

WORKING PAPER

Regional Investment Strategies: How can regional integration projects attract both foreign direct investment and facilitate domestic investment?

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1. Introduction

In the last two decades, globalization has received an additional boost – and has been deepened. Previously, production was often organized nationally or regionally. Cross-border production networks are the norm today – and this change has profound effects for investment decisions. The global economy has been affected by two distinct, but related developments: the increasing transnationalization of production networks and the rapid emergence of regional trade agreements. Both developments are important for developed and developing countries alike. Transnationalization of production networks results in the relocation of production to other countries, and these changes affect the economic prospects for workers in many parts of the world.

Societies that wish to benefit from ever-deeper globalization have to accommodate the interests of investors – both domestic and foreign – and have to provide the conditions for new investment. Some countries find these expectations unacceptable and consider the subordination of their political preferences as unacceptable.

Of course, it is an illusion to assume that there is a North-South divide in this development. OECD-countries are frequently exposed to the demands of investors that threaten to take their capital and invest elsewhere. In today's negotiations for the Transatlantic Trade and Investment Partnership (TTIP), the private sector is demanding a far-reaching alteration of the national jurisdictions in both Europe and the USA and requests the establishment of private dispute settlement mechanisms to protect investors. Unsurprisingly, some observers have been extremely critical of these proposals, e.g. the former German Minister for Justice, Hertha Däubler-Gmelin (2014, p. 34). She has been suggesting that the division of the juridical system – an inevitable consequence of the proposals – would result in an unacceptable weakening of the rule-of-law principle.

Of course, there are intense debates both in OECD- and in emerging countries regarding the benefits of deeper integration into the global economy. In addition, societies may prefer not to participate in deep globalization. Of course, countries and

regions that continue to ignore the recent changes in production patterns will not be benefitting from the deeper division of labor. Indeed, that is a legitimate choice. Dani Rodrik, a Harvard economist, has shown that societies have to choose between three goals: They can't have hyperglobalization, a nation state and democracy at the same time (Rodrik 2011).

The consequences of this impossible trinity are obvious: If societies want to have democracy and a nation state, deep globalization is impossible. Inevitably, some of the choices of democratic societies will diverge from the "optimum" economic policy. Moreover, societies that wish to shed some economic benefits in order to safeguard some specific preferences may benefit from this choice – either by enhanced political or economic stability.

The alternative – labelled "Golden Straitjacket" by New York Times columnist Thomas Friedman – severely limits the autonomy of societies, and not wishing to subscribe to that concept is totally legitimate. Nevertheless, demanding "policy space" may result in slower economic development – and societies opting for that approach have to bear the consequences.

In Europe, the same discussion occurs. Some countries – namely Italy – have failed to embrace the concept of global value chains, but Italian society does not want to accept the loss of welfare – and they blame either German Chancellor Angela Merkel or simply the Germans for their economic decline. The former President of the European Commission, Manuel Barroso, suggested in an Italian newspaper (*Corriere de la Sera*) that Europeans have to stop to nationalize success and to europeanize failure.¹ This debate is potentially of interest for other regional integration project. Enabling divergence, i.e. different approaches in economic policy, without socializing failure ought to be the aim.

¹ *Corriere della Sera*, 23 October 2014, available at: http://www.corriere.it/politica/14_ottobre_23/barroso-irritato-l-italia-la-pubblicazione-lettera-f64a37d6-5aac-11e4-a20c-1c0cce31a000.shtml

In the remaining sections of this paper, I will analyze three specific issues. Firstly, what are the changes in production patterns we observe? Secondly, how can regions benefit from the emergence of global value chains? Thirdly, how can regional trade policy facilitate investment in the region?

2. Changes in production patterns

25 years ago, cross-border production networks were an exception. Management advisors – for instance Michael Porter from Harvard Business School – advocated production in regional clusters (Porter 1998). Essentially, production was organized at the nation level. In Europe, Italy was the champion of the cluster economy: A regional division of labor made very competitive production possible. However, since then, globalization has moved on. Companies have to source inputs from suppliers outside their domestic economy and failing to do so results in decline.

The developments in the car industry are particularly interesting, for they demonstrate the changing nature of production processes quite clearly. In that sense, the automotive industry can be identified as the archetypical global industry, which contributes significantly to the homogenization of the global economy. Consider two examples from Europe: The German and the Italian car industry. In Europe, both the enlargement of the European Union in 2004 and the creation of an even larger area for the sourcing of inputs in 1999 have enabled European manufacturers to deepen intraregional division of labour.

In 1990, Italy was a competitive producer of cars and more than 2.1 million vehicles were made there. In 2013, Italy produced 660.000 cars – less than Slovakia, Argentina and Iran. The Italian manufacturer FIAT failed to develop new production structures – and so did Italian suppliers. Specifically, FIAT failed to participate in the opening of Eastern Europe as a manufacturing site for the European car industry.

By contrast, the German car industry modernized and so did their suppliers. Audi, for instance, is producing in Hungary – since 1997. Audi has organized an internal division of labor: Since the late 1990s, all Audi engines are made in Hungary. Audi

has created a cross-border production network – within a company. But how was this facilitated? The investment of course commenced long before EU Membership of Hungary. The tool applied was the cumulation of origin, which I will discuss in section 4.

More fundamentally, a key feature of successful global players is to use opportunities that arise due to diverging factor prices and specialization. Jack Welsh, long-time chairman of General Electric, pointed to the shifting conditions for production. In globalization, Welsh argued, the perfect factory is mounted to a barge – and towed to new shores whenever condition change – wages, exchange rates, taxation.²

The deepening of production networks not limited to Audi: The entire German car industry is diversifying – and is investing heavily abroad. Of course, this investment in other economies partly explains the large German current account surpluses. Germany finances consumption and investment – abroad. Jobs and production sites are created outside of Germany, and production figures are rising quickly. In 2010, the German makers for the first time produced more cars abroad than in Germany – and in 2013 the figures were 5.6 million at home, 8.6 million abroad.

The emergence of value chains is of course a global phenomenon. Even low-tech products like apparel is integrated in Global Value Chains: American cotton being shipped to China for manufacturing, then shipped back to the USA for imprinting, subsequently being sold in NAFTA.

More complicated is the value chains for an i-phone, which is assembled in China, but components from the USA, Korea, Japan, Taiwan, France and Germany. Why is that possible? What are the regulations that enable Apple to source inputs globally and pay minimal duties (for their minimal tax payments Apple uses Luxembourg, of course)?

² The Economist, Welcome Home, 19 January 2013, available at <http://www.economist.com/news/leaders/21569739-outsourcing-jobs-faraway-places-wane-will-not-solve-wests>.

The reason is the Information Technology Agreement from 1997. Today, 78 countries have removed tariffs on IT-components to zero, covering 97 percent of trade in IT-products. The ITA is plurilateral agreement, i.e. not all WTO member countries participate, but the benefits of the ITA are available to all WTO member countries on an MFN-basis.

Objective of the ITA was to eliminate tariffs and other restrictions on a list of 190 products. This strategy has fuelled investment. The instrument has been the abolishment of tariffs on intermediate products in a specific sector. The results have been amazing: There have been enormous cost reductions, bolstering the balance sheets of Apple and Samsung, and unexpected benefits to consumers – an affordable i-phone or at least a smartphone for everyone.

3) How can regions benefit from Global Value Chains and how can investment be increased at the regional level?

The European Union represents a comprehensive model for regional integration, and the second half of the twentieth century has served to consolidate a process that was initiated soon after World War II. The original six member countries included three major automobile producers: Germany, France and Italy. Belgium benefited from its membership and received significant foreign direct investment in the automotive industry in the 1960s and 1970s (Layan/Lung 2004: 58).

It is not necessary to rehearse all the stages of the European integration process here, but the major changes with regard to the car industry should be considered. In 1973, the United Kingdom joined the EEC, together with Denmark and Ireland, both not being important producers of automotive products. The joining of Greece also was not important for the automotive industry, but the arrival of both Spain and Portugal in 1986 was. In addition, Germany's unification in 1990 and the joining of Sweden, Austria and Finland enlarged the automotive region. In the former East Germany, substantial new investments were made in the automotive industry. Sweden has a substantial own car industry, and both Austria and Finland have

significant component and assembly factories. The last widening of the Union happened in 2004, and the addition of Eastern European countries has effects on the car industry. In particular, new or modernised facilities have become operational in Poland, Hungary, the Czech and Slovak Republics as well as in Slovenia. Romania, not yet a member, is another Eastern European country that has become integrated into the European automobile system.

The restructuring of the 1990s and the integration of Eastern Europe into the region's automotive space also put pressure on suppliers, many of which were too small to both develop the new products required by the manufacturers and simultaneously expand their production facilities into Eastern Europe (Jürgens 2003: 19).

In the 1960s, the countries of the then European Economic Community were creating a joint economic space, but primarily foreign companies took advantage of it. In 1967, the French journalist Jean-Jacques Servan-Schreiber published his best-selling essay "The American Challenge", in which he criticised the fact that American transnational companies – rather than Europeans – were taking advantage of the integrated European market.

Since then, European companies have been utilizing the advantages of European integration. The process of integration has in fact led to substantial reorganisation of existing production networks and to the creation of Pan European networks by both existing and new transnational corporations (Dicken 2005: 14). One can even argue that the entire EU can be seen a gigantic international production complex made of the networks of companies that cross national boundaries and form their own trade networks (Amin 2000: 675). Looking at Europe with a comparative perspective, it is obvious that the redefinition of the production system and the supply and demand links in Europe are more advanced than in any other region (Lung/van Tulder 2004: 16).

Regional economic integration in a single regulatory sphere

The integration process in Europe reached a relatively advanced level as early as 1968, when the customs union between the original six members was completed.

Since 1974, the common external tariff of the EU stands at 10 percent (van Tulder/Lung 2004: 32). For passenger cars, this level of protection is relatively high when compared to the regime applied in the United States, where the tariff for cars stands at 2.5%. It is, however, quite low when compared to the tariff for light in the US, where the tariff is as high as 25%.

The EU effectively opened up its own automotive market to a large number of countries. In addition, the cumulation of origin was in fact extended to a large number of countries, which resulted in greater flexibility for manufacturers in securing inputs from a larger pool of countries (van Tulder/Audet 2004: 33). The result of these policy changes has been a substantial increase in competitive pressures for established manufacturers and in general, more options both for component producers and manufacturers of vehicles.

Without the creation of a single regulatory sphere, the integration processes could not have taken place. There are two important steps to be considered: First, the expansion of the European Union in itself enlarged the space for business. Second, the PANEURO scheme that enabled the enlargement of the area available for sourcing of components without having to consider local content requirements of the EU also had a significant impact. However, this trade-policy effect is not always taken into consideration. For example, Rob van Tulder claims that “the legal status of European-based firms enabled those firms to evade EU local content regulation, more easily set up supplier networked and integrate them in their own regional networks” (van Tulder 2004a: 79). This, however, is a misinterpretation. The “legal status” of a firm does not matter, what matters is the trade regulation. WTO rules do not permit the discrimination between European and non-European producers, but they do permit the discrimination between European and Non-European production.

The collapse of the socialist regimes in Eastern Europe opened new opportunities for Western European producers. In fact, in car manufacturing Eastern Europe today has become a pole of attraction, assuming the role the Iberian Peninsula had had in the 1970s and 1980s (Freyssenet/Lung 2004: 43). The importance of changes in trade policies should not be underestimated. With the collapse of the Berlin wall, the

process of integration commenced. As early as 1992, free trade agreements between the EU and Eastern European countries were implemented. The creation of the Central European Free Trade Agreement (CEFTA) had two effects. First, the tariffs between CEFTA and EU countries were reduced to zero. Second, the tariffs vis-à-vis the rest of the world was raised (van Tulder 2004a: 84). Trade regulation facilitated the regional division of labour. This process was followed by further harmonisation of technical requirements. From 1993 on, these specifications were uniform for the entire EU.

In contrast to American producers, who had production facilities outside the USA as early as the 1920s and 1930s, European manufacturers were very timid in their regional integration strategies. Although some had production facilities in other parts of the world, there was very limited investment in intraregional division of labour (Freysenet/Lung 2004: 46). German producers built the cars for European markets in Germany, just like French producers or Swedish manufacturers. Although there was a (more or less) integrated European market in the 1970s and 1980s, manufacturers produced exclusively from their national facilities. As late as 1989, most of the European automobile industry's productive base remained concentrated in the manufacturers' country of origin (Freysenet/Lung 2004: 47).

What lessons does the European experience provide for the BRICS countries? In essence, as long as there is no regional economic community, it will be difficult to develop a regional strategy for investment facilitation. But even at an early stage, i.e. an FTA, it is possible to create regional strategies. Considering the changing production patterns, regions trying to attract FDI and – increasingly – retaining investment from domestic players have to identify trade regimes that match the commercial interests of investors. Bluntly put: Cheap, productive labor is no longer sufficient. Even moderate tariffs are a problem – due to the nature of Global Value Chains:

“The longer and more complex the value chain, the more trade costs are amplified as tariffs are levied on the full value of a good at each stage rather than on the value added in the last production stage” (Miroudot et al. 2013, S. 9).

The OECD has analyzed the effects of revisions of the Canadian trade policy – which were specifically targeted at attracting investment. In 2010, Canada eliminated tariffs on a broad range of manufacturing inputs – more than 7 billion C \$ of previously dutiable imports will be tariff-free from next year. Canada is the 1st G 20 economy that does no longer apply tariffs on inputs and imported machinery. Canada implements unilateral trade-liberalization – and the aim is to boost manufacturing.

This approach has several benefits: Firstly, Canadian manufacturers benefit from greater choice of input sources at competitive prices. Domestic suppliers will be exposed to greater competition – and that will result in improved competitiveness of Canadian manufacturers. Secondly, Canadian manufacturers can use inputs from global market leaders, rather than Canadian market leaders. In effect, Canada has become a more attractive location for manufacturing – and that approach can be applied in a regional context as well.

Thus, regional trade agreements can be modified in order to strengthen the competitive position of the region. Following the Canadian example, regions could abolish tariffs on inputs and machinery – strengthening their manufacturers, but of course increasing pressure on existing regional suppliers. Europe and North America have implemented trade policies that cover all significant partners in the value chain – recall the integration of Eastern Europe in car manufacturing. The tool applied are rules of origin, specifically the diagonal cumulation of origin – which I will explain in the next section.

4) What are the specific regional trade policies that would contribute to attracting investment?

After having established more than two dozens FTAs until the mid-1990s, the EU was confronted with a dilemma: Cross-border production was not facilitated – because sourcing inputs from different countries was costly.

Although supporters of bilateral free trade agreements are suggesting that these measures are trade facilitating, in reality this may not always be the case. The main

reason for that is that free trade agreements require the documentation of the origin of a product.

In an entirely open world economy with no restrictions of the flow of goods, rules of origin would not matter because it would be irrelevant where goods originate. Today, however, the origin of a product matters, in particular in preferential agreements. All free trade areas including bilaterals require rules of origin to establish the “nationality” of a product. The reason is that in FTAs participating countries continue to have diverging external tariffs. One country might have a high tariff on, say, cars in order to protect domestic producers, whilst the other might have a low or no tariff on that product. Since only goods produced within the free trade area qualify for duty free trade, there have to be procedures that differentiate between goods produced with the FTA and goods from the rest of the world. The preferential system becomes complicated. Moreover, expensive: On average, the cost of issuing and administering certificates of origin is estimated to be five percent of the value of a product (Dieter 2004: 281; Roberts and Wehrheim 2001: 317).³

Methods for Establishing Origin

First, it is important to understand that there are two categories of certificates of origin, non-preferential and preferential ones. The former are used to differentiate between foreign and domestic products, for instance for statistical purposes, for anti-dumping or countervailing duties or for the application of labelling or marketing requirements (Jakob and Fiebinger 2003: 138). The second type is the one that can distort trade because it provides preferential access to a market.

To begin with, customs regulation does not permit multiple origin of a product. Current customs regulation requires that a single country of origin is established (Jakob and Fiebinger 2003: 138). There are four methods to establish the

³ In NAFTA, the costs of meeting rules of origin requirements have been estimated at two percent of the value of *all* Mexican exports to the United States (Dee 2005: 22).

“nationality” of a product, to establish origin. There is natural origin and origin due to substantial transformation, this category being subdivided into three other forms: a change in the tariff heading, a minimum percentage of value added and specific production processes (Estvadeordal and Suominen 2003). Natural origin (wholly produced or obtained) is the least complicated approach. This applies to raw materials and non-processed agricultural products, i.e. to a relatively small part of international trade.

A change of tariff heading is already much more complicated. The Harmonized System (HS) is a set of regulations that has been agreed upon in the World Customs Organisation (WCO). It consists of 1241 categories on the four-digit level and more than 5000 categories on the six-digit level. If a product receives a different tariff heading after the production process, this can be used to qualify for origin. This method has considerable advantages. It is both transparent and easily established. Using the Harmonized System is simple, easy to implement and causing relatively little cost. The necessary documentation is undemanding. The trouble is that a change of tariff heading does not necessarily constitute a significant step in the production process. Minor changes to a product can lead to a change of tariff heading. Furthermore, if a final product consist of a large number of components, documenting origin becomes complicated, and therefore costly (Woolcock 1996: 200). Therefore, merely requiring a change of tariff heading to establish origin is the exception in FTAs.

The minimum value-added rule is probably the most complicated method to establish origin. Incidentally, it is also the most widely used scheme. A certain percentage of the value of the product has to be produced within the FTA to qualify for duty free trade.

The calculation of minimum value added is difficult and varies between different free trade areas. It also varies between product categories. Furthermore, technical details have to be considered. Which methods to calculate local content are accepted? For

example, are capital costs counted as local content?⁴ If so, up to which percentage? In FTAs between developing and developed countries, the lower wages in the poorer countries ironically result in a disadvantage, because the minimum value added can be reached more easily if wages are higher.

Finally, specific production processes can be identified and agreed upon in order to establish origin. The trouble is that this method both requires complex negotiations on agreed production processes and continuous updating. Due to the changing patterns of production, new forms of production emerge that would constitute substantial transformation, but unless they are listed in the catalogue of agreed production processes, they would not qualify for duty free trade.

Various free trade agreements have demonstrated how complex rules of origin can be. The NAFTA rules of origin cover more than 200 pages. There are byzantine regulations on local content, for instance a 62.5 percent local content requirement for motor cars (for more details Dieter 2004). However, complex rules of origin are not an American speciality. In some FTAs in Asia, rules of origin are just as complex. For example, in the Japan-Singapore Economic Partnership Agreement, the Japanese government insisted on detailed, product-specific rules of origin, which cover 200 out of the 360 pages of the agreement (Ravenhill 2003: 308).

For producers, these rules of origin result in an additional administrative effort rather than a facilitation of trade. An example where this is particularly obvious is the clothing industry in Asia. Today, state-of-the-art production chains need as little as three weeks from sample making to delivery. Production and sourcing processes are divided into up to 10 or 12 stages in various countries. By introducing rules of origin, this model will no longer be manageable due to the complexity of rules of origin (Dee 2005: 39). Of course, one might argue that slowing down the international division of labour is a useful development. That is an entirely different debate: Preferential trade agreements are justified because they are supposed to facilitate trade, rather than obstruct it. On balance, rules and certificates of origin create arbitrary incentives that

⁴ In NAFTA, the cost of capital for machinery can be included (Krueger 1995: 8).

contribute to the rise, not decline, of transaction costs in international trade (Garnaut and Vines 2006: 10).

The cumulation of origin

One of the most important issues for the viability of transnational networks of production is the question whether the cumulation of origin from different FTAs is possible. Cumulation of origin is an important exception from the principle of giving preference only to products produced within an FTA (Jakob and Fiebinger 2003: 144). The underlying question is whether in overlapping FTAs inputs can be sourced from various member countries and still achieve origin.

The European Union has been actively promoting free trade areas both with other European as well as with non-European countries. This has resulted in complicated rules of origin that potentially harm transnational production processes and could reduce the competitiveness of European manufacturers. In Europe, this awareness has led to the Pan European cumulation of origin. In 1997, PANEURO was established, which permits the cumulation of origin between the free trade areas of the EU and the European Free Trade Association (EFTA). PANEURO today covers as many as 50 FTAs (Estevadeordal and Suominen 2003: 16).

What is the cumulation of origin? Bilateral cumulation is the conventional version: It permits the use of intermediate products coming from the other country in an FTA. Diagonal cumulation permits the use of intermediate products from all countries that are participating in the cumulation scheme without risking origin. Diagonal cumulation can also be called the cumulation of origin between free trade areas. Full cumulation of origin is more comprehensive still, because it allows the use of intermediate products from all countries, but this type of cumulation is rare in customs administration (Estevadeordal and Suominen 2003: 5; Priess and Pethke 1997: 782). Full cumulation would dilute any preferential arrangements, because from wherever an input would be sourced, this would count as an input from within the free trade area.

Outside Europe, hitherto there are only limited attempts to permit the diagonal cumulation of origin. But the rapid increase of bilateral and plurilateral free trade agreements calls for a diagonal cumulation of origin, if increasing welfare indeed were the main goal of the free trade agreements. The system of paneuropean cumulation of origin is in principle less protectionist than other systems to obtain domestic origin because it allows the use of inputs from a range of countries without threatening preferential treatment. That approach might be helpful for the network of trade agreements of BRICS countries. A system of cumulation of origin may facilitate investment in a region. Companies would not be limited to source inputs from within a country or a single FTA, but from a large set of economies.

5. Conclusion:

To sum up: production patterns have changed – and so have investment patterns. Economies that wish to participate in cross-border production networks can try to attract investment. Of course, this a dynamic process – and production may be shifted to more competitive production sites unexpectedly. But many countries that have embraced this change have benefitted, e.g. Germany and South Korea.

The European experience underlines the importance of cross-border trade and the advantages of transnational production networks. A prominent example is the case of Audi, which uses its Hungarian plant to produce a labour-intensive part of a car – the engine. This relocation of an important part of the manufacturing process has resulted in substantial job creation in Hungary. It has not, however, led to dramatic job losses in Germany, but instead may have contributed to the stabilisation of employment in the German plants of Audi. Since a major component can be sourced from a relatively low-cost production site, the company is quite able to compete on price, which would have been more difficult without the relocation of the engine production.

This structural change can be witnessed in the entire European car industry. Beyond the examples analysed in this report, there is more evidence when looking at other manufacturers. Take Volkswagen and Porsche, who relocated the body manufacturing of their sports-utility-vehicles (VW Touareg and Porsche Cayenne) to

Slovakia. In the case of Porsche, the final assembly still takes place in Germany, but a significant proportion of the value-added is created in Slovakia.

Whilst these examples are just the more prominent ones, they demonstrate the usefulness of a single regulatory sphere for efficiency and competitiveness. The European Union – having achieved a single market – enables companies to source inputs from a range of countries without having to consider the origin of the product. Furthermore, the relocation of production to low-cost countries in Eastern Europe has enabled manufacturers – not just in the car industry – to improve their competitive position. Nevertheless, Europe has an additional advantage, which is the possibility to source inputs from many other associated countries organised in the PanEuro scheme. With that diagonal cumulation of origin, European manufacturers can buy inputs from non-EU countries, e.g. Switzerland Turkey, and still have all advantages unrestricted trade flows with relatively little administrative burden.

Rules of origin and their application have to be taken into consideration when evaluating the usefulness of free trade areas. They make transnational production processes more complicated, if not impossible. The inherent need for documentation of the production process is resulting in additional bureaucratic procedures. Rules of origin may contribute to trade diversion, because manufacturers may use the cheapest supplier from within the free trade area rather than the cheapest supplier worldwide. Trade policy therefore has the ability to attract investment, both from domestic as well as from foreign investors. Zero tariffs on inputs as well as the cumulation of origin may be the tools that could be applied.

The political bottom line is simple: Countries have a choice, and they should ask themselves whether they wish to expose themselves to tough global competition or whether they prefer to shed some economic benefits in order to enjoy greater “policy space”.

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