NAFTA Negotiations Start Late Summer – An Opportunity Not Only to Update But to Address Underlying Causes of Continuing Distortions

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The Trump Administration on May 18th notified Congress of its intent to enter into trade negotiations with Canada and Mexico to update ("modernize") the 1990s agreement and to address issues of interest consistent with the 2015 Trade Promotion Authority Act. Reactions from members of Congress and the business community have been mixed, with many concerned that any new negotiation not upset the existing trade liberalization and the relationships with our neighbors, which have dramatically expanded trade and investment amongst the countries since the early 1990s, and with others concerned that the President's promise to withdraw/renegotiate the agreement to address persistent trade deficits might be being abandoned.

With the Administration being able to start negotiations as early as August 16th and with a desire, apparently held by each of the three governments, to conclude the new negotiations quickly, the challenge will be whether the unique opportunity presented by the new negotiations results in a comprehensive reassessment of our trilateral relationship coupled with an identification of domestic policy changes needed to ensure U.S. competitiveness, or simply becomes an effort to add the elements from the TPP addressing unaddressed issues in the NAFTA plus a handful of other issues where agreement can be achieved quickly. While one would hope for the former result, the latter course appears more likely because of the time framework being suggested, the difficulties likely for addressing issues within the relationship that have proven problematic for certain industries or groups, and the challenges of achieving policy changes domestically or even understanding the changes that may be needed.

Human nature prefers the status quo over change, and one can see that preference dominating much of the debate when one looks at current Administration and Congressional efforts to change trade policy and domestic policy. For example, many agree that corporate tax reform is an important element in restoring competitiveness for U.S. companies. Similarly, the U.S. has identified discrimination flowing from differential treatment of direct and indirect taxes in the GATT, and now WTO, for more than fifty years as harmful to U.S. interests. Yet, import interests have mobilized in the current early debate on tax reform to maintain the status quo, vehemently opposing any change to the existing U.S. tax system that would add a form of indirect tax even though, for the Republican House leadership, the additional revenue is a key element supporting broader tax reform. The import community is supported by many members of Congress concerned with harm to consumers even though other countries address such concerns through having indirect taxes not apply to various essential products.**[1]** Similarly, companies that have altered the location of investments over the last quarter century to take advantage of the existing system don't want changes to U.S. trade or tax policy that could require a reexamination of past investment decisions or could result in changes to future ones, and that could have the effect of making the U.S. a more attractive investment/production location. The risk for the United States as we approach the start of negotiations with our NAFTA partners is that the pressure for maintaining the status quo both in trade and domestic policies will result in the U.S. achieving a less-than-desired result with two very important trading partners.

One industrial sector that embodies both promise and risk is motor vehicles and parts. The promise is what a comprehensive review could deliver in NAFTA talks and, more broadly, in dealings with other trading partners, and the risk is from interests fighting for the status quo. If one looks at our trade in products covered under Chapter 87 of the Harmonized Tariff Schedule (which covers various types of motor vehicles and parts thereof, though not all parts), one sees dramatic growth in trade among the three countries during the time NAFTA has been on the books. For the U.S., exports to Canada and Mexico in 1993 (the year before the NAFTA) were $21.1 billion and $4.7 billion, respectively. U.S. exports grew to $48.1 billion and $21.4 billion by 2016. At the same time, U.S. imports from Canada and Mexico, which had been $33.1 billion and $6.1 billion in 1993, had grown to $57.9 billion and $74.8 billion, respectively, in 2016. So growth on a value basis occurred for all countries, although the largest growth occurred in terms of Mexican exports to the U.S. The U.S. trade deficit on Chapter 87 goods declined from $12.0 billion with Canada in 1993 to $9.8 billion in 2016 while the deficit with Mexico went from $1.4 billion in 1993 to $53.4 billion in 2016. Because motor vehicles within Chapter 87 are major consumers of steel, aluminum, electronics, textile products, and rubber products (to name just a few), getting the trade policy and domestic policy tools right for trade in motor vehicles and parts is critical to a host of other manufacturing sectors in the United States and elsewhere. Whether the growing deficit with Mexico and the continuing significant deficit with Canada in Chapter 87 products is problematic or not depends on the drivers of the growth, barriers that exist, policies that don't favor equitable investment, and manufacturing in the U.S. Such an analysis is likely very complex. However, a quick test of whether the change in trade balance experienced by the U.S. in Chapter 87 trade is problematic is a comparison of the U.S. experience with the experience of other major developed trading partners. Have all such major developed countries experienced similar trends, or is the development in the U.S. trade balance peculiar to the United States? If the latter, there is at least a need to carefully review the relationships, trade policy issues that may result in distortions, and domestic policies that may lead to economic outcomes inconsistent with global norms.

There are, of course, important reasons for market integration and utilization of lower-cost labor in Mexico for certain parts of motor vehicle manufacture. In a recent event hosted by the Global Business Dialogue looking at the NAFTA negotiations, one of the panels focused on auto trade within NAFTA. In excerpts of the panel discussion posted by GBD, comments by Charles Uthus, Vice President for Policy, American Automotive Policy Council (members include GM, Ford and the U.S. interests of Fiat Chrysler), make the case for why market integration has been beneficial for U.S. motor vehicle producers: "Around the world, there are three major automotive producing centers, in Asia, Europe, and North America. Each of those has, as part of that grouping, some low-cost and [some] high-end, [some] labor intensive and [some] technology intensive countries that are part of that mix. And Mexico serves a really incredibly important role, providing labor intensive imports into the automotive industry." TTALK Quotes, June 2, 2017, The Car Markets of Canada and Mexico (published by the Global Business Dialogue), **http://gbdinc.org/the-ttalk-quotes/**.

While there is obviously truth in the statement made, the factual reality of what has happened to three major developed-country motor vehicle-producing states suggests that there are factors at play besides a division of labor between high- and low-cost labor environments. Consider the following table taken from UN Comtrade data for Germany, Japan and the United States that looks at five years (1994, 2000, 2005, 2010, and 2016) and the overall trade balance the countries have with the world and then with selected geographic areas. Only the United States shows a worsening trade balance with the world and with its own economic integration area. The same trend is not true for Germany vis-à-vis trade with Europe or for Japan vis-à-vis trade with Asia. Indeed, the U.S. has a worsening trade balance with the world, with North America, with Europe, and with Asia. Germany has an improving trade balance with all of those; Japan has an improving trade balance with the world, with Asia, and with North America, and a relatively flat trade surplus with Europe.

Trade by Germany, Japan, and the United States under Chapter 87 - Vehicles other than railway or tramway rolling stock

	Germany					Japan					USA				
Partner Region	**1994**	**2000**	**2005**	**2010**	**2016**	**1994**	**2000**	**2005**	**2010**	**2016**	**1994**	**2000**	**2005**	**2010**	**2016**
World															
Exp. $Mln	$ 62,030	$ 90,423	$ 170,403	$ 203,158	$ 244,400	$ 81,090	$ 89,349	$ 125,126	$ 146,752	$ 141,799	$ 49,209	$ 61,928	$ 83,161	$ 99,149	$ 124,256
Imp. $mln	$ 29,961	$ 39,275	$ 68,305	$ 79,294	$ 111,293	$ 9,177	$ 10,352	$ 13,866	$ 14,541	$ 20,894	$ 99,163	$ 166,711	$ 203,248	$ 185,982	$ 285,008
Export - Import	$ 32,069	$ 51,147	$ 102,098	$ 123,864	$ 133,106	$ 71,914	$ 78,997	$ 111,260	$ 132,211	$ 120,905	$ (49,954)	$ (104,783)	$ (120,087)	$ (86,833)	$ (160,752)
Europe															
Exp. $Mln	$ 42,311	$ 61,562	$ 117,619	$ 124,191	$ 148,345	$ 15,146	$ 17,071	$ 23,482	$ 20,874	$ 19,519	$ 5,514	$ 6,986	$ 11,608	$ 11,379	$ 17,286
Imp. $mln	$ 22,814	$ 30,986	$ 54,716	$ 64,099	$ 88,558	$ 5,649	$ 6,269	$ 7,889	$ 6,982	$ 10,329	$ 13,647	$ 28,838	$ 42,582	$ 33,026	$ 56,510
Export - Import	$ 19,496	$ 30,576	$ 62,902	$ 60,092	$ 59,788	$ 9,496	$ 10,802	$ 15,593	$ 13,892	$ 9,190	$ (8,133)	$ (21,852)	$ (30,974)	$ (21,646)	$ (39,224)
North America															
Exp. $Mln	$ 8,211	$ 16,721	$ 28,224	$ 26,751	$ 36,097	$ 38,487	$ 47,020	$ 56,892	$ 50,437	$ 58,089	$ 30,606	$ 45,191	$ 53,999	$ 56,828	$ 69,538
Imp. $mln	$ 1,483	$ 2,429	$ 4,859	$ 7,007	$ 10,339	$ 2,826	$ 2,370	$ 1,835	$ 1,326	$ 2,082	$ 45,811	$ 82,718	$ 89,053	$ 86,794	$ 133,496
Export - Import	$ 6,728	$ 14,291	$ 23,365	$ 19,744	$ 25,758	$ 35,661	$ 44,650	$ 55,057	$ 49,110	$ 56,007	$ (15,205)	$ (37,527)	$ (35,054)	$ (29,966)	$ (63,958)
Asia & Pacific															
Exp. $Mln	$ 7,582	$ 6,745	$ 11,711	$ 31,777	$ 42,681	$ 18,294	$ 15,046	$ 24,920	$ 43,991	$ 38,582	$ 6,734	$ 5,209	$ 6,351	$ 12,050	$ 20,451
Imp. $mln	$ 5,379	$ 5,275	$ 7,762	$ 5,913	$ 9,521	$ 691	$ 1,582	$ 3,110	$ 5,792	$ 7,933	$ 39,145	$ 54,041	$ 69,470	$ 63,386	$ 92,205
Export - Import	$ 2,203	$ 1,470	$ 3,949	$ 25,863	$ 33,160	$ 17,604	$ 13,464	$ 21,810	$ 38,199	$ 30,649	$ (32,411)	$ (48,831)	$ (63,119)	$ (51,336)	$ (71,753)
Middle East															
Exp. $Mln	$ 1,522	$ 2,095	$ 4,463	$ 4,974	$ 4,832	$ 3,785	$ 4,484	$ 8,516	$ 14,448	$ 14,528	$ 2,850	$ 1,604	$ 5,495	$ 8,784	$ 9,312
Imp. $mln	$ 7	$ 12	$ 18	$ 27	$ 40	$ 0	$ 1	$ 1	$ 4	$ 2	$ 14	$ 28	$ 76	$ 495	$ 98
Export - Import	$ 1,516	$ 2,083	$ 4,445	$ 4,947	$ 4,792	$ 3,785	$ 4,483	$ 8,516	$ 14,444	$ 14,526	$ 2,836	$ 1,575	$ 5,419	$ 8,290	$ 9,214
South/Latin America															
Exp. $Mln	$ 630	$ 783	$ 1,414	$ 3,526	$ 2,642	$ 3,355	$ 3,776	$ 4,237	$ 6,462	$ 4,394	$ 2,612	$ 2,271	$ 3,267	$ 5,902	$ 4,858
Imp. $mln	$ 92	$ 99	$ 658	$ 915	$ 355	$ 4	$ 3	$ 20	$ 8	$ 15	$ 485	$ 921	$ 1,748	$ 615	$ 1,061
Export - Import	$ 538	$ 685	$ 756	$ 2,610	$ 2,288	$ 3,351	$ 3,773	$ 4,218	$ 6,453	$ 4,379	$ 2,127	$ 1,350	$ 1,519	$ 5,287	$ 3,797
Africa															
Exp. $Mln	$ 798	$ 1,417	$ 3,817	$ 5,442	$ 5,484	$ 1,894	$ 1,718	$ 3,476	$ 4,663	$ 3,096	$ 700	$ 577	$ 1,648	$ 3,333	$ 1,872
Imp. $mln	$ 50	$ 453	$ 247	$ 1,278	$ 2,345	$ 6	$ 124	$ 1,011	$ 428	$ 533	$ 28	$ 161	$ 312	$ 1,662	$ 1,627
Export - Import	$ 748	$ 964	$ 3,571	$ 4,165	$ 3,139	$ 1,888	$ 1,594	$ 2,466	$ 4,235	$ 2,562	$ 672	$ 417	$ 1,336	$ 1,670	$ 244
CIS															
Exp. $Mln	$ 960	$ 1,042	$ 3,115	$ 6,497	$ 4,317	$ 109	$ 201	$ 3,554	$ 5,855	$ 3,575	$ 192	$ 90	$ 793	$ 871	$ 938
Imp. $mln	$ 135	$ 22	$ 43	$ 47	$ 136	$ 0	$ 2	$ 0	$ 1	$ 1	$ 32	$ 4	$ 7	$ 4	$ 11
Export - Import	$ 825	$ 1,020	$ 3,072	$ 6,449	$ 4,181	$ 109	$ 199	$ 3,553	$ 5,854	$ 3,574	$ 159	$ 85	$ 786	$ 867	$ 928
Unknown															
Exp. $Mln	$ 15	$ 58	$ 40	$ 1	$ 1	$ 21	$ 32	$ 47	$ 23	$ 17	$ 1		$ 0	$ 0	
Imp. $mln	$ 0	$ 0	$ 1	$ 7			$ 0								
Export - Import	$ 15	$ 57	$ 39	$ (6)	$ 1	$ 21	$ 32	$ 47	$ 23	$ 17	$ 1	$ -	$ 0	$ 0	$ -

Source: UN Comtrade, DESA/UNSD

As all three countries' motor vehicle industries and part suppliers have expanded supply chains and moved some manufacturing to lower-cost countries, the starkly different outcomes experienced by the U.S. vs. either Germany or Japan suggests that there are other causes that have resulted in such dramatically different outcomes.

Certainly one of the known differences is in taxation. While in the U.S., individual states may have sales taxes that are assessed, Mexico and Canada have an indirect tax system (VAT, GST) at the central government level and, in Canada, at the provincial level. Mexico's VAT is 16%; Canada's combination rate varies by province but, for Ontario and Quebec, the joint rate is 13% - 14.975%. The same distinction exists with respect to Germany and Japan (2017 VAT rates of 19% for Germany and 10% for Japan). While a way of neutralizing the disadvantage globally would be to adopt the House Republican leadership's idea of a Border Adjustment tax (or adoption of a straight value-added tax), the issue could also be addressed by negotiating a change in how indirect taxes are treated by all members of NAFTA. If the latter approach is pursued and adopted, it could then be used in other bilateral or plurilateral negotiations by the Administration. Specifically, rebates on export could be prohibited or limited to the indirect tax at the central and state level that is assessed on importation and the assessment of indirect tax on importation could be limited to the level of rebate.

Other issues that may account for the difference in outcomes could be corporate tax rates, regulatory hurdles, gasoline tax rates and whether such rates encourage purchasing behavior likely to lead to vehicle production that has appeal internationally, past agreements which may have skewed the structure of industry (*e.g.*, the United States-Canada Automotive Products Agreement of 1965, terminated in 2001), cultural issues, and other matters.

For example, the United States – Canada Automotive Products Agreement which took effect on January 1, 1965 had as its objective to ensure a percentage of trade in autos and parts accrued to Canada's benefit:

Canada-US Automotive Products Agreement

Canada-US Automotive Products Agreement (Autopact), a conditional free-trade agreement signed by Canada and the US in January 1965 to create a single North American market for passenger cars, trucks, buses, tires and automotive parts. In Canada Free Trade does not apply to consumer sales; it applies solely to manufacturers who meet certain conditions. Under the agreement, motor-vehicle manufacturers are obliged to maintain the same ratio of production to sales in Canada as existed in the 1964 model year; to maintain Canadian value-added or Canadian content equal to the 1964 model year; and have been required (from 1965 onwards) to increase Canadian value-added by 60% of the growth in the value of passenger cars sold (50% for trucks and 40% for buses).

Between 1965 and 1982 Canada had an overall automotive trade deficit of $12.1 billion with the US, with a surplus of about $28 billion in assembled vehicles and a deficit of about $40.5 billion in automotive parts. Canada had overall surpluses in 1970, 1971, 1972 and 1982. Since 1982 Canada has had a continuing surplus with the US. In 1982-86 exports were $135.5 billion and imports were $112.9 billion, for a 5-year surplus of $22.5 billion.

The 2 principal purposes of the Autopact were to lower Canadian production costs through more efficient production of fewer lines of motor vehicles and parts, and to lower consumer prices. However, critics note that the industry has remained essentially foreign controlled and that Canadian subsidiaries are less autonomous than they once were. In addition, they note that the industry spends little on research and development in Canada. Automotive industry employment totalled 70 600 in 1965, reached about 125 000 in 1978 before falling to about 99 000 in 1982. Since then employment has recovered to about 140 000.

Under the Free Trade agreement negotiated with the US in 1987, Canadian safeguards would remain, with North American auto producers losing their right to import parts and vehicles duty-free from other countries unless the safeguards were met. Japanese and other offshore automakers would not be able to join the Autopact. The Canada-US pact can be terminated at any time by 12 months written notice by either government.

Historica Canada, article by David Crane, published 2/6/2006, last updated 6/19/2015,**http://www.thecanadianencyclopedia.ca/en/article/canada-us-automotive-products-agreement/**.

Japan filed a request for consultations in 1998 and then a panel request at the WTO challenging the limitations of the Auto Pact. The panel report, Appellate Body report and arbitration report were each issued in 2000 (*e.g.*, WT/DS/139/AB/R, 31 May 2000). The panel and AB determined that the Auto Pact violated WTO commitments by failing to provide MFN and national treatment. Canada reported compliance with the AB report as of February 18, 2001.

Other challenges have faced the U.S. in Japan and the European Union and need to be addressed with Japan and the EU going forward. But there will likely be a number of common issues affecting trade in motor vehicles and parts that have resulted in less robust outcomes for U.S. producers and their workers.

The Trump Administration is to be congratulated on making the question of trade deficits an issue of inquiry. The NAFTA negotiations are the likely first place for a comprehensive review of the challenges to truly reciprocal trade with two of our most important trading partners. Let's hope that the Administration and the Congress will focus on the broader issues to ensure an outcome that is both good for all parties and that addresses challenges that remain (whether in trade policy or in national domestic policies).

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[1] By contrast, some American manufacturers are working to nurture U.S. manufacturing and understand the importance of leveling the playing field by instituting a border adjustment tax. Companies like General Electric, Boeing, Dow Chemical, Cummins Allison, and many others formed an American Made Coalition to support the House Republican border tax proposal.