Chapter 16

Escaping from FTA Trap and Spaghetti Bowl Problem in East Asia: An Insight from the Enterprise Survey in Japan

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INTRODUCTION

FTA has proliferated in East Asia. There are many FTAs being enforced and still to be enforced between 2005 and 2010. Those FTAs implements the phase-out tariff reduction schedules, hence, exporters face different tariffs by year and by destination. In addition, FTA requires the rules of origin (ROO), which imposes additional administrative costs on firms instead of eliminating tariff.[1] ROOs and corresponding application form differ for every FTA. This is because the General Agreement on Tariffs and Trade **(**GATT) has no specific rules governing the identification of the country of origin of goods in international commerce. "Each contracting party is free to determine its own origin rules, and could even maintain several different rules of origin depending on the purpose of the particular regulation."[2] An increase of FTAs may cause the overlapping FTA problem or the so-called spaghetti bowl problem. It is what exporter faces with different tariffs and ROOs for a product heading to different destinations.

There have been numerous ex ante studies on the impacts of FTAs. Those studies, which utilized the computable general equilibrium (CGE) models, assume that any firm wants to maximize profits and is able to behave to realize it. Results of these studies can provide quantitative analysis that FTAs generate benefits and improve the welfare of the world. However, we do not know how much firms intensively utilize FTAs because FTAs are not compulsory and administrative costs to get certificate of origin is costly. The CGE model used in the ex ante studies can not include the complex

factors such as, phase-out tariff reduction schedule, the ROO problem and the overlapping of ROOs.

At the onset of its proliferation in East Asia, it was a critical/urgent task to evaluate FTAs. Particularly in East Asia, where the production networks have developed, the ROO issue and the overlapping FTAs may increase service link costs. This paper aims to identify the existing and potential problems due to the enforcement of FTAs and its proliferation. Likewise, it intends to examine what measures and reforms are necessary to ensure that small countries and SMEs benefit the most from the FTAs. Furthermore, it also aims to provide insight and learning to the ASEAN Economic Community (AEC) Blueprints, which has to reform the Common Effective Preferential Tariff (CEPT) ROO to match with production fragmentation or production networks.

Given the abovementioned objectives, the paper proves on the following research questions. How intensively firms are utilizing FTAs? Which ROOs are used in East Asia? Are those ROOs really costly? If so, what attributes to its cost? Are there any best practices in implementing the ROO? Are the overlapping FTAs or the spaghetti bowl problem really costly for the firms? What are the consequences of the spaghetti bowl problem? What reforms and arrangements are needed to avoid these consequences? This paper attempts to evaluate the FTAs and answer these questions.

The following sections review the FTAs in East Asia in the light of tariff and ROO. Section 3 introduces the results of Japan External Trade Organization (JETRO) survey which investigated the utilization of the enforced FTAs in East Asia. Section 4 summarizes the results of interviews with Japanese enterprises. The last section presents a conclusion and provides the policy recommendations.

This study claims that enterprises in Japan, in general, are interested in FTAs involving Japan as well as those between foreign countries. It concludes that the ROO is very costly, particularly the value added criterion (VA). Bilateral FTA has proliferated but enterprises will use FTAs selectively, specifically those with large economies. Plurilateral FTAs such as the AFTA, ASEAN-Japan are better than bilateral FTAs. It implies that wide regional FTA should replace the existing bilateral FTAs. The option of value added criterion and change of tariff line code was found most favorable. However, it recommended the examination of the self-certificate system to shorten the custom clearance time.

2. COMPLICATED FTAS IN EAST ASIA

2.1. Costs and benefits of FTAs

There are several *ex ante* studies on the impacts of FTAs in East Asia based on CGE models. The estimated results obtained from *ex ante* studies provide several common results. First is the trade creation effect or it is when FTAs result to gains in terms of welfare, GDP, export and so on, among the FTA member countries. Second is the trade diversion effect or when FTAs generate negative impacts on non-member countries. Studies showed that if a large economy is included in the FTA Member country, the negative effect will be larger. It is also a very important issue how and why member countries benefit from FTAs while non-member countries do not. Negative impacts on non-member countries should be minimized. Region-wide trade facilitation measures intend to lower the service link cost and improve the trading efficiency to extend the benefit to non-member countries. Third, the larger the number of FTA members, the larger the gain from a FTA. Ando and Urata (2005) estimated that ASEAN+Japan will increase Japan's GDP by 0.18 percent while ASEAN+3 (additional Member countries) will increase it by 0.19 percent. Kawai and Wignaraja (2007) projected an increase in Japanese income by 1.54 percent with ASEAN+3 combination, and by 1.59 percent with ASEAN+6. Recent study of JETRO (2007) supported earlier results, with a projected increase in Japan's GDP by 0.3 percent with Japan-ASEAN FTA, ASEAN+3 by 2.0 percent, and ASEAN+6 with 2.6 increases. Furthermore, Brown, Kiyota, and Stern (2004) estimated that the unilateral free trade liberalization is expected to increase its Members' welfare by 7.4 percent with partner countries to get large gains as well.

The CGE model studies are very useful in measuring effects of tariff reduction on goods. The model studies assume that all the firms use the available FTAs to maximize its profits and disregard important issues of FTAs (e.g., rules of origin problem, the complexity caused by overlapping FTAs or the as spaghetti bowl problem among others).

2.2. Complicated tariff liberalization

ASEAN has lead East Asia in tariff liberalization, which is a matter of pride in the region. The original ASEAN 6 planned to reduce tariffs from 99.4 percent tariff lines to 0 percent by 2010 and 98.2 percent tariff lines to 0 percent up to 2015 for new Member Countries. This means that, after 2010, the original ASEAN 6 will accomplish 0 percent tariffs for substantially all of its products.

On the contrary, other FTAs in the region employ complicated tariff liberalization. First, almost FTAs put large products including significant manufactured products into the sensitive lists and some products have quotas. Second, several FTAs employ the reciprocal principle, which means that all the products identified by participating countries in the sensitive lists are excluded from liberalization. In a China-Thailand FTA, for instance, China placed 251 products while Thailand included 178 products into their sensitive lists, so, a sum of 429 products will be excluded from the liberalization between them. Third, most of FTAs in East Asia employ the phase-out tariff reduction schedule. For example, in the Japan-Malaysia Economic Partnership Agreement (EPA), implementing the phase-out schedule means eliminating the tariffs within 10 years since the day it was enforced (in April 1, 2005). The same with the Japan-Thailand EPA where their tariffs will be eliminated within 10 years from its enforcement date in November 1, 2005. As a result, Japanese exporters will face different tariff rates for a product per year. Japanese uses EPA instead of FTA.

The complication in tariff liberalization stems from sensitive lists, quota system, the reciprocal principle, and the phase-out tariff reduction schedule. These complications make it difficult for enterprises in East Asia to consider FTAs as profitable business applications.

2.3. Different rules of origin

ROOs differ by FTA and by destination. For manufactured goods, for instance, there are three types of ROOs: (1) Value content (VC) rule means that a product must satisfy a minimum local or regional value ratio; (2) a change in tariff classification (CTC) rule, defined at Harmonized System (HS) Level; and, (3) a specific process (SP)

rules which requires a specific production process. Minimum local ratio is defined in the VC rule, and HS digit number is defined in the CTC rule.

Kawai and Wignaraja (2007) summarizes the ROOs adopted in several FTAs for automobile and auto parts, which provide the basis in understanding how much complicated the ROO problem is (Table 1). In motor vehicles for human transport, except buses (87.03), the adopted rules differ by FTA: (1) VC rule. VC for AFTA and ASEAN-China FTA is not less that 40 percent while for ASEAN-Korea FTA it is 45 percent; (2) CTC. CTC rules for Japan-Singapore EPA;(3) CTC or VC Rule. For Japan-Malaysia EPA it is a choice of 60 percent of either CTC or VC, same with the Japan-Thailand EPA which requires for 40 percent of CTC or a VC; (4) CTC rule plus a VC rule. CTC plus a 55 percent VC rules for Korea-Singapore FTA, a CTC plus a 30 percent VC rules for United States-Singapore FTA, and a CTC plus a 40 percent VC rules for Thailand-Australia FTA); and lastly is the (5) SP rule. It is the last process of manufacture within territory of the party.

Exporters face different rules of origin by destination. For example, a Thai exporter has to prepare a CTC rule or a 40 percent VC rule document to export to Japan; a 40 percent of VC for exports within ASEAN and China; a 45 percent VC rule document for exports to Korea; and, a CTC plus a 40 percent VC rule document for Australia. Furthermore, the Thai exporter faces different format to apply certificate of origin for those destinations.

Table 1: Rules of origin for major auto and auto parts products in selected East Asian FTAs

FTA		JAPAN			KOREA	PRC	ASEAN			SINGAPORE		THAILAND
		Japan - Malaysia EPA (2006)	Japan - Singapore EPA (2002)	Japan - Thailand EPA (2007)	Korea - Singapore FTA (2006)	PRC - Pakistan FTA (2006)	ASEAN Free Trade Area (1993)	ASEAN - PRC FTA (2005)	ASEAN - Korea FTA (2006)	Singapore - Australia FTA (2003)	United States - Singapore FTA (2004)	Thailand - Australia FTA (2005)
HS Code	**Product Description**											
87.01	Tractors (other than works, warehouse equipment)	CTH (6 digit) or RVC of 40%	CTH; last substancial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.03	Motor Vehicles for transport of persons (except buses)	CTH or RVC of 60%	CTH; last substancial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC 0f not less than 40%	RVC of 45%	Last process of manufacture within territory of the party	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.04	Motor Vehicles for the transport of goods	CTH or RVC of 50%	CTH; last substancial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	VC of not less than 50%	CTH plus RVC of at least 30% (build up)	CTH plus RVC of 40%
87.08	Parts and accessories for motor vehicles		CTH; last substancial manufacture*	CTH or RVC of 40%	CTH plus RVC of 50% / 55%	RVC of not less than 40%	RVC of not less than 40%	RVC of not less than 40%	RVC of 45%	Last process of manufacture within territory of the party	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%
87.11	Motorcycles, bicycles, etc. with auxiliary motor	CTH or RVC of 60%	CTH; last substancial manufacture*	CTH or RVC of 40%	CTH plus RVC of 55%	RVC of not less than 40%	RVC of not less than 40%	RVC 0f not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (4 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits) plus RVC of 40%
87.14	Parts and accessories of bicycles, motorcycles, etc.	CTH or RVC of 40%	CTH; last substancial manufacture*	CTH or RVC of 40%	CTC (4 digits)	RVC of not less than 40%	RVC of not less than 40%	RVC 0f not less than 40%	RVC of not less than 40% or a CTH (4 digits)*	VC of not less than 50%	CTH (6 digits) or CTH plus RVC of at least 30% (build up)	CTH (6 digits)

Notes: The general rules of origin of the FTA are adopted when there is no Specific Product (SP) rule provided. CTH=Change of Tariff Headings; RVC=Regional Value Content; VC= Value Content.

Source: Kawai and Wignaraja (2007).

3. IMPLICATIONS OF THE JETRO FIRM SURVEY

East Asian exporters are expected to face the spaghetti bowl problem as tariffs, ROOs, and even application formats differ by FTA and by destination. How do firms in East Asia perceive this situation? JETRO conducted a large sample survey[3] in late 2006 to have a glimpse of FTA utilization among Japanese firms and how they assess FTAs. However, the survey has acceptable limitations because the section on FTA included only three questions on the following concerns: 1) the actual utilization and the firms' plan of utilization on the enforced FTAs; 2) the problems encountered with overlapping ROO in the Asia Pacific Region; and, 3) the necessity to harmonize ROO. Likewise, the survey did not ask about the plan of negotiations, such as, Japan-ASEAN FTA and Japan-Thailand FTA. The questionnaires were sent to 2,537 JETRO member firms that were familiar with the international trade procedure and those engaged in manufacturing, trading (export/import), and wholesale/retailing. A total of 729 out of the responded.

3.1. Utilization of FTAs by Japanese enterprises

Table 2 shows that only 13.3 percent (97 firms) out of 729 respondent were utilizing or had plan to utilize FTAs. The survey allowed multiple answers to questions. Only 5.1 percent (37 firms) were utilizing and 8.5 percent (62 firms) had plan to utilize the preferential FTA tariff schemes (i.e., early harvest schemes) in the Asia Pacific region (ASEAN, Australia, China, Japan, India, New Zealand and Republic of Korea). Majority of the firms (42.7 percent), however, do not plan to utilize the schemes. More a third (34.2 percent) of the respondent remained undecided on FTA. The results of JETRO survey suggest that the FTAs are not widely known or utilized by the Japanese firms.

Which FTA is well utilized by Japanese firms? Table 3 provides an overview of how intensively the Japanese firms, including affiliates operating overseas, were utilizing FTAs. The question allowed for multiple answers. Among 37 firms currently utilizing FTAs, the ASEAN Free Trade Agreement (AFTA) was mostly utilized, 24 firms or 3.3 percent of the total respondents; this is followed by Japan-Malaysia FTA

(15 firms, 2.1 percent of total); Thailand-Australia (8 firms, 1.1 percent); China-Hong Kong (7 firms, 1.0 percent); Thailand-India (6 firms, 0.8 percent); China-ASEAN (4 firms, 0.5 percent); and, Thailand-New Zealand (2 firms, 0.3 percent).

Table 2: Utilization and plan of utilizing FTAs by Japanese enterprises

		Currently utilizing FTA or plan to do so	not utilizing and no plan to utilize	no idea
	Number of firms	%	%	%
Total	729	13.3	42.7	34.2
Large enterprise	314	19.4	41.4	34.4
SMEs	415	8.7	43.6	34.0
Manufacturing	525	14.7	39.6	37.0
having palants in overseas	330	19.7	37.0	37.0
only domestic plants	195	6.2	44.1	36.9
Non-manufacturing	204	9.8	50.5	27.0
Beverage	49	6.1	42.9	38.8
Textile & garment	24	20.8	37.5	25.0
Wood, furniture, paper and pulp	16	18.8	6.3	56.3
Chemical	46	19.6	41.3	32.6
Medical products & cosmetic	27	3.7	40.7	40.7
Petroleume, coaks, plastic, rubber products	30	13.3	33.3	43.3
Pottery	17	29.4	47.1	23.5
Iron steel, non-metal and metal products	45	13.3	37.8	37.8
General machinery	63	15.9	44.4	39.7
Electrical appliances	39	17.9	41.0	41.0
Electronics, telecommunication machinery	25	-	60.0	40.0
Automobile, auto parts	56	30.4	32.1	30.4
Precisonary machinery	40	2.5	45.0	42.5
Other	48	12.5	35.4	31.3
Trade & wholesale	180	10.0	48.3	28.9
Retaile	20	10.0	60.0	15.0
Others	4	-	100.0	-

Note: Multiple answers were allowed.

Source: JETRO (2007).

The results emphasized three points. First, the Japanese firms were very interested in FTAs between foreign countries. In particular, the mostly used AFTAs were those in East Asia for Japanese firms and its affiliates operating overseas. Perhaps, the Japanese

firms were considering their established production and procurements networks in utilizing an AFTA covering the ASEAN region. In addition, in ASEAN-AFTA the CEPT tariffs are less than 5 percent on 98.1 percent tariff lines and 0 percent on 75.7 percent tariff lines for the original ASEAN 6 countries (e.g., Brunei, Indonesia, Malaysia, the Philippines, Singapore), and Thailand at the end of 2007.

Table 3: Utilization of FTAs by Japanese firms by FTA

	currently utilizing or plan to utilize	to be harmonized by any rule	to be harmonized by VC rule	to be harmonized by CTC rule	choice of VC or CTC	undeicded	not to be harmonized	no idea
	Number of firms	%	%	%	%	%	%	%
Total	97	24.7	20.6	18.6	24.7	3.1	1.0	28.9
Large enterprise	61	24.6	21.3	18.0	24.6	3.3	1.6	29.5
SMEs	36	25.0	19.4	19.4	25.0	2.8	-	27.8
Manufacturing	77	22.1	23.4	15.6	22.1	2.6	1.3	31.2
having palants in overseas	65	20.0	26.2	15.4	20.0	3.1	1.5	30.8
only domestic plants	12	33.3	8.3	16.7	33.3	-	-	33.3
Non-manufacturing	20	35.0	10.0	30.0	35.0	5.0	-	20.0
Beverage	3	33.3	66.7	-	33.3	-	-	-
Textile & garment	5	20.0	20.0	20.0	20.0	-	-	40.0
Wood, furniture, paper and pulp	3	-	66.7	33.3	-	-	-	-
Chemical	9	22.2	22.2	11.1	22.2	-	11.1	11.1
Medical products & cosmetic	1	100.0	-	-	100.0	-	-	-
Petroleume, coaks, plastic, rubber products	4	25.0	-	-	25.0	-	-	75.0
Pottery	5	-	80.0	20.0	-	-	-	-
Iron steel, non-metal and metal products	6	16.7	16.7	33.3	16.7	-	-	33.3
General machinery	10	20.0	10.0	30.0	20.0	-	-	40.0
Electrical appliances	7	57.1	14.3	-	57.1	14.3	-	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-	-	-
Automobile, auto parts	17	17.6	17.6	17.6	17.6	5.9	-	35.3
Precisonary machinery	1	-	-	-	-	-	-	100.0
Other	6	16.7	16.7	-	16.7	-	-	66.7
Trade & wholesale	18	33.3	11.1	33.3	33.3	-	-	22.2
Retaile	2	50	-	-	50.0	50.0	-	-
Others	-	-	-	-	-	-	-	-

Note: Allowed providing multiple answers.
Source: JETRO (2007).

Second, Japanese firms who responded were intensively utilizing the FTAs involving Thailand. This could be attribute to Thailand as an important production and export base for Japanese firms in shipping their products to markets outside the ASEAN region. Thailand's FTAs are very useful for the Japanese affiliates operating in Thailand.

Third, firms had been vigorously utilizing schemes under the Japan-Malaysia FTA, which was introduced in July 2006. This suggests that more Japanese firms will likely to use very recently enforced FTAs, like that of the Thailand-Japan FTA (November 2007).

Table 3 also shows which among the FTAs that the Japanese firms plan to utilize. Among the 62 firms that plan to utilize preferential tariff scheme(s), the Japan-Malaysia FTA ranked highest (24 firms) or preferred by most of the firms. It implies the high expectations set for the newly introduced Japan-Malaysia FTA. Japanese enterprises also showed interests in the China-ASEAN FTA (21 firms) and AFTA (20 firms). The result suggests that, indeed, Japanese firms were eyeing the ASEAN as a possible base for their China and Indian market. The Thailand-India FTAs ranked as the highly preferred scheme, reiterating a possibility of Thailand as base for the growing Indian market.

Will SMEs utilize or plan to utilize FTAs? Of the total respondents, 415 were from SMEs and 314 from large enterprises. With regards to the firm size and FTA utilization, 19.4 percent of the respondent from large firms were already utilizing or plan to utilize FTAs, while only 8.7 percent of the those from SMEs are utilizing FTAs. Thus, the results implied that FTAs are being utilized and planned to be utilized by large firms rather than SMEs. Another implication could be that FTAs benefit and will benefit the large enterprises more than the SMEs and that some factors could be impeding SMEs' utilization of FTA.

3.2. ROOs and Spaghetti bowl problems

The JETRO survey also asked the problems caused by overlapping FTAs. As shown in Table 4, among the 97 firms currently utilizing FTAs or plan to do so, 27.8 percent considered the certificate procedures of ROOs as complicated and lead to increased costs. A little higher number of firms (33.0 percent), however, did not experience any problem at the time of the interview but possible problems may occur in future. Generally, 70 percent of firms interviewed perceived that the certificate procedures of ROOs as complicated or problems may occur in future, while only 14.4 percent experienced no problem at all. It can be concluded that firms suffered from the high costs of acquiring the certificate of ROO. It is important, however, to take into account that the respondents may be deceived by the complicated procedure of acquiring the certificate of ROO rather than the operational complications stemming from the different ROOs.

Table 4: Problems caused by overlapped FTA in East Asia by Japanese firms

	currently utilizing or plaqn to utilize	certificate procedure is complicated and lead to an increase of costs	A change manufacturing process, leading an increase of costs	not causing any problem	no problem at present but problems may occurre in future	no idea
	Number of firms	%	%	%	%	%
Total	97	27.8	2.1	14.4	33.0	22.7
Large enterprise	61	27.9	3.3	16.4	41.0	18.0
SMEs	36	27.8	-	11.1	19.4	30.6
Manufacturing	77	27.3	2.6	13.0	29.9	24.7
having palants in overseas	65	29.2	1.5	13.8	32.3	21.5
only domestic plants	12	16.7	8.3	8.3	16.7	41.7
Non-manufacturing	20	30.0	-	20.0	45.0	15.0
Beverage	3	66.7	-	-	-	33.3
Textile & garment	5	60.0	-	-	40.0	-
Wood, furniture, paper and pulp	3	33.3	-	33.3	-	33.3
Chemical	9	11.1	11.1	33.3	11.1	33.3
Medical products & cosmetic	1	100.0	-	-	-	-
Petroleume, coaks, plastic, rubber products	4	-	-	-	-	100.0
Pottery	5	-	-	20.0	60.0	20.0
Iron steel, non-metal and metal products	6	50.0	-	-	33.3	16.7
General machinery	10	20.0	-	-	80.0	-
Electrical appliances	7	42.9	-	14.3	42.9	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-
Automobile, auto parts	17	23.5	5.9	11.8	17.6	29.4
Precisonary machinery	1	-	-	-	100.0	-
Other	6	16.7	-	33.3	-	33.3
Trade & wholesale	18	33.3	-	22.2	44.4	11.1
Retaile	2	-	-	-	50.0	50.0
Others	-	-	-	-	-	-

Note: Allowed providing multiple answers.
Source: JETRO (2007).

The JETRO survey also asked the respondents' views on the future directions in the harmonization of ROO under FTAs in the region. Among the 97 enterprises utilizing or plant use FTAs, 20.6 percent answered that "the VC criterion should be implemented as a common rule," against the 18.6 percent who answered that "the CTC should be implemented as a common rule." The other 24.7 percent indicated that either VC or CTC rule is the best rule. Results indicate the familiarity of the Japanese firms operating in ASEAN with the VC rule under the AFTA, the ASEAN-China FTA, and the ASEAN-Korea FTA.

Table 5: Views of necessity of harmonization and harmonized rules by Japanese firms

	currently utilizing or plan to utilize	to be harmonized by any rule	to be harmonized by VC rule	to be harmonized by CTC rule	choice of VC or CTC	undeicded	not to be harmonized	no idea
	Number of firms	%	%	%	%	%	%	%
Total	97	24.7	20.6	18.6	24.7	3.1	1.0	28.9
Large enterprise	61	24.6	21.3	18.0	24.6	3.3	1.6	29.5
SMEs	36	25.0	19.4	19.4	25.0	2.8	-	27.8
Manufacturing	77	22.1	23.4	15.6	22.1	2.6	1.3	31.2
having palants in overseas	65	20.0	26.2	15.4	20.0	3.1	1.5	30.8
only domestic plants	12	33.3	8.3	16.7	33.3	-	-	33.3
Non-manufacturing	20	35.0	10.0	30.0	35.0	5.0	-	20.0
Beverage	3	33.3	66.7	-	33.3	-	-	-
Textile & garment	5	20.0	20.0	20.0	20.0	-	-	40.0
Wood, furniture, paper and pulp	3	-	66.7	33.3	-	-	-	-
Chemical	9	22.2	22.2	11.1	22.2	-	11.1	11.1
Medical products & cosmetic	1	100.0	-	-	100.0	-	-	-
Petroleume, coaks, plastic, rubber products	4	25.0	-	-	25.0	-	-	75.0
Pottery	5	-	80.0	20.0	-	-	-	-
Iron steel, non-metal and metal products	6	16.7	16.7	33.3	16.7	-	-	33.3
General machinery	10	20.0	10.0	30.0	20.0	-	-	40.0
Electrical appliances	7	57.1	14.3	-	57.1	14.3	-	14.3
Electronics, telecommunication machinery	-	-	-	-	-	-	-	-
Automobile, auto parts	17	17.6	17.6	17.6	17.6	5.9	-	35.3
Precisonary machinery	1	-	-	-	-	-	-	100.0
Other	6	16.7	16.7	-	16.7	-	-	66.7
Trade & wholesale	18	33.3	11.1	33.3	33.3	-	-	22.2
Retaile	2	50	-	-	50.0	50.0	-	-
Others	-	-	-	-	-	-	-	-

Note: Allowed providing multiple answers.
Source: JETRO (2007).

4. SMALL SAMPLE SURVEY OF SELECTED INDUSTRIES

The JETRO survey (2007) provided a reference in understanding the intensity of FTA utilization or plan to do so among the Japanese firms and their affiliates operating overseas. It did not ask their plan to use the FTAs that are under negotiation (i.e., Japan-ASEAN EPA and Japan-Thailand EPA) at the time of the survey. More importantly, the survey did not investigate several significant research issues related to the evaluation of FTAs, such as: Why are Japanese enterprises interested in FTAs? What are the impediments of FTAs? Why are the ROOs costly on enterprises? Which ROO is the best one, and why it is so? This section tries to answer these issues. For this purpose, 17 Japanese firms were interviewed between July 2007 and January 2008. The interview focused on selected industries involved in electronics & electrical appliances,

automobile, and garments.

In Japan, these three industries posses different characteristics. Electronic industry has manufacturing processes that are separated into many stages and located in different industries in different countries in Asia. Only the capital-intensive processes remain in Japan. It has an advance vertical division of labor or fragmentation. On the contrary, electrical appliance industry has progressive horizontal division of labor. Low and medium-priced goods are being assembled in Asia while high-priced goods remain being manufactured in Japan. Automobile industry is quite different from the previous industries. Their production bases are located where demands are high, such as China, Thailand, Indonesia, the Philippines, Malaysia, and India among others. Only key parts requiring high precision technology and economies of scale, like the engine, are exported from Japan to Asia. Meanwhile, low prices parts are imported from Asia to Japan. The textile and garment or the apparel industry is the only one that has moved almost totally to Asia, China in particular. Only head offices, with design and marketing functions, are located in Japan.

4.1. Characteristics of FTA utilization by Japanese enterprises

To understand the characteristics of FTA utilization, 20 enterprises from three industries (i.e., electronics and electrical appliance, automobile and parts, and textile and garment) were interviewed.

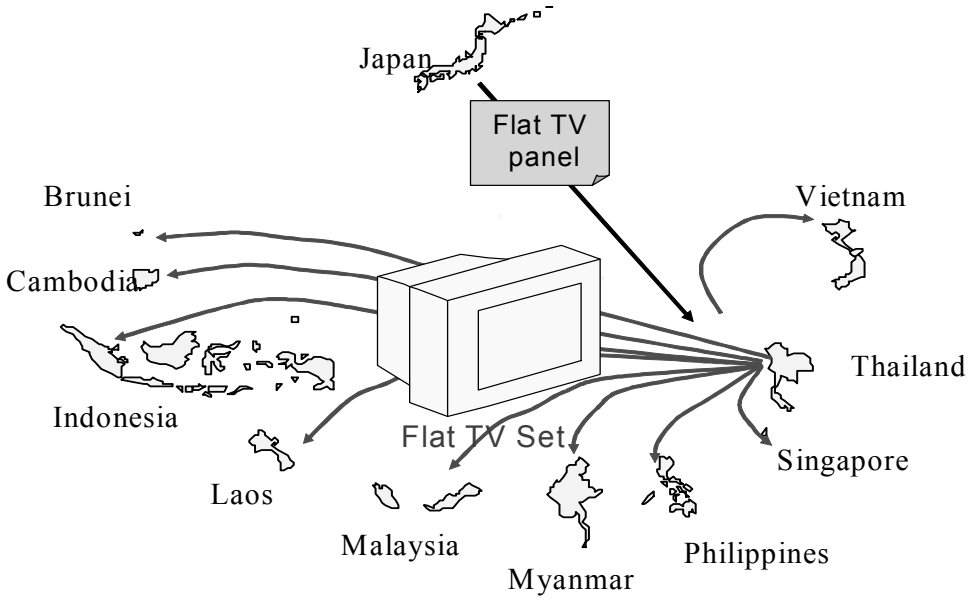
About half, 8 firms of the 17 interviewees were currently utilizing FTAs. Interviewees were allowed to provide multiple answers. Japanese enterprises most often used the AFTA and other FTAs between foreign countries[4]. Most of the trading arrangements under FTAs were intrafirm rather that interfirm. Intrafirm trades are transactions between overseas plants but supervised by head offices located in Japan. Such that, most of the interviewees (Japanese enterprises), expressed that they were actually using or plan use the FTAs between foreign countries. Not so many enterprises are currently utilizing FTAs involving Japan. Among the respondent, four (4) enterprises had been utilizing Japan-Mexico EPA while one enterprise had been utilizing the Japan-Malaysia EPA. This implies that it takes time for these enterprises to be familiar with the procedures of FTAs[5], despite the fact that Japan-Mexico EPA was

enforced in April 2005 and the Japan-Malaysia EPA was enforced in July 2006.

Which FTAs do firms plan to utilize? This question is relevant because several important EPAs involving Japan had almost concluded but not enforced. The Japan-ASEAN EPA, to be concluded in 2008, was mostly preferred because it is a plurilateral EPA between ten ASEAN countries and Japan. It provides more business opportunities than any multiple bilateral EPAs can do. Initially, the electronics and electrical appliance industry considered the Japan-ASEAN EPA for their flat TV panels only. These were excluded from the non-tariff lists under the Information Technology Agreement (ITA) and occupied more than half of content value of the flat TV sets. Therefore, Japanese suppliers had to export the flat panel with high tariffs. The flat panel TV sets made in Malaysia and Thailand, which use the flat panels made in Japan, were not subject to the AFTA CEPT tariff since they did not meet the 40 percent local content requirement. On the contrary, Korea can export the flat panels with the FTA preferential tariffs under the ASEAN-Korea FTA to Malaysia and Thailand. Furthermore, these flat panel TV sets can be exported from these two countries to other ASEAN countries with the FTA preferential tariffs under the FTA. The ASEAN-Korea FTA had affected the Japan' flat panel business in ASEAN. Thus, the Japan-ASEAN EPA will position Japan's flat panel business on equal footing with the Koreans (Figure 1).

Today, Japan's electronics and electrical appliance industry is eagerly waiting for the Japan-ASEAN EPA because recently they realized that they cannot utilized the bilateral Japan-Malaysia EPA well than they initially expected. Many Japanese electronic and electrical appliance enterprises had been using Singapore as a regional logistic hub for distributing goods from Japan to other ASEAN countries. This logistic system had enabled Singapore's to use its know-how on intermediate trading. The Japan-Malaysia EPA, on the contrary, does not allow Japan to ship its goods to Malaysia via Singapore due to its "direct shipment" requirement. The Japan-ASEAN EPA, however, enables the Japanese firms to utilize the Singapore's efficient logistic distribution system in transporting goods to other ASEAN countries.

Figure 1: Possible Production and Distribution under the Japan-ASEAN EPA



Source: by Authors**.**

In the same context, the automobile and auto part industry is likely to utilize the ASEAN-Japan EPA. Currently, the AICO scheme provides a 5 percent privilege tariffs for auto parts. The ASEAN-Japan EPA enables the importation of high value parts from Japan and exportation of the assembled components to other ASEAN countries.

The Japan-ASEAN EPA will be advantageous for textile and garment industry as well. There are many textile factories in Thailand but no garment factory. In Vietnam, there is no textile manufacturing but many garment factories. With the Japan-ASEAN EPA, it is possible to export the textile from Thailand to Vietnam and export the garment to Japan.

Nevertheless, all the interviewees who had either been utilizing FTAs or plan to do so had not established the necessary internal system of the firms to cope with the FTAs. Studies are currently being done on how much can these firms export under the EPA scheme.

4.2. Benefits and harms of FTAs/EPAs

With the question, "What benefits do Japanese firms expect from the FTAs?," most replies focus on the FTAs expected benefits on "an increase in exports," followed by

"easier to import." Most of the Japanese firms expected for the trade effects of FTAs.

In addition, "concentration of production" was also cited by some enterprises. These enterprises perceived that FTAs will provide an incentive to divert the location of production. Automobile and auto part industry is an example where econimies of sale worked and AFTA promoted the relocation of industrial processes in countries with such specialization for some types of cars. The same is true with the textile and garment industry, where manufacturing processes vary accordingly. FTAs are expected to promote specialization on specific manufacturing process.

Firms from electronics & electrical appliance industry, however, referred to benefits on the "concentration of production." Due to various investment promotion programs and the ITA, factories operating in Asia had already been engaged in highly specialized production process. Parts and components are being traded without any tariff. In other words, de facto economic integration had already advanced in the form of production networks, particularly in the electronics and electrical appliance industry prior to the de jure (formal integration) of FTAs. Hence, industries of electronics and electrical appliances need not change locations even with the enforcement.

Contrary to other's firms perceptions, several firms consider the FTAs as harmful. They complained that their businesses had been affected by the "disadvantages due to precedents of FTAs." Japanese firms expressed worry over its possible disadvantages, particularly against Korea who had enforced FTA with ASEAN, with the United States, and plans to negotiate with the EU. They claimed that, with Korea's FTAs, Japan cannot operate on an equal-footing with its competitors; it had been and it be at the disadvantage side compared with Korea in the abovementioned expanded markets.

4.3. Impediments of FTA utilization

What has impeded the utilization of the FTAs by Japanese enterprises? There were several factors that impede the utilization of FTAs. First, the enterprises, particularly SMEs, were not aware that the FTAs had already been enforced with lower tariff rates incentives as compared with the most favored nation (MFN)'s. Most of the FTAs in East Asia adopted the phase-out tariff reduction or the gradual reduction of tariffs within a 10-year period. Smaller impacts distributed over a long period of time lowers the

firms' motivation to utilize FTAs. In the Japan-Thailand EPA, Thailand offered the concession tariffs (e.g., mould, HS 8480, to be 4.17 percent in the first year; 3.33 percent in second year; 2.50 percent in third year; 1.67 percent in fourth year; 0.83 percent in fifth year; and, 0.00 percent in sixth year) against the MFN tariff which is 5 percent.[6] Since the information dissemination on the extent of benefits and processes on the preferential tariff and its comparison with the MFN was quite low, motivation among the Japanese firms to use FTAs turned out to be low as well. Utilization of Japan-Thailand EPA remained low even after its enforcement.

Second, almost Asian governments had arranged for the import tax exemption schemes. Thailand, for instance, had already provided the Board of Investment (BOI) certificate exempting selected materials and parts from import tariff. In 2008, the BOI announced the new regulation to report all the materials including those procured from domestic sources[7]. This announcement made some enterprises to consider the FTAs.

Third, the FTAs in East Asia were problematic. Exporters were burdened with the costs of preparation, yet, the benefits went to importers. Since incentive was low, exporters' motivation to utilize FTAs was low as well. On the contrary, the United States had employed the self-certificate system for the Generalized System of Preferences (GSP). Under this system, Thai exporters can export the goods with 0 percent tariff without any obligation to prepare the documentation.

Fourth, administrative costs were expensive. The application and certificate fee was only 3000-4000 yen in Japan. The fee, which was not so high,[8] covered the cost of developing the software systems that differs by EPA. The administrative costs to prepare for documents and obtain the certificate of origin, however, were very expensive. In particular, the documentation costs to meet the VC rule were quite expensive as well. Furthermore, it was quite difficult to calculate the value content for a single item since the machinery industry normally purchases various items for several clients. In addition, procurement sources of parts/materials were frequently switched depending on the market conditions. This whole process pushed up easily the costs of verification and compliance to ROO. Preparing documentation for certificate of origin was not easy for SMEs. Sometimes, SMEs were requested to prepare the documents for their clients, even if they were not the direct exporters. If SMEs were unable to submit necessary data, such SMEs will lose business by finding another supplier. With these,

SMEs tend to have lesser benefits from FTAs than large enterprises. In Japan, even large enterprises chose only few EPAs that could bring greater benefits to the firm due to their lack of human resources to comply with all its requirements.

Fifth, application data sometimes contained confidential information. In those cases, the FTAs were not utilized by firms. To meet the ROO, the components of products have to be reported to the Chamber of Commerce. But, information on components of the products and/or procurement sources was highly confidential for some products. If the component contained patented material, the manufacturer did not use the EPA at all. The OEM manufacturers inhibited the use of FTAs to protect the secrecy of its sources of materials.

Besides the abovementioned factors, a large number of Japanese firms have already advanced to ASEAN and China. Thus, the benefits gained by the remaining enterprises in Japan were not actually from Japan. The EPAs involving Japan had been too late to influence the remaining enterprises. Also, the large enterprises in Japan, which produced highly differentiated and customized products had stable demand that were not sensitive to changes in prices caused by tariff reduction. For these reasons, EPAs involving Japan will more likely to generate smaller impacts than initially expected, except for very few products.

4.4. Measures to encourage the utilization of EPAs

What measures will encourage the utilization of FTAs? The “less demanding administration,” including the self-certificate system, was cited by most of the interviewees as a motivating factor to use FTAs. This reflected the strong concern for an implementation flexibility from organizations issuing the certificates. An exporter was required to submit the application with the complete set of documents, including invoices, to the Chamber of Commerce to be able to calculate the VC. Most applicants complained against the Chamber of Commerce for being very strict on required documents, yet, there was no accurate information on how will it be implemented. In addition, the application forms differ by EPA, which further bothered the exporters. It seemed that it will, indeed, take time to familiarize the Japanese exporters with the current application system.

Surprisingly, only an enterprise answered that "less restrictive ROO" may encourage the utilization of FTAs. An electronics and electrical appliance-related firm, which refused to respond to the questionnaires, claimed for the less restrictive ROO.[9] In general, most of FTAs agreements required certificates of origin for every part and/or component, except when exporting the main unit as well as its parts. However, it was difficult to get certificates of origin for some parts. In particular, there were a large number of parts for automobile and the exemption of certificates of origin for the parts attached to the main units may encourage the utilization of FTAs.

Most of current FTAs employed "direct shipment" requirement, wherein goods were directly shipped from an exporter to an importer. However, Singapore has good sea ports to serve as hub station and skilled human resources that can handle the trading transaction between the countries in ASEAN. Thus, the respondent suggested to allow indirect shipment by "re-invoice" or "back to back invoice" operation.

4.5. Best ROO and the spaghetti bowl problem

Now, EPA involving Japan had proliferated; Japan-Singapore, Japan-Mexico, Japan-Malaysia, Japan-Chili and Japan-Thailand had been enforced. Therefore, a Japanese exporter had faced the "spaghetti bowl" problem, where tariff on a product differed by destination and ROO (including format difference by destination). How do firms in Japan perceive the "spaghetti bowl" problem? Has the "spaghetti bowl" problem excluded to use some EPAs?

When asked about the overlapping of FTAs involving Japan, several enterprises expressed that different ROOs might cause increase of costs. If utilizing even one FTA is already hard for a firm, utilizing several FTAs could be much difficult. It should be noted, however, that there was only one firm, an auto parts maker, who answered that overlapped FTAs actually increased the cost. Other enterprises perceive no problem at this point, but could occur in future.

With regards to the necessity of harmonization of ROO, the option to choose the VC rule or the CTC rule was mostly preferred, followed by the harmonization of the CTC rule. No enterprises chose the VC rule because firms perceived the preparation of necessary documents as time consuming. In particular, machinery part industry

complained about the VC rule due to the difficulty in calculating the local content of a single part. Normally, every manufacturer has “bill of materials” for each product, which is the lists of all intermediate materials and parts. The bill of materials can be used as the documentary requirement for the CTC rule only if the tariff line codes had been added on. A choice of VC or CTC rule plus“self-certificate system” may be considered as the best practice to avoid the FTA trap and spaghetti bowl problem.

Which organizations are expected to help the Japanese enterprises? The highly cited organizations were the Ministries of Economy, Trade, and Industry (METI) and Foreign Affairs (MOFA); and, followed by the business associations. Their preferences implied confidence and reliance to METI, which should provide the venue for consultationsa and sharing of ideas among the business associations, large firms, and SMEs. Some firms, however, complained that the FTAs by Japan were already too late because most of the firms had already advanced to ASEAN countries.

Lastly, since most of the FTAs took the phase-out tariff schedule where tariffs reduction were gradually over a long period of time. If only that the tariff reduction schedules were well displayed, then, it would promote the utilization of FTAs.

5. FINDINGS AND POLICY IMPLICATIONS

Several findings can be obtained based on the evaluation of FTAs by Japanese firms and its affiliates operating in overseas. These are the following:

1) The impact of FTAs involving Japan on business activities by Japanese firms seemed to be smaller than what the CGE model estimated because not many firms were utilizing FTAs.
2) Firms, particularly SMEs, were not aware of FTAs. Generally, firms had very poor information about FTAs.
3) Owing to the Information Technology Agreement (ITA), most IT-related products had been traded without tariffs.
4) Investment promotion schemes, which provide tariffs exemption on intermediate goods for export purpose, like a BOI scheme, had been intensively used instead

of FTAs.

5) Phase-out tariff schedules made FTAs unimpressive, lowering the firms' motivation to use FTAs.
6) The current FTAs in East Asia were problematic because the exporters were burdened with the costs of document preparation with benefits going to the importers. The incentive for exporters to utilize FTAs, therefore, decreased.
7) The administrative costs to prepare documents to acquire ROO were costly for firms, particularly due to the high cost of labor in Japan.
8) More importantly, it took time to acquire the certificate of origin from the organizations. It does not match with "just in time" production principle.
9) The value content (VC) rule is quite costly. It is quite difficult to calculate the VC since purchasing sources of parts as well as prices frequently change.
10) The document of the VC rule required information on costs and procurement sources. Such information, sometimes, contained confidential data because of the patented material and secret sources of the OEM suppliers.
11) The change of tariff code (CTC) rule was better practiced than that of the VC rule. The Bill of Materials (BOM) that described a flow chart of production process can be used as a CTC rule certificate material, only if tariff codes were placed on it. Nevertheless, negotiation on the digit level of the CTC rule was a difficult issue. More importantly, acquiring the certificate of origin also took time, even with the CTC rule.
12) Due to the high cost of labor in Japan, the overlapping FTAs might force the firms to use FTAs/EPAS selectively; choosing a few selected FTAs/EPAs for a certain products, such as high volume and high MFN tariffs products, mainly on an intra-firm trade.
13) Since the ROOs in Asia were cumbersome, FTAs benefited the large enterprises and penalize SMEs. Perhaps, utilization of the FTAs by firms in the least developing countries (LDCs) may not be beneficial.
14) Japanese firms ship goods to Singapore and then distribute them to neighboring countries. Bilateral FTAs do not allow "indirect shipment" via Singapore.

Based on the above research findings, a six-policy recommendation is listed below.

1) Efforts to dissemination FTAs are quite important. Seminars on how to use of the FTAs, especially for SMEs, should be held frequently, throughout the country.
2) The disclosure of operational guidelines, attached with several examples, is necessary. Information on rules of origin and phase-out tariff schedules should be well disseminated.
3) The change of tariff line code rule should be launched. Equally, the self-certificate system should be examined and launched as well.
4) Rules of origin are burdensome, and unilateral tariff liberalization on a MFN should be launched.
5) Trade facilitation measures, such as quick custom clearance, should be launched more intensively to enhance the production networks.
6) “Direct shipment” requirement is an unexpected problem. “Indirect shipment” should be allowed. Bilateral FTAs, involving Japan, may not be well fitted with current logistic and production networks. Regional wide FTAs, such as ASEAN, ASEAN+3, or ASEAN+6, should be launched.

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NOTES

[1] Rules of origin are the criteria used to define where a product was made.

[2] See "Technical Information on Rules of Origin," posted on the WTO website.

[3] The survey was conducted as a component of the annual survey on Japanese firms' international operations:

[4] The firms are allowed providing multiple answers.

[5] Japan uses the term of Economic Partnership Agreement (EPA) instead of Free Trade Agreement (FTA).

[6] The Japan-Thailand EPA was enforced in November 2007, and the first year is the November 2007-March 2008, the second year is April 2008-March 2009.

[7] Up to 2007, the BOI of Thailand required the report and registration of imported materials and parts.

[8] However, the application and certificate fee is expensive for automobile part makers because

application is submitted by part each time. In the United States, the certificate fee is free.

[9] The firm is not counted in the tables.