

## Modernizing NAFTA

### *A Look at Key Issues*



**The North American Free Trade Agreement (NAFTA) between the United States, Mexico, and Canada, entered into force in 1994 is to be renegotiated.** Talks began earlier this month following the conclusion of the 90-day US Congressional notification period. The status quo is not an option; NAFTA will emerge with a new look.

There's angst within the trade community, fearful of the impact changes may have on their business plans. The US Trade Representative (USTR) website shows 12,549 comments received during the recent public solicitation period. At the annual meeting of the American Association of Exporters and Importers in June 2017, the NAFTA renegotiation dominated many of the panel presentations.

Does this pending renegotiation now bring an opportunity to modernize the decades-old agreement? Could NAFTA be brought into conformance with more recent trade agreements and accrue benefits to all parties and their citizens?

#### **Dispute settlement issues**

**One area to look at is NAFTA's Chapter 11 regarding investment. This provision is intended to guarantee investors protection for operations in one of the other parties. It's controversial because of the clauses that allow for an investor-state dispute settlement (ISDS) system. ISDS**

allows an investor to file claims against alleged violations by the foreign government. The suits are decided by private arbitrators, who may award significant monetary awards to the investor.

So far, under NAFTA, **the US has not lost a single case**, while Canada and Mexico have lost cases amounting to over \$100 million in compensation. Opposition to Chapter 11 may be common ground among the parties. They concur in the opinion that many of these cases circumvent their sovereignty and confuse the domestic populace.

Alternatives being suggested vary. Many recommend the elimination of ISDS and in favor of relying on their own government's diplomatic efforts. Some think the solution is to move to a state-to-state enforcement. Others advocate moving to a proposed multilateral investment court. However, these ideas can be negatively viewed as moves towards "secret courts" and "globalism". In the end, the easiest and least controversial idea is to adopt the investment chapter contained in the Trans-Pacific Partnership (TPP). This system would maintain investor rights, while also defining the sovereign governments' rights and obligations. To its advantage, it's already on the shelf and ready to use.

### Labor issues

Another long-standing gripe among those opposing NAFTA is the **lack of provisions to protect labor standards**. Although there's nothing in the NAFTA text, a side agreement called the **North American Agreement on Labor Cooperation (NAALC) was signed by the three parties coincident with NAFTA to allay those concerns**. However, critics state that the NAALC is not adequate to uphold Mexican labor rights (i.e., protect against low wages and subpar occupational health standards). They maintain that while the NAALC puts forward eleven labor standards along with certain oversight mechanisms monitored by the parties, it lacks enforcement provisions through sanctions or other means. Of 39 cases brought forward to date, none have gone beyond the consultation stage.

**Under a NAFTA renegotiation, it may be possible to incorporate provisions of the NAALC along with the introduction of an independent oversight body with enforcement empowerment.** The control could also be extended to monitor corporations.

### Environmental issues

Although NAFTA was recognized as the first agreement to include environmental provisions, it immediately came under fire. **Side agreements such as the North American Agreement on Environmental Cooperation (NAAEC) were put into place** attempting to assuage the deficiencies of those original provisions. Still, those opposed, continued to assail the agreements for the lack of effective enforcement. The issue is that if stronger rules exist in one Party, it tends to create a competitive advantage in the country with less restrictive standards. A new NAFTA clause may require parties to put into place stronger environmental domestic laws, enforce them, and not make concessions to attract trade and investment.

## Rules of origin

An area of possible change, different from those discussed thus far and with an immediate bottom-line impact would be changes to NAFTA rules of origin. Rules of origin are used to determine whether or not duties will be assessed on imported goods. The slightest wording change may move a product out of eligible status.

If rules are changed, the likely focus and easiest lever of change would be to adjust content thresholds. Certainly, a higher regional value content (RVC) requirement would force reductions in non-NAFTA inputs. Going a step further, it is possible that the RVC thresholds will be made specific to individual NAFTA Parties rather than regionally applicable as they are today. Certain sensitive industries may be the targets of such a change to reduce trade deficits. For example, imagine qualification rules that require specific levels of US content in combination with overall NAFTA content.

NAFTA Article 303, which prohibits duty drawback, is another possible negotiating target. It applies to all parties, but Canada and Mexico have regimes that reduce the impact of the restrictions (e.g., Mexico sectoral programs) by allowing duty reductions for specific industries. Opponents state that US manufacturers are disadvantaged by these work-arounds and Article 303 should be eliminated.

The subject of additional border imposed value-add taxes such as Mexico's Impuesto al Valor Agregado (IVA) and Canada's Goods and Services Tax (GST) has come under scrutiny.

These taxes are not prohibited under World Trade Organization rules because they are ultimately assessed on final consumers (whether an import is involved or not). However, it's argued that these taxes subsidize tariffs as a non-tariff barrier to the detriment of US exports. The US Congress has contemplated the institution of a Border Adjustment Tax (BAT) to be similar to IVA or GST. The role of these taxes is likely to be addressed in the renegotiation talks.

## Be ready for change

The foregoing represents some of what may materialize from the renegotiation. They are politically-charged topics with controversy for every alteration assured. In any negotiation, there is give and take. Changes that are difficult to accept on their own may be palatable in conjunction with the full slate of adjustments. The conclusion is that NAFTA can be modernized and brought into conformance with contemporary free trade agreements, but not everyone will be pleased with the changes. Knowing that NAFTA will not stand still, be diligent, be informed, and be ready for the new NAFTA.

*Philip Sutter is director of strategic analysis at Livingston International.*