NAFTA 2.0 and Canada: Upgrading a 20th-Century Deal for a 21st-Century World

James Welsh  
Affiliation not available

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## Preface

This report recommends five broad objectives for Canada as it sets out to renegotiate NAFTA: adopt a transparent, trilateral approach; facilitate cross-border mobility of business people; maintain and enhance access for goods; encourage innovation and digital trade while protecting intellectual property and culture; and modernize the agreement to today’s business realities and standards. In each area, we make specific recommendations to advance Canada’s interests.

# Executive Summary

## At a Glance

* The election of Donald Trump has pushed renegotiation of the North American Free Trade Agreement to the top of the list of Canada’s trade priorities. Canada will face a balancing act between defending existing market access outlined in NAFTA as it exists now and updating the agreement to meet the requirements of a 21st-century economy.
* Freer trade in North America led to significant benefits for Canada in the form of increased trade, significant output and productivity gains in the manufacturing sector, and a greater variety of products available to Canadians.
* The impacts of NAFTA were also positive for the United States, as increased trade across the region led to twice as many jobs being created than were lost in import-competing segments. Moreover, U.S. exports to Canada and Mexico support nearly 3 million jobs in the United States.
* This report recommends five broad objectives for Canada as it sets out to renegotiate NAFTA.

Until just a few months ago, renegotiating the North American Free Trade Agreement (NAFTA) was not high on the list of Canada’s trade priorities—if it was on the list at all. However, the election of Donald Trump to the U.S. presidency on a protectionist platform has made the preservation and modernization of NAFTA a top priority for the Canadian government.

Since the 1980s, Canada has negotiated three major trade agreements that involved the United States—the Canada–U.S. Free Trade Agreement (CUSFTA), NAFTA, and the Trans-Pacific Partnership (TPP). The U.S. has consistently been a tough negotiating partner, but the various administrations, whether Republican or Democrat, all sought to reach bilateral and multilateral agreements. That default position in the United States has been turned upside-down. The Trump administration has officially pulled the U.S. out of the TPP and has threatened to withdraw from NAFTA in spite of the disruption that such a decision would cause in the North American economy. This shift in the negotiating tone coming from Washington creates a new level of uncertainty compared with previous bargaining rounds.

Canada should, however, still come to the table with the objective of expanding, improving, and strengthening NAFTA.

Extensive research on the impact of freer North American trade confirms that NAFTA led to benefits for Canada, the U.S., and Mexico. For example, an extensive review by the Washington-based Peterson Institute for International Economics of the impacts of NAFTA concluded that:

NAFTA was designed to promote economic growth by spurring competition in domestic markets and promoting investment from both domestic and foreign sources. It has worked. North American firms are now more efficient and productive. They have restructured to take advantage of economies of scale in production and intra-industry specialization. (Feinberg, Hufbauer, and Schott 2006; “NAFTA Revisited: Achievements and Challenges” 2006)

In Canada, freer trade with the U.S. following the signature of CUSFTA had a net positive impact on employment; led to significant gains in bilateral trade, output, and productivity in the manufacturing sector; and made a greater variety of products available to Canadians.

In the United States, freer trade across North America allowed the creation of an additional 1 million jobs in the decade after NAFTA entered into force, more than compensating for the 525,000 jobs that were displaced in import-competing industries.22Ibid. And today, U.S. exports to Canada and Mexico combined support nearly 3 million U.S. jobs.33Schaefer and Rasmussen, *Jobs Supported by Export Destination 2014* .

NAFTA is of key importance to the functioning of North American supply chains. However, most of the gains in merchandise trade made possible by CUSFTA and NAFTA have already materialized. So, what should be the key focus of the NAFTA renegotiation? The Conference Board of Canada’s proposed actions (see Table 1 for details) for the upcoming NAFTA renegotiation can be grouped into five broad recommendations:

1. Adopt an inclusive, transparent, and trilateral approach.
2. Facilitate the cross-border mobility of business people to support trade in services.
3. Maintain and enhance market access for traded goods.
4. Encourage innovation and digital trade while protecting intellectual property and culture.
5. Modernize NAFTA to reflect new business realities and standards.

First, NAFTA is a trilateral agreement, and Mexico is an important partner within the continental economy. Efforts should thus be made to ensure the agreement is renegotiated with all three member countries. Also, the federal government should commit to a comprehensive consultation and engagement strategy to keep Canadians regularly informed about the progress of NAFTA renegotiations, the changes being considered, and their implications. Also, provincial government input and feedback throughout the negotiations will be crucial to maintaining public engagement. In turn, an open, transparent negotiation process could bolster Canada’s deal-making strength if the positions being presented at the bargaining table are shown to have broad public support.

Second, a key goal of NAFTA 2.0 should be to facilitate the cross-border mobility of business people. Free trade agreements have liberalized the flow of goods for several decades. However, extensive barriers to the mobility of people remain, hampering trade in services, given that services often require face-to-face encounters to be delivered. In this regard, we recommend that NAFTA 2.0 clarifies the rules on the temporary entry of business visitors and extends the list of professional occupations to include new professions, particularly in the technology sector, that have emerged since the original deal was signed,. Examples of occupations that should be added to the NAFTA list include software developers, data scientists, and supply chain and logistics professionals.

Third, there are several sensitive sectors for which Canada should seek to maintain and enhance market access in the United States. These include government procurement, softwood lumber, and the auto sector. However, maintaining and enhancing Canada’s market access on these fronts will likely require us to make some concessions in the dairy industry and other supply-managed sectors. The report proposes specific recommendations for each of these sensitive sectors.

Fourth, a revised NAFTA should encourage digital trade and innovation, while protecting intellectual property and Canadian culture. As such, NAFTA 2.0 should have a chapter dedicated to e-commerce, as found in the TPP and CETA. However, with digital trade rapidly evolving and often leading to a “winner takes all” dynamic, Canada will have to be careful with the provisions related to e-commerce, making sure that we keep some flexibility with regards to future digital policies at home. This will be especially true in the cultural sector, where content is increasingly created, delivered, and consumed via digital channels. For this reason, the cultural exceptions included in NAFTA should be maintained in a renegotiated agreement.

Fifth, we should take this opportunity to modernize the agreement to new business realities and standards. In particular, the NAFTA rules of origin should be reviewed to make it as easy as possible for small and medium-sized businesses to comply with them. Also, we should seek to restore the public’s trust in investor–state dispute settlement (ISDS) mechanisms, notably by reviewing the composition of ISDS tribunals and opting for publicly appointed tribunal members who will serve longer terms (as under CETA). The NAFTA renegotiation also provides an opportunity to incorporate the labour and environmental side agreements into the main text of NAFTA and to update them based on recent trade deals. Lastly, in the energy sector, the proportionality clause currently found in NAFTA should be removed, as there is little evidence of its use or positive impact on North American energy trade and investments.

The Conference Board of Canada’s proposed actions for the upcoming NAFTA renegotiation

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| Recommendations | Themes | Specific Actions |
| 1. Adopt an inclusive, transparent, and trilateral approach. | Trilateral agreement | Ensure the agreement is renegotiated with all three member countries. |
|  | Transparency and inclusiveness | Involve the provinces throughout the process and keep Canadians regularly informed about the progress of NAFTA renegotiations, the changes being considered, and their implications. |
| 2. Facilitate the cross-border mobility of business people to support trade in services. | Cross-border mobility of business persons | Clarify the requirements for business visitors and update the list of professional occupations covered by NAFTA. |
| 3. Maintain and enhance market access for traded goods. | Government procurement | Update the Canada-U.S. Agreement on Government Procurement and negotiate a permanent waiver for Canada from Buy America requirements. |
|  | Softwood lumber | Seek more stability and predictability for softwood exporters through securing a long-term solution to the dispute. |
|  | Auto sector | If changes are made to the auto sector’s rule of origin, Canada should seek to maintain North American content rules rather than country-specific rules. |
|  | Supply management | Offer U.S. dairy producers access to the Canadian market up to the limits negotiated in other trade agreements, and use a phase-in period to undertake reform of the supply management system. |
| 4. Encourage innovation while protecting intellectual property and Canadian culture. | Intellectual property | Find the right balance for intellectual property protection provisions while encouraging greater knowledge transfer and exchange. |
|  | Digital trade | Reduce barriers to digital trade while maintaining Canada’s ability to support industries disrupted by the digital economy. |
|  | Culture | Maintain the cultural exception to ensure that Canadian culture can thrive in the digital age. |
| 5. Modernize NAFTA to reflect new business realities and standards. | Rules of origin | Streamline NAFTA’s rules of origin to reduce the burden on SMEs. |
|  | Investor-state dispute settlement | Clarify the scope and meaning of key investment principles and concepts and review the constitution of ISDS tribunals based on CETA. |
|  | Labour and environmental standards | Update the labour and environmental side agreements based on progress made in recent trade deals and incorporate them into the main agreement. |
|  | Energy sector | Remove the proportionality clause that requires Canada to maintain a consistent ratio of exports to supply for energy commodities and derived products. |

# Freer North American Trade: The Road Thus Far

**Summary**

* Freer trade in North America led to significant benefits for Canada—increased trade, significant manufacturing output and productivity gains, and a greater variety of products available to Canadians.
* The impacts of NAFTA were positive for the United States, as increased trade across the region led to twice as many jobs being created than were lost in import-competing segments. Moreover, U.S. exports to Canada and Mexico support nearly 3 million jobs in the United States.
* Most of the gains in merchandise trade that freer North American trade made possible have already materialized. However, there are still significant improvements that can be made—especially in the areas of cross-border mobility, government procurement, and labour and environmental standards.

Canada’s economy over the past century can be divided into two distinct periods—before free trade, and after free trade. The Canada–U.S. Free Trade Agreement (CUSFTA) was followed by the signature of the North American Free Trade Agreement (NAFTA), and both were key milestones along this transition. NAFTA was controversial when it was negotiated and ratified in the early 1990s, and it has remained contentious ever since it came into force in 1994. However, until now, its continued existence had never been in question.

Since Donald Trump’s inauguration in January 2017, his administration has made frequent informal indications that it intends to renegotiate the agreement. The administration has not yet given the U.S. Congress the formal notification needed to launch the process, and notice to Congress is only one of many steps that will need to occur before formal negotiations with Canada and Mexico can begin.

Trade talks are inevitably both extensive and difficult before agreements are reached. Nonetheless, the importance of NAFTA to Canada’s economy means that governments, business leaders, and stakeholders (such as labour unions and civil society interests) need to develop a strategy to address the concerns of our NAFTA partners while also protecting Canadian interests.

To support Canada in this effort, this Conference Board of Canada report offers key recommendations for the upcoming NAFTA renegotiation. It is part of the Conference Board’s international trade research, conducted under the banner of the Global Commerce Centre. Before delving into our recommendations, let’s look at the impacts of freer North American trade on the Canadian and U.S. economies.

## CUSFTA and NAFTA: The Impacts on Canada and the United States

In theory, freer international trade should support economic growth, by allowing countries, industries, firms, and individuals to leverage their comparative advantages and specialize in what they do best. Through trade, a country’s available resources—whether natural resources, human capital, or technology—can be used more effectively. However, in the short term, there are adjustment costs associated with freer trade. The resulting changing market dynamics lead to disruptions for domestic industries, firms, and workers. Still, the long-term gain should outweigh the short-term pain.

Looking back at nearly three decades of freer trade in Canada, starting with the signing of the Canada–U.S. Free Trade Agreement in 1987, what does the evidence tell us about the impact of freer North American trade?

Over the past 20 years, an extensive body of research has looked at the impact of North American trade agreements on the Canadian economy.11A review of the evidence on the economic impact of CUSFTA and NAFTA on the Canadian economy can be found in Harris, ”The Economic Impact of the Canada–U.S. FTA and NAFTA Agreements for Canada” and in Global Affairs Canada, ”International Trade and Its Benefits to Canada.” Available research focused extensively on the decade that followed the signing of CUSFTA in 1987. CUSFTA is an ideal trade policy to study, since it led to the elimination of most tariffs between Canada and the United States, our largest trading partner. In fact, by the time NAFTA came into force in 1994, most tariffs between Canada and the U.S. had already been removed and the economy had already adjusted to freer North American trade. With the U.S. still accounting for over 98 per cent of Canada’s merchandise trade in North America, looking at the benefits and costs of CUSFTA gives us a good sense of the impact freer North American trade had on the Canadian economy.

Research has shown that CUSFTA contributed to an increase in bilateral trade.22Harris, ”The Economic Impact of the Canada–U.S. FTA and NAFTA Agreements.” See the “Trade Creation and Trade Diversion” section. led to significant output and productivity gains in the manufacturing sector,33The productivity gains from CUSFTA are reviewed in Foreign Affairs and International Trade Canada, ”International Trade and Its Benefits to Canada.” and was associated with a large increase in the variety of products available to Canadians.44Chen, ”The Variety Effects of Trade Liberalization.” However, the agreement also led to adjustment costs. Manufacturing employment declined by 5 per cent, with a 12 per cent loss in those industries that faced the greatest competition from imports.55Trefler, ”The Long and Short of the Canada–U.S. Free Trade Agreement.” What is more, the job losses associated with the tariff reductions under CUSFTA affected less-skilled workers the most.66Beaulieu, ”The Canada–U.S. Free Trade Agreement and Labour Market Adjustment in Canada.” Still, overall, freer North American trade, thanks to CUSFTA and then NAFTA, has had a net positive impact on Canadian employment.77Harris, ”The Economic Impact of the Canada–U.S. FTA and NAFTA Agreements.” See the “Jobs, Wages, and Employment” section. Increased trade led to job gains in other sectors of the economy, which more than offset the losses in manufacturing.

For NAFTA, which brought Mexico into the free trade area, the evidence is positive for all three participating countries.88For an extensive review of the evidence on the impacts of NAFTA on the U.S., Canada, and Mexico, see Hufbauer and Schott, *NAFTA Revisited* ; Harris, ”The Economic Impact of the Canada-U.S. FTA and NAFTA Agreements”; Burfisher, Robinson, and Thierfelder, ”The Impact of NAFTA on the United States.” In an extensive review of the impacts of NAFTA, the Washington-based Peterson Institute for International Economics concluded that:

NAFTA was designed to promote economic growth by spurring competition in domestic markets and promoting investment from both domestic and foreign sources. It has worked. North American firms are now more efficient and productive. They have restructured to take advantage of economies of scale in production and intra-industry specialization.99Hufbauer and Schott, *NAFTA Revisited,* 61.

On the impacts of NAFTA on U.S. employment in particular, the authors noted that “trade pacts are far from the most prominent cause of job churn—and have only a third-order impact on the absolute level of employment.”1010Ibid., 39. As such, NAFTA had only a limited impact on overall employment trends in the United States between 1994 and 2003. During that period, an estimated 525,000 jobs were disrupted in import-competing industries, while an estimated 1 million jobs were created as a result of increased North American trade.1111The expansion of North American trade contributed to the creation of an estimated 100,000 additional U.S. jobs each year in the decade after NAFTA came into force, representing a total of 1 million jobs. Also, as of 2014, the United States’ exports to Canada and Mexico supported an estimated 2.8 million U.S. jobs.1212Schaefer and Rasmussen, *Jobs Supported by Export Destination 2014* .

Therefore, the economic evidence on the impact of CUSFTA and NAFTA on Canada and the U.S. generally supports the economic theory that freer trade brings major benefits.

## Recommendations for NAFTA 2.0

The 1990s were a crucial period for the liberalization of merchandise trade in North America. And, the resulting trade gains were concentrated during that period. Between 1990 and 2000, Canada’s North American trade (exports and imports) nearly tripled in nominal terms, compared with a twofold increase for our trade with non-NAFTA countries. Then, in the 2000s, Canadian trade with non-NAFTA partners picked up, significantly outpacing growth with our NAFTA trading partners. These trade gains with non-NAFTA partners were largely made on the back of China joining the World Trade Organization in 2001.

Most of the gains in merchandise trade made possible by CUSFTA and NAFTA have thus already materialized. So, what should Canada seek to improve in a NAFTA 2.0? The Conference Board of Canada’s proposed actions for the upcoming NAFTA renegotiation can be grouped into five broad recommendations:

1. Adopt an inclusive, transparent, and trilateral approach.
2. Facilitate the cross-border mobility of business people to support trade in services.
3. Maintain and enhance market access for traded goods.
4. Encourage innovation and digital trade while protecting intellectual property and culture.
5. Modernize NAFTA to new business realities and standards.

Obviously, there are risks to the upcoming renegotiation. The greatest threat would be a tearing up of the treaty, which could see tariffs re-established, although this appears a very remote risk. And there is also talk in the U.S. of imposing a border adjustment tax, although it seems highly unlikely to be adopted. A border adjustment tax would pose a significant threat to North American merchandise trade and would have considerable implications for North American supply chains and the competitiveness of Canadian exporters vis-à-vis U.S. firms. (See “U.S. Border Adjustment Tax: A Threat to Exports.”).

**U.S. Border Adjustment Tax: A Threat to Canadian Exports**

One of the major areas of concern for Canada in the bilateral trade and economic relationship might not be addressed formally in NAFTA or trade relations. The proposed border adjustment tax would impose a tax on imports into the United States. For a Canadian economy that sends more than three-quarters of its merchandise exports to the U.S., the potential impact of a border adjustment tax is staggering.

The border adjustment tax was outlined by the Congressional Republican leadership in 2016 in its *A Better Way* document—a blueprint of the Republicans’ legislative priorities. Such a measure would be one component of the Republicans’ transformation of the tax system for individuals and businesses.11Tax Reform Task Force, *A Better Way* . Although a border adjustment tax would appear to help the Trump administration meet its goal of curtailing imports and encouraging exports, it is not at all clear that the measure has much in the way of political support. One reason for the lack of support is that it would significantly hurt the competitiveness of U.S. firms that rely extensively on imports and would lead to higher prices for U.S. consumers.22Hufbauer and Lu, *Border Tax Adjustments: Assessing Risks and Rewards* ; Ciuriak and Xiao, *Aftershocks: Quantifying the Economic Impacts of a Us Border Adjustment Tax* . In addition, the implementation of a border adjustment tax would undoubtedly prompt challenges under the World Trade Organization rules.33Hufbauer and Lu, *Border Tax Adjustments* .

Although unlikely to be adopted, a border adjustment tax would have a significant impact on Canadian industries that export heavily to the U.S., including oil and gas producers and auto or auto-parts manufacturers. (Dattu 2014) . The Toronto-based C.D. Howe Institute estimated that if the U.S. implemented a border adjustment tax, Canadian real GDP growth could be reduced by as much as a full percentage point.55Ciuriak and Xiao, *Aftershocks: Quantifying the Economic Impacts*

# Recommendation #1: Adopt an Inclusive, Participatory, and Trilateral Approach

* The perception that free trade agreements are negotiated in secret for the benefit of business and the political elite has contributed to a backlash against existing and future trade pacts. To guard against this perception, Canada must maintain and enhance the communication and transparency with key stakeholders and the public before, during, and after the negotiations.
* The federal government should continue to ensure that the provinces are consulted when objectives are defined and when matters under provincial jurisdiction are on the bargaining table.
* Canada’s best interests would be served by a trilateral negotiation in which it deals with both the United States and Mexico, rather than through separate bilateral discussions.

Canadians have generally accepted the importance of international trade to their economic well-being. Free trade agreements, although often the subject of contentious debate, are viewed as crucial enablers of prosperity because they open larger markets to Canadian goods and services. Public support for trade agreements, however, should not be taken for granted. Canadian negotiators can contribute to the trust and support by reducing the perception that negotiations are being conducted in secret.

Similarly, Canada also needs to maintain trust with its trade partners in NAFTA. While the United States is still the dominant market for Canadian trade, our commercial relationships with Mexico have expanded greatly since NAFTA took effect. As much as possible, those links with Mexico need to be maintained or even enhanced under a renegotiated NAFTA, ideally through the continuation of a trilateral agreement.

## Increasing the Transparency of Trade Negotiations

Free trade agreements have implications for the broad Canadian economy and society. They are also extremely complicated and detailed. Yet, trade negotiations take place largely in private. The perceived secrecy of the negotiating process can contribute to a sense that agreements are crafted in the interests of a privileged few and that the benefits of these deals are not widely shared among middle-class and working-class workers.

However, support among Canadians for trade deals has remained relatively strong, as shown by an Angus Reid survey in February, which found that support for NAFTA had increased since a similar question was asked just eight months earlier.11Angus Reid Institute, *Facing Tough Talk Over NAFTA Renegotiations* . Nonetheless, the question of who wins and who loses in trade agreements is one that Canadian decision-makers cannot ignore.

In a report released this past February, the Senate Standing Committee on Foreign Affairs and International Trade devoted significant attention to the issue of transparency. The report made several recommendations to increase public awareness of and consultation for trade agreements.22Standing Senate Committee on Foreign Affairs and International Trade, *Free Trade Agreements* . In particular, the committee called on the government to:

* report quarterly to relevant House and Senate committees during free trade negotiations;
* report on expected economic, labour, environmental, social, and other outcomes prior to the ratification of a free trade agreement;
* develop a “free trade agreement implementation strategy” and create a task force to coordinate federal measures that would help Canadian businesses to benefit from the deal and would mitigate any adverse impacts on workers, sectors, and businesses;
* commission independent evaluation of the effectiveness of federal measures that are put in place to mitigate adverse impacts;
* commission an independent review of trade agreements after five years.

Trade agreements have long been conducted in private. However, secretive trade negotiations make an agreement prone to greater opposition during the ratification stage when citizens learn the contents of the deal.33Kucik and Pelc, ”Measuring the Cost of Privacy”; Kucik and Pelc, ”Secret Negotiations.” Therefore, the federal government should commit to a comprehensive consultation and engagement strategy to keep Canadians regularly informed about the progress of NAFTA renegotiations, the changes being considered, and their implications. Provincial governments have an especially important role before, during, and after the negotiations. The federal government should ensure that the provinces continue to be consulted when objectives are defined and when matters under provincial jurisdiction are on the bargaining table.

A majority of Canadians supports trade agreements, especially NAFTA.44Angus Reid Institute, *Canadians See More Benefits From NAFTA Than Americans* ; Angus Reid Institute, *CETA: As Support Softens, Canadians Still Back Trade Deal* ; Angus Reid Institute, *Trans-Pacific Partnership: Canadians Say Trade Deal Is Good for Consumers* . Moreover, Canadians’ support for NAFTA increased as the future of the agreement became uncertain following the 2016 U.S. election.55Angus Reid Institute, *Facing Tough Talk Over NAFTA Renegotiations* . Therefore, Canadians are unlikely to advocate for a withdrawal from NAFTA unless terms become egregious. Canadian negotiators thus have little reason to hide the progress in negotiations from stakeholders or the public.

In fact, an open and transparent negotiation process could bolster Canada’s deal-making strength if the positions being presented at the bargaining table have broad public support. Moreover, it would also be in the best interest of all negotiating parties, especially in an era in which “alternative facts” and “fake news” can get in the way of evidence-based dialogue. In other words, there is no reason for Canada to conduct these talks in secret.

## Maintaining a Trilateral Agreement

Canada–U.S. relations have always been a key focus of Canada’s diplomatic and trade efforts. However, NAFTA is a trilateral agreement, and businesses have been leveraging the strength of all three partners along their supply chains for over two decades. Given the close integration of the three economies, efforts should be made to ensure the agreement is renegotiated with all three member countries at the table.

Mexico is already the fifth-largest destination for Canadian goods exports (after the U.S., China, the United Kingdom, and Japan). Exports to Mexico grew 30 per cent between 2010 and 2015. Automobiles, agriculture, primary metal manufacturing, chemical manufacturing, food manufacturing, and machinery manufacturing accounted for more than 75 per cent of Canadian goods exports to Mexico in 2015. Led by commercial services, Canada’s services exports to Mexico grew 37 per cent compared with 2010.66Audet, *Reaching out for Business Opportunities in Mexico* . The advanced state of North American supply-chain integration means that isolating Mexico to focus on strictly bilateral issues would be costly to Canadian firms.

Many Canadian firms, such as Bombardier and Magna International, have significant investments in Mexico, and disrupting NAFTA would have implications for these and other firms making or considering plans in Mexico. The Canadian government has thus far called on negotiations to be trilateral, as has Mexico. And both countries have influential allies within the U.S. business community. For example, U.S. Chamber of Commerce President Tom Donohue said the termination of NAFTA would be “devastating” for workers and businesses and emphasized how critical it is to maintain a single agreement.77Donohue, ”The U.S. and Canada: An Indispensable Trade Relationship.” This kind of broad support among U.S. interests will be crucial in maintaining a trilateral trade agreement.

Conference Board research has also identified opportunities for Canadian companies in Mexico that could disappear should NAFTA be replaced by bilateral agreements. Opportunities were found in sectors such as auto parts, machinery, fabricated metal manufacturing, and food manufacturing, as well as commercial services and transportation services.88Audet, *Reaching out for Business Opportunities in Mexico* . Despite Mexico’s lower manufacturing wage costs, most of the opportunities for Canadian companies are in the manufacturing sector, particularly in value-added niche segments that can leverage the global manufacturing hub Mexico has become.99Ibid.

# Recommendation #2—Facilitate Cross-Border Mobility of Business People to Support Services Trade

* The cross-border flow of business people across North America is essential for firms if they are to identify trade and investment opportunities and act on them. Moreover, these flows are key to delivering the crucial services that power North American supply chains. Services often require face-to-face encounter to be delivered. However, despite NAFTA granting temporary access to four categories of business persons, barriers to their mobility remain.
* The “business visitors” category is the only one that allows individuals temporary entry for business purposes without them being considered “workers.” However, distinguishing between what does and does not constitute work is subject to much interpretation. To improve the consistency and predictability of decisions made at the border, the business visitor category should be clarified in NAFTA 2.0.
* The list of professional occupations covered in NAFTA has not been updated since the Agreement came into force, and thus leaves out numerous occupations that have emerged since then, particularly in the technology sector. This list should thus be extended to include occupations such as software developers, data scientists, project managers, etc.

When thinking of NAFTA, the free flow of goods between Canada, the U.S., and Mexico is generally what comes to mind, especially since the first wave of liberalization was focused on eliminating tariffs. However, just as important is the cross-border flow of business people—essential for firms to identify trade and investment opportunities and execute on them. Unfortunately, there are still significant barriers to the mobility of business people across borders. Reducing these barriers should be a priority for Canada.

Cross-border mobility of business people is essential to unlock the full potential from trade and investment opportunities. For our closely integrated North American economies to operate efficiently, thousands of business people need to cross North American borders daily, whether it is to oversee an expansion project, meet prospective clients and suppliers, or deliver a service.

To encourage cross-border trade and investment in the region, NAFTA’s Chapter 16 facilitates the temporary entry of four categories of business persons: business visitors, professionals, intra-company transferees, and traders and investors. Table 2 summarizes these categories, along with their respective visa requirements, in both Canada and the United States.

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| Categories | Visa Requirements\* |  | Definition |
|  | Canada | U.S. |  |
| Business visitors | R186(a). No need for a work permit. | B-1 visa. Classified as temporary visitors for business. | Individuals who are engaged in business activities covering the entire business cycle, such as research and design, production, marketing, sales, distribution, after-sales service, and general service.\*\* |
| Professionals | R204, T23. Requires a work permit, but no Labour Market Impact Assessment (LMIA). | TN NAFTA Professionals visa. Classified as temporary workers. | Qualified professionals providing their services to a business in another party, either as salaried employees or direct contractors, or through their employer having a contract with this business. Over 60 occupations qualify under this category, including management consultant, accountant, lawyer, dentist, psychologist, and numerous scientific occupations.\*\*\* |
| Intra-company transferees | R204, T24. Requires a work permit, but no LMIA. | L-1 visa. Classified as temporary workers. | Managers, executives and employees with specialized knowledge being transferred by their company to another affiliate, branch, subsidiary, etc. |
| Traders and investors | R204, T21, and T22. Requires a work permit, but no LMIA. | E-1, E-2. Classified as temporary workers. | Individuals in a supervisory or executive role who regularly engage in trade in goods or services with the other party or who are involved in the process of making an investment in the party where they are seeking temporary entry. |

On paper, the four categories outlined in Table 2 can appear all-encompassing and broad enough to cover most situations under which firms might need their employees to cross the border for business, trade, or investment purposes. In practice, however, firms still face several challenges when trying to carry out their cross-border activities, as shown in the results of a survey of large businesses with extensive ties across the two countries.11Council for Global Immigration and Canadian Employee Relocation Council, *Cross Border Mobility Survey: Service Level Survey* . Firms’ challenges can be summarized as two key issues: the difficulties of border officials to interpret and apply existing rules, and the current limitations in the list of professional occupations covered by the agreement.22Shotwell, Yewdell, and Cryne, *Barriers to Cross-Border Labor Mobility for Professionals* ; Council for Global Immigration and Canadian Employee Relocation Council, *Cross Border Mobility Survey: Service Level Survey* .

Barriers to the cross-border mobility of business persons can have significant economic costs for two key reasons. First, North American multinationals operating on both sides of the border have a significant economic footprint. As such, affiliates of Canadian-owned firms in the United States employ over half a million U.S. workers and generate annual revenues of more than $300 billion. 33Based on 2014 data from Statistics Canada, *Table 376-0065—Activities of Canadian Majority-Owned Affiliates Abroad, by Countries* . Conversely, affiliates of U.S.-owned companies in Canada employ over 1.2 million Canadians and generate over $600 billion in revenues.44Based on 2014 data from Statistics Canada, *Table 376-0151—Activities of Foreign Majority-Owned Affiliates in Canada, by Country* . These North American multinationals have hundreds of employees who regularly need to cross the border for business purposes. Barriers preventing them from carrying on with their day-to-day activities on both sides of the border leads to significant costs and missed opportunities for these firms.

Second, barriers to the cross-border mobility of business persons have important costs in terms of forgone trade in services, whether these services are traded as standalone products or as intermediate inputs. Services such as research and design, professional services, financial services, and transportation and logistics are essential inputs into North America’s supply chains. They are the “connective tissue” of global value chains, powering all steps of the process, from the initial product development all the way to their sales and exports.55The Conference Board of Canada’s Global Commerce Centre dedicated a three-part series to Canada’s services trade. For more information, see Palladini, *Spotlight on Services in Canada’s Global Commerce;* Palladini, *Good Service Is Good Business* ; Goldfarb and Palladini, *Becoming a Services Superpower* .

Traditional measures of trade do not reveal the full contribution of services to the well-functioning of North American supply chains. However, value-added trade data measures developed in recent years have filled this gap. The “value added” concept refers to the amount by which the value of a good or service increases at each step of the production process. In contrast with conventional trade measures, which consider the total value of a good or a service when it crosses the border, value-added trade measures allow for the split between each activity taking place across supply chains.66The Conference Board of Canada published a series of briefings on value added trade measures. For more information, see Armstrong, *Adding Value to Trade Measures: An Introduction to Value-Added Trade* ; Armstrong and Burt, *Adding Value to Trade Measures: Understanding Canada’s Role in Global Value Chains* .

When using value-added trade data, we can see how crucial services are to Canadian trade, accounting for as much as 40 per cent of total Canadian exports (compared with 16 per cent when using traditional trade measures).77Palladini, *Good Service Is Good Business: How Services Add Value to Canadian Goods Exports* , 14. In fact, based on value-added trade data, Canadian services exports in the form of intermediate inputs are 40 per cent larger than our exports of standalone services.88Based on 2011 data from OECD, *Trade in Value Added (TiVA) Database* . And, close to 60 per cent of Canada’s services exports as intermediate inputs go to the U.S. market.99Ibid.

To be delivered, services often require people to interact with each other. And this is also true for services trade, whether they are exported as standalone products or as intermediate inputs in traded goods. For example, a Canadian architectural firm selling its services to a client in the U.S. (a service traded as a standalone product) may need to send employees south of the border to meet with the client and discuss its needs. Similarly, a Canadian manufacturing company could hire the services of a Canadian consultant to assess its transportation and logistics needs before starting to export its manufactured goods to the United States. To provide that service, the Canadian consultant may need to travel to the U.S. to meet with the U.S. firms that will be importing the goods from Canada. These two examples illustrate how essential the cross-border mobility of business people is for services trade to take place.

To reduce barriers to the cross-border mobility of business people, we propose the following:

* Clarify the differences between business visitors and other categories requiring a work permit.
* Broaden the professional occupation coverage and improve clarity of the professionals category.

## Business Visitors: The Need for Clearer Rules

How entry is granted under each of the four categories of business entry depends largely on the interpretation of border officials. A survey of businesses found that border officials can make unpredictable and inconsistent decisions. That can be explained in part by a lack of training.1010Shotwell, Yewdell, and Cryne, *Barriers to Cross-Border Labor Mobility for Professionals* . However, the lack of clarity for some of these categories leaves too much room for interpretation, making it difficult for border officials to apply the rules consistently and fairly.

For example, the broad “business visitor” category (the only one that allows temporary entry to individuals without them being considered “workers”—includes a wide range of activities that can easily be interpreted as “work” by border officials, including research and design, marketing, and after-sales service.1111NAFTA Secretariat, *Chapter Sixteen: Temporary Entry for Business Persons* . See “Annex 1603.” Therefore, distinguishing between what does and does not constitute work is subject to much interpretation by border officials and leads to inconsistent decisions.

As such, in a survey of 24 large companies operating in the U.S. and Canada,1212Respondents to the survey were firms with over 1,000 employees in North America. Among these firm, 57 per cent employ more than 10,000. some firms reported that their employees were required to first get a work permit (either as professionals or intra-corporate transferees) before crossing the border to attend business meetings or provide after-sales services.1313Council for Global Immigration and Canadian Employee Relocation Council, *Cross Border Mobility Survey: Service Level Survey* . Technically, business meetings and after-sales services should count as “business visitor” trips under the sales and marketing and after-sales activities.

Moreover, the same survey also found that, among the various categories of business persons covered under NAFTA, the business visitor category was the one for which border officials’ decisions were the least consistent. For temporary entry to both Canada and the United States, close to 60 per cent of respondents said that decisions for the business visitor category were not consistent, compared with only one-third of respondents for the professional category.1414Ibid. Here are some quotes from businesses who took part in this survey1515Ibid.:

* “We have some of our executive that travel to the U.S. strictly for business meetings, yet they are told to obtain an L-1A [intra-company transferees] because they cross the border so much.”
* “We received border denials for individuals attempting to enter the U.S. to perform non-productive work (just attend meetings) where officer instructed individual to return to the border with a work permit.”
* “Many border officials have a different interpretation regarding what constitutes ‘productive work.’ The definition of ‘productive work’ needs to be better defined in order to ensure consistency.”

The interpretation of border officials on both sides of the border varies widely depending on the nature of the relationships with the firm in the other party, the accompanying documentation presented at the border, and how frequently a person crosses the border.1616Shotwell, Yewdell, and Cryne, *Barriers to Cross-Border Labor Mobility for Professionals* ; Council for Global Immigration and Canadian Employee Relocation Council, *Cross Border Mobility Survey: Service Level Survey* . Therefore, the business visitor category should be clarified in NAFTA 2.0 so that border officials and firms can clearly differentiate those circumstances that require employees to get a work permit from those that do not.

## Professionals: Broadening the List of Covered Occupations

The list of occupations covered for temporary business entry under the “professionals” category has not been updated in over two decades. According to businesses on both sides of the border, the fact that the list of occupations is outdated is one of the key barriers to the flow of business persons between the two countries.1717Shotwell, Yewdell, and Cryne, *Barriers to Cross-Border Labor Mobility for Professionals* . The list excludes a wide range of occupations that have emerged since NAFTA was first negotiated. This is true across all sectors of the economy, but particularly in information technology. These include such occupations as software developers, data scientists, analysts, project managers, supply chain and logistics professionals, and investment managers, to name a few.1818Council for Global Immigration and Canadian Employee Relocation Council, *Cross Border Mobility Survey: Trusted Employer Program Survey* .

To update this list, NAFTA 2.0 could leverage the work done under CETA.1919For a discussion of labour mobility under CETA, see Brender, *Across the Sea With CETA* . Instead of relying on a list of occupations that must be clearly stated, CETA lists the actual services for which professionals are allowed temporary entry, based on the Central Product Classification (CPC).2020United Nations, *Central Product Classification (CPC) Ver.* *2.1* . Services covered by CETA in Chapter 10 of that accord include legal advisory services, accounting and bookkeeping, computer and related services, financial services and consulting services, travel services, research and development services, and other.2121Government of Canada, *Text of the Comprehensive Economic and Trade Agreement—Annex 10* . This list is not as closely tied to specific occupations (aside from those that are regulated professions) and could provide more flexibility as new occupations emerge.

However, the sectoral approach proposed in CETA is highly technical and could also be difficult for border officials to interpret. Therefore, other options may need to be considered during the renegotiation of NAFTA to ensure a broader coverage of occupations, facilitate interpretation by border officials, and reduce uncertainty for professionals crossing the border.

Another option could be to opt for a “negative listing” approach in specific sectors, particularly where job titles continuously change—as they do, for example, in information technology. Under such an approach, all occupations in a sector would be covered unless otherwise specified. NAFTA 2.0 could also include a provision allowing for new types of occupations or services to be added to the list on an ongoing basis so as to ensure that the agreement can be updated in the future as technological changes continue to transform business and trade realities.

In turn, a more extensive coverage of occupations under the professionals category would make cross-border travel a lot easier for many North American businesses.

Lastly, two other aspects where the work of CETA could be incorporated into a NAFTA 2.0 to improve labour mobility and support trade and investment outcomes include:

* streamlining the process for regulators and professional bodies to pursue mutual recognition agreements, as included in CETA’s Chapter 11 (which goes beyond what is currently included in NAFTA)2222CETA was the first free trade agreement signed by Canada that included specific provisions on the mutual recognition of professional qualifications, with an entire chapter (Chapter 11) dedicated to this issue. See Government of Canada, *Text of the Comprehensive Economic and Trade Agreement—Chapter Eleven: Mutual Recognition of Professional Qualifications* .;
* granting work permits that are exempt from a Labour Market Impact Assessment to the spouses of intra-corporate transferees and other temporary migrant workers, as included in other recent FTAs.2323Mertins-Kirkwood, *Labour Mobility in Canada* .

# Recommendation #3—Maintain and Enhance Goods Market Access

* Canada should seek greater access to U.S. federal transportation projects and a permanent waiver on Buy America provisions. This could be done through updating the Canada–U.S. Agreement on Government Procurement.
* The renegotiation of NAFTA would be a good opportunity to start the process to reach a new Softwood Lumber Agreement that would provide stable and predictable access to the U.S. market for Canada’s softwood lumber exporters.
* If changes are made to the auto sector’s rules of origin, Canada should seek to maintain North American content rules rather than country-specific rules.
* The NAFTA negotiations could be the springboard from which Canada undertakes reform of its supply management system.

Much of the commercial activity governed by NAFTA goes on day-to-day without incident or notoriety. However, as close as the relationships are among the three NAFTA countries (especially between Canada and the U.S.), there are bound to be trade irritants. These ongoing disagreements include government procurement and its associated Buy America provisions in the U.S., softwood lumber, and dairy supply management in Canada, as well as the auto sector (given the uncertainty around future changes to the sector’s rules of origin).

## Government Procurement: Securing Access to U.S. Transportation Projects and Increasing Coverage at the State Level

The renegotiation of NAFTA would be a good opportunity to update the Canada–U.S. Agreement on Government Procurement and negotiate permanent waivers to the Buy America provisions that apply to federally funded transportation projects.

Canada and the U.S. are both parties to the three-year-old Revised WTO Government Procurement Agreement (GPA). For the 19 signatory parties, the Revised WTO GPA opened domestic procurement markets to foreign competition for a wide range of goods and services, including construction services.11The WTO GPA is a multilateral free trade agreement on government procurement signed by 18 parties, including Canada, the United States, the European Union’s 28 member states, and Japan. The aim of the agreement is to ensure “fair, transparent, and non-discriminatory” competition for government procurement of goods, services, and construction services. See World Trade Organization, *The GPA in Brief* . In contrast with NAFTA’s Chapter 10, which covers only federal government entities and a selection of federal enterprises,22NAFTA Secretariat, *Chapter Ten: Government Procurement* . the WTO GPA extends the coverage to sub-central entities, including all provinces and territories (except Nunavut) in Canada and 37 U.S. states.33World Trade Organization, *Agreement on Government Procurement: Coverage Schedules* .

Although Mexico has not signed the WTO GPA, Mexico did sign the TPP, which has the same obligations as the WTO GPA. What is more, in side letters to the TPP, Canada, Mexico and the United States all agreed to have TPP rules apply to government procurement under NAFTA.44Global Affairs Canada, *Trans-Pacific Partnership (TPP)—Side Instruments Involving Canada* . Therefore, it would make sense for NAFTA 2.0 to incorporate the TPP government procurement commitments directly in the main text.

There is also potential for Canada to negotiate further access to government procurement in the United States through bilateral negotiations. In 2010, Canada and the United States signed the Canada–U.S. Agreement on Government Procurement. The agreement granted Canada certain exemptions to the Buy American provisions that were included in the 2009 *American Recovery and Reinvestment Act* in exchange for the inclusion of Canadian provinces in the WTO GPA.55The Canadian Trade Commissioner Service, *Canada–U.S. Agreement on Government Procurement* . Another key component of this bilateral agreement was a commitment by both parties to “explore the scope for a long-term government procurement agreement” that would extend market access beyond the commitments made in the WTO GPA.66Ibid.

The renegotiation of NAFTA would be a good opportunity to revisit this promise. In an upgraded Canada–U.S. Agreement on Government Procurement, Canada’s goal should be to obtain a permanent waiver on the Buy America requirements that prevent Canada from taking part in projects funded by the U.S. Department of Transportation’s various agencies. The waiver would also prevent future domestic content restrictions from applying to Canada.77The U.S. Department of Transportation agencies include the Federal Highway Administration, Federal Transportation Administration, Federal Aviation Administration, Federal Airport Authority, AMTRAK, and the Federal Railroad Administration. Each of these agencies has a separate set of Buy America requirements. (See “The Difference Between Buy America and Buy American.”)88For more information on the various Buy America provisions applying to federally funded transportation projects, see Platzer and Mallett, *Effects of Buy America on Transportation Infrastructure and U.S. Manufacturing* .

In 2015, the U.S. passed the *Fixing America’s Surface Transportation (FAST) Act* , which authorizes over $300 billion in funding for transportation projects through 2020.99U.S. Department of Transportation, *Fixing America’s Surface Transportation Act.* However, existing Buy America provisions would limit Canada’s ability to participate in these projects. Given the extensive supply chain links between Canada and the United States in the iron, steel, and transportation equipment manufacturing sectors, Canadian firms should be given access to these projects. From a U.S. perspective, allowing Canadian firms to take part in transportation projects could reduce their costs and completion time and lead to more efficient use of public funds.1010According to a report from the U.S. Congressional Research Service, Buy America may increase the cost and completion time of transportation projects. See Platzer and Mallett, *Effects of Buy America on Transportation Infrastructure and U.S. Manufacturing* .

Within a revised agreement on government procurement, Canada and the U.S. could also work together to open procurement markets further at the state level.1111Global Affairs Canada, *Canada–European Union Comprehensive Economic and Trade Agreement* . In the Revised WTO GPA, all Canadian provinces and territories (except Nunavut) are covered, whereas only 37 of the 52 American states have agreed to these obligations. What is more, the comprehensiveness of the coverage varies from one state to another. A revised Canada–U.S. Agreement on Government procurement would be the right framework for Canada to negotiate increased access to government procurement markets for the remaining states not included in the Revised WTO GPA.

An additional goal for a revised Canada-U.S. Agreement would be to open government procurement markets at the municipal level, as negotiated in CETA. As such, CETA provides the most favorable access to government procurement markets that both Canada and the EU have agreed to in a free trade agreement.1212Under CETA, Canada opened its government procurement markets at the municipal level, also covering school boards. For the list of local entities covered in CETA, see Government of Canada, *Text of the Comprehensive Economic and Trade Agreement—Annex 19-A* .

**The Difference Between “Buy America” and “Buy American”**

The U.S. is known for its “domestic content restrictions,” which require certain public funds to be spent on goods made in the United States. The *Buy American Act* and Buy America requirements are the most common ones. As they have similar names, the terms “Buy American” and “Buy America” are often used interchangeably. However, they do not apply to the same goods, public entities, or circumstances. For the upcoming negotiation, the focus should be on exempting Canadian businesses from Buy America requirements.

The Buy American Act of 1933 technically prevents U.S. federal agencies from purchasing “foreign” goods. However, in practice, the domestic content restrictions under this act rarely applies to Canada. As such, under the *Trade Agreements Ac* t *of 1979* , the *Buy American Act* can be waived to ensure the U.S. complies with its international trade agreements’ commitments, including those found in NAFTA and the WTO GPA.11Manuel and others, *Domestic Content Restrictions* . The *Buy American Act* therefore does not apply to the U.S. entities listed in the WTO GPA, allowing Canadian firms to compete with U.S. firms for these public contracts, unless specified otherwise.

**Buy America** refers to a group of domestic content restrictions that apply to states, municipalities, and other government organizations as a condition to obtain funds from the Department of Transportation’s various agencies.22Ibid. The name “Buy America” goes back to the *Surface Transportation Assistance Act* of 1978, in which these requirements were first introduced.33Platzer and Mallett, *Effects of Buy America on Transportation Infrastructure and U.S. Manufacturing* . Buy America restrictions vary depending on the source of federal funds being used. Key examples of Buy America domestic content restrictions preventing Canadian firms from bidding on transportation contracts include44The Canadian Trade Commissioner Service, *Buy America(n) Acts* .:

* requirements that all iron and steel materials for state and local highway projects be produced in the U.S.;
* requirements that 60 per cent of the total cost of rolling stock (e.g., subways, buses, railways) come from U.S.-made components and that final assembly takes pace in the United States.55In 2016, the U.S. Department of Transportation announced that the minimum domestic content requirement for rolling stock would be increased to 70 per cent by 2020. For more information, see U.S. Department of Transportation, *FTA Issues Final Buy America Policy* .

In contrast with the *Buy American Act* , Buy America requirements do not have to be waived by the *Trade Agreements Ac* t for the U.S. to comply with its international obligations. As such, these restrictions are specifically excluded from the United States’ commitments under the Revised GPA. In the Revised GPA, the United States specifies that “the Agreement shall not apply to restrictions attached to federal funds for mass transit and highway projects.”66Platzer and Mallett, *Effects of Buy America on Transportation Infrastructure and U.S. Manufacturing,* 3 (footnote #17). However, waivers can still be granted to foreign bidders when specific criteria are met.77For more information, see U.S. Department of Transportation, *Buy America* ; The Canadian Trade Commissioner Service, *Exceptions and Waivers* .

## Softwood Lumber: More Stability and Predictability for Canadian Producers and Exporters

Failure to renegotiate a new softwood agreement—even a less favourable agreement with new quotas and higher tariff rates—would hurt the growth potential of Canada’s softwood producers. Around 60 per cent of Canada’s softwood lumber production is exported,88Calculations based on data from Natural Resources Canada. Source: Natural Resources Canada, *Forest Resources—Statistical Data* . and three-quarters of those exports went to the United States in 2016.99Calculations based on data from ISEDC. Source: Government of Canada, *Trade Data Online* . The goal in a NAFTA 2.0 negotiation should be to ensure stable and predictable access for Canada’s softwood lumber exporters to the U.S. market.

With the expiration of the one-year grace period1010While signing the previous Softwood Lumber Agreement in 2006, it was decided that a one-year grace period would apply upon its expiration, preventing any trade action from taking place for that given year. last October, and no renewed softwood lumber agreement (SLA) in sight, the long-standing trade dispute between the U.S. and Canada is set to continue. At the heart of this 35-year-old dispute lies the U.S. claim that the Canadian lumber industry continues to be unfairly subsidized. In Canada, stumpage fees are set administratively, as most forests are provincially owned. By contrast, these fees are established through private sales in the U.S., as most forests there are privately owned.1111Hoover and Fergusson, *Softwood Lumber Imports From Canada* .

Despite Canada’s positive track record in winning cases brought before the World Trade Organization and NAFTA tribunals, the U.S. Department of Commerce (DOC) is once again investigating softwood lumber trade with Canada. Recently, the DOC announced a preliminary determination in its countervailing duty (CVD) investigation of imports of softwood lumber from Canada. These duties will range from a low of 3 per cent to a high of 24 per cent for the investigated respondents, with all other Canadian lumber exporters facing a CVD of 20 per cent. A separate verdict on anti-dumping duties, is expected in late June.

Since the end of the recession, improving U.S. demand has boosted Canadian softwood lumber exports, which recovered to their highest levels since the U.S. housing market downturn in 2006. With limited growth potential expected in Canada’s housing market going forward, softwood lumber producers will remain dependent on stable and predictable access to the U.S. market to take advantage of growth opportunities.

U.S. consumers are likely to bear the brunt of the decision to impose duties on imports of Canadian lumber. According to a study on the welfare impacts of the 2006 SLA by U.S. researchers Rajan Parajuli and Daowei Zhang, the largest net losers were U.S. consumers themselves due to higher U.S. lumber prices resulting from the constraints on imports from Canada.1212Parajuli and Zhang, ”Welfare Impacts of the 2006 United States–Canada Softwood Lumber Agreement.” Based on their findings, the Montréal Economic Institute calculated that U.S. consumers spent an additional $6.4 billion as a result of the higher prices. That is more than three times the $2.0-billion-dollar loss suffered by Canadian producers due to reduced exports.1313The amounts calculated by the Montréal Economic Institute are based on the estimates found in Parajuli and Zhang, ”Welfare Impacts of the 2006 United States–Canada Softwood Lumber Agreement”.

A renegotiation of a bilateral softwood lumber agreement, whether incorporated into NAFTA 2.0 or separate from it, could address the issue of the share of the U.S. market accessible to Canadian producers. Under the previous SLA, Canada’s share of the U.S. softwood lumber market declined from around 33 per cent to around 28 per cent.1414Hoover and Fergusson, *Softwood Lumber Imports From Canada.* However, the drop was due largely to the collapse of the U.S. housing market; and with the recovery of the market in recent years, demand for Canadian lumber imports increased.

A potential approach to solving this dispute would be to allocate guaranteed (or “free trade”) shares of U.S. consumption for every province. These levels, which would be based on historic levels, would also include provisions, such as export taxes or quotas (as in the previous SLA), to prevent these shares from being exceeded. In addition, an exchange rate mechanism could be included that would offset competitiveness advantages resulting from currency fluctuations. Overall, such a settlement would enhance predictability in trade conditions on both sides of the border, while sharing the risk of fluctuations in U.S. consumption.

A favourable trade outcome between Canada and the U.S. also needs to consider the differences among provinces. Since the last SLA, Quebec has adapted its stumpage regime to further mimic market-based structures, and the Maritime provinces continue to have a greater share of their forests on private lands.1515Miller, *From Log Export Restrictions to a Market-Based Future* . Given that producers in these provinces could be disproportionately hurt by import tariffs due to generally lower margins, it will be preferable for provinces to maintain flexibility with regards to the trade restrictions they would face, as in the previous SLA. There should be no “one size fits all” solution.

## Auto Sector: Finding Opportunity in Change

A highly competitive environment for attracting new investments, the lingering effects of the 2008–09 financial crisis on the industry, and the integration of Mexico into the sector’s supply chain have resulted in Canadian auto sector revenues being little different today than they were at the turn of the century. Still, despite the Canadian industry’s recent struggles, the sector accounted for 16.5 per cent of Canada’s merchandise exports in 2016 and directly employed 140,000 people.

In this environment, Canada has an interest in ensuring that any changes to NAFTA with regards to autos creates new opportunities for growth in this key sector. In particular, should changes to the sector’s rules of origin be necessary under NAFTA 2.0, the best course of action would be an increase in the North American content requirements.

Free trade in the auto industry between Canada and the U.S. has a long history. The 1965 U.S.–Canada Automotive Products Agreement (commonly referred to as the “auto pact”) was a groundbreaking agreement that liberalized auto sector trade between the two countries. A key component of the auto pact were provisions about rules of origin, which set a minimum threshold of how much domestic content must be present in a product for it to receive preferential tariff access to the domestic market.

The rules of origin for autos and parts were gradually changed—first, under the U.S.–Canada Free Trade Agreement, and then under NAFTA. Today, we have North American content rules, rather than domestic content rules. Light autos, engines, and transmissions must have 62.5 per cent North American content before they can be imported duty-free into Canada.1616Government of Canada–Justice Laws Website, *NAFTA Rules of Origin Regulations* . This share falls to 60 per cent for other types of auto products.

The implementation of NAFTA brought about significant changes in Canada’s auto industry. As Mexico became integrated into the sector’s supply chain, a new production cluster in the U.S. Southeast and Mexico developed. The shift in investment toward this region contributed to a prolonged stagnation in Canadian auto production and trade. After growing throughout the 1990s, the value of Canada–U.S. trade in autos and parts reached a peak in 2002, and that peak was not surpassed until 2016.1717Based on data for HS code 87 from Innovation Science and Economic Development Canada, *Trade Data Online* .

Since the turn of the century, Mexico has experienced exceptional growth in auto-related trade with its NAFTA partners. The U.S. and Canada have seen their auto imports from Mexico nearly triple, reaching US$74.8 billion1818Based on data for HS code 87 from U.S. Department of Commerce, *TradeStats Express* . in the U.S. and C$10.2 billion in Canada in 2016.1919Based on data for HS code 87 from Innovation Science and Economic Development Canada, *Trade Data Online* . And while Mexico’s imports of autos and parts from Canada and the U.S. have also risen, they have not kept pace. As a result, Mexico has developed a large trade surplus in autos and parts with both countries. Given the large number of planned auto investments in Mexico, this situation is unlikely to reverse itself.2020Swiecki and Menk, *The Growing Role of Mexico* .

The rapid growth in U.S. auto imports from Mexico, combined with the auto sector’s size (it employs nearly 1 million people directly in the U.S.2121U.S. Bureau of Labor Statistics, *BLS Data Viewer* . and accounts for 8.5 per cent of all merchandise exports), means that autos and parts are a prime target for renegotiation in NAFTA. Preliminary indications are that the U.S. will seek to adjust the current rules of origin for autos and parts.2222Keenan, ”Auto Sector Gears Up.” These changes are likely to take one of two forms—an increase in the current levels of required North American content, or the imposition of U.S.-specific content requirements.

An increase in the North American content requirements would be the less intrusive of these options. It would require supply chain adjustments, as firms would need to source fewer inputs from Europe and Asia, and that would likely raise costs. It could also mean increased compliance costs for firms, as they may need to better track the source of their inputs. While these costs would likely lead to higher prices for consumers, the increased focus on North American suppliers would also create new opportunities for Canadian parts suppliers.

A shift to country-specific content requirements would be far more disruptive. This could effectively lead to a trifurcation of the highly integrated North American industry and require significant changes in supply chains. In this situation, Canada’s negotiation strategy would likely centre on maximizing its share of the North American content requirements. This may include trade-offs, with lower Canadian content required in areas where Canada currently has a limited market presence, such as heavy trucks.

If too restrictive, changes in the rules of origin embedded in NAFTA could also have another unintended consequence—they could reduce the attractiveness of the region for auto-related investment. For example, if compliance costs associated with new rules of origin are too high relative to the tariffs imposed on vehicles that don’t meet them, auto assemblers could choose to not comply. In short, unrealistic changes in the rules of origin could end up leading to less investment in North America.

Beyond changes in the rules of origin, Canada might also want to table another issue in the negotiations— the heavy use of subsidies to attract auto investments. In recent years, financial incentives have accounted for, on average, more than 20 per cent of the value of new auto-related investments; in some extreme situations, they have accounted for the majority.2323Swiecki and Menk, *The Growing Role of Mexico in the North American Automotive Industry* . The competition for new investments and the heavy use of financial incentives could lead to undesirable outcomes, such as rent seeking (the practice of manipulating public policy or the economy to boost profits) or sub-optimal location decisions by auto firms. Establishing a limit to the size of incentives on offer would help to level the playing field for investment decisions.

## Supply-Management: An Opportunity for Fundamental Reform

Canada’s supply management system is expected to be a contentious and high-profile issue in the NAFTA negotiations, and it is one sector where Canada should embrace greater openness in its own market. The Conference Board’s view is that supply management has served Canada poorly for decades, and the NAFTA renegotiation could be the first step toward a gradual transition away from this long-standing system altogether.

Canada uses supply management to manage its dairy, eggs, and poultry industries. The policy provides a stable price for producers through a three-pronged approach that controls supply through allocation of production quotas, a price-setting mechanism to ensure that production costs are covered, and high tariffs on imports.2424An explanation of Canada’s dairy supply management system can be found in Goldfarb, *Making Milk* . In a 2014 report, The Conference Board of Canada described supply management as “Canada’s most contentious public policy.” The report said supply management contributes to higher prices for consumers and reduces growth opportunities for producers, both at home and abroad.2525Grant and others, *Reforming Dairy Supply Management* .

Canada was able to maintain its supply managed systems during the negotiations for the Canada–U.S. Free Trade Agreement and NAFTA. While Canada has defended its supply management policy in more recent deals, it ultimately agreed to increase the share of dairy products it allows in from other countries. For example, the Comprehensive Economic and Trade Agreement (CETA) with the European Union will double the amount of EU-produced cheese allowed into Canada.2626European Commission, *CETA—Summary of the Final Negotiating Results* . The Liberal government of Justin Trudeau also announced a $350 million investment over five years in November 2016 to “support the competitiveness of the dairy sector” specific to CETA.2727Agriculture and Agri-Food Canada, *Government of Canada Invests in Dairy Sector* .

During the TPP negotiations, Canada agreed to provide TPP countries with duty-free access to 3.25 per cent of Canada’s dairy market and 2.1 per cent of its poultry market.2828Curry, ”The ABCs of TPP.” In relation to this trade deal, the previous Conservative government had announced a $4.3-billion, 15-year compensation package to Canadian dairy farmers affected by the TPP, although the current government has not committed to it.2929McGregor, ”Liberals Waver on Trade Deal Compensation.”

The U.S. dairy industry calls Canada’s supply management system “protectionist” and is putting pressure on U.S. officials to gain better access for U.S. dairy products.3030U.S. Dairy Export Council, *U.S. Dairy Companies Push Back* . U.S. industry leaders are particularly unhappy with the National Ingredients Strategy for ultra-filtered milk, a type of dairy ingredient not subject to tariffs. U.S. producers were increasingly supplying Canadian dairy processors with ultra-filtered milk until Canada enacted regulations that reduced the price paid by processors for Canadian ultra-filtered milk.

Canada’s traditional trade negotiating position has been not to make supply management a part of the discussions. The dairy concessions made in CETA and TPP were offset in part by the opportunities for greater access to new, large, and growing markets. In contrast, there is not as much room for growth in a mature U.S. market. Nevertheless, Canada should be prepared to offer increased market access for U.S. dairy products (as well as other supply-managed commodities). First, Canadian consumers would benefit from greater product choice and more price competition. Second, a willingness to compromise on an issue such as supply management could help achieve Canada’s interests in other areas of the negotiations, including government procurement, softwood lumber, and the auto sector.

The NAFTA renegotiation could be the springboard from which Canada undertakes fundamental reform of the supply management system. Canada’s negotiating priority should be a multi-year, phase-in period for NAFTA provisions governing supply-managed industries, giving Canada the time to transition out of the policy altogether. The Conference Board has called for reform of dairy supply management for almost a decade, arguing that the policy has imposed costs on domestic consumers3131The Organisation for Economic Co-operation and Development estimates that the market price support cost Canadian dairy consumers an average of $2.6 billion per year in the decade to 2011. That adds up to roughly $200,000 per dairy farm per annum and around $276 per family every year. See Grant and others, *Reforming Dairy Supply Management* . and limited the ability of supply-managed producers to export their own products to growing markets, primarily in Asia. In 2014, the Conference Board proposed a multi-faceted reform plan for the dairy industry, which included buying out farmers’ production quota at the value at which it was purchased (“book value”) and an aggressive push to gain access to international markets for Canadian dairy products.

Canadian dairy operators would be negatively affected in the short term, and the burden would likely fall hardest on smaller, less-efficient operators. The Conference Board estimates that about half of Canada’s milk comes from just 25 per cent of its producers.3232In *Reforming Dairy Supply Management: The Case for Growth* , the Conference Board examined data from the Ontario Dairy Farm Accounting Project Report (ODFAPR) for 2011, dividing the operations into three groups—most efficient, medium efficiency, and least efficient. The most efficient farms had more than 160 head of cattle, approximately twice the average herd, and earned about $1.4 million in revenue. Extrapolating the Ontario data to the national industry, we estimate that the farms in this group would hold almost half of the dairy production. These operators would have the resources to expand their herds and invest in their operations to compete internationally. The outcome would likely be a dairy industry with fewer farms but higher production and greater export potential, as well as an expectation of price declines for Canadian consumers and processors over the medium and long terms.

# Recommendation #4: Encouraging Innovation and Digital Trade While Protecting Intellectual Property and Canadian Culture

**Recommendation Summary**

* Canada should aim for balanced IP rules in NAFTA 2.0 that encourage new innovative activities yet do not unduly penalize the buying of ideas.
* NAFTA 2.0 should include a chapter dedicated to e-commerce. However, with the digital economy rapidly evolving and often leading to “winner takes all” dynamics, Canada should be careful with the provisions that will be included in the e-commerce chapter, making sure Canada maintains some flexibility with regards to future digital policies.
* One of the key areas transformed by our digital age is culture. Supporting Canadian content in the digital age will require us to keep our freedom to develop our own cultural policies. NAFTA 2.0 should maintain the broad cultural exception, rather than agreeing to the weaker cultural reservations found in the Trans-Pacific Partnership.

Innovation is the key driver behind greater wealth and prosperity for the Canadian economy. However, Canada has been a consistently poor performer on measures of innovation.11The Conference Board of Canada, *How Canada Performs: Innovation* . Thanks in part to trade, Canada has been able to maintain a high standard of living despite struggling on innovation and the commercialization of ideas. Most discussions about NAFTA focus on maintaining Canada’s access to the U.S. market for existing goods and services. However, it is also critical that a new agreement addresses provisions that enhance, or at least maintain, Canada’s potential to create the innovations that will lead to future growth.

Intellectual property protection can create the commercial incentives for organizations to innovate, while at the same time stifling the knowledge transfer and exchange that produce innovations in the first place. Similarly, Canada has a rich cultural base, and culture and creativity go hand in hand. Canada’s NAFTA negotiators will need to identify and strike a fine balance on these complex and controversial subjects.

## Intellectual Property: Maximizing Canada’s Innovation Potential With Balanced IP Rules [L2]

Most discussions about renegotiating NAFTA focus on maintaining Canada’s access to the U.S. market. But it is also critical that the new deal maintains and enhances Canada’s innovation potential.

While innovation goals may be better addressed through domestic policy tools, intellectual property (IP) rules have now been brought into free trade agreements.22Curtis, “What’s Not in the TPP.” IP rules—such as patents, trademarks, and copyright protection—protect creators of IP. Transparent IP rules can create incentives to innovate. But IP rules that are too stringent can discourage innovation. This can happen, for example, if they encourage patent trolls or enrich existing patent holders rather than encourage new innovative activities.

NAFTA was the first trade deal to include IP provisions. More recently, in the TPP, the U.S. negotiated stronger IP rules that more closely mirror U.S. rules. It is therefore likely that the U.S. will push for similarly strong provisions in a renegotiated NAFTA. These could include extending copyright terms or reforms to patents, such as pharmaceutical patents (which were strengthened under CETA).

Canadian researchers and policy-makers need to spend much time thinking through the innovation and economic impacts of U.S. IP rules that will likely be part of the NAFTA renegotiation.

On the one hand, Canada imports more IP (copyrights, patents, trademarks, etc.) than it exports, making this country a net importer of ideas. Even so, Canadian companies do not buy enough new ideas and technologies. Stronger IP standards in NAFTA could make it more expensive to buy IP, disadvantaging a country such as Canada and reducing investments in new technologies even further. Moreover, whatever gets enshrined in a renegotiated NAFTA could set a precedent for stronger global IP standards, which could further disadvantage net IP importers.

On the other hand, innovating Canadian firms that are commercially minded and globally oriented will aim to obtain U.S. patents to be able to operate globally. For them, renegotiated NAFTA rules more aligned with existing U.S. patent rules should have little impact, since their aim is obtaining the U.S. patent. Harmonizing basic IP rules with U.S. IP rules would also have a positive effect on domestic innovators and copyright holders.33Schwanen and Jacobs, *Patents, Copyright, and Competition* . And, as Canada increasingly exports culture and research, there may also be a longer-term opportunity to become more active IP exporters, in turn benefiting from stronger IP protections.44Ibid.

Canada should therefore aim for balanced IP rules in NAFTA 2.0 that encourage new innovative activities yet do not unduly penalize the buying of ideas.

## Digital Trade: Updating NAFTA to the Digital Age While Protecting Canada’s Interests [L2]

NAFTA 2.0 will likely include a chapter on e-commerce to take into account the trade implications related to the digital economy. To ensure Canada’s interests are protected, this chapter will have to be carefully drafted and reviewed to ensure the protection of Canadian citizens’ privacy and to maintain Canada’s ability to support industries affected by the winner-takes-all dynamics characterizing the digital economy.

When NAFTA was signed 23 years ago, the Internet was still in its infancy. Today, information and communications technologies are the backbone of our economy, powering all economic sectors and fostering the creation of new digital products, services, and business models. The rise of the digital economy has been accompanied by booming digital trade (i.e., domestic and international commerce leveraging the Internet to order, produce, or deliver products and services).55There are no standard definitions for digital trade. This definition is based on the United States International Trade Commission’s digital trade definition in Stamps and Coffin, *Digital Trade in the U.S. and Global Economies, Part 2* . Examples of products traded and delivered electronically include IT services (software as a service, cloud computing), digital content (books, news, music, games, movies, videos), and social media.

In turn, increased digital trade is contributing to the explosion in cross-border data flows (i.e., the constant stream of information transmitted through digital networks across countries).66For more information, see Hodgson and Goldfarb, *Canada’s New Trade and Technology Paradigm* . While global trade in goods and services has flatlined in recent years, cross-border data flows have soared, quadrupling since 2012, and they are expected to post another fivefold increase within the next five years. 77Global trade in goods and services, based on UN Comtrade data. Cross-border data flows based on the McKinsey Global Institute’s estimates and definition found in Dobbs, Manyika, and Woetzel, *Digital Globalization* . In fact, according to the McKinsey Global Institute, cross-border data flows already contribute more to the global economy than trade in goods.88Ibid.

With global digital trade and cross-border data flows rising rapidly, it became imperative for free trade agreements to address international trade taking place electronically. As such, both CETA and the TPP have an e-commerce chapter to promote digital trade across the countries involved, and this will be an essential addition to NAFTA 2.0.

As found in CETA and the TPP, NAFTA 2.0’s e-commerce chapter should include a provision preventing countries from imposing customs duties on products and services delivered electronically.99CETA’s provision 16.3 and TPP’s provision 14.3. See Government of Canada, *Text of the Comprehensive Economic and Trade Agreement* . This provision, as outlined in CETA and the TPP, still maintains each country’s ability to charge internal taxes on digital products and services should it wish to, in the same way that these would normally apply to products and services produced and consumed domestically.

The TPP goes several steps further than CETA by also including provisions to prevent parties from restricting cross-border data flows or requiring computing facilities to be located domestically (also known as “data localization” rules). Although these provisions do not apply to government procurement under the TPP, if incorporated into a NAFTA 2.0, they could limit the Canadian government’s future leeway to protect the privacy of Canadian citizens.1010Geist, ”What Would a Digital-Economy-Era NAFTA Mean for Canadians?”

Given that the digital economy is still in its infancy, and given the growing concerns around data privacy and cybersecurity, more consultation and research should be dedicated to these issues. In particular, potential provisions on data localization and cross-border data transfers should be studied carefully during the renegotiation of NAFTA to ensure they are in line with Canada’s interests and provide enough flexibility to protect the privacy of Canadian citizens in the future.

Another aspect that will be important for Canadian trade negotiators to keep in mind for the e-commerce chapter is the tendency of the digital economy to lead to winner-takes-all dynamics.1111Baller, Dutta, and Lanvin, *The Global Information Technology Report 2016* . Given these rapidly evolving market dynamics, Canada should aim to maintain a certain level of flexibility with regards to future digital policies at home should Canadian firms and industries need some support to stay competitive in markets dominated by a few digital players.

We are seeing winner-takes-all dynamics in numerous markets, including social media (Facebook, Twitter), cloud computing (Amazon, Microsoft), search engines (Google), online streaming (Netflix and YouTube), e-commerce (Amazon and E-bay), ride sharing (Uber), and online payments (PayPal), to name a few. Through their disruptive innovations that are used by customers around the world, these players have transformed traditional industries and come to dominate their markets. In turn, this can lead to market dynamics closely akin to monopolies, with the associated rent-seeking behaviour. In fact, market domination can be a deliberate business strategy pursued by digital players.1212The business strategies pursued by Amazon and Uber to gain monopoly power are discussed in Khan, ”Amazon’s Antitrust Paradox,” and Horan, *Can Uber Ever Deliver?*

A business with a large degree of monopolistic power may not be problematic when it operates in a small niche market. However, when its ramifications are global in nature and capture value across entire industries, it can lead to undesirable consequences, as we are seeing today in the Canadian news industry. According to a report from the Ottawa-based Public Policy Forum on the state of news and democracy in Canada, Google and Facebook together collect-two thirds of online ad spending in this country, leaving little for Canadians news outlets and putting the long-term survival of these outlets at risk.1313Public Policy Forum, *The Shattered Mirror* .

## Culture: Ensuring Canadian Culture Can Thrive in the Digital Age [L2]

Over the past two decades, the Canadian government has protected the cultural sector from the commitments that apply to most goods and services under free trade agreements. Canada should maintain this position in the upcoming NAFTA negotiation, especially given the growing importance of digital channels in the creation, distribution, and consumption of cultural content.

Culture is the backbone of a country’s social fabric. Creative expression—such as music, films, TV shows, books, magazines, and documentaries—contributes to building stronger communities, promoting the culture of minorities, and building a greater sense of national identity. What is more, the economic footprint of culture is significant, accounting for 3 per cent of Canada’s GDP and 3.5 per cent of employment.1414Statistics Canada, *Income and Expenditure Accounts Technical Series: Provincial and Territorial Culture Indicators, 2010 to 2014* . The country’s film and television production industry alone drives over 140,000 full-time equivalent jobs.1515Nordicity Group Ltd, *Profile 2016: Economic Report on the Screen-Based Media Production Industry in Canada* .

Historically, Canadian governments have provided extensive support to cultural industries, notably through “policies and programs that promote Canadian content, foster culture participation, encourage active citizenship and participation in Canada’s civic life, and strengthen connections among Canadians.”1616Statistics Canada, *Conceptual Framework for Culture Statistics 2011* . Culture can be viewed as a “public good,”1717Dachis and Schwanen, *Changing the Channel* . one that if left to market forces alone would be underproduced. Culture’s benefits for society go well beyond the economic value attached to it.

For this reason, when negotiating free trade agreements over the past 25 years, the Canadian government made sure that cultural industries would not be subject to the provisions that apply to most goods and services. As such, NAFTA includes a broad cultural exception, which maintains the right of each party to adopt measures and policies that support its cultural sector.1818NAFTA Secretariat, *Chapter Twenty-One: Exceptions—Annex 2106.*

When negotiating NAFTA 2.0, Canada’s goal should be to maintain this exception, rather than agreeing to the kind of weaker cultural “reservations” found in recent trade agreements, including the Trans-Pacific Partnership. The significant change in Canada’s stance with regards to cultural industries under the TPP was the subject of much debate when the agreement was signed, and several voices have expressed their concerns.1919For a detailed explanation of the different treatment of culture under the TPP compared with other free trade agreements Canada has signed, see Maltais, *The TPP and Cultural Diversity* ; Geist, *The Trouble With the TPP, Day 18* ; Geist, *The Trouble With the TPP, Day 26* ; Geist, *The Trouble with the TPP, Day 29* ; Alliance of Canadian Cinema Television and Radio Artists, *Trans-Pacific Partnership Agreement* ., 2020An article in *Le Devoir* also discusses the importance of maintaining NAFTA’s cultural exception to protect French content and culture, especially in the digital age. See Baillargeon, ”L’exception Culturelle.”

In particular, the TPP treatment of culture could have implications with regards to purely digital cultural content. Under the TPP, cultural content delivered solely through digital channels could be subject to provisions that require the non-discriminatory treatment of digital products, as found in the e-commerce chapter.2121Geist, *The Trouble with the TPP, Day 29* . Therefore, maintaining NAFTA’s current broad cultural exception in NAFTA 2.0 would ensure that Canada keeps its ability to support cultural content, whether delivered digitally or not.

In a digital world characterized by winner-takes-all dynamics, having the freedom to develop our own cultural policies will be essential to our ability to create and distribute a wide variety of Canadian content.2222The ongoing digital transformation and its implications for the creation and distribution of Canadian cultural content are discussed at length in the following reports: Nordicity Group Ltd, *Canadian Media in a Digital Universe* ; Stursberg, *Cultural Policy for the Digital Age* ., 2323In the fall of 2016, the Canadian government led an extensive public consultation on *Canadian Culture in a Digital World* . The findings and conclusions from this consultation are presented in Ipsos, *What We Heard Across Canada* .

# Recommendation #5—Modernize NAFTA to Today’s Business Realities and Standards

* Key areas that need to be modernized in NAFTA 2.0 include the agreement’s rules of origins, the proportionality clause attached to the energy sector, investor-state dispute settlement mechanisms, and labour and environmental standards.
* The NAFTA rules of origin should be reviewed to make it as easy as possible for small and medium-sized businesses to comply with them and to take into account today’s global supply chains.
* To restore the public’s trust in investor-state dispute settlement mechanisms, the composition of NAFTA’s investment tribunals should be reviewed to ensure decisions are consistent and predictable and to prevent unreasonable claims by foreign investors.
* The labour and environmental side agreements should be incorporated into the main agreement and updated based on recent trade deals.
* In the energy sector, the proportionality clause currently found in NAFTA, which requires Canada to maintain a consistent ratio of export to supply for energy commodities and related products, should be removed. There is little evidence of its use and impact on North American energy trade and investments to date.

Despite being in effect for less than a quarter-century, NAFTA is a mature trade agreement. Moreover, NAFTA itself has completely transformed trade patterns across North America, powering the close integration of North American supply chains. Canada has an interest in the modernization of key aspects of NAFTA for two reasons. First, to support trade, investment, and economic growth across the region. And second, to ensure NAFTA’s rules and regulations are fair to both firms and the public. Key areas that need to be modernized include NAFTA’s rules of origins, investor-state dispute settlement mechanisms, labour and environmental standards, and the proportionality clause currently attached to the energy sector.

## Rules of Origin: Reducing the Burden on SMEs [L2]

Among the key requirements firms need to comply with to get preferential treatment under NAFTA are the rules of origin (ROO). These rules are incorporated into trade agreements to ensure that only the goods originating from participating countries are subject to preferential treatment.11Brenton, ”Preferential Rules of Origin.” However, as they currently stand, these rules disproportionately disadvantage SMEs in all three NAFTA countries. Canada should work closely with the U.S. and Mexico to streamline the NAFTA rules of origin to make it easier for SMEs to comply with them and to take into account in today’s global supply chains.

Rules of origin can take various forms, with the most common ones being changes of tariff classification and value added requirements. To prove that their products meet the NAFTA rules of origin, exporting firms need to produce a certificate of origin for their goods.22Office of the United States Trade Representative, *Fact Sheet: NAFTA Certificate of Origin* ., 33Brenton, ”Preferential Rules of Origin,” 308. Under existing rules, it can be particularly cumbersome for SMEs to qualify for the preferential treatment under NAFTA. As such, for small shipments, SMEs may find it makes more financial sense to pay the “most favoured nation” duties rather than have to pay the additional costs required to comply with the NAFTA requirements.44Kunimoto and Sawchuk, ”NAFTA Rules of Origin.” In contrast with larger firms, SMEs are less likely to have the available financial resources needed to afford the necessary legal and accounting advice on how to comply with these requirements.

Based on a measure of rules of origins’ overall restrictiveness level, the NAFTA rules of origin are among the world’s most restrictive.(Brenton 2011) (Estevadeordal and Suominen 2009) Estevadeordal and Suominen, *Bridging Regional Trade Agreements in the Americas* , 32; and Kunimoto and Sawchuk, ”NAFTA Rules of Origin,” 283. One of the key reasons for this is that the NAFTA rules of origin are detailed at a product-by-product level, spanning over 450 pages. The product-by-product approach is considered as more restrictive than necessary and can result in “an overly complex system (Brenton 2011) for businesses to comply with and for governments to administer. In line with this assessment, a 2006 report on the state of NAFTA after 10 years found that:

NAFTA rules of origin are restrictive, create policy-induced inefficiencies in sourcing and production, impose compliance costs on firms engaged in intra-NAFTA trade, and inhibit NAFTA trade. The elimination or reduction of these costs associated with the NAFTA rules of origin would provide positive economic benefits to Canada by lowering costs to producers and prices to consumers, by increasing intra-NAFTA trade, and by reducing NAFTA ROO-induced inefficiencies.(Kunimoto and Sawchuk, n.d.)

Luckily, over the past 15 years, rules of origin have been the subject of ongoing revisions to adapt them to changing trade and production patterns. Between 2005 and 2009, three sets of changes to NAFTA rules of origin were fully implemented. The fourth package of amendments is currently at the preliminary implementation stage, and preliminary work on a fifth package is under way.88 Audet, e-mail communication with Global Affairs Canada in March 2017; Global Affairs Canada, *2012 NAFTA Commission Meeting*, *2009 NAFTA Commission Meeting*, and *2007 NAFTA Commission Meeting* .

The rules of origin applying to crude oil exports are a good example of rules of origin that could be updated under this fifth package or within NAFTA 2.0. (See “Crude Oil Exports: Adopting the TPP’s Revised Rule of Origin for Diluent.”) NAFTA 2.0 would also be a good opportunity to seek further and more extensive reforms to the rules of origin, particularly with the goal of reducing the compliance burden put on SMEs across North America.

In a report by the Toronto-based C.D. Howe Institute, author Dan Ciuriak proposed a practical reform to the administration of rules of origin that could meet this goal.99More details on this reform can be found in Ciuriak, *Making Free Trade Deals Work for Small Business* ;also Ciuriak and Bienen, *Overcoming Low Preference Utilization in Preferential Trade Agreements* . The proposal calls for modifying the threshold above which businesses need a certificate of origin to comply with the NAFTA rules of origin and obtain preferential treatment.

Under existing rules, this threshold stands at US$1,000 worth of shipments.1010Global Affairs Canada, *North American Free Trade Agreement—Customs Procedures* . Under the proposed reform, the $1,000 threshold would be a cut-off point for the corresponding payable duties under standard most favoured nations (MFN) tariffs. The hypothetical $1,000 of payable duties would be used to determine the threshold above which a shipment must comply with the rules of origin to get NAFTA treatment. The lower the MFN tariff, the higher would be the shipment threshold under which no certificate of origin is required. In turn, this would make it easier for firms with small shipments crossing the borders to qualify for NAFTA preferential treatment. To illustrate this concept, let’s look at the following examples.1111Ciuriak, *Making Free Trade Deals Work for Small Business,* 8.

For an MFN tariff of 20 per cent, the threshold above which a certificate of origin would be required would be $5,000 (the shipment value corresponding to payable duties of $1,000). Similarly, for goods with an MFN duty rate of 5 per cent, only shipments above $20,000 would need a certificate of origin to get NAFTA treatment. And for MFN tariffs of 1 per cent, the shipment threshold would be $100,000.

Such a change in the exemption thresholds would be highly beneficial for many SMEs, since the value of their shipments is more likely to be small compared with those of larger firms. Also, it would allow them to benefit from preferential treatment without having to bear the costs of producing a certificate of origin. This could be a way for many SMEs to test the market for their products, before having to dedicate significant resources to comply with NAFTA requirements.

**Crude Oil Exports: Adopting the TPP’s Revised Rule of Origin for Diluent [title]**

Under NAFTA, crude oil shipments containing non-originating diluent11A diluent is a thinning agent used to facilitate the transportation of crude oil. cannot be exported duty-free due to the existing rules of origin. That makes them subject to tariffs that can be as high as 10.5¢ per barrel. To comply with this rule and ensure their crude oil exports enter the U.S. duty-free, Canadian crude oil producers need to produce a NAFTA certificate of origin that confirms that all the product’s constituents are from North America.

Aside from the associated compliance costs, this rule of origin is not much of a problem, because the North American market is well supplied with North American diluent.22Based on unpublished analysis and calculations made for this report by Carlos Murillo, The Conference Board of Canada’s energy sector expert. However, to remove unnecessary burdens, NAFTA 2.0 should adopt the rules of origin for crude oil exports that were negotiated in the TPP. These updated rules ignore the origin of the diluent found in crude oil exports, so long as the diluent accounts for no more than 40 per cent of the volume of the good.33See Government of Canada, “Chapter 27—Heading Note 3: Diluent Rule,” *Consolidated TPP Text–Annex 3-D–Product–Specific Rules of Origin* .

## Investor-State Dispute Settlement: Restoring Consistency and Predictability in Tribunal Decisions [L2]

Investor-state dispute settlement (ISDS) mechanisms are common in free trade agreements. They allow foreign investors to sue domestic governments and ask for financial compensation in cases where governments allegedly breach certain obligations under the free trade agreement. However, they have been highly criticized in recent years for being too favorable to private interests. To restore the public’s trust in these mechanisms, NAFTA’s Chapter 11 should be reviewed to clarify the applicable standards so that decisions from these tribunals are consistent and predictable and to ensure that unreasonable claims by foreign investors are dismissed.

Under NAFTA, investors and corporations have used the dispute settlement provisions found in Chapter 11 to challenge government measures and regulations considered incompatible with each country’s obligations. Since 1994, Canada, Mexico, and the U.S. have all been brought to investor-state tribunals. Only the U.S. has never lost a case.11UNCTAD, *Investment Dispute Settlement Navigator* . Nonetheless, the Trump Administration has indicated that ISDS will be one of the top priorities for the upcoming NAFTA. Newly appointed U.S. Secretary of Commerce Wilbur Ross described investment tribunals as “unaccountable” and giving “too much power to Mexico and Canada.”22Fife, ”Canada Given Advance Notice of Trump’s NAFTA Demands.”

Although it is unlikely the U.S. will seek the elimination of ISDS, each country has an interest in undertaking significant reforms to address its main issues. These include inconsistent jurisprudence, as well as foreign corporations’ abusive use of ISDS tribunals, which can undermine governments’ ability to adopt legitimate public policies.33For an overview of the global discussion on investment treaties, government policy space, and the “regulatory chill,” see Gaukrodger, *The Balance Between Investor Protection and the Right to Regulate* . Other international organizations have also looked at these issues from a development point of view. See, for instance, Chapter IV in UNCTAD, *Trade and Development Report, 2014* . To address these issues and restore the public’s trust in ISDS mechanisms, Canada should pursue the following in the upcoming renegotiation of NAFTA:

* Clarify the scope and meaning of key investment principles and concepts.
* Review the constitution of ISDS tribunals, based on CETA.

## Clarifying the Scope and Meaning of Key Investment Principles and Concepts

Over the past two decades, key concepts and principles found in free trade agreements’ investment chapters have been interpreted differently by tribunals, leading to inconsistent jurisprudence and an unpredictability of dispute outcomes. In turn, unpredictable dispute outcomes have led to the multiplication of claims brought to ISDS tribunals, as firms see a chance to win their cases, or at least be able to negotiate financial compensations.

With the multiplication of claims, Canada has become the most sued country by foreign investors under NAFTA Chapter 11 and the sixth worldwide, according to UNCTAD.11Sinclair, *NAFTA Chapter 11 Investor–State Disputes* .,22UNCTAD, *Investment Dispute Settlement Navigator—Filter by Country* . Those disputes lead to costs for Canada for the proceedings of each case and for the damages paid to foreign investors when tribunals find the government did breach its obligations under NAFTA. Since 1994, a total of 40 claims have been made against the government of Canada. Out of those, the Government of Canada had to pay damages (or settlements) in only six cases, for a total of just over $185 million (compared with $1.8 billion in damages claimed by the investors). 33Canada has paid a total of $54 million in damages and at least $130 million in settlements, based on publicly available information. See Global Affairs Canada, *NAFTA—Chapter 11—Investment* . Of the 34 remaining claims, nearly half are now inactive or have been withdrawn by investors.

Clarifying the scope and meaning of key investment principles and concepts could thus improve predictability in dispute settlement and avoid unreasonable claims made by foreign investors. In particular, within the NAFTA 2.0 negotiations, countries should agree on the meaning of the “fair and equitable treatment” standard. At the moment, the interpretation of this standard can be subjective and divergent, depending on the wording of the agreement, negotiation history, and context.44OECD, ”Fair and Equitable Treatment.” In fact, there has been jurisprudential divergence about the practical meaning of this minimum standard of treatment and how to establish whether there is a breach of this standard or not. In addition, further clarity should be sought on which government actions, laws, regulations, or other measures can be considered as “indirect” or “creeping” expropriation and under which conditions compensation can be claimed. In that respect, as in the TPP, interpretation guidelines on expropriation and compensation provisions could be added to the investment chapter.55See Annex 9-B in the TPP; Cortes, *Indirect Expropriation Under the TPP* .

**Reviewing the Constitution of ISDS Tribunals, Based on CETA [L2]**

To address the issues of unpredictability and inconsistency in ISDS rulings, Canada and the EU agreed to change the traditional rules11The traditional approach consists of each dispute being settled by three panelists, one appointed by the responding government, one by the complaining investor, and the third one by agreement of the two disputing parties or by arbitrators. The CETA approach gives no appointment role to the complaining investor. on tribunals and their constitution in favour of a “roster” approach.22The Canadian Bar Association, “CETA’s New Dispute Settlement Court.” Under CETA, the tribunal will have 15 members (five Canadians, five Europeans, and five third-country nationals) who will be appointed for a five-year term, renewable once. In turn, each dispute will be ruled by a panel composed of three of these appointed public international law experts (one Canadian, one European, and one third-party national), and each will be chosen randomly.

Canada and the EU have also agreed to create a permanent Appellate Tribunal to revise the tribunal’s decisions. If adopted under NAFTA 2.0, this new approach would improve arbitrators’ legitimacy, as they would no longer be appointed by foreign investors but by democratically elected governments. It would also considerably improve the predictability of dispute outcomes, since a permanent Appellate Tribunal would ensure more consistent and coherent decisions by arbitrators.

Combined, clearer definitions and investment principles; long-standing and publicly appointed tribunal members; and a permanent Appellate Tribunal would help avoid situations in which foreign corporations use ISDS tribunals to make unreasonable claims and challenge legitimate regulations.

## Labour Rights and Environmental Protection: Raising the Standard [L2]

NAFTA was the first trade agreement to address labour and environmental issues at all. Since then, Canada, the United States, and Mexico have included labour standards and environmental protection in agreements that they have signed with other countries. In a renegotiated NAFTA, the labour and environmental agreements should be updated, based on these more recent trade deals, and incorporated into the main agreement.

The North American Agreement on Labour Cooperation (NAALC) and the North American Agreement on Environmental Cooperation (NAAEC) are the specific side agreements to NAFTA. The Wilson Centre has described these side agreements as “essentially toothless” and argues for incorporating the side agreement on labour into the main agreement, while increasing enforcement mechanisms for both.

NAALC calls for each of the three countries to ensure that it enforces its own labour laws. However, NAFTA countries cannot enforce labour laws on others’ territories, and enforcement is limited to a panel report and development of an action plan to resolve violations. The discrepancy in labour standards among the three NAFTA partners is one of the most common critiques made by opponents in both Canada and the United States.

More recent international agreements offer a model for strengthening labour and environmental standards. By most analyses, the TPP has the most ambitious labour provisions among recent free trade agreements because it requires that all member countries abide by the International Labor Organization Declaration on Fundamental Principles and Rights at Work. Canada has signed agreements on labour cooperation as part of its trade agreements with Chile, Costa Rica, Peru, Colombia, Jordan, Panama, and Honduras, and labour chapters are included in the agreements with the Republic of Korea and the EU. The U.S.–Colombia Trade Promotion Agreement of 2012 is another recent agreement for which workers’ rights were part of the negotiation. Colombia had to strengthen its labour laws before the U.S. would consider the treaty.

As with labour, the TPP negotiations produced a higher standard for environmental commitments than exists in NAFTA. TPP signatories are required to maintain current environmental laws and protect endangered species, based on existing commitments. TPP is the first trade agreement in history that addresses illegal, unregulated, and unreported fishing. Enforcement of violations would be conducted through the same dispute settlement provisions as the rest of TPP.

The Trump administration’s initial approach to environmental issues, as seen in its key appointments and early executive orders, raises doubts about its intentions regarding continent-wide environmental challenges, including climate change. Finding common ground is thus likely to be difficult, and NAFTA renegotiations are probably not the best venue for broader environmental discussions.

However, energy is one interest that is shared by all three NAFTA countries, and energy production and consumption account for two-thirds of global greenhouse gas emissions. The NAAEC side agreement created the Commission for Environmental Cooperation, which offers a forum for all three parties to collaborate on climate change issues. The Washington-based Wilson Center notes that the all three countries’ shared energy interests have already driven cooperation on environmental and climate issues. Last year, Mexico joined existing agreements between Canada and the U.S. to reduce methane emissions. Furthermore, Mexico launched a new environmental regulatory agency in 2015 that has enhanced contact with its U.S. and Canadian counterpart organizations.

## Energy Sector: Removing the Proportionality Clause [L2]

Energy commodities (including oil, natural gas, coal, electricity, and refined petroleum products) are a significant component of Canada’s trade, accounting for one-fifth of Canada’s total exports in 2016, with nearly all of them going to the United States. Despite their importance, energy had relatively light treatment in the original NAFTA, with the “proportionality clause” and exemptions related to Mexico’s energy sector being the most substantive elements. However, given that some of these provisions are outdated and the importance of energy policy in addressing climate change, the opportunity to renegotiate NAFTA is timely.

The existing agreement was driven by the principles of self-determination (i.e., respect for the signatories’ constitutions) and the gradual liberalization of energy markets. NAFTA also recognizes the importance of having viable and internationally competitive energy sectors to advance the signatories’ national interests. These are principles that should continue to be the at the centre of North American energy trade and investment. But there are several potential areas for improvement.

NAFTA currently contains a proportionality clause, which stipulates that Canadian energy exports must maintain a consistent export/supply ratio, as determined by a moving average of this ratio over the most recent 36-month period.33See Article 605 of NAFTA in NAFTA Secretariat, *Chapter Six: Energy and Basic Petrochemicals* . The proportionality clause is only applicable to trade between Canada and the United States. Mexico does not have a similar requirement in NAFTA. Ever since its inception in the Canada–U.S. Free Trade Agreement, the implications of this clause have been widely debated in the context of Canadian energy policy and trade.

Critics of the clause have argued that it may push us to a point where we are unable to meet our own energy needs.44Laxer and Dillon, *Over a Barrel* . Another concern is that it could impede Canada’s transition to a lower-carbon economy by locking us into meeting U.S. energy needs.55Laxer, ”NAFTA and Proportionality: A Devil’s Bargain”. And, some believe the clause was imposed to ensure unlimited U.S. access to Canadian energy.66Laxer, ”If We’re Renegotiating NAFTA, Let’s Be Ready.”

A more sober and grounded look at the clause suggests that these claims are overblown and unfounded. The clause is likely to have been introduced to restrict the Canadian government’s ability to arbitrarily and unilaterally curtail energy supplies to the U.S., as was the case under Canada’s National Energy Program in the 1980s.77Holden, *Canadian Oil Exports to the United States Under NAFTA* . As well, the proportionality clause applies to both Canada and the U.S.—that is, it does not apply in only one direction. As such, Canadian energy consumers and end-users may benefit from the clause just as much as their U.S. counterparts.

There is little evidence that the proportionality clause has had an impact on North American energy trade and investments to date. When taken in concert with many of the challenges and changes that the sector is expected to face in the coming years, it is not clear what value the proportionality clause has provided in the past or could in the future. As such, there is little reason for it to be part of NAFTA 2.0.

## Conclusion [L2]

The renegotiation of the North American Free Trade Agreement seems inevitable, with formal talks expected to begin in the second half of 2017. NAFTA has been responsible for reshaping much of the Canadian economy since it took effect, and the outcome of the negotiations will affect the prosperity of all Canadians for decades to come.

While this report is comprehensive and covers a broad range of issues related to NAFTA, it could not cover every possible item that might come up during what are likely to be extensive and lengthy negotiations. Issues that we did not cover include Canada’s low duty-free thresholds for international shipments (also known as “de minimis”), restrictions on foreign direct investment and ownership in protected sectors such as telecommunications and air transportation, and technical barriers to trade. Furthermore, the report does not examine the current political or diplomatic relationships among the three countries, nor does it address negotiating tactics that Canada could employ to best advance its interests.

Canada should expect these negotiations to be unlike any other that we have undertaken in recent decades. Since the 1980s, Canada has reached trade deals with the U.S., including the Canada–U.S. Free Trade Agreement, NAFTA, and the Trans-Pacific Partnership. In every case, the U.S. has consistently driven a hard bargain—with Canada and with all its other trading partners. However, there is a notable difference in the upcoming negotiations. While previous administrations arrived at the negotiating table with the goal of achieving agreement, it is unclear whether this is the preferred outcome for the current administration.

Nevertheless, Canada should arrive at the negotiations with a clear philosophy and strategy to build on the benefits of NAFTA and enhance it wherever possible.

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