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The future of North American trade policy: lessons from NAFTA

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Reforming North American Trade Policy: Lessons from NAFTA

By Kevin P. Gallagher and Timothy A. Wise | December 2, 2009

I voted against CAFTA, never supported NAFTA, and will not support NAFTA-style trade agreements in the future. NAFTA's shortcomings were evident when signed and we must now amend the agreement to fix them. While NAFTA gave broad rights to investors, it paid only lip service to the rights of labor and the importance of environmental protection.¹

—Candidate Barack Obama, February 28, 2008

After 15 years there is now widespread agreement that the North American Free Trade Agreement (NAFTA) has fallen short of its stated goals. Rather than triggering a convergence across the three nations, NAFTA has accentuated the economic and regulatory asymmetries that had existed among the three countries. Since 2001, the region has actually seen a decline in levels of integration in key areas such as manufacturing.²

Thus, it is no surprise that the agreement continues to generate controversy. While proponents credit the agreement with stimulating the flow of goods, services, and investment among the North American countries, critics in all three countries argue that this has not brought improvements in the standards of living of most people.

In the United States, the agreement is blamed for job loss, for adding downward pressure on wages, particularly in manufacturing, and for contributing to a large U.S. trade deficit. In Canada, critics point to job losses, the declining competitiveness of the manufacturing sector, and the constraints NAFTA has put on Canada to deploy adequate policies for public welfare. In Mexico, NAFTA is blamed for creating few new jobs while decimating many existing sources of livelihood, particularly in agriculture. In all three countries, citizen groups and government officials decry the capability granted foreign investors to sue governments if legislation negatively affects their profits, or expected profits.

The demands for changes in NAFTA, made by the civil societies of each of these three countries, go well beyond the May 2007 concessions that the newly elected Democratic majority in the U.S. Congress won from the Bush administration. These concessions include reforms in labor, environmental, and intellectual property provisions for future trade agreements, which were incorporated into the pending agreements with Peru, Panama, and Colombia. As of this writing only the first has been approved, while serious

criticisms on human rights and financial issues continue to hold up the other two.

Reformers in the U.S. Congress introduced the “Trade Reform, Accountability, Development, and Employment Act” (TRADE Act) of 2009 in the summer of 2009. With more than 100 co-sponsors from both chambers, the TRADE Act calls for a review of existing trade pacts, including NAFTA. The act also sets forth instruments to be included in the template for future agreements.

President Barack Obama has yet to demand renegotiation of NAFTA, but he has reiterated the need to rethink NAFTA and to change the template for U.S. trade agreements. To contribute to the review process—and the broader discussion of NAFTA as the prevailing template for trade agreements—Boston University’s Frederick Pardee Center for the Study of the Longer-Range Future convened a Task Force on Trade Policy in North America. Chaired by Kevin P. Gallagher, Enrique Dussel Peters, and Timothy A. Wise, the task force brought together academic experts from the three NAFTA countries to identify the areas that are in need of reform under NAFTA and to put forth concrete proposals for such reform.³

Task force members drafted a report titled *The Future of North American Trade Policy: Lessons from NAFTA*, which provides detailed proposals for reforming NAFTA and future trade agreements in eight areas: services, manufacturing, agriculture, investment, intellectual property, environment, labor, and migration.

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Proposals for Reform

Following are brief summaries of the more detailed reform proposals presented in the task force report.

While each chapter is the responsibility of the member who wrote it, task force members shared three broad conclusions:

NAFTA and the other trade agreements based on the NAFTA template need deep reform. These changes must go beyond the important but limited reforms outlined in the May 10 bipartisan agreement. For NAFTA to promote prosperity and sustainable economic development, the agreement must be re-opened, and other current or pending trade agreements must also be revised.

Trade agreements must address the asymmetries among trading partners and provide well-funded institutions to support weaker partners. NAFTA established some important institutions, but they have not received the mandate or the funding to be effective in assisting Mexico to become a more equal economic partner.

A trade agreement is no substitute for a coherent national development strategy. Developing countries should learn from Mexico's experience that increasing trade and foreign investment will not alone generate dynamic economic development.

Specific proposals for reform:

Services – Though more attention has focused on goods than services, NAFTA's services chapter is in greater need of reform, according to Robert Stumberg. A potential dispute over Canadian tar sands oil production illustrates how NAFTA limits governments' ability to regulate the services trade effectively. The Canadian government has warned that proposed U.S. climate policies, nationally and in the State of California, would discriminate against the distribution of crude oil extracted from Canadian tar sands. Canada also warns against state policies that could weaken exports of hydropower. Because both issues relate to the distribution, they are covered by NAFTA's Chapter 12 governing cross-border trade in services.

The agreement protects the government's responsibility in areas "necessary to protect human, animal, or plant life or health" or measures "relating to the conservation of exhaustible natural resources ..." but these exceptions are available for trade in goods and do not apply to services. Challenges under NAFTA's provisions for cross-border trade in services can undermine the efforts of national, state, and local governments to regulate in the public interest.

This is particularly important now in relation to new efforts to address energy and climate change. NAFTA must be reformed immediately to allow exceptions or broad carve-outs for key policy measures relating to climate change and the public good. Otherwise, trade disputes may deter governments from implementing new laws to address vital issues. Future trade agreements should treat goods and services trade in comparable ways that recognize the value of regulation in the public interest.

Manufacturing – NAFTA stimulated a significant reorganization of North American manufacturing, particularly in the automotive, apparel, and electronics sectors. These changes produced expanding trade and investment, but also led to job losses that were inadequately addressed by trade adjustment measures. Since 2000 North American manufacturing has faced problems competing globally, argues Enrique Dussel Peters. The North American region has lost more than one-quarter of its manufacturing jobs, and the downward trend predated the current recession.

The three NAFTA countries need to develop a new regional strategy to compete effectively with other manufacturing exporters, particularly China. This effort should take NAFTA's promise of regional integration seriously by expanding economic cooperation, increasing funding for development in strategic industries (with help from a revitalized NADBANK), and allowing governments to take measures to ensure that future expansion of manufacturing goes beyond the current "enclave development" and builds genuine links to the economy.

Agriculture – NAFTA has had harsh socio-economic and environmental impacts in Mexico due to the wide development gap in agriculture between the United States and Mexico. The Mexican government did not take advantage of the transition periods built into NAFTA's liberalization schedule, nor did it come through with public investment in yield-enhancing projects such as irrigation. Aside from extended transition periods, NAFTA's terms failed to take into account the gaps or provide for the social and economic disruption in the sector that would result from rapid and unmitigated liberalization.

As a result, Mexico faces high rural poverty, the loss of rural livelihoods, rising food dependency, and significant out-migration from rural areas. Reforms must address continued asymmetries in agricultural development by borrowing concepts from other trade negotiations, says Timothy A. Wise. Borrowing from the WTO, Mexico needs "special and differentiated treatment" as a developing nation, with the right to designate key food crops as "special products" free from full liberalization and to defend itself from import

surges with a “special safeguard mechanism.” Borrowing from European integration, a renewed NADBANK needs to invest in productivity-enhancing projects to stimulate agricultural development. Finally, governments need to address persistent market failures, such as environmental externalities from industrialized agriculture and high levels of market concentration.

Investment – NAFTA’s Chapter 11 on investment has been controversial since it was learned, after the treaty took effect, that it granted foreign investors the right to sue governments for actions that are deemed by international arbitrators to be unfair, discriminatory, or “tantamount to expropriation” by impeding the investors’ rights to profit. This has resulted in a wide range of threatened and actual investor suits against governments, many for environmental or health regulations.

NAFTA authorizes the Free Trade Commission—made up of cabinet-level representatives of each NAFTA state—to make interpretations of the treaty that are binding on tribunals. As Gus Van Harten points out, this is an important tool to clarify the treaty. It would not require reopening the agreement and could restrain suits against non-discriminatory measures in the public interest and establish investor-state arbitration as an exceptional remedy after others have been exhausted. Other administrative actions could appropriately limit the discretion of tribunals and ensure fairer and more independent panelists with policy-related expertise. Some reforms, such as removing the investor-state regime from the treaty, require reopening the agreement. So too would reforms to the investment chapter’s restrictions on the limited use of capital controls, key for managing financial crises, and performance requirements, which have proven useful in stimulating technology transfer and local development.

Intellectual Property (IP) – While NAFTA’s IP provisions have introduced some restrictions that go beyond the World Trade Organization’s TRIPs agreement, the main problem for Mexico is not NAFTA but the Mexican government’s adoption of IP rules that make it more difficult for innovation to be disseminated and widely used within the country. According to Kenneth Shadlen, Mexico thus retains significant policy space within NAFTA to adopt important reforms, such as limiting the granting of second-use patents and reversing more recent reforms that restrict the use of compulsory licensing to obtain reduced prices on drugs.

That said, some important reforms would require changes to NAFTA, such as allowing parallel importing of less expensive patented drugs from a third country, a procedure

allowed under TRIPs. Finally, Mexico needs to strengthen local actors’ capacities for innovation, an effort that could be enhanced by greater regional cooperation on research and development, and also funding through a strengthened NADBANK or other regional institutions.

Environment – This is one of the few areas in which there is agreement to make modest reforms, based on the May 10 agreement in the United States and the subsequent revisions of the Peru, Panama, and Colombia FTAs. Those changes—making the environment a chapter with violations subject to full enforcement measures—would be an important first step, but a small one.

The environmental damage from expanding trade in North America is large. The Mexican government estimates the cost of environmental degradation at 10% of GDP annually. North America needs deeper reforms to NAFTA’s environmental provisions to ensure gradual improvement in environmental standards and enforcement in all three countries, says Kevin P. Gallagher. It needs institutions with expanded funding to address chronic problems. Beyond the environment chapter, NAFTA also needs reforms to its investment rules, to ensure governments have the right to demand transparency and environmental compliance; its IP rules to promote the transfer of green technologies and adequate benefit-sharing; and the services agreement to allow exceptions for regulations in the public interest, particularly as they relate to climate change.

Labor – NAFTA’s side agreement on labor, the first of its kind in a trade agreement, had the stated goal of promoting an upward convergence of labor standards in North America. There is little evidence that this happened, which is why the side agreement has been targeted for reform in subsequent agreements. Incorporating those reforms into NAFTA would be valuable. They recognize the ILO’s core labor standards and establish enforcement mechanisms more likely to ensure compliance. Reforms should also strengthen the funding and mandate of the Labor Commission set up by NAFTA. The United States could gain from improvements in Mexico’s labor standards, argues Christian Weller, as researchers have shown that low standards contribute to trade deficits, primarily because rising incomes in trading partner countries create rising demand for U.S. goods.

Migration – The promise at NAFTA’s inception was that economic prosperity would enable Mexico to “export goods, not people.” Yet migration from Mexico to the United States has more than doubled since, driven by weak job creation in Mexico and strong demand for migrant labor in the United States, and undeterred by expanding

border-control measures. NAFTA liberalized trade in goods, services, and investment but not labor.

That is unlikely to be addressed by upcoming reforms to NAFTA, but some measures can make a difference, according to Rodolfo García Zamora. The Mexican government needs to make job creation the top priority in its economic policies, with particular attention to depressed regions. Regional financial institutions, such as a revitalized NAD-BANK, must assist these efforts. Reforms to NAFTA's agricultural provisions, outlined elsewhere, can slow the relatively recent flow from the Mexican countryside. Reforms to NAFTA's labor rights provisions should include protections for the rights of migrants. Finally, the United States needs a comprehensive immigration reform that decriminalizes the flow of workers, which is the direct result of NAFTA-led economic policies.

Official recognition of the need to reform NAFTA and the template for U.S. trade agreements is most welcome. It will take continued pressure from civil society to ensure that such reforms go deep enough to produce meaningful change.

To download the full report:
www.bu.edu/pardee/files/2009/11/Pardee-Report-NAFTA.pdf

To consult research on NAFTA's impacts in Mexico and Beyond:
www.ase.tufts.edu/gdae/policy_research/MexicoUnderNafta.html

END NOTES

- 1 Ohio Conference on Fair Trade, February 28, 2008, http://www.citizenstrade.org/pdf/OCFT_%20PresPrimaryTradeQuestionnaire_Obama_022008.pdf.
- 2 For a good overview of NAFTA's economic impacts, see Blecker, Robert (2003), "The North American Economies after NAFTA: A Critical Appraisal," *International Journal of Political Economy*

33, no. 3 (2003): 5-27. For a review of the economic impacts of NAFTA in Mexico see Zepeda, Eduardo, Timothy A. Wise, and Kevin P. Gallagher (2009), *Rethinking Trade Policy for Development: Lessons from Mexico Under NAFTA*, Carnegie Endowment for International Policy; Dussel Peters, Enrique, Luis Miguel Galindo Paliza, Eduardo Loría, and Michael Mortimore, *Inversión Extranjera Directa en México: Desempeño y Potencial. Una perspectiva macro, meso, micro y territorial. Siglo XXI, 2007*, Secretaría de Economía and UNAM, México; and Gallagher, Kevin P., and Lyuba Zarsky (2007), *The Enclave Economy: Foreign Investment and Sustainable Development in Mexico's Silicon Valley*, Cambridge: MIT Press.

- 3 The task force addressed the issues of services (Robert Stumberg), manufacturing (Enrique Dussel Peters), agriculture (Timothy A. Wise), investment (Gus Van Harten), intellectual property (Kenneth Shadlen), environment (Kevin P. Gallagher), labor (Christian Weller), and migration (Rodolfo García Zamora). While this is by no means a comprehensive list of the areas of the agreement that merit review and reform, these important areas have been the subject of significant debate since NAFTA took effect.

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