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Free trade...but at what price?

By Andrew Vanderwal

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Free trade ... but at what price?

The cost saving opportunities and regulatory risks of free trade agreements must be carefully considered when making strategic production and procurement decisions, believes Andrew Vanderwal of PricewaterhouseCoopers.

In the last decade, there has been an explosion of free trade agreements. While current WTO multilateral negotiations remain mired in disagreements between developed and developing countries, bilateral and regional free trade agreements, or FTAs, are being signed and implemented, and many more are either proposed or being negotiated by impatient nations – both developed and developing.

Aptly, countries – such as the U.S. – have replaced the term "Most Favoured Nation" (MFN) with "Normal Trade Relations" (NTR) when referring to the rates between established trading partners, because such rates are no longer the best available. Rather, the bilateral or regional FTA duty rate is the rate to be had and, best of all, it's not just favourable, it's usually free!

Is there a catch?

Yes, not surprisingly, there's a catch – several in fact. Claiming the NTR rate requires meeting standardized customs proof of origin rules. Obtaining the FTA rate, on the other hand, requires proof that the goods qualify under FTA-specific origin rules. This is rarely an easy task, and one that could result in customs penalties if ignored. Countries that implement FTAs actively enforce the FTA-specific origin rules because it is not their intention to offer free trade with all countries – just those with which they have FTAs. The FTA is negotiated with certain trade-offs and rules of conduct that apply specifically to the named signatories and none other.

Qualifying for FTA-specific "rules of origin" is not to be taken lightly. Companies reading the origin rules for the first time may find them arcane. IFTA origin rules first introduced the "tariff shift" and "regional value content" concepts, as well as a myriad of not-so-obvious clauses with either extra requirements and/or exceptions that can either help or hinder a company's effort to qualify its products for FTA duty-free treatment.

To make matters worse, the burden of qualifying products for FTA savings falls significantly upon the producer. However, the producer is commonly not the company that benefits directly from the FTA savings, as it may sell to distributors or other producers who actually obtain the FTA duty-free treatment – for themselves or for their customers. In these cases, producers cannot always justify to their management the cost incurred to track and evaluate data required to prove FTA eligibility to their customers. Of course, the producer benefits indirectly by offering more regionally competitive products to their customers (for example, either duty-free finished goods or an "originating" material that the customer may use to help qualify their finished product for FTA benefits). However, domestic sellers and buyers typically focus on specifications, quality and price, rather complex customs considerations even when FTA duty cost avoidance opportunities exist – or they assume that "bought from" the U.S. or Mexico translates directly into "U.S. origin" or "Mexican origin" for customs and FTA purposes.

Matters are further complicated because the front line staff typically faced with determining FTA origin qualification are commonly the sales, production or engineering staff with whom the buyer's purchasing staff has primary contact...and leverage. Although these staff possess knowledge about the types of materials or components used to make the product, they are not usually familiar, or experienced, with customs matters in general, or FTA origin rules in particular. They may also not have a corporate process to track the country of origin of production inputs systemically.

In a perfect world, all producers and customers would have efficient systems to analyze the costs and benefits of providing, collecting and/or applying FTA origin rules to each international situation. In reality, they are simply not equipped, or given the incentive, to do so, especially in the current environment of administrative and production cost containment.

FTA origin compliance activities may be one of the first tasks to fall victim to cost cuts (regulatory compliance or penalty cost-avoidance is often not perceived as cost-justified until after a company has endured significant "pain" or fear of impending penalties). Another reality is that origin responsibility may not be properly placed in an organization with the requisite specialists. Often employees with other primary, non-regulatory functions may be assigned the task of FTA certificate issuance without proper training and experience.

International trade association courses are like revolving doors of such poor souls who eagerly attend to learn what they need to know to perform their job well. They are usually shocked (jaws fixed in a dead drop) when they see what is actually involved. At their first opportunity, they try to pass the onerous responsibility on to another unwitting soul who soon discovers what they've inherited. Unfortunately, if this hot potato continues to be passed about, management may only learn the reality when faced with a customs verification, audit, additional duty or penalty assessment - on past as well as current sales.

The bad news may not end there. These days, governments are downright compulsive about identifying and entering into new FTAs – selling their benefits to business without equal communication to corporate executives

Biography

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about the administrative and regulatory burden each new set of FTA origin rules requires. We expect this is not due to government's lack of awareness about the complexity of FTA origin rules because, as noted above, they have a vested interest in setting rules which are difficult to violate. Because of this, in certain low duty rate jurisdictions, for example, the U.S., unless volume is substantial, the cost of FTA compliance may be greater than the actual NTR duty rate as a cost of goods sold. But negotiations continue.

It is important to note that when a business qualifies a product for duty-free treatment under one FTA agreement, the results cannot be directly used to qualify the same product under another FTA – that would be too efficient. Alas, the wisdom of WTO multilateral trade agreements may eventually dawn, and global enterprises may invest in their government's efforts to revive the successful WTO multilateral trade negotiating rounds of the past. However, government trade negotiators have many masters to please – domestic industry as well as competitive exports, environmentalists as well as trade unions – so separate and different FTA origin rules remain the order of the day.

Because FTA origin rules are not uniform, companies qualifying a part or a finished good under one FTA must then move on to the task of qualifying the same part or finished good under the next FTA affecting the company's markets or customers...and then the next, and then the next and so on. Canada has four FTAs implemented and a further eight identified or under negotiation. The U.S. has nine FTAs implemented and a further 13 identified, under negotiation, or signed but not yet implemented. Mexico – which has seized the FTA gold ring as a foreign trade strategy – has 12 FTAs implemented and several more identified or under negotiation. So, the only certainly is the extra workload to determine If goods qualify under these various FTAs.

So what is a company to do?

In the past, some producers and distributors have just issued FTA certificates of origin and hoped for the best. This carries substantial corporate risk relating to the imposition of import and/or export penalties and interruption of supply chains. With bilateral and regional FTAs on the increase, the exposure is too great, and the competitive advantage too significant to the bottom line, to simply ignore the FTA benefits.

In the first decade following the implementation of the North American Free Trade Agreement (NAFTA), many Canadian, Mexican and U.S. companies simply assumed their products would automatically qualify for this duty-free trade. They made their products locally using locally sourced materials – how could they not qualify? Consequently, many companies did not establish complete free trade qualification audit trails that could be shown to national customs authorities upon request to demonstrate their regulatory compliance with the origin rules. (Let's not forget to mention that FTA origin rules are adopted as national law by each participating country.) Nonetheless, when push comes to shove, some companies with informal audit trails were vindicated – that is, products under audit retained duty-free benefits, though not until after substantial resources were invested to rapidly collect data and prove eligibility under NAFTA origin rules.

But this approach is simply bad business. Now companies in most industries, large and small – domestic and global – supplier and manufacturer, are rushing to remain competitive by buying more and more materials, parts and components from lower cost countries...and to implement origin management "Best Practices". Many lower cost country sources, such as China, are stepping up to meet the increased demand. This means that North American companies can no longer risk a wait-and-see attitude for NAFTA qualification or other FTAs; they must perform advanced planning as part of routine business practice.

Being caught with having claimed duty-free status for products that do not actually qualify under origin rules for a particular FTA can result in substantial retroactive duty assessments with interest and penalties heaped on top. Moreover, if it is the company's customer that gets hit with these unexpected costs as a result of the company not being able to support the certifications made to their customer by an officer or authorized employee, many a customer will be none too happy, in civil court, or simply gone. Buyers who have "gone global" are becoming more and more savvy and are commonly including information responsibility and liability clauses in purchase orders and contracts. As a result, customers may both require origin data as a condition of payment as well as charge back to the supplier any unexpected customs assessments due to inaccurate supplier data.

As noted above, there is always the alternative of not issuing FTA origin certificates. That is, a supplier may simply inform its customers that it will not evaluate FTA eligibility for one or all pertinent FTAs and will issue a "non-eligible" certificate, or even no certificate at all. That may work – in the short term – as customers may not consider FTA duty rates in the buying decision. However, customers are discovering the extra duty cost they are paying, and/or the difficulty

Nissan: a case study

Let's consider the case of Nissan North America. Until recently, Nissan North America, the U.S. subsidiary of the global parent in Japan, had both automated and manual origin solicitation and certificate issuance processes with its suppliers, and only a manual regional and domestic content calculation process. Additionally, as with others in the domestic and international car industry, Nissan is diversifying its sourcing and expanding export markets and creating new challenges to maximizing savings under an increasing number of FTAs. Although Nissan qualifies intermediate and finished goods (vehicles, after-market parts and production components) under NAFTA, it now has to qualify many of the same goods under the U.S. - Chile Free Trade Agreement, the U.S. - Australia Free Trade Agreement, and soon, under the U.S. - Bahrain, U.S. - Jordan and U.S. - Dominican Republic - Central America free trade agreements and others. Successful global expansion means the list will keep growing. Nissan concluded that the increased volume in origin solicitation, analysis, processing and routine administration would be more effectively conducted with the use of external, centrally administered automation-support which would reduce the need to expand in-house staff and systems as additional FTAs were implemented. To accomplish these objectives, Nissan secured the services of a third-party service provider that had developed a XML web-services technology. This technology was designed to provide leading-edge automation, without the hassles and cost of running it on in-house hardware, developing customized code or adding additional staffing resources to support each newly applicable FTA, source country and/or export market. Moreover, the technology comes with a manned-service support centre. This technology also provides an opportunity to establish visibility into the FTA implications for sourcing decisions.

Leslie Cazas, Senior Manager, Customs & Trade for Nissan North America, provided information for this article.

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they are having qualifying their own production for FTA savings. Customers are increasingly incorporating FTA eligibility requirements into their sourcing decision and contracts. Oh, and lest we forget, to import and export any goods into or out of any country, the importer and exporter typically must state in writing (either on the commercial documents or other non-FTA certificate of origin) what the country of origin of the product is in accordance with prevailing WTO rules of origin. Therefore origin data is required for all global transactions, whether or not duty-free benefits attach. The only voluntary part of this is the producer's inclusion of certain parts in their determination of end product FTA eligibility or the importer's claim for duty free FTA benefits.

Other options?

Obviously, the head-in-the-sand approach doesn't work. The onerous FTA origin requirements will not go away anytime soon, even if there is a resurgence of support for the WTO multilateral tariff reduction approach. There has been talk of evolving some FTAs into customs unions, such as the one in place within the EU. In a customs union, "border crossings" subsequent to the customs formalities at the first port of entry in the union do not require proof of origin to avoid reassessment. With customs unions, once a good has been entered by the customs authority of any one member of a customs union, it may move "freely" anywhere within the union without additional duties or customs formalities. Duties initially collected at the first port of entry are pooled into union revenues. However, don't hold your breath on this. Implementing a customs union entails a significant abdication of sovereignty, something most countries (the U.S. being no exception) are loath to do.

What about ignoring FTAs? This is simply unrealistic to corporate survival for many companies. It has become imperative to secure FTA duty rates – whether for a company's own imports or those of their customers. Almost always, normal duty rates result in a competitive disadvantage.

Take for example an automobile made in North America. The North American automobile industry is rationalized so that individual plants serve the entire North American market, as well as other export markets for which each country may have its own separate FTAs, in addition to Nafta. It would be devastating for an automotive line not to qualify under NAFTA when the NTR duty rate is 6.1% into Canada, 2.5% into the U.S. and 20% (and higher) into Mexico. With a high volume and value of automobiles crossing North American borders daily, the extra duty for any company – and the consumer – is huge and can be sufficient to make a car uncompetitive in the marketplace.

Using technology

Some companies have developed complex and expensive in-house programmes to automate the solicitation of origin data from the supplier, analysis of the data against the FTA origin rules for their main markets and the FTA certificate issuance process. These companies may eventually find themselves having to incur the cost, not only of maintaining this software, but also rewriting it to be compatible with other system developments. Information technology evolves so rapidly that specialized programmes are obsolete within a matter of a few years. Even if initially cost effective, the cost of new programming to add and manage all the new FTAs, is not.

Some companies transfer the entire internal processing to an outsourced alternative while retaining strategic planning and regulatory compliance oversight. With technological advances over the last number of years, service providers can now offer technology to clients without requiring the client to run customized software on their own machines. Computer infrastructure run and maintained by a service provider are becoming seamless extensions to client IT infrastructures. Customs origin applications are now entering this new realm of technology, making it much more cost-effective for clients to adopt the technology to automate and improve their origin processes.

Imagine this situation: a company's bill of material and other production data are passed to the outsourced service provider's origin applications through secure data transfers. Origin data is solicited electronically by the service provider from suppliers which provide supporting documentation online, accessing the origin application through a company's portal with seamless single sign-on. Data is tested for integrity and processed against multiple FTA origin rules. Origin analysis results are available to authorized company users through a secure internet connection. Experienced staff review the data to identify the impact that changes to cost, origin source or production location would have on the specific FTA eligibility for a particular product. Strategic purchasing and/or production decisions are made. FTA (as well as non-FTA country of origin) evidence and an audit trail are available to company staff which issue certificates of origin through several mouse clicks. Science fiction? Hardly. This functionality is available now, and is becoming increasingly robust by the day.

Time for best practices?

Competitive companies cannot ignore the need to manage FTA origin properly, nor should they relegate it to non-expert staff to be dealt with off the corner of his or her desk. The costs saving opportunities and regulatory risks of FTAs must be carefully considered when making strategic production and procurement decisions. Attendant administrative costs and responsibilities must be embraced as an investment in competitiveness. However, these costs may be defrayed with a combination of experienced in-house management and appropriate use of external automation and specialized service providers.