THE LIMITED UTILIZATION OF FREE TRADE AGREEMENTS: AN EMPIRICAL STUDY OF THE USE OF THE INDONESIA-JAPAN ECONOMIC PARTNERSHIP AGREEMENT BY FIRMS

By

Lintang Paramitasari Parnohadiningrat Wibawa

SUMMARY

The number of Free Trade Agreements (FTAs) in the Asia-Pacific region has been growing remarkably in the past two decades. An increasing number of empirical studies, however, have found that those tariff rates lowered by FTAs are used only for a small number of traded goods and by a small number of trading firms. This dissertation presents an empirical study investigating the association of FTA use with firm and manager characteristics, so to gain a better understanding of the limited use of FTAs. Firm characteristics is defined as the size, age, years in operation, and FDI status of firms, as well as their trading behavior. Manager characteristics is defined as the age, years of schooling and professional experience, and FTA knowledge of managers. The Indonesia-Japan Economic Partnership Agreement (IJEPA) is used as a case study.

The empirical study finds that the limited FTA use is associated to two factors: the FTA structure and the ROO fixed cost selection effect. The FTA structure consist of the tariff margin or the saving benefit obtained from the difference between the MFN tariffs and FTA tariffs, and the Rules of Origins (ROO) or a fixed cost firms pay

to be eligible for FTA tariffs. Firms pay a higher fixed cost for a more restrictive ROO. The study finds that firms respond to the FTA structure by trading products with highly restrictive ROO and largest tariff margin. Since the tariff margin is a variable cost calculated based on the value of shipments, products are sent in large-scale shipments and on an irregular pattern. This behavior allows firm to accumulate large tariff savings and compensate for the costly ROO. Hence, the FTA's ROO and tariffs are endogenous factors in the FTA structure that determine firms' use of an FTA.

The highly restrictive and costly ROO creates a ROO fixed cost selection effect or a condition in which firms face a short-term capacity constraint. Firms that trade a large proportion of their production with the FTA-market, have been in operation for long years, and capitalize by FDI are more likely to manage the ROO selection effect and use FTA. The results suggest that firms use an FTA for the long-term prospect of engaging in an intensive trade activity, since continuous large-scale shipments would make the ROO fixed cost negligible in the long run. The results also indicate that firms do not use FTA tariffs in ad-hoc trading activity. Future research can use transaction-level data to test such an association.

The characteristics of managers in FTA-using firms also relates to the firms' large proportion of trade to an FTA-market. FTA use is associated with the managers' years of work experience or the process of learning-by-doing. Due to the firms' intensive trade activity to an FTA-market, managers tend to specialize their knowledge on a specific FTA. Attendance to government-organized awareness campaigns are useful know-how to managers, but do not trigger FTA use.