# The ASEAN Economic Community (AEC)

Managing Risks and Opportunities in Trade, Tax and IP

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# Content

## 1.0 The ASEAN Economic Community

The official launch of the ASEAN Economic Community (AEC) at the end of 2015 will not set off any fireworks. No light switch will go on. Nevertheless, the official launch date on December 31, 2015, will mark the continuation of a multi-year process leading to the emergence of a new globally competitive economic zone that could be worth US$4.7 trillion by 2020. Companies expect both their operations and profits in the region to expand.

The emergence of the AEC as a more integrated and competitive economic zone is a significant development both for individual companies and the global economy. The actual launch date is less important than forward momentum towards integration.

The aim of this paper is to identify the more significant risks and solutions in areas such as trade, taxation and intellectual property (IP) linked to the AEC. Discussion of these risks and possible solutions was a key focus of the Thomson Reuters ASEAN Integration Summit in Singapore on March 26.

Companies from around the world are not oblivious to the opportunities that greater integration among the 10 nations that make up the Association of Southeast Asian Nations (ASEAN) will generate. They are certain to benefit from closer trade ties, easier movement of products and services and links to global trade within a region that is home to 600 million people. The eventual harmonization of trade rules, standards and enforcement will open up even more opportunities.

Two thirds of companies surveyed by the American Chamber of Commerce (AmCham) in Singapore say ASEAN markets will become increasingly important over the next two years in terms of revenues. Nine out of every 10 companies expect trade or investment into ASEAN countries to rise over the next five years.


These things will not happen easily. As they expand in the region, companies will have to address a series of key risks, often linked to changing regulations, particularly in these areas of trade and taxation, and consider and implement solutions that manage these risks before any adverse events occur.

There are solutions available to address all these risks, solutions that can help companies take the most advantage of free trade agreements (FTAs) in the region, optimise their tax position by strategically localising their various operations and supply chains or manage and protect their IP. Addressing these risks early will make it easier for companies to leverage the many opportunities that could arise out of the emergence of a more tightly knit AEC, such as more and easier cross-border trade, greater access to new and growing markets, lower costs of manufacturing and logistics, effective research and development and access to talent.

[1] *Singapore Institute of International Affairs*

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## 2.0 Changing Environment

Even after the official launch, work towards full implementation of the AEC agreements will continue. Various initiatives that have been evolving since 1993 should start having a more significant impact in terms of enhancing competitiveness and lowering transaction costs in the region, says Aladdin Rillo, a senior economist at the Asian Development Bank Institute.

Greater integration will remain a work in progress even after the launch date but to reach all its targets the AEC will have to overcome some significant challenges.

The first such challenge is the enormous differences in levels of development across the 10 ASEAN countries. The GDP per capita in the richest country in ASEAN, Singapore, is 33 times higher than the poorest, Lao PDR. In contrast, GDP per capita in Luxembourg, the wealthiest country in the European Union, is just four times higher than Romania, the poorest. There are also huge gaps in infrastructure, legal development, corruption, transparency and IP protection.

A second challenge is competition for resources, exports and investments among ASEAN members. This competition is both a cause and effect of mutual suspicion and a focus on national interests that permeates the region.

A third challenge is weak institutions at both national and supranational levels. Weak institutions make it difficult to implement agreements, including agreements countries have signed up for.

These challenges have very real impact on companies. Trade in services, for example, is still far from being seamless even though liberalising service sectors is a stated priority in the AEC blueprint. Moving people from one country to another also remains difficult. At the same time, product standards are far from being harmonised while agreements on investment are in place but compliance is spotty.

"They all agree at various regional commitments under the AEC. The (problem) is how to implement them at the national level" says Rillo. "In the area of investments, countries are still constrained in terms of raising foreign equity participation."

Ultimately, implementation might represent the biggest risk for companies in the AEC over the next few years. There is an office at the ASEAN Secretariat (based in Jakarta, Indonesia) to monitor implementation but the office is small and does not have a regular budget. Countries and the region as a whole are approaching this implementation risk in three different ways.

One is better communication and collective management of regulations. Another is better coordination of integration efforts. A third is a more holistic approach to implementing AEC agreements by considering the needs of economic and market integration, says Rillo. Integration in some areas is happening much faster than in others. Tariffs for the trade in goods are virtually at zero but reducing non-tariff measures (NTMs) is proving to be a more difficult challenge. Integrating product standards or investment regulations is also proving to be a difficult challenge.

To date, around 84% of the goals set out in the AEC Scorecard have been implemented. The AEC Scorecard is a compliance tool but one without an enforcement mechanism.

"A problem right now is that each issue is treated individually. There is a need for a more holistic approach at implementing the various aspects of market integration. It is like looking at a supply chain, each part of the chain should be connected," says Rillo.

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## 2.1 Trade Concerns

ASEAN members have already reduced tariffs to the point that trade is mostly free thanks to various agreements, including a Common Effective Preferential Tax Rate (CEPT) scheme. There are also agreements that extend free trade agreements (FTAs) beyond ASEAN to countries such as Australia, New Zealand, China, Japan and South Korea. More of such deals are likely to emerge. A Regional Comprehensive Economic Partnership (RCEP) is under negotiation that would bring these agreements under one large umbrella.

For companies, the hurdles that remain are not linked to tariffs but to NTMs. NTMs range from regulations on food safety and product quality to quotas on imports. Some restrictions on foreign exchange also remain. In some cases, these NTMs are actually getting higher. After the Global Financial Crisis, countries like Indonesia, Malaysia, Thailand and Vietnam raised these barriers further. To facilitate trade further, countries across ASEAN will need to invest in infrastructure and implement uniform standards to ensure such things as product quality and IP protection.

Companies across Asia are building ever more complex supply chains traversing different ASEAN countries, driven by 1) increasing manufacturing capabilities in the region; 2) wage differentials that are often increasingly favourable to China; 3) liberal trade policies such as FTAs that make such supply chain structures tax-efficient and 4) policies that favour investment in manufacturing operations in the region. This is helping ASEAN countries drive migration toward a manufacturing-based economy in the region, thus helping in their development.

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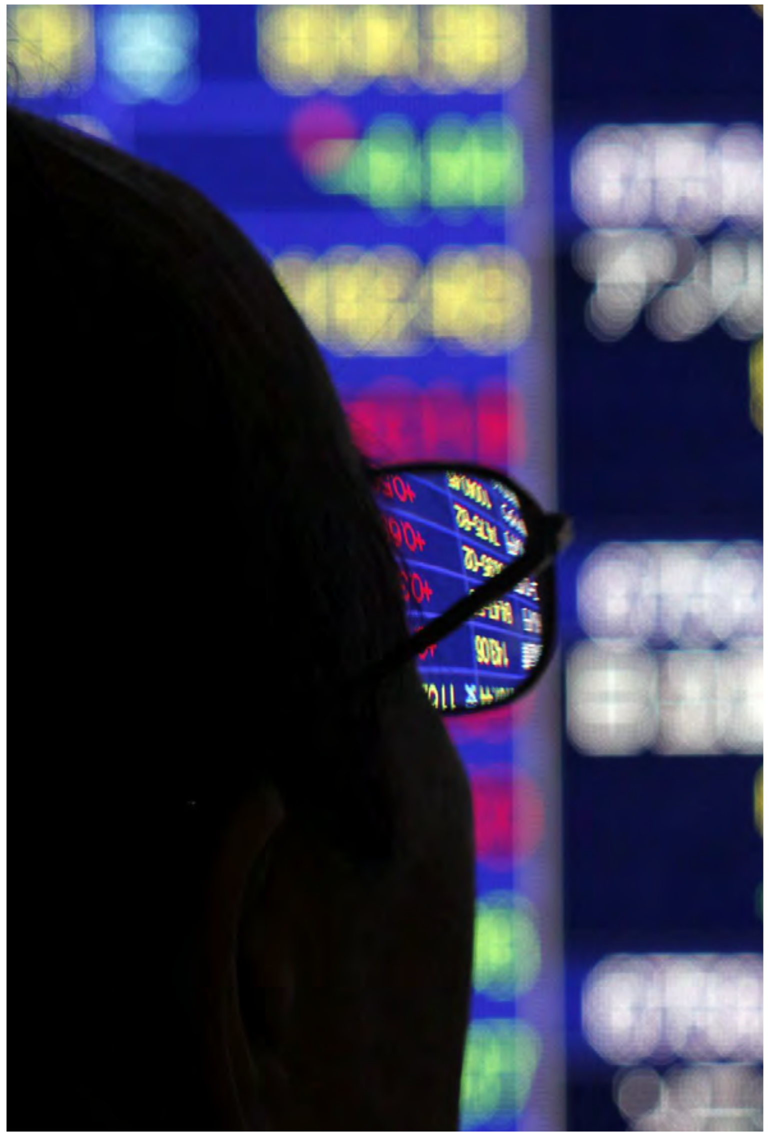
For their part, companies will have to manage tax and legal requirements as well as a complex spaghetti bowl of Free Trade Agreements (FTAs). Effective management can help lower the costs of trade in ASEAN and with ASEAN's partners, says KPMG's Brahma Sharma. For example, a US company that exports juice drinks directly to China has to pay a 30% most favoured nation (MFN) tariff but if the company exports juice concentrate to Thailand and then the finished juice products to China, the levy drops to 10% on each move.

FTAs have proliferated since the first such agreement, the Asia-Pacific Trade Agreement (APTA), was signed in 1976. The ASEAN FTA was signed in 1993. By January 2000, there were three FTAs in the region. By April 2013, there were 76. More broadly, the number of FTAs around the world involving at least one nation in Asia or the Pacific jumped to 215 by March of 2015 and 126 are now effective. The 10 ASEAN countries are, individually, involved in 164 FTAs. There are nine FTAs involving ASEAN as a region that have been launched or are under negotiations, including the Regional Comprehensive Economic Partnership (RCEP) of ASEAN+6 – Australia, India, Japan, China, South Korea and New Zealand.

A study in 2013 found that 49% of exports out of South Korea and 42% out of Thailand between 2008 and 2011 relied on FTAs. By 2011, about a third of all enterprises in China, Japan, South Korea, Malaysia, Philippines, Singapore and Thailand regularly used FTAs in trading2. Another survey in 20143 found that half of all exporters use the ASEAN FTA.



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Companies also have to overcome challenges linked to different standards, such as those linked to testing. Trading is straightforward enough, but meeting various standards can be difficult. Different countries often have different testing and licensing requirements or mechanisms. Such differences can be expensive for companies to comply with.

Aligning all these regulations is the holy grail of economic groupings like the AEC, but this is not likely to happen for some time. Between now and then, companies will have to implement solutions that are available to identify savings and streamline supply chains.

## 2.2 Taxation Integration

Greater integration across the AEC does not extend to tax policy or rates. Taxation remains a domestic concern.

There are significant differences in tax structures from country to country, with Lao PDR, Philippines and Vietnam having the most complex taxes. However, notes Thomas McNutt, Head of Government and Public Affairs at AmCham Singapore, there is more clarity of tax structures across ASEAN than most companies expect even though the differences are large.

Tax rates also vary significantly from country to country. Singapore, for example, has a corporate income tax (CIT) rate of 17% while the rate in the Philippines is 30%. Brunei has no personal income tax but both Thailand and Vietnam charge 35%. Aligning tax rates is, if not impossible, extremely difficult, said KPMG's Sharma.


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This is not to say that the AEC will not concern itself with tax issues. There are plans to amend the way withholding taxes are structured to facilitate investment in ASEAN-issued debt. At the same time, since 2010, there is a network of bilateral tax treaties among the 10 countries in the region to eliminate double taxation. Still, complete harmonisation is unlikely to happen any time soon. Such harmonisation is difficult even for smaller and more developed economic blocks.

One of the reasons for the lack of harmonisation in taxation is due to control. Governments typically want to hold on to the ability to maximise their taxes and revenues.

A second reason is tax competition. Governments often use lower taxes to attract foreign direct investment (FDI). Vietnam, for example, lowered the income tax rate from 25% to 22% in 2014. In 2015, Singapore announced plans to promote innovation and internationalisation through a series of tax incentives. Such competition could hurt the region's tax base. One option, adopted by the European Union in the 1990s, is to coordinate tax competition and minimise harmful practices.

Companies will have to find ways to deal with multiple tax rates and tax structures across the region. Many are looking to leverage tools and technology to help manage global taxation in a systematic way.

[2] *Asian Development Bank*
[3] *Economist Intelligence Unit*

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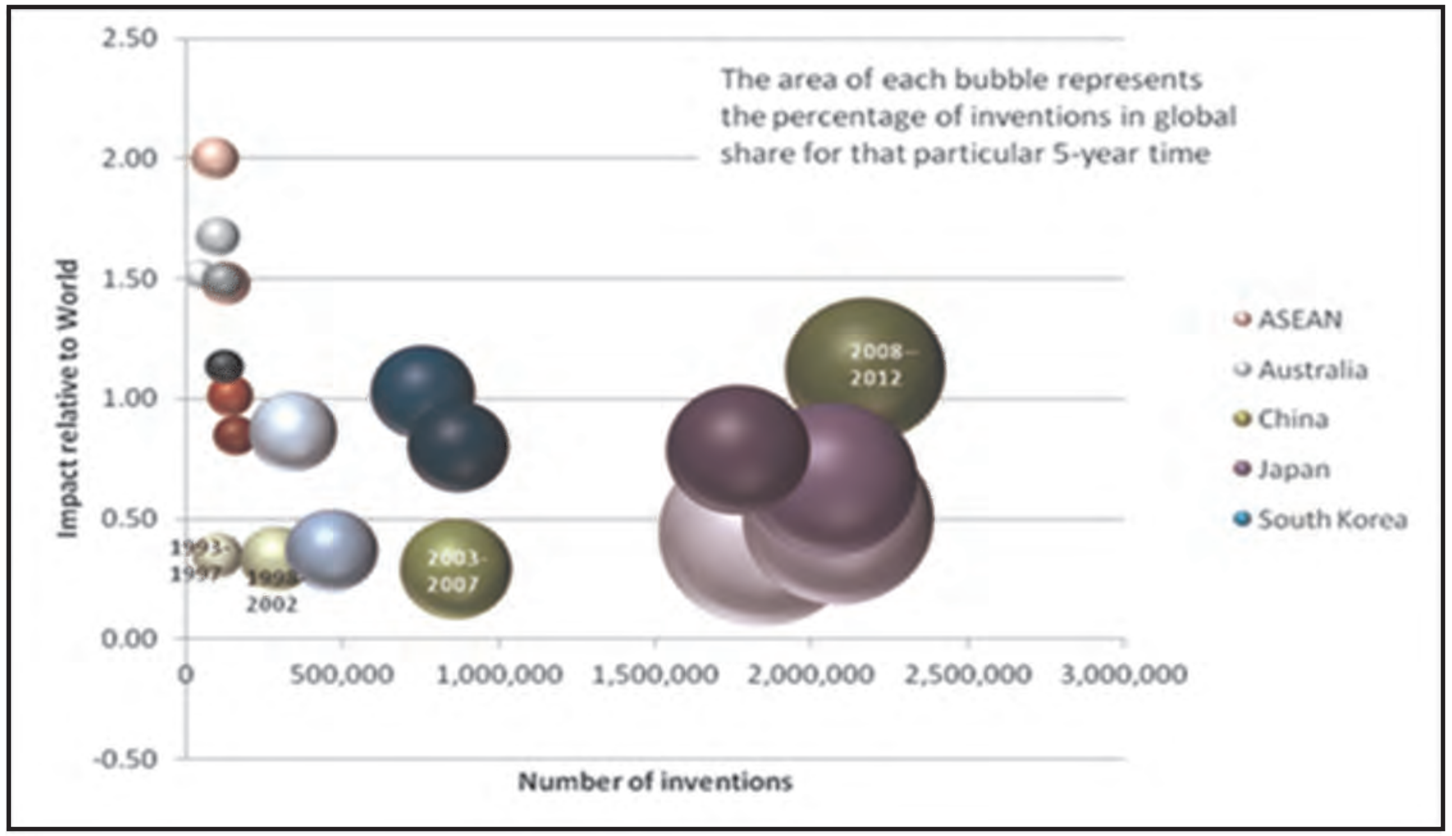


***Fig. 1: Overview of ASEAN Inventions as compared to Asia Pacific countries***

*Source: Thomson Innovation® by Thomson Reuters*

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## 2.3 IP Concerns

Issues linked to intellectual property (IP) will remain a key concern even after the launch of the AEC. Standards and regulations are far from uniform and protections vary widely.

The best IP environment in the region may be in Singapore, which is looking to become an IP hub to attract innovation. Malaysia and Thailand are chasing Singapore in their efforts to become innovation hubs, but they have some way to go.

Over the last few decades, the IP output of ASEAN countries has changed dramatically. ASEAN countries produce a much smaller share of the world's patents than they once did but more of the world's research is done in the region.

On the other hand, the share of patents filed in ASEAN relative to the world total has dropped to below the global average. ASEAN produced twice as many patents and the world average in the 1990s (See Figure 1)

A concern is the quality of IP protection in the region and the differences from country to country, differences that many hope the AEC will address over the next few years.

"They are not there yet, but they are moving in that direction," says AmCham's McNutt.

Across ASEAN, an Intellectual Property Portal is part of a concerted effort to raise standards of protection across the region. The ultimate idea is to allow for IP such as patents to be recognised across all countries in the region. The various trade agreements the AEC is involved with rarely include complicated protections for issues such as IP, protections that are included in newer agreements like the Trans-Pacific Partnership (TPP), currently being negotiated.

"We hear about all these next generation higher standards such as IP protections and cross border data flows. None of the ASEAN+1 FTAs have these sort of protections. They are very basic, lowering-the-tariff type of agreements," says McNutt.

Effectively managing and protecting intellectual property across the AEC will remain challenging for companies for some time. It will be important for companies to plan ahead and develop a strategy for managing and protecting their IP assets across the region in order to maintain their key competitive advantage and sustain their business growth.

[4] *Thomson Innovation*

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## 3.0 Moving Towards the AEC

The closer trade ties and regulatory alignment brought about by the AEC later this year are key to addressing challenges of trade, taxation and IP.

One way to get around the various hurdles and challenges is to pre-empt them. For example, companies may agree to avoid local courts and resolve disputes in specific dispute resolution centres. Singapore has emerged as the regional hub for dispute resolution. It is one of the world's leading seats of arbitration, alongside London, New York, Paris and Geneva.

Singapore continues to position itself to be a legal services hub in Asia. Singapore is building capabilities and infrastructure to support international commercial mediation and litigation. One step in that direction is the recent establishment of the Singapore International Commercial Court ("SICC") says Ho May Kim, Associate Director at Duane Morris & Selvam LLP, a law firm.

The region is unlikely to follow the experience of European integration. Given ASEAN diversity, one important step would be to achieve abiding respect for justice and the rule of law throughout Southeast Asia.

"If we can achieve that, then there would be far more investment into the ASEAN region."

Overall, however, companies are generally happy with the forward movement towards integration. The actual date when the AEC agreements come to be may be less of an issue than the imperative of constant forward movement.

"If you ask businesses 'is ASEAN integration important?' almost every American business in ASEAN has said 'yes'," says McNutt. "If you ask them: 'Does your company value ASEAN integration? Does your company plan to use ASEAN integration?' almost all of them lean towards 'yes'. If you ask: 'When is the AEC going to be realised?' almost no one says 2015."

But this question misses the point.

"Essentially, companies are pleased with the direction of the change," says McNutt. "Any change towards greater integration makes it easier for them to do business. When it actually comes about, that is more of a political deadline that they don't find much relevance in. If it comes about in 2017 rather than 2015, our businesses are fine with that."

"It seems like ASEAN is going in the right direction here."

It will be up to the companies themselves, however, to leverage the changes into profits. There are tools available to companies that can help them manage and maximise the benefits of the raft of FTAs, changing tax rules and the new-and-improved IP environments that the AEC will usher in.

The forward momentum will likely continue for several years. It will make trade easier across the region, lead to changes in tax structures and ensure greater IP protection, all of which should help companies that are both aware of the changes that are happening and in a position to take advantage of them.

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