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NAFTA Exit, Who Really Gets Hurt?

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We conducted a U.S. state-level analysis of tariffs that would apply in a hypothetical case where the U.S. pulls out of the North American Free Trade Agreement (NAFTA) and trade relations revert to the World Trade Organization (WTO)'s Most Favored Nation (MFN) regime. U.S. exports into Mexico would face higher tariffs than those of Mexican exporters entering the U.S. Agricultural states would be harmed the most under the MFN scheme, whereas manufacturing states dependent on the North American value chain would also face disruptions, despite facing relatively lower tariffs. Furthermore, as states worst positioned to an MFN-tariff regime voted for Donald Trump in the November 2016 presidential elections, a decision to exit NAFTA could prove politically costly to his administration. These results provide further support to our baseline view of a mild NAFTA renegotiation with U.S. Congress ratification by early 2019.

Many news articles and research pieces have already addressed several of the negative economic implications of a U.S. withdrawal from the North American Free Trade Agreement (NAFTA). These arguments include: severe disruptions in the highly integrated value chains of key industries such as automotive, losses in the U.S.

agricultural sector due to impaired access to the Mexican market, low likelihood of a recovery in manufacturing jobs or a reduction of the U.S. trade deficit. In addition, the possibility that such a drastic decision would trigger trade wars and prompt the U.S. to exit from the WTO. Potential disruptions to NAFTA could threaten this year's incipient recovery in trade volumes[1] as NAFTA, as a bloc, represents 14% of world exports and 19% of world imports of merchandise.[2]

As NAFTA talks[3] approach decisive stages, in this piece we attempt to study the implications on the U.S. state level of a NAFTA exit and a reversion to WTO's MFN rules.[4] We find a mixed picture on the potential costs of leaving the free trade agreement due to several factors: (1) different MFN tariff schedules between the U.S. and Mexico which depend on type of merchandise traded (e.g., agricultural vs. industrial), (2) heterogeneous U.S. states' export and import baskets and (3) diverse levels of dependence on Mexico's market.

Since Mexican MFN import tariffs would be higher than those the U.S. would impose on Mexican imports, states with high export dependence on Mexico could suffer the most, as would those states with export baskets tilted towards goods with high MFN tariffs. In particular, some agricultural states would be harmed the most as Mexico represents about a quarter of their export market and Mexican MFN tariffs are high (animal and vegetable products tariffs average 11-14%). Even though industrial tariffs are lower (machinery and electrical Mexican tariff at about 3%), losses could arise from the fact that goods in this category cross the border multiple times (as part of a value chain) and that duty drawbacks (that is, refund of duty paid for imported goods if exporting or returning the goods to the supplier) would need to be claimed.

When we add state-level voting results from last year's presidential election to our economic analysis, we find that a decision to leave NAFTA risks alienating several states that are part of President Trump's constituency, and so reduce the probability of the exit scenario.

NAFTA renegotiation comprises three stages: negotiation of a new agreement (and signature by the U.S. and Mexico presidents and Canada's prime minister), Congressional ratification of the signed agreement and implementation of the ratified agreement.[5] Making the timeline more complicated are Mexico's presidential and congressional elections scheduled in July 2018, the expiration of Trump's Trade Promotion Authority in July 2018 (subject to renewal)[6] and the U.S.-midterm elections due in November 2018. Given this process, our base case scenario is a NAFTA renegotiation (not repudiation), where agreement among parties is only reached by early 2018, with official agreement signing by mid-2018 and a U.S. Congressional ratification of the new agreement after mid-term elections—that is, early 2019. At this stage, we think the NAFTA exit scenario is a low-probability event with no obvious benefits to any of the parties involved.

Methodological Note

For each U.S. state, we combine 2016 exports and imports from Mexico based on merchandise type[7] (using 97 categories in the Harmonized System (HS))[8] with the WTO MFN tariffs imposed by both countries on these goods.[9] Our analysis faces a few limitations: (1) we exclude nontariff barriers that could arise from the collapse of NAFTA but are difficult to measure and understand at this stage, (2) the HS includes further subcategories beyond the main 97 broad merchandise groups, featuring heterogeneous tariffs. For instance, for the very relevant category No. 87 (vehicles other than railway or tramway rolling stock, and parts and accessories thereof) and subcategory No. 870120 (road tractors for semi-trailers), the U.S. imposes an average ad valorem duty of 4%, while subcategory No. 870130 (track-laying tractors (excluding pedestrian-controlled)) is duty free. We disregard subcategories and work with the 97-category level of aggregation using the average ad valorem tariff as provided by the WTO (that is, for category No. 87 the average ad valorem duty is 3.09%). However, this subcategory average does not necessarily reflect the actual tariff structure between the U.S. and Mexico.

U.S. Exports Into Mexico To Face Higher Relative Tariffs Than Mexican Exports Into The U.S.

The first takeaway of our analysis is that under WTO MFN rules the U.S. would face an average 4.68% tariff on its exports to Mexico and would levy a 2.42% average tariff on Mexican imports. That

1 Monthly year-on-year growth rate in world trade volumes averaged 2.4% in 2011-2016 and 4.1% from January to June 2017. Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor June 2017.

2 As of 2015, based on the WTO's World Trade Statistical Review 2016.

3 The third round of meetings begin in Canada on September 23, 2017.

4 Note that NAFTA exit does not necessarily imply a fallback into WTO MFN rules. However, we study WTO MFN rules as the default trade framework in the absence of any other alternative agreement.

5 Please note this is a summarized renegotiation timeline where omissions were made for purposes of this paper.

6 Trade Promotion Authority allows a Congressional ratification by "yes" or "no" vote without amendments.

7 As provided by U.S. Census Bureau (https://usatrade.census.gov/).

8 The Harmonized System is an international nomenclature for the classification of products. It allows participating countries to classify traded goods on a common basis for customs purposes. It has been developed and maintained by the World Customs Organization, an independent intergovernmental body comprising over 200 member countries (https://unstats.un.org/unsd/tradekb/Knowledgebase/50018/Harmonized-Commodity-Description-and-Coding-Systems-HS).

9 As provided by World Trade Organization (http://tariffdata.wto.org/default.aspx).

is, Mexico charges higher tariffs than the U.S. under the WTO MFN regime, which could potentially hurt those U.S. states with an export concentration tilted towards their southern neighbor.

This asymmetry in WTO MFN tariffs is shown in *Display 1*, where the y-axis represents tariffs that would be levied by U.S. states on Mexican imports and the x-axis shows tariffs that would be levied by Mexico on U.S. states' export baskets. Most data points are below the 45 degree line: that is, Mexico's tariffs on American exports would be higher than those levied by the U.S. on Mexican imports. This asymmetry would strengthen Mexico's leverage in ongoing NAFTA negotiations.

Trump-Voting States To Hurt The Most In A Nafta Exit Scenario

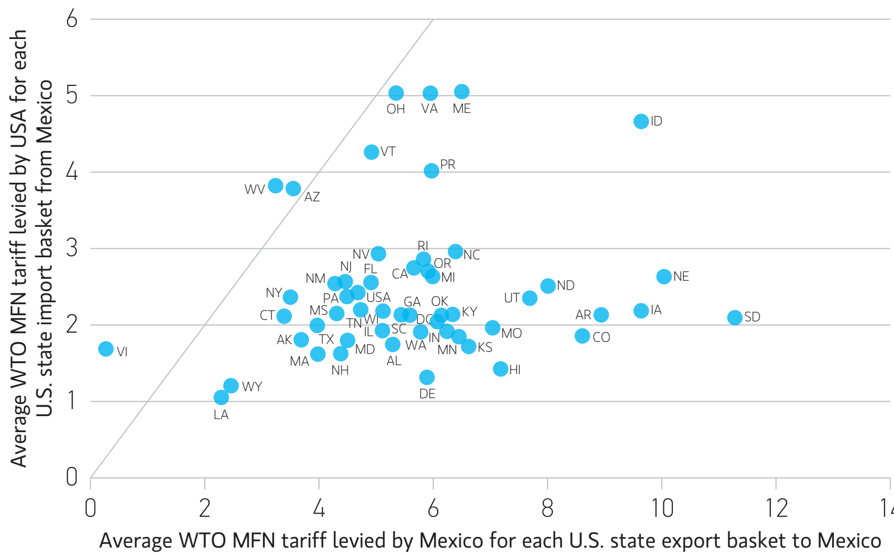
Display 2 addresses the question of which U.S. states stand to suffer the most from a potential NAFTA collapse: the y-axis shows Mexico's MFN WTO tariffs applicable on each U.S. state's export basket, whereas the x-axis shows the percentage of U.S. states' exports to Mexico. Red (blue) color represents states where Donald Trump (Hillary Clinton) won the popular vote in last year's presidential elections. States farther northeast in the chart would face a higher cost from leaving NAFTA.

States like South Dakota (main export to Mexico—meat and edible meat, with an average Mexican tariff of 18%), Nebraska (main export—cereals, with an average Mexican tariff of 6%), Iowa (main export—cereals), Idaho (main export—milling products; malt; starch; inulin; wheat gluten, with an average Mexican tariff of 7.2%) would face average tariffs higher than 9% to enter the Mexican market. Furthermore, South Dakota and Nebraska's geographic concentration of their exports is very high, with over 22% of total exports sent to Mexico last year.

Therefore, a U.S. exit from NAFTA would prove economically damaging for states with high export dependence to Mexico and producing goods subject to

DISPLAY 1

U.S. Exports Into Mexico To Face Higher Relative Tariffs Than Mexican Exports Into The U.S.

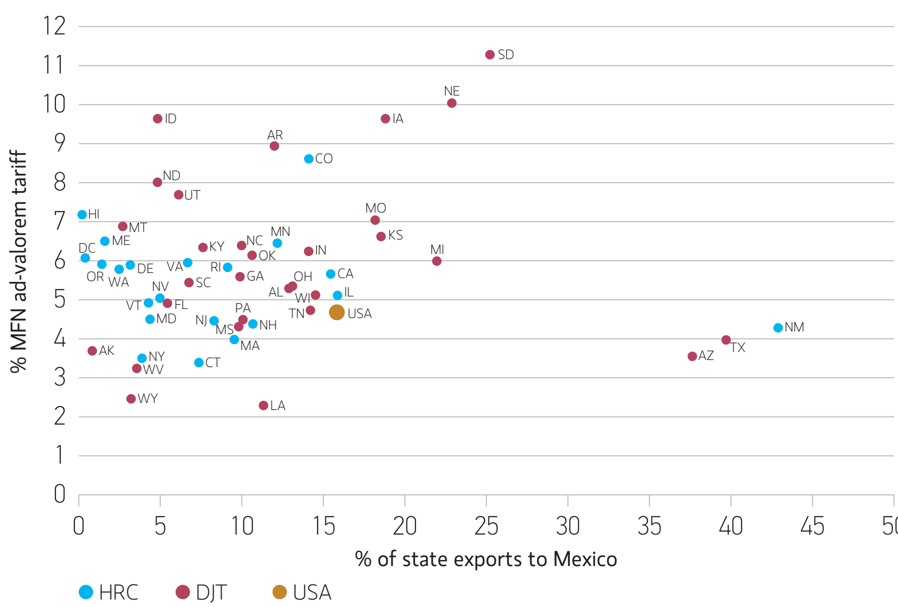


Source: MSIM. As of August 31, 2017.

Note: Montana is excluded from the chart. The WTO MFN tariff that the U.S. would levy on Montana's imports from Mexico would be 82%. The reason is that 40% of Montana's imports from Mexico are tobacco products, which are levied with a hefty 205% tariff.

DISPLAY 2

Trump-Voting States To Hurt The Most In A NAFTA Exit Scenario



Source: MSIM. As of August 31, 2017.

high potential MFN tariffs. In addition, leaving NAFTA would likely entail sizable political costs to the current U.S. government, since part of President Trump's support base stems from those potentially affected states. Finally, even though most of these states are small in population size, they exert oversized political influence in key institutions such as the Senate and the Electoral College, given the current U.S. electoral system.

States Hosting Industries In Integrated Value Chains To Suffer Disproportionately

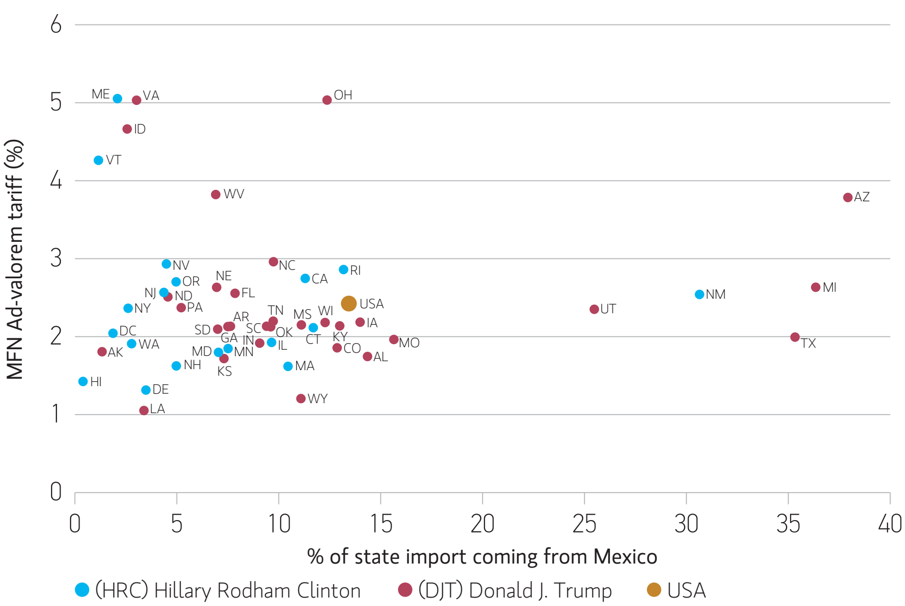
Display 3 plots WTO MFN tariffs that would fall on Mexican imports into each U.S. state (y-axis) versus states' dependence on Mexican imports (x-axis). As trade theory predicts, states neighboring Mexico display a higher trade connection with the latter. The exception is Michigan, whose high level of import dependence on Mexico is explained by the highly integrated automotive industry residing in it. Furthermore, Michigan is also the main state contributing to the U.S.'s total trade deficit with Mexico: it reached $64 billion in 2016, of which about $53 billion is explained by one category (out of 97 HS categories): Category No. 87 (vehicles other than railway or tramway rolling stock, and parts and accessories thereof). Michigan alone is responsible for 55% of this category's deficit ($30 billion). Under WTO MFN rules, the U.S. would levy an average tariff of 3.09%, while Mexico would impose a 10.54% tariff for category No. 87, thus negatively affecting Michigan's economy. Even though Mexico could potentially lower WTO MFN tariffs to protect the North American value chain in the absence of NAFTA, a low tariff could accumulate to a large total tariff as the same product crosses the border multiple times. For instance, according to anecdotal evidence,[10] an average vehicle crosses the border eight times in the assembly process. Thus, a low 3.09% tariff could then grow into an effective 28% (compounding 3.09% eight times). Such a high cumulative duty is unlikely, given duty drawbacks (that is, refund of duty paid for imported goods if exporting or returning the goods to the supplier), but it illustrates the many challenges that the North American value chain would face in a world without NAFTA.[11]

Conclusion

We conducted a U.S. state-level analysis of tariffs that would apply in a hypothetical case where the U.S. pulls out of NAFTA and trade relations revert to the WTO's Most Favored Nation regime. In such a scenario, U.S. exports into Mexico would face higher tariffs than those the U.S. would apply on Mexican imports, potentially hurting states with high dependence on Mexico as an export market (particularly, those strong in auto production and agriculture), and with export baskets that are biased towards high-tariff products. Additionally, many of those states' Electoral College votes went to Donald Trump, thus weakening the case for a politically-driven NAFTA exit. These results provide further support to our baseline view of a mild NAFTA renegotiation with U.S. Congress ratification by early 2019.

DISPLAY 3

U.S. Consumers In Border States Stand To Lose Under MFN Tariffs



Source: MSIM. As of August 31, 2017.

Note: Montana is excluded from the chart for reasons mentioned earlier.

[10] https://economia.elpais.com/economia/2017/08/29/actualidad/1503973886_606405.html

[11] As the U.S. Custom and Border Protection states "Be aware the process of filing for drawbacks can be involved and the time it takes to receive refunds can be lengthy." https://help.cbp.gov/app/answers/detail/a_id/378/~/refund-%28drawback%29-of-duty-paid-for-imported-goods-if-exporting-or-returning-the

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