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FORGING A NEW CONSENSUS ON TRADE.

NAFTA, AUTO RULES, AND CHINA

As details of the Trans-Pacific Partnership began to emerge in 2014 and 2015, Democrats raised concerns about the provisions of the agreement governing the terms under which autos and auto parts would benefit from preferential tariff treatment. These terms are known as "rules of origin."

The reason this issue was front and center in TPP is because the parties to NAFTA were also parties to the TPP. As a practical matter, this meant that the TPP rules could have superseded the NAFTA rules. Here's how.

Unless otherwise stipulated, the importer of a good gets to choose the basis for claiming preferential tariff treatment (usually, but not always, duty-free). So if the car was made in the TPP region, which includes Canada and Mexico, the importer could choose whether to claim the preference based on NAFTA or TPP.

The NAFTA rules require 62.5% of the car to be sourced in the region, and the TPP rules require only 45% of the car to be sourced in the region. That means that under NAFTA an importer can source 37.5% of the content of the car in places like China; but under TPP, the importer can source 55% of the content of the car in places like China. It's not hard to see that an importer is going to prefer the TPP rules because of the additional flexibility to source 17.5% more content form anywhere in the world, including China.

There are complexities with the rules that make the analysis less straightforward than that, but that's the gist of it.

Then-candidate Trump borrowed these points from Democrats and campaigned on the issue in the Rust Belt. The Rust Belt is also where, according to MIT economists, there has been significant import penetration and job loss. Carrying Michigan, Wisconsin, and Pennsylvania by just 100,000 votes, Trump won the election. In fact, that speech where he most clearly borrowed Democratic talking points was delivered in Western Pennsylvania.

To fulfill a campaign promise, the President has renegotiated NAFTA and changed the automotive rules. He can correctly claim credit for strengthening them.

At the same time, these new rules seem to continue to allow significant sourcing of Chinese goods, including major components of the vehicles. That in turn raises the question of whether, and how, the NAFTA renegotiation squares with the President's efforts to address the ongoing threat of Chinese industrial policy, which targets, among other advanced manufacturing, electric vehicles.

This blog will focus on passenger vehicles. There are similar provisions for light trucks, though the provisions are not identical.

<u>The NAFTA 2.0 Rules</u>

The new rules have four components, all of which have to be met in order to be eligible for duty-free entry. There are phase-in periods, but we won't go into that here.

- *Regional Value Content (RVC)*. This is the amount of value attributable to work performed in the region. For finished vehicles, the original NAFTA requires 62.5% of the value to be sourced in the region. In the new NAFTA, it's 75%. ([Appendix Article 3.1])[1] For parts, the analysis more complex. In the original NAFTA, it's generally 60% to 62.5%. In the new NAFTA, it's generally 70% to 75%. (Appendix Article 3.2-3.3)

  There are some technical details around the calculation that mean it isn't a perfect apples-to-apples comparison, but the gist is accurate.

- *Core parts requirement.* The new NAFTA identifies seven core parts (Appendix Table A-2):
  - Engines
  - Transmissions
  - Bodies and Chassis
  - Axles
  - Suspension Systems
  - Steering Systems
  - Advanced Batteries

  Although one provision in the agreement states that *all* core parts must originate in the region (Appendix Article 3.7), a separate provision appears to unwind that rule, only requiring that these parts *collectively* – not individually -- meet the 75% content requirement (Appendix Article 3.9).

  The incentives for producing these parts in the NAFTA region will depend, therefore, on the relative values of these core parts to the vehicle as a whole. If an engine and the transmission together make up 75% of the vehicle and are themselves originating, then the other five core parts can be sourced from outside the region – for example, China.

  The original NAFTA incentivized the manufacturing of *all* these core parts in the region.[2]

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[1] The Appendix starts on page 4-B-1-1.

[2] Advanced batteries are complicated. It seems that special treatment was given to lithium ion batteries *after* NAFTA entered into force, exempting them from the regime that incentivized their sourcing in the region.

- *Labor value content*. This is a novel concept. One of the criticisms of the original NAFTA is that significant production was offshored from high-wage Canada and the United States to lower-wage Mexico. The problem is not the wage disparity *per se*, but the view that the Mexican government has had an incentive to collude with business to keep wages down in order to maintain a (false) comparative advantage over its Northern neighbors.

  The labor value content requirement provides that, in addition to meeting the content above, an originating good must also meet a wage threshold. (Appendix Article 7). That is, the producer has to certify that its production consists of at least 25% of material and manufacturing expenditures of $16 per hour, and 5% of assembly expenditures of $16 per hour. (There is also a requirement of 10% for technology expenditures, but the wage debate is over manufacturing and assembly, not technology.) There are some technical issues around how these percentages are calculated, and it seems as though managerial salaries can be included if the employees are "directly" involved in the production. (Appendix fn. 76)

- *Steel and aluminum content*. The global steel and aluminum industries suffer from overcapacity. Because of technical rules under NAFTA, steel and aluminum from outside the NAFTA region counts as having been made *in* the region. That means the rules act as a funnel for non-NAFTA excess steel and capacity into NAFTA automotive products.

  The new NAFTA changes the incentives for sourcing steel and aluminum by requiring 70% of a producer's purchases of aluminum and steel, each, to be sourced in the region. (Appendix Article 6)

There is also an article in the agreement that provides for "transitions." (Appendix Article 8). It applies to 10% of a producer's production (Appendix Article 8.4), but it allows the rules set out above to be watered down. (Appendix Article 8.2)

Lastly, the agreement includes a "de minimis" provision. In the current NAFTA, the de minimis provision for rules of origin is 7%. (Article 405) That is, you get a 7% margin of error when it comes to figuring out if your good meets the rules of origin. The way de minimis works with a regional value content is complicated (it doesn't suddenly mean a 60% rule is a 53% rule). But that doesn't matter so much as the fact that the new NAFTA actually *raises* de minimis to 10%. (Article 4.12). That's extra 3% of stuff from outside the NAFTA region that's allowed in. As usual, a bunch of agricultural goods (especially dairy products) aren't subject to this rule. (Annex 4-A)

Questions about the New Rules

The new rules raise questions about their impact in the real world.

1. What do these rules mean in terms of changing supply chains? Will they ***in practice*** require 17.5% more parts to be sourced in the NAFTA region than is currently the case? In other words, does this agreement memorialize existing sourcing patterns, or does it change them, and if it changes them, then how?

2. If, for example, sourcing two core parts suffices, then will all the other core parts (indeed, all other parts) be sourced from outside the region – from China, for example?

3. Can lithium-ion batteries can still be sourced from China? If so, how does that square with the Administration's efforts to address Made in China 2025, which includes electric vehicle manufacturing? According to data available from the U.S. International Trade Commission, in 2017 the United States imported some 90 million lithium ion batteries from China. Korea was a distant second, with 22 million.

4. Right around the signing of the new NAFTA, GM announced that it was moving some of its vehicle production from the United States and Canada to Mexico. What does this say about the new LVC rules, which were designed to limit the kind of production shifts that GM announced?

5. The Administration states that the rules of origin will provide greater incentives to source goods from the United States, help "re-shore" vehicle and parts production in the United States, and transform supply chains to use "more United States content." The agreement is regional, and the rules are regional. How, exactly, will the agreement provide greater incentives to source *in the United States,* as opposed to Canada or Mexico? If the answer is the LVC, then how does this incentivize production in the United States, instead of Canada – and is all of that undermined by GM's move?

6. Can the "transitions" language be amended without going through Congress? That is, could the three NAFTA parties increase the vehicles subject to the exemption from 10% to say 25% or 100%, without obtaining legislative approval?

7. Of all manufacturing content issues, the Trump Administration spent the *most* time and energy reforming the automotive rules. If even these rules continue to allow significant content to be sourced from China, then what does that say about the rest of the manufacturing rules, which are weaker than the automotive rules?

8. The President complained about too much free-riding off NAFTA from countries like China. Why, then, would the new NAFTA *raise* the de minimis level and allow that much

more content from these free-riders? While Mexico will have to abide by the new labor rules, China, as a non-party, will not.

9. Agricultural products, mainly dairy, are given a reprieve from this margin of error. Why is the Administration, which is focused on returning manufacturing to U.S. shores, perpetuating the exclusion of some agricultural products from these rules, instead of either eliminating de minimis altogether, or applying it equally to all products?

Part of the reason the United States is limited in its ability to craft stronger rules to incentivize increased sourcing within the region, and away from China, is because the tariff on passenger vehicles is absurdly low – 2.5%. While Mexico is subject to the $16/hour requirement, China is not. That means that if the rules make it sufficiently expensive to source these goods within the NAFTA region, producers will simply opt to pay the tariff instead, where they have the option of sourcing *everything* outside the region.

It would not be a stretch to assume that this dynamic has informed the Administration's consideration of invoking Section 232 to impose duties on automobiles more generally. (Note that light trucks have a duty of 25%, and there is much more room to craft strict of rules of origin there.)

These low duties are the result of the age-old view that the United States could model good behavior by slashing its own tariffs more than others'. The outcome for cars can be traced back to Jimmy Carter. But modeling good behavior did not inspire copycat goodness, instead allowing our trading partners to have asymmetrically excellent access to the U.S. market.

This only goes to show that supply chains are now so complex that reining in China – which Ambassador Lighthizer is serious about -- will not merely be a matter of slapping duties on Chinese imports. It will require a wholesale reconsideration of the regime we have constructed since NAFTA first entered into force. We often think of NAFTA as offshoring U.S. manufacturing jobs to Mexico, but in fact NAFTA, and all the agreements that followed, offshored U.S. manufacturing jobs to China and other non-parties too.