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How do Rules of Origin Affect Investment Flows? Some Hypotheses and the Case of Mexico

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HOW DO RULES OF ORIGIN AFFECT INVESTMENT FLOWS? SOME HYPOTHESES AND THE CASE OF MEXICO

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The proliferation of free trade agreements around the world has accentuated the role of preferential rules of origin (RoO) in global companies' sourcing and investment decisions. However, there are few theoretical and practically no empirical analyses on the effects of RoO on foreign direct investment (FDI). This paper strives to shed light on the relationship between RoO and FDI. We put forth a set of hypotheses on the impact of RoO on FDI, and perform an empirical exercise on the effects of RoO of the North American Free Trade Agreement (NAFTA) on FDI in 122 Mexican manufacturing industries 1994-2000. The findings indicate that NAFTA RoO have played a central role in foreign investors' cost assessments of locating production to Mexico, and that FDI in post-NAFTA Mexico has flowed in sectors with flexible RoO. This suggests that NAFTA-era investment in Mexican final and intermediate goods industries has been made by efficient, globally competitive firms that thrive on flexible RoO.

I. INTRODUCTION

Rules of origin (RoO) are a powerful trade policy instrument arbitrating firms' sourcing and investment decisions around the world. However, the effects of RoO on investment flows have received scant empirical attention. Indeed, the notion that RoO could independently affect foreign direct investment (FDI) is relatively new even in the theoretical realm (Rodriguez [2001]). The purpose of this paper is to start mending this gap. We develop hypotheses on the potential effects of the restrictiveness of RoO on FDI, and conduct a preliminary empirical exercise on the impact of product-specific RoO of the North American Free Trade Agreement (NAFTA) on FDI in 122 manufacturing industries in Mexico in 1994-2000.

The main notion emerging from this paper is that both restrictive and flexible RoO can attract investment. Restrictive RoO -RoO that compel producers to obtain inputs or carry out production processes within the preferential trading arrangement (PTA) rather than from the globally most efficient source- can encourage investment in particularly upstream sectors and protectionist downstream sectors, while flexible RoO can attract FDI in globalized sectors -sectors where producers rely or expect to rely on genuinely global sourcing strategies-. Our empirical results indicate that NAFTA RoO have played a central role in foreign investors' cost assessment of locating production to Mexico, and that FDI in post-NAFTA Mexico has flowed in sectors with flexible RoO. However, we also find that flexible RoO in downstream industries encourage investment upstream. Both findings suggest that NAFTA-era investment in Mexican final and intermediate goods industries has been made by efficient, globally competitive firms thriving on flexible RoO.

This study focuses on the investment effects of RoO, a market access discipline included in virtually all PTAs. There are no comparable empirical studies. Also theoretical treatments are very limited. Rodriguez [2001], focusing on content protection, the domestic analogue of preferential RoO, shows restrictive RoO can lead to an inefficient relocation of production among the PTA partners.

Besides pioneering in exploring the RoO-FDI nexus, this study strives to foster the incipient understanding of the relationship between FDI and trade disciplines embedded in PTAs. Indeed, one of the key motivations for especially developing countries to form and join PTAs has been to attract FDI. Some ways in which PTAs can spur investment include greater competition, new opportunities for exploiting scale economies, and dynamic effects, such as permanent growth once the initial efficiency and output gains increase factor rewards.¹ However, the bulk of empirical works on PTAs and FDI has centered on assessing aggregate pre- and post-PTA flows and analyzing the PTA area as whole.² Few analysts have (1) examined the cross-sectoral variation in FDI flows in PTA members once the PTA has been set in motion; or (2) considered the effects of PTAs on FDI in the individual PTA partner countries.³ This study strives to accomplish both tasks by focusing on Mexico, a NAFTA member, employing industry-level data on FDI flows, and operationalizing the actual contractual provisions of PTAs -RoO, preferential

¹ See, for example, Eden [2001], World Bank [2000], Blomström and Kokko [1997], and Baldwin [1989]. To be sure, FDI can also be seen as exogenous to economic growth in the PTA market and thus to subsequent FDI in the sense of generating spillover effects, such as technology diffusion, technical assistance, and training (Blomström and Kokko [1997] p. 13). As such, a virtuous cycle of FDI and growth can result (Baldwin [1989]). World Bank ([2000] pp. 38-39) notes that tariff-jumping FDI can reduce real incomes -even though most usually, the benefits of FDI outweigh the costs, and FDI can be expected to stimulate local production in related industries, technology transfer, productivity in neighboring firms, exports, and incomes-.

² The existing theories have yielded few conclusive predictions about the relationship between PTAs and FDI, while the existing empirical works have offered mixed results. See, for example, Behrman [1972] on the Latin American Free Trade Agreement; Mytelka [1979] on the Andean Community (*Comunidad Andina de Naciones - CAN*); Bulmer-Thomas [1982] on the Central American Common Market (*Mercado Común Centroamericano - MCCA*); Chudnovsky [2001] on the Southern Common Market (*Mercado Común del Sur - MERCOSUR*); and Winters [1996], Balasubramanyam and Greenway [1992], Dunning [1992], Molle and Morsnik [1991], Thomasen and Nicolaidis [1991], Lipsey [1990], Pelkmans [1984], Mayes [1983], O'Farrell [1983], Franko [1976] on the European Community (EC).

³ In the case of Mexico, Waldkirch [2002] finds that had NAFTA not been formed, intra-regional FDI flows would have been 42 percent lower between 1994 and the end of 1999. World Bank [2000] speculates that extra-regional investors may have redirected part of their FDI from the US and Canada to Mexico following NAFTA's implementation. Blomström and Kokko [1997] argue, albeit without presenting empirical evidence, that the agreement has been instrumental in inducing extra-regional investors to move to Mexico in order to enjoy preferential access to the North American market. Blomström, Kokko and Gliberman [1998] posit that it is not possible to conclude that there has been an intensification of either intra or extra-regional FDI in Mexico since NAFTA. Eden [2001] discerns the impact of NAFTA from qualitative changes in firm behavior: the agreement has made North America a single spatial unit, resulting in locational reshuffling and integration of the three countries' industries into regional production networks, particularly in the automotive sector. NAFTA's predecessor, the 1989 Canada-US Free Trade Agreement (CUSFTA), is seen as having had relatively little influence on FDI patterns in Canada, mainly because much of the trade between Canada and the United States had been liberalized long before the CUSFTA was established (Blomström and Kokko [1997]). Also the impact of NAFTA on the US and Canada in terms of FDI is judged as being rather neutral, as most effects should have taken place since the CUSFTA (Rugman and Gerstin [1993]). Little [1996] finds that US and Canadian firms tend to rely on trade rather than on FDI to serve the binational market. However, Hanson [1996] finds that NAFTA has influenced the relocation of US manufacturing production to the US-Mexico border region, particularly in cases where transportation costs play a central role in considerations of industry location. Hanson [1998] finds a similar pattern of relocation in Mexico to the northern border. The International Trade Commission (ITC) [1997] concludes that production sharing along the US-Mexican border would continue to expand due to the complementarities of the US and Mexican economies.

tariffs, and rules governing foreign entry-.⁴ By disaggregating a PTA into its component parts, we strive to help disentangle the investment effects of the various PTA provisions from each other, as well as from the manifold competing explanations beyond PTAs, such as comparative advantages of the FDI target country. As such, our findings are not limited to those on RoO alone; we also encounter evidence that both preferential tariffs and limits on investment permitted under NAFTA have the expected and significant effect on the patterns of FDI -a result that can have immediate implications to the design of PTAs-.

The second section of this paper discusses the potential effects of RoO on FDI. The third section reviews the patterns of sectoral FDI flows in Mexico during the first seven years of NAFTA, explores the structure of our key independent variable, NAFTA RoO, and puts forth the empirical specifications. Section four concludes.

⁴ PTAs can also foster the odds for FDI inflows by helping to enhance domestic policy credibility in the member countries. Indeed, whereas the proliferating Bilateral Investment Treaties (BITs) tend to contribute to negative integration -they preclude certain policies that would discriminate against investment, rather than requiring policies that encourage investment- PTAs hold the potential to motivate investment by seeking to create a more predictable policy environment for foreign investors and by adding credibility to government policies (Winters [2000] pp. 5-6). The case is seen as accentuated in North-South PTAs when the Northern country is willing and able to enforce investment-encouraging club-rules (Winters [2000] p. 6). FDI inflows could also receive a boost should the PTA institutionalize or lock-in the elimination of trade-related investment measures (TRIMs) -requirements on foreign affiliates to satisfy certain export targets- or guarantee strong investor property rights that reduce the risk of expropriation (Blomström and Kokko [1997] p. 9).

II. RoO AND FDI: IS THERE A CONNECTION?

Do rules of origin help arbitrate FDI flows? There are at least three reasons to believe so.

First, there are two ways in which restrictive RoO in particular can work to boost investment. For one, entailing a high share of the cost of production that has to arise within the PTA area, stringent RoO can lock final goods producers into obtaining supplies and/or performing production processes within the PTA even if supplies and production in the rest of the world (ROW) were cheaper. As such, demanding RoO downstream provides PTA-based intermediate goods producers a specter of higher rents, which, in turn, should attract foreign intermediate producers to locate to the PTA area.

Moreover, by requiring a certain cost share of the final good to rise within the PTA, RoO can alter the margins of comparative advantage between a PTA member and a non-member, in essence expanding the *range* of intermediate goods produced (and/or production processes carried out) in the PTA -and do so even if the PTA area were not the globally most efficient location of production (Rodriguez [2001])- . Thus, FDI can also flow to "new" intermediate industries -industries in which the PTA partners do not have a comparative advantage in the non-PTA equilibrium-. In short, RoO can induce both more and a wider rangel of intermediates to be produced (or production process to be performed) within the PTA, which, in turn, can be expected to attract investment in intermediate industries.⁵

However and second, it could be expected that flexible, non-binding RoO⁶ are conducive to investment in downstream industries that procure inputs from around the world (and strive to qualify for the PTA-conferred preferences). Investors in these industries would likely favor flexible RoO even if intra-PTA suppliers were relatively efficient in order to hedge against future increases in the relative cost of intra-PTA supplies and/or unforeseen inadequacies in intra-PTA production technologies.⁷ The attraction of flexible RoO is accentuated (1) in sectors where the linkages between different stages of production in the industry are tight, so that downstream producers with global sourcing and production links would be hard-pressed to locate appropriate components, identify appropriate input producers, and/or forge new contracts in the PTA area even if they did locate there;⁸ and (2) in sectors where the production chain cannot be conveniently sliced up so as

⁵ This implies that RoO would cause intermediate industries to migrate from non-member countries to the Free Trade Agreement (FTA) area, shift the margin of comparative advantage between the FTA members and non-members, and thus have direct implications to non-member countries (Rodriguez [2001]).

⁶ We follow Krishna [2004] in defining as binding those RoO that render the choice of inputs different from the non-RoO unconstrained equilibrium. Binding RoO thus imply additional costs to the consumers of the inputs.

⁷ See Suominen [2004ab] for the policy preferences of import and export-competing up and downstream producers over RoO.

⁸ See, for instance, Krueger [1993], Krishna and Krueger [1995], and Bond [2001]. The specialization of inputs to the needs of the final goods producer creates a bilateral monopoly problem and the potential for opportunism when contracts between the parties are incomplete and when the parties are not tied by a vertically integrated firm. Even if intra and extra-PTA supplies were compatible, switching suppliers involves a time lag in the presence of contractual obligations. De Silanes, Rutherford and Markusen [1994] show that when foreign firms in a PTA area rely on imported inputs more than domestic industries do, RoO can reduce output and shift profits to domestic firms.

to enable allocating production within and without the PTA area in a cost-efficient manner -i.e., to move to the PTA area only the part of operations that allows for meeting the RoO-.

Firms that have or plan to establish extensive sourcing and production links in extra-PTA countries are likely deterred from investing in the PTA area in the presence of stringent RoO. However, stringent RoO can encourage "RoO-jumping" investment -investment diversion to the PTA area that is made in order to circumvent the RoO altogether-. Investors may simply choose to locate in the territory of the PTA partner where they can obtain the highest rents and service the market from within, rather than paying the high compliance costs of RoO that would be incurred when exporting to that market from the other PTA members under the PTA preferences. As such, stringent RoO can boost FDI inflows to the PTA and the main PTA market, in particular. When compliance costs are high, the RoO-jumping investor would have a cost advantage *vis-à-vis* producers located in the other PTA partners, *ceteris paribus*.

Much like an upstream investor that has an interest in the RoO governing downstream industries, a potential downstream investor may consider RoO "upstream". For one, restrictive RoO in the upstream industries that supply the downstream industry might signal to the downstream investor the presence of an uncompetitive upstream provider that itself is unable to access cheap inputs from ROW. Furthermore, downstream investors may see stringent RoO upstream as a proxy for high external tariffs in upstream industries -which is an additional signal of the existence of inefficient supplier and which would further complicate the downstream investors' possibilities for tapping into cheap and efficient supplies outside the PTA area-. In short, downstream industries would have incentives to invest in the PTA when the RoO governing their industry and the upstream industries that supply them are flexible.

Third, flexible, non-binding RoO are not necessarily conducive to FDI among all downstream investors. Consider downstream producers that have important existing intra-PTA links and are not globally the most competitive ones, yet intent on exporting within the PTA area. Such producers might be attracted by RoO that are flexible enough to accommodate any of their existing extra-PTA supply links, yet restrictive enough to bar more competitive ROW downstream producers from immediately meeting the RoO and thus qualifying for the PTA-conferred preferences. In the presence of such RoO, ROW downstream producers would need to switch to intra-PTA input sources in order to obtain the PTA-provided preferential treatment: they would incur the costs beyond the increased cost of inputs, namely the costs of locating suppliers with appropriate components and of altering production techniques to meet the RoO, assuming that intra and extra-PTA inputs are not perfect substitutes.⁹ Sufficiently stringent RoO can thus provide downstream producers that are not globally the most competitive ones an edge over their more competitive ROW counterparts in exporting from one PTA partner to another. As such, RoO that are restrictive enough to bar the entry of globalized producers could boost investment by some downstream producers.

⁹ This assumes that intermediate and final goods producers are two separate, competitive firms engaged in arms-length transactions with each other. The costs of inputs and the attendant bilateral monopoly problems will be reduced should the input and the final good be produced within a vertically integrated firm. In the presence of specialized production ties and/or vertical integration, RoO can raise the costs for the downstream producer's rivals.

In sum, there are a number of ways in which product-specific RoO can arbitrate the incentives to invest in the PTA. However, it is hardly clear whether restrictive RoO are more conducive to FDI than loose RoO are. There are five further considerations that obscure the effect of product-specific RoO on FDI.

1) Most PTAs carry regime-wide RoO, such as cumulation and de *minimis*, that can ameliorate or accentuate the degree of restrictiveness of product-specific RoO (Suominen [2004a] and Estevadeordal and Suominen [2006a]). Capturing the effects of regime-wide RoO on FDI would inherently require a multi-PTA analysis.

2) The incentives generated by RoO are filtered through firm-level factors, such as the downstream producer's geography of pre-existing sourcing and production linkages -which, after all, determine whether RoO are binding or not- and the completeness and duration of the existing contracts between the producer and its input suppliers.¹⁰

3) The depth of the tariff preferences can arbitrate RoO's investment effects.¹¹ If and when the benefits of the "carrot" of preferential market access exceeds the costs of the "stick" of having to comply with the RoO -incur higher production and administrative costs- a firm with pre-PTA sourcing and/or production ties outside the PTA will post-PTA have incentives to shift its operations to the PTA area to source intermediate goods from and/or to perform RoO regime-mandated production processes there, and to subsequently serve the entire PTA market by exporting under the preferential regime. In other words, the higher the payoff of qualifying for preferential treatment, the greater the incentives for firms to adjust the geography of their production processes in order to meet the RoO even if such an adjustment implied inefficiencies and raised their costs of production from the pre-PTA equilibrium.¹² By definition, this payoff has to be higher than that obtained by exporting to the PTA market under the partners' MFN regimes.¹³

4) RoO are an endogenous instrument: particularly firms operating in the forthcoming PTA area can play an important role in designing the RoO regime. This implies that the restrictiveness of the resulting RoO for such firms may be immaterial. Endogeneity of RoO can also mean that RoO-jumping investment remains deterred: as hypothesized in the literature on endogenous tariffs, intra-PTA firms threatened by extra-PTA FDI flows may moderate their demands for restrictive RoO in order to keep RoO-jumping FDI at bay.

5) In the longer-term, the interplay of intermediate and final goods markets can alter the prices of intra-PTA inputs and/or production processes, changing the incentives for investment. For instance, any RoO-induced inflows of FDI in intermediates could eventually crowd out the

¹⁰ See Thoenig and Verdier (2006) for a nuanced pioneering treatment.

¹¹ See Krishna [2004] and Ju and Krishna [1998] for theoretical treatments of the long-term effects of RoO.

¹² This is a particularly feasible strategy for firms that are engaged in easily divisible multistage production, and that are able to quickly terminate their contracts with the existing extra-FTA suppliers. RoO can induce a greater range of production processes for final goods to be diverted to the FTA than is the case in the pre-FTA equilibrium.

¹³ Indeed, given that RoO hold the potential of increasing local sourcing, governments can use RoO to encourage investment in certain strategic or high-value sectors -for instance in order to create lucrative jobs (Jensen-Moran [1996]; Hirsch [2002])-.

market for inputs, and, as such, reduce the possibilities of extracting surplus in intermediate production and reverse the prior incentives for both up- and downstream producers to invest in the PTA area. Or, increases in production costs entailed by stringent RoO can reduce the final goods producers' derived demand for intermediates, undermining the price of intermediates and again discouraging investment in the intermediate goods industries, while encouraging intra-PTA final goods production.

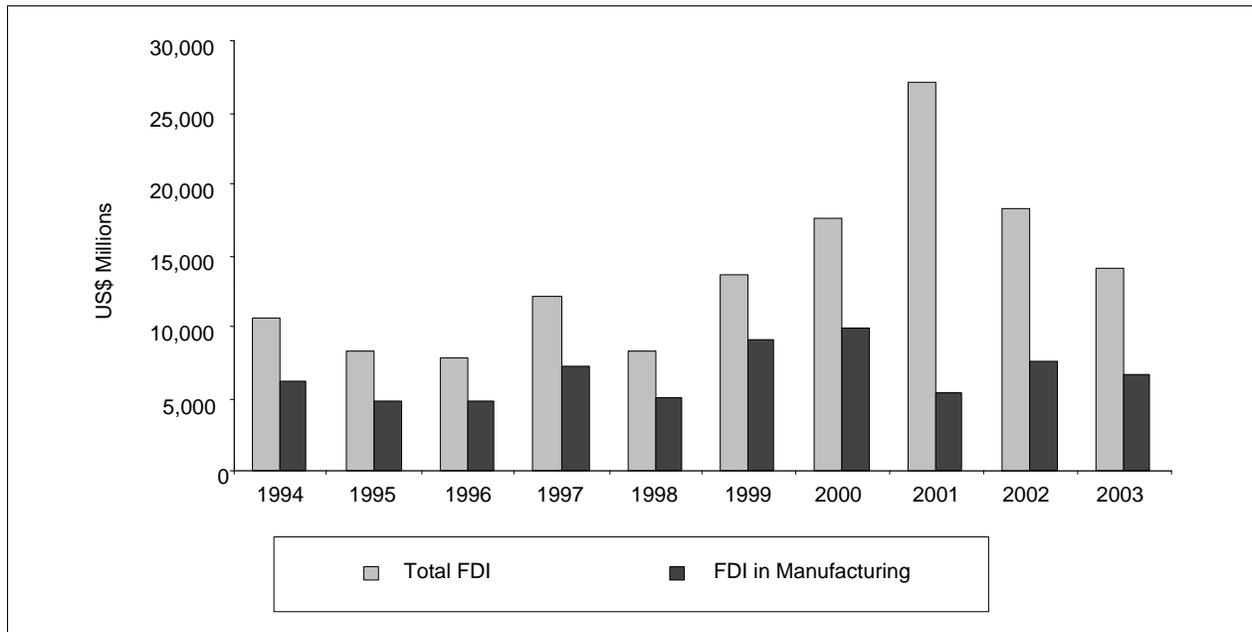
III. EFFECTS OF RoO ON FDI: THE CASE OF MEXICO

That there are multiple equilibria in the presence of RoO relegates the relationship between RoO and FDI to an empirical matter. This section conducts an empirical investigation of the role of NAFTA RoO in the location of FDI in Mexican manufacturing industries. The first part discusses the cross-sectoral variation in FDI in Mexico. The second part specifies the construction of the independent variable, restrictiveness of RoO, while the third part puts forth the empirical specification, and discusses the results.

A. FDI Flows in Mexico in the NAFTA Era: Industry-Level Data

Mexico has experienced impressive increases in the inflows of FDI in the wake of the formation of NAFTA in 1994 (Figure 1). According to the Ministry of the Economy, aggregate flows shot up from an annual average of US\$ 4.6 billion in 1989-1993 to US\$ 10.7 billion in 1994 and further to US\$ 12.2 billion in 1997, reaching US\$ 26.6 billion in 2001. The inflows leveled off in 2002 to US\$ 13.3 billion; the estimated total in 2003 was US\$ 9.4 billion. In 1994-2000, manufacturing inflows accounted for more than a half of FDI each year; however, the share of manufacturing of the total has been less pronounced in the 2001-2003 period. The main source of investment in the Mexican manufacturing sector is the US, followed by the European Union, Canada, and Japan. The share of the US and Canada, Mexico's NAFTA partners, of total FDI in Mexico rose from 54% in 1994 to 80% in 2001, leveling off somewhat to 63% in 2002 and 54% in 2003.

FIGURE 1
TOTAL AND MANUFACTURING FDI FLOWS TO MEXICO, 1994-2003



Source: Ministry of the Economy, Mexico.

However, the distribution of FDI in the Mexican manufacturing sector has hardly been uniform. Table 1 presents the sectoral breakdown on investment flows in Mexican manufacturing sector in the period examined in this paper, 1994-2000, by the Division of the International Standard Industrial Classification (ISIC) Revision 3 classification. We focus on this period because a change in 1994 in the Mexican classification system to exclude all intended investment from FDI data undercuts the compatibility between FDI data before and after that year. The highest average annual growth rates are in tobacco, wood, non-metallic mineral products, publishing and printing, leather goods and footwear, and office machinery. Tobacco, office machinery, publishing and printing, fabricated metal products, machinery and equipment, and apparel top the list for greatest increases in FDI inflows from the 1994 level to 2000.

TABLE 1
FDI FLOWS TO MEXICAN MANUFACTURING INDUSTRIES, 1994-2000
(in thousands of US\$)

Division	Description	Total FDI 94-00	Share of Total (%)	Annual Avg. Change (%)	Change 94-00 (%)
15	Food and beverages	5,855,000	11.5	-8.6	-44.3
16	Tobacco products	3,260,941	7.4	256741.8	9835.7
17	Textiles	1,165,000	2.3	28.5	-12.0
18	Wearing apparel	815,000	1.7	35.3	207.8
19	Leather goods and footwear	86,461	0.2	149.4	-88.2
20	Wood and wood products	56,199	0.1	366.2	-114.0
21	Paper and paper products	700,600	1.4	73.2	54.5
22	Publishing, printing, reproduction of recorded media	327,890	0.6	241.3	411.3
23	Coke, refined petroleum products, nuclear fuel	247,742	0.6	42.3	-97.6
24	Chemicals and chemical products	4,712,000	10.4	47.3	-56.9
25	Rubber and plastics products	1,511,100	3.0	25.3	150.9
26	Other non-metallic mineral products	653,443	1.3	242.1	140.4
27	Basic metals	2,454,900	5.1	49.0	-78.9
28	Fabricated metal products	1,114,400	2.1	37.1	311.3
29	Machinery and equipment	3,051,000	5.8	32.7	247.8
30	Office and computing machinery	2,028,900	3.5	106.3	1817.9
31	Electrical machinery and apparatus	4,520,000	9.1	23.3	69.0
32	Radio, TV, communication equipment	4,013,000	8.6	50.8	49.2
33	Medical and optical instruments	300,900	0.6	19.9	15.8
34	Motor vehicles, trailers, semi-trailers	8,829,000	17.3	53.1	65.0
35	Other transport equipment	105,900	0.2	-10.0	-100.0
36	Furniture; misc. manufacturing	3,823,000	7.4	51.0	356.9

Source: Authors' calculations based on data by the Ministry of the Economy, Mexico.

B. NAFTA RoO

The NAFTA RoO regime is among the most complex RoO regimes in the world. While the majority of the tariff lines in NAFTA are governed by the change in chapter and change in heading rules, the agreement incorporates no fewer than 19 different RoO combinations in the 6-digit tariff universe of the Harmonized System (HS) (Estevadeordal, Suominen [2005, 2006a]). The greatest variation in RoO types takes place in the manufacturing sector.

TABLE 2
RESTRICTIVENESS OF RoO IN NAFTA, BY ISIC DIVISION

Division	Description	ROORI	ROORI down	ROORI up
15	Food and beverages	5.47	4.78	5.78
16	Tobacco products	6.00	0.00	5.67
17	Textiles	6.07	5.89	5.37
18	Wearing apparel	5.44	5.83	5.38
19	Leather goods and footwear	5.40	6.28	5.56
20	Wood and wood products	4.13	4.99	4.89
21	Paper and paper products	4.69	5.64	5.30
22	Publishing, printing, reproduction of recorded media	5.00	4.89	5.05
23	Coke, refined petroleum products, nuclear fuel	4.00	5.19	5.02
24	Chemicals and chemical products	5.02	5.32	4.95
25	Rubber and plastics products	4.46	5.10	5.46
26	Other non-metallic mineral products	5.61	5.14	5.59
27	Basic metals	4.84	4.82	5.30
28	Fabricated metal products	4.54	4.88	4.85
29	Machinery and equipment	4.14	4.77	4.72
30	Office and computing machinery	3.78	4.80	4.92
31	Electrical machinery and apparatus	4.35	4.49	4.90
32	Radio, TV, communications equipment	2.39	4.62	4.91
33	Medical and optical instruments	4.32	5.14	5.00
34	Motor vehicles, trailers, semi-trailers	4.51	4.99	4.78
35	Other transport equipment	4.15	4.72	4.64
36	Furniture; misc. manufacturing	5.50	5.07	4.90
<i>Average</i>		<i>4.81</i>	<i>5.00</i>	<i>5.13</i>
<i>Complexity (Standard Dev.)</i>		<i>0.99</i>	<i>0.95</i>	<i>0.43</i>

Source: Authors' calculations.

Have NAFTA RoO arbitrated the location of FDI flows in the Mexican manufacturing sector? This paper strives to answer the question by operationalizing NAFTA's product specific RoO. We employ Estevadeordal's [2000] categorical index for the restrictiveness of RoO that ranges from 1 (least restrictive) to 7 (most restrictive).¹⁴ The index can be conceptualized as an indicator of how

¹⁴ See Estevadeordal and Suominen [2006a] for the observation rule and the behavior of restrictiveness values in the HS tariff universe governed by NAFTA.

demanding a given RoO is for an exporter. The restrictiveness values are here coded at the HS 6-digit level of disaggregation, and subsequently aggregated to the 4-digit level of the ISIC Rev. 3 classification by taking simple averages. We employ the Mexican input-output table to calculate the restrictiveness of RoO also in up- and downstream industries. Table 2 summarizes the sectoral restrictiveness values of the three key independent variables by ISIC Division.¹⁵

C. Empirical Specification

This section explores the relationship between NAFTA RoO and FDI in Mexico at the 4-digit level disaggregation through estimating the following equation in OLS:

[1]

$$\ln(FDI_{it}^{MX}) = \beta_0 + \beta_1 \ln(Tariff_{it}^{MX}) + \beta_2 (FDI_Global_i^{US}) + \beta_3 (Salary_Dum2_i^{MX}) + \beta_4 (Salary_Dum3_i^{MX}) + \beta_5 (Preference_{it}^{US}) + \beta_6 (FDI_cap_i^{MX}) + \beta_7 \ln(ROORI_i) + \varepsilon_{it}$$

where:

$\ln(FDI_{it}^{MX})$ is the log of FDI flows in Mexico in industry I in time t;

$Tariff_{it}^{MX}$ is Mexico's weighted average of the tariff in Mexico's FTAs and Mexico tariff applied on-FTA partners;

$\ln(FDI_Global_i^{US})$ is the log of US FDI flows to the world;

$Salary_Dum2_i^{MX}$ is a dummy variable for the second tercile of salary levels in Mexico, as measured as level of remunerations/number of workers;

$Salary_Dum3_i^{MX}$ is dummy variable for the highest tercile of salary levels in Mexico;

$Preference_{it}^{US}$ is the preferential margin offered by US to Mexico, and expressed as the absolute difference between US tariff to the rest of the world and US preferential tariff to Mexico;

$FDI_cap_i^{MX}$ is Mexico's imposed ceiling on sectoral FDI inflows under NAFTA, and expressed as the percentage of ownership allowed in a sector by foreign investors;

$\ln(ROORI_i)$ is the log of RoO restrictiveness, and takes values between 1 and 7;

and ε is a normally-distributed error term.

All regressions include year dummies. The data on FDI flows into Mexico come from Mexico's Ministry of the Economy at the 6-digit level of the Mexican Classification of activities and products (CMAP - *Clasificación Mexicana de Actividades y Productos*), and are deflated by using the US consumer price index. Data on Mexico's external tariff are calculated on the basis of Ministry of the Economy data at the 6-digit level CMAP. US FDI flows to the world are at 3-digit level US SIC classification and come from US Bureau of Economic Analysis. Mexican salary levels are obtained from the 1994 census of Mexico's *Instituto Nacional de Estadística Geografía e Informática (INEGI)*. US preferential margin is from US ITC 8-digit level HS data. Mexico's

¹⁵ The average and standard deviation values at the bottom of the table are based on calculations at the 4-digit level.

cap on incoming FDI is obtained from the NAFTA text. All variables are converted into 4-digit level ISIC Rev.3 classification by using United Nations correspondence tables.

The main interest here is on the effect that RoO may have on FDI flows. We control for several other factors that can influence FDI. (1) FDI may simply have been of tariff-jumping kind, flowing into industries where Mexico's most favored nation (MFN) tariff is high.¹⁶ (2) The location of FDI in Mexico may simply have followed the global patterns in FDI flows, proxied here by the sectoral FDI outflows from the US to the world. (3) FDI flows may have been of efficiency-seeking kind, flowing to industries where Mexico has a comparative advantage -in labor-intensive, low-wage industries, such as apparel production-.¹⁷ (4) A wide preferential margin by the US to Mexico under NAFTA can be expected to have induced industries to locate in Mexico in order to use Mexico as the export platform to the US market. (5) A low ceiling on the level of permitted FDI inflows into Mexico could be expected to dampen FDI.¹⁸

Table 3 shows the results. The results in columns I and II indicate that NAFTA has indeed played a central role in arbitrating the location of FDI in Mexico: investment has been drawn to sectors enjoying deep preferences by the US and few Mexican restrictions on foreign investment under NAFTA. Meanwhile, the key independent variable, the restrictiveness of NAFTA RoO, enters with a negative and significant sign. This is the first main result of this paper: *restrictive NAFTA RoO appear to have discouraged FDI in Mexico*. This suggests that FDI in Mexico has flown to sectors that allow for flexibility in sourcing patterns, rather than tying the investors to purchasing intermediates and/or performing production processes in the NAFTA region. Should flexible RoO be attractive to globally integrated industries in particular, the result could be interpreted to mean that it is globalized producers that have entered Mexico in NAFTA's early years. This

¹⁶ The most traditional explanation is that FDI is tariff-jumping: Multinational Corporations (MNCs) move to produce in host in order to avert the high tariff and to service the host market directly from within. FDI would thus flow to industries most protected by tariffs, with trade and capital mobility becoming substitutes (Mundell [1957] pp. 321-335; Corden [1967] pp. 209-232; Johnson [1967] pp. 151-154; Brecher and Díaz [1977] pp. 317-322; Bhagwati and Brecher [1980] pp. 103-115; Bhagwati and Tironi [1980] pp. 71-84). Trade liberalization in the host would increase the incentives to export from home rather than servicing host market through FDI: production would consequently become centralized in the home market (Rugman and Gestrin [1993] pp. 18-29).

¹⁷ In the case of intra-regional investment, this assumes trade and investment are complementary, rather than substitutes -or that FDI is efficiency-seeking rather than tariff-jumping type, and thus geared to producing at lower costs in host in order to export subsequently to third markets-. Under this expectation, FDI flows to industries with low production costs and, should intermediate products need to be imported to host from abroad, with low barriers to trade in intermediates. As such, trade and investment would be complementary -a view shared in a growing body of theoretical and empirical literature (Swedenborg [1979]; Lipsey and Swedenborg [1981]; Donnefeld and Weber [2001]; Baldwin and Ottaviano [2001])- . These findings have been found to hold even at the firm-level (Blomstrom *et al.* [1998]; Ries and Head [1999]) and product-level (Blonigen [2000]). Moreover, there is not only a correlation between FDI and exports of investor countries to host countries, but also with exports from host countries to investor ones (Gundlach and Nunnenkamp 1996).

¹⁸ Mexico's 1993 Foreign Investment Law (FIL) is inseparable from NAFTA: it was adopted on 27 December 1993, only five days before NAFTA's entry into force, as part of the legislation required to implement Mexico's NAFTA commitments. Conversely, Mexico incorporated in NAFTA Annexes I-III the reservations of FIL *vis-à-vis* foreign investment (and, in particular, investment provisions pertaining to national treatment, most-favored-nation treatment, performance requirements, and senior management and board of directors) that corresponded to the reservations. As such, NAFTA and FIL are highly compatible: the exceptions to national treatment under the two instruments are the same, as are the thresholds for foreigners to acquire Mexican enterprises; investors responding to the FIL automatically responded to the incentives of NAFTA and *vice versa*. The only difference is that under FIL, the actual monetary threshold will be determined annually by the National Foreign Investment Commission.

interpretation is all the more compelling given that Mexico's tariff to the world has little effect on FDI flows: FDI does not appear to have been geared to jump either RoO or tariffs.¹⁹

TABLE 3
RESTRICTIVENESS OF RoO AND FDI IN MEXICAN MANUFACTURING SECTORS 1994-2000

Independent Variables	Dependent Variable: ln(FDI)				
	I	II	III	IV	V
	94-00	94-00	IV 94-00	94-00	IV 94-00
Mexico's Tariff World	-0.015 (1.690)	-0.006 (0.610)	-0.003 (0.250)	-0.005 (0.560)	-0.003 (0.270)
ln(US FDI to World)	0.588 (5.620)**	0.540 (5.210)**	0.515 (4.930)**	0.543 (5.240)**	0.519 (4.960)**
Salary Tercile 2 (1 = yes, 0 = no)	0.313 (1.010)	0.496 (1.610)	0.406 (1.310)	0.506 (1.640)	0.417 (1.340)
Salary Tercile 3 (1 = yes, 0 = no)	1.720 (6.140)**	2.042 (7.080)**	2.077 (7.170)**	2.052 (7.110)**	2.087 (7.210)**
Preferential Margin, US to Mexico	0.096 (1.930)	0.127 (2.550)*	0.065 (1.180)	0.129 (2.580)*	0.066 (1.200)
Mexico's Cap on FDI in NAFTA	0.048 (2.360)*	0.032 (1.600)*	0.032 (1.550)	0.032 (1.560)	0.031 (1.510)
ln(Restrictiveness of RoO)		-2.110 (3.770)**	-2.125 (3.700)**	-0.838 (0.650)	-0.857 (0.660)
ln(Restrict)* 1995				-2.166 (1.200)	-0.660 (1.230)
ln(Restrict)* 1996				-1.005 (0.550)	-1.036 (0.570)
ln(Restrict)* 1997				-0.146 (0.080)	-0.189 (0.100)
ln(Restrict)* 1998				-3.751 (2.090)*	-3.727 (2.070)*
ln(Restrict)* 1999				-0.985 (0.540)	-0.886 (0.480)
ln(Restrict)* 2000				-0.827 (0.430)	-0.723 (0.380)
Constant	2.104	7.138	7.638	5.196	5.700

¹⁹ The result could well be different for FDI located in the US, the largest NAFTA market.

TABLE 3 (continued)

Independent Variables	Dependent Variable: ln(FDI)				
	I	II	III	IV	V
	94-00	94-00	IV 94-00	94-00	IV 94-00
	(0.840)	(2.550)*	(2.710)**	(1.560)	(1.700)
Observations	439	439	439	439	439
Adjusted R-squared	0.250	0.270	0.270	0.270	0.270

Notes: Absolute value of t statistics in parentheses.

* significant at 5%.

** significant at 1%.

All regressions include year dummies.

IV regressions: instrumenting Mexican tariff and US preferential margin.

Source: Author's calculations.

The other control variables shed further light on the pattern of FDI. The positive and significant sign on US FDI to the world indicates that the trends in Mexico form part of a broader global pattern of the sectoral distribution of FDI. Meanwhile, the positive and significant sign on the highest salary tercile indicates that foreign investment has sought out skilled labor -and, as such, potentially flown to sectors where Mexico has not traditionally held a comparative advantage.²⁰ The result is driven in good part by the heavy FDI flows in the Mexican automotive sector, where the salaries also tend to be higher than in most other manufacturing sectors. To be sure, the results do not tell anything about the number of employees affected by the growth of FDI: it is sectors with more limited FDI inflows -particularly textiles and apparel- that also employ important segments of the labor force.

Importantly from the methodological point of view, both Mexican tariff and US preferential tariff can be viewed in part endogenous to FDI flows to Mexico. For example, some investors driven to capture the Mexican market may have lobbied Mexico to increase its external tariff. Meanwhile, US investors that located to Mexico may have called on the US for deeper preferences for US-bound exports from Mexico. We strive to account for these possibilities by instrumenting Mexico's tariff and US preferential tariffs with Mexican tariffs offered to all Mexico's FTA partners, and US MFN tariff, respectively. Column III shows the results. While instrumenting has very little effect on the behavior of the Mexican tariff variable, the US preferential margin does lose its significance. Although the instrument is not necessarily optimal given its potential endogeneity to the FDI flows, the result is a disclaimer to the notion that US preferential margin alone would have been a key factor behind the location of FDI inflows in Mexico.

Column IV extends the investigation to exploring the relationship between restrictiveness of RoO and FDI inflows over time *vis-à-vis* the base year of 1994. The results indicate that the effect of RoO on FDI has been relatively consistent over time: the effect is significantly different from that in 1994 only in 1998. The other variables behave as before. Column V displays the results of the

²⁰ We also explored the possibility that injury-prone and polluting industries in the US may have moved to Mexico to take advantage of the laxer enforcement of labor and environmental regulations; however, neither variable was significant or added to the explanatory power of the model. The data for the exercise were from the US Environmental Protection Agency and US Bureau of Labor Statistics.

regression with the instrumented tariff variables. (Appendix II contains the separate annual regressions and IV regressions, respectively).

However, there are grounds to believe that restrictiveness of NAFTA RoO is in part *a function of* the depth of preferences offered by the US to Mexico: investors may be more willing to bear the potentially heightened production costs entailed by stringent RoO when the lure of preferences is strong. We explore this hypothesis by interacting RoO restrictiveness with the US preferential margin as follows:

[2]

$$\ln(\text{FDI}_{it}^{\text{MX}}) = \beta_0 + \beta_1(\ln \text{Tariff}_{it}^{\text{MX}}) + \beta_2(\text{FDI_Global}_i^{\text{US}}) + \beta_3(\text{Salary_Dum2}_i^{\text{MX}}) + \beta_4(\text{Salary_Dum3}_i^{\text{MX}}) + \beta_5(\text{Preference}_{it}^{\text{US}}) + \beta_6(\text{FDI_cap}_i^{\text{MX}}) + \beta_7 \ln(\text{ROORI}_i) + \beta_7 \ln(\text{ROORI}) * \text{Preference}_{it}^{\text{US}} + \varepsilon_{it}$$

where:

$\ln(\text{ROORI}) * \text{Preference}_{it}^{\text{US}}$ is the interaction term of the log of RoO restrictiveness and the US preferential margin.

All other variables are as in [1].

Table 4 shows the results. They indicate that the interaction is indeed central to the pattern of FDI.

TABLE 4
RESTRICTIVENESS OF RoO AND FDI
IN MEXICAN MANUFACTURING SECTORS, 1994-2000

Independent Variables	Dep. Var.: ln(FDI)
Mexico's Tariff to World	-0.006 (0.280)
ln(US FDI to World)	0.556 (4.950)**
Salary Tercile 2 (1 = yes, 0 = no)	0.417 (1.130)
Salary Tercile 3 (1 = yes, 0 = no)	2.011 (5.730)**
Preferential Margin, US to Mexico	-0.504 (1.680)
Mexico's Cap of FDI	0.030 (1.290)
ln(Restrictiveness of RoO)	-2.798 (3.970)**
ln(Restrict)* Pref Margin, US to Mexico	0.366 (2.230)*

TABLE 4 (continued)

Independent Variables	Dep. Var.: ln(FDI)
Constant	8.344 (2.500)*
Observations	439
Adjusted R-squared	0.300

Note: Robust t statistics in parentheses.
 * significant at 5%.
 ** significant at 1%.
 All regressions include year dummies.

Source: Author's calculations.

Importantly, investors do not operate in a vacuum, but will have to consider the trade policies, including RoO, also in industries with which they interact. Most immediately and as discussed above, upstream producers will be particularly interested in the restrictiveness of RoO in the downstream industries for which they sell, as stringent RoO downstream will compel downstream producers to limit their sourcing to the PTA area. Meanwhile, potential downstream investors may be concerned about restrictive RoO upstream, as such RoO might signal to the downstream investor the presence of an uncompetitive upstream provider with limited chances for accessing the least expensive inputs from ROW. Tariffs can be hypothesized to lead to similar considerations: a downstream investor that depends heavily on imported intermediate goods will likely be deterred from locating in a country that imposes high external tariffs on intermediates.

We investigate these possibilities through the following specification:

[3]

$$\begin{aligned} \ln(FDI_{it}^{MX}) = & \beta_0 + \beta_1(\ln \text{Tariff}_{it}^{MX}) + \beta_2(\text{FDI_Global}_i^{US}) + \beta_3(\text{Salary_Dum2}_i^{MX}) + \\ & \beta_4(\text{Salary_Dum3}_i^{MX}) + \beta_5(\text{Preference}_{it}^{US}) + \beta_6(\text{FDI_cap}_i^{MX}) + \beta_6(\text{ROORI}_i) + \\ & \beta_7 \ln(\text{ROORI_down}_i) + \beta_8(\text{Sales to Tradables}_i^{MX}) + \beta_9 \ln(\text{ROORI_down}_i) * (\text{Sales to Tradables}_i^{MX}) \\ & + \beta_{10} \ln(\text{ROORI_up}_i) + \varepsilon_{it} \end{aligned}$$

where:

$\ln(\text{ROORI_down}_i)$ is the restrictiveness of RoO in downstream industries to which industry i supplies;
 $\text{Sales to Tradables}_i^{MX}$ is the percentage share of the downstream industry's production that is traded rather than destined to domestic consumption;

$\ln(\text{ROORI_down}_i) * (\text{Sales to Tradables}_i^{MX})$ is an interaction term between the restrictiveness of RoO in industry i 's downstream industries and the percentage share of their production sold to the tradable sector; and

$\ln(\text{ROORI_up}_i)$ is the restrictiveness of RoO in upstream industries from which industry i purchases supplies.

All the other variables are as in [1].²¹

The results in table 5 indicate that restrictiveness of RoO in downstream industries is indeed significantly related to FDI flows. However, the negative sign suggests that upstream investors that have located in Mexico have not done so in order to benefit from stringent RoO in downstream industries. Rather, upstream industries have entered sectors whose downstream purchasers have flexible RoO; this, in turn, suggests that it is upstream suppliers that are relatively efficient -able to competitively supply downstream customers that have the option of turning to suppliers outside the NAFTA region-. Should that be the case, upstream producers would see few advantages in restrictive RoO downstream: efficient and competitive, they are the most-preferred supplier for downstream industries regardless of whether RoO downstream are binding or not. Importantly, the results also indicate that the competitiveness of the upstream suppliers is likely in part due to the efficiency that RoO in the upstream sectors *per se* provides for them: the negative sign on the restrictiveness of RoO-variable indicates that upstream investors are attracted to the Mexican market by loose RoO, which provide flexibility for them to procure *their own* supplies from outside the NAFTA theater. Although the result must be taken with a grain of salt due to the relatively high level of aggregation and the correlation between the two RoO variables, it allows for preliminarily concluding that Mexico post-NAFTA has been marked by the entry of globalized, competitive, and efficiency-seeking FDI both up- and downstream.

There are also reasons to believe that flexible RoO downstream may have played a role in encouraging upstream producers to invest in Mexico. Flexible RoO downstream may signal to upstream producers the presence of a dynamic, globalized, and competitive and hence high-demand sector downstream, while restrictive RoO downstream may communicate the presence of a dying industry with low prospects for sustained demand.

Moreover, three unobserved firm-level factors may be at play. (1) The negative sign on both the RoO restrictiveness and RoO restrictiveness downstream-variables may simply indicate that the upstream supplier and downstream customer operate within the same firm. Competitive downstream investors may simply have brought with them their upstream operations when locating into Mexico -and done so precisely due to the attraction of loose RoO both up- and downstream-. (2) Upstream industries providing to downstream industries with restrictive RoO are or have located in the US rather than in Mexico, and use NAFTA's preferential market access to export intermediates from US market to the downstream industries in Mexico rather than actually investing in plants in Mexico. (3) Long and binding pre-existing contracts between up- and downstream firms may simply have opened fewer possibilities for new upstream providers to move to Mexico to supply downstream industries with restrictive RoO.

Column II strives to control for the possibility that RoO are irrelevant to downstream producers, which could be the case if downstream producers were indifferent to exporting to the US market and,

²¹ NAFTA's elimination of duty drawback mechanisms, under which Mexico's *maquiladoras* operated through 2000, can be seen as a further inducement for especially intermediate goods producers to move operations to Mexico. Although the data presented here may contain signs of economic actors anticipation of the end of the duty drawback program, the analysis of the impact of the actual ending of the program in the beginning of 2001 remains beyond the scope of our data.

rather, destined their produce to the domestic market only.²² We do this to interact the downstream RoO variable with a variable that captures the share of the downstream sectors' production that is traded rather than destined to domestic consumption. The result remains unchanged.

Columns III and IV investigate the possibility that restrictiveness of RoO in upstream industries has played a role in investor decisions to enter the Mexican market. However, the results indicate that downstream investors have by and large been indifferent to the restrictiveness of RoO upstream.

TABLE 5
RoO IN DOWN- AND UPSTREAM INDUSTRIES AND FDI FLOWS IN MEXICO, 1994-2000

Independent Variables	Dependent Variable: ln(FDI)			
	I	II	III	IV
Mexico's Tariff to World	0.002 (0.170)	0.000 (0.030)	0.001 (0.070)	-0.002 (0.240)
ln(US FDI to World)	0.542 (5.300)**	0.559 (5.430)**	0.542 (5.290)**	0.561 (5.450)**
Salary Tercile 2 (1 = yes, 0 = no)	0.505 (1.680)	0.434 (1.420)	0.507 (1.680)	0.425 (1.390)
Salary Tercile 3 (1 = yes, 0 = no)	2.108 (7.410)**	2.165 (7.540)**	2.121 (7.440)**	2.197 (7.610)**
Preferential Margin, US to Mexico	0.138 (2.780)**	0.125 (2.470)*	0.140 (2.820)**	0.126 (2.490)*
Mexico's Cap on FDI in NAFTA	0.033 (1.680)	0.031 (1.580)	0.032 (1.630)	0.030 (1.490)
ln(Restrictiveness of RoO)	-1.889 (3.370)**	-1.846 (3.250)**	-2.031 (3.370)**	-2.077 (3.410)**
ln(Restrictiveness Downstream)	-3.258 (3.040)**	-3.384 (2.130)*	-3.508 (3.080)**	-3.760 (2.300)*
Sales to Tradable Industries (% of total)		-0.050 (0.680)		-0.056 (0.750)
ln(Restrict Downstream)* Sales to Tradable Industries		0.027 (0.600)		0.030 (0.660)
ln(Restrictiveness Upstream)			1.010 (0.650)	1.667 (1.040)
Constant	11.892 (3.760)**	12.205 (3.370)**	10.954 (3.150)**	10.624 (2.700)**
Observations	428	428	428	428
Adjusted R-squared	0.300	0.300	0.300	0.300

Note: Absolute value of t statistics in parentheses.
* significant at 5%.
** significant at 1%.
All regressions include year dummies.

Source: Author's calculations.

²² Such producers could, to be sure, prefer stringent RoO in order to deter imports.

Mexico's external tariffs in up- and downstream industries may also have figured in investors' considerations. For example, high tariffs in upstream industries could presage high cost of imported intermediates for the industry, and hence reduce incentives for investment. Meanwhile, high tariffs surrounding a potential investor's downstream customer might signal the presence of an import-competing downstream industry with a relatively limited future demand for intermediates.

We explore these hypotheses by running [3] with Mexican tariffs to the world in up- and downstream industries. The results in Table 6 are somewhat surprising in the case of upstream tariff, which enters with a positive sign and is significant at the 5% level. However, the relationship is relatively unpronounced and dissipates altogether in column III. Moreover, even if the Mexican tariff on intermediates is high, downstream industries may be able to access duty-free inputs from US upstream industries, so that the high Mexican tariff on upstream industries does not curb the downstream producers' access to relatively cheap inputs upstream. In other words, the upstream tariff-variable may only proxy for a deep preferential margin in Mexico. Overall, the results indicate that the single most relevant trade policy variable affecting investors' considerations about locating to Mexico has been NAFTA RoO in their *own* sector.

TABLE 6
TARIFFS AND RoO IN DOWN- AND UPSTREAM INDUSTRIES
AND FDI FLOWS IN MEXICO, 1994-2000

Independent Variables	Dependent Variable: ln (FDI)		
	I	II	III
Mexico's Tariff to World	-0.009 (0.870)	-0.005 (0.510)	-0.007 (0.710)
ln(US FDI to World)	0.590 (5.670)**	0.579 (5.610)**	0.583 (5.620)**
Salary Tercile 2 (1 = yes, 0 = no)	0.435 (1.400)	0.521 (1.700)	0.522 (1.640)
Salary Tercile 3 (1 = yes, 0 = no)	2.200 (7.470)**	2.162 (7.410)**	2.228 (7.470)**
Preferential Margin, US to Mexico	0.124 (2.460)*	0.148 (2.930)**	0.141 (2.740)**
Mexico's Cap on FDI in NAFTA	0.027 (1.360)	0.030 (1.520)	0.030 (1.490)
ln(Restrictiveness of RoO)	-2.410 (4.000)**	-2.071 (3.350)**	-2.098 (3.370)**
Downstream Mexican MFN tariff	-0.014 (0.540)	0.015 (0.530)	0.010 (0.350)
Upstream Mexican MFN tariff	0.028 (2.160)*	0.028 (2.060)*	0.023 (1.600)*
ln(Restrictiveness Downstream)		-3.624 (3.080)**	-3.066 (1.790)

TABLE 6 (continued)

Independent Variables	Dependent Variable: ln (FDI)		
	I	II	III
ln(Restrictiveness Upstream)		-1.267 (0.700)	-0.570 (0.290)
Sales to Tradable Industries (% of total)			0.011 (0.130)
ln(Restrict Downstream)* Sales to Tradable Industries			-0.010 (0.190)
Constant	7.256 (2.620)**	14.062 (3.780)**	12.351 (2.910)**
Observations	422	422	422
Adjusted R-squared	0.290	0.310	0.310

Note: Absolute value of t statistics in parentheses.
 * significant at 5%.
 ** significant at 1%.
 All regressions include year dummies.

Source: Author's calculations.

D. Methodological Issues

Five methodological issues should be considered when interpreting the results of this paper.

1) The relatively high level of aggregation may obscure some nuances in the RoO-investment nexus. NAFTA RoO were negotiated at up to 8- and 10-digit level of disaggregation. Moreover, as discussed above, FDI flows are also in part driven by firm-level considerations. A further complication stems from changing all our variables into the ISIC classification from other schemes.

2) The relationship between RoO and FDI is not necessarily linear but possibly quadratic, so that FDI flows only to sectors with very stringent and very loose RoO -which would indicate heterogeneous trade policy preferences among the set of companies that have invested in the Mexican market-. Indeed, some regressions with a quadratic RoO restrictiveness variable suggest that both relatively loose and stringent RoO may have attracted FDI.

3) The empirical exercises here do not account for transportation costs, another variable that arbitrates the effect of RoO on FDI. Transportation costs prohibitive of exporting to the PTA region from the ROW can encourage extra-PTA producers to invest in the PTA market. And high transport costs within the PTA market can, much like stringent RoO, encourage investors to jump the transport cost via locating in the largest PTA market to serve it from within.

4) The patterns of FDI may be affected by domestic policies pursued by Mexico, many of which precede NAFTA. For example, NAFTA merely extended Mexico's unilateral reforms of 1980s in FDI regulations in automotives, textiles, and apparel. Furthermore, FDI in textile and

apparel may also be affected by the 1989 US elimination of some quotas and expansion of others on Mexican textile and apparel, and on US expansion of Mexican steel quotas.²³ Moreover, Mexico's 1989 sweeping domestic reforms of investment regulations may have impacted particularly glass, iron, steel, cellulose, automotive, autopart, electronic component, furniture, and textiles and apparel industries.²⁴ However, the unavailability of compatible FDI data in the pre-NAFTA era with the data in the NAFTA years and the high correlation between Mexican policies and NAFTA's provisions complicates efforts to disentangle the respective contributions of these two sets of variables.

5) The empirical exercises do not consider the other several PTAs into which Mexico has entered during the NAFTA era. RoO, preferential tariffs, and investment provisions in these agreements are plausible to have had an effect on FDI inflows into Mexico. To be sure, these agreements were signed with other Latin American countries, and thus their effects are likely pale in comparison with those of NAFTA. The EU-Mexico FTA, a major PTA with plausibly important effects on FDI in Mexico, entered into force only in July of 2000, and thus remains outside the temporal scope of this paper, except for the potential investments made in anticipation of the agreement.

²³ The US and Mexico concluded bilateral agreements on trade and investment between 1985 and 1989. These general agreements were accompanied by sectoral accords on steel and textiles (Hufbauer and Schott [1993]). In October 1989, the US doubled Mexico's annual steel import quota from 400,000 to 800,000 tons. In February 1990, the US agreed to eliminate quotas on 52 textile and apparel products from Mexico, and to expand quotas by an average of 25% for products that remained under quota restrictions. The improvement in Mexico's market access was accentuated by the fact that the US had concurrently been tightening or creating quotas on the imports of the main textile and apparel exporters to the US market.

²⁴ The 1989 reforms, made under Regulation of the Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment, to the regulations designed to implement the 1973 Law to Promote Mexican Investment and Regulate Foreign Investment extended to a number of activities previously sheltered by restrictions (so-called classified activities) and activities marked by less restrictive rules (unclassified activities) (Hufbauer and Schott [1993] pp. 76-77). They provided for an automatic approval of FDI of up to \$ 100 million and also permitted 100% foreign control in companies in the unclassified economic activities as long as a number of conditions were met, such as that the project at hand guarantees an equilibrium in its balance of foreign exchange over the first three years, generates employment for Mexicans, and is not located in Mexico City, Guadalajara, or Monterrey. The unclassified activities were subsequently expanded to previously restricted areas of glass, iron, steel, and cellulose industries. The regulations also abolished the requirement for foreigners to obtain the National Foreign Investment Commission's approval prior to participating in or acquiring Mexican *maquiladoras* -the in-bond production facilities involved in the processing or secondary assembly of imported components for re-export-. The in-bond arrangement entails that imported inputs can enter Mexico duty-free as long as the finished products are re-exported afterwards; in practice, importer posts a bond to ensure that the finished products will be exported rather than sold on the domestic market. US imports of Mexico's *maquiladora* products particularly in the automotive, autopart, electronic component, furniture, and textiles and apparel sectors had boomed in the 1980s under the US Generalized System of Preferences (GSP) and the US HTS items 9802.00.60 (metals of US origin) and 9802.00.80 (goods containing US-made components) (Hufbauer and Schott [1993] p. 96). The HST provisions allowed any *maquiladoras*, including third-country ones, as well as other Mexican industries to receive duty-free treatment for the value of US content of their exports to the US market; moreover, Mexico's duty drawback allowed third-country *maquiladoras* to avoid paying duties on imported components when the final product is being exported.

IV. CONCLUSION

The proliferation of PTAs has been accompanied by a surge in FDI flows around the world. However, both theoretical and empirical studies have yet to establish a clear causal relationship between the two phenomena. This paper has sought to connect PTAs and FDI by focusing on a central market access provision embedded in virtually all PTAs, rules of origin. We have explored the various theoretical ways in which RoO can referee FDI flows. Our empirical exercises suggest that foreign investment in Mexico during the NAFTA era has been attracted to sectors with flexible RoO -RoO that allow industries to establish production and supply networks of global reach-. Should flexible RoO be viewed to attract globalized and competitive industries, the news is good to Mexico: NAFTA has paved the way for the entry of globalized and efficiency-seeking investors to the Mexican market. There are, however, various methodological limitations to the conclusiveness of the evidence; the results are also not immediately generalizable beyond the case of Mexico. This study has nonetheless illustrated ways to apply RoO in empirical work, and is hoped to inspire further work on the effects of RoO on FDI.

PTA provisions other than RoO can also arbitrate investment flows in a PTA partner. We have found that Mexican manufacturing sectors that enjoy deep NAFTA preferences in the US market and are governed by liberal investment rules under NAFTA in Mexico have seen an increase in FDI. These findings are instructive and generalizable beyond NAFTA to other North-South PTAs, many of which, like NAFTA, are marked by high degree of sectoral selectivity. Moreover, much like Mexico, many developing country PTA members have experienced impressive surges in FDI inflows in selected industries. By operationalizing PTAs, this study has provided a fresh interpretation for cross-sectoral variation in FDI flows.

The need for further work on the effects of PTA provisions on FDI is compelling given the rapid proliferation of PTAs -and of PTAs with distinct and detailed market access and investment regimes-. Three avenues of investigation would be particularly fruitful: consideration of FDI inflows in the entire PTA area rather than a single member; exploration of the determinants of FDI in the pre-and post-PTA eras; and an analysis of the ultimate welfare effects of FDI spurred by PTAs.

APPENDIX I

DESCRIPTIVE STATISTICS

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
ln(FDI)	689	15.984	2.602	-0.055	21.414
Mexico's Tariff to World	777	10.512	13.951	0.000	136.317
ln(US FDI to World)	510	14.474	1.199	10.389	17.746
Salary Tercile (1 = yes, 0 = no)	784	0.339	0.474	0	1
Salary Tercile 2 (1 = yes, 0 = no)	784	0.339	0.474	0	1
Salary Tercile 3 (1 = yes, 0 = no)	784	0.321	0.467	0	1
Preferential Margin, US to Mexico	758	2.243	2.649	-5.856	17.933
Mexico's Cap on FDI in NAFTA	739	97.321	13.009	0	100
ln(Restrictiveness of RoO)	725	1.549	0.218	0.780	1.931
ln(Restrictiveness Downstream)	833	1.629	0.099	1.230	1.885
ln(Restrictiveness Upstream)	854	1.633	0.082	1.489	1.787
Downstream Mexican MFN Tariff	826	10.742	4.971	3.040	47.037
Upstream Mexican MFN Tariff	854	10.237	9.791	2.477	75.080
Sales to tradable industries (% of total)	854	25.980	23.005	2.186	93.512

Source: Author's calculations.

APPENDIX II

Annual Regressions

TABLE II - 1
RESTRICTIVENESS OF RoO AND FDI IN MEXICAN MANUFACTURING SECTORS, 1994-2000

Independent Variables	Dependent Variable: ln(FDI)						
	I	II	III	IV	V	VI	VII
	1994	1995	1996	1997	1998	1999	2000
Mexico's Tariff to World	0.032 (1.270)	-0.077 (4.090)**	-0.063 (3.530)**	0.050 (2.350)*	0.039 (1.200)	0.035 (1.460)	0.022 (0.540)
ln(US FDI to World)	0.831 (2.750)**	-0.124 (0.530)	0.430 (2.130)*	0.957 (4.170)**	0.371 (1.040)	0.889 (3.920)**	0.742 (2.910)**
Salary Tercile 2 (1 = yes, 0 = no)	-0.228 (0.260)	1.167 (1.500)	-0.252 (0.390)	0.023 (0.030)	1.825 (1.780)	0.473 (0.720)	0.632 (0.820)
Salary Tercile 3 (1 = yes, 0 = no)	1.552 (1.910)	2.758 (3.880)**	1.643 (2.730)**	1.001 (1.520)	3.061 (3.240)**	1.630 (2.700)**	1.901 (2.690)**
Preferential Margin, US to Mexico	-0.173 (0.770)	0.320 (1.820)	0.175 (1.740)	0.074 (0.710)	0.307 (1.800)	0.163 (1.680)	0.150 (1.360)
Mexico's Cap on FDI in NAFTA	0.010 (0.200)	-0.007 (0.150)	-0.112 (0.450)	0.019 (0.490)	0.101 (1.740)	-0.059 (0.250)	0.027 (0.660)
ln(Restrictiveness of RoO)	-1.101 (0.730)	-1.507 (1.050)	-0.618 (0.550)	-1.104 (0.880)	-5.969 (3.270)**	-2.196 (1.910)	-2.089 (1.390)
Constant	4.310 (0.590)	19.567 (3.030)**	22.010 (0.860)	1.124 (0.190)	6.566 (0.760)	11.889 (0.480)	5.304 (0.820)
Observations	63.000	62.000	63.000	64.000	66.000	60.000	61.000
Adjusted R-squared	0.200	0.360	0.400	0.330	0.290	0.390	0.280

Notes: Absolute value of t statistics in parentheses.

* significant at 5%.

** significant at 1%.

Source: Author's calculations.

TABLE II - 2
RESTRICTIVENESS OF RoO AND FDI IN MEXICAN MANUFACTURING SECTORS
WITH INSTRUMENTED MEXICAN TARIFF AND US PREFERENTIAL MARGIN, 1994-2000

Independent Variables	Dependent Variable: ln(FDI)						
	I	II	III	IV	V	VI	VII
	1994	1995	1996	1997	1998	1999	2000
Mexico's Tariff to World	0.020 (0.620)	-0.060 (2.600)*	-0.040 (1.970)	0.054 (2.270)*	0.046 (1.160)	0.040 (1.360)	0.003 (0.060)
ln(US FDI to World)	0.759 (2.410)*	-0.182 (0.760)	0.456 (2.140)*	0.984 (4.200)**	0.424 (1.120)	0.939 (3.910)**	0.684 (2.600)*
Salary Tercile 2 (1 = yes, 0 = no)	-0.175 (0.200)	0.778 (0.970)	-0.594 (0.910)	0.028 (0.040)	1.632 (1.580)	0.416 (0.630)	0.524 (0.670)
Salary Tercile 3 (1 = yes, 0 = no)	1.662 (1.980)	2.797 (3.800)**	1.662 (2.670)*	0.945 (1.420)	3.082 (3.220)**	1.659 (2.730)**	1.973 (2.750)**
Preferential Margin, US to Mexico	-0.324 (1.540)	-0.001 (0.000)	0.036 (0.310)	0.101 (0.820)	0.182 (1.040)	0.150 (1.400)	0.081 (0.660)
Mexico's Cap on FDI in NAFTA	0.025 (0.470)	-0.006 (0.130)	-0.092 (0.360)	0.018 (0.460)	0.105 (1.800)	-0.046 (0.190)	0.034 (0.810)
ln(Restrictiveness of RoO)	-0.090 (0.050)	-2.425 (1.600)	-0.970 (0.810)	-1.210 (0.950)	-5.870 (3.140)**	-2.138 (1.820)	-1.464 (0.940)
Constant	2.739 (0.360)	22.404 (3.360)**	20.406 (0.780)	0.960 (0.160)	5.590 (0.630)	9.823 (0.390)	4.816 (0.730)
Observations	63.000	62.000	63.000	64.000	66.000	60.000	61.000
Adjusted R-squared	0.130	0.320	0.380	0.330	0.290	0.380	0.250

Notes: Absolute value of t statistics in parentheses.
* significant at 5%.
** significant at 1%.

Source: Author's calculations.

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