

CHAPTER 1

ESSENTIALS OF THE NORTH AMERICAN FREE TRADE AGREEMENT

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OVERVIEW

The North American Free Trade Agreement (NAFTA) came into effect on January 1, 1994, covering the United States, Canada and Mexico. It is based on the successful model of the Canada-US Free Trade Agreement (FTA), which was implemented in 1989. NAFTA extended and expanded this accord in a number of areas.

The overall goal of NAFTA is to establish in the region a more integrated market for goods, services and capital, at the same time providing for greater mobility for business and professional persons. Its major objectives are to:

- eliminate barriers to trade and facilitate the cross-border movement of goods and services between the territories of the three signatories;
- promote conditions of fair competition in the free trade area;
- increase investment opportunities in the territories of the parties;
- provide effective protection of intellectual property rights in each jurisdiction; and,
- establish a clear set of rules for administration of the agreement including the determination of “rules of origin”, and binding procedures and mechanisms for dispute resolution.

Unlike the European Union (EU), NAFTA is primarily directed towards opening up markets and increasing the trade of goods and services within the region. It is not a common market, it has no political aims, and it does not provide for the free movement of labour except for the designated small professional and business group mentioned above. This agreement does address environmental concerns, committing the three signatory countries to promoting and enforcing sustainable development.

REGIONAL ECONOMIC PROFILE

In 1993, the NAFTA region constituted a market comprising a population of 372 million and a gross national product (GNP) of \$7287 billion. The three NAFTA countries show significant disparity in terms of population and economic outputs. The United States is

the world's largest economy, with a high per capita GNP. Canada, with just over ten per cent of the population of the United States, is among the top ten economies of the world in terms of size. Canada's per capita GNP is slightly lower than that of the United States.

Canada and the United States, partly because of their proximity and partly because of physical and other advantages, have long been each other's major trading partner. This situation culminated in the signing of the Canada-US Free Trade Agreement (FTA) in 1989. Although very different size in terms of population and economic output, both countries have highly advanced economies. But both countries continue to run high budgetary deficits, and although receiving increasing government attention, these deficits are a major cause of the recent instability and depreciation of the US and Canadian dollars.

Mexico has introduced more open market operations as a result of NAFTA. This follows a long period of protectionism caused at least partially by concerns that the United States, with its size and wealth, posed a potential threat to Mexican economic and possibly political sovereignty. In December, 1994, after several years of relatively strong growth, Mexico suffered a severe currency crisis that resulted in a major devaluation of the peso.

Population and GNP in the EU are close to NAFTA levels. However, land areas differ dramatically; NAFTA countries, at 21.3 million square kilometres, occupy an area over six times that of the EU.

Table 1 provides a summary of size and economic output statistics of each NAFTA country.

Table 1: North American Economic Summary 1993

	United States	Canada	Mexico
Population (million)	258	27	86
GNP (US\$ billion)	6387	574	325
GNP per capita (US\$)	24,750	20,670	3,750
Growth Rate (1985-93)%	1.2	0.4	0.9
Ave. Inflation (1985-93)%	3.5	3.3	45.1
Imports (US\$ billion)	581	132	65
Exports (US\$ billion)	465	145	52

Sources: The World Bank Atlas 1995; United States Dept. of Commerce, Bureau of the Census; Statistics Canada; Bank of Mexico

North American Trade Flows

Table 2 indicates that, major trade flows in the NAFTA region have been until the present, between Canada and the United States; and between the United States and Mexico. Trade between Canada and Mexico has been relatively small, with Canada importing approximately four times as much as it exports to Mexico. Prior to NAFTA, Mexico imposed tough tariffs and licenses on Canadian products.

Table 2: Import/Export Data 1993

\$US millions	Imports into:				
	United States	Canada	Mexico	Rest of World	Total
Exports from:					
United States		100,177	41,636	322,954	464,767
Canada	110,922		639	33,692	145,253
Mexico	39,930	2,876		8,994	51,800
Rest of World	429,659	28,712	23,125		481,496
Total	580,511	131,765	65,400	365,640	1,143,316

Sources: United States Dept. of Commerce; Statistics Canada; Bank of Mexico

Table 3 shows trade flows for each Commonwealth country with Canada and the US. Commonwealth exports to Canada amount to approximately \$8 billion, 6% of total Canadian imports; U.S. imports from the Commonwealth are approximately \$74 billion, 13% of total imports. The value of US imports from the Commonwealth are relatively balanced by exports. Canada imports approximately \$2.3 billion more than it exports to the Commonwealth.

Table 3: Commonwealth Imports/Exports 1993

\$ U.S. Millions Country	Canada's Imports	U.S.' Imports	Canada's Exports	U.S.' Exports
Anguilla	N/A	N/A	N/A	14
Antigua & Barbuda	N/A	15	7	73
Australia	826	3,294	630	8272
Bahamas	26	348	15	704
Bangladesh	44	886	19	245
Barbados	7	34	17	146
Belize	9	54	9	136
Bermuda	3	15	35	265
Botswana	N/A	9	2	25
British Indian Ocean Territory	N/A	N/A	N/A	N/A
British Virgin Islands	N/A	14	1	46
Brunei	6	30	1	478
Cayman Islands	1	35	2	179
Cyprus	1	16	7	138
Dominica	N/A	6	1	27
Falkland Islands	N/A	N/A	N/A	N/A
Fiji	18	69	2	27
The Gambia	N/A	9	N/A	10
Ghana	9	209	22	215
Gibraltar	N/A	4	7	9
Great Britain	3,467	21,736	2,306	26,376
Grenada	N/A	8	2	24
Guyana	118	91	8	123
Hong Kong	930	9,558	602	9,873
India	278	4,551	218	2,761
Jamaica	140	720	71	1,113
Kenya	12	92	9	117
Kiribati	N/A	2	N/A	31
Lesotho	2	56	N/A	4
Malawi	1	60	N/A	16
Malaysia	680	10,568	173	6,065
Malta	9	104	5	172
Mauritius	7	197	2	18
Montserrat	N/A	N/A	N/A	N/A
Nauru	N/A	N/A	N/A	N/A

\$ U.S. Millions Country	Canada's Imports	U.S.' Imports	Canada's Exports	U.S.' Exports
New Zealand	197	1,208	94	1,247
Nigeria	533	5,301	46	891
Papua New Guinea	2	98	3	50
Pitcairn Island	N/A	N/A	N/A	N/A
St. Helena	N/A	N/A	N/A	N/A
St. Kitts - Nevis	N/A	N/A	1	N/A
St. Lucia	N/A	N/A	6	N/A
St. Vincent & the Grenadines	N/A	N/A	2	N/A
Seychelles	N/A	N/A	1	N/A
Sierra Leone	3	47	1	21
Singapore	619	12,796	264	11,676
Solomon Islands	N/A	N/A	N/A	N/A
Sri Lanka	34	1,002	12	203
Swaziland	7	N/A	N/A	N/A
Tanzania	2	11	6	33
Tonga	N/A	N/A	N/A	N/A
Trinidad & Tobago	18	803	43	529
Turks & Caicos	N/A	4	N/A	22
Tuvalu	N/A	N/A	N/A	N/A
Uganda	4	10	5	21
Vanuatu	N/A	N/A	N/A	N/A
Western Samoa	N/A	1	N/A	10
Zambia	N/A	41	32	42
Zimbabwe	2	111	7	84
TOTAL	8,014	74,223	4,690	72,531

N/A = less than \$1 million

Sources: United States Department of Commerce; Statistics Canada

KEY FEATURES OF THE AGREEMENT

NAFTA contains all the rights and obligations of its FTA predecessor, although these may take a different form and be repositioned within the new agreement. FTA already provided for the elimination of tariffs between the US and Canada over a period of ten years. This, along with other FTA provisions, is incorporated within NAFTA. NAFTA now contains additional provisions for the practically complete elimination of Mexican tariffs and import licensing requirements on exports from the United States and Canada

over ten years; more openness in cross border transportation services; and clearer content rules in automobiles and textiles.

Specific items of interest to Commonwealth exporters include:

- the tightening of rules of origin to narrow the ground for disputes;
- establishment of specific rules on how customs authorities will interpret the agreement and formal procedures for redress of grievances;
- clear rule provisions that preserve each country's sovereignty in certain areas but do not permit these to be applied as constraints on trade within the region;
- standards and rules of enforcement with respect to the increasingly important issue of intellectual property rights in international trade;
- independent binational panel review and enforcement mechanisms with respect to antidumping and countervailing duty determinations by each country; and,
- emergency action rules to provide temporary relief from the adverse effects of import surges.

Rules of Origin

Rules of origin define goods that are eligible for preferential tariff treatment under NAFTA. They are designed to ensure that non-tariff benefits apply only to goods produced substantially in the NAFTA countries. NAFTA rules of origin specify that:

- goods are deemed to originate in North America if they are totally North American in content;
- goods containing non-regional materials are deemed to originate in North America provided that these are sufficiently transformed in the NAFTA region so as to undergo a specified change in tariff classification;
- in some cases, goods must include a specified percentage of North American content in addition to meeting the tariff classification requirement; and,
- goods are permitted to be treated as originating in North America when the finished good is specifically named in the same tariff subheading as its parts, and it meets the Regional Value Content (RVC) test.

RVC is calculated using either one of two methods:

- the “transaction value” method is based on the total price paid by the final buyer of the good. For example, a good with a market price of \$100 must normally have an RVC of at least \$60, that is 60 percent, to be considered as an originating North American good;
- the “net cost” method is based on the total cost of the good less selling, marketing, packing, shipping and royalty expenses. Interest expense is allowable within limits. For example, a good with a net cost of \$100 must normally have an RVC of \$50, that is 50 percent, to be considered an originating North American good.

Sample calculations of the Regional Value Content (RVC) test are provided at the end of this chapter.

Either method may normally be used by producers, but the net cost method must be used where the transaction value is not acceptable under the World Trade Organisation (WTO) Customs Valuation code. The net cost method must also be used for certain products, for example automotive goods.

NAFTA also contains a de minimis rule to prevent goods from losing preference eligibility solely on the basis that they contain minimal amounts of non-originating material. A good with no more than seven percent of the price or cost composed of non-originating, that is non-NAFTA, materials will be considered to be of North American origin.

Customs Administration

Procedures are in place to ensure that only goods satisfying rules of origin criteria are accorded preferential treatment under NAFTA. Uniform regulations also ensure that rules of origin are interpreted and administered uniformly.

Exporters to NAFTA countries are required to complete a certificate of origin. This certificate acts as the basis for a declaration (if applicable) for preferential treatment. Procedures for processing this documentation may vary by country. Copies of these certificates shall also be provided to the exporting country’s customs administration upon request. Customs authorities are empowered under NAFTA to verify the authenticity of the certificate of origin. Records pertaining to the export of goods into NAFTA countries shall be maintained for a minimum of five years.

Exporters may obtain advance rulings from customs authorities regarding application of rules of origin to future importation of goods into North America.

Technical Standards

NAFTA contains policies that promote and protect human, animal and plant health and safety. The agreement specifies that the three countries will work together to pursue the enhancement and compatibility of these measures throughout the free trade area. Standards shall not be used as a means of introducing trade barriers between countries. Each country, however, has the freedom to adopt standards to achieve the level of protection and promotion it desires.

NAFTA also affirms each country's obligations and rights under the WTO agreements on technical barriers to trade, and conservation and environmental issues.

Each country's technical standards must provide for both "Most Favoured Nation Treatment" and "National Treatment". This has two important implications:

- goods and services imported by one NAFTA country from another cannot be treated less favourably than like goods and services imported from a non-NAFTA country;
- each NAFTA country must treat goods and services originating from another NAFTA country as favourably as its own goods and services. For example, a government tender in Mexico may not treat a bid from a Mexican company more favourably than a similar bid from a Canadian or American company.

Intellectual Property

NAFTA recognises the growing importance of intellectual property rights and sets out specific commitments with respect to copyrights, patents, trademarks, trade secrets, integrated circuits (semiconductor chips), industrial designs, plant breeders' rights and geographical indications. The general approach has been to build on the work done in the General Agreement on Tariffs and Trade (GATT), now the WTO, and various other international property treaties

Each country is committed to provide adequate protection and enforcement of intellectual property rights against infringements, internally and at the border.

Antidumping and Countervailing Duty Determinations

NAFTA explicitly preserves the right of each country to retain its antidumping and countervailing duty determinations. Each country also retains the right to amend its laws subsequent to NAFTA coming into effect.

It is important that exporters to NAFTA countries ensure that costs and prices do not infringe upon these anti-dumping regulations.

Emergency Actions

This section of the agreement establishes the rules and procedures under which a country may take “safeguard” actions, through the use of tariffs and quotas, to provide temporary relief to industries affected by import surges. These are intended to operate internally in the NAFTA region, but their intent is similar to the protection provided to an importing country under Article XIX of the WTO.

LIKELY FUTURE DEVELOPMENTS

It is a basic assumption that trade improvement initiatives such as NAFTA result in positive benefits. There is no doubt that they cause business shifts and restructuring, and some level of labour redeployment. But there is clear evidence that the overall economic health of a participant country is enhanced as trade and other barriers are eliminated.

NAFTA provides for the admission of additional member countries and there is every indication that this will occur in the near future. Candidates for membership must receive the approval of each of the three founding signatories and be subject to acceptance of their terms and conditions. There is no provision in the agreement for any of the content of NAFTA to be changed as the result of the admission of new members.

Negotiations are already in process with the first applicant, Chile. These are likely to proceed without undue delay. Chile, although only a small country of 14 million people, has for the past decade instituted market reforms, lowered trade barriers, and reduced inflation. These actions have attracted outside investment and resulted in a sustained high annual economic growth rate -- an average of 7% over the past eight years.

As much of Latin America has already experienced initial free trade effects, further applicants are expected to follow. Argentina and Colombia are being mentioned as probable leaders in this regard. Current free trade groupings in Central and South America include Mercosur (Brazil, Argentina, Paraguay, Uruguay), Andean Pact (Ecuador, Bolivia, Colombia, Venezuela, Peru), and a Central American Common Market aligned with Mexico. The population of these countries, which could eventually join NAFTA, would add more than 300 million people to the current market, almost doubling its size.

There have also been suggestions that NAFTA could extend beyond North and South America. There appear to be no legal exclusions to this potential expansion path. New Zealand has been mentioned as a possible candidate for future membership.

Experience suggests that new entrants, to the extent possible, must have their fiscal and monetary “house” in order prior to admittance to membership in NAFTA. Although the long term benefits of increased trade and economic growth remain attractive, countries with a high level of protectionism and state intervention are not well prepared to deal with open markets that result from free trade agreements.

SAMPLE CALCULATION OF REGIONAL VALUE CONTENT (RVC)

Using the Transaction Value Method (TV)

TV = the total payment made by the buyer to the producer of the good

VNM = the value of non-originating materials used to produce the good

$$RVC = \frac{(TV - VNM)}{TV} \times 100$$

Example: $RVC = \frac{(1000 - 600)}{1000} \times 100 = 40\%$

Conclusion: This product does not qualify for preferential treatment - it does not achieve the 60% RVC level for the TV method.

Using the Net Cost Method (NC)

NC = the total cost of the good less selling, marketing, shipping and royalty expenses

VNM = the value of non-originating materials used to produce the good

$$RVC = \frac{(NC - VNM)}{NC} \times 100$$

Example: $RVC = \frac{(1000 - 450)}{1000} \times 100 = 55\%$

Conclusion: This product qualifies for preferential treatment - it achieves the 50% RVC level for the NC method.