LAOS IN THE ASEAN FREE TRADE AREA: TRADE, REVENUE AND INVESTMENT IMPLICATIONS*

The Lao People's Democratic Republic (PDR) is a transitional economy, and one of the few least developed economies in the Southeast Asian region. Laos became a member of ASEAN in July 1997, and will participate in the ASEAN Free Trade Area (AFTA) from 1 January 1998. This paper examines the likely impact of AFTA membership on Laos's trade, government revenue and foreign investment flows. It is found that: (i) trade diversion is likely to be low, and that AFTA will provide the vehicle to negotiate market access issues with Thailand; (ii) the reduction in government revenue from trade taxes is likely to be low, particularly in the light of the high share of informal trade and low levels of trade diversion; and (iii) foreign direct investment (FDI) flows are likely to grow sharply, as the legal, administrative and institutional framework in Laos develops to meet the ASEAN standard.

Introduction

The Lao People's Democratic Republic (PDR) is one of the few least developed economies in the Southeast Asian region. It is a small land-locked country which shares borders with Thailand, Cambodia, Vietnam, Myanmar and China. In 1986, the government introduced the New Economic Mechanism (NEM), a radical program of reform to transform Laos from a centrally-planned or command economy to a market economy.[1] In July 1992, Laos was granted observer status in ASEAN. At the 28th ASEAN Ministerial Meetings (AMM) in Brunei, Lao PDR applied to join ASEAN. At the 30th AMM in Kuala Lumpur in July 1997, Laos (together with Myanmar) was accepted as a full member of ASEAN. Membership of ASEAN brings with it membership of the ASEAN Free Trade Area (AFTA). Laos will participate in AFTA from 1 January 1998.

This paper examines the likely impact on the Lao economy of joining AFTA, focusing on three issues. The first relates to trade. This impact is important for any type of economy (transitional or otherwise) joining a Free Trade Area (FTA).[2] Revenue from trade taxes constitutes a significant share of total government revenue in countries like Laos. It also provide much needed foreign exchange to finance public sector imports. Given its importance, we examine the likely impact on revenue of trade taxes associated with AFTA membership. Foreign direct investment (FDI) flows play an important role in financing the development of Laos's export potential. The third area for attention is the likely impact of AFTA on FDI flows to Laos.

The following section presents an overview of the Lao economy, describing general features of the economy as well as the industry and country composition of trade, the nature of trade protection, sources of government revenue and the industry composition of FDI flows. Next, a brief overview of AFTA as it relates to Laos is outlined. This is followed by a discussion of the likely impact of AFTA on trade, revenue and FDI flows. The final section provides a summary of the major findings, and directions for future research.

The Lao economy: an overview

The principal economic sector in Laos is agriculture, which in 1995 accounted for about 55 per cent of GDP and employed almost 80 per cent of the workforce (see Table 1). Since the introduction of the NEM in 1986, but particularly from 1990 onwards, growth in the industrial sector (mainly manufacturing and construction) and services (mainly wholesale and retail trade) has outstripped growth in agriculture.[3] Overall growth in GDP (measured at constant market prices) has also been impressive, averaging almost 6.5 per cent since 1990. Per capita GDP, while still low, has increased from US$200 per head in 1990 to US$350 per head in 1995.[4]

Structure of international trade

It is important to note at the outset that there are only limited trade data available from Lao sources, and that these data may be subject to substantial measurement errors. In this section, these problems are overcome by using the data collected and reported by trading partner countries on import and export trade with Laos. Issues relating to problems with data from Lao sources, as well as the method and sources used in constructing our database are discussed below.

Compiling a trade database for Laos using trading partner country data

There are only limited trade data measured in value terms currently available from Lao sources. The preoccupation with measuring quantities is presumably a hangover from the days of the command economy, when prices mattered little. Furthermore, the limited amount

Table 1 GDP by industrial origin, 1991–95, (at constant 1990 market prices, million kip

Items	1990	1991	1992	1993	1994 (R)	1995 est.
Agriculture	371,835	365,537	395,537	406,234	439,980	461,641
Crops		195,625	221,166	196,729	221,634	236,250
Livestock & fishery		145,693	158,851	165,478	172,569	178,430
Forestry		24,029	15,520	44,027	45,777	46,961
Industry	88,105	105,634	113587	125,258	138,664	154,393
Mining & quarrying		825	932	1,272	1,659	1,620
Manufacturing		78,400	85,775	92,358	98,798	110,350
Construction		17,735	19,055	22,130	25,926	31,654
Electricity, gas & water		8,674	7,825	9,499	12,252	10,769
Services	147,337	156,993	163,038	175,633	185,376	201,086
Transport, storage & com.		32,124	34,333	35,409	36,920	37,535
Wholesale & retail trade		46,163	49,415	58,553	63,158	68,800
Banking		6,202	6,908	7,820	8,465	9,326
Ownership of dwellings		27,950	23,409	25,282	27,456	30,476
Public wage bill		31,888	31,034	30,967	28,923	27,619
Non-profit institutions		9,653	11,659	10,513	10,114	11,177
Hotels & restaurants		2,231	5,229	6,001	9,218	15,004
Other services		692	1,051	1,088	1,121	1,150
Import duties	5,364	9,186	9,635	14,718	16,668	19,263
GDP at market prices	612,681	637,140	681,797	721,842	780,657	836,382
Change in GDP at constant market prices		4.0	7.0	5.9	8.1	7.1
GDP at current market prices		721,998	844,349	950,973	1,107,753	1,395,049

Note: (R) — revised.

Source: State Statistical Center.

of trade data in value terms collected by Lao sources may be subject to substantial measurement errors due to the limited resources devoted to the task of collecting and processing economic data. Signs that suggest problems with the data include substantial differences in the value of imports (exports) recorded in Laos as opposed to that recorded by its trading partners. For instance, official Lao statistics indicate that imports from Vietnam in 1992 totalled US$3.44 million, whereas official Vietnamese trade show exports to Laos for that year at more than four times that level, at US$16.3 million (ADB 1994: 312).

To avoid the problems associated with the data collected by Lao sources, we use data collected and reported by trading partner countries on import and export trade with Laos. That is, we assemble a trade database inversely, using data reported by trading partners. These data are compiled from the UN's COMTRADE database. This was a major task which involved manipulating and summarising a trade matrix consisting of more than 17,000 entries. These data allow us to provide, for the first time, import and export value data that are defined by country and commodity. This database is more comprehensive than any other available source, and overcomes most of the problems associated with data from Lao sources.

Nevertheless, there are at least two limitations of our data which should be borne in mind. The first is the problem of cross-border or informal trade. Given the nature of this type of trade, neither Laos nor its trading partners are able to record it. Second, the sample of countries for which data is reported to the UN is incomplete. Most of these countries, of which there are not many, are not significant trading partners of Laos. A notable exception, however, is Vietnam, whose trade with Laos has increased recently. For these reasons, more than the usual degree of scepticism about the quality of economic data is still justified. (For more discussion on the pros and cons of compiling a database inversely, see Yeats 1992.)

Commodity composition of exports

Table 2 presents percentage shares of export commodities defined at the 1-digit level of the Standard International Trade Classification (SITC) for the period covering 1980 to 1995.[5] From Table 2, we find that crude materials (excluding fuels) and miscellaneous manufactures account for the vast majority of commodity exports throughout the period. Over recent years, exports of food and live animals and basic manufactures have also become significant. The main export item in the crude materials category is wood, lumber and cork (SITC 24), whose share in total exports has ranged between 30 and 60 per cent over the period. Since 1990, however, its share has been falling.[6] The main export item in the miscellaneous manufactures category is clothing (SITC 84). In 1995, exports of clothing accounted for 36 per cent of total merchandise exports.

Clothing exports deserve closer scrutiny because they represent the first attempt to export manufactures and diversify the export base away from primary commodities. Laos began exporting clothing in 1989. Almost all production of clothing is exported, with domestic requirements met by cheaper imports from Thailand. As of 1995, Laos was exporting garments to 34 countries, with about 80 per cent of exports going to the European Community

Table 2 Commodity composition of exports (1-digit SITC, % shares), 1980–95

SITC	Product	1980	1985	1990	1991	1992	1993	1994	1995
0	Food, live animals	13.19	56.2	3.73	2.93	5.41	5.69	4.47	10.67
1	Beverages, tobacco	0.11	0	0	0	0.08	0	0.54	0.4
2	Crude materials	49.98	34.29	75.88	63.04	52.91	49.14	53.14	40.54
3	Mineral fuels	0	0	0.04	0	0.17	0.3	0.01	0.25
4	Oils and fats	0.07	0	0	0	0	0	0.01	0
5	Chemicals	1.06	0.12	0.2	0.08	0.18	0.77	0.61	1.72
6	Basic manufactures	25.96	5.28	7.43	2.39	2.99	3.74	3.52	8.71
7	Machines, transpt eq.	0.82	1.86	1.21	0.51	0.77	0.97	0.62	0.28
8	Misc manufactures	8.09	1.23	10.08	30.22	37.08	39.24	36.83	37.1
9	Other goods	0.72	1.02	1.42	0.83	0.4	0.14	0.25	0.32
	Total	100	100	100	100	100	100	100	100
	Total (in US$ million)	23.9	9.1	65.6	82.7	101.8	144.9	189.5	241.2

Source: Compiled from COMTRADE database, United Nations.

(EC), and about 10 per cent to the US market. The growth in exports between 1993–95 was due mainly to the fact that Laos enjoyed privileges under the Generalised System of Preferences (GSP) in the European Community. This explains why Laos can export most of its production, and satisfy domestic requirements through cheaper imports (mainly from Thailand). The European Community revoked GSP privileges effective as of the end of the 1995 financial year. This decision was made on the basis of a recommendation of an EC Customs delegation that visited Laos in 1995, and found that minimum domestic content requirements based on rules of origin (ROOs) were not being met.[7]

The minimum domestic content requirement for accessing the GSP in the European Community is 60 per cent. About 90 per cent of the fabric and yarn used in the production of garments in Laos is imported (with about 80 per cent of the fabric coming from Thailand). The share of value-added in Laos varies between 15 and 35 per cent, with an average share of about 27 per cent.[8] Following the removal of GSP privileges in the European Community, clothing exports have fallen sharply. Based on preliminary estimates from the Chamber of Commerce and Industry (CCI) for the 9 months of the 1996 calendar year, exports of garments are down by more than 30 per cent compared with the same period for the previous year.

Commodity composition of imports

Table 3 presents percentage shares of import commodities defined at the 1-digit level of the SITC for the period 1980–95. The two main categories of imports are basic manufactures, and machinery and transport equipment. In 1995 for instance, machinery and transport equipment accounted for more than one-third of total imports, while basic manufactures accounted for almost a quarter. Motor vehicles (SITC 781) are the largest import category. Most of the basic manufactures imports consist of textile yarn and fabrics (SITC 65), although non-metallic mineral manufactures (SITC 66) and iron and steel (SITC 67) are also significant. Other important import categories include tobacco and tobacco manufactures (SITC 12) and petroleum and petroleum products (SITC 33).

Country composition of exports

The major export market for Laos is Thailand. While the share of exports to Thailand has been falling in the 1990s, it still constitutes 30 per cent of its total exports (see Table 4). The next two major markets are France and Japan, with shares of about 12 per cent each in 1995. The fourth major market in 1995 is the United Kingdom, whose share in total exports has jumped sharply from about 1.5 per cent in 1994 to 9 per cent in 1995. The fifth largest market is Germany, whose share has averaged above 8 per cent in the 1990s.

Table 3 Commodity composition of imports (1-digit SITC, % Shares), 1980–95

SIT	Product	1980	1985	1990	1991	1992	1993	1994	1995
0	Food, live animals	21.12	6.53	10.04	15.14	12.41	7.55	7.92	9.12
1	Beverages, tobacco	0.59	0.76	0.96	0.9	3.21	3.62	7.04	8.8
2	Crude materials	0.21	0.57	0.26	0.44	0.15	0.19	0.26	0.27
3	Mineral fuels	18.16	20.16	5.49	7.54	6.87	8.88	7.03	8.11
4	Oils and fats	0	0.07	0.22	0.36	0.4	0.21	0.25	0.27
5	Chemicals	6.6	10.83	8.52	7.53	7.75	7.66	5.77	6.73
6	Basic manufactures	19.47	23.19	19	19.63	17.83	18.84	18.04	22.22
7	Machines, transpt eq.	28.37	29.54	46.72	39.06	45.16	46.76	43.24	36.44
8	Misc manufactures	4.37	7.08	6.94	7.43	4.7	5.36	9.55	6.74
9	Other goods	1.12	1.28	1.84	1.96	1.53	0.93	0.91	1.31
	Total	100	100	100	100	100	100	100	100
	Total (in US$ million)	95.5	48.2	117.3	122.3	199.4	289.4	445.2	535.9

Source: Compiled from COMTRADE database, United Nations.

Country composition of imports

Thailand is overwhelmingly the largest supplier of imports to Laos, with a share of 60 per cent or higher throughout the 1990s (see Table 5). China is the second largest supplier of imports,

Table 4 Commodity exports by major market (% Shares), 1991–95

		1991	1992	1993	1994	1995
1	Thailand	56.84	40.41	43.58	36.49	29.17
2	France	10.97	13.08	12.70	10.66	12.27
3	Japan	5.39	11.98	8.02	16.39	12.27
4	United Kingdom	0.08	0.35	0.10	1.46	9.16
5	Germany	11.46	5.68	9.22	10.79	7.78
6	Netherlands	2.24	6.36	6.57	5.70	6.78
7	United States	2.51	6.22	6.29	5.01	4.56
8	Singapore	0.00	0.48	0.24	1.51	4.41
9	China	2.69	3.62	2.42	2.31	2.67
10	Norway	0.58	0.31	0.35	0.71	2.07
	Other countries	7.24	11.52	10.51	8.96	8.85
	Total	100.00	100.00	100.00	100.00	100.00

Source: Compiled from the COMTRADE database, United Nations.

with a share of close to 9 per cent in 1995, while Singapore accounted for more than 7.5 per cent of imports. The next two largest suppliers of imports are Japan and France, each accounting for about 5 per cent of total Lao imports in 1995.

Table 5 Commodity imports by major supplier (% Shares), 1991–95

		1991	1992	1993	1994	1995
1	Thailand	62.65	60.71	59.77	65.16	66.07
2	China	5.84	13.96	12.83	8.08	8.91
3	Singapore	0.00	2.11	3.46	6.26	7.60
4	Japan	17.46	14.06	12.79	7.58	5.24
5	France	2.49	1.51	1.28	4.51	4.51
6	Italy	4.98	0.49	0.62	0.68	2.98
7	United Kingdom	1.70	0.58	0.77	0.45	1.02
8	Germany	0.66	0.65	1.40	1.67	0.89
9	Australia	0.29	2.21	0.83	1.26	0.81
10	United States	0.73	0.40	1.82	1.23	0.30
	Other countries	3.21	3.31	4.42	3.11	1.66
	Total	100.00	100.00	100.00	100.00	100.00

Source: Compiled from the COMTRADE database, United Nations.

Thailand, France and Japan feature in the 1995 top five list as both export destination and import source markets for Laos. Thus, the major markets for Lao exports are also the major suppliers of its imports.

Structure of trade protection

Table 6 summarises the structure of tariff protection in Laos. Relative to other developing economies, Lao tariffs are low. The product with the highest tariff is motor vehicles (rates begin at 50 per cent and increase to 150 per cent for motor vehicles with an engine capacity of 3,000 cubic centimetres or more). Other imports with relatively high tariff rates are consumer imports classified as luxury goods. These include both food and non-food items, with tariffs levied at a maximum rate of 100 per cent. Import-substituting industries such as the Lao beer industry and motorcycle assembly also receive quite substantial protection.

In practice, however, the impact of tariffs is lower than that suggested by the published rates. This occurs for a number of reasons. The first is the duty exemption scheme that allows imports of inputs used in export production to enter at zero tariff. As well as this scheme, a subsidiary tariff exemption scheme operates both liberally and somewhat arbitrarily. This

Table 6 Official Lao tariff rates

Sector	Product	Tariff Rate (%)
Agriculture	Seeds	5*
	Fertiliser	5
	Other	5–40
Fisheries		5–20
Stock	Feed	5
	Other	5–30
Manufacturing	Raw Materials	5–10
	Packaging	10–20
	Energy	5–20
	Machinery and Equipment	5– 20
	Trucks	5–30
	Cars	50–150*
	Beer and Alcohol	30–80
	Other Manufactures	10–20*
Consumption	Luxury - food	10–30*
Goods	Luxury - non-food	10–60*

Sources: World Bank; Lao PDR Customs.(*)

scheme has no clear guidelines governing the granting of exemptions, nor is it clear which government agencies have the authority to grant exemptions. As a result, a variety of exemptions has been granted by a diverse group of agencies and authorities (World Bank 1994). There are also exemptions from tariffs provided on a case-by-case basis for imports of consumption goods by individuals. With these exemptions, the IMF Customs Adviser estimates that the average effective import duty rate in 1992 was only 8.5 per cent (reported in World Bank 1994, Table 3.3).

The problem with the structure of protection in Laos does not lie in the tariff level, but rather with its lack of uniformity and neutrality. The dispersion in the current tariff structure makes it not only difficult to administer, but also distorts prices and incentives in an arbitrary manner. A 1993 IMF proposal recommended greater uniformity and neutrality in the tariff structure. Under this proposal, the maximum tariff rate would fall from 150 per cent to 40 per cent, and a new system of excise taxes would be introduced. This proposal was officially submitted to the Lao PDR National Assembly for approval in January 1997. Current indications are that this proposal will be approved and adopted.

While the impact of tariffs might be low, the same cannot be said about non-tariff barriers (NTBs). The real story of protection in Laos, as for most countries, is about NTBs. Quantitative restrictions are applied to the import of motor vehicles and the export of timber. There is a two-tier system of licences and permits that applies to imports and exports. There is also a system of conventions which involves individual agreements between the government and import–export firms. These conventions allow firms to import or export specified products free of all applicable taxes (including tariffs, local business taxes and profit taxes) in return for payment of an individually negotiated sum.

Patterns of FDI flows

Table 7 presents information on the proposed investment value and number of foreign investment licences by industry for the period 1988 to 1996 (first six months). It is clear from Table 7 that most of the proposed investment since 1994 has been in the hydro-power energy sector. Over the period 1988 to 1996, this sector has accounted for more than 70 per cent of the value of licences granted. The only other sectors that are significant are banking and insurance, telecommunications and transport, and mining.

Table 7 Foreign Investment Licences (in US$'000 and number of projects) 1988–96

Sector	1988	1989	1990	1991	1992	1993	1994	1995	1996	Total	Total (%)
1. Agriculture	0	0	440	9770	15666	16898	6792	5097	1036	55700	0.78
	(0)	(0)	(3)	(6)	(14)	(23)	(7)	(3)	(3)	(59)	(9.55)
2. Textiles & clothing	0	84	9,300	6,578	13,231	13,598	12,340	13,137	1,000	69,268	0.97
	(0)	(1)	(8)	(12)	(20)	(14)	(8)	(6)	(1)	(70)	(11.33)
3. Processing industry	0	7,153	2,394	10,500	20,255	59,561	18,006	46,027	12,160	176,056	2.47
& handicraft	(0)	(9)	(4)	(10)	(17)	(34)	(20)	(9)	(8)	(111)	(17.96)
4. Wood processing	446	1,855	2,011	2,791	34,512	6,829	22,371	578	0	71,393	1.00
	(2)	(4)	(3)	(7)	(5)	(5)	(5)	(1)	(0)	(32)	(5.18)
5. Mining	246	22,650	29,500	5,078	200,157	18,043	9,562	27,100	0	312,336	4.38
	(1)	(4)	(2)	(2)	(2)	(5)	(3)	(9)	(0)	(28)	(4.53)
6. Trade	2,200	7,309	2,063	23,831	2,664	6,907	8,946	380	175	54,474	0.76
	(2)	(13)	(10)	(11)	(12)	(24)	(16)	(4)	(1)	(93)	(15.05)
7. Hotel, tourism	0	0	6,975	95,836	6,576	4,825	279,318	295	211,120	604,944	8.49
	(0)	(0)	(6)	(6)	(5)	(6)	(6)	(1)	(2)	(32)	(5.18)
8. Banking & insurance	0	25,800	0	2,000	15,000	15,000	5,000	5,000	6,000	73,800	1.04
	(0)	(1)	(0)	(1)	(3)	(3)	(1)	(1)	(1)	(11)	(1.78)
9. Consultant services	30	2,470	318	160	119	1,727	1,699	709	0	7,232	0.10
	(1)	(3)	(3)	(4)	(3)	(7)	(18)	(8)	(0)	(47)	(7.61)
10. Other services	30	30	60	340	2,074	5,114	4,128	12,225	810	24,811	0.35
	(1)	(1)	(2)	(3)	(9)	(19)	(24)	(16)	(5)	(80)	(12.94)
11. Construction	0	239	0	0	18,029	13,886	19,330	6,000	0	57,484	0.81
	(0)	(1)	(0)	(0)	(5)	(9)	(16)	(3)	(0)	(34)	(5.50)
12. Telecom, transport	0	0	5,000	814	200	740	64,800	62	400,000	471,616	6.62
	(0)	(0)	(1)	(2)	(1)	(3)	(3)	(1)	(1)	(12)	(1.94)
13. Energy	0	0	0	1,398,900	0	0	2,054,000	1,107,900	586,820	5,147,620	72.23
	(0)	(0)	(0)	(2)	(0)	(0)	(3)	(2)	(2)	(9)	(1.46)
	2,952	67,590	58,061	1,556,598	328,482	163,127	2,506,292	1,224,511	1,219,121	7,126,733	100.00
Total	(7)	(37)	(42)	(66)	(96)	(152)	(130)	(64)	(24)	(618)	(100.00)

Notes: 1 Figures in parentheses refer to the number of projects.
2 Figures for 1996 are for the first six months of the year only.

Source: Permanent Office of the Foreign Investment Management Committee (FIMC), Lao PDR.

It should be noted that foreign investment approvals data do not always provide an accurate indication of actual or implemented investments. An initial survey by the Foreign Investment Management Committee (FIMC) of 131 projects found that only about 25 to 30 per cent of licensed investment flows had been realised five years after the proposed starting date. Why is there such a large discrepancy between the approved and actual investment figures? The first reason relates to the concentration of foreign investment interest in large and cumbersome projects like hydro-power. These projects are generally long term, and the cut-off period of five years for the survey may not capture a significant portion of the planned investment. The second reason relates to the fact that many applications may not represent a genuine interest in investing in projects applied for and approved. Investment applications are often submitted to a number of potential countries in the hope that at least one submission will be successful. Furthermore, a successful application in one country is often used to strengthen the applicant's case in gaining approval in the preferred investment site. For these reasons, approvals data on foreign investment need to be interpreted with caution.

The only data available on actual (net equity) investment flows by industry is that published by the Bank of Thailand and summarised in Table 8. Thailand is the largest

Table 8 Net Flows of Thai Investment to Laos (Equity Investment, million baht), 1989–95

	1989	1990	1992	1993	1994	1995
1. Financial Institutions	0.0	0.0	117.8	4.0	0.0	4.7
2. Trade	1.1	1.7	15.3	-56.6	2.0	62.0
3. Industry	24.5	0.0	1.3	328.2	74.6	76.2
3.1 Food	21.9	0.0	0.0	318.3	1.6	0.0
3.2 Textiles	0.0	0.0	1.3	5.7	28.8	1.3
3.3 Electrical appliances	0.0	0.0	0.0	3.4	15.5	75.8
3.4 Machinery & Transport Equip.	0.0	0.0	0.0	0.0	2.3	0.0
3.5 Chemicals	0.0	0.0	0.0	0.0	25.2	0.0
3.6 Construction Materials	0.0	0.0	0.0	0.8	1.2	-0.8
3.7 Others	2.6	0.0	0.0	0.0	0.0	0.1
4. Services	0.0	0.0	0.0	0.0	31.8	0.0
5. Real Estate	0.0	0.0	0.0	1.7	0.0	0.0
6. Other	0.0	0.0	2.7	0.0	26.5	0.0
Total	25.6	1.7	137.1	277.3	134.9	142.9

Source: Bank of Thailand, unpublished estimates.

investor in Laos, accounting for more than 40 per cent of approved licences. The focus of investment appears to shift from sector to sector over the period covered in Table 8. The financial sector was the focus in 1992, while the food industry was heavily invested in 1993. While textiles and chemicals received a substantial amount of investment in 1994, the services sector (which includes hydro-electric power generation) received the most. In 1995, interest shifted towards the trade and electrical appliances sectors, and interviews with FIMC officials suggest that recent flows (1996–97) have centred on the hotels and tourism sector.

Sources of government revenue

How important are revenues collected from trade (import and export) taxes to Laos's economy? In 1989, trade tax collections accounted for 2.1 per cent of GDP, and 31.3 per cent of total tax revenues. By the 1991–92 financial year, trade taxes accounted for 38.13 per cent of total tax revenues (see Table 9).[9] Since then, however, this share has decreased. By 1994–95, trade taxes accounted for only 28.7 per cent of total tax revenue. Despite the decline in this share over time, it is clear that trade taxes continue to make a substantial contribution to the revenue base of the government.

Laos and AFTA: an overview

At the summit meeting of ASEAN Heads of State in January 1992, the six countries of ASEAN (or ASEAN6) agreed to establish AFTA by the year 2008. This deadline has since been moved forward to the year 2003. The centrepiece of the AFTA proposal is the Common Effective Preference Tariff (CEPT). It differs from the earlier Preferential Trading Arrangement (PTA) in that its approach is essentially sectoral, making it more comprehensive and less cumbersome than the product-by-product approach of the PTA. According to the current time frame, more than 85 per cent of tariff lines in the Inclusion List (for ASEAN6) will be in the 0–5 per cent range by the year 2000 (ASEAN Secretariat 1996).[10]

Vietnam joined ASEAN in 1995, and will have ten years to reduce its tariffs to 0–5 per cent, beginning on 1 January 1996 and ending on 1 January 2006. Laos and Myanmar joined ASEAN on 23 July 1997, and will also have ten years to satisfy AFTA obligations, beginning 1 January 1988 and concluding on 1 January 2008.[11] At the Senior Economic Officials' Meeting (SEOM) in Ho Chi Minh city in April 1997, it was agreed that the Sensitive List be

Table 9 Government revenues (millions of Kip)

	1991/92	1992/93	1993/94(R)	1994/95
Tax revenue	54,355	85,928	114,476	134,886
Profit tax	13,274	8,552	11,300	17,345
Income tax	1,323	4,773	6,336	10,677
Agric./land tax	2,041	1,235	2,187	1,754
Business licences	136	115	156	184
Turnover tax	9,994	14,265	20,000	27,557
Tax on foreign trade	20,728	25,068	31,854	38,668
Import duties	9,976	21,980	25,700	33,767
Export duties	10,752	3,088	6,154	4,901
Excise taxes	1,873	4,398	5,101	5,523
Timber royalties	-	23,550	31,520	26,727
Other taxes	4,986	3,972	6,022	6,451
Non-tax revenue	20,317	27,328	29,088	30,803
Depreciation/dividends (State-owned enterprises)	4,755	4,695	3,024	2,980
Other	15,562	22,633	26,064	27,823
Leasing	3,756	4,895	4,642	5,023
Concession	1,071	553	375	397
Overflight	4,618	8,360	7,236	7,898
Interest/Amortisation	5,821	7,004	11,999	10,618
Other	296	1,821	1,812	3,887
Total revenue	74,672	113,256	143,564	465,689

Source: Ministry of Finance. (R)- Revised

divided into two groups for new members: Normal Sensitive and Highly Sensitive. The tariff on products in the Normal Sensitive list will be reduced to 0–5 per cent by 1 January 2010, while the tariff on products in the Highly Sensitive list will be reduced to 0–5 per cent by 1 January 2015 (Menon 1998).

Laos has put forward 533 tariff lines for the Immediate Inclusion List. This represents only 15 per cent of all tariff lines. All of these 533 tariff lines already carry tariff rates of between 0–5 per cent, however. Thus, at this stage, no tariffs will be reduced when Laos joins AFTA on 1 January 1998. There are 2,818 tariff lines in the Temporary Exclusion List (almost 80 per cent of all tariff lines). Products in this list will be phased into the Inclusion List between 1 January 2000 and 1 January 2005. There are 119 tariff lines (or 3.35 per cent of all tariff lines) of unprocessed agricultural products in the Sensitive List, with 112 in the Normal Sensitive list, and 7 in the Highly Sensitive list.

The remaining 81 tariff lines are in the General Exceptions List. Items in this list are supposed to satisfy the conditions provided for under Article XX of the GATT, which allows goods to be excluded from tariff reductions if such goods are necessary for the protection of national security, public morality, human and plant life, or health, or if such products are articles of artistic, historic or archaeological value. There are many products in this list put forward by the Lao authorities that clearly do not satisfy any of the criteria specified in Article XX. These include, for instance, passenger motor vehicles, boats, jewellery and various excise products such as cigarettes, beer, wine whisky and petroleum products. In their current submission, Lao authorities are using this list as an instrument of protection for various sensitive products.

The economic impact of AFTA

Impact on trade

In analysing the likely impact of AFTA on trade, the impact in the short run is examined separately from that in the medium to long run. In looking at the medium to long run, this section focuses on issues relating to trade diversion and trade creation, market access, and whether AFTA will provide a new market for final goods.

Impact in the short run

As noted earlier, Laos has been very cautious in its submission of product lists for the CEPT. At present, the earliest date for any AFTA-related tariff reductions is 1 January 2000. In practical terms, however, tariff reductions are unlikely to begin before 1 January 2003. Thus, AFTA on its own is unlikely to have much of an effect on its imports in the short term. Most of the products in the 533 tariff lines submitted in the Inclusion List will have immediate access, on a reciprocal basis, to relatively low CEPT tariffs in the ASEAN6 countries (since the program of tariff reductions in these countries has been in operation for five years). Since less than 20 per cent of tariff lines are in the Inclusion List, the impact on exports is also likely to be minor in the short term.

Impact in the medium to long run

(i) Trade diversion and trade creation

Laos is the only ASEAN member which conducts most of its trade with other ASEAN countries. Thus, it will be the only country for which the potential for trade diversion is low. Nevertheless, there are some product sectors where trade diversion is likely to be high. The main candidate for trade diversion is motor vehicles, the product currently with the highest tariff (50 to 150 per cent). Laos does not currently import many motor vehicles from ASEAN, but this could change with AFTA, if intra-ASEAN rates do indeed fall as part of the CEPT commitment and extra-ASEAN tariffs on motor vehicles remain high. It is reasonable to expect that ASEAN will not accommodate Laos's attempt to place motor vehicles in the General Exceptions List.

The issue of how the CEPT commitments will be applied by ASEAN governments to the automobile sector is unresolved. A number of ASEAN countries have so-called national cars, and there are already signs that foreign car manufacturers will set up operations in the region to service the AFTA market.[12] If Laos reduces its tariff on intra-ASEAN imports of motor vehicles to CEPT rates while maintaining current or even the IMF-proposed maximum rate of 40 per cent on extra-ASEAN trade, then imports of motor vehicles from ASEAN could grow quite sharply in the future. This is trade-diverting. To avoid this, Laos should multilateralise its CEPT tariffs on an MFN basis.[13]

Reductions in tariffs on goods already sourced from ASEAN (of which there is a high share) will be welfare-enhancing if reductions in the price of these goods in the Lao market lead to increases in consumption or, if they are inputs to production, lead to increases in exports.[14] NTBs that apply to the 533 tariff lines in the Immediate Inclusion List will have to be phased out within five years. Eventually, NTBs on all products will have to be phased out as part of the AFTA obligations. Thus, AFTA will provide Laos with the opportunity to deal with, and to eventually dismantle, the many NTBs that currently restrict trade (see Section 2). As long as ASEAN is serious about its members' complying with this obligation, and monitors the process closely, then the dismantling of NTBs in Laos could be trade-creating. Since only a very small share of domestic demand for non-agricultural goods is currently met by domestic production, however, the potential for trade creation associated with AFTA is low. The main benefit to accrue from the dismantling of NTBs is the more efficient allocation of domestic resources.

(ii) Market access

The literature suggests that, as part of the FTA negotiations, small or weak countries may be made worse off by being pushed into policy concessions in excess of those made by their larger partners as a result of their poor bargaining power (see Bhagwati and Krueger 1995; Helleiner 1996). Laos is certainly both small (relative to existing members) and weak (in terms of bargaining power). Does this mean that Laos is likely to be worse off by joining AFTA? This is unlikely. However weak its bargaining position, gaining a seat at any negotiating table would be an improvement on its current position.

Currently, Laos has a catalogue of claims with respect to unfair treatment and restricted market access in its trade with Thailand. In agriculture in particular, Lao authorities claim that Thailand operates a system of implicit and variable quotas on imports from Laos. These apply mainly to trade in livestock (cattle and pigs), coffee and wood products. Because Laos is not a member of the World Trade Organisation (WTO), it has no international legal right to have most-favoured nation status (mfn) or national treatment extended to its exports by its trading partners. AFTA will provide Laos with legal rights to mfn and national treatment for its exports to Thailand and the other ASEAN countries.

For transitional economies such as Laos that are not members of the WTO, the magnitude of the benefits from membership of a trade agreement such as an FTA, in terms of market access in particular, is likely to be inversely related to the level of their initial bargaining power. This position runs counter to that posited by Helleiner (1996). Perhaps Helleiner's position derives, in part at least, from focusing on the likelihood, rather than the potential, of benefits accruing to new and weak members. In this context, the question is whether legal rights to mfn and national treatment are likely to be enforced when it comes to weak countries such as Laos. Membership of AFTA will do more than simply confer Laos with legal rights to mfn and national treatment, however. ASEAN now has a new dispute settlement procedure, modelled along the lines of the WTO mechanism, to deal with contraventions of these rights.[15] With the conferment of legal rights to fair treatment and access to dispute settlement procedures, ASEAN should provide Laos with an effective forum to negotiate market access issues involving Thailand.

(iii) Can AFTA provide a new market for final goods?

Section 2 discussed how the removal of GSP privileges in the European Community resulted in exports of clothing falling quite sharply in 1996 (at least 30 per cent down compared with the previous year). Will AFTA enable Laos to replace some of the lost sales in the European Community by increasing its market share in ASEAN? Thailand and Indonesia have committed to reduce tariffs on garments in the CEPT system to an average of 5 per cent by 2003. At present, it appears that they will retain higher tariffs on imports of garments from non-ASEAN economies. These could range from 10 to 30 per cent. Thus, the margin of preference available to garment exporters in Laos could lie anywhere between 5 and 25 per cent, depending on whether or not other ASEAN countries reduce their tariffs on a multilateral basis. Laos will easily satisfy the minimum ASEAN content requirement of 40 per cent because almost 80 per cent of the fabric used in clothing production comes from Thailand. Indeed, there is room for Laos to increase the share of fabric and yarn from much cheaper non-ASEAN sources such as China. But Lao garment exporters will have to compete, on an equal basis, with exporters from Thailand and Indonesia in the ASEAN market. At present, it appears unlikely that Laos will be able to match these exporters in terms of quality. While wages in Laos are currently lower than in Thailand and Indonesia, the average wage share in value-added in Laos is only 25 per cent. Thus, without improvements in quality, any price advantage due to lower wage costs is likely to be small, and thus unlikely to deliver Laos a large share of the ASEAN market. Improvements in quality will require the involvement of foreign multinational firms.

Impact on revenue

Is membership of AFTA likely to have a significant impact on total revenues collected from trade taxes? There are two problems associated with providing a quantitative assessment of the tariff revenue change associated with membership of AFTA. The first and binding constraint is the absence, even at the aggregate level, of data on tariff revenue collections by country or country group. Even if these data were available, the quality of the trade data would seriously limit the ability to make projections for future trade flows with any degree of certainty. Given the current state of the data for Laos, it is difficult enough to be sure about the past, let alone the future! There is the added problem of suspected high volumes of unrecorded informal or cross-border trade, particularly with Thailand. Furthermore, as we shall see later, the extent of this type of trade may change in response to AFTA, which would further complicate the revenue change calculation by changing the share of recorded (and thus tariff-assessable) trade in total (recorded plus unrecorded) trade. In other words, any quantitative assessment of revenue change would also require a quantification of how the shares of recorded and unrecorded trade in total trade are likely to change in response to tariff reductions. Such an exercise at quantification would be extremely difficult, if not arbitrary. In the light of these problems, a quantitative assessment of revenue change is not attempted here, in favour of a qualitative assessment informed by the available data.

First, it is worth reiterating that most of Laos's trade is with Thailand, and that Thailand is the only ASEAN country with significant trading relations with Laos. Thus, to a large extent, the impact of AFTA on tariff revenue depends on estimating how much revenue is currently collected on trade with Thailand, and how this may change as a result of AFTA. How this changes depends on how trade patterns are likely to change as a result of AFTA.

Tariff revenue from trade with Thailand

This estimate of the extent of revenue currently collected from trade with Thailand focuses only on recorded trade. There are a number of reasons to suspect that the contribution of trade with Thailand to total tariff revenue collected is lower than its share in trade would imply. First, a substantial proportion of imports from Thailand consists of electricity, raw materials and food items. The tariff on imports of electricity is only 5 per cent. Raw materials such as yarn used in the production of garments for export enter at zero tariff under the duty exemption scheme. Apart from this duty exemption scheme, a subsidiary tariff exemption scheme operates, somewhat arbitrarily (see Section 2). It is quite likely that a significant share of imports from Thailand enters Laos under one or the other of these two duty exemption schemes.

As a result of these schemes, it is not surprising to come across estimates that put the share of recorded imports (from all countries) that have tariffs assessed at only between 30 to 50 per cent (Sundberg 1994: 86–7). Furthermore, as discussed in Section 2, the effective average import duty rate in 1992 was estimated at only 8.5 per cent. Thus, as far as recorded trade is concerned, it would appear unlikely that intra-ASEAN trade liberalisation associated with AFTA would have a major impact on total tariff revenue collection.

Much of the trade between Thailand and Laos consists of cross-border or unrecorded trade (see Bank of Thailand and Bank of Lao PDR 1994). Indeed, most of Laos's total cross-border trade, which is officially estimated to be at least 30 per cent of total recorded trade (but unofficially, government officials will admit to suspicions of this share being 50 per cent or higher), involves trade with Thailand. Of course, no customs revenue is collected on this type of trade. Reducing tariff and other barriers may affect the extent of unrecorded trade, however; this is discussed in the next section.

Smuggling activity in Laos

Cross-border trade or smuggling is rampant in Laos. In assessing the impact that AFTA might have on this type of trade, it is useful to divide it into two types: legal and illegal.[16] Most of the legal but unrecorded trade relates to trade in consumer and food items. Many of these items are cheaper across the Mekong in Thailand than they are in Laos. As a result, residents of Vientiane often travel across the border to do their weekly household shopping. According to current customs regulations, consumer goods amounting to US$20 or less brought in by passengers are exempt from duty (there is some minor variation in this limit across check-points). In practice, however, this limit of around US$20 is not strictly enforced, and only traders bringing in large consignments of goods are stopped, checked and charged duties. These small quantities of imports brought in by consumers are examples of trade that is legal but unassessed as far as tariffs are concerned.

Illegal and unrecorded trade includes prohibited goods, which constitute illegal trade, by definition. With respect to trade with Thailand, these relate mainly to goods such as antiques (items 20 or more years old) and various pharmaceuticals. Reducing this type of trade is unlikely to have revenue effects, but is important on social and security grounds. Various 'vice' products which are not prohibited but subject to high taxes and tariffs (alcoholic beverages, cigarettes and so on) are also regularly smuggled across the Mekong River. Smuggling activity is not limited to high tariff items. Many items with relatively low tariff rates are also often smuggled across the long and porous borders. Examples include household consumables such as soap, toothpaste, detergent, cosmetics and soft drinks. Various agricultural commodities subject to price controls are also regularly smuggled. One of the main commodities smuggled from Thailand is rice, which is subject to quantitative restrictions to encourage domestic production. The trade licensing system sometimes operates as an implicit quota system which restricts the imports of agricultural products such as vegetables, fresh water fish and animal feed from Thailand in particular (World Bank 1994). When this implicit quota operates, smuggling activity in these products increases, depriving the customs authorities of rents and mitigating the effects of the quota itself.

Effect of AFTA likely on the pattern and nature of trade

How are trade patterns likely to change as a result of AFTA? As discussed above, the fact that most of Laos's trade is with Thailand implies a low level of trade diversion associated with AFTA. Thus, the extent of the switching from low-cost high-tariff extra-ASEAN sources to high-cost low-tariff intra-ASEAN sources following preferential tariff reductions is likely to be minimal. This suggests that the change in tariff revenue is likely to be lower than in the case of substantial trade diversion. It follows from the view that the welfare cost of trade diversion derives from the loss in tariff revenue to the country pursuing preferential liberalisation.[17]

While trade patterns are unlikely to change in a way that impacts significantly on tariff revenue, the nature of trade with Thailand in particular may change as a result of AFTA. Reducing or removing tariff and other barriers to trade is likely to remove much of the incentive to engage in informal trade, or smuggling. Apart from tariffs, other barriers to trade include various technical non-tariff barriers (see Section 2), excessive red tape and problems with transport at the border. In the presence of these barriers, smuggling will occur if

$$s < t(1) \qquad (1)$$

i.e. $$p\,(1+s) < p\,(1+t(1))\,. \qquad (1a)$$

where p is the marginal cost of the import, $t(1)$ is the original or pre-reform tariff rate plus the tariff equivalent of non-tariff and other barriers to trade (measured as a fraction of p), and s is the 'smuggling premium', that is the payment that the syndicate extracts for the smuggling activity (also measured as a fraction of p). (For simplicity, we assume that the cost to the smuggler associated with organising the import of the good through illegal channels is less than the benefit, $p\,.\,s$.)

If tariffs and other barriers are reduced to $t(2)$ such that

$$s > t(2)\,, \qquad (2)$$

then the incentive to smuggle is removed (it is assumed that since the magnitude of s is likely to depend on factors such as the perceived risk of detection, rather than the magnitude of t, it remains unchanged in the pre- and post-reform periods). Smuggling activity ceases because it is now cheaper for the importer to pay the new tariff-inclusive price than the smuggling-premium-inclusive price;

i.e. $$p\,(1+s) > p\,(1+t(2))\,. \qquad (3)$$

If the import was smuggled in the pre-reform period because of the height of the tariff (i.e. $t(1) > s$), but smuggling ceased when tariffs were reduced (i.e. $t(2) < s$), then this has important implications for revenue collection. First, as long as $t(2) > 0$, tariff revenue collections will now increase because no tariff revenue was collected on the smuggled good. Second, it is clear from equation (3) that the price of the import in the Lao market will fall (relative to the smuggling premium-inclusive price). If domestic taxes (such as sales or value-added tax) are levied on the smuggled good in the exporting (source) country, then the reduction in price in the domestic market from the switch from illegal to legal importing channels will be even greater. This is because such domestic taxes are not usually levied on exports, but such taxes will be reflected in the price of the good if smuggling is organised beyond the wholesale stage of distribution.[18] Assuming that equation 2 holds, and if we measure the value-added or sales tax in the source country as a fraction of marginal cost (p) and denote it as v, then we obtain:

$$p\ (1+s+v) \quad > \quad p\ (1+s) \quad > \quad p\ (1+t(2))\ . \qquad (4)$$

As can be seen from equation 4, the potential price reduction from the switch from smuggling to legal import of the good is greatest when domestic taxes are levied in the exporting country. In other words, while prices will be lower when smuggling ceases and the good is imported legally, the size of the price reduction will depend on whether or not domestic taxes are levied in the exporting country. Irrespective of this, however, the reduction in price associated with the cessation of smuggling will increase the volume of the import. This will further increase total tariff revenue collections (again assuming that $t(2) > 0$).[19]

Impact on FDI flows

The standard approach to analysing the impact that the formation of an FTA is likely to have on FDI flows begins by dividing such flows according to their motivation: market-seeking (tariff jumping and market enlargement effects) and efficiency-seeking (export-platform and investment in internationally integrated industries) investment (see Athukorala and Menon 1997). The analysis then proceeds to identify the ways in which the formation of an FTA is likely to affect each type of investment. The standard approach is unlikely to be useful in analysing the impact on a transitional economy such as Laos. This is because these motivations do not generally apply in the context of FDI flows to transitional economies. Given the current state of its infrastructure and human resource base, Laos is not yet in a position to attract efficiency-seeking investment (with or without AFTA). For these reasons, and the likelihood that the margin of preference will be low, AFTA is unlikely to induce much market-seeking investment.

How, then, would membership of AFTA affect FDI flows to a country such as Laos? AFTA is unlikely to alter significantly the composition of FDI flows to Laos. That is, the bulk of FDI is likely to continue to flow into traditional areas of investment, such as hydro-electric power generation, mining, logging, and the recent growth area of hotels and tourism. AFTA will have various indirect effects that are likely to increase both the volume and quality of FDI into these sectors.

Perhaps the most significant constraint on FDI flows to Laos is the perceived risk of investment. This derives from the absence of a strong legal and regulatory environment. In such an environment, investors will require a higher (minimum) return on their investment to compensate for the higher level of perceived risk. This has implications for both the level and nature of foreign investment flows to Laos. First, the total amount of foreign investment in any industry is likely to be lower than it would be if this additional risk could be reduced or eliminated. Second, the higher levels of return required usually result in a large share of investments that are short-term in nature. Apart from these effects, the weak legal and institutional environment may result in foreign investors trying to protect their investments through *ad hoc* arrangements with Lao officials and partners. Corruption in this instance occurs not as a means to bypass government regulations, but rather to substitute for their lack! Such arrangements provide opportunities for rent-seeking activities that can impose costs on the domestic economy and distort the local investment climate. Most rent-seeking activities also run counter to national interests.[20]

Membership of AFTA would signal to foreign investors the need for changes to administrative, legal and bureaucratic systems to satisfy membership obligations. In other words, membership of AFTA would signal to foreign investors that the transition to a fully-fledged market economy would be certain and more rapid than would otherwise be the case.[21]

As a member of ASEAN, Laos would have to adopt ASEAN's Agreement on the Promotion and Protection of Investment (signed in 1987). It should be noted, however, that the 1991 amendment to the Lao PDR Constitution covered most of the issues in the ASEAN Investment Agreement by explicitly noting the right of foreign investors to repatriate capital and dividends, as well as protecting investors against uncompensated nationalisation or expropriation of foreign investment. Nevertheless, the imprimatur of ASEAN is likely to provide foreign investors with greater confidence in the security of their investments. This added sense of security is important because the risk of expropriation continues despite legal and/or constitutional assurances since international contracts are practically impossible to enforce. The security of investments is likely to be particularly important to potential investors in large-scale projects in politically and environmentally sensitive areas such as hydro-electric power generation.

The Protocol to amend the (1987) ASEAN Agreement for the Promotion and Protection of Investment was signed in September 1996. This amendment dealt mainly with practical and procedural issues. It contained measures to simplify investment procedures and approval processes, to increase transparency of the rules governing investment, and to improve accessibility to information on a timely basis. Simplifying investment procedures and increasing the transparency of rules governing investment will be welcomed by those considering investing in Laos. It will also help curtail the rent-seeking activities referred to earlier.

The perception of a weak administrative system, particularly with regard to screening of applications and enforcement of penalties for breach of conditions, may also induce investors with dubious business reputations to seek to invest in Laos when other countries may not be willing to host them. Anecdotal evidence from the FIMC suggests that many approved investments do not have sufficient funding to carry out their proposed operations even after a Memorandum of Understanding has been signed. The transaction costs associated with this process yield no economic benefit to Laos. There may also be significant opportunity and adjustment costs associated with non-viable projects that have to be terminated mid-stream. The legal costs of dealing with serious breaches of the conditions of investment can also be substantial. Improving access to information across ASEAN countries, which is provided for in the recent amendment to the Protocol on Investment, will assist Lao officials in detecting applications with insecure funding, or applicants with a dubious business reputation or a history of failed business dealings.

Conclusion

In this paper, we examined the likely impact on the Lao economy of joining AFTA, focusing on trade, government revenue and FDI flows. We found that trade diversion is likely to be low, since most of Laos's trade is already with Thailand. AFTA will provide Laos with the opportunity to negotiate market access issues in the Thai market, which could lead to increased exports. The impact of AFTA on revenues from trade taxes is a concern to Lao authorities because of the heavy reliance on such taxes as a source of revenue. The reduction in government revenue from trade taxes is likely to be low for at least two reasons: the high share of existing informal trade with Thailand in particular, and the likelihood of only low levels of trade diversion associated with AFTA. Perhaps the most significant constraint on FDI flows to Laos is the risk associated with investing there, due to the absence of a strong legal and regulatory environment. As the legal, administrative and institutional framework in Laos develops to meet the ASEAN standard, FDI flows are likely to grow strongly.

In analysing the economic impact of AFTA on Laos, we have treated it as if it were one cohesive nation state. In other words, we have ignored the regional dimension. Laos is essentially a nation of eighteen, quite disparate, provinces or prefectures. Addressing the regional dimension sheds new light on the impact of AFTA on trade, revenue and FDI flows. It is important in any analysis of the impact on trade because often these provinces are more closely integrated with one of the five countries bordering Laos than they are with the rest of the economy. Three of its five neighbouring countries are also ASEAN members. This is important in an analysis of the impact on revenue because while almost 70 per cent of recorded trade is conducted through Vientiane Prefecture, much unrecorded trade occurs in the provinces that border the Mekong River. Furthermore, since the provinces do not generally receive an equal share of the revenues collected in Vientiane, they are often forced to raise them by levying their own trade and other taxes. This has obvious implications for the implementation of the AFTA program. FDI flows are also likely to be concentrated in a few provinces that can harness the resources of the Mekong for hydro-electric power generation. For these reasons, the impact of AFTA at the regional or provincial level is a worthy candidate for future research.

Notes

* This paper draws upon earlier work commissioned by the United Nations Development Program (UNDP) and AusAID (Menon and Oxley 1997) and ongoing work for the Asian Development Bank (ADB 1994; Menon 1998). I am grateful to officials in various government departments in Laos, particularly in the ASEAN Department of the Ministry of Foreign Affairs, Ministry of Commerce, Customs Department and Foreign Investment Management Committee, for their assistance with data and valuable discussions. Sayphet Aphayvanh, Somphet Khousakoun, Somchith Inthamith, One-Sy Boutsivongsakd and Khempeng Pholsena deserve special men-

tion for their assistance. I thank Romeo Reyes, Suthad Setboonsarng, Raymond Yee, Peter Warr, Richard Pomfret, an anonymous referee of this series and participants at seminars at the Cambodia Development Resource Institute in Phnom Penh and the School of Oriental and African Studies at the University of London for their comments. I am grateful to Mark Horridge for assistance in compiling the trade database, and Yunyong Damrongsiri and Somsachee Siksamat for translating Lao and Thai text.

1 For an overview of the NEM and an assessment of its performance, see Saignasith (1997).

2 The AFTA-Plus component deals with various non-trade issues such as services and intellectual property. The impact of these measures on Laos is considered in Menon (1998). It is worth noting that the main impact is likely to come from adopting the ASEAN standard (which is based on the WTO standard) on customs valuation and tariff nomenclature.

3 While agriculture grew by only 3.1 per cent in 1995, the industrial sector grew by 13.4 per cent (with manufacturing growth of 17.4 per cent) and services by 10.3 per cent.

4 For an overview of recent macroeconomic developments focussing on exchange rate, fiscal and monetary policies, see Menon (1998).

5 It is worth noting that these data do not include service exports, which is where exports of electricity would be classified. Electricity is an important export item for Laos, and its exclusion from our tables should be borne in mind when interpreting the export shares.

6 It should be noted, however, that a proportion of log and wood products, and motor vehicles, are re-export items.

7 Apparently, many Thai garment manufacturers were also using the made-in-Laos label to gain GSP access to the EC.

8 This is not surprising given the low level of wages, and the limited amount of processing involved. The main activities in the garment industry in Laos are knitting, cutting, printing, embroidery and packaging (into locally-produced plastic bags).

9 Total import tariffs as a share of total imports equalled 6.2 per cent in 1991, and 7.4 per cent in 1992 (World Bank 1994).

10 For an recent overview of AFTA, see Menon *et al*. (1998).

11 Cambodia was to join with Laos and Myanmar in becoming new members of ASEAN on 23 July 1997. The rupture of the coalition between Mr Hun Sen and Prince Ranaridh (formed following the 1993 UN-brokered elections) in June 1997, however, led ASEAN to postpone Cambodia's membership indefinitely.

12 Two large US car manufacturers, Ford and Chrysler, have recently announced plans to set up manufacturing operations in Thailand to supply the AFTA market.

13 Apart from avoiding trade diversion, this approach would also assist Laos in its preparations to join the WTO. If there were a need to constrain rapid growth in such imports over a short period of time, Laos could impose a sales tax which would be

applied equally and independently of the import supply source. This would also assist in replacing revenue lost as a result of tariff reductions.

14 Increases in exports, if they lead to significant deterioration in the terms of trade, can be welfare-reducing. This is, however, unlikely for a small country such as Laos.

15 The ASEAN Economic Ministers (AEM) signed the Protocol on Dispute Settlement Mechanism (DSM) on 20 November 1996 in Manila. Under this mechanism, a panel of experts convened by the Senior Economic Officials' Meeting (SEOM) will assist in the making of rulings by undertaking fact-finding missions and advising on the applicability of relevant ASEAN agreements. The AEM will serve as the final appellate body. The entire process of dispute settlement has a maximum duration of 290 days. Affected parties must implement the ruling of SEOM or the AEM within 30 days. Failure to do so will require parties to enter into negotiations in order to determine satisfactory compensation. If a mutually acceptable compensation cannot be determined, then the party invoking the DSM can seek authorisation from the AEM to suspend the application of any concessions to the member concerned.

16 Given the nature of unrecorded trade, most of the information provided here is based on unstructured interviews with officials in the Lao Customs department.

17 The existence of trade diversion demonstrates that the margin of preference is sufficiently large to shift the import source from the lowest cost supplier to one within the region. That is, in terms of duty-paid prices, imports from within the region are now cheaper than from outside. The welfare loss arises from the fact that the reduction in the price of the import from the regional source does not fully offset the loss in tariff revenue associated with the switch in import sources. The magnitude of the welfare loss is equal to the difference between the change in tariff revenue and the change in price in the domestic market.

18 Anecdotal evidence suggests that most of the goods smuggled (on a small scale) from Thailand into Laos are purchased at the retail level, which implies that the prices of these goods would incorporate the 8 to 10 per cent VAT imposed in Thailand.

19 Apart from the potential to increase tariff revenue collections, the reduction in smuggling has at least two other effects. First, the share of recorded trade in total (recorded plus unrecorded) trade will increase, thus improving the reliability of trade data (indeed, some of the recent increases in trade among the original ASEAN members are attributed to an increase in the reporting, rather than the volume, of trade). Second, the informal market for finance, which is the monetary dual to the informal trade problem, is likely to diminish in significance, thus improving the ability of monetary authorities to conduct monetary policy.

20 A recent analysis by Tanzi and Davoodi (1997) suggests that corruption induced by inadequate control or auditing systems may alter the design of projects, by increasing their size and complexity. The size of the 'commission' that public officials receive for assisting an enterprise win a foreign investment licence or contract is usually a function of the size or complexity of the project itself.

21 The experience of Vietnam, another transitional economy that recently became a member of AFTA, is useful in inferring how FDI flows to Laos may change. In their assessment of Vietnam's accession to AFTA, the ASEAN Secretariat (1996: 38) noted that 'The accession to the CEPT Agreement and Vietnam's participation in many

other areas of ASEAN economic cooperation ... sends a strong signal to foreign investors of the direction of her economic policies. They strengthen the perception that Vietnam is firmly committed to the continuing liberalisation of her trade and investment regime'. There are other examples of developing countries using membership of an FTA to send similar signals. According to Lawrence (1996: 31), 'a key Mexican motive for NAFTA was to ensure that its economic reform policies would be credible and permanent'.

References

ASEAN Secretariat (1996) *AFTA Reader: The Fifth ASEAN Summit* (Volume IV), Jakarta: ASEAN Secretariat.

Asian Development Bank (ADB) (1994) *Subregional Economic Cooperation among Cambodia, China, Lao PDR, Myanmar, Thailand and Vietnam*, Manila: Asian Development Bank.

Athukorala, Premachandra and Jayant Menon (1997) 'AFTA and the investment-trade nexus in ASEAN', *World Economy,* 20(2), pp. 159–74.

Bank of Thailand and Bank of Lao PDR (1994) *The Problem of Border-trade between Thailand and Lao PDR*, (in Thai), Bangkok: Bank of Thailand, 30 June.

Bhagwati, Jagdish and Anne Krueger (1995) *The Dangerous Drift to Preferential Trade Agreements*, Washington DC: American Enterprise Institute for Public Policy Research.

Helleiner, Gerald K. (1996) 'Why small countries worry: neglected issues in current analyses of the benefits and costs for small countries of integrating with large ones', *World Economy*, pp. 759–63.

Lawrence, Robert Z. (1996) *Regionalism, Multilateralism and Deeper Integration*, Washington DC: Brookings Institution.

Menon, Jayant (1998) 'Lao PDR in ASEAN: exchange rate management, the current account and financial reforms', Report to the Asian Development Bank, Manila, forthcoming.

Menon, Jayant and Alan Oxley (1997) 'Lao PDR's participation in AFTA: economic impacts', UNDP/AusAid Study for the Ministry of Foreign Affairs, Lao PDR, Vientiane: UNDP.

Menon, Jayant, Joseph Tan and Manuel Montes (1998) 'Trade patterns, trade cooperation and AFTA', in Chia Siow Yue, ed., *Thirty Years of ASEAN*, Singapore: Institute of Southeast Asian Studies, forthcoming.

Saignasith, Chantavong (1997) 'Lao-style New Economic Mechanism', in Mya Than and Joseph Tan, eds, *Laos' Dilemmas and Options*, Singapore: Institute of Southeast Asian Studies, pp. 23–47.

Sundberg, Mark (1994) 'Trade policy and Lao development', in Chi Do Pham, ed., *Economic Development in Lao P.D.R.: Horizon 2000*, Vientiane: Lao PDR, pp. 82–92.

Tanzi, Vito and Hamid Davoodi (1997) 'Corruption, public investment and growth', *IMF Working Paper 97/139*, Washington DC: International Monetary Fund.

World Bank (1994) *Lao PDR Country Economic Memorandum*, Washington DC: World Bank.

Yeats, Alexander (1992) 'Are partner country statistics useful for estimating "missing" trade data?', Washington DC: World Bank.

Acronyms

AEM	ASEAN Economic Ministers
ASEAN	Association of Southeast Asian Nations
AFTA	ASEAN Free Trade Area
AMM	ASEAN Ministerial Meetings
CCI	Chamber of Commerce and Industry
CEPT	Common Effective Preference Tariff
DSM	Dispute Settlement Mechanism
EC	European Community
FDI	Foreign direct investment
FIMC	Foreign Investment Management Committee
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
Lao PDR	Lao People's Democratic Republic
mfn	Most-favoured nation
NAFTA	North American Free Trade Area
NEM	New Economic Mechanism
NTB	Non-tariff barrier
IMF	International Monetary Fund
PTA	Preferential Trading Arrangement
ROO	Rules of origin
SEOM	Senior Economic Officials' Meeting
SITC	Standard International Trade Classification
VAT	Value-added tax
WTO	World Trade Organisation
UN	United Nations
UNDP	United Nations Development Program

Previous *Pacific Economic Papers*

261 East Asia and Eastern Europe trade linkages and issues
Jocelyn Horne, November 1996

260 National choice
Wang Gungwu, October 1996

259 Australia's export performance in East Asia
Peter Drysdale and Weiguo Lu, September 1996

258 Public infrastructure and regional economic development: evidence from China
Weiguo Lu, August 1996

257 Regional variations in diets in Japan
Paul Riethmuller and Ruth Stroppiana, July 1996

256 Japanese FDI in Australia in the 1990s: manufacturing, financial services and tourism
Stephen Nicholas, David Merrett, Greg Whitwell, William Purcell with Sue Kimberley, June 1996

255 From Osaka to Subic: APEC's challenges for 1996
Andrew Elek, May 1996

254 NAFTA, the Americas, AFTA and CER: reinforcement or competition for APEC?
Richard H. Snape, April 1996

253 Changes in East Asian food consumption: some implications for Australian irrigated agriculture
Philip Taylor and Christopher Findlay, March 1996

252 Behaviour of Pacific energy markets: the case of the coking coal trade with Japan
Richard J. Koerner, February 1996

251 Intra-industry trade and the ASEAN free trade area
Jayant Menon, January 1996

250 China and East Asia trade policy, volume 3:
China and the world trade system
Various authors, December 1995 (special volume)

249 China and East Asia trade policy, volume 2:
Regional economic integration and cooperation
Various authors, November 1995 (special volume)

248 China and East Asia trade policy, volume 1:
East Asia beyond the Uruguay Round
Various authors, October 1995 (special volume)

247 The question of access to the Japanese market
Peter Drysdale, September 1995

246 The Asia factor in US–Japan relations
Urban C. Lehner, August 1995

245 ASEAN's new role in the Asia Pacific region: can it be a driving force of wider regional economic cooperation?
Jiro Okamoto, July 1995

244 Dollar shortage — yen shortage?
Heinz W. Arndt, June 1995

243 The dynamics of employment, wages and output: a comparative study of Korea and Japan
Francis In and Arlene Garces, May 1995

242 On exports and economic growth: further evidence
Ligang Song and Tina Chen, April 1995

241 US trade policy towards the Asia Pacific region in the 1990s
John Kunkel, March 1995

240 A simple model of main bank monitoring in Japan
Luke Gower, February 1995

239 The impact of economic reform on technical efficiency: a suggested method of measurement
Peter Drysdale, K. P. Kalirajan and Shiji Zhao, January 1995

238 Price flexibility in Japan, 1970–92: a study of price formation on the distribution channel
Kenn Ariga and Yasushi Ohkusa, December 1994

237 Political economy of the large-scale retail store law: transforming 'impediments' to entering the Japanese retail industry
Terada Takashi, November 1994

236 A microeconomic model of Japanese enterprise bargaining
Akira Kawaguchi, October 1994

235 Building a multilateral security dialogue in the Pacific
Liu Jiangyong, September 1994

234 Changing patterns of world trade and development: the experience from the 1960s to the 1980s
Ligang Song, August 1994

233 Taiwan's industry policy during the 1980s and its relevance to the theory of strategic trade
Heather Smith, July 1994

232 Why is Japanese working time so long? Wage working time contract models
Akira Kawaguchi, June 1994

Annual subscription rate for twelve issues:
Individuals A$60.00
Institutions A$100.00

Cost for single issues:
A$15.00
A$10.00 (Students)

All prices include postage

Available from: Publications Department
Australia–Japan Research Centre
Research School of Pacific and Asian Studies
The Australian National University
Canberra ACT 0200, Australia
Facsimile: (61 2) 6249 0767
Telephone: (61 2) 6249 3780
Email: ajrcgen@ajrc.anu.edu.au