Status of Philippine Commitments to AEC 2015 and Recommendations[1]

This brief paper summarizes the status of Philippine commitments to AEC 2015 and provides some policy recommendations that could help the economy to maximize opportunities arising from economic integration.

Implications of the AEC for the Philippines

Overall, there will be a large market offering tremendous opportunities for firms, Filipino professionals and labor, and consumers. The key to participation in this large market is competitiveness of firms, investment climate conducive to investments and other economic activities and well-educated and trained human capital.

a. Market access opportunities for Filipino firms to expand: Filipino companies can sell to 600 million people. Consumers will have wider choice of lower priced products.
b. Investment liberalization, facilitation, promotion, protection, national treatment, and most favored nation treatment: Filipinos can own 100 percent of companies in other ASEAN countries and should be able to own 70 percent (maybe more) of services companies; Filipinos will have access to capital markets, take advantage of repatriation of profits and dividends; Filipinos will be treated equally as local companies/people. Other ASEAN firms/nationals can likewise invest in the Philippines and contribute to greater productivity of domestic manufacturing and industry.
c. Labor mobility: it will be easier for firms to bring in workers, which will be complementary to services, and for Filipinos to likewise tap opportunities in ASEAN-wide labor markets.
d. Lower transaction costs relating to transport and logistics, trade facilitation, product standardization and conformance through improved administrative processes (customs, mutual recognition) and easier/less costly movement goods. The government has put up the National Single Window to link government agencies and streamline customs processes. AEC will have an ASEAN Single Window to facilitate trade among the members.

AEC Blueprint and Agreements

To deepen economic integration of ASEAN, the ASEAN Economic Community (AEC) is envisioned in the AEC Blueprint as having four pillars: (a) a single market and production

[1] Presented by Gilberto Llanto, President, Philippine Institute for Development Studies to the House of Representatives Committee on Economic Affairs in response to House Resolutions 666 (by Rep. Ma. Lourdes Acosta-Alba) and 746 (by Reps. Rufus Rodriguez and Maximo Rodriguez), May 27, 2014. Inputs from Senior Fellows Rafaelita Aldaba, Adora Navarro, and Roehl Briones are acknowledged.

base, (b) a highly competitive economic region, (c) a region of equitable economic development, and (d) a region fully integrated into the global economy.

(a) Under "single market and production base", AEC is expected to achieve free(r) flow of goods, services, investment, capital, and skilled labor.
(b) Under "highly competitive economic region", efforts include adopting competition policy, protecting intellectual property rights, infrastructure development, and improving taxation and E-commerce.
(c) Under a "region of equitable economic development", efforts include SME development and the Initiative for ASEAN Integration with the objectives of narrowing the development gap and accelerating economic integration of the newer members of ASEAN, namely Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV).
(d) Under a "region fully integrated into the global economy", ASEAN seeks to adopt a coherent approach towards external economic relations and achieve enhanced participation in global production networks (GPNs).

The ASEAN Trade In Goods Agreement (ATIGA) now governs the ASEAN Free Trade Area (AFTA) for intra-ASEAN trade in goods. It covers the elimination of tariff barriers under a tariff reduction program; the elimination of quantity restrictions and nontariff barriers; and rules of origin (ROO) in which only ASEAN products that are directly produced within the region will qualify for benefits of AFTA. The ASEAN Free Trade Area (AFTA) has now been virtually established. In the ASEAN-6 countries, more than 99% of tariff lines already have 0% tariff (starting in 2010). Issues remaining are trade facilitation measures and remaining non-tariff barriers.

The ASEAN Comprehensive Investment Agreement (ACIA) governs intra-ASEAN investment. It has four pillars: liberalization, protection, facilitation, promotion. Its objectives are to enhance ASEAN competitiveness, attract foreign direct investment (FDI), and increase intra-ASEAN investment. The agreement seeks to extend non-discriminatory treatment, reduce/eliminate restrictions to entry of investments, and reduce/eliminate restrictive investment measures and other impediments including performance requirements.

To achieve freer movement of capital, ASEAN finance ministers are working to develop and integrate the region's capital markets. Steps are being undertaken to achieve greater harmonization in capital market standards in areas of offering rules for debt securities, disclosure requirements, and distribution rules; facilitate mutual recognition of market professionals; achieve greater flexibility in language and governing law requirements for securities issuance; enhance the withholding tax structure to promote the broadening of investor base in ASEAN debt issuance; and facilitate market-driven efforts to establish exchange and debt market linkages, and bond market development. The ASEAN Banking Integration Framework (ABIF) was endorsed by ASEAN central bank governors in April 2011. It calls for the harmonization of prudential regulations principles; building financial stability infrastructure as well as capacity building for Brunei and CLMV; and agreed criteria for ASEAN Qualified Banks (QAB) to operate in any ASEAN country.

To facilitate the flow of skilled labor, there are already seven mutual recognition arrangements (MRAs) providing common professional standards. These involve medical practitioners, dental practitioners, accountancy services, engineering services, nursing services, architectural services, and surveying qualifications.

To promote the free flow of services, ASEAN has adopted the ASEAN Framework Agreement on Services (AFAS) to remove barriers such as market access (no. of services providers) and national treatment (foreign equity restrictions). Priorities are the sectors of business, professional, construction, distribution, education, environmental, healthcare, maritime, telecoms, and tourism. There will be no restrictions on ASEAN services suppliers in providing services and in establishing companies across national borders. Up to 70 percent foreign (ASEAN) equity in services companies will be allowed.

Connectivity is central to an integrated production base and a unified market. The AEC's three-pronged strategy involves physical connectivity, institutional connectivity and people-to-people connectivity. Physical connectivity is being pursued through cooperation in and investments on physical infrastructure, e.g., air and maritime transport, not only to facilitate trade but also to enable the movement of labor within the region.

Physical connectivity initiatives:

- Transport: ASEAN Highway Network, Singapore-Kunming Rail Link, ASEAN RORO Shipping Network, multi-modal transport corridors
- ICT: ASEAN ICT Masterplan 2015
- Energy: ASEAN Power Grid, Trans-ASEAN Gas Pipeline

Institutional connectivity initiatives (among others):

- framework agreements on transport facilitation: ASEAN Framework Agreement on the Facilitation of Goods in Transit (AFAFGIT), ASEAN Framework Agreement on the Facilitation of Inter-State Transport (AFAFIST), ASEAN Framework Agreement on Multimodal Transport (AFAMT), ASEAN Framework Agreement on the Full Liberalization of Air Freight Services (AFAFLAFS), ASEAN Multilateral Agreement on Air Services (MAAS), and the Multilateral Agreement on the Full Liberalization of Passenger Air Services (MAFLPAS)
- ASEAN Single Aviation Market, ASEAN Single Shipping Market
- liberalization of logistics services

Status of Philippine Commitments

The Philippines is advanced in terms of allowing the free flow of goods. Tariffs have been removed for most goods in 2010 under EO 850. Rice and sugar are categorized as sensitive products with tariff protection of 40 percent and 10 percent, respectively.

In ASEAN, various nontariff measures may potentially function as nontariff barriers, namely sanitary and phytosanitary (SPS) measures, import licensing, and market segmentation for sugar. Given the sensitivity of competition in agriculture, this sector may be among the last holdouts of economic isolation in an era of ASEAN integration. So, free competition in agriculture by 2015 is a distant goal. Reforms need to be pursued along lines of ASEAN integration to improve efficiency in agriculture, such as: repeal of remaining quantitative restrictions (QRs); further tariff cuts for some sensitive products (rice, corn, maize, poultry); and not least, harmonizing food safety standards and assurance system with the rest of ASEAN. In the case of SPS, the country has recently passed a food safety law (Republic Act 10611) and is still refining the implementing rules and regulations, which is a golden opportunity to improve the competitiveness of the food industry.

Efforts to promote the free flow of investments and skilled labor have commenced. While the government's investment promotion agencies are working to promote the Philippines as an investment destination and facilitate the entry of FDI, the country still has to deal with remaining foreign equity restrictions due to constitutional limitations. In skilled labor, Republic Act 8981 already allows the entry of foreigners subject to foreign reciprocity provisions. The Professional Regulation Commission and the Department of Labor and Employment (DOLE) are facilitating MRA implementation. DOLE is tasked to come up with a positive list and identify skills shortages. The positive list will contain a list of occupations that are hard to fill, and may include two professions from each of the priority areas of the ASEAN.

The Philippines is behind in its services commitments due to foreign equity restrictions under the 1987 Constitution. For example, no foreign equity is allowed in mass media except recording, practice of all professions, and retail trade enterprises with paid-up capital more than USD 2,500,000. Only 20 percent foreign equity is allowed in the operation of private radio communications networks; up to 25 percent in private recruitment, contracts for construction, and repair of locally funded public works defense-related structures; up to 30 percent in advertising; and up to 40 percent in exploration, development and utilization of natural resources; land ownership; operation and management of public utilities; ownership/establishment and administration of educational institutions; culture, production, milling, processing, trading excepting retailing, of rice and corn; contracts for supply of materials, goods and commodities to GOCCs or municipal corporations; BOT requiring public utilities franchise; and operation of deep sea commercial fishing vessels.

The ADB notes that ASEAN banking market has seen little integration; ASEAN 5 has opened up the banking industry but cross-border banking and penetration has been slow to develop.

Other reforms related to economic integration efforts include the passage of the Enhanced Basic Education Act of 2013 (K to 12) which provides a more solid basic foundation for students and aligns the country with international standards for the recognition of students and professionals abroad.

The Data Privacy Act of 2012 seeks to bring the Philippines' data protection policies and measures in line with the international standards of data privacy protection. It is intended to protect the integrity and security of personal data in both the private and public sectors and will enhance the country's competitiveness particularly in ICT-enabled services.

As a result of effective governance reforms, the Philippines was recently removed from the US Trade Representative Office's Watch List in the 2014 Special 301 Report. This decision was based on the collective weight of a series of significant legislative reforms, a move toward more effective civil and administrative enforcement efforts, sustained and constructive engagement with the US Government and members of the private sector by the authorities, and commitments to continue to address remaining concerns.

Meanwhile, the list of "Key strategies to Enhance Connectivity" through physical infrastructure is being monitored by the ASEAN Secretariat. The following are status updates from the ASEAN Secretariat, which were supplemented with Philippine-specific information (as of 10 March 2014).

- Strategy 1. Complete the ASEAN Highway Network (AHN)
    - Install common road signs in designated routes - the Philippines has approved budget for AHN26 route signages
    - Upgrade Class II or III sections with high traffic volume to Class I (by 2020) - Philippines: rehabilitation of Davao-General Santos Road
    - Feasibility study on bridging archipelagic countries and mainland ASEAN (by 2015)
- Strategy 2. Complete the implementation of Singapore-Kunming Rail Link project
    - Not an immediate Philippine concern
- Strategy 3. Establish an efficient and integrated inland waterways network (in CLMV countries)
    - Not an immediate Philippine concern
- Strategy 4. Accomplish an integrated, efficient and competitive maritime transport system
    - Upgrading of selected ASEAN ports. Philippines: Cebu Port (CPA, purely private funds); 5 PPA ports: Davao Ports (privatization, BOT mode, in the

PPP Center pipeline), Iloilo Port modernization (ROK-funded, FS completed), Cagayan de Oro Port (ROK-funded FS completed), Gen San (modernization plan), Zamboanga (modernization plan)
  - Feasibility Study on ASEAN RORO Network and Short-Sea Shipping - completed in 2013
- Strategy 5. Establish integrated and seamless multimodal transport system to make ASEAN the transport hub in the East Asia region
  - Thailand and Malaysia prepared proposals; a list of ASEAN dry ports (in mainland ASEAN) has been prepared
- Strategy 6. Accelerate the development of ICT infrastructure and services in each of the ASEAN Member States
  - ASEAN ICT Master Plan 2015. Philippines: ongoing - Submarine Cable Protection Project (with ITU); ASEAN Internet Exchange, ASEAN International Gateway, and ASEAN International Diversity (with Indonesia and Thailand)
- Strategy 7. Prioritize the processes to resolve institutional issues in ASEAN energy infrastructure projects
  - ASEAN Power Grid and Trans-ASEAN Gas Pipeline: the economic viability of the planned projects has yet to be established and accepted by the participating ASEAN members
  - Energy infrastructure is one of the "beyond 2015" measures under the AEC. Navarro and Tri Sambodo (2013)[2] opine that the following is the possible pathway to ASEAN energy market integration through 2030: expand the initiated GMS power grid integration effort; at the same time, accumulate shared assessments of resource, trading, investment, market structures and regulations; then forge a regional accord; and pursue energy security through integration that is flexible enough given that national constraints include subsidies, lack of independent regulators, and energy resource imbalances.

The Study on the ASEAN RORO and Short-Sea Shipping Network conducted by JICA was completed in March 2013 and the Philippines is set to benefit from the network connection that will be established. The study initially identified Brooke's Point (Palawan), Zamboanga City, General Santos City, and Davao City as possible ASEAN RORO ports that can connect to the rest of ASEAN via Indonesia. The final recommendation is the Davao Port as primary gateway and General Santos City Port as connecting port. The Bitung (Indonesia)-Davao-General Santos route is recommended as a priority project under the AEC.

[2] Navarro, A.M. and M. Tri Sambodo. 2013. The Pathway to ASEAN Energy Market Integration. Bangkok: ASEAN Studies Center, Chulalongkorn University.

Challenges and Threats Posed by the AEC

The major threat is posed by competition from new entrants to the market who are bigger, have more financial capability and have better technical products/service systems. These new entrants may get support from home countries, and may already have more experience competing overseas.

Under the AEC, the winners will be firms that gain from market expansion and improved competitiveness, workers who get employed in growing sectors, the government which will collect higher revenues, and consumers who will be able to choose from a wide variety of goods and services at lower prices. The losers will be inefficient, uncompetitive sectors.

A challenge is SMEs' lack of access to finance, technology, skilled labor, as well as their inability to comply with standards and weak linkages to high-tech sectors. For SMEs, penetrating the export market a major hurdle.

The Way Forward

Given a market of more than 600 million people, AEC represents opportunities for increased FDI flows, market access, lower input costs, reduced transaction costs, and availability of a wide range of better quality goods and services at lower prices. Businesses including SMEs could gain especially those that are integrated with regional production networks. . However, firms that remain uncompetitive, will have a hard time surviving an open economy characterized by intense competition.

At the heart of the game plan is improving the country's competitiveness. This is key to empowering business to facilitate the adjustment process to AEC integration. To achieve this, government and the private sector need to focus on industry upgrading and restructuring, revitalize manufacturing, and move up the value chain. Firms' strategy must be based on a global perspective—the market is not just the Philippines but the entire ASEAN region. Competitiveness is crucial, along with strengthening institutional and regulatory environment to lower the cost of doing business and make the Philippines a regional hub for MNCs.

The government has adopted a new Industrial Policy as a strategy to take advantage of globalization and regional economic integration efforts. It is anchored on the Manufacturing Industry Roadmap, which was motivated by the following:

- Globalization and rising regional economic integration imply both opportunities and challenges. Competition will be intense, and to take advantage of the opportunities, productivity improvement and competitiveness will be crucial.
- The best way for Philippine firms to be competitive is through manufacturing and industry upgrading. Manufacturing and industry upgrading will lead to inclusive growth, create quality jobs, increase income, and reduce poverty.

There are 800,000 new entrants to the job market every year, adding to the current 3 million unemployed and the 7.3 million underemployed. Services cannot provide all the needed jobs, while manufacturing can employ skilled, semi-skilled, unskilled workers, and thus, will be able to absorb annual large increases in the labor force.

The new industrial policy will improve competitiveness by removing obstacles to growth, promoting efficient use of existing capacity and expansion of productive capacity, deepening participation in regional production networks, and engaging in innovation and technology upgrading. The new Industrial Policy is not about across the board income tax holidays or export subsidies; it is about coordination and facilitation to address the most binding constraints to growth and create a proper environment for private sector development along the country's comparative advantages.

The AEC should be viewed as an enabler of regional integration and a facilitator of industrial development. By requiring competitiveness and productivity from firms to be able to stay in the market, it provides an opportunity to empower businesses. Firms need to formulate their own strategies based on a global perspective and address gaps in their supply chain. Is it raw materials and/or logistics that are making them uncompetitive? Firms need to know consumers in ASEAN and create product niches as well as engage in innovation. To access the markets of ASEAN neighbors, firms must comply with the ROO, product standards and conformance procedures, and be prepared for joint ventures and partnerships.

A constant refrain in regional presentations and briefings by PIDS about AEC and infrastructure and logistics is that the actions needed to be taken in order to boost competitiveness in a single ASEAN market are <u>actions that the Philippines needs to do anyway even without the AEC</u>. We need to take those actions given the poor quality and inadequate stock of our infrastructure. These actions should include the following:

- Boost infrastructure spending
    - target is 5% of GDP by 2016
- Make critical investments in airport infrastructure facilities and air navigation system
    - congestion in airport terminals is a serious problem: e.g., NAIA 1 served 7.5 million passengers in 2012 but its capacity is only 5.5 million passengers
    - takeoff and landing capacity constraint is also a problem: e.g., NAIA is designed to accommodate 36 aircraft movements (takeoff and landing) per hour but served 50 aircraft per hour in summer of 2012
- Improve port infrastructure and modernize port operation
    - through efficient PPPs as much as possible
- Remove conflict-of-interest situation in ports operation
- Have a strategy for optimizing underutilized ports (e.g., Batangas and Subic ports)