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The New NAFTA and Its Business Implications

Government





CHEAT SHEET

- **USMCA.** US President Trump, Canadian Prime Minister Trudeau, and Mexican President Peña Nieto signed the United States-Mexico-Canada Agreement (USMCA) on November 30, 2018, replacing the North America Free Trade Agreement (NAFTA).
- **Ratification.** The agreement will come into force on the first day of the third month following the date the last party notifies the others of its legislature's ratification of the agreement. All countries are awaiting ratification.
- **Automotive industry.** The USMCA will most impact the automotive industry, increasing content requirements for vehicles and trucks, and introducing new labor-value content requirements for assembly plants.
- **Chapter 19.** Although the United States attempted to eliminate the Chapter 19 dispute resolution process from the agreement, it remains. The process is used to challenge governmental decisions in antidumping and countervailing duty cases

After more than a year of negotiations, the United States, Mexico, and Canada signed the United States-Mexico-Canada Agreement (USMCA) on November 30, 2018. The agreement fulfilled one of US President Donald Trump's main campaign promises: to renegotiate the North American Free Trade Agreement (NAFTA), which removed tariffs among the three countries. Other than a new name, the changes were few. USMCA updates some aspects of NAFTA, but otherwise leaves the core components of the original agreement in place. This article provides some background on NAFTA and the negotiation of the USMCA, explores the changes in the new agreement, and discusses the elements that remain the same, the ratification process, and the implications for businesses, particularly automotive companies, operating in the three signatory countries.

It is fair to say that NAFTA was generally successful. Trilateral trade between the three countries grew 370 percent between 1994 and 2016, and 16 percent of total global trade was generated by the NAFTA countries during this same time period.

NAFTA defined

The idea of a North American agreement for free trade was proposed by President Reagan during the 1979 US presidential campaign. This proposal led to the United States-Canada Free Trade Agreement, which took effect in 1989. The United States and Mexico began bilateral talks on a free trade agreement in 1990. Canada joined the talks in 1991. NAFTA was officially signed by US President George H.W. Bush, Mexican President Carlos Salinas, and Canadian Prime Minister Brian Mulroney in 1992. The three countries then ratified the agreement, and it went into force in January 1994. NAFTA immediately abolished tariffs on 50 percent of trade among all three countries, and the rest were gradually eliminated over time. The agreement also removed investment restrictions and contained provisions protecting intellectual property rights.

It is fair to say that NAFTA was generally successful. Trilateral trade between the three countries grew 370 percent between 1994 and 2016, and 16 percent of total global trade was generated by the

NAFTA countries during this same time period. The auto industry in particular adapted its supply chain and manufacturing operations to maximize the benefits gained from NAFTA. The US agricultural industry has also seen exports to Mexico grow as a result of NAFTA, but this has led to increased unemployment in Mexico's agricultural sector.

With respect to jobs, estimates indicate the growth in trade created jobs in the United States, but manufacturing jobs in general have declined by a third since 1994. However, this may have been more the result of China joining the World Trade Organization in 2001 than NAFTA.

Manufacturing wages in Mexico have remained flat, which may have suppressed wage growth in the United States and Canada.

The negotiation of the USMCA

During the 2016 US presidential campaign, Donald Trump decried NAFTA as “the worst trade deal ever” and pledged to withdraw from the agreement if Mexico and Canada did not agree to renegotiate. They agreed, and the renegotiations began in August 2017.

The United States' key objectives were:

1. To reduce the trade deficit and barriers to trade in services;
2. To gain commitments not to impose tariffs on digital products;
3. To move the NAFTA ancillary agreements on labor and environment into the main body of the agreement;
4. To eliminate the Chapter 19 dispute settlement provision; and
5. To include a five-year sunset clause.

Canada's objectives were:

1. To include new chapters on labor and environmental standards;
2. To obtain new chapters on indigenous people and gender rights;
3. To eliminate “Buy American” rules for state and local government construction projects;
4. To relax restrictions on the movement of professionals;
5. To continue restrictions on dairy and poultry imports from the United States; and
6. To preserve the Chapter 19 dispute resolution process.

Mexico sought:

- To prioritize free access for goods and services;
- To increase labor market integration;
- To strengthen energy security; and
- To bolster the Chapter 19 dispute resolution process.

Negotiations continued for more than a year, and was complicated by the United States' imposition of tariffs on imported steel and aluminum from all countries, including Mexico and Canada. Australia was eventually exempted from the steel and aluminum tariffs, while the tariffs on steel and aluminum products from Argentina, and steel products from Brazil and South Korea, were replaced with absolute quotas. The negotiations concluded with an agreement on September 30, 2018. President Trump, Canadian Prime Minister Trudeau, and Mexican President Peña Nieto signed the USMCA on November 30, 2018, at the G20 summit in Buenos Aires, Argentina.

The basics of the USMCA

During the 2019 State of the Union Address, President Trump asked Congress to end “the catastrophe known as NAFTA” by replacing it with the USMCA. Doing so, he proclaimed, would “deliver for American workers like they haven’t had delivered to for a long time.” **Most commenters, however, have concluded that the USMCA is essentially NAFTA 2.0, with a few updates and a new name.**

The most significant changes affect the automotive industry. The revisions concern the rules of origin, which determine whether a product qualifies for tariff-free trade among the three countries. Under the current agreement, the North American (United States, Canada, and Mexico) content requirements for passenger vehicles and light trucks is 62.5 percent, and for heavy trucks it is 60 percent. In addition, NAFTA contains a “tracing list” of certain auto parts and components. These parts and components remain non-originating regardless of any additional processing in North America, and their value cannot be included in North American content.

The new agreement increases the North America content requirement, but eliminates the tracing list. The new content requirements for passenger vehicles and light trucks to qualify for tariff reductions will increase to 66 percent on January 1, 2020, then rise incrementally up to 75 percent by 2023. The content requirements for heavy trucks will start at the current level of 60 percent and increase incrementally up to 70 percent after seven years. There are also North American content requirements for core parts (engines, chassis with engines, vehicle bodies, etc.), principal parts (tires, safety glass, bearings, brake systems, gears, etc.), and complementary parts (pipes, locks, electric motors, catalytic converters, electric motors, etc.).

In addition to the content requirements, the USMCA introduces a labor-value content requirement. NAFTA did not include a labor-value requirement. This new requirement uses the following terminology: “High-wage material and manufacturing” is a vehicle assembly plant; “high-wage technology” is research and development and IT; and “high-wage assembly” is engine, transmission, and advanced battery assembly. The term high-wage means an average production wage of US\$16 per hour. As of January 1, 2020, 30 percent of the labor content of a passenger vehicle must occur in high-wage operations. The 30 percent labor value content must consist of at least 15 percentage points of high-wage material and manufacturing expenditures, no more than 10 percentage points of high-wage technology expenditures, and no more than five percentage points of high-wage assembly expenditures. The labor value content requirement increases incrementally each year up to 40 percent by 2023, of which at least 25 percentage points must be high-wage material and manufacturing.

The final change to the automotive rules is that the USMCA requires 70 percent of a vehicle producers’ purchases of steel and aluminum to come from North America. This requirement is based on the previous year’s purchases.

With the USMCA, the United States also accomplished its objective to open the Canadian dairy market to more US products. Under NAFTA, Canada was allowed to restrict imports of US dairy products to protect its domestic dairy industry. The USMCA requires Canada to increase the quantities of dairy products that parties can import into the country. In addition, Canada agreed to eliminate its milk pricing system for two classes of products.

The United States did not succeed in eliminating the Chapter 19 dispute resolution process, which remains essentially unchanged. The Chapter 19 dispute resolution process is used to challenge

governmental decisions in antidumping and countervailing duty cases. Dumping occurs when goods from one country are sold in another at less than fair value. Countervailing duties are imposed when imported goods benefit from subsidies in the exporting country. Outside of the NAFTA context, challenges against the imposition of these duties take place in the usual judicial system. For example, a Chinese producer who wishes to challenge the government's decision to assess antidumping duties must file suit in the US Court of International Trade. Under NAFTA, a Canadian producer would challenge a United States antidumping and countervailing duty decision in front of an expert panel composed of members from each country involved in the dispute.

The Chapter 19 dispute settlement process arose out of the negotiations for the United States Canada Free Trade Agreement. In those negotiations, Canada wanted the United States to forego the right to bring antidumping cases against Canadian goods. The United States refused. Chapter 19 was the compromise, but it didn't come easily. Just days before the agreement was to be signed, Prime Minister Mulroney walked away from the negotiations. Two days later the United States agreed.

With respect to digital trade, the USMCA prohibits tariffs on electronically distributed digital products such as e-books, videos, music, software, and games. It also protects cross-border data transmissions and limits the ability of countries to require data localization (a requirement that data collected in one country be stored in that country) or disclosure of source code and algorithms. The USMCA extends the term of copyright protection from 50 to 70 years after the life of the author. Biologic drugs have been given 10 years of protection of effective market protection through protection of undisclosed test and other data. This is less than the 12 years of protection provided in the United States, but more than the five and eight year protection under Mexican and Canadian law, respectively.

The rules for government procurement will be more complex under the USMCA. **The USMCA will control government procurement contracts between the United States and Mexico, but the rules of the World Trade Organization will govern government contracts between the United States and Canada. The Trans-Pacific Partnership agreement will govern contracts between Mexico and Canada.** Navigating these rules will be challenging because contractors from all three countries may participate in government procurement projects.

The parties also agreed to include a sunset clause in the USMCA. This clause specifies that the agreement will terminate 16 years after coming into force unless each party affirms that the treaty should continue for another 16 years. Moreover, the agreement will be subject to joint review by the Free Trade Commission years after it enters into force. The commission will be composed of government representatives from each country at the minister or cabinet secretary level.

The United States also agreed, in a side letter, to exempt Canada and Mexico from any tariffs that President Trump is considering imposing on autos and auto parts imported into the United States. However, the governments of Canada and Mexico were not able to convince the United States to remove the tariffs on steel and aluminum, which may impede ratification of the agreement by Canada and Mexico.

What happens now?

The agreement will enter into force on the first day of the third month following the date the last party notifies the others of its legislature's ratification of the agreement. The ratification process is distinct in each country, and it is by no means certain that the USMCA will go into force.

The ratification process in the United States requires the president to submit to Congress a finalized text of the agreement and draft implementing legislation. The US International Trade Commission must also conduct impact assessments of the agreement. The Trade Commission's report was originally due to Congress by March 15, 2019, but was delayed by the government shutdown that occurred in December 2018 and January 2019.

While these steps have not yet been completed, congressional approval has been complicated by the results of last year's mid-term elections, which saw Democrats take control of the House of Representatives. Labor and environmental constituencies want to see firm enforcement commitments of the USMCA's labor and environmental provisions. Some conservative lawmakers have objected to the USMCA's provisions to protect workers from discrimination on the basis of gender identity.

The trade war with China serves to further complicate matters. In the current environment, congressional approval seems unlikely in 2019 without changes to the agreement to address these concerns. As a result, the issue could be pushed into 2020, with further complications presented by the upcoming presidential and congressional elections.

President Trump may attempt to force congressional action by initiating withdrawal from NAFTA. This action could further complicate ratification of the USMCA, however, because the withdrawal process is vague. Article 2205 of NAFTA explicitly allows a party to withdraw six months after providing written notice of withdrawal to the other parties, but neither NAFTA nor its implementing legislation establishes a clear-cut process for withdrawal.

President Trump would likely assert that the Treaty Power in Article II of the Constitution gives him the authority to withdraw from NAFTA. Article II, Section 2, grants the president the power to make treaties with the advice and consent of the Senate. The Constitution is, however, silent on whether the Senate's consent is required to withdraw from a treaty. The scholars who have written on this subject are divided, and the Supreme Court has not issued a definitive decision. In a suit brought by Senator Barry Goldwater and other senators after US President Carter withdrew from a mutual defense treaty with Taiwan, the Supreme Court dismissed the case without resolving the underlying constitutional question.

Goldwater v. Carter, 444 U.S. 996, 100 S. Ct. 533, 62 L.Ed 2d 428 (1979). Zivotofsky ex rel. Zivotofsky v. Clinton, 566 U.S. 189, 132 S. Ct. 1421, 182 L.Ed. 2d 423 (2012).

The distinctive nature of NAFTA and other trade agreements adds to the complexity of this puzzle. These agreements are not treaties, nor are they legislation enacted by Congress. They are instead a hybrid of the two, in which Congress authorizes the president to negotiate the agreement and to propose implementing legislation. Congress, in turn, agrees to consider the implementing legislation as presented, without proposing amendments.

So, can President Trump unilaterally withdraw from NAFTA? He certainly can provide the requisite notice to Canada and Mexico. It would then be up to Congress to challenge his action in court.

More importantly, some level of congressional involvement in the withdrawal would be necessary to unravel the legislation that implemented NAFTA. This clearly cannot be done unilaterally by the US president.

Similarly, the ratification process in Canada requires Parliament to approve implementing legislation. It remains uncertain whether this can be accomplished before the current parliament adjourns in the

summer prior to the federal elections on October 21, 2019.

While Mexico's new president, Andrés Manuel López Obrador (AMLO), has been a NAFTA critic, he has also indicated that he will support approval of the USMCA as a concession to Mexican business interests. AMLO has already initiated increases in Mexico's minimum wage, and the labor reform legislation required under the USMCA is expected to pass in April.

The ultimate passage of the USMCA in Canada and Mexico will not occur until the three countries resolve the steel and aluminum tariff issue. Canada and Mexico want the tariffs removed before approving the agreement. Some members of the US Congress also want this issue resolved before approving the agreement.

Implications for business

While many of the details of the USMCA remain uncertain until the implementing legislation is presented to Congress, it appears that with the exception of the automotive industry, most businesses, in our opinion, will not be greatly impacted by the new agreement. For those in the automotive industry, adapting to the new regional value and labor-content requirements will be the primary consideration.

Companies in this sector should initiate preliminary studies to determine whether supply chain adjustments will be needed to meet the new requirements.

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