NAFTA and Beyond: Challenges for Extending Free Trade in the Hemisphere

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The NAFTA increasingly looks like a “one-shot” deal with little of the ongoing deepening of economic relationships expected at the time of its negotiation and no provisions for ongoing negotiations. As a result, alternative trading arrangements may provide an opportunity to move the North American trade agenda forward. The FTAA is one alternative. The FTAA, however, is an extremely ambitious undertaking bringing together a large number of very divergent economies in terms of size, stage of economic development, economic performance and economic philosophy. This increases the complexity of negotiations and the probability of failure. The paper outlines the major areas where negotiations are likely to be difficult and provides suggestions regarding what has been learned from the NAFTA experience that is relevant to the FTAA.

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Introduction

As a political vision, the Free Trade Area of the Americas (FTAA) is bold and inherently appealing. It is the type of initiative with which heads of government can step above the stifling politics of their daily lives, meet in amiable conclave and, in fact, set new courses and put bureaucratic wheels in motion towards realising a collective vision. It can alter their stature, however temporarily, to that of statesmen. Trade agreements are also relatively safe visions because they hinge on long processes of negotiations that can, if necessary, be spun out until their failure can be attributed to one’s successor. Once set in motion, however, these initiatives do tend to take on a life of their own and grind toward a conclusion that will always be less than the original vision, but can range considerably in its ultimate efficacy. The international political landscape is littered with trade agreements that have proved to be nothing more than “scraps of paper” – particularly in Latin America – but the European Union, the North American Free Trade Agreement (NAFTA), MERCOSUR and a range of lesser agreements in different parts of the world have fundamentally altered the course of economic development in their regions. Like the failures, each of these started with a bold political vision.

Looking past its political vision, the FTAA is the most ambitious regional trade undertaking ever attempted. It encompasses 34 countries; the multilateral GATT negotiations in 1947 had only 23 signatories. When the GATT came into being on January 1, 1948, there were only 10 countries that had ratified the agreement (Kerr, 2002). The EU started with only 6 countries, has grown over its long life to encompass only 15 countries, and is currently embroiled in an extremely acrimonious debate about the accession of future members. The NAFTA has only grown from 2 to 3 members. The Asia Pacific Economic Cooperation (APEC) is the only major trade agreement that rivals the FTAA for membership but, as yet, it has been far less ambitious in its liberalisation agenda than the proposed FTAA (Yeung et al., 1999).

The potential membership of the FTAA also encompasses an extremely wide range of economies. Arguably, it includes the world’s best long-run economic performer, the United States, and one of its worst (if not the worst), Haiti. It includes only two members of the G8 and three members of the Organisation for Economic Cooperation and Development (OECD). It includes countries whose economic performance has been sluggish for decades and countries whose performance plots like the plan for a roller coaster. It includes economic giants like Brazil and the United States and a large group of what are classed as “small island economies” in the
Caribbean. While it is no longer official policy, the import substitution theory of Latin America’s most famous economist, Raul Prebisch, still heavily influences thinking on economic policy and characterizes the intellectual approach of many of the region’s economists (Clement, 1999). What has been dubbed by some as a more than decade-long neoliberal experiment has failed to produce its promised prosperity, dampening the enthusiasm of many for trade liberalisation. According to The Economist (August 17, 2000, pp. 12-13), however:

… it is just too simple to blame all of this, as many do, on the supposed failure this past decade of the region’s experiment in ‘neoliberal’ economics. For one thing, there has been no such experiment; none, anyway, as uniform as the caricaturists say.

… nowhere in the region does there exist a mass movement calling for a return to the state-led economic nationalism that characterised the populists of Latin America’s past…

None of this is to deny that after a wretched half-decade much of Latin America is in need of a set of policies capable of generating growth. But there is little sign that people think they can achieve this by harking back to the failed policies of the past.

It seems clear that Latin America is looking for a new economic paradigm that can remove one of the major hindrances to its economic performance, corruption and cronyism, and deliver prosperity without the booms and busts that have become associated with being part of global capital markets. Of course, the economic busts simply represent the rough discipline of the international market for poor economic management (Kerr, 2000); the real problem is the market’s predilection to punish those countries that manage well but simply happen to be nearby – the flu effect – and represents a lack of sophistication among those who make decisions in financial institutions and not an endemic economic management problem in Latin America. In the run up to the FTAA, it is going to be particularly difficult to convince those countries that have suffered from the Argentine flu, and before that the Asian flu, that the benefits of the discipline on economic decision making of open markets (Hobbs et al., 1997) outweigh the costs associated with its lack of sophistication. Of course, the United States and Canada remain committed to the open-economy paradigm (of course tempered by the political reality of their domestic protectionist interests).

The point of this discussion laying out the heterogeneity of both the physical characteristics of potential FTAA members’ economies and their thinking on
economic policy is that it is a generally accepted principle that negotiations pertaining to regional trade organisations have a greater chance of success when the number of countries negotiating is small, their economies are relatively homogeneous and they share a common economic paradigm. The potential members of the FTAA share none of these characteristics. One might point to the Uruguay Round where in excess of 120 countries successfully negotiated a new GATT (with a host of new sub-agreements), the General Agreement on Trade in Services (GATS), the Agreement on Trade Related Aspects of International Property (TRIPS) and a new institutional structure that became the WTO. In the wake of the acrimonious negotiations at the 1999 Seattle WTO Ministerial and the 2001 Doha Ministerial, it is clear that many countries felt effectively excluded from the negotiations though a variety of procedural mechanisms (green rooms, etc.) and side deals among powerful members of the club (e.g., the Quad). In effect, this meant that the negotiations involved large numbers, diverse economies and divergent economic philosophies in name only (Kerr, 2002). The Seattle-Doha experience has made it clear that this type of negotiation will not happen again, particularly at the FTAA, given the long-standing and widespread fear of U.S. hegemony that exists in the region. As with the WTO, the FTAA negotiations will be actively conducted by the whole of the membership. This will increase the effort required to reach an agreement and lengthen the time required for deliberations. It also raises the probability that the FTAA will be stillborn. Until now, the U.S. trade establishment has been focussed on the politics of obtaining “trade promotion authority”. Now, armed with that authority, it needs to do a careful assessment of what will be required to obtain an agreement. It is still the case that there can be no FTAA without the acquiescence of the United States, and the United States must provide leadership if an agreement is to come to fruition. This paper will examine two aspects of the FTAA. First, it will briefly examine the major agenda issues that have already been agreed and attempt to outline the major areas where concession must be made relative to stated positions. Second, it will look at the NAFTA experience as a guide to the elements that an FTAA should contain. The latter is important because a large number of potential FTAA members have expressed interest in the NAFTA as a model and because two of the largest potential members of the FTAA comprise the NAFTA partners of the United States. These two countries may well see the FTAA as a means to move the North American trade agenda forward in ways that have not been possible within the NAFTA’s structure. These aspects may be crucial to the FTAA’s success, as there can be no FTAA without the participation of Canada and Mexico.
Disparate Views on Where to Start Negotiations

Negotiations are taking place over a range of major areas of international trade law, for example, market access, government procurement, investment and services. At this point, the negotiations are still at the stage of attempting to establish the modalities that will serve as starting points for the actual negotiations. Negotiations under some agreed modalities are slated to start late in 2002 and the entire agreement is to be wrapped up by January 2005. As yet, there remains no agreement on major modality items except tariffs. The modalities for tariffs were agreed at a vice-ministerial meeting held August 26 – 30, 2002 in Santo Domingo.

While an agreement on tariff modalities is somewhat understandable, and certainly welcome, the emphasis on negotiating the reduction of tariffs seems somewhat misplaced. Tariff modalities are probably the easiest barrier to international transactions to negotiate because the negotiating parameters are well defined, and it is in this area that the skills and experience of negotiators are strongest. The problem is that tariff reduction is also one of the least important aspects of what needs to be accomplished in an FTAA. The emphasis of the FTAA needs to be placed elsewhere, on trade in services, rules for investment, government procurement and other market access issues such as sanitary and phytosanitary rules.

The negotiations regarding tariffs were, however, difficult. The central disagreement was over whether “bound” or “applied” tariffs should be the modality from which tariff offers would commence. WTO bound tariffs are, in many cases, well above those that countries actually apply. If the “bound” tariffs are used as the starting point for tariff offers, then reductions can be offered that give little or no additional market access. This means that countries whose bound and applied tariffs are the same, or close to being the same, give larger increases in market access than those countries whose applied and bound tariffs diverge considerably. Even if tariffs are phased down to zero in the long run, those countries with large differences in bound and applied rates are, effectively, able to delay opening of their markets until later in the phase-in period. The United States, in particular, was insistent that applied tariffs be used as the starting point for tariff offers. The Caricom countries, on the other hand, wanted bound tariffs to be applied in the case of at least some countries – special and differential treatment. In the end, the compromise reached was that applied tariff rates would be the general rule, but that the Caricom countries would be granted an exception for the use of WTO bound rates on a limited list of, largely, agricultural products. This concession was secured by stipulating that the applied rates would be
those extended on a Most Favoured Nation basis, which are in many cases higher than
the rates actually charged under the “general system of preferences” (GSP)
agreements or other preferential arrangements entered into by the United States and
Canada with developing countries. Thus, in their tariff offers, the United States and
Canada do not have to use the low GSP rates as their starting point.

The countries have also agreed that there will be four categories for tariff
elimination: (1) products that would go to zero when the FTAA enters into force; (2)
products on a five-year phase-out schedule; (3) products on an eight- to ten-year
phase-out and; (4) products on an unspecified “longer” phase-out period (Inside US
Trade, 2002c). The latter category allows the United States and other countries
considerable wiggle room when it comes to sensitive products such as steel and
textiles. On this basis, the tabling of tariff offers can take place from December 15,
2002 until February 15, 2003. Countries will then table their requests for concessions
from February 15 to June 15, 2003. This is the “tried and true” GATT approach to
tariff liberalisation.

In other areas concerning market access, the United States is insisting that the
exact WTO provisions on Sanitary and Phyto-Sanitary Measures and Technical
Barriers to Trade be adopted by the FTAA. This demand may prove contentious in
areas such as biotechnology where some countries fear loss of EU markets if they
cannot exclude genetically modified products from their domestic economies.

Unfortunately, the aspects of FTAA negotiations that do not deal with market
access are likely to be much more complex, and there are fewer precedents for
reaching agreement. In addition to the negotiating group addressing market access,
there are eight other negotiating groups covering investment, services, government
procurement, dispute settlement, agriculture, intellectual property rights, subsidies,
antidumping and countervailing duties, and competition policy.

One of the most contentious issues is trade remedies – and in particular U.S.
antidumping and countervailing duties mechanisms. It is well known that the WTO anti-
dumping definitions are based on a fundamentally flawed economic premise (Kerr,
2001a). Further, the existing domestic U.S. mechanisms for investigating and
penalizing dumping and imposing countervailing duties, while WTO compliant, are
open to abuse in the form of harassment of foreign firms, and available to extend
temporary protection in times of economic downturns. For just these reasons, they are
dear to the hearts of many in the U.S. Congress, primarily because they make it easy
to deflect protectionist pressure. Major trading partners of the United States, such as
Canada, have been trying to escape U.S. trade remedy laws. Canada attempted to have
these laws not apply in the CUSTA but were unable to accomplish this goal (Kerr, 2001b). Canada did, however, secure agreement in the CUSTA to negotiate a mutually acceptable definition of dumping and countervailable subsidies over seven years. The deadline was, however, removed in the NAFTA negotiations and no progress has been made since that time (Kerr, 2001b). Canada has tried to use the alternative model approach to show the United States that trade arrangements can work without trade remedy provisions. The Canada-Chile Free Trade Agreement exempts parties from dumping and countervail.

In the FTAA negotiations, cognizant of the protectiveness of the U.S. Congress towards trade remedy legislation, countries have suggested much more modest improvements over the WTO provisions for trade remedies. Proposals have included provisions to tighten the criterion for determining when material injury has taken place from the current range of economic indicators that may be considered to only one – that the domestic industry must have suffered a financial loss. Another proposal suggested raising the threshold of industry support required for a case to be accepted from the current 25 percent to 50 percent. Other proposals include raising the *de minimis* level below which cases cannot be brought from 2 percent of the export price to 5 percent and raising the definition of negligible imports from 3 percent to 7 to 10 percent. The United States has resisted all of these proposals. Essentially, the United States does not want any new limits put on its application of trade remedies but has agreed to talk about the issues under extreme pressure from other western hemisphere countries. The United States wants to ensure that other countries’ trade remedy procedures are transparent (*Inside US Trade*, 2001). Further, the United States does not want NAFTA-like provisions in the FTAA that would allow for external review of domestic trade remedy findings. All of these issues remain outstanding and it will be very difficult to reach agreement on the modalities, much less a final agreement.

The negotiating group on services is bogged down over the issue of whether the modality should be a positive list approach or a negative list approach. The positive list approach would see markets opened up only for industries put on the list. The negative list approach would have markets opened up in all industries not explicitly excluded by being put on the list. The major difference in the two approaches is that under the negative list approach new service industries would automatically be open to foreign competition. Given that developed countries are the major developers of new services, and they see “knowledge economy” aspects of services being a major future source of their competitive advantage, it is probably not surprising that the United States favours the negative list approach. Countries such as Brazil do not want...
to forgo the opportunity to promote the establishment of domestic service industries in new areas without foreign competition. Further, there has been discussion of whether services delivered by foreign firms with a physical presence in the country should be treated using investment provisions, as they are in NAFTA, or under services as they are in the WTO’s GATS agreement.

For the investment negotiating group, a major issue has been whether the provisions should cover only foreign investors already established in the country or prospective investors as well. Extending coverage only to firms already established would allow discrimination against prospective investors in favour of domestically owned industries. Again, Brazil has been the major proponent of the more restrictive approach.

The negotiating group on government procurement has had difficulties dealing with whether or not its provisions should apply to subnational governments. Of course, exclusion of subnational governments discriminates against unitary states and countries too small to justify having subnational governments because, effectively, all of their government procurement is covered while this would not be the case for federations such as Brazil, Canada and the United States. The United States, however, opposes the extension to subnational governments because, by its constitution, it cannot require compliance of subnational governments. Brazil, on the other hand, argues that its companies may have a competitive advantage bidding on state-level contracts in the United States that may not exist for much larger U.S. Federal Government contracts (Inside US Trade, 2002a). The other negotiating groups have experienced similar difficulties in agreeing on the modalities. In all of these important areas, it is not yet clear what acceptable compromises might entail.

**Lessons from the NAFTA**

The experience with the NAFTA is very important for those negotiating the FTAA. This is because of the central role that the United States has played in the NAFTA and will play in the FTAA. Unlike the European Union, which has been involved in a large number of plurilateral trade arrangements, until the NAFTA the United States eschewed regional trade agreements, instead choosing to focus on the multilateral GATT. The NAFTA remains the only major regional trade agreement entered into by the United States, although latterly the country has become involved in less ambitious arrangements such as APEC and bilateral agreements with some smaller countries. Thus, the U.S. track record in the NAFTA provides the sole
example for those seriously considering entering into a trading arrangement with the United States.

On the whole the NAFTA experience has been mutually beneficial for all three parties. While the benefits actually arising from trade agreements are almost impossible to assess because their implementation takes place over very long periods when other forces are inevitably at work – in economists terms it is impossible to study the effects of trade agreements ceteris paribus, i.e., all other things held constant (Perdikis and Kerr, 1998) – the evidence from the NAFTA is fairly conclusive. Further, there has been virtually no backsliding: all three parties continue to live up to the letter of their NAFTA obligations and there appears to be no wavering on those commitments.

The problem with the NAFTA is what has not happened. The NAFTA was signed with high expectations that it would be the first step in a long process of deepening economic integration. This was particularly important for the smaller NAFTA partners, Mexico and Canada. Deepening economic integration is the only way that these countries can protect themselves from changes in U.S. perspective on international commercial relations. The more deeply integrated the three economies, the more difficult it will be for a government to abrogate an agreement – the government’s own nationals would have too much to lose from a major change in the relationship. Of course, deepening must be accomplished without an unacceptable loss of sovereignty for any of the parties and it is clear that deepening of the economic relationship raises sovereignty concerns among some members of the public, and at times members of all three governments. The commitment to deepening in the NAFTA, however, was not institutionalized and, in retrospect, was rather personally embodied in those who were responsible for fostering the agreement. It seems clear that this was a major mistake. In the absence of such institutionalization, when the fanfare died down the attention of political leaders was drawn elsewhere; the inherent inertia of government bureaucracies (Kerr, 1997) and sometimes overt protectionism gained sway (Kerr, 2001c). As a result, the NAFTA looks increasingly like a “one-shot” deal which, while very beneficial to all three partners, has delivered far less than was initially hoped. It seems clear that the NAFTA’s failure to “be all it could be” was the result of inexperience and not purposeful design.

The most obvious failure of the deepening process was the inability to find a satisfactory resolution to the application of trade remedy laws among NAFTA partners. The threat of the application of trade remedy laws as currently structured, which have both an untenable economic rationale and mechanisms which are open to
abuse in the form of harassment (Kerr, 2001a), significantly increases the risks associated with conducting transboundary transactions in the NAFTA environment and, hence, inhibits the types of investment that would foster deeper integration of the three economies.

The major institutional problems with the NAFTA are that it has no formal supernational body to foster a NAFTA agenda and no automatic provisions for ongoing negotiations. The United States, in particular, is suspicious of supernational institutions largely because of concerns with the limits on sovereignty that they might impose. In the case of the NAFTA, it would be more important that the supernational body have profile and prestige rather than any actual power to affect sovereignty. If one compares the NAFTA with the European Union, the most striking difference is the absence of the equivalent of the European Commission. Of course the European Commission has considerable power but it plays an extremely important role beyond that directly related to the power it controls. The Commission is comprised of commissioners appointed by the governments of member states. Once appointed, however, an individual commissioner is expected to take an EU perspective rather than to be an advocate for the government that appointed him or her. By and large, the commissioners have taken on that role – although there have been some notable exceptions. Commissioners “speak for Europe”. No one in the NAFTA system is expected to “speak for North America” – one is either an American, a Canadian or a Mexican. Of course, all of those who work in the European Commission also “speak for Europe”. This means that at almost any meeting, conference, policy forum or media event there is someone there to provide a European Union–wide perspective. This does two things: it forces people to consider this broader perspective and respond to it and it keeps it continually in front of them. This helps break down narrow nationalism and gives people a sense of being part of Europe. The cumulative effect of these activities should not be underestimated.

The European Commission is also charged with devising European Union–wide policy proposals. Even if the proposals are rejected by the Council of Ministers or the European Parliament, the mandate means that proposals with such a perspective must be considered. In the NAFTA, there is no institution that plays this role. Instead, everything must be negotiated by advocates of the individual countries. While, admittedly, the European Commission has been endowed with more political power than would ever be conceded by the United States, efficacy in either of these roles is not contingent on an institution having a significant degree of power. The NAFTA has suffered from the absence of this type of institution. Such an institution needs to be
created within the FTAA structure. Given the number of countries involved, an organisation will be needed to oversee and administer the FTAA. It is important that such an organisation be structured so as to be able to play a similar role to that of the European Commission even if its power is severely constrained.

Unlike the WTO and the EU, the NAFTA has no mechanisms for ongoing negotiations. This means that it would take a major political effort to launch an initiative designed to promote further deepening of the economic relationship in the NAFTA. Further, no agreement will be perfect when written, and circumstances will change over time. Without an institutionalized renegotiation provision, it is difficult to correct deficiencies that are discovered and to keep the agreement relevant. For example, all three NAFTA countries agree that there is a problem with the dispute mechanism embedded in the NAFTA’s Chapter 11 pertaining to investment. There is no provision for renegotiation and the parties are having to deal with the problem through suboptimal methods such as “interpretive notes”. In discussing the NAFTA’s Chapter 11 provisions, Joe Papovich, assistant U.S. trade representative for services, investment and intellectual property rights

… conceded that this goal would be easier to achieve in new trade agreements than in NAFTA, because of the political difficulty in reopening the agreement. In the case of the NAFTA, improvements can be made to the investment chapter via so-called interpretations, such as the one the signatories’ trade ministers agreed to last July.

But for NAFTA, it would be difficult to make changes that would require amendments … Mexico in particular is “loathe” to return to its parliament with an amendment for the NAFTA. … Changes that required rewriting text of the agreement would require an amendment … (Inside US Trade, 2002b).

Automatic provisions for renegotiation would make it easier to move the deepening agenda forward, to respond to new issues and to correct mistakes. Ongoing negotiation provisions can be structured to ensure that backsliding is not permitted, as in the case of the WTO’s bound tariffs. Of course, any agreed amendments would still be subject to political approval, but the process of initiating negotiations could be to a considerable degree depoliticized. A supranational FTAA institution could have a considerable role in shepherding this process in a similar fashion to the WTO Secretariat.

The mechanisms established in the NAFTA to deal with deepening through harmonization of standards or the granting of equivalence have not worked. A number
of technical committees were established to accomplish this task in the case of technical standards, sanitary and phytosanitary regulations, etc. These committees, however, have no mechanism to force a conclusion to their deliberations and, as a result, they have become venues simply to “talk and talk”. For example, since the inception of the CUSTA (the precursor to the NAFTA) more than a decade ago, Canada has been trying to have the grading of beef harmonized – even going so far as to alter its grading standard to match U.S. specifications. The removal of even this minor trade irritant has not yet been achieved, largely due to inertia in the U.S. domestic agency that would have to approve it and resistance from a small proportion of the U.S. domestic beef industry (Kerr, 1997). Thus, in the FTAA some mechanism to ensure that such technical negotiations eventually conclude would seem desirable.

Finally, the NAFTA has no mechanism to supervise implementation. Again, to draw on an example from the beef industry, in the original CUSTA negotiations Canada wanted border inspections for meat discontinued because there was some evidence that these inspections were being used for protectionist purposes (Kerr et al., 1986). The United States agreed that the inspections would no longer take place with the implementation of the agreement. It took years, however, before the provision was acted upon. There was no mechanism in the NAFTA to ensure that domestic agencies responsible for policy implementation responded to the commitments made in the NAFTA. This is a general problem with trade liberalization when it extends beyond the realm of trade ministries (e.g., the administration of tariffs) and into the domain of agencies responsible for domestic policy (Kerr, 1997). At the very least, the FTAA should have a “report card” mechanism where a country’s record on implementation can be publicized and moral suasion brought to bear. Again, this would seem to be an appropriate role for a supranational institution in the FTAA. This role is played by the WTO Secretariat when it issues its regular assessments of individual countries’ compliance with WTO provisions.

If the FTAA is to be an agent for the long-term deepening of economic integration in the Western Hemisphere, then it must be endowed with the wherewithal to move this process forward. Otherwise it will be a “one-shot deal” as the NAFTA appears to be. Endowing the FTAA with the opportunity to foster a hemisphere-wide trade liberalization agenda over the long run can likely be accomplished without compromising sovereignty to an unacceptable degree.
Conclusion

The FTAA is a bold vision that runs in the face of almost all of the conventional wisdom regarding either the rationale for regional trade agreements or the likelihood of their success. Regional trade agreements are supposed to be comprised of a small number of countries with similar economies and similar economic philosophies – the FTAA is none of these things. If nothing else, this means that the negotiations will be complex and difficult. The current difficulties in even agreeing to the modalities upon which negotiations will be based underline the diversity of the countries engaged in the FTAA negotiations. One question that arises is: What is centrally important to the negotiations?

The NAFTA has many of the characteristics that bode well for a successful regional trade agreement (but not all of them, given the differences in the level of development between the United States and Canada on one side and Mexico on the other). Can the NAFTA experience help focus the FTAA negotiations? At one level, the NAFTA was a great success. Its failing is that it has no mechanism embedded within it to move a North American trade liberalization agenda forward over the longer term. It would seem important that the FTAA be endowed with this ability on a hemispheric basis. If the FTAA has institutions that can foster (but not force) a hemispheric trade liberalization agenda over the long run, then the specific provisions agreed in the current negotiations will be less important. Certainly, the initial FTAA must provide sufficient benefits for all its members to ensure that it is taken seriously, but it is equally important that provisions for ongoing negotiations be included. If done carefully, the FTAA may be able to move the North American liberalization agenda forward in ways that the NAFTA cannot.
References


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