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NAFTA Motor Vehicle Talks Reopen Old Trade Debate

Automotive trade is among the most sensitive issues in negotiations with Mexico and Canada over revisions to the North American Free Trade Agreement (NAFTA). The United States has proposed major changes in the rules of origin that determine which vehicles and parts qualify for tariff-free treatment when traded among the three countries.

The proposal has reopened a decades-old debate about regulating the content of vehicles sold in the United States. If some variant of the proposed changes is accepted by Canada and Mexico and then ratified by all three countries, it would make the fifth time since 1965 that Congress has sought to encourage greater use of domestic content in cars and light trucks.

History

Motor vehicle content rules were originally a response to rising imports of passenger vehicles, primarily from Japan. Such rules were included in the Automotive Products Trade Agreement of 1965, better known as the U.S.-Canada Auto Pact, which was designed to integrate U.S. and Canadian vehicle manufacturing. Vehicles covered had to have 50% U.S. or Canadian content for free entry into the United States, and separate provisions required Canadian content for vehicles sold and parts used in Canada. (The Auto Pact was terminated in 2001 after the World Trade Organization found that some provisions violated its trade rules.)

In 1975, the Energy Policy and Conservation Act (EPCA; P.L. 94-163) established the corporate average fuel economy standards for light vehicles sold in the United States. To prevent U.S. automakers from importing fuel-efficient vehicles to meet fleet-wide efficiency standards, the law set one standard for domestic vehicles and a stricter standard for imports. For a vehicle to be considered domestic, at least 75% of its content had to be manufactured in the United States or Canada. (After NAFTA went into effect in 1996, EPCA was amended to count Mexican content as "domestic.") EPCA states that the value added from parts manufacturing and final assembly is the basis of determining whether a vehicle meets the 75% domestic value standard. For components assembled outside the NAFTA region, only the value of parts produced in a NAFTA country counts as domestic content. Unlike with other content provisions in later laws, transportation and insurance costs within the NAFTA area are included as domestic costs.

A third attempt at mandating vehicle content came during the Reagan Administration, at a time when recession reduced U.S. vehicle sales and Japanese automakers were increasing their U.S. market share. The proposed 1982 Fair Practices in Automotive Products Act would have eventually required vehicles sold in the United States to have 90% U.S. content (including parts and labor). Seen as targeting imports from Japan, the bill passed the House twice, but was not voted on in the Senate amid concerns that it violated international agreements and faced a pledge by President Reagan to veto it.

Congress revisited the domestic content of vehicles again in 1992, when the American Automobile Labeling Act (AALA; P.L. 102-388) required a label on all new vehicles showing domestic and foreign content of parts and the final assembly location. Parts content does not include final assembly, distribution, or other non-parts costs.

AALA specifies that only U.S. and Canadian content is domestic; Mexican content does not qualify. If imported parts count for no more than 30% of the value of a vehicle component made in the United States or Canada, 100% of the value of the component is counted as domestic. For engines and transmissions, however, a broader category of assembly and labor costs is also included in the domestic content calculation. The country that contributes the most value to the engine or transmission is considered the country of origin, even if some parts are imported.

Table 1.Top 10 Domestic Content Vehicles in 2007

Automaker	Vehicle	U.S./Canada Content
Ford	Lincoln MKX	95%
Ford	Expedition	95%
Ford	Edge	95%
General Motors	Pontiac Grand Prix	90%
General Motors	GMC Sierra	90%
General Motors	Chevrolet Silverado Pickup Truck	90%
General Motors	Chevrolet Monte Carlo	90%
General Motors	Chevrolet Impala	90%
General Motors	Buick LaCrosse	90%
Ford	Mercury Mariner	90%

Source: American Automobile Labeling Act, 2007 Report, by percentage, https://www.nhtsa.gov/part-583-american-automobile-labeling-act-reports.

The overall domestic content of many vehicles sold in the United States, as measured under AALA, has declined over the past decade as the vehicle supply chain has globalized. AALA reports show that many motor vehicle parts manufactured in 2007 contained well over 75% domestic content. **Table 1** shows the 10 models with the greatest domestic content in 2007. In contrast, only a few vehicles

had as much as 75% domestic content in 2017 (**Table 2**). Despite the requirement that dealers post AALA information for new cars, surveys have shown that few car buyers use the data in making purchase decisions.

Table 2.Vehicles with At Least 75% Domestic Content in 2017 AALA Report

Automaker	Vehicle	U.S./Canada Content
Kia Motors	Optima 1.6L	83%
Kia Motors	Optima 2.4L	83%
Fiat Chrysler	Wrangler 4 Door	75%
Honda	Acura	75%
Honda	CR-V All Wheel Drive	75%
Honda	Ridgeline Pickup Truck	75%
Kia Motors	Optima 2.0	75%
Toyota	Camry	75%

Source: American Automobile Labeling Act, 2017 Report, by percentage.

NAFTA

NAFTA has no provisions concerning U.S. content. It provides that vehicles and parts produced in Canada, Mexico, and the United States may move tariff-free in that zone as long as at least 62.5% of the value of the assembled motor vehicle is produced in the region. Parts and components sold separately must have 60% regional content to qualify for tariff-free status.

The calculation of regional value content (RVC) under NAFTA is far more complex than the domestic content determinations under EPCA and AALA. Vehicle and parts producers are required to use a "net cost" method that includes calculating six separate costs for each vehicle: materials, processing, labor, production equipment, overhead, and general expenses. In addition, the net cost method requires that intermediate and indirect materials be traced back to their raw material origins. Tracing was included in NAFTA to eliminate imported material in a part or vehicle net cost calculation. For example, engine components purchased in Asia and assembled into a finished engine in Mexico must be traced so that the Asian parts are not counted as NAFTA content. This cumbersome process is governed by a list of products that must be traced by automakers back through each stage of production, until there is a raw material not on the list. Not all products used in producing vehicles are included on the tracing list, however.

Evolving Motor Vehicle Supply Chain

Since NAFTA took effect more than two decades ago, the motor vehicle industry has changed significantly. More vehicles are being produced in North America by automakers from Japan, South Korea, and Germany as the market share of the Detroit Three—General Motors, Ford and Chrysler (now Fiat Chrysler)—has declined.

Over the same period, three factors have reshaped the vehicle supply chain. First, vehicle assemblers have sourced more parts from specialized parts makers. An estimated 70% of the value added in a finished motor vehicle now originates with the parts makers, compared with about 40% 25 years ago. (Value added is the amount by which the value of a product is increased at each stage of its production, minus initial costs.) Second, the parts industry itself has seen a major consolidation in the past decade and is now global in its own right, as parts makers have followed their vehicle assembler customers to new markets. The auto parts industry now sources components from Asia, Europe, and Latin America. Third, parts suppliers have increasingly turned to new production methods in which they deliver complex modules to auto assemblers that include parts from many suppliers—and potentially many countries. With as many as 15,000 parts in typical passenger motor vehicles, tracing the origin of parts becomes much more complex than it was at the time current laws governing domestic content were enacted.

Current Issues

An increase in the required RVC alone would not assure that more parts and vehicles would be manufactured in the United States. The Trump Administration has called for an additional change in NAFTA, requiring that vehicles imported from Canada or Mexico have 50% U.S. content in order to benefit from tariff-free access to the U.S. market. Canada and Mexico have reportedly opposed this change. A 50% U.S. content provision might not lead manufacturers to assemble cars in the United States rather than in Mexico; it could instead encourage auto producers in Mexico to import cheaper parts from Asia or Europe and pay the 2.5% U.S. tariff on cars shipped to the United States. (This is less likely with light trucks, on which the U.S. tariff is 25%.)

Revising or eliminating the NAFTA tracing list is also an issue. Calculating each of the separate costs required to determine RVC may be costly, especially for small parts manufacturers. One option would be to eliminate tracing; it was not included in the proposed Trans-Pacific Partnership (TPP) trade agreement, which instead would have required automotive products to undergo "substantial transformation" in North America to qualify as domestic. The United States withdrew from that agreement in 2017.

Other options would lead to an expanded use of tracing. Under current NAFTA rules, not all materials are included on the tracing list. Some steel, aluminum, electronics, and electric batteries are excluded from tracing, which means that even if they are produced in a NAFTA country, their value does not count towards the 62.5% threshold for tariff-free trade. Another proposal is to include research, development, and software costs in determining RVC. Little software was installed in vehicles at the time NAFTA was signed, but software is now a significant cost factor in vehicle assembly and will likely become more so as manufacturers develop increasingly automated vehicles.

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