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# NAFTA's Rule of Origin and its Effect on the North American Automotive Industry

*Jonathan M. Cooper*

## I. INTRODUCTION

If enacted,<sup>1</sup> the North American Free Trade Agreement (NAFTA) would gradually eliminate 7000 tariffs, duties, and non-tariff barriers between the United States, Canada, and Mexico.<sup>2</sup> NAFTA would open trade between the second and third largest trading partners of the United States, Canada and Mexico respectively.<sup>3</sup> NAFTA would result in the world's largest free trade area, encompassing approximately 363 million people and a gross national product of \$7.5 trillion.<sup>4</sup>

NAFTA's stated objectives include expanding trade between the participating nations and increasing investment opportunities within the free trade area.<sup>5</sup> Mexico potentially has the most to gain from

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<sup>1</sup> See *infra* notes 39-43 and accompanying text for remaining procedural steps necessary for NAFTA's enactment.

<sup>2</sup> North American Free Trade Agreement, Sept. 6, 1992 [hereinafter *NAFTA Draft #2*]. (To date, there have been two drafts of NAFTA released. Neither of these drafts have been enacted into law).

<sup>3</sup> United States' trade with Mexico and Canada represents 25 % of all United States' foreign trade. Trade between the United States and its neighboring countries has more than doubled since 1980 to reach \$234 billion. See *Leaders Express Concern Over Stalled GATT, Examine Trade Dynamics of Pacific Basin*, Int'l Trade Rep. (BNA) (May 8, 1991).

<sup>4</sup> The combined gross national product of NAFTA's free trade area is \$1.4 trillion greater than the European Economic Community's free trade area. See Peter Newman, *Falling into Bush's Mexican Trade Trap*, MACLEAN's, Aug. 17, 1992, at 30.

<sup>5</sup> NAFTA's stated objectives are to: eliminate barriers to trade and facilitate cross-border movements of goods and services, promote conditions of fair competition, increase investment opportunities, provide adequate protection for intellectual property rights, establish effective procedures for the implementation and application of the Agreement and for the resolution of

NAFTA, as NAFTA would accelerate the pace of its movement towards more open trade<sup>6</sup> and secure its access to the expansive North American market.<sup>7</sup> The United States stands to increase its exports of sophisticated products and services to Mexico, suppress the tide of illegal immigration, and increase its investment in Mexico.<sup>8</sup> Canada's interests in NAFTA appear more defensive, aimed primarily at preserving its interests under the Canada-United States Free Trade Agreement (CFTA).<sup>9</sup>

NAFTA has drawn particular attention in the automotive industry since this industry is heavily dependent on international trade.<sup>10</sup> NAFTA's provisions on automotive trade were heavily debated and were among the last issues resolved in trade negotiations.<sup>11</sup> In its current form, NAFTA would enable automotive corporations to export automobiles to the United States, Mexico, and Canada without incurring tariff costs on automobiles deemed to originate in the NAFTA region.<sup>12</sup> By receiving preferential tariff treatment, qualifying automotive corporations would be placed at a competitive advantage over non-qualifying automotive corporations when exporting to the NAFTA region.

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disputes and to further trilateral, regional and multilateral cooperation. See *NAFTA Draft #2* Art. 102.

<sup>6</sup> See *infra* notes 28-38 and accompanying text for discussion of Mexico's recent movement towards open trade.

<sup>7</sup> For a discussion of the goals of each of the countries participating in NAFTA, see Gary C. Hufbauer & Jeffrey J. Schott, *Options for a Hemispheric Trade Order*, 22 U. MIAMI INTER-AM L. REV. 261, 282 (1991).

<sup>8</sup> *Id.* at 282. President Bush stated that "By moving forward with NAFTA, we will . . . [open] . . . up new horizons of opportunity and enterprise in the New World." The White House, Office of Press Secretary, Statement by the President, Aug. 12, 1992 [hereinafter *Press Release*].

<sup>9</sup> U.S.-Canada Free Trade Agreement Implementation Act of 1988, Pub. L. No. 100-449, 102 Stat. 1859 (1988) [hereinafter *CFTA*] (this agreement substantially eliminates tariffs between the United States and Canada).

<sup>10</sup> Provisions related to automobiles were expected to receive substantial scrutiny by Congress, even prior to NAFTA's signing. See *NAFTA Should Contain Plans for Bi-National Infrastructure Commission*, Kolbe Says, Int'l Trade Rep. (BNA) (May 27, 1992). Mexico's chief negotiator, Herminio Blanco, noted the importance of NAFTA on the automotive industry, stating that "the auto sector, of course, is a very important sector in these negotiations, . . . We believe that an agreement can be negotiated. . . which will strengthen the industries that we have in our three countries [and make them] more able to compete in the global market place." *NAFTA Negotiators Struggle With Rule of Origin for Autos*, Int'l Trade Rep. (BNA) (Aug. 29, 1992).

<sup>11</sup> *NAFTA Negotiators Struggle With Rule of Origin for Autos*, *supra* note 10.

<sup>12</sup> See *NAFTA Draft #2*, ch. 4; see also part IV, *infra*, for discussion of NAFTA's rule of origin requirement.

The determination of an automobile's place of origin for treaty classification purposes, however, is frequently unclear. Even automobiles that are fully assembled in one country generally contain several parts that are manufactured throughout the world. While past free trade agreements ("FTAs") have utilized rule of origin requirements to determine the origins of automobiles, rule of origin requirements have not always led to predictable results.<sup>13</sup>

The problems surrounding the use of rule of origin requirements were recently highlighted when the United States Customs Service ruled that certain automobiles assembled by Honda in Canada and exported to the United States did not satisfy CFTA's rule of origin requirement.<sup>14</sup> The United States Customs Service concluded that certain of these automobiles did not possess a sufficient amount of content manufactured in the treaty region ("domestic content") to qualify for preferential tariff treatment.<sup>15</sup> The executive vice president of Honda, Scott Whitlock, stressed that this interpretation was in direct conflict with an earlier interpretation by the customs service of Canada.<sup>16</sup> The Minister of International Trade and Industry in Japan, Kozo Watanabe, expressed concern that the United States might be using the ruling to discriminate against foreign firms.<sup>17</sup>

Under the ruling, Honda was ordered to pay penalties for past unpaid tariffs which former United States Trade Representative, Carla Hills, estimates could exceed \$16 million.<sup>18</sup> The extent of these damages, as well as the sharp disagreement over their applicability illustrate the importance of having clear and predictable rule of origin requirements.

This comment will specifically address how NAFTA's rule of origin requirement will affect the North American automotive industry. To provide a thorough understanding of this topic, this comment will (1) discuss how NAFTA evolved and detail the remaining procedural steps necessary for its enactment; (2) briefly discuss the current North American automotive industry; (3) compare and contrast rule of origin requirements under previous FTAs; and (4) analyze NAFTA's

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<sup>13</sup> See *infra* part III. B. for a discussion of rule of origin requirements used under previous FTAs.

<sup>14</sup> See United States International Trade Commission, 1992 ITC Lexis 195, Apr., 1992; *Customs Rules That Canadian Honda Civics Failed to Meet Content Standard Under FTA*, Int'l Trade Rep. (BNA) (March 4, 1992).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> See Lindsay Chappell, *Honda has big incentive to back new trade treaty*, AUTOMOTIVE News, Sep. 14, 1992, at 33.

proposed rule of origin requirement and its potential effects on the North American automotive industry.

## II. BACKGROUND

### A. Definition and Purpose of Free Trade Agreements

FTAs are forms of preferential trade liberalization in which two or more nations eliminate or substantially reduce trade barriers amongst themselves. The General Agreement on Tariffs and Trade ("GATT"), which regulates trade amongst nations,<sup>19</sup> defines FTAs as agreements under which participants remove tariffs and "other restrictive regulations on commerce . . . on substantially all the trade between themselves."<sup>20</sup>

FTAs are generally seen as an effort to improve efficiency in international trade. FTAs allow participating countries to maximize economies of scale by concentrating their production efforts in areas in which they are most efficient, while trading with other participating countries for their remaining needs absent tariff costs.

### B. Evolution of NAFTA

The concept of dismantling trade barriers and thereby opening trade is consistent with the United States' notion of a free market system. The United States has been engaged in extensive free trade with other countries since GATT was enacted in 1947.<sup>21</sup> Presently the United States has FTAs with both Israel<sup>22</sup> and Canada.<sup>23</sup>

The enactment of a FTA between the United States and Mexico, however, involves unique obstacles since the relationship between the

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<sup>19</sup> GATT has been described as "at the same time a legal framework for the conduct of trade relations between its member countries, a forum for trade negotiations and for the adaptation of its legal framework, and an organ for conciliation and settlement of disputes. It is modified sometimes in its structure and its *modus operandi* so as to adapt to the economic and political conditions in which world trade develops." OLIVER LONG, *LAW AND ITS LIMITATIONS IN THE GATT MULTILATERAL TRADE SYSTEM* 5 (1985).

<sup>20</sup> General Agreement on Tariffs and Trade, Article XXIV, 55 U.N.T.S. 194 para. 8(b) (1947) [hereinafter GATT].

<sup>21</sup> GATT governs the trade of over 100 countries. For an overview of GATT, see generally LONG, *supra* note 19, at 4-6.

<sup>22</sup> 24 I.L.M. 653 (1985) [hereinafter Israel-United States Free-Trade Agreement]. See generally Ira Nikelsberg, *The Ability to Use Israel's Preferential Trade Status With the United States and the European Community to Overcome Potential Trade Barriers*, 24 GEO. WASH. J. INT'L L. & ECON. 371 (1990); but see *Roundtable Discussion: The North American Free Trade Agreement: In Whose Best Interest?*, 12 Nw. J. INT'L L. & BUS. 536, 538 (noting that the Israel-United States Free Trade Agreement is not of great economic importance).

<sup>23</sup> See CFTA, *supra* note 9.

two countries has been strained by a troubled history.<sup>24</sup> Tensions between the two countries stem back to 1847<sup>25</sup> and have continued into the present.<sup>26</sup> Unlike the open economic policies that the United States and Canada share, which helped lead to the enactment of CFTA, Mexico's economic policies traditionally have been closed to avoid the perceived threat of economic domination by the United States.<sup>27</sup>

In the past few decades, however, Mexico has moved towards a more open trade policy. In 1965, Mexico adopted the Maquiladora program, which to a limited extent allows foreign corporations to establish operations in Mexico and export part of their production without incurring full tariff costs.<sup>28</sup> General Motors, Chrysler, and Ford each participate in the Maquiladora program.<sup>29</sup> In 1982, Mexico's debt crisis forced the government of Mexico to further reconsider its protectionist stance.<sup>30</sup> Mexico began to dismantle its trade barriers, and in 1986 joined GATT.

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<sup>24</sup> See Alejandro Ogarrio & Leonel P. Castro, *Mexico-United States Relations: Economic Integration and Foreign Investment*, 12 Hous. J. INT'L L. 223, 226 (1990) (noting past strained relations between Mexico and the United States).

<sup>25</sup> Mexico has experienced poor relations with the United States originating back to 1847 when United States invaded Mexico City and annexed Texas as a state. The United States then forced Mexico to sell its interests in what is now California, Nevada, Utah, Arizona, and New Mexico. See ROBERT R. MILLER, *MEXICO: A HISTORY* 229 (1985).

<sup>26</sup> "A variety of issues-immigration, narcotics trafficking, foreign investment, trade, and foreign policy (especially relating to Central America) have generated a barrage of rhetoric and negative reaction between both nations." Ambassador Abelardo L. Valdez, *Strengthening the United States-Mexico Relation: A Proposal for Establishing a Free-Trade Zone and Co-Production Zone*, 18 CALIF. W. INT'L L. J. 65, (1987-88).

<sup>27</sup> Statement by Dr. Alejandro Carrillo Castro, Consul General of Mexico that "we Mexicans tend to think of our northern neighbor as a very powerful and sometimes dangerous neighbor in economic and political terms." See *Roundtable*, *supra* note 22, at 542. Mexico has relied on import substitution policies, restrictions on foreign investment, and a controlled exchange rate in an attempt to foster domestic growth and establish self sufficiency. See Press Release, *supra* note 8; Jesus Silva & Richard K. Dunn, *A Free Trade Agreement Between the United States and Mexico: The Right Choice?*, 27 SAN DIEGO L. REV. 937 (1990) (analyzing Mexican attitudes towards foreign investment).

<sup>28</sup> The original Maquiladora program focused primarily on border development. The program allowed foreign corporations to export products and avoid paying tariffs on raw materials imported as part of the manufacturing process. See generally Cheryl Schechter & David Brill, *Maquiladoras: Will the Program Continue?*, 23 ST. MARY'S L.J. 697 (1992). "U.S. manufacturers using the maquiladoras, for example, may import raw materials, equipment and components duty-free from the United States to produce goods for sale back home. The U.S. Customs Service assesses duty only on the value added in assembly or manufacture in Mexico." Kevin G. Hall, *NAFTA May Spur Maquiladoras To Move Inland, Officials Say*, J. OF COM., Dec. 3, 1992, at 9C.

<sup>29</sup> Schechter & Brill, *supra* note 28.

<sup>30</sup> During the early 1970s, Mexico's discovery of large oil deposits in a period of global oil shortage enabled the country to secure numerous foreign loans. However, due to rising interna-

Under the current leadership of President Salinas, the pace of Mexico's movement towards more open trade has quickened.<sup>31</sup> President Salinas has encouraged the open trade movement by issuing a more expansive Maquiladora decree,<sup>32</sup> encouraging the privatization of certain public enterprises,<sup>33</sup> controlling the value of the Mexican peso,<sup>34</sup> increasing Mexico's efforts to curb drug trafficking,<sup>35</sup> and enacting tougher environmental laws.<sup>36</sup> During this time, the United States' exports to Mexico have more than tripled to an estimated \$44 billion in 1992,<sup>37</sup> and several trade agreements have been reached between the two countries.<sup>38</sup>

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tional interest rates and declining oil prices, Mexico's \$6.1 billion of foreign debt in 1970 escalated to \$81 billion in 1982. This led the administration of President de la Madrid to conclude that Mexico's long standing protectionist stance was ineffective. U.S. Libr. Cong., Cong. Res. Services, Rep. No. IB91061, Mexico-U.S. Relations in the Salinas Period (1988-1994): Issues for Congress 5 (Dec. 3, 1991).

<sup>31</sup> See Press Release, *supra* note 8.

<sup>32</sup> See generally Schecter & Brill, *supra* note 28 (noting changes made to the Maquiladora program from 1965 to 1992). Unlike the original Maquiladora Decree, which was passed primarily to promote Mexican labor, the new decree allows goods produced in the Maquiladora program to be sold in Mexico. Silva & Dunn, *supra* note 27, at 259.

<sup>33</sup> See Mexico: State Run Telephone Company to Go Private, With Foreign Investment Limited to 23 Percent, Int'l Trade Rep. (BNA) (Sept. 20, 1989), at 1198; Louis Uchitelle, *Going Private is a Very Public Affair*, N.Y. TIMES, Aug. 25, 1990, at 33.

<sup>34</sup> President Salinas has acted to reduce the pace of the devaluation of the Mexican peso against the United States dollar. See *New Leader Drops Freeze on Prices, Wages, and Currency*, N.Y. TIMES, Dec. 12, 1988, at D1.

<sup>35</sup> See Mexico Tough on Drugs, L.A. DAILY J., Jan. 3, 1990, at 6; *U.S. Mexico Set Anti-Drug Pact*, WASH. POST, Aug. 9, 1990, at A1; US-Mexico Relations, U.S. Department of State, Bureau of Public Affairs, Office of Public Communication, July 31, 1992 [hereinafter *Relations Report*] (noting that the Salinas administration has increased Mexico's effort to curb drug trafficking by increasing the funds allocated to drug control in Mexico from \$37 million in 1989 to \$77 million in 1991).

<sup>36</sup> See Daniel I. Basurto Gonzalez & Elaine Flud Rodriguez, *Environmental Aspects of the Maquiladora Operations: A Note of Caution for U.S. Parent Corporations*, 22 ST. MARY'S L.J. 659, 678-80 (1991) (noting Mexico's recent cooperation with the United States on environmental control issues); *Relations Report*, *supra* note 35 (noting that in 1992 President Bush and President Salinas released a plan to deal with U.S.-Mexico border pollution problems, with Mexico committing \$460 million to the project); but see *NAFTA may Bring Import of Pollution to Mexico*, J. OF COM., Aug. 20, 1992 (noting Mexico's more lenient stance towards environmental issues).

<sup>37</sup> See *Relations Report*, *supra* note 35. Exports of consumer goods tripled during this same period to \$3.4 billion and exports of capital goods more than doubled. The White House, Office of the Press Secretary, Fact Sheet, The North American Free Trade Agreement for Immediate Release, Aug. 12, 1992.

<sup>38</sup> These agreements include the Framework Understanding on Bilateral Trade and Investment 27 I.L.M. 438 (1988) (establishing a framework for future bilateral trade negotiations between Mexico and the United States and setting up a mechanism to work out trade disputes), the Textile Agreement (1988), 27 I.L.M. 451 (1988) (providing Mexican-made textiles greater access to American markets), the Understanding Regarding Trade and Investment Facilitation Talks (1989), 29 I.L.M. 36 (1990) ("expanding consultations under the Framework Understanding to

Building on the momentum of the improved relations and increased trade between the United States and Mexico, as well as the recent enactment of a FTA between the United States and Canada,<sup>39</sup> the negotiations for NAFTA proceeded with unprecedented speed.<sup>40</sup> After fourteen months of confidential negotiations, the three countries agreed to sign NAFTA on August 12, 1992,<sup>41</sup> and actually signed the agreement on December 17, 1992.<sup>42</sup> However, NAFTA becomes effective only if enacted by each country's respective legislature, and future modifications are uncertain.<sup>43</sup>

### C. Structure of the North American Automotive Industry

The automotive industry is critical to the maintenance of the American and Canadian economies,<sup>44</sup> and has shown growing importance to the Mexican economy.<sup>45</sup> The automotive industry is the large-

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include negotiations on market access and trade and investment facilitation in product areas and interrelated issues"), the Understanding Regarding the Joint Committee for Investment and Trade (1989), 29 I.L.M. 40 (1990) (promoting trade and investment opportunities between the United States and Mexico), the Agreement on the Development and Facilitation of Tourism (1989) 29 I.L.M. 42 (1990) (facilitating tourism between Mexico and the United States), and the Tax Information Exchange Agreement, 29 I.L.M. 50 (1990) (preventing tax evasion and fraud).

<sup>39</sup> See CFTA, *supra* note 9.

<sup>40</sup> Former U.S. Trade Ambassador, Carla Hills testified before the Subcommittee on Trade that from the time President Bush and Salinas first took office, the progress of trade negotiations went far beyond initial expectations. *United States-Mexico Economic Relations: Hearing Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 101st Cong., 2d Sess. 47, 49 (1990); See also Carla A. Hills, *America's Free Trade "First"*, J. OF COM., Aug. 14, 1992, at 8A ("Never before has such an ambitious trade negotiation been accomplished so quickly"). On June 10, 1990, President Bush and President Salinas issued a joint statement endorsing the idea of a comprehensive free trade agreement between the United States and Mexico. See *Key Points in NAFTA Negotiations to Date* (White House Press Release), Aug. 1992. Partially in a defensive move to maintain its established trade relation with the United States under CFTA, Canada announced its intention to join the negotiations soon thereafter. *Id.*

<sup>41</sup> See North American Free Trade Agreement, Aug. 12, 1992 [hereinafter *NAFTA Draft #1*].

<sup>42</sup> See John Maggs, *Bush, Mulroney Salinas Sign North America Trade Accord*, J. OF COM., Dec. 18, 1992, at 3A.

<sup>43</sup> *Id.* President Clinton's stated concerns over NAFTA focus on environmental and employment issues. See Bill Clinton, *Expanding Trade and Creating American Jobs*, 23 ENVTL. L. 683 (1993); AFL-CIO, *Other Unions Blast Free Trade Pact as Prescription for U.S. Job Loss*, Int'l Trade Rep. (BNA) (Aug. 13, 1992). A ruling handed down on June 30, 1993 by a U.S. district court judge in Washington could delay the NAFTA implementation. The ruling requires a full evaluation of the NAFTA's environmental impact. See Brenda Dalglish, *Setback: NAFTA at Risk*, MACLEAN'S, July 12, 1993 at 30.

<sup>44</sup> See generally *Competitiveness of the North American Automotive Industry: Report of the U.S.-Canada Automotive Select Panel at 7* (1992) [hereinafter *Competitiveness Report*] (On file with author).

<sup>45</sup> The Mexican automotive industry is growing rapidly in terms of both production and sales. See Rules of Origin Issues Related to NAFTA and the North American Automotive Industry, Report to the Committee on Ways and Means, U.S. House of Representatives, on Investigation



est manufacturing sector in the American and Canadian economies, accounting for over four percent of GDP and approximately 1.2 million jobs.<sup>46</sup> In 1990, over 11 million automobiles were produced in North America. The United States and Canada produced 9.6 million and 1.9 million automobiles respectively,<sup>47</sup> and Mexican output stood at approximately 821,000.<sup>48</sup>

The American and Canadian automotive industries are dominated by the American-owned automotive corporations of General Motors, Ford and Chrysler ("the Big Three"), which operate approximately fifty assembly plants in the United States and ten in Canada.<sup>49</sup> This dominance, however, recently has been challenged by foreign-owned automotive corporations.<sup>50</sup> The American and Canadian automotive market is subject to few trade regulations,<sup>51</sup> which has helped foreign-owned automotive corporations, such as the Japanese, to capture nearly twenty-eight percent of the total North American automotive market.<sup>52</sup> In recognition of these growing figures, Japanese-

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No. 332-314 Under Section 332 of the Tariff Act of 1930 at 14 [hereinafter *Rule of Origin Report*]. Mexico accounted for record sales of 614,823 cars and trucks in 1991. See *VW Sees Gains, Risks in Mexican Free Trade*, AUTOMOTIVE NEWS, Aug. 31, 1992, at 35.

<sup>46</sup> See *Competitiveness Report*, *supra* note 44, at 8.

<sup>47</sup> *Competitiveness Report*, *supra* note 44, at 8. For a good discussion of automotive trade in the United States and Canada, see Shelly P. Battram & Blake Murray, *The United-States-Canada Free Trade Agreement and North America Automotive*, 494 PLI/COMM (1989).

<sup>48</sup> *Competitiveness Report*, *supra* note 44, at 8. For a good discussion of automotive trade in Mexico, see GARY C. HUFBAUER & JEFFREY J. SCHOTT, NORTH AMERICAN FREE TRADE: ISSUES AND RECOMMENDATIONS, 213 (1992).

<sup>49</sup> General Motors, Ford and Chrysler accounted for 35.5%, 23.9% and 12.2% respectively of the United States' automobile market in 1990 and 34.8%, 20.8% and 15.3% respectively of Canada's automobile market in 1990. See *Rule of Origin Report*, *supra* note 45, at 9.

<sup>50</sup> The market share of North American automotive manufacturers declined from 83% in 1978 to 56% in 1991. *Id.*

<sup>51</sup> The United States and Canada are two of the most open countries for automotive trade. The most favored rate of duty for passenger automobiles is 2.5% ad valorem. The most favored rate of duty for passenger automobiles imported into Canada is 9.2% ad valorem. Tariffs between the United States and Canada are being phased out under CFTA. There is a voluntary restraint agreement between Japan and the United States limiting imports of Japanese automobiles to 2.3 million units, however, imports have generally exceeded this amount. See *Rule of Origin Report*, *supra* note 45, at 13.

<sup>52</sup> This amount is based on 1990 figures and includes production in America by foreign-owned automotive producers. See James B. Treese, *War, Recession, Gas Hikes. . . GM's Turn-around Will Have to Wait*, BUSINESS WEEK, Feb. 4, 1991, at 104. The four largest foreign automobile producers in America in 1990 were Toyota, Honda, Nissan, and Mazda with 7.6%, 6.2%, 4.5% and 2.5% share of the automotive market respectively. In Canada the largest foreign automobile producers in 1990 were Honda, Toyota, Mazda, Nissan, and Volkswagen with 7.8%, 7.2%, 3.2%, 3.0%, 2.8%, and 4.5% share of the automotive market respectively. See *Rule of Origin Report*, *supra* note 45, at 9.

owned automotive corporations<sup>53</sup> and automotive parts corporations<sup>54</sup> have shifted a significant number of their production plants to North America. At present, there are approximately 500 foreign-owned automotive related corporations operating in North America.<sup>55</sup>

Mexico's automotive industry bears little resemblance to the automotive industry in the United States or Canada.<sup>56</sup> Mexico's automotive industry is entirely foreign-owned, consisting solely of eight automotive plants owned by Volkswagen, Nissan, General Motors, Ford and Chrysler.<sup>57</sup> While these plants tend to be older and less efficient than those in the United States and Canada,<sup>58</sup> Mexico's restrictive trade policies have helped to protect these plants from outside competition.<sup>59</sup> Mexico's recent trade liberalization, however, has enabled the United States to double its automotive exports to Mexico in the past three years.<sup>60</sup> The Mexican automotive market is the fastest growing market in the Western Hemisphere and promises to be a fertile ground for automotive trade expansion in the near future.<sup>61</sup>

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<sup>53</sup> As of 1990, 1,496,748 and 215,970 automobiles were produced in America and Canada respectively by foreign owned automotive producers. Honda had the most automotive production with 433,317 automobiles produced in America and 103,781 in Canada. See *Rule of Origin Report*, *supra* note 45, at 10.

<sup>54</sup> *Rule of Origin*, *supra* note 45, at 10.

<sup>55</sup> *Rule of Origin*, *supra* note 45, at 10.

<sup>56</sup> For a good discussion of the automotive industry in Mexico, see HUFBAUER & SCHOTT, *supra* note 48, at 234-41.

<sup>57</sup> *Id.*; See Max Gates, *Free Trade Talks in Mexico to Work Out Vehicle Pact*, AUTOMOTIVE NEWS, July 27, 1992.

<sup>58</sup> *Id.*

<sup>59</sup> Mexico's current tariff is 20% ad valorem on imported automobiles and 10-13% ad valorem on auto parts. Under the Mexican Automotive Decree, auto producers must maintain a trade surplus in Mexico such that for each dollar's worth of automobiles sold in Mexico the automotive producers have to generate \$2 in exports. Mexico limits automotive imports to 15% of automotive sales, increasing to 20% in 1993. Mexico limits foreign investment in the automotive parts industry to 40% equity participation and requires at least 36% Mexican content in automobiles that are manufactured in Mexico. See *Rule of Origin Report supra*, note 45, at 14.

<sup>60</sup> See *supra* part II.B. for discussion of Mexico's movement towards open trade. In the past three years U.S. exports of auto parts to Mexico have amounted to 5.4 billion a year. This has resulted in the first automotive parts trade surplus with Mexico since the U.S. has been monitoring trade. See Lindsay Chappell, *Suppliers Welcome More Access; Trade Group Sees More Export Sales*, AUTOMOTIVE NEWS, Aug. 17, 1992, at 35. Nonetheless, by American and Canadian standards, the Mexican automotive market is still highly protective. For a discussion of Mexico's automotive trade liberalization, see North American Free Trade: Issues and Recommendations, *supra* note 56, at 213.

<sup>61</sup> See Roger W. Wallace & Max Scoular, *The North American Free Trade Agreement and United States Employment*, 24 ST. MARY'S L.J. 945 (1993).

D. NAFTA's Provisions Relating to the Automotive Industry.<sup>62</sup>

NAFTA includes various provisions which specifically address the North American automotive industry.<sup>63</sup> Automotive export tariffs among NAFTA parties will be completely eliminated within ten years, although phase-out schedules will differ among Mexico,<sup>64</sup> Canada,<sup>65</sup> and the United States.<sup>66</sup> Tariffs on automotive parts would be largely reduced within five years of NAFTA's enactment.<sup>67</sup> Each of the participating countries would be able to review the effectiveness of NAFTA on the automotive sector to determine whether additional actions should be taken to improve the integration and international competitiveness of the sector.<sup>68</sup>

NAFTA also calls for the modification of existing automotive trade regulations in Canada,<sup>69</sup> the United States,<sup>70</sup> and Mexico.<sup>71</sup> The most significant modifications relate to the Decree for Development and Modernization of the Automotive Industry of 1989 ("Mexican

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<sup>62</sup> A detailed analysis of the rule of origin requirement under NAFTA is provided in Section IV of this comment. See *infra* notes 103-16 and accompanying text.

<sup>63</sup> See *NAFTA Draft #2*, Annex 300-A: Trade and Investment in the Automotive Industry Sector (this section of NAFTA specifically addresses automotive trade).

<sup>64</sup> For imports from Canada and the United States, Mexico will: (1) immediately reduce tariffs on passenger automobiles by 50%, with the remaining tariffs being eliminated within ten years; (2) immediately reduce tariffs on light trucks by 50%, with the remaining tariffs being eliminated in five years; (3) eliminate all other tariffs within ten years. *NAFTA Draft #1*, at 8.

<sup>65</sup> Canada will eliminate its tariffs on the same schedule as Mexico. *NAFTA Draft #1*, at 8.

<sup>66</sup> Tariffs on imports from Canada were eliminated under CFTA. Under NAFTA, imports from Mexico will be treated as follows: (1) tariffs on all passenger automobiles will be immediately eliminated; (2) tariffs on light trucks will be immediately reduced to 10% and eliminated within five years; and (3) all other tariffs on other vehicles will be eliminated within 10 years after NAFTA's enactment. *NAFTA Draft #1*, at 8.

<sup>67</sup> *NAFTA Draft #1*, at 8.

<sup>68</sup> *NAFTA Draft #2*, Annex 300-A para. 2. (This review would have to occur no later than Dec. 31, 2003).

<sup>69</sup> Canada would continue to be able to operate under the Auto Pact entered into between Canada and the United States in 1966, which calls for the elimination of tariffs on automotive trade and CFTA. *NAFTA Draft #2*, Annex 300-A.1 para. 1. Certain new restrictions would be placed on Canada's ability to limit importation of used vehicles from Mexico. See generally *NAFTA Draft #2*, Annex 300-A.1 para. 4.

<sup>70</sup> The most significant modification would be that the United States would be required to amend the Energy Policy and Conservation Act of 1975 ("CAFE"), 42 U.S.C. § 6201 et seq., to permit existing manufacturers beginning in 1997 to count Mexican content and production as domestic content of the United States towards CAFE standards. This would have a significant impact as it would allow United States automotive producers an additional option in structuring the sourcing requirements to meet CAFE standards. See generally *NAFTA Draft #2*, Annex 300-A.3.

<sup>71</sup> See generally *NAFTA Draft #2*, Annex 300-A.2. These modifications focus on the existing Mexican Automotive Decree, the auto parts industry in Mexico, national value added requirements, and trade balance requirements.

Automotive Decree”), which restricts foreign automotive investment in Mexico.<sup>72</sup> Under NAFTA, a modified Mexican Automotive Decree would remain in effect until 2004.<sup>73</sup> The modified Mexican Automotive Decree would reduce current value added restrictions,<sup>74</sup> and require automobiles manufactured in Mexico to contain at least thirty-four percent Mexican content, falling to twenty-nine percent in 2003.<sup>75</sup> The modified Mexican Automotive Decree would phase out the current trade balance restrictions, which restrict the number of vehicles that a manufacturer may import into Mexico in relation to the total number of vehicles that the manufacturer sells in Mexico.<sup>76</sup>

### III. ANALYSIS AND PURPOSE OF RULE OF ORIGIN REQUIREMENTS

#### A. Definition of Rule of Origin Requirements

Rule of origin requirements are regulations that govern the determination of the country of origin of an imported product under FTAs. Rule of origin requirements are an attempt by FTA members to capture most of the benefits of the FTA for themselves. The main focus of these requirements is to prevent trade deflection. That is to prevent firms from countries outside the free trade region from simply being able to assemble their final products in one area of the free trade region so that they could qualify for preferential tariff treatment on exports to other areas of the free trade region. For example, under CFTA’s rule of origin requirement, Honda was unable to qualify for preferential tariff treatment since its automobiles did not possess sufficient domestic content, even though its automobiles were assembled in Canada.<sup>77</sup>

Rule of origin requirements generally have been expressed in one of the following four forms: (1) *a change of tariff heading test*, which focuses on whether a certain product has undergone sufficient processing in a country covered under the treaty to warrant a change in its tariff classification;<sup>78</sup> (2) *a value added content standard*, which focuses on whether a certain product contains sufficient “local con-

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<sup>72</sup> For an explanation of the Mexican Automotive Decree see *supra* note 59.

<sup>73</sup> NAFTA Draft #2, Annex 300-A.2 para 1.

<sup>74</sup> See *supra* note 59.

<sup>75</sup> NAFTA Draft #2, Annex 300-A.2.

<sup>76</sup> NAFTA Draft #2, Annex 300-A.2 paras 12-16.

<sup>77</sup> See *supra* note 14 and accompanying text for a discussion of the Honda ruling.

<sup>78</sup> For an example of a change of tariff heading test, see *infra* note 103 and accompanying text, discussing “tier one” of NAFTA’s rule of origin requirement.

tent" to be afforded the benefits of the free trade agreement;<sup>79</sup> (3) a *critical process requirement*, which requires that certain processes be conducted in the free-trade area;<sup>80</sup> or (4) combinations of the above.<sup>81</sup>

As global automotive trade increases, the importance of rule of origin requirements will also increase. Due to the international linkages and the technical complexities, the automotive industry has always been a difficult industry in which to apply rule of origin requirements. In such context, a predictable rule of origin requirements is imperative to enable automotive producers to properly plan and structure their operations to avoid massive penalties associated with negative custom rulings.

## B. Rule of Origin Requirements Under Previous FTAs

To understand the potential impact of NAFTA's rule of origin requirement on the North American automotive industry, it is helpful to examine rule of origin requirements included in previous FTAs.<sup>82</sup>

### 1. The Substantial Transformation Test

The traditional rule of origin requirement employed in the United States is the "substantial transformation test." While no statute or regulation specifically defines the substantial transformation test, it has received considerable attention from the courts. The Supreme Court, first articulated this standard in *Anheuser-Busch Brewing Ass'n v. United States*.<sup>83</sup> This case held that a product possessing content manufactured from outside the free trade area must undergo sufficient manufacturing in the free trade area so that it emerges as a new and different article, having a distinctive name, character, or use to qualify for preferential tariff treatment.<sup>84</sup>

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<sup>79</sup> For examples of value added content standards see *infra* notes 91, 95 & 107 and accompanying text, discussing certain aspects of the rule of origin requirements under Israel-United States FTA, CFTA and NAFTA.

<sup>80</sup> This standard is currently used in the European Community, but it is opposed by most North American automobile manufacturers because it reduces sourcing flexibility. *Rule of Origin Report*, *supra* note 45, at 2.

<sup>81</sup> See *infra* note 103 and accompanying text discussing NAFTA's utilization of the change in tariff heading test and value added content standard.

<sup>82</sup> This comment discusses the (1) substantial transformation test, (2) the rule of origin requirement under the Israel-United States Free Trade Agreement, and (3) the rule of origin requirement under CFTA. While this discussion is sufficient to lay the necessary groundwork for this comment, readers interested in additional analysis should see N. David Palmeter, *Rules of Origin or Rules of Restriction? A Commentary on a New Form of Protectionism*, 11 *FORDHAM INT'L L.J.* 1 (1987).

<sup>83</sup> 207 U.S. 556 (1908).

<sup>84</sup> *Id.* at 562.

While this standard certainly has some strengths, it would not be an appropriate standard to determine the origin of automobiles under NAFTA. Even though the substantial transformation test is flexible enough to accommodate the constantly evolving automotive industry, has been applied for numerous years, and involves no record keeping responsibilities, it has been criticized for not providing predictable results.<sup>85</sup> In considering whether a particular good satisfies the substantial transformation test, courts have focused on varying factors including whether the imported product had lost its original identity,<sup>86</sup> whether the good was transformed from one used primarily by producers to one used primarily by consumers,<sup>87</sup> whether significant value was added to the product,<sup>88</sup> and whether the production process was significantly complex.<sup>89</sup> The lack of objective criteria used in administering this test would hinder automotive producers' ability to properly plan their complex, long term operations.

## 2. Israel-United States Free Trade Agreement

The ambiguities noted in the substantial transformation test were considered when formulating the rule of origin under the Israel-United States Free Trade Agreement. The rule of origin under this FTA provides more objective criteria by requiring that a certain percentage of a product's contents be manufactured in the free trade area to qualify for preferential tariff treatment.<sup>90</sup> This rule of origin specifies that the sum of the costs of material produced in Israel, including

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<sup>85</sup> Several commentators have noted that the old "substantial transformation" test was plagued with confusion and contradictions. See Paul Asker, *Changes in the Rules of Origin in the United States-Canada Free Trade Agreement: A Preliminary Evaluation*, 36 WAYNE L. REV. 1545, 1549-52 (1990); C. Edward Galfand, *Heeding the Call for a Predictable Rule of Origin*, 11 U. PA. J. INT'L BUS. L. 469 (1989); Palmeto, *Canada-United States Free Trade Agreement Rule of Origin and a Multilateral Agreement*, 16 INT'L BUS. LAW. 513, 514 (1988) (noting international pressure to abolish the substantial transformation test).

<sup>86</sup> See, e.g., *United States v. Gibson-Thomsen Co.* 27 C.C.P.A. 267 (1940) (substantial transformation occurs when imported products are so processed that they lose their individual identity and become part of a new product "hav[ing] a new name, character and use").

<sup>87</sup> See, e.g., *Midwood Indus. v. United States*, 313 F. Supp. 951, 957 (Cust. Ct. 3d 1970) (substantial transformation occurs when processing alters an article from one primarily used by a producer to one used by a consumer).

<sup>88</sup> See, e.g., *United States v. Murray* 621 F.2d 1163, 1169 (1st Cir. 1980), *cert. denied*, 449 U.S. 837 (1980) (addition of significant value and significant production costs result in a substantial transformation).

<sup>89</sup> See, e.g., *Texas Instruments, Inc. v. United States* 681 F.2d 778 (C.C.P.A. 1982) (assembly process may be viewed as substantial transformation if it is complex and requires further processing or transformation).

<sup>90</sup> This rule is based upon those provided in the Caribbean Basin Initiative with minor modifications. Trade and Tariff Act of 1984, Pub. L. No 98-573, § 402(a)(1), 98 Stat. 3015 (1988).

the direct costs of processing operations performed there, must exceed thirty-five percent of the estimated value of the merchandise to qualify for preferential tariff treatment.<sup>91</sup>

This rule of origin, however, would not be acceptable for governing the origin of automobiles under NAFTA. While certainly there is no "magic" percentage at which to set the domestic content threshold requirement, the thirty-five percent figure is too low. This figure would enable automotive producers from outside the NAFTA region to exploit NAFTA and circumvent tariff costs. Non-NAFTA parties would be able to qualify for preferential tariff treatment simply by assembling automobiles in the free trade area from a majority of foreign produced parts. Although one of the primary goals of any free trade agreement is to dismantle trade barriers, this goal must be balanced with the goal of preserving the benefits of a FTA primarily for the FTA members.<sup>92</sup> Considering the unique international competition which is already plaguing the North American automotive industry,<sup>93</sup> it is imperative to provide some protection for domestic automotive producers.

### 3. The Canada-United States Free Trade Agreement<sup>94</sup>

CFTA's rule of origin requirement addressed the aforementioned problem by raising its domestic content requirement to fifty percent of assembly costs.<sup>95</sup> In calculating this amount, CFTA utilizes the "direct cost method," which requires fifty percent of the value of originating materials plus costs of processing be produced domestically.<sup>96</sup> Direct costs are limited to direct labor, materials and processing costs.<sup>97</sup> This is a significant provision, as it removes manipulative costs such as overhead and advertising from the calculation, leading to more predictable customs rulings.

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<sup>91</sup> *Id.* at Annex 3 para. 1(c). This provision, however, does not specifically cover automotive trade.

<sup>92</sup> See *supra* part III.A., noting the importance of preserving the benefits of a FTA solely for its participating members.

<sup>93</sup> See *supra* notes 50-52 and accompanying text.

<sup>94</sup> While the following discussion of CFTA is sufficient to establish the foundation for this comment, a more detailed discussion is provided in the *Rule of Origin Report*, *supra* note 45.

<sup>95</sup> United States-Canada Free Trade Agreement Implementation Act of 1988, Pub. L. No. 100-449, § 202(c)(3), 102 Stat. 1851, 1857 (1988); Canada-United States Free Trade Agreement, 27 I.L.M. 281, 306 (1988).

<sup>96</sup> *Id.*

<sup>97</sup> Direct costs include all costs associated with labor, inspection and testing of goods, energy and fuels, machine maintenance and depreciation, development and engineering costs, rent, and royalty or licensing fees. *Id.* at § 202(f)(3)(A-F), 102 Stat. at 1859; 27 I.L.M. at 296.

CFTA utilizes the "roll up" method to calculate domestic content of automotive parts that consist of materials manufactured throughout the world. This method considers an automotive part to originate in the country that accounts for the majority of its content. For example, if a given automotive part possesses more/less than fifty percent domestic content, its entire costs will be counted as domestic/foreign.<sup>98</sup>

While in theory the "roll up" method should have a zero sum gain, this method may be manipulated to skew domestic content calculations.<sup>99</sup> For example, if an automotive part which is shipped from Canada to the United States possesses domestic content valued at \$501 and foreign content valued at \$499, its entire cost of \$1,000 would be considered domestic. If the part is then combined in the United States with another foreign produced part valued at \$900 and then re-enters Canada, its entire cost of \$1,900 would be considered domestic even though the "true domestic content" is only worth \$501. Some commentators claim that this type of manipulation was attempted by Honda and is now the focus of its recent customs dispute.<sup>100</sup>

As such, even though CFTA's rule of origin raises the content requirement from past FTAs and eliminates various costs that could be subject to manipulation such as promotional expenses, it would not be the optimum rule of origin to govern automotive trade under NAFTA. As evidenced by the Honda ruling,<sup>101</sup> the rule of origin under CFTA has proved to be ambiguous and has been inconsistently applied by customs officials.<sup>102</sup>

#### IV. RULE OF ORIGIN REQUIREMENT UNDER NAFTA

##### A. Overview

The primary concern in negotiating NAFTA's rule of origin requirement was to limit non-NAFTA parties from simply assembling their products in one area of the treaty region and receiving preferen-

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<sup>98</sup> If, however, a given component contains less than the 50 percent content requirement, the entire component is considered foreign made. *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> See Paul Magnusson & James B. Treece, *Honda, is it an American Car?*, BUSINESS WEEK, Nov. 18, 1991, at 107.

<sup>101</sup> See *supra* notes 14-18 and accompanying text for a discussion of the Honda dispute.

<sup>102</sup> See *Rule of Origin Report*, *supra* note 45, at 75 (the primary problem with the CFTA's rule of origin is its complexity); *Strict Origin Rules Could Result in NAFTA Benefits Being 'Obliterated' Conference Told*, Int'l Trade Rep. (BNA) (June 3, 1992) (Toyota Motor Sales official, Robert Wade, noting language problem of CFTA, stating that it is not simple, clear, and easy to administer).



tial tariff treatment on exports to other areas of the treaty region. NAFTA contains a stringent and detailed rule of origin requirement to prevent such trade deflection and to provide clear and predictable origin rulings. Products exported into the treaty region that do not satisfy the rule would be subjected to continued tariff application.

While NAFTA's rule of origin requirement continues to apply several of the concepts adopted under CFTA, there have been some substantial modifications. Under NAFTA's rule of origin requirement, automotive goods would be subject to a two tier test. The first tier is applicable to all goods imported into the treaty region.<sup>103</sup> This tier considers whether a given article has undergone enough processing in the free trade region to be deemed to originate from the region.<sup>104</sup> Articles wholly obtained or produced entirely in the territory of one or more of the parties clearly satisfy this test.<sup>105</sup> A more complicated situation is when the article consists of a number of foreign parts or consists of parts produced in a NAFTA country from third world raw materials. In this situation, the foreign parts must be substantially transformed in the NAFTA region so as to undergo a specified change in tariff classification.<sup>106</sup>

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<sup>103</sup> The first tier is provided as follows in *NAFTA Draft #2* Art. 401:

"Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:

- (a) the good is wholly obtained or produced entirely in the territory of one or more of the parties, as defined in Article 415;
- (b) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the Parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this Chapter;
- (c) the good is produced entirely in the territory of one or more of the Parties exclusively from originating materials; or
- (d) except for a good provided in Chapters 61 through 63 of the Harmonized System, the good is produced entirely in the territory of one or more of the Parties but one or more of the non-originating materials provided for as parts under the Harmonized System that are used in the production of the good does not undergo a change in tariff classification because:
  - (i) the good was imported into the territory of a Party in an unassembled or disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or
  - (ii) the heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts, provided that the regional value content of the good determine in accordance with Article 402, is not less than 60 percent where the transaction value method is used, or is not less than 50 percent where the net-cost method is used, and that the good satisfies all other requirements of this Chapter."

<sup>104</sup> See *supra* note 78 and accompanying text describing the change in tariff heading test.

<sup>105</sup> *NAFTA Draft #2* Art. 401(a).

<sup>106</sup> *NAFTA Draft #2* Art. 401(b); See Annex 401 for specific change of tariff classification requirements.

The second tier, which is specifically applicable to automotive trade, adds a regional value content requirement expressed as a percentage of the automobile's total value.<sup>107</sup> This tier calls for an eventual increase in the necessary domestic content level of an automobile from the fifty percent figure provided in CFTA, to sixty-two and one half percent for passenger automobiles and light trucks<sup>108</sup> and sixty percent for other vehicles.<sup>109</sup>

Regional value content is calculated using the "net-cost" method,<sup>110</sup> in contrast to CFTA's "direct cost" method.<sup>111</sup> The net-cost of an automobile equals the automobile's total cost less the costs of: marketing, royalties, shipping, packing, and certain non-allowable interest costs.<sup>112</sup> To qualify for preferential tariff treatment, the net-cost of an automobile minus the value of the automobile's materials manufactured outside the NAFTA region must exceed sixty-two and one half percent of the automobile's net-cost.<sup>113</sup>

The value of automotive parts from outside the NAFTA region will be traced through the production chain in calculating the domestic content of automotive goods ("trace through method"),<sup>114</sup> in contrast to using the CFTA's "roll up" method.<sup>115</sup> Specifically, the "trace through method" requires "the value of non-originating materials used by the producer in the production of the good shall be the sum of the values of non-originating materials, determined. . . at the time the non-originating materials are received by the first person in the territory of a Party who takes title to them."<sup>116</sup>

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<sup>107</sup> *NAFTA Draft #2*, Art. 403 & 402(3).

<sup>108</sup> *NAFTA Draft #2*, Art. 403 5(a).

<sup>109</sup> *NAFTA Draft #2*, Art. 403 5(b).

<sup>110</sup> *NAFTA Draft #2*, Art. 402 5(d)(i).

<sup>111</sup> See *supra* note 96 and accompanying text.

<sup>112</sup> *NAFTA Draft #2*, Art. 402(8) & Article 415 (definition of net cost).

<sup>113</sup> NAFTA provides a formula to determine regional value content of a good as follows:

$$\begin{aligned} \text{RVC} &= \text{NC-VNM/NC} \times 100. \\ \text{RVC} &= \text{regional value content} \\ \text{NC} &= \text{net cost of the good} \\ \text{VNM} &= \text{value of non originating} \\ &\quad \text{materials used by the} \\ &\quad \text{producer in the production} \\ &\quad \text{of the good.} \end{aligned}$$

*Id.* at Art. 402(3). Note: the 62.5% content figure is only applicable once NAFTA is fully implemented.

<sup>114</sup> *NAFTA Draft #2*, Art. 403(1)(a). Note, although the word "tracing" is not used in the Agreement, its practical effect calls for such tracing.

<sup>115</sup> See *supra* note 98.

<sup>116</sup> *NAFTA Draft #2*, Art. 403(a).

B. The Effect of NAFTA's Rule of Origin Requirement on the  
North American Automotive Industry

As expected, NAFTA's rule of origin requirement drew substantial attention from the automotive industry.<sup>117</sup> While NAFTA increases the domestic content requirement from past FTAs in an attempt to preserve NAFTA's benefits solely for the participating countries, American-owned automotive corporations initially complained that NAFTA's content requirement was not set high enough. American-owned automotive corporations fear that the sixty-two and one half percent content requirement may enable foreign-owned automotive corporations operating in either Mexico or Canada ("transplant corporations") to avoid tariff costs and flood the United States with their imports.<sup>118</sup> At a minimum, some American-owned automotive corporations desired a threshold requirement of sixty-five percent domestic content.<sup>119</sup>

Unlike the government of the United States, the governments of Canada and Mexico both desired a lower domestic content requirement. Canada and Mexico do not share the same concern as the United States regarding outside automotive competition since each country's automotive industry is predominately foreign-owned.<sup>120</sup> Their primary concern is to attract foreign-owned automotive corporations to establish production facilities in their respective countries.<sup>121</sup> The lower the domestic content requirement under NAFTA, the more apt foreign-owned automotive corporations that desire to export duty-free to the United States would be to shift some of their production facilities to either Mexico or Canada, as re-tooling costs would be limited.<sup>122</sup>

Foreign-owned automotive corporations operating in Canada have criticized NAFTA's rule of origin requirement, claiming that it cre-

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<sup>117</sup> See *supra* note 10 and accompanying text.

<sup>118</sup> As stated by Chamber of Commerce economist, Debra Reinhart "U.S. auto makers don't want Mexico [or Canada] being used as a trampoline for imports." See *Trade in Auto Parts, Rules of Origin Likely to be Major Issues in NAFTA Talks*, Int'l Trade Rep. (BNA) (July 10, 1991).

<sup>119</sup> See *U.S. Car Makers Cautiously Back NAFTA, But Say They Want to See Details*, Int'l Trade Daily (BNA) (Aug. 18, 1992).

<sup>120</sup> See *supra* notes 49, 57 and accompanying text.

<sup>121</sup> The International Automobile Manufacturers of Canada noted that the 62.5 percent content requirement would discourage foreign investment in the Canadian automotive sector. See *Canadian Reaction to NAFTA is Divided; Political Fight Over Approval is Expected*, Int'l Trade Rep. (BNA) (Aug. 19, 1992).

<sup>122</sup> See *infra* notes 131-32 and accompanying text for a discussion of re-tooling costs.

ates a "Fortress North America".<sup>123</sup> Specifically, these corporations complain that the rule of origin's provisions are too stringent and violate the free trade spirit of GATT.<sup>124</sup> GATT provides that FTAs are permissible as long as they do not erect *additional* trade barriers.<sup>125</sup> While any rule of origin requirement by definition is a barrier to trade since it discriminates against foreign produced goods,<sup>126</sup> it does not necessarily create an *additional* trade barrier. Generally since foreign produced goods never received preferential tariff treatment prior to the enactment of a FTA, FTAs simply tend to preserve the tariff status of these products and do not erect any *additional* trade barriers.

NAFTA's rule of origin requirement, however, arguably does impose an *additional* trade barrier.<sup>127</sup> Under CFTA, transplant corporations currently can export tariff-free from Canada to the United States if their automobiles contain a minimum fifty percent domestic content. NAFTA seems to add an *additional* trade barrier by eventually increasing the domestic content requirement to sixty-two and one half percent for such exports. Moreover, the institution of the trace through method closes the aforementioned loop hole available under CFTA's roll up method, which currently enables content level manipulations.<sup>128</sup> Depending on the actual application by customs officials, it is currently unclear whether this increase is substantial enough to be deemed violative of GATT.

Even if the rule is not deemed to violate GATT, it most likely will still burden transplant corporations operating in Canada. Existing transplant corporations, such as Toyota, Honda and Suzuki export up

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<sup>123</sup> See *Japan Seeks Assurance That NAFTA Will Not Affect GATT Obligations*, Int'l Trade Rep. (BNA) (Aug. 19, 1992).

<sup>124</sup> *Id.* Japanese officials argue that FTAs are only permissible if they expand free global trade, and the stringent local content requirements are a "giant step in the wrong direction." See *Japanese Transplants Decry Increase in Content Levels; Costly Changes in Tooling Needed*, AUTOMOTIVE NEWS, Aug. 17, 1992, at 34.

<sup>125</sup> GATT, Article XXIV, 55 U.N.T.S. 194 (1947).

<sup>126</sup> A United States Treasury Department official and Chief Rule of Origin Negotiator, John Simpson, noted that rules of origin have always been used for discriminatory purposes. See *Strict Rules Could Result in NAFTA Benefits Being 'Obliterated,' Conference Told*, Int'l Trade Rep. (BNA) (June 3, 1992).

<sup>127</sup> James M. Sheehan, *Not Quite Free Trade*, J. OF COMM., Nov. 30, 1992, at 10A. "The North American Free Trade Agreement is free trade in name only. Its 2,000 pages of rules and fine print are aimed at achieving the opposite: managed trade. The treaty contains several provisions that protect interest groups from competition in order to build political support. The main mechanism the agreement uses to protect favored constituencies is the rule of origin, an industrial policy device that restricts trade in certain products that are not manufactured in North America. . . If applied to all products, rules of origin would be widely recognized as protectionist; when applied to a few select industries, they are called "keeping America competitive".

<sup>128</sup> See *supra* part III.B.2.

to eighty percent of their output to the United States duty-free under CFTA.<sup>129</sup> If NAFTA's rule of origin requirement hinders the ability of these transport corporations to continue to export duty-free to the United States, it is conceivable that they will begin to shift their operations to produce directly in the United States,<sup>130</sup> or limit their production in North America altogether.

In particular, Japanese-owned automotive corporations operating in Canada may be hindered by a stringent rule of origin requirement. Japanese-owned automotive corporations place substantial emphasis on maintaining long term relationships with a limited number of automotive parts suppliers.<sup>131</sup> As NAFTA marks the second time in five years that the content rules for automobiles sold in North America have changed,<sup>132</sup> NAFTA could greatly strain these supplier relationships and result in expensive re-tooling costs.

Despite NAFTA's rule of origin requirement's increase in domestic content level over that set forth in CFTA, the governments of Canada and Mexico eventually supported the rule. This is largely attributable to the influence the Big Three had in NAFTA negotiations.<sup>133</sup> It is important to remember that the Big Three not only dominate automotive trade in the United States, but also dominate such trade in Canada and Mexico.<sup>134</sup> It appears that the governments of Canada and Mexico were more concerned with maintaining positive relations with the Big Three than gaining investment from Asian or European-owned automotive corporations.<sup>135</sup>

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<sup>129</sup> See *Japan Seeks Assurance That NAFTA Will Not Affect GATT Obligations*, *supra* note 123.

<sup>130</sup> The president of the Association of International Automobile Manufacturers of Canada, Don McArthur, stated that higher content figures will result in increased foreign investment in the United States. He noted that Toyota Canada and other foreign manufacturers are currently looking to the United States for their expansion plans. *Canada May Accept U.S. Auto Proposal In NAFTA for 60 Percent Content Rule*, *Int'l Trade Daily* (BNA) (June 10, 1992).

<sup>131</sup> Unlike the average American-owned automotive corporation that typically has established relations with thousands of automotive suppliers, Japanese-owned automotive corporations typically have relationships with as few as 200 to 300 automotive suppliers. See *Rule of Origin Report*, *supra* note 45, at 11.

<sup>132</sup> William Duncan, executive director of the Japanese Automobile Manufacturers Association, stated that "Changing a critical factor like content level amounts to changing the rules in the middle of the game." See *U.S. Car Makers Pleased With NAFTA; Japanese Makers Predict Higher Costs*, *Int'l Trade Rep.* (BNA) (Aug. 19, 1992).

<sup>133</sup> See David Crane, *Experts Raise Doubts About NAFTA*, *TORONTO STAR*, Feb. 23, 1993, at C2 (noting influence of the Big Three).

<sup>134</sup> See *supra* notes 49-59 and accompanying text.

<sup>135</sup> Automotive part suppliers from each of the three countries supported an increased domestic content requirement as they stand to profit from such an increase by increased demand. See Chappell, *supra* note 60, at 35; John Watling, *Parts of the Pie*, *Auto Parts Manufacturers See*

To best serve these somewhat conflicting constituencies, NAFTA was negotiated to also provide some protection for existing transplant corporations operating in Canada. NAFTA's higher content requirement will be reached only by gradually increasing the content level set forth in CFTA. NAFTA's content requirement will remain at fifty percent until 1998 and will not be raised to sixty-two and one half percent until the year 2002.<sup>136</sup> To attract new investment, there is an even greater delay for automobiles produced in the free trade region in newly constructed automotive plants.<sup>137</sup> This transition period should allow ample time for transplant corporations operating in Canada to re-tool without substantially interrupting their current operations.<sup>138</sup>

Moreover, while NAFTA's rule of origin requirement will indeed eventually be twelve and one half percent higher than that provided in CFTA's rule of origin requirement,<sup>139</sup> the manner in which domestic content is calculated under NAFTA has been substantially modified from CFTA to provide new protection for transplant corporations currently operating in Canada.<sup>140</sup> First, NAFTA's use of the trace through method should result in more accurate content calculations. Under this method, both the actual domestic and foreign content in the automotive part would be counted in determining origin, in con-

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*Dollar Signs*, BUSINESS MEXICO, Nov. 1992. The Canadian Auto Workers also supported a high domestic content requirement to avoid job displacement from increased operations in Mexico. See Jeremy Sinek, *Free-Trade Deal Wins Friends, Foes in Canada*, AUTOMOTIVE NEWS, Aug. 24, 1992, at 24.

<sup>136</sup> These increases will be phased in over a transition period, ending January 1, 2002. For passenger automobiles and light trucks the content level would be 50% initially, increase to 56% on January 1, 1998, and increase to 62.5% on January 1, 2002 and remain at that level thereafter. For other vehicles and automotive parts the content level would be 50% initially, increase to 55% on January 1, 1998, and increase to 60% on January 1, 2002 and remain at that level thereafter. *NAFTA Draft #2*, Art. 403(5).

<sup>137</sup> See *NAFTA Draft #2*, Art. 403(6)(a), providing that the 50 percent content rule shall apply for automobiles produced in a plant that consists of a new building in which the motor vehicle is assembled and the plant contains substantially all new machinery that is used in the assembly of the motor vehicle.

<sup>138</sup> The president of the Automotive Parts Manufacturers' Association of Canada, Neil DeKoker noted that NAFTA's phase-in period should give foreign-owned automotive plants operating in Canada adequate time to re-tool to meet NAFTA's increased content requirements. See Lindsay Chappell, *Japanese transplants decry increase in content levels; Costly Changes in Tooling Needed*, AUTOMOTIVE NEWS, Aug. 17, 1992, at 34.

<sup>139</sup> See *supra* note 136.

<sup>140</sup> See *NAFTA Negotiators Struggle With Rules of Origin for Autos*, Int'l Trade Rep. (BNA) (April 29, 1992) (statement by a chief NAFTA negotiator that the manner in which the rule of origin requirements are calculated is of equal importance to the content level requirement in determining a rule of origin requirement's effects on a given industry).

trast to the roll up method used under CFTA.<sup>141</sup> Automobiles with numerous automotive parts possessing just under fifty percent domestic content would now get credit for their domestic content, which could result in an increase of overall domestic content by approximately three to four percent for certain automobiles.<sup>142</sup> Most importantly, this more accurate calculation will lead to more predictable customs rulings, thus better enabling automotive corporations to plan their operations.

Second, NAFTA's net-cost method<sup>143</sup> provides more protection to transplant corporations operating in Canada than CFTA's direct-cost method.<sup>144</sup> In attempting to protect the American automotive market, the United Auto Workers ("UAW") lobbied for the direct-cost method, which relies on a set of calculations to build up the cost of the automobile in calculating the domestic content.<sup>145</sup> By building up the domestic costs of an automobile, the direct-cost method concentrates solely on the actual North American manufacturing costs, whereas the net-cost method may include various indirect costs, such as indirect labor and overhead costs.<sup>146</sup> The UAW insisted that if the net-cost method was used, the content level should be no lower than seventy-five percent to protect American automotive corporations.<sup>147</sup>

Third, NAFTA's rule of origin provides more flexibility than the rule of origin under CFTA. In calculating the content level of a motor vehicle, automotive corporations may elect to average the automobile's content over an entire product line or over an entire class of automobiles.<sup>148</sup> As such, foreign-owned automotive corporations will

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<sup>141</sup> See *supra* part III.D. describing the roll up method, and notes 114-16 and accompanying text describing the trace through method.

<sup>142</sup> See Chappell, *supra* note 138, at 34. Note, however, the trace through method may also lower the domestic content of certain automobiles that possess several component parts with just over 51 percent domestic content.

<sup>143</sup> See *supra* notes 112-13 and accompanying text.

<sup>144</sup> See *supra* note 96 and accompanying text.

<sup>145</sup> See *U.S. Car Makers Pleased With NAFTA; Japanese Makers Predict Higher Costs*, Int'l Trade Rep. (BNA) (Aug. 19, 1992).

<sup>146</sup> See *NAFTA Draft #2*, Art. 408.

<sup>147</sup> Statement by UAW president, Owen Bieber. See *U.S. Car Makers Pleased With NAFTA; Japanese Makers Predict Higher Costs*, Int'l Trade Rep. (BNA) (Aug. 19, 1992).

<sup>148</sup> *NAFTA Draft #2*, Art. 403(3). "[For the purposes of] calculating regional value content of a motor vehicle. . . , the producer may average its calculation over its fiscal year, using any one of the following categories, on the basis of either all motor vehicles in the category or only those motor vehicles in the category that are exported to the territory of one or more of the other Parties:

- (a) the same model line of motor vehicles in the same class of vehicles produced in the same plant in the territory of a Party;
- (b) the same class of motor vehicles produced in the same plant in the territory of a party;

be able to increase the domestic content level of certain automobiles simply by strategically structuring their content calculations.

In fact, the protections afforded by these calculation modifications are so significant that several commentators claim if NAFTA is enacted that the recent ruling of the Customs Service of the United States against Honda would be reversed.<sup>149</sup> Under the trace through method, Honda would be allowed to retroactively count certain costs that Customs had previously excluded under CFTA's roll up method. Components that were previously considered fully foreign under CFTA's roll up because they possessed more than fifty percent foreign content, would now be given credit for their domestic content. Moreover, under NAFTA's net-cost method some costs excluded from consideration under the CFTA's direct cost method, such as indirect labor costs, would be included.<sup>150</sup> A reversal of this ruling would set an important precedent for other similarly situated automotive corporations.<sup>151</sup>

NAFTA also provides certain limited exceptions to existing transplant corporations operating in Canada. NAFTA provides a limited exception to CAMI Automotive, Inc. ("CAMI"),<sup>152</sup> a joint venture between Suzuki and General Motors of Canada Ltd. that produces approximately 200,000 vehicles annually.<sup>153</sup> Under the CAMI clause, CAMI products can be averaged together with General Motors' other Canadian-made vehicles to determine an average United States-Canada content level.<sup>154</sup> Since most of General Motors' products contain

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(c) the same model line of motor vehicles produced in the territory of a Party; or

(d) the basis described in Annex 403.4."

<sup>149</sup> "At Canada's insistence, the new rules [of origin] are being drafted so that automobiles produced at Honda's factory in Alliston, Ontario will qualify as made in North America." See Keith Bradsher, *North American Trade Talks Focus on Car Parts*, N.Y. TIMES, Aug. 8, 1992, at 8. "The new content rules would be precisely what Canada needs to avoid a return of the U.S. Customs Service ruling against Honda Canada." *Canada May Accept U.S. Auto Proposal in NAFTA for 60 Percent Content Rule*, Int'l Trade Daily (BNA) (June 10, 1992).

<sup>150</sup> See *supra* notes 97-98 and accompanying text for a discussion of such costs; see also David Everett, *Proposed Trade Pact to Benefit Honda*, DETROIT FREE PRESS, Aug. 14, 1992, at 1E; *Customs Rules That Canadian Honda Civics Failed to Meet Content Standard Under FTA*, Int'l Trade Rep. (BNA) (March 4, 1992) (noting controversy over the valuation of engines under the CFTA's roll up method and whether certain employee health care expenses should be considered in the domestic content calculation).

<sup>151</sup> See Honda Ruling, *supra* notes 14-18, and accompanying text.

<sup>152</sup> NAFTA Draft #2, Annex 403.3.

<sup>153</sup> See Lindsay Chappell, *GM Suzuki get break on trade content*, AUTOMOTIVE NEWS, Sep. 28, 1992, at 36.

<sup>154</sup> NAFTA Draft #2, Annex 403.3(1) ("For purposes of Article 403, in determining whether motor vehicles produced by CAMI Automotive, Inc. ("CAMI") in the territory of Canada and imported into the territory of the United States qualify as originating goods, CAMI may average



more than ninety percent North American content, the averaging is almost certain to enable CAMI products to satisfy NAFTA's rule of origin requirement.<sup>155</sup>

The greatest impact on the North American automotive market stems from Mexico's inclusion in NAFTA. If NAFTA is enacted, as has similarly occurred with the enactment of CFTA,<sup>156</sup> foreign owned automotive corporations would consider establishing operations in Mexico to avoid tariff costs on exports to the United States. In fact, in some instances, transplant corporations would be more apt to establish operations in Mexico than Canada, since Mexico offers the advantage of substantially reduced labor rates.<sup>157</sup> This could lead to a decrease in automotive investment in Canada from transplant corporations relocating their existing or restricting their future investments to Mexico.

Similarly, American-owned automotive corporations would be inclined to shift a significant portion of their automotive production facilities to Mexico, both to take advantage of lower labor rates and to consolidate their automobile production lines.<sup>158</sup> This has already been seen to a limited extent through the Big Three's participation in the Maquiladora program.<sup>159</sup> If Mexico's automotive demand continues to grow as expected,<sup>160</sup> these corporations would be further in-

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its calculation of the regional value content of a class of motor vehicles or a model line of motor vehicles produced in a fiscal year in the territory of Canada by CAMI for sale in the territory of one or more of the Parties with the calculation of the regional value content of the corresponding class of motor vehicles or model line of motor vehicles produced in the territory of Canada by General Motors of Canada Limited."

<sup>155</sup> See Chappell, *supra* note 153, at 36.

<sup>156</sup> See *supra* note 118 and accompanying text.

<sup>157</sup> The combined benefits and wages for a Mexican automotive worker equals a little more than two dollars an hour. See Harley Shaiken, *Mexico's Poorly Paid Workers Are as Highly Skilled as Their U.S. Counterparts*, L.A. DAILY J., May 29, 1991, at 6. This wage disparity between the U.S. and the Mexican auto workers is similar to the disparity of the Japanese and the Mexican hourly rate. Mary Ann Maskery, *Free trade in the West threatens auto jobs in Japan*, AUTOMOTIVE NEWS, Sep. 7, 1992, at 42.

<sup>158</sup> "The Big 3 face the prospect of consolidating redundant production. That will be expensive at first, but should pay off over time." Lindsay Chappell, *Trade Pact to Force Hard Choices*, AUTOMOTIVE NEWS, Aug. 24, 1992, at 4.

<sup>159</sup> See *supra* notes 28-29 and accompanying text.

<sup>160</sup> "Mexico has about 75 cars for every 1,000 people . . . And with Mexico's economic house apparently in order, demand for cars can only grow with free trade." See Max Gates, *Trade pact sets off era of opportunity*, AUTOMOTIVE NEWS, Aug. 17, 1992, at 1. Automotive trade accounts for one-fifth of trade between Mexico and the United States and is predicted to grow when Mexico's remaining trade barriers are lifted. John Maggs, *Auto Trade Poised for Rapid Acceleration*, J. OF COMM., Dec. 3, 1992, at 11C.

clined to establish operations in Mexico to better serve this growing market.<sup>161</sup>

This shift towards establishing production facilities in Mexico, however, would proceed slowly. Access to lower labor rates alone would not trigger an immediate shift in production to Mexico. If low labor rates were the most important reason for selecting a production site, Haiti would likely be the most industrious nation in the world. Mexico's weak infrastructure,<sup>162</sup> low worker productivity, and remaining trade regulations, particularly the Mexican Automotive Decree,<sup>163</sup> serve as significant obstacles to shifting automotive operations to Mexico.

During this transition period, American-owned automotive corporations should be in a better position to penetrate the Mexican automotive market than foreign-owned automotive corporations. In contrast to American-owned automotive corporations that currently produce automobiles with high domestic content, foreign-owned automotive corporations would have to incur substantial re-tooling costs to meet NAFTA's stringent rule of origin requirement.

Mexico's low labor rates<sup>164</sup> would also serve to increase the burden imposed by the origin requirement. Since the Mexican labor rates are substantially less than those in the United States or Canada, an equal number of labor hours performed in Mexico as compared to the United States or Canada would produce a smaller effect on domestic value calculations. The local content requirement posed by the Mexican Automotive Decree,<sup>165</sup> would also serve as a barrier.

Moreover, unlike several of the foreign-owned automotive corporations,<sup>166</sup> each of the American-owned automotive corporations already has established production plants and supplier relations in Mexico. This presence would help in establishing production facilities

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<sup>161</sup> Ford Motor Co.'s executive director of corporate strategy, Jack Eby, stated that opening up the Mexican market—consisting of 90 million potential automobile customers—is the best aspect of NAFTA. *Automakers, Workers at Odds Over Trade Pact*, BOSTON GLOBE, Aug. 13, 1992, at 52.

<sup>162</sup> See *Infrastructure Gets Mixed Reviews; Port Rail System Receives Low Grades*, J. OF COM., Dec. 3, 1992, at 6C.

<sup>163</sup> See *supra* notes 56-59 and accompanying text for discussion of the Mexican Automotive Decree.

<sup>164</sup> See *supra* note 157.

<sup>165</sup> See *supra* note 59 and accompanying text.

<sup>166</sup> Nissan and Volkswagen are the only foreign-owned automotive corporations that presently have production facilities in Mexico. See *supra* notes 56-59 and accompanying text for a description of the automotive industry in Mexico.

to satisfy domestic content requirements, and serve as a foundation from which to expand future operations.

American-owned automotive corporations must nonetheless overcome certain obstacles in shifting their operations to Mexico. First, they must work closely with the Mexican government to ease tensions between the two countries and build a lasting relationship.<sup>167</sup> This will be greatly aided by the recent improved relations between the two countries under the Salinas administration.<sup>168</sup>

Second, American-owned automotive corporations must work closely with the UAW to avoid potential strikes and negative public reaction triggered by shifting American jobs to Mexico.<sup>169</sup> American-owned automotive corporations should strongly consider supporting re-training programs to assist displaced automotive workers. These programs would help to maintain a positive public image and help avoid massive unemployment that would deplete consumer spending power.

NAFTA's actual impact on automotive job displacement, however, may be limited. The anticipated growth in the Mexican economy triggered by NAFTA, combined with the eventual elimination of tariffs on automobile exports to Mexico which presently stand at 20 percent,<sup>170</sup> would lead to increased demand for American automotive exports in Mexico. The Big Three would also become more competitive with European and Asian automotive producers by operating in an integrated North American automotive market.

Moreover, growth in the North American automotive parts industry would also dampen job displacement. Foreign-owned automotive corporations would have to restructure their sourcing strategies and align themselves with North American automotive parts suppliers to satisfy NAFTA's domestic content requirement.<sup>171</sup> This restructuring will clearly lead to an increase in demand for North American automotive parts.

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<sup>167</sup> For a discussion of past negative relations between the United States and Mexico, see *supra* notes 24-26 and accompanying text.

<sup>168</sup> *Id.*

<sup>169</sup> Union workers have been quick to condemn NAFTA in fear that it "will encourage the flight of high-paying American jobs to Mexico with no corresponding benefits to U.S. workers or consumers." *ALF-CIO, Other Unions Blast Free Trade Pact as Prescription for U.S. Job Loss*, Int'l Trade Rep (BNA) (Aug. 13, 1992); see also Thomas R. Howard, *Free Trade Between the United States and Mexico: Minimizing the Adverse Effects on American Workers*, 18 WM. MITCHELL L. REV. 507 (1992).

<sup>170</sup> See *supra* notes 56-58.

<sup>171</sup> See Chappell, *supra* note 60, at 35.

While this increased demand would lead to price increases for North American automotive parts,<sup>172</sup> American-owned automotive corporations would be less burdened than foreign-owned automotive producers by such increases. American-owned automotive corporations tend to be more vertically integrated than are foreign-owned automotive corporations.<sup>173</sup> Thus, American-owned automotive corporations are less dependent on outside automotive parts producers for their supply of automotive parts.

NAFTA's rule of origin requirement also poses several practical concerns for the North American automotive industry. First, the trace through method will undoubtedly lead to more administrative costs and burdensome documentation requirements than CFTA's roll up method.<sup>174</sup> The figures on which origin determinations are based are generally held in the accounting records of the corporations that make or process the components. These corporations, however, may not be the importers of record, thus posing tracing and verification problems where multiple manufacturing activities are involved.

Second, as with any value-based content requirement, fluctuations in the currency exchange rates can drastically affect the outcome of origin determinations. These fluctuations tend to occur during economic turmoil, and may hinder automotive corporations when they can least afford additional strain. While a content requirement that focuses on a given component's weight of domestic material or limits its inquiry to whether certain critical components are domestic<sup>175</sup> would avoid the currency fluctuation problem, these standards fail to give adequate protection to the free trade area since they may be easily manipulated. A better rule would recognize the currency fluctuation problem and provide a limited exception for severe currency fluctuations.

Finally, it is yet to be determined whether the final version of NAFTA's rule of origin requirement will be simple and unambiguous. Considering the attention that the Honda case has drawn<sup>176</sup> and the continued elimination of manipulative costs under NAFTA's two tier

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<sup>172</sup> See *Automobiles: U.S. Car Makers Pleased With NAFTA; Japanese Makers Predict Higher Costs*, Int'l Trade Rep. (BNA) (Aug. 19, 1992).

<sup>173</sup> See *Rule of Origin Report*, *supra* note 45; See also Doron P. Levin, *G.M. to Shut Down 7 Parts Factories in Strategy Shift: Will Buy From Suppliers*, N.Y. TIMES, Dec. 4, 1992, at A1 (noting the extent of vertical integration at G.M.).

<sup>174</sup> See Max Gates, *Parts-tracing set for trade pact*, AUTOMOTIVE NEWS, Aug. 31, 1992, at 35.

<sup>175</sup> See *supra* note 80 discussing the critical process requirement standard.

<sup>176</sup> For a discussion of the Honda case see *supra* notes 14-18 and accompanying text.

domestic content analysis,<sup>177</sup> it appears probable that the final version of NAFTA's rule of origin will lead to more predictable custom rulings.

## V. CONCLUSION

If NAFTA is enacted, its rule of origin requirement would have a significant effect on the North American automotive market. Existing foreign-owned automotive corporations operating in Canada should be able to satisfy NAFTA's content requirement without having to incur substantial re-tooling costs. While NAFTA's content requirement would be twelve and one half percent higher than CFTA's content requirement, it would only be gradually introduced and would provide certain protections for foreign-owned automotive producers that are presently not included in CFTA.

NAFTA, however, would alter the existing American and Canadian automotive market by including Mexico in the free trade agreement. Automotive corporations, particularly those currently operating in Canada, would attempt to shift their operations to Mexico to take advantage of lower labor rates, to better serve Mexico's growing automotive market, and to gain increased economies of scale; while still being able to export duty-free to the United States under NAFTA. North American-owned automotive producers would have a considerable advantage over foreign-owned automotive producers, as they already have established automotive plants in Mexico and will not have to incur significant re-tooling costs to satisfy NAFTA's stringent rule of origin requirement.

While this movement of operations to Mexico will result in some American automotive job displacement, overall this displacement will be limited. The anticipated improvement of the Mexican economy and the elimination of tariffs under NAFTA should result in an increased demand for American automotive exports. NAFTA should enable North American automotive producers to operate more efficiently and better compete with international competitors. Moreover, increased demand for North American automotive parts from automotive corporations attempting to meet NAFTA's increased rule of origin requirement should dampen the effect of any job displacement.

As further revisions are made to NAFTA before its enactment, there must be a continued effort to avoid trade deflection and to promote predictable custom rulings. While political pressures will un-

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<sup>177</sup> For a discussion of the two tier method *see supra* notes 103-16 and accompanying text.

doubtedly figure into this process, it is imperative to keep the impact of these pressures at a minimum to aid the North American automotive industry in the new global market.