Rules of Origin
and
Supply Chains

"Rules of origin are very, very complex. You don't want to deal with them. They're terrible things to deal with."

Hon. Michael Wilson, then-Minister of Industry, Science, Technology and International Trade, in 1992 during Honda dispute and NAFTA negotiations

What's What on Rules of Origin (ROO)

- what are Rules of Origin (ROO)
- what are the key ROO policy and negotiation issues
- what are implications and impacts on supply chains
- focus on preferential ROO used in Free Trade Agreements (FTAs), but also used in many other policy areas
- starring textile and apparel sector, and CUSMA auto ROO (but not the only ones in the ROO show)

What and Why ROO in FTAs

- define production/sourcing required in the FTA area for goods to be “originating” and hence qualify for tariff preferences

- stated goal: ensure benefits to local producers, and prevent free riders and transshipment

- often protectionist tool to protect or re-shape supply chains

Three Key Policy Factors

- liberal vs restrictive ROO: how much production and sourcing required
- compliance costs to meet ROO
- cumulation - key for negotiations and supply chains

Liberal vs Restrictive ROO

- liberal ROO: final production required in FTA area, but most/all inputs can be "non-originating" (i.e., can be imported from outside the FTA area)

- restrictive ROO: final production, plus key or designated inputs must be produced in FTA area and meet own ROO (must also be originating)

- small/medium-sized economies mostly prefer liberal ROO as more dependent on imports for key inputs

- larger economies mostly prefer restrictive ROO as have input producers (who lobby for restrictive rules)

Compliance Costs

- administrative costs: track inputs and their costs; certification procedures; record keeping for verifications; plus risk of paying duties/fines

- may need to change input sourcing to meet ROO:
  - costs of finding new suppliers
  - potentially pay more for originating inputs

- compliance costs may exceed tariff preference benefits (producers always have option of ignoring ROO and just paying MFN duties)

Cumulation

- originating good made in one FTA party qualifies as an originating input when used to produce a good in any of the parties to that FTA

- under CUSMA

  - originating piston made in Mexico can be exported duty-free to U.S. to make an originating engine

  - that originating engine can be exported duty-free to Canada to make an originating car

  - that originating car can be exported duty-free to Mexico or U.S.

Cumulation and NAFTA/CUSMA

- encouraged resource-rich North American production platform linking two high-wage countries with a low-wage country
- fostered full range of production encompassing lower-skilled, labour-intensive stages and higher-skilled, capital-intensive stages in North America
- alternative: labour-intensive production of input or final good done offshore - Mexico vs Asia
- not unique - e.g., EU (and its FTAs), Japan's FTAs

ROO: To Comply or Not to Comply

- higher incentive / likelihood of compliance if:
  - high tariffs on traded goods = higher tariff preference benefit
  - less restrictive or complex ROO = lower compliance costs
  - good seal of approval = market as “North American”
  - input buyers demand compliance so their products can comply
- compliance varies by goods, sectors and countries (e.g., goods with low tariffs can have high compliance)
- negotiations on ROO, and influence of and impact on supply chains, also vary by goods, sectors and countries

U.S. Textiles and Apparel ROOs

- yarn/fabric production more capital intensive, while apparel production more labour intensive

- U.S. FTAs include restrictive yarn-forward apparel ROO:

  - yarn must originate, fabric must originate (using originating yarn), and apparel must be cut/sewn/assembled in FTA area

- U.S. FTA partners must use U.S. yarns and fabrics to avoid high U.S. apparel tariffs (over 15%) in big U.S. market

- protect high-cost U.S. textile producers from low-cost Asian yarns and fabrics, and high-end European fabrics, from entering U.S. inside imported apparel

TPP and Textiles and Apparel

- U.S. demanded restrictive “yarn-forward” ROO

- Vietnam: major apparel exporter: sources fabrics from China and other Asian countries - wanted cut and sew ROO (one-stage production ROO)

- Mexico and Peru supported U.S. to protect their apparel producers exporting duty-free under their FTAs with the U.S. (using U.S. yarns and fabrics)

- protect FTA-based Western Hemisphere supply chain of U.S. textile producers and Latin American apparel producers from Asian competition

Good Bye NAFTA, Hello CUSMA

- more restrictive auto was key U.S. demand in CUSMA
- U.S. goal: bring back manufacturing and jobs to U.S.
- autos (and steel and aluminum) major employers in U.S., especially mid-west “rust-belt” states
- big U.S. auto trade deficit (especially with Mexico)
- U.S.share of content in NAFTA vehicles down (but absolute level of U.S. content way up as North American auto production way up)
- <u>big factor:</u> major plant closings/job losses in northern states (and Canada) as auto production shifted first to southern U.S. states and then to Mexico (now over 20% of assembly)

Does CUSMA Auto ROO Matter for Canada

- autos Canada's largest manufacturing sector, employer and exporter:
  - highly integrated with U.S./North American supply chains
  - over 85% of vehicles and 50% of value of parts exported, almost all to U.S.
  - many parts in Canadian vehicles imported from U.S. and starting to grow from Mexico
  - 98% of Canadian vehicles and over 80% of Canadian parts enter U.S. duty free under NAFTA/CUSMA

NAFTA Auto ROO

- NAFTA auto ROO already restrictive (and complicated):

  - regional value content (RVC) calculation based on tighter “net cost” (excludes profits and various over-head costs, but North American R&D (but not offshore R&D) included)

  - 62.5% RVC for cars and light trucks, and their engines and transmissions (vs 40% to 55% based on price in most FTAs)

  - 60% RVC for heavy trucks, their engines and transmissions, and all other auto parts

  - tracing of designated non-originating inputs used to make major components (e.g, engines, transmissions)

CUSMA Auto ROO

- higher RVC levels: 75% for passenger cars and light trucks and their “core parts” (e.g., engines, transmissions, axles, steering systems), 70% for heavy trucks, and 65% or 70% for other parts

- **new:** each “core part” for cars and light trucks must also be originating (must meet its own ROO)

- **new:** 70% of steel and aluminum in vehicles must be North American (plus melt and pour rule for steel)

- **new:** Labour Value Content (LVC): 40/45% of car/truck content must be made in plants paying workers at least US$16 per hour (allowed up to 10 percentage points from R&D and IT wages and up to 5 percentage points for engine, transmission or battery assembly)

- phase-in periods (e.g., 3 years) plus some flexibilities

Key Factors for Assessing Impact

- auto assemblers and major parts companies are global - prefer to produce in major regions where sell, but can source globally

- NAFTA auto supply chains key for competitiveness of North American, but not immune to global competition

- ROO incur compliance costs - CUSMA auto ROO more restrictive and administratively burdensome

- can opt out of ROO: pay MFN duties and source offshore (including from own plants) - vehicle tariffs: Canada 6.1%, Mexico 20%, and U.S. 2.5% for cars and 25% for trucks

- situation varies for each company and each model line

Potential Impact of Tighter Auto ROO

- assemblers likely will comply with CUSMA auto ROO for most model lines, but increase off-shore sourcing for certain auto goods (e.g., smaller vehicles)

- steel/aluminum requirements benefit Canada and U.S. at the margin (a lot already sourced within North America)

- LVC direct attempt to influence where auto goods produced <u>inside</u> North America (U.S. (and Canada) benefit):

  - not likely to affect significantly Mexican wages (gap too big) or shift significantly current production back to U.S. (or Canada), but may dissuade future shift of key parts and vehicle production to Mexico

- erode competitiveness of North American auto platform: some production and job losses, and higher costs/prices

For Canada: Relief

Not Just Autos or Textiles & Apparel

- Various FTAs (e.g., CUSMA, CPTPP, EU and U.S. FTAs) require, for example:
  - certain seafood products be produced from fish caught in FTA territorial waters
  - all, or most, of raw sugar used in sugar-containing products be grown and refined in FTA territory
  - dairy products be made from raw milk sourced in FTA area
  - beef products be made from cattle born and raised in FTA area
  - steel products be made from steel melted and poured in FTA area

Not Just Tariff-Preferences ROO

- other “ROO” can impact production location and supply chains
- proposed U.S. subsidy (up to U.S.$12,500) for consumer purchases of electric vehicles “made in America”:
    - after 5 years, $7,500 only for vehicles “made in America” (ROO = assembled + ?)
    - $500 if batteries made in U.S. (ROO?)
    - $4,500 if vehicle made in unionized plant
- potential major negative impact on Canadian auto sector
- possible solution: use CUSMA ROO for eligibility

ROO Sum Up

- ROO used to try to influence production location and shape (re-shape) supply chains (including within a FTA area):
  - defining which inputs for good must be originating
  - content level when use RVC tests
    - other requirements (e.g., LVC in CUSMA auto ROO; R&D)
- competing supply chains can directly impact ROO negotiations (e.g., TPP and textiles and apparel)
- success in affecting production and supply chains depends on many factors (e.g., tariff levels, competitive conditions)
- devil always in the details

Do CUSMA ROO Matter for Canada

- many Canadian industries depend heavily on U.S both as their source of inputs and their market for goods

- over 75% of Canadian commercial exports go to U.S. (and over 50% of imports from U.S.)

  - 12% of Canadian exports pay duties in U.S.
  - 38% entered U.S. under U.S. MFN-free tariff lines
  - 50% entered U.S. duty-free under NAFTA

- U.S. tariffs generally low - most below 5% and many below 3%, but even low tariff rates can bite

Roll Up and Regional Value Content

- regional value content (RVC) tests calculate percentage of originating content in a good - usually as percentage of price of good

- required content levels can vary (e.g., 40% in CPTPP and 50% in CUSMA for most goods)

- roll-up: full value of originating input counts as eligible content in RVC test for final good, even if made using non-originating inputs:

  - value of any non-originating materials used to make an input is converted to originating content if that input meets its ROO

CUSMA: Core Parts Dispute

- ROO disputes rare - (Honda and Cami cases under Canada-U.S. FTA, solved during NAFTA negotiations)

- CUSMA: alternative core part test (CPT): if all core parts combined together (super-core part) originates, then meet CPT even if includes some individual non-originating core parts (e.g., non-originating engine)

- Mexico and Canada: if super-core part meets CPT, then its full value qualifies as originating content for vehicle RVC calculation

- U.S.: even if super-core part meets CPT, must still determine if each core part itself originates when doing vehicle RVC calculation (e.g., if engine not originate, then only value of originating materials used to make that engine qualifies as originating content for vehicle RVC calculation)

- potential impact varies by company/country, but disputes create uncertainty, increasing pull of locating in larger U.S. market