Intelligence MEMOS

From: Jon Johnson

To: Members of Congress

cc: The US Auto Industry

Date: May 18, 2018

Re: **America First and Auto Rules of Origin Don't Mix**

International trade rules widely prohibit local content requirements because such requirements force businesses to operate inefficiently. Likewise, subsidies contingent on using domestic goods are prohibited under WTO subsidies rules and, further, requirements that foreign investors use host country goods are prohibited under investment treaties.

Having said this, rules of origin ("ROOs") are necessary in any agreement establishing a free trade area. To qualify and be exempt from the most-favoured-nation requirement under GATT 1994, members of the free trade area must eliminate duties on substantially all the trade in products "originating" in their territories. It is up to the members to decide what products are "originating." ROOs are structured as content requirements, requiring that goods qualifying for duty-free treatment contain prescribed levels of "regional" content, the region being the territories of the free trade area members.

The theory behind permitting free trade areas is that the inefficiencies resulting from discriminating against products from non-member countries will be more than offset by the benefit of eliminating duties on qualifying products traded among the members. This theory can be easily frustrated by ROOs that add significantly to the cost of doing business, particularly if the added cost of complying exceeds the duty saved by qualifying.

The US proposal for the NAFTA(2) automotive ROOs imposes a 75 percent content threshold that is far higher than the threshold in any US trade agreement (though the US originally proposed 85 percent). The US proposal has content thresholds for various categories of parts (core, principal and complementary) with core parts (high value-added components like engines and transmissions) having the highest threshold. The US proposed ROOs set out high requirements for NAFTA-region steel and aluminum content.

The US proposal also includes a labour-value content component that requires that prescribed levels of content in automobiles originate in countries where the workers receive salaries far in excess of Mexican wage levels. Mexican factories would thereby be excluded from providing this content.

In a meeting at the White House on May 11 with senior automotive executives, President Trump pushed hard for America First, stating that the US objective in the NAFTA negotiations is to ensure that many more automobiles are produced in the US. President Trump also maintained that the US approach would increase exports of automobiles from the US.

The Center for Automotive Research, in a report last month, reaches the opposite conclusion. Adoption of the US proposals would increase costs and decrease efficiency in the NAFTA region, which would make US-produced vehicles less competitive both domestically and in export markets. Producers could partially offset this effect by opting for paying the low US duties on cars and sourcing cheaper parts from offshore, with negative effects on US employment. The high US duties on trucks would cut off sales of inexpensive vehicles from Mexico and increase costs overall.

Higher costs will also result in fewer automobiles being sold in the US market, which could have a significant negative impact on US production of after-market parts, as well as on employment of skilled employees servicing vehicles.

ROOs are ineffective instruments for pursuing an industrial policy like America First. Congress should use its powers of oversight over the negotiation of trade agreements to insist that the US NAFTA negotiators listen to concerns expressed by the US auto industry and propose ROOs that preserve and build upon the considerable automotive efficiency gains that have been achieved under NAFTA.

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