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NAFTA Renegotiation: State of Play and a Look Ahead

By Michael McKeon

Trade officials from the United States, Mexico and Canada are gathered in Ottawa this week for the third round of negotiations to modernize the North American Free Trade Agreement (NAFTA). The first two rounds, which took place over the past month in Washington and Mexico City, covered an uncommonly comprehensive range of content for opening discussions and yielded limited progress in areas of easy convergence. Negotiators are expected to begin tackling thornier issues this week, and their differing statements on what they hope to achieve augur a difficult road ahead.

President Donald Trump made renegotiation of NAFTA a central campaign promise, appealing to widespread disillusionment with shifts in the American labor market and manufacturing landscape over the past 20 years. He has called NAFTA the “worst deal ever made by any country” and has claimed that by renegotiating or withdrawing from the agreement, his administration could bring U.S. manufacturing jobs back to pre-NAFTA levels. Setting aside campaign hyperbole, the pitch to renegotiate the United States’ first substantial trade and investment agreement appealed to many who stood to profit from it as well. Industry leaders were eager to update NAFTA with provisions on digital trade, especially after U.S. withdrawal from the Trans-Pacific Partnership (TPP) quashed prospects to set e-commerce and other digital standards with Mexico, Canada and nine other countries around the Pacific Rim. Civil society leaders have long criticized NAFTA’s side agreements on labor and the environment as weak and inadequate, and welcomed the opportunity to recast their provisions in updated and enforceable chapters of a new deal. The governments of Canada and Mexico were cautiously open to renegotiation as well – calling instead for modernization – and urged Trump to pursue this route over wholesale withdrawal.

Trump has predicted that renegotiation will be easy, and administration officials say talks will wrap up by the end of 2017. But even though the parties are building on an existing agreement, a four-month timeline is highly, perhaps unrealistically, ambitious. The updated NAFTA is expected to contain approximately 30 chapters, and negotiators have yet to put forward proposals for several contentious areas. Canada and Mexico have pushed back against proposals from the United States that reflect key goals of the Trump administration and, for their part, have floated texts that are sure to be rejected in Washington. NAFTA’s complexity and the incongruity of some of the parties’ objectives make the prospect of conclusion in 2017 unlikely. If this timeline is to be maintained, the United States, Mexico and Canada will likely have to compromise some of their more hardline negotiating positions or settle on an agreement that is not significantly different from its current form.

Status of Negotiations

The opening talks to modernize NAFTA have been unique, in that negotiators could begin discussing text proposals right away. The agreement in its current form may serve as a starting point for some chapters, but the parties have other sources – including provisions of the suspended TPP and the recently concluded EU-Canada Comprehensive Economic and Trade Agreement (CETA) – that may serve as frameworks for what an updated NAFTA may ultimately contain.

In the first two rounds in Washington and Mexico City, negotiators discussed market access for goods and services, agriculture, financial services, investment, digital trade, textiles, small- and medium-sized

enterprises (SMEs), legal and institutional issues, technical barriers to trade (TBT), sanitary and phytosanitary issues (SPS), labor and the environment, government procurement, trade remedies, intellectual property rights (IPR), temporary entry of workers and rules of origin. So far, negotiations have been rather basic and straightforward, centered on “detailed conceptual presentations” and preliminary proposals, some of which have been consolidated into common texts, according to joint statements of the parties after the first and second rounds. The parties have tabled text for most areas of the agreement but have so far avoided serious treatment of more contentious points. Stakeholders expect discussion of some of those issues, such as investment-dispute settlement and rules of origin for automobiles, to begin in earnest this week.

Negotiators have tabled text on **digital trade**, which all three parties consider a necessary component of an updated NAFTA. The United States, in particular, is keen to secure commitments from trading partners on the duty-free movement and equitable treatment of its digital products and services abroad, given that e-commerce accounts for more than half of U.S. services exports and supports around 6.4 million American jobs.¹ The digital trade proposals on the table reflect some outcomes achieved by President Barack Obama in the TPP and reportedly seek to expand coverage to new areas, such as data flows for financial services, data privacy frameworks and protections against forced transfer of source code.

Trade in **agriculture** will garner significant attention among stakeholders in Canada, Mexico and the United States, since each country is a major – if not the primary – market for commodities of the others. So far, negotiators have focused on basic SPS issues and export subsidies – government policies that encourage the exportation of goods through measures such as direct payments, exporter tax relief and low-interest loans. Of particular focus is Canada’s dairy industry, which enjoys WTO-sanctioned export subsidies set to expire in 2020. The United States is reportedly seeking an outright ban on such subsidies, but Canada hopes to keep them in place so long as they comply with its WTO commitments.

The parties are discussing **regulatory issues** and considering the creation of trilateral councils to promote regulatory compatibility and cooperation where appropriate. The United States and Canada already have a regulatory cooperation council, but it is relatively inactive and does not facilitate specific regulatory ends. CETA, Canada’s agreement with the EU, created a regulatory cooperation council that will be led at the political level, will meet regularly and will establish agendas for specific regulatory outcomes. The Canadian government hopes to create a similar mechanism with NAFTA partners, but it is unclear whether Mexico and the United States would go along. While the United States shares Canada’s goal of inducing Mexico to automatically accept U.S. and Canadian standards for goods such as automobiles – an outcome that might be facilitated through regulatory cooperation – the U.S. government has long been reluctant to take part in such bodies, on the grounds that they could hamper U.S. agencies’ ability to regulate as they see fit. Some areas that may be considered for regulatory cooperation in coming NAFTA rounds include pharmaceutical-approval processes, maximum residue levels for pesticides, biotechnology authorizations and safety standards for goods ranging from automobiles to medical devices.

Negotiators discussed **intellectual property (IP)** rights in the first two rounds, and the United States tabled an IP proposal specifically related to **biologics** – genetically engineered medical and pharmaceutical products such as vaccines, tissues and allergenics. The U.S. proposal seeks to extend the 12-year market exclusivity period for biologics codified in U.S. law to Canada and Mexico, where domestic law and interpretation of international agreements limit exclusivity to eight and five years, respectively. Mexican and Canadian negotiators strongly oppose the 12-year timeline and argue that current NAFTA provisions on regulatory data exclusivity – which secure only five years for goods such as biologics – is a better starting point for discussion. The Obama administration’s failure to enshrine the 12-year U.S. market exclusivity period for biologics into the TPP generated opposition to the agreement in Congress last year, most notably from Republican Senator Orrin Hatch of Utah, chairman of the Finance Committee. An updated NAFTA that does not meet this threshold may face similar challenges when Congress eventually votes to ratify it.

Negotiators hope to incorporate NAFTA’s side agreements on **labor** and the **environment** into the updated accord. Critics of NAFTA often argue that the agreement has created incentives for American

and Canadian companies to move manufacturing operations to Mexico, where labor costs are relatively low and worker-protection laws are weaker. NAFTA's current provisions on labor are also unenforceable and are therefore seen as little more than symbolic. Although all three negotiating parties agree on the need to update labor provisions in NAFTA, they seem to diverge on the specific ends they hope to achieve. Canadian Prime Minister Justin Trudeau is pushing a progressive agenda and taking aim at conditions in both Mexico and the United States. Specifically, Canada would like to address "right to work" laws, which exist in 28 American states and prohibit union agreements that compel workers to join unions or pay for union representation. Canadian labor unions are also pressuring the Trudeau government to oblige the United States and Mexico to ratify all eight of the International Labor Organization's (ILO) fundamental conventions; to date, Mexico has signed seven and the United States has adopted only two. The United States is unlikely to agree to provisions that require changes to U.S. law, especially given the procedural, political and legal difficulties of overriding policies that fall under jurisdiction of the individual states.

Dispute settlement may prove among the most difficult issues to negotiate, as the parties' stated preferences differ considerably and the political stakes to achieve particular outcomes are equally high in Washington, Ottawa and Mexico City. NAFTA was the first agreement of its kind to include investor-state dispute settlement (ISDS) and, in this regard, has served as a model for subsequent trade deals of the United States and other countries. Critics say ISDS gives undue rights to corporations and limits governments' ability to regulate in the public interest. Supporters contend that by protecting companies against discrimination in foreign markets, it attracts and sustains foreign direct investment. The United States did not table text on investment-dispute settlement during the first two negotiating rounds, but U.S. officials have expressed interest in allowing NAFTA parties to opt in or out of the mechanism or to remove it from the agreement altogether. Pro-trade lawmakers and the business community, however, view ISDS as a necessary protection for U.S. investments abroad and would surely object to removing the provision. An updated NAFTA, therefore, will likely include investment protection in some form.

In its recently concluded agreement with the EU, Canada established an independent, supranational court system for the adjudication of investment disputes, which it hopes will address some of the deficiencies of the current ISDS system, including partiality of adjudicators, lack of transparency and waste incurred by frivolous claims. If Canadian negotiators push for a similar system in NAFTA, the United States will likely balk. During talks on the Transatlantic Trade and Investment Partnership (TTIP) – which was suspended toward the end of 2016 for political and technical reasons – U.S. negotiators consistently rejected EU bids to establish a similar investment court system, claiming that ISDS works well enough and does not impinge on a government's ability to regulate in the public interest, so long as the government does so in a fair, consistent and evidentiary way. Although some U.S. officials have expressed willingness to scrap ISDS provisions, they are not necessarily prepared to establish and accede to a standalone investment court. The TPP agreement did not include an investment court system but did contain provisions intended to address some of shortcomings mentioned above; that text – agreed upon by the United States, Canada and Mexico – may therefore serve as a reasonable starting point for discussions on investment-dispute settlement in NAFTA as well.

The Trump administration hopes to abolish another form of dispute settlement in the updated NAFTA that pertains specifically to antidumping (AD) and countervailing duty (CVD) matters. **Chapter 19** of the current NAFTA is used to arbitrate disputes over duties imposed by one country to counteract specific unfair trade practices of another, namely exporting goods at below-market prices or providing illegal subsidies that make domestically produced goods more competitive in foreign markets. Mexico and Canada insist that Chapter 19 remain in a modernized NAFTA, in great part because each country has been the subject of U.S. AD and CVD investigations, and each has avoided the imposition of tariffs thanks to favorable rulings under the Chapter 19 dispute-settlement process. Trump is eager to reduce the United States' trade-in-goods deficit and may see tariffs as a means to achieve that goal. The elimination of Chapter 19 dispute settlement would remove a significant barrier to the imposition of tariffs – a tool used practically to reduce the number and volume of goods imported into the United States. Negotiation of Chapter 19 dispute settlement in the original NAFTA took over a year and a half, and a fight over its fate in an updated agreement would likely be protracted and combative as well.

In the context of NAFTA renegotiation, Trump's focus on reducing the U.S. trade-in-goods deficit is perhaps most evident in discussions on **rules of origin**, which determine the amount of a good that must be produced within a trade agreement partner country in order to receive preferential treatment. Of particular focus is the automotive industry, which accounts for the majority of the \$63.2 billion U.S. goods-trade deficit with Mexico.² The United States tabled text on general rules of origin during the first NAFTA modernization round last month, but has not yet put forward a proposal for an annex on automobiles. The Trump administration proposes an increase in the overall regional content requirement for autos – currently 62.5 percent of a finished car – as well as the establishment of a U.S.-specific content requirement between 35 and 50 percent. Mexico and Canada have rejected this idea outright, as have U.S. auto industry leaders. Car manufacturers argue that higher content requirements would increase their administrative costs as well as the price of their products, in turn rendering North American autos less competitive in domestic and foreign markets. Some have claimed that, if a higher regional or U.S.-specific content requirement were imposed, they would continue to use some inputs from non-NAFTA partners and simply forgo the tariff-free benefits of the agreement. Industry leaders in NAFTA partner countries have suggested that negotiators expand auto tracing lists – which catalogue inputs contributing to regional content requirements – to include research and development and software components, such as touchscreens and built-in GPS devices, common elements that did not exist when NAFTA was first negotiated. North American hubs such as Silicon Valley, Detroit and Toronto are already leaders in such activities and technology, so modernizing tracing lists could serve as a political achievement – technically raising content requirements – without significantly disrupting existing supply chains.

Negotiators are discussing a range of other issues in NAFTA talks. First among them, perhaps, is **services**, which make up the majority of U.S. economic output and are ripe for modernization. **Energy** will figure meaningfully into an updated NAFTA, as its landscape has changed significantly with innovation in renewable resources, the rise of U.S. natural gas extraction, Canadian access to tar sand oil reserves and the privatization of Mexican energy enterprises. Other issues, such as **customs processes** and **currency manipulation** – which is not necessarily a problem among NAFTA partners, but may serve in the agreement as a model for future deals with other countries – are on the table as well.

Looking Ahead

The joint statement of U.S. Trade Representative Robert Lighthizer, Canadian Foreign Affairs Minister Chrystia Freeland and Mexican Secretary of the Economy Ildefonso Guajardo Villarreal after the second NAFTA negotiating round in Mexico City affirmed the parties' "commitment to an accelerated and comprehensive negotiation, with the shared goal of concluding the process towards the end of this year." While the goal is highly ambitious, NAFTA negotiators do have frameworks to adopt or otherwise build upon, namely the current agreement and provisions of the TPP. Given that all three countries were party to both sets of negotiations, they should, in theory, share much common ground.

Using one or the other of these two frameworks as the starting point for negotiations, however, has developed as a point of conflict in the first two rounds of talks. The first draft of U.S. NAFTA negotiating objectives released to Congress last spring mirrored many of the outcomes achieved by the Obama administration in the TPP, suggesting that the current administration was not wholly opposed to the content of the agreement it abandoned in January 2017. The administration's updated objectives, released in July, maintained many of its original aims and added elements that more clearly reflect Trump's trade priorities, such as the reduction of the U.S. trade-in-goods deficit. Using TPP as the baseline for NAFTA renegotiation seems the most expeditious way forward, but doing so may not be in the interest of all three parties.

Canada and Mexico are wary of using TPP as a starting point for renegotiation across the board, in part because doing so would amount to granting the United States an immediate concession without gaining something in return. It is not that Mexico and Canada are opposed to updating NAFTA with TPP provisions, but the circumstances and stakes are different in NAFTA modernization than they were in the TPP negotiation. Trump issued an executive order to pull the United States out of the TPP during his first week in office, seemingly for political reasons and without serious consideration of the economic and,

more importantly, strategic costs of doing so. TPP partners had spent nearly a decade crafting a comprehensive, if imperfect, trade and investment agreement, and now Canada and Mexico are faced with an offer to renegotiate the foundation of North American economic relations along similar lines. To acquiesce to using TPP provisions as a baseline for negotiations would squander valuable negotiating leverage.

Mexico and Canada's reservations are not merely tactical. In the TPP, each party made concessions in exchange for greater access to a network of 11 other countries, which together make up 40 percent of global GDP. Although some elements of the agreement could be considered bilateral, many of the anticipated benefits would have arisen from trade and investment activity generated among multiple, if not all, partners. Since each party's gains may be less than what they had expected from the TPP, it stands to reason that their offers in NAFTA renegotiation would be different as well.

The question of negotiation starting points is complicated by the parties' timeline. The United States and Mexico, in particular, are eager to wrap up NAFTA before negotiations are hamstrung by political campaigns. If NAFTA is not concluded before midterm elections in the United States, candidates may capitalize on the speed of negotiations and their relative lack of transparency to undercut the president and his supporters, selling the retooled agreement as a bad deal for the American people. In Mexico, President Enrique Peña Nieto is eager to prove his willingness and ability to stand up to trading partners, in particular Trump. He hopes to conclude negotiations before his term ends in July 2018 and before a new president – who may be less inclined to engage in NAFTA modernization – ascends to office. Populist Andrés Manuel López Obrador has positioned himself as a vocal anti-Trump force and would undoubtedly use languishing NAFTA negotiations as a campaign tool if, as observers expect, he runs for office.

In the end, the technical and procedural processes inherent in negotiation of a comprehensive trade and investment agreement may outweigh the deadline aspirations of the parties, rendering the enterprise more complicated than it already is. The modernization of NAFTA covers a broad range of complex issues both old and new, and reflects the interests of three deeply integrated economies that have evolved significantly over the past two decades. As in any international negotiation, NAFTA parties must seek to advance as many of their domestic interests as possible and, at the same time, accept the realities of compromise attendant to striking a deal.

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¹ United States Congress Joint Economic Committee, "JEC to Hold Hearings on Dynamic Gains From Free Digital Trade," September 12, 2017, <https://www.jec.senate.gov/public/index.cfm/hearings-calendar?ID=EC4C2DC7-2CD9-4175-989C-B46E6DA9B74E>.

² Office of the United States Trade Representative, "U.S.-Mexico Trade Facts," <https://ustr.gov/countries-regions/americas/mexico>. <http://money.cnn.com/2017/01/09/news/economy/us-mexico-trump-cars-imports-trade-deficit/index.html>