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From Exit Threats To Tiny Tweaks: What's Next For NAFTA?

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With the first 100 days of the Trump administration just underway, President Trump has already taken steps to fulfill his campaign promises and renegotiate or withdraw from various U.S. trade deals, including the Trans-Pacific Partnership and the North American Free Trade Agreement.

President Trump's formal withdrawal from the TPP on Jan. 23, 2017, (three days after taking office) was expected and had a limited immediate impact since it had not yet been implemented. More importantly, because it had not received congressional approval, the president's authority to withdraw was not questioned. A withdrawal from NAFTA would be a different story.

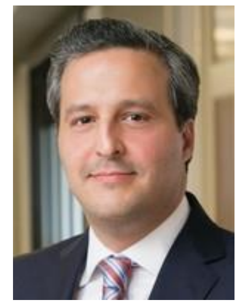
President Trump's threats to withdraw from NAFTA pose substantial concerns and questions on both the legal and business fronts as any action taken by the Trump administration in connection with NAFTA could have tremendous implications for the complex and intertwined U.S.-Mexico commercial relationship. The question on everyone's mind is whether President Trump has the authority to unilaterally withdraw or substantially amend NAFTA and, if so, what doing so would mean for U.S. companies doing business in the region or wishing to invest in Mexico. This article will focus on the effect of a NAFTA withdrawal on U.S.-Mexico trade and the likelihood of a renegotiation of the agreement.[1]

Since its inception in 1994, NAFTA has had a significant impact on the economies of the United States, Mexico and Canada by:

- according to analysts, increasing overall trade between the three countries from $290 billion in 1993 to $1.1 trillion in 2016;[2]

- eliminating tariff barriers to qualifying products, with at least 50 percent of tariffs abolished immediately and the remainder eliminated gradually (this also addressed the imbalance in Mexican tariffs on U.S.-made products, which were on average 250 percent higher than U.S. duties on Mexican products);

- increasing cross-border investment, by removing foreign investment restrictions and helping increase corresponding foreign investment protections (with the subsequent investment in the Mexican infrastructure as a catalyst for further economic development and benefits);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- facilitating the integration of the three countries' supply chains;
- removing other nontariff barriers; and
- implementing rules governing the conduct of trade among NAFTA partners (covering topics such as direct investment, intellectual property, services, trade and government procurement).

President Trump's threat to withdraw from NAFTA, if carried out, would lead to more than just increased tariffs. The scope and effects of a withdrawal would be much broader than that, affecting the commercial and legal framework on which both nations and their respective businesses have come to rely, with tremendous repercussions on U.S. business. Withdrawal, then, seems unlikely. Instead, the new administration will likely opt to renegotiate major provisions of NAFTA, such as local content requirements and other labor matters, over outright withdrawal. Indeed, the Trump administration has recently indicated it may pursue such an approach and both Mexican and Canadian authorities have publicly expressed their willingness to renegotiate aspects of the agreement (as recently as March 29, a draft proposal circulated to Congress by the U.S. Trade Representative's office suggests the Trump administration may seek mostly modest changes and the renegotiation route). However, this article will address all possible scenarios, including withdrawal (the worst case scenario) and will analyze the likelihood of each outcome.

Below, we have compiled a list of questions and answers that are likely to come up under the various scenarios.

Scenario 1: Withdrawal — The Least Likely Scenario

The president likely has authority to unilaterally withdraw from NAFTA without congressional approval but would likely need congressional approval to repeal the NAFTA Implementation Act.

Article 2205 of NAFTA provides that "{*a} party may withdraw from this Agreement six months after it provides written notice of withdrawal to the other Parties*."[3] Therefore, President Trump could withdraw from NAFTA by providing six months' notice of such intent.

Free trade agreements (FTAs) are not treaties, which are self-executing. Instead, they fall within the legal construct of "congressional-executive" agreements, which come into effect for purposes of the United States only when approved and implemented through federal legislation. Article 1, Section 8, of the Constitution gives Congress the power to regulate commerce with foreign nations. Congress has delegated to the president some of this authority through a series of U.S. trade laws, including the Trade Act of 1974, so that the president can efficiently execute domestic trade laws and implement trade agreements. However, Congress retains the ultimate constitutional authority over international trade, approving or rejecting trade deals and amending U.S. trade laws or enacting legislation to implement any foreign trade deal.

NAFTA was negotiated through the congressional process "fast-track" provisions and the authorizations granted to the president under the Trade Act of 1974.[4] It was approved and implemented by Congress through the NAFTA Implementation Act. Although the 1974 Trade Act grants the president the authority to terminate or withdraw from an FTA after giving notice, the president would still need Congress to step in and repeal the implementing legislation.

President Trump could argue that the NAFTA Implementation Act terminates upon his withdrawal from NAFTA. However, such an argument would not hold water (even if you were to use the authority granted to the president under the Trade Act of 1974 as support for such a position) because of the explicit constitutional powers granted to Congress to regulate commerce with foreign nations[5] and the presentment clause, which prevents a president from unilaterally amending or repealing parts of statutes that have been duly passed by Congress.[6] Similarly, the president lacks the authority to unilaterally terminate the NAFTA Implementation Act for these same reasons.

Withdrawal under NAFTA without a repeal of the NAFTA Implementation Act would restrict the U.S. from taking any trade measures (U.S. tariff and other commitments implemented by the NAFTA Implementation Act would remain in force), while Mexico and Canada would be free to immediately abandon their commitments under NAFTA.[7] Essentially, Mexico and Canada would be protected under NAFTA while the U.S. would not.

Scenario 2: Increase in Tariffs

If the United States withdraws from NAFTA, the president may, under international law, only raise tariffs on imports from Mexico or Canada up to the most-favored nation (MFN) treatment under the World Trade Organization Agreement.

Section 125(e) of the Trade Act of 1974 grants the president the authority to modify "*duties or other import restrictions required or appropriate to carry out any trade agreement entered into pursuant to the Act*" after the termination or withdrawal from any trade agreement. Under this act, the president could technically increase tariffs through proclamation up to either 50 percent above the general U.S. tariff schedule rate on Jan. 1, 1975, or 20 percent above the rate of the relevant country as of Jan. 1, 1975. However, because Mexico is a member of the World Trade Organization, U.S. commitments in WTO agreements would, on their face, limit the president's discretion to raise import duties beyond the limits specified in the Trade Act. Action by the president would be subject to MFN "bound rates" set forth in the WTO U.S. Goods Schedule. The United States has an MFN rate of 3.5 percent. WTO commitments expressly limit members' rights or abilities to impose additional duties for retaliatory or other economic purposes.

In theory, the Trump administration could pursue withdrawal from or a renegotiation of United States WTO commitments. However, doing so would be enormously controversial and complex as it would require multilateral negotiations and congressional approval per the Uruguay Round Agreements Act (URAA)[8]. Adding to this complexity is the WTO rule that requires consensus among its members to amend the WTO agreements, making the multilateral negotiations even more difficult. Any increase beyond the WTO tariff rates is unlikely. Either way, the 1974 Trade Act appears to provide for the continuation of preferential tariff rates on imports of products from former FTA partner countries for a year following United States termination or withdrawal. Therefore, any increase would not go into effect until at least 18 months from the date that President Trump elects to terminate NAFTA.

The real story is the tariff rate that exports from the United States to Mexico would be subject to — the Mexico MFN rate is much higher than the United States rate of 3.5 percent and could increase to as much as 36 percent. This means that the tariff impact of NAFTA withdrawal would be felt more on the U.S. side of the border, as the rate levied by Mexico on exports from the United States would rise to a much greater degree than the rate that could be levied by United States on imports from Mexico.

Scenario 3: Renegotiation — The More Likely Scenario

Likewise, although the president has authority under the Trade Act of 1974 to constrain U.S. trade by negotiating trade agreements, an amendment of the NAFTA Implementation Act to implement renegotiated provisions of NAFTA would be subject to congressional approval. Unilateral actions *undertaken by President Trump in this regard would be subject to the same legal challenges presented above under the withdrawal scenario.*

Canada and Mexico are, respectively, the first and second largest export markets for the United States. Additionally, because Canada shares some of the concerns about the transfer of jobs to Mexico, there are strong indicators to suggest that renegotiation is more likely than outright withdrawal. Much of trade with Mexico, in particular, involves the shipment of U.S. goods, parts and components to Mexico for assembly for later reintroduction to the U.S. market as manufactured products. Eliminating NAFTA without a replacement would create tremendous problems in international supply chains, particularly those of major U.S. companies that have structured their business around it. The Mexican and U.S. supply chains are so intertwined — particularly in the assembly of complex manufactured goods, such as cars — that the political and economic costs of unraveling them would be highly complex and costly. Reinstating any nontariff barriers would be equally difficult. Therefore, a renegotiation of NAFTA is the most likely scenario. Indeed, the comments made by U.S. Commerce Secretary Wilbur Ross on March 8 suggest this is the route the Trump administration will take, with the commerce secretary expecting negotiations to occur later this year. As previously mentioned, the Trump administration has recently signaled to Congress that it would seek modest changes to NAFTA through the draft currently being circulated by the U.S. Trade Representative's office.

It is unclear what a renegotiation would cover beyond labor as both Canada and Mexico have already indicated that they would oppose new trade barriers or trade balancing mechanisms. Even Ross acknowledges that although all parties know that they will have to make concessions, the question remains regarding the magnitude of such concessions. In his vision, entire new chapters dealing with the digital economy would be added and substantive changes on auto parts would be made, including an adjustment of the rules of origin for tariff-free vehicles. The draft proposal currently being circulated to Congress retains some of NAFTA's most controversial positions, including arbitration, but includes some trade protectionist changes allowing a NAFTA nation to reinstate tariffs in the case of a flood of imports that cause serious injury or threat of serious injury to domestic industries.[9] Additionally, the letter accompanying the draft proposal indicates the administration may seek changes to the government-procurement section and measures to close the deficit by modifying the rules of origin.

As more details emerge, the more likely it looks that the Trump administration will seek renegotiation of NAFTA by involving Congress instead of withdrawal. However, it remains to be seen whether Ross' vision lines up with that of President Trump and the rest of the administration. Also, as recent congressional fights indicate, it may be a long road before the administration can reach an agreement with Congress and the final draft of the revised NAFTA may look substantially different once consensus is reached among both political parties (*and that's before even presenting it to Mexico and Canada*). Either way, a revised version of NAFTA may just raise the cost of trade between the U.S. and Mexico and slow its growth, but it would not undo the U.S.-Mexico links that NAFTA has created over the past two decades.

Current Outlook on Mexico Response and Future Talks

As previously mentioned, a renegotiation of NAFTA is the likely scenario at this stage. NAFTA is too important to the Mexican economy for Mexico to give up its free-trade access to the United States without a fight. Even if Mexico would prefer that the agreement remain as written, giving up trade concessions would be a much better option than risking a potential recession that would accompany a NAFTA withdrawal, and the ensuing shift of U.S. multinational companies to other locations. NAFTA was a key factor in propelling the liberalization of the Mexican markets over the last two decades and is to credit in large part for the country's recent economic prosperity that goes well beyond opening the doors to commerce with the United States. Therefore, if U.S. withdrawal, however unlikely, were to occur, Mexico would not shut the door to U.S. investors upon which its economy has come to rely.

Although it may require a rethinking of some of the legal and commercial concepts surrounding NAFTA, these economic concepts have been so ingrained into Mexican society that most of them, like the country's reliance on foreign investment, will not run out of favor. To put it into perspective, U.S. companies' direct investment in Mexico increased from US$2.5 billion in 1993 to US$9.3 billion in 2014, according to the UN Conference on Trade and Development. Mexico has become a much friendlier place for foreign investment than in 1994, even going as far as amending its constitution so that foreign players could enter the Mexican energy market.

While Mexico has previously stated that it will take retaliatory actions if President Trump proceeds with his promise to increase tariffs on Mexican products, and the two countries got off to a rough start, the talks have recently become more conciliatory in nature. Given recent statements by both the Trump administration and Mexico officials, along with recent reports of the draft proposal currently being circulated to Congress, renegotiation is looking more and more to be the most likely scenario. NAFTA has become outdated in many respects so now may be the time to revamp it in a way that addresses all signatories, ushering in a new era of trade relations between both Mexico and the United States, as well as Canada.

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[1] Since Canada can fall back on the Canada-U.S. Free Trade Agreement if the United States withdraws from NAFTA, the impact on that cross-border relationship is much more limited and beyond the scope of this release.

[2] Wharton U. Penn., NAFTA's Impact on the U.S. Economy: What Are the Facts? (Sept. 2016)

[3] Note that if a party withdraws from NAFTA under this provision, the agreement would remain in force for the remaining parties.

[4] Specifically, NAFTA was negotiated under the fast-track authority of the Omnibus Trade and Tariff Act of 1988, which made the termination and withdrawal provisions of Section 125 of the Trade Act of 1974 applicable to NAFTA.

[5] U.S. Const. art. I, §8, cl. 3.

[6] *See Clinton v. City of New York*, 524 U.S. 417 (1998), where the Supreme Court held that the Line Item Veto Act of 1996 was unconstitutional and violated the Presentment Clause because it gave the President unilateral authority to amend or repeal laws that had been duly passed by Congress.

[7] There is some argument that some of the provisions of NAFTA are rendered inapplicable once a party ceases to be a NAFTA country. However, such language does not appear to apply in the case of U.S. withdrawal (i.e., it would apply if Mexico ceases to be a NAFTA country). Therefore, this legal analysis is beyond the scope of this article.

[8] Section 125 of the URAA provides a detailed process for Congressional termination of the act.

[9] The question remains whether this would run counter to WTO commitments as noted above and whether Mexico would accept such a "snapback" proposal since it previously rejected it in negotiations with the Clinton administration 24 years ago.
