



# **Escaping the Middle-Income Trap in ASEAN An Institutional Economy**

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# Escaping the Middle-Income Trap in ASEAN An Institutional Economy<sup>1</sup>

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## ABSTRACT

The middle-income trap is highly relevant for member states of ASEAN, home to a number of middle-income countries (MICs). In transitioning to high-income status, MICs must upgrade their institutional quality to reflect a higher stage of development. A key challenge in this transition, however, is institutional persistence: While a set of institutions may have been functional for growth at one stage of development, at a higher stage these same institutions may provide an impediment to further growth. In light of the success of European MICs that escaped the middle-income trap through accession to the European Union, some have put forward integration through the ASEAN Economic Community as a strategy to commit MICs to upgrading domestic institutional quality. However, as this paper shall examine, the institutional structures of the ASEAN Economic Community do not hold promise of enabling ASEAN's upper-middle income members to escape the middle-income trap. This paper put forward that ASEAN's secondary (formal) institutional design is *institutionally trapped* by the primary (informal) institutional norms of the 'ASEAN Way' coupled with the persistence of the ASEAN 'Development Gap'. This results in the institutional structures of the ASEAN Economic Community reflecting development strategies of low and lower-middle income economies. This paper conclude that for ASEAN's upper-middle income economies, relying on the ASEAN Economic Community could project the challenges of the middle-income trap by disincentivizing reform and accentuating institutional persistence. Thus, national development strategy, rather than regional integration, is likely to remain the priority in escaping the middle-income trap.

*Keywords:* Middle-income trap, ASEAN, regional integration, emerging markets

## Author's Bio

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<sup>1</sup> This paper is part of the author's master's thesis with some added and removed sections.

## 1. Introduction

The concept of the middle-income trap is highly relevant for member states of the Association of Southeast Asian Nations (ASEAN). The middle-income trap refers to the phenomena where middle-income countries (MICs) struggle to make the transition from middle- to high-income status. For these economies, growth is based on cheap labor and capital-intensive (intrinsic) production. However, as the economy reaches middle-income status through rising wages, this comparative advantage is eroded, leading to growth slowdowns. To make the transition to high-income status, economies must subsequently shift their factors of production toward technology, knowledge and innovation led (extrinsic) production (Garrett, 2004; Gill & Kharas, 2007).

A key challenge in overcoming the middle-income trap is the upgrading of institutional quality relative to a country's stage of development. As economies transition through productive capabilities and hence income levels, their institutions must simultaneously undergo a structural transformation to reflect their higher stage of development (Ohno, 2009; North, 1990). While a set of institutions may have been good quality and functional for growth at one stage of development, at a higher stage these same institutions may provide an impediment to further growth (Dollar, 2015). In light of this, escaping the middle-income trap requires not simply improving on the key drivers of growth, but a structural and institutional transformation to reflect a higher stage of development (Kang, 2017). However, given that institutions are persistent, MICs are struggling to make this transition, leaving them 'trapped' between lower cost competitors and high-income technological frontier countries (Gill & Kharas, 2007; Acemoglu & Robinson, 2008).

Southeast Asia is home to a number of MICs, including Malaysia, Indonesia, Thailand, the Philippines and Vietnam. Given their shared dilemma in making the transition to high-income status, one method advocated by policy makers to escape the middle-income trap is to utilize regional economic integration strategies through the ASEAN Economic Community, which was launched in December 2015 (Devaraj, 2015). Regional economic integration has been advocated in light of the success of European countries such as Spain, Portugal, Ireland and Greece, who graduated to high-income status during accession to the European Union (EU) (Balaoing-Pelkmans & Tulder, 2016). Given that the EU's original members were developed economies, the EU's institutional form reflected their high-income status (North et al, 2007). Significantly, the EU's accession criteria committed MICs to an institutional transformation to a relatively higher stage of development, which coercively facilitated shifting the factors of production from intrinsic to extrinsic led growth (Gill & Raiser, 2012; Toviias, 2004; Pridham, 1991; Van Appeldoorn, 2002; Pinto, 2002; Royo, 2007; Armstrong, 1995; Moravcsik, 2000; Alter, 2011; Maduro, 1998; EU, 1957; Sebastian, 2001). The EU, as a supranational institution, has been a *trendsetter* in institutional reform.

However, as this paper shall examine, the institutional structures of the ASEAN Economic Community do not hold the promise of enabling ASEAN's upper-middle income members to escape the middle-income trap.

ASEAN's 'institutional form' comprises its secondary (formal) and primary (informal) institutional structures (North et al, 2007; North, 1990; Buzan, 2014; Helmke & Levitsky, 2004). Primary institutions are deep and durable social practices and values that undergo evolution rather than design. Secondary institutions are the formal institutional design constitutive of primary institutions. Thus, primary institutions define both the rules of the game (primary institutions) and what the pieces are (secondary institutions) (Manning, 1962; Buzan, 2014).

ASEAN's primary institution is defined as the 'ASEAN Way'. This includes norms such as informality, decision-making by consensus, non-interference in one another's domestic affairs, open regionalism and an aversion to legally binding agreements (ASEAN, 1976). The 'ASEAN Way' is constitutive of ASEAN's secondary (formal) institutional design, which reflects consensus decision-making mechanisms, and intergovernmentalism as opposed to supranationalism (Acharya, 1997; Narine, 2002). Significantly, these norms mean that ASEAN's formal institutional

evolution can only move as fast as its slowest member, and agreements are usually of a lowest common denominator outcome (Pitsuwan, 2001). Thus, contrastingly to the supranationalism of the EU, which is a *trendsetter* in institutional reform, ASEAN is a *trend taker*, given that it reflects the trends and national preferences of its member states.

This primary institutional framework is especially pertinent given the persistence of the multifaceted ASEAN 'Development Gap'. This refers to ASEAN's diverse membership that contains low income (Cambodia, Laos, Myanmar), lower-middle income (Indonesia, the Philippines, Vietnam), upper-middle income (Thailand, Malaysia) and high income (Singapore, Brunei) economies (Menon, 2012). It further refers to high levels of domestic economic inequality with millions of poor in ASEAN MICs, such as in Indonesia and the Philippines (Sumner, 2012; McGilvray & Carpenter, 2013). It finally refers to restrictive economic freedom, especially in Cambodia, Laos and Myanmar (Severino, 2007; Sen, 1997).

In light of this, this paper argues that the primary institution of the 'ASEAN Way', particularly the norm that ASEAN can only move as fast as its slowest member, coupled with the persistence of the ASEAN 'Development Gap', means that ASEAN's secondary formal institutional design is *institutionally trapped* in reflecting the institutional quality of low and lower-middle income economies. Thus, this paper puts forward that the institutional structures of the ASEAN Economic Community prospectively provides a development strategy for low- and lower-middle income economies to transition to upper-middle income status through functionally improving on the key drivers of intrinsic production. However, the ASEAN Economic Community does not commit member states to the structural transformation necessary to upgrade institutional quality and production to extrinsic led growth. Therefore, for upper-middle income economies, the ASEAN Economic Community does not hold promise for escaping the middle-income trap.

Moreover, this paper puts forward that the ASEAN Economic Community prospectively accentuates the challenges of the middle-income trap, as its structural weakness disincentivizes reform in upper-middle income economies and allows for domestic institutional quality to stagnate. Indeed, this refers to the classical institutional challenge of the middle-income trap of institutional persistence (Acemoglu & Robinson, 2008; Dollar, 2015; Ohno, 2009). Thus, for upper-middle income ASEAN economies, national development strategy shall continue to be the priority in escaping the middle-income trap, rather than through regional economic integration (Balaoing-Pelkmans & Tulder, 2016).

Indeed, ASEAN's structural weakness in economic integration has led some scholars to argue that it is an 'imitation community', which consists of an attractive facade of public pronouncements that mask a deliberate lack of real substance, as in reality elites are pursuing different national strategies rather than the regional ones advocated in public announcements (Jones & Smith, 2002; Green, 2008). Given ASEAN's *institutional trap*, this paper put's forward that this criticism is reflected in the ASEAN Economic Community: It is a rhetorical drive in which to promote the ASEAN region to attract foreign direct investment (FDI), rather than genuinely seeking closer political and economic integration that upgrades domestic institutional quality (Green, 2008).

This paper aims to answer the following questions: What is the nature of the middle-income trap in ASEAN and how can it be best defined? What challenges does ASEAN's regional political economy present to upgrading domestic institutional quality? Does ASEAN and the ASEAN Economic Community's institutional structures commit members to domestic structural reform that enables a shift to higher and qualitatively better growth, in order to break out of the middle-income trap?

This paper shall be structured as follows. The second section of this paper reviews the literature regarding the middle-income trap and identifies the gap that overemphasizes national development strategies and neglects the role of regional integration as a method to escape the middle-income trap. Moreover, this section examines the theoretical framework on institutional quality and growth traps, which puts forward that as countries progress through income levels, their institutions must undergo a structural transformation to reflect their new stage of

development. The third section expands on whether the 'ASEAN Way' can be considered a primary institution and explains how this is constitutive of ASEAN's secondary institutional design. It further analyses how the primary institution of the 'ASEAN Way' coupled with the persistence of the ASEAN 'Development Gap' results in ASEAN's secondary *institutional trap*.

In the fourth section, the paper examines the empirical evidence and features of the ASEAN Economic Community's secondary institutional design, namely through the (i) dichotomy between the Single Market and Single Production Base, (ii) the Enhanced Disputes Settlement Mechanism and (iii) mechanisms for addressing the 'Development Gap'. In the final analytical section, this paper concludes that given its *institutional trap*, the ASEAN Economic Community does not hold promise in assisting ASEAN members to escape the middle-income trap. The paper further contends that for ASEAN's upper-middle income economies, the ASEAN Economic Community could prospectively accentuate the challenges of the middle-income trap by disincentivizing reform, and that national development strategies will likely remain the priority over regional integration in escaping the middle-income trap.

## **2. Institutional Quality and Growth Traps: A Theoretical Framework**

Middle-income ASEAN economies have achieved impressive growth rates in recent decades (ADB, 2011). While global growth between 2010-2014 stood at 2.8%, Indonesia, Malaysia and Thailand grew 5.7%, 5.4% and 3.6% respectively (WDI, 2017). Furthermore, after learning the lessons of the 1997 Asian Financial Crisis (AFC), growth has been resilient, illustrated where following the 2009 Global Financial Crisis, growth rates were maintained (Myrvoda et al, 2016). However, ASEAN growth has not been at the levels seen before the AFC, where between 1990-7 Malaysia, Indonesia and Thailand grew 9.2%, 7.6% and 7.4% respectively (WDI, 2017). This slowdown in growth has led to fears of ASEAN's MICs succumbing to the middle-income trap.

In conceptualizing the middle-income trap, Gill & Kharas (2007) observed that there was a theoretical absence for growth strategies in MICs. As argued by Garrett (2004), based on the endogenous growth model, globalization processes benefit wealthier countries whose institutions and human capital bases encourage innovation. Moreover, based on the Solow Growth Model, globalization also benefited poorer nations that focused on routine tasks and easily available low-cost technology. Yet through this process MICs find themselves increasingly uncompetitive as they are sandwiched between lower cost locations in mature sectors such as China and India, yet do not possess the institutions, human capital nor technological capability that would transition them to the higher income status of the technological frontier countries, such as the United States.

Existing development theories give little account for MICs, which contain the majority of the world's poor (Sumner, 2012; Gill & Kharas, 2007). For ASEAN MICs, growth in the post-colonial period came from reallocating the factors of production from agriculture to industry, with growth of output and employment in industry dwarfing that of agriculture. This allowed labor abundant ASEAN MICs to utilize economies of scale and engage in capital formation to acquire technological capabilities (Booth, 2007). Industrialization was export oriented and focused on low-value added and high-volume assembly production, with ASEAN MICs becoming integrated into production networks in the broader East Asian region. However, ASEAN member states did not integrate with one another, given that their production was of a competing rather than complementary nature, and that export markets were outside of the region (Chia, 1997).

Overtime, ASEAN economies have advanced through the value chain by upgrading products and processes (World Bank, 2010). Malaysia and Thailand have achieved upper-middle income status, while Indonesia, the Philippines and Vietnam have advanced to lower-middle income status. Indeed, in 1980 Malaysia, Thailand and Indonesia had per capita incomes of US\$1,803 US\$683 and US\$536 respectively. By 2014, the corresponding figures increased fourfold to US\$10,830, US\$5,561 and US\$3,315 (WDI Online).

However, this transition has been through the 'easy phase of growth' (Hutchinson & Das, 2016: 14). A transition that MICs face is the Lewis Turning Point, where surplus agricultural labor is exhausted and industrial wages begin to rise (Lewis, 1954). At the same time, productivity gains due to inter sectoral factor reallocations start to slow (Eichengreen et al, 2013). If this is not accompanied with increased productivity, technological progress and advancement through the value chain, national economies become uncompetitive (OECD, 2013). This difficulty in transitioning from middle income, based on labor and capital intensive (intrinsic) production, to high income, based on skills, innovation and productivity (extrinsic) led growth, is termed the middle-income trap (Gill & Kharas, 2007).

So prevalent is the middle-income trap that only 13 out of 101 countries classed as middle income in 1960 have transitioned to high income status (World Bank, 2013: 12). Indeed, as we shall argue, the regional political economy of ASEAN presents a specific set of structural challenges in escaping the middle-income trap.

In elucidating our argument that ASEAN is *institutionally trapped*, we use the theoretical framework put forward by North (1986; 1990) Ohno (2009), Acemoglu & Robinson (2008) and David Dollar (2016), which analyses institutional quality and growth traps relative to stages of development.

Economic growth and productive capability is dependent on institutional quality (Rodrik, 2002; North, 1990). The framework puts forward that in a developmental context, high quality political and economic institutions are those that enable countries to adjust policies to changing circumstances and maintain relatively high growth (North, 1986). As countries progress through stages of development, and thus income levels, simultaneously their institutions must also reform to reflect their new stage of growth (Dollar, 2016). However, secondary institutions are persistent, and thus difficult to reform, which is expected given that the underlying primary institutions are defined by deep seated features and values of a society (Buzan, 2014; Acemoglu & Robinson, 2008).

Thus, a country that has good quality institutions at one stage of development soon finds that these same institutions are of poorer quality relative to a higher stage of development. Not constantly improving institutions is a kind of trap that countries can fall into at any level. Institutions that successfully reform hold greater promise of avoiding the middle-income trap. Conversely, institutions that fail to change, or do not have the institutional structures to match their stage of development, will impede graduation to the next income level (Dollar, 2016).

As conceptualized by Ohno (2009), there are four broadly defined stages of development. (1) In stage one, institutions must encourage the arrival of FDI by creating a production base conducive to simple production such as textile manufacturing, food processing and manual assembly. Virtually all inputs are imported from abroad and value creating processes such as management, research and development as well as marketing are performed by foreigners. (2) In stage two, as contract manufacturing and machine assembly reach critical mass, institutions must reform to be conducive toward building domestic supporting industries. Over time, most parts and components are produced either by FDI or local suppliers. However, production and firm competitiveness is still highly dependent on foreign technology and management. Stages (1) and (2) rely on intrinsic factors of production.

(3) Critically, in stage three, the factors of production shift from intrinsic to extrinsic led growth. Localization expands from physical inputs to human capital, and foreign dependency is significantly reduced. The country becomes an exporter of high-quality manufactured products and invests to build production bases abroad. Thus, institutions must be conducive toward the internalization of technology and management capability. (4) Finally, in stage four, institutions must be conducive toward creating new products and lead global industrial markets through innovation.

Thinking about institutions relative to stages of development leads to the question of whether there is regular institutional improvement as the economy develops. However, given that institutions are persistent, this is rarely the case, and as countries graduate through income levels, they experience growth slowdowns. Such economies are competing with a newer, higher quality group of peers, and without continual institutional improvement growth rates slow sharply (Acemoglu & Robinson, 2008; Dollar, 2016). This tends to be the experience of ASEAN economies (Ohno, 2009).

Thus, the dilemma of the middle-income trap, from an institutionalist perspective, is how to encourage structural reform that upgrades institutional quality. The academic literature has focused on national strategies, yet underemphasized the role of external commitments, regional institutions and economic integration (World Bank, 2015; Felipe et al, 2012; Eichengreen et al, 2013; Gill & Kharas, 2007; 2016; Dollar, 2015; Rodrik, 2015; Kang, 2017; Gill & Kharas, 2007, 2016; ADB, 2013; IMF, 2013; Aiyar et al, 2013; Ohno, 2009; Acemoglu & Robinson, 2008; Gill & Raiser, 2012). Indeed, Gill and Kharas (2015; 35-53) acknowledge in their chapter, *The Middle Income Trap Turns 10*, that they have neglected the role of external commitments as a strategy to avoid the middle-income trap, despite the evidence in favor of this. For example, the political and economic integration of southern European countries with more open northern European countries in the European Union led to income convergence (Gill & Raiser, 2012). For South Korea and Taiwan, openness and political dependence on the United States pressured them to carry out political and economic institutional reform, enabling them to upgrade productive capability (Amsden, 1989). Poorer societies integrating with richer ones will generally pay off with stronger institutions and income convergence (Venables, 2003). This evidence suggests that external commitments are important drivers of structural reform to upgrade institutional quality, and a method for escaping the middle-income trap. This paper aims to fill this gap in the literature.

### **3. ASEAN's Institutional Structure**

#### **3.1. ASEAN's Primary Institution: The 'ASEAN Way'**

The conceptual approach of this paper is innovative in that it defines the 'ASEAN Way' as constitutive of ASEAN's primary institutional norms, and it is necessary to present a defense of the concept grounded in theory. The approach does not explicitly use the term English School, from which the concept of primary institutions is taken from, given that the interdisciplinary nature of the paper goes beyond international relations theory. It further goes beyond the normative applications to Southeast Asian regional relations and the 'ASEAN Way' that overly focus on diplomatic culture and security (Nair, 1984; Haacke, 2003; Acharya, 1997; 2001) or societal approaches (Quayle, 2012; Gerard, 2013). Nor does this paper engage with approaches to institutionalism or liberal institutionalism in the IR literature. The paper instead incorporates theories of developmental and institutional economy in the tradition of North (1990) where growth is dependent on institutional quality, which was expanded on in the theoretical framework.

Nevertheless, this still warrants discussion to justify why the concept of primary institutions is relevant to the core argument. This paper utilizes the functional approach to primary institutions as put forward by Albert and Buzan (2011), Buzan (2014), Stichweh (2013) and Holsti (2004). There are broad definitions for what primary institutions entail. Expanding on the early conceptualization by Manning (1962) where primary institutions define both the rules of the game (primary institutions) and what the pieces are (secondary institutions), in a functional approach Holsti (2004) offers an operational definition for identifying primary institutions, namely the existence of patterned, recurrent practices; the existence of a coherent set of beliefs that frame these practices and make them purposive; as well as the presence of norms, rules and etiquette that both prescribe and proscribe legitimate behavior. Buzan (2004) more generally

defines primary institutions as relatively fundamental and durable practices that are evolved more than designed, which are constitutive of actors and their patterns of legitimate activity in relation to each other. These scholars further argue that the utilization of the concept of primary institutions rests on the empirical identification of such primary institutions. There is no fixed set of primary institutions because they are emergent from complex, localized processes of human society (Buzan, 2014). Therefore, if primary institutions are potentially infinite, then empirical identification is the only way of determining what such institutions exist in any given case. As argued by Stichweh (2013), primary institutions only need identification as a catalogue of a function system in order to perform analysis on them.

Conceptualizing the 'ASEAN Way' as primary institutional norms and the ASEAN Economic Community as a secondary institution adheres to the functional criteria of Manning (1962), Buzan (2004; 2014), Stichweh, 2013 and Holsti (2004). The primary institutional norms include decision making by consensus, informality, non-interference in one another's domestic affairs, respect for one another's sovereignty, open regionalism and an aversion to legally binding rules (Severino, 2010). These norms were formally institutionalized in the 1976 Treaty of Amity and Cooperation (ASEAN, 1976) and reaffirmed in the 2007 ASEAN Charter (ASEAN, 2007), indeed Buzan (2014) argues mining the constitutional documents of international organizations will tell us something useful about the primary institutions of modern international society.

In regard to ASEAN's institutional origins, ASEAN was formed during the Bangkok Declaration in 1967 by its original members of Singapore, Malaysia, Thailand, Indonesia and the Philippines (ASEAN, 1967). ASEAN was primarily formed to legitimize the sovereignty of its members' domestic governments, given the Cold War security context of competing external hegemonies of the United States and Soviet Union, the ongoing conflict in Indochina and security threats from domestic communist cells (Haacke, 2003). Furthermore, given the recent conclusion of border disputes such as *Konfrontasi* between Malaysia and Indonesia, and the North Borneo Dispute between Malaysia and the Philippines, there was a need for consensus in respecting one another's territorial boundaries and political entities. This was compounded by members' recent histories of colonialism and only recently attained independence (Beeson, 2009). This backdrop of external pressure and internal tension provided the impetus for greater regional cooperation (Acharya, 1997). Thus, ASEAN's institutional origins lie in the notion of enhancing individual state sovereignty, consensus building and pursuing mutual interests, as opposed to transferring sovereignty to a supranational institution, in dealing with the political and security challenges members faced at the time (Tarling, 2011). Given these institutional origins, the primary institutional norms of the 'ASEAN Way' were established. The 'ASEAN Way' is propagated as a successful instrument for bringing stability between Southeast Asian member states in the context of their divergent political forms and ideologies, while the economic benefits that stability brings has helped to propel five members to middle-income status (Booth, 2007).

### **3.2. ASEAN's Secondary Institutional Design**

The primary and informal institutional norms of the 'ASEAN Way' are constitutive of ASEAN's secondary and formal institutional design. ASEAN is an intergovernmental organization, where sovereign states remain the primary actors, with the highest decision-making body being the biennial ASEAN summits. The ASEAN Secretariat does not have a mandate to engage in policy making and is instead tasked with organizing meetings and summits (Beeson, 2009). Significantly, ASEAN does not have the power to discipline members who do not follow ASEAN agreements, as implementation is on a voluntary basis (Severino, 2011). Finally, ASEAN engages in 'open regionalism', which allows individual member states to pursue their own independent foreign economic relations with third parties, as opposed to the common approach of a customs union (Ariff, 1994; Ba, 2011).

Significantly, given the norms of decision making by consensus and non-criticism, ASEAN can only move as fast as its slowest member, and decision making is often the result of lowest common denominator outcomes (Pitsuwan, 2001). Indeed, significant reform in ASEAN has often been in

reaction to exogenous pressures (Beeson, 2003). In light of this, ASEAN's secondary formal institutional design is that of a *trend taker*, as it reflects trends of its members, as opposed to being a *trendsetter*.

### **3.3. The ASEAN Development Gap**

Low-income economies Vietnam (1995), Myanmar and Laos (1997) and finally Cambodia (1999) (CLMV) have been granted ASEAN membership, which increased the political and economic diversity of ASEAN (Menon, 2012). ASEAN's accession criteria simply required applicants to be geographically situated in Southeast Asia and subscribe to ASEAN's primary institutional norms by signing the Treaty of Amity and Cooperation (ASEAN, 1976). This was a relatively simple process, given that applicants did not need to undergo secondary institutional reform in joining ASEAN (Weatherbee, 2015).

Significantly, expansion accentuated the multi-faceted ASEAN 'Development Gap', which is defined by three key features. First, ASEAN now contains member states with the full spectrum of income status. Indeed in 2010, Singapore, ASEAN's richest member, had a per capita annual income that was almost 45 times higher than that of Myanmar, ASEAN's poorest member. The proportion of people living under US\$1 per day in 2013 was 33.9% in Laos and 28.3% in Cambodia, while there were practically no people living under this amount in Singapore and Brunei (McGillivray & Carpenter, 2013).

Second, a 'Development Gap' of domestic inequality also exists within ASEAN's MICs. Despite the Philippines and Indonesia being classified as MICs, they contain significant proportions of people on low incomes (Sumner, 2012). For example, the Philippines contains 12 million people living in extreme poverty out of a population of 103 million (World Bank, 2017). In Indonesia, while Java is relatively well developed, outer lying regions such as Papua and Sulawesi exhibit low levels of development and also contain sizeable numbers of extremely poor people (UNDP, 2017).

Finally, there is a political and economic freedom gap between the ASEAN-6 and the CLMV (Tarling, 2011). Moreover, political freedom within the ASEAN-6 fluctuates, as demonstrated by the cycles of military coups in Thailand (Bunbongkarn, 2014). According to the Heritage Foundation's Index of Economic Freedom (2015), Singapore was ranked at number 2 in the world, scoring high in areas such as legal system, freedom to trade internationally and devising useful institutions. Cambodia (52), Malaysia (58), Brunei (62), the Philippines (67) and Indonesia (76) sit in the second quartile; Thailand (103) and Vietnam (109) sit in the third quartile; while worst performing Myanmar sits at 146. This also implies a development gap as defined by Sen (1999), in that development is an outcome where people are able to exercise reasoned agency.

### **3.4. ASEAN's Institutional Trap**

We put forward the concept that the primary institution of the 'ASEAN Way' coupled with the persistence of the ASEAN 'Development Gap' means that ASEAN's secondary institutional evolution is *institutionally trapped* in reflecting the institutional structures of low and lower-middle income economies. Furthermore, we argue that ASEAN is a *trend taker*, as opposed to a *trendsetter*, in institutional reform.

As we shall explore in the next section, this *institutional trap* is reflected in the institutional structures of the ASEAN Economic Community. ASEAN's institutional features are structured toward improving the key drivers of intrinsic growth, such as attracting FDI for labor-intensive tasks. This subscribes to the growth strategies of low and lower-middle income economies. However, this is opposed to committing members to a structural transformation that would upgrade domestic institutional quality to reflect a higher stage of development and facilitate moving the factors of production to extrinsic led growth. Thus, while the ASEAN Economic Community's institutional structures are functional for improving on the key drivers of growth, they are unlikely to commit members to upgrading domestic institutional quality to escape the middle-income trap.

#### **4. Assessing the ASEAN Economic Community**

In assessing the institutional structures of the ASEAN Economic Community, we take a conceptual approach to examine (a) the Single Market and (b) Single Production Base, (ii) the Enhanced Dispute Settlement Mechanism and finally (iii) the ability of ASEAN to address its 'Development Gap'.

##### **4.1. The 'Single Market' & 'Single Production Base'**

The dichotomy between the 'Single Market' and 'Single Production Base' is not immediately obvious, indeed many features are overlapping. However, closer analysis reveals that ASEAN deliberately prioritizes the Single Production Base over the Single Market. Explaining why ASEAN prioritizes the Single Production Base is critical to analyzing the development strategy envisioned by the ASEAN Economic Community, which reflects that of low and lower-middle income economies.

##### **4.2. The Single Market**

The Bali Declaration calls for the establishment of a Single Market (ASEAN, 2003). A general definition of a Single Market is that it entails far reaching cross border liberalization based on the fundamental obligation to ensure non-discrimination and mutual market access. A Single Market encompasses negative integration, referring to the removal of restrictions on economic freedom in areas including goods, services, capital, labor and codified technology. This is coupled with positive integration, referring to the implementation of market institutions and regulations (Lloyd, 2005).

However, the ASEAN Economic Community's 'Single Market' falls short of this definition. In a fully-fledged single market, market fundamentals such as competition policy, consumer protection and intellectual property rights are subjects of positive integration. However, the ASEAN Economic Community's Single Market instead stipulates for national regulation, policy emulation and best practices (ASEAN, 2015). This ambiguity allows significant policy space for ASEAN members to forgo commitments they find politically inexpedient at the domestic level, while members are protected by ASEAN norms of non-criticism (Lall & McEwin, 2013). Essentially, implementation remains voluntary, and positive integration of the Single Market suffers from both structural weakness and an implementation gap (Nesadurai, 2013).

This structural weakness and implementation gap is also apparent in negative integration, with the ASEAN Economic Community calling for closer cooperation, yet not committing members to far reaching reform. (i) Movement of labor is limited to skilled labor and only provides for seven professions. Furthermore, it does not guarantee the right to free movement, but instead the facilitation of access to ASEAN labor markets (ASEAN, 2015; Das & Dasgupta, 2016). (ii) The ASEAN Economic Community stipulates for the 'freer' flow of capital, as opposed to the 'free flow', which contradicts the concept of mutual access in a Single Market. However, investment is distinguished from capital and given free flow status, highlighting the ASEAN Economic Community's priority of attracting FDI to the region (ASEAN, 2015; Green, 2008). (iii) The Bali Declaration calls for the 'free flow' of services, which is in accordance with a Single Market. However, going by the 2013 High Level Task Force report on service implementation, the ASEAN Economic Community approach to services would eventually consist of a World Trade Organization (WTO) General Agreement on Trade in Services-plus approach, far short of a single market for services (Plummer & Wignaraja, 2016; ASEAN, 2013). (iv) Last, in terms of the free flow of goods, the Single Market suffers from the persistence of non-tariff barriers and practical questions about implementation, common regulation and compliance. Indeed, non-tariff barriers have been a persistent issue in regional trade since the 1992 ASEAN Free Trade Agreement (AFTA) (ASEAN, 2017; Austria, 2015).

Fundamentally, the Single Market suffers from the fatal flaw in that ASEAN members' key export markets are outside of the region, while ASEAN economies are competitive rather than complementary (Chia & Plummer, 2015). Thus, the ASEAN Economic Community essentially retains its FTA status, as opposed to Single Market status, which leaves in place national autonomy for countries to trade and conclude investment agreements with third countries, termed 'open regionalism' (Ba, 2011). This autonomy to conclude bilateral deals contradicts the pursuit of a Single Market, which should entail a common approach in mutual third-party market access (Lloyd, 2005).

#### **4.3. The Single Production Base**

ASEAN deliberately prioritizes the Single Production Base over the Single Market. This is logical, given that the main drivers of economic integration are due to external competition from the scale economies of China and India (Chia, 2013). It reflects the ASEAN Economic Community's attempt to improve the key drivers of growth in two main domains: reducing transactions costs for cross border movement and coordinating ASEAN regional infrastructure (Pelkmans, 2016). Provisions of the production base include ASEAN rules of origin, an ASEAN authorized traders scheme, ASEAN eCustoms, a Single Window, ASEAN Cargo Processing, ASEAN Customs Transit, selective standardization, selective mutual recognition agreements in goods and services, the ASEAN Comprehensive Investment Agreement, avoiding double taxation and ASEAN infrastructure initiatives (ASEAN, 2003; 2015; 2017).

ASEAN envisages a region of increased backward and forward linkages among various production facilities and networks that are dispersed in Southeast Asia, through facilitating intra-ASEAN complementation of components and cost-effective fragmentation of tasks in global value chains, while promoting competitiveness in the region more generally. Eliminating intra-ASEAN barriers is vital in facilitating this exchange (Pangestu, 2016). This would effectively utilize economies of scale, which ASEAN members suffer a disadvantage from compared to the massive scale economies of China and India (Hill & Menon, 2010).

Moreover, given that ASEAN contains economies of different endowments, levels of development and a dynamic division of labor, it is envisioned that a production base will result in the reallocation of industries from more developed to less developed ASEAN countries, with the continuous expansion and upgrading of regional production networks, which will attract sustained flows of investment (Chia & Plummer, 2009). This geographical economy of location is expected to have a developmental impact through higher quality backward and forward linkages (Menon, 2012).

Finally, the Single Production Base adheres to the principles of 'open regionalism'. It implies that production activities in each ASEAN country will become more regionalized and simultaneously internationalized at the same time. Thus, links with East Asia and other critical trade partners such as the EU and the US have to be deepened simultaneously with the strengthening of the ASEAN production base, implying that prior and subsequent connections to ASEAN-based production are critical to intra-ASEAN liberalization (Ba, 2011)

#### **4.4. Explaining the Dichotomy**

Explaining why ASEAN prioritizes the Single Production Base over the Single Market is critical to analyzing the development strategy of the ASEAN Economic Community, which we put forward reflects that of low and lower-middle income economies. Given that ASEAN members' economic models are tied to export-oriented industrialization to extra-regional markets, the provisions of the Single Production Base signal a clear intention to prioritize an internationalized value-chain agenda. Collectively, the Blueprint seeks to signal to investors that the previous organized forms of government-led complementation, such as the ASEAN Industrial Cooperation Scheme, have been discontinued. Instead, ASEAN is committing to market driven mechanisms in coordinating economic interactions. Thus, ASEAN is seeking to take a common approach that would be more attractive for multinationals to invest in the region (ASEAN, 2007; 2015; Green, 2008).

Moreover, the development strategy of the Single Production Base seeks to improve the key drivers of intrinsic growth through enhancing investment, capital- and labor-intensive production, which continues to rely on importing foreign technology and foreign management of firms (Chia & Plummer, 2015). According to our theoretical framework on stages of development, this reflects the development strategy of low and lower-middle income economies. However, this does not amount to upgrading institutional quality to reflect a higher stage of development, which is a necessary precondition for breaking out of the middle-income trap.

Achieving a true Single Market in ASEAN would entail significant domestic adjustment, a common approach to extra-regional relations and reallocation in shares of trade, leaving some members to gain and others to lose (Venables, 2003). However, this is incompatible with the primary institution of the 'ASEAN Way', given that achieving a Single Market contradicts norms of 'open regionalism' and non-interference in one another's domestic affairs. Instead, the ASEAN 'production base' suggests a combination of intra-ASEAN deepening and selective business friendly market integration with leading trading partners, without necessarily going through the politically sensitive process of achieving a Single Market (Chia & Plummer, 2015). This secondary institutional outcome is compatible with the primary institution of the 'ASEAN Way', given that it protects national sovereignty and adheres to norms of 'open regionalism'. Thus, at this stage achieving a Single Market is a low priority for ASEAN.

For economies with higher levels of development, the separation of a Single Market and Single Production Base makes less sense. Upper-middle income economies such as Thailand and Malaysia have exhausted export-led growth strategies and should thus be seeking to enhance endogenous and extrinsic factors of growth such as productivity and innovation, which the provisions of a Single Market should enhance. However, this separation remains relevant to Myanmar, Cambodia and Laos as low-income economies, and the Philippines, Vietnam and Indonesia as lower-middle income economies, who seek to enhance intrinsic competitiveness, while retaining domestic policy space to coordinate export-led growth strategies in order to transition to upper-middle income status (Menon, 2012; Pelkmans, 2016). This outcome reflects ASEAN's *institutional trap*, as it reflects the current development strategies of low and lower-middle income ASEAN members, instead of setting the agenda to reflect a higher stage of development.

#### **4.5. ASEAN Enhanced Disputes Settlement Mechanism**

In the discourse of escaping the middle-income trap, analyzing dispute settlement mechanisms (DSMs) is fundamental to ascertaining whether regional integration can commit MICs to upgrading domestic institutional quality through positive integration. DSMs are included in international institutions to address collaboration problems and enhance the credibility of commitments through exposing free riding and penalizing non-compliance. Economic actors need DSMs to be effective, even if not necessarily used, so that they know economic bargains will be honored (North, 1990; Keohane, 1982). To establish credibility, one can either centralize regulations and institutions such as the EU, with the credible threat of referral to the European Court of Justice, or create legal certainty about the extent of liberalization with precision from the outset, such as in the North American Free Trade Agreement, together with the public and private instruments to defend one's economic rights (Alter, 2011).

In ASEAN, a DSM has been active since the 1992 AFTA. Since the launch of the ASEAN Economic Community, ASEAN has sought to strengthen the DSM. The Protocol to the ASEAN Charter on Dispute Settlement Mechanisms was signed in April 2010, providing greater definition to the original DSM, known as the Enhanced Dispute Settlement Mechanism (EDSM) (ASEAN, 2012).

However, the ASEAN EDSM suffers from fatal institutional flaws. Fundamentally, a functional DSM that disciplines members who violate agreements is incompatible with the primary institution of the 'ASEAN Way', particularly given the norms of non-criticism and non-interference. Thus, the secondary institutional outcome of the EDSM is structurally weak in that it is essentially voluntary, reflecting the preference for protecting national sovereignty (Aggarwal, 2010).

ASEAN's EDSM is modeled on the WTO Dispute Settlement Understanding (DSU), of which all ASEAN members already subscribe to. This includes panels of independents, an appellate body, strict timelines and options for sanctions. However, ASEAN's EDSM suffers from practical flaws. The timelines adopted are even more expedited than the WTO DSU. The EDSM adopts half the time of the DSU, which even the WTO itself has difficulty in following (Chase, 2013; ASEAN, 2010; 2012). Furthermore, the ASEAN Secretariat is tasked with supporting the EDSM process with administrative and logistical support yet has inadequate funding and legal expertise allocated to the EDSM process (Aggarwal, 2010). Finally, state induced dispute settlement does not specify the sanctions for violations (Hsu, 2013).

Thus, the EDSM establishes a dispute resolution procedure that cannot practically be followed. Indeed, this structural weakness means that the EDSM has never been invoked (ASEAN, 2017). Instead, members favor using the WTO DSU rather than the EDSM to resolve disputes to avoid violating the primary institutional norms of the 'ASEAN Way'. For example, in Thailand's dispute with the Philippines on Customs and Fiscal Measures on Cigarettes in July 2016, the WTO DSU was used, as it was seen as strategically less confrontational and would save face among ASEAN members by allowing third parties outside of the region to participate. Additionally, the WTO DSU was seen to give a more credible outcome, given that the ASEAN EDSM is untested (Alter & Hooghe, 2016).

Furthermore, the EDSM only envisages participation by ASEAN member states and does not permit private entities or investors to participate in the adjudicatory process. This minimizes the involvement of non-state actors, disallows domestic courts from seeking preliminary rulings and deprives adjudicators of the means to compel compliance. Thus, the state-controlled EDSM functions to protect the sovereign state by shielding it from independent adjudication, conforming to ASEAN's primary institutional norms of non-interference (Hsu, 2013). While this non-confrontational approach may be suitable for diplomacy, ASEAN EDSM decisions made behind closed doors by bureaucrats or politicians is not suitable for market transactions where private decisions implying private money or private efforts are based on public obligations or rights (Pelkmans, 2016).

Finally, effective DSMs must be independent. However, the EDSM is vulnerable to politicization. The EDSM recognizes a variety of dispute settlement methods, ranging from dialogue, consultation and negotiation, to reference of unresolved disputes to the ASEAN Summit, the highest political decision-making body (ASEAN, 2010; 2012). However, it is possible under the current language of the ASEAN Charter for an ASEAN member to refuse cooperation with the EDSM in the panel process or compliance proceedings, and thus create an 'unresolved dispute' (ASEAN, 2007; 2012). The EDSM stipulates that unresolved disputes have to be adopted by ASEAN's political organs such as the ASEAN Economic Ministers Meeting, where both parties are represented. In this sense, dispute settlement becomes politicized rather than independent (Aggarwal, 2010). Moreover, in light of ASEAN's primary institutional norms of aversion of conflict, adjudication with political rather than independent approval means the EDSM will likely be avoided, illustrated by the fact that the EDSM has never been invoked (Pelkmans, 2016; ASEAN, 2017).

Essentially, the primary institution of the 'ASEAN Way' results in the structural weakness of the secondary institution of the ASEAN EDSM. The outcome is a state-controlled EDSM that is voluntary, as there is an opt-out from the institutions of dispute settlement, which is functional for protecting state preferences and national sovereignty. Thus, the EDSM accentuates ASEAN's *institutional trap* by allowing members to forgo domestic reform, rather than setting the agenda for institutional reform through preliminary ruling and the threat of discipline if members violate agreements (Alter & Hooghe, 2016). It is thus unlikely to be functional in committing members to upgrade domestic institutional quality that is necessary to escape the middle-income trap.

#### 4.6. Addressing the ASEAN 'Development Gap'

ASEAN acknowledges that to advance as a regional institution, it must address its development gap as a priority (ASEAN, 2007; Caballero-Anthony, 2005). However, given the primary institution of the 'ASEAN Way', the role that ASEAN's secondary institutions can play in narrowing the development gap is questionable given its limited funding, lack of supranational power and no mandate to formulate development policy. Indeed, ASEAN is not a donor body, but rather a regional cooperation body that coordinates development efforts across the region (Alavi & Ramadan, 2008). Furthermore, the nature of extra-regional development assistance reflects the notions of 'open regionalism', in that the majority of development funds are administered on a bilateral basis to meet national, rather than regional, development goals (Menon & Melendez, 2017).

ASEAN's primary means of addressing the 'Development Gap' is through the Initiative for ASEAN Integration (IAI), which was first launched in 2000 and has subsequently been incorporated into the ASEAN Economic Community (ASEAN, 2000; 2003; 2012). The first IAI Work Plan (2002-08) focused on four priority areas: infrastructure, human resource development, ICT and regional economic integration (ASEAN, 2000). A second IAI Work Plan (2009-15) continued with these pillars, with greater emphasis in assisting the CMLV implement the ASEAN Economic Community Blueprint (ASEAN, 2009).

The IAI Work Plan primarily targets implementing the Single Production Base, integration into the global economy and enhancing participation in global supply networks (Chia & Plummer, 2015; ASEAN, 2000). Furthermore, while the majority of activities under the IAI Master Plan map against the ASEAN Economic Community Blueprint, most of these activities are not meant to contribute directly to narrowing the development gap or upgrade regional production capabilities, but instead enhance the current drivers of intrinsic production (McGilvray & Carpenter, 2013). Linked to our argument in the previous section, this reflects the development strategy of low and lower-middle income economies.

Significantly, the IAI suffers from a lack of funding and ambition. Indeed, economic assistance from the ASEAN-6 to the CLMV pales in comparison to extra-regional Official Development Assistance (ODA). Under the First IAI Work Plan, between 2002 and 2008 aid contributions from the ASEAN-6 amounted to US\$159 million, with most funds coming from Singapore, Malaysia and Thailand (Menon, 2012). Total bilateral OECD ODA, with Japan, the US and Australia contributing most funds, to the CMLV between 2002 and 2010 was US\$37.4 billion. Key multilateral ODA, totaling US\$11.1 Billion, came from the Asian Development Fund, World Bank, European Commission and various UN agencies (McGilvray & Carpenter, 2013). Additionally, Chinese investment often amounts to development aid, such as through subsidized investment, concessional loans and grant making, totaling US\$37 Billion between 2002 and 2009 (Mathai, 2016). Furthermore, given that Indonesia and the Philippines contain millions of poor people, they were also net recipients of ODA. Total ODA to Indonesia between 2002 and 2010 was US\$12.8 billion, while the Philippines received US\$4.97 billion, with Indonesia receiving 70% and the Philippines 90% from bilateral partners.

In light of its limited development contributions, ASEAN seeks to coordinate regional development cooperation with its 12 external Dialogue Partners (DP), comprising key trading partners and the United Nations Development Program, who provide support for regional economic programs and implementation of the ASEAN Roadmap. However, these programs are structured around specific DP priorities toward ASEAN, determined on a case-by-case basis, and not all DP's operate through the ASEAN Secretariat. Fundamentally, many priorities are not specifically development orientated but take in geopolitical considerations. Australia, Japan, South Korea, India and China tend to focus on economic cooperation and integration, the US and Russia focus on strategic links and counterterrorism, while the European Union focuses on social-cultural development (Chheang, 2011).

Thus, despite ASEAN's attempts to coordinate regional development, ASEAN's secondary institutional structures suffer from structural weakness and reflect that of a *trend taker* rather than *trendsetter*. Development assistance adheres to the primary institutional norms of 'open regionalism', given that the majority is administered on a bilateral basis or seeks to advance DP interests. Furthermore, national rather than regional development goals are prioritized (Menon, 2012). This is a reflection of ASEAN's *institutional trap*. Given that ASEAN's membership contains low and lower-middle income economies, national and human development goals in areas such as health, education and poverty are prioritized, as opposed to regional integration or upgrading productive capabilities.

## 5. Conclusion: The ASEAN Economic Community and the Middle-Income Trap

A classical challenge of the middle-income trap is the trap of policy misdiagnosis and institutional persistence. A country that has good quality institutions at one stage of development soon finds that these same institutions are of poorer quality relative to a higher stage of development. Economies that fail to change or lack the institutional structures to match their stage of development will impede themselves from graduating to the next income level (Dollar, 2016; Acemoglu & Robinson, 2008). Those that adopt policies and institutions successfully to their circumstances avoid the middle-income trap; those that do not, risk becoming trapped (Gill & Kharas, 2007).

In our examination of the institutional structures of the ASEAN Economic Community, we determine they are insufficient in enabling ASEAN members to escape the middle-income trap. (i) The prioritization of the Single Production Base over the Single Market illustrates an economic strategy that is functional for improving the key drivers of intrinsic growth, but not for structural adjustment to drive extrinsic production. (ii) The structural weakness of the EDSM is functional for protecting national sovereignty yet is a flaw in committing ASEAN members to binding agreements, as it is essentially voluntary. (iii) ASEAN's structural weakness in addressing its 'Development Gap' and membership of low-income economies results in development funding aimed at promoting human development goals rather than upgrading productive capabilities.

Fundamentally, the primary institution of the 'ASEAN Way' means that ASEAN's secondary institutional design can only move as fast as its slowest members (Pitsuwan, 2001). Given the persistence of the ASEAN 'Development Gap', the institutional structures of the ASEAN Economic Community are thus *institutionally trapped* in reflecting the development strategies of low and lower-middle income economies. Thus, the ASEAN Economic Community's institutional structures reflect that of intrinsic driven growth, rather than that of a higher stage of development of extrinsic driven growth.

ASEAN's poor record on integration as a result of its *institutional trap* has led some scholars to argue that ASEAN is an 'imitation community', which consists of an attractive facade of public pronouncements that mask a deliberate lack of real substance, as in reality elites are pursuing different national strategies rather than the regional ones advocated in public announcements (Jones & Smith, 2002; Green, 2008). Indeed, the promotion but structural weakness of the 'Single Market', EDSM and IAI reflects elements of ASEAN being an 'imitation community'. The ASEAN Economic Community reflects a rhetorical drive in which to promote the ASEAN region to attract FDI, in an effort to boost national political objectives by elites who derive legitimacy from economic growth, rather than genuinely seeking deep integration.

Moreover, 'open regionalism' is a feature of the middle-income trap for ASEAN, as it supports 'embedded mercantilism' by promoting openness to trade and investment in internationally competitive sectors, thereby maintaining the flow of inward FDI and export strategies, but within an institutional framework that simultaneously permits the continued protection of politically important enterprises. This implies an avoidance of binding targets and legal enforcement of integration for social and economic development in favor of political objectives. ASEAN's

domestic political institutions remain extractive, where they direct resources away from the people and toward the state and small number of elites. By their very nature, extractive states are against the kind of innovation and extrinsic led growth that leads to widespread prosperity (Jones, 2015).

Significantly, while ASEAN members will continue to grow in the near term, their limited institutional models place major restrictions on members' long-term prospects for prosperity. The ASEAN Economic Community continues to afford protection to vested interests, who prevent moving the factor of production from intrinsic to extrinsic driven growth, as this kind of change threatens the hold on political and economic power that elites in such states fight to maintain (North et al, 2007). In light of our argument that the ASEAN Economic Community is *institutionally trapped* in reflecting structures of low and lower-middle income economies, we put forward that for upper-middle income economies, relying on the ASEAN Economic Community as a strategy to escape the middle-income trap could in fact accentuate policy challenges through disincentivizing reform in which to upgrade institutional quality and productive capability.

ASEAN's upper-middle income members would do better by relying on national development strategies rather than regional integration through the ASEAN Economic Community to escape the middle-income trap. For ASEAN's low and lower-middle income economies, the ASEAN Economic Community prospectively complements their transition to upper-middle income status. However, this growth strategy has its limits, and these countries must consider that they too could fall victim to the middle-income trap if they fail to pursue institutional transformation relative to their stage of growth.

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