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## **The Feasibility of an ASEAN Customs Union Post-2015<sup>1</sup>**

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### **EXECUTIVE SUMMARY**

- As ASEAN member economies start their discussion on the ‘deepening’ of economic integration, an ASEAN Customs Union (CU) may become a possibility.
- Given that Singapore already operates a zero tariff regime on trade in goods there are two options for ASEAN in moving towards a CU: either all its members will need to inch closer to a zero Common External Tariff (CET), or they will have to form a CU with a positive CET minus Singapore. The latter would however mean that the customs union would only be a partial one.
- The trend in ASEAN’s intra-regional tariff protection suggests that while member countries have achieved a free trade agreement, the grouping’s move towards a customs union will require them to eventually implement a low positive CET for non-ASEAN members.

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<sup>1</sup> This paper is based on an ISEAS Economics Working Paper - AEC Vision Post-2015: Is an ASEAN Customs Union (ACU) Feasible? February 2015 (available on <http://www.iseas.edu.sg/ISEAS/upload/files/EWP20151.pdf>).

- According to our modelling exercise, the creation of a partial ASEAN CU with a positive CET of between 2-5 percent demonstrates that while there may be net benefits for ASEAN as a whole, some members may not gain from it. A CET of 0 percent shows that ASEAN-9 members overall will gain in terms of GDP, while Singapore will experience a negative GDP growth due to potential intra-regional trade diversion. However, the modelling does not capture Singapore's entrepot trade characteristics and comprehensive nature of trade agreements that may affect the results positively.
- Promoting deeper regional integration like the ASEAN CU also entails significant challenges in terms of: tariff peaks and divergence; gaps in beyond-the-border and regulatory measures; a trade diversion risk for Singapore; as well as political economy challenges due to ASEAN's unique characteristics and differing levels in economic development.
- Despite the challenges, an ASEAN CU with more unifying and coherent commercial policies could be considered by ASEAN leaders post-2015. It could be visualised as a form of deeper integration that will not only help strengthen ASEAN's single market objective, but also further the organisation's strategic objectives.

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## INTRODUCTION

As ASEAN member economies inch towards the milestone of an economic community by 31 December 2015, questions have been raised about what the next step of economic integration will be. A common theory of economic integration states five stages: free trade area (FTA), customs union (CU), common market, economic union and total economic integration.<sup>2</sup> The essential difference between an FTA and a CU is the requirement of a Common External Tariff (CET) for non-members.<sup>3</sup> In other words, in a CU there is zero duty between members on imports of goods and services, and a positive CET applicable to all non-members. Besides tariffs, a CU also requires its members to harmonise customs procedures, especially when governing trade with non-members at the regional level. This is because, within a single CU system, customs administrations are required to apply the CET and other regulatory measures in a uniform and consistent manner.<sup>4</sup>

With regard to ASEAN, studies have suggested that the future of the AEC should involve the creation of an ASEAN Customs Union (CU) to ensure the free movement of goods. But the process to establish it will definitely be difficult. Presently, the trade policies of ASEAN countries range from free trade (like Singapore) to some relatively protected economies. Moreover, the varied levels of economic development among the member economies will make it difficult to achieve a Common External Tariff (CET) and a harmonised customs procedure.<sup>5</sup>

This Perspective revisits the issue of establishing a customs union for ASEAN, and seeks to identify key challenges that would arise should the grouping decide to deepen economic integration. To this end, this article analyzes the GDP implications of an ASEAN customs union and discusses the border, beyond-the-border and political economy challenges in establishing such a deeper economic integration. The analysis concludes that despite net positive GDP gains from an ASEAN CU, there are significant economic and political challenges. However, ASEAN's track record, especially in economic integration, suggests that it has the capability to overcome them. Hence, there are grounds for cautious optimism about ASEAN's progress towards a full or partial CU post-2015.

## AFTA – AN ENABLING STEP FOR A CUSTOMS UNION

As of 2012, the ASEAN Free Trade Agreement (AFTA) preferential tariff, especially for the top ten intra-ASEAN imports (which constitute about three fourths of intra-ASEAN trade), suggests that tariffs have been eliminated for ASEAN-6 members, except for a few goods for

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<sup>2</sup> Balassa, Bela. (1961). *The Theory of Economic Integration*. Homewood, Illinois: Richard D. Irwin

<sup>3</sup> Krueger, A. O. (1997). 'Free trade agreements versus customs unions'. *Journal of Development Economics*, 54(1), 169-187

<sup>4</sup> Yasui, Tadashi (2014). *Customs Administrations Operating Under Customs Union Systems*, WCO Research Paper No 29, World Customs Organisation, January

<sup>5</sup> Plummer, Michael. (2006) 'An ASEAN Customs Union?', *Journal of Asian Economic*, 17: 923-938

Indonesia.<sup>6</sup> Barring a few sectors, the CLMV countries have also largely been successful at reducing their AFTA tariffs (Table 1).

**Table 1: Trends in ATIGA Applied Preferential Tariffs across Top Ten Industries in Intra-ASEAN Imports, as of 2012**

HS code	ASEAN-6*	Cambodia**	Lao PDR**	Myanmar**	Vietnam**
15- Animal or vegetable fats and oils	0.0	5.0	10.0	0.0	5.0
27 - Mineral fuels, mineral oils and their products	0.0	5.0	5.0	0.0	20.0
29 - Organic chemicals	0.0	5.0	5.0	0.0	0.0
39 - Plastics and articles thereof	0.0	5.0	20.0	3.0	5.0
40 - Rubber and articles thereof	0.0	5.0	10.0	5.0	3.0
71 -Natural or cultured pearls, precious or semi-precious stones	0.0	5.0	5.0	0.0	5.0
72-Iron and Steel	0.0	5.0	5.0	1.0	5.0
84 - Nuclear reactors, boilers, machinery	0.0	5.0	10.0	1.5	5.0
85 - Electrical machinery and equipment	0.0	5.0	10.0	1.0	5.0
87 - Vehicles other than railway	0.0	5.0	40.0	5.0	5.0

Source: Authors' calculations based on ASEAN Secretariat website (<http://www.asean.org/news/item/annex-2-tariff-schedules>).

Note: \* For Indonesia, some products under HS 29 and 87 continue to apply MFN rates.

\*\* The ATIGA tariffs for CLMV countries show peak tariffs of between 5-10% and higher than that for specific products within the above HS 2 digit sectors. Myanmar ATIGA tariffs are based on 2013 data.

<sup>6</sup> To see the top ten intra-ASEAN imports, please see the discussion of Section 3 in ISEAS Economics Working Paper of Basu Das, Sanchita; Sen, Rahul and Srivastava, Sadhana (2015). 'AEC Vision Post-2015: Is an ASEAN Customs Union (ACU) feasible?' (available on <http://www.iseas.edu.sg/ISEAS/upload/files/EWP20151.pdf>)

The above trends in tariff protection suggest that while ASEAN-6 has partially achieved the AEC goal of a free trade area by implementing a zero tariff regime across nearly three-fourths of intra-ASEAN trade, a move towards a customs union will require them to implement a low positive Common External Tariff (CET) for non-ASEAN members.

## **GDP IMPLICATIONS OF AN ASEAN CUSTOMS UNION**

Given that Singapore already operates a zero tariff regime on trade in goods, an ASEAN move towards a CU requires either all its members to inch closer to a zero CET, or to form an ASEAN CU with a positive CET minus Singapore.<sup>7</sup> The latter option would mean that it would be a partial customs union, where Singapore would still be charged zero tariff on its intra-ASEAN goods exports as per AFTA rules, while non-members will be charged a positive CET on their imports into ASEAN.

In order to explore the Gross Domestic Product (GDP) implications of an ACU, three policy scenarios are imaginable:<sup>8</sup>

- Scenario 1 or base scenario: AFTA implementation with zero tariffs – this would entail zero tariffs among ASEAN-10 members.
- Scenario 2: A customs union minus Singapore with a positive CET of 2-5% on all goods. This ASEAN-9 (minus Singapore), in addition to having the AFTA with zero tariffs, would apply a CET of 2-5 per cent on all imported goods from outside ASEAN. The scenario assumes that imports from Singapore continue to be tariff-free into ASEAN as per ATIGA.
- Scenario 3: A customs union including Singapore with a zero CET on all goods – this futuristic scenario represents a move from an ASEAN FTA with zero tariffs to an ASEAN CU involving a CET of 0 per cent on all imported goods.

Using a Computable General Equilibrium (CGE) model framework, the changes in real GDP in ASEAN countries can be observed under the three scenarios (Table 2). This assumes the ASEAN CU to be on all goods and that all non-ASEAN members do not undertake any tariff changes.

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<sup>7</sup> While this may be an unlikely scenario, ASEAN has in the past crafted innovative policies such as ASEAN-X under ASEAN Framework Agreement on Services as a means to speed up the liberalization process. The ASEAN-X principle allows member countries that are ready to liberalize to move ahead first, while other members join at a later stage. Whether such an approach can be considered for ACU is the question.

<sup>8</sup> The GTAP Version 8.1 based on 2007 data is used for these policy simulations, see [www.gtap.org](http://www.gtap.org) for further details on this database.

**Table 2: Percentage Changes in Real GDP due to AFTA and ACU  
(base year= 2007)**

	Scenario 1		Scenario 2		Scenario 3	
	AFTA	ACU with CET 5% only	ACU with CET 4% only	ACU with CET 3% only	ACU with CET 2% only	ACU with CET 0% only
Cambodia	2.70	1.58	1.88	2.19	2.49	3.09
Lao	0.91	0.54	0.57	0.60	0.63	0.68
Vietnam	1.60	5.38	5.90	6.43	6.95	7.97
Indonesia	0.22	-0.18	-0.07	0.03	0.13	0.33
Malaysia	0.38	0.02	0.34	0.65	0.96	1.56
Philippines	0.69	-0.24	-0.08	0.08	0.24	0.52
Thailand	0.51	0.04	0.25	0.46	0.66	1.03
ROSEAsia	0.27	0.09	0.14	0.20	0.25	0.34
Singapore	0.21	0.10	0.03	-0.03	-0.09	-0.21
OECD	-0.01	0.01	0.01	0.02	0.02	0.02
RestofWorld	-0.01	0.01	0.01	0.01	0.02	0.03

Note: ROSEAsia includes Brunei and Myanmar

Source: ISEAS Working Paper;<sup>9</sup> Authors' calculations

From the above, it can be observed that an AFTA with zero tariffs intra-ASEAN would unambiguously increase the members' real GDP growth. Post-AFTA, creation of a partial ASEAN CU (minus Singapore) with a positive CET of between 2-5 per cent demonstrates that all ASEAN members may not benefit individually, although there may be net benefits for ASEAN-9 as a whole. Singapore is estimated to have a positive GDP gain in a partial ACU at a CET of 5 per cent, the magnitude of which reduces as the CET is lowered progressively. This is because of the erosion of tariff preferences between Singapore and the rest of ASEAN and hence trade diversion occurs from the rest of the world towards ACU members.

For the other ASEAN members, as the CET is progressively reduced from 5 to 2 per cent, it is observed from Table 2 that, while Indonesia and the Philippines will initially experience some negative GDP percentage change, this turns positive thereafter. The rest experience a positive GDP gain from a partial CU. Lastly, if the CU is considered for all ASEAN members

<sup>9</sup> Basu Das, Sanchita; Sen, Rahul and Srivastava, Sadhana (2015). 'AEC Vision Post-2015: Is an ASEAN Customs Union (ACU) feasible?', ISEAS Economics Working Paper (February) (available on <http://www.iseas.edu.sg/ISEAS/upload/files/EWP20151.pdf>)

and a zero tariff is applied towards non-members (Scenario 3), all non-ASEAN members and ASEAN members will benefit, excepting Singapore.

However, an important caveat for all the three scenarios is that they do not capture Singapore's entrepot trade characteristics, the comprehensive nature of trade agreements, member countries' existing bilateral trade agreements and the industry-wise tariff level structure. Including these will most likely increase GDP gains further and may also affect Singapore positively.

Beyond GDP implications, challenges to establish a customs union for ASEAN post-2015 remain. These involve not only border and beyond-the-border measures but also in political economy issues.

## **CHALLENGES TO AN ACU**

### **Protectionist Trends within ASEAN**

Table 3 presents the average MFN applied tariff rates by individual ASEAN members. It is observed that except for Singapore, every ASEAN-6 country charges a positive applied MFN tariff across most of these industries, ranging from a simple average of 3.3 percent across these industries (for Brunei) to 13.2 percent for Thailand. It is notable that Brunei, Indonesia, Thailand and Malaysia are charging a maximum applied MFN Tariff rate across ASEAN-6 for at least two of the top ten industries that contribute around three-fourths of intra-ASEAN trade. Thailand applies the highest average MFN tariff of 60.4 per cent on HS 15 (comprising animal fat and vegetable oil products), followed by 32.2 per cent for HS 87 (comprising parts and components of vehicles other than rail and trams).

**Table 3: Trends in MFN Applied Tariffs Across Top Ten Industries  
in Intra-ASEAN Imports**

HS code	Bru	Indon	Mal	Php	Sgp	Th	Cam	Laos	Mya	Vnm
15	0.0	4.3	2.9	5.8	0.0	60.4	7.0	10.9	1.9	9.6
27	0.0	3.9	0.4	1.7	0.0	2.2	7.2	6.2	0.9	2.3
29	0.0	3.8	0.1	2.0	0.0	0.5	6.3	5.0	1.0	0.8
39	0.0	8.6	10.7	8.4	0.0	7.7	5.4	8.9	2.4	7.4
40	3.6	7.5	19.2	5.0	0.0	8.3	11.8	7.9	3.3	9.0
71	2.3	6.1	0.4	4.9	0.0	4.9	1.7	5.0	14.5	8.7
72	0.0	5.2	7.0	2.8	0.0	3.3	3.5	5.0	1.1	2.9
84	7.5	4.8	3.3	2.1	0.0	3.9	13.3	6.0	1.6	3.0
85	13.3	5.6	4.1	3.9	0.0	8.3	16.9	8.1	4.7	8.0
87	6.0	15.3	16.7	12.4	0.0	32.2	15.3	17.2	5.4	28.1
Simple average MFN for top 10	3.3	6.5	6.5	4.9	0.0	13.2	8.8	8.0	3.7	8.0
Minimum across sectors	0.0	3.8	0.1	1.7	0.0	0.5	1.7	5.0	0.9	0.8

Note: the description of HS codes is given in Table 1.

Source: WTO Tariff Analysis Online database, 2014. Tariff data corresponds to 2008 for Lao, 2011 for Brunei, 2012 for Cambodia and 2013 for all the other ASEAN members.

The above trends in tariff protection suggest that while ASEAN-6 has partially achieved the goal of an FTA, a move towards an ASEAN CU will require them to eventually implement a low positive Common External Tariff (CET) for non-ASEAN members. This, as observed from Table 3, will require significant harmonization efforts across sectors and across countries, resulting in tariff revenue losses that can have serious fiscal consequences<sup>10</sup>.

### **Institutional barriers to trade**

In addition to harmonisation efforts in border tariffs, a possible ASEAN CU will also need elimination or alignment of “beyond-the-border” measures (also known as non-tariff barriers) that restrict trade in goods and cross-border investment flows. ASEAN members currently face significant challenges in terms of institutional barriers to market integration.

The World Economic Forum’s *Enabling Trade Report* (2014)<sup>11</sup>, observes that Singapore represents the most liberalized trading environment, keeps transparency in border-crossing

<sup>10</sup> Plummer, Michael. (2006) ‘An ASEAN Customs Union?’, *Journal of Asian Economics*, 17: 923-938

<sup>11</sup> Enabling Trade Index compares the quality of institutions, policies & services that facilitate the cross-border flow across 138 countries.

procedures and is well supported by strong infrastructure and an enabling environment for business. Among other ASEAN members, Malaysia is also well regarded in terms of its institutional quality for facilitating trade with an overall ranking of 25. Among the four sub-indices, it is found that Cambodia, Laos and Thailand perform poorly with respect to allowing domestic market access. In terms of non-tariff barriers (NTBs) such as the efficiency and transparency of border administration, most ASEAN members, with the exception of Singapore, perform poorly. The same can be said for infrastructure and business operating environment in the region (Table 4).

**Table 4: Enabling Trade Index Rankings for ASEAN Members, 2014**

	Enabling Trade Index 2014 Rankings	Market Access sub-index		Border administration sub-index	Infrastructure sub-index	Operating environment sub-index
		Domestic market access	Foreign market access	Efficiency and Transparency of border administration		
Singapore	1	3	13	1	1	2
Malaysia	25	75	42	33	23	27
Thailand	57	113	12	56	46	75
Indonesia	58	26	37	69	64	61
Philippines	64	19	26	71	89	82
Vietnam	72	76	28	86	60	81
Cambodia	93	133	1	108	101	74
Laos	98	121	4	114	115	68
Myanmar	121	97	6	117	136	134

Source: World Economic Forum (2014)

The above implies that for an initiative like ASEAN CU, the harmonization of the NTBs, especially against the rest of the world, is likely to be a key challenge.

### **Political Economy Challenges**

Although an ASEAN CU may allow for greater gains from trade and FDI, the diversity of ASEAN members and their varied interests can pose formidable obstacles. Some political economy challenges are discussed below.

First, can a CU materialize without ASEAN changing its unique characteristics? For example, will the ‘ASEAN Way’ have to be change? Can it continue preferring loose arrangements rather than formal agreements, depend on personal relations among ministers and leaders rather than strong institutions and rely on consensus and common interests rather than on high-level binding commitments?<sup>12</sup> Furthermore, can the centrality of national sovereignty continue at the cost of ‘pooled’ sovereignty under any regional initiative? Another stumbling block is ASEAN’s principle of ‘non-interference’<sup>13</sup>. Indeed, the adoption of Common External Tariff (CET) will deepen ASEAN integration but will challenge some fundamentals in the organisation’s make-up.

Second, ASEAN countries have at present divergent tariff structures. Singapore is already duty-free and Brunei almost similarly so. Creating an ASEAN CU may either require Singapore to abandon a regime that is fundamental to their economies or require other members to lower their tariff levels to zero. Either of these are hard to achieve.

Third, in ASEAN countries; interest groups at the domestic level play an important role in regional economic cooperation matters. It has been repeatedly mentioned by analysts that protectionism persists despite free trade being an official optimal policy choice. In practice, domestic politics and domestic interest groups seek to maintain trade barriers and economic restrictions, under the guise of ‘national interest’.<sup>14</sup>

Finally, an ASEAN CU would be difficult to devise and implement. This is because, moving from an FTA to a CU is not only an economic advancement but also a significant political step. In addition to the above mentioned issues, there are other questions that need to be addressed. For example, who gets the revenue from a CET? How will countries having to eliminate external tariffs be compensated for the fiscal shock? It is this difficulty that explains the fact that only around six percent of preferential trade agreements (PTAs) notified to the GATT/ WTO are custom unions<sup>15</sup>. This implies that although many sign up for a Free Trade Area, very few are prepared to pool their sovereignty.

## CONCLUSION

As the end of 2015 milestone approaches, the debate continues to be on the vision and direction of the AEC beyond that point. Given the current economic situation, characterized

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<sup>12</sup> Severino, Rodolfo. (2006) *Southeast Asia in Search of an ASEAN Community*, Singapore: Institute of Southeast Asian Studies

<sup>13</sup> ASEAN Secretariat (1976), Treaty of Amity and Cooperation in Southeast Asia, Indonesia, 24 February 1976

<sup>14</sup> Sally, Razeen. (2008) *Trade Policy, New Century*, The Institute of Economic Affairs ; (Balboa, J.D., del Prado, F.L.E and Yap, J.T. (2012). ‘Achieving the AEC 2015: Challenges for the Philippines’ in Sanchita Basu Das (Eds.), *Achieving ASEAN Economic Community 2015: Challenges for Member Countries and Businesses*, Singapore: ISEAS, pp. 99-124

<sup>15</sup> According to the WTO, as of 15 June 2014, some 585 notifications of RTAs has been received by the GATT/ WTO. Of these, 379 were in force and 25 have progressed to CU.

by the tilting of the global ‘centre’ of economic gravity to the east, continuing proliferation of mega-FTAs and the increasing ASEAN footprint in the global and regional environment, the grouping’s economic integration needs to be viewed on an evolving continuum. In this scenario, promoting deeper regional economic integration in terms of a customs union can be considered a possibility. ASEAN as a whole would gain in terms of GDP. However, not all ASEAN members will individually gain from an ASEAN CU. Such being the case, members may need to devise a mechanism wherein a member country’s losses can be compensated by members who benefit from the exercise.

Promoting deeper regional integration within ASEAN entails significant challenges such as: tariff peaks and divergence; gaps in beyond-the-border and regulatory measures; trade diversion risks for Singapore (though the modelling exercise does not consider Singapore’s unique feature of entrepot trade and many other features of a comprehensive trade agreement); as well as political economy challenges due to ASEAN’s unique characteristics and differing levels of economic development among members.

Nevertheless, ASEAN economic integration has not developed solely as an economic project.<sup>16</sup> There could be pressing strategic imperatives, including the economic vulnerability of the West; the desire to maintain a competitive edge with China particularly to attract FDI; and the desire to entrench ASEAN Centrality. These factors may provide added incentive for ASEAN states to cooperate and overcome the challenges mentioned. This organizational consolidation has happened in the past as ASEAN, for example when it moved from the AFTA in the 1990s to the more rules-based approach of the AEC. Hence, going beyond 2015, ASEAN leaders may not consider the Customs Union an impossible target. Instead, they may visualise the union as a form of deeper integration that will not only help attain its single market objective, but will also help to further its strategic goals.

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<sup>16</sup>Basu Das, Sanchita (2015). The ASEAN Economic Community – An Economic and Strategic Project, ISEAS Perspective #4, 29 January ([http://www.iseas.edu.sg/documents/publication/ISEAS\\_perspective\\_2015\\_04.pdf](http://www.iseas.edu.sg/documents/publication/ISEAS_perspective_2015_04.pdf))