

The Fate of NAFTA: Possible Scenarios and their Implications for Canada

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Executive Summary

The United States, Canada, and Mexico are scheduled to commence negotiations on the North American Free Trade Agreement (NAFTA) in mid-August 2017. While many observers believe that the negotiations will be “successful,” in that the Agreement will continue in some amended form, the recently announced US goals, as set out in a report by the US Trade Representative’s Office, suggest that both Canada and Mexico will face difficult political challenges if they accede to US negotiating objectives.

For the Canadian government, a number of negotiating objectives pose political challenges. Most notably, the US goal of unrestricted access to Canada’s domestic agricultural markets represents a direct threat to Canada’s dairy (and other) supply management programs. The US demand for Canada to allow entry of US firms in all sectors would require that Canada eliminate foreign investment restrictions in banking, telecommunications, and a number of cultural industries, among others. The US call for Canada to adopt US intellectual property protections would require the Canadian government to strengthen legal protections enjoyed by foreign manufacturers of branded pharmaceuticals, while the US government’s desire for unrestricted cross-border flows of digital information will, over time, threaten Canadian broadcasting regulations that directly and indirectly promote the production and distribution of Canadian entertainment programming.

While these various consequences can all be argued to be in Canada’s long-run economic interests, they might prove too politically contentious for Canada to accept, especially if Canadian negotiators fail to gain concessions from the US that are important to Canada. These include a robust dispute resolution mechanism with clear limitations on the ability of the US Administration to take trade actions against Canadian exporters.

In short, there is a reasonable prospect of NAFTA’s demise, and it is therefore important to think about the potential consequences of this development. This report addresses the trade governance consequences of NAFTA’s demise. It also offers some observations about the potential consequences for the Canadian economy in the event of NAFTA’s demise.

Our report notes that the two governments never formally ended the Canada-US Free Trade Agreement (FTA), which went into effect in 1989. Hence, a reasonable premise is that if NAFTA is disbanded, the FTA will “snap back” as the legal structure governing Canada-US trade and investment relations. However, if the US Administration is unhappy with Canada’s negotiating position at the upcoming NAFTA meeting, it will not be happy with a fallback to the FTA, especially since the FTA does not address the concerns recently expressed by the US Trade Representative. As such, the US Administration will undoubtedly either withdraw from the FTA or call for a renegotiation of that Agreement. Moreover, if the Canadian government found US demands at the NAFTA negotiations to be politically unacceptable, it will be even more difficult politically for Canada to agree to the demands in a purely bilateral negotiation without its Mexican partner also making obvious concessions.

If the FTA were not the governance structure for bilateral economic relations, those relations would be governed by the rules of the World Trade Organization (WTO). On the surface, there would not be a dramatic change in the governance structure, since the FTA (and NAFTA, for that matter) incorporate the major principles of the WTO including national treatment, rights-of-establishment, and transparency. Furthermore, the average most-favoured nation Canadian and US tariff rates for most commodities are relatively low, although there would certainly be substantial tariff increases for specific commodities including in the important transportation equipment sector. As well, while the WTO has a dispute resolution process, many would argue that it is weaker (from Canada’s perspective) than the admittedly problematical dispute resolution process under NAFTA.

The inference one can draw is that there will be increased barriers to Canada-US trade under the WTO compared to either the FTA or the NAFTA. Empirical evidence suggests that the trade liberalization measures under the FTA increased bilateral trade and promoted efficiency gains in Canadian industries that experienced the largest decreases in trade protection, although the magnitudes of these FTA-related changes are uncertain. Indeed, some economists argue that the magnitudes are relatively small when other factors influencing bilateral trade are taken into account, such as the Canada-US exchange rate.

Against this background, one might conclude that a reversion to the WTO as the governance regime for Canada-US economic relations would have only modest impacts on the Canadian economy, especially if Mexico did not conclude a successful bilateral agreement with the US. This conclusion is strengthened by the observation that Canada can and should continue to work towards liberalizing trade with its other trade partners,

including those in the relatively fast-growing Pacific Rim. Nevertheless, a successfully renegotiated NAFTA is more economically advantageous for Canada than a reversion to the WTO regime or than two separate US bilateral agreements with its NAFTA partners.

Even though domestic trade and investment liberalization may hurt specific Canadian producers, such liberalization is in the long-run economic interests of Canada as a whole. Furthermore, some of the US demands, such as the call to reduce trade barriers related to differences in regulations and for expedited customs procedures, would unequivocally improve the bilateral trade environment. However, if NAFTA cannot be successfully renegotiated, it would not be economic Armageddon for Canada.

Introduction

Prior to his election, Donald Trump excoriated the North American Free Trade Agreement (NAFTA) as the worst trade deal the US ever signed (Gandel, 2016). Subsequently, he has threatened to withdraw the United States from NAFTA, although that threat has been interspersed with expressions of willingness to renegotiate NAFTA, which is, at the time of writing, his latest public position (Hjelmgaard, 2017).¹ Indeed, in June 2017, the newly appointed US trade representative, Robert Lighthizer, wrote to Congressional leaders in both the House of Representatives and the Senate to give official notice that President Trump will initiate negotiations regarding changes to NAFTA. Formal talks will begin when the US completes legislatively required congressional consultations in mid-August 2017 (Pascual 2017).

The consensus opinion is that the US is very unlikely to withdraw from NAFTA given the deep economic ties that have been established between the United States, Canada, and Mexico under the Agreement (Kronby and Barutciski, 2017). Rather, it is seen as being more likely that the US will use the threat of withdrawal to renegotiate aspects of NAFTA that it does not like.

Regardless of President Trump's stated willingness to renegotiate NAFTA, there is a real possibility that the concessions and changes that the United States will demand will be unacceptable to Canada and/or Mexico. Conversely, the United States Administration might be unwilling to make changes that compensate either Canada or Mexico for modifications that the United States demands. While the Canadian government has clearly expressed a strong desire to resolve US grievances with NAFTA (Rouselle, 2017), and while both the Mexican and Canadian governments have expressed a preference for a new trilateral agreement, serious thought must be given to the implications for the Canadian economy if the discord surrounding NAFTA results in the dissolution of that trade treaty and, particularly from Canada's perspective, if the United States withdraws from a regional free trade arrangement.

¹ On May 18, 2017, the Trump Administration wrote Congress, officially triggering the 90-day consultation period required before renegotiation of NAFTA with Canada and Mexico can begin (McGregor, 2017).

The purpose of this paper is to offer some perspective on the issues surrounding the NAFTA negotiations and the implications for the Canadian economy if NAFTA is terminated. This is not to say that the demise of the trilateral trade regime is necessarily the most likely outcome of the upcoming NAFTA negotiations. It is certainly possible that the negotiating parties will agree to a revised NAFTA. However, the negotiation environment is a difficult one, and there is a significant possibility that NAFTA will not be successfully renegotiated. In this context, it is important for Canadians to understand the implications of what might be considered the “worst case scenario” of the upcoming negotiations. Furthermore, there is a substantial possibility that there will be enough differences in the conditions surrounding Canada-US trade relations and Mexico-US trade relations that even a resulting trilateral agreement would be more realistically viewed as separate bilateral agreements. In this case, the North American trading environment would look substantially different from today’s environment, even if a new trilateral agreement were renegotiated.

In brief, this paper focuses on several key issues surrounding the upcoming NAFTA negotiations. The first is the main points of contention that are likely to arise insofar as bargaining between Canada and the United States is concerned. A second is to set out the various potential trade and investment governance scenarios that Canada would face given the dissolution of NAFTA. The third is to assess in broad terms the implications for the Canadian economy if the US-Canada trade and investment environment were governed neither by NAFTA nor by the prior Canada-US Free Trade Agreement (FTA). Several factors are relevant to this evaluation. First, what rules, if any, would govern the trade and investment relationships between Canada and the United States in the absence of a trade agreement between the two countries—through either a trilateral or a separate bilateral agreement? Second, how would the new relevant rules differ from those provided by NAFTA or the FTA? Third, how would economic relations between Canada and its largest trade and investment partner, the United States, be affected by the relevant changes in the rules governing their economic integration? Finally, what would be the implications of the resulting changes for the Canadian economy? This is clearly an ambitious set of issues to address. Given the uncertainties surrounding the upcoming NAFTA negotiations, as well as the necessarily speculative nature of the ensuing developments following the dissolution of NAFTA, the analysis in this paper is meant to be suggestive rather than definitive. That is to say, the paper is aimed at stimulating thinking about possible scenarios facing Canada’s economy if the current North American legal trade regime changes in significant ways.

The Bargaining Environment Around NAFTA

The June 2017 letter that the US Trade Representative sent to Congress was followed on July 17, 2017, by a report from the Office of the United States Trade Representative that outlines the Trump Administration's objectives for the NAFTA renegotiation (Office of the United States Trade Representative, 2017). It should be noted that the objectives outlined in the report represent the Trump Administration's initial set of demands. The US Congress will also weigh in on the negotiation process and will likely have a voice in the ultimate set of US bargaining positions (Sands, 2017). Nevertheless, the Trade Representative's report fleshes out earlier complaints and concerns raised by the Trump Administration and sets out the initial US negotiation agenda.

Before reviewing the objectives set out in the report, it is important to note what was not in the report. In particular, there is no direct reference to what is arguably the most pressing current bilateral trade issue, namely, the renewed US import tariffs against Canadian softwood lumber exports. Whereas the Canadian government might have been willing to renew the recently expired Softwood Lumber Agreement between the two countries, the US government clearly was not. Hence, any settlement of the softwood lumber dispute through a new trade agreement might require Canada to make substantial changes to the legal regime surrounding its lumber industry.² In particular, it might oblige the government of British Columbia to remove legal limitations on the export of raw logs and/or the privatization of provincial government timberland. If one or both changes were made, US lumber producers, in principle, would have access to logs at the “factory gate” price on the same terms as Canadian producers. From an economist's perspective, restrictions on log exports are inefficient. If US mills outbid Canadian mills for raw logs, it is presumably because the former can create more market value from processing the

² The US Administration has also raised concerns about other Canadian exports such as steel and aluminum, which might also be subjected to import duties.

logs than can the latter. In this case, allowing raw log exports will result in higher prices for logs, which would create more wealth for the citizens of British Columbia. However, raw log exports would presumably hurt the profits of Canadian sawmills by raising the price of a key input. It might also put downward pressure on wages and employment levels in the province's wood products industry. The latter developments would make such changes politically difficult for the provincial government, particularly given the minority status of the ruling provincial government.

Turning to the Trade Representative's report, an anticipated US demand is a call for reducing or eliminating tariffs and non-tariff barriers on US agricultural goods. This would presumably encompass the elimination (or substantially weakening) of Canada's dairy supply management system, which President Trump recently called "a disgrace" (Globerman, 2017). While Canadian consumers would enjoy substantial increases in their real incomes by being able to buy dairy products at world prices, the government of Canada would face tremendous political pressure from dairy farmers and their lobbyists.³ As in the case of export bans on raw logs, satisfying a US demand to dismantle Canada's dairy support program would actually be efficiency enhancing for the Canadian economy. However, the fierce political conflict it would create given the substantial wealth losses it would impose on Canadian (mainly Quebec) dairy farmers makes it questionable whether the Canadian government would accede to the demand, even at the risk of jeopardizing a successful renegotiation of NAFTA. It is worth noting in this regard that the Canadian government would likely face similar demands to liberalize trade in agricultural products as part of any Pacific Rim trade negotiation in which it participated. However, it might be politically more feasible for the Canadian government to eliminate tariffs on dairy and other food products as part of a multilateral trade agreement, as opposed to a bilateral agreement with the US, or even as part of the NAFTA renegotiations. Indeed, this claim might be made about other potential changes to Canada's trade regime.

Other US objectives outlined in the report might also lead to the improved efficiency of the Canadian economy were they to be implemented. For example, the report calls for Canada and Mexico to impose standards of protection for intellectual property rights similar to those found in US law. This demand might oblige Canada to make changes to its patent legislation, particularly as it applies to pharmaceutical products. A recent decision by the Canadian Supreme Court overturning the "promise doctrine" as a test of patent utility removed one likely US objection to

³ Supply management also exists for eggs, chicken, and turkey. It has been estimated that Canadian families pay about 40 percent more for dairy products than they would in a free market (see Gunter, 2017).

Canada's patent policies. However, others remain, including the length of time Canada allows for exclusive use of data from drug testing. Lybecker (2016) argues that strengthening patent protection for small and especially large molecule branded pharmaceuticals is in Canada's national interest. However, Canadian manufacturers of generic drugs will strongly oppose any such initiative, as will consumer groups representing large users of prescription drugs, such as seniors.

The US Trade Representative's report also indirectly addresses Canadian foreign ownership restrictions affecting telecommunications and "culture" industries, as well as Canadian broadcasting regulations favouring Canadian produced entertainment content. Specifically, it calls for reducing or eliminating barriers to US investment in all sectors in NAFTA countries. This presumably includes eliminating restrictions on US direct investments in Canadian cultural industries. It also calls for promoting the competitive supply of telecommunications services by facilitating market entry. This directly opposes Canadian regulatory restrictions on foreign takeovers of Canadian telecommunications carriers. As well, given the convergence between telephone carriers and cable companies as distributors of entertainment and information content, this US objective is also indirectly at odds with Canadian government restrictions on foreign ownership of broadcasting entities.

US objectives to ensure non-discriminatory treatment of digital products transmitted electronically across borders and to allow unrestricted cross border data flows also indirectly threaten Canadian regulatory policies that give preference to Canadian content in broadcasting. As more and more entertainment programming is distributed over the Internet, non-discriminatory and unrestricted access by Canadians to US-originated data effectively limits the ability of the Canadian regulator to mandate preferential access to Canadian programming, as it is delivered by broadcast distributors.

Globerman (2014) has argued that the broad policy of the Canadian government to protect and subsidize Canadian producers and distributors of entertainment programming is inefficient and increasingly unfeasible, particularly as the Internet plays a more important role as a distribution medium. Nevertheless, Canadian cultural nationalists continue to be an extremely vocal and arguably very effective lobby group. As such, concessions to the US that can be portrayed as "weakening" Canadian culture might be politically difficult for Canadian negotiators to accept.

Other issues raised in the Trade Representative's report have implications for both Mexico and Canada. For example, US Commerce Secretary Wilbur Ross hinted prior to the issuance of the report that US-initiated claims of illegal trade subsidies and dumping of products be

heard by US courts, rather than by NAFTA trade tribunals. In this regard, the report calls for the elimination of the Chapter 19 dispute settlement mechanism. This demand would be problematic for both US NAFTA partners, especially for Canada, which made strong demands for a dispute resolution process in the FTA negotiations. However, the fact that trade disputes could still presumably be brought to the World Trade Organization (WTO) might keep this U.S. demand from being a negotiation deal-breaker. Also, and somewhat confusingly, the report encourages the early identification and settlement of disputes through consultation and other mechanisms and even mentions panel determinations as part of a dispute settlement mechanism.

Potentially problematic, albeit perhaps more so for Mexico than for Canada, is a US call to update and strengthen rules-of-origin in order to promote the increased use of US-made parts, particularly in auto production. While the US Administration stopped short of demanding quotas for US-made inputs, including in the auto sector, the stated overriding objective of the US government to reduce trade deficits with NAFTA countries hints at the possibility that implicit quota targets will be set, especially if Mexico's large trade surplus in automobiles and parts does not decrease over time. The ability of the US to enforce implicit trade quotas would be facilitated by the goal stated in the report to eliminate the exemption that Canada and Mexico enjoy under NAFTA from US safeguard actions against imported goods. Safeguards are global restrictions that apply when US industries are being injured by an unexpected flood of imports that are neither dumped nor subsidized.

Also likely more problematic for Mexico than for Canada is the US Administration's call to bring the environmental and labour side agreements in the current NAFTA into the core of a new NAFTA Agreement. Mexico might see the call for strong and enforceable environmental regulations and labour provisions as an indirect initiative to increase domestic costs of production, at the same time as it mitigates expected objections by Canadian environmental and social justice organizations to a renewed free trade agreement.

While this summary of the stated US objectives for the NAFTA renegotiation is incomplete, it does highlight a number of bargaining issues that raise a realistic possibility of the renegotiation being unsuccessful.

Developments that are not directly related to the upcoming negotiations might also contribute to the dissolution of NAFTA. For example, aggressive actions by the Trump Administration to deport Mexican nationals "illegally" in the United States, along with actual initiatives to build a wall between the US and Mexico might sour the trade negotiation atmosphere such that compromise on controversial points is impossible. This is espe-

cially relevant if the negotiations carry through to the next federal election in Mexico when there is a good chance that a leading anti-US candidate will be elected as the country's president. In combination with some of the troubling demands that both Canada and Mexico will face from US negotiators, it is certainly plausible that the upcoming negotiations to reform NAFTA will be unsuccessful. The question then becomes: what happens if NAFTA is dissolved? The next section outlines possible scenarios.

Before moving on to consider possible scenarios, we note that the dissolution of NAFTA could be prolonged and messy. NAFTA was negotiated by the United States as a "congressional-executive agreement" under which Congress first authorized the talks, the executive branch conducted the negotiations, and the signed agreement was implemented by statutes granting executive branch agencies authority to adjust hundreds of regulations and procedures to give effect to US commitments conducted under normal rule-making procedures. If the Trump Administration triggers US withdrawal from NAFTA, the existing statutes would remain in effect, as would rules and regulatory changes adopted under statutory authority (Smith, Shedd, and Murrill, 2013). Congress could begin repealing its prior statutes, and agencies could alter NAFTA-prompted changes to rules and procedures, but such changes would also need to be undertaken through formal rule-making. As a result, the end of NAFTA could materialize in piecemeal fashion and over an extended period. While the drawn-out process could certainly condition the consequences of NAFTA's demise for Canada and its North American partners, we proceed with our analysis assuming simply that NAFTA ends at some specific date.

Scenarios for a Changing Trade and Investment Regime

Figure 1 summarizes the potential governance alternatives in the event of the dissolution of NAFTA. The first scenario identified follows from the fact that the Canada-US Free Trade Agreement (FTA), which came into existence in 1989, was never terminated with the implementation of NAFTA in 1994; it was merely suspended for so long as the NAFTA was in force between Canada and the United States (Kronby and Barutciski, 2017). Further, NAFTA amended the FTA implementing legislation to supersede certain of its provisions while continuing other provisions. Since NAFTA only supersedes but does not replace the FTA, there is an argument that if the US were to withdraw from NAFTA, the FTA would “snap back” into force. In this case, the FTA would legally govern the bilateral trade and investment environment. However, it is not clear if some sort of affirmative action would be required from the US Congress to authorize an FTA snap-back. Scenario 1 assumes that the FTA replaces the NAFTA insofar as the Canada-US trade regime is concerned. Subsets of this scenario allow for the US and Mexico to form a separate bilateral trade agreement, as well as for Canada and Mexico to form a separate bilateral agreement.

Scenario 2 assumes that the US and Canada will renegotiate the FTA rather than have the original FTA snap back. Evaluating this scenario requires some speculation about what a new FTA might look like compared to the original FTA. Our view is that if the US cannot resolve its grievances with Canada through a renegotiation of NAFTA, it is unrealistic to believe that the US government would be happy with a return to the original FTA regime. It is more plausible to argue that the US government would insist on a renegotiation of the FTA or it would ultimately withdraw from that agreement as well. However, if the US keeps its list of demands that it is likely to bring to NAFTA, and brings them to any renegotiation of the FTA, it might prove even more difficult for the Canadian government to accede to those demands, as discussed earlier.

There are, again, several subsets of scenario 2. In one subset, Mexico has no separate bilateral free trade agreement with either Canada or the

Figure 1: Scenarios if NAFTA is Disbanded

Scenario 1: Fall back to Canada-US Free Trade Agreement

- 1(A) No Mexico agreement with either the US or Canada
- 1(B) US + Mexico free trade agreement
- 1(C) US + Mexico free trade agreement and/or
Canada + Mexico free trade agreement

Scenario 2: A new Canada-US Free Trade Agreement

- 2(A) No separate Mexico-U.S agreement
No separate Mexico-Canada agreement
- 2(B) US + Mexico agreement
- 2(C) US + Mexico agreement and/or
Canada + Mexico agreement

Scenario 3: Fall back to WTO

- 3(A) No Mexico +US or
Mexico +Canada agreement
- 3(B) US + Mexico agreement
- 3(C) US + Mexico agreement and/or
Canada + Mexico agreement

US. In other subsets, Mexico signs a bilateral agreement with the US, but not with Canada, or it signs separate bilateral agreements with both of its North American partners.

Given that we do not believe that the US Administration would simply accept an automatic snap-back of the FTA, we consider scenario 2 more likely than scenario 1. However, for reasons discussed above, a failure to renegotiate NAFTA diminishes the likelihood that either Canada or Mexico will succeed in negotiating a new bilateral trade agreement with the US. In this circumstance, Canada might or might not negotiate a separate bilateral deal with Mexico, but there would be little pressing economic reason to do so, especially given Canada's priorities to implement its free trade agreement with Europe and to commence trade negotiations with China and possibly other Pacific Rim partners.

Therefore, assuming that the US and Canada could not successfully negotiate a new FTA, the rules governing the bilateral trade relationship

would presumably be those of the World Trade Organization (WTO), which constitutes the third scenario. There are, again, subsets of this third scenario. In one subset, Mexico has no separate bilateral agreements with either of its North American partners, in which case Mexico's trade regime with Canada and the US would also be governed by WTO rules. Alternatively, Mexico might successfully conclude its own bilateral agreement with the US and/or with Canada. A US-Mexico bilateral agreement seems unlikely in the event of NAFTA's demise, while, as noted above, a separate Canada-Mexico agreement might be a symbolic but not an economic priority for the two governments. In the event, if North American trade were governed by WTO rules, it seems to us unlikely that there would be separate bilateral agreements qualifying that scenario. If NAFTA and separate Canada-US bilateral negotiations failed, it would probably signal profound divergences in the trade priorities of the various North American governments.

A fourth possible scenario not identified in figure 1 is for the US to withdraw from the WTO. This would truly be a "doomsday" option for the Trump Administration. While that administration has strongly indicated its preference for bilateral trade deals and antagonism for multilateral trade agreements, it is hard to imagine even the most ardent economic nationalists within the administration, including President Trump, supporting such a drastic step as withdrawing the United States from its global commitments. We therefore do not consider the implications of a US withdrawal from the WTO. Suffice it to say, were this to happen, there would be profoundly damaging economic consequences for Canada and other WTO member economies.

Since scenario 3 is at least a plausible development, and in some sense the "worst" possible outcome of future trade North American trade negotiations, it is relevant to consider the implications for Canada if there was a fallback to WTO rules. In order to do so, it is useful to consider first what the demise of NAFTA would mean for Canada—assuming that the FTA would snap back—and then to consider the implications for Canada if the FTA itself were dissolved and bilateral trade governance reverted to WTO rules.

The next section identifies the main differences that NAFTA has made to Canada's legal trade and investment environment with the FTA as the counter-factual background for this discussion. It then discusses the economic impacts on the Canadian economy of the differences identified between NAFTA and the FTA.

The North American Free Trade Agreement

We first consider how the implementation of NAFTA changed the legal environment surrounding the Canada-US relationship. As far as Canada is concerned, NAFTA represents a marginal direct change to the bilateral legal trade regime established under the FTA (Hufbauer and Schott, 1993). In particular, for the most economically important bilateral trade sector, automobiles and parts, NAFTA reduced uncertainty for producers surrounding whether particular direct costs would be challenged under the rules-of-origin governing the auto sector. NAFTA also reduced the amount of flexibility provided to customs officials in the determination of the eligibility of a particular product to be transported duty free across the borders of the participating countries (Globerman and Walker, 1993). At the same time, the 50 percent rule-of-origin for the auto sector under the FTA was raised to 62.5 percent.⁴ Furthermore, the auto sector continued to be governed by a complex array of rules and regulations regarding the regional content of automobiles.⁵

In the case of textiles and apparel, the FTA required specific manufacturing processes to take place in the free trade area for goods to qualify for tariff-free trade, although exceptions were allowed. NAFTA continued the FTA's basic rules-of-origin, although the NAFTA rules were seen by Canadian manufacturers as being even more complex and protectionist than those of the FTA (Barry and Siwecki, 1993). NAFTA left the agricultural provisions of the FTA in place, while providing for separate bilateral agreements between the US and Mexico and between Canada and Mexico.

With respect to financial services, NAFTA was structured according to general principles with appropriate provisions for the right of establishment and national treatment. Chant (1993) has noted that nothing in *de jure* national treatment guarantees that foreign institutions will not be

⁴ For another discussion of how NAFTA has directly amended the North American trade regime for Canada, see Waverman (1993).

⁵ Note that the Auto Pact between Canada and the US that was implemented in 1965 was terminated in 2001 in response to a case brought by Japan and the European Commission against Canada at the WTO.

harmed by seemingly equal legal treatments that effectively limit them because of their different circumstances. In this regard, NAFTA took a more comprehensive attitude towards national treatment than did the FTA in that it required “competitive national treatment,” i.e., that the differential impact of the law on domestic and foreign institutions does not place foreign institutions at a disadvantage in their ability to compete. As well, NAFTA extended to the financial sector provisions for dispute settlement mechanisms, which were not available under the FTA.

The bilateral legal environment for the energy sector was left relatively unchanged by NAFTA in comparison to the FTA. One change was that Canada was given protection of the right to export energy into the US market subject only to national security restrictions. However, the practical relevance of this change was called into question by, among other things, regulatory restrictions that the Obama Administration placed on the construction of the Keystone Pipeline, which was meant to carry oil from Alberta’s oil sands plants to US refineries. The Obama Administration took this action ostensibly for reasons of environmental protection, although the Canadian company involved sued the US government for violation of the NAFTA investor protections. In any case, the Trump Administration reversed the Obama Administration restriction, while imposing side conditions, particularly the use of US-made steel that would have scuttled, if not terminated progress on the construction of the pipeline. Trump ultimately excluded Keystone from his “made in USA” pipe requirement once he learned that Trans Canada had already acquired the pipe it was going to use.

The Keystone Pipeline and ongoing softwood lumber disputes highlight the relevance of dispute resolution procedures in the FTA and NAFTA. At least one author (Winham, 1993) has noted that unprecedented arrangements were included in the FTA for the review, by bi-national, objective panels, of decisions taken by domestic government agencies including anti-dumping and countervail actions. Under the FTA, these provisions were temporary expedients with a maximum life of seven years. NAFTA made bi-national dispute panels a permanent feature. Hence, depending upon one’s assessment of how the dispute resolution process has worked out for Canada under the NAFTA, it potentially represents a significant distinction between NAFTA and the FTA.

Gagne (2000) offers an assessment of the dispute resolution process under NAFTA (and the FTA) from Canada’s perspective. His broad conclusion is that while the dispute resolution provisions made permanent under NAFTA have enhanced Canadian access to the US market, they have not made for secure access. The evidence he cites is the fact that a greater percentage of Canadian appeals of US anti-dumping and counter-

vailing duty decisions before bi-national panels have been successful compared to decisions affecting non-NAFTA countries in decisions made by US tribunals. Furthermore, particularly since NAFTA's inception, there has also been a reduction of trade remedy instances pursued by the US against Canadian exports.

Notwithstanding some positive evidence of this sort, Gagne concludes, overall, that the panel process has had a mixed record. He also notes that the workings and impacts of the panel process over the period he reviews may have been relatively favourable in part because economic conditions in the US were relatively good over that time. Certainly, recent trade actions and complaints on the part of the US, outlined earlier, support Gagne's caveat. As noted above, the US will ostensibly demand that all US-initiated trade disputes, including those involving Canada, be decided by US courts as part of any NAFTA renegotiation. While the establishment of trade dispute panels was a high priority for Canadian negotiators during the FTA negotiations, the ultimate hope of the Canadian government was that troublesome aspects of US trade laws and practices would be done away with. This now seems unlikely. Hence, if NAFTA is ultimately dissolved, the dispute panel process will disappear, as the provisions under the FTA have presumably expired.

Investment provisions are important features of trade agreements. Rugman and Gestrin (1993) identify how the investment chapter in NAFTA modifies or extends the treatment of investment under the FTA. Specifically, the chapter broadens the definition of what constitutes an investment, provides for international arbitration and full and fair compensation in the event of expropriation, applies the most favoured nation principle to investments, requires explicit lists of restrictions (which makes NAFTA more transparent than the FTA in terms of sectors and activities that are open to foreign investment), and makes several changes to rules regarding performance requirements imposed on foreign investors.

Immigration rules changed modestly when comparing NAFTA to the FTA. NAFTA instituted a special visa, the TN visa, which gives Canadians in qualified professions the ability to work in the US without a limit on the number of times they can renew their work permits and with minimal paperwork.⁶ Presumably, if NAFTA is disbanded, the TN visa program is as well. However, the FTA included a visa category, the TC

⁶ In fact, the TN confers a work status on Canadians and is not technically a visa. That is, Canadian TN holders do not need a visa to enter the US, although Mexican holders do need a visa. The US modified the TN in 2008 to extend for three years duration rather than one. Extending the terms of TC visas to three years would require the Department of Homeland Security to issue a rule modifying the TC terms.

visa, that is nearly identical to the TN visa with slightly fewer recognized professions (Little, 2017). Hence, the elimination of the TN visa would have a very limited impact on bilateral migration rules, assuming that the FTA became the relevant bilateral governance instrument.⁷

Finally, and uniquely, the NAFTA also resulted in the establishment of a Commission for Environmental Cooperation and a Commission on Labor Cooperation. Both were meant to be consultative bodies focused on promoting trilateral efforts to improve environmental and labor market conditions. There is no evidence that the impacts of these commissions on trade and investment flows have been anything but *de minimis*. Nor is there evidence that the environmental and labour standards side agreements to NAFTA have promoted stronger or more effective bilateral environmental cooperation than would have been the case in the absence of NAFTA.

In short, NAFTA represented a modest direct modification of the pre-existing FTA insofar as the Canada-US trade and investment governance regime is concerned. Hence, the main direct impact of NAFTA on Canada involved Canada's governance regime with Mexico, i.e., NAFTA reduced trade barriers against Mexican goods in Canadian markets and offered Canadian investors and exporters privileged access to the Mexican market. Since Canadian tariffs for manufactured goods imported from Mexico were relatively low pre-NAFTA, the main direct impact of NAFTA was to reduce significant Mexican tariffs against Canadian manufactured goods. At the same time, NAFTA phased out Mexico's auto decrees that limited imports of parts and vehicles and that promoted Mexican exports of those products. It also committed Mexico to modify its preferential treatment of the maquiladora sector.

Mexico recently eased its restrictions on foreign ownership in its energy sector by amending its constitution and implementing new legislation. So long as NAFTA remains in effect, Mexico's energy sector liberalization extends investor protection and rules to cover US and Canadian investments in energy through the NAFTA "ratchet" clause. In short, NAFTA primarily improved access to Mexico's market for Canadian exporters and investors; however, NAFTA also did the same for US exporters and investors. In effect, NAFTA increased competition for Canadian exporters in the US market while creating greater access for Canadian exporters in the Mexican market.

⁷ In 2008, the TN visa period was extended from one to three years under NAFTA. If there were a reversion to the TC visa, there would also presumably be a return to a one-year work permit period.

The Effects of NAFTA on the Canadian Economy

This section reviews and assesses the available evidence surrounding the impact of NAFTA on the Canadian economy. Since the major legal changes introduced by NAFTA applied to Canadian-Mexican trade and investment relations, it first considers whether and how bringing Mexico into the North American free trade relationship affected Canada's economy.

The available evidence on the direct effects has been interpreted as showing that while Canada-Mexico trade grew more rapidly under the NAFTA than it otherwise would have (Dawson, 2014), the change in the trade and investment regime between Canada and Mexico brought about by NAFTA has had very modest effects. Table 1 identifies Canada's six largest trading partners in 2016 by merchandise exports and imports. Mexico is one of those six largest partners. Specifically, it is the fifth largest market for Canadian merchandise exports and the fourth largest source country for Canadian merchandise imports. According to the data in table 1, Mexico accounted for approximately 2.0 percent of Canada's total exports and 4.0 percent of Canada's imports in 2016. It accounted for 1.4 percent of Canada's total trade in 1994, the year of NAFTA's implementation. To be sure, some Canadian content also makes its way into Mexico by being incorporated into US goods that are exported to Mexico. Likewise, some Mexican content makes its way into Canada by being incorporated into US goods that are exported to Canada. Dawson (2014) notes that data are insufficient to estimate the extent of such value-added trade between Mexico and Canada. However, it is unlikely to alter the basic conclusion that Mexico and Canada are modest partners in international trade, and, hence, that the dissolution of NAFTA is unlikely to result in a significant reduction in Canada's total trade with Mexico, especially if the trade regime between the two countries reverts to the WTO.

The foreign direct investment linkages between Mexico and Canada are also quite modest. Canada's direct investment presence in Mexico is concentrated primarily in banking and mining. In 2016, Canada's total stock of outward foreign direct investment (OFDI) was \$1,049 billion. Mexico accounted for \$16.8 billion or about 1.6 percent of Canada's total

Table 1: Canada's Largest Trading Partners (2016)

| | Exports (millions \$CA) | % | Imports (millions \$CA) | % |
|-------------|------------------------------------|----------|------------------------------------|----------|
| World | 521,322 | 100 | 547,322 | 100 |
| US | 392,274 | 75 | 359,903 | 66 |
| China | 22,359 | 4 | 37,593 | 7 |
| UK | 17,957 | 3 | 7,591 | 1 |
| Japan | 11,004 | 2 | 11,768 | 2 |
| Mexico | 8,879 | 2 | 18,903 | 4 |
| South Korea | 4,623 | 1 | 8,952 | 2 |

Source: Statistics Canada, *Imports, Exports, and Trade Balance of Goods*: <http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/gblec02a-eng.htm>.

OFDI stock. In the same year, Canada's total stock of inward foreign direct investment (IFDI) was \$825.7 billion with Mexico accounting for \$1.7 billion or well less than 1 percent of Canada's IFDI. Again, the inference one might draw is that even if the dissolution of NAFTA resulted in a somewhat less favourable foreign direct investment environment between Mexico and Canada, the growth of Canada's stocks of OFDI and IFDI are unlikely to be much affected.⁸

A fundamental empirical issue is whether NAFTA, on balance, has been trade- and investment-creating for Canada or whether trade and foreign direct investment flows involving Canadian companies would have been different had Mexico not gained tariff-free access to the US market, and had Mexico not loosened its inward foreign direct investment restrictions. While this paper does not go into detail on this issue, the available evidence suggests that Canadian exporters did lose market share in the US to Mexican producers in specific industries, most notably motor vehicles (Globerman and Storer, 2015). For now, we merely note that if the Canada-US trade regime reverts to the FTA, the implications for Canada may depend heavily upon whether or not Mexico and the United States conclude

⁸ This is not to say that if Canada lost investor protections in Mexico with the dissolution of NAFTA, it would be irrelevant for all Canadian companies outside of, perhaps, those in banking and mining. For example, the Canadian energy company Trans Canada has substantial pipeline investments in Mexico.

their own separate bilateral trade agreement. If they do not, then US-Mexico trade and investment relations would presumably be governed by WTO rules, which effectively means that US tariffs against Mexican products would be higher than they would be under NAFTA.⁹ If so, Canadian producers would gain an advantage in the US market relative to Mexican producers. Were all other things to remain constant, this would mean that Canadian companies would enjoy greater demand for their products in the US market, which, in turn, implies an improvement in Canadian terms-of-trade and/or increased domestically produced real output. However, US producers would also face an increase in Mexican tariffs, which could lead to some trade diversion away from Mexico to Canada. That is, US companies might export more to Canada, which, at the margin, could affect profit margins, employment, and wages in Canada.

What might be noted in this regard are the relatively small overall welfare impacts associated with NAFTA that have been identified for Canada. The small welfare effects encompass both the impacts of increased trade in final goods, as well as in intermediate goods, and essentially measure changes in the terms of trade and the increased availability of lower cost imports. In this regard, Caliendo and Parro (2015) conclude that NAFTA left Canada's economic welfare virtually unchanged. They also highlight the relatively small overall impact of NAFTA on Canada's North American trade. Specifically, they found that intra-bloc trade increased by only 11 percent for Canada compared to 41 percent for the US and 118 percent for Mexico.

⁹ A later section of this paper reviews tariff differences for the various NAFTA countries under the WTO versus NAFTA and, in the US-Canada case, the FTA.

Summary of Implications of NAFTA for Canada

In summary, the change in the institutional governance structure from the FTA to NAFTA arguably did not have substantial implications for the Canadian economy. Nor did it change the rules of the trade and investment environment surrounding the US-Canada relationship in fundamental ways. It might be argued that the most fundamental change the NAFTA made to the bilateral economic relationship was making permanent the dispute resolution mechanism. However, there is at least a question about how much more effective the NAFTA dispute resolution process has been for Canada than the process available under the WTO.

Taking all of the foregoing into account, it seems reasonable to infer that if NAFTA is dissolved, and an unchanged FTA once again governs US-Canada bilateral relations, the economic consequences for Canada are likely to be relatively benign, particularly if Mexico and the US do not sign a separate bilateral free trade agreement. Canadians should be less sanguine if Mexico and the US form a bilateral trade agreement in parallel with a restoration of the FTA. In this case, the US would presumably be the only country with duty-free access to the North American marketplace—assuming that the Mexico-US bilateral agreement gives Mexico duty-free access to the US. In this latter scenario, Canada would continue to face competition from Mexican products in the US market. Furthermore, unless Canada signed its own bilateral trade pact with Mexico, Canadian producers would also be at a competitive disadvantage compared to US producers when it came to selling in Mexico's domestic market. As mentioned above, while Canada trades a relatively small amount of final goods with Mexico, supply chain linkages across the three countries mean that Canadian-made products, especially in the motor vehicle and parts sector, can wind up as value-added exports when they are embodied in goods that are exported from the US to Mexico. If the US and Mexico did sign a bilateral free trade agreement, it would presumably have rules of origin, as does the FTA. This would mean that there would be limitations on the value of Canadian-originated goods that could enter Mexico duty free when they were embodied in US exports to Mexico.

The scenario where the US winds up with two separate bilateral trade agreements—one with Canada and one with Mexico—has been identified as a “hub-and-spoke” system, with the US as the hub and Canada and Mexico as spokes. As the hub, only the United States would enjoy duty-free access to all North American markets. Because of this asymmetric market access, the US would be a more preferred location for any company wanting duty-free access to all three countries (Wonnacott, 1990). An important implication is that the US would be the preferred location for corporate investment, both capital investments originating inside North America, and investments from outside North America. Clearly, this development would not be good for Canada, although it might be an intended consequence of the Trump Administration’s emphasis on companies maintaining and increasing capital investments in the US. Hence, the implications for Canada of a snap back to the FTA would depend in part upon the corresponding US-Mexico governance arrangement.

Assessing Post-NAFTA Scenarios

Figure 1, discussed earlier, summarizes a set of post-NAFTA scenarios. The preceding section essentially addressed scenario 1. The general conclusion was that Canada's economy would be worse off under this scenario, although arguably only modestly so, particularly if there was no separate bilateral agreement between the US and Mexico. Given the lack of clarity surrounding US complaints about NAFTA as well as the shifting emphasis on the degree to which the Trump Administration is focusing on "unfair" trade practices of Mexico versus those of Canada, it is very difficult to assign probabilities to the subsets of possibilities under scenario 1. However, what does seem likely is that the Canadian government would be prepared to make strong concessions to ensure that the access to the US market that it does retain is at least as favourable as Mexico's. Hence, a scenario in which Canada does not have a bilateral agreement with Mexico while the US does seems unlikely.

To the extent that the US strongly favours separate bilateral agreements with Canada and Mexico, an important issue from Canada's perspective is whether the US and Canada will revert to the FTA or whether a new bilateral agreement will be concluded between the two countries. As noted above, NAFTA did not alter the FTA in fundamental ways, such that the US and Canada simply falling back to the FTA would satisfy US complaints about the bilateral trade regime.¹⁰ As such, one possible hub-and-spoke scenario is scenario 2B, where the US and Canada conclude a renegotiated FTA, while the US signs a separate agreement with Mexico. Canada might or might not conclude a separate free trade agreement of its own with Mexico. If it did, scenario 2C could represent an alternative hub-and-spoke model depending upon the specific nature of the two separate agreements. Specifically, scenario 2C could still effectively represent a hub-and-spoke model if separate free trade agreements between each pair of countries resulted in the US having more favourable access to the rest of North American markets than did Mexico or Canada. However, for rea-

¹⁰ We discussed specific complaints that have been raised by the Trump regime about the Canada-US trade relationship in an earlier section.

sons noted above, under either specification of scenario 2, the economic impacts on Canada of the demise of NAFTA would primarily reflect the specific terms of a renegotiated Canada-US free trade agreement.

In fact, Mexican and Canadian officials jointly identified a strong preference for a new trilateral agreement as opposed to concluding separate bilateral agreements with the US (Harrup, 2017). Canada's Minister for Foreign Affairs Chrystia Freeland acknowledged that some issues within the region are bilateral by nature, such as the softwood lumber dispute between Canada and the US. Nevertheless, she stated that NAFTA can be modernized only with the agreement of the three parties. Mexican Foreign Minister Luis Videgaray, who said that three bilateral pacts between the three countries would be impractical, echoed her view. To the extent that a new trilateral agreement cannot be worked out and Mexico and Canada do not agree to separate bilateral trade deals with the US, the likely fallback scenario would have the trilateral trade relationship governed by WTO rules.

While the probabilities of the various scenarios are highly uncertain, our subjective assessment is that scenario 2 (with or without a separate Canada-Mexico free trade agreement) is the most likely outcome of the failure of the "three amigos" to renegotiate NAFTA successfully as a trilateral agreement. This would make a renegotiated FTA particularly relevant for the future of the Canada-US trade relationship along with the future impacts on the Canadian economy. Thus, the next section of the paper sets out the main features of the FTA, paying particular interest to how the FTA embellished or changed the rules in the WTO governing the bilateral trade regime. It also presents some evidence on the impacts of the FTA on Canada's economy. It then highlights the specific provisions that are most likely to be the focus of any renegotiation of the FTA. The ensuing discussion argues that a renegotiation of the FTA is likely, but far from a foregone conclusion. Hence, a fallback to WTO rules is a possible, if not the most likely, end game to the upcoming NAFTA renegotiations.

The FTA

A major feature of the FTA is that it provided for the elimination of all tariffs on trade between Canada and the United States over a 10-year period. However, both countries continued to apply their existing tariffs to imports from other countries. Consequently, rules of origin were imposed (as in NAFTA) whereby goods other than those originating wholly in either Canada or the US were required to incorporate a significant amount of Canadian or US content (in most cases 50 percent). As well, tariff-related measures, quantitative restrictions, and other restrictive measures applied at the border were to be removed by January 1, 1998. However, Canada maintained its agricultural supply management programs, which kept in place import restrictions on poultry products and eggs, while Canada's dairy supply management system continued to protect Canadian producers of milk and milk products. US tariffs remained in place for specific agricultural products including sugar and cotton. While the FTA called for each country to treat wine and distilled spirits products in a transparent and non-discriminatory manner, Ontario and British Columbia were not prevented from allowing private wine outlets existing before a certain date from favouring their own wines.

Besides eliminating all remaining tariffs, Chapter 3 of the FTA also stipulated that no existing tariff could be increased unless specifically provided for elsewhere in the FTA. This was most notably in reference to Chapter 11, which provided for temporary emergency safeguards against surges in imports. The agreement also provided that customs users' fees would be phased out and could not be established on imports of goods that met the origin rules. Duty drawbacks on third-country materials and similar programs were eliminated, as were customs duty waivers.

Note that a substantial amount (around 75 percent) of Canada-US trade was already free of duty prior to the FTA (Canada, 1987). The implication is that in the event of the dissolution of NAFTA, if the FTA were not renewed for whatever reason, the WTO tariff rates that would come into place would not be substantially different in many cases from those in place under the FTA. This latter point is underscored by the data reported in tables 2 and 3. Specifically, table 2 reports most-favoured-nation (MFN)

Table 2: US MFN Applied Tariffs, 2016

| Industry | Average of AV duties (%) | Maximum AV duty (%) | Duty Free TL% |
|-----------------------------|--------------------------|---------------------|---------------|
| HS 87—Vehicles | 3.4 | 25 | 50.3 |
| HS 72—Iron and Steel | 0.3 | 10 | 92.2 |
| HS 27—Mineral Fuels | 0.5 | 7 | 85.2 |
| HS 44—Wood Products | 1.3 | 10.7 | 71.6 |
| HS 48—Paper Products | 0 | 0 | 100 |
| HS 85—Electrical Machinery | 1.6 | 15 | 51.1 |
| HS 39—Plastics | 4.2 | 6.5 | 19.9 |
| HS 76—Aluminum | 3.5 | 6.5 | 12.4 |
| HS 30—Pharmaceuticals | 0.2 | 5 | 95.2 |
| HS 31—Fertilizers | 0 | 0 | 100 |
| HS 71—Gems/ Precious Metals | 2.1 | 13.5 | 62.1 |
| HS 84—Machinery | 1.2 | 9.9 | 64.4 |
| HS 88—Aircraft | 0.2 | 3 | 93.3 |

Source: World Trade Organization, *Select Tariffs*: <http://tariffdata.wto.org/ReportersAndProducts.aspx>.

tariffs applied by the US under the WTO as of 2016 for a set of industries for which Canada is a prominent exporter of goods to the United States. The first column reports the HS (Harmonized System) industry code; the second column identifies the industry; the third column gives the average *ad valorem* tariff for that industry; the fourth column provides the maximum *ad valorem* tariff for any sub-industry in the given HS category, and the fifth column cites the percentage of all imports in the given HS category that enter the country duty-free. (There are many sub-categories of industries under each broad HS category reported, so that the average *ad valorem* duty can be misleading for specific and more narrowly defined HS categories.)

The average 1988 (pre-FTA) US tariff against Canadian goods was 4 percent (Trefler, 2004). Hence, a fair takeaway from table 2 is that in the absence of a renewal of the FTA, Canadian exporters would be facing US tariffs that would remain modest across most Canadian industries that are major exporters to the United States. To be sure, the tariff increase on vehicles would not be insignificant, particularly for specific sub-categories of that industry, and the supply chain linkages between Canada and the

Table 3: Canada MFN Applied Tariffs, 2016

| Industry | Average of AV Duties (%) | Maximum AV Duty (%) | Duty-Free TL% |
|-----------------------------------|---------------------------------|----------------------------|----------------------|
| HS 87- Vehicles | 3.6 | 13 | 44.3 |
| HS 72- Iron and Steel | 0 | 0 | 100 |
| HS 27- Mineral Fuels | 0.7 | 12.5 | 90.6 |
| HS 85- Electrical Machinery | 1.2 | 9 | 82.1 |
| HS 39- Plastics | 1 | 6.5 | 84.3 |
| HS 88- Aircraft | 1 | 15.5 | 88.9 |
| HS 30- Pharmaceuticals | 0.1 | 6.5 | 98.4 |
| HS 29- Organic Chemicals | 0 | 0 | 100 |
| HS 84- Machinery | 0.3 | 9 | 96.1 |
| HS 20- Prepared Vegetables, Fruit | 5.3 | 17 | 40.3 |

Source: World Trade Organization, *Select Tariffs*: <http://tariffdata.wto.org/ReportersAndProducts.aspx>.

United States in the automobile sector might well be compromised by a fallback to WTO tariff levels. In this regard, the Center for Automotive Research finds that the elimination of free trade among the North American partners would lead to China, South Korea, and Japan becoming more important sources of auto parts to US-based assemblers at the expense of Canada and Mexico (Dziczek, et. al., 2017).

Table 3 reports 2016 MFN tariffs that Canada applies to a set of industries that represent prominent categories of imports from the United States. Once again, the 2-digit level HS industrial categories obscure differences across multiple more finely disaggregated industry categories. Trefler (2004) highlights this phenomenon using Canadian data. In 1988, the average Canadian tariff rate against the US was 8.1 percent; however, at the 4-digit Canadian standard industrial classification level, one in four Canadian industries had tariffs in excess of 10 percent. Nevertheless, the conclusion drawn from the data in table 2 seemingly apply to the data in table 3. Namely, the tariffs that US exporters would face selling into Canada under tariff rates bound by the WTO are mostly fairly low. Indeed, most of the industrial goods identified in table 3 enter Canada duty free with the notable exception, again, of vehicles.

The FTA incorporates the fundamental national treatment obligation enshrined in the General Agreement on Tariffs and Trade (GATT), the forerunner of the WTO. This means that once goods have been imported into either country, they cannot be the object of discrimination. Chapter 5 of the FTA made the GATT national treatment obligation more explicit with respect to measures adopted by provinces or states. This means that a province or state cannot discriminate against imported products using measures that fall within its jurisdiction.

Besides tariff reductions, other features of the FTA worth noting are national treatment for the establishment of new businesses and the provision of disciplines covering a large number of service sectors. One of the provisions affecting services was a right of establishment. This gives Canadian firms the right to establish in the US for purposes of providing services with reciprocal rights for US firms. A related provision was the right granted to some professions to meet the licensing standards imposed by the other signatory country as a condition of offering a service. An example is architecture. National treatment means that Canadian firms operating in the US cannot, in principle, be discriminated against in favour of American firms with a similar interpretation for US firms operating in Canada.

It should be noted that a right of establishment does not apply to a range of services including government-provided services, transportation, and basic telecommunications. As well, both the US and Canada retained legislation that allows foreign direct investment acquisitions made by investors headquartered in the other country to be screened for government approval.¹¹ In this regard, the FTA reduces the size threshold that triggers screening by Investment Canada of acquisitions of domestic companies by US companies. Chapter 17 of the FTA exempts US financial firms from some Canadian restrictions on the size of US banks operating in Canada, although US financial institutions must apply and be approved to establish operations in Canada. Canadian and other foreign banks were generally permitted to operate in more than one US state prior to the FTA. However, the FTA grandfathered that privilege indefinitely for Canadian banks.

As noted earlier, the FTA allowed certain classes of workers to work more easily in the other country. It also implemented steps to facilitate business travel between the two countries in order to expedite the sale of goods and services and after-sales services. However, facilitation was restricted to a set of specific activities. The FTA also set more stringent standards than exist under the GATT for the application of emergency safeguards to bilateral trade. Among other things, no emergency measure

¹¹ Both the FTA and NAFTA prohibit foreign investment in Canada's cultural sector, whereas the WTO contains no such prohibition.

could extend beyond December 31, 1998. After that, neither country could take measures to counteract a surge in imports resulting from the agreement except by mutual consent. Furthermore, Canada and the US agreed to exempt each other from global actions under the GATT, except where the other's producers were important contributors to the injury caused by a surge of imports from all countries. This provision is relevant primarily because it kept US and Canadian companies from being "sideswiped" by emergency actions aimed largely at exports from third countries.

In most other respects, the FTA adopted principles set out under the GATT/WTO. For example, it affirms Canadian and US rights and obligations under the GATT on trade restrictions in energy products, with some modest extensions. It somewhat broadens and deepens the obligations both countries have under the GATT with respect to government procurement including improving upon the GATT code in transparency procedures. Chapter 6 of the FTA affirms the two governments obligations under the GATT for federal government technical regulations and standards affecting industrial products, while chapter 7 does the same for agricultural and fish products. Chapter 20 reproduces the national security clause of the GATT and incorporates the provisions of GATT articles justifying import and export controls for various reasons.

In summary, the FTA liberalizes trade in goods and services between Canada and the US in ways that go beyond those provided for by the WTO. However, it is far from being a true free trade agreement. In particular, major sectors of the two economies, particularly the Canadian economy, are protected from the entry or expansion of foreign competitors. Furthermore, rules of origin create costs for exporters, while agriculture remains subject to protectionism on both sides of the border. Differences in regulations and standards also create added costs to the bilateral trade process.

Perhaps the most important gap in the FTA is the failure of the two governments to establish a new regime to address problems of dumping and subsidization that continue to plague the bilateral relationship. Specifically, Canada and the US could not negotiate a common set of rules for subsidies, and countervailing and anti-dumping duties. Canada was particularly concerned about this given the US government's propensity for bringing "unfair" trade practices actions (Weintraub, 1997).

The dispute resolution process may have helped somewhat in this regard, as discussed earlier, but the threat of trade actions undermines, to some extent, the confidence that is meant to be provided to investors by initiatives such as national treatment and right of establishment. Hence, the promotion of bilateral trade and foreign direct investment could have been more robust with a more comprehensive FTA. The paper now turns

to a brief consideration of the evidence regarding the impact of the FTA on the Canadian economy.

The Impact of the FTA

There is little question that the FTA secured greater access to the US market for Canadian firms, at least for the decade following its implementation. The data in table 4 provide some anecdotal evidence in support of this assertion. The data show that exports to the US as a share of total Canadian exports increased substantially from 73.2% in 1989 to 86.4% in 1999. However, by 2009, this share had declined to 77.6% and it declined further to 75.4% in 2016. Hence, the share in 2016 was only slightly higher than the share in the year that the FTA was implemented.

Clearly, a variety of factors besides the FTA influenced Canada's share of exports going to the United States. Perhaps most notable is the drop in the value of the Canadian dollar relative to the US dollar over much of the post-FTA period. The Canadian dollar declined almost consistently from 1990-2002. It appreciated strongly from 2008-2011, after which it again declined through 2016.¹² On the other hand, Canada's share of US imports was roughly constant in the 1980-89 and in the 1990-99 periods, suggesting that the FTA did not promote the competitiveness of US goods in the Canadian market, although one must again acknowledge the influence of the strong US dollar, which would have discouraged US exports to Canada from 1980 to 2003, and likely beyond. More recently, US exports to Canada have faced strong competition from exports from China, while Canada has faced strong competition in the US market from exports from China and Mexico.¹³

In short, a number of factors influenced bilateral trade flows in the post-FTA period and it is difficult to isolate the unique impact the FTA had on those flows. Nevertheless, the finding that trade in goods that were liberalized by the FTA grew faster than trade in goods that were unaffected by the FTA provides some evidence that the FTA did have an independent impact on bilateral trade flows (Haggart, 2001). As well, from 1989 to 2000, Canada's exports of services covered by the FTA increased by more than those that the FTA did not cover (Haggart, 2001). Table 5 shows that

¹² For data, see <http://www.canadianforex.ca/forex-tools/historical-rate-tools/yearly-average-rates>.

¹³ For some evidence on these patterns, see Gliberman and Storer (2015).

Table 4: US Share of Canada's Merchandise Trade (Percent of Total)

| | 1989 | 1999 | 2008 | 2016 |
|------------------|------|------|------|------|
| Canada's Imports | 65.2 | 67.3 | 52.3 | 52.2 |
| Canada's Exports | 73.2 | 86.4 | 77.6 | 75.4 |

Source: Statistics Canada, *Canadian International Merchandise Trade Database*: <http://www5.statcan.gc.ca/cimt-cicm/home-accueil?lang=eng>.

over the period 1988 to 1998, Canada's merchandise trade with the US increased much faster than did interprovincial trade, and trade between the US states bordering Canada grew substantially faster than national bilateral trade (Hufbauer and Schott, 1998).¹⁴

Based upon the available information, one might conclude that the FTA contributed to increased trade integration between Canada and the US, as was expected. However, most researchers conclude that the unique contribution of the FTA is difficult to identify separately from other factors that influence international trade flows. For example, Globerman and Storer (2003) conclude that statistical results, on balance, provide modest evidence of incremental integration in the post-FTA period, although Canada's fluctuating exchange rate was an important factor influencing bilateral trade. Additionally, a study by Industry Canada (1999) concluded that the growth of the US economy and changes in Canada's real exchange rate accounted for most of the growth of Canada's exports to the US over the 1990s, while free trade (including NAFTA) contributed to less than 10 percent of the growth of Canada's exports to the US over this period.

To the extent that the FTA did contribute to increased economic integration, it is not possible as a practical matter to identify which specific features of the agreement contributed significantly to that effect. As noted above, tariff reductions were relatively small for the most part. Furthermore, economic integration in the auto sector had been substantially promoted through the earlier Canada-US Auto Pact. Easing restrictions on services trade may well have been important, but services remain a relatively small part of bilateral trade. It might be argued that the dispute resolution process incorporated into the FTA promoted bilateral trade by

¹⁴ The export share of end products also increased for Canada from 41 percent before the FTA to 48 percent in 1996. See Britton (1996).

**Table 5: Interprovincial versus US Trade
(\$ Billion—Current Dollars)**

| | 1988 | 1998 |
|-------------------------|------|------|
| US Exports | 101 | 252 |
| US Imports | 86 | 203 |
| Total | 187 | 455 |
| Interprovincial Exports | 133 | 177 |
| Interprovincial Imports | 133 | 177 |
| Total | 266 | 354 |

Source: Hufbauer and Schott (1998) as summarized in Haggart (2001).

reducing the threat of trade actions, which, in turn, encouraged firms on both sides of the border to dedicate more resources to doing business in the neighbouring country. However, as noted earlier, the effectiveness of the dispute resolution mechanism is a matter of debate.

The relevance of the issue raised in the preceding paragraph is that if the FTA is renegotiated, or portions of the NAFTA particularly relevant to the Canada-US relationship are renegotiated, the impacts on trade may well depend upon the specific changes that are made to the relevant agreement. Since we do not know with confidence which specific features of the FTA had the most prominent impacts on bilateral economic integration, it is very difficult to assess the impacts on the Canadian economy of specific potential changes.

A major anticipated benefit of the FTA was improved productivity growth in Canada because of increased scale and specialization of Canadian firms and increased competition from US firms. There are numerous potential determinants of productivity performance, as there are of trade flows. Hence, it is again difficult to isolate the influence of the FTA on productivity performance from other determinants. Nevertheless, it is clear from the available data that over a period of time for which the FTA might have had an impact on productivity performance separate from whatever impact the NAFTA might have had, there is no evidence of a convergence of productivity growth rates between Canada and the US. This is illustrated by the data in table 6, which reports annual growth rates in multifactor productivity for the two countries. While there are years during which multifactor productivity grew faster in Canada than in the US, the average

Table 6: Multifactor Productivity—Annual Growth Rate

| | Canada | US |
|-------------------|--------|------|
| 1988 | 0.73 | 0.80 |
| 1989 | -0.34 | 0.42 |
| 1990 | -1.07 | 0.68 |
| 1991 | -0.94 | 0.04 |
| 1992 | 1.01 | 2.57 |
| 1993 | 1.54 | 0.14 |
| 1994 | 1.86 | 0.79 |
| 1995 | 0.81 | 1.00 |
| 1996 | -0.58 | 1.68 |
| 1997 | 1.92 | 0.90 |
| 1998 | 1.14 | 1.29 |
| 1999 | 1.95 | 1.69 |
| Average 1988-1995 | 0.67 | 0.91 |

Source: OECD, *Multifactor Productivity*: <https://data.oecd.org/lprdy/multi-factor-productivity.htm>.

growth rate over the entire 1988-1999 period was slower in Canada than in the US.¹⁵

This is not to say that the FTA had no impact on Canadian productivity performance. In fact, Trebler (2004) finds quite dramatic productivity changes for the most affected, import-competing group of industries. Specifically, for industries that experienced the deepest Canadian tariff cuts, the contraction of low-productivity plants resulted in a 15 percent increase in industry-level labour productivity. These industries were also those that experienced reduced employment (Beaulieu, 2000). An issue to consider is whether a return to higher WTO tariff rates would result in corresponding drops in productivity for industries experiencing higher tariffs. To the extent that low-productivity plants were largely rationalized during the era of North American free trade, the consequences of tariff increases might not be identical to those of tariff decreases.¹⁶ That

¹⁵ The experience is similar for measures of labour productivity. That is, it grew more slowly over the 1990s in Canada than in the US. See Britton (1996).

¹⁶ For some evidence on the emergence of larger and more specialized manufacturing

is, to the extent that increased protection of domestic Canadian producers promoted greater investment in Canadian production facilities, those facilities are presumably now operating at a more efficient scale than they were pre-FTA. Hence, the resulting inefficiencies from trade protection-induced domestic investment might be less consequential than they were in the pre-FTA period. To be sure, increased trade protection might discourage domestic firms from making investments and changes to improve productivity. In this regard, however, there is nothing to prevent Canadian authorities from lowering Canada's WTO tariff rates given concerns about higher Canadian tariffs harming domestic productivity performance.

In summary, the FTA arguably promoted increased bilateral trade, improved Canada's productivity performance, and made available lower-priced goods for consumers. What is much less clear is the magnitude of the FTA's contribution to these developments. On balance, most economists believe that the overall contribution of the FTA to Canada's standard of living was modest. This underscores a dilemma for Canadian negotiators. Namely, if the United States insists on major changes to NAFTA, or to the FTA if there is a fallback to that agreement, and the changes are difficult politically for the Canadian government to implement, do the presumably modest economic costs of falling back on the WTO justify the social and political unrest that might result from implementing the changes sought by US negotiators in order to salvage an FTA relationship with the US? The paper's next section discusses how Canada might fare in a post-FTA environment.

facilities in Canada post-FTA, see Britton (1996).

Canada under a WTO Trade Regime

As noted earlier, if the FTA is discontinued, the trade regime between Canada and the United States would be governed by WTO rules.¹⁷ The magnitude of the consequences for Canada is uncertain, although the evidence on the impacts of the FTA suggests that there would be less bilateral trade integration, particularly given the arguably weaker dispute resolution procedures under the WTO compared to the FTA. The increased uncertainty surrounding the potential for the US taking successful trade actions against Canada, such as imposing countervailing or anti-dumping duties, could be expected to discourage capital investment in Canada, other things constant. This is especially likely if Mexico and the US were to establish a new bilateral trade agreement. Were that to happen, Mexico would become a more desirable location than Canada for serving the US market. This is particularly likely to be the case in the motor vehicle and parts sector where Mexico's share of US imports increased substantially from 2000 to 2013 (from 15.9 percent to 23.9 percent), while Canada's share declined from 34.2 percent to 23.6 percent (Globerman and Storer, 2015). However, it seems unlikely that the US would negotiate a new bilateral agreement with Mexico and not Canada given that much of the US Administration's expressed dissatisfaction with NAFTA has focused on the US trade deficit with Mexico.

In fact, one should perhaps not make too much of the emergence of a weaker trade dispute resolution process in the wake of a dissolution of the FTA given the failure of the process thus far to settle the softwood lumber dispute.¹⁸ As well, the basic concepts of non-discrimination and right of establishment are WTO principles that would continue to constrain the actions of the US in its trade relationship with Canada. To the extent that rules of origin content requirements are effectively reduced by a fallback to the WTO regime, Canadian companies might be able to

¹⁷ A US withdrawal from the FTA would be similar in process to its withdrawal from NAFTA.

¹⁸ Canada has argued against US trade actions in the case of softwood lumber under both WTO and NAFTA dispute resolution processes.

reduce costs by sourcing more inputs from outside of North America to incorporate into their exports to the US. This would mitigate the adverse effect of higher tariffs facing Canadian exporters under the WTO regime. It might also be argued that companies would be reluctant to reorganize their supply chains geographically given relatively small increases in tariff rates if bilateral trade arrangements were governed by WTO rather than FTA rules.

The adverse economic consequences of reduced bilateral trade integration (relative to what would occur under a continuation of either the NAFTA or FTA regimes) might also be mitigated by unilateral Canadian trade liberalization, as well as Canadian initiatives to expand trade and investment liberalization agreements with other countries. For example, Canada could reduce its tariffs on dairy and other food products unilaterally, which would lower domestic food prices substantially, as noted above. The pending Canada-EU free trade agreement should provide increased access to markets in high-income countries for Canadian exporters, as well as increased domestic competition in Canada, including in goods markets such as electrical and industrial machinery for which the US is a relatively large exporter to Canada. Perhaps the greatest offset to the adverse economic impacts of reduced trade and investment integration with the US would be realized by Canada negotiating one or more new Pacific Rim free trade agreements. In particular, while the US has pulled out of negotiations for the Trans-Pacific Partnership, the negotiation process involving other participants, while currently dormant, has not been officially terminated. A free trade agreement with China would arguably be a substantial modification of Canada's trade environment, which could outweigh the impact of weakened bilateral trade and investment integration on the Canadian economy.

In sum, if the worst-case scenario was to happen, and the upcoming NAFTA renegotiations failed to conclude successfully and there was a fallback to the WTO regime, Canadian real incomes would likely be adversely affected. However, the magnitude of any decline is likely to be modest, particularly if Canada implements new bilateral and multilateral free trade agreements. This is not to say that Canada should adopt a hard line against accepting all US demands in the upcoming renegotiation process. As discussed earlier, some of the likely US demands would arguably improve Canadian economic welfare, though specific groups of producers in Canada, such as dairy farmers, would be hurt by acceding to US demands were Canada to eliminate its support program for that industry.

The prospect of a modest adverse impact from a fallback to the WTO trade regime as the governance mechanism for bilateral economic relations should embolden Canadian negotiators to press hard for changes that would substantially enhance the benefits of Canada-US trade and

investment. Most important in this regard, perhaps, is the imposition of clearer and tighter rules regarding when countervailing and anti-dumping actions can be taken by either country. Indeed, Canada should argue for dumping to be subsumed under national competition policy rules. Specifically, complaints about dumping should be treated equivalently to charges of predatory pricing raised by domestic firms against domestic competitors. Economists are skeptical about the validity of most claims of predatory pricing. The relevance of such claims depends heavily upon entry and exit costs being prohibitively high, so that new entry is unlikely after the predator raises prices to recover the costs of predation. Competition policy experts are better able than trade authorities to evaluate the market structure characteristics surrounding claims of predation. A Canadian request for domestic competition policy authorities to hear complaints raised by domestic firms about possible dumping might not be objectionable to US trade administrators who favour trade actions to be heard by domestic courts.

Canadian negotiators should also be firm in advocating for open and transparent bidding processes for government contracts. The objectives included in the US Trade Representative's report effectively call for more open access to Canadian government contracting for US companies while limiting access for government contracting work in the US for Canadian companies.

The interest by provincial and state governments in cross-border innovation corridors also argues for enhanced initiatives to facilitate the cross-border movement of technical and managerial personnel. An example of this is the ongoing discussion between the governments of British Columbia and the State of Washington to more closely link the technology sectors in Vancouver and Seattle. The continuation of the TN work permit arrangement between Canada and the US, and even an expansion of the categories of skills that are covered by the arrangement should be yet another goal of Canadian negotiators.

Summary and Conclusions

While the process of renegotiating NAFTA is imminent, the dynamics that will be set in motion by that process remain unclear. Most observers agree that changes to NAFTA are inevitable, but that the agreement itself will survive. Nevertheless, it is possible that the renegotiation parties will fail to renew the agreement, either because demands for changes will be made that are too difficult politically for one or more of the three governments to accept, or because political antagonisms will dominate economic logic. In any case, it is useful for an informed Canadian public, including managers and policy makers, to understand the potential consequences of NAFTA's dissolution so they can plan their actions accordingly.

This paper sets out a series of scenarios that might ensue should the renegotiation of NAFTA prove to be unsuccessful. The likelihood of individual scenarios differs, and the scenarios are not independent of each other. In particular, if Canada and the US fail to agree on changes necessary to implement a “modernized” NAFTA, it is unlikely that the Canada-US Free Trade Agreement will wind up being the fallback governance structure for the bilateral relationship. Furthermore, if Canada and the US cannot agree on terms for a continuation of a free trade agreement, it is unlikely that Mexico and the US will find common ground for a new bilateral agreement, since potential US demands might be even more difficult for the Mexican government to accept than the demands the US makes of the Canadian government. In this context, a fallback to the WTO governance arrangement is plausible.

Core features of the NAFTA, including national treatment and right of establishment, as well as non-discrimination, are embedded in WTO agreements such as the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). Hence, there would be substantial continuity in the bilateral trade regime, even if the “end-game” were a fallback to WTO governance. Furthermore, the integration of cross-border supply chains might be durable, even in the event of the dissolution of regional free trade arrangements. To be sure, the investment environment in Canada would become less attractive were a free trade arrangement with the US to dissolve, especially in the unlikely event

that Mexico and the US negotiated a separate bilateral free trade agreement. Reduced trade and investment integration with the US would also have harmful, albeit modest, effects on Canadian productivity growth and living standards, although the Canadian government could, and arguably should, take unilateral actions to mitigate some of the harmful impacts.

Perhaps the most important policy inference from the assessment of the scenarios discussed is that the Canadian government should continue to pursue multilateral and bilateral trade agreements with other countries while seeking to maintain a beneficial trade regime with its largest trading partner. In a related vein, if Canada's productivity performance is to be improved, it requires fundamental policy changes that go beyond trade initiatives. The policy environment for entrepreneurship and small business start-ups and growth is still poorly understood, but it might be far more important than the specific details of a renegotiated NAFTA, or even the dissolution of NAFTA, to the improvement of Canada's productivity performance and to raising the standard of living of Canadians.

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