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Committee Secretary
Joint Standing Committee on Foreign Affairs, Defence and Trade

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Re: Submission to the Parliamentary Inquiry into Access to Free Trade Agreements by Small and Medium Sized Enterprises (SMEs)

Disclaimer: This submission was written by Associate Professor Melatos in his personal capacity as an academic in the School of Economics at the University of Sydney. The opinions expressed in this article are the author's own and do not necessarily reflect the views of the University of Sydney.

Summary

In order to maximise the benefit of free trade agreements (FTAs) to the Australian economy, such agreements need to be designed to ensure that firms of all sizes can take advantage of the enhanced (preferential) trade access they deliver.

This can be facilitated by adherence to the following principles:

1. In evaluating an FTA, a careful and explicit accounting must be undertaken not just of the benefits of enhanced market access, but also of the costs (especially for SMEs) of complying with associated rules of origin.
2. An FTA should not require firms – especially SMEs – to re-optimize their production/distribution networks in order to exploit enhanced market access opportunities.
3. Trade negotiators could consider making individual firms the 'unit of account' in FTA negotiations by including lists of accredited firms that are recognised (i.e. pre-approved) as RoO-compliant by all parties to the agreement.
4. Australian firms should, as far as possible, face a homogeneous experience when seeking to access the benefits of different FTAs to which Australia is a signatory.

FTA design and the costs of trade

1. The fundamental aim of any FTA should be to make it less costly for domestic firms – exporters and importers – to do business with customers and suppliers overseas.
 - ✓ This means that FTA design must be led by the needs of domestic firms.
 - ✓ Given their comparative lack of resources, it is important to integrate SME concerns directly into FTA negotiations.



2. FTA negotiations too often over-emphasise market access ‘paper’ gains for exporters at the expense of demonstrating real reductions in the costs associated with exporting.
 - ✓ The price of preferential treatment and enhanced market access in an FTA is costly Rules of Origin (RoO).
 - ✓ Ultimately, it is the *net* benefit (or cost) of enhanced market access that will determine whether or not firms can exploit any market access gains that have been negotiated.
 - ✓ Net benefit of market access gains = (the additional benefits of market access gains) – (the cost of adhering to associated rules of origin).
 - ✓ An example: while a trade partner may agree to levy preferential tariff rates on imports of a particular product or service (i.e. a gain in market access), the RoO required to access these preferences may impose prohibitive costs on the exporter. As such, the cost of exporting may actually rise under the FTA leading exporters to prefer trade on an MFN basis outside the FTA.

3. To better understand the trade-off between market access and trade costs, it is useful to think about the incentives firms face to: (i) participate in (i.e. export to) a market and (ii) participate (i.e. utilise the preferences) in the FTA rather than accept MFN tariffs.
 - ✓ Market access gains achieved via an FTA are valuable to the extent they allow: (i) existing exporters to export more and (ii) firms that didn’t export *ex ante* the formation of the FTA to export *ex post*.
 - ✓ However, to the extent that associated RoO are introduced that raise trade costs beyond the *ex ante* MFN level, then any market access gains become moot. Firms trading on MFN terms prior to the creation of the FTA will continue to do so. Firms that didn’t trade on MFN terms prior to the FTA will not consider doing so *ex post*.
 - ✓ An optimal FTA maximises not just the amount of market access for exporters, but also ensures that the net benefits of accessing this within the FTA exceed the net benefits of *ex ante* MFN trade.
 - ✓ Given the complementary nature of enhanced market access and costly RoO in FTA negotiations, FTA negotiators must trade-off maximising market access with minimising the costs firms face exploiting this enhanced market access *ex post* the creation of the FTA.

4. FTAs are not implemented in a vacuum. They are an instrument of trade policy that is superimposed on *pre-existing* production and distribution networks that firms have optimised given existing trade rules.
 - ✓ For exporters, there are significant ‘switching costs’ associated with altering such networks; for example, dealing with new suppliers.
 - ✓ Moreover, since RoO vary from one FTA to the next, it may not be possible for an SME to simultaneously satisfy the RoO of all FTAs. Therefore, utilisation of FTA preferences might be effectively limited; the cost of RoO



- compliance may not just include paperwork, time etc, costs may include sacrificed market access due to the incompatibility of production and distribution networks with some FTA RoO. Policymakers cannot expect firms, especially SMEs, to re-optimize their production and distribution networks every time a new FTA signed.
- ✓ Unless there is overwhelming evidence of substantial inefficiencies in existing production/distribution networks, new FTAs:
 - Should enable exporters to reduce their trade costs while maintaining their existing production and distribution networks,
 - Should provide exporters with the ability to gain additional market access utilising their existing production and distribution networks
 - Should NOT *require* firms to re-optimize their production and distribution networks in order to realise any benefits from the FTA. (Although, for some firms, re-optimising may lead to substantial benefits and, therefore, make it worthwhile to incur any associated switching costs).
5. It is likely that the costs of complying with RoO in FTAs vary with firm and industry characteristics as well as over time due to changes in factors such as exchange rates.
- ✓ This means that the optimal set of RoO is likely to vary from one FTA to another and, for that matter, within a given FTA over time.
 - ✓ In turn, this means that firms exporting to more than one destination are likely to have to deal with multiple RoO regimes, incurring significant administrative costs in the process; costs that may turn out to be prohibitive to their exporting aspirations.
 - ✓ For large, well-resourced firms, it may be optimal to maintain parallel production and distribution networks to supply different markets governed by different RoO. For SMEs, however, this is unlikely to be the case.

Some implications for policy

1. When commissioning economic evaluations of FTAs, the Department of Foreign Affairs and Trade should explicitly require an evaluation of the potential costs of rules of origin compliance on different stakeholders (e.g. SMEs) and its likely impact on the realisation of market access gains.
2. FTA negotiators should be required to clearly report, for a representative sample of companies (e.g. large, SME, product exporter, service exporter, from a selection of industries):
 - ✓ The estimated costs of complying with associated rules of origin for each firm type.
 - ✓ The estimated *net* benefit (or cost) of enhanced market access (as defined above) for each firm type.
 - ✓ This information will: (i) help firms determine whether or not trading within the FTA is in their interest and (ii) concentrate the minds of FTA negotiators



to ensure that the *net* (rather than *gross*) benefit of market access gains, forms the basis on which negotiations take place.

3. FTA negotiators should consider making individual firms the fundamental 'unit of account' in FTA negotiations.
 - ✓ This approach requires trade negotiators to design FTAs that:
 - Recognise that firms have already optimised their production and distribution networks based on the existing trade environment.
 - Enhance market access with minimal impact on existing firm operations.
 - ✓ Signatories to an FTA can create a list of 'accredited' firm-product pairs that is approved by all parties and incorporated into the agreement at the time it is signed. Thereafter, accredited firms are free to trade these products subject to the FTA's preferences without having to demonstrate compliance, once again, with the RoO. They are pre-approved.
 - ✓ The accreditation list can be developed as a 'living' document, in the sense that new exporters can seek accreditation and existing exporters can amend (or rescind) their accreditation as circumstances change (e.g. suppliers change, new products are developed for export etc).
 - ✓ In this way, the costs of RoO compliance are a one-time event for firms who thereafter are only required to update their government of any changes to their circumstances that require their accreditation status to be amended.
 - ✓ Firms above a threshold size can be asked to pay an accreditation fee to reimburse government costs of maintaining the accreditation list. SMEs can be exempt from paying such a fee. Firms should also be allowed to self-manage their RoO compliance if they prefer. In short, the accreditation list can operate on an opt-in basis.
4. Australian firms should face a homogenous experience in seeking to exploit the market access benefits of Australia's growing number of FTAs.
 - ✓ The system of accreditation lists described above can help achieve this goal. The list of accredited firms can vary from one FTA to another, mirroring variations in RoO between agreements. However, once a firm has been accredited for one FTA, their government can determine whether or not they can be accredited for other FTAs which the government has signed.
 - ✓ Moreover, once government has created a database of the accreditation details of different firms, FTA negotiators will be much better equipped to negotiate on the basis of maximising enhanced market access and rules of origin that maximise the net benefits of firms, especially SMEs.
 - ✓ It should also be noted that regional FTAs are more likely to promote a homogenous market access experience for firms than bilateral FTAs.
5. Every FTA should include an explicit commitment to re-evaluate the operation of RoO within five years of the FTA coming into force. The aim of this re-evaluation



should be to determine the accuracy of the original *ex ante* estimates of the costs of RoO compliance and the net benefits of enhanced market access.

Yours Sincerely,

Mark Melatos