THIRD WAY

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Renegotiating NAFTA: Supply Chains, Interrupted

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Over the course of three grueling days in June, over 140 trade associations, business groups, and labor interests delivered testimonies to Congress regarding the Trump Administration's upcoming renegotiation of the North American Free Trade Agreement, or NAFTA. In a number of instances, these groups came to overwhelmingly different conclusions on which provisions in the 23-year-old trade agreement should be fixed, preserved, or jettisoned.

But one thing was clear: Canada, the U.S., and Mexico are deeply linked.

In the past, a product would be made in one place and sold in another. But that era is gone. ***Now, products in a range of industries are made using complex supply chains where the parts and services that go into an item might come from all over the globe***.

Take, for example, that burger you just had for lunch. Cows can be bred in Northern Mexico but raised on American corn. Or, look at the computer on your desk—Dell computers are designed in Texas, manufactured in Mexico, and shipped all over the world. Or take the car you drove to work—bumpers and seats from Mexico might be combined with transmissions and electronic components built in the U.S. and Canada. In fact, automotive components cross NAFTA countries' borders as many as eight times before being installed in a final assembly plant.

Final export balances between NAFTA countries oversimplify the picture. These numbers overshadow trade of product components, like mufflers or computer chips—known as "intermediate goods." Indeed, simple NAFTA export totals misrepresent America's actual share of production. In truth, between 25 and 40 cents of every dollar of Mexican and Canadian imports to the U.S. are actually "Made in USA" content. This approach also overlooks trade in services, for which the U.S. is a net exporter to both Canada and Mexico (services, by the way, are also inextricably tied up into all kinds of supply chains between NAFTA countries).

A recent OECD report found that sourcing intermediate goods internationally improves product quality while lowering overall cost, thereby increasing local companies' competitiveness and supporting jobs and wages at home. Brookings recently found that 43% of U.S. goods imports in 2015 were intermediate goods, over half of which were sourced through NAFTA. Easy access to affordable component parts is essential to American agriculture, manufacturing, and energy production.

The Trump Administration's proposed changes to NAFTA could throw a major wrench into these complicated supply chains. While the Administration has largely backed off of Trump's campaign promise to pull out of the agreement entirely, the recently released negotiating objectives from the Administration suggest that changes may be afoot to one provision in particular: rules of origin.

Rules of origin define whether a product has sufficient NAFTA-based content to qualify for preferential NAFTA treatment. Rules can be based on the percentage of content produced in the NAFTA countries or other means, such as where substantial processing occurs.

For instance, NAFTA allows duty-free imports and exports for motor vehicles if 62.5% of the value of the car comes from the three NAFTA countries, along with other detailed requirements. This means that if Canada is manufacturing cars mostly made up of cheap components from China, those cars are ineligible for preferential tariff treatment when they are shipped to the U.S. and Mexico.

Keeping up with these regulations is already onerous for many companies that have to keep close track of where their various component pieces come from. Further tightening these rules could cause businesses to choose instead to pay regular import tariffs or move operations entirely outside of the U.S. and source imports from cheaper locations overseas.

For example, increasing the rules of origin percentage on automobiles—already higher than in America's other free trade agreements—could require auto manufacturers to source more parts regionally instead of globally, driving up costs. If costs become too high, manufacturers could bypass the increased requirements by paying the relatively low 2.5% duty on automobiles wholly manufactured outside the United States. Or, they could increase the final price to consumers of NAFTA automobiles.

Thanks to increased connectivity, many companies across trading blocs are working as partners, not competitors. It's true that NAFTA isn't perfect and could be updated in a variety of areas—but it's also important to recognize that changes affecting supply chains could have vast consequences.

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