Breakpoint:
What Canada needs to consider to save NAFTA

The cost to Canada of 5 key U.S. proposals

Washington and Ottawa are experiencing one of their coldest winters in decades—a fitting backdrop to the frosty state of NAFTA renegotiations between the U.S., Canada and Mexico. Amid heightened speculation that President Donald Trump will trigger the U.S.'s withdrawal from the trade pact, the parties remain at odds over five U.S. priorities stemming from Trump's "America First" agenda. We take a closer look at the potential deal-breakers, how wedded Canada is to each stance, and whether any alternatives exist to break the impasse.

What are the U.S. demands that Canada currently deems unacceptable?

1. **Tightening rules of origin within the automotive sector to the benefit of the U.S.**
2. **Opening government procurement dollar-for-dollar—thereby providing U.S. firms with access to a much greater share of the Canadian market.**
3. **Eliminating the binational dispute settlement mechanism that shields Canadian exporters from having to fight trade disputes in U.S. courts.**
4. **Introducing a sunset clause that could terminate NAFTA every five years, creating long-term uncertainty for the trade pact.**
5. **Dismantling the Canadian supply management system, in particular for dairy products.**

Key 2018 Dates

Jan. 21-29
Sixth round of NAFTA renegotiations
As political space for making tough concessions narrows, for both Mexico in its election year and the U.S. with its Congressional midterms in the fall, this Montreal round may be a make-or-break moment.

Jan. 26
Trump goes to Davos ...
The president will meet the global business elite.

Jan. 30
...and then gives his first State of the Union address
Days later, Trump will lay out the administration's trade policy priorities in 2018.

Apr. 1
First deadline to extend the TPA
If the administration intends to extend the Trade Promotion Authority, it must send a first notice to Congress by this date. The TPA is a legislative tool that allows the administration to present Congress with a NAFTA 2.0 deal that it can either vote up or down, but not amend.

Jul. 1
TPA expiry
The current TPA is set to expire.

Jul. 1
Mexican election
Mexicans' choice may result in the country charting a very different course for their country's trade policy.

Nov. 6
Congressional mid-term elections
All House seats and a third of Senate seats will be up for grabs. A GOP loss of either chamber could hamper the president's ability to legislate trade policy.

1. Rules of origin: an unprecedented demand
The U.S. is seeking to ensure that NAFTA's rules of origin boost manufacturing in North America, "as well as specifically in the United States." The talks have focused on stricter content requirements in the automotive sector. NAFTA currently requires 62.5% North American content in auto production for duty-free movement. The U.S. is seeking to raise that threshold to 85%, while at the same time specifying that at least 50% of the content be U.S.-made. Washington is also pushing for extensive traceability of parts, in an attempt to curtail the inclusion of materials such as steel originating from China under preferential tariffs.

Canada opposes U.S.-specific content threshold requirements and is likely to tolerate only a small increase to the current overall North American content requirement. A country-specific content requirement runs counter to trade liberalization, as it would explicitly seek to draw production to one of the pact's signatories, rather than generate investment and production gains across the trading bloc as a whole. It would be disruptive to the automotive supply chain, and particularly for trade between the U.S. and Mexico. U.S. content in Mexican auto assembly is estimated at 40%, implying a significant adjustment would be required to meet the U.S.'s demands. For Canada, the constraint appears less onerous, with U.S. content already accounting for 60-70% of Canadian-assembled vehicles. However, that average share can differ by vehicle line, and auto makers would likely want wiggle-room for price fluctuations and production flexibility—meaning even a 50% across-the-board content requirement could cause disruption.

A U.S.-content requirement could ultimately backfire on the U.S. Given the complexity of production, some firms may simply increase offshore production and opt to ship lighter components, or even assembled vehicles, to North America under a simple import tariff such as the WTO's 3.5% average Most Favored Nation tariff (or 2.5% for most light vehicles).

Canadian negotiators are likely to hold firm in their position, not only to prevent disruption in the auto sector—which directly employs some 130,000 Canadians, including 75,000 in parts production—but also to avoid setting a precedent for country-specific content requirements in future trade agreements.

Canadian and Mexican negotiators may have some ability to placate U.S. concerns regarding rules of origin. An updated NAFTA that better harmonizes labour standards would reduce Mexico's advantage in parts production relative to the U.S. Another proposal that has been floated is changing the way content is measured to include services, digital and IP inputs, given these represent a material share of value in manufacturing. A report by the U.S. International Trade Commission found that services account for a quarter of intermediate inputs in manufacturing. Such inputs are areas in which the U.S. is a leader, and would presumably raise the measured U.S. content in vehicle production. While that would not change the reality of how vehicles are produced in North America, the appearance of higher U.S.-content could be viewed as a "win" for the U.S.

2. Government procurement: not really reciprocal
A large part of the US$1.7 trillion U.S. procurement market is not openly accessible to Canadian suppliers—including state and local government contracts, federal assistance to state and local projects, and defense contracting. For instance, of up to US$500 billion in U.S. federal procurement, some two-thirds falls under the Department of Defense. The U.S. aims to keep these exclusions in place under a revamped NAFTA, while also seeking "reciprocity" with Canada and Mexico on a dollar-for-dollar basis.

It is highly unlikely that Canada would accept such a proposal. The size of the U.S. procurement market is nearly ten times Canada's, so major concessions would mean a large number of firms south of the border accessing a much greater share of Canada's procurement market, in return for a smaller number of Canadian firms having access to a much smaller share of a fiercely competitive U.S. federal procurement market. Moreover, winning a major public client can give a big boost to domestic firms, allowing them to gain scale, experience and credibility to subsequently enter foreign markets. For example, local consortiums have pursued infrastructure opportunities abroad after gaining experience through alternative financing and procurement contracts in Ontario and British Columbia.

Large Canadian companies that are active in federal procurement (about a quarter of the total Canadian procurement market) would be affected. With the Government of Canada committing C$180 billion over twelve years to public infrastructure, engineering, design and construction firms that build and maintain larger capital projects may be exposed, unless the devolution of funding down to the provinces and municipalities shields them.

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Barring the status quo, *Canada has some leeway in agreeing to limited reciprocal market opening on a proportional basis,* while also improving transparency along the lines of the original Trans-Pacific Partnership (TPP), to ensure Canadian firms can effectively understand and bid in the U.S. procurement market. The question of whether U.S.-owned subsidiaries in Canada are deemed Canadian or American in terms of their access to U.S. contracts would also require clarification.

For Canada, the experience with softwood lumber and the U.S. duties on Bombardier CSeries jets are pointed reminders of what dropping the bilateral dispute settlement channel could mean. Canada in January lodged an extensive trade complaint with the WTO that challenges the U.S.'s use of anti-dumping and countervailing duties, citing some 200 cases going back decades and involving many countries—a clear sign that it will put up a fight to uphold Chapter 19. Canada's aggressive move may also up the ante at the upcoming sixth round of talks in Montreal.

3. Chapter 19: history is likely to guide Canadian negotiators
The U.S. aims to "eliminate the Chapter 19 dispute settlement mechanism," so as to preserve its ability "to enforce rigorously its trade laws, including the antidumping, countervailing duty, and safeguard laws". Chapter 19 shields Canadian companies from having to contest U.S. anti-dumping or countervailing duties through the complex and costly U.S. court system, by providing a binational panel of trade experts for resolution of disputes on objective grounds.

Heavily trade-intensive Canadian industries that largely export to the U.S. would be relatively more vulnerable without Chapter 19, as they would be challenged to quickly shift exports to alternative markets or absorb U.S. tariffs if they were targeted. This represents a large portion of Canada's exports and includes industries such as automotive, oil and gas, and household appliances. While the carbon and steel sectors have been most vulnerable to U.S. countervailing tariffs in the past, seafood, chemicals, resins, wood, paper and aerospace have also been targeted.

WTO dispute settlement would remain a backup, yet this channel can take years—an unpalatable recourse for exporters, and in particular SMEs and firms operating on thin margins, if targeted.

4. Sunset clause: a neverending story?
Faced with the prospect of either a revamped NAFTA at risk of termination every few years or no deal at all, adapting to the latter—i.e. a no-NAFTA scenario (but with WTO conditions holding)—would probably be the easier course for many North American firms.

The U.S. desire to insert a sunset clause that obliges the three countries to either agree or disagree on extending NAFTA every five years would institutionalize cyclical uncertainty within intra-continental trade. Trade-intensive industries that are largely focused on North America, such as automotive, oil and gas, resins and rubbers, and plastics, and their upstream goods and services suppliers, would experience adjustment costs (or have to anticipate such potential costs) every half-decade. WTO research shows trade-policy uncertainty does weigh negatively on irreversible investment decisions. The uncertainty generated by putting NAFTA into question twice a decade could deter long-term, competitiveness-boosting investment decisions in products, processes and capacity—and further weaken productivity. Canada is more likely to reject the sunset clause on these grounds.

There may be room for creative, politically face-saving alternatives. One would be to include a clause that ensures periodic, targeted reviews every five years, or periodic improvements to the agreement (provided all sides agree) as the economy evolves, but with a ratchet that ensures existing NAFTA market access gains are not rolled back.

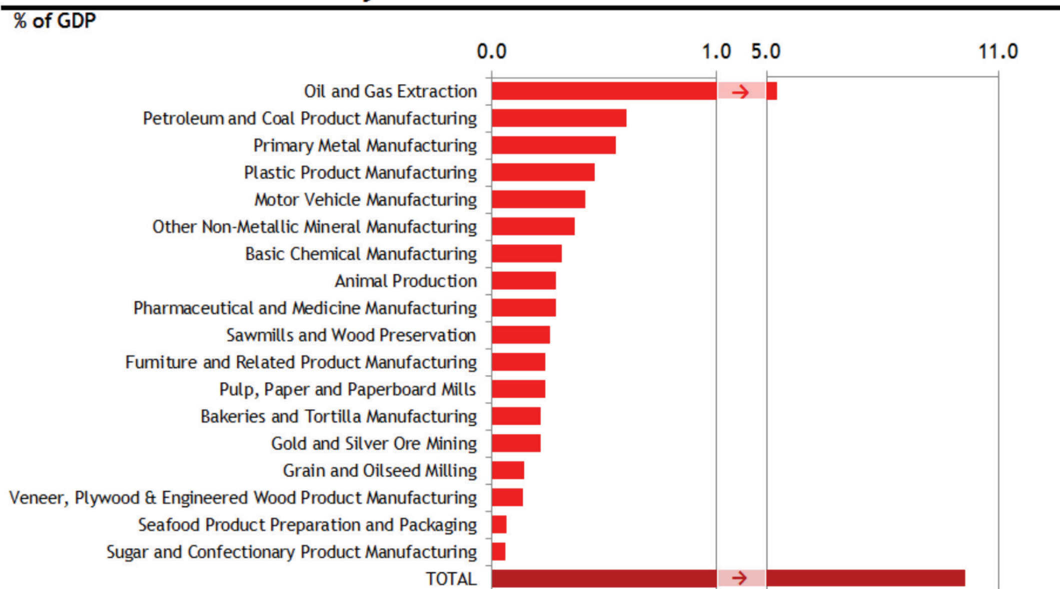
5. Dismantling supply management: a political no-go
The supply management system overseeing production and imports in the Canadian dairy, poultry and egg sectors is politically sensitive, especially in parts of rural Ontario and Quebec, though its economic importance to Canada overall should not be overstated: dairy—the supply-managed sector most targeted by the U.S. in the negotiations—represents less than 0.2% of Canadian GDP and some 20,000 jobs.

It is not likely that Canada would dismantle the supply management system or eliminate dairy import tariffs. *The more likely scenario would involve ceding some market share to the U.S. and Mexico,* with compensation for Canadian dairy farmers, though the 3.25% dairy market share that Canada had conceded to the group of TPP countries may not satisfy Washington.

The traditional sticking points remain

The traditionally difficult areas in trade negotiations involving Canada, the U.S. and Mexico seem almost quaint when compared to the “poison pills” outlined above, and the three countries are also grappling with these issues in NAFTA 2.0. There is speculation that some of the U.S.’s most unpalatable demands are leverage to obtain concessions on some of these issues, notably:

- Intellectual property: the U.S. wants Canadian standards to more closely align with its own, for instance on the length of patent terms for pharmaceuticals and copyright terms. Canada will likely walk a fine line in this area—supporters of tighter IP protection under trade rules suggest this is good for domestic innovation, whereas detractors say tighter rules favour IP-owning (and largely U.S.-based) incumbents at the expense of new Canadian innovators. The issue is especially sensitive in the digital economy, where much innovation is the product of recombined existing ideas and new platforms, and where excessive copyright and patent protections can act as a barrier to new entrants.
- Movement of professionals: the U.S. will resist giving in to Canada and Mexico in light of its immigration stance. But Canada sees more liberalization in this space as important to cross-border trade in services, and made a push on this in its CETA trade negotiations with Europe. Up to 40,000 Canadians work in the U.S. under NAFTA Professional (TN) visas.



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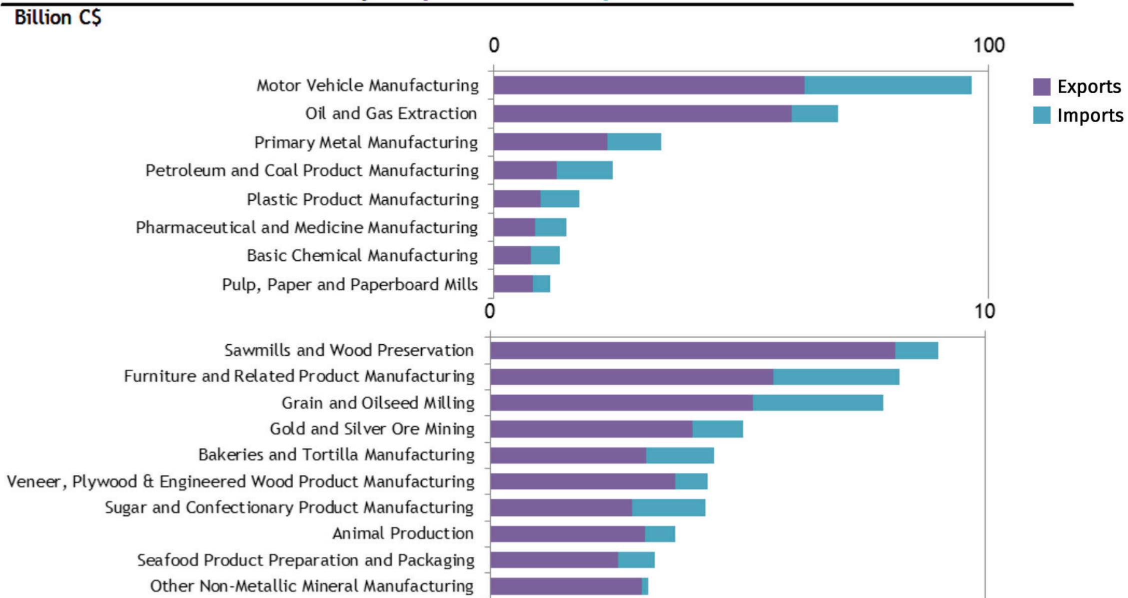

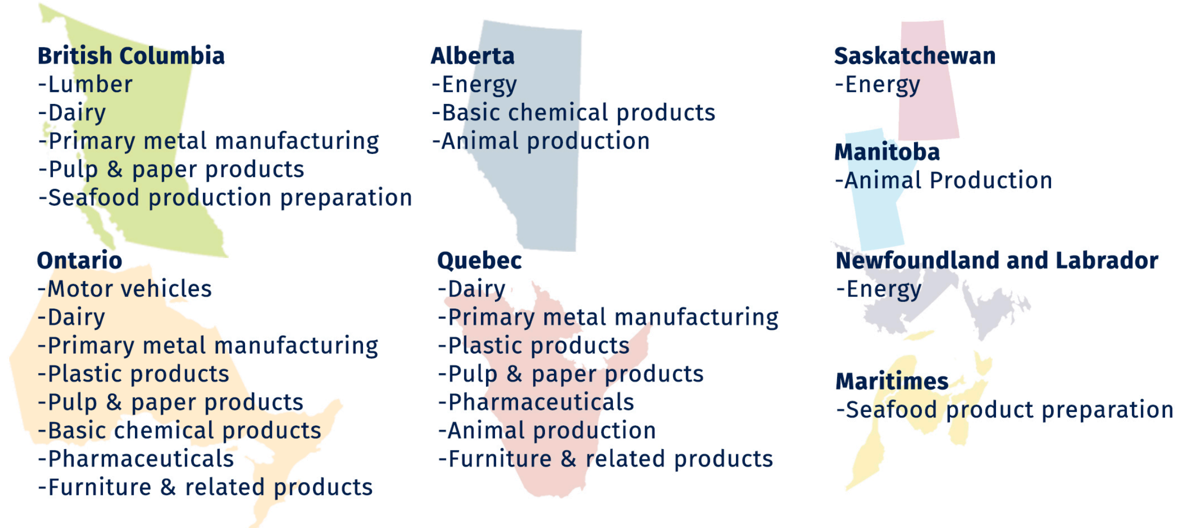

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