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June 12, 2017

Edward Gresser
Chair, Trade Policy Staff Committee
Office of the U.S. Trade Representative
Winder Building
600 17th St. NW Washington, D.C.

Re: Docket Number USTR-2017-0006 - NAFTA Negotiations

R Street's perspective on free trade

Founded in 2012, the R Street Institute is a nonpartisan, nonprofit pragmatic free-market think tank headquartered in Washington, D.C. We support limited but effective government. We believe that economic growth and freedom depends on the relatively free flow of goods between countries and that free trade agreements like the North American Free Trade Agreement (NAFTA) are an integral part of ensuring continued American prosperity.

The case for free trade is twofold. First, the economic benefits are crystal clear. No largely protectionist nation has ever thrived economically. Trade and comparative advantage allow specialization, which leads to better, more efficient outcomes. A recent Peterson Institute study found that the gains for Americans from trade and globalization since World War II have been enormous.¹ The authors note that, measured in 2016 dollars, U.S. gross domestic product per-capita and GDP per-household increased by \$7,014 and \$18,131, respectively. There is evidence that disproportionate gains accrue to lower-income households.² Turning our back on this commitment to largely free, rules-based trade would dramatically decrease American standards of living.

There is an equally strong moral argument for free trade. Tariffs are regressive taxes. They mostly benefit those special interests with sufficiently strong lobbies to secure protection from foreign

¹ Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, "The Payoff to America from Globalization: A Fresh Look with a Focus on Costs to Workers," Peterson Institute for International Economics, May 2017.

<https://piie.com/system/files/documents/pb17-16.pdf>

² Ibid.

competition at the expense of those who are forced to shoulder higher costs from restrictions on imports. Free trade also serves to expand freedom by enlarging the sphere of individual and business autonomy outside the scope of governmental decisionmaking. Allowing consumers—both individuals and businesses—to purchase legal goods from outside of the United States if they can find a better price is a net positive for society.

General comments about NAFTA

Despite dire warnings from protectionists on both the political right and left during the original NAFTA debate, the North American Free Trade Agreement has been an unqualified bipartisan success since it went into effect Jan. 1, 1994. R Street retains some skepticism that renegotiation would produce outcomes for businesses and consumers as positive as the original agreement. Though we believe the agreement *can* be modernized, the Office of U.S. Trade Representative's top priority should be to ensure no harm is done. In short, any updates to NAFTA should provide at least as much trade liberalization as the original agreement. A retreat from the high-water mark of the original agreement will be deemed a failure.

Countless studies have found that NAFTA has produced meaningful benefits for our economy.³ A 2014 working paper from Yale economist Lorenzo Caliendo and Fernando Parro, a Federal Reserve economist, found trade within the NAFTA zone increased by 41 percent for the United States, 118 percent for Mexico and 11 percent for Canada.⁴ The same study found an increase in real wages and improved economic welfare for all three countries.⁵ Another recent study estimates the annual gains to the United States from NAFTA are about \$50 billion in 2014 dollars.⁶ A comprehensive study on the state-by-state impact of NAFTA on U.S. jobs found the agreement decreased annual unemployment growth by 4.4 percent.⁷

Though USTR is proceeding with renegotiation, the White House has suggested that, should NAFTA renegotiation fail, the United States would withdraw from the agreement. Make no mistake: this would be a catastrophic blunder, the effects of which would resonate throughout the country and touch numerous industries. A recent study on the impact of withdrawing from NAFTA, based on reasonable assumptions about Mexico and Canada's reactions to such a decision, found it would lead "to a decline in real GDP, trade and investment" in all three NAFTA countries.⁸ Further, the authors find that:

³ U.S. International Trade Commission, "Economic Impact of Trade Agreements Implemented Under Trade Authorities Procedures, 2016 Report," June 2016. https://www.usitc.gov/publications/332/pub4614_old.pdf

⁴ Lorenzo Caliendo and Fernando Parro, "Estimates of the Trade and Welfare Effects of NAFTA," Yale University, July 24, 2014. <http://faculty.som.yale.edu/lorenzocaliendo/ETWENAFTA.pdf>

⁵ Ibid.

⁶ Peter Dixon and Maureen Rimmer, "Identifying the Effects of NAFTA on the U.S. Economy between 1992 and 1998: a decomposition analysis," Purdue University, June 17, 2015.

https://www.gtap.agecon.purdue.edu/resources/res_display.asp?RecordID=4657

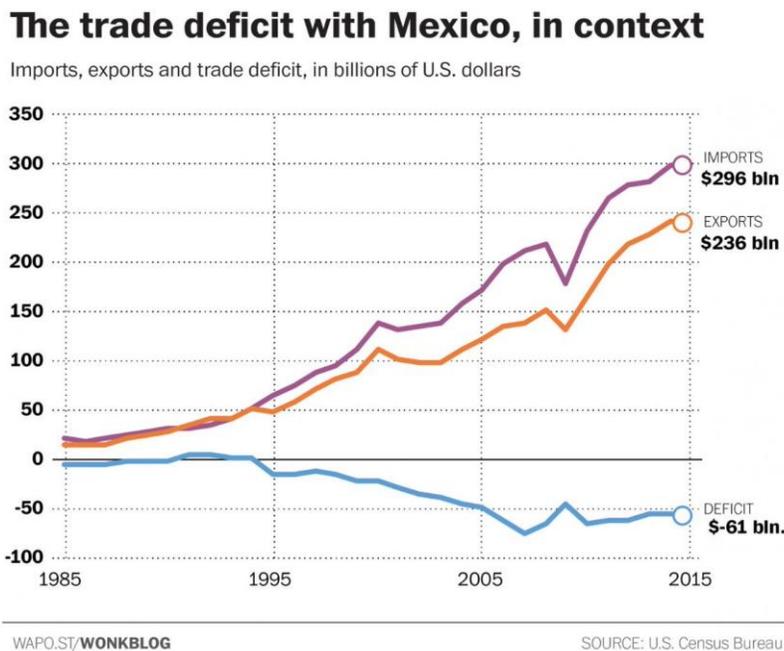
⁷ John Francis and Yuqing Zheng, "Trade Liberalization, Unemployment and Adjustment," *Journal of Applied Economics*, 2011. <http://www.tandfonline.com/doi/abs/10.1080/00036840903194212>

⁸ Ibid.

The reversal of NAFTA (with reciprocation) leads to 256,000 unemployed low-skilled workers in the U.S. within the short to medium run (3-5 years), with thousands more workers having to relocate to other sectors to find employment. If skilled workers are also assumed vulnerable to reversing NAFTA, then US unemployment rises by over 1.2 million.⁹

Given these costs, withdrawal should be taken off the table entirely.

Though much has been made of the United States' growing trade deficit with Mexico since NAFTA's implementation in 1994, it is important to put this trend into proper context. As the chart below from *The Washington Post* demonstrates, while the bilateral trade deficit with Mexico has increased, trade between the two countries has grown exponentially.¹⁰



In short, the United States still experiences economic benefits from increased trade in spite of the trade deficit with Mexico. As *The Washington Post* noted, "Since 1993, the annual trade deficit with Mexico has grown from essentially zero dollars to \$60 billion. But over the same period, we added about \$193 billion in annual exports to our neighbors to the south." This is a positive development. Bilateral trade deficits are always a poor gauge of whether trade agreements between nations are positive on net and trade negotiators would be well-served to avoid focusing on reducing deficits in negotiations.

⁹ Ibid.

¹⁰ Christopher Ingraham, "The smart way to think about that trade deficit with Mexico," *The Washington Post*, Jan. 26, 2017. https://www.washingtonpost.com/news/wonk/wp/2017/01/26/the-smart-way-to-think-about-that-trade-deficit-with-mexico/?utm_term=.c6491bf64971

Thankfully Congress has provided an adequate roadmap to cover trade negotiations, including NAFTA renegotiation, with the passage of Trade Promotion Authority (TPA) in 2015. TPA is a three-year authority granted to the executive branch, with the possibility of an additional three years if the president requests it and Congress does not disapprove. R Street worked hard to ensure passage of TPA and encourages President Donald Trump to seek the three-year extension of authority by the end of 2018. Ensuring expedited review of trade agreements, provided such agreements comport with congressional priorities, is an important tool for USTR and Congress.

Finally, R Street vehemently disagrees with President Trump's decision to withdraw from the Trans-Pacific Partnership (TPP). A high-quality yet imperfect agreement among 12 Pacific Rim nations, including Mexico and Canada, TPP easily could have been improved upon by the Trump administration. An improved TPP would have obviated the need to renegotiate NAFTA, since both Mexico and Canada are parties to the agreement. This, in turn, would have freed valuable time and resources for USTR to complete negotiations with other nations and institutions, including the Transatlantic Trade and Investment Partnership (T-TIP), the Trade in Services Agreement (TiSA) and a post-Brexit bilateral agreement with the United Kingdom. Nonetheless, all is not lost; TPP still can serve as a baseline for NAFTA renegotiation. To the extent possible, USTR negotiators should draw upon various chapters of TPP when they begin discussions with their Mexican and Canadian counterparts.

Digital trade

As NAFTA came into effect in 1994, before significant expansion of the commercial internet, the agreement lacked provisions to protect and foster digital trade. In the two decades since NAFTA's passage, digital trade and the data economy have assumed a larger and ever-growing role in U.S. economic growth. With the advent of the commercial internet, there has been a boom in international digital commerce, such that the U.S. Commerce Department estimates more than half of U.S. trade in services now is composed of digitally delivered services.¹¹ Growth in data flows jumped 45-fold from 2005 to 2014, faster than conventional trade and financial growth.

Because digital trade—international delivery of goods and services delivered through the internet—is expected to continue to play a strong role in American economic growth for the foreseeable future, it is important that any updates to NAFTA protections provide an express legal framework that lowers or eliminates digital trade barriers among Canada, Mexico and the United States. Just as customary international trade barriers present market-access challenges, so do tariff and nontariff barriers within digital trade. The digital trade agenda should address, but not limit itself to, the free cross-border flow of data; data privacy issues; data localization measures; e-commerce; expansion of the telecommunications "bill of rights"; de minimis requirements; regulation of online services; and custom duties on digital transmissions.

¹¹ Rachel F. Fefer, Shayerah Ilias Akhtar and Wayne M. Morrison, "Digital Trade and U.S. Trade Policy," Congressional Research Service, June 6, 2017. <https://fas.org/sgp/crs/misc/R44565.pdf>

The Trans-Pacific Partnership (TPP) is credited as advancing the digital trade conversation by preventing data localization, enabling cross-border data flows, prohibiting digital customs duties and sustaining cybersecurity technologies like encryption and VPN. R Street notes that it not only large and successful American companies such as Apple Inc. and Microsoft Inc. that have backed TPP provisions designed to promote and advance digital trade among signatories. Smaller stakeholders such as Etsy— which provides a venue for international sales of handmade, craft or vintage goods—see lowering or eliminating digital-commerce barriers as essential to enable participants to reach their largest potential audiences of consumers. Because larger American companies need minimized trade barriers in order to reach their markets (including coordination with supply-chain partners) and small and medium-sized enterprises (SMEs) need minimized barriers to find and build their markets, R Street believes it essential for NAFTA negotiations to build on digital-trade negotiations that took place during development of the draft language for the TPP. We agree with the Cato Institute's assessment of Chapter 14 of TPP in this regard:

It succeeds by prohibiting the imposition of customs duties on electronic transmissions; establishing a general principle of nondiscriminatory treatment for digital products; prohibiting TPP Parties from requiring the use of local computing facilities as a condition for conducting business in their territory; requiring that Parties "allow the cross-border transfer of information by electronic means, including personal information, when this activity is for the conduct of the business of the covered person"; precluding Parties from requiring the "transfer of, or access to, source code of software owned by a person of another Party, as a condition for the import, distribution, sale or use of such software, or of products containing such software, in its territory."¹²

In particular, with regard to whether NAFTA signatories should be barred from requiring "the use of local computing facilities as a condition for conducting business in their territory," we look expressly to the question of so-called "data localization," which would require companies to store user data within the territorial borders and jurisdiction of signatory nations. As the Congressional Research Service reported in 2015: "[w]hile localization can be motivated by privacy and security interests, there are concerns that such measures can be trade distorting and may be used for protectionist purposes."¹³

Copyright

As the Cato Institute observed with regard to the draft TPP language on intellectual property, in these matters, the TPP is "protectionist"—that is, not really consistent with the general purpose of

¹² Daniel Ikenson, Simon Lester, Scott Lincicome, Daniel Pearson and K. William Watson, "Should Free Traders Support the Trans-Pacific Partnership? An Assessment of the Largest-Ever U.S. Preferential Trade Agreement," Cato Institute, June 30, 2016. <https://object.cato.org/sites/cato.org/files/pubs/pdf/cato-trade-tpp-abstract-june-30-2016.pdf>

¹³ Ian F. Fergusson and Richard S. Beth, "Trade Promotion Authority (TPA): Frequently Asked Questions," Congressional Research Service, July 2, 2015. <https://fas.org/sgp/crs/misc/R43491.pdf>

agreements whose design is to advance free trade. In its 2016 discussion of TPP provisions, Cato's authors wrote:

It is difficult to describe the intellectual property protections in trade agreements as "liberalizing." While a case can be made for some level of intellectual property protection, it is not clear why such protection should be included in trade agreements, as opposed to international intellectual property agreements.¹⁴

R Street agrees with that analysis. The primary forum for harmonizing intellectual-property obligations historically has been through the World Intellectual Property Organization (WIPO). However, many IP-industry stakeholders have sought to use other international or bilateral agreements—including, of course, copyright agreements—as separate points of entry to enable the ratcheting up of intellectual property obligations in ways that, in fact, may ultimately increase trade barriers. As Cato's analysis puts it:

The IP chapter [of the TPP draft language] is protectionist. The structure of the chapter, like IP chapters in other agreements, remains generally unbalanced in requiring protection of exclusive rights while merely permitting limitations and exceptions to those rights. Although the chapter's provisions do not exceed the protection under U.S. law, they do lock in that level of protection and impose new obligations on foreign countries to change their laws.

R Street takes the view that free-trade agreements should be designed essentially to liberalize trade, and not to impose duplicative or excessive intellectual-property protections on partner signatories who already have labored to meet their obligations under the Berne Convention and related international treaties. While it cannot be disputed that imposing more intellectual-property enforcement burdens on partners under NAFTA may favor the interests of one particular set of stakeholders (IP interests), it is unclear how such impositions advance the general cause of free trade.

In addition, R Street wishes to underscore its agreement with the comments filed by the Re:Create Coalition stressing the pro-trade value of what its comments refer to as the "fair use based economy," in which limitations and exceptions under exclusive-rights frameworks allow for innovation and economic growth. The Re:Create Coalition, of which R Street is a member, relies on the Internet Association's white paper to demonstrating the economic value of fair use of copyrighted works.¹⁵

R Street also wishes to express agreement with Library Copyright Alliance submission on NAFTA negotiations, which endorsed the TPP draft language concerning the need for exceptions and limitations—subject to the substitution of the words "shall achieve" for the words "shall endeavor to achieve," simply because the latter language runs the risk of being interpreted as merely precatory

¹⁴ Ikenson, et al., 2016.

¹⁵ Re:Create Coalition, "Re:Create Coalition Calls For Any NAFTA Negotiations On Copyright To Incorporate Limitations And Exceptions," May 18, 2017. http://www.recreatecoalition.org/press_release/recreate-coalition-calls-nafta-negotiations-copyright-incorporate-limitations-exceptions/

rather than as a commitment of signatories.¹⁶ Alternatively, R Street accepts the Library Copyright Alliance's suggestion that NAFTA negotiations follow the example of the reported Australian suggested language in the Regional Comprehensive Economic Partnership negotiations, which does use the word "endeavor" in the context of a larger obligation to create exceptions and limitations that include, but are not limited to, "education, research, criticism, comment, news reporting, libraries and archives and facilitating access for persons with disability."

State-owned enterprises

State-owned enterprises (SOEs) often are a hindrance to freer trade. Governments routinely use SOEs to serve protectionist ends by showering preferential treatment to them through domestic subsidies and discriminatory treatment of foreign competitors. As USTR recently noted: "[I]n 2000, there was only one SOE in the Fortune Global 50 list of the largest companies in the world, now there are close to a dozen."¹⁷ Article 1503 of the original NAFTA agreement spells out the treatment of SOEs between the United States, Canada and Mexico. The extent of the coverage, however, is essentially limited to ensuring nondiscriminatory treatment to foreign firms' sales of goods and investments.

Consistent with congressional demands in TPA about the need to address SOEs in trade negotiations, R Street believes NAFTA negotiators should look to TPP's SOE chapter for guidance. SOE abuse is not as widespread among NAFTA parties as it is among TPP parties, particularly Malaysia, Singapore and Vietnam. Nevertheless, R Street believes TPP's SOE chapter can be useful in NAFTA renegotiations. A strong SOE chapter could set a worthwhile precedent for future trade agreements.

Unlike prior trade agreements, TPP made significant inroads in curbing abuses of SOEs, particularly by prohibiting SOEs from receiving domestic subsidies in ways that impede foreign trade between parties and prohibit discrimination against foreign companies. Likewise, TPP's SOE chapter requires member countries "to provide their courts with jurisdiction over commercial activities of foreign SOEs so that a foreign SOE operating in a TPP country could not evade legal action regarding its commercial activities merely by claiming sovereign immunity."¹⁸ In addition, TPP's SOE chapter requires parties to the agreement to "ensure that administrative bodies regulating both SOEs and private companies do so in an impartial manner and do not use their regulatory authority to provide preferential treatment to their SOEs."¹⁹ This was a positive development.

The one weakness with TPP's SOE chapter is the large number of exceptions to its general rules. Curbing these exceptions should be a high priority for trade negotiators.

¹⁶ Library Copyright Alliance, "Comments of the Library Copyright Alliance on NAFTA negotiations," June 9, 2017. <http://www.librarycopyrightalliance.org/storage/documents/NAFTAComments.pdf>

¹⁷ Office of U.S. Trade Representative, "TPP: Made in America, State-Owned Enterprises," 2015. <https://ustr.gov/sites/default/files/TPP-Chapter-Summary-State-Owned-Enterprises.pdf>

¹⁸ Ibid.

¹⁹ Ibid.

Customs and trade facilitation

R Street believes customs and trade facilitation processes should be a significant area of focus during NAFTA renegotiations, particularly with respect to the de minimis threshold (DMT) exemptions. Low DMTs pose considerable barriers to trade for small businesses, in particular, who often do not have the technical expertise or resources to comply with costly and complicated customs forms and levies. Harmonizing DMTs between NAFTA parties would benefit businesses in all three countries by reducing unnecessary costs.

The DMT exemptions vary widely between the United States, Mexico and Canada. Imports entering the United States valued at \$800 or less are exempt from taxes, duties and much of the customs paperwork. Meanwhile, in Canada, the general DMT is C\$20 for items shipped into the country and C\$800 for items carried by individuals into the country.²⁰ This is the lowest DMT in the industrialized world.²¹ Mexico has a bifurcated DMT: US\$50 for goods entering the country from couriers, with a US\$300 exemption for postal shipment.

In 2016, Congress passed and President Barack Obama signed the Trade Facilitation and Trade Enforcement Act. Among other provisions, the bill provided a sense of Congress that USTR negotiators should seek to "encourage other countries ... to establish commercially meaningful de minimis values for express and postal shipments that are exempt from customs duties and taxes and from certain entry documentation." This is a perfectly reasonable goal for trade negotiators. NAFTA negotiators should seek to increase the DMT for American exports to both Canada and Mexico.

While R Street acknowledges that part of the reason for the lower thresholds in Canada and Mexico is that those countries level value-added taxes (VAT) and are dependent on the customs revenue, there is reason to believe the revenue benefits are outweighed by the gains in trade that would accrue if the DMT were significantly raised.²² Studies have indicated that the Canadian government spends almost four times as much to enforce the DMT on low-value imports than it collects.^{23 24} In fact, a very recent study from Canada's Auditor General found that the Canadian government spends more to collect duties on items valued under \$200 CAD than it collects from the duties.²⁵ Increasing the DMT up to \$800 is

²⁰ Canada Border Security Agency, "Determining duty and taxes owed," Canada Border Security Agency. <http://www.cbsa-asfc.gc.ca/import/courier/menu-eng.html>

²¹ Christine McDaniel, Simon Schropp and Olim Latipov, "Rights of Passage: The Economic Effects of Raising the *de minimis* Threshold in Canada," C.D. Howe Institute, June 23, 2016.

https://www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/E-brief_Rights%20of%20Passage_June16.pdf

²² Ibid.

²³ Ibid.

²⁴ Office of the Auditor General of Canada, "2017 Spring Reporters of the Auditor General of Canada to the Parliament of Canada," Office of the Auditor General of Canada, June, 2017. http://www.oag-bvg.gc.ca/internet/English/parl_oag_201705_02_e_42224.html#

²⁵ Ibid.

ideal. Though that may be a nonstarter, raising it considerably should be a priority for USTR's negotiators.

Likewise, customs harmonization would be enormously beneficial to all NAFTA parties. Transparent, easy-to-understand rules and forms will go a long way toward increasing trade flows between NAFTA nations. TPP, for instance, required countries to ensure that goods moved as quickly as possible through customs, with a target of release within 48 hours. This is a worthwhile standard.

R Street is mindful that the World Trade Organization's (WTO) Trade Facilitation Agreement entered into force in February 2017. The WTO estimates the agreement "could reduce trade costs by an average of 14.3 percent and boost global trade by up to \$1 trillion per year."²⁶ In short, the global community is concerned that red tape can pose significant barriers to foreign trade. The success of the Trade Facilitation Agreement is demonstrative proof that multilateral negotiations can modernize outdated customs and trade facilitation processes. NAFTA negotiators would be wise to emulate this multilateral success.

Rules of origin

In light of the complex supply chains that have developed as a result of trade agreements and globalization, R Street would like to see rules of origin (ROO) further liberalized as part of NAFTA renegotiations. ROOs are essentially the criteria used to determine the source of a product. In particular, they specify how much of a final product needs to be made within the free trade zone covered by the trade agreement in order to receive duty-free or preferential treatment.

Often overlooked in the conversations about trade deficits is that a significant percentage of the items imported into the United States have American-made component parts. According to a 2010 study: "The United States contributes the highest share (10.0 percent) of its own value added to its imports of final goods. One-quarter of U.S. imports from Canada consist of value added from the United States itself, and a huge 40 percent of U.S. final good imports from Mexico consist of its own value added."²⁷ This is a testament to highly complex global supply chains that emerged with the increase in global trade.

While R Street is supportive of measures that significantly reduce ROOs, we are mindful of the balancing act inherent in any ROO negotiation. High thresholds create a trading bloc that can inhibit companies from using component parts made outside of the zone, while extremely loose or nonexistent ROOs allow nonparties to the agreement to realize large commercial gains without making any concessions. In light of this delicate balancing act, R Street urges trade negotiators to use TPP's ROO chapter as the

²⁶ World Trade Organization, "World Trade Report 2015," World Trade Organization, 2015. https://www.wto.org/english/res_e/booksp_e/world_trade_report15_e.pdf

²⁷ Robert Koopman, William Powers, Zhi Wang and Shang-Jin Wei, "Give Credit Where Credit is Due: Tracing Value Added in Global Production Chains," National Bureau of Economic Research, September 2010. <http://www.nber.org/papers/w16426>

baseline for any NAFTA ROO changes, though it suffers from product-specific rules rather than a generally applicable rule.

Though TPP's ROO chapter is preferable to NAFTA's original ROO chapter, R Street believes there is a simpler way to address ROO issues in future trade negotiations. There should be a universal ROO applicable to all products, with a 50.1 percent regional value content (RVC) threshold, which measures the ratio of the value to the originating or nonoriginating materials contained within the product. This can be coupled with a cumulative rule that allows goods from other free trade agreement partners to count toward the RVC threshold. This would dramatically simplify the ROO negotiation tensions mentioned above. Using NAFTA renegotiation to set this simple precedent for ROOs would be enormously beneficial for future trade negotiations.

Government procurement

In recent years, there has been a proliferation of so-called "Buy American" laws that require government procurement contracts to source from domestic suppliers. The American Recovery and Reinvestment Act signed by President Obama in 2009 contained a Buy American provision requiring public works funded by the act to use domestic steel, iron and manufactured goods. Likewise, President Trump routinely calls for domestic content requirements for public works projects as part of his so-called "Buy American, Hire American" program. While this may make for good politics, it makes for bad trade policy and economics.

Domestic preferences for government procurement contracts and projects are highly inefficient and a waste of taxpayer dollars. With certain exceptions, one of the benefits of NAFTA was to eliminate domestic content requirements for government contracts between the United States, Mexico and Canada. As the Congressional Research Service has noted: "NAFTA opened up a significant portion of federal government procurement in each country on a nondiscriminatory basis to suppliers from other NAFTA countries for goods and services."²⁸ This served domestic companies' interests well, as they can compete with Mexican and Canadian businesses on an equal footing for government contracts.

R Street urges trade negotiators to reaffirm this general commitment to open competition for government contracts. Any backsliding away from NAFTA's procurement chapter will hamper domestic companies and damage American credibility. Indeed, one way to improve NAFTA's government procurement chapter would be to further limit the exceptions to its general open competition requirements of the original agreement.

Conclusion

²⁸ M. Angeles Villarreal and Ian F. Fergusson, "The North American Free Trade Agreement (NAFTA)," Congressional Research Service, May 24, 2017. <https://fas.org/sgp/crs/row/R42965.pdf>

In closing, R Street appreciates the opportunity to provide our thoughts on NAFTA renegotiation objectives. Ensuring largely unimpeded commerce flows between the United States, Canada and Mexico is vitally important to businesses and consumers. We look forward to working with USTR throughout the negotiation process and would be glad to answer any questions you may have.

Sincerely,

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