital flows to support foreign direct investment and initiatives to promote capital market development, while ensuring that the liberalization is consistent with member countries' national agenda and readiness of the economy and the benefits of liberalization is to be shared by all ASEAN countries as well as allowing adequate safeguard against potential macroeconomic instability and systemic risk that may arise from the liberalization process including the right to adopt necessary measures to ensure macroeconomic stability.

#### **4. POLICY ISSUES IN ASEAN INVESTMENT LIBERALIZATION AND FACILITATION**

The AIA and the ACIA are some big steps in the right direction of deepening ASEAN economic integration. Considering the ongoing development of international trade and investment globally as well as regionally, however, there are still several points of consideration in ASEAN investment liberalization and facilitation.

First, under the AIA, the accession to other ASEAN member countries' investment liberalization is conditional on ASEAN-X basis, and remain so under the ACIA. This mechanism serves to encourage voluntary reciprocal liberalization and discourage free riding. However, it allows X countries to fall behind in the liberalization process and thus will weaken the regional force of attracting investment as well as reduce the

potential benefits of the induced investment as the sources of inputs and the markets for the output will be rather limited. It would be desirable for ASEAN to have a concerted collective investment liberalization commitment of all ASEAN member countries in stead of allowing for –X during a given time frame of investment liberalization.

Second, the time frame of investment liberalization by 2015 is rather long, considering rapid pace of globalization, private sector dynamism, and strong competition for FDI. Investors will not wait that long for the investment opportunity. To shorten the time frame of investment liberalization, ASEAN member countries might review impediments to inward FDI which could be classified into a) administrative impediments, b) market access and national treatment standards, c) incentives, and d) operational restrictions (Pangestu and Bora, 1995) and consider the causes or rationale of those impediments (or restrictions) with the aim to remove them as many and soon as possible. Among other things, it was found that regulations on several stages of business undertaking, from starting a business to closing it were significant impediments to FDI inflows to developed and developing countries (Sudsawasd, 2008). Hence administrative impediments should be targeted for removal through investment facilitation program of action, most of which could be dealt without reservation and delay.

Furthermore, Sudsawasd (2008) also found that distance which reflects transaction cost of trade and investment had significant negative effect on FDI flows from OECD countries to East Asian countries while the size (GDP), labor costs and corporate income tax rates in the home countries had significant positive effects. On the other hand, corporate income tax rates in host countries had no significant effect on FDI flows to East Asian countries implying that tax incentive was not effective in attracting FDI. However, in the case of ASEAN-5, bilateral income tax treaties was found to affect FDI inflows positively.

Focusing on intra-developing Asian FDI flows, Rajan (2008) found also that distance significantly deterred bilateral FDI flows while depreciated host country currency, lower political risk and presence of FTA between host and home countries stimulated bilateral FDI flows.

Based on these findings, investment facilitation through logistics and communication improvement to reduce the transaction cost of distance will be a priority

while tax incentive competition will be futile. ASEAN countries would be better off with harmonized tax incentive and even better, tax incentive removal, the sooner the better.

Third, it is observed that the AIA offers preferential treatment to only ASEAN investors for a certain period of time and extend to all investors in later years. Given the fact that FDI in ASEAN has been and will continue to be largely from non-ASEAN, the impact of investment liberalization in favour of ASEAN investors will be rather limited and not conducive to achieving ASEAN's competitiveness in attracting FDI and competitive production base. To achieve competitiveness in attracting FDI and competitive product base, ASEAN investment liberalization needs to be unconditional MFN. Therefore, it would be a significant improvement of the ACIA if the national treatment and most favored nation treatment to "investors in ASEAN" refers to ASEAN as well as non-ASEAN investors.

Fourth, trade liberalization and investment liberalization have to progress in tandem to reinforce each other's impact and generate the greatest benefits. Therefore The TEL and The SL in trade in goods and services will limit the investment opportunities and benefits and vice versa. It is, therefore, of utmost important to minimize The TEL and The SL in both trade and investment liberalization and eliminate them as soon as possible.

Fifth, trade and investment liberalization needs to be accompanied by structural adjustment. There will be losers who resist and protest liberalization. To realize the benefits of liberalization, there must be structural adjustment. Without structural adjustment assistance measures and facilities, restructuring is difficult to realize. On the contrary, a well designed program of restructuring assistance may help accelerate the pace of liberalization. Therefore, ASEAN member countries need to unilaterally and, if possible, collectively come up with restructuring assistance and capacity building for those adversely affected by trade and investment liberalization to move ahead with and reap the benefits from trade and investment liberalization (Pupphavesa, 1993).

## **5. POLICY RECOMMENDATIONS ON INVESTMENT LIBERALIZATION AND FACILITATION**

ASEAN has made a courageous commitment to achieve an ASEAN Economic Community. Investment liberalization and facilitation is instrumental to such achievement. After reviewing the AIA and the ACIA, it is viewed that the AEC could be of greater success through the following commitment and actions:

1. ASEAN member countries make stronger commitment to collective approach and common time frame of trade and investment liberalization;
2. ASEAN member countries commit to faster acceleration and harmonization of trade and investment liberalization and facilitation;
3. ASEAN trade and investment liberalization should be multilateralized rather than preferential to ASEAN member countries;
4. ASEAN member countries should pursue coherent and broader coverage of trade and investment liberalization and facilitation;
5. ASEAN member countries unilaterally and collectively set up and implement structural adjustment and reform assistance and capacity building measures and facilities to ease the adversely affected parties.

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## NOTE

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1. Based on Pupphavesa, Wisarn and Sasatra Sudsawasd, "Progress of ASEAN Initiatives for Investment and Services Cooperation and Its Implications for Wider Regional Economic Integration in Asia," prepared for Workshop on Preferential Trading Agreements in Asia: Towards an Asian Economic Community, organized by Indian Council for Research on International Economic Relations, India Habilrat Centre, March 30, 2006.

## Chapter 8

# Competition Policy for ASEAN

*Mohamed Ariff*

In ASEAN, only four countries, namely Indonesia, Philippines, Thailand and Vietnam, have competition policies, although some others, including Malaysia, have enacted laws aimed at curbing monopolistic and restrictive business practices in a somewhat ad hoc manner. The ASEAN Blueprint expects all member countries to have full-blown competition policies in place by 2015, and intends to arrive at a set of guidelines for the crafting of competition policies by 2010. The main purpose of this study is to help ASEAN in its quest to have a set of competition policy guidelines.

Competition policy relates to a coherent and consistent body or structure of competition laws and mechanisms for effective enforcement. Competition law refers to the sets of rules enacted by governments to outlaw or limit anti-competitive practices.

This study provides some intellectual support for the introduction of competition policy in countries where it does not exist and underscores the need for an integration of competition policies among all ASEAN countries. This study however recognizes that there is no such thing as “one size fits all”, as the ASEAN economies are too heterogeneous.

The rationale for competition policies and laws is compelling, although empirical analysis is daunted by the paucity of data. A review of cross-country experiences does show that competition policy has served generally well. First, it is good for efficiency by promoting competitiveness. Second, it is good for economic growth through productivity gains and greater innovation. Third, it is good for price stability, as competition tends to keep prices low. Fourth, it is good for trade and investment, as it tends to make liberalization more effective and meaningful. Last but not least, consumers are the biggest beneficiaries, as it not only protects consumers against monopolistic and restrictive practices but also enables them to enjoy the fruits of competition in the form of lower prices and/or better products.



Developed and developing country experiences show that competition policy reinforces macroeconomic stabilization policies and contributes to industry development. One major outcome is the avoidance of abuses of dominance. “Dominant position of market power” refers to a situation where an enterprise, either by itself or acting together with a few other enterprises, is in a position to control the relevant market for a particular good or service or group of goods or services.

There are three main types of business practices that can have anti-competitive effects. Practices undertaken by a single firm enjoying a dominant position and abusing its market power, anticompetitive mergers and acquisitions and restrictive agreements. Restrictive agreements are further classified into *horizontal restraints* (i.e., arrangements between competitors to restrain competition, as shown in Table 1) and *vertical restraints* (anti-competitive arrangements between firms along the production-distribution chain, as shown in Table 2).

Horizontal and vertical restraints include the following arrangements, which can be undertaken individually or in combination, as listed in Tables 1 and 2.

**Table 1: Horizontal restraints**

Price fixing	Competing suppliers enter into cooperative agreements regarding prices and sales conditions.
Restraint of output	Competing suppliers enter into agreements regarding output and product quality
Market allocation	Competing suppliers allocate customers amongst themselves, who therefore cannot benefit from competition by other suppliers.
Exclusionary practices	Competing suppliers employ practices that inhibit or preclude the ability of other actual or potential suppliers to compete in the market for a product.
Collusive tendering (bid rigging)	Competing suppliers exchange commercially sensitive information on bids and agree to take turns as to who will make the most competitive offer.
Conscious parallelism	Competing suppliers generally set the same prices, but without an explicit agreement
Other restraints on Competition	Generally characterized by suppliers entering into Cooperative agreements not to undertake certain actions of competitive value (e.g., advertising).

Source: MIER (2008).

**Table 2: Vertical restraints**

Exclusive dealing	A producer supplies distributors and guarantees not to supply other distributors in a given region.
Reciprocal exclusivity	A producer supplies on the condition that the distributor does not carry anybody else's products.
Refusal to deal	A supplier refuses to sell to parties wishing to buy.
Resale price maintenance	A producer supplies distributors only on the condition that the distributor sells at a minimum price set by the supplier.
Territorial restraint	A supplier sells to distributors only on the condition that the distributor does not market the product outside a specified territory.
Discriminatory pricing	A supplier charges different parties different prices under similar circumstances.
Predatory pricing	Suppliers sell at a very low price (or supply intermediate inputs to competitors at excessive prices) in order to drive competitors out of business.
Premium offers or loyalty rebates	A dominant supplier offers discounts or other inducements only to certain parties on the condition they do not sell someone else's products.
Tied selling	Producers force purchasers to buy goods they do not want as condition to sell them those they do want, or force resellers or wholesalers to hold more goods than they wish or need.
Full-line forcing	A supplier requires distributors, for access to any product, to carry all of the supplier's products.
Transfer pricing	May involve over-invoicing or under-invoicing of intermediate inputs between foreign affiliates. Under invoicing can be used to facilitate predatory pricing.

*Source:* MIER (2008).

To be sure, competition policy does not necessarily call for a proliferation of firms in small economies: it only requires two or three competitive producers, as long as there is the threat of entry by domestic firms or by foreign firms through imports or investment.

There is hardly any need for competition policy or competition laws if “perfect competition” prevails. Seen from the opposite angle, a market is not going to function “perfectly” if at least one of the following factors exists:

- a) Imperfect information in terms of prices

- b) Time lags in prices to “clear” markets
- c) High transaction costs
- d) Barriers to entry to new firms
- e) Firm exit that involves significant costs to the company because of “sunk” expenditures
- f) Circumstances for natural monopoly
- g) Positive or negative externalities
- h) Situations of “public goods”

The above list refers to a situation of “market failures” which is known to give sub-optimal level of social welfare. In a realistic environment of “market failures”, there are still disagreements among economists on the best policy to follow. If one of the conditions is not satisfied, the best policy is to put in place the corrective measures to move towards the attainment of the social welfare optimum. If however more than one condition cannot be fulfilled, then it may or may not be beneficial to satisfy one condition if the others cannot be met.

In reality, for policy makers, it is more useful to consider what is called “workable competition” and a fruitful competitive environment. Competition is good for producers, as it forces them to be continuously technologically efficient. “Technologically efficient” means that firms are always striving to reach their “possibility technology frontier”, and once they have reached this frontier they always adjust to stay on the frontier. This “efficiency drive” pushes producers to be innovative realizing productivity benefits in order to gain (or maintain) their market shares.

Consumers, being at the receiving end of the chain, should be the ultimate beneficiaries of the firm efficiency gains under a competition regime. Consumers, under a competition regime, specifically profit from better price-value ratios, better choices and higher quality products.

There are different ways of defining a “workable competition”. A simple way is to state that it is a situation where all economic agents (producers, workers and consumers) are limited in the economic power they can exercise over all other agents.

In a workable competition, firms do realise reasonable profits and government is also present, as this is not a pure situation of “laissez faire”. Some government

intervention is required to put in place measures favouring and protecting competition. Under proper “guidance” a competitive system is the engine of growth because firms have the *incentive* to improve their performance. However, a fully functioning competitive system is not self-generating. In a free market economy, firms would like to see competition for everyone while trying to secure a monopoly position for themselves.

Economies of scale pose a barrier for new entrants into the industry when the minimum efficient scale of new entrants constitutes a substantial proportion of industry sales as well as when the average cost of production increases substantially at sub-optimal scale. The larger the minimum efficient scale of the firm, the higher the entry forestalling price. When the minimum optimal scale is large relative to market size, new entry at that scale could significantly depress post-entry price, making the venture less attractive.

For industries with large capital requirements, the number of potential new firms is substantially reduced since the large amount of capital forms a cost barrier to entry as established firms incur lower unit costs than new entrants. This may arise due to several reasons. For example, well-established firms may have control of superior production techniques relative to new entrants, for instance through patents and trademarks. Alternatively, established firms may have access to superior resources, including management, and thirdly, new entrants may have to pay higher prices for inputs compared to established firms.

Product differentiation via advertising can also affect industrial concentration. High prevailing levels of advertising create additional costs for new firms as more advertising messages per prospective customer must be supplied to induce brand switching as compared with repeat buying. In addition, the effect of advertising on firm revenues is subject to economies of scale deriving from the increasing effectiveness of the advertising message per unit of output and also from decreasing costs for each advertising message purchased. Thus, a small firm will suffer an additional cost disadvantage.

Furthermore, if economies of scale exist either in production or in advertising, the need to obtain funds for advertising will give rise to additional capital requirement over and above those needed for the physical plant and equipment. Another important factor that influences industrial concentration is capital intensity of many industries. The more

capital intensive the industry is, the more costly it would be to operate at less than minimum efficient scale.

Finally, high research and development (R&D) expenditures by incumbents leading to product and process innovations can deter entry. The use of high R&D and advertising expenditures by incumbents to deter entry is called in the industrial organisation literature “raising rivals costs”.

In an open economy, if tariff rates were low, imports from abroad would enter the market when the selling price substantially exceeds transportation costs. The *threat from imports* may weaken monopoly positions and collusive agreements and individual firms may cut their prices in order not to lose their share of the domestic market to competing imports. In the case of exports, the existence of a competitive export market induces monopolists and oligopolists to be more competitive in pricing.

In a liberalised market open to *export competition*, firms find it difficult to discriminate between the domestic market and the global market, the monopolist then becomes a price taker in both domestic and world markets. The oligopolists tend to encounter great difficulty in achieving tacit collusion with foreign sellers due to the differences in markets and the business environment (which can include a strong competition law enforcement capacity in the second country). The relevant economic market for competition law purposes would no longer be a national market but rather regional multi-country markets or the total international market.

Another crucial market structure variable for developing economies is the presence of *foreign investment*, either in the form of foreign subsidiaries of MNCs or foreign-owned firms operating in the country. Foreign investment in many cases can be an important competitive market force, which improves the resource allocation of the domestic economy by bringing in large investments and more advanced technologies and business methods, and by providing strong competition in markets that previously could be characterized as monopolistic or oligopolistic markets.

Foreign investment can often be expected to reduce industrial concentration, reduce entry barriers, and help to reduce the market power enjoyed in the past by domestic companies that operated in monopolistic or oligopolistic markets. This is because the domestic incumbents may not have the necessary capital or expertise, technology and market access for their products to maintain their market power in the

face of foreign investment, especially when the minimum efficient plant size necessary to capture the full economies of scale is large in relation to the local market.

However, there are counter arguments that foreign firms in many developing countries tend to cluster around industries with high levels of concentration and could in fact increase industry concentration. There is also the danger that foreign investors would introduce RBPs (which they employ in their home and other country markets) into the domestic market.

Over the past two decades, competition laws, enforcement practices and institutions in both industrialised and developing countries have become more similar in terms of their objectives, provisions, exceptions and exemptions, enforcement practices, analytical techniques, and kinds of competition law cases that are taken to their courts and tribunals. This process of greater uniformity and semi-harmonization -- sometimes called "convergence" -- results from both formal and informal processes of competition law harmonization.

The more formal processes large involve the European Union. Among the industrialised countries outside the EU, greater harmonization and convergence of competition rules and procedures have been promoted through information sharing and discussions at the OECD, WTO, APEC, NAFTA and other international forums, through bilateral competition law cooperation agreements, and through a large body of academic work on competition law and competition law harmonization that has been produced over the past 15 years.

The non-country analysis reveals growing similarity across competition laws and institutions. The major findings are summarised very briefly in the following Table 3.

To be meaningful and effective, the coverage of competition policy has to be broad and comprehensive so as to ensure that there is a level playing ground for all firms in all fields, including government-owned or government-linked business enterprises. Increasingly, competition laws entail an international dimension, as globalization, trade liberalization and rapid technological change bring about an inter-face of competition issues involving international corporations and multiple competition laws jurisdictions.

**Table 3: Exceptional Features of Competition Laws in Other Countries and Jurisdictions**

Country or Jurisdiction	Exceptional Features : Different From Other Countries
<b>United States</b>	<p>Major use of private actions. Large number of competition law enforcement agencies at the federal and state levels. Greater emphasis on <i>per se</i> illegal anticompetitive offenses rather than offenses conditioned by the rule of reason (essentially a benefit-cost) approach. Large number of exceptions and exemptions built up through time that are now of questionable benefit and validity.</p> <p>Global leader in the development and application of best-practice analytical techniques and the application of advanced industrial organization and related economic theory in such areas as market definition, barriers to entry, corporate strategy, and defining and assessing the competition and efficiency impacts of RBPs.</p>
<b>Canada</b>	<p>Most enforcement activity largely concentrated in a single agency, the Competition Bureau, with relatively few private actions. Total efficiency test over the narrower consumer welfare approach in the U.S. (particularly important to merger review). Proactive approach conducted jointly with the business community to promote voluntary compliance with the Act. Major concerns with mergers and increasing concentration in the banking sector – recognizing that dominance in banking and other financial services will result in higher interest rates and bank service charges which in turn reduce new business formation, limits expansion of smaller businesses (that are more dependent on bank funding to finance investment) and reduces competition in non-financial markets.</p>
<b>European Union</b>	<p>Emphasis on economic integration in the European Common Market rather than economic efficiency and consumer welfare. Leading arguably to stricter treatment of intellectual property rights, exclusive territories and other vertical restraints that may be pro-efficiency but can deter cross-border trade.</p> <p>Quite extensive use of individual and block exemptions for horizontal and vertical arrangements that are deemed to be pro-efficiency.</p> <p>Use of competition law to discipline state aids/subsidies and to replace anti-dumping measures under trade law. EU agency responsible for competition law enforcement an integral part of the European Commission – leading to greater influence on all relevant EU economic and social policies at the expense perhaps of some loss of enforcement and policy independence.</p>
<b>United Kingdom</b>	<p>Objectives and assessments especially for mergers based on the public interest test rather than the narrower economic efficiency test or even narrower consumer welfare test.</p> <p>The new 1998 Competition Act, which replaced some but not all competition provisions – the merger provisions and some conspiracy provisions from previous statutes were retained. The alternative approach, which may better promote transparency, understanding and certainty among the business community and consumers, may be for the new law to completely replace all previous competition statutes and their provisions. This is the approach used in the 1986 Competition Act in Canada and by many other countries.</p> <p>Publication of guidelines on the web and in hard copy for all major provisions and competition issues under the new act. Separate regulatory bodies to apply competition law and other market regulation to previously regulated infrastructure sectors.</p>
<b>Central and Eastern European Countries</b>	<p>Modernization of existing competition laws and institutions to bring them more closely into line with EU competition rules – seen as a precondition for EU membership. EU competition rules for member countries and new members recognize that trade liberalisation must be complemented by competition rules in order to realize the full benefits from market integration.</p>
<b>Japan</b>	<p>Much more active enforcement of competition law since the early 1990s, initially in response to foreign pressure (particularly the U.S. and to a lesser degree the EU) and more recently as part of the domestic reform agenda.</p>
<b>Australia</b>	<p>Enforcing competition and consumer protection laws under the same commission. Major attention in recent years to expanding the scope of competition policy and law to newly deregulated industries and the legal, medical and other professions, to the actions of government owned corporations and of government ministries that conduct business, and to inter-state trade barriers that result from state government regulations and other state measures.</p>

<b>New Zealand</b>	Specific competition rules and regulatory legislation for three industries – dairy, electricity and telecommunications – where there are concerns that competition issues may not be adequately addressed by the more generic competition rules of the Commerce Act. Separate competition rules and regulatory regimes are also found in the UK (infrastructure sectors) and Peru (electricity).
<b>South Korea</b>	Major attention in recent years to reducing market dominance and corporate concentration through disciplining the behaviour of the <i>chaebols</i> . South Korea since the East Asia crisis of 1997 has been one of the most rapidly growing economies in Asia and the world. Reducing the market size, influence and dominance of the <i>chaebols</i> may be an important reason for South Korea's current economic success – just as the break up of the zaibatsu helped to lay the foundation for the Japanese economic miracle in the 1950s and 1960s. Specific prohibitions on industry associations to prevent them from engaging in anti-competitive acts under the pretext of protecting the interests of the member corporations.
<b>India</b>	Proposal to establish the Competition Fund based on government grants and the fees charged by the Commission – to be used to cover the pay, allowances and other expenses of the Competition Commission.
<b>China</b>	Some competition-like provisions in the 1993 Unfair Competition Law, but most RBPs, including monopolies, abuses of dominant position, cartels and mergers, are not addressed. The 1993 law as well does not address in any detail how these provisions on unfair business practices are to be enforced, except for noting that the State Administration of Industry and Commerce is to administer the act. China reportedly is now drafting its first comprehensive competition law.
<b>Chinese Taipei, Mexico and Brazil</b>	Drafted concise competition laws of about 15 pages in each case. A concise statute makes the new law easier to understand, but may lack the detail to properly guide the enforcement agency and the business community. This guidance will have to come from enforcement cases/the case law as well as guidelines, information bulletins and other public documents.

Source: MIER (2008).

The study however cautions against rigid competition laws that do not permit innovative vertical arrangements. Provisions on vertical restraints would make sense only where there is room for exploitation of market power with barriers to new entry. Competition laws have to be flexible enough to accommodate the special needs of small businesses that look for horizontal and vertical arrangements.

Although it would be impractical for ASEAN countries to have a uniform set of competition policies and laws at this juncture, the study lends support to the call for some convergence of competition laws. This would make absolute sense, as ASEAN economies integrate with one another through intra-regional trade and investment. In the absence of a convergence of competition policies, there is the danger of the legitimacy of the competition law in one country being challenged under the existing laws in other countries.

Competition laws convergence is particularly noticeable where international and intra-regional factors come into play, especially in areas relating to the treatment of mergers or acquisitions and dominant positions, vertical restraints, R&D joint ventures,



sectoral exemptions, anti-competitive effects of state aids and government subsidies, anti-dumping and other trade measures. The global trend favors competition agencies to be independent from government interference and free from undue political influence.

It is in the realm of analytical techniques and methods that there is greatest convergence taking place across countries, both developed and developing, especially with regards to the definitions and measurements of restrictive business practices, static and dynamic efficiencies, and barriers to entry.

Investigations into three sectors, namely cement, telecommunications and transport & logistics in selected ASEAN countries do provide further credence for competition policy. In addition, they also highlight significant differences in market conditions and outcomes in countries that have different competition policies.

Countries with fewer barriers to entry tend to have more competitive markets and more efficient outcomes. By encouraging competitive conduct, competition policy tends to promote competitive and efficient performance outcomes. There are signs of better market conditions and outcomes in countries where competition laws are more advanced.

In the sectors covered in the study, there is a fairly strong positive correlation between competition law status and market conditions and outcomes, especially in the case of cement and trade freedom. However, there are a few aberrations.

In the case of cement, the Philippines is rated above Indonesia and Thailand, both of which have more established laws, thanks mainly to greater excess capacity and lower barriers to entry. In the case of telecommunications, Cambodia (which has no competition policy) rates better than Thailand and Vietnam (which do have competition policy) in terms of market concentration, barriers to entry and prices, thanks primarily to early liberalization and trade reform.

In transport & logistics, there is greater trade freedom in countries that have competition laws. Interestingly, in sea freight, Malaysia, which is yet to formulate competition laws, rates better than Singapore and Indonesia, both of which have competition laws in place, thanks to its lesser market concentration and larger space for capacity expansion.

On the basis of the above findings, the policy recommendations can only be broad and general. Needless to say, country-specific recommendations are beyond the scope

of the present study. Competition laws can make a significantly positive contribution, although they are by no means the sole determinant of how well markets behave and perform.

Based on the literature surveys and empirical observations embodied in the study, the following pointers to serve as ASEAN guidelines, which member countries should take into account in crafting their competition policy or fine-tuning what is already in place, are put forward:

- Enact competition laws, as they can make positive contributions to economic growth, price stability, industry development, macroeconomic stabilization efforts, and consumer welfare
- Pay special attention to the needs of small and medium enterprises (SMEs), which may include technical assistance to domestic companies in preparing licensing arrangements with much larger international corporations
- Adopt a relaxed or flexible approach to restraints on vertical arrangements, so as not to thwart innovations in establishing new distribution systems
- Include misleading advertising, misrepresentations and frauds in competition laws to enhance consumer protection
- Prepare concise laws with a clear focus on a comparatively few objects such as barriers to entry, market power and abuse of dominant positions
- Develop provisions directed explicitly at the abuse of intellectual property rights (IPR), as firms tend to hinder the latter.
- Incorporate explicit provisions to ensure that all government business activities are adequately covered
- Craft specific laws to address the special circumstances of industries undergoing regulatory reforms
- Put in place explicit provisions that would empower competition agencies to handle the negative effects of local regulations on competition, e.g. inter-state trade barriers
- Apply competition rules in regional trade agreements, instead of anti-dumping rules or subsidy countervail, which serve to restrict entry and lessen competition

- Create provisions to address trans-border restrictive business practices (RBP) where the RBP activity takes place abroad with injury to consumers and industry in the home country through local counterparts
- Work toward convergence in competition laws and cooperative efforts in the enforcement of such laws with member countries
- Ensure that the legitimacy of the competition laws cannot be challenged under the existing laws in ASEAN
- Publish guidelines and other information products that explain the main purposes of the key provisions
- Develop a detailed program of work for the manpower of the competition agency to ensure smooth administration and effective enforcement.

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## Chapter 9

# **Narrowing the development gap in ASEAN: Approaches and Policy Recommendations**

*Vo Tri Thanh*

## **INTRODUCTION**

Regional economic integration has been accelerating both in South East Asia as a sub-region and between South East Asia and the rest of East Asia. This process is leaving no country unaffected, particularly the less developed ASEAN countries, including Cambodia, Lao PDR, Myanmar and Vietnam (CLMV). CLMV countries view deeper regional economic integration as a necessary and unavoidable process, albeit one that presents both benefits and challenges. The key question for CLMV countries is how, given their limited resources, they should proceed to be able to catch up with more the advanced economies in the region. More specifically, CLMV needs to engage in consultation, both among themselves and with other countries, to share experiences, which will help them identify appropriate priorities for their constrained resources and the available Overseas Development Assistance (ODA). In addition, they have a dire need for lessons and experiences about how best to employ their resources properly and most effectively to enable them to reach their pre-determined targets.

With its location at the heart of the East Asia, ASEAN is playing an important role in the process of the regional integration. With their geographical proximity to and long-established economic (and historical) relations with other major East Asian countries, the ASEAN countries possess important factors to effectively drive East Asian integration. East Asian (institutionalized) integration will, therefore, come to no major success without the strengthening of ASEAN integration. In turn, ASEAN integration cannot succeed if the development gap in ASEAN, particularly between the CLMV and the more advanced ASEAN member countries, continues to widen. Thus, reducing the gap in development between the CLMV and other ASEAN member countries is critical

to the success of East Asian integration. Having said that, it should be noted that development gaps always exist; however, not all gaps are impediments to integration.

This paper attempts to present some approaches to reducing development gaps within ASEAN countries, and to draft concrete policy recommendations for undertaking such approaches<sup>1</sup>. Section I discusses alternative ways to address, and to narrow, the development gap between the CLMV and the more advanced ASEAN member countries. Section II provides some major policy recommendations to realize the goal of “an ASEAN with less of a development gap”.

## **2. APPROACHES TO THE PROBLEM OF NARROWING THE DEVELOPMENT GAP**

There are two approaches to narrowing the development gap within ASEAN member countries. The first is on a more *technical* basis, which refers to the key “gap indicators” we should think of. More specifically, this approach assumes that development gaps can be reflected in a number of aspects and disciplines, i.e. multi-dimensional and inter-disciplinary. Alternatively, one may proceed to discuss the problem of reducing the development gap by thinking of the reforms to be undertaken by each newer member (the CLMV), the possible forms of intra-CLMV cooperation to be pursued, and the type of external assistance required.

It should be pointed out that the CLMV countries are at significantly different stages of reform and international integration. Vietnam and Cambodia have progressed rather rapidly in terms of international economic integration, at least in terms of the number of international economic arrangements they participate in and their (relatively early) timing. Meanwhile, Lao PDR and Myanmar have stayed rather closed<sup>2</sup>. Thus, it is not easy to generalize about propositions/conclusions for reforms in each of the newer ASEAN members.

Using an indicator basis, Bui and Vo (2007) present a “4-I” *approach to address the development gaps in ASEAN*, with the four “I”s referring to Income, Infrastructure, Integration, and Institutional Gaps. The ideas for selecting these indicators are rather

simple. First, income indicators, including Human Development Index (HDI), can depict the progress made in catching-up to the other countries. Faster growth in per capita income enables less developed countries like the CLMV to progress in other aspects of development, such as education level and health, although rising income by itself is by no means sufficient to ensure an improvement in the level of development. The ability to utilize the rise in income levels to enlarge the set of choices for its people and to attain high development level is a real concern, particularly for less developed countries. Besides, infrastructure, integration, and institution have all been well-established in theoretical and empirical literature to have material effects on economic growth and development. Secondly, improvements in those critical “*I aspects*” enlarge both the sets of choices available to people and the ability to exploit the benefits of the newer choices.

Great disparity of income does exist within ASEAN, with member countries falling into three groups of per capita GDP. High-income members include Singapore and Brunei; middle-income members include Malaysia, Thailand, Philippines and Indonesia; and the low-income members are the CLMV countries. The gaps among the three groups of members are huge and among individual members are extremely high, both in absolute and relative terms. Income in CLMV countries is equivalent to only 1/3–1/5 of the average income of ASEAN members, whereas Singapore’s GDP per capita is 50 times that of Vietnam’s and 75 times that of Cambodia (Helen Nesadurai 2003, cited in Bui and Vo 2005). Looking at other aspects of income gaps such as human development, gender development, poverty reduction and Purchasing Power Parity (PPP), Bui and Vo (2007) also find evidence of significant development gaps within ASEAN member countries, particularly between the CLMV countries and the ASEAN-6.

In terms of infrastructure development, the average infrastructure score of the ASEAN-6 is almost twice as high as that of the CLMV (IWEP, 2005). The paved road ratios are almost 100% in Singapore and Thailand, 78% in Malaysia, and 58% in Indonesia, while the ratios for Cambodia, Laos and Vietnam are under 20 %<sup>3</sup> (Bui and Vo 2007). Poor infrastructure, such as transportation system and utilities, poses a significant barrier to mobility of factors and technological transfer into the new ASEAN

members, which in turn would widen the development gaps between the ASEAN-6 and the CLMV countries.

Looking into such sectors as information, science and technology, energy and telecommunications, exposed large gaps among ASEAN member countries, which can be divided into three groups. The first group, with the most developed infrastructure, includes Brunei, Singapore and Malaysia. The second group (fairly-developed infrastructure) includes Thailand, the Philippines and Indonesia, while the last group (members with poorly- developed infrastructure) are the CLMV countries, although Vietnam is catching up fast. There is a high gap in Internet users per 1000 persons among the three groups, which is a warning about the “digital divide” in ASEAN, which would even widened integration and institutional gaps among ASEAN member economies.

All the ASEAN-6 members have been WTO members for a long time, while the accession of Cambodia (October 2004) and Vietnam (November 2006) occurred only recently and Laos is still working on its application. The ASEAN-6 members are also more experienced in various regional and global economic arrangements, whereas the CLMV countries made their very first moves in regional and international integration within the last decade.

Singapore, Malaysia, Vietnam, Thailand, Cambodia and Brunei (in 2001 data) had the highest trade openness ratio (over 100%), quite a contrast with the ratios of Laos and Myanmar, which were under 50%, or even the 54% for Indonesia in 2005. The openness levels of ASEAN member economies reflect ASEAN’s strong dependence on trade activities, as well as the benefits from foreign trade to the growth of individual economies.

In another aspect, “Integration Gap” should be considered in terms of the FDI inflows as well as outflows, if applicable. Data from UNCTAD (2006) show that Singapore, Brunei, and Vietnam had the highest FDI openness to GDP, and Singapore, Malaysia, Thailand, and Vietnam recorded the largest inward FDI stock, whereas Myanmar, Cambodia and Laos were much less open and had lower inward stock (in 2005). As will be discussed, while it is rather convenient to look at this simple statistical data, it is insufficient to assist with more insightful analyses of problems underpinning the widening development gaps within ASEAN.

The last reference can be made to institutional gap. The different economic and political systems are key to the gaps in ASEAN. As elaborated by Ulrich Volz (2005, cited in Bui and Vo 2007), ASEAN members encompass the full scale of political (from free democracy to authoritarian) and economic (from free market to state-led) systems.

Even the market economies in ASEAN are dissimilar. Singapore is unique in size, highly outward-looking and free market-driven. Malaysia and Thailand have long adopted the market economy principles and have highly export-oriented economies. However, the CLMV are all transition economies, gradually shifting from centrally-planned to market-oriented and from agricultural to industrialized economies. Such a dual shift has made the CLMV economies a mixture between import-substitution and export-oriented models of development.

The gap in economic freedom is also large. According to the 2005 Freedom House assessment of the state of freedom for ASEAN countries, Philippines and Thailand live in “free societies” that grant them comprehensive political rights and civil liberties, whereas the societies of Indonesia, Malaysia and Singapore are only classified as “partly free, and Brunei, and the CLMV countries are classified as “not free”. While the preciseness and relevance of the index remain to be considered, the index does show the diversity in economic rights among ASEAN members.

Furthermore, there exists an asymmetry in macro-economic policy. The capital markets of the ASEAN-6 are more market-based, while those of the CLMV are much more dependent on the banking system. Differences in financial deepening levels and the development of financial markets could also lead to asymmetric effects in terms of intra-regional financial market integration. Monetary and exchange rate policy would, therefore, be difficult to coordinate. Public institutions for governance are also a key determinant of the fourth “I” – Institution. The large gaps within ASEAN in terms of public administration, law enforcement and governance effectiveness would likely hinder deeper integration among member economies (Bui and Vo 2007).

The “4-I” approach brings about a number of advantages, whilst embodying certain disadvantages. Firstly, the approach can be employed for monitoring the process of reducing the development gap. With its well-established foundations and simplicity, the approach appeals to users since it helps to figure out which aspects have progressed sufficiently, and which have not. Secondly, it can be used for finding some (significant)



causality and, accordingly, the areas/policies that need to be prioritized. Nevertheless, this approach may remain far too simple, and may rely too much on *ex-post* observations of the indicators, with hardly-precise implications for the future (and the policies). Therefore, the approach requires further analyses before having suggestions on institution-settings.

In the 2<sup>nd</sup> approach, Vo (2005) postulates that certain valuable information (and experience) can be learned from the reform process in each of the CLMV countries<sup>4</sup>. Vo (2005) then describes the two major components of external assistance: the special and differential treatment (SDT) (allowing a longer period of implementation of liberalization or easier access to other members' markets), and technical assistance.

Yet, there are some notes to this. Firstly, the SDT can make it easier for governments in developing countries to surrender to pressure-group demands for import restrictions and, consequently, to encourage rent seeking activities. Secondly, institutional building should also be seen as the key, since the CLMV are all transition economies. Thirdly, the effectiveness of the Initiative for ASEAN Integration (*IAI*) (with its focus on four areas: infrastructure, human resource development, information and telecommunication technology, and capacity building) remains questionable. The problems remain, as widely discussed in the literature, of limited financial resources, inadequate capability, and collaboration or incorporation with other assistance programs (various donors' ODA, Development Strategy in GMS, etc.).

Vo (2005) also addresses the problem of efficiency and effectiveness of cooperation among the CLMV countries. The author asserts that limited human and financial resources, small market size, and trade structure — which is more competitive than complementary — are posing serious challenges to the CLMV in forming an effective partnership to help them in the development process. Nevertheless, the author notes an important advantage of CLMV cooperation: with their low level of development and with their many common issues, the CLMV countries can learn/talk rather easily from/with each other.

### 3. POLICY RECOMMENDATIONS

The objective of “narrowing the development gaps in ASEAN” should be a key mission in any community-building strategy/action in the region.

- It is important, in particular, to develop a set of quantitative and qualitative indicators for assessing/monitoring the progress of ASEAN integration and of reducing the development gap in ASEAN. There have been a number of studies on this issue (e.g. Denis & Yusof 2003, Lloyd 2005, Vo & Bartlett 2006, Bui & Vo 2007). Obviously, the ERIA can play an essential role in developing and analyzing these indicators.
- Besides, greater flexibility should be allowed for in applying ASEAN’s “core” principles. Various formulas for facilitating and accelerating ASEAN integration (10 – X, 2+X, etc.) can be considered, and even applied, as they take into account the interests of and the costs-benefits to the CLMV.
- Finally, to have the SDT in regional agreements is necessary. But the SDT itself should be *temporary* and *firmly* implemented. For Vietnam and Cambodia, to have easier market access seems to be better than to have a longer period of liberalization implementation.

In another direction, the IAI needs to be transformed into *a new initiative/program* (say, *Initiative for East Asian Integration (IEAI)*, which can be under ASEAN Secretariat “umbrella”). Under this proposal, all ASEAN + 3 or even ASEAN + 6 countries are to join the IEAI with financial contributions (e.g. by rule and voluntarily). The IEAI could have three important tasks/functions:

- The first is to review the development gap in the region and to recommend the major assistance policies, especially those related to institutional building, human resource development, and infrastructure improvement.
- The second is to have consultations with individual CLMV countries to better understand their reform process and their need for assistance and then, recommending corresponding assistance programs, which are left at the core of the IEAI framework.

- The third is to collaborate with other international institutions and donors to ensure the effectiveness and efficiency of the assistance programs, especially sub-regional programs.

As a third major recommendation, the “2+1” cooperation scheme (cooperation between 2 or more low-income countries, with financial/technical support provided by a more advanced country/international institution) needs to be encouraged. Vietnam has had quite good experiences elsewhere and may serve as a good “bridge” for a better mutual understanding and cooperation between the CLMV and ASEAN-6.

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## NOTES

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1. There are two types of ‘so-called’ concrete recommendations. The first is to suggest the policies and the instruments that can be used for implementation. The second is to recommend appropriate institutions for preparing and implementing (various) necessary policies.
2. It could be said that despite the fact that Myanmar has been much earlier a member of WTO.
3. Data for Myanmar is not available.
4. The CLMV Development Strategies Study Group has also set up a number of common policy recommendations for CLMV as a group as well as specific recommendations for each of the CLMV countries.

## Chapter 10

# **ASEAN Economic Community: In Search of a Coherent External Policy**

*Raymond Atje*

## **INTRODUCTION**

ASEAN is one of the most diverse regions in the world. It comprises ten countries with diverse economic development, culture, and social and political systems. Some of these countries may be regarded as still in the post-colonial stage; they have a strong sense of national identity and jealously guard their sovereignties. It may be argued that, because of such a background, ASEAN has opted for consensus-based decision-making, which is preserved in the recently adopted ASEAN Charter. Needless to say, the decision-making process in such a system tends to be very slow and the countries involved tend to adhere to the lowest common denominator in every decision to be made. In 2006 ASEAN as whole had a population of about 567 million, and a combined nominal GDP of US\$1066 billion.

ASEAN members presumably also differ in their endowments, tastes, and expectations. As a result, member states prefer different external policies as evident in, among other things, the increasing number of ASEAN member countries that have established or are in the process of establishing bilateral preferential trade arrangements (PTAs) with other countries. There is no reason to believe that they do not understand the consequence of their actions on other members, or that PTAs may create a noodle bowl syndrome in the region<sup>1</sup>.

Some governments in the region, most notably that of Singapore, view PTAs as building blocks toward global freer trade. One may, nevertheless, argue that, on the contrary, each time a country establishes a PTA with another country, the two countries will have less incentive to engage in multilateral trade negotiations. Moreover, as Dee (2005) argues, quite often concessions are made preferential under a PTA when in fact

it is better if they stay non-preferential. In addition, in general, PTAs do not promote comprehensive liberalization. Rather they tend to target only those provisions that explicitly discriminate against foreigners and leave restrictions that, from an economic point of view, should be removed, untouched by reform. For instance, regulatory restrictions on some sectors, such as power generation and distribution, clearly raise real economic costs, yet tend not to be targeted in PTAs because they tend to be difficult to liberalize. As such, the benefits from PTAs are likely to be smaller than if the countries in question pursue comprehensive unilateral liberalization instead.

Moreover, a study by de Dios (2007) shows that PTAs in the region tend to target only tariff barriers and neglect non-tariff measures (NTMs). Yet, NTMs are quite prevalent in the region. She cites two studies by Ando and Fujii (2004) and Ando (2005), which estimate the tariff equivalents of the NTMs in the ASEAN priority sectors and find substantial overall tariff equivalents in these sectors.

In Indonesia, tariff equivalents ranged between 27.5 percent for food products and 102.2 percent for live animals and products. Meanwhile, tariff equivalents for vegetable products and live animals in Malaysia are, respectively, 65.9 percent and 21 percent, whereas in Singapore the numbers are higher, i.e., 257.2 percent and 150.3 percent, respectively. Thailand registers the highest tariff equivalents of 596.6 percent for animal and vegetable oil, and 132.4 percent for food products (p.93). De Dios also points that out of all the PTAs involving ASEAN as a group, only AFTA specifies a time frame for the elimination of NTMs. ASEAN-Korea FTA calls for identification of NTMs for immediate elimination but ASEAN-China FTA only states that NTMs should come under negotiations.

In view of the foregoing, the call for ASEAN member states to maintain 'ASEAN Centrality' in their external economic relations is appropriate. This call is stated in the newly adopted ASEAN Economic Community (AEC) Blueprint (hereafter referred to as Blueprint). It implies that member states should take into account ASEAN interests in the formulation of their external economic relations.

At the ASEAN Summit Meeting in Singapore in November 2007, the ASEAN Leaders adopted two important documents, i.e., the ASEAN Charter and the AEC Blueprint. AEC is one of the three pillars of the ASEAN Community to be established by 2020. The other two pillars are ASEAN Political and Security Community and

ASEAN Social and Cultural Community. The AEC is the ultimate goal of ASEAN's deliberate push toward greater regional economic integration, which was started in 1992 when AFTA was launched. There were two other initiatives introduced following AFTA, namely, AFAS in 1995 and AIA in 1998. The three initiatives form the basis for the AEC.

## **2. A REVIEW OF THE EXISTING ASEAN EXTERNAL POLICIES**

Before the creation of AFTA in 1992, ASEAN countries had already experienced rapid economic growth. Such growth was a result of unilateral economic liberalization, including unilateral tariff reductions, undertaken by these countries. In the 1970s and 1980s, countries in the region began to pursue unilateral economic liberalization. They liberalized their economies partly as attempt to attract foreign direct investment (FDI). During the same period, Japan, and later Korea and Taiwan, began to experience a hollowing out phenomenon. High wages in these countries prompted companies to relocate their production facilities to other countries in East and Southeast Asia, where wages were lower. These two factors complemented each other. The unilateral liberalization acted as a pull factor and the hollowing out phenomenon as push factor that led to significantly to large FDI flows into the region during the period under consideration. One unintended consequence of the process was an increased regional economic integration, a market-driven economic integration (Baldwin 2006).

AFTA was the first concrete attempt to create a formal regional economic integration. It dealt only with trade in goods and the plan was to allow preferential tariffs for trade between ASEAN members through the Common Effective Preferential Tariff (CEPT) scheme. Under the scheme, tariffs for most goods traded within ASEAN were lowered to 0 to 5 percent by January 2002. Notwithstanding the CEPT scheme, intra-ASEAN trade share has not grown significantly with the implementation of AFTA. The utilization rate of AFTA preferential tariff rates has been low. One reason for this, according to Baldwin (2006), is that AFTA's margins of preference on the high

trade-volume goods are too small to compensate for the administrative costs and delay of applying for the CEPT. Given that the margins of preference are thin, it is no surprise that AFTA was almost never used. With regard to advancing regional trade in services and stimulating cross border investment activities, ASEAN introduced two schemes i.e., AFAS and AIA.

Despite AFTA, ASEAN member states continued to pursue unilateral economic liberalization. In this case, they have been fairly consistent. Even the 1997/98 East Asian financial crisis did not seem to have a significant effect on this pursuit. None of the member states reversed their commitment to liberalization because of the crisis. As such, their liberalization programs were only partial when, arguably, they should be more comprehensive.

In addition, the member states also began to consider establishing preferential trade arrangements with other countries as a way to increase their external trade and, therefore, economic growth. Hence, toward the turn of the century, ASEAN countries' attitudes toward regionalism began to change. Some ASEAN countries that had not previously embraced preferential agreements began experimenting with FTAs. For instance, Singapore, perhaps the strongest proponent and practitioner of FTAs in ASEAN, already signed a number of FTAs with various countries such as the U.S. and Japan. The same is true for ASEAN as a whole. ASEAN has signed framework agreements on a number of preferential trade arrangements such as ASEAN-China Comprehensive Economic Cooperation, ASEAN-Korea Comprehensive Economic Partnership, ASEAN-Japan Comprehensive Economic Cooperation, ASEAN-India Comprehensive Economic Partnership, and AFTA-CER Closer Economic Partnership.

Notwithstanding, or perhaps more accurately, because of, unilateral liberalization, there has been a significant variation in member states' external policy. Sally and Sen's (2005) study of national trade policy in six ASEAN countries, i.e., Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam show that trade policies vary significantly from one country to another. Unilateral liberalization and domestic regulatory reform have transformed Singapore's economy to become one of the most liberal in the world, especially in trade. They have also helped reduce barriers in some service sectors. While Malaysia has a very high trade-to-GDP ratio, its trade policy is only relatively liberal. It has tariff peaks, tariff escalation, and non-tariff barriers in



politically sensitive sectors. In addition, protection in service sectors remains high. Thailand retains relatively high protection according to the standards of the ASEAN-6. Its average tariff is significantly higher; it has greater tariff dispersion, tariff escalation, and non-tariff barriers. Protection in service sectors is considerable.

Meanwhile, despite the recent economic crisis that had swept Indonesia, it retains a relatively liberal trade policy. While its average tariff is relatively low, it has tariff peaks and tariff escalations, especially in agriculture. The situation in the Philippines is quite similar to that of Indonesia. The average tariff is well below 10 percent but it has tariff peaks and tariff escalation, especially in agriculture. In addition, there is a sign of creeping protectionism, especially in agriculture, and has been backtracking on its AFTA commitments on petrochemical products. Finally, Vietnam as a new comer has undertaken significant steps to liberalize its economy. Trade liberalization has picked up since 2000 and tariff and non-tariff barriers have come down although its tariff structure indicates the existence of tariff peaks as well as high tariff dispersion. Protection in service sectors is very high.

Table 1 supports the above observation. Tariff peaks are common among the ASEAN-6 members with Singapore as an exception. Thailand and Malaysia have very high (simple) average MFN tariffs of 11.92 percent and 7.18 percent, respectively, in 2006. With regard to tariff-binding coverage, the Philippines and Singapore have the lowest percentages, i.e., 66.95 percent and 69.74 percent, respectively. Cambodia is the only ASEAN member that has tariff-binding coverage of 100 percent. Indonesia and Brunei have the highest tariff-binding coverage among the ASEAN-6 at 96.59 percent and 95.35 percent, respectively.

Sally and Sen also show the increasing tendency among the countries under consideration to pursue bilateral preferential trade arrangement with other countries. As noted above, Singapore is perhaps the strongest proponent of such a policy. But other members such as Thailand, Malaysia, and to a lesser extent Indonesia and the Philippines have also embarked on a similar path. A study by Chia and Soesastro (2007) corroborates this finding. It shows that in fact all ASEAN members are pursuing the same policy. As of October 2006, there were 139 FTAs involving ASEAN members (Table 2). This does not include de facto bilateral FTAs involving the ASEAN members<sup>2</sup>.

**Table 1: Average Tariff, Tariff Peaks and Tariff-Binding Coverage**

Country	Year	Duty Type	Simple Average	Weighted Average	Total Lines	Dom. Peaks*	Int. Peaks**	Coverage (%)
Brunei	2005	AHS	2.93	3.99	34,181	23.9	23.2	
Brunei	2005	BND	24.33	26.49	6,843	0.0	99.6	95.35
Brunei	2005	MFN	2.61	5.28	10,689	21.4	20.5	
Indonesia	2005	AHS	5.99	4.31	132,048	3.1	7.9	
Indonesia	2005	BND	37.14	33.71	8,027	0.4	96.9	96.59
Indonesia	2005	MFN	6.95	6.07	11,153	4.7	10.5	
Malaysia	2006	AHS	6.20	3.38	208,147	10.3	22.9	
Malaysia	2006	BND	14.54	6.79	8,684	0.6	50.8	84.25
Malaysia	2006	MFN	7.18	4.06	12,583	13.3	29.2	
Philippines	2005	AHS	5.40	3.22	117,098	3.9	4.8	
Philippines	2005	BND	25.65	11.40	4,366	0.0	81.6	66.95
Philippines	2005	MFN	6.26	3.75	11,091	5.7	7.9	
Singapore	2006	AHS	0.00	0.00	224,147	0.0	0.0	
Singapore	2006	BND	6.96	2.63	4,729	0.0	0.0	69.74
Singapore	2006	MFN	0.00	0.00	10,687	0.0	0.0	
Vietnam	2005	AHS	13.08	13.21	109,833	2.5	33.5	
Vietnam	2005	BND						0.00
Vietnam	2005	MFN	16.81	14.70	10,689	3.1	41.7	
Thailand	2006	AHS	10.82	4.61	85,159	4.7	22.8	
Thailand	2006	BND	25.70	15.96	4,631	1.1	60.7	75.02
Thailand	2006	MFN	11.92	5.35	5,504	6.2	26.4	

*Note:* \* denotes domestic (national) tariff peaks (the percentage of tariff lines that have bound tariff rates at least three times higher than the country's average tariff), and \*\* denotes international tariff peaks: the percentage of tariff lines that have bound tariff rates more than 15%. AHS (effectively average tariff), BND (bound tariff), and MFN (most favored nation).

*Source:* WITS.

**Table 2: FTA Status of ASEAN Countries (As of October 2006)**

Country	Proposed	Framework Agreement Signed/Under Negotiation	Under Negotiation	Concluded & Signed	Under Implementation	Total
Brunei	3	2	2	1	3	11
Coambodia	2	2	1	1	2	8
Indonesia	4	3	2	2	2	13
Lao PDR	2	2	1	1	4	10
Malaysia	5	3	5	2	3	18
Myanmar	2	3	1	1	2	9
Philippines	4	2	1	2	2	11
Singapore	5	2	8	2	11	28
Thailand	5	6	4	1	6	22
Vietnam	2	2	2	1	2	9

*Source:* Adapted from Chia and Soesastro (2007), Table 8.1.

Investment policy varies among the ASEAN member states. Policy concerning foreign investment has to take into account foreign investors' interests, such as the need

for protection, transparency of laws and regulations, etc., and host country's interests with its own economic and, perhaps, political objectives. Foreign investment policy in the region invariably has certain features (Hew et al. 2006). First, the relevance of domestic laws is evident, e.g., controls over entry as well as the utilization of foreign investment after entry. Second, many ASEAN countries use administrative agencies to screen the entry of foreign investment. Third, in general, there is a distinct preference for joint ventures between foreign establishments and local entrepreneurs. Fourth, some sectors are completely or partially excluded from foreign investment. Fifth, some countries offer incentives, particularly tax-related ones, to attract FDI into sectors regarded as important to the countries' economies. Sixth, performance requirement is widely used in ASEAN, e.g., to use a certain percentage of local labor, to use local inputs, etc. In addition, because of differences in the origin of their legal systems (common law vs. civil law), the definitions of investor, investment, and corporate nationality may vary across ASEAN member states.

In addition to investment policy, investment activities also depend on a host of behind-the-border issues such as competition policy (or the lack of it), protection of property, including intellectual property rights, corporate tax rate, the availability of efficient financial institution, etc. A study by Sudsawasd (2008) shows that various business regulations, such as procedures and time needed to start a business, cost of obtaining licenses, cost of firing workers, procedures and time needed to enforce contracts and declare bankruptcy have notable impacts on FDI inflows to the country in question. All of these factors inhibit FDI inflows.

### **3. CONFLICT OF INTERESTS AND EXTERNAL POLICIES IN ASEAN**

Three tentative conclusions may be drawn from the foregoing discussion. First, despite AFTA, ASEAN members continue to pursue unilateral liberalization. The pursuits, nevertheless, do not lead to a convergence in their external policies. Part of the reason, it seems, is that liberalization is only partial. For one reason or another, they

continue to protect certain sectors of their economies either through prohibitive tariffs, non-tariff barriers or outright exclusion. This is not to say they should stop liberalizing their economies. On the contrary, they should be encouraged to go even further and pursue a more comprehensive, rather than partial, liberalization policy. Arguably, as these economies become more liberal, their perspectives about various aspects of external policy will converge.

Second, more members are likely to actively establish bilateral FTAs with other countries. This too will create problems. In addition to the usual noodle bowl syndrome, a bilateral FTA is, by its nature, an exclusive arrangement. Since FTAs tend to target only provisions that discriminate against foreigners, their coverage tends to be partial rather than comprehensive. As the number of FTAs in the region increases, the members' views on their role in the development of regionalism in the region will become increasingly compartmentalized as well. In the end, these views will tend to deviate further and further away from one another and will undoubtedly be reflected in their external policy.

Third, investment policy deals primarily with domestic issues pertaining to national treatment, competition policy, protection of property, including intellectual property rights, the availability of efficient financial institution, etc., but laws and regulations pertaining to these issues are likely to vary significantly among the ASEAN members. This will certainly affect their foreign investment policy.

While the Blueprint's call for ASEAN members to maintain ASEAN centrality in their external policy may be appropriate, it remains to be seen if it is attainable. In light of the foregoing, it may be argued that the call constitutes a difficult proposition to put into practice. Much of the discussion that follows explains the reason and explores ways to mitigate the difficulty. But first, one needs to explain the meaning of 'ASEAN centrality'. One way to interpret the concept is by emphasizing that each ASEAN member should take into account ASEAN interests each time it issues a new external policy. This implies that it should also take into account the other members' interests since it is not in the interest of ASEAN to see some of its members suffer because of the action of one of its members. Otherwise, it defeats the purpose of establishing ASEAN in the first place. In other words, each member should ensure that none of the other members will be worse off because of its policy. Herein lies the difficulty.

Two problems arise. First, there is no reason to believe that members will voluntarily heed the call unless they see advantages in doing so. Otherwise, they have very little, if any, incentive to do so. Second, ASEAN as an institution has no mechanism to enforce it. Moreover, the call itself is too vague to be enforceable. The most that ASEAN can do is to ask for non-binding commitment from its members.

Attaining a coherent external policy will not be a problem if ASEAN members have the same objective function. In such a case, ASEAN can act as a benevolent authority to devise a common external policy to be implemented by all members. But as earlier noted, ASEAN members have different endowments and, presumably, tastes. It is also fair to assume that they have different expectations about the outcomes of a certain external policy. Given this ex-ante heterogeneity, each of them will try to optimize its expected gains from the policy in question. Inevitably, they will try to maximize different objective functions.

Take ASEAN-China Comprehensive Economic Cooperation (or ASEAN-China FTA) as an example. Immediately after the agreement for its establishment was signed, Thailand started to negotiate a separate bilateral PTA with China. This indicates that what the members agreed upon in ASEAN-China was simply the lowest common denominator. Thailand clearly believed that it could get a better deal than what it got under ASEAN-China FTA. But even without a separate bilateral PTA, the ASEAN-China FTA already constitutes ten de facto bilateral PTAs. The reason is each of the ASEAN members has its own exclusion or inclusion list, i.e., a list of goods to be excluded from the early harvest program, or list of goods to be included in the early harvest program. The question is why?

Trade often means reallocation of resources from the sectors where the country does not have comparative advantage to the sectors where it has comparative advantage. By implication, trade activities may not be Pareto efficient, at least not in the short run. Some sectors gain at the expense of others. Also, even if there is an obvious aggregate gain, the political cost is perhaps too high for the authority to bear. Hence the protected sectors as manifested in tariff peaks and exclusion list. This could have been avoided had ASEAN had a mechanism to share the combined gains, the cost and perhaps the risk associated with the ASEAN-China FTA. Needless to say, even if it has such a mechanism, the members might still have different perspectives on their distribution.

Meanwhile, five ASEAN members have signed bilateral economic partnership agreements (EPAs) with Japan, namely, Indonesia, Malaysia, the Philippines, Singapore, and Thailand. A study by Hiratsuka *et al* (2008) shows how these members settled on different rules of origin (ROO) formula. Singapore agreed to use change in tariff classification (CTC) rule, whereas Malaysia agreed to a choice of CTC or 60 percent value content (VC) and Thailand to a choice of CTC or 40 percent VC. Alas, members that fare badly under those agreements cannot take advantage of related concessions given to ASEAN in ASEAN-Japan Comprehensive Economic Partnership (CEP) agreement. A careful reading of the ASEAN-Japan Framework for CEP suggests that concessions given under bilateral EPA cannot be renegotiated in the negotiation of ASEAN-Japan CEP. That is, even if the ASEAN manages to get better concessions from Japan than those accorded to its members under bilateral agreements, the members in question are not entitled to those concessions.

It should also be noted that even ASEAN has not been very consistent in this regard. AFTA and ASEAN-China FTA use a 40 percent VC rule, while ASEAN-Korea FTA uses 45 percent VC rule.

#### **4. SEARCHING FOR COMMON GROUND AND POLICY OPTIONS**

The discussion in the previous section rests on the assumptions well known among economists: individual rationality and greed. But there may be limits to this approach, especially when applied to relations between states. First, the reciprocity principle (i.e., to respond to recognition or action of one state in with similar recognition or action) is common in states' relation. States also use the reciprocity principle when trying to preserve beneficial long-term relationships or to establish reputation as a reliable partner. Second, repeated interactions among states may lead convergence given their expectations of the future outcomes of their collective endeavor.

ASEAN's own experience is instructive in this case. The decision to form AFTA came only after many false starts. After the first summit meeting in 1976 in Bali,

ASEAN began experimenting with several cooperation programs such as the ASEAN Industrial Projects (AIP), the ASEAN Preferential Trading Arrangement (PTA), ASEAN Industrial Joint Venture (AIJV), and ASEAN Industrial Cooperation (AICO). The programs, however, mainly ended up in failure partly because the member countries were not prepared to share their markets (Chia *et al*, 2007).

That attitude began to change with the introduction of AFTA. Tariff reduction under AFTA has been quite progressive, having moved from the original timeframe of reducing tariffs to the 0-5 percent range in 15 years (beginning in 1993) to 1 January 2002. The zero-tariff target is to be achieved by 2010 for ASEAN-6 and 2015 for CLMV. Recognizing the development gaps between its member countries, nearly all liberalization commitments in ASEAN face two separate timelines: one for the ASEAN 6 and a later date for the CLMV countries. For ASEAN-6, by January 2005, 99 percent of all products in the CEPT Inclusion List had their tariffs reduced to the 0 to 5 percent target while 64.2 percent had achieved zero tariffs. In addition, all CEPT products had been transferred to the Inclusion List, and the average tariff brought was down to 1.87 percent compared to 12.76 percent in 1993. For CLMV, 87.2 percent of the products had been moved to the CEPT Inclusion List and tariffs on 71.05 percent had been brought down to the 0 to 5 percent level (Chia and Soesastro. 2007).

Now ASEAN members are trying to deepen and widen further the regional economic integration by agreeing to establish the AEC. Under the AEC, 12 priority sectors have been identified for accelerated integration, covering about 4,000 tariff lines or 40 percent of the total tariff lines in ASEAN. These priority sectors are subject to an earlier deadline than AFTA. These are agro-based products, air travel, automobile products, e-ASEAN, electronics, fisheries, healthcare, rubber-based products, textiles and apparel, tourism, wood-based products, and logistics. Under this scheme, tariffs will be eliminated on 85 percent of the products in the priority sectors by 2007 for ASEAN-6 and 2012 for CLMV.

There are a number of interesting observations concerning the ASEAN experience. First, there had been a long learning curve between the inception of the organization and the establishment of AFTA. Prior to 1976, ASEAN did not produce any important economic cooperation initiative, but only began experimenting with a number of economic cooperation programs after that year. The learning process continued even

after the establishment of AFTA. Second, the pace and intensity of economic cooperation among the members seem to accelerate over the years. One possible explanation for this is that repeated interactions help foster mutual trust among the members. This, in turn, provides an impetus for further cooperation. Third, as they were intensifying their economic cooperation, the members also continued to pursue unilateral economic liberalization. It may be argued that the unilateral liberalization agenda helped make possible the cooperation efforts that led to an agreement on CEPT. They saw similar long-term benefits from these two approaches to liberalization.

The AEC Blueprint mandates ASEAN to work toward achieving a coherent approach to ASEAN's external economic relations, including its negotiations for free trade and comprehensive economic partnership agreements. As stated earlier, the main obstacle is the fact ASEAN members do not have the same objective function. One way to go around this problem is for ASEAN to clearly indicate the viable external policy options that can be pursued by members. Members should see the long-term benefits of these options.

Following are a number of possible options, which are not necessarily mutually exclusive in their implementation. First, ASEAN is to multilateralize the CEPT. This is not a new idea, since it is already cited in the AIA scheme. Under the AIA, ASEAN members are committed to a gradual elimination of investment barriers, liberalize investment rules and policies, and grant national treatment to ASEAN investors by 2010 and to all other investors by 2020. ASEAN can do the same for the CEPT by gradually extending preferential treatments among the members to other countries. To achieve this objective, ASEAN members should develop a common strategy to reduce their MFN tariffs, eliminate peak tariffs and lower the bound tariffs. The aim is to gradually bring MFN tariffs down to zero, say, five years after the CEPT. To prevent the reversal of the decision, the bound tariffs should be lowered as well. The timeline should be consistent with that of the AEC. Hence, there should be two separate timelines for ASEAN-6 and CLMV. In short, ASEAN should start aiming at pursuing a truly open regionalism. Essentially, by multilateralizing the CEPT, ASEAN will be establishing a *de facto* customs union.

Table 3 shows that the above is attainable. First, the average MFN tariffs for ASEAN-6 and CLMV are relatively low, even with peak tariffs. The same is true for the



standard deviation of tariffs, which is small relative to the average tariff. Without peak tariffs, the average tariff will become even smaller. At the same time, the discrepancy between standard deviation and average tariff will also become narrower. Based on this observation and the previous discussion, it may be argued that the attempt to bring down MFN tariffs to zero is doable. What is needed is for ASEAN members to have a guideline that provides a clear direction on how to achieve the objective and implementation timeline. The guideline should be executable as well measurable.

**Table 3: ASEAN average tariff, standard deviation, maximum and minimum rate**

Region	Year	Duty Type	Simple Average	Weighted Average	Standard Deviation	Minimum Rate	Maximum Rate
ASEAN-6	Latest Available	AHS	5.46	2.43	10.60	0.00	170.00
ASEAN-6	Latest Available	BND	23.04	11.19	14.82	0.00	226.00
ASEAN-6	Latest Available	MFN	5.81	2.96	11.48	0.00	170.00
CLMV	Latest Available	AHS	11.28	12.22	16.31	0.00	150.00
CLMV	Latest Available	BND	28.27	32.23	41.29	0.00	550.00
CLMV	Latest Available	MFN	11.60	13.67	14.64	0.00	150.00
ASEAN	Latest Available	AHS	6.47	3.01	12.32	0.00	170.00
ASEAN	Latest Available	BND	24.09	11.33	22.77	0.00	550.00
ASEAN	Latest Available	MFN	8.13	3.60	13.17	0.00	170.00

*Note:* AHS (effectively average tariff), BND (bound tariff), and MFN (most favored nation).

*Source:* WITS.

To facilitate trade in services, ASEAN members should strengthen their regulatory environment and institutional capacity, improve transparency and predictability of domestic regulation, and use international standards to achieve harmonization. At the same time, ASEAN should start multilateralizing its liberalization of trade in services, i.e., by opting for global opening rather than regional opening. Meanwhile, in negotiating trade liberalization commitments, ASEAN members should shift from being on a ‘positive list’ to a ‘negative list’.

Meanwhile, in dealing with investment, ASEAN members should be encouraged to adopt national treatment in their domestic laws. Alternatively, the AIA should immediately accord national treatment to all investors and apply non-discrimination in the opening up of industries to foreign investment. As mentioned earlier, investment policy mainly deals with behind-the-border issues. ASEAN members must harmonize

these laws and regulations. By doing so, the members will be compelled to adopt investment policies that are increasingly favorable to one another.

In light of the above, it may be argued that ASEAN members should harmonize their laws and regulations that are relevant to external policy, i.e., laws and regulation that policymakers will consider or refer to when formulating external policies. Of course, the harmonization should be toward more liberal laws. There is no point of harmonizing the laws toward less liberal ones. In other words, it should be made clear at the outset that the aim of the harmonization is not for the sake of harmonization but for the sake of arriving at a more liberal regulatory environment.

With regard to standards, ASEAN members need to harmonize all their industrial standards. Whenever possible, ASEAN should aim at adopting widely acceptable international standards. This would enable ASEAN companies to compete in the world market as well as within ASEAN itself. A piecemeal approach to the adoption of standards is costly and should, as much as possible, be avoided. However, care should be taken to ensure that a higher standard does not constitute a de facto barrier to entry and hence less choices for consumers.

Finally, ASEAN should establish a regional mechanism for closer consultation and coordination among the members. Consultations should not be limited only among government officials but should also include relevant stakeholders, with a view to facilitating the process of arriving at regional negotiating positions in ASEAN's free trade and comprehensive economic partnership negotiations with dialogue partners. In addition, ASEAN should consider developing templates to be used as guidelines by ASEAN negotiators in the negotiating trade, investment, and FTA agreements. ASEAN members should also alert each other when planning to enter negotiations to establish preferential trade arrangements with other countries. ASEAN should provide a set of guiding principles that would be used by ASEAN members in their negotiations. Such a guideline should not be as rigid as a template. There should also be a mechanism for closer consultation and coordination among the members in dealing with FTA negotiations with non-member countries.

## 5. CONCLUSION

When ASEAN members decided to establish the AEC, the organization had gone through a long learning process. It took almost ten years before ASEAN started experimenting with a number of economic cooperation programs. Most of them ended up in failure but not necessarily in vain. They were part of the learning process. Arguably, it was the accumulated knowledge from the process that led to an ambitious decision to establish AFTA in 1992. AFTA was the first serious attempt to establish regionalism in East Asia.

From this point of view, AFTA itself may be regarded as part of the learning process, which eventually led to an even more ambitious program, namely AEC. One component of the AEC is for the members to have coherent external policies. Various studies suggest that ASEAN members do not have the same point of view concerning external affairs and how to approach them. This is reflected in the members' external policies concerning trade, FTA, and investment. They vary across member states. Making these policies coherent will not be easy.

However, if ASEAN's experience is any indication, it may not be impossible at all. To succeed, members ought to see the merits of having coherent external policies in ASEAN. Alternatively, they should understand the cost of having incoherent trade policies among member states that are trying to create a single market, or the dire consequences to ASEAN exporters of members having different rules of origin in the various FTAs. In addition, the member states should be able to see merits of all the proposed options to achieve coherent external policies in the region. Only then will they be willing to voluntarily pursue those options.

It is important to stress the need for voluntary participation of the member states because the existing decision-making mechanism in ASEAN, which is based on consensus and ten minus X formula, implicitly rules out the possibility of imposing a certain rule on the members without their prior consent.

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## NOTES

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1. Trade diversion is one possible adverse effect of a preferential trade arrangement. Since each of the parties to the arrangement offers preferential treatment to goods imported from the others, the arrangement is likely to increase the trade volumes between each other. Unfortunately, the gains may be at the expense of other countries' trade with each of them.
2. For further discussion on de facto FTAs within ASEAN, see Baldwin (2006).

## Chapter 11

### **Policy Recommendations to Facilitate Implementation**

*Hank Lim*

The deepening economic integration project examines issues regarding to economic integration of ASEAN and East Asia. They involve three areas: 1) liberalization and facilitation issues; 2) regional cooperation of ASEAN and beyond; and 3) analysis of trade and investment and its promotion policies. Specifically, many of the following policy recommendations are examined and analyzed in more detail in Dr Hadi Soesastro's executive summary on "Deepening Economic Integration" under ERIA Research Project No1-2. The purpose of this chapter is to put those policy recommendations in a more cohesive, cogent and simplified manner to facilitate implementation by policy makers.

1. Given the different levels of development among ASEAN member countries, there arises the need to ensure the deepening and broadening integration in ASEAN is accompanied by technical and development cooperation to address the development divide and accelerate the economic integration of the less developed ASEAN Member Countries so that the benefits of ASEAN integration are shared by all ASEAN Member Countries. This process should be undertaken in the first phase of ASEAN Blueprint, 2008-2009;
2. The three principal pillars of regional cooperation of deepening integration, narrowing development gaps and sustainable development should be pursued and implemented simultaneously. Specifically, deepening economic integration should be complemented by the provision of "public goods" in terms of development assistance, concessionary grants and loans (ODAs), trade and investment facilitation, infrastructure and human resource development;

3. Deepening integration can be realized by a simultaneous implementation of the three pillars of regional cooperation as well as a facilitation in the movement of goods, services, investment, capital and skilled labour across the region as well as the elimination of non-tariff barriers (abide by the commitment of a standstill and roll-back on NTBs) effective immediately;
4. Such deepening integration shall agglomerate industry in the enlarged economic space of East Asia and through dispersal forces would tend to narrow development gap through reduction of service link costs and set-up costs;
5. De facto integration has progressed significantly in the region. De jure integration has to provide support and facilitation to accelerate de facto economic integration through improvements in ROOs to become less restrictive, simple and more flexible. For example, the change of tariff code (CTC) rule is not business friendly than the value-content (VC) rule, trade facilitation, customs integration through ASEAN Single Window and Standards and Conformance initiative as indicated in the ASEAN Blueprint;
6. Assessment and implementation of actual levels in liberalization and facilitation of goods, services, investment and competition policy are necessary and urgent as specified in the ASEAN Blueprint. ASEAN member countries must give serious attention to the effective implementation of the Blueprint and each member country will have to start this process by preparing a more detailed national action plans. It is equally important to identify the costs of specific barriers in specific sector and to clearly spell out the cost of restrictions to the domestic economy and not just to the foreign partners;
7. Partnership arrangements involving government agencies, sectoral bodies, business associations as well as the civil society will need to be established to ensure participation of all stakeholders in the preparation of national action plans;
8. Liberalization in service, including the establishment of foreign firms, is important for the region where production fragmentation and network have developed. Service liberalization can generate benefits beyond the service sector itself by

facilitating further development of production and distribution networks through the reduction of service link costs and network set-up costs;

9. With a view to minimize and avoid the so called “spaghetti bowl syndrome” because of the proliferation of FTAs in the region, an architecture of Asia wide economic integration is necessary. The AEC Blueprint stipulates the importance of developing coherent external economic policy because of its critical role in the economic integration of East Asia as a whole. Incoherence can be found in the areas of trade, FTA and investment policy;
10. Trade facilitation measure such as mutual recognition and standardization will provide new business opportunities and create innovation in the region;
11. Free flow of skilled labour is vital and necessary for transfer of technology and enhanced production network as clearly specified in the ASEAN Charter;
12. Harmonization and streamline of rules of origin (RoO) should be urgently implemented. Value content criterion is not favoured by firms in particular in machinery and automobile sector. Option system that firms can choose the value content criterion and change of tariff code might encourage trade in the region;
13. An Asian version of self-certificate system should be studied. Direct shipment requirement has reduced the effectiveness of regional FTAs;
14. Sectoral competition policy tends to establish a level playing field and to reform domestic market structure;
15. ASEAN Single Window should be implemented in all countries as early as possible, and the system will effectively work if national single window systems are successfully implemented to cover all provinces. At this stage. Coordination among government agencies and standardization of rules and regulations are of particular importance. For example, Indonesia has introduced the Single Administration Document (SAD) system in the Riau Island in December 2006;
16. The development of SMEs and infrastructure are important in the process of reducing development gap and equally important in establishing domestic industrial linkages and providing employment;



17. The concept and framework of ASEAN Economic Community can provide a useful benchmark and vital policy framework and stimulus to wider East Asia economic integration.
18. Investment has been the key driver of regional economic integration through the emergence of dynamic production network. In fact, investment issues have assumed more urgency requiring policy action to re-examine the concept of ASEAN Investment Area (AIA) as intra-Asian investment has been much more important than intra-ASEAN investment, particularly after the Asian Financial crisis in 1997;
19. The AEC Blueprint intends to develop a regional guideline on competition policy by 2010 and the introduction of competition policies in all member countries by 2015. While it is recognized that it would be impractical for ASEAN countries to have a uniform set of competition policies and laws but it is imperative to lend support to the initiative for some convergence of competition laws and “level of playing fields” where economic resources will be utilized more efficiently;
20. The desirable architecture of competition policy varies depending on the nature and characteristics of the sectors concerned. Sectoral competition policy, if carefully designed, can establish a level playing field and reform domestic market structure;
21. Deepening economic integration should be pursued among more participating countries so that economies of scale operate. A large economic space in East Asia would enhanced agglomeration forces and thereby dispersion forces. This implies that a larger regional trade and investment arrangement would be a more effective way in pursuing deepening economic integration and narrowing development gaps at the same time;
22. Ultimately, ASEAN member countries must give serious attention to the effective implementation of the ASEAN Blueprint, developing AEC scorecards in the areas of trade facilitation and services liberalization, streamlining ROOs in the region and re-examining the ASEAN Investment Area initiative as a first priority in the first stage (2008-2009) of the implementation of the ASEAN Blueprint.

## Chapter 12

# Investment Cooperation and Liberalization in ASEAN+6

*Nagesh Kumar*

## INTRODUCTION

A key motivation for pursuing deeper regional economic integration in the new age regional trading arrangements (RTAs) such as those in Europe and North America has been to facilitate restructuring or rationalization of industry across the region on the most efficient basis so as to exploit the economies of scale and specialization and strengthen the competitiveness of their industries. These RTAs have over time become major factors in shaping global patterns of trade, foreign direct investments (FDI), production, and competitiveness. As they began to account for the bulk of global trade, other regions also started to evolve their own schemes of global economic integration.

Asian countries also began to respond to the trend of regionalism towards the late-1990s. The East Asian Crisis of 1997 provided a much needed stimulus for regional economic integration in the region. The ASEAN countries expedited the programme of implementation of ASEAN Free Trade Area (AFTA) from 2008 to 2002 and moved on to further deepen the economic integration. Japan revised its trade policy in 1999 giving a due place to regional economic integration and concluded its first FTA with Singapore. Other Asian countries also followed the trend. In particular, ASEAN facilitated the trend of regional economic integration by bringing all major Asian countries viz. Japan, China, India, South Korea, and Australia and New Zealand together as dialogue partners. This has led to ASEAN+1 FTAs evolving between ASEAN countries and the dialogue partners besides a number of FTAs between the dialogue partners themselves such as those under negotiation between India and South Korea and India and Japan.

The East Asian cooperation led to launch of several regional initiatives such as the Chiang-Mai Initiative which brought together ASEAN plus three countries viz. Japan, Korea and China. Another initiative of interest is the launch in December 2005 of the East Asia Summit (EAS) as an annual forum of dialogue on regional affairs bringing together leaders of ASEAN10, Japan, China, South Korea, India and Australia and New Zealand or (ASEAN+6). Bringing together leaders of 16 largest and most dynamic economies of Asia, EAS is likely to provide a forum to launch a broader Asian community. Asia has therefore finally woken up to the importance of regional economic integration for its development and to respond to the challenge thrown by the worldwide trends. The emerging Asian regionalism has to be accompanied by investment liberalization to enable region's businesses to rationalize their operations to exploit the locational advantages or synergies for mutual benefit.

Against that backdrop, this paper begins by summarize the conceptual rationale for investment liberalization to fully exploit the potential of regional trading arrangements. It goes on to examine the treatment of investment in emerging FTAs/RTAs in the EAS region and the specific investment provisions and their consistency with the existing multilateral provisions on investment viz. WTO's TRIMs Agreement. The provisions of ASEAN framework on investment area and industrial cooperation are summarized in Section 4. Finally Section 5 concludes the paper with a few remarks on the importance of a broader framework for regional economic integration.

## **2. RELEVANCE OF INVESTMENT LIBERALIZATION IN RTAS**

Foreign direct investment (FDI) has a close relationship with the process of regional economic integration. By extending the effective size of the market by linking the partner countries, RTAs strengthen the investment climate for investors from outside the region. The EU has increased its share in global FDI inflows following the formation of the Single market from nearly 30 per cent in 1980s to about 50 per cent in 1990s and has stayed there(Kumar, 1994; UNCTAD, 2006). More recent studies show that Mexico has seen a sharp rise in FDI inflows since becoming a part of NAFTA from US\$ 12

billion per year on average during 1991-93 to US\$ 54 billion during 2000-02 (Kose *et al*, 2004). A number of quantitative studies conducted in inter-country contexts have also found strong association between membership in RTAs and FDI inflows<sup>1</sup>. However, market extending (or enlargement) effect is only one and a relatively minor effect of RTAs. It is argued here that a more important effect of RTAs is strengthening of overall competitiveness of the region forming it through extensive industrial restructuring or rationalization across the region. This process of efficiency-seeking industrial restructuring is accomplished by intra-regional FDI. It is not a coincidence that the new age RTAs or FTAs generally extend their scope beyond trade to include investment liberalization and facilitation.

The trend of 'new regionalism', as the phenomenon is described to distinguish it from the earlier wave of shallow regional economic cooperation, was clearly motivated by the desire to strengthen the competitiveness of their industries is evident from the case of the EU. The major motivation of formation of the Single Market was not promotion of intra-regional trade as is commonly understood. The intra-regional trade was already quite high in the EU before the Single Market Plan and MFN tariffs were quite low and were nearly zero for intra-EU trade. The deeper regional economic integration was undertaken to facilitate restructuring or rationalization of industry across the region on the most efficient basis so as to exploit the economies of scale and specialization. The Cecchini Report commissioned by the European Commission which provided the basis for the White Paper on the Single European Market had empirically established that the European economies were losing substantially in welfare terms by not cooperating between themselves. The projected gains from industrial restructuring to exploit economies of scale and increased competition within the EU were estimated to be of the order of 3.7 per cent of GDP (Cecchini, 1988).

The efficiency-seeking industrial restructuring is facilitated by liberalization of trade and investment regimes as a part of regional trading arrangements that enables free movement of goods across borders facilitating internal restructuring by removing the need to maintain horizontal national operations for multinational enterprises (MNEs). Therefore, MNEs restructure their operations by assigning the responsibility for serving specific regional or even global markets in particular product lines to certain affiliates. This strategy is sometimes called product mandating and results from the efficiency

seeking restructuring or specialization within the MNE. The EU integration as also facilitated industrial restructuring of European businesses by adopting a statute of a European Company (*Societas Europaea*, S.E.) and through another legal instrument called the European Economic Cooperation Agreement (EECA). The latter is a form of cooperation between two or more firms which become a single body corporate with the aim of furthering the business activities of the participating firms (Kumar, 1994).

The formation of Single European Market has led to a substantial restructuring of industry to seek efficiency or competitiveness. The restructuring takes the form of specific subsidiaries receiving their parent's mandate for specific goods or services for the given markets. The product mandates are given for the entire regional market in the specific product lines. For instance, Unilever decided to make all its dishwasher powder meant for European market at its Lyons (France) plant and all its toilet soap for Europe at Port Sunlight (UK) in preference to smaller plants catering to each individual market in the entire range of products (Kumar, 1994).

The Single Market Plan of the European Union has also prompted extensive industrial restructuring of American and Japanese MNEs operating in the EU to restructure their operations on a pan-European basis. For instance, IBM has reorganized its operations in pan-European basis with IBM UK looking after PCs, IBM Germany, mainframe computers and manufacturing industry; IBM France, telecommunications, and IBM Italy, mid-range machines. Thus this type of restructuring enables the enterprise to exploit the economies of scale and specialization. The location for specific product mandates is chosen on the basis of the advantages a particular country has for the particular activity. These could include factor availability and their prices, agglomeration economies and other locational advantages<sup>2</sup>. Quantitative studies conducted in the inter-country contexts have also found strong evidence of the role of RTAs in shaping the patterns of export-oriented investments made by US and Japanese MNEs across countries to exploit the potential of efficiency-seeking industrial restructuring (Kumar, 1998, 2002).

The studies on the existing RTAs have shown that in the deeper type of integration, the biggest beneficiaries are relatively poorer or lesser developed economies because of migration of industry to them helping their economy converge with those of more developed ones. It is evident that poorest economies of EU, viz. Spain, Portugal, Greece

and Ireland have rapidly converged with more developed economies of the region such as Germany, France or the UK. Although resource transfers have also played a role, investment restructuring (such as relocation of production to low wage locations within the EU) has played an important role bringing about this convergence. It is also clear that investment liberalization becomes a key to facilitate the process of industrial restructuring (UNCTAD, 2006). The barriers to investment flows may not allow the full benefits to be reaped from the regional trade liberalization.

### **3. REGIONAL TRADING ARRANGEMENTS IN EAS REGION AND INVESTMENT LIBERALIZATION**

As observed earlier, Asian countries have been rather late entrants in exploiting the potential of FTAs/RTAs. According to data compiled by the Asian Development Bank, Asian countries were involved in only 35 FTAs –bilateral as well as plurilateral- and with regional as well as outside the regional partners in 2000. However, there is an indication that once started, Asian countries are fast catching up in the trend of signing FTAs/RTAs. By the end of 2006, Asian countries were involved in as many as 191 FTAs/ RTAs between themselves or with the outside world. The bulk of these FTAs/RTAs are at different stages of evolution and many of them may take years to implement their provisions. But the trend is clear that Asia has woken up to the potential of bilateral and regional arrangements like other regions to supplement trade liberalization in the multilateral framework.

As the focus of this paper is on RTAs of EAS countries, we leave out FTAs initiated by them with countries outside the region e.g. Singapore-US, or Australia-US (Kumar, 2007b). The FTAs initiated by Asian countries within Asia whether bilateral or plurilateral- are summarized in Table 1. It is apparent that they have been involved in 84 FTAs with other regional partners. As many as 26 of these agreements have been notified to WTO and 58 were in different stages of their evolution. Patterns across sub-regions suggest that countries in Central and West Asia were integrating between themselves with 17 FTAs. The other sub-regions such as East Asia, Southeast Asia and

South Asia were integrating across the sub-regions. It is clear from as many as 12 FTAs between East Asia and Southeast Asia and 10 between Southeast and South Asian countries. The East Asian and Southeast Asian countries are also having 12 FTAs with the Pacific nations. These three sub-regions of Asia viz. East, Southeast and South Asia and the Pacific seem to be integrating with each other which might eventually lead to formation of a broader community.

### **3.1. Treatment of investment in Asia-Pacific RTAs**

As regionalism is a relatively recent trend in Asia, most of the FTAs are in early stages of their evolution. A number of them are still being considered by the countries concerned and others are in the process of negotiation or implementation. Table 2 lists 38 FTAs/RTAs initiated by EAS countries with Asian partners, for which some information is available. It also indicates whether the scope of FTA/RTA extends to cover investment and commercial presence as a mode of service delivery which is akin to FDI in services. It finds that only 23 of 38 RTAs listed do cover investment provisions. 18 of them also cover commercial presence which is akin to investment as a mode of services delivery. A closer examination will suggest some patterns. One is that more recent agreements are generally more likely to include investment than the older ones. This is because of the recognition of the importance of investment liberalization in overall scheme of economic integration and its role in facilitating efficiency-seeking industrial restructuring. The other noticeable pattern is that FTAs/RTAs involving capital exporting countries such as Japan, Australia, New Zealand, Singapore tend to include investment provisions.

**Table 1: Free Trade Arrangements Involving Asian Countries within the Region, 2006**

BILATERAL FTAs	NOT WTO NOTIFIED												TOTAL				
	WTO NOTIFIED		Under Implementation		Signed		Under Negotiation		(FA) Signed/Under Negotiation		Proposed		Total Not Notified		2000	2006	
	2000	2006	2000	2006	2000	2006	2000	2006	2000	2006	2000	2006	2000	2006			
<b>Within sub-region</b>																	
Central and West Asia	2	9	0	0	8	8	0	0	0	0	0	0	0	8	8	10	17
East Asia	0	1	0	0	0	0	0	1	0	0	0	2	0	3	0	0	4
South Asia	0	1	0	2	0	1	0	1	0	0	0	1	0	5	0	0	6
Southeast Asia	1	1	0	0	0	0	0	0	0	0	0	0	0	0	0	1	1
The Pacific	2	2	0	0	0	0	0	0	0	0	0	0	0	0	0	2	2
<b>Across sub-region</b>																	
Central and West Asia + South Asia	0	0	0	0	0	0	0	0	0	0	0	0	0	2	0	0	2
East Asia + South Asia	0	0	0	0	0	1	0	0	1	0	0	2	0	4	0	0	4
East Asia + Southeast Asia	0	3	0	1	0	1	0	5	0	0	0	2	0	9	0	0	12
East Asia + The Pacific	0	0	0	0	0	0	0	1	0	2	1	3	1	6	1	6	6
Southeast Asia + South Asia	0	0	0	1	0	0	0	2	0	2	0	5	0	10	0	0	10
Southeast Asia + The Pacific	0	4	0	0	0	0	0	2	0	0	0	0	0	2	0	0	6
The Pacific + South Asia	0	0	0	0	0	0	0	0	0	0	0	1	0	1	0	0	1
<b>Regional or Plurilateral</b>																	
Asian Bloc	4	4	0	2	0	0	0	0	0	0	1	0	1	4	4	4	8
Asian Bloc + Asian Country	0	1	0	0	0	1	0	1	0	2	0	0	0	4	0	0	5
<b>TOTAL</b>	9	26	0	6	8	12	0	14	0	7	1	19	9	58	18	84	84

Notes: As of December 2006.

*Central and West Asia* - Afghanistan; Armenia; Azerbaijan; Kazakhstan; Kyrgyz Republic; Pakistan; Tajikistan; Turkmenistan; and Uzbekistan.

*East Asia* - China, People's Republic of; Hong Kong, China; Japan; Korea, Republic of; Mongolia; and Taipei, China.

*South Asia* - Bangladesh; Bhutan; India; Maldives; Nepal; and Sri Lanka.

*Southeast Asia* - Brunei Darussalam; Cambodia; Indonesia; Kiribati; Marshall Islands; Micronesia, Federated States of; Nauru; New Zealand; Palau; Papua New Guinea; Samoa; Solomon Islands; Timor-Leste; Tonga; Tuvalu; and Vanuatu.

*The Pacific* - Australia; Cook Islands; Fiji Islands; Kiribati; Marshall Islands; Micronesia, Federated States of; Nauru; New Zealand; Palau; Papua New Guinea; Samoa; Solomon Islands; Timor-Leste; Tonga; Tuvalu; and Vanuatu.

*Asian Plurilateral* - refers to groupings of more than two countries where all the members are Asian countries.

Source: Kumar (2007b).



**Table 2: Treatment of Investment in East Asian RTAs**

Short Title	Agreement	Status	Coverage of Investment and Mode 3 in Services	
			Commercial Presence	Investment (Others)
AJCEP	Framework Agreement for ASEAN – Japan Comprehensive Economic Partnership	in force since 2004	No	Yes
ANZCERTA	Australia-New Zealand Closer Economic Relations Trade Agreement	in force since 1983	Yes	No
APTA	Asia-Pacific Trade Agreement (Bangkok Agreement)	in force since 1976	No	No
ASEAN-CER	Framework Agreement for ASEAN-ANZCERTA Free Trade Agreement	under negotiation since 2004	Yes	Yes
ASEAN	ASEAN Free Trade Area	in force since 1993	No	Yes
ASEAN Services	ASEAN Framework Agreement on Services	in force since 1996	Yes	No
ASEAN-China FA	ASEAN-China Framework Agreement on Comprehensive Economic Cooperation	in force since 2003	Yes	Yes
ASEAN-India FA	ASEAN-India Framework Agreement on Comprehensive Economic Cooperation	in force since 2004	Yes	Yes
ASEAN-Korea FA	ASEAN-Korea Framework Agreement on Comprehensive Economic Cooperation	in force since 2006	Yes	Yes
Australia-China	Australia – China Free Trade Agreement	under negotiation since 2005	No	Yes
Australia – Japan	Australia-Japan Trade and Economic Framework	under negotiation since 2007	No	Yes
Australia-Malaysia	Australia-Malaysia Free Trade Agreement	under negotiation since 2005	No	Yes
Australia-Thailand	Thailand-Australia Free Trade Agreement	in force since 2005	Yes	Yes
China-Hong Kong, SAR	Mainland and Hong Kong Closer Economic Partnership Agreement	in force since 2004	Yes	No
China-Korea	China-Korea Free Trade Agreement	under negotiation since 2005	No	No
China – MACAO,	Mainland and Macao-SAR Closer Economic Partnership Agreement	in force since 2004	Yes	No
China – Thailand	China-Thailand Free Trade Agreement	in force since 2003	No	No
India-Singapore	India-Singapore Comprehensive Economic Cooperation Agreement	in force since 2005	Yes	Yes
India-Thailand	India-Thailand Framework Agreement for establishing a FTA	in force since 2004	No	Yes
Japan-Brunei	Japan-Brunei Darussalam Economic Partnership Agreement	under negotiation	No	No
Japan-India	Japan-India Economic Partnership Agreement	under negotiation since 2007	Yes	Yes
Japan-Indonesia	Japan-Indonesia Economic Partnership Agreement	under negotiation since 2005	No	No
Japan-Korea	Japan-Korea Free Trade Agreement	under negotiation since 2004	No	No
Japan-Malaysia	Japan-Malaysia Economic Partnership Agreement	in force since 2006	Yes	Yes
Japan-Philippines	Japan-Philippines Economic Partnership Agreement	pending country ratification	Yes	Yes

Japan-Singapore	Japan-Singapore New-Age Economic Partnership Agreement	in force since 2002	Yes.	Yes
Japan-Thailand	Japan -Thailand Economic Partnership Agreement	pending country ratification	Yes	Yes
Japan-Vietnam	Agreement between Japan and Vietnam on Economic Partnership	under negotiation since 2006	No	No
Korea-India	Korea-India Comprehensive Economic Partnership Agreement	under negotiation since 2006	Yes	Yes
Korea-Singapore	Free Trade Agreement between Republic of Korea and Republic of Singapore	in force since 2006	No	Yes
Lao, PDR – Thailand	Lao PDR – Thailand Preferential Trading Arrangement	in force since 1991	No	No
Malaysia-Korea	Malaysia-Korea Free Trade Agreement	under negotiation since 2005	No	No
Malaysia-New Zealand	Malaysia-New Zealand Free Trade Agreement	under negotiation since 2005	No	No
New Zealand-China	New Zealand-China Free Trade Agreement	under negotiation since 2004	No	Yes
New Zealand-Hong Kong	Hong Kong-New Zealand Closer Economic Partnership	Under negotiation since 2001	No	No
New Zealand-Singapore	Agreement between New Zealand and Singapore on a Closer Economic Partnership	in force since 2001	Yes	Yes
New Zealand-Thailand	New Zealand – Thailand Closer Economic Partnership Agreement	in force since 2005	No	Yes
Singapore-Australia	Singapore-Australia Free Trade Agreement	in force since 2003	Yes	Yes

*Source:* Adapted from Kumar (2007b).

### **3.2. Scope of investment provisions in RTAs of EAS countries**

To examine in greater detail the scope of investment provisions in Asian RTAs, we focused on 17 Agreements involving investment provisions of which texts are available. Generally the investment chapter of the agreements follows a structure beginning with definitions of investments, treatment of investors and investments from the partner country including liberalization of that, sometimes it defines the criteria of determining the origin of investors (like rules of origin in the case of trade in goods) and provisions for MFN. Some investment chapters also cover treatment of performance requirements (which are like non-tariff barriers in the case of trade in goods), such as local content requirements. Some times they specify the types of performance requirements prohibited with the framework of the agreement like TRIMs Agreement in WTO, others may just quote TRIMs provisions. An important part of investment chapters is devoted to investment protection and promotion and some times on cooperation and

transparency etc. Investors from the partner countries are assured of a fair compensation in the event of any nationalization or expropriations. They also list the conditions that can be treated as expropriations. These provisions may seem innocuous but have become important in the light of NAFTA disputes on regulatory takings viz. where companies have filed suits against governments of partner countries on the policy changes affecting their profitability or prospects and seeking compensation as deemed expropriation. The investment chapter also covers provisions on settlement of investment disputes and whether investor from one party can resolve disputes against the host governments or disputes between governments. Finally, there are provisions for safeguards, exceptions, and review of the agreement.

The investment provisions included in recent FTAs/RTAs are generally more ambitious compared to bilateral investment protection and promotion agreements (BIPAs). The scope of BIPAs generally tended to include limited national treatment of investments (as opposed to investors) made in accordance to national laws and policies, investment protection and promotion and dispute settlements. Therefore, BIPAs did not generally cover investment liberalization which has been the main objective of the RTAs/FTAs.

The key investment provisions in the 18 agreements are summarized in Table 3. In what follows, we summarize the highlights of these agreements.

### *3.2.1. Definition of investments*

Most of the FTAs/RTAs signed by Asia-Pacific countries have adopted a broad definition of investments covering transfer any assets or intellectual property. However, some of them such as ASEAN Investment Area and New Zealand-Thailand FTA have employed a narrow definition restricting the scope to only direct investments. ASEAN Investment Area and Japan-Malaysia FTA have specifically excluded portfolio investments from its scope thus effectively confining to direct investments. Most of the agreements also define criteria of determining the origin of an enterprise or investor and generally tend to adopt majority ownership in the country of origin as a basis of determining the nationality.

**Table 3: Key investment provisions in selected East Asian RTAs**

Agreement	Definition of Investment	Pre-establishment National Treatment	Post-establishment National Treatment	MFN	Performance Requirements	Investment Protection, Promotion, Facilitation,	Dispute Settlement Provisions
ASEAN Investment Area (1998, amendments 2001, 2003)	Direct investments	-ive list	-ive list	yes	-	Yes	ASEAN DSM
ASEAN-China Framework	To be defined	Progressive (+list)	implicit	implicit	to be defined	Yes	to be defined
ASEAN-Australia-NZ CER Framework	To be defined	progressive	implicit	implicit	to be defined	Yes	to be defined
ASEAN-India Framework	To be defined	progressive	Implicit	implicit	to be defined	Yes	to be defined
ASEAN-South Korea Framework	To be defined	Progressive (+list)	Implicit	implicit	to be defined	Yes	to be defined
ASEAN-Japan Framework	To be defined	To be defined	Implicit	implicit	to be defined	Yes	to be defined
China-Hong Kong SAR CER	-	-	-	-	-	Yes	-
Japan-Singapore	broad	-ive list	-ive list	yes	TRIMs-plus	Yes	Investor-State (I-S), State-State (S-S)
Japan-Malaysia	broad	-ve list (excludes portfolio investments)	-ive list	yes	TRIMs	Yes	I-S, S-S
Japan-Philippines	broad	-ve list	-ive list	Yes	TRIMs-plus; (labour and environmental standards)	Yes	to be negotiated
South Korea-Singapore	broad	-ive list	-ive list	yes	TRIMs-plus	yes	I-S, S-S
India-Singapore Comprehensive Economic Cooperation Agreement	broad	+ive list	+ive list	yes	TRIMs	yes	I-S, S-S
India-Thailand Framework for FTA	To be defined	progressive	Implicit	implicit	to be defined	yes	to be defined
Australia-Singapore	broad	-ive list	-ive list	-	-	yes	I-S, S-S
Australia-Thailand	broad	+ive list	-ive list	yes	-	yes	I-S, S-S
New Zealand-Singapore	broad	-ive list	-ive list	yes	-	yes	I-S, S-S
New Zealand-Thailand	Direct investments	+ive list	-ive list	yes	-	yes	I-S, S-S

Source: adapted from Kumar (2007b).

### *3.2.2. Treatment of 'investors' or pre-establishment national treatment*

A key provision of the investment arrangements in FTAs relates to pre-establishment national treatment as it determines the level of investment liberalization. Most of the FTAs/RTAs involving Asia-Pacific countries provide pre-establishment national treatment on a positive list basis or they provide a progressive liberalization through putting sectors on an annex where foreign investors are treated on par with national or domestic investors. However, an increasing number of agreements have also incorporated pre-establishment national treatment based on a negative list basis. These typically include countries that have adopted open regimes for foreign capital already such as countries like Singapore. These agreements therefore provide a liberal treatment to foreign investors because unless specified in the annex; all investments from the partner country receive a treatment 'not less favourable' to that given to a national investor (however, more favourable treatment is not excluded).

### *3.2.3. Treatment of 'investments' or post-establishment national treatment*

More countries tend to accord national treatment of investments that have been made. Hence, NT in post-establishment phase is generally built on the negative list basis or on the same basis as pre-establishment NT. Thailand's FTAs with Australia and New Zealand are cases in point where the pre-establishment NT is based on a positive-list basis and post-establishment NT is on a negative list basis.

### *3.2.4. Performance requirements and consistency with TRIMs*

Treatment of performance requirements is another aspect of liberalization of investment policy regimes. Here the benchmark or MFN treatment is provided by the WTO Agreement on Trade Related Investment Measures (TRIMs). TRIMs Agreement seeks to eliminate a few types of performance requirements such as local content regulations and requirements limiting imports to certain proportion of output. It leaves a number of other performance requirements and investment measures including export obligations that can be imposed by WTO members on enterprises and investors<sup>3</sup>. A number of FTAs/RTAs have tended to expand the list of investment measures included in TRIMs to cover others such as export obligations, requirement to transfer technology or perform R&D etc. By prohibiting such performance requirements for investments

originating in FTA partner countries, these provisions seek to liberalize the conditions for investment. A number of Asian RTAs/FTAs have included TRIMs plus provisions on performance requirements. These include Japan-Singapore New Age Partnership Agreement which lists a number of investment measures that will not be imposed by the parties. Japan-Philippines Agreement also includes TRIMs-plus provisions. The Japan-Philippines Agreement is perhaps unique in Asia to include performance requirements based on labour and environmental standards also. These two Agreements tend to follow the treatment of performance requirements as incorporated by the FTAs signed by the US which is trying to evolve WTO plus provisions in investments and IPRs, among other spheres, through bilateral FTAs. Other FTAs/RTAs have provided for TRIMs type of treatment either explicitly (India-Singapore, Japan-Malaysia) or implicitly (by being silent and hence leaving the treatment to TRIMs).

### *3.2.5. MFN, investment protection, promotion and facilitation*

MFN provisions are generally included in most RTAs/FTAs. Different RTAs/FTAs vary in terms of the extent of investment promotion and facilitation covered. Some of them, as China-Hong Kong CER focus on investment facilitation exclusively. Some of them go on to specify facilitation activities such as cooperation between the investment promotion agencies, linking up of websites (as provided in the India-Singapore CECA) to promote investment flows. Provisions on investment protection are also generally found in almost all FTAs/RTAs providing a fair and equitable treatment in the event of an expropriation although there is a variation in terms of coverage of what constitutes an expropriation. A liberal definition of expropriation adopted by NAFTA covers the changes in business prospects resulting from any policies or regulations imposed by the host government. This liberal treatment has led to a large number of disputes in NAFTA brought by companies against governments. Asian RTAs have followed a more cautious approach in this respect although there is a variation across them.

### *3.2.6. Dispute Settlement Mechanism*

Most of the FTAs/RTAs also provide guidelines for settlement of investment disputes. They provide limited form of investor to state dispute settlement through consultation and suggest other means of dispute settlement if the consultation does not

work in some circumstances. Most of the FTAs/RTAs also refer to dispute settlement mechanism available within the framework of ICSID (International Convention of Settlement of Investment Dispute) managed by the World Bank and UNCITRAL (such as setting up of ad hoc tribunals). State-to- state dispute settlement is generally provided in most of the RTAs/FTAs.

#### **4. Investment in ASEAN Economic Integration**

Among the Asian RTAs, ASEAN stands out as one having recognized the potential of regional trade and investment liberalization in fostering efficiency-seeking industrial restructuring and overall competitiveness of the grouping. ASEAN has closely followed the EU's example in regional trade liberalization through AFTA, liberalizing trade in services through ASEAN Framework Agreement for Trade in Services (AFAS) and facilitating the exploitation of the potential of industrial restructuring through additional policy measures viz. ASEAN Industrial Cooperation (AICO) scheme and ASEAN Investment Area (AIA). In what follows we take a brief look at the steps taken by ASEAN to exploit the potential of regional economic integration especially in industry.

##### **4.1. ASEAN Free Trade Agreement (AFTA)**

The decision taken during the Fourth ASEAN Summit in 1992 to establish the ASEAN Free Trade Area (AFTA) by the year 2008 is the most significant and ambitious step taken by ASEAN so far in terms of regional economic integration. The AFTA Treaty was signed in Singapore by the six original founding members, Indonesia, Malaysia, Philippines, Singapore, Thailand, and Brunei. In mid-1995, Vietnam gained admission as the seventh member of ASEAN. Laos and Myanmar followed suit two years later in 1997 with Cambodia joining in 1999. AFTA provides a framework and forum for ASEAN members-states for moving towards deeper economic integration between themselves. The main mechanism for the implementation of AFTA is the Common Effective Preferential Tariff (CEPT). The CEPT is an agreed effective tariff

which is preferential to ASEAN member-states, and is to be applied to goods that have been identified for inclusion under the CEPT scheme originating from member-states. The original schedule required the CEPT tariffs to be reduced to between 0-5 percent within 15 years, i.e. by 2008, while non-tariff barriers were to be eliminated beginning 1 January 1993. In September 1994, ASEAN agreed to accelerate the establishment of AFTA by reducing the initial time frame from 15 to 10 years. Under the 1994 amended timetable, the full realisation of AFTA with tariffs falling between zero and 5 percent was expected by the year 2003 for the original ASEAN five: Indonesia, Malaysia, Thailand, Singapore and the Philippines as well as Brunei. The deadline for Vietnam was 2006 and for Myanmar and Laos, 2008. To facilitate recovery from the economic crisis of 1997, ASEAN members announced a further advancement of the AFTA schedule in December 1998 for the six original signatories by one year from 2003 to 2002. The six also agreed to achieve a minimum of 90 percent of their total tariff lines with tariffs between 0-5 percent by the year 2000. In theory, this would account for 90 percent of intra-ASEAN trade<sup>4</sup>.

Furthermore, ASEAN has complemented formation of AFTA with other initiatives to facilitate intra-regional trade and speed up the industrial restructuring with other initiatives. These include harmonization of customs procedures and standards. ASEAN initially targeted 2002 for the adoption of an ASEAN Harmonized Tariff Nomenclature and has brought forward the adoption of the WTO Valuation Agreement (WVA) to 2000. ASEAN is developing product-specific mutual recognition arrangements (MRAs) for cosmetics, pharmaceutical, electrical and telecommunication products, among other products. ASEAN harmonized national standards with international standards such as those of the International Standards Organisation (ISO), the International Electrotechnical Commission (IEC) and the International Telecommunications Union (ITU) for 20 priority product groups that some of the most widely traded in the region such as radios, televisions, refrigerators, air conditioners and telephones.

#### **4.2. ASEAN Framework Agreement on Trade in Services (AFAS)**

In recognition of the growing importance of trade in services, ASEAN adopted AFAS on 15 December 1995 to substantially eliminate barriers to trade in services



among ASEAN countries and in order to improve the efficiency and competitiveness of ASEAN services providers. AFAS provides the broad guidelines for ASEAN Member Countries to progressively improve market access (MA) and provide national treatment (NT) for ASEAN services providers following GATS-Plus commitments. To further expedite liberalization of trade in services, ASEAN amended AFAS in 2003 to enable for the application of “ASEAN Minus X” formula in the implementation of Member Countries’ services commitments. Under this formula, countries that are ready to liberalize a certain service sector may proceed do so without having to extend the concessions to non-participating countries. Under AFAS major progress has been achieved in liberalization of financial services and air transport services. Mutual Recognition Arrangements (MRAs) have also been concluded on engineering services and nursing services and negotiations are in progress for architecture, accountancy, surveying, medical practitioners, and tourism. ASEAN expects to have free flow of services across all sectors and modes across the region by 2015<sup>5</sup>.

#### **4.3. ASEAN Industrial Cooperation (AICO)**

To facilitate efficiency-seeking industrial restructuring and strengthen the competitiveness of ASEAN’s manufacturing industry, the ASEAN Industrial Cooperation (AICO) Agreement was signed in 1996. For companies in the AICO scheme, the ASEAN market was almost fully integrated even before the 2002 deadline for CEPT of 0-5%. In AICO, goods produced by and traded between companies operating in two or more ASEAN countries enjoyed full AFTA treatment immediately i.e. 0-5 per cent tariffs. Therefore, participating companies could benefit from economies of scale by restructuring across the region by taking advantage of preferential tariff rates. To maintain the relevance of the AICO scheme beyond 2002 when the CEPT rates reached 0-5% as per the AFTA, AICO scheme was amended to provide for new preferential tariff rates to be given to new approved AICO projects: zero percent for Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia and Singapore; 0-1 percent for the Philippines; 0-3 percent for Thailand; and 0-5 percent for Myanmar and Viet Nam. The Philippines, Thailand and Myanmar will work towards reducing the preferential tariff rates to zero percent for AICO arrangements by 1

January 2005, while Viet Nam will do so by 1 January 2006. By early 2004, 118 applications for AICO arrangements had been approved, which were expected to generate an estimated value of about US\$ 1.2 billion worth of transactions per year<sup>6</sup>.

#### **4.4. ASEAN Investment Area (AIA)**

The Framework Agreement on the AIA was signed in 1998 to allow free flow of direct investment, technology and skilled professionals between ASEAN countries to enable investors to harness synergies of Member Countries in order to maximize business and production efficiency by adopting regional business strategies and regional production networks. The AIA calls for opening up of all industries in the region to ASEAN investors and granting of national treatment (NT) to them (excepting those on temporary exclusion lists, TEL). The industries on the temporary exclusion lists were to be reviewed after 2 years and phased out by 2010 by ASEAN-6 countries and by 2015 by the CLMV countries. In 2001 the AIA Agreement was amended to cover manufacturing, agriculture, mining, forestry and fishery sectors, and services incidental to these sectors and provided a new expedited schedule for phasing out the TEL. The new schedules required TEL (as summarized in Table 4) in manufacturing in the case of ASEAN-6 countries and Myanmar by 2003 and by 2010 for the other three countries. The 'ASEAN investor' for the purpose of according NT has been defined very liberally and qualifies a number of foreign joint ventures too. Recognizing the importance of investment in delivery of services, and to exploit business opportunities to globally competitive services industries, ASEAN in yet another amendment to AIA adopted in 2003 expanded the AIA to include services such as, education services, health care, telecommunication, tourism, banking and finance, insurance, trading, e-commerce, distribution and logistics, transportation and warehousing, professional service such as accounting, engineering and advertising, even on ASEAN-X principle as agreed in AFAS.

A ministerial-level AIA Council has been established to oversee the implementation of the Framework Agreement. The Council is assisted by the ASEAN Coordinating Committee on Investment. The main pillars of the AIA are as follows<sup>7</sup>:

- Cooperation and Facilitation Programme: It is designed to enhance ASEAN's competitiveness and provide investors with an efficient and low-transaction cost investment environment. It includes activities aiming at facilitating investment flows, human-resource development and the upgrading of skills of ASEAN investment agencies.
- Promotion and Awareness Programme: It seeks to promote ASEAN as a single investment destination. It aims to give investors a better understanding and awareness of the region's investment opportunities. This programme includes regular high-level outward ASEAN Joint Investment Promotion Missions, the creation of investment websites and databases, and the publications of timely and useful investment information.
- Liberalization Programme: It aims to open up investment regimes throughout the region by eliminating investment barriers, liberalizing investment rules and policies, and granting national treatment.

**Table 4: Schedules of Phasing Out Temporary Exclusion List for ASEAN Investors under AIA**

<b>End Date</b>	<b>Manufacturing</b>	<b>Agriculture, Fishery, Forestry and Mining + Services incidental to the Five Sectors</b>
1 Jan 2003	ASEAN 6 + Myanmar	
1 Jan 2010	Vietnam, Lao PDR and Cambodia	ASEAN-6 + Cambodia
1 Jan 2013		Viet Nam
1 Jan 2015		Lao PDR and Myanmar

*Note:* ASEAN-6 comprises of Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand.

*Source:* <http://www.aseansec.org/6460.htm>.

#### **4.5. Beyond AFTA and AIA**

ASEAN has moved towards deepening regional economic integration by aiming to create an ASEAN Economic Community by 2020 as a part of ASEAN Vision 2020

adopted in Bali Summit in 2003. Subsequently the date of completion of the ASEAN Economic Community has been advanced to 2015.

As a part of further deepening of economic integration through free flows of investment, ASEAN is proposing to evolve AIA into an ASEAN Comprehensive Investment Agreement (ACIA). The objective is to evolve a comprehensive multilateral regional framework on investment including commercial presence mode of trade in services. A working group has already been set up on ACIA which had its first meeting in October 2007, in Bali, Indonesia. Experts from NAFTA (Canada, and the US), OECD, UNCTAD, METI (Japan), and so on, were invited to the meeting. The working group is expected to suggest the contours of ACIA, such as provisions on MFN, national treatment, and their exemptions. A first draft of ACIA is likely to be submitted to the ASEAN Economic Ministers' Meeting in August 2008<sup>8</sup>.

## **5. INVESTMENT LIBERALIZATION AND INDUSTRIAL RESTRUCTURING: POLICY IMPLICATIONS**

It may be premature to examine the effects of Asian RTAs and FTAs and associated investment liberalization as they have just begun to be evolved. However, some early patterns that have begun to be emerging are suggestive of businesses starting to start efficiency-seeking restructuring to take advantage of the new arrangements. For instance, India-Singapore Comprehensive Economic Cooperation Agreement (CECA) was signed only in 2005, one can already see a growing interaction and integration happening stimulated by it. Following the signing of CECA, the financial institutions of the two countries have come interacting. Singapore investment company Temasek has become an important investor in India. Over 2000 Indian companies have reportedly set up bases in Singapore to expand into East Asian region. Some large IT companies like TCS and Satyam have made Singapore as their regional headquarter. However, the emerging pattern of industrial restructuring is best illustrated by the acquisition of NatSteel, Singapore by Tata Steel of India recently and the emerging pattern of supply chain integration. Apparently Tata Steel and NatSteel plants in different Southeast

Asian countries would be covered by a scheme of regional production network which would involve pallets going from India to the NatSteel plants and special steels to come from NatSteel's Southeast Asia plants to India. This way the synergy or the locational advantages of India emanating from the iron ore deposits will be available to the NatSteel plants and their specialization for some special steels to Tata Steel, will be exploited for mutual advantage (Kumar, 2007a).

Similarly, following the early harvest scheme of India-Thailand FTA in 2004, Toyota started to restructure its operations in the two countries under which some models of vehicles will be sourced from Thailand for Indian market and gearboxes are exported to Thailand from India. A similar restructuring is on in Sony's operations in India and Thailand. On the other hand Hyundai is making India a regional and global hub for compact cars and will source them from India. Other MNEs like Honda which have built up sizeable capacities in India for two-wheeler production might use it as a regional base for them while sourcing some models of cars from Thailand (Kumar, 2007a).

Therefore, RTAs have a major potential of efficiency-seeking industrial restructuring in Asia. Investment cooperation and liberalization is crucial for facilitating the fuller exploitation of this potential.

Secondly, the industrial restructuring taking place in East Asia may be sub-optimal because of the lack of a broader regional framework providing a seamless or unified market. As observed earlier, almost all the pairs of ASEAN+6 countries are involved in FTAs, these FTAs fail to provide a seamless market due to varying scopes, coverage and rules governing different agreements. ASEAN needs to drive this process of regional economic integration to creation of a broader framework that can coalesce all these bilateral arrangements in a single framework. Such attempts have not succeeded so far in the framework of ASEAN+3 bringing together Japan, China, and South Korea because of differences between major dialogue partners viz. Japan and China. In December 2005 in Kuala Lumpur a new forum of East Asia Summit was launched with leaders of ASEAN and six dialogue partners viz. Japan, China, South Korea, India, Australia and New Zealand. At their second session in Cebu in January 2007, EAS leaders have launched a track-II study on the feasibility of a Comprehensive Economic Partnership of East Asia (CEPEA) covering the 16 countries. It is conceivable that

CEPEA could provide a framework for a broader regional arrangement for liberalization of trade and investment regimes in Asia for facilitating the exploitation of efficiency seeking industrial restructuring in the continent. A number of studies have highlighted the relevance of a broader regional arrangement like CEPEA including investment liberalization in bringing major welfare gains for the region and the rest of the world because of its trade creating potential (Kumar, 2007c).

## **6. CONCLUDING REMARKS**

To sum up the foregoing discussion, it has been argued that investment liberalization occupies an important place in the schemes of regional economic integration complementing trade liberalization to facilitate the process of restructuring of industry on more efficient lines. This restructuring enables fuller exploitation of the locational advantages or synergies between the member countries of the regional trading bloc besides facilitating businesses reaping the economies of scale and specialization. The Single Market Plan of the European Union has unleashed such a pattern of industrial restructuring not only European corporations but also the operations of foreign multinationals operating in the EU. Such restructuring also facilitates creation of supply capabilities in relatively poorer countries thus facilitating a convergence of levels of development.

In recent times, Asian countries have also started to attach a far greater importance to regional economic integration in their trade policy after decades of faithful adherence to multilateralism. A large number of free trade arrangements are taking shape in Asia at the sub-regional levels in Southeast Asia (ASEAN) and their dialogue partners and between the dialogue partners. There is also a discussion on building on these attempts and evolve broader grouping. Although many of Asian RTAs are at early stages of their development, the trend is quite clear. Another noticeable trend is an increasing number of Asia-Pacific RTAs extend their scope to investments. Hence, there is a recognition of the importance of investment cooperation and liberalization for exploiting the full benefits of RTAs.

The investment provisions included in Asian RTAs have tended to follow progressive liberalization approach given the varying levels of development existing in the region. They have also included provisions on investment protection, promotion and facilitation, MFN and dispute settlement. Asia-Pacific RTAs are consistent with the provisions of multilateral disciplines on investment as enshrined in the WTO's TRIMs Agreement and have some times attempted to adopt a more ambitious approach to elimination of performance requirements.

ASEAN's attempt to progressively deepen regional economic integration through expedited schedules of implementation of AFTA, adoption of ASEAN Investment Area, ASEAN Industrial Cooperation (AICO) Schemes and Framework Agreement on Trade in Services indicate recognition of the potential of industrial restructuring by the grouping.

ASEAN has also facilitated economic integration with other Asian countries by bring them together as dialogue partners. This process has led to a number of bilateral FTAs that together form an emerging virtual community. However, due to varying scope and coverage of trade and investment rules in these initiatives, they hardly provide a seamless market to region's enterprises for facilitating efficiency-seeking industrial restructuring. It is imperative that these attempts are viewed as building blocs of a broader Asian Community as has been envisioned by some Asian leaders which could become an arc of advantage, peace and shared prosperity in Asia.

The launch of East Asia Summit (EAS) bringing together leaders of ASEAN and its six dialogue partners viz. Japan, China, Korea, India, Australia and New Zealand, provides an important forum for initiatives towards creating an East Asian economic space. The Second EAS has agreed to launch a feasibility study of a Comprehensive Economic Partnership of East Asia (CEPEA). By providing a framework for removing trade and investment barriers, CEPEA has the potential of unleashing a process of efficiency-seeking restructuring across countries in Asia and facilitating exploitation of their locational advantages or synergies for mutual benefit!

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## NOTES

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1. See e.g. Kumar (2000) and Medvedev (2006), among others.
2. See Dunning (1998) for a typology of restructuring; Kumar (1994, 2001) and Cool and Walters (1992), for a detailed analysis and case studies.
3. See Corea and Kumar (2003) for a detailed analysis of TRIMs Agreement and its provisions.
4. See <http://www.aseansec.org/> for more details.
5. See for more details <http://www.aseansec.org/6626.htm>.
6. See for more details <http://www.aseansec.org/6361.htm>.
7. See for more details <http://www.aseansec.org/6480.htm>.
8. Based on interview notes of So Umezaki (BRC-JETRO) with the ASEAN Secretariat, on 4 December 2007.

## Chapter 13

# **Intra-Developing Asia FDI Flows: Magnitudes, Trends and Determinants**

*Ramkishen S. Rajan*\*

## **INTRODUCTION**

Global economic expansion has been increasingly fuelled by the rapid growth in and transformation of China and India along with the revitalization of Japan and the recovery of the emerging economies in Southeast Asia and North Asia from the crisis of 1997-98. While Asia has been integrating rapidly with the global economy, there is clear evidence of closer *de facto* intra-developing Asian integration as well. While the focus of a great deal of scholarly work thus far has been on intra-Asian integration of trade flows and business cycle synchronizations, there are signs that intra-Asian capital flows have also been intensifying (see Kharas et al., 2006 in the case of East Asia). Of particular interest in this regard has been the rise of intra-regional FDI flows. Certainly, investments in the region by Japanese multinationals are not something new, having been fuelled partly by the Plaza Accord of 1984-85. This was followed by intra-regional investments by companies from high income economies such as Hong Kong, Korea, Singapore and Taiwan.

An interesting phenomenon in recent times (since early 2000), however, has been the rise of investments by Chinese and Indian companies around the world and in particular, in the rest of Asia. Anecdotal evidence of this phenomenon abounds, with many multinationals from China and India being in particularly expansive mood. In other words, intra-Asian FDI flows are no longer a North-South phenomenon but increasingly a South-South one as well. Much of these South-South investments tend to invest close to their home economy in the immediate neighbourhood or region (Aykut

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\* This paper was co-authored with Rabin Hattari.

and Goldstein, 2006) and in countries with similar levels of development (World Bank, 2006). The phenomenon of South-South FDI flows, particularly those arising from multinationals from China and India, has generated significant interest from policymakers, academia and the popular press in recent times (see reference list). The limited aggregate data that is available indicates South-South FDI to have increased almost three-fold (from \$14 billion in 1995 to \$47 billion in 2003), and accounts for almost 37 percent of total FDI flows to developing countries, up from 15 percent in 1995 (Table 1).

**Table 1: Growing Importance of South-South FDI, 1995-2003 (US\$ billions)**

	1995	1999	2000	2001	2002	2003e
Total inflows (1)	90.3	163.5	154.7	159.3	135.3	129.6
from high-income OECD (2)	48.1	95.4	93.7	84.8	55.1	59.4
from high-income non-OECD (3)	28.2	35.0	22.7	24.8	27.2	22.8
South-South FDI (1)-(2)-(3)	14.0	33.1	38.3	49.7	53.0	47.4
<i>South-South FDI (percent)</i>	15.5	20.2	24.8	31.2	39.2	36.6

*Note:* The South–South estimates are based on 35 countries that account for 85 percent of total FDI flows to developing countries. The estimates are based on the World Bank’s classification of developing countries.

*Source:* World Bank (2006).

The Chinese government has stated its intention to help develop 30-50 “national champions” that can “go global” by 2010 (Accenture, 2006 and Sauvant, 2005). Given this, along with aggressive overseas acquisition plans by cash-rich and highly confident firms from India, Hong Kong, Korea and Taiwan, as well as by national holdings companies and sovereign wealth funds (SWFs) in China, Singapore Malaysia and elsewhere, outward investments by Asian companies are set to rise further both intra-regionally and globally. Apart from the usual efficiency-seeking, resource-seeking and market-seeking investments, outward FDI from developing Asia is motivated by a desire to build a global presence and buy brand names, technology, processes, management know-how and marketing and distribution networks. The international expansion of some Asian firms may also have been motivated by a desire to offset or

diversify risks at home, for tariff-jumping reasons, geopolitical factors, etc.<sup>1</sup> Policy makers in many Asian countries have been particularly keen on promoting an internationalization thrust and have facilitated outward FDI via gradual liberalization of rules governing capital account outflows and in many cases, providing a financing mechanism to domestic firms looking to invest abroad.<sup>2</sup>

While Asian entities have become significant foreign direct investors abroad, a large share of outward investments from Asia may have been recycled intraregionally. According to some very rough estimates, intra-Asian FDI flows in 2004 have accounted for about 40 percent of Asia's total FDI inflows in 2004 (Kwan and Cheung, 2006; also see UNCTAD, 2006, Chapter 2). If correct, this share is broadly comparable to the extent of intra-Asian trade flows. However, unlike trade flows there has been little to no detailed examination of FDI flows between Asian economies at a bilateral level. This paper uses bilateral FDI flows data to investigate trends and drivers of intra-Asian FDI flows over the period 1997 to 2004-2005. Eichengreen and Tong (2007), Li, Chow and Li (2007) and Sudsawasd and Chairisawatsuk (2006) are three of possibly just a handful of papers that examine FDI to Asia using bilateral data. However, these papers only consider FDI from OECD economies as the source economy since they use data from the OECD.<sup>3</sup> In contrast, the focus of this paper is on developing Asian economies (i.e. Asia ex Japan) as the sources of FDI to other developing Asian economies using data from UNCTAD.

The remainder of the paper is organized as follows. Section 3 discusses broad patterns and trends in intra-Asia FDI flows using bilateral net FDI flows over the period 1990 to 2005. Section 3 employs a slightly augmented gravity model framework to examine the main determinants of intra-Asian FDI flows using bilateral data based on a panel dataset. The final section offers a few concluding remarks.

## 2. DEFINITIONS AND DATA SOURCES OF FDI

Before analyzing the FDI data, it might be instructive to say a few words on the official definition of FDI and data sources to be used. According to the IMF *Balance of Payments Manual (5th Edition, 1993)*:

FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Further, in cases of FDI, the investor's purpose is to gain an effective voice in the management of the enterprise. The foreign entity or group of associated entities that makes the investment is termed the 'direct investor'. The unincorporated or incorporated enterprise—a branch or subsidiary, respectively, in which direct investment is made—is referred to as a 'direct investment enterprise'.

At an operational level, FDI commonly bears three broad characteristics. First, it refers to a source of external financing rather than necessarily net physical investment or real activity per se.<sup>4</sup> Second, as a matter of convention FDI involves a 10 percent threshold value of ownership. Third, FDI consists of both the initial transaction that creates (or liquidates) investments as well as subsequent transactions between the direct investor and the direct investment enterprises aimed at maintaining, expanding or reducing investments. More specifically, FDI is defined as consisting of three broad aspects, viz. new foreign equity flows (which is the foreign investor's purchases of shares in an enterprise in a foreign economy), intra-company debt transactions (which refer to short-term or long-term borrowing and lending of funds including debt securities and trade credits between the parent company and its affiliates) and reinvested earnings (which comprises the investor's share of earnings not distributed as dividends by affiliates or remitted to the home economy, but rather reinvested in the host economy). New equity flows could either be in the form of M&A of existing local enterprises or Greenfield investments (i.e. establishment of new production facilities).<sup>5</sup>

While this is the most common definition as set out by the OECD *Benchmark Definition of FDI (3<sup>rd</sup> Edition, 1996)* and IMF *Balance of Payments Manual (5<sup>th</sup> Edition,*

1993), it is not always adhered to by all countries systematically. In fact, reported outward FDI often tends to be under-reported as it often excludes the financing and reinvested components. For emerging economies, the two most comprehensive databases on FDI inflows and outflows are IMF-BoP Manual and UNCTAD (see Duce, 2003 for a comparison of the two sources). Neither source divides FDI into M&A versus Greenfield investments.<sup>6</sup> While most M&A statistics are compiled by commercial data sources, they tend to include announced rather than actual financial flows and some of the announced flows may not even include activities considered to be FDI (as defined above). More to the point, announced flows often includes funding of capital via equity from local minority share-holders or local/international borrowing (as opposed to funds from the parent or sister companies) and are thus of limited use for the purposes at hand.

For developing economies, the two most comprehensive databases on FDI inflows and outflows are IMF-BoP Manual and UNCTAD (see Duce, 2003 for a comparison of the two sources). Neither source divides FDI into M&A versus Greenfield investments.<sup>7</sup> UNCTAD by far has the most complete FDI database, and unlike the IMF-BOP data, it compiles data on *bilateral* FDI flows -- both inflows and outflows.<sup>8</sup> The UNCTAD data are on a net basis (capital transactions credits less debits between direct investors and their foreign affiliates). The main sources for UNCTAD's FDI flows are national authorities (central banks or statistical office). These data are further complemented by data obtained from other international organizations such as the IMF, the World Bank (*World Development Indicators*), the Organisation for Economic Co-operation and Development (OECD), the Economic Commission for Europe (ECE) and the Economic Commission for Latin America and the Caribbean (ECLAC), and UNCTAD's own estimates.

### **3. THE EXTENT OF INTRA-ASIAN FDI FLOWS: TRENDS AND PATTERNS**

One could analyze FDI data on either *stocks* (i.e. International Investment Positions) or *flows* (i.e. financial account transactions) data. While much empirical analysis to date has been undertaken using the former, changes in stocks could arise either because of net new flows or because of valuation changes and other adjustments (such write-offs, reclassifications etc). To abstract from these valuation and other changes we primarily consider data on flows of outward FDI (net decreases in assets or when a foreign economy invests in the economy in question) and inward FDI (net increases in liabilities or when the source economy invests abroad). Our focus is on selected South, Southeast and East Asian developing economies. The economies included in our sample are Bangladesh, Cambodia, China (Mainland), Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, Taiwan, Thailand, South Korea, and Vietnam. Thus, apart from excluding West Asia and some smaller Asian economies in South, South-East and East Asia, we exclude Japan but follow UNCTAD in defining the NIEs like Hong Kong, Singapore, South Korea and Taiwan as “developing”.

#### **3.1. Aggregate inflows to and outflows from developing Asia**

Table 2 reveals relative shares of global FDI inflows and outflows as well as inward and outward stocks. As is apparent, the Triad (the EU, Japan and the United States) continue to dominate both as sources and destinations of FDI in terms of both stocks and flows. However, it is interesting to note that in 2003-2005 the Triad’s share of FDI flows declined to a low of below 60 percent compared to about 80 percent on average between 1978 and 1990, while that to developing economies rose to a corresponding high of 40 percent, over half of which was destined to Asia. The share of FDI outflows from developing economies which were negligible until the mid 1980s, rose to about 15 percent of world outflows in 2005. According to the UNCTAD (2006), the stock of outward FDI from developing economies rose from around \$70 billion in



1980 to about \$150 billion in 1990 and to more than \$1 trillion in 2005. However, as Table 2 makes apparent, this 2005 figures was still only 12 percent of global outward FDI stocks, little different from 1980. Thus, while the FDI outflows from developing economies appear to be rising relative to their developed economy counterparts, it has made little difference to the existing relative stocks of FDI.

Table 3 focuses specifically on FDI inflows and outflows of selected Asian developing economies between 1990 and 2005 compiled by the authors from UNCTAD sources. Between 1990 and 1996, FDI inflows to Asia grew at an average annual rate of just over US\$ 50 billion, while outflows grew at a rate of US\$ 30 billion during the same period. Buoyant global economic conditions and the liberalization of most of the Asian economies in the early 1990s led to an influx of FDI inflows to the region. In contrast, during 1997 to 2005 average annual FDI growth in outflows from Asia outpaced inflows to Asia (US\$ 29 billion on average compared with US\$ 50 billion annually).

The two countries with the highest magnitudes of inflows and outflows are Mainland China and Hong Kong. In both of our sample periods 1990 to 1996 and 1997 to 2005, Mainland China has been the single largest destination of FDI, constituting about two-fifths of inflows to developing Asia during the last 15 years. More specifically, for the period 1990 to 1996, the average FDI inflows to Mainland China was around US\$ 20 billion, while for the second sub-period, 1997 to 2005, the average FDI inflows to Mainland China crossed US\$ 50 billion. With regard to outflows, Hong Kong is clearly the single largest source of FDI outflows from Asia. FDI outflows from Hong Kong averaged just under US\$ 15 billion annually in the first sub-period and over US\$ 25 billion in the second sub-period.<sup>9</sup> As will be noted below, a large part of outflows from Hong Kong is bound for Mainland China, some of which is due to round-tripping from the Mainland to begin with. This round-tripping significantly inflates the amount of outward FDI from the Mainland which itself experienced a spurt between 1990 and 2005 (UNCTAD, 2006, p.12).<sup>10</sup>

**Table 2: Distribution of FDI by Region and Selected Countries, 1980-2005 (in percent)**

Region	Inward Stock					Outward Stock				
	1980	1990	2000	2005		1980	1990	2000	2005	
Developed Economies	75.6	79.3	68.5	70.3		87.3	91.7	86.2	86.9	
European Union	42.5	42.9	37.6	44.4		37.2	45.2	47.1	51.3	
Japan	0.6	0.6	0.9	1.0		3.4	11.2	4.3	3.6	
United States	14.8	22.1	21.7	16.0		37.7	24.0	20.3	19.2	
Developing Economies	24.4	20.7	30.3	27.2		12.7	8.3	13.5	11.9	
Africa	6.9	3.3	2.6	2.6		1.3	1.1	0.7	0.5	
Latin America and the Caribbean	7.1	6.6	9.3	9.3		6.5	3.4	3.3	3.2	
Asia	10.5	10.8	18.4	15.4		2.9	3.8	9.5	8.2	
West Asia	1.4	2.2	1.1	1.5		0.3	0.4	0.2	0.3	
South, East and South-East Asia	8.8	8.5	17.2	13.8		2.5	3.4	9.3	7.6	
South-East Europe and CIS	-	0.01	1.2	2.5		-	0.01	0.3	1.2	
World	100.0	100.0	100.0	100.0		100.0	100.0	100.0	100.0	
<b>Region</b>	<b>Inflow</b>					<b>Outflow</b>				
Developed Economies	79.7	82.5	77.3	59.4		97.0	93.1	90.4	85.8	
European Union	39.1	40.3	46.0	40.7		44.8	50.6	64.4	54.6	
Japan	0.4	0.04	0.8	0.8		4.9	19.7	2.6	4.9	
United States	23.8	31.5	24.0	12.5		39.7	13.6	15.9	15.7	
Developing Economies	20.3	17.5	21.7	35.9		3.0	6.9	9.4	12.3	
Africa	2.0	1.9	1.0	3.0		1.0	0.4	0.2	0.2	
Latin America and the Caribbean	13.0	5.0	9.7	11.5		1.1	1.0	4.1	3.5	
Asia	5.3	10.5	11.0	21.4		0.9	5.6	5.1	8.6	
West Asia	-1.6	0.3	0.3	3.0		0.3	0.5	0.1	1.0	
South, East and South-East Asia	6.7	10.0	10.7	18.4		0.6	5.1	5.0	7.7	
South-East Europe and CIS	0.0	0.02	0.9	4.7		-	0.01	0.2	1.8	
World	100.0	100.0	99.9	100.0		100.0	100.0	100.0	100.0	

Source: UNCTAD FDI/TNC database.

**Table 3: FDI Inflows and Outflows of Selected Asian Countries (In billions of U.S. dollars)**

	1990-1996	1997-2005	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>Inflows</b>											
<i>World</i>	248.30	816.23	489.71	712.03	1,099.92	1,409.57	832.25	617.73	557.87	710.75	916.28
<i>Asia (excluding Japan)</i>	51.31	114.56	100.40	91.06	108.66	143.83	103.99	88.61	93.72	137.02	163.72
<i>NIEs ex Hong Kong</i>	9.18	21.55	18.64	12.60	29.13	30.06	23.62	11.83	14.72	24.45	28.91
<i>Korea</i>	2.34	5.75	2.64	5.07	9.63	8.65	3.87	3.04	3.89	7.73	7.20
<i>Singapore</i>	5.89	13.60	13.75	7.31	16.58	16.48	15.65	7.34	10.38	14.82	20.08
<i>Taiwan POC</i>	0.95	2.21	2.25	0.22	2.93	4.93	4.11	1.45	0.45	1.90	1.63
<i>China</i>	25.00	76.40	56.63	60.23	64.90	102.64	70.65	62.42	67.13	94.66	108.30
<i>China: Mainland</i>	20.43	50.88	45.26	45.46	40.32	40.71	46.88	52.74	53.51	60.63	72.41
<i>Hong Kong SAR</i>	4.57	25.52	11.37	14.76	24.58	61.92	23.78	9.68	13.62	34.03	35.90
<i>ASEAN-4</i>	8.48	8.50	16.13	11.72	9.37	4.83	1.66	5.84	4.32	8.62	14.05
<i>Indonesia</i>	2.71	0.19	4.68	-0.24	-1.87	-4.55	-2.98	0.15	-0.60	1.90	5.26
<i>Malaysia</i>	3.62	3.50	6.32	2.71	3.90	3.79	0.55	3.20	2.47	4.62	3.97
<i>Philippines</i>	0.92	1.17	1.25	1.75	1.25	2.24	0.20	1.54	0.49	0.69	1.13
<i>Thailand</i>	1.23	3.63	3.88	7.49	6.09	3.35	3.89	0.95	1.95	1.41	3.69
<i>South Asia</i>	2.44	5.90	5.34	3.87	3.21	4.65	6.38	6.97	5.70	7.29	9.75
<i>India</i>	1.38	4.42	3.62	2.63	2.17	3.59	5.47	5.63	4.59	5.47	6.60
<i>Pakistan</i>	0.34	0.79	0.71	0.51	0.53	0.31	0.38	0.82	0.53	1.12	2.18
<i>Sri Lanka</i>	0.09	0.23	0.43	0.15	0.20	0.17	0.17	0.20	0.23	0.23	0.27
<i>Bangladesh</i>	0.63	0.47	0.58	0.58	0.31	0.58	0.35	0.33	0.35	0.46	0.69

**Table 3 (continued): FDI Inflows and Outflows of Selected Asian Countries (In billions of U.S. dollars)**

	1990-1996	1997-2005	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>Outflows</b>											
<i>World</i>	269.72	776.31	483.14	694.40	1,108.17	1,244.47	764.20	539.54	561.10	813.07	778.73
<i>Asia (excluding Japan)</i>	29.14	50.05	51.23	31.69	39.87	80.69	48.35	33.76	21.15	76.11	67.63
<i>NIEs ex Hong Kong</i>	8.92	16.87	20.60	10.74	16.62	17.62	28.07	9.79	12.25	20.32	15.86
<i>Korea</i>	2.25	3.98	4.45	4.74	4.20	5.00	2.42	2.62	3.43	4.66	4.31
<i>Singapore</i>	3.62	7.40	10.90	2.16	8.00	5.92	20.17	2.29	3.14	8.51	5.52
<i>Taiwan POC</i>	3.05	5.49	5.24	3.84	4.42	6.70	5.48	4.89	5.68	7.15	6.03
<i>China</i>	17.21	29.22	26.97	19.62	21.14	60.27	18.23	19.98	5.34	47.52	43.87
<i>China: Mainland</i>	2.32	3.36	2.56	2.63	1.77	0.92	6.89	2.52	-0.15	1.81	11.31
<i>Hong Kong SAR</i>	14.89	25.85	24.41	16.98	19.37	59.35	11.35	17.46	5.49	45.72	32.56
<i>ASEAN-4</i>	2.94	2.96	3.57	1.20	1.98	2.28	0.60	2.26	2.17	6.17	6.44
<i>Indonesia</i>	0.91	0.80	0.18	0.04	0.07	0.15	0.13	0.18	0.01	3.41	3.07
<i>Malaysia</i>	1.44	1.73	2.68	0.86	1.42	2.03	0.27	1.90	1.37	2.06	2.97
<i>Philippines</i>	0.16	0.17	0.14	0.16	0.13	0.13	-0.14	0.07	0.30	0.58	0.16
<i>Thailand</i>	0.43	0.26	0.58	0.13	0.35	-0.02	0.35	0.11	0.49	0.13	0.25
<i>South Asia</i>	0.07	1.00	0.10	0.11	0.13	0.52	1.45	1.72	1.38	2.09	1.46
<i>India</i>	0.07	0.95	0.11	0.05	0.08	0.51	1.40	1.68	1.33	2.02	1.36
<i>Pakistan</i>	0.00	0.03	-0.02	0.05	0.02	0.01	0.03	0.03	0.02	0.06	0.04
<i>Sri Lanka</i>	0.00	0.01	0.01	0.01	0.02	0.00	0.00	0.01	0.03	0.01	0.04
<i>Bangladesh</i>	0.00	0.01	0.00	0.00	0.00	0.00	0.02	0.00	0.01	0.01	0.01

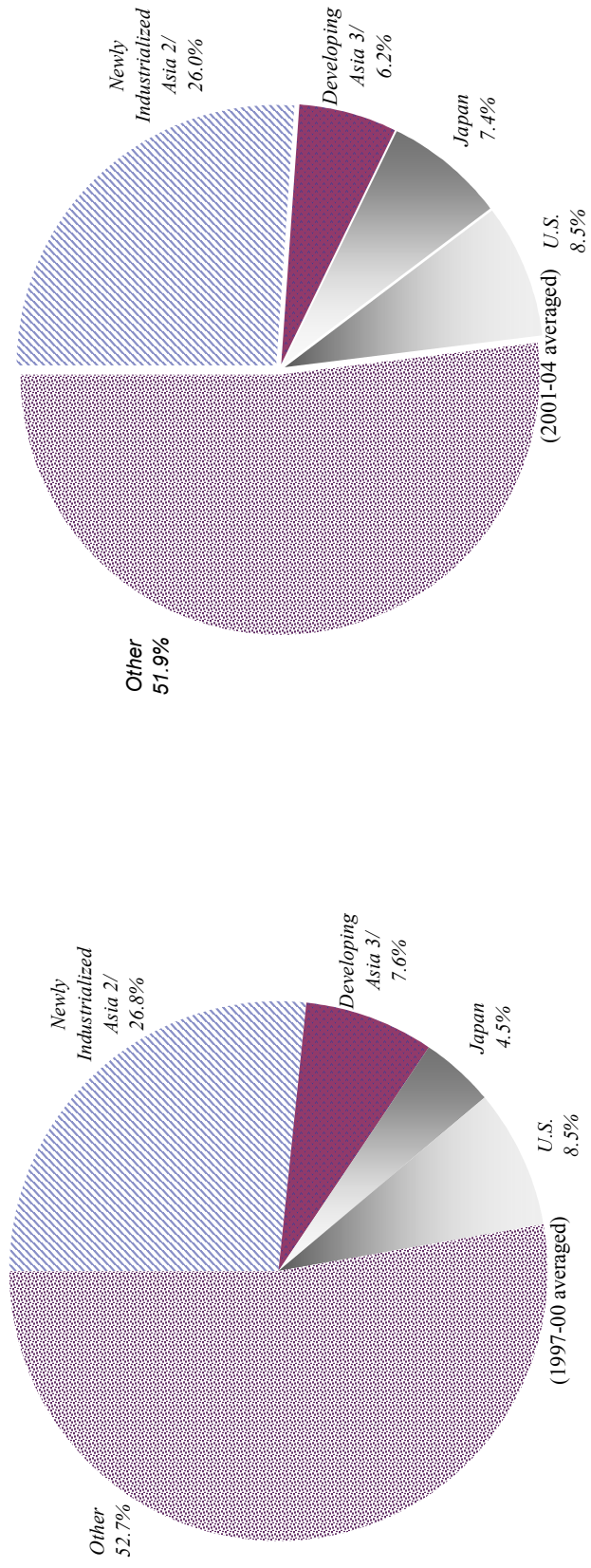
Source: UNCTAD FDI/TNC database.

Referring again to Table 3, apart from Hong Kong and China, the three NIEs of Singapore, South Korea and Taiwan have consistently remained among the top developing economy sources of FDI over the last two decades. Malaysia (a near-NIE) is also notable for the size of their outward FDI flows, particularly since the 1990s. While there is not necessarily a one-to-one link between nationality of TNCs and FDI outflows, it is instructive to note that the handful of firms from developing economies that made the top 100 list were from Hong Kong, Taiwan, Mainland China, Singapore, Korea and Malaysia. TNCs from the first four economies (i.e. Greater China and Singapore) constituted 60 percent of the top 100 TNC from developing economies (UNCTAD, 2006, Chapter 1).

### **3.2 Intraregional Asian FDI flows: A first look**

Having considered broad economy aggregate outflows and inflows to and from Asia, we analyze bilateral FDI between Asian economies. This exercise is far from straightforward. UNCTAD data on inflows and outflows do not match exactly (also see UNCTAD, 2006, Chapter 3). It is apparent that UNCTAD FDI outflows data from source countries are incomplete for many countries. While some source countries have relatively complete outflows data, others either have incomplete data or no data at all. Different reporting practices of FDI data create bilateral discrepancies between FDI flows reported by source and host countries, and the differences can be quite large. For example, data on FDI flows to China as reported by the Chinese authorities and by the investing countries' authorities differ by roughly US\$ 30 billion in 2001, US\$ 8 billion in 2001, and US\$ 2 billion in 2002.<sup>11</sup> Faced with these concerns we draw inferences on FDI flows by examining FDI inflow data reported in the host economies as they are more complete and are available for all developing Asian economies under consideration. In other words, we focus on the *sources of inflows* rather than *destination of outflows*. To keep the analysis manageable we examine data for the averages of 1997 to 2000, and 2001 to 2005 rather than on an annual basis.<sup>12</sup>

**Figure 1: Source of FDI inflows, 1997-2004**



Source: UNCTAD.

1/ Asia consists of Newly Industrialized Asia, ASEAN-4, China, India, Low Income Asia, and Other Asia.

2/ Newly Industrialized Asia consists of Korea and Singapore.

3/ Developing Asia consists of ASEAN-4, China, India, Low Income Asia, and Other Asia.

**Table 4: Average of intra-Asian bilateral FDI outward flows**

(In millions of U.S. dollars, unless otherwise noted)

	Host region 1/					
	(1997-00)			(2001-05)		
	Asia 2/	In percent of Asia	In percent of World	Asia 2/	In percent of Asia	In percent of World
<i>Donor countries</i>						
<i>Newly Industrialized Asia</i>	11,051.3	28.7	1.2	9,490.7	27.0	1.4
Korea	656.4	1.7	0.1	276.8	0.8	0.0
Singapore	7,018.5	18.2	0.8	5,197.2	14.8	0.8
Taiwan POC	3,376.5	8.8	0.4	4,016.6	11.4	0.6
<i>ASEAN-4</i>	1,101.2	2.9	0.1	1,129.2	3.2	0.2
Indonesia	254.9	0.7	0.0	194.5	0.6	0.0
Malaysia	376.6	1.0	0.0	433.3	1.2	0.1
Philippines	180.4	0.5	0.0	263.8	0.8	0.0
Thailand	289.3	0.8	0.0	237.6	0.7	0.0
<i>China</i>	26,226.6	68.2	2.8	24,436.0	69.6	3.6
Mainland China	7,356.8	19.1	0.8	5,651.7	16.1	0.8
Hong Kong SAR	18,869.8	49.1	2.0	18,784.3	53.5	2.8
<i>India</i>	43.9	0.1	0.0	34.9	0.1	0.0
<i>Low Income Asia</i>	10.7	0.0	0.0	5.5	0.0	0.0
Bangladesh	0.2	0.0	0.0	0.5	0.0	0.0
Cambodia	0.5	0.0	0.0	3.1	0.0	0.0
Lao PDR	2.6	0.0	0.0	-0.5	0.0	0.0
Myanmar	4.7	0.0	0.0	2.2	0.0	0.0
Sri Lanka	2.7	0.0	0.0	0.2	0.0	0.0
Vietnam	0.0	0.0	0.0	0.0	0.0	0.0
<i>Other Asia</i>	26.4	0.1	0.0	17.4	0.0	0.0
Pakistan	1.4	0.0	0.0	6.2	0.0	0.0
Brunei Darussalam	25.1	0.1	0.0	11.1	0.0	0.0
<i>Developing Asia 3/</i>	27,408.9	71.3	3.0	25,623.0	73.0	3.8
<b>Asia 2/</b>	<b>38,460.2</b>	<b>100.0</b>	<b>4.1</b>	<b>35,113.6</b>	<b>100.0</b>	<b>5.2</b>

Note: 1/ Asia data is based on FDI inflow data in host economy; world data is based on FDI outflow from donor economy. 2/ Asia consists of Newly Industrialized Asia, ASEAN-4, China, India, Low Income Asia, and Other Asia. 3/ Developing Asia consists of ASEAN-4, China, India, Low Income Asia, and Other Asia.

Source: UNCTAD FDI/TNC database.

FDI inflows between Asian countries averaged around US\$ 37 billion between 1997 and 2005. This has constituted about one-third of all FDI inflows to the region. Intra-regional FDI rises to over 40 percent if we include Japan as a source economy (Table 4 and Figure 1). Intra-Asian FDI flows are particularly pronounced between and within East Asian economies and South-East Asia economies. This is more clearly apparent from Table 5 which emphasizes that the intra-East Asia bilateral flows are the highest in Asia with an average of US\$ 28 billion for the period of 1997 to 2005.

**Table 5: Average intra-Asian bilateral FDI flows (US\$, Mil.)<sup>1/</sup>**

	<i>Host region</i>					
	<i>(1997-00)</i>			<i>(2001-05)</i>		
	<i>East Asia</i> <sup>2/</sup>	<i>South- East Asia</i>	<i>South Asia</i> <sup>4/</sup>	<i>East Asia</i> <sup>2/</sup>	<i>South- East Asia</i>	<i>South Asia</i> <sup>4/</sup>
<i>Donor region</i>						
East Asia <sup>2/</sup>	28,453.6	1,604.2	201.6	27,482.5	1,168.1	78.9
South-East Asia <sup>3/</sup>	6,328.7	1,748.2	86.6	3,622.3	2,641.7	111.1
South Asia <sup>4/</sup>	0.0	43.4	5.2	0.0	27.9	14.6
Rest of the world	45,393.3	20,845.5	3,971.4	49,070.8	20,403.7	4,060.3

*Note:* 1/ Based on FDI inflow data in host economy. 2/ East Asia consists of China, Hong Kong SAR, Korea, Taiwan POC, Macau SAR, and Mongolia. 3/ South-East Asia consists of Brunei Darussalam, Cambodia, Lao PDR, Malaysia, Myanmar, Singapore, Philippines, Thailand, and Vietnam. 4/ South Asia consists of Bangladesh, India, Maldives, Sri Lanka, and Pakistan.

*Source:* UNCTAD FDI/TNC database.

**Table 6: Top 20 bilateral FDI flow between Asian countries**

Donor	Host	Average		In percent to Asia	
		(1997-00)	(2001-05)	(1997-00)	(2001-05)
Hong Kong SAR	China	17,750.8	17,819.1	46.2	50.7
China	Hong Kong SAR	7,266.9	5,459.4	18.9	15.5
Singapore	China	2,706.3	2,136.7	7.0	6.1
Singapore	Hong Kong SAR	2,835.3	353.1	7.4	1.0
Singapore	Malaysia	844.1	1,133.8	2.2	3.2
Singapore	Thailand	441.7	1,381.9	1.1	3.9
Malaysia	China	290.8	316.7	0.8	0.9
Hong Kong SAR	Malaysia	272.3	296.5	0.7	0.8
Hong Kong SAR	Thailand	360.1	160.8	0.9	0.5
Korea	Hong Kong SAR	313.0	155.7	0.8	0.4
Thailand	China	185.8	183.7	0.5	0.5
Philippines	China	135.9	212.2	0.4	0.6
Hong Kong SAR	Singapore	250.1	81.9	0.7	0.2
Malaysia	Hong Kong SAR	62.0	147.2	0.2	0.4
Singapore	Philippines	88.9	76.1	0.2	0.2
Hong Kong SAR	Korea	79.2	51.5	0.2	0.1
Thailand	Hong Kong SAR	-3.1	110.7	0.0	0.3
Hong Kong SAR	Philippines	50.0	54.4	0.1	0.2
Singapore	India	22.0	67.6	0.1	0.2
China	Singapore	-17.3	99.9	0.0	0.3
China	Philippines	71.8	-0.1	0.2	0.0
India	Singapore	36.8	24.9	0.1	0.1
Philippines	Thailand	4.9	48.4	0.0	0.1
China	Cambodia	18.3	33.4	0.0	0.1
Malaysia	Cambodia	24.9	16.7	0.1	0.0
Malaysia	Thailand	19.4	21.2	0.1	0.1
Singapore	Cambodia	19.6	12.9	0.1	0.0
Thailand	Cambodia	19.1	13.4	0.0	0.0
Philippines	Malaysia	6.3	18.7	0.0	0.1
Malaysia	Bangladesh	5.1	19.4	0.0	0.1

*Note:* Based on FDI inflow data in host economy.

*Source:* UNCTAD FDI database.



Consideration of intra-Asian bilateral flows highlights a few other important characteristics of intra-Asian FDI flows (Tables 4-6).

First, the leading investors from the region have stayed the same between 1997 to 2006, with Hong Kong as the top Asian investor, followed by Singapore, Taiwan, Korea, China, and Malaysia, in that order. The importance of China as a source of capital is noteworthy in that there has been a great deal of debate on whether China has diverted extra-regional FDI from the rest of Southeast and East Asia (for instance, see Chantasawat et al., 2004, Eichengreen and Tong, 2007, Li, Chow and Li, 2007, Mercereau, 2005 and Sudsawasd and Chaisrisawatsuk, 2006).<sup>13</sup>

Second, the average of FDI flows from Hong Kong to China and vice versa from 1997 to 2005 has been around US\$ 24 billion and accounts for almost of two-thirds of intra-Asia flows. While Hong Kong's FDI to the Mainland has remained stable between the two sub-periods, that from the Mainland to Hong Kong has declined.

Third, almost three-fifths of flows from East Asia to South-East Asia have been destined for the relatively higher-income South-East economies, viz. Singapore, Malaysia, Philippines and Thailand. Singapore has attracted about half of all East Asian FDI destined for South-East Asia. Conversely, Singapore has been a particularly important investor in the region, with flows from the city state largely destined to China, Hong Kong as well as South-East Asia.

Fourth, intra South-East Asia investment accounted for just over 10 percent of FDI flows in Asia between 1997 and 2005. Comparing the two sample periods, intra South-East Asia's investment share of cumulative FDI flows in Asia increased between the two periods from 8 percent in 1997-2000 to 12 percent in 2001-2005, with Singapore as the leading investor in both periods. Singapore's investments to its South-East Asian neighbors, Malaysia and especially Thailand, have increased in the second sub-period. According to Table 7, Singapore's inflows to Malaysia and Thailand have constituted the bulk of intra-South-East Asia flows -- 78 percent in the first sub-period and massive 97 percent in the second sub-period.

**Table 7: Top 7 bilateral flows between ASEAN countries (US\$. Mil.)** <sup>1/</sup>

Source	Host	Average		In percent of total Intra-ASEAN FDI inflows	
		(1997-00)	(2001-05)	(1997-00)	(2001-05)
Singapore	Malaysia	844.1	1,273.3	51.2	46.5
Singapore	Thailand	441.7	1,381.9	26.8	50.4
Singapore	Philippines	88.9	95.0	5.4	3.5
Indonesia	Singapore	104.5	16.1	6.3	0.6
Philippines	Thailand	4.9	48.4	0.3	1.8
Indonesia	Malaysia	26.0	15.8	1.6	0.6
Malaysia	Thailand	19.4	21.	1.2	0.8

*Note:* 1/ Based on FDI inflows data in host economy.

*Source:* UNCTAD FDI database.

Fifth, FDI flows between East Asia and South Asia remains low and stagnant, with most of the limited interest in South Asia having involved India. India is becoming an important host from for investments from Korea, Hong Kong and Singapore.<sup>14</sup> Conversely, many Indian firms use Singapore as a regional headquarters, particularly following the signing of a bilateral Comprehensive Economic Cooperation Agreement (CECA). More interestingly, a great deal of investments into India has thus far taken the form of foreign portfolio investments which have purchased stakes in existing Indian enterprises or in the form of private equity (including venture capital). These flows do not necessarily show up in the FDI statistics but are clearly contributing to domestic investment in India which has been rising rapidly. In addition, Mauritius has low corporate tax and has signed a liberal Double taxation agreement (DTA) with India. As such, many investments from other sources have been re-routed to India via Mauritius which has consistently been the top source of FDI to India, but this not captured in our data. Therefore, the actual extent of flows of FDI between India and East and Southeast Asia may be understated.<sup>15</sup>

In relation to the last point, it is important to note that the data analyzed above exclude the offshore financial centers (OFCs) such as the British Virgin islands (BVI), Bermuda, Cayman islands, Mauritius and Western Samoa as sources of FDI. Insofar as at least some part of inflows from the OFCs involve FDI that originated from other Asian economies, and the inflows are not destined back to originating economy (i.e. trans-shipping as opposed to round-tripping), we may be undercounting the size of

intra-Asian FDI flows. For instance, the BVI has consistently been the second largest source of FDI into China, surpassed only by Hong Kong, with the Cayman Islands and Western Samoa also being among the top 10 in 2006.<sup>16</sup>

#### **4. DETERMINANTS OF FDI OUTFLOWS FROM ASIA**

The previous section has highlighted the extent of FDI outflows from developing countries and more specifically, the intensification of intraregional FDI flows. But what explains the rise of intraregional FDI flows in Asia? This section undertakes an empirical investigation of some of the possible determinants of FDI flows from Emerging Asia to the rest of the region over the period 1997 to 2005. Can a gravity model framework that is commonly used to rationalize outward FDI flows from OECD economies be used to understand intra-ASIAN FDI flows?

##### **4.1. The model**

The aim of this section is to develop a relatively parsimonious model which includes commonly-used determinants as well as focus on specific bilateral variables. To this end we follow the basic gravity type framework which argues that market size and distance are important determinants in the choice of location of direct investment's source countries. The theoretical basis for a gravity model of FDI has recently been proposed by Head and Ries (2007). The model has been used in a host of papers with some variations.<sup>17</sup>

Our sample is based on annual data on 14 source countries and 10 host countries between 1990 and 2005. The data contains a large number of missing variables - approximately 40 percent - and a very small number of disinvestment figures—approximately 50 observations (shown in the data as negative). A missing variable for bilateral FDI may indicate either “unreported FDI”, reflecting the fact that the two countries have chosen to report low FDI values as zero, or “no FDI,” indicating no FDI flows between the two. After a thorough observation of our data we feel that most of missing variables in our dataset happen because of “no FDI”. As for the negative

disinvestment figures, we treated them as zero observations since they represent no investment in the destination countries. Following normal convention in treating missing variables in bilateral data (see Eichengreen and Irwin, 1995 and Stein and Daude, 2007), we expressed the dependent variable as  $\ln(1 + \text{FDI})$ .<sup>18</sup> This gives us around 1456 observations.

The basic specification of our estimated model is outlined below:

$$\ln(1 + \text{FDI}_{ijt}) = \beta_0 + \beta_1 \ln(\text{GDP}_{jt}) + \beta_2 \ln(\text{GDP}_{it}) + \beta_3 \text{LANG}_{ij} + \beta_4 \ln(\text{DIST}_{ij}) + \beta_4 \mathbf{X}_{ijt} + \lambda_t + v_{ijt} \quad (1)$$

where:  $\text{FDI}_{ijt}$  is the FDI inflow to host economy ( $j$ ) from the host economy ( $i$ ) in time ( $t$ );  $\text{GDP}_{it}$  and  $\text{GDP}_{jt}$  are nominal GDPs for the source economy ( $i$ ) and the host economy ( $j$ ) in time ( $t$ );  $\text{LANG}_{ij}$  is a binary variable equal to 1 if the source and host countries have same official language;  $\text{DIST}_{ij}$  is the geographical distance between host and source countries;  $\mathbf{X}_{ijt}$  is a vector of control variables influencing FDI outflows;  $\lambda_t$  denotes the unobservable time effects (we use year dummies); and  $v_{ijt}$  is a nuisance term.

The set of controls used are: difference in GDP per capita of the host and source countries, lag of export of goods from economy  $i$  to  $j$ ; volatility of exchange rate of  $i$  with respect to  $j$  (constructed by first taking the log difference of end-of-month exchange rates and then calculating a five-years rolling standard deviation), nominal exchange rate of  $i$  with respect to  $j$ ; average corporate tax rates in economy  $j$ ; a political risk index in economy  $j$ ; and a binary variable equal to 1 if  $i$  and  $j$  have a free trade agreement.

We expect the coefficients of the GDP of the source and destination countries to both be positive as they proxy for masses which are important in gravity models.<sup>19</sup> A destination economy that has a large market tends to attract more market-seeking FDI. The sign of the source economy size is ambiguous. While large GDP could indicate greater aggregate income and therefore higher ability to invest abroad, small GDP implies limited market size and consequent desire by companies to expand their wings overseas to gain market share. The sign for distance from the source to the host

economy should be negative, as greater distance between countries makes a foreign operation more difficult and expensive to supervise and might therefore discourage FDI.<sup>20</sup> Apart from these standard variables included in the gravity model, we have also included a set of controls on trade, exchange rates, institutions, etc.<sup>21</sup>

The prior sign of the difference in GDP per capita (source minus host) is unclear, depending on whether FDI flows are vertical or horizontal in nature. However, a positive sign may also suggest that FDI flows could help reduce income gap between countries. The nexus between FDI and trade is similarly ambiguous a priori. Insofar as both are a means of servicing a market, they could be competitive in nature. On the other hand, their relationship could be complementary if FDI is export-oriented or if greater exports increase familiarity with an economy, hence stimulating FDI inflows as well. Clearly there may be issues of reverse causality between FDI and exports. We therefore lag the exports variables by one period.<sup>22</sup> The bilateral nominal exchange rate should have a positive sign, as a depreciated nominal exchange rate in the host economy should raise FDI flows from the source economy (due to the wealth effects). However, there are other channels that could lead to ambiguity of the signage (Cushman, 1985). Similarly, while it could be argued that higher exchange rate volatility could deter FDI, the relationship is more complex. For instance, when one thinks about acquisitions, higher exchange rate volatility could lead to more inflows since expected future cash flows from the target firm is correlated with liquid assets.

Anghel (2005), Busse and Hefeker (2005), Bénassy-Quéré et al. (2007), Daude and Stein (2004) and others have discussed and explored in some detail the importance of political risk and institutional variables in determining FDI flows and Hur et al. (2007) have analyzed the importance of institutions in the case of M&A deals. In view of this we include a Political Risk Index -- broadly defined to reflect government stability, socioeconomic conditions, investment climate, internal and external conflict, corruption, involvement of the military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucracy quality -- of International Country Risk Group (ICRG) database.

We also included two other controls sometimes used in other studies. One, higher corporate tax in the host economy should deter FDI.<sup>23</sup> However, the presence of double tax agreements, tax sparing agreements, tax incentives, transfer pricing etc may muddy

the results as we have not accounted for them. Two, Free trade agreements (FTAs) in form of regional trade agreements (RTAs) and bilateral trade agreements (BTAs) between Emerging Asia have proliferated rapidly. It is commonly believed that FTA tends to stimulate FDI flows (for instance, see Levy Yeyati et al., 2002). We examine this linkage by including dummies for *operational* bilateral trade agreements.<sup>24</sup>

#### **4.2. Data, methodology and results**

Tables A1 and A2 in the Appendix summarize the data sources to be used and Table A3 offers the summary statistics. The FDI data are based on the *UNCTAD FDI/TNC* database. Nominal GDP in US dollar and GDP per capita in US dollar are taken from the IMF's *World Economic Outlook* database. Export data from the source to the host countries are taken from the IMF's Direction of Trade and Statistics database.<sup>25</sup> Data on distance and common official language are taken from the CEPII.<sup>26</sup> As noted, the Political Risk index is taken from International Country Risk Group (ICRG) database. The source of average corporate tax rate is a combination of the World Tax Database created by the Office of Tax Policy Research (OTPR) at the University of Michigan Business and KPMG Corporate Tax Survey.<sup>27</sup> The data on FTAs is constructed from the World Trade Organization (WTO) website (Table A4).

The results are summarized in Table 8 (Regression 1).

**Table 8: Gravity model**

Dependent variable: ln of bilateral FDI outflows	Regression (1)	Regression (2)
ln(GDP <sub>i</sub> )	0.239*** (0.088)	0.128 (0.081)
ln(GDP <sub>j</sub> )	0.682*** (0.076)	0.536*** (0.076)
Common official language	0.269** (0.132)	0.066 (0.130)
ln (distance <sub>ij</sub> )	-0.302*** (0.114)	-0.395*** (0.114)
Difference in GDP per capita <sub>ij</sub>	-0.011*** (0.001)	-0.011*** (0.001)
ln (export <sub>ij</sub> (-1))	0.192*** (0.056)	0.201*** (0.056)
ln (nominal exchange rate <sub>ij</sub> )	0.010 (0.021)	0.003 (0.02)
ln (volatility of exchange rate <sub>ij</sub> )	-0.078 (0.084)	0.121* (0.07)
Corporate tax <sub>j</sub>	-0.061*** (0.013)	-0.053*** (0.013)
Political risk <sub>j</sub>	0.032*** (0.007)	0.040*** (0.006)
FTA <sub>ij</sub>	0.666*** (0.179)	0.089 (0.140)
Observations	1,219	1,187
Adjusted R <sup>2</sup>	0.48	0.45

Note: Robust standard errors in parentheses.  
\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.  
Year dummies and constant are not shown.  
Regression 1 includes entire sample.  
Regression 2 excludes bilateral flows between China and Hong Kong, vice versa.

Source: Authors' estimation.

Greater distance between the host and source economy tends to lower bilateral FDI. In particular, a 1 percent increase in distance between two countries reduces bilateral FDI by about 0.3 to 0.4 percent. This elasticity is broadly consistent with most studies using FDI stocks which find distance elasticities in the range of 0.05 to 1 percent (for

instance, see Loungani et al., 2002). Common official language appears to encourage more FDI inflows from source to host countries. Host and source market sizes are positive and statistically significant. Apart from the standard gravity variables, the difference in GDP per capita between host and source countries is negative, implying that the lower the degree of income divergence between the countries, the more likely there is to be bilateral FDI flows between the countries. Lagged exports from source to host economy shows up with a positive sign and is statistically significant, suggesting a degree of complementary between exports and FDI flows. Currency appreciation of the source economy vis-à-vis the host economy facilitates FDI, though the effect is not statistically significant.<sup>28</sup> Similarly, higher exchange rate volatility does not appear to impact bilateral FDI flows significantly. Lower political risk (i.e. a higher ICRG rating) in the source economy leads to more FDI inflows.<sup>29</sup> Consistent with the findings of Büthe and Milner (2005), we find that an operational FTA also seems to facilitate FDI flow between the source and host countries. The corporate tax rate has a negative sign and is statistically significant though weakly economically significant.<sup>30</sup> As a quick robustness check, we also excluded the economy pairings between China and Hong Kong as the bulk of bilateral Asian FDI flows were between these two economies (Regression 2). Reassuringly, the results remain largely unchanged. Therefore, China-Hong Kong flows are not driving our results.<sup>31</sup>

## **5. CONCLUDING AND POLICY IMPLICATIONS**

Intra-Asian investment flows in the region by Japanese multinationals are not something new, having been fuelled partly by the Plaza Accord of 1984-85. However, an interesting phenomenon in recent times has been the rise of outward investments by many other developing Asian economies. Many governments in Asia have clearly taken a very positive attitude towards outward FDI and have taken notable steps to liberalize capital account transactions, foreign ownership policies and foreign exchange policies and related regulations as a means of facilitating the international expansion of firms in their countries. Consequently, intra-Asian FDI flows are no longer a North-South



phenomenon but increasingly a South-South one as well, and a substantial portion of FDI from Asia is intraregional in nature. However, much of the discussion surrounding intra-Asian FDI flows has been anecdotal and qualitative in nature (largely based on case studies), and most existing quantitative studies have only considered FDI from OECD sources to Asia.

This paper has investigated trends, patterns and drivers of intra-Asian FDI flows using bilateral FDI flows involving 15 developing Asian countries for the period 1990 to 2005. In other words, the primary contribution of this paper is that it is one of the first -- if not the first -- to examine the magnitudes and determinants of FDI flows from developing Asian sources to other developing Asian hosts. The data indicates that around 35 percent of FDI flows to developing Asia between 1990 and 2005 has come from within the region, with over 90 percent of the flows originating from Hong Kong, China, Singapore and Taiwan. Including Japan, intra-Asian FDI flows rise to about 40 percent. Clearly some of these flows are overstated as they involve recycling or round-tripping of funds (especially between China and Hong Kong). Against this, transshipping from offshore financial centers have not been included, implying a degree of understating.<sup>32</sup> Thus, it would be fair to say that at least 40 percent of flows to emerging Asia are from its Asian neighbours. While the intra-Asian flows are substantial, two issues stand out. One, a large part of these flows pertains to bilateral flows between Hong Kong and Mainland China. Two, the data do not indicate that intra-Asian flows are necessarily intensifying. Given that developing Asia is investing aggressively overseas, what this suggests is that relatively more investments are being made outside developing Asia.<sup>33</sup>

Having described the outward FDI boom in East Asia since 1997, the paper goes on to examine the determinants of intra-Asian FDI flows. An augmented gravity model appears to fit the data fairly well. The baseline regression is able to capture almost 50 percent of the variations in existing intra-Asian FDI flows. Most of the estimates are the correct signs and are statistically and economically significant. Apart from market size (especially of source economy), a depreciated host economy currency, lower political risk and the presence of a free trade agreement between source and host countries appear to stimulate bilateral FDI flows. As in the case of international trade, larger distance stands out as an important determinant that deters bilateral FDI flows.<sup>34</sup> This

result is robust to changes in specifications.<sup>35</sup> Exports and FDI appear to be complementary to one another; more specifically, higher exports appear to stimulate future FDI flows. This is suggestive of vertical specialization and production fragmentation between Asian economies *a la* Ando and Kimura (2003, 2005). The larger the per capita GDP difference between the host and source economy, the lower is FDI, further suggesting that FDI in the region is driven largely by a desire of firms to integrate vertically within the region.

While geographical distance is “natural”, there could still be a role for government policy in reducing “transactional distance” and “informational distance” between countries *a la* Loungani et al. (2002).<sup>36</sup> International and spatial economists use the narrower terms of “trade costs” or “transport costs”, respectively (see Anderson and Wincoop, 2004).<sup>37</sup> Arguably these terms are too narrow insofar as distance proxies transport and trade costs, informational asymmetries, lack of cultural familiarity, and all other factors that could hinder FDI flows. For instance, using bilateral FDI stocks data to China (from 28 OECD economies and 5 non-OECD Asian economies), Gao (2005) finds that both culture and geography matters in the case of FDI to China. As he notes, “the total FDI stock would be lowered by about 45% if China's economic center were located in New Delhi, India, and would be lowered by about 70% if it were located in New Delhi and there were no cultural ties.”<sup>38</sup> In the final analysis, while some determinism is due to factors that are “natural” and cannot be shaped by policy, governments in Asia need to focus much greater attention on reducing communications and transactions costs and informational barriers that might hinder intra-regional FDI flows.

There are three immediate areas of future research. One, examine how much of the hindrances to FDI are actually due to informational barriers versus actual physical constraints. Two, investigate the share of Greenfield investments versus mergers and acquisitions (M&As) to the region, as the latter could have quite different macroeconomic consequences from the former. Three, compare the share of FDI flows to the region from the rest of the region versus FDI flows from the US and Europe. Clearly there is scope for much more important policy-oriented work in this area.

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## APPENDIX

**Table A1: Variables included in the dataset**

Variables	Source
FDI Outflows	UNCTAD FDI/TNC database
Nominal GDP in US dollar	World Economic Outlook, IMF
Per capita GDP difference	
Consumer price indices	World Economic Outlook, IMF
Exports of goods	Direction of Trade Statistics, IMF
Nominal Bilateral Exchange Rate	International Financial Statistics, IMF
Distance	CEPII
Common Official Language	CEPII
Political risk	ICRG
Trade agreements	WTO website
Corporate tax rate	KPMG Indirect and Corporate Tax Survey, and OTPR's World Tax Database

**Table A2: Host and source economies in the dataset**

Host	Source
Bangladesh	Bangladesh
China (Mainland)	China (Mainland)
Hong Kong, SAR	Hong Kong, SAR
India	India
Indonesia	Korea
Korea	Malaysia
Malaysia	Pakistan
Pakistan	Philippines
Philippines	Singapore
Singapore	Thailand
Sri Lanka	
Taiwan, POC	
Thailand	
Vietnam	



**Table A3: Summary of statistics**

Variables	Units	Mean	Std dev.	Min.	Max.
Bilateral FDI outflows from i to j	U.S. \$ millions	614	2,593	0	20,677
Nominal GDP in country i	U.S. \$ billions	245	313	6	2,244
Nominal GDP in country j	U.S. \$ billions	251	404	31	2,244
Common official language	Dummy 1 = yes; 0 = no	0	0	0	1
Distance between i and j	Kilometers	2,610	1,394	0	5,221
Difference in GDP per capita <sub>ij</sub>	U.S. \$	-10	129	-267	262
Exports from i to j	U.S. \$ millions	3,954	10,631	0	130,283
Bilateral nominal exchange rate <sub>ij</sub>	Nominal rate	200	888	0	7,929
Exchange rate volatility <sub>ij</sub>	Nominal change	0.01	0.02	0.00	0.14
Corporate tax <sub>j</sub>	Percent	31	7	16	55
Political risk <sub>j</sub>	100 = min 0 = max	66	12	29	89
Free Trade Agreements	Dummy 1 = yes; 0 = no	0	0	0	1

**Table A4: Established trade agreements between emerging Asian economies, 1990-2004**

RTAs	BTAs
AFTA (ASEAN Free Trade Area)	India-Sri Lanka
SAPTA (SAARC Preferential Trade Agreement)	China-Hong Kong
	China-Thailand
	India-Thailand

## NOTES

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<sup>1</sup> A rather tangential rationale for - or rather, result of - overseas acquisitions and concomitant capital outflows has been an easing of exchange rate pressures on Asian currencies, thus reducing the need for reserve buildup and having to manage its inflationary consequences.

<sup>2</sup> See Lunding (2006) for a discussion of China's outward investments. Gopinath (2007) discusses the steps taken by the Indian government to facilitate outward FDI. Sauvart (2005) describes steps taken by both India and China to promote outward FDI. For case-studies of outward FDI from China, India and other Asian economies, see chapters in Rajan, Kumar and Virgill (eds.) (2008).

<sup>3</sup> A selective list of recent papers that use bilateral FDI data from OECD but are not specifically limited to Asia are Bénassy-Quéré, Coupet and Mayer (2007), Daude and Stein (2004), Head and Ries (2007), Lougani, Mody and Razin (2002). Razin, Rubinstein and Sadka (2003) and Stein and Daude (2007).

<sup>4</sup> A priori it is unclear whether FDI over or under-estimates actual real economic activity as this requires consideration of the impact of FDI on existing domestic investment, extent of technology transfer, employment creation, and the like. The impact on FDI on net capital flows is also uncertain as greater FDI inflows could encourage portfolio and bank flows, while simultaneously, M&A inflows could lead to the previous local owners choosing to invest some of their returns overseas, leading to capital outflows. The nexus between FDI and other sources of financing is explored in Rajan (2005).

<sup>5</sup> Globerman and Shapiro (2005) find many common determinants in both modes of FDI.

<sup>6</sup> See UNCTAD (2006, pp.15-21) for a discussion of Greenfield versus M&As. In the past three years, cross-border merger and acquisition (M&A) have been experiencing a surge. UNCTAD reports that in 2005 both value and the number of cross-border M&A rose to US\$ 716 billion and to 6,134 which are increased of 88 percent and 20 percent, respectively. Bloomberg, Thomson Financial, Dealogic and OCO Consulting's LOCO Database record all M&A deals that are reported by news and media in their database. UNCTAD M&A database is drawn out from Thomson Financial.

<sup>7</sup> See UNCTAD (2006, pp.15-21) for a discussion of Greenfield versus M&As. Cross-border M&As in the past three years, have been experiencing a surge. While most M&A statistics are compiled by commercial data sources, they tend to include *announced* rather than *actual* financial flows, and some of the announced flows may not even include activities considered to be FDI (as defined above). More to the point, announced flows often includes funding of capital via equity from local minority share-holders or local/international borrowing (as opposed to funds from the parent or sister companies).

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<sup>8</sup> For ASEAN economies, there is an additional data source, viz. ASEAN Secretariat database. However, this database is based on appropriations rather than actual flows and it is only limited to the manufacturing sector.

<sup>9</sup> Chen and Lin (2006) discuss patterns and determinants of FDI outflows from Hong Kong and Mainland China.

<sup>10</sup> Estimates put round-tripping at between 25 and 50 percent of total FDI flows from Hong Kong, SAR to Mainland China (UNCTAD, 2006, p.12).

<sup>11</sup> Apart from round-tripping and trans-shipping issues (discussed later in this section), part of the data inconsistencies between inflows and outflows arise because many countries do not include retained earnings or loans when considering FDI outflows.

<sup>12</sup> It is instructive to note that the top destinations of FDI using data based on FDI inflow data in host economy and FDI outflow data from source economy have roughly stayed the same during the period under consideration.

<sup>13</sup> This said, the bulk of FDI flows from China have been to Hong Kong. However, there is evidence of growing investments by China into Southeast Asia.

<sup>14</sup> According to UNCTAD (2007), FDI inflows worldwide to India rose sharply in 2005-2006, making it the third most attractive developing Asian economy, after Hong Kong and Mainland China, and ahead of Singapore, Taiwan, Korea and Malaysia.

<sup>15</sup> Some of the Indian FDI from Mauritius is also round-tripping from Indian firms.

<sup>16</sup> <http://www.uschina.org/info/forecast/2007/foreign-investment.html#table4>. In the literature, OFCs have mainly been discussed in the context of bank flows and portfolio flows. For instance, see Dixon (2001), Rose and Spiegel (2006) and Zoromé (2007).

<sup>17</sup> The augmented gravity model for FDI is broadly similar -- but by no means identical -- to those used in recent papers, including Lougani, Mody and Razin (2002). Stein and Daude (2007), Liu, Chow and Li (2007). di Giovanni (2005) applies a gravity model to analyze cross-border M&A transactions, while Portes and Rey (2005) and Lee (2006) apply a gravity model for portfolio equity flows.

<sup>18</sup> Other bilateral FDI flow studies, such as Eichengreen and Tong (2007), only treat FDI flows data that have only zero observations by replacing zeros with the lowest positive FDI in the data, while not treating the missing variables. However, this methodology is not useful for our data since our data does not have zero observations. Another alternative is using two-stage Tobit models, such as di Giovanni (2005), or use the Poisson pseudo maximum likelihood method as suggested by Santos Silva and Tenreyro (2006). The latter methodology has been recently applied to FDI by Head and Ries (2007). Coe, Subramanian and Tamirisa (2007) suggest another log-linear estimation method to deal with this problem.

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<sup>19</sup> In physics, the law of gravity states that the force of gravity between two objects is proportional to the product of the masses of the two objects divided by the square of the distance between them. Most gravity models in bilateral trade and FDI have replaced the force of gravity with the value of bilateral trade or direct investments and the masses with the source and destination countries' GDP.

<sup>20</sup> If the foreign firm is looking to service the destination economy's market, a longer distance also makes exporting from source countries more expensive and might therefore make local production more desirable and encourage investment. This argument is not unlike the tariff-jumping one.

<sup>21</sup> The other standard variable in the gravity model, viz. dummies for common border was not robust and incorrect signs so we dropped it.

<sup>23</sup> Bénassy-Quéré et al. (2005) explore the impact of various tax schemes on FDI.

<sup>24</sup> We have dated FTAs based on when they have been operationalized rather than when they were signed.

<sup>25</sup> The data are limited to merchandise trade only.

<sup>26</sup> The distance is calculated following the "great circle" formula, which uses latitudes and longitudes of the most important cities/agglomerations (in terms of population). For more information, see CEPII's website at <http://www.cepii.fr/>.

<sup>27</sup> The corporate tax figures in OTPR's tax database refers only to the top marginal tax rate on corporations, while KPMG Tax Survey data refers to top marginal tax rates and other local taxes that burden a foreign corporation. OTPR's tax database goes up only to 2002, while KPMG extends to 2005. However, OTPR has a longer history which extends back to 1990, while KPMG only starts at 1993. To reflect the real situation in an economy, we used KPMG data as our starting point. We filled in the missing data on our economy samples by comparing tax rates data for each economy in our sample.

<sup>28</sup> The positive sign is aligned with works by Cushman (1985), Froot and Stein (1991), Blonigen (1997), and others.

<sup>29</sup> See Busse and Hefeker (2005) for a more detailed analysis of the impact of various types of political risks on FDI. Using a data set of 83 developing countries for the period 1984 to 2003, they find that government stability, the absence of internal conflict and ethnic tensions, basic democratic rights and ensuring law and order are highly significant determinants of foreign investment inflows.

<sup>30</sup> Bénassy-Quéré et al. (2005) notes that the impact of corporate taxation on FDI is asymmetrical. Using a panel of bilateral FDI flows 11 OECD countries over 1984-2000, they find that lower tax rates in the host countries do not appear to attract FDI, though higher taxes seem to discourage new FDI inflows. In a more recent study, Jensen (2007) utilized a panel data set for 19 OECD countries

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from 1980-2000 and failed to not find any empirical relationship between the level of corporate taxation and FDI flows.

<sup>31</sup> We also tried weighted distance, which was developed by Head and Mayer (2002), share of common ethnic language (i.e. if a language is spoken by at least 9 percent of the population in both countries), and other institutional type controls, including investment profile. Results stayed the same with the benchmark. Results are available from authors on request.

<sup>32</sup> See UNCTAD (2006, pp.12-3) for a brief discussion of round-tripping and trans-shipping in the context of cross-border FDI flows.

<sup>33</sup> For instance, Pardhan (2005) has argued that outward investments from Indian multinationals since the mid 1990s have been more global in nature. Similarly Singapore through its holdings company (Temasek) and sovereign wealth fund (GIC) has been aggressively purchasing assets in the US and elsewhere outside Asia in addition to intraregionally.

<sup>34</sup> Coe et al. (2007) discuss the issue of distance and international trade, referring to it as the “missing globalization puzzle”.

<sup>35</sup> For instance, we have included financial variables, altered time period, economy coverage, etc. Results available from authors on request.

<sup>36</sup> Loungani et al. (2002) and Jeon et al. (2004) find that the distance variable remains statistically and economically significant even with the inclusion of a communications variables (such a cross-border telephone flows). Also see di Giovanni (2005) in the case of M&As and (Portes and Rey (2005) in the case of portfolio flows.

<sup>37</sup> Hiratsuka (2006) emphasizes the importance of such costs in the case of FDI to ASEAN.

<sup>38</sup> Gao (2005) suggests that these variables were specific to the ethnic Chinese business and social networks (however, he excludes Hong Kong because of data unavailability), a point confirmed empirically by Gao (2003) and Tong (2005). Accordingly it would be interesting to re-run the equations without China, Hong Kong, Taiwan and Singapore bilateral FDI flows.

## Chapter 14

# **Taxation, Business Regulation, and Foreign Direct Investment in East Asia**

*Sasatra Sudsawasd*

## **INTRODUCTION**

Many countries worldwide have experienced remarkable growth in FDI flows and greater economic integration in recent years. Not surprisingly, there is increasing recognition of FDI as an important means of achieving deeper economic integration. Because it encourages the growth of dynamic production networks, investment is regarded as a key driver of regional economic integration, and the role of FDI in economic development, especially of developing countries, is widely accepted.

As a result, governments increasingly adopt tax instruments in order to compete for and attract new FDIs. The commonly used tax instruments are the provision of tax incentives and low corporate income tax rates. The effectiveness of these two measures, however, is still unclear. Hence, the first aim of this research is to review the tax instruments used in East Asia. Second, it will empirically examine the effects of those tax instruments, corporate income taxes and tax treaties in particular, on FDI inflows.

Another important concern of this research is the relationship between business regulations and FDI inflows. It is known that more efficient and transparent regulation systems are associated with lower business costs, which, in turn, foster a good investment environment. Although the positive effects of efficient regulation systems on FDI are somewhat expected, there is a scarcity of supporting empirical research due mainly to the limited amount of business-regulation data available.

Fortunately, the World Bank recently published a series of business-regulation indicators derived from numerous surveys conducted in 178 countries worldwide<sup>1</sup>. Hence, another objective of this study is to examine whether and how business regulations affect the investment decisions of multinational firms. The findings will

point to which regulation policies are crucial in enhancing a country's attractiveness as an FDI destination.

In summary, this research aims to accomplish several things. First, it seeks to present an overview of tax instruments used in East Asia, which is done in Section 2. Then, by using econometric frameworks in Sections 3 and 4, it examines the effects of corporate income tax rates and tax treaties on FDI flows to East Asian countries and to ASEAN-5 countries in Section 3. An empirical examination of the relationship between various business-regulation indicators and FDI inflows is provided in Section 4. The paper concludes with the policy implications for deepening economic integration in East Asia in Section 5.

## **2. AN OVERVIEW OF TAX INSTRUMENTS IN EAST ASIA**

This section presents an overview of tax instruments used in 15 East Asian countries. Summaries of selected tax instruments are shown in Table 1 below. These selected tax instruments include tax incentive provisions<sup>2</sup>. Although the tax incentive schemes in the East Asian countries studied vary considerably, they share similar characteristics such as the provision of tax holidays and import duty exemptions.

Tax incentives are widely used, despite the inconclusiveness of evidence on the cost-effectiveness of using these incentives in encouraging new investments (*Zee et al.*, 2002). In the East Asian context, *Morisset and Pirnia* (2000) and *Chalk* (2001) reviewed the literature on the effectiveness of tax incentives on FDI inflows in the region. They pointed out that even if tax policy mattered, it is not the most important consideration for multinational firms when selecting a recipient for FDI compared to other factors such as political and economic stability, labor cost, size of domestic market, and the availability of basic infrastructure and raw materials. Nonetheless, they accepted that tax incentives provisions are still important tools for investment promotions, especially in developing countries.

**Table 1: Selected tax instruments in 15 East Asian countries**

Tax Instrument	Australia	Brunei	Cambodia	China	India	Indonesia	Japan
Corporate income tax	30%	30%	5-30%	33%	33.99%,42.23%	10-30%	30%
Value-added tax	10%	No	10%	13%, 17%	12.50%	10%	5%
Additional taxes on branch profits remitted to the foreign head office	No	No	No	No	No	20%	No
Withholding taxes for nonresidents							
- Dividends	30%	Nil	14%	0%	Nil	20%	20%
- Interest	10%	20%	14%	10%	20%	20%	15%, 20%
-Royalties	30%	No	14%	10%	20%	20%	20%
Tax incentives							
-Tax holidays, tax exemptions	Yes	up to 5 yrs	up to 6 yrs	Yes	up to 15yrs	Yes	Yes
-Import duty exemptions	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Loss treatment: Carry forward	Infinite	Yes	5 yrs	5 yrs	8 yrs	5-10 yrs	7 yrs

Tax Instrument	Korea	Malaysia	New Zealand	Philippines	Singapore	Thailand	Vietnam
Corporate income tax	14.3, 27.5%	27%	33%	35%	18%	30%	28%
Value-added tax	10%	5-10%	12.5%	12%	7%	7%	0-10%
Additional taxes on branch profits remitted to the foreign head office	25%	No	No	15%	No	10%	No
Withholding taxes for nonresidents							
- Dividends	25%	Nil	30%	25%,35%	Nil	10%	Nil
- Interest	25%	Nil or 15%	15%	25%,35%	15%	15%	Nil or 15%
-Royalties	25%	10%	15%	25%,35%	10%	15%	10%
Tax incentives							
-Tax holidays, tax exemptions	5 yrs	Yes	Yes	3-8yrs	up to 15 yrs	3-8 yrs	Yes
-Import duty exemptions	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Loss treatment: Carry forward	5 yrs	Infinite	infinite	3 yrs	Infinite	5 yrs	5 yrs

Source: Data collected from the PricewaterhouseCoopers website. <http://www.pwc.com> (accessed August 15, 2007).



Additionally, a study by Halvorsen (1995) analyzed the cost-effectiveness of various fiscal incentive instruments in Thailand and found little justification for the use of such incentives. However, he acknowledged the need for correct incentives when the objective is to alter the composition of investments, not to promote or attract investments in general.

Fletcher (2002) analyzed tax incentives in the Lower Mekong (Cambodia, Lao PDR, and Viet Nam) region and found that tax incentives are not a primary driver of FDI inflows. Although his findings could be interpreted as evidence of the ineffectiveness of tax incentives, the methodology he used was somewhat questionable because he defined tax incentives simply as the natural log of the number of lines in the description PricewaterhouseCoopers provided in its tax summary. By defining tax incentives in this manner, the correct measure of the tax incentive schemes that could be more generous with the shorter number of lines may not be provided.

On the issue of corporate income taxes, Singapore offers one of the lowest tax rates in the region. Its tax rate is flat at 18 percent, around half of the tax rates in China and the Philippines. Theoretically, lower corporate income tax rates increase the net return on capital, which, in turn, encourages new investment and capital inflows<sup>3</sup>. Empirical evidence also points to the same direction. A country with higher tax rates appears to be less attractive for investment inflows (e.g., Hartman, 1984; Shah and Slemrod, 1990). With its low corporate income tax rate, Singapore is a very attractive investment destination in East Asia.

There is pressure on countries to lower their corporate income tax rates to ensure their competitive position in today's global economy. Many countries have attempted to shift their tax system from income-based taxes to consumption-based taxes such as the value-added (VAT) tax.<sup>4</sup> As a result, the world has been experiencing more tax competition as economies globalize and capital mobility increases.

This inevitably leads to a "race-to-the-bottom" situation, which could harm all countries involved as collected tax revenues decrease, leading to less provision of public goods. In addition, tax competition itself makes economic integration difficult.

**Table 2: Date of conclusion of bilateral tax treaties**

Country	Australia	Japan	Thailand	Philippines	Malaysia	Vietnam	China	Singapore	India	Indonesia	Korea	Brunei	Laos	Myanmar	NZ
Australia	-	Mar-69	Aug-89	May-79	Aug-80	Apr-92		Feb-99	Jul-91	Apr-92	Jul-82				Jan-95
Japan	Mar-69	-		Feb-80	Feb-99	Oct-95	Feb-83	Apr-94	Mar-89	Mar-82	Oct-98				Jan-63
Thailand	Aug-89		-	Jul-82	Mar-82	Dec-92	Oct-86	Sep-75	Mar-85	Jun-01	Aug-74		Jun-97		Oct-98
Philippines	May-79	Feb-80	Jul-82	-	Apr-82	Nov-01	Nov-99	Aug-77	Feb-90	Jun-81	Feb-84				Apr-80
Malaysia	Aug-80	Feb-99	Mar-82	Apr-82	-	Sep-95	Nov-85	Oct-04	May-01	Sep-91					Mar-76
Vietnam	Apr-92	Oct-95	Dec-92	Nov-01	Sep-95	-	May-95	Mar-94	Sep-94	Dec-97	May-94				
China		Sep-83	Oct-86	Nov-99	Nov-85	May-95	-	Apr-86	Jul-94	Nov-01	Mar-94		Jan-99		Sep-86
Singapore	Feb-69	Apr-94	Sep-75	Aug-77	Oct-04	Mar-94	Apr-86	-	Jan-94	May-90	Nov-79	Aug-05		Feb-99	Aug-73
India	Jul-91	Mar-89	Mar-85	Feb-90	May-01	Sep-94	Jul-94	Jan-94	-	Aug-87	Jul-85				Oct-86
Indonesia	Apr-92	Mar-82	Jun-01	Jun-81	Sep-91	Dec-97	Nov-01	May-90	Aug-87	-	Nov-88	Feb-00		Apr-03	Mar-87
Korea	Jul-82	Oct-98	Aug-74	Feb-84		May-94	Mar-94	Nov-79	Jul-85	Nov-88	-		Nov-04	Feb-02	Oct-81
Brunei								Aug-05		Feb-00					
Laos			Jun-97				Jan-99				Nov-04				
Myanmar								Feb-99		Apr-03	Feb-02				
New Zealand	Jan-95	Jan-63	Oct-98	Apr-80	Mar-76		Sep-86	Aug-73	Oct-86	Mar-87	Oct-81				-

Source: International Bureau for Fiscal Documentation website. <http://www.ibfd.org> (accessed September 15, 2007).

**Table 3: Dividend withholding tax rates in tax treaties**

	Contracting State														
	Australia	Japan	Thailand	Philippines	Malaysia	Vietnam	China	Singapore	India	Indonesia	Korea	Brunei	Laos	Myanmar	NZ
Australia	-	15%	15%,20%	15%,25%	0%	0%		0%	15%	15%	15%				15%
Japan	15%	-		10%,25%	5%,15%	0%	10%	0%	15%	10%,15%	5%,15%				15%
Thailand	15%,20%	20%	-	15%,20%	0%	0%	15%,20%	0%	15%,20%	15%,20%	15%,20%		15%		15%
Philippines	15%,25%	10%,25%	15%,20%	-	0%	0%	10%,15%	0%	15%,20%	15%,20%	10%,15%				15%
Malaysia	0%,15%	5%,15%	15%,20%	15%,25%	-	0%	10%	0%	10%	15%	15%				15%
Vietnam	15%	10%	15%	10%,15%	10%	-	10%	0%	10%	15%	10%				15%
China		10%	15%,20%	10%,15%	0%	0%	-	0%	10%	10%	5%,10%		5%		15%
Singapore	15%	5%,15%	20%	15%,25%	5%,10%	0%	7%,12%	-	10%,15%	10%,15%	10%,15%	10%		5%,10%	15%
India	15%	15%	15%,20%	15%,20%	10%	0%	10%	0%	-	10%,15%	15%,20%				15%
Indonesia	15%	10%,15%	15%,20%	15%,20%	0%	0%	10%	0%	10%,15%	-	10%,15%	15%			15%
Korea	15%	5%,15%	15%,20%	10%,15%	0%	0%	5%,10%	0%	15%,20%	10%,15%	-		5%,10%	10%	15%
Brunei								0%		15%					
Laos			15%				5%				5%,10%				
Myanmar								0%			10%				
New Zealand	15%	15%	15%	15%	0%		15%	0%	15%	15%	15%				-

Note: The rates provided are the maximum withholding rates should a contracting state impose a withholding tax on dividends in the future. Where a treaty rate is higher than the domestic rate, the latter is applicable. If the treaty provides for a rate lower than the domestic rate, the reduced treaty rate may be applied at source.

Source: Data are collected from the International Bureau for Fiscal Documentation website. <http://www.ibfd.org> (accessed September 15, 2007).

Another tax instrument worth considering is the bilateral tax treaty agreements. Tables 2 and 3 below provide a summary of conclusion date and dividend withholding tax rate of the existing bilateral tax treaty agreements across 15 East Asian countries. Apparently, there is a lack of a comprehensive network of tax treaty agreements within East Asia. This lack is associated with double taxation, tax avoidance, and inconsistent definition of tax bases. In addition, it increases business costs, compliance costs, and administrative costs.

While many East Asian countries (e.g., Singapore and Indonesia) have extensive bilateral treaty networks, many others (e.g., Brunei, Lao, Myanmar) have very limited networks with other East Asian countries. Cambodia, though not reported, does not have tax treaty agreements with any of the 15 East Asian countries. Several ASEAN member countries also offer more favorable treaty agreements to non-ASEAN member countries than they do to ASEAN member countries (Farrow and Jogarajan, 2006). This is an impediment to economic integration in East Asia.

The bilateral tax treaty agreements of each East Asian country differ substantially among themselves. For instance, New Zealand offers a single, flat withholding tax rate on dividends to all bilateral treaty partners. This flat tax rate results in lower business and administrative costs compared to other tax rate regimes.

Many tax treaties were concluded a long time ago. Some of them, such as Japan's and New Zealand's treaties, are more than 40 years old, which means they may be obsolete and out of step with the changes that have happened in the global economy since then. It is time-consuming and costly to revise each bilateral tax treaty separately. This may also result in tax treaties with less bargaining power than treaties that are negotiated as a whole region. One possible direction to take in order to deepen the process of economic integration in East Asia is to develop a standard regional framework of tax treaty agreements to be implemented across the entire East Asia. Such framework will definitely enhance regional economic integration.

### 3. CORPORATE INCOME TAX, TAX TREATY, AND FOREIGN DIRECT INVESTMENT

#### 3.1. Model specification

This section analyzes factor determinants of bilateral FDI inflows and undertakes an empirical assessment of the impacts of tax instruments; namely, corporate income taxes and tax treaties on FDI inflows to East Asian countries and specifically to ASEAN-5 countries.<sup>5</sup> The model used is simply a modification of the standard gravity model of bilateral FDI flows, augmented by adding corporate tax rates and tax treaty variables as parameters of interest. The model specification is in the form:

$$\ln FDI_{ijt} = \beta_0 + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 \ln GDPPC_{it} + \beta_4 \ln GDPPC_{jt} \\ + \beta_5 \ln Dist_{ij} + \beta_6 Z_{ijt} + \varepsilon_{ijt},$$

where  $FDI$  denotes flows of outward FDI from FDI home country;  $i$  to FDI recipient country  $j$  in year  $t$ ;  $Z$  is the set of parameters of interest; and  $\varepsilon_{ijt}$  is a residual term, which may not be a well-behaved white noise. To remedy potential estimation errors, a country-specific effect and a time-specific effect are introduced to capture omitted country, time-invariant effects and omitted time-variant effects.

FDI flows are basically determined by traditional gravity variables including GDP ( $GDP$ ) and GDP per capita ( $GDPPC$ ) of FDI home and recipient countries, capturing the sizes of economies and proxy of labor costs. In addition, FDI flows are determined by the distance ( $Dist$ ) between FDI home and recipient countries' proxy for transportation and other trade costs that may influence firms' investment decisions.

For the parameters of interest, the effects of corporate income tax rates ( $Tax$ ) in FDI home and recipient countries are examined. The estimated effects are hypothesized to be positive in the case of home country tax rates ( $Tax_i$ ) and negative in the case of recipient country tax rates ( $Tax_j$ ). As stated, an increase in the corporate income tax rate

lowers the level of investment by increasing the net return to capital. This encourages capital outflows. Hence, the estimated coefficient of  $Tax_i$  is expected to be positive.

Likewise, recipient countries with higher corporate income tax rates would be less attractive for foreign investments, resulting to less capital inflows. Thus, the estimated coefficient of  $Tax_j$  is hypothesized to be negative. This research also examines the sensitivity of the difference between FDI recipient and home countries' corporate income tax rates ( $Tax_{jt} - Tax_{it}$ ), which is hypothesized to have a negative impact on FDI inflows.

Tax treaties, which are the rules on how taxes paid in an FDI recipient country are treated in an FDI home country, are expected to have some influence on the level of FDI inflows. Tax treaties are believed to increase investment since they indicate the tax cooperation between treaty partners and claim to remove tax barriers to investment (Davies, 2003; Blonigen and Davies, 2002). However, it is less certain whether tax treaties can actually increase investment. Since tax treaties reduce double taxation and minimize opportunities for tax avoidance and other tax savings, treaties may hamper the level of investment outflows instead (Blonigen and Davies, 2002). Hence, the effects of tax treaties on FDI flows are theoretically ambiguous. What is more important at this point is empirical evidence. Unfortunately, the existing empirical evidence on the effects of tax treaties on FDI flows showed mixed results and hardly support the theory that tax treaty formation is associated with more FDI inflows.

For instance, Blonigen and Davies (2002) used panel data of OECD countries over the period 1992 to 2002 and found strong negative impacts of tax treaties on FDI flows. Their findings are in contrast with the FDI promotion rationale for tax treaty formation. Later, Davies (2003) used the same panel data as Blonigen and Davies (2002) to estimate the effect of U.S. treaty renegotiations on FDI from 1966 to 2000 and found tax treaties to have an insignificant effect.

In particular, there is scarcity of literature examining the impacts of tax treaties in East Asia. Thus, another aim of this research is to examine the impact of tax treaties (*Treaty*) on FDI inflows to East Asian countries as well as to the ASEAN-5 countries. In line with this aim, the *Treaty* variable is added in the models described above. The

findings in this section will provide more insight on factors determining FDI inflows to East Asia.

### **3.2. Data and empirical issues**

The analysis was limited to FDI outflows from 30 OECD countries to 11 East Asian countries over the period 1990 to 2003<sup>6</sup>. Data on FDI outflows were obtained from the Source OECD database. Data on GDP and GDP per capita were collected from the *World Development Indicators*. All data are in U.S. dollars and are adjusted for inflation. Distance between the FDI host and recipient countries data were obtained from Andrew Rose's (2005) data set.

For the *Tax* variable, corporate income tax rates were measured by the apparent average tax rates (e.g., Benassy-Quere *et al.*, 2003; Desai *et al.*, 2004) expressed as percentages of GDP, which is calculated by taking the ratio of the actual tax collected to GDP multiplied by 100. Data on corporate income taxes were collected from the *Government Financial Statistics*. The *Treaty* variable is a dummy variable, which takes a value of one when tax treaties for bilateral FDI partners are in force and zero otherwise. Tax treaties defined by income tax treaties were collected from the International Bureau for Fiscal Documentation.

For the estimation technique, this research implemented the ordinal least square regression (OLS) model estimator. As previously mentioned, an error term may not be a white noise leading to estimation errors. Thus, this research introduced unobservable recipient country and/or time fixed effects error components to capture the influence individual recipient country characteristics and individual year characteristics may have on FDI inflows. These estimations are known as one-way fixed effects and two-way fixed effects model estimators. In all estimators, robust standard errors are employed.

### **3.3. Empirical findings**

All estimation results are reported in Tables 4 to 9. Note that the estimated time effects are rarely significant. The findings suggest no common unobservable time

factors influencing the level of FDI flows to East Asian countries during the sample periods. Hence, the following analysis was based mainly on the one-way fixed effects model estimations. The findings are summarized next.

First, the coefficient of FDI home country GDP levels is significantly positive. This indicates that the size of FDI home countries is relevant to firms' investment decisions. The larger the size of the home country, the higher are the FDI outflows expected. On the other hand, it was found that the size of FDI recipient country GDP levels did not have a strong influence on the decision to invest for OECD multinational firms, especially in the case of the 11 East Asian recipient countries' estimation.

Second, this research used GDP per capita to proxy labor costs in FDI home and recipient countries. The estimation suggests that labor costs in the OECD home countries are positively associated with FDI outflows. Thus, OECD investors are sensitive to their domestic labor costs. From the estimation of the ASEAN-5 recipient countries, labor costs in recipient countries were found to be significantly related to the level of FDI inflows. Moreover, from the estimation of the 11 East Asian recipient countries, the estimated coefficient of recipient labor costs turned out to be positive and significant. This is perhaps because some of the 11 East Asian countries (e.g., Japan and Singapore) are developed countries. The level of FDI flows to these countries is probably not induced by lower labor costs, but by their highly developed capital markets. Consequently, the estimated coefficient of the  $GDPPC_j$  variable was found to be positive.

Third, FDI flows were found to be a negative function of the distance between FDI home and recipient countries. This finding indicates that transportation costs between home and recipient countries are another relevant factor on firms' decisions to invest in East Asian countries. Investors from OECD member countries tend to prefer investing in recipient countries that are nearer the home countries.

Corporate income tax rates were introduced next. Interestingly, the recipient country tax rates ( $Tax_j$ ) variable appears to be insignificant. The findings indicate that corporate income tax rates of East Asian countries do not have a significant impact on the level of FDI inflows from the 30 OECD countries. In contrast, when the home country corporate income tax rates ( $Tax_i$ ) variable was included, the coefficient of

$Tax_i$  variable turned out to be significant and positive. These findings point to the importance of OECD home countries' tax policies on firms' decisions to invest in East Asian countries. A home country with higher corporate income tax rates is highly likely to invest more in East Asia.

When the sensitivity of the difference between FDI recipient country and home country corporate tax rates was assessed, the estimated coefficient was significantly negative. Now home country corporate income tax rates become relevant to firms' investment decisions. This finding contradicted earlier findings on the  $Tax_j$  variable. It is not clear whether the significant effects of the tax rates differentials are the results of either of these two factors: the relevance of the home and recipient countries' tax policies or the home countries' tax policies dictating the outcomes. The findings, however, suggest that both the FDI home and recipient countries' tax policies may exert some influence on the level of FDI flows. While holding all other factors equal, an increase in the recipient country's tax rates reduces its attractiveness as an FDI destination.

Regarding the impacts of bilateral income tax treaties on FDI flows, several findings are worth noting. First, the impacts are not significantly different from zero when data from all 11 East Asian recipient countries are estimated. This suggests that the level of FDI decisions is not affected by the formation of tax treaties alone. However, when the estimation includes only the ASEAN-5 recipient countries, the estimated effects become different. Now with the inclusion of the recipient country tax rates or the tax rates differentials variables, the estimations show the positive impact of tax treaties on the level of FDI inflows. Compare this with the insignificant impact of tax treaties when the home country tax rates variable is included. Nonetheless, the findings provide some evidence supporting the view of the FDI promotion rationale for tax treaty formation, especially in the case of the ASEAN-5 countries.



**Table 4: OLS estimations for determinants of bilateral FDI flows from 30 OECD countries to 11 East Asian countries**  
(Dependent variable is  $\ln FDI_{ij}$ .)

	1	2	3	4	5	6	7	8
$\ln GDP_i$	0.0036 (0.0004)	0.0031 (0.0003)	0.0047 (0.0005)	0.0036 (0.0005)	0.0036 (0.0004)	0.0031 (0.0003)	0.0047 (0.0006)	0.0036 (0.0005)
$\ln GDP_j$	0.0008 (0.0004)	-0.0004 (0.0004)	0.0013 (0.0006)	-0.0012 (0.0004)	0.0008 (0.0004)	-0.0003 (0.0004)	0.0013 (0.0006)	-0.0012 (0.0004)
$\ln GDPPC_i$	0.0046 (0.0005)	0.0045 (0.0005)	0.0067 (0.0010)	0.0061 (0.0010)	0.0047 (0.0005)	0.0046 (0.0005)	0.0066 (0.0010)	0.0062 (0.0011)
$\ln GDPPC_j$	0.0013 (0.0003)	0.0014 (0.0003)	0.0017 (0.0004)	0.0016 (0.0004)	0.0013 (0.0003)	0.0014 (0.0003)	0.0016 (0.0004)	0.0017 (0.0004)
$\ln DIST_{ij}$	-0.0020 (0.0008)	-0.0016 (0.0010)	0.0008 (0.0008)	0.0010 (0.0012)	-0.0020 (0.0008)	-0.0016 (0.0010)	0.0008 (0.0008)	0.0010 (0.0012)
$Tax_j$		0.00004 (0.0002)			0.00004 (0.0002)			
$Tax_i$			0.0016 (0.0004)				0.0016 (0.0004)	
$Tax_j - Tax_i$				-0.0004 (0.0002)				-0.0004 (0.0002)
$Treaty$					0.0005 (0.0008)	0.0012 (0.0008)	-0.0011 (0.0011)	0.0013 (0.0011)
Constant	23.9722 (0.0259)	24.0140 (0.0206)	23.8802 (0.0373)	23.9828 (0.0249)	23.9717 (0.0258)	24.0120 (0.0212)	23.8801 (0.0373)	23.9820 (0.0252)
No. of obs.	2616	1250	1478	790	2616	1250	1478	790
R-squared	0.1121	0.1881	0.1509	0.1894	0.1122	0.1898	0.1515	0.191
Country-fixed effects	No	No	No	No	No	No	No	No
Time-fixed effects	No	No	No	No	No	No	No	No

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels, respectively. Robust standard errors are in parentheses.

**Table 5: One-way fixed effects estimations for determinants of bilateral FDI flows from 30 OECD countries to 11 East Asian countries (Dependent variable is  $\ln FDI_{ij}$ .)**

	9	10	11	12	13	14	15	16
$\ln GDP_i$	0.0037 (0.0004)	0.0030 (0.0003)	0.0047 (0.0005)	0.0038 (0.0005)	0.0037 (0.0004)	0.0030 (0.0003)	0.0048 (0.0006)	0.0038 (0.0005)
$\ln GDP_j$	0.0011 (0.0011)	0.0004 (0.0012)	0.0020 (0.0017)	-0.0003 (0.0017)	0.0011 (0.0011)	0.0005 (0.0012)	0.0015 (0.0018)	-0.0001 (0.0018)
$\ln GDPPC_i$	0.0049 (0.0005)	0.0046 (0.0005)	0.0074 (0.0010)	0.0072 (0.0012)	0.0050 (0.0005)	0.0047 (0.0005)	0.0073 (0.0010)	0.0072 (0.0012)
$\ln GDPPC_j$	0.0092 (0.0022)	0.0070 (0.0026)	0.0148 (0.0037)	0.0026 (0.0038)	0.0091 (0.0022)	0.0067 (0.0025)	0.0158 (0.0037)	0.0023 (0.0037)
$\ln DIST_{ij}$	-0.0027 (0.0010)	-0.0045 (0.0010)	-0.0004 (0.0009)	-0.0035 (0.0013)	-0.0027 (0.0010)	-0.0044 (0.0010)	-0.0006 (0.0009)	-0.0034 (0.0013)
$Tax_j$		0.0003 (0.0002)			0.0003 (0.0002)			
$Tax_i$			0.0015 (0.0004)				0.0015 (0.0004)	
$Tax_j - Tax_i$				-0.0009 (0.0003)				-0.0009 (0.0003)
$Treaty$					0.0002 (0.0008)	0.0005 (0.0008)	-0.0014 (0.0012)	0.0005 (0.0011)
Constant	23.9189 (0.0393)	23.9835 (0.0402)	23.7815 (0.0601)	23.9666 (0.0630)	23.9185 (0.0396)	23.9823 (0.0408)	23.7890 (0.0608)	23.9650 (0.0646)
No. of obs.	2616	1250	1478	790	2616	1250	1478	790
R-squared	0.1391	0.2509	0.1873	0.2502	0.1391	0.2512	0.188	0.2504
Country-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time-fixed effects	No	No	No	No	No	No	No	No

*Note:* \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

**Table 6: Two-way fixed effects estimations for determinants of bilateral FDI flows from 30 OECD countries to 11 East Asian countries (Dependent variable is  $\ln FDI_{ij}$ .)**

	17	18	19	20	21	22	23	24
$\ln GDP_i$	0.0037 (0.0004)	0.0030 (0.0003)	0.0046 (0.0005)	0.0038 (0.0005)	0.0037 (0.0004)	0.0030 (0.0003)	0.0047 (0.0005)	0.0038 (0.0005)
$\ln GDP_j$	0.0029 (0.0021)	0.0012 (0.0026)	0.0086 (0.0038)	0.0048 (0.0045)	0.0029 (0.0021)	0.0012 (0.0026)	0.0081 (0.0037)	0.0049 (0.0046)
$\ln GDPPC_i$	0.0050 (0.0006)	0.0045 (0.0005)	0.0077 (0.0010)	0.0074 (0.0012)	0.0050 (0.0006)	0.0046 (0.0005)	0.0076 (0.0010)	0.0074 (0.0012)
$\ln GDPPC_j$	0.0005 (0.0056)	0.0092 (0.0118)	-0.0092 (0.0104)	-0.0127 (0.0192)	0.00004 (0.0056)	0.0092 (0.0119)	-0.0087 (0.0103)	-0.0129 (0.0195)
$\ln DIST_{ij}$	-0.0027 (0.0009)	-0.0045 (0.0010)	-0.0009 (0.0010)	-0.0035 (0.0014)	-0.0027 (0.0010)	-0.0044 (0.0010)	-0.0011 (0.0011)	-0.0035 (0.0014)
$Tax_j$		0.0002 (0.0003)				0.0002 (0.0003)		
$Tax_i$			0.0017 (0.0004)				0.0017 (0.0004)	
$Tax_j - Tax_i$				-0.0010 (0.0003)				-0.0010 (0.0003)
$Treaty$					0.00005 (0.0009)	0.0005 (0.0008)	-0.0023 (0.0013)	0.0003 (0.0011)
Constant	23.9269 (0.0515)	23.9516 (0.0605)	23.7583 (0.0886)	23.9765 (0.1459)	23.9268 (0.0517)	23.9516 (0.0605)	23.7707 (0.0890)	23.9757 (0.1457)
No. of obs.	2616	1250	1478	790	2616	1250	1478	790
R-squared	0.1458	0.2588	0.218	0.2642	0.1458	0.2591	0.2198	0.2643
Country-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

**Table 7: OLS estimations for determinants of bilateral FDI flows from 30 OECD countries to ASEAN-5 countries**  
(Dependent variable is  $\ln FDI_{ij}$ .)

	25	26	27	28	29	30	31	32
$\ln GDP_i$	0.0032 (0.0005)	0.0028 (0.0003)	0.0041 (0.0006)	0.0031 (0.0004)	0.0032 (0.0005)	0.0028 (0.0003)	0.0041 (0.0006)	0.0031 (0.0004)
$\ln GDP_j$	0.0035 (0.0008)	0.0017 (0.0011)	0.0038 (0.0010)	-0.0004 (0.0012)	0.0035 (0.0008)	0.0019 (0.0011)	0.0038 (0.0011)	0.0003 (0.0012)
$\ln GDPPC_i$	0.0050 (0.0008)	0.0043 (0.0006)	0.0068 (0.0012)	0.0061 (0.0012)	0.0050 (0.0008)	0.0044 (0.0006)	0.0068 (0.0012)	0.0061 (0.0012)
$\ln GDPPC_j$	0.0031 (0.0008)	-0.0002 (0.0007)	0.0043 (0.0011)	-0.0012 (0.0012)	0.0032 (0.0009)	0.0001 (0.0008)	0.0045 (0.0013)	-0.0004 (0.0012)
$\ln DIST_{ij}$	-0.0010 (0.0013)	-0.0055 (0.0013)	0.0014 (0.0014)	-0.0027 (0.0015)	-0.0009 (0.0014)	-0.0051 (0.0013)	0.0016 (0.0016)	-0.0023 (0.0015)
$Tax_j$		0.000005 (0.0002)				0.000005 (0.0002)		
$Tax_i$			0.0013 (0.0007)				0.0013 (0.0007)	*
$Tax_j - Tax_i$				-0.0003 (0.0002)				-0.0003 (0.0002)
$Treaty$					0.0004 (0.0013)		0.0010 (0.0019)	0.0021 (0.0010)
Constant	23.8904 (0.0384)	24.0155 (0.0340)	23.8064 (0.0588)	24.0277 (0.0439)	23.8888 (0.0412)	24.0044 (0.0364)	23.8024 (0.0629)	24.0072 (0.0471)
No. of obs.	1165	631	647	361	1165	631	647	361
R-squared	0.1502	0.3194	0.2111	0.3409	0.1503	0.3236	0.2116	0.3506
Country-fixed effects	No	No	No	No	No	No	No	No
Time-fixed effects	No	No	No	No	No	No	No	No

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

**Table 8: One-way fixed effects estimations for determinants of bilateral FDI flows from 30 OECD countries to ASEAN-5 countries (Dependent variable is  $\ln FDI_{ij}$ .)**

	33	34	35	36	37	38	39	40
$\ln GDP_i$	0.0032 (0.0005)	0.0028 (0.0003)	0.0041 (0.0006)	0.0031 (0.0004)	0.0032 (0.0005)	0.0028 (0.0003)	0.0041 (0.0006)	0.0032 (0.0004)
$\ln GDP_j$	0.0022 (0.0010)	0.0014 (0.0012)	0.0018 (0.0016)	0.0004 (0.0016)	0.0022 (0.0011)	0.0016 (0.0012)	0.0018 (0.0019)	0.0015 (0.0017)
$\ln GDPPC_i$	0.0051 (0.0009)	0.0043 (0.0006)	0.0069 (0.0012)	0.0061 (0.0012)	0.0051 (0.0009)	0.0044 (0.0006)	0.0069 (0.0012)	0.0060 (0.0012)
$\ln GDPPC_j$	0.0093 (0.0047)	0.0017 (0.0031)	0.0141 (0.0069)	-0.0038 (0.0035)	0.0095 (0.0045)	0.0009 (0.0031)	0.0141 (0.0068)	-0.0058 (0.0035)
$\ln DIST_{ij}$	-0.0012 (0.0013)	-0.0055 (0.0014)	0.0010 (0.0013)	-0.0027 (0.0014)	-0.0013 (0.0014)	-0.0051 (0.0014)	0.0010 (0.0015)	-0.0021 (0.0014)
$Tax_j$		0.0001 (0.0002)				0.0001 (0.0002)		
$Tax_i$			0.0013 (0.0007)				0.0013 (0.0007)	
$Tax_j - Tax_i$				-0.0006 (0.0002)				-0.0006 (0.0002)
$Treaty$					-0.0002 (0.0013)	0.0015 (0.0008)	-0.00004 (0.0020)	0.0025 (0.0010)
Constant	23.8840 (0.0577)	24.0059 (0.0436)	23.7630 (0.0999)	24.0236 (0.0446)	23.8844 (0.0584)	24.0031 (0.0440)	23.7632 (0.1019)	24.0020 (0.0478)
No. of obs.	1165	631	647	361	1165	631	647	361
R-squared	0.1568	0.3200	0.2189	0.3470	0.1569	0.3241	0.2189	0.3595
Country-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time-fixed effects	No	No	No	No	No	No	No	No

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

**Table 9: Two-way fixed effects estimations for determinants of bilateral FDI flows from 30 OECD countries to ASEAN-5 countries (Dependent variable is  $\ln FDI_{ij}$ .)**

	41	42	43	44	45	46	47	47
$\ln GDP_i$	0.0032 (0.0005)	0.0028 (0.0003)	0.0040 (0.0005)	0.0033 (0.0004)	0.0033 (0.0005)	0.0028 (0.0003)	0.0041 (0.0005)	0.0033 (0.0004)
$\ln GDP_j$	0.0058 (0.0025)	0.0053 (0.0031)	0.0100 (0.0055)	0.0015 (0.0032)	0.0058 (0.0025)	0.0052 (0.0031)	0.0098 (0.0057)	0.0018 (0.0032)
$\ln GDPPC_i$	0.0051 (0.0009)	0.0042 (0.0006)	0.0069 (0.0011)	0.0059 (0.0011)	0.0051 (0.0009)	0.0043 (0.0006)	0.0069 (0.0011)	0.0059 (0.0011)
$\ln GDPPC_j$	-0.0095 (0.0136)	-0.0313 (0.0240)	-0.0020 (0.0118)	0.0223 (0.0281)	-0.0095 (0.0136)	-0.0301 (0.0242)	-0.0019 (0.0118)	0.0281 (0.0282)
$\ln DIST_{ij}$	-0.0013 (0.0013)	-0.0055 (0.0014)	0.0010 (0.0015)	-0.0025 (0.0014)	-0.0014 (0.0014)	-0.0051 (0.0014)	0.0007 (0.0018)	-0.0019 (0.0014)
$Tax_j$		0.00002 (0.0003)				0.00002 (0.0003)		
$Tax_i$			0.0016 (0.0007)				0.0016 (0.0008)	
$Tax_j - Tax_i$				-0.0009 (0.0002)				-0.0010 (0.0003)
$Treaty$					-0.0005 (0.0013)	0.0014 (0.0008)	-0.0008 (0.0021)	0.0024 (0.0010)
Constant	23.9117 (0.0965)	24.1710 (0.1345)	23.7174 (0.1596)	23.8304 (0.1427)	23.9125 (0.0973)	24.1604 (0.1369)	23.7232 (0.1645)	23.7802 (0.1482)
No. of obs.	1165	631	647	361	1165	631	647	361
R-squared	0.1643	0.3289	0.2569	0.3954	0.1644	0.3326	0.2572	0.407
Country-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time-fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

*Note:* \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

## 4. BUSINESS REGULATION AND FOREIGN DIRECT INVESTMENT

### 4.1. Model specification and methodology

The World Bank recently conducted the *Doing Business Project*, which involved publishing a series of *Doing Business* annual reports since 2004. The project's main objective was to provide quantitative indicators of business regulations and their enforcement across 178 countries. The *Doing Business 2008* annual report discussed business regulations involving the 10 stages of business' life; namely, starting a business; dealing with licenses; employing workers; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing business<sup>7</sup>.

These business regulation indicators are linked to such activities as investment and trade and have found widespread use in a broad range of research. For instance, by using these indicator data, Djankov *et al.* (2007) found significant effects of time costs on trade. Their findings highlight the importance of reducing trade costs in stimulating trade. Djankov *et al.* (2002) also used data of regulation costs of entry in their study. They found that countries with heavier regulation costs had higher levels of corruption and a larger unofficial economy.

The main interest of this research is FDI environments, particularly how business regulations may directly affect FDI inflows. By employing the World Bank's *Doing Business Project* database, this research is able to identify whether and how various business regulation indicators affect aggregate FDI inflows. The findings will point to which stages regulations should be considered for reforms in order to enhance the investment environment.

Following Hsiao and Hsiao (2004), the aggregate FDI inflows are basically determined by the FDI recipient country's GDP ( $GDP_j$ ), the rest of the world's GDP ( $GDP_{ROW}$ ), the recipient-country's wage rate proxy by GDP per capita ( $GDP_{jt}$ ), the recipient country's openness ( $OPENESS_j$ ), and real exchange rates ( $REER_j$ ). In addition, the standard model is augmented by adding a dummy variable of developing

countries ( $Developing_j$ ) to capture the effects that developing countries have on FDI inflows and adding a set of business regulation indicators ( $R$ ) for the purpose of the investigation. The model is specified below:

$$\ln FDI_{jt} = \beta_0 + \beta_1 \ln GDP_{jt} + \beta_2 \ln GDP_{ROWt} + \beta_3 \ln GDPPC_{jt} + \beta_4 \ln OPENESS_{jt} + \beta_5 \ln REER_{jt} + \beta_6 Developing_{jt} + \beta_7 R_{jt} + \varepsilon_{jt},$$

where a  $Developing_j$  variable takes a value of one for developing countries and zero otherwise.<sup>8</sup>

Data on aggregate FDI flows are in real U.S. million dollars and collected from the International Monetary Fund's (IMF) *International Financial Statistics (IFS)*-2007 CD-ROM. All explanatory variables, except business regulation indicators, are defined as before and data are obtained mainly from the World Bank's *World Development Indicators (WDI)*-2007 CD-ROM. The real effective exchange rate is defined as the nominal exchange rate adjusted for the effects of inflation by multiplying the ratio of a recipient country's consumer price index to another major country's consumer price index. This research chooses the U.S. to be the comparison base country. Finally, openness is simply measured by the sum of a recipient country's imports and exports divided by its GDP.

For the methodology used, the standard OLS estimator was employed due to the small data set constraint. Although some data on business regulation indicators were available starting 2003, the bulk was not be obtainable until 2005. As a result, it was not appropriate to limit the study to East Asia alone. Therefore, this research extended the scope of the analysis to include all the 98 countries from which data were available over the period 2003 to 2005.<sup>9</sup>

## 4.2. Empirical findings

Estimation results are reported in Table 10. When pooling data of all countries are used, all estimated coefficients are significant. Most of them have the expected signs. For instance, the larger a recipient country's GDP is, the higher is its level of FDI inflows. Recipient country GDP per capita is found to be negatively related with the



level of FDI inflows. Note that although the estimated coefficient of the rest-of-the-world GDP variable is negative, it is barely significant.

**Table 10: OLS estimations for determinants of aggregate FDI inflows**  
(Dependent variable is  $\ln FDI_{jt}$ .)

	All countries	Developed countries	Developing countries
$\ln GDP_j$	0.0400 *** (0.0057)	0.1103 *** (0.0253)	0.0183 *** (0.0025)
$\ln GDP_{ROW}$	-0.8505 * (0.4525)	-0.7019 (0.7020)	0.1090 (0.0804)
$\ln GDPPC_j$	-0.0210 *** (0.0066)	0.0206 (0.0470)	0.0006 (0.0023)
$\ln OPENNESS_j$	0.0335 ** (0.0161)	0.1083 ** (0.0453)	0.0159 *** (0.0051)
$\ln REER_j$	0.0079 *** (0.0026)	0.0338 *** (0.0104)	0.0006 (0.0009)
<i>Developing<sub>j</sub></i>	-0.1088 *** (0.0289)		
Constant	36.5165 *** (14.1070)	29.6872 (22.2759)	6.8038 *** (2.5068)
No. of obs.	322	77	245
R-squared	0.4084	0.4184	0.4087

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively.  
Robust standard errors are in parentheses.

A recipient country's openness to trade has quite a robust, positive impact on firms' decision to invest. The findings also suggest that an appreciation of the real exchange rate is associated with more FDI inflows. In addition, developing-country factors are found to have prominent roles in determining FDI inflows. The significant negative intercept indicates that developing countries receive less FDI inflows compared to developed countries.

When the estimation is limited to developed countries, the estimated coefficients of the rest-of-the-world GDP and recipient country GDP per capita variables are insignificant. In addition, the coefficients of all explanatory variables appear to be larger compared to the coefficients from the estimation of all 98 countries. This implies that investors' decisions to invest are more likely to be sensitive to a change in economic environments in developed countries. Finally, from the estimation of developing countries, the findings indicate that only the size of country GDP and country openness factors are relevant to the level of FDI inflows.

Now the analysis will focus on business-regulation variables. The estimated coefficients of various business-regulation indicators are summarized in Table 11 below. The findings suggest that not all business regulations are related to FDI inflows. From the total of 38 indicators, only 10 indicators were found to be significant. Moreover, the number of significant indicators was reduced to five when the estimation included only developed countries. In contrast, the number of significant indicators increased to 12 in the estimation of developing countries. This indicates that a larger number of business-regulation indicators are relevant to investment decisions in developing countries. Other findings on developing countries are highlighted next.

First, the number of procedures and the time involved in starting a new business are significantly related to investment decisions. There are less FDI inflows to a country that requires a large number of official procedures to start up a new business or where it takes a long time to complete a procedure in starting up a business. The difficulty in hiring new workers and the high cost involved in terminating redundant workers also have significant negative impacts on the level of FDI inflows.

This research also noted the negative effects of the number of procedures legally required to register property. The indicators on protecting investors measured the strength of shareholder protection against directors' conflict of interest. Though all indicators appeared insignificant in the case of developing countries, the disclosure index indicator was shown to be significant when all 98 countries were included. This finding underscores the importance of corporate transparency in promoting good investment environments.

For indicators on enforcing contracts, FDI inflows were negatively influenced by the efficiency of the judicial system in resolving commercial disputes and by the time that elapses from the moment a plaintiff files a lawsuit in court until restitution is made. Hence, a country with a more efficient judicial system definitely becomes more attractive as an FDI destination.

Finally, in a last stage of business's life--closing a business--none of the indicators was shown to be significant in the case of developing countries. Nonetheless, in the estimation of all countries, a higher level of FDI inflows is associated with a shorter time in the bankruptcy process.

**Table 11: Estimated coefficients of various business regulation indicators**  
(Dependent variable is  $\ln FDI_{jt}$ .)

Business regulation indicators	All countries	Developed countries	Developing countries
<b>1. Starting a Business</b>			
Procedures (numbers)	-0.0101 *** (0.00320)	-0.0172 (0.01053)	-0.0022 ** (0.00095)
Duration (days)	-0.0006 *** (0.00020)	-0.0005 (0.00150)	-0.0002 ** (0.00007)
Cost (% of income per capita)	0.000017 (0.00003)	-0.0031 (0.00214)	0.00001 (0.00001)
Paid in Min. Capital (% of income per capita)	-0.000047 * (0.00003)	-0.0001 ** (0.00006)	-0.000001 (0.00001)
<b>2. Dealing with Licenses</b>			
Procedures (numbers)	0.0018 (0.00160)	0.0171 (0.02301)	0.0010 (0.00085)
Duration (days)	0.000001 (0.00006)	0.0001 (0.00058)	-0.00001 (0.00003)
Cost (% of income per capita)	0.000005 ** (0.00000)	-0.0016 ** (0.00063)	0.000003 (0.00000)
<b>3. Employing Workers</b>			
Difficulty of Hiring Index	0.000033 (0.00032)	0.0023 * (0.00130)	-0.0002 *** (0.00007)
Rigidity of Hours Index	-0.0002 (0.00060)	-0.0004 (0.00260)	0.0003 *** (0.00011)
Difficulty of Firing Index	-0.0004 (0.00040)	-0.0007 (0.00220)	0.0002 (0.00016)
Rigidity of Employment Index	-0.0003 (0.00080)	0.0009 (0.00266)	0.0002 (0.00015)
Nonwage labor cost (% of salary)	0.0007 (0.00200)	0.0003 (0.00646)	0.0008 (0.00050)
Firing costs (weeks of wages)	-0.0005 *** (0.00020)	-0.0017 (0.00111)	-0.0002 *** (0.00006)
<b>4. Registering Property</b>			
Procedures (numbers)	-0.0102 * (0.00600)	-0.0155 (0.02135)	-0.0040 *** (0.00139)
Duration (days)	0.000018 (0.00005)	0.0009 ** (0.00041)	-0.000003 (0.00002)
Cost (% of property value)	0.0022 (0.00160)	0.0111 (0.00904)	-0.0001 (0.00043)
<b>5. Getting Credit</b>			
Legal Rights Index	0.0096 (0.01160)	0.0374 (0.04393)	-0.0003 (0.00167)
Credit Information Index	0.0058 (0.00470)	0.0088 (0.02852)	0.0008 (0.00131)
Public registry coverage (% adults)	0.0009 (0.00130)	0.0021 (0.00149)	-0.0016 *** (0.00059)
Private bureau coverage (% adults)	0.0001 (0.00070)	-0.0010 (0.00137)	0.0004 * (0.00021)

**Table 11: (Continued)**

Business regulation indicators	All countries	Developed countries	Developing countries
<u>6. Protecting Investors</u>			
Disclosure Index	0.0127 ** (0.00640)	0.0629 (0.03718)	0.0011 (0.00207)
Director Liability Index	0.0009 (0.00630)	0.0357 (0.05634)	-0.0037 ** (0.00176)
Shareholder Suits Index	0.0034 (0.00580)	0.0317 (0.06059)	0.0010 (0.00197)
Investor Protection Index	0.0203 (0.01650)	0.1129 (0.08448)	-0.0030 (0.00360)
<u>7. Paying Taxes</u>			
Payments (number)	-0.0007 (0.00040)	-0.0063 (0.00645)	-0.0002 (0.00022)
Time (hours)	-0.000045 (0.00003)	-0.0015 (0.00087)	-0.000003 (0.00002)
<u>8. Trading Across Borders</u>			
Documents for export (number)	-0.0009 (0.00420)	0.0501 (0.08214)	-0.0030 (0.00217)
Time for export (days)	0.0006 (0.00080)	0.0196 (0.02149)	0.0001 (0.00027)
Cost to export (US\$ per container)	0.000008 (0.00001)	0.000001 (0.00023)	0.00001 * (0.000004)
Documents for import (number)	-0.0008 (0.00490)	0.0085 (0.03391)	-0.0018 (0.00165)
Time for import (days)	0.0008 (0.00050)	0.0191 (0.01235)	0.0001 (0.00020)
Cost to import (US\$ per container)	0.000006 (0.00001)	0.00003 (0.00021)	0.00001 * (0.000005)
<u>9. Enforcing Contracts</u>			
Procedures (number)	-0.0052 *** (0.00160)	-0.0192 *** (0.00614)	-0.0002 (0.00040)
Time (days)	-0.0001 *** (0.00003)	0.000004 (0.00007)	-0.00003 ** (0.00001)
Cost (% of debt)	0.0002 (0.00020)	-0.0026 (0.00447)	0.00003 (0.00008)
<u>10. Closing Business</u>			
Time (years)	-0.0156 *** (0.00550)	-0.0399 (0.02564)	-0.0016 (0.00297)
Cost (% of estate)	0.0002 (0.00090)	0.0024 (0.00502)	0.0003 (0.00033)
Recovery rate (cents on the dollar)	-0.0004 (0.00100)	-0.0019 (0.00160)	0.0005 (0.00035)

Note: \*\*\*, \*\*, \* denote 1%, 5%, 10% significant levels respectively. Robust standard errors are in parentheses.

## 5. POLICY IMPLICATIONS

This research provides an overview of tax instruments in East Asia where tax instruments generally vary regionwide. There is increasing pressure on countries to lower their corporate income tax rates to ensure their competitiveness as capital mobility increases. Despite the fact that the effectiveness of tax instruments on attracting FDI inflows remains unclear, East Asian countries offer generous packages of tax incentives. The lack of a regional framework for tax harmonization may result in unnecessary competition within the region.

Empirical evidence on key determinants of bilateral FDI inflows confirms existing literature. FDI inflows are basically determined by the size of FDI home countries' GDP, labor costs in FDI home countries, and distance between FDI home and recipient countries. In addition, the significant relationship between home-country corporate income tax rates and FDI outflows from 30 OECD countries was found. There was, however, inadequate evidence that recipient-country corporate income tax rates have a significant impact on FDI inflows to East Asian countries. Bilateral income tax treaties were also found to positively affect the level of FDI inflows to the ASEAN-5. These findings support the view of the FDI promotion rationale for tax treaty formation.

The lack of a comprehensive network of tax treaty agreements within the East Asia region may increase business costs and be a major obstacle to the regional economic integration process. Besides, many tax treaties were concluded a long time ago and could be out of date. It is crucial that these tax treaties be revised. Hence, the development of a regional tax regime and a comprehensive tax treaties network with a standard framework for the East Asia region would definitely contribute to a good investment environment in the region.

Finally, the efficiency of business regulations in the various stages of business life, from starting a business to closing a business, was found to have critical roles in multinational firms' investment decisions. Thus, improvements in the domestic business environment, including economic regulations, corporate governance, and labor laws, would increase FDI inflows and would also be a key driver toward a single investment and production base in the East Asia region.

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## NOTES

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<sup>1</sup> For more details on business regulation indicators, see <http://www.doingbusiness.org> (accessed December 28, 2007).

<sup>2</sup> Tax incentives are defined as tax provisions granted only to qualified projects for which provisions are not applicable in general.

<sup>3</sup> For theoretical links between tax policy and investment, see Sasatra and Moore (2008) and Hassett and Hubbard (2002).

<sup>4</sup> Hall (1997) provided a detailed analysis on the move to a consumption tax base.

<sup>5</sup> The ASEAN-5 countries are Indonesia, Malaysia, Philippines, Singapore, and Thailand.

<sup>6</sup> The 30 OECD countries are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States. The 11 East Asian countries are Australia, China, Japan, Indonesia, India, Korea, Malaysia, New Zealand, Philippines, Singapore, and Thailand.

<sup>7</sup> For details on business regulation indicators in each of 10 stages of business life, see the *Doing Business 2008* annual report.

<sup>8</sup> The World categorizes developing countries into low- and middle-income countries. See <http://www.worldbank.org/depweb/english/beyond/global/glossary.html> (accessed November 1, 2007).

<sup>9</sup> The 98 countries are the United States, the United Kingdom, Belgium, Denmark, France, Germany, Italy, Norway, Sweden, Switzerland, Canada, Japan, Finland, Greece, Iceland, Portugal, Spain, Australia, South Africa, Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Peru, Uruguay, Guyana, Jamaica, Israel, Jordan, Kuwait, Oman, Saudi Arabia, Egypt, Bangladesh, Cambodia, Sri Lanka, India, Indonesia, Korea Rep., Malaysia, Maldives, Nepal, Pakistan, Philippines, Singapore, Thailand, Angola, Botswana, Burundi, Cameroon, Chad, Congo, Republic of Democratic Rec. Congo, Benin, Ghana, Cote d'Ivoire, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Namibia, Togo, Tunisia, Burkina, Faso, Zambia, Solomon Islands, Armenia, Albania, Georgia, Kyrgyz Republic, Bulgaria, Moldova, Czech Republic, Latvia, Hungary, Lithuania, Mongolia, Croatia, Slovenia, Poland, and Romania.



## Chapter 15

### **Rules of Origin: Regimes in East Asia and Recommendations for Best Practice**

*Erlinda M. Medalla* \*

#### **INTRODUCTION**

Throughout the globe, many governments have signed, are negotiating or are contemplating new regional or bilateral free trade and investment agreements. In general, there is consensus in principle that these agreements should be stepping stones toward full integration into a global free market, and keeping within WTO ideals is often explicitly articulated. In practice, however, there are risks about where these could eventually lead to. Political factors could intrude. Embedded vested interests could be created by the preferential trading arrangements which could become too resistant. The “noodle bowl” impact could prove difficult to unravel. And convergence into one single, larger (if not global) block may become impeded.

In the meanwhile, the more immediate problem is the complexity created by simply having multiple trading agreements, not just by the preferences offered, but by the rules of origin (ROOs) and the different regimes these rules are applied across agreements. In a nutshell, ROOs refer to rules used to define where a product was made. As straightforward as it may sound, determining origin within the context of international trade is not so simple. ROOs would involve laws, regulations and administrative determinations to ascertain a product’s country of origin which are not costless to comply with. In many cases, many steps, certifications, requirements are involved. And if different ROOs are used for different agreements with different partners, it is not difficult to imagine the intricate ‘noodle-bowl’ effect of these ROOs.

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Hence, the type of ROOs, and how it is administered would play a crucial role in the global trading order. Even now, in East Asia (throughout this paper, this refers to the ten countries of ASEAN plus six countries including China, Japan, South Korea, India, Australia and New Zealand), there are apprehensions that the increasing number of FTAs is creating a complex and inconsistent web of rules of origin that could limit and/or distort the use of the trade preferences. These concerns are well recognized as manifested in the numerous studies and discussions covering the related issues, especially in recent years. See for example, Estevadeordal and Suominen (2003), Haddad (2007), Manchin and Pelkmans-Balaoing (2007), Kirk (2007) and Kawai and Wignaraja (2007).

The history of ROO is at least as old as the practice of discriminatory commercial policy by nation states. (Harilal and Buena, 2003) ROO developed gradually with the development of differentiated tariffs and other trade measures and has been likened to domestic content requirements often imposed by developing countries. Over time, varying forms of ROOs have evolved for different purposes and across different trade regimes.

The growing importance of ROO issues in international trade and commerce is driven by a number of factors. *First*, the globalization of the means of production has made origin determination increasingly difficult and dispute prone.<sup>1</sup> Few products today are made solely in one country, or even within one enterprise, arising from the increasingly globalizing nature of international trade and commerce. Determining the 'nationality' of these products and the treatment under various international trading rules are crucial. *Second*, ROOs are a key element determining the magnitude of the economic benefits that accrue from RTAs and who gets them. *Third*, there is opportunity to make use of ROO as protectionist tool *per se*. There has been the increasing incidence of using ROO as discriminatory trade policy tool to protect domestic sectors and intermediate goods. *Fourth*, the various plurilateral and bilateral FTAs in East Asia give rise to the noodle bowl effect of a complex and possibly inconsistent web of ROOs, product standards and conformance requirements and diverse tariff liberalization schedules (Lazaro and Medalla, 2006).

Many critics have already noted the irony of the rules of origin negotiated as part of FTAs, appearing to take away with the left hand, what the right hand has given.

There could come a point where the complex ROOs, in themselves, generate new barriers to trade. Haddad (2007), for example, has made the following observations about how ROOs fared in practice, even in the case of ASEAN whose ROO regime is considered to be among the least restrictive: (1) low AFTA preference utilization rate, (2) difficult compliance even for supposedly simple value-added rule, (3) administrative cost of compliance to prove origin acting as deterrent, (4) low margin of preference for goods traded within ASEAN, and (5) the bulk of intra-ASEAN trade occurring in commodities where preference margins are below the threshold that would justify the cost of compliance (See Box 1).

Due to the fall of MFN rates and the complexity of ROO invariably used in any FTA, some analysts question whether in fact there is an achieved market access afforded by the FTA. This is because what should have been a preferential access has been largely eroded by high compliance costs, supporting the suggestion that southern partners are effectively left on their “participation constraint.”<sup>2</sup> (Anson et al 2004) The steps prescribed and the nature of production technology imposed as an ROO by the other partner restricts market access and trade participation. For instance, in the case of American imports of apparel under NAFTA, the rule is one of “triple transformation.” Only if each step of the transformation from raw material to finished garment has been undertaken within the FTA will preferential treatment be given. This of course is beneficial to American textile producers because the other partner country would have difficulty in complying with such a requirement (Krishna and Krueger, 1995).

Because of the complex rules of origin, it becomes more profitable to alter production patterns simply to fulfill the rules for market access rather than reduce costs and improve efficiency. (ADB 2002) Producers may be induced to shift their imports from low-cost third country suppliers to higher cost member sources or develop production facilities in the FTA partner. (Krueger 1993) This creates a bias toward economic inefficiency, highlighting the negative effect of trade-diversion.

**Box 1: Excerpt from Haddad (2007), “Rules of Origin in East Asia: How Are They Working in Practice?”**

*AFTA preference utilization rates are low.* ASEAN countries have implemented unilateral trade liberalization over the past two decades, and achieved low MFN rates (with average tariffs around 7 percent) by the time AFTA was implemented. This contributed to a limited impact of AFTA—today, less than 5 percent of intra-ASEAN trade makes use of the AFTA preferences. This is low compared with other FTAs. There are several reasons for the low utilization rates of AFTA: difficulty in satisfying the required value added requirement, difficulty in proving that the required value added has been satisfied, low preference margins, and high administrative costs of compliance. When the costs of complying with the rules of origin exceed the margin of preference then the trade agreement becomes irrelevant and trade will take place under the MFN regime.

*The value added rule is simple in principle, but difficult to comply with.* AFTA members, especially CLMV countries, are often unable to cumulate the necessary local/regional content. This is partly due to the high degree of production fragmentation in East Asia—half of its trade is in electronics and machinery where production networks are widespread. The import content (from outside ASEAN) of export is high, making it difficult to comply with the 40 percent valued added rule. Further, countries with low labor costs will find it more difficult to comply with a given value-added requirement than higher labor cost countries. The value added rule is also vulnerable to exchange rate fluctuations—any movement in the exchange rate leads to a change in import costs. This becomes problematic when the exchange rate fluctuations are widespread such as during the 1997 financial crisis. Moreover, the cost of proving origin is high. Computation of costs, invoicing, and other documentation demands inherent in the value added rule are complex, especially for smaller firms or firms from less developed East Asian countries.

*The administrative cost of compliance to prove origin is a deterrent for the use of preferences.* Surveys in a range of ASEAN countries highlight concern over the time and paperwork involved in obtaining Form D (official form to prove origin in AFTA), and the large amount of documentation required to prove origin (including invoices and other evidence to each input used in the final product). These problems are particularly acute for small firms and for firms for whom prompt delivery is a key element of competitiveness. The requirement that all Form Ds should be issued by designated government departments significantly increases the compliance costs compared to many other FTAs where private sector associations are permitted to issue certificates of origin. Estimates of the costs of requesting preferences within AFTA might be in the range of 10-25 percent—larger than those of other preferential schemes. Moreover, customs valuations differ across countries, pre-export inspections required by AFTA add to cost, transactions remain time-intensive and required face-to-face contact with officials, and incoming goods enjoying preferences are randomly subjected to post-audit checks.

*Preference margins for products traded within ASEAN are low.* Another reason for the low utilization rates of AFTA preferences is the low margin of preference on the products that are traded in large quantities within ASEAN... Intra- ASEAN trade is dominated by computer/machinery and electrical equipment where the tariffs are very low (around 1.5 percent), making AFTA preferences largely irrelevant. Products with the highest margins of preference typically have a low value of import as a share of total intra- ASEAN trade such that the 40% value-added rule of origin is a binding constraint to preferential trade. This is known as the snow-plough effect—in the AFTA agreement, vehicles especially designed for traveling in snow are given a high preference margin, but are irrelevant for ASEAN trade. Moreover, countries that confer the highest margins also appear to impose non-tariff measures on these same products (such as quantity control measures on certain categories of vehicles).

*The bulk of intra-ASEAN trade occurs in commodities where preference margins are below the threshold that would justify the cost of compliance.* Estimates based on other FTAs show that preferences start to have a trade stimulating effect only when preferential rates are at least 25 percentage points lower than the MFN rates. Over 90 percent of intra-ASEAN4 (Malaysia, Indonesia, Thailand, Philippines) trade occurs in commodities where preferences are below 25 percent—the threshold for using the preference. Only about 8 percent of eligible trade flows have a preferential margin above 25 percent (and are therefore “worth using”).

Another point of concern is the possible “privatization” of trade policy in certain cases due to its potential use as a protectionist tool, especially with using ROO in product specific cases. Individual industries and concerned industrial lobbies play a very important role in determining the level of protection including ROO. The cumbersome administrative process involved and the scope of involvement by the import competing interests, make the system less predictable as well as less transparent when compared to the overt methods of protection (Palmer cited in Haribal and Beena 2003).

Nonetheless, despite of all these issues, a regime of ROO is a necessary feature of any regional trading arrangement (RTA). Otherwise, “trade deflection” (the transshipment of products from non-members to FTA-members through a low-tariff FTA partner) could occur and the trade preference offered by the RTA is eroded. The ROO regime attempts to prevent trade deflection by imposing criteria that ensures an adequate degree of transformation in a preference-receiving country to justify allowing the good to benefit from the preference.

In moving toward the East Asian vision of a community, any regional trading arrangement it would endeavor to establish should set a rational, enabling regime of ROO that would encourage deeper economic integration and shared prosperity. This means a set of ROOs that is trade facilitating even as it attempts to prevent trade deflection, with enough safeguards for inclusive development both within and across countries in the region. Tough as this is, to complicate matters, it would have to deal with the proliferation of FTAs in the East Asian countries. As such it is necessary to take a look at the different ROO regimes under different existing agreements in the region, and the implication of these simultaneous agreements on the integration of the regional markets.

This paper primarily aims to look for best practice which could be adopted eventually in the region by proposing best practice for East Asia. It aims to suggest a road map where the ROOs in the region would converge into one consolidated, consistent rule that would:

- Prevent trade deflection/circumventions
- Reduce cost of doing cross-border business and regional production,
- Encourage cumulation to promote intra-regional trade

- Incorporate development objectives.

It starts with a discussion of the different approaches to ROO in Section 2, and the recurring ROO issues in Section 3 to highlight key elements that need to be considered to formulate best practice ROO. Section 4 then provides an inventory and general assessment of the ROO regimes in existing East Asia RTA. Section 5 presents the conclusions and recommendations for best practice in ROO for East Asia.

## **2. APPROACHES TO ROO<sup>3</sup>**

ROO refers specific provisions known as “origin criteria” that are established in international/regional trading agreements to determine the origin of goods being traded. Their importance has grown significantly as the number of preferential agreements grew, and countries increasingly have treated similar imported goods differently according to where the product was made (La Nasa 1995).

In general, there are at three (3) basic standards used to set ROO. These are:

- wholly obtained criteria,
- minimal operation criteria<sup>4</sup> and
- substantial transformation criteria<sup>5</sup>

‘Wholly obtained’ criteria would apply to goods that are clearly produced domestically. These are more easily identified and have clear HS (Harmonized System) nomenclature and coding. They are mainly in the first eight HS chapters covering mining, live animals, fruits, with some processing. Various agreements have more or less harmonized definition and identification of the HS codes covered. The three standards is usually reduced to two – as either wholly obtained or non-wholly obtained, as minimal operation criteria would usually be categorized as “wholly” obtained.

To provide an example, the ROO in ASEAN-CEPT is spelled out under a number of provisions as follows:

- Originating products: conditions 1) products wholly produced or obtained; 2) products not produced or obtained
- Wholly Produced or Obtained: List of qualified products
- Not Wholly Produced or Obtained: Products with at least 40 percent of its content originates from ASEAN Member States
- Cumulative Rule of Origin: Specific conditions
- Direct consignment: Specific conditions
- Treatment of Packing
- Certificate of Origin: issued by a government authority of the exporting Member State
- Review

‘Substantial’ transformation is a generally accepted concept as a criterion for origin for non-wholly obtained goods. Among its advantages are flexibility, evolution over time, and development through application to specific facts in an adversarial situation where interested parties are represented. On the other hand the potential disadvantages include: inconsistent applications, discretionary nature and the costs of making an origin determination under it. The adoption or rejection of particular criteria of substantial transformation as a method of determining origin depends on which principle one puts more value on: *flexibility* or *certainty* (La Nasa, 1995).

There are several approaches to defining whether ‘substantial’ transformation has occurred to satisfy originating criteria. In general, these include three major methods, used singly or in combination. The first is the *value-added measure (VA)*, which refers to the (minimum) percentage of value added created at the last stage of the production process (also the *domestic content test*)<sup>6</sup>. The second is the *tariff-heading criterion*<sup>7</sup>, also referred to as change in tariff classification (CTC), whereby origin is conferred if the activity in the exporting country results in a product classified under a different heading of the customs tariff classification of the Harmonized System of Tariff Nomenclatures, than its intermediate inputs. This criterion is comparatively simple and predictable, but trade classification systems have not been designed with the objective of distinguishing substantial transformation. The third is the *specified processes* or *technical test*<sup>8</sup>, which determines, on a case-by-case basis, specific production activities or specific processing

operations that may confer originating status. This prescribes certain production or sourcing processes that may (positive test) or may not (negative test) confer originating status. (UNCTAD 2002) An example is the so-called *yarn forward (sometimes from fiber to fabric)* rule for textile and garment products.

The advantages, disadvantages and key issues using the different methods are highlighted in Table 1 below as summarized by Brenton (2003).

There are other tests utilized for different types of products. Some FTAs also apply so-called “hybrid tests” which require both a minimum percentage of domestic value-added content *plus* a change in tariff classification for a product to undergo a “substantial transformation.” (Coyle, 2004). On the other hand there is the more liberal either/or test, which provides a choice about which rule to use (alternative rule). Given that there are no internationally agreed standards, an importing country can vary rules of origin according to its trading partners and products.

Additional typical features of ROOs are also utilized to simplify or refine the process of conferring origin. Examples of these are provisions allowing a certain degree of *de minimis*, the roll-up principle and various types of cumulation. The *de minimis rule* allows for a specified maximum percentage of non-originating materials to be used without affecting origin. *Roll-up or absorption principle* allows materials that have acquired origin by meeting specific processing requirements to be considered originating when used as input in a subsequent transformation. (Estevadeordal and Suominen 2003) Finally, cumulation (also known as *accumulation*) is a measure that permits countries to use inputs from a specific country or group of countries without affecting the origin of the products. In essence, cumulation provisions permit inputs to be obtained from *outside* the FTA and be counted as *domestic* for the purposes of determining the origin of the product (Coyle 2004).

There is a growing trend in the use of the cumulation<sup>9</sup> type of ROO-- in particular, the *diagonal cumulation* which expands the geographical and product coverage of an ROO regime in FTAs. The traditional interpretation of this diagonal cumulation is to permit three or more countries to effectively merge their individual bilateral treaties into a single comprehensive FTA in which inputs can be sourced anywhere within the network. The issue raised however is whether this should benefit a non-party to the FTA as in the case of US-Singapore Integrated Sourcing Initiative (ISI) (Box 2).



**Table 1: Summary of the different approaches to determining origin**

<b>Rule</b>	<b>Advantages</b>	<b>Disadvantages</b>	<b>Key Issues</b>
Change of Tariff Classification (in the Harmonised System)	<ul style="list-style-type: none"> <li>● Consistency with non-preferential rules of origin.</li> <li>● Once defined, the rule is clear, unambiguous and easy to learn</li> <li>● Relatively straightforward to implement.</li> </ul>	<ul style="list-style-type: none"> <li>● Harmonised System not designed for conferring origin, as a result there are often many individual product specific rules, which can be influenced by domestic industries</li> <li>● Documentary requirements maybe difficult to comply with.</li> <li>● Can be conflicts over the classification of goods which can introduce uncertainty over market access</li> </ul>	<ul style="list-style-type: none"> <li>● Level of classification at which change required – the higher the level the more restrictive.</li> <li>● Can be positive (which imported inputs can be used) or negative (defining cases where change of classification will not confer origin) test<sup>a</sup> – negative test more restrictive.</li> </ul>
Value Added	<ul style="list-style-type: none"> <li>● Clear, simple to specify and unambiguous.</li> <li>● Allows for general rather than product specific rules</li> </ul>	<ul style="list-style-type: none"> <li>● Complex to apply – requires firms to have sophisticated accounting systems.</li> <li>● Uncertainty due to sensitivity to changes in exchange rates, wages, commodity prices etc.</li> </ul>	<ul style="list-style-type: none"> <li>● The level of value added required to confer origin</li> <li>● The valuation method for imported materials – methods which assign a higher value (eg CIF) will be more restrictive on the use of imported inputs</li> </ul>
Specific Manufacturing Process	<ul style="list-style-type: none"> <li>● Once defined, clear and unambiguous</li> <li>● Provides for certainty if rules can be complied with</li> </ul>	<ul style="list-style-type: none"> <li>● Documentary requirements can be burdensome and difficult to comply with.</li> <li>● Leads to product specific rules.</li> <li>● Domestic industries can influence the specification of the rules.</li> </ul>	<ul style="list-style-type: none"> <li>● The formulation of the specific processes required – the more procedures required the more restrictive</li> <li>● Should test be negative (processes or inputs which cannot be used) or a positive test (what can be used) – negative test more restrictive.</li> </ul>

*Source:* Notes on Rules of Origin with Implications for Regional Integration in South East Asia by Paul Brenton (2003).

## Box 2: US-Singapore FTA: Integrated Sourcing Initiative (ISI)

– from Statement made by US Ambassador to Singapore Frank Lavin.

The ISI, declared to be the “most significant economic aspect<sup>1</sup>” of the FTA, exempts certain goods from having to “prove” that they originated in the United States or Singapore when passing through customs, thereby reducing the administrative costs associated with shipping these goods from one country to another.

The impressive level of economic integration in so-called growth triangle (Singapore-Malaysia-Indonesia), prompted the negotiators on both sides of US-Singapore FTA to include a means by which businesses operating in Singapore could continue to take advantage of the complementarities between Singapore and Indonesia. This means is now the ROO region known as the ISI. For example, if an Indonesian manufacturer (or any non-signatory third party WTO member for that matter) would want to export to US, even with zero tariff, it could consider exporting first to Singapore then to US to avail of the exemption from administrative cost of proving origin. Furthermore, the ISI in effect represents an opportunity for non-WTO members to take advantage of any variations in tariff rates between Singapore and United States.

ISI was seen as an additional step towards establishing a simplified global sourcing regime for certain types of IT products. It is also aimed at muting criticism of Singapore within the ASEAN for entering into FTA with United States by offering to other countries in the region the opportunity to take advantage of the FTA. On the other hand, this will also permit US multinationals operating in Singapore to capture existing complementarities within the Growth Triangle aside from limiting extra red tape, fees and paperwork. (Coyle 2004)

### 2.1. ROOs in Textiles and Clothing

It is mainly with respect to sectors like textiles and clothing, agricultural and automotive products which are most especially sensitive to the type of ROO adopted. These are the sectors usually accorded higher tariff (and often also non-tariff) protection, leading to concerns of protectionist capture in the design of the ROO. (OECD 2002) Ironically, or maybe not, these sectors are also where the FTA would have highest impact. The ROO is especially relevant in the case of textiles and clothing given the elimination of quota allocation in the Multi-Fibre Arrangement (MFA).

NAFTA’s ROO regime is particularly complex and the most complicated rules apply to special cases, including the so-called “maquiladoras”<sup>10</sup> and the special regime covering textiles and clothing. The basic rules are so-called “*yarn forward*” and “*fiber forward*” rules according to which textiles and clothing products are deemed originating provided they are made of yarn or fiber produced in the area which would include all the cutting and sewing. (Krueger 1993) Apparel products imported into the US must satisfy a “*triple transformation*” rule requiring domestic content at each one of three

transformation stages: *fiber to yarn, yarn to fabric and fabric to garment*. (Cadot et al 2002) An examination of US ROOs would contain these rules although there are some 3<sup>rd</sup> country allowances to countries like Israel, Morocco and Jordan.

### **3. RECURRING ROO ISSUES**

With globalization and advances in ICT (information and communication technology) leading to growing international production sharing, amidst the increasing trend in preferential trading arrangements, the administration of ROO has been beset with difficult recurring issues which are increasingly becoming an urgent concern.

#### **3.1. Issue of spaghetti (noodle) bowl effect**

The technical nature of the ROO makes it *per se* difficult but the variations across FTAs (as discussed above) and the labyrinth rules make it even more problem-ridden. Precisely, it is the number and disparities of ROOs which give rise to the *spaghetti bowl effect*. Such overlap and inconsistency of the ROO systems must be addressed if one is to address trade facilitation issues.

#### **3.2. Cost of administration**

Even without the spaghetti-bowl effect, costs of implementing ROO could be substantial. Estimates vary: 3 percent of the value of goods traded for EFTA countries (Herin, 1986), between 4-4.5 percent (Manchin 2006) and 6-8 percent (Cadot et al., 2005) for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimates the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

Various ROO regimes would differ in their administrative requirements which would entail varying demands among exporters and importers alike. Compliance to the rules set may be difficult enough (whether VA, CTC or some other variation which would have different degree of restrictiveness). What more with a burdensome administrative process of verification and certification, and one that varies with the partner trading country. Usually, a certification serves as a verification of the origin of a given product. Hence, the type of certification adopted would have implication on the facilitation of trade. Some types (as in the case of EU's two-step system) require heavier involvement by the exporting country government and increase the burden of the exporters. On the other hand, there is the increasing adoption of a "self-certification" model (certified by a public or a private umbrella entity approved by the government) which entails lower administrative costs to exporters and government by transferring the burden of proof of origin to the importers themselves. (Estevadeordal and Suominen, 2003) However, this method could be too untraditional for most ASEAN countries and its acceptability may pose a problem.

Another issue aside from cost is the potential arbitrariness in the process. Verification of origin is generally done at the national level in accordance with guidelines agreed upon in the ROO of the FTA. This mechanism creates several sources of rents, as the guidelines for valuing the final product and the domestic inputs are generally vague and can thus be manipulated and interpreted differently by national authorities, which have wide discretion in applying these rules (or even in the case of valuation of inputs), and can do so arbitrarily (ADB 2002) .

In any case, the differences in the rules and how they are administered, not just across but within countries would entail confusion and more likely result in the limitation of potential market depending on its consistency with one's domestic policies. It is thus logical for countries engaging in numerous FTAs to adopt uniform rules of origin. Indeed, it makes coordination in ROO regimes in the region imperative.

### **3.3. ROO as a protectionist tool: differential impact of restrictive/lax rules**

ROO can either facilitate or restrict trade depending on the adoption of permissive or restrictive rules. In designing the ROO, a country can increase or decrease the degree

of restrictiveness of ROOs using certain provisions—e. g. the preparation of a separate listing of operations that are in all circumstances considered insufficient to confer origin such as simple operations of cleaning, packaging and labeling; the prohibition of duty drawback which preclude the refunding of tariffs on non-originating inputs that are subsequently included in the final product exported to a FTA partner market; and the imposition of high administrative costs. (Estevadeordal and Suominen 2003) In this regard, ROOs could be used as a protectionist trade instrument. Since ROOs are negotiated industry by industry, there is enormous scope for well-organized industries to essentially insulate themselves from the effects of the FTA by devising suitable ROO. Political variables that arbitrate the level of tariff and trade protection could come into the picture and affect the restrictiveness of ROOs. This has been suggested to be the case for developed countries, e. g. the EU and the United States. A report by Australian Productivity Commission found ROO laws under the two Australian FTAs (the United States and Thailand) are possibly among the most restrictive in world trade.<sup>11</sup> Furthermore, agricultural products and textiles and apparels appear to have relatively more restrictive ROOs. (Estevadeordal and Suominen, 2003)

#### **3.4. Issue of Investment diversion**

ROOs could be an important determinant of specialization patterns in preferential trade agreements. Restrictive ROOs could create an incentive to increase the amount of intermediate and final good manufacturing, processing and assembly done within the preferential area at the expense of the facilities in the other country which would otherwise have a comparative advantage. Firms base their decisions on production and location on country's trade protection creating an incentive for trade diversion in favor of a particular FTA to avail of the preferential treatment (ADB, 2002). Furthermore, this may encourage intra-FTA producers to shift to suppliers in the cumulation area. (Estevadeordal and Suominen, 2003) This distortion causes an inefficient allocation of global resources. (La Nasa 1995). For a larger FTA grouping with multiple members, ROO provision for cumulation would address this problem (at least as far as intra-regional allocation is concerned).

### **3.5. Treatment of Duty Drawback**

Related to the issue of trade and investment diversions is the treatment of the duty drawback. Most preferential agreements prohibit duty drawbacks granted to non-originating materials used in the production of a final product for export to partner country. This policy discourages the use of third country inputs in the production processes and thus contributes to allocation inefficiencies. In addition, it could be very important for countries with heavy production links with third party manufacturing networks. Clearly, the policy on duty drawback reflects ROO restrictiveness and protectionist tendencies of receiving countries. The most affected would be an exporting developing country partner.

These are just some of the major issues which the “new age” cooperation initiatives would need to deal with. Detailed issues about its administration can be even more important to actual trader and importer. Nonetheless, it is crucial that these general concerns be addressed in a rational framework when setting the best-practice ROO.

The next section looks at the different ROO regimes in East Asia. This would provide an idea about the initial conditions and how serious these issues are in the region.

## **4. INVENTORY AND COMPARISON OF ROO REGIMES IN EAST ASIA RTAS**

There are currently at least 20 RTAs in East Asia. Bilateral FTAs involving East Asian countries, previously leaning more towards a multilateral (and unilateral) approach, have been rising in recent years. It would be difficult to keep track of the various bilateral arrangements especially those involving third-parties. As such, the discussion would focus mainly on ROOs not involving third party agreements.

ASEAN represents the largest grouping involving the East Asian countries considered in this paper. In addition, most of the other arrangements in East Asia would revolve around ASEAN, such the “ASEAN+1” agreements namely the ASEAN-China agreement, ASEAN-South Korea, and on-going negotiations between ASEAN and Japan; and as the East-Asia-wide initiative under the “ASEAN Plus Three” (APT) mechanism. More recently, there is also a proposal to forge a Comprehensive Economic Partnership of East Asia (CEPEA), a multilateral trade agreement that would encompass ASEAN Plus 6 (ASEAN+3 plus India, Australia and New Zealand).

In the case of bilateral agreements among East Asian countries, the most prominent are the various bilateral economic partnership agreement (EPA) being forged by Japan with individual ASEAN country, in parallel with its ASEAN-Japan track. This includes five which have been concluded and in force (with Singapore, Malaysia, Thailand, Indonesia and Brunei). The Japan-Philippine EPA has been signed but as yet to be ratified by the Philippine Senate and Japan’s EPA with Vietnam is in the process.

The inventory below would cover mainly the smaller East Asian grouping including ASEAN and the northeast countries of China, Japan and Korea. Nonetheless, the analysis, findings and discussion could easily be extended and would be applicable to all the 16 East Asian countries.

### **4.1. ASEAN (AFTA) ROO**

The AFTA ROO provides that:

- (i) A product shall be deemed to be originating from ASEAN Member States, if at least 40 percent of its content originates from any Member States;*
- (ii) Locally-procured materials produced by established licensed manufacturers, in compliance with domestic regulations, will be deemed to have fulfilled the CEPT origin requirement; locally-procured materials from other sources will be subjected to the CEPT test for the purpose of origin determination;*
- (iii) Subject to sub-paragraph (i) above, for the purposes of implementing the provisions of Rule 1 (b), products worked on and processed as a result of which the total value of the materials, parts or produce originating from non-ASEAN countries or of undetermined origin does not exceed 60 percent of the FOB value of the product produced or obtained and the final process of manufacture is performed within the territory of the exporting Member State.*

As observed by Estevadeordal and Suominen (2003), the AFTA ROO is prominent for its generality in application, originally utilizing just the single method of value-added criterion. It provides for 40 percent regional value added content (RVA) to qualify as originating good for non-wholly produced or obtained goods. At least on paper, the rule is simple and relatively generous provision for imported inputs. The main reason for this is the reliance of most member countries on electronics and textile and garments for their exports, products produced within GPNs accounting for low value-added/local content, such that even 40 percent VA may be too high. Reforms of the ROO were sought to further clarify and simplify procedures so that in 2003, the AFTA decided in principle to adopt the CTC (change in tariff heading) rule as a general alternative rule to 40 percent RVA, starting with priority sectors based on private sector requests and those sectors prioritized by the AEM for accelerated integration (AFTA Council, 2003).

It has started to introduce CTC as a substitute criterion. Earlier product coverage is limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour, aluminum and wood-based products. An increasing number of products are now being covered to apply CTC as alternative criteria to the VA rule for products in



additional nine priority sectors, namely: (i) agro-based products; (ii) automotives; (iii) e-ASEAN; (iv) electronics; (v) fisheries; (vi) healthcare; (vii) rubber-based products; (viii) textiles and apparels; and (ix) wood-based products.

ASEAN is also further refining its cumulation rule and developing a “partial” cumulation approach-- that is, even goods of “partial” origin not having satisfied the 40 percent threshold can be cumulated as part of RVA. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN structure would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent . (Manchin and Pelkmanns-Balaoing, 2007)

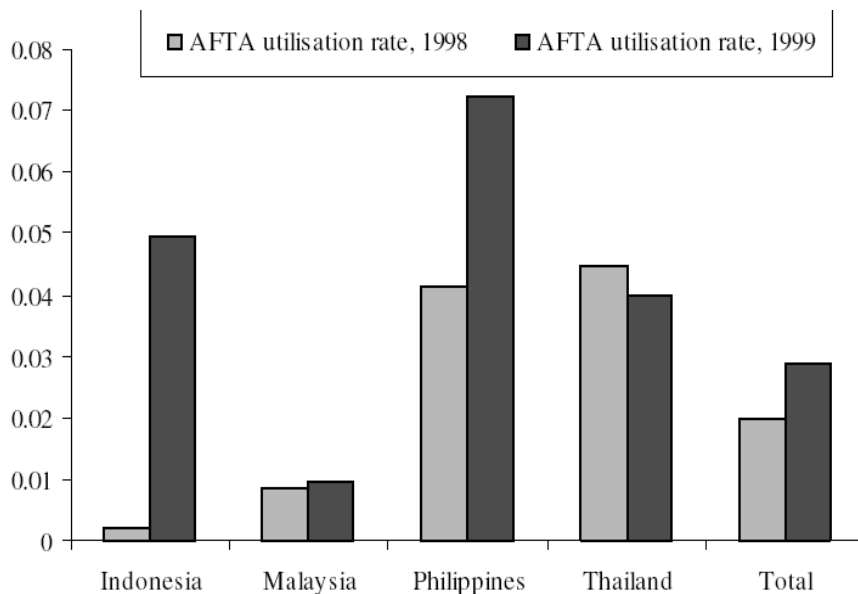
Hence, in general, reforms to simplify the ROO are continuously being sought. However, there are no provisions as yet for the treatment of duty drawback or the Absorption or Roll Back principle.

#### *4.1.1. The issue of low utilization rate*

Rules of origin, no matter how simple, would necessarily dampen the utilization rate of trade preference. Of course, the more complex it is, the larger the dampening effect. Indeed, such is the finding for AFTA. Despite the fact that as noted by many, AFTA ROO is among the simplest, CEPT utilization rates have been low. Some studies estimate that only about 3 percent of intra-ASEAN trade used the CEPT rates (Baldwin, 2006). JETRO reports that in 2002, only 11 percent of Thailand’s exports to AFTA and 4.1 percent for Malaysia used the CEPT. This is far below the utilization rates in the EU which are rarely below 50 percent.

While a large part of this can be explained by the already generally low MFN tariffs of ASEAN, much would be due to practical reasons that yield high cost of administration and compliance. This implies a need to for continuous reforms in ROO.

**Figure 1: AFTA utilization ratio**



*Source:* PriceWaterhouseCooper (2002) as cited in Baldwin (2006)

JETRO (2004) on ASEAN’s FTAs and Rules of Origin reports some improvement in the share of CEPT exports. It noted that the share of CEPT exports to total ASEAN exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This likely indicates better utilization of the CEPT preference. This could also indicate that reforms undertaken do matter.

#### **4.2. ASEAN + 1 ROO**

In addition to the ASEAN Free Trade Area, ASEAN as a whole is also engaged with various Dialogue Partners to implement or discuss free trade areas under the “ASEAN plus” framework. Agreements have been signed with China (ACFTA) and Korea (AKFTA). Other dialogue partners for potential partnerships include Australia-New Zealand, India, EU and the United States.

Both ACFTA and AKFTA adopt the general 40 percent local/regional value added (RVA) rule, with full cumulation. They also provide for alternative rule using CTC for certain products. The progression from AFTA to ASEAN plus one, thus far, has been towards more flexibility (and thus less restrictiveness). The ACFTA ROO is more flexible (and less restrictive) than AFTA ROO covering a larger number of products

with alternative CTC rule. These include 424 (HS6) textile and textile products items, 2 items of preserved fish, 6 items of wool, 22 of leather goods, 14 for furskins and 4 item lines of footwear. The AKFTA appears even more liberal with even larger product coverage allowed to use CTC as an alternative rule (except for a few cases in the automotive sector where the RVA requirement is 45 percent). It even introduces the novel approach of back-to-back Certificate of Origin (CO) for re-exports of partner A into partner B of products which was first exported by partner C into A, e.g. transit exports of Singapore from another ASEAN country (Manchin and Pelkmans-Balaoing, 2007).

A continuing trend toward a more liberal approach would bode well for the achievement of a best-practice East Asia ROO.

#### **4.3. Bilateral FTAs among East Asian countries**

Among the northeast countries (China, Japan and Korea), Japan has been the most active in pursuing bilateral agreements with other East Asian countries, specifically ASEAN-6 and Vietnam.<sup>12</sup> Its strategy is to follow a dual track approach of forging bilateral partnership with individual ASEAN country along side negotiating an agreement with ASEAN as a group. A number of reasons have been cited, including the most practical one of threshing out first the details and difficult areas with specific countries, which would pave the way for a smoother implementation of an ASEAN-Japan partnership. The bilateral agreements forged by Japan with individual ASEAN countries are intended to be incorporated (as annexes) in the ASEAN-Japan FTA (AJEPA). If individual EPAs are not completed by the time AJEPA is concluded, the ROO will not be open to renegotiation.

The advantage of the dual track approach of Japan is the opportunity for one country to demand more flexible terms from Japan than what would otherwise happen in negotiating as a group. However, this is also a disadvantage since in all probability, a non-uniform outcome per industry across country would result, which would make consolidation difficult later on. While ACFTA and AKFTA are in essence also a series of bilateral agreements, with each country having bilateral negotiations with China and Korea in terms of preferences, at least, the ROO regime would be uniform per product.

And as it turns out (as earlier discussed), what has emerged is even more liberal ROO regime than AFTA.

In examining Japan's bilateral with individual ASEAN countries, the trend is similar, although generally more restrictive. The earliest of Japan's EPA, that with Singapore, is indeed generally more restrictive than the newer EPAs of Japan. JSEPA (Japan-Singapore EPA) is characterized by particularly complex ROO especially for agricultural products, textiles and apparel. (Manchin and Pelkmans-Balaoing, 2007). Majority uses mainly the change of tariff heading rule defined for specific products. Alternative RVC rule is allowed for a few products but at a high rate of 60 percent and where it is lower than 40 percent, the RVA rule is an additional rule. However, Singapore and to a lesser extent Japan, already have duty-free MFN status so that the ROO regime (and for that matter, the preferential treatment) is almost immaterial. *De minimis* is also provided for, but as a product specific rule.

Japan's more recent EPA has less restrictive ROO compared to JSEPA. The general rule is the CTC approach, defined for specific products, but in many cases, an alternative VA rule of 40 percent as in AFTA is used. As in JSEPA, there is provision for *de minimis*, but as a product specific rule.

Kawai and Wignaraja (2007) provide an overview of the main ROOs adopted by 30 concluded FTAs in East Asia. Their summary table is reproduced here as Table 2 below. Their study notes that majority of FTAs in East Asia (20) have adopted a combination of the three ROOs rather than applying a single rule. The AFTA and the ASEAN-PRC FTA use what they consider the simplest ROO—the VA rule, which specifies a 40 percent regional value content across all tariffs. They observe that the developed countries in East Asia, namely Japan, Korea and Singapore, tend to use a combination of ROOs, adding to the complexity and costs for business.

With respect to types of products, they provide some additional insights. For example, they note some variation in the case of major automotive and automotive parts in 11 major concluded FTAs (see Table 3- lifted from Table 10 of Kawai and Wignaraja, 2007). The VA rule is generally 40 percent for AFTA and ASEAN-China, but higher for ASEAN-Korea at 45 percent. The VA criterion is 60 percent in Japan-Malaysia for HS8703 and 8711 in contrast with 40 percent in Japan-Thailand FTA for the same two

products. There are similarly instances in the case of Singapore-Australia FTA and Thailand-Australia FTA.

In sum, some key observations can be gleaned from examining the ROO regimes in the various FTAs in East Asia:

- The relatively simple and liberal ROO provision of AFTA, and the generality in application. In addition, reforms being sought lean towards more liberal rules by “expanding/easing standards”
- The existing FTAs in East Asia (again, limited to ASEAN-10 plus China, Japan and Korea) are more or less consistent with AFTA ROO, with the use of 40 percent RVA.
- Most sensitive sectors for most countries include automotive, textile and garments sectors.
- There is a trend toward using CTC as an alternative rule, albeit being defined for product specific countries.
- Japan appears to have greater tendency for more restrictive ROO.
- However, in general, there is a trend towards progressively more liberal ROO regime in East Asia.

**Table 2: Rules of Origin of Concluded FTAs<sup>/a</sup> in East Asia, 2007**

Agreement	Notes	Compared with AFTA (40%) VA rule
<b><u>Value-Added Rule (VA) only (3 FTAs)</u></b>		
1 Singapore-New Zealand Closer Economic Partnership Agreement (2001)	At least 40% of the cost is of New Zealand or Singapore origin, and the last place of manufacture is in New Zealand or Singapore	consistent
2 Singapore-Australia Free Trade Agreement (2003)	For manufactured products: (a) Local value-added (VA) content of 50% or (b) VA content of 30% for 114 tariff subheadings. These include electrical & electronic equipment and precision instruments.	some products more/less restrictive
3 Singapore-Jordan Free Trade Agreement (2005)	All products, with the exception of textile and apparel goods, need only fulfill a general rule of origin of a relatively low threshold of 35% local VA content. For textile and apparel goods, specific process rules apply.	less restrictive
<b><u>VA and/or Change of Tariff Classification (CTC) Rules (3 FTAs)</u></b>		
1 Taipei, China-Panama Free Trade Agreement (2004)	Regional VA content requirement: 35%, 40%, 45%	some products more/less restrictive
2 Thailand-New Zealand Closer Economic Partnership Agreement (2005)	Regional VA content requirement: 50%	more restrictive
3 PRC-Chile Free Trade Agreement (2006)	Regional VA content requirement: 40% or 50%	some products more restrictive
<b><u>VA and/or Specific Product Rules (4 FTAs)</u></b>		
1 Asia-Pacific Trade Agreement (1976)	Regional VA content requirement: 45% for most products. <u>Special Criteria Percentage</u> : Products originating in Least Developed Participating States can be allowed a favorable 10 percentage points applied to the percentages established in Rules 3 and 4 of APTA.	more restrictive

- |   |  |  |            |
|---|--|--|------------|
| 2 | ASEAN Free Trade Agreement (1993)        | Local or regional VA content of 40% or product specific rule for the following sectors: (a) Process criterion for textiles and textile products; (b) Change in chapter rule for wheat flour; (c) CTC for wood-based products; (d) CTC for certain aluminum and articles thereof. | consistent |
| 3 | ASEAN-PRC Free Trade Agreement (2005)    | Regional or local VA content of 40% or product specific rule. Process criterion required for textiles and textile products.  | consistent |
| 4 | PRC-Pakistan Free Trade Agreement (2006) | Regional VA content requirement: 40%   | consistent |

**Combination of all Rules (VA, CTC, SP, others) (20 FTAs)**

- |   |  |   |                                     |
|---|--|---|-------------------------------------|
| 1 | Singapore-European Free Trade Association (EFTA) Free Trade Agreement (2001) | Regional VA content requirement: 40% or 50%   | some products more restrictive      |
| 2 | Japan-Singapore Economic Agreement for a New-Age Partnership (2002)          | For manufactured products, change in tariff heading (CTH) for all imported inputs used in the manufacture of the product; Singapore must be the place where the last substantial manufacture takes place. Additional flexibility for 264 products; CTH or local value-added content (VA*) of 60%.   | more restrictive                    |
| 3 | Korea-Chile Free Trade Agreement (2004)                                      | Regional or local VA content requirement: 30% or 45%  | some products more/less restrictive |
| 4 | PRC-Hong Kong, China Closer Economic Partnership Arrangement (2004)          | Local VA content requirement: 30%   | less restrictive                    |
| 5 | PRC-Macao Closer Economic Partnership Arrangement (2004)                     | Local VA content requirement: 30%   | less restrictive                    |
| 6 | Singapore-United States Free Trade Agreement (2004)                          | For manufactured products, (a) CTC for all imported inputs used in the manufacture of the product; Singapore must be the place where the last substantial manufacture takes place; (b) Regional value-added content (VA*) of 35-60% (applies mainly to electronic products); (c) Process rule (applies mainly to chemicals and petrochemicals). | some products more/less restrictive |
| 7 | Korea-European Free Trade Association (EFTA) Free Trade Agreement (2005)     | Regional VA content requirement: 25%, 30%, 45%, 50%, or 60%   | some products more/less restrictive |
| 8 | Singapore-India Comprehensive Economic Cooperation Agreement (2005)          | Local VA content requirement: 40%   | consistent                          |

9	Japan-Mexico Economic Partnership Agreement (2005)	Regional or local VA content requirement: 50%, 65%, or 70%	more restrictive
10	Thailand-Australia Free Trade Agreement (2005)	Regional VA content requirement: 40-45 or 55%	some products more restrictive
11	ASEAN-Korea Free Trade Agreement (2006)	Regional VA content requirement: 40%, 50%, or 60%. Specific manufacturing process for textiles and garments.	some products more restrictive
12	Japan-Malaysia Economic Partnership Agreement (2006)	Regional VA content requirement: 40%	consistent
13	Japan-Philippines Economic Partnership Agreement (2006)	Regional VA content requirement: 40%	consistent
14	Trans-Pacific Strategic Economic Partnership Agreement (2006)	A product will qualify for preferential treatment if (a) it meets the specific rule of origin applicable to it (in many cases, this is a liberal CTH rule) or (b) where so stipulated, if at least 45% of the cost originates from the party.	more restrictive
15	Singapore-Panama Free Trade Agreement (2006)	Local VA content requirement: 35%	less restrictive
16	Korea-Singapore Free Trade Agreement (2006)	Regional VA content requirement: 55%	more restrictive
17	Japan-Thailand Economic Partnership Agreement (2007)	Regional VA content requirement: 40%	consistent
18	Japan-Chile Strategic Economic Partnership Agreement (2007)	Local VA content requirement: 30% or 45%	some products more/less restrictive
19	Japan-Brunei Economic Partnership Agreement (2007)	Regional VA content requirement: 40%	consistent
20	Korea-United States Free Trade Agreement (2007)	Regional VA content requirement: 35/45%; 40/50%; 55% (build-up/build-down method)	some products more/less restrictive

*Note:* /a The list does not include Taipei,China-Nicaragua FTA; Laos-Thailand PTA; PTA of Group of Eight Developing Countries (PTA-D-8); Taipei,China-Guatemala FTA; PRC-Thailand PTA; and Taipei-China-El Salvador-Honduras FTA.

*Source:* Reproduced from Table 9 in Kawai and Wignaraja (2007), ADB FTA Database; James (2006); Cheong and Cho (2006); and authors' compilations.



**Table 3: Rules of origin for major auto and auto parts products in selected East Asian FTAs**

FTA	JAPAN		KOREA	PRC	ASEAN		SINGAPORE		THAILAND		
	Japan - Malaysia EPA (2006)	Japan - Singapore EPA (2002)			Japan - Thailand EPA (2007)	Korea - Singapore FTA (2006)	PRC - Pakistan FTA (2006)	ASEAN Free Trade Area (1993)		ASEAN - PRC FTA (2005)	ASEAN - Korea FTA (2006)
<b>HS Code</b>	<b>Product Description</b>										
87.01	CTH (6 digit) or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%	Tractors (other than works, warehouse equipment)
87.03	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	Last process of manufacture within territory of the party	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%	Motor Vehicles for transport of persons (except buses)
87.04	CTH or RVC of 50%	CTH; last substantial manufacture*	CTH or RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%	Motor Vehicles for the transport of goods
87.08		CTH; last substantial manufacture*	CTH or RVC of 50% / 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	Last process of manufacture within territory of the party	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%	Parts and accessories for motor vehicles
87.11	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (4 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%	Motorcycles, bicycles, etc. with auxiliary motor
87.14	CTH or RVC of 40%	CTH; last substantial manufacture*	CTC (4 digits)	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits)	Parts and accessories of bicycles, motorcycles, etc.

*Notes:* The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

*Source:* Lifted from Table 10 in Kawai and Wignaraja (2007).

## 5. CONCLUSIONS AND RECOMMENDATIONS

Complex ROOs are associated with increased administration costs to governments and transactions costs to business firms. Moreover, multiple ROOs in overlapping FTAs are particularly burdensome, giving rise to the “noodle bowl” effect. The textile and garment sector is particularly affected by stringent and restrictive ROOs.

Estimates of ROO costs vary. Herin (1986) estimated the cost to be around 3 percent of the value of goods traded for EFTA countries. Manchin (2006) estimated a range between 4-4.5 percent and Cadot *et al* (2005) between 6-8 percent for other EU schemes. For NAFTA, Carrère and de Melo (2004) estimated the cost of ROO to be around 6 percent of the value of goods traded. Manchin and Pelkmans-Balaoing, using a gravity model, finds that in ASEAN, for the preferential trade to positively influence trade flows, the margin of preference should be higher than 25 percent, suggesting an equivalent cost of ROO administration and compliance in ASEAN, much higher than estimates for EU and NAFTA.

JETRO surveys in ASEAN countries note the considerable amount of time and paperwork involved in obtaining Form D (the official form to prove origin in AFTA). Compliance with ROO involves numerous documentation requirements (including invoices and other evidence for each input used in the final product). These problems are magnified for small firms. In addition, ASEAN requires that Form D should be issued by designated government departments, unlike many other FTAs where private sector associations are allowed to issue certificates of origin. The 2006 JETRO Survey of Japanese Firm’s International Operations shows that around 30 percent of 97 Japanese MNCs surveyed using or planning to use FTA preferences in East Asia view the existence of different rules of origin as complicating their trade businesses and leading to increased costs—either through having to deal with complicated procedures to prove country of origin or even having to change to productions processes. Another 33 percent expected to see increased costs in the future. Furthermore, 64 percent of firms thought that rules of origin should be harmonized, with the largest number (24.7 percent) preferring to be able to choose either the value added (VA) rule or the change in tariff classification (CTC) as the common rule. Thus, it seems that multiple ROOs are

beginning to manifest themselves as a problem in East Asia (Kawai and Wignaraja, 2007).

How then is the vision of an East Asian community to be achieved? What ROO regime would be an enabling factor that would facilitate trade among members and augment intra-regional trade and investments flows? The answer depends primarily on whether the ROO regime would lead to the reduction of the cost of doing business across the region and promote seamless trade and production. In this regard, the discussion above suggests some key features of such a regime.

### **5.1. Simplicity and efficacy**

There is a consensus that the movement should be towards more simple and unrestrictive ROO. Simpler ROO will help promote regional trade and international competitiveness of member states. Simple rules will reduce compliance costs and administration itself of trade and customs procedures. To minimize the potential for unproductive rent-seeking and corruption, a simple and transparent ROO is important (ADB, 2002).

In general and in theory, this means using a single, least restrictive rule. But in practice using an either/or approach might be more practical.

In this regard, the use of CTC as an alternative (either/or) method to the VA rule would help. The CTC method is easy for Customs authorities to implement. At the same time, SMEs might also find it easier to comply with, simply needing to show import and export invoices with different classification code. The question is determining the level of disaggregation the member countries would deem to satisfy “substantial” transformation, which would vary across commodities. Here, protectionist tendencies would surface and agreements (especially between developed and developing countries) might be difficult. Nonetheless, the general rule should lean towards less restrictiveness. This implies using a common rule across products, possibly at a 4 to 6-digit level, and if any, with very limited product-specific exemptions.

The reforms in ASEAN ROOs appear to be heading toward this direction. It has started to introduce CTC as a substitute criterion. Earlier the product coverage is limited to: iron & steel products in HS Chapter 72, textiles and textiles products, wheat flour,

aluminum and wood-based products. An increasing number of products are now being covered to apply CTC as alternative criteria to the VA rule for products in additional nine priority sectors, namely: (i) agro-based products; (ii) automotives; (iii) e-ASEAN; (iv) electronics; (v) fisheries; (vi) healthcare; (vii) rubber-based products; (viii) textiles and apparels; and (ix) wood-based products.

Japan's latest bilateral agreements with ASEAN countries have similar elements—predominantly CTC, with alternative use of VA for most. The problem would be the different levels of disaggregation used and it is doubtful how liberalizing the regime could be. In any case, it appears that Japan's plan is to more easily consolidate the ROO into a Japan-ASEAN ROO.

Another suggestion being considered in various FTAs is the use of self-certification. It is not without its own problem, as previously mentioned, but this would simplify and lighten the administrative burden considerably.

Finally, *de minimis* rules (which allow for a specified maximum percentage of non-originating materials to be used without affecting origin) can greatly simplify ROO. It could be set well within a level for the intent and purposes of “substantial transformation” but a higher cut-off would represent a more liberal approach to ROO.

While the use of *de minimis principle* appears to become a common feature in newer partnership agreements, upon closer examination, application is usually on a product specific (PSR) basis. A wider application of *de minimis* rule using generous ceiling would be a major step to simplifying ROO and lowering the cost of compliance.

## **5.2. Flexibility**

Internationalization of production and accompanying technological changes would require periodic revision of the ROO, especially in product groups where technologies and production processes change fast. ROO should be flexible enough to accommodate these changes. Nonetheless, product specific rules should be avoided. Otherwise, there would be a tendency of “privatization” of trade policy brought about by the need for periodic revision. There should at least be some well-defined procedures or guiding principles for introduction of amendments in the harmonized ROO. Again, in practice, an either/or approach might be useful.

### 5.3. Accumulation Rule

One important consideration is the adoption of a full cumulation type ROO. Full cumulation is an important factor allowing for the development of regional production networks. This provides for deeper integration and allows for more advanced countries to outsource labor-intensive production stages to low-wage partners. Coupled with simple ROO, this full cumulation will make it easier for regionally-based firms to exploit the economies of scale (Brenton, 2003).

ROO provision for cumulation (referred to as well as accumulation) would be a crucial feature to include in a regional trading agreement. It would address problems of protectionist tendency in the ROO and investment (and trade) diversion effects, at least within the wider grouping of member countries. An issue is how to deal with non-member countries. To what extent should cumulation be allowed so as not to frustrate the preferential status of the FTA partners? Should this follow the traditional Pan-European system or the more aggressive US-Singapore ISI? What combination of policies or rules is acceptable? The easy answer is to include a guiding principle, for example, a development dimension in these rules involving simple interpretation.

Aside from accumulation, roll-up or absorption principle which allows materials that have acquired origin by meeting specific processing requirements to be considered an originating good when used as input in a subsequent transformation could also be recommended for a more liberal ROO approach.

For its part, ASEAN is developing a “partial” cumulation approach. The practice in ASEAN is to count “components as part of ASEAN content which themselves have ASEAN content of 40 percent or more.” Upon recommendation during the September 2004 AFTA Council Meeting, the percentage content requirement was reduced to 20 percent of ASEAN content.

This move is envisioned to help most developing ASEAN member countries, whose sources of inputs, given the GPN (global production network) structure, would come from outside the region. Some estimates show that in most ASEAN countries, for major manufactured exports (e. g. textile, garments and electronics) total ASEAN content is less than 20 percent . (Manchin and Pelkmanns-Balaoing, 2007)

#### **5.4. Harmonization of customs procedure**

Customs clearance is still a problem in most of the less developed countries of East Asia. A complex ROOs accompanying a free trade agreement can further complicate rather than facilitate trade in the region. Along with harmonization of ROO standards, there is even greater need for the streamlining of customs procedures and simplification of customs clearances including the introduction of paperless trading in many FTAs. The objective is to minimize documentation costs. Harmonization of customs procedures in general would be a big step in this direction. This is consistent with the principles of predictability, transparency and consistency required in the ROO.

#### **5.5. Developing country dimension**

Establishing an international regime of ROO is one thing. Ensuring that it does not pose disadvantages to developing countries is another. There is a need to add this dimension to the ROO regime. Arguments against free trade, competition policy and the like are a result of lack of safeguards for those who are not prepared to participate and more so compete.

Developing countries need to be able to latch on to the GPN. This means gearing the ROO regime towards the preparation, development, and internationalization of SMEs. The ideal ROO therefore should have a developing country dimension. What would this entail? Needless to say, capacity building is crucial, for exporters, importers and administrators in developing countries, if the region is to achieve the best practice in the rules of origin. Developments in the EC for development-friendly ROO includes a single value-added method, use of statement of origin by registered exporters, and training and technical assistance to improve evaluation, information flows and monitoring of compliance. Another key element is allowing alternative means of proving origin more suited to the development stage of the developing country member.

A logical concession to developing member countries is to lower the VA criteria for its exporters. Findings for the EU shows that a decline in the value-added requirement would tend to increase utilization rates. This could be a most useful incentive for CMLV countries.<sup>13</sup>

In sum,

- Consolidation of the multiple membership agreements in the region around more liberal ROO should be the general guideline to achieve the vision of an East Asian community.
- The ASEAN ROO is considered relatively simple and liberal. The generality in application is also a plus factor. In addition, reforms being sought lean towards more liberal rules by attempts toward “expanding/easing standards.” However, a lot remains to be done to improve the system.
- The existing FTAs in East Asia (again, limited to ASEAN-10 plus China, Japan and Korea) are more or less consistent with AFTA ROO, specifically with the use of 40 percent RVA.
- In general, there is a trend towards progressively more liberal ROO regime in East Asia.
- As such, especially with continuous effort to clarify and improve issues of implementation, the AFTA ROO would provide a good starting point for EAFTA.
- Necessarily, there should be a coordinated and cooperative action among member countries.
- Rules toward adopting full cumulation, and roll-up (absorption) process should be developed. *De minimis* provisions should be applied more extensively. These would be significant impetus for deeper regional integration.
- Sensitivity – applying restrictive ROOs targeted at sensitive products is not an effective mechanism for protecting domestic industry and should be limited.
- Special and Differential Treatment: ROO be devised by taking into account the different levels of development of countries in the East Asia region, e.g. using lower value added content.

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## NOTES

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<sup>1</sup> What used to be a simple application of the origin of rules became complicated due to technological innovations in communications and transportation permitting the outsourcing by the companies of their manufacturing operations globally. Rarely can be seen a country claiming exclusive domestic inputs of a certain product. (Coyle 2004)

<sup>2</sup> A term borrowed from contract theory meaning “just indifferent between signing and not signing”. See Cadot *et al* (2002)

<sup>3</sup> This part draws heavily from Lazaro, D. and Medalla, E.M. (2006). Rules of Origin: Evolving Best Practices for RTAs/FTAs. PIDS Discussion Paper Series No. 2006-01

<sup>4</sup> For simple processing that is negligible in origin determination. Often, this would be lumped with “wholly-obtained” goods.

<sup>5</sup> More than two countries are involved in the production of goods and their origin will be conferred upon the country where the last substantial transformation took place.

<sup>6</sup> The value-added test yet simple and precise can be very costly because to comply with a value-added rule differences in calculation method, fluctuation in values and the compliance costs, the value-added rule requiring tracing, a manufacturer of a complex product would need a highly sophisticated inventory and accounting system to adequately ensure that particular goods contain specific local components at specific values. (La Nasa, 1995)

<sup>7</sup> While the Harmonized System reflects the most sophisticated and refined tariff classification system, its primarily designed for the dual purposes of commodity classification and compilation of statistics. (La Nasa, 1995)

<sup>8</sup> This is as good only as a supplemental test of origin because of its rigidity and difficulty of defining a process test for the enormous array of products made and the continuous need to update these rules for new products and technological advances in production. This process is also highly susceptible to capture by industry lobbying groups, because drafters and administrators would have to rely upon the industry for information. Lastly, negative technical tests leave large gray area, in that they only delineate which processes do not confer origin. (La Nasa, 1995)

<sup>9</sup> There are three types of cumulation. *Bilateral cumulation* operates between the two FTA partners and permits them to use products that originate in the other FTA partner as if they were their own when seeking to qualify for preferential treatment. *Diagonal cumulation* means that countries tied by the same set of preferential origin rules can use products that originate in any part of the area as if they originated in the exporting country. *Full cumulation* provides that countries tied by the same set of preferential origin rules among each other can use goods produced in any part of the area, even if these were not originating products. (Estevadeordal and Suominen, 2003)

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<sup>10</sup> *Maquiladoras* is a term referring to production units doing offshore assembly work for the US market.

Generally, they are US owned companies enjoying preferential tariff treatment in the US before and even

during the early years that NAFTA was formed. (Cadot *et al*, 2002)

<sup>11</sup> [www.news.com.au](http://www.news.com.au), December 12, 2004.

<sup>12</sup> Singapore and Thailand are of course more prolific, starting much earlier on in their pursuit of bilateral agreements, but Japan has been the more active with respect to forging partnerships with other East Asian countries, as Singapore and Thailand are already being a member of ASEAN.

<sup>13</sup> The value-added requirement should be based on whether the potential gains in terms of greater regional trade significantly outweigh the risks of trade deflection. Kirk (2007) suggests 30% value-added requirement would be sufficient to prevent significant trade deflection.

## Chapter 16

# **Escaping from FTA Trap and Spaghetti Bowl Problem in East Asia: AN Insight from the Enterprise Survey in Japan**

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## **INTRODUCTION**

FTA has proliferated in East Asia. There are many FTAs being enforced and still to be enforced between 2005 and 2010. Those FTAs implements the phase-out tariff reduction schedules, hence, exporters face different tariffs by year and by destination. In addition, FTA requires the rules of origin (ROO), which imposes additional administrative costs on firms instead of eliminating tariff.<sup>1</sup> ROOs and corresponding application form differ for every FTA. This is because the General Agreement on Tariffs and Trade (GATT) has no specific rules governing the identification of the country of origin of goods in international commerce. “Each contracting party is free to determine its own origin rules, and could even maintain several different rules of origin depending on the purpose of the particular regulation.”<sup>2</sup> An increase of FTAs may cause the overlapping FTA problem or the so-called spaghetti bowl problem. It is what exporter faces with different tariffs and ROOs for a product heading to different destinations.

There have been numerous ex ante studies on the impacts of FTAs. Those studies, which utilized the computable general equilibrium (CGE) models, assume that any firm wants to maximize profits and is able to behave to realize it. Results of these studies can provide quantitative analysis that FTAs generate benefits and improve the welfare of the world. However, we do not know how much firms intensively utilize FTAs because FTAs are not compulsory and administrative costs to get certificate of origin is costly. The CGE model used in the ex ante studies can not include the complex

factors such as, phase-out tariff reduction schedule, the ROO problem and the overlapping of ROOs.

At the onset of its proliferation in East Asia, it was a critical/urgent task to evaluate FTAs. Particularly in East Asia, where the production networks have developed, the ROO issue and the overlapping FTAs may increase service link costs. This paper aims to identify the existing and potential problems due to the enforcement of FTAs and its proliferation. Likewise, it intends to examine what measures and reforms are necessary to ensure that small countries and SMEs benefit the most from the FTAs. Furthermore, it also aims to provide insight and learning to the ASEAN Economic Community (AEC) Blueprints, which has to reform the Common Effective Preferential Tariff (CEPT) ROO to match with production fragmentation or production networks.

Given the abovementioned objectives, the paper probes on the following research questions. How intensively firms are utilizing FTAs? Which ROOs are used in East Asia? Are those ROOs really costly? If so, what attributes to its cost? Are there any best practices in implementing the ROO? Are the overlapping FTAs or the spaghetti bowl problem really costly for the firms? What are the consequences of the spaghetti bowl problem? What reforms and arrangements are needed to avoid these consequences? This paper attempts to evaluate the FTAs and answer these questions.

The following sections review the FTAs in East Asia in the light of tariff and ROO. Section 3 introduces the results of Japan External Trade Organization (JETRO) survey which investigated the utilization of the enforced FTAs in East Asia. Section 4 summarizes the results of interviews with Japanese enterprises. The last section presents a conclusion and provides the policy recommendations.

This study claims that enterprises in Japan, in general, are interested in FTAs involving Japan as well as those between foreign countries. It concludes that the ROO is very costly, particularly the value added criterion (VA). Bilateral FTA has proliferated but enterprises will use FTAs selectively, specifically those with large economies. Plurilateral FTAs such as the AFTA, ASEAN-Japan are better than bilateral FTAs. It implies that wide regional FTA should replace the existing bilateral FTAs. The option of value added criterion and change of tariff line code was found most favorable. However, it recommended the examination of the self-certificate system to shorten the custom clearance time.

## 2. COMPLICATED FTAS IN EAST ASIA

### 2.1. Costs and benefits of FTAs

There are several *ex ante* studies on the impacts of FTAs in East Asia based on CGE models. The estimated results obtained from *ex ante* studies provide several common results. First is the trade creation effect or it is when FTAs result to gains in terms of welfare, GDP, export and so on, among the FTA member countries. Second is the trade diversion effect or when FTAs generate negative impacts on non-member countries. Studies showed that if a large economy is included in the FTA Member country, the negative effect will be larger. It is also a very important issue how and why member countries benefit from FTAs while non-member countries do not. Negative impacts on non-member countries should be minimized. Region-wide trade facilitation measures intend to lower the service link cost and improve the trading efficiency to extend the benefit to non-member countries. Third, the larger the number of FTA members, the larger the gain from a FTA. Ando and Urata (2005) estimated that ASEAN+Japan will increase Japan's GDP by 0.18 percent while ASEAN+3 (additional Member countries) will increase it by 0.19 percent. Kawai and Wignaraja (2007) projected an increase in Japanese income by 1.54 percent with ASEAN+3 combination, and by 1.59 percent with ASEAN+6. Recent study of JETRO (2007) supported earlier results, with a projected increase in Japan's GDP by 0.3 percent with Japan-ASEAN FTA, ASEAN+3 by 2.0 percent, and ASEAN+6 with 2.6 increases. Furthermore, Brown, Kiyota, and Stern (2004) estimated that the unilateral free trade liberalization is expected to increase its Members' welfare by 7.4 percent with partner countries to get large gains as well.

The CGE model studies are very useful in measuring effects of tariff reduction on goods. The model studies assume that all the firms use the available FTAs to maximize its profits and disregard important issues of FTAs (e.g., rules of origin problem, the complexity caused by overlapping FTAs or the as spaghetti bowl problem among others).

## **2.2. Complicated tariff liberalization**

ASEAN has lead East Asia in tariff liberalization, which is a matter of pride in the region. The original ASEAN 6 planned to reduce tariffs from 99.4 percent tariff lines to 0 percent by 2010 and 98.2 percent tariff lines to 0 percent up to 2015 for new Member Countries. This means that, after 2010, the original ASEAN 6 will accomplish 0 percent tariffs for substantially all of its products.

On the contrary, other FTAs in the region employ complicated tariff liberalization. First, almost FTAs put large products including significant manufactured products into the sensitive lists and some products have quotas. Second, several FTAs employ the reciprocal principle, which means that all the products identified by participating countries in the sensitive lists are excluded from liberalization. In a China-Thailand FTA, for instance, China placed 251 products while Thailand included 178 products into their sensitive lists, so, a sum of 429 products will be excluded from the liberalization between them. Third, most of FTAs in East Asia employ the phase-out tariff reduction schedule. For example, in the Japan-Malaysia Economic Partnership Agreement (EPA), implementing the phase-out schedule means eliminating the tariffs within 10 years since the day it was enforced (in April 1, 2005). The same with the Japan-Thailand EPA where their tariffs will be eliminated within 10 years from its enforcement date in November 1, 2005. As a result, Japanese exporters will face different tariff rates for a product per year. Japanese uses EPA instead of FTA.

The complication in tariff liberalization stems from sensitive lists, quota system, the reciprocal principle, and the phase-out tariff reduction schedule. These complications make it difficult for enterprises in East Asia to consider FTAs as profitable business applications.

## **2.3. Different rules of origin**

ROOs differ by FTA and by destination. For manufactured goods, for instance, there are three types of ROOs: (1) Value content (VC) rule means that a product must satisfy a minimum local or regional value ratio; (2) a change in tariff classification (CTC) rule, defined at Harmonized System (HS) Level; and, (3) a specific process (SP)

rules which requires a specific production process. Minimum local ratio is defined in the VC rule, and HS digit number is defined in the CTC rule.

Kawai and Wignaraja (2007) summarizes the ROOs adopted in several FTAs for automobile and auto parts, which provide the basis in understanding how much complicated the ROO problem is (Table 1). In motor vehicles for human transport, except buses (87.03), the adopted rules differ by FTA: (1) VC rule. VC for AFTA and ASEAN-China FTA is not less than 40 percent while for ASEAN-Korea FTA it is 45 percent; (2) CTC. CTC rules for Japan-Singapore EPA; (3) CTC or VC Rule. For Japan-Malaysia EPA it is a choice of 60 percent of either CTC or VC, same with the Japan-Thailand EPA which requires for 40 percent of CTC or a VC; (4) CTC rule plus a VC rule. CTC plus a 55 percent VC rules for Korea-Singapore FTA, a CTC plus a 30 percent VC rules for United States-Singapore FTA, and a CTC plus a 40 percent VC rules for Thailand-Australia FTA); and lastly is the (5) SP rule. It is the last process of manufacture within territory of the party.

Exporters face different rules of origin by destination. For example, a Thai exporter has to prepare a CTC rule or a 40 percent VC rule document to export to Japan; a 40 percent of VC for exports within ASEAN and China; a 45 percent VC rule document for exports to Korea; and, a CTC plus a 40 percent VC rule document for Australia. Furthermore, the Thai exporter faces different format to apply certificate of origin for those destinations.



**Table 1: Rules of origin for major auto and auto parts products in selected East Asian FTAs**

FTA	JAPAN		KOREA	PRC	ASEAN Free Trade Area (1993)	ASEAN		SINGAPORE		THAILAND
	Japan - Malaysia EPA (2006)	Japan - Singapore EPA (2002)				Japan - Thailand EPA (2007)	Korea - Singapore FTA (2006)	PRC - Pakistan FTA (2006)	ASEAN - PRC FTA (2005)	
<b>HS Code</b>	<b>Product Description</b>									
87.01	CTH (6 digit) or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.03	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	RVC of 45%	Last process of manufacture within territory of the party	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.04	CTH or RVC of 50%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	RVC of 45%	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.08		CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	RVC of 45%	Last process of manufacture within territory of the party	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%
87.11	CTH or RVC of 60%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (4 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%
87.14	CTH or RVC of 40%	CTH; last substantial manufacture*	CTH or RVC of 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits)

*Notes:* The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

*Source:* Kawai and Wignaraja (2007).

### **3. IMPLICATIONS OF THE JETRO FIRM SURVEY**

East Asian exporters are expected to face the spaghetti bowl problem as tariffs, ROOs, and even application formats differ by FTA and by destination. How do firms in East Asia perceive this situation? JETRO conducted a large sample survey<sup>3</sup> in late 2006 to have a glimpse of FTA utilization among Japanese firms and how they assess FTAs. However, the survey has acceptable limitations because the section on FTA included only three questions on the following concerns: 1) the actual utilization and the firms' plan of utilization on the enforced FTAs; 2) the problems encountered with overlapping ROO in the Asia Pacific Region; and, 3) the necessity to harmonize ROO. Likewise, the survey did not ask about the plan of negotiations, such as, Japan-ASEAN FTA and Japan-Thailand FTA. The questionnaires were sent to 2,537 JETRO member firms that were familiar with the international trade procedure and those engaged in manufacturing, trading (export/import), and wholesale/retailing. A total of 729 out of the responded.

#### **3.1. Utilization of FTAs by Japanese enterprises**

Table 2 shows that only 13.3 percent (97 firms) out of 729 respondent were utilizing or had plan to utilize FTAs. The survey allowed multiple answers to questions. Only 5.1 percent (37 firms) were utilizing and 8.5 percent (62 firms) had plan to utilize the preferential FTA tariff schemes (i.e., early harvest schemes) in the Asia Pacific region (ASEAN, Australia, China, Japan, India, New Zealand and Republic of Korea). Majority of the firms (42.7 percent), however, do not plan to utilize the schemes. More a third (34.2 percent) of the respondent remained undecided on FTA. The results of JETRO survey suggest that the FTAs are not widely known or utilized by the Japanese firms.

Which FTA is well utilized by Japanese firms? Table 3 provides an overview of how intensively the Japanese firms, including affiliates operating overseas, were utilizing FTAs. The question allowed for multiple answers. Among 37 firms currently utilizing FTAs, the ASEAN Free Trade Agreement (AFTA) was mostly utilized, 24 firms or 3.3 percent of the total respondents; this is followed by Japan-Malaysia FTA

(15 firms, 2.1 percent of total); Thailand-Australia (8 firms, 1.1 percent); China-Hong Kong (7 firms, 1.0 percent); Thailand-India (6 firms, 0.8 percent); China-ASEAN (4 firms, 0.5 percent); and, Thailand-New Zealand (2 firms, 0.3 percent).

**Table 2: Utilization and plan of utilizing FTAs by Japanese enterprises**

		Currently utilizing FTA or plan to do so	not utilizing and no plan to utilize	no idea
	Number of firms	%	%	%
Total	729	13.3	42.7	34.2
Large enterprise	314	19.4	41.4	34.4
SMEs	415	8.7	43.6	34.0
Manufacturing	525	14.7	39.6	37.0
having palants in overseas	330	19.7	37.0	37.0
only domestic plants	195	6.2	44.1	36.9
Non-manufacturing	204	9.8	50.5	27.0
Beverage	49	6.1	42.9	38.8
Textile & garment	24	20.8	37.5	25.0
Wood, furniture, paper and pulp	16	18.8	6.3	56.3
Chemical	46	19.6	41.3	32.6
Medical products & cosmetic	27	3.7	40.7	40.7
Petroleume, coaks, plastic, rubber products	30	13.3	33.3	43.3
Pottery	17	29.4	47.1	23.5
Iron steel, non-metal and metal products	45	13.3	37.8	37.8
General machinery	63	15.9	44.4	39.7
Electrical appliances	39	17.9	41.0	41.0
Electronics, telecommunication machinery	25	-	60.0	40.0
Automobile, auto parts	56	30.4	32.1	30.4
Precisionary machinery	40	2.5	45.0	42.5
Other	48	12.5	35.4	31.3
Trade & wholesale	180	10.0	48.3	28.9
Retaile	20	10.0	60.0	15.0
Others	4	-	100.0	-

*Note:* Multiple answers were allowed.

*Source:* JETRO (2007).

The results emphasized three points. First, the Japanese firms were very interested in FTAs between foreign countries. In particular, the mostly used AFTAs were those in East Asia for Japanese firms and its affiliates operating overseas. Perhaps, the Japanese

firms were considering their established production and procurements networks in utilizing an AFTA covering the ASEAN region. In addition, in ASEAN-AFTA the CEPT tariffs are less than 5 percent on 98.1 percent tariff lines and 0 percent on 75.7 percent tariff lines for the original ASEAN 6 countries (e.g., Brunei, Indonesia, Malaysia, the Philippines, Singapore), and Thailand at the end of 2007.

**Table 3: Utilization of FTAs by Japanese firms by FTA**

	currently utilizing or plan to utilize	to be harmonized by any rule	to be harmonized by VC rule	to be harmonized by CTC rule	choice of VC or CTC	undecided	not to be harmonized	no idea
	Number of firms	%	%	%	%	%	%	%
Total	97	24.7	20.6	18.6	24.7	3.1	1.0	28.9
Large enterprise	61	24.6	21.3	18.0	24.6	3.3	1.6	29.5
SMEs	36	25.0	19.4	19.4	25.0	2.8	-	27.8
Manufacturing	77	22.1	23.4	15.6	22.1	2.6	1.3	31.2
having palants in overseas	65	20.0	26.2	15.4	20.0	3.1	1.5	30.8
only domestic plants	12	33.3	8.3	16.7	33.3	-	-	33.3
Non-manufacturing	20	35.0	10.0	30.0	35.0	5.0	-	20.0
Beverage	3	33.3	66.7	-	33.3	-	-	-
Textile & garment	5	20.0	20.0	20.0	20.0	-	-	40.0
Wood, furniture, paper and pulp	3	-	66.7	33.3	-	-	-	-
Chemical	9	22.2	22.2	11.1	22.2	-	11.1	11.1
Medical products & cosmetic	1	100.0	-	-	100.0	-	-	-
Petroleum, coaks, plastic, rubber products	4	25.0	-	-	25.0	-	-	75.0
Pottery	5	-	80.0	20.0	-	-	-	-
Iron steel, non-metal and metal products	6	16.7	16.7	33.3	16.7	-	-	33.3
General machinery	10	20.0	10.0	30.0	20.0	-	-	40.0
Electrical appliances	7	57.1	14.3	-	57.1	14.3	-	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-	-	-
Automobile, auto parts	17	17.6	17.6	17.6	17.6	5.9	-	35.3
Precisionary machinery	1	-	-	-	-	-	-	100.0
Other	6	16.7	16.7	-	16.7	-	-	66.7
Trade & wholesale	18	33.3	11.1	33.3	33.3	-	-	22.2
Retail	2	50	-	-	50.0	50.0	-	-
Others	-	-	-	-	-	-	-	-

*Note:* Allowed providing multiple answers.

*Source:* JETRO (2007).

Second, Japanese firms who responded were intensively utilizing the FTAs involving Thailand. This could be attribute to Thailand as an important production and export base for Japanese firms in shipping their products to markets outside the ASEAN region. Thailand's FTAs are very useful for the Japanese affiliates operating in Thailand.

Third, firms had been vigorously utilizing schemes under the Japan-Malaysia FTA, which was introduced in July 2006. This suggests that more Japanese firms will likely to use very recently enforced FTAs, like that of the Thailand-Japan FTA (November 2007).

Table 3 also shows which among the FTAs that the Japanese firms plan to utilize. Among the 62 firms that plan to utilize preferential tariff scheme(s), the Japan-Malaysia FTA ranked highest (24 firms) or preferred by most of the firms. It implies the high expectations set for the newly introduced Japan-Malaysia FTA. Japanese enterprises also showed interests in the China-ASEAN FTA (21 firms) and AFTA (20 firms). The result suggests that, indeed, Japanese firms were eyeing the ASEAN as a possible base for their China and Indian market. The Thailand-India FTAs ranked as the highly preferred scheme, reiterating a possibility of Thailand as base for the growing Indian market.

Will SMEs utilize or plan to utilize FTAs? Of the total respondents, 415 were from SMEs and 314 from large enterprises. With regards to the firm size and FTA utilization, 19.4 percent of the respondent from large firms were already utilizing or plan to utilize FTAs, while only 8.7 percent of the those from SMEs are utilizing FTAs. Thus, the results implied that FTAs are being utilized and planned to be utilized by large firms rather than SMEs. Another implication could be that FTAs benefit and will benefit the large enterprises more than the SMEs and that some factors could be impeding SMEs' utilization of FTA.

### **3.2. ROOs and Spaghetti bowl problems**

The JETRO survey also asked the problems caused by overlapping FTAs. As shown in Table 4, among the 97 firms currently utilizing FTAs or plan to do so, 27.8 percent considered the certificate procedures of ROOs as complicated and lead to increased costs. A little higher number of firms (33.0 percent), however, did not experience any problem at the time of the interview but possible problems may occur in future. Generally, 70 percent of firms interviewed perceived that the certificate procedures of ROOs as complicated or problems may occur in future, while only 14.4 percent experienced no problem at all. It can be concluded that firms suffered from the high costs of acquiring the certificate of ROO. It is important, however, to take into account that the respondents may be deceived by the complicated procedure of acquiring the certificate of ROO rather than the operational complications stemming from the different ROOs.

**Table 4: Problems caused by overlapped FTA in East Asia by Japanese firms**

	currently utilizing or plant to utilize	certificate procedure is complicated and lead to an increase of costs	A change manufacturing process, leading an increase of costs	not causing any problem	no problem at present but problems may occur in future	no idea
	Number of firms	%	%	%	%	%
Total	97	27.8	2.1	14.4	33.0	22.7
Large enterprise	61	27.9	3.3	16.4	41.0	18.0
SMEs	36	27.8	-	11.1	19.4	30.6
Manufacturing	77	27.3	2.6	13.0	29.9	24.7
having plants in overseas	65	29.2	1.5	13.8	32.3	21.5
only domestic plants	12	16.7	8.3	8.3	16.7	41.7
Non-manufacturing	20	30.0	-	20.0	45.0	15.0
Beverage	3	66.7	-	-	-	33.3
Textile & garment	5	60.0	-	-	40.0	-
Wood, furniture, paper and pulp	3	33.3	-	33.3	-	33.3
Chemical	9	11.1	11.1	33.3	11.1	33.3
Medical products & cosmetic	1	100.0	-	-	-	-
Petroleum, coals, plastic, rubber products	4	-	-	-	-	100.0
Pottery	5	-	-	20.0	60.0	20.0
Iron steel, non-metal and metal products	6	50.0	-	-	33.3	16.7
General machinery	10	20.0	-	-	80.0	-
Electrical appliances	7	42.9	-	14.3	42.9	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-
Automobile, auto parts	17	23.5	5.9	11.8	17.6	29.4
Precisionary machinery	1	-	-	-	100.0	-
Other	6	16.7	-	33.3	-	33.3
Trade & wholesale	18	33.3	-	22.2	44.4	11.1
Retail	2	-	-	-	50.0	50.0
Others	-	-	-	-	-	-

Note: Allowed providing multiple answers.

Source: JETRO (2007).

The JETRO survey also asked the respondents' views on the future directions in the harmonization of ROO under FTAs in the region. Among the 97 enterprises utilizing or plant use FTAs, 20.6 percent answered that "the VC criterion should be implemented as a common rule," against the 18.6 percent who answered that "the CTC should be implemented as a common rule." The other 24.7 percent indicated that either VC or CTC rule is the best rule. Results indicate the familiarity of the Japanese firms operating in ASEAN with the VC rule under the AFTA, the ASEAN-China FTA, and the ASEAN-Korea FTA.

**Table 5: Views of necessity of harmonization and harmonized rules by Japanese firms**

	currently utilizing or plan to utilize	to be harmonized by any rule	to be harmonized by VC rule	to be harmonized by CTC rule	choice of VC or CTC	undecided	not to be harmonized	no idea
	Number of firms	%	%	%	%	%	%	%
Total	97	24.7	20.6	18.6	24.7	3.1	1.0	28.9
Large enterprise	61	24.6	21.3	18.0	24.6	3.3	1.6	29.5
SMEs	36	25.0	19.4	19.4	25.0	2.8	-	27.8
Manufacturing	77	22.1	23.4	15.6	22.1	2.6	1.3	31.2
having plants in overseas	65	20.0	26.2	15.4	20.0	3.1	1.5	30.8
only domestic plants	12	33.3	8.3	16.7	33.3	-	-	33.3
Non-manufacturing	20	35.0	10.0	30.0	35.0	5.0	-	20.0
Beverage	3	33.3	66.7	-	33.3	-	-	-
Textile & garment	5	20.0	20.0	20.0	20.0	-	-	40.0
Wood, furniture, paper and pulp	3	-	66.7	33.3	-	-	-	-
Chemical	9	22.2	22.2	11.1	22.2	-	11.1	11.1
Medical products & cosmetic	1	100.0	-	-	100.0	-	-	-
Petroleum, coals, plastic, rubber products	4	25.0	-	-	25.0	-	-	75.0
Pottery	5	-	80.0	20.0	-	-	-	-
Iron steel, non-metal and metal products	6	16.7	16.7	33.3	16.7	-	-	33.3
General machinery	10	20.0	10.0	30.0	20.0	-	-	40.0
Electrical appliances	7	57.1	14.3	-	57.1	14.3	-	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-	-	-
Automobile, auto parts	17	17.6	17.6	17.6	17.6	5.9	-	35.3
Precisionary machinery	1	-	-	-	-	-	-	100.0
Other	6	16.7	16.7	-	16.7	-	-	66.7
Trade & wholesale	18	33.3	11.1	33.3	33.3	-	-	22.2
Retail	2	50	-	-	50.0	50.0	-	-
Others	-	-	-	-	-	-	-	-

*Note:* Allowed providing multiple answers.

*Source:* JETRO (2007).

#### 4. SMALL SAMPLE SURVEY OF SELECTED INDUSTRIES

The JETRO survey (2007) provided a reference in understanding the intensity of FTA utilization or plan to do so among the Japanese firms and their affiliates operating overseas. It did not ask their plan to use the FTAs that are under negotiation (i.e., Japan-ASEAN EPA and Japan-Thailand EPA ) at the time of the survey. More importantly, the survey did not investigate several significant research issues related to the evaluation of FTAs, such as: Why are Japanese enterprises interested in FTAs? What are the impediments of FTAs? Why are the ROOs costly on enterprises? Which ROO is the best one, and why it is so? This section tries to answer these issues. For this purpose, 17 Japanese firms were interviewed between July 2007 and January 2008. The interview focused on selected industries involved in electronics & electrical appliances,

automobile, and garments.

In Japan, these three industries possess different characteristics. Electronic industry has manufacturing processes that are separated into many stages and located in different industries in different countries in Asia. Only the capital-intensive processes remain in Japan. It has an advanced vertical division of labor or fragmentation. On the contrary, electrical appliance industry has progressive horizontal division of labor. Low and medium-priced goods are being assembled in Asia while high-priced goods remain being manufactured in Japan. Automobile industry is quite different from the previous industries. Their production bases are located where demands are high, such as China, Thailand, Indonesia, the Philippines, Malaysia, and India among others. Only key parts requiring high precision technology and economies of scale, like the engine, are exported from Japan to Asia. Meanwhile, low priced parts are imported from Asia to Japan. The textile and garment or the apparel industry is the only one that has moved almost totally to Asia, China in particular. Only head offices, with design and marketing functions, are located in Japan.

#### **4.1. Characteristics of FTA utilization by Japanese enterprises**

To understand the characteristics of FTA utilization, 20 enterprises from three industries (i.e., electronics and electrical appliance, automobile and parts, and textile and garment) were interviewed.

About half, 8 firms of the 17 interviewees were currently utilizing FTAs. Interviewees were allowed to provide multiple answers. Japanese enterprises most often used the AFTA and other FTAs between foreign countries<sup>4</sup>. Most of the trading arrangements under FTAs were intrafirm rather than interfirm. Intrafirm trades are transactions between overseas plants but supervised by head offices located in Japan. Such that, most of the interviewees (Japanese enterprises), expressed that they were actually using or plan use the FTAs between foreign countries. Not so many enterprises are currently utilizing FTAs involving Japan. Among the respondent, four (4) enterprises had been utilizing Japan-Mexico EPA while one enterprise had been utilizing the Japan-Malaysia EPA. This implies that it takes time for these enterprises to be familiar with the procedures of FTAs<sup>5</sup>, despite the fact that Japan-Mexico EPA was

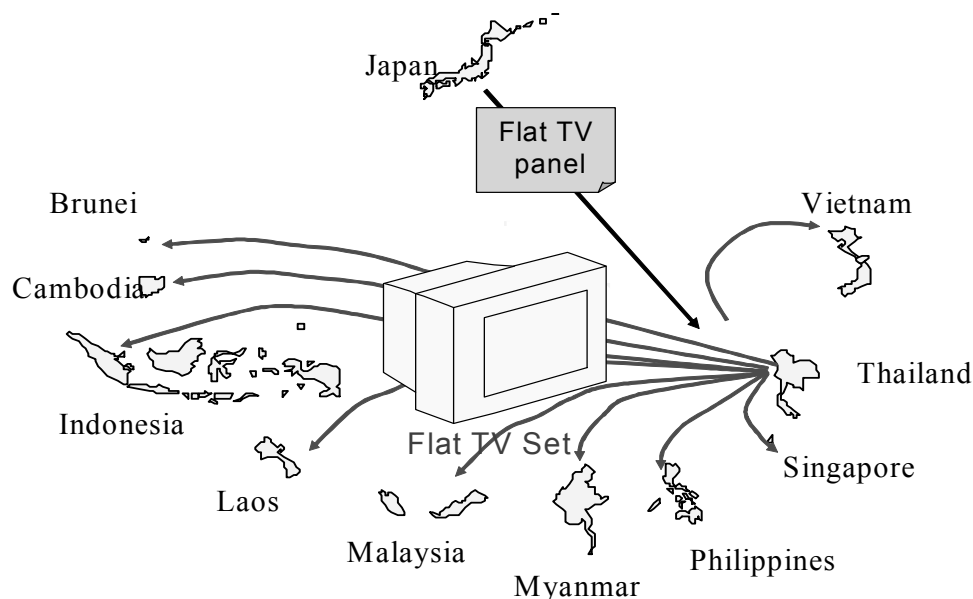


enforced in April 2005 and the Japan-Malaysia EPA was enforced in July 2006.

Which FTAs do firms plan to utilize? This question is relevant because several important EPAs involving Japan had almost concluded but not enforced. The Japan-ASEAN EPA, to be concluded in 2008, was mostly preferred because it is a plurilateral EPA between ten ASEAN countries and Japan. It provides more business opportunities than any multiple bilateral EPAs can do. Initially, the electronics and electrical appliance industry considered the Japan-ASEAN EPA for their flat TV panels only. These were excluded from the non-tariff lists under the Information Technology Agreement (ITA) and occupied more than half of content value of the flat TV sets. Therefore, Japanese suppliers had to export the flat panel with high tariffs. The flat panel TV sets made in Malaysia and Thailand, which use the flat panels made in Japan, were not subject to the AFTA CEPT tariff since they did not meet the 40 percent local content requirement. On the contrary, Korea can export the flat panels with the FTA preferential tariffs under the ASEAN-Korea FTA to Malaysia and Thailand. Furthermore, these flat panel TV sets can be exported from these two countries to other ASEAN countries with the FTA preferential tariffs under the FTA. The ASEAN-Korea FTA had affected the Japan's flat panel business in ASEAN. Thus, the Japan-ASEAN EPA will position Japan's flat panel business on equal footing with the Koreans (Figure 1).

Today, Japan's electronics and electrical appliance industry is eagerly waiting for the Japan-ASEAN EPA because recently they realized that they cannot utilize the bilateral Japan-Malaysia EPA well than they initially expected. Many Japanese electronic and electrical appliance enterprises had been using Singapore as a regional logistic hub for distributing goods from Japan to other ASEAN countries. This logistic system had enabled Singapore's to use its know-how on intermediate trading. The Japan-Malaysia EPA, on the contrary, does not allow Japan to ship its goods to Malaysia via Singapore due to its "direct shipment" requirement. The Japan-ASEAN EPA, however, enables the Japanese firms to utilize the Singapore's efficient logistic distribution system in transporting goods to other ASEAN countries.

**Figure 1: Possible Production and Distribution under the Japan-ASEAN EPA**



Source: by Authors.

In the same context, the automobile and auto part industry is likely to utilize the ASEAN-Japan EPA. Currently, the AICO scheme provides a 5 percent privilege tariffs for auto parts. The ASEAN-Japan EPA enables the importation of high value parts from Japan and exportation of the assembled components to other ASEAN countries.

The Japan-ASEAN EPA will be advantageous for textile and garment industry as well. There are many textile factories in Thailand but no garment factory. In Vietnam, there is no textile manufacturing but many garment factories. With the Japan-ASEAN EPA, it is possible to export the textile from Thailand to Vietnam and export the garment to Japan.

Nevertheless, all the interviewees who had either been utilizing FTAs or plan to do so had not established the necessary internal system of the firms to cope with the FTAs. Studies are currently being done on how much can these firms export under the EPA scheme.

#### **4.2. Benefits and harms of FTAs/EPAs**

With the question, “What benefits do Japanese firms expect from the FTAs?,” most replies focus on the FTAs expected benefits on “an increase in exports,” followed by

“easier to import.” Most of the Japanese firms expected for the trade effects of FTAs.

In addition, “concentration of production” was also cited by some enterprises. These enterprises perceived that FTAs will provide an incentive to divert the location of production. Automobile and auto part industry is an example where economies of scale worked and AFTA promoted the relocation of industrial processes in countries with such specialization for some types of cars. The same is true with the textile and garment industry, where manufacturing processes vary accordingly. FTAs are expected to promote specialization on specific manufacturing process.

Firms from electronics & electrical appliance industry, however, referred to benefits on the “concentration of production.” Due to various investment promotion programs and the ITA, factories operating in Asia had already been engaged in highly specialized production process. Parts and components are being traded without any tariff. In other words, de facto economic integration had already advanced in the form of production networks, particularly in the electronics and electrical appliance industry prior to the de jure (formal integration) of FTAs. Hence, industries of electronics and electrical appliances need not change locations even with the enforcement.

Contrary to other’s firms perceptions, several firms consider the FTAs as harmful. They complained that their businesses had been affected by the “disadvantages due to precedents of FTAs.” Japanese firms expressed worry over its possible disadvantages, particularly against Korea who had enforced FTA with ASEAN, with the United States, and plans to negotiate with the EU. They claimed that, with Korea’s FTAs, Japan cannot operate on an equal-footing with its competitors; it had been and it be at the disadvantage side compared with Korea in the abovementioned expanded markets.

### **4.3. Impediments of FTA utilization**

What has impeded the utilization of the FTAs by Japanese enterprises? There were several factors that impede the utilization of FTAs. First, the enterprises, particularly SMEs, were not aware that the FTAs had already been enforced with lower tariff rates incentives as compared with the most favored nation (MFN)’s. Most of the FTAs in East Asia adopted the phase-out tariff reduction or the gradual reduction of tariffs within a 10-year period. Smaller impacts distributed over a long period of time lowers the

firms' motivation to utilize FTAs. In the Japan-Thailand EPA, Thailand offered the concession tariffs (e.g., mould, HS 8480, to be 4.17 percent in the first year; 3.33 percent in second year; 2.50 percent in third year; 1.67 percent in fourth year; 0.83 percent in fifth year; and, 0.00 percent in sixth year) against the MFN tariff which is 5 percent.<sup>6</sup> Since the information dissemination on the extent of benefits and processes on the preferential tariff and its comparison with the MFN was quite low, motivation among the Japanese firms to use FTAs turned out to be low as well. Utilization of Japan-Thailand EPA remained low even after its enforcement.

Second, almost Asian governments had arranged for the import tax exemption schemes. Thailand, for instance, had already provided the Board of Investment (BOI) certificate exempting selected materials and parts from import tariff. In 2008, the BOI announced the new regulation to report all the materials including those procured from domestic sources<sup>7</sup>. This announcement made some enterprises to consider the FTAs.

Third, the FTAs in East Asia were problematic. Exporters were burdened with the costs of preparation, yet, the benefits went to importers. Since incentive was low, exporters' motivation to utilize FTAs was low as well. On the contrary, the United States had employed the self-certificate system for the Generalized System of Preferences (GSP). Under this system, Thai exporters can export the goods with 0 percent tariff without any obligation to prepare the documentation.

Fourth, administrative costs were expensive. The application and certificate fee was only 3000-4000 yen in Japan. The fee, which was not so high,<sup>8</sup> covered the cost of developing the software systems that differs by EPA. The administrative costs to prepare for documents and obtain the certificate of origin, however, were very expensive. In particular, the documentation costs to meet the VC rule were quite expensive as well. Furthermore, it was quite difficult to calculate the value content for a single item since the machinery industry normally purchases various items for several clients. In addition, procurement sources of parts/materials were frequently switched depending on the market conditions. This whole process pushed up easily the costs of verification and compliance to ROO. Preparing documentation for certificate of origin was not easy for SMEs. Sometimes, SMEs were requested to prepare the documents for their clients, even if they were not the direct exporters. If SMEs were unable to submit necessary data, such SMEs will lose business by finding another supplier. With these,

SMEs tend to have lesser benefits from FTAs than large enterprises. In Japan, even large enterprises chose only few EPAs that could bring greater benefits to the firm due to their lack of human resources to comply with all its requirements.

Fifth, application data sometimes contained confidential information. In those cases, the FTAs were not utilized by firms. To meet the ROO, the components of products have to be reported to the Chamber of Commerce. But, information on components of the products and/or procurement sources was highly confidential for some products. If the component contained patented material, the manufacturer did not use the EPA at all. The OEM manufacturers inhibited the use of FTAs to protect the secrecy of its sources of materials.

Besides the abovementioned factors, a large number of Japanese firms have already advanced to ASEAN and China. Thus, the benefits gained by the remaining enterprises in Japan were not actually from Japan. The EPAs involving Japan had been too late to influence the remaining enterprises. Also, the large enterprises in Japan, which produced highly differentiated and customized products had stable demand that were not sensitive to changes in prices caused by tariff reduction. For these reasons, EPAs involving Japan will more likely to generate smaller impacts than initially expected, except for very few products.

#### **4.4. Measures to encourage the utilization of EPAs**

What measures will encourage the utilization of FTAs? The “less demanding administration,” including the self-certificate system, was cited by most of the interviewees as a motivating factor to use FTAs. This reflected the strong concern for an implementation flexibility from organizations issuing the certificates. An exporter was required to submit the application with the complete set of documents, including invoices, to the Chamber of Commerce to be able to calculate the VC. Most applicants complained against the Chamber of Commerce for being very strict on required documents, yet, there was no accurate information on how will it be implemented. In addition, the application forms differ by EPA, which further bothered the exporters. It seemed that it will, indeed, take time to familiarize the Japanese exporters with the current application system.

Surprisingly, only an enterprise answered that “less restrictive ROO” may encourage the utilization of FTAs. An electronics and electrical appliance-related firm, which refused to respond to the questionnaires, claimed for the less restrictive ROO.<sup>9</sup> In general, most of FTAs agreements required certificates of origin for every part and/or component, except when exporting the main unit as well as its parts. However, it was difficult to get certificates of origin for some parts. In particular, there were a large number of parts for automobile and the exemption of certificates of origin for the parts attached to the main units may encourage the utilization of FTAs.

Most of current FTAs employed “direct shipment” requirement, wherein goods were directly shipped from an exporter to an importer. However, Singapore has good sea ports to serve as hub station and skilled human resources that can handle the trading transaction between the countries in ASEAN. Thus, the respondent suggested to allow indirect shipment by “re-invoice” or “back to back invoice” operation.

#### **4.5. Best ROO and the spaghetti bowl problem**

Now, EPA involving Japan had proliferated; Japan-Singapore, Japan-Mexico, Japan-Malaysia, Japan-Chili and Japan-Thailand had been enforced. Therefore, a Japanese exporter had faced the “spaghetti bowl” problem, where tariff on a product differed by destination and ROO (including format difference by destination). How do firms in Japan perceive the “spaghetti bowl” problem? Has the “spaghetti bowl” problem excluded to use some EPAs?

When asked about the overlapping of FTAs involving Japan, several enterprises expressed that different ROOs might cause increase of costs. If utilizing even one FTA is already hard for a firm, utilizing several FTAs could be much difficult. It should be noted, however, that there was only one firm, an auto parts maker, who answered that overlapped FTAs actually increased the cost. Other enterprises perceive no problem at this point, but could occur in future.

With regards to the necessity of harmonization of ROO, the option to choose the VC rule or the CTC rule was mostly preferred, followed by the harmonization of the CTC rule. No enterprises chose the VC rule because firms perceived the preparation of necessary documents as time consuming. In particular, machinery part industry

complained about the VC rule due to the difficulty in calculating the local content of a single part. Normally, every manufacturer has “bill of materials” for each product, which is the lists of all intermediate materials and parts. The bill of materials can be used as the documentary requirement for the CTC rule only if the tariff line codes had been added on. A choice of VC or CTC rule plus “self-certificate system” may be considered as the best practice to avoid the FTA trap and spaghetti bowl problem.

Which organizations are expected to help the Japanese enterprises? The highly cited organizations were the Ministries of Economy, Trade, and Industry (METI) and Foreign Affairs (MOFA); and, followed by the business associations. Their preferences implied confidence and reliance to METI, which should provide the venue for consultations and sharing of ideas among the business associations, large firms, and SMEs. Some firms, however, complained that the FTAs by Japan were already too late because most of the firms had already advanced to ASEAN countries.

Lastly, since most of the FTAs took the phase-out tariff schedule where tariffs reduction were gradually over a long period of time. If only that the tariff reduction schedules were well displayed, then, it would promote the utilization of FTAs.

## **5. FINDINGS AND POLICY IMPLICATIONS**

Several findings can be obtained based on the evaluation of FTAs by Japanese firms and its affiliates operating in overseas. These are the following:

- 1) The impact of FTAs involving Japan on business activities by Japanese firms seemed to be smaller than what the CGE model estimated because not many firms were utilizing FTAs.
- 2) Firms, particularly SMEs, were not aware of FTAs. Generally, firms had very poor information about FTAs.
- 3) Owing to the Information Technology Agreement (ITA), most IT-related products had been traded without tariffs.
- 4) Investment promotion schemes, which provide tariffs exemption on intermediate goods for export purpose, like a BOI scheme, had been intensively used instead

of FTAs.

- 5) Phase-out tariff schedules made FTAs unimpressive, lowering the firms' motivation to use FTAs.
- 6) The current FTAs in East Asia were problematic because the exporters were burdened with the costs of document preparation with benefits going to the importers. The incentive for exporters to utilize FTAs, therefore, decreased.
- 7) The administrative costs to prepare documents to acquire ROO were costly for firms, particularly due to the high cost of labor in Japan.
- 8) More importantly, it took time to acquire the certificate of origin from the organizations. It does not match with "just in time" production principle.
- 9) The value content (VC) rule is quite costly. It is quite difficult to calculate the VC since purchasing sources of parts as well as prices frequently change.
- 10) The document of the VC rule required information on costs and procurement sources. Such information, sometimes, contained confidential data because of the patented material and secret sources of the OEM suppliers.
- 11) The change of tariff code (CTC) rule was better practiced than that of the VC rule. The Bill of Materials (BOM) that described a flow chart of production process can be used as a CTC rule certificate material, only if tariff codes were placed on it. Nevertheless, negotiation on the digit level of the CTC rule was a difficult issue. More importantly, acquiring the certificate of origin also took time, even with the CTC rule.
- 12) Due to the high cost of labor in Japan, the overlapping FTAs might force the firms to use FTAs/EPAS selectively; choosing a few selected FTAs/EPAs for a certain products, such as high volume and high MFN tariffs products, mainly on an intra-firm trade.
- 13) Since the ROOs in Asia were cumbersome, FTAs benefited the large enterprises and penalize SMEs. Perhaps, utilization of the FTAs by firms in the least developing countries (LDCs) may not be beneficial.
- 14) Japanese firms ship goods to Singapore and then distribute them to neighboring countries. Bilateral FTAs do not allow "indirect shipment" via Singapore.



Based on the above research findings, a six-policy recommendation is listed below.

- 1) Efforts to dissemination FTAs are quite important. Seminars on how to use of the FTAs, especially for SMEs, should be held frequently, throughout the country.
- 2) The disclosure of operational guidelines, attached with several examples, is necessary. Information on rules of origin and phase-out tariff schedules should be well disseminated.
- 3) The change of tariff line code rule should be launched. Equally, the self-certificate system should be examined and launched as well.
- 4) Rules of origin are burdensome, and unilateral tariff liberalization on a MFN should be launched.
- 5) Trade facilitation measures, such as quick custom clearance, should be launched more intensively to enhance the production networks.
- 6) “Direct shipment” requirement is an unexpected problem. “Indirect shipment” should be allowed. Bilateral FTAs, involving Japan, may not be well fitted with current logistic and production networks. Regional wide FTAs, such as ASEAN, ASEAN+3, or ASEAN+6, should be launched.

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## NOTES

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- <sup>1</sup> Rules of origin are the criteria used to define where a product was made.
- <sup>2</sup> See “Technical Information on Rules of Origin,” posted on the WTO website.
- <sup>3</sup> The survey was conducted as a component of the annual survey on Japanese firms’ international operations:
- <sup>4</sup> The firms are allowed providing multiple answers.
- <sup>5</sup> Japan uses the term of Economic Partnership Agreement (EPA) instead of Free Trade Agreement (FTA).
- <sup>6</sup> The Japan-Thailand EPA was enforced in November 2007, and the first year is the November 2007-March 2008, the second year is April 2008-March 2009.
- <sup>7</sup> Up to 2007, the BOI of Thailand required the report and registration of imported materials and parts.
- <sup>8</sup> However, the application and certificate fee is expensive for automobile part makers because

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application is submitted by part each time. In the United States, the certificate fee is free.

<sup>9</sup> The firm is not counted in the tables.

## Chapter 17

### **Future Research**

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As identified in Chapter 1, the immediate projects urgently needed include the following: further analysis on the interaction between de facto and de jure economic integration; post-evaluation of integration initiatives (e.g., text and implementation of FTAs); assessment of actual liberalization levels (e.g., scorecards for services); assessment of economic institutions and the necessity for convergence or harmonization (e.g., competition policy); and designing the architecture of economic integration (e.g., inputs for the ASEAN Economic Community and beyond). Followings are some of the details of the future research projects for the Economic Research Institute for ASEAN and East Asia (ERIA).

#### **1. Assessing the structure and content of existing and emerging FTAs**

As we have discussed in this report, the pattern of regional FTAs is not optimal at present and is beginning to impose business costs that are detrimental to competitiveness in regional production networks (Chapters 4, 15, and 16). The summary recommends that a more consistent approach is adopted within ASEAN and the region and that a common template be used for trade agreements. Developing such a template requires a research, as well as policy, input.

A method similar to the index methodology, described in the ERIA joint research projects on services liberalization (NZIER, 2008; and ANU 2008), has recently been applied to assessing the liberalizing content of bilateral FTAs. It requires a careful reading of a large number of agreements and building a database that scores the important elements of each. This forms the basis for indexes for each agreement and can also be used for empirical analysis of the real effects of the agreements on trade and

investment flows.

The use of indexes enables a judgment about whether agreements are GATS plus. That same methodology allows a more objective way to compare agreements, showing whether some agreements have more liberalizing content than others. The research also identifies which elements of FTAs matter most in promoting trade between the partners. This is an important step in designing a template of best practice for FTAs and it is extremely important that this evidence-based approach is used. In the absence of evidence, it is likely that templates will be designed on the basis of what is most convenient for negotiators or what is politically expedient. The risk is that if a template with limited economic benefits is imposed it will be ignored by trade policy makers and will not be implemented and proliferation of inconsistent FTAs will continue. Furthermore the research identifies which elements of FTAs have no significant impact on outcomes. These elements do not need to be completely harmonized across countries since their effect is minimal. Thus the research will identify those elements that do need to be imposed on all members but also those where local choices can be allowed with little impact.

In evaluating the structure and content of FTAs, post evaluation of existing FTAs based on large sample surveys can provide a useful information base. As revealed in our analyses, the utilization ratio of existing FTAs has not been very impressive. Identifying the reasons behind this can be the first step to optimize the existing policy framework toward economic integration in East Asia.

## **2. Defining priorities for services sector liberalisation**

Efforts to liberalize services should be concentrated on the most costly barriers in the most restricted sectors (where the gains are greatest). These costly barriers should be the focus of both unilateral reforms and trade negotiations for mutual or multilateral liberalization. Present approaches to reform tend to concentrate either on sectors that are considered easiest to liberalize or on those brought up in the request and offer process of trade negotiations. These are unlikely to be the economically most beneficial sectors nor the measures that need to be tackled first.

Research methods exist to identify a more economically beneficial set of priorities. Data collection for this research requires local knowledge of actual restrictions in place and an analytical effort to establish the costs of different measures. A considerable database has already been created but further research, using local research knowledge, is needed to refine the data. The analytical work can then use this comprehensive and reliable data to establish *which* barriers in *which* sectors are most costly.

The research can produce indexes of restrictiveness of different types of barriers in different sectors in different countries. The research also gives estimates of the aggregate (general equilibrium) cost of the barriers and the benefit (in terms of % of GDP) of removing them. As an important policy aid, the data can also generate “scorecards” showing which restrictions are in place, where progress has been made and where future progress is required. These scorecards come naturally from the templates used to compile the data on restrictions. They are therefore much less arbitrary than many alternative proposals for scorecards. Some system of scorecards will be needed to enable monitoring progress towards the strategic schedule of the ASEAN Economic Community (AEC) Blueprint and this research would provide state-of-the-art methods. These methods should also be introduced at the earliest possible date into the ASEAN Secretariat’s plans for a Services Stocktake so that the data collected for that initiative will be in a format that gives the maximum possible usability for other policy purposes. It is important that there is consultation at an early stage with researchers familiar with the best practice methods for doing such a stocktake. ERIA and its network of research institutes in the region could be a useful structure for compiling the additional information needed to carry out this task.

### **3. Developing and maintaining the scorecard of trade facilitation for ASEAN**

ERIA could maintain and refine the statistical indicators and scorecards for the ASEAN Secretariat to monitor and report on progress towards trade facilitation in the region.

By combining the priorities of the AEC Blueprint and the information relating to each country in two World Bank data sources relating to trade, we have developed a scorecard for measuring trade facilitation in ASEAN.

The objectives of this research are (1) to refine the scorecards and statistical indicators of trade facilitation; (2) to provide annual updates to the scorecards and use these to monitor and compare the progress towards trade facilitation over time; and (3) to emphasise the importance of trade facilitation by comparing the scorecard results with economic outcomes such as trade revenue and economic growth.

Annual updates can be made by incorporating updates to the same and new information sources. Statistical analysis can be employed to analyse the relationship between the scorecard results and economic outcomes.

The initial calculation of the scorecard shows that in 2007 Singapore is the best performer among ASEAN countries in terms of trade facilitation while the Philippines, Lao PDR and Myanmar have substantial room for improvement (Chapter 5). The scorecard will motivate some politicians to seek improvements in and integration of logistics and customs services within ASEAN by indicating which countries have made improvements towards trade facilitation overtime. Over time, it will also provide a check on the rate of progress being made by each ASEAN country. It will also assist policy makers and bureaucrats determine where to devote limited resources to improve trade facilitation.

#### **4. Policy measures to enhance ASEAN's participation in production networks**

ASEAN's intention to enhance its participation in "global supply networks" is very much consistent with the strategic framework developed in our project (Chapter 1). By incorporating the findings of other ERIA research projects<sup>1</sup>, a set of practical policy measures to achieve this objective can be elaborated within a comprehensive and unified framework to pursue deepening economic integration and narrowing development gaps at the same time.

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<sup>1</sup> Kumar (2008), Ariff (2008), Lim (2008), and Sotharith (2008).

Our study on intra-regional trade in East Asia revealed that parts and components transactions led the expansion and intensification of the intra-regional trade, which was different from other regions such as NAFTA and EU (Chapter 2). As the next step, we need to identify the reasons why such trade have been boosted more in East Asia compared to other regions. This issue should be analyzed with careful reference to the findings on the intra-regional FDI flows in East Asia (Chapters 13).

## **5. Research into the benefits and costs of reform**

Another role for ERIA would be to provide the research to establish the benefits and costs of reform and identify their distribution.

While there are typically many who will benefit from trade facilitation reform there are also, in some cases, a few who will suffer significantly because a monopoly rent or source of income they previously enjoyed is taken away. The losers are often employees in the very same public entities which need to develop and implement the reforms. For example, reducing the amount of paper work clearly threatens those whose job it is to create and manage it.

Research into the costs and benefits of reform would include the following specific components of research with ASEAN economies:

- a gravity model study to assess the impact of the costs and time of border procedures on trade flows;
- case studies of the likely level of leakage of trade revenue;
- case studies of the impact of border costs and delays on the investment decisions of potential foreign direct investors; and
- case studies monitoring the outcomes of trade facilitation reforms to see if there are lessons to be learned by other ASEAN economies.

The results from research into the costs and benefits of reform would be expected to produce measures of quantifiable potential gains for the economy. It would provide the quality information needed for policy makers and politicians to take action towards reform and identify the distribution of the costs and benefits to different groups in society during and after the reform.



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