

# BARRING THE BACKDOOR: RULES OF ORIGIN IN A NORTH AMERICAN FREE TRADE AREA

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*The prospect of establishing a North American Free Trade Area (NAFTA) has raised serious concerns regarding the so-called "backdoor" problem. With regard to NAFTA, the fear is that foreign companies — particularly companies from Japan and the Asian newly industrialized companies (NICs) — will utilize Mexico as an assembly site or distribution center to "sneak" their products into the United States market. Rules of origin have constituted the major defense against such incursions. However, there are many difficulties in applying and enforcing those rules, and those difficulties may be compounded by differing interests among the countries participating in a free trade agreement. This paper explores the backdoor issue as it pertains to a free trade arrangement between Mexico and the United States.*

**T**he current movement to form a North American Free Trade Area (NAFTA) has brought renewed attention to an old concern. This concern — sometimes referred to as the "backdoor" or "Trojan Horse" problem — involves the possibility that nonmember countries will take advantage of a preferential trade arrangement in order to circumvent import or investment barriers and gain easier access to the market of one or more member countries.

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This possibility was a significant issue in the development of the United States-Canadian free trade arrangement (CFTA), but the prospect of widening that arrangement to include Mexico appears to be creating even more consternation in the United States. The fear is that Mexico will become a gigantic entrepôt or "export platform", via which companies based in nonmember countries (notably Japan and the Asian NICs) will flood the United States market with their products (Awanohara, 1991).

This fear is predicated upon a number of conditions and circumstances, including:

- 1) the abundance of low-cost labor in Mexico, which makes that country an attractive site for establishing labor-intensive manufacturing or distribution operations, as well as an eager recipient of such activities;
- 2) Mexico's extensive involvement in the *maquiladora* phenomenon (American-owned factories in Mexico near the United States border), which has created both a base of experience and a legal and physical infrastructure that would support an expanded entrepôt/export platform role;
- 3) the new openness to imports and foreign direct investment which the Mexican government has initiated and promoted since the mid-1980s. This dramatic reversal of Mexico's historically protectionist and statist economic policies makes it much easier for foreign firms to utilize the country as a locale for export-oriented production or distribution;
- 4) the recent buildup of direct investment in Mexico by Japanese and other Asian companies, which can be interpreted as a positioning strategy targeted toward the United States market (Lamoriello, 1991).

The principal means that the United States and other countries have employed to counteract the backdoor problem is to specify that concessions and benefits granted in free or preferential trade agreements are available only to products *originating in* the countries participating in and/or designated in those agreements. The enforcement of these decrees requires the application of *rules of origin*, which are described as "laws, regulations, and administrative practices that ascribe a country of origin to products in international trade" (United States International Trade Commission, 1985).

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Although this means of preventing nonparticipating countries from exploiting preferential trade arrangements appears simple and straightforward, its implementation has been fraught with difficulty. Despite repeated efforts to develop uniform, objective tests or criteria for determining the actual origin of products, these criteria still are highly subjective and vary widely from country to country. Moreover, establishing origin has become more complicated in recent years, due to the proliferation of products traded internationally and the expansion of worldwide sourcing of materials and components by globally-integrated business firms (Banco Nacional de Mexico, 1991).

In addition to the problems associated with the application of rules of origin, the implementation and operation of free trade arrangements may be prone to another difficulty. This has to do with the possibility that the interests and motives of the countries participating in such

arrangements will diverge significantly with respect to the backdoor issue. Whereas some of the participants may be deeply concerned with preventing nonmember countries from invading their markets through a trading partner's territory, other participants may be willing or even eager to countenance such activities. Such opposing viewpoints could lead those nations to propose and promote dissimilar if not conflicting policies on rules of origin and related questions.

This paper examines the concerns and problems identified above in relation to the proposed North American Free Trade Area. It reviews the background and current status of the rules of origin conundrum and its relevance to this particular free trade arrangement. It also analyzes the economic circumstances, interests, and objectives of the United States and Mexico to determine how they may affect the positions of these two countries with regard to the backdoor issue.

## UNITED STATES RULES OF ORIGIN

Over the past century, the United States has frequently applied special tariff treatment (either preferential or punitive) to certain foreign countries. Consequently, it has repeatedly faced the task of ascertaining the origin of imported products. The magnitude and importance of this task has grown over the past fifteen years, as the United States has become more heavily involved in special trade arrangements, such as the Generalized System of Preferences (GSP), the Caribbean Basin Initiative (CBI), and bilateral free trade agreements with Israel and Canada.

The determination of origin becomes problematic whenever a product that is exported to the United States from a so-called beneficiary country (i.e., a country that is being accorded preferential tariff treatment through one of these special trade arrangements) has not been *totally* produced or grown in that country. The basic method that has been utilized to decide if such a product still can be deemed

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to have originated in the beneficiary country is the "substantial transformation" test. In this test, imported materials or components are regarded as having been substantially transformed if they emerge from a processing operation with a name, character, or use which differs from that which they possessed before processing.

Unfortunately, substantial transformation has always been an ambiguous standard, which United States customs officials have interpreted and applied on a case-by-case basis. This ambiguity has generated a great deal of confusion and uncertainty among exporting and importing firms, and has given rise to numerous costly and time-consuming disputes and court cases involving these firms and the United States government (Nunez, 1991).

One device that the United States has employed for clarifying and tightening its rules of origin is local content (or value added) requirements. The language of several United States trade agreements with other countries specify a minimum contribution to the final value of a product that must take place within a beneficiary country before the product qualifies for importation into the United States on preferential terms. In the Generalized System of Preferences, Caribbean Basin Initiative, and Israel Free Trade Agreement programs, this local content/value added requirement has been set at 35 percent, i.e., the sum of the cost of materials produced in a beneficiary country plus the direct costs of processing must constitute at least 35 percent of the value of a product being exported to the United States (Banks, 1991).

Although such value/content requirements do impart a degree of objectivity and measurability to the process, they have by no means overcome all of the perplexities involved in establishing the origin of products. Instead, they have given rise to another set of troublesome questions, regarding what should be "counted" toward fulfilling these requirements.

Many of these questions have to do with situations in which machinery or materials imported from a nonbeneficiary country are utilized in manufacturing products in a beneficiary country. If, for example, a machine made in Japan is used to produce auto parts in Canada, should the cost of operating or depreciating that machine be included as Canadian content within the United States-Canadian Free Trade Agreement? Or, if factories in Barbados use Egyptian cotton fibers to produce textiles which are then used to produce articles of clothing, should the imported cotton be counted in calculating value added in Barbados within the Caribbean Basin Initiative? This latter example falls under the "dual substantial transformation" rules, which require that imported materials undergo substantial transformation into intermediate goods which must then be substantially transformed into final products before those materials can be included in the value/content requirements (United States International Trade Commission, 1987).

A variant of this situation involves cases in which materials used in one beneficiary country are imported from another beneficiary country within the same trade agreement. The United States has been inconsistent in its treatment of these cases, in that the CBI allows the cumulation of the costs of materials and processing incurred in more than one beneficiary country, whereas such cumulation is not permitted under the Generalized System of Preferences (United States International Trade Commission, 1991A).

The United States-Canadian Free Trade Agreement (CFTA), which took effect in January, 1989, introduced a new method of determining whether substantial transformation has occurred. This is the "change-of-tariff-classification" method, in which a product processed in Canada which contains imported parts or materials is deemed to have originated in Canada if the processing results in the final product's having a different tariff classification (under the Harmonized Tariff System) than the precursor inputs. The presumption is that processing or manufacturing that is extensive enough to effectuate such

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a change constitutes substantial transformation. For example, manufacturing a desk from imported lumber would be enough of a change to qualify the desk as Canadian in origin, whereas assembling a desk from imported parts would not constitute substantial transformation (O'Dell, 1992).

The CFTA contains some exceptions to this change-of-tariff-classification rule. Certain products regarded as especially sensitive must also meet a value-added test. On the other hand, products that fulfill a 50 percent value added requirement may be regarded as originating in Canada even if a change of tariff classification does not occur (Homolac, 1990).

A recent contretemps exemplifies the problems that can arise out of the interpretation and application of such rules. In February, 1992, the United States Customs Service announced that automobiles which Honda Motor Company was producing in Canada did not fulfill the 50% North American content requirement specified in the CFTA and therefore could no longer be shipped to the United States duty free. The Customs Service declared that Honda owed nearly \$19 million in import duties on cars previously sent to the United States, and that future shipments would be subject to a 2.5 percent duty.

The Customs Service ruling — which was based upon its calculations of the value of the parts, processing, and other inputs which it considered to actually be of North American origin — has elicited strong protests from both Honda and the Canadian government. Honda officials have hotly disputed the Service's content valuations and criticized it for a lack of clarity in its regulations (*Business Week*, November 18, 1991). Meanwhile this action, together with other punitive measures that the United States has recently taken against Canadian imports, has raised the ire of several groups in Canada to an extent which could threaten the survival of the United States-Canadian free trade pact (*Business Week*, March 2, 1992).

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## EVALUATION

The foregoing review indicates that the United States approach to the application of rules of origin is something of a hodge-podge, characterized by anomalies, subjectivity, and lack of uniformity. This is not entirely surprising nor blameworthy, given the different circumstances and objectives associated with the various trade agreements in which the United States has become involved and the inherent difficulties of assigning origin to goods emanating from an increasingly-complex and interdependent global production system.

In fairness, it should be pointed out that United States government agencies and officials are well aware of the shortcomings of the existing rules-of-origin mechanism and of the problems which they create for virtually everyone involved in international commerce. Furthermore, the United States has been a leader in efforts to rationalize rules of origin. These efforts include the implementation of the change-of-tariff-classification methodology — which is regarded by some as more objective and easier to administer than other criteria — and a push to harmonize rules of origin multilaterally through the General Agreement on Tariffs and Trade (GATT).

Such initiatives on the part of the United States are commendable, but their results and effects still are very uncertain. Experience with



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the tariff classification method has been brief and limited to the CFTA, and several administrative problems have emerged in this area (Hirsch, 1990). This has prompted customs brokers and others operating in the "front lines" of United States-Canadian trade to plead for further clarification and simplification of these rules and the procedures for applying them (King, 1991). In the meantime, the attempt to establish uniform rules of origin through the GATT has been caught up in the Uruguay Round fiasco, so that the prospects for any breakthrough on this front appear to be bleak.

As regards the proposed North American Free Trade Area, the upshot of all this is that the United States will be negotiating a free trade agreement with Mexico with only a flawed and obsolete instrument available for dealing with the critical backdoor issue. The potential seriousness of this situation is compounded by the different (if not diametrically opposed) points-of-view which Mexico and the United States hold on this issue. The basis of these differences, and the conflicts that they may engender, are explored in the following section.

### **MEXICO VERSUS THE UNITED STATES**

The differing philosophies of the United States and Mexico regarding the backdoor issue and the appropriate use of rules of origin are the outgrowth of the marked disparity in the economic status of the two countries. It has frequently been noted that the proposed NAFTA will be unique in that it entails economic integration among First World and Third World nations (Business Week, 1990). While these appellations may be somewhat anachronistic and imprecise, the fact remains that there is a very wide gap between the level of economic development of Mexico and that of its two North American neighbors. That gap is reflected in substantive dissimilarities in economic conditions and economic priorities.

Thus, as a developing nation, Mexico faces conditions of massive underemployment in a young and rapidly-growing population, widespread poverty with its accompanying social ills, chronic inflation, and a heavy external debt burden. Although it has a large and diversified industrial base, many of its industries evolved in protected

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markets with extensive government support and control. The notorious inefficiency and lethargy of these quasi-public industries played a large part in bringing on the economic crisis which gripped Mexico in the early 1980s. And the dramatic reform movement which was launched in 1985 constitutes a desperate effort to restructure and revitalize this industrial sector (Weekly, 1991).

Given these problems and needs, it is hardly surprising that one of Mexico's chief motives for pursuing a free trade agreement is to attract more foreign investment (Federal Reserve Bank of San Francisco, 1991). Its hope is that such investment would not only generate jobs for the nation's unemployed and impoverished citizens, but might also help to provide the advanced technology and managerial skills required to build a modern, world-class economy.

Even though Mexico's domestic market is large in terms of population and unsatisfied needs, it is not yet rich or homogeneous enough to independently constitute a magnet for large-scale foreign investment. For many potential investors, the country's more

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immediate appeal derives from the combination of its supply of cheap labor and its proximity to the United States market. These attractions obviously would become significantly stronger if and when Mexican products acquire free and guaranteed access to that market.

The proposed NAFTA will, in a broad sense, provide such access. However, the applicability and usefulness of this arrangement to particular foreign investors will depend upon how it defines *Mexican products*. In general, the more lenient the rules of origin that are eventually incorporated in a free trade agreement, the more wide-reaching and powerful that agreement will be as a stimulus to direct investment in Mexico.

Unfortunately, the type of rules of origin that would best serve Mexico's circumstances and goals are not compatible with the interests and objectives of its major NAFTA partner. As a more advanced and wealthy nation that already has become the world's primary destination for both exports and direct investment, the United States does not share Mexico's eagerness for further foreign penetration of its economy. On the contrary, the United States government has expressed its determination to ensure that third countries will not use the NAFTA as a passkey to its markets. According to at least one observer, the United States government may also be attempting to discourage Japanese or other foreign investment in some Mexican industries in order to preserve the predominance of American firms in those industries (Lindsey, 1992). Whatever their true motives, United States negotiators have been pushing for much tougher rules of origin in the NAFTA agreement than Mexico would prefer (United States-Mexico Free Trade Reporter, 1991).

### THE OUTLOOK

The general "messiness" of rules of origin and the conflicting interests of the United States and Mexico pose difficult problems for

the negotiation and subsequent operation of a free trade agreement. It is unlikely that this issue will prevent the negotiations from being completed, given the determination of the current United States and Mexican presidential administrations to conclude such an agreement. However, the backdoor issue could delay congressional ratification of the agreement or, more ominously, become a source of chronic friction in its implementation and operation.

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There are several ways in which these threats might be defused. One possibility is that a multilateral agreement for the harmonization of rules of origin may yet be reached through the GATT. Even though such an agreement might not be binding on the United States and Mexico, it could at least provide some common ground for resolving or narrowing their divergent positions on appropriate rules of origin.

A more likely and promising possibility would entail compromise between the "tough" rules of origin stance of the United States and the lenient stance of Mexico. This could involve across-the-board local content requirements that are below the high level that is presently being advocated on the United States side and the low level that Mexico would prefer. Another alternative would be to set low content requirements in general, while imposing higher requirements to protect industries (e.g., automotive, textiles, electronics) that the United States regards as especially vulnerable to a "backdoor" invasion.

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With regard to the prospects for compromise, a good argument can be made that the United States, as the stronger and wealthier party, should be the most willing to bend. This argument is bolstered by studies which indicate that increased investment in Mexico will result in greater economic gains for the United States from a free trade agreement (KPMG Peat Marwick, 1991). It is also supported by the proposition that the most important long-term benefit which the United States can realize from such an agreement is a more open, prosperous, and politically-stable Mexican neighbor.

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