

## Diagonal cumulation of origin as the EU's institutional incentive mechanism for promoting international trade and business\*

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### Abstract

*In this paper we explore the effects of a diagonal cumulation of origin as the EU's Common Commercial Policy (CCP) incentive mechanism that affects the intra-regional trade and transaction cost structure of firms engaged in cross-border business operation. The research explores how firms should frame their cross-border physical flows of goods and the configuration of their value-adding processes for taking advantage of diagonal cumulation of origin. The empirical analysis is based on an in-depth case study of effects of the 'SAP+ diagonal cumulation of origin' on changes in the transaction cost structure of a selected Slovenian firm operating within the household-appliance sector in one of the Western Balkan Countries. Based on eligibility of local subsidiary for using origin of goods in its import/export transactions the cost calculations were made for its products and then three different business scenarios were developed for showing the effects of the mechanism on transaction cost changes of a firm. The paper*

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*concludes that, at the conceptual level, the mechanism of diagonal cumulation of origin may serve as an effective institutional cross-border trade-promoting tool.*

**Key words:** *international business, institutional incentive mechanism, diagonal cumulation of origin, European Union, transaction costs, Western Balkan Countries*

**JEL classification:** *D21, F13, F15, F23*

## 1. Introduction

Extant empirical analyses, based on gravity model estimations (Montanari, 2005; Bussière *et al*, 2008), have shown that the trade potential between EU member states and Western Balkan Countries (WBCs) is not fully utilized, since trade flows between the two remain at 2 to 3 times below their potential level. Hence, there are great opportunities for EU's companies to increase their sales within this region. Besides the trade potential, in making a detailed evaluation of trade between particular countries/regions it is also necessary to examine the qualitative aspects of mutual trade flows and the integration potential of a country/region, respectively. One of the relevant indicators is the share of intra-industry trade within the total trade of the country/region, reflecting the prevailing type of specialization regarding trade among developed countries. Intra-industry trade is not determined by the relative differences in factor endowments like inter-industry trade but rather by specializing in the limited variety of differentiated products, thus allowing economies to take advantage of increasing returns. Škufflić and Botrić (2008) have ascertained that the share of intra-industry trade within the total trade of WBCs with the EU is relatively low. At the total trade level, Croatia demonstrates the highest level of intra-industry trade, slightly exceeding 30 percent of its trade with the EU in 2004. However, in comparison with developed countries, in which this type of trade often exceeds 70%, a relatively low-level of intra-trade flows may indicate a weaker business interaction among firms operating in the same networks for supplying parts and components, which leads to a limited utilization of economies of scale during the production of semi-finished products. Much lower product differentiation through international trade is an obvious consequence of such country trading pattern.

The low level of intra-industry trade within the WBCs' trade with the EU suggests that trade among WBCs and the EU is based more on the utilization of economies of scale associated with supplying a larger market than on differences in factor endowments of local firms. Such approach of firms from the WBCs is reflected in strategies based on price/cost competitiveness as their key strategic focus in the marketplace. This is consistent with the findings of some researchers (Zajc Kejžar, 2008:122) that the comparative advantage indices of WBCs are showing the comparative advantages of these countries particularly in industries with relatively intensive use of unskilled labour and raw materials.

In this paper we examine specific linkages between the international institutional context, not only as a source of trade barriers, but, at the same time, also as *the source of incentives* that may improve business performance of firms when they properly integrate their international operation strategies and operational procedures with institutional requirements. In particular, we focus our research on the diagonal cumulation of origin as the EU's incentive mechanism for promoting cross-border trade flows<sup>2</sup> and lowering of transaction costs of participating firms in a specified geographic region. With such a perspective, we contribute to broadening the traditional view of *institutional influences* on firms' behaviour in their cross-border operations from the *constraint* perspective to the *incentive* perspective. With proper understanding of relevant institutional context and external incentive mechanisms and their integration into international operations and business processes, firms may improve their market performance through improved transaction cost structures. With a presented case-study analysis, we show in the empirical part of the paper that firms may enjoy lower costs of their local operations by taking advantage of available institutional incentives provided by the host country *or* by institutions at the *supranational level* (e.g. at the level of economic integration). We assume that the key condition for taking advantage of such institutional incentive mechanism is a holistic approach in designing a strategy of proper alignment and adjustment of firms' final product assembly processes and a proper spatial configuration of their supply-chain network in such a way that they will be able to take advantage of institutional mechanisms' available benefits.

### 1.1. Research aims and methodology

In dynamic international business context market knowledge is viewed as a key ingredient of firms' competence to effectively manage their international operations. As key knowledge is usually experiential in its nature, firms differ in their capabilities regarding the understanding and application of this knowledge in their business processes and operational procedures. As note Kogut and Zander (1993), a key added value of knowledge for firms is derived from the proper alignment of their strategic and operational activities with contextual and institutional requirements in each country market in which they operate. Transaction cost optimization resulting

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<sup>2</sup> While diagonal cumulation may represent an important institutional mechanism for increased trade dynamics of WBCs, it is far from being the single lever available for enhancing trade/export capacity. In addition to efforts that are part of the EU's institutional mechanisms, the European Commission continues to provide technical assistance to Bosnia and Herzegovina, Montenegro and Serbia for their accession negotiations with the WTO. Other measures to support trade integration include participation in tenders under the pre-accession and neighbourhood instruments (IPA and ENPI) and continued significant financial support for alignment of the WBCs with the main trade-related parts of EU legislation. Finally, to benefit from an unlimited duty free access to the EU market for nearly all products originating in WBCs, the EU proposed to prolong the special autonomous trade preferences for WBCs until 2015.

from the utilization of location specific advantages is thus seen as firms' important competitive driving-force for their internationalization processes. Exploiting various institutional incentive mechanisms in their strategies can be an important step for strengthening their competitiveness, when the value of such institutional initiatives for their competitive positions and business performances is properly recognized by managers and then integrated into their strategic and operational decisions.

The key aim of this paper is to explore the effects of a diagonal cumulation of origin as the EU's Common Commercial Policy (CCP) incentive mechanism on the intra-regional trade flows and its effect on the transaction cost structure of firms in their cross-border business operation configuration in a selected regional context. We start our research with a conceptual research of linkages between the firm internationalization process and effects of institutional mechanisms that influence the strategic and organizational alignment of their international operations with institutional mechanism framework. Our key research aim in the theoretical part of the paper is to explore the effects of institutional incentive mechanisms, in particular the diagonal cumulation of origin, on the cross-border trade development between eligible countries and on the cross-border physical flows of goods of firms as part of strategic adjustment of their value-adding processes in the cross-border configuration of the component assembly system for taking advantage of this institutional incentive framework.

Based on a theoretical framework of effects of diagonal cumulation of origin as the EU's incentive mechanism on cross-border trade in a specified region, in the empirical analysis we then explore the effects of the 'SAP+ diagonal cumulation of origin' on changes in the transaction cost structure of firms and their business performance. This part of the research was conducted by the use of in-depth case-study research of a selected Slovenian firm operating within the household-appliance sector and marketing its products extensively in the EU's markets and in countries in Central and Eastern Europe. In particular, the firm's local subsidiary located in Serbia was chosen and for the import/export transactions of its products detailed cost calculations were made as a starting point for developing three different business scenarios in order to explore their effects on transaction cost changes of the firm under the assumption that its location eligibility enables the firm the use of the goods of origin as a corresponding incentive framework. The aim was to develop a conceptual framework that would show firms how they can properly align the spatial configuration of their value-chain systems and flows of semi-finished products for optimizing their overall transaction costs in terms of taking advantage of incentives offered by the *diagonal cumulation of origin* institutional framework. In particular, we have explored in detail a framework determined by the EU's '*SAP+ diagonal cumulation of origin*' from the perspective of its effects on firm transaction cost that might be realized through proper business configuration and implementation of firms' international operations. Firms can optimize their processes and cost

structures through deliberate spatial configuration of their value-chains, if managers understand how different institutional initiatives can affect the organization of their firms' business activities. We assumed that such understanding might frame their strategic thinking for responding properly to institutional incentives by optimizing the firm performance at three levels:

1. Through optimal spatial configuration (location) of their physical value-chain within institutionally defined geographical and trading area;
2. By striking a proper balance between the ownership vs. control strategic alternatives in searching for appropriate strategic production options for producing product components (in-house, outsource them through contractual arrangements, etc.);
3. By optimizing cost decisions through searching for cheaper production input options (to lower overall production costs) from the perspective of taking advantage of available institutional incentive schemes in specified geographic area of their business operations.

Our key research interest in the paper was thus to explore the effects of the SAP+ diagonal cumulation of origin' on changes in cross-border trade of countries and on transaction cost structure of firms inside this incentive scope, therefore we framed our research with the following two research hypotheses:

*H<sub>1</sub>: The EU's diagonal cumulation of origin is an important institutional incentive mechanism for promoting external trade by encouraging firms' international operations and improving their transaction cost optimization through a proper spatial configuration of their value chain processes.*

*H<sub>2</sub>: The business performance optimization of internationally operating firms may be improved with proper strategic alignment of physical flows in their product-component assembly system with institutionally framed incentives for cross-border trade in a specific trading scope.*

In the first part of this paper we discuss some key drivers of firms' internationalization process in their effort to strategically optimize own value-chain and assembly processes. We present the origin of goods with the cumulation of origin concept that affects the firms' strategic and operational decisions in their cross-border business expansion strategies. In this part of the paper we explore how firms can optimize their revenue and cost structures by aligning and adjusting their strategies and operations in their international value-chain configuration in such a way that they will comply with the beneficiary status regulation defined by the SAP+ diagonal cumulation of origin. The study shows how firms can integrate this mechanism into their internationalization strategies in order to improve their business performance.

## 2. Theoretical backgrounds

### 2.1. Firm internationalization in dynamic external context

With fiercer international competition firms are increasingly faced with pressures to cut their costs and improve pricing, and as a result of these pressures their performance may deteriorate. Traditionally, their model of internationalization, known as the Uppsala model of internationalization (Johanson and Vahlne, 1977), was based on a psychic distance concept and market knowledge accumulation through international experience as a key input into their gradual international expansion. This internationalization paradigm has recently been criticized as being unable to properly explain the internationalization of firms operating in an increasingly changing international business context.

More and more, due to external dynamics markets and various industries (particularly in high-tech field) firms are forced to internationalize their business activities at early stage of their business development and with increased speed. In addition, the previous international experience of the entrepreneurs, their development of personal business contacts and networks abroad are seen as visible drivers of early firm internationalization. However, the temporal dimension of firm internationalization (precocity and speed) (Zucchella *et al*, 2007) and first-mover advantage (Eisenhardt and Brown, 1998) are seen as key drivers of their business performance. These are only few of reasons, noted by researchers, for the need to broaden the internationalization paradigm with new insights into firms' international behaviour: developing a configuration of their spatial activities globally within emerging business networks or through a born global firm approach (Rial *et al*, 2005), by using newer strategic approaches, e.g. strategic alliances (Anand and Khanna, 2000) and virtual international business ventures etc.

Detailed discussion of various internationalization paradigms is beyond the scope of this paper; however, we may conclude that the globalization has broadened the geographic scope of firm business operations that enables managers to integrate various external drivers of business performance in their firm strategies. In particular, in parallel with the growing dynamics of international business context also strategic and operational aspects of firms' international operations have broadened and become more complex; therefore, crafting effective international business strategies requires a much deeper managers' understanding of various strategic options about the levels and scope of possible effective leverage of firms' domestic advantages in the process of developing strong competitive positions in international markets (Craig and Douglas, 1997). Dynamic view of internationalization is based on the assumption that internationally operating firms should continuously readjusting their internationalization strategies with changing external rules of the game in international business context in order to optimize the use of their resources for achieving competitive advantages and desired performance in a variety of institutional settings. In this process, and by engaging in

various forms of value-added activities outside their home country, firms configure their multi- or transnational character (Dunning and Lundan, 2008). As business performance and competitiveness of firms are tightly related with *spatial configuration* of their activities and processes, they can better exploit differences in productivity with a proper strategic design and implementation of processes and activities, take advantages of arbitrage in local cost of production, and other available location specific incentives for their cross-border performance optimization (Ghemawat, 2007). However, as noted by researchers (Rugman and Verbeke, 2004; Rugman and Greidanus, 2009), the majority of internationalization activities in internationally operating firms are performed inside their home region and the regionalization phenomenon in firm cross-border expansion strategy seem also to be a key international expansion strategy for the world's largest multinational firms.

A firm's strategy and the extent of its cross-border production activities greatly depend on the industry within which it operates, and on its product characteristics (the tradability of its semi-finished goods, etc.). However, a true level and the extent of its intra-firm trade pattern and the international supply-chain development pattern or, broadly speaking, its *global business model*, will not depend only on the industry within which a specific firm operates, on its product characteristics (level of product technology sophistication, the tradability of its semi-finished components, developed supply networks, etc.), but equally on the relevant external institutional and production factor incentives (UNCTAD, 2006) and other rules (e.g. technical standards). In this process, firms may efficiently exploit a location specific advantages based on various *institutional mechanisms* that have been introduced by local (national) or supranational institutions (e.g., economic integrations) with the intention to promote a cross-border trading of goods and/or establish a certain country or region as an attractive production location. Such institutional incentive mechanisms enable foreign firms to lower their transaction cost structure by optimizing processes within their local production facilities, and adjust their international flows of goods with the requirements for granting institutional incentives. As a careful design of their geographical scope of operations might be viewed as a driver for achieving a sustainable competitive advantage, firms should carefully design the *spatial configuration* of their assets, capabilities and resources (Craig and Douglas, 2000) together with their ability to effectively manage these activities as a key dimension of their global strategies.

## **2.2. Contextual information and international expansion of a firm**

Discussion on the internationalisation process has revealed the importance of a knowledge development process for efficient foreign market entry (Petersen et al, 2008:1097), both at the strategic and operational level. With gaps in their market knowledge during their initial foray into foreign markets it is, then, understandable that firms usually focus their initial international expansion efforts on markets that are similar to their home market because with such strategy managers may lower

their perception of uncertainties that derive from foreign market entry (psychic distance). Gradual learning from experience in a cross-border expansion may lower the uncertainty perceptions of managers and, at the same time, by entering similar foreign markets, firms may transfer their domestic market knowledge into a foreign market in order to lower the cost of foreign market entry. Proper understanding and interpretation of a contextual situation is also important for objective market opportunity assessment, because, the managers' access to objective market knowledge is usually imperfect. The understanding of commercial policy incentives – of the EU or other trading regions of interest to a firm – and their eligibility requirements for firms within a selected trading area is considered as an important part of the objective knowledge provided through the gathering of objective information from institutional official sources (Eriksson *et al*, 1997). Thus, the institutional context should not be overlooked in the decision-making process of managers (Pucik *et al*, 2009:392) as in their everyday's business life a firm's true exploitation of offered incentives depends on a proper adjustment of its operational value-adding processes, business activities, procedures, and routines in order to comply with the obligatory requirements for demonstrating the status of an eligible beneficiary of offered institutional incentives. The accumulation of relevant experiential knowledge serves as a key final test of a true firm's ability to take advantage of available institutional incentives.

### **2.3. Institutional view of international business development and value-chain optimization**

Traditional international business paradigm has recently been broadened with the *institutional view* of international business as the contextual framework that affects a firm's international expansion and market performance in international business environment. As recent research (Peng *et al*, 2009; Peng *et al*, 2008; Meyer *et al*, 2009) shows, both formal and informal institutions (North, 1990), affect the international business activities of firms. According to the institutional view of international business, institutional factors affect the attractiveness of a given country or region for multinational enterprises (Dunning and Lundan, 2008:139) in its dual role, either as a host country or a home location for their business activities. Other important factors to be considered in this process are the industry within which a firm operates, and its capabilities based on a resource-based perspective of competition, respectively. Firm's capabilities are seen as a dynamic concept based on processes that are embedded in a firm (Eisenhardt, 2000:1106). Observed from this perspective, a firm will be able to take advantage of opportunities that rely on offered duty reductions if managers are capable of adjusting all required firm's operational *processes* and *procedures* (e.g. in a firm's supply and assembly processes) with the requirements of the EU's regulation concerning awarding a firm a status of eligible beneficiary of offered institutional incentives that have been developed for promoting trade inside a specified trading area. In order to take advantage of various institutional incentive mechanisms, the product component assembly strategy and geographical



reconfiguration of business operations of a firm should be coordinated from its international operations and from a wider cross-border supply-chain management perspective. For example, the efficiency of a firm's outward foreign direct investment (FDI) may be based on developing a comprehensive intra-firm trade pattern with a cross-border supply of components between the firm's own production plants (subsidiaries) located in different national (institutional) environments in order to take advantage of production cost arbitrage with an appropriate cost-reduction strategy. The aim of such strategy is to develop the firm's system wide efficient cost optimization framework by spreading its geographic configuration of business activities, and, at the same time, integrate them in a consistent portfolio of business activities based on reaping synergies of its international operations.

The improvement of a firm's business performance may, thus, be achieved by exploiting available institutional incentives for *lowering* its transaction costs through a purposeful implementation of key routines in its business operations at various spatial locations (in carefully selected countries). Such efficiency oriented measures should be carefully analysed in a consistent way, as, because of differences between home and host contexts the implementation and adaptation costs may increase as the firm's home location routines are not fully applicable or may be fully inappropriate in a new institutional and business setting (Madhok, 1997:47).<sup>3</sup> In a final cost-benefit analysis all relevant costs should be considered in order to assess a final overall net transaction cost effects and net contribution of institutional incentives based on import duty to the lowering of overall transaction costs.

The principal objective of private enterprises in undertaking foreign production is to advance their long-term profitability (Dunning and Lundan, 2008:66) by exploiting those firms' sources of competitive advantage that the above authors summarize as the 'OLI framework of the international business paradigm'. They show how international expansion of a firm and its competitive performance are dependent on exploitation of its *ownership-specific*, *location-specific*, and *internalization advantages*. However, in this paper we do not explore, in detail, market seeking investment as a source of firms' international expansion, but rather how they may integrate their value-chains and physical presence in foreign countries with their overall business optimization in order to improve their performance. However, besides their *ownership-specific* advantages that are usually labelled as *key competencies*, firms also develop *location-specific* advantages that are linked to a specific location and may rest, inter alia, also on local institutional incentive mechanisms.

The existence of transactional market imperfections (failures) may stimulate firms to develop a third stream of advantages, the *internalization advantages* that arise from common governance of business activities by controlling their performance at different

<sup>3</sup> The same has been experienced by Japanese car manufacturers in their strategies of moving car production to the UK and USA location.

locations of their value-adding network. Selected location specific advantages may evolve *also* from institutional foreign trade and investment-climate policies developed either by a local government or by other institutions at a supranational level (as is the case of our focus on EU's institutional incentive mechanisms). For example, managers may take advantage of the EU's status of origin facility as part of the EU's external commercial policy by aligning their firms' international supply-chain strategy and all other required activities, processes and routines with the EU's import duties lowering scheme in order to reap the advantages of such incentive mechanism. With such a perspective we extend the traditional understanding of the institutional view of international business of firms, by which a firms should purposefully align their organizational effort in a broadest sense in order to avoid the negative effects of *institutional restrictions and barriers* on their operations in a foreign country's institutional context. We suggest that managers in firms should also take into consideration available *institutional incentive facilities* that are introduced by various institutional regulating bodies aimed at increasing the attractiveness of a country's local business environment as a production location site or as a platform for encouraging its international trade flows. During this process, both objective and experiential knowledge are required by a firm in order to develop a proper organizational context, i. e. transform its strategic decisions into efficient operational procedures, activities, and routines in such a way that it would comply with the prescribed institutional requirements (formal condition) for achieving *the* status of eligible entity for utilizing available institutional incentives.

The consideration of such requirements should be made very early in the business process planning, preferably during the phase of a firm's international expansion strategy formation, in order to properly integrate them with its foreign market entry mode decisions and with its evolving operational business framework (organization, processes, etc.) in order to fully comply with prescribed institutional requirements. The firm's direct exposure to local institutional context should provide managers with relevant experiential knowledge for developing and cultivating relationships with key partners in its supply-chain network and assembling a consistent and efficient international assembly network. This effort should lead toward the providing of such flows of supplied components and semi-finished assemblies that will enable the firm to comply with all required formal provisions that were prescribed by the incentive package offering institution. Besides the objective (regulatory) knowledge managers should get a direct access to learning about local business and administrative practices that is usually a key success factor for proper organizational and procedural alignment of a firm with its external institutional settings. With such experiential learning based on a firm's direct presence in a foreign country, its liability of foreignness will gradually diminish or even disappear (Chang and Rosenzweig, 2001:752) and its ability to adequately perform all required activities and procedures for lowering its transaction costs would be increased. The firm will thus be in a better position to reap external benefits in a foreign institutional context. We may conclude from the research on the resource-based view of a firm competitive advantage that

strategies are always *context specific* as they are moderated by the characteristics of the particular context (country market, industry, and region) within which a firm operates and which also defines *the* specifics of its performance framework. Obviously, the key test of the value of a firm's resources must be performed, as notes Barney (2001:52), in the *specific market context* within which a firm is operating and which is formally shaped by relevant mechanisms, practices, procedures, and actions of various institutions and their policies (*contextually specific incentive packages*).

As various incentive packages are always focused on achieving some strategic institutional goals of the propounding institution(s), managers should view such benefit packages as a dynamic concept that is usually introduced only for a limited time period. Due to the temporal nature of such institutional incentives, timing of firms' strategic steps is a key factor for taking advantage of offered benefits. After a certain period, incentive mechanisms may change or be abolished. Contextual nature of international operations strategies is thus closely linked with the dynamics of external change; therefore, managers should regularly monitor key changes in their firm's external context. However, as noted by Delios and Henisz (2003), there is not so rare situation that managers are forced to change their strategies in the midst of their implementation in order to adjust a responsive behaviour of a firm with changing institutional context. Therefore, also the EU's CCP and the 'SAP+ diagonal cumulation of origin' should be understood by managers as a temporal institutional package, the duration of which is closely linked with the strategic goals of EU's CCP and the nature of its institutional relations with selected non-member countries.

Developing strategic advantages of a firm in international business settings is, obviously, a comprehensive, multifaceted, and dynamic concept that should be put into its relevant external context. This may require that firms use an integrative (holistic) approach to their strategic management by combining various elements of their product and component structures, organizational processes (supply-chain, production, sales, etc.) from the perspective of their internationalization strategies, which may include also a geographical diversification of the purchasing *and* sales sides of their business models. Finally, decisions of managers on strategies for international operations of a firm are made by facing some *ex ante* limitations in their sight and which are based on their understanding of relevant institutional policy mechanisms *at the point of* making decisions on market entry into a *selected* country market. However, managers' decisions are always exposed to *ex post* uncertainties arising from changes in the institutional framework that may put seriously into question their initial assumptions about the market performance framework and designed strategies.

#### **2.4. The concept of diagonal cumulation of origin and firm value-chain optimization**

The EU's *Common Commercial Policy (CCP)*, as a key dimension of its economic relations with the rest of the world, has comprised a broad variety of instruments

that have been put into practice over recent decades for strengthening its position in a global society (Europedia, 2009): common external tariffs, trade-defence instruments, multilateral negotiations and *free trade agreements* (FTAs)<sup>4</sup>. Its strategic intentions for a broader regional economic integration (REI) as part of its foreign trade policy framework have been made viable with a proposed concept of *origin of goods* as one of the key pillars of such policy. Under comprehensive provisions on the origin of goods, products traded with third countries are subject to preferential or non-preferential treatment when entering REI. Goods labelled with non-preferential origin, are subject to tariffs, quotas, anti-dumping measures, and various non-tariff barriers with which the EU regulates its external economic relations with non-member countries. On the other hand, all goods labelled with preferential origin can benefit from a reduction in or even exemption from customs duties and, in defined cases, can enter a REI without non-tariff barriers.

The key idea of the rules of origin is a detailed specification of rules that should be considered when deciding on eligible beneficiaries for offered incentives. Therefore, the rules of origin specify that only products entirely produced in one country, using only materials from that country, or products having been treated in a regulated way in that country, can be regarded as originating products (Krishna, 2005; Inama, 2009; EC, 2009a). Only these products are eligible for benefitting from preferential treatment and are eligible for autonomously granted preferences under the FTA or under the General System of Preferences (GSP). Such goods (components, parts, final products) must fulfil the relevant conditions laid down in the origin protocol to the FTA or in the rules of origin of the autonomous arrangements and which demand that they must (1) be manufactured from raw materials or components that have been grown or produced in the beneficiary country or, alternatively, (2) undergo a certain amount of work or processing in the beneficiary country. Additionally, in rules also the least amount of work or processing required on non-originating materials is explicitly defined as a required condition for resulting goods to be awarded the *originating status*. Thus, the mechanism of rules of origin may, in great extent, limit the expected economic benefits of REI, or, even more importantly, they may cause distortions in favour of the partner who has been able to negotiate rules of origin that best match the capacities of its domestic industries.

The above conceptual explanation can be illustrated with a following short practical explanation of the mechanism's economic impact from the perspective of beneficiary parties that are involved in such trading transactions. The rules of origin set in a FTA between countries A and B, are designed to prevent trade deflection, which would happen if, for example, the third party (C) would try to export to B via A as a country with lower tariffs. Therefore, the exporters to A and B need to prove intra-FTA originating status in order to obtain reduced or free customs duty access

<sup>4</sup> For the preferential arrangements of the EU see EC, 2009.

to each other's market. If, for example, A and C sign a similar FTA as do countries A and B, both goods – goods originating in B and goods originating in C would have preferential access to country A. However, goods produced in B, by using intermediates from C, would not meet the rules of granting an originating status for exporters from B (as defined in according to the rules applied between A and B), would then be subject to non-preferential status when exported to A. On the one hand, goods directly exported from country C to country A would be granted preferential access. On the other hand, the goods exported from B using intermediates from C, would not enjoy the preferential access (Augier *et al*, 2005). The solution for such situation may be to allow the cumulation of use of materials or processes across countries with parallel or mutually overlapping FTAs. *Cumulation of origin*, therefore, exists in order to encourage the use of materials and processing within the FTA(s) while maintaining a common standard (identical protocols on rules of origin) for treating third country non-preferential inputs (EC, 2009d). In the literature, the following three types of cumulation are described as institutional incentive tools<sup>5</sup>: bilateral cumulation (between any two countries or in a single FTA), diagonal cumulation (between three or more countries or a variety of FTAs with mutually interlinked trading agreements), and full cumulation (the same as diagonal cumulation, but with a more flexible arrangements than those defined by the diagonal cumulation).

In 1997, the Pan-European diagonal cumulation of origin was put into effect between the EU and EFTA (European Free Trade Agreement) member states<sup>6</sup>; later on (in 2005), it was transformed into the *Pan-Euro-Mediterranean (PEM) diagonal cumulation of origin*.<sup>7</sup> Further initiatives, e.g. the Euro-Mediterranean (Euro-Med) Ministerial conference in Lisbon in October 2007 (CEU, 2009), have evolved into consensus on joint drafting of a single regional Convention on preferential rules of origin for the entire PEM area. The basic idea was to replace the current network of protocols regarding rules of origin with a single regulating mechanism for cross-border trade flows in the region. From strategic reasons were included also countries that enjoyed a participating partner status in the Stabilization and Association Process (SAP)<sup>8</sup> with the EU (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Serbia, as well as Kosovo under United

<sup>5</sup> Readers may find a more detailed review of literature on the topic in Augier *et al.*, 2004.

<sup>6</sup> Turkey was included in the Pan-European diagonal cumulation of origin in 1999.

<sup>7</sup> The PEM operates between the EU and EFTA member states, Turkey, Faroe Islands and the countries of Barcelona Declaration - Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Palestinian Authority of the West Bank and Gaza Strip.

<sup>8</sup> The Stabilisation and Association Process (SAP), as the framework for EU negotiations with the WBCs has three main aims: firstly, stabilizing the countries and encouraging their swift transition to a market economy, secondly, promoting regional cooperation, and thirdly, eventual membership of the EU. The countries covered by the SAP are Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia, including Kosovo as defined in UN Security Council Resolution 1244/99 (EC, 2009b).

Nations Security Council resolution 1244/99 (Western Balkan Countries (WBCs)) into the PEM diagonal cumulation of origin (see EC, 2009c). The conclusions of the Convention were finally supported at the Euro-Med Ministerial conference in Brussels in December 2009 (EC UN, 2009) and is expected that upon this final consideration it will soon become fully operational.

Some preliminary results of recent developments show that although it is difficult to generalize, in some sectors the rate of PEM diagonal cumulation of origin utilization was as high as 70 percent of exports. On the other hand, surveyed experts in industries with a high-level of vertical integration (i.e. textiles, automobiles, electronics, etc.) find the current rules of origin out of date and too strict. A study exploring the economic integration of the Euro-Med region (CEPS, 2009) was based on a survey of government and business representatives in the EU and in 5 Euro-Med countries (MED5) – Egypt, Israel, Jordan, Morocco and Tunisia. The study has revealed that, among the MED5 countries, the overall picture on the percentage of companies that were benefiting from this new system, changes from sector to sector. Surveyed experts deeply doubt that exporters may substantially benefit from this mechanism, because, by not recognizing the ‘division’ of labour, the current rules of origin are seen as too rigid.

However, the underlying rationale for a decision of Euro-Med trade ministers to include WBCs into the PEM diagonal cumulation of origin was rooted in the fact that current bilateral cumulation of origin, whose viability emerged with the Stabilization Association Agreements (SAAs) between EU and WBCs, was not efficient enough in promoting a more dynamic growth between countries inside a broader region. As inputs from other WBCs countries were treated as ‘external’ imports, the bilateral cumulation of origin in trade with the EU has actually *discouraged* firms from the WBCs from developing mutual production links with a focus on supplying EU markets. In business reality, these arrangements may also prevent multinational corporations from establishing production networks across WBCs, because the established bilateral cumulation of origin rules erect a barrier to the development of trade that would be based on staged fragmentation of production, i.e., supporting the moving of various fragments of a supply-chain or assembly operations across borders. But, as the CCP of the EU has a central role in the SAP, the inclusion of WBCs in the PEM cumulation of origin is the EU’s strategic aim (EC, 2009c; CEC, 2008). We may contemplate that in the established trade flows above mentioned (and some other) shortcomings of the PEM cumulation of origin for WBCs are reflected, and obviously, the intention that such incentive mechanisms would have a key impact on long-term trade and economic growth prospects will not be fully fulfilled (CEP, 2008:11). However, the reason for such situation may also lie in the fact that the EU with its actual trade policy is still not able to offer an efficient trading tool which could additionally support the inter-regional trade growth among the WBCs (Kumar and Kandžija, 2009: 11).

In spite of the fact that this assessment is based on limited trade relations between the WBCs and their potential partners within the Mediterranean region, it remains questionable whether in the long run, the WBCs could make a much broader and effective use of diagonal cumulation with Mediterranean business partners. As inclusion of the WBCs within the PEM cumulation of origin should be seen as long-term evolving process<sup>9</sup>, it is important that, along the way, the authorities pay sufficient attention to the emerging shortcomings of the arrangement in force and respond accordingly by solving pressing formal shortcomings and dilemmas in existing procedures. Rather, there still remains a main dilemma concerning the lengthy introduction of tentative proposals about amending the protocols on rules of origin of WBCs, because they cannot enter into force before being harmonized within all PEM countries. At the same time, urgently resolved should also be a dilemma on proposed technical amendments to the PEM protocol, which prescribes the use of EUR-MED certificates in trade between them as such formalities that are reflected in the double certification (movement certificates EUR1 and EUR-MED) may make the existing trade flows between the EU and the WBCs more complicated (ibidem: 11-12).

Amongst the four forms of rules of origin, which could be used for the WBCs in the meantime and were presented by the European Commission in 2007 (CEC, 2007), was also a form of *the SAP+ diagonal cumulation of origin* with the aim to a diagonal cumulation zone between the EU, EFTA, WBCs (CEFTA 2006)<sup>10</sup> and Turkey. The latter is seen as particularly justifiable from the point of view of existing business ties between these partners. With its mechanisms, the proposed SAP+ diagonal cumulation was seen, at the same time, as a practical, procedurally fast and straightforward solution for eliminating and preventing some of the negative effects arising from the current lack of diagonal cumulation, where the trade suppression and trade diversion effects were particularly seen as key negative influences (CEP, 2008:13). Particularly beneficial would be the extended free-trade zone, enabled by SAP+ diagonal cumulation, for those foreign companies that would be ready to invest in the WBCs, but were before hindered in this by existing limiting rules of origin. With increased attractiveness of the WBCs as business locations for foreign direct investment (FDI) for foreign companies, including larger multinational corporations, such institutional incentives should support their intentions to invest in establishing their local production networks across the WBCs' region. The key point here is that the inclusion of a small national market into the larger area of regional trade area framed by freely accessible markets could substantially increase its attractiveness for FDIs inflow (Kumar and Kandžija, 2009: 8).

<sup>9</sup> However, it has to be taken into account that, so far, the Southern Mediterranean countries have not delineated any free trade agreements among themselves (either on bilateral or on multilateral level).

<sup>10</sup> As of 1 May 2007, members of CEFTA are: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Moldova, Serbia and Kosovo (under UN Security Council Resolution 1244/99). Moldova is not covered by the SAP. For CEFTA 2006 impacts and problems see Kumar (2008:106)

Also companies that have already established their business presence in this region, may despite some already mentioned unfavourable conditions reduce their unnecessary costs relating to customs barriers and, as a result of the improved transaction cost structure, increase their competitiveness accordingly. Moreover, it is expected that a removal of technical barriers would provide additional impetus for increased trade in intermediate goods, based on assembly relocation and, thus, a share of intra-industry trade should increase. Recent research (see Augier *et al*, 2005) has shown that a form of SAP+ diagonal cumulation of origin may lead to three positive effects – trade creation, trade reorientation, and trade expansion. There exists rather also a visible negative effect, namely the possibility of trade diversion. Such deviation might occur if some of the goods imported from the most efficient suppliers in certain segments from the rest of the world, could be redirected towards less-efficient partners in the system of cumulation. However, in view of the overwhelming share of WBCs' trade that is already taking place with those partners in the prospective SAP+ diagonal cumulation zone (see Tables 1 and 2), there exists a negligible reason for an extensive spread of trade diversion.

### 3. Empirical research

#### 3.1. Foreign trade trends between countries in the SAP+ diagonal cumulation zone

The underlying rationale for introducing the SAP+ diagonal cumulation of origin may be traced in the actual trade flows between prospective partner countries of this cumulation of origin arrangement. The existing EU-extra trade in goods with EFTA member states, WBCs, and Turkey is a good indicator of actual trade trends that have evolved between countries within this region over years, in particular through their economic relations. We present the volume of external EU trade in goods (in 2008) with its main trading partners – China and USA – in comparison with trade flows with Turkey and WBC countries. In that year, the external EU trade in goods with WBCs represented a modest 0.9 and 2.5%, respectively.

Table 1: Extra EU-trade in goods with EFTA, WBCs and Turkey (2008, in %)

	<i>Imports</i>	<i>Exports</i>	<i>Imports + Exports</i>
World	100.0	100.0	100.0
Main trading partner	16.0 (China)	19.1 (USA)	15.2 (USA)
EFTA	11.3	11.1	11.2
Turkey	3.0	4.1	3.5
WBCs	0.9	2.5	1.6
EFTA + WBCs + Turkey	15.2	17.6	16.3

Sources: EC, 2009e, 2009f



When we observe these trade flow developments from the perspective of WBC countries, the picture is totally different (Figure 2). The importance of WBCs' trade in goods with prospective partner countries from the SAP+ diagonal cumulation zone is substantially higher as it has climbed in 2008 above the 70% level of all trade with the world.

Table 2: WBCs trade in goods with EU27, EFTA and Turkey (2008, in %)

	<i>Imports</i>	<i>Exports</i>	<i>Imports + Exports</i>
World	100.0	100.0	100.0
Main trading partner	66.3 (EU27)	69.7 (EU27)	67.3 (EU27)
EFTA	1.8	1.1	1.6
Turkey	3.5	0.8	2.7
EU27 + EFTA +Turkey	71.6	71.6	71.6

Sources: EC, 2009e, 2009f

In last five years period (2004-2008) EUs' trade with WBCs averaged an optimistic 13.2% growth, which shows a significantly more dynamic trade flows in comparison with a 9.7% average growth rate with the rest of the world over the same period (9.7%) (EC, 2009e). However, the WBC countries have marked a much lower annual growth of trade with the EU (1.1%) during the same period; however, a growth of WBCs exports to the EU climbed to the 5.7% growth rate which is close to the growth rate of the whole WBCs exports (6%). Kumar and Kandžija (2009: 11) noted a similar picture of trade flows for the period from 2003 to 2007 when the value of WBCs exports to the EU27 grew on average by 7,7% and imports from EU27 by 1,5%. However, they also noted a noteworthy shift in relative shares of WBCs exports and imports to the EU27, which were gradually decreasing (2003/07) in spite of the growing value of their trade with the EU countries. They see a possible explanation for such a change in the WBCs trade structure and point to a need of developing a new approach in supporting the WBCs accessing process to the EU.

More recent data (EC, 2009e) again confirm a higher average share of exports to WBCs within the total EU-27s' exports (2.5%) in comparison to the average share of WBCs imports in the total EU-27s' imports (0.9%): At the product groups level the highest shares belong to the exports of textiles (6.2%) and imports of iron and steel (3.8%). Within the EU-27 exports to WBCs, as well as within the EU-27 imports from WBCs, the highest trade flows belong to machinery and transport equipment with the 35% and 19.4% shares, respectively. The structure of trade between the EU-27 and the WBCs shows that the larger parts of imports and exports are represented by goods with low value-added. Similar results have been found by Kumar (2008:102). Kumar and Kandžija (2009: 11) point to the need of WBCs to make their great effort for keeping the growth of trade with EU and, at the same time, to improve structure

of their exports by increasing the share of higher value added products which may be the result of improved inter-regional trade and cooperation of partners inside the region in joint production of technologically more sophisticated products.

In the next chapter a case study is presented with certain key calculations regarding the effects of import duty allowances on business performance from the perspective of the subsidiary of a Slovenian firm located in one of the Western Balkan Countries (WBCs).

### **3.2. The case study of a tentative value-chain optimization via SAP+ diagonal cumulation of origin**

To examine the possible effects of SAP+ diagonal cumulation of origin on business performance at a company level we have used the calculated summaries of export prices for two selected products from a company's production program at its Serbian subsidiary. On this basis the importance of the concept of origin of goods and the consequences of accepting SAP+ diagonal cumulation of origin was tested and then, upon available calculations, a simulation of three possible scenarios concerning the origin of goods was made.

We present basic pricing data in the Tables 3 and 4. It is evident from the presented data that from the company's break down of pricing structure the following key conditions are fulfilled for acquiring the status of preferential origin (according to Article 15 of the Protocol on origin (EC, 2009d) that defines exemption from customs duties) for the two observed products that should be exported from Serbia to the EU: in the assembly process of both products more materials with preferential origin than with non-preferential origin are used. With the 95% and 75% shares, respectively, the company even substantially exceeds the prescribed necessary conditions which amount 50% of the total value of the used materials; at the same time less than 40% of materials without origin are used (amounting 4% and 20%, respectively), and less than 10% of materials without origin (2% and 5%, respectively) from the same tariff number as the products are used.

Table 3: The structure of EXW and CIP export price of deep freezers

	<i>Euros</i>	<i>% (in EXW price)</i>	<i>% (in material)</i>
Value of material	112.38	74%	100%
Materials with preferential origin	106.90	71%	
EU preferential origin	83.34	55%	74%
RS preferential origin	23.56	16%	21%
Materials without preferential origin	5.48	4%	5%
Labour, profit and others	39.12	26%	
EXW price at WBC »X«	151.50	100%	
Transport, insurance and other costs	3.50		
CIP consignee WBC	155.00		

Note: RS – Republic of Serbia

Source: own calculations of company's data

Table 4: The structure of EXW and CIP export price of refrigerators

	<i>Euros</i>	<i>% (in EXW price)</i>	<i>% (in material)</i>
Value of material	98.28	81%	100%
Materials with preferential origin	74.31	61%	
EU preferential origin	56.38	46%	57%
RS preferential origin	17.93	15%	18%
Materials without preferential origin	23.97	20%	24%
Labour, profit and others	23.22	19%	
EXW price at WBC »X«	121.50	100%	
Transport, insurance and other costs	4.50		
CIP consignee in the EU country	126.00		

Note: RS – Republic of Serbia

Source: own calculations of company's data

From the perspective of the Serbian subsidiary of household appliance producer, we may conclude that the conditions for the Serbian products to acquire the status of preferential origin (the exemption from the import tariffs for Serbia as the importing country on the basis of the movement certificate EUR.1 or on the basis of the statement on the invoice) are fulfilled, not only for member states of EU and EFTA, but also for member states of CEFTA 2006 and Turkey. The validity of such conclusion is based on the fact that, from 1<sup>st</sup> February 2010 onwards, the Interim Agreement between EU and Serbia on trade and trade related matters has definitely entered into force (EC, 2010).

The current situation of a Slovenian household subsidiary in Serbia is still a bit different, as in its assembly process, it uses mainly materials with the European origin (50%), to which an approximately the 15% share of materials from Serbia is added. A true situation from the perspective of present position in the market, and before the enforcement of the Interim Agreement between EU and Serbia, shows that the subsidiary was obliged to bear the extremely high tariff costs for all of the WBCs markets that offered to the firm also the highest actual sales potential.

Table 5: Company's exports and tariffs in selected WBCs, Moldova and Turkey

	<i>Quantity (pieces)</i>	<i>Value (Euros)</i>	<i>Tariff costs (Euros)</i>	<i>Export price (Euros)</i>	<i>Tariff costs per piece (Euros)</i>	<i>Tariff (%)</i>
Bosnia and Herzegovina	25257	3.518.470	351.847	139.00	13.9	10.0
Croatia	30444	4.255.390	313.998	140.00	10.3	7.4
Kosovo	7151	1.082.650	108.265	151.00	15.1	10.0
Macedonia	4218	628.540	33.861	149.00	8.0	5.4
Montenegro	5278	710.296	69.531	135.00	13.2	9.8
Average export price				142.80		
Average tariff costs per unit					12.1	
Average tariff						8.5
Moldova	38	7.073	379	186	10.0	5.4
Turkey	1036	156.623	3.461	151	3.3	2.2

Note: The data are for 2008.

Sources: EC, 2009g and own calculations of company's data

Before the enforcement of the above-mentioned agreement, the relatively higher cost burden of the local subsidiary of a Slovenian firm was a result of high customs expenses per year that have been incurred by the subsidiary for a realized imports in each year. The calculations did not include the possible savings, if the subsidiary could import raw materials from the CEFTA 2006, EFTA and Turkey, respectively, instead of buying materials in China, South Korea and other countries. The opportunity benefits of such cost saving would be substantial, as the savings could be committed to productive purposes, e.g. for new product and technologies development. The end result of such strategy would be shown in increased assembly of final products, lowering of subsidiary's production costs, in more competitive

pricing for new products that may finally strengthen the firm's overall competitive position vis-à-vis other key competitors in the European marketplace.

As to the documentation performance in the import process, the subsidiary which was used in our case study has implemented the "customs procedures with an economic impact"<sup>11</sup> which allow for refunding the duties that were paid on imports of goods once these goods have been exported. Thus, the subsidiary has avoided the payment of import duties for materials supplied from third countries and, as it is evident from above calculations, a greater part of the tariff costs is incurred as import tariffs for products there were sold to other WBCs. After the enforcement of the agreement, the costs of products being sold to Croatia are lower, on average, by approximately 10€, whilst the costs of products being sold to Bosnia and Herzegovina, and Kosovo are lower, by some 14€ and 15€, respectively. Taking into consideration the company's forecasted sales volume to other WBCs, the absolute figure for additional costs of import duties had reached approximately 1.000.000€ per year. This amount is, however, considerably higher than the cumulative amount of additional costs calculated for the import tariffs for materials (on average 6€ per product unit) being used in the assembly of products for the Serbian market.

Under the assumption of the subsidiary's eligibility for using origin of goods in its import/export transactions and the calculations made for its products the following three business scenarios were delineated:

1. In the period before the bilateral acceptance of SAA between EU-Serbia is put in force, the viable option for the subsidiary would be to postpone the payment of import duties for its import transactions, as such act is possible under the valid duty relief scheme called 'customs procedures with an economic impact'. In the export transactions with other WBCs, however, subsidiary should pay, on average, 12.1€ tariff duty per product unit, since for this transactions it would not comply with the conditions for issuing the Movement Certificate EUR.1.
2. After the enforcement of the SAA between EU and Serbia, the subsidiary may abandon above scheme "customs procedures with an economic impact" for its import transactions as it may pay import tariff duties on materials to be used for its assembly in the Serbian location (at that time, the average import tariff duty for Serbian market amounted to 5.6%). In its export transactions with other WBCs, however, the subsidiary should issue the Movement Certificate EUR.1.
3. After the enforcement of SAP+ diagonal cumulation of origin is realized the subsidiary may postpone the payment of its import tariff duties for materials without origin, but not for all its imported materials. On the other hand, in its

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<sup>11</sup> Specific form of customs duty relief known as 'drawback' allows the companies to refund their import duties once the goods have been exported (WB, 2008).

export transactions to the countries covered by the SAP+ diagonal cumulation of origin arrangement (despite Article 15 of the Protocol on origin (EC, 2009e)) the subsidiary should issue the Movement Certificate EUR.1. In case the origin of materials, used in the assembly of product in the company's subsidiary in Serbia, would fully be declared as materials from the EU, Serbia and other SAP+ diagonal cumulation of origin arrangement signatory countries, the subsidiary should not pay the tariff duties, neither on these materials nor for final products being exported to the countries of SAP+ diagonal cumulation of origin.

#### **4. Discussion of research results**

From the empirical research in our paper we conclude that the volume of actual trade between the EU and prospective partner countries in the SAP+ diagonal cumulation of origin zone is comparable with the volume of actual trade between the EU and its main trading partners. However, the share of the WBCs and Turkey in cumulative EU's extra trade is quite moderate. Obviously, the existing FTAs (SAAs) between the EU and CEFTA 2006 member countries and the customs union between the EU and Turkey have not substantially changed the traditional trade patterns between these countries. On the other hand, the share of the WBCs' trade with the prospective SAP+ diagonal cumulation of origin zone is much higher, irrespectively of the fact that the trade of WBCs with EFTA and Turkey markedly lags behind the trade of WBCs with the EU-27. A possible explanation for such trends may lie in the fact that WBCs are not part of the Pan-European diagonal cumulation of origin. However, the full enforcement of this arrangement would enable signatory companies to develop a geographically more dispersed value-chain activities in order to reap the benefits of less costly trade inside the broader region of the WBCs, EU, EFTA and Turkey. WBCs have been under-performing relative to their potential gains from the magnitude and quality of their trade flows with the EU. However, the WBCs' trade is characterized by a poor intra-industry trade and specialization in industries based on unskilled labour and intensive use of natural resource, but rather with a low technological inputs. Therefore, also the rules of origin that allow for bilateral cumulation of origin solely for trade with the EU, offer limited advantages to firms from the Western Balkans and as such they discourage also the intra-regional trade.

With our case study analysis we have shown that before the enforcement of the Interim Agreement, a local subsidiary of the Slovenian household appliance producer located in Serbia would be confronted with additional costs regarding levied customs duties during the processes of sourcing and selling its products within the broader region. We concluded that quite comprehensive difficulties existed for exporters from the EU to the WBCs. As shown by some studies (see CEP, 2008), companies could not benefit from the status of preferential origin at the WBCs' markets when their

exported products mostly contained components or raw materials originating from EFTA countries. Under such circumstances also the firms' foreign direct investment decisions are complicated because it was quite difficult to exactly assess whether a specific location truly offers adequate institutional advantages as a main argument for an assumed investment in assembly facilities at new location. The subsidiary that was used as a case study in our paper has elaborated three possible business scenarios for its import and export operational procedures, where the implementation of the third scenario discussed in the paper was seen as the best option for cost optimization of the firm's overall value-chain activities.

For companies from the EU that are already operating in the WBCs, the SAP+ cumulation arrangement would result in a simplification of formal procedures relating to the determination of origin of goods and a simplification of trade operations in the face of the extended options for the usage of materials, and by taking advantage from wider possibilities for achieving the preferential treatment of their goods. The final result would be reduced costs and more competitive pricing strategies of companies, and finally, their business performance may be improved. Additional side effect of this zone of cumulation would be increased attractiveness of the whole region as an export destination and as a location for FDI. That would possibly encourage companies from the WBCs to upgrade their trading practices with the development of mutual production links with their business partners and other, more complex types of cooperation among firms, leading towards the multiplication of trade and investment flows at a broader international level.

## 5. Conclusions

In the paper we have shown that for institutional incentive mechanisms to be effective, besides their conceptual consistency also their clear operationalisation is required. At its conceptual level, *the 'SAP+ diagonal cumulation of origin mechanism* is seen as a comprehensive framework for promoting a dynamic growth of trade flows among signatory countries. The mechanism is viewed also as a driver of firm transaction cost lowering that may be achieved through a proper spatial configuration of their operations for product component assembly inside the incentive geographic area. Our research has revealed also some drawbacks of such incentive tool that do not fully support our first hypothesis. The partial implementation of the incentive mechanism shows that it did not stimulate the growth of the WBC's trade with the EU as it was expected to do.

Based on the empirical validation of the benefits of the incentive mechanism and by simulating different scenarios on how it affects the firms' transaction cost structure, we concluded that potential cost savings might be realized by the proper mix of firms' cross-border flows of semi-finished goods that are supported by a corresponding

spatial configuration of their value-adding processes and trade flows throughout their supply chain. Thus, the second hypothesis was fully supported. At the conceptual level, business performance of internationally operating firms should be designed by having in mind also existing rules of the game prescribed by the incentive policy providers.

The key contribution of this paper is rooted in the institutional theory perspective of international business as we proposed that the institutional mechanisms for encouraging more dynamic international trade flows among countries should be conceived more comprehensively by considering a *granular understanding* of country industries structures, their external trade flows and typical value added structures of key sectors in countries that are covered by institutional promotional packages. However, in an underlying incentive mechanism analysis, key features of country historical international trade flows should be considered. And, equally important the incentive framework should be carefully monitored during its implementation, particularly during the initial stage of the incentive scheme exploitation. Therefore, more comprehensive approach is proposed in order to increase its sensitivity to country economic differences and their involvement into international trade flows, if it is to motivate increased cross-border trade dynamics and provide the effective incentive schemes for eligible actors in a specific geographic scope. In addition, we propose that the institutional view of international business, based mostly on institutional barriers as a rationale for explaining firms' cross-border activities, should be extended by *inclusion of institutional incentives* as equally important explanatory argument of firms' international expansion process. The analysis of the incentive mechanism net effect on business performance should be put into the overall firm cost structure framework.

Despite the limitations of the empirical research on a single case study in a single industry that does not permit the generalization of our propositions, our study offers several issues that have important implications for policy makers, managers, and for future academic research. We propose, first, that future studies should consider the effects of differences in the firm cost structure and their different export/import dependence levels as triggers of their international operations and performance improvement along with studying the effects of institutional incentive mechanism at a country level. Second, in a research framework preparation, the international trade flows of selected countries in a sample should be considered at a more disaggregated level by broadening the number of industries to be studied, and considering different historical settings of companies included in the sample. Third, a useful future research stream would also be to explore possible *differences* in effects of institutional incentive schemes on international trade flows and firm performance in relation to possible linkages between the value added structure of key tradable goods in country exports/imports and key differences in cost structure of different country industries, respectively. Such research focuses would provide researchers with a more comprehensive picture regarding *the* true effects



of institutional incentive mechanisms both at the firm level and the level of national economy policy making. A more comprehensive research of different cost structures of firms operating in different industries would enrich the understanding of how sensitive is final effect of incentive mechanism to firm demography in different industries, particularly those with key shares in national cross-border trade flows. Such research perspective may also reveal a better insight into strategic aspects of firm international behaviour and their processes of adjusting own operations in taking advantage of the rules of origin as an incentive mechanism *in comparison to* other strategic options that are available to them (e.g. outsourcing, licensing, etc.).

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## Dijagonalna kumulacija porijekla kao institucionalni poticajni mehanizam EU za promociju međunarodne trgovine i poslova

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### Sažetak

U ovom radu istražujemo dijagonalnu kumulaciju porijekla kao institucionalni mehanizam zajedničke trgovinske politike EU za poticanje intra-regionalne trgovine, a koja može istovremeno pogodno utjecati i na strukturu transakcijskih troškova poduzeća. Ovaj rad izučava implikacije ovog mehanizma za transakcijske troškove poduzeća u međunarodnom poslovanju osobito iz perspektive načina na koje mogu poduzeća konfigurirati vlastite prekogranične fizičke robne tokove i procese za kreiranje dodane vrijednosti kako bi mogla iskoristiti efekte dijagonalne kumulacije porijekla. Empirijsko istraživanje je provedeno bilo pomoću detaljne studije slučaja na temelju simulacije efekata 'SAP dijagonalne kumulacije porijekla' na promjene u strukturi transakcijskih troškova određenog slovenskog poduzeća u sektoru proizvodnje kućanskih aparata u jednoj od država Zapadnog Balkana. Na temelju statusa lokalne podružnice kao korisnika koncesije porijekla robe u njenim izvozno/uvoznim transakcijama napravljene su kalkulacije troškova za njene proizvode kao osnova za simulaciju tri scenarija učinaka mehanizma porijekla na promjene transakcijskih troškova poduzeća. U radu se zaključuje, da na konceptualnoj razini mehanizam dijagonalne kumulacije porijekla može poslužiti kao efikasan institucionalni mehanizam za poticanje prekogranične trgovine.

**Ključne riječi:** međunarodno poslovanje, institucionalni poticajni mehanizmi, dijagonalna kumulacija porijekla, Europska unija, transakcijski troškovi, države Zapadnog Balkana

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