Comment on "Knife Edge? Switzerland as a base for multinational companies as relations worsen with the European Union" by Simon J. Evenett

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The already strained relationship between Switzerland and the European Union looks like it might get worse. While there is a lot of speculation over the economic effects of the Swiss-EU treaties, there is remarkably little evidence, in particular at the firm level. Simon Evenett's paper aims to address this question. The quality of market access is central for the location choice of firms. With this in mind, Evenett investigates the impact of an unwinding of Swiss-EU bilateral accords on the profitability of US multinationals operating in Switzerland.

Using data from the United States Bureau of Economic Analysis, the paper shows that US MNCs earned higher average returns on assets in Switzerland than in all other major European countries for the years 2009 to 2013. The returns in Switzerland reached 9.5%, compared to an average of 4.2% earned in the EU. The size of US MNCs in Switzerland is also significant: the value of their investments in Switzerland is equal to US$700 billion, with 90,000 persons employed. Even more striking, US companies expanded their R&D expenditures in Switzerland sharply and at a much higher rate than in the rest of Europe. R&D by US MNCs in Switzerland doubled since 2009 from US$6 billion to US$12 billion, whereas it increased only by 20% in the rest of Europe.

The paper then assesses whether a "breakdown" in Swiss-EU economic relations would erase the return differences of US MNCs altogether. The returns would only decrease to the EU average if costs were raised by more than 16%. Compared to the best performer in the EU, the Netherlands, costs in Switzerland could still increase by 5%. These are large numbers, given the standard estimates on imputed trade costs differences of bilateral free trade agreements. Miroudot et al. (2013) estimate the trade cost difference for services delivered from inside and outside the EU at only about 5%, which is rather small given the fact that imputed trade costs in services are normally somewhere above 100%. Hence, the author concludes that threats to relocate MNCs are not substantiated by trade cost arguments.

This is a neat and novel result in the economic policy discussion. Such simple but informative calibration exercises based on imputed trade costs help to gain some quantitative estimates of the cost effects of overall market access, including some elements which are notably more difficult to measure, such as mutual recognition

agreements. The results show that Switzerland seems to be much less vulnerable than the present policy sometimes suggests, in particular because sectors like R&D are less affected by market barriers.

The obvious question is how far we may apply this result. The author acknowledges that many other factors, such as real exchange rate appreciations, determine the returns on FDI. Going beyond that, one may ask what contributes to the comparative advantage of Switzerland. Maybe it is precisely good access to both the European and the international markets. Switzerland is a small country, so higher trade costs might weigh more heavily. Furthermore, because of firm heterogeneity, even a small rise in trade costs might be significant for some MNCs in their location decision. The associated uncertainty would matter for firm owners and their managers as well.

More fundamentally, a discussion – also for future research – of whether we measure the returns to FDI well enough would be worthwhile. High profits might be partly due to profit-shifting across countries. The generally favorable tax regime in Switzerland may therefore lead to an overestimation of the profits accruing from Swiss FDI, when some profits are allocated to the Swiss office of a MNC simply due to tax reasons. The ongoing debate on international corporate taxation (so-called BEPS) puts this possible advantage of a Swiss domicile at risk. It will be interesting to compare whether and to what extent we see such profit-shifting, and how it affects relative returns of MNCs across countries.

The relative rise in R&D expenditures, however, proposes a counter-argument against the profit-shifting hypothesis. It shows that the tax regime is not the only comparative advantage of Switzerland as a location. The rise in R&D is consistent with the argument that the high returns in Switzerland could also be the result of high value-added due to, for example, product differentiation, which is typically R&D intensive. It would have been interesting to explore further the fact that US MNCs invest more in R&D in Switzerland, but I admit this is also an interesting topic for future research.

Reference

Miroudot, Sébastien, Jehan Sauvage and Ben Shepherd (2013), "Measuring the cost of international trade in services," *World Trade Review* 12 (04), pp. 719-735.