Canadian Centre for Policy Alternatives
June 2017

What is the NAFTA advantage?

Putting the tariff impacts of a Trump termination in perspective

Pierre Laliberté and Scott Sinclair

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ISBN 978-1-77125-350-5

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ACKNOWLEDGMENTS

The authors wish to acknowledge Gary Schneider and Stuart Trew for their editorial assistance, Tim Scarth for his work on layout and Alyssa O'Dell for help with communications. Angella McEwan provided helpful comments and suggestions on an earlier draft.

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What is the NAFTA advantage?

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Introduction

Earlier this year, U.S. President Donald Trump notified Congress of his administration's intent to renegotiate the North American Free Trade Agreement (NAFTA). The May 18 notice, required under U.S. law, triggered a 90-day waiting period after which formal negotiations can begin, likely in mid-August.

Both Canada and Mexico have already agreed to come to the negotiating table, with business groups in the three countries calling for a "modernization" of the 23-year-old agreement. Yet, with negotiations looming, many observers have expressed grave concerns about Canada's vulnerability to a U.S. turn toward greater protectionism.

President Trump has repeatedly threatened to withdraw from NAFTA and in April apparently came close to doing so.[1] The president has stressed that scrapping NAFTA remains an option if the U.S. is dissatisfied with the Canadian or Mexican responses to his administration's demands for a new "America First" agreement.

This brinkmanship about ending NAFTA could be a genuine threat or merely a pressure tactic to strengthen the U.S. hand in the coming talks.

Either way, it raises an important question: what would be the impacts on Canada–U.S. trade if President Trump made good on his threat to terminate NAFTA?

This report seeks to answer one key aspect of that question. It examines the consequences of a possible U.S. withdrawal from NAFTA on tariffs applied to Canadian exports to the U.S. Such an appraisal is vital to making informed decisions about the potential bilateral trade impacts of NAFTA termination and also in correctly assessing the strength of Canada's bargaining position in the coming NAFTA 2.0 negotiations.

Tariff-free versus secure market access

There is understandably a great deal of concern in Canada about the Trump administration's demands to rework NAFTA and to tilt North American trade rules and relations further toward what the administration considers to be America's interests. These concerns are often expressed in quite alarmist terms, assuming that the loss of preferential tariff access under NAFTA would disastrously disrupt North American trade while exposing Canadian exports to arbitrary U.S. trade actions. Such scare stories are typically extrapolated from the fact that Canadian exports to the U.S. account for 25% of the value of our GDP.

Such impressionistic accounts of the impacts of losing the NAFTA advantage of preferential access to the U.S. market do not do justice to what is a more complex reality. Nor do they accurately portray Canada's actual vulnerability to U.S. threats or, by extension, the strength of our bargaining position at the NAFTA renegotiation table.

This alarmist narrative also overlooks the fact that, despite NAFTA, Canada has been and remains subject to a certain degree of arbitrary U.S. trade behavior. The fifth round of the softwood lumber conflict is just the most dramatic illustration of this reality. If Canada remains so vulnerable to U.S. trade actions it is because though NAFTA produced, for the most part, tariff-free access to the U.S. market, it left each party's trade remedy laws (countervailing duties, safeguards and anti-dumping measures) largely untouched.[2]

When the Mulroney government negotiated the 1988 Canada–U.S. Free Trade Agreement, its chief goal was to achieve secure market access by getting an exemption from U.S. trade remedy laws. These had been used repeatedly against Canadian products, including softwood lumber. Canada

failed in this effort. Instead, it got a binational review of U.S. trade remedy rulings, a feature that was carried over into NAFTA.

NAFTA Chapter 19 allows an exporter to go to an independent, binational panel to review final anti-dumping and countervailing duty rulings instead of using domestic judicial review.[3] The binational panel's mandate is strictly to determine whether the importing country's trade remedy laws have been applied properly.[4] If it agrees that they have not been, it can remand the determination to trade authorities to bring the decision in line with their domestic law.

Canadian exporters have had some successes using the NAFTA Chapter 19 process. But the Trump administration is unhappy with it and clearly intends to eliminate or seriously weaken the process in a revamped NAFTA. Moreover, U.S. industries and the administration are currently pursuing a broad range of trade remedy challenges or investigations against Canadian exports in key sectors including lumber, aircraft, steel and aluminum.

This puts Canada in a dilemma. NAFTA's supposed crowning achievement — its dispute settlement mechanism — has not lived up to expectations. As a parliamentary committee observed in 2005, the Chapter 19 dispute settlement process "was the bare minimum Canada would accept in the negotiations for the original Canada–United States Free Trade Agreement and without [it] Canada would not have signed the FTA."[5] Some analysts now suggest that, given the importance of North American supply chains and seamless, tariff-free flow of finished goods and components, Canada has little choice but to give in to the Trump administration's demands on this and other even more sensitive matters, some of which are discussed below.

The impacts of reverting to WTO tariff rates

This pessimistic view of Canada's bargaining power overlooks an important factor. If the Trump administration made good on its threat to terminate NAFTA, trade between Canada and the U.S. would still be covered under the WTO's General Agreement on Tariffs and Trade (GATT). As such, the GATT's most-favoured-nation (MFN) tariffs would become the de facto fallback custom duties for Canadian exporters and importers alike. The choice then is not between NAFTA access and the law of the jungle, but between NAFTA access and access under GATT.

In theory, if the Trump administration withdrew from NAFTA, the U.S. and Canada could still go back to their 1988 free trade agreement (CUSFTA).

The earlier agreement was suspended but not terminated when NAFTA came into force in 1994. But if the NAFTA talks end acrimoniously, it seems unlikely that the U.S. would accommodate Canada so readily. A more likely option would be reverting to World Trade Organization (WTO) obligations, which continue to bind the U.S., Canada and Mexico.

An appropriate assessment of Canada's position in the negotiations requires therefore that we look at what a hypothetical reversion to WTO tariffs would mean for Canadian exports. To do so, we will perform a simple exercise using the U.S. International Trade Commission's data for 2016.[6] The starting assumption is that all Canadian exports for that year entered the U.S. under preferential NAFTA tariff rates.[7] We will then apply WTO duty rates (the most-favoured-nation tariff rates bound under the WTO's General Agreement on Tariffs and Trade) to the same export content and calculate the difference. This analysis will focus only on Canadian exports to the U.S., since they are the main issue of public concern.[8]

Two types of tariffs

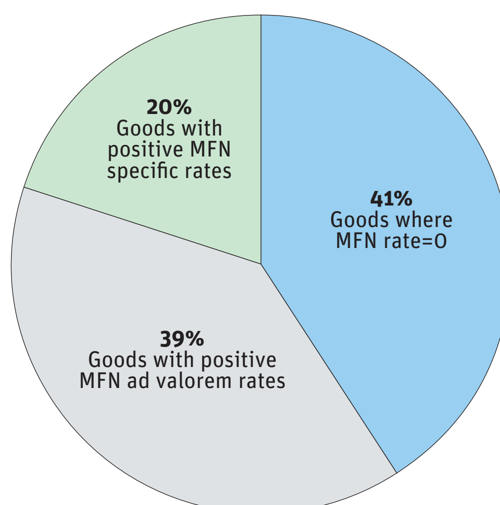
An *ad valorem* tariff is an import tax charged according to a percentage of the value of the imported product. For example, the U.S. currently applies a 2.5% *ad valorem* tariff on imported automobiles, meaning they collect $2,500 in tariffs for every $100,000 of imported automobiles. A *specific tariff* is an import tax that is levied as a fixed amount on each item imported.

Canada's goods exports to the United States

In 2016, Canada exported US$278 billion in goods to the United States and imported US$267 billion, resulting in a trade surplus of some US$11 billion. *Figure 1* divides the overall value of these exports into three groups of products: exported goods for which the MFN tariff is zero; goods where a positive MFN *ad valorem* rate would apply; and goods to which a specific tariff would apply.

The first important thing to note is that no less than 41% of total Canadian exports to the U.S. in 2016 (worth US$114 billion) face an MFN duty rate of zero. A substantial portion of Canada–U.S. trade, including products such as natural gas, hydroelectricity and aircraft, would be unaffected by reverting to WTO duty rates since there is no NAFTA tariff advantage for these products (see *Table 1*). In other words, these goods would continue to enter the U.S. market duty free even without NAFTA.

FIGURE 1 Proportion of Canada's exports with positive MFN rates



Source United States International Trade Commission. "Trade and Tariff DataWeb."

TABLE 1 Ten top Canadian exports where MFN rate is zero (2016)

	Value of exports US$
Natural gas, in gaseous state	$5,941,923,703
Coniferous wood, sawn or chipped	$5,551,420,354
Medicaments consisting of mixed or unmixed products for therapeutic or prophylactic uses	$3,412,941,693
Gold, nonmonetary, bullion and ore	$3,021,134,498
Aluminum (other than alloy), unwrought	$2,305,509,150
Electrical energy	$2,210,640,077
Aluminum alloys, unwrought	$1,903,713,368
Potassium chloride	$1,779,446,599
Airplanes and other powered aircraft, unladen weight over 2,000 kg but not over 15,000 kg	$1,716,631,866
Airplanes and other powered aircraft, unladen weight over 15,000 kg	$1,592,276,982

Source United States International Trade Commission. "Trade and Tariff DataWeb."

TABLE 2 Value of *ad valorem* exports by duty rate (2016)

Duty Rate	Value of Exports
Less than 2 per cent	5%
2 to 3 per cent	60%
3 to 4 per cent	8%
4 to 5 per cent	6%
5 to 6 per cent	6%
6 to 7 per cent	10%
7 to 8 per cent	1%
8 to 9 per cent	2%
9 to 10 per cent	0%
10 to 15 per cent	1%
16 to 25 per cent	1%
25 per cent and over	1%

Source United States International Trade Commission. "Trade and Tariff DataWeb."

Hence, in 2016, there was a NAFTA advantage for 59% of Canadian exports, valued at some US$165 billion. This group is divided between goods where *ad valorem* duties are applied (tariffs are charged as a percentage of the price) and goods where specific tariffs are collected (tariffs charged as a fixed amount per quantity).

The NAFTA advantage: *ad valorem* tariffs

In 2016, Canada exported US$110 billion worth of products that would be subject to positive *ad valorem* tariffs in the absence of the NAFTA. This amounted to 39% of our total exports to the U.S. (see *Figure 1*).

Looking at the distribution of tariff rates by value of exports (see *Table 2*), it is apparent that, for a major segment of this trade, relatively small duties would have applied under GATT MFN rates. In fact, for about two-thirds of those exports the applicable tariff rate would have been below 3%.

On the other end of the spectrum, 3% of all goods exported (US$2 billion worth) would have faced a tariff greater than 10%. Among the goods where higher MFN rates would apply, 34% are foodstuffs (most of which are agricultural products), 25% are made up of textiles, apparel and footwear prod-

TABLE 3 Ten top Canadian exports where a specific tariff rate would have applied

Ten Top Canadian Exports where a specific tariff rate would have applied	Value of exports US$
Petroleum oils and oils from bituminous minerals, crude, testing under 25 degrees	$23,420,324,581
Petroleum oils and oils from bituminous minerals, crude, testing 25 degrees or more	$12,770,005,890
Distillate and residual fuel oil derived from petroleum oils or oil of bituminous minerals, testing 25 degrees or more	$2,149,932,350
Light oil motor fuel blending stock from petroleum oils & bituminous minerals (other than crude) or prep 70%+	$1,979,539,174
Light oil motor fuel from petroleum oils and bituminous minerals (other than crude)	$1,390,058,783
Bovine meat cuts, boneless, not processed, fresh or chilled	$942,228,330
Oilcake and other solid residues, resulting from the extraction of vegetable fats or oils	$918,870,597
Distillate and residual fuel oil derived from petroleum or oils from bituminous minerals, testing < 25 degrees A,P,I,	$667,686,865
Wheat & meslin other than durum or seed wheat	$331,340,232
Fruits of the genus capsicum (peppers)	$271,974,707

Source United States International Trade Commission. "Trade and Tariff DataWeb."

ucts, and 26% is comprised of trucks of various categories.[9] The final 15% is made up of miscellaneous goods from across a wide range of classifications.

In the absence of NAFTA's preferential access to the U.S. market, then, just under 40% of current Canadian exports would face higher *ad valorem* tariffs, averaging 3.7% on a trade-weighted basis. In what is otherwise a fairly low-tariff environment, there are definitely certain products that would face relatively high tariffs or "tariff peaks," including pickup trucks, apparel and footwear. Losing the NAFTA advantage would be most seriously felt in those sectors.

But it is important to keep these sector-specific impacts in perspective. Only 2% of Canada's current exports would face an MFN duty rate of 10% or more under WTO bound tariff rates. When averaged over the value of all those products to which higher *ad valorem* tariffs would apply, the additional MFN duties faced by Canadian exports would amount to US$4.1 billion — about 1.47% of the value of Canada's total exports to the U.S. in 2016.

The NAFTA advantage: specific tariffs

In 2016, exports where specific tariffs (or a combination of specific and *ad valorem* tariffs) applied represented about 20% of Canada's total exports to the U.S., or US$55 billion worth (see *Table 3*). Most products where such duties would apply are agricultural goods. However, the product category

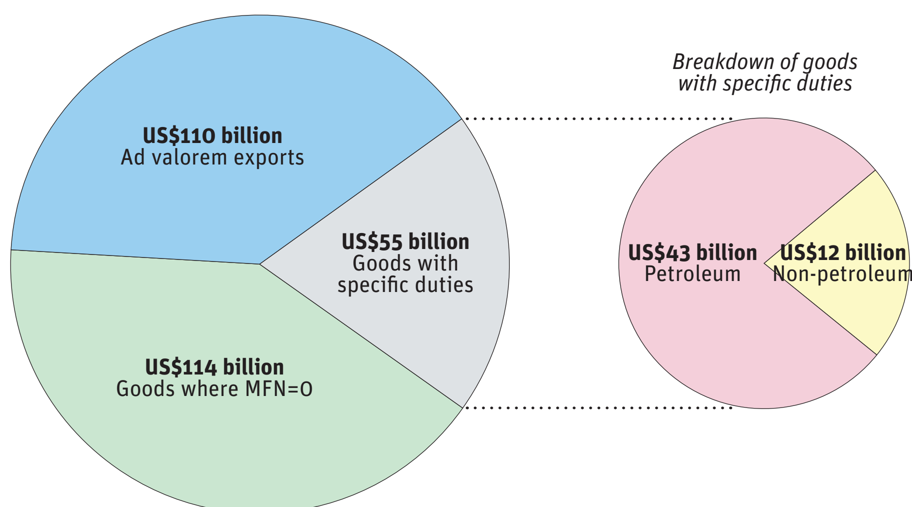
that stands out the most, representing 78% of the overall value of exports where specific rates apply, is petroleum products.

U.S. duties on petroleum products are relatively low, ranging from US$0.0525 to US$0.84 per barrel for a trade-weighted average rate of US$0.06 per barrel across the range of petroleum export products. In other words, if Canadian producers had been subject to this U.S. import tax in 2016, they would have incurred US$68 million of extra duties on their overall exports of more than a billion barrels of petroleum products, valued at some US$43.3 billion.

It is beyond the scope of this briefing paper to calculate how specific rates would translate for hundreds of other products besides petroleum. But because the volume of trade in those goods is small, it can safely be concluded that the impacts of added U.S. import charges would not have a significant impact on overall Canada–US trade.

In short, one-fifth of Canadian exports would face a combination of specific and *ad valorem* tariffs. The vast majority of this category (about 78%) is made up of petroleum products, which would face an average duty of US$0.06 per barrel. The extra duties incurred on these products, which represent 80% of Canadian exports in this category (or 16% of total exports), would amount to a modest US$68 million (see *Figure 2*).

FIGURE 2 Value of overall exports (US$ 2016)



Source United States International Trade Commission. “Trade and Tariff DataWeb.”

A further caveat

So far this study has assumed that all the goods exported to the U.S. go under the duty-free NAFTA rate. The reality is clearly otherwise. As many people who shop across the border can attest, products that are shipped across the border are often hit by duties.

This occurs because the preferential NAFTA treatment only applies to goods that originate from the three NAFTA parties. The so-called rules of origin are the complex way it's decided which products are eligible for duty-free treatment under NAFTA. For example, products are only entitled to preferential treatment if a certain percentage of the value added of the product (62.5% in the case of automobiles) originates within North America.

To qualify for preferential treatment, exporters need to acquire a certificate of origin and submit to a dedicated administrative process. Since there are costs involved in this process, some exporters reportedly opt instead to pay the less administratively cumbersome MFN tariffs. This is especially so where the difference between the preferential and the MFN tariff rate is small.

The most serious study of this issue is more than a decade old, but probably still provides a reasonable approximation of the current situation.[10] The authors estimated that even when there was a positive NAFTA tariff advantage over the corresponding MFN rate, 20% of Canadian exporters still chose to pay MFN duties. Going back to *Table 1*, which shows that about two-thirds of Canadian exports face tariff differentials of less than 3%, it is not unreasonable to think that, for goods with many imported components, exporters might indeed elect to "swallow the difference" and simply pay the MFN rates. In other words, the US$4.1 billion figure in extra *ad valorem* tariff costs presented above might well be an overvaluation by as much as 20%.

TABLE 4 The NAFTA tariff advantage

	Value of overall exports (US$ billion 2016)	Extra duties involved if NAFTA no longer applies (US$ billion 2016)
Goods where MFN=0	114	0
Ad valorem exports	110	4.1
Goods with specific duties, of which		
Petroleum	43	0.07
Non-petroleum	12	n/a
Total	279	4.17

Source United States International Trade Commission. "Trade and Tariff DataWeb."

Conclusion

The overall finding of this analysis is that for 96% of total Canadian exports (MFN zero, *ad valorem* and petroleum products under the specific tariff category) the effective cost of losing the NAFTA advantage would be, at most, around US$4.2 billion dollars in additional tariff costs.

The two gaps in this analysis concern the US$12 billion worth of goods exports (besides petroleum) that are subject to specific tariffs, as well as the proportion of Canadian exporters who do not bother with NAFTA because of the costs involved in complying with regulations over rules of origin. Let's assume, for the sake of argument, that these two unknowns cancel each other out.

The bottom line, then, is that even if the U.S. were to make good on its threat to terminate NAFTA, Canadian exporters could face additional duties amounting to 1.5% of the value of Canadian exports in 2016. In other words, reverting to WTO rules and bound tariff rates would be disruptive but by no means catastrophic. It is an option if U.S. negotiating demands become too unreasonable, costly or harmful to Canadian interests.

Of course, this does not address the sectoral specificities where high MFN tariffs would apply. Producers in those industries would clearly face significant new barriers in accessing the U.S. market. The agricultural and apparel sectors are most vulnerable because such products fall disproportionately in the high tariff lines under MFN. Another sector, as noted, is light truck production, where tariff rates of 25% would be applicable. However, it is important to keep in mind that in that sector the U.S. currently exports more to Canada than it imports.[11] This is a useful reminder that the disappearance of NAFTA tariff preferences would cut both ways.

It is certain that Canada will be faced with aggressive and potentially costly demands in the coming negotiations with the U.S. and Mexico. We have already discussed U.S. demands to weaken NAFTA's Chapter 19 dispute settlement mechanism, without which Canada would not have signed the FTA or NAFTA. But there will be pressure on Canada to at least meet the concessions it made in the Trans-Pacific Partnership (before the U.S. pulled out), and likely to go further in key areas of importance to U.S. industry.[12]

For example, U.S. negotiators will almost certainly press Canada to further align its patent protection system with that in the U.S. (e.g., in the area of patent term extensions and longer periods of data protection for biologic drugs), which would cost Canadian governments and consumers several billions of dollars annually.[12] Other changes to intellectual property protection,

such as longer copyright terms, could also be costly, while U.S. demands around digital trade threaten Canadians' data privacy.[14]

Furthermore, inevitable U.S. demands for greater market access in dairy products would harm an important agricultural sector critical to the health of rural economies. Finally, reverting to WTO rules would also have the benefit of avoiding some of NAFTA's worse features, including its investor–state dispute settlement mechanism, while restoring some policy flexibility in energy and industrial policy, for example.

The purpose of this note is not to suggest there are no costs to leaving NAFTA, but rather to propose we collectively approach the whole renegotiation process with the knowledge that the cost of the worst-case scenario would be modest, and that Canada has more latitude than is often appreciated to stand its ground and assert its national interests in the coming negotiations. All in all, looking at a possible overall 1.5% tariff hike, it is difficult not to be a bit sanguine when we consider the fact that the Canada–U.S. exchange rate has experienced far greater fluctuations than this during the NAFTA years.

Reverting to WTO bound tariff rates would be disruptive but not unthinkable. If a revamped "America First" NAFTA is worse than the multilateral alternative, then Canada can and should choose the latter.

Notes

1 Under NAFTA Article 2205 any party can withdraw from the agreement on six months' notice.

2 Among the few exceptions to general tariff elimination on Canadian exports to the U.S. are chicken, turkey and egg products, as well as refined sugar. See "NAFTA." Agriculture and Agri-food Canada. http://www.agr.gc.ca/eng/industry-markets-and-trade/agri-food-trade-policy/trade-agreements-in-force/north-american-free-trade-agreement-nafta.

3 Anti-dumping duties are applied against goods that are allegedly sold in a foreign market at below cost. Countervailing duties are applied against goods that are allegedly subsidized.

4 Under NAFTA, U.S. trade remedy laws continue to apply fully to Canadian exports. The U.S. can amend its trade laws without Canadian consent. If a new U.S. trade law or amendment specifies Canada, then it will apply.

5 "Dispute Settlement in the NAFTA: Fixing an Agreement under Siege," Report of the Standing Committee on Foreign Affairs and International Trade, May 2005: http://www.parl.gc.ca/HousePublications/Publication.aspx?DocId=1856888&Language=e&Mode=1&Parl=38&Ses=1.

6 ITC, 2017 U.S. Tariff and Trade Data for a specific product: https://dataweb.usitc.gov/scripts/tariff_current.asp.

7 Because of the application of rules of origin to NAFTA trade, we will see that this is unlikely to be the case.

8 In the event of NAFTA termination, Canada could unilaterally reduce or eliminate any of its own import tariffs on U.S. and other imported products if it deems this in the national interest.

9 Canada's own MFN tariff for trucks is 6.1%. In 2016, Canada ran a trade deficit with the U.S. of about US$9 billion for those tariff lines.

10 Robert Kunimoto and Gary Sawchuk (2005), *NAFTA Rules of Origins*, Policy Research Initiative discussion paper: http://www.publications.gc.ca/site/eng/9.687588/publication.html

11 See note 9 above.

12 U.S. Commerce Secretary Wilbur Ross has said, "A card laid is a card played. And even though that hand [the TPP] is cancelled, somebody has put something on the table in writing that is an

agreed thing," and, "It will be our intention to make it very hard for them to go back." See Shawn Donnan and Demetri Sevastopulo, "IMF warnings of US protectionism 'rubbish', says Ross," *Financial Times*, April 16, 2017.

13 Scott Sinclair (2016), Major Complications: The TPP and Canadian Health Care, a report for the Canadian Centre for Policy Alternatives: https://www.policyalternatives.ca/publications/reports/major-complications.

14 Michael Geist (2016), The Trouble with the TPP's Copyright Rules, a report for the Canadian Centre for Policy Alternatives: https://www.policyalternatives.ca/publications/reports/trouble-tpp-copyright-rules.

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