

Policy Issues Regarding the Promotion of FTA Utilization in Japan

By Arata Kuno



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3 Conditions for Securing Economic Gains through FTAs

When pursuing economic gains from free trade agreements (FTAs), we must always bear in mind, at a minimum, whether the following three conditions are met.

The first is whether a country's FTAs offer sufficient coverage in terms of the number of partner countries as well as trade values. If the number of partners is insufficient, or if the FTAs are not concluded with countries that have strong business needs, their trade expansion effects are likely to be limited. The second is whether a sufficient level of trade liberalization is committed to under the agreements. No matter how many partners a country enters into FTAs with, if the ratio of liberalized items is limited, or if important trade items are excluded from liberalization, then the economic gains from FTAs are likely to fall short of expectations. The third is whether firms will actually utilize FTA preferential tariffs when trading with FTA partner countries. No matter how ambitious the liberalization achieved through FTA negotiations, if potential users are unaware that FTAs can be utilized as a corporate strategic tool, or if they face significant transaction costs when utilizing FTAs, an expansion of users is unlikely.

What policy issues are revealed by looking at these three conditions together in a Japanese context? To date, there has been active discussion in Japan about the first and second conditions, that is, which countries Japan should negotiate FTAs with and which items should be subject to liberalization. On the other hand, once FTA negotiations have been settled, the attention of the media and the people tends to turn toward the next FTA negotiations; there has not necessarily been sufficient discussion either of the state of utilization of existing FTAs or of obstacles to utilization. Needless to say, the conclusion of FTAs alone does not automatically bring the economic benefits to firms and consumers. In order to maximize the economic benefits of FTAs, it is necessary to ensure that the agreements are actually utilized by as many firms as possible through increased awareness of agreements and improved usability.

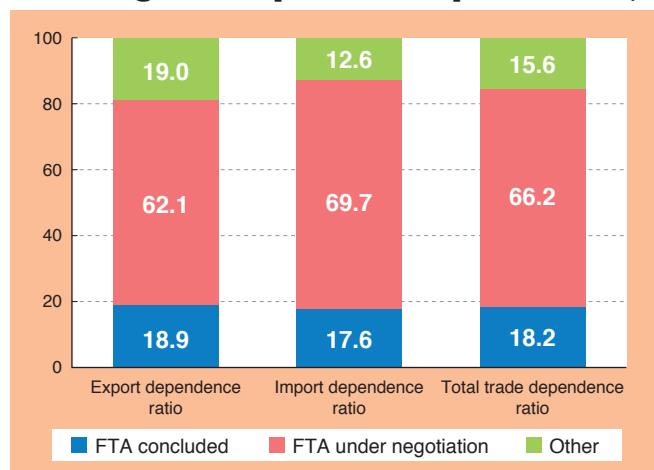
This paper is organized as follows. First, I will briefly describe Japan's current situation with regard to the first and second conditions. Second, I will discuss the third condition, which has also been taken up in the *White Paper on International Economy and Trade 2014*. That is, I will focus on the difficulties that firms are facing when utilizing FTAs. Finally, some policy implications will be addressed.

1st Condition: Coverage of FTA Partners

Among the three conditions mentioned above, improvement in the near future is assured for the first, that is, we can expect broader coverage of FTA partner countries. Until now, Japan has been said to be relatively reluctant to negotiate FTAs with economic superpowers. Indeed, according to trade statistics in 2013, Japan's export dependence ratio with respect to its 15 FTA partner countries was only 18.9%, with import dependence ratio at 17.6%, and total trade dependence ratio (exports and imports) at 18.2% — in all cases below 20% (*Chart 1*).

This situation, however, is expected to improve drastically in the not-so-distant future. The reason is that Japan is now actively engaged in negotiating “mega FTAs” with countries and regions upon which Japanese trade depends heavily, including the China, Japan and South Korea FTA (CJK FTA) and the Regional Comprehensive Economic Partnership (RCEP), both of which include China, Japan's largest trading partner; the Trans-Pacific Partnership (TPP), which includes the United States, Japan's second-largest trading partner; and an Economic Partnership Agreement (EPA) with the European Union, Japan's third-largest trading partner. Including trade data from the 42 countries with which Japan is already negotiating and the one country with which it has agreed to initiate negotiations, the above figures rise to 81.0% for export dependence, 87.4% for import dependence, and 84.4% for total trade dependence. The issue of

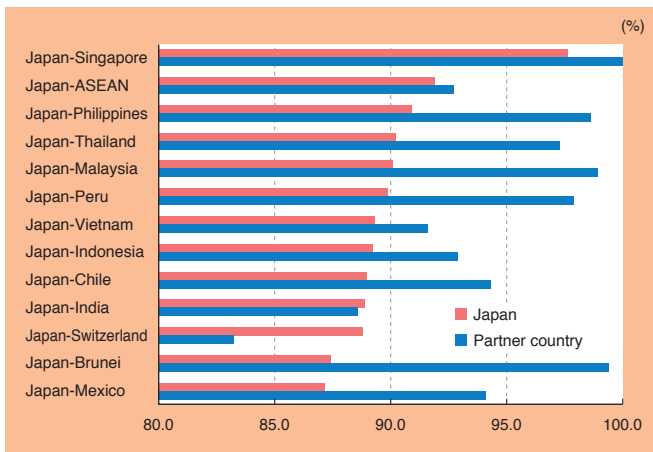
CHART 1
Coverage of Japan's FTA partners (%)



Source: Trade Statistics of Japan

CHART 2

Level of liberalization in Japan's FTAs



Note: The Japan-ASEAN value was calculated by the author.
Source: WTO (2013), *World Tariff Profiles 2013*

entering into FTAs with other important trading partners such as Taiwan, Russia, and the Mercosur countries remains, but if agreements are reached in all of the negotiations currently underway, it will enormously improve the situation with respect to the first condition.

2nd Condition: Level of Liberalization under FTAs

Despite the name, it is very unusual for “free” trade agreement negotiations to result in the complete elimination of tariffs. Japan is certainly no exception, and the FTAs it has entered into so far have exempted many items from liberalization, primarily “sacred ground” items (568 on a tariff line basis) related to rice, wheat, dairy products, sugar, and beef and pork. *Chart 2* indicates the level of liberalization in Japan’s existing FTAs for both Japan and its partners. Two points in this regard bear further comment.

First, as a result of maintaining a policy of not liberalizing sacred ground items, the Japan-side level of liberalization is below 95% on a tariff line basis for every FTA except that with Singapore. This is relatively low compared to the FTAs entered into by other advanced nations. For example, the FTA between the EU and South Korea achieves a 99.5% level of liberalization for both countries, that between the US and Australia more than 98% for both countries, and that between Australia and Thailand 100% for both countries (WTO, *World Tariff Profiles 2013*, pp.184-188). Second, for the majority of Japan’s FTAs, the level of liberalization for the partner country is also below 95%. The low level of liberalization among partner countries can be seen as the price paid for the low level of liberalization on the Japan side. The more stubbornly Japan refuses to liberalize certain agricultural products, the lower its bargaining power when seeking to open markets in the partner country.

Will Japan pursue a more ambitious opening of its markets than it

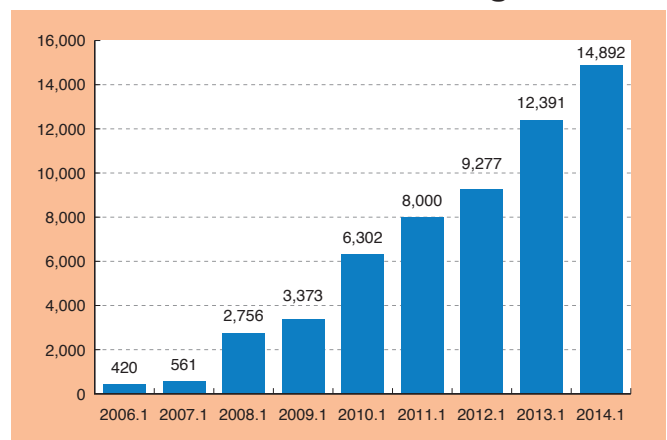
has to date? The answer to this question lies in the course of the mega-FTA negotiations currently underway. In terms of the magnitude of outside pressure to open Japanese markets, and the magnitude of the economic interests to Japanese exporters of opening up partner country markets, these mega-FTA negotiations are clearly of a different order from what has come before. If the Japanese government is unable to achieve open markets even when faced with such an opportunity, it will likely be a long time before we can hope to see qualitative improvement in Japan’s FTAs. On the other hand, if it can achieve an ambitious liberalization through a series of mega FTAs, it will not only provide hope that the negotiation of any new FTAs in the future would lead to a high level of liberalization but also provide momentum for members of Japan’s existing FTAs to seek additional liberalization through renegotiation.

3rd Condition: Utilization of FTA Preferential Tariffs

How much are FTA preferential tariffs actually being used in the course of trade with Japan’s FTA partners? Looking at the issuance of certificates of origin — which are necessary when utilizing preferential tariffs for exports, their number increased four-fold during the five-year period between January 2009 and January 2014, from 3,373 to 14,892 (*Chart 3*). Considering that Japan entered into a growing number of FTAs over this period, we can also look to the average number of issuances per FTA over time, which shows a 2.9-fold rise over the same period, from 422 to 1,241. Seen in terms of the number of certificate of origin issuances, then, the use of FTA preferential tariffs in exports has increased. If we look at the distribution of issuances by partner country, more than 80% of issuances are related to exports to just four countries: Thailand (5,435), Indonesia (3,293), India (2,351), and Malaysia (1,041) (*Chart 4*).

CHART 3

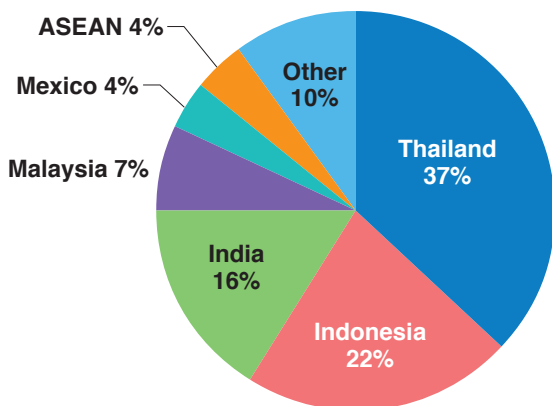
Number of certificates of origin issued



Source: Ministry of Economy, Trade, and Industry
http://www.meti.go.jp/policy/trade_policy/epal/file/co_issuance.pdf (as of Jan. 2014)

CHART 4

Proportion of certificates of origin issued, by partner country



Source: Ministry of Economy, Trade, & Industry (as of Jan. 2014)

Next, let's look at the utilization ratio of FTAs in terms of the number of firms using FTAs. According to the results of an annual survey conducted by the Japan External Trade Organization (JETRO), among firms engaged in trade with FTA partner countries, the utilization ratio of FTA preferential tariffs rose 6.7 percentage points, from 36.2% to 42.9%, between 2009 and 2013 (Chart 5). This growth, however, is relatively slow compared to the rise in issuance of certificates of origin, suggesting that there remains room to expand the pool of users.

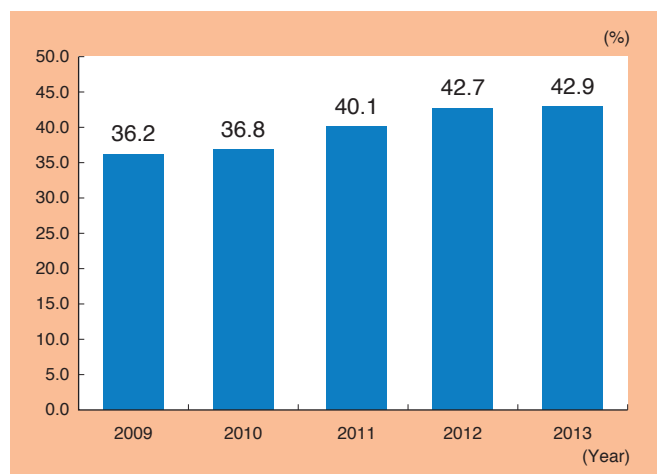
There are a number of reasons why a company might not utilize an FTA that has been entered into with a given country. One such case is when the tariffs on the items a firm trades have already been eliminated prior to the conclusion of the FTA. When past GATT/WTO negotiations have already eliminated the most-favored-nation (MFN) tariff on a given item, there is no need for a firm to go out of its way to conduct trade using FTA preferential tariffs. A second reason, as described already, is when the items a firm trades have still not been liberalized even after the FTA has been negotiated. A third is when tariffs have been eliminated as a result of FTA negotiations but prohibitively high compliance costs must be borne in order to meet restrictive rules of origin (ROOs) requirements. A fourth is when there are transaction costs associated with determining whether to use the FTA or with its actual utilization. Specifically, the use of FTAs is hindered by the fact that searching for and fully understanding information about the tariff-saving effects, ROOs, and other administrative procedures involved in using an FTA, and then making a management decision to do so, requires a not insignificant amount of management resources.

Transaction Costs that Arise in Deliberating FTA Use

In Japan, a range of FTA-related information is already available

CHART 5

FTA utilization rate



Source: JETRO (2014), FY 2013 Survey on the International Operations of Japanese Firms

through sources such as public agency websites. Previous research, however, indicates that the FTA-related information provided by public agencies is too technical for most business people to understand correctly, and difficult to track tariff rates and other legal provisions in every possible FTA from year to year, and notes the need to create manuals that bridge the gap between the legal provisions and actual administrative work (Japan Economic Foundation (2010), *Wagakuni ga teiketsu shita EPA riyo no jokyō, koka, kadai ni kansuru chosa kenkyū hokoku* [A Report on Survey Results Concerning the Use of Japan's EPAs, their Effectiveness, and Related Issues], pp.72–73). The following are examples of the sort of difficulties that company staff who are not experts in FTA-related matters may encounter when trying to determine whether to utilize an FTA.

(a) Identifying the correct commodity classification number

The most important information for all firms considering FTA utilization is whether or not the reduction in tariffs will be sufficient to compensate for the compliance costs of ROOs. The first difficulty a firm faces in trying to identify the amount of tariff reduction is correctly identifying the classification number (HS code) for the items being traded. Without identifying the HS code, it is impossible to know what FTA preferential tariff rate will be applied to the item in question, so this step is unavoidable.

The HS codes used for classifying traded items generally take the form of an eight to 10-digit number. The first six digits are assigned according to international standards, but from the seventh digit on, each country can independently determine the number of digits and the numbers assigned. As a result, when a Japanese company utilizes an FTA for export, it must submit to the customs authorities of the importing country not the number as used in Japan but the number determined by the importing country. It is no easy task to

access information from overseas and correctly determine which of the many thousands of HS codes applies to the export items. In addition, as touched upon in the *White Paper on International Economy and Trade 2014*, in the event there is a difference of interpretation between the exporting company and the customs authorities in the importing country, problems may arise such as preferential tariffs not being applied when passing through customs. One way to avoid such problems is to make use of the importing country's advance rulings system, but human resources limitations makes it difficult for small and medium-size enterprises (SMEs) to make full use of such overseas systems.

(b) Identifying the preferential tariff rate

After identifying the HS code for the item to be traded, the next challenge faced by company staff is determining the preferential tariff rate that applies to the item in question. Needless to say, in order to make a management decision the company needs to grasp not only the tariff rate applied in the current year, but also how the preferential tariff rate will change over the phase-out period.

Understanding the preferential tariff rate imposed by the partner requires either using the external tariff database under contract to JETRO or referring to the original text of the agreement itself. Because this database provides its services in English, however, it is not necessarily easily accessible to company staff who lack sufficient English skills. In fact, the *White Paper* suggests that SMEs use the database at only one-third the rate of large corporations.

At the same time, even though Japanese versions of the texts of agreements are available, simply looking through these legal documents is not enough to directly determine preferential tariffs by item over time. To learn the rate, one must first understand the meaning of the various codes used to indicate tariff concession status (e.g., A: immediate elimination; B5: eliminate over six years; X: exclude) and then calculate the rate for a given year on one's own. Furthermore, the HS code classification method and numbers are revised every five years to ensure they keep up with the times. When HS codes are revised, however, there is sometimes no effort made to

revise the body of the text of the agreement itself to reflect the change. The work of determining the preferential tariff rate therefore becomes more difficult, when the most recent code that must be submitted to the customs is not the same as the old code that appears in the agreement.

(c) Comparing multiple trade agreements

When there are multiple trade agreements that could be used, companies must look across all such agreements to determine which one could bring about the largest tariff-saving effects. For example, there are two FTAs between Japan and Thailand: the Japan-Thailand Economic Partnership Agreement and the ASEAN-Japan Comprehensive Economic Partnership. In such cases, the preferential tariff rates may differ by FTA or by year even for the same item. Furthermore, a company that has production facilities in multiple countries may also need to consider not only Japan's FTAs but also those of third countries, such as the ASEAN-China FTA or the ASEAN-India FTA. In addition, as was the case between Japan and Thailand when a temporary reversal meant that the FTA preferential tariff was actually higher than the MFN tariff, utilizing an FTA can sometimes actually be detrimental, so companies must also be careful to make comparisons against MFN tariffs. In the event that the RCEP and TPP are successfully negotiated in the future, there will be some countries that have concluded three or four FTAs with Japan; this will only increase the difficulty of making a decision to the degree that it increases the number of agreements that must be compared.

(d) Understanding ROOs

For a company to engage in exports utilizing FTA preferential tariffs, the company must obtain a certificate of origin affirming that the exported item satisfies the ROOs stipulated in the FTA and submit it to customs authorities in the importing country. ROOs, however, may differ by partner country even for the same item (*Table*). Furthermore, when multiple FTAs have been concluded with a particular country, selecting which FTA to utilize requires

TABLE
Examples of rules of origin provisions that differ by FTA

	Japan-ASEAN	Japan-Malaysia	Japan-Chile	Japan-Mexico	Japan-India
Color TVs	40% of regional value content	40% of regional value content	40% of regional value content or Change of tariff classification at the 4-digit level	Change of tariff classification at the 4-digit level	35% of regional value content & Change of tariff classification at the 6-digit level
Lithium-ion batteries	40% of regional value content or Change of tariff classification at the 4-digit level	40% of regional value content or Change of tariff classification at the 6-digit level	Change of tariff classification at the 6-digit level	50% of regional value content & Change of tariff classification at the 6-digit level or Change of tariff classification at the 4-digit level	35% of regional value content & Change of tariff classification at the 6-digit level

Source: *White Paper on International Economy & Trade 2014*

understanding and comparing all the ROOs requirements for each, as well as the steps and procedures needed to obtain and submit certificates of origin.

Providing Information to Facilitate FTA Utilization

Obtaining further economic gains through FTAs requires expanding the users of the FTAs. Promoting such utilization by as many companies as possible, including SMEs with limited management resources, requires policy efforts to resolve the various issues mentioned in the previous section. For example, it is essential to find user-friendly ways to provide information in order to minimize the company-side cost of searching information. In this section, I discuss some policy implications for further supporting and promoting the use of FTAs.

First, compared to other countries, there are a very wide variety of governmental agencies in Japan that provide FTA-related information, and much of this information overlaps across the agencies. Moreover, it is not uncommon for such agencies to mix the specific, detailed information that potential FTA users need with more generic information about the significance and impact of FTAs that targets a broader audience. Going forward, information should be consolidated to provide a one-stop portal site where potential FTA users can gather the information they need.

Second, a system should be built to enable searches, in Japanese, for HS codes, preferential tariff rates, and ROO provisions by FTA, item, and year. Examples of such websites that already exist for other countries include International Enterprise Singapore's Tariff Calculator, the New Zealand Ministry of Foreign Affairs and Trade's Tariff Finder, and the South Korean Customs Service's FTA Portal.

Third, from a management strategy perspective, the most important information companies want to know is not really a list of tariff rates for each FTA but rather information about tariff savings: how much their tariffs will actually be reduced, and when, through the use of which FTAs. As it stands now, no countries currently provide information that meets all of these conditions, but International Enterprise Singapore has incorporated into its website a system by which inputting HS code, export trading partner, and value of trade produces a list, by FTA, of expected reductions in tariffs for the current year. Although it is not possible to calculate tariff reductions for a future year of one's choice, this is surely a very effective means of encouraging potential FTA users to actually take advantage of FTAs.

Fourth, it would be desirable to have manuals produced that cover ROOs from the user standpoint. Because so many unfamiliar technical terms appear in discussions of ROOs, high-quality manuals written from the user's point of view are essential. For example, the US Department of Commerce provides a user's guide outlining ROOs for each FTA. These easy-to-understand guides include examples of how to read ROO provisions, explanations of the different types of

ROOs, information on how to calculate Regional Value Content, and glossaries.

Fifth, success stories and case studies showing how other companies in similar industries have utilized FTAs, and how doing so has been beneficial, are another valuable form of information for potential FTA users. One such example is the "Success Stories" page on the International Enterprise Singapore website. This page includes examples of how companies have used FTAs successfully, complete with the names of the companies and links to related newspaper articles. In the US, Industry Opportunity Reports are produced that publicize, say, what particular companies hope to gain through the US-South Korea Free Trade Agreement and why.

Conclusion

Finally, I would like to touch on recent initiatives in South Korea as an example of a comprehensive effort to increase the FTA utilization rate. In 2010, the South Korean government, after conducting a thorough review of the effectiveness of its information provision and support efforts up to that point, introduced a new comprehensive package designed to raise the FTA utilization rate to at least 60%. This package launched with the goal of establishing a National FTA Utilization Center and Regional FTA Assistance Centers to implement related measures, regularly monitoring utilization rates, establishing a portal site for potential FTA users, training FTA consultants, establishing FTA-related courses at universities and graduate schools, opening an FTA call center to answer questions from companies at no charge, and offering four years of FTA utilization consulting services to 10,000 SMEs engaged in trade with partner countries ("Korea's Policy Package for Enhancing its FTA Utilization and Implications for Korea's Policy," by Inkyo Cheong, *ERIA-DP-2014-11*). Through such efforts, the FTA utilization rate, which had not exceeded 30% prior to 2010, exceeded 60% by the end of 2013 and reached more than 70% for the US-South Korea FTA and the EU-South Korea FTA.

The benefits of promoting FTA utilization through such measures surely go beyond securing short-term economic gains from trade expansion effects. Increasing the number of users means increasing the number of beneficiaries who enjoy the economic benefits of the FTA. Increasing the number of those who benefit from FTAs can be expected to have the politico-economic effect of expanding and strengthening the domestic base of support for future trade policy, including trade liberalization and regional economic integration.

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