INTERNATIONAL TRADE

SUMMARY OF AUTOMOTIVE PROVISIONS OF USMCA[1]
by Mark R. High

The automotive industry has a long history in North America. For example, Ford started making cars in the US in 1903. It started making cars in Canada in 1904. By 1925, it had production in Mexico. Interestingly, this production was for domestic consumption only – trade barriers prevented cars from being transported for sale among the three countries. By the way, Canada did pretty well on its own for many years because it was able to ship cars into the English Commonwealth countries, an early example of the effects of free trade.

This all started to change in 1965 with the US-Canada Auto Parts Pact, which eliminated tariffs on vehicles and parts. This led to the broader US-Canada Free Trade Agreement in 1989. By then, the then-Big Three had rationalized vehicle and parts production across the two countries.

Mexico started liberalizing its trade policies during the 1980s. The most visible example of that was probably the maquiladora regime, allowing production using Mexican labor for components used in US assembly plants.

This merging of the economies culminated with the North American Free Trade Agreement ("NAFTA") being adopted in 1994. There was a phase-in period, lasting as long as 10 years, but today, 25 years into the process, the borders have ceased to exist for North American producers. If you look at a map of original equipment manufacturer ("OEM") and supplier plant locations, you can see an apparent attempt to localize parts production near each model's assembly plant, but those plants are scattered across all three countries. The supplier industry is even more obviously integrated, with that proverbial part crossing just the US/Canadian border seven times.

It is true that this opening of the borders has resulted in a realignment of ultimate production. In broad brush, US light vehicle production went from 78% of the total North American production in 1995 to 65% in 2018, and Canada's share of production went from 16% to 12% in that period. Meanwhile, Mexico's share of production went from 6% in 1995 to 23% in 2018. I expect there were similar changes in parts production as well.

Some in the US saw this re-allocation of production as a bad thing, stemming from a single wicked source. Without getting into the details, let's just jump to the present, and say that we are now faced with a new reality. The United States-Mexico-Canada Agreement ("USMCA") is here, it is mostly settled, it is probably on its way to be adopted by the three countries at some point in the next two to fifteen months, and we need to get ready for it.

Certainly with respect to autos, it is complex, with many new concepts, and tight time frames. For example, the 10 year phase-in for NAFTA is history. Ignoring some limited staging exceptions which might be available, we are now talking about new requirements that will kick in upon effectiveness, and which will ratchet up to their final requirements by the third anniversary. For an industry generally working in six year model cycles, that is the blink of an eye.

So what changes are we talking about? Again, this is blindingly complex, certainly to a non-trade lawyer. But let's focus on a relevant slice to serve as an example of what is coming – light vehicle production at the OEM level, realizing that there will be different rules for light and heavy duty trucks, diesels, off-road vehicles, RVs, and so forth. Of course, USMCA will apply not just to the OEMs, but also to the suppliers up and down the chain. Suppliers will have their own compliance issues but, as usual, will also get the problems of the OEMs crammed down on them, further affecting how they structure their business.

USMCA imposes three different requirements which vehicles will have to meet to be able to qualify under the USMCA. In brief, after the phase-in, finished vehicles will have to meet a 75% required value content standard for localized content. In addition to that general requirement, there are sub-requirements for different categories of parts. Thus, certain "core parts," meaning engine, transmission, body, chassis, axle, suspension, steering, and advanced batteries, have to also meet a 75% localized value content, while "principal parts" (tires, glass, starter motors, mufflers, etc.) have a 70% requirement, and "complimentary parts" (lights, switches, small electric motors, locks . . .) have a 65% standard. These are the so-called Rules of Origin. This 75% general standard is up from the current 62.5% Rules of Origin standard in NAFTA (and the calculation methods are very different). The various parts sub-standards are new.

That's the first requirement. In addition, there is a new requirement that 70% of the steel and aluminum used in auto production come from North America. This isn't connected to any particular part or component of a vehicle, but is just a qualifying requirement to come within the USMCA's tariff treatment.

Finally, in this broad brush outline, there is a new labor value content requirement. Specifically, at least 40% of the manufacturing labor incorporated in a vehicle (45% for trucks) must have a wage rate above $16 per hour. Up to 10% of this 40% or 45% amount can come from high-value engineering/design/R&D and so forth, plus up to 5% for final assembly, but that still means at least 25% of a vehicle's content needs to be manufactured in a high-wage environment.

There, in three paragraphs, is the skeleton of what USMCA is about. There will be volumes written about the details here. There will be regulations which will hopefully spell a lot of this out in much more detail. What is certainly clear is that everyone's recordkeeping and compliance costs are about to explode. This will have a disproportionate effect on smaller companies which are not equipped to absorb extra costs. As mentioned, there is a short phase-in period, but that current 62.5% Rules of Origin requirement jumps immediately to 66% when USMCA is implemented, and there are annual increases for the next two years until the 75% level is achieved at Year Three.

Will these new rules achieve their goal? It might be good to revisit what that stated goal is. Free trade agreements are intended to expand an available market by removing barriers. This allows goods made in one country to be sold in another country, and lets the market determine what gets made where.

That is not USMCA's goal, at least with respect to autos. Note it is not even called a Free Trade Agreement. This is a managed trade or, less euphemistically, a directed trade approach. With the steel and aluminum purchase requirements and the labor content requirements, USMCA is seeking to impose requirements (or barriers) to achieve certain economic outcomes. The intended outcomes sought by the US here are to channel investment away from a low cost jurisdiction, and encourage increased jobs and production in the US of both parts and vehicles.

Will that happen? The US Trade Representative thinks so, as described in his report from this past April. The US International Trade Commission's report released at the same time concurs there may be a 'modest' increase in US jobs, but the cost of vehicles produced in the US will increase, with a corresponding decline in vehicle production. The International Monetary Fund has concluded even more emphatically that the new content rules and minimum wage requirements will lead to a less competitive North American auto industry, with higher costs, increased consumer prices, and reduced demand, both domestically and abroad.

The Center for Automotive Research in Ann Arbor has reported at the beginning of this year that, if we factor in the full Monty, i.e., USMCA, the Sec. 232 steel and aluminum tariffs (now rescinded or at least held in abeyance with respect to Canada and Mexico, but still in place for everyone else), the Sec. 301 China tariffs, and the potential Sec. 232 auto and parts tariffs on Japan and Europe (which could come by November), we could be looking at an average increase in the cost of a vehicle of $2,800 ($3,700 per vehicle for imports, $1,900 per vehicle if domestically produced).

CAR estimates this would result in 1.2 million fewer vehicles sold in the US, a loss of over $30 billion in GDP, and a loss of 368,000 jobs (77,000 just in the dealership ranks). Most of that results from the anticipated 232 tariffs, but (1) does anyone believe those won't come this year in some form, and (2) the general direction of US trade policy resulting in higher costs is clear. (As part of the recent US-Japan trade deal, Japan has received "assurances" that it will not get hit with the 232 national security tariffs, which will mitigate these effects.)

CAR concludes that just implementing the USMCA will impose an average of a $350 price increase on a vehicle, which could result in a reduction of almost 200,000 in vehicle sales. There is certainly some benefit resulting from removing the trade uncertainty which has swirled around the industry for three years now, but it remains to be seen as to whether those benefits will outweigh the effects of increased industry costs.

USMCA will have a dramatic impact on auto production in North America. There will be winners, and losers, coming out of these rule changes. Some domestic and Canadian suppliers may see their sales rise in terms of number of programs which they are involved in. Businesses south of the US border might lose some programs over time, or at least see their growth curtailed. Perhaps ironically, many of the "transplant" OEMs have already located production and suppliers domestically for their own purposes, and so may be better placed to weather these changes. Whether increased US automotive jobs and revenues will result, especially in light of escalating compliance costs, remains to be seen. What is certain is that an industry already in flux as it tries to prepare for the future of "mobility" will also have to change the way it operates now.

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[1] Adopted from remarks presented to the State Bar of Michigan, International Law Section, on September 18, 2019

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