
Article:
Eckhardt, Jappe orcid.org/0000-0002-8823-0905 and Lee, Kelley (2018) Global Value Chains, Firm Preferences and the Design of Preferential Trade Agreements. Global Policy. pp. 58-66. ISSN 1758-5899

https://doi.org/10.1111/1758-5899.12612

Global Value Chains, Firm Preferences and the Design of Preferential Trade Agreements

Forthcoming in *Global Policy*

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ABSTRACT The conventional view in the literature is that only the largest and most productive and firms in a country benefit, and hence support the signing of, preferential trade agreements (PTAs), as they are able to take advantage of the key benefits such agreements offer. In this paper we argue that such firms may indeed be generally supportive of PTAs, but that their preferences often differ when it comes to the exact design of PTAs. These different preferences stem from the ways firms have organized their value chains. We focus on one crucial issue where firms may hold different preferences, depending on the organization of their value chain: Rules of Origin (RoO). We test the plausibility of our argument through a detailed analysis of the preferences and political strategies of tobacco firms in the context of the NAFTA negotiations.

Key words: global value chains; NAFTA; rules of origin; PTAs; tobacco; lobbying

INTRODUCTION[1]

The proliferation of Preferential Trade Agreements (PTAs) since the late 1980s is often described as one of the most important changes to the international trading system in recent decades. Over time, PTAs have gone beyond eliminating tariffs and non-tariffs barriers for market access, to increasingly covering "behind the border" measures such as regulations related to production processes, investment protections and dispute settlement mechanisms. These developments are often linked to the "unbundling of production", and the formation of regional and global value chains (GVCs). In order for GVCs to function optimally, the argument goes, there is need for countries to lower trade barriers, as well as, harmonize policies, rules, and standards governing trade and investment. PTAs have been seen as a key means for achieving these goals and, therefore, part of a supporting institutional framework for deepening value chains formed by transnational corporations. Research suggests that the signing of PTAs indeed leads to increased trade within production networks among PTA members.

Given the importance attributed in the literature to GVCs, firm performance and PTAs, it is surprising how little we still do not know about the exact link between, on the one hand, PTA formation and, on the other hand, GVC integration, firm preferences and their political strategies. There has been an important, and rapidly growing, literature showing that the only firms really benefiting from the signing of PTAs are the largest and most productive. This is because they are able to take advantage of certain key benefits offered by such agreements such as access to closed or restricted markets for their exports, and the opportunity to move (stages of) production across borders.. However, with a few notable exceptions, most of this "heterogeneous firm" literature does not explicitly take the role of GVCs into consideration.

Building on existing scholarship, we propose in this paper that GVC integration may affect firm preferences regarding PTAs and their political strategies to further these preferences. Although we expect that the largest/most productive firms in a country will be generally supportive of PTAs, we argue that they may differ in their preferences over the exact PTA design (i.e. the inclusion of certain provisions), depending on the organization of their value chains at the time of negotiations. We suggest that one issue where large and and productive firms may differ in particular are Rules of Origin (RoO). That is, firms producing or sourcing the bulk of their inputs from within the PTA area

[1] We would like to thank Shamila Kara and Farah Syed for their assistance in searching internal tobacco industry documents, and two anonymous reviewers for their helpful comments and suggestions. An earlier version of this paper was presented at "The Politics of Global Value Chains: The Globalization of Production and the Challenge of Governance" workshop at the 2017 ECPR Joint Sessions in Nottingham, UK, and the "New Perspectives on Global Value Chains and Global Production Networks: Bringing Institutions Back in" Workshop held at the University of York in December 2017. We wish to thank the workshop participants for their helpful comments. This research is supported by the National Cancer Institute, US National Institutes of Health, Grant R01-CA091021.

are expected to have a strong preference for stringent RoO, while firms depending on offshore procurement from outside the PTA area are expected to be in favour of more lenient RoO to accommodate their foreign production or sourcing of inputs. As such, we contribute towards a more systematic understanding of the relationship between GVCs and (trade) institutions (Eckhardt and Poletti 2018).

We test the plausibility of our argument through an in-depth case study on the preferences and political strategies of transnational tobacco companies (TTCs) in the context of the North American Free Trade Agreement (NAFTA) negotiations. We draw, in particular, on internal company documents available through the Truth Tobacco Industry Documents (TTID) database, an archive of more than 14 million documents, largely released as a result of US litigation. These documents offer unique insights into the market and political strategies of tobacco firms and, as such, allow us to understand their preferences and GVC activities.

A BRIEF REVIEW OF THE LITERATURE

Many students of trade politics treat policy outcomes as a function of political conflict shaped by the preferences of domestic industries (Frieden and Rogowski 1996). There are two basic assumptions here. Firstly, decision-makers are political support-maximizers and have no explicit trade policy preferences of their own (Grossman and Helpman 1994) and therefore give in to the demands of those societal interests best able to overcome their collective action problems (Olson 1965). Secondly, the trade preferences of firms correspond with their material interests: industry actors to whom the net result of international trade is detrimental prefer protectionist trade policies, while those who win overall are expected to favor trade openness (Baldwin 1989).

Traditionally, it is argued that the losers of trade consists of import-competing producers, while export-oriented firms benefit from trade and that, in turn, industries dominated by the former will lobby for the imposition of domestic tariffs on foreign imports, while those dominated by exporters lobby for foreign market access (e.g., Bailey et al. 1997; Gilligan 1997; Dür 2010). The balance between import-competitors and exporters in a sector can change over time, leading to shifts in sectors' trade preferences. For instance Milner (1987) has argued that if sectors become more export dependent and internationalized, trade preferences are influenced in the sense that they are expected to become more pro-market opening. The reason behind this is that the connection of that sector to the international economy makes protection a costly strategy: closing markets risks retaliation as well as the loss of foreign markets.

Key shortcomings of this literature are that actors' trade policy preferences are often taken as a given and unproblematic (Frieden 1999) and that the focus is on trade preferences and lobbying

strategies at the industry level. To be sure, some of the literature mentioned above does take into account the fact that preferences can change over time because of internationalization, yet a) trade policy preferences are treated as one-dimensional in the sense that firms either favor or oppose trade liberalization with respect to market access; and b) it is assumed that sectors as a whole will find a common position on protection/market access and/or that actors defending the minority position will accept this without making their voice heard in the political arena (Kim et al 2018).

In recent years we have seen a growing literature on trade (policy) preferences and firm heterogeneity, which has looked at the question whether "firm differences within sectors may be more pronounced than differences between sector averages" (Baldwin and Robert-Nicoud, 2008: 21). Most attention in this regard has been paid to firm heterogeneity in export performance and whether and how this causes intra-industry disagreements on trade policy. A key finding of this literature is that less productive firms in a sector, which are incapable of exporting, oppose freer trade, while the most productive export-oriented firms will typically prefer- and lobby in favour of trade liberalization (Madeira 2016;Weymouth and Broz, 2013; Baccini et al. 2017; Osgood 2017a). Yet, the heterogeneity of firms within the same sector goes beyond variation in (export) performance: firms also differ in their ability to engage in transnational production activities and to establish (global and/or regional) value chains (Osgood 2017b). Scholars have found that firm' preferences depend to a significant extend on their ability to source (intermediates) from- and open production facilities overseas, as well as their integration and position within (regional or global) value chains (Manger 2014; Curran 2015; Kim 2015; Eckhardt 2015; Eckhardt and Poletti 2016, Osgood 2017b; Yildirim et al 2018). That is, firms that heavily depend on foreign imports- and production and/or are integrated in GVCs are most likely to have pro-trade preferences.

By building on the aforementioned literature, we argue in this paper that globally engaged firms may all be supportive of freer trade but have diverging preferences over exact design features of trade agreements. More in particular, we argue that firms might evaluate different dimensions of- and provisions within PTAs differently depending on the way they have organized their overseas production and investment. This issue has received only scant attention in the existing literature (for notable exceptions see Osgood 2017b; Kim et al 2018).

GLOBAL VALUE CHAINS AND FIRM PREFERENCES OVER PTA DESIGN

We now present our argument. Our focus is on firm PTA preferences. A PTA is based on an intergovernmental treaty between two or multiple countries. PTA partners grant each other preferential market access for goods, services, investments or labor, which means that imports from a PTA member are subject to lower trade barriers than those stemming from non-PTA signatory

countries. The exact products, issue areas, etc. included in the agreement varies from one PTA to the other.

The (general) economic benefits of PTAs

The conventional view in the literature is that PTAs offer firms the following two potential benefits. Firstly, they give firms access to closed or restricted markets for their exports. Getting access to larger-than-national markets enables firms to take advantage of economies of scale. The basic idea here is that production is more efficient and lowers unit costs the larger the scale at which it takes place and trade offers firms the opportunity to increase output by producing for a bigger market (Dixit and Norman 1980). Chase (2003: 144) explains why PTAs are particularly attractive in this regard: "regional trade liberalization opens new markets [allowing] firms to reduce unit costs as output increases for export to regional partners, [while retaining] barriers against outside competition [ensuring] that firms in the region fully internalize the scale effects of larger markets." Secondly, PTAs offer firms the opportunity to move (stages of) production across borders and, as such, to take advantage of cross-national differences in factor endowments (Arndt 2004; Florensa et al. 2015).

The aforementioned link between, economies of scale, cross border-production sharing and business support for PTAs is by now well established in the literature. However, as argued above, there is only a selective number of firms in any given society that can take advantage of PTAs in terms of increased trade, investment and redeployment of production from labor-scarce to labor-rich areas: the largest and most productive firms in a country or sector and these are the kind of firms that will rally in support of signing PTAs (Madeira 2016; Weymouth and Broz, 2013; Baccini et al. 2017; Osgood 2017a). We maintain that, although large and very productive firms in the same sector may indeed be in favour of trade agreements in general, this type of firms may have different preferences when it comes to the signing of PTAs with particular countries and/or different dimensions of- and provisions within PTAs.

Divergent preferences over PTA design

The nature of trade policy has become more complex over time, with the establishment of the WTO and particularly the proliferation and increasing depth/scope of PTAs and rules of origin (RoO) and tariff levels that substantially differ by agreement (Dür et al 2014; Young 2016; Curran and Eckhardt 2017). These developments have implications for (changes in) trade preferences of firms. That is, as contemporary PTAs are not just aimed at eliminating tariffs and non-tariffs barriers for market access, but also include rules and standards related to production processes, environmental protection, investment protection, dispute settlement mechanisms and so forth, firms are likely to

have diverging preferences over the exact design of PTAs.

We argue that these dissimilarities in preferences, even among firms within the same industry, stem from the different ways firms have organized their value chains. In case firms within the same industry have indeed organised their production and investment differently and, as such, show different levels of integration in regional or global value chains, we expect to find that their preferences will differ. They may have different preferences on the signing of PTAs with certain countries over others as well on the design of PTAs. Kim et al. (2018) have found for instance that "investment protection is the most salient trade policy dimension for firms who are most deeply integrated into global production networks [while] strong dispute settlement procedures are most valued by [firms] who are not central to global supply networks."

We suggest that another key issue where large and productive firms are expected to differ in their preferences on PTA design are RoO. RoO are the criteria for determining the national source of a product, and thus the basis of assessing, for example, the rate of duty, labelling and marketing requirements, and preferential treatment under a PTA. A RoO can be variably defined, product specific and negotiated industry by industry, under different PTAs. RoO are an integral, but often overlooked, part of PTAs: member countries "confer duty-free status on a product only if a pre-specified proportion of its value added originates within the [PTA]" (Duttagupta and Panagariya 2003: 3). In other words, RoO lay out the conditions under which goods are eligible for zero tariffs in a PTA. As said, RoO are negotiated industry by industry and it is this ability to differentiate RoO to a product's unique characteristics, which allows trade negotiators to devise measures, which in turn incentivizes - and leaves ample scope for firms to influence negotiating outcomes (Augier et al. 2005; Cadot et al. 2006; Chase 2008).

As Cadot and Ing 2016 (p.2) argue, RoO "constrain the sourcing choices of multinational firms along regional patterns dictated by [the PTA], whereas GVC optimisation may call for different choices." In other words, firms may have different preferences on RoOs provisions in PTAs depending on the organization of their value chain. In earlier work, Chase (2008) has already shown that this logic indeed holds at the industry level: in his study on RoO and NAFTA he found that industries dominated by firms engaged in transnational production (or multi-stage production as he calls it) were most likely to lobby in favour of accommodating RoO to allow them to source outside the PTA. We look at the firm level, however, and argue that firms within the same industry may have different preferences over RoO, which in turn may lead to intra-industry disagreements on the exact RoO in PTAs. That is, we suggest that firms producing (and/or sourcing the bulk of their inputs from) within the PTA-area will prefer strict RoO to block foreign firms from fragmenting the PTA market and hindering cost reduction. Firms mainly depending on offshore production and/or procurement

outside the PTA area, on the other hand, are expected to be in favor of lenient RoO in order to accommodate their foreign sourcing of inputs.

TOBACCO COMPANIES, NAFTA AND RULES OF ORIGIN

In this section we present evidence concerning the preferences of firms and PTA formation. Our empirical analysis is based on in depth study of the preferences and political strategies of tobacco firms during the NAFTA negotiations. Negotiations for NAFTA – a PTA between Canada, Mexico and the US – started in June 1991 and were completed by the end of 1992. After side agreements on labour and environmental protection were negotiated, NAFTA officially came into force in 1994. At the time, the agreement was (and still is) generally regarded as one of the most extensive and comprehensive PTAs ever signed, offering in particular "Corporate North America" tremendous economic opportunities (Zinser 1994).

The timing of the NAFTA negotiations and its implementation coincide with internal tobacco industry documents available through the TTID database (see: https://www.industrydocumentslibrary.ucsf.edu/tobacco/?). The TTID has been our main source of primary data, which helped us to systematically search and analysis internal tobacco industry documents. We used key words to search documents related to NAFTA, the three States parties, and the preferences of tobacco firms on the specific topic of RoO. We also searched Google Scholar and Web of Science – using search terms 'NAFTA and tobacco', 'NAFTA and Tobacco, and negotiations', and, 'NAFTA and tobacco and health and negotiations' – for secondary sources for existing analyses of NAFTA related to the tobacco industry in each of the States Parties. This was followed by a search of news reports in the LexisNexis database. We also searched industry publications and websites, tobacco control materials, and policy documents related to NAFTA and tobacco. These secondary sources were used to contextualize and triangulate primary data sources.

The tobacco value chain and NAFTA

Before turning to our analysis of tobacco industry lobbying during the NAFTA negotiations, we first provide a brief overview of the tobacco value chain and tobacco production in North America. The tobacco value chain consists of three stages (Goger et al 2014). Firstly, the post-harvest stage, which can be divided into two distinct activities, each of which typically takes place in different locations and under different institutional arrangements: a) curing (i.e. drying) green tobacco leaf, usually done on farm; and b) stemming, stripping, and blending tobacco. The tobacco is then shipped to the manufacturing destination for the second stage: transforming raw tobacco into finished products,

such as cigarettes, cigars, cigarillos and chewing tobacco. The major transnational tobacco companies (TTCs) all tend to manufacture internally, as the quality is very important for branding purposes, which they do in factories all over the world. The final stage consists of branding, marketing and distribution of final products, which TTCs typically also coordinate themselves. It is estimated that this final stage of the chain accounts for as much as 50% of the product value (Goger et. al. 2014).

In North America, the focus of our paper, three TTCs dominate the tobacco market: Philip Morris International (PMI), RJ Reynolds (RJR) and British American Tobacco (BAT), through its then US subsidiary Brown and Williamson (B&W). These firms had the biggest stake in the successful completion of NAFTA and will therefore be the focus of our analysis. All three TTCs had a historically strong presence in the US and Canada, but in the 1980s tobacco consumption started to fall considerably in high-income countries across the global. The US and Canada were no exception to that trend. Consumer preferences changed, while anti-tobacco sentiments in both Canada and the US were increasing as well (Jha and Chaloupka, 2000). At the same time, tobacco consumption was increasing in emerging markets, which means that TTCs had a strong incentive to lobby for "tariff reduction and open markets to enable them to compete with domestically manufactured tobacco products in high growth markets in Latin America, Eastern Europe, and Asia" (WHO /WTO 2002: 71).

NAFTA offered TTCs the opportunity to increase their level of investment in one of such markets: Mexico. At that time, Mexico applied high tariffs on tobacco products and had in place a restrictive Foreign Investment Law and import licensing policy. These limited the degree of TTC ownership in the Mexican tobacco industry and thus the presence of international brands in the Mexican market. TTCs had to sign license/joint venture agreements with Mexican companies, as this was the only way for them to sell tobacco products to Mexican consumers. When choosing a Mexican partner there was little choice: the Mexican tobacco market was essentially a duopoly, with local firms Cigatam and Cigarrera La Moderna (CLM) controlling approximately 55% and 45% of the market respectively. Around the start of the NAFTA negotiations, PMI and RJR had joint ventures and agreements with Cigatam and CLM. BAT and its US subsidiary B&W had sold its 45% stake in CLM in 1989 and was left with licensing agreements for selected brands (see Table 1).

[TABLE 1 HERE]

The general preferences of tobacco companies on NAFTA

Our analysis suggests all three TTCs mentioned above were generally in favour of NAFTA, and eager to make sure that tobacco would be included in the agreement (see BAT 1992a; PMI 1993a, 1993b;

RJR 1993). The first reason for this support was, as indicated above, that NAFTA had the potential to open up the Mexican tobacco market by lifting trade and investment barriers. This was recognized as an opportunity for TTCs to increase sales in Mexico and Latin America (LA) more broadly (BAT 1993a). TTCs expected NAFTA to heavily impact the industry's future in the region at large. But protectionist policies made it very difficult for TTCs to control the sale of their products to Mexican consumers.

Moreover, NAFTA had the potential to not just boost sales in Mexico but, by lifting the foreign ownership and import licensing rules and import barriers, offered TTCs the opportunity to engage in production sharing. As said before, the three TTCs studied in this paper had a different starting point when NAFTA negotiations started in this regard. BAT was the only TTC that had no manufacturing presence in the Mexican market when NAFTA negotiations began. Documents suggest that BAT was particularly eager to use the agreement to restructure its production process and that it already started to prepare the ground for the post-NAFTA era during the negotiations (BAT 1993b). But also PMI and RJR indicated in their internal documents that NAFTA could help make its production and investment process more cost efficient. PMI for instance indicated that it would be possible to cut costs by providing its own leaf to its Mexican subsidiary Cigatam (sourced and manufactured either in the US or in Mexico). An alternative option the company considered was to cancel the agreement with Cigatam altogether and open their own plants in Mexico, which could become possible within NAFTA (PMI 1993c). Similar issues were raised by RJR in its internal documents (RJR 1994). Moreover, all three TTCs saw NAFTA, and expanding within the Mexican market in particular, as part of a broader business strategy for the Latin American region. The inclusion of tobacco in NAFTA was seen as fundamental in light of their regional interests. In one of its internal documents, BAT for instance reveals the company's concerns for excise taxes on tobacco products in Latin America, particularly in Mexico, and how removing these barriers could help the company to develop a pan-NAFTA production, marketing and distribution strategy (BAT 1991a, 1993b). PMI's Latin American Region Strategic Plan (1991-1993) states that the company plans "to grow volume by 8.1 billion units to 85.3 billion by 1993", with "the most significant volume increase in 1990" to come from Mexico (PMI 1991a).

Our analysis so far has shown that all three TTCs were indeed generally in favor of NAFTA. However, as we have argued above, pro-liberal firms may differ in their preferences over the exact design of- and certain provisions in PTAs, depending on their integration in regional and global value chains. In order to see if this indeed holds for the tobacco firms in the case of NAFTA we have analysed TTCs preferences on the issue of RoO discussed during the NAFTA negotiations

Diverging preferences over RoO

Under NAFTA, Article 401 (Originating Goods) sets out the criteria applicable to how most goods would be deemed to wholly originate from a NAFTA member state; and Article 405 (De Minimis) sets out the criteria by which a non-wholly originating good is permitted to be treated as such (i.e. non-originating component not more than 7% of the transaction value). During NAFTA negotiations, the RoO and *de minimis* applicable to tobacco leaf and products became the subject of intense lobbying among TTCs.

Under the Canada–United States Free Trade Agreement (CUSFTA), signed just before NAFTA was negotiated, location of "manufacturing activities alone confer origin," regardless of the origin of inputs, resulting in no impact on TTCs. For NAFTA negotiators initially accepted a Mexican proposal to extend the 7% *de minimis* rule to tobacco products. This meant that "any cigarette product containing offshore tobacco, the cost of which exceeds seven percent of the product's 'transaction value', would not qualify for tariff preference under the NAFTA" (B&W 1992a). Documents describe each TTC responding differently to the proposed 7% rule depending on whether they stood to gain or lose a competitive advantage.

For PMI, the proposed 7% *de minimis* rule was acceptable. In 1991 PMI owned a 28% share in Mexico's second largest tobacco company, Cigatam (the remaining share held by Grupa Carsa owned by Carlos Slim) (BAT 1991b). PMI's investment was earning substantial dividends and royalties, driven by the rapid growth of Marlboro sales since the early 1980s (PMI 1990):

> Marlboro is showing exceptional growth in Mexico….our largest Marlboro market [in Latin America]…volume will be up 30% this year to 13 billion units….Volume has nearly doubled in just two years…..we project Marlboro will achieve a record market share of 24% this year [1990], up more than 4 points over 1989.

PMI's Latin American Region Strategic Plan (1991-1993) expected "to grow volume by 8.1 billion units to 85.3 billion by 1993", with "the most significant volume increase in 1990" to come from Mexico (PMI 1991b). A 7% *de minimis* rule would not have impacted these plans because PMI already produced its brands in Mexico using North American sourced leaf. The proposed rule "would allow Philip Morris to take advantage of the preferential import duty structure of the North American Free Trade Agreement" (PMI 1992). Importantly, the competitive advantage to be gained over BAT at this rate, as part of a battle for global market share, was particularly important (PMI 1991c):

> Ten years ago we were a medium-sized competitor. Today, together with Philip Morris U.S.A. we form the largest private tobacco enterprise in the world. We are growing at a rate in excess of our competition….Philip Morris International is the market leader in…Mexico….The challenge we face is to bring our strengths to bear in order to realize the huge unexploited potential in world markets before the competition.
>
> These companies represent formidable threats. BAT is still larger than PMI internationally, is well entrenched in many major markets, and its tobacco business is very profitable.

Similarly, the ambitions of RJR, as the second largest US tobacco company, led to support of the 7% rule. RJR maintained licensing agreements with CLM to produce RJR brands to sell in Mexico. The prospects of NAFTA prompted RJR to conclude a fifty-fifty joint-venture agreement with La Moderna, as that would give them "access to this large and growing market….Attractiveness of Mexico as a development market has increased appreciably in recent months with the free enterprise policy of the Salinas government and the possibility - longer term - of a North American free-trade zone" (RJR 1990). Documents suggest RJR's ambitions extended to Hispanic populations along the US-Mexico border. A Hispanic Border Program was initiated in 1989 as "a starting point to provide information for the development of strategies and tactics for hispanic program border related activities." This was followed by RJR sponsorship of cultural and business events on both sides of the border (RJR 1989). Given this established presence in Mexico, RJR would not have been adversely affected by a ROO of 7%.

In contrast, BAT's US subsidiary B&W, along other US tobacco companies without a going concern in Mexico at that time, opposed a 7% rule. Having sold its 45% stake in CLM in 1989 without securing a new investment, and also limiting its licensing agreements with Mexican manufacturers, B&W was reliant on exporting US-manufactured cigarettes to Mexico (BAT 1992b). To qualify for preferential tariffs under NAFTA, the proportion of leaf used in B&W brands sourced outside of NAFTA countries became important. Moreover, B&W cigarettes contained 15-20% Oriental tobacco leaf (largely sourced from Turkey) to achieve "the distinctive, popular taste of American blended cigarettes". The blend was also used "to help control cigarette costs and thus prices". B&W Senior Vice President Ernest Pepples assured US trade negotiators that the remaining leaf used by the company was American-grown burley and flue-cured, except when "natural disasters" might cause a shortfall in domestic supply (B&W 1992b). Writing to USTR Carla Hills on July 2, 1992, and with no mention of BAT's previous investments in or licensing agreements with CLM, B&W Chairman Raymond Pritchard argued that a 7% rule would, not only "provide an overwhelming competitive

advantage for those companies who now manufacture their cigarette brands in Mexico through licensing arrangements or equity investments in Mexican producers," but that "U.S.-made cigarettes would not be eligible for NAFTA tariff benefits under this rule" (B&W 1992a).

On July 21, 1992 Ernest Pepples (Senior Vice President, B&W) wrote a detailed memorandum to US Deputy Trade Representative and Chief NAFTA negotiator, Julius Katz (BAT 1992b), supporting a "flexible rule of origin for cigarettes" so that "American tobacco and cigarette workers can benefit from this historic agreement". He argued that "[c]igarettes made in America by American workers using primarily American tobacco currently are locked out of the legal Mexican market entirely….Even these American brands sold in Mexico are made in Mexico by presumably non-American workers using non-American tobacco." He claimed that Mexico refused "to provide the license it requires for imports of cigarettes" which effectively closed the market to American companies. He concluded (B&W 1992b):

> We are not an industry pleading with you to protect us from competition from Mexico. We are happy to compete with the Mexican companies in our market; all we ask is for a meaningful opportunity to compete in theirs. Our request is simply to ensure that, with respect to cigarettes, the NAFTA accomplishes its objective in opening markets and stimulating greater competition.

B&W – along with Lorillard, Liggett and the American Tobacco Company – called for Oriental tobacco to be excluded from the RoO or to have the *de minimis* rule raised to 9%. The centrality of debates during the US presidential election, concerning NAFTA's potential impact on American workers, invariably influenced negotiations. On July 31, 1992, Pepples reported to the other companies that, despite the preferences of RJR and PM, (B&W 1992c):

> the USTR tried to get Oriental out of the test. USTR offered to cap the cost of offshore burley and flue-cured at 5% of FAS. The offer was rejected but Mexico finally compromised at 9% FAS as a cap on the cost of all offshore tobaccos including Oriental tobacco. I hope you find the improvement in the de minimis rule sufficient to represent an opportunity for your company assuming a trade pact is signed and implemented. It would not have happened if you had not participated in the effort to persuade USTR.

In September 1992, Deputy USTR Julius Katz wrote to Alexander Spears (VP and CEO Lorrillard) to confirm the ROO change. He concluded his letter by saying that he would look forward to the company's support of NAFTA in light of this change (Lorilard 1992).

CONCLUDING REMARKS

In this paper we have studied the relationship between GVCs and firm preferences on PTA design, through an in-depth case study on the preferences and political strategies of tobacco firms in the context of NAFTA negotiations. We believe our findings contribute towards a more systematic understanding of the relationship between GVCs and (trade) institutions, the theme of this special issue (Eckhardt and Poletti 2018), while suggesting an easily expandable research program.

Although we find support for the claim made by others that highly productive firms are generally supportive of PTAs, we show that preferences of such firms over the design of these trade institutions may vary considerably depending on how they have organized their GVCs. More in particular, we find that whether or not firms source the bulk of their inputs from PTA partner countries affects their preferences on RoO provisions. In case firms indeed mainly source from within the PTA area, they will have a preference for stringent RoO, while firms that depend on offshore procurement from outside the PTA area will prefer more lenient ROO. This finding has important implications because it underscores that even the most productive firms in any country may have divergent preferences over important design features of PTAs.

Our empirical analysis was based on a detailed case study on the preferences and political strategies of tobacco firms in the context of NAFTA. Future research could test our argument by looking at the preferences of firms on RoO in PTAs in other sectors, as well as at a broader set of PTA design features. What is more, there are of course a wide range of other issues related to PTAs and GVCs that need further scrutiny (see also Eckhardt and Poletti 2018). A key issue is the way firms adapt their business strategies (i.e. the organization of their value chains) once a PTA is signed and how this, in turn, may affect their trade preferences and political strategies. If firms indeed decide to make changes to the organization of their value chain in light of a PTA, this could also have severe socio-political implications such as job losses. This is despite the fact that during PTA negotiations firms often promise that trade agreements will increase exports and domestic jobs. Future research could analyse whether these promises to the signatory countries are realized since implementation.

In case of NAFTA and tobacco for instance, TTCs lobbied for the agreement on the basis that it would create lucrative export markets and, in turn, generate new agricultural and manufacturing jobs, particularly in the US and Canada. Yet in reality tobacco leaf and product manufacturing has

undergone fundamental change since the 1990s, spurred by regional integration and global competition. Prior to NAFTA, Canada, the US and Mexico had substantial domestic tobacco farming and manufacturing sectors, albeit of varying sizes. The US had the largest tobacco sector, serving a substantial domestic market alongside extensive export markets worldwide. Over the next two decades, the tobacco sector, like many other sectors in North America, underwent regional consolidation, under NAFTA and as a result of global market pressures. The number of US farms growing tobacco declined, from 93,330 to 4,268 between 1997 and 2015 (*USA Today 2015*). Consolidation and economies of scale among remaining farmers have lowered prices and increased exports (*Globe and Mail* 2005). In Canada, leaf production has declined dramatically to a handful of producers by 2017, spurred by declining demand and the relocation of almost all manufacturing to lower cost Mexico, Cheaper leaf has led to a boom for Mexican farmers despite controversy surrounding low wages and child labour. Mexican farm workers have also migrated north in large numbers to work on American tobacco farms (Benson 2012; *The Guardian* 2018).

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