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USMCA: Automotive Rules of Origin

The United States-Mexico-Canada Agreement (USMCA; P.L. 116-113) entered into force on July 1, 2020, replacing the 1994 North American Free Trade Agreement (NAFTA). NAFTA was viewed as instrumental in creating a highly integrated North American motor vehicle industry. USMCA negotiations over new rules for North American automotive trade created tensions among and within the three trading partners. Some uncertainty remains over the implementation of the automotive trade rules and potential impacts on the North American motor vehicle industry. Congress has an oversight role in USMCA implementation and U.S.-North American trade relations.

Automotive Rules of Origin

The criteria used to determine the national origin of a product are called rules of origin (ROO). Most free trade agreements (FTAs) have ROO provisions to determine which goods traded between member countries are eligible for preferential treatment (reduced tariffs or duty-free trade). They generally seek to ensure that the benefits of the agreement are granted to goods primarily produced by a member country (and therefore subject to the entirety of its commitments) rather than to goods made wholly, or in large part, in other countries.

NAFTA phased out tariffs on automotive products traded among the three member countries as long as the products met the ROO, particularly regional value content (RVC) requirements (i.e., a certain percentage of North American content). USMCA maintains these tariff eliminations, but tightens the ROO, as shown in **Table 1**.

During the negotiations, motor vehicle and parts producers generally supported retaining NAFTA ROO. The Trump Administration and labor advocates sought to require higher wages and RVC thresholds, which they argued would incentivize manufacturing in the United States. Some economists contend that the higher RVC requirements in USMCA may have unintended consequences. For example, they state that it may be more cost efficient for manufacturers to pay the 2.5% U.S. most-favored nation (MFN) tariff on passenger vehicles rather than meet the extensive ROO requirements. They argue that the new rules pose a risk to North American auto production because they may raise production costs, resulting in higher vehicle prices, reduced demand for motor vehicles, and fewer auto exports, as well as incentivize more automation in automotive production, thereby reducing demand for workers. Even with these concerns, some motor vehicle producers support USMCA and say that complying with the new ROO may be challenging, but probably manageable.

Entry into Force and Economic Impact

USMCA provided a three-year transition period for the new automotive ROO. It also allowed vehicle producers to request an alternative staging regime that would permit a longer transition period to implement the new ROO (up to five years after USMCA's entry into force, unless a request for a longer period is granted). The Office of the U.S. Trade Representative (USTR) approved alternative staging requests from 13 companies.

Table 1. NAFTA and USMCA Automotive ROOs

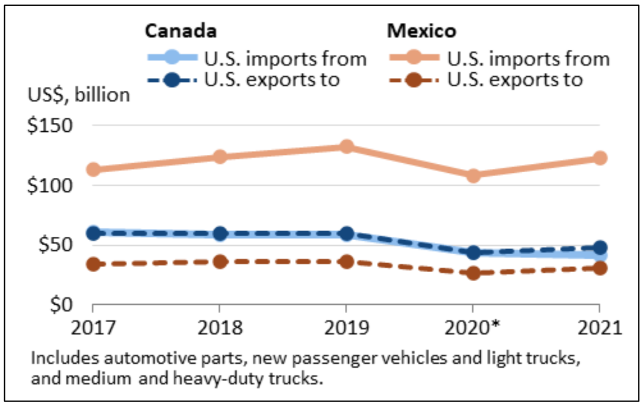
NAFTA	USMCA
62.5% RVC for passenger vehicles, light trucks, engines and transmissions	75% RVC for passenger vehicles, light trucks, core auto parts
60% RVC for other vehicles and auto parts	65%-70% RVC for other vehicles and auto parts
No labor value content rule (LVC) (no wage requirement)	LVC rule stating that 40%-45% of a vehicle's production by value be made by workers earning at least $16 per hour
No steel and aluminum requirement	70% of a vehicle manufacturer's steel and aluminum purchases by value must originate in North America

Source: CRS based on USMCA and NAFTA text.

According to USMCA implementing legislation (P.L. 116-113), USTR, in consultation with the Interagency Committee on Trade in Automotive Goods, also established by P.L. 116-113, is required to submit a biennial report to Congress on motor vehicle trade. The first report was submitted to the House Ways and Means and Senate Finance Committees in July 2022. In the report, USTR stated that there was evidence of producers making "significant investments" in North America in order to meet the automotive ROO, but industry is still adapting to the more complex rules. USTR noted that it will continue to assess the effectiveness of the rules. In November 2023, USTR launched its second biennial review, with a report to be submitted to Congress by July 2024.

P.L. 116-113 also requires the U.S. International Trade Commission (ITC) to publish biennial reports on the economic impacts of the USMCA automotive ROO through 2031. Since USMCA's entry into force, U.S. trade of motor vehicles and parts with Canada and Mexico has been relatively stable (**Figure 1**). In its June 2023 report, ITC estimated that through the end of 2022, the USMCA automotive ROO had marginal impacts on U.S. competitiveness, and the full impact of the USMCA automotive ROO may not be apparent until the ROO are to be fully implemented in 2027. ITC noted that other factors, such as supply chain disruptions during the COVID-19 pandemic, had a greater impact than the ROO during the analysis period (July 2020-December 2022). ITC estimated that through the end of 2022, the USMCA automotive ROO contributed to an increase in U.S. aggregate employment of less than 0.01%, including an estimated 3,912 U.S. vehicle and parts production workers. ITC also estimated that the ROO led to 487,048 fewer imports of core auto parts from non-USMCA countries and 1,464 more vehicles produced in the United States in 2022, which were lower than previously forecasted numbers. ITC stated that although cost increases have not yet been significant, the ROO will likely lead to higher production costs over time. Some manufacturers are also choosing to pay a 2.5% tariff for some vehicles rather than comply with the ROO. Both cases could lead to higher vehicle prices. ITC initiated the second report in November 2023, scheduled to be reported to the President and Congress in July 2025.

Figure 1. U.S. Automotive Trade with Canada and Mexico, 2017-2021



Source: CRS analysis of data from U.S. International Trade Administration, accessed November 24, 2023.

Notes: *USMCA entered into force.

Automotive ROO Dispute

Since USMCA's entry into force, Mexico and Canada have disputed the U.S. interpretation of the RVC calculation method. In December 2022, a USMCA dispute settlement panel ruled against the United States. The three countries have stated that they are continuing to work towards a resolution. The USMCA panel decision cannot be appealed.

The dispute involves the treatment of material in core motor vehicle parts (see **textbox**). The Mexican and Canadian governments argued that if a core part qualifies for USMCA, 100% of its value should count towards the larger RVC calculation (referred to as "roll up"). USTR's interpretation was that the overall RVC calculation should exclude the value of materials in core parts that are not sourced from a USMCA country ("non-originating"). Mexico and Canada contended that these flexibilities were negotiated to help North American motor vehicle producers meet the RVC requirements.

Under USMCA rules, Canada and Mexico could have begun suspending certain benefits to the United States 45 days after the panel's final report was issued, but they have not done so to date. Some U.S. stakeholders, such as labor groups, expressed concerns that the ruling undermines efforts to boost the U.S. auto industry and undercuts workers' confidence in trade agreements. Some analysts have argued that the United States may undermine the USMCA dispute settlement process if it continues not to comply with the ruling.

Core Parts and Components for Determining Origin

Engine: Heads, blocks, crankshafts, crankcases, pistons, rods, head subassembly.

Transmission: Transmission cases, torque converters and housings, gears and gear blanks, clutches, valve body assembly.

Body and Chassis: Major body panels, secondary panels, structural panels, frames.

Axle: Axle shafts, axle housings, axle hubs, carriers, differentials.

Suspension System: Shock absorbers, struts, control arms, sway bars, knuckles, coil springs, leaf springs.

Steering System: Steering columns, steering gears/racks, control units.

Advanced Batteries: Cells, modules/arrays, assembled packs.

Source: Table A.2 in USMCA Chapter 4, Annex 4-B.

Issues for Congress

Electric Vehicle Tax Credit. The electric vehicle (EV) tax credit in P.L. 117-169, referred to as the Inflation Reduction Act of 2022 (IRA), provides a total of $7,500 for new EV purchases if the EV meets various requirements, including being assembled in North America and having a battery that meets specific sourcing requirements. These requirements may further change the North American automotive supply chain if producers choose to qualify for the EV tax credit. Various companies have announced investment plans for new and existing facilities to manufacture EVs and batteries in North America, but some companies have expressed concerns about the strict implementation of requirements. U.S. trading partners, including the European Union, Japan, and South Korea, have claimed that the requirements violate World Trade Organization rules. Some Members of Congress have stated that these requirements are important for lessening reliance on China and supporting U.S. jobs. Labor groups have raised concerns about ensuring that the EV transition does not negatively impact U.S. workers.

As USMCA implementation continues, Congress may examine and consider oversight over the following issues:

- What is the impact of USMCA's automotive ROO on U.S. producers, particularly small- and medium-sized companies, and the North American auto industry?
- What are the implications of the January 2023 USMCA ROO panel decision?
- How many producers have fully adapted to the rules? Will producers need more than the five years allowed under the alternative staging regime?
- What, if any, are the implementation and/or compliance issues with the LVC requirements?
- How will the IRA EV tax credit requirements and general industry pivot towards EVs impact the North American auto industry and USMCA utilization?

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