Factors Affecting Use or Nonuse of Free Trade Agreements in the Philippines

GANEESHAN WIGNARAJA, DOROTHEA LAZARO, AND GENEVIEVE DE GUZMAN

ABSTRACT

Within East Asia, the outward-oriented Philippine economy is a latecomer to using free trade agreements (FTAs) as a trade policy instrument and has relied heavily on the Association of Southeast Asian Nations (ASEAN) for regional liberalization. While negotiating FTAs has consumed scarce time and other resources, limited attention has been hitherto given to evaluating the impact of FTAs—particularly the 15-year-old ASEAN Free Trade Area (AFTA)—on business activity in the Philippines.

Using a survey of 155 manufactured goods exporters from three sectors (machinery and transport equipment, processed foods, and electronics), this study deals with three questions: (1) Do firms use AFTA and why and how are firms responding to AFTA and other FTAs? (2) What impedes firms from using either AFTA or other FTAs? (3) What can be done to improve FTA use at the firm level in the future?
The study finds that utilization of AFTA is higher than expected from existing studies and is set to double in the future. A lack of information has been identified as the biggest barrier to FTA use. Other impediments include the availability of export-processing zone incentive schemes, low most-favored-nation rates, delays in origin administration, rent-seeking behavior, and nontariff measures in partner country markets.

The paper concludes by making the case for better mainstreaming of FTAs into Philippine national trade policy, effectively encouraging the use of FTAs, and putting in place support mechanisms to Philippine firms.

**INTRODUCTION**

“We view the ASEAN community and our other neighbors like China and India as partners in economic development. We are working together to build a more cohesive regional community that will strengthen the economic clout of all our nations in our rapidly growing region.” — President Gloria Macapagal-Arroyo (2008)

Alongside an outward-oriented development strategy, the Philippines’ approach to tariff liberalization through free trade agreements (FTAs) started in 1992 with its membership in the Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA). Between 2005 and 2010, the country, relying heavily on the ASEAN in negotiating FTAs, implemented three ASEAN FTAs with major regional powers in Asia (namely, the People’s Republic of China [PRC], Japan, and the Republic of Korea [hereafter Korea]) and one with the Pacific (with Australia and New Zealand). It has also signed a regional FTA with another emerging economic giant, India. From January 2010, the Philippines benefited from the full implementation of the world’s largest FTA—the ASEAN-PRC Comprehensive Economic Cooperation Agreement (CECA)—which effectively reduced tariffs on around 90 percent of all products between six founding members of the ASEAN and PRC, collectively comprising around 1.7 billion consumers. The Philippines has also been involved in efforts on the bilateral front, though less actively, implementing only one bilateral FTA to date (the Japan-Philippines Economic Partnership Agreement [JPEPA]).

Following its FTA involvement, the Philippines’s trade flows have become increasingly focused on regional partners (with existing FTAs) and less on traditional markets (e.g., the United States [US]). These developments underline a burgeoning interest in regional economic integration efforts toward an ASEAN Economic Community by 2015 and a single regionwide FTA. Policymakers
began to recognize that FTAs not only improve the countries’ market access but also promote increased specialization, better trade performance, and the country’s link to the global and regional supply chain.

Nonetheless, the impact of FTAs, particularly their value to Philippine business, is still being debated. The lack of official and published data on the utilization of FTA makes ex post facto evaluation of such agreements difficult. Existing FTA studies also generally involve ex ante simulations of the FTAs’ macroeconomic effects (e.g., Kawasaki 2003; Urata and Kiyota 2003; and Yasutake 2004). For example, using a computable general equilibrium (CGE) model, Cororaton (2004) estimated that a JPEPA could bring industry expansion—particularly in the nonfood manufacturing sector—but a contraction in agriculture. Meanwhile, Park et al. (2008) suggested an increase in Philippine exports of agricultural products, extractive industry, and technology-intensive manufacturing as a result of the ASEAN-PRC CECA. A recognized limitation of the use of CGE, however, is that economic benefits may be overstated (Yap 2005). There are also a number of sectoral studies using strength-weakness-opportunity-threat (SWOT) analyses (Tan 2004; Austria 2006; Costales 2008; Pineda and Tongco 2007). While this method identifies the potential advantages and disadvantages of FTAs to industry players, it does not give a clear picture of their actual use among Philippine firms.

As the Philippines enters into more agreements in the future, it becomes increasingly important to determine whether Philippine firms actually benefit from FTAs, particularly given the current perception that FTA use is extremely limited. For instance, Baldwin (2007) cited less than 3 percent AFTA utilization in the 1990s. In the Philippines, Avila and Manzano (2007) attempted to estimate AFTA use of around 15 percent by getting the proportion of the total value of exports declared in certificates of origin to the total value of Philippine exports.

This study offers new data on the actual use of FTAs, particularly the 15-year-old AFTA on business activity in the Philippines. It deals with three questions: (1) Do firms use AFTA and why and how are firms responding to AFTA and other FTAs? (2) What impedes firms from using either AFTA or other FTAs? (3) What can be done to improve FTA use at the firm level in the future? An enterprise survey was conducted nationwide between May and November 2008 on 155 randomly selected firms from the machinery and transport equipment, processed foods, and electronics industries exporting manufactured goods.2 Table 1 shows the profile of surveyed Philippine firms. Together, the three sectors account for around 73 percent of total Philippine exports, with electronics accounting for 63 percent of the total exports; machinery and transport equipment, 5 percent; and

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2The Philippines firm survey was conducted as a part of an ADB multicountry, multienterprise survey of several Asian countries. See Kawai and Wignaraja (Eds. forthcoming) for details.
<table>
<thead>
<tr>
<th>Size</th>
<th>All</th>
<th>Sector</th>
<th>Ownership</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Machinery and Transport Equipment</td>
<td>Processed Foods</td>
<td>Electronics</td>
</tr>
<tr>
<td>SME</td>
<td>64</td>
<td>13</td>
<td>26</td>
<td>25</td>
</tr>
<tr>
<td>Large</td>
<td>81</td>
<td>22</td>
<td>16</td>
<td>43</td>
</tr>
<tr>
<td>Giant</td>
<td>10</td>
<td>1</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>All</td>
<td>155</td>
<td>36</td>
<td>43</td>
<td>76</td>
</tr>
</tbody>
</table>

SME = small and medium enterprise; NCR = National Capital Region; PEZA = Philippine Economic Zone Authority

Notes: Foreign firms are defined as firms with at least 10 percent foreign equity share.
Size is by number of employees: SME = 100 or fewer; large = 101–1000 and giant = more than 1000.
Location is by economic zone membership (PEZA, non-PEZA) and geographic location (NCR, non-NCR).
Source: Authors' computation based on survey data.
processed foods, 4 percent. The three sectors were selected for the study in view of their importance in the Philippine economy and the fact that they are priority integration sectors for ASEAN.

The paper is organized as follows: Section 2 offers some policy background and export trends; Section 3 presents data on the firm use and perceptions of AFTA; Section 4 discusses the impediments to use of FTAs; and Section 5 concludes with some policy considerations.

**POLICY BACKGROUND AND EXPORT TRENDS**

This section reviews the Philippines’ trade and investment policy history and examines trends in Philippine export performance, with a particular focus on the shift in trade patterns from traditional markets to FTA partners, including ASEAN and other regional markets.

**Evolution of the Philippines’ trade and investment strategy**

The country has a multitrack approach to trade liberalization: unilateral, regional, and bilateral. However, since signing AFTA in 1992, the Philippines’s outward orientation has had more regional focus (Austria 2001). Since then, the country has become a party to four more regional FTAs in effect, namely, ASEAN-PRC CECA, ASEAN-Korea CECA, ASEAN-Japan Comprehensive EPA (CEPA), and the ASEAN-Australia-New Zealand FTA. It has also signed the ASEAN-India CECA. The Philippines seems to be adopting a pragmatic approach to FTA. In part, the Philippines’s reliance on ASEAN regional FTAs may be due to its limited FTA negotiating capacity and domestic political constraints, particularly in ratifying comprehensive bilateral FTAs. A case in point is the JPEPA, the country’s only bilateral FTA signed in 2006 and which took effect only in 2008 (Philippine Exporters Confederation [PHILEXPORT] 2007b; Senate of the Philippines, Senate Economic Planning Office 2007). Table 2 lists Philippine FTAs and their status.

Aside from engaging in FTAs, the Philippines signed a trade and investment framework agreement³ with the United States in 1989 and various types of bilateral trade and investment treaties with more than 35 countries. In addition, major investment reforms were undertaken in the early 1990s, including the enactment of the Foreign Investment Liberalization Act and the Special Economic Zone Act. These reforms attracted substantial foreign direct investments (FDI) in manufacturing, and underscored the contribution of foreign-owned firms (particularly multinational corporations [MNCs]) in increasing output as well as in linking the Philippines to global and regional production networks. To help

³ A trade and investment framework agreement is a prerequisite to negotiating a bilateral FTA with the US.
Table 2. Status of Philippine FTAs

<table>
<thead>
<tr>
<th>Status</th>
<th>Regional</th>
<th>Bilateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN-PRC CECA (July 2005 for TIG; July 2007 for TIS)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN-Korea CECA (June 2007 for TIG; Sept 2009 for TIS)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN–Japan CEPA (2008)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN–Australia–New Zealand FTA (2010)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASEAN–India CECA (signed in 2009; implemented 1 January 2010 for TIG by India, Singapore, Thailand, and Malaysia only)</td>
<td></td>
</tr>
<tr>
<td>Under Consideration/Proposed</td>
<td>ASEAN–EU FTA</td>
<td>US–Philippines FTA (TIFA signed 1989)</td>
</tr>
<tr>
<td></td>
<td>EAFTA (ASEAN+3 FTA)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CEPEA (ASEAN+6 FTA)</td>
<td></td>
</tr>
</tbody>
</table>

ASEAN = Association of Southeast Asian Nations; CEPA = comprehensive economic partnership agreement; EPA = economic partnership agreement; CECA = comprehensive economic cooperation agreement; CEPEA = Comprehensive Economic Partnership for East Asia; EAFTA = East Asia Free Trade Area; EU = European Union; FTA = free trade agreement; Korea = Republic of Korea; PRC = People’s Republic of China; TIFA = trade and investment agreement; TIG = trade in goods; TIS = trade in services; US = United States.

Source: ADB 2010.

establish itself as a production base (particularly in the auto and electronics sectors), the country has participated in both the ASEAN Industrial Cooperation (AICO) scheme and the Information Technology Agreement (ITA) under the World Trade Organization (WTO 2005).

The government’s medium-term development plan (2004–2010) reaffirms the Philippines’ commitment to the multilateral trade negotiations under the WTO and the conclusion of the Doha Development Round. Nonetheless, it also recognizes the need to maximize exports and investment opportunities offered by trade agreements and undertakes to: (a) continue to participate in international trade agreements; (b) implement liberalization initiatives under the concluded FTAs; (c) pursue diversification of export markets and goods in order to minimize the impact of the economic slowdown of major trade partners such as the U.S. and the European Union (EU); and (d) explore partnership cooperation agreement with the EU and FTA with the US, among others (National Economic Development Authority 2009).

4 The AICO scheme is ASEAN’s industrial cooperation program to promote joint manufacturing industry activities between ASEAN-based companies.

5 ITA is a global tariff-reduction or elimination scheme applied by WTO members on selected electronics and information and communications technology (ICT) products. Under the ITA, the Philippines committed itself to reducing the tariff rates of some 188 ICT product lines to zero by 2000 and of 47 more ICT product lines by 2005.
Tariff, trade, and investment profile

Tariff structure and AFTA liberalization

Overall tariffs, despite recalibrations and reversals, were gradually liberalized to a simple average applied most-favored-nation (MFN) tariff rate of 6.35 percent by 2009. Electronic inputs are mostly duty-free, with an average MFN tariff rate of 3.8 percent for electrical machinery (WTO 2009). Dispersion has also fallen, with most items within the 0–10 percent tariff range and only four items at the 60–65 percent tariff level (down from 53 items in 2000) (Philippine Tariff Commission 2009).

Under the AFTA regime is a Common Effective Preferential Tariff (CEPT) scheme, which aims to increase ASEAN’s competitive edge as an integrated production base in overseas markets and by reducing intraregional tariffs to 0–5 percent on 99 percent of tariff lines by 2010 for ASEAN-6 countries, including the Philippines (PHILEXPORT 2007a; Balboa et al. 2007). While the average applied MFN tariffs for the Philippines fell from 12.1 percent to 6.3 percent between 1997 and 2008, the average CEPT rate applied by the Philippines fell from 9.1 percent to 3.7 percent between 1997 and 2003, and is expected at a negligible rate by 2010. The average Philippine rate was also reduced between 2008 and 2009 from 3.71 percent to 1.27 percent under the ASEAN-PRC CECA, and from 3.3 percent to 0.43 percent under ASEAN-Korea CECA.

Trade and investment trends with FTA partners

Increased regional liberalization in ASEAN has coincided with a shift in Philippine exports toward its existing FTA partners and away from traditional markets like the US and the EU. The Philippines’s exports to ASEAN countries grew at an impressive rate of 20.4 percent per year in 1992–2008 while the share of ASEAN in its total exports reached 16.6 percent in 2008 (Figure 1).

The effect on Philippine exports of ASEAN+1 FTAs with its Northeast Asian neighbors is also becoming evident. Particularly impressive have been Philippine exports to the PRC, which have grown by 36.6 percent per year and now account for a quarter of the country’s exports, despite worries of competitive threats from cheap imports (Palanca 2004). Meanwhile, exports to the US—the Philippines’ largest trading partner in the 1980s and early 1990s—have contracted by more than two-thirds over the same period to 12.8 percent of total exports. By comparison, exports to Japan have remained relatively unchanged probably due to the guarantees of preferential market access via the bilateral FTA with Japan and the ASEAN-Japan FTA. The rapid intraregional growth in trade has created new markets for consumer goods from Philippine firms, as well as opportunities to participate in robust regional production (e.g., shipping intermediate goods to
the PRC for further processing). Overall, this structural shift suggests a link to the growth of regional production networks, increased participation of firms in exporting, and increased FTA activity.

Increasing inward investment from FTA partners is also evident. Available data suggest that the growth of net FDI from FTA partners, particularly from Japan, is particularly noteworthy. Overall, the net equity share of the Philippines’ current FTA partners increased from 19.6 percent in 2000–2001 to 39.4 percent in 2007–2009 (Bangko Sentral ng Pilipinas 2009).

USE AND PERCEPTION OF FTA

This section sheds light on the first key question on whether or not firms use AFTA by looking at the survey findings on broad patterns of use, costs, and benefits of FTAs, and business responsiveness to FTAs, and supplementing the findings with an econometric analysis based on a set of firm characteristics predicting utilization.

Patterns of AFTA use

Twenty percent of the surveyed Philippine firms use AFTA. With 31 firms reporting using or having used AFTA, the results revealed higher than expected FTA utilization rates. Looking ahead, the overall FTA use will potentially increase dramatically with at least 63 firms (40.7% of all firms) reporting that they plan to use AFTA and other concluded FTAs. The ASEAN–PRC CEPA is also generating interest among Philippine firms, which sees the PRC as a market opportunity instead of a threat. At the time of the survey, only one firm reported using the ASEAN–PRC CEPA (and three firms reported that they planned to use it in the
future), the agreement ranks among the most important FTAs to business. Other FTAs that are regarded as important are JPEPA, the ASEAN–Korea CEPA, and the ASEAN–EU FTA. Table 3 shows the number of firms that use or have used AFTA and those that plan to use AFTA or other FTAs.

**The machinery and transport sector uses AFTA the most**

More than a third (38.9%) of machinery and transport sector firms interviewed use or have used AFTA. The high usage of AFTA in this sector can partly be explained by the high margins of preference (5–43%) for these products. The successful implementation of the AICO scheme has also contributed to AFTA usage. In 2006, Philippine firms\(^6\) entered into at least 20 AICO arrangements with Indonesia, Malaysia, and Thailand (ASEAN Secretariat 2009; Philippine Tariff Commission 2009). The AICO scheme grants special preferential rates of 0–5 percent for imported intermediate products and raw material inputs.\(^7\)

The lower AFTA utilization rate among processed food firms (18.6%) can be explained by the smaller margins of preference (e.g., 0–5% for most major Philippine export products to Malaysia and Viet Nam). One processed food firm claimed use of AFTA solely for sourcing packaging materials like high bars and plastic bags from other ASEAN countries. The similarity of food products produced by ASEAN countries also limits intra-ASEAN trade and, consequently, the use of AFTA by processed food firms.

In the electronics sector, only nine respondent firms (11.8%) use or have used AFTA. This low usage rate is generally attributed to: (1) low or zero MFN tariff rates and (2) firms’ use of export processing zones (EPZs) (or economic zones) and other investment schemes as will be explained in Section 4.

While all firms that have used or are using AFTA perceive net benefits from this trade agreement, there appears to be some sectoral difference in their perceptions of such benefits and costs involved (Box 1).

**Domestic firms favor using AFTA**

Domestic firms show a higher AFTA utilization rate (23.6%) than foreign-owned firms (18.0%). Moderate AFTA usage by foreign firms could be explained by their traditional major export markets (like the US and the EU), with which the Philippines has no outstanding FTAs, yet could avail itself of lower tariffs under the generalized system of preferences.

\(^6\) Including Honda Cars Philippines, Toyota Motor Philippines, Philippine Auto Components, Inc., and Ford Motor Company.

\(^7\) Avila and Manzano (2007) suggested that the high use rate of the CEPT scheme by the machinery and transport sector was intended to save costs through AFTA, particularly for moving parts and accessories within the ASEAN.
Table 3. Use and future use of AFTA as stated by Philippine firms

<table>
<thead>
<tr>
<th>Sector</th>
<th>Ownership</th>
<th>Size</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All</td>
<td>SME</td>
</tr>
<tr>
<td></td>
<td>Machinery and Transport Equipment</td>
<td>Domestic</td>
</tr>
<tr>
<td>All</td>
<td>31</td>
<td>10</td>
</tr>
<tr>
<td>Plan to Use</td>
<td>63</td>
<td>21</td>
</tr>
<tr>
<td>Number of Firms Interviewed</td>
<td>155</td>
<td>64</td>
</tr>
</tbody>
</table>

AFTA = Association of Southeast Asian Nations Free Trade Area
Notes: Foreign firms are defined as firms with at least 10 percent foreign equity share.
Size is determined by number of employees: SME = 100 or fewer; large = 101–1000 and giant = more than 1000.
Source: Authors' computation based on survey data.
Large and giant firms tend to use AFTA more

Large and giant firms have higher AFTA utilization rates (23.5% and 20.0%, respectively) than small and medium enterprises (SMEs) (only 15.6%). The high usage rate among large firms can be attributed to three factors: (1) they realize larger gains from tariff preferences because they export more; (2) they have export departments that facilitate compliance with FTA documentation requirements that encourages them to use FTAs; and (3) they are either subsidiaries of or suppliers to MNCs, where origin cumulation in FTAs is implemented or required in their production networks.
**Users are largely located outside EPZs**

Of the 31 AFTA users, at least 61.3 percent are located outside the EPZs. Because non-EPZ firms do not enjoy tax and nontax incentives available to firms located in EPZs, they are more inclined to use FTA preferences.

**Firm-specific factors predicting AFTA use**

*Model specification and hypotheses*

Based on the general patterns of AFTA use discussed above and other observations arising from this study, a firm-level AFTA use function can be specified as:

\[
FTA_{\text{USE}} = F(\alpha_0 + \alpha_1\text{EMP} + \alpha_2\text{AGE} + \alpha_3\text{FOR} + \alpha_4\text{FTAMKT} + \alpha_5\text{NCR} + \alpha_6\text{EPZ} + \alpha_7\text{CONSULT} + \alpha_8\text{AWARE} + \alpha_9\text{AUTO} + \alpha_{10}\text{FOOD}),
\]

where variables are described in Table 4. All variables except for EPZ were expected to be positively associated with use.

**Probit model of AFTA Use**

A causal relationship between firm characteristics and the use of AFTA was estimated by means of a two-stage multivariate modeling strategy (binary outcomes for the probit model were 1 = firm is an AFTA user and 0 = firm is not an AFTA user) using the firm characteristics described above. After a general form of the model was tested, a reduced form was also tried in order to retest the significant variables from the general form. Probit coefficients and results are presented in Table 5.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTA_USE</td>
<td>Dependent variable, binary outcome (1 = firm uses AFTA, 0 = firm does not use AFTA)</td>
</tr>
<tr>
<td>EMP</td>
<td>Number of permanent employees in 2006</td>
</tr>
<tr>
<td>AGE</td>
<td>Number of years a firm has been in operation</td>
</tr>
<tr>
<td>FOR</td>
<td>Dummy variable (1 = 10% or more foreign equity, 0 = otherwise)</td>
</tr>
<tr>
<td>FTAMKT</td>
<td>Dummy variable (1 = exports to FTA markets only, 0 = otherwise)</td>
</tr>
<tr>
<td>NCR</td>
<td>Dummy variable (1 = firm is located in the National Capital Region, 0 = otherwise)</td>
</tr>
<tr>
<td>EPZ</td>
<td>Dummy variable (1 = firm is located in a special economic zone, 0 = otherwise)</td>
</tr>
<tr>
<td>CONSULT</td>
<td>Dummy variable (1 = firm has participated in consultations, 0 = otherwise)</td>
</tr>
<tr>
<td>AWARE</td>
<td>Dummy variable (1 = firm has some or thorough and detailed knowledge of FTA provisions, 0 = otherwise)</td>
</tr>
<tr>
<td>AUTO</td>
<td>Dummy variable (1 = firm belongs to the machinery and transport equipment sector, 0 = otherwise)</td>
</tr>
<tr>
<td>FOOD</td>
<td>Dummy variable (1 = firm belongs to the processed foods sector, 0 = otherwise)</td>
</tr>
</tbody>
</table>
Age is a significant predictor of AFTA use, with older firms more likely to be users. This highlights the critical link between experience (i.e., years in operation) and the likelihood of a firm using AFTA. On average, the probability of firms in the sample that are less than 10 years old using AFTA is about 10 percent or less, while the probability for firms that have been in operation for more than 25 years increases to over 25 percent.

Table 5. Firm characteristic predictors of AFTA use among Philippine firms (probit estimates, dependent variable: 1 = firm uses AFTA, 0 = otherwise)

<table>
<thead>
<tr>
<th>Explanatory Variables</th>
<th>General Form (1)</th>
<th>Reduced Form (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMP</td>
<td>0.0004 (1.13)</td>
<td></td>
</tr>
<tr>
<td>FOR</td>
<td>-0.8474 (-1.85)*</td>
<td>-0.7277 (-2.18)**</td>
</tr>
<tr>
<td>FTAMKT (a)</td>
<td>0.622 (1.58)*</td>
<td>0.5761 (1.44)</td>
</tr>
<tr>
<td>NCR</td>
<td>0.0842</td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.19</td>
<td></td>
</tr>
<tr>
<td>EPZ</td>
<td>0.1684 (0.45)</td>
<td></td>
</tr>
<tr>
<td>CONSULT</td>
<td>0.8197 (2.97)**</td>
<td>0.8564 (3.17)**</td>
</tr>
<tr>
<td>AWARE (b)</td>
<td>0.9678 (2.20)**</td>
<td>1.0016 (2.46)**</td>
</tr>
<tr>
<td>AUTO (c)</td>
<td>0.924 (2.61)**</td>
<td>0.8031 (2.47)**</td>
</tr>
<tr>
<td>FOOD (c)</td>
<td>0.1127 (0.26)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>-2.3369 (-3.62)**</td>
<td>-2.1372 (-4.24)**</td>
</tr>
</tbody>
</table>

N: 155
Wald c²: 36.18***
Pseudo R²: 0.29

Notes: Dependent binary variable: 1 = firm uses FTAs. Coefficients are estimated using robust standard errors; z-values are in parentheses: significant at 1% level (***), 5% level (**) or 10% level (*).

(a) Indicator that firm exports only to FTA markets.
(b) Refers to an awareness level that involves thorough and detailed knowledge or some knowledge of FTA provisions that affect business.
(c) All zeros for sector dummies refer to firms that are located in the processed foods sector.
(d) Indicator for market orientation is significant at the 11% level in the general form.
Source: Authors’ calculation based on survey data.
Domestic ownership and market orientation matter in predicting AFTA use. Surprisingly, local firms have a 28.7 percent probability of using AFTA, compared to only 7.9 percent for foreign firms. This may reflect the influence of market orientation in the Philippines. With their orientation toward the larger, traditional markets, foreign firms could be expected to have a weaker propensity to use AFTA. In fact, market orientation is likely to be linked to AFTA use. Firms that export exclusively to FTA markets have a predicted AFTA usage rate of 18 percent compared to only 6 percent for firms that export to more traditional markets.

AFTA users are firms that have participated in FTA consultations with government or the private sector and have at least some knowledge of FTA provisions. AFTA use appears to depend on a firm’s FTA awareness and technical capacity, which is highly predicated on whether or not firms have taken an active role in the FTA process. The average firm that has been involved in consultations has a 29.7 percent likelihood of using AFTA compared to only 8.8 percent among firms that have never participated in such consultations. More tellingly, companies that are knowledgeable about FTA provisions have a predicted AFTA use rate of 40.0 percent compared to a mere 11.1 percent for the less informed ones.

Industry plays a significant role in the likelihood of AFTA use. Underlying the strong sectoral patterns of use found in the data and described in the previous section is the fact that firms in the machinery and transport sector are significantly more likely to use AFTA (34.5%) than those in other sectors (9.3%), which can be accounted for by the large margins of preference enjoyed by machinery and transport firms.

Firm size and firm geographical location in the National Capital Region or in special economic zones were not statistically significant as predictors of AFTA use. This may be related to the sample size; a bigger sample may yield statistically significant results for these variables.

Business response to AFTA and other FTAs
Not only does firm-level evidence show higher than expected AFTA use rates, it also confirms that AFTA users factor in AFTA when they consider their business strategies. Note, however, that regardless of whether or not a firm uses AFTA or plan to use other FTAs, it may be changing its business

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8 Interestingly, the same model was specified and estimated separately for SMEs and for large/giant firms. Results revealed that firm size was statistically significant for SMEs but not for large and giant firms. This suggests that large and giant firms are already at a sufficient operating capacity (number of workers employed), where variation in firm size does not affect the propensity to use AFTA. In contrast, SMEs (with 100 employees or less) are more sensitive to variation in operational capacity.
plans in response to AFTA. Findings show that 45.2 percent of AFTA users and 50.8 percent of those that plan to use AFTA or other FTAs reported that FTAs have influenced their business plans or may prompt them to change their business strategies.

Some sectoral patterns apparent in business response

Machinery and transport, which has the highest FTA utilization rate among the selected sectors, also has the highest rate of business response to FTAs (50.0% among AFTA users and 60.0% among those who use or plan to use FTAs). The electronics sector is second with 44.4 percent among AFTA users and 48.5 percent among those who plan to use FTAs.

Interestingly, processed food firms seem to have adapted less or likely to adapt their business plans to FTAs (37.5% of AFTA users and 40.0% among those planning to use FTAs). The market orientation of processed food manufacturers could explain the slight discrepancy between FTA use and business response. A number of large and giant processed food manufacturers claim that the country’s current FTA partners are limited to countries of existing revenue streams and do not include other potential strategic markets such as the Middle East (Box 2). Furthermore, there is no food supply chain equivalent to existing regional production networks in the electronics and auto sectors, thus increasing their propensity to use FTAs.

Interestingly, despite their lower use and plan to use rates, the business response pattern among SMEs (40.0% of users and 52.4% of those who plan to use) is comparable to the response rate of large and giant firms. A possible explanation is that SMEs may be responding to FTAs in a defensive manner for survival (for example, through product development or intensified marketing).

While AFTA utilization rates are much lower for both processed food firms and SMEs in general, business response rates are higher than expected, suggesting that these enterprises, regardless of whether or not they use AFTA, may be changing their business plans in response to AFTA as a means of experimenting, engaging new markets, and testing business strategies. Nonusers adapt and make adjustments—recognizing that a forward-looking stance, calibrated to potential growth markets, is especially critical in an increasingly FTA-oriented trading environment.

IMPEDIMENTS TO FTA USE

The second key question in this paper is addressed in this section: what factors did respondent Philippine exporters perceive as impediments to their use of AFTA or other FTAs? Properly addressing these factors could lead to a higher probability of FTA use in the future, especially if the 41 percent of firms that indicated they
Box 2. Responding to AFTA and future FTAs: The case of RFM Foods Corporation

RFM Foods began exporting in 2000 and is the only domestic food conglomerate that exports Philippine food products, supplying multiple markets in Asia, the Middle East, and the US. RFM Foods’ overall experience with FTAs has been positive. The company began using AFTA and became CEPT-accredited when importers from Thailand and Viet Nam suggested that they could make their products more competitive by lowering import costs under AFTA provisions. Lower tariffs and increased market access are what RFM Foods consider as the greatest benefits of using AFTA.

The forward-looking company has responded to FTAs by seeking “strategic or emerging markets” for its products rather than focusing on conventional “revenue stream-based” business strategies. While using AFTA exclusively for its exports, it has expressed interest in other FTAs, particularly the ASEAN–PRC CECA and the proposed ASEAN–Gulf Cooperation Council FTA, because the company believes they serve as conduits to nontraditional markets for its top two exports: beverages and pasta.

In addition to adjusting its market orientation in response to FTAs, RFM Foods has also changed the way it deals with FTA procedural matters, in particular, rules of origin (ROOs) issues. RFM Foods claims that typical ROOs issues, such as documentation costs, time delays, and administrative costs, add to its business costs. However, the actual costs lie mainly in the great difficulty the firm has in complying with sanitary and phytosanitary (SPS) measures, rather than in completing AFTA’s origin certificate application (Form D). Processed food firms like RFM Foods may experience a potential “noodle bowl” of a different flavor (relating to food safety and animal and plant health measures, as well as tariff and customs administration).

As an example, halal certification was especially challenging for RFM Foods. The company complained that regulations were not harmonized and that inconsistent requirements across countries made it extremely difficult to export products. In December 2008, RFM Foods made a breakthrough, securing accreditation as the owner of the first and only halal-certified meat processing plant in the country. With over 70 percent of the Muslim world strictly following halal food standards, and a global halal food market of over US$500 billion, the increased export opportunities for RFM Foods may now change the way it views compliance with SPS measures.

Source: Based on detailed firm interviews and survey data.

Table 6. Impediments to FTA use, as indicated by Philippine firms

<table>
<thead>
<tr>
<th>Impediments to FTA Use</th>
<th>Nonusers of FTAs (A)</th>
<th>FTA Users (B)</th>
<th>Total (A+B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of information</td>
<td>86 (78.9)</td>
<td>8 (32.0)</td>
<td>94 (70.1)</td>
</tr>
<tr>
<td>Delays and administrative costs</td>
<td>34 (31.2)</td>
<td>7 (28.0)</td>
<td>41 (30.6)</td>
</tr>
<tr>
<td>Use of EPZ schemes and/or ITA</td>
<td>31 (28.4)</td>
<td>5 (20.0)</td>
<td>36 (26.9)</td>
</tr>
<tr>
<td>Arbitrary classification of origin</td>
<td>20 (18.3)</td>
<td>11 (44.0)</td>
<td>31 (23.1)</td>
</tr>
<tr>
<td>Too many exclusions</td>
<td>14 (12.8)</td>
<td>6 (24.0)</td>
<td>20 (14.9)</td>
</tr>
<tr>
<td>Confidentiality of information required</td>
<td>11 (10.1)</td>
<td>6 (24.0)</td>
<td>17 (12.7)</td>
</tr>
<tr>
<td>Small margin of preference</td>
<td>9 (8.3)</td>
<td>9 (36.0)</td>
<td>18 (13.4)</td>
</tr>
<tr>
<td>Nontariff measures used by FTA partners</td>
<td>6 (5.5)</td>
<td>6 (24.0)</td>
<td>12 (9.0)</td>
</tr>
<tr>
<td>Number of Respondents</td>
<td>109</td>
<td>25</td>
<td>134</td>
</tr>
</tbody>
</table>

Note: Multiple answers allowed.
Source: Authors’ computation based on survey data.

See Kawai and Wignaraja (2009) for an account of the Asian “noodle bowl” phenomenon relating to transaction costs caused by multiple, overlapping FTAs.
plan to use FTAs in the future are taken into consideration. Table 6 summarizes the impediments to FTA use reported by respondents. Among the 109 respondents that were nonusers of FTAs, the lack of information emerged as the top impediment. Delays and administrative costs and the use of export incentives other than FTA preferences were the second and third major impediments identified by firms, respectively. This section also explores the impact of a potential improvement in ROO system.

**Lack of information**

Surprisingly, despite more than 15 years of experience with AFTA, the firm survey revealed that a lack of information is the primary reason firms do not use FTAs (as reported by around 80% of nonusers). Notably, 32 percent of AFTA users also cited lack of information as an issue. When firms are classified by sector and size, the emerging finding indicates that a lack of information correlates to low usage rates among these respondents (Figure 2). A lack of information tends to be a greater impediment to FTA use in the processed foods sector (93.5%) and among SMEs (84.1%).

That there is a dearth of information resulting in low use or nonuse of FTAs is corroborated by the strong demand for information-related services as well as the low awareness of FTA provisions among Philippine firms. In terms of awareness, only 2.6 percent of companies in the sample had thoroughly studied the FTA provisions affecting their businesses while an alarming 66.5 percent had not read any part of the agreements. The percentage of firms that had not read any of the provisions of the FTAs was highest among SMEs at 71.9 percent, the group that reported a lack of information as a major impediment to FTA use.

These findings make a case for the need to evaluate the quality of information

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**Figure 2.** Lack of information as an impediment to FTA use among Philippine firms (% respondents in each category, nonusers)

![Graph showing lack of information as a major impediment among different sectors and firm sizes](image)

Note: 109 firms responded to this question on the survey.
Source: Authors’ computation based on survey data.

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10Notably, 32 percent of AFTA users also cited lack of information as an issue.
and awareness-raising campaigns on FTAs in the Philippines. In particular, firms complained that the tariff rates of concluded FTAs are not immediately published in the Tariff and Customs Code or in customs circulars, nor are they readily made available on the internet. Firms also said they do not have access to detailed information on whether and how their export products can actually gain from FTA preferences. Finally, only a small number of firms reported attending FTA training seminars, which, in most cases, are offered by consulting companies for a fee.

**Delays and administrative costs**

Non-utilization of AFTA and other FTAs is generally attributed to the tedious and complex process involved in applying for the certificate of origins (e.g., Baldwin 2007, Avila and Manzano 2007). Survey results, however, show that around one-third of nonuser firms indicated that overall delays and administrative costs—more of a barrier than ROOs per se—was the second greatest obstacle to FTA use. Despite government-led reforms and programs to streamline the processing of imports and exports such as the one-stop export documentation center, some procedural lapses persist (Philippine Bureau of Customs 2008). The system also remains paper-based and people-driven. Exporters complain that mistakes committed by some customs officers invalidated their export documents, particularly certificates of origin when presented abroad. Basic information on the step-by-step procedure for export documentation, including origin application, is not readily available to firms or, ironically, even to some customs officers. Traders have suggested the adoption of a system that allows for electronic applications for certificates of origin.

Some improvements to origin administration could potentially increase AFTA use. Surveyed firms were asked to evaluate the current AFTA ROO system and how they would react to some improvement to the system, specifically to the use of a lower value content requirement and the introduction of a self-certification mechanism. The results show that these improvements could encourage AFTA use among 43.0 percent of nonusers (53 firms), potentially increasing the overall utilization rate from 20.0 percent to 54.2 percent (31 current users plus 53 new firms). From a sectoral perspective, an improved ROO system

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11 An example of this electronic system is the Singapore TradeNet System (ADB 2005).
12 Value content refers to the percentage of a product originating from an FTA member country (or multiple countries if cumulation is allowed) required for the product to qualify as originating in that country (or countries). The most popular rule among AFTA users is still AFTA's 40 percent value content rule (although ASEAN has already adopted the alternative ROO) (Lazaro and Medalla 2006).
13 A self-certification mechanism would essentially allow an exporter or producer within the territory of an FTA member country to declare or affirm that the items covered by the export invoice qualify as originating in that country for purposes of claiming a tariff preference. Currently, AFTA's Form D requires that exporters list product components and raw materials at the six-digit harmonized system heading level and include values thereof.
is likely to increase AFTA usage to about 75.0 percent in the transport sector and to 59.2 percent in the electronics sector. Similarly, large and giant firms revealed a proportionately strong positive reaction (a total of 62.0%) could use an improved AFTA ROO system (Figure 3). There would also be a probable rise in AFTA utilization in the food sector and among SMEs. This could be explained by other factors, as discussed earlier, the food sector is more concerned with nontariff measure (NTM) surveillance and standards harmonization than ROO per se. Meanwhile, SMEs require technical and financial support to improve their level of competitiveness (Aldaba 2008).

Other trade and investment schemes: use of EPZs and ITA
Firms identified export incentives other than FTA preferences as another impediment to their use of FTAs. Thirty-one nonuser firms (28.4%) cited their use of other schemes as their reason for not using FTAs. Examples of such schemes include the duty-free importation and exportation of electronic products under the WTO’s ITA, duty drawback schemes, and EPZs. Most nonuser firms (particularly, electronics ones) are located in Philippine Economic Zone Authority (PEZA) economic zones. Firms located in any of the 111 PEZA economic zones are exempt from import and other such tariffs and are entitled to other benefits such as income tax holidays, simplified export-import procedures, domestic sales allowance, and employment of

<table>
<thead>
<tr>
<th>Sector</th>
<th>Nonusers that will consider use</th>
<th>Actual users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and Transport</td>
<td>4</td>
<td>13</td>
</tr>
<tr>
<td>Equipment</td>
<td>9</td>
<td>38</td>
</tr>
<tr>
<td>Processed Foods</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>Electronics</td>
<td>8</td>
<td>19</td>
</tr>
<tr>
<td>SME</td>
<td>10</td>
<td>28</td>
</tr>
<tr>
<td>Large</td>
<td>19</td>
<td>14</td>
</tr>
<tr>
<td>Giant</td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>

Note: Includes firms that responded “Yes” to current use of the CEPT scheme, and nonusers who replied “Yes” or “Maybe” to using the CEPT scheme if the system is improved.
Source: Authors’ computation based on survey data.
foreign nationals. Other firms that are not located in economic zones may avail themselves of suspended payment of duties and local taxes within the customs manufacturing bonded warehouse.

**Arbitrary classification of product origin**

At least 20 nonuser firms (18.3% of nonusers) identified arbitrary classification of product origin as their reason for not using FTAs. Even more relevant is that 44.0 percent of AFTA users also complained that this is an issue for them. The slow adoption of harmonized tariff classifications could result in different classifications being used by exporting and importing countries. There are still specific products that are difficult to classify even with the ASEAN harmonized tariff nomenclature. Arbitrary classification causes disputes between customs authorities and opens the doors for rent-seeking behavior that is a disincentive to FTA use.

**Market access: too many exclusions and small margins of preference**

Product coverage and margins of preferences are two factors that influence a firm’s decision to use or not to use FTAs. Fourteen nonuser firms (12.8%) complained about exclusion or sensitive lists in FTAs. For example, some engines, diesel trucks, chassis, and gear boxes are on the PRC’s sensitive list under the ASEAN–PRC CEPA. The small marginal difference between MFN and AFTA tariff rates also discourages the use of AFTA. In fact, nine nonuser firms (8.3%) found the applied MFN tariff rate more advantageous (i.e., lower) than the AFTA tariff rate. For instance, electronics firms were already eligible for very low or zero MFN tariffs. The processed foods sector has variable incentives to use AFTA for major products, with a 0–5 percent preference margin for Philippine exports to Malaysia and Indonesia, and a preference margin of 5–45 percent for exports to Thailand and Viet Nam. On the other hand, firms in the machinery and transport sector have consistently had high margins of preference. This shows a direct relationship between a low margin of preference and nonuse.

**Confidentiality of information**

When applying for a certificate of origin, firms have to submit documents with specific information on source, components, and raw materials to prove origin. Some firms perceive this process as requiring the disclosure of confidential information. Eleven nonuser firms cited this as a reason for not availing themselves of FTA preferences. However, this requirement of disclosure holds true only when complying with AFTA’s value content rule. With the introduction of the co-equal or option rule, whereby firms can choose between value content and a change in tariff classification, the risk is mitigated and as such, confidential information is not required.
Nontariff measures employed by FTA partners

Nontariff measures, such as SPS measures and technical requirements, also contribute to FTA nonuse. Philippine firms in the processed foods sector are particularly affected by these types of barriers (Pasadilla 2007) because they are required to comply with SPS measures in FTA markets. Of the processed food firms interviewed, 48.8 percent reported that they have to produce additional export documents and comply with a number of standards, such as quality and chemical-free certification, SPS certification, and a certification from authorized agencies or certifying bodies (e.g., World Health Organization’s Codex Alimentarius Commission and the World Halal Council). At least 38.5 percent of all SMEs and more than half of large firms (56.3%) in the processed foods sector found it difficult to comply with these measures imposed by importing countries (i.e., ASEAN and the PRC). Nontariff measures are expected to become more of an issue when the negotiations for ASEAN-EU FTA and ASEAN-Gulf Cooperation Countries FTA commence.

CONCLUSION

Engagement in FTAs is becoming a significant trade policy tool for the Philippines. Recent trends suggest that the country’s FTA involvement has coincided with a shift in Philippine exports and investment flows from traditional markets toward its FTA partners. Nonetheless, the direct impact of FTAs, particularly their value to Philippine business, is still being debated, especially with the perception that FTA use is extremely limited.

This paper provides new evidence that firms in the Philippines use AFTA more than was expected. About 20 percent of the companies interviewed reported using or having used AFTA, with firms in the machinery and transport sector using AFTA the most. The high margins of preference accorded to machinery and transport products and the implementation of the AICO scheme are possible reasons for the higher utilization rate in machinery and transport relative to the other sectors. Among the perceived net benefits to AFTA users include cheaper intermediate inputs due to preferential tariffs and increased export sales to regional markets. The overall FTA utilization rate among sample firms also is projected to double to 41 percent in the future. As firms eye new export markets and business opportunities, other FTAs (e.g., the ASEAN–PRC CEPA and JPEPA) are beginning to draw interest. Firms in the processed foods sector are boldly considering new and emerging markets and may increasingly turn to FTAs to be more competitive.

Nonetheless, several impediments to use of FTAs persist. Nonusers of FTAs indicated that a lack of information was the most significant impediment to FTA use. Other impediments to use include the availability of export processing zone
incentive schemes, low MFN rates, delays in origin administration, rent-seeking behavior, and NTMs in partner country markets. The findings further revealed a strong demand for a range of support services—information, technology-based, and SME extension services—that will enable them to use FTAs more effectively in the future (Wignaraja et al., 2010).

Beyond FTA issues, there are also a number of systemic issues underlying Philippine exports and the trading environment. For instance, a multicountry research has demonstrated that technological capabilities increase the propensity to export among firms. However, the Philippines continues to lag behind the PRC and Thailand in terms of technological competence (Wignaraja 2008) and Philippine exports, particularly in electronics, belong to the low-skill, labor-intensive segment of the supply chain (Austria 2003). Inadequate infrastructure in transportation and logistics also spawns inefficiencies in the movement of goods. The poor state of public finance and a low domestic savings rate also stand in the way (Bautista and Lamberte 2005).

To address these concerns, the government started to enact measures to simplify procedures and reduce transaction costs. However, much needs to be done, including better mainstreaming of FTAs into Philippine national trade policy, effectively encouraging FTA use, and implementing support mechanisms. Accordingly, this paper offers the following policy recommendations:

- **Adopt a more proactive FTA strategy**
  
  As the Philippines’ regional trading partners; PRC, Japan, and Korea, define their FTA policies and approaches, the need for a national FTA strategy and response cannot be overemphasized. An FTA strategy provides a general framework for negotiating agreements to achieve the country’s national economic objectives and ensure the effective management of scarce resources and skills in negotiations (ADB 2008). While the Philippines’s pragmatic and cautious approach to FTA has its own merits, a more explicit and strategic FTA policy could prove to be more beneficial (Medalla and Lazaro 2004). To be effective tools for business, FTAs must be embedded in wider programs of economic reforms and a clear FTA strategy should form part of the next medium-term development plan. Broadly, the strategy should complement the country’s overall development and competitiveness strategy and establish an improved administrative mechanism for trade negotiations backed by adequate research capacity.

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14 In 2006, Executive Order 554 was issued to eliminate export clearances and fees and streamline documentation procedures. Recently (February 2010), the Philippine Senate also signed the accession documents of the Philippines to the Revised Kyoto Convention.
Encourage enterprise use of FTAs

*Improve business participation in FTA consultations and advocacy.* Philexport, business and industry associations (e.g., the Philippine Food Processors and Exporters Organization; Semiconductor and Electronics Industries in the Philippines, Inc.; Motor Vehicle Parts Manufacturers Association of the Philippines; and Chamber of Automotive Manufacturers of the Philippines, Inc.), business clubs (e.g., the Makati Business Club), and the Philippine Chamber of Commerce and Industry should take a more active leadership role in providing support for firms adjusting to FTAs and encouraging FTA use. These organizations can prepare industry position papers on FTAs, organize consultations with government on trade negotiations, raise enterprise awareness, and lobby for technology upgrades. Information is the key to effective FTA implementation. Trade officials rely on information in making policy decisions and in negotiating FTAs. Improving data collection, particularly on the use of FTAs, would be useful in assessing and enhancing the effectiveness of FTAs. Businesses also require equivalent information to fully benefit from FTAs. Thus, innovative and cost-effective methods of disseminating information on FTAs could be explored to increase awareness (e.g., use of FTA portals, creation of an FTA experts’ pool, and highlighting success stories from other firms).

*Consultation and training are crucial.* Broad-based consultations (before and during FTA negotiations) help address the concerns of all stakeholders. Consultations also help firms to assess the potential gains from FTAs and to change their business plans, if need be. Seminars and other forms of training tailored to each type of industry or sector maybe more relevant to firms.

*Simplicity is a powerful incentive to firms to adopt FTAs.* The probable savings from using FTAs are sometimes disregarded by firms because the process of availing themselves of FTA preferences tends to be complicated. A simpler ROOs regime with harmonized tariff classification, use of co-equal or option rules, streamlined procedures, self-certification features, and/or a one-stop-shop export documentation facility would promote the use of FTAs among firms.
SME-focused FTA outreach is needed. SMEs require assistance in enhancing their export performance and product diversification and in analyzing trends in international demand. Enabling SMEs to restructure, set marketing priorities, and eventually increase their foothold in the newer, more dynamic markets with which the Philippines has negotiated FTAs, will encourage use.

Also, in view of the high AFTA usage rates in the machinery and transport sector, other sectors could explore the possibility of adopting cooperation arrangements (e.g., similar to AICO scheme).

- Implement supporting mechanisms to competitiveness

Supporting mechanisms are essential. Learning to export under FTAs involves acquiring the requisite technological capabilities to meet world-class price, quality, and delivery standards. Within or outside the FTA framework, government support for technology transfer and skills upgrading is essential in improving overall firm competitiveness (Wignaraja 2008). The creation of backward linkages is also needed to sustain the investments promoted by the FTAs (Aldaba 2008). Support for NTM surveillance, trade finance, and the use of technology (e.g., electronic data interchange or EDIs) in trade transactions have proven to be essential.

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