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Remaking NAFTA: Its Origin, Impact and Future

by **Eric Miller**
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► Executive Summary

As Canada, the United States and Mexico head back to the negotiating table to re-make the North American Free Trade Agreement (NAFTA), they will use the existing deal as their baseline. NAFTA is a complex arrangement with a multitude of provisions covering most parts of the economy. Understanding why the original agreement was negotiated and what it included is a necessary precursor to understanding the options for a re-negotiated deal. This paper will open by assessing the history and content of NAFTA. It will then offer an assessment of the likely content and approach to the new agreement, as well as the probable points of friction. It will close by assessing how the new NAFTA should strengthen North America as a unit.



The renegotiation of the North American Free Trade Agreement (NAFTA), the commercial framework governing one of the world's largest trade relationships, is upon us. Some \$3.5 billion in trade flows among Canada, the United States and Mexico every day. Trade and investment among the three countries has grown exponentially since NAFTA entered into force on Jan. 1, 1994. Yet, a quarter-century after it was negotiated, NAFTA remains a lightning rod in many parts of the United States.

While the Trump-Clinton contest was hardly the first presidential campaign in American history to have trade as a core issue, this is the first time in the modern era that a proponent of the dissolution of trade agreements won. Donald Trump declared NAFTA to be a “disaster” throughout the campaign. He committed to scrap the deal or renegotiate it. He also advanced a new yardstick for measuring the relative success of U.S. trade policy – America's trade surplus or deficit with other countries.

Since arriving in the White House, Trump has moved expeditiously to make good on his NAFTA promise. Canada and Mexico have reacted with both concern and a determination to protect their market access gains while modernizing the agreement.

Things were particularly touch-and-go in April 2017 when Trump reportedly came close to triggering Article 2205 of the agreement that would have put the U.S. on a six-month timetable to withdraw from NAFTA. Only calls from Prime Minister Justin Trudeau and a map of U.S. farm state exports, which Secretary of Agriculture Sonny Perdue showed Trump, caused him to pull back.

As Canada, the United States and Mexico head back to the negotiating table, their positions will not emerge in a vacuum. They will use the existing NAFTA agreement as their baseline and also will reach for inspiration in the more cutting-edge parts of the Trans-Pacific Partnership (TPP) text. Yet, there is an imperfect understanding of the origins of NAFTA, the specific provisions that make up the deal, and the policy questions it sought to address.

This paper will offer some context about NAFTA before providing an assessment of where the deal will (and should) go. Specifically, it will first examine how and why NAFTA was negotiated in the first place. It will then summarize the content of the agreement – the very essence of what will be re-examined. Next, it will assess why NAFTA has remained a political lightning rod in the United States. It will then present an overview of the key points of negotiation. Finally, it will look ahead to scenarios for the negotiations and the future of North America.

How and Why NAFTA Came to Be

The origins of NAFTA can be found in the economic crisis of the early 1980s. Canada, the U.S. and Mexico each faced their own particular struggles to improve their competitiveness and drive economic growth.



In the postwar period, Canada had secured substantial investment from U.S. firms looking to supply the growing Canadian market. In 1965, the concept of an integrated cross-border supply chain took a substantial leap forward when the U.S. and Canada signed the Auto Pact. This linked together their production of automobiles, meaning that the same vehicles were sold in both countries. By the early 1980s, however, Canada was suffering from significant job losses and flagging competitiveness. There was also significant concern about growing U.S. protectionism. In 1982, the government of then-prime minister Pierre Trudeau appointed the Royal Commission on the Economic Union and Development Prospects for Canada, also known as the Macdonald Commission. When it reported in 1984, one of its key recommendations was the negotiation of a free trade agreement with the United States. The new prime minister, Brian Mulroney, accepted the recommendation and moved over the next couple of years to turn this objective into a reality.

The United States had its own reasons for supporting a free trade agreement with Canada. The U.S. was feeling the pinch from increased competition from Asia and a shifting international position. The multilateral General Agreement on Tariffs and Trade (GATT) process seemed stalled, having failed to launch a new round at the 1982 ministerial meeting. Moreover, then-president Ronald Reagan was market-oriented, making free trade with Canada an attractive project. The U.S. completed a modest free trade agreement with Israel in 1985, but its negotiation with Canada would be a first with a partner with whom it had substantial volumes of trade.

Canada and the U.S. launched free trade negotiations in the fall of 1985 and concluded them in the fall of 1987. Free trade with the United States was deeply controversial in Canada. The Mulroney government, facing the need to return to the voters, staked its re-election wholly on the trade agreement. The decision worked. Mulroney was returned to power with another majority government. The Canada-U.S. Free Trade Agreement entered into force on Jan. 1, 1989.¹

Mexico followed the Canada-U.S. free trade negotiations with interest. In June 1990, then-president George H.W. Bush and Mexico's former president, Carlos Salinas de Gortari, agreed to launch negotiations toward a U.S.-Mexico free trade agreement. Salinas de Gortari had been laying the groundwork for months to win Washington's support for a free trade agreement.

The remarkable journey to this point began in the misery of the 1982 debt crisis. In August of that year, Mexico announced that it was unable to pay its debts, prompting the U.S. Federal Reserve, other western central banks, and later the International Monetary Fund (IMF) to provide emergency financing. In September 1982, it nationalized the private banking system and imposed strict exchange controls. The government also imposed licensing requirements for

¹ For a complete history of the origins, negotiations and content of the Canada-U.S. Free Trade Agreement, please see Michael Hart, *Decision at Midnight: Inside the Canada-US Free Trade Negotiations*. (Vancouver: UBC Press, 1995).



virtually all of its imports. The old statist, import substitution model was completely discredited by the worst economic crisis in modern Mexican history.

The emergence of the new Mexican economy began with the election of Miguel de la Madrid in December 1982. The president and his team of skilled technocrats began to move Mexico toward a freer market and a more competitive economy. The nationalized banks were consolidated as a prelude to an eventual return to private ownership. The import tariff structure was steadily simplified and rates reduced. The percentage of imports requiring licences was also repeatedly cut. In an effort to lock in these reforms and improve its competitiveness, Mexico joined GATT in 1986.

Yet, by the late 1980s, the Mexican government felt it needed a bold strategy to catapult the country to the next level of development. Consequently, Salinas de Gortari opted to pursue a free trade agreement with the United States. This bold move would put aside decades of hostility between the two countries and firmly link Mexico's economy to that of the United States.²

The U.S. was receptive to Mexico's overtures for a variety of reasons. With the waning of the Cold War, the rise of pro-market sentiment and the post-debt crisis reform trajectory of Mexico, the United States was ready for a new strategy with its southern neighbour. The negotiation of trade agreements came to be seen, in both the U.S. and Mexico, as an ideal path for making this strong market orientation permanent. Having broken the mould of its traditional multilateral-centric trade policy with Canada, it was much easier for the U.S. to forge a bilateral path toward free trade with Mexico.

The full extent of Bush's post-Cold War vision for U.S.-Latin America relations was articulated in his announcement of the Enterprise for the Americas Initiative in June 1990.³ In various forms, the Bush vision would shape relations in the Americas for the next decade and a half. One of the key pillars of the initiative was the creation of a network of free trade agreements in the region, of which NAFTA would be the first. When taken together, they would form a "free trade area of the Americas".

For Canada, the U.S. announcement of free trade negotiations with Mexico created a dilemma. Having locked in preferential access to the U.S. market in its own bilateral agreement, it was loath to see its benefits eroded. The deepest fear of Canadian policy-makers was the so-called "hub and spoke" scenario. The bilateral free trade agreement put the Canadian and U.S. markets on an equal footing from an investment perspective. If the U.S. had preferential access to both the Canadian and Mexican markets, but Canada lacked preferential access to the whole North American market, it would be reduced to being a "spoke" to America's "hub". From an investment perspective this would make the U.S. a more attractive destination than Canada because it would be the only location from which one could service the whole North American

² For a complete overview of this period, please see Nora Lustig, *Mexico: The Remaking of an Economy*. (Washington, DC: Brookings Institution Press, 1998).

³ In addition to the trade pillar, the initiative announced the creation of investment vehicles for the region, including the IDB's Multilateral Investment Fund, and the furthering of sovereign debt restructuring. George Bush, "Remarks Announcing the Enterprise for the Americas Initiative," June 27, 1990. Available at <http://www.presidency.ucsb.edu/ws/?pid=18644>. Accessed Dec. 26, 2015.



market. Consequently, Canada, which had few economic ties to Mexico, sought entry and was invited on Feb. 5, 1991 to join the U.S.-Mexico bilateral process.

The NAFTA negotiations were formally launched in June 1991. While Mexico sought wholly new market access to the rest of North America, Canada and the U.S. took the opportunity to make improvements to their existing bilateral framework. The negotiations were incredibly complex and the methodologies deployed in many parts of the agreement proved transformative and enduring. The three countries reached an agreement in principle in August 1992 and signed a final agreement in December 1992.

It is one thing for heads of government to sign free trade agreements; it is another to get legislatures to ratify them. NAFTA's fate was called into question when Bill Clinton defeated Bush in the 1992 U.S. presidential election. Clinton had promised a different economic approach in his campaign. In order to make NAFTA palatable to members of his party, he demanded the inclusion of side agreements on labour and environment. This would not result in a formal re-opening of the agreement. After all, each country had things that it would like to change. Nor would the side agreements be subject to NAFTA's dispute settlement mechanism. They nonetheless would create institutional mechanisms for monitoring and, somewhat tepidly, addressing labour and environmental challenges in the three countries. With these changes and an intensive lobbying campaign on Capitol Hill, Congress approved implementing legislation for NAFTA in December 1993.

Canada was also undergoing political change in 1993. Mulroney resigned earlier in the year and Jean Chrétien's Liberal Party thoroughly defeated Mulroney's Progressive Conservative Party in the October elections. Chrétien campaigned on a promise of renegotiating NAFTA, although his platform declared his support for a North American trade agreement in principle. Once he was in power, it became clear that the political window for making changes had closed. Faced with a take-it-or-leave-it scenario, Chrétien accepted the agreement.

After clearing all political hurdles, the North American Free Trade Agreement entered into force on Jan. 1, 1994.

Content of NAFTA

At its most basic level, NAFTA sought to eliminate all barriers to goods and services trade among the three countries. It also created a complex framework for governing commerce among the three nations, including investment protections, rules of application to particular parts of the agreement, and dispute settlement provisions.

NAFTA meshed the different philosophies of the three countries. An essential conviction of Canadian trade policy is that rules-based mechanisms are fundamental to Canada's ability to deal with large countries such as the United States on more or less equal terms. This conviction can be seen throughout the agreement, but particularly in the dispute settlement mechanisms.



Mexico's objective was to lock in its market-oriented reforms through substantial liberalization of sectors across the economy. With the exception of the energy sector, which was constitutionally reserved to the state, Mexico took virtually no exceptions, even eschewing permanent protection of sensitive agricultural sectors such as corn.

The United States sought the same level of market access in Mexico as it had with Canada. It also sought mechanisms to fix some of the operational issues that had emerged with the Canada-U.S. Free Trade Agreement, most notably with the specificity and administration of the rules of origin.

Trade in Goods

Tariffs

NAFTA eliminated most tariffs among the countries of North America. This was done through three separate bilateral tariff phase-out schedules – Canada-Mexico, U.S.-Mexico and the existing Canada-U.S. FTA schedule. The schedules had 10-year progressively eliminated tariffs with a handful of products reserved for 15 years.

Rules of Origin

The purpose of rules of origin is to determine which products benefit from a trade agreement and which do not. Origin is always, to a greater or lesser degree, about shaping industrial outcomes. Consequently, these rules are central to every trade agreement and inherently political.

A defining characteristic of the NAFTA rules of origin is that they are highly specific. Consequently, they were often developed with specific political economy outcomes in mind. One example is the approach the U.S. pushed to help its domestic textile industry, the so-called “triple transformation test”. As I. M. Destler recounts:

So the textile industry shifted its stance: if a growing share of clothing sold in the United States was to be imported, they would look for ways to have that imported clothing made with US cloth ... They could live with NAFTA with the likely flood of apparel imports from lower-wage Mexico if North American clothing had to be made with North American cloth. For USTR negotiators knowing that NAFTA was politically controversial and looking to broaden NAFTA's support, this was an offer they could not refuse. So the mills got their triple transformation test. And NAFTA got Carolina votes. In the 1991 vote extending fast-track rules that was a de facto authorization of the NAFTA negotiations, representatives from North Carolina had voted 9-2 in the negative. But this was before the rules of origin ... Once the triple transformation test



was embedded ... and it came before the House for its dramatic final vote in 1993, legislators from that state shifted to 8-4 in favor.⁴

Key Exceptions

Like most free trade agreements, countries included key exceptions to make the agreement politically viable.⁵ In NAFTA, these included:

- *Supply-managed products*: Dairy, poultry and eggs under Canada's supply-management regime were subject to punitive tariffs in the 300 per cent+ range.
- *Sugar*: While the U.S. and Mexico have fought bitterly over sugar and sweeteners since NAFTA was negotiated, the U.S. has succeeded in ensuring less than free trade in this sector over the long term.
- *Energy*: NAFTA's regime with respect to investment, production and trade of energy products is bifurcated between a liberalizing Canada-U.S. approach and a Mexico exemption. With energy reforms in Mexico in 2013, there is potential for this to change.⁶

Investment

NAFTA's investment obligations (Chapter 11) are strongly weighted toward facilitating and protecting investments across North America. Chapter 11 was consistent with an evolving set of international norms about how investors should be treated and their rights in the event that governments expropriated or undermined their investments. Despite this, the chapter has become notorious for the uses, and some would argue, abuses of the investor state dispute settlement (ISDS) mechanism. Imprecise drafting and the creativity of lawyers have led to numerous allegations that government practices are "tantamount to expropriation".

As of January 2015, Canada had been sued 35 times under NAFTA's ISDS rules and had to pay out US\$137 million in damages. Mexico has been sued 22 times and has had to pay out US\$204 million in damages. The United States has been sued 20 times, has never lost and has never paid a penny.⁷ Such results have hardly endeared politicians and the public to NAFTA's ISDS regime.

⁴ I.M. Destler, "US Trade Politics and Rules of Origin: Notes Toward a Paper," May 24, 2003. Available at <http://faculty.publicpolicy.umd.edu/sites/default/files/mdestler/files/roa.pdf>. Accessed Feb. 27, 2016.

⁵ For an overview of how and why these items received special treatment in the NAFTA negotiations, please see Eric Miller, "The Outlier Sectors: Areas of Non-Free Trade in the North American Free Trade Agreement," *INTAL-ITD-STA Working Paper 10*. Inter-American Development Bank, July 2002. Available at <https://publications.iadb.org/handle/11319/2649?locale-attribute=en>. Accessed Jan. 4, 2016.

⁶ Clare Ribando Seelke, et al., "Mexico's Oil and Gas Sector: Background, Reform Efforts, and Implications for the United States," Congressional Research Service, Sept. 28, 2015. Available at <https://www.fas.org/sgp/crs/row/R43313.pdf>; and Adrian Lajous, "Mexican Energy Reform," Center on Global Energy Policy, Columbia University, June 2014. Available at <http://www.goldmansachs.com/our-thinking/pages/north-american-energy-summit/reports/cgep-mexican-energy-reform.pdf>.

⁷ Scott Sinclair, "NAFTA Chapter 11 Investor-State Disputes," Canadian Centre for Policy Alternatives, 2015. Available at https://www.policyalternatives.ca/sites/default/files/uploads/publications/National%20Office/2015/01/NAFTA_Chapter11_Investor_State_Disputes_2015.pdf. Accessed Jan. 10, 2016.



Trade in Services

The NAFTA provisions on trade in services were ambitious and designed to deepen liberalization in the part of the economy that, when NAFTA was negotiated, accounted for almost two-thirds of U.S. GDP.⁸ NAFTA's services obligations are set forth in a general chapter (Chapter 12) and specific chapters on telecommunications, financial services and temporary entry for business persons.

While each party maintains numerous exceptions, NAFTA's services regime is weighted to a significant degree toward market opening. In its structure, NAFTA's services obligations are based on a negative-list approach. This means that everything is liberalized except what is deliberately excluded. This stands in stark contrast to the Canada-U.S. agreement and the General Agreement on Trade in Services (GATS), which used a positive-list approach. A key advantage of the negative-list approach is that it defaults to liberalization as the economy changes.⁹

Financial Services

Canada and the United States were relatively modest in their financial services commitments. For example, Canada retained its long-standing policy that deposit-taking institutions (Schedule A banks) must be domiciled in Canada.¹⁰ Mexico, by contrast, was very aggressive. Having negotiated NAFTA in the aftermath of the post-1982 financial sector restructuring, the government was keen to use NAFTA to both strengthen and internationalize the Mexican financial services providers. Under the agreement, Mexico agreed to a detailed path that would eventually allow U.S. or Canadian entities to acquire 100 per cent ownership in Mexican financial institutions. The pace of liberalization was accelerated over the course of implementing the agreement. At the time of writing, five of the seven largest financial institutions are wholly or partially foreign-owned.

Temporary Entry

Services often require people to deliver them. Business visitors, traders and investors, intra-company transferees and select professionals are permitted, with documentary and other caveats, entry into another NAFTA country for the purposes of delivering a broad array of commercial activities. Such entry is temporary and non-immigrant in nature.

Chapter 16 is best known today for Appendix 1603.D.1, which sets forth a list of professions and corresponding educational requirements whose practitioners are eligible for a NAFTA visa. It

⁸ According to the Bureau of Economic Analysis, services accounted for 63.8 per cent of GDP in 1992 and 77.8 per cent in 2014.

⁹ Eric Miller, John Dillon, and Colin Robertson, "Made in North America: A New Agenda to Sharpen our Competitive Edge," Canadian Council of Chief Executives, December 2014. Available at <http://www.ceocouncil.ca/wp-content/uploads/2014/12/Made-in-North-America-paper-Nov-2014-FINAL-2-Dec-2014.pdf>. Accessed Feb. 28, 2016.

¹⁰ For a detailed description of the content and context of Chapter 14, please see Eric Miller, "Financial Services in the Trading System: Progress and Prospects," *INTAL-ITD Occasional Paper 4*, Inter-American Development Bank, July 1999. Available at <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=33036501>. Accessed Jan. 11, 2016.



catalyzed the cross-border integration of professions in North America as never before. Yet, despite – or, perhaps, because of – its success, NAFTA’s temporary entry provisions have become politically controversial, especially in the United States.

Congressional hostility toward temporary entry has made updating existing rules very difficult. Canada and Mexico have each repeatedly sought to secure a meeting of the NAFTA Temporary Entry Working Group, but the U.S. has refused to engage. Nevertheless, Canadians and Mexicans continue to use the NAFTA Temporary Entry Framework more than ever.¹¹ Old titles are reinterpreted for new professions – an imperfect solution that provides little predictability.

Dispute Settlement

There were three main dispute settlement provisions in NAFTA: the aforementioned investor-state regime in Chapter 11, the review of trade remedy actions in Chapter 19 and the resolution process of government-to-government disputes in Chapter 20. Each of these dispute settlement processes contains detailed rules of procedure, clear processes for bringing a case and clear standards for how judgments are to be interpreted and applied. There is even a review mechanism for the Chapter 19 panel process to ensure that the integrity of the process is safeguarded.

Chapter 19

Chapter 19 permits a NAFTA party to request a final review of anti-dumping or countervailing duty determinations undertaken through the domestic trade remedy process of another party. Its origins can be found in the Canada-U.S. Free Trade Agreement, where it was literally the last issue to be settled. Canada, like many countries, resented what it regarded as the politicized and protectionist nature of the U.S. trade remedies system. Securing this supranational review mechanism was a fundamental demand in that agreement. Canada therefore wanted to carry it over to NAFTA. Given that Mexico had also suffered from U.S. anti-dumping actions, they were very happy to see it included in NAFTA.

The mandate of a Chapter 19 panel is to assess, based on the administrative record, whether the relevant administrative agency applied its national anti-dumping/countervailing duty laws correctly. The panel’s review determinations are binding.

Recognizing the potentially political nature of trade remedies disputes, Chapter 19 includes the Extraordinary Challenge Procedure. If either party believes that the integrity of the panel process has been compromised, they can request the creation of a three-member Extraordinary Challenge Committee (ECC). Given the seriousness of the matters under review, this committee is staffed by sitting and former judges.

¹¹ *Yearbook of Immigrant Statistics: 2013 Temporary Admissions*, Office of Immigration Statistics, Department of Homeland Security. Available at <https://www.dhs.gov/publication/yearbook-immigration-statistics-2013-temporary-admissions-nonimmigrants>. Accessed Feb. 28, 2016.



Over the last 20 years, there have been 69 Chapter 19 panels. Each country has been an active user of the system. The record indicates a mix of results, with some domestic trade remedy decisions being upheld and some being remanded. During that time, three ECCs have been convened. The U.S. has sought each review and each time the judges have failed to overturn the panel's decision.

Chapter 20

Chapter 20 provides for the resolution of all government-to-government disputes regarding the interpretation and application of NAFTA. The basic procedure is as follows: the disputing parties first hold consultations. If these do not work, there is an appeal to the NAFTA Free Trade Commission, comprised of the member countries' trade ministers. If this does not resolve the issue, a five-member arbitral panel is convened. Chapter 20 panels do not offer binding decisions. Rather, they offer findings of fact. This includes determinations of inconsistency with NAFTA obligations and whether benefits of the agreement have been impaired. The panels also offer recommendations on resolving the dispute at hand. To date, there have only been three such panels under the agreement.

America's NAFTA Ambivalence

NAFTA was politically controversial when it was negotiated, especially in the United States, and it passed Congress by the narrowest of margins. As the first major trade agreement with a developing country, NAFTA became synonymous with all of the other changes in the economy over the past two decades, whether driven by technology, China's rise or other factors.

On its core mission – to increase trade – NAFTA has succeeded spectacularly. Trade flows among the three countries have grown from \$290 billion in 1993 to \$1.1 trillion in 2016. The U.S. stock of investment in Mexico has grown from \$15 billion to \$100 billion over this period. The Canadian stock investment in the U.S. grew six-fold during this period while the U.S. stock of investment in Canada grew five-fold.¹² All of this trade and investment reshaped supply chains and made the countries mutually dependent as never before.

Yet, people do not determine their support for a policy based on macro statistics. It is about how individuals and communities are faring. For communities that have undergone significant de-industrialization, it is easy to understand their agreement with Trump's assessment that NAFTA has been a disaster.

One of the great failings of the proponents of NAFTA after 1994 was that nobody took on the job of offering a counter-narrative, explaining the positive aspects of the agreement and how

¹² M. Angeles Villarreal and Ian F. Fergusson, *The North American Free Trade Agreement*, Congressional Research Service, April 16, 2016. Available at <https://www.fas.org/sgp/crs/row/R42965.pdf>. Accessed Nov. 25, 2016.



distinct phenomena affected the economy. As Daniel Ujzco, president of the Ohio-Canada Business Association, explains:

The big mistake we made after NAFTA was we got the deal passed in '94 and everybody went home. They left the hall in Congress and went home and just said, "Trade will prove itself." Well, no. What we've learned is we've got to continue to get out there and talk about this.¹³

In addition, there was no meaningful trade adjustment assistance to help the losers from NAFTA, technology, China or much else. What assistance exists is notoriously hard to get, making it effectively meaningless in militating against both the down sides and negative perceptions about trade.

Until the Trump election, proponents of open trade could rest comfortably in the notion that a path could always be found to advance further liberalization. With NAFTA up for renegotiation and the U.S. out of the TPP, this is clearly no longer the case. Shifting economic conditions have resulted in shifting politics. According to the U.S. Bureau of Labor Statistics, the U.S. has lost five million manufacturing jobs since 2001 when China entered the World Trade Organization (WTO).¹⁴

The consequences for American politics have been profound. A groundbreaking 2016 study, *Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure*, found that areas hardest hit by trade shocks were much more likely to move to political extremes. As Gordon Hanson, one of the study's authors, stated, "(e)xposure to import competition is bad for centrists." David Autor, another of the study's authors, explains that trade delivers "diffuse benefits and concentrated costs, but our political system hasn't addressed those costs."¹⁵ In a postelection update, the economists examined the correlation between increased Chinese imports and increased votes for Trump relative to George W. Bush. They found that for every one per cent increase in Chinese imports into communities, Trump's relative vote share rose by two per cent.¹⁶

It is imperative that we at least get the narrative piece right around the new NAFTA while concurrently developing an aggressive adjustment package to assist communities and workers who have been hard hit by economic change. This is hardly a distinctly American problem. Canada of late has been pushing the notion of a progressive trade agenda. Unless this includes

¹³ Chris Hall, "Is Trump's tough talk on trade all bluster?: Business Leaders shouldn't wait to find out.", *CBC*, Nov. 18, 2016. Available at <http://www.cbc.ca/news/politics/nafta-tpp-trump-trade-deals-chris-hall-1.3856142>

¹⁴ Heather Long, "U.S. Has Lost 5 Million Manufacturing Jobs Since 2000," *CNN*, March 29, 2016. Available at <http://money.cnn.com/2016/03/29/news/economy/us-manufacturing-jobs/>

¹⁵ Nelson Schwartz and Quoc Trung Bui, "Where Jobs Are Squeezed by Chinese Trade, Voters Seek Extremes," *New York Times*, April 26, 2016. Available at <http://www.nytimes.com/2016/04/26/business/economy/where-jobs-are-squeezed-by-chinese-trade-voters-seek-extremes.html>. The original study, *Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure*, is available at <http://www.ddorn.net/papers/ADHM-PoliticalPolarization.pdf>.

¹⁶ Bob Davis, "Jump in Chinese Imports Gave Trump Election Boost, Study Finds," *Wall Street Journal*, Nov. 22, 2016. Available at <http://www.wsj.com/articles/jump-in-chinese-imports-gave-trump-election-boost-study-finds-1479849833>.



elements targeted specifically at helping those displaced in the new economic world, Canada itself risks seeing a diminishment of the relatively pro-trade sentiment that presently exists.

Remaking NAFTA

So what should the three countries expect in the new NAFTA negotiations? What do they want out of a revised deal? What does this process mean for the conception and reality of North America in the years ahead?

Objectives

Going into the NAFTA negotiations, Canada's and Mexico's focus has been quite simple – defend existing market access and framework of rules while looking for ways to modernize the agreement. Because U.S. political considerations have made NAFTA largely unchangeable since it was created, the optimists see Trump's reopening of NAFTA as an important opportunity. Others have expressed concerns about retrenchment in key areas.

The U.S. objectives have been somewhat complicated. Trump never specified parts of NAFTA that he disliked. Rather, his view was based on a perception of what NAFTA had done to America. Yet, because NAFTA is a trade agreement with chapters and clauses, Secretary of Commerce Wilbur Ross, United States Trade Representative Robert Lighthizer and their officials have had to think through how to translate their president's perception of unfairness and preoccupation with America's trade deficit into meaningful policy solutions.

While the U.S. statement of negotiating objectives¹⁷ is extensive, it seems to indicate that America's strategy for fixing NAFTA's perceived unfairness includes a combination of tighter rules of origin that create an incentive for North American production and new market access in previously restricted sectors ranging from dairy to financial services to telecom. Importantly, nothing in the U.S. objectives document includes new tariffs or quotas. This comes as a great relief, especially to Mexico, which deeply feared a substantial U.S. push to curtail its market access in manufactured goods. Yet, they would be wise as the negotiations unfold to keep their eyes open for any deviation from this policy direction.

Process

Since the Trump administration came to office, a cottage industry has emerged in speculating how the NAFTA process will unfold. In practical terms, it will look a lot like other trade

¹⁷ The U.S. statement of NAFTA negotiating objectives is available at <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/july/ustr-releases-nafta-negotiating>.



negotiations. Negotiating sessions will be structured into rounds during which multiple tables will work simultaneously on an array of topics.

Importantly, the Trump administration has opted to retain NAFTA's trilateral nature. This is a far cry from the formula articulated in February 2017 when Trudeau visited Washington, namely a "tweak" in the provisions governing trade relations with Canada and deep changes with Mexico. Rather, there will be a single set of rules for everyone. In practical terms, this means a single agreement with a single set of rules of origin, common dispute settlement mechanisms and other key provisions.

While the negotiation will be trilateral, there will be plenty of specific provisions that are bilateral. After all, the original NAFTA contained significant areas of bilateralism, including three separate tariff schedules and three separate agreements that together comprise the agriculture chapter. Potential bilateral topics include specific border management measures and temporary entry of business travellers.

In terms of the calendar, the first round will take place in Washington, D.C. and will rotate among the three countries thereafter. The planning going into the negotiations is to hold seven rounds at three-week intervals.¹⁸ Of course, trade negotiations are a non-linear enterprise, so the precise schedule will be determined as the process unfolds.

What Each Side Wants (and Their Likelihood of Getting It)

United States

As noted, the United States has set forth detailed list of negotiating objectives for the new NAFTA. While most negotiators will tell you that revealing objectives up front is unwise, the legislative framework under which the U.S. will operate in the negotiations requires it.

NAFTA is the first trade agreement to be initiated under the 2015 Trade Promotion Authority (TPA) legislation. TPA requires the administration to notify Congress at least 90 days before initiating, of its intent to launch negotiations. At least 30 days prior to commencing, the administration must set forth detailed negotiating objectives that link back to the goals and targets set forth in the TPA legislation. As a consequence, the United States has been very specific about its initial positions

For the most part, the list of U.S. objectives is surprisingly mainstream compared to the administration's rhetoric. In part, this is structural. After all, the TPA legislation sets forth its own detailed list of negotiating priorities that the executive branch is bound to follow. Yet, it also seems clear that the administration is moderating its views about the use of certain trade

¹⁸ Anthony Esposito and David Ljunggren, "Exclusive: U.S., Canada, Mexico Agree on Fast-Paced NAFTA Talks – Sources," *Reuters*, July 19, 2017. Available at <https://www.reuters.com/article/us-usa-trade-nafta-exclusive-idUSKBN1A41PU>.



instruments to achieve policy goals. While raising tariffs, for example, may reduce trade (and the trade deficit) with the partners on the receiving end, it would hurt the United States and create disruptions across the economy. Considering that 40 cents of every dollar that Mexico exports to the United States (and 25 cents that Canada exports) is U.S. content, large numbers of mid-size U.S. manufacturers of inputs to regional supply chains would pay the price.¹⁹

While raising tariffs or introducing quotas does not seem to be in the cards, tightening rules of origin to create an incentive for more production in North America is central. This potentially includes both increasing regional content thresholds where they exist and ending certain accounting practices such as “roll-up” for automobiles that allow non-regional content to be counted as originating. Outside of autos, the majority of the NAFTA rules of origin are based on the so-called “tariff shift” methodology. Engineering policy outcomes are very much doable, but will require incredibly specific sectoral knowledge. Tighter rules of origin in North America may come at the expense of production in Asia. More production in North America potentially means some measure of increase in manufacturing jobs, meaning that Canada and Mexico should be agreeable.

On agricultural goods, the U.S. wants to go after existing barriers, including in the dairy and wine sectors. Canada may seek an approach like that of the Canada-European Union Comprehensive Economic and Trade Agreement (CETA) which offers a quota on certain categories of products. Fundamentally changing the Canadian supply management regime would be a more politically fraught and certainly a long process.

The U.S. is seeking to get Canada and Mexico to raise their *de minimus* thresholds to at or near US\$800. Canada’s *de minimus* is presently C\$20 and Mexico’s is US\$40. It seems unlikely that Canada and Mexico will move anywhere close to \$800. At the recent U.S. Customs and Border Protection Trade Symposium, at least one senior Customs official carefully expressed the view that \$800 may be too high. It is also known that the Canada Border Services Agency focuses its risk management efforts at a level well above Canada’s legal threshold. It is hard to see Canada and Mexico moving higher than US\$500. More realistically, they will probably land in the US\$200-\$300 range.

A newer area on the U.S. list is regulatory co-operation. NAFTA’s renegotiation offers an excellent opportunity to institutionalize the important work of the Canada-U.S. Regulatory Co-operation Council and to catalyze an even more ambitious level of collaboration between the two countries in this field.

Financial services are on the U.S. target list. While not explicitly clear, the intent seems to be to try to give U.S. banks the ability to take over Canadian banks and/or to offer deposit-taking services. This would pose huge difficulties from a political and regulatory perspective for

¹⁹ Robert Koopman, William Powers, Zhi Wang, and Shang-Jin Wei, “Give Credit Where Credit is Due: Tracing Value Added in Global Production Chains,” National Bureau of Economic Research *Working Paper* 16426. Available at <http://www.nber.org/papers/w16426>



Canada. Nevertheless, with TD being America's eighth largest bank and Canada's third largest bank, the U.S. will be in a strong position to argue for reciprocity.

Digital trade and cross-border data flows are an import from the TPP. While some Canadian jurisdictions have limited restrictions on data flows out of their provinces, the U.S. is in a reasonably good position to get what it is looking for on this issue.

The U.S. draft speaks of how NAFTA investors are to not be granted greater rights than domestic investors. This suggests a U.S. push to make further changes to NAFTA's investor state dispute settlement regime. ISDS is unloved by the NAFTA parties, suggesting that substantive changes are possible.

The U.S. has included a number of other topics from the TPP, such as state-owned enterprises, currency manipulation and transparency. These are less aimed at the countries of North America than at setting an international precedent for dealing with these themes. There are not huge numbers of state-owned enterprises in North America engaged in international trade. The risk of including these non-core themes in the new NAFTA is that poor drafting could lead to unintended consequences. For example, is the Canada Pension Plan Investment Board a state-owned (or controlled) enterprise? Did the Federal Reserve's policy of quantitative easing constitute currency manipulation? If the countries feel that it is important to include these themes, one must clearly delineate the parameters of what is covered and what is not covered.

Labour and environment are key themes. They were added to the original NAFTA as side agreements. The U.S. is now proposing to make them a core part of the agreement. The tenor of the U.S. proposal seems to be to raise the labour and environmental standards in Mexico with a view to equalizing the competitive positions of the two countries. Mexico is expected to resist such a push, fearing that it will erode its competitiveness.

The U.S. is seeking to eliminate the Chapter 19 dispute settlement mechanism. Given how hard Canada fought to get this process included in the Canada-U.S. FTA, they will not give it up easily. A core belief of Canadian trade policy is that trade agreements must include mechanisms to allow the smaller country to be put on a level playing field with the larger country and to have disputes resolved on the basis of fact, not power. Given its use over the years in cases involving such products as softwood lumber, Chapter 19 has taken on an emotional quality in Canada. This complicates the pathway to a resolution on this point.

The government procurement section makes explicit the U.S. desire to protect "Buy American" and other domestic preference programs. Knowing that Canada will seek an exemption from "Buy American" and offer sub-federal procurement in exchange for greater access, the U.S. is saying, in effect, that it is not interested. The formula worked for Canada in CETA. It looks like a heavy lift in the new NAFTA.

The language on energy in the U.S. statement of objectives is rather general. It is well known that both the United States and Canada would like to see Mexico's 2013 energy reforms locked into the new NAFTA. Yet, they also know how sensitive this issue is in Mexico. The rather



general statement by the U.S. is an effort to flag the issue of energy without courting controversy.

Canada and Mexico

Canada and Mexico will, of course, bring their own demands to the table. Tactically, both governments have decided to wait to see the U.S. proposals before engaging.

Canada is expected to push for a modernization of the NAFTA Chapter 16 professionals list and, despite the U.S. view, a greater integration of procurement markets. Other logistics measures, including empty trailer repositioning for trucks and a phasing out of the Jones Act for shipping may be on the agenda.

Mexico is expected to join Canada in opposing changes to Chapter 19. It also will seek a greater harmonization of labour markets and agricultural safety standards as well as the adoption of a robust set of rules governing the digital economy.

The Jones Act and labour market integration seem out of reach for the two countries. Movement on Chapter 16 and agriculture seems possible.

How to Strengthen North America

A key question for Canada, the United States and Mexico is: what will North America look like when the new NAFTA is done and implemented?

The original NAFTA deliberately avoided the creation of significant institutions to administer the free trade area. The Free Trade Commission, comprised of the three trade ministers plus a series of working groups, was about the extent of it. The concept of North American co-operation mostly existed through supply chains and informal co-ordination mechanisms. While few in North America want a European-style bureaucracy, there are mechanisms that can make the operation of the North American trading zone work better.

North American Commercial Framework (NACF)

NAFTA was developed to free economic forces and integrate markets among the U.S., Mexico and Canada. It genuinely delivered the boost in competitiveness and productivity that its policy architects sought. The renewed NAFTA must deal with today's concerns. While catalyzing competitiveness remains important, the nations of North America are facing a series of new challenges. These range from effectively dealing with actors such as China that appear to widely subsidize their products and services to energizing investments in infrastructure.

While many of the themes that would be included in such a framework are trade-related, they are not classically accommodated in the structure of a free trade agreement. Consequently, the three countries should develop a parallel framework. So what should be included in the NACF?



- **Institutionalizing NALS:** The North American Leaders Summit is run on a haphazard basis. The three countries should agree to forward dates for NALS well into the future and put them on the forward calendar with the permanence of the NATO Summit or the UN General Assembly. They also should more formally develop a structure for preparing for and following up from the NALS summits.
- **Co-ordination on Anti-Circumvention and Efforts to Combat Unfair Trade Practices:** One of the vexing trade challenges in recent years has been how to deal with the corrosive effects of subsidized products and services flooding world markets from Asia. China in particular has been accused of substantively subsidizing an array of products from steel to telecom equipment to logistics services with the objective of acquiring market share and pushing competitors out of the market. Some products such as steel and aluminum have garnered significant attention in the United States, causing the Commerce Department to undertake a Section 232 national security investigation. The inflow of massively subsidized Chinese products hurts Canadians and Mexicans as much as it does the Americans. Consequently, the NACF should include a mechanism to both permit and encourage the three countries to work together in a co-ordinated fashion on anti-circumvention investigations and other efforts to combat illegal or dumped products originating in third-party countries. This would range from information sharing to joint investigations to co-ordinated penalties and enforcement actions. By definition, these types of co-ordinated investigations would mean that Canada and Mexico would not be covered in the type of global investigations such as the Section 232 process for steel and aluminum. They would be regarded by the U.S. as part of the solution, not part of the problem.
- **Creation of a North American Trade Infrastructure Bank.** High quality border and trade infrastructure is fundamental to a competitive North America. The continent needs a genuine border and trade infrastructure bank (or facility) to facilitate the financing of critical trade infrastructure that is not receiving the necessary funding.²⁰ The resources would be both supplied by the governments and leveraged from pension funds and private investors looking for high quality long-term infrastructure investments. It has long been understood that delays in the supply chain constitute de facto trade barriers. It is time to ensure that North America's trade infrastructure is not undermining its competitiveness.

These are but some of the commercial policy measures that could lead to a stronger North America.

²⁰ The Bush Institute has done excellent work in defining what such a bank would look like. Available at <http://www.bushcenter.org/publications/resources-reports/reports/investments-in-north-america.html>.



Conclusion

For the three countries involved, the renegotiation of NAFTA will be one of the most important economic policy actions of this decade. The Trump administration is learning that the depth of America's integration with the economies of its neighbours is much deeper than it first thought. Given the relative pragmatism of the U.S. negotiating objectives document, the prospects for constructively modernizing NAFTA are quite good.

A key question is how do we build a stronger, more prosperous North America that can out-compete any region in the world? Facilitating trade and linking up energy markets are an important part of the story. Yet, something like a NACF that does not rely solely on market forces and trade rules to deliver is also important. Selectively strengthening the region's operational instruments and governance framework is crucial.

Separate from these processes but related to the NAFTA story is the question of how we build a structure to ensure a robust relationship between Canada and Mexico well into the future. While the two countries, after some bumps in the road, are enjoying their closest relationship in years, the key question is what happens when the new NAFTA is completed and the sense of urgency diminishes? The old Canada-Mexico Partnership (CMP) was neither senior enough nor focused enough. The CMP should be reimagined to include a ministerial-led process and a focused agenda with the right people in the room.

Rahm Emanuel, former president Barack Obama's first chief of staff, famously said: "You never let a serious crisis go to waste ... it's an opportunity to do things you think you could not do before." Trump's opening of NAFTA creates substantial opportunities to modify and amplify the North American commercial regime. Let us seize the moment. The window will not last forever.

▶ **About the Author**

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► **Canadian Global Affairs Institute**

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