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Bumper to Bumper: Will the CUSMA Rules of Origin Make America's Auto Industry Great Again?

In negotiating a new trade deal with Canada and Mexico, the US targeted the rules of origin for auto products to right perceived wrongs of the past. The resulting rules in the Canada-United States-Mexico- Agreement (CUSMA) are both more stringent than those in NAFTA, and needlessly complex. Clarification is needed.

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The Study In Brief

In the negotiations for a new NAFTA, the Trump administration targeted the North American auto industry for major change. The Trump administration objected to the NAFTA rules of origin – with which a good must conform to be eligible for NAFTA duty-free treatment – as permitting too much non-NAFTA content in North American automobiles, and was fixated on the US's significant balance-of-trade deficit with Mexico, most of which is accounted for by trade in automotive goods.

For Canada's auto industry, there is much at stake. In 2017, Canada exported automotive goods to the United States valued at close to $62 billion, and the US market is overwhelmingly the destination for vehicles produced in Canada. Therefore, it is important that the rules of origin with which the Canadian automotive industry must work be transparent and administratively workable.

Under the new deal, the Canada-United States-Mexico- Agreement (CUSMA), the rules of origin that will apply to motor vehicles and their parts are considerably more stringent than their NAFTA counterparts. This *Commentary* analyzes the CUSMA rules of origin for automotive goods, identifies ambiguities and areas of uncertainty, and makes suggestions for clarifications through the adoption of the Uniform Regulations – for which CUSMA fortunately provides – that will provide greater certainty to both businesses and administrators in how to apply the rules.

Adapting to the CUSMA rules will require major adjustments in supply chains. This is particularly the case with the substantially higher Regional Value Content (RVC) thresholds required for most automotive goods. While some relief is possible through limited alternative staging alternatives, the staging to the higher RVC thresholds under CUSMA is only three years for passenger vehicles and light trucks, as compared with eight years under NAFTA.

Further, the CUSMA rules of origin are needlessly complex. There are multiple categories of parts for different categories of vehicles with varying RVC requirements that depend on the end use of the part. Complexity increases compliance costs, which are burdensome for all producers, but particularly for smaller producers that are less able to afford investment in expensive compliance systems. While the CUSMA rules mostly eliminate NAFTA tracing requirements, the CUSMA text inexplicably retains a form of tracing for several narrow categories of vehicles.

The CUSMA rules of origin regime contains two requirements that are unprecedented in such regimes; namely a steel and aluminum purchase requirement and a labour value content requirement. These are performance requirements that are consistent with a managed trade regime (where rules are designed to achieve certain economic outcomes) and not with a free trade regime (which seeks to remove barriers to trade so that economic results are dictated by market forces).

Two reports cast doubt on the benefits of the deal for the US. A US International Trade Commission report found, overall, the new rules should lead to a modest increase in employment in the US automotive sector, but the costs of vehicles produced in the United States will increase and production of vehicles there will decline. An International Monetary Fund working paper states quite bluntly that the tighter auto rules of origin will not achieve their desired outcomes by reason of higher costs, increased consumer prices and reduced demand.

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The North American auto industry was a prime target of the Trump administration for major change in the renegotiation of the North American Free Trade Agreement (NAFTA).

The administration argued that the NAFTA rules of origin – the rules with which a good must conform to be eligible for NAFTA duty-free treatment – permitted too much non-NAFTA content in North American automobiles. The United States also has a significant balance-of-trade deficit with Mexico, most of which was accounted for by trade in automotive goods. The renegotiation has resulted in the Canada-United States-Mexico Agreement (CUSMA), which Mexican Senate has now approved but which has not yet been approved by either the US Congress or the Canadian Parliament.

The CUSMA rules of origin that will apply to motor vehicles and parts are considerably more stringent than their NAFTA counterparts. In 2017, Canada exported automotive goods to the United States valued at close to $62 billion, so it is a matter of considerable importance that the rules of origin with which the Canadian automotive industry must work once CUSMA comes into effect be transparent and administratively workable.[1] Furthermore, the US market is overwhelmingly the destination for vehicles produced in Canada: in 2017, 95.4 percent of passenger vehicles, 95.9 percent of light trucks and 98.5 percent of heavy trucks exported from Canada went to the United States.[2]

The purpose of this *Commentary* is to analyze the CUSMA rules of origin that will apply to automotive goods, to identify ambiguities and areas of uncertainty and to suggest some clarifications through the Uniform Regulations referred to below.[3]

Overview of the CUSMA Rules of Origin

The structure of the CUSMA product-specific rules of origin closely follows that of the rules set out in NAFTA, and is based on prescribed changes in tariff classification and regional value content (RVC) requirements, as described below. In both agreements, the product-specific rules respecting automotive goods have unique characteristics designed to address concerns that existed at the time each agreement was negotiated. When NAFTA was negotiated in the early 1990s, the Big Three (General Motors, Ford and Chrysler) were

The author thanks Daniel Schwanen, Dennis DesRosiers, Christopher Sands, Magna International Inc. (Karin Muller), anonymous reviewers and members of the International Economic Policy Council for comments on an earlier draft. He retains responsibility for any errors and the views expressed.

1 The value of goods exported to the United States in 2017 under tariff headings 8701, 8702, 8703, 8704, 8705 and 8706 was $61.8 billion. This figure does not include goods exported under other tariff headings for use in automobiles. All figures in this *Commentary* are in Canadian dollars unless otherwise specified. All export statistics are taken from Canada, "Trade Data Online," available at https://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/home.

2 The figures for "passenger vehicles," "light trucks" and "heavy trucks" are based on the CUSMA definitions of these expressions.

3 For further details on the automotive rules of origin in CUSMA, an online Technical Addendum to this *Commentary* is available here https://www.cdhowe.org/sites/default/files/Comm 547 Addendum.pdf.

concerned – arising from their experience under the Canada-US Free Trade Agreement – with a rules-of-origin concept known as "roll-up." If a material, such as an engine, used in the production of a vehicle is considered as "originating" under the specific rule of origin that applies to it, the value of non-originating materials, such as pistons, contained in the engine is rolled up into the value of the engine, and does not count against the producer.[4] The Big Three were the drivers behind the NAFTA automotive rules, and they considered that Japanese automakers Toyota and Honda were abusing roll-up.[5]

The NAFTA solution was to adopt a system of tracing for light-duty vehicles (vehicles, small trucks and small buses), which required that the value of specified parts and components – set out in a light-duty vehicle tracing list in NAFTA Annex 403.1 – imported from outside the NAFTA countries contained in vehicles or parts be traced back to the point of importation and counted against the producer, regardless of the originating status of the part or component into which they were incorporated. A somewhat different tracing system was adopted for heavy-duty vehicles (tractors, larger trucks and buses, specialty vehicles) that applied only to specified materials in engines and transmissions.

In the time, after NAFTA came into effect in 1994, the Big Three and other vehicle assemblers, as well as their suppliers, learned to live with the NAFTA tracing regimes and were seemingly content with them. US negotiators, however, were critical of tracing because automotive components not on the tracing list – such as car batteries other than batteries for electric cars – did not count against the producer even if imported from outside North America. Also, the NAFTA light duty vehicle tracing list had not been updated since NAFTA came into effect over 25 years ago.

The light-duty vehicles tracing concept has been dropped from the CUSMA automotive rules of origin. The mechanism chosen for achieving greater North American content is to increase substantially the RVC thresholds in the content rules relating to passenger vehicles and light trucks, heavy trucks and for many parts incorporated into these vehicles.[6] The heavy-duty vehicle tracing concept has been retained (and made more complicated) for a narrow range of vehicles that do not include any in the passenger vehicle and light truck category or in the heavy truck category.

In addition to increasing RVC thresholds, the CUSMA introduces two other rules-of-origin requirements for automobiles that have nothing to do with content and are unprecedented in rules-of-origin regimes. The first is a steel and aluminum purchase requirement that must be satisfied by producers of passenger vehicles and light trucks and those of heavy trucks. The second, which is directed at shifting North American content away from Mexico, is a labour value requirement (based on a

4 The opposite of "roll-up" is "roll-down": if the engine in the example is non-originating, its entire value counts against the producer, even though the engine might contain parts that qualify as originating.

5 A case involving Honda Canada highlights the concerns at the time; see Cantin and Lowenfeld (1993). The operations of international automakers such as Toyota and Honda in North American were commonly referred to as "transplants."

6 To put the relative importance of these categories in perspective, in 2017 Canada exported $56.1 billion under the "passenger vehicle" category, $1.0 billion under "light truck" and $1.8 billion under "heavy truck." In addition, Canada exported $0.9 billion of vehicles with compression ignition engines (diesel and semi-diesel), curiously excluded from the definition of "passenger vehicles" in CUSMA. However, the $56.1 billion reported here for passenger vehicle exports includes three- or four-wheeled motorcycles, motor homes, entertainer coaches and vehicles principally for off-road uses, which are not considered "passenger vehicles" in CUSMA.

US$16 hourly wage) that must also be satisfied by producers of passenger vehicles and light trucks and of heavy trucks.[7]

Uniform Regulations

Rules of origin impose an additional border measure that must be complied with if a producer's goods are to enter the territory of another party to a trade agreement and benefit from agreed preferential tariffs. Suppliers lower down a supply chain are also affected by rules of origin because their customers will demand that the products they buy satisfy rules-of-origin requirements. The need to comply with rules of origin causes producers to adopt practices such as sourcing inputs and establishing special accounting and recordkeeping systems that they would not otherwise adopt and that can put them at a competitive disadvantage vis-à-vis their global competitors. The more complex the rules, the greater the compliance costs. Compliance with rules of origin can be particularly onerous for smaller producers that lack the staff to ensure the producer has systems in place to satisfy origin requirements and, if necessary, withstand a customs audit.

Rules of origin are applied daily in thousands of cross-border transactions, and it is imperative that their meaning and application be as free from doubt as possible. The NAFTA parties accomplished this objective by adopting Uniform Regulations that harmonized the regulations implementing the NAFTA rules of origin.[8] These Uniform Regulations clarified many ambiguities in the NAFTA text , and provided greater certainty to both businesses and administrators in their application. Fortunately, the CUSMA negotiators decided, in Article 5.16, to follow this same approach. The CUSMA Uniform Regulations will be very useful in clarifying uncertainties in the CUSMA rules of origin, and numerous provisions in those rules specifically contemplate clarifications through the Uniform Regulations.

Below, I point out the many provisions of the CUSMA automotive rules of origin that require clarification to be workable.

Basic Structure of CUSMA Product-Specific Rules of Origin

Like NAFTA, CUSMA prescribes product-specific rules of origin for each good classified in the Harmonized System (HS) that must be satisfied for the good to be "originating" and eligible for CUSMA tariff treatment. In general, these rules of origin are based on substantial transformation, expressed in terms of required changes in tariff classification that non-originating materials[9] must undergo as they are transformed into the finished good through the production process. Many rules also impose an RVC requirement. As in NAFTA, CUSMA RVC requirements provide two options for calculation – namely, a transaction value method and a net cost method (see Box 1). For some

7 Jeffrey J. Schott (2018) has stated that the US$16 per hour requirement is "presumably to discourage companies from moving assembly operations to Mexico."

8 The Canadian version of the NAFTA Uniform Regulations is set out in the NAFTA Rules of Origin Regulations SOR/94-14. The US version, the wording of which is virtually identical to the Canadian, is set out in the NAFTA Rules of Origin Regulations, Title 19, Chapter 1, of the US Code of Federal Regulations, Appendix Part 181. Other than being in Spanish, the Mexican version is virtually identical to the Canadian and US versions.

9 A non-originating material is a material imported from outside the CUSMA countries or produced in a CUSMA country but that does not satisfy the rule of origin that applies to it or for which the origin is undetermined.

Box 1: Two Options for Calculating Regional Value Content

Transaction Value Method

The formula is: RVC = (TV-VNM)/TV x 100

Where

RVC is the is the regional value content, expressed as a percentage;

TV is the **transaction value** of the good, adjusted to exclude any costs incurred in the international shipment of the good; and

VNM is the value of non-originating materials including materials of undetermined origin used by the producer in the production of the good.

The "**transaction value**" is essentially the price paid or payable for the good, with some adjustments.

Net Cost Method

The formula is: RVC = (NC-VNM)/NC x 100

Where

RVC is the is the regional value content, expressed as a percentage;

NC is the **net cost** of the good; and

VNM is the value of non-originating materials including materials of undetermined origin used by the producer in the production of the good.

The "**net cost**" of the good is total cost of the good minus sales promotion, marketing and after-sales service costs, royalties, shipping and packing costs, and non-allowable interest costs that are included in the total cost.*

* These expressions are all defined in CUSMA Article 4.1.

goods, the rules do not require a change in tariff classification, but can be satisfied through an RVC requirement alone.

The CUSMA product-specific rules of origin are set out in CUSMA, Chapter 4, Annex 4-B, which also contains an appendix (hereafter the "Auto Appendix") that sets out the product-specific rules that apply to vehicles and vehicle parts, as well as provisions related to the application of the product-specific rules to all automotive goods.

Product-Specific Rules of Origin in the Auto Appendix

Product-specific rules of origin for vehicles (HS headings 8701–8706) are set out in the Auto

Appendix, Article 2. Each rule sets out a change in tariff classification requirement[10] and a mandatory RVC requirement using the net cost method.[11] The RVC thresholds vary by type of vehicle.[12] Each rule for vehicle bodies (HS 8707) and parts (HS 8708) sets out a change in tariff classification with no RVC requirement or, alternatively, a less stringent change in tariff classification coupled with an RVC requirement or an RVC requirement with no change in tariff classification requirement. The RVC thresholds vary depending on the end use of the good.

Many goods not classified under HS headings 8701-8708, with product-specific rules of origin set out in Annex 4-B, can be used as parts in motor vehicles, as well as for other purposes. These rules take a variety of forms. Some prescribe a change in tariff classification only, with no RVC requirement. Other rules provide for a choice between a change in tariff classification by itself or a less stringent change in tariff classification (or occasionally no required change in tariff classification) coupled with an RVC requirement – most commonly of at least 60 percent using the transaction value method or of at least 50 percent using the net cost method.[13] The Auto Appendix substantially increases these RVC thresholds for parts used in certain categories of vehicles – that is, the rule for a dual-use good is more stringent if the good is incorporated into a vehicle, rather than used for some other purpose.

Rules of Origin for Passenger Vehicles and Light Trucks and Parts

For Canadian producers, passenger vehicles and light trucks is clearly the most important category of vehicle covered by the Auto Appendix in terms of volume of exports.

RVC Calculations and Additional Requirements for Passenger Vehicles and Light Trucks

The rules of origin for passenger vehicles and light trucks are set out in the Auto Appendix, Article 4. RVC requirements for this category of vehicle are mandatory, and are based on the net cost method. The RVC requirements in each of these rules are modified as provided in Article 3(1), which increases the RVC requirement to 66 percent, starting from the later of January 1, 2020, or the date of CUSMA's entry into force, then the next year to 69 percent, the following year to 72 percent and finally to 75 percent from the later of January 1, 2023, or three years after the date of the agreement's entry into force. There are no transaction value method alternatives.

In addition to satisfying the RVC requirements,

(a) a passenger vehicle or light truck is originating only if the parts in Table A.2, column 1, of the Auto Appendix – namely, engine, transmission, body and chassis, axle, suspension system, steering system and advanced battery – used in

10 Except for the rules for heading 87.06, which set out RVC requirements only without a change in tariff classification.

11 The only exception is subheading 8703.10, snowmobiles, which provides for an RVC of 50 percent using the net cost method or an RVC of 60 percent using the transaction value method.

12 The NAFTA rules of origin respecting vehicles also require the use of the net cost method. In CUSMA, the RVC threshold is 62.5 percent for light-duty vehicles and 60 percent for heavy-duty vehicles, rather the 50 percent threshold that usually applies when the net cost method under NAFTA is used.

13 There are variations from these percentages for some goods.

the production of a passenger vehicle or light truck are originating;[14]

(b) the vehicle producer must satisfy the steel and aluminum purchase requirement in Article 6 (described below); and

(c) the vehicle producer must satisfy the labour value content requirement in Article 7 (described below).

RVC Calculations for Parts of Passenger Vehicles and Light Trucks

Auto Appendix, Article 3, sets out special requirements for the RVC calculations for three categories of parts used in passenger vehicles and light trucks: core parts for passenger vehicles and light trucks, listed in Table A.1 of the Auto Appendix; principal parts for passenger vehicles and light trucks, listed in Table B of the Auto Appendix; and complementary parts for passenger vehicles and light trucks, listed in Table C of the Auto Appendix.

The Auto Appendix phases in higher RVC thresholds for each of these categories of parts that are subject to an RVC requirement. As with passenger vehicles and light trucks, the full phase-in of the higher thresholds will be complete by the later of January 1, 2023, or three years after the date of entry into force of CUSMA.

Rules of Origin for Heavy Trucks and Parts

In terms of sheer volume, exports of heavy trucks from Canada to the United States are much less important than exports of passenger vehicles and light trucks. At a little over $1.8 billion in 2017, however, the volume is considerable.

RVC Calculations for Heavy Trucks

The rules of origin for heavy trucks are set out in the Auto Appendix, Article 4. RVC requirements for heavy trucks are mandatory, and are based on the net cost method. The RVC requirements in each of these rules are modified by Auto Appendix, Article 4(1), which sets the RVC requirement at 60 percent, starting from the later of January 1, 2020, or the date of CUSMA's entry into force, then at 64 percent from the later of January 1, 2024, or the date of the agreement's entry into force and finally at 70 percent from the later of January 1, 2027, or seven years after the date of CUSMA's entry into force. Heavy trucks are subject to both the steel and aluminum purchase requirement and the labour value content requirement, described below.

RVC Calculations for Parts of Heavy Trucks

The Auto Appendix, Article 4, sets out special requirements for the RVC calculations for two categories of parts used in heavy trucks: principal parts for heavy trucks, listed in Table D of the Auto Appendix and covered in Article 4(2); and complementary parts for heavy trucks, listed in Table E of the Appendix and covered in Article 4(3). The Auto Appendix phases in higher RVC thresholds for both categories of parts that are subject to an RVC requirement. As with heavy trucks, the full phase-in of the higher thresholds

14 Auto Appendix, Article 3(7), sets out this requirement and states that additional descriptions and other requirements will be provided in the CUSMA Uniform Regulations. Article 3(8) sets out several options for the calculation of the value of non-originating materials for parts listed in Table A.2, column 1, and Article 3(9) sets out further options respecting the calculations for these parts.

will be complete by the later of January 1, 2027, or seven years after the date of entry into force of CUSMA.

Averaging RVC Calculations

As in NAFTA, Article 5 of the Auto Appendix sets out various averaging options that producers of vehicles and parts can use in making their RVC calculations. Averaging calculations over fiscal periods simply recognizes the realities of accounting.

Calculations for Passenger Vehicles, Light Trucks and Heavy Trucks

The RVC calculation for a passenger vehicle, light truck or heavy truck may be averaged over the producer's fiscal year, using any one of the following categories, based on either all motor vehicles in the category or only those motor vehicles in the category that are exported to another CUSMA country:

(a) the same model line of motor vehicles in the same class of vehicles produced in the same plant in a CUSMA country;

(b) the same class of motor vehicles produced in the same plant in a CUSMA country;

(c) the same model line or same class of motor vehicles produced a CUSMA country; or

(d) any other category as the parties may decide, which provides flexibility and can be covered in the Uniform Regulations.

As in NAFTA, a model line is a group of vehicles having the same platform or model name. The classes of vehicles are the same as in the NAFTA averaging provisions, and cover broad categories of vehicles. For example, all vehicles falling within the definition of "passenger vehicle" fall within a single class.

Calculations for Parts

Many parts of passenger vehicles, light trucks and heavy trucks are subject to RVC requirements. The RVC calculation for parts produced in the same plant may be averaged over the fiscal year of the motor vehicle producer to whom the good is sold, or over any quarter or month or over the fiscal year of the producer of the automotive material. The producer can also average RVC calculations for parts using the same categories for passenger vehicles, light trucks and heavy trucks described above.

The Steel and Aluminum Purchase Requirement

The steel and aluminum purchase requirement, set out in Auto Appendix, Article 6, states that a passenger vehicle, light truck or heavy truck is originating only if, during specified periods, at least 70 percent of the vehicle producer's purchases of steel and aluminum in North America are originating. Article 6(2) sets these periods as the producer's previous fiscal year, the previous calendar year or over the quarter, month, fiscal or calendar year in which the vehicle is exported.

A report by the European Parliamentary Research Service[15] states that the CUSMA regional-sourcing provision for steel and aluminum "appears to be a local content requirement" that would be difficult to justify under World Trade Organization (WTO) national treatment and most-favoured-nation (MFN) obligations. Rules of origin based on prescribed changes in tariff classification routinely require that certain materials must originate in the free trade area. Although rules of origin in free trade agreements are content requirements, they do not offend WTO prohibitions because the required content can come

15 Titievkaia with Pietsch (2018).

from anywhere in the free trade area. The steel and aluminum purchase requirement, however, goes far beyond any provision that normally would appear in rules of origin. The idea behind rules of origin based on changes in tariff classification is to identify (through their tariff classifications) the materials incorporated into a good that give the good its essential character. Thus, the NAFTA (and CUSMA) specific rule of origin rule for rear-view mirrors requires that the glass originate in a NAFTA (or CUSMA) country because, unlike other materials used to produce the mirror, glass is considered the material that creates the essential character of the mirror and hence is required to be originating (that is, North American) for the mirror to be originating.

Although steel and aluminum obviously are used in the production of motor vehicles, the steel and aluminum purchase requirement has no connection to the character of any part or component of a passenger vehicle, light truck or heavy truck, but exists as an additional performance requirement that must be satisfied to benefit from CUSMA tariff treatment. The requirement might or might not be open to challenge under WTO rules, but it is unprecedented in rules of origin in a free trade agreement, the purpose of which is to facilitate free trade. As its title suggests, however, CUSMA does not purport to be a "free trade" agreement. Rather, as the website of the Office of the United States Trade Representative states, the new rules will "transform supply chains to use more United States content, especially content that is key to future automobile production and high-paying jobs." Historically, US trade negotiators in free trade agreements such as NAFTA and in the many investment treaties to which the United States is a party have insisted on prohibiting requirements that certain goods be purchased as a condition for receiving a benefit or preference. The steel and aluminum purchase requirement, in contrast, expressly conditions the benefit of CUSMA tariff treatment for vehicles on compliance with it, as one might find in a managed trade regime.

Article 6(3) of the Auto Appendix requires that the parties develop whatever description of the steel and aluminum covered by the provision that might be necessary for implementation be set out in the CUSMA Uniform Regulations. The Uniform Regulations should go beyond this, however, and spell out exactly what a producer must do to comply with the steel and aluminum requirement so that there is no ambiguity.[16]

The Labour Value Content Requirement

In addition to other requirements, Auto Appendix Article 7 imposes a labour value content requirement that must be satisfied by producers of passenger vehicles, light trucks and heavy trucks if their vehicles are to be treated as originating. The requirement is unprecedented in rules-of-origin regimes. As indicated above, the purpose of the requirement appears to be to direct automotive investment in North America from lower-wage Mexico to higher-wage Canada and the United States.According to Jesús Seade, chief negotiator for then Mexican president-elect Andrés Manuel López Obrador, the idea of labour value content originally was advanced by Canada as an alternative to the earlier US demand that at least 50 percent of the content of a qualifying vehicle be specifically of US origin. Seade stated that there was a sense of betrayal over this rule, but its effect was mitigated by the allowance for engineering and design management, areas where Mexican wages are

16 Identifying products using each CUSMA country's eight-digit harmonized tariff schedule classifications would add clarity and help to avoid inconsistent application.

relatively high (Siripurapu 2018). As indicated on its website, the Office of the United States Trade Representative considers the US$16 per hour requirement a "key achievement" that will "support better jobs for United States producers and workers by requiring that a significant portion of vehicle content be made with high-wage labor" (United States n.d.).

Like the steel and aluminum requirement, the labour value content requirement is a performance requirement consistent with a managed trade regime. The idea of using tariffs to equalize costs of production between domestic and foreign producers is not new in US tariff law: the Fordney-McCumber tariff enacted in the early 1920s gave the president authority to adjust tariffs to that end (Irwin 2017, chap. 7). The labour value content requirement, by mandating that a vehicle be eligible for CUSMA tariff treatment only if its producer maintains prescribed wage rates, will have the effect of offsetting Mexico's lower labour costs.

Passenger Vehicles

The CUSMA labour value requirement with which producers of "passenger vehicles" must comply is set out in the Auto Appendix, Article 7(1). The requirement begins at 30 percent from the later of January 1, 2020, or the date of CUSMA's entry into force, increases the next year to 33 percent, the following year to 36 percent and finally to 40 percent from the later of January 1, 2023, or three years after the date of the agreement's entry into force. These percentages are broken out into various components. When the required labour value content reaches 40 percent,

(a) at least twenty-five percentage points must consist of "high wage material and manufacturing expenditures" for which the production wage rate must be no less than US$16 per hour;

(b) no more than ten percentage points may consist of "technology expenditures" – including on prototype development, design, engineering, testing and information support operations – with no specified wage or salary rate; and

(c) no more than five percentage points may consist of "assembly expenditures," with an average production wage of at least US$16 per hour.[17]

Light and Heavy Trucks

The labour value content components for light and heavy trucks are the same as for passenger vehicles, but the required content starts at 45 percent, and the breakout is thirty percentage points consisting of "high wage material and manufacturing expenditures," no more than ten percentage points consisting of "technology expenditures" and no more than five percentage points consisting of "assembly expenditures."

Calculating the Labour Value Content of Components

To calculate the percentage points attributable to "high wage material and manufacturing expenditures,"[18]

(a) the numerator is the annual purchase value of parts or materials produced at a plant or facility, plus labour (if the producer elects) at the vehicle assembly plant or facility with a production wage rate of at least US$16 per hour;[19] and

17 Auto Appendix note 80, sets out various requirements concerning plant size, production capacity and so on, the details of which should be sorted out in the Uniform Regulations.

18 See Article 7(3)(a); this description is an oversimplification.

19 This is defined in the Auto Appendix, note 76, as an average hourly base wage rate, excluding benefits, of employees directly involved in production, and excludes salaries of those not involved in direct production.

(b) the denominator is the net cost of the vehicle (used to apply the net cost method).

To calculate the percentage points attributable to high-wage technology expenditures (Article 7(3)(b)),

(a) the numerator is the annual expenditures by vehicle producer in North America for research and development or information technology; and

(b) the denominator is the total annual expenditures by the vehicle producer on production wages in North America.

The producer can earn a single credit of five percentage points if it has an engine assembly plant, a transmission assembly plant or an advanced battery assembly plant, or long-term contracts with such a plant located in North America, with an average production wage of US$16 per hour (Article 7(3)(c)). The text does not describe how these percentage points are calculated.

Footnotes throughout the text add to the complexity of these calculations. For example, "high wage material and manufacturing expenditures" can also be based on the annual purchase value of parts or materials produced in a plant or facility within the CUSMA countries with a production wage of at least $US16 per hour (Auto Appendix, note 77). Application of this option requires that a vehicle producer obtain information from its suppliers. Just how this is supposed to work is not at all clear.

Averaging Labour Value Content Calculations

A producer of a passenger vehicle, light truck or heavy truck may average its labour value content calculations using the same categories, described above, as for averaging RVC calculations for these vehicles. As with the steel and aluminum purchase requirement, calculations may be made over the producer's previous fiscal year, the previous calendar year or over the quarter or month or fiscal or calendar year in which the vehicle is exported.

Need for Clarification through the Uniform Regulations

As noted above, the labour value content requirement is unprecedented, and the way it is to be applied is far from clear in the CUSMA text. The CUSMA Uniform Regulations should spell out exactly how a producer of a vehicle is to satisfy its labour value content obligations, otherwise the application of these requirements will be left to the whim of customs officials.

Alternative Staging Regimes

The Auto Appendix, Article 8, provides for the development of staging regimes for passenger vehicles and light trucks, and for heavy trucks, as alternatives to the staging provided for these vehicles in Auto Appendix, Articles 3 and 4. Staging refers to the transition by producers from the initial RVC levels to the final RVC levels.

As described above, for passenger vehicles and light trucks the initial stage under Article 3 requires an RVC of 66 percent by the later January 1, 2020 and the date that CUSMA enters into effect, and the final stage requires an RVC of 75 percent by the later of January 1, 2023 and three years after CUSMA enters into effect. Under an alternative staging regime, the RVC achieved must not be lower than 62.5 percent, and must reach 75 percent by the later of January 1, 2025 and five years after CUSMA enters into effect.[20]

The number of a producer's vehicles to which an alternative staging regime may apply is limited to not more than 10 percent of the greater of the producer's total production of these vehicles during the twelve months before CUSMA enters into

20 Auto Appendix, Article 8(2)(a).

effect and the average of such production during the 36-month period prior to CUSMA entering into effect.[21] The CUSMA parties may agree to increase the number of eligible vehicles to which a producer is entitled upon the presentation by the producer of a detailed and credible plan for meeting Auto Appendix requirements within five years of CUSMA coming into effect.

Alternative staging is also provided for goods listed in Table A.1 of the Auto Appendix (core parts referred to above) with an RVC not lower than 62.5 percent using the net cost method and 72.5 percent using the transaction value method (where available) and reaching 75 percent using the net cost method or 85 percent using the transaction value method by the later of January 1, 2025 and five years after CUSMA enters into effect.[22]

The steel and aluminum and the labour content requirements continue to apply throughout any transition period. However, the "high wage material and manufacturing expenditures" component of the labour content requirement may be reduced by up to five percentage points under an alternative staging regime.

Auto Appendix Article 8(4) contemplates alternative staging regimes for heavy trucks for a period ending the later of January 1, 2027 and seven years after CUSMA enters into effect. However, unlike with passenger vehicles and light trucks, the CUSMA text does not specify requirements for a heavy truck alternative staging regime.

The Uniform Regulations should set out the requirements for a heavy truck alternative staging regime and specify various mechanics of how all alternative staging regimes will work in practice.

NAFTA increased RVC thresholds for vehicles from those that applied under the Canada -U.S. Free Trade Agreement and did not provide for alternative staging. However, the NAFTA higher thresholds were staged over eight years as opposed to the CUSMA's three years for passenger vehicles and light trucks and seven years for heavy trucks.

Retention of Tracing for Vehicles

Article 10 of the Auto Appendix sets out two relatively narrow categories of vehicles and parts to which special rules apply for RVC calculations. The wording of these special rules closely follows the wording of the heavy-duty vehicle-tracing language in NAFTA Article 403(2).

The first category of vehicles and parts is set out in Article 10(1), and includes certain small buses, cars with diesel engines, light trucks for off-road use and engines and gear boxes for these vehicles. The RVC threshold for these goods is fixed at 62.5 percent. The second category is set out in Article 10(2), and includes tractors (except tractors for semi-trailers), larger buses, dumpers, other trucks for off-road use, mobile drilling derricks, concrete mixers and fire-fighting vehicles, as well as engines, gear boxes and parts (with some exceptions) as set out in the NAFTA light-duty vehicle-tracing list. The RVC threshold for these goods is fixed at 60 percent.

Article 10.3 sets out the rules for applying the value of the non-originating materials (VNM) component of the RVC requirement. For the second category just described, the calculation of

21 Auto Appendix, Article 8(2)(c).

22 Auto Appendix, Article 8(2)(b). Batteries classified under HS 8507.60 used as the primary source of electrical for the propulsion of a vehicle are excluded from this provision, but footnote 82 provides that during the transition period, the change in tariff classification rule is modified to permit a change from parts subheading 8507.90 as conferring originating status.

VNM follows the NAFTA heavy-duty vehicle methodology. For the first category, VNM is calculated using the NAFTA heavy-duty vehicle methodology, but it is strangely coupled with the NAFTA light-duty vehicle-tracing list into some sort of hybrid heavy/light-duty vehicle-tracing regime.

The application of these very difficult and, frankly, inexplicable provisions should be translated into a workable regime in the Uniform Regulations. Alternatively, the parties could adopt, through the Uniform Regulations, rules of origin for the vehicles and parts covered by Article 10 that dispenses with tracing and its complications.

Failure to Comply with the Rules of Origin

An automotive good that does not comply with its applicable CUSMA rule of origin will not be eligible for CUSMA duty-free treatment and will be subject to applicable MFN rates.

Canadian and Mexican producers are particularly concerned with access to the US market. US MFN tariffs on most automotive goods are low: the tariff on cars is 2.5 percent, while the average US duty on parts has been calculated to be 3.1 percent (Yates and Holmes 2019, 15); some parts are tariff free. While Canadian and Mexican exporters of automotive goods to the United States obviously would prefer not to pay these tariffs, particularly on low-margin goods, these rates do not present a major impediment to access the US market. If the cost of complying with the CUSMA rule of origin is higher than the duty saved, the exporter could simply elect to pay the duty. This option might not be available, however, to an exporter whose customer (such as an assembler or a Tier 1 supplier) insists that the product supplied qualify as originating. The US MFN tariff on both light and heavy trucks is 25 percent, which is a compelling incentive to incur whatever additional expense there might be in complying with CUSMA rules.

Access to the US automotive market is complicated by the report of the US Department of Commerce on its investigation into the effect of imports of automotive goods on US national security under Section 232 of the *Trade Expansion Act of 1962*. The president now has wide discretion to impose tariffs on imports of automotive goods, including those from Canada and Mexico, allegedly to protect US national security as expansively defined in Section 232. Side letters between the United States and both Canada and Mexico, however, limit the application of any Section 232 tariffs. Each side letter provides that, if imposed, Section 232 tariffs will not be applied to the import of the first 2.6 million passenger vehicles (an amount considerably above the current level) into the United States from each of Canada and Mexico or to imports of light trucks (without limitation as to number).[23] Also, Section 232 tariffs will not be applied to prescribed levels of imports of automotive parts from each of Canada and Mexico that exceed current import levels from the two countries. On this basis, and if the United States does not renege on these commitments, Section 232 tariffs should not create a practical problem for exporters of passenger vehicles, light trucks and automotive parts from Canada and Mexico to the United States. However, each side letter establishes a quota, albeit a high one, and US authorities might require monitoring and reporting. The Uniform Regulations should ensure that any administrative burden imposed by the side letters is kept to an absolute minimum.

By a proclamation issued on May 17, 2019, President Trump directed the United States Trade Representative to adjust imports by negotiating

23 The side letters are not contingent on CUSMA's coming into effect.

agreements with respect to imported automobiles and parts from the European Union, Japan and any other country the Trade Representative deems appropriate, and to report back in 180 days (United States 2019a).[24] This effectively postpones any presidential decision on Section 232 tariffs on automotive goods until late October 2019. The imposition of such tariffs would be a major blow to the world trading system, but it could increase auto investment in North America, as occurred in the 1980s when the United States entered into restraint agreements with Japan

Neither side letter makes any mention of heavy trucks, which, as noted, are already subject to a 25 percent tariff.

Concluding Remarks

NAFTA has been in effect for more than twenty-five years, and North American automotive producers have developed supply chains based on complying with the NAFTA rules of origin. The CUSMA rules are substantially different, and adapting to them will require major adjustments in supply chains. This is particularly the case with the much higher RVC thresholds required for passenger vehicles and light trucks, heavy trucks and many of their parts.

The CUSMA rules of origin are needlessly complex. There are three separate categories of parts for passenger vehicles and light trucks, with staging to differing and higher RVC thresholds. There are two more categories of parts for heavy trucks, with staging to higher RVC thresholds. The parts listed for passenger vehicles and light trucks overlap with the parts listed for heavy trucks, with the result that differing RVC thresholds and staging can apply to the same part, depending on whether its end use is for a passenger vehicle or light truck, or for a heavy truck. As noted above, complexity increases compliance costs, which are burdensome for all producers, but particularly for smaller producers that are less able to afford investing in expensive compliance systems.

Although NAFTA's light-duty tracing has been dropped, the retention of a form of the NAFTA heavy-duty vehicle tracing and the creation of some sort of NAFTA heavy/light-duty vehicle hybrid for a relatively narrow range of vehicles (such as cars with diesel engines, off-road vehicles) is inexplicable, and adds a further and unnecessary complication to an already complex regime.

The sole purpose of rules of origin in a free trade agreement should be to define the degree of processing, either through substantial transformation or adding value, or a combination of the two, that a good should undergo within the free trade region to be eligible for duty-free treatment. The incorporation of performance requirements to encourage particular industries (such as CUSMA's steel and aluminum purchase requirement) and to channel investment away from a low-wage free trade area party (the labour value content requirement) is consistent with a managed trade regime, where rules are designed to achieve certain economic outcomes, rather than with a free trade regime, which seeks to remove barriers to trade so that economic results are dictated by market forces.

Returning to the question raised at the beginning of this *Commentary*, the US negotiators of the CUSMA automotive rules of origin and their political masters made no secret of the fact that their objective was to increase automotive production in the United States. Whether this objective will be achieved is questionable. In a report published in April 2019, the Office of the United States Trade Representative was confident that the automotive provisions will significantly increase not only the purchase of auto parts in

24 The approach of adjusting imports by negotiating agreements is authorized by 19 U.S.C. 1862(c)(3)(A)(i).

the United States but also automotive investment and jobs in that country (United States 2019b). The US International Trade Commission, in a report released simultaneously, is less optimistic (USITC 2019). Overall, according to the report, the new rules should lead to a modest increase in employment in the US automotive sector, but the costs of vehicles produced in the United States will increase and production of vehicles there will decline. An International Monetary Fund working paper is decidedly pessimistic, and states quite bluntly that the tighter auto rules of origin will not achieve their desired outcomes by reason of higher costs, increased consumer prices and reduced demand (Burfisher, Lambert, and Matheson 2019). Jeffrey Schott has predicted that the "new content rules and minimum wage requirements will likely lead to a less competitive North American auto industry with less investment in US plants and fewer US jobs in the sector – just the opposite of the claims of US officials" (Schott 2018).

If CUSMA is approved and comes into effect, the North American automotive industry will have to live with the agreement's rules of origin for a long time.[25] Once a trade agreement comes into effect, it is very difficult to change. This is particularly the case in the United States, with its complex rules for approving trade agreements and its separation of powers. CUSMA has not yet come into effect, however, and there is still time for extensive clarification through the CUSMA Uniform Regulations. North American automotive producers should review carefully the CUSMA rules of origin and urge their respective governments to negotiate and implement Uniform Regulations that clarify ambiguities, establish procedures to reduce compliance costs and facilitate the routine application of rules of origin to the greatest extent possible.

25 For at least 16 years, unless a party withdraws, or longer if the parties choose to extend the agreement for further periods of 16 years, as provided in CUSMA Article 34.7.

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