Bilateral Arbitration Treaty

The costs and benefits to small and medium sized New Zealand businesses

NZIER public good report

August 2015

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New Zealand has predominately small to medium sized businesses. These firms find it difficult to trade outside its borders because of the high fixed servicing costs and risks associated with maintaining and growing trade. This is important since for New Zealand to succeed New Zealand requires all businesses meet its peak potential (MBIE, 2014 p6).[1] This is particularly important for SMEs since they make approximately 30% of our GDP (MBIE, 2014 p8).[2]

Part of the risk issue for small to medium sized firms is the uncertainty associated with dispute resolution in foreign countries. How will they reduce the risk of not being paid for the goods and services they have exported if they are involved in disputes with counterparties? One way around this problem would be a more transparent approach to disputes resolution.

The idea of a Bilateral Arbitration Treaty (BAT) is that international arbitration would be used as a default mechanism of international commercial dispute resolution. The BAT would reduce the risks/uncertainties associated with overseas trade disputes resolution and would thereby provide a boost to international trade – contributing to our aim of taking the ratio of exports to GDP to 40% by YEAR? 2025[3]. It also fits into New Zealand's wider objective of improving access to better quality dispute settlement.

The purpose of this report is to assess the economic benefits of widespread adoption of a BAT to SMEs in New Zealand. This report will provide an illustration of such benefits.

Small and medium-sized enterprises (SMEs) play a significant role in New Zealand economy. The definition of SMEs in New Zealand is enterprises with less than 20 employees and will be used in this report. Indeed, we focus on businesses with 6-19 employees. SMEs in New Zealand not only supply goods and services domestically, but they also export them. The costs and risks associates with commercial dispute resolution are significant barriers to international trade for SMEs (see Butler and Herbert et al).

Currently such trade would have its commercial disputes resolved by international litigation, international arbitration, mediation, and negotiation. There are some issues with international litigation such as unfairness, inequities.

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1 http://www.mbie.govt.nz/what-we-do/business-growth-agenda/sectors-reports-series/pdf-document-library/the-small-business-sector-report-2014.pdf

2 Ibid p8.

3 http://www.interest.co.nz/business/60678/govt-wants-double-real-value-nz-exports-2025-increasing-exports-30-gdp-40-warns-fall

1.1. Current Situation

Business Operations Survey: 2011 revealed that there were 26,337 businesses with 6-19 employees in 2011 (Table 1).

Table 1 Number of businesses with 6-19 employees

Year	Total businesses	Businesses that export	Businesses interest in export
2007	26316	3600	4603
2008	26538	3192	5250
2009	26814	4293	6279
2010	26181	3336	5997
2011	26337	3939	6210
2012	26598	6237	6192
2013	26796	6072	6843
2014	27882	5976	6930

Source: Statistics NZ: Business Operations Survey: 2011

New Zealand Demography Statistics showed that New Zealand SMES were dominated by the following industries (Table 2):

- Agricultural, forestry and fishing
- Accommodation and food service
- Retail trade
- Manufacturing
- Construction.

Table 2 Businesses with 6-19 employees by industry

Industries	Percentage
Agriculture, forestry, & fishing	11.27%
Accommodation & food services	10.97%
Retail trade	10.67%
Manufacturing	9.64%
Construction	9.57%
Professional, scientific, & technical services	8.75%
Other services	8.35%
Wholesale trade	6.51%
Health care & social assistance	6.24%
Education & training	4.69%
Transport, postal, & warehousing	2.95%
Administrative & support services	2.83%
Rental, hiring, & real estate services	2.76%
Arts & recreation services	2.04%
Financial & insurance services	1.17%
Information media & telecommunications	0.75%
Public administration & safety	0.42%
Electricity, gas, water, & waste services	0.27%
Mining	0.14%
Total	100.00%

Source: Statistics NZ: NZ Business Demography Statistics 2011

There were only 15 percent of these businesses generating overseas income [exporting]. Another 84 percent of businesses did not currently generate overseas income, while 80 percent of businesses have never generated overseas income (Table 3).

Table 3 Business size 6-19 employees with overseas income engagement

Overseas income engagement	Percentage
Generate overseas income	15%
Never generated overseas income	80%
Previously generated overseas income	4%

Source: Statistics NZ: Business Operations Survey, 2011

1.2. SMEs currently generating overseas income

An average firm's overseas income was $2.435 million. About 36 percent of businesses generated overseas income from sale of manufactured, processed, or finished goods for use by other business, while 17 percent of businesses generated overseas income through sale of manufactured, processed, or finished goods for personal/household use (Table 4). Another significant source of overseas income was the provision of services (33 percent of businesses generating overseas income).

Table 4 Sources of overseas income by goods and services

Source of overseas income	Percentage
Sale of manufactured, processed, or finished goods for use by other businesses	36%
Sale of manufactured, processed, or finished goods for personal / household use	17%
Provision of services	33%
Sale of goods manufactured overseas	19%
Licensing / franchising arrangements and royalties	6%
Sales of raw unprocessed material	4%
Earning from assets	1%
Other	4%

Source: Statistics NZ: Business Operations Survey, 2011

About 71 percent of businesses generating overseas income were interested in future overseas expansion (Table 5). Australia and Asia were the most targeted regions for overseas expansion (Table 6).

Table 5 Future expansion of businesses currently export

Future expansion	Percentage
No interest	29%
Interest	
• Initiative underway	34%
• Actively exploring options	20%
• Interested in exploring options	17%

Source: Statistics NZ: Business Operations Survey, 2011

Table 6 Regions targeted for overseas expansion of businesses currently export

Regions	Percentage
Australia	44%
Pacific	3%
Asia	22%
America	15%
Europe	6%

Source: Statistics NZ: Business Operations Survey, 2011

The Australian market was important to New Zealand SMEs as 74 percent of export businesses earned income from Australia (Table 7). The factors causing withdrawal from overseas included competition in overseas market increased, profitability lower than expected, exchange rate, jobs completed (Table 8). There were barriers preventing exporting firms to expand their business overseas. The major barriers to generating overseas income included exchange rate, increased competition in overseas markets, distant from the market, limited knowledge about specific market and others (Table 9).

Table 7 Sources of overseas income by country

Countries	Percentage
Australia	74%
United States	43%
United Kingdom	41%
Pacific	40%
China	32%
Japan	28%
India	19%
Other Europe	42%
Other Asia	35%

Source: Statistics NZ: Business Operations Survey, 2011

Table 8 Factors causing withdrawal from overseas

Factors	Percentage
Increased competition	51%
Profitability lower than expected	40%
Exchange rate level	29%
Exchange rate volatility	20%
Specific jobs or orders completed	19%
Change in ownership	10%
Increased overseas regulations	3%
Other	4%

Source: Statistics NZ: Business Operations Survey, 2011

Table 9 Barriers to generating overseas income of businesses generated overseas income

Barriers	Percentage
Exchange rate volatility	38%
Exchange rate level	36%
Low demand / increased competition in overseas markets	32%
Distance from the market	32%
Limited experience in expanding beyond NZ	20%
Limited knowledge about specific market	17%
Limited access to distributor networks	16%
Limited access to finance for expansion beyond NZ	16%
Language and culture differences	13%
Overseas government regulations and tariffs	11%
Inability to rapidly increase supply	8%
Other	21%

Source: Statistics NZ: Business Operations Survey, 2011

1.3. SMEs currently not generating overseas income

Only 9 percent of businesses were interested in the future expansion and 74 percent of businesses were not interested in the future expansion (Table 10). The regions most targeted for overseas expansion were Australia and Asia (Table 11).

Table 10 Future expansion of non-exporting firms

Future expansion	Percentage
No interest	74%
Interest	
• Initiative underway	1%
• Actively exploring options	2%
• Interested in exploring options	6%

Source: Statistics NZ: Business Operations Survey, 2011

Table 11 Regions targeted for overseas expansion of non-exporting firms

Regions	Percentage
Australia	49%
Pacific	10%
Asia	13%
America	2%
Europe	2%

Source: Statistics NZ: Business Operations Survey, 2011

There were barriers preventing non-exporting firms to enter into international markets. The significant barriers to generating overseas income included limited experience in expanding beyond New Zealand, and limited knowledge about specific markets (Table 12). The reasons for not being interested in generating overseas income were importance of physical proximity to its customers, New Zealand market is sufficient, goods/services satisfy demand specific to New Zealand, business structure is limited to New Zealand market, and costs, risks, or barriers are prohibitive (Table 13).

Table 12 Barriers to generate overseas income of business did not generate overseas income but were interested in future expansion

Barriers	Percentage
Limited experience in expanding beyond NZ	48%
Limited access to finance for expansion beyond NZ	34%
Limited knowledge about specific market	33%
Limited access to distributor networks	32%
Distance from the market	26%
Exchange rate volatility	22%
Other	21%
Exchange rate level	18%
Low demand / increased competition in overseas markets	18%
Overseas government regulations and tariffs	17%
Language and culture differences	11%
Inability to rapidly increase supply	9%

Source: Statistics NZ: Business Operations Survey, 2011

Table 13 Reasons for not being interested in generating overseas income

Reasons	Percentage
Importance of physical proximity to its customers	39%
NZ market is sufficient	29%
Goods/services satisfy demand specific to NZ	11%
Business structure is limited to NZ market	8%
Costs, risks, or barriers are prohibitive	5%

Source: Statistics NZ: Business Operations Survey, 2011

2. The BAT proposal

Under the BAT proposal, a commercial dispute would be resolved by international commercial arbitration as a default mechanism. These disputes would be fairly and efficiently resolved, and enforced.

The BAT treaty will promote international trade between New Zealand SMEs and the businesses of the treaty partner because businesses would have less legal uncertainty and risk than the commercial litigation mechanism.

3. Costs and benefits of the proposal

3.1. Counterfactual

Setting up the counterfactual for a CBA can be difficult because there is:

- limited baseline data from which to measure any change
- uncertainty about the motivations of firms and their views towards exports (i.e. a lack of solid data)
- uncertainty whether other alternatives that might emerge.

Therefore, there are potentially a number of credible counterfactuals. The one we assume here is open to question, and should be treated as "work in progress". We treat the counterfactual here as a tentative "peg in the ground".

We assume that if no new approach put in place to assist firms they would continue the same processes they already have in place. This may include implementation of electronic solutions. We expect that:

- some firms would successfully continue to trade the way they had always done
- others would not enter the export game because the risks to the firm of non-payment would be too high
- overall risk and uncertainty levels would remain the same.

This approach may have some benefits for some firms since they have specific knowledge of particular country's legal system which gives them an edge in that market. However, it does not assist in encouraging experimentation and learning for new exporters which is a national aim.

Regardless, under the counterfactual, firms involved in exporting are likely to pursue their own initiatives aimed at mitigating dispute risk. They will also incur costs of investing and running the associated systems and processes.

A lack of information means we are not able to identify such actions, and thus cannot identify these costs and effects in any credible way. Instead, our approach is to assume that both the full costs and the full benefits would not have occurred in absence of BAT.

This approach is not ideal. But we have assumed that this approach minimises the risk of biasing the benefits and costs.

3.2. Identification of costs and benefits

3.2.1. Costs

- Negotiation costs
- Running costs
- Promoting costs.

3.3. Benefits

As BAT would enhance international trade between New Zealand SMEs and the treaty partners, this would benefit to businesses as sales increased, to community through employment and New Zealand economy. This report would provide preliminary investigation of New Zealand SMEs international trade performance. We have made hypotheses to help in developing benefits from BAT.

3.4. Illustrative results

As an illustration, we estimated international trade expansion under different scenarios associated with our hypotheses. Given an average overseas income of SMEs, we calculated the **total overseas income of SMEs** by multiplying an average overseas income by the number of businesses exporting:

$2.435*3939 = $9,591 million

As the Business Operations Survey provided the most targeted regions for future expansion and source of overseas income by country, we selected countries associated with the top bilateral trading partners of New Zealand. These countries include Australia, United States, United Kingdom, Germany, Singapore, Japan, Korea, Malaysia, India, China, Indonesia and Fiji. Percentage of New Zealand's exports to selected bilateral trading partners is used to allocate the overseas income of SMEs by country. For example, an estimated overseas income from Australia would be $2181 million. (Percentage of New Zealand's export to Australia, 22.74% of total overseas income of SMEs $9591 million).

The international trade impact can be estimated on the hypothesis that there would be a positive reaction to countries with lower risk of commercial dispute resolution in two ways:

- the expansion of the current exporters into new markets; and
- new exporters who are interested in international trade.

The Worldwide Governance Indicator (WGI) for the rule of law is used as a reference. WGI reflects an assessment of outsider confidence in the courts and the law enforcement of the country.

As the risks of commercial dispute resolution should be reduced by the treaty, a BAT would motivate exporters to expand their business to those countries under the treaty. Depending on the country in question, the report assumes that there would be a positive reaction to countries with BAT and the growth rate could be 1 to 10 percent of the overseas income from each country proportional to the WGI. The growth rate of overseas expansion to countries with a low WGI would be higher than those with high WGI following a commitment to resolve trade disputes by the international commercial arbitration BAT.

To illustrate a quantitative benefit assessment from selected countries to SMEs in New Zealand, we multiply the expected growth rate in trade with the estimated overseas income from that particular country to produce a trade gain. For example, the trade gain from China to SMEs in New Zealand would be $36 million (a 3 percent growth in trade applied to an estimated overseas income from China in 2011 to produce a trade gain around $22 million - Table 15).

Overall, the trade gain to SMEs in New Zealand would be $96 million with 1percent average growth rate in export and the trade gain to SMEs in New Zealand would be $288 million with 3 percent average growth rate.

Table 14 Regions most targeted for overseas expansion and value of exports to bilateral trading partners

Countries	Regions most targeted for overseas expansion		Value of exports to selected bilateral trading partners ($ million)	Rank	Percentage of NZ's export to selected bilateral trading partners
	Business without current overseas income and interested in overseas expansion	Business with current overseas income and interested in overseas expansion			
Australia	49%	44%	10,848	1	22.74
Europe	2%	6%			
United Kingdom			1545	6	3.24
Germany			775	8	1.62
America	2%	15%			
United States			3997	3	8.38
Asia	13%	22%			
Singapore			813	11	1.70
Japan			3441	4	7.21
Korea			1675	5	3.51
Malaysia			875	9	1.83
India			938	7	1.97
China			5887	2	12.34
Indonesia			856	10	1.79
Pacific	10%	3%			
Fiji			343	28	0.72
Sub total			31,993		67.07
Total			**47,702**		**100**

Source: Statistics NZ: Business Operations Survey: 2011 and Global New Zealand International Trade, Investment, and Travel Profile 2012

Table 15 Worldwide governance indicator (WGI) and estimated overseas income under different growth rates

Countries	Worldwide Governance indicator	Overseas income (million)	Estimated overseas income expansion under different growth rates (million)			
			1%	3%	5%	10%
Australia	95.73	2181	22	65	109	218
Europe						
United Kingdom	92.89	311	3	9	16	31
Germany	91.84	156	2	5	8	16
America						
United States	90.52	804	8	24	40	80
Asia						
Singapore	95.26	163	2	5	8	16
Japan	89.57	692	7	21	35	69
Korea	78.67	337	3	10	17	34
Malaysia	64.45	176	2	5	9	18
India	52.61	189	2	6	9	19
China	39.81	1184	12	36	59	118
Indonesia	36.49	172	2	5	9	17
Pacific						
Fiji	22.27	69	1	2	3	7
Subtotal		6433				
Total		**9591**	**96**	**289**	**481**	**962**

Source: Worldwide governance indicators (WGI)

4. Conclusions

The benefits from the proposal of BAT to New Zealand SMEs are examined as an illustration based on the hypothesis that the proposal of BAT has a positive impact on exports. The international trade performance might be expanded by the existing exporters and potential exporters as the risks of international trade dispute resolution have been reduced by the BAT treaty. The implementation of a proposed BAT would lower perceived risk barriers and enhance businesses’ confidence to expand their trade overseas.

5. References

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