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The United States–Mexico–Canada Agreement: Tariffs, Customs, and Rules of Origin

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INTRODUCTION

The first report in this series provided an overview and initial analysis of the United States–Mexico–Canada Agreement (USMCA).[1] This report analyzes what most see as the essence of a preferential trade agreement—tariffs, customs, and rules of origin issues. Discussion of these issues is simplified because the USMCA[2] makes relatively few significant changes to the North American Free Trade Agreement (NAFTA) rules, whereby virtually all manufactured goods and most agricultural goods are traded duty-free and quota-free.[3] However, in several sectors, particularly the automotive industry, the USMCA incorporates major changes from the NAFTA provisions. Additional major areas of significant modification between NAFTA and the USMCA include the new de minimis rules for imposing tariffs on small package delivery services. Other sector-specific changes are noted but not discussed in detail. Changes in the treatment of textiles and clothing and in agricultural products, including the politically sensitive opening of Canada's dairy market and rules related to geographical indications, will both be addressed in a later report.

For those who have not studied the details of trade under preferential trade agreements such as NAFTA and the USMCA, one key fact is worth emphasizing: such agreements do not provide for duty-free movement of goods traded among the states that are parties to the agreement. Rather, duty-free trade applies only to products that "originate" in North America, usually those that meet specific rules of origin. Such rules are variously based on regional value content, utilization of specific major components produced in the region, or a shift in tariff headings (i.e., the classification of goods).[4] (The general rules of origin in the USMCA are very similar to those in NAFTA.)[5] Rules of origin are designed to ensure that goods that enjoy duty-free trade status in the region ("originating goods") have substantial regional content rather than being transshipped from Asia or assembled from parts and components that are completely or largely imported from outside of North America.[6] Thus, for example, a finished product made in China and imported into the United States would not qualify for duty-free entry into Mexico or Canada unless the product was considered duty-free under Mexico and/or Canada's World Trade Organization tariffs.

As in other regional trade agreements, demonstrating that a good produced entirely in one or more of the USMCA parties is an originating good, such as copper ore mined and smelted in Arizona or Mexico, is typically a straight-forward process.[7] Similarly, a good produced entirely from originating materials in the territory of one or more

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USMCA parties,[8] such as flour milled in one of the USMCA countries from wheat grown in the United States or Canada, rarely raises questions about origin. However, manufactured goods often depend on global supply chains and use materials and components from different sources both within and outside of North America. Such goods must satisfy product-specific rules of origin—or in some instances meet a minimum regional value content (RVC) requirement—to qualify as an originating good and enjoy duty-free trade status in North America.[9]

The customs procedures for establishing that a product is an originating good are often complex and thus costly to meet, particularly for small- and medium-sized enterprises that do not have in-house lawyers or customs experts to assure compliance. It is not unusual for importers of goods that are subject to low or zero most-favored-nation (MFN) tariffs (not including footwear, clothing, and small trucks)[10] to opt against seeking NAFTA treatment because of the high compliance costs and the risk that a subsequent customs audit will discover errors, resulting in charges to the importer for additional duties, interest, and penalties.

The Office of the U.S. Trade Representative (USTR) in announcing the USMCA characterized the agreement as follows:

> *The United States, Mexico, and Canada have concluded substantive discussions on new rules of origin and origin procedures, including product-specific rules for passenger vehicles, light trucks, and auto parts. This update to the rules of origin will provide greater incentives to source goods and materials in the United States and North America.*[11]

Further,

> *This deal exceeds NAFTA 1.0 and the TPP [Trans-Pacific Partnership] by establishing procedures that streamline certification and verification of rules of origin and that promote strong enforcement. This includes new cooperation and enforcement provisions that help to prevent duty evasion before it happens.*
>
> *The new rules will help ensure that only producers using sufficient and significant North American parts and materials receive preferential tariff benefits.*[12]
>
> Overall, USTR explains that the USMCA for the most part retains the NAFTA market access provisions, albeit with some important modifications:
>
> - Maintaining duty-free treatment for originating goods.
> - Maintaining the prohibition on export duties, taxes, and other charges and the waiver of specific customs processing fees.
> - Adding new provisions for transparency in import and export licensing procedures.
> - Prohibiting parties from: (a) requiring the use of local distributors in importation; (b) restricting the import of commercial goods that contain cryptography; (c) placing import restrictions on used or remanufactured goods; and (d) requiring consular transactions and their associated fees and charges.
> - Updating provisions for the duty-free temporary admission of goods to include shipping containers or other substantial holders used in the shipment of goods.[13]

It is evident that North American trade will benefit from some strengthened standards in areas such as trade facilitation and transparency. Changes in rules of origin and customs procedures are relatively minor except as indicated herein, although importers will want to carefully review the specific rules of origin for their imported products to assure that they are aware of any changes from the NAFTA rules of origin. This is particularly true with the extensively modified and highly complex automotive goods rules.[14]

One positive change in the rules of origin is the increase in the de minimis exception for non-originating goods from 7% to 10%.[15] In most instances where a specific rule of origin requires that *all* materials used in the production of a good originate in North America, that change is based on a complete tariff shift (where the parts and components are all classified under one or more four-digit subchapters of the harmonized tariff system). Origin typically would be conferred when the finished product is classified in a different four-digit subchapter, but under the new rules, up to 10% of the materials used in auto and auto parts production do not have to meet the tariff shift.

AUTOMOTIVE GOODS

Automobiles and auto parts account for more than 20% of total NAFTA trade and for about 950,000 jobs in the United States.[16] Some automotive components cross the Canada and/or Mexico borders as many as eight times before they are assembled into a finished automobile in one of the three NAFTA countries.[17] It is thus not surprising that this was the focus of the NAFTA renegotiations. The elements of the USMCA that directly address the auto industry include modifications to the NAFTA rules of origin and related content requirements, plus some protections for Mexico and Canada should the Trump administration impose 20–25% tariffs on U.S. auto and auto part imports (presumably on "national security" grounds under Section 232 of the Trade Expansion Act of 1962).[18]

In assessing the new USMCA rules for autos and auto parts, we first discuss what the United States did not achieve in the negotiations. The U.S. sought to depart from the regional content rules used in NAFTA and other U.S. free trade agreements reached over the past 20 years. Rather than NAFTA's requirement that 62.5% of the net cost of the auto be made of North American content, the U.S. initially demanded to raise the threshold to 82.5% North American content, of which 50% must be from the United States (including steel and aluminum).[19] Due to strong opposition from Mexico during bilateral negotiations in August and September 2018, the United States was forced to compromise. Still, by adding a $16 per hour wage requirement to the agreement, as discussed below, the United States indirectly assured that a higher percentage of total automotive content would be produced in the U.S. (or Canada), given higher wages in the U.S. compared to Mexico.

The final changes for the automotive industry include raising the percentage of regional value content required for automobiles and light trucks from 62.5% to 75%. These requirements are to be phased in over three years from the date the USMCA goes into effect.[20] In addition, 70% of the steel used in the manufacture of cars and small trucks must originate in USMCA countries.[21] Most significantly for Mexico, 40% of the materials for cars and 45% of the content for light trucks must be produced by enterprises that pay workers at least $16 per hour.[22] Automotive enterprises that conduct research and development and/or assemble advanced components such as batteries, engines, and transmissions in Mexico would count toward up to 15% of these thresholds if they pay workers at this level. These calculations are subject to complex tracing rules,[23] which likely will add to auto manufacturing costs in North America, although some of the NAFTA tracing rules for parts and components have been relaxed.[24]

Since typical auto industry wages in Mexico are approximately $3.60–$3.90 per hour (a level some studies attribute in part to the lack of union support for workers),[25] this wage requirement means most of the materials and components that would count toward the 40–45% content rule must be produced in the United States or Canada. It is possible that wages in Mexico will eventually increase to the $16/hour level; Mexico President Andrés Manuel López Obrador (AMLO) presumably will seek to implement policies encouraging higher wages for Mexican workers, including policies that support workers' rights to organize independent unions, as required under the USMCA.[26] (Until Mexico enacts such legislation, it is unlikely the USMCA will be submitted for congressional

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or parliamentary approval in the three countries.[27]) Moreover, at least at present, the $16/hour rate is not indexed to inflation, although with inflation in the United States averaging about 2% per year, the lack of indexing probably would not significantly help Mexico.

Mexico officials have asserted that about 70% of the country's current auto production would meet the 75% RVC requirements.[28] Automobiles that would have met the NAFTA rules of origin but not the new USMCA rules would continue to benefit from the current most-favored-nation (MFN) duties (with some limits, at the United States' discretion) though not small trucks, for which the U.S. tariff is 25% of the customs value. This is potentially a significant limitation on Mexico's production of automobiles intended for export to the United States. Without it, auto producers in Mexico would not face potentially higher costs of meeting the new regional value content/minimum wage rules and their accompanying administrative burdens; they could simply pay the U.S. MFN tariff of 2.5%.

Separately, side letters effectively establish a tariff-rate quota for vehicles produced in both Mexico and Canada, whereby 2.6 million passenger vehicles per year and a set amount of auto parts (valued at $32.4 billion for Canada and $108 billion for Mexico), as well as light trucks from both countries would be excluded from the additional Section 232 tariffs if applied by the Trump administration.[29] All such figures are well above the value of current Canadian and Mexican exports to the United States.

Few objective observers would agree that the more protectionist rules for vehicles and auto parts will benefit auto manufacturers or consumers, and it remains to be seen whether the changes will benefit workers in the industry. Accurately estimating the additional North American production costs due to the more restrictive rules of origin and related minimum salary requirements is almost impossible, in part because they likely will vary company by company and vehicle model by vehicle model. The $16/hour wage requirement may impose a significant tracing and record-keeping burden on enterprises that produce finished passenger vehicles or light trucks and on associated parts suppliers, at least temporarily.[30] This will add to vehicle manufacturing costs in North America, compared to automotive production costs in Asia or the European Union. Still, one can reasonably expect that within a few years, the major auto producers will have devised means of minimizing the costs, given the phase-in period and potential detailed regulatory guidance the U.S. government may provide.[31]

As noted earlier, the rules of origin for autos under NAFTA have been a significant burden in part because of the requirement to track the production origin of not only major components but also parts of major components[32] (both of which are relaxed under the USMCA). However, auto manufacturers in North America appear to have learned how to minimize the administrative costs of compliance. As industry representatives noted in a supplementary advisory report,

> *While the changes to the automotive rules of origin methodology and the increases in the Regional Value Content (RVC) levels present challenges, and increased costs in the near term, ITAC-2 automotive industry representatives appreciate that helpful flexibilities were maintained in the automotive rules of origin [tracing] that temper some of those challenges and minimizes many of the longer-term administrative burdens and costs.*[33]

The overall economic impact of these provisions on the North American auto industry depends on several other factors, such as the increased cost of steel and aluminum due to U.S. tariffs and quotas on steel and aluminum imported from most countries other than Australia, which the Trump administration imposed in June 2018 on Section 232 "national security" grounds.[34] The tariffs that apply to Canada and Mexico remain particularly troubling to the industry[35] and remain in effect as of February 2019, with several U.S. legislators indicating that Congress will not consider the USMCA for approval until after these tariffs are lifted.[36] If these increased costs are added to the higher costs of complying with the USMCA rules of origin, increasing the overall cost of North American production, one can reasonably expect U.S. and other North American vehicle sales to fall, although predicting the magnitude of the decrease—and the resulting job losses, if any—is difficult. In addition, China's retaliatory tariffs on imports of American-made autos, now set at 25% in addition to the standard MFN tariff of 15%, if not eliminated as promised by China[37] could also cause a reduction in exports, further impacting U.S. auto production and employment.[38]

In the future, some of the auto parts production now in Mexico may move to the United States or Canada because of the $16/hour wage rule. (The extent to which additional U.S. workers are hired depends in part on the extent to which manufacturers invest in robots and other labor-saving equipment.) Moreover, the increase in North American content requirements will apply to lower priced parts currently imported from Asia and are thus most likely to be produced in Mexico rather than in Canada or the United States, given Mexico's much lower labor costs. At the same time, while the RVC threshold is increasing from 62.5% to 75%, 25% of the total content may still be obtained from non-North American sources. For Mexican auto producers, sourcing some components from China, elsewhere in Asia, and the European Union will still be feasible, even if the Trump administration ultimately imposes 20-25% tariffs on auto parts from those countries under Section 232. For some USMCA market producers, these additional tariffs many encourage a shift in the production of auto parts to be exported to the U.S. from China to alternatives such as Malaysia, Vietnam, South Korea, or Mexico. This could further increase the cost advantage of producing auto parts in Mexico, but only if uncertainties regarding the investment climate under AMLO are favorably resolved.[39]

TARIFF AND CUSTOMS TREATMENT OF EXPRESS SHIPMENTS

When NAFTA was originally negotiated, online shopping barely existed because most of the technology was not available, and low-value parcels were not a significant aspect of international trade within North America. At the time, the de minimis threshold for the United States was only $200. But by 2017, the number of packages delivered by the U.S. Postal Service, most of them generated by online sellers such as Amazon.com, had increased from less than a billion in 1992 to 5.7 billion.[40]

Given the importance of internet-based shopping today, companies that ship goods from the U.S. to Canada and Mexico, including but not limited to the U.S. Postal Service and Amazon, have long objected to the very low thresholds for expedited customs services and duty exemptions imposed by Mexico and Canada. Exemption from customs duties and value-added taxes (Mexico) or provincial and national sales taxes (Canada) for small, relatively low-value packages shipped from the United States would facilitate international sales by online retailers in the United States. U.S. law stipulates that shipments worth up to $800 may be imported into the U.S. with expedited processing and without facing customs duties.[41] In significant contrast, these thresholds are currently C$20 (US$15) for packages exported to Canada and $50 for Mexico.[42] These levels often mean that the administrative costs for completing the shipments exceed the value of the goods shipped.

The USMCA requires Mexico to increase these thresholds to $117 for customs duties and $50 for value-added taxes, while Canada's limits must increase to C$150 (US$112.50) for customs duties and C$40 (US$30) for national sales taxes.[43] Industry spokespersons have expressed disappointment that the U.S. trade negotiators were "unable to secure more ambitious commitments from Canada and Mexico." However, they also expressed concern regarding a provision in the USMCA

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that would permit the United States to decrease the de minimis level for express shipments from Mexico and Canada below $800, effectively in retaliation for their intransigence. This, according to the industry, would be the wrong response[44] (presumably because U.S. imports from all countries, not just Canada and Mexico, benefit from the relatively high U.S. threshold). It seems likely given the relative unresponsiveness of Canada and Mexico to U.S. requests that there will be further negotiations among the USMCA parties on de minimis levels in the future.

OTHER PRODUCT AREAS AND PROCEDURES

Changes to the rules of origin are not limited to automotive goods. Other affected areas include chemicals, steel-intensive products, and glass and optical fiber goods. These are not discussed in detail in this report. Further information can be found in the product-specific rules of origin Annex.[45] Similarly, this report does not address changes, many reflecting desired modifications 25 years after NAFTA negotiations were concluded, to rules of origin in areas such as information and communication technology, pharmaceuticals, medical devices, cosmetics, and chemicals.[46] Those interested in these sectors are directed to the USMCA's sectoral annexes and to the Industry Trade Advisory Committee reports.[47]

The Office of the U.S. Trade Representative has also identified some significant procedural changes related to rules of origin, including "allowing importers as well as exporters and producers to makes [sic] certifications of origin and enhancing cooperation and enforcement tools for compliance with rules for all goods."[48] The author believes this is a significant improvement over the current NAFTA rules. In the author's experience with rules of origin under NAFTA, the importers, who are responsible under U.S. law for paying any applicable customs duties and penalties for negligence,[49] were often concerned that their exporter/producers in Canada or Mexico might have made errors in completing the certificates of origin, the liability for which would fall to the importers. In the author's view, importer concerns about inaccurate certificates of origin—which after an audit several years later might result in higher duty liability for past imports, interest on additional duties and penalties for negligence or even gross negligence—were a factor that discouraged some importers from seeking NAFTA treatment for their imports.[50]

ENDNOTES

1. See David A. Gantz, *The United States-Mexico-Canada Agreement: Overview and Analysis*, Baker Institute Report no.12.11.18, Rice University's Baker Institute for Public Policy, Houston, Texas, https://www.bakerinstitute.org/media/files/files/1f9f406a/bi-report-121118-mex-usmca.pdf.

2. Agreement between the United States of America, the United Mexican States, and Canada, November 30, 2018 (not yet in force), https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between.

3. See North American Free Trade Agreement, U.S.-Can.-Mex., December 15, 1992, https://www.nafta-sec-alena.org/Home/Texts-of-the-Agreement/North-American-Free-Trade-Agreement, ch. 3.

4. See NAFTA, chs. 3 and 4; USMCA, chs.2 and 4.

5. See USMCA, art. 4.2; NAFTA, art. 401.

6. See "Implementing the NAFTA Rules of Origin: Are the Parties Helping or Hurting Free Trade?" *Arizona Journal of Int'l and Comparative Law* 12 (1995): 367.

7. USMCA, art. 4.3.

8. USMCA, art. 4.2(c).

9. USMCA, art. 4.2(b) and (d), Annex 4-B.

10. Duties assessed on U.S. imports amounted to only 1.4% of all imported goods; more than two-thirds of all imported goods were not subject to any tariffs at all. See Drew Desilver, "U.S. Tariffs Vary

a Lot, But the Highest Duties Tend to be on Imported Clothing," Pew Research Center, *Factank* (blog), March 28, 2018, http://www.pewresearch.org/fact-tank/2018/03/28/u-s-tariffs-vary-a-lot-but-the-highest-duties-tend-to-be-on-imported-clothing/.

11. Office of the United States Trade Representative, "United-States-Mexico-Canada Trade Fact Sheet: Rebalancing Trade to Support Manufacturing," October 2018, https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/october/united-states%E2%80%93mexico%E2%80%93canada-trade-fa-0. Small trucks are dutiable at 25%. See HTSUS 8704.

12. Ibid.

13. Ibid.

14. USMCA, Annex 4-B, appendix, esp. art. 2.

15. USMCA, art. 4.12.

16. Bureau of Labor Statistics, "Automotive Industry: Employment, Earnings and Hours," October 2018, https://www.bls.gov/iag/tgs/iagauto.htm. Another 3.3 million are employed in vehicle and parts dealerships.

17. See Kristin Dziczek, Bernard Swiecki, Yen Chen, Valerie Brugeman, Michael Schultz and David Andrea, "NAFTA Briefing: Trade benefits to the automotive industry and potential consequences of withdrawal from the agreement," *Center for Automotive Research*, January 2017, https://www.cargroup.org/publication/nafta-briefing-trade-benefits-to-the-automotive-industry-and-potential-consequences-of-withdrawal-from-the-agreement/.

18. 19 U.S. Code § 1862 – Safeguarding National Security.

19. David Lawder, "U.S. seeks to include steel, aluminum in NAFTA autos rules – sources," *Reuters*, October 13, 2017 https://uk.reuters.com/article/uk-trade-nafta-steel-exclusive/exclusive-u-s-seeks-to-include-steel-aluminum-in-nafta-autos-rules-sources-idUKKBN1CI1XC.

20. USMCA, app. to annex 4-B, art. 3.1.

21. USMCA, app. to annex 4-B, art. 6.

22. USMCA, app. to annex 4-B, art 7.

23. See, for example, USMCA app. to annex 4-B, arts. 3.4-3.6, 3.8-3.9.

24. USMCA, app. to annex 4-B, arts. 3.4, 3.5.

25. "Study Points to Large Wage Gaps for Mexican Auto Workers," *Mexico News Daily*, July 2, 2018, https://mexiconewsdaily.com/news/study-points-large-wage-gaps-mexican-auto-workers/.

26. See USMCA, annex 23-A ("Worker Representation in Collective Bargaining in Mexico").

27. "It is the expectation of the Parties that Mexico shall adopt legislation described above before January 1, 2019. It is further understood that entry into force of this Agreement may be delayed until such legislation becomes effective." See USMCA, annex 23-A, para. 3.

28. See Sharay Angulo, "Most Mexican Auto Exports Can Meet New NAFTA Rules, Says Minister," *Reuters*, August 27, 2018, https://www.reuters.com/article/us-trade-nafta-mexico-autos/most-mexican-auto-exports-can-meet-new-nafta-rules-says-minister-idUSKCN1LC2HC.

29. USMCA, U.S.-Canada 232 side letter, U.S. Mexico 232 side letter. The many side letters included in the USMCA package to address specific issues are binding on the parties in the same manner as if they were part of the text of the agreement and will be approved as part of the same process in which the U.S. and Mexican congresses and the Canadian Parliament approve the USMCA.

30. USMCA, app. to annex 4-B, art. 7.

31. See USMCA, app. to annex 4-B, art. 3.

32. See NAFTA, annex 300-A.

33. "Addendum to the Earlier (September 28, 2018) Report of the Industry Trade Advisory Committee on Automotive Equipment and Capital Goods," October 24, 2018, https://ustr.gov/sites/default/files/files/agreements/FTA/AdvisoryCommitteeReports/ITAC_2_REPORT-Automotive_Equipment_and_Capital_Goods_Addendum.pdf, 4.

34. Australia is the only country exempted to date, as of December 2018. See Michael Cowden, "Australia Joins 232

Tariff Exemption Parade," *Fastmarkets AMM*, March 12, 2018, https://www.amm.com/Article/3793254/Australia-joins-232-tariff-exemption-parade.html.

35. Addendum to Automotive Equipment and capital goods, 3.

36. "Brady: Congress Not Willing to Consider USMCA until Steel, Aluminum Issues Resolved," *World Trade Online*, January 29, 2019, https://insidetrade.com/daily-news/brady-congress-not-willing-consider-usmca-until-steel-aluminum-issues-resolved.

37. See Peter Wells, "Carmakers Rise on Reports China Moving Towards Cutting US Auto Tariffs," *Financial Times*, December 11, 2018, https://www.ft.com/content/27a8a5a0-fd3e-11e8-ac00-57a2a826423e.

38. For example, BMW was preparing to shift some auto production from the United States to. See "BMW May Shift Production to China from U.S. as Trade War Bites," *Bloomberg Law*, November 8, 2018, http://bit.ly/2N5uOxy.

39. See, for example, Colby Smith, "Investors Face Big Call as Mexico's Lopez Obrador Prepares Budget," *Financial Times*, December 11, 2018, https://www.ft.com/content/52a1e866-fc4e-11e8-ac00-57a2a826423e.

40. See Gary Clyde Hufbauer and Euijin Jung, "Higher de Minimis Thresholds: a Win in the USMCA," Peterson Institute for International Economics, *Trade and Investment Policy Watch* (blog), October 15, 2018, https://piie.com/blogs/trade-investment-policy-watch/higher-de-minimis-thresholds-win-usmca.

41. Addendum to Industry Trade Advisory Report on Services, 2.

42. Addendum to the Industry Trade Advisory Report on Services, October 19, 2018, 2, https://ustr.gov/sites/default/files/files/agreements/FTA/AdvisoryCommitteeReports/ITAC_10_REPORT-Services_Addendum.pdf.

43. USMCA, art. 7.8(1)(f).

44. USMCA, art. 7.8, n. 3.

45. USMCA, annex to ch. 4.

46. See USMCA, ch. 12 (sectoral annexes).

47. See USMCA, ch. 12, https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/12_Sectoral_Annexes.pdf; Advisory Committee Reports, https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/advisory-committee.

48. Office of the U.S. Trade Representative, "Changes in Existing Law Required to Bring the United States into Compliance with Obligations Under the Agreement between the United States of America, the United Mexican States and Canada (USMCA), January 29, 2019, 2,https://www.finance.senate.gov/imo/media/doc/USMCA%20Changes%20To%20Existing%20US%20Law%20Document.pdf. See USMCA, art. 5.2.1 (providing that a "certification of origin [may be] completed by the exporter, producer or importer").

49. NAFTA, art. 501.3(a).

50. See 19 U.S.C.§ 1592(f)(1): "[I]t is unlawful for any person to certify falsely, by fraud, gross negligence, or negligence, in a NAFTA Certificate of Origin (as defined in section 1508(b)(1) of this title) that a good to be exported to a NAFTA country (as defined in section 3301(4) of this title) qualifies under the rules of origin set out in section 3332 of this title."

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