Reimagining “NAFTA 2.0”:

A CASE STUDY IN THE APPLICATION OF SOCIAL SCIENTIFIC METHODS FOR POLITICAL RISK ANALYSIS

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Introduction

Humanity is increasingly grappling with the consequences of its own progress in what German sociologist Ulrich Beck refers to as the “World Risk Society”. In defining this concept, Beck recognizes that modernity has begun to outpace traditional risk management strategies in the 21st century. Globalization and technological progress create new threats that cross borders, are beyond calculation, and undermine the ability of individual countries to address their national problems alone. A “cosmopolitan” reality in politics where states must work collaboratively is now required to develop effective solutions to complex challenges in the new risk landscape.[1]

The international cooperation that Beck sees as an adaptation to the World Risk Society, however, could be difficult to foster in an environment where the structure of geopolitics is changing so dramatically. In their account of the power shifts underway, Ian Bremmer and Nouriel Roubini describe a “G-Zero” world in which no single country has the will or capacity to define the global agenda.[2] The international community is entering a period where a competition between states to shape new economic rules and norms has replaced the world order created by the United States. In domains ranging from trade to financial regulation and climate change, conflict will increase among countries.[3] This will likely make collective action even more difficult to broker.

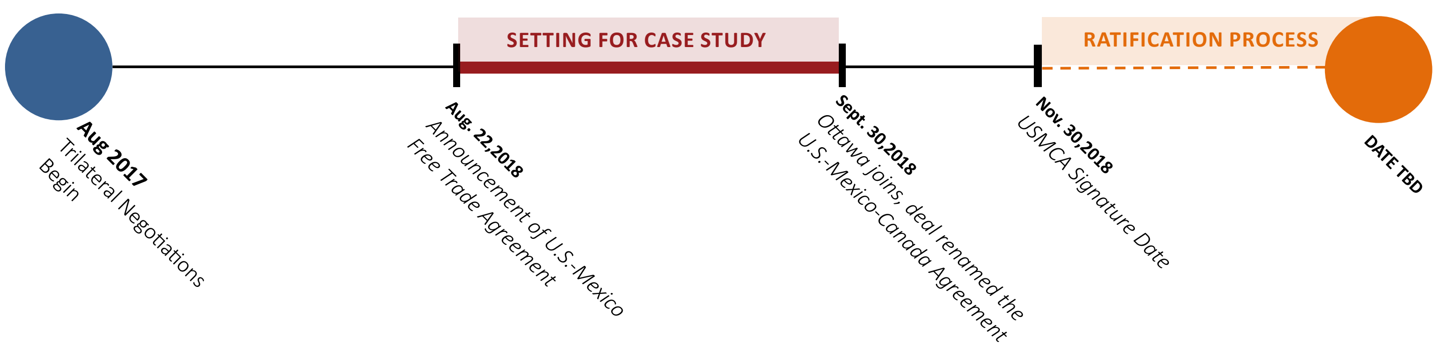
Thus, it is the inability of states to independently protect against modern threats that limits the governance of the more pressing risks – or more accurately uncertainties – that exist in a World Risk Society, and this could be significant to the financial services industry. Without effective multilateralism among nations, new hazards could proliferate beyond the ability of risk managers to handle. Geopolitical factors may determine whether cooperation between countries will succeed within Beck’s paradigm, and so professionals that better understand the course of international relations can gain insight into many of the complex and emerging risks that most threaten their enterprises.

The goal of this report is to move beyond traditional approaches to risk management in the financial services industry and focus specifically on understanding political uncertainty. The report uses the renegotiation of the North American Free Trade Agreement (NAFTA) as a case study to illustrate the value of social scientific theory when analyzing multilateral negotiations. Ultimately, the concepts applied forthwith are only a sample of the different theoretical approaches to uncertainty in international relations that are explored in the academic literature. Risk managers that use qualitative analysis to construct political scenarios and gauge the associated effects should seek to use models that are contextually relevant.

Structure

Section 1 of this report outlines concepts from negotiation theory and game theory that can be used to interpret multiparty bargaining scenarios. In Section 2, the renegotiation of the North American Free Trade Agreement (NAFTA) is introduced as a case study with which to apply the concepts introduced in Section 1. NAFTA is the chosen topic for assessment because of the principal importance of the rules and regulations it sets forth for both the Canadian financial services industry and the larger economy. To demonstrate the utility of the framework described herein for risk managers, the report assesses the renegotiation process from a specific vantage point in time. Mid-September 2018 was a critical moment in the NAFTA talks when Canada and the U.S. specifically engaged with and resolved some of the most contentious trade issues between them, and so the flexibility and explanatory power of the framework is demonstratable when applied to this particular time period. For greater clarity, the timeline in Figure 1 illustrates precisely where the reader should situate themselves when interpreting the case study.

Figure 1: NAFTA Renegotiation Timeline



Section 1
A Framework for Analyzing International Negotiations

The theory of conflict and negotiation is a complex and interdisciplinary subject for scholarship, informed by social scientific expertise in fields ranging from social psychology and anthropology to political science and international relations.[4] Expounded upon in prominent academic literature and by pioneering initiatives like the Program on Negotiation (PON) at Harvard Law School,[5] Negotiation Theory has the potential to yield some insightful conclusions when applied to the interpretation of bipartisan or multiparty trade talks. The specific theoretic framework in this study strikes a balance between concision and intellectual rigour, applying select concepts and modelling techniques to best depict, analyze and infer consequences from the NAFTA renegotiation process.

Key Concepts

The Best Alternative to a Negotiated Agreement (BATNA)

The BATNA refers to the next best option available to a party independently and outside of the negotiation process.[6] It effectively sets the boundaries of a good agreement, distinguishing between the outcomes that are value-adding or "inferior" in a bargaining process.[7] The BATNA is a key determinant of power relations in a negotiating scenario, although it is not necessarily derived from economic, military or political sources. Instead, the superior BATNA is retained by the party with the least to lose if arbitration were to prematurely terminate.[8] As sufficient motivation to work towards an agreement, a party must gain enough advantage from mutual cooperation to outweigh whatever utility it gains from settling on its BATNA.[9] The negotiators with weaker BATNA's risk paying a greater opportunity cost if they walk away from the table, and so are compelled to accept a sub-optimal (in-terms of their own specific preference ordering) agreement rather than settle for the comparatively less appealing alternative.

Although the BATNA can be a compelling tool for negotiations, the best means of advertising and deploying it may vary with the circumstances of a given exchange. Publicising a strong negotiating alternative can signal a party's resolve to withdraw from talks in the case of a "bad deal," and force cooperation in its favour. If the weaker player perceives the BATNA to be better than it truly is, however, an advantaged party may actually lose strategic ground by disclosing it.[10]

The Zone of Possible Agreement (ZOPA)

The size of a ZOPA is determined by the range of outcomes wherein the perceptions of acceptability for all negotiators overlap, thus meeting the conditions for a successful agreement.[11] In other terms, it is effectively the space between the reservation prices of the parties,[12] or the thresholds beyond which a country's BATNA is the more ideal outcome (see *"Reservation Price" section for more*).

Reservation Price (Reservation or Walk-Away Point)

The Reservation Price is the "walk-away" line for a given party, beyond which an agreement has insufficient utility to warrant further mediation.[13] It is effectively the indifference point, where a negotiator interprets no trade-off between staying at and leaving the bargaining table in favour of the BATNA.[14] Thus, on one side of the reservation point are the terms of a possible deal (or the ZOPA), and on the other side is the next-best alternative to a negotiation.

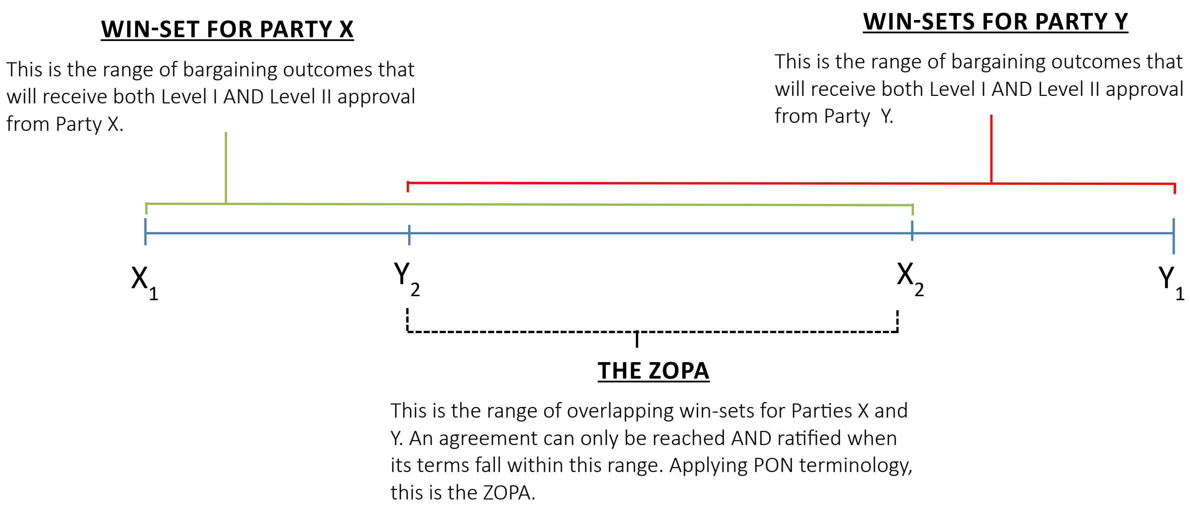
Two-Level Game Theory

International negotiations involve both external and local dimensions, as parties seek not only grounds for mutual agreement, but the consent of national political interests through processes like ratification.[15] Two-level game theory provides a model for a "general equilibrium" analysis that accounts for the simultaneous interaction of both international and domestic politics.[16] First conceived by Harvard Political Scientist Robert Putnam,[17] a two-level game divides the bargaining process into binary levels.[18] Level I accounts for the frontline negotiation team that bargains for a provisional agreement on behalf of constituent organizations or interests.[19] In contrast, Level II refers to the internal deliberative process required for the full accession of a party, or the "separate discussions within each group of constituents about whether to ratify the agreement." The verification process that takes place at Level II can be formal or informal in nature.[20] The two-level negotiation also hinges on active interchange: the priorities at Level I are derived from the preference ordering held at Level II, which in turn can be the product of an intra-constituency bargaining and discussion process. Talks essentially take place at two different tables, where progress at Level I is tested iteratively against Level II preferences.[21] There is also a prevailing assumption that undergirds Putnam's approach: the chief negotiator at Level I is a unitary actor that does not have a unique preference ordering, but rather is only guided by the objectives of the constituents that it represents (ex. In accordance with the model, The United States Trade Representative (USTR) holds no individual position on NAFTA, but is merely the voice of the Trump Administration at large).[22]

Win-Sets

A key component of Putnam's approach is the win-set: "the set of all possible Level I agreements that would 'win' –that is, gain the necessary majority among the constituents–when simply voted up or down."[23] The win-sets between the Levels I and II for each Party in a bargaining process must intersect in order to find a mutually acceptable agreement, and so the larger the sets are, the greater the chance that a negotiation will be successful.[24] In accordance with the model, win-sets can also influence the power dynamics in a bargaining process, as parties with fewer options can use their narrower window for Level I/II agreement to gain concessions from other countries.[25] Applying the structure of the two-level game theory, the win-set effectively becomes synonymous with the ZOPA.

Figure 2: Structure of the Two-Level Game



The Schelling Conjecture and its Shortfalls

Additional scholarship compliments Putnam (1988) with new insights concerning the relationship between domestic politics and international negotiations.[26] Milner and Rosendorff (1997) build upon the two-level game theory model by integrating an analysis of “a two-dimensional policy space.”[27] They look specifically at the role of elections in the international negotiations process, and the causal relationship between electoral uncertainty and the content and ratification (or failed ratification) of international agreements.[28] The authors start with a benchmark case for their study: a complete information game in which Level I is fully cognisant of both Level II’s preference ordering and how an upcoming election result will change it, and coordinates the negotiating position in such a way as to ensure that a ratified agreement is always achieved. Milner and Rosendorff also look at the implications of a complete information game in a state of divided government, and conclude by examining a scenario of incomplete information in which a politically disruptive election during or shortly after a negotiation (but before ratification) can create significant uncertainty.[29]

An important concept raised by Milner and Rosendorff is the Schelling Conjecture. This theory posits that a negotiator for the executive branch (“Level I” in Putnam’s vocabulary) can actually use a hostile legislature (“Level II”) to make gains at the expense of an opponent.[30] The model is analogous to a classic “Chicken” Game, whereby a doubling-down of commitment on the part of one player can maximize utility gains at the expense of an opponent.[31] The Conjecture is the theoretical concept underpinning Putnam’s own argument that win-set size is a determining factor in the distribution of bargaining power.[32] Milner and Rosendorff conclude that the Schelling Conjecture is valid, but only in cases of complete information and limited divisions in government. When conflicts between Level I and Level II are too great, foreign parties do not interpret an opponent’s move to “double-down” at the bargaining table as a credible commitment.[33] Alternatively, in a state of electoral uncertainty, the negotiating power that a rigid legislature bestows upon the executive actually decreases further. The Level I actor may get so concerned about reaching an agreement for which it can secure Level II support that it effectively hedges against potential opposition and adjusts its preference ordering in such a way as to reach a sub-optimal outcome.[34] The consequence then is that “Periodic elections of the legislature have the effect of limiting the executive’s negotiating range in the international game.”[35]

Section 2: NAFTA: A Case Study

This report uses the NAFTA renegotiation as a case study only and is intended to illustrate a new approach to the analysis of political risk in a bargaining situation rather than to specifically address the course or resolution of the North American trade talks. It is written in the context of mid-September 2018, predicated on the trilateral negotiating positions of each participating country as discernible after the announcement of the U.S.-Mexico bilateral trade agreement on August 27th but prior to Canada’s incorporation on September 30th. The NAFTA renegotiation was chosen because of the significance that the deal holds for both the Canadian financial services industry and the wider economy. NAFTA revolutionized financial services trade, setting a precedent as the first agreement to apply a principles-based method to liberalization.[36] Since it came into force, financial sector business has increased, with results that have substantially benefitted Canadian institutions. The temporal setting of the case study (mid-September 2018) illustrates both the flexibility and utility of the framework, given that Canada and the U.S. engaged in direct bilateral discussions through this period to address the most contentious issues between them.

Historical Overview of NAFTA

The conceptual antecedent to North American free trade developed in the late 1950s when the idea of regional economic integration started to germinate across the Atlantic. The founding of the European Economic Community (EEC) in 1957 created a “Common Market” among six neighbouring countries, binding France, West Germany, Italy, Belgium, the Netherlands and Luxembourg in an open economic zone.[37] The EEC set common trade and agricultural policies for its constituent states, established supranational institutions for governance and administration,[38] lowered-tariffs and increased trade.[39] It also set a precedent that would inspire political action in North America.[40] In 1979, Ronald Reagan provided a description of regional free trade when announcing his candidacy for the Republican presidential nomination.[41] He spoke of a “developing closeness” between Mexico, Canada and the United States in the form of a “North American accord,” and suggested that at some future date, “…a map of the world might show the North American continent as one in which the peoples and commerce of its three strong countries flow freely across their present borders.”[42] Reagan’s announcement did not illicit universal appeal, however, since both Canadian and Mexican leadership worried that a free trade regime could facilitate U.S. economic domination.[43]

Political developments soon interceded to help boost the prospect for an integrated North American trading system. The Progressive Conservative Party’s 1984 election victory under Brian Mulroney set Canada on the path towards a formal pact with the U.S.[44] At the 1985 “Shamrock Summit,” President Reagan and Prime Minister Mulroney decided to explore the creation of a new comprehensive free trade agreement.[45] Negotiations began in 1986, with the parties arriving at a final agreement in the following year. The ratified Canada-United States Free Trade Agreement (CUSFTA) came into effect on January 1, 1989, eliminating tariff barriers, innovating provisions for services trade and implementing measures for dispute resolution.[46] A key component of the CUSFTA was its Chapter 19 provision covering binational dispute settlement over anti-dumping and countervailing duties.[47] The Canadian negotiating team had insisted upon the inclusion of Chapter 19, motivated by perceived inequities in American trade practices.[48] Conflict over the dispute mechanism nearly undermined the talks when the Mulroney government temporarily walked away from the negotiating table to demonstrate that the provision would be treated by Ottawa as an “essential condition” for an acceptable agreement.[49]

Although the CUSFTA engendered little backlash in the U.S., it remained acutely controversial in Canada, where it drew opposition from the Liberal and New Democratic parties.[50] From the American perspective, continental free trade advanced the country’s wider liberalization agenda, and that effort was bolstered when President Carlos Salina de Gortari approached President George H.W. Bush to propose an additional bilateral agreement between the U.S. and Mexico.[51] For Salina, an open trading relationship with Washington would help to attract investment and secure his party’s legitimacy. The ruling People’s Revolutionary Party (PRI) had begun a process of market liberalization following Mexico’s national debt crisis in the early 1980s, and investors were still uncertain about the permanence of government reforms and the overall stability of the economy.[52] The key goal for NAFTA was to integrate the Mexican economy with the developed markets of its northern neighbours, opening up new export opportunities and facilitating operational competitiveness.[53] However, in both the U.S. and Canada, the trilateral proposal also aroused concern that a race to the bottom would drive down labour and environmental standards in response to Mexican competition.[54] Former U.S. Presidential candidate Ross Perot characterized this downside risk as a “‘giant sucking sound,’” created when NAFTA shifted jobs south to chase lower wages.[55]

Regardless of the public anxiety it generated, NAFTA was duly signed by Prime Minister Mulroney and Presidents Bush and Salina in December 1992 and ratified by each of the three participating governments in the following year, subject to enforcement on January 1, 1994.[56] The new agreement became the most controversial of American trading relationships, however, and the ratification process in Washington was only achieved with great effort by the Clinton Administration in 1993.[57] The new Democratic President sought additional agreements that addressed concerns over labour and environmental laws in Mexico.[58] The accompanying North American Agreement on Labour Cooperation (NAALC) and North American Agreement on Environmental Cooperation (NAAEC) also came into effect in 1994,[59] but lacked the enforcement processes included in the main NAFTA text.[60]

In the decades following its initial application, the economic consequences of NAFTA were significant for the North American bloc. As of 2013, trade volumes between Canada, Mexico and the U.S. had tripled and production processes grew more integrated.[61] Regional supply chains spanning the three nations are particularly evident in the automotive sector.[62] After 20 years, U.S. labour unions continued to be ardent opponents of NAFTA, driven by anxiety over job losses to Mexico. Indeed, Midwestern states like Ohio, Michigan and Indiana did experience substantial decreases in the manufacturing workforce.[63] Economists attribute the majority of this decline to Asian market competition and technological innovations rather than to greater North American convergence.[64] Furthermore, unlike the European approach to trade liberalization, the NAFTA model did not seek greater political amalgamation between its three signatories, and failed to construct any institutions for collective problem solving. NAFTA offices were created in all three countries, but the North American Leaders Summit (NALS), referred to colloquially as the “Three Amigos”, remained the primary forum for interstate cooperation.[65]

In the absence of transnational institutions, opposition to NAFTA still manifested in domestic political discourse after the negotiations had concluded. During the initial ratification process in 1993, the Liberal party under Prime Minister Jean Chretien won an election on a platform that called for a renegotiated NAFTA, although the new government backed down from this pledge when met with American opposition. In the 2008 Presidential campaign, then candidate Barack Obama also pledged to either renegotiate or back out of NAFTA, although he did not follow through on this commitment.[66]

NAFTA also became a focal point of the 2016 U.S. Presidential election. Both President Donald J. Trump and the runner-up nominee for the Democratic primary, Senator Bernie Sanders, ran on platforms that emphasized dissatisfaction with North American free trade and promoted reform. Both men garnered support from American voters weary of trade and its effect on their livelihoods. This sentiment helped the new President secure his election victory, and the administration soon took political action accordingly. On May 18, 2017, Robert E. Lighthizer, U.S. Trade Representative, submitted notice to Congress on behalf of the Trump Administration to begin a process of NAFTA renegotiation.[67]

Washington's decision to impose steel and aluminum tariffs on both Canada and Mexico complicated trade discussions. On June 1, 2018, the Trump Administration withdrew exemptions for its North American and European partners and imposed a tariff of 25% on steel and 10% on aluminum imports. The White House originally imposed the tariffs in March 2018, justified on national security grounds, but had excluded Canada, Mexico and the EU until June 1. In response to these measures, Canada imposed C$16.6 billion worth of countermeasures (surtaxes) against imports of steel, aluminum, and other products from the U.S., matching the value of 2017 Canadian exports affected by the American tariff.[68]

In August 2018, the U.S. and Mexico engaged in bilateral trade discussions to resolve key issues around auto rules of origin and labour standards in the industry. The negotiations soon expanded to cover other points of tension between the two parties, and on August 27, 2018, President Trump announced a new deal named the "U.S.-Mexico Free Trade Agreement."[69]

Key Issues from NAFTA (1994)

The terms of NAFTA (1994) initiated a gradual removal of tariffs, as well as an end to most quantitative trade restrictions and duties.[70] The agricultural, automobile and textile industries were key focal points of the liberalization process. The NAFTA provisions were implanted slowly over a 14-year period, and the remaining barriers were removed as of January 2008. [71]

The sector-specific provisions established under NAFTA (1994) include: Trade and Investment in the Automotive Sector (Chapter 3: Annex 300-A); Textile and Apparel Goods (Chapter 3: Annex 300-B); Energy and Basic Petrochemicals (Chapter 6); Agriculture and Sanitary and Phytosanitary Measures (Chapter 7); Cross-Border Trade in Services (Chapter 12); Telecommunications (Chapter 13); and Financial Services (Chapter 14).[72]

In the chart below (Table 1), the key sections of the NAFTA agreement under discussion are summarized. A thorough description of the provisions contained in these Chapters can be found in the Appendix to this report.

Table 1: Key Sections of NAFTA (1994)

Chapter	Topic	Key Provisions Summary:
Chapter 1	*General Objectives*	• Eliminate barriers to trade and facilitate the cross-border movement of goods and services between the territories of the NAFTA partners; • Promote fair competition in the free trade area; • Increase investment opportunities in the territories of the NAFTA partners; and • Provide adequate and effective protection and enforcement of intellectual property rights for each partner.
Chapter 4	*Rules of Origin*	Rules of Origin effectively prevent goods produced outside of a trading bloc from crossing the borders between partners and receiving the same preferential treatment granted to internally produced goods and services.
Chapter 7	*Agriculture*	The NAFTA partners will work toward improving access to their agricultural markets by striving to reduce or eliminate import barriers. There is a recognition that domestic support for agricultural industries is permitted but the partners must work toward support for these industries which do not have trade distorting effects.

Chapter	Topic	Key Provisions Summary:
Chapter 11	*Dispute Resolution (ISDS)*	The creation of the Investor State Dispute Settlement Mechanism (ISDS) which manages disputes between states and commercial actors. The ISDS allows companies to sue governments for alleged discriminatory treatment under NAFTA. The ISDS is an impartial tribunal and decisions made in these cases are enforceable in the domestic courts of each trading partner.
Chapter 14	*Financial Services*	NAFTA partners agree to: • National Treatment – provide investors and service providers of another Party with treatment no less favourable than that which they grant their own investors and service providers. • Most-Favoured Nation Treatment – provide the investors and service providers of another Party with treatment no less favourable than they accord investors and service providers of any other Party or **non-Party.** Prudential Carve-out – NAFTA cannot prevent a partner from adopting or maintaining reasonable regulatory measures for their own financial system.
Chapter 17	*Intellectual Property Provisions*	NAFTA defines minimum standards for IP and ensures that the three trading partners enforce those standards for entities within their respective jurisdictions. Countries are not limited to the minimum IP provisions under NAFTA, and can enforce more stringent domestic legal protections if they so choose, as long as they do not contradict the agreement.
Chapter 19	*Dispute Resolution (countervailing duties and anti-dumping)*	The creation of a binational panel to determine disputes arising from cases involving countervailing duties and anti-dumping measures.
Chapter 21	*Cultural Exemptions*	Annex 2106, referred to in Article 2106, confirms cultural protections for Canadian media industries based on the CUSFTA.
North American Agreement on Environmental Cooperation (NAAEC)	*The Environment*	A commitment to the promotion of environmental sustainability by the three partners, and to not degrade the environment for a competitive advantage. This is a side agreement and not included in the NAFTA agreement. As a result, the provisions of this side agreement are not subject to the Chapter 20 State to State dispute resolution process.
North American Agreement on Labour Cooperation (NAALC)	*Labour*	A commitment to enforce strong labour standards within the three jurisdictions. Like the environmental side agreement, these provisions are not enforceable through NAFTA.

NAFTA Renegotiation 2017-2018: Establishing the Preliminary Negotiating Objectives

This segment outlines the publicly stated initial negotiating objectives of each NAFTA partner in 2017 and highlights their respective priorities, from which the tension points in the bargaining process can be inferred and explained.

Table 2: NAFTA Partners' Key Bargaining Priorities (2017)

Country	Key Priorities Summary:
Canada	• The preservation of Chapter 19 and the modernization of the Chapter 11 dispute resolution mechanism • The preservation of the exceptions within NAFTA that protect the Canadian supply management system in agriculture and the exception for Canadian cultural protection • The integration of the side agreements on Labour (NAALC) and the Environment (NAAEC) into the main text of NAFTA • The inclusion of mechanisms to facilitate and ease business between the NAFTA partners • No added sun-set clause, which would mandate a review after a 5-year period, and cancel the agreement by default if the three parties do not recommit • Adding into the agreement progressive elements such as new Chapters on Indigenous Peoples and Gender[73]
Mexico	• The preservation and modernization of Chapters 11, 19 & 20 • Tariff protections for Mexican textiles • No inclusion of auto-rules of origin stipulations • No inclusion of seasonal protections from the U.S. against the Mexican agricultural sector • No sun-set clause to be included in the final agreement • Legal certainty for Mexican suppliers in the public procurement procedures for the region • Enhancing provisions contained in Chapter 16 which would allow for greater labour mobility • Enhancing provisions contained in the Labour (NAALC) and Environmental (NAAEC) side agreements • The inclusion of Gender provisions within the main agreement • An update to energy stipulations in the agreement and a focus on the integration of telecommunication markets between NAFTA partners[74]

U.S.	• Reduce the U.S. trade deficit with NAFTA partners
	• Eliminate and prevent non-tariff barriers to U.S. agricultural products
	    ◦ Seek to eliminate the Canadian limits on U.S. agricultural products
	• Ensure that the rules of origin stipulations in the agreement incentivize production in North America, and particularly the U.S.
	    ◦ With respect to auto parts, cars must include 50% U.S. content and 85% content from North America overall, to avoid a tariff at the last stage of production
	• Promote access and opportunities for U.S. financial service suppliers in NAFTA countries and secure investment opportunities for U.S. investors
	• Enhance protections for U.S. intellectual property
	• Bring the labour provisions (under the NAALC) into the core agreement and require parties to abide by the International Labour Organization (ILO) declaration
	• Bring the environmental provisions (under the NAAEC) into the core agreement, and create strong and enforceable obligations in this section that are subject to a dispute settlement mechanism
	• Eliminate the Chapter 19 Dispute Settlement mechanism
	• For government procurement, ensure reciprocity in terms of market access for U.S. goods, services and suppliers in Canada and Mexico – this would limit Canadian and Mexican access to U.S. government procurement contracts to a dollar-for-dollar amount that equals the value of the government procurement markets in both countries[75]
	• The creation of a 5-year sunset clause which would automatically open up the agreement to review, and void the document if all parties do not actively recommit to its terms.[76]

Major Issues of Disagreement

The 5-Year Sunset Clause

Two months into the NAFTA talks in Mid-October 2017, the U.S. negotiating team brought forward a proposal for a "Sunset Clause." This provision would allow for the agreement to be automatically cancelled after 5 years unless all three member states actively recommitted to its terms.[77] Both the Canadian and Mexican ambassadors spoke out in opposition to the clause, arguing that it would bring greater uncertainty to the trade agreement and hinder long-term business planning.[78] Canadian Foreign Minister Chrystia Freeland also highlighted that NAFTA (1994) already includes exit provisions that a country can invoke if it wishes to leave the trade zone.[79] Ottawa did show some inclination to compromise on Washington's demands in June 2018, as Prime Minister Trudeau stated his willingness to entertain some sort of alternative provision for NAFTA re-evaluation that does not create the same economic insecurity.[80] However, former USTR Michael Froman argues that the uncertainty created by the Sunset provision is actually a calculated objective of the Trump Administration, as it would encourage companies to invest in the U.S. rather than in Mexico.[81]

Canadian Supply Management

First implemented in the early 1970s, the Canadian supply management system for agricultural products was initially intended to address interprovincial trade tensions and price volatility.[82] The scheme applies to the dairy, chicken, turkey and egg markets,[83] and unlike subsidization policy, builds agricultural sector supports directly into product pricing rather than factoring it into public expenditures and taxation.[84] There are three policy mechanisms that undergird supply management: quotas, price controls and import restrictions. For adjusting production, government first estimates the level of market demand, and then sells licenses to farmers that set out exactly how much yield they can produce in any given year.[85] Price floors establish the minimum compensation that processors can offer producers for their goods,[86] and tariffs enforce stiff penalties against foreign stock, although there are some goods admitted without incurring duties when quantities fall below a certain threshold (10% of the dairy market is reserved for imports tariff-free).[87]

Proponents of supply management argue that the program limits the exposure of farmers to price volatility, ensures the production of safer and higher quality goods, and reduces the need for public bailouts. On the contrary, critics contend that it disproportionately hurts low-income Canadians by pushing up the cost of managed goods, and that it is frequently an obstacle to forming new trading relationships. [88] Supply management has been a subject of note in past trade negotiations, including in talks for the Trans-Pacific Partnership (TPP) and the Comprehensive Economic and Trade Agreement (CETA).[89] For the NAFTA renegotiation, the U.S. has made supply management reform an aim of its strategy. The revised statement of objectives from the Office of the USTR refers specifically to the expansion of "competitive market opportunities for U.S. agricultural goods in NAFTA countries, substantially equivalent to the competitive opportunities afforded foreign exports into the U.S. market, including by eliminating remaining Canadian tariffs on imports of U.S. dairy, poultry and egg products."[90] President Trump has also complained publicly about Canadian supply management on multiple occasions,[91] including during the U.S.-Mexican bilateral talks in mid-August 2018.[92] The Trudeau Government's response to American pressures has been to stand firm in defence of the system, and the Prime Minister has repeated statements in opposition to supply management repeal that he suggests have motivated the protests from the White House.[93]

Dispute Resolution (Chapters 11 & 19)

Dispute resolution mechanisms are included in Chapters 11, 19 and 20 of NAFTA. The tension over dispute resolution centres in-part on the American request for reform of the Investor-State Dispute Settlement System (ISDS) delineated in Chapter 11, making compliance optional for a party if the arbitration panel is deemed to have erred in its judgement. The amended provision could call the authority of the ISDS into question when it rules on disputes between governments and the private-sector. Another point of controversy concerns Chapter 19; the repeal of which remains a specified American objective for the renegotiation process. Both Canada and Mexico have stated that they wish to maintain and enhance the dispute resolution regimes set forth in the agreement. From the Canadian perspective, the inclusion of Chapter 19 has been a red line historically, arising in both the CUSFTA and original NAFTA negotiations.[94] The Trudeau government filed a case under Chapter 19 as recently as January 2018, responding to the American duties imposed on Bombardier aircraft and softwood lumber.[95] The U.S.-Mexico Free Trade Agreement omitted any provision analogous to Chapter 19,[96] suggesting that it was a priority albeit not a red-line for Mexico.

With respect to the proposed transformation of the ISDS, Canada has noted in its negotiating objectives that it would be willing to modify this mechanism to ensure that governments have the right to regulate for their public interest.[97] As a result, there may be room to move on this demand from the U.S.

Government Procurement

The controversy over government procurement is predicated on the U.S. demand for reciprocity in access to the different NAFTA countries. The Trump Administration wishes to limit the access of Canadian and Mexican suppliers to American procurement opportunities, based on a dollar-for-dollar cap equal to the size of their own respective procurement markets. The White House believes that there is an imbalance in the size of the three national procurement markets, unfairly favouring both Canada and Mexico. Responding to this demand in November 2017, the Mexican government suggested that it would limit American bidders to the same amount of contracts Mexican suppliers are awarded in the U.S., which is a negligible figure.[98] According to the U.S. Federal Procurement Data System, in fiscal year 2016, only one Canadian headquartered company appeared in the top 100 contractors for U.S. government procurement deals, and no headquartered Mexican companies made the list.[99] As a result, both countries have been hesitant to accept the revised provision in a renegotiated NAFTA. It also seems that the Americans would stand to lose overall if their partners imposed limitations on procurement equal to the value of their own suppliers' contracts in the U.S.

At the same time, the U.S. also wishes to increase their own access to the Canadian and Mexican procurement markets, encapsulated in their demand for fair, transparent, predictable and non-discriminatory rules. From the American perspective, there are still domestic policies in the other NAFTA countries that discriminate against U.S. companies in the bidding for procurement contracts. For instance, in Canada, privacy laws and security clearances favour Canadian companies in government procurement bids as opposed to U.S. firms.[100] Both Canada and Mexico have been reluctant to loosen domestic policy safeguards to help facilitate access for U.S. firms and appeared unlikely to compromise on this issue as negotiations began.

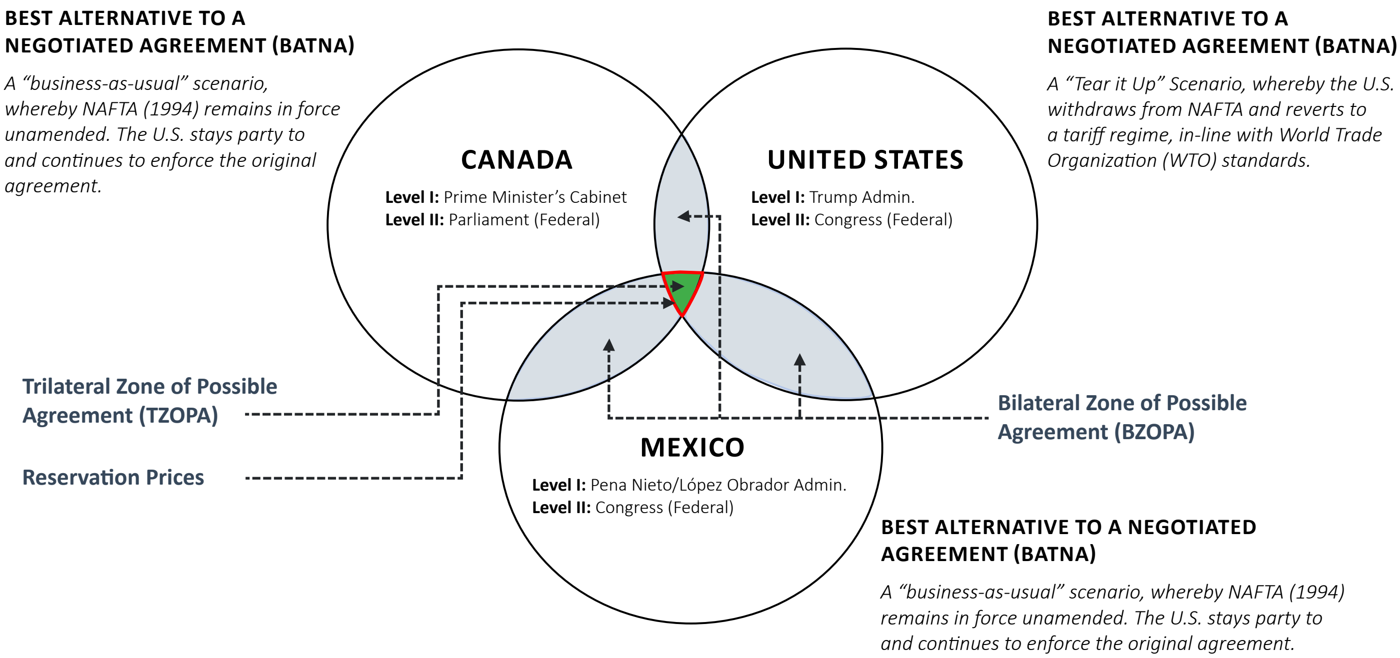
Auto Rules of Origin

The dispute over auto rules of origin largely involves the U.S. and Mexico. The initial position of the Trump Administration was that cars should include 50% U.S. content and 85% total North American content in order to avoid a tariff at the last stage of production.[101] These objectives fit into the Trump Administration's desire to bring back manufacturing jobs to the U.S. and balance the playing field for American manufacturers through NAFTA. Of all the highlighted tension points, the auto rules of origin issues have largely been resolved through the U.S-Mexico Free Trade Agreement. In this deal, the U.S. and Mexico agreed to have 75% of auto content made in Mexico and the U.S. to avoid tariffs, along with a commitment that 40-45% of auto content will be made by individuals earning at least $16 per hour.[102] Canada is likely to agree to these provisions as well in the event that they join the bilateral deal.[103] Thus, as of September 2018, this tension point has been largely resolved.

Applying the Framework

Level I: Negotiation

Figure 3: Modelling the NAFTA Renegotiation Process



BATNAs

The optimal substitutes to a renegotiated NAFTA for each member state are largely influenced by political priorities, legal standards and economic power. Impugning NAFTA for depressing wages and employment prospects for American workers, and for devastating the manufacturing base, Donald Trump pledged to either renegotiate the agreement or withdraw from it altogether in his 2016 presidential campaign.[104] Thus, for the Administration, a "tear it up" scenario remains the likely BATNA, whereby the U.S. formally withdraws from the agreement and resorts to some alternative trade regime. Possible substitutes in a No-NAFTA scenario could include WTO most-favoured nation provisions, or a free-for-all trade policy with "across-the-board" tariffs.[105] The American BATNA could also manifest as a kind of "Zombie" NAFTA, where the White House officially renounces the agreement but the underpinning tariff regime remains in-force, subject to Congressional authority.[106] In fact, due in part to the superseding power of the legislature over trade policy, many experts argue that the NAFTA termination proposal is really an empty threat which the President invokes as a negotiating tactic rather than as a viable BATNA.[107] It follows then that with respect to a proposed U.S. withdrawal, the other two NAFTA partners may have a bargaining advantage over Washington.

For Canada and Mexico, the shared BATNA is a return to the existing NAFTA, as first enacted in 1994.[108] Both countries might gain from an update to the document, but benefit more from the original agreement than they would in a U.S. exit scenario. As the dominant economy, the U.S. may be better able to weather a downside NAFTA scenario than either of its partners. Furthermore, as Gary Clyde Hufbauer of the Peterson Institute for International Economics (PIIE) suggests, there is actually a good chance that the White House could get judicial support for a termination without explicit Congressional approval, and that the President would have some leeway to amend the underpinning laws governing the U.S. trade relationship with Canada and Mexico.[109] Depending on the outcome of the midterm elections, a reconstituted House of Representatives and Senate may even provide enough support to ensure legislative consent for the Administration's decision to withdraw. Thus, given Hufbauer's analysis, the U.S. negotiating team not only has the economic resiliency to outperform its neighbours, but the means to implement its BATNA through a NAFTA repeal. The Canadian and Mexican preference for the existing agreement, however, is contingent upon American acquiescence, and it seems highly unlikely that the Trump Administration will settle for the status quo given its rhetoric to the contrary.

ZOPAs

The ZOPA can be assessed by determining the reservation prices (red-lines) for the NAFTA countries and the points of unanimity between the three negotiating teams. As outlined previously, each NAFTA partner has clear objectives for the bargaining process. The ZOPA is bounded where these goals are also the outright minimum terms for a successful negotiation. Given its superior BATNA, the U.S. has more stringent "walk-away" conditions than its partners. Nevertheless, both Canada and Mexico have clear red-lines as well, which help to shape the terms for a possible consensus. Based on the model outlined in Figure 3, there are also three bi-lateral ZOPA's at-play. However, the trilateral ZOPA is the key focus of this analysis. Table 3 summarizes each NAFTA partner's estimated reservation prices:

Table 3: NAFTA Partner's Reservation Prices (Red-Lines)

Country	Estimated Reservation Prices (Red Lines)
Canada	• The preservation of Chapter 19 relating to dispute resolution • The preservation of the agricultural supply management system (some concessions may be permitted) • No inclusion of the 5-year sunset clause • The preservation of the exception related to Canadian cultural industries in Chapter 21
Mexico	• No inclusion of the 5-year sunset clause
U.S.	• Enhanced auto rules of origin to balance the playing field in auto manufacturing between NAFTA partners • The prevention of non-tariff barriers to U.S. agricultural products

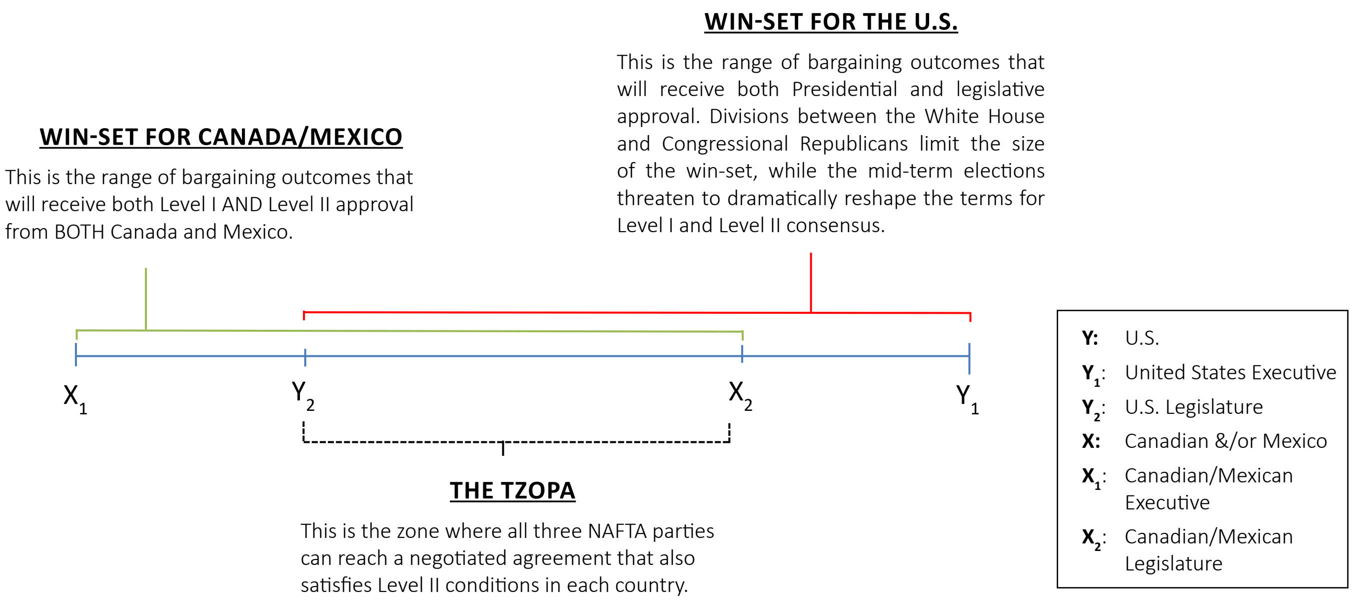
Based on the reservation prices listed above, the boundaries of a potential negotiation can be established. A key inference is that a renegotiated NAFTA would have to exclude a 5-year sunset clause. If the U.S. persists in this demand, both Canada and Mexico are likely to walk away from the negotiating table.

Level II: Ratification

The United States

To seek Congressional approval of a trade agreement, the U.S. President must first notify the legislature at least 90 days before the signing ceremony, and then publish the full text for review within one month of the announcement. After the President signs the document, various disclosure and reporting requirements need to be fulfilled before a bill is submitted to the House of Representatives, where it is reviewed in accordance with internal processes before moving on to the Senate.[110] As of August 2018, the Republican Party maintains a firm grip on both the Executive and Legislative branches of government, and so a degree of political consistency might be expected between Capitol Hill and the Oval Office. Many Congressional Republicans remain free-trade proponents,[111] however, and the Administration is concerned that GOP members could oppose a renegotiated agreement if it calls for amendments that challenge their pro-business policy stance.[112] This internal party divide narrows the U.S. negotiating win-sets (see Figure 4), as the Trump Administration must account for the GOP’s pro-trade faction at the bargaining table. The two-level game is further complicated by negotiating delays that have stretched the timeline for ratification beyond a key election date. NAFTA talks have already extended past the May 17th 2018 deadline (with possibly some leeway into early June) set by House Speaker Paul Ryan for seeking Congressional approval within the current session.[113] Thus, the House and Senate will not have sufficient time to approve a renegotiated NAFTA before the November mid-terms,[114] introducing a degree of uncertainty to the trade talks that could hinder the ratification process and weaken the American bargaining position.

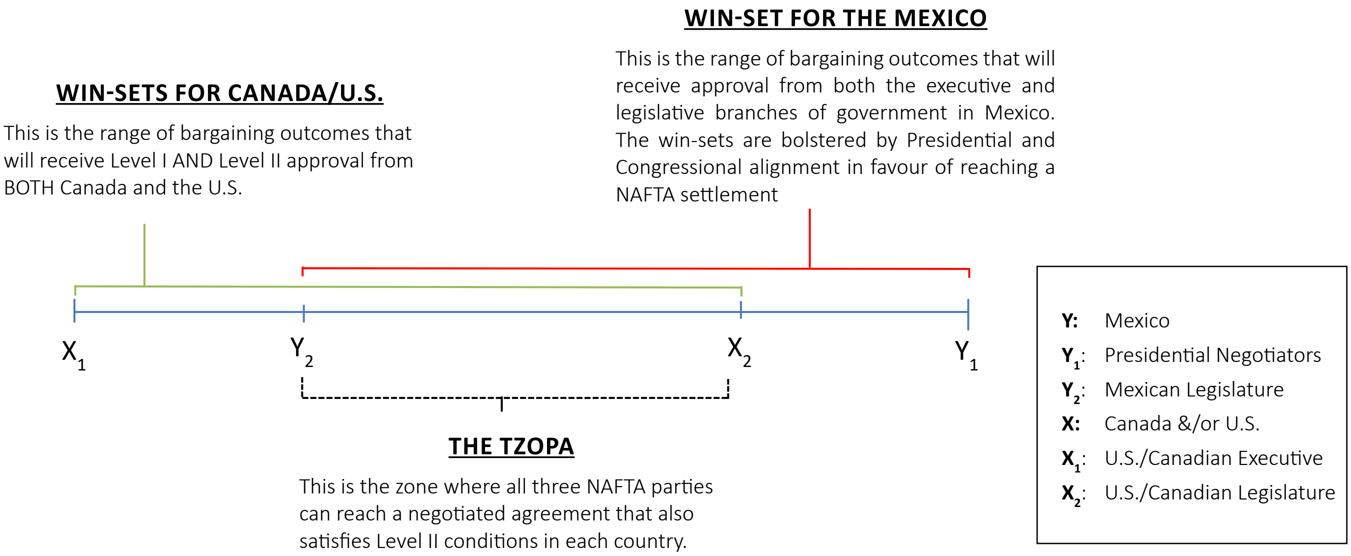
FIGURE 4: U.S. Two-Level Game (August 2018)



Mexico

In the case of Mexico, the ratification process varies depending on the scope of NAFTA revision. For minor changes, the President has the power to authorize the agreement independently, while a Congressional vote is mandated in the case of more extensive reforms.[115] In the ongoing renegotiation, the Pena Nieto Administration has benefitted from seemingly numerous win-sets between Level I and Level II in the Putnam model (see Figure 5), with both the dominant Institutional Revolutionary Party and the National Action Party in support of NAFTA.[116] Furthermore, the results of the federal elections in July portend an equally sizeable win-set range for the Mexican negotiating team moving forward. President-Elect López Obrador has committed to seeing the NAFTA talks through to a signed agreement,[117] and his political coalition won majorities in Congress.[118] Thus, the probability of ratification remains moderate to high, even if talks extend into 2019.

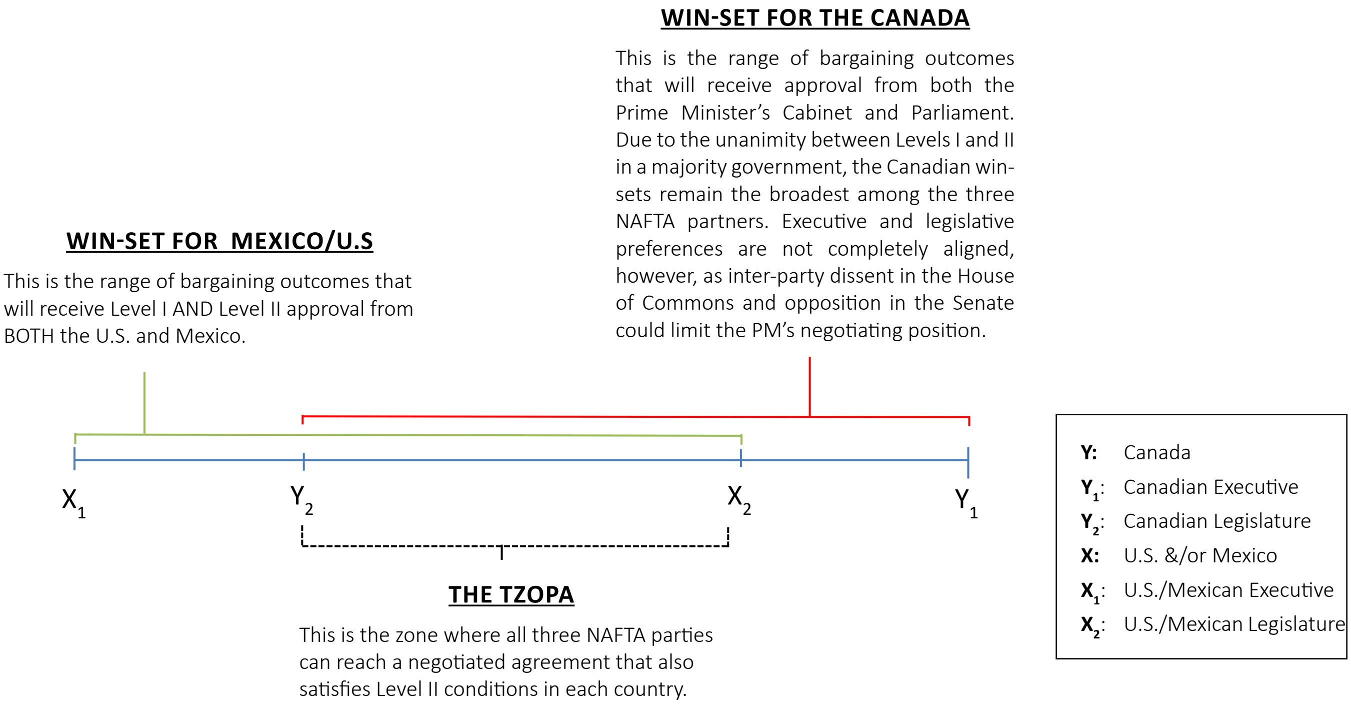
Figure 5: Mexico Two-Level Game (August 2018)



Canada

Both houses of the Canadian Parliament must vote on NAFTA to complete the ratification process.[119] The agreement is sent to the Commons for a 21 day review period, and then implementing legislation is usually passed in order to integrate the new provisions into domestic law.[120] Given the political dynamics at-play, with the Prime Minister's party in control of the legislature, it is highly likely that a renegotiated NAFTA will receive approval.[121] The relationship between Levels I and II in Canada is unique among the NAFTA partners because of differences in political structure and procedure. The functional executive in Canada, the Prime Minster's cabinet, is also represented in Parliament. As a result, its negotiating position could nearly align by default with that of Level II under a majority government (see Figure 6) where party discipline is successfully enforced in any ratification vote (although it is possible that divisions within the Liberal Party could form if the terms of the agreement create tension between different national constituencies).[122] If NAFTA is not successfully negotiated and endorsed before the October 2019 Federal Elections, however, the Level I/Level II relationship in Canada could shift to more closely resemble the American process, as a Liberal minority or Conservative minority/majority (or an NDP government) reduces the probability of ratification for any agreement reached under the existing Level I. Moreover, the upper house of Parliament could also be an impediment to confirmation. As an appointed body, the Senate remains insulated from the election cycle, yet recent trends cast uncertainty over how the "red chamber" will vote on a revised trade deal.[123] Thus, a renegotiated NAFTA could still encounter challenges in Ottawa, despite the relative expediency of the Westminster legislative process.

Figure 6: Canada Two-Level Game (August 2018)



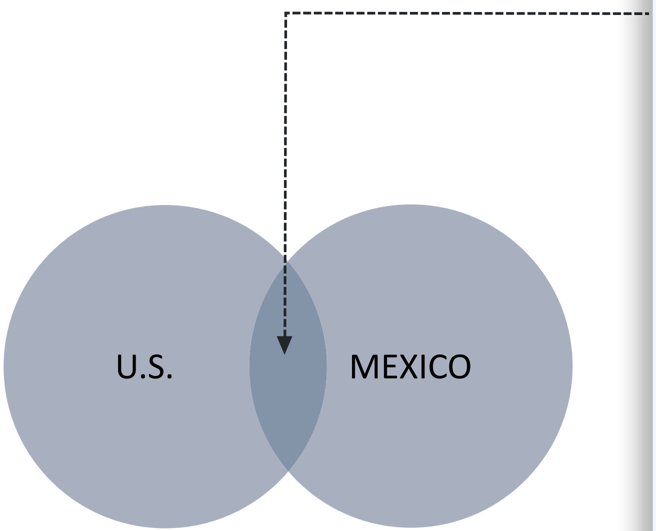
Key Development: U.S.-Mexico Free Trade Agreement

By September 2018, the renegotiation of NAFTA was strongly impacted by the bilateral negotiations between the U.S. and Mexico. Over the course of the month, trade representatives from the two countries met on a bilateral basis and addressed points of continued disagreement, beginning with an emphasis on the auto rules of origin, but soon expanding to cover other important areas like intellectual property, financial services, and environmental and labour standards. The Canadian government was not a party to the discussions. On August 27, 2018, President Trump announced that a new trade agreement had been reached which would substitute for the existing tri-party relationship. The President also suggested that it would be called the "U.S.–Mexico Free Trade Agreement," replacing the old "NAFTA" title.[124] The Administration submitted notice to Congress on August 31, 2018, advising of their intention to sign a trade agreement with Mexico and possibly Canada within 90 days.[125] This segment describes some noteworthy elements of the new U.S.–Mexico trade agreement and introduces the key political risk to the ratification process: the U.S. midterm elections, once again from the mid-September 2018 vantage point.

The U.S. – Mexico Free Trade Agreement

The USTR disclosed the general contents of the deal at the time of its announcement,[126] Figure 7 highlights the bilateral ZOPA between the U.S. and Mexico and provides more detail on the proposed agreement.

Figure 7: U.S.–Mexico Free Trade Agreement (Bilateral ZOPA)



KEY PROVISIONS FROM THE U.S.-MEXICO FREE TRADE AGREEMENT

AUTO RULES OF ORIGIN:
- 75% of auto content to be made in the U.S. and Mexico
- 40-45% of auto content to be made by individuals earning at least $16 USD per hour

AGRICULTURE:
- Zero tariffs on agricultural products

DIGITAL TRADE:
- Increase in the de minimis shipment value to $100 USD

FINANCIAL SERVICES:
- Updated provisions to facilitate the cross-border transfer of data

LABOUR:
- The addition of a chapter that brings labour provisions into the agreement

THE ENVIRONMENT:
- The addition of a chapter that brings environmental provisions into the agreement

SUNSET CLAUSE:
- 16 year term for the new deal and a 6-year review process, at which point the agreement could be extended for another 16 years if all parties concur

INTELLECTUAL PROPERTY:
- Stronger IP protections, including an extension for the minimum copyright protection for certain works to 75 years

U.S. Trade Promotion Authority (TPA) & the U.S.-Mexico Bilateral Agreement

The Trade Promotion Authority (TPA) or "Fast Track" defines the relationship between the legislative and executive branches of government in free trade negotiations. Under the TPA, Congress delegates authority over trade to the White House, allowing the executive branch to represent it at the negotiating table while bound by certain rules and regulations.[127] The House and Senate can then rule on a deal negotiated by the executive in a "yes-or-no" vote, with a simple majority needed for approval.[128] TPA also denies Congress the right to make content changes to an agreement which provides negotiators with some certainty that their work will not be subject to sudden legislative amendments.[129] Nevertheless, unlike in Canada and Mexico, where the risk of significant political disagreement between the executive and legislative branches over the renegotiated NAFTA provisions is judged to be negligible (see Section 2), the current structure and partisanship of the U.S. political process could mire the new U.S.-Mexico agreement in a congressional divide that ultimately leads to its rejection. As described by former USTR Carla Hills, when the notice for NAFTA renegotiation was first issued, it was with the understanding that the Trump Administration would be seeking a trilateral agreement. Thus, it is possible that the existing bilateral deal with Mexico could stretch beyond the terms of the existing TPA issuance, to the point that some voices on Capitol Hill might suggest the Fast Track designation should no longer apply.[130]

However, as argued by Gary Hufbauer, Nonresident Senior Fellow at the Peterson Institute, it is ultimately up to the Congressional leadership to decide whether the Trump Administration’s new bilateral deal meets the threshold for the TPA. If the Democratic Party were to retake control in Congress following the November elections, the new Speaker of the House or Senate Majority leader could conclusively rule that the TPA provisions are not applicable to the U.S.-Mexican Trade Agreement.[131] Even if the TPA were to remain in place, however, a shifting partisan alignment in Congress could still pose challenges for the ratification of a new NAFTA, whether it is bilateral or trilateral, since a dissenting party could vote against a signed deal on the basis of a simple majority. Thus, the need for legislative approval of agreements under American trade law, coupled with the political uncertainty introduced by the midterm elections, could create a scenario where partisan disputes manifest through the TPA regulations and prevent a renegotiated NAFTA from ever passing into full-force.

Political Risk: The 2018 U.S. Midterm Elections

Overview

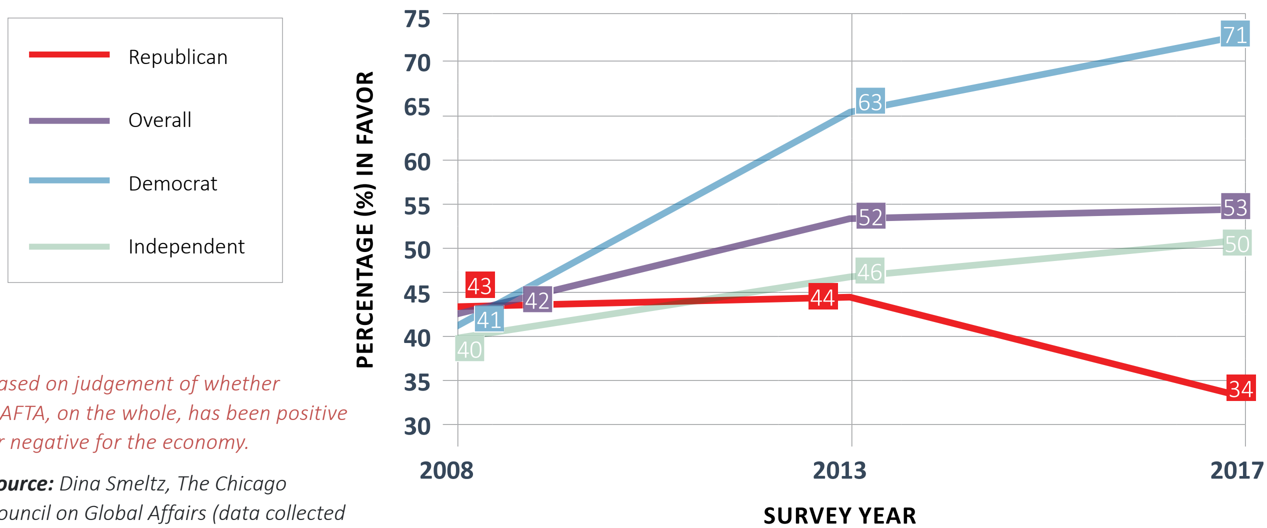
The NAFTA renegotiation process coincides with a critical moment in the American election cycle; one that poses significant political risk to the domestic approval and ratification process required for integrating new trade agreements into U.S. law. Held on November 6, 2018,[132] the midterm elections could bring a significant change to party politics in Congress, with one-third of the Senate and the entire House of Representatives contested.[133] Midterms have historically marked partisan shifts in the U.S. Congress, expressing voter backlash against the White House incumbent[134] in a kind of executive referendum.[135] The party of the sitting president has consistently suffered defeats in midterm elections since 1862, with an average loss (as of 2010) of approximately 32 House seats and greater than two Senate seats.[136]

In the current assembly, the Republican Party controls the legislative branch of government in Washington, with 51 and 236 seats in the upper and lower chambers respectively. With 195 seats (as of mid-August 2018) in the House and 49 in the Senate, the Democratic Party is relegated to the minority position on Capitol Hill, but it could make sufficient gains in the November elections to take control of at least one of the two legislative bodies. Out of 435 House seats, the Democrats would need to add 23 more to their existing count in order to reach the key 218-member threshold demarcating a simple majority.[137] Conversely, Democratic control in the Senate would require the Party to add at least two more seats to its current total of 49. A 51-member majority is an improbable midterm result, however, because of the particular assortment of seats in-play: only 35 are open for re-election and 26 of them have Democratic incumbents. Furthermore, of those 26 seats, 10 fall within states that Donald Trump won in the 2016 presidential election.[138]

As of the summer 2018, pre-election analysis suggests a medium-to-high chance of a partisan shift in the House of Representatives. The Economist Mid-Term Election Model estimates a slightly more than 50% probability that the Democratic Party retakes control of the lower chamber (July 2018),[139] as does Sabato’s Crystal Ball at the University of Virginia’s Center for Politics (July 2018).[140] More recently, the polling site FiveThirtyEight assigned a significant 80.3% or 4/5 probability to the same outcome (Sep. 19th, 2018) using their “Classic” forecasting model.[141]

The Politics of Trade

Figure 8: U.S. Public Support For NAFTA By (Self-Identified) Political Affiliation*



* *Based on judgement of whether NAFTA, on the whole, has been positive or negative for the economy.*

Source: *Dina Smeltz, The Chicago Council on Global Affairs (data collected by GfK Custom Research), 2017* [210]

Democrats

Trade policy is an issue that has divided the Democratic Party, its representatives and voters. In 1993, the ratification of the original NAFTA by the Clinton Administration created strident internal tensions, pitting the pro-free trade wing of the Party against its traditional supporters in organized labour.[142] Internal conflict intensified over the Trans-Pacific Partnership talks during the Obama presidency and the debate over extending Trade Promotion Authority (TPA).[143] Ideological differences over trade endure as the NAFTA renegotiations proceed, with Democrats recently conflicting over their alignment for or against the Trump Administration's use of steel and aluminum tariffs. Only a small number of Democratic incumbents sided with Republicans in their vocal criticism of the President's actions, warning of the net job losses and larger trade war the tariffs could instigate, while a somewhat larger group came out in-support of the measures.[144] Meanwhile, the Party at-large has begun to steer a new course on free trade in its policy planning and messaging. Released in August 2017, the "Better Deal" platform sets forth a more protectionist outlook for the Democratic Party. In his public announcement for the plan, Senate Minority leader Chuck Schumer argued that existing "'trade laws have shortchanged American workers for far too long, and we Democrats are aiming to change that.'"[145] The platform criticizes NAFTA (1994) in-part for favouring major corporations at the expense of workers and other interests, for including ineffective labour and environmental standards that have fed a "race to the bottom" in regulation, and for compromising U.S. sovereignty to facilitate dispute resolution processes.[146] In response, the Better Deal calls for a reformative policy plan that rebalances the unequal relationship between capital ("corporate profits") and labour ("working families") at the trade table, rejects trade provisions that conflict with various domestic regulations, benefits American wages and employment, and increases environmental and labour regulations in Mexico to help reverse the race-to-the-bottom spiral, among other recommendations.[147]

The "Better Deal" platform may be a concerted attempt by the Democratic leadership to appeal to the "Blue-Collar" vote that chose President Trump in 2016,[148] but it could also deviate from ideological changes already underway among the Party's bedrock support. The Democratic base increasingly centres on internationally-connected, high-exporting metropolitan regions, where the predominately service economies benefit more from free trade than smaller, import-sensitive manufacturing communities.[149] The results from the last presidential election provide some evidence of this new globalist party under development. As per analyses from the Metropolitan Policy Program at the Brookings Institution, the fewer than 500 U.S. counties Hillary Clinton won in 2016 (Trump won more than 2600) represented 64% of total U.S. GDP (2015 data),[150] but also accounted for 58% of all American exports (2015 data).[151] Furthermore, recent polling trends suggest that the adjustment in the Party's economic profile is reflecting in the attitudes of Democratic voters toward international trade policy (See Figure 8). As per data from the Chicago Council on Global Affairs (survey conducted by GfK Custom Research), public support for NAFTA among self-identified Democrats has dramatically increased over a 10-year period, from 41% in 2008 to 71% in 2017; a near 20-points greater than the cross-party average (53%).[152]

Republicans

Apart from some internal disagreement among members, the Republican Party has remained largely in favour of free trade principles over the past 50 years, with strong majorities supporting initiatives like the original NAFTA and the Trans-Pacific Partnership;[153] completion of the latter agreement featured as an explicit commitment in the Party's 2012 election platform.[154] Congressional Republicans also supported the Obama Administration in its push for TPA renewal to facilitate trade negotiations when most members of the President's own party opposed this action. Although President Trump has taken a critical stance against conventional free trade policy, prominent Republican legislators in Congress like Senate Majority Leader Mitch McConnell and Speaker of the House Paul Ryan remain committed proponents of open markets.[155] However, the White House's trade scepticism does coincide with a declining trend in pro-NAFTA sentiment among Republican voters, which could cast a disparity between the GOP electorate and Party representatives in Washington. Chicago Council survey data charts a stark decrease in support among self-identified Republicans over a ten-year period, with a particularly steep decline between 2013 and 2017 from 44% to 34% in favour of the agreement (see Figure 8).[156]

What Consequences Could the Midterm Elections Have For NAFTA?

The timeline restrictions set forth in the U.S. trade appeal process ensure that any renegotiated NAFTA will not be voted on by the outgoing, Republican-controlled Congress, but will instead pass along to members of the incoming session scheduled to begin on January 3, 2019. If at that point in time, President Trump has successfully signed a finalized agreement with Mexico and/or Canada, Congress will only need to rule on implementing legislation that makes the required changes to U.S. domestic law rather than vote on the full text of the document.[157] Nevertheless, failure to complete this stage of the TPA process could effectively deprive the new deal of any legal or regulatory substance.

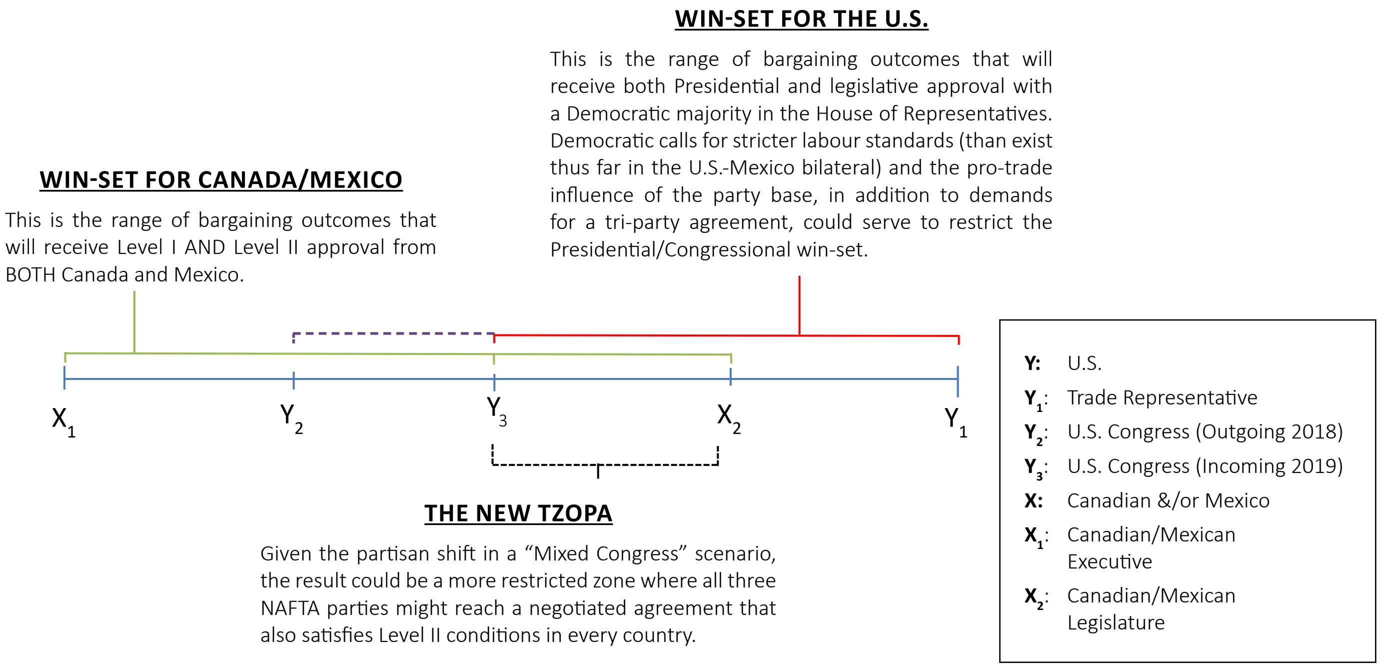
To bolster the chances of full ratification, the Trump Administration could try to manage the electoral uncertainty as it pushes forward to conclude its negotiations with Canada and draft a final text of a trilateral agreement for mandatory Congressional review. The White House is already confronted with a Republican establishment that harbours some resistance to its trade policy stance, which could complicate the legislative review process even if the partisan breakdown of the House and Senate remains unchanged after the elections. If the Democrats secure a majority in one or both chambers, or if the more protectionist wings in either party gain greater influence in the new session, the probability of a successful "NATA 2.0" ratification could fluctuate substantially. Thus, in accordance with Milner and Rosendorff's (1997) thesis, the midterm election cycle disrupts the two-level NAFTA game playing out between Congress and the executive branch. If the trade preferences of the new legislature differ sufficiently from those of the current Republican majority, they could warp the existing U.S. win-set, and prompt the Administration to take steps that change its bargaining position in the ongoing bilateral talks. The next segment further applies the theoretical concepts developed in Section 2 to project the course of the NAFTA renegotiations, given the domestic ratification challenges that could arise in two probable U.S. election scenarios: A "Mixed" Congress and another Republican "Sweep".

**** Another midterm outcome would be a Democratic Sweep, where the GOP loses both the House of Representatives and the Senate. However, given the TPA provisions requiring simple majority votes in both chambers to pass implementing trade legislation (which vests a party controlling only one of the two houses with the power to reject an agreement), the probable consequences of a Democratic Sweep for NAFTA are deemed to be only marginally distinguishable from the Mixed Congress result, and so the scenario is excluded from this analysis.*

The Prospects for a Ratified NAFTA Agreement: Midterm Election Scenarios

a) MIXED CONGRESS: *MEDIUM TO HIGH PROBABILITY*

Figure 9: NAFTA RATIFICATION WITH A MIXED CONGRESS



As available election forecasting suggests,[158] it is likely that the Democratic Party will take back the House of Representatives in the November midterms, leaving the Republicans to hold on to majority control in the Senate. In this "Mixed Congress", either party would have the power to overturn the implementing legislation for NAFTA with a simple majority vote, as per the terms of the TPA. The Democrats would suddenly have the power to reject an agreement negotiated by the executive branch at a time of high political polarization. However, the Party's recent pronouncements on trade, culminating in the "Better Deal" call for American labour protections and NAFTA reform, suggests that its preferences now align somewhat more with that of the Trump Administration than with previous Democratic presidents.[159] It follows then that a Democratic chamber could actually endorse many of the terms negotiated by the White House, expanding the win-set in the two-level game. The midterm elections may result in gains for trade-skeptical Democrats,[160] which could serve to solidify the Party's alignment with the President. Although, it remains to be seen how a more protectionist turn by the political class will interact with the overwhelming pro-trade sentiment of the Democratic base (see again Figure 8). It is possible that the Party's distrust of trade will be tempered by voters once the new Congress is in-session, which could actually shrink the win-set for a ratified NAFTA deal.

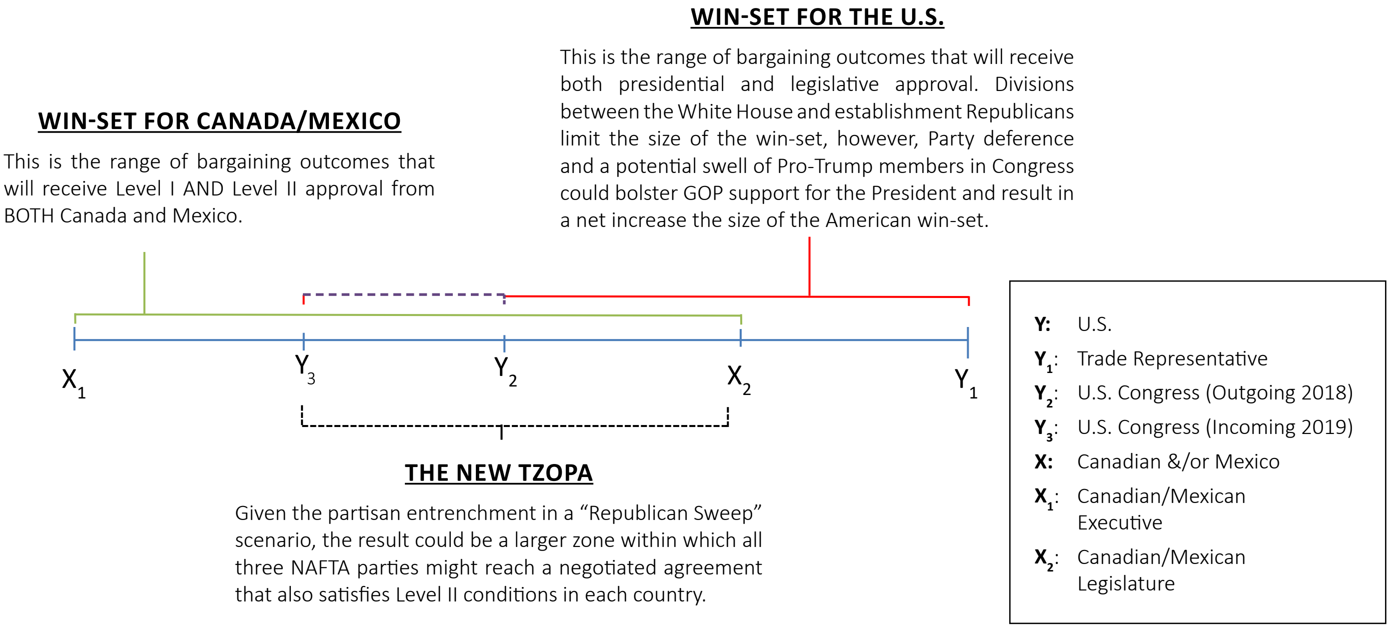
Another plausible scenario could see a Democratic Party that aligns with President Trump in their general distrust of NAFTA, but that is just not satisfied with regulatory gains made in the new trade deal. The Mexico-U.S. bilateral agreement reached at the end of August 2018 did specifically address labour and environmental concerns.[161] However, as argued by William Alan Reinsch, Senior Adviser and Scholl Chair in International Business at the Centre for Strategic and International Studies (CSIS), it is likely that left-wing trade opponents will remain unsatisfied with the Mexican deal, and that many Democrats will oppose a finalized agreement just as they did the original NAFTA.[162] Reinsch also points to the partisan dynamic at-play, arguing that the Democrats are so opposed to the Trump Administration on principle that they could move to vote down any trade deal regardless of its content; the kind of rigid opposition the White House faced from Congressional Republicans during the Obama presidency.[163] The Putnam model would be made functionally invalid in this "Protest Vote" scenario. However, weighing Democratic opposition (both to the terms of the agreement and the President) against the Party's general trade skepticism, the best estimate for changes to the two-level game in a Mixed Congress remains a decrease in the size of the win-set, making it harder for the executive and legislative branches of government to arrive at mutually acceptable terms for a deal (see Figure 9).

The Effect on U.S. Bargaining Power: The Failure of the Schelling Conjecture

If the Schelling Conjecture were applied to the "Mixed Congress" scenario, it would suggest that a restricted win-set would actually empower the Trump Administration in the NAFTA renegotiations rather than inhibit it. The President could use the prospect of an unfriendly House of Representatives to pressure Canada and Mexico at the negotiating table in a "Chicken Game", arguing that they must make more concessions for the sake of U.S. labour interests if the final deal is ever to meet with the approval of Democratic lawmakers. Applying Milner and Rosendorff's addendum to the Putnam model, however, it is possible to argue that current partisanship in U.S. politics coupled with midterm election uncertainty could have the opposite effect of that which Schelling predicted. The White House may come to realize that it needs to hedge against Democratic opposition in Congress, and so compromise on certain bargaining objectives with Canada in order to get a tri-party agreement completed as soon as possible. Some of the Party's key incumbents have already suggested that a Democrat-controlled House of Representatives would vote down a new trade deal if it omitted Canada or neglected to improve American wages.[164] The Administration's position in the talks with Ottawa could be markedly weakened if the agreement with Mexico cannot pass without Canadian accession, and so there is an increased probability that the White House may choose to concede to the Trudeau Government's key reservation prices. In this regard, the midterm elections not only alter the calculus of the two-level game playing out in the U.S. domestically, but the power dynamics underpinning the inter-party negotiations that will ultimately determine the finalized NAFTA text.

b) REPUBLICAN SWEEP: *LOW PROBABILITY*

Figure 10: NAFTA RATIFICATION WITH A REPUBLICAN HOUSE/SENATE



Although a Republican House of Representatives is a less likely midterm result according to cited election forecasts,[165] the GOP's advantage in the Senate highlights that it still has a significant chance to retain the primary decision-making power on Capitol Hill. In this "Sweep" scenario, the Republicans would secure at least a simple majority in both chambers of Congress, and prevent the Democratic Party from rejecting any signed NAFTA deal through the approval process required under TPA. The two-level game would be simplified accordingly in that the controlling interest in the new Congress (Y_3 in Figure 10) would not be stratified along partisan lines, but would share a common political affiliation with the current administration. Thus, for the White House trade team, the NAFTA win-set would be constrained primarily by the scope of disagreement between the President and his own political allies. The grounds for dispute may not be inconsequential though, since the long-standing open market ethos of the Republican Party defies President Trump's own antipathy toward the existing North American trade relationship. GOP legislators may need to mediate the disparities between White House policy and their own pro-trade bias.

Reflecting on the Congressional approval process, Reinsch argues that free-traders in the GOP are still more likely to vote "yes" to a new bilateral or trilateral deal, notwithstanding concerns they may have over the terms, on the judgement that a sub-optimal agreement is preferable to the complete termination of NAFTA (the Administration is likely to execute a withdrawal from the original accord when submitting the new text to Congress). Conversely, the Pro-Trump Republicans are disposed to back the deal precisely because it has the support of the executive branch: they cannot demand an even more protectionist document, but must work within the political maneuvering space provided to them by the President.[166] Finally, it is also plausible that the shifting attitudes toward NAFTA among Republican voters could be an important factor when achieving Party unity in support of the White House (see again Figure 8). Pro-trade members of the caucus may be forced to moderate their policy stance to maintain support among an increasingly protectionist base. Thus, with this comprehensive Party support, it is reasonable to conclude that the U.S. win-set in a Republican Sweep will increase in size; providing greater opportunities for reaching Level I and II consensus.

What Might "NAFTA 2.0" Look Like?

There is a medium-to-high estimative probability that a renegotiated NAFTA will be agreed upon by the end of September 2018. Based on the preceding analysis, the U.S. midterm elections coupled with the TPA provisions give Canada an increased advantage at the bargaining table. Putnam's two-level game theory when complemented by insights from Milner and Rosendorff suggests that partisan conflict in the high probability "Mixed Congress" scenario could significantly complicate the ratification process required to fully implement the updated agreement. Contrary to the dictates of the Schelling Conjecture, Congress' insistence on a trilateral deal could diminish rather than bolster the Trump Administration's bargaining power in its talks with the Trudeau Government and increase the likelihood that the U.S. will eventually concede on Canada's red-line issues.

Bringing Ottawa On Board

In order for the Canadian government to accede to a revised NAFTA, a number of key issues need to be addressed. Prime Minister Trudeau has publicly stated that "no deal is better than a bad deal" in the renegotiation process.[167] The Prime Minister and the Canadian trade team are focussed on securing an outcome that sufficiently addresses their three remaining reservation prices (red-line issues):

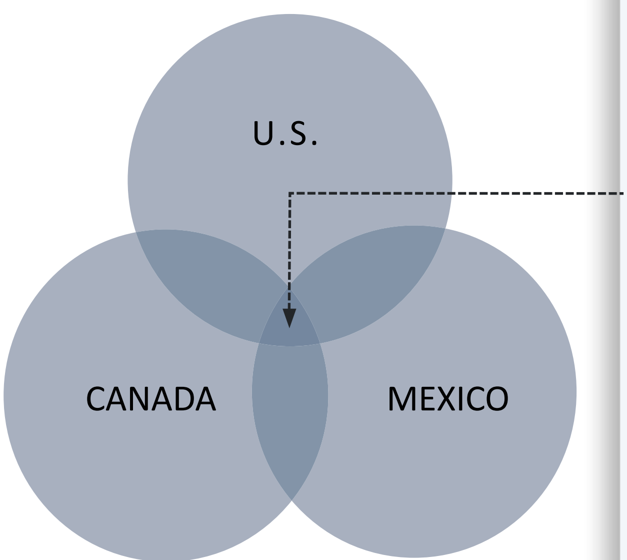
1. The Chapter 19 dispute resolution mechanism
2. Canadian supply management in the dairy sector
3. Canadian cultural protections

While a potential trilateral agreement will include a number of new and altered provisions, the negotiations between the Canadians and Americans are still likely to revolve around Ottawa's three essential demands. **Figure 11** depicts the likely terms of a deal between all three of the North American countries.

It is reasonable to infer that Mexico would accept Canada's red-lines in a "NAFTA 2.0" as they do not appear to conflict with key national priorities or infringe upon the terms to which the country has already agreed with the U.S. However, there are two tension points that may remain unaddressed in the trilateral deal: The Chapter 11 ISDS mechanism and the disputes around government procurement. These two issues were left out of the U.S.-Mexico Free Trade Agreement, and as of September 2018, there was little mention of them in the bilateral talks between Canada and the U.S.

The Trump Administration has championed a fairer playing field for American auto manufacturers and farmers. The U.S.-Mexico bilateral agreement addressed the White House's concerns over the auto sector. The projected "NAFTA 2.0" would likely open up (but not dismantle) the Canadian supply management system in the dairy sector. A concession from Canada on supply management would probably take the form of an increase in the amount of tariff-free foreign dairy exports that are allowed into the country; the CPTPP and CETA trade agreements already set a precedent for Canadian concessions in this regard.[168] Furthermore, as previously stated, the U.S. will likely have to accept the preservation of Canadian cultural protections and the Chapter 19 dispute resolution mechanism. Nevertheless, there could be clauses in the final agreement that modernize the anti-dumping and countervailing duties dispute process to help satisfy the concerns of both the U.S. and Canada over issues like the alteration of the procedure for selecting panelists and the increase in the role of domestic courts in the arbitration process.

Figure 11: Projected Trilateral Agreement “NAFTA 2.0” (trilateral ZOPA)



Projected Trilateral Agreement “NAFTA 2.0”

NEW PROVISIONS

CANADIAN SUPPLY MANAGEMENT:

- Opening up of the Canadian supply management system in dairy to a similar level as was conceded in the TPP and CETA trade agreements

PRESERVATION OF CANADIAN CULTURAL EXCEPTIONS:

- Continued preservation of Canadian cultural exceptions

PRESERVATION AND ENHANCEMENT OF THE CHAPTER 19 DISPUTE RESOLUTION MECHANISM:

- The modernization of the Chapter 19 dispute resolution mechanism

PROVISIONS FROM U.S.-MEXICO FTA

AUTO RULES OF ORIGIN:

- 75% of auto content to be made in the U.S. and Mexico
- 40-45% of auto content to be made by individuals earning at least $16 USD per hour

AGRICULTURE:

- Zero tariffs on agricultural products

DIGITAL TRADE:

- Increase in the de minimis shipment value to $100 USD

FINANCIAL SERVICES:

- Updated provisions to facilitate the cross-border transfer of data

LABOUR:

- The addition of a chapter that brings labour provisions into the agreement

THE ENVIRONMENT:

- The addition of a chapter that brings environmental provisions into the agreement

SUNSET CLAUSE:

- 16 year term for the new deal and a 6-year review process, at which point the agreement could be extended for another 16 years if all parties concur

INTELLECTUAL PROPERTY:

- Stronger IP protections, including an extension for the minimum copyright protection for certain works to 75 years

Conclusion

The renegotiation of NAFTA has been a topic of significant concern for the Canadian financial services industry. Since coming into force, NAFTA has benefited both the sector and the economy at-large, increasing trade and allowing institutions to expand their presence across the North American region. Consequently, the negotiations serve as a timely subject with which to test an alternative method of risk analysis.

At its core, the purpose of this report was to demonstrate that applying a social scientific lens to the assessment of risk in dynamic political bargaining situations can be a useful complement to standard modelling. The report introduced a theoretical framework and used the renegotiation of NAFTA as a case study for its deployment, set specifically in mid-September 2018. Section 1 introduced the concepts of the BATNA and ZOPA along with two-level game theory to help assemble a model for conceptualizing the strategic dynamics of the trade talks. Section 2 contextualized the original NAFTA historically and highlighted the more significant provisions of the agreement. The baseline positions of each trading partner were also described, along with the main points of discord. Section 2 then summarized the U.S.-Mexico bilateral deal as the key development in the renegotiation process and discussed the main political risk factor that could affect the successful ratification of a new agreement: the U.S. midterm elections. The report concluded by applying the theory and political factors introduced earlier to outline a projected “NAFTA 2.0,” circumscribed by the tension points between the three parties.

Political uncertainty continues to affect the landscape of financial risk. Like the wider push to reappraise global trade relationships, course changes to domestic governance and international relations may increasingly disrupt rules and standards in the G-Zero world. Industry leaders should look beyond their conventional toolbox for the means to cope with the paradigm shift underway. The framework developed in this report can help risk managers to model other cases where two or more countries pursue their interests in a process of competitive bargaining, whether on matters of trade, security, cross-border taxation or other contested issues with multilateral dimensions. The settlements negotiated under these circumstances can determine the business environment in which financial institutions operate. Lenders, insurers and investors with a grounding in the underlying theory can start to extrapolate the probable outcomes of a negotiation. With a more nuanced understanding of what could happen, they can then refine their scenario analyses and institutional stress tests and design proactive enterprise strategies that pre-empt or hedge against the prevailing risks and better reflect what are largely non-numerical variables. In the process, risk managers may also gain insight into the political forces shaping the complex and transboundary hazards that characterize the World Risk Society, and that could present new challenges to financial service providers in the medium- to long-term.

Appendix

NAFTA (1994) Key Chapters:

Objectives (Chapter 1):

a. eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;

b. promote conditions of fair competition in the free trade area;

c. increase substantially investment opportunities in the territories of the Parties;

d. provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;

e. create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and

f. establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.[169]

Rules of Origin (Chapter 4):

Rules of Origin effectively prevent goods produced outside of a trading bloc from crossing the borders between partners and receiving the same preferential treatment granted to internally produced goods and services.[170] Under Chapter 4 of NAFTA, a widget must either originate in Canada, Mexico or the U.S. or involve a significant transformation, indicated by either a change in product classification (in accordance with the system set forth in the agreement) and/or by the fulfillment of minimum regional content requirements.[171] The rules can apply differently depending on the specific "tariff item" in-question,[172] and an item-level breakdown is included in Annex 401 of the NAFTA text.[173] As described in Article 402, there are two formulae that can be used to calculate the value of NAFTA-derived content in a given product, the choice of which is at the discretion of the producer unless otherwise specified.[174] One approach is the ***Net Cost Method (NCM)***:

RVC = [NC – VNM]/NC * 100

When:

RVC = Regional value content
NC = Net cost of good [Total cost – [royalties + packing & shipping + non-allowable non-allowable interest + sales promotion)][175]
VNM = Value of materials from outside the NAFTA trade zone[176]

The second approach is the ***Transaction Value Method (TVM)***:

RVC = [TV– VNM]/TV * 100

When:

RVC = Regional value content
TV = Transaction value (adjusted on a Free-on-Board basis)
VNM = Value of materials from outside the NAFTA trade zone[177]

The minimum RVC value is higher when applying the ***Transaction Cost Method*** than for the ***Net Cost Method***.[178]

Dispute Resolution:

Chapter 11

This chapter is divided into two sub-sections. Part A includes the provisions governing cross-border investment in NAFTA, with the exception of issues pertaining to Financial Services (Chapter 14).[179] Included is Article 1102 mandating "National Treatment," whereby states are required to regulate foreign investors in the same manner that they would domestic investors. Furthermore, Article 1103 establishes a "Most Favoured Nation" principle, which prohibits any country from treating investors from one of its trading partners better than investors from the other.[180]

Section B of Chapter 11 sets forth the Investor-State Dispute Settlement System (ISDS), which manages disputes between states and commercial actors. The provision allows companies to sue governments for alleged discriminatory treatment under NAFTA.[181] The judicial process is overseen by an impartial tribunal,[182] and the decisions made in these cases are enforceable in the domestic courts of each trading partner.[183] If direct consultation and negotiation between two parties under Chapter 11 fail to resolve the issue, there are multiple arbitration mechanisms in which the dispute process can play out. If both the plaintiff's home nation and the accused state are parties to the associated convention,[184] claims can be submitted to the World Bank International Centre for the Settlement of Investment Disputes (ICSID).[185] They can also seek resolution under the ICSID's Additional Facility Rules, given that only one of the two countries involved is party to the convention,[186] or the Rules of the United Nations Commission for International Trade Law (UNCITRAL Rules).[187] As one final recourse, an investor can look to the domestic court system in their host nation for a ruling.[188]

Note: During the NAFTA (1994) negotiations, American multinationals operating in Canada and Mexico pushed for the inclusion of Chapter 11 under the dispute resolution provisions.[189]

Chapter 19

This chapter creates a system for managing disputes concerning anti-dumping and countervailing duties imposed by a NAFTA member, commissioning an independent binational panel to review cases. Each of the disputing parties chooses two representatives for the panel, drawn from pre-existing roster lists, while the power to appoint the fifth and final member alternates between the two countries with each new case.[190] Under Chapter 19, the rulings of the arbitration panel are binding, except when the integrity of the members are questioned on the grounds of alleged procedural violations, conflict of interest, or the over-extension of authority. When anti-dumping or countervailing duties disputes arise, legal options still exist at the domestic level. These cases may be heard in the Court of International Trade in the U.S., the Federal Court in Canada or the Tribunal Fiscal de la Federación in Mexico.[191]

Chapter 20

This chapter governs state-to-state dispute settlement over NAFTA interpretation and implementation. The resolution process has three stages, beginning with direct government-to-government consultations. If this approach fails to yield agreement, the case is brought before the NAFTA Free-Trade Commission: A panel comprised of the Trade Ministers from Canada, Mexico and the U.S.[192] The third and final option is a five-member arbitration panel, selected from roster lists maintained by the two disputing countries. However, unlike the Chapter 19 provision, each party chooses two members from its opponent's list, while the Chairperson is decided by mutual consensus (can be a North American national or from a state outside of the NAFTA).[193] In its rulings, the state-to-state dispute panel cannot mandate that a government change its domestic policies to align with the NAFTA terms, but it can award damages to an "injured" corporate interest which national judiciaries can then enforce.[194]

The specific NAFTA chapters that can be subject to state-to-state dispute settlement include:

- *Chapter 7 (Agriculture and Sanitary and Phytosanitary Measures)*
- *Chapter 10 (Government Procurement)*
- *Chapter 11 (Only if a state fails to comply with an investor-state dispute ruling)*
- *Chapter 14 (Financial Services)*[195]

Agriculture and Sanitary and Phytosanitary Measures (Chapter 7):

Section A – Agriculture

In Section A, Article 703, NAFTA partners agree to work toward improving access to their agricultural markets by striving to reduce or eliminate import barriers. Article 704 describes a recognition that domestic support for agricultural industries is permitted but the partners must work toward support for these industries which do not have trade distorting effects.[196]

Financial Services (Chapter 14):

NAFTA was the first international agreement to include financial services and has served as a template for subsequent agreements including this sector.[197] Chapter 14 was unique in its creation because it highlights four important components: National Treatment; Most Favoured Nation Treatment; Prudential Carve Out; and Dispute Settlement.[198]

Article 1405 – National Treatment

In Article 1405, the Parties agree that they will provide investors and service providers of another Party with treatment no less favourable than that which they grant their own investors and service providers. The Article also stresses that one Party must afford to the other Parties equal competitive opportunities.

Article 1406 – Most Favoured Nation Treatment

Article 1406 stipulates that Parties agree to provide the investors and service providers of another Party with treatment no less favourable than they accord investors and service providers of any other Party or **non-Party.** Additionally, Parties recognize the prudential rights of others. This recognition may be accorded unilaterally, through an agreement or achieved through harmonization. When national treatment is a different standard than that required under most-favoured-nation treatment, the better of the two treatments must be accorded.

Article 1410 – Exceptions (Prudential Carve-Out)

The Prudential Carve-Out section of Chapter 14, Article 1410, stipulates that nothing in the Agreement should prevent a Party from adopting or maintaining reasonable measures for prudential reasons. These reasons could include:

- *A Party's intention to protect investors, depositors, financial market participants, policyholders, policy claimants, or persons to whom a fiduciary duty is owed;*
- *To maintain the safety, soundness, integrity or financial responsibility of financial institutions or cross-border financial service providers; and*
- *To ensure the integrity and stability of a Party's financial system.*

Dispute Settlement

Article 1412 Financial Services Committee

The Financial Services Committee supervises the implementation and development of the financial services chapter. The committee considers issues regarding financial services at the request of a Party and participates in dispute settlement procedures as required. The Committee meets annually and is comprised of senior government officials responsible for financial institutions.

Article 1414 Dispute Settlement

This section applies to disputes arising under Chapter 20 regarding the interpretation or application of NAFTA.

Article 1415 Investment Disputes in Financial Services

Article 1415 describes terms under which the Committee will respond to a referral from a NAFTA tribunal (Chapter 11) when the prudential exception (Article 1410) is used as a defence against the claim of an investor.

Intellectual Property Protections (Chapter 17):

NAFTA was the first international trade agreement to set forth modern provisions for intellectual property (IP) protection; negotiated concurrently with the World Trade Organization's TRIPS Agreement providing an international framework for IP rights enforcement.[199] NAFTA defines minimum standards for IP and ensures that the three trading partners enforce those standards for entities within their respective jurisdictions.[200] Under Article 1702, countries are not limited to the minimum IP provisions under NAFTA, and can enforce more stringent domestic legal protections if they so choose, as long as they do not contradict the agreement. Under Article 1703, Chapter 17 includes a National Treatment clause, prohibiting the unequal treatment of foreign and domestic firms, but an exception is provided for a state to apply "its judicial and administrative procedures for the protection or enforcement of intellectual property rights."[201] Forms of IP protected under the NAFTA include:

Copyright (Article 1705)
Trademarks (Article 1708)
Patents (Article 1709)
Layout Designs of Semiconductor Integrated Circuits (Article 1710)
Trade Secrets (article 1711)
Industrial Designs (Article 1713)[202]

Cultural Exceptions (Chapter 21):

Article 2106 refers to Annex 2106 which provides protections for Canadian cultural industries in media versus the U.S. based on the Canada-U.S. FTA.[203]

Side Agreements

North American Agreement on Labour Cooperation (NAALC):

This agreement came into force in January of 1994,[204] coinciding with the NAFTA, and obligated Mexico, Canada and the U.S. to enforce their own domestic laws with respect to employment standards.[205] As iterated in the text of the

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