How NAFTA Affects US Retail

US retailers and consumers alike enjoy a wide variety of affordable goods thanks to free trade. The ongoing efforts to modernize NAFTA could preserve those benefits, which extend to healthy bottom lines, jobs, and the economy.

The next time you are in a US supermarket, pick up a bunch of asparagus. The tag that hangs from the rubber band holding the bright green spears together likely says "Product of Mexico." The fact that Mexico can make fresh asparagus available and affordable in the United States across seasons has been a distinct advantage to US consumers and retailers, creating a win-win situation for them both. For decades now, the North American Free Trade Agreement (NAFTA) has influenced trade between Mexico, Canada, and the United States. The benefits like those we enjoy when we shop for asparagus extend to thousands of other products that are also imported each year into the United States.

> Without NAFTA, tariffs would increase the cost of products from NAFTA partners by $5.3 billion annually, and retailers' bottom lines would fall by up to $15.8 billion each year.

A.T. Kearney, in partnership with the Food Marketing Institute, the National Retail Federation, and the Retail Industry Leaders Association, has modeled the impact of NAFTA across the retail industry. According to our model, retail carries $182 billion-worth of products from NAFTA partners. Retailers are, in effect, importers of these goods. Without NAFTA, tariffs would increase the cost of these products by $5.3 billion annually. These tariffs and impacts to revenue from loss of consumer purchasing power would reduce retailers' bottom lines by up to $15.8 billion each year. The effects could extend to employment and could lead to the loss of 128,000 retail and retail-supported jobs within the next three years.

Retailers in different sectors would be affected in different ways—even product to product. We find that the best way to understand NAFTA's impact is to explore the three major areas where it affects retailers' business now and would in the future as well: increased costs, reduced customer spending, and employment.

In this paper, we will look closely at all three areas, examining the first—cost increases—with deep dives into NAFTA's effect on retail goods from four directions, illustrating each with a popular product. We will conclude with a discussion of the steps retailers can take now.

First, let's look at NAFTA and what it has meant to the US economy and retailers for the past 24 years.

A Brief History of NAFTA

NAFTA is the world's largest free-trade agreement, spanning 28 percent of global gross domestic product (GDP). Initial NAFTA negotiations began during the George H. W. Bush presidential administration and concluded with President Bill Clinton signing it into law in 1994. NAFTA has influenced the US economy, the retail sector, and Americans' standard of living ever since.

While NAFTA has been in force, most goods crossing the borders between Canada, Mexico, and the United States have been exempt from tariffs. This has helped US trade with Mexico and

Canada to more than triple—the most rapid growth in trade that the United States has seen of any region it does business with in the world. Mexico and Canada are the second- and third-largest exporters to the United States (after China). And the two countries are the leading importers of American products. In 2017, US trade was $523 billion with Canada and $540 billion with Mexico. Exports to Canada and Mexico combined are currently 34 percent of total US exports.

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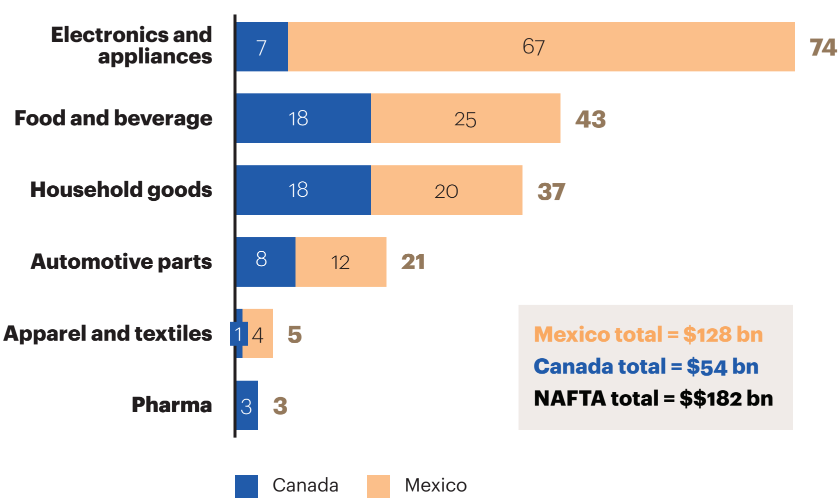
Focusing on the retail industry, US retailers import $182 billion-worth of products from the NAFTA partners each year, ranging from t-shirts to televisions (see figure 1). Among the categories for NAFTA retail imports in 2017 were electronics and appliances, food and beverage, household goods, automotive parts, apparel and textiles, and pharmaceuticals. US retailers imported $128 billion in goods from Mexico and $54 billion in goods from Canada in 2017.

While NAFTA has sparked significant growth, it has some opportunities for improvement. Many people in business and government agree that it needs reform and modernization to be relevant for the world of today and in the future. Negotiations are under way between the member countries with that objective in mind. It is, however, possible that American, Mexican, and Canadian negotiators may not be able to come to a new agreement at this time, leaving NAFTA to hang in the balance.

Figure 1
The retail industry imports $182 billion-worth of products from NAFTA partners

NAFTA retail imports
(2017, US$ bn)



What is retail import?

- Goods that are sold in retail stores are included
- This includes everything from tea to t-shirts to TVs
- Non-retail imports include oil, machinery, and aircraft

Note: Numbers may not resolve due to rounding.
Source: A.T. Kearney analysis

Without NAFTA, the trade relationship between the United States, Mexico, and Canada would revert to rules set by the World Trade Organization (WTO) that govern trade between most nations. Under these rules, tariffs known as most-favored-nation (MFN) rates would come into force. MFNs are effectively a uniform rate that the United States, as a WTO member, is obligated to establish with all trading partners with which it does not have a free trade agreement, such as NAFTA.

If NAFTA was to go away, US retailers would be directly impacted in two major areas and indirectly affected in a third key area (see figure 2).

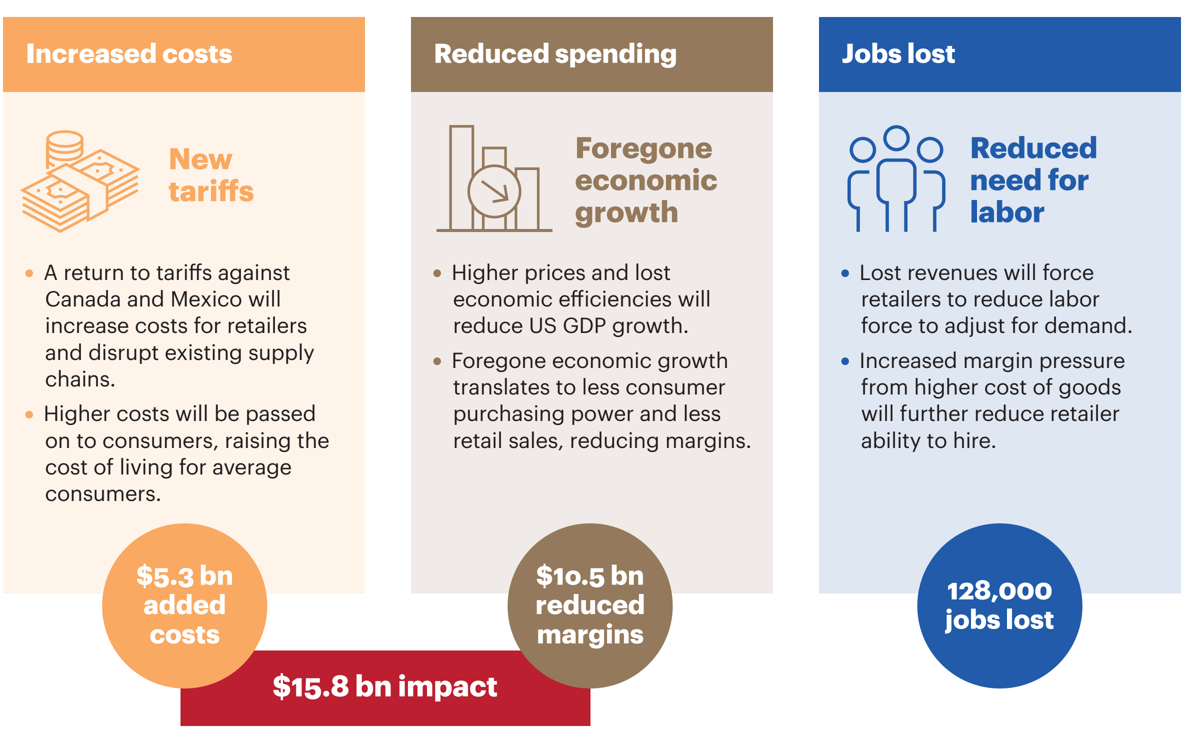
1. **Impact on retailers' costs.** New tariffs levied against Canada and Mexico would result in $5.3 billion in higher costs for US retailers and would also disrupt existing supply chains. Retailers could either absorb these costs or, more likely, pass them on to consumers, raising the cost of living for average individuals.

2. **Impact on consumer spending.** Higher prices and lost economic efficiencies would reduce US GDP growth. Foregone economic growth translates to less consumer purchasing power and a $39 billion drop in retail sales, reducing margins by $10.5 billion.

3. **Impact on labor.** Lower revenues could force retailers to adjust their labor force to meet lower demand. Increased margin pressure from the higher cost of goods could further reduce retailers' ability to hire workers, resulting in up to 128,000 jobs at risk over the next three years.

Figure 2
A withdrawal from NAFTA would have wide-reaching impact on American retailers and consumers

NAFTA withdrawal retail impact areas



Source: A.T. Kearney analysis

The Impact of NAFTA on Retailers

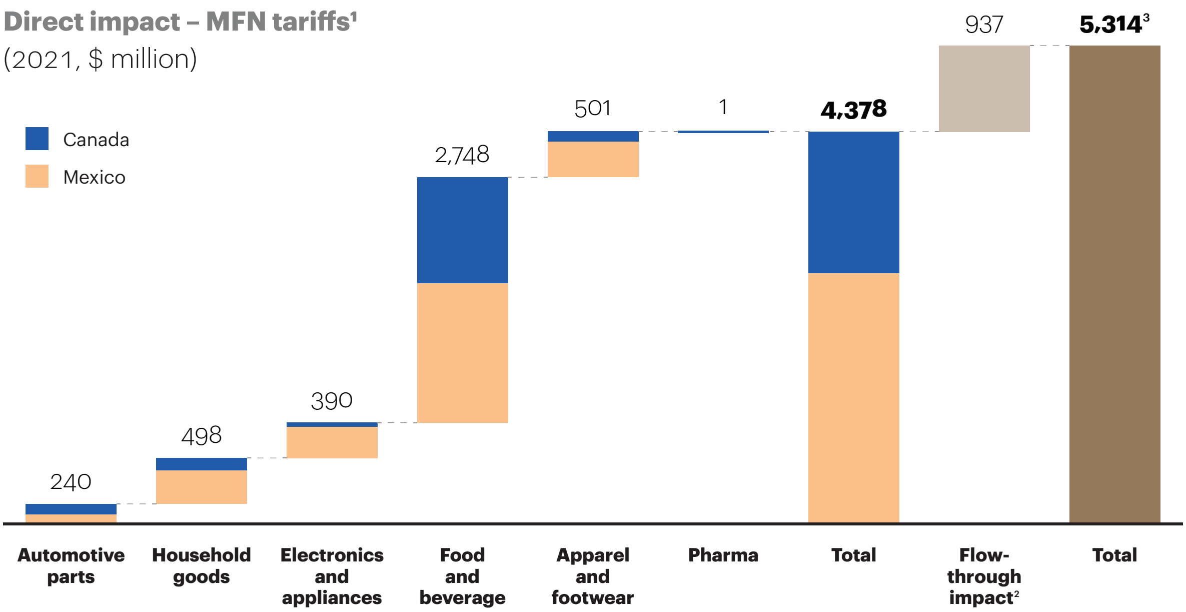
The three potential impact areas for retailers are significant and interrelated. A closer look at each reveals numerous implications. (For the purposes of this study, we have applied US MFN tariffs to current import volumes from Canada and Mexico to measure impacts.)

1. Impact on Retailers' Costs

Without NAFTA, retailers would have to pay $5.3 billion more annually to import the same NAFTA-covered goods they import today (see figure 3). We would anticipate that over time the balance and mix of goods that are being imported versus produced domestically would evolve as other corrections occur; for the sake of discussion, however, let us illustrate the point using current volumes in a NAFTA withdrawal trade setting.

Figure 3

The total direct impact of the added tariffs on NAFTA imported goods generates $5.3 billion in increased costs of products



[1] MFN is most favored nation.

[2] Impact of added tariff costs for non-retail goods that will flow through to add to retailers' costs (for example, tariffs that impact transportation goods that will impact retailers' transportation costs)

[3] Numbers may not resolve due to rounding.

Sources: US Census Exports Data 2017, Tariff Schedule 2017; A.T. Kearney analysis

In this scenario, food and beverage would be the category most impacted, with a total of $2.7 billion in increased costs. Apparel and footwear could see $501 million in higher costs, electronics and appliances could see $390 million, household goods could see $498 million, and auto parts could experience $240 million in increased costs. Combined with an additional $937 million in flow-through impact, which accounts for the effect of added tariff costs for non-retail goods that also affect retailers (such as new tariffs on imported transportation goods including machinery, oil, and aircraft that ultimately raise retailers' transportation costs), the total direct impact of new tariffs reaches $5.3 billion annually.

Retailers would face two choices then: absorb the higher costs or pass them on to consumers. If they attempt to absorb them, the new tariffs' impact could cause significant damage to retailers, who operate on low margins—in particular in the grocery business. The US food and beverage retail sector generated total operating profits of $20 billion in 2017, from sales of $719 billion, an operating margin of 2.8 percent. Taxes of $5 billion were paid on these profits, implying an effective tax rate of 25 percent. The additional $2.7 billion in costs arising from new tariffs in this industry would equal an increase in the effective tax rate from 25 percent to 35 percent, equivalent to a 10 percent rate increase.

Tariffs are a complex subject because they affect various products differently.

Alternatively, and most likely given their thin margins, if retailers pass the higher cost on to their customers in the form of higher prices, consumers would be forced to make harder choices with their money.

Tariffs—and their link to importing and exporting—are a complex subject because they affect various products differently. Four themes or factors surrounding those products lead to the differences in impact. They are:

1. The direct effect of cost increases with higher tariffs
2. A lack of alternative tariff-free sources for a given product
3. A product whose production involves multiple, cross-border, tariff-generating stages of production
4. Products whose integrated supply chain and multiple sources are a competitive advantage for the American export industry; a loss of tariff-free access would end up hurting the domestic economy

To understand each of these important factors more clearly, it helps to illustrate each with a product that is popular with US consumers. NAFTA withdrawal could markedly impact the cost or the supply chain for each of these products.

Four popular products (as they relate to the four key tariff themes)

While the following examples pertain to these products, they are also relevant to hundreds more products in their categories.

Chocolate: cost increases

The United States consumes $18 billion-worth of chocolate each year—20 percent of all the chocolate eaten around the world annually. To keep up with this gigantic sweet tooth, US retailers import $2 billion-worth of this candy from Canada and Mexico. Fifty percent of it comes from Canadian plants of companies such as Ferrero, Storck, Lindt, Barry Callebaut, and Mondelez, and 20 percent comes from Mexico. While consumers love their European chocolate, just $341 million of it is imported into the United States annually from Belgium, Switzerland, and France.

Without NAFTA, 10 percent of all chocolate consumed in the United States would be hit by tariffs, at a total cost of $261 million annually. For Valentine's Day alone, when 5 percent of all sales of chocolate occur, new tariffs could cost US consumers an additional $13 million.

Asparagus: lack of alternative sources of supply

As we mentioned in our introduction, US retailers often carry asparagus from Mexico, which produces 55 percent ($426 million worth) of the crop for US stores. Asparagus has boomed in popularity in the United States, where consumption has doubled since 1980, from 0.8 pounds to 1.5 pounds per consumer per year. During the same period, retailer imports of the vegetable grew from 11 percent to 91 percent of consumption.

Asparagus is a labor-intensive crop, and production costs in Mexico have made it affordable to US buyers and a competitive advantage to Mexico. Without NAFTA, asparagus would face MFN tariffs of 5 to 21.3 percent for product coming from Mexico, resulting in an average $50 million in higher costs each year for this single vegetable.

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For retailers wishing to avoid these higher costs, alternative sources of supply are limited. While farms in California, Michigan, and Washington, among other states, produce asparagus, they grow just 10 percent of current supply and acreage for growing the crop has dropped 61 percent in the past 10 years. In winter months, US farmers have limited ability to grow asparagus at all. All told, switching to US supply would not be possible in the short term, and would likely require significant cost increases due to the cost of labor. We anticipate that over time, as asparagus prices rise, most US farmers would allocate acreage to asparagus, helping mitigate some of the supply constraints. However, the year-round constraint would still remain and prices would likely be higher the rest of the year.

Farther south, Peru is a top global producer of asparagus and a large producer for the US market in the winter months. We could see its share of imports increase, along with the required expensive and emissions-heavy air transport to the United States.

Looking at produce in general, retailers that carry fruits and vegetables will be forced to make this kind of difficult choice for many items. Their most likely reaction will be to charge significantly higher prices, especially in winter months when domestic production is not feasible. Pushing the cart through the produce department, among items imported from Mexico, asparagus' tariff rate would take it from $2.48 a pound, based on a composite average for the vegetable across select states, to $3.01 a pound, based on retailer imports of $426 million annually.[1] The price of a watermelon would increase from $4.88 to $5.71 for the $248 million in imports each year. Avocados would go from $3.26 per pound to $3.42 on $2.3 billion of imports each year. Tomatoes, which retailers import at a rate of $1.2 billion annually, would see their price raised

[1] Based on US Census Bureau data and A.T. Kearney research

from $2.24 to $2.29 per pound. Broccoli, imported at a rate of $248 million each year, would rise from $3.31 to $3.97 per pound. And cucumbers, imported at a rate of $463 million, would be hit with a tariff, taking this salad favorite from $0.63 to $0.66 per cucumber.[2]

During just one shopping trip, a basket filled with these fruits and vegetables would go from $16.80 to as much as $19.06 during winter months—an increase of 13 percent. This anticipates a worst-case scenario; however, we would expect some adjustment in domestic sources of supply as farmers see opportunities to reallocate acreage to take advantage of rising prices for some of these produce items.

Jeans: multiple tariffs

Consumers have significantly benefitted over the years from the ability to buy affordable and fashionable jeans, thanks in part to competitive production costs for their assembly in Mexico. However, the "Made in Mexico" label obscures the fact that the value chain for jeans includes many production stages occurring in the United States. Once the final product is imported from Mexico, it contains a large percentage of US inputs. This back-and-forth nature of production over borders would generate multiple, expensive tariffs in a post-NAFTA world.

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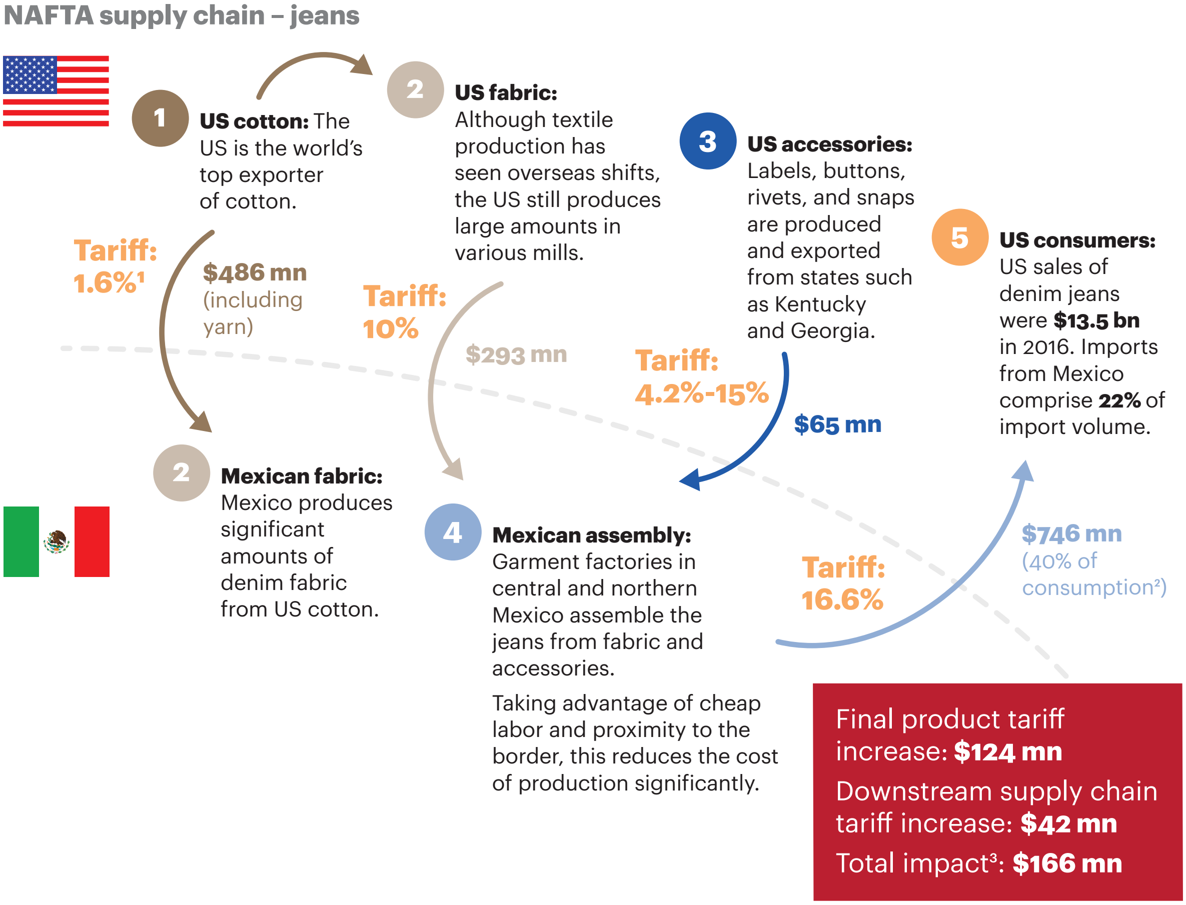
The jeans value chain includes a variety of materials and production steps in its journey to end customers. First, there is the production of cotton. Nearly half of all textiles are made of cotton, and it is the key fiber in jeans fabric. Cotton is woven into denim fabric by first spinning it into yarn, weaving it into fabric, and then finishing with dye. Jeans feature various notions, too, including buttons, rivets, labels, zippers, interfacings, and thread, which must be manufactured, sourced, and transported. The fabric and accessories are assembled in a manufacturing process to make finished jeans. The final product is then packaged, shipped, and sold to consumers in retail stores.

Given the integrated supply chains, one pair of jeans would get hit by tariffs multiple times before it arrives in stores (see figure 4 on page 8). While the United States is the world's top exporter of cotton and produces large amounts of cotton fabric, due to the capital-intensive nature of cotton fabric production, Mexico also produces a lot of cotton fabric using US cotton. Without NAFTA, Mexican-made fabric would trigger tariff number one: a 1.6 percent surcharge on $486 million of cotton annually. If the fabric used in the jeans was made in the United States and goes to Mexico for manufacturing into jeans, that triggers tariff number two: a 10 percent surcharge on the $293 million in US denim currently going over the Mexico border each year. The notions or accessories that make jeans look the way they do are produced in and exported

[2] Import data uses codes from the US Harmonized Tariff Schedule in order of produce mentioned above: 0709.20.90, 0807.11.40, 0804.40.00, 0702.00.20, 0704.90.40, 0707.00.20. Product quantities varied by item to simulate a typical shopping trip, and prices were based on sampling prices in stores in Kansas, Iowa, and Arkansas. Tariff impact is calculated by applying the tariff rate to the estimated cost of goods portion of the retail price of the item and assessing the new retail price based on maintaining the same retailer margin.

Figure 4

Given the integrated supply chains, one pair of jeans would get hit by tariffs multiple times before it arrives to US consumers



[1] Average, including yarn, weighted by US exports to Mexico across HS codes 5201-5212

[2] For men's and boys jeans

[3] The wider supply chain impact is not included in the total $5.3 bn; the stated figure is an illustrative example of wider supply chain costs.

Sources: US Office of Textiles and Apparel, US HTS, NDP Group; A.T. Kearney analysis

largely from the states of Kentucky and Georgia, triggering tariff number three, which ranges from 4.2 to 15 percent on the current $65 million of accessories exported today. Finally, when the finished jeans make their way back north to US retailers and consumers, tariff number four is added to the price tag, at a rate of 16.6 percent on $746 million in jeans that arrive in US stores from Mexico each year. That is 40 percent of men's and boys' jeans. Total US sales of denim jeans were $13.5 billion in 2016. Imports from Mexico comprised 22 percent of import volume.

The impact of tariffs on just the finished jeans going to US retailers would be $124 million each year. Adding up the total impact of the multiple border crossings involved in jeans production, the interim steps would add $42 million in tariffs, making the full supply chain cost increase $166 million annually.[3]

It is interesting to note that, according to the US Commerce Department, nearly 40 percent of parts used in a typical Mexican import originate in the United States, creating similar dynamics for many retail products beyond jeans and causing companies to rethink various supply chain strategies.

[3] US Office of Textiles and Apparel; US HTS; NDP Group; A.T. Kearney

Beef: effect on exports and US production

Another complex process, beef production, involves an integrated supply chain with multiple border crossings much like blue jeans, except for this—both US exporters of beef and importers from other countries have relied heavily on NAFTA over the years to sell this product at a profit or easily obtain it at affordable prices. US retailers have effectively imported lower-value beef, which has allowed US farmers to produce and sell higher-value beef products to markets outside the country at attractive prices. Higher tariffs would make beef more expensive for US importers, US exporters, and other countries accustomed to sourcing their beef from us.

The total impact of tariffs on beef (fresh and frozen) coming into the United States would be $284.2 million—$159.9 million on imports from Canada and $124.3 million on imports from Mexico.

A closer look reveals how highly integrated the beef value chain has become across NAFTA countries.

Feed: The United States is a major producer and exporter of the corn and other feed used to raise cattle. The country exported 15 million tons of corn to Mexico and 1 million tons to Canada in 2017.

Rearing: Maintaining cattle occurs in a variety of regions across NAFTA countries. Texas, Nebraska, and Kansas are the largest US producers. In Canada, the four Western provinces account for 85 percent of production. In Mexico, cattle rearing occurs across the North, South, and Central regions.

Processing: Many Canadian and Mexican live cattle are transported across the border to be processed in the United States. In 2017, the United States imported $864 million of cattle from Canada and $715 million from Mexico for slaughter.

Consumption: Beef is consumed in the United States and exported to NAFTA countries. In 2017, $1.23 million of fresh and frozen beef was *imported* from Canada and $1.01 million from Mexico. That same year, the United States *exported* $612 million of fresh and frozen beef to Canada and $752 million to Mexico. The integrated market has allowed US farmers to focus on producing and exporting higher-value grain-fed beef in large quantities. Some 2.8 billion pounds go foremost to Japan, then South Korea, Mexico, Canada, and other countries. Meanwhile, most US beef imports—$1 billion-worth—are lower-value boneless cuts for mixing into ground beef used in hamburgers of various lean-to-fat ratios.

The total impact of tariffs on beef (fresh and frozen) coming into the United States would be $284.2 million—$159.9 million on imports from Canada and $124.3 million on imports from Mexico. US beef would be subject to Canadian and Mexican tariffs as well.

2. Impact on Growth and Consumer Spending

An end to NAFTA would affect retailer revenues through its impact on the economy. The consensus among economists is that the loss of economic efficiencies that tariff-free access across North America implies would impact GDP growth negatively. By combining studies from major banks and economists for a consensus view and averaging their yearly GDP impact results, it appears that GDP growth rates would fall in a range from 0.1 to 0.4 percent from 2018 through 2021. We estimate that lower growth in GDP could reduce expected output by as much as $232 billion annually by 2021.

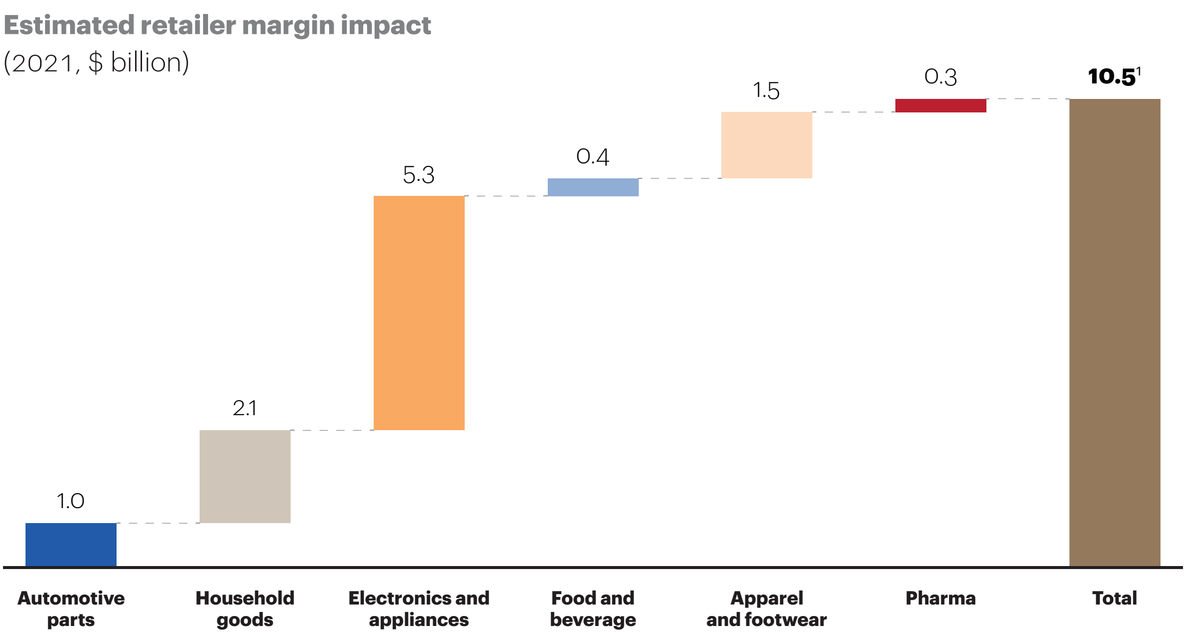
This lower growth would translate to $290 less retail purchasing for each US household than expected in the base scenario. Consumers will re-evaluate what they want and need, likely passing up a new flat screen TV before cutting back on needed groceries. As consumers reduce spending to avoid higher-priced items, retailers could see sales drop. We estimate that retailers could experience up to a $39 billion loss in revenue each year.

That loss of sales equates to $10.5 billion in reduced margins on an annual basis by 2021. Price elasticities would affect retailer margins in various product categories differently. Most impacted would be the electronics category, with a $5.3 billion margin reduction, followed by household goods with a $2.1 billion hit and apparel and footwear with a $1.5 billion hit to margin (see figure 5).

Looked at from the point of view of US income and household spend, 73 percent of US income typically goes to essential items such as rent, fuel, power, medical care, transportation, communication, and food, while the remaining 27 percent goes to discretionary items. So, we

Figure 5

Retailers would further take an $11 billion hit to industry margins, felt most acutely in discretionary categories such as electronics



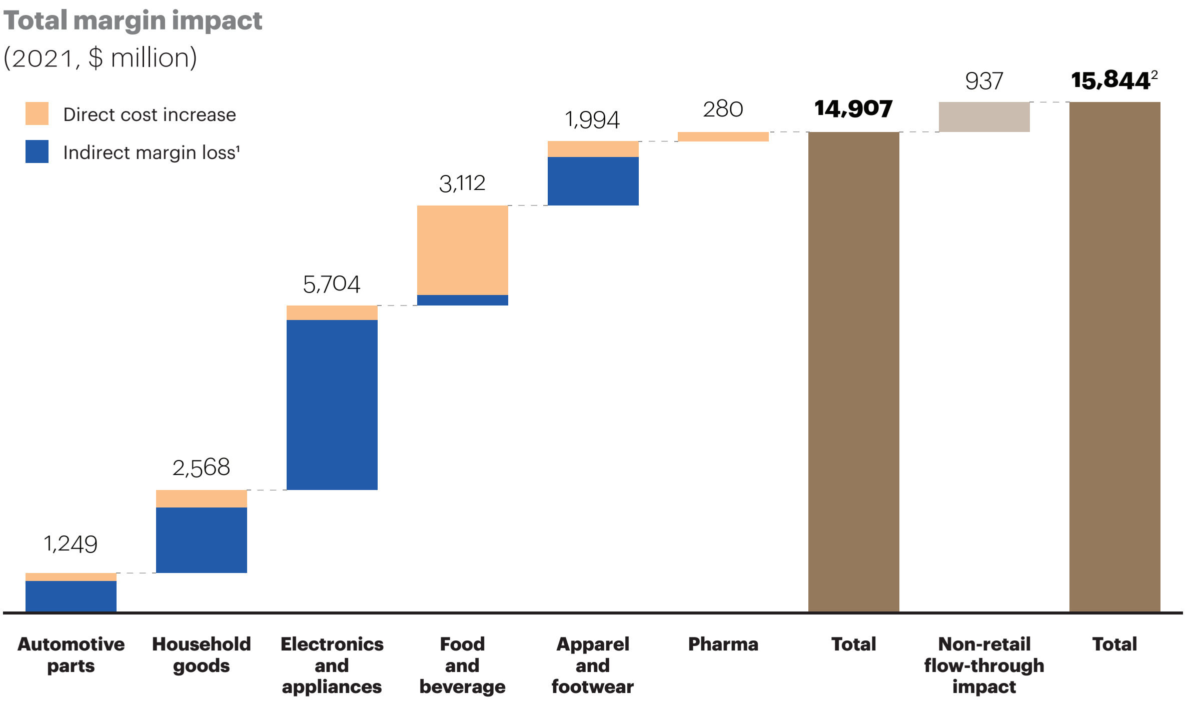
[1] Numbers may not resolve due to rounding.

Sources: BLS (US consumer expenditures), Scotiabank, BMO Capital, Oxford Economics (GDP reduction), *Wall Street Journal* (baseline growth), USDA (elasticities); A.T. Kearney analysis could see a drop of $148 spent per year, per household in the electronics and appliances category, $49 less per year in the household goods category, $45 dollars less per year in the automotive parts category, and $27 less per year spent in the apparel and textiles category.[4]

Taken together, the direct cost of tariffs and the indirect cost of margin loss could reduce retailers' bottom lines by up to $15.8 billion annually (see figure 6).

Figure 6

Tariff and revenue impacts together mean retailer bottom lines will be reduced by $16 billion



[1] Based on USDA-defined price elasticities of demand across expenditure categories for developed countries; data specific for US.

[2] Numbers may not resolve due to rounding.

Sources: BLS (US consumer expenditures), Scotiabank, BMO Capital, Oxford Economics (GDP reduction), *Wall Street Journal* (baseline growth), USDA (elasticities); A.T. Kearney analysis

3. Impact on Employment

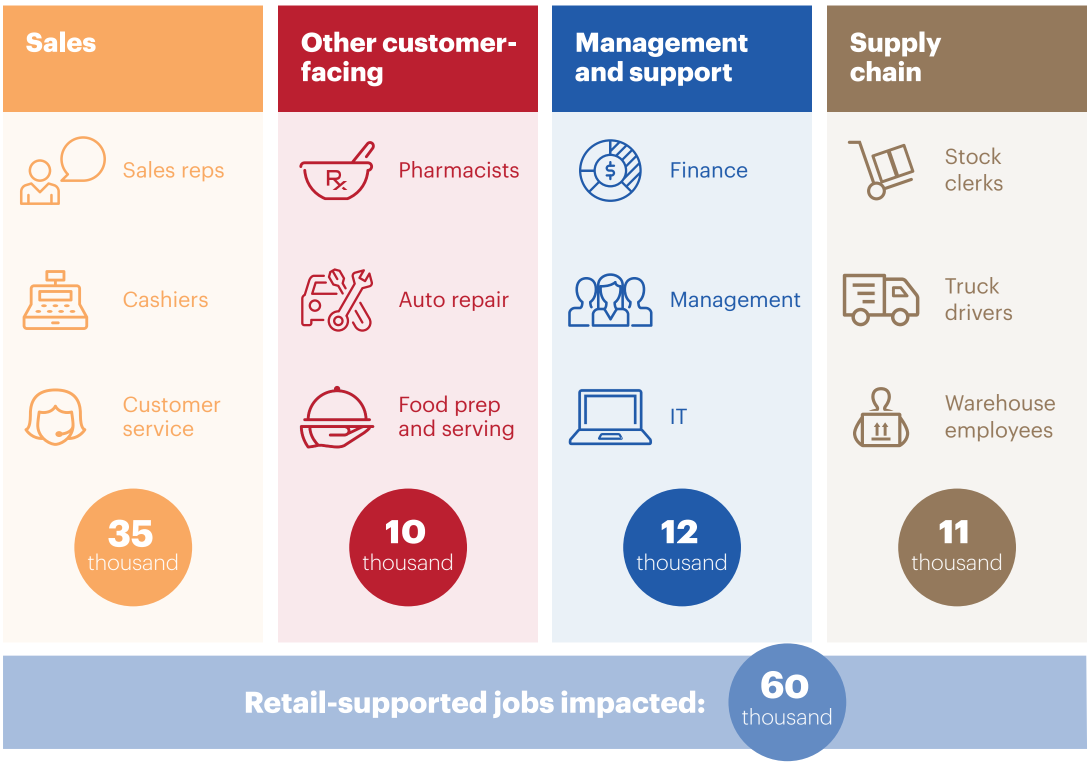
As a result of lost retail sales, we estimate that up to 128,000 jobs would not be filled cumulatively over the next three years.

We have modeled this based on a drop in retail sales, which has a correlation with retail employment (see figure 7 on page 12). Looking forward, retailers may choose not to hire 68,000 direct retail jobs, further impacting 60,000 retail-supported jobs by 2021. Most of the direct jobs (35,000) would be in sales, including sales representatives, cashiers, and customer service. Another 12,000 could be cut from management and support (such as finance and IT), 11,000 from the supply chain (including stock clerks, truck drivers, and warehouse employees), and 10,000 from other customer-facing positions (such as pharmacists, auto mechanics, and food preparation and serving).

[4] Automotive excludes finished vehicles.

Figure 7

128,000 retail-related jobs are at risk in the next three years: 68,000 directly employed in retail, and 60,000 in retail-supported industries



Sources: BLS occupational data; A.T. Kearney analysis

Steps Retailers Can Take Should NAFTA be Ended Instead of Modernized

Retailers can prepare now to reduce their risk prior to the outcome of ongoing NAFTA negotiations.

Start by understanding your risk exposure. Quantify the potential impact to both your business's and your competitors' cost of goods sold (COGS) under different scenarios. Consider category COGS spend, the proportion of imports coming from Canada and Mexico, and the current versus future tariff structure. For retailers in the food and beverage, apparel and footwear, and automotive retail sectors, it is particularly important to consider the direct effect of tariffs.

Lower revenue growth and a falling share-of-wallet would affect the household goods and electronics and appliances categories the most. Retailers in these areas may have to revisit their assortment strategy, choosing products that can withstand or partially offset slower overall growth. They also may have to revisit merchandising, adjusting their strategy to compete for a now-stressed share-of-wallet. They should also consider working with suppliers to explore alternate supply chain configurations that could mitigate some of the impact of the tariffs. Any way to make pricing more attractive, and adjusting it for an inflationary environment, could also help retailers.

Retailers Play a Vital Role in NAFTA

Retailers are significant importers from NAFTA countries because their customers demand the products that NAFTA has allowed them to purchase easily, affordably, and at great variety. Tariffs on goods from Canada and Mexico would effectively be a tax on domestic consumption of imports from these countries, throwing retailers directly into the path of cost increases. Retailers need to be prepared and craft strategies to best cope with a potentially new environment and consider alternate structures to help mitigate the impact. As NAFTA partners renegotiate to modernize the agreement, preserving its win-win environment will be crucial to support healthy retail businesses and their bottom lines, jobs, customer relationships, and the economy as a whole.

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