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Rules Of Origin For Automobiles Under A New NAFTA

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The Trump administration announced on May 18 that it is initiating a process to renegotiate the North American Free Trade Agreement, which comes on the heels of its decision to pull out of the Trans-Pacific Partnership Agreement. Depending on where you get your news, you may either have heard that the rules of origin for automobiles under NAFTA are so flexible that they left a gaping hole for TPP negotiators to fill or that it is the TPP rules that cry out for tightening. As the administration begins the process of renegotiating NAFTA, industry stakeholders will wish to know whether TPP rules are to be emulated or avoided. As with many matters of trade policy, the answer is, "It's complicated."

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As background, it is clear that the automotive industry plays a key role in the U.S. economy. According to U.S. Census data, the industry generates more exports for the United States than any other industry. Its role will only grow as vehicles become more technologically complex. Autonomous vehicles, an emerging segment of the market in which U.S. companies play a leading role, will generate technological breakthroughs that will be felt throughout the economy. As we all know, however, international trade in automobiles generates a great deal of friction between the United States and many of its major trading partners. The perception is, and the data tends to show, that the U.S. market is simply more open to these imports than are the markets of several countries that export to the United States.

Rules of origin in trade agreements have a major impact on the pattern of imports and exports. A trade agreement typically establishes preferential tariffs for goods moving between the countries that are parties to the agreement. The preferences are intended, among other things, to give companies an incentive to source their inputs from within the region of the agreement, enabling consumers to benefit from the comparative advantages enjoyed by each country and supporting regional cooperation and prosperity. If a tradeable good contains value both from inside and outside of the region, there have to be rules governing whether it will benefit from the preferences.

If the rules are too strict — say they require 100 percent content from the region — they will be ignored by producers, because as a practical matter producers must source some components from other countries. If the rules are too weak, on the other hand, nonparties would enjoy the same benefits as parties, and there would be no reason for countries to commit to the obligations set forth in the agreement. Even if they do nevertheless commit to the obligations, the goal of regional integration of supply chains would be thwarted by the ability of so-called third countries to benefit from the preferences.

Market access for countries that do not “play by the rules” can be very costly to companies that are required to play by them. For example, in a renegotiated NAFTA, it is very likely that there will be obligations to enforce intellectual property rights, just as there are in TPP. As the U.S. International Trade Commission has found, non-enforcement of intellectual property rights by foreign countries can be very costly to U.S. companies. If trading partners with weak intellectual property regimes can use NAFTA rules of origin to enjoy tariff-free access to the U.S. market, they will have little incentive to enhance their enforcement efforts. The same kind of dynamic is in play in regard to other U.S. negotiating objectives, including reducing non-tariff barriers to market access abroad.

Even if we can all agree that effective rules of origin are important, the details are important and controversial. Although there is more than one method for calculating regional value content, let us focus on the “net cost” method, which is common to NAFTA and TPP. The NAFTA threshold for automobiles is that a vehicle is considered to be from the NAFTA region if its regional value based on net cost is at least 62.5 percent. The comparable TPP threshold is 45 percent. According to Professor Mark Wu of Harvard Law School, the TPP threshold was kept relatively low because Japanese producers source many of their components from non-TPP countries, especially China.

The 17.5 percentage point gap between the NAFTA and TPP thresholds should not, however, be taken at face value, as calculations under NAFTA rules of origin are in certain respects more complicated than TPP calculations. There are two key principles, “deemed originating” and “tracing,” that are applied under NAFTA but not under TPP. Under the first principle, some parts are automatically treated as originating within the region. Under the second principle, a part from outside of the region that is on the “tracing list” retains its country of origin no matter how much it is processed within the region. Although these two tweaks pull in opposite directions, the tracing principle tends to predominate and, thus, the NAFTA percentages are somewhat inflated. It has been estimated that, using TPP methods, the 62.5 percent NAFTA threshold would become a 53 or 54 percent threshold, which is still higher than the 45 percent TPP threshold.

The NAFTA rules have achieved many of their objectives, as North American supply chains are highly integrated, and Canada and Mexico are major export destinations for the U.S. industry. According to the U.S. Department of Commerce, the United States exports more new passenger vehicles and light trucks to Canada than to any other country, and Mexico is somewhere in the top five export markets for the United States, with its ranking dependent on whether one measures U.S. exports by volume or by value.

Looking forward, it is likely that “deemed originating” and “tracing” will not be included in a renegotiated NAFTA. They create needless complexity. But it is unlikely, in light of the Trump administration’s criticisms of TPP, that it will embrace TPP’s 45 percent threshold. Given that automobile manufacturers benefit from increasingly global supply chains, particularly as cars and trucks become more technologically complex, a threshold somewhere between 45 and 55 percent may strike just the right balance.

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