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The NAFTA Rules of Origin Revisited

Supply chain executives making key sourcing decisions need to pay particular attention to these negotiations as the likely outcomes may alter their thinking about both the opportunities and risks facing their businesses.

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The Trump administration has begun the process of renegotiating the North American Free Trade Agreement ("NAFTA") with Canada and Mexico. The administration's overarching objective is to improve the U.S. trade balance wherever possible, and negotiations over NAFTA rules of origin represent an opportunity to advance that objective. Supply chain executives making key sourcing decisions need to pay particular attention to these highly technical negotiations as the likely outcomes may alter their thinking about both the opportunities and risks facing their businesses.

Rules of origin in trade agreements have a major impact on the pattern of imports and exports by influencing decisions on where to locate production. A trade agreement typically establishes preferential tariffs for goods moving between the countries that are parties to the agreement. The preferences are intended to give companies an incentive to source their inputs from within the region of the agreement, enabling consumers to benefit from the comparative advantages enjoyed by each country and supporting regional cooperation and prosperity.

If a tradeable good contains value both from inside and outside of the region, there have to be rules governing whether it will benefit from the preferences. If the rules are too strict – such as requiring 100% content from the region to qualify for trade preferences – they will be ignored by producers, because as a practical matter producers must source some components from other countries. If the rules are too lax, non-parties will enjoy the same benefits as parties, and there will be no reason for countries to commit to the obligations set forth in the agreement. Even if they do nevertheless commit to the obligations, the goal of regional integration of supply chains will be thwarted by the ability of third countries to benefit from the preferences.

While the need for effective rules of origin is not controversial, the details are hotly contested. Generally, in order to be considered a NAFTA product, a good must either originate entirely within the three NAFTA countries or must have undergone processing in accordance with the product-by-product rules set forth in General Note 12(t) of the Harmonized Tariff Schedule of the United States. Under the latter, in order to qualify for NAFTA preferences, a non-NAFTA input must normally be processed in a NAFTA country to such an extent that (a) it undergoes one of the shifts in tariff classification that are specified in the rules; (b) the finished product has a specified amount of value added to it in the NAFTA territory ("regional value content"); or (c) both of these two criteria are satisfied.

Caroline Freund of the Peterson Institute for International Economics points out that the rules of origin in NAFTA are extremely complex – they reflect the world as it existed before global supply chains began to emerge – and they impose substantial compliance costs on small businesses. She advocates replacing them with a uniform rule that would apply to all products, with regional content above a fixed threshold always permitted as an alternative means of qualifying for trade preferences.

Although such simplification represents an unlikely outcome of the current negotiations, Freund's premise, that the NAFTA rules are extremely complex, is borne out by a close look at the NAFTA rules of origin for automobile production. Those rules, which have become a political lightning rod, govern whether inputs that are imported into the NAFTA area and incorporated into new cars and light trucks disqualify the finished automotive product from NAFTA preferences. The controversial details concern how to calculate regional value content and how much regional value content is needed to qualify for preferential status.

To illustrate the business context, consider automobile production in Mexico that is intended for export to other NAFTA countries – many of the inputs used in that production are sourced from outside of the region. Consider also that NAFTA steel producers would prefer that more of their steel be used in such automobile production.

There is more than one method for calculating regional value content, but the method that is common to many recent trade agreements is based on "net cost." The NAFTA threshold for automobiles based on net cost is that a vehicle is considered to be from the NAFTA region if its regional value content is at least 62.5%. The comparable threshold in the Trans-Pacific Partnership Agreement ("TPP"), an agreement that the United States recently pulled out of, is 45%. The calculations are made significantly more complex by the application of two key principles, "deemed originating" and "tracing," that are applied under NAFTA but not under TPP. Under the first principle, some automotive inputs are treated as originating within the region regardless of their actual country of origin. Under the second principle, an automotive input from outside of the region that is on the tracing list retains its country of origin no matter how much it is processed within the region.

The administration may well seek to advance its objectives by focusing on adjustments to the rules of origin that require increased use of regionally produced inputs. Provided that the rules do not become so strict that they are ignored by producers of finished products, this could benefit U.S., Canadian and Mexican input producers.

If the rules of origin for automobiles move in that direction, "deemed originating" might be eliminated. In fact, the U.S. trade representative already appears to have expressed a concern that "deemed originating" is essentially a legal fiction – in his opening remarks at the talks with Canada and Mexico, he said that country of origin should be "verified," not deemed. If "tracing" is enhanced by adding items to the tracing list, that could also boost regional content. Even if "tracing" is eliminated in the interests of simplicity, the substance of the rules of origin could be modified in ways intended to benefit regional producers of inputs. And, of course, the regional value content percentage threshold could itself be adjusted.

But the administration may have a more targeted objective in mind than simply to increase regional value content. It has expressed interest in rules of origin that specifically require the increased use of U.S. content. It is unclear, however, how this might be accomplished, and Canada and Mexico have already expressed concern that such a move would be harmful to companies in all three NAFTA countries. Mexican Economy Secretary Ildefonso Guajardo Villarreal has said, "It's not good for American companies, it's not good for Mexican companies. So I think that we should find other policy tools to really incentivize investment in our countries."

Thus, a very likely outcome of the negotiations on NAFTA rules of origin is that the agreement will be modified in an effort to improve the balance of trade for the NAFTA countries, as a group, versus the rest of the world, by requiring the increased use of regionally produced inputs. Adjusting the rules of origin, however, is only one of the instruments that could be used to address U.S. concerns about the balance of trade, and the administration will continue to explore avenues for incentivizing the increased use of U.S.-produced inputs.

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