U.S. Foreign-Trade Zones: Trade Agreement Parity (TAP) Proposal

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Summary

The National Association of Foreign Trade Zones (NAFTZ) has developed the Trade Agreement Parity (TAP) proposal, introduced as H.R. 6415 (Pascrell in the 110th Congress) to address what NAFTZ claims as the "unintended consequences" of free trade agreements. These are that free trade agreements (FTAs), in granting tariff advantages to businesses that import components or products from FTA countries, put companies that import components from *third countries* (not a party to an FTA) at a tariff disadvantage. Critics, however, say the effects the bill generally sought to address are the exact intended consequences of FTAs: the United States extends preferential tariff treatment to components from an FTA partner country in exchange for that country's lowering of its tariff rates on U.S. products.

The TAP proposal would permit certain businesses to permanently "borrow" U.S. free trade agreements (FTAs) in order to import components at rates below those they would normally be charged under U.S. tariff law. There would be two stipulations: (1) the products using third-country components would have to be produced in a U.S. *foreign-trade zone;* and (2) the product would have to meet the rules-of-origin (domestic content) requirements of any FTA—which could be satisfied by using entirely third country parts and U.S. labor, without input from any other FTA partner country.

The TAP proposal is reportedly being widely promoted on Capitol Hill by its association sponsor, the NAFTZ, as a tool for helping multinational corporations sourcing from *non-FTA* countries "level the playing field" to achieve tariff parity with manufacturers sourcing from U.S. FTA countries. In addition, it has been the subject of an editorial in the *Wall Street Journal* and the subject of two economic studies: a staff study by the U.S. International Trade Commission (USITC); and a study prepared for the NAFTZ by economists Dean A. DeRosa and Gary C. Hufbauer.

Major policy implications of extending FTA-related benefits to goods from non-FTA countries include impacts on U.S. parts producers, customs revenue collections, and trade and diplomatic relations with FTA partner countries; the potential for the FTZ Board to be swamped with new applications for FTZ status, and to be under increased political pressure to grant such status; a debatable assertion by its association sponsor that it would create new U.S. jobs; and its impact on the ability of the U.S. Trade Representative (USTR) to negotiate future FTAs.

The primary beneficiaries of TAP appear, from the analysis that follows, to be foreign multinational corporations (especially motor vehicle producers) that source components from non-FTA countries (i.e., China, Japan and the European Union), and some oil companies that operate U.S. refineries. Potential losers could include parts producers in the United States and FTA countries and U.S.-owned motor vehicle producers that source components from Mexico and Canada.

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Introduction

The National Association of Foreign Trade Zones (NAFTZ) developed the Trade Agreement Parity (TAP) proposal, introduced as H.R. 6415 (110th Congress) by Representative William Pascrell,[1] to address claimed "unintended consequences" of free trade agreements.[2] These are that free trade agreements (FTAs), in granting tariff advantages to businesses that import components or products from FTA countries, put companies that import components from *third countries* (not a party to an FTA) at a tariff disadvantage. To remedy this "problem," TAP would "level the tariff playing field" by permitting companies operating in foreign-trade zones (FTZs) to "borrow" permanently[3] U.S. free trade agreements (FTAs) for their own use, to reduce or eliminate tariffs on components from third countries.

Critics of the TAP proposal view the "unintended consequences" TAP seeks to address as exactly the intended consequences of FTAs. The United States agrees to preferential duty treatment on components coming from an FTA partner country in exchange for that country's lowering its duty rates on U.S. products. The effect of the TAP proposal would be to provide FTA-related preferential duty treatment to components from third countries that have *not* signed FTAs with the United States and have *not* made compensating reductions in their own duty rates on U.S. products.

Under the TAP proposal, companies with U.S. manufacturing facilities could apply to the U.S. Foreign Trade Zones (FTZ) Board for manufacturing authority. With FTZ manufacturing authority, such corporations would then be entitled to reduce or eliminate tariffs on imported components under the rules of origin and tariff provisions of *any* free trade agreement.[4] This means that so long as the product meets the rules of origin (U.S. domestic content or value added and/or substantial transformation) requirements of any FTA, the tariff benefits of that FTA would apply. The rules of origin requirement can be satisfied by using any combination of U.S. and/or third country parts and labor exclusively. No parts, labor or input of any kind would need to come from any FTA country.

U.S. foreign-trade zones and subzones are physical areas geographically located in the United States but considered to be outside of U.S. customs territory for purposes of the tariff laws and customs entry procedures.

Subzones are special-purpose zones established as an adjunct to a zone project for a limited purpose (for example, a stand-alone manufacturing facility).

FTZs and subzones provide special customs procedures to U.S.-located facilities using foreign inputs, which consist of FTA-country inputs and/or third country inputs. For items that are processed in FTZs and then exported, no duties are payable. If, instead, the processed items are

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[1] The Pascrell bill did not mention the words "trade agreement parity," although its provisions were substantively identical to those in the NAFTZ proposal. H.R. 6415 would have "provide[d] that goods that are manufactured in a foreign trade zone and comply with the rules of origin under a trade agreement to which the United States is a party may enter the customs territory of the United States at the rate of duty applicable under that agreement.

[2] National Association of Foreign-Trade Zones. Trade Agreement Parity (TAP) Initiative Endorsement Statement.

[3] Unless the privilege were revoked.

[4] For information on rules of origin, see CRS Report RL34524, *International Trade: Rules of Origin*, by Vivian C. Jones and Michael F. Martin.

then imported into the United States, no duties are payable on the foreign inputs until the goods leave the zone. At the time the merchandise leaves the zone for sale in the United States (i.e., is "entered for consumption"), the duty may be paid either on the condition of the merchandise as it leaves the zone (with authority from the FTZ Board), or on its condition as it was first brought into the zone.

FTZs help offset customs advantages available to businesses which produce goods offshore and then import them into the United States for consumption duty-free under FTAs or preferential tariff programs such as the Generalized System of Preferences (GSP), the Caribbean Basin Economic Recovery Act (CBERA), the Andean Trade Preference Act (ATPA), and the African Growth and Opportunity Act (AGOA).

In recent years, growth in FTZ activity has continued. While average zone savings per facility may be lower, the contributory effect from the use of zone procedures on a U.S. plant's overall cost reduction efforts may be more significant than in the past. While the contributory effect will vary by industry, the savings from the use of zone procedures may have an impact on whether the production costs at a U.S. facility are competitive with a plant abroad. Many companies maintain manufacturing facilities throughout the world and are able to shift production among plants. Any action taken by the U.S. facility to reduce its costs can have an impact on the maintenance of the activity and associated employment in the United States.

Why is This Proposal of Interest to Congress?

The TAP proposal is of interest to Congress for a number of reasons. It reportedly is being widely publicized and promoted on Capitol Hill by its association sponsor, the NAFTZ as a tool for increasing competitiveness and economic development. It is reflected in legislation that has been introduced in Congress (H.R. 6415 in the 110th Congress). It has been the subject of an editorial in the *Wall Street Journal*.[5] In addition, two economic studies have been undertaken on it. One is a staff study by the U.S. International Trade Commission (USITC). The other is a study prepared for the NAFTZ by economists Dean A. DeRosa and Gary C. Hufbauer.[6]

Economic, Policy, and Administrative Implications

The TAP proposal is a complex issue, with potential economic, policy, and administrative issues and implications. Economic issues, if Congress were to approve TAP, would include (1) the effect of TAP on U.S. parts producers; and (2) the effect on Customs duties collectable.

A major trade policy consideration is that U.S. FTA partners agreed to preferential duty treatment for components coming from the FTA partner country in exchange for that country's lowering its duty rates on U.S. products. The effect of the TAP proposal would be to provide FTA-related preferential duty treatment to components from third countries that have not signed FTAs with the United States and have not made compensating reductions in their own duty rates on U.S. products. Identified trade policy issues include (1) the tariff benefit given operations that would

[5] A Democrat's Good Idea. The *Wall Street Journal*, July 12, 2008, p. A-10.

[6] *The Economic Impact of Trade Agreements Parity for Manufacturing Firms Operating in U.S. Foreign-Trade Zones*. Study prepared for the National Association of Foreign-Trade Zones by Dean A. DeRosa and Gary Clyde Hufbauer, March 27, 2008.

ordinarily be required to pay tariffs on imports; (2) the extension of FTA benefits to non-FTA countries; (3) the impact of TAP on trade and diplomatic relations with FTA partner countries; (4) the creation of a new trade preference program through TAP; and (5) the impact of TAP on the USTR's ability to negotiate future FTAs.

The TAP proposal may have implications for the USFTZ Board, made up of designees of the Secretaries of Commerce and Treasury, an Executive Director, and a staff of seven professionals. The USFTZ Board would be the gatekeeper charged with ensuring on a case-by-case basis, after a lengthy process, that granting FTZ status for TAP purposes would not be "detrimental to the public interest."

Possible issues include (1) the potential that a flood of new applications by businesses for FTZ status could swamp the U.S. Foreign-Trade Zones Board, necessitating a substantial increase in administrative resources to handle the increased requests for FTZ status; (2) the FTZ Board staff would take on the new burden of determining whether or not processing activities in subzones would meet the rules of origin requirements of an FTA and whether duty-free treatment for articles meeting the requirements would be in the public interest; (3) the potential that TAP could shift certain tariff policy decision-making responsibilities from the Office of the U.S. Trade Representative to the U.S. Foreign-Trade Zones Board.

Organization of This Report

The box below is a quick reference guide assisting the reader in going directly to key sections of this report, which is organized, in greater detail, as follows.

First this report defines and describes USFTZs: What are they? How did they come about? How do they relate to the world-wide system of free trade zones? What are the benefits of producing in a USFTZ today?

Second, the report explains the TAP proposal and how it would work. TAP (H.R. 6415 in the 110th Congress) would amend two separate laws—the US Foreign Trade Zones Act and the NAFTA implementing legislation. This second section explains the implications of the TAP language, the application process for FTZ status under TAP, and how the Harmonized Tariff Schedule would apply to businesses with FTZ status under TAP. It then includes real-life examples of how TAP could be applied to the automotive industry.

Third, the paper identifies potential winners and losers and reports on the arguments of proponents and opponents of TAP.

Fourth, the report examines and analyzes two economic studies—one a staff report from the U.S. International Trade Commission (USITC), and the other a study prepared for the NAFTZ by economists Dean A. DeRosa and Gary C. Hufbauer.

Quick Reference Guide for Highlights of this Report

Fifth, the report examines policy implications of the TAP proposal.

Sixth, it examines legislative options for Congress, including possible legislative approaches that could accomplish the same purposes of TAP without some of the negative implications.

Finally, this report offers some conclusions.

What are U.S. Foreign-Trade Zones?[7]

US-FTZs are Free Trade Zones

U.S. foreign-trade zones are the U.S. version of what are commonly known as *free trade zones.* In general, free trade zones are geographic areas which are physically located *inside* the boundaries of a country, but are treated as though they were located *outside* the country for customs purposes. U.S. FTZs operate under the direct daily supervision of U.S. Customs and Border Protection (CBP). In addition, U.S. FTZs remain within the jurisdiction of local, state or federal governments or agencies.

Because zones exist in many countries worldwide, goods in the making can move from zone to zone under streamlined customs procedures, having value and parts added until they are at last complete. No tariffs are owed on goods or materials until they exit the zone system, at which time the importing company pays any applicable duties.

The U.S. system of foreign-trade zones consists of *general purpose zones*, which are essentially secure, multi-user facilities where activities such as warehousing, repackaging, labeling, quality assurance, manufacturing, and distribution can take place; and *special purpose subzones*, which are single-use sites which are geographically separated from general purpose zones but affiliated with them for recordkeeping and organizational purposes.

History and Purpose of USFTZs

The U.S. Foreign-Trade Zone program was created in 1934 by the *U.S. Foreign-Trade Zones Act* (P.L. 73-97).[8] It was designed to accelerate U.S. trade in the wake of the restrictive impact of the *Smoot-Hawley Tariff Act* of 1930, which raised U.S. tariffs on imported goods as high as 53%. Other countries had retaliated similarly, and international trade, considered a major force for economic growth in most countries, came to a near standstill. At the time, the FTZ concept was controversial because some feared that it would promote imports of cheaper components in the manufacturing process, and thereby put U.S. components manufacturers at a competitive disadvantage. As a result, zone activity was initially limited, and manufacturing was not permitted in FTZs until 1950.

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[7] Information from this section, except as otherwise indicated, was taken from CRS Report RL30268, *U.S. Foreign-Trade Zones: Current Issues*, by Mary Jane Bolle. See also, U.S. Customs and Border Protection. *Importing into the United States: A Guide for Commercial Importers*. (2006, Ed.), p. 151-154. In addition, see Frequently Asked Questions, available on the U.S. Foreign-Trade Zones Board website at http://is/ita.doc.gov/FTZpage/index.html.

[8] The act and its amendments over the years can be found at 19 USC 81(a) et seq. Regulations issued by the U.S. Foreign-Trade Zones Board for establishing and maintaining a foreign-trade zone can be found at 15 CFR 400.

Most zones around the world are "export" processing zones in that they produce for export abroad. While FTZs in the United States were primarily *export processing zones* between 1982 and 1995, since 1995 they have become primarily *import processing zones* in that 84% of the imported components end up in the United States (2006 FTZ data).[9] This is due largely to the fact that the United States is the world's largest market and is the destination market for both goods produced offshore and goods produced at U.S. facilities which compete with offshore facilities.

The system of U.S. foreign-trade zones has evolved greatly over its nearly 75-year history. Envisioned by some as an engine of export growth, USFTZs have continued to evolve and have become largely a system for reversing the *inverted tariff structures* on U.S. imports (higher duties on imported components than on finished products) under the U.S. Harmonized Tariff Schedule (HTSUS). Inverted tariff structures can disadvantage U.S. facilities and can be reversed in FTZs because when assembled goods enter into the customs territory of the United States, the importer has a choice. He can choose to pay the lower of either the rate applicable to the imported input or the rate applicable to the finished article.

Benefits of FTZs Today

In recent years, trade agreements (including the multilateral Uruguay Round Agreements in 1993 and bilateral and regional FTAs) have systematically eliminated many inverted tariff structures. As a result, some observers conjectured a decade ago that FTZs would soon become obsolete. However, in the last 10 years, usage of the FTZ system has continued to grow. As a share of GDP, the value of shipments into foreign-trade zones has grown by two-thirds, from 2.2% in 1996 to 3.7% in 2006.[10]

Despite the overall reduction in tariff rates and the fact that tariff differentials are lower than in the past, global cost competition in many industries has increased. This means that companies focus more than ever on squeezing small savings from every part of the production and distribution process. As a result, although average zone savings may be lower than in the past, their contributory effect on a U.S. plant's overall cost reduction efforts may be more significant than in the past. While the contributory effect will vary by industry, the savings from the use of zone procedures may have an impact on whether the production costs at a U.S. facility are competitive with a plant abroad.

Many companies maintain manufacturing facilities throughout the world and are able to shift production among plants. Any action taken by the U.S. facility to reduce its costs can have an impact on the maintenance of the activity and associated employment in the United States. In 2006 (most recent data), the total value of imported materials entering the United States through USFTZs was $159 billion, which represented roughly 9% of the total customs value of all imports for consumption for that year.[11]

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[9] These statistics reflect 2006 data from the most recent *68th Annual Report of the U.S. Foreign-Trade Zones Board to Congress*, December, 2007. See also, CRS Report RL30268, *U.S. Foreign-Trade Zones: Current Issues*, op. cit., Figure 3, p. 12.

[10] CRS calculations from data included in the *68th Report of the U.S. Foreign-Trade Zones Board to Congress*, listed above, and the *Economic Report of the President,* February 2008.

[11] USITC Dataweb lists the total customs value for all imports in 2006 at $1,845 billion.

Today businesses use zones to save money in at least seven ways aside from avoiding inverted tariffs: (1) *Duty deferral*: Duties need not be paid until goods are transferred from the zone to U.S. customs territory for import; (2) *Duty exemption*: No duty is payable on goods exported from a zone or scrapped, or destroyed in a zone; (3) *Duty drawback elimination*: Zones eliminate the need for duty drawback—the refunding of duties previously paid on imported and then re-exported merchandise; (4) *Tax savings*: Foreign goods and domestic goods held for export in zones are not subject to state and local ad valorem taxes, such as personal property tax; (5) *Quota storage*: Quota restrictions do not apply to merchandise admitted to or stored in a zone until it exits the zone and is entered into a customs territory; (6) *Zone to zone* transfer: Merchandise can be transferred from zone to zone "in bond;"[12] and (7) *Customs inventory efficiencies*: cost savings (especially cash-flow savings) can occur from zone efficiencies affecting inventory control, such as "direct delivery" and weekly (instead of individual) entries on zone deliveries.

Details of the TAP Proposal[13]

The TAP proposal and H.R. 6415 (110th Congress) are substantively the same.

TAP vs. FTAs

FTAs are free trade agreements that are concluded between the United States and one or more foreign countries to eliminate tariffs and various non-tariff barriers over time (usually 10-15 years), on goods traded between or among them. TAP would permit companies to use existing FTAs to import third country components at reduced tariff rates. TAP is distinct from FTAs in that it would (1) permit companies that have applied for and been granted FTZ status for this purpose to import a specific share of third country components (as permitted under the domestic content requirements of the specific FTA) into USFTZs; and (2) "substantially transform" them into finished goods, thus being able to import them into the United States duty-free or at substantially reduced rates.

Purpose of the TAP Proposal

As mentioned, according to its designers, the main purpose of the TAP proposal would be to "equalize the unintended consequences of free trade agreements." NAFTZ argues that U.S. FTAs never intended to put U.S. facilities that import components from "third" countries at a tariff disadvantage relative to companies that source either their components or their final products from FTA countries. A "level playing field," NAFTZ argues, could keep companies from moving abroad in order to obtain tariff-free treatment on third country components.[14]

[12] "In bond" refers to the status of merchandise admitted provisionally to a country without payment of duties, either for storage in a warehouse or for transshipment to another point where duties will eventually be imposed.

[13] See National Association of Foreign-Trade Zones. Draft Proposal for Trade Agreement Parity for U.S. Manufacturers Fact Sheet—Discussion Draft.

[14] See four documents available on the NAFTZ Website at http://www.NAFTZ.org: (1) Trade Agreement Parity (TAP) Legislation; (2) Trade Agreement Parity (TAP)(H.R. 6415) Questions and Answers; (3) Trade Agreement Parity (TAP) Initiative Endorsement Statement; and (4)The Truth about TAP—Setting the Record Straight.

The TAP proposal could then offer companies operating in U.S. FTZs access to "the best and cheapest suppliers worldwide, as a tonic to domestic manufacturing activity." In addition, businesses operating in U.S. FTZs, NAFTZ argues, should be able to obtain components from foreign sources on terms that are at least as favorable as the terms available to" businesses operating in FTA partner countries.[15] Further, the provision, if adopted, could arguably provide a reason for some producers to remain in the United States instead of relocating abroad, to the extent that tariff rates contribute to decisions on where to locate production.

Overview of TAP Legislative Provisions

The TAP legislative proposal is in three parts. Part (a), the main part, would amend the *U.S. Foreign-Trade Zones Act* of 1934[16] to "correct" what the National Association of Foreign Trade Zones (NAFTZ),[17] views as a "problem" or inequality in the Harmonized Tariff Schedule: Functionally identical components for manufactured goods in this country carry different tariff rates under the U.S. Harmonized Tariff Schedule (HTSUS) depending on the country or country group from which they are imported. Components imported from countries with which the United States has a free trade agreement or trade preference program[18] carry a much lower tariff than goods imported from other countries. To remedy this "problem," the TAP proposal would permit importers to pay tariff rates on third country components *as if* they had been imported from an FTA country.

Businesses could qualify for reduced tariff treatment on a case-by-case basis if they met two conditions:

1. The business would have to apply to and be granted U.S. foreign-trade zone (FTZ) authority by the U.S. FTZ Board. This means businesses would need to go through the application process and convince the USFTZ Board that FTZ manufacturing authority and permission to import under a selected FTA would not be "detrimental to the public interest."
2. The finished product produced in the zone would need to meet the relevant rules of origin requirements of any FTA.

Part (b) of the TAP proposal would renumber provisions in the *North American Free Trade Agreement (NAFTA) Implementation Act* (P.L. 103-182) to eliminate a provision which denies NAFTA benefits to goods produced in USFTZs. While this provision was designed to protect U.S. parts manufacturers from competition from Mexico or Canada, it has arguably served to encourage certain businesses to drop their USFTZ status and/or relocate to Mexico or Canada

[15] Evaluation of CRS Memorandum Dated June 16, 2008, Titled: "Proposed NAFTZ Changes to the Draft U.S. Customs Reauthorization Bill (Updated). Comment Prepared for the National Association of Foreign-Trade Zones, July 2, 2008, by Dean De Rosa & Gary Hufbauer.

[16] 48 Stat 98-1003, 19 USC 81a-81u, as amended.

[17] NAFTZ is an organization comprised of 800 businesses, public entities and service providers focused on promoting the use of the U.S. Foreign-Trade Zone Program.

[18] Congress has approved implementing legislation for free trade agreements with Mexico, Canada, Israel, Jordan, Chile, Singapore, Australia, Morocco, Bahrain, Oman, Peru, and the Dominican Republic, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua under the Dominican-Republic-Central America Free Trade Agreement (CAFTA-DR). In addition, four U.S. trade preference programs are currently in effect: the Generalized System of Preferences, the Andean Trade Preference Act, the Caribbean Basin Economic Recovery Act, and the African Growth and Opportunity Act.

instead. The denial of FTA benefits for firms producing in USFTZs was not included in subsequent FTAs.

Part (c) of the TAP proposal would set an effective date of 15 days after enactment.

Legislative Language of H.R. 6415 (110th Congress)

The technical language of TAP proposal parts (a), (b), and (c) was as follows:

Part (a)

Part "a," of the TAP proposal would have authorized businesses to apply for reduced tariff rates on third country components by adding a small provision to the *U.S. Foreign Trade Zones Act* [19 USC Sec. 81(c)(a)] after the word "provided" at the end of the paragraph immediately below. Thus, the proposed new language appears in the indented paragraph below that.

Sec. 81(c)(a) of the U.S. Foreign-Trade Zones Act lists activities that may be undertaken on a good that has been brought into a U.S. foreign trade zone. This section says that a good may be "stored, sold, exhibited, broken up, re-packed, assembled, distributed, sorted, graded, cleaned, mixed with foreign or domestic merchandise, or otherwise manipulated, or manufactured." It may then be "exported, destroyed, or sent into customs territory of the United States ... subject to the laws and regulations of the United States affecting imported merchandise: *Provided,*" and then Part (a) of H.R. 6415 read:

> *further*, That if foreign merchandise is incorporated into a finished good, or is processed, manipulated or manufactured in a zone, and complies with the rules of origin under any agreement which affects the rates of duty for merchandise and to which the United States is a party, then upon authorization under this Act, such merchandise shall enter the customs territory of the United States at the rate of duty provided under the Harmonized Tariff Schedules of the United States for such merchandise that complies with such rules of origin.

Part (b)

Part (b) of the proposed legislative language would have amended the *North American Free Trade Agreement Implementation Act* (P.L. 103-182). It would have renumbered provisions to eliminate language which denies NAFTA benefits for goods produced in USFTZs for importation and consumption in the customs territory of the United States. If the currently existing language included below were removed, NAFTZ users would be eligible to import under NAFTA in the same way that they are currently eligible to import under all other FTAs. The language which H.R. 6415 would have eliminated reads:

> 19 USC Sec. 3332(a)(2)(A) RULES OF ORIGIN: FOREIGN-TRADE ZONES Subparagraph (B) of paragraph (1) shall not apply to a good produced in a foreign-trade zone or subzone (established pursuant to the Act of June 18, 1934, commonly known as the Foreign Trade Zones Act [19 U.S.C.A. Sec. 81a et seq.]) that is entered for consumption in the customs territory of the United States.

If the above clause were eliminated, the currently existing clause below would then govern tariff charges on third country components for goods produced in USFTZs:

> A GOOD ORIGINATES IN THE TERRITORY OF A NAFTA COUNTRY IF: (B)(i) each nonoriginating material used in the production of the good –
>
> (I) undergoes an applicable change in tariff classification set out in Annex 401 of the Agreement as a result of production occurring entirely in the territory of one or more of the NAFTA countries; or
>
> (II) where no change in tariff classification is required, the good otherwise satisfies the applicable requirements of such Annex; and
>
> (ii) the good satisfies all other applicable requirements of this section;

Part (c)

Finally, the amendment would have set as an effective date applicable to any merchandise entered into the United States or withdrawn from warehouse for consumption, 15 days or later after the date of enactment of the bill.

The FTZ Application Process Under TAP

Under TAP, in order to import third country components at tariff rates and under domestic content requirements prescribed under any FTA, a business would need to have FTZ manufacturing authority. To obtain FTZ manufacturing authority a business would have to follow normal USFTZ procedures and apply to the USFTZ Board[19] under guidelines set forth in the Code of Federal Regulations (15 CFR Part 400), with information showing why its proposed manufacturing activity would not be "detrimental to the public interest" based on two sets of criteria.

The first set of criteria is *threshold factors*. To meet threshold factors, the business would have to convince the USFTZ Board that FTZ status for purposes of importing components tariff free under an FTA (1) would *not* be "inconsistent with U.S. trade and tariff law or policy ... formally adopted by the Executive Branch;" that (2) FTZ status would *not* "seriously prejudice U.S. tariff and trade negotiations or other initiatives;" and that (3) "the activity involves items subject to quantitative import controls or inverted tariffs, and the use of zone procedures would be the direct and sole cause of import that, but for such procedures, would not likely otherwise have occurred."[20]

The second set of criteria is *economic factors*. Under economic criteria, the USFTZ Board would consider an application for FTZ status based on its net impact on (1) overall employment; (2) exports and re-exports; (3) retention or creation of manufacturing or processing activity; (4) value-added activity; (5) import levels of relevant products; (6) import displacement; (7) foreign competition in relevant products; (8) related domestic industry; and (9) other factors including technology transfers and investment effects.[21]

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[19] There is a fee to apply for FTZs and subzones. Fees are: for general-purpose zones within a port of entry: $3,200; for subzones, non-manufacturing processing or fewer than 3 products: $4,000; for manufacturing/processing 3 or more products: $6,500; expansions: $1,600.

[20] U.S. Foreign-Trade Zone Regulations, CFR Title 15, Part 400.31(b)(1).

[21] U.S. Foreign-Trade Zone Regulations, CFR Title 15, Part 400.31(b)(2).

The application process for FTZ authority is lengthy and involved for both the applicant and the USFTZ Board, and typically takes six months to a year. However, the Board may determine that it requires additional time based on special circumstances.

Processing any business application for FTZ status requires considerable research and preparation on the part of the Board, which shall be responsible for publication in the Federal Register of a notice, invitation for public comment, and time for rebuttal by the applicant. During the process, Board examiners must also conduct their own research in addition to that presented, conduct hearings as necessary, review case records and public comments, request evidence, develop information and evidence necessary for analysis of the threshold and economic factors, and report on their findings. An examiner's report, along with the technical report from the local Customs and Border Patrol (CBP) Port Director, is circulated to CBP headquarters and the Treasury Department for review and concurrence before final action can be taken by the FTZ Board in the Commerce Department.

FTZ Board regulations provide that in the course of being considered for FTZ status, the applicant will be permitted a number of opportunities to provide supplemental information. The applicant may be notified of deficiencies in the application. If a USFTZ Board decision on the application is *unfavorable*, it shall be considered preliminary. The applicant may then provide additional evidence, which the Board would consider in its review.

If, in its final report, the Board rules against the applicant, based on any of the threshold or economic factors, it shall deny or restrict authority for the activity. In evaluating the economic factors, "previous evaluation in similar cases are considered. The net effect is arrived at by balancing the positive and negative factors and arriving at a net economic effect." [15 CFR 400.31 (c)].

The Board has, on occasion, denied FTZ status, particularly in certain kinds of cases. More frequently, the Board implements specific restrictions on approval to address in a targeted manner issues or concerns. The Board will deny or restrict an application where granting zone status would handicap other businesses in the industry. On the other hand, once a business in a specific industry has obtained FTZ status, this could provide a precedent for future applications involving similar activity. In other cases, the USFTZ has denied zone status based on policy considerations such as those relating to agricultural products and textiles.

Which Tariff Schedule Rates Would Apply to Businesses Granted FTZ Status Under the TAP Proposal?

Once a business receives FTZ Board approval to undertake manufacturing under a specific FTA, as provided by the TAP proposal, it would be eligible for the reduced tariff rates applicable to that FTA under the U.S. Harmonized Tariff Schedule (HTSUS)[22] The tariff rates to be assessed the business on third country components would be determined as follows:

[22] The HTSUS, produced by the U.S. International Trade Commission (USITC), provides the applicable tariff rates and statistical categories for all merchandise imported into the United States; it is based on the international Harmonized System, the global system of nomenclature that is used to describe most world trade in goods.

In the HTSUS, there are three columns representing tariffs assessed to three different groups of countries. The first is called "*Column 1, General.*" It shows the "general" rate—often referred to as either the "most favored nation" (MFR) rate or "normal trade relations" (NTR) rate—assessed to most countries.[23] The second is called "*Column 1 Special.*" It shows the "special" rates assessed articles from countries with which the United States has free trade agreements (FTAs); articles from beneficiary countries under various trade preference laws (i.e., the Generalized System of Preferences—GSP); articles eligible for duty-free treatment under special programs, such as the Civil Aircraft Agreement; and articles eligible for the temporary suspension or reduction of duties. The third is called *Column 2*. It provides the much higher rate charged to countries to which the United States does not apply NTR rates. Currently in this list are Cuba and North Korea.[24]

With FTZ status, approved businesses would then be eligible to pay the reduced tariff rate in *"Column 1, Special"* for the FTA they are authorized to import under, instead of the current tariff rates under "*Column 1, General*."

Potential Real-Life Examples: Importing Without vs. With TAP

The following examples show how a business might save money on tariff assessments under TAP, when importing under the applicable FTA of its choice.

Example 1: An Auto Assembly Plant Importing Components from China under the Jordan FTA

As the law currently stands, without the TAP proposal, assume Company A, a foreign-owned, U.S. based business, has an auto assembly plant in the United States and is operating in an FTZ to take advantage of the inverted tariff structure for autos. The company imports auto parts from China (some with a duty rate up to 5%) and assembles the finished vehicle, which has a duty rate of 2.5%. Under FTZ procedures the company has the choice of paying the duty on the foreign components in their condition as they leave the zone (i.e., as an assembled car) rather than as they enter the zone as components. In this way, it is able to reduce its duty rate on foreign components from 5% to 2.5%. As in all FTZ operations currently, the duty rate comes from the general Column 1 duty rate in the Harmonized Tariff Schedule of the United States.

Under the TAP proposal as written, Company A could seek authority to apply the rules of origin (including local content requirements) and duty rate from the *U.S. Jordan FTA* to the assembled cars leaving the subzone. Under the Jordan FTA, the duty rate on the cars would be zero, providing the company with a savings of the 2.5% tariff it pays currently on the value of the parts imported from China.

[23] Column 1 "general" tariff rates differ by industry, and many tariff rates are zero, especially on products not manufactured in the United States. Components involved in FTZ manufacturing activity generally have duty rates less than 10%. Average U.S. tariffs, as reported by the World Bank, were 2.7% for 2007. Source: The World Bank. Table 1. *Trends in Average Applied Tariff Rates in Developing and Industrial Countries, 1981-2007* (Unweighted in %).

[24] Source: *Harmonized Tariff Schedule of the United States (2008)*, General Notes 3(b).

Discussion

In the *U.S.-Jordan FT*A, no specific rules of origin provision was included for automobiles. As a result, the Jordan FTA *general* rules of origin apply. This means that Company A's finished vehicles would quality for duty-free treatment under the Jordan FTA if they contained the minimal amount of 35% U.S. or Jordanian content (including value added by labor). Further, up to 65% of the value of a finished automobile could be comprised of third-country components, and the car would still qualify as "originating" under the Jordan FTA. Thus, it is conceivable that a car with 65% of its value comprised of components from China could have 20% U.S. components and 15% "value added" through the assembly process in a U.S. factory, and then qualify as "originating" (duty-free) automobile under the Jordan FTA.

Since negotiators of the U.S.-Jordan FTA (which was signed in 2000) may not have foreseen that there could be a significant number of vehicle imports from Jordan, the language of the *U.S.-Jordan FTA* and the rules of origin negotiations may not have taken into account potential concerns of the U.S. automobile and auto parts industries. The proposed legislation does not require that the parts used in the assembly be from Jordan, or that Company A or the industry have any connection to Jordan to qualify under the Jordan FTA. While the tariff effect from one company may appear small, the broader impact on U.S. industry could be significant. In addition, the specific impact of allowing duty-free treatment for the industry may not have been evaluated during the FTA negotiations.

Company A's auto assembly is one example of a situation that would be allowed under the TAP proposal. However, the proposal would allow for similar duty free treatment in *any* industry under the rules of *any* FTA.

Example 2: A Truck Assembly Plant Importing Components Under the Morocco FTA

As the law currently stands, assume that Company A also has another assembly facility for pick-up trucks in the United States. Assume further that for this facility, Company A is importing some components from Japan at a duty rate of 5%. The general *column 1* HTS duty rate on the trucks themselves is 25%. Currently Company A would not benefit from FTZ procedures for reversing inverted tariffs, since the *inverted tariff* situation does not exist for trucks (because the U.S. tariff rate is higher on completed trucks than on its components). Therefore, the company has chosen not to pursue FTZ designation for the factory.

Under the TAP proposal, however, Company A could apply for subzone status for its truck assembly operations. In this case, instead of the Jordan FTA (which maintains a 5% duty on the trucks), assume that the company decides to use the Morocco FTA. The Morocco FTA also requires only 35% U.S. or Moroccan content (including value added) to qualify under its rules of origin provision. In addition, the Morocco FTA also has a more favorable—duty-free—rate for trucks. Company A has no connection to Morocco (as it had no connection to Jordan in Example 1), and none of the parts are imported from Morocco. Further, up to 65% of the value of a finished truck could be comprised of third-country components, and the truck would still qualify as "originating" under the Morocco FTA.

Potential Winners and Losers Under the TAP Proposal

The primary beneficiaries of the TAP proposal would appear, from the analysis that follows, to be foreign multinational corporations—especially foreign motor vehicle producers, which could save on their customs duties. Many foreign motor vehicle producers are companies which already do or could assemble their products in USFTZs from foreign parts sourced from countries like Japan, South Korea, and the European Union. These are countries with which the United States does not have free trade agreements, and on whose imports relevant duties may typically be around 2.5%.

Other beneficiaries could include some oil companies that operate refineries in FTZs. Their savings come from an inverted tariff situation on petrochemical products (which are generally duty-free) produced from imported crude oil (which is assessed a duty rate of either 5.25 or 10.5 cents per barrel). Currently, the duty rate on gasoline is 52.5 cents per barrel; however, it is duty free under many FTAs. TAP could increase refinery savings by allowing gasoline produced from imported crude oil to be entered at a rate of duty-free.[25]

U.S. FTZs and various FTZ support groups would also stand to benefit from the TAP legislation.

U.S.-owned motor vehicle producers might not stand to benefit from this proposal to the same extent as foreign-owned motor vehicle producers, because Canada and Mexico are the principal suppliers of foreign auto parts used to supplement the U.S. made parts used in their U.S. vehicle assembly operations. Because most of the imported parts used in the assembly plants of the U.S.-based motor vehicle companies enter free of duty under NAFTA, there was little incentive for these operations to maintain their FTZ special purpose subzone status following the implementation of NAFTA.

Potential losers under TAP could be both U.S. parts manufacturers who could lose market share to imported third country components, and other U.S. manufacturers whose products would compete with articles assembled in FTZs.

Proponents

The TAP proposal is being promoted by some groups as an economic development and economic growth tool, with U.S. employment benefits. These groups include some multinational corporations (especially foreign-owned motor vehicle producers), the National Association of Foreign Trade Zones (NAFTZ) and some economic development groups.

More specifically, according to NAFTZ, proponents of the TAP proposal include the following: Abbott, BMW Manufacturing Co., Centrepot International Logistics, Inc., DNP Electronics America, Eastman Kodak Company, Hitachi Automotive Products, Logistics International, LLC, Toyota, the Association of International Automobile Manufacturers, Sony Electronics, Valero, Conoco Phillips, and Daimer. They also include the following FTZs and related support

[25] For list of oil refineries that operate in U.S. FTZ subzones, see U.S. Department of Commerce, U.S. Foreign-Trade Zones Board. *68th Annual Report of the U.S. Foreign-Trade Zones Board to Congress of the United States*, December, 2007, p. 26-58.

organizations: the National Association of Foreign Trade Zones, Colombus Regional Airport Authority FTZ #138, Dallas/Fort Worth International Airport FTZ #39, Eastern Distribution Center FTZ #24, Florida Free Trade Zones Association, Georgia FTZ Inc, FTZ #26, Greater Dayton FTZ #100, Kansas City FTZ Inc FTZ#15, Greater Rockford Airport Authority FTZ #176, Lawrence Economic Development Corp FTZ #270, NEOTEC FTZ #181, PAC-AM Oakland FTZ #56, Point Trade Services, Port of South Louisiana FTZ #124, Port of Stockton FTZ #231, Organization for international Investment, Summit County Port Authority FTZ #181, South Carolina State Ports Authority, Piedmont Triad FTZ #230, Greater Indianapolis FTZ Inc., and the Rockefeller Group.[26]

Opponents

According to the Automotive Trade Policy Council, representing domestic companies Chrysler, Ford, and General Motors, among other things, the TAP proposal (1) undermines the primary goal of FTAs and offers FTZ producers a subsidy to continue using non-originating content; (2) provides an incentive to minimize NAFTA content, since producers would be able to decrease NAFTA sourcing down to the bare minimum in order to import theoretically cheaper non-originating content duty-free; (3) further disadvantages U.S. corporations operating outside an FTZ, because the most favored nation (MFN) duty rates on third country imports would still apply to those goods not admitted and processed in an FTZ; (4) would not create job growth in the United States because non-originating goods may become duty-free, thus encouraging the expanded use of non-originating goods or components. Thus, any job growth would more likely occur in non-FTA countries; and (5) does not contain an approval process that can limit the inherent flaws, since any FTZ that wanted to participate in this program could do so by receiving the approval of the FTZ authority.[27]

Economic Studies on the TAP Proposal: Findings and Analysis

Two economic studies have analyzed the possible impact of the TAP proposal. The first, a USITC staff report examined the potential effect of the proposal on Customs revenues lost through tariff reduction or elimination. Another study, by two economists Dean DeRosa and Gary Clyde Hufbauer, examines the potential effect of the TAP proposal on Customs revenue losses and counter-balancing economic gains.

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[26] Source: NAFTZ. Trade Agreement Parity (no date) and Trade Agreement Parity (TAP) Initiative Endorsement Statement (also no date).

[27] Automotive Trade Policy Council. Foreign Trade Zone-FTA Parity Proposal. Fact Sheet. (No date.)

USITC Technical Assistance Staff Report[28]

Findings and Methodology

The USITC staff report estimated the potential annual Customs revenue loss from the TAP proposal of "at least $437 million (or 1.5% of the total duties receivable for 2005)[29] if FTZs were granted "parity with" FTAs.

This estimated customs revenue loss is based on actual Customs duties paid in 2005 on the foreign parts and materials that were used in processing operations in FTZs where the processing operations appeared to satisfy the rules of origin requirements of an FTA.

To estimate the potential loss of Customs revenue resulting from implementation of the TAP proposal, Commission staff identified:

> (a) Companies in General Purpose FTZs and Special Purpose Subzones whose processing operations would sufficiently transform or add value to imported parts and materials that the assembled articles would qualify for duty-free entry. This duty-free entry would result from the fact that the processing met the rules of origin requirements of an FTA; and
>
> (b) the duty paid by each company with "FTA-eligible" FTZ operations on third country (non-FTA) components.

The USITC staff then tabulated duty paid by each company with operations that would meet the rules of origin requirements under NAFTA (as a proxy for any FTA) and whose components imported from third countries could thus be eligible for duty-free treatment under the TAP proposal.

Results of the USITC study suggest that the TAP proposal could eliminate almost 90% of actual duties paid by FTZ subzone users, based on 2005 data. The estimate does not take into account FTZ processing operations that became active in 2006 and 2007. The estimate is based on public information contained in annual reports submitted by operators of FTZs including FTZ subzones.

The USITC study noted that the TAP proposal may increase the incentive to use dutiable foreign parts and materials in FTZ processing operations instead of U.S. parts and materials, because the dutiable foreign parts and materials could qualify for "de facto" duty-free treatment.

The summary of estimated Customs revenue loss by principal sectors, based on USITC staff tabulations indicates that the sectors responsible for the $437 million estimated total revenue loss includes motor vehicle assembly ($305 million), petroleum refining ($77 million),

[28] Staff of the U.S. International Trade Commission. *Potential Loss of Customs Revenue Resulting from FTZ Parity with Trade Promotion Agreements*, June, 2007. A USITC "Technical Assistance Staff Report" is different from a "USITC Report" in that it is prepared by a specific Office within the USITC for purposes of providing technical assistance, and is not released by the USITC as an official document. It also contains the disclaimer "This technical assistance does not reflect the views of the U.S. International Trade Commission or any of the Commissioners and is not an official Commission document. It should be referenced as the work of the staff of the USITC." For copies of this study contact Lyn Schlitt, Director, Office of External Relations, USITC (202) 205-3141.

[29] Source of duty figure: U.S. Customs and Border Protection. *Performance and Accountability Report, Fiscal Year 2006*, p. 84.

chemicals/pharmaceuticals processing ($19 million), and other assembly operations ($36 million). Thus, under the TAP proposal, the largest estimated customs revenue loss ($305 million or 70%) would come from the motor vehicle assembly sector.

According to the USITC, 10 companies accounted for 76% of the total revenues paid, and may be the leading beneficiaries of the proposal for FTZ "parity" with FTAs. All but three of these are foreign multinational corporations in the automotive sector. These are, in order of the duties they paid on operations which potentially would be considered FTA-eligible (i.e., potentially TAP-eligible) because their operations would have met rules-of-origin requirements of NAFTA had they been performed in Mexico or Canada, combining U.S.-origin and third country inputs: BMW, Toyota, Honda, Mazda, Nissan, Motiva Enterprises (petroleum refinery), Subaru, Sony Electronics, Hyundai, and Valero Refining.[30]

The USITC staff study is static. It predicted customs revenue losses based on a "snapshot" of actual 2005 FTZ usage by businesses that already hold USFTZ status. It did not take into account the potential for new FTZ applications if businesses were to take advantage of the TAP proposal, should it become law. Thus, it did not project ahead to estimate the potential additional Customs revenues foregone that might occur over the next 5, 10, or 15 years if TAP were adopted.

DeRosa-Hufbauer Study[31]

The NAFTZ retained two economists, Dean DeRosa and Gary Clyde Hufbauer, to produce "an economic development study on the impact of TAP on the U.S. economy and manufacturing sector." The study estimated the potential impact of TAP over the "medium term" at (1) "over $66 billion in new shipments from the FTZs into the U.S. market;" (2) "the creation of nearly 95,000 new manufacturing jobs in FTZs;" (3) a total annual gain to the U.S. economy of $530 million; (4) "higher pay and living standards for manufacturing and other zone workers;" and (5) "clear evidence that the proposal will benefit the U.S. economy in both job increases and U.S. business growth."[32]

Findings and Methodology [33]

The DeRosa-Hufbauer study bases its estimates on a gravity model (which predicts bilateral trade flows based on the GDP levels of trade partners and the geographic distances between them). Using this model, it assumes that the TAP proposal will shift output from non-zone to zone

[30] *Potential Los of Customs Revenue*, USITC staff, op. cit., p. 5.

[31] *The Economic Impact of Trade Agreements Parity for Manufacturing Firms Operating in U.S. Foreign-Trade Zones*. Study prepared for the National Association of Foreign-Trade Zones by Dean A. DeRosa and Gary Clyde Hufbauer, March 27, 2008. Thirty sponsors of the study include 12 multinational corporations (including Toyota, BMW, Daimler, ConocoPhillips, Sony, Hitachi, Abbott, and Kodak) and 18 U.S. foreign-trade zones and related operations. The study states that the views expressed are solely those of the authors, and do not necessarily represent the official views of their respective organizations.

[32] Taken from the NAFTZ website at http://www.naftz.org/index_categories.php/resources/66: *Trade Agreement Parity* (no date); and *The Economic Impact of Trade Agreements Parity for Manufacturing Firms Operating in U.S. Foreign-Trade Zones*. Study Prepared for the National Association for Foreign-Trade Zones by Dean A. DeRosa and Gary Clyde Hufbauer, March 27, 2008.

[33] Dean A. DeRosa and Gary Clyde Hufbauer, op. cit., full cite at footnote #8.

production, amounting to a 13% (or $66 billion) increase in shipments from zones, in 2006, and a counter-balancing decline in shipments from locations outside of FTZs.

Estimates of Economic Losses: Customs Revenues Foregone

The DeRosa-Hufbauer study's gravity model estimates foregone customs revenues to the U.S. economy from the TAP proposal at $186 million per year (or 18% of 2005 Customs revenue), of which $146 million, or nearly 80% (similarly to the USITC staff study) would be in the motor vehicle sector—notably vehicles, other transport equipment, and related parts and accessories.

This estimate of Customs revenues foregone, at $186 million, is less than half the estimate reported by the USITC Staff study of $437 million based on 2005 data. The different estimates reflect the difference in methodology between the two studies.

While the DeRosa-Hufbauer study obtained its estimate from economic modeling, based on imports actually arriving from present and prospective FTA partners, the USITC staff obtained its numbers by sorting through public information contained in annual reports submitted by operators of FTZs and subzones and actually tabulating tariffs paid on third country components by companies that would be eligible to apply for FTZ status under TAP. This estimate is based on calculations that, based on NAFTA rules of origin, the processing/assembly in the FTZ of third-country parts and materials with U.S.-origin content and labor would qualify the processed or assembled good leaving the FTZ for duty-free entry into the United States under NAFTA had the processing or assembly occurred in Mexico or Canada.

Estimates of Economic Gains

The DeRosa-Hufbauer study mentions three kinds of gains to the U.S. economy: job gains to FTZs, annual wage gains of $394 million and producer gains of $136 million, for a total benefit to the U.S. economy of $530 million. It finds that these gains "dwarf [estimated] foregone customs revenues" at $186 million.[34]

Job Gains. The DeRosa-Hufbauer study estimated that the TAP proposal would shift 95,000 additional full-time equivalent jobs from a location outside FTZs to a location inside FTZs, as existing businesses gain zone status.[35] This number, accounts for about 0.7% of all manufacturing employment in 2005. It is not clear from the study whether any of these FTZ job gains would represent actual job gains to the company (as opposed to job gains to FTZs which would result from a simple switch of the company from non-zone to zone status).

The DeRosa-Hufbauer study acknowledges that this shift of workers from non-zone to zone status would not change total U.S. employment. Citing the DeRosa-Hufbauer study, NAFTZ claims the addition of 90,000 U.S. manufacturing jobs."[36]

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[34] Dean A. DeRosa and Gary Clyde Hufbauer, op. cit., p. 1, abstract.

[35] This would include 45,000 jobs in the transport equipment, 14,000 jobs in machinery production, and 14,000 jobs in mineral products. The jobs with new subzone status would be located primarily in Ohio, Tennessee, Texas, and Florida.

[36] NAFTZ. Trade Agreement Parity (TAP) Legislation fact sheet. Available at http://www.naftz.org/docs/news/TAPFactSheetfromPBN.pdf

Wage Gains and Producer Gains. DeRosa-Hufbauer use a 95,000 figure as the basis for their argument that the TAP proposal would result in U.S. wage gains of 7% or $394 million ($179 million in the transportation sector and $82 million in the petroleum sector.)[37]

DeRosa and Hufbauer arrived at this 7% estimate using research published by Lewis and Richardson in 2001, incorporating data from the late 1980s and early 1990s. Lewis and Richardson's research found that on average, workers in ***export-oriented*** *multinational firms with foreign investment backing operating in the U.S.* enjoy earnings that are about 7% higher than their counterparts in the same U.S. industries.[38] However, DeRosa and Hufbauer apply this 7% wage differential in a different way—to workers in primarily import-oriented firms.[39]

The estimate of $82 million in wage gains in the petroleum sector (the second largest set of wage gains) is problematical because these projected gains appear to be attached to new jobs in the petroleum sector that the authors suggest are likely not to materialize because anticipated investment and expansion in that sector are unlikely to occur, reflecting "the complexities of the petroleum-based fuel blends demanded in the U.S. market, [and] increasingly stringent environmental standards regulating the construction of new refineries."[40] As a result, a projected elimination of the 0.01% trade-weighted tariff on crude petroleum might not yield sufficient cost savings to promote the investment required to build more petroleum refineries. While this might lead to producer gains (estimated at $136 million), if these producer gains do not lead to new investment, there would likely not be significant increases in employment or wages relating to the TAP legislation.

Policy Analysis of the TAP Proposal

If FTZ status were obtained and permission thus granted, the following conditions would come into play for TAP beneficiaries:

- The beneficiary company under TAP would be entitled to reduced or zero tariffs on third country components so long as the completed good leaving the FTZ met the rules-of-origin requirements of any FTA.
- The beneficiary company would not need to import any components *from* or *through* the FTA country under whose FTZ goods were being imported.
- Neither the beneficiary company nor the U.S. government would be required to notify the country whose FTA was being thus used, that this was occurring.

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[37] However, some wage gains could result if tariff reductions achieved by businesses were passed on to workers.

[38] Lewis, Howard III, and Richardson, J. David. *Why Global Commitment Really Matters!* Institute for International Economics, Washington, D.C., 2001, p. 29-31.

[39] Other issues are: (1) the research quoted is nearly 20 years old, over which time the capital structure of businesses—especially multinational businesses—has changed considerably; and (2) the Lewis and Richardson study, in a footnote, pointed out that different wage premiums are largely explained by the heavier capital intensity of plants backed by foreign investors, and that premiums vanish if plants are made comparable in their machinery and equipment per worker as well as in industry and location. Since the plants are already in existence and there would not necessarily be any capital changed involved as a result of a shift from non-FTZ to FTZ status, and workers themselves would not necessarily change jobs or employers or locations, the arguments for wage increases might not apply.

[40] DeRosa-Hufbauer, op. cit., p. 18.

- The beneficiary company could meet the rules-of-origin requirements of the selected FTA entirely by using U.S. components and labor. Remaining non-domestic components could come from any FTA or non-FTA trading partner.
- Thus, through this proposal, FTA benefits could be extended to non-FTA countries. That is, components from non-FTA countries could potentially receive import benefits to which they would not otherwise be entitled.
- The only U.S. "gatekeeper" regulating or intervening in this practice would be the U.S. foreign-trade zones Board (FTZ Board) which could restrict or prohibit zone activity "that in its judgement is detrimental to the public interest." (15 CFR 400.31).

Potential Trade Policy and Administrative Implications

The TAP proposal is a complex issue, with both economic and policy implications. Policy effects of TAP could include the following:

Businesses Otherwise Required to Pay Tariffs Could Obtain a Large Tariff Benefit

Businesses likely to reap the most benefits from reduced tariff obligations under TAP would be multinational corporations headquartered in Asia and Europe, with production operations located in the United States that source components from the home country. Based on manufacturing subzone activities in 2005, the USITC estimated that subsidiaries of 15 German, Japanese, and Korean motor vehicle and parts producers would account for 70% of the revenue lost to the U.S. Treasury if the current TAP proposal were enacted.[41]

Effects on Trade and Diplomatic Relations With U.S. FTA Partner Countries and Third Countries

If the TAP proposal were approved by Congress, it could affect trade with FTA partner countries and third countries. FTAs negotiated between the United States and various partner countries could be used to allow non-FTA countries to reap the benefits of the FTAs in terms of duty-free access to the U.S. market without providing equivalent access to exports from the United States. This would reduce the advantage of FTA partners in the U.S. market, undercutting the value of the agreements that they signed with the United States. The TAP legislation arguably would be a disincentive for potential future FTA partners to negotiate a free trade agreement with the United States.

TAP Would be Like a Broad Trade Preference Program

If adopted, the TAP could offer equivalent tariff treatment on certain goods to suppliers in all foreign countries and to all U.S. businesses incorporating those goods under certain circumstances in FTZ subzones. The TAP proposal would, in essence, be another trade preference

[41] *Potential Loss of Customs Revenue Resulting from FTZ Parity with Trade Promotion Agreements*, USITC staff report, op. cit.

program, offering tariff reductions on a business-by-business basis. As with other trade preference programs, the TAP program would offer unilateral tariff reductions without requiring any reciprocating tariff reductions by other countries, and without investment protections for U.S. businesses that FTAs would carry.

Dilution of USTR Authority; Shifting of Some USTR Responsibilities to the USFTZ Board

TAP could decrease the usefulness to USTR of being able to cite the potential elimination or reduction of U.S. tariffs on specific articles as a "carrot"—an incentive for trading partners to take action of interest to the United States. Such action could include improving access for U.S. exports, protecting worker rights, improving protection of intellectual property, or participating in multilateral efforts to eliminate tariffs on a sectoral basis (known as "zero for zero" agreements). Responsibility for determining eligibility for duty-free access to the U.S. market through FTZ manufacturing authority would flow to the USFTZ Board located in the Department of Commerce's Import Administration.

The FTZ Board Could Be Swamped with FTZ Applications

It is not clear how the FTZ Board would handle its charge to determine whether the use of FTZs in this way would be in the "public interest." If, in fact, the 144 companies that the USITC staff report identified as TAP-eligible manufacturing operations were to immediately assert to the USFTZ Board that duty-free treatment for imported components used in their FTZ operations would be in the public interest, the task of verifying the assertion could overwhelm the small board.[42] In addition, new applications would likely add to this overload as businesses calculate the potential costs and benefits of applying for FTZ status to achieve tariff savings on third country components.

The TAP Proposal Could be a Problem with the WTO

The TAP proposal could also potentially violate U.S. obligations under the World Trade Organization (WTO). Pursuant to the WTO, countries cannot normally discriminate between their trading partners. This principle is known as "most-favored-nation" (MFN) treatment. Some exceptions, however, are allowed. Specifically relevant to this discussion, countries are permitted to establish free trade agreements that afford more favorable treatment (e.g., lower tariff rates) to goods traded between parties to the agreement. Because, if enacted, the TAP proposal could possibly result in the granting of FTA benefits to non-FTA members, it could arguably be interpreted as providing more favorable treatment to some importers for which no WTO exception applies. As a result, the proposal could potentially be challenged through the WTO's dispute settlement process if a WTO Member determined that the effect would be severe enough to warrant bringing the dispute.[43]

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[42] The board consists of the Secretaries of the U.S. Commerce Department and Treasury (whose designees—the Assistant Secretary of Commerce for Import Administration, and the Deputy Assistant Secretary of the Treasury for Tax, Trade, and Tariff Policy—typically function for them; plus the Executive Director and a professional staff of seven.

[43] World Trade Organization website: http://www.sto.org.

Options for Congress

Take No Action

Congress has several options available to it. First, Congress could have decided to take no action. If this were to occur, the FTZ program would likely continue as a way for producers to save money through continued use of zones for purposes such as righting "inverted tariffs," duty deferral, duty exemption, duty drawback elimination, tax savings, quota storage, zone to zone transfer, and customs inventory efficiencies.

Include Only Part (a) of the TAP Proposal

If Congress had adopted only Part (a) of the TAP proposal, a company could apply to the USFTZ Board for permission to import components from third countries under any FTA except NAFTA. This is because the NAFTA implementing legislation still prohibits NAFTA benefits to businesses producing in USFTZs. Any company wishing to import under NAFTA would thus need to import under another FTA instead, and meet that other FTA's rules of origin requirements.

Include Only Part (b) of the TAP Proposal

Congress could have decided to approve Part (b) of the TAP proposal, but not Part (a). If Congress were to adopt Part (b) but not Part (a), businesses manufacturing in USFTZs could at last receive NAFTA benefits on components they import from Mexico or Canada. This would make the NAFTA implementing legislation comparable to that of subsequent FTAs.

Include Parts (a) and (b)

If Congress had adopted both parts (a) and (b)—the entire TAP proposal—businesses could import components from third countries under any FTA, including NAFTA.

Consider Other Amendment

Finally, Congress could have considered another amendment(s) to modify or replace the TAP proposal.

If the objective were to reduce or eliminate tariffs on components incorporated into goods produced in the United States, one possibility would be to do it more directly. Legislation could be constructed to eliminate tariffs on components incorporated into other goods in the United States, so long as the final product met rules of origin requirements designed specifically for the legislation. These rules could call for a flat percent of domestic content (e.g., somewhere between 35 and 65%), or specific domestic content shares for different products. The importer would have to certify to Customs and Border Protection that the value-added requirements of such legislation had been met.

Such an amendment might include further qualifications. For example, the legislation could also limit the TAP benefit eligibility to components imported from countries that afford reciprocal treatment for U.S. components exported to certified assembly operations in the partner country.

Such a proposal would (1) not directly involve current FTA partners; and (2) not overload the USFTZ board.

As with all trade legislation, however, there would still be winners and losers. Losers could still be the volume of trade with current FTA partner countries, whose trade with the U.S. could be diverted to other countries. Losers could also be U.S. parts producers. On the other hand, opening up the U.S. economy to reduced or zero tariffs on components imported from third countries could stimulate a new round of U.S. business process reorganizations, as companies look for new ways to cut production costs while maintaining a required level of U.S. value added in parts and labor.

Conclusions

Conclusions regarding the TAP proposal can be divided into two groups: economic conclusions and policy conclusions.

Economic Conclusions

Economic conclusions include the following:

- The primary benefit of TAP would be tariff benefits for corporations that source components from third countries.
- Loses in customs revenues could be between the $186 million estimated by the DeRosa-Hufbauer study and $437 million estimated by the USITC staff study. However, neither study projected ahead to take into account the extent to which U.S. businesses might re-engineer their products to take advantage of small tariff savings per item produced—savings which, on a large production scale, could end up being considerable. In addition, the estimated loss in customs revenue figures were based on existing levels of zone activity. Any shift to FTZ manufacturing (as exemplified through the shift of an estimated existing 95,000 U.S. jobs into zones in the DeRosa-Hufbauer study) would substantially increase the loss in customs revenue.
- The TAP proposal could result in a potential decrease in demand for U.S.-made parts as a result of any tariff-free benefits for third country components. Neither the USITC staff study nor the DeRosa-Hufbauer study addresses this issue or estimates its impact. The potential decrease in demand could be considerable since it could spread across many industries. A study estimating this impact would be useful.
- Estimated employment increases of 95,000 in the DeRosa-Hufbauer study would not represent a net gain to the U.S. economy. They would represent primarily a shift among existing plants from non-FTZ to FTZ status. Some additional job shifts from elsewhere in the economy into plants operating in zones, however,

could result if businesses were to pass cost savings from tariff elimination on to consumers in the form of lower prices.

- Estimated wage gains of 7% for certain jobs, for a total of $394 million nationwide, were based on a 20-year old study which found that workers producing for *export* from multinational corporations enjoyed higher wages. The data are then applied to workers producing primarily for import.
- Some producer gains may not materialize; however, profits could increase The DeRosa-Hufbauer study estimate of producer gains of $136 million annually from the TAP proposal, if it were adopted, may overstate investment benefits in some firms, as the authors acknowledged. For example, elimination of the approximately 0.01% duty (trade-weighted ad valorem equivalent) on crude petroleum under TAP may not convince petroleum refiners to expand their capacity. Instead, the primary economic benefit of TAP may be increased profits to foreign-based multinational corporations which would be afforded tariff savings on third-country imports.

Trade Policy Conclusions

Among policy conclusions are the following:

- The potential effects the TAP proposal generally seeks to address are widely considered to be the *intended* consequences of FTAs: the United States extends preferential tariff treatment to components from an FTA partner country in exchange for that country's lowering of its tariff rates on U.S. products.
- TAP would give FTA benefits to non-FTA components, with likely effects on trade and diplomatic relations with FTA partner countries and with third countries. There could be a negative impact on diplomatic relations with FTA partner countries, since FTA benefits would be extended to non-FTA partner countries without the permission or knowledge of the partner country whose FTA would be used in this way. This could put the FTA partner country at a competitive disadvantage vis-a-vis other countries whose businesses would be using the FTA without the partner country's permission, to import third-country components duty-free. Conversely, third countries which have not negotiated FTAs with the United States could reap the benefits of FTA duty rates without any compensating concessions on their duty rates for American goods.
- TAP could complicate diplomatic relations with FTA partner countries, since FTA benefits would be extended to non-FTA partner countries without necessarily any notification to or consultation with the partner country whose FTA would be used in this way.
- TAP would in essence create a new trade preference program offering all countries tariff benefits equal to those included in FTAs, with permission granted by the FTZ Board on a business case-by-case basis.
- TAP would extend FTA benefits to non-FTA countries, without requiring reciprocal tariff reductions of the part of the country whose companies are supplying components for FTZ subzone assembly operations.

Administrative Policy Conclusions

- TAP would remove in a *de facto* sense, certain tariff policy responsibilities from the Office of the U.S. Trade Representative and delegate them to the U.S. Foreign-Trade Zones Board. It would create a new category of administratively determined tariff beneficiaries—specific businesses.
- TAP could potentially overload the USFTZ Board with investigations to determine whether granting duty-free entry of components for use in assembly operations meets the "public interest" mandate of the TAP legislation. The FTZ Board could also face many new requests for approval of FTZ manufacturing authority.

Ultimately the potential costs and benefits of TAP if it were adopted, as well as its effects, would depend on the extent to which businesses would apply for FTZ status to take advantage of potential tariff relief offered. Some crucial questions for further research are: Would adoption of the TAP proposal encourage businesses with assembly operations in the United States to substitute imported components for domestic components? To what extent would adoption of the TAP proposal impact U.S. parts producers and suppliers? To what extent would TAP encourage businesses to stay and expand in the United States instead of moving operations abroad?

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