

A literature review on the effects of regional trade agreements (RTAs) on micro-, small- and medium-sized enterprises (MSMEs)

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Abstract: This document presents a literature review of the effects of regional trade agreements (RTAs) on micro-, small- and medium-sized enterprises (MSMEs). It focuses on the extent to which MSMEs use RTAs to engage in international trade, and addresses other recurrent themes in the literature, such as the determinants of RTA use, MSME challenges in utilizing RTAs, and potential benefits RTAs can have for MSMEs. Most of the studies available in the literature focus on economies in North America, East Asia and the Pacific, with limited coverage of other regions such as Africa, Europe and Latin America. These studies do not provide definitive conclusions on the direction of RTA effects on MSME trade participation given that their principal focus was RTA utilization rates and not effectiveness of MSME-specific RTA provisions. Rather, the literature describes the potential benefits MSMEs can experience from RTAs such as access to cheaper intermediate goods due to lower tariffs, increased exports, more business opportunities, larger production networks and further participation in regional and global supply chains. Studies, however, also document challenges MSMEs can face to use RTAs including complex regulatory requirements and high administrative costs or downside effects RTAs can have such as increased competition from foreign firms.

Introduction

Recent years have seen an increase in the number of regional trade agreements (RTAs) with provisions on micro-, small- and medium-sized enterprises (MSMEs⁹). In 1971, the first MSME reference in an RTA notified to the WTO was recorded in the EU – Overseas Countries and Territories agreement. Since then, the number of RTAs with at least one MSME provision has grown steadily up to 196 RTAs by the end of 2021. With these RTAs accounting for more than a half of the 353 RTAs notified to the WTO in that time, there has been an interest in academic and policy circles to assess the extent to which those provisions, and RTAs in general, affect MSME trade participation. To contribute to such growing interest, this document presents a review of studies that have evaluated the impact of RTAs on MSMEs. The document also reports on potential government initiatives to evaluate the impact that MSME-related provisions in RTAs have had on MSME trade participation, such as a review the European Union is projecting to undertake over the next five years.

Until the 1990s, only a few studies investigated the potential effects RTAs can have on MSMEs. These studies intended to address research motivations to understand how globalization had impacted small businesses. Julien et al. [1994], for example, documented a number of studies that revealed MSMEs generally have less resources to counter increased competition from foreign exporters. Through a survey of 879 small manufacturing firms (those with fewer than 250 employees) that were impacted by tariff reductions from the 1988 Canada-United States Free Trade Agreement, they aimed to explore how small firms were affected. Their findings suggested that only a small number of businesses knew about the agreement and had taken actions to benefit from it.

These results eventually led other early studies to examine how MSMEs benefit from RTAs and which factors hinder small businesses from using trade agreements. On the one hand, Julien [1995], by following previous work undertaken in Julien et al. [1994], observed that small businesses seeking to use RTAs pursued organizational changes and investments in marketing and technology to develop foreign market entry strategies. In particular, they identified studies suggesting that MSMEs are likely to adopt new production technologies, such as computer-controlled machines or CAD (computer-aided design) systems, or to develop product differentiation strategies in order to face up to challenges and opportunities created by RTAs [Carriere et al., 1994; Acs & Audretsch, 1990]. On the other hand, Litvak [1988] noted that MSMEs have significant challenges in using RTAs because of their resource constraints to, for example, bear the procedural costs in applying for any favorable market access conditions granted by a given trade agreement. In Canada, for example, MSMEs are usually defined as those firms whose annual sales do not exceed \$2 million (Canada's currency) and/or firms employing fewer than 50 employees, meaning focusing attention on new procedures comes at a higher relative cost. In this context, Litvak (1988) stressed that differences in firm characteristics such as organizational size, product-service mix and resource endowments, mean that the risks, such as being squeezed out of local markets by foreign competition introduced by an RTA, vary considerably. MSMEs tend to be at higher risks when RTAs lead to increased foreign competition, and when domestic labor and capital have limited time-horizons to adapt to freer trade.

With the various trade liberalization waves and the establishment of the World Trade Organization (WTO), a growing set of studies on RTA effects on MSMEs started to emerge in the literature by the early 2000s. These studies addressed both the positive and negative effects of RTAs in MSMEs by

⁹ The terms “MSMEs” and “small businesses” will be used interchangeably throughout the document.

looking into factors that may support, or constrain, small business use of preferential market access benefits granted by RTAs. A starting place for many of these studies to investigate the RTA utilization rate among MSMEs to measure the extent of small business RTA-use was to measure the degree small businesses use the reduce tariff rates granted by applicable trade agreements. Regarding the factors that may help, or hold back, businesses when using RTA benefits, the literature documents firm size, business support programs or institutions, market conditions, managerial business practices, and the policy regulatory environment, among other factors. In terms of geographical focus, most of the studies have focused on economies across the East-Asia and the Pacific region. But it is worth highlighting that studies on some economies in Africa, the Americas and Europe have been documented [Ulloa & Wagner, 2012; Chingwaru, n.d.; De Ville & Gheyle, 2021; Garcia, 2009].

MSMEs have had different definitions across the studies reviewed in this document. Most studies converge in defining MSMEs as firms with less than 100, 200 or 300 employees.

However, other studies can present slightly different definitions. For example, Litvak [1988] defines MSMEs as firms that employ less than 50 employees and/or report annual sales below 2 million (local currency). Garcia [2009], on the other hand, documents MSME definitions used in Mexico and Europe, suggesting these are firms with less than 250 employees and annual turnover between USD 13.4 million and USD 67.28 million [https://ec.europa.eu/regional_policy/sources/conferences/state-aid/sme/smedefinitionguide_en.pdf]¹⁰ MSMEs included in these firm-level surveys also participate in a variety of economic sectors, including: automobiles; electronics; textile and garments; wholesale; retailing; and services; among others.

The studies reviewed in this document do not provide conclusive evidence on the direction of RTAs' impacts on MSME trade. Two main methods of reviewing MSME RTA utilization rates are described by Ulloa and Wagner [2012]. The first is through surveys of businesses and the second through modelling. Both of these types of studies are reviewed in this paper although MSME specific evidence is found mainly in the former while broader firm-level findings are generated with modelling. Regardless of the data collection methods used across studies, such as firm-level surveys, business interviews, or quantitative modelling, none of the studies have defined a research strategy aiming at evaluating the direct impacts of RTAs on MSMEs, in particular RTA MSME chapters or other specific provisions. Rather, they have intended to measure the extent to which MSMEs use RTA preferences, which have been mostly approached in terms of tariff reduction benefits, and to assess which are the factors either supporting or constraining MSMEs in using RTAs.

¹⁰ For more information, see: European Commission (2015). User guide to the SME definition.

¹¹ When disaggregated by economy, this study documented varying levels of RTA utilization rates among businesses. Firms surveyed in Japan and Thailand reported RTA utilization rates of 29 per cent and 25 per cent respectively while the rates observed in the

The present document is structured as follows. Section 1 presents a review of findings and approaches on RTA utilization rates among MSMEs that have been documented in the literature. Section 2 documents a set of studies that have found positive effects of RTAs on MSMEs and presents a discussion on factors that support RTA-use by small businesses.

Section 3 depicts another group of studies that have revealed negative effects of RTAs on MSMEs and the particular challenges the latter encounter in learning about and benefitting from RTAs. Section 4 discusses research gaps identified in the literature to shed light on potential avenues for further analysis on MSME issues in using RTAs. Section 5 concludes.

To what extent do MSMEs use RTA provisions?

The relatively scarce data on the specific users of RTAs, especially for provisions other than tariff reductions, has meant that research on the use of tariff provisions has relied heavily on surveys. Many of the studies have also looked more generally at RTA effects on economic growth and international trade, or more specifically at tariff preference use, and most have surveyed samples of firms that are not MSME-specific and with varying definitions for a "small business". Consequently, MSME use of RTAs has been documented within a wide range of levels in the literature.

The literature on RTA effects on businesses identifies a first set of studies that have analysed firms within groups of Asian economies. For example, Kawai and Wignaraja [2009] surveyed 609 exporting firms of varying sizes in five economies in East Asia and the Pacific, including: Japan; Singapore; Korea, Republic of; Thailand; and the Philippines. These firms operate in various sectors, including: electronics, automotive, textile and garments, pharmaceuticals, metals and machinery, and food processing. The results found that 22 per cent of all surveyed firms use market access preferences granted by RTAs adopted by the aforementioned economies¹¹ Although this study was not only reviewing MSMEs and therefore reported aggregate results obtained for the full sample of firms, it is worth noting that small businesses (defined as those firms with 100 or fewer employees) were included in the sample and represented 39 per cent of all surveyed firms.

Another multi-economy study on RTA effects on Asian businesses was undertaken by Wignaraja [2013] who surveyed a total of 595 firms from three economies: Indonesia, Malaysia and the Philippines. These economies were selected because of their involvement in negotiating and implementing RTAs adopted between member countries of the Association of Southeast Asian Nations (ASEAN). Firms that were surveyed in this study included MSMEs (defined as those firms with 100 or fewer employees) and represented different shares of the firms in each economy¹². RTA

Republic of Korea, the Philippines and Singapore were slightly lower at 20.8 per cent, 20 per cent and 17.3 per cent accordingly.

¹² In Indonesia, 23.3 per cent of respondents were firms with 100 or fewer employees, in Malaysia 88.5 per cent and in the Philippines 41.3 per cent.

utilization rates among all surveyed firms ranged from 20 per cent to 31 per cent across the three economies. As in Kawai and Wignaraja [2009], RTA use rates were not disaggregated by firm size.

A second set of studies has focused on the RTA effects on businesses in single Asian economies. For example, Cheong and Cho [2009] found that in their survey of firms from the

Republic of Korea, only one out of five of the 120 exporting firms used preferential tariffs under RTAs. This study defined MSMEs as those firms with less than 300 employees, with surveyed firms representing a range of sectors, including: automotive parts, electrical goods, machinery, petrochemicals, textiles, steel and metal products, and sundries. In particular, the results indicated that only 22 per cent of surveyed MSMEs used RTA preferences compared to 60 per cent of large firms. In China, Yunling [2010] surveyed 232 firms in electronics, automobiles, textile and garments, machinery, and other sectors. MSMEs made up 18 per cent of surveyed firms and they were defined as those with less than 100 employees. The results found that 45 per cent of surveyed businesses were using RTA preferences, significantly higher than the previously mentioned studies from elsewhere in Asia.

The studies that were discussed previously documented varying proportions of businesses using RTA preferences. In general, RTA utilization rates among firms of all sizes were observed to range from 20 per cent to 45 per cent of those surveyed depending on the business surveys conducted by study [Kawai & Wignaraja, 2009; Wignaraja, 2013; Yunling, 2010]. According to the studies that disaggregated results by firm size, small businesses using RTA preferences accounted for about one fifth of firms surveyed [Cheong & Cho, 2009].

In other world regions like Africa, Europe and the Americas, studies on RTA effects on small businesses are scarce and do not focus on obtaining concrete measures for RTA utilization by firms. However, they address relevant research dimensions that are identified in the literature, such as the factors that either support or constrain MSMEs from taking advantage of RTA benefits.

What factors support MSME RTA use?

As the previous section emphasized, MSMEs have reported varying levels of RTA use. Understanding the differences of such RTA utilization rates has been a core research motivation in the literature by analysing the factors that support or constrain MSMEs to pursue preferential market access. This section focuses on the factors that make small businesses more likely to use RTA preferences.

Studies covering multiple economies have looked into the macro- and firm-level factors driving MSMEs to use RTA preferences. Kawai and Wignaraja [2009] examined some of these factors in their survey of southeast Asian firms¹³. With regard to macro-level factors, they found that high RTA use among businesses were observed in economies with higher levels of industrial structures linked to regional production networks, and a dense network of business associations and public trade support institutions that assist businesses to

adjust to RTA conditions. Firm characteristics that were found to be positively associated with RTA utilization rates among firms were number of employees, foreign ownership percentage, awareness of RTA provisions, and likelihood for changing business plans. These results have

also been somewhat similar to findings Kawai and Wignaraja [2011] obtained in a study covering a sample of 841 firms across China, Japan, Thailand, Republic of Korea, the Philippines, and Singapore. In another multi-economy study covering 595 firms in Indonesia, Malaysia and the Philippines, Wignaraja [2013] found that business perceptions of higher benefits over costs in using RTA provisions were another factor associated with increased RTA use by businesses.

Economy-level studies have also contributed to the literature by identifying determinants of RTA-use among businesses. In Malaysia, Arudchelvan and Wignaraja [2015] pointed out that MSMEs with higher technological capabilities, such as experience in holding technology licences from overseas, R&D spending and certification processes, are more likely to use RTA preferences. The authors also noted that small businesses belonging to production networks were observed to use RTA preferences to a larger extent than those who are not.

Other sets of studies have identified factors such as international networks and business ownership types as playing a role in supporting MSMEs to adopt international business strategies that can potentially drive them to use RTA preferences. For example, Zimmerman et al. [2009] found using questionnaire data that small businesses having strong international network ties may influence them to pursue new foreign market entry strategies. Size of international network ties was not found to have an association with MSME growth, but rather the strength of it as measured by the frequency, length and intimacy through which small business owners interact with their international business contacts. Regarding business ownership type, Fernandez and Nieto [2006] found from a firm-level government dataset including 10,579 MSMEs in Spain that the participation of corporate shareholders in firm equity was associated with a higher likelihood of small businesses in adopting internationalization strategies. The authors observed that MSMEs with all or part of their capital owned by external corporations are more prone to internationalize and seek new foreign market entry opportunities because of strategic resources and governance mechanisms introduced by the shareholders. In Africa, Chingwaru [2015] issued a questionnaire to look at the impacts trade and economic liberalisation policy reforms—which are broader in scope than RTA effects—have had on manufacturing MSMEs in Africa and South Africa, and found the latter have been negatively affected because of their low capabilities to compete with resource-rich multinationals. In Europe, De Ville and Gheyle [2021] have analysed the political discourse in Europe around the benefits of RTAs on MSMEs, and have underscored the latter face barriers, such as relatively higher fixed costs when using RTA

¹³ This initial survey covered 609 firms from Japan, Thailand, the Republic of Korea, the Philippines and Singapore.

references due to their inability to spread costs out over a larger volume of exports.

Separately, using modelling of export data, Ulloa and Wagner [2012] analysed Chilean firms exporting to the United States and found that until a relatively high export value threshold was attained, the costs for RTA preference-use outweighed the benefits, meaning smaller traders were less likely to benefit. Further, their study suggested that smaller exporting firms not using the RTA may be negatively impacted by larger firms using the RTA that are then exporting more, and demanding more inputs thereby increasing factor prices. Other studies using modelling to estimate firm-level impact of RTAs include Kohpaiboon [2010] and Hayakawa et al. [2008]. Using Thai administrative records of approved certificates of origin, Kohpaiboon [2010] finds that complying with rules of origin (ROO) adds an equivalent cost of a 2 to 8 per cent tariff, a cost which is harder for smaller firms to bear, partially explaining why large local conglomerates are most likely to use RTA provisions. Hayakawa et al. [2008] use ASEAN affiliate data and find that the larger the affiliate, the more likely they are to use RTA provisions, or, in other words, smaller affiliates use RTAs less. Noted reasons are high fixed costs, investment incentive schemes that reduce the relative benefits, and already low, or zero, tariffs in key sectors like electrical machinery.

What challenges do MSMEs face when using RTA provisions?

With the majority of studies obtaining RTA utilization rates among selected surveyed MSMEs of significantly less than 50 per cent, the literature has also drawn attention to challenges small businesses encounter when using RTAs. A fact that has been observed in the literature is that not all MSMEs benefit equally from RTAs because of associated costs in meeting complex procedures and lack of business support. Ulloa and Wagner [2012], for example, studied RTA-use among firms in Chile and found that small businesses export smaller quantities and therefore will have lower, overall, tariff costs, meaning the cost of compliance can outweigh the benefit of favorable tariffs. In a somewhat similar finding, Takahashi and Urata [2008] observed high costs of using RTAs in a sample of firms studied in Japan. The authors noted that only at quantities beyond those a small business could trade would the RTA benefits outweigh the costs.

Multi-economy studies have also underscored impediments businesses face in using RTA benefits. Kawai and Wignaraja [2011] found that lack of information, small preference margins, delays and administrative costs associated with rules of origin, and other administrative procedures embedded in using RTA preferences were among the obstacles that businesses report in utilizing RTAs. Wignaraja [2013] and Arudchelvan and Wignaraja [2015] both find that lack of information is a key difficulty for MSMEs when it comes to understanding the detailed tariff preferences and other provisions of RTAs under consideration. Other challenges identified are "irrelevance" or unapplicable measures for MSMEs using RTAs; absence of RTAs with major export markets where a MSME would be more likely to focus its

exports; small margins of preference that make them cost ineffective for smaller traders; complex rules of origin; time delays and administrative costs in preparing RTA-related documentation; preferences in using other duty free treatment schemes; and non-tariff measures in RTA partners. Another recurring MSME challenge in using RTAs is complying with different rules of origin. Hiratsuka et al [2009] found that businesses viewed the existence of multiple rules of origin as a procedural complexity that can lead eventually to increased costs in proving the applicable rules of origin.

Other studies with a focus on drivers of international business strategies provide insights in broader challenges MSMEs face in seeking access to foreign markets and using RTAs. For example, Ottaviano and Volpe Martincus [2009] found that lower levels of employment, sourcing from abroad, investment in product improvement and productivity may all be associated with the probability for a firm to engage in exporting activities. These results were found under the context of the MERCOSUR trade area in which Argentina participates. In other geographical locations, Winch and Bianchi [2006] conducted a case study of companies across the European Union and found that small businesses face internationalization challenges if they have stretched capabilities in new and unfamiliar markets, low levels of word-of-mouth marketing, and increased competition for resources.

In addition to firm-level factors driving MSME challenges in seeking foreign market access, studies have also identified macro-level factors that may pose difficulties for MSMEs. For example, Govori [2013] researched socio-economic country-level conditions and found that limited access to finance, competition, corruption and complex government policies can be detrimental for small business growth and development.

The macro-level factors pointed out by Govori [2013] are important to place in perspective, especially when comparing the differing RTA impacts between MSMEs and large firms. With this regard, Chingwaru [2015] researched factors explaining the differences between MSMEs and large firms in terms of being affected by trade and liberalizing economic policy reforms – which can come in the form of increased adoption of RTAs. In Zimbabwe, this study found that manufacturing MSMEs have been negatively affected by trade and economic liberalisation policies in Zimbabwe and South Africa. Some of the factors explaining the adverse effects faced by MSMEs are cash constraints and high competition posed by resource-rich multi-national corporations. Lack of knowledge and resources along with low innovation levels were other factors hindering the ability of MSMEs to benefit from sweeping market conditions created by trade and economic liberalization policy reforms in the economies studied.

Research gaps for RTA effects on MSMEs

The literature on RTA effects on MSMEs is scarce and does not provide conclusive assessments on how trade agreements impact MSMEs in their business performance and engagement in international trade. This is a fact that De Ville and Gheyle [2021] also concluded after reviewing recent

academic analyses that have analysed the impact RTAs have had on MSMEs. Most of the studies discussed in this literature review have researched RTA utilization rates and the benefits and costs that RTAs can pose for businesses via surveys, with even fewer studies on MSMEs. Attempts to model RTA impacts typically use data that include firms of all size [Hayakawa et al. 2008; Kohpaiboon, 2010; Ulloa and Wagner, 2012] with limited MSME-specific findings.

While studies are few and the evidence is inconclusive about RTA impacts on MSMEs, those studies that exist frequently suggest that RTAs can affect MSMEs negatively by squeezing them out of markets because of their limited capacities to compete with larger firms in using

RTA preferences and adapting their productivity levels to adjust to changing economic conditions created by RTAs and broader trade and economic liberalization policies [Ulloa & Wagner, 2012; Chingwaru, 2015; Baccini et al., 2017; Rodrik, 2018]. Further, the studies that have been identified in this literature do not look at MSME-specific provisions within RTAs but rather at RTAs as a whole. Therefore, the necessity for more studies on RTA effects on MSME economic dimensions, as well as the specific language concerning small businesses in the agreements such as for competitiveness, information sharing or contact points, is clear.

Another important gap observed in the literature is the geographic concentration of available studies. Most of the studies identified focus on East Asia and the Pacific, but evidence is more limited outside of these areas.

Government impact assessments are also limited, and many are initiated before an RTA is implemented [USITC, 2019; U.K. Department for International Trade, 2021] meaning they remain somewhat speculative. On the other hand, the European Union provides regular ex- post evaluations of its RTAs [https://policy.trade.ec.europa.eu/analysis-and-assessment/ex-post-evaluations_en]¹⁴, which may provide future insights into the impacts MSME Chapters have had on smaller traders in agreements such as the recent EU-Japan European Partnership Agreement [2019] or the EU-UK Trade and Cooperation Agreement [2020] once these reviews are conducted.

Lastly, the literature studies the extent to which businesses use tariff reduction benefits granted by RTA preferential market access terms. However, no studies that analyse the impact of other RTA provisions on MSMEs have been identified so far. This is particularly important given that recent studies have suggested the broader disproportionate impacts that RTA provisions beyond tariff preferences can have for firms of varying sizes. With this regard, Rodrik (2018) noted that RTAs are becoming more about domestic rules and regulations than tariff and nontariff barriers, which creates the necessity to assess the holistic impact of RTAs on business, particularly on MSMEs as discussed in this study. Furthermore, addressing research efforts in understanding which RTA provisions MSMEs use the most and their related

business and economic impact can further contribute to the literature on micro-level effects of RTAs, as most of the literature has focused so far on the macroeconomic impacts led by RTAs.

Conclusion

This document presents a literature review of RTA effects on MSMEs and the recurrent themes that have been investigated. Most of the studies that were identified did not convey definite conclusions on the directions of RTA impacts on small businesses because the research strategy focused on analysing RTA utilization rates among MSMEs and the factors constraining or supporting the latter to use RTA preferences. Further, the few studies that exist do not look at MSME provisions specifically within RTAs, but rather at the impact of the entire agreement on small businesses. Data constraints are one reason for this limitation, but government impact assessments may provide one way of looking deeper into RTA effects on MSME trade.

Nevertheless, the literature suggests that RTAs have the potential to benefit MSMEs to source cheaper intermediate goods and increase their exports if they receive adequate business support and build their productive capacities to compete with larger firms in using RTA preferences. Studies also signalled potential gains in terms of business opportunities, production networks and participation in regional and global supply chains. As per the negative effects associated with RTAs, small businesses often report increased competition from foreign firms, complex regulatory compliance requirements and high administrative costs and time delays.

Some of the recurrent themes in the literature on RTA effects on MSMEs discussed in this document were the varying levels of RTA utilization rates among MSMEs, and the factors that either support or constrain small businesses to use RTA preferences. According to the literature reviewed, less than half of MSMEs surveyed across studies report using RTA preferences. Observed rates vary from 20 per cent to 45 per cent among firms of all sizes, and MSME users of RTAs account for about a fifth of small businesses surveyed in the studies that were reviewed. However, there is limited evidence of their impact on MSMEs specifically. A combination of macro- and firm-level factors were found to explain the varying RTA utilization rates among small businesses. Macro-level factors that are supportive of RTA use by businesses are industrial infrastructure, production networks, and availability of business support organizations. When looking at firm-level characteristics, firms with more employees, awareness of RTA provisions, foreign ownership and business change plans were found to be more prone to use RTA preferences. On the contrary, some of the obstacles constraining MSMEs RTA preference-use were lack of relevant information and compliance costs related to trade requirements derived from multiple rules of origin.

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