

Rules of Origin: The New Old Protectionism

“Rules of origin are very, very complex. You don't want to deal with them. They're terrible things to deal with.”

Hon. Michael Wilson, then-Minister of Industry, Science, Technology and International Trade, Feb 12, 1992, at time of Honda/CAMI rules of origin dispute and NAFTA negotiations

“These NAFTA rules [of origin] are killing our jobs.”

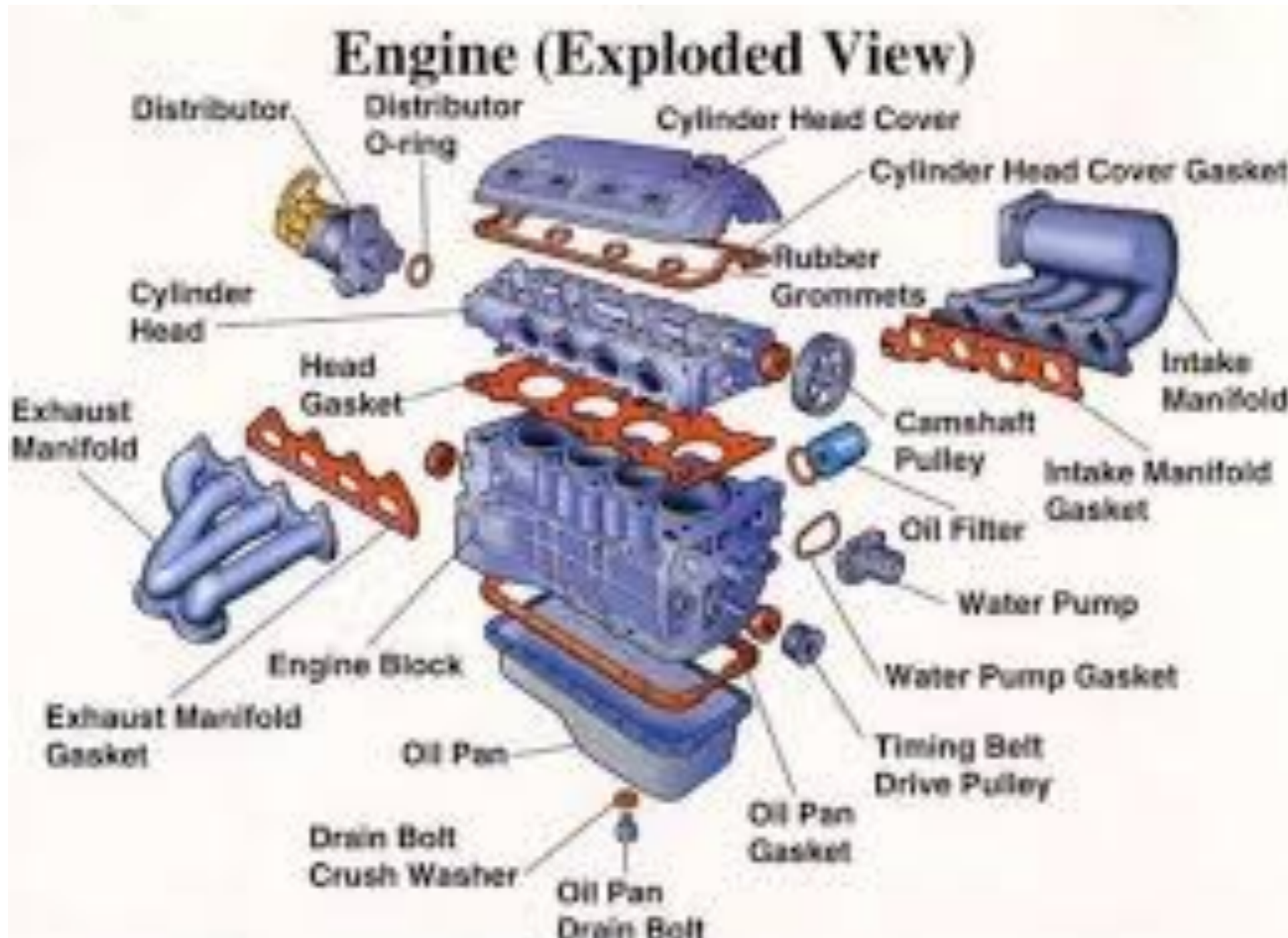
Wilber Ross, U.S. Secretary of Commerce, Washington Post, September 21, 2017

This is a Piston



Which Gets Together With Other Parts

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To Make an Engine

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That Goes into a Car



Eric F. design 2006.

Does Really It Matter Where the Piston Is From?

Outline of Presentation

- What are Rules of Origin (ROO)
 - technical stuff
 - policy stuff
- NAFTA ROO Renegotiations
 - What does the USA want, and what's behind it
 - Do ROO matter for Canada
 - Supply chains and ROO
 - What's at stake on autos
 - But not just auto ROO on table
- Conclusions

Technical Stuff: Rules of Origin (ROO)

- define production/inputs required in a Free Trade Agreement (FTA) area for goods to be “originating” and hence qualify for tariff preferences
- stated goal: ensure benefits to local producers, and prevent free riders and transshipment through low-tariff FTA countries
- but often used as protectionist device, either to stifle preferential trade or to protect/divert input sourcing and distort/re-shape supply chains
- three key factors: liberal vs restrictive, compliance costs and cumulation

Policy Stuff: Liberal vs Restrictive ROO

- liberal rules of origin:
 - final production required in RTA territory, but most if not all inputs, including major parts, can be “non-originating” (i.e., can be imported from outside the RTA)
- restrictive rules of origin:
 - final production required in RTA territory, plus many inputs, particularly major parts, must also be “originating” (i.e., must be produced in RTA territory and meet own rules of origin)
- small/medium-sized economies mostly prefer liberal ROO as more dependent on imports for key inputs
- larger economies mostly prefer restrictive ROO as have many input producers (who lobby for restrictive rules - see later)

Policy Stuff: Firms' Compliance Costs

- firm must learn ROO for their goods
- must track inputs, record keeping, certification; plus risk of being audited and paying duties/fines
- may need to change input sourcing to meet ROO:
 - costs of finding new suppliers
 - potentially pay more for originating inputs
- administrative costs or switching suppliers may exceed benefits of tariff preferences
- producers always have option of foregoing dealing with ROO and instead pay MFN duties on exports

Policy Stuff: Cumulation

- an originating good produced in one FTA party qualifies as an originating input when used to produce other goods in any party to that RTA
- NAFTA: an engine originating in Mexico and a suspension system originating in the US can be assembled with other NAFTA originating materials (e.g. body parts, transmission) made in Canada to make a car in Canada that qualifies for NAFTA tariff preferences
- trilateral cumulation key factor in fostering growth of North American supply chains, but supply chains complicate ROO negotiations and outcomes

Supply Chains: A TPP Example

- U.S. pressed (successfully) in TPP for restrictive NAFTA “yarn-forward” ROO: both yarn and fabric must originate (be made in TPP area) and apparel cut and sewn in TPP area
- Vietnam major apparel exporter and faces high U.S. tariffs
- Vietnam sources fabrics from China and other Asian non-TPP countries, and preferred cut and sew ROO for apparel
- Mexico and Peru supported USA - use U.S. yarns and fabric to make apparel exported to USA under their FTAs with U.S.
- protect U.S. textile producers from Asian yarn and fabric competition (imported in Vietnamese apparel) and maintain existing supply chain in Western Hemisphere under U.S. FTAs

NAFTA Renegotiation: U.S. ROO Objectives

- ROO key element in U.S. NAFTA overall objectives:
 - reduce U.S. goods trade deficit with NAFTA parties (read: manufactured goods trade deficit)
 - increase U.S. manufacturing production and “high-paying” jobs
- specific U.S. ROO negotiating objectives:
 - strengthen ROO to “incentivize the sourcing of goods and materials from the United States and North America” - (read: increase U.S. content)
 - streamline administrative procedures and ensure vigorous enforcement (read: increase U.S. exports and content)

What's Driving U.S. Objectives

USA argues NAFTA ROO increasing U.S. goods trade deficit and costing American manufacturing production and jobs because:

- share of U.S. content in manufactured imports from Canada fell from 21% to 15%, and from Mexico fell from 26% to 16%, from 1995 to 2011 (latest year data available), but
 - value of US content in NAFTA imports up 62% to US\$54.5 billion in 2011
 - Canadian and Mexican content share also down in U.S. imports
 - U.S. and NAFTA content share also down in U.S.-made goods

Do NAFTA ROO Matter for Canada

- many Canadian industries depend heavily on USA as main input supplier and main market
- 75% of Canadian exports go to USA
 - 38% entered USA under U.S. MFN-free tariff lines
 - 12% of Canadian commercial exports pay duties in USA because they do not meet ROO
 - 50% entered USA duty-free as meet NAFTA ROO
- U.S. MFN tariffs generally low - most below 5% and many below 3% (cars is 2.5%) -
- but even low tariff rates can bite

What's With Supply Chains and NAFTA ROO

- NAFTA supply chains both increase global competitiveness of North American producers and generate significant benefits for all three parties
- large share of North American trade comprises inputs (e.g., estimated 40% of U.S. imports from, and 75% of U.S. exports to, Mexico)
- NAFTA ROO more restrictive than most FTAs (including other Canadian, Mexican and U.S. FTAs), and major share of trilateral trade meets NAFTA ROO
- may now become even more restrictive
- challenge for Canada (and Mexico) is avoid disruption of North American supply chains and loss of current NAFTA benefits

Autos: Stakes for Canada and Auto ROO

- Canadian auto sector heavily integrated with North America sector
 - Canada's largest manufacturing sector and exporter
 - 85% of vehicles and 50% of value of parts exported, mainly to USA
 - many parts imported from USA and increasingly Mexico
 - 98% of Canadian vehicles and 90% of parts enter USA NAFTA duty-free
- current NAFTA auto ROO:
 - 62.5% for light vehicles and their engines and transmissions
 - 60% for heavy trucks, their engines and transmissions, and all other auto parts
 - tracing (must trace listed parts through out production chain)
- some erosion of NAFTA auto ROO since 1994 as new parts (electronics) not on tracing list
- maybe now around 53%, but still amongst toughest in world

Autos: Who Wants What In USA

- news reports that USA has demanded:
 - 85% content level for vehicles and parts
 - expanded tracing list (add steel, aluminum, plastics, new electronic parts)
 - 50% U.S.-content requirement for vehicles
- USA argues runs major NAFTA auto trade deficit and U.S. (but also Canadian) content share down but Mexican share up in U.S. NAFTA vehicle imports, but
 - NAFTA content of U.S. light vehicle imports averages around 70%
 - U.S. content share also down in U.S. made cars
 - 48% (assemblers say higher) and 40% U.S. content in Canadian and Mexican light vehicles, and 28% U.S. content in Canadian-made parts
- assemblers and parts producers oppose tighter NAFTA auto ROO - want to preserve existing supply chains (“do no harm”)
- UAW and UNIFOR advocate tighter auto ROO, but oppose U.S. demands - but focussed on raising Mexican wages and environmental and labour standards
- steel companies (and aluminium?) want their products on tracing list

Autos: Politics vs Economics

- U.S. domestic politics on auto ROO driven by plant closings in northern U.S. states (also in Canada) as auto production shifted first to southern U.S. states and now increasingly to Mexico (now 20% of assembly)
- Mexico appears main U.S. target but Canada affected
- Key Factors for accessing impact of tighter ROO
 - auto assemblers and major parts companies are global - prefer to produce most models in regions where sell, but produce and compete globally (including with own plants in other regions)
 - trilateral supply chains under NAFTA key factor in competitiveness of North American auto sector, with parts crossing borders many times
 - complicated auto ROO incurs compliance costs
 - situation/impact not same for each company or each model line

Autos: Let Me Take You Higher?

- maybe some limited scope to raise auto content level with minimum risk of harm
- expand tracing list:
 - how much steel (aluminium, etc) already sourced in North America; what is cost of sourcing more, including on prices of parts made from these inputs?
 - many new electronic parts imported from Asia and Europe - can they be produced competitively in North America?
- U.S.-specific content is economic/political charged issue for Canada and Mexico
 - how apply and measure?
 - disrupt, if not paralyze, North American supply chains and reduce future flexibility of North American producers to adjust and remain competitive
 - raise compliance costs further if also need to track each country-content

Autos: There's Always the MFN Tariff

- if ROO too tight or burdensome, assemblers can opt out of NAFTA and pay MFN tariff (Canada 6.1%, Mexico 30%, USA 2.5% on light vehicles), giving them options to:
 - source globally from most competitive parts suppliers for vehicles assembled in North America (and can shift assembly within)
 - supply vehicles from own offshore production, including under duty-free under FTAs (e.g., EU or South Korea)
 - China now largest and fastest growing auto market - Ford Focus
- disrupt North American supply chains and erode North American competitiveness
- USA, Canada and Mexico could lose parts production and jobs, if not also in assembly - including in steel and electronics

But Not Just Autos On Table

- USA may seek tighter ROO for other manufactured goods, both to entice shift of production from Canada and Mexico and to protect U.S. input producers (e.g., aluminium, steel)
 - USA wants to eliminate special Tariff Preference Levels (TPLs) and may also seek to further tighten textiles and apparel ROO
- but Canada also has opportunity to address problems:
 - crude oil - 13% of Canadian exports to USA in 2016 but paid \$46 million in U.S. duties on 65% of these exports because used non-originating diluent to move oil thru pipelines
 - take any opportunity to liberalize ROO for products, particularly in manufacturing

Administrative Procedures

NAFTA renegotiation offers opportunity to also reduce administrative compliance costs and burden (particularly for exporting to Mexico)

- allow producers/traders to make origin claim electronically or directly on commercial documents (as in CETA) as opposed to separate NAFTA Certificate of Origin
- for basic chemical products: convert regional value content tests (RVC) to chemical processing rules (e.g., chemical reaction rules) - \$2 billion in annual Canadian exports to USA claim NAFTA preferences
- add focussed RVC to list of RVC options for various manufactured goods - allows producers to focus only on key inputs

Enforcement

- USA wants vigorous enforcement of ROO
- USA has highlighted textiles and apparel - not new - but likely also push for other products (e.g., autos)
- to date, no public details on U.S. proposals
- Mexico wants Canada and USA to enact penalties for producers who make false origin declarations
- Canada should be open to any reasonable proposal, but guard against proposals for aggressive monitoring and verification (e.g., textile and apparel jump teams)

Conclusion

- ROO will be controversial in NAFTA renegotiations
- challenge for Canada (and Mexico) is avoid disruption of North American supply chains and loss of current NAFTA benefits
- will need to minimize potential damage of tightening ROO or making them more burdensome, including opposing country-specific content requirements
- take every opportunity to liberalize ROO for products and reduce administrative burdens where ever possible

And Back to the Piston

