

## Executive Summary

*Advice on the opportunities and challenges facing small and medium Australian export-oriented businesses that seek to leverage free trade agreements for the export of goods and services.*

This submission draws on empirical evidence (see appendix) to consider the terms of the inquiry in relation to the nine key barriers to free trade agreement (FTA) utilisation outlined in the 2016 KPMG report on leveraging FTAs for Australian trade growth, including: lack of awareness of FTA benefits; IT infrastructure challenges; internal capability limitations; complex rules of origin for each FTA; opaque trade regulations in Asian markets; multi-jurisdictional supply chain challenges; market access difficulties and non-tariff barriers; increasing services export to Asia (not products); lack of comprehensive, affordable FTA advisory services.

The empirical evidence demonstrates that small and medium enterprises (SMEs):

- Display sufficient productivity and profitability levels to fully benefit from Australia's comparative advantage in key FTA partner countries.
- Do have access, but largely underutilise FTAs relative to their contribution to the domestic economy.
- Pay lower wages than large exporting enterprises on average.

This indicates that underutilisation of, and not access to FTAs is the fundamental cause of the low levels of exports and below average wages in SMEs.

Furthermore, the empirical evidence refutes the existence of all but two of the key barriers identified in the KPMG report, namely:

- Opaque trade regulations.
- Multi-jurisdictional supply chain challenges.

In order to overcome these two barriers, this submission recommends the introduction of targeted trade adjustment measures.

Accordingly, the following sections seek to demonstrate how the implementation of one such measure, a destination-based cash flow border adjustment tax (BAT), can lead to greater leverage of FTAs by Australia's small and medium export-oriented businesses.

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## FTA challenges for SMEs

Overcoming opaque trade regulations and multi-jurisdictional supply chain challenges

### **The data says that Australia's SMEs largely underutilise FTAs**

Australia's economy maintains a comparative advantage in respect to key markets across the Asia Pacific region. However, Australia's SMEs maintain disproportionately low levels of exports relative to their contribution to gross domestic product and consequently attain lower than average wage rates, despite being profitable and productive in most of the sectors under analysis.

### **To boost SME exports and wages earnings we need targeted trade adjustment measures**

The relevant public bodies should measure the utilisation of FTAs in terms of their contribution to the actual productivity of enterprises by sector rather than to the potential export coverage by total market value. As demonstrated by the empirical evidence (for details see the final section of this submission), this kind of productivity assessment would provide a much sharper indicator of overall FTA efficiency that calculates in which sectors and to what markets Australian enterprises actually gain or lose from international trade instruments. With such information, the Australian government would find substantial economic evidence and political legitimacy to implement trade adjustment measures aimed at increasing the leverage of free trade agreements by Australia's small and medium export-oriented businesses.

**\*\*\* See recommendations in the section below \*\*\***

## Recommendations

### **Leveraging FTAs for SMEs through a border adjustment tax (BAT)**

Accordingly, we recommend the introduction of a destination-based cash flow form of BAT. In general, this kind of measure is based on a simple idea to impose a flat tax rate on imports, and to grant corresponding tax rebates on exports. In other words, exports are untaxed, while imports are taxed. Border adjustment measures are normally used under a value added tax, like the GST, which applies to all consumption. The BAT also excludes any goods or services that are produced domestically, but consumed abroad.<sup>1</sup>

More specifically, the proposed BAT measure requires to shift the current approach to corporate income tax on destination-based cash flows. The key point of the proposed method is that it would combine the fiscal calculation of cash flow (like with income tax) and border adjustment (as what happens with the GST). Accordingly, the resulting destination-based cash flow BAT shifts taxation from the country of production to the country of sale. This would particularly benefit SMEs that rely on inherently smaller economies of scale (in terms of production costs) and of scope (in terms of sale capability).

### **Overcoming FTA barriers and anticipated benefits of a BAT for SMEs**

Implementing the destination-based cash flow BAT would raise government revenue at any time when Australia's balance of trade is in deficit. For instance, if Australia adopted a blanket 20% cash flow border adjustment tax in the last financial year, which in official data registered a total trade deficit in goods and services of about A\$14 billion, the Treasury would have raised A\$2.8 billion at the net of tax breaks for exporters.

More importantly, the proposed destination-based cash flow BAT would provide a strong economic incentive for SMEs to fully utilise FTAs and expand their export markets, thus boosting production, growth, jobs and wages in underperforming sectors.

Similarly, in a nominally high-tax jurisdiction such as Australia, a BAT on cash flows would be a more efficient way to raise revenue from cross-border trade between and intra-firms than the current corporate income tax, especially in the services sector. In particular, it would

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<sup>1</sup> The idea of using border tax instruments to improve trade efficiency dates back to [John Maynard Keynes' Macmillan Report to the British Parliament in 1931](#). In recent times, there is emerging economic scholarship to update Keynes' original approach into a destination-based cash flow taxation (DBCFT), see for instance Auerbach, Alan J. and Devereux, Michael P. and Keen, Michael and Vella, John, *Destination-Based Cash Flow Taxation* (February 6, 2017). Oxford Legal Studies Research Paper No. 14/2017; Oxford University Centre for Business Taxation WP 17/01. Available at <http://dx.doi.org/10.2139/ssrn.2908158>.

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reduce the incentive of large multinational corporations to shift profits and jobs to lower-tax jurisdictions.

Accordingly, a destination-based cash flow BAT would overcome, at a systemic level, the opaque trade regulations and multi-jurisdictional supply chain challenges by providing a mechanism capable of leveraging FTAs for SMEs through economy-wide fiscal effectiveness rather than industry-level anti-competitive tactics, such as anti-dumping and countervailing measures.

### **Potential risks of a destination-based cash flow BAT for SMEs**

Some economists estimate that border adjustment provisions eventually result in stronger currencies and higher interest rates.<sup>2</sup> In such case, any BAT would only work on the assumption that boosted exports and wages would promptly and fully offset higher interest and exchange rates, as well as possible trade retaliations and inflationary surges.

Nevertheless, Australian SMEs are well poised to mitigate monetary risks as the primary beneficiaries of the destination-based cash flow BAT due to their significant importance and contribution to the domestic economy in terms of production and employment, as demonstrated by the empirical evidence in the next section.

This type of tax may also come under the scrutiny of the World Trade Organization, which normally allows for border adjustments only through indirect taxes (for example on transactions, such as sales and payroll), and not so indisputably through direct taxes on individuals or businesses. However, on the surface BAT measures do not distort trade, as long as the import tax and export rebate offset each other and also do not discriminate between economic sectors and trading partners.

**\*\*\* See empirical evidence in the appendix below \*\*\***

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<sup>2</sup> For instance, see Emmanuel Farhi, Gita Gopinath and Oleg Itskhoki, *Fiscal Devaluations*, The Review of Economic Studies, Volume 81, Issue 2, 1 April 2014, Pages 725–760, Oxford University Press, at <https://doi.org/10.1093/restud/rdt036>.

## APPENDIX

### **Empirical Evidence: SMEs in Australia's key export markets**

The remainder of this submission contains an empirical assessment of the SME utilisation of Australia's bilateral FTAs with major trade partners in the Asia Pacific region (the USA, China, Japan, South Korea, Singapore and New Zealand) across key economic sectors (agriculture, manufacturing, mining, retail trade and transportation) between 2009 and 2015.

This section of the submission provides the economic evidence to support our recommendations. The empirical assessment demonstrates that SMEs are exporting largely below potential capacity in relation to their weight in the Australian economy. This means that SMEs would be the main beneficiaries from the proposed BAT, as this measure would efficiently maximise their utilisation of FTAs with a positive impact on Australia's economy in terms of jobs and growth.

#### **Key empirical findings**

1. What really matters for assessing the utilisation of FTAs is not total market value, but instead the productivity and profitability of businesses in relation to their exporting comparative advantage.
2. Overall, Australian enterprises maintain a comparative advantage in their export potential in agriculture (to China and the USA), in mining (to China, Japan, Korea, New Zealand, Singapore and the USA), and in retail trade (to New Zealand). There is no comparative advantage in manufacturing and transportation.
3. By size, most of Australia's exports in these key economic sectors occur by large enterprises, ranging from 72% to 100% of total trade, despite the fact that Australian SMEs are profitable and productive in most sectors under analysis.
4. The levels of exports by Australia's SMEs are disproportionately low in comparison to their contribution in each industry to gross domestic product.
5. In all sectors, the average wage of workers in small enterprises are below that of the sector averages. As wages earned are linked to the price and sales of final goods and services, increasing exports would boost the average worker's pay packet.

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## **How to assess the utilisation of FTAs**

It has been suggested that the ability of Australian enterprises to grow domestically influences their capacity to compete in export markets. Much of the debate in this regard has focused on contemporary design of domestic industrial policies.

To export successfully, it is generally held that enterprises need to possess a competitive advantage to overcome the advantages typically enjoyed by rival enterprises located in the country into which they export.

The competitive advantage of enterprises arise through internal or external features that contribute to economies of scale and scope. Economies of scale refers to enterprise production of goods at a lower average total cost than its rivals. Economies of scope refers to the ability of the supplier to sell more than one product internationally.

The Australian Productivity Commission's empirical investigation found that the larger the domestic base, the more likely the enterprise would be an exporter. Exporters were also found to have larger overall size in terms of the value of their total sales, employment and/or business assets.

The Productivity Commission concluded that having some competitive advantage is essential for enterprises to overcome the inherent advantages enjoyed by rival enterprises located overseas.

International trade has traditionally been perceived as the exclusive playground of large enterprises. However, no evidence was found to support the proposition that to succeed internationally an enterprise first needs to be of a certain size i.e. securing a large domestic base or employing more than 200 workers.

It is on this basis that high percentages of coverage of exports under existent FTAs tell us very little of what enterprises are being catered for under FTAs. What really matters for international trade is not market value, but is instead the productivity of an enterprise. It is through such an assessment of productivity that the utilisation of FTAs can be observed.

## **Revealed Comparative Advantage**

Revealed comparative advantage (RCA) uses actual trade patterns to identify the sectors in which enterprises in the economy have advantage in productivity over rival enterprises located in the country into which they export. RCA is important as it provides an indicator of efficiency that simultaneously demonstrates which sectors and to what markets will a domestic business gain from international trade. RCA is represented by an index number with values greater than 1 demonstrating a potential gain to be had from engaging in international trade. Similarly, a value less than 1 indicates a potential loss to be incurred from engaging in international trade. A rising trend in RCA following an event such as the commencement of

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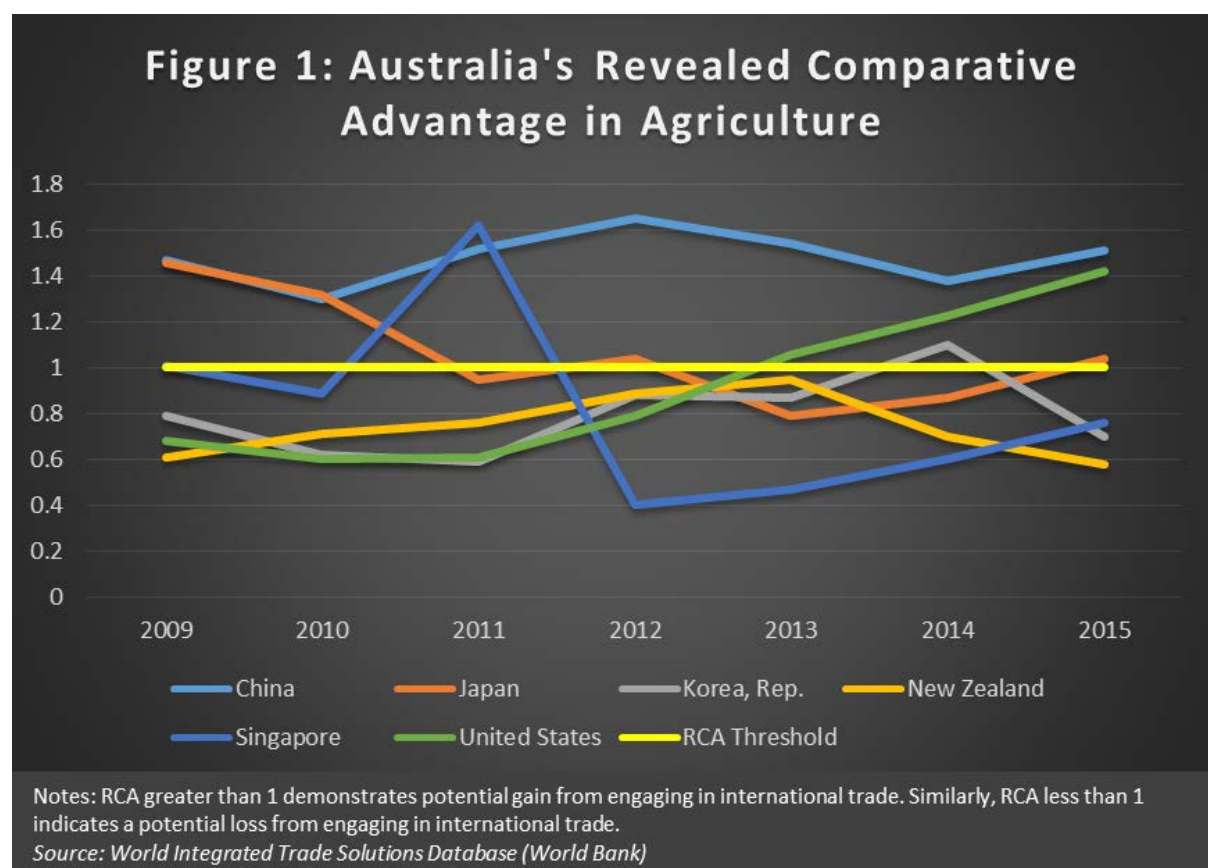
an FTA will be indicative of greater utilisation of free trade arrangements with the export destination.

RCA was assessed for six FTA export destinations (China, Japan, Korea, New Zealand, Singapore and the USA) for five sectors (Agriculture, Manufacturing, Mining, Retail Trade and Transportation) over the period 2009 to 2015

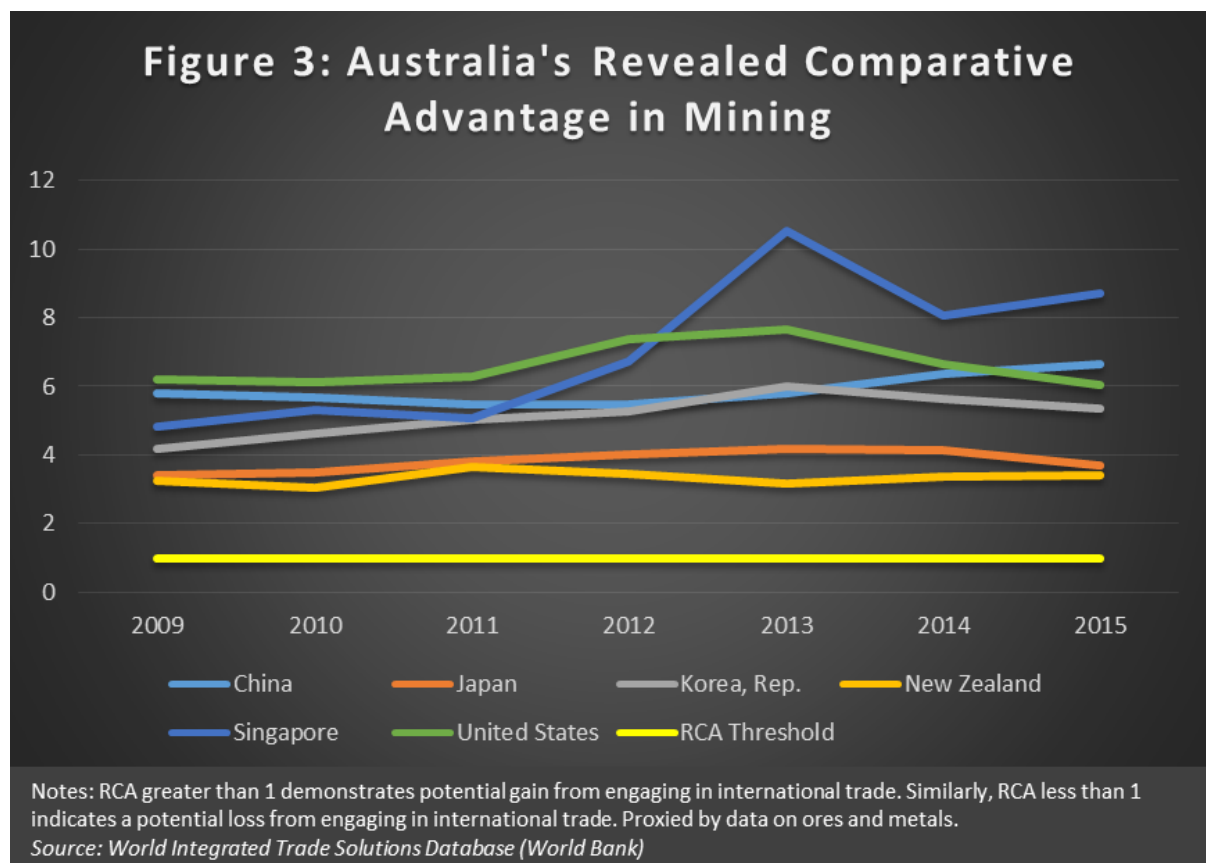
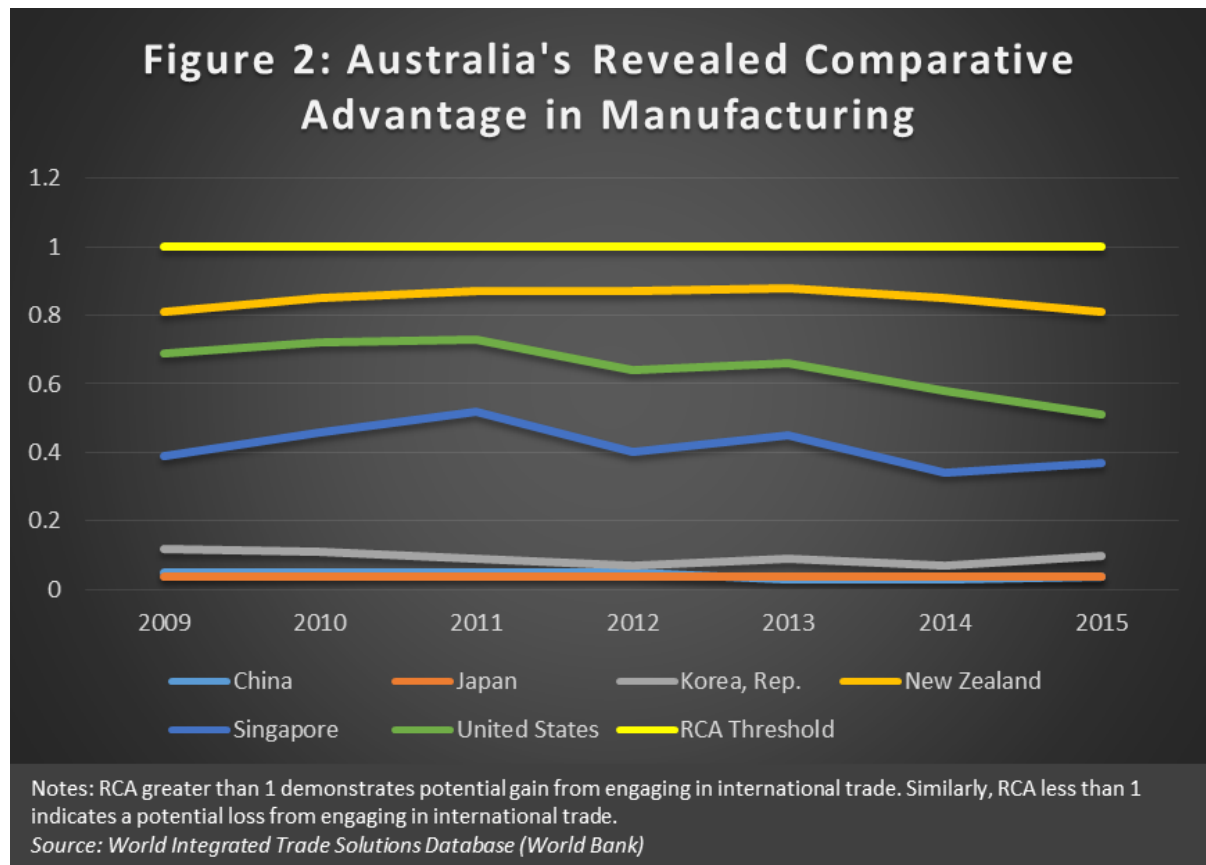
The results of this RCA assessment in these export destinations and sectors identified that Australian enterprises maintain a comparative advantage in their:

- Export potential in agriculture: China and USA – Figure 1
- Export potential in manufacturing: None – Figure 2
- Export potential in mining: China, Japan, Korea, New Zealand, Singapore and the USA – Figure 3
- Export potential in retail trade: New Zealand – Figure 4
- Export potential in transportation: None – Figure 5

These identified sectors are anticipated to experience gains from international trade through FTAs with these export destinations.

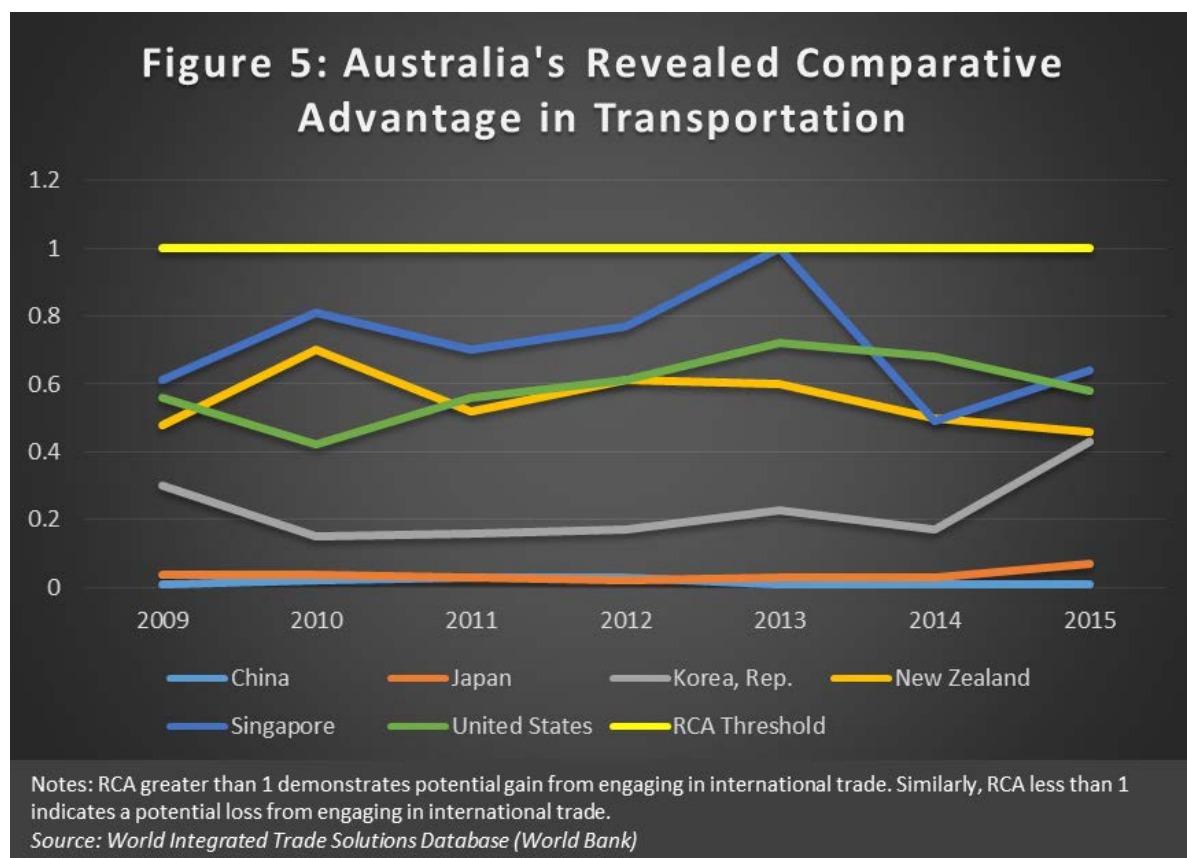
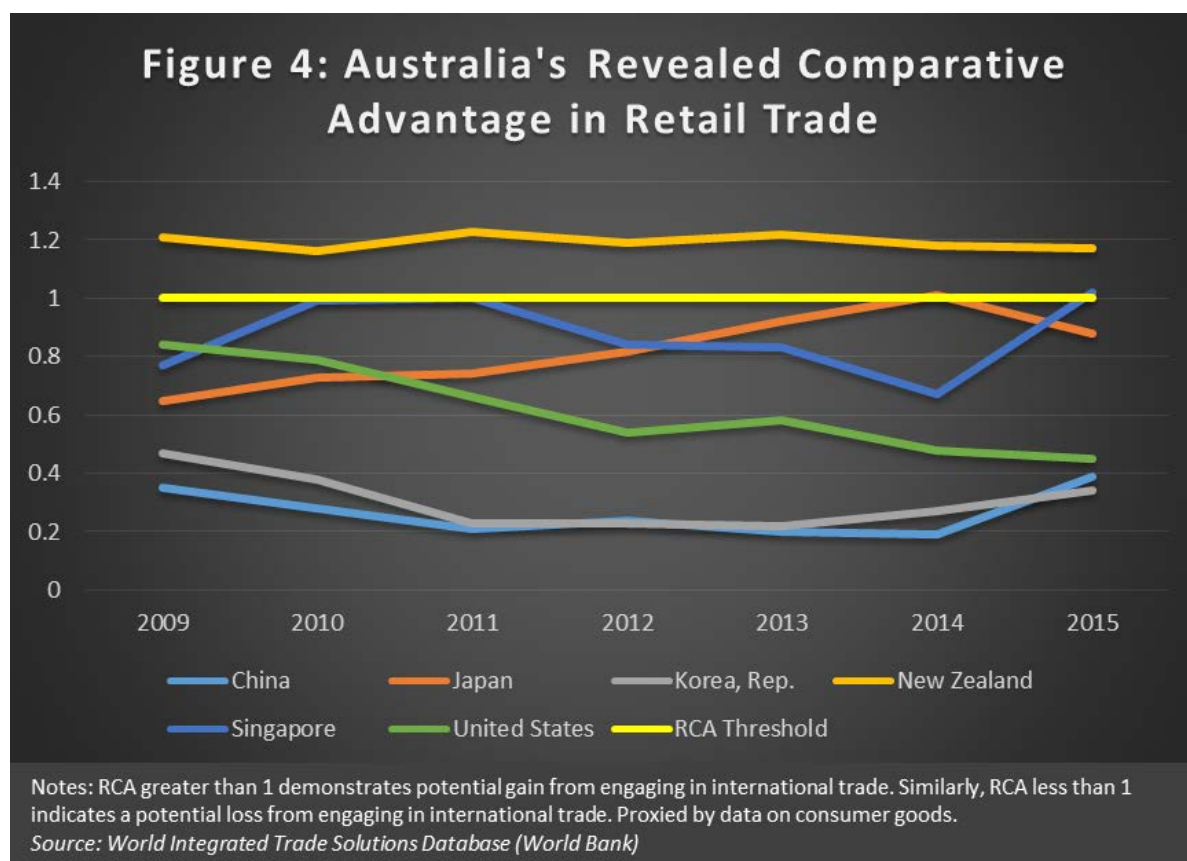


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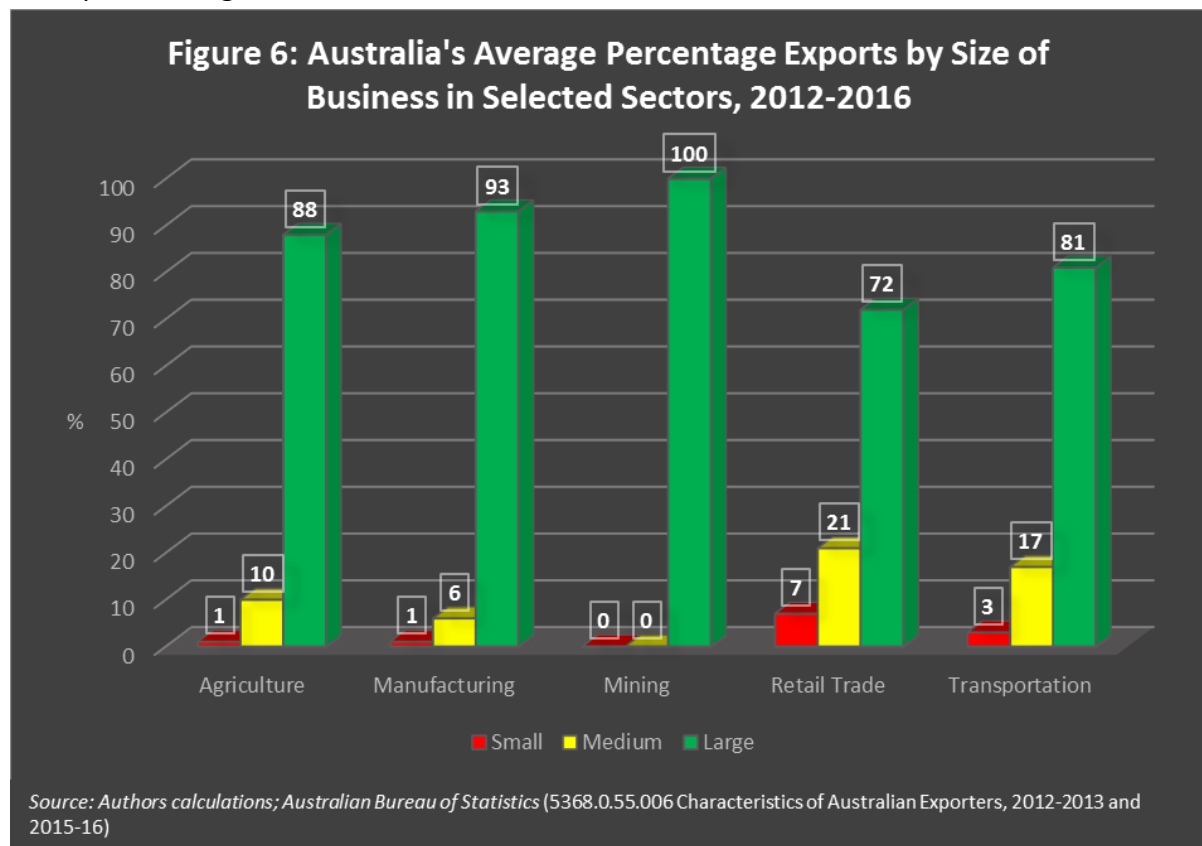


## Exports by Sector and Enterprise Size

The exports from these sectors were further analysed by enterprise size in order to assess the characteristics of Australian businesses engaging in international trade. Of primary interest was the size of the enterprise (as defined by the Australian Bureau of Statistics – ABS) engaged in international trade, namely:

- Small (S): businesses that employ less than 20 persons;
- Medium (M): businesses that employ 20 to 199 persons;
- Large (L): businesses that employ more than 200 persons.

The analysis revealed the following average exports by firm size and sector over the 2012 to 2016 period – Figure 6.



It would appear from the analysis that most of Australia's exports in these sectors are conducted by large enterprises.

The traditional explanation for low contribution of small and medium businesses to the export market is that they maintain a low level of productivity. However, this standard conclusion is not robust in terms of the performance of Australia's small and medium enterprises nor given the long entrenched position held by such businesses in the national economy.

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## Performance, Productivity and Profitability

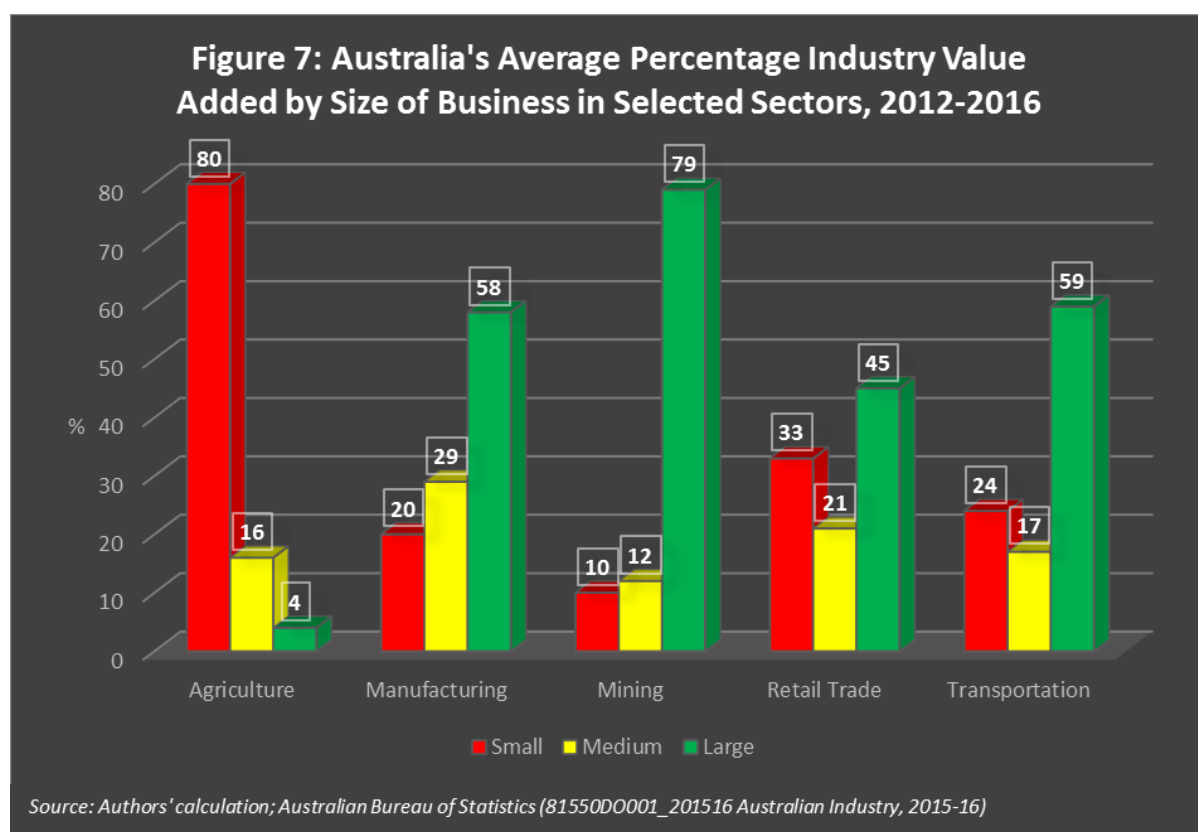
In order to demonstrate the performance of Australia's enterprises by size and sector, the analysis deployed the measure of operating profit margin– Table 1. Operational profitability is a measure of productivity in its own right and provides insights as to how the operations of a business are simultaneously meeting overall demand for the company's products or services (sales) and the company's efficiency in delivering those products or services (costs). When expressed at ratio over sales, operating profit margin simultaneously gauges profitability and efficiency of a business.

<b>Table 1: Operating Profit Margins Before Tax for Australian Small and Medium Businesses in Selected Sectors, 2012-2016</b>						
<i>Small Businesses</i>						
	2012	2013	2014	2015	2016	2012-2016
	%	%	%	%	%	% Variation
Agriculture, forestry and fishing	17	20	19	22	24	8
Manufacturing	12	9	9	8	8	6
Mining	33	11	27	-24	-30	0
Retail trade	7	6	6	5	7	7
Transport, postal and warehousing	16	17	19	21	18	9
<i>Medium Businesses</i>						
	2012	2013	2014	2015	2016	2012-2016
	%	%	%	%	%	% Variation
Agriculture, forestry and fishing	10	8	8	9	7	8
Manufacturing	5	5	4	6	6	7
Mining	32	11	8	0	-16	0
Retail trade	3	4	3	3	3	5
Transport, postal and warehousing	8	1	10	9	9	2
<i>Large Businesses</i>						
	2012	2013	2014	2015	2016	2012-2016
	%	%	%	%	%	% Variation
Agriculture, forestry and fishing	-1	6	6	14	13	1
Manufacturing	4	3	4	5	6	3
Mining	40	32	26	15	12	2
Retail trade	5	5	5	5	3	5
Transport, postal and warehousing	7	10	7	9	7	6
Note: Operating profit margins calculated by dividing operating profit by sales and services income. Yellow text indicates higher operating profit margins than large businesses in the same sector and year.						
Source: Authors' calculation; Australian Bureau of Statistics (81550D0001_201516 Australian Industry, 2015-16)						

In terms of performance, as indicated by the yellow text in Table 1, over the period under assessment, most small enterprises and several medium enterprises outperformed the larger competitors from the same industry. Although, variation in operating profit margins were typically more pronounced in small and medium enterprises.

## Industry Value Added and Employment

The analysis thus far has established that Australia's economy maintains a comparative advantage in respect to several trading partners and, although productive, its small enterprises contribute a minor component of total exports. In order to assess whether the levels of exports by Australia's small businesses are disproportionately low, the investigation turns its attention to the contribution by businesses in each industry to gross domestic product, referred to as industry value added (IVA) between 2012 and 2016. IVA is recorded by the ABS on the basis of sector and enterprise size by number of employees.

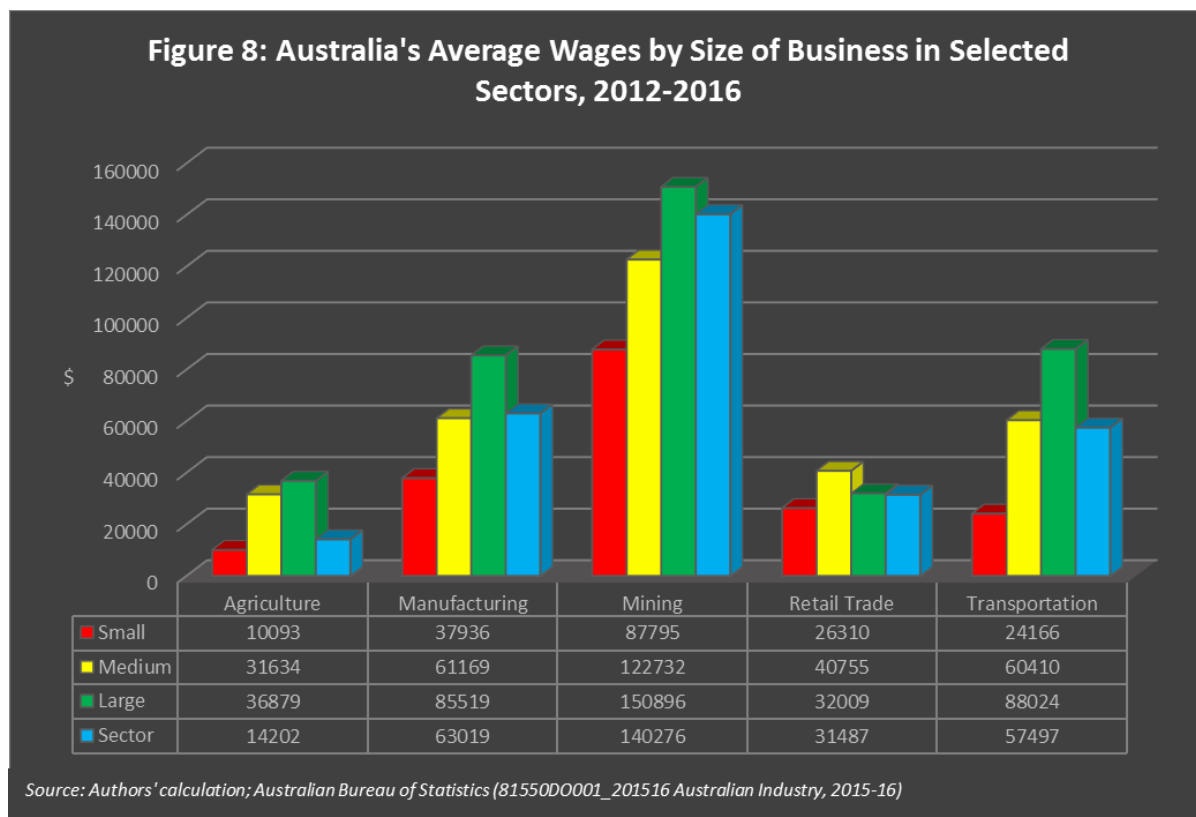


As indicated in Figure 7, the percentage of IVA by size and sector strongly supports the view that in some sectors small and medium businesses are the life blood of the domestic economy. An equivalent statement cannot be said for small and medium businesses in terms of exports. By comparing the percentage IVA by small business in these sectors with the matching percentage exports by small businesses, it becomes clear that the exports of small Australian businesses is disproportionately small.

Together, these findings indicate that more can be achieved by small Australian businesses by engaging in international trade and by leveraging free trade agreements through a border adjustment tax.

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These findings are further reinforced when average wages in dollars per worker by sector and size of enterprise are assessed over the same period – Figure 8.



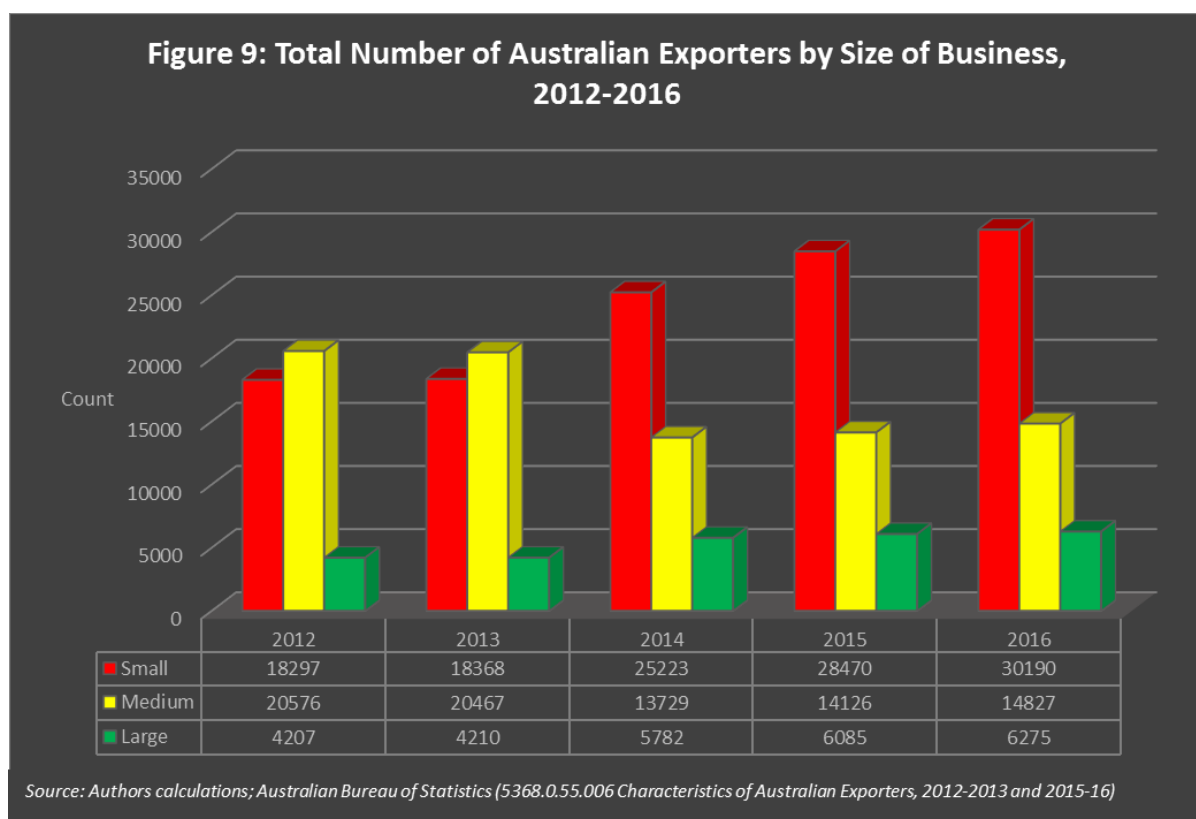
In all sectors, the average wage of workers in small businesses are below that of the sector averages. Average wages in medium business were closer to the sector average with a notable differential appearing in retail trade. Nonetheless, as wages earned are linked to the price and sales of the final goods and services, increasing exports would boost the average worker's pay packet.

### Scope for Greater Utilisation by SMEs

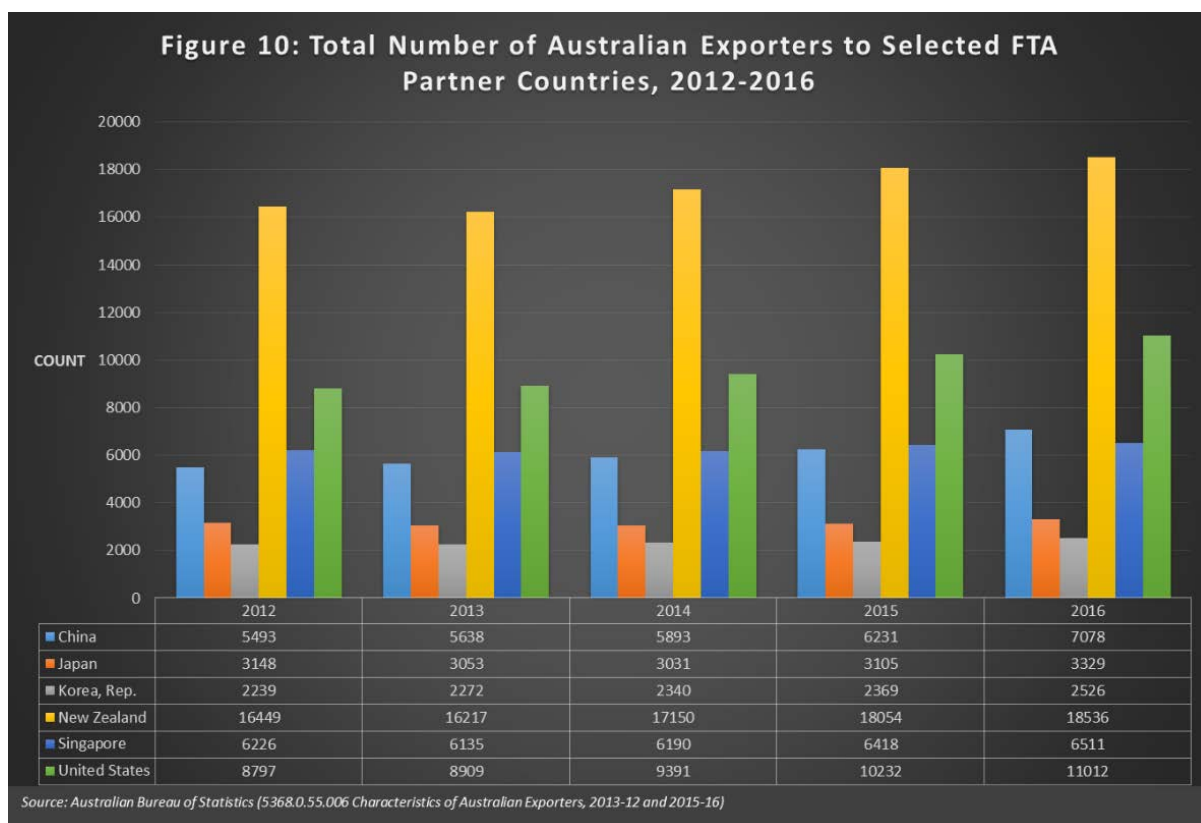
The analysis thus indicates that Australian enterprises do out compete rival enterprises located in several countries into which they export, and that small and medium businesses are productive, but maintain disproportionately low levels of exports and lower than average wage rates.

However, as indicated in Figure 9, the number of small businesses exporting has increased since 2012. This is in contrast to medium size businesses which experienced a decline over the same period.

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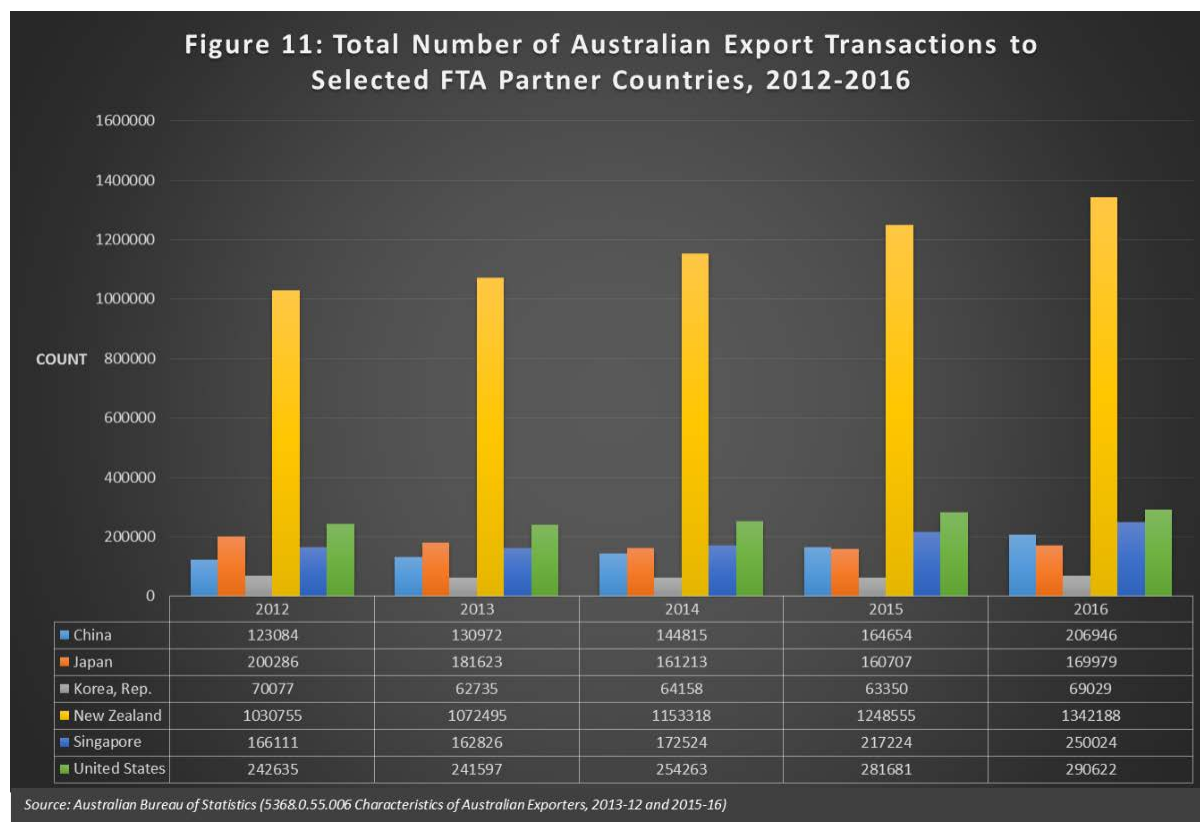


Similarly, in terms of specific FTA partners, the number of Australian exporters to FTA partners has grown steadily in all years apart from an anomaly in Japan in 2012 – Figure 10.



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However, the number of Australian transactions to FTA partners has proven to be erratic with growth in some years and contraction in other – Figure 11.



Together, these findings provide evidence that SMEs are accessing FTAs, but are exporting below their potential capacity. This, in turn, supports the view that small and medium enterprises are underutilising FTAs with significant detriment to Australia's economy in terms of productivity, jobs and growth.

### Disclaimer

*The views expressed in this submission are those of the authors, and do not represent those of the organisations to which they are affiliated. The authors do not receive funding, fees or payments in any forms from individuals and organisations that may be advantaged in any way by this submission.*

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