Whither NAFTA? (Part III: Rules Of Origin)

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This the third post in a series of posts commenting on the NAFTA renegotiation process. For Part I click here, for Part II click here.

The rule of origin for conferring duty-free treatment to imports of motor vehicles within the NAFTA region has become one of the most contentious issues in the renegotiation process. Currently, no less than 62.5% NAFTA content is required.[1] The United States is seeking to raise this threshold up to 85%. Reportedly, Mexico might be agreeable to a minor increase in the minimum regional content, perhaps up to 70%, while Canada would make any increments in NAFTA content contingent upon meaningfully expanding the scope of the costs that go into the relevant calculation. In this Post I discuss whether a significantly tighter regional content rule would be enforceable given the facts involved in U.S.-Mexico bilateral trade in automobiles.

So what are those facts? Mexico's production of light vehicles (automobiles and light trucks) more than tripled from nearly 1 million units in 1994 (the year NAFTA went into effect) to close to 3.5 million in 2016.[2] Contrary to conventional wisdom, U.S. affiliates only account for about one third (36% to be exact) of the additional 2.5 million units involved.[3] In other words, the growth in Mexico's production of light vehicles triggered by NAFTA is mostly attributable to increased investment by Japanese, Korean and European producers, not to U.S. producers fleeing to Mexico. Unsurprisingly, over half (55%) of the 3.5 million light vehicles produced in 2016 were shipped to export markets,[4] albeit not to the United States exclusively.

Importantly, because Mexico's rejuvenated motor vehicle industry is highly specialized, so are Mexico's motor vehicle exports. Small cars and pickups represent close to 75% of Mexico's production of light vehicles.[5] On their own, small cars (including subcompact and compact cars) represent slightly over 50% of Mexico's light vehicle production.[6] About 50% of Mexico's small cars output is exported to the United States and Canada, 27% is exported to third countries, and the rest is consumed domestically.[7] Mexico has thus become a leading international hub for manufacturing and exporting small cars. This is so much so that exports from Mexico make up 48% of all small cars sales in the entire NAFTA region.[8]

What makes Mexico so appealing for producing small cars? The story one gathers from the specialized literature is as follows. The price of a car is closely correlated to its size. While the price of large luxury cars can be easily thrice the price of small cars, the difference between the cost of producing large luxury cars and the cost of producing small cars is not anywhere as large.[9] Accordingly, the profit rate of producing large luxury cars is much higher than the profit rate of producing small cars (reportedly, the latter could be in the low single-digits). However, producers will not exit this market because of a number of reasons, including that small cars is the entry-level segment and producers are keen to build brand loyalty amongst first-time buyers.

Against this backdrop, it would seem that U.S. producers regard manufacturing in Mexico as a strategic tool to ensure better profitability –through lower labor costs- in their small cars operations.

What would happen if the NAFTA rule of origin for motor vehicles were substantially increased from 62.5% with the intent to boost exports of U.S. auto parts?

There are indications that some of the vehicles produced by in Mexico already exceed the 62.5% minimum regional content rule and that, in few cases, even the 85% level is met or surpassed.[10] This suggests that U.S. affiliates in Mexico have already raised their NAFTA regional content to the extent this makes sense business wise. From this perspective, tightening the regional content rule for motor vehicles is likely to increase the cost of production of U.S. affiliates (by forcing U.S. affiliates to purchase auto parts originating in the region that are comparatively expensive).

In theory, U.S. affiliates could either absorb the entirety of the cost increase involved, they could fully pass it forward to their customers, or they could absorb it in part and pass it forward in part.

In practice, however, absorbing the cost increase involved would not be a good business proposition because doing so would dent significantly the already low profitability of manufacturing small cars which could then result in either small car operations shutting down altogether or relocating production to China. Either option would involve declining sales of U.S. auto parts and, through this effect, declining U.S. production and employment.

Thus, in the event of a tighter regional content rule, one would expect U.S. affiliates to pass forward the cost increase involved through higher prices. But this option has its limitations too because U.S. affiliates fiercely compete in the U.S. market with imports originating outside NAFTA and with the U.S. output of “transplants”, particularly in the small car market segment.

The U.S. MFN (‘most favored nation”) import duty rate for automobiles is

2.5%. This fact is crucial. If the cost increase arising from a tighter regional content rule requires an upward adjustment in prices in excess of 2.5% (to maintain profitability at current levels), it would make more sense for U.S. affiliates to decline NAFTA treatment for their exports and shift to exporting to the United States under the MFN rate of 2.5%.[11] This would be so because continuing to export under the terms of NAFTA (with zero import duty but subject to a regional content higher than 62.5%) would make exports from U.S. affiliates more expensive than exporting outside NAFTA (with an import duty of 2.5% but freed from a tighter rule of origin). Importantly, shifting to exporting under the MNF rate would open the door to decreasing purchases of U.S. auto parts by U.S. affiliates because in such circumstances they would not be bound by NAFTA content requirements any longer.

Thus, in the small cars market segment there appears to be very little space for enforcing a NAFTA content rule higher than 62.5%. By contrast, in respect of pickup trucks the prospects for enforcing a tighter regional content rule could be better, because the applicable MFN import duty is ten times as high.[12] In sport utility vehicles (SUV's) enforcing a tighter regional content rule could also be viable, not because the MFN import duty is high, but because the profit rate is reportedly much higher than in small cars and might accommodate the cost increase involved.

However, if a tighter regional content rule induces U.S. affiliates producing small cars to boost their purchases of non-NAFTA auto parts (because, having switched to exporting under the MFN rate, they are not bound by the NAFTA content requirements any longer), the increase in sales of U.S. auto parts for pickup and SUV production could likely be offset (especially in light of the fact that, as noted above, small cars account for more than 50% of total production of light vehicles in Mexico), which would make the net effect of tightening the regional content rule negligible.

Clearly, whatever is done in the end in respect of the regional content rule as part of the renegotiation of the NAFTA has to be done very carefully.

[1] In the Canada-U.S. Free Trade Agreement, the predecessor of NAFTA, the regional content rule was 50%. See, for instance, Sabrena A. Silver, "NAFTA's Rules of Origin for Automobiles: A Need for Reform", *Fordham Law Review,* Volume 62 (1994), Issue 7, at page 2268.

[2] Thomas H. Klier and James Rubenstein, "Mexico's Growing Role in the Auto Industry under NAFTA: Who Makes What and What Goes Where, Federal Reserve Bank of Chicago, *Economic Perspectives*, Vol. 41 (2017), No. 6, at page 2.

[3] Klier and Rubenstein, at pages 7 and 10.

[4] Klier and Rubenstein, at page 10.

[5] Klier and Rubenstein, at Table 4 in page 13.

[6] Klier and Rubenstein, at Table 4 in page 13.

[7] Klier and Rubenstein, at page 15.

[8] Klier and Rubenstein at Table 5 in page 14.

[9] Thus, although the development and retooling costs of producing a large luxury car are significantly higher than the development and retooling costs of producing a small car, and producing a large luxury car requires more and better materials, and larger and more powerful equipment than producing a small car, the overall cost of producing a large luxury car is not necessarily triple the overall cost of producing a small car.

[10] See, "U.S. Pushes Stiffer Rules for Nafta Car Makers", *Wall Street Journal*, November 17, 2017, and *NAFTA, 20 Years Later: Do the Benefits Outweigh the Costs?*, Knowledge@Wharton, February 19, 2014, at page 5.

[11] Qualifying for the MFN rate would not be an issue because this rate applies to vehicles originating in any Member of the World Trade Organization.

[12] The 25% MFN import duty for trucks is an oddity resulting from a 1960s trade conflict between the United States and then then European Economic Community known as "the chicken war".

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*The opinions presented in this Post are mine alone and do not represent in any way official views of King & Spalding LLP or its clients.
