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STREAMLINING TARIFFS AMONG NAFTA PARTNERS POTENTIAL SAVINGS FOR ALBERTA

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I. Introduction

The Agenda for the World Trade Organization's (WTO) Doha Round of Negotiations has now been agreed upon. There is again hope that further obstacles to increasing trade and reducing poverty can be removed on a global scale. At the same time, the North American Free Trade Agreement (NAFTA) celebrates 10 years of operation and Canada – US free trade its 15th anniversary. The NAFTA Commission (2003) observed that "certain export-related transactions costs still impede possibilities for even more vigorous growth in trilateral trade." The purpose of this paper is to provide an assessment of the impact on Alberta of small trade policy changes in NAFTA that should prove consistent with the WTO's agenda. Specifically, this paper addresses the issue of Rules of Origin (ROO) application at the Canada-US border.

II. Export-Related Transactions Costs: What Happens at the Border?

Because NAFTA-partners maintain separate tariff schedules vis-à-vis non NAFTA-countries, ROO are necessary to prevent "trade deflection," the possibility that goods from outside NAFTA enter the NAFTA-country with the lowest Most Favoured Nation (MFN)-tariff for the purpose of being transhipped to a NAFTA country with a higher tariff.

In practice, these ROO turn out to be complex to administer and a source of distortions. NAFTA devotes approximately 200 pages of fine print in an annex that deals with ROO-definitions and implementation issues. A 'certificate of origin", only one page long, accompanies a shipment across the border, certifying that the goods in question comply with the required percentage of North-American origin, hence qualify for NAFTA-status and duty-free access to the partner country. But behind the one-page certificate is a long form, with the simplified instructions for filling it out running to 11 pages. The long form has to be kept on record, and the exporter assumes legal liability for its accuracy. Supporting documentation must be presented to the customs authorities upon request.

As a result, a number of transactions costs arise from the application of ROO. Government agencies face administrative costs when implementing and monitoring ROO. Exporters face compliance costs which are shared with importers and downstream producers. The required paper-work, the resources devoted to determining, meeting and proving origin, explicit filing fees at the US-border, and necessary computer systems and programs impose sufficient costs that some Canadian exporters have chosen to pay the US-MFN tariff rather than undertake the process of obtaining a certificate of NAFTA-origin.

Especially small exporters may choose this course of action, and since Canadian firms are predominantly small and medium-sized, the compliance costs of ROO are an issue of special interest to Canada. It has also recently been ascertained that of all the free trade agreements in existence globally, the ROO of NAFTA are the most restrictive and therefore onerous and costly (Kunimoto and Sawchuk, 2004).

III. Proposed Administrative Simplifications for NAFTA-ROO-Application

US and Canadian MFN-tariffs are presently quite similar. Were it not for a few highly protected products, such as dairy and poultry in Canada, and peanuts and sugar in the US, the level of tariffs for most imports that are still subject to duty would be very similar. Excluding agricultural products, the average tariff levels are approximately 2.5% for both Canada and the US.

In view of this fact, the administrative and compliance costs of ROO may loom large relative to their intended benefit, namely the prevention of tariff-avoidance through transhipment.[1] And as Canada and our NAFTA-partners will be engaging in negotiations under the WTO-Doha Round, an opportunity arises to streamline (harmonize) tariff lines to the levels imposed by the low-tariff member. In many cases that would be the US, and in many other cases that would be Canada.[2] In short, if such harmonization could be achieved for a large number of products, these products could be exempted from ROO-application at the border. The reason for the exemption would be the lack of any meaningful economic rationale for ROO when MFN-tariffs are equal.

As a practical transitional step Canada and the US might agree to waive ROO-application

- for all products for which both countries apply 0% MFN-tariffs;
- for products on which Canadian and/or US MFN tariffs are non-zero but less than 5%;
- for products other than those in i) and ii) above for which Canadian and US MFN tariffs fall within 2% of each other.

In what follows an attempt is made to determine the benefits Alberta's exporters would derive from such a practical interim step toward further growth in Canada-US trade.

IV. The Impact on Alberta Exports of Simplified ROO-Application

Extent of Exports Affected

There are presently a large number of product categories for which both Canada and the US no longer impose MFN-tariffs. This is the case for live swine and sheep, for beer and whiskey, many raw materials and very nearly the case for crude oil, where the US imposes a tariff of 5.25 or 10.5 cents per barrel, depending on the type, *i.e.*, a very small fraction of the current price. Many machinery products also no longer carry duties on imports in both countries.

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1 There is of course, the protectionist effect of making exporters rely on more expensive domestic products as inputs. Some see this as a benefit, though higher prices result for consumers or those purchasing inputs.

2 In this paper, we are not considering Mexico as Canada-Mexico exports are only about 1.1% of Canada US exports (2003).

Nevertheless, when these types of products are traded among NAFTA partners, the ROO-documentation needs to be provided and the applicable processing fees have to be paid.

How much of an obstacle to trade these ROO-rules are overall depends, of course, on the volume of trade that is affected by their application. For that reason, an estimate of the benefits possible from the simplifications proposed above will require that we measure those Alberta NAFTA-exports that would stand to benefit from the proposed ROO-exemptions.

Thus we examine those Alberta exports to the NAFTA-region that exceeded $0.5 million at the 6-digit level of the Harmonized Commodity Description and Coding System (HS), representing 98.1% of Alberta's total exports in 2002 and 95.8% on average for the years 1998-2002.[3]

Products were identified according to the criteria mentioned earlier:

- Canada and the US apply 0% MFN tariffs;
- Canada and/or the US apply ≤ 5% MFN tariffs;
- Canada and/or the US apply MFN rates >5%, but the difference in tariff rates is ≤ 2%.

Products meeting the above criteria were categorized according to product type: agricultural products (HS-chapters 1-24), energy products (HS-chapters 25-39), other commodity-based products (HS-chapters 40-83), machinery and equipment (HS 84), electrical equipment (HS 85) and other manufactured products (HS 86-97).

In some cases Canada (the US) applies a tariff at the 6-digit level while the US (Canada) applies a tariff at the 8-digit level. In these cases the criteria may be met only for part of the exports at the 6-digit level of detail. Because neither country provides a comprehensive breakdown of province-specific exports at the 8-digit level, it is impossible to further assess the extent to which these exports may fulfill the criteria. As a result, we can only provide an upper and lower estimate of the potential impact, ranging from the full value of the 6-digit export in question to zero. Thus Table 1 shows the affected Alberta exports for 2002, and the annual average for 1998-2002, with the "low end of band" excluding and "high end of band" including exports for which only "partial matches" existed as regards tariff application at the 6-digit level.

[3] Data was taken from Statistics Canada, via the World Trade Atlas (January 2004), and includes both domestic and re-exports.

Table 1. Value of Alberta Exports to NAFTA Partners According to MFN-Tariff Criteria ($ millions, Cdn.)

Categories	2002		5-Year Average	
	Low End of Band	High End of Band	Low End of Band	High End of Band
MFN Tariffs of 0%				
HS 1-24: Agricultural Products	$281.0	$957.1	$290.6	$963.2
HS 25-39: Energy Products	$17,276.4	$18,676.5	$15,854.4	$17,107.3
HS 40-83: Other Commodity Based Products	$1,764.5	$1,784.1	$1,669.8	$1,682.7
HS 84: Machinery and Equipment	$2,565.6	$2,649.6	$483.9	$561.7
HS 85: Electrical Equipment	$1,232.4	$1,233.7	$1,916.3	$1,927.8
HS 86-97: Other Manufactured Products	$310.5	$418.8	$312.0	$404.2
Total Value	**$23,430.4**	**$25,719.8**	**$20,527.0**	**$22,646.9**
MFN Tariffs of 5% or less				
HS 1-24: Agricultural Products	$20.2	$46.6	$15.6	$20.9
HS 25-39: Energy Products	$640.5	$739.3	$260.6	$352.2
HS 40-83: Other Commodity Based Products	$544.9	$574.1	$224.4	$250.4
HS 84: Machinery and Equipment	$214.5	$334.3	$159.8	$243.5
HS 85: Electrical Equipment	$336.8	$348.3	$335.5	$352.8
HS 86-97: Other Manufactured Products	$109.5	$134.7	$63.1	$76.8
Total Value	**$1,866.4**	**$2,177.3**	**$1,059.0**	**$1,296.6**
MFN Tariffs of within 2%				
HS 1-24: Agricultural Products	$169.2	$171.3	$109.7	$110.1
HS 25-39: Energy Products	$173.2	$664.4	$212.5	$783.4
HS 40-83: Other Commodity Based Products	$27.7	$43.3	$21.3	$40.5
HS 84: Machinery and Equipment	$8.9	$8.9	$4.4	$4.4
HS 85: Electrical Equipment	$-	$5.7	$-	$3.0
HS 86-97: Other Manufactured Products	$3.1	$3.1	$2.5	$2.5
Total Value	**$382.1**	**$896.7**	**$350.4**	**$943.9**
COMBINED TOTAL				
HS 1-24: Agricultural Products	$470.4	$1,175.0	$415.9	$1,094.2
HS 25-39: Energy Products	$18,090.1	$20,080.2	$16,327.5	$18,242.9
HS 40-83: Other Commodity Based Products	$2,337.1	$2,401.5	$1,915.5	$1,973.6
HS 84: Machinery and Equipment	$2,789.0	$2,992.8	$648.1	$809.6
HS 85: Electrical Equipment	$1,569.2	$1,587.7	$2,251.8	$2,283.6
HS 86-97: Other Manufactured Products	$423.1	$556.6	$377.6	$483.5
Total Value	**$25,678.9**	**$28,793.8**	**$21,936.4**	**$24,887.4**

Overall, an estimated $21.9 billion to $24.9 billion worth of exports would be captured based on five-year average figures, and $25.7 - $28.8 billion based on the data for 2002.[4]

[4] Note that, over the five-year period, an average of $14.4 billion of the captured total was due to a single product: natural gas (HS271121), on which both countries apply MFN-tariffs of 0%. In 2003, natural gas accounted for $15.7 billion of Alberta's exports to the US.

On the Cost of ROO-Compliance

Anne Krueger (1995) and Richard Harris (2001) have provided estimates or anecdotal evidence of the costs of applying ROO in practice. This range of costs is 1.0% - 5.0% of the value of goods shipped. In this paper we apply a two-pronged approach and use what we believe to be conservative estimates, with the intent of focusing on compliance costs.

For those products (HS-categories) for which MFN-tariffs in Canada and the US are zero and hence the likelihood of transhipment is also (close to) zero, the documentation requirements for ROO are assumed to be small. Canadian origin might be deemed self-evident for raw materials and energy products, and for manufactured products it should not be too onerous to show that any non-North American components have been so substantially transformed as to meet the current zero-MFN-tariff classification. Therefore we apply cost estimates for ROO-documentation of 0.25% and 0.5% of export value.

For those HS-classifications for which one or both countries levy positive MFN-tariffs we will assume the ROO-compliance costs to be 1%, 1.5%, or 2% of export value.

Applying the presumed costs of ROO-compliance to the estimated export values of the affected products leads to the ranges of benefits the proposed streamlining of ROO-application would bring to Alberta exports.[5] Table 2 summarizes the findings.

Table 2. Estimated Impact of ROO on Alberta's Exports ($ millions, Cdn.)

Categories	2002		5-Year Average	
	Low End of Range	High End of Range	Low End of Range	High End of Range
MFN Tariffs of 0%				
Assumption A: ROO cost of 0.25%	$58.6	$64.3	$51.3	$56.6
Assumption B: ROO cost of 0.5%	$117.2	$128.6	$102.6	$113.2
MFN tariffs Meeting the 5% or 2% Criteria				
Assumption A: ROO cost of 1%	$22.5	$30.7	$14.1	$22.4
Assumption B: ROO cost of 1.5%	$33.7	$46.1	$21.1	$33.6
Assumption C: ROO cost of 2%	$45.0	$61.5	$28.2	$44.8

By their very nature these estimates are coarse. Identifying the most likely beneficiaries is complicated by a number of factors. It is particularly difficult to determine the impact of ROO on NAFTA exports, inasmuch little is known about how individual companies may change their input mix to abide by ROO-requirements. Thus the overall export data relied upon here serve as an approximation. Similarly, the focus in this study is on exports of $0.5 million or more. While this allows the production of a manageable database that is still

[5] In our view these estimates do not include the border inspection resources that would be saved by the proposed simplification. Hence, additional benefits are likely.

comprehensive in $-value terms, it potentially understates the impact of ROO, especially if one were to accept the argument that the application of ROO has a disproportionately negative effect on small exporters.

As already mentioned, at the technical level this study is bedevilled by the inconsistency in the categorization of products among NAFTA-partners. For example, tariff classifications diverge at the eight digit level, the coding level at which MFN-tariffs are frequently assigned. It is therefore not possible to easily match all MFN-tariffs, as any attempt to do so would require a high degree of subjective interpretation and a substantial and time-consuming effort. As a result a number of products could not be included but properly should have been. Similarly, the use of specific tariffs by both countries impaired our ability to make comparisons of tariffs applied by the two countries.

For these reasons we likely have underestimated the extent to which Canada and the US maintain similar levels of MFN-tariffs, hence the estimated benefits of streamlining ROO-application at the border (and before) are bound to be at the lower end of the probable range.

V. Conclusion

An estimated $25.7 to $28.8 billion of Alberta's 2002 exports to the NAFTA-region would have been affected by the three specific border simplifications analyzed in this paper. According to the most conservative of our estimates of ROO-compliance costs for firms, the simplified ROO-application would have saved resources on the order of $80 million in 2002. Clearly, as trade grows, so do the benefits of administrative simplification. Moreover, there is symmetry, in that the benefits accrue similarly to US-and Mexican exporters. In Alberta's case, the benefits would be distributed over a wide range of products and exporters. Taking a present value approach of $80 million per year in perpetuity, at the Bank of Canada rate of 2%, results in a $4.0 billion pay-off from the proposed streamlining of ROO-application for Alberta alone. Based on Alberta's trade structure and the fact that it supplied 11.4% of Canada's exports in 2002, $3.5 billion would be the present value benefit for the country, with a similar amount accruing to US-exporters when they ship goods to Canada.

Substantial benefits would be possible, based on this analysis. Not only is our estimate of the benefits based on conservative assumptions, the benefits are "low-hanging fruit" that do not require high-level/high-profile negotiations. Rather, they can be obtained by administrative arrangements.

In addition, much can be gained by moving in the direction of harmonizing North-American tariffs in the current Round of the WTO. The NAFTA-partners should consider setting their MFN-tariffs at the level of the member with the lowest rate when the Doha negotiations resume.

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