

PIIE Briefing

# 17-2 A Path Forward for NAFTA

C. Fred Bergsten and Monica de Bolle, editors

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## CHAPTER 1

# Overview

### C. Fred Bergsten and Monica de Bolle

The North American Free Trade Agreement (NAFTA) ranks at the top of anyone’s list of the most controversial trade deals of all time. Reviled by critics as unfair and as a job destroyer, praised by its defenders as having a documented record of success in spurring economic growth, NAFTA reduced tariff barriers to zero for the United States, Mexico, and Canada and led to a tripling of trade among these three countries over the last 23 years (figure 1). The Peterson Institute for International Economics (PIIE) has abundantly detailed the many gains and acknowledged costs of NAFTA in numerous publications (see, e.g., Hufbauer and Schott 2005; Hufbauer, Cimino-Isaacs, and Moran 2014). Now that President Donald Trump has launched a renegotiation of NAFTA—having at least for the moment abandoned his 2016 campaign pledge to cancel the pact outright after tentatively deciding to do so on April 22—the fundamental question is: Can such a renegotiation produce a positive result?

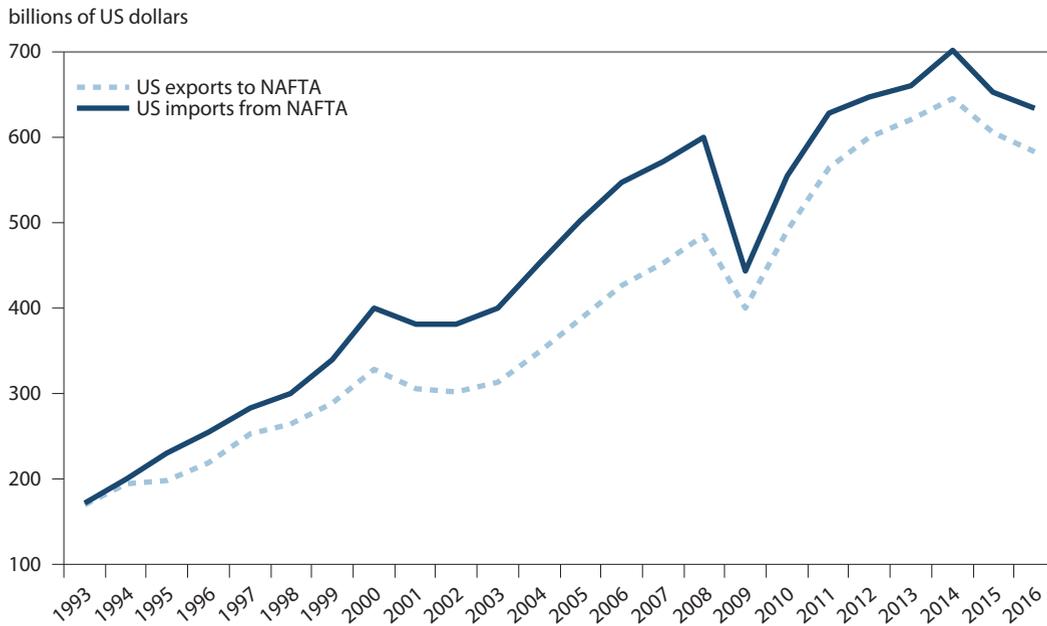
A broad range of experts who have contributed to this PIIE Briefing say “yes.” The new negotiations can succeed only if they focus on how the agreement can be updated and upgraded, however. The overarching goal of negotiators from the three participating countries must be to boost the competitiveness of North America as a whole, liberalizing and reforming commercial relations between the three partner countries and responding to the many changes in the world economy since NAFTA went into effect in 1994. These changes include the digital transformation of commerce, which has enabled sophisticated new production methods employing elaborate supply chains, transforming North America into a trilateral manufacturing and services hub. But concerns about labor, the environment, climate change and energy resources, and currency issues have become more acute than they were at the time NAFTA started. Commerce Secretary Wilbur Ross was thus correct when he said that NAFTA “didn’t really address our economy or theirs [Mexico and Canada] in the way they are today.”<sup>1</sup>

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1. “Commerce Secretary Wilbur Ross talks trade,” *Wall Street Journal*, June 18, 2017, [www.wsj.com/articles/commerce-secretary-wilbur-ross-talks-trade-1497838380](http://www.wsj.com/articles/commerce-secretary-wilbur-ross-talks-trade-1497838380).

**Figure 1 US-NAFTA goods and services trade, 1993–2016**



Note: Pre-1999 services data based on data using BEA methodology, which has since been revised.

Sources: UN Comtrade via World Bank's World Integrated Trade Solutions (WITS) database for goods data; US Bureau of Economic Analysis for services data.

Ultimately, however, NAFTA can be modernized only if President Trump's zero-sum "America First" agenda is replaced by one that seeks to benefit all three countries and improve their competitiveness in an increasingly competitive global economy. Prioritizing American interests is of course essential in any US trade negotiation. But an obsessive concern about bilateral trade balances and narrow special interests in the United States, as opposed to broader national and regional interests, would not only deadlock the negotiations but also likely lead to inferior outcomes for all three countries, or even a breakdown in the talks and an abrogation of the agreement. And walking away from NAFTA altogether would be disastrous for consumers, producers, and retailers in the United States. As argued in several chapters of this Briefing, abandoning NAFTA would degrade regional competitiveness and terminate jobs across North America, undoing the integration achieved since the agreement's inception.

## WHY NAFTA MUST BE RETAINED

President Trump in fact tentatively decided to withdraw the United States from NAFTA on April 22.<sup>2</sup> He subsequently relented, in response to protests from both the leaders of Canada and Mexico and a number of his own top officials and US business leaders, in favor of his earlier call for renegotiation "to get a better deal for the United States" but reiterated (including to the foreign leaders) that he would terminate if he is "unable to make a fair deal for the United States."<sup>3</sup> If that renegotiation fails to satisfy the US adminis-

2. Ashley Parker, Philip Rucker, Damian Paletta and Karen DeYoung, "I was all set to terminate": Inside Trump's sudden shift on NAFTA," *Washington Post*, April 27, 2017.

3. Robbie Gramer, "Trump Pulls Back from the Brink of NAFTA Withdrawal—For Now," *Foreign Policy*, April 27, 2017.

tration and Congress (where many Democrats are also hostile toward NAFTA) as well as the two partner governments,<sup>4</sup> a breakup of the world's largest economic compact is a real possibility, in the same way that Trump withdrew the United States from the Trans-Pacific Partnership (TPP) after seven years of negotiation on his third day in office.

Such a breakup would significantly damage the economies, competitiveness, and consumers of all three countries. The costs would stem importantly from disruption of the supply chains that have come to dominate their trade flows and play important roles in their overall economies. As developed in [chapter 2](#), the United States would face tariffs at least twice as high, and perhaps ten times as high, as those it could impose on Mexico, disrupting numerous sectors in the economy (notably including agriculture). It would confront discrimination by Mexico in favor of the 43 countries (including Canada, the European Union, and Japan) with which Mexico would continue to have preferential trade agreements, a list that will increase if Canada and Mexico along with the other members succeed in implementing the TPP without the United States. It would lose sales to a weakened Mexican economy with a substantially weaker peso. The US bilateral trade deficit with Mexico would undoubtedly increase, perhaps sharply—an outcome opposite to that sought by Trump.

There is thus substantial risk of a lose-lose outcome. There is little point in attempting to assess who would lose most in a scenario where all three countries would experience negative effects. Any negotiation that turns confrontational can of course invite such a collapse. UK Prime Minister Theresa May has, for example, argued in the negotiations over Britain's withdrawal from the European Union that “no agreement is better than a bad agreement.” In this case, however, “a bad agreement” could well mean no agreement at all. The NAFTA governments would be courting disaster if the renegotiation descends to such a level.

## **ACHIEVING SHARED GOALS IN RENEGOTIATION**

Renegotiating NAFTA is not a new idea. President Barack Obama proposed it during his campaign for the presidency in 2008, and the NAFTA participants in the ill-fated TPP discussions—which included the United States, Mexico, Canada and nine other countries in the Asia-Pacific rim—sought in part to update NAFTA. The TPP embodied a readiness by the United States, along with Canada and Mexico, to update NAFTA to the mutual benefit of all participants.

A popular fallacy about trade in general, and the negotiations over revising NAFTA in particular, is that trade and trade agreements are a zero-sum game and that whatever benefits one country in a trade deal necessarily hurts its trading partner in that deal. This PIIE Briefing therefore starts with an effort to enumerate and elucidate goals that are compatible and thus might provide the basis for a successful outcome.

The broadest consistent goal shared by the NAFTA countries should be to strengthen the international position of North America as a whole in a world of tough competition from China and others. Beyond that objective, the negotiators can take steps toward achieving regional energy independence, since all three countries are large consumers and producers of different kinds of energy, from those based on fossil fuels to those derived from new technologies and renewable sources. There is also plenty of room for additional or indeed full liberalization of key sectors, such as financial services and telecommunications, to the benefit of all three economies.

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4. A US withdrawal from NAFTA would leave most of the original US-Canada bilateral FTA and the Canadian-Mexico component of NAFTA in place, meaning that the chief impact would be the end of free trade between the United States and Mexico, unless the United States decided to withdraw from its bilateral agreement with Canada too.

The new NAFTA could borrow some of the TPP's innovative approaches and embrace cutting-edge standards for issues such as e-commerce, state-owned enterprises (SOEs), and other sectors that have become central to international trade and investment. The North American partners might be able to help resolve a politically inflammatory issue plaguing trade agreements worldwide: incorporating dispute settlement mechanisms that will make their provisions enforceable and thus credible without being perceived as undermining national sovereignty and widely shared concepts of fairness.

Another step in this direction would be to work out a North American competition policy that would enable the three countries to disavow the use of antidumping and countervailing duties against each other, as Australia and New Zealand have done. The NAFTA partners might also strive to achieve a degree of regulatory coherence that has so far eluded the United States and the European Union in their efforts to forge a transatlantic agreement. NAFTA negotiators could permit like-minded countries, notably the members of the Pacific Alliance (Chile, Colombia, and Peru, as well as Mexico), all of which are already free trade agreement partners of the United States, to join NAFTA. They could contemplate converting their free trade area into a customs union, by adopting a common external tariff and channeling their discussion on currency issues toward a North American monetary union.

One misguided approach certain to lead to sharp clashes among the three countries must be rejected at the outset, however. The potential for a breakdown in talks derives chiefly from the frequently expressed desire of President Trump and some of his associates to use the NAFTA renegotiation to reduce the bilateral US trade deficit with Mexico (and perhaps even its bilateral goods deficit with Canada despite the overall balance between the two countries). Largely because of these imbalances, Trump has repeatedly called NAFTA “the worst trade agreement ever negotiated.” He seeks to eliminate “unfair” trade practices from the agreement, sometimes seeming to equate the US bilateral deficit with Mexico with “unfairness,” and his attacks have called for converting it into a “NAFFTA,” where the second “F” stands for “fair.”

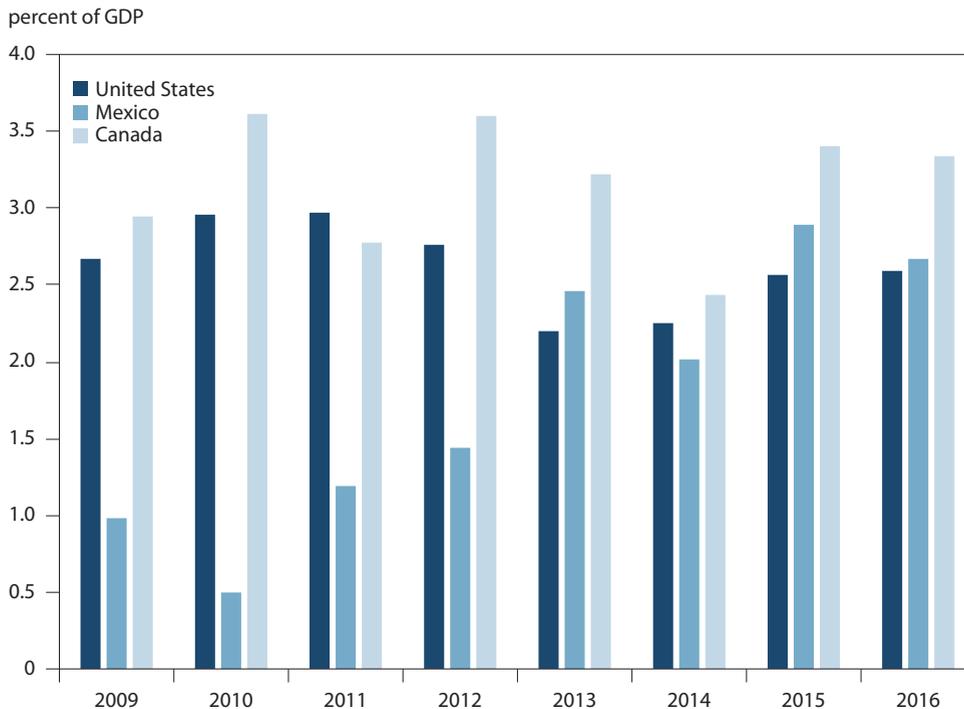
The problem, as described in [chapter 2](#), is that trade agreements are inappropriate and ineffective vehicles for attempting to reduce trade imbalances. The reason is that external imbalances are created by internal macroeconomic imbalances and can be remedied only by changes in the latter. Hence continued US insistence on cutting its trade deficit, especially via bilateral efforts with Mexico, would almost surely lead to dissatisfaction with the outcome and a potential blowup of the entire agreement.

Taking the concern about trade deficits at face value, moreover, is a prescription for deadlock with Canada and Mexico, both of which run global trade and current account deficits on the same order of magnitude as the United States ([figure 2](#)). Hence they properly view themselves as deficit countries that need to strengthen, not weaken, their external economic positions. They are most unlikely to accede to US demands to strengthen its external position at their expense, even if the economics were to make that possible, and can in fact be expected to argue (correctly) that the three North American deficit countries should work together to improve their joint and several external positions with the rest of the world.

The improbability of fulfilling this apparently key US negotiating goal derives from politics as well as economics. A cardinal principle of international trade arrangements is reciprocity. No government can go to its Congress or public for approval of an accord that seems to “give away more than it gets in return”—especially if its partner country were loudly trumpeting its gains at the same time. Such considerations will apply with particular force in Mexico as a presidential election looms in July 2018 amid increasing resentment of the rhetoric against immigration and “unfair” trade deals emanating from Washington.

Despite Mexico's tense political atmosphere, its negotiators may have room to offer cosmetic or face-saving steps to ease the way toward a deal. Mexico has adopted internal reforms in the energy, financial services, and telecommunication sectors, for example. These steps could enable it to make “concessions” to the United States without significant domestic political cost. Its nontariff barriers, on average, remain about

**Figure 2 Global current account deficits in NAFTA countries, 2009–16**



Source: International Monetary Fund, *World Economic Outlook*.

three times higher than those of the United States so it might be able to liberalize asymmetrically on the principle that “reciprocity” can mean establishing equal *levels* of restrictions (rather than similar *cuts* in those restrictions), as argued in [chapter 2](#).

For its part, Canada might open its supply management sectors (especially dairy) a bit further, as it agreed to do in its new agreement with the European Union (Canada-EU Comprehensive Economic and Trade Agreement [CETA]) and offered in the TPP, and it might enable US firms to compete for some provincial procurement as it has done for the Europeans. An increase in NAFTA’s rules of origin, which place restrictions on the level of components from outside the region before countries qualify for tariff-free access for their exports, could return production of components to the United States, although, as described in [chapter 9](#), tightening the rules of origin would likely increase consumer prices in the United States while hurting firms across various sectors.

Pragmatic negotiations might be able to resolve these seemingly intractable positions and thus clear the decks to move to the more positive agenda. Otherwise, to avoid jeopardizing the entire agreement, Mexico would probably have to adopt extensive managed trade techniques. These techniques include “voluntary” export restraints, as Mexico recently agreed on its sugar exports to the United States, and the “voluntary” import expansions and market share agreements that the Trump administration has already signaled it might ask Mexico to undertake.<sup>5</sup> These might cut Mexico’s bilateral surplus with the United States but,

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5. Secretary Ross has argued that “Mexico could divert to US sources products they’re already buying abroad but from a country other than the United States so they could just as well give us a better market share than we have now” (“Business Groups on NAFTA: TPA Must Be Followed,” *Inside US Trade*, June 2, 2017). Such

importantly, they would do so without having much, if any, impact on the US global deficit or overall economy. The United States of course might take unilateral steps to achieve its goals; the Trump administration has already initiated actions under an expanded interpretation of existing laws (invoking national security, for instance) that could restrict an estimated \$20 billion of imports from Canada and \$6 billion from Mexico (Bown 2017).

The most reliable way to expand US exports to Mexico, and to reduce the imbalance between the two countries, is to strengthen the Mexican economy. Faster growth and more rapid development in Mexico will increase its total imports, including from the United States. The exchange rate of the peso would likely strengthen, further improving US competitiveness. A stronger NAFTA with freer trade and more effective rules would support such improved outcomes for the Mexican economy and should be the major goal of the United States (as well as its partners) for the NAFTA renegotiation.

Canada and Mexico will of course have a series of negotiating objectives as well. Some of these will be defensive in nature, consisting of opposition to US demands, sectoral as well as aggregate. A few will be offensive, as outlined in [chapters 3, 4, and 5](#), e.g., reducing US “Buy American” preferences at both the federal and subfederal levels. One issue could be potentially explosive: If the United States continues to reject the Paris Agreement on climate change and fails to adopt any type of carbon tax, Canada and Mexico could apply border adjustments (i.e., taxes) against US products that contribute to global warming or cause pollution. Just as the United States demanded that Mexico adhere to certain environmental standards in the original NAFTA side agreement, Mexico might require the United States to avoid “pollution dumping” on certain exports. Both Canada and Mexico have been largely satisfied with the existing NAFTA, however, and their major goal in the renegotiation is to avoid its demise by persuading the United States of the virtues of the agreement or preserving it through modest concessions that will not roil their own politics.

The relevant debate in 2017 (and perhaps beyond, since any serious renegotiation will almost certainly take a year or more) is not whether NAFTA has been a success over its past quarter century. The issue is how best to avoid a damaging breakup and reach an agreement that would carry net benefits for all three participants. This PIIE Briefing is organized around a series of possible approaches to strengthen North America as a whole in an increasingly competitive world economy. Each chapter describes how that objective might be accomplished.

## **A Positive NAFTA Renegotiation**

[Chapters 2 to 5](#) discuss in some detail what should and should not be the NAFTA negotiating agenda for each of the three partners. While potential pitfalls in the negotiations are highlighted, the focus of each of these chapters is on what the United States, Mexico, and Canada should ask of each other in order to enhance North American competitiveness by improving the existing agreement.

[Chapter 6](#) outlines the reasons that NAFTA needs to be updated. It notes that NAFTA was state of the art when it was negotiated in the early 1990s but many important issues were omitted, including liberalization of a range of specific goods and services. Trade agreements since NAFTA came into effect have revised and improved the original NAFTA template in a changing global environment. But US negotiators never went back to renegotiate NAFTA out of fear that failure would cause their hard-won gains to unravel.

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blatant trade diversion would of course violate all precepts of trade policy, although Mexico has indirectly encouraged such thinking by suggesting that it could divert some of its agricultural purchases away from the United States in retaliation against any new US protectionism.

The TPP involved a first attempt to update NAFTA after Canada and Mexico joined the talks mid-stream. The attempt suffered a serious setback when President Trump decided to pull the United States out of TPP soon after his inauguration. Nonetheless, TPP remains an important template for modernizing NAFTA, as recognized by experts and US authorities alike, although not always in the same manner. Several chapters in this Briefing support using TPP as a template for introducing e-commerce and digital trade regulations and obligations into NAFTA, as well as stricter agreements on labor and environmental standards. Secretary Ross has also (however ironically in light of President Trump's criticisms) highlighted that provisions worked out under TPP could serve as a basis for the NAFTA renegotiation.<sup>6</sup>

Secretary Ross has also spoken constructively about modernizing the agreement to broaden its scope over services trade, particularly financial services, digital services, and natural resources.<sup>7</sup> He focused his comments on TPP specifically on concessions Canada made under the agreement to compensate dairy farmers in other member countries, and on Mexico's agreement on labor reforms that would strengthen collective bargaining, helping to raise Mexican manufacturing wages, an issue that has long been a focus of NAFTA. These areas could serve as a foundation for the upcoming talks, although it must be recognized that concessions made by Canada and Mexico in the context of TPP would not necessarily be transferable to NAFTA. As a multiregional trade agreement involving 12 nations, TPP concessions afforded Mexico and Canada the ability to bargain with other member countries over aspects of the deal that would not be directly relevant to negotiating with the United States alone.

## Sector-Specific Issues in a NAFTA Renegotiation, Rules of Origin, and Sustainable Development

As discussed in [chapter 7](#), the energy landscape in North America has changed dramatically over the past two decades. Canada and Mexico are the first and second largest US trading partners in energy products and, currently, the United States is a net exporter of energy products to Mexico and a net importer from Canada.

Three factors explain the dramatic changes in the North American energy sector since NAFTA was introduced: Mexican energy reforms, which have been underway since 2013, amended the country's Constitution to allow private investment in the electricity and oil sectors and ended the monopolies held by two state-owned companies (PEMEX and CFE); US natural gas production from shale; and Canadian oil sands extraction on a large scale. Advanced technology, such as hydraulic fracturing, has made the United States a large natural gas producer and exporter, while Canada's specialized techniques sharply increased its production from the oil sands. The updated NAFTA should build on these changes to promote deeper energy cooperation within North America.

Nonetheless, sensitive sectoral issues intertwined with political dynamics could hinder productive negotiations. [Chapter 7](#) underscores the following potential pitfalls to a positive negotiation on energy matters in NAFTA:

- Rising anti-American sentiment in Mexico that already seems to be resurrecting energy nationalism. Energy nationalism could derail energy reform in Mexico. The issue has already appeared as a major campaign theme in leftist firebrand Andrés Manuel López Obrador's presidential bid for 2018.

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6. "Ross says TPP could form "starting point" for U.S. on revamped NAFTA talks," Bloomberg News, May 3, 2017, [www.bloomberg.com/news/articles/2017-05-03/ross-says-tpp-could-form-starting-point-for-u-s-on-nafta-talks](http://www.bloomberg.com/news/articles/2017-05-03/ross-says-tpp-could-form-starting-point-for-u-s-on-nafta-talks).

7. "Commerce Secretary Wilbur Ross talks trade," *Wall Street Journal*, June 18, 2017, [www.wsj.com/articles/commerce-secretary-wilbur-ross-talks-trade-1497838380](http://www.wsj.com/articles/commerce-secretary-wilbur-ross-talks-trade-1497838380).

- President Trump’s “Buy American” approach to pipeline construction, which would not be accepted by Canada and Mexico.
- Widespread subsidies to renewable energy, which are typically coupled with local content requirements leading to the obstruction of North American commerce both in components and construction.
- The blending of Canadian crude oil with imported diluents, which could fail eligibility tests for duty-free treatment under potentially tighter NAFTA rules of origin.

Despite the range of sensitive issues in the energy sector, NAFTA renegotiations should seek full liberalization in trade and investment in North America. To this end, the US administration should follow the recommendations outlined in this introductory chapter and add “Buy American” restrictions to the negotiations. “Buy American” provisions and local content requirements in renewable energy projects should be curtailed if not eliminated, while rules of origin should not be permitted to be an obstacle to North American integration.

Another key sector in the NAFTA negotiations is agriculture. Indeed, as [chapter 8](#) discusses, agriculture will feature prominently in the talks. Several reasons explain why the sector might be a key driver of the negotiations despite its modest contribution to total intra-NAFTA trade. Notably, agriculture generally tends to be one of the most contentious aspects of trade negotiations due to the importance of trade to the sector and thus its proclivity to organize and lobby for its interests. In the specific case of the United States, such political economy considerations play an even larger role: Disruptions to NAFTA could create major problems for Trump-voting states and states with Republican and split Senate delegations. Indeed, [chapter 8](#) argues that the Trump administration cannot hope for successful ratification of a renegotiated NAFTA without the support of the heavily agricultural states that are highly dependent on intra-NAFTA trade, such as Nebraska, Iowa, Kansas, Missouri, Montana, and the Dakotas. A successful NAFTA renegotiation would incorporate many of the provisions of TPP, including the removal of export subsidies and resolution of several sanitary and phytosanitary standards (SPS) issues.

[Chapter 9](#) discusses in great detail the treatment of rules of origin, a theme that is repeated throughout this Briefing. Indeed, Secretary Ross has prioritized rewriting the chapter on “rules of origin” negotiated in the original NAFTA accord. The ostensible aim of rewriting this chapter, according to the administration, would be to avoid countries like China or Japan or Germany exporting components to Mexico duty free and then having those components exported in products to the United States duty free, circumventing tariffs if such components were exported to the United States directly. The original NAFTA “rules of origin” chapter defines the regional value share and/or transformation that must occur to ensure goods imported into the United States from Canada and Mexico contain components that are produced in these three countries. As already mentioned, in several recent comments, Secretary Ross emphasized that the United States will try to toughen these rules of origin, which govern how much North American content needs to be included in a range of products,<sup>8</sup> notably automobiles.

[Chapter 9](#) concludes that the existing rules of origin need to be streamlined, not made more strict. Tightening rules of origin, as advocated by the Trump trade team, would be costly to consumers and make businesses more inefficient. Indeed, they could induce firms to ignore the NAFTA preferences and thereby

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8. “Commerce’s Wilbur Ross accuses Mexico of taking advantage of NAFTA rules in trade with China,” CNBC April 27, 2017, [www.cnbc.com/2017/04/27/it-appears-canada-and-mexico-are-ready-to-start-renegotiating-nafta-says-commerce-secretary-wilbur-ross.htm](http://www.cnbc.com/2017/04/27/it-appears-canada-and-mexico-are-ready-to-start-renegotiating-nafta-says-commerce-secretary-wilbur-ross.htm); “U.S. seeks to shift trade tides as it starts NAFTA overhaul,” Bloomberg TV, May 18, 2017, [www.bloomberg.com/politics/articles/2017-05-18/u-s-said-to-start-nafta-renegotiation-process-on-thursday](http://www.bloomberg.com/politics/articles/2017-05-18/u-s-said-to-start-nafta-renegotiation-process-on-thursday).

escape the rules of origin by simply paying the (usually low) most-favored-nation tariffs. Rather than becoming tougher on regional content requirements, particularly on stricter obligations related to US content, a positive renegotiation of NAFTA would simplify the rules by creating a single, lower regional value content threshold that could be applied uniformly across products. The Trump administration, which favors cutting regulations and not adding to them, should be interested in streamlining rules of origin requirements and not in making them more complex.

One of the many reasons that made NAFTA a groundbreaking achievement was the fact that, before NAFTA, no trade agreement had ever directly addressed environmental issues. Chapter 10 underscores the concern about NAFTA guiding much of the debate among environmentalists in the early 1990s, who worried that entering into a free trade agreement with a developing country—Mexico—would lead to more polluting factories along the border with the United States and to lower environmental standards. The authors contend that, over the past several decades, a consensus has emerged that trade liberalization cannot ignore other policy priorities, including environmental sustainability. Indeed, chapter 10 argues that without proper internalization of environmental impacts, trade agreements may lead to net negative outcomes. The authors espouse the view that the upcoming NAFTA negotiation should promote, not diminish, environmental goals. Notably, they recommend:

- *Formulating a Sustainable Development Framework:* Sustainability, understood as an integrated commitment to economic, environmental, and social progress, should be seen as a foundational element of any new NAFTA. Sustainability should therefore figure not only in the Preamble of the Agreement but as a touchstone for all of the policy decisions reflected in a reconfigured NAFTA.
- *Including a Sustainability Impact Assessment:* The NAFTA renegotiation should be preceded by such an assessment designed to flag potential trade-environment conflicts and effects that should be addressed in the course of the negotiations.

Finally, chapter 11 addresses a crucial aspect of NAFTA: border security and other broader issues related to security collaboration among the three North American partners. Specifically with regard to Mexico, NAFTA has been crucial in solidifying the country's democracy, thus allowing it to effectively contribute to security matters in North America. Mexico's transformation has also made for a vastly improved economic security situation for the United States. NAFTA created sophisticated and integrated business connections, which led, by necessity, to integrated security operations. All of this is at risk if NAFTA were to collapse.

## “Buy American” and Trade Enforcement Measures

Although this Briefing does not explicitly cover “Buy American” procurement policies or the increasing use of trade enforcement measures by the Trump administration, these issues could hamper the forthcoming negotiation.

In addition to the general problems caused by such protectionist policies (see Hufbauer and Cimino-Isaacs 2017), “Buy American” in the context of NAFTA could mean eliminating or substantially altering the government procurement chapter in the agreement. NAFTA's procurement chapter prohibits its members from favoring domestic companies in government contracting. Although Secretary Ross has not explicitly discussed modifications to the procurement chapter, he has signaled skepticism over the inclusion of provisions in trade agreements that allow foreign firms to bid for government contracts as if they were American companies, thus undermining “Buy American” policies and provisions.<sup>9</sup>

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9. “Ross: NAFTA is job one,” *Politico*, January 18, 2017, [www.politico.com/story/2017/01/wilbur-ross-confirmation-hearing-commerce-department-233756](http://www.politico.com/story/2017/01/wilbur-ross-confirmation-hearing-commerce-department-233756).

President Trump's executive order calling on agencies to "more narrowly construe" the public interest provisions of federal contracting, such as evaluating whether contractors use foreign-sourced materials like steel and other products, also suggests that "Buy American" may find its way into the NAFTA negotiations. Modifying or scrapping the procurement chapter to close the US market to Canadian and Mexican suppliers could backfire, however. The two NAFTA partners could retaliate by adopting rules favoring their own companies in contracting, thus adversely affecting American companies and jobs.<sup>10</sup> Mexico, which is not a member of the Government Procurement Agreement in the World Trade Organization (WTO), has no obligations to the United States on this issue outside NAFTA. If the chief aim of a NAFTA renegotiation is to "do no harm," as both Secretary Ross and US Trade Representative Robert E. Lighthizer have recently emphasized, NAFTA's procurement chapter should remain untouched.

Although US authorities have repeatedly insisted that NAFTA negotiations should strive to first do no harm, a substantial increase in trade enforcement measures under existing US trade laws since Trump took office could affect NAFTA negotiations adversely. Bown (2017) shows that the Trump approach towards trade has entailed aggressive enforcement of an ever-widening set of existing laws that permit unilateral steps to restrict imports, or "stealth protectionism."<sup>11</sup> The growing use of antidumping measures and countervailing duties, as well as other mechanisms allowed by US trade legislation, could take a heavy toll on Mexico and Canada as regards imports of particular products such as steel, aluminum, and softwood lumber. Continuing with ever-stricter trade enforcement by the United States could sour the upcoming NAFTA negotiations and lead Canada and Mexico to be less constructive and more confrontational, which would dim the prospects of a positive outcome. Thus, US authorities should refrain from protectionist actions that affect Canadian and Mexican imports. Issues pertaining to these countries should be left to the NAFTA talks and not be taken up outside of its scope.

A NAFTA renegotiation can succeed only if it is focused on how the agreement can be modernized, without burdening it with misconceptions about trade deficits and protectionist policies or resorting to a managed trade approach to the revamped agreement. The purpose of this PIIE Briefing is to lay out a path to that objective.

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10. Hufbauer and Cimino-Isaacs (2017) argue that government procurement accounts for around 15 percent of global GDP and that the United States excels at supplying items governments buy. As a result, retaliation by its two major trading partners against "Buy American" policies perceived as unfair to their interests could harm American companies.

11. "This administration will not be taken advantage of or cheated through illegal subsidies and market manipulation, and we are acting aggressively against those countries that mock our trade laws. To start, we have brought a new energy to enforcement, working to ensure that all countries play fair and by the agreed-upon rules. We have been executing these trade investigations very rapidly" (Wilbur Ross, "Free and Fair Trade for American Workers and Businesses", White House blog, April 13, 2017).

## CHAPTER 2

# The US Agenda: Trade Balances and the NAFTA Renegotiation

C. Fred Bergsten

The Trump administration has indicated repeatedly that the primary goal of its aggressive trade policy will be to reduce the large bilateral US trade deficits with several key countries. It reiterated that objective in its original draft approach to the renegotiation of the North American Free Trade Agreement (NAFTA), but not in its formal notification to Congress on May 18. The administration has not indicated how it intends to pursue the objective but would presumably seek to use the renegotiation primarily to reduce the bilateral deficit with Mexico, which totaled \$63 billion in 2016 (far less than with China but about the same as with Japan and Germany), as trade with Canada is close to balance.<sup>1</sup>

Several unique features surround the NAFTA renegotiation when seen from Trump's perspective. Canada and Mexico, despite the latter's bilateral surplus with the United States, both run large global current account deficits. The deficits of both countries have in fact been larger than that of the United States in three of the last four years (figure 1). They thus differ sharply from the three other trading partners about which the administration has expressed major concerns—China, Germany, and Japan—all of which run large global (as well as bilateral) surpluses and have no trade agreements with the United States. The administration appears to perceive Mexico and perhaps Canada as surplus countries whereas they (more accurately) see themselves as deficit countries, whose policies should seek to strengthen rather than weaken their external balances. The administration is starting with the wrong countries if it wants to pursue its goal of reducing the US trade deficit via trade agreements.

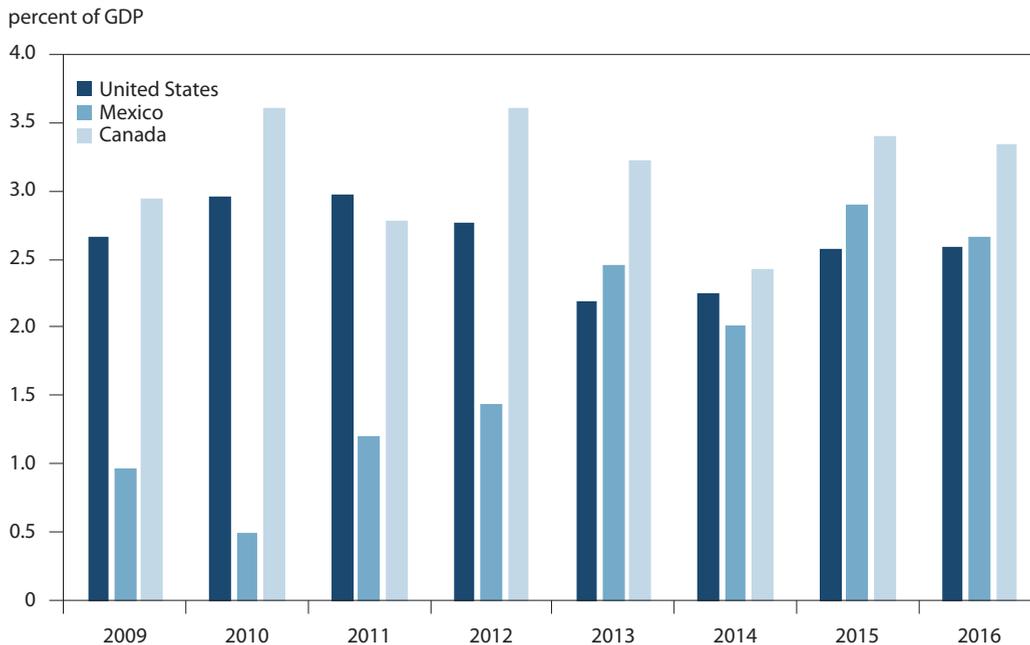
Mexico is in fact a prototypical example of the triangular trade that is characteristic of the world economy. (Canada is, too, to a lesser extent.) Most countries run a mix of surpluses and deficits with their major trading partners, based on their comparative advantage in production with respect to each. Even China, with its large

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1. In 2014, the more valid value-added measure of the bilateral US deficit with Mexico was about one-third lower than the traditional measure of the deficit (Bown and Johnson 2017).

**Figure 1 Global current account deficits in NAFTA countries, 2009–16**



Source: International Monetary Fund, *World Economic Outlook*.

global surpluses, runs deficits with a large number of countries that produce primary products (Saudi Arabia for oil, Australia for iron ore, etc.) and that supply inputs (such as Korea) for the finished manufactured goods that China sells to Europe and the United States. These patterns are an inherent feature of international trade and should be regarded as highly desirable as well as normal.

Triangular trade is particularly common in the context of global supply chains. Firms producing finished goods in higher-income countries typically import intermediate inputs from supplier firms in low-cost countries. German auto companies, for example, buy components from suppliers in the Czech Republic, Slovakia, and Hungary. Germany, with the world's largest global trade surplus, runs a bilateral deficit with the Czech Republic about equal (as a share of their total trade) to the US deficit with Mexico (Amiti, Freund, and Bodine-Smith 2017).

The administration has not publicly recognized these key considerations, however, so may still pursue its bilateral trade balance goals in the forthcoming talks. But the strategy of the administration toward trade agreements in general, and toward NAFTA in particular, is fundamentally misplaced for two reasons: (1) its apparent desire to use trade policy rather than macroeconomic policy including exchange rate policy to reduce trade imbalances and (2) its focus on the bilateral rather than global scope of those imbalances. This chapter outlines the dangerous and self-defeating implications for the negotiation of such an unusual approach. Accordingly, provisions that could be included in the agreement to pursue that purpose are not likely to be feasible.

## **TRUMP'S (MISPLACED) STRATEGIC OBJECTIVES**

Trade imbalances are determined by underlying *macroeconomic* fundamentals. On the real side of the economy, the key is the relationship between domestic absorption (consumption, investment, and government spending) and domestic production: An excess of absorption produces a trade deficit, as the gap is

made up by net imports, while an excess of production leads to a trade surplus as that excess is exported. On the financial side, the centerpiece is the relationship between saving and investment within each country: A shortage of savings generates a net capital inflow that finances a trade deficit while insufficient investment (or excess savings) requires a net capital outflow that is the counterpart of a trade surplus.

Most economists thus agree that the most effective, perhaps the only, policy initiative that would reduce the US current account deficit on a lasting basis would be a reduction in the US budget deficit, which would simultaneously reduce domestic absorption and the demand for foreign capital to finance it—especially with the economy near full employment as is now the case. By contrast, further increases in the budget deficit, perhaps driven by tax cuts as proposed by the Trump administration, would increase the external deficit whatever NAFTA or other trade partners might do. Virtually all agree that trade imbalances should continue to be addressed by macroeconomic and monetary policy instruments, including exchange rates, and by monetary officials in finance ministries and central banks.

Even the full achievement of bilateral balance with a major trading partner, such as Mexico, would be highly unlikely to significantly reduce the global trade deficit of the United States and thus have any favorable impact on its overall economy. This is because, as just noted, a country's aggregate international balance is determined by the fundamentals of its own economy and their interaction with the rest of the world. Hence any reduction in the US deficit with Mexico that was not based on a change in those fundamentals would shortly be replaced by an increase in its deficit with other countries. US imports would simply shift from Mexico to other countries as production of the relevant products shifted, or US exports would shift to Mexico from other countries with little or no net impact on the overall balance.<sup>2</sup> The apparent Trump approach to trade agreements is thus rooted in two fundamental economic misconceptions.

These practical realities underpin the conceptual focus of trade agreements on increasing the *level* of trade rather than altering trade *balances*. Those agreements thus address the *microeconomic* factors that determine trade flows, especially border measures such as tariffs and quotas but increasingly behind-the-border measures such as competition policy and patent policy that affect international transactions as well. The goal of free trade agreements (FTAs) is to maximize the productive efficiency and economic welfare of the countries participating in them. They are negotiated by trade officials in the relevant ministries. The goal of trade agreements (and trade policy more broadly) should continue to be the reduction of barriers to international exchange and the writing of rules to govern that exchange, including to assure that trade is fair as well as free.<sup>3</sup>

Another way to conceptualize this distinction is to apply the basic theory of economic policy, which posits that the number of policy targets must equal the number of policy instruments and that each instrument should be assigned to the single target that it can address most effectively. In the case under discussion, this means that trade policy should be assigned to achieving the level of trade that will maximize national economic welfare and that the exchange rate should be assigned to achieve and maintain an external balance that is sustainable in both international financial and domestic political terms. The exchange rate will in turn reflect the internal balances (or imbalances) in the economy as described above.

“Fair trade” is of course in the eye of the beholder. The Trump administration, for example, seems to define a trade deficit itself as “unfair trade.” On that definition, both Canada and Mexico could regard themselves as major victims because of their large global deficits. However, most trade participants and

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2. The United States should in fact prefer to import from Mexico than from other countries. Studies show that Mexico spends a much higher share of its export earnings in the United States (its “reflection ratio”) than do most other US trading partners.

3. A rare proposal for using trade policy to promote adjustment to trade imbalances can be found in Hufbauer (1986).

observers accept the rules of the World Trade Organization (WTO) and other trade agreements as setting out the moral as well as legal foundation for global commerce. Those rules are both imperfect and imperfectly implemented but they provide an agreed framework within which international exchange has flourished, with major benefits for all countries, for the past 70 years. Careful studies show, for example, that the United States is \$2 trillion per year richer as a result of the globalization that has occurred over that period (Hufbauer and Lu 2017).

Trade agreements are rooted in the principle of reciprocity: Each country balances its import “concessions” against its export gains to win domestic political support. Countries in practice, of course, jockey for mercantilist advantage, but it would be politically infeasible to explicitly base a trade negotiation on a goal of achieving an unbalanced outcome that favored one of the parties and thus disfavored the other(s).

There are two different definitions of “reciprocity”: equal reductions in trade barriers *at the margin* (“marginal” reciprocity) and achieving equal *levels* of barriers as a result of the negotiation (“level” or “mirror image” reciprocity). The former is the traditional modality of most trade negotiations, reflecting the political reality just noted. The Trump administration seems to be aiming for the latter, which would require Mexico to liberalize more because the United States now has a lower level of (mainly nontariff) barriers.<sup>4</sup> Gary Cohn, director of the National Economic Council, has quoted President Trump as explicitly espousing “level reciprocity.”<sup>5</sup>

In the particular case of NAFTA, pursuit of an improved US bilateral trade balance would be especially inappropriate. Mexico runs a substantial bilateral surplus with the United States but it simultaneously runs a substantial global trade and current account deficit (2.7 percent of its GDP in 2016). Mexico in fact wants and needs to run an external deficit in order to import capital that helps finance its development.

Under the standard rules and norms of the international economic system, as well as basic economics, Mexico is viewed as a deficit country rather than as a surplus country and is thus not expected to undertake initiatives—via its domestic economy, exchange rate, trade policy, or anything else—to weaken its international balance. To the contrary, it might be expected to take steps to strengthen its position. The United States would thus face both pragmatic and conceptual hurdles in any effort to get Mexico to reduce its bilateral surplus.

Canada’s bilateral trade with the United States is roughly in balance: It runs a modest goods surplus and an offsetting (or slightly more than offsetting) services deficit. But, like Mexico, it runs a large global current account deficit (3.3 percent of its GDP in 2016). Hence both NAFTA partners are deficit rather than surplus countries as conventionally defined. In fact, both Canada and Mexico have run larger global current account deficits than the United States (2.6 percent of GDP in 2016) in recent years. It might seem more logical for the three NAFTA countries to try to improve their global competitive positions together rather than attacking each other bilaterally.

It is also worth noting the potential impact on US trade with Mexico of a dissolution of NAFTA if the renegotiation were to fail and President Trump realized his threat to withdraw from the agreement. Mexico’s most-favored-nation (MFN) tariffs on imports from the United States would then average 7.4 percent and rise by that amount from their zero level under NAFTA if the United States lost its NAFTA preferences (whereas US tariffs on imports from Mexico would rise by only half as much). In addition, Mexico could

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4. The World Bank’s 2009 Trade Restrictiveness Index, as updated in 2012, assigned an overall trade restrictiveness index of 15.2 percent to Mexico and 5.7 percent to the United States. The two countries’ tariff levels were very similar so the difference derived from nontariff measures. See Kee, Nicita, and Olarreaga (2012).

5. Jack Catoral, “White House: Trump Detailed Views on Fair Trade, Reciprocity at G-7 Meeting,” *Inside US Trade*, June 2, 2017.

legally raise its tariffs that cover most US exports to an average of 35 percent because it has bound its rates only at those levels under the WTO. Under either of these circumstances, the United States would face substantial discrimination against its exports in the Mexican market vis-à-vis the 19 others (including the European Union as a group, Japan, and several other major competitors as well as Canada, whose NAFTA preferences would continue) with which Mexico has FTAs (and potentially several others, including Korea, with which it is now negotiating). The result would almost certainly be a sharp increase in the US bilateral trade deficit with Mexico. At a minimum, US exporters would face huge uncertainty concerning their future trade relations with Mexico (Amiti and Freund 2017).

In addition, a US withdrawal from NAFTA would sharply lower confidence in the Mexican economy, which would presumably lead to a sharp fall in the exchange rate of the peso. This would of course strengthen Mexican competitiveness. In addition, Mexican growth would be adversely affected for at least a while. These macroeconomic effects would compound the increase in the bilateral US trade deficit with Mexico (de Bolle 2017).

These flaws in the Trump approach to trade agreements do not mean that those agreements, or trade policy more broadly, cannot have important implications for the sectoral and geographical composition of US trade. Trade policy can affect the structure of that trade, another of its microeconomic features, as well as its overall levels. The profile of both border and behind-the-border barriers can promote or discourage US imports, for example, in steel rather than chemicals or, more broadly, in manufacturing rather than services. Likewise, typical FTAs provide preferential treatment to partner countries (as in NAFTA) and thus favor trade with them compared with countries that are not involved in such arrangements. (A country's total trade is likely to go up when it enters into an FTA because the resulting trade creation usually exceeds the induced trade diversion, and its overall import protection declines.) But it would be a serious mistake, and probably futile, to try to significantly reduce the global US external deficit through (re)negotiating trade agreements and by emphasizing bilateral imbalances.

## **MANAGED TRADE UNDER NAFTA?**

Suppose, however, that the Trump administration nevertheless pursues its stated goals. In that case, its pacts should be called “trade balance agreements” or “trade deficit agreements” rather than free trade agreements. One immediate implication is that its trade balance objective points toward breaking NAFTA into two bilateral agreements, at least de facto with two separate negotiations, rather than a continued trilateral arrangement, as in fact indicated publicly by Secretary of Commerce Wilbur Ross. US trade with Canada has been close to balance for the past couple of years, after running a substantial deficit a decade ago when energy prices were much higher, so the starting point with the two partner countries is fundamentally different on that metric. In addition, while the United States does have market access problems with Canada (and vice versa), the economies and trade policies of the two partner countries are very different. Canada is of course a high-income country on a par with the United States while Mexico, despite its enormous progress over the past two decades (due importantly to NAFTA), remains an emerging-market economy with a per capita income about one-fourth that of the United States and Canada. Hence the basic modality of the renegotiation would have to be considered at the outset.

The key operational question is what, if any, elements could be incorporated in a trade agreement to achieve, or even credibly pursue, changes in the trade balance between the two countries. Following the logic of basic economics, there are two possible approaches, one based on quantities and the other on prices.<sup>6</sup>

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6. The Trump administration might simply want Mexico to agree to a targeted reduction in its surplus with the United States and itself figure out how to achieve that goal. That would pass the same operational ques-

The quantitative avenue would require some form of managed trade, perhaps along the lines the United States pursued with Japan from the late 1970s through the early 1990s (Bergsten and Noland 1993; Bayard and Elliott 1994; Bergsten, Ito, and Noland 2001) to counter the perceived costs to the United States of Japan's government intervention in its economy and "unfair" trade policies. There are of course huge differences between Japan then and Mexico now. Japan was running large surpluses globally as well as with the United States bilaterally and was already the world's largest creditor country, whereas Mexico, as noted, runs large global deficits and is a large debtor country. Japan was widely viewed as managing its economy, and especially its trade policy, to the disadvantage of foreigners whereas the major Trumpian critique of Mexico is simply that it is running large surpluses with the United States. Indeed, there is far greater integration between the US and Mexican economies today, including via their extensive participation in global supply chains, than there was then between the United States and Japan, with its very restrictive policies toward inward direct investment, so the costs to the United States of disrupting existing trade patterns would be considerably higher. The main similarity is the heavy dependence of the other country on the United States, Japan in security terms and Mexico primarily in economic terms, which presumably provides the United States with considerable leverage in the relationship and the trade negotiations.

All of those initiatives with Japan, in any event, focused on specific sectors—especially autos, auto parts, and semiconductors, although there were at least a dozen more—rather than the large aggregate imbalance of the day (and still) between the two countries.<sup>7</sup> The United States eventually induced Japan to accept quantitative targets for some of its exports ("voluntary export restraints" or VERs), imports ("voluntary import expansions" or VIEs), and market shares (the semiconductor agreements). The results of these efforts, which were justified as second best responses to highly managed Japanese markets, were idiosyncratic to the sector involved and decidedly mixed: Bergsten, Ito, and Noland (2001), along with a number of other analysts, concluded that several of the agreements (especially semiconductors and auto parts, where market shares were targeted) led to US export gains in the specific products but no reduction in the overall bilateral or global deficits of the United States (Noland 1997) and a substantial fraying of relations with Japan. The overall US deficit and Japanese surplus declined significantly only when the two countries (along with the rest of the G-5) intervened in the currency markets via the Plaza Accord in 1985 to dramatically reduce the exchange rate of the dollar (Bergsten and Green 2016; see below).

Bergsten and Noland (1993) calculated "apparent gains from liberalization implemented to date" and "potential gains from future liberalization" in ten sectors that the United States prioritized in its extended efforts with Japan (table 1), ranging from cigarettes to computers and covering Japanese policy changes ranging from genuine liberalization to extensively managed trade. The total of those "speculative estimates" aggregated to about \$4 billion with almost \$2 billion more generated from sales from the foreign affiliates of US firms. Gold and Nanto (1991) found that US exports increased by \$5 billion in sectors discussed in bilateral US-Japan negotiations. In all these cases, the United States sought opening of Japanese markets that were perceived to be closed to foreign participation rather than any aggregate trade balance goal. As the Trump administration pursues trade that is "fair as well as free," it could presumably find sectors where barriers presently exist and emphasize them in the NAFTA renegotiation.

The "lesson" from the Japan case, the only precedent in modern US trade policy history that is possibly relevant to the current Mexican situation, is that the most feasible quantitative tools for reducing the US bilateral deficit would be VERs and VIEs. VIEs are less undesirable from an economic standpoint, in that they

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tions to Mexico, however, and additionally subject the outcome to macroeconomic and global developments that could substantially affect Mexico's ability to deliver even it tried to do so in good faith.

7. Although Japan, in the Strauss-Ushiba Agreement in October 1978, agreed "to make all reasonable efforts to reach equilibrium in its balance of payments" (Wolff 2017).

expand trade rather than contract it as VERs do, but they raise the same inefficiency and discrimination issues as any policy-induced distortions of trade (Irwin 1994). They are also much more difficult to implement because the Mexican government would have to induce or force domestic purchasers to buy any agreed increase in US exports. (Japanese bureaucrats came to love VERs, which enhanced their power by enabling them to curtail activities of the private sector, and to hate VIEs because they required the bureaucrats to become supplicants to the private sector).

Mexico could nevertheless presumably shift some (particularly government) imports from third countries to the United States at some economic cost and by courting considerable problems with the countries involved (which, rather than Mexico itself, would then bear the heaviest costs of the US demands and might well retaliate as a result). Commerce Secretary Ross has reportedly proposed just that, suggesting that Mexico could “divert to US sources products they’re already buying abroad but from a country other than the US.... They could just as well give us a better market share than we have now.”<sup>8</sup> Such blatant trade diversion would of course violate the most fundamental principles of trade comity.

Mexico could also presumably limit exports to the United States in particular sectors but might be required to compensate the Mexican firms for the economic losses they incurred as a result. The Trump administration could try to assist the Mexican government in this process by seeking to induce US firms to shift their production from Mexican affiliates to US plants, as it has already tried to do on several occasions with meager results, purposely disrupting the firms’ supply chains to return specific jobs and sales to the United States.

The third option, market share arrangements, appears to have been the “most successful” in Japan. It would seem to be of limited relevance in Mexico, however, unless sectors can be found that exclude foreign participation through restrictive practices that could legitimately be attacked through such devices. It must be stressed, however, that there is no evidence that the US economy derived any aggregate net benefit, defined in terms of its global trade deficit or even its bilateral deficit with Japan, from over a decade of intensive effort with Japan over all these trade policy issues—in stark contrast to the sharp changes in the aggregate imbalances that derived from the large changes in exchange rates promoted by the Plaza Accord.

## SETTING TRADE BALANCE TARGETS?

No modern trade agreement has sought to set a target for the trade balances of the participating countries (although the House of Representatives passed a Gephardt Amendment in 1987 that authorized retaliation if countries with large bilateral surpluses did not meet specified deficit reduction targets).<sup>9</sup> By contrast,

**Table 1 Apparent and potential US gains from liberalization in Japan** (millions of dollars)

Apparent gains from liberalization implemented to date		Potential gains from future liberalization	
Cigarettes	1,200	Computers <sup>a</sup>	1,075
Beef	500	Fuels	789
Semiconductors <sup>b</sup>	≤415	Wood products	750
Citrus	100	Retailing <sup>c</sup>	150
Fiber optics	33	Supercomputers	30

a. Does not include an estimated \$1 billion in US firms’ foreign-sourced products.

b. Does not include an estimated \$715 million in US firms’ foreign-sourced products.

c. Includes gains attributable to Toys “R” Us only.

Source: Bergsten and Noland (1993).

8. “Business Groups on NAFTA: TPA Must Be Followed,” *Inside US Trade*, June 2, 2017.

9. Nazi bilateral trade agreements in the 1930s and some of the European payments agreements immediately after World War II, and Soviet trade agreements with their satellites, did set trade balance goals but those aimed to avoid the need to finance deficits due to the shortages of reserves of the participating countries, hardly a problem for the United States today with the massive net capital inflows that have financed the US current account deficit and pushed the dollar up rather than down for the past six years.

targets for countries' global current account balances have frequently been considered in international discussions of macroeconomic and currency policy but without tangible results either (Williamson 2011). The most recent case was the US effort to forge agreement by the G-20 in 2010 to limit surpluses to 4 percent of countries' GDPs (which was rejected, primarily by Germany and China). On the unilateral front, the currency legislation voted by Congress in early 2016 requires the president to pursue "enhanced engagement" with any major US trading partner that runs a "material current account surplus," which was subsequently defined by the Treasury Department as exceeding 3 percent of its GDP, and meets two other criteria. If a country fails to remedy the problem in a year, the legislation requires the president to adopt one of four designated retaliatory measures (Bergsten and Gagnon 2017).

Price mechanisms have been discussed more frequently but without noticeably different results. The United States pursued two such strategies with Japan, with components of the market-oriented sector-specific (MOSS) talks of the mid-1980s and the Structural Impediments Initiative (SII) of the late 1980s. Alongside their quantitative siblings during the same periods of time, as just described, those efforts sought liberalization in specific sectors and were unique to the perceived management and "unfairness" of the Japanese economic system. They did not explicitly address the bilateral, let alone global, imbalances of the two countries (although those imbalances were of course an important part of the context and rationale for the US efforts, and motivated the Plaza Accord on macroeconomic issues in 1985).

In the original draft of its NAFTA renegotiation plan, the Trump administration suggested several methods that might be pursued to reduce the bilateral imbalances (as well as, in some cases, sectoral grievances): tighter rules of origin, a general safeguard clause that would permit "reinstatement of tariff against a flood of imports," and achievement of a "level playing field" on tax policy. Trade actions already initiated by the Trump administration during its first 100 days—mainly covering softwood lumber, steel, and aluminum—could, if fully implemented, cover an estimated \$20 billion of imports from Canada and \$6 billion of imports from Mexico (Bown 2017).

The surge protection option could of course run afoul of WTO limitations and lead to retaliation against US exports. The tax alternative could be addressed via US adoption of a border tax adjustment of its own, as has been actively discussed in the current context of US tax reform, or a more conventional value-added tax. It could also be addressed by Mexican abandonment of its value-added tax, as implied by some Trump administration pronouncements, or more likely a reduction in its level and/or border adjustability, perhaps discriminatorily in favor of the United States; either is highly unlikely since border adjustment of such a tax is clearly legal under the WTO and the United States is virtually the only country in the world that does not employ it and because discrimination in favor of the United States would give it an advantage over domestic Mexican firms.

The most comprehensive price mechanisms for addressing a trade imbalance are tariffs and exchange rates. Increased tariffs, however, are demonstrably ineffective in improving a country's current account (Bergsten and Gagnon 2017, International Trade Center 2016). This is partly because they are usually illegal under the WTO and can thus produce offsetting retaliation by trading partners, but even more importantly because appreciation of the exchange rate normally ensues and precludes any net aggregate improvement.

A more promising possibility would be for Mexico to further reduce its own trade barriers vis-à-vis the United States, under the renegotiated NAFTA, either in tandem with similar US reductions or unilaterally to promote a net expansion of US exports (in violation of the principle of marginal reciprocity discussed above but possibly under the principle of achieving "level" or "mirror image" reciprocity). Virtually all Mexican tariffs on US exports are now zero, due to NAFTA, but liberalization of nontariff measures might

be enough in some sectors to divert trade flows and generate some expansion in US sales (though without necessarily improving the global US trade balance for the macroeconomic reasons outlined above).<sup>10</sup>

Any steps that Mexico might take to reduce its bilateral surplus with the United States would of course be subject to the same macroeconomic considerations discussed above for the United States. Changes in its trade policies, whether reduced nontariff barriers or new VIEs in particular sectors, would be offset at least partially by depreciation of the exchange rate of the peso. The result would therefore include an *improvement* in Mexico's trade balance with the United States in sectors not covered by the new policy initiatives and in its trade balances with other countries, which would at least partially offset any deterioration in its balance with the United States in the covered products. This would somewhat mitigate the costs of the policy action to Mexico but could exacerbate the problems of noncovered sectors in the United States and of other countries.

Many proposals over the years have targeted exchange rates to promote global economic equilibrium, some of which have been implemented for at least brief periods of time (e.g., the target zones or "reference ranges" adopted by the G-5 through the Louvre Agreement in 1987). Any such arrangements would of course relate closely to the underlying economies and economic policies of the countries involved, however, so have been addressed in a macroeconomic context by the economic policy officials of those countries rather than as part of trade agreements.

Such agreements have occasionally been worked out and implemented by major governments, including those of the United States and Canada, in the context of multilateral management of the international monetary system. The Smithsonian Agreement of 1971 carried out the first wide-ranging realignment of fixed exchange rates in the postwar period. The Plaza Accord of 1985 agreed to drive down the hugely overvalued floating dollar of the day, especially against the Japanese yen. The Louvre Agreement of 1987 installed (for a short time) target zones or "reference ranges" among the major currencies. These of course were all plurilateral rather than bilateral initiatives, although one or two foreign currencies (notably the yen and the deutsche mark) were central to the agreements. All such arrangements have been worked out by the monetary and financial, rather than the trade, officials of the relevant countries.

The major lesson from the US-Japan experience of the 1980s and 1990s is in fact the need to augment any trade policy steps with a major monetary initiative, in that case the Plaza Accord of 1985 on exchange rates, to gain traction on the international imbalances, both global and bilateral. This in turn requires pursuing the issue on a multilateral, or at least plurilateral (G-5 in that case), basis rather than bilaterally. Doing so at the present time would of course take the administration's current strategy well beyond a renegotiation of NAFTA but may ultimately become necessary if its trade balance goals are to be realized (Bergsten 2016).

The most likely contemporary counterpart within the NAFTA context itself would be for the member countries to agree to avoid any misalignment among their currencies (or even to push the Mexican peso and Canadian dollar to overvalued levels that would reduce their surpluses with the United States and further increase their global deficits). Since the dollar is the world's key currency, and its exchange rate reflects its relationships with all of the major monies, such an agreement would essentially require commitments by Canada and Mexico to avoid any undervaluation of their currencies—whether caused by market forces, notably capital flows that did not accurately reflect underlying economic fundamentals, or government

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10. The Smithsonian Agreement on exchange rates in December 1971 was accompanied by a US demand that its major trading partners (Canada, European countries, Japan) unilaterally reduce their nontariff barriers to US exports. Secretary of the Treasury John Connally famously explained that all he wanted was a "fair advantage." The other countries refused, but the subsequent talks paved the way for the launch of the Tokyo Round of multilateral trade negotiations in the GATT in 1973.

actions such as direct or oral intervention in the foreign exchange markets. The extreme version of this approach would be for both countries to peg their exchange rates to the dollar, as both did for extended periods in the past, at levels that were agreed to accurately reflect equilibrium. That “equilibrium” would of course reflect the global positions of the two economies so might well encompass continued bilateral surpluses with the United States.

Neither Mexico nor Canada have been accused of currency manipulation throughout the “decade of manipulation” (2003–13) when the practice was widespread in East Asia and some other parts of the world (Bergsten and Gagnon 2017). Nor has either been accused in recent decades of experiencing an undervalued currency due to market forces, except perhaps ironically in the case of Mexico when the peso sank sharply after the election of President Trump as a result of his sharp criticisms of the country (a move that had been largely reversed at the time of this writing). The Trump administration has nevertheless indicated that it will pursue an agreement on currency manipulation, primarily for precedential reasons, but would seem more likely to favor the managed trade approach if it wanted to use the NAFTA renegotiation to attempt to reduce the bilateral US trade deficit with Mexico.

## CONCLUSION

A final, and much more constructive, alternative would be to try to use the NAFTA renegotiation to strengthen the Mexican economy and thus boost its imports from the United States (and everywhere else). A country’s growth rate is the dominant driver of its import expansion so achieving a more dynamic Mexico would be the best way to achieve the trade balance goal of the Trump administration. A stronger Mexican economy would probably also lead to appreciation of the peso, which would further improve US competitiveness. Mexico could agree to implement more expansionary fiscal and monetary policies, in the same way that Germany could obviate much of the US (and others’) criticisms of its large global surpluses via such measures (including by the European Central Bank for the euro).

Faster growth could be fostered by maximizing the freedom of trade (in services as well as goods) between the two countries and writing new rules to promote that objective. The best “new NAFTA” to meet the new goals might thus be an updated and expanded “old NAFTA” to complete the goals to which the three countries committed themselves a quarter century ago.

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## CHAPTER 3

# Toward a Positive NAFTA Renegotiation: A Mexican Perspective

Antonio Ortiz-Mena

Relations between Mexico and the United States are going through their most complex and contentious phase since the signing of the North American Free Trade Agreement (NAFTA), in 1994. During the 2016 presidential campaign, Donald Trump labeled NAFTA as “perhaps the greatest disaster trade deal in the history of the world.”<sup>1</sup> He claimed that the agreement was “unfair,” as exemplified by the United States’ trade deficit with Mexico, and promised to renegotiate it to reduce the deficit or withdraw if the new agreement was unsatisfactory. He called Mexican migrants criminals, drug traffickers, and rapists and promised to build a wall along the US-Mexico border, which Mexico would pay for.

Once in office, President Trump doubled down on the construction of the wall and his insistence that Mexico would eventually pay for it. In April 2017, he was close to announcing withdrawal from NAFTA without even attempting to undertake negotiations to amend it, but on May 18 US Trade Representative Robert Lighthizer notified Congress that President Trump intended to renegotiate NAFTA.

The Mexican government has stated its willingness to upgrade NAFTA. It considered the Trans-Pacific Partnership (TPP) a way to do so. Now that the Trump administration has withdrawn from the TPP, Mexico is ready to engage in direct negotiations, but attempts to reduce the bilateral trade deficit through managed trade would undo many of the economic gains attained under NAFTA, forestall the possibility of a win-win approach to trade relations, and make productive negotiations difficult.

The Mexican government and civil society are keenly concerned about the US administration’s stance toward Mexican migrants. Aggressive rhetoric from the Trump administration toward Mexico could tilt the country’s delicate political landscape away from NAFTA. A positive negotiation would need to avoid export

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1. Meera Jagannatha, “Here Are All the Terrible Things President Trump Has Said about NAFTA—Before Deciding to Stick with It,” *New York Daily News*, April 27, 2017, [www.nydailynews.com/news/politics/terrible-president-trump-nafta-article-1.3107104](http://www.nydailynews.com/news/politics/terrible-president-trump-nafta-article-1.3107104).

and import restrictions, new tariffs or other measures that would hurt supply chains across the border, and negative rhetoric on Mexico and its US-based nationals.

## MEXICO'S NEGOTIATING PRINCIPLES AND OBJECTIVES

In contrast to the original NAFTA negotiations, in which Mexico was the *demandeur* and had a delicate balance of offensive and defensive aims, Mexico is now responding to a US request for renegotiation and has mostly offensive aims.<sup>2</sup> On January 23, 2017, President Peña Nieto laid out 5 principles and 10 objectives to guide NAFTA negotiations.<sup>3</sup>

The five negotiating principles include the following:

1. *National sovereignty*: Mexico will defend its interests with firmness, while recognizing that its relations with the United States are fundamental but that the United States' relations with Mexico are also very important.
2. *Respect for the rule of law*: Mutual respect for the rule of law should be the basis of interaction.
3. *A constructive vision*: Mexico will maintain a win-win focus and seek novel and pragmatic solutions.
4. *North American integration*: The dynamism and competitiveness of the region depends on joint action by all three countries.
5. *Comprehensive negotiations*: Mexico will address trade issues but also immigration and security.

The 10 negotiation objectives include the following:

1. Obtain a commitment from the US government to respect the rights of Mexican migrants.
2. Ensure that any repatriation of undocumented migrants by the US is carried out in an orderly and coordinated manner, maintaining or improving current agreements on the matter.
3. Work jointly with the US government to promote the development of Central American countries, which are a source of undocumented migration to the United States via Mexico.
4. Ensure the free flow of remittances from Mexicans in the United States, avoiding any new difficulties or expenses.
5. The US government should commit to work with Mexico to stop the illegal flow of arms and cash from illicit sources.
6. Maintain free trade between Canada, the United States, and Mexico. Trade flows between the three countries should be free from tariffs and quotas (as has been the case since 2008). The competitiveness of North America and its regional supply chains should be strengthened, with a view to increasing Mexican exports to Canada and the United States on the basis of healthy competition and the development of sectors with higher value-added.
7. Include new sectors, such as telecommunications, energy, and e-commerce, in the modernized NAFTA.

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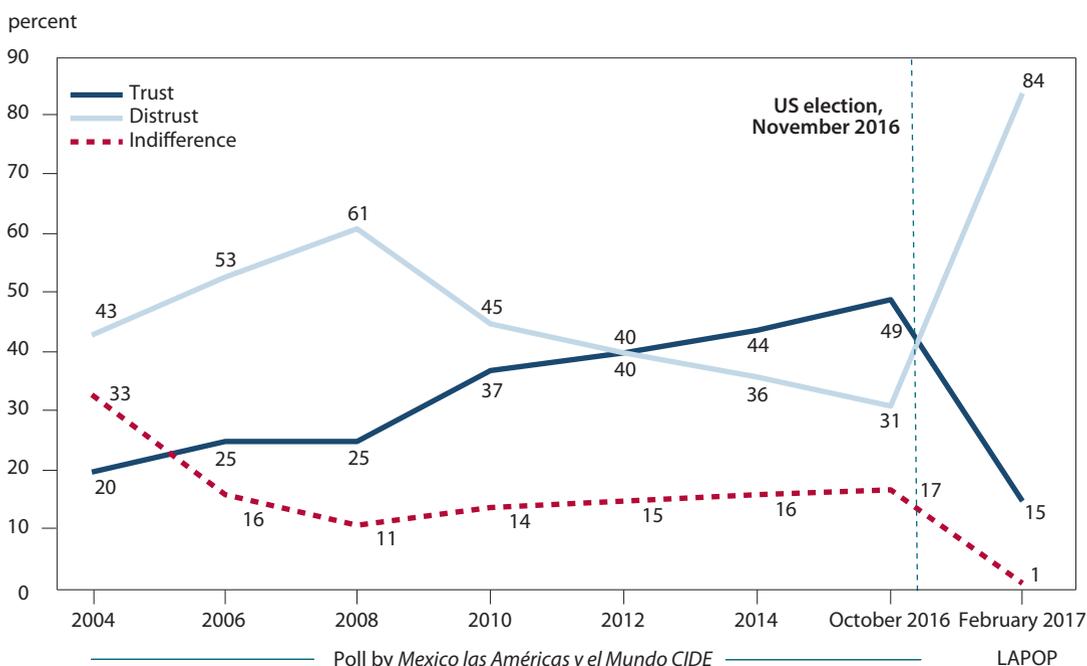
2. In the original NAFTA negotiations, the main defensive aims pertained to the oil sector. For an assessment of Mexico's defensive aims and strategies in NAFTA negotiations, see Ortiz-Mena (2006). Mexico also insisted that the agreement reflect the asymmetry, in terms of size and productivity, between the Mexican economy and the economies of Canada and the United States and that the dispute settlement mechanism for dealing with unfair trade practices be stronger than the one in the Canada-US Free Trade Agreement. However, should the Mexican government not make significant gains in its offensive objectives, it will be politically difficult for it to acquiesce to United States requests in the trade negotiations.

3. For the (Spanish-language) text of the negotiating principles, see [www.gob.mx/presidencia/articulos/5-principios-que-guiaran-la-negociacion-con-el-gobierno-de-los-eua?idiom=es](http://www.gob.mx/presidencia/articulos/5-principios-que-guiaran-la-negociacion-con-el-gobierno-de-los-eua?idiom=es). For the (Spanish-language) text of the objectives, see [www.gob.mx/presidencia/articulos/10-objetivos-del-gobierno-de-la-republica-en-la-negociacion-con-eua?idiom=es](http://www.gob.mx/presidencia/articulos/10-objetivos-del-gobierno-de-la-republica-en-la-negociacion-con-eua?idiom=es).

8. Ensure that any new agreement with the United States translates into better wages for Mexican workers.
9. Protect the flow of investment into Mexico. The government of Mexico will ensure that the country remains a safe and attractive destination for investment.
10. Work toward creating a border that unites rather than divides. Mexico recognizes the right of every sovereign nation to guarantee its security, but it does not believe in walls. It believes in bridges, road and railroad crossings, and the use of technology as the best way to promote good relations with its neighbors.

The statements from candidate and now president Donald Trump on trade with Mexico, Mexicans, and the wall have created an environment that makes it politically difficult for the Mexican government to maintain “business as usual” engagement on trade and security if NAFTA negotiations fail. Indeed, Mexican public opinion has shifted from a long-term trend of growing trust toward the United States to one of overwhelming distrust in just a short time (figure 1). Adverse public statements and especially actions regarding Mexico and Mexican migrants in the United States could complicate trade negotiations.<sup>4</sup>

**Figure 1 Mexican feelings towards the United States, 2004 to February 2017**



Note: The figure shows responses to the polling question, “From the following words, which one best describes your feelings towards the United States?” The results for 2004–16 are from the México, Las Américas y el Mundo survey conducted by CIDE (<http://lasamericasyelmundo.cide.edu>). Each data point is based on a national representative sample of 2,000 adults. The February 2017 result is from the Americas Barometer, the Latin America public opinion project (LAPOP) at Vanderbilt University ([www.vanderbilt.edu/lapop/](http://www.vanderbilt.edu/lapop/)). It is based on interviews with 1,560 representatives of the national adult population. Both surveys were conducted by Data OPM ([www.dataopm.net](http://www.dataopm.net)). The author thanks CIDE and Pablo Parás, from Data OPM, for permission to use the polling data.

4. See remarks by the Mexican ambassador to the United States, Gerónimo Gutiérrez, at the Brookings Institution May 24, 2017, [www.brookings.edu/events/trade-security-and-the-u-s-mexico-relationship](http://www.brookings.edu/events/trade-security-and-the-u-s-mexico-relationship); and the statement from the Mexican Foreign Ministry regarding a June 22, 2017, tweet by President Trump on the proposed wall, [www.gob.mx/sre/en/articulos/foreign-ministry-press-release?idiom=en](http://www.gob.mx/sre/en/articulos/foreign-ministry-press-release?idiom=en).

## POSITIVE AND NEGATIVE FEATURES OF NAFTA NEGOTIATION

From a Mexican perspective, a positive NAFTA negotiation would do the following:

- Use NAFTA as the “floor” for negotiations (no tariffs or quotas would be introduced).
- Focus on modernizing rather than renegotiating the agreement.
- Strive to craft trilateral rules, as opposed to bilateral deals, among the three North American countries. NAFTA has allowed the development of efficient North American supply chains in sectors such as aerospace and automobiles; new ones can develop on the basis of energy and demographic complementarity (Council on Foreign Relations 2014). Regional regulatory cooperation, as well as infrastructure planning, will be instrumental in this regard.
- Attempt to reach a prompt agreement, at least in terms of the general scope and coverage of new commitments. With the presidential election in Mexico in July 2018 (and November 2018 midterm elections in the United States), it is important to wrap up the negotiations quickly, as it would be very difficult for Mexican negotiators to make credible commitments while the country has two presidents (a lame-duck president and a newly elected president, as there will be between July and December 1), especially if the president-elect is from an opposition party.
- Result in an agreement that provides certainty for producers and consumers in all three countries yet is flexible enough to encompass developments that stem from the convergence of physical, biological, and digital technologies, which will transform both production and trade.

From a Mexican perspective, a negative NAFTA negotiation would do the following:

- Entail full renegotiation rather than modernization.
- Include new tariffs and quotas, resulting in managed trade.
- Include overly restrictive rules of origin, which would disrupt existing supply chains.
- Attempt to restrict trade based on the trade balance.
- Lack significant further liberalization, especially in services.
- Be longwinded and without any interim agreements in principle, generating uncertainty for economic actors.

Trade, as well as macroeconomic policy and technological changes, can affect jobs and wages, but the best way to address employment challenges is not through protectionism or managed trade. Providing new and better rules to allow Mexico, Canada, and the United States to produce as a bloc and having strong and enforceable labor laws is part of the answer, as is retraining and a robust social safety net.

Mexico’s general aim remains the same today as it was when it negotiated the original NAFTA: to reach an agreement with stable and clear rules that support the free flow of trade and investment in North America and generate certainty for economic actors. Given the technological changes that have taken place since NAFTA entered into force, and the momentous transformations that will come in the coming decades, it would be useful to craft rules that are attuned to current needs and can encompass new technological developments.

Mexico should strive for a modern, comprehensive, and ambitious new agreement, but it should not attempt to salvage NAFTA if the new agreement entails new trade and investment barriers; results in managed trade; gives greater scope for unilateral protectionist actions without recourse to consultations or, in certain cases, arbitration; or requires rules of origin that would severely disrupt supply chains. In such a case, it may be preferable to regulate trade under the World Trade Organization (WTO) rules.<sup>5</sup>

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5. In the original NAFTA negotiations, Mexican Secretary of Trade and Industrial Development Jaime Serra Puche stated that should a new NAFTA result in amendments that put Mexico put at a disadvantage vis-à-

## TYPES OF ACTIONS TO MODERNIZE NAFTA

Three types of actions can be used to modernize NAFTA:

- *Updates*: Committing to doing what should have been done
- *Upgrades*: Incorporating new issues
- *Architecture*: Creating an agreement attuned to future needs, as technology affects trade and investment.

Some complementary measures—on exchange rate manipulation, financial integration and anti-money laundering, fiscal policy, aviation, and physical connectivity—could be addressed outside trade negotiations, as discussed in the last section.

### NAFTA Updates

NAFTA already contains a number of commitments to improve the agreement and deepen regional cooperation. The modernization of NAFTA would be an appropriate occasion to take stock of the degree to which prior commitments have been met, bring the agreement up to date, and provide for improved engagement and progress monitoring mechanisms in the new agreement. Some salient examples include Chapters 3, 4, 7, 9, 10, 15, and 19.

#### Chapter 3: Trade in Goods

Article 316 (3) mandates that the three countries meet at least annually to address issues related to problems with the movement of goods across borders. Article 317 (2) provides for consultations on third-country dumping.

Although trade disputes are inevitable in a relationship as intense as that of the North American countries, concerns over unfair trade have at times been misdirected against its regional partners rather than toward large exporters from outside the bloc.<sup>6</sup> Greater intraregional cooperation against unfair trade practices from outside the region and greater dialogue to avoid and resolve intraregional disputes would be positive developments.

#### Chapter 4: Rules of Origin

Rules of origin will be one of the main topics for negotiation. They need to be set just right. If they are set too low, there will be few incentives to invest in the region; if they are set too high, existing supply chains

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vis other economies, it would be better to abandon NAFTA and trade under WTO rules. See the interview with him in “La renegociación del TLCAN,” *Foreign Affairs Latinoamérica* 17, no. 2 (April–June 2017): 9. Nonetheless, there is also uncertainty over how the United States policy towards the WTO will evolve under the Trump administration.

6. For example, although the three North American countries work together at the Organization for Economic Cooperation and Development (OECD) on steel issues affecting them, including both regional production and imports from outside the region (<https://ustr.gov/issue-areas/industry-manufacturing/industry-initiatives/steel>), a current investigation under Section 232 of the 1962 Trade Expansion Act generates uncertainty for aluminum and steel producers in Canada and Mexico. Canadian and Mexican producers have also been the object of numerous antidumping/countervailing duties investigations on a wide variety of steel products, and Mexican cement and cement clinker producers faced a barrage of antidumping actions for years. Although it was not the case when NAFTA entered into force, China is now the world’s top steel and cement producer.

may be disrupted and companies may opt to trade under WTO rules and pay most favored nation (MFN) tariffs, bypassing NAFTA rules of origin and preferences. It would be ideal to include a transition phase for rules of origin, so that supply chains can adjust, just as in the original agreement there was a transition phase for tariff reductions.

## Chapter 7: Agriculture and Sanitary and Phytosanitary Measures

Several of the most intractable disputes in the region have been over agricultural goods (tomatoes and sugar between Mexico and the United States, dairy and wheat between the United States and Canada).<sup>7</sup> The Advisory Committee on Private Commercial Disputes regarding Agricultural Goods could play a stronger role in fostering greater technical cooperation on sanitary and phytosanitary issues and in facilitating dialogue to resolve agricultural disputes.

## Chapter 9: Standards-Related Measures

More than two decades after NAFTA's entry into force, nontariff barriers and (particularly) standards still impose significant transactions costs on intraregional trade and investment.<sup>8</sup> Greater cooperation on standards, with a view to mutual recognition at a minimum and harmonization where possible, would be a boon for the region. The original NAFTA provides the possibility for representatives from states and provinces to participate in such deliberations.

## Chapter 10: Government Procurement

Although the Buy American Provisions of the 2009 American Recovery and Reinvestment Act included exceptions for NAFTA,<sup>9</sup> complex regulations still represent a significant barrier to access to certain tenders, small business procurement programs have shown meager advances, and many subfederal barriers remain. Improving access for small businesses, especially at the subfederal level, would create significant employment opportunities.

## Chapter 15: Competition Policy

As intrafirm and intraindustry trade increases in the region, the three countries could gradually focus more on competition policy to deal with trade distortions, instead of antidumping/countervailing duty measures.<sup>10</sup> Article 1504 establishes a Working Group on Trade and Competition to address issues regarding the link between competition laws and trade in the region.

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7. See Cullen S. Hendrix's chapter in this volume.

8. The WTO trade policy reviews of Canada, Mexico, and the United States provide detailed information on nontariff barriers. See [www.wto.org/english/tratop\\_e/tpr\\_e/s314\\_e.pdf](http://www.wto.org/english/tratop_e/tpr_e/s314_e.pdf) for Canada, [www.wto.org/english/tratop\\_e/tpr\\_e/s352\\_e.pdf](http://www.wto.org/english/tratop_e/tpr_e/s352_e.pdf) for Mexico, and [www.wto.org/english/tratop\\_e/tpr\\_e/s350\\_e.pdf](http://www.wto.org/english/tratop_e/tpr_e/s350_e.pdf) for the United States.

9. See "Buy American Provisions in the American Recovery and Reinvestment Act (ARRA)," [www.ncsl.org/print/statefed/BuyAmericanGuidanceSummary.pdf](http://www.ncsl.org/print/statefed/BuyAmericanGuidanceSummary.pdf) and "The Buy American Act and Buy America Provisions," Canadian Trade Commissioner Service, <http://tradecommissioner.gc.ca/sell2usgov-vendreaugouvusa/procurement-marches/buyamerica.aspx?lang=eng>.

10. For a recent discussion of intraindustry and intrafirm trade in North America, see Wilson (2017).

## Chapter 19: Review and Dispute Settlement in Antidumping/Countervailing Duty Matters

Some US congressional leaders have called for the elimination of Chapter 19.<sup>11</sup> Given that the US government has announced that it will double down on enforcement, it would be inadvisable for Mexico to give up access to Chapter 19. The United States may also need Chapter 19 to avoid unwarranted protectionist measures by its NAFTA partners.

### NAFTA Upgrades

An upgrade to NAFTA entails modernizing existing commitments and including new issues. The TPP is an excellent starting point for both approaches. It should be neither a floor nor a ceiling but a template, given the different tradeoffs in plurilateral versus regional negotiations. Some issues that could be modernized using the TPP as reference point include services, government procurement, competition policy, labor and the environment, administrative and institutional provisions, dispute settlement, e-commerce, state-owned enterprises, cooperation and capacity building, small and medium-size enterprises, and regulatory coherence.

### Services

The significance of services for the competitiveness of the region has vastly increased since the early 1990s. A central focus should therefore be on services, particularly telecommunications, energy, and financial services.

The scope and coverage of NAFTA on financial services and telecommunications was very limited, largely because Mexico was in the process of privatizing its banks and its public telephone monopoly (TELMEX). For political and historical reasons, Mexico also decided to leave energy largely out of NAFTA negotiations (see Ortiz-Mena 2006). Since NAFTA was signed, Mexican banks have been privatized, and reforms to further liberalize the financial services, telecommunications, and energy sectors have been incorporated into the Mexican constitution.<sup>12</sup>

It would be both economically sensible and politically viable to seek ambitious agreements on energy, financial services, and telecommunications in the new NAFTA and to maintain the investor–state dispute settlement mechanism to make sure there is no policy reversal. These reforms are in Mexico’s economic self-interest and also benefit the United States and Canada. Mexico should in turn seek ambitious reciprocal concessions.

Deeper agreements on the temporary entry for business persons will be necessary to complement the new scope and coverage of trade in services.

### Government Procurement

Gaining access to US and Canadian subfederal procurement would be beneficial for Mexican providers of goods and service, especially small businesses; granting subfederal access to US and Canadian companies would provide new business opportunities for Canadian and US companies and increase transparency, which would help combat corruption in Mexican states. There will likely be significant resistance in Mexico to such changes, however. Additionally, should the United States insist on maintaining or reinforcing “buy American, hire American” provisions while seeking improved access to the Canadian and Mexican procurement market, this could become one of the more intractable issues in the upcoming negotiations.

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11. See, for example, “Wyden Statement on NAFTA Renegotiation Notice,” US Senate Committee on Finance, [www.finance.senate.gov/ranking-members-news/wyden-statement-on-nafta-renegotiation-notice](http://www.finance.senate.gov/ranking-members-news/wyden-statement-on-nafta-renegotiation-notice).

12. See the 2014 Investment Climate Statement by the US State Department, [www.state.gov/documents/organization/227420.pdf](http://www.state.gov/documents/organization/227420.pdf).

## Competition Policy

If NAFTA serves as a template for new regional trade agreements in the absence of TPP, it should be at the forefront in terms of competition policy. Regional production chains merit much greater cooperation between national competition agencies, with a view to an increasing use of competition policy instead of anti-dumping/countervailing duty policies to address market distortions. Agreement to move toward a common external tariff (CET) with a sectoral approach could set the basis for greater use of competition policy.

## Labor and the Environment

The labor and environmental side agreements in NAFTA were cutting edge when they were signed, but they have been frozen in time. The status quo is unsustainable, not only for the United States but also for a more vibrant Mexican civil society. Mexico has undertaken constitutional reforms to make labor laws more flexible and is contemplating further reforms on union representation and labor dispute resolution.<sup>13</sup>

The TPP template could be used for both labor and the environment, insofar as the new NAFTA provisions do not open the door for unwarranted nontariff barriers instead of addressing legitimate labor and environmental concerns.<sup>14</sup> In addition, some Mexican companies will be concerned about unfair competition if US environmental regulations are increasingly lax. The Trump administration has proposed revoking a provision that allows the Environmental Protection Agency (EPA) to regulate the pollution of wetlands, reversed commitments on carbon emission reductions required by the Obama administration's Clean Power Plan and ended the ban on coal leasing in federal lands, decided not to ban a pesticide (chlorpyrifos) despite evidence that it poses health risks to consumers, and withdrew from the Paris Agreement on Climate Change. In contrast, the Mexican government stated its commitment to the Paris Agreement and to continued implementation of its Intended Nationally Determined Contributions (INDC) and its National Climate Change Strategy. The 2015 Energy Transition Law, which establishes goals for the reduction of greenhouse gas emissions and the use of renewable energies and energy efficiency, is a central component of Mexico's national strategy.<sup>15</sup>

## Administrative and Institutional Provisions

The commission, secretariat, and working groups of the new NAFTA must have the financial and human resources to fulfill their mandates. During the original NAFTA negotiations, there was concern about the possible creation of a Brussels-type bureaucracy. In the event, the institutional structure was so slim that it had difficulty fulfilling some NAFTA mandates.

## Dispute Settlement

NAFTA's interstate dispute element system did not function well, in part because of difficulties in panelist selection (see Hufbauer and Schott 2005). The problem can be fixed with the new TPP template. In addition, there should be greater emphasis on consultations, good offices, conciliation, mediation, and alternative dispute resolution over arbitration.

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13. See Secretaría del Trabajo y Previsión Social, "Reforma en materia de justicia laboral," [www.gob.mx/stps/documentos/reforma-en-materia-de-justicia-laboral?idiom=es](http://www.gob.mx/stps/documentos/reforma-en-materia-de-justicia-laboral?idiom=es).

14. One issue that could prove controversial is any insistence on specific wage levels in Mexico, devoid of any links to productivity increases.

15. See Ley de Transición Energética, [www.iea.org/policiesandmeasures/pams/mexico/name-153753-en.php](http://www.iea.org/policiesandmeasures/pams/mexico/name-153753-en.php).

Should a dispute reach the panel stage, enforcement should be quick and effective. It is in Mexico's interest to ensure prompt and effective redress and to forestall potentially frivolous actions. The United States should have no qualms about such a change, given its insistence on enforcing trade agreements.

## E-commerce

The Mexican government lists e-commerce as a new issue for inclusion. It is in Mexico's interest to address it, but the negotiations should focus on the digital economy as a whole, not only on e-commerce.

Some US express carriers have requested that Canada and Mexico lift their de minimis standards (C\$20 for Canada and US\$50 for Mexico), to no avail. Commitments on regulatory cooperation on norms affecting e-commerce would be a more effective way to deal with nontariff barriers in this area.

## State-Owned Enterprises

Mexican civil society would welcome international disciplines on state-owned enterprises as an additional way to bring greater transparency and efficiency to its two major companies, PEMEX (Petróleos Mexicanos) and CFE (the Comisión Federal de Electricidad) (Guerrero n.d.).

## Cooperation and Capacity Building

Specific and pragmatic commitments should be easier to negotiate in a regional than in a plurilateral (TPP) setting. The opportunity cost of low-level commitments and achievement in this realm are higher in NAFTA, given the deep integration that already exists, than in other less successful agreements. Accordingly, the Mexican government should seek more ambitious commitments in the new NAFTA than in the TPP.

## Small and Medium-Sized Enterprises

Creating new trade and investment opportunities for small and medium-size enterprises in North America could have a positive effect on employment. It would also create more stakeholders with a stake in maintaining a constructive economic agenda between Canada, Mexico, and the United States. It would be in Mexico's interest to seek more ambitious commitments than in the TPP.

## Regulatory Coherence

Regulatory coherence was covered in NAFTA, but only to a limited extent; most political capital was spent on negotiations over tariffs and rules of origin. The deep integration that now exists in North America translates into high opportunity costs from inconsistent or incompatible regulations. Both Mexico and the United States recognize as much. In 2010 they launched the High-Level Regulatory Cooperation Council; in 2013 they established the High-Level Economic Dialogue, which included regulatory cooperation. Advances have been modest, however. Mexico should aim for very ambitious and specific commitments on regulatory coherence.

## Transparency and Anticorruption

Mexican civil society would welcome strong commitments on transparency and anticorruption. The Mexican Competitiveness Council (IMCO), one of the leading think tanks in Mexico, has made fighting corruption and promoting transparency the thrust of its work on competitiveness.<sup>16</sup>

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16. See, for example, Juan E. Pardini, "Impunidad, corrupción y competitividad," [http://imco.org.mx/indices/#!/competitividad\\_internacional\\_2015/analisis](http://imco.org.mx/indices/#!/competitividad_internacional_2015/analisis).

Starting from a premise of no new tariffs or quotas, Mexico could seek to increase the certainty of access to US (and Canadian) markets with new rules that deepen commitments on norms and standards; procurement; sanitary and phytosanitary issues; telecommunications, energy, and financial services; and e-commerce. It would also be beneficial to foster greater cooperation among the competition agencies of each country and to strive to increasingly use competition policy instead of antidumping/countervailing duty remedies. As a major recipient of foreign direct investment and Latin America's main investor in the United States, Mexico would be loath to part with the investor-state dispute settlement provisions.

Mexican civil society would likely support commitments on anticorruption and transparency, as well as labor and the environment, while questioning double standards, especially on environmental issues. Possible negotiation over subfederal procurement in Mexico would be highly controversial, but with US initiatives favoring national and local companies, it is a discussion worth having.

## **NAFTA Architecture**

NAFTA is a quarter-century old. Even its strongest supporters recognize that it is dated and due for an upgrade.<sup>17</sup>

Two possible ways to modernize NAFTA were not fully used. The first was using provisions in NAFTA to deepen commitments and further cooperation (as described in the section on updating NAFTA). That channel would have addressed some challenges, but the changes would have been relatively modest. The second was using the TPP to modernize NAFTA. That channel closed when the United States withdrew from the TPP.

The negotiations that will commence this year represent a third way to modernize NAFTA. They will likely be complex and contentious at times, leaving little appetite to revisit NAFTA any time soon after these negotiations conclude, especially if the new agreement is as politically and technically complex to update as the current one. It would thus be in Mexico's interest to seek a new NAFTA that is more flexible than the current one and that could be adjusted without spending as much political capital and effort as the upcoming negotiations will require. Some observers have called the current convergence of physical, biological, and digital technologies the fourth industrial revolution (Gates and Bremicker 2017). The McKinsey Global Institute identified 12 technologies that could change production and trade. They include the mobile Internet, the automation of knowledge work, the Internet of things, the cloud, advanced robotics, autonomous vehicles, genomics, energy storage, 3-D printing, advanced materials, advanced oil and gas exploration and recovery, and renewable energy (Manyika et al. 2013).

No one knows how the North American economy will look a quarter-century from now, but it is a safe bet that the transformation will be greater than the one that took place during the past quarter-century. Unless the new NAFTA is more flexible than the original one, many provisions, including on rules of origin, could soon become obsolete. The TPP did not fully take into account the potential of vertiginous technological change. The new NAFTA has the opportunity to do so.

## **Additional Issues**

Several issues could complement a new NAFTA. They include exchange rate manipulation, financial integration and anti-money laundering, fiscal policy, aviation, and physical connectivity. Mexico has a floating exchange rate regime and is therefore not concerned about being accused of currency manipulation. It is also not unduly concerned about competitive devaluations by the United States or Canada. It should therefore

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17. See the interview with Jaime Serra Puche cited above.

be possible to address the issue, especially if NAFTA is envisaged as a new international trade agreement template, insofar as it does not impinge upon the Banco de México's ability to buy and sell dollars or otherwise hedge against exchange rate volatility.

Mexico, Canada, and the United States work both individually and jointly to combat anti-money laundering (AML). However, cost-benefit analysis of AML regulations and actions—especially of how current AML rules may affect North America, a region that is deeply integrated in terms of trade and investment and is seeking new commitments on financial services—is rarely conducted (see Saperstein, Sant, and Ng 2015). A region that is already deeply integrated in terms of trade and investment and is seeking greater financial integration would do well to address the best way to deal with AML without imposing an undue burden on legitimate transactions.

Cooperation on fiscal issues will be necessary to address issues such as e-commerce<sup>18</sup> and to deal with tensions between two countries that use the VAT (Canada and Mexico) and the United States, which does not.

Agreements on aviation fall outside the scope of NAFTA (and the WTO, for that matter). In 2016 a new agreement on aviation between Mexico and the United States entered into force.<sup>19</sup> It offers a significant opportunity for improved regional connectivity for both passengers and cargo and can complement the new NAFTA. Explicitly addressing how the bilateral aviation agreement and the new NAFTA fit together would ensure that their synergies are maximized.

North America needs new trade rules, but it also needs new roads and better connectivity in general. Borders must be secure but also efficient. North America can do much better in that regard: In the latest *Global Competitiveness Report*, which ranks 138 economies on the quality of their infrastructure, the United States placed 12th, Canada 21st, and Mexico 69th (World Economic Forum 2016).

Infrastructure plans tend to be national rather than regional. Given “Buy American” provisions, so are business opportunities. A regional vision and regional business opportunities could help ramp up infrastructure. A more streamlined process to authorize cross-border connection of the electric grid and cross-border pipelines would also be desirable.

None of the negotiation priorities recommended above has a zero-sum focus; deeper trade and investment links increase regional competitiveness and spur job creation. The best way for the United States to deal with concerns over its bilateral trade deficit is to support greater economic integration with Mexico. A more prosperous Mexico would boost US exports and increase Mexican investment in the United States.

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18. See OECD, “Taxation Aspects of Electronic Commerce: Publication of Reports and Technical Papers,” [www.oecd.org/tax/treaties/ecommercereportsandtechnicalpapers.htm](http://www.oecd.org/tax/treaties/ecommercereportsandtechnicalpapers.htm).

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## CHAPTER 4

# NAFTA Modernization: A Canadian Perspective

Wendy Dobson, Julia Tory, and Daniel Trefler

The Trump administration is about to begin renegotiating the North American Free Trade Agreement (NAFTA). It believes the deal has been bad for the United States and that Canada and Mexico have been the beneficiaries because they were better negotiators.

In fact, Canada has not fared particularly well under NAFTA. Canada runs a \$78 billion trade deficit with the United States on nonenergy manufacturing, making American manufacturing workers big winners. Further, Canadians pay out \$6 billion a year for the use of American intellectual property (royal payments), making American technology firms big winners. An authoritative study concludes that as a result of the NAFTA tariff concessions, Mexico and the United States experienced gains while Canada experienced losses (Caliendo and Parro 2015).

The negotiations should start by acknowledging that workers throughout North America face disruptions from new technologies and international competition from low-wage countries. These factors are reaching hurricane force as artificial intelligence, robotics, and an increasingly innovative China batter the average North American worker.

Unfortunately, trade negotiations always attract special interests whose agendas are incompatible with competitiveness and the public interest. Of particular concern are voices that seek to reduce innovation and carve out monopolies in new technological areas. These monopolies hurt consumers and reduce countries' ability to compete globally.

For all these reasons, NAFTA negotiators should avoid finger-pointing and trying to gain incremental advantages for narrow special interests in their countries. Instead, they should seek to make the entire region more competitive in the changing global economy. The opportunity to do so exists, because NAFTA has irrevocably cemented cross-border value chains in North America in energy and manufacturing. Any policy

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disruption of these value chains risks sending the North American economy into a tailspin; building on these value chains could strengthen the region as a whole.

In this dynamic context, few would question initiatives to update such trade agreements. Chapter 22 of NAFTA allows members to modify the agreement or withdraw after giving other members six months' notice.<sup>1</sup>

The Trump administration seemed to support the case for modernization in its May 18, 2017 notification, in which US Trade Representative (USTR) Robert Lighthizer signaled the administration's intention to "initiate negotiations with Canada and Mexico regarding modernization of NAFTA" in order to "support higher-paying jobs in the United States and to grow the US economy by improving US opportunities under NAFTA." The administration argues that many NAFTA chapters are outdated and not reflective of modern standards and that implementing and "aggressively" enforcing commitments by trading partners will be vital to successful agreements.

Although the negotiating issues have not been made explicit, the notification identifies 10 areas of focus: intellectual property rights, state-owned enterprises, labor, the environment, small and medium-sized enterprises (SMEs), electronic commerce (e-commerce), regulatory practices, services, customs procedures, and sanitary and phytosanitary measures. Some of these are dealt with in the Trans-Pacific Partnership (TPP), which implies a channel for NAFTA updating. Others are not and no detail is yet available about issues beyond outdated standards. Congress, which has to authorize the negotiations, will likely provide more shaping and elaboration.

NAFTA can be an instrument for win-win negotiations that improve NAFTA by recognizing converging interests; setting new standards appropriate to the changing structure of trade, investment, and people flows; and making NAFTA a living agreement, periodically updated to remain in step with economic change, along the lines adopted in the Canada–European Union Comprehensive Trade Agreement (CETA). To do so, all partners should update and reevaluate the standards and policies referred to in the notification.

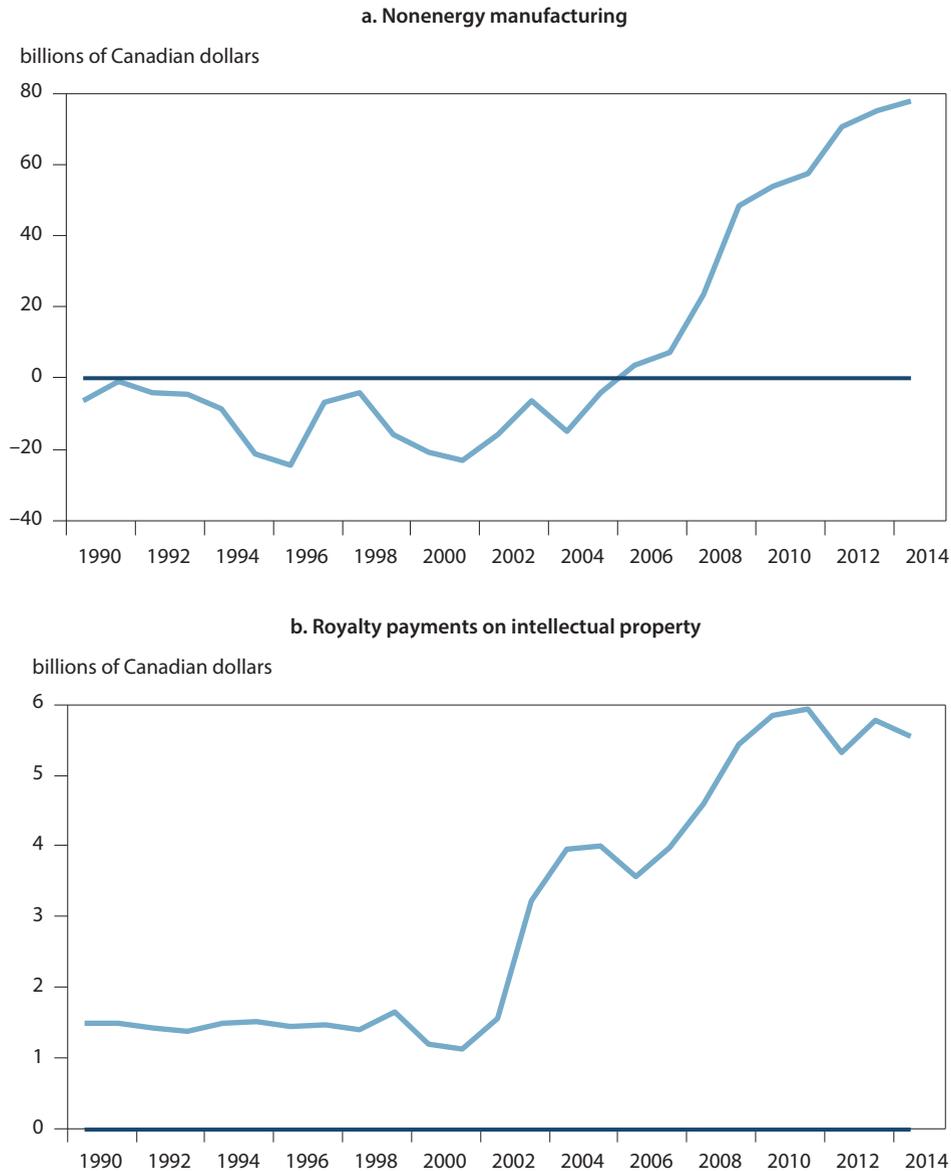
A quarter century has passed since NAFTA went into force. Negotiating full modernization could therefore take years. Canada is willing to enter protracted negotiations that produce a best-on-the-planet trade agreement, but there is broad-based concern that the Trump administration is looking for a "quick win," although Ambassador Lighthizer recently stated that there is no NAFTA timetable. If the United States insists on "quick wins," negotiators would seem to have a choice: At the outset they can limit the set of issues to be negotiated, or they can embark on a comprehensive overhaul that includes a series of attainable short-term goals.

This chapter is organized as follows. The first section demonstrates the risks and pitfalls of framing the negotiation narrowly around trade balances. The second section presents the major common interests all partners share in making North America more globally competitive. The third section examines Canada's interests in NAFTA modernization. The fourth section turns to how Canada might address US concerns about rules of origin; supply management; and Canada's low threshold for customs procedures, duties, and taxes on cross border shipments.

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1. As Article 2202 states, "the Parties may agree on any modification of or addition to this Agreement.... When so agreed, and approved in accordance with the applicable legal procedures of each Party, a modification or addition shall constitute an integral part of this Agreement."

**Figure 1 US trade surplus with Canada, 1990–2014**



Source: Authors' calculations based on Statistics Canada data.

### KEY ISSUES IN CANADA-US TRADE AND TRADE IMBALANCES

The Trump administration is preoccupied with large bilateral trade deficits with many of its trade partners (see [chapter 2](#) by C. Fred Bergsten in this volume). Canada views this concern as a nonstarter, as it leads to only one conclusion: NAFTA is a bad deal for Canada.

Figure 1 displays the US trade balance with Canada between 1990 and 2014. In nonenergy-related manufacturing, the US trade surplus skyrocketed to a massive \$78 billion by the end of the period. The surplus on royalty payments for intellectual property, an issue of repeated USTR complaint, skyrocketed to

\$6 billion in the same period. Were NAFTA's success or failure judged only by the bilateral trade imbalances, the conclusion would be that US manufacturing workers and technology firms, including drug companies, have been big winners from NAFTA and that Canada was the loser.

Yet measured in terms of broad economic benefits, NAFTA has irrevocably cemented cross-border value chains in North America in energy and manufacturing. Canada is the number one market for most US states' exports. By Department of Commerce estimates, in 2015 Canada-US bilateral exports of goods and services supported 1.6 million American jobs. When bilateral investment is added in, the Canadian Embassy estimates that 9 million American jobs were supported. Further, there have been the benefits to consumers of lower prices and greater choice.<sup>2</sup>

## COMMON INTERESTS IN A MODERNIZED NAFTA

Although there are clearly key common interests in modernizing NAFTA, current US discussion tends to be couched in zero-sum terms: Any win by one party is a loss for the others. A modernized NAFTA, updated to a world that has moved on in 25 years, is a major potential tool to promote North American competitiveness from which all three partners would gain. Their common interests are served by promoting innovation through improved chapters on intellectual property and by updating the agreement with a new chapter on e-commerce. Associated changes are needed to promote labor mobility so as to free the flows of knowledge carried by business managers and skilled workers across borders within North America.

### Promoting Innovation and North American Competitiveness

Innovation is one of the keys to competitiveness. A modernized NAFTA should therefore promote innovation. Yet because of certain aspects of US treatment of intellectual property, a modernized NAFTA may discourage innovation.

The early 1980s saw a sudden and unprecedented growth in the legal protection of patents and hence the rights of patent holders (see Landes and Posner 2004).<sup>3</sup> As these rights strengthened, patents became more valuable because they became easier to defend and use to extract settlements in patent infringement cases.

The annual number of patents granted was stable for decades until the 1980s, when it began growing explosively in response to strengthened patent holder rights (figure 2). But research and development as a percentage of GDP was no higher in 2015 than it was half a century earlier, suggesting that almost four decades of increased granting of patents did not produce more innovation, a phenomenon known as the *patent puzzle* (see Boldrine and Levine 2013). The consensus among economists studying innovation is that the US patent system gives patent holders too many rights, which reduce innovation and raise consumer prices, most spectacularly in the case of pharmaceuticals.<sup>4</sup>

Judging by their recent actions, Congress, state legislatures, the Supreme Court, the Food and Drug Administration (FDA), the Department of Justice, and the Federal Trade Commission (FTC) all understand that the US patent system has drifted too far toward protecting the rights of patent holders, data

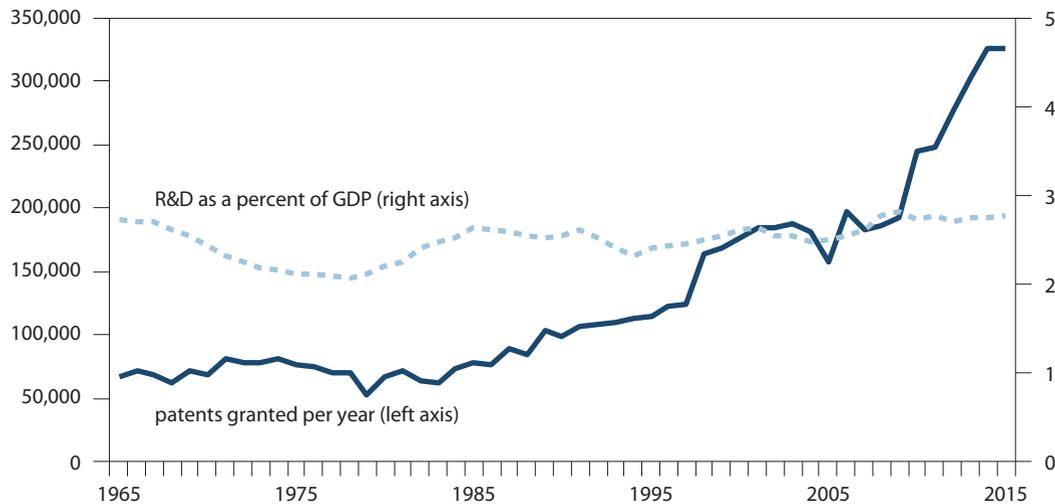
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2. See Melitz and Trefler (2012) for a comprehensive review of these benefits.

3. The rights of holders of copyrights and biologics data also increased.

4. See surveys by Jaffe (2000), Lerner (2000), Landes and Posner (2004), Boldrine and Levine (2013), and Moser (2013), all of whom argue that increased patent protection has not increased innovation and in many instances reduced it. For recent studies showing that patent protection reduces innovation, see Cohen, Gurun, and Kominers (2016) on patent trolls; Hall, Helmers, and von Graevenitz (2015) on patent thickets; Williams (2013) on the human genome; and Galasso and Schankerman (2015) on drugs, biotechnologies, medical instruments, information technology, and electronics.

**Figure 2 The patent puzzle: Number of patents granted and ratio of research and development (R&D) to GDP in the United States, 1965–2015**



Source: Data are from the National Science Foundation and the US Patent and Trademark Office.

holders (in biologics), and copyright holders. All of these institutions and agencies are actively seeking to scale back the scope of intellectual property rights.<sup>5</sup>

What does this mean for NAFTA modernization? Innovation is a key driver of competitiveness, but it is difficult for trade negotiators to measure or regulate innovation. Even modest US attempts to limit the rights of patent holders have required enormous policy flexibility to fight off patent holder interests (Landes and Posner 2004). For new technologies such as biologics, which are in a state of flux, policy flexibility is even more essential to allow regulatory environments to evolve as new technologies mature.

If the goal of forthcoming NAFTA talks is to modernize and promote long-run growth, intellectual property rights should promote rather than inhibit innovation-led growth. North American competitiveness demands policy flexibility in areas related to innovation. It is not that each region necessarily needs its own policy. It is that regulation of these areas is dynamic and should not be locked in by an inflexible international treaty. Flexibility is in the interests of all three NAFTA parties.

A modernized NAFTA is not about Canada versus Mexico versus the United States, it is about consumers. As drug companies and other holders of intellectual property use the USTR to push for strengthened rights, a gap is developing between what the USTR demands and what may be good for the American people.

What this means for the USTR is already apparent in the TPP outcomes in the areas of patents, biologics, and copyrights.

5. For example, the US Supreme Court has restricted patents on DNA, combination products, diagnostics tests, and business methods (Kesselheim, Avorn, and Sarpatwari 2016). Congress passed the America Invents Act of 2011, and the House passed the Innovation Act of 2013. The FDA continues to post articles about ongoing reforms to the regulatory process. The Department of Justice is investigating the inappropriate use of patents in promoting anticompetitive behavior (Scott Morton and Shapiro 2015). In making a case for changes to patent law, the FTC (2011, 3) noted that “we see increasing activity and complexity of business models in markets for patents that do not involve technology transfer. ... This activity risks distorting competition among technologies and deterring innovation.” The International Trade Commission (ITC) bucked the trend. Both the Department of Justice and former USTR Michael Froman rebuked it for doing so.

## Patents

NAFTA modernization should not make it easier for patent holders to use legal arguments that extend the life of patents or make patents easier to defend in court. Among these legal arguments are the following:

1. At the time of filing a patent, evidence must be provided that the idea works. However, when a patent is challenged on the grounds that it was not proven to work at the time of filing, US courts increasingly allow the patent holder to defend the patent using postfiling evidence. Canadian courts have not followed this trend, and a NAFTA panel has ruled in favor of Canada on this issue.
2. Patent holders often seek to lengthen their patent term through patent “extensions” and “restorations.” A justification for lengthening the term of a patent is that a prolonged regulatory review effectively reduces the patent length. In practice, however, patent holders often intentionally and strategically prolong regulatory reviews. To deal with this issue, the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) requires patent terms to start on the date of filing. In contrast, the language of the TPP seems to reinstate regulatory delay as a cause for patent term lengthening. This language would not advance NAFTA modernization.<sup>6</sup>
3. Pharmaceutical firms use a set of practices called “secondary patenting” to very significantly delay the entry of generics and maintain drug prices (Kapczynski, Park, and Sampat 2012). Such practices should be limited in any NAFTA modernization.
4. Pharmaceutical companies sometimes pay enormous sums to generic companies to keep generic products off the market. The US Supreme Court has criticized such pay-for-delay practices as anticompetitive<sup>7</sup> and for good reason: The FTC estimates that the practice raises US drug costs by \$3.5 billion every year. New NAFTA language should ban this practice.

## Biologics

Biologics are complex molecules associated with living organisms. They have much more complicated structures than most conventional drugs and hence a more complex and evolving regulatory environment under the FDA.

Companies are looking to extend patent life via FDA regulatory processes. The pharmaceutical industry argues that protection is necessary given the risks firms take to invest in drug development. These firms earn very high rates of return on equity, however, suggesting that the returns far outweigh the risks.

Under US law, there is a 12-year period during which data generated by a clinical trial can be used exclusively by the company conducting the trial. The data exclusivity period is shorter in the rest of the world (eight years in Canada and the European Union, five years in Australia).

The FDA is actively working on how to regulate data exclusivity and promote generics for biologics (called biosimilars). At a time when rising drug prices have been the focus of public attention, locking in regulatory inflexibility via an international trade agreement would have very undesirable effects, raising drug prices. NAFTA modernization should restrict data exclusivity to no more than eight years, limit its application and introduce provisions to update rules as the biologics industry matures.

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6. There has been some confusion about CETA on this point. The EU regulatory framework for drugs is very different from the framework in Canada and the United States. CETA partially harmonized the two frameworks. The harmonization language has been seized on as evidence that Canada is prepared to consider longer patent terms for drugs, which is not the case.

7. *FTC v. Actavis Inc.*, 133 S. Ct. 2223 (2013).

## Copyright

Under the Berne Convention and Canadian law, copyright material is protected for 50 years after the author's death. The TPP would have added an additional 20 years of protection. There is abundant evidence that such extended copyright enriches copyright holders without inducing any increase in creative output.<sup>8</sup> Further, copyrighted material is less likely to be digitized (Gómez, Uceda, and Keller 2015) and hence less likely to be available to researchers, thus hindering innovation.<sup>9</sup>

In light of this, a modernized NAFTA should contain the following two copyright provisions. First, copyright should be set at 50 years after the author's death: There should be no 20-year extension. Second, there should be clarification of existing "fair use" and "fair dealing" exceptions to copyright. For example, both Canada and the United States should explicitly recognize what they already have in domestic law, namely, a broad educational and research exception. More generally, and in the words of the USTR in 2012, there should be clear "copyright exceptions and limitations for purposes such as criticism, comment, news reporting, teaching, scholarship, and research."

## E-commerce

Trade policy is straining to catch up with the rapid development of e-commerce. The TPP included an e-commerce section on which NAFTA renegotiators could build.

In thinking about an e-commerce transaction between two parties, A and B, who reside in the same country, policy makers must bear two technological facts in mind. First, internet traffic between A and B cannot be confined within national borders, because the Internet routes data in complicated ways. Second, data about the transaction between A and B may be stored on a server located in another country.

TPP's Chapter 14 addresses these issues. Section 14.13 states that a government cannot require a business to locate computing facilities in the government's territory as a condition for doing business (a practice known as localization). It also states that localization requirements are allowed for a legitimate public policy objective. Section 14.8 seems to recognize the protection of personal information as a legitimate public policy objective.

Two differences between Canada and the United States may create disputes. First, Canada tends to have stronger privacy laws than the United States.<sup>10</sup> Second, certain areas of commerce (including health and education) tend to be public in Canada and private in the United States. Canadian and US laws and regulations regarding the use of health data for profit may differ in ways reminiscent of the regulatory differences that led to the softwood lumber disputes. Given these difference, explicit exemptions may be necessary for health, education, and possibly some other areas. In addition, there may be a need to clarify that privacy differences are a legitimate reason for localization.<sup>11</sup>

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8. See, for example, Varian (2005, 127). An amicus curiae filed by 17 Harvard economists in a case relating to the 70-year copyright extension outlines the net harm such extensions cause (see *Eldred v. Ashcroft*, 537 U.S. 186 (2003) (No. 01-618) 2002).

9. Pablo Uceda Gómez and Paul Keller, "The Missing Decades: The 20th Century Black Hole in Europeana," Blog Post, Europeana Pro, November 13, 2015, <http://pro.europeana.eu/blogpost/the-missing-decades-the-20th-century-black-hole-in-europeana>.

10. Canadian privacy concerns have helped consumers on both sides of the border. Facebook, for example, tightened its privacy rules as a direct response to concerns raised by the Privacy Commissioner of the Province of Ontario.

11. In addition, artificial intelligence algorithms used in e-commerce have been in violation of US antidiscrimination laws, so the issues extend beyond privacy.

## **Facilitating Labor Mobility and Trade in Goods and Services**

The need for professionals and skilled workers to cross North American borders has increased steadily as a result of the ongoing deepening of North American supply chains. NAFTA must be updated to facilitate this movement of people. NAFTA special visas facilitate only certain types of activities; work permits are required for others. NAFTA's "positive list" approach (a list of activities for which travel is permitted) presents further barriers to professionals. Moves to facilitate cross-border business should include a review of NAFTA Chapter 16 (on temporary entry for businesspeople) with a view to reducing restrictions. Serious consideration should be given to adopting a negative list approach, like the one included in CETA (a list of activities for which travel is not permitted). Credential recognition of professions should also be revisited, as the professional services that are recognized are very narrowly defined. The CETA provision for mutual recognition provides a potential model. Further opportunities for trade facilitation lie in facilitating goods shipments through the streamlining of customs clearance procedures. As both Canada and the United States have worked for years on joint action plans to reduce border barriers and both have signed the World Trade Organization (WTO) Trade Facilitation Agreement, consideration should be given to integrating similar provisions into a modernized agreement.

## **SAFEGUARDING CANADIAN INTERESTS**

A revised NAFTA should address various Canadian concerns, particularly the scope and operation of dispute settlement mechanisms, government procurement, the Jones Act, and market access concerns such as country of origin labeling (COOL). Some of the tactics used by the Trump administration to advance its "America First" job-creating agenda are of particular concern.

## **Preserving Binational Dispute Settlement Mechanisms**

NAFTA provides for three types of dispute settlement mechanisms. Chapter 11 deals with investor-state dispute settlement (ISDS). Chapter 19 deals with judicial review (whether a country implemented its own laws correctly); it is typically applied to antidumping and countervailing duties calculated by the US Department of Commerce. Chapter 20 deals with state-to-state disputes; it is rarely used.

Chapter 11 was a valuable addition to NAFTA, but could be improved upon. It has been criticized for the lack of independence of its panelists, the weak quality and consistency of panel decisions, and the lack of an appeal process. CETA addresses these criticisms by establishing, among other things, a standing dispute settlement tribunal as well as an appellate body. A modernized NAFTA would benefit from adopting these and other ISDS-related CETA innovations.

The relevance of Chapter 19 has increased in the wake of a series of recent actions against Canada, including allegations of illegal subsidies brought by Boeing against Bombardier and similar allegations against the Canadian softwood lumber industry. These and other cases arise out of US Department of Commerce determinations of dumping or illegal subsidies. Unfortunately, the law and process through which the Department of Commerce arrives at these determinations are often opaque, factually incorrect, and heavily biased against Canadian firms. For these reasons, Canada has a strong interest in strengthening Chapter 19.

The US International Trade Commission (ITC) has been subject to the same criticisms as the Department of Commerce. In addition, the ITC is criticized for its handling of cases involving infringement of US intellectual property by a foreign company. For example, the ITC is twice as likely as a US domestic court

to rule in favor of a US patent holder, and ITC remedies go beyond those offered by US domestic law.<sup>12</sup> The ITC has been expanding the scope of patent and copyright investigations in a way that has adversely affected Canadian interests.<sup>13</sup> A modernized NAFTA would limit ITC remedies against Canadian firms. While strong remedies are needed in dealing with China, they are not needed in dealing with Canada.

Section 232(b) of the Trade Expansion Act of 1962 is used to address national security concerns associated with imports. The Trump administration is increasingly using Section 232(b) investigations as a trade policy tool. The United States is concerned that the massive Chinese industrial overcapacity created through Chinese government subsidies poses a potential threat to the US steel industry and a realized threat to the US aluminum industry. Canada is being caught in the crossfire between the United States and China. Modernizing NAFTA could build on the long history of US–Canada cooperation on steel issues by providing an exemption from Section 232(b)-imposed trade sanctions.

### **Opening Up Government Procurement**

NAFTA renegotiation provides an opportunity to open government procurement markets across North America. Both Canada and the United States have signed the WTO Government Procurement Agreement (WTOGPA); Mexico has not, which helps explain why access to government procurement in NAFTA is more restrictive than in the WTO.

In 2010 Canada and the United States agreed to exempt Canada from certain Buy American provisions and considered the possibility of a long-term agreement; there has been no follow-through since then. While Canadian companies are mostly exempt from the Buy American Act, Canada’s access to transit-related projects remains limited. In a global context in which China is emerging as a major transit-related supplier as a result of generous subsidies and demand from very large public sector projects, it is time to think Buy North American. The North American reality is a bewildering thicket of agreements at various levels of government. Municipalities and off-balance-sheet entities such as Canada’s crown corporations are not covered. This fragmentation makes it easy to avoid government procurement commitments. NAFTA renegotiation could provide an opportunity for Canada and the United States to open government procurement markets further, possibly using CETA as a model for creating more favorable access. If such changes cannot be incorporated into NAFTA because Mexico has yet to sign the WTO Government Procurement Agreement, Canada and the US should adopt a supplementary bilateral agreement.

An example illustrates the potential for improvement. The USTR has criticized the local content requirements used by Hydro-Quebec, a government corporation, in a wind power project. But Hydro-Quebec is not covered by any of Canada’s procurement agreements with the United States, and the United States uses its own domestic content requirements for transit-related projects under the Buy America Act. Canada would like to see the scope of government procurement extended to include permanent waivers to Buy America provisions covering transit-related projects and iron and steel domestic content requirements. It would also like to extend coverage to states, regions, and municipalities, because doing so would increase competition for local infrastructure contracts and increase international market opportunities for North American suppliers.

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12. ITC remedies include embargoes on imports. Under US domestic law, a firm cannot typically exclude a rival from entry without first being required to seek much more limited remedies. For discussions of the ITC, see Scott Morton and Shapiro (2015), Bultman (2017), and the Department of Commerce criticism of the ITC noted in footnote 5 above.

13. See, for example, “Certain Potassium Chloride Powder Products,” ITC Notice 337-TA-1013.

## **Modifying US Legislation Protecting US Shipping between US Ports**

The Merchant Marine Act of 1920 (known as the Jones Act) requires that all ships transporting goods between US ports be built by, owned, and operated by Americans. The blatantly protectionist law affects Canadian interests in shipping on the Great Lakes.

Canada has argued that it should be excluded from the act or be designated a permitted ship builder. NAFTA renegotiation should at least update this outdated law, possibly by removing its applicability to NAFTA countries (see [chapter 5](#) by Gary Clyde Hufbauer and Euijin Jung in this volume).

## **Maintaining Market Access for Canadian Beef and Pork**

The United States introduced COOL requirements in 2009, as part of the 2008 Farm Act; they apply to a wide range of meats and fresh vegetables and fruit. Animals designated as having originated in the United States have to be born, raised, and slaughtered there.

COOL's protectionist impact on Canadian imports is particularly damaging to beef and pork sales. Canada complained to the WTO, where both a dispute settlement panel and the appellate body ruled that the United States violated its WTO obligations. US authorities enforced the ruling in 2015, but in 2017 two states (Wyoming and South Dakota) moved toward reinstating such labeling for beef products sold there. In a NAFTA renegotiation, Canada could demand that the US government take measures to block reintroduction of this trade barrier (see [chapter 5](#)).

## **ADDRESSING US CONCERNS**

Canadian negotiators have an opportunity to address the US administration's reported desire to create jobs and promote growth. One of the top areas of US focus is the revision of rules of origin, in order to increase production within the United States. Indeed, the United States has threatened to replace or augment NAFTA rules of origin with US rules. Canada's supply management policy is another area of US complaint that could be addressed in a way that increases US exports to Canada. Reforming customs treatment of online shopping could also increase US exports and jobs. Caution is necessary, however, to ensure that policy choices align with the realities of North American value chains.

Bargaining and mutual concessions are possible in two high-profile and contentious areas: revising rules of origin and improving supply management. Concessions by both sides would improve the functioning of both economies, save jobs that could be lost in a standoff, and improve prospects for job creation.

## **Revising Rules of Origin**

NAFTA's rules of origin are very complex and subject to widespread complaints that they raise transactions costs to the extent that numerous producers find paying the most-favored-nation (MFN) tariff a less costly and resource-consuming alternative. Under NAFTA, 62.5 percent of a North American-made vehicle must originate in NAFTA countries. Rules of origin are also important in the energy sector, where crude oil shipments containing diluents sourced outside of the NAFTA area can be subjected to tariffs rather than exported duty free.

Renegotiation of NAFTA could adopt rules of origin for crude oil that were negotiated in the TPP, in which diluent accounts for no more than 40 percent of volume. Any move to increase rules of origin in automobiles to the advantage of US producers would have mixed implications for Canada. Initially, the impact would be negative; in the longer term, the effect would be to reduce foreign competition.

The arguments for North American advantages look compelling, but they overlook the realities of competing in global markets. It is likely that anticompetitiveness measures in North America would have negative impacts on global markets and would not increase the competitive positions of exporters or of North American producers in world markets.

### **Improving Supply Management**

US agriculture has been a big winner from NAFTA (see [chapter 8](#) by Cullen Hendrix in this volume). Canada made major concessions in the original NAFTA/Canada-US Free Trade Agreement (CUSFTA) negotiations in order to protect its agricultural marketing boards. Even so, Canada could make goodwill concessions in the NAFTA renegotiation in this area.

Canada's dairy and poultry industries have long been protected by the supply management regime. Canada prices milk based on intended usage, imposes high tariffs on ultrafiltered milk (a protein liquid concentrate used to make cheese), and determines how much milk dairy farmers can produce. This protectionist regime, kept in place by a powerful political lobby, makes it difficult for Canadian producers to access foreign markets. It also exposes Canadian consumers to high milk prices: In 2012 the average price for four liters of milk was \$6.48, compared with \$3.50 in US cities. In 2012 Canada had about 13,000 dairy farms, half of which were located in the province of Quebec, making them a source of sensitivity in Canadian politics (Findlay 2012).

The system is vulnerable to charges by US lobby groups that Canadian policies protect the Canadian market from US exports and therefore destroy American jobs. Canada's room for response is limited by concessions already made to other trade partners in the CETA and TPP negotiations. Market access concessions to Europeans in the CETA negotiations included opening 4 percent of Canadian cheese production (more than 17,000 tons) to European firms. In the TPP negotiations, Canada offered to increase tariff rate quotas gradually over 10–20 years for specified milk products, cheese, eggs, and poultry products (Conference Board of Canada 2017). Refusal to make comparable changes in NAFTA is not an option. Adjustment assistance will also be required for the Canadian industry, something that was already agreed to in the context of the concessions made in CETA and the offer of concessions in the TPP.

### **Increasing the Threshold for Customs, Duties, and Taxes on Cross-Border Shipments**

Canada's levels of value below which international shipments are exempted from customs procedures, duties, and taxes are out of step with its NAFTA partners. The current threshold (C\$20) is one of the lowest in the world. In comparison, the threshold is US\$800 in the United States and US\$300 in Mexico on postal shipments.

Significant benefits could be realized from raising the threshold—not least to taxpayers, given the costs to the government of collecting the duties and taxes (McDaniel, Shropp, and Latipov 2016). Large retailers have resisted change, arguing that it would cost them customers; critics argue that these enterprises have failed to update their business models to account for changing consumer demands. Overlooked are the interests of SMEs, which must become more active in cross-border commerce: The low threshold forces them to pay more than their international competitors do for business inputs. This area is one in which Canada could make concessions to its partners while aiding its own e-commerce and SMEs, which produce the majority of Canadian jobs.

## Resolving the Perennial Disputes over Softwood Lumber

These cases illustrate issue areas in which changes in Canadian policy could improve economic efficiency and create jobs in both Canada and the United States. They are logical components of what could be a “quick” negotiation. Other components include an e-commerce chapter, which would be valuable to both countries and to large corporations such as Google and Amazon.

In return, Canada could require concessions on government procurement and antidumping and countervailing duties, which could include an agreed path to resolve the perennial disputes over softwood lumber. Negotiators should aim for a permanent solution, through negotiation that is separate from the main agreement, for reasons outlined below. Should there be temptation to push for quick fixes on such issues as intellectual property or the Chapter 19 panels, the negotiations would likely drag on for years.

Chapter 19 is particularly significant for its use in addressing the softwood lumber dispute. The US market is Canada’s most important market for lumber exports (although some diversification to China and other markets has occurred in the past 20 years) and one with a sectoral trade surplus. The core trade issue for American producers is the prices their Canadian competitors pay for their wood. In many parts of Canada, lumber is sourced from public (crown) lands, and provincial governments rather than market forces determine prices (stumpage fees). US complainants allege that Canadian imports are subsidized, giving them an unfair advantage in the US market.

For decades, long-running disputes have been resolved by agreements that establish export charges or quota limits on Canadian exports when market prices fall below established levels. The latest softwood lumber agreement expired in October 2016. In subsequent negotiations the United States sought a market share quota for Canadian exports, while Canada sought to reduce export charges.

When no deal was reached, the US lumber industry exercised its rights to file charges of dumping and subsidies with the US International Trade Commission and the Department of Commerce. Antidumping and countervailing duties have now been temporarily imposed and a final determination is due in September 2017.

Canada can invoke a Chapter 19 panel review to challenge the determination. Chapter 19 was created as part of a series of complex compromises in the CUSFTA negotiations. Canada “paid” for the right to Chapter 19 challenges by, among other things, agreeing to continental free trade in energy. US lumber interests have lobbied for Chapter 19 removal since the system was incorporated into NAFTA, but Canada will never agree to this.

It is in Canada’s interest to find a long-term solution to the softwood lumber issue, but institutional differences are at the root of the disagreement. Another Chapter 19 panel review is the most obvious option, but it could exacerbate political tensions and is unlikely to produce a timely decision on the penalties Canadians have already paid.

Canada could seek judicial review in the US Court of International Trade or at the WTO, but neither is likely to provide a clear-cut solution. Some experts predict the US Court’s judicial review would likely defer to Department of Commerce subsidy and dumping findings (Johnson 2017). WTO findings would not legally bind the US government.

The remaining option is to recognize the institutional differences and shift the focus away from anti-dumping or countervailing duties to a permanent negotiated settlement outside of NAFTA. Such an approach could fall victim to special interests, but it could address the institutional differences if Canadian provinces were willing to revise stumpage practices to allow the greater play of market forces. This option may seem politically unpalatable, but it may be the only permanent solution.

## CONCLUSION

The goal of NAFTA renegotiation should be to make North America more competitive, by building on the cross-border value chains in energy and manufacturing that have developed since NAFTA was adopted 25 years ago. Focusing narrowly on the trade balance, by which measure Canada is a big loser from NAFTA, is futile. Instead, the perspective should be much broader, focusing on promoting innovation and competitiveness in today's knowledge-driven world as a common interest shared by all three NAFTA parties. Achieving this goal will require adding a new chapter on e-commerce and updating intellectual property issues. Incorporating forward-looking features agreed to in CETA and the TPP negotiations could help reconcile trade policy interests between Canada and the United States.

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## CHAPTER 5

# NAFTA Renegotiation: US Offensive and Defensive Interests vis-à-vis Canada

Gary Clyde Hufbauer and Euijin Jung

Previous US administrations—whether Republican or Democrat—have focused on reducing barriers to trade and investment during trade negotiations, but the Trump administration will prioritize reducing the US trade deficit when it renegotiates the North American Free Trade Agreement (NAFTA).<sup>1</sup> While President Trump has frequently stressed the US trade deficit with Mexico (about \$60 billion annually), NAFTA talks will necessarily revisit US-Canada commercial relations. Trade barriers remain between the United States and Canada, so a new agreement holds the potential for fresh liberalization. The benefits from mutual reforms will be forgone, however, if Trump insists on extreme and one-sided concessions from Canada.

In NAFTA talks, Trump will emphasize “fairness” and cite both trade balances and mirror image reciprocity to distinguish between “bad deals” and “good deals.” These litmus tests will generally put US commercial relations with Canada in the “good deal” column. As [table 1](#) shows, two-way US trade with Canada, approaching \$700 billion, is practically balanced and, if energy trade is excluded from the tally, the United States enjoyed a goods and services trade surplus with Canada in 2016.<sup>2</sup> Moreover, thanks to NAFTA, nearly all tariffs are zero for three-way trade between Canada, Mexico, and the United States, in this respect satisfying the mirror image reciprocity test.

But a feature that conspicuously fails Trump’s mirror image reciprocity test is Canadian and Mexican border adjustment of taxes in the value-added tax (VAT) family. The Canadian goods and services tax

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1. “Commerce Sec. Ross: ‘One Size Doesn’t Fit All’ When Dealing with Trade,” *Fox News Insider*, March 12, 2017, <http://insider.foxnews.com/2017/03/12/wilbur-ross-commerce-secretary-mexico-nafta-free-trade> (accessed on March 17, 2017).

2. Complementing large two-way trade flows is a large stock of two-way foreign direct investment (FDI), about \$622 billion in 2015, which undergirds and reinforces the trade relationship.

(GST) averages around 13 percent, counting both provincial and federal charges, while the general Mexican VAT rate is 16 percent. Mirror image reciprocity calls either for Mexico and Canada to stop adjusting these taxes at the border (in other words, stop imposing the taxes on imports and exempting exports from the taxes) or for the United States to adopt a similar tax in the VAT family and adjust it at the border. In Trump’s perspective of fair trade, GST and VAT adjustments at the border with Canada and Mexico might be put on the negotiating table. However, while Trump has specifically complained about Mexico’s adjustment of its VAT, he has not leveled a similar complaint against Canada’s adjustment of its GST.

At the negotiating table, each country will advocate its own objectives, using a mercantilist handbook to separate “offensive” and “defensive” interests. In the US offensive column, Trump will seek to lower Canadian barriers to US exports; in the US defensive column, Trump will oppose changes that would lower US barriers to Canadian exports. The *2017 National Trade Estimate Report on Foreign Trade Barriers* (USTR 2017a) lists old and new Canadian barriers that discourage US exports. Other sources identify US barriers that discourage Canadian exports.<sup>3</sup>

The US trade surplus with Canada in nonenergy trade is a card that Canada can play during negotiations. Citing Trump’s logic about trade balances, Canada can emphasize its trade deficit with the United States as a reason for retaining provisions that shield certain sectoral interests from US competition. On the other hand, the United States would rather steer the conversation to Canadian barriers that limit US exports of agricultural and digital products. In recent speeches, Trump has targeted Canadian practices, repeating his characterization of NAFTA as a “disaster.”<sup>4</sup>

This chapter first calls out a few “blockbuster” demands that the Trump administration might raise. The term “blockbuster” refers both to unconventional issues that have not been covered in previous free trade agreements (FTAs) and to sticky points that are very difficult to resolve. This section speculates on elements that might match Trump’s concept of unfair trade. The second section examines “traditional” Canadian barriers to agriculture, intellectual property rights, services, investment, cross-border data flows, and a few other sectors. The third section lays out US defensive interests in softwood lumber, beef, government procurement, cabotage, and a few other sectors. The fourth section identifies topics where the United States and Canada perhaps share a mutual interest in improving NAFTA. To take advantage of the scope for the United States and Canada to liberalize trade in goods and services, to their mutual benefit, the Trump trade team should drop its obsession with trade deficits, at least in talks with Canada, and instead enhance NAFTA through fresh and reciprocal trade liberalization.

**Table 1 US trade balance with Canada and Mexico, 2016** (billions of US dollars)

Component	Canada	Mexico
Exports of goods and services	322	262
Exports of energy	17	22
Imports of goods and services	314	324
Imports of energy	56	9
Trade balance on goods and services	8	-62
Trade balance on goods and services excluding energy	47	-75

Note: Energy includes coal, crude oil, petroleum products, electric energy, and other energy products, using the North American Industry Classification System (NAICS) codes.

Sources: US Bureau of Economic Analysis and US Census Bureau.

3. Other sources include McDaniel, Schropp, and Latipov (2016) and comments from Lawrence Herman and Jeffrey Schott.

4. “Trump promises ‘big changes’ or withdrawal from NAFTA, calls TPA ‘ridiculous,’” *Inside US Trade*, April 18, 2017.

## BLOCKBUSTER DEMANDS

The Trump administration is not a traditionalist when it comes to negotiating trade agreements. Consequently, it's worth speculating on "blockbuster" demands that might be put on the negotiating table with Canada. The first three demands in this section may seem less relevant to Canada since Canada has not been criticized for the US trade deficit. Nevertheless, it is worthwhile highlighting those potential demands because US demands on Mexico may be symmetrically proposed to Canada. Unconventional demands will, however, prolong the negotiation and some will provoke strong opposition in Canada.

### Border Tax Adjustments

Trump has still not declared whether he supports the border tax adjustment (BTA) component of the "cash flow" tax advocated by House Speaker Paul Ryan and Ways and Means Committee Chairman Kevin Brady.<sup>5</sup> The BTA would impose the 20 percent "cash flow" tax on all imported goods and services and exempt all exports. If Trump decides to support the BTA, and if it is enacted by the House of Representatives (two big "ifs"), the US trade team will ask Canada, Mexico, and other countries not to launch cases in the World Trade Organization (WTO) or retaliate in other ways.<sup>6</sup> The unstated threat will be "or else."<sup>7</sup>

If the BTA dies in the US Senate, the US trade team could ask Canada and Mexico to desist from border adjustments for their GST and VAT, respectively, for trade with the United States. Acceding to this request would have huge repercussions in both Canada and Mexico, especially in their business communities. The Canadian dollar and the Mexican peso would probably depreciate by a substantial fraction of the erstwhile GST and VAT border adjustments.

### Trade Balance Chapter

Trump and his trade team are fixated on bilateral trade balances, especially US trade deficits. Multilateral balances and macroeconomic analysis do not appear to enter their calculations. Accordingly, China, Mexico, Germany, Japan, and Korea have been singled out as taking advantage of the United States.<sup>8</sup> Canada escapes criticism both because the bilateral trade balance (all goods and services) is near zero and because the United States runs a bilateral surplus in nonenergy trade (table 1).

Nevertheless, to create a template for other trade agreements, and to guard against future imbalances, the United States might seek a trade balance chapter in the new agreement with Canada. The chapter could (1) place a burden on the trade surplus partner (above a certain threshold) to take measures to reduce its

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5. For more details on the border tax adjustment (BTA), see Hufbauer and Lu (2017); Cline (2017); Bown (2017); Freund and Gagnon (2017); and Caroline Freund, "PIIE Debates Border Adjustment Tax," PIIE RealTime Economic Issues Watch blog, February 9, 2017, <https://piie.com/blogs/realtime-economic-issues-watch/piie-debates-border-adjustment-tax> (accessed on February 27, 2017). Even in his address to Congress on February 28, 2017, President Trump skirted the BTA debate.

6. Shawn Donnan and Demetri Sevastopulo, "Trump team looks to bypass WTO dispute system," *Financial Times*, February 27, 2017, [www.ft.com/content/7bb991e4-fc38-11e6-96f8-3700c5664d30](http://www.ft.com/content/7bb991e4-fc38-11e6-96f8-3700c5664d30) (accessed on February 27, 2017).

7. Specifically, the United States might threaten to impose Section 301 penalties, equal to the amount of VAT remissions, on imports from partner countries that bring WTO cases.

8. Gary Hufbauer and Euijin Jung, "US Bilateral Trade Balances: A New Guide to Trade Policy?" PIIE Trade and Investment Policy Watch blog, November 15, 2016, <https://piie.com/blogs/trade-investment-policy-watch/us-bilateral-trade-balances-new-guide-trade-policy> (accessed on February 27, 2017). In 2015, the respective bilateral surpluses in trade with the United States were: China (\$334 billion); Mexico (\$58 billion); Germany (\$77 billion); Japan (\$55 billion); and South Korea (\$19 billion).

bilateral surplus and (2) allow the trade deficit country to “snap back” to its most-favored-nation (MFN) tariffs if the deficit persists for an undue period.

## Currency Undervaluation Chapter

No one has accused Canada or Mexico of “currency manipulation” (meaning large one-way intervention in the foreign exchange market), but at some point, Canada or Mexico could be accused of “currency undervaluation” (meaning a currency value that strongly favors trade surpluses with the United States). Moreover, to establish a template for other trade negotiations, US trade negotiators might seek a binding currency chapter in agreements with Canada and Mexico. The chapter might cover both manipulation and undervaluation and might contemplate both surveillance and arbitration. Although Canada and Mexico agreed on the Declaration of the Macroeconomic Policy Authorities in the Trans-Pacific Partnership (TPP), designed to promote cooperation on macroeconomic and exchange rate policies, the declaration does not include an arbitration mechanism.<sup>9</sup> Coverage of that nature, accompanied by remedial measures, would intrude on turf historically claimed by central banks, finance ministries, and the International Monetary Fund (IMF). If pursued, these ideas would entail a landmark departure from trade agreements enacted since the Second World War.

To be sure, Article XV of the General Agreement on Tariffs and Trade (GATT) declares, “Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement,” but the practical application of this exhortation has long been consigned to the IMF. Putting teeth in language akin to Article XV in a bilateral or trilateral trade agreement would break a great deal of institutional crockery. This obstacle might be resolved by consigning surveillance and arbitration to the US Treasury and the Canadian and Mexican finance ministries.

## Rules of Origin

Trump is extraordinarily concerned with the fate of the US auto industry, partly for iconic reasons, partly for political reasons (“battleground states”). He has aimed numerous tweets at auto executives urging them to retain and enlarge US plants. In 2016, the US bilateral trade deficit in autos and parts was \$54 billion with Mexico and \$10 billion with Canada. Trump wants to change this picture and ensure that more autos and parts purchased by Americans are produced by Americans. The Trump team could advocate a rule of origin for US auto production within the overall NAFTA rule of origin (currently 62.5 percent, with special rules for large components like transmissions and engines—but all these would likely be tightened). If US demands take this route, the revised rules would be fashioned to shift more auto parts and assembly production to the United States. An obvious limitation of the rule of origin approach to bolstering US production is that the US MFN tariff on autos is just 2.5 percent, and tariffs on auto parts are generally less than 4 percent, so auto companies might choose to pay the tariffs and ignore the tighter rules of origin. To cut off this response, the Trump team might advocate a higher MFN tariff, despite US bound tariff obligations in the WTO.

Rules of origin for textiles and apparel and electronic goods could likewise be “tweaked” (Trump’s phrase with respect to Canada) to foster US production.<sup>10</sup>

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9. See Joint Declaration at [www.treasury.gov/initiatives/Documents/TPP\\_Currency\\_November%202015.pdf](http://www.treasury.gov/initiatives/Documents/TPP_Currency_November%202015.pdf) (accessed on April 17, 2017).

10. Andrea Hopkins, “Trump expects only ‘tweaking’ of trade relationship with Canada,” Reuters, February 13, 2017, [www.reuters.com/article/us-usa-trump-canada-idUSKBN15S14S](http://www.reuters.com/article/us-usa-trump-canada-idUSKBN15S14S) (accessed on February 27, 2017).

## Review of Antidumping and Countervailing Duty Determinations

NAFTA Chapter 19 provides a mechanism to review final determinations in antidumping (AD) and countervailing duty (CVD) cases. Under this mechanism, binational panels of five experts can be established to review whether CVD and AD cases have been decided in a reasonable manner consistent with a country's national laws. The United States was never enthusiastic about this "second look" at US trade remedy determinations and frequently resorted to delaying tactics when Canada or Mexico sought a Chapter 19 review.

In the renegotiation of NAFTA, the United States may seek to drop Chapter 19 and instead consign all disagreements over AD and CVD determinations to the WTO Dispute Settlement Body. However, in its *2017 Trade Policy Agenda and 2016 Annual Report*, the US Trade Representative (USTR 2017b) essentially declared it would ignore WTO rulings that it regards as unreasonable. Given the likely surge in US AD and CVD cases, with the encouragement of Commerce Secretary Wilbur Ross,<sup>11</sup> both Canada and Mexico will resist any attempt to jettison Chapter 19. From the standpoint of Canada and Mexico, a big advantage of Chapter 19 is that a favorable resolution under that chapter leads to a retroactive refund of wrongly imposed AD or CVD duties. Retroactive relief is not available under the WTO dispute settlement system.

## Telecommunications

The Canadian threshold for foreign ownership in telecommunications is one of the most restrictive regimes among advanced economies. If a facilities-based telecommunications service supplier has more than 10 percent market share, Canada applies a 46.7 percent limit on foreign ownership of the supplier; further, more than 80 percent of members on the board of directors must be Canadian citizens. These restrictions prohibit the presence of US firms in the Canadian telecommunications market in the legal form of wholly US-owned operators, instead forcing them to rely on Canadian operators. By contrast, in the United States, telecommunications service providers are not subject to foreign ownership restrictions. With approval from the Federal Communications Commission (FCC), common carrier wireless licensees may have more than 25 percent foreign ownership. The United States could ask for mirror image reciprocity in this sector.

## Canadian Broadcasting Content

The Canadian Radio-Television and Telecommunications Commission (CRTC) imposes quotas on Canadian programming expenditure (CPE) and Canadian programming hours (Exhibition quotas). Large English language private broadcasting groups must spend at least 30 percent of their gross revenue on CPE. They must show a minimum of 50 percent Canadian programming during primetime hours (6pm to 11pm). Non-English broadcasting groups face a lower quota: 35 percent Canadian programming to air throughout the day. For cable television and direct-to-home broadcast services, the ratio of Canadian programming services must be more than 50 percent of the channels. Non-Canadian channels are required to obtain preapproval from the CRTC.

A new Wholesale Code released by the CRTC took effect in January 2016, to the discomfort of US stakeholders. The Wholesale Code governs commercial arrangements between broadcast distribution, programming, and exempt digital media. The previous Wholesale Code was designed for Canadian programming suppliers who own video distribution infrastructure and programming in Canada. The new

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11. "Commerce could resume self-initiation of AD, CVD cases if Ross confirmed," *Inside US Trade*, January 18, 2017. In recent cases, the US Department of Commerce issued its preliminary determination to impose CVDs on Canadian softwood lumber and initiated an AD and CVD investigation on Canadian aircraft producer Bombardier.

code applies to foreign programming suppliers: They are not allowed to own such distribution facilities. In renegotiation talks, the United States might seek to scrap these rules, which would, however, provoke a strong Canadian backlash.

In short, Trump's potential blockbuster demands have both market closing and opening features. His rhetorical support for some form of border taxation, equivalent bilateral imports and exports, and rules of origin that ensure greater automotive production in the United States all portend more protective fences around US markets. On the other hand, potential demands to relax Canadian telecommunications and broadcasting rules have a market opening character. Trump appears to advocate a "give nothing and take everything" approach. If so, and if coupled with blockbuster demands, the renegotiation of NAFTA could take years to conclude.

## **TRADITIONAL US OFFENSIVE INTERESTS<sup>12</sup>**

Apart from such blockbuster demands, the United States can be expected to pursue a long list of offensive requests that have been on the table for years, if not decades.

### **Agricultural Barriers**

Canada's supply management system regulates its dairy, chicken, and egg industries and imposes tariff-rate quotas (TRQs) on imports to buttress high domestic prices. Claimed as a means of shielding Canadian farmers (especially those in Quebec) from price volatility, the supply management system is controversial within Canada because consumers pay much higher prices for dairy products than consumers in other countries.<sup>13</sup> Imports from the United States (and elsewhere) in excess of quota levels are subject to steep MFN tariffs, raising prices for Canadian consumers and deterring sales by US farmers. Notable examples include above-quota tariffs of 245 percent on cheese and 298 percent on butter.

#### **Seeds and Grains**

Under the Canadian Seeds Act, varietal sales are prohibited unless the variety is registered in a prescribed manner. The registration system is claimed to serve health, safety, and antideception purposes. However, registration generally takes six to eight weeks, which can be burdensome. Unlike Canada, the US federal government does not operate a seed variety registration system.

The Canadian Grain Act probably hinders US wheat and barley exports. Under the Act, the Canadian Grain Commission establishes distinct grades for "western grain" and "eastern grain." The grades translate into grains grown within Canada, which implies that only Canadian grains are eligible for official grading, not imports from the United States. Without the benefit of a Canadian grade, high-quality US wheat and barley are classified as feed grade (the lowest grade), which leads to price discounts.<sup>14</sup> In addition, most Canadian grain sales benefit from bulk handling through grain elevators, while most US grain imports are blocked as a consequence of the grading system. In short, the Act effectively discounts the value of high-quality US grain. By contrast, the US grading system is based on grain quality characteristics, not on geographic location, and provides equal access to bulk facilities and grain elevators for imports.

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12. This section is largely based on the Canada chapter in USTR (2017a).

13. Findlay (2012) finds that Canada's supply management system costs \$276 per family per year more.

14. Under the Canada Grain Act, grain of varieties registered under Canada's Seed Act may receive a grade higher than the feed grade.

Proposed legislation would reform the Canadian Grain Act. The Modernization of Canada's Grain Industry Act, introduced in the House of Commons in December 2014, would enable US grain varieties to receive an official Canadian grade. However, the bill has been stalled.

## Dairy Standards

Canada's regulations on compositional standards require that cheese derive a minimum amount of casein from milks that meet or exceed designated percentages for their total protein content. US dairy exporters complain that this regulation amounts to a technical trade barrier since US dairy producers use different technologies.<sup>15</sup>

The Canadian dairy industry has also pushed a national ingredient strategy that allows Canadian dairy processors to purchase domestic ingredients at discounted prices (namely world market prices).<sup>16</sup> This program was originally intended to reduce a price gap between Ontario and other provinces. The background story is that Ontario first launched its own program that offered lower prices for dairy ingredients for dairy manufacturers. The Ontario program placed other provincial dairy products at a disadvantage in the national Canadian market. Consequently, Canada's federal Milk Supply Management Committee (CMSMC) introduced a tentative program to provide competitive prices for dairy ingredients to all Canadian dairy processors, categorizing such ingredients under Milk Class 4(m).

Under NAFTA, Canadian cheese manufacturers have increased their consumption of ultra-filtered milk (also called nonfluid protein) imported from the United States. It is a cheaper substitute for liquid skim milk because it enters Canada tariff free and quota free. However, the new CMSMC program would add liquid skim milk to dry and liquid milk protein concentrate under Milk Class 4(m) and include a wider range of Canadian dairy ingredients under Milk Class 7, thereby providing discounted prices for dairy processors and undercut US exports.

This initiative prompted a surge of criticism from US dairy exporters, claiming that it violates NAFTA and would put US exports at a disadvantage.<sup>17</sup> Speaking in Wisconsin, President Trump amplified these complaints.<sup>18</sup> At the moment, implementation of the Canadian national ingredient strategy has been delayed.

In a similar vein, Canada established the Special Milk Class Permit Program (SMCPP), which allows Canadian dairy processors to purchase domestic milk components at discounted prices (again, world prices). This program makes Canadian milk more competitive and thus could limit US exports.<sup>19</sup>

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15. Very early, Felt, Larue, and Gervais (2012) suggested that cheese compositional "standards may have had an impact on the ability of foreign firms to compete in the Canadian market."

16. Contrary to this strategy, domestic dairy ingredients are generally set at prices well above world levels, controlled by Canada's national supply management system.

17. "Canada delays implementation of dairy strategy as US criticism mounts," *Inside US Trade*, November 11, 2016; the interest group estimates that companies in Wisconsin and New York lose \$150 million worth of ultra-filtered milk exports. See [www.nmpf.org/latest-news/press-releases/jan-2017/jan-11-canada%E2%80%99s-protectionist-policies-will-harm-us-economy](http://www.nmpf.org/latest-news/press-releases/jan-2017/jan-11-canada%E2%80%99s-protectionist-policies-will-harm-us-economy) (accessed on March 21, 2017).

18. White House, "Remarks by President Trump on Buy American, Hire American Executive Order in Kenosha, Wi," April 18, 2017, [www.whitehouse.gov/the-press-office/2017/04/18/remarks-president-trump-buy-american-hire-american-executive-order](http://www.whitehouse.gov/the-press-office/2017/04/18/remarks-president-trump-buy-american-hire-american-executive-order) (accessed on May 19, 2017).

19. The main objective of this program is to increase the competitiveness of local dairy products against foreign products. The discounted prices of milk components are calculated each month based on US milk and dairy product prices published by the US Department of Agriculture, and on a pricing formula created in a consultative process. For more details, see Canadian Dairy Commission, [www.milkingredients.ca/index-eng.php](http://www.milkingredients.ca/index-eng.php) (accessed on February 9, 2017).

## Wine, Beer, and Spirits

In Canada, provincial import barriers on alcoholic beverages are deliberately more restrictive than federal barriers. When Canadians return from the United States, their personal imports of US wine, exceeding one bottle duty free, face high provincial taxes (e.g., 85 percent in British Columbia).

Most Canadian provinces have their own liquor control boards, which are the sole authorized sellers of wine, beer, and spirits. The boards implement their own market access restrictions. In British Columbia, imported wines are banned from grocery shelves, unlike local wines. In January 2017, the USTR launched a case against Canada in the WTO, claiming that British Columbia's regulation discriminates against the sale of US wine in Canadian grocery stores.<sup>20</sup>

## Geographical Indications

Geographical indications (GIs) are names that designate specific places where goods are made and convey reputational value for the products in question. Many GIs for wines, spirits, meats, and cheeses originated in European countries, and the European Union has long sought their recognition and protection worldwide. Champagne, Bordeaux, Roquefort, and Parma Ham are well-known examples. Canada and the European Union concluded the Canada-EU Comprehensive Economic and Trade Agreement (CETA) on August 5, 2014, which was ratified by the EU Parliament on February 15, 2017, and is now provisionally applied pending ratification by the EU member states.<sup>21</sup> Under CETA, Canada granted the highest level of protection to the great majority of the European Union's proposed list of 145 GI names. Accordingly, US agricultural and food products will not be allowed to use the 145 protected GIs for export to Canada.

## Other Barriers

### Personal Duty and Tax Exemptions

Canadian personal exemptions are much more restrictive than their US counterparts. If a Canadian resident's foreign trip lasts more than 48 hours, up to C\$800 of goods purchased abroad are exempt from duties and the Canadian GST. If the value of the goods exceeds C\$800, then duties and taxes are applicable only on the amount of the imported goods that exceeds C\$800. If a Canadian's trip abroad lasts more than 24 hours but less than 48 hours, the duty-free and tax-free allowance is up to C\$200. If the value of the purchases exceeds C\$200, duties and taxes are applicable on the entire amount of the imported goods.<sup>22</sup> This is similar to the US allowance. US duties are imposed on the total purchased goods over \$200 if a traveler has been abroad less than 48 hours (for a traveler spending longer than 48 hours abroad, personal duty exemption is allowed for \$800).<sup>23</sup> The major difference affects very short trips. If a US traveler's trip abroad lasts less than 24 hours,

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20. United States Trade Representative, "United States Challenges Canadian Trade Measures That Discriminate Against U.S. Wine," January 18, 2017; the British Columbia government plans to grant a limited number of new licenses that permit the sales of only local wines in grocery stores. See [www.straight.com/food/813541/california-wine-producers-claim-bc-liquor-reforms-violate-nafta-gatt-and-eu-canada-agreement](http://www.straight.com/food/813541/california-wine-producers-claim-bc-liquor-reforms-violate-nafta-gatt-and-eu-canada-agreement) (accessed on February 9, 2017).

21. European Commission, "European Commission welcomes Parliament's support of trade deal with Canada," press release, February 15, 2017, <http://ec.europa.eu/trade/policy/in-focus/ceta/> (accessed on February 22, 2017).

22. Canada Border Services Agency, "Residents Returning to Canada," [www.cbsa-asfc.gc.ca/travel-voyage/ifrc-rpcrc-eng.html](http://www.cbsa-asfc.gc.ca/travel-voyage/ifrc-rpcrc-eng.html).

23. See US Customs and Border Protection, "Types of Exemptions," at [www.cbp.gov/travel/international-visitors/kbyg/types-exemptions](http://www.cbp.gov/travel/international-visitors/kbyg/types-exemptions) (accessed on June 8, 2017).

he or she can bring home up to \$200 duty-free goods, but similar Canadian travelers must pay both duties and taxes on their purchased goods. Clearly this discourages Canadian travelers from shopping in US stores.

Likewise, the low Canadian *de minimis* threshold discourages internet purchases from US sellers. The *de minimis* threshold sets a maximum value for imported goods (by post or express delivery) below which tax and duty are not charged and the customs declaration is very simple. Canada's threshold is C\$20, one of the lowest among advanced economies. In comparison, the US *de minimis* threshold was raised to \$800 in February 2016. A higher Canadian threshold would benefit not only US firms, including online retailers and express delivery companies, but also Canadian consumers and many business firms in terms of lower prices of goods and greater efficiency by reducing time and costs of delivery at customs. A higher threshold would increase the volume of low-value (and small sized) shipments between the United States and Canada. Total direct economic benefits to Canadians from raising the *de minimis* threshold are estimated between C\$202 million and C\$648 million (see McDaniel, Schropp, and Latipov 2016).

### Intellectual Property Rights (IPR)

The USTR objects to the patent utility test adopted by Canadian courts, namely the “promise doctrine.”<sup>24</sup> It means that a patent applicant must demonstrate that its invention provides sufficient usefulness as of the Canadian filing date to be patentable. The problem with this doctrine is that the usefulness of pharmaceuticals may be demonstrated only by clinical trials conducted after the patent application. Yet Canadian courts have invalidated patents held by US pharmaceutical companies, finding that the “promise” of the patent was insufficiently substantiated on the filing date. Notably, Canadian federal courts ruled that two Eli Lilly patents were invalid because the drugs did not satisfy their “promised” utility on the filing date.<sup>25</sup> “Promise” is something of a Catch 22 doctrine because if Eli Lilly had waited to file its patent until clinical trials had been completed, it might have lost out to a rival firm. In late 2012, Eli Lilly brought a case against the Canadian government asserting violation of NAFTA. In March 2017, the tribunal convened by the International Centre for the Settlement of Investment Disputes (ICSID) rejected Eli Lilly's claims and awarded about \$3.7 million in costs to Canada.<sup>26</sup> Nevertheless, the United States might seek to overturn the “promise doctrine” in a revised NAFTA text.

As for IPR enforcement, Canada's Combating Counterfeit Products Act, enacted December 9, 2014, did not enable Canadian customs officers to inspect and detain pirated and counterfeit goods that travel through Canada on their way to the United States. Accordingly, Canada remains on the Watch List in USTR's 2016 *Special 301 Report* (USTR 2016), regarding country IPR protection.

### Domestic Support Measures

The Canadian federal government funds the Strategic Aerospace and Defense Initiative (SADI) for R&D projects in the aerospace, defense, space, and security areas, having authorized C\$1.53 billion since 2007. Meanwhile, the Quebec provincial government persuaded Bombardier to maintain its aircraft manufacturing operations in Quebec for 20 years, by purchasing 49.5 percent of the equity in a CSeries joint venture

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24. This section is largely drawn from USTR (2016), which covers more detailed concerns about intellectual property rights protection with regard to Canada.

25. “US sides with Canada on NAFTA interpretation in Eli Lilly ISDS case,” *Inside US Trade*, April 24, 2016.

26. International Centre for the Settlement of Investment Disputes, “Final Award,” Case No. UNCT/14/2, March 16 2017, [www.italaw.com/sites/default/files/case-documents/italaw8546.pdf](http://www.italaw.com/sites/default/files/case-documents/italaw8546.pdf) (accessed on March 29, 2017).

for C\$1 billion in 2015. In the future, the Canadian federal government could support commercial sales of CSeries aircraft in the US market.

Aircraft and aerospace design and production have a long history of public subsidies worldwide. From time to time these subsidies provoke trade battles. Canadian programs may fall into that pattern. No US-Canada disputes had erupted in aerospace until Boeing filed an AD and CVD petition with the US Department of Commerce (DOC) against Bombardier on April 27, 2017. Boeing alleged that Bombardier has received massive government subsidies in the form of “launch aid,” which distorts trade by removing development risks and, as a result, Bombardier can sell the CSeries aircraft to US air carriers at below the relevant market price.<sup>27</sup> When DOC initiated the AD and CVD investigation on Bombardier, the Canadian government threatened to cancel its plan to purchase Boeing fighter jets.<sup>28</sup>

### Investment Barriers

The Investment Canada Act (ICA) requires prospective foreign investors to notify Industry Canada or the Department of Canadian Heritage. Direct or indirect acquisition of Canadian firms by foreign investors are then subject to review and ministerial approval if the investment in acquiring the Canadian firm equals or exceeds a threshold of C\$600 million.<sup>29</sup> Proposed investments should demonstrate the likelihood of “net benefit” to Canada. Net benefit criteria include effects on employment, productivity, R&D, competition, and the compatibility of the investment with national industrial, economic, and cultural policies.<sup>30</sup> These criteria are more subjective than the “national security” test in US legislation that governs the Committee on Foreign Investment in the United States (CFIUS). Trump could seek to emulate the more subjective Canadian approach when vetting foreign investments in the United States, especially from China. However, investment barriers do not appear to be an issue in Canada-US relations, since complaints have not been voiced by US firms trying to acquire Canadian firms.

### Cross-Border Data Flows

As a major information technology (IT) services exporter, the United States strongly supports the free flow of data across borders. However, many countries prevent the transfer of certain data abroad, for national security, privacy, and industrial development reasons. Canada is one of them.

At the provincial level, British Columbia and Nova Scotia have set privacy rules that require personal information collected by schools, universities, hospitals, government-owned utilities, and public agencies to be stored and accessed in Canada. The purchase of US services that could store personal information in the United States is prohibited. Privacy rules of this type would be a bigger problem for US service providers if other Canadian provinces decided to adopt them.

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27. “Boeing files AD and CVD complaint against Canada’s Bombardier,” *Inside US Trade*, May 4, 2017.

28. “Analysts: Canada getting ‘tough’ by linking defense procurement to Bombardier AD, CVD case,” *Inside US Trade*, May 22, 2017.

29. The threshold rose to C\$800 million in April 2017 and will rise to C\$1 billion in 2019. See Government of Canada, “Regulations Amending the Investment Canada Regulations,” *Canada Gazette*, March 25, 2015, [www.gazette.gc.ca/rp-pr/p2/2015/2015-03-25/html/sor-dors64-eng.php](http://www.gazette.gc.ca/rp-pr/p2/2015/2015-03-25/html/sor-dors64-eng.php) (accessed on February 15, 2017); Oliver J. Borgers and Michele Siu, “Investment Canada Act Review Threshold increases to C\$800 Million,” *Canadian M&A Perspectives*, April 24, 2017, <http://www.canadianmergersacquisitions.com/2017/04/24/investment-canada-act-review-threshold-increases-to-c800-million> (accessed on June 2, 2017).

30. For more details, see Government of Canada, “Investment Canada Act,” [www.ic.gc.ca/eic/site/ica-lic.nsf/eng/h\\_lk00007.html#q8](http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/h_lk00007.html#q8) (accessed on February 15, 2017).

US service providers are prevented from bidding on the Canadian federal government project under the Shared Service Canada Act. Created in August 2011, Shared Service is designed to ensure more efficient, reliable, and secure IT infrastructure for the delivery of Canadian government programs and services.<sup>31</sup> Under this procurement project, the Canadian government requires firms to store and process data within the Canadian territory. The prohibition of cross-border data flow prevents some US service exporters, such as “cloud” computing suppliers, from participating in the Shared Service project. To qualify as bidders, US service providers would need to establish data storage and processing facilities in Canada, an expensive proposition. But US government procurement is also highly restricted for foreign firms.

## TRADITIONAL US DEFENSIVE INTERESTS

Canada has its own list of US barriers that prevent Canadian exports or otherwise disadvantage Canadian commerce. From the US perspective, these are defensive interests.

### Softwood Lumber

Lumber is an important industry in both Canada and United States, and trade disputes can be traced back more than a century. To resolve the latest chapter in the modern but long-running “softwood lumber wars,” which started in the 1980s, Canada and the United States signed the fourth Softwood Lumber Agreement in 2006. A key provision established export charges and/or quota limits on Canadian lumber exports to the United States when the price of US softwood lumber products falls below \$355 per thousand board feet.<sup>32</sup>

After the agreement expired on October 6, 2016, the Obama administration launched bilateral negotiations to establish a new chapter but no conclusion was reached. Canada sought more flexibility in applying export charges while the United States demanded a market share quota not to exceed 22 percent for Canadian softwood lumber exports.<sup>33</sup>

In the absence of a new agreement, the US lumber industry filed petitions with the US International Trade Commission (USITC) and the US Department of Commerce (DOC) against Canadian producers, claiming Canadian subsidies and dumping practices. On January 6, 2017, the USITC issued a preliminary determination finding material injury to the US lumber industry.<sup>34</sup> DOC announced its preliminary determination that Canadian softwood lumber producers have received countervailing subsidies ranging from 3.02 to

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31. The Shared Service priorities are to migrate 43 government agencies and departments from various email services into a single platform, to consolidate data centers, and to strengthen the security of government data and technology assets.

32. Under the agreement (now expired), if the price of US softwood lumber ranged between \$336 and \$355 per thousand board feet (MBF), Canadian softwood exports had to pay a 5 percent export charge, or a 2.5 percent export charge with volume restraints, for shipments to the US market. If the price ranged between \$316 and \$335 per MBF, Canadian softwood lumber had to pay a 10 percent export charge, or a 3 percent export charge plus volume restraints. If the price dropped below \$315 per MBF, the export charge rose to 15 percent, or 5 percent and volume restraints. See Hoover and Fergusson (2016).

33. “ITC to continue lumber investigation as Canada rejects latest US proposal,” *Inside US Trade*, January 12, 2017. Hoover and Fergusson (2016) find that, since 2006, the Canadian share of the US softwood lumber market has averaged 28 percent annually. President Carter endorsed the penalty duties supported by the White House and the Commerce Department. See Jimmy Carter, “Trump is right. Canada’s lumber trade practices are unfair,” *Washington Post*, May 9, 2017, [www.washingtonpost.com/opinions/jimmy-carter-trump-is-right-canadas-lumber-trade-practices-are-unfair/2017/05/09/249c7bb4-31b8-11e7-8674-437ddb6e813e\\_story.html?utm\\_term=.fa099addfbd6](http://www.washingtonpost.com/opinions/jimmy-carter-trump-is-right-canadas-lumber-trade-practices-are-unfair/2017/05/09/249c7bb4-31b8-11e7-8674-437ddb6e813e_story.html?utm_term=.fa099addfbd6) (accessed on May 19, 2017).

34. US International Trade Commission, “USITC Votes to Continue Investigations on Softwood Lumber Products from Canada,” January 6, 2017, [www.usitc.gov/press\\_room/news\\_release/2017/er010611702.htm](http://www.usitc.gov/press_room/news_release/2017/er010611702.htm) (accessed on February 14, 2017).

24.12 percent. In response to the US tariff on lumber, the Canadian government is considering a federal ban on US thermal coal shipments transiting British Columbia ports and considering imposing duties on exports from Oregon.<sup>35</sup> Also, preliminary antidumping determination that Canadian companies sell softwood lumber in the United States at less than its fair value is scheduled in June 2017. Once DOC and USITC make final determinations, DOC will issue a countervailing duty order on Canadian softwood lumber producers.<sup>36</sup>

In renegotiation talks, the United States could use preliminary DOC and USITC determinations as leverage to impose its quota solution in the next chapter of the “softwood lumber wars.” Alternatively, Canada could play other bargaining chips as leverage for a modified export charge solution.

## Beef and Pork

Recently Wyoming and South Dakota launched efforts to reinstate mandatory country of origin labeling (COOL) requirements at the state level. On February 3, 2017, Wyoming introduced a bill to require COOL for retail beef products sold in the state.<sup>37</sup> South Dakota is contemplating a similar COOL bill.

Under the 2008 Farm Act, COOL was implemented as a national measure in March 2009, requiring retail stores to label the country of origin for food products such as fresh fruits and vegetables, fish, and ground and muscle cuts of beef, pork, lamb, chicken, and other items. Under this Act, a US origin mark was awarded only to an animal that was born, raised, and slaughtered in the United States. If cattle are born and raised in Canada and slaughtered and processed in United States, they receive two country of origin marks, both US and Canadian origin.

While somewhat useful for consumers, COOL requirements discriminate against imported products, especially beef and pork, owing to the high cost of monitoring a separate supply stream in slaughterhouses. Canadian objections led to a WTO case against the United States. The WTO Dispute Settlement panel and the Appellate Body ruled that the federal COOL requirement violated US trade obligations.<sup>38</sup> On December 18, 2015, the US Department of Agriculture halted enforcement of COOL requirements for muscle cut and ground beef and pork.

State-level COOL requirements conflict with the WTO ruling and decisions by the US federal government. Canada could seek federal preemptive legislation in renegotiation talks.

## Government Procurement

The US public sector is one of the largest procurement markets in the world, since US federal and state government procurement account for 10 percent of US GDP.<sup>39</sup> However, the United States is far more

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35. “Ross to Canada: Threats of retaliation for lumber duties ‘inappropriate’,” *Inside US Trade*, May 11, 2017.

36. The final determination on CVD is expected on September 7, 2017. See the press release from Department of Commerce on April 24, 2017, [www.commerce.gov/news/press-releases/2017/04/us-department-commerce-issues-affirmative-preliminary-countervailing](http://www.commerce.gov/news/press-releases/2017/04/us-department-commerce-issues-affirmative-preliminary-countervailing) (accessed on May 3, 2017).

37. “Two States Move to Require COOL Labeling for Beef: Country of Origin,” *National Law Review*, February 6, 2017, [www.natlawreview.com/article/two-states-move-to-require-cool-labeling-beef-country-origin](http://www.natlawreview.com/article/two-states-move-to-require-cool-labeling-beef-country-origin) (accessed on February 22, 2017). For in-depth analysis on COOL, see Bown (2016).

38. For more details, see Greene (2015).

39. Canadian government procurement represents 13 percent of Canadian GDP. See Organization for Economic Cooperation and Development (OECD), *Government at a Glance—2015 edition: Public procurement*, <http://stats.oecd.org> (accessed on February 21, 2017).

protective than Canada with respect to government procurement. The protective edge was recently sharpened by President Trump's call to "Buy American and Hire American."<sup>40</sup>

The Buy American Act of 1988 (an amended version of the original Buy American Act of 1933) and related executive orders limit foreign participation in the US federal procurement market through bid preferences for US firms and other discriminatory tests.

The Act allows the president to waive discriminatory requirements in order to comply with US liberalization commitments under the WTO Agreement on Government Procurement (GPA) and procurement chapters in US FTAs. Under NAFTA, the United States scheduled 53 government entities and 6 government enterprises for liberalization.<sup>41</sup> Covered procurements valued at or above specified US dollar thresholds are open to bids by Canadian and Mexican firms. US federal government entities, such as the Department of Defense, have a \$77,533 threshold for goods and services and a \$10 million threshold for construction contracts open to Canadian and Mexican bids. For government enterprises, the US thresholds are set at \$387,667 for goods and services and \$12 million for construction services.<sup>42</sup>

The American Recovery and Reinvestment Act of 2009 (ARRA, also known as the stimulus act) disrupted these NAFTA commitments. Under ARRA, Buy American requirements for projects needing iron, steel, or manufactured goods were waived only if the mandatory use of made-in-USA products would increase the total cost of a project by more than 25 percent. The immediate effect of this measure was that ARRA-financed procurement at the state and local levels for iron, steel, and manufactured products was effectively shut down to Canadian bidders. The ensuing debate was resolved by a 2010 agreement between Canada and the United States that allowed Canadian iron, steel, and manufactured goods to be used in future ARRA-financed procurement projects.<sup>43</sup> Bearing this episode in mind, Canada might seek a restatement of the 2010 agreement, especially since Trump's economic plans contemplate major infrastructure spending (see Robertson 2017).

## Jones Act

The Jones Act (originally called the Merchant Marine Act of 1920) requires vessels that carry goods between US ports be built in the United States and owned and operated by Americans. The Act applies both to coastal ports and Great Lake ports and is an extremely protective and costly piece of legislation. US Senator John McCain has been a tireless advocate for repeal, arguing that abolishing the Jones Act could lower shipping costs by 22 percent.<sup>44</sup>

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40. White House, "Presidential Executive Order on Buy American and Hire American," April 18, 2017, [www.whitehouse.gov/the-press-office/2017/04/18/presidential-executive-order-buy-american-and-hire-american](http://www.whitehouse.gov/the-press-office/2017/04/18/presidential-executive-order-buy-american-and-hire-american) (accessed on April 18, 2017).

41. The six government enterprises are Tennessee Valley Authority, Bonneville Power Administration, Western Area Power Administration, Southeastern Power Administration, Southwestern Power Administration, and St. Lawrence Seaway Development Corporation.

42. Office of the United States Trade Representative, "Procurement Thresholds for Implementation of the Trade Agreements Act of 1979," in *Federal Register Notice with 2016-2017 Thresholds* 80, no. 240, December 15, 2015, <https://ustr.gov/issue-areas/government-procurement/thresholds> (accessed on February 21, 2017).

43. However, the federal government allocated the bulk of ARRA funding to US suppliers before the 2010 agreement entered into force. For more details, see Hufbauer et al. (2013).

44. Larry Luxner, "US Sen. McCain sets sights on Jones Act," *Joc.com*, December 5, 2014, [www.joc.com/regulation-policy/transportation-regulations/us-transportation-regulations/us-sen-mccain-sets-sights-jones-act\\_20141205.html](http://www.joc.com/regulation-policy/transportation-regulations/us-transportation-regulations/us-sen-mccain-sets-sights-jones-act_20141205.html); Senator McCain filed the amendment to repeal the Jones Act on January 13, 2015, [www.mccain.senate.gov/public/index.cfm/press-releases?ID=F7198ACD-C54E-4595-987A-1D76410742C9](http://www.mccain.senate.gov/public/index.cfm/press-releases?ID=F7198ACD-C54E-4595-987A-1D76410742C9) (accessed on February 22, 2017). Grennes (2017) provides in-depth analysis of the Jones Act, arguing that the total cost of the Act exceeds the total benefit.

Canada might renew its request to exclude the Great Lakes from Jones Act coverage and also ask to be included under the Jones Act as a permitted shipbuilding country. The Canadian minister of public services and procurement stated, in March 2016, that the National Shipbuilding Strategy (NSS) for Vancouver Shipyards Co. Ltd. would provide funding of \$65.4 million.<sup>45</sup> This type of government project is more likely to succeed if vessels could be used in US coastal trade.

### **Investor-State Dispute Settlement**

Canada has lost several investor-state dispute settlement (ISDS) cases and for that reason many Canadians resent Chapter 11 of NAFTA. By contrast, to date the United States has lost no ISDS cases. Hence in renegotiation talks Canada might call for sharp modification of the Chapter 11 arbitration rules. It might seek to replicate the ISDS mechanisms set forth in the EU-Canada CETA mechanism, which call for permanently appointed arbitrators and an appeals process. US representatives of business interests, such as the Chamber of Commerce, would oppose such an initiative. The views of the Trump administration on ISDS are unknown.

### **Oil and Gas Pipeline**

US defensive interests in the energy sector might center on the construction of new cross-border pipelines. In the NAFTA era, Canada and the United States have greatly expanded bilateral energy trade. US imports from Canada of crude oil and petroleum products increased three-fold from 1.2 million barrels per day in 1993 to 3.8 million barrels per day in 2016.<sup>46</sup> However, the construction of transborder and national pipelines sparked US political opposition from environmental groups. The Keystone XL Pipeline project and Dakota Access project are major contributors to this debate.

Canada could raise legitimate concerns over policies regulating US pipelines and transmission lines. One concern is uncertainty embedded in the approval process. Pipelines and transmission lines that connect with a foreign country, such as Keystone XL and Dakota Access, must obtain a presidential permit for construction. The Keystone XL Pipeline connecting Alberta to Houston was under construction until President Obama refused to issue a permit in 2015. While President Trump issued a permit,<sup>47</sup> the delay inflicted financial damages on TransCanada, the pipeline owner. In renegotiation talks Canada could seek immediate approval for current pipeline and transmission line projects, as well as an expedited process for future projects.

A second concern is the “Buy America” requirement for future pipeline construction. Under Trump’s memorandum of January 24, 2017, pipelines laid in US soil must use materials and equipment produced in the United States.<sup>48</sup> This violates NAFTA and WTO obligations that prevent discrimination between domestic and foreign goods. In any event, Canada might seek a fresh waiver of “Buy America” requirements with respect to Canadian iron and steel products under the new NAFTA.

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45. Government of Canada, “Government of Canada makes important shipbuilding investment,” press release, March 14, 2016, <http://news.gc.ca/web/article-en.do?nid=1039769> (accessed on February 22, 2017).

46. Data are from US Energy Information Administration.

47. Obama’s rejection prompted TransCanada to file an ISDS case seeking \$15 billion in damages against the US government. After Trump’s approval, the case was dropped. “Approval of Keystone XL’s presidential permit ends NAFTA claim,” *Inside US Trade*, March 24, 2017.

48. Keystone XL pipeline is exempted from this condition. See “Trump won’t require Keystone XL pipeline to use American steel after all,” *Los Angeles Times*, March 3, 2017, [www.latimes.com/politics/washington/la-na-essential-washington-updates-trump-won-t-require-keystone-pipeline-1488585551-htmistory.html](http://www.latimes.com/politics/washington/la-na-essential-washington-updates-trump-won-t-require-keystone-pipeline-1488585551-htmistory.html) (accessed on March 24, 2017).

## Steel Capacity

Trump's campaign headlines called for bringing back US manufacturing jobs, "Buy American and Hire American," and a 45 percent tariff on imports from China. Against this background, the steel industry will be a model US defensive interest in renegotiation talks. The most recent action of the Trump administration was to instruct the Department of Commerce to investigate the national security implications of steel imports, triggering Section 232(b) of the Trade Expansion Act of 1962.<sup>49</sup> Following the investigation, President Trump will likely impose quotas on imported steel products from a number of countries, possibly including Canada.

Excess global steelmaking capacity is a serious concern of the US government. The USTR claims that excessive global supply of steel, largely caused by overproduction in China, resulted in falling steel prices, closing of steel factories, and loss of over 12,000 US jobs in 2015.<sup>50</sup> To mitigate this problem, the United States filed six enforcement actions against China at the WTO and agreed with Mexico and Canada to address global excess steelmaking capacity. The United States and Canada are members of the OECD Steel Committee and cochair the Global Forum on Steel Excess Capacity (set up by G-20 and interested OECD countries), which analyzes challenges resulting from excess capacity such as trade frictions and structural imbalances.<sup>51</sup> Based on their mutual understanding, Canada and the United States might propose a framework centered on steel export quota. Or Canada might request its exemption from trade restrictions imposed by the outcome of the Section 232(b) investigation.

## Provincial and State Representation

A distinctive feature of the EU-Canada CETA negotiation was that the Canadian negotiating team was composed of federal, provincial, and territorial governments, upon the request of the European Union. It asked for Canadian subfederal representatives because some of the EU negotiating demands directly or indirectly involved provincial and territorial jurisdiction such as financial services, agriculture supply management, and public procurement (Goff 2016). US state-level regulations sometimes restrict Canadian exports, particularly in public procurement and agriculture. Following the CETA format, Canada might ask the United States to include selected state representatives in the negotiation.

## POSSIBLE COMMON INTERESTS

The United States and Canada may find a few topics that do not fall squarely in the offensive or defensive columns but instead might be endorsed by both countries. Such topics would align with the approaches adopted in the Trans-Pacific Partnership (TPP) agreement.

A possible item of mutual interest would be the establishment of new rules for e-commerce and digital information exchange. The McKinsey Global Institute (2016) reported that the volume of global data flows increased by 45 times from 2005 to 2014, by far the fastest growing segment of world commerce.

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49. "Trump orders Ross to expedite 232 investigation into steel imports," *Inside US Trade*, April 20, 2017; see Memorandum for the Secretary of Commerce, April 20, 2017, [https://insidetrade.com/sites/insidetrade.com/files/documents/apr2017/wto2017\\_0119a.pdf](https://insidetrade.com/sites/insidetrade.com/files/documents/apr2017/wto2017_0119a.pdf).

50. The OECD projected that global steelmaking capacity would be 700 MMT in excess of global steel demand in 2015 due to Chinese overproduction of steel. Office of US Trade Representative, "Fact Sheet: Addressing Steel Excess Capacity and Its Impacts: Ensuring a Level Playing Field for American Businesses and Workers," April 2016, <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2016/april/addressing-steel-excess-capacity-its> (accessed on March 27, 2017).

51. OECD, "82nd Session of the OECD Steel Committee—Chair's Statement," [www.oecd.org/sti/ind/82-oecd-steel-chair-statement.htm](http://www.oecd.org/sti/ind/82-oecd-steel-chair-statement.htm) (accessed on March 27, 2017).

E-commerce has become deeply integrated with economic activity via Google, Facebook, Amazon, Netflix, and other internet firms. To establish rules for this rapidly growing segment, TPP Chapter 14 on Electronic Commerce offers a good template. The TPP chapter prohibits customs duties on digital goods and services, although sales or value-added taxes may be imposed. The chapter fosters cross-border data flows and eliminates requirements for the establishment of physical facilities to run an e-business. However, one weakness of the TPP chapter is that it does not create uniform standards to ensure data privacy. The United States and Canada could design common consumer privacy standards in their talks.

Second, Canada and the United States might share an interest in establishing guidelines for state-owned enterprises (SOEs). While both countries have few SOEs (though some are giants, such as the Tennessee Valley Authority), their partner Mexico has a large state-owned sector (mainly energy), with about 70 SOEs in 2012, valued at over \$80 billion.<sup>52</sup> According to NAFTA Article 1503, state enterprises should provide fair and equal treatment to foreign investors in procuring goods and services and exercise regulatory authority delegated by government in a consistent manner. The new NAFTA could embrace the SOE obligations set forth in TPP Chapter 17 on State-Owned Enterprises. Under this chapter, member countries are prohibited from discriminating against other members in SOE procurement and sales of goods or services and from using noncommercial public assistance. Additionally, they are required to reveal detailed information of SOE operations upon the request of another member and to subject SOEs to the dispute resolution mechanism.<sup>53</sup>

Next, Canada and the United States could enhance the NAFTA labor and environment side agreements by adopting features from the TPP text.<sup>54</sup> On the environment, NAFTA members could strengthen obligations subject to the binding dispute settlement procedures and reinforce their commitments not to erode their domestic environmental standards to boost investment. Also, they could add new obligations to reduce fishery subsidies, suppress illegal trafficking in wildlife and illegal logging, and enforce multilateral environmental agreements (MEAs). On labor, NAFTA could adopt the ambitious provisions set forth in the TPP. These provisions include domestic enforcement of labor standards agreed by the International Labor Organization (ILO) and dispute resolution procedures with recourse to trade sanctions. Canada and the United States could reinforce the protection of workers' rights by adding obligations to establish a minimum wage level, set maximum working hours per day, and regulate the occupational health and safety environment.

Fourth, NAFTA could add a chapter for trade facilitation that promotes cross-border trade by expediting shipments and streamlining customs procedures. Canada and the United States have already ratified the WTO Trade Facilitation Agreement (entered into force in February 2017) and in 2011 announced their "Beyond the Border Declaration: A Shared Vision for Perimeter Security and Economic Competitiveness."<sup>55</sup> The Declaration institutionalizes bilateral cooperation to improve security and facilitate trade and travel. Under this Declaration, various action plans expedite customs procedures at the US-Canada border.<sup>56</sup> Particularly, the Agreement on Land, Rail, Marine, and Air Preclearance was signed in 2015. This agreement will provide a consistent approach to preclearance operations covering all modes of transportation. When renegotiating NAFTA, the two countries could integrate key issues of the Declaration into a new trade facilitation chapter of NAFTA.

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52. SOE data from the OECD, <http://stats.oecd.org> (accessed on March 13, 2017).

53. For detailed analysis, see Miner (2016).

54. Schott (2017) and Cimino-Isaacs (2017) provide in-depth analysis on the environment and labor chapters of the TPP.

55. Department of Homeland Security, "Beyond the Border," [www.dhs.gov/beyond-border](http://www.dhs.gov/beyond-border) (accessed on March 14, 2017).

56. Major accomplishments in 2015 under the Declaration are fully described in the Department of Homeland Security's *2015 Beyond the Border Implementation Report*.

Fifth, NAFTA could increase the coverage of small and medium-sized enterprises (SMEs), which have been major beneficiaries of the regional pact. Some 50 percent of US exporters sold their goods to Canada and Mexico in 2014, and of these 94 percent were US SMEs.<sup>57</sup> Regional supply chains in sectors such as autos and electronics have indirectly created markets for additional SMEs. When engaged in direct cross-border trade, SMEs face high fixed costs.<sup>58</sup> In the NAFTA renegotiation, Canada, Mexico, and the United States could propose a chapter similar to the one in the TPP to benefit SMEs. If ratified, TPP Chapter 24 on Small and Medium-Sized Enterprises would require member countries to make information on customs procedures, investment rules, taxation, and business regulation available to SMEs and to address difficulties that SMEs might face in entering Pacific trade.

Last, Canada and the United States could further integrate the energy market in North America. Hufbauer and Schott (2005) argue that NAFTA Chapter 6 on Energy and Basic Petrochemicals had a limited influence in harmonizing energy policies and prices, even though NAFTA contributed to the rapid growth of energy trade between Canada and the United States. Canada now supplies almost half of US energy imports. But energy regulatory policies still differ between federal, state, and provincial jurisdictions. Trilateral efforts to create an integrated energy market, outside the NAFTA framework, led to the North American Electric Reliability Corporation (NERC) to develop and enforce reliability standards for electrical grid connections in North America.<sup>59</sup> Canadian and US negotiators might expand the NERC model to other parts of energy infrastructure.

## CONCLUSION

This chapter identifies well-known US and Canadian trade barriers and speculates on possible “blockbuster” demands that the Trump trade team might make on Canada. NAFTA renegotiation gives the Trump administration an opportunity to resolve longstanding trade grievances with Canada, provided the United States makes its own concessions. Both countries can benefit from updating NAFTA to address issues not foreseen in the early 1990s, such as digital commerce and SOEs. In renegotiation talks, several questions might be resolved in a reciprocal fashion that allows each country to claim victory. On the other hand, US insistence on “blockbuster” demands could put not only the talks but also the entire relationship between Ottawa and Washington at risk.

NAFTA renegotiation can cover a wide range of issues between Canada and the United States to the benefit of both countries. Trade liberalization pays off as much, if not more, for the importing country as for the exporting country. To realize potential gains, the Trump administration should put aside its obsession with trade deficits, at least in talks with Canada. Instead, in these talks, the US trade team should emphasize basic principles: The purpose of a Canada-US trade agreement is to create an integrated market that fosters the free flow of goods and services and establishes the norms for fair competition. Trade across the US-Canadian border should meet no greater obstacles than trade between British Columbia and Alberta or between California and Texas.

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57. In 2014, 152,349 US exporters sold goods to Canada and Mexico, and 143,915 US SMEs exported goods to NAFTA countries. See “Exhibit 5a: 2014 Exports by Company Employment Size to World Areas and Selected Countries,” [www.census.gov/foreign-trade/Press-Release/edb/2014/exh5a.pdf](http://www.census.gov/foreign-trade/Press-Release/edb/2014/exh5a.pdf) (accessed on April 18, 2017).

58. The International Trade Centre (2015) listed relevant fixed costs, including “accessing information about export opportunities, overcoming nontariff barriers, coping with border procedures, establishing delivery system to foreign customers, and contracting for network infrastructure (ICT, electricity and water).”

59. For background and analysis on electricity reliability, see Ek and Fergusson (2014).

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## CHAPTER 6

# Updating the North American Free Trade Agreement

**Jeffrey J. Schott and Cathleen Cimino-Isaacs**

President Donald Trump's antipathy toward the North American Free Trade Agreement (NAFTA) is long-standing and well-known. He has threatened to withdraw from NAFTA unless the deal is renegotiated. Canada and Mexico have agreed to talk, and negotiations could well start in August.

NAFTA has a documented record of success (see Hufbauer and Schott 2005; Hufbauer, Cimino-Isaacs, and Moran 2014). But new negotiations are warranted. NAFTA was state of the art when constructed in the early 1990s but imperfect. It contained notable flaws (e.g., excluding Mexican energy investment; weak rules and enforcement of labor and environment obligations) and its implementation over two decades has exposed other areas where NAFTA rules are inadequate or lacking. Subsequent FTAs have built on and improved the NAFTA framework, expanding rulemaking in areas that affect trade and investment in goods and services, and refining dispute resolution and enforcement procedures. In terms of content, the US-Peru FTA is more comprehensive than NAFTA!

NAFTA needs to be revised and modernized. Without undertaking major structural reforms, negotiators should bring the pact up to code with 21st century trading practices. The Trans-Pacific Partnership (TPP), negotiated in the Obama years but scrapped by Trump, was meant to do that; now the NAFTA partners will try again.

This analysis presents options for modernizing NAFTA to boost North American competitiveness and better address the conditions of international commerce in the 21st century. It lays out reasons for modernizing the agreement and possible priorities for the three countries and identifies the most challenging points of contention, some of which have eluded compromise for decades. New NAFTA rules liberalizing and reforming commercial relations would benefit all three countries and advance the competitiveness of North American firms in global markets.

NAFTA negotiations should primarily focus on new and/or improved rulemaking. Almost all tariffs on intra-NAFTA trade were eliminated long ago; remaining border restrictions are limited in number but highly contentious. NAFTA negotiators should aim to advance new trade liberalization in goods and

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services as much as possible, and avoid rule changes that reduce trading opportunities (e.g., more restrictive rules of origin and public procurement requirements).

The US negotiating objectives set out in the 2015 Trade Promotion Authority (TPA) legislation provide the basis for constructive new trade talks with Mexico and Canada. While not all of the TPA objectives are required to be covered in a final agreement, we believe a modernized NAFTA should at least include:

- new rights and obligations regarding e-commerce and digital trade,
- upgraded and enforceable obligations on labor and environment,
- sectoral cooperation in energy, and
- improved dispute settlement procedures with respect to Chapter 11 on investor-state dispute settlement and Chapter 19 on the review of trade remedies.

This is a discrete agenda that could be done in a relatively expeditious manner. But this limited agenda would not yield the bigger dividends to North American competitiveness that could result from broader reforms on trade facilitation and customs measures, services, intellectual property rights and disciplines on state-owned enterprises. In addition, US auto and steelmakers have argued that a currency chapter is needed to “establish an important precedent for future trade agreements”;<sup>1</sup> the TPA includes the objective of forestalling manipulation and there is bipartisan support in Congress for new NAFTA rules in this area. However, such a broader agenda would take more time to prepare and execute.

Care should be taken to avoid US goals that sharply deviate from past US practice. For example, limiting access to US federal government procurement contracts in favor of discriminatory Buy America policies would invite emulation by Canada and Mexico and hurt US exporters. So, too, could new restrictions on US imports of dairy and softwood lumber. If the United States seeks to lower Mexican and Canadian barriers to US exports while resisting change to US policies, or significantly alters NAFTA rules of origin for autos and other products, prospects for a revised deal that advances regional competitiveness greatly diminish.

What are the alternatives to a successful renegotiation? President Trump has threatened to withdraw from NAFTA, which is permitted after six months’ written notice.<sup>2</sup> If the United States abrogated NAFTA, US-Canada trade relations would largely revert to the terms of the US-Canada FTA, which entered into force in January 1989 but was suspended when NAFTA superseded it. In large measure, the old deal would carry on much of the trade preferences applied to bilateral trade; but the deal did not address long festering problems that provoked Trump administration criticism of NAFTA, and officials also could abrogate the US-Canada bilateral if they decided to ditch NAFTA. Canada and Mexico would continue to apply NAFTA to their bilateral trade.

Abrogating NAFTA would have a profound impact on US-Mexico trade and cause substantial losses to US firms, workers, and farmers. Without NAFTA, Mexico and the United States would revert to most favored nation (MFN) tariff treatment like other World Trade Organization (WTO) members—US applied MFN tariffs average 3.5 percent, while Mexican MFN tariffs average 7 percent, with much higher tariffs in sectors like agriculture.<sup>3</sup> Moreover, Mexico has high bound tariffs—the upper threshold that WTO members

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1. “The North American Steel Industry’s Recommendations for Updating the North American Free Trade Agreement,” June 2017, [www.steel.org/Steel\\_org/document-types/news/2017/nafta-comments.aspx?siteLocation=17d77c91-adc3-4c5b-9158-056d31998ed9](http://www.steel.org/Steel_org/document-types/news/2017/nafta-comments.aspx?siteLocation=17d77c91-adc3-4c5b-9158-056d31998ed9) (accessed on June 21, 2017).

2. “Transcript of AP Interview with Trump,” Associated Press, April 23, 2017, <https://apnews.com/c810d-7de280a47e88848b0ac74690c83> (accessed on April 26, 2017).

3. WTO tariff profiles, <http://stat.wto.org/TariffProfile/WSDbTariffPFView.aspx?Language=E&Country=MX,US> (accessed on March 10, 2017).

commit not to raise tariff rates above—which gives it great latitude to raise tariffs beyond its current MFN levels without violating WTO commitments. Mexico’s bound rates average 35 percent compared with US bound rates averaging 4 percent, and more than 90 percent of US exports to Mexico (by value) are in products with bound rates above 30 percent.<sup>4</sup> Moreover, if NAFTA ended, the Mexican currency would likely depreciate substantially, widening the US bilateral trade deficit—Mexican-produced cars would become more competitive in the US market, just as US agricultural exports become more expensive in Mexico.<sup>5</sup> President Trump’s past threats to impose significant import barriers against Mexico, beyond MFN levels, would be sure to prompt retaliation.

More importantly, abrogating NAFTA would disrupt critical North American supply chains, raising production costs and undercutting competitiveness of US firms in domestic and export markets.<sup>6</sup> Several industries in the United States rely on intermediate inputs imported from Mexico for production and exports—a diverse array of industries from audio and visual equipment, to dental equipment, to autos rely on Mexico for more than 10 percent of total inputs. Ending NAFTA would have more severe and immediate consequences for the US economy than the withdrawal from the TPP—a deal that had not been ratified and entered into force. US exports to Mexico would face high tariffs, which would put US farmers and manufacturers at a disadvantage compared with their competitors from the many other countries who would still have duty-free access to the Mexican market under bilateral FTAs with Mexico. States like Arizona, Texas, and New Mexico rely on the Mexican market for roughly 40 percent of exports and potentially would be hard hit by the resulting trade diversion away from US firms and farmers.<sup>7</sup> US companies invested in Mexico would also suffer losses. These risks raise the stakes for a successful NAFTA negotiation.

## **BACKGROUND: WHAT’S CHANGED?**

Since the inception of NAFTA in 1994, the world trading system has transformed with the fragmentation of production and growth of supply chains, and the advent of digital trade. Technological innovations—the internet, information and communication technology, and automation—have fundamentally altered the way goods and services are produced, traded, transported, and financed. More than 80 percent of global trade takes place across global supply chains and within multinational corporations that send services, inputs, and final goods to and from locations at home and abroad (Moran and Oldenski 2016). Manyika et al. (2016) estimates that 12 percent of global goods trade is now conducted via e-commerce and that international data flows have grown 45 times over the past decade. Meanwhile, US negotiators expanded the NAFTA template in subsequent trade agreements to better address these new realities in the global trading system. Since NAFTA, the United States has extended its trade deals to cover 20 countries in total, Mexico has FTAs in force with 19 countries, and Canada has FTAs in force with 16 countries.<sup>8</sup>

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4. Mary Amity and Caroline Freund, “US Exporters Could Face High Tariffs without NAFTA,” PIIE Trade and Investment Policy Watch blog, April 18, 2017, <https://piie.com/blogs/trade-investment-policy-watch/us-exporters-could-face-high-tariffs-without-nafta> (accessed on April 18, 2017).

5. Monica De Bolle, “Trump’s NAFTA Approach Could Worsen US-Mexico Trade Deficit,” PIIE Trade and Investment Policy Watch blog, March 10, 2017, <https://piie.com/blogs/trade-investment-policy-watch/trumps-nafta-approach-could-worsen-us-mexico-trade-deficit> (accessed on March 27, 2017).

6. Mary Amity, Caroline Freund, and Tyler Bodine-Smith, “Why Renegotiating NAFTA Could Disrupt Supply Chains,” PIIE Trade and Investment Policy Watch blog, April 18, 2017, <https://piie.com/blogs/trade-investment-policy-watch/why-renegotiating-nafta-could-disrupt-supply-chains> (accessed on April 21, 2017).

7. Based on calculations using US Census Bureau goods trade data for 2016.

8. Counts EU member states as one country for Canada and Mexico. “Free Trade Agreements,” Office of US Trade Representative, <https://ustr.gov/trade-agreements/free-trade-agreements>; “Trade Agreements,”

**Table 1 US trade and investment, 1993 versus 2016** (billions of current US dollars)

Partner	1993						
	US imports		US exports		Trade balance	Inward FDI stock	Outward FDI stock
	Goods	Services	Goods	Services			
Canada	113	9	101	17	-4	40	70
Mexico	40	8	41	11	4	1	15
NAFTA total	153	17	142	28	0	42	85
World total	589	124	457	186	-70	467	564
NAFTA as a share of world (percent)	26	14	31	15	0	9	15

Partner	2016						
	US imports		US exports		Trade balance	Inward FDI stock <sup>a</sup>	Outward FDI stock <sup>a</sup>
	Goods	Services	Goods	Services			
Canada	283	30	266	54	7	269	353
Mexico	297	23	231	31	-58	17	93
NAFTA total	580	53	497	85	-51	286	446
World total	2,250	503	1,453	752	-547	3,134	5,041
NAFTA as a share of world (percent)	26	11	34	11	9	9	9

FDI = foreign direct investment

a. FDI data for 2015 (latest available).

Sources: Goods data from UN Comtrade via World Bank's World Integrated Trade Solution database; FDI and services data from US Bureau of Economic Analysis; authors' calculations.

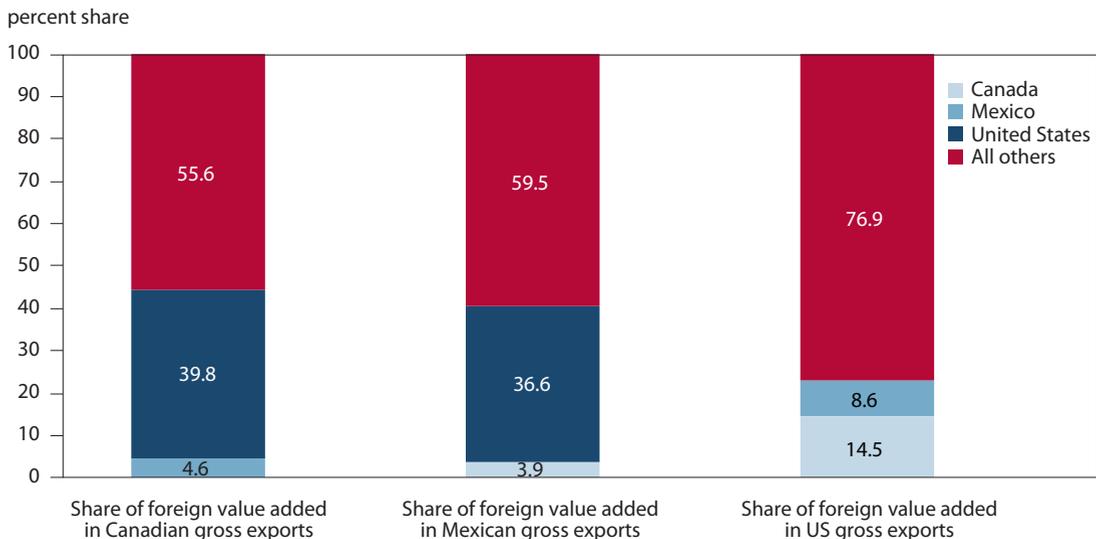
Over this period, NAFTA trade significantly expanded. Since 1993, US two-way goods and services trade with NAFTA partners increased by a factor of three in current US dollars—\$340 billion to \$1.2 trillion in 2016 (table 1). In 2016, Canada and Mexico were the largest and second largest markets, respectively, for US exports of goods and services. Among top suppliers of US imports, Canada and Mexico ranked third and second respectively behind China. For 43 out of 50 US states, either Canada or Mexico is the largest goods export market—for more than half of US states, both NAFTA partners are the top two markets. For 38 US states, either Canada or Mexico is the largest source of goods imports. Combined, the NAFTA partners accounted for 26 percent of total US exports of goods and services and 23 percent of total US imports. However, NAFTA services trade only accounted for 11 percent of US global services trade in 2016 down from 15 percent in 1993. This is an area where NAFTA has underperformed.

In 2015, the stock of US foreign direct investment (FDI) in NAFTA partners combined totaled \$446 billion, while Canadian and Mexican FDI in the United States totaled \$286 billion—the majority accounted for by US-Canada investments. Compared to 1993 levels, NAFTA partner FDI in the United States has grown by more than US FDI in North America. US FDI in Canada and Mexico remains a small share, just 9 percent, of US global FDI, which has grown much faster since 1993 than total US FDI in the NAFTA countries. Mexico is home to only 2 percent of US FDI abroad—little evidence of an epidemic of runaway plants.

NAFTA supported the deepening of regional supply chains, especially between the United States and Mexico. Forty percent of US imports from Mexico and 75 percent of exports to Mexico are in intermediate inputs, and a large share of trade takes place within firms, especially in the transport, electrical, and machinery

ProMéxico, <http://www.gob.mx/se/acciones-y-programas/comercio-exterior-paises-con-tratados-y-acuerdos-firmados-con-mexico>; and "Canada's Free Trade Agreements," Global Affairs Canada, <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fta-ale.aspx?lang=eng> (all accessed on February 6, 2017).

**Figure 1 NAFTA partner share of foreign value added embodied in gross exports, 2011**



Note: By definition, figures do not include value added of origin country.

Source: OECD Trade in Value Added (TIVA) database, October 2015, <https://stats.oecd.org>; authors' calculations.

industries.<sup>9</sup> More broadly, US content makes up a large relative share of NAFTA partner's global exports: In 2011, the United States accounted for a 40 percent and 37 percent share of the foreign value added in Canadian and Mexican global exports, respectively, the largest of any single trade partner (figure 1).

## WHY UPDATE NAFTA?

NAFTA was state of the art when it was negotiated in the early 1990s. But some important issues were omitted and some goods and services were excluded or only subject to partial reforms. Obligations regarding labor and trade related environmental issues were belatedly appended to the final text in side agreements not subject to NAFTA's dispute settlement procedures. Trade agreements since NAFTA was signed have revised and improved the NAFTA template of rights and obligations. But negotiators never went back to renegotiate NAFTA for fear that failure would cause their hard-won gains to unravel.<sup>10</sup> The TPP involved a first attempt to update NAFTA after Canada and Mexico joined the talks mid-stream.

A renegotiation of NAFTA could also revive efforts to resolve longstanding bilateral irritants. The NAFTA partners have litigated several cases against one another under NAFTA procedures as well as under the WTO (table 2)—as Chad Bown notes, “None of these disputes ever escalated to threaten the existence of NAFTA.”<sup>11</sup> Canada and Mexico have used the WTO system more often to issue complaints against the United States—Mexico primarily regarding US import restrictions or policy measures against steel and cement,

9. Mary Amity, Caroline Freund, and Tyler Bodine-Smith, “Why Renegotiating NAFTA Could Disrupt Supply Chains,” PIIE Trade and Investment Policy Watch blog, April 18, 2017, <https://piie.com/blogs/trade-investment-policy-watch/why-renegotiating-nafta-could-disrupt-supply-chains> (accessed on April 21, 2017).

10. Over the years, the NAFTA partners have agreed to some reforms in specific areas: the pact's rules of origin and clarifications of criteria for litigating investor-state dispute settlement claims.

11. Chad P. Bown, “What is NAFTA, and what would happen to U.S. trade without it?” *Washington Post*, op-ed, February 15, 2017, [www.washingtonpost.com/news/monkey-cage/wp/2017/02/15/what-is-nafta-and-what-would-happen-to-u-s-trade-without-it/?utm\\_term=.f6cd07073dd9](http://www.washingtonpost.com/news/monkey-cage/wp/2017/02/15/what-is-nafta-and-what-would-happen-to-u-s-trade-without-it/?utm_term=.f6cd07073dd9) (accessed on April 7, 2017).

**Table 2 WTO dispute cases between NAFTA partners**

Complainant	Respondent			Percent of total disputes with WTO countries <sup>a</sup>
	Canada	Mexico	United States	
Canada	0	0	16	46
Mexico	0	0	9	38
United States	6	6	0	10

a. Based on disputes initiated as a complainant.

Note: Number of cases does not include third-party case participation.

Source: World Trade Organization, Disputes by Member, [www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_by\\_country\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm).

several products such as dairy, grains, corn, wine, as well as certain patent protections for pharmaceuticals, and Mexico primarily over agricultural products and processed foods (e.g., pork and beef, corn syrup, and soft drinks), as well as telecommunications services.

### United States

The Trump administration has not detailed its specific objectives in the negotiations, but the administration is likely to seek outcomes comparable to those achieved in the TPP for new areas such as digital trade and cross-border data flows, disciplines on state-owned enterprises, and environment and labor standards. In other areas, however, US goals could sharply deviate from past US practice, especially if US officials seek more restrictive rules of origin and reduce Canadian and Mexican access to federal procurement contracts due to stricter Buy America requirements. Broadly, President Trump's main impetus for demanding new NAFTA talks has been reducing the "persistent US deficit in goods trade with Canada and Mexico." To that end, the United States is likely to seek expanded market access for US exports. US complaints against Canadian and Mexican barriers have long been documented in the annual *National Trade Estimate Report on Foreign Trade Barriers*, which details a long list of market access requests related to technical barriers to trade, sanitary and phytosanitary (SPS) measures, import policies, domestic support measures, government procurement, intellectual property rights, services and investment, and digital trade (USTR 2017).

Among the priority areas related to Canada are restrictions on US exports of grain, dairy, and alcoholic beverages; the low de minimis threshold preventing low-value shipments from qualifying as duty free; Canadian state support for its aerospace sector; restrictions in telecommunications and broadcasting; and data localization requirements. Key market access issues highlighted for Mexico include SPS measures limiting US agricultural exports and import licensing and other regulations affecting steel products, footwear and textiles/apparel, and express packages. Other priorities may include restrictions in telecommunications and broadcasting and investment barriers in energy, residential real estate, and transportation services.

### Canada and Mexico

Canada and Mexico already had good access to the US market before negotiating FTAs with the United States. US MFN tariffs are low, so eliminating US tariffs in NAFTA provided only modest additional benefits. Maintaining good access to the US market has been and remains of critical importance. In new NAFTA negotiations, Canada and Mexico will seek commitments that existing access to the US market not be undercut by (1) unwarranted use of trade remedy legislation such as antidumping and countervail-

but also agricultural products such as tomatoes and tuna, among others; Canada regarding agricultural products (e.g., cattle, wine, grains, corn, and sugar) and long-standing disputes over softwood lumber and US country of origin labeling requirements for livestock. The United States has challenged Canada over restrictions on

ing duties, import safeguards, and section 232 and 301 measures;<sup>12</sup> and (2) more restrictive rules covering domestic content and the supply of goods and services under government contracts.<sup>13</sup>

Beyond preserving existing access to the US market, Canada and Mexico have their own list of offensive interests regarding US trade and other reforms that they would like included in the NAFTA talks. In their chapter in this volume, Hufbauer and Jung highlight key Canadian interests including:

- resolving the longstanding softwood lumber dispute;
- US country of origin labeling requirements for beef, pork, and other livestock from Canada and Mexico;
- exemptions for Canadian suppliers from “Buy America” requirements; and
- modifying NAFTA’s investor-state dispute settlement mechanism to reflect reforms in the EU-Canada Comprehensive Economic and Trade Agreement (CETA).

Mexican interests include trade facilitation and modernizing border procedures to decrease waiting times at the border, energy cooperation, promoting investment, and educational exchange and workforce development.<sup>14</sup> Mexico also gives priority to modernizing the NAFTA framework with new coverage of telecommunications, energy, and e-commerce sectors.<sup>15</sup>

Initially, Mexico sought to broaden negotiations to include migration and border security issues, but Mexican officials now favor a short and discrete agenda in hopes the revised pact can be finished before the July 2018 Mexican presidential election. In any event, the US Congress has long prohibited trade negotiators from covering immigration issues so that was not going to be part of the NAFTA negotiation.

## MODERNIZING THE NAFTA TEMPLATE

This section sets out a basic agenda that builds on recent negotiating experience and could be addressed in expedited NAFTA negotiations. None of the areas involve major structural reforms—the NAFTA foundation is sound. Covering all the TPA negotiating goals would require a more protracted effort.

- **New rulemaking on “21st century” issues:** A number of issues have become increasingly important to international commerce in the decades since NAFTA was signed. In particular, e-commerce and

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12. Under Section 232(b) of the Trade Expansion Act of 1962, the president can impose restrictions if imports are found to “threaten to impair” national security interests—President Trump has already initiated such investigations for steel and aluminum. Under Section 301 of the Trade Act of 1974, the president can impose import restrictions if a trade partner is “denying the United States its rights under a trade agreement or is carrying out practices that are unjustifiable, unreasonable, or discriminatory and burden or restrict US commerce” (Hufbauer 2016a).

13. An executive order issued in April directs US agencies to “scrupulously monitor, enforce, and comply with Buy American laws”—mandates that public projects use domestically-produced iron, steel, and manufactured goods—and minimize exceptions. Gary Clyde Hufbauer and Cathleen Cimino-Isaacs, “Buy American, Hire American!": A Worrisome Slogan,” PIIIE Trade and Investment Policy Watch blog, April 19, 2017, <https://piie.com/blogs/trade-investment-policy-watch/buy-american-hire-american-worrisome-slogan> (accessed on May 17, 2017).

14. “Joint Statement: 2016 U.S.-Mexico High-Level Economic Dialogue,” White House Office of the Vice President, February 25, 2016, <https://obamawhitehouse.archives.gov/the-press-office/2016/02/25/joint-statement-2016-us-mexico-high-level-economic-dialogue> (accessed on April 27, 2017).

15. “With the United States, we do not wish for either confrontation or submission; the solution is dialogue and negotiation: Enrique Peña Nieto,” Government of Mexico, January 1, 2017, [www.gob.mx/presidencia/en/prensa/with-the-united-states-we-do-not-wish-for-either-confrontation-or-submission-the-solution-is-dialogue-and-negotiation-enrique-pena-nieto](http://www.gob.mx/presidencia/en/prensa/with-the-united-states-we-do-not-wish-for-either-confrontation-or-submission-the-solution-is-dialogue-and-negotiation-enrique-pena-nieto) (accessed on April 27, 2017).

digital trade should be incorporated into NAFTA to preempt new trade restrictions and set precedents for future trade pacts. All three countries have expressed strong support for updating NAFTA with rules that better enable e-commerce and address barriers to digital trade. Other issues also warrant close examination, such as new rulemaking related to state-owned enterprises, currency practices, and intellectual property rights, among others included by Congress in TPA legislation as priority US negotiating objectives.

- **Enforceable rules.** President Bill Clinton added side agreements related to these issues to shore up political support for the deal's passage in 1993. US FTAs have evolved significantly since then with stronger provisions protecting labor and environmental standards. The NAFTA countries should build on the most advanced precedents in the TPP text and ensure that new obligations in these areas are enforceable under the agreement's general dispute settlement procedures.
- **Sectoral cooperation in energy.** NAFTA covered US-Canada energy trade but largely excluded investment in the Mexican energy sector. NAFTA partners should promote new investment in energy infrastructure to advance the development of North American energy resources, especially natural gas and renewables. Care needs to be taken, however, to not burden new initiatives with costly local content requirements lest projects that would literally fuel US exports could be delayed or dropped.
- **Modernized dispute settlement.** New talks should revisit two of NAFTA's dispute mechanisms. First, US FTAs and investment treaties have included investor-state dispute settlement as a restraint against national expropriation or unfair treatment, particularly as a legal safeguard in developing countries. Since NAFTA, US trade agreements have evolved to better safeguard the government's right to regulate in the public interest, to preclude bias in panel selection, and to narrow the scope for frivolous cases. NAFTA Chapter 11 should be updated to incorporate improvements in these areas based on recent experience in US FTAs, the CETA, and the TPP. Second, Chapter 19 on antidumping (AD) and countervailing duties (CVD) establishes a unique NAFTA mechanism to review final determinations in trade remedy cases and allow decisions to be challenged before an extraordinary challenge committee (ECC). Since the 1990s, 145 panel reviews have been requested under Chapter 19, and the ECC invoked three times. The United States seeks to modify or eliminate the mechanism, which has been used infrequently in recent years. But the focus of the Trump administration on more aggressive use of trade remedies and the self-initiation of AD/CVD cases may stiffen opposition in Canada and Mexico to changes in Chapter 19 procedures. Discrete changes to the panel selection procedures would be feasible and desirable and mitigate a major US concern in this area.

## Rules on E-commerce and Digital Trade

The internet has fundamentally transformed global commerce, but trade deals have failed to keep up with the pace of technological change.<sup>16</sup> US FTAs are evolving to better address these issues, but the NAFTA framework was conceived in a much different era. The McKinsey Global Institute estimates that e-commerce accounts for about 12 percent of global goods trade and that more than 60 percent of global services trade was digitally enabled by 2012 (Mankiya et al. 2016). Cross-border data flows have expanded significantly, with firms relying on such data to connect with customers, manage and improve supply chains, and better utilize software, cloud computing, and new technologies—data are not only important to technology companies but also to sectors like autos, manufacturing, retail, and finance (for example, see Branstetter, Drev, and Kwon 2015; Mankiya et al. 2016; Castro and McQuinn 2015). Importantly, digital platforms

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16. Some WTO agreements touch on issues affecting digital trade but none comprehensively: WTO members agreed to a moratorium on taxing electronic transmissions in 1998; the Information Technology Agreement eliminates duties for certain digital products; the Trade-Related Aspects of Intellectual Property Rights protects some IT-related intellectual property; and the General Agreement on Trade in Services provisions addresses cross-border flows of information to a limited extent (Aaronson 2016). WTO members are now attempting to develop a new e-commerce work program.

like Amazon, eBay, and Paypal have helped small and medium-sized enterprises (SMEs)—which generally comprise a small share of a country’s exporters—sell products to foreign markets. For example, among commercial sellers on eBay—defined as those with \$10,000 or more in sales—the majority are also exporters (eBay 2016). In North America, of “e-Bay enabled SMEs,” 100 percent were also exporters in Mexico, 99 percent in Canada, and 97 percent in the United States.

The United States, Canada, and Mexico have expressed strong support for an updated NAFTA with rules that better enable e-commerce and address barriers to digital trade, which are often imposed based on privacy or national security concerns. The USITC (2014) broadly defines “digital trade” as “international trade in which the internet and internet-based technologies play a particularly significant role in ordering, producing, or delivering products and services.” Rules governing digital trade have thus come to encompass various interconnected issues from open market access through duty-free treatment of digital goods like software and national treatment for foreign online service providers, to intellectual property protections for digital products and technologies, to consumer and data privacy protections. Primary US concerns related to digital trade include requirements to store and process data within a country, compel firms to disclose technology or source code or restrict data flows as conditions of doing business, intellectual property rights infringement, and cybercrime. Canada and Mexico have generally not been among the top countries of concern cited by the United States for barriers to digital trade—though it has expressed concern with Canadian data localization requirements and Mexican enforcement of intellectual property rights.<sup>17</sup>

The NAFTA countries stand to benefit from shared e-commerce rules. The United States is a major player in the global digital economy, as the home to top internet and technology firms and as a dominant global supplier of online and cloud computing services (for more detail, see Aaronson 2016, Castro and McQuinn 2015, Alaveras and Martens 2015). The Canadian e-commerce market has developed alongside the US market, which accounts for one-third of Canada’s e-commerce spending.<sup>18</sup> Mexico’s e-commerce market has grown significantly in recent years and is the second largest market in Latin America.<sup>19</sup> Mexico faces substantial challenges such as low internet connectivity and digital literacy, and public distrust of online payments systems. Key Mexican priorities have been reform of its telecommunications sector and promoting inclusivity for SMEs.

One concrete way to support the digital marketplace and promote inclusivity for SMEs, which face much higher costs complying with administrative and customs procedures, is an agreement to raise North American de minimis thresholds—the import levels for low-value shipments that count as duty-free and require minimal customs paperwork. Among G-20 countries, the United States has the highest de minimis level at \$800 (increased from \$200 in 2016); Mexico’s threshold is \$50; and Canada’s threshold is \$15, among the lowest of any country (Freund, Hufbauer, and Jung 2016). Hufbauer and Wong (2011) find that the savings to customs, consumers, SMEs, and express shipping services from raising the de minimis threshold outweigh lost government revenue. McDaniel, Schropp, and Latipov (2016) calculate large net gains from increasing Canada’s de minimis level from C\$20 to C\$80 or higher, finding that the change would be fiscally neutral or positive. Other complementary trade facilitation measures have been advocated to support e-commerce and could be incorporated into NAFTA rules, such as frameworks for electronic

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17. “Key Barriers to Digital Trade,” US Trade Representative fact sheet, March 2017, <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2017/march/key-barriers-digital-trade> (accessed on April 27, 2017).

18. “Canada—e-commerce,” International Trade Administration, [www.export.gov/article?id=Canada-eCommerce](http://www.export.gov/article?id=Canada-eCommerce) (accessed on March 6, 2017).

19. “Mexico—eCommerce,” International Trade Administration, [www.export.gov/article?id=Mexico-ECOMmerce](http://www.export.gov/article?id=Mexico-ECOMmerce) (accessed on March 6, 2017).

payments, paperless trading, recognition of esignatures and authentication, and other measures that encourage interoperability of technical standards.

Several cooperative efforts by the three partners could inform the approach to e-commerce and digital trade in the NAFTA talks. All sides agreed to groundbreaking provisions in the TPP (Branstetter 2016). In August 2016, Mexico and Canada submitted a joint proposal, along with nine other WTO members, outlining an e-commerce work program.<sup>20</sup> Canada's most comprehensive agreement to date, the CETA with the European Union, also covered key concepts governing e-commerce—though less comprehensive than the TPP (Leblond and Fabian 2017).<sup>21</sup> Given past collaborative efforts of NAFTA partners, the main features that could form the basis of NAFTA rules include:

- Ensuring an open market for digital goods and services, such as prohibiting customs duties on digital goods; requiring nondiscriminatory treatment of foreign suppliers of digital services and products; permitting cross-border data flows and prohibiting requirements of data localization, local computing facilities, servers, or other information and communication technology infrastructure as conditions for market access.
- Protecting proprietary technologies like source code or encryption keys from involuntary disclosure; strengthening intellectual property protections against online piracy and unauthorized duplication; and requiring criminal procedures and penalties for cybercrime.
- Protecting privacy of consumers, such as requiring legal frameworks for protection from online fraud and deceptive practices and protection of online user personal information.

Free digital trade and cross-border data flows can be controversial given divergent data privacy protections across countries. Trade agreements do not stipulate a uniform set of data privacy standards, preserving a country's regulatory discretion. Compared with the United States, privacy laws in other countries can be more comprehensive and prescriptive. For example, the United States has had to negotiate a safe harbor agreement with the European Union, the EU-US Privacy Shield, to address how US firms treat transfers of EU citizens' data to US servers (Branstetter 2016). Like the European Union, Mexico recognizes a consumer's "right to be forgotten" (removal of personal data from search engine results), the subject of an ongoing legal dispute with Google Mexico.<sup>22</sup> NAFTA will no doubt continue to safeguard national jurisdiction over regulatory requirements in the public interest, but the agreement could seek more guidelines for stronger, common consumer privacy standards.

## Labor Standards

The original NAFTA deal did not cover protection of labor rights, but a side deal was negotiated after the Clinton administration threatened to delay ratification.<sup>23</sup> The North American Agreement on Labor Cooperation (NAALC) was motivated by concerns over Mexico's enforcement of labor laws—the first developing-

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20. "Work Programme on Electronic Commerce: Trade Policy, The WTO, and The Digital Economy," Communication from Canada, Chile, Colombia, Côte d'Ivoire, the European Union, the Republic of Korea, Mexico, Montenegro, Paraguay, Singapore and Turkey, JOB/GC/97/Rev.3, [www.wto.org/english/tratop\\_e/ecom\\_e/ecom\\_e.htm](http://www.wto.org/english/tratop_e/ecom_e/ecom_e.htm) (accessed on April 27, 2017).

21. See CETA Chapter 16, <http://www.international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/ceta-aecg/text-texte/16.aspx?lang=eng> (accessed on April 27, 2017).

22. Emily Pickrell, "Renegotiated NAFTA Might Help Bridge Mexico-U.S. Privacy Issues," Bloomberg Law: Privacy & Data Security, [www.bna.com/renegotiated-nafta-help-n57982087521](http://www.bna.com/renegotiated-nafta-help-n57982087521) (accessed on May 9, 2017).

23. For a summary see "North American Agreement on Labor Cooperation: A Guide," US Department of Labor, October 2005, [www.dol.gov/ilab/trade/agreements/naalcd.htm#NAALC](http://www.dol.gov/ilab/trade/agreements/naalcd.htm#NAALC) (accessed on March 28, 2017).

country FTA partner for the United States—and fears that the trade deal would fuel a “race to the bottom” in workplace conditions and lower wages. Concerns over Mexican labor practices still hold over from the NAFTA era, notably the prevalence of employer-dominated unions, use of protection contracts—collective bargaining agreements signed with limited input from workers—and systemic corruption on labor conciliation and arbitration boards. Reform efforts are under way in Mexico—in part due to pressure from the TPP negotiations—to reform its labor justice system and set new requirements for bargaining contracts.<sup>24</sup>

The original NAALC was a step forward for promoting consultation and cooperation on labor issues, but overall it was limited in scope: In a 10-year review, Hufbauer and Schott (2005) concluded that the largely hortatory deal lacked adequate funding and was never designed to effectively deal with labor problems. One major shortcoming of the NAALC that weakened its bite is that labor disputes are subject to different dispute procedures than the main trade deal. If ministerial consultations fail to resolve a labor complaint, dispute settlement can be initiated only for disputes related to a country’s safety and health standards, child labor, and minimum wages. Arbitration and trade penalties cannot be pursued for disputes related to the rights to organize, bargain collectively, and strike—importantly, about two-thirds of the labor complaints filed under the NAALC relate to such issues. Of 38 labor petitions filed, 22 were filed in the United States with all but two directed at alleged abuses in Mexico.

Trump officials have said little on enforcing labor rights in trade agreements. The administration’s “2017 Trade Policy Agenda” released in March 2017 provided some new, albeit broad, guidance: Among the key principles and objectives was “enforcing labor provisions in existing agreements and enforcing the prohibition against the importation and sale of goods made with forced labor.” The initial draft negotiating notice to Congress detailed three related objectives for NAFTA:<sup>25</sup>

- seek a commitment by the NAFTA countries to adopt and maintain measures implementing internationally recognized labor rights and effectively enforce their respective labor laws concerning those rights,
- seek to improve mechanisms for consultations and cooperation to strengthen capacity of the NAFTA parties to promote respect for internationally recognized labor rights, including those embodied in the International Labor Organization’s (ILO) Declaration on Fundamental Principles and Rights at Work and ILO Convention 182 on the Worst Forms of Child Labor, and to effectively enforce their respective labor laws, and
- seek enforceable labor obligations within the body of the agreement that are subject to dispute settlement and remedies as other enforceable obligations.

These provisions essentially reflect TPA negotiating objectives set by Congress and those incorporated into US trade deals of the past decade.<sup>26</sup> When asked whether “improved and enforceable labor standards” would be a priority in the NAFTA renegotiation, US Trade Representative Robert Lighthizer responded that he would work to ensure NAFTA “is updated in ways that comply with TPA objectives for labor,”

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24. Pietro Straulino-Rodriguez and Stefano Sandoval Malori, “Mexico Finalizes Significant Changes to Its Labor Justice System,” *Lexology*, February 24, 2017, [www.lexology.com/library/detail.aspx?g=8eb71056-8a15-4bdf-9e3a-6b03b4a72983](http://www.lexology.com/library/detail.aspx?g=8eb71056-8a15-4bdf-9e3a-6b03b4a72983) (accessed on March 29, 2017); “Labor Department Report Urges Mexico To Adopt Labor Law Reforms,” *Inside US Trade*, July 11, 2016, [www.insidetrade.com](http://www.insidetrade.com) (accessed on March 29, 2017).

25. This draft letter was since revised and differs from the final issued May 18, 2017. See <https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/03/tnf-draft-nafta-letter.pdf>.

26. Section 102(a) of TPA outlines overall objectives, several of which relate to labor standards. Section 102 (b)(10) details more specific objectives with respect to labor (and the environment). For the text, see [www.congress.gov/114/plaws/publ26/PLAW-114publ26.pdf](http://www.congress.gov/114/plaws/publ26/PLAW-114publ26.pdf).

including putting enforceable labor commitments in the main text.<sup>27</sup> He noted “when trading partners fail to enforce labor laws and do not uphold high standard protections for workers, it can create a competitive disadvantage for US workers, farmers, ranchers, and businesses.”

The US approach to labor in trade agreements has evolved significantly since NAFTA. Trading partners must agree not only to enforce their own domestic labor laws but also to uphold internationally recognized labor rights—these include the freedom of association and right to bargain collectively, elimination of forced labor and child labor, and elimination of discrimination in the workplace.<sup>28</sup> Labor practices are no longer exempt from possible trade sanctions in the event an obligation is violated and are subject to the full spectrum of dispute settlement procedures.

NAFTA should be updated but also improve upon the current benchmark for labor provisions in US trade deals. The most recent US bilateral FTAs (Colombia, Korea, and Peru) require that national laws enforce core labor standards of the ILO Declaration and subject a country’s violations of labor commitments to trade sanctions. Under the insistence of the United States, the TPP labor chapter went even farther (Cimino-Isaacs 2016). NAFTA should improve upon TPP innovations. As a baseline, labor standards should require enforcement of ILO labor rights and acceptable conditions of work—namely limits on working hours, minimum wage, health and safety regulations—including in export processing zones. NAFTA should also preserve the 11 labor rights principles covered in the NAALC, which include issues beyond the scope of ILO fundamental labor rights, for example, migrant worker protection, equal pay for men and women, and prevention of occupational injury. As Kimberly Nolan García cautions, “narrowing the scope of labor rights protected by the agreement would amount to a half-step backward,” moreover, “these same rights are presently included at the regional level precisely because domestic compliance remains weak.”<sup>29</sup>

NAFTA could set precedents by strengthening trade agreement protections against forced or child labor in particular—reforms that have been supported by the International Trade Union Conference.<sup>30</sup> The US Department of Labor (2016) has flagged child labor in Mexican agricultural sectors, such as tomatoes, tobacco, sugarcane, and coffee, and Mexico remains on the State Department’s Tier 2 list for human trafficking—countries that do not fully uphold minimum protections but are improving compliance—with forced labor still reported in some trade-related sectors such as agriculture, manufacturing and food processing (US State Department 2016). Consistent with the administration’s stated objectives, NAFTA could agree to fully prohibit imports of goods produced by forced or child labor. To strengthen the scope of protections, and given the importance in both Mexican and US agriculture and food processing sectors, the trade deal should maintain explicit protections for migrant labor ensuring coverage of core labor rights.

Even while labor provisions in US FTAs have strengthened, critics claim the enforcement process for complaints about labor violations is “slow and cumbersome” relying “on the political will of governments” (AFL-CIO 2015). The NAALC has processed more labor complaints than any US FTA. But among cases adjudicated under US FTAs, only one against Guatemala under the Central American Free Trade Agree-

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27. “Lighthizer says renegotiated NAFTA could go beyond TPP provisions,” *Inside US Trade*, March 20, 2017, [www.insidetrade.com](http://www.insidetrade.com) (accessed on March 28, 2017).

28. For the text of the ILO Declaration on Fundamental Principles and Rights at Work, see [www.ilo.org/declaration/lang--en/index.htm](http://www.ilo.org/declaration/lang--en/index.htm) (accessed on April 27, 2017).

29. Kimberly A. Nolan García, “Labor Rights Enforcement under the NAFTA Labor Clause: What Comes Next under a Potential Renegotiation?” Mexico Institute, Wilson Center, May 3, 2017, [www.wilsoncenter.org/article/labor-rights-enforcement-under-the-nafta-labor-clause-what-comes-next-under-potential](http://www.wilsoncenter.org/article/labor-rights-enforcement-under-the-nafta-labor-clause-what-comes-next-under-potential) (accessed on May 5, 2017).

30. For example, see draft labor chapter, [www.ituc-csi.org/IMG/pdf/final-official\\_ituc\\_transpacific\\_partnership\\_labor\\_chapter.pdf](http://www.ituc-csi.org/IMG/pdf/final-official_ituc_transpacific_partnership_labor_chapter.pdf).

ment–Dominican Republic (CAFTA-DR) has proceeded to the dispute settlement phase—the original petition was filed almost a decade ago, with dispute settlement initiated in 2014.<sup>31</sup> In a review of enforcement of labor provisions, the US Government Accountability Office (GAO 2014) concluded that US trade partners have taken steps to improve labor rights pursuant to FTA obligations. But it also found persistent gaps in protections, attributed to a country’s poor capacity to enforce labor laws but also to procedural shortcomings, limited resources, and lack of coordination at USTR and Departments of Labor and State—the US agencies responsible for monitoring compliance and assisting with trade-capacity building.<sup>32</sup> Reforms to NAFTA labor provisions should respond to complaints about undue delays, possibly considering fast track provisions for the resolution of labor disputes. The AFL-CIO and other labor groups would welcome the right to initiate labor petitions directly with governments, in parallel with investor-state dispute settlement procedures, but that proposal has garnered little support.

A criticism of the labor outcome in the TPP deal was the absence of an enforceable, bilateral plan for Mexico comparable to those negotiated by the United States with Brunei, Malaysia, and Vietnam—those labor consistency plans mandated certain legal and institutional reforms to help ensure compliance with the deal. Mexico resisted supplemental commitments throughout the TPP talks and may do so again in the context of NAFTA. An implementation plan that establishes Mexican reforms, planned and underway, to comply with the stronger NAFTA labor chapter may not satisfy labor advocates but would be a useful step forward.

## Trade-Related Environmental Issues

The North American Agreement on Environmental Cooperation (NAAEC) was an afterthought of the NAFTA negotiations but the side agreement was a critical prerequisite for US ratification. It advanced a framework of environmental cooperation in the region dating back to the 1889 International Boundary Commission involving the United States and Mexico. Its obligations are relatively modest and its enforcement mechanisms favor the promulgation of factual records over binding panel arbitration, but its institutional mechanisms have established a platform for closer cooperation on environmental matters of common interest to the three partner countries (see Hufbauer et al. 2000; Hufbauer and Schott 2005, chapter 3). Compared with the NAALC, the NAAEC has been much more productive—albeit a low bar to clear. But severe budget constraints and inadequate data have limited the effectiveness of the Commission for Environmental Cooperation (CEC), and North American environmental initiatives have suffered as a result.

Subsequent US FTAs have improved on the NAAEC precedent, except for the budgetary issues. US legislation, and the May 2007 bipartisan accord, put forward detailed objectives for what should be covered in FTA environmental chapters and required that environmental provisions be included in the body of the agreement and subject to the pact’s general dispute settlement procedures. Recent bilateral FTAs now include detailed obligations regarding enforcement of specific multilateral environmental agreements (MEAs) as well as requirements for greater transparency and public participation in environmental rulemaking.

The TPP was the culmination of this process and arguably the greenest trade accord ever concluded because of its disciplines that discourage abusive environmental practices (e.g., depletion of fish stocks), its new obligations to deter the illegal taking and trade of wildlife, and its binding dispute settlement provisions

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31. In its final decision, the arbitration panel ruled against the United States and in favor of Guatemala in June 2017. “Sources: U.S. loses to Guatemala in first-ever FTA labor dispute settlement case,” *Inside US Trade*, June 20, 2017, [www.insidetrade.com](http://www.insidetrade.com) (accessed on June 21, 2017).

32. In fiscal year 2016, about 40 percent of US spending on trade capacity building assistance (\$102 million out of \$256 million funding) went to helping FTA partners comply with labor commitments (GAO 2017).

that reinforce existing commitments not to lower environmental standards to encourage investment (see Schott 2016). Overall, the TPP environment chapter comprises obligations that are more comprehensive than those in any other trade accord. In updating NAFTA, North American negotiators should draw heavily on TPP precedents in this area.

But the TPP model had flaws; some resulted from concerns by developing-country participants about administrative and compliance burdens and others from an ill-considered aversion to addressing cooperative approaches to deal with greenhouse gas emissions and similar problems related to global warming.

Two specific areas should be added to the NAFTA rulebook in this area. First, the NAFTA countries should encourage the commercial development and distribution of renewable energy resources through investment in energy infrastructure and cooperative regulatory policies. Second, the three countries should commission a study on the impact of carbon taxes on NAFTA trade and investment.

Carbon taxes already are imposed to a limited extent in Mexico and some Canadian provinces. The topic has also reemerged in Washington in the context of options to offset revenue shortfalls from new tax legislation, though prospects for new taxes of any kind are remote given the fiery opposition of Tea Party Republicans.

But NAFTA negotiators should not ignore carbon taxes and other climate change policies, despite Trump's opposition to the Paris Agreement. Why? Because if Canada and Mexico extend their carbon tax and regulatory policies in support of their Paris Agreement commitments, it could distort intra-NAFTA trade and investment. If the problem became too big, Canada and Mexico (and others) probably would consider import charges against carbon-intensive products, just as the US Congress discussed in the context of the Waxman-Markey legislation during the first Obama administration against trade from countries not pursuing greenhouse gas mitigation policies (Fickling and Schott 2011), claiming that such products were unfairly priced because they did not reflect the true cost of production including a "fair" price for carbon content.<sup>33</sup>

This intra-NAFTA issue could become a global problem. The NAFTA partners have an opportunity to develop policy guidelines and constraints on trade interventions to preclude new trade frictions in the future. Commissioning a NAFTA report on the potential impact of new carbon taxes on intraregional trade could help define the size and scope of the possible distortions and inform policymakers on whether new NAFTA rules are needed in the future.

## Energy Cooperation

Energy remains an essential component of the North American economy as each neighbor relies heavily on NAFTA partners for energy trade. Canada and Mexico are the top two US trading partners in energy—the United States is a net exporter of energy products to Mexico, driven by sales of refined petroleum products, and a net importer from Canada, driven by purchases of crude oil (see [chapter](#) by Hufbauer and Jung in this volume). But NAFTA fell short of creating a fully integrated energy market. NAFTA reduced or eliminated tariffs and nontariff barriers on energy products but granted special carveouts for Mexico from core obligations, most notably exempting investment in Mexico's energy sector.

What should NAFTA negotiators do to further strengthen trade and investment in energy resources? Mexico first needs to fully adhere to NAFTA's investment obligations. The new pact should lock in recent

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33. The WTO consistency of such duties is untested and uncertain (see Hufbauer, Charnovitz, and Kim 2009 and Fickling and Schott 2011) but the existence of the Paris Agreement added weight to the carbon-offset arguments.

Mexican energy reforms that now allow extensive foreign participation in the exploration and development of national energy resources. Such commitments would reinforce existing plans to increase investment in new natural gas pipelines—both across the border and across Mexico—to supply the Mexican power sector.

In 2015, Mexico imported more than 1 billion cubic feet (Bcf) of natural gas from the United States. Pipeline capacity is sufficient for current US exports to Mexico, and additional capacity is being planned or in the works to accommodate substantial increases in US gas shipments from Texas.<sup>34</sup> New NAFTA commitments would provide greater policy predictability that the new construction will be completed.

But will US gas be available to supply substantially larger volumes of exports to Mexico? The pipeline projects could be downsized if adequate supplies are not assured. Prospective US exports of liquefied natural gas (LNG) from Gulf Coast terminals to foreign countries could divert gas available to Mexico, depending on how many licenses for LNG shipments are granted to non-FTA partners. The revised NAFTA needs to promote closer coordination among energy officials of the three countries to ensure that regulatory policies support an integrated energy market and bolster US energy exports.

While US gas exports can help fuel Mexican power generation, US firms also can export electricity directly to Mexico. Currently, the United States has modest net imports of electricity from Mexico; US exports are very small. The volume of US-Canada electricity trade is 10 times greater. The reason is simple: unlike US-Canada electricity trade, the national grids are not well integrated. There are only a handful of US-Mexico transmission connections and most are used only for emergencies (Parfomak et al. 2017, 33). As a recent CRS report notes, “transmission development and grid integration, requiring fully synchronous operations on both sides of the US-Mexico border, are crucial to increasing future electricity trade between the countries” (Parfomak et al. 2017, 36). NAFTA provisions should bolster regulatory cooperation in this area to enable investment in additional interconnections of the national grids and ensure system reliability in an expanding regional network.

## Dispute Settlement Procedures

NAFTA includes six distinct dispute settlement procedures that apply to specific areas of trade and investment. Chapter 14 provisions apply to financial services and have never been used. Chapter 20 sets out procedures comparable to those in the WTO; it too is rarely invoked, though it was used to assess the long-running US-Mexico dispute on trucking. The labor and environment side accords each has its own limited dispute resolution process, not subject to the binding arbitration that applies to other issues included in the body of the agreement. NAFTA should be revised in those two areas to expand the scope of rights and obligations and make them all subject to binding dispute settlement.

The most used and most criticized procedures are those included in NAFTA Chapter 11 (investor-state dispute settlement or ISDS) and Chapter 19 (affording binational reviews of final antidumping and countervailing duty determinations).

Since NAFTA, US trade agreements and investment treaties have included ISDS to protect firms that invest abroad against unfair or arbitrary treatment by foreign governments. Broadly, investment rules in NAFTA ensure that foreign firms enjoy the same rights and benefits as domestic firms (national treatment), require governments to give “fair and equitable treatment” to foreign firms, and compel fair compensation for expropriated property (Hufbauer 2016b). These protections are enforced by an international arbitration system in which foreign investors can challenge discriminatory treatment. For Mexico, in particular, agree-

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34. According to the US Energy Information Administration, cross-border pipeline capacity could possibly double to 14 Bcf/day by 2019. See Parfomak et al. (2017, 18–22).

ing to NAFTA's investment protections and framework for arbitration of disputes created a much more certain investment climate for attracting FDI, just as Mexico began to pursue major opening of protected sectors in the mid-1990s.

Fifty-nine ISDS cases have been filed under NAFTA, including 25 against Canada, 18 against Mexico, and 16 against the United States.<sup>35</sup> The United States has yet to lose a case, but Canada and Mexico have seen cases resolved in favor of the investor, which combined required compensation of over \$100 million (Gertz 2017). One recent prominent ISDS case was the TransCanada suit against the United States after the Obama administration blocked the Keystone XL pipeline—TransCanada claimed a breach of the clause in Article 1105 calling for “fair and equitable treatment” and sought damages of \$15 billion.<sup>36</sup> President Trump has since granted approval for the Keystone project resulting in suspension of the TransCanada's suit in February 2017.<sup>37</sup>

The investment provisions underlying most disputes under NAFTA involve national treatment (Article 1102), most favored nation treatment (Article 1103), “minimum international standards of treatment” (Article 1105), performance requirements (Article 1106), and the provision for compensation in the event of expropriation (Article 1110) (Hufbauer and Schott 2005, 205). To take one example, Article 1110 states a country cannot expropriate from a foreign investor indirectly or directly, unless done for a public policy purpose, on a nondiscriminatory basis with fair compensation.<sup>38</sup> The main controversy arises from broad language that covers measures “tantamount to nationalization or expropriation,” which has led to concerns over “regulatory takings”—that such broad language enables investors to challenge regulations designed to further domestic policies related to the environment, health, and safety (Hufbauer and Schott 2005).

In response to such concerns, US trade agreements have evolved to better safeguard the government's right to regulate in the public interest, to preclude bias in panel selection, and to narrow the scope for frivolous cases (Hufbauer 2016b). NAFTA Chapter 11 should be updated to incorporate improvements in these areas. For example, the Korea-US FTA explicitly clarifies that “except in rare circumstances... non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, the environment, and real estate price stabilization...do not constitute indirect expropriation” (annex 11-B). Canada, the United States, and Mexico also agreed to additional provisions in the TPP that address several complaints and create a better framework for dealing with investment disputes; for example, terms like “fair and equitable treatment” are more narrowly defined,

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35. UNCTAD, Investment Policy Hub, <http://investmentpolicyhub.unctad.org/ISDS> (accessed on May 18, 2017).

36. Gary Clyde Hufbauer and Tyler Moran, “Keystone Pipeline Lawsuit is not a Precedent for the TPP,” PIIE Trade and Investment Policy Watch blog, January 8, 2016, <https://piie.com/blogs/trade-investment-policy-watch/keystone-pipeline-lawsuit-not-precedent-tpp> (accessed on May 18, 2017).

37. Trump's Buy America mandate broadly requires US infrastructure projects to use domestically-produced steel, while a memorandum regarding pipeline construction requires “all new pipelines, as well as retrofitted, repaired, or expanded pipelines...use materials and equipment produced in the United States.” The Keystone pipeline however, is exempt from the new requirements, avoiding potential conflict in the NAFTA talks. See “Presidential Memorandum Regarding Construction of American Pipelines,” January 24, 2017, Office of the Press Secretary, [www.whitehouse.gov/the-press-office/2017/01/24/presidential-memorandum-regarding-construction-american-pipelines](http://www.whitehouse.gov/the-press-office/2017/01/24/presidential-memorandum-regarding-construction-american-pipelines); Ben Lefebvre, “White House: Keystone exempt from ‘Buy American’ requirements,” Politico, March 2, 2017, [www.politico.com/story/2017/03/keystone-pipeline-buy-american-exemption-235639](http://www.politico.com/story/2017/03/keystone-pipeline-buy-american-exemption-235639) (accessed on June 1, 2017).

38. But concerns over expropriation are not just limited to developing countries such as Mexico—for example, US company AbitibiBowater filed a claim against Canada in 2008 after the Newfoundland government expropriated some \$300 million worth of assets when the company announced it would close its pulp and paper mill in the province. See Cris Best, “The Federal Government Settles AbitibiBowater's NAFTA Claim,” The Court, August 27, 2010, [www.thecourt.ca/canada-settles-abitibibowaters-nafta-claim/](http://www.thecourt.ca/canada-settles-abitibibowaters-nafta-claim/) (accessed on May 18, 2017).

investors bringing a case bear the burden of proving all elements of its claims, ISDS proceedings must be fully open and transparent, and civil society organizations and others not party to the dispute are allowed to participate (Hufbauer 2016b).

Several of these features are also reflected in Canada’s trade deal with the European Union. But unlike the TPP, CETA sets a major precedent by establishing a formal appeals mechanism.<sup>39</sup> Such a mechanism in NAFTA would help reconcile conflicting arbitration decisions and provide more continuity in legal decisions.

Chapter 19 procedures are unique to NAFTA and the Canada-US FTA, and reflect an awkward political compromise over the proper role for antidumping and countervailing duties in a FTA. Originally, Canada wanted intra-bloc trade exempted from AD and CVD cases—following the practice of Australia and New Zealand in their FTA—because of concerns about the overzealous use of unfair trade statutes against its exports to the US market. US officials adamantly refused, recognizing that such a concession would be the kiss of death for the trade pact in Congress. Instead, the US-Canada deal agreed to leave AD and CVD practices untouched but to establish expedited reviews of final determinations in place of more protracted appeals of those decisions in national courts.

NAFTA panels are empowered to issue binding rulings regarding the conformity of AD and CVD decisions with the national law of the partner country. These decisions either uphold or require the national agency to change (in whole or part) the decision to impose penalty duties. NAFTA countries also can invoke an ECC procedure if they believe the NAFTA panel overstepped its authority or was biased. The United States has invoked the NAFTA ECC three times, most recently in 2004–05 involving softwood lumber, and each time the US claim was rejected.

Table 3 demonstrates why US politicians dislike Chapter 19 reviews. Since 1994, 145 cases have been filed under Chapter 19, including active, completed, and terminated cases: 99 cases out of 145, or almost 70 percent, have been brought by Canada and Mexico against US final AD and CVD duties.<sup>40</sup> The United States has contested 20 decisions each by Canada and Mexico. After a blistering start, however, the Chapter 19 process has not been used very often. In NAFTA’s first decade, 94 reviews were requested; in the past decade, only 27 (see figure 2). But the overall numbers mask two politically sensitive classes of cases involving steel and softwood lumber, which seem to be driving US opposition to Chapter 19 and its ECC procedures.

**Table 3 NAFTA disputes under Chapter 19, Article 1904, 1994–2017**

As petitioner/ complainant	As respondent/defendant			Total
	Canada	Mexico	United States	
Canada	—	3	47	50
Mexico	3	—	52	55
United States	20	20	—	40
Total cases	23	23	99	145

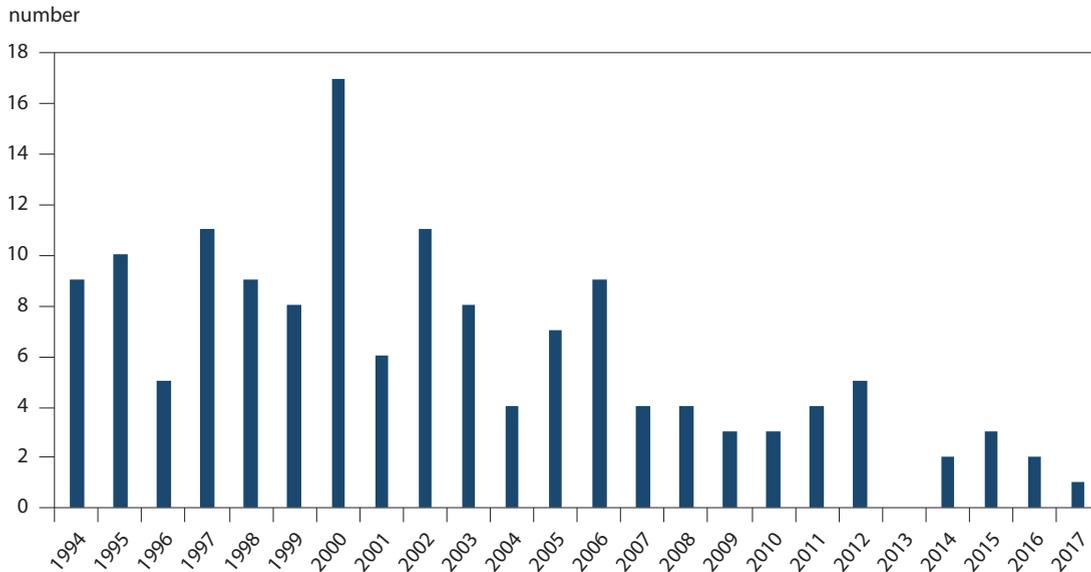
Note: Article 1904 establishes a mechanism for review by independent binational panels of an investigating authority’s antidumping and countervailing duty decisions involving imports from a NAFTA country. The total figures reported include active, completed, and terminated cases as of February 2017.

Source: NAFTA Secretariat, 2017, [www.nafta-sec-alena.org/Home/Dispute-Settlement/Status-Report-of-Panel-Proceedings](http://www.nafta-sec-alena.org/Home/Dispute-Settlement/Status-Report-of-Panel-Proceedings).

39. “CETA: EU and Canada agree on new approach on investment in trade agreement,” European Commission press release, February 29, 2016, [http://europa.eu/rapid/press-release\\_IP-16-399\\_en.htm](http://europa.eu/rapid/press-release_IP-16-399_en.htm) (accessed on May 18, 2017).

40. Based on the NAFTA Secretariat’s “Status Report of Panel Proceedings,” [www.nafta-sec-alena.org/Home/Dispute-Settlement/Status-Report-of-Panel-Proceedings](http://www.nafta-sec-alena.org/Home/Dispute-Settlement/Status-Report-of-Panel-Proceedings).

**Figure 2 Number of panel reviews requested under NAFTA Article 1904, 1994–2017**



Note: Includes active, completed, and terminated cases as of February 2017.

Sources: NAFTA Secretariat, 2017, [www.nafta-sec-alena.org](http://www.nafta-sec-alena.org).

Steel accounts for more than 30 percent of cases requested under Chapter 19 since its inception and half of the cases over the past decade; US decisions in steel cases have been the target of two-thirds of those recent cases. Softwood lumber represents 10 of the 145 total cases; the focus of US political ire against the NAFTA process derives from an ECC decision in 2005 against the US Commerce Department determination to impose duties on Canadian softwood lumber. Current Commerce Secretary Wilbur Ross strongly condemns the 2 to 1 vote in this case as evidence that the rules are stacked against US interests.<sup>41</sup>

ECC panels comprise one judge chosen by each party to the dispute from an established roster of judges, and a third selected by one of the involved parties who “decide by lot which of them shall select the third member” (NAFTA Annex 1904.13). Under this procedure, Canada selected 2 of the 3 judges who ruled in August 2005 against the US decision on softwood lumber. The selection process is not biased against the United States as Ross claims, but the third judge could be selected differently to assuage US concerns.

Should there be more wholesale reform of Chapter 19 procedures, including possibly their deletion? Hufbauer and Schott (2005) argued a decade ago that the NAFTA countries could use the WTO dispute settlement system to address concerns about AD/CVD determinations. But the WTO process has become increasingly sluggish and doesn’t provide the expeditious relief foreseen under NAFTA Chapter 19. Moreover, recent US criticisms of WTO dispute decisions caution against exclusive reliance on WTO litigation, especially when USTR and Commerce officials aggressively pursue import relief under a broad range of US trade statutes. Moreover, for strategic reasons, Canada and Mexico are unlikely to agree to drop Chapter 19 reviews while longstanding steel and softwood lumber issues remain unresolved. Discrete revisions to panel procedures should be considered instead to avoid the appearance of national bias in the selection of three-member panels.

41. Demetri Sevastopulo, Katrina Manson, and Anna Nicolaou, “Trudeau and Trump clash over lumber and dairy tariffs,” *Financial Times*, April 25, 2017, [www.ft.com/content/525756a0-2943-11e7-9ec8-168383da43b7](http://www.ft.com/content/525756a0-2943-11e7-9ec8-168383da43b7) (accessed on April 25, 2017).

## POTENTIAL PROBLEM AREAS FOR THE NEGOTIATIONS<sup>42</sup>

US officials vow to do no harm in NAFTA negotiations but have signaled interest in several goals that would sharply deviate from past US practice, and if pursued, could derail the NAFTA negotiations. In particular, efforts by the Trump administration to reduce the US trade deficit in goods and “rebalance” its trading relationships would risk NAFTA failure (as discussed in the [chapter](#) in this volume by C. Fred Bergsten). The administration also wants to change NAFTA rules of origin placing limits on imports into the US of products that contain high levels of components made outside the NAFTA trading zone. Caroline Freund’s [chapter](#) indicates why this idea is also poorly aimed and likely to provoke a counterreaction.

The auto sector has been one of the main beneficiaries of North American integration but could suffer from US-led demands to change NAFTA rules of origin. To be sure major US automakers would welcome improved NAFTA origin rules (e.g., by deleting inefficient tracing requirements), but they do not want new rules that would disrupt existing supply chains and require them to source inputs from more expensive suppliers (as would likely occur if regional content requirements were significantly increased). Such changes would raise production costs and undercut their competitiveness in the US and third-country export markets. Rather than changes in origin rules, their priorities target harmonized standards and the development of NAFTA rules to counter currency manipulation that would set a precedent for future trade accords. US Trade Representative Robert Lighthizer has indicated that the administration is considering inclusion of currency rules in NAFTA, even though NAFTA countries have not engaged in currency manipulation in recent decades.<sup>43</sup> Rules on currency are preferable to more restrictive rules of origin. In any event, Congress may insist that NAFTA add a currency chapter since it is called for in the TPA and covered by the Trade Facilitation and Trade Enforcement Act of 2015.

Trump officials also intend “to level the playing field on tax treatment,” a reference to Canadian and Mexican use of value-added taxes. Whether this becomes an issue in the NAFTA talks will depend on the direction of congressional deliberations over US tax reform and border tax adjustments (BTA), which if implemented would raise the cost of US imports. The BTA proposal so far has garnered tepid support from the Trump administration. However, President Trump appeared to float the idea of the BTA as a possible mechanism for imposing a 20 percent “border tax” on imports from Mexico—such targeting of a single country would violate US obligations under NAFTA and the WTO.

President Trump’s insistence on strong Buy America policies for US government contracts could also complicate NAFTA talks, especially if Congress authorizes massive new spending on US infrastructure projects, affecting steel and many other products. The administration’s new Buy America policies would reduce access that Canadian and Mexican firms already have in bidding on US public procurement and probably would lead those countries to scale back access of US firms to their government contracts. The US policy thus might backfire, making it harder for US firms to compete for Mexican and Canadian contracts against other trade partners of those countries that get procurement preferences under bilateral trade pacts. US financial services firms would stand to lose hefty contracts providing services to Mexican government agencies.

Last, specific disputes regarding longstanding bilateral irritants over dairy, sugar, softwood lumber, and tuna-dolphin could prevent broader progress in new trade talks. Currently, bilateral negotiations are seeking

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42. This section draws from, Jeffrey J. Schott, “The Trump Administration’s Potentially Constructive Objectives for NAFTA,” PIIE Trade and Investment Policy Watch, March 30, 2017, <https://piie.com/blogs/trade-investment-policy-watch/trump-administrations-potentially-constructive-objectives-nafta> (accessed on March 31, 2017).

43. William Maudlin, “Trump Administration Weighs Adding Currency Rules to Nafta,” *Wall Street Journal*, May 17, 2017, [www.wsj.com/articles/trump-administration-weighs-adding-currency-rules-to-nafta-1495037487](http://www.wsj.com/articles/trump-administration-weighs-adding-currency-rules-to-nafta-1495037487) (accessed on May 17, 2017).

to conclude agreements on sugar and softwood lumber that would regulate prices and trade volumes to protect US producers against dumped or subsidized imports. The pacts would suspend pending AD/CVD cases and provide price floors for sales in the US market. The United States and Mexico finalized a deal over sugar in July 2017.

In both cases, such managed trade runs counter to the broader NAFTA objective of removing market distortions. The sugar dispute, dating from the original NAFTA negotiation, is due to big distortions caused by US sugar policy that effectively requires import controls to ensure that US consumers pay higher than world market prices. The softwood lumber talks seek market share caps and price controls on US imports of Canadian lumber to compensate for the subsidies conveyed to Canadian firms through rights to harvest timber on public (crown) lands. In this case, the initial distortion derives from provincial timber policies and export controls on logs. In general, Canada prefers to export cut lumber to promote domestic jobs and value-added production. The better remedy would be for each province to institute auctions for cutting rights, open to all bidders, as Hufbauer and Schott (2005, 242) suggested a decade ago. Such a policy would reduce the implicit subsidies to Canadian producers and lower CVDs (and possibly obviate the need for them).

In the long-running tuna-dolphin dispute in the WTO, Mexico has been authorized to retaliate against \$163 million in US exports. Depending on the forthcoming WTO compliance panel ruling due later in summer 2017 regarding whether recent changes in US fishing regulations bring US practice into WTO compliance, the dispute could finally conclude. If that ruling is appealed, however, the case would extend into 2018 and increase trade tensions, which could spill over to the new NAFTA talks.

## **CONCLUSION**

US negotiators have improved upon the NAFTA template in each subsequent trade agreement to better address new realities in the global trading system; meanwhile NAFTA remains stuck in the 1990s. The TPP negotiations were the first attempt to modernize the North American trade deal, which excluded important issues from its rulemaking and some key sectors from full liberalization. Trilateral talks between the three countries could build on those efforts and better address issues specific to North American integration. New rules that govern trade in the digital economy, enforceable labor and environment rules, sectoral cooperation on energy, and modernized dispute settlement procedures would be a start.

In new rulemaking for the 21st century, NAFTA should set precedents for future deals, including rules that better enable e-commerce and address barriers to digital trade. In labor and environment, NAFTA should build on precedents in the TPP and ensure new obligations are enforceable under dispute settlement procedures. In energy, NAFTA partners should promote new investment in energy infrastructure to further develop North American energy resources, especially natural gas and renewables. In dispute settlement, NAFTA should incorporate improvements in ISDS to better safeguard the government's right to regulate, to preclude bias in panel selection, and narrow the scope for frivolous cases. Panel selection procedures in NAFTA's mechanism to review final determinations in trade remedy cases should also be revised to avoid the appearance of national bias.

These discrete changes to NAFTA are unlikely to significantly affect regional trade and investment, which already exceeds \$1.2 trillion annually. However, new NAFTA rules could encourage greater participation by SMEs in NAFTA trade and help boost the competitiveness of North American firms in domestic markets and abroad. To boost the long-term payoff of a new NAFTA deal, negotiators also would have to build on existing NAFTA commitments in other areas, especially services and other regulatory reforms. Such a deal would require additional US concessions as well as new commitments from Mexico and Canada and would be a more complicated negotiation. Harder to do but worth the effort.

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## CHAPTER 7

# NAFTA and Energy

Gary Clyde Hufbauer and Euijin Jung

The energy sector is a crucial part of the integrated economies of Mexico, Canada, and the United States, all of which are producers, exporters, and importers of a variety of energy products. Under the North American Free Trade Agreement (NAFTA), which entered into force January 1994, tariffs and nontariff barriers on trade in energy products were reduced or eliminated. Indeed, the agreement's Chapter 6 on Energy and Basic Petrochemicals has been praised even by critics for facilitating rapid growth in US energy trade with Canada, and to a limited extent with Mexico, over the past 23 years. NAFTA excused Mexico from a number of core obligations, however. Despite the importance of trade and investment for the future growth of the NAFTA countries, NAFTA disciplines were substantially absent in the energy chapter because of Mexico's insistence (Hufbauer and Schott 2005). Building on the Canada-US Free Trade Agreement of 1989 (CUSFTA), the United States and Canada have fully integrated their energy sectors in terms of supply, transport, production, and distribution, but Mexico remains less engaged.

The energy landscape in North America has changed dramatically over the past two decades. Canada and Mexico are the first and second largest US trading partners in energy products. Currently the United States is a net exporter of energy products to Mexico and a net importer from Canada. Notable transformations include Mexican energy reforms, US natural gas production from shale, and Canadian oil sands extraction on a large scale. Mexico implemented a constitutional reform that allows foreign investment in the domestic energy sector. With advanced technology (hydraulic fracturing, or fracking), the United States became a natural gas producer and exporter. Using specialized techniques, Canada sharply increased its production from oil sands. The new NAFTA should build on these changes to promote deeper energy cooperation within North America.

However, sensitive energy issues are intertwined with political dynamics that could hinder productive negotiations:

- Rising anti-America sentiment within Mexico could resurrect energy nationalism and derail energy reform in Mexico.
- Trump's Buy American approach to pipeline construction will not be readily accepted by Canada, and Mexico may object as well.

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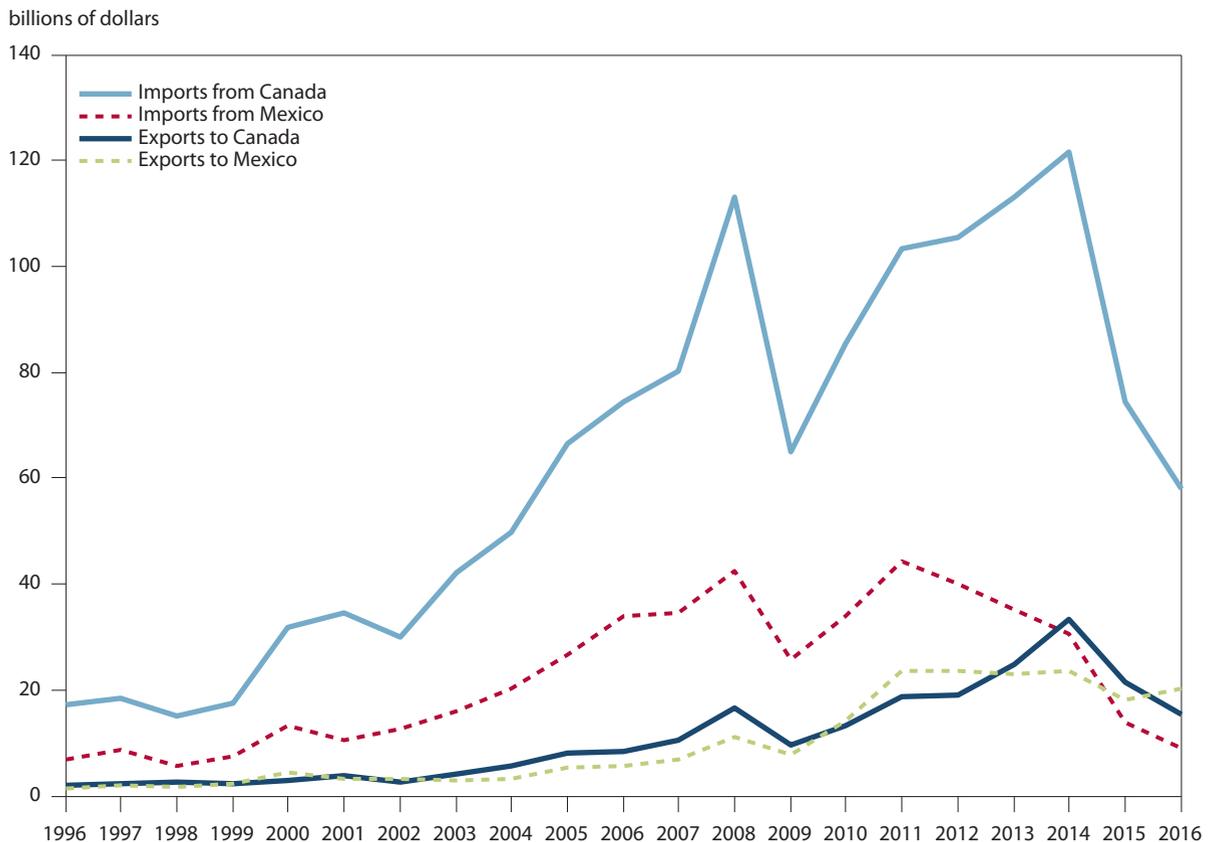
- Widespread subsidies to renewable energy are typically coupled with local content requirements that obstruct North American commerce both in components and construction.
- The blending of Canadian crude oil with imported diluents could fail the eligibility tests for duty-free treatment under stronger NAFTA rules of origin.

This chapter first surveys US energy trade with Canada and Mexico since NAFTA entered into force. Next, it examines major developments in the energy sector of North America. Finally, it highlights energy issues that could make for difficult negotiations or even put the entire venture at risk.

## US ENERGY TRADE WITH NORTH AMERICA

US energy trade with North America has continued to grow but experienced declines in 2009, following the financial crisis, and also in 2015–16 because of falling oil prices. Figure 1 portrays US energy exports and imports over two decades with Canada and Mexico. US energy imports from Canada peaked at \$121.8 billion in 2014, after ramping up from \$17.4 billion in 1996. The sharp rise reflects both price and volume trends. The annual volume of crude oil and petroleum products that the United States purchased from

**Figure 1 US energy trade with Canada and Mexico in 1996–2016**

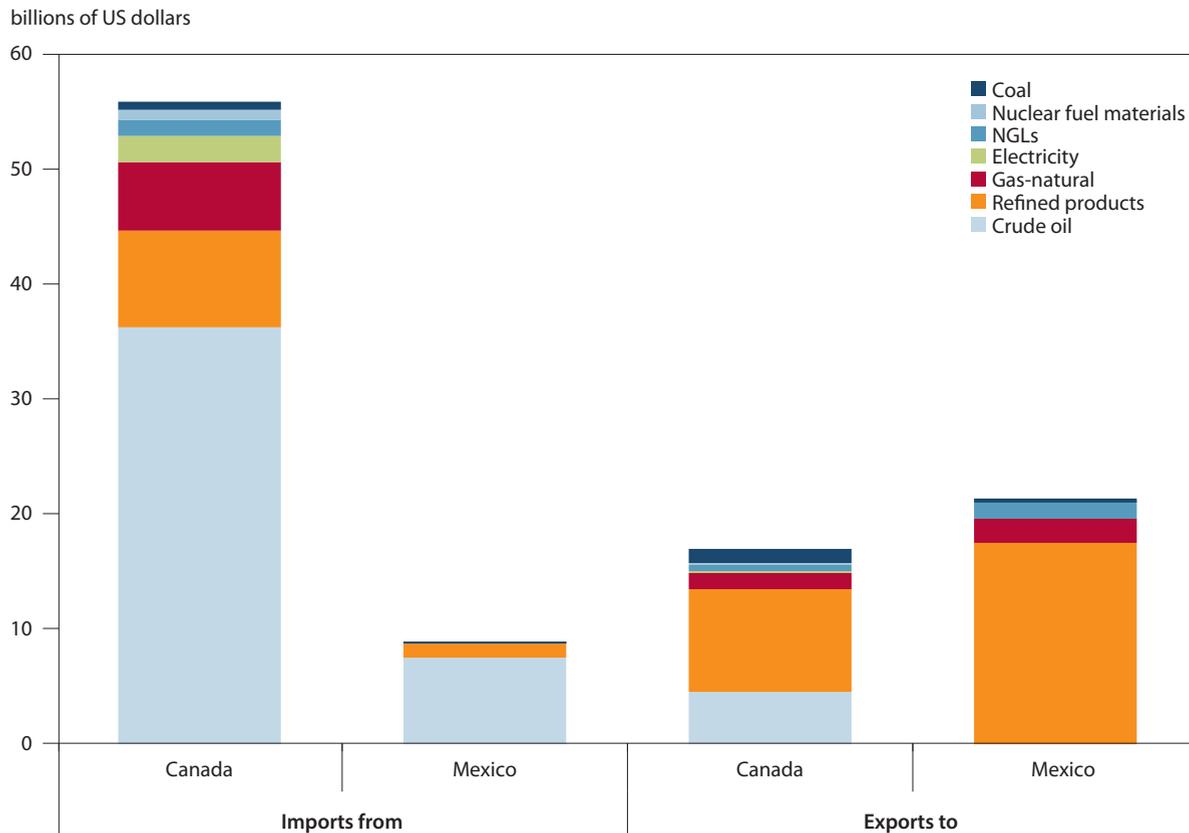


HS=Harmonized System

Note: Energy covers all products under HS 27 such as crude oil, refined petroleum products, natural gas, and electricity.

Source: US International Trade Commission, Interactive Tariff and Trade DataWeb.

**Figure 2 US energy trade with Canada and Mexico, by product (2016)**



NGL = natural gas, liquid

Source: Census Bureau, "Country by 5-digit End-Use Code, Annual totals, 2007–2016," <https://www.census.gov/foreign-trade/statistics/country/index.html> (accessed on April 3, 2017).

Canada increased from 0.5 billion barrels in 1996 to 1.4 billion barrels in 2016.<sup>1</sup> The recent decline in the value of US imports from Canada reflects the declining oil price in global markets, not falling energy volume from Canada. US energy imports from Mexico reached \$44.4 billion in 2011, but then rapidly fell. The main reasons were the global decline in oil prices and stagnant Mexican energy production (see Seelke et al. 2015).

US energy exports to North America also expanded at a brisk clip. US exports to Canada rose from \$1.9 billion in 1996 to \$33.2 billion in 2014. To Mexico, the United States exported \$1.5 billion in energy products in 1996, rising to \$20.3 billion in 2016. The United States became a net energy exporter to Mexico in 2015, and the average annual growth of US exports to Mexico was 19 percent between 1996 and 2016.

In 2016, US energy imports from Canada and Mexico were \$55.8 billion and \$8.7 billion, respectively, while US energy exports to Canada and Mexico were \$17.0 billion and \$21.3 billion, respectively (see figure 2).<sup>2</sup> The United States mainly imported crude oil from Canada, amounting to \$36.2 billion and accounting

1. See US Energy Information Administration, "US imports by country of origin," [https://www.eia.gov/dnav/pet/pet\\_move\\_impcus\\_a2\\_nus\\_ep00\\_im0\\_mbb1\\_a.htm](https://www.eia.gov/dnav/pet/pet_move_impcus_a2_nus_ep00_im0_mbb1_a.htm) (accessed on April 12, 2017).

2. Since the Census Bureau uses the 5-digit NAICS (North American Industry Classification System) code for total trade of energy products, there is a discrepancy in total trade data between figures 1 and 2.

for two-thirds of US energy imports from Canada. Crude oil is mainly produced in the Canadian province of Alberta and transported through pipelines to the Midwest and Gulf Coast regions of the United States. Refined products and natural gas represented a quarter of US energy imports from Canada. The United States exported crude oil and refined products to Canada valued at \$13.4 billion. US refined products include diluents to enable pipeline transportation of heavy crude oil produced in Canada.<sup>3</sup>

After Canada, Mexico is the second largest US partner in energy trade, but Mexico is a net importer. In 2016, the United States imported \$7.6 billion of crude oil from Mexico and exported \$17.5 billion of refined product to Mexico. Simply put, crude oil produced by Chevron in Mexico is shipped to refineries in Texas or Louisiana, and then refined products return to Mexico. Mexican supplies of refined products were unable to meet domestic demand, and the shortfall was met by a spike in US exports.<sup>4</sup> US refined products supported about half of Mexico's domestic consumption.<sup>5</sup> US natural gas exports to Mexico rose to \$2.2 billion in 2016 because of rising demand for gas-fired electricity.

## ENERGY DEVELOPMENTS SINCE NAFTA

Although NAFTA Chapter 6 on Energy and Basic Petrochemicals removes tariffs and quotas on energy products, it provides special provisions and “carve-outs” for Mexico. NAFTA Annex 602.3 enables Mexico to prohibit any private investment in all strategic activities that include everything from exploration to distribution of crude oil and natural gas and from supply to sales of electricity. NAFTA Annex 603.6 permits Mexico to maintain its licensing system that restricts foreign trade in crude oil and gas. Mexican state-owned enterprise Petróleos Mexicanos (PeMex) controls all activities, including foreign trade, relating to oil and gas, while Comisión Federal de Electricidad (CFE) controls the electricity sector, including supply, purchase, and pricing. The energy chapter allowed Mexico to resist deeper integration with its northern neighbors and to forestall trade and investment liberalization by grandfathering these state energy monopolies.<sup>6</sup>

After 20 years, Mexico decided to change its nationalistic energy policy. On December 20, 2013, Mexican president Enrique Peña Nieto signed constitutional reforms that opened Mexico's oil, natural gas, and power sectors to private and foreign investment. Key elements of the reforms were: allow private companies to take ownership of extracted resources; enable private exploration and production via profit-sharing and production-sharing contracts and licenses; and open refining, transport, storage, natural gas processing, and petrochemical sectors to private investment (see Seelke et al. 2015). This means that PeMex, with its monopoly over oil and natural gas in Mexico, can build partnerships with international firms in exploration, production, and transportation of oil and natural gas. In the electricity sector, private companies are permitted to enter the wholesale power market in Mexico, no longer requiring the approval of CFE for sales contracts.<sup>7</sup> Since the constitutional reform, the first foreign company granted permission to drill in offshore

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3. US Energy Information Administration, “Canada is the United States' largest partner for energy trade,” *Today in Energy*, March 1, 2017, <https://www.eia.gov/todayinenergy/detail.php?id=30152> (accessed on April 3, 2017).

4. US Energy Information Administration, “U.S. energy trade with Mexico: U.S. export value more than twice import value in 2016,” *Today in Energy*, February 9, 2017, <https://www.eia.gov/todayinenergy/detail.php?id=29892> (accessed on April 3, 2017).

5. “Build pipelines, not walls,” *Economist*, June 17, 2017.

6. Still, PeMex and CFE are subject to the disciplines of national treatment, limitations on import and export restrictions, and on export taxes provided in NAFTA Chapter 6.

7. For more details, see Goldwyn et al. (2014).

Mexican waters was Argentina's Pan American Energy.<sup>8</sup> Also, US oil companies won five out of the eight blocks in auction for deepwater oil license, and ExxonMobil announced it would invest \$300 million in fuel distribution facilities in Mexico over the next decade.<sup>9</sup>

The objectives of Mexico's energy reforms are to increase oil production, to grow the natural gas supply, and to reduce the cost of electricity generation. Decades of high protection for the Mexican energy sector led to severe inefficiency and underinvestment. Owing to heavy fiscal demands from the Mexican government and vast overstaffing, PeMex often operated at a loss, and accumulated considerable debt. Facilities wore out, investment was neglected, and energy production declined (Hufbauer and Schott 2005). Meanwhile, CFE controlled the Mexican power market from generation to distribution. Because few generation options existed and transmission connections between regions were limited, wholesale electricity prices within Mexico varied enormously, for example, from \$23 per megawatt hour in Tijuana zones to \$118 per megawatt hour in southern Baja.<sup>10</sup> Subpar performance by PeMex and CFE finally persuaded the Mexican government to pursue structural reforms in the energy sector.

Mexico's energy reform is subject to the article 1108(1)(c) of NAFTA Chapter 11 on Investment, known as the ratchet clause:

“[A]n amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment.”

This ratchet clause intends to lower nonconforming measures of member countries in the future. Simply put, after member countries amend to liberalize any nonconforming measure, they are prohibited to restore the level of its measures established prior to the amendment. It means that Mexico is not allowed to undo its liberalization in investment in the energy sector under NAFTA. Specifically, the energy reform removed Mexico's reservations to investment in energy products addressed in its schedule to Annex I. However, a legal vagueness embedded in the Section B (2) of Annex III of NAFTA might allow Mexico to provide preferential treatment for its state-owned enterprises in the oil sector.<sup>11</sup> Mexico might continue to provide preferential treatment to PeMex in acquiring and establishing investments in exploration to production of Mexican crude oil and natural gas in the schedule to Annex III and to impose performance requirements. For a full energy integration in North America, such legal leeway could be forgone under the new NAFTA.

Another development after NAFTA was the boom in US and Canadian fossil fuel production owing to new technologies. The United States engaged in hydraulic fracturing while Canada deployed new tech-

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8. The owners include British giant BP Plc, China National Offshore Oil Corporation, and Argentine conglomerate Bidas. James Stafford, “Why Mexico's Oil Reform Is A Huge Opportunity For Investors,” *Oilprice.com*, November 21, 2016, <http://oilprice.com/Energy/General/Why-Mexicos-Oil-Reform-Is-A-Huge-Opportunity-For-Investors.html> (accessed on June 19, 2017).

9. “Build pipelines, not walls,” *Economist*, June 17, 2017.

10. US Energy Information Administration, “Mexico electricity market reforms attempt to reduce costs and develop new capacity,” *Today in Energy*, July 5, 2016, <https://www.eia.gov/todayinenergy/detail.php?id=26932> (accessed on June 19, 2017).

11. NAFTA Annex III Section B on Deregulation of Activities Reserved to the State reads “If Mexican law is amended to allow private equity investment in an activity set out in Section A, Mexico may impose restrictions on foreign investment participation notwithstanding Article 1102, and describe them in Annex I.” There are several ways of reading “private equity investment.” For indepth legal analysis, see Vazquez (2016).

niques to extract from oil sands. US oil production grew from 5.1 million barrels per day (mmb/d) in 2006 to 8.9 mmb/d in 2016, while Canadian production rose from 2.5 mmb/d in 2006 to 3.6 mmb/d in 2016.<sup>12</sup>

Larger US production made the United States the leading natural gas exporter to Mexico. While natural gas production declined in Canada and Mexico, the United States increased from 19.4 trillion cubic feet in 2006 to 28.3 trillion cubic feet in 2016. The growth of US natural gas exports to Mexico supported rapid expansion of Mexico's electricity supply (see Parfomak et al. 2017). Mexico began to import substantial volumes of natural gas from the United States in 2009. Two factors fostered natural gas imports from the United States: Natural gas pipelines from the United States to Mexico were already installed, and the cost of US natural gas was lower than alternative sources. New natural gas supplies from the West Texas region have attracted new investment in oil drilling, fracking, and new pipelines.<sup>13</sup> The implication can be drawn that lower gas prices resulting from an increase in supply will boost US natural gas exports to Mexico. To secure even greater supplies of natural gas, Mexico has announced plans to construct more pipelines across the US border. The Sur de Texas-Tuxpan pipeline is planned to transport natural gas from southern Texas to the Mexican state of Tamaulipas and to Veracruz through the Gulf of Mexico.<sup>14</sup> The capacity of cross border pipelines for natural gas is expected to double over the next three years. Growing energy trade and investment between the United States and Mexico underscores the need for legal certainty within NAFTA in the realms of regulation and investment protection.

A new NAFTA energy chapter should reflect these changes in North American energy production. As it stands, NAFTA has deepened energy market integration between Canada and the United States, but not between Mexico and the United States (White House 2015). The new NAFTA should revise "carve-out" clauses for Mexico, to promote private investment in the Mexican energy sector and foster cross-border integration. The new NAFTA should create a strong presumption in favor of cross-border electrical transmission lines and fossil fuel pipelines. It should set forth norms for state-owned enterprises, drawing on Chapter 17 in the Trans-Pacific Partnership agreement. It should mandate cooperation between the relevant federal, state, and provincial regulatory authorities. These are all positive steps that a new NAFTA could accomplish.

## WHAT COULD GO WRONG?

Given the breadth of trilateral energy trade within North America and the foundation created by NAFTA, renegotiation of the energy chapter should be relatively easy. However, a handful of issues that might obstruct the talks are surveyed in this section.

***Stirring Mexican nationalism.*** If the United States presses sensitive issues such as payment for the border wall promised by President Trump during the election campaign, deportation of immigrants, and border tax adjustments, Mexican nationalism could flare up in the energy sector. In the context of the Mexican revolution (1910–20) that ousted President Porfirio Díaz, partly because of his close ties with foreign companies, the 1917 Mexican Constitution prohibited foreign investment in the energy sector. In 1938,

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12. US Energy Information Administration, "International Energy Statistics," online database, [https://www.eia.gov/beta/international/data/browser/#/?pa=00000000000000000000000000000002&c=00000010000000000000000000000002&ct=0&tl\\_id=5-A&vs=INTL.57-1-CAN-TBPD.A&ord=CR&cy=2014&vo=0&pin=a&v=H&start=2006&end=2016](https://www.eia.gov/beta/international/data/browser/#/?pa=00000000000000000000000000000002&c=00000010000000000000000000000002&ct=0&tl_id=5-A&vs=INTL.57-1-CAN-TBPD.A&ord=CR&cy=2014&vo=0&pin=a&v=H&start=2006&end=2016) (accessed on April 10, 2017).

13. Timothy Puko and Christopher M. Matthews, "The Oil Play That Could Flood the Natural-Gas Market," *Wall Street Journal*, May 30, 2017, <https://www.wsj.com/articles/the-oil-play-that-could-flood-the-natural-gas-market-1496136602> (accessed on June 22, 2017).

14. US Energy Information Administration, "U.S. natural gas exports to Mexico continue to grow," *Today in Energy*, November 29, 2016, <https://www.eia.gov/todayinenergy/detail.php?id=28932> (accessed on April 6, 2017).

the Mexican government, under President Lázaro Cárdenas, gave this prohibition teeth: It expropriated all foreign oil assets, including Standard Oil of New Jersey controlled by the Rockefeller family. With huge popular support, PeMex became the state-owned monopoly that controlled the entire energy sector. Foreign companies were only allowed marginal roles as contractors to PeMex.

Following the constitutional reforms of December 2013, Mexico slowly opened its energy sector to US and foreign firms. The Mexican government offered 10 exploratory blocks for bids, with estimated reserves of about 11 billion barrels of oil and natural gas equivalents, and awarded 8 blocks to companies such as Exxon Mobil and Chevron of the United States, Total of France, and the China National Offshore Oil Corporation (CNOOC).<sup>15</sup> Current warm relations between US oil firms and Mexico could be disrupted by anti-American sentiment in the wake of excessive US pressure. Many read recent events as a preview to such disruption: In January 2017, after Trump insisted that Mexico pay for a border wall, Mexican president Peña Nieto canceled his planned trip to Washington. Anti-Trump and anti-American protests have started to appear in Mexico.<sup>16</sup> Leftist politician Andrés Manuel López Obrador (AMLO), a perennial presidential candidate, now leads the polls for the Mexican presidential election in July 2018.<sup>17</sup> Like other left-wing politicians, he opposes the current energy reforms. Unfortunately, the stage has already been set for a return to Mexican nationalism in the energy sector.

**Pipeline construction.** Trump has invoked a populist phrase, “Buy American and Hire American,” to justify protection for US steel manufacture and workers. A presidential memorandum, issued on January 24, 2017, requires that pipelines in US territory use materials and equipment produced in the United States. The memorandum defines “produced in the United States” to mean:<sup>18</sup>

- (i) With regard to iron or steel products, that all manufacturing processes for such iron or steel products, from the initial melting stage through the application of coatings, occurred in the United States.
- (ii) Steel or iron material or products manufactured abroad from semi-finished steel or iron from the United States are not “produced in the United States” for purposes of this memorandum.
- (iii) Steel or iron material or products manufactured in the United States from semi-finished steel or iron of foreign origin are not “produced in the United States” for purposes of this memorandum.

Recognizing prior purchases of pipe, the White House subsequently exempted the Keystone XL and Dakota Access pipeline projects from the requirement that they not use foreign steel. However, “produced in the United States” remains the policy for all future pipelines. As well, it could be extended to electrical transmission lines and other infrastructure projects.

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15. Elisabeth Malkin and Clifford Krauss, “Oil and Gas Industry Leaders Eagerly Take Stakes in Mexican Offshore Fields,” *New York Times*, December 5, 2016, <https://www.nytimes.com/2016/12/05/business/energy-environment/oil-and-gas-industry-takes-stakes-in-mexican-offshore-fields.html> (accessed on April 6, 2017).

16. Laura Tillman, “In Mexico, Trump triggers a surge in patriotism, anti-American sentiment,” *Los Angeles Times*, February 5, 2017, <http://www.latimes.com/world/mexico-americas/la-fg-mexico-patriotism-trump-2017-story.html> (accessed on April 6, 2017).

17. Carrie Kahn, “Mexican Leftist Politician Rising In Polls With Anti-American Rhetoric,” *NPR*, March 12, 2017, <http://www.npr.org/2017/03/12/519879405/mexican-leftist-politician-rising-in-polls-with-anti-american-rhetoric> (accessed on April 6, 2017).

18. Donald Trump, “Presidential Memorandum Regarding Construction of American Pipelines,” White House, January 24, 2017, [https://insidetrade.com/sites/insidetrade.com/files/documents/jan2017/wto2017\\_0027.pdf](https://insidetrade.com/sites/insidetrade.com/files/documents/jan2017/wto2017_0027.pdf) (accessed on April 4, 2017).

This policy has three consequences. The US steel industry lacks the capacity to produce all the necessary grades of oil and gas pipeline, meaning that some construction projects will be delayed.<sup>19</sup> Domestic pipe may be more expensive than imported pipe, meaning higher construction costs. Finally, the policy violates NAFTA and World Trade Organization (WTO) obligations, and does not sit well with Mexico or Canada.

Taking a further look at NAFTA and the WTO, two obligations come into play. If the US federal government pays for construction, the WTO Government Procurement Agreement (GPA) and Article 1003 of NAFTA call for open bidding by Canadian and Mexican firms. If the project is purely private, GATT Article III and NAFTA Article 301 require nondiscrimination and national treatment of foreign goods and services entering the US market. Canada and Mexico will resist surrendering these rights in the new NAFTA. The European Union and Canada have alleged that such local content requirements would be in violation of US obligations at the WTO.<sup>20</sup>

***Renewable subsidies and local content requirements.*** To deal with the threat of climate change, the renewable energy sector has been promoted with the wholehearted support of governments. Trade and investment restrictions were permitted as exceptions in order to foster the nascent renewable energy industry. The Organization for Economic Cooperation and Development (OECD 2015) reports that solar and wind energy sectors have faced additional trade and investment barriers, such as local content requirements (LCRs). LCRs are measures that require a specified ratio of intermediate goods to be purchased from domestic producers to entire products or investments to be made solely by domestic firms.

The Canadian province of Ontario significantly developed its wind energy sector while insisting on strict LCRs in wind power projects.<sup>21</sup> In 2009, Ontario introduced LCRs requiring suppliers to purchase within Ontario 50 percent of total value for wind projects and 60 percent for solar projects. The LCRs were enforced through the provisions of a feed-in tariff (FiT) scheme. After a WTO ruling that Ontario's FiT violated Canada's obligations, Ontario lowered its LCRs for small-sized FiT programs and removed them for large-sized programs. As a remaining concern, the Office of the US Trade Representative (USTR 2017) identified a 60 percent LCR for wind turbine projects in Quebec as a hindrance to US suppliers seeking to enter procurement bidding controlled by the public utility Hydro-Quebec.

The decisions to apply LCRs to renewable energy projects in the Ontario and Quebec governments were made by policymakers who believed that the LCRs would bring local jobs and strengthen local industry. Policymakers elsewhere hold similar beliefs, and since renewable energy projects are often subsidized by a mix of FiTs and tax credits, LCRs can be easily implemented as a condition for receiving the subsidy. Unfortunately, this policy combination raises the cost and slows the adoption of renewable energy, while being almost invisible to public surveillance (Hufbauer et al. 2013). The new NAFTA faces a major challenge in providing some degree of openness to this segment of the energy sector—perhaps by banning quantitative LCRs and specifying maximum bid preferences (e.g., 20 percent) for local suppliers to subsidized renewable energy projects.

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19. "Questions raised over steel industry's capacity to meet Trump's American-made demand," *Inside US Trade*, March 27, 2017, <https://insidetrade.com/daily-news/questions-raised-over-steel-industrys-capacity-meet-trumps-american-made-demand> (accessed on April 4, 2017).

20. "EU, Canada skeptical that Trump's American-made pipeline request is WTO-compliant," *Inside US Trade*, April 10, 2017, <https://insidetrade.com/daily-news/eu-canada-skeptical-trumps-american-made-pipeline-request-wto-compliant> (accessed on April 12, 2017).

21. Electricity generation, transmission, and distribution within Canada are governed at provincial and territorial levels. Information on LCRs in Ontario and Quebec are largely drawn from Hufbauer et al. (2013).

**Rules of origin.** Trump and his officials claim that weak rules of origin have disadvantaged US trade and jobs.<sup>22</sup> This is mainly an issue in the auto sector, but it could find an echo in the energy sector. Under an agreement such as NAFTA, rules of origin confine duty-free treatment to products largely made in the partner countries. Annex 401 of the NAFTA lists specific rules of origin that apply to crude oil and natural gas. Essentially the rules require a change in tariff classification, a so-called “tariff shift,” for inputs from a third country to be considered originating in North America when embodied in a product that crosses a NAFTA border. In order to qualify, all nonoriginating inputs from third countries that are used in a North American product must be classified in a heading of the Harmonized System (HS) other than the heading in which the exported product is classified. Otherwise, if non-NAFTA originating inputs are classified in the same heading, the whole product is treated as being of non-NAFTA origin, and must pay the applicable most favored nation tariff when crossing a NAFTA border. The most restrictive tariff shift is a change in the HS chapter heading; less restrictive tariff shifts entail a change in the 8- or 10-digit HS heading assigned to specific products.

Crude oil and raw bitumen produced in Canada are too thick to move smoothly through pipelines. Canadian exporters must therefore blend their crude oil with diluents to enable transportation. The blended crude oil will qualify for duty-free entry only if the combination of diluents and crude oil results in a “tariff shift,” consistent with NAFTA Annex 401.<sup>23</sup> The problem arises when diluents originate from non-NAFTA countries. Crude oil is classified in HS heading 2709, and diluent in either HS 2709 or HS 2710. If diluent imported from non-NAFTA countries is classified in HS 2709, the blended crude oil with this diluent will be deemed as non-NAFTA origin because it does not undergo an approved tariff shift. Under NAFTA, Canadian crude oil exported to the United States is entitled to a zero tariff if it satisfies the rules of origin. If it fails to meet the rules of origin, US Customs will impose a duty of between 5.25 cents and 10.5 cents per barrel on Canadian crude oil.<sup>24</sup> Given that the United States imported 1.4 billion barrels from Canada in 2016, the approximate duty imposed on imported oil could cost between \$147 million and \$201 million per year, if Canadian producers use non-NAFTA diluents. The United States has no compelling reason to protect its exports of diluents through this obscure rule of origin, and the energy sector should not be side-swiped by a rule-of-origin debate in the new NAFTA that mainly concerns the auto industry.

## CONCLUSIONS

NAFTA, building on CUSFTA, provided a robust foundation for energy integration between Canada and the United States. Owing to these agreements and market forces, US energy trade with Canada and Mexico has rapidly increased and diversified over the past two decades. Since NAFTA, the energy industry has experienced two major developments: Mexico’s energy reform, and larger oil and natural gas production in the United States and Canada enabled by advanced technologies. These advances that have accelerated energy trade and investment among the three countries should be reflected in the new NAFTA.

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22. Dave Graham, “Pressured by Trump, Mexico ready to discuss NAFTA rules in U.S. talks,” *Reuters*, January 24, 2017, <http://www.reuters.com/article/us-usa-trade-nafta-mexico-idUSKBN1582UQ> (accessed on April 4, 2017).

23. Glenn A. Cranker and Harold K. Andersen, “Exporting Canadian Oil and Gas: The Challenge of NAFTA Compliance,” sponsored by Stikeman Elliott LLP, Association of Corporate Counsel, November 1, 2011, <http://www.acc.com/legalresources/quickcounsel/exognafta.cfm> (accessed on April 5, 2017).

24. The tariffs are 5.25 cents per barrel for crude oil testing under 25 degrees API (a measure of petroleum liquid density), and 10.5 cents per barrel for crude oil testing at 25 degrees API or more. See Harmonized Tariff Schedule of the United States, <https://hts.usitc.gov/?query=27090010> (accessed on June 19, 2017).

Although energy issues are often sensitive, the new NAFTA should seek full liberalization in trade and investment in North America. To reach this goal, President Trump should avoid rhetorical jabs against Mexico, and he should put Buy American restrictions on the negotiating table. Mexico has already become a leading consumer of US natural gas, and sales should increase as Mexico expands its electrical production. Mexico's energy reforms, which permit foreign investment in selected energy sectors, should be expanded and codified in the new NAFTA. Buy American provisions and LCRs in renewable energy projects should be curtailed if not eliminated. Rules of origin should not be an obstacle to North American energy integration.

Putting these themes together in the new NAFTA, renegotiation can significantly contribute to a more robust and efficient North American energy sector, which in turn can enhance North American competitiveness in the world economy.

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## CHAPTER 8

# Agriculture in the NAFTA Renegotiation

Cullen S. Hendrix

Candidate Donald Trump’s campaign promises to “renegotiate or rip up” the North American Free Trade Agreement (NAFTA) mostly focused on issues affecting manufacturing and border tax policy. Recent statements—like promises to “stand up for our dairy farmers”—signal that agriculture may be a significant issue as well, although it is one of the areas where the benefits of NAFTA for US producers and consumers have been most manifest.<sup>1</sup> Indeed, Agriculture Secretary Sonny Perdue and Commerce Secretary Wilbur Ross may have temporarily saved NAFTA—which President Trump claims he was “all set to terminate”—by showing the president a map of the heartland states and districts, most of them solidly red, that depend on agricultural exports and imports.<sup>2</sup>

Although the volume of intra-NAFTA agricultural trade is relatively high—the United States and Canada are among the world’s top agricultural exporters and, with Mexico, among the largest importers—its contribution to total trade and resultant surpluses/deficits is relatively small (WTO 2016). Agriculture accounted for roughly 7 percent of US trade with Canada and with Mexico and 8 percent of US trade’s modest surplus with Canada and deficit with Mexico in 2016 (table 1). These shares are small but significant. For select products, however, the shares are much higher: Mexico received 28 percent of the US maize crop and Canada and Mexico account for nearly a third of US beef exports. These market shares imply large potential for retaliation—as US losses—even if agriculture’s contribution to intra-NAFTA trade is relatively minor.<sup>3</sup>

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1. “Trump: Canada’s dairy measures a ‘disgrace,’” CNN, April 20, 2017, [www.cnn.com/2017/04/20/politics/donald-trump-canada-dairy-farmers](http://www.cnn.com/2017/04/20/politics/donald-trump-canada-dairy-farmers) (accessed on May 7, 2017).

2. “The New Agriculture Secretary Helped Trump Change His Mind on NAFTA,” Daily Caller, April 28, 2017, <http://dailycaller.com/2017/04/28/the-new-agriculture-secretary-helped-trump-change-his-mind-on-nafta> (accessed on May 9, 2017).

3. “US Corn Exports to Mexico Could be At Risk – DTN,” AgFax, February 14, 2017, <http://agfax.com/2017/02/14/u-s-corn-exports-to-mexico-could-be-at-risk-dtn> (accessed on May 30, 2017); “Beef and Cattle Trade,” USDA Economic Research Service, April 26, 2017, [www.ers.usda.gov/topics/animal-products/cattle-beef/trade](http://www.ers.usda.gov/topics/animal-products/cattle-beef/trade) (accessed on May 30, 2017).

**Table 1 US agricultural imports and exports with NAFTA partner countries, 2016** (billions of US dollars)

	Canada	Mexico
Imports	22	23
Exports	23	17.9
Surplus/deficit	1	-5.1
Total surplus/deficit	12.5	-63.2
Percent of bilateral surplus/deficit	8	8.1
Percent of total bilateral trade	7.2	7.1

Source: USTR (2017), author's calculations.

This chapter makes four points related to the role of agricultural interests in any NAFTA renegotiation:

1. Despite agriculture's comparatively small contribution to GDP in all three countries, agricultural issues will be a thorny aspect of these negotiations—just as in other FTA negotiations.
2. US and Canadian agricultural producers like NAFTA and will fight hard to preserve it. Aside from some wrangling over market access issues for dairy, poultry, and eggs and recent spats over Canadian soft lumber, farm organizations in both countries view NAFTA positively. Public opinion in Mexico is more ambivalent, but NAFTA has created strong export-oriented agricultural interests in the country's north that balance more protectionist interests in the south.
3. Despite not being as extensive as those in other industries, NAFTA has created complex cross-border agricultural supply chains that create value added for the US economy, particularly in GOP-leaning states.
4. Disruptions to NAFTA could create big problems for Trump-voting states and states with GOP and split Senate delegations, especially those that rely heavily on agricultural exports and intra-NAFTA trade.

Given all of this, what would a productive conclusion of a NAFTA renegotiation look like? This chapter concludes with a consideration of this question. Ironically, it will probably look a lot like the agricultural and sanitary and phytosanitary standards (SPS) provisions of the Trans-Pacific Partnership (TPP), which addressed most of the issues and from which the Trump administration withdrew on its third day in office. However, there is considerable potential risk for agricultural producers—many concentrated in heavily GOP-leaning states—who saw large gains from NAFTA in terms of market access and the creation of cross-border supply chains. If agricultural interests in GOP strongholds are linked to negotiations over nonagricultural sectors/issues or sacrificed in favor of increasing market access for agricultural products from more electorally competitive states, the Trump administration may face an uphill battle in securing Senate approval for any deal.

## **AGRICULTURE WILL BE A SIGNIFICANT BONE OF CONTENTION**

Despite agriculture's modest contributions to GDP and employment in upper- and upper-middle-income countries, it is often among the thorniest issues in negotiating free trade agreements. This was true of the original NAFTA negotiations—which took place when Mexico was a much more rural and agriculturally dependent economy—and will be of any future renegotiation (see table 2).

**Table 2 Agriculture as share of GDP, employment, and exports in NAFTA countries**

<b>Partner</b>	<b>Value added</b> (percent of GDP)	<b>Employment</b> (percent of total employment)	<b>Raw materials share of merchandise exports</b> (percent)	<b>Food share of merchandise exports</b> (percent)
Mexico	3.6 (2014)	13.4 (2013)	0.3 (2015)	6.9 (2015)
United States	1.3 (2014)	1.6 (2010)	2.3 (2015)	10.1 (2015)
Canada	1.8 (2012)	2.1 (2014)	4.6 (2015)	12.7 (2015)

Source: World Bank (2017). Most recent estimates used for each.

The reasons are several. First, agriculture makes intense use of a highly specific factor—rural land—that is effectively “stuck” in its present use (Alt et al. 1996). Farmers adjacent to urban areas may find lucrative opportunities to sell to real estate developers, but in the main

agricultural interests face very high costs in adjusting to trade policy changes. Thus, they fight hard in the political arena to protect their interests—both via institutional channels and in the streets and jungles. Dairy farmers in Ontario and Quebec have repeatedly snarled traffic around Parliament Hill with cattle and tractors to protest proposed changes to Canada’s dairy supply management system,<sup>4</sup> and in Mexico the rural, indigenous Zapatista National Liberation Army chose the day NAFTA went into effect, January 1, 1994, to launch its short-lived rebellion against the Mexican government. Among their grievances were opposition to the NAFTA-related initiatives like the repeal of indigenous land rights established by the Constitution of 1917 and fears that US corn producers would immiserate indigenous corn producers. Mexico still has a comparatively large share of employment in agriculture—13.4 percent versus 1–2 percent in the United States and Canada—and an anti- TPP march drew 65,000 to Mexico City in February 2014. Given that the TPP was branded “NAFTA on steroids” by opponents in all three countries, it is likely that popular mobilization around the NAFTA renegotiation will be at least as contentious.<sup>5</sup>

Second, agricultural interests tend to wield significant political clout in upper- and upper-middle-income economies. In the postwar era, many policy outcomes in the developing world have tended to be biased in favor of urbanites, including the use of marketing boards and other mechanisms to suppress farm-gate prices and transfer benefits to cities (Bezemer and Headey 2008). In more industrialized and service-oriented economies agriculturalists are fewer in number and have clear common interests. As food declines as a share of household expenditures the political salience of lower prices declines as well—people are generally well-off enough to afford agricultural protectionism (Anderson and Hayami 1986). All of this translates into outsized political clout evident in the significant programs of subsidies and tax incentives that increase developed-country producer prices above those that would obtain in free markets (Anderson, Rausser, and Swinnen 2013).

4. “Tractors, cows take over Ottawa, Parliament Hill as dairy farmers protest TPP,” CBC News, September 29, 2015, [www.cbc.ca/news/canada/ottawa/trans-pacific-partnership-dairy-farmers-ottawa-protest-1.3248479](http://www.cbc.ca/news/canada/ottawa/trans-pacific-partnership-dairy-farmers-ottawa-protest-1.3248479) (accessed on March 7, 2017).

5. “Robert Reich on Trans-Pacific Partnership as ‘NAFTA on steroids,’” Business and Human Rights Resource Centre, <https://business-humanrights.org/en/robert-reich-on-trans-pacific-partnership-as-nafta-on-steroids> (accessed on March 13, 2017); “TPP set to worsen food insecurity in Mexico,” Telesur, November 9, 2015, [www.telesurtv.net/english/news/TPP-Set-to-Worsen-Food-Insecurity-in-Mexico-20151109-0030.html](http://www.telesurtv.net/english/news/TPP-Set-to-Worsen-Food-Insecurity-in-Mexico-20151109-0030.html) (accessed on March 13, 2017); “NAFTA on Steroids: With New Trade Deal, ‘If You’re Not at the Table, You’re on the Menu,’” Sierra Club Canada, April 21, 2016, [www.sierraclub.ca/en/NAFTA-on-steroids-with-new-trade-deal-if-you-re-not-at-the-table-you-re-on-the-menu](http://www.sierraclub.ca/en/NAFTA-on-steroids-with-new-trade-deal-if-you-re-not-at-the-table-you-re-on-the-menu) (accessed on March 13, 2017).

Third, NAFTA members' political institutions bias policy outcomes in favor of agricultural interests, endowing them with greater political clout than their contributions to either employment or GDP would suggest. All three NAFTA members have bicameral legislatures in which representation in the Senate is apportioned according to administrative units—states or provinces—rather than population.<sup>6</sup> This mode of apportionment significantly overrepresents rural interests. The 10 most populous US states<sup>7</sup>—representing 54 percent of US population—have the same number of senators as the 10 top per capita agriculture-exporting states, which account for 34 percent of US agricultural exports but only 8.5 percent of the population.<sup>8</sup> The smaller, agriculturally dependent states have less diverse economies and export bases, rendering their Senate delegations issue obsessionists when it comes to agricultural policy (Bellemare and Carnes 2015). These circumstances are not unique to the United States: Canada's Maritime Provinces have a total population of less than 2 million but the same size Senate delegation as Ontario (population 14.1 million), and the state of Mexico has seven times the population of agricultural powerhouse Sonora but the same representation in el Senado de la República.

For these reasons, agriculture is one of the few sectors that still benefits from large, complex systems of producer supports and both tariff and nontariff barriers in the NAFTA partner countries. Wrangling and hyperbole will likely play a larger role in agricultural trade negotiations than the sector's contributions to intra-NAFTA trade, overall employment, or GDP would suggest.

## US AGRICULTURE LIKES NAFTA

Donald Trump's campaign rhetoric around NAFTA played well in the industrial upper Midwest and former textile powerhouses North and South Carolina, which experienced declines in manufacturing employment and wages after NAFTA's introduction (Hakobyan and McLaren 2016). But it has played less well in agricultural powerhouses like Iowa, Nebraska, and Kansas—and for good reason. NAFTA has been a significant boon to US agriculture, having produced broad benefits for Canadian and Mexican agricultural interests as well.

NAFTA has stimulated agricultural exports in all member countries. [Table 3](#) presents data on NAFTA partner exports and export growth from 1991–93 to 2010–12, when the three countries' agricultural exports grew much faster than the price of either food or agricultural raw materials. Although prices rose, intra-NAFTA exports rose even more.

US exports to NAFTA partners grew significantly in absolute terms and much faster than exports to the rest of the world. Canada's exports to NAFTA partners grew at roughly the same rate as its exports to the rest of the world. While Mexico's exports outside of NAFTA grew more rapidly than intra-NAFTA exports, this is due in large part to the minimal contribution of non-NAFTA partner agricultural exports to total exports

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6. Mexico's senate includes both directly elected senators (two per state and the Federal District, awarded by plurality), minority senators (one per state and the Federal District, awarded to the party with the second-highest vote total), and 32 at-large senators apportioned by proportional representation according to the national vote share. Canada's 105 Senate seats are allocated with 24 each going to the provinces of Ontario and Quebec, 24 each to the Western (Alberta, British Columbia, Manitoba, and Saskatchewan) and Maritime (New Brunswick, Nova Scotia, and Prince Edward Island) Provinces. The remaining 9 are apportioned to Newfoundland and Labrador as well as the three northern territories (Northwest Territories, Nunavut, and Yukon).

7. California, Florida, Georgia, Illinois, Michigan, New York, North Carolina, Ohio, Pennsylvania, and Texas (US Census Bureau 2016a).

8. Alaska, Delaware, Maine, Montana, New Hampshire, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming (US Census Bureau 2016a).

**Table 3 NAFTA partners' intra-NAFTA and rest of world (ROW) exports, 1991–93 vs. 2010–12** (values in billions of US dollars)

Period	Food Price Index	Agriculture	USA-NAFTA	USA-ROW	MEX-NAFTA	MEX-ROW	CAN-NAFTA	CAN-ROW
		Raw Materials Index						
1991–93	98.5	97.4	8.4	33.5	3.3	0.4	6.2	5.5
2010–12	169.1	137.5	36.1	95.1	17	4	23.4	20.2
Growth (percent)	71.7	41.2	329.8	183.9	415.2	900	277.4	267.3

Sources: IMF Commodity Price Statistics, 2017; author's calculations from Zahniser et al. (2015).

in the earlier period. Even Canada, the comparative laggard in terms of intra-NAFTA export growth, saw its exports to NAFTA countries nearly quadruple.

Of course, these benefits have not been spread equally across agricultural producers. Market integration has meant increased competition for less efficient producers and spurred some exit, mostly in the form of mid-size farm consolidation into larger, more competitive enterprises (MacDonald, Korb, and Hoppe 2013).<sup>9</sup> However, even for products like Mexican maize, where NAFTA has been identified as a major contributor to falling prices and declining smallholder livelihoods (de Janvry and Sadoulet 1995), the evidence for NAFTA *alone* as the culprit is weak (Yúnez-Naude 2002, Yúnez-Naude and Barceinas Paredes 2003, Puyana and Romero 2004). Other studies point to gains from trade as US corn (mostly yellow corn used for animal feed) complements Mexican domestic production of white corn for human consumption and reduces environmental impacts of farming (Eakin, Bausch, and Sweeney 2014; Martinez-Melendez and Bennett 2016).

These data are borne out in farmer sentiment in all three countries. The US Farm Bureau, the largest farm lobbying organization in the United States, is decidedly pro-NAFTA, arguing that “Any renegotiation [of NAFTA] must protect the gains achieved in agricultural trade and work to remove remaining barriers to trade with Canada and Mexico.”<sup>10</sup> The National Cattlemen’s Beef Association expressed a similar sentiment regarding prominent trade deals like TPP and NAFTA: “since NAFTA was implemented, exports of American-produced beef to Mexico have grown by more than 750 percent. We’re especially concerned that the Administration is taking these actions without any meaningful alternatives in place that would compensate for the tremendous loss that cattle producers will face without TPP or NAFTA.”<sup>11</sup> US farmers do not, in the main, want to curtail or roll back market access—they want to expand it.

The same is true by and large of Canadian and Mexican agriculture, though opinion in Mexico is more ambivalent. A sizable share of the Mexican workforce is still in agriculture and much of this employment is concentrated in Mexico’s poorest southern states (Guerrero, Oaxaca, and Chiapas) that benefit the least from cross-border market integration and export-oriented agricultural employment. Moreover, Mexico

9. The number of small farms, which had been on the decline since the 1950s, actually increased from 2000 to 2013. This increase is being driven largely by part-time farmers engaged in specialized production of boutique products for local distribution. “Big Farms Are Getting Bigger And Most Small Farms Aren’t Really Farms At All,” *FiveThirtyEight*, November 17, 2016, <https://fivethirtyeight.com/features/big-farms-are-getting-bigger-and-most-small-farms-arent-really-farms-at-all> (accessed on May 1, 2017).

10. US Farm Bureau, “NAFTA Factsheet,” February 2017, [www.fb.org/files/Trade-NAFTA.pdf](http://www.fb.org/files/Trade-NAFTA.pdf) (accessed on March 17, 2017).

11. National Cattlemen’s Beef Association, “Cattlemen Express Concerns with Trump Administration’s Trade Action,” January 23, 2017, [www.beefusa.org/newsreleases1.aspx?NewsID=6166](http://www.beefusa.org/newsreleases1.aspx?NewsID=6166) (accessed on March 17, 2017).

still has pockets of chronic food insecurity in these southern states, with indigenous households bearing the brunt; as recently as 2012, 33 percent of the indigenous population was chronically undernourished (Secretario de Salud 2012). NAFTA has been a lightning rod for political concerns there about the loss of traditional rural livelihoods and uneven benefits and burdens from economic integration. But negative views in Mexico's south are offset by support in the north. Sinaloa, a northern agricultural powerhouse with access to abundant fisheries, employs almost as many (27,000) commercial agriculturalists as Guerrero and Chiapas combined (28,500).<sup>12</sup> The states of Baja California Norte and Sur, Sonora, and Sinaloa account for 54 percent of Mexico's agricultural GDP, while the southern states account for less than 8 percent.<sup>13</sup>

In Canada, farmers' opinions of NAFTA are largely dependent on whether they are in competitive, export-oriented sectors or protected sectors like dairy and beef (see section on "What Would a Productive Renegotiation Look Like?" below). As recently as February 2017, however, the president of the Canadian Federation of Agriculture (CFA; Canada's largest farm organization), Ron Bonnett, noted that any NAFTA renegotiation would need to stay focused to avoid becoming derailed by discussions about nonagricultural issues, as NAFTA had "worked well" for agriculture in both the United States and Canada.<sup>14</sup>

## **NAFTA HAS CREATED CROSS-BORDER SUPPLY CHAINS IN AGRICULTURE**

Market integration does not just mean more Mexican consumers eating US beef or Super Bowl parties serving Mexican avocado-based guacamole. NAFTA has created cross-border supply chains that would be significantly damaged by market deintegration, denying member-country producers access to inputs and member-country consumers access to a wider array of products. These cross-border supply chains are not as complex as those in the automotive industry, for example, but they are significant.

Consider pork. In 2014 the United States imported 4.9 million Canadian pigs, 3.9 million of which were feeders, 8- to 12-week old juvenile pigs weighing 10–60 pounds (USDA 2015). These pigs are birthed and weaned on Canadian farms before being exported to states such as Iowa, Minnesota, Illinois, and Indiana, where they can be finished—fed to eventual slaughter weight—on inexpensive US corn and soybean meal, and then slaughtered and processed in US facilities. The resulting pork products are then either consumed domestically in the United States or exported to the Canadian and Mexican markets. Thus a pork cutlet consumed in Toronto may have started life as a piglet on an Ontario farm before being exported to the United States and then reimported as a US-produced finished cut. Interrupting this supply chain would have adverse effects for both Canadian and US producers and consumers. Losing access to cheaper US-finished pork would result in either (or both) higher Canadian consumer prices or (and) reduced high-value Canadian exports to lucrative markets like Japan, where Canadian-raised and finished pork commands a significant market premium.<sup>15</sup> Similarly, US producers would face higher input costs in the form of more expensive feeder pigs. Mexico's pork industry has grown as well, buoyed by access to inexpensive feed from the US grain belt.

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12. Instituto Nacional de Estadística y Geografía (INEGI; National Institute of Statistics and Geography), Censos Económicos 2014: Resultados Definitivos, [www.inegi.org.mx/est/contenidos/proyectos/ce/ce2014/default.aspx](http://www.inegi.org.mx/est/contenidos/proyectos/ce/ce2014/default.aspx) (accessed on April 4, 2017).

13. *Ibid.*, author's calculations.

14. "CFA President Discusses NAFTA in Washington," Steinbach Online, February 9, 2017, <https://steinbachonline.com/ag-news/cfa-president-discusses-nafta-in-washington> (accessed on April 4, 2017).

15. "Pampered Canadian Pigs Feed Japan's Hunger for Pricey Pork," Reuters, November 16, 2016, [www.reuters.com/article/us-pork-japan-idUSKBN13B0EF](http://www.reuters.com/article/us-pork-japan-idUSKBN13B0EF) (accessed on May 1, 2017).

The pork industry is emblematic of a broader trend: From grains and oilseeds to processed foods and livestock, the North American market has become significantly more regionally integrated in both trade and investment. Of the six main agricultural subsectors,<sup>16</sup> only sugar and sweeteners remain characterized by low market integration—defined as the presence of substantial tariffs, quotas, and other trade restrictions—in large part due to the power of the US sugar lobby (see section on “What Would a Productive Renegotiation Look Like?” below). The other five sectors are marked by high levels of integration (Zahniser et al. 2015).

## **DISRUPTIONS TO US AGRICULTURAL TRADE WOULD DISPROPORTIONATELY AFFECT TRUMP SUPPORTERS**

If the Trump administration’s efforts to renegotiate NAFTA disrupt intra-NAFTA agricultural trade, the pain will be felt disproportionately in states that strongly supported Trump. For a host of complex reasons, there is a large rural/urban partisan gap in the United States, with rural voters—especially southern rural voters—favoring the Republican Party and urban voters predominantly voting Democratic (McKee 2008).<sup>17</sup> This pattern was borne out in the 2016 presidential election: President Trump carried 8 of the 10 least densely populated states, and Hillary Clinton 8 of the 10 most densely populated (including the District of Columbia).<sup>18</sup>

Agriculture tends to predominate in more land-abundant, rural states. Any disruption to agricultural trade and value chains brought about by the NAFTA renegotiation will thus be felt first and hardest in the rural, agriculturally dependent states that Trump carried, often by large margins. [Figure 1](#) plots each US state by agricultural exports as a share of the state’s top 25 exports in 2013–16 against exports to NAFTA partner countries as a share of total state exports for the same period. Trump-voting states are both, on average, more dependent on agricultural exports (9.9 percent vs. 4.5 percent share of top 25 state exports) and more dependent on exports to NAFTA partners (38.2 percent vs. 26.9 percent). Of the states where agricultural exports accounted for more than 10 percent of the state’s top 25 exports, only three (Colorado, Maine, and Washington) broke for Clinton; the remaining nine went for Trump.

Further evidence of the GOP’s agricultural bent is evident in the roll call results for the Agricultural Act of 2014 ([table 4](#)), the most recent iteration of the “farm bill” that governs US agricultural and food policy and funds crop insurance and commodity price supports. GOP representatives voted “yea” by a nearly 3-1 margin, while the majority of Democrats (53.7 percent) voted against, even though the bill funds the Supplemental Nutrition Assistance Program (SNAP), which is included to address more urban interests and craft a majority voting coalition.

In the Senate, the voting pattern was the opposite of that in the House, with GOP senators lending only 22 of the 68 votes that secured passage. However, those 22 votes included both senators from Idaho, Mississippi, and Nebraska as well as Senate Majority Leader Mitch McConnell (KY), Appropriations Committee Chair Thad Cochran (MS), Budget Committee Chair Mike Enzi (WY), and Finance Committee Chair

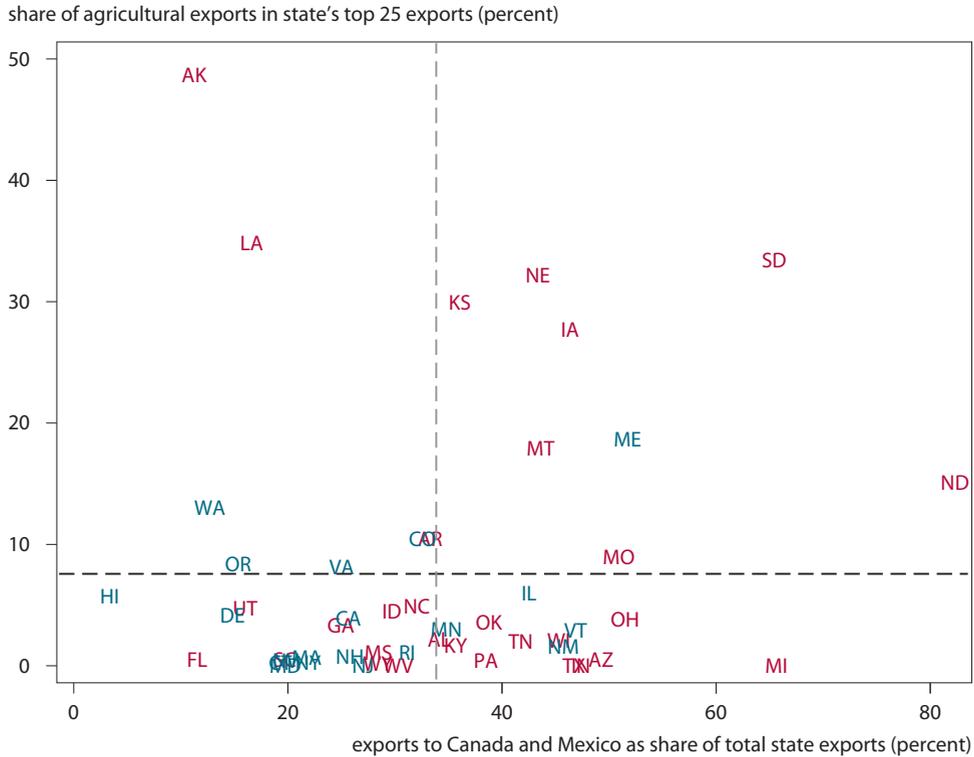
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16. Grains and oilseeds; livestock and animal products; fruits and vegetables; sugar and sweeteners; cotton, textiles, and apparels; and processed foods.

17. The gap is attenuated somewhat by “recreational rural” counties, like Teton County, Wyoming, home to the Jackson Hole ski resort and the Grand Teton and Yellowstone National Parks, that attract more young adults and retirees (Scala, Johnson, and Rogers 2015).

18. Least densely populated: Alaska, Idaho, Montana, Nebraska, North Dakota, South Dakota, Wyoming, and Utah (Clinton carried New Mexico and Nevada); most densely populated: Connecticut, Delaware, District of Columbia, Maryland, Massachusetts, New Jersey, New York, and Rhode Island (Trump carried Florida and Pennsylvania).

**Figure 1 Agricultural shares of top 25 US state exports and NAFTA partner shares of state exports, 2013–16**



Note: Blue denotes states carried by Hillary Clinton in the 2016 US presidential election. Red denotes states carried by Donald Trump. Black dashed horizontal line is the mean for agricultural share of state exports (7.7 percent); grey dashed vertical line is the mean for NAFTA share of state exports (33.6 percent).  
 Source: Author's calculations based on US Census (2016b).

**Table 4 Partisan breakdown of votes on the Agricultural Act of 2014 in the US House of Representatives**

Vote	Democrat	Republican	Total
Nay	103 (53.7 percent)	63 (28.0 percent)	166 (39.8 percent)
Yea	89 (46.4 percent)	162 (72.0 percent)	251 (60.2 percent)
Total	192	225	417

Source: US House of Representatives (2014).

Orrin Hatch (UT) (US Senate 2014). Agricultural states are well represented at the highest levels of Senate leadership.

Given the prevailing and historically unprecedented levels of partisanship in the Senate, President Trump cannot hope for successful ratification of a renegotiated NAFTA without the support of the heavily agricultural, highly intra-NAFTA trade-dependent delegations from the Dakotas, Iowa, Kansas, Missouri, Montana, and

Nebraska. Reopening NAFTA entails mostly downside risk for these delegations, as the status quo favors their products. Meanwhile, industries such as US dairy—which still face significant market access issues in Canada (Hufbauer and Jung 2017)—are concentrated in swing states like Michigan, Pennsylvania, and Wisconsin and Democratic strongholds California and New York. These swing states may thus see their interests elevated in the coming renegotiations—potentially at the expense of agriculture interests in more “safe” GOP territory—via a hard push by US negotiators to secure greater access to the Canadian market.

## WHAT WOULD A PRODUCTIVE RENEGOTIATION LOOK LIKE?

US Trade Representative Robert Lighthizer's May 18, 2017, letter to Congress notifying intent to open NAFTA renegotiations was very light on specific content, although it at least mentioned farmers and ranchers.<sup>19</sup> For guidance about specific content, however, then-acting US Trade Representative Stephen Vaughn's March 30, 2017, draft letter identified four priorities related to agriculture and sanitary and phytosanitary standards (Vaughn 2017, 3):

1. seek to reduce or eliminate nontariff barriers (NTBs) to US agricultural exports, including permit and licensing barriers, restrictive administration of tariff-rate quotas, unjustified trade restrictions that affect new US technologies, including biotechnology, and other restrictive trade measures,
2. maintain commitments to eliminate all export subsidies on agricultural products, while maintaining the right to provide bona fide food aid and preserving US agricultural market development and export credit programs,
3. seek to secure more open and equitable market access for agricultural products through robust rules on SPS measures and eliminate any SPS restrictions that are not based on science, and
4. seek to strengthen cooperation between US and NAFTA countries' SPS authorities.

If these are the main objectives the Trump administration would bring to a renegotiation, they will not have to look far for a blueprint: the moribund Trans-Pacific Partnership (TPP), the 12-country trade agreement from which the United States formally withdrew in January 2017. It addressed all four of these objectives, though there may have been less movement on issues related to NTBs and market access than the administration might have liked (more on that later). All three NAFTA partners were parties to the TPP negotiations and via those talks achieved agreement on a host of market access and SPS-related issues. Indeed, it would not be much of an overstatement to have called the TPP a NAFTA-Japan trade agreement, since the four countries accounted for 89 percent of total TPP GDP and 77 percent of TPP exports (author's calculations based on Petri and Plummer 2016).

The TPP would have required all members to abolish export subsidies, including Mexico's for wheat and Canada's for dairy products sold in the United States (USTR 2016). Regarding points 3 and 4, the SPS chapter of the TPP would have obligated member countries to use science-based risk analysis for evaluating SPS threats, effectively harmonizing these procedures to those of the United States, and would have established a rapid reporting system for all SPS-related detained shipments, a cooperative technical consultation system for SPS issues, and a dispute resolution mechanism for SPS-related issues (Hendrix and Kotschwar 2016). Finally, TPP Article 7.9 would have required that SPS measures conform to relevant international standards (the Codex Alimentarius and World Trade Organization's SPS agreement) and that deviations from these be undertaken only on the basis of "documented and objective scientific evidence" (USTR 2016, Article 7.9.2). This requirement would have addressed concerns of US purveyors of genetically modified organisms (GMOs) and biotechnology, as the World Health Organization (WHO), US American Medical Association, and EU Directorate-General for Research and Innovation have all indicated that GMOs are no more risky per se than conventionally bred organisms.<sup>20</sup>

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19. The letter is available at <https://ustr.gov/sites/default/files/files/Press/Releases/NAFTA%20Notification.pdf> (accessed on May 28, 2017).

20. According to WHO, "GM foods currently available on the international market have passed safety assessments and are not likely to present risks for human health. In addition, no effects on human health have been shown as a result of the consumption of such foods by the general population in the countries where they have been approved. Continuous application of safety assessments based on the Codex Alimentarius principles and, where appropriate, adequate post market monitoring, should form the basis for ensuring

Thus, a productive basis for the negotiation would simply revive these provisions of the TPP, with some room to negotiate regarding market access.

However, many of the market access issues that have come to the fore in the Trump administration's rhetoric around the NAFTA renegotiation—such as the Canadian dairy market—are unlikely to see much larger concessions. Despite pushing hard, US trade negotiators were able to achieve only modest concessions on Canadian dairy during the TPP negotiations because of the politicized nature of the Canadian dairy market, which is concentrated in highly competitive ridings (legislative districts) in Ontario and Quebec and makes Canada's supply management system—which establishes prices and restricts market access in the dairy, egg, and poultry industries—something of a “third rail” in Canadian politics. For similar reasons, Mexico's 166,000 sugar farmers have not been able to significantly increase their share of the US sugar and sweetener market because of effective lobbying from a US sugar industry that is highly concentrated in the swing state of Florida. The TPP set the bar for what could reasonably be expected from a productive renegotiation of NAFTA.

What would an unproductive renegotiation look like? It would likely take one of two forms. In the first, agricultural interests—especially those that are heavily concentrated in electorally “safe” blue or red states—get used as a bargaining chip in wrangling over nonagricultural issues like domestic content or the restriction of government procurement to national firms. One of the reasons trade agreements have increased in their complexity is that they contain myriad logrolls that make the agreement as a whole more palatable than any one section or chapter, and these logrolls often cross issue domains, trading concessions in one for gains in another (O'Halloran 1994). The Trump administration might, for example, wager that there is more political hay to make in crucial swing states like Michigan and Ohio by pushing issues like rules of origin and threatening loss of agricultural market access in order to force concessions from Canada and Mexico. Threats of reciprocal market access restrictions by Canada and Mexico could then make US agricultural exports a casualty of an argument over the auto industry, especially if Mexico can make good on threats to turn southward to Argentina and Brazil for corn and soy.<sup>21</sup> Of course, Senate delegations in agriculturally dependent, marginally industrialized states like the Dakotas, Nebraska, and Iowa would threaten to block any such agreement. However, if the Trump administration only secures market access concessions from trade partners and does nothing that requires new legislation, it will not have to seek congressional approval under the trade promotion authority (TPA) mechanism.

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the safety of GM foods” (see “Frequently asked questions on genetically modified foods,” [www.who.int/foodsafety/areas\\_work/food-technology/faq-genetically-modified-food/en](http://www.who.int/foodsafety/areas_work/food-technology/faq-genetically-modified-food/en) [accessed on October 28, 2015]). The American Medical Association “recognizes the continuing validity of the three major conclusions contained in the 1987 National Academy of Sciences white paper ‘Introduction of Recombinant DNA-Engineered Organisms into the Environment’: 1. There is no evidence that unique hazards exist either in the use of rDNA techniques or in the movement of genes between unrelated organisms; 2. The risks associated with the introduction of rDNA-engineered organisms are the same in kind as those associated with the introduction of unmodified organisms and organisms modified by other methods; 3. Assessment of the risk of introducing rDNA-engineered organisms into the environment should be based on the nature of the organism and the environment into which it is introduced, not on the method by which it was produced”; see “H-480.958 Bioengineered (Genetically Engineered) Crops and Foods,” [www.ama-assn.org/ssl3/ecomm/PolicyFinderForm.pl?site=www.ama-assn.org&uri=/resources/html/PolicyFinder/policyfiles/HnE/H-480.958.HTM](http://www.ama-assn.org/ssl3/ecomm/PolicyFinderForm.pl?site=www.ama-assn.org&uri=/resources/html/PolicyFinder/policyfiles/HnE/H-480.958.HTM) (accessed on October 28, 2015). The EU Directorate-General for Research and Innovation has stated that “The main conclusion to be drawn from the efforts of more than 130 research projects, covering a period of more than 25 years of research, and involving more than 500 independent research groups, is that biotechnology, and in particular GMOs, are not per se more risky than e.g. conventional plant breeding technologies”; see “A decade of EU-funded GMO research,” [https://ec.europa.eu/research/biosociety/pdf/a\\_decade\\_of\\_eu-funded\\_gmo\\_research.pdf](https://ec.europa.eu/research/biosociety/pdf/a_decade_of_eu-funded_gmo_research.pdf) (accessed on October 28, 2015).

21. “Reshaping NAFTA Could Benefit Mexico, Brazil and Argentina,” *US News*, April 18, 2017, [www.usnews.com/news/best-countries/articles/2017-04-18/reshaping-nafta-could-benefit-mexico-brazil-and-argentinas-economy](http://www.usnews.com/news/best-countries/articles/2017-04-18/reshaping-nafta-could-benefit-mexico-brazil-and-argentinas-economy) (accessed on May 17, 2017).

In the second, the Trump administration might seek to renegotiate many of the contentious issues that have been litigated via the World Trade Organization's dispute settlement mechanisms and reopen discussions around several issues that have flared up since Trump's election. Regarding the former, the list is significant and includes antidumping and country of origin labeling (COOL) issues. The United States has won or drawn often, but the losses—especially on COOL—have been bitter (Bown and Brewster 2016). Regarding the latter, ongoing disputes regarding Mexican tomatoes and sugar—which are currently under suspension agreements—will likely be discussed as well. US sugar is especially entrenched and politically influential, so this becomes a point of friction.

## CONCLUSION

Because of complex political economies, agricultural interests will likely loom larger in NAFTA renegotiations than their purely economic contributions to intra-NAFTA trade would suggest. NAFTA has created a large market for member-country agricultural products that has boosted exports and farm incomes in each country. A productive NAFTA renegotiation would essentially mimic the market access, export subsidy, and SPS agreements achieved in the TPP negotiations.

Given the Trump administration's dependence on agricultural states for political support and the Senate votes necessary to pass *any* renegotiated NAFTA, the status quo ex ante is likely to be preserved, and some TPP-related gains should be realized.

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## CHAPTER 9

# Streamlining Rules of Origin in NAFTA

Caroline Freund

After promising last year to terminate US participation in the North American Free Trade Agreement (NAFTA), President Donald Trump has opted for a more traditional tactic. He seeks to renegotiate the pact in several areas, including an adjustment in the “rules of origin” chapter. This chapter defines the regional value share and/or transformation that must occur to ensure goods imported into the United States from Canada and Mexico contain components actually produced in these three countries. The purpose of this provision, negotiated in the early 1990s, was to make sure that goods made outside the region do not enter the United States duty free.

Secretary of Commerce Wilbur Ross has been especially outspoken on the issue, stating that “the rules of origin in NAFTA need some tightening” and that there are “holes where people from outside can benefit.”<sup>1</sup> His comments imply that one possible outcome from a NAFTA renegotiation is stricter rules of origin.

The existing rules of origin in NAFTA are already strict. They vary from product to product and typically require higher regional value shares than other similar trade agreements. Tightening rules of origin would be costly to consumers and introduce inefficiencies for businesses. A positive reform of NAFTA would *simplify* rules of origin and create a single, lower regional value content threshold that can be applied uniformly across products. The Trump administration, which favors cutting regulations and not adding to them, should be more interested in streamlining rules of origin requirements than making them more complex.

International trade rules permit rules of origin in free trade agreements to prevent goods from outside countries from receiving duty-free treatment when traded across regional borders. But in practice rules of

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1. “Commerce’s Wilbur Ross accuses Mexico of taking advantage of NAFTA rules in trade with China,” CNBC, April 27, 2017, <http://www.cnbc.com/2017/04/27/it-appears-canada-and-mexico-are-ready-to-start-rene-gotiating-nafta-says-commerce-secretary-wilbur-ross.html> (accessed on June 7, 2017); and “Renegotiating Nafta’s Rules of Origin,” interview with the *Wall Street Journal*, April 25, 2017, <http://www.wsj.com/video/renegotiating-nafta-rules-of-origin/CD898145-42FD-480B-86A5-67D13B0644FA.html> (accessed on June 7, 2017).

origin are used as a form of trade protection, particularly for sensitive products such as autos and apparel. Because strict rules expand the share or type of value added that must be produced regionally, the protection intended for final goods is also transferred onto the parts used to produce them. This cascading of protection means some regionally produced parts are used even when foreign parts are cheaper.

While using more parts produced in Canada, Mexico, or the United States benefits regional production, it also makes production less efficient and raises the prices of the final goods. To the extent that rules of origin shift the production of parts from more efficient external producers to Mexican or Canadian firms, it is a pure welfare loss for US citizens who face higher prices without benefitting from domestic job creation. The fact that it was Mexican and Canadian auto parts suppliers that were most concerned about loosening rules of origin during negotiations of the Trans-Pacific Partnership suggests that they have the most to gain from tighter rules.

Complex rules of origin additionally create administrative inefficiencies because they are cumbersome to comply with and add to trade costs. To be granted duty-free access under NAFTA, firms are required to document the origin of parts used in production and obtain a certificate of origin. These additional administrative costs imply that some trade between NAFTA countries enters through most favored nation (MFN) tariffs instead of NAFTA trade preferences. It also means that some businesses end up not participating in NAFTA trade, particularly small businesses that lack the legal personnel with knowledge on the NAFTA certification process.

This chapter examines the rules of origin in NAFTA to determine whether they need to be tightened to prevent foreign goods from using NAFTA trade preferences or loosened to improve efficiency. It describes the rules of origin in NAFTA and discusses how they have been utilized, with a focus on the auto industry. It also considers how they could be improved to make regional supply chains more efficient, while protecting against leakage of NAFTA preferences to nonmembers.

The analysis shows, consistent with numerous academic studies of the agreement, that NAFTA rules of origin are strict and highly complex, as compared with rules in other free trade agreements. Tightening them could perversely lead to lower regional content in final goods and disrupt regional supply chains, as more importers eschew NAFTA preferences because of costly rules of origin and instead trade under standard MFN tariffs. Once goods are imported through nonpreferential channels, rules of origin become irrelevant so regional content is likely to fall. The Brief also shows that even if NAFTA content increases, rules of origin do little to increase the share of US content. Thus, if the real goal is more US content, rules of origin are not an effective tool. And finally, small businesses are especially disadvantaged by cumbersome rules of origin because the bureaucratic costs of doing business are a larger share of their total costs.

Given the complexity of the NAFTA rules of origin, this Brief argues in favor of streamlining rules, with regional content requirements for all goods set at one rate, as opposed to the current product-by-product rules in NAFTA. Moving toward a global norm is an important goal to ensure that firms exporting to multiple destinations are not forced to choose between agreements.

## **WHAT ARE RULES OF ORIGIN AND WHY DO WE HAVE THEM?**

Rules of origin are allowed in free trade agreements to ensure that products produced outside the member countries are not entitled to the preferences that regionally produced goods receive. Since countries in a free trade agreement have different MFN tariffs on externally produced goods, without rules of origin, imports could evade tariffs by being imported to the lowest-tariff country and then reexported to another regional agreement member. For example, the US MFN average tariff on imported peanuts (Harmonized System [HS] code 1202) is over 100 percent; in contrast, the tariff on imported peanuts in Mexico is zero. To

export peanuts to the United States from Mexico, a certificate of origin must show that the peanuts were grown in a NAFTA country. Without rules of origin, peanuts could enter Mexico duty free from a peanut producing nation outside of NAFTA, such as Brazil, and then be shipped to the United States through NAFTA, avoiding the hefty duty.

Chapter 4 of NAFTA describes the rules of origin requirements. As with other trade policies, the devil is in the details, and they can be found in the 304-page Annex 401 to NAFTA that specifies the rules of origin at the product level. NAFTA rules of origin require goods to originate in the region or be significantly transformed; goods that are significantly transformed, meaning produced with components from other countries, require a change in tariff code and/or must meet a required percentage of regional content. To be eligible for NAFTA preferences, a NAFTA certification of origin must be completed by the exporter and provided to the importer.

For example, the rules of origin on cars (HS 8703.21-8703.9) require:

A change to subheading 8703.21 through 8703.90 from any other heading, provided there is a regional value content of not less than 62.5 percent under the net cost method.

There are three parts to this rule. The first part requires an HS code heading change to ensure that the assembly of a motor vehicle originates in the region, preventing a motor vehicle made abroad from qualifying for special treatment. The second part is the content requirement, which ensures that there is significant NAFTA value added. And the third part explains how regional content is calculated. The net cost method, preferred in NAFTA, excludes costs of distribution, shipping, royalties, interest, promotion, and retail.

The net cost method also incorporates “tracing” rules for large car parts that may themselves be made up of regional and imported parts (these are contained in a separate annex to chapter 4). For example, if an electric motor imported from Asia is attached to a Mexican-made car seat and sold to a car company, the electric motor is subtracted from the calculation of regional value because it is a traced product.<sup>2</sup> The rules also dictate other parameters, such as the level of aggregation, that provide manufacturers with more or less flexibility in meeting rules of origin requirements. For autos, for example, the level of aggregation over which a company determines content is within the plant (as opposed to the model or firm).

Textiles and apparel also have complex rules of origin. For example, the rule for men’s cotton boxer shorts extends for more than a page, listing in detail the types of fabric that qualify. Many agricultural and food products also have cumbersome technical requirements.

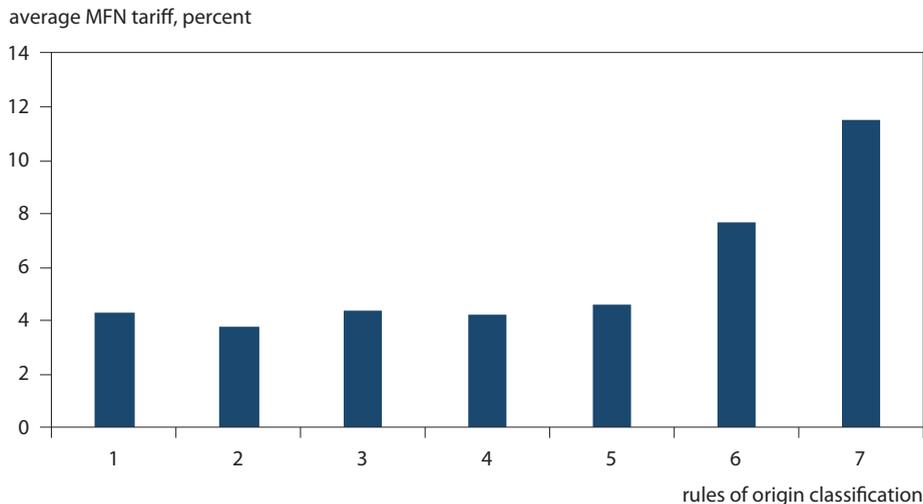
## Rules of Origin Are Used as Protection

The World Trade Organization imposes few strict disciplines on rules of origin, and as a result they have been used not only to legitimately protect against transshipment abuse but as a form of trade protection, particularly in sensitive products such as apparel and autos. Economic theory shows that rules of origin can be used to transfer protection of a final good onto the parts and components used to produce it (Krishna and Krueger 1995, Falvey and Reed 1998, Krishna 2005). Parts that are more efficiently produced outside of the region may be bought from local suppliers or imported from a regional trade partner. For example, because of the 62.5 percent content requirement for autos, some parts and components that would otherwise be purchased from Asia or Europe are instead purchased in the NAFTA region.

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2. As described in NAFTA Rules of Origin Regulations, available at [https://www.law.cornell.edu/cfr/text/19/appendix-to\\_part\\_181](https://www.law.cornell.edu/cfr/text/19/appendix-to_part_181) (accessed on June 9, 2017).

**Figure 1 Rules of origin and tariffs are correlated**



MFN = most favored nation

Note: Rules of origin rated on a scale of 1 to 7, where 7 is the strictest.

Sources: US Department of Commerce and Estevadeordal and Suominen (2003).

While content requirements ensure that most auto parts used in production in Mexico are from the region, it is important to note that they do not necessarily expand sales of US parts, as Mexican- and Canadian-made parts are counted similarly. When NAFTA was created in 1994, content requirements favored US car companies that used more NAFTA-originating parts, as compared with Japanese or German producers that relied more heavily on parts from Asia and Europe. As global supply chains have expanded, however, the relative benefits have changed, as many foreign models are produced in North America, with mostly regional inputs.<sup>3</sup>

An extensive empirical literature finds that rules of origin are designed to protect some industries and result in production distortions (Cadot and de Melo 2007). The correlation between MFN tariffs and rules of origin in NAFTA supports the view that they are used as protection in NAFTA. Figure 1 shows the average MFN tariff for products according to the rules of origin as defined by Estevadeordal and Suominen (2003), where 1 is less strict and 7 is the most strict. The products with stricter rules of origin tend to be special interest goods that also have higher MFN average tariffs.

The most comprehensive empirical paper to date on the subject finds that NAFTA rules of origin have a large and significant effect on Mexican imports of parts. Conconi et al. (2016) find that, on average, strict rules of origin reduced imports of parts from non-NAFTA countries by 30 percent. Cadot et al. (2002) also find that NAFTA rules of origin roughly offset tariff preferences in some industries, especially footwear and food and tobacco. Using data on a large cross section of countries, Estevadeordal and Suominen (2009) find that free trade agreements expand trade, but stricter rules of origin reduce trade.

3. For example, of the eight top American-made cars, five are made by Toyota and Honda. 2016 Cars.com American-made index, <https://www.cars.com/articles/the-2016-carscom-american-made-index-1420684865874/> (accessed on June 7, 2017).

## Comparing Rules of Origin

Compared with other trade agreements, NAFTA's rules are relatively strict. Estevadeordal and Suominen (2003) examine rules of origin in 35 trade agreements. After characterizing the restrictiveness of each rule on the 1 to 7 scale, they average the scores across products covered by those rules. NAFTA is found to have the strictest rules of all agreements, with an average score of 5.1. In comparison, the EU-Mexico agreement has an average score of 4.8 and Japan-Singapore 4.6.

One reason NAFTA rules tend to be more onerous is because they require more extensive transformations by tariff category. Substantial transformation under NAFTA often requires a change of chapter, the broadest classification of goods (indicated by the first two digits of the HS code). In contrast, EU rules requiring tariff class changes are typically at the classification heading (first four digits). EU rules therefore allow some products from the same chapter to be transformed and still qualify for EU preferences, whereas NAFTA does not. For example, Mexican-made canned tomato soup requires a change from another chapter under NAFTA rules, thus the soup cannot be made from imported canned tomatoes; in contrast such a soup would qualify under EU preferences.

As the number of free trade agreements grows, so too does the problem of their differing rules of origin. For producers, this proliferation of rules means their products have to be uniquely made and certified to qualify for preferences in different agreements. The often substantial differences sometimes force firms to choose between regional trade agreements (Moroz 2017).

Given the large and increasing number of trade agreements, coordination among countries to work toward a global set of accepted rules would improve business efficiency. As regional agreements multiply, coordination would also ease the move toward cumulation, where countries can count goods from countries in different or expanded free trade agreements towards the content requirement.

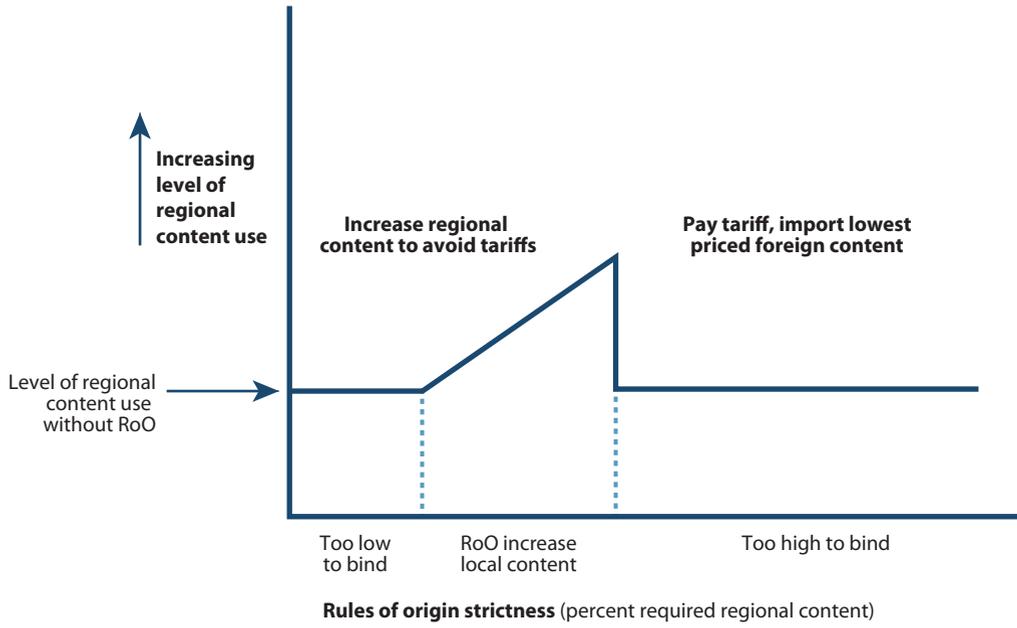
### WHEN IT COMES TO RULES OF ORIGIN, STRICTER DOES NOT MEAN BETTER

While rules of origin encourage producers to use regional inputs, they also increase production and administrative costs. Exporters have to balance the costs of complying with rules of origin against the tariff preferences received. If the tariff is low and foreign inputs are relatively inexpensive (or administrative costs associated with rules of origin are high), firms may choose to eschew NAFTA preferences and trade through MFN tariffs instead. Because rules of origin raise the costs of obtaining duty-free access under NAFTA, as they become stricter, use of regional content can fall if the rules lead firms to trade under MFN tariffs instead of NAFTA preferences (Ju and Krishna 2005).

The relationship between rules of origin and regional content for an individual firm is displayed in [figure 2](#). When regional content requirements are low, assuming some fraction of the total content is optimally of NAFTA origin, rules of origin will not bind, and regional content will remain constant. Eventually, the level of regional content required to receive preferences becomes binding, and the firm replaces foreign inputs with more costly NAFTA inputs. This relationship is represented in the figure where the rise in regional content use equals the increasing strictness of the rule of origin. The firm will pick those parts where the cost (or quality) differential between NAFTA produced goods and foreign produced goods is lowest. As rules of origin become stricter, the firm replaces more foreign parts with NAFTA parts. At some point, however, the cost differential between NAFTA inputs and foreign inputs is too great and it becomes more profitable to pay the MFN tariff than use NAFTA inputs. Once the firm decides to pay the tariff, regional content falls, dropping back to the optimal input mix.

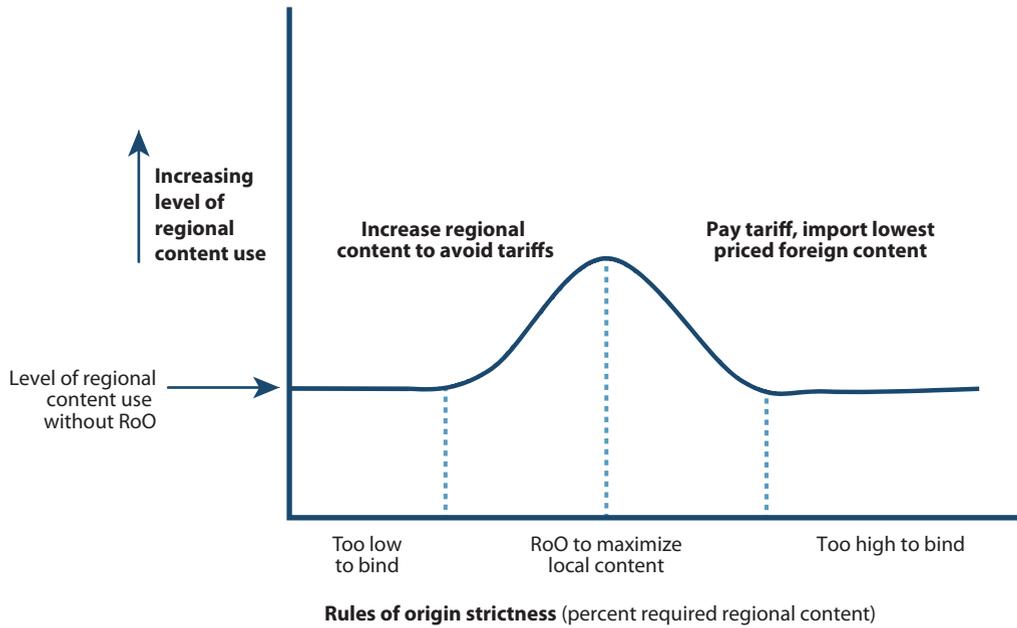
For total imports of a product, where a heterogeneous group of firms uses different input mixes in production, the maximum point will differ somewhat across firms. But overall, the shape will still have a maximum, with a point beyond which stricter rules of origin begin to lower regional content ([figure 3](#)). This

**Figure 2 Regional content and rules of origin at the firm level**



RoO = rules of origin

**Figure 3 Regional content and rules of origin at the industry level**



RoO = rules of origin

point occurs when the loss in regional content from the marginal firm that stops using NAFTA equals the gain in regional content from all the firms that comply with the new rule.

The shape of the curve will also depend on the tariff preference. When the MFN tariff is high, firms will be more willing to substitute expensive NAFTA intermediates for cheaper foreign ones to avoid paying it. A higher tariff therefore shifts the point at which regional content is maximized to the right—toward a stricter rule of origin.

Even when stricter rules lead to more regional content, there can be a significant loss from a welfare perspective. Increasing regional content must also be balanced against efficiency. As the industry approaches the maximum regional content, the product mix is moving away from the efficient mix, raising costs. If stricter rules lead to more Mexican content, then from a US perspective, there is a pure loss from higher regional content requirements, as consumers face higher prices, but no new US jobs are created.

### **Higher MFN Tariffs Lead to Higher NAFTA Utilization, But Stricter Rules of Origin Lower Utilization**

The costs of NAFTA rules of origin are apparent by the fact that trade between NAFTA partners does not fully use NAFTA preferences and NAFTA utilization varies with the extent of preferences. Two forces determine the extent to which NAFTA preferences will be utilized: the costliness of adhering to the rule and the extent of tariff protection. When external MFN tariffs are high, companies have more to gain from abiding by rules of origin and entering through NAFTA.

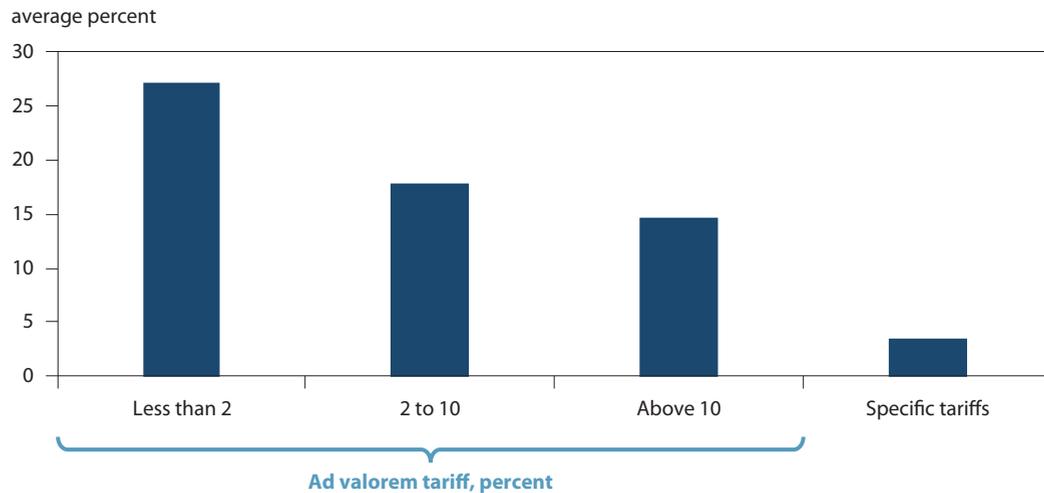
The US Commerce Department provides data at the product level on the share of goods that enter the United States through NAFTA preferences. The data show that the costs associated with complying with rules of origin discourage some firms from importing using NAFTA preferences. When MFN tariffs are low, on average across tariff lines, a greater share of imports enter the United States through MFN. [Figure 4](#) shows the average share of products that enter the United States through MFN tariffs instead of NAFTA preferences, for goods with positive tariffs. Products with zero tariffs always enter through MFN (not shown). When tariffs are positive but below 2 percent, on average, one quarter of the value of a product enters through MFN, with the remaining three quarters using NAFTA preferences. As tariffs rise, a smaller share of goods use MFN and a greater share of goods enter through NAFTA. When specific tariffs are present, which typically are more costly than ad valorem tariffs, over 95 percent of the value of goods on average enters through NAFTA, though even in these high tariff categories, there are some products with low NAFTA utilization rates.

### **Small Exporters and Startups Are Disadvantaged by Rules of Origin**

Rules of origin create a barrier to entry for new or small businesses because certificates of origin must be obtained. Because large and incumbent exporters have bigger administration offices that can handle the additional costs of documenting origin, they are at an advantage. For small businesses interested in entering the export market, the added costs of documenting origin discourages exporting. Since the administrative cost of rules of origin acts as a fixed cost, it places a heavier burden on small firms and low-value products.

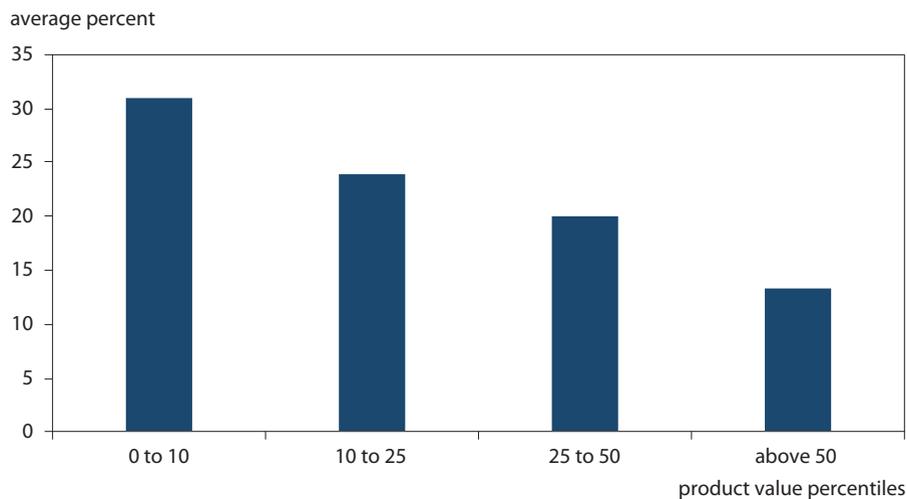
While import data are not available at the firm level to show this barrier, the effect of rules of origin on low-value exports is apparent in product-level data. [Figure 5](#) shows the share of products from Mexico imported into the United States where NAFTA preferences are not utilized, for 3,903 products with positive MFN tariffs, by product value percentile. For the nearly 400 products that are in the lowest value class of the products the US imports from Mexico—the smallest 10 percent of products by size—more than 30 percent on average enters without using NAFTA preferences. In contrast, less than 15 percent of products in the highest value class enters without using NAFTA.

**Figure 4 Average share of products entering the United States through MFN tariffs instead of NAFTA preferences, 2016, by tariff level**



MFN = most favored nation; NAFTA = North American Free Trade Agreement  
 Sources: US Department of Commerce and author's calculations.

**Figure 5 Average share of US imports from Mexico through MFN tariffs by product size, 2016**



MFN = most favored nation  
 Sources: US Department of Commerce and author's calculations.

One potential way to improve market access for small businesses is to raise the de minimis threshold under which rules of origin do not bind. Currently, shipments under \$2,500 are not obliged to meet the NAFTA certification requirement. But even for small businesses this is not a commercially viable amount. One alternative would be to base the threshold not on the value of the goods shipped but on the value of the tariff revenue, with higher de minimis thresholds on lower tariff products (Ciuriak 2015). The incentive to cheat is small on low tariff goods, and this adjustment would potentially allow a little more wiggle room for small businesses.

## Rules of Origin Constrain the Transport Sector

The transport sector (chapter 87)—which includes cars, trucks, tractors, and their associated parts—accounts for a large and growing share of US-Mexico trade because of the extensive auto supply chain. Transport now accounts for 25 percent of US imports from Mexico, up from less than 10 percent in the early 1990s, before NAFTA.

Imports from Mexico largely replaced imports from Canada over the last two decades. Figure 6 shows that NAFTA's share of US imports in the transport sector have remained fairly flat at 40 to 50 percent; what has changed is a shift away from Canada towards Mexico.

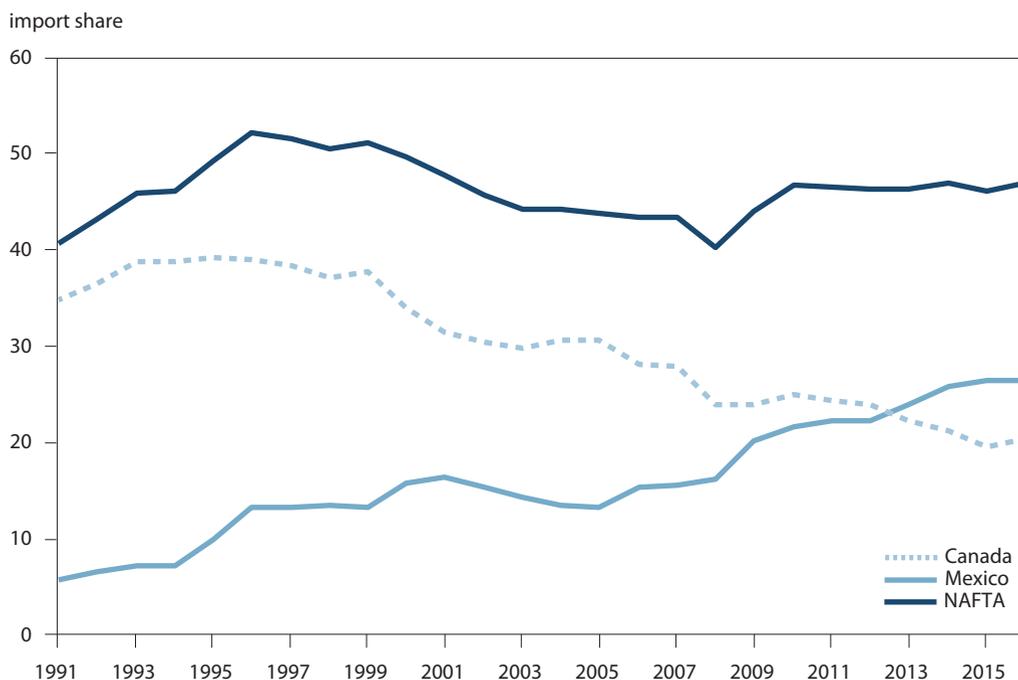
A serious concern about changing rules of origin requirements is that supply chains, which have developed with current rules in place, would be disrupted. The importance of supply chains is visible in terms of the types of products that are traded (table 1). There are high shares of intermediate goods and intrafirm trade in US-Mexico trade, as compared with US trade with the world. Supply chains are especially prevalent in the transport sector, where intermediates make up half of imports and three quarters of exports, and most trade is within the firm (referred to as related-party trade). These complex global supply chains make certifying origin more difficult, as products are shipped back and forth across borders.

Evidence shows that rules of origin in transport are already tight. Not only are cars and trucks required to have 62.5 percent NAFTA content, but, as noted above, many parts used in the production of cars and trucks are “traced” for content. Traced parts are decomposed by origin and only the regional ones, within any given component, are counted toward the 62.5 percent. By comparison, the rules of origin in the free trade agreements signed by the European Union require 45 percent of value added and, instead of tracing, use a simpler rollup method, where individual parts get counted as wholly regional provided they meet content rules.

Evidence that the rules are strict is apparent in preference utilization in autos, where some imports forgo NAFTA preferences. On average, across product lines in the transport category with positive MFN tariffs, 23 percent forgo preferences and enter the United States through MFN as opposed to NAFTA, above the 18 percent for all products with similar tariffs. While, as noted above, many of the smaller product lines have low NAFTA utilization, there are also some high-volume products where NAFTA utilization is relatively low. As an example, consider the \$1.5 billion of drive axles (HS 870850) the United States imports from Mexico. The tariff is 2.5 percent and the rule of origin is complex: The rule lists in detail which transformations permit a drive axle to qualify for NAFTA preferences. The rule also requires a minimum of 60 percent NAFTA content, if the drive axle uses parts from specific drive axles categories (8482.10 through 8482.80). Roughly 20 percent of the value of drive axles enter through MFN tariffs, i.e. without using NAFTA. Another important part, with low NAFTA utilization, is car radiators (HS 87089150), where the tariff is also 2.5 percent and the rule of origin requires a 60 percent NAFTA content, unless the radiator is made without using radiator parts (transformed from category 870891). About 25 percent of the value of radiator imports enter without using NAFTA. Raising the regional content requirement would further reduce the share of imports that come through NAFTA—and thus, likely, the share with a high NAFTA content.

Over the last decade, according to the Organization for Economic Cooperation and Development's Trade in Value Added database, the NAFTA and US share of value added in Mexican exports of “motor vehicles, trailers and semitrailers” has fallen somewhat. The NAFTA share for the sector is estimated at around 70 percent in 2011 (the most recent year available), suggesting the rules of origin are binding. While the share is above the 62.5 percent rule of origin, it includes some value added that would not qualify under NAFTA, such as the US value added in car parts imported from Asia or Europe. In addition, car companies regularly use slightly more regional content than the restrictions require to ensure that potential disruptions from regional suppliers or paperwork/verification issues do not prevent them from achieving NAFTA certi-

**Figure 6 Share of US imports in the transport sector, by country**



NAFTA = North American Free Trade Agreement

Sources: World Bank, World Integrated Trade Solution, and author's calculations.

**Table 1 Supply chains are important**

	All goods				Transport sector goods			
	US imports from		US exports to		US imports from		US exports to	
	Mexico	World	Mexico	World	Mexico	World	Mexico	World
<b>Shares of US trade in goods (percent):</b>								
Intermediate input trade	40	41	75	61	46	38	76	45
Related-party trade	67	51	40	29	84	74	61	34
Majority-owned affiliate trade	21	16	22	29	43	26	n.a.	34

n.a. = not available

Note: Related-party trade is defined as trade within firms with at least 10 percent ownership in the trading partner.

Sources: Amiti, Freund, and Bodine-Smith (2017); US Census Bureau; and Bureau of Economic Analysis.

fication. Given that global supply chains make it more difficult to certify where goods are produced, many producers state that they are operating very close to the margin, with a small buffer to ensure they meet NAFTA requirements.

While there is a chance that raising content thresholds could lead to more NAFTA content (especially Mexican), there is a risk that raising these thresholds would lead conversely to more autos and parts entering through MFN, thus with lower NAFTA content. There are also the higher production distortions and added costs of complying with rules of origin to consider.

## TOWARD A BETTER SYSTEM OF RULES OF ORIGIN

Because the rules of origin in NAFTA are especially complex and were designed before the global-supply-chain revolution, it is time to reform them. Replacing the 304-page annex describing rules at the product level with a simple rule that can cut across all NAFTA trade would be an improvement. Three ideal reforms would be:

- A uniform rule applying to all products, with a simple regional content rule of, for example, 40 to 50 percent. The complex tariff category change restrictions should be amended to always allow for showing regional value above the required amount as an alternative. A simple regional content rule is more transparent, while maintaining the alternative tariff category transformation offers some flexibility to firms.
- Expanding the de minimis threshold under which products do not have to be certified, especially for low tariff products, to help small businesses that find compliance with rules of origin cumbersome.
- Move towards a global norm that would make it easier for exporters to conform to the rules in different trade agreements and that would also allow cumulation when regional agreements expand to include other countries.

Making rules of origin stricter and more complicated would be bad for producers and lead to higher prices for consumers, without guaranteeing more US content will end up in final products. Stricter rules could lead to more trade going through MFN tariffs and thereby lower regional content. In cases where regional content does expand, any NAFTA partner could benefit, not just the United States. Small businesses are especially deterred from trading, as the added compliance cost is a higher share of their low-value shipments.

Going forward, coordination on rules of origin among WTO members to achieve one simple set of rules that all free trade agreements follow would be an improvement on the current system, where companies must learn the intricacies of a growing number of unique trade agreements, each with its own product-specific rules, and obtain a corresponding certification. Ideally, a single certification for goods with value added of say at least 50 percent from the source country could be used for all trade agreements to which the source country is a signatory.

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## CHAPTER 10

# Rethinking NAFTA: Deepening the Commitment to Sustainable Development

Daniel C. Esty and James Salzman

Before the North American Free Trade Agreement (NAFTA), no trade agreement had directly addressed environmental issues. Indeed, prior to 1990, trade policymakers considered international economic cooperation and environmental protection distinct policy domains with little, if any, connection. Attitudes, however, were rapidly changing as environmental issues moved to the top of the American public's concerns.

NAFTA represented, moreover, the first trade liberalization agreement between industrialized countries, whose environmental standards were comparatively stricter, and a developing country with weaker environmental standards and less stringent enforcement. Environmental groups feared that expanded economic interaction with Mexico would lead to more polluting factories along the border, more imports of products made under weak environmental standards, and competitive pressure on US companies constrained to comply with more stringent environmental rules. NAFTA opponents also raised the specter of Mexico as a "pollution haven," inviting manufacturers to cut costs by moving their production out of the United States (or Canada) to Mexico, where pollution control and other regulatory requirements would be more relaxed and less costly. For all these reasons, the environment became an explicit topic of the NAFTA negotiations.

But the inclusion of a "trade and environment" dialogue in the NAFTA negotiations alarmed some trade experts, who feared that environmental commitments would limit the scope of market liberalization. They worried that NAFTA provisions designed to protect environmental regulations would become *protectionism* in green garb, and argued that trade and environmental policies should be managed separately. Trade agreements, the conventional wisdom held, should liberalize trade, not be burdened with trying to advance environmental goals.

The world has dramatically evolved since those disagreements, leading to a new consensus that promoting free trade without careful attention to other public policy priorities, including environmental *sustain-*

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*ability*, risks endangering the public's health and welfare (Esty 2008). A more concerted effort is therefore needed to ensure that trade policymaking in general, and any NAFTA renegotiation in particular, encompasses environmental and social goals including labor rights, worker dislocation, public health, poverty alleviation, and income distribution.

This chapter proposes several broad measures to reach that objective. First, sustainable development should be explicitly articulated as a core commitment in any new framework for Canada-US-Mexico trade. To this end, a sustainability impact assessment should be undertaken to flag potential trade-environment (and social) conflicts and effects. In addition, NAFTA Article 104, which establishes environmental protection as a priority obligation of the trading partners, should be updated and upgraded. And other provisions on the environment should be strengthened consistent with recent World Trade Organization (WTO) precedents.

Particular attention should be paid to the investor-state dispute resolution mechanism in NAFTA, which must be revised to ensure that it does not weaken the regulatory sovereignty of the participating countries. A new NAFTA should also be recast to be more transparent, provide better public access to its provisions and decision-making processes, and require regular reports on how environmental goals are being met. Any new agreement should encourage a stronger commitment among corporations to robust sustainability strategies and address more systematically the pollution and natural resource management issues that arise whenever economic activity expands in the wake of trade liberalization. Finally, the NAFTA governments should commit themselves to far greater data collection and analysis of the environmental costs and benefits delivered by expanded trade—and the efficacy of policies to mitigate the burdens that arise.

## **TRADE-ENVIRONMENT LINK IN NAFTA**

Given that no prior trade agreement had any significant focus on environmental concerns, NAFTA broke new ground with its environmental provisions. But even with these commitments environmental groups remained skeptical. Thus, Bill Clinton pledged during his 1992 presidential campaign that, if elected, he would strengthen the environmental and labor aspects of the agreement, and in 1993 further commitments were set out in the North American Agreement on Environmental Cooperation (NAAEC or Environmental Side Agreement). The environmental safeguards in NAFTA and this Side Agreement directly responded to the range of concerns raised during negotiations by NGOs and EPA officials who were, for the first time ever, part of the negotiating team.

The environmental elements that negotiators first incorporated in NAFTA 25 years ago have stood up surprisingly well, although weaknesses have emerged and other issues and priorities have come to the fore. This chapter reviews and assesses NAFTA's environmental provisions and their effects. It then explains how a revised NAFTA might strengthen the commitment to sustainable development and create a model for 21st century international economic integration that connects trade law and sustainability (Esty 2017).

## **NAFTA's Environmental Provisions**

NAFTA's preamble calls on the three countries to undertake trade liberalization in a manner that promotes "sustainable development" and strengthens "the development and enforcement of environmental laws and regulations." It further specifies that NAFTA's trade goals should be achieved in a "manner consistent with environmental protection and conservation." These commitments to sustainability in the context of trade policymaking, incorporating pollution control and natural resource conservation in the trade agreement, were unprecedented. Indeed, NAFTA's environmental provisions have been a model for subsequent trade agreements (Knox 2010, Esty 2004). A renegotiation of NAFTA should take into account this critical role while updating and enhancing the commitment to sustainable development as a fundamental underpinning for any new program of trade liberalization.

## Safeguarding International Environmental Agreements

NAFTA Article 104 specifies that three international environmental agreements with trade implications—the Montreal Protocol on protecting the ozone layer, the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal (the Basel Convention), and the Convention on International Trade in Endangered Species (CITES)—take precedence if a conflict emerges between obligations under these agreements and NAFTA commitments. The three countries further agreed that the “protected” list of international environmental agreements could be expanded by an exchange of letters—thus anticipating future agreements that might need to be similarly prioritized in the context of any clash with NAFTA trade obligations (though no agreement has been added to the list).

By privileging obligations under the Montreal Protocol, Basel Convention, and CITES, NAFTA directly addressed one of the core concerns raised by environmentalists: that when trade and environmental values or commitments came into conflict, trade would trump the environment. This “safe harbor” provision expressly declared that the trade liberalization to be undertaken would respect the named environmental agreements, thus providing a very different starting point for resolving trade-environment conflicts than existed under the General Agreement on Tariffs and Trade (GATT) Article XX “environmental exceptions” jurisprudence.

## Recasting GATT Language to Protect Environmental Policies

The NAFTA environmental negotiations were colored by the 1990 GATT *tuna-dolphin* case in which a dispute panel unexpectedly determined that the United States had violated its trade obligations by imposing import restrictions on Mexican tuna that had been caught with purse seine nets that resulted in large numbers of dolphin deaths. This decision shocked the US environmental community and launched the “trade and environment” movement (Esty 1994a). Environmentalists and their political allies worried that trade agreements threatened regulatory sovereignty. The *tuna-dolphin* case raised the possibility that GATT dispute resolution rules and processes could undermine any environmental standards or programs. Notably, under the GATT standard, parties had to choose environmental policy alternatives that were “least inconsistent” with their trade obligations. In the mid-1990s the *shrimp-turtle* case refined the *tuna-dolphin* holding, implying that trade restrictions based on process and production methods might be viable if they were not applied in an arbitrary or unjustifiably discriminatory manner.

NAFTA text further softened the GATT requirement by indicating that parties need only search for the least trade restrictive policies among options considered “equally effective” and “reasonably available,” giving environmental officials much broader regulatory leeway. This “rebalancing” of trade and environmental goals has meant that NAFTA implementation has not generated disputes related to trade policies or principles that undermine environmental protection choices. As we discuss below, however, regulatory challenges brought by *private companies* under the investor-state dispute resolution provisions of NAFTA Chapter 11 have become a source of controversy.

## Regulatory Discretion

Although critics of trade liberalization have argued that trade agreements systematically undermine environmental rules and regulations, the experience under NAFTA provides little evidence to support this. In fact, the sanitary and phytosanitary provisions of NAFTA Article 712 explicitly address the regulatory sovereignty issue and make it clear that the parties retain an unrestricted right to set their own environmental, health, and safety standards and establish their own risk preferences and levels of protection. This regulatory discretion is subject only to the constraints that the standards be based on scientific principles and not create “unnecessary obstacles to trade.” NAFTA further specifies that the Mexican and US states and Canadian provinces may choose their own standards.

## Pollution Havens

Concerns about pollution havens are addressed in NAFTA Article 1114, which declares that it is “inappropriate to encourage investment by relaxing domestic health, safety, or environmental measures” or by relaxing enforcement of regulations in a way that would provide “encouragement for the establishment, acquisition, expansion, or retention” of foreign investment and new businesses. This can be thought of as a one-way ratchet—standards can be raised but never lowered to attract foreign investment. And in fact, as described below, Mexico has actually adopted and implemented stronger, not weaker, environmental standards and programs since NAFTA (Carpentier 2002, Wisner and Epstein 2005).

Despite concerns about a “race to the bottom,” there is limited evidence of factories moving to Mexico to avoid pollution control obligations in the United States or Canada (Gallagher 2004, Fredriksson and Millimet 2002, Carpentier 2002). To be sure, some industries, such as textiles and furniture manufacturing, have expanded in Mexico and contracted in the United States, but these shifts were driven largely by wage differentials rather than lax environmental standards (Carpentier 2006). And some industries that have grown in Mexico under NAFTA, notably automaking, have factories that are world class in their pollution controls and environmental management systems (Cristóbal and Figueroa 2018).

Ironically, the primary NAFTA-related “pollution haven” effect seems to have been an increase in hazardous waste exports from the United States to Canada. The flow of US hazardous waste into Canada jumped 400 percent in the decade after NAFTA’s adoption (CEC 2002), reflecting Canada’s comparative advantage (lower costs) in waste disposal. But there has been no evidence that the waste has been mishandled in Canada or that there has been any race to the bottom in waste management standards.

## Investor Protections

Environmental concerns about NAFTA have focused not so much on the agreement’s environmental provisions or the Environmental Side Agreement but rather on the investment chapter. Designed to protect foreign investors from arbitrary treatment, NAFTA Chapter 11, on Investment, provides a number of guarantees including rules to protect investors from expropriation of their property unless the host government’s intervention reflects a legitimate public purpose, is undertaken in a nondiscriminatory manner (treats domestic and foreign companies alike), and provides the foreign company with due process of law and fair compensation. Most controversially, companies that believe they have been subject to government actions tantamount to expropriation have recourse through an investor-state dispute resolution mechanism.

While Chapter 11 (Article 1114) guarantees the governments the right to set—or raise—environmental standards as they see fit, environmental policy choices have been regularly challenged. One in three cases brought under the dispute resolution mechanism has focused on environmental regulations (Gaines 2007, Sinclair 2015). Canada has faced 35 challenges, 22 of them concerning pollution control, resource management, or other environmental regulations, such as restrictions on toxic waste disposal, lumbering, and mining (Sinclair 2015). One of the most high-profile ongoing actions is a challenge to Quebec’s fracking ban, brought by Lone Pine Resources, a US oil and gas company that is seeking nearly \$120 million in damages (ICSID 2017).

Environmentalists, however, point to the 1998 *S.D. Myers* case as a particularly egregious example of NAFTA running roughshod over environmental law (Sinclair 2015). In that dispute, regarding Canada’s ban of toxic PCB waste exports, the government argued that its policy was dictated by the Basel Convention. The NAFTA tribunal rejected this contention and ordered Canada to pay \$6 million in damages. In total, Canada has lost four cases and settled another six—paying out more than \$170 million in compensation (Sinclair 2015).

Mexico has faced 22 Chapter 11 challenges, resulting in more than \$200 million in claims or settlements. Although only four cases involved environmental issues, NAFTA critics have highlighted the *Metalclad* case as an abuse of the investor-state dispute settlement structure. In this case, Mexico paid \$15.6 million plus interest in damages to a US waste management company after denying the company a permit to operate a hazardous waste facility and being found to have violated the “minimum standard of treatment.” Industry observers argued that this outcome was appropriate because local Mexican officials had deferred the company’s permit request for years in response to local opposition to the facility. Environmentalists, on the other hand, claimed that Mexico had legitimate ecological concerns and should have been permitted to reject the proposed facility. In their view, *Metalclad* confirms that the Chapter 11 dispute mechanism systematically favors industry and investor interests to the detriment of the public and the environment.

The United States has not paid out compensation as a result of any of the 20 claims brought against it, which have included six challenges to its environmental regulations and resource management programs. Perhaps the challenged US regulations were drafted more carefully or the United States has been more energetic in defending its policy choices. But the fact that the United States has not paid out any Chapter 11 claims suggests that the environmental community’s contention that Chapter 11 undermines environmental protection is not a factor at least for the United States.

Our analysis suggests that some of the Chapter 11 claims that resulted in compensation involved regulatory overreach that unfairly targeted single companies—upholding the original intent of the dispute settlement mechanism (Alvarez and Park 2003). Other cases are not so clear.

Controversy over the investor-state dispute settlement mechanism persists, as was evident during negotiations for the Trans-Pacific Partnership (TPP) trade agreement. As we discuss below, NAFTA Chapter 11 should be substantially modified in the renegotiation. In particular, the standards for adjudicating claims should be tightened to avoid any “regulatory chill” on environmental rules and standards (Esty 1994a), including requirements tightened based on new information and improved scientific analyses.

### **Commission for Environmental Cooperation**

Created in the Side Agreement, the Commission for Environmental Cooperation (CEC) has ensured a systematic focus on environmental issues associated with trade among the three NAFTA parties. It meets on a regular basis to review relevant concerns, and has spurred the collection of data to track environmental trends and generated studies of trade-environment issues (Wold 2008, Knox 2010, Gallagher 2004).

But the CEC has been a disappointment to many environmentalists because of its limited substantive impact (Wold 2008, Charnovitz 1994). The Side Agreement calls on each country to “ensure that its laws and regulations provide for high levels of environmental protection” and to “effectively enforce its environmental laws and regulations,” but there has been little follow-through on these commitments. In fact, the CEC has always been underfunded and understaffed (Wold 2008, Knox 2010).

On the other hand, the CEC’s “citizen submission” process allows citizens and nongovernmental organizations (NGOs) to shine a spotlight on environmental shortcomings in the NAFTA countries. Under Articles 14 and 15 of the Side Agreement, NGOs and members of the public can file Submissions on Enforcement Matters against a party country, charging that its failure to enforce its environmental laws represents a clear environmental harm to the submitter. If the Secretariat deems the submission eligible, it can ask the CEC to develop a “factual record.” But this review process results only in information generation—not monetary judgments.

The CEC has received 88 submissions—45 against Mexico, 30 against Canada, 12 against the United States, and one against both Canada and the United States—but produced only 22 factual records (13 on

Mexico, 7 on Canada, and only 2 on the United States). In even fewer cases have the national governments changed policies or project outcomes (Hufbauer and Schott 2005, Zepeda, Wise, and Gallagher 2009).

Among these few cases, the citizen submission process has produced some notable policy successes. After the CEC's 1996 *Cozumel* report cited possible violations of Mexican law in the context of a proposed new cruise ship port, Mexican president Ernesto Zedillo declared the Cozumel coral reef a protected marine reserve. The CEC submission process also helped to motivate pollution management changes at a major Mexican shrimp farm, kick-start cleanup efforts of a shuttered lead smelter in Tijuana, and bring new scrutiny to illegal logging in Chihuahua (Dorn 2007).

While citizen petitions have been most effective at moving policy in Mexico, they have also facilitated some environmental improvements in the United States and Canada (Graubart 2010). For example, CEC investigations into the British Columbia Hydro and Power Authority led the Canadian government to adopt new fish habitat protections (Allen 2012). Similarly, in the United States, a citizen petition helped to sharpen the focus on environmental issues in the San Pedro River basin in Arizona (Varady, Moote, and Merideth 2000).

### **Tripartite Environmental Cooperation**

Cooperation along the US-Mexico border has been uneven. The agreement's Border Environmental Plan drew attention to a number of issues, particularly consequences of unplanned development in the maquiladora zone of northern Mexico. The process of developing the plan, which involved not just government-to-government dialogue but 17 public hearings on both sides of the border, introduced Mexican officials to the importance of public participation in policymaking (Esty 1994b).

Implementation of the plan faltered after NAFTA's adoption, but a renegotiation of NAFTA can be a new opportunity to assess border conditions and opportunities for improved environmental collaboration and outcomes. Indeed, EPA's Border XXI Program has refocused attention on critical issues and reengaged Mexican and US environmental officials in joint capacity-building efforts (Sowell 2001).

The US-Mexico Border Environment Cooperation Commission (BECC) and North American Development Bank (NADB) have delivered concrete results. In the first two decades after NAFTA's adoption, the BECC identified and certified the feasibility and potential positive environmental and health impacts of 227 environmental infrastructure projects along the border (120 in Mexico and 107 in the United States) with a total investment of more than \$7 billion in water systems, wastewater services, municipal solid waste disposal, water conservation, air quality improvement, and clean energy (BECC and NADB 2014, Villareal and Fergusson 2014). The NADB has provided more than \$2 billion in loans and grants for these projects. A recast NAFTA, coupled with the "green banks" emerging across the country and the world (Leonard 2014), could build on this record of success by ensuring that resources are devoted to addressing trade-related environmental stresses.

For all its faults, NAFTA's inclusion of environmental concerns has ensured ongoing attention to pollution and natural resource management issues, especially in Mexico, where improved environmental enforcement, increased pollution-related research and training, and strengthened institutional abilities have enhanced capacity to manage environmental challenges (Torres 2002, Carpentier 2006).

In the next section we assess empirically whether the strengthened governance capacity has translated into improved environmental performance.

## NAFTA'S ENVIRONMENTAL IMPACT

Environmentalists have long worried that NAFTA-induced liberalized trade would lead to greater industrialization in Mexico and that the growth in economic activity among the three parties would drive up levels of pollution and natural resource consumption. Research indicates that NAFTA seems to have had such “scale effects” in particular sectors. For example, higher emissions have been found in the oil, base metals, and transportation equipment sectors (Reinert and Roland-Holst 2001). And a 2002 study reported a rise in carbon monoxide (CO), nitrogen oxide (NO<sub>x</sub>), and sulphur dioxide (SO<sub>2</sub>) emissions in Mexico associated with the growth of the country’s petroleum sector (Vaughan and Block 2002).

But beyond these sector-specific developments, there are no indications of overall environmental degradation (Fredriksson and Millimet 2002). In fact, pollution levels have generally trended down in all three NAFTA countries. [Figures 1 and 2](#) show trends in two core air pollution indicators that cause a variety of health and ecological harms: emissions of particulate matter (which causes respiratory harm) and NO<sub>x</sub> (which contributes to smog and acid rain) (Stern 2007, EPI 2016, World Bank 2017).

As anticipated, NAFTA has produced substantial economic growth in Mexico: the economy rose (in current US dollars) from a GDP of \$263 billion in 1990 to over \$1.1trillion in 2015 (World Bank 2016a). Consistent with the predictions of the environmental Kuznets curve (Carpentier 2006, Gallagher 2004), this vast increase in financial flows has allowed the country to invest in improved infrastructure, which has led to better environmental health outcomes. For example, in 1992 the UN declared that Mexico City had the worst air pollution in the world. In the two decades since NAFTA, air quality in the city dramatically improved: ozone levels decreased 75 percent and particulates 70 percent as a result of investments in cleaner cars and power plants and tighter regulation of factories and refineries.<sup>1</sup>

Likewise, as shown in [figure 3](#), access to piped drinking water in Mexico jumped from 60 percent to 90 percent in rural communities and from 92 percent to 97 percent in urban areas since NAFTA’s inception (UNICEF/WHO 2010). The percentage of Mexican city dwellers with access to advanced sanitation, demonstrated in [figure 4](#), rose from 79 percent to 88 percent in 1990–2015 (UNICEF/WHO 2010). The country has also steadily, and in some cases dramatically, improved its capacity to collect and treat waste. For instance, the share of the Mexican population connected to a wastewater treatment plant through a public sewage system more than doubled, from about 22 percent in 1993 to 50 percent in 2013 (OECD 2017). And by 2006, 90 percent of Mexico had municipal waste collection services (United Nations Statistics Division 2011).

Not all trends have been positive. For instance, municipal solid waste increased by 108 percent in the decade after NAFTA (Gallagher 2004). But this increase can likely be attributed to rising affluence and consumption rather than trade liberalization per se.

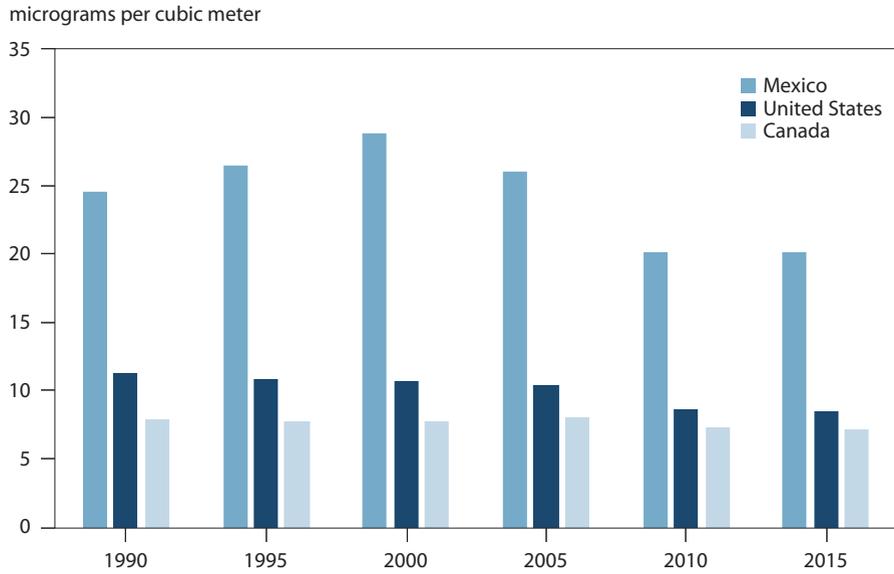
In short, although problems persist and pollution levels have risen in some sectors and certain locales, overall Mexico’s environmental circumstances have improved considerably since 1990 (EPI 2016).

One must be cautious in attributing these gains to the environmental provisions of NAFTA rather than economic development and rising wealth more generally. Correlation does not mean causation. That said, studies have found that NAFTA helped to spur the Mexican government to strengthen both its environmental regulations and their enforcement (e.g., Knox 2010, Wisner and Epstein 2005). And multinational companies that share environmental management strategies and best practices across their Canadian, US, and Mexican production platforms (especially in the auto and electronics sectors) have helped to improve pollution control (Studer 2005, Schatan and Castillejo 2005).

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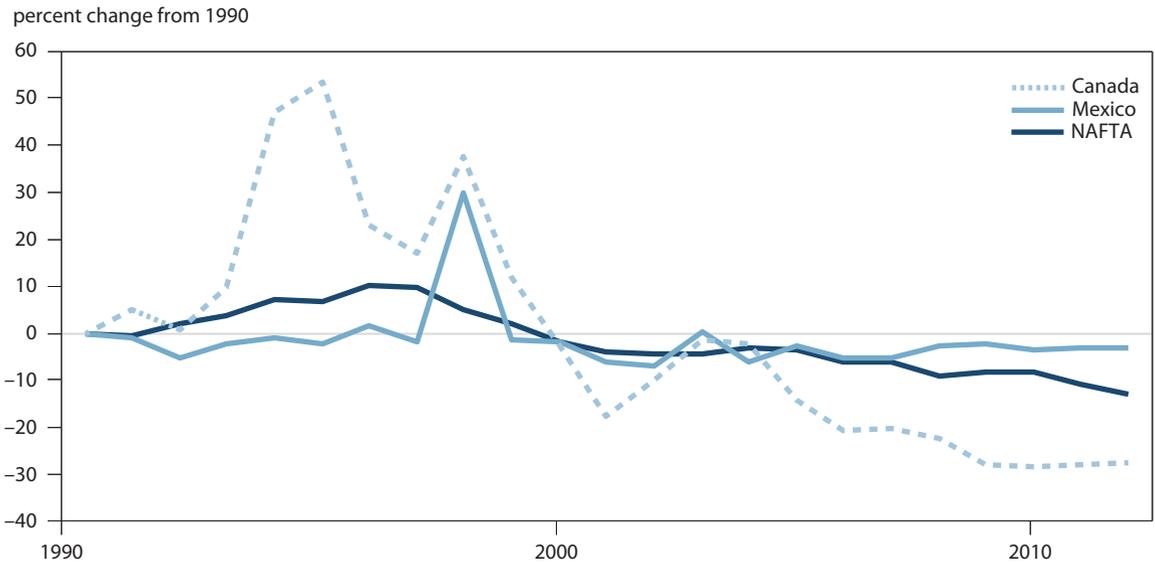
1. Anne-Marie O’Connor, “Mexico City drastically reduced air pollutants since 1990s,” *Washington Post*, April 1, 2010.

**Figure 1 Mean national annual exposure to particulate matter (PM<sub>2.5</sub>) air pollution, 1990–2015**



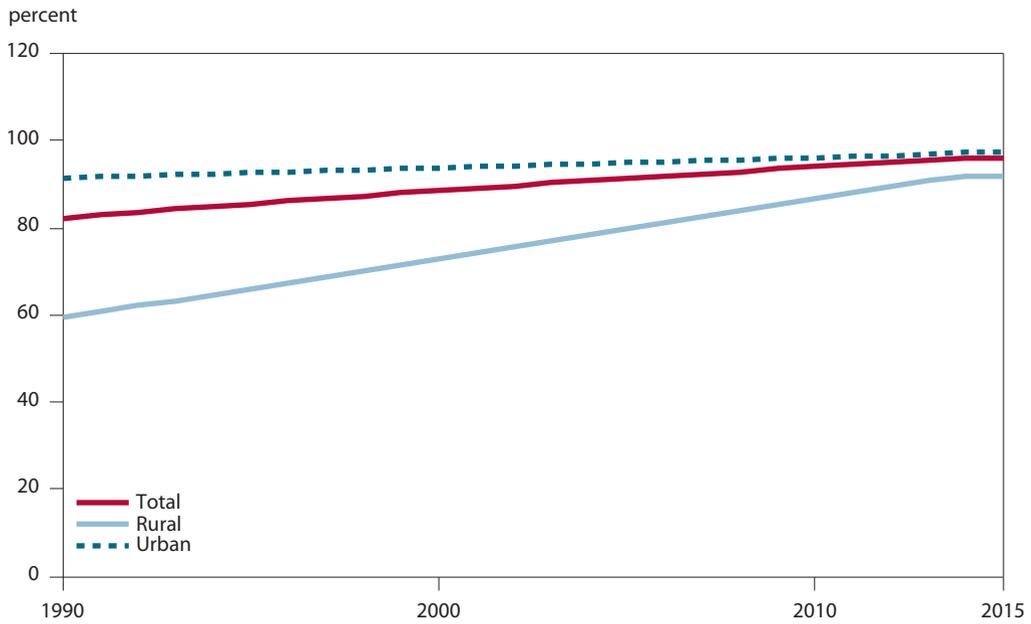
Source: World Bank (2017).

**Figure 2 Nitrogen oxide emissions, 1990–2012**



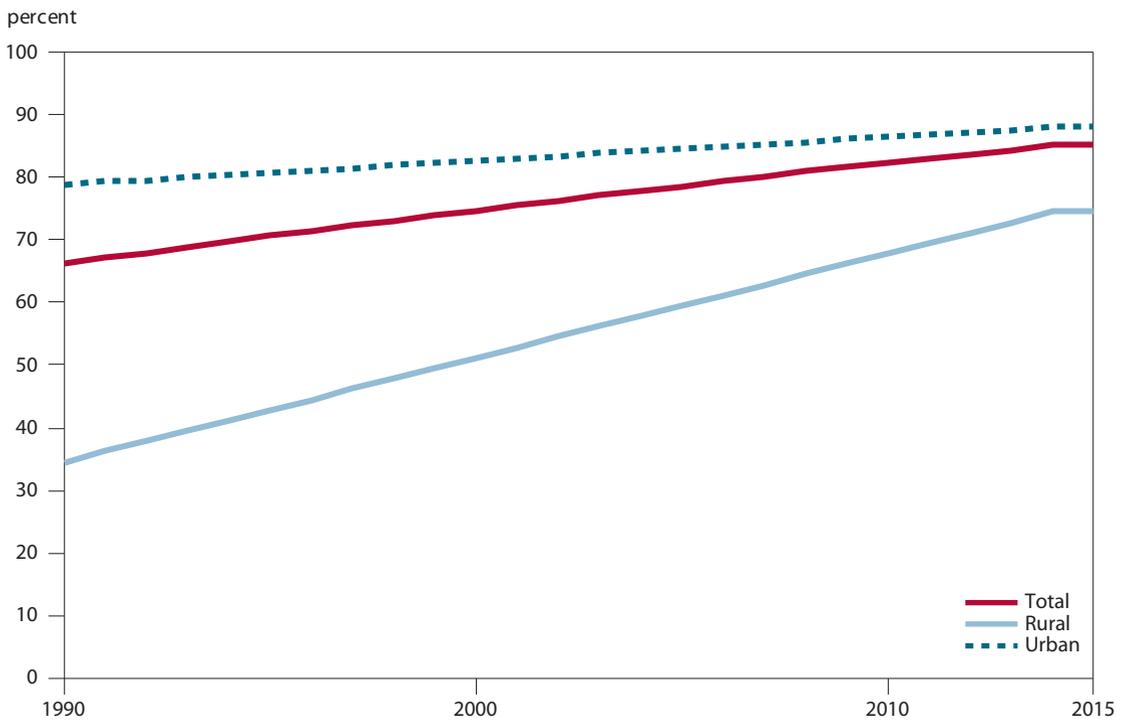
Source: World Bank (2017).

**Figure 3 Access to improved drinking water sources in Mexico, 1990–2015**



Source: World Bank (2017).

**Figure 4 Access to improved sanitation in Mexico, 1990–2015**



Source: World Bank (2017).

Ultimately, most NAFTA assessments and studies of trade agreements more generally conclude that expanded trade and the resulting economic growth cannot alone produce gains in environmental performance. Policy advances and institutional structures are needed to ensure systematic progress (Vaughan and Block 2002). With the exception of a few sectors, since the adoption of NAFTA most measures of environmental quality have improved, some of them significantly.

## **ENVIRONMENTAL AGENDA FOR NAFTA RENEGOTIATION**

Even the most ardent free traders today recognize that welfare gains from open markets cannot be assured unless environmental externalities are internalized (Bhagwati 2004, Esty 2008). A NAFTA renegotiation can build on the understanding that trade liberalization can affect environmental outcomes—and environmental policies can shape trade flows.

The agenda laid out in the following sections builds both on lessons from the NAFTA experience and on observations from other trade-environment developments. The policy recommendations would go a long way toward ensuring that a new NAFTA not only delivers economic gains but also ensures progress on broader goals, including a more sustainable future.

### **Sustainable Development Framework**

Our proposed path forward reflects and builds on a global commitment to sustainable development (Sachs 2015). The 17 United Nations Sustainable Development Goals (SDGs) present targets and actions for nations in both their international interactions and their domestic policy strategies.<sup>2</sup> Similarly, the 2015 Paris Climate Change Agreement calls on the international community to address climate change in particular and to commit to a sustainable future more generally (Esty 2017). These agreements make clear that sustainability—understood as an integrated commitment to economic, environmental, and social progress—should be a foundational element and a touchstone for all policy decisions reflected in a reconfigured NAFTA.

### **Sustainability Impact Assessment**

The NAFTA renegotiation should be preceded by a sustainability impact assessment (SIA) to flag potential trade-environment (and associated social) conflicts and effects that should be addressed in the negotiations. Precedents for such a commitment include President Clinton's Executive Order 13141, which calls for environmental reviews of trade agreements (Salzman 2001). The NAFTA renegotiation should also draw from the EU experience, which has developed a more far-reaching SIA model<sup>3</sup> that could be adapted to the NAFTA context.

### **International Environmental Agreements**

NAFTA Article 104, which references three international environmental agreements as priority obligations around which NAFTA commitments must be adjusted, should be updated to include the 2030 Agenda for Sustainable Development (the 2015 UN compact that put forward the 17 SDGs) and the 2015 Paris Climate Change Agreement. These agreements underpin international efforts to manage global interdependence generally and the world trading system in particular and therefore must be given special attention and priority (Esty 2017, Berger and Brandi 2016).

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2. Available at [www.un.org/sustainabledevelopment/sustainable-development-goals/](http://www.un.org/sustainabledevelopment/sustainable-development-goals/) (accessed on June 18, 2017).

3. Available at [http://trade.ec.europa.eu/doclib/docs/2016/april/tradoc\\_154464.PDF](http://trade.ec.europa.eu/doclib/docs/2016/april/tradoc_154464.PDF) (accessed on June 28, 2017).

## Environmental Protection in the Agreement Itself

The environmental provisions of NAFTA should be retained and strengthened consistent with recent WTO dispute resolutions that embed environmental protection and sustainability more deeply in trade rules and practices. While NAFTA helped to move trade policy beyond the perceived threats from the GATT *tuna-dolphin* decision, the new NAFTA should reflect the language of the more recent *shrimp-turtle* decision and other cases. These cases make clear that environmental programs and rules should not be challenged under trade law if they comport with international agreements and are implemented in a legitimate nondiscriminatory manner.

The revised NAFTA should state clearly that regulations related to process and production methods (PPMs) will be regarded as consistent with trade obligations to the extent that they (a) address transboundary harms or (b) implement internationally agreed upon standards. This policy framework would codify and clarify the emerging WTO jurisprudence on PPMs, making clear the need for both PPM regulations and reasonable restraints against their use as a disguise for protectionist measures.

Clearly establishing the right of each NAFTA party to maintain environmental protection laws, regulations, and programs that meet nationally determined goals, priorities, and risk standards would serve as a model for broader efforts to make the international trading system more attentive to 21<sup>st</sup> century concerns about sovereignty (Rodrik 2011, Allen et al. 2014, Grewal 2008).

## Recast Investment Chapter

No part of NAFTA requires more substantial reworking than Chapter 11. The investor-state dispute resolution mechanism needs refinement to ensure that it does not undermine the regulatory sovereignty of any of the three countries (Sinclair 2015). The experience of the past 25 years suggests that the circumstances under which private parties can claim compensation should be narrowed considerably. The US “regulatory takings” jurisprudence might provide some guidance for the needed reframing, as might the narrower language of other recent trade agreements, such as the US-Chile deal.

Specifically, the new NAFTA should state that each country’s environmental rules or standards are presumed to reflect national priorities and preferences and are therefore to be considered NAFTA-consistent unless a challenge demonstrates, with clear and convincing evidence, that a particular provision (a) operates as a disguised barrier to trade or (b) burdens trade clearly disproportionately to any environmental gains.

As a starting point, negotiators should consider the relevant language from the Trans-Pacific Partnership Trade Agreement, in which Article 9.16, Investment and Environmental, Health and Other Regulatory Objectives, states that:

Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental, health or other regulatory objectives.

TPP Annex 9-B, Expropriation, similarly makes clear that:

Non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute indirect expropriations, except in rare circumstances.

The TPP was the result of negotiations among 12 countries, including Mexico, Canada, and the United States, and thus reflects widely shared thinking on how best to promote both investor protection and envi-

ronmental regulations. There is a strong foundation for the inclusion of this language in a reconfigured NAFTA. It is also possible that the three NAFTA parties would welcome more stringent provisions than the TPP text, consistent with the principles outlined in part I above.

We also recommend consideration of the TPP provisions on illegal logging, wildlife trafficking, and fishing, in addition to restrictions on fishery subsidies. These elements—widely heralded in the environmental community—represent major advances compared to other trade agreements.

Last, the environmental priorities outlined above should be in the new NAFTA itself, not in a side agreement. Putting these elements at the core of any new trade liberalization agenda will ensure that their importance is recognized.

## **Transparency**

Confidence that any new trade agreement will deliver enhanced welfare broadly conceived—and not simply material gains in a narrowly defined economic sense—would be strengthened by a commitment to transparency in whatever structure of NAFTA governance emerges. In the years since NAFTA was negotiated, the importance of public access to information and participation in decision making has grown. Transparency should thus be a core value of the new NAFTA, with expanded opportunities for public engagement in the negotiations as well as the governance system set up to implement the new agreement.

## **Metrics and Reporting**

One of the conclusions of the CEC NAFTA assessments centers on the value of more data and analysis of issues that arise at the trade-environment interface. The revised NAFTA should specify sustainability metrics that the parties will report annually to enable a better gauge of whether their commitment to liberalized trade across North America is delivering better environmental (and social) outcomes.

Quantitative indicators of progress are recognized as a fundamental element of good governance in the Information Age. Data analytics and carefully defined metrics can improve the capacity of government officials (as well as the public, media, business community, and NGOs) to spot environmental problems, track trends, assess the effectiveness of policy interventions, highlight leaders, spur laggards, identify best practices, and ensure that the impacts of policy tradeoffs are carefully considered (Esty 2018, Noveck 2015).

## **Corporate Sustainability Leadership**

Analysis of the NAFTA experience reveals significant pollution control progress due to corporate environmental management efforts, particularly by multinational companies that expanded their investments in Mexico. Major automakers and other companies with big brands (e.g., Walmart, Nestlé, Unilever, Bimbo) have developed environmental programs and initiatives that have delivered improved results in a number of sectors (Carpentier 2006, Studer 2005, Schatan and Castillejo 2005). Supply chain management, attention to the environmental impacts of raw material sourcing, and internal environmental standards have combined to create more effective private environmental governance. A renegotiated NAFTA might encourage further corporate sustainability efforts and investments by ensuring that *all* environmental goods and services move across the NAFTA borders without tariffs.

## Institutional Reform

A stronger CEC would help a revised NAFTA deliver more fully on the capacity of trade liberalization to enhance welfare broadly defined—not simply provide gains for a narrow set of economic interests. Toward this end, the NAFTA governments should commit additional resources to the CEC for data collection and analysis, more thorough follow-up on citizen submissions, enhanced capacity building, and the development of a more effective environmental dispute resolution mechanism. The success of the BECC and the NADB indicates that the reach of these organizations should be extended with increased funding and expanded mandates—perhaps beyond the border zone to any place where trade-induced environmental impacts might be addressed through infrastructure investments.

## CONCLUSION

NAFTA was a trail-blazing initiative that recognized for the first time in a trade agreement the importance of environmental protection. In many respects, its ambitions have been confirmed. In the more than two decades since the passage of NAFTA and its Side Agreement, all three NAFTA parties have enjoyed improved environmental quality by most measures, with the strongest advances in Mexico.

But important local environmental challenges remain in all three countries—such as groundwater depletion, surface water and urban air pollution, and poor fisheries management, to name just a few. And much more is known today than in the 1990s about the trade-environment dynamic, effective and efficient environmental regulation—and planetary threats such as the buildup of greenhouse gases in the atmosphere that must be confronted (Rockstrom and Klum 2015, Sachs 2015). Renegotiation of NAFTA offers an important opportunity to address these issues and establish new goals, programs, procedures, and institutional arrangements to ensure that expanded trade helps move the NAFTA nations toward a more sustainable future.

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## CHAPTER 11

# NAFTA as a National Security Priority

**John J. Hamre**

For over 150 years, the United States has enjoyed peaceful borders and peaceful neighbors in Mexico and Canada. A potential collapse of the North American Free Trade Agreement (NAFTA) would not only imperil the region's economic health but also pose a risk to the three countries' cooperative relationship on security issues.

### **MEXICAN-US RELATIONS**

Before NAFTA was negotiated in the early 1990s, the Mexican-US relationship was frequently fraught. NAFTA fundamentally changed the framework of mutual cooperation between the two countries. During the last 23 years, Mexico and the United States have developed deep and intimate structures of cooperation. NAFTA first transformed business ties between the two countries. Businesses adopted new techniques for managing the manufacturing process, depending extensively on outsourced subcomponent fabrication. A new term entered business lexicons—supply chain management. Manufacturing became distributed across the two countries in deep and complex ways.

The implementation of NAFTA required both Mexico and the United States to transcend historic patterns of border management. Efficiency at the border became a priority for entrepreneurs and firms from both countries seeking to benefit from the better terms of trade now available. Consequently, customs and immigration services now needed to work side by side to keep up with the demand for exploding business opportunities. The trade agreement reinforced the benefits of cooperation and helped the parties to overcome long-held suspicions.

At the same time, the insatiable US demand for illegal drugs led to security challenges in Mexico. The United States struggled to deal with the “war on drugs” but found it needed extensive cooperation with Mexican authorities to reach deeper into enemy territory. This led to extensive structures for collaboration and sharing of intelligence and even to joint operations.

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Today, the United States has sophisticated and intimate security collaboration with Mexican counterparts. Both countries jointly man intelligence centers and actively collaborate to counter money laundering. US security personnel join Mexican border control officers on both the northern and southern borders of Mexico. Counter-drug teams operate jointly to combat the menace posed by sophisticated drug cartels.

US security cooperation with Mexico is extensive, deep, and constant. But it is grounded in the mutual respect and economic energies created by NAFTA. When negotiations were launched, Mexico was a poor neighbor reeling from a “lost decade” of economic dislocation. Mexico’s leaders had just begun adopting international trade rules by joining the General Agreement on Tariffs and Trade (GATT), but they were seeking a way to deepen reform by deepening ties with their rich, rules-based neighbors to the north.

Gradually, Mexico’s economic performance improved behind the reform agenda. Alongside the NAFTA’s economic reforms came improvements in democratic institutions, leading to the election of President Vicente Fox in 2000—the first opposition party candidate to win the presidency since 1910, and the first to defeat a candidate from the Institutional Revolutionary Party in 71 years. Today, over two decades after NAFTA, Mexico is a member of the Organization for Economic Cooperation and Development (OECD) with a stable middle class as well as a multiparty democracy. Without question, this transformation has made for a vastly improved economic security situation for the United States. NAFTA created sophisticated and integrated business connections, and this led by necessity to creating integrated security operations. All of this is at risk if NAFTA were to collapse.

These achievements were all the more impressive given the history of tension between the two countries going back to the early 19th century. Mexico became an independent state in 1821 and a republic in 1824. Its northern territories (now the state of Texas) were being populated by Americans surging west. By 1836, Texans declared independence from Mexico and established the Republic of Texas. In 1845, the United States offered to grant Texas statehood in the growing United States of America, which took effect in December of that year.

The Texas-Mexico borders were never mutually agreed. The United States inherited a territorial dispute in the process. Initially, President James K. Polk offered to pay Mexico for the disputed lands. Mexico rejected that offer, and Polk dispatched the US Army to seize control. This led to escalating tensions. In May 1846, war broke out between Mexico and the United States. Initially, the conflict was limited to disputed territories between Mexico and Texas, but Anglos living in California saw this as an opportunity to create a California that might also join the United States. The Mexican Army was weak, and the United States threw considerable resources into the fight. The United States invaded Mexico and occupied many cities and vast territory. Eventually, Mexico signed the Treaty of Guadalupe Hidalgo, which ceded to the United States territories that ultimately produced the states of California, Nevada, Utah, New Mexico, most of Arizona, and Colorado, as well as parts of Texas, Oklahoma, Kansas, and Wyoming.

Mexico’s domestic struggles were amplified by the war, leaving the young nation’s democracy strained. Mexico’s European creditors invaded the country at the outset of the American Civil War. Benito Juárez and the Mexican republican forces defeated the French-backed imperial government with material and diplomatic assistance from US President Andrew Johnson. Between 1910 and 1920, Mexico was again wracked by unrest and civil strife, ultimately leading to what Mexican historians call the Revolution and the establishment of the ruling “revolutionary party” (with various manifestations) that carries the name up to this day.

Understandably, through all of this, Mexico had complex emotions about US foreign and security policy. Both countries worked to maintain peaceful borders, but Mexico sought to exert an independent trajectory in foreign policy, and security cooperation was limited.

## **CANADA-US RELATIONS**

The story of US-Canada relations is a different one but hardly to be taken for granted.

During the last 70 years, security relations with Canada were largely shaped by the Cold War competition with the Soviet Union and Canada's membership in the North Atlantic Treaty Organization (NATO). Canada struggled to have a meaningful identity in North American security matters. Canada would face no security threat that wasn't ultimately aimed at the United States. But Canada knew that unless it actively engaged in North American security matters, the United States would simply act on its own without considering Canada's sovereign needs or dignity.

To address this problem, Canada adapted its historic foreign policy approach to deal with a surging United States. Prior to World War II, Canada saw its role as a broker of cooperation between the United Kingdom and the United States. World War II effectively shattered the United Kingdom's ability to be a global security partner. Therefore, Canada needed to join NATO in order to preserve its independence. When the Soviet Union demonstrated to the world that it had nuclear weapons, Canada again sought to preserve its sovereign status by joining the United States to create the North American Air Defense (NORAD) Command. As such, Canada had a stable and constructive relationship with the United States on foreign and security policy matters.

## **NAFTA AS AN EXOSKELETON FOR COOPERATION**

Repeal of NAFTA would be a damaging economic blow to the United States, but it would be a far more serious threat to US homeland security. The United States would have to increase police and military forces dramatically along the southern border to compensate for the loss of Mexican cooperation. US intelligence insights into drug cartels would drop dramatically, and since criminal networks also become the logistics backbone for terrorists, the United States could anticipate a far more dangerous environment in which to counter terrorism. Absent NAFTA, the United States would have to face a demonstrably worse security situation on its southern border.

Contrary to President Donald Trump's emotional claims, NAFTA is a highly beneficial security structure, helping the United States defend its borders in a far more modern and efficient way. Repealing NAFTA would be a tragic reversal of the clock to an earlier and less secure era.