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Enhancing Thailand's Trade Policy Through AFTA

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The following is a paper presented at a conference on "Pacific Trade and Investment: Options for the 90's," held in Toronto, Canada from June 6 to 8, 1994. The conference was organized by the John Deutsch Institute at Queen's University, the Centre for International Business at the University of Toronto, and the Thailand Development Research Institute.

The implementation of the ASEAN Free Trade Agreement (AFTA) will provide an opportunity for Thailand to review and rethink its approach to trade policy. This should be in terms of intra-ASEAN trade and competition, attracting foreign direct investment and enhancing the competitiveness of Thai industries to face global markets. While AFTA will eventually bring tariff levels down to 5 percent or less for intra-ASEAN trade in manufactured goods after 15 years, the ASEAN countries will be reducing their own tariffs with differing timetables. At the same time, multilateral tariffs will be falling, due to the recently completed Uruguay Round of GATT. Thailand needs to consider how its AFTA tariff reduction schedule will affect its competitiveness vis-a-vis the other ASEAN countries and the world. It must also structure its trade policy to provide appropriate incentives to its producers.

THAILAND'S TRADE POLICY PRE-AFTA

Over the past two decades, Thailand has achieved an impressive record of economic growth, averaging 9.5 percent from 1986 to 1991. This growth has largely been attributed to an export-oriented industrialization strategy, combined with a stable macroeconomic environment. Thailand's competitiveness has been and continues to be based on cheap sources of inputs, both labor and material.

During the 1980s, Thailand's tariff structure was characterized by low tariff protection for raw materials. Tariff rates increased with additional processing and were quite high for finished products. Tariffs had an anti-export bias, with rates for import substitution industries fixed at much higher levels than those for export-oriented industries. To combat this, the government introduced incentives to encourage the growth of export-oriented manufacturing and agriculture, resulting in the favorable treatment of imported inputs over local intermediate goods[1] (see Table 1). Rather than revamp the overall policy, these incentives were layered over the existing import substitution supporting framework. This inconsistent policy has led to conflicting interests among those who want to liberalize (exporters) and those who want to maintain protection (producers for the domestic market). It has also created distortions which give artificial advantages to particular industries. Thailand's dramatic export growth has occurred in spite of these factors, but future growth may depend on the rationalization of distortions and inefficiencies.

A large portion of Thailand's imports are intermediate and capital inputs from non-ASEAN sources. Table 2 shows Thailand's principal imports in 1991 and their sources. While lowering tariff barriers to other ASEAN countries will be an initial step in improving competitiveness and reducing costs to Thai producers, lowering tariff barriers to the world through unilateral liberalization would be more appropriate. This would facilitate imports necessary for export-oriented industries and maintain Thailand's competitive advantage. Artificial and transaction costs, including the tax burden on these imported inputs, must be eliminated.

Moving in this direction, the Seventh National Economic and Social Development Plan identified six industries as particularly important for Thailand's economic development. These are agro-industry, electronics, iron and steel, metal working, petrochemicals and textiles and garments. The Plan calls, for example, for a reduction in import duties for upstream and intermediate textiles to promote investment in weaving and spinning. This will benefit the Thai textile and apparel industries by lowering input costs. The plan also endorses a similar cost reduction for the plastics industry by reducing the protection of upstream and intermediate petrochemicals. These are positive steps toward rationalizing import duties and promoting lower costs for downstream Thai producers. As mentioned above, however, the plan targeted only six industries, rather than promoting a broad liberalization for Thai industry as a whole.

Conflicts of interest among industry groups and subsequent political pressures have precluded general liberalization of import barriers. The result is a high wall of protection undermined by import duty exemptions and exceptions for specific industries or investors. These exceptions become increasingly costly to monitor and administer as they multiply in number. They also foster conditions which benefit only a minority of firms. A more equitable and efficient approach would be to lower import barriers for the economy as a whole. This would address another goal of Thailand's overall economic policy--to reduce income distribution width. The interests of large, influential producers are more likely to be heard in policy circles than those of consumers. A trade barrier liberalization, however, will lower consumer costs, thereby producing a welfare gain which is likely to be more equitably distributed than welfare gains accruing to individual producers.

THE ROLE OF FOREIGN DIRECT INVESTMENT

By the second half of the 1980s, foreign direct investment (FDI) into Thailand had rapidly accelerated from 9,000 million baht in 1987 to a peak of 65,000 million baht in 1990. It declined slightly in the early 1990s.[2] Major investors in Thailand are the United States, Japan, the newly-industrialized economies (NIEs, i.e., Hong Kong, Taiwan, South Korea) and Singapore. The recent period of high FDI inflow has resulted in a diversification of exports from primarily natural resource-based products into growing shares of technology-intensive and skilled-labor-intensive goods.[3]

Due to the gap between savings and investment, Thailand needs to maintain FDI inflow for continued growth. According to a recent study,[4] cost reduction and investment for export to the home market were primary reasons for FDI into Thailand. The study also found that tariffs on intermediate products and capital equipment were hindering FDI. Infrastructure availability was noted as another important factor contributing to FDI. Thus, to further attract foreign investors, Thailand should strengthen and broaden policies to facilitate cost effectiveness; this would include reducing tariffs on imported inputs. Existing plans to improve telecommunications and transportation infrastructure will also be important in maintaining foreign inflows.

Many economists feel that AFTA will contribute to further foreign direct investment in the region. The ASEAN region's increased appeal will stem from the expanded ASEAN market's economies of scale, as well as the free movement of goods between the ASEAN economies. These factors will facilitate the formation of ASEAN's international production networks. These networks will be composed of production units based in different locations created by lowered transportation costs and improved infrastructure. As new technologies are introduced to lower costs and boost competitiveness, the ASEAN economies' diverse production base should attract investors by eliminating barriers to intra-firm trade and imports of intermediate inputs.[5]

Within the region, however, Thailand will be competing against other ASEAN nations for a limited pool of foreign investment funds. For this reason, Thailand cannot simply wait for AFTA to bring investors to the region. It must ensure that it maximizes its areas of comparative advantage relative to the other ASEAN economies.

One example where Thailand may be missing out under AFTA is in the case of automobiles. Of Thailand's exclusion items, 57 of 117 are automobile-related. Similarly, automobile items make up 181 of Indonesia's 1,708 exclusions, 160 of Malaysia's 648 excluded items and 55 of the Philippines' 1,179 excluded items. The automobile industry has been targeted by ASEAN as a prime source of FDI through the ASEAN Industrial Complementation (AIC) and Brand to Brand Complementation (BBC) Schemes,[6] relying primarily on import duty exemptions to ease the flow of intermediate inputs. The goals of these schemes seem to be thwarted by the placement of automobiles and parts on most AFTA exclusion lists.

In recent years, the Thai automobile industry has slowly been moving toward lower levels of protection. The industry started exporting cars and trucks for the first time in 1987. Import duties on completely built-up units (CBU) and completely knocked-down units (CKD) were slashed in 1991. A recent article states that "Thai auto policy is more effective than that of Indonesia, Malaysia and the Philippines" with respect to local content, rationalization and exports.[7] It maintains that Thailand "should have given some priority to using the ASEAN Free Trade Area to enlarge the country's local parts and components markets, particularly as Thailand has a competitive edge in some subsidiary auto items."[8] The exclusion list will be amended from time to time. Serious consideration should be given to the Thai auto industry's possible expansion by removing the excluded auto items from the AFTA exclusion list.

INTEGRATING AFTA INTO THAILAND'S TRADE POLICY

The ASEAN countries have introduced AFTA to lower their trade barriers and promote competition among themselves before being faced with future multilateral liberalizations. Protected industries will be able to adjust to a more competitive environment on a limited basis, before being exposed to global markets. Thailand should make the most of this opportunity to strengthen weak industries and further solidify strong industries' market position. An appropriate tariff reduction schedule, coupled with adjustment assistance programs for previously protected industries, will help Thailand take advantage of the opportunities offered by AFTA, and prepare it to face global competition.

To date, Thailand has a mixed record on achieving these goals. There has been a conflict between government claims that tariff rates will be reduced within AFTA targets and actions which delay tariff reductions for several years. Normal track goods, for example, with rates presently above 30 percent will not be subject to reductions until 1998.[9] Similarly, Thailand has proposed to reduce trade barriers on a much slower schedule than the other ASEAN countries for many normal track items. This may drag out the adjustment period for Thai industries.

In response to industry pressures, petrochemicals have recently been moved from the fast track to the normal track. Thus, despite the importance placed on liberalizing this sector in the Seventh Plan, influential upstream producers and large producers receiving Board of Investment (BOI) or Customs Department privileges have succeeded in delaying the phase-out of their protected position, to the detriment of small producers.[10]

Delays in tariff reductions will also hinder Thailand's intra-ASEAN exports, because under Article 4.2 of the AFTA Agreement, Thailand will not be eligible to take advantage of the other ASEAN countries' concessions until it reaches the 20 percent level itself. Hence, Thai exporters will have to pay import duties for intra-ASEAN exports while other ASEAN exporters will not. Comparisons between major export items with a delayed tariff reduction schedule and the rest of ASEAN and their existing tariff rates are listed in Tables 3 and 4. They include such products as cereals, sound recording equipment, transistors, switchgear, plastic articles, textiles and apparel, some iron and steel products, optical instruments, watch cases and some imitation jewelry.

The reduction of tariffs for previously protected industries will inevitably cause adjustment pains. Thusfar, the Thai government has not addressed the need to assist affected industries in their adjustment process. While those protected are often viewed as inefficient and privileged, in fact most have simply responded to the incentives and signals set forth by the government. The goal is to help these industries to respond to market signals and become more competitive, not to punish them for taking advantage of prior opportunities.

A recent article[11] sets forth criteria for industrial restructuring assistance. These criteria include directly targeting adversely affected groups, being neutral and equally accessible to eligible firms of all sizes, providing assistance in an amount tied to the extent of required restructuring, and being economical and administratively simple. The mechanism proposed to meet these tough criteria is an accelerated depreciation allowance for capital equipment and machinery, equivalent to a corporate income tax deduction. This measure would be administratively simple, transparent and automatic. Fresh capital freed by the allowance would have uses determined by the firms themselves, for example, to upgrade technology or to diversify into more competitive industries.

POLICY RECOMMENDATIONS

Trade policy must continually be reviewed in the face of changing global circumstances and evolving comparative advantages. AFTA's implementation provides a chance for Thai policymakers to review existing policies for inconsistencies and inefficiencies. The following measures are recommended to integrate Thailand's AFTA commitments into a more coherent and forward-looking trade policy:

- Respond to calls for a shorter 10-year AFTA timeframe by adjusting and restructuring tariffs quicker than the existing AFTA schedule requires. This is particularly important for those items where Thailand lags behind in reducing to the 20 percent concession level.
- Unilaterally reduce import duties on raw materials and intermediate inputs in deeper and more immediate ways, to encourage foreign investors and provide cheaper inputs sourced outside the ASEAN region.
- Take advantage of AFTA's phase-in period by providing an adjustment scheme to promote restructuring of uncompetitive industries.

These measures will not only increase AFTA's benefits to Thailand, but will help to rationalize Thailand's overall trade policy. The unilateral measures will balance the gains for consumers and users of lower priced imports with the potential losses of existing protected producers. By strengthening uncompetitive industries within AFTA, multilateral liberalization can be pursued more quickly. This will give Thai exports better access to world markets and help to continue Thailand's export-led success.

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