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Mexico-Canada Agreement

[2]—is in many respects an outstanding success story for integrated North American manufacturing. With co-production between auto and auto parts producers in high wage cost countries, Canada and the United States, and lower-wage Mexico, automobiles made in North America compete economically with those made in Europe and Asia. The auto industry is also vital to the three North American economies with such trade (where a particular component may cross North American borders six to eight

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1. North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 7, 1992, 32 I.L.M. 289 [hereinafter NAFTA].

2 Agreement between the United States of America, the United Mexican States, and Canada, July 1, 2020, U.S.T.R.

inconclusive, complicated by the gradual conversion from gasoline powered vehicles to the production of electric vehicle (EVs) and their batteries in North America and world-wide.

Can the North American auto industry survive the various U.S. federal and state subsidy policies for electric vehicles (EVs) and EV batteries? In the future, will this poster child for efficient North American integration, where annually, the U.S imports $29.5 billion worth of car parts from Mexico, exports $5.9 billion to Canada, exports $11.7 billion worth of completed vehicles to Canada, and $67.5 billion to Mexico,[11]continue? What would be the result if EV and EV battery producers are strongly discouraged from establishing facilities in Canada and Mexico? While the BBBA EV subsidies will never be resurrected now that a different program has been established under the Inflation Reduction Act of 2022,[12] both bills strongly suggest that when there are conflicts between the Biden Administration's "Buy American, Invest American, Employ Americans" focus[13] and the principles of the USMCA, there exists a risk that the former will prevail, to the potential detriment of North American economic integration and to other foreign suppliers of autos and auto parts, and to consumers who may ultimately pay more for their vehicles.

At the time of this writing (August 2022), the future of this integrated auto market remains uncertain. Still, three factors suggest to many observers that with the gradual shift to electric vehicles (EVs) over the next ten to fifteen years, and demand for the batteries that power them, auto and auto parts production in both Mexico and Canada will decline, with the United States reaping the lion's share of new investment and related employment. This essay discusses the three factors in the following sections: new Rules of Origin that are designed to discourage production in Mexico and, to a lesser extent, Canada, and favor investment and job creation in the United states (Part II); massive subsidies for EV and EV battery production and sales offered by the U.S. federal and state governments (Part III); and anti-capitalist, statist investment policies under the Lopez-Obrador presidency (December 1, 2018 to November 30, 2024) that are having a substantial negative impact on new investment in Mexico (Part IV). Part V provides key conclusions.

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## II. USMCA RULES OF ORIGIN[14]

NAFTA itself incorporated Rules of Origin that were designed to assure that autos and small trucks that were traded duty-free in North America would have substantial North American, not just U.S., content. Most significantly, 62.5% of the total cost of the vehicle was required to be derived from North American sources.[15] It was intentionally made difficult for a major component, such as a transmission, to qualify as entirely of North American origin simply because the final production or assembly took place in one of the NAFTA countries. This was accomplished by a rule that required the tracing of the individual parts for such major components.[16] For example, if a transmission produced in Mexico was valued at $1,000 and it incorporated $750 worth of North American parts and $250 of third country parts, only $750 of its value could be counted toward the 62.5% North American content requirement.

In assessing the new USMCA rules, the United States did achieve much of what it sought in the negotiations. The United States sought to depart from the content rules used in NAFTA and other U.S. free trade agreements reached over the past twenty years. Rather than NAFTA's requirement that 62.5% of the net cost of the auto be made from North American content, the United States initially demanded that the threshold be raised to 82.5%, of which 50% must have been from the United States[17]denalg7[(de)98(%) -1.7 (got)6.3 Tw 02[12.9 (v)25

the United States (or Canada), given higher wages in the United States when compared to Mexico.[20]

The USMCA changes for the automotive industry also include raising the percentage of regional value content required for automobiles and light trucks from 62.5% to 75%.[21] These requirements are to be phased in over three years from July 1, 2020; certain core components such as engines, advanced batteries for electric cars and transmissions must originate in North America.[22] In addition, 70% of the steel used in the manufacturing of cars and small trucks must originate in USMCA countries.[23] The full significance of the 70% rule was clarified only by the December 10, 2019 Protocol of Amendment to the USMCA.[24] In a further step, designed by the Trump Administration rather than the Democratic Congress, the steel rules (but not those relating to aluminum), were further tightened. Steel automotive products such as chassis and bodies, will not count toward the 70% after a seven-year grace period unless the steel is "melted and poured" in North America.[25]

The USMCA Protocol also added a requirement that ten years after the USMCA enters into force, the Parties will consider the application of similar requirements to aluminum.[26] Mexico apparently resisted these latter changes until a seven-year grace period was added, and was reluctant to accept such rules applied to aluminum, as Mexico does not produce raw aluminum.[27] The full impact of the 70% rule, including regional value calculations, depends on the USMCA uniform regulations and their ultimate interpretation by the Parties, to determine, for example, whether the rule means 70% by company, brand, plant, or something else.[28]

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22 , note 2, at 4-B-1-19.

23 at 4-B-1-25.

24 , U.S OFF. OF THE U.S. TRADE REPRESENTATIVE (Dec. 10, 2018), https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Protocol-of-Amendments-to-the-United-States-Mexico-Canada-Agreement.pdf [hereinafter ].

25 note 2, at 4-B-1-25.

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27 , WORLD TRADE ONLINE (Dec. 8, 2019, 9:43 PM), https://insidetrade.com/daily-news/foreign-minister-mexico-considering-us-steel-demand-conditions.

28 , WORLD TRADE ONLINE (Jan. 13, 2020, 1:21 PM), https://insidetrade.com/daily-news/seade-uniform-regulations-usmca-auto-rules-under-development (discussing the ongoing negotiations of uniform regulations for autos and auto parts).

Most significantly for Mexico, 40% of the materials for cars and 45% of the components for light trucks must be produced by enterprises that pay workers at least $16 per hour.[29] Some employees of automotive enterprises that conduct research and development or assemble advanced components such as batteries, engines, and transmissions in Mexico would count toward up to 15% of these thresholds, if the workers are paid at this level.[30] These calculations are subject to complex tracing rules,[31] which will add to auto manufacturers' administrative costs in North America, even though some other NAFTA tracing rules for parts and components have supposedly been relaxed.[32] Whether these minimum pay rules will be less harmful to Mexico than the original Trump anOle483o ( a)-1.( t)-4.6 (r)-(n )10.53 (s)8.5 (i)-4.6 (or)-3.9 ( t)-4 (

production and investment,[37] a matter that was formally referred to the USMCA dispute settlement procedures.[38] Mexico (and Canada) are right to be worried. The new USMCA Rules of Origin have been interpreted by both the Trump and Biden administrations in a manner that is much less favorable to Mexico (and Canada) than many believe was intended during the USMCA negotiations. The panel proceeding is ongoing at the time of this writing. And could be concluded before the end of 2022.

As I understand the U.S. position, the effect of the U.S. approach is to ban any "rounding up" or substantial transformation of major subassemblies, as with my transmission example noted earlier. Even if there is no longer any formal tracing, Mexican or Canadian production is

## III. U.S. PROPOSED AND ENACTED EV SUBSIDIES

The Build Back Better Act (BBBA)[40] was a mammoth legislative package costing over $1.8 trillion designed to address a wide range of

American (and North American) auto producers, workers, and consumers. Also, the full subsidies would have been provided only for EVs produced in the United States with U.S. batteries, union labor and 50% U.S. content, by reducing consumer choices, seem inconsistent with another Biden administration objective, realistic or not, of EV sales of 50% of the U.S. market by 2030.[45]

Under the now defunct subsidy scheme specified in the draft legislation, for the first five years, EV buyers would have received a federal

unwillingness to support the BBBA was crucial with the Senate divided fifty-fifty—apparently in part because Toyota has a major non-unionized auto plant in West Virginia.[50] However, Manchin's opposition to the BBBA, which ultimately doomed its passage, was said to be far more a result of his fears about rising inflation, debt and foreign supply chains.[51] In the more recent discussion of what he was willing to accept in the IRA, Senator Manchin apparently insisted on a reduced total per-buyer subsidy amount and the removal of any tie-in between the subsidies and unionized production. He was also quoted in July 2022 as emphasizing that the bill gives incentives to make new car batteries in America "and not only be able to assemble them but be able to extract the minerals that we need, critical minerals, in North America."[52]

Most significantly for this article, the new subsidies regime enacted in August 2022 removes the obvious discrimination against auto and auto parts production in Canada and Mexico. The reduced subsidies, up to $7,500 for new vehicles and $4,000 for used EVs (an incentive for lower-income Americans to go electric), are available for vehicles and components produced anywhere in North AD[(pa)-2 ( )]Tcp7 (o.)104 ( )11. gl6i fc.6 ()-1

integrated auto production compared to the BBBA, but it falls short of resolving Canada and Mexico's competitiveness problems.

It is notable that even if vehicles and key battery and other components produced in Canada and Mexico as well as the United States are eligible, vehicles imported from significant auto exporting nations (and key U.S. allies) such as Germany, Japan and South Korea are not. As noted earlier, eligible vehicles must be produced with battery materials from the U.S., or from a country that has a free trade agreement with the U.S., e.g., from Canada, Mexico and South Korea among others, but not Japan, The European Union or (of course) China. Some foreign officials have complained about the discrimination and charged that the subsidies specific to EV and EV battery manufacturers are a violation of the WTO's Agreement on Subsidies and Countervailing Measures if they cause injury to other producers.[58] (Injury is difficult in practice to demonstrate). Moreover, while Canada and Mexico have not committed resources to b s a t t

investment climate. Their billions of dollars in investments over more than thirty years and generally successful operations, as well as Mexico's lower labor costs, argue strongly against it. Ford, for example, has been producing the Mustang Mach-E in Cuautitlan, Mexico, for more than a year and apparently intends to continue to do so, although the vehicles are exported to more than twenty countries, not just to the United States.[59] However, it seems more probable that major new auto-related investment, coming at a time of a gradual shift from gasoline engine to battery-powered cars and to more North American-sourced steel, may take place in the United States instead.

Mexico's competitive position in North America may be further weakened by the massive U.S. subsidies to be offered to producers of chips (including those used in the auto industry), batteries, and key battery components for electric car production. Such U.S. industrial policies may further skew investment decisions as the auto industry slowly shifts from gasoline powered to electric cars. Mexican states and Canadian provinces typically do not have the resources to compete with such incentives.

Thus, when U.S. investors balance the benefits and costs of investment in Mexico, where investment in the United States means more expensive up-front purchases of robots and other automation, the various U.S. and state subsidies as well as the investment climate in Mexico must have some impact on many companies' decision-making. The advantages of doing business in Mexico include, among others, a quality, relatively low-priced labor force, proximity to the U.S. Interstate highway system, and a rules-based system under the USMCA. However, these advantages may no longer be sufficient as discussed in the next section.

## IV. AMLO's Anti-Business, Anti Private Investment Policies

Aside from the differences over Rules of Origin, existing and new enterprises in the auto, steel and many other industries may not be as likely to make major new investments in Mexico when the investment climate overall is perceived as strongly negative. A spillover effect is likely even though President Lopez Obrador's principal targets to date have been existing and new private investment in hydrocarbons and electricity, given his obsession with supporting the government monopolies Pemex and the Corporation Federal de Electricidad (CFE). Still, other evidence of the anti-business climate beginning with the terminati 34 TD[(C)eoy-2.6 (n)12.8

completed Mexico City airport project at the outset of his presidency with the substitution of a different one has been widely reported.[60]

Thus, AMLO's anti-business, anti-private-investment policies have become an equally significant threat to the future of the Mexican auto industry and to investment in Mexico in general.

The overall rate of investment in Mexico was down 24% from 2016-2019.[61] The current policies, which focus on rolling back Mexico's 2013 energy reforms under President Peña Nieto to something approaching the statist, monopolistic approach of the 1970s, have already engendered several notices of intent to bring investor-state dispute settlement procedures to bear against Mexico.[62] While the focus of the policies have been on hydrocarbons (both exploration and distribution) and on elimination of private foreign investments in clean energy (windmills and solar arrays), other sectors are being affected.

## V. CONCLUSIONS

may seek to comply promptly with the USMCA Rules of Origin if it loses the arbitration, additional positive steps in support of North American integration even when there is a possible conflict with "Buy American" policies, would benefit industry and consumers in all three countries, in the automotive as well as other sectors, and help to ensure that the North American auto industry remains competitive with those in Europe and Asia.