

NAFTA's a Bad Deal. Fix It!

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That title should have made you do a cartoon-style double take, especially for those that know me and follow my articles. Are you ill John? NAFTA bad? Do away with it as we know it?

Back up! I did not say do away with it. I said fix it. And no, I have not lost my senses. I remain a steadfast free trader and view NAFTA and other trade agreements that minimize the distorting effects of duties and other trade barriers to be positive for jobs and our economy. My reasons for wanting to fix NAFTA are much more prosaic.

Calling NAFTA a bad deal as I did in the title is admittedly a bit of hyperbole. Let's remember, however, that NAFTA was negotiated over a quarter of a century ago. It was the first multi-lateral trade agreement the U.S. implemented. Retrospectively it appears the framers of the NAFTA were being cautious in the ways in which they assembled the rules for participation. It was, however, a document of its time. In hindsight, portions of the NAFTA have not aged well. When compared with more contemporary trade agreements, NAFTA rules can seem overly complex and burdensome to implement. This limits participation in the agreement and works at odds with its intent.

If we are going to reopen NAFTA negotiations, we may as well dust off the furniture and fix a few things while we are at it. Some of the more likely candidates requiring updates include the following.

Update the rules to HS 2017

Those of you that participate in NAFTA know there is no single rule of participation under NAFTA. (NAFTA uses the term origination.) Rules of origination are commodity based and rely on the Harmonized System (HS) classification of the good under consideration. This results in about 1200 rules within which are sub-rules of interpretation. The HS system on which these rules are constructed undergoes periodic updates. The last update to the HS was in 2017 yet the NAFTA rules still reflect the system that was in place in 2007. This creates confusion as some HS codes named in the current tariff do not exist in the NAFTA. Some users have to reclassify their goods to 2007 HS codes before they can evaluate their origination.

Simplify the product specific rules.

NAFTA often relies on regional value content (RVC) based on the concepts of Net Cost and Transaction Value. Net cost is a dicey and imprecise method of measuring cost. On the surface it would appear to represent a company's actual production costs. Companies, however, ascertain net cost using varying accounting methods. It is also difficult for customs authorities to verify. Subsequent free trade agreements rely on a concept called adjusted value. The adjusted value reflects the WCO valuation agreement and mirrors the customs value of a good. The adjusted value method also relies on build up and build down methods that offer participants options that align with their business practices.

NAFTA could also back way from an overreliance on RVC in preference for simple tariff change. The concept of tariff change quantifies the subjective idea of substantial transformation by

comparing the HS classification of non-NAFTA materials to the classification of the good manufactured using those materials. The process favors higher-level manufacturing in North America. Many goods are subject to a combination tariff change and RVC rules. Rules that do this seem to ignore the inverted structures of the Canadian, Mexican and U.S. tariffs that assign higher duty rates to raw materials than to finished goods. Goods made with non-originating materials will incorporate duty costs making them price uncompetitive with goods produced using originating materials. Even if both originate, the goods containing originating materials will have a competitive advantage. At this point I risk getting too wonky, but I would encourage readers to explore the onerous rules of HS chapter 39 for plastics and to compare these rules with other FTAs.

As an alternative to removing RVC, I would encourage any NAFTA review to consider a simplified RVC method known as focused value that requires participants to ensure that a specific non-originating material does not exceed a specified threshold.

Eliminate Criteria D, E and F

Criterion D provides for exceptions to tariff change rules in two unique instances where goods are imported in an unassembled form or when their parts are classified the same as the finished good. These exceptions are rare and would better be addressed within the product specific rule itself. A focused value rule would be one method of accomplishing this.

Criterion E has also outlived its utility. It originally provided for NAFTA preference for a limited list of non-originating electronic goods and components upon which duty had been paid in one of the NAFTA countries. At the initiation of the NAFTA the three countries had varying duties for these products. The three countries now have harmonized their duty rates at zero. Claiming NAFTA criterion E provides no benefit as this criterion never exempted goods from the Mexican user fee known as DTA or the U.S. user fee known as MPF.

Criterion F, like its counterparts above, has become an historical echo that excepted agricultural goods from quotas that existed upon the implementation of NAFTA. NAFTA agricultural quotas no longer exist making criterion F obsolete.

Eliminate the NAFTA Origin Marking Rules

It is not widely understood that claiming NAFTA requires meeting two sets of country of origin rules. A good must both originate and meet country of origin marking rules. The marking rules imbedded in 19 CFR §102 are usually more liberal than the origination rules. Because of this, users tend to ignore them. They also represent a level of complexity that is not necessary and one that other FTAs have eschewed. Those of you familiar with a concept called tariff preference override know that my suggestion shifts the needle on what may be labeled as country of origin U.S. I agree with you and would welcome a conversation on the ramifications of such a change.

Rethink Tariff Preference Levels within Textiles

Textile origination rules within the NAFTA are some of the strictest giving preference to all levels of textile manufacturing. Under yarn-forward and fiber-forward rules, textile articles must be produced using North American fabric that was produced using North American yarns and fibers. For some garments, however, there are exceptions to these rules allowing for manufacturing in North America using non-originating fabrics generally those that are in short supply in North

America. The exceptions are quantitatively based and are a type of quota that gives preference to cut and sew operations in North America but does not promote production of these specialty fabrics in North America. It may be time to revisit our public policy in this area of NAFTA and to weigh the effects of eliminating the tariff preference levels or altering the product specific rules making the quotas unnecessary.

Rethink Automotive NAFTA

The mechanisms within the automotive sections of the NAFTA are byzantine at best. They include rules that require higher RVC requirements for vehicles based on a concept known as traced value that accounts for North American value within essential components within the vehicle. NAFTA also contained incentives for companies to invest in new manufacturing facilities and for retooling older ones. While these rules have successfully generated North American manufacturing throughout the automotive supply chain they have also created a level of complexity that is not necessary. The ill-fated TPP developed a more elegant model that NAFTA might consider.

Simplify the Rules of Origin for Chemistry

Other FTAs have implemented what are generally referred to as chemical reaction rules. These allow for origination in the country in which a new chemical bond is created. They also allow for a range of other rules relating to purification, mixing and blending and the presence of diluent among others. But for one exception, NAFTA relies on classification-based tariff change rules for chemistry. This is problematic for an area of the tariff that is open to classification interpretations based on principal and actual use. This leads to confusion in an industry where companies along the supply chain may not be aware if the formula they have been asked to produce is for an intended end use. The chemical industry however, does know and can prove where a chemical reaction has occurred or if their chemicals have met another of the origination rules. This does not remove the full classification challenge, but it removes origination reliance based on tariff change and replaces it with a verifiable mechanism.

Change Origin Certification Requirements

NAFTA is one of the few duty preference programs in which the U.S. participates that requires a specific format for a certificate of origin. It also requires that the importer have this official format issued by the exporter in its possession at the time it makes a NAFTA duty exemption claim. These rigid requirements have led to the customs authorities in all three countries overturning NAFTA claims based on technicalities within the documents instead of focusing on if the duty exemption claim was indeed an accurate one. NAFTA also did not specifically mention if electronic versions of documents were acceptable and, if so, what reasonable controls should exist around electronic documents. It is high time that origin certification be modernized and a focus placed on if a good actually originates and not on the formatting of a document. Other FTAs have addressed this administrative issue successfully without sacrificing regulatory control

Place Responsibility on the Importer

NAFTA relied on an innovative inverted legal accountability that holds the exporter primarily accountable for a NAFTA claim. It then proceeds to evaluate the producer before finally addressing the importer actually making a NAFTA claim. This has created an unexpected imbalance in the trade. Importers, with little to lose and everything to gain, have become insistent on receiving certificates of origin from their exporting suppliers. Happy to oblige their customers,

exporters willingly create valid-looking certificates of origin often with little knowledge or understanding of the NAFTA. The three customs agencies find this situation difficult to oversee as they have limited enforcement tools with which to motivate compliance. Other trade agreements hold the importer accountable for their FTA claims. With more at risk, importers emphasize accuracy and voracity of FTA statements they receive from their suppliers.

And More...

The above are some of the more obvious tactical areas where NAFTA could tolerate an update. We could certainly add to the list by expanding NAFTA's reach into broader policy issues such environmental, labor and energy standards. NAFTA was negotiated long before today's technology existed and could include telecommunication and e-commerce provisions. NAFTA's regulatory transparency provisions could be updated to facilitate cross border trade regulated by other government agencies. With roads and ports at capacity a NAFTA infrastructure strategy could be in order. Finally, NAFTA should address security concerns.

Whatever the list, it is clear that a little house cleaning is overdue. Of course caution in any negotiation should be the order of the day. The relationship between the three countries is so intertwined and so important that any failed negotiations risk harm to the North American economy.

In the meantime, I look forward to your constructive suggestions about how to refurbish the agreement.