Intelligence MEMOS

As NAFTA renegotiations proceed through the summer and fall, the C.D. Howe Institute Intelligence Memos will be looking at what to expect and provide analysis on the latest developments at the table. This post is part of that series.

From: Jon Johnson

To: The Honourable Ministers of International Trade, and Foreign Affairs

Date: September 7, 2017

Re: **ANOTHER FLY IN THE NAFTA OINTMENT**

The Opening Statement of USTR Robert Lighthizer at the First Round of NAFTA Renegotiations includes the following demand:

> "Rules of origin, particularly on autos and auto parts, must require higher NAFTA content and substantial US content."

The demand for "substantial US content" in the renegotiated rules of origin is an invitation to Canada and Mexico to assist the US in perpetrating a subsidy scheme for the sole benefit of US producers that is prohibited by the WTO *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement").

Under the SCM Agreement, conferring a benefit by foregoing revenue through exempting goods from duty that would otherwise be charged constitutes a subsidy. Article 3.1(b) of the SCM Agreement prohibits "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."

Consider the case of an automobile imported into the US from Canada or Mexico. The US measure implementing a rule of origin requiring substantial US content would grant NAFTA duty free treatment to the automobile only if a prescribed level of the materials (parts, components, etc.) contained in the automobile consisted of domestic goods sourced in the US. Canadian or Mexican goods or goods from other countries incorporated into the imported automobile would not count towards achieving the required level of US content. For the automobile to enter the US duty free under the renegotiated NAFTA, the Canadian or Mexican producer of the automobile would have to use US domestic materials instead of materials from other countries until the prescribed US content level had been achieved. Thus the US measure allowing the automobile to benefit from NAFTA duty free treatment only if the prescribed level of US content was achieved would fall squarely into the prohibition in Article 3(b) of the SCM Agreement.

Free trade areas such as that established by NAFTA are sanctioned by Article XXIV of GATT 1994. This is necessary because the elimination of trade restrictions required in a free trade area applies only to products originating in member countries of the free trade area. Without Article XXIV, this necessary feature of a free trade area would contravene the most-favoured-nation obligation in Article I of GATT 1994 that requires that advantages conferred on products of any country be applied to products of all WTO member countries.

Rules of origin, which are a necessary component of a free trade area, are normally based on achieving certain levels of "regional" content. The "region" is the region consisting of the member countries of the free trade area. Materials from within the region count towards achieving the required content levels while materials from outside the region do not count. Rules of origin based on regional content do not create any inconsistencies with the SCM Agreement because the regional materials that count are not "domestic goods" of any specific member country. However, a rule of origin based on achieving a specified level of domestic content from a single member country crosses over from being a necessary and legitimate component of a free trade area into being a component of a subsidy scheme for the sole benefit of one country, a scheme that the SCM Agreement expressly prohibits and that Article XXIV of GATT 1994 does not excuse.

Jon R. Johnson is a Senior Fellow at the C.D. Howe Institute.

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