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Deep preferential trade agreements and
upgrading in global value chains:
the case of Vietnam

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Studies / Deutsches Institut für Entwicklungspolitik
ISSN 1860-0468

Die deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

The Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data is available in the Internet at <http://dnb.d-nb.de>.

ISBN 978-3-96021-016-0

Printed on eco-friendly, certified paper

© Deutsches Institut für Entwicklungspolitik gGmbH
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Acknowledgements

This report is the outcome of a collaborative research project conducted in the framework of the 51st Postgraduate Training Programme at the German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE) in close cooperation with the Central Institute for Economic Management (CIEM) and the WTO Center of the Vietnam Chamber of Commerce and Industry (VCCI). At CIEM, we immensely benefitted from the overall guidance of Vo Tri Thanh and the generous support of Tran Binh Minh and Pham Tien Hoang during three months of field research in Vietnam. The joint business survey of DIE and VCCI would not have been possible without the support of Nguyen Thi Thu Trang, Nguyen Thi Thuy Dung and their team. We are grateful for the input, advice and critique we received at different stages of the report's conceptualisation and drafting from a number of colleagues, among them, Tilman Altenburg, Fabian Bohnenberger, Lisa Brahms, Clara Brandi, Dao Ngoc Tien, Lidija Christmann, Javier Revilla Diez, Claudio Dordi, Aimée Hampel-Milagrosa, Juliana Kliesch, Phan Le, Alexandros Ragoussis, Sonja Schirmbeck, Evita Schmiege, Hubert Schmitz, Jakob Schwab, Erwin Schweißhelm, Stefanie Sörensen, Tieu Dung Tien, Jörg Wischermann and Peter Wolff. We also benefitted from valuable support from our research assistants Dennis Appenfeller and Daniel Siejak. Last but not the least, we would like to thank our interview partners who shared their insights and knowledge in the understanding that their identities would remain anonymous. Funding from the German Federal Ministry for Economic Cooperation and Development (BMZ) is gratefully acknowledged. The responsibility for all remaining errors lies with the authors.

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Abbreviations

AANZFTA	Australia–New Zealand Free Trade Agreement
ACFTA	ASEAN–China Free Trade Agreement
AEC	Asian Economic Community
AFTA	ASEAN Free Trade Agreement
AIFTA	ASEAN–India Free Trade Agreement
AHKFTA	ASEAN–Hong Kong Free Trade Agreement
AJCEP	ASEAN–Japan Economic Partnership
AKFTA	ASEAN–South Korea Free Trade Agreement
ASEAN	Association of Southeast Asian Nations
BIT	Bilateral Investment Treaty
CMT	Cut Make Trim
DIE	German Development Institute / Deutsches Institut für Entwicklungspolitik
E&E	Electrical and Electronics Sectors
EFTA	European Free Trade Association
EU	European Union
EVFTA	EU–Vietnam FTA
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GVC	Global Value Chain
HCMC	Ho Chi Minh City
HS	Harmonised System
HTS	Harmonized Tariff Schedule
IPR	Intellectual Property Right

ISDS	Investor-State Dispute Settlement
MFN	Most-Favoured Nation
MNC	Multinational Corporation
OBM	Original Brand Manufacturer
ODM	Original Design Manufacturing
OEA	Original Equipment Assembler
OECD	Organisation for Economic Co-operation and Development
OEM	Original Equipment Manufacturer
PTA	Preferential Trade Agreement
R&D	Research and Design
RCEP	Regional Comprehensive Economic Partnership
RoO	Rules of Origin
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
T&G	Textiles and Garments
TPP	Trans-Pacific Partnership
TRIMS	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
TTIP	Transatlantic Trade and Investment Partnership
VCCI	Vietnam Chamber of Commerce and Industry
VCFTA	Vietnam–Chile Free Trade Agreement
VCUFTA	Vietnam–Customs Union Free Trade Agreement
VEFTA	Vietnam–European Free Trade Association
VEUFTA	Vietnam–European Union Free Trade Agreement
VINATEX	Vietnam National Textile and Garment Group
VJEPA	Vietnam–Japan Economic Partnership Agreement
VKFTA	Vietnam–South Korea Free Trade Agreement
VUSFTA	Vietnam–United States Free Trade Agreement
WTO	World Trade Organization

Executive summary

Global trade rules are increasingly being negotiated within a complex network of preferential trade agreements (PTAs) rather than in the context of the World Trade Organization (WTO) and its 162 member countries. The complexity of the evolving global trade system is magnified by the fact that modern PTAs – characterised as “deep” agreements – increasingly cover disciplines beyond the rulebook of the WTO such as investment, competition and intellectual property rights, requiring significant adaptation processes by the participating countries. The spread of deep PTAs potentially has profound implications for developing countries’ economic prospects and their chances of participating and upgrading to higher value-added tasks in global value chains (GVCs), thus avoiding the infamous “middle-income trap”.

Vietnam is a case in point to study these implications. Vietnam is actively participating in the current wave of the mega regional trade deals and, in 2015, signed deep PTAs with the United States and the European Union (EU). This report investigates how and to what extent deep PTAs can contribute towards upgrading in GVCs with a special focus on Vietnam’s textiles and garments (T&G) as well as electrical and electronics (E&E) sectors, the two most important export sectors of the Vietnamese economy. Although there is abundant literature on upgrading in GVCs and a growing body of literature on the spread and effects of deep PTAs, research investigating the relationship of both global trends and their effects on developing countries is scarce. Such an integrated research approach is of high practical relevance, given the evolving new global economic environment and the fact that large trading powers such as the United States and the EU are increasingly resorting to deep PTAs to negotiate global trade rules among each other but also with developing countries. Analysing the potentials and risks for upgrading for Vietnamese firms in GVCs under these conditions yields important insights for other developing countries.

It is projected that Vietnam will be the main beneficiary of both the Trans-Pacific Partnership (TPP) and the EU–Vietnam Free Trade Agreement (EVFTA). It is therefore not surprising that the conclusion of these two trade pacts has been emphatically welcomed by the Vietnamese government and business sector alike. Vietnam not only gains preferential market access to several major economies such as the United States, Japan and the EU.

The TPP and the EVFTA will further increase Vietnam's attractiveness for foreign investments, potentially transforming the South East Asian economy into a major production hub for the region and beyond. However, the potential gains for Vietnam from signing the TPP and the EVFTA are thought to mainly occur in low value-added sectors where it already enjoys a strong comparative advantage. The question how and to what extent deep PTAs can be used as a vehicle to support upgrading in GVCs is of high relevance from a development policy perspective.

The report is based on evidence from more than 80 interviews with managers from the T&G and E&E firms, both domestic and foreign; business associations; Vietnamese government officials; and experts from academia, law firms and consultancies. In addition, the report builds on a business survey of 250 firms spanning different types of ownership and sectors that has been conducted in cooperation with the Vietnamese Chamber of Commerce and Industry (VCCI). These approaches are complemented by detailed analysis of those chapters in the TPP and the EVFTA that we consider most relevant for upgrading.

Our results are not only relevant for Vietnamese policy-makers engaged in implementing the TPP and the EVFTA and drafting industry strategies, or for managers of Vietnamese businesses who have to rethink their corporate strategies in light of these new generation PTAs. The findings are also relevant for other middle-income countries that aim at achieving upgrading in GVCs and may face the decision to negotiate deep PTAs, which have become the trade instrument of choice of the major trading powers.

Main findings

We find that deep PTAs, such as the TPP and the EVFTA, provide new opportunities for Vietnamese firms to upgrade in GVCs – either directly, by providing concrete incentives for Vietnamese companies to upgrade, or indirectly, by addressing relevant barriers to upgrading. However, PTAs are only one of many factors for PTAs to spur upgrading in GVCs. In line with previous research, we find that the national business environment, the promotion of linkages with foreign direct investment (FDI) and the absorptive capacity of domestic firms are of paramount importance and require enabling policies and an active role of the government.

A special focus of our report is on the effects of the new generation of deep PTA provisions such as investment, intellectual property rights, customs administration and state-owned enterprises. These rules are seen by many observers as a relevant condition for firms from developing countries to enter into – and upgrade within – GVCs. We find that, in general, these deep provisions impact the upgrading potentials of Vietnamese firms in an indirect way. By improving the business environment, attracting FDI and establishing equal opportunities between all types of companies, they can help to build the foundation required to enable Vietnamese firms to upgrade.

Although the new generation of deep rules has rather indirect effects, the more traditional PTA rules, such as preferential market access and rules of origin (RoO), impact the upgrading potential of companies much more directly. With regard to the T&G sector, Vietnamese companies are currently most active in the low-skilled and labour-intensive “cut make trim” (CMT) segment of the garment chain, importing the main inputs from other countries. The strict “yarn-forward” rule in the TPP and “fabric-forward” rule in the EVFTA require that all production stages starting with the yarn (or fabric) must be undertaken in Vietnam (or other PTA member countries) to benefit from the agreements’ tariff cuts and gain preferential market access. Although these strict RoO have been designed to protect textile producers in developed countries, they can nevertheless be used by Vietnamese T&G firms to upgrade to higher value-added tasks by building up an upstream industry. As Vietnam is importing most of its yarn and fabrics from outside the PTA partners’ territories – in particular China, which is neither part of the TPP nor the EVFTA – developing the upstream industries domestically seems to be an attractive option to meet the RoO. The conditions for realising and fully benefitting from these potentials, however, are challenging: the slow tariff elimination for many T&G products, the lack of skilled labour and capital of domestic T&G firms, and the possibility of competitors joining the TPP or negotiating their own PTAs with the United States and the EU demand some caution when considering the costly establishment of upstream industries.

In the Vietnamese E&E sector, the potential impact of deep PTAs on upgrading is far from straightforward. Comprehensive and enforceable investment rules promise to attract more FDI, which is important to spur the know-how and technology spillovers needed for upgrading. Yet, we expect

the impact of the TPP and the EVFTA on FDI attraction to be moderate. The TPP and the EVFTA are unlikely to attract much additional efficiency-seeking FDI with the aim of using Vietnam as an export platform. In contrast to the T&G sector, tariffs on major export markets of E&E products are already low, and the new PTAs do not bring substantial changes. Moreover, market access, investor and intellectual property right (IPR) protection are not considered major obstacles for doing business in Vietnam, according to the results of our business survey. The greatest potential that could make a difference lies in the legal enforceability of these provisions. Yet, it remains a challenge in Vietnam to establish beneficial linkages between FDI and domestic companies. By signing the new PTAs, Vietnam would have to sacrifice one potential policy instrument that other countries have used to achieve linkages, namely imposing performance requirements on foreign investors. Vietnam has nevertheless negotiated a number of exceptions and still has a range of other, less distortive policy instruments at hand to become more attractive as a partner in GVCs and make use of the opportunities arising from PTAs.

In sum, the report shows that signing deep PTAs is only one piece of the puzzle to support upgrading in GVCs. Improving the national business environment, supporting the establishment of linkages with FDI firms and improving domestic firms' absorptive capacities are key factors for a conducive policy environment. Hence, reaping the benefits from economic integration and realising upgrading potentials requires enabling policies and an active role of the government.

Policy implications

As the potential positive effects of the TPP and the EVFTA will not materialise automatically, the Vietnamese government and business sector have to play an active role. We highlight five key policy implications.

First, the Vietnamese government can use the external reform pressure exerted by its trading partners to improve the overall business environment. The need to bring a wide array of domestic laws and regulations in line with the extensive rulebook of the TPP and the EVFTA offers reform-minded policy-makers the opportunity to tackle important barriers to upgrading relating to the overall business environment. As various trade partners are likely to set up support programmes with overlapping

objectives, Vietnam has to remain in the driver's seat, coordinating these initiatives according to its own priorities.

Second, the Vietnamese government can use the opportunity and provide business incentives on a more equal basis. The TPP and the EVFTA will increase the attractiveness of Vietnam for foreign investors, and thus expand the room for manoeuvre to undertake such an initiative. At present, small and medium enterprises (SMEs) suffer from distorted competition in light of generous preferences granted to larger companies – be they state-owned or foreign-owned. Government funds should be available and accessible to all companies whose investments support Vietnam's economic development strategy.

Third, Vietnam can benefit from strengthening its investment promotion framework to attract quality FDI. Vietnam is an increasingly attractive destination for foreign investors due to its favourable ratio of labour and production costs to the level of skills and technologies, relative to other countries in the region. Investment promotion should be strengthened to attract higher levels of FDI in sectors that are in need of additional foreign capital and know-how, to support linkages between foreign and domestic companies, and to take advantage of stringent RoO.

Fourth, the Vietnamese industry's absorptive capacity needs to be strengthened, and linkages between foreign and domestic companies supported. In order to build linkages with beneficial spillover effects to the domestic economy, there is a need to increase the capacities of Vietnamese firms to make them ready and attractive for cooperation with international firms, support the matching between foreign investors and suitable local suppliers and, if necessary, use the remaining policy space to set incentives for linkages between foreign and domestic firms.

Fifth, in order to benefit from the TPP and the EVFTA, the analytical capacities of the government and the business sector need to be strengthened. It is key for the Vietnamese government and the business sector to conduct in-depth analyses of the new tariff schemes and assess if it is worth building up certain industries in Vietnam in order to take advantage of improved access to large markets. The proper implementation of the deep PTA provisions against the background of national development priorities equally requires analytical capacities, a strategic vision and increased coordination across different branches of government.

1 Introduction

The world trading system is currently at a turning point. Since the founding of the WTO in 1995, its members have not been able to agree on a comprehensive set of new trade rules. As a result of the sluggish multilateral trade negotiations, some countries – most notably the EU and United States – increasingly resort to bilateral or regional preferential trade agreements. Although the negotiation of PTAs is all but a new trend, the current phase of trade regionalism is characterised by the proliferation of deep PTAs. These new generation PTAs are characterised as “deep” because they cover disciplines beyond the rulebook of the WTO, such as investment, competition and IPRs, and require significant adaptation processes by the participating countries. Prominent examples of recently negotiated deep PTAs include the Transatlantic Trade and Investment Partnership (TTIP), currently under negotiation between the EU and the United States, and the Trans-Pacific Partnership (TPP), signed between the United States and 11 other Pacific Rim countries in November 2015.

The proliferation of deep PTAs is closely intertwined with the expansion of global value chains. In the context of GVCs, production processes become increasingly fragmented and production steps are spread across different countries. The traditional mode of trade in final goods is increasingly being replaced by trade in tasks. This allows developing countries to industrialise by taking over certain tasks within GVCs instead of developing whole production chains by themselves. However, what ultimately matters is not only participation in GVCs, but the extent of the associated value created in the economy, which effectively contributes to job creation and growth. Although growth in low-skilled activities also increases the countries' value added, eventually they will reach a point where they no longer have a comparative advantage in low-skilled sectors and are not yet able to compete in sectors requiring higher skill and technology levels. For many developing countries, upgrading to higher value-added tasks in GVCs therefore remains both a challenge and a key policy objective to avoid this “middle-income trap”.

For developing countries aiming at participating and upgrading in GVCs, the implications of deep PTAs are of particular interest. On the one hand, the comprehensive rules of deep PTAs can increase trade and investment, generate a more stable and reliable environment for economic activities and therefore build a foundation for upgrading. On the other hand, the

extensive coverage of behind-the-border regulations in deep provisions, which affect many more policy areas than just directly trade-related issues, often require major national reforms and can tie governments' hands when trying to enact policies aimed at supporting the upgrading of local companies. Given this ambiguity, we ask in this report whether, how and to what extent deep PTAs can contribute towards upgrading in GVCs, and which policy measures are useful and still available to support this process.

This question is of high relevance from an academic and policy-making perspective. Although there is an abundance of literature on upgrading in GVCs and a growing body of academic literature on deep PTAs, research investigating the relationship between the two is scarce. This is all the more striking as many developing countries, such as Vietnam, have just signed – or are currently negotiating – deep PTAs with the prospect of “moving up the ladder” in GVCs. We aim to fill this gap in the literature by using Vietnam as a case study. Vietnam's experience is particularly relevant in the context of our research focus, as in 2015 alone it concluded four PTAs – most notably the TPP and the EVFTA – and is projected to be the main beneficiary of both agreements. However, these potential gains are thought to mainly occur in low value-added sectors where Vietnam already enjoys a strong comparative advantage. These projections underline the challenge the Vietnamese government faces in following up on its stated policy objective of moving up the value chain. The fact that Vietnam is one of the first developing countries to take part in the new wave of ever deeper PTAs promoted by large trading powers such as the United States and the EU makes the Vietnamese experience an interesting case for other countries at similar stages of development.

We explore the research question using a mixed-methods approach. Besides qualitative interviews with managers from T&G and E&E firms, both domestic and foreign; business associations; Vietnamese government officials; and experts from academia, law firms and consultancies, we conduct a quantitative survey in cooperation with VCCI among Vietnamese firms spanning different types of ownership and sectors. We complement these approaches by analysing in detail those chapters in the TPP and the EVFTA that we consider most relevant for upgrading.

We find that deep PTAs, such as the TPP and the EVFTA, can provide new opportunities for Vietnamese firms to upgrade in GVCs – either directly, by

providing concrete incentives for upgrading, or indirectly, by addressing some of the identified barriers to upgrading. In general, deep provisions, such as rules on investment and state-owned enterprises (SOEs), impact upgrading potentials in a rather indirect way. By improving the business environment, attracting FDI and establishing equal opportunities for all types of companies, they can help to build the foundation required to enable Vietnamese firms to upgrade.

In the T&G sector, strict RoO are considered the main conditioning factor for upgrading. Vietnamese companies are currently most active in the low-skilled and labour-intensive CMT segment of the garment chain. The yarn-forward rule in the TPP and fabric-forward rule in the EVFTA require that all production stages, starting with the yarn (or fabric), must be undertaken in Vietnam or other PTA member countries to benefit from the agreements' tariff cuts and therefore gain preferential market access. Originally designed as instruments to protect powerful industries mainly in developed countries, strict RoO – combined with high tariff cuts – nevertheless provide a direct incentive for upgrading to higher value-added tasks by building up an upstream industry.¹ Our empirical analysis highlights that this localisation of additional upstream segments of the T&G value chain is a challenging task: tariffs are phased out only after a considerable time lag, new competitors are likely to join these agreements or negotiate their own PTAs with the United States and the EU and, most importantly, Vietnamese T&G firms at the moment lack the skills and capital needed to expand in new value-chain segments.

In the Vietnamese E&E sector, where tariffs have already been eliminated to a large extent, the potential impact of deep PTAs on upgrading is less clear-cut. Comprehensive and enforceable investment rules promise to attract more FDI, which is important to spur know-how and technology

1 Our report is confined to the analysis of the effects of strict RoO on Vietnam. However, we acknowledge that strict RoO can also have negative trade diversion effects for countries outside the PTAs under investigation. In the case of the TPP, for example, Vietnamese companies have a competitive advantage over T&G firms in countries from the region, such as Cambodia and Bangladesh, as the latter do not enjoy preferential access to the US market. At the same time, in order to fulfil the yarn-forward rule, Vietnam will have to produce yarn and fabrics locally or source them from within the TPP area, which cuts off existing sourcing patterns, mainly involving China. The diversion of trade flows as a consequence of RoO also has diversion effects for FDI flows. Vietnam, as a member of the TPP, is projected to receive more FDI in the textiles sector.

spillovers needed for upgrading. However, the effect of the TPP and the EVFTA on FDI attraction to the sector is likely to be moderate. What is more, beneficial linkages to foreign investors do not materialise by themselves. Paradoxically, some investment rules of deep PTAs that tend to attract investors, such as the ban on many performance requirements, at the same time restrict Vietnam's policy options to link the domestic private sector to the attracted FDI and reap the associated benefits. Despite the restriction of available instruments, there is enough space for targeted public support measures. In sum, deep PTAs are only one of many factors that can support upgrading in GVCs. Improving the national business environment, establishing linkages with FDI and improving a firm's absorptive capacity are of paramount importance. Hence, reaping the benefits from economic integration and realising upgrading potentials requires enabling policies and an active role of the government.

The report is structured as follows. Chapter 2 outlines the existing literature on upgrading in GVCs and deep PTAs. Chapter 3 introduces Vietnam as our country of interest by highlighting current economic challenges as well as its growing PTA network. Chapter 4 explains our research methodology, which is based on qualitative interviews, a quantitative survey and the analysis of relevant PTA chapters. Chapter 5 establishes an indirect link between deep PTAs and upgrading by first identifying Vietnam's major obstacles to upgrading and, second, highlighting the role that relevant PTA provisions can play to address these obstacles. Zooming into the sector level, Chapter 6 investigates the direct link between the RoO and upgrading in the T&G sector, while Chapter 7 sheds light on the potential impact of strict investment and IPR rules on establishing linkages for upgrading in the E&E sector. Based on those findings, Chapter 8 presents policy recommendations and identifies lessons learnt. Chapter 9 concludes.

2 Literature review

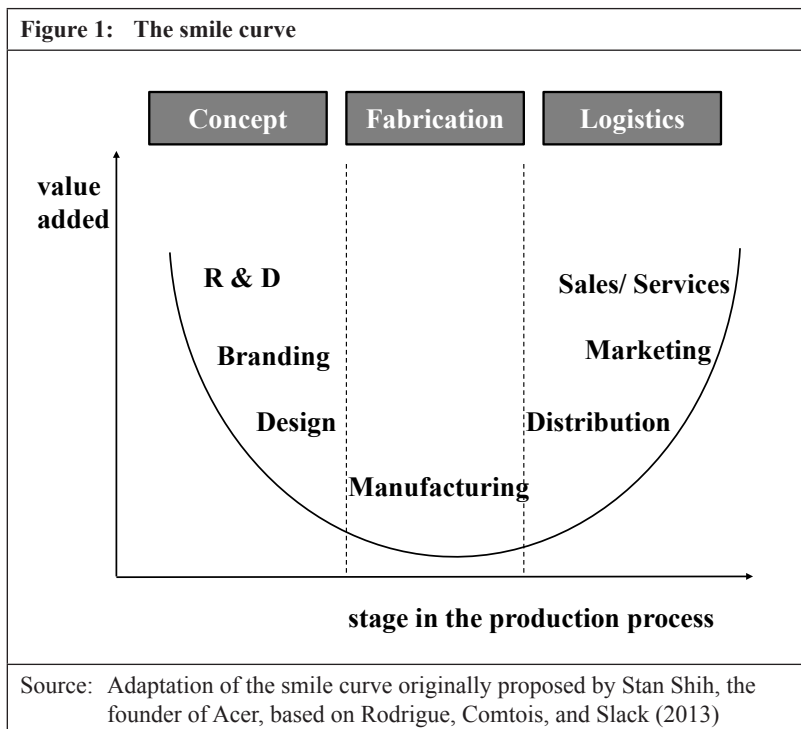
Current developments in the world economy are characterised by the simultaneous expansion of GVCs and the proliferation of deep PTAs. In this chapter, we review the existing literature on GVCs, deep PTAs and the relationship between the two trends.

2.1 The expansion of GVCs

GVCs as a driver of economic development have received a fair amount of attention in the academic as well as policy-oriented literature since the 1990s. The rapidly increasing fragmentation of production processes and growth of trade in intermediate products – along with improvements in measuring these flows – have resulted in a renewed interest in GVCs. Literature on GVCs has investigated how GVC participation can be measured, what the driving factors and effects of GVC trade are and which potentials and challenges arise for developing countries (e.g. Kowalski, Gonzalez, Ragoussis, & Ugarte, 2015; Organisation for Economic Co-operation and Development [OECD], 2013a; Park, Nayyar, & Low, 2013; Taglioni & Winkler, 2016; Nicita, Ognitvsev, & Shirotori, 2013; World Trade Organization [WTO], 2014). As the fragmentation of production processes along the value chain has led to trade in final goods being increasingly substituted by trade in tasks, countries no longer need to be competitive in the production of final goods, but rather in certain tasks incorporated in the production process. This allows developing countries to industrialise by joining value chains, rather than building whole chains by themselves (Baldwin, 2011). However, what ultimately matters is not only participation in GVCs but the extent of the value captured, which contributes to employment and economic growth. Although a strong expansion of low-skilled activities also increases value added, these segments face high levels of competition. A large body of literature deals with explaining and quantifying the middle-income trap (e.g. Ohno, 2009; Kharas & Kohli, 2011; Eichengreen, Park, & Shin, 2013), which captures countries in a position of medium income because they are no longer competitive in low-wage segments but have not yet achieved a competitive advantage in higher-skilled activities. In order to avoid this middle-income trap, many countries therefore aim at shifting their comparative advantage towards more sophisticated tasks with higher value added. This upgrading in GVCs remains a challenge for many developing countries.

Types of upgrading in GVCs

Various definitions of upgrading exist, yet upgrading is consistently associated with two phenomena: innovation and/or intensification. Definitions of upgrading range from the mere “insertion into local and global value chains in such a way as to maximize value creation and learning” (Gereffi, Humphrey, Kaplinsky, & Sturgeon, 2001) to “broadening value added performed in a GVC in which integration has already been achieved” (WTO, 2014). The more demanding definition of the WTO implies “climbing up the value ladder (or “smile curve”), moving away from low-skilled activities characterized by low entry barriers and high competition” (WTO, 2014). Although definitions differ on their starting point for upgrading – into or within a value chain or between different chains – they all include the notion of increasing the share of value added. Figure 1 describes the distribution of value added in the different production stages.



In general, countries providing “core” inputs account for most of the final product’s value (International Monetary Fund [IMF], 2013). This includes raw materials and “intangible or knowledge-based assets” that are hard to imitate or reproduce such as research, branding and design (OECD, 2013a). Developing countries typically find themselves in the manufacturing part of the production process, that is, at the bottom part of the smile curve, such as assembly tasks, which rely on high proportions of imported content and are associated with low value added (United Nations Conference on Trade and Development [UNCTAD], 2013). These low value-added segments of GVCs are easy entry points for developing countries with low labour costs. Eventually, however, domestic wages will rise. Hence, developing countries risk being caught in a middle-income trap, in which their low-cost advantage is eroded even though they have not been able to build up the capacity to compete in higher value-added segments (e.g. Agenor & Canuto, 2012).

Humphrey and Schmitz (2002) distinguish four types of economic upgrading²:

Process upgrading: refers to increased efficiency of production as a result of enhanced technology or better organisation of the production process. For example, the production changes from craft production to mass production and from there to lean production (on-time deliveries).

Product upgrading: includes the launch of new products, changes in design and the move to producing higher-quality products. For example, a company shifts from supplying discount chains to supplying department stores within the garment commodity chain.

Functional upgrading: refers to taking on functions at higher levels of the smile curve. For instance, a company specialised in manufacturing assumes

2 Apart from these four types of economic upgrading, Barrientos, Gereffi, and Rossi (2011) refer to a fifth type of upgrading, the so-called social upgrading, as a response to international pressure for compliance with corporate codes of conduct and social standards within GVCs. Social upgrading relates to improved working conditions, for example fair wages, reasonable working hours, social protection as well as the freedom of assembly.

upstream or downstream activities.³ Upstream activities involve higher value-added tasks preceding manufacturing, that is, design, branding and research and development (R&D) in the left part of the smile curve. Upstream activities also include higher value-added stages within manufacturing preceding the assembly tasks, for example weaving, knitting, dyeing and finishing in the T&G sector. Downstream activities refer to all steps succeeding the manufacturing activities, that is, distribution, marketing, sales and services in the right part of the smile curve.

Intersectoral or chain upgrading: relates to entering a new value chain or industry that is more advanced. Samsung is a recent example, as the firm decided to expand its functions into new industries such as for LEDs and solar panels (OECD, 2013a).

Projecting these four types of upgrading on the smile curve, product and process upgrading imply an upward shift of the curve, whereas functional upgrading refers to moving along the smile curve. Functional upgrading can be achieved through upstream upgrading and downstream upgrading. Intersectoral upgrading can be visualised with a new smile curve at a higher level of value added.

Determinants for upgrading in GVCs

Although there is consensus on the importance of upgrading in GVCs, especially for developing countries, evidence on how to achieve upgrading is less clear-cut. A variety of factors influences a country's potential for upgrading in GVCs.

Featured at the centre of discussions is the acquisition of **knowledge and skills**. Innovations and improvements that increase the value of a firm's product or service result from a learning process through which firms can translate the newly gained knowledge and skills into higher value-added business activities (Humphrey & Schmitz, 2002). Firms can acquire knowledge and skills through their relationship with other, mainly foreign, firms or through the local learning and innovation system, including the basic, higher and vocational education systems (Farole, Staritz, &

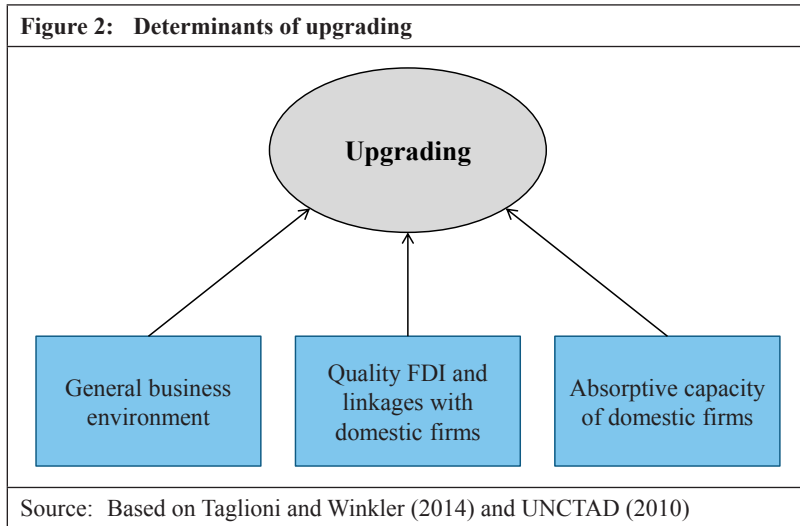
3 Among other studies, Gereffi (1999) as well as Lee and Chen (2000) demonstrate typical trajectories of functional upgrading by East Asian firms. These firms started as Original Equipment Assemblers (OEAs) and became Original Equipment Manufacturers (OEMs) and Own Design Manufacturers (ODMs), and finally Original Brand Manufacturers (OBMs) (see Park et al., 2013).

Winkler, 2014). In their analysis across four industries in 19 developing countries, Fernandez-Stark, Bamber, and Gereffi (2012) find that workforce development initiatives facilitated upgrading in GVCs, but also that the local education institutions are not well aligned with the skills required in GVCs. Farole, Staritz, and Winkler (2014) find that education influences the share of skilled human capital in firms, which significantly affects knowledge spillovers of FDI. The local learning and innovation infrastructure is a crucial determinant of how effectively knowledge is transmitted. Similarly, Tytell and Yudaeva (2007) show cross-country evidence that education is a major pre-condition for the absorption of spillover effects from foreign firms by domestic firms in Poland, Romania, Russia and Ukraine.

The importance of **foreign direct investment** as a crucial driver for the transfer of knowledge and skills – and thus upgrading in GVCs – is addressed in numerous additional studies that analyse the effects of FDI on horizontal and vertical spillovers⁴ (for an overview of studies, see Görg & Strobl, 2001; Görg & Greenaway, 2004; Lipsey & Sjöholm, 2005). The effects are quite ambiguous. According to Paus and Gallagher (2008), regression analyses based on cross-sectional data are more likely to find positive horizontal spillovers, whereas panel data analyses tend to find negative spillovers, which may be due to differences in estimation strategies and the possibilities for dealing with endogeneity concerns. Evaluating 55 studies on vertical spillovers, Havranek and Irsova (2011) find positive and large vertical spillovers from multinationals on local suppliers in upstream sectors and small positive effects on local customers in downstream sectors, whereas they do not find evidence for horizontal spillovers.

The ambiguous findings on FDI spillovers indicate that the benefits from linkages do not materialise automatically. Following Taglioni and Winkler (2014) they depend on the spillover potential of the FDI firm, the absorptive capacity of local firms and the general business environment in the FDI-receiving country (see Figure 2).

4 According to Stancik (2007), horizontal and vertical spillovers are indirect effects from a more productive – oftentimes foreign – company to less productive companies. Whereas horizontal spillovers refer to the effects on other companies in the same sector, spillovers are the effects on companies in other sectors. This includes companies that supply or provide services for foreign firms, as well as companies that are supplied by foreign firms.



The degree of foreign ownership, the motivations for FDI, the FDI firm's sourcing strategy, the technology intensity of the production and the culture of – and distance to – the foreign investor's home country, among others, determine an **FDI firm's spillover potential**. Generally, joint ventures, a higher dependence on local inputs and a more technology- and R&D-intensive production are associated with more positive spillovers, but empirical results are often mixed (Taglioni & Winkler 2016, Chapter 7). In order to enable domestic firms to benefit from linkages with foreign firms, quality FDI must be attracted. Such foreign investors are interested in building up backward linkages with local suppliers and forward linkages with customers, linkages with competitors and/or with technology partners (Altenburg, 2000).

FDI spillover effects not only depend on the FDI firm's propensity to share its knowledge and technology with local firms but also on the **absorptive capacity of local firms**. Larger firms are better able to absorb FDI spillovers, as they are more likely to imitate FDI business practices (Crespo & Fontoura, 2007). The type of ownership can also influence a firm's absorptive capacity. Private firms may be more likely to benefit from spillovers due to their market orientation than SOEs (Sinani & Meyer, 2004). On the other hand, SOEs are typically larger and enjoy easier access to finance (United States Agency for International Development, 2013). Finally, firm location is another determinant for absorbing FDI spillovers. Special economic zones

are negatively associated with FDI spillovers to the domestic economy, as they typically rely on imported inputs for export processing (Abraham, Konings, & Sloomakers, 2010). By contrast, clusters can foster business linkages and attract potential foreign and domestic suppliers (UNCTAD, 2006). For instance, clusters in East Asian countries have helped the region to shift to higher stages beyond being simple manufacturing bases, that is, proceeding from quantity-oriented to quality-oriented development (Kuchiki & Tsuji, 2011).

The **business environment** also plays an important role for attracting FDI and generating spillover and upgrading effects. Evidence shows that spillovers are larger in countries with an open trade regime, as investors are less restricted by the size of the local market, and local firms may learn from exporting and increased competitive pressures (Crespo & Fontoura, 2007; Farole, Staritz, & Winkler, 2014; Havranek & Irsova, 2011). The quality of institutions – in particular the rule of law and protection of property rights – can influence the type of FDI attracted. Evidence suggests, however, that there is no significant effect of corruption or red tape on FDI spillovers. Strong protection of IPRs can attract high-quality FDI and promote FDI spillovers (Gorodnichenko, Svejnar, & Terrell, 2007). Yet, a high protection level may also restrict knowledge transfer (Havranek & Irsova, 2011). Findings from a 2013 survey from the Organisation for Economic Co-operation and Development (OECD) and the WTO survey with firms in developing countries suggest that regulatory uncertainty – often tied to the difficulties that firms have coping with a weak business environment – is another major obstacle preventing firms from moving up in GVCs. Inefficiencies and delays in customs procedures also rank high as an obstacle to upgrading in GVCs (OECD/WTO, 2013). However, Altenburg and von Drachenfels (2008) argue that although reforms of the business environment can be conducive to private-sector development, they may not be sufficient without having in place support measures for the local private sector. They call for a “combined approach that builds on market forces wherever possible and offers targeted public support schemes where necessary” (Altenburg & von Drachenfels, 2008).

The literature shows that upgrading does not occur automatically with GVC participation. It requires a sound business environment, quality FDI, sufficient absorptive capacities of local firms and policies that support linkage building (UNCTAD, 2010). Ravenhill (2014) criticises that recent GVC research mainly focusses on the liberalisation of trade and

investment without considering the role of industrial policies. Whereas trade liberalisation and investment provide opportunities for a country's participation and upgrading in GVCs, supportive policies are needed to capitalise on the opportunities. This is all the more important when a country's objective is not just to participate but to upgrade in GVCs.

2.2 The proliferation of deep PTAs

There has been extensive literature on PTAs that investigates their determinants and effects (e.g. Baier & Bergstrand, 2004; Baier & Bergstrand, 2007; Baldwin, 1993; Grossman & Helpman, 1995; Magee, 2008). These studies mostly treat PTAs as a homogenous variable without differentiating PTAs by scope or depth. This may have been sufficient for describing PTAs concluded in the 20th century, when trade was mainly in final goods and PTAs were essentially about reducing tariffs (so-called shallow PTAs). This does, however, fall short in reflecting the nature of PTAs signed in the 21st century, when trade in tasks has become the new norm and PTAs have become considerably deeper, extending their coverage to new disciplines beyond trade in goods. Trying to keep pace with these recent developments, a new strand of literature has started to look at these "deep" PTAs, investigating their causes and impacts.

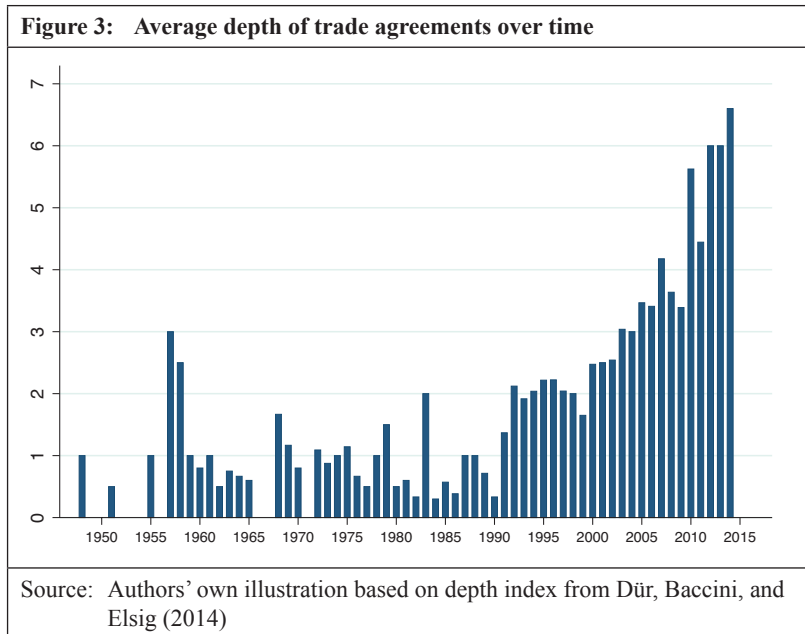
Although multiple multilateral trade rounds in the context of the General Agreement on Tariffs and Trade (GATT) – the predecessor of the WTO – have resulted in a significant reduction of tariffs, recent deep PTAs focus on the reduction of non-tariff barriers to trade and include a number of new disciplines that are thought to be important against the background of increasing the international fragmentation of production. According to Horn, Mavroidis, and Sapir (2010), deep PTAs differ from their predecessors in two dimensions.

In a vertical dimension, deep PTAs demand much larger commitments in areas that are part of the WTO's rulebook (WTO+). In a horizontal dimension, deep PTAs cover topics that are outside the current WTO mandate and are often not directly related to trade (WTO-X).

Examples of WTO+ areas include IPRs, technical barriers to trade and services liberalisation. Examples of WTO-X are investment protection, competition policy, environment and human rights. Extending the dataset from Horn, Mavroidis, and Sapir (2010) from 28 to 96 PTAs, the WTO (2011) identifies four core disciplines that prominently feature in more than

a third of PTAs but do not exist in WTO agreements: competition policy, movement of capital, IPRs beyond the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) and investment beyond the WTO Agreement on Trade-Related Investment Measures (TRIMS). Evidently, deep PTAs go substantially further than the trade rules of the WTO and shift their focus to regulatory measures, whereas the focus of shallow PTAs rests under the WTO roof and mainly deal with tariff measures.

Empirical analyses confirm the proliferation of deep PTAs in recent years, particularly between developed and developing countries. Dür, Baccini, and Elsig (2014) have developed an indicator that measures the depth of PTAs along seven dimensions (elimination of tariffs, services trade, investment, standards, public procurement, competition and intellectual property rights). Figure 3 illustrates the increasing average depth of PTAs over time, measured by a depth indicator ranging from 0 to 7 according to the dimensions listed above. PTAs have become deeper from the 1990s onwards, with the turn of the century witnessing a major surge in the average depth of PTAs. In fact, all the agreements receiving the maximum score of seven have been signed in the 21st century.



Yet, there are notable differences in the depth of PTAs depending on the countries engaged. Trade agreements between developed and developing countries are significantly deeper on average than between countries of similar income levels. Agreements among developing countries themselves are the shallowest, focussing on the elimination of tariffs (Bruhn, 2014).

The policy motives for developing countries to adopt deep PTA provisions may vary from one case to another. Deep provisions such as investment and IPR protection are seen as important signalling and commitment devices that can help to remedy local institutional deficiencies in developing countries and promote FDI and trade flows (Hicks & Kim, 2015). In other instances, developing countries' governments sign up to deep provisions as a means to overcome domestic reform deadlocks or to "tie the hands" of future governments, making the reversal of economic reforms more costly (Hicks & Kim, 2015). For many developing countries, deep provisions are also part of a package deal they have to accept to gain access to the markets of major trading powers. Allee and Peinhardt (2014), for example, find that the bargaining power and preferences of capital-exporting countries explain much of the design of investment treaties, although they cannot confirm the notion of "tying hands" in their data.

2.3 The relationship between GVCs and deep PTAs

A few studies have investigated the relationship between the expansion of GVCs and the proliferation of deep PTAs, and they clearly show that these two trends are highly interconnected. The rise in GVC trade has created new incentives for signing deep PTAs for two reasons. First, trade costs – both tariffs and non-tariff barriers – are magnified within GVCs as products cross borders multiple times, with costs rising proportionately (magnification effect). Second, GVCs are more affected by behind-the-border policies such as investment, IPRs and competition, which pose risks for the smooth operation of GVCs and are not sufficiently resolved at the multilateral level (Lawrence, 2000; Antràs & Staiger, 2012). From a GVC perspective, the motive for signing deep PTAs is therefore to further reduce or eliminate tariffs and non-tariff barriers and to fill the governance gap with respect to behind-the-border issues. The WTO (2011) provides empirical evidence that countries with higher trade in parts and components relative to total trade are more likely to sign deep agreements. Orefice and Rocha (2013) show that a 10 per cent increase in the share of production network

trade over total trade increases the depth of an agreement by roughly six percentage points. Moreover, the likelihood of signing deeper agreements is higher for countries involved in North-South production-sharing and for countries in the Asian region.

The rationale of GVC trade explaining the formation of deep PTAs also holds the other way around: deep PTAs increase GVC trade for the signing parties by reducing the costs of trade. Kohl, Brakman, and Garretsen (2015) find that more comprehensive PTAs have a stronger effect on trade flows. Similarly, the WTO (2011) finds that PTAs increase trade in parts and components by 35 per cent among country members. An additional provision included in the PTA increases trade in parts and components by almost two percentage points. Particularly, deep provisions in competition policy and technical barriers to trade have a positive effect on production networks. Noguera (2012), Dür, Baccini, and Elsig (2014), and Orefice and Rocha (2013) corroborate these findings in similar analyses.

The existing studies find a clear positive relationship between the expansion of GVCs and the proliferation of deep PTAs, highlighting that the “pattern of deep agreements is shaping and is shaped by GVCs” (IMF, 2013). What remains rather unclear, however, is the effect of deep PTAs on upgrading in GVCs. An exception is Gereffi and Sturgeon (2013), who establish a relationship between GVCs, PTAs and industrial policy. Yet, they focus on the characteristics of industrial policy in GVCs and treat international agreements as a secondary factor. Bruhn (2014) argues more explicitly that deep PTAs have the potential to restrict governments’ room of manoeuvre for introducing industrial policies that could support upgrading. In our research, we will address this remaining research gap and further investigate the impact of deep PTAs on upgrading potentials in GVCs, using Vietnam as a case study.

3 The case of Vietnam

Vietnam is a case in point for both trends described in the previous chapter. As for many other developing countries engaged in GVCs, Vietnam's challenge is to move up the value chain if it wants to continue on its economic growth path and avoid the middle-income trap. At the same time, Vietnam can be seen as a prime example for increasing and deepening international economic integration. It has not only concluded an impressive number of PTAs but, crucially, it has also signed up to the new generation of deep PTAs. Vietnam is projected to be the main beneficiary of both the TPP and the EVFTA. However, the potential gains are thought to mainly occur in low value-added sectors, underlining the challenge of upgrading in GVCs. This section introduces Vietnam's current economic situation and its PTA network.

3.1 Vietnam's current economic situation

According to the OECD, "Vietnam's economic growth performance in the last two decades can be considered one of the most spectacular in the developing world" (OECD, 2013b). The country's average gross domestic product (GDP) growth rate of 7.25 per cent in the first decade of the 21st century was one of the highest in the world (Binh, 2010). Trade has been the engine of this remarkable performance: the total volume of trade has become nearly 20 times larger, increasing from US\$ 15 billion in 1995 to more than US\$ 270 billion in 2013 with a slightly positive trade balance (Observatory of Economic Complexity, 2016). The most important trading partners, such as the Association of Southeast Asian Nations (ASEAN) countries, China, the EU, Japan, the Republic of Korea and the United States, have constantly been increasing their trade volumes with Vietnam. The basis for this economic performance was the gradual integration of Vietnam into global markets by means of signing trade agreements.

Vietnam's success story started in 1986 with the policies of *Doi Moi* (*renovation*), which introduced a series of legal and economic reforms. *Doi Moi* was the first step in transforming the country from a planned into a market-based economy (Abbott, Bentzen, & Tarp, 2006). The reforms initially focused on the agricultural sector by reallocating production from cooperatives to privately owned production sites and by promoting the export of Vietnamese products (Tho, 2013). In the following years,

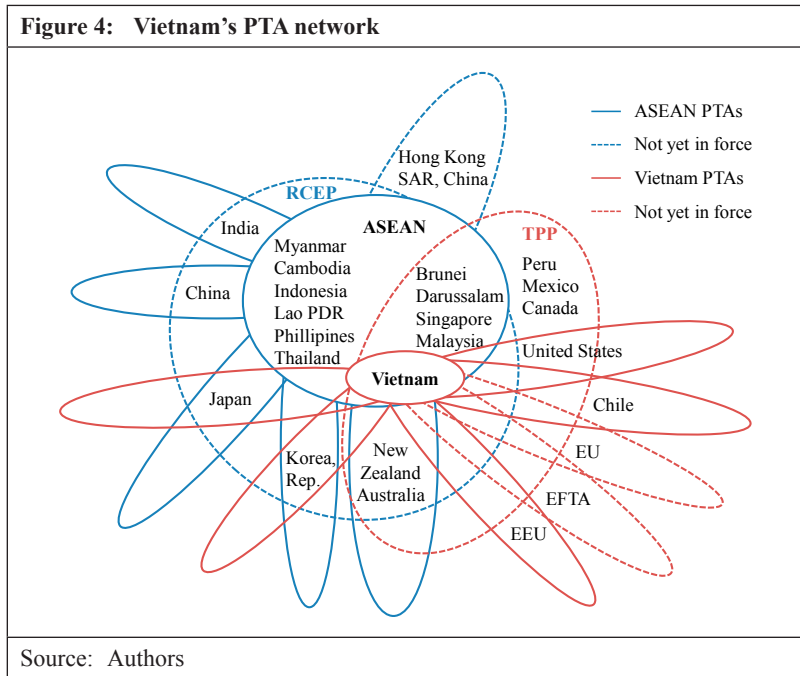
Vietnam's economy attracted substantial amounts of FDI, which in turn led to higher international trade flows (Tho, 2013). After having been one of Asia's most closed economies for several decades, Vietnam managed to develop into the country with the highest degree of openness to international trade and investment flows in the region. In addition to macroeconomic stabilisation (Binh, Anh, & Phuong, 2012), the achievements in poverty reduction and other social indicators have been remarkable: "Over the past 20 years, Vietnam has shown an economic strength that is both stunning and out of the ordinary for developing countries, even those in Asia" (Olivié & Steinberg, 2014).

Despite its past economic success, Vietnam faces a number of challenges. They range from rural poverty and environmental problems to a problematic domestic firm structure, which is dominated by SOEs and foreign-invested companies. Vietnam's business sector is characterised by low labour productivity, also when compared to its peers in the region. Moreover, labour productivity has decreased sharply in the last 15 years, whereas China has increased its labour productivity in the same period (World Bank, 2016b). Vietnam's exports are still highly dependent on imported inputs. Multinational corporations (MNCs) account for a large share of Vietnam's exports, indicating Vietnamese firms' low level of competitiveness (World Bank, 2015). Moreover, technological spillovers from FDI to domestic firms are limited. FDI-led production structures with few linkages to domestic firms often do not activate domestic processes of knowledge creation and research. The lack of know-how within the country restricts the ability of domestic firms to move up in GVCs, trapping them in low value-added production stages (World Bank, 2016b). To circumvent this middle-income trap, it is crucial for Vietnam to overcome the challenges of low labour productivity and low value-added production stages. In order to spur these processes, Vietnam has opted to engage in a second wave of economic liberalisation by signing deep PTAs with economic heavyweights such as the United States and the EU.

3.2 Vietnam's PTA network

Since its decision to open up and enter the global economy in the late 1980s, Vietnam has quickly evolved into one of the most active countries in the Asian region regarding international economic integration. As of today, the country has joined the WTO, signed a number of PTAs as part of ASEAN

and is one of the first developing countries to participate in the recent wave of ever deeper PTAs (see Figure 4).



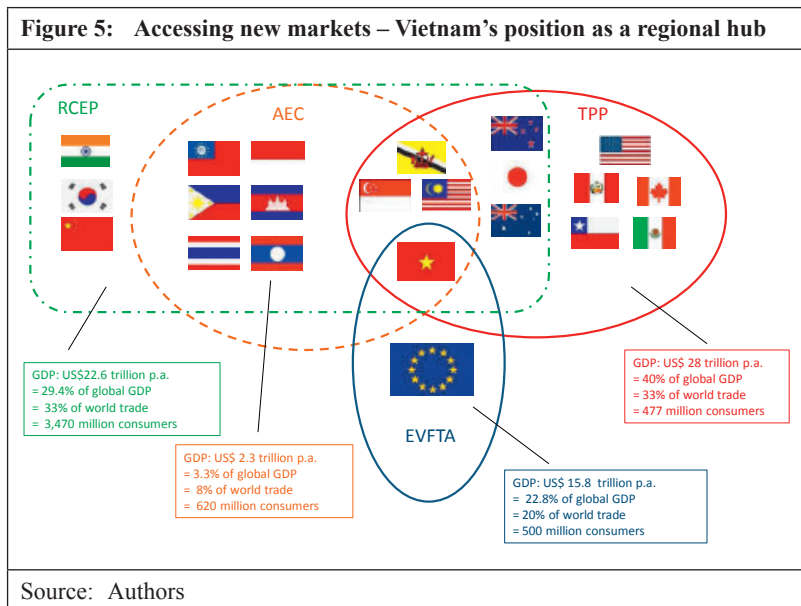
The year 2015 marks a milestone on the path of Vietnam's international economic integration. The country signed both the TPP and the EVFTA with its major trading partners, the United States, Japan and the EU, as well as PTAs with South Korea and Eurasian Economic Union. Another major agreement, the Regional Comprehensive Economic Partnership (RCEP), is being negotiated between ASEAN and its six partner countries: China, India, Korea, Japan, New Zealand and Australia. Vietnam is now embedded in a dense network of trade agreements. In addition to being a member of the WTO, it has six interregional PTAs in place as part of ASEAN, it forms part of the Asian Economic Community (AEC)⁵ and signed seven PTAs within and outside the region.⁶ Vietnam is currently negotiating PTAs with

5 To be established prospectively by the end of 2016 (see Balboa & Wignaraja, 2014).

6 For a detailed overview of Vietnam's PTAs (signed and/or under negotiation), please refer to Appendix 1.

the European Free Trade Association (EFTA) and is actively collaborating within ASEAN to negotiate yet another regional PTA with Hong Kong (ActionAid, 2015). Once all pending PTAs are concluded, Vietnam’s integration efforts will sum up to as much as 16 bilateral and regional PTAs with up to 56 preferential trading partners around the globe.

Figure 5 gives an overview of Vietnam’s most recent PTAs and their importance for Vietnam’s access to foreign markets. In terms of market potential, the TPP alone represents up to 40 per cent of global GDP and one-third of global trade (World Bank, 2016a). The TPP region is of exceptional importance to Vietnam, as it accounts for two-fifth of Vietnamese total exports (Vo, 2015) with the potential of reaching 477 million consumers. The EVFTA will add another 500 million consumers and a market size of 22.8 per cent of global GDP (European Commission, 2014). Taking the soon-to-be-signed AEC and RCEP into account, Vietnam will have preferential access to more than half of the world’s population, and its goods will enter almost two-thirds of the world economy duty-free or at reduced tariff rates.



Available studies suggest that Vietnam will be among the countries that benefit the most from the conclusion of the TPP and the EVFTA (e.g. Petry, Plummer, & Zhai, 2012; Baker, Vanzetti & Huong, 2014; PIIE, 2016; World Bank, 2016a). These two deep PTAs provide Vietnam preferential market access to the markets of the United States, Japan and the EU, among others. The country will gain a competitive advantage vis-à-vis its competitors – China in particular – that do not have PTAs in place with these major economies. Vietnam is thus expected to be one of the main beneficiaries of potential trade diversion effects of the TPP and the EVFTA.

Until it is fully implemented in 2030, the TPP is expected to yield overall gains of 1.1 per cent on average for its members (PIIE, 2016; World Bank, 2016a). With estimated GDP gains ranging from 8.1 to 10 per cent relative to the counterfactual scenario (PIIE, 2016; World Bank, 2016a), Vietnam is the country that has the biggest potential to benefit from the TPP. The preferential access to the markets of the TPP member states will help Vietnam to better exploit its comparative advantages in labour-intensive manufacturing sectors. Unskilled labour is projected to gain 14 per cent in real wages by 2030. Skilled labour, however, may even see its real wages drop by around 3 per cent (World Bank, 2016a).

The EVFTA is expected to yield positive effects in similar magnitudes as the TPP. Baker, Vanzetti, and Huong (2014) estimate that the EVFTA has the potential to increase Vietnam's GDP in the long run by around 7 to 8 per cent relative to the counterfactual scenario. Vietnam's exports to the EU are estimated to increase by 50 per cent and imports by 43 per cent. From a sectoral perspective, in particular the textiles, garments and footwear industries will benefit from the EVFTA.

In sum, the recently signed PTAs have the potential to increase Vietnam's attractiveness as a production location and promote Vietnam's participation in GVCs. Going beyond GVC participation, Vietnam has also declared upgrading in GVCs as its policy objective, which it aims to pursue by means of deeper economic integration. The next chapter introduces the research approach that we will use to investigate whether PTAs can actually support upgrading of Vietnamese firms in GVCs.

4 Research methodology

Although there is a growing body of literature on deep PTAs and an abundant amount of literature on upgrading in GVCs, research investigating the relationship between deep PTAs and upgrading in GVCs is scarce. This is all the more startling because many developing countries have just signed – or are negotiating – deep PTAs with the prospect of entering or moving up the value chain in global production networks. Therefore, whether, how and to what extent deep PTAs can contribute towards upgrading in GVCs – and which policy measures are useful and still available to support this process – is an open and important question for policy-makers and firms in developing countries. We will address this gap in the literature by using Vietnam as a case study. Vietnam's fast velocity in concluding deep PTAs – notably the TPP and the EVFTA – as well as its policy objective of moving up the value chain by means of increased international economic integration, make the country a suitable case in point. The results are applicable also to countries at similar stages of development that are considering joining or negotiating deep PTAs.

We investigate our research question by applying a mixed-methods design, taking advantage of both quantitative and qualitative approaches. First, we conduct a firm survey across sectors, allowing us a general evaluation of firms' upgrading plans, obstacles to upgrading and the role of deep PTAs in this regard. Second, we use the information gained from in-depth interviews with a variety of stakeholders, enriching our general knowledge from the survey with sector-specific information. Third, we complement these two approaches by analysing the legal texts, data and secondary literature on selected PTA provisions of interest for upgrading. By using such a triangular approach, we obtain information from sources with different advantages and shortcomings and improve the validity of our research results.

Quantitative business survey: The business survey is conducted in collaboration with the Vietnam Chamber of Commerce and Industry. The sample frame includes all manufacturing companies listed with the Vietnamese tax authorities from the 21 provinces that represent the four largest economic regions in Vietnam. From this sample of 36,000 firms, 1,500 firms were randomly targeted as survey respondents. With a response rate of roughly 17 per cent, the analysed sample consists of 250 firms and is distributed across ownership structures (domestic/foreign/joint-ventures,

public/private) as well as Vietnam's key sectors, including electronics, textiles, garments, footwear, machinery and plastics. Unfortunately, we do not have information on the distribution of these categories in the full sample frame, so we cannot guarantee the representativeness of our results. The objective of the survey is to better understand firms' assessments of PTAs and upgrading potentials. After a general part on the firms' characteristics, the survey asks for their business plans for upgrading, which obstacles a firm faces for realising its plans and in which areas the government's support is needed. In the last section, the expected influence of different PTA provisions is discussed. For further information on the constitution of the sample, please refer to Appendix 2.⁷

Qualitative interviews: As another main part of our research project, we conducted 80 individual interviews with different stakeholders and participated in six conferences on the implications of deep PTAs on Vietnam to further discuss the topic with experts. The objective of the interviews was to get an in-depth evaluation of the opportunities and challenges of deep PTA provisions for GVC upgrading from the perspectives of both political and economic actors. In interviews with business associations and firms in the T&G and E&E sectors, we investigated firms' needs for upgrading and discussed the experienced and expected effects of deep PTA provisions for their businesses. In interviews with ministries, we talked about the government's assessment of the PTAs, how to support the T&G and E&E sectors to benefit from the PTAs and the need for reform triggered by deep PTA provisions. We further probed their national strategies for upgrading and their future room for manoeuvre in supporting the upgrading in GVCs against the background of deep PTAs. We also talked to experts from Vietnamese universities and international organisations to get an assessment of the impact of deep PTA provisions on Vietnam's upgrading in GVCs. The interviews took place in Hanoi and Ho Chi Minh City in February, March and April 2016.

Analysis of PTA provisions: Based on the legal texts, data and secondary literature, we studied the TPP and the EVFTA provisions on investment, IPRs, customs procedures and SOEs, as these are core provisions of deep trade agreements and often go beyond the WTO rulebook. We also included the RoO specific to the T&G sector, as they have important

7 The survey questions can be obtained from the authors upon request.

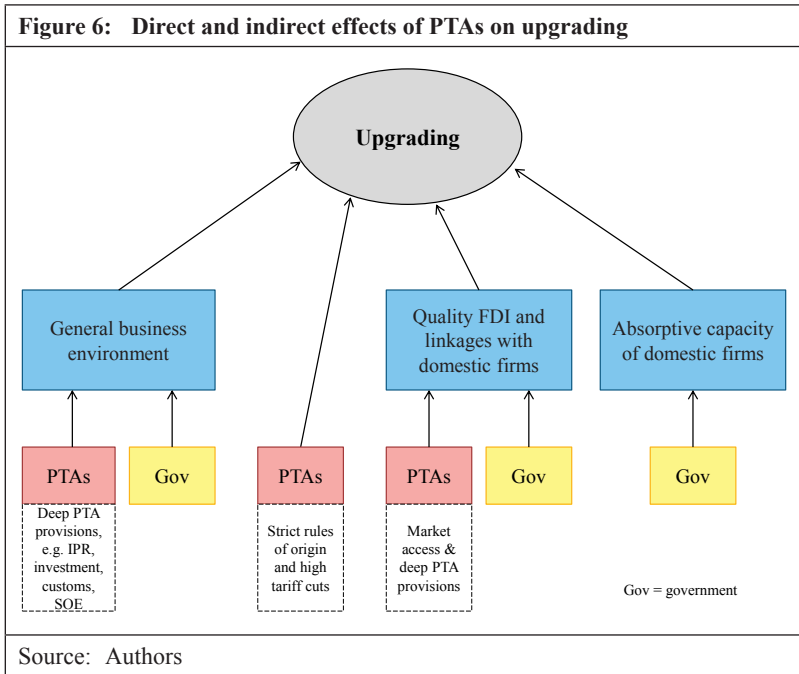
repercussions for upgrading within GVCs. When analysing the texts, we focussed on their implications for Vietnam's upgrading in GVCs, that is, which changes would be induced by ratification of the PTAs and whether upgrading opportunities or supportive policy instruments would be affected.

The different research methods are complementary to each other. Whereas the survey enables us to grasp the overall picture in the business sector, the qualitative interviews provide more in-depth and sector-specific insights as well as perspectives of policy-makers and economic experts. The analysis of legal texts, data and secondary literature on deep PTA provisions guided our interviews and survey questions and enriches the insights from survey respondents and interview partners.

5 The big picture: upgrading in Vietnam and the role of PTAs

As shown in Chapter 2, the upgrading potential of firms is influenced by several key factors: the soundness of the general business environment, the attraction of quality FDI, which contributes to the establishment of linkages with domestic firms, and the absorptive capacity of domestic firms. Figure 6 illustrates that these factors can be addressed both by the rules of deep PTAs and by targeted government action. Our approach is selective: we focus mainly on those obstacles that are affected by PTAs while identifying what type of government action is needed to reap the full benefits of deep economic integration through PTAs.

This chapter takes a bird's eye view on the Vietnamese business sector. In a first step, we identify the main obstacles to upgrading among Vietnamese firms. In the next step, we analyse how various disciplines included in deep PTAs may impact these obstacles – thus having an indirect effect on the upgrading potential of Vietnamese companies – and how important they are for Vietnamese firms. The chapter mainly draws on the results of the business survey conducted in collaboration with VCCI, being complemented by the information acquired in interviews and by our analysis of the PTA provisions.

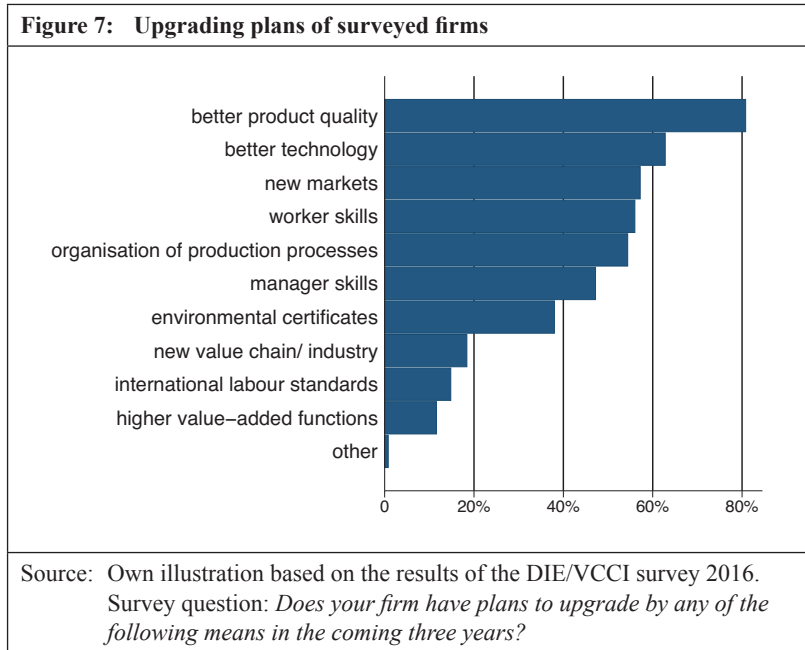


5.1 Obstacles to upgrading

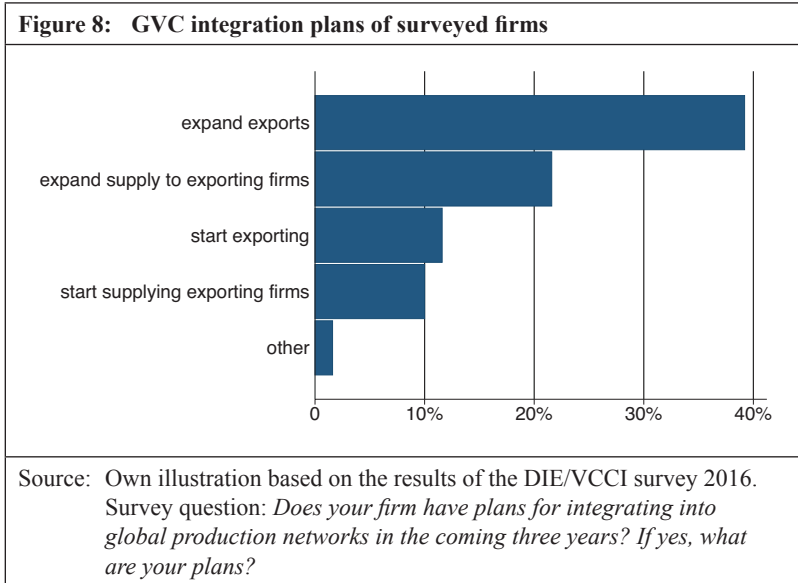
Before identifying the main obstacles to upgrading, we analyse to what extent Vietnamese companies want to upgrade and integrate in GVCs in the first place. Understanding the intentions of Vietnamese firms with regard to upgrading in GVCs is a necessary step to analyse the role deep PTAs can play in achieving this goal.

The results from the business survey show that almost 90 per cent of the surveyed companies have plans to upgrade. In Chapter 2 we distinguished four different upgrading strategies: process, product, functional or intersectoral upgrading. The majority of the firms that have the intention to upgrade want to produce higher-quality products (80.8 per cent), use better technology (62.8 per cent), cater to new markets (57.2 per cent), improve workers' skills (54.4 per cent) or improve the organisation of production processes (54.4 per cent). These factors almost exclusively imply product or process upgrading. Intersectoral upgrading, that is, entering new value

chains or industries, is on the agenda of only 18.4 per cent of the firms. Only 11.6 per cent of the firms want to assume higher value-added functions within GVCs, additionally to their existing production stages, which would be equivalent to functional upgrading (Figure 7).



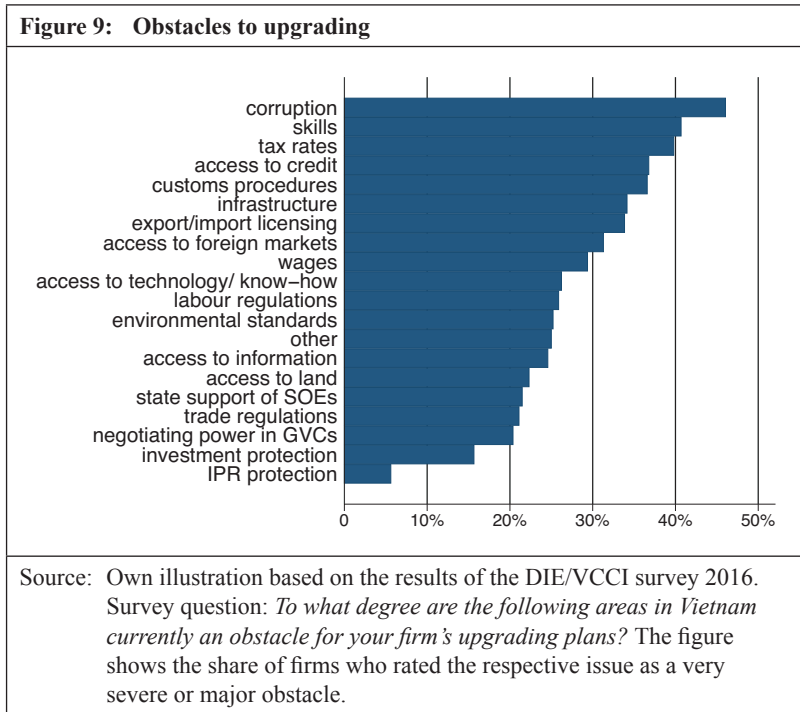
The opportunity of entering new export markets and joining GVCs has received high attention in recent policy debates in Vietnam, in particular in light of the conclusion of the TPP and the EVFTA in 2015. According to the survey results, 58 per cent of the surveyed firms have plans to (further) integrate into GVCs within the next three years. The majority of them want to expand their exports (39.2 per cent), and nearly one-quarter of the firms want to expand their already prevalent supply to exporting firms (21.6 per cent). Starting to export and starting to supply to exporting firms remain alternatives for a rather small share of companies (11.6 per cent and 10 per cent, respectively). These results show that firms rather intend to strengthen their existing business models than enter new types of business models (Figure 8).



After having noted that the overwhelming majority of firms want to upgrade or integrate into GVCs, the question arises as to which obstacles are most obstructive for the surveyed companies to achieving this goal. Figure 9 summarises the results of the business survey. It shows the percentage of interviewees who consider an obstacle to be very severe or major.

According to the results, the major obstacle to upgrading in Vietnam that firms see is **corruption**. Nearly half of the surveyed companies identify corruption as being a very severe or major obstacle for their upgrading plans. This was also confirmed through various individual interviews with Vietnamese companies and government officials. Many firms complained about the so-called under-the-table costs of doing business in Vietnam. One government official mentioned that doing business in Vietnam depends on “subsidies and friendship” and that this needs to change in order to become more competitive.⁸ Corruption distorts fair competition and therefore constitutes a high barrier – especially for smaller enterprises – to upgrade and compete with larger firms.

⁸ Senior representative of Vietnamese investment promotion agency, Hanoi, March 2016.



Skills and education are identified as the second major obstacle in the survey, which also corresponds to the evaluation of the qualitative interviews. Several interviewees pointed out that Vietnam currently lacks the management and language skills needed for domestic companies to upgrade their production or establish linkages to foreign companies and international markets. According to a Vietnamese scholar, public education is not sufficient in terms of quality in contrast to private schools and universities, which are very expensive.⁹ A staff member from a big university stated that education in Vietnam is very theoretical instead of practical.¹⁰ Even though students have to complete internships, their education cannot meet the requirements of the companies as it is not based on the firms' needs.

⁹ Vietnamese scholar III, Hanoi, February 2016.

¹⁰ Vietnamese scholar VI, Hanoi, March 2016.

Tax rates and **access to capital** are the third and fourth most important obstacles to upgrading. Vietnamese firms, and in particular SMEs, still do not have sufficient financial resources to compete with foreign firms, which can access the capital from their parent companies or international banks. Moreover, many foreign firms enjoy preferential tax treatment from the Vietnamese government. Some observers refer to this preferential treatment of foreign firms as “reverse discrimination”. In contrast to this, taxes for domestic enterprises are perceived as comparatively high and increasing during the last years.¹¹ Although some banks preferably offer loans to SOEs, access to capital for firms in general is restricted, as they have to provide collateral for a loan.¹² Most of the SMEs do not have any kind of collateral, which limits their access to additional financial resources. Upgrading typically requires large investments to build new production sites, acquire additional technologies, etc. Financial constraints consequently decrease firms’ ability to upgrade.

The fifth most important obstacle named in the survey is **customs procedures**. The goods’ time in transit is too high for firms to compete internationally: in Vietnam it takes about 64 hours on average for import and 67 hours for export, as compared to two hours for import and export, respectively, in the United States (World Bank, 2016a). In order to speed up customs clearance as well as the processes of licences and certificates, firms need to pay money instead of relying on international standards and regulations of border procedures. Indeed, many interviewees established a relationship between the lengthy customs procedures and opportunities for corruption, which is ranked as the number one obstacle to upgrading in our survey. Moreover, cross-border regulations are often too complicated for most Vietnamese firms to understand.¹³

Physical infrastructure is also mentioned as one of the most severe barriers to upgrading. Its improvement is described as one of the four bottlenecks for future economic development.¹⁴ The electricity supply, for example, as

11 Senior manager of Vietnamese E&E company III, Ho Chi Minh City (HCMC), March 2016.

12 Vietnamese scholar VIII, Hanoi, March 2016.

13 Representative of international cooperation agency I, Hanoi, March 2016.

14 Vietnamese scholar III, Hanoi, February 2016.

well as the funding of infrastructure in general, is currently not sufficient. Additionally, this particular policy area needs enhanced coordination.¹⁵

Labour issues such as **labour regulations** and the **labour costs** themselves are also highly ranked in the list of obstacles. For small companies, stricter labour regulations and rising wages represent a barrier to expanding their businesses. Moreover, local firms cannot compete with foreign firms for labour, as they cannot pay equal wages.

International standards in the areas of labour, product quality and environmental protection can also be barriers to upgrading. The survey shows that many firms agree that compliance with higher standards allows them to cater to new markets (74.6 per cent), whereas many of the firms are not sure whether they can really comply with these standards (36 per cent).

The technology gap between Vietnam and foreign firms is huge, and the technology transfer of FDIs is relatively limited. Both in the survey and the individual interviews, **technology** is mentioned as an important obstacle. Most of the machinery in Vietnam is not up to date.¹⁶ A government official suggested the enlargement of cooperation with foreign firms in the manufacturing sector to receive new technologies.¹⁷ By contrast, many interviewees questioned whether the government's strategy of relying on foreign investors – given that many are not willing to share their knowledge with Vietnamese industries – is an adequate industrial development strategy.

Even though **SOEs** are not mentioned as a prominent obstacle in the survey, many interviewees pointed out that competition with SOEs appears to be a huge barrier for smaller firms to upgrade. The level of state ownership is still very high in Vietnam. Vietnamese private firms fear competition with SOEs when they grow into market segments that are dominated by SOEs.¹⁸ An international expert criticises that SOEs consume a lot of resources in

15 Representative of World Bank, Hanoi, March 2016.

16 Vietnamese scholar III, Hanoi, February 2016.

17 Vietnamese scholar III, Hanoi, February 2016.

18 Representative of international cooperation agency I, Hanoi, March 2016.

an inefficient way and receive a lot of privileges, such as preferential tax treatments, compared to their contributions to GDP and employment.^{19, 20}

All mentioned obstacles can be classified into one of the above-explained components for upgrading. Corruption, for example, is part of the general business environment, whereas skills are part of the absorptive capacity of domestic firms. Access to technology and know-how can be attributed to the channel of quality FDI and linkages with domestic firms. Nevertheless, it has to be noted that the link between upgrading and these obstacles is mostly indirect – going predominantly through the general business environment, which turns out to be crucial for upgrading potentials of private domestic firms. These obstacles can be addressed through domestic regulations but also via international regulations, as we show in the following section.

5.2 How deep PTAs address obstacles to and policies for upgrading

This section illustrates to what extent the TPP and the EVFTA can help to address the identified obstacles to upgrading. Many obstacles to upgrading relate to the general business environment in Vietnam. However, as argued above, upgrading potentials hinge on the right balance between a sound and liberal business environment and targeted policies for local private-sector development. At the same time, therefore, this chapter asks whether deep PTAs also pose a risk to upgrading by restricting the room for manoeuvre for the government to support the domestic business sector.

Both the TPP and the EVFTA regulate behind-the-border issues such as investment, competition and IPRs, and they require substantial institutional reforms towards enhanced market efficiency in these areas. Reforms in these areas will potentially generate spillover effects to other areas, creating a momentum for an overall reform push and improvement of the general framework conditions in Vietnam. The TPP and the EVFTA will have a direct effect on the dimensions of the business environment regulated in the agreements, such as investment and IPR protection, but are expected to also have an indirect effect on related dimensions such as access to technology

19 International expert IV, Hanoi, March 2016; Vietnamese scholar XI, Hanoi, April 2016.

20 According to Vietnam's General Statistics Office, state-owned enterprises contributed roughly to 30 per cent of GDP and 10 per cent of employment in 2013. The most recent data is available here: https://www.gso.gov.vn/default_en.aspx?tabid=775

and know-how through linkages to FDI, which are essential for upgrading (see Figure 6).

Although the issues directly addressed by the TPP and the EVFTA rank relatively low as obstacles, firms are optimistic about the impacts of the TPP and the EVFTA on the business climate²¹: the overwhelming majority of firms (89 per cent) tends to agree or strongly agree that the TPP and the EVFTA will increase the pressure on the Vietnamese government to reform the business environment, and 98 per cent find that a thorough reform of the business environment is needed for Vietnam's economic development. In interviews, firm representatives, government officials, lawyers and scholars alike stated that a push for reform is one of the key opportunities of the TPP and the EVFTA for Vietnam, along with better market access and increased FDI. A number of interviewees are convinced that Vietnam's main motivation for concluding the TPP and the EVFTA has been a political move to put the reform process forward,²² improve government transparency and accelerate the move towards a market economy, thereby making Vietnam more competitive. Implementing and enforcing the required reforms will, however, be challenging for Vietnam, as the reforms imply significant structural changes.

There is also optimism about the impact of the TPP and the EVFTA on upgrading in GVCs: 96 per cent of surveyed firms believe that the PTAs will offer opportunities for Vietnamese firms to move to higher value-added stages in GVCs. This optimism was more carefully echoed in interviews. More often than not, PTAs do not directly lead to upgrading but improve the conditions for upgrading via an enhanced legal and business framework.

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- 21 It is important to note that respondents' assessments of the TPP and the EVFTA are often based on their perceptions and expectations rather than their knowledge of the PTA contents. Only about half of the surveyed firms consider themselves as having good or fair knowledge of the TPP, while the figure is much lower (35 per cent) for the EVFTA. Knowledge of the PTA commitments also varied significantly in the qualitative interviews, with international lawyers, international experts and Vietnamese scholars tending to be more informed than Vietnamese firms and ministries. The limited knowledge of the PTAs' contents might be in part due to the fact that the TPP text was only released in November 2015 and the EVFTA text in February 2016 (both in English), that is, just one and four months before we conducted our survey and interviews. Nevertheless, the survey and interview responses offer valuable insights into respondents' assessments of the PTAs and can uncover gaps between presumed and actual PTA contents.
- 22 Interviewee called the PTA-induced reforms a "Doi Moi reloaded". International expert IV, Hanoi, March 2016.

Although interviewees clearly considered market access – including tariff eliminations – as being the most important chapters in the TPP and the EVFTA, they found the chapters on investment, IPR, customs and trade facilitation as well as SOEs to be relevant for improving Vietnam’s general business environment. In the following subsections, we discuss the potential direct and indirect effects of these chapters on the general business environment in Vietnam as well as their potentials and risks for upgrading.

Box 1: Firms’ knowledge of the TPP and the EVFTA

As earlier studies indicate (e.g. Vietnamese Chamber of Commerce and Industry [VCCI], 2015), the majority of Vietnamese firms (70 per cent) is aware of Vietnam’s participation in the TPP. However, few firms have in-depth knowledge of the PTA contents. Only about half of the firms in our survey report having good or fair knowledge of the TPP, whereas the figure is much lower (35 per cent) for the EVFTA.²³ This contrasts with the knowledge firms have about the WTO and ASEAN, with 60–70 per cent of firms claiming to have good or fair knowledge. Notably, the knowledge about trade agreements is much higher for firms that report plans to (further) engage in GVCs and firms that intend to upgrade their businesses. The following table gives an overview of the share of firms that report good or fair knowledge of the TPP, the EVFTA, the WTO and ASEAN, disaggregated by firms with upgrading or GVC integration plans.

	good or fair knowledge of TPP	good or fair knowledge of EVFTA	good or fair knowledge of WTO	good or fair knowledge of ASEAN
Firms with upgrading plans	57%	37%	70%	63%
Firms with no upgrading plans	42%	19%	62%	50%
Firms with GVC integration plans	64%	38%	73%	69%
Firms with no GVC integration plans	44%	31%	64%	52%

Source: DIE/VCCI survey 2016

23 The remaining share of survey participants has either reported poor or no knowledge, or not responded to the question at all.

We also noticed different knowledge levels of PTA contents in the qualitative interviews, with international lawyers, international experts and Vietnamese scholars tending to be more informed than Vietnamese firms and even some ministries. The limited knowledge of the PTA contents might be in part due to the fact that the TPP text was just released in November 2015 and the EVFTA text in February 2016 (both in English), that is, just four or one month before we conducted our survey and interviews. We had the impression that the media is the main source of information for many of our interviewees. Increased media coverage of the TPP over the EVFTA contributes to the higher levels of awareness and knowledge of the TPP vs. the EVFTA.

Investment

The investment chapters in the TPP and the EVFTA include similar substantive rules on the protection of foreign investments, such as the requirement to guarantee fair and equitable treatment, national treatment, most-favoured nation (MFN) treatment, compensation in the case of direct as well as indirect expropriation and the free transfer of investment-related funds.²⁴ Both treaties also include commitments to liberalise market access for foreign investors and prohibitions on the use of performance requirements. Those substantive rules are typically enforceable via investor-state dispute settlement (ISDS) mechanisms.²⁵

Comprehensive investment rules can help to improve investment protection but may also indirectly address higher-ranked obstacles to upgrading, such as skills (ranked second) and access to technology and know-how (ranked tenth) (see Figure 9): strong protection of FDI and a secure legal environment signalled by those provisions can increase FDI flows into the country, which can – under certain conditions – spur spillovers of technology and know-how and promote upgrading (Borensztein, De Gregorio, & Lee,

24 See TPP Chapter 9, EVFTA Chapter 8.

25 The TPP and the EVFTA differ in the design of the respective dispute settlement mechanisms. Whereas the investment chapter of the TPP includes a traditional ISDS mechanism that is modelled on the US approach, the EVFTA includes a novel mechanism. The EVFTA is the first treaty to include the new “investment court system” including clauses for the appointment of permanent judges, their random selection and the establishment of an appeals mechanism, designed to follow the WTO’s arbitration systems.

1998; de Mello, 1997). The evidence on the effects of protection provisions included in international investment treaties on FDI flows is mixed (Berger, 2015), but some studies have found that market access provisions help to attract additional investment (e.g. Leshner & Miroudot, 2007; Berger, Busse, Nunnenkamp, & Roy, 2013). Although the TPP and the EVFTA investment provisions clearly go beyond WTO commitments, many of these investment provisions have already been incorporated into international investment agreements signed by Vietnam and into Vietnam's renewed investment law in 2015.²⁶ According to an international expert, the domestic law, however, does not provide for the fair and equitable treatment rule and does not incorporate ISDS mechanisms.²⁷ As foreign investors already enjoy de facto preferential treatment from the Vietnamese government,²⁸ the effect of the TPP and the EVFTA investment protection on FDI flow is expected to be moderate. It seems that for the Vietnamese economy as a whole,²⁹ increased market access for foreign investors as a result of the TPP and the EVFTA has the greatest potential to increase FDI, whereas an improved business framework, including enhanced investment protection, plays a minor role.

Irrespective of the potential of increased FDI, linkages between foreign investors and domestic companies rarely materialise by themselves. Encouraging these linkages, however, can become more difficult with signing the TPP and the EVFTA, since a significant number of performance requirements are prohibited by the investment chapters, restricting the Vietnamese government's room for manoeuvre to support the domestic business sector. Performance requirements have been used – with mixed results – by many countries in the past to foster those linkages.

Moreover, the national treatment provision requires that foreign investors are treated in a “no less favourable” way than domestic investors, restricting policy space for supporting domestic companies in their upgrading process. Against this background, there is a risk that competition from foreign companies crowds domestic ones out of the market. Stronger competition

26 Vietnamese scholar XI, Hanoi, April 2016.

27 International expert I, first interview, Hanoi, March 2016; Vietnamese scholar X, Hanoi, February 2016.

28 Senior manager Vietnamese T&G company I, Hanoi, February 2016; Representative of consultancy I, Hanoi, March 2016.

29 The expected effects can differ significantly across sectors. T&G already sees a strong inflow of FDI in view of the TPP, whereas the E&E sector is likely to be only moderated affected. For more details, see Chapters 6 and 7.

from foreign firms has indeed been expressed as a major concern by interviewees and surveyed firms. Interviewees are very sceptical that Vietnamese firms are able to compete with foreign firms, and 76 per cent of surveyed firms believe that Vietnamese firms will be crowded out. This concern is further aggravated by the prevalence of reverse discrimination, with foreign firms enjoying preference over domestic ones.³⁰ Chapter 7 discusses the relationship between investment rules, FDI attraction and linkage-building in a more detailed way for the E&E sector in Vietnam.

Intellectual property rights

The IPR chapters in both the TPP and the EVFTA go beyond the WTO TRIPS agreement. The TPP strengthens IPRs, in particular in the area of the digital economy, backed by a strong enforcement mechanism as, for the first time, a trade agreement stipulates criminal penalties for trade secret theft.³¹ The EVFTA focuses more on the protection of geographical indications,³² although the enforcement mechanism is not as strong as in the TPP.³³

Similar to the investment provisions, deep PTAs will help improve IPR protection but may also have an indirect effect on some of the previously identified obstacles to upgrading, such as skills and access to technology and know-how (see Figure 9). On the one hand, the legal protection of intellectual property can attract foreign investors, encourage investment into R&D and innovations, and promote upgrading (Adams, 2010; Falvey & Foster, 2006). Domestic firms can benefit from more advanced foreign technology and know-how (Gorodnichenko, Svejnar, & Terrell, 2007). On the other hand, strong IPRs could also limit access to knowledge and impede spillovers to domestic firms because of their high levels of protection (Havranek & Irsova, 2011).

Foreign investors are not very concerned about IPRs, as Vietnamese firms currently lack the capability to copy foreign technologies.³⁴ Strong IPRs are, however, likely to become more important in the future when the

30 Senior manager Vietnamese T&G company I, Hanoi, February 2016.

31 See TPP Chapter 18.

32 Nearly all of the geographical indications in the EVFTA relate to the agriculture and food processing sector and therefore were not studied in more detail in our research; see EVFTA Chapter 12.

33 The EVFTA does not include criminal penalties for theft of trade secrets.

34 Senior representative of international law firm II, Hanoi, March 2016.

skills level of Vietnamese workers and the technological capabilities of Vietnamese firms will have risen. Moreover, the need to implement stronger IPR protection, for example in the area of criminal penalties for trade secret theft stipulated in the TPP, will potentially strengthen Vietnam's weak legal system, which is currently the bottleneck for IPR enforcement.³⁵

Customs administration and trade facilitation

Customs procedures rank as the fifth obstacle among the surveyed firms (Figure 9). Especially in emerging economies, cumbersome customs procedures often constitute a greater obstruction to trade than tariffs, precluding especially small domestic firms from exporting or sourcing inputs from abroad (Freund, 2016). Once tariffs are eliminated, the costs of getting goods through the borders become much more relevant (Freund, 2016). Studies estimate that one day in transit is equivalent to an ad valorem tariff of 0.6 to 2.1 per cent (Hummels & Schaur, 2013).

As the first PTA, the TPP stipulates customs to be cleared within 48 hours.³⁶ Enforcement of this provision falls under the dispute settlement mechanism. A reduction of time in transit from the current 64 hours for imported and 67 hours for exported goods can translate into significant cost savings for Vietnamese firms. As Vietnam relies on imported materials and machinery, faster customs procedures will lower costs for Vietnamese producers, making them more competitive. This is especially relevant for SMEs aiming to increase the size of their business or to improve the efficiency of production processes via new machinery (process upgrading).³⁷

Additionally, shorter and more predictable customs procedures increase the predictability of lead times – a factor that could raise the attractiveness of Vietnamese suppliers for international lead firms. Furthermore, stricter regulations on time limits at the border diminish the potential for corruption by reducing the number of opportunities or stages at which corrupt

35 Senior representative of international law firm V, HCMC, April 2016.

36 The goal of customs clearance within 48 hours and 6 hours for express shipments is stipulated in Art. 5.10.2 of TPP's Chapter 5. The EVFTA employs much broader language, requiring the release of goods within "a period no greater than that required" (see EVFTA Chapter 5, Article 4.1).

37 International expert I, first interview, Hanoi, February 2016.

individuals can intervene,³⁸ thereby addressing the number one obstacle mentioned by the surveyed firms.

Whereas the EVFTA does not bring along significant innovations compared to existing legislation, the TPP's customs chapter seems to provide the chance to enhance the upgrading potential of Vietnamese firms by making them more competitive and more attractive for foreign buyers.

State-owned enterprises

The TPP (Chapter 17) and the EVFTA (Chapter 10) are among the first PTAs that seek to comprehensively address the commercial activities of SOEs (United States Trade Representative, 2016). Both agreements stipulate that SOEs are required to compete fairly in economic activities and make purchases and sales on the basis of commercial considerations such as price, quality and marketability. Enforceable under the dispute settlement mechanism, the provisions discipline policies that give SOEs an unfair advantage over private firms and restrict the Vietnamese government's space to support SOEs (Miner, 2016). An SOE reform would not only benefit foreign investors but also improve the business environment for the domestic private sector. It is important to note though that SOEs operating at the sub-federal level of government and those under the revenue threshold of 200 million Special Drawing Rights are exempted from the SOE regulations in both PTAs. Additionally, a large number of non-conforming measures are listed that are allowed to remain in force, despite violating the requirements of the PTAs, in particular for Vietnam, thus limiting the impact of the chapters to certain SOEs (Elms, 2015).

State support for SOEs is ranked as a lower-level obstacle to upgrading in our survey (see Figure 9). The underlying rationale of SOE provisions in the EVFTA and the TPP are associated with a more competitive business environment, which should enable private firms – Vietnamese as well as foreign-owned – to enter into and expand within certain market segments dominated by SOEs, forcing the latter to operate according to market-economy principles. The provisions may also undermine SOE's preferential access to credit and lead to a more efficient allocation of capital, indirectly improving access to credit for private firms. Since the transparency regulations in the TPP – and to a lower extent in the EVFTA –

38 International expert I, first interview, Hanoi, February 2016.

allow the public, or at least TPP members, to access more information on SOEs, this may reduce the opportunity for hidden political interference, curtailing corruptive practices and improving the ability of domestic private companies to influence policy-making processes. According to a Vietnamese scholar, the reform of SOEs features high on Vietnam's reform agenda, as SOEs consume too many public resources in an inefficient way.³⁹ This is confirmed by the Vietnam Development Report 2012, which finds that SOEs employ more capital to produce one unit of output than the industry average, and that the accumulation of capital in the 2000s did not result in an increase of production or labour productivity (Mishra, 2011). Although the TPP commitments on SOEs are largely part of Vietnam's enterprise laws already,⁴⁰ the TPP can increase the pressure for enforcing these laws.

The commitments in the SOE chapter might, however, have drawbacks as well. They deprive Vietnam of the opportunity to use SOEs for supporting industrial development and attempting to increase domestic value capture. This concern was not expressed in interviews and only 59 per cent of surveyed firms think that SOEs are needed to promote Vietnam's economic development, whereas the overwhelming majority of firms (96 per cent) consider equal opportunities provided to all types of firms to be important. Interviewees overwhelmingly embraced SOE reforms, while acknowledging that implementation will be challenging.⁴¹

Summary

The discussion of the selected TPP and EVFTA chapters shows that deep PTAs can be conducive to the business environment if PTA disciplines are properly enforced. Deep PTAs have a direct effect on the business environment for the issues regulated in the agreements (e.g. higher investment and IPR protection, faster customs procedures, more competitive market structure) and a potential indirect effect for related issues (e.g. access to technology and know-how, skills). Table 1 summarises the potential effects of the PTA chapters discussed in this section. It is noteworthy that the effect on the business environment prevails in particular in the case of deep PTAs, as they cover behind-the-border issues, which shallow PTAs do not.

39 Vietnamese scholar XI, Hanoi, April 2016.

40 Senior representative Vietnamese business association IV, Hanoi, April 2016.

41 Senior representative of international law firm II, Hanoi, March 2016.

Table 1: Effect of PTA chapters on business environment

Obstacles addressed \ PTA chapter	Investment protection	IPR protection	Access to technology and know-how/skills	Increased competition	Customs procedure	State support of SOEs
Investment						
IPRs						
Customs						
SOE						
Source: Authors						

However, the issues directly addressed in the TPP and the EVFTA are not necessarily those that were ranked as the biggest obstacles to upgrading in the survey, and several provisions, such as investment protection and SOE reform, have already been incorporated into Vietnamese law and previous trade and investment agreements. This leaves the question to what extent the new deep PTAs really have the potential to change Vietnam’s overall business environment.

Although the PTA regulations may not be totally new for Vietnam, the innovative factor will be the increased pressure for implementation and enforcement of laws resulting from the TPP and the EVFTA – a factor that should not be underestimated in a country with deficient institutions and high levels of corruption. A number of interviewees expressed that Vietnam needs this external pressure to overcome system-inherent barriers for law enforcement and reform. The PTAs leave the Vietnamese government with no choice other than to reform the institutional and legal system and enforce PTA commitments if it wants to benefit from the TPP and the EVFTA and avoid trade disputes with its partners. The simultaneous conclusion of PTAs with major trading powers doubles the pressure on Vietnam to reform. The reforms required by the PTAs potentially trigger an overall reform process in the country, tackling Vietnam’s framework conditions on several fronts. The TPP and the EVFTA are therefore seen by many observers as kicking off a reform push – similar to the one preceding WTO accession – which is expected to improve the business environment beyond what is regulated in the PTAs (e.g. Boudreau, 2015; Massmann, 2016).

In sum, deep PTAs do not directly lead to upgrading but help set the right conditions for upgrading via an enhanced business environment.⁴² However, a more conducive business environment does not automatically translate into upgrading. Upgrading also depends on the promotion of FDI linkages and the absorptive capacity of domestic firms (Figure 6). It is therefore the government's call to attract quality FDI, encourage linkages and build domestic firms' capacities, skills in particular, in order to achieve upgrading – deep PTAs are just one piece of the puzzle.

In this chapter, we took a cross-sectoral view on upgrading potentials and challenges and introduced the PTA provisions that are most relevant for upgrading. In the following chapters, we are zooming in and discuss how upgrading can be achieved against the background of the TPP and the EVFTA in the T&G and E&E sectors. We do so by analysing one of the “traditional” disciplines of PTAs in the T&G sector, namely market access through tariff elimination. Focussing on the E&E sector, we analyse rules on investment and IPR as examples of deep PTA disciplines.

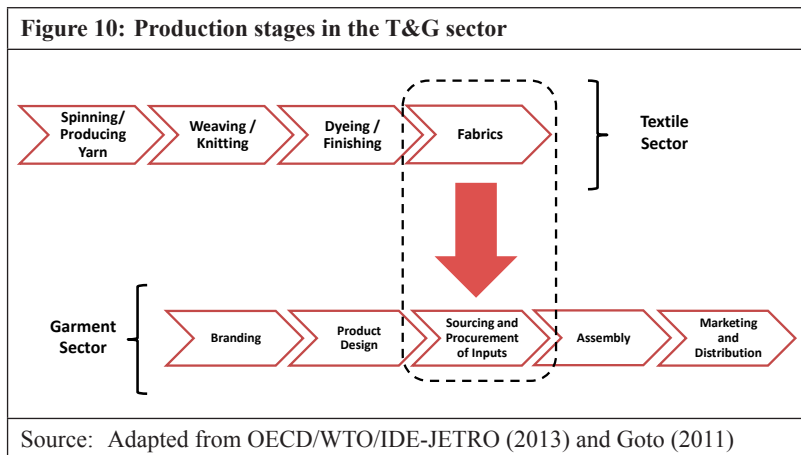
6 Back to the roots: upgrading in T&G through strict rules of origin?

T&G is Vietnam's second-largest export sector behind electronics and represents 13.6 per cent of Vietnam's total exports (Tot, 2014). Globally, Vietnam ranks ninth among the top T&G exporters in 2014 (Vietnam Industry Research and Consultant [VIRAC JSC], 2015, p. 67). Vietnam's main export destinations are the United States (48 per cent), followed by the EU (15 per cent), South Korea (15 per cent) and Japan (13 per cent) (Tot, 2014). Leading export products are jackets (21 per cent), t-shirts (21 per cent) and trousers (17 per cent). Fabrics are mainly imported from China (50 per cent), followed by South Korea (20 per cent), Taiwan (15 per cent) and Japan (6 per cent) (VIRAC JSC, 2015). Both imports and exports of T&G products have risen over the last years.

42 A more direct effect PTAs can have on upgrading is the rules of origin, especially in the case where RoO are strict and tariff reductions substantial. Compliance with RoO can be synonymous with upgrading, as is the case for the T&G rules of origin in TPP and the EVFTA (see Section 6.1).

Textiles and garments are often treated as one industrial sector and are both classified under “textiles” in the Harmonised System (HS) classification.⁴³ Yet there are notable differences between the two value-chain segments – these differences are important for our later discussion about upgrading possibilities in the context of Vietnam.⁴⁴

Factor intensity and economies of scale: In general, the textile sector is more capital-intensive, relies more heavily on technology and requires higher skill levels than the garment sector, which is characterised by more labour-intensive and less skill-intensive production stages. Countries with abundant labour resources, such as Vietnam, and low levels of capital are typically engaged in manufacturing in the garment sector, denoted as the assembly stage in Figure 10. Assembly refers to the stages of cutting, sewing and finishing the products (“cut make trim”), which requires only basic skills and is the least demanding production stage in the global T&G chain. Given the high entry costs (e.g. US\$ 20–30 million for dyeing lines, including wastewater treatment technologies), economies of scale play



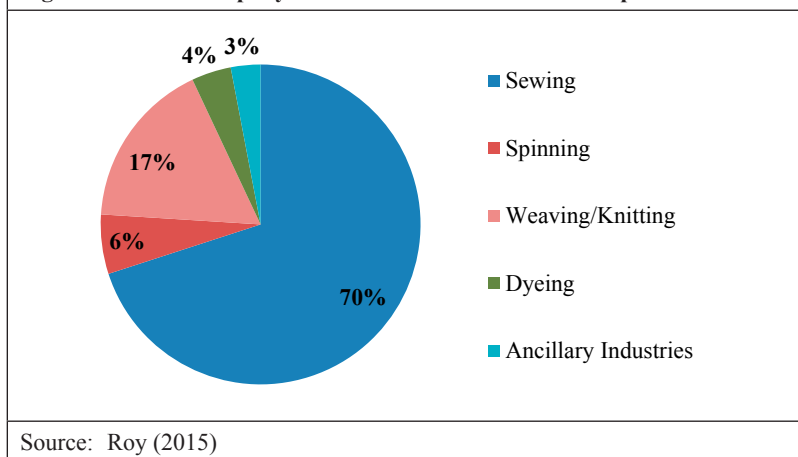
43 Note that footwear and leather are not part of the T&G sector. The HS clearly distinguishes between textiles (HS codes 50–63), footwear/headgear (64–67) and raw hides, skins, leather and furs (41–43).

44 We follow OECD/WTO/IDE-JETRO (2013) in outlining the differences between the two sectors.

a larger role for the textile sector than for the garment sector, where the investment into tailoring machines costs on average US\$ 50,000–100,000 (VIRAC JSC, 2015). It is thus much more difficult to operate and become competitive in the textile than in the garment sector. In what follows, we analyse both the Vietnamese textile and garment sectors, treating the two as closely linked – but distinct – sectors.

Vietnam is currently much more engaged in the garment sector than in the textile sector. Garment firms account for about 70 per cent of enterprises in the Vietnamese T&G industry, and the majority of them are export-oriented and mainly active in the CMT segment (75.3 per cent).⁴⁵ Figure 11 visualises the operations of T&G firms in Vietnam. Sewing accounts for 70 per cent of all firm operations. Tasks such as weaving, knitting, spinning and dyeing require much more capital and expertise due to sophisticated machines and technologies. By the end of 2014, Vietnam had only 116 companies producing yarn (VIRAC JSC, 2015). Even ancillary industries (212 companies) such as retail services, embroidery, labels, etc., are underdeveloped in the Vietnamese T&G sector, as most of their products cannot be used for export production due to the lacking quality of domestic raw materials (VIRAC JSC, 2015).

Figure 11: T&G company structure in Vietnam based on operation



45 Mr Nguyen Cong Ai, Deputy General Director at KPMG Vietnam, Seminar “TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?” in HCMC, March 2016.

Size and ownership structure: The Vietnamese T&G sector is characterised by diverse ownership structures and size patterns. The industry is operated by around 6,000 companies (Roy, 2015; Tot, 2014),⁴⁶ dominated by SMEs. The majority are domestic, privately-owned companies (84 per cent), whereas 15 per cent are foreign-invested companies and 1 per cent state-owned enterprises (Roy, 2015, Table 2). The foreign-invested enterprises are either 100 per cent foreign-owned or listed as joint ventures with Vietnamese SOEs or private enterprises (Nguyen & Dornberger, 2013). A high number of SOEs are grouped under the Vietnam National Textile and Garment Group (Vinatex), a state-owned umbrella corporation, which is the largest company in the Vietnamese T&G sector and one of Vietnam's largest companies overall (Ngo, 2013). Although foreign-invested companies account for only 15 per cent of all T&G firms in Vietnam, they made up 59.4 per cent of total exports in 2013. Their export share has steadily increased in the last decade, indicating their higher productivity compared to domestic firms (Nguyen & Dornberger, 2013).

Exports and destination countries: Vietnam's T&G exports have been steadily rising in the last years. According to an industry expert, the WTO accession, the PTAs with the United States, Japan and South Korea as well as the ASEAN agreements contributed to the increase in exports from US\$ 2 billion in 2001 to US\$ 27 billion in 2015,⁴⁷ of which 85 per cent were garment exports.⁴⁸ However, 70 per cent of raw materials for the Vietnamese T&G sector are sourced from abroad (Roy, 2015).

Labour force, wages and productivity: Around 2.5 million employees work in the Vietnamese T&G sector, accounting for 25 per cent of the total labour force in the manufacturing sector.⁴⁹ Whereas 30 per cent of the total labour force in T&G is employed by foreign-invested enterprises, 70 per cent of the labour force works for local businesses.⁵⁰ All in all, T&G accounts for the

46 Numbers vary significantly between different sources, between 2,000 and 6,000 companies.

47 Senior manager Vietnamese T&G company I, February 2016; see also VIRAC JSC (2015, p. 109).

48 Mr Le Quang Hung, Chairman of Garmex Saigon, Seminar "TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?" in HCMC, March 2016.

49 Mr Dang Huy Dong, Deputy Minister of Planning & Investment, Seminar "TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?" in HCMC, March 2016.

50 Mr Le Quang Hung, Chairman of Garmex Saigon, Seminar "TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?" in HCMC, March 2016.

largest share of the labour force's wage earnings in Vietnam (Tran & Nørlund, 2015). Although wages in the garment sector have been rising rapidly, they have not kept pace with the wage levels in other industries. This has put garment suppliers in the difficult position of attracting enough workers (Goto, 2012). Overall, labour productivity levels in the Vietnamese T&G sector is low: currently, the average labour productivity levels are one-third for Hong Kong, one-quarter for China and one-eighth for South Korea (VIRAC JSC, 2015). Thus, low labour productivity levels are one of the biggest challenges of the Vietnamese T&G sector. At the same time, it is one of the reasons why CMT is the prevalent production modality among Vietnamese firms, with 75.3 per cent, whereas Free on Board contracts accounted for 22.2 per cent and Original Design Manufacturing for only 2.5 per cent in 2016.⁵¹

The Vietnamese T&G industry faced difficulties in the past in overcoming the low value-added CMT operations and has not yet managed to establish a competitive textile industry within the country that could supply the garment industry.⁵² Against this background, Vietnam's recently signed deep PTAs – the TPP and the EVFTA in particular – might be game changers: substantial tariff reductions and preferential market access to 50 per cent of the global garment market – namely the United States and the EU, conditional on meeting the strict RoO – provide a direct incentive for upgrading in the Vietnamese T&G sector.

6.1 Rules of origin as an incentive for functional upgrading

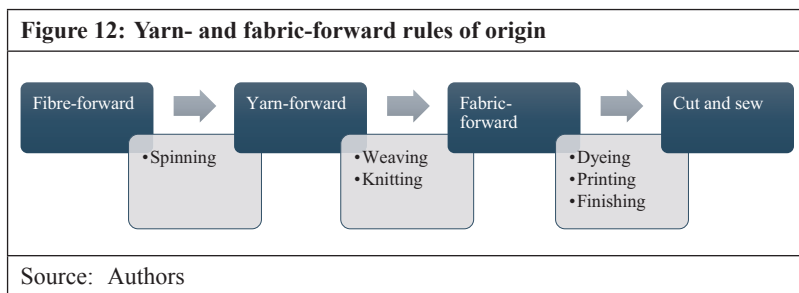
RoO set the criteria used to determine the origin of goods based on which preferential access to PTA members' markets is granted. This is to prevent trade deflection, whereby products from non-PTA countries are redirected

51 Mr Nguyen Cong Ai, Deputy General Director at KPMG Vietnam, Seminar "TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?" in HCMC, March 2016. Further elaboration on contract systems within the T&G sectors (see VIRAC JSC, 2015, p. 49): Under CMT, Vietnamese garment suppliers receive the fabrics free of charge and only do the assembly part. This means that they cannot decide where to source the fabrics from and get only the margin from labour, which is the lowest margin in the supply chain (Goto, 2012). Few Vietnamese suppliers (22.2 per cent) managed to sign FOB contracts, which give them autonomy in the sourcing and procurement of inputs and grant significantly higher margins. Under FOB level III or ODM, which accounts for only 2.5 per cent of Vietnamese firms, manufacturers initiate production of garments based on their own design, with no prior commitment of any kind from foreign buyers (Goto, 2007, p. 8).

52 Senior manager Vietnamese T&G company II, Hanoi, February 2016.

through a PTA member country to take advantage of preferential treatment. In a world of fragmented production, defining the nationality of a product is all but straightforward. Origin is often conferred once a defined percentage of domestic value added or specified manufacturing or processing operations are met (Brenton, 2011).

Rules of origin for T&G exports in the TPP and the EVFTA: The RoO is yarn-forward in the TPP and fabric-forward in the EVFTA. The yarn-forward rule requires every step from the spinning of the yarn to the assembly of the final product to occur in TPP member countries in order to be eligible for preferential tariffs (see Figure 12). The fabric-forward rule is less restrictive, as yarn may be sourced from any country, but the fabric must be woven or knitted in the EVFTA region.⁵³



Both RoO are challenging for Vietnam, as 75 per cent of Vietnam’s exporting garment firms carry out CMT⁵⁴ and Vietnam imports 86 per cent of its textiles from non-TPP and non-EVFTA member countries, most notably China, South Korea and Taiwan (Tot, 2014). The cumulation rule in the EVFTA provides some leeway, allowing Vietnam to source its inputs from South Korea, which has also signed a PTA with the EU. There is, however, less flexibility in the TPP to depart from the yarn-forward rule (Elliott, 2016). One reason is that the major intention of the United States to negotiate the yarn-forward rule was not to support upgrading of Vietnam’s textile industry, but to protect US manufacturers from competition through Vietnamese-

53 Cumulation with Korea is possible: since Korea has also signed a PTA with the EU, the country is treated as if it was also part of the EVFTA when it comes to meeting the RoO.
 54 Mr Nguyen Cong Ai, Deputy General Director at KPMG Vietnam, Seminar “TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?” in HCMC, March 2016.

made garments.⁵⁵ Instead of sourcing yarns and fabrics from non-TPP member countries such as China, Taiwan and South Korea, yarn-forward obliges Vietnam to source yarns and fabrics from TPP member countries, for example from the United States. Contrary to other US PTAs, the TPP does not include tariff preference limits, which grant preferential treatment for a defined quantity of specified garment exports using inputs from non-PTA countries. The TPP short-supply list does provide some flexibility to source, for example, 187 fabrics for cotton dress shirts from outside the TPP region if not produced in sufficient quantity within the region. All but eight products will remain on the short-supply list permanently (Congressional Research Service, 2016). The TPP also includes an earned import allowance provision, which provides preferential access to the United States for certain garment products if a specified amount of fabrics are purchased from US producers. However, it is possible that the costs for procuring the fabric from the United States outweigh the benefits from tariff gains for Vietnam. Vietnam therefore has to come to terms with the yarn-forward rule if it wants to benefit from preferential access to its largest export market.

In the following, we focus on the yarn-forward rule in the TPP, as compliance with yarn-forward implies compliance with fabric-forward as well. As most domestic and foreign firms in the T&G sector confirmed during the interviews, the main bottleneck that the Vietnamese T&G industry has to overcome to build up the textile supply chain is the fabric-making. This involves weaving and knitting as well as dyeing and finishing. A high-ranked representative of one of the leading T&G companies in Vietnam states that since the weak link of Vietnam is in fabric- and not in yarn-making, fabric-forward or yarn-forward basically pose the same challenge to Vietnam.⁵⁶ Also, meeting yarn-forward provides a greater incentive for Vietnam, as the United States is by far Vietnam's most important T&G export market – with exports three times as high as to the EU, despite higher current tariffs for the United States.⁵⁷ Finally, the TPP provides less leeway to comply with its RoO, as compared to the EVFTA, increasing the pressure and incentive for Vietnam to meet yarn-forward.

55 Senior representative international business association V, Hanoi, April 2016.

56 Senior manager Vietnamese T&G company I, February 2016.

57 The average tariffs for Vietnam's garment exports to the EU is about 12 per cent (see EVFTA EU Tariff Elimination Schedule for HS codes 61 and 62). For garment exports to the United States, it is 18 per cent (Elliott, 2016).

Implications of yarn-forward for Vietnam's upgrading potential in T&G:

There are three scenarios for Vietnam to deal with the yarn-forward rule: (1) Vietnam sources its yarn from other TPP member countries and benefits from preferential tariffs, but the net benefit might be limited, or even negative, depending on the relation of sourcing costs from more costly suppliers inside the TPP to tariff savings; (2) Vietnam builds its own textile industry and thereby gains preferential access or (3) Vietnam keeps sourcing the yarn from the same countries as before and continues to pay the MFN tariff for its garment exports, if scenarios 1 and 2 are unviable or unfeasible. Note that under scenarios 1 and 2, additional costs incur for complying with the RoO (e.g. documentation costs), which are estimated to be between 2–6 per cent of total production cost (World Bank, 2014). Under scenarios 1 and 3, there is no effect on upgrading, whereas scenario 2 implies functional upgrading: the assumption of additional production stages within the country.

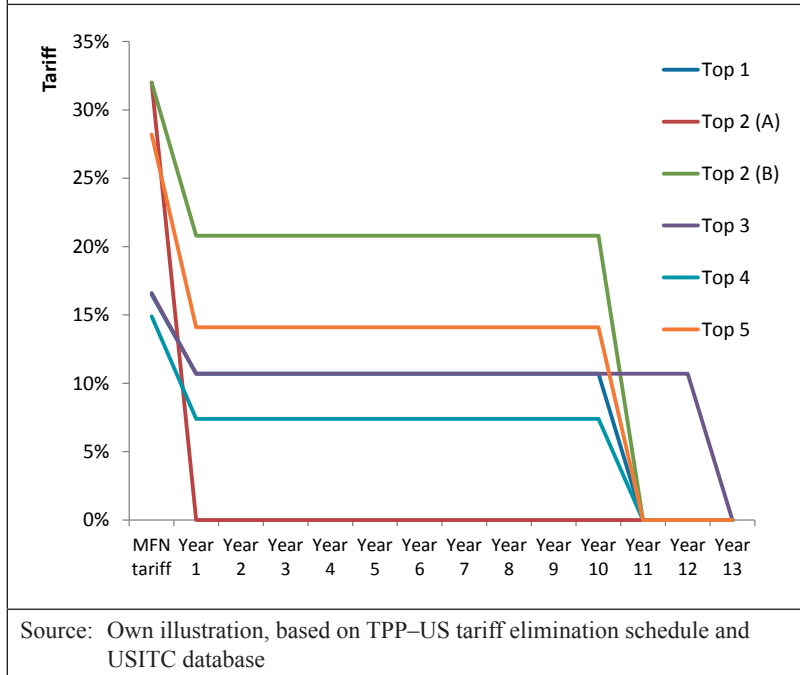
Despite the protectionist rationale behind the TPP's yarn-forward rule, it provides a strong incentive for Vietnam to develop its own textile industry. Even without the TPP, Vietnam has an interest to upgrade and capture more value added in the production process than it currently does under CMT. The prospect of preferential access through the TPP magnifies this interest for Vietnam and creates a powerful incentive also for foreign investors outside the TPP to enter the Vietnamese market. Vietnam's garment exports are currently among the most highly protected items in the US tariff schedule, with an average tariff of 18 per cent, or US\$ 1.7 billion (Elliott, 2016). If Vietnam meets the yarn-forward rule, garment producers in Vietnam will substantially gain from tariff elimination in the United States.

There is, however, a drawback to this story. It will take more than a decade for many US tariffs for garments to be phased out completely. Figure 13 shows the TPP tariff elimination schedule for Vietnam's top 5 garment export items. Only one of them will be phased out completely in year one; the others will take up to 13 years to be eliminated completely. This picture looks similar for Vietnam's top 20 T&G exports, as summarised in Appendix 3.⁵⁸ In order to make best use of the yarn-forward rule, companies in Vietnam could adapt their export structure to the TPP–US

58 See Appendix 3 for a detailed account of the tariff elimination schedule for Vietnam's top 20 garment exports to the United States based on eight-digit-level Harmonized Tariff Schedule codes.

tariff elimination schedule by focussing on those garment export items for which tariff reduction is most profitable. This could change the share of certain garment export items as a percentage of Vietnam's total T&G exports to the United States in the future.

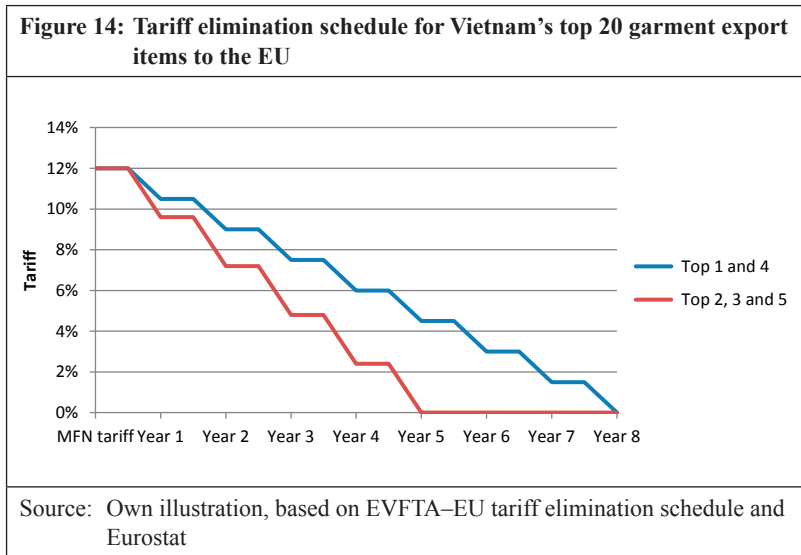
Figure 13: TPP–US tariff elimination schedule for Vietnam's top 5 garment exports to the US in 2015 (by value)



The long time horizon for complete tariff elimination lowers the incentive to build the upstream textile value chain in Vietnam. Labour costs are expected to continue rising, making it economically less attractive to invest in new industry segments. Important textile producers such as South Korea and Taiwan might join the TPP in the near future (e.g. Hyo-sik, 2015; Kaushik, 2015; Lee, 2015; Tiezzi, 2016), which would make it possible for Vietnam to keep sourcing yarn from these countries and meeting the RoO without having to build up an own upstream industry.

In contrast to the United States, the tariff elimination schedule for Japan might provide an additional incentive to establish the upstream textile value chain in Vietnam, as 97 per cent of Vietnamese garment exports to Japan will be duty-free upon entry into force of the TPP. Vietnam exports roughly three times more garments to the US market than to Japan, and existing garment tariffs for Japan are only half the level of US tariffs, but with an average of around 9–10 per cent, the tariff elimination in Japan is still high enough to provide a substantial premium for Vietnamese garment exporters.

The picture of the impacts for the tariff elimination schedule of the EVFTA looks less clear cut: 89 per cent of Vietnam’s total T&G exports to the EU will be duty-free in years 4, 6 and 8 after entry into force, respectively (see Figure 14). Only 10 per cent of Vietnam’s total T&G exports to the EU will become duty-free upon entry into force in year one. The current tariff level of Vietnamese T&G exports to the EU amounts to 12 per cent on average (for further details, see Appendix 4).



In conclusion, the yarn-forward rule in the TPP is very challenging for Vietnam to comply with, yet it sets a strong incentive for garment producers in Vietnam to upgrade by assuming upstream stages of production. This incentive is, however, dampened by the long phase-out periods in the

US schedule, which places a risk on how high the preference margin of the tariff cuts will be in a changed environment in a couple of years' time. Interviewees across ministries, academia, business associations and firms expressed their expectations and concerns regarding yarn- and fabric-forward and confirmed that the RoO are a double-edged sword (see Box 2).

Box 2: Reactions on yarn-forward in TPP and fabric-forward in EVFTA

Yarn-forward in TPP

“The rules of origin are the most important provision for the textile and garment sector.”

~ *Senior manager Vietnamese textile company V, Hanoi, March 2016*

“They (yarn-forward and fabric-forward) are basically the same to us because our weak link is in fabric-making not yarn-making.”

~ *Senior manager Vietnamese textile company V, Hanoi, March 2016*

“The Vietnamese government wanted to negotiate the best conditions for T&G industry, but it failed.” ~ *Senior manager Vietnamese textile company II, Hanoi, February 2016*

“Yarn-forward will give Vietnam the opportunity to build up its own industry.”

~ *Senior manager Vietnamese textile company III, Hanoi, March 2016*

“The commitment to this rule may have been a ‘fail of our negotiation’ and maybe we (Vietnam) sent the wrong guys.”

~ *CEO international textile company II, Hanoi, February 2016*

Fabric-forward in EVFTA

“EVFTA is less strict than TPP.”

~ *Representative of foreign embassy I, Hanoi, February 2016*

“With regard to fabric forward in EUVFTA, it looks better than yarn-forward in TPP, because the rules of origin are not that strict.”

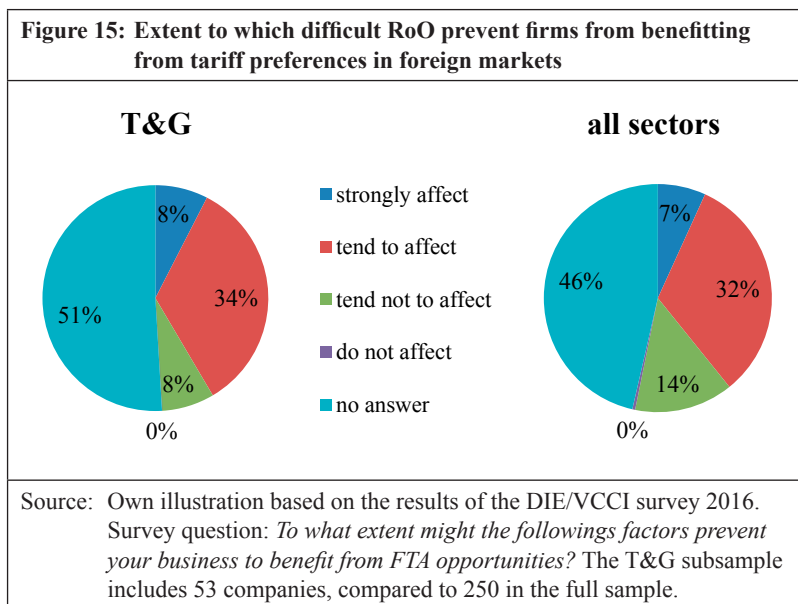
~ *Vietnamese government official II, Hanoi, February 2016*

“The EVFTA includes an exception allowing such cumulation as normally practiced under the general system of preferences, with Korea for textiles.”

~ *First interview with international expert I, Hanoi, February 2016*

6.2 Conditions to meet and make best use of the rules of origin

Despite their potential to incentivise upgrading, yarn- and fabric-forward are not sure-fire successes. As the survey results in Figure 15 illustrate, when asked about the extent to which RoO prevent each firm to benefit from access to foreign markets, roughly half of the firms were not able to answer this question. This could be an indication of a **lack of awareness or lack of understanding of RoO**. At the same time, many respondents indicated that the difficult RoO strongly affect, or tend to affect, their potential to benefit from tariff preferences and the associated access to foreign markets. This share is slightly higher in the T&G sector (42 per cent) than for the whole sample across sectors (39 per cent). When only counting respondents who answered the question, almost 85 per cent in the T&G sector see RoO as an important barrier for their business to benefit from PTA opportunities.



In order to enable firms to make best use of RoO and to make the national upgrading scenario more likely, several domestic conditions need to be improved. The Vietnamese T&G sector faces a substantial **shortage of skilled labour**. The lack of qualified personnel was mentioned across

firms, research and government institutions as being an essential barrier to upgrading in the T&G sector. According to these interviewees, the lack of well-educated employees is most obvious on the management level, but also on the technical side, such as engineering, as well as for branding and design. Many interviewed T&G firms pointed out the absence of sufficient merchandising capacities and business skills, such as the setting up of business plans, managing risks and financial understanding among employees, as being a crucial barrier preventing the expansion to higher value-added production segments. According to them, this has a lot to do with the low quality of higher education and vocational training in Vietnam, including poorly educated teachers and professors, a lack of teaching materials and appropriate learning spatiality. At the same time, the focus of the universities offering textile educational programmes often does not match with the needs of T&G firms.⁵⁹ In order to tackle this mismatch between the existing educational and vocational programmes and the firms' needs, both domestic and foreign T&G firms are urged to train their staff themselves.⁶⁰

In order to expand into the more capital- and technology-intensive segments of the value chain, initiatives from the government, the private sector and FDI firms are needed. The investment in spinning machines, but also in dyeing, printing and finishing, is difficult for local SMEs due to their **lack of capital**.⁶¹ According to one of the three largest state-owned banks in Vietnam, special financing programmes with low interest rates and tailored to a firm's production line will be set up in light of the TPP to support SMEs in the T&G sector.⁶² This is an important initiative, as many stakeholders criticised that SMEs receive no financial incentives to expand their investments to other production stages due to unfavourable credit conditions, high interest rates in particular. However, as investment in the upstream production stages of the supply chain in the T&G sector require large amounts of capital, the support of Vietnamese SMEs alone will most likely not be enough to build up the textile sector. As several T&G firms and government officials agreed, former SOEs – now often referred to as “joint stock companies” after their equitisation – have better access

59 International expert IV, Hanoi, March 2016.

60 Senior manager Vietnamese T&G company II, Hanoi, February 2016; CEO international T&G company I, Hanoi, February 2016, among others.

61 Senior manager international T&G company I, HCMC, March 2016.

62 Ms Phan Thi Hong Diep, Deputy Director at Vietinbank, Seminar “TPP and the Textile, Apparel & Footwear sectors: How to seize opportunities?” in HCMC, March 2016.

to finance and better linkages to foreign retailers than SMEs. They could use this position to invest in supply industries. Vinatex plays a leading role in the development of the industry.⁶³ Nevertheless, as most interviewees stated, the majority of investment in yarn- and fabric-producing production stages has to come from foreign firms.⁶⁴

Even though the EVFTA and the TPP have not yet entered into force, the strict RoO already provide incentives for foreign firms to invest in the Vietnamese textile industry to benefit from future tariff cuts. Foreign investors mainly come from Japan, Taiwan, Singapore and China.⁶⁵ However, attracting FDI through RoO to build up the textile supply industry may also have downsides. On the one hand, FDI may bring the needed capital to invest in the upstream supply industry. Also, since in most cases SMEs cannot join the textile supply chain directly, there is the chance for SMEs to become subcontractors.⁶⁶ Depending on FDI firms' spillover potential and the absorptive capacity of local firms, Vietnamese firms could benefit from **technology and knowledge spillovers**. Since buying the machinery is often not the only problem but also acquiring the tacit knowledge to use, repair and build them, these spillovers are essential.⁶⁷ On the other hand, the risk remains that foreign firms will not really invest in Vietnam but only rent factories.⁶⁸ These firms have only short-term interests in Vietnam and are less likely to make long-term investments in the textile supply chain. In order to make best use of FDI investing in the textile supply industry, it is important to **control for the quality of FDI**.⁶⁹ This indicates the importance of focussing investment promotion efforts on investors that aim at building up local suppliers and have a long-lasting interest in the Vietnamese T&G sector and/or MNCs that operate in industries that can rely on Vietnamese inputs. All of these characteristics make foreign investors more likely to engage in business linkages with the domestic support industries. In practice, measures such as the setting up of

63 Representative international export promotion agency, telephone interview, March 2016.

64 Senior representative Vietnamese business association II, Hanoi, March 2016, among others.

65 Senior manager international testing service provider I, HCMC, March 2016; Vietnamese scholar IX, HCMC, March 2016.

66 Vietnamese scholar IV, Hanoi, February 2016.

67 International expert III, Hanoi, March 2016.

68 International expert IV, Hanoi, March 2016.

69 Senior manager Vietnamese T&G company VI, Hanoi, March 2016.

clusters could enable a more targeted attraction of FDI while establishing business linkages. This counts in particular for the dyeing and finishing industries, which are more skill- and capital-intensive than weaving and knitting, which are more mechanical.⁷⁰ Tax incentives could not only attract foreign investors to invest in costly wastewater treatment plants, allowing Vietnamese textile firms to cluster around them,⁷¹ they could also provide incentives to cope with environmental standards. Since dyeing is very harmful to the environment, foreign investors attracted through RoO should be incentivised to commit to environmental protection/standards. This is important because, currently, the de facto obligations for foreign investors to comply with environmental regulations are perceived to be very lax, whereas they are much stricter for local enterprises.⁷² Many local authorities are reluctant to allow investments in the textile industry in their provinces because they fear environmental damages arising with these production sites.⁷³ In order to increase the level of investment in the supply industry in Vietnam, it is of utmost importance to strengthen compliance with domestic environmental regulations, particularly for foreign investors. The EVFTA and the TPP oblige the Vietnamese government to do so by effectively implementing domestic laws and monitoring its compliance.

Summing up, the high tariff cuts, coupled with the strict RoO in the TPP and the EVFTA, set a direct incentive for upgrading to higher value-added production stages, that is, developing a textile industry in Vietnam. However, questions remain whether this strategy – implying costly investments – will pay off at the end of the day. First, the time lag in the elimination of tariffs for exports to the United States raises the question whether having an upstream industry still makes sense in a decade's time, when wages may have risen and other major textile producers may have joined the TPP or negotiated their own PTAs with Vietnam's main trading partners. Second, the development of an upstream industry hinges strongly on Vietnam's capacities to do so against the background of a lack of skilled labour, finance and technologies. Since FDI firms often have better qualified labour, more capital and a higher level of technology than Vietnamese companies, it remains a critical question whether local or foreign firms will reap most of the potential benefits involved with the RoO. Hence, benefitting

70 Ibid.

71 Senior manager Vietnamese T&G company II, Hanoi, February 2016.

72 Vietnamese scholar XI, Hanoi, April 2016.

73 Senior manager Vietnamese T&G company II, Hanoi, February 2016.

from the upgrading incentives induced by the recent deep PTAs requires accompanying policies and domestic reforms that generate an enabling framework, particularly for Vietnamese companies. The same is true for the electronics sector, as we explain in the following.

Box 3: Alternative upgrading strategies in the Vietnamese T&G sector

Expanding towards upstream activities of the textile sector in order to make use of the preferential TPP or EVFTA tariffs is not the only possibility for Vietnamese CMT manufacturers to increase value added. One story that we investigated is that of a Vietnamese cut-and-sew garment company managing to sign a Free on Board contract allowing the firm to independently source its fabric and design its products in Vietnam. When prices increased and the quality of Chinese fabric went down in 2008, the company, based in Ho Chi Minh City, decided to source fabric outside China and to buy their own cotton yarn from India. This shift has been associated with higher risks and investment, but it has given the company autonomy in the sourcing and procurement of inputs and has allowed it to control the price of its fabric yarn. Thus, the firm has been less vulnerable to price and quality fluctuations. Moreover, the company has assumed some substantial functional responsibilities of buyers, which are associated with higher revenues and knowledge transfer. At the same time, the company managed to initiate the production of garments based on their own design and product development, including the approval of samples and the selection, purchase and production of required materials, with no prior commitment from foreign buyers. According to a senior manager of the company, one of the key factors to successful design and brand development has been the targeting of the brand to the needs of the customers.⁷⁴ This requires qualified staff to conduct in-depth market research. The other crucial success factor has been the investment in brand marketing, including follow-up marketing to improve customer satisfaction for the upcoming seasons. In case T&G production moves out of Vietnam due to increasing labour costs, the investment in branding and design is “insurance for the future”.⁷⁵

74 Senior manager international T&G company IV, HCMC, March 2016.

75 Ibid.

7 Off to new horizons: new PTA disciplines as momentum for upgrading in E&E?

The E&E sector is Vietnam's largest export sector, making up 30 per cent of Vietnam's total exports, with a value of US\$ 150.2 billion in 2014. The most important trading partners in E&E products (HS 84 and 85) are the United States, the United Arab Emirates, China, Japan and South Korea. The ownership structure of the sector is characterised by the dominance of FDI, which generates most of the employment and export share.

Exports and destination countries: The main E&E export products of Vietnam are mobile phones, followed by personal computers, printers and televisions, among others. Especially the export value of mobile phones has increased drastically over the last years, which is likely a result of Samsung's business activities in Vietnam. The main import products are computer components, phone components, printed circuits, photosensitive semiconductor devices and electronic integrated circuits, indicating a high dependency on imported intermediates for export products.⁷⁶ The import ratio for purchasing components in the electronics industry is estimated to be between 66.9 per cent and 98.2 per cent in 2013, depending on the specific item (Supporting Industry Enterprise Development Center [SIDECE], 2015).

The majority of Vietnam's E&E exports go to China, the United Arab Emirates, the United States, Japan and European countries such as Austria and Germany. Most of the E&E imports are coming from China, Korea and Japan; much lower values are imported from Singapore, Thailand, the United States and Germany. The beneficial tariff rates – in combination with other pull factors, such as relatively low wages and tax incentives – attracted MNCs from Korea, Japan and Taiwan to start E&E production in Vietnam.

Size and ownership structure: The sector's ownership structure is rather asymmetric, with many big FDI companies and few domestic SMEs,⁷⁷ both types of firms mainly focussing on assembly activities in Vietnam. An interviewee estimated the workforce employed in the sector at about 300,000 workers, with fewer than 20 per cent of them working for local

76 This fact is underlined by SIDECE (2015); interview with Vietnamese scholar V, Hanoi, March 2016, estimating the domestic value-added in exports at 25–28 per cent.

77 By the end of 2012, there were 739 electronics companies, according to the Vietnam Statistical Yearbook 2013 (SIDECE, 2015).

enterprises, and the remaining 80 per cent for foreign-invested companies.⁷⁸ In terms of employment, the E&E sector is relatively small compared to the T&G sector, even though it takes the lead as the largest contributor to Vietnam's exports.

Many important multinational E&E companies such as Intel, Nokia, LG, Canon, Fujitsu, Foxconn, Microsoft and Panasonic have already started production in Vietnam. The biggest foreign investor in Vietnam is Samsung, with tens of thousands of employees accounting for nearly 20 per cent of Vietnam's export volume in E&E (Tomiya, 2015). Currently, Samsung relies on 100 Korean supply companies in Vietnam, whereas the Vietnamese share of the Samsung supply chain in Vietnam remains very limited; this holds true for many other FDI companies based in Vietnam, for example Intel (Tran & Nørlund, 2015; Tuoi Tre News, 2015; Tomiyama, 2016). A sector expert estimates the total number of local manufacturing suppliers producing for foreigners to be less than 10 firms.⁷⁹ Despite a certain number of local SMEs active in the E&E sector, many have not yet upgraded their technology and are not ready to join GVCs. Only a few Vietnamese firms producing simple items sell them to foreign firms, and at a rather small volume (Viet Nam News, 2015).

In addition to the small number of private-owned Vietnamese companies supplying FDI firms, there are some SOEs that are active beyond the assembly stage, for example in design, R&D and services. With own brand names, they produce home appliances and entertainment products for the local market. Viettronics is such an example – formerly one of the largest SOEs (now a joint stock company) with more than a dozen firms under its umbrella. Experts still see some growth potential in supplying to the domestic market despite tough competition from Japanese and Korean companies with better technologies. However, going beyond assembly is currently not a feasible option for most Vietnamese companies, as this is rather capital-intensive.

78 Interview with Vietnamese government official IV, Hanoi, April 2016; SIDEC (2015).

79 Senior manager Vietnamese E&E company IV, HCMC, April 2016.

7.1 Product and process upgrading through linkages with FDI

The sector description highlights that Vietnam's E&E sector is highly dependent on imported intermediates and FDI and undertakes mainly assembly activities with low value added. What is more, in contrast to the T&G sector, most experts, policy-makers and firm representatives do not expect the additional PTAs to have a big impact on the E&E sector. E&E tariffs in Vietnam's main export markets, such as the United States and Japan, will already be low at the time that the TPP will enter into force.⁸⁰ Equally, tariffs in the ASEAN region were already eliminated for the most part with the ASEAN Trade in Goods Agreement in 2009.⁸¹ The picture is similar for the EU: from Vietnam's top ten E&E exports to the EU, merely two gain improved market access through the EVFTA – all other tariffs have already been eliminated.⁸² In general, due to the low level of tariffs in the E&E sector, the new PTAs do not seem to critically improve firms' access to foreign markets or provide a clear-cut incentive for functional upgrading in order to meet the RoO for substantial tariff cuts (as is the case for T&G). Consequently, for electronics, the traditional means of PTAs, that is, tariff elimination and market access for goods, are not expected to give a big push to the sector. We argue in the following that the impact of the TPP and the EVFTA will rather lie in their implications for product- and process-upgrading opportunities through linkages with foreign investors.

Although Vietnam has been very successful in attracting foreign investors in the recent past, linkages with domestic firms remain below expectations. The Vietnamese government has identified upgrading and linkage-building, respectively, as being major challenges and policy objectives alike and reacted by issuing a number of policies to support the development of a local E&E industry (Appendix 8). The most prominent ones have been Decision No. 879/QD-TTg and Decision No. 9028/QD-BCT, both approved in 2014. The two documents highlight the importance of the electronics sector and set very ambitious goals, such as: "By 2020, Vietnam has about 1,000 enterprises qualified for

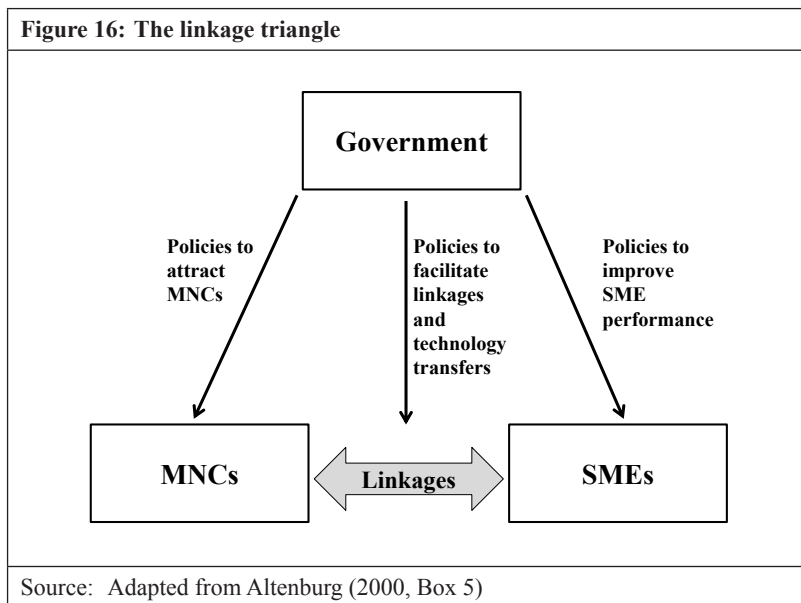
80 See tariff schedules in Appendixes 5 and 6.

81 Senior manager Vietnamese E&E company II, HCMC, March 2016; Senior representative international business association IV, Hanoi, April 2016.

82 See tariff schedules in Appendix 7.

supply to assembling enterprises and multi-national corporations in [...] Vietnam” (SIDECE, 2015, p. 161). Furthermore, with regard to SMEs, the Ministry of Planning and Investment published a “White Paper on Vietnam SME 2014” by its Agency of Enterprises Development in the same year. Nevertheless, it remains to be seen to what extent policies will be implemented to achieve these goals.

Altenburg (2000) conceptualises that successful linkages that ultimately lead to upgrading require the right relationship between MNCs, SMEs and the government. The linkage triangle in Figure 16 illustrates that successful linkages require government policies to (i) attract FDI, (ii) facilitate technology transfers and (iii) improve SME performance (Altenburg, 2000, Box 5). This linkage triangle serves as a conceptual framework for the discussion of this chapter, where we elaborate how and to what extent the deep rules in the TPP and the EVFTA can impact the three channels illustrated in the figure, using rules on investment and IPR as examples.



Attracting FDI through strict rules on investment and IPR

Most of our interview partners expect the TPP and the EVFTA to further increase FDI flows to the Vietnamese E&E sector. We have argued in Chapter 5 that stricter rules on investment and intellectual property rights improve the business environment by improving legal certainty and promoting the rule of law, that is, increasing protection for foreign investments and their (intellectual) property. Moreover, both the TPP and the EVFTA liberalise market access for foreign investors. However, in order to assess the impact of these new PTAs on FDI attraction, we have to compare the new rules with existing regulations.

First, Vietnam has already granted many foreign investors protection through a web of roughly 60 bilateral and other international investment agreements signed over the last three decades. Moreover, investors from ASEAN and a number of TPP member countries, such as Australia, New Zealand, Japan and the United States, already enjoy free market access to Vietnam, as their existing treaties include pre-establishment provisions (see AANZFTA 2009, ASEAN Investment Agreement 2012, Japan–Vietnam BIT 2009, US–Vietnam BTA 2000). In general, the further attraction of FDI is therefore more likely for European investors, whose countries for the most part have not negotiated the liberalisation of market access in their bilateral investment treaties (BITs) with Vietnam. Moreover, for most BITs between Vietnam and European countries, the MFN clause does not extend to pre-establishment, meaning that so far they cannot refer to more generous market access provisions in other existing treaties. Note, however, that Europe is not (yet) a major trading partner for Vietnam in E&E and not a major FDI origin country in that sector.

Second, the laws and regulations for FDI in Vietnam, as stipulated in the revised investment law, are already at a relatively high level and do not differ substantially from the rules in the TPP and the EVFTA.⁸³ Hence, in terms of content, there is little innovation that could make Vietnam more attractive for FDI than it already is. The difference, however, lies in the degree of enforceability. This is especially true for IPR protection, which is at a relatively low enforcement level in Vietnam and where breaches could trigger penal actions under the TPP (Vietnam Breaking News, 2016).

83 Senior representative Vietnamese business association IV, Hanoi, April 2016.

In sum, we expect the impact of the TPP and the EVFTA on FDI attraction to be moderate. The TPP and the EVFTA are unlikely to attract further foreign investors that aim to use Vietnam as an export platform, because tariffs on major export markets are already low, and the new PTAs do not bring substantial changes. Moreover, market access, investor and IPR protection are not considered major obstacles for doing business in Vietnam (see Chapter 5). However, the high degree of legal enforceability and far-reaching commitments – coupled with a potentially growing and more integrated Vietnamese economy – may nevertheless attract some foreign investors.

Yet, many economic experts in Vietnam emphasise that although a new influx of capital is crucial to develop the sector, an elevated export value does not automatically translate into more value added for Vietnamese firms.⁸⁴ In fact, partly due to attractive tax incentives, Vietnam was already very successful in attracting FDI in the past. However, most interview partners agree that the domestic economy has benefitted little beyond the improved export statistics of the E&E sector. This indicates the importance of focussing investment promotion efforts on quality FDI, that is, on investors with a tradition of working with and supporting local suppliers that have a long-lasting interest in the region and/or MNCs that operate in industries which can rely on Vietnamese inputs. Moreover, it is important to assess which instruments Vietnam (still) has available to support linkages and local private-sector development.

(Remaining) instruments to build linkages and facilitate technology transfers

In order to benefit from FDI, it is important to build linkages with the Vietnamese business sector. By linking Vietnamese firms to large MNCs, either via becoming a supplier or via cooperating in a joint venture, local electronic firms could familiarise themselves with the newest technologies employed by the international firm (*technology spillovers*) as well as learn how to manage production processes more efficiently. They could access higher-quality input materials via the larger company and profit from its information advantage about international markets, orders or buyers' quality demands (*knowledge spillovers*).⁸⁵ As some Vietnamese success

84 Senior representative Vietnamese business association IV, Hanoi, April 2016.

85 See Chapter 2 for a more detailed description of the importance of FDI for upgrading.

stories have shown (see Box 4), these technology and knowledge spillovers induced by linkages to foreign firms can be an important stepping stone for Vietnamese companies to comply with international standards and quality requirements (product upgrading), improve the organisation and efficiency of production processes (process upgrading) or even to move from assemblers to producing parts and components (functional upgrading).

Box 4: Success stories from the E&E sector in Vietnam

Some Vietnamese companies stand out as success stories for upgrading in the E&E value chain. One common denominator is that they all had some kind of business relationship with foreign partners before setting up their own firm. Some have started by building up personal experience as an engineer in a foreign company, leading to strong connections and making the partners reliable customers, while some companies started as a joint-venture, sharing facilities, staff and working processes. Being pushed by their partners to meet high-quality requirements, some have moved beyond supplying the domestic market and today export to Japan or Korea. Most of them focus on a few specialised products and specific partners, allowing them to build up technologies and know-how in-house.⁸⁶ For them, producing in sufficient quantity has become a bigger challenge than maintaining product quality. This outlines the importance of establishing linkages with foreign companies and encouraging know-how and technology spillovers.

Yet, building up these business linkages with large international companies remains the main challenge for Vietnamese electronic firms. On their path of economic development, countries such as South Korea and Taiwan have achieved linkages by legally requiring foreign investors to cooperate with domestic companies, for example by imposing local content or joint venture requirements that impose certain obligations on an investor. In Korea, they took the form of subsidising and coordinating investment decisions. Among others, underpriced credit was accorded to firms based on their level of domestic linkages. Additionally, local content provisions were instituted for all major investment projects regulating firms to use domestic products (e.g. domestic vehicles for transport) and services (e.g.

86 Some interview partners raised the point that focussing on a few buyers also comes at a cost. In the long run, diversification could be a smart strategy to decrease dependency on certain buyers.

local transport companies) in the 1970s (Westphal, 1990). Taiwan, on the other hand, developed its most competitive industries by providing a state-led entry into new material production (e.g. via a state-owned company or a private firm under state supervision) and finally forcing FDI firms to merge in a joint venture with this local supplier. Using these tools, policy-makers managed to engineer a significant increase in the private return to capital and expanded their manufacturing sectors primarily through the growth of existing firms, rather than the entry of new firms (Rodrik, 1995). In general, local content requirements in building linkages are highly debated due to their distortive nature and potential to deter investments or attract the wrong ones (Lim, 2001). Moreover, although some countries in East Asia have employed selective industrial policies and experienced remarkable economic growth, it is unclear to what extent this success can be attributed to industrial policies (Warwick, 2013). Yet, there is empirical evidence that under certain circumstances, industrial policies have helped countries to build and support local suppliers and establish linkages (e.g. Wong, 1992; Dahlman & Sananikone, 1990). Another, related strategy is to go from “imitation to innovation”, which has also been pursued by a range of countries, for example Korea (Kim, 1997). The idea behind this is to learn from – and copy – existing technologies to get ready for own R&D activities and move to a high-tech manufacturing country. In the following, we will analyse to what extent Vietnam could use these instruments and achieve these objectives against the background of the TPP and the EVFTA.

Performance requirements and national treatment: To the best of our knowledge, the Vietnamese government has not employed legal performance requirements for establishing linkages in the recent past. Moreover, with its accession to the WTO – and even more so with the signing of the TPP and the EVFTA – Vietnam has lost the possibility to employ a wide range of comparable instruments in the future (see Table 2).⁸⁷

87 Both agreements include more performance requirements than listed in the tables (e.g. related to the level of exports, foreign exchange earnings, etc.). They are not included here because they are not considered as relevant to the topic of upgrading and establishing linkages. Some sectors or some specific measures may be exempted from the rules on performance requirements. An in-depth analysis would go beyond the scope of this paper (for details, see non-conforming measures in the agreements' appendixes).

Similarly to the WTO TRIMS regulation, the TPP and the EVFTA do not allow imposing requirement to accord preferences to Vietnamese goods. Although the WTO Agreement on TRIMS still provides for special treatment of developing countries, for example transition periods for implementation that can be extended under certain conditions (WTO TRIMS Agreement, Article 5), the EVFTA and the TPP are reciprocal in nature and do not grant this possibility anymore. The EVFTA even restricts the preferential purchase of Vietnamese services, thereby going beyond existing WTO regulation (i.e. TRIMS). What is more, the TPP and the EVFTA explicitly prohibit any requirements for the “transfer of technology, a production process or other proprietary knowledge”,⁸⁹ thereby withdrawing any option for Vietnamese policy-makers to impose technology transfer via legislation.⁹⁰ In sum, the performance requirements in the TPP and the EVFTA go beyond WTO regulations and most of Vietnam’s other international agreements that are in force (most of which refer only to the TRIMS agreement). Exceptions are the Vietnam–US bilateral trade agreement and the Vietnam–Japan BIT.⁹¹

The EVFTA’s and the TPP’s investment chapters also include a national treatment provision, which implies that foreign investors must be treated in a “no less favourable” way than domestic ones, that is, domestic firms, in general, cannot receive any preferential treatment from the state that does not also apply to foreigners. This is an innovation compared to many BITs Vietnam has signed with European countries.⁹² Despite ruling out many possibilities for the Vietnamese government to directly support domestic

89 See the EVFTA Chapter 8, Article 6 1f (draft text as of April 2016) and the TPP Chapter 8, Article 9.10, p. 1f.

90 Although compelling, this policy measure is likely to miss its target, because forced technology spillovers, even if legally possible, could scare off foreign investors employing high-level technologies.

91 It is not entirely clear to what extent provisions on the prohibition on performance requirements can be “imported” through MFN clauses in other countries’ BITs. It might be the case that all investors whose countries have signed a BIT with Vietnam can refer to the strict rules in the Vietnam–Japan BIT and Vietnam–US BTA. In that case, the TPP and the EVFTA will not have an impact on foreign investors’ rights. However, by making the prohibition on performance requirements explicit in the TPP and the EVFTA, breaches are more likely to be challenged and taken to court than via the MFN detour.

92 However, it is likely that the MFN clause would grant European countries the same rights as other foreign investors if challenged in ISDS cases.

companies, some exceptions exist.⁹³ Especially for the services sector Vietnam reserves the “right to adopt or maintain any measure regarding assistance to small and medium-sized enterprises” in certain areas.⁹⁴ This maintains some governmental room for manoeuvre for domestic private-sector support. Additionally, incentivising some crucial measures for technology spillovers is still within the range of available policy instruments: the TPP explicitly leaves the option to demand the employment of workers and their training in Vietnam, yet, with the limitation that this training must not “require the transfer of particular technology, production process or other proprietary knowledge” (Article 9.10, 4: pp. 9–15). Both the EVFTA and the TPP explicitly allow granting advantages to investors, conditional on meeting the requirements to employ or train workers, supply services, construct or expand facilities in Vietnam and/or to carry out research and development in the country.

Protection of intellectual property rights: Even though the investment chapters already touch on issues of intellectual property rights by restricting the transfer of technologies, the IPR chapters in the new deep PTAs, in particular in the TPP, go substantially beyond that – and evidently also beyond WTO rules. The TPP increases the length of patents to 70 years. Moreover, breaches of IPRs are no longer only civil offences but can trigger penal action. As mentioned above, many of our interview partners share the view that IPR protection in E&E is currently not a huge problem, as E&E companies lack the abilities to copy.⁹⁵ Given the increased strength of IPR protection that comes with the TPP, then reverse engineering is also not a feasible upgrading alternative for Vietnamese firms in the future. However, Altenburg (2000) argues that although foreign firms may be reluctant to share their knowledge on “core competences”, they may be

93 Especially in the transport sector (container-handling, shipping, water, road and railway services), Vietnam reserves the right to condition foreign activities on joint ventures (see the TPP Investment Chapter, Annex I). Additionally, Vietnam already maintains the right to granted non-conforming measures with regard to minorities, land ownership, distribution and telecommunication services as well as sea-, river- and airports (see the TPP Investment Chapter, Annex II).

94 “[I]n production site selection and related regulatory measures, human resource training, providing research assistance and information on technology and equipment, legal assistance, and providing marketing assistance and promotional information” (The TPP Investment Chapter Annex II 2015, p. 7).

95 Senior representative international business association IV, Hanoi, April 2016 and Senior representative of international law firm II, Hanoi, March 2016.

willing to introduce local firms to their often more advanced industrial organisation strategies in fields such as human resource management, logistics or quality management. This leaves some possible alternatives with regard to knowledge spillovers to make local companies benefit from linkages.

In sum, the IPR and investment rules in the TPP and the EVFTA restrict the extent to which Vietnamese companies can take over the technologies from foreign investors. They also limit the range of performance requirements available to support linkages more generally. However, as argued above, the usefulness of such policies is highly debated and can have unintended consequences, such as diverting investors away, attracting the wrong FDI or picking the wrong winners. Vietnam has rejected such policies in the recent past and – with the new PTAs – will have to do so in the future as well. We have outlined that some instruments remain at Vietnam’s disposal that do not breach PTA obligations, yet may support linkage-building between FDI and domestic companies. In the following, we address the third vital component for building such linkages and highlight the challenges that still exist for enabling the local private sector to benefit from FDI.

7.2 Conditions to realise and benefit from linkages

In addition to the attraction of FDI and policies that remain at the disposal of policy-makers to support linkage-building and technology transfers under the realm of the TPP and the EVFTA, Vietnamese firms need to become more attractive as suppliers or business partners for MNCs and build absorptive capacities in order to benefit from the potential FDI influx induced by the deep PTAs. So far, however, a number of barriers have prevented local companies from doing so. Figure 17 lists the most severe obstacles that E&E firms in Vietnam face for upgrading and compares the responses to the full sample (the results of which are displayed in Figure 10).

Customs procedures, export/import licensing and other trade regulations seem to be less important obstacles for E&E firms, which reflects the strong openness of the sector relative to other sectors in the economy. On the other hand, some obstacles were rated as being major or very severe by a larger share of E&E firms than in the full sample. Notable examples include lacking **skills** and **access to technology/know-how**, which are even more pronounced in the E&E subsample, indicating that they constitute crucial barriers to upgrading in the sector. This was also confirmed by a number

of interview partners.⁹⁶ Vietnamese firms are currently scattered in many small and medium-sized companies all across the country, most of which lack the ability to meet international markets' demands in terms of time and quality, as they mainly have to rely on obsolete equipment for the production of rather unsophisticated products.⁹⁷ This makes them quite unattractive partners for foreign investors relocating their production to Vietnam.⁹⁸ Many interviewees identified the lack of capital and know-how – the latter stemming from **deficient education** – as being the root causes for this problem. The Vietnamese education system falls short on providing students with the necessary practical experience, for example via internships or vocational training, in such important domains as business management and/or accounting, as well as language skills.⁹⁹

Another obstacle to the upgrading of Vietnamese firms in the E&E supporting industry is the fact that the Vietnamese government strongly incentivises foreign investors, thereby disadvantaging domestic ones. More than “national treatment” is granted not only to the big foreign investors themselves, but also to their foreign suppliers establishing their businesses in Vietnam.¹⁰⁰ Phan (2016) calculates that in 2013 the share of taxes and fees over total revenues in the electronics supporting industries was 11.3 per cent for domestic firms, whereas it was only 7.3 per cent for FDI. This puts Vietnamese suppliers in a difficult position: on the one hand, they are facing the above-described difficulties of SMEs, on the other hand, they have

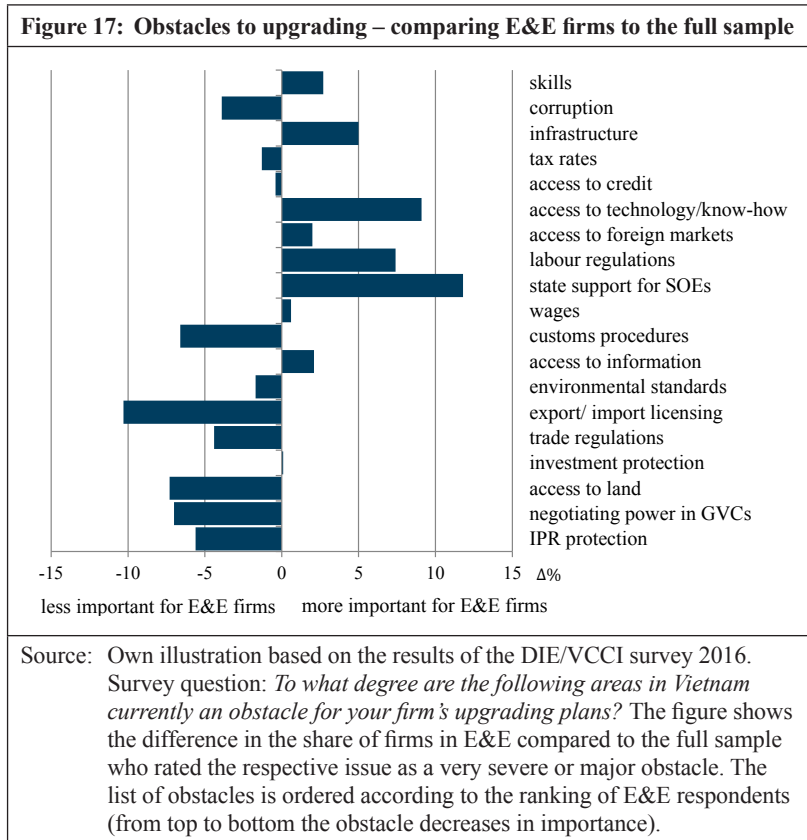
96 The overwhelming majority of firms in the business survey agree that FDI is needed for transfer of technology and know-how (DIE/VCCI survey 2016, question 14.4).

97 Senior manager Vietnamese E&E company I, HCMC, March 2016.

98 Vietnamese scholar VIII, Hanoi, March 2016.

99 Vietnamese scholar VI, Hanoi, March 2016.

100 Several interviewees exemplified this preferential treatment for investors with the case of Samsung: in line with Vietnamese Corporate Income Tax Law, Samsung acquired a “high-tech” status, which implies corporate tax exemption for the first 10 years of operation in Vietnam, a 50 per cent tariff cut for the following 10 years and preferential access to land. The same holds true for all 100 Korean suppliers that Samsung has brought with it (Vietnamese scholar IX, Hanoi, April 2016; representative of international export promotion agency, telephone interview, March 2016). It also holds true for new investments: “The highest possible investment incentives have been offered to the investor. Recently, the Civil Aviation Authority of Vietnam agreed to reserve a special terminal at Noi Bai International Airport to serve Samsung’s import/export activities. Besides the investment incentives offered by the government, the Bac Ninh provincial authorities have also offered a 50 per cent tax reduction to three Samsung subsidiaries. The province has spent a lot of money to clear land to allocate to Samsung” (VietNamNet Bridge, 2015).



to compete with already highly profitable foreign suppliers enjoying the benefits of tax-free production. Despite being entitled to the same benefits by law,¹⁰¹ Vietnamese suppliers often lack access to these privileges, as they

101 Generally, “both domestic companies and foreign invested companies are governed by the same tax framework” (International Financial Law Review, 2014). In 2015, the government’s decree 12/2015/ND-CP laid out investment incentives applying to large manufacturing projects in prioritised sectors. These include the exemption of business income taxes for up to four years, and a tax rate-cut by half in the next nine years. In addition, if investors’ bases are located outside industrial zones, the land rent will be reduced by 50 per cent for 11 years. The incentives also include exemption from import duties for goods imported to create fixed assets for production and products of supporting industries, among others (Decree 12/2015/ND-CP; VN Express 2015).

are based on conditions that local SMEs struggle to meet.¹⁰² Even though not explicitly stated on paper, some experts call these de facto hurdles for domestic private companies “**reverse discrimination**”.¹⁰³ The importance of this obstacle is reflected in the consent of the overwhelming majority of surveyed firms on the importance of equal opportunities for all types of firms in Vietnam. Moreover, the fact that this result is more pronounced for E&E firms than for the whole sample reinforces the severity of the problem in the electronics sector.¹⁰⁴

In sum, the investment provisions in the EVFTA and the TPP only have an indirect and ambiguous impact on the upgrading potential of the E&E sector. Although they, at least partially, promise to attract more FDI, they also limit the range of policy instruments that could support linkages and knowledge and technology spillovers. It is therefore unclear whether they are able to attract quality FDI and support linkages. Moreover, Vietnamese firms face other serious obstacles that have kept them from becoming suppliers for foreign firms and joining or upgrading in GVCs that are of a domestic nature, such as skills, quality requirements and reverse discrimination. Building absorptive capacity therefore remains a major challenge and requires government action. The TPP and the EVFTA still seem to leave enough room for such targeted public support measures.

Many of the obstacles putting the brakes on Vietnam’s upgrading potentials coincide between the two sectors we have analysed in more detail, namely T&G and E&E. In the following, we therefore make a range of policy recommendations that draw upon insights from the two sectors but are applicable to Vietnam in general – as well as to other developing countries at similar stages of development.

102 For instance, corporate income tax incentives apply to large manufacturing projects with investment capital of at least VND 12,000 billion (equivalent to approximately US\$ 560 million) or new investment projects in the list of industrial products prioritised for development (i.e. in the high-technology, garment, textile and footwear as well as IT, automobile assembly and mechanics sectors (Fitzgerald, Irqin, Than Trung, Quynh Van, & Hung Giang, 2015), However, many Vietnamese companies do not yet fulfil the conditions (productivity, quality, etc.) to be ranked as a high-tech factory and would need the tax incentive to become competitive in this field in the first place. Moreover, they lack access to financing an investment of such magnitude (see also Chapter 5 of this report).

103 Vietnamese scholar XI, Hanoi, April 2016.

104 DIE/VCCI survey (2016), question 15.1.

8 Policy implications and lessons learnt

Vietnam is at a critical stage of its development process. It celebrated 30 years of Doi Moi in 2015, a bold reform process that led to a fundamental transformation of the Vietnamese economy. Growth rates over the past three decades averaged 5.5 per cent. In the first decade of the 21st century, GDP increased by a staggering 7.25 per cent (Binh, 2010). This economic success story was to a great extent driven by Vietnam's ever deeper integration into the global economy. The year 2015 marked the temporary climax of this development. In this year alone, Vietnam signed four major PTAs, including the TPP and the EVFTA. It is projected that Vietnam will be the main beneficiary of both agreements. It is therefore not surprising that the conclusion of these two trade pacts has been emphatically welcomed by the Vietnamese government, the business sector and the domestic press alike. Vietnam not only gains preferential market access to several major economies such as the United States, Japan and the EU. The TPP and the EVFTA will further increase Vietnam's attractiveness for foreign investments, potentially transforming the South East Asian economy into a major production hub for the region and beyond. However, our analysis showed that the potential gains for Vietnam from signing the TPP and the EVFTA will not materialise automatically but require a strategic approach by the government to pursue comprehensive accompanying reform initiatives.

Use the reform pressure to improve the overall business environment

Literature has shown that a sound business environment improves the conditions for the upgrading of domestic companies. Signing up to deep PTAs will not, however, automatically lead to an improvement in the quality of a countries' overall business environment and political framework conditions. But the need to bring a wide array of domestic laws and regulations into line with the extensive rulebook of deep PTAs offers a reform-minded government the opportunity to tackle important barriers to upgrading that relate to the overall business environment. In the case of Vietnam, the pressure that is exerted by large trading powers such as the United States and the EU to implement the rules of deep PTAs such as the TPP and the EVFTA can be used by the government to overcome endemic reform backlog and opposition from actors with vested interests. Conditional on their implementation and enforcement, deep PTAs will signal a credible business environment by initiating and locking-in policy

reforms. Examples are the reform of SOEs, the enforcement of IPRs as well as strengthening transparency and the rule of law.

For the reform process and PTA implementation, Vietnam can expect support from TPP partners. The United States in particular and the EU are already setting up programmes to support the Vietnamese government in the implementation of the TPP and the EVFTA. Given the overlapping objectives of the support programmes, Vietnam has to remain in the driver's seat, coordinating international efforts according to its strategic priorities. Instead of relying only on the support of its treaty partners, Vietnam could seek additional support from regional and international organisations such as the WTO, the UN Conference on Trade and Development or the International Trade Centre, which can help to develop an overall strategy.

Scale-back reverse discrimination of domestic private businesses

The current Vietnamese business environment is characterised by extensive preferences granted primarily to larger companies – be they SOEs or MNCs – that put SMEs at a disadvantage. The preferences granted to SOEs and MNCs include tax incentives as well as better access to capital and land. Therefore, a reform objective could be to provide incentives and support programmes on a more equal basis. Deep PTAs – in particular the provisions on the protection of foreign investors – sanction the revoking of preferences the Vietnamese government already grants to MNCs. However, Vietnam could rethink its future tax incentive policy, which is exempted from PTA investment rules. It is likely that membership in the TPP and the EVFTA increases the attractiveness of the Vietnamese economy for foreign investors even further. Vietnamese policy-makers should thus have increased room for manoeuvre to discontinue the preferential incentive policy, or target it more towards quality investments aligned with Vietnam's development strategy. Incentives are an important element in the toolbox of governments and should be available for all companies – foreign as well as domestic, large as well as small – whose investments support Vietnam's economic development strategy. At the same time, it needs to be acknowledged that SMEs are often not equipped with the administrative capacities to use the incentive policies to their advantage. Policy-makers and business associations need to ensure that SMEs can easily access information about policy initiatives and receive support with administrative procedures in order to make use of them.

Strengthen investment promotion to attract high-quality FDI

Vietnam is an increasingly attractive destination for foreign investors due to the low labour and production costs relative to the skill levels, in particular in comparison to other economies in the region. The recently signed TPP and the EVFTA will potentially accelerate this trend even further. Such FDI is welcome, as it creates additional employment opportunities for Vietnam's young population. However, these investments are often conducted in isolation and linkages to domestic suppliers are limited. The increased attractiveness of Vietnam as a result of its membership in deep PTAs such as the TPP and the EVFTA should enable the Vietnamese government to attract higher levels of quality FDI, that is, FDI in sectors that are in need of additional foreign capital and know-how, FDI with a high propensity to engage in linkages and FDI that is operating in compliance with economic, social and environmental policies and regulations.

Investment promotion has a key role to play here. Improved coordination between investment promotion agencies and the government should lead to the identification of sectors that are in need of foreign investments. The stringent RoO in the TPP and the EVFTA, for example, incentivise the localisation of new production steps inside the country in order to benefit from preferential tariffs. In the case of the T&G sector, so far fabrics are imported from countries that are not member of the TPP and the EVFTA (mainly China), and there exists a huge potential to attract foreign investments from these countries. Investment promotion should, however, focus mainly on those production stages where Vietnamese companies still lack financial resources or capacities in order to avoid crowding out effects. Moreover, the investment rules still allow the government to incentivise foreign investors to supply certain services or construct facilities in relation to their investments. In case there is a lack of financial resources on the side of Vietnamese firms or the government, foreign firms that want to invest in dyeing in the T&G sector, for instance, could be encouraged to build up wastewater facilities. In any case, smart and targeted investment promotion requires intensified coordination with government and business agencies with sectoral knowledge. Investment promotion should also provide information for foreign investors of existing clusters and competitive domestic suppliers in order to support linkages.

Increase industries' absorptive capacities and support linkages

Linkages between foreign and domestic companies are often weak, suggesting that the latter are not able to compete in the current business environment and provide inputs in a quality and quantity demanded by MNCs. In order to build linkages with beneficial spillovers to the domestic economy, there is a need to increase the capacities of Vietnamese firms to make them ready and attractive for cooperation with international firms, support the matching of foreign investors with suitable local suppliers and, if necessary, use the remaining policy space to set requirements or incentives for linkages between foreign and domestic firms. Even if domestic firms are able to meet the requirements of MNCs, they are often hesitant to become their suppliers, as this would mean that they have to invest in specialised machinery and knowledge that is not necessarily suitable to supply other MNCs. In the absence of long-term commitments from MNCs, domestic firms refrain from such investments.

First, one of the main conditions for beneficial effects of linkages is the absorptive capacity of local firms. The policy options available to improve this capacity range from improving the education system by adjusting the curricula and making it more open for cooperation with foreign universities or the business sector, encouraging internships and investing in vocational trainings to achieve a better match between university curricula and practical needs of businesses, to expanding existing support programmes for SMEs via the government or business associations to get ready for integrating into GVCs.

Second, once Vietnam has achieved attracting quality FDI and built the absorptive capacity of local companies, the country needs to ensure that foreign investors are aware of suitable local suppliers and that, in turn, Vietnamese suppliers have opportunities to establish contacts with foreign investors. Hence, the Vietnamese government, in cooperation with national and foreign business associations, could try to encourage and strengthen business-to-business linkages by providing information for both sides via different channels, for example internet platforms or trade fairs. In order to overcome the problem that domestic firms refrain from upgrading their production facilities and the skills levels of their workers in light of lacking long-term commitments of MNCs, the government could step in as a mediator. Another option is supporting the establishment of industrial clusters where leading companies are located in one geographical space and other smaller companies surround them in order to benefit from knowledge and technology spillovers.

Third, in the case that linkages and clusters do not materialise automatically, the Vietnamese government can use its remaining policy space to spur this development. Although the stringent investment rules in the TPP and the EVFTA restrict the use of many performance requirements, some measures are still legal and available for policy-makers, in particular with regard to SME support. For example, although Vietnam cannot force its investors to source inputs locally, there is room to incentivise foreign investors to locate their production in a certain location to establish a cluster, or employ and train local workers.

Strengthen analytical capacities in government and business sector

Although most observers refer to PTAs as “free trade agreements”, these treaties do not necessarily lead to the abolishment of all tariffs – and not all tariff lines are phased out immediately. In fact, in some of the sectors where Vietnamese exporters are strong, high tariffs are phased out only after a considerable time lag. This is especially relevant for textile exports to the United States under the TPP. In order to benefit from preferential tariffs, exporters have to comply with stringent RoO such as the TPP’s yarn-forward rule. It is therefore key for the Vietnamese government and the business sector to conduct an in-depth analysis of the new tariff schemes and assess if it is worth building up certain industries in Vietnam in order to take advantage of improved access to large markets, which is contingent on meeting the strict RoO. Such an assessment may depend on the level of the preferential tariff and the difference to the MFN tariff, potential time lags until tariffs are eliminated and the stringency of the RoO. This assessment should also be informed by broader trade policy developments, for example whether key competitors are likely to join the TPP or negotiate their own PTAs with Vietnamese main export markets such as the United States and the EU.

The assessment and implementation of the deep provisions in PTAs against the background of national laws and regulations equally requires analytical capacities. Bringing national laws and regulations in line with international commitments as well as ensuring consistency of different policies and decrees is of paramount importance – especially with regard to the high enforceability of PTA provisions. The fact that Vietnam has signed a number of overlapping PTAs makes this task even more difficult and important. Vietnam’s policies should become as transparent and coherent as possible to avoid claims via the dispute settlement mechanisms.

Analytical capacities need to be strengthened both within the government and between the government and the business sector. For the abovementioned analysis of future comparative advantages of the Vietnamese industry, an intensified inter-ministerial coordination is necessary. In particular, the ministry responsible for negotiating trade agreements should be involved in the (re)formulation of industry-specific policies and regulations in light of the recently signed deep PTAs. In turn, the know-how that will be gained in this process should inform ongoing and future trade negotiations.

In addition to efforts of joint policy-formation at the level of the central government, an intensified communication process with the business sector needs to be established. Experience from Vietnam's WTO accession has shown that information given by the government on trade liberalisation is often too broad and not targeted at the industries' specific questions. Information has to be adapted to the respective knowledge levels and the specific industry needs. There is a special need for the government – in cooperation with business associations – to reach out to SMEs, which often lack specific knowledge about the opportunities resulting from deep PTAs.

9 Conclusion

The 21st century is characterised by the parallel expansion of GVCs and the proliferation of deep PTAs. Yet, so far, relatively few scholars have investigated the relationship between the two phenomena. Although there is consensus that PTAs increase participation in international trade and production networks, it remains unclear whether they will merely increase countries' activities in low value-added production stages or provide opportunities for companies from developing countries to capture more value added and upgrade in GVCs. For a wide range of developing countries, upgrading is a major policy objective, as they fear losing their comparative advantage in low-skilled segments due to rising wages without being ready to compete in higher-skilled stages of production – the so-called middle-income trap. Since international economic integration has been one of the most important growth factors in the last decades, deep PTAs present themselves as an attractive policy option to pursue that aim. The new generation of deep PTAs go beyond the mere reduction of tariffs and include an increasingly comprehensive rulebook that covers disciplines on investment, IPR, competition and SOEs. These rules are seen by some observers as being a relevant condition for firms from developing countries

to enter into – and upgrade within – GVCs, but they may also restrict governments’ policy tools to support such processes.

Based on a mix of qualitative and quantitative methods, using Vietnam as a case study, we address the above-described gap in the academic literature by investigating the questions of whether, how and to what extent deep PTAs can contribute to the upgrading of Vietnamese firms in GVCs.

We find that deep PTAs such as the TPP and the EVFTA provide new opportunities for Vietnamese firms to upgrade in GVCs – either directly, by providing concrete incentives for upgrading, or indirectly, by addressing relevant barriers to upgrading. In general, deep provisions such as rules on investment, SOEs and customs procedures impact upgrading potentials in a rather indirect way. By improving the business environment, attracting FDI and establishing equal opportunities for all types of companies, they can help to build the foundation required to enable Vietnamese firms to upgrade.

In the T&G sector, the strict RoO – yarn forward in the TPP and fabric forward in the EVFTA – combined with high tariff cuts, provide a direct incentive for upgrading to higher value-added tasks. Meeting the RoO of the TPP requires that all production stages, starting with the yarn, must be undertaken in Vietnam or the TPP area. The RoO of the EVFTA are less stringent at first glance, as it merely requires Vietnam to produce fabrics in Vietnam.¹⁰⁵ As the production of fabrics is likely to be the actual bottleneck for Vietnam’s upgrading efforts, the implications for complying with the RoO are likely to be similar for yarn- and fabric-forward. Since Vietnam is importing most of its yarn and fabrics from outside the PTA partners’ territory, developing the upstream industries domestically seems to be an attractive option to meet the RoO. The conditions for realising and fully benefitting from these potentials, however, are challenging: the slow tariff elimination for many T&G products, the lack of skilled labour and capital, and the possibility of competitors joining the new wave of economic integration demand some caution when considering the costly establishment of upstream industries.

In the E&E sector, the potential impact of deep PTAs on upgrading is less clear-cut. Comprehensive and enforceable investment rules liberalising

105 Or source from countries that have signed a PTA with the EU. The EVFTA, for example, allows for cumulation of tariff preferences with Korea.

market access and granting protection promise to attract more FDI, which is important to spur know-how and technology spillovers needed for upgrading. Yet, the effect on FDI attraction is expected to be moderate and, more importantly, it remains a challenge in Vietnam to establish beneficial linkages between FDI and domestic companies. By signing the new PTAs, Vietnam would have to sacrifice one potential policy instrument that could achieve linkages, namely imposing performance requirements on foreign investors. However, Vietnam still has a range of policy instruments at hand, especially in the case of SME support, to become more attractive as a partner in GVCs and make use of the opportunities arising from PTAs.

In sum, we find some positive connections between deep PTAs and upgrading potentials. Whereas the traditional PTA elements, namely tariff elimination in combination with strict RoO, provide a concrete and direct incentive for functional upgrading in the T&G sector, deep provisions such as rules on investment, SOEs and customs procedures impact upgrading processes in a more indirect way via an enhanced business framework. However, PTAs are only one of many factors that can spur upgrading in GVCs – the domestic business environment, the promotion of FDI linkages and the absorptive capacity of domestic firms are of paramount importance. Hence, reaping the benefits from economic integration and realising upgrading potentials requires enabling policies and an active role of the government. Policy instruments that are still available and complementary to economic integration policies include horizontal measures that are beneficial for the economy at large – in particular private businesses – that is, improving infrastructure, human capital, vocational training, and the rule of law and establishing equal opportunities for all types of businesses.

This study provides important lessons for other developing countries that aim at achieving upgrading in GVCs and face the decision of signing deep PTAs with major trading powers. The pressure to sign deep PTAs or to join existing agreements is likely to increase in the near future, as many developing countries may seek to offset the first-mover advantage of countries such as Vietnam that are part of the current wave of deep PTAs. The complex set of rules of modern PTAs is thus likely to become an increasingly important factor in developing countries' national development and industrialisation strategies. As the case of Vietnam has shown, it is important to be aware of challenges and opportunities arising from PTAs, negotiate the agreements against this background and

carefully weigh the benefits of market access against potential restrictions of national policy space for supporting industrial development. Yet, as our analysis has shown, PTAs are only one piece of the puzzle, and countries aiming at upgrading in GVCs need to set the right national economic framework conditions beyond trade liberalisation and establish an enabling environment for domestic companies, while taking new PTA commitments into account.

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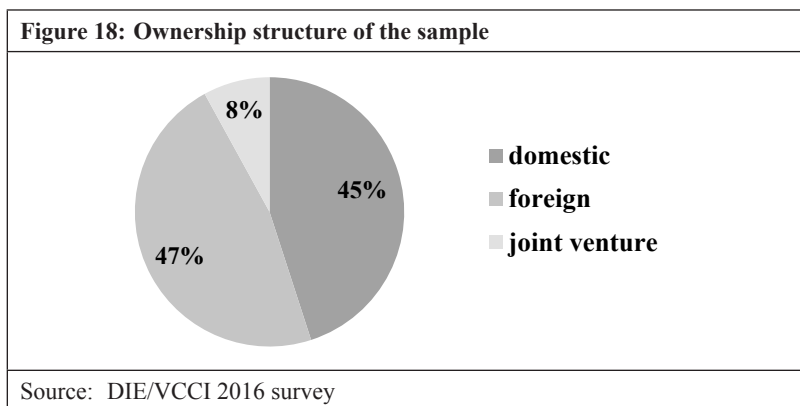
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Appendixes

Appendix 1: PTAs Vietnam signed by the end of 2015				
	PTA	Partner	Signed	In effect
	WTO			2007
1	AFTA	Intra ASEAN Brunei, Burma (Myanmar), Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam	1992	1993
2	VUSFTA	Vietnam – United States	2000	2001
3	ACFTA	ASEAN – China	2002	2010
4	AKFTA	ASEAN – South Korea	2006	2007
5	AJCEP	ASEAN – Japan	2008	2008
6	VJEPA	Vietnam – Japan	2008	2009
7	AANZFTA	ASEAN – Australia – New Zealand	2009	2010
8	AIFTA	ASEAN – India	2009	2010
9	VCFTA	Vietnam – Chile	2011	2014
10	VKFTA	Vietnam – South Korea	2015	2015
11	VCUFTA	Vietnam – Custom Union (Russia, Belarus, Kazakhstan) [Eurasian Economic Union]	2015	2016
12	TPP	Vietnam – US, Canada, Peru, Chile, Mexico, Japan, Singapore, New Zealand, Australia, Brunei, Malaysia	2015	
13	VEUFTA	Vietnam – European Union	<i>Negotiations concluded 2015</i>	
14	VEFTA	Vietnam – European Free Trade Association (EFTA)	<i>Negotiations concluded 2015</i>	
15	RCEP	ASEAN – China – Korea – Japan – New Zealand – Australia – India	<i>Negotiations launched 2012</i>	
16	AHKFTA	ASEAN – Hong Kong	<i>Negotiations launched 2014</i>	

Appendix 2: Description of the survey sample



Total permanent employees in 2015	Absolute	Per cent
No answer	11	4.4
<5	15	6
5–19	44	17.6
20–49	34	13.6
50–99	35	14
100–199	35	14
200–299	13	5.2
300–499	19	7.6
500–999	22	8.8
>999	22	8.8

Size of firm according to World Bank definition	Absolute	Per cent
Small	59	26.11
Medium	69	30.53
Large	96	43.36

Firm's total annual sales in 2015 (in VND)	Absolute	Per cent
No answer	33	13.2
< 1 billion VND	29	11.6
1–10 billion VND	60	24
10–50 billion VND	54	21.6
50–200 billion VND	40	16
200–1000 billion VND	19	7.6
> 1000 billion VND	15	6

Appendix 3: TPP–US tariff elimination schedule for Vietnam’s top 20 garment export items to the United States						
Rank	HTS code	Description	Export value in 1,000 USD	% of Vietnam’s total T&G exports to US	MFN tariff	TPP–US tariff elimination schedule
1	61102020B	Pullovers and similar articles knitted or crocheted, of cotton, nesoi, classified in HTSUS subheadings 6110202005, 6110202030, 6110202035, 6110202040, 6110202045, 6110202067, 6110202069, 6110202077, and 6110202079	1,096,159	10.1 %	16.5 %	US6
2	61103030A	Sweaters, pullovers and similar articles, knitted or crocheted, of acrylic fibres, nesoi	887,568	8.2 %	32.0 %	EIF
	61103030B	Sweaters, pullovers and similar articles, knitted or crocheted, of manmade fibres other than acrylic, nesoi			32.0 %	US6
3	62046240	Women’s or girls’ trousers, breeches and shorts, not knitted or crocheted, of cotton, nesoi	509,385	4.7 %	16.6 %	US7
4	61046220	Women’s or girls’ trousers, breeches and shorts, knitted or crocheted, of cotton	374,296	3.4 %	14.9 %	US10

Appendix 3 (cont.): TPP–US tariff elimination schedule for Vietnam's top 20 garment export items to the United States						
Rank	HTS code	Description	Export value in 1,000 USD	% of Vietnam's total T&G exports to US	MFN tariff	TPP–US tariff elimination schedule
5	61046320	Women's or girls' trousers, breeches and shorts, knitted or crocheted, of synthetic fibres, nesoi	340,685	3.1%	28.2%	US10
6	62034240	Men's or boys' trousers and shorts, not bibs, not knitted or crocheted, of cotton, not containing 15% or more by weight of down, etc.	307,376	2.8%	16.6%	US7
7	61071100	Men's or boys' underpants and briefs, knitted or crocheted, of cotton	277,050	2.5%	7.4%	US6
8	62052020A	Men's or boys' shirts, not knitted or crocheted, of cotton, nesoi: Men's or boys' dress shirts, not knitted or crocheted, of cotton, classified in HTSUS subheadings [...]	276,729	2.5%	19.7%	EIF
	62052020B	Men's or boys' shirts, not knitted or crocheted, of cotton, nesoi: other shirts				
9	61044320	Women's or girls' dresses, knitted or crocheted, of synthetic fibres, nesoi	261,337	2.4%	16.0%	EIF

Appendix 3 (cont.): TPP-US tariff elimination schedule for Vietnam's top 20 garment export items to the United States							
Rank	HTS code	Description	Export value in 1,000 USD	% of Vietnam's total T&G exports to US	MFN tariff	TPP-US tariff elimination schedule	
10	61052020	Men's or boys' shirts, knitted or crocheted, of manmade fibres, nesoi	257,699	2.4 %	32.0 %	US8	
11	62034340	Men's or boys' trousers, breeches & shorts, of synthetic fibres, con under 15% wt down etc, cont under 36% wt wool, n/water resist, not k/c	246,314	2.3 %	27.9 %	US7	
12	61091000	T-shirts, singlets, tank tops and similar garments, knitted or crocheted, of cotton	239,722	2.2 %	16.5 %	US6	
13	62019330	Men's or boys' anoraks, windbreakers and similar articles, not knitted or crocheted, of manmade fibres, nesoi, water-resistant	234,016	2.2 %	7.1 %	EIF	
14	62046335	Women's or girls' trousers, breeches and shorts, not knitted or crocheted, of synthetic fibres, nesoi	228,598	2.1 %	28.6 %	US9	
15	61051000	Men's or boys' shirts, knitted or crocheted, of cotton	222,808	2.0 %	19.7 %	US8	

Appendix 3 (cont.): TPP-US tariff elimination schedule for Vietnam's top 20 garment export items to the United States						
Rank	HTS code	Description	Export value in 1,000 USD	% of Vietnam's total T&G exports to US	MFN tariff	TPP-US tariff elimination schedule
16	62064030	Women's or girls' blouses and shirts, not knitted or crocheted, of manmade fibres, nesoi	176,610	1.6 %	26.9 %	US11
17	62104050	Men's or boys' garm, nesoi, of fab of 5903/5906/5907, of mmf, other than w/outer sur. impreg/coated/etc. w/rub/plast, n k/c	173,018	1.6 %	7.1 %	EIF
18	62114300A	Non-flame-resistant women's or girls' track suits or other garments nesoi, not knitted or crocheted, of man-made fibres	163,311	1.5 %	16.0 %	US11
	62114300B	Flame-resistant women's or girls' track suits or other garments nesoi, not knitted or crocheted, of man-made fibres, made using certain fibres or other elements, including finishing processes, that resist flammability and burning and will self-extinguish when the ignition source is removed from the apparel				US7

Appendix 3 (cont.): TPP–US tariff elimination schedule for Vietnam's top 20 garment export items to the United States						
Rank	HTS code	Description	Export value in 1,000 USD	% of Vietnam's total T&G exports to US	MFN tariff	TPP–US tariff elimination schedule
19	61034315	Men's or boys' trousers, breeches and shorts, knitted or crocheted, of synthetic fibres, nesoi	163,111	1.5 %	28.2 %	US6
20	62029345	Women's or girls' anoraks, windbreakers and similar articles, not knitted or crocheted, of manmade fibres, nesoi, water-resistant	158,042	1.5 %	7.1 %	EIF
Total			6,593,834	60.6 %		

Legend:	
EIF	Duty-free upon entry into force in year 1
US6	Tariff reduction of 35% in year 1, duty-free in year 11
US7	Tariff reduction of 35% in year 1, duty-free in year 13
US8	Tariff reduction of 35% in year 1, additional reduction of 15% in year 6, duty-free in year 11
US9	Tariff reduction of 35% in year 1, additional reduction of 15% in year 7, duty-free in year 13
US10	Tariff reduction of 50% in year 1, duty-free in year 11
US11	Tariff reduction of 50% in year 1, duty-free in year 13

Source: Own calculation, based on the TPP–US tariff elimination schedule and USITC database

These 20 items accounted for 61 per cent of Vietnam's total T&G exports to the United States in 2015. Tariffs will be eliminated completely for only six of these items in the first year that TPP enters into force (coloured green). For the remaining items, tariffs will be reduced by 35–50 per cent in the first year and typically stay on this level for more than a decade until they will finally be completely eliminated. Nine items will not benefit from zero tariffs until year 11 (coloured orange) and eight items will have to wait until year 13 (coloured red) to be duty-free.

Appendix 4: Vietnam's top 20 export items (HS 61–62) to the EU based on eight-digit HTS codes						
Rank	HTS code	Description	Export value in EUR	% of Vietnam's total T&G exports to EU	MFN tariff	EVFTA tariff schedule
1	62029300	Women's or girls' overcoats [...], other, of man-made fibres	188,460,974	7%	12%	B7
2	62019300	Men's or boys' overcoats [...], other, of man-made fibres	184,879,663	7%	12%	B5
3	62052000	Men's or boys' shirts, of cotton	163,979,747	6%	12%	B5
4	62046318	Women's or girls' trousers and breeches, of synthetic fibres, other	98,041,839	4%	12%	B7
5	62104000	Garments made up of fabrics [...], other men's or boys' garments	95,442,024	3%	12%	B5
6	61099020	T-shirts, singlets and other vests, knitted or crocheted, of other textile materials, of wool or fine animal hair or man-made fibres	84,515,643	3%	12%	B5
7	62064000	Women's or girls' blouses, shirts and shirt-blouses, of man-made fibres	79,434,272	3%	12%	B5
8	61103099	Jerseys, pullovers, cardigans, waistcoats and similar articles, knitted or crocheted, of man-made fibres, women's or girls'	77,435,239	3%	12%	B5

Appendix 4 (cont.): Vietnam's top 20 export items (HS 61–62) to the EU based on eight-digit HTS codes							
Rank	HTS code	Description	Export value in EUR	% of Vietnam's total T&G exports to EU	MFN tariff	EVFTA tariff schedule	
9	62034319	Men's or boys' trousers and breeches, of synthetic fibres, other	76,041,599	3%	12%	B5	
10	62043390	Women's or girls' jackets and blazers, of synthetic fibres, other	67,711,239	2%	12%	B5	
11	62121090	Brassières, other	65,571,849	2%	6.5%	B5	
12	61046300	Women's or girls' trousers, bib and brace overall, breeches and shorts, of synthetic fibres	65,087,240	2%	12%	B3	
13	62105000	Garments made up of fabrics [...], other women's or girls' garments	60,297,583	2%	12%	B5	
14	61051000	Men's or boys' shirts, knitted or crocheted, of cotton	56,370,370	2%	12%	B5	
15	62021310	Women's or girls' overcoats, raincoats [...], of man-made fibres, of a weight, per garment, not exceeding 1 kg	49,063,976	2%	12%	B7	
16	62046239	Women's or girls' trousers, bib and brace overalls, breeches and shorts, of cotton, other	47,763,511	2%	12%	B7	

Appendix 4 (cont.): Vietnam's top 20 export items (HS 61–62) to the EU based on eight-digit HTS codes

Rank	HTS code	Description	Export value in EUR	% of Vietnam's total T&G exports to EU	MFN tariff	EVFTA tariff schedule
17	61091000	T-shirts, singlets and other vests, knitted or crocheted, of cotton	46,127,715	2%	12%	B5
18	62034311	Men's or boys' trousers and breeches, of synthetic fibres, industrial and occupational	42,787,518	2%	12%	B5
19	62044300	Women's and girls' dresses, of synthetic fibres	41,644,423	1%	12%	B7
20	62033390	Men's or boys' jackets and blazers, of synthetic fibres, other	41,410,560	1%	12%	B5
			1,632,066,984	58%		

Legend:

Note: Colouring based on year of duty-free

B3 Tariff removal in four equal annual stages, i.e. duty-free in year 4

B5 Tariff removal in six equal annual stages, i.e. duty-free in year 6

B7 Tariff removal in eight equal annual stages, i.e. duty-free in year 8

Source: Own illustration, based on EVFTA–EU tariff elimination schedule and Eurostat

Appendix 5: TPP tariff elimination schedule for top 20 E&E import items from Vietnam 2014

Rank	HTS number 8 digits	Description	Base rate	TPP tariff elimination schedule	Import value in 1,000 USD (2015)	% of US total E&E imports from VN
1	85171200	Telephones for cellular networks or for other wireless networks	Free	EIF	3,427,639	34 %
2	85423100	Processors and controllers, whether or not combined with memories, converters, logic circuits, amplifiers, clock and timing circuits, or other	Free	EIF	2,459,502	25 %
3	84713001	Portable automatic data processing machines, not over 10 kg, consisting at least a central processing unit, keyboard and display	Free	EIF	1,171,111	12 %
4	85176200	Machines for the reception, conversion and transmission or regeneration of voice, images or other data, including switching and routing apparatus	Free	EIF	597,117	6 %
5	85443000	Insulated ignition wiring sets and other wiring sets of a kind used in vehicles, aircraft or ships	5 %	EIF	377,029	4 %

Appendix 5 (cont.): TPP tariff elimination schedule for top 20 E&E import items from Vietnam 2014						
Rank	HTS number 8 digits	Description	Base rate	TPP tariff elimination schedule	Import value in 1,000 USD (2015)	% of US total E&E imports from VN
6	84433100	Multifunction units (machines which perform two or more of the functions of printing, copying or facsimile transmission, capable of connecting	Free	EIF	291,389	3%
7	84433210	Printer units, capable of connecting to an automatic data processing machine or to a network	Free	EIF	219,949	2%
8	85414060	Diodes for semiconductor devices, other than light-emitting diodes, nesl	Free	EIF	174,283	2%
9	84439950	Parts and accessories of other printing, copying or facsimile machines; nesoi	Free	EIF	134,270	1%
10	84733011	Printed circuit assemblies, not incorporating a cathode ray tube, of the machines of 8471	Free	EIF	120,202	1%
11	85177000	Parts of telephone sets; parts of other apparatus for the transmission or reception of voice, images or other data, including apparatus for wired or wireless network	Free	EIF	108,199	1%
12	84812000	Valves for oleohydraulic or pneumatic transmissions	2%	EIF	76,513	1%

Appendix 5 (cont.): TPP tariff elimination schedule for top 20 E&E import items from Vietnam 2014						
Rank	HTS number 8 digits	Description	Base rate	TPP tariff elimination schedule	Import value in 1,000 USD (2015)	% of US total E&E imports from VN
13	84521000	Sewing machines of the household type	Free	EIF	75,114	1%
14	85072080	Lead-acid storage batteries other than of a kind used for starting piston engines or as the primary source of power for electric vehicles	3.5%	EIF	73,034	1%
15	85182980	Loudspeakers nesoi, not mounted in their enclosures, nesoi	4.9%	EIF	62,283	1%
16	85011040	Electric motors of an output of under 18.65 W, other than synchronous valued not over US\$ 4 each	4.4%	EIF	61,989	1%
17	84705000	Cash registers	Free	EIF	61,202	1%
18	85016400	AC generators (alternators) of an output exceeding 750 kVA	2.4%	EIF	57,499	1%
19	85235100	Semiconductor media, solid state non-volatile storage devices	Free	EIF	57,365	1%
20	All others	Mixed		Mixed	340,463	3%
Total					9,946,152	100%

Source: Own illustration, based on and TPP–US tariff elimination schedule and USITC database

Appendix 6: Japan–TPP tariff elimination schedule for top 10 E&E import items from Vietnam 2014					
Rank	HS number 9 digits	Description	Base rate	TPP tariff elimination schedule	% of Japan total E&E imports from VN
1	854430010	Ignition wiring sets and other wiring sets of a kind used in vehicles, aircraft or ships – For motor vehicles	Free	EIF	39%
2	848180010	Other appliances – of iron or steel	Free	EIF	8%
3	853400000	Printed circuits	Free	EIF	3%
4	851762000	Machines for the reception, conversion and transmission or regeneration of voice, images or other data, including switching and routing apparatus	Free	EIF	3%
5	854442099	Other electric conductors, for a voltage not exceeding 1,000 V – Other – Other	4.80%	EIF	2%
6	853690000	Other apparatus	Free	EIF	2%
7	840991010	Suitable for use solely or principally with spark-ignition internal combustion piston engines – For motor vehicles	Free	EIF	1%
8	844332090	Other, capable of connecting to an automatic data processing machine or to a network – Other	Free	EIF	1%
9	844331090	Machines which perform two or more of the functions of printing, copying or facsimile transmission, capable of connecting to an automatic data processing machine or to a network – Other	Free	EIF	1%
10	All others	Mixed	Mixed	Mixed	39%
				Total	100%

Source: Own illustration, based on TPP–Japan tariff elimination schedule, Japanese customs database

Appendix 7: EU–EVFTA tariff elimination schedule for top 20 E&E import items from Vietnam 2014						
Rank	HS number 8 digits	Description	Base rate	EVFTA tariff elimination schedule	Import value in EUR (2014)	% of EU total E&E imports from VN
1	85171200	Telephones for cellular networks or for other wireless networks	Free	EIF	6,677,131,051	67 %
2	84713000	Portable automatic data-processing machines, weighing not more than 10 kg, consisting of at least a central processing unit, a keyboard and a display	Free	EIF	1,475,734,627	15 %
3	84733020	Electronic assemblies	Free	EIF	237,669,750	2 %
4	85176200	Machines for the reception, conversion and transmission or regeneration of voice, images or other data, including switching and routing apparatus	Free	EIF	198,644,426	2 %
5	84433210	Printers	Free	EIF	133,158,946	1 %
6	85177090	Parts – Other	Free	EIF	125,492,124	1 %
7	84705000	Cash registers	Free	EIF	115,733,989	1 %

Appendix 7 (cont.): EU–EVFTA tariff elimination schedule for top 20 E&E import items from Vietnam 2014						
Rank	HS number 8 digits	Description	Base rate	EVFTA tariff elimination schedule	Import value in EUR (2014)	% of EU total E&E imports from VN
8	84716070	Input or output units, whether or not containing storage units in the same housing – Other	Free	EIF	58,265,948	1 %
9	85011099	Electric motors and generators (excluding generating sets) – DC motors	2.7 %	EIF	53,571,238	1 %
10	85072080	Electric accumulators, including separators therefore, whether or not rectangular (including square) – Other	3.7 %	EIF	51,504,806	1 %
11	19108452	Sewing machines, other than book-sewing machines of heading 8440; furniture, bases and covers specially designed for sewing machines; sewing machine needles – Other	9.7 %	EIF	42,896,532	0 %
12	84439990	Other	Free	EIF	41,758,496	0 %
13	84719000	Other	Free	EIF	38,384,962	0 %
14	85081900	Other	1.7 %	EIF	27,627,399	0 %

Appendix 7 (cont.): EU–EVFTA tariff elimination schedule for top 20 E&E import items from Vietnam 2014							
Rank	HS number 8 digits	Description	Base rate	EVFTA tariff elimination schedule	Import value in EUR (2014)	% of EU total E&E imports from VN	
15	85171100	Line telephone sets with cordless handsets	Free	EIF	20,909,917	0%	
16	84733080	Other	Free	EIF	20,460,238	0%	
17	85081100	Of a power not exceeding 1500 W and having a dust bag or other receptacle capacity not exceeding 20 l	2.2%	EIF	19,307,631	0%	
18	85182995	Other	3%	EIF	17,951,366	0%	
19	84732990	Other	Free	EIF	16,865,439	0%	
20	84819000	Parts	2.2%	EIF	16,034,788	0%	
21	All others	Mixed	Mixed	Mixed	540,375,784	5%	
					Total	9,929,479,457	100%
Source: Own illustration, based on EVFTA–EU tariff elimination schedule and Eurostat							

Appendix 8: List of policies relevant for the E&E sector				
No.	Name	Number/symbol	Date issued	Authority
1	Decree guidelines for implementation of the law on amendments to tax laws and contains amendments to some decrees on taxation	12/2015/ND-CP	12/02/2015	Government
2	Approving the Strategy on Vietnam's industrial development through 2025, with a vision toward 2035	879/QĐ-TTg	09/06/2014	Prime Minister
3	Approving the Master plan of industrial development in Vietnam by 2020 with a vision towards 2030	880/QĐ-TTg	880/QĐ-TTg	Prime Minister
4	Approving the action plan to develop electronics industry in implementation of Vietnam's industrialization strategy within the framework of Vietnam – Japan cooperation through 2020, with a vision toward 2030	1290/QĐ-TTg	1/8/2014	Prime Minister
5	Approving the master plan for supporting industrial development by 2020, with a vision to 2030	9028/QĐ-BCT	08/10/2014	Ministry of Industry and Trade
6	Decision on policies on development of a number of supporting industries	12/2011/QĐ-TTg	24/02/2011	Prime Minister
7	Promulgating the list of products of supporting industries prioritized for development	1483/QĐ-TTg	26/08/2011	Prime Minister

Appendix 8 (cont.): List of policies relevant for the E&E sector

No.	Name	Number/symbol	Date issued	Authority
8	Guiding the financial policies specified in the prime ministers decision no. 12/2011/QĐ-TTg on February 24, 2011 on policies on development of a number of supporting industry	96/2011/TTBTC	04/07/2011	Ministry of Finance
9	Instructing orders and procedures to make, appraise and approve of the project of industrial product manufacture supported to the development priority	9734/BCT-CNNg	20/10/2011	Ministry of Industry and Trade
Source: Own illustration, based on SIDECE (2015, p. 144f.)				

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