

# Chapter 2

## Utilisation of Free Trade Agreements by Services Industries in ASEAN

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*In this paper, we investigate the utilisation of free trade agreements (FTAs) by services industries in eight member countries of the Association of Southeast Asian Nations (ASEAN). Using original survey data, we examine, in particular, the linkage between the trade in goods, rather than the trade in services, of services companies and their utilisation of FTAs. Our findings are as follows. First, a slight majority of services firms engaged in direct imports use FTA Certificates of Origin (COOs). Second, firms often use FTAs without recognising what these are due to lack of understanding of the legal meaning of COOs. Amongst services firms utilising FTAs, the ASEAN Trade in Goods Agreement and the ASEAN-China Free Trade Agreement are the most popular. Third, 'lack of information' and 'small trade volume' are the two main reasons cited by services firms for not using FTAs. Fourth, 70 percent of firms claim that information on FTAs is either poor or very poor. Last, only 10 percent of firms consider FTAs as a factor to be taken into account in making decisions on their investment locations.*

Key Words: ASEAN, FTA utilisation, services industry

JEL Classification: F10, F13, F15

## 1. Introduction and Literature

While the multilateral trading system faces difficulties in delivering new trade agreements, free trade agreements (FTAs) are steadily increasing in importance in trade liberalisation and are becoming highly relevant in the context of the Association of Southeast Asian Nations (ASEAN). ASEAN signed its first regional trade agreement, the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area in 1992, and has since prompted the ASEAN member states to negotiate more FTAs. The ASEAN countries as a regional group have expanded their FTA networks by signing five ASEAN+1 FTAs.<sup>1</sup> Individual states have also signed bilateral FTAs with non-ASEAN trading partners (e.g. the Thailand-Japan FTA). There are further ongoing FTA negotiations, including the Regional Comprehensive Economic Partnership and the ASEAN-Hong Kong FTA.

Many ex-ante simulation studies have contributed to and argued for the formation of these FTAs. These studies assume that firms fully utilise FTAs. Most important, therefore, for an ex-post study of the economic impacts of FTAs is to determine whether and to what degree firms are using FTAs and what sort of challenges they face, if any.

There are two main methodologies used in the study of FTAs. The first uses official data on trade value using FTA preferences and the issuance of Certificates of Origin (COOs). Firm characteristics, unfortunately, are not covered in these official data and thus this approach does not match our research purpose. The second methodology is firm survey. A specifically designed survey allows us to analyse the key research questions. For example, under the initiative of the Asian Development Bank, Kawai and Wignaraja (2010) collected a large number of survey responses in the Philippines, Singapore, and Thailand and laid the foundations for FTA utilisation research in ASEAN. Their study, however, focused solely on manufacturing firms. On the other hand, studies using the survey responses from the Japan External Trade Organization cover a large number of services industries in Asia-Pacific (e.g. Hiratsuka et al., 2009). In *Survey of Japanese-Affiliated Firms in ASEAN, India, and Oceania* (2013), the Japan External Trade Organization asked whether respondent firms use FTAs in trade with Japanese affiliate companies in ASEAN. The utilisation rate for export was 42.8 percent for manufacturing firms. Interestingly, 37.1 percent of services firms also reported

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<sup>1</sup> At the time of writing, the five ASEAN+1 FTAs are ASEAN-Australia and New Zealand FTA, ASEAN-China FTA, ASEAN-India FTA, ASEAN-Japan Economic Partnership Agreement, and ASEAN-Korea FTA.

FTA utilisation for export. Ninety-five percent of respondent services companies that reported FTA utilisation were classified as wholesale and retail, and logistics. The utilisation rate for import was 45.9 percent for manufacturers and 45.6 percent for non-manufacturers. In particular, 51.8 percent of wholesale and retail services utilised an FTA for importation. Again, wholesale and retail, and logistics account for 95.5 percent of respondent services companies who reported using an FTA. Unfortunately, the Japan External Trade Organization survey covered only Japanese affiliates and thus did not capture the state of FTA utilisation by indigenous services firms in ASEAN.

This study is intended to fill this gap by using original survey data collected from services industries in eight ASEAN countries. It looks at the utilisation of FTAs by services firms in trading goods.<sup>2</sup>

## 2. Data

The Economic Research Institute for ASEAN and East Asia (ERIA), in collaboration with the ASEAN Business Advisory Council and national think tanks, conducted surveys on the utilisation of FTAs by the private sector.<sup>3</sup> The surveys gathered responses from 630 manufacturing firms and 182 services firms. This paper focuses its analysis on the responses from the services firms.<sup>4</sup>

Our sample includes 90 small firms (i.e. 50 or fewer employees), 44 medium-sized firms (50–300 employees), and 43 large firms (301 or more employees). In terms of ownership, 133 firms are domestically owned, 16 are owned by foreign entities, and 23 are joint ventures. As there exists a huge variety of services industries, we targeted industries likely to use imported products for their services provision. The overall sample is thus

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<sup>2</sup> As most Asian FTAs include services liberalisation, a natural and important question is whether services firms are using the services components of FTAs. However, this aspect is difficult to assess academically for a couple of reasons. First, there are still large gaps between national commitments and actual regulations. Thus, in contrast to tariff reductions, services liberalisation does not necessarily involve changes in the actual regulations. Second, even if an FTA leads to changes in the actual regulations, governments often implement such reform in a non-discriminatory manner. There is no most-favored-nation vs. FTA rule in such a case. Finally, the statistics on trade in services have many limitations, not least of which is that they do not capture mode 3 and mode 4 trade in services.

<sup>3</sup> The surveys were conducted by the following national study teams: Cambodia Institute for Cooperation and Peace, Cambodia; Institute for Economic and Social Research, Indonesia; National Economic Research Institute, Lao PDR; Yangon Institute of Economics, Myanmar; Malaysian Institute of Economic Research, Malaysia; Philippine Institute for Development Studies, Philippines; Chulalongkorn University, Thailand; and Central Institute for Economic Management, Viet Nam. Singapore's survey unfortunately did not collect data for service industries. Considering the relatively small number of firms in Brunei, focus group discussions were organised by the ASEAN Business Advisory Council in Brunei, instead of surveys. Thus, we do not have numerical data for Brunei.

<sup>4</sup> Chapter 11 of this report analyzes the responses from manufacturing firms.

categorised into subsectors: hotel and restaurant (45 firms), telecommunications (36 firms), construction (25 firms), trading (25 firms), and others.

**Table 1. Characteristics of Respondent Firms**

Country	Small		Medium		Large		Missing		Total
	Obs	%	Obs	%	Obs	%	Obs.	%	Obs.
1- Cambodia	14	70.00%	5	25.00%	1	5.00%		0.00%	20
2 - Indonesia	17	39.53%	8	18.60%	15	34.88%	3	6.98%	43
3 - Lao PDR	17	85.00%	2	10.00%	1	5.00%		0.00%	20
4 - Malaysia	11	100.00%		0.00%		0.00%		0.00%	11
5 - Myanmar	3	20.00%	6	40.00%	6	40.00%		0.00%	15
6 - Philippines	20	58.82%	10	29.41%	4	11.76%		0.00%	34
7 - Thailand	3	15.79%	4	21.05%	10	52.63%	2	10.53%	19
8 – Viet Nam	5	25.00%	9	45.00%	6	30.00%		0.00%	20
Total	90	49.45%	44	24.18%	43	23.63%	5	2.74%	182

Lao PDR = Lao People’s Democratic Republic. Obs. = Observation. Missing = Not stated in the survey.

Notes: Small (<=50 employees); medium-sized (51–300 employees); large (>300 employees) based on International Financial Corporation (2012).

Source: ERIA FTA Utilisation Survey.

**Ownership**

Country	Fully Domestic		Fully Foreign		Joint Venture				Total
	Obs	%	Obs	%	Obs	%	Obs.	%	Obs.
1- Cambodia	7	35.00%	7	35.00%	4	20.00%	2	10.00%	20
2 - Indonesia	28	65.12%	3	6.98%	6	13.95%	6	13.95%	43
3 – Lao PDR	14	70.00%	5	25.00%	1	5.00%		0.00%	20
4 - Malaysia	11	100.00%		0.00%		0.00%		0.00%	11
5 - Myanmar	15	100.00%		0.00%		0.00%		0.00%	15
6 - Philippines	30	88.24%	1	2.94%	3	8.82%		0.00%	34
7 - Thailand	12	63.16%		0.00%	5	26.32%	2	10.53%	19
8 – Viet Nam	16	80.00%		0.00%	4	20.00%		0.00%	20
Total	133	73.08%	16	8.79%	23	12.64%	10	5.49%	182

Lao PDR = Lao People's Democratic Republic.

Notes: Fully domestic (total share in paid-in capital = 100% local), fully foreign (total share in paid-in capital = 100% foreign), joint venture (share between foreign and local).

Source: ERIA FTA Utilisation Survey.

### 3. Key Findings

#### 3.1. Discrepancy Between FTA Utilisation and COO Utilisation

Amongst the 90 small companies surveyed, one used an FTA but did not specify the COOs used; seven used an FTA and specified the names of the COOs; and 18 did not use an FTA but specified the COOs. In fact, 16 firms stated that they used preferential rate offered by the ASEAN Free Trade Area (Form D), but did not use an FTA. This means that 8.9 percent of the small companies used an FTA whilst the other 17.8 percent did not use an FTA but nonetheless utilised Form D.

Of the 87 medium-sized and large companies, four used an FTA but did not specify the COOs used, and nine used an FTA and specified COOs. Eight did not use an FTA but specified the names of COOs, and five out of the eight companies reported using Form D but did not use an FTA.

The survey indicates that some companies seem to be confusing FTA utilisation with COO utilisation, especially Form D. They seem to regard Form D as a prime export/import document that should be used for whatever trade, whether they use an FTA or not. This

aspect was omitted in most of the surveys, which only asked about the utilisation of FTAs. Otherwise, the small firms' utilisation rate could be much higher than those reported in existing studies. Some exporters, however, obtained COOs even if they had no FTA with their trade partners, or the import tariff was zero (e.g. in Cambodia). In this kind of case, utilisation of a COO does not represent utilisation of an FTA and care is therefore needed when asking companies about FTA utilisation.

### **3.2. Overall Utilisation Rate<sup>5</sup>**

Of the 182 respondent firms, 62 companies directly import, and of these, 32 or 51.6 percent utilise COOs. Of the other 30 companies, 17 use distributors for indirect importation in addition to their own direct importation, and three reported they benefit from an FTA through indirect importation of their distributors. In terms of direct-import firms' sub-sectors, the hotel and restaurant group has the highest user rate (66.7%), followed by 'others' (65.4%), trading (54.5%), construction (42.9%), and telecommunications (33.3%).

Of the other 118 companies which do not import directly, 10 companies utilise COOs; 12 companies reported that they do not utilise COOs but that they benefit from indirect importation by distributors.

Of the 42 companies who utilise COOs, 30 use only one kind of COO, 11 use two kinds, and only one large company utilises five kinds.

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<sup>5</sup> Hamanaka (2013) comprehensively reviewed the literature on the use of FTAs in Asia and distinguished the 'rate' by giving different definitions for utilisation rate, usage rate, and utility rate. The three definitions assume the availability of trade data. As this paper uses survey data instead of trade data, however, we cannot follow Hamanaka's definition. Thus, we simply use 'utilisation rate' which is defined as the ratio of the number of firms that responded that they utilise COOs for FTAs, divided by the total number of respondent firms. It is important to mention, though, that Hamanaka points out several risks associated with such an approach. The first is a specification problem that occurs when surveys simply ask about FTA utilisation without distinguishing multiple FTAs signed by the country. The second problem is the trade-volume problem where a survey treats both small and large firms equally as '1', the trade volume is not reflected in the result of the survey. Another problem is the possibility of zero most-favored-nation imports and zero margin-of-preference imports, in which case firms have no incentives to use FTAs. Lastly, even if a firm reports its use of an FTA, this does not necessarily mean that the firm uses an FTA for all its trade. Most likely, they use an FTA only for a limited number of exported products. Unfortunately, this paper is not immune from these problems, except for the first (specification), which we addressed by asking for the specific COOs used by firms.

**Table 2. COO Usage by ASEAN Services Firms**

	Small	Medium	Large	NA	Total
<b>Engaging in Direct Imports</b>	<b>34</b>	<b>16</b>	<b>12</b>		<b>62</b>
<i>Utilising a COO</i>	18	8	6		32
<i>Not Utilising</i>					
Utilising distributors and benefiting from an FTA	3	0	0		3
Utilising distributors and not benefiting from an FTA	4	5	5		14
Not utilising distributors	9	3	1		13
<b>Not Engaging in Direct Imports</b>	<b>55</b>	<b>27</b>	<b>31</b>	<b>5</b>	<b>118</b>
<i>Utilising a COO</i>	7	2	1		10
<i>Not Utilising</i>					
Utilising distributors and benefiting from an FTA	6	1	4	1	12
Utilising distributors and not benefiting from an FTA	10	5	12		27
Not utilising distributors	32	19	14	4	69

COO = Certificate of Origin, FTA = free trade agreement.

Source: ERIA FTA Utilisation Survey.

**Table 3. The Number of Different COOs Used by ASEAN Services Firms**

	1	2	5	Total
<b>Small</b>	20	5		25
<b>Medium-Sized</b>	5	5		10
<b>Large</b>	5	1	1	7
<b>Total</b>	30	11	1	42

COO = Certificate of Origin.

Note: '1', '2', and '5' mean that firms are using only one type, and two and five types of COO(s), respectively.

Source: ERIA FTA Utilisation Survey.

#### 4. Use of COOs Analysed by FTA

Of the different COOs, Form D (for the ASEAN Trade in Goods Agreement) is used the most, followed by Form E (for the ASEAN-China Free Trade Agreement). The other COOs, such as Form ASEAN-Japan (for the ASEAN-Japan Economic Partnership Agreement), Form ASEAN-Korea (for the ASEAN-Korea Free Trade Agreement), Form AI (for the ASEAN-India Free Trade Agreement), and Form ASEAN-Australia-New Zealand (for the ASEAN-Australia and New Zealand Free Trade Agreement) are less commonly used. Other non-FTA



forms , such as Form Generalised System of Preferences (for Generalised System of Preferences) and Form B (for most-favored nations) are less used than Form D and Form E.

**Table 4. Use of Various COOs by ASEAN Services Firms (Multiple Answers, by Size of Firms)**

	GSP	Form B	Form D	Form E	Form AJ	Form AK	Form AI	Form AANZ
<b>Small</b>	7	4	18	10	0	0	1	1
<b>Medium-sized and Large</b>	4	1	9	11	3	3	1	0
<b>Total</b>	11	5	27	21	3	3	2	1

AANZ = ASEAN-Australia and New Zealand , AI = ASEAN-India, AJ = ASEAN-Japan, AK = ASEAN-Korea, COO = Certificate of Origin, GSP = Generalized System of Preference.

Note: The number of firms who use at least one COO is 42.

Source: ERIA FTA Utilisation Survey.

## 5. Reasons for Not Utilising COOs

Of the surveyed firms that do not use any kind of COO, many cited as a reason lack of information rather than specific COO issues such as fees for COOs or small tariff margins. Many replied that, given their small trade volume, it does not make sense to use COOs. Other reasons given (grouped as ‘others’) include a) no direct import, b) buying from local distributors, and c) the origin country for the imported goods is not covered by an FTA. Compared with the manufacturing firms, services firms complain much less about the following problems: ‘cannot meet the rules of origin (ROO)’, ‘small tariff margins’, and ‘using other duty-free schemes available’. As importers of goods, they do not worry much about ROO or small tariff margins. On the other hand, they are unable to benefit from the duty-free schemes that are available for manufacturing firms (e.g. special economic zones, export processing zones).

**Table 5. Reasons for Not Utilising COOs Given by ASEAN Services Firms (Multiple Answers, by Size of Firms)**

	Small	Medium and Large	Missing	Total
Lack of information	45	36	3	84
Cannot meet ROO	2	3	0	5
Small trade volume	25	23	0	48
Small tariff margins	2	1	0	3
Other schemes available	0	1	0	1
Fee for COOs too costly	1	2	0	3
Complicated procedures	5	6	0	11
Others	7	22	1	30

COO = Certificate of Origin, ROO = rules of origin.

Source: ERIA FTA Utilisation Survey.

## 6. Perception of the Level of Available Information about FTAs

Regarding the availability of information about FTAs, 69.8 percent of respondents answered that it was poor or very poor. Only one company claimed that information availability was very good. More small firms reported that information availability was poor or very poor (78.9%) than the medium-sized and large firms (60.9%).

**Table 6. Perception of the Available Information About FTAs by ASEAN Services Firms (by Size of Firms)**

	Small	Medium and Large	Missing	Total	
Very Poor	28	18	1	47	25.8%
Poor	43	35	2	80	44.0%
Good	16	27	1	44	24.2%
Very good	0	1	0	1	0.5%
Missing	3	6	1	10	5.5%
<b>Total</b>	90	87	5	182	

FTA = free trade agreement.

Source: ERIA FTA Utilisation Survey.

## 7. Investment Decisions and FTAs

Only 16 out of 182 companies consider FTA availability as a factor in deciding investment locations. When allowed multiple answers, 10 of the 16 companies replied that they considered ASEAN Free Trade Area (ASEAN Trade in Goods Agreement); followed by ASEAN-China FTA, four companies; and ASEAN-Korea FTA, three companies. Ten companies pointed out that a lower preferential tariff is beneficial and five said that better investment protection is a factor they consider.

Twenty-two out of 182 companies consider expanding their existing business overseas or opening a new establishment. Of these, 18 said that a growing market is the reason for expansion; followed by investment incentives, six companies; and FTA availability, four companies.

## 8. Conclusion

The increasing number of FTAs in ASEAN benefits services firms by providing a better trading environment for their imported goods. It is important to disseminate accurate information about FTAs, utilisation of COOs, and other operational procedures to services as well as to manufacturing companies. In particular, providing updated information and instructions to small companies should be a priority to enable them to benefit from FTAs.

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