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NORTH AMERICAN FREE TRADE AGREEMENT

Assessment of Major Issues

Volume 1

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Comptroller General
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To the President of the Senate and the
Speaker of the House of Representatives

To assist Members of Congress in their deliberations over the proposed North American Free Trade Agreement (NAFTA), we have prepared this report on the major issues associated with the agreement.

NAFTA represents a dramatic step in the process of North American economic integration that has engendered substantial controversy over its potential impact. NAFTA has been negotiated to enter into force on January 1, 1994, but must first be ratified by the legislatures of Canada, Mexico, and the United States.

Our work is presented in two volumes. In the first volume we briefly summarize major provisions of the agreement and provide a discussion of its broad impacts—on the economy, the environment, labor, and immigration. In the second volume, organized as a sourcebook, we give more detail on specific provisions of the agreement. In particular, we discuss the objectives of negotiators from each country, the major components of the agreement, and the issues that remain unresolved. Specifically, the sourcebook includes information on NAFTA's (1) provisions to liberalize trade and investment in North America, (2) special provisions for trade-sensitive economic sectors, (3) rules to implement the agreement, and (4) potential impacts.

To obtain information on NAFTA's efforts to liberalize trade and investment in North America, treatment of trade-sensitive economic sectors, and rules to implement the agreement, we reviewed government documents and studies from the United States, Mexico, and Canada. We also interviewed negotiators and other officials in each country. In order to provide additional perspective, we analyzed nongovernment reports and studies and interviewed issue area experts.

To obtain information on NAFTA's potential impacts, we reviewed existing studies estimating the economic impact of NAFTA. We also interviewed representatives of environmental and labor groups in each country. Finally, we drew upon the analysis and conclusions of previous GAO reports, a listing of which is found at the end of this report. A detailed discussion of our scope and methodology is presented in volume 2.

This report summarizes the competing viewpoints on the potential impacts of NAFTA and provides comments, where possible, on the reliability of this information. In the following sections we discuss both the gains and the losses associated with passage of NAFTA. This discussion includes potential effects on labor, the environment, and immigration as well as potential economic consequences and government policy responses. Just as passage of NAFTA will have various effects, so too will rejection of NAFTA engender certain consequences. Therefore, we comment briefly on the potential effects that a rejection of NAFTA might have.

We conducted our work between June 1992 and July 1993 in accordance with generally accepted government auditing standards.

Results in Brief

NAFTA's potential effects include both the benefits that accrue from liberalization of trade and investment and the costs of adjustment present in a dynamic economy. NAFTA is an accord that breaks new ground, while securing existing arrangements. It eliminates tariffs and other measures that protect domestic industries, but it also provides a period of adjustment for trade-sensitive sectors. It offers the promise of modest economic expansion, but it will likely cause some job dislocation. Both NAFTA proponents as well as trade theory argue that the agreement promises net benefits to all three countries, but opponents vigorously reject it primarily for reasons outside the scope of the agreement itself—notably, because they believe it will adversely affect the U.S. labor market and the environment.

NAFTA's broad goal is to improve productivity and standards of living through the free flow of commerce in goods and services and investment capital throughout North America. To do so, NAFTA, over a specific period, provides for removal of tariffs and other barriers to trade and establishes principles designed to protect North American investors from arbitrary interference by governments. NAFTA will create the largest free trade area in the world, with 360 million people and an annual gross national product (GNP) totalling over $6 trillion.

While providing overarching trade liberalization measures and principles, NAFTA establishes special provisions for trade and investment in certain trade-sensitive economic sectors including agriculture, automotive products, energy, and textiles and apparel. NAFTA provides detailed provisions for the phased elimination of tariff and nontariff barriers to

trade and establishes specific trade and investment rules for each of these sectors.

NAFTA sets up systems needed to help implement the agreement, improving upon those in the U.S.-Canada Free Trade Agreement (CFTA). These systems include a committee to oversee the implementation of the agreement and mechanisms to resolve certain disputes that may arise. Also, NAFTA is regarded by trade officials as setting the highest standards of protection and enforcement for intellectual property found in any multilateral agreement. Finally, the agreement contains provisions to restore protection temporarily for industries that are injured by imports.

Much of the controversy sparked by NAFTA has revolved around issues not generally negotiated in trade agreements, such as its effect on the environment, labor, and immigration. Furthermore, the three countries' measures taken to address these issues, both in NAFTA and in side negotiations, have not satisfied critics of the agreement. In an effort to address outstanding concerns, parallel negotiations have focused on environmental protection and workers' rights and safety. These complex negotiations were recently concluded after we completed our work and prepared this report. We have not assessed the resulting agreements.

Migration issues were not addressed in NAFTA. Analysts expect illegal Mexican migration to grow in the short run, whether NAFTA is implemented or not. However, they expect NAFTA to reduce unauthorized Mexican migration to the United States in the long run to the extent that NAFTA can help increase economic growth and job opportunities in Mexico.

A central issue is the overall impact of NAFTA on the U.S. economy in general and the labor market in particular. Projecting the economic impact of specific trade agreements such as NAFTA is difficult, and any estimates should be interpreted with caution. Although there is a range of results, general equilibrium models used to assess NAFTA's potential impact generally project small net macroeconomic gains, including a growth in employment for the United States and Canada. Larger gains are projected for Mexico, given the country's relatively small and less-developed economy.

Despite the fact that models project net employment gains, the effects would not be evenly spread across the economy. Certain sectors of each country's economy will require restructuring to strengthen their competitiveness or to adjust to a diminished market position. Job

dislocations, especially among low-skilled workers, could be anticipated in certain U.S. industries.

Opponents of NAFTA believe that job losses in industries unable to compete are more important than the promise of small future benefits to the economy as a whole.

Economic theory and global experience with trade liberalization suggest that the overall interests of the United States are served by promoting and facilitating change that increases U.S. productivity and the standard of living, such as trade liberalization. However, these benefits are accompanied by costs, some of which fall more directly on certain sectors of the economy and labor force. The ultimate decision on NAFTA should come from a weighing of its broad-based benefits against the costs incurred by certain identifiable sectors. However, if NAFTA is ratified, policymakers should also consider a strong commitment to an effective, well-funded worker adjustment assistance program to aid those who will bear the heaviest burden of adjustment.

Background

NAFTA, signed in December 1992 by the United States, Canada, and Mexico, is the latest step along the path of trade liberalization that has characterized trade and investment between the three countries for over a decade. The most important trade development between the United States and Canada is CFTA, which was implemented in 1989. The most important developments in Mexico have resulted from its self-initiated efforts to liberalize and reform its economy. In addition, the United States and Mexico have negotiated a number of trade liberalization agreements, including the 1987 Bilateral Framework Agreement on Trade and Investment, which established routine consultations between the two countries on commercial issues.

NAFTA incorporates features designed to meet the main objectives of the three parties to the agreement. The agreement addresses traditional U.S. trade policy objectives, such as general tariff reduction, the elimination of nontariff barriers to trade, and the settlement of disputes between parties of the agreement; it also covers new ground in the areas of intellectual property rights, services, investment, and government procurement. The NAFTA negotiation process also addressed nontraditional trade issues such as environment and labor standards, and workplace safety.

In addition, the agreement addresses Mexico's main objectives in the negotiations, such as locking in its self-initiated market-oriented reforms, increasing employment by attracting new investment, and gaining greater access to U.S. and Canadian markets. Canada's main objectives in joining NAFTA were to preserve, clarify, and strengthen the CFTA provisions and to ensure that Canada shares in the benefits that are expected to accrue from increased access to Mexico's traditionally closed market sectors.

GAO's Analysis

NAFTA Will Reduce Barriers to North American Trade and Investment

NAFTA is a significant step in the process of liberalizing North American trade and investment. To remove obstacles to trade in North America, NAFTA progressively eliminates almost all U.S.-Mexico tariffs over a 10-year period, with a small number of tariffs for trade-sensitive industries phased out over a 15-year period. Mexico-Canada tariffs are also phased out over a 10-year period. Tariff reduction schedules between the United States and Canada negotiated in CFTA are retained. In addition, NAFTA eliminates other barriers to trade such as import licensing requirements and Customs user fees. At the same time, NAFTA establishes the principle of national treatment, ensuring that NAFTA-origin products traded between NAFTA countries will receive treatment equal to similar domestic products.

NAFTA also guarantees service providers of the three countries equal treatment in the NAFTA area, including the right to invest and the right to sell services across borders. For example, in the area of financial services, NAFTA will enable U.S. banks and securities firms to establish full-service offices in Mexico for the first time in about 50 years.

In addition, NAFTA establishes five basic principles to protect foreign investors and their investments in the free trade area. These principles are (1) nondiscriminatory treatment, (2) freedom from performance requirements,[1] (3) free transference of funds related to an investment, (4) expropriation only in conformity with international law, and (5) the right to seek international arbitration for a violation of the agreement's protections.

At the same time, NAFTA will not bring about totally free trade. For example, Mexico reserved the right to prohibit foreign activity in its oil

[1]"Performance requirements" refers to government-mandated or -approved activities that investors must undertake, usually as a condition of establishment or operation in a particular country.

sector, Canada retained the right to protect certain culturally sensitive information industries, and the United States retained the right to maintain its domestic price supports and marketing orders for agricultural products that set quality standards for certain crops.

NAFTA Has Special Provisions for Sensitive Economic Sectors

NAFTA will address barriers to trade and investment in certain specific sectors sensitive to the economic interests of each country. Examples of these specific provisions follow.

- Agriculture. Special agriculture provisions gradually phase out existing trade barriers over a maximum period of 15 years. This liberalization regime provides each country's agricultural sector with an opportunity to adjust to more competitive conditions. We have previously reported that increased liberalization of U.S.-Mexico agricultural trade will generally benefit the U.S. agriculture industry and that U.S. producer groups largely support increased trade liberalization. NAFTA is generally expected to provide the U.S. agricultural sector with continued opportunities for export growth, particularly in sectors such as grains, certain fruits, dairy products, poultry, and meat. However, some U.S. fresh fruits and vegetables are likely to lose market share to the increased competition under NAFTA. While this competition would hurt producers, it could lead to lower prices for consumers. Special import protection provisions may be triggered if a particular industry is determined to be injured by imports.
- Automotive products. Automotive products are currently the largest component of bilateral manufacturing trade between the United States and Canada and the United States and Mexico. NAFTA will increase U.S. and Canadian access to Mexico's traditionally protected automotive market. Specifically, NAFTA will eliminate over a 10-year transition period all barriers to trade in North American automotive goods and all investment restrictions in the automotive sector. CFTA will largely remain in effect for U.S.-Canadian trade. NAFTA also establishes a North American Automotive Standards Council to work toward harmonized standards. Stringent automotive rules of origin are designed to prevent non-NAFTA countries' products from enjoying NAFTA's preferential treatment.
- Energy. NAFTA will provide substantive opportunities for new foreign investment in the areas of both electricity and petrochemicals in Mexico. NAFTA also increases opportunities in the area of government procurement by allowing North American firms to compete on a non-discriminatory basis for government contracts in selected energy markets. However, Mexico retains a reservation for its constitutional prohibition against foreign or private activity in oil exploration, production, and refining. Thus

the potential gains to U.S. petroleum producers are limited, and Mexico's dilemma over how to raise sufficient capital for its energy sector is left unresolved.

- Textiles and apparel. NAFTA will eliminate tariffs between the United States and Mexico, and between Canada and Mexico, either immediately or phased out over 10 years for products manufactured in North America that meet NAFTA rules of origin. Import duties between the United States and Canada will continue to be phased out on the schedule set forth under CFTA. NAFTA provides more strict and detailed rules of origin than CFTA. These rules define when textile or apparel goods traded among NAFTA countries qualify for preferential duty treatment. NAFTA also establishes a safeguard threshold for a NAFTA country to invoke emergency protection against imports that threaten or result in serious damage to the domestic industry. This safeguard threshold is lower for textiles and apparel than for other products.

NAFTA Rules Will Help Implement the Agreement

CFTA created rules and mechanisms to facilitate implementation of the agreement that have been widely viewed as successful. NAFTA adopts and expands on these mechanisms. First, it provides for a Free Trade Commission to oversee the continual process of implementing the agreement and further liberalizing North American trade. This oversight includes the authority to supervise special working groups that clarify various aspects of the agreement and address unresolved issues. Second, when disputes arise among the parties concerning either unfair foreign trade practices or the interpretation and application of NAFTA itself, distinct settlement mechanisms can be applied to achieve a resolution through timely and impartial proceedings. However, at the insistence of the United States, each country will retain its laws regarding unfair foreign trade practices and may apply these laws to trade from a NAFTA partner.

NAFTA also includes comprehensive provisions for the protection and enforcement of intellectual property among the three countries. The agreement would provide protection for existing and future intellectual property, including copyrights, patents, and trademarks. However, at the insistence of Canada, NAFTA, as in CFTA, provides an exception to the general relaxation of trade barriers in the agreement for so-called "cultural industries," including those heavily reliant on intellectual property rights, such as the movie, recording, broadcast, and publishing industries. Canada, for example, could implement measures restricting trade and investment in publishing or in the production and distribution of movies

and records. The cultural exception does not apply between the United States and Mexico.

Finally, NAFTA will permit governments to impose temporary import protection, or safeguards, in cases where a domestic industry is determined to be injured or threatened by injury. Safeguards must be applied through fair and open administrative procedures, and compensation is to be provided for the affected countries.

Concern Over NAFTA Includes Nontrade Issues

Debate over NAFTA has included factors outside the normal scope of trade negotiations, such as the environment and labor rights. Both the former and current U.S. administrations have acknowledged the importance of these factors by initiating parallel efforts, which address concerns over NAFTA's potential impact on the enforcement of environmental laws and labor rights and standards. Negotiations on these issues were concluded in August 1993 after we completed our work and prepared this report. We have not assessed the resulting agreements.

Supporters of NAFTA argue that the agreement will enhance environmental protection by spurring economic growth in Mexico and thereby increasing the desire for, and ability to pay for, environmental protection. NAFTA is also expected to encourage trilateral cooperation on environmental issues. NAFTA critics argue that increased economic activity resulting from NAFTA will exacerbate existing environmental problems, particularly along the southern U.S. border. Nevertheless, both critics and supporters have widely recognized NAFTA as a landmark trade accord because it is the first to significantly address environmental issues. It has received widespread, though qualified, support among environmentalists. While most environmental groups generally support NAFTA, they would like to see enforcement powers in a parallel environmental agreement. Such an agreement was recently concluded, but some groups regard it as inadequate.[2]

Labor groups in the United States and Canada generally oppose NAFTA, while Mexican labor groups generally favor the agreement as a means for promoting economic growth and job creation in Mexico. The main concerns of the U.S. and Canadian labor groups are that free trade with Mexico will depress wages and will lower U.S. and Canadian standards for

[2]On June 30, 1993, a U.S. district court judge ruled that the administration must prepare an environmental impact statement for NAFTA. The judge ruled in a suit filed by three environmental groups: Public Citizen, the Sierra Club, and Friends of the Earth. The administration has appealed this decision on an expedited basis, and the appeals ruling is expected to be issued in September.

workers' rights, health, and safety. NAFTA does not directly address these issues, but a parallel agreement just negotiated is intended to establish oversight of labor standards and rights in the three countries.

Although NAFTA itself does not provide for open borders or the free movement of labor, there is considerable speculation over NAFTA's impact on Mexican migration to the United States. It is unclear what NAFTA's impact will be on illegal Mexican migration to the United States in the short run. Whether or not NAFTA is implemented, illegal Mexican migration is expected to grow during the next decade due to Mexico's economic restructuring and its expanding working-age population. In the long run, however, most analysts predict that NAFTA will decrease illegal Mexican immigration to the United States by spurring economic growth in Mexico and creating jobs.

NAFTA's Potential Economic Impacts

NAFTA incorporates a number of trade-offs designed to approach, over time, the fundamental goals of free trade and investment and ultimately provide net benefits to all parties in the agreement. Most studies predict that Mexico, due in large part to its smaller and less-developed economy, will gain most from the agreement, while the United States and Canada will enjoy better and more secure access to growing Mexican markets. These benefits do not come without a cost. It is clear that certain sectors of each country's economy will require restructuring to strengthen their competitiveness or to adjust to a diminished market position.

Assessing the impact of NAFTA presents a particular challenge for the Congress, which, under the current rules, has to vote for or against the proposed implementing legislation without possibility of amendment. The breadth and complexity of the agreement make it difficult to readily sort out all of its potential effects. In addition, no set of analyses or studies in and of itself provides definitive estimates of these effects.

A considerable amount of research using a variety of economic models has been done on the effects NAFTA may have on the U.S. economy. There has been an ongoing debate over the assumptions used in these models as well as their general usefulness. Despite these weaknesses, a substantial majority of the studies reached a similar conclusion: limited net gains for the U.S. and Canadian economies if NAFTA is implemented. According to the U.S. International Trade Commission's (ITC) synthesis of a large number of economic studies, NAFTA would result in an increase in

economic growth of less than one-half percent of GNP for these economies.[3] The meagerness of this result was explained by (1) the currently low trade and investment barriers between the United States and Canada, allowing for generally free movement of goods and services; and (2) the limited immediate gains from expanded exports to Mexico because of Mexico's small size relative to the U.S. economy. For Mexico, however, the ITC symposium reported an estimated benefit of up to 11 percent under the most optimistic scenario. These projections are consistent with trade theory.

While the models project net employment gains as a result of NAFTA, the effects would not be evenly spread across the economy. Job dislocations could be anticipated in certain impacted industries, particularly among low-skilled workers. Opponents are particularly concerned about the possible adverse effect NAFTA could have on the job prospects of unskilled laborers in the United States. Since Mexican workers are generally paid much lower wages, the potential for U.S. plant closures and relocations to Mexico could intensify wage competition in the United States and lead to lower real earnings for unskilled workers in the United States. However, many economists note that production relocations to Mexico or other developing countries will likely occur regardless of NAFTA's implementation, with accompanying dislocation of U.S. workers.

The United States has two major federal programs to aid adjustment of workers who have lost their jobs. Trade Adjustment Assistance (TAA) helps workers dislocated because of increased imports, while the Economic Dislocation and Worker Adjustment Assistance (EDWAA) program authorizes services to all dislocated workers, regardless of the reason for their job loss. The two programs offer similar services, including providing economic resources for training, job search, and placement assistance. Individuals eligible for TAA can also receive income support payments for up to 1 year after the expiration of their unemployment insurance.

GAO analysis of the two programs in 1992 revealed shortcomings[4] that included delays in providing assistance to participants, limitations in the services offered, and inadequacy in tailoring services to meet the specific needs of individual participants. Other analysts estimated that the programs were reaching only one-fifth of the individuals who were potentially eligible for services. The analysts were unsure whether the

[3]In general, these results from general equilibrium models should be interpreted as if NAFTA provisions were to be implemented all at once.

[4]Dislocated Workers: Comparison of Assistance Programs (GAO/HRD-92-153BR, Sept. 10, 1992).

shortfall was due to inadequate funding or to perceptions that the two programs were unhelpful.

On August 24, 1992, then-President Bush, in response to congressional concern about NAFTA, proposed creating a replacement worker adjustment assistance program combining elements from existing programs. It was to have a funding level of $2 billion annually, more than double the existing funding for worker adjustment assistance, and $335 million was specifically reserved for NAFTA-related worker displacement assistance, with an additional $335 million to be available if needed. President Clinton has requested more than $1.9 billion for EDWAA in fiscal year 1994 and is expected to propose a comprehensive program for dislocated workers.

We believe that a comprehensive dislocated worker assistance program is needed to correct the problems of existing programs. Further, we believe that combining TAA and EDWAA should eliminate confusion about eligibility and simplify the delivery of services. However, program development efforts would be needed to resolve the remaining problems of tailoring services to the needs of individual workers and delivering those services in a timely manner.

Liberalized trade is generally considered important to the long-run health of the U.S. economy, and thus it has long been U.S. policy to seek to remove trade barriers and promote "transparency" of trade rules. Disruption, adjustment, and change are inevitable in a dynamic economy, providing new opportunities for reallocating investment and employment that improve economic efficiency. These adjustments will occur, indeed are occurring, whether NAFTA is implemented or not. According to the Organization for Economic Cooperation and Development, attempts to refrain from adjustment are the real threat to employment. A healthy economy must have the ability to change and redirect economic resources and people to its most efficient and productive sectors in order to grow and create new employment.

The benefits realized by society as a whole from such change are accompanied by costs, however, some of which fall heavily on certain sectors of the economy and labor force. Consequently, trade liberalization without specific programs to help those who are injured means that the benefits are spread broadly across the economy, while certain groups bear a disproportionate share of the cost. Therefore, if NAFTA is ratified, policymakers should also consider a strong commitment to an effective,

well-funded worker adjustment assistance program to aid those who will most bear the burden of adjustment.

Potential Impacts From NAFTA Rejection

Just as a decision to support NAFTA has to balance potential gains and losses, a decision to reject the agreement must do the same. Rejection of NAFTA may protect the economic interests of certain industries and workers in the short term. Presumably, CFTA would remain in effect to govern trade between the United States and Canada. However, rejection of NAFTA could result in changes in Mexico that would have adverse consequences for the United States. Mexico has recently undertaken action to open up its economy, and during this period the U.S. merchandise trade balance with Mexico has changed from a deficit to a sizable surplus. It is not clear whether these market opening reforms could survive NAFTA rejection. A decision not to ratify NAFTA could also have adverse impacts on Mexico's financial markets. Additionally, Mexico's ongoing restructuring of its communal farm system may lead to increased illegal immigration into the United States should Mexico's economy not grow sufficiently to absorb the excess workers.

Conclusions

NAFTA presents a particular challenge for the Congress, which, under the current rules, has to vote for or against the proposed implementing legislation without possibility of amendment. The breadth and complexity of the agreement make it difficult to readily sort out all of its potential effects. In addition, no set of analyses provides definitive estimates of these effects. There are indications, however, that the agreement will produce both benefits and costs with some costs falling more directly on certain sectors of the economy and labor force. For example, NAFTA may produce benefits at the macroeconomic level but at the expense of job dislocations in certain industries, particularly among low-skilled workers. An important consideration in this regard is the notable weaknesses we found in our analysis of the two major federal programs designed to aid adjustment of workers who have lost their jobs.

Matter for Congressional Consideration

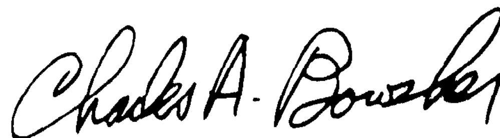
If the Congress decides to ratify NAFTA, it should also ensure that an effective, well-funded worker adjustment assistance program is in place to facilitate the structural adjustment that may be needed in the workplace.

Agency Comments

We discussed the information contained in this report with program officials from the U.S. Departments of State, Agriculture, Commerce, Energy, Transportation, Labor, and the Treasury; the U.S. Customs Service; the Immigration and Naturalization Service; the Office of the U.S. Trade Representative; and the Environmental Protection Agency, and included their comments where appropriate. They generally agreed with our analysis.

We are sending copies of this report to Members of Congress; the Attorney General of the United States; the Secretaries of State, Agriculture, Commerce, Energy, Transportation, Labor, and the Treasury; the U.S. Trade Representative; the Administrator, Environmental Protection Agency; the Chairman, U.S. International Trade Commission; and other interested parties. Copies will also be made available to others upon request.

This report was prepared under the direction of Allan I. Mendelowitz, Director, International Trade, Finance, and Competitiveness, who may be reached on (202) 512-4812 if you or your staff have any questions. Other major contributors to this report are listed in volume 2, appendix II.



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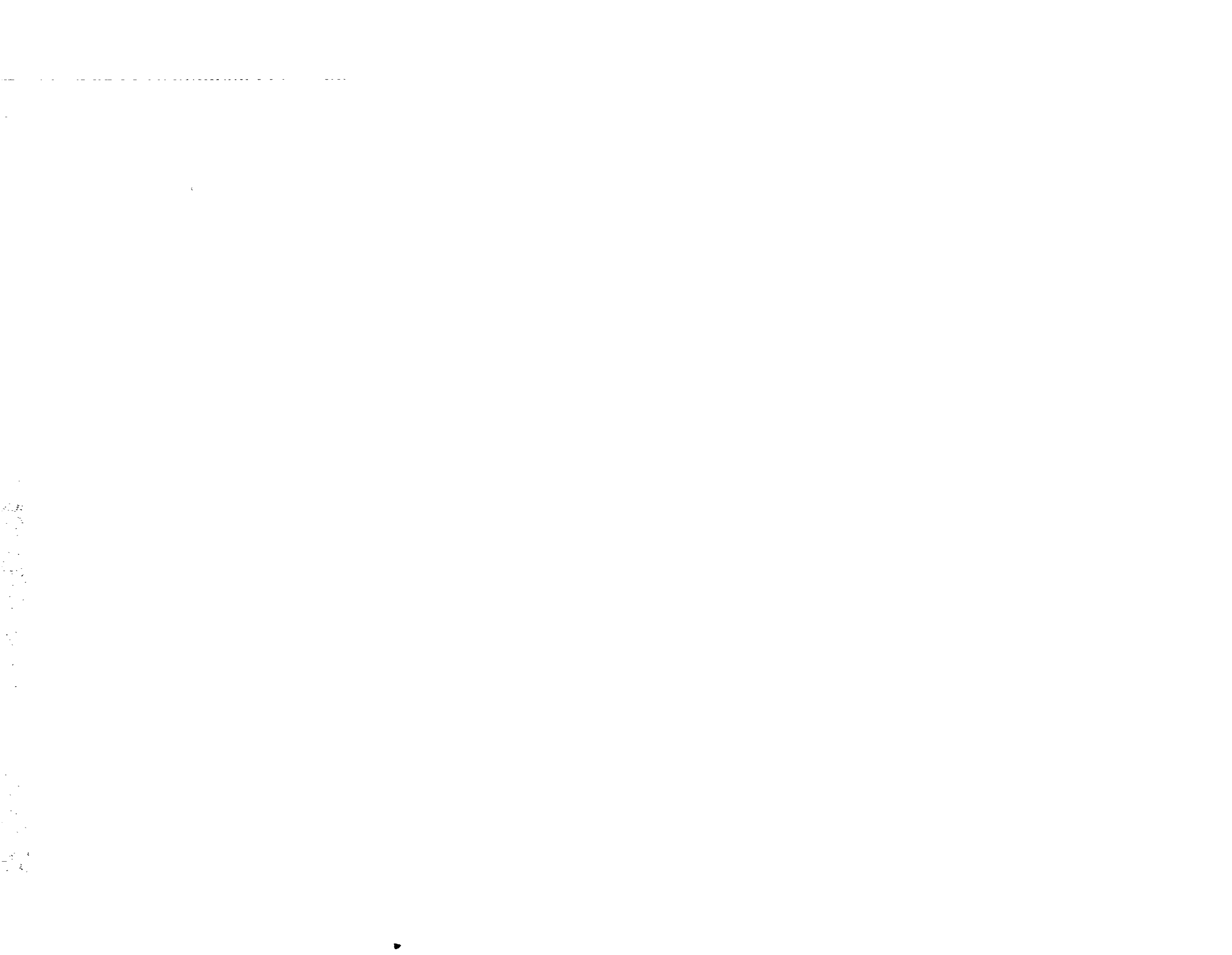

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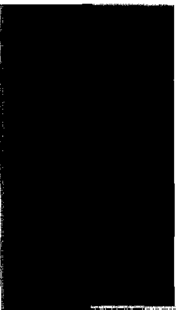


Preface

This volume of GAO's study of the North American Free Trade Agreement (NAFTA) is a reference document assessing the major issues associated with the agreement. Our assessment incorporates the objectives of negotiators from each country and the major accomplishments of the agreement, and identifies issues that remain unresolved. We report information on NAFTA's efforts to liberalize trade and investment in North America, treatment of sensitive economic sectors, rules to implement the agreement, and potential impact. Specifically, we address six major areas related to NAFTA:

(1) NAFTA's rules to facilitate the free flow of trade in goods and investment capital throughout North America (ch. 2);

(2) NAFTA's principles governing trade and investment in services and financial services (ch. 3);

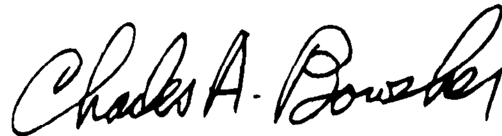
(3) NAFTA's treatment of key economic sectors, including agriculture, automotive products, energy, government procurement, and textiles and apparel (ch. 4);

(4) NAFTA's trade rules, including rules for dispute settlement, unfair trade practices, intellectual property protection, emergency actions, and standards (ch. 5);

(5) NAFTA's impact on the environment, worker standards and safety, and immigration, issues not generally negotiated in trade agreements (ch. 6); and

(6) Assessment of the likely economic impacts of NAFTA (ch. 7).

Any questions concerning this study can be addressed to Allan I. Mendelowitz, Director, International Trade, Finance, and Competitiveness Issues, who may be reached on (202) 512-4812.



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Abbreviations

ACTPN	Advisory Committee on Trade Policy and Negotiations
ATAC	Agricultural Technical Advisory Committee
BIT	Bilateral investment treaty
CAFE	Corporate Average Fuel Economy
CBI	Caribbean Basin Initiative
CFE	Comision Federal de Electricidad
CGE	Computable General Equilibrium model
CFTA	U.S.-Canada Free Trade Agreement
DOC	U.S. Department of Commerce
EDWAA	Economic Dislocation and Worker Adjustment Assistance
EPA	Environmental Protection Agency
EPI	Economic Policy Institute
ESI	Economic Strategy Institute
GAO	General Accounting Office
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
GSP	Generalized System of Preferences
HS	Harmonized Commodity Description and Coding System
IFAC	Industry Functional Advisory Committee
IIE	Institute for International Economics
IPAC	Industry Policy Advisory Committee
ISAC	Industry Sector Advisory Committee
INS	Immigration and Naturalization Service
ITC	International Trade Commission
MFA	Multifiber Arrangement
MFN	Most favored nation
MMF	Manmade fiber
MOU	Memorandum of Understanding
NACE	North American Commission on the Environment
NAFTA	North American Free Trade Agreement

OSHA	Occupational Safety and Health Administration
OTA	Office of Technology Assessment
PEMEX	Petroleos Mexicanos
SPS	Sanitary and phytosanitary
TAA	Trade Adjustment Assistance
TPL	Tariff preference level
TRIP	Trade-Related Aspects of Intellectual Property Rights
TRQ	Tariff-rate quota
USDA	U.S. Department of Agriculture
USTR	U.S. Trade Representative

Introduction

Background

On December 17, 1992, the leaders of the United States, Canada, and Mexico signed the North American Free Trade Agreement, the most comprehensive free trade pact ever negotiated and the first free trade pact between a developing country and industrial countries. NAFTA will create the largest free trade zone in the world, with 360 million people and an annual gross national product (GNP) totaling over $6 trillion. If ratified by the legislatures of all three countries, NAFTA is expected to enter into force on January 1, 1994.

If NAFTA is implemented, it will phase out virtually all tariff and nontariff barriers to trade in goods, improve access for services trade, establish fair rules for investment, strengthen intellectual property rights, maintain each country's ability to set standards, and provide a mechanism for dispute settlement. Significantly, NAFTA would bind Mexico's recent market-oriented economic reforms to international obligations, thereby making these reforms more permanent.

Experts predict that NAFTA will result in modest gains for the U.S. and Canadian economies and larger gains for the Mexican economy. In theory, free trade benefits consumers by providing higher-quality goods at lower prices because of comparative advantage and competition. However, much controversy remains as to the scope and extent of social and economic adjustments that will be caused by NAFTA's implementation, such as effects on employment, immigration, and the environment. Chapter 7 of this report provides an assessment of related economic analyses and proposals to assist dislocated U.S. workers.

Recent North American Trade Liberalization

NAFTA represents the culmination of a gradual process of trade liberalization that has been occurring over the years between the United States, Canada, and Mexico. U.S.-Canadian trade liberalization entered a new phase with implementation in 1989 of the bilateral U.S.-Canada Free Trade Agreement (CFTA). That agreement allows over 70 percent of merchandise trade between the two countries to enter duty free. CFTA placed both countries' economic relationship on a stronger, more open, rule-based footing.

The United States and Mexico began to liberalize bilateral trade in the 1980s. The 1987 Bilateral Framework Agreement on Trade and Investment established routine consultations between the two countries on commercial issues. Unilaterally, the United States has provided opportunities for Mexican exports to enter the United States under

programs such as the Generalized System of Preferences (GSP), which grants duty-free treatment to selected commodities from developing countries, and production-sharing tariff provisions, which allow return of processed U.S. goods without duty. Mexico's accession to the General Agreement on Tariffs and Trade (GATT) in 1986 led to the reduction of its tariffs and the elimination of many nontariff barriers.

Negotiators' Objectives

According to U.S. negotiators, one of their foremost objectives was to ensure that Mexico would lock in the recent economic and political reforms it has instituted since 1985. These reforms created a more predictable, stable business environment for U.S. exporters and investors. The United States believes NAFTA will benefit the U.S. economy by accelerating Mexico's liberalization process and by giving U.S. exporters and investors increased access to Mexico's relatively more closed markets. NAFTA will also safeguard and strengthen CFTA's achievements.

By allowing NAFTA to lock in its extensive market-oriented policy reforms, Mexico hoped to encourage investment by sending a positive signal that Mexico's current favorable climate toward trade and investment will not be easily reversed. Mexico sought to reduce the threat of U.S. protectionism and enhance export opportunities in the U.S. and Canadian markets. Furthermore, Mexico believes NAFTA will be beneficial by permitting it increased access to U.S. and Canadian technology and capital, according to a leading Mexican negotiator.

Through NAFTA, Canada will achieve its objectives of improving its access to the Mexican market; safeguarding, improving, and clarifying certain provisions of CFTA; and ensuring that Canada remains an attractive location for investors. Canada wanted to avoid separate U.S. agreements with Canada and Mexico because Canada realized that reforms by the United States and Mexico would affect the Canadian position in the U.S. market whether Canada participates in NAFTA or not. The Canadian government reported NAFTA will promote change in an orderly manner. It also reported that NAFTA will ensure that Canada is better positioned to keep what it has achieved through CFTA and enable it to take advantage of new opportunities.

NAFTA Implementation Schedule

Before NAFTA can take effect, all three countries' legislatures must approve the agreement. In the United States, the Congress must also approve implementing legislation for the provisions in the agreement. There is no

statutory deadline for submitting implementing legislation because NAFTA was signed before "fast-track" provisions of the U.S. trade law expired.[1] The Bush administration had anticipated submitting implementing legislation to the Congress in time for NAFTA's scheduled implementation by January 1, 1994. Congress is allowed 90 session days for action on the agreement. Delay in U.S. ratification of NAFTA could complicate the political timetables in Mexico and Canada, preventing them from ratifying NAFTA before general elections in these countries. The negotiation of side agreements on labor, the environment, and further safeguards has delayed submission of implementing legislation. The Clinton administration reported in July 1993 that it still plans to meet the January 1, 1994, NAFTA implementation date.

Side agreements were negotiated to address concerns that NAFTA would not adequately protect the North American environment or the unskilled segment of the labor force in the United States. Some unions and some environmental groups in the United States have stated that the side agreements announced August 13, 1993, do not adequately address their concerns.

Advisory Committees Generally Support NAFTA

The U.S. negotiating position, coordinated by the U.S. Trade Representative (USTR), was formulated using the most extensive congressional and private sector consultations ever conducted in conjunction with a major trade agreement, according to USTR. In addition to briefings with trade associations and private sector organizations throughout the country, USTR consulted its federally mandated private sector advisory committees. The private sector advisory system consists of almost 40 committees, with a total membership of approximately 1,000 advisers. The system is arranged in three tiers: the President's Advisory Committee on Trade Policy and Negotiations (ACTPN); seven policy advisory committees, including one on labor; and more than 30 technical, sectoral, and functional advisory committees. By providing technical advice to U.S. negotiators, the industry sector and functional advisory committees form the backbone of the advisory system. These advisory committees submitted advisory reports on NAFTA to the Congress on September 18, 1992.

Almost all of the reports prepared by the advisory committees (with the exception of several commodity reviews by the agricultural policy

[1] Fast-track authority means the Congress must vote within a certain time to accept or reject the implementing legislation for a negotiated agreement without amendment.

committee; the labor advisory committee; and the committee on footwear, leather, and leather products) concluded that NAFTA would generally be beneficial to their particular industry or sector, according to a USTR official.

Canada's business and industry position on NAFTA is that of general support, since free trade already dominates U.S.-Canadian trade and the impact of freer trade with Mexico is expected to be relatively small. As in the United States, Canadian labor unions oppose NAFTA. Some Mexican labor unions oppose NAFTA while the predominant trade union confederation, the state-affiliated Confederation de Trabajadores de Mexico, favors it. Mexico expects NAFTA to increase the demand for labor and raise incomes, as Mexico's unique strengths complement U.S. and Canadian technology, capital, and natural resources.

GAO Reports on U.S.-Mexico Trade-Related Issues

Since 1989, we have issued a number of reports to the Congress relating to U.S.-Mexico and U.S.-Canada trade. These reports reviewed agricultural trade, border infrastructure needs, hazardous waste, the U.S. Customs Service, relocation of wood furniture manufacturers, Mexico's oil and petrochemical sectors, aspects of Mexico's maquiladora program, environmental efforts, labor practices, and wage information. The reports are listed at the end of this report.

Objectives, Scope, and Methodology

We prepared this report on NAFTA's major issues to assist the Congress in its deliberations on NAFTA. Specifically, we obtained information on NAFTA's (1) efforts to liberalize trade and investment in North America, (2) treatment of sensitive economic sectors, (3) rules to implement the agreement, and (4) potential economic impact.

To obtain information on NAFTA's efforts to liberalize trade and investment in North America, treatment of sensitive economic sectors, and rules to implement the agreement, we reviewed government documents and studies (i.e., Congressional Research Service, U.S. International Trade Commission (ITC), and USTR publications) from the United States, Mexico, and Canada. In the United States, we interviewed negotiators and other officials from the U.S. Departments of State, Agriculture, Commerce, Energy, Transportation, Labor, and the Treasury; the U.S. Customs Service; the Immigration and Naturalization Service; the Office of the U.S. Trade Representative; the Environmental Protection Agency; and the U.S. International Trade Commission. We also met with officials at the U.S.

embassies in Mexico City and Ottawa. In Mexico, we interviewed negotiators and officials at the Secretariat of Commerce and Industrial Development (SECOFI), the Secretariat of Labor and Social Security (STPS), the Secretariat of Social Development (SEDESOL), and the National Commission on Foreign Investment. In Canada, we interviewed negotiators and officials at External Affairs and International Trade, Environment Canada, Investment Canada, and the Binational Secretariat of the Canada-United States Free Trade Agreement. We also met with the Trade Critics from the Liberal Party and New Democratic Party, as well as the President of the Parti Quebecois.

Information in this report interpreting NAFTA's provisions is drawn from a number of sources, including what U.S., Canadian, and Mexican negotiators and officials provided in interviews and in written documentation. We also drew upon previous GAO reports.

In order to provide additional perspective, we analyzed other reports and studies, such as the Industry Sector and Industry Functional Advisory Committee (ISAC and IFAC) reports, studies by the Institute for International Economics (IIE), and articles published in various private books and journals. We also obtained papers analyzing NAFTA legal issues by U.S., Canadian, and Mexican attorneys. We did not verify the accuracy of the information provided in these reports and studies.

To obtain information on NAFTA's potential economic impact, we reviewed studies presented at the U.S. ITC's symposium and at The Brookings Institution's conference in 1992. We also reviewed studies requested by the National Commission for Employment Policy and studies conducted at IIE, the Economic Strategy Institute (ESI), and the Economic Policy Institute (EPI) in 1992. We reviewed about 20 studies that assessed economic impacts of NAFTA, including studies with diverse methodologies and political interests. We also evaluated, where possible, the usefulness of these studies in providing realistic and defensible results to guide policymaking.

To obtain additional information on NAFTA's potential impact we interviewed representatives at the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), Natural Resources Defense Council, and the National Wildlife Federation. In Mexico we interviewed representatives at the Confederation of Mexican Workers (CTM), the Authentic Labor Front (FAT) union, and the private environmental group Grupo de los Cien. In Canada, we interviewed

representatives from the Canadian Chamber of Commerce and the Canadian Manufacturer's Association. We also met with officials from the Canadian Labor Congress, Quebec Federation of Trade Unions, the Ontario Federation of Labor, and the private Canadian environmental group Pollution Probe. We conducted our work between June 1992 and July 1993 in accordance with generally accepted government auditing standards.

We discussed the information contained in this report with program officials from the U.S. Departments of State, Agriculture, Commerce, Energy, Transportation, Labor, and the Treasury; the U.S. Customs Service; the Immigration and Naturalization Service; the Office of the U.S. Trade Representative; and the Environmental Protection Agency. We included their comments where appropriate.

Market Access Issues in NAFTA

NAFTA, by establishing a free trade area between Canada, the United States, and Mexico, is expected to facilitate the free flow of goods and investment capital throughout North America. NAFTA sets the progressive elimination of virtually all tariffs on North American trade in goods over a period generally of 10 years. It also would generally eliminate many nontariff trade barriers and "duty drawback" programs that allow duty rebates on reexported goods. NAFTA also provides basic protections for NAFTA investors and their investments, liberalizes restrictions on the flow of investment within the North American area, and includes investment provisions dealing with the environment.

In order to preserve the benefits of NAFTA for its participants, NAFTA provides specific rules of origin that define which goods are entitled to the agreement's preferential tariff treatment. As such, goods that are wholly produced in the United States, Mexico, or Canada will qualify for NAFTA treatment. Most goods containing nonregional components will qualify if they are sufficiently transformed in the NAFTA region so that they undergo a specified change in tariff classification.

Tariffs and Nontariff Barriers

NAFTA will establish a free trade area between Canada, the United States, and Mexico through the combined elimination of tariffs and other barriers to trade. Thus, it is the culmination of several important trade liberalization measures taken by the three countries during the 1980s.

Background

Trade between the United States and Canada has been substantially liberalized recently through the U.S.-Canada Free Trade Agreement, which created the world's largest bilateral free trade area with bilateral merchandise trade of over $160 billion in 1989, its first year of operation. CFTA calls for the elimination of all tariffs—in stages—by January 1, 1998.[1] Before CFTA's implementation, Canada's trade-weighted average tariff was 9.9 percent, versus the U.S. average of 3.3 percent, according to USTR. Since the mid-1980s, Mexico has taken a series of actions to open its markets as well. In 1986, Mexico joined GATT and at that time reduced its tariffs from peaks of 100 percent to a maximum level of 50 percent. In December 1987, Mexico continued its liberalization by unilaterally reducing its maximum applied tariff to 20 percent. According to USTR, most Mexican tariffs are currently between 10 and 20 percent.

[1]The United States and Canada have completed three rounds of accelerated tariff reduction in addition to the staged tariff phase-outs. These rounds have produced agreements covering over 1,000 products with trade valued at almost $9 billion.

Negotiators' Objectives

NAFTA negotiators sought to extend the benefits of tariff reduction achieved by CFTA throughout the North American market. U.S. negotiators called for the immediate or phased elimination of all tariffs among the three countries, as well as the reduction of nontariff trade barriers. The general U.S. objective was to maximize the gains from liberalizing trade while minimizing adjustment pressures in sensitive sectors through such measures as gradual tariff reduction phase-ins. A U.S. Department of Commerce (DOC) official explained that the United States negotiated the liberalization of trade in goods while considering both the import sensitivity and export interest for specific goods.

Canadian and Mexican negotiators also hoped to derive benefits from reduced tariffs with minimal trade disruption. The Canadian government sought to strengthen the benefits negotiated in CFTA. It also sought to obtain access for Canadian goods, services, and capital to Mexico on an equal footing with the United States. Mexican negotiators stated that they sought to obtain quick access to U.S. and Canadian markets, while negotiating a manageable timetable for tariff phase-outs to avoid any imbalance or inherent protection that would harm Mexican industries.

NAFTA Will Facilitate Trade Within North America

NAFTA will establish a free trade area between Canada, the United States, and Mexico through the combined elimination of tariffs and other barriers to trade. NAFTA proclaims the fundamental principle of the national treatment of goods for each of the parties. It also establishes the progressive elimination of all tariffs on North American goods, mostly within 10 years. Finally, the agreement generally eliminates duty drawback provisions and nontariff trade barriers.

National Treatment

NAFTA upholds a principle fundamental to the facilitation of liberalized trade within the three countries: national treatment of goods. NAFTA states that, as GATT signatories, each party must accord national treatment to the goods of another party. This statement means that imported products must be treated no less favorably than similar domestic products. The agreement goes farther than GATT in this regard, however, by stating that the national treatment requirements are binding on provincial, state, and local governments as well.

Tariff Reduction

NAFTA establishes the progressive elimination of all tariffs on goods qualifying as North American.[2] Tariff duties will be phased out in stages

[2]NAFTA creates rules of origin to establish the eligibility of goods qualifying for North American treatment. See Rules of Origin in a following section.

over a period of 15 years, with the great majority of tariff reduction taking place within 10 years. These tariff reductions were achieved through two simultaneous negotiations between the United States and Mexico and between Canada and Mexico. The United States and Canada agreed not to alter the tariff reduction schedules created in CFTA.

NAFTA creates three different tariff phase-out schedules—one for manufactured goods in general, a second for agricultural goods, and a third for textiles and apparel (see ch. 4 for a discussion of agriculture and textiles). NAFTA tariff phase-outs for manufactured goods generally fall into four broad categories: immediate, intermediate, long term, and extra-long term. The latter three categories generally correspond to 5-year periods beginning with NAFTA implementation. U.S. officials state that negotiators worked within these broad parameters to create a variety of different tariff reduction schedules for specific manufactured goods, taking into consideration the specific needs of the affected industrial sectors and their vulnerability to increased imports.

All Mexican tariffs on North American manufactured goods will be eliminated within 10 years, while U.S. tariffs for the most sensitive U.S. products will not be eliminated for up to 15 years. USTR reports that approximately half of all Mexican tariff duties will be eliminated when NAFTA takes effect. Officials estimate that within 5 years, up to 70 percent of all U.S. goods entering Mexico will be duty free. Mexico will also gain rapid access to most U.S. markets, obtaining tariff elimination for about 90 percent of manufactured goods within 5 years, according to DOC officials. However, a small percentage of products that are import sensitive in the United States will not receive complete tariff elimination until 15 years from NAFTA's implementation. Some of these sensitive categories include products such as household glassware, footwear, and ceramic tile.

Tariff rates under NAFTA will be phased out from baseline rates in effect on July 1, 1991. Once NAFTA is implemented, tariff rates among the parties cannot be increased unless a "safeguard" action is taken by one of the parties (see ch. 5 for a discussion of NAFTA safeguard provisions). However, the agreement does have a provision for accelerated tariff reduction, upon concurrence of the involved parties.

Duty Drawback

NAFTA modifies other tariff-related trade processes, most notably through its provisions on the export-oriented program called "duty drawback." All three countries have some form of drawback program, wherein duties on imported components used to manufacture products for ultimate export

may be either waived or rebated. U.S. foreign trade zones and Mexico's maquiladora program, for example, benefit from duty drawback programs.[3]

NAFTA provides for the eventual removal of duty drawback under most circumstances. U.S. negotiators sought elimination of the drawback program, as had been done in CFTA, in order to prevent the possibility that one NAFTA country could be used as an "export platform" for the duty-free entry to another NAFTA country of non-NAFTA country products. However, Mexican negotiators told us they were concerned about the effect of a rapid elimination of drawback, and of the effects of double taxation on imported components that would subsequently be exported.

NAFTA ultimately requires Mexican maquiladoras and U.S. foreign trade zone firms to pay duty on all non-North American components and raw materials used to make products eligible for NAFTA duty-free treatment. This rollback of the duty drawback provisions occurs after a 7-year transition period following NAFTA implementation. Subsequently, NAFTA permits its parties to adopt limited drawback procedures on goods still subject to duties in the free trade area to prevent double taxation.[4] NAFTA also modifies CFTA by incorporating these limited drawback procedures and by extending from January 1994 to January 1996 the general drawback elimination date currently set in CFTA. USTR states that the elimination of duty drawback in NAFTA means that a manufacturer will pay the same tariffs on imported components regardless of the ultimate market for the good. This requirement will reduce the incentive for operations, such as the Mexican maquiladoras, to export their products.

Nontariff Trade Barriers

In addition to tariff-related reform, NAFTA adopts a series of measures that are designed to eliminate various other impediments to free trade among the parties. These impediments are known as "nontariff trade barriers" and generally refer to practices that burden imports as opposed to domestically produced products. Many of the negotiated resolutions to various nontariff barriers are found in the sector-specific chapters of NAFTA. However, the agreement also includes the following general nontariff barrier provisions:

[3]Mexico established the maquiladora program in 1965 to allow duty-free imports of manufacturing components to Mexico for processing or assembly of products that generally must be reexported from Mexico.

[4]The U.S. ITC notes that third-country goods would be eligible for duty exemption of the lesser amount of the initial duty owed on imported components or the duty paid on the final goods shipped to another NAFTA signatory.

- Import and Export Restrictions. All three countries will eliminate prohibitions and quantitative restrictions applied at the border, such as quotas and import licenses.[5]
- Customs User Fees. The three countries have agreed not to impose new user fees and to phase out existing user fees by June 1999.[6]
- Temporary Admission of Goods. NAFTA permits eligible business persons to bring in "tools of the trade," professional samples, and other such goods on a duty-free, temporary basis. It also permits, beginning in 1998, the duty-free reentry of goods that are repaired or altered in another NAFTA country.

NAFTA's Investment Provisions

NAFTA's chapter on investment provides five basic protections for NAFTA investors and their investments: nondiscriminatory treatment;[7] freedom from performance requirements;[8] the right to freely transfer funds related to an investment; expropriation only in conformity with international law; and the right to go to international arbitration for a violation of the agreement's protections. In addition, the agreement sets out certain country-specific exceptions and reservations to these obligations (usually applicable to non-NAFTA countries as well), liberalizes restrictions on the flow of investment within the North American area, and includes investment provisions dealing with the environment.

Background

In CFTA, investment issues between the United States and Canada are addressed in a chapter that sets out four basic rules to govern treatment of investors from each country: (1) national treatment for investors from a CFTA country, (2) elimination of performance requirements, (3) expropriation only in accordance with international law standards, and (4) free transfer of funds related to an investment. The provisions of the CFTA chapter on investment do not apply to certain sectors, most notably "cultural industries," transportation services, maritime, basic telecommunications, government procurement, and financial services

[5]In limited circumstances, each NAFTA country may impose border restrictions to protect human, animal, or plant life or health, or the environment.

[6]The phase-out of U.S. user fees will continue as specified in CFTA. It will be completed by January 1994.

[7]Nondiscriminatory treatment requires a government to treat foreign investors from a particular country no less favorably than its own investors (national treatment) and no less favorably than investors of other countries (most-favored-nation, or MFN, treatment) with respect to investments in its territory.

[8]"Performance requirements" refer to government-mandated or -approved activities that investors must undertake, usually as a condition of establishment or operating in a particular country.

(except insurance).[9] Both countries may maintain certain restrictions on investment in these areas. In addition, although CFTA liberalizes the review of acquisitions of Canadian companies by U.S. investors under the Investment Canada Act, it did not eliminate this general entry restriction.[10]

Unlike Canada, Mexico does not have any bilateral investment agreements with the United States. Before the mid-1980s, foreign direct investment was highly restricted and played a relatively small role in Mexico's external financing. During the past several years, the Mexican government has made a concerted effort to modernize its economy and attract more foreign capital. As part of this effort, it has adopted less restrictive foreign investment policies. Nonetheless, the Mexican government still requires government approval of new foreign investment and the expansion of existing investment. It also reserves certain activities to the state or Mexican nationals in a number of sectors, including transportation services, petroleum, petrochemicals, and financial services. In addition, the Mexican government restricts the percentage of foreign equity ownership in others such as auto parts, insurance, and mining. Moreover, mandatory price controls continue to distort investment patterns; numerous performance requirements hinder productive investments and distort trade flows; and the lack of protection, including national treatment status, for foreign investors and their investments discourages foreign investment.

Negotiators' Objectives

The U.S. government's main objective for the NAFTA section on investment was to liberalize Mexican restrictions on investment and to lock in legal protections for investors. U.S. negotiators based the negotiations for NAFTA's investment section on CFTA's investment chapter and a prototype bilateral investment treaty (BIT).[11] NAFTA provisions dealing with

[9]Under CFTA, certain "cultural" activities are exempt from the provisions of the agreement. These activities include the publication, sale, distribution, or exhibition of books, magazines, and newspapers; film and video recordings; audio or video music recordings; and radio, television, and cable dissemination. In addition, obligations for government procurement and financial services are set out in separate chapters of CFTA.

[10]The Investment Canada Act is the Canadian government's principal mechanism for regulating investment into Canada and sales of Canadian businesses to foreign investors. The act requires the federal government to "screen" (i.e., review and possibly reject) proposed acquisitions above certain thresholds by U.S. and other foreign investors to ensure a "net benefit to Canada."

[11]The U.S. government negotiates BITs using a prototype treaty that has the following main objectives: (1) nondiscriminatory treatment; (2) elimination of performance requirements; (3) unrestricted "transfers," including capital and profit repatriation; (4) expropriation protection based on international legal standards, including compensation equivalent to the "fair market value" of the investment; and (5) binding third-party arbitration to resolve disputes.

investment are set out mainly in (1) chapter 11, which details each signatory's obligations with respect to any measure of a NAFTA party that affects investment in its territory by an investor of another NAFTA party; and (2) annexes I, II, III, and IV located in Volume II of the agreement, which detail each country's reservations and exceptions to the chapter's obligations.

Scope of Investment Coverage

NAFTA's investment chapter covers all forms of existing and future investments, including partial ownership interests, by investors of a NAFTA country. The chapter's provisions apply to various investments not covered by CFTA, including real estate, stocks, bonds, certain contracts, and intangible property, such as goodwill and intellectual property. Moreover, the agreement expands CFTA's definition of "investor" to cover firms established in a partner country and that have substantial business activity there (i.e., "shell" organizations are not covered), but that may be owned or controlled by nonparty nationals. In other words, NAFTA defines an investor of a party based on a "residency" test. Thus, for example, a Japanese-owned subsidiary established in the United States could establish or acquire enterprises in Canada and Mexico, and these firms would be considered investments of U.S. investors. Therefore, they would be accorded the same NAFTA investment protections (subject to certain exceptions), such as national treatment, as a U.S.-owned firm that establishes or acquires an enterprise in Canada or Mexico. Such treatment is consistent with BIT practice.

Unlike CFTA or the prototype BIT, NAFTA (through provisions found in another chapter of the agreement) explicitly binds state enterprises to the obligations of the investment chapter. Thus, state enterprises, such as Petroleos Mexicanos (PEMEX) in Mexico or Crown corporations in Canada, cannot be used by NAFTA governments to evade the obligations of the chapter.[12] For example, according to U.S. negotiators, if a NAFTA government delegates certain aspects of its regulatory authority to a state enterprise, that state enterprise is bound to nondiscriminatory treatment, as when it grants a license or sells its goods and services (e.g., energy).

The provisions of NAFTA's investment chapter do not apply to government procurement of goods and services or financial services, unless specified in their respective chapters. In addition, general exceptions to NAFTA as a whole, detailed in chapter 21 of the agreement, for national security,

[12]PEMEX is Mexico's government-owned oil company. "Crown corporations" are Canadian government-owned companies such as the Canadian National Railway Company.

taxation, and balance of payments apply to the investment chapter (i.e., investment obligations apply in these areas only as specified in ch. 21). Also, at the insistence of the Canadian government, NAFTA, by virtue of provisions in chapter 21, preserves the CFTA exemption for so-called cultural industries (as described earlier). Thus, similar to CFTA, each NAFTA country reserves the right to take (1) any action regarding cultural industries that would violate NAFTA's obligations, if not for the exemption; and (2) measures of "equivalent commercial effect" in response to such actions. The cultural industries exemption does not apply to obligations between the United States and Mexico.[13]

Five Basic Protections

Nondiscriminatory Treatment

The investment chapter provides five basic protections for NAFTA investors and their investments. First, the agreement guarantees nondiscriminatory treatment by requiring each party to extend national treatment and (unlike CFTA) MFN treatment, whichever is better, to investors with respect to the purchase or establishment of an investment, its operation, and its sale. As a further clarification of a government's obligation under national treatment status, NAFTA requires each party to the agreement to treat investors of another party as favorably under its state or provincial requirements as any of the investors or investments from that country, including investors or investments from that state or province. In addition, the signatories expressly agree not to (1) impose limitations on the share of equity that an investor from another party may own, subject to certain reservations; or (2) require divestment by reason of nationality of a NAFTA investor.

NAFTA's national treatment obligation does not apply to government subsidies. This nonapplication means, for example, that if the U.S. government were to subsidize semiconductor research and development in the United States, it would not have to subsidize research and development conducted by semiconductor plants owned or controlled by investors from the other NAFTA countries.

Elimination of Performance Requirements

Second, NAFTA establishes a list of seven performance requirements that may not be imposed as a condition for the establishment or operation of an investment. Specifically, NAFTA governments may not require businesses to

[13]For a further discussion of NAFTA's cultural industries exemption, see our section on intellectual property, chapter 5.

- export a given level or percentage of goods or services;
- achieve a specified level of domestic content (in effect, require import substitution);
- purchase from or give preference to a local supplier;
- restrict imports to a certain volume or value of exports or to an amount of foreign exchange inflows (i.e., "trade balancing");
- restrict domestic sales to a certain volume or value of exports or to an amount of foreign exchange earnings;
- transfer technology, a production process, or other proprietary knowledge to any domestic entity[14]; and
- act as the exclusive supplier of the goods or services it produces to a specific region or world market (i.e., "product mandating").

Elimination of the use of these trade-distorting performance requirements applies to non-NAFTA investors as well. Thus, once NAFTA takes effect, Mexico and Canada no longer will be able to require investments by, for example, Japanese investors, to (1) export any amount of its product to the United States, (2) limit imports of components from the United States, or (3) buy components from a domestically owned supplier. Most existing performance requirements for NAFTA and non-NAFTA investors are to be phased out over periods of up to 10 years. According to U.S. negotiators, NAFTA eliminates the most important Mexican performance requirements and should favorably affect U.S. trade balances with both Mexico and Canada.

With some exceptions and clarifications, a NAFTA government may not use the first five performance measures previously listed as a condition to receive an "advantage," such as a tax concession or some other investment incentive. NAFTA does permit the parties to the agreement to condition the receipt of an advantage on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in the territory of the offering party. In addition, the agreement does not prohibit NAFTA governments from applying local content requirements to government procurement, export promotion, or foreign aid activities (i.e.,

[14]As in CFTA, the Canadian government reserves the right, permitted in connection with its review of acquisitions under the Investment Canada Act, to impose requirements on, or enforce any commitment by, a NAFTA or non-NAFTA investor to transfer technology, production processes, or other proprietary knowledge solely to its Canadian subsidiary as a condition to establish and operate in Canada. This reservation will mean that if a U.S. company buys a Canadian firm with gross assets valued at more than $150 million (Canadian), the Canadian government could require the U.S. parent to transfer technology to its Canadian subsidiary although the government could not require the U.S. parent to license its technology to a Canadian competitor.

products benefitting from these activities may be limited to domestically produced products).

Free Transfer of Funds

Third, NAFTA prohibits parties from restricting transfers into or out of a party that are related to an investment, including profits, dividends, interest, capital gains, royalties, management fees, returns in kind, and other amounts derived from the investment. NAFTA also prohibits restrictions on transfers of proceeds from the sale or liquidation of all or any part of an investment; payments under a contract entered into by an investor or investment, including loan repayments; compensation; and payments arising out of an investment dispute. Each party commits to ensure that transfers may be freely converted into usable foreign currency at a market rate of exchange.

However, the balance of payments exception to the agreement permits a party to use multiple exchange rates under narrowly defined circumstances for balance of payments reasons. In addition, a provision in the investment chapter permits a party to prevent transfers under specified laws of general application, such as the regulation of securities or bankruptcy laws. The latter exception would, for example, protect U.S. creditors of a Mexican- or Canadian-owned business in the United States that has declared bankruptcy. Specifically, the exception would permit the U.S. government to continue to prohibit the removal of liquid assets from the United States by investor(s) involved in a bankruptcy case.

Expropriation Protection

Fourth, NAFTA protects investors in the event of a direct or indirect expropriation or nationalization of property. Specifically, expropriation will be permitted only for a public purpose, on a nondiscriminatory basis, upon payment of fully realizable and transferable compensation without delay at fair market value (plus any applicable interest), and in accordance with due process of law and general principles of international law.[15] Moreover, an investor will be able to challenge a taxation measure as, in effect, being an expropriation. Such a case will be referred to the appropriate tax authorities of the relevant NAFTA countries. If the competent authorities do not agree to consider the issue, or fail to agree within 6 months that the measure is not an expropriation, the investor may invoke NAFTA's dispute resolution provisions for investment issues.

[15]"Fully realizable and transferable compensation" means, for example, that a NAFTA government could not compensate an investor in local currency for expropriated property and then prevent that investor from converting the local currency into another country's currency before removing it from the country.

Dispute Resolution Mechanism

Fifth, unlike CFTA, NAFTA incorporates a dispute resolution mechanism specific to breaches of obligations of the investment chapter, such as the tax expropriation case previously cited. The remedy provided is monetary damages or restitution of property where appropriate.[16] In the case of a dispute between an investor and the host country, the participants are first required to seek resolution through consultation and negotiation. If settlement is not reached, the NAFTA investor, at its option, may seek monetary damages through binding international arbitration rather than using the host country's domestic courts or administrative tribunals. The choice of international arbitration, once made, is irrevocable.[17]

According to U.S. negotiators, U.S. investors were most concerned about obtaining guaranteed access to international arbitration for investor-state disputes. A U.S. negotiator also told us that it is noteworthy, in light of the Mexican and other Latin American governments' historical opposition to such access, that Mexico has accepted international arbitration.[18]

Country-Specific Reservations

NAFTA includes explicit country-specific reservations and exceptions to the agreement's rules, thereby, according to the IPAC report, assuring transparency. These reservations deal principally with national treatment, MFN treatment, and performance requirements. Specifically, the agreement includes four annexes in Volume II listing all federal reservations to the chapter's obligations. These reservations fall into one of two categories. The first category includes measures where the parties exempt themselves from the investment chapter's provisions but, unlike in the prototype BIT, commit not to (1) increase existing restrictions; or (2) under a so-called "ratchet" clause, step back from any liberalization of them.[19] The bulk of reservations will fall into this category, including issues such as foreign ownership of airlines and Mexico's constitutional requirements reserving certain activities to the Mexican state. Moreover, within 2 years of the date of entry into force of the agreement, the parties will develop an annex of

[16]The award must state that a party may pay monetary damages in lieu of restitution.

[17]For a discussion of NAFTA's general dispute settlement procedures, see chapter 5 in our report.

[18]Mexico's and other Latin American countries' opposition to resolving investor-state disputes through international arbitration is manifested by the inclusion of the so-called "Calvo Clause" into their constitutions. Among other things, the clause, named after a 19th-century Argentinean diplomat and legal scholar, precludes an investor from invoking the assistance of its government to present any international claim on its behalf.

[19]This provision would mean, for example, that if the U.S. government increased the acceptable level of foreign control of a domestic air carrier to a maximum of 25-percent voting stock from 10 percent, it could not subsequently reverse its decision and establish a level lower than 25 percent without violating NAFTA.

any nonconforming measures in this category (existing as of NAFTA's effective date) maintained by a state or province. The second category covers sectors in which the parties reserve the right to increase as well as maintain existing restrictions. These sectors include maritime services, basic telecommunications, and certain social services, such as social security, public education, and law enforcement.

In addition, at the insistence of the U.S. government, NAFTA, similar to CFTA, includes a national security exemption that will enable each government to restrict investments for national security considerations. According to a Treasury official, this exception will allow the U.S. government to continue to investigate and prohibit or suspend foreign acquisitions or mergers, as authorized under the Exon-Florio amendment.[20] According to a Canadian negotiator, the Canadian government has no complaints with how the Exon-Florio provision has been administered. However, Canadian government officials have noticed that in the past couple of years, U.S. national security concerns have become blurred with economic security and confused with national advantage, especially in high-technology areas. The Canadian government, according to this official, had hoped to discuss U.S. policy in this area but the U.S. government removed the discussion of national security restrictions from the negotiating table.

On the other hand, following precedent set in CFTA, Canada and Mexico reserve the right to screen foreign acquisitions of existing companies above certain financial thresholds. As in CFTA, Canada's screening will be limited to direct acquisitions in excess of $150 million (Canadian) in gross assets.[21] Mexico may review acquisitions above an initial threshold of $25 million (U.S.), rising to $150 million (U.S.) in gross assets over 10 years in any unrestricted sector.[22] Threshold levels will be indexed for inflation and, unlike CFTA, economic growth.

[20]The Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988 provides the presidential authority to review transactions possibly affecting U.S. national security. By executive order, the President delegated his authority to review such transactions to the interagency Committee on Foreign Investment in the United States, chaired by the Treasury Department.

[21]The Canadian government's review threshold applicable to investors of Mexico or of the United States will be higher than for non-NAFTA investors. However, as in CFTA, this higher review threshold will not apply in the following sectors: the uranium industry; oil and gas; financial services; transportation services; and cultural businesses.

[22]Under NAFTA, Mexico will be able to review direct and indirect acquisitions only if (1) the Mexican enterprise is directly or indirectly owned or controlled by Mexican nationals, (2) the purchase is for more than 49 percent of the ownership interest, and (3) the value of the gross assets of the Mexican enterprise is more than the applicable threshold.

Market Liberalization Commitments

NAFTA does not provide for any new market liberalization commitments between the United States and Canada (i.e., sectoral investment restrictions protected under CFTA are preserved under NAFTA). However, NAFTA sets out market liberalization commitments made by Mexico. Specifically, the agreement eliminates or liberalizes investment restrictions immediately or within a set number of years in previously restricted sectors of the Mexican economy such as auto parts, accounting, agriculture, petrochemicals, financial services (including insurance), publishing, land transportation, mining, and construction. Moreover, according to U.S. negotiators, once NAFTA takes effect, U.S. and Canadian investors will no longer need to obtain government approval for investments in most sectors of the Mexican economy.

NAFTA's investment chapter also obligates Mexico, when it privatizes its considerable state companies, to sell such assets on a nondiscriminatory basis to NAFTA investors. Where Mexico takes a reservation for this obligation, NAFTA limits the reservation to 3 years from the date of privatization. In other words, U.S. investors will have access to any privatized asset within 3 years of initial privatization.

Environmental Provisions

The investment chapter includes environmental provisions that, among other things, provide that (1) no NAFTA country should lower its environmental standards to attract an investment and that (2) the countries will consult on the observance of this provision. The agreement also specifies that a NAFTA country may take action consistent with the chapter's investment provisions to protect its environment. For example, according to U.S. negotiators, NAFTA would permit each country to require that investors adopt pollution abatement and other environmental technologies as long as the requirement is instituted and enforced on a nondiscriminatory basis (i.e., both foreign and domestic investors must abide by the requirement).

NAFTA's Rules of Origin and Customs Procedures

NAFTA provides specific rules of origin that define which goods are entitled to preferential tariff treatment. As such, goods that are wholly produced in the United States, Mexico, or Canada will qualify for NAFTA treatment. Most goods containing nonregional components will qualify if those components are sufficiently transformed in the NAFTA region so that the ultimate article undergoes a specified change in tariff classification. In some cases, goods must include a set percentage of North American

content in addition to meeting the tariff classification requirement. NAFTA also provides specific provisions dealing with customs procedures.

Background

Most countries establish standards to determine the country of origin, or "legal nationality," of imported goods. These rules serve multiple purposes, such as (1) allowing the assessment of customs duties on the basis of country of origin; (2) ensuring that origin marks are correct; (3) assisting in the analysis of trade and capital flows; and (4) applying country-specific trade measures, such as quotas, voluntary restraint agreements, or preferential tariff treatment under programs like GSP, CFTA, and NAFTA.

The general rule of origin used by the U.S. Customs Service is "substantial transformation." This standard assigns origin of an import to the country where the processing, manufacture, or assembly of inputs results in the creation of a "new and different article of commerce." Under current practice, substantial transformation determinations are made by Customs officials on a case-by-case basis and involve considerable subjective judgment.

CFTA's Rules of Origin

For CFTA, the United States and Canada wanted to develop a general rule of origin for goods containing third-country materials that was more transparent and predictable than the case-by-case method of determining substantial transformation. As such, the agreement describes the substantial transformation standard in terms of a change in tariff classification.[23] This method of determining a product's origin aims to eliminate the arbitrary nature of substantial transformation determinations by using the internationally recognized nomenclature of the Harmonized Commodity Description and Coding System (HS).[24] As generally applied under CFTA, a Canadian or U.S. company must alter any inputs imported from nonmember nations so that the finished good's HS tariff classification undergoes a specified change that will qualify it for preferential duty treatment. Depending on the good involved, the tariff change may occur at

[23]For a discussion of CFTA's rules of origin, see International Trade: Implementation of the U.S.-Canada Free Trade Agreement (GAO/GGD-93-21, Oct. 27, 1992).

[24]HS is composed of General Rules for the Interpretation of the HS and a nomenclature consisting of 21 sections divided into 99 chapters, with the last 2 chapters reserved for national purpose. Each chapter (identified with 2-digit codes) can be further subdivided into headings (4-digit codes) and subheadings (6-digit codes), each with an associated article description. Articles are generally identified by name or categorized on the basis of their end use or constituent materials. Eight-digit and 10-digit codes are set aside for individual country use.

the "chapter" level of 2 digits, at the "heading" level of 4 digits, at the "subheading" level of 6 digits, or at the "tariff item" level of 8 digits.[25]

CFTA's rules of origin are needed to define those products entitled to preferential treatment. Goods wholly produced in either the United States or Canada qualify. As discussed, goods containing third-country materials also require a change in tariff classification to qualify. A number of industries (e.g., chemicals, footwear, machinery, electronics, and autos) require, in addition to a tariff classification change, a 50-percent regional value-content rule of origin. That is, at least 50 percent of a good's value must be attributable to U.S. or Canadian materials and/or direct processing costs incurred in the United States and/or Canada.

Negotiators' Objectives and Concerns

The U.S. negotiating team had three objectives for the NAFTA section on rules of origin: (1) to ensure that the benefits of free trade are secured principally by the parties to the agreement; (2) to provide clear and predictable rules understood by exporters, importers, and producers trading under NAFTA; and (3) to develop enforceable rules by which each country's customs officials could easily verify a product's compliance with NAFTA's rules of origin. Provisions dealing with the rules of origin and customs procedures are set out in NAFTA chapters 4 and 5, respectively, while each product's specific rule appears in annex 401. According to U.S. Treasury officials, the U.S. negotiating team proposed product-specific rules of origin created through consultation with U.S. industry, labor and consumer representatives, and U.S. government officials. As in CFTA, NAFTA describes the substantial transformation standard in terms of a change in tariff classification.

According to the U.S. lead negotiator, the experience of implementing CFTA's rules of origin provided Canadian and U.S. negotiators with useful information on how to improve the rules under NAFTA. For example, according to this official, the Honda audit case demonstrated that CFTA's regional value-content method for determining a product's origin was

[25]For example, if an input is classified under tariff line 2500.10, the finished product would pass a change in tariff classification test at the chapter level if its HS number were 5200.10 (i.e., any product with an HS number beginning with 2 digits other than 25), at the heading level if its HS number were 2501.00, and at the subheading level if it were 2500.11.

imprecise.[26] Moreover, some industry representatives, such as those from the electronics industry, informed members of the U.S. negotiating team that they were not taking advantage of CFTA's tariff reductions because, in their estimation, the regional value-content rule was too costly and burdensome to administer. As a result, U.S. negotiators sought (1) to replace most of CFTA's regional value-content rules of origin with changes in tariff classification rules and (2) to develop explicit and easy-to-administer methods of calculating regional value content.

NAFTA's Rules of Origin

Similar to CFTA, NAFTA will eventually eliminate all tariffs on trade in goods originating in Canada, Mexico, and the United States. Rules of origin are necessary to define which goods are eligible for this preferential treatment. NAFTA provides five general rules of origin for products made or assembled in North America with inputs originating in the free trade area or imported from outside this area. According to the U.S. lead negotiator, these rules are better than CFTA's rules of origin in three ways: (1) They are more detailed and product specific; (2) they eliminate the regional value-content rule for numerous products, including machinery, and electrical machinery and equipment such as copying machines and televisions; and (3) they change the method for calculating regional value content to make it less ambiguous and more closely tied to standard accounting principles.

Goods Wholly Obtained or Produced in North America

Under NAFTA, goods wholly obtained or produced in North America qualify for the agreement's preferential tariff treatment. "Wholly produced" means that the goods are produced in the North American free trade area and made up entirely of NAFTA-originating components.

Change in Tariff Classification Requirement

As in CFTA, goods containing imported materials from outside the free trade area will be generally considered NAFTA originating if the foreign materials undergo processing or assembly in North America sufficient to result in a specified change in HS tariff classification. Under this tariff-shift rule, depending on the good involved, NAFTA requires non-NAFTA components to be in a different HS chapter, heading, subheading, or tariff item than the final product if the latter is to receive the agreement's preferential duty treatment. For example, wood molding (which has an HS heading number of 44.09) that is manufactured in North America from logs

[26]The Honda audit case refers to the U.S. Customs' analysis of the local and/or North American content of cars produced by Honda Motor Company at a plant in Canada in 1989 and 1990. In March 1992, Customs announced that its audit had determined that Honda Civic cars that had entered the United States between January 1, 1989, and March 30, 1990, did not qualify for CFTA duty preference because these cars did not contain the necessary 50-percent North American content. See also the chapter in this report on the automotive industry, chapter 4.

(with an HS heading number of 44.03) imported from Indonesia or some other non-NAFTA country will be considered a North American product because the manufacturing process (1) is performed in the United States, Canada, and/or Mexico; and (2) results in the required shift in HS headings set forth in the agreement.

According to U.S. negotiators, for a very small number of products, mostly high-technology ones, NAFTA negotiators could not design a rule of origin based on a change in tariff classification due to limitations associated with the HS classifications (i.e., detailed nomenclature is not provided for these products). As a result, NAFTA (1) provides a narrative description of the processing steps that must be performed in North America for some of these goods to qualify for preferential tariff treatment; or (2) includes new tariff classifications (at the 8-digit level) and nomenclature for the components of certain products such as computers, electrical machinery, and other high-technology products.[27] The creation of these tariff classifications enabled the negotiators to define the rule of origin for these finished goods in terms of a change in tariff classification.

Regional Value Content in Addition to a Change in Tariff Classification Requirement

Some goods will qualify for NAFTA's preferential tariff treatment only if, in addition to a tariff classification change, they contain at least 50- or 60-percent (depending on the valuation method) regional value-content. This value content rule applies mostly to automotive, footwear, and chemical products. Under this rule, the exporter or the producer generally has the option to calculate the regional value content based on a "transaction value" or "net-cost" method. However, the net-cost method must be used to calculate the regional value-content for a good where the transaction value method is unacceptable under the GATT Customs Valuation Code (i.e., the sale was not made by a willing seller to a willing buyer, commonly known as an "arm's-length transaction").[28] This method must also be used for certain products, such as automotive goods (see our automotive chapter for a detailed discussion of this sector's rule of origin).

Under the transaction value method, in general, at least 60 percent of the transaction value of a good must be made with NAFTA-originating components in order for the good to receive tariff preference under the agreement. Based on the GATT Customs Valuation Code, NAFTA defines the

[27]For computer products, the parties have agreed to harmonize their MFN rates of duty by 10 years after NAFTA takes effect.

[28]The Customs Valuation Code, which took effect in 1981, establishes a single set of rules for valuation of imports that revise and expand existing customs valuation provisions under GATT. The code details five valuation methods to be used in sequence by customs officials in all participating countries.

transaction value as the arm's-length sale price of a product adjusted to a free-on-board basis (i.e., minus any costs associated with freight and duties). According to the U.S. lead negotiator, the agreement uses the transaction value of a good adjusted to a free-on-board basis so a producer can calculate the value of his product using the same method no matter where the product is shipped. In other words, for example, this method will allow a company operating in Rhode Island to use the same calculation method and come up with the same transaction value for a good it sells in Idaho, Mexico, or Canada.

Under the net-cost method, in general, at least 50 percent of the net cost of a good must represent NAFTA labor and/or NAFTA-originating components in order for the good to qualify. The net cost of a good is based on the total cost of the good less the costs of sales promotion, marketing and after-sales services (e.g., training of customers' employees), packing and shipping, royalties, and nonallowable interest costs. The agreement explicitly defines what these costs cover. Total cost includes all the costs incurred by a company to produce a good. According to the U.S. lead negotiator, total cost is the figure used by accountants to determine if a company has made a profit (i.e., total revenues minus total costs). The use of total cost will enable customs officials to verify more easily a company's compliance with NAFTA's conditions for preferential treatment because this figure is often determined by independent auditors and should be readily available.

Regional Value-Content Requirement for Goods That Do Not Undergo Any Change in Tariff Classification

As in CFTA, certain goods can receive preferential tariff treatment under NAFTA's rules of origin if they meet the required regional value-content test (based on either the transaction value or net-cost method) even though they do not change their tariff classification. According to the U.S. lead negotiator, certain finished products, such as toys and fishing reels or imported assembly kits, have the same tariff classification code as their parts and components. As a result, if a producer can prove that the costs associated with assembly (i.e., the NAFTA-based value added) are greater than 50 percent of the net cost or 60 percent of the transaction value, the finished product is eligible for NAFTA's preferential tariff treatment.

"De Minimis" Provision

Unlike CFTA, NAFTA includes a "de minimis" provision that will enable goods containing materials that fail to undergo a required change in tariff classification to be considered North American if the value of such non-NAFTA materials constitutes no more than a given percentage, usually 7 percent, of the transaction value (adjusted to a free-on-board basis) or the total cost of the good. The U.S. lead negotiator told us that this

provision will prevent products from losing NAFTA's preferential tariff benefits because they include relatively insignificant non-NAFTA components. For example, the rule of origin for cigarettes requires that they be made with North American tobacco. This official told us that the "de minimis" provision will allow North American companies to incorporate a small percentage of Oriental tobaccos into their production process, as many currently do, without risking a loss of tariff benefits.[29]

Customs Procedures

NAFTA includes provisions on customs administration and enforcement in order to (1) ensure that only goods satisfying the agreement's rules of origin are accorded preferential tariff treatment and (2) provide certainty to and streamlined procedures for the commercial community of the three countries. For example, NAFTA provides for

- uniform regulations among the parties regarding the interpretation, application, and administration of the rules of origin;
- advance rulings for importers, exporters, and producers from the customs authority of the country into which the goods are to be imported on such matters as whether (1) a good qualifies under NAFTA's rules of origin and (2) the proposed or actual marking of a good satisfies country-of-origin marking requirements;
- cooperation among the parties regarding, among other things, (1) the enforcement of their respective customs-related laws or regulations dealing with NAFTA; and (2) the detection and prevention of unlawful transshipments of textile and apparel goods;[30]
- national treatment with respect to rights of review and appeal of each party's customs administration's origin determinations and advance rulings; and
- the creation of a trilateral Working Group on Rules of Origin to meet at least four times each year to (1) monitor the implementation and administration of the rules of origin, marking rules, and customs procedures; (2) address future modifications of NAFTA rules of origin and the uniform regulations; and (3) consider any other matters referred to it by a party.

[29]NAFTA requires a de minimis percentage of 9 percent of the transaction value (free-on-board) or total cost of cigarettes.

[30]Transshipment refers to the act of sending an exported product through an intermediate country before routing it to the country intended to be its final destination. Transshipment can be an enforcement problem for Customs if, during the shipping process, the product's country-of-origin marking is illegally changed to (1) circumvent U.S. quota restrictions or antidumping and countervailing duty orders and/or (2) take advantage of lower U.S. duty rates on products from the intermediate country.

Certificate of Origin

NAFTA also provides for a common certificate, to be executed under penalty of law by a producer or exporter, certifying that goods meet the NAFTA requirements for preferential treatment. Exporters or producers that sign a certificate of origin must maintain supporting records for at least 5 years from the date of the signed certificate. An importer must also keep supporting records for a minimum of 5 years from the date the good is imported under preferential treatment. Customs officials told us that the common certificate of origin, along with a requirement that exporters or producers provide records of their invoices, should help Customs identify whether a product qualifies under NAFTA.

Administration and Enforcement

According to the U.S. lead negotiator, each of the NAFTA parties has agreed that any person subject to its jurisdiction who falsely executes a certificate of origin will be liable for penalties under its laws. In addition, an importer who becomes aware of false information on a certificate of origin, or who has reason to know that the information is likely to be false, must report that information to the importing country's customs administration or be liable for penalties under domestic law. NAFTA directs each country to maintain measures imposing criminal, civil, or administrative penalties for violations of its law and regulations relating to NAFTA's customs procedures.[31]

According to Customs officials, Customs will be able to audit selected producers' and importers' records to verify that their products meet NAFTA's requirements for preferential treatment. These officials told us that the threat of a potential Customs audit can be an effective source of enforcement.

In addition, NAFTA provides detailed procedures for a country's customs administration to conduct an investigation in a partner country to verify the origin of imported goods from that country. Verification can be undertaken through (1) written questionnaires addressed to an exporter or producer; (2) visits to the premises of an exporter or producer with their written consent, to review records and observe facilities; and (3) any other procedures agreeable to the countries involved. Customs officers are to verify that such goods actually are produced in the NAFTA country that a producer or exporter claims, and not imported from a third country.

[31]In the United States, Customs assesses civil monetary penalties for violations such as misclassification, knowingly falsifying the country of origin, and other fraudulent acts. Customs may take seizure actions when merchandise is illegal or not admissible, and Customs may also seize merchandise that has been repeatedly misclassified.

Marking Rules

Under NAFTA, there will be separate rules of origin for determining (1) preferential tariff treatment and (2) a product's origin mark. According to Treasury officials, in many cases NAFTA's tariff preference rule will require more North American processing than the U.S. Customs Service's rules for marking. Customs officials told us that the different rules of origin could create administrative burdens. For example, NAFTA producers may inadvertently apply for preferential tariff treatment simply because their product has received a NAFTA country marking even though it has not qualified under the agreement's rule of origin for preferential treatment.[32] These officials told us that Customs will need to educate the business community on such matters and that the agency has begun developing a proposed training program for Customs officials in the field, importers, and customs brokers that addresses the marking issue and other NAFTA-related customs issues.

As with NAFTA's rules of origin for tariff preference, the three signatories have agreed to write the marking rules for trade among the three countries based on the tariff-shift method of defining substantial transformation. As formerly noted, U.S. Customs generally uses a case-by-case method to determine if an import has undergone substantial transformation. As a result, imports from Canada and Mexico may, in some cases, be marked differently than imports from non-NAFTA countries. The U.S. lead negotiator told us that if NAFTA's tariff-shift marking rules prove to be better than the current rules based on the case-by-case method (because the rules are published, transparent, and predictable), the U.S. government may apply the tariff-shift rules to trade with all other countries.[33]

NAFTA does not require the signatories to create common rules for marking the origin of products traded within the free trade area. Thus, although the three countries have agreed to try to harmonize their rules of origin for marking purposes, it is possible that each country will have different marking rules for some products. According to Customs officials, this situation currently exists for U.S. trade with Mexico, Canada, and the rest of the world, so it is not expected to cause any additional enforcement problems.

[32] According to a Treasury official, administrative burdens associated with NAFTA's different rules of origin for marking and preferential tariff treatment are not unique. Customs currently faces such problems with goods imported under other U.S. preferential trade agreements.

[33] According to this official, the United States has proposed in the Uruguay Round of GATT negotiations that the tariff-shift concept be adopted for rules of origin on nonpreferential trade.

Services and Financial Services

NAFTA services providers in partner countries will be guaranteed certain rights concerning nondiscriminatory treatment, cross-border sales and entry, investment, and access to information. A noteworthy feature of the agreement is that these principles will apply to all services unless they are explicitly exempted. Therefore, all new services created in the future automatically are covered by NAFTA. Also, NAFTA will make progress beyond CFTA in liberalizing trade in telecommunications and land transportation. However, each country sought to exempt certain service sectors from NAFTA's liberalization, such as maritime shipping (United States), film and publishing (Canada), and oil and gas drilling (Mexico).

Comprehensive principles in NAFTA also will regulate government measures regarding financial services, although each country has taken certain reservations or other exemptions from these principles. While U.S. and Canadian financial services markets were liberalized on a bilateral basis through CFTA, NAFTA will give firms from these countries significant access to Mexico's financial services market. For example, after a transition period, U.S. and Canadian firms will be allowed to establish a commercial presence in Mexico's banking, securities, insurance, and other nonbank financial services sectors.

NAFTA's Treatment of Services

NAFTA expands upon CFTA initiatives to facilitate trade in services, a sector that employs over three-quarters of the U.S. labor force. In particular, NAFTA reaffirms and strengthens CFTA's "bill of rights," which will guarantee to NAFTA services providers in partner countries (1) equal treatment with domestic firms under any new laws and regulations, (2) the right to invest in certain service sectors, (3) the right to sell services across the border, (4) the right of professionals to cross the border under streamlined visa procedures, and (5) public access to information on any law or regulation regarding services trade. NAFTA expands CFTA's liberalization of services trade, particularly for certain telecommunications, land transportation, and financial services. However, other service activities, such as broadcasting, telephone service, and maritime transport, will remain limited or off limits. Some U.S. industry representatives object to certain of these exceptions but otherwise are satisfied with NAFTA.

Background

Service industries dominate the U.S. economy and generate a trade surplus. Services encompass transportation, communications, tourism, banking, insurance, professional and business services, and construction. U.S. service industries employ over three-quarters of the workforce and

generate almost 70 percent of the gross domestic product (GDP). U.S. service exports have risen from 35 percent of the value of merchandise exports in 1989 to almost 41 percent in 1992. The U.S. surplus in services trade more than doubled since 1989 to an estimated $56 billion in 1992.

The United States has given high priority to including services in international trade negotiations because of the growing importance of services in the U.S. economy and the lack of internationally accepted rules and principles to deal with practices restricting services trade, according to a USTR official. The United States included services in its bilateral trade agreements with Israel and Canada. The free trade agreement with Israel contains a services declaration, which specifies general rules and principles to be applied to services. CFTA also establishes extensive rights and obligations relating to bilateral trade in services. For example, CFTA principles (1) ensure that no new services restrictions will be applied in the future, (2) liberalize financial services trade, and (3) make temporary border crossing by professionals easier.

Negotiators' Objectives and Concerns

According to a USTR official, the U.S. objectives were to eliminate barriers to trade in services to the maximum extent possible, including barriers to investment in services within North America and barriers that prohibit trade in services across the border. For example, a key tenet for the United States was national treatment. Also, the United States sought to reduce or eliminate licensing and registration requirements that effectively exclude foreign providers or that bar individuals from providing professional services, according to a U.S. official. In addition, this official said that the United States wanted NAFTA's principles to apply to all services unless they are expressly listed as excluded, so that NAFTA's principles could be broadly applied and able to cover all new services created in the future. By contrast, CFTA's services principles apply only to the services that are explicitly listed in the agreement or are added to the agreement in the future.

According to a U.S. official, each country had particular sectors that it sought to have reserved from NAFTA's services principles. For example, the United States sought to protect the maritime services industry, while Canada and Mexico were reluctant to liberalize the provision of basic telecommunications services (e.g., voice telephone services and telex).

NAFTA Is Largely Modeled After CFTA

NAFTA (1) largely adopts CFTA's agreement on trade in services with a few improvements and (2) makes additional progress beyond CFTA in liberalizing certain service sectors.

NAFTA Adopts CFTA's Services Provisions With Some Modifications

NAFTA reaffirms CFTA principles governing trade in services. In particular, NAFTA reaffirms and strengthens CFTA's "bill of rights," which will guarantee to NAFTA services providers in partner countries (1) equal treatment with domestic firms under any new laws and regulations, (2) the right to invest, (3) the right to sell services across the border, (4) the right of professionals to cross the border under streamlined visa procedures, and (5) the right of public access to information on any law or regulation regarding services trade.

Compared to CFTA, NAFTA (1) broadens the definition of services that the agreement covers and (2) strengthens CFTA provisions to facilitate the delivery of services.

NAFTA Has a Broader Coverage of Services

NAFTA principles governing services trade cover all service industries, except those that are explicitly exempted. According to the U.S. ITC,[1] this proviso will allow the widest possible coverage of existing services and any new services in the future. In addition, NAFTA specifies that remaining restrictions cannot be worsened, and if liberalized, cannot subsequently be made more restrictive.

NAFTA Facilitates the Delivery of Services

NAFTA adopts and strengthens CFTA rules that facilitate the delivery of services. Like CFTA, NAFTA service providers will have the right to sell across the border, or when a local presence is preferred, they have the right of establishment. Also, service professionals have the right to cross the border following streamlined procedures.

Whereas CFTA encourages mutual recognition or harmonization of standards related to professional licensing and certification, a U.S. official says that NAFTA goes further in targeting laws or regulations that bar individuals from providing professional services. Two years after NAFTA's implementation, members will remove any citizenship or permanent residency requirement for licensing and certification of professional services providers. NAFTA also strengthens the three countries' commitment to harmonize professional services standards by including a professional services annex that can be used as a model for all professions. The annex states that each country should encourage the

[1]Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement, U.S. International Trade Commission, Publication 2596 (Washington, D.C.: Jan. 1993).

development of mutually acceptable or mutually recognized standards and criteria for licensing and certification of professional services providers. These standards and criteria may be based on factors such as education, qualifying examinations, and professional experience.

NAFTA Extends Sectors Covered by Service Principles

Compared to CFTA, NAFTA makes significant progress in liberalizing services trade in particular sectors, including certain telecommunications, land transportation, and financial services. Also, NAFTA is the first U.S. trade agreement to cover government procurement contracts for services. However, some other services activities remain outside the scope of the agreement.

Telecommunications Services

According to U.S. industry and government officials, telecommunications services are typically divided into two parts: basic services and enhanced services. Basic services include, for example, telephone services, telex, facsimile, and other commonly used services. Enhanced or value-added services are defined within NAFTA as "employing computer processing applications that (a) act on the format, content, code, protocol or similar aspects of a customer's transmitted information; (b) provide the customer additional, different, or restructured information; or (c) involve customer interaction with stored information." This definition includes the following examples of services: electronic mail; on-line information and database retrieval; electronic data interchange; store and forward facsimile services; code and/or protocol conversion; on-line information and data processing, including transaction processing; and alarm services.

All three NAFTA countries have agreed to exclude the provision, but not the use, of basic telecommunications services from NAFTA. However, according to U.S. industry and government representatives, NAFTA substantially improves U.S. access to public telecommunications transport services and the enhanced or value-added telecommunications services market in Mexico. In addition, NAFTA addresses existing major market access barriers in value-added telecommunications services and intracorporate communications. According to U.S. industry and government analysts, parts of the telecommunications chapter of NAFTA may be interpreted as a "bill of rights" for the providers and users of these telecommunications services. These rights include the following:

- Users will be able to obtain access to or use a menu of public telecommunications services, including private lines.
- Users can connect private lines with other private lines or with public networks, for their own purposes (such as intracorporate

communications) or to provide services (other than basic or other monopoly-provided telecommunications services) to third parties.

- Such private lines must reflect economic costs and be available on a flat-rate pricing basis—an important advantage for large users that try to avoid volume- or time-sensitive rates for private lines.
- Service providers will be able to perform switching, signaling, or processing functions within their networks, without having to rely on the public network provider to carry out those functions.
- All users, including providers of value-added or other advanced telecommunications services, will be able to use operating protocols of their choice.
- Users will have the right to choose, purchase, or lease terminal equipment best suited to their needs and attach such equipment to public networks.

NAFTA conveys additional benefits, such as the following:

- NAFTA expressly permits providers and users to move information within and across national borders without restriction and have access to information contained in databases, wherever in North America they may be located.
- NAFTA limits regulators' discretion to impose onerous licensing procedures on providers of enhanced or value-added services. The countries commit to granting any such licenses on a transparent, nondiscriminatory, and expeditious basis.
- NAFTA provides that the terms and conditions for the provision and use of telecommunications services must be transparent. Information, including information on tariffs, specification of interfaces, conditions for attaching terminal equipment, and any licensing requirements, must be made publicly available.

Land Transportation Services

Mexico's strictly regulated land transportation sector has long impeded foreign participation by trucking, railroad, and bus companies seeking to service and invest in Mexico's markets. The lack of common safety standards and regulations for motor carriers has created an additional challenge to these entities' market access. In response to Mexico's restrictions on U.S. commercial carriers, the United States sought to limit the access of Mexican trucks into the United States through section 226 of the 1984 Motor Carrier Safety Act. Reciprocal access for commercial motor carriers has been a major obstacle to normalizing transborder commercial traffic between the United States and Mexico.

NAFTA will open up the important land transportation sector, through which over 85 percent of U.S. trade with Canada and Mexico moves. U.S. and Canadian negotiators lobbied heavily in the NAFTA negotiations for unrestricted access to Mexico's land transportation sector and for strict adherence to safety standards for motor carriers. Mexican negotiators likewise wanted the United States to lift restrictions on Mexican carriers and ensure an adequate phasing in of trade liberalization to protect its sheltered land transportation sector. The three countries' negotiators succeeded in establishing timetables for the removal of barriers in land transportation services and for the harmonization of technical and safety standards concerning land transport. Restrictions on cross-border land transportation services among the NAFTA members are to be phased out in order to liberalize the North American international land transportation market.

NAFTA phases in complete cross-border access for trucking companies to transport international cargo and will lock in Mexico's market-oriented policy of railroad reforms. These reforms have increased U.S. railroads' access to Mexico. Under NAFTA, Mexico is encouraged to work toward making its motor carrier and rail safety standards compatible with those of the United States over a period of 6 years. Also under NAFTA, U.S. companies will have the right to set up subsidiaries or new companies to transport international cargo in Mexico and make equity investments. NAFTA provides for complete liberalization of access for charter and tour bus operators when the agreement goes into effect, and for scheduled bus companies within 3 years. According to a leading U.S. trucking association, U.S. transportation companies generally support these NAFTA provisions but have a number of concerns regarding specific details of the provisions.

In cross-border access, NAFTA provides for a gradual phase-in of complete cross-border access for trucking companies to transport international cargo. U.S. trucking companies will have access to Mexican border states for international shipments 3 years after the agreement is signed and to all of Mexico by the sixth year after the agreement goes into effect. Similarly, the United States will provide Mexican trucking companies with the same phased access to the United States. For the first time, U.S. trucking companies have the right to use their own drivers and equipment for shipments into Mexico, a cross-border market that is now completely controlled by Mexican carriers. Under NAFTA, U.S. trucks would no longer have to transfer cargo to Mexican carriers at the border and return home empty. In addition, Mexico is permitting trucking companies to operate

temporarily leased vehicles in its territory for the first time. NAFTA also ensures continued access to Canadian markets by prohibiting future Canadian laws, regulations, and policies from discriminating against U.S. providers of land transportation services. Mexico will eliminate restrictions prohibiting foreign commercial drivers.

According to an official in the U.S. Department of Transportation, the resulting agreement will benefit the U.S. transportation industry—especially trucking companies. For example, unionized truckers may resent Mexican carriers' access to the entire U.S. territory under the provisions of NAFTA but at the same time would enjoy the benefits of unrestricted access to Mexico's market. Also, shipping companies could cut their costs under NAFTA by being able to deliver their goods directly to Mexican destinations.

Government Procurement

Each country will open a significant portion of its government procurement market on a nondiscriminatory basis to NAFTA services suppliers. A major innovation is NAFTA's coverage of services procurement by governments as well as state-owned enterprises. U.S. services suppliers will be able to compete for contracts of many Canadian Crown corporations and major Mexican entities, such as PEMEX and the Comision Federal de Electricidad (CFE). This competition should open important new sales opportunities for U.S. services firms. (See ch. 4 of this report.)

Some Service Industries Are Exempted From NAFTA

According to a U.S. negotiator, each country sought to have certain service sectors exempted from NAFTA's liberalization. NAFTA exempts civil aviation, maritime shipping, the provision of basic telecommunications, and Canada's cultural industries, which include film, video, broadcasting, cable, publishing, and sound recording. These exemptions were also included in CFTA. In addition, sectors now reserved for the Mexican state or Mexican nationals by the Mexican constitution are not covered by NAFTA. Thus, U.S. and Canadian citizens cannot invest in selected Mexican service sectors, including oil and gas drilling services; gasoline retailing; and some air, maritime, and land transportation services.

According to some U.S. services industry representatives, NAFTA comes close to their goals of maximum freedom of investment, operation, and movement of people within the NAFTA area. They believe there should be a minimum of reservations and exclusions from NAFTA's services principles and that these, too, should be eliminated through future negotiations. For example, some U.S. industry representatives object to Canada's exemption

of cultural industries, stating that it is inequitable for their U.S. counterparts. In response, a U.S. official said that U.S. firms in Canda dominate these markets, so that this exception has not been a barrier to U.S. companies.

Financial Services Provisions in NAFTA

NAFTA's financial services provisions cover banking, securities, insurance, and other nonbank financial services.[2] NAFTA establishes a comprehensive set of principles and rules governing trade and investment in financial services. Specific provisions allow each government to maintain and apply its own regulatory regime. In addition, the agreement sets out certain country-specific reservations and market liberalization commitments as well as transition periods for compliance with the agreed principles. As a result of NAFTA, U.S. financial services providers will be granted both market access—through commercial presence and limited cross-border trade—and full national treatment in Mexico. The Mexican government's commitments under the agreement will eliminate most restrictions on U.S. and Canadian firms establishing a commercial presence in Mexico after a maximum of 13 years in the banking and securities sectors, a minimum of only 6 years in insurance, and either immediately or after a minimum of 6 years for other nonbank financial services sectors.

Background

CFTA was the first U.S. bilateral agreement to cover the entire financial sector. The agreement includes a chapter that deals specifically with financial services.[3] CFTA's financial services provisions were built upon the concept of national treatment, although this principle is not specifically spelled out or guaranteed in the agreement. Instead, Canada removed virtually all discrimination on the basis of nationality in its financial services sector through specific amendments of Canadian law. According to a U.S. Treasury official, the U.S. government has followed a general policy of national treatment for foreign banks since the International Banking Act of 1978. The U.S. government agreed under CFTA to extend the benefits of any amendments to the Glass-Steagall Act to Canadian financial institutions operating in the United States.[4] U.S. financial services trade with and investment in Mexico, on the other hand, is not covered by any

[2]Nonbank financial services providers include finance companies, warehousing and bonding companies, foreign exchange houses and mutual fund management companies, and leasing companies.

[3]Chapter 17 of CFTA is entitled "Financial Services"; chapter 14 ("Services") also covers financial services offered by nonfinancial institutions and insurance providers.

[4]The Glass-Steagall Act of 1933 requires the separation of commercial banking activities from investment banking activities in the U.S. market.

bilateral agreement and has traditionally been limited, primarily because of Mexican strictures on cross-border trade and foreign ownership. Although the Mexican government has made numerous changes to its banking and financial laws and regulations since the late 1980s,[5] Mexico has continued to prohibit the establishment, and/or limit the operations of, foreign banks, securities firms, insurance providers, and other nonbank financial services providers.

Negotiators' Objectives and Concerns

The United States had two distinct objectives for the NAFTA negotiations on financial services: obtain (1) Mexican and Canadian agreement with basic investment principles; and (2) U.S. access—through the right of company establishment and majority control—to the Mexican financial market, with a transition period as short as possible. Canada and Mexico, among other things, wanted to eliminate, or at least relax, U.S. restrictions associated with Glass-Steagall and interstate bank branching.[6]

NAFTA negotiators followed the "top-down" negotiating concept incorporated into the financial services section of the GATT Director-General's December 1991 Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations. Under such an approach, general principles are set out in the agreement, followed by provisions to reduce or remove country-specific barriers over a certain period of time. Provisions in NAFTA dealing with financial services are mainly found in two sections of the agreement: (1) chapter 14 establishes a comprehensive, principles-based approach to disciplining government measures regulating financial services and incorporates CFTA's provisions regarding financial services; and (2) annex VII of the agreement provides reservations to the agreement and country-specific market access commitments.

NAFTA's Principles and Rules Governing Trade and Investment in Financial Services

According to NAFTA negotiators, NAFTA, unlike CFTA, includes a comprehensive set of principles and rules governing trade and investment in financial services. U.S. negotiators told us that the principles-based approach to providing national treatment—rather than the

[5]The most significant developments occurred in 1990 when Mexico changed its constitution to permit the privatization of its nationalized banks. The first Mexican commercial bank was privatized in June 1991, and the 18th and final nationalized bank was sold in July 1992. Mexico also lifted its ban on new foreign investment in the financial services sector and raised the limits on foreign ownership of Mexican banks, securities firms, and insurance companies.

[6]The McFadden Act of 1927 and various state regulations generally prevent interstate bank branching in the United States.

barrier-removal, or "bottom-up," approach used in CFTA—provides protection against future legislation, rules, or regulations that discriminate on the basis of nationality. Among other things, NAFTA

- guarantees the right of establishment for financial services institutions;
- requires national treatment and MFN treatment;
- guarantees residents from each country the right to purchase financial services in the territory of another NAFTA country (known as cross-border trade) and prohibits new restrictions on currently permitted cross-border sales of financial services;
- provides for procedural transparency, e.g., an administrative determination is required within 120 days, where possible, on a completed application related to the provision of a financial service;
- contains specific provisions for the maintenance of "prudential regulation" through the national regulatory system present in each NAFTA country to assure the protection of consumers and financial services providers (i.e., according to U.S. negotiators, NAFTA does not prevent the U.S. government from applying its regulatory regime); and
- provides a dispute settlement mechanism (unlike CFTA) that will allow panels, run by financial experts, to resolve state-to-state investment disputes.

According to U.S. negotiators, the NAFTA chapter on financial services also differs from CFTA in that it covers state or provincial laws in the banking and securities field. Specifically, NAFTA provides a "standstill" for state or provincial laws that do not conform to the terms of the agreement. In other words, current state or provincial laws, even if they are discriminatory toward foreigners, override any provision in NAFTA. However, subnational governments will not be allowed to impose new discriminatory measures. Moreover, as in the investment chapter, NAFTA includes a ratchet clause that will prohibit any federal, state, or provincial government from subsequently reversing (by making more restrictive) any laws that have been liberalized after the agreement goes into effect.

Although NAFTA recognizes the principle of cross-border trade, the agreement does not fully liberalize cross-border marketing and selling of financial services. For example, Mexican or Canadian consumers will continue to be allowed to purchase such items as U.S. securities, bank certificates of deposit, or certain other financial services or products from the United States; however, the right to conduct cross-border trade is limited because the agreement does not give the U.S. offices of financial services providers a right to solicit business in either Mexico or Canada.

The same restriction applies to Mexican or Canadian companies interested in soliciting business in the United States.[7]

Country-Specific Reservations

Most of the U.S. reservations to the provisions of NAFTA's financial services chapter deal with existing U.S. legislative restrictions on national treatment of financial institutions. Mexico lists its existing restrictions on foreign investment with exceptions made for U.S. and Canadian investors. Canada, according to U.S. negotiators, declares a significant reservation, the right to adopt a "control test" as the rule of origin for the financial services sector. Under Canada's control test, only foreign-owned financial services providers controlled by one or more residents of the United States and/or Mexico (i.e., the individual(s) own(s) more than a 50-percent interest) will be considered a resident of a NAFTA party and thus eligible for NAFTA benefits, such as national treatment.

The United States and Mexico, on the other hand, adopt the investment chapter's "residency rule," which means that if a company is incorporated in a NAFTA country and has a "substantial presence" (whether or not it is the subsidiary of a third country such as Japan), it is considered to be a "resident" of that country and can enjoy the benefits of the agreement. Thus, under NAFTA, for example, a Japanese bank subsidiary in Mexico or Canada could establish a subsidiary in the United States and be accorded the same rights and privileges of a Mexican or Canadian bank subsidiary in the United States. According to a Treasury Department official, the residency test is consistent with long-standing U.S. policy, which recognizes the importance of not discriminating among foreign investment from different countries in the United States and of assuring that U.S. investment abroad is not discriminated against by foreign governments.

Mexico's Market Liberalization Commitments

According to U.S. negotiators, NAFTA does not provide U.S. and Canadian firms with any additional access to each other's market than had been obtained already under CFTA.[8] However, firms from both countries do gain significant access to the restricted and protected Mexican financial services market through specific liberalization commitments made by the Mexican government. Specifically, as a result of NAFTA, U.S. and Canadian financial services providers will be granted both market access—through commercial presence and limited cross-border trade—and full national

[7]Under the terms of the agreement, each country reserves the right to define "solicitation."

[8]Canada provides Mexican firms with increased market access through commitments similar to those made to the United States in CFTA.

treatment in Mexico. The Mexican government's commitments under the agreement will allow with virtually no restrictions U.S. and Canadian firms to establish a commercial presence in Mexico after a maximum of 13 years in the banking and securities sectors; a minimum of 6 years in insurance; and either immediately or after a minimum of 6 years for other nonbank financial services sectors.

Banking and Securities

U.S. negotiators told us that NAFTA will enable U.S. banks and securities firms to (1) establish full-service offices in Mexico for the first time in about 50 years and (2) own other financial services companies in the rapidly growing Mexican market. In addition, the provisions of the agreement will enable U.S. securities firms to assist Mexican companies in issuing securities on the Mexican market. This situation will help to expand the Mexican stock market, which is relatively small but growing. Currently, according to the negotiators, Mexican companies have been borrowing abroad to finance a substantial part of their domestic needs.

Specifically, under NAFTA, U.S. and Canadian banks and securities firms will be able to establish and operate in Mexico through acquisitions or formation of separately capitalized subsidiaries, subject to certain restrictions. For example, as in Canada, U.S. banks and securities firms will be prohibited from establishing branches in Mexico although the U.S. subsidiaries will be able to set up branches throughout the country. In addition, Mexico reserves the right to do the following:

- It may require that the Mexican affiliate of a U.S. or Canadian bank or securities firm be wholly owned.
- It may approve on a case-by-case basis any affiliation of a commercial bank or securities firm with a commercial or industrial corporation that is established in Mexico. According to U.S. negotiators, (1) Mexican law, as a practical matter, currently prohibits industrial or commercial ownership of Mexican banks or securities firms; and (2) the Mexican government included this commitment in the agreement to retain its discretion to prohibit a Canadian or U.S. commercial or industrial corporation from owning a Mexican bank or securities firm.
- It may restrict the Mexican affiliate of a Canadian or U.S. bank or securities firm from establishing agencies, branches, or other direct or indirect subsidiaries in the territory of another country. According to a U.S. negotiator, this provision means, for example, that the Mexican government will be able to prohibit the Mexican subsidiary of a U.S. bank or securities firm from establishing a branch or subsidiary in Israel, Costa Rica, the United States, or any other foreign country.

Under the terms of the agreement, the Mexican government will permit U.S. and Canadian banks and securities firms to form holding companies or "financial groups," as they are known in Mexico. The financial groups may separately operate a bank, a securities firm, or an insurance firm, as well as other financial institutions, such as leasing and factoring businesses, on a national treatment basis. As a result, unlike in the United States, U.S. banks and securities firms will be able to own full-service securities firms or banks, respectively, in both Mexico and Canada. On the other hand, Mexican, Canadian, and U.S. banks and securities firms operating within the United States must continue to abide by Glass-Steagall restrictions as well as interstate branching prohibitions.

U.S. and Canadian banking and securities affiliates in Mexico will be subject to the following individual and aggregate market share limits that will apply during a transition period running for 6 years from January 1, 1994, to January 1, 2000:[9]

- Individual Mexican subsidiaries of U.S. and Canadian banking and securities firms will be limited in size to 1.5 percent and 4 percent of the aggregate capital for the Mexican banking and securities industries, respectively.
- The combined market share of U.S. and Canadian banks' subsidiaries in Mexico will be limited initially to 8 percent of the Mexican banking system. These firms will be able to increase their aggregate market share annually in equal increments, to a limit of 15 percent of the Mexican banking system by the beginning of the last year of the transition period, i.e., 1999.
- The aggregate market share of U.S. and Canadian securities firms' subsidiaries in Mexico will similarly be limited to 10 percent of the Mexican securities system once the agreement takes effect, rising annually in equal increments to a maximum of 20 percent at the beginning of 1999.

On January 1, 2000, the individual and aggregate market share caps will be removed. Nevertheless, Mexico has retained the right to impose an optional, onetime, 3-year moratorium on any further expansion by a U.S. or Canadian bank's or securities firm's subsidiary in Mexico during the years 2000 to 2003. The Mexican government will be able to impose this moratorium if the sum of the authorized capital of all U.S. and Canadian commercial banks' and securities firms' subsidiaries in Mexico reach 25

[9]The market shares discussed in this section are based on the authorized capital of individual or aggregate (as appropriate) U.S. and Canadian financial affiliates in Mexico measured as a percentage of the aggregate capital of all financial institutions of the same type in Mexico.

percent or 30 percent, respectively, of the aggregate capital of the Mexican market for that type of financial institution. Even if Mexico implements the onetime moratorium, there will be no permanent caps on banking or securities firms, either in terms of aggregate market share or in terms of individual firm size, after the year 2006.

As previously reported, U.S. and Canadian banks and securities firms will be able to establish a commercial presence in Mexico through wholly owned acquisitions, subject to reasonable prudential considerations and transitional market share limits formerly described. However, U.S. and Canadian banks or their Mexican affiliate will be permanently barred from acquiring a Mexican bank if the purchase were to result in an increase of the U.S.- or Canadian-owned entity's individual market share to greater than 4 percent of the aggregate capital of all commercial banks in Mexico.

This prohibition effectively fences off from foreign acquisition the four largest Mexican banks currently operating in Mexico.[10] According to a report by the Advisory Committee for Trade Policy and Negotiations on the North American Free Trade Agreement, the fencing off of Mexico's largest commercial banks "...is not opposed by the U.S. banking sector in the context of the overall achievements of the agreement. [I]t should not set the standard for future negotiations, however, and must be viewed in the context of the recent privatization of Mexican banks."

Insurance

According to a Department of Commerce official, NAFTA will strengthen the U.S. insurance industry's ability to capture a significant share of the Mexican insurance market and facilitate the operations of U.S. insurers that have had no previous international experience. According to the U.S. lead negotiator for insurance, NAFTA will provide U.S. firms and investors with significant opportunities in one of the largest undeveloped insurance markets in the world. For example, according to a recent ITC report, only 20 percent of cars in Mexico are insured, less than 8 percent of houses have any kind of household insurance, and only 20 percent of the Mexican population holds any kind of life insurance policy.[11]

NAFTA's provisions on insurance will allow U.S. and Canadian insurance companies (providers of life and/or property/casualty insurance) to

[10]The four commercial Mexican banks which, according to Treasury Department officials, currently have individual market shares of 4 percent or greater are, in order of size, Banco Nacional de Mexico (BANAMEX), Bancomer, Banca Serfin, and Multibanco Comermex.

[11]Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement.

establish a commercial presence in Mexico through acquisitions, joint ventures, or formation of subsidiaries. The firms will receive national treatment. They also will be able to operate throughout Mexico, subject only to prudential considerations and, similar to the banking and securities sectors, certain limitations lasting until the end of a 6-year transition period on January 1, 2000. However, unlike commercial banks and securities firms, foreign-owned and domestic insurance companies operating in Mexico will continue to be prohibited from forming holding companies.

Specifically, NAFTA will allow U.S. and Canadian insurance companies to establish a commercial presence and/or attain majority equity holdings in the Mexican insurance market in three ways:

- U.S. and Canadian firms that had a minimum ownership interest of 10 percent of a Mexican insurance company as of July 1, 1992, may increase their equity participation up to 100 percent by January 1, 1996.
- Firms that have existing joint ventures or form new ones with Mexican insurers may increase their foreign equity participation in steps from 30 percent in 1994 to 51 percent by 1998, and to 100 percent by the year 2000. These firms will not be subject to individual or aggregate market share limits.
- U.S. and Canadian insurers may establish wholly owned subsidiaries once NAFTA takes effect. Similar to the banking and securities sector, the U.S. and Canadian insurance affiliates in Mexico will be subject to market share caps on individual companies of 1.5 percent, with an aggregate market share limit of 6 percent, gradually increasing to 12 percent by 1999.[12] The individual company and aggregate limits will be eliminated at the end of the transition period.

U.S. and Canadian insurance intermediaries (e.g., agencies and brokerages) will be allowed to own and operate insurance agencies and brokerages in Mexico. This action may be taken through the establishment or acquisition of Mexican insurance agencies and brokerages. These Mexican subsidiaries will not be subject to any equity or market share limitations, or other transition period arrangements. In addition, according to the DOC official, auxiliary, or ancillary, insurance service providers, such as (but not limited to) insurance claims adjusters and actuaries, will be

[12]As with the banking and securities sectors, individual and aggregate market share limits for the insurance sector are based on authorized capital measured as a percentage of the aggregate capital of all insurance companies in Mexico. The individual and aggregate capital limits will be measured through separate accounting for life and non-life insurance operations.

allowed to invest in Mexican service companies and provide cross-border services.[13]

U.S. and Canadian insurers will also have the right to provide certain insurance products that are international by nature on a cross-border basis into Mexico, including reinsurance and cargo insurance.[14] Specifically, NAFTA will maintain the present liberalized access by reinsurers into Mexico. Thus, U.S. and Canadian reinsurance providers will continue to be able to purchase all or parts of the insurance coverage sold by Mexican insurance companies. U.S. and Canadian insurance companies also will be allowed to provide cargo insurance for goods in transit between the United States, Canada, and Mexico, from point of origin to final destination. In addition, the Mexican government confirms the right of Mexican residents to purchase U.S. or Canadian life and health insurance while visiting those countries.

Nonbank Financial Services

NAFTA also includes specific market access provisions agreed to by Mexico for nonbank financial services providers. Most importantly, the Mexican government agreed to allow a new type of financial intermediary to operate in Mexico.[15] According to Treasury Department officials, current Mexican law stipulates that only the categories of firms specifically mentioned in Mexico's financial legislation are able to serve as financial intermediaries.[16] The categories of financial institutions eligible to operate in Mexico include banks, securities firms, and auxiliary credit institutions.[17] However, many U.S. financial intermediaries do not fit into any of these categories. As a result, the Mexican government agreed in NAFTA to establish a new type of financial intermediary, the "limited scope financial institution," which will be allowed to provide separately consumer lending, commercial lending, mortgage lending, or credit card

[13]According to the DOC official, the ability of U.S. auxiliary insurance service companies to invest or provide cross-border services in Mexico or Canada is covered by provisions in NAFTA's investment and services chapters, respectively, and not the financial services chapter.

[14]Reinsurance is the assumption by one insurance company of all or part of a risk undertaken by another insurance company, i.e., it is a method of further spreading risks.

[15]In addition, the Mexican government agreed to allow (1) leasing and factoring companies to establish operations in Mexico, but during the transition period they will be subject to aggregate market share limitations; and (2) U.S. and Canadian warehousing and bonding companies, foreign exchange houses, and mutual fund management companies to establish subsidiaries immediately, with no ownership or aggregate market share limitations once NAFTA takes effect.

[16]"Financial intermediaries" are defined in Mexico as firms that borrow funds directly from the public for the purpose of relending these funds to the public.

[17]The latter group includes leasing companies, factoring companies, bonding companies, and foreign exchange houses.

services (i.e., a nonbank investor could be required to establish four separate companies to provide these four financial services in Mexico).

According to Treasury Department officials, the Mexican government's decision to increase the variety of financial intermediaries operating in Mexico will allow a greater number of U.S. financial firms to benefit from NAFTA by offering services without having to establish a bank in Mexico. In the United States, nonbank financial institutions that provide consumer and personal finance, such as Ford Financial Services Group, GE Credit, GM Capital, and Household Finance, are large financial intermediaries. In fact, according to a Treasury official, Ford's financial group is the third largest financial conglomerate in the United States after Citibank and Bank of America. However, in Mexico, Ford's financing activities are circumscribed by rules that require it either to bring in capital or to borrow from Mexican banks in order to lend to consumers interested in financing the purchase of a Ford automobile. According to U.S. negotiators, under the terms of NAFTA, Ford and other U.S. or Canadian finance companies will be able to access the Mexican stock market and issue their own commercial paper to raise the necessary capital to lend to Mexican consumers.[18]

As with other industries in the financial services sector, NAFTA restricts the aggregate (though not the individual) market share of limited scope financial institutions during a 6-year transition period lasting from 1994 to the year 2000. Specifically, NAFTA prohibits the aggregate assets of foreign financial affiliates that are limited scope financial institutions from exceeding 3 percent of the sum of (1) the aggregate assets of all commercial banks in Mexico plus (2) the aggregate assets of all types of limited scope financial institutions in Mexico.[19] The aggregate market cap will be removed at the end of the transition period, and there is no provision for a moratorium period as could occur in the banking and securities industries.

Issues to Be Resolved or Addressed in the Future

The agreement provides specific procedures for NAFTA countries to consult on financial services matters. In addition, certain issues have been identified in the NAFTA text for future consultations or reviews.

[18]Under NAFTA, the Mexican government retains the right to restrict limited scope financial institutions from taking deposits directly from the public.

[19]According to the agreement, lending by affiliates of automobile manufacturing companies with respect to the manufacturers' vehicles shall not be subject to or taken into account in determining compliance with the 3-percent limit.

Specifically, the parties to the agreement have agreed to (1) review the issue of international bank branching if U.S. law is liberalized to permit interstate banking and (2) consult on further liberalization of cross-border trade in financial services no later than January 1, 2000. The latter consultations will consider, among other things, the possibility of allowing a wider range of insurance services to be provided on a cross-border basis in or into the territories of the three countries. In addition, 3 years after NAFTA's date of entry into force, the parties have agreed to consult on the aggregate market limit placed on limited scope financial institutions. Finally, Mexico has agreed to conduct a study 2 years after the agreement comes into force to determine the possibility of requiring a smaller capital requirement for certain securities firms.[20]

[20]The Mexican government sets a minimum capital requirement of $10 million to establish a securities firm in Mexico. According to Treasury Department officials, this substantial downpayment could prohibit smaller U.S. firms that provide limited services from establishing a commercial presence in Mexico.

Key Economic Sectors

Negotiations of the provisions for agriculture, the automotive industry, energy and government procurement, and textiles and apparel proved to be difficult because of the sensitivity in opening these sectors to free trade. While the goal of the negotiations was to eliminate all tariff and nontariff trade barriers, the three countries recognized that a gradual transition or phase-out period is needed to allow industries in these sectors to prepare for cross-border competition.

NAFTA will eliminate tariff and nontariff trade barriers over a gradual transition period and will reduce investment barriers in the agricultural, automotive, and energy sectors. For example, in agriculture and textiles and apparel, nontariff barriers will be converted to special types of quotas or ordinary tariffs and then phased out to zero either immediately or over periods of 10 to 15 years depending on the sensitivity of the commodity.

Negotiations in the automotive and energy sectors concentrated on trade and investment rules in Mexico's highly protected industries to make them more comparable to the rules in the U.S. and Canadian industries that are already marked by relatively liberalized trade and investment. In particular, NAFTA will create substantial new opportunities for U.S. firms to compete for government procurement contracts in Mexican and Canadian energy industries.

NAFTA has unique safeguards and rules of origin for these sensitive economic sectors. Special agricultural and textile and apparel safeguards may be triggered if an industry is determined to be injured through the liberalization process. NAFTA provides stricter rules of origin for automotive goods and textiles and apparel than were provided for under CFTA provisions. These strict rules are intended to prevent non-NAFTA countries from using NAFTA countries as an export platform to gain NAFTA's preferential treatment.

Both the U.S. agricultural and automotive industries, as a whole, are expected to enjoy increased export opportunities under NAFTA, although some selected products are predicted to face increased competition from Mexico. Mexican production of apparel is expected to replace rather than augment imports from Asia, which currently dominate the U.S. apparel import market. Gains to the U.S. energy sector will be limited, however,

due to investment and trade barriers in Mexico, Canada, and the United States that NAFTA will not eliminate.

Agriculture Provisions in NAFTA

Over the last decade, the United States and Mexico have benefited from a gradual process of agricultural trade liberalization as they have lowered tariffs and eliminated nontariff barriers to trade. Nevertheless, some trade barriers to agricultural imports persist between the United States and Mexico, while Canada and the United States continue to resolve agriculture issues through the CFTA. NAFTA negotiators' principal objective was to eliminate tariff and nontariff trade barriers between the three countries. NAFTA would accomplish this goal by converting nontariff barriers between the United States and Mexico to "tariff-rate quotas" (TRQ) or ordinary tariffs,[1] and then phasing out to zero all tariffs either immediately or over periods of up to 15 years, depending on the import sensitivity of the commodity. Government and academic studies of NAFTA's final text indicate that NAFTA is likely to have little impact on most U.S. agricultural sectors and that the U.S. agricultural sector as a whole stands to gain under the agreement by providing continued opportunities for export growth.

Background

The United States has enjoyed a substantial net surplus in agricultural trade during the last decade. Mexico is currently the fastest-growing export market for U.S. agricultural products and is the U.S.' third largest single-country market; Canada ranks second. U.S. agricultural exports to Mexico since 1986 have tripled, amounting to almost $3.8 billion in 1992, according to the U.S. Department of Agriculture (USDA). Mexican agricultural exports to the United States have grown more slowly from $2.1 billion in 1986 to almost $2.4 billion in 1992, according to USDA. The principal U.S. agricultural exports to Mexico are feed grains, oilseeds, live animals, meat, and dairy products. Mexico's principal agricultural exports to the United States include coffee, fruits and vegetables, and live animals.

The demands of a growing population will provide opportunities for the United States to export greater amounts of agricultural products to Mexico, according to a USDA official. Our conclusion in a series of three reports on U.S.-Mexico agricultural trade was that increased liberalization of agricultural trade will generally be beneficial for the U.S. agriculture

[1]NAFTA TRQs will allow a certain quantity of product to enter duty free, while anything over this amount will be subject to an over-quota tariff. There are provisions for growth in this duty-free amount, and the over-quota tariff will decline to zero over a 10-or 15-year period.

industry and that U.S. producer groups generally support increased trade liberalization.[2]

In an effort to modernize its traditional farming sector and increase productivity, Mexico has recently enacted constitutional changes in the rules for land ownership and its use, and in private sector participation. These reforms are one of the Mexican President's key modernization tools, along with NAFTA, to boost agricultural production and productivity and to provide the legislative framework that allows the government to ease out of its heavy involvement in the agricultural sector. However, Mexico suffers from diminishing water supplies and arable land, and is quite near its maximum productivity level in agriculture, according to Mexican and USDA officials. Furthermore, irrigation costs in Mexico are high, and efforts to modernize quickly are hampered by Mexico's high interest rates.

Negotiators' Objectives

The U.S. and Canadian objectives in the negotiations were to eliminate Mexico's tariff and nontariff barriers to trade and to ensure that appropriate safeguards protect their producers from sudden import surges from Mexico. Mexico's objectives were to eliminate nontariff barriers in the United States and Canada and to phase in tariff reductions as slowly as possible in order to protect sensitive commodities, according to a Mexican negotiator.

With respect to nontariff barriers, U.S. officials say that Mexico's import licensing requirements—which now restrict one-fourth of U.S. agricultural exports to Mexico—represent the principal barrier to agricultural trade.[3] Mexican officials contend that the United States unfairly uses plant and animal health requirements, marketing orders,[4] and quotas to keep some Mexican exports out of U.S. markets. Border processing and administrative controls pose difficulties for both countries.

[2]See U.S.-Mexico Trade: Impact of Liberalization in the Agricultural Sector (NSIAD-91-155, Mar. 29, 1991); U.S.-Mexico Trade: Extent to Which Mexican Horticultural Exports Complement U.S. Production (NSIAD-91-94BR, Mar. 20, 1991); and U.S.-Mexico Trade: Trends and Impediments in Agricultural Trade (NSIAD-90-85BR, Jan. 12, 1990).

[3]Importers are required to obtain Mexican government import licenses for grains, dairy products, poultry, and some horticultural products. Under pressure from the United States, which perceives import licenses as a nontariff barrier to trade, Mexico has been eliminating other import license requirements.

[4]Marketing orders are USDA-sponsored agreements among domestic producers of a given commodity to provide collective solutions for marketing and distribution problems, such as quality control, promotion, and sharp fluctuations in supply. Marketing orders will not be changed under NAFTA, according to a USDA official. Products entering the United States must continue meeting marketing order requirements.

NAFTA Provisions

NAFTA's agriculture chapter contains separate bilateral market-access agreements between Mexico and the United States and Mexico and Canada. CFTA rules will continue to govern U.S.-Canadian agricultural trade. In addition to provisions addressing tariff and nontariff trade barriers, NAFTA governs agricultural trade through provisions for (1) safeguard measures, (2) domestic supports, (3) export subsidies, (4) rules of origin, (5) commercial dispute settlement, (6) sanitary and phytosanitary standards (SPS),[5] and (7) investment opportunities.

NAFTA establishes a joint committee on agricultural trade and a committee on sanitary and phytosanitary measures to monitor how provisions in the bilateral agreement on agriculture are carried out.

Tariff and Nontariff Barriers

Under the U.S.-Mexican bilateral agreement, all agricultural tariffs will either be eliminated immediately or over 5-, 10- or 15-year transition periods, depending on the sensitivity of the commodity. According to a USDA official, the average agricultural tariff in the United States is approximately 4-1/2 percent, and eliminating these tariffs will not significantly affect the United States. Mexico's average agricultural tariff, on the other hand, is approximately 10 percent, and the United States stands to benefit greatly by its elimination, according to a USDA official.

Generally, nontariff trade barriers between the United States and Mexico will be revoked without delay, generally through their conversion either to TRQs or ordinary tariffs. The agreement reached by Mexico and Canada also will eliminate most tariff and nontariff trade barriers either immediately or over a phase-out period of up to 15 years; however, it maintains trade barriers in the dairy, poultry, egg, and sugar sectors.

Agricultural Safeguards

All agricultural commodities are eligible for NAFTA's general safeguard provisions as stated in NAFTA's chapter 8 (emergency actions). If the criteria for a safeguard action are met, it provides for suspension of further tariff reductions of up to 4 years, reestablishment of a rate not more than the MFN rate, and compensation to trading partners. However, there are 11 highly import-sensitive commodities for the United States which have a special agricultural safeguard provision. Seven of these highly import-sensitive commodities (chili peppers, eggplant, onions, squash, two seasons of tomatoes, and watermelon) currently have tariffs, but do not have other nontariff barriers. During the NAFTA transition period, these commodities will be protected from import surges by a special safeguard provision in the form of a TRQ. NAFTA will allow a certain

[5]Sanitary refers to human and animal health; phytosanitary refers to plant health.

amount of imports from Mexico (quotas generally based upon recent import levels) to enter under its preferential tariffs, while the amounts imported in excess of the quota will be assessed the MFN tariff. The safeguard quantity, which will gradually increase, will not restrict trade under normal circumstances, but would be available to cushion the impact of sudden import surges.

Special forms of the TRQ, however, have been agreed upon for four commodities for which imports are restricted under section 22 of the U.S. Agriculture Adjustment Assistance Act of 1933, as amended. These include sugar-containing products,[6] cotton, dairy products, and peanuts.[7] The TRQs for these commodities (which have existing nontariff barriers) are based rather on a duty-free quota. All volume within the quota enters duty free while the over-quota tariff is phased out over time to zero at the end of a 10-year transition period. Peanuts, however, have a 15-year phase-out period. It is important to note that the over-quota tariffs applied to these four commodities may be much higher under NAFTA provisions than the regular TRQs covering the seven commodities mentioned in the previous paragraph.

Mexico has also designated 17 agricultural commodities as highly import sensitive and subject to NAFTA's special safeguard provision, including TRQs. These include live swine and various pork products, processed potato products, fresh apples, and coffee extracts.

An essential difference between the NAFTA safeguard and CFTA snapback mechanisms is that the former is triggered on the basis of import volume, while the latter is triggered by import price.[8] One of the reasons negotiators decided to base NAFTA's safeguard trigger on import volume was because Mexico does not have adequate data collecting processes in place for monitoring prices and acreage. Some U.S. agriculture industry representatives, however, pressed for continuance of the import price strategy because of concerns that the safeguard will not protect U.S. fruit and vegetable producers from downward price pressures resulting from the lowering of tariffs.

[6]Sugar products include such commodities as confectionaries, cocoa powder, etc. Raw sugar and refined sugar are not included in sugar-containing products.

[7]In Mexico, this section includes corn, nonfat dry milk, and dry beans.

[8]See CFTA/NAFTA Agricultural Safeguards (GAO/GGD 93-14R, Mar. 18, 1993).

Special Provisions for Sugar and Orange Juice

Sugar and syrup goods and orange juice are also considered highly import sensitive, and have additional unique transitional arrangements. For example, sugar will be regulated by NAFTA's 15-year TRQ phaseout. Special rules for sugar, however, will allow Mexico unlimited exports of its surplus to the United States by year 7 in the unlikely event that it becomes a net surplus producer for 2 consecutive years.[9] The U.S. sugar industry is concerned that Mexico may become a net surplus producer by substituting high fructose corn syrup for domestic sugar and thus freeing up more of its sugar for export. However, this possibility is mitigated under NAFTA in that (1) sugar, like all other agricultural commodities, is eligible for the NAFTA general safeguard throughout the 15-year phase-out period; and (2) U.S. domestic supports for the sugar industry will not be dismantled.

Domestic Supports

NAFTA allows countries to continue domestic support programs, recognizing their importance for agriculture within each country. NAFTA strongly encourages each party to move toward practices that are not trade distorting and that do not conflict with commitments under GATT.

Export Subsidies

NAFTA encourages the three countries to work toward the elimination of export subsidies, recognizing that they should only apply when countering subsidized exports from non-NAFTA countries. For example, if the European Community exports subsidized goods to Mexico, the United States can counter them with their own export subsidies to the Mexican market, according to a USDA official. However, if Mexico imposes a countervailing duty on imports from the European Community, then the United States could be challenged to stop its use of export subsidies. NAFTA rules require that the party give the other two parties a 3-day notice of its intent to introduce a subsidy. NAFTA rules also allow for consultations between the NAFTA members to agree on measures the importing country could take against such subsidized exports.

Rules of Origin

For rules of origin, U.S. negotiators sought strong provisions to prevent third countries from using Mexico as an export platform to gain duty-free access to the U.S. market. Specifically, NAFTA rules of origin are designed to prevent subsidized bulk materials from the European Community from gaining NAFTA preferential treatment by being processed in Mexico. NAFTA's strong rules of origin are aimed at highly import-sensitive areas such as dairy, citrus, and processed fruits, nuts, and vegetable commodities.

[9]Mexico is unlikely to become a net surplus producer in the near future, according to a USDA official, because Mexico currently relies on imports to supplement its sugarcane production to meet domestic demand. In addition, it would take considerable time for Mexico to make its sugar production and marketing systems more efficient.

Commercial Dispute Mechanism

The NAFTA chapter on agriculture defers to the dispute settlement procedure for resolving private cross-border commercial disputes involving agricultural products. Special provisions for perishable commodities do apply under the dispute settlement procedure, requiring action within 15 days.

Sanitary and Phytosanitary Measures

NAFTA safeguards each country's right relating to the development, adoption, and enforcement of SPS measures that protect human, animal, and plant life and health from risks arising from animal or plant pests or diseases, food additives, or contaminants. NAFTA disciplines are designed to prevent SPS measures from being used as disguised restrictions on trade.

NAFTA explicitly recognizes each country's right to determine the level of protection necessary to ensure safety in agricultural products. Such flexibility permits each country to set more stringent SPS regulations, as long as they are scientifically based and treat imports the same as domestic products. At the same time, NAFTA encourages trading partners to adopt international SPS standards. NAFTA ensures each country's ability to enforce and develop its own grade and quality standards as it chooses.[10]

According to a Mexican negotiator, reaching agreement on SPS provisions proved to be very time-consuming because there was no model for negotiations to follow. The United States wanted specific agreements and the establishment of an SPS oversight committee; Mexico wanted acknowledgment of pest-free zones. Negotiators agreed that differing SPS standards were acceptable as long as the effects on health and risk assessment were recognized as equivalent.

Investment Opportunities

NAFTA eliminates investment barriers in agriculture among the three countries, particularly in Mexico. Specifically, NAFTA makes investing in Mexico much easier because it (1) eliminates most Mexican requirements for government approval of new investments and (2) gives U.S. and Canadian investors full rights to repatriate all profits and capital flows in "hard" (internationally acceptable) currency.

[10]Grade standards for agricultural products define different levels of quality, which in turn facilitate trade by giving buyers and sellers a common language. Grade standards serve as the basis for grading and certification of quality.

Comments on NAFTA's Agricultural Provisions

The U.S. Agricultural Policy Advisory Committee[11] and the Agricultural Technical Advisory Committee (ATAC)[12] have both assessed NAFTA's impact on the U.S. agricultural industry.

According to its report, the Agriculture Policy Advisory Committee generally believes NAFTA will provide long-term net export growth opportunities and preferential treatment for U.S. agriculture over non-NAFTA countries. The agreement allows increased export opportunities for grains, oilseeds, dairy products, tree nuts, and meats. However, greater import competition may occur in the United States for cotton and sugar, as well as selected vegetables and subtropical fruits, particularly those products with shorter transition adjustment periods and limited safeguards.

ATAC did not develop a consensus position on NAFTA but did determine that NAFTA in general achieves ATAC's negotiating objectives. Concerns raised through ATAC by the U.S. fruit and vegetable industry's report include (1) the need for longer phase-in periods, (2) the desire for further assurance that Mexico will not continue to use SPS measures to artificially restrict market access, and (3) the need for assurance that NAFTA's enforcement measures will ensure compliance with applicable laws and regulations.

Automotive Industry Provisions in NAFTA

Automotive products are the largest component of bilateral manufacturing trade between the United States and Canada and between the United States and Mexico. The importance of automobiles in the economies of Canada, Mexico, and the United States has warranted comprehensive treatment in NAFTA (ch. 3, annex 300A). Negotiations of this complex and sensitive issue concentrated on dismantling Mexico's restrictions on automotive trade and investment and integrating Mexico's highly protected automotive industry with a U.S.-Canadian industry already marked by free trade. NAFTA would gradually achieve complete liberalization of trade and investment between the parties and seeks to create a more competitive North American automotive industry through

[11]The Agricultural Policy Advisory Committee conducted its work pursuant to section 135(e) of the Trade Act of 1974, as amended (19 U.S.C. 2155(e)), assessing NAFTA from the viewpoint of the U.S. agricultural sector. Comments solicited and received from this committee's members formed the basis of its report.

[12]ATAC is a congressionally established private sector advisory committee that reports to the Secretary of Agriculture and the USTR. ATAC membership is highly diverse, including a cross-section of the U.S. fruit and vegetable industry. ATAC, as required by the statute, prepared its report to summarize the views of its various members regarding the impact of NAFTA on the industry it represents.

free trade. Stringent rules in the agreement prevent non-NAFTA products from enjoying the preferential treatment given to the three NAFTA countries. The U.S. motor vehicle and parts industries support NAFTA and expect expanded export opportunities as a result of NAFTA. Organized labor in the United States believes NAFTA will result in U.S. job losses.

Background

Automotive goods make up the largest component of trade between Canada, Mexico, and the United States, totaling $59 billion in three-way trade.[13] The U.S./Canadian automotive market is one of the most competitive in the world, as well as one of the most accessible. Most trade in automotive goods between Canada and the United States is conducted on a duty-free basis under the terms of either the 1965 U.S.-Canada Automotive Products Trade Agreement (auto pact) or CFTA, which significantly strengthened the auto pact's rule-of-origin requirements.

On the other hand, Mexico's assembly and auto parts industries are relatively small and have been strictly regulated by the government through auto decrees since 1962. Mexico's auto industry today is a result of government policies that have required manufacturers to produce domestically in order to sell in its market.[14] While Mexico's modern export-oriented assembly plants are competitive internationally, vehicles manufactured for the Mexican market are not competitive by international quality or price standards, according to recent Office of Technology Assessment (OTA) and Congressional Research Service reports.[15] Manufacturers in Mexico report continuing difficulty in meeting high domestic content requirements (discussed later in this chapter) because of the lack of reliable suppliers and the shortage of skilled labor. According to a U.S. negotiator, U.S. auto manufacturers would rather supply Mexico from the United States but are currently unable to do so because of Mexico's restrictions.

Recognizing the importance of competition in the development of its auto industry, however, the Mexican government in 1989 significantly liberalized the industry through its latest auto decree. Nevertheless, many

[13]Automotive goods include autos, trucks, buses, and parts.

[14]The Mexican auto assembly industry is entirely foreign owned, consisting of eight assembly plants owned by General Motors, Ford, Chrysler, Nissan, and Volkswagen.

[15]U.S.-Mexico Trade: Pulling Together or Pulling Apart?, Office of Technology Assessment (Washington, D.C.: U.S. Government Printing Office, Oct. 1992); CRS Report for Congress: U.S.-Mexico Trade in the Automotive Industry, Congressional Research Service 91-533E (Washington, D.C.: The Library of Congress, June 24, 1991).

barriers to automotive trade still exist in Mexico, including import and investment restrictions and the requirements that vehicle manufacturers maintain trade surpluses and a high percentage of local content in their automotive products.[16]

Negotiators' Objectives

U.S. and Canadian negotiators were eager to gain full and unrestricted access to Mexico's protected market in order to increase sales of automotive goods and expand investment in Mexico's automotive industry, according to a U.S. negotiator. The U.S. manufacturers wanted to ensure that non-NAFTA countries would not be able to gain NAFTA preferential treatment by using Mexico as an export platform to gain access to U.S. and Canadian markets. U.S. negotiators also insisted on each country's right to maintain, enact, and enforce its own automotive standards as it felt necessary and to prevent the importation of any automotive products not meeting these standards.

In seeking continued access to the U.S. market, Canada wanted to prohibit overly restrictive rules of origin requirements that might handicap Canadian assembly operations.

Mexican negotiators saw NAFTA as an opportunity to modernize their automotive industry and achieve full integration into the U.S. and Canadian markets, even though they recognized that this opportunity would create a difficult transition period. With this transition in mind, Mexican negotiators insisted that the phase-in periods for auto trade liberalization be long enough to cushion the impact of competition as much as possible.

Recognizing that they would have to meet the U.S. Corporate Average Fuel Economy (CAFE) standards, Mexico insisted—as one of its primary goals in the negotiations—on being able to enjoy the same flexibility in CAFE rules as U.S. and Canadian automakers.[17] Autos produced in the United States and Canada can currently be counted as domestic.[18] Autos assembled in

[16]Only manufacturers in Mexico are allowed to import vehicles, and they must maintain a trade surplus at the rate of $2 exported for every $1 imported. This amount will drop to $1.75 exported for every $1 imported in 1994 under the Auto Decree.

[17]Following the 1973-74 oil embargo and energy supply crisis, the U.S. Congress passed the CAFE law in 1975 establishing mandatory average fuel economy standards for passenger automobiles and light trucks. The objective of the CAFE law was to increase fuel efficiency. U.S. and Canadian carmakers currently must maintain separate average fuel efficiencies of 27.5 miles per gallon for both their domestic and imported fleets.

[18]"Domestic" fleet is defined as vehicles whose U.S. plus Canadian content totals at least 75 percent of their total manufacturing value.

Mexico, however, can only be currently counted as part of an auto manufacturer's "imported" fleet. Further, parts manufactured or assembled in Mexico are considered imported for CAFE purposes. Mexico believes its lack of equal treatment places its suppliers at a disadvantage in the U.S. market relative to U.S. and Canadian suppliers and also discourages assembly of fuel-efficient vehicles in Mexico for the U.S. market.

The negotiations concluded with a provision that, after 3 years, treats Mexican automotive production the same as Canadian production for the purposes of the U.S. CAFE requirements. NAFTA will not change the CAFE standards for vehicles sold in the United States nor affect the unilateral right of the United States to change or raise them.

NAFTA's Automotive Rules

To liberalize and integrate the North American market, NAFTA will eliminate over a 10-year transition period all barriers to trade in North American automotive goods and all investment restrictions in the automotive sector. CFTA will largely remain in effect for U.S.-Canadian trade. NAFTA establishes tariff phase-out periods on automotive goods, specifies clear rules for phasing out Mexico's auto decree and investment restrictions, mandates stringent rule-of-origin requirements, and establishes a North American Automotive Standards Council to work toward harmonized standards.

Phasing Out Tariffs on Automotive Goods

Each NAFTA country will phase down to zero all duties on its imports of North American-"originating" automobiles, trucks, and buses. Mexico is the most protected market of the three countries and therefore has the most trade barriers to eliminate. U.S.-Canadian automotive trade will continue under CFTA and the auto pact. In addition, Canada will eliminate its tariffs on vehicles imported from Mexico on the same schedule as Mexico will follow for imports from Canada.[19]

Seventy-five percent of Mexican tariffs on U.S. exports of auto parts to Mexico will drop to zero within 5 years. For its imports from Mexico, the United States will immediately eliminate its 2.5-percent tariff on passenger automobiles and reduce its tariffs on light trucks to 10 percent. Many auto parts already enter the United States duty-free under GSP, or at reduced duty (only on Mexican value added) under U.S. production-sharing tariff

[19]Mexico will lower its tariffs on autos and light trucks from 20 to 10 percent immediately, and then phase out the remaining tariffs on autos to zero over 10 years, and for light trucks over 5 years. Mexico will phase out its tariffs on medium-sized and heavy trucks and buses over 10 years.

provisions. The latter, used extensively by Mexico's maquiladora industry, excludes duty on returned U.S. goods.

As for imports of used motor vehicles, Canada's remaining restrictions on these imports from the United States will be eliminated on January 1, 1994, in accordance with CFTA. Mexico will phase out its import ban on used vehicles over a 10-year period beginning 15 years after NAFTA's implementation. U.S. vehicle assemblers expressed concern that the elimination of the import ban would disrupt Mexico's new vehicle market by flooding it with large quantities of used vehicles from the United States. Fifteen years after NAFTA's implementation, Canada will also phase out import restrictions on used vehicles from Mexico over a 10-year period.

Phasing Out Mexico's Auto Decrees and Investment Restrictions

By phasing out Mexico's auto decrees over a 10-year period, NAFTA will lift Mexico's import bans and eliminate trade balance requirements, local content rules, and investment restrictions. Upon implementation, NAFTA will require Mexico to (1) eliminate the trade-balancing and trade surplus requirements over 10 years[20] and eliminate, at the end of the transition period, the requirement that only manufacturers in Mexico may import vehicles; (2) eliminate over 10 years the local content requirements, gradually reducing the percentage of parts required to be purchased from Mexican parts producers[21] and counting purchases from certain maquiladoras toward this percentage; and (3) phase out some investment restrictions immediately and others over a period of 5 years.

As a transitional measure, a 5-year progressively liberalized import quota system would replace the auto transportation decree upon NAFTA's entry into force. NAFTA eliminates Mexican restrictions on buses and medium-sized and heavy truck production within 5 years. In addition, it provides growing import quotas for 5 years as a transition to free trade.

Rules of Origin Requirements

NAFTA tightens CFTA rules of origin requirements and closes certain loopholes evident in CFTA. NAFTA mandates tough rules of origin specifying that, in order to qualify for NAFTA's preferential tariff treatment, cars, light trucks, transmissions, and engines must contain 62.5-percent North

[20]Mexico will immediately reduce its trade-balancing requirement from $2 of car exports for every dollar's worth of imported cars to 80 cents, then gradually down to 55 cents in 2003, and then eliminate the requirement in January 2004.

[21]Mexico's domestic content requirement will be phased out from 36 percent to 34 percent for the first 5 years, to 29 percent over the next 5 years, and to zero after 10 years. A special provision for established manufacturers liberalizes the phase-out schedule by only holding them to the domestic content percentage achieved in model year 1992—less than 34 percent for most firms.

American content based on a net cost formula. Other parts and vehicles must meet a 60-percent rule on domestic content.

In calculating the content level of automotive goods, the value of imports of automotive parts from outside the NAFTA region will be traced through the production chain to improve the accuracy of the content calculation.[22] NAFTA will limit goods that contain some non-NAFTA materials from having their full value counted as NAFTA-originating goods. This situation, known as "roll-up," was a problem prevalent under CFTA. The domestic content calculation method under NAFTA rules will prevent countries from being host to "pass-through" operations using lower levels of North American content and benefiting from NAFTA preferential tariff treatment.[23]

The North American Automotive Standards Council

NAFTA creates a special intergovernmental group to review and make recommendations on federal automotive standards in the three countries, including recommendations to achieve greater compatibility in standards.

Anticipated Results

According to a Mexican negotiator, NAFTA will be beneficial to Mexico's assembly and auto parts industries. The industries are expected to grow substantially as commitments under NAFTA attract foreign investment, create jobs, and permit globalization of the industry. Major net exporters in the Mexican auto industry are said to be pleased with the outcome of the negotiations.

The segment of the Mexican auto assembly and auto parts industries that primarily serve the Mexican market, however, is unhappy with the agreement, according to a Mexican negotiator. He acknowledged that these industries will face tremendous competition under the liberalization NAFTA would achieve. This segment of the Mexican auto industry feels that elimination of the Mexican local content requirement and import and foreign investment restrictions will dramatically increase imports from the United States and Canada, rendering it uncompetitive. This segment of industry wanted a longer phase-out period for Mexican rules that protect it.

Both the U.S. and Canadian motor vehicle and parts industries support NAFTA and are generally satisfied with NAFTA's outcome, according to a U.S.

[22]NAFTA requires use of the net-cost method to calculate regional value content, which is simpler and more predictable than the CFTA formula.

[23]"Pass-through" operations (also called transshipments) involve a foreign country's use of one country in a trade bloc as a means of gaining preferential trade treatment from other countries in the bloc.

negotiator. According to the ISAC on transportation equipment, the agreement will result in expanded export opportunities for U.S. manufacturers, which will have some slight employment benefits in the United States. A U.S. negotiator expects an increase of $1 billion-$2 billion in U.S. exports of automotive goods to Mexico in the first year of NAFTA's implementation. Studies by ITC and the consulting firm KPMG Peat Marwick estimate negligible effects on the U.S. industry, but sizable effects in the long term on investment in the Mexican industry. Organized labor in the United States and Canada, however, believes NAFTA will result in significant job losses by encouraging companies to move to Mexico.

According to a recent OTA report,[24] NAFTA is unlikely to have the devastating effects on U.S. workers that the United Auto Workers has charged. To some extent, NAFTA has become a lightning rod for fears over the future of jobs in an already shrinking industry with declining wages. The market-driven conditions established by NAFTA would do little to encourage or discourage auto job relocation to Mexico for the following reasons: (1) Labor costs are a decreasing component of automotive manufacturing costs and (2) Mexico has higher infrastructure costs than the United States. Furthermore, a good deal of the low-skilled, labor-intensive work suited to maquiladora plants has already moved away from the United States.

Energy and Government Procurement

Energy issues were a very delicate part of NAFTA's formulation, according to negotiators, because of energy's importance to each of the countries. NAFTA energy negotiations focused mainly on attempts to open trade and investment opportunities in the Mexican energy sector since the U.S. and Canadian energy sectors are already relatively open. Government procurement became an important component of energy negotiations because of the procurement power of Mexico's state-owned oil company, PEMEX, and its national electricity company, CFE.

NAFTA is generally expected to facilitate trade in the energy sector through the adoption of a series of tariff reduction and trade facilitation measures. In addition, NAFTA provides much more substantive opportunities for foreign investment in the areas of both electricity and petrochemicals in Mexico. Finally, NAFTA further liberalizes government procurement by increasing opportunities to compete on a nondiscriminatory basis for government contracts offered by Mexico's PEMEX and CFE, and Canada's Canadian Crown corporations.

[24]U.S.-Mexico Trade: Pulling Together or Pulling Apart? p. 150.

Mexico maintains a reservation for its constitutional prohibition against foreign or private activity in oil exploration, production, and refining.

Background

Energy trade among the three NAFTA partners is substantial. ITC reported that in 1991, U.S. trade with Canada and Mexico in petroleum and natural gas products, primary petrochemicals, and electrical energy totaled 21 percent ($1.87 billion) of total U.S. exports of these products and 28 percent ($15.2 billion) of total U.S. imports of these products.[25]

The volume of energy trade, however, was overshadowed by the sensitivity with which Mexico regards this sector, a measure of which is reflected in the fact that when initial free trade discussions began, energy issues were not included. In 1938, Mexico nationalized its oil industry, and from that time until now, Mexico's large petroleum resources have served as a symbol of Mexico's sovereignty. Mexico's constitution vests direct ownership of petroleum deposits in the Mexican government and restricts private companies from controlling activities in the petroleum industry. Unlike the United States and Canada, Mexico's energy sector is conducted by two state-owned energy companies: PEMEX, which controls all oil exploration, production, refining, and retail sales; and CFE, which has similar responsibilities for electricity.

Negotiators' Objectives

At the outset of NAFTA, the Mexican President stated that Mexico would not negotiate changes to its constitution. Mexican negotiators subsequently told us that their main negotiating concern was to ensure constitutional integrity. From their point of view, NAFTA instead serves as an important component of the unilateral modernization of the energy sector, begun in 1990.

The U.S. administration accepted Mexico's position by saying that the United States would not seek to obtain constitutional changes through NAFTA. Thus, U.S. and, later, Canadian negotiators had difficulty directly addressing the broader issues of Mexican oil exploration, production, and refining. Instead, they focused on opportunities for trade and investment liberalization that were not specifically precluded by Mexican constitutional restrictions. These opportunities included seeking greater liberalization in government procurement, particularly as it applied to state-owned enterprises. Concurrently, U.S and Canadian negotiators

[25]Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement, U.S. ITC Publication 2596 (Washington, D.C.: Jan. 1993).

sought to incorporate enhancements to CFTA, including improvements in trade rules raised in the Uruguay Round of the GATT negotiations.

NAFTA's Energy-Related Elements

NAFTA adopts tariff reduction and trade facilitation measures, provides much more substantive opportunities for foreign investment in the areas of both electricity and petrochemicals in Mexico, and achieves substantial liberalization in the area of government procurement.

Trade Rules

Tariff barriers in the energy sector under NAFTA will be reduced. For example, the Mexican tariff on coal, currently 10 percent, will be eliminated upon enactment of the agreement. Mexican tariffs on other commodities, such as crude petroleum, refined products, and primary petrochemicals, will be phased out in several stages over a period of 10 years. U.S. and Canadian duties for these products, currently lower than Mexican duties, will also be phased out over the same period.

In addition, NAFTA allows U.S. and Canadian natural gas and electricity suppliers to enter into sales contracts directly with Mexican businesses. This provision is expected to facilitate cross-border trade in these commodities. However, NAFTA provisions effectively allow PEMEX and CFE approval authority over these contracts. The ISAC for energy reports that these provisions may allow the Mexican national energy companies veto authority over contracts, but also states that NAFTA should lead to more transparent and therefore reasonable contract negotiations.

Negotiators reached agreement on other measures that should also improve energy trade and generally ensure national treatment for energy consumers doing business in any of the NAFTA countries. CFTA included provisions designed to limit the application of various energy trade restrictions in order to prevent one country's consumers from having to bear the burden for the other's supply limitations. These provisions were retained by NAFTA for both Canada and the United States.[26] Mexico did not accede to these specific provisions, citing sovereignty concerns, according to U.S. officials. However, Mexico did agree to abide by GATT disciplines on energy trade, effectively allowing limitations on its right to impose barriers to the flow of energy goods across its borders.

Investment Opportunities in Electricity and Petrochemicals

Until NAFTA, Mexico's efforts to open its energy sector to foreign investment have been limited, primarily due to its constitutional

[26]Trade restrictions on volume or price can be placed only in special circumstances, such as in a short supply situation.

restrictions. Since 1986, Mexico has gradually made unilateral efforts to attract foreign investors, particularly in the area of petrochemicals, with limited results.[27] However, NAFTA provides more opportunities for investment in both electricity and petrochemicals in Mexico.

Under the terms of NAFTA, foreign investors will be permitted to own and operate electric generating plants for three purposes: for their own industrial use, for co-generation, or for independent power production. However, U.S. negotiators point out that electricity generation is considered a public service in Mexico and is reserved for the state. Therefore, NAFTA requires that any excess electricity produced by private plants must be sold to CFE, or exported with CFE's approval, with terms to be negotiated between the private parties and CFE.

NAFTA also provides for increased opportunities in the area of petrochemicals. Until 1986, the Mexican petrochemical industry was highly protected, with a substantial portion of the products reserved for production solely by PEMEX. Since then, Mexico has unilaterally changed its classification system for petrochemicals several times to permit increased private and foreign investment. NAFTA formalizes these changes, and goes beyond by

- reducing the number of petrochemical feedstocks reserved to PEMEX, called "basic petrochemicals," to eight;[28]
- eliminating foreign investment limitations, previously restricted to 40 percent for some intermediate petrochemicals, for all nonreserved petrochemicals; and
- requiring state enterprises and state-controlled monopolies to provide goods and services on the basis of national treatment.

Liberalization in Government Procurement

NAFTA achieves substantial liberalization in the area of government procurement by opening up a significant portion of the government procurement market in each country on a nondiscriminatory basis to suppliers from the other NAFTA countries for goods and services. It does so both by expanding on progress made in CFTA between the United States and Canada, as well as by increasing opportunities to compete for contracts offered by government enterprises such as Mexico's PEMEX and CFE.

[27]See The U.S. Reaction to Recent Reforms in Mexico's Petrochemical Industry (GAO/NSIAD-91-212, May 3, 1991) and Mexican Oil: Issues Affecting Potential U.S. Trade and Investment (GAO/NSIAD-92-169, Mar. 18, 1992).

[28]The eight feedstocks are butane, ethane, heptane, hexane, pentane, propane, naptha, and carbon black feedstock.

NAFTA government procurement provisions are different for U.S.-Canada trade, as compared to U.S.-Mexico trade, in part due to the differences between the three countries' procurement systems. Canada and the United States are both parties to the GATT procurement code and used this code as a point of departure for negotiations in CFTA. Upon completion of that agreement, the two countries had lowered procurement value thresholds below those of the GATT code.[29] They also adopted other procedures generally making it easier for both U.S. and Canadian companies to bid on government contracts.

NAFTA expands on CFTA by incorporating several new elements affecting U.S.-Canada government procurement. NAFTA increases the number of government entities, such as Canadian Crown corporations[30] and the U.S. Departments of Energy and Transportation, open for bidding by U.S. and Canadian suppliers. NAFTA also extends coverage to trade in services, including construction contracts. It retains the procurement value thresholds negotiated in CFTA.

U.S.-Mexico provisions to liberalize government procurement under NAFTA are somewhat different than the U.S.-Canada provisions. First, Mexico will open its government procurement subject to an annual $1-billion set-aside. Mexico will immediately open 50 percent of procurement of goods and services by PEMEX and CFE, an estimated $6 billion-$9 billion market. The 50-percent set-aside for procurement by these government enterprises will be reduced to zero, under a graduated schedule, in 10 years.[31] In addition, while Mexico is not a member of the GATT procurement code, it did agree to a high standard of procurement practices and procedures, including transparent tendering and bid protest procedures not yet in the GATT procurement code. Finally, Mexico, as well as Canada and the United States, agreed to prohibit the practice of offsets[32] and other discriminatory "buy-national" requirements.

[29]General procurement thresholds for federal entity procurement are $50,000 for goods and services, and $6.5 million for construction.

[30]Other Canadian Crown corporations include the Royal Canadian Mint and the St. Lawrence Seaway Authority.

[31]Certain negotiated exclusions will remain for each country, including U.S. small business and minority set-asides; U.S. transportation services; and the permanent set-aside taken by Mexico of $1 billion annually would be raised to $1.5 billion at the end of the phase-in period.

[32]Offsets include requiring local content, investment, or licensing of technology in exchange for obtaining a contract.

U.S. energy service contractors are especially likely to benefit from the procurement provisions under NAFTA, according to both industry analysts and representatives from service contractor organizations. ITC estimates that it is likely that the reforms will result in a significant increase in contract awards to U.S. energy equipment and technology suppliers. NAFTA also permits PEMEX and CFE to negotiate performance bonuses with service contractors, a practice previously prohibited in Mexico.

While NAFTA provides for substantially increased procurement opportunities for PEMEX and CFE contracts, it also contains several limitations. Under NAFTA, state-owned entities like PEMEX and CFE have contract thresholds for when NAFTA rules apply that are higher than for general procurement: $250,000 for goods and services and $8 million for construction. PEMEX and CFE will also be able to set aside contracts totaling up to $300 million annually exclusively for Mexican firms after full NAFTA implementation. Some experts believe that Mexico will use these set-asides to support uncompetitive small suppliers.

Unresolved Issues

Concerns over the energy sector of NAFTA generally focus on the extent to which the parties differ in the openness of their energy sectors. The ISAC for energy concluded that despite the achievements of NAFTA, the energy sector will be prevented from realizing its full potential due to investment and trade barriers still in place in each country. The ISAC pointed out that the U.S. energy market is virtually open, while Mexico's remains essentially closed, and Canada maintains limited but important restrictions.

Other experts argue that NAFTA failed to capitalize on an opportunity to encourage the Mexican government to seek an alternative course to its constitutional prohibitions against foreign investment in energy production. They maintain that further liberalization in areas such as retail sales, basic petrochemicals, oil storage tank capacity, and onshore development may be possible in the future.

Textiles and Apparel Provisions in NAFTA

NAFTA provides special rules for trade in fibers, yarns, fabrics, textile products, and clothing in the North American market. The agreement's textiles and apparel provisions take precedence over those of the Multifiber Arrangement (MFA) and other agreements between NAFTA countries that are applicable to textile and apparel products, including CFTA. Among other things, NAFTA provides for (1) specific rules of origin

stricter than the rules under CFTA, (2) the elimination of tariff and nontariff barriers over a 10-year transition period, (3) special safeguard provisions, (4) review clauses, (5) the establishment of two special committees, and (6) customs cooperation and enforcement.

Background

The textile industry primarily produces yarns, fabrics, home furnishings, carpets, and industrial and commercial textile products such as bags, belting, and cordage. The apparel industry produces clothing and accessories such as headwear and gloves. The Arrangement Regarding International Trade in Textiles, known as the Multifiber Arrangement, has governed world trade in textiles and apparel since 1974. MFA allows signatories to place quantitative limits, or quotas, on most imports of textiles and apparel.[33] Quotas can be established through the negotiation of bilateral agreements or, in the absence of mutually agreeable limits, imposed unilaterally, with certain qualifications, by the importing country for up to 2 years. In 1992, the United States maintained quantitative restraints under the auspices of MFA covering about 67 percent of U.S. textile and apparel imports. Since the 1960s, the U.S. government has imposed quotas on various textile and apparel imports from Mexico.

Trade between the United States and Canada has never been disciplined by MFA.[34] CFTA, however, includes provisions affecting trade in textiles and apparel. Specifically, the agreement sets out rules of origin that determine which yarns, fabrics, and finished products (made-up textile and apparel products) receive preferential tariff treatment.[35] In addition, the agreement requires a phase-out of all tariffs on textile and apparel products by January 1, 1998. Most tariffs were scheduled to be reduced to zero in 10 equal annual installments beginning January 1, 1989. (The fifth cut occurred on January 1, 1993.) However, Canada and the United States have taken some mutually agreed-upon exceptions by which tariffs have already reached zero or will be reduced to zero more quickly than originally prescribed in the tariff phase-out schedule.

According to an ITC report, U.S. trade with Mexico in textiles and apparel has long been dominated by production-sharing operations in the Mexican maquiladora sector, where many U.S.-owned firms assemble garments

[33]Quotas are not placed on products made with pure silk.

[34]According to a DOC official, before the implementation of CFTA, Canada and the United States had a "gentlemen's agreement" with each other (and the European Community) not to invoke MFA on one another.

[35]Made-up textiles include consumer goods such as towels, tablecloths, and bedsheets.

from U.S. components for "reexport" to the United States.[36] Under such an arrangement, Mexican maquiladora operations benefit from preferential tariff treatment on both sides of the border. In 1988, the United States and Mexico signed a bilateral textile agreement that increased Mexico's U.S. quotas above their 1987 base levels to accommodate the so-called "special regime" that was created for most apparel products imported (subject to quota) from Mexico. Under the special regime, a significant portion of Mexico's quotas were, for the first time, set aside for articles assembled with fabric formed (i.e., knit or woven) and cut in the United States. According to a USTR official, the special regime was set up to accommodate U.S. coproduction with Mexican maquiladoras. Although U.S. textile and apparel exports to Mexico are not restricted by quotas, in the past they were held back primarily through limits on Mexican issuances of import licenses and, until 1986, high tariffs.

Negotiators' Objectives

The United States had three objectives for the NAFTA section on textiles and apparel: (1) to strengthen and simplify CFTA's rules of origin through the acceptance of a "yarn forward" principle, (2) to obtain lengthy transition periods for import sensitive sectors in the United States, and (3) to gain rapid access to the Mexican market. NAFTA supersedes the provisions of CFTA and MFA as they apply to the United States, Canada, and Mexico. In addition, the bilateral textile agreement between the United States and Mexico terminates on the date NAFTA enters into force.

During congressional consideration in 1991 of extension of the authority for fast-track approval of international trade agreements, including NAFTA, USTR promised stricter rules of origin for certain industries, such as textiles and apparel, in order to prevent Mexico from becoming an "export platform" for products from non-NAFTA countries. For the textiles and apparel industries, this goal means the United States aims to prevent Mexican firms from exporting textile and apparel finished products cut and/or sewn with non-NAFTA fabric to the United States under NAFTA's preferential duty regime. According to the U.S. lead negotiator, NAFTA's strict rules of origin will accomplish this objective.

[36] Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement.

NAFTA Provisions

Rules of Origin

NAFTA provides specific rules of origin, stricter than those found in CFTA, that define when textile or apparel goods traded among NAFTA countries qualify for preferential duty treatment.[37] In order to understand the textile and apparel sectors' rules of origin, it is necessary to understand the manufacturing process. Manufacturing of most finished textile and apparel products is generally considered to be a three-step process. First, fiber is spun into yarn.[38] Then, yarn is knitted or woven into fabric. In the final stage, the assembly, fabric is cut and sewn into apparel or other consumer goods such as made-up textile products.

For most products, the basic rule of origin is "yarn forward." This rule means that most made-up textile and apparel products must be manufactured in North America with fabric (1) formed in the free trade area and (2) made with North American yarn in order to qualify as a NAFTA-originating product. In other words, most made-up textile and apparel goods that contain imported fiber inputs will still be eligible for NAFTA's preferential tariff treatment.

The agreement provides four exceptions to the basic yarn forward rule of origin for determining which products will qualify as a NAFTA-originating good.

- "The fiber forward" rule of origin: NAFTA requires that the cotton and manmade fiber (MMF)[39] in certain textile and apparel products must be made in North America in order for the goods to be eligible.[40] This rule is stricter than the yarn forward rule of origin because it requires that the final product and every input, including fiber, be made in North America with NAFTA-originating components.
- "The substantial transformation" rule of origin: NAFTA also sets forth a list of fabrics deemed to be in short supply that can be used to make apparel products that will be eligible under a substantial transformation rule of

[37]For a general discussion of rules of origin, see chapter 2.

[38]Certain yarns, such as filament, are not spun but are extruded and twisted.

[39]Manmade fibers are manufactured from such things as cellulose and petroleum, and include, among other products, rayon, acetate, nylon, polyester, acrylic, aramid, and olefin. Natural fibers include, among others, cotton, ramie, silk, flax, wool, hemp, and animal hair.

[40]These products include cotton and MMF knit fabric; MMF nonwoven and specialty fabrics; spun cotton and MMF yarns; and MMF carpeting, MMF made-ups, and MMF sweaters (the last product applies only for trade between the United States and Mexico).

origin.[41] According to the U.S. lead negotiator, this exception was developed to allow apparel producers to use fabrics not made in North America, such as silk and linen, or in short supply, such as certain shirting fabrics, and still receive NAFTA benefits. Any of these fabrics may be imported into a NAFTA country from outside the free trade area (subject to individual country quotas and at the applicable MFN or non-MFN tariff rates) and transformed into apparel products that will qualify as NAFTA-originating goods.

- The tariff preference level (TPL): As in CFTA, NAFTA permits preferential tariff treatment for certain goods traded among NAFTA countries that are made in North America but do not satisfy NAFTA's rules of origin. NAFTA sets agreed annual quantitative amounts, known as TPLs, for these products.[42] As in CFTA, imports in excess of TPL will be charged duty at the MFN rate.
- "The de minimis" provision: NAFTA, unlike CFTA, generally allows any textile or apparel good that would otherwise fail to meet a specific rule of origin to be considered North American if non-NAFTA materials constitute no more than 7 percent of the weight of the component that imparts the essential character of the product (as spelled out in the product's HS tariff classification).[43]

Tariff and Quota Elimination

NAFTA will eliminate tariffs between the United States and Mexico, and between Canada and Mexico, either immediately or phased out over 10 years for products manufactured in North America that meet NAFTA rules of origin. Import duties between the United States and Canada will continue on the schedule set forth under CFTA; thus, all tariffs on textile and apparel products will be phased out by January 1, 1998. As pointed out, the agreement requires the termination of the U.S.-Mexico bilateral textile agreement once NAFTA takes effect. As a result, U.S. import quotas will be lifted immediately for Mexican goods that conform to NAFTA's rules of origin or that satisfy the special regime requirements. The quotas will be gradually phased out for Mexican textile and apparel goods that do not

[41]This rule confers origin when manufacturing "substantially transforms" a product so as to produce a "new and different article of commerce" with a name, character, or use distinct from that of its components. In this case, the substantial transformation rule will be satisfied through the single transformation of the specified fabric into apparel.

[42]CFTA uses TRQ rather than TPL. According to the U.S. lead negotiator, the NAFTA section on textiles and apparel uses the term TPL instead of TRQ because the latter (1) misled people into thinking CFTA limited the importation of textile and apparel goods to a certain threshold and (2) was used for other sectors covered by NAFTA.

[43]For example, an acrylic yarn, which has a fiber forward rule of origin, made with a fiber from Austria that provides a particular characteristic to the yarn (perhaps it absorbs dye in a unique fashion), could be considered a NAFTA-originating product if the Austrian fiber weighs no more than 7 percent of the total weight of the yarn.

meet the special regime or NAFTA rules of origin but conform to the U.S. government's normal rule of origin, i.e., substantial transformation.

According to a USTR official, tariff and quota barriers covering over 80 percent of textile and apparel trade between the United States and Mexico will be eliminated in 6 years or less. Similar to CFTA, NAFTA contains an "acceleration clause" that will permit a faster phase-in period to reduce tariffs and quotas on goods mutually agreed upon between two (or more) of the parties. The agreement prohibits NAFTA governments from raising tariffs or imposing any new quota, except in accordance with specified "safeguard" provisions.

Safeguard Mechanisms

Unlike CFTA, the three NAFTA signatories agreed to establish special rules under which any government may take action to provide temporary relief against disruptive increases, or surges, in textile and apparel imports from another NAFTA country during the 10-year transition period. Specifically, NAFTA contains two bilateral safeguard measures. The first provision applies to goods that satisfy NAFTA's rule of origin (as well as TPL trade between the United States and Canada). It allows the duty for a particular product to be temporarily increased to MFN rates if imports are determined to have caused or threaten to cause "serious damage" to the domestic industry. This safeguard action (1) is limited to 3 years; (2) must be compensated for; and (3) may only be used once for a particular product during the transition period, subject to specific requirements.[44]

The second safeguard provision applies to textile and apparel goods made in North America that do not satisfy NAFTA's rules of origin, including virtually all TPL trade with Mexico. If, after consultations, the parties do not agree on a level of export restraint, the agreement permits the threatened or damaged party to apply a quota against disruptive imports for up to 3-1/2 years without any compensation being paid. The use of this quantitative safeguard may not be applied to U.S.-Canadian textile and apparel trade.

According to a USTR official, NAFTA's transitional safeguard provisions for textiles and apparel are distinct from the agreement's general bilateral safeguard mechanism in three ways. First, a NAFTA government may act to grant relief to a domestic industry if textile and apparel imports from another NAFTA country result in "serious damage, or actual threat thereof,"

[44]The use of this safeguard mechanism must be compensated for by the country applying this measure in the form of concessions (1) having substantially equivalent trade effects or (2) equivalent to the value of the additional duties expected to result from the action.

to domestic producers.[45] This standard is a lower threshold than the "substantial cause of serious injury, or threat thereof," standard of the normal NAFTA safeguard provision. Second, the safeguard provisions for the textiles and apparel sectors permit the use of quantitative restrictions (except for U.S.-Canada trade). Third, NAFTA does not require compensation for the (re)imposition of quotas on textile and apparel trade between the United States and Mexico, and Canada and Mexico.

Review Clauses

The U.S. lead negotiator told us that determining NAFTA's rules of origin for textile and apparel products can be a fluid process, due to the evolutionary nature of production for some textile and apparel products. As fashions change or mills alter their line of production, the parties to the agreement may have to reevaluate certain products' rules of origin. For example, if a North American mill starts producing a particular product that had previously been unavailable in the North American free trade area, the product's rule of origin could be changed from perhaps a substantial transformation rule to a yarn forward rule (or vice versa in other circumstances) in order to receive NAFTA benefits, such as preferential tariff treatment.

The agreement requires NAFTA countries to undertake a general review of the textile and apparel rules of origin before January 1, 1999. In addition, parties may also request consultations (1) to add or delete items subject to the substantial transformation rule of origin; (2) to add or delete items eligible for TPL access; (3) to review the appropriateness of individual tariff preference levels; and (4) to determine whether specific goods should be made subject to different rules of origin, taking into account availability of supply within the free trade area. NAFTA will allow industries to petition the three governments to change a product's rule of origin.

Special Committees Established

NAFTA establishes two special committees to deal with labeling, and trade in worn clothing issues. The first, a joint government and private sector venture, will recommend ways to eliminate unnecessary obstacles to textile trade resulting from different labeling requirements in the three

[45]According to this official, the Committee for the Implementation of Textile Agreements will determine whether U.S. textile and apparel imports from Canada or Mexico cause or threaten to cause serious damage. The committee is an interagency one chaired by the Commerce Department's Deputy Assistant Secretary for Textiles, Apparel, and Consumer Goods.

countries.[46] The second committee, also consisting of government and private sector representatives, will assess the potential benefits and risks that may result from the elimination of existing restrictions on trade in worn clothing and articles.

Customs Cooperation and Enforcement

NAFTA includes provisions dealing with customs cooperation and enforcement.[47] As a result, textile and apparel exporters must provide written certification that the imported product meets NAFTA's rule of origin; they must maintain these certificates for a minimum of 5 years. As in CFTA, each country's customs administration may audit books and verify production of exporting firms in the other NAFTA countries to determine if the products satisfy the agreement's rules of origin requirements. In addition, each country's customs administration will have the ability to conduct timely, on-site plant inspections to verify production and capacity in all NAFTA countries to prevent illegal transshipment of textile and apparel products. According to U.S. Customs officials, the United States will be able to use special enforcement efforts, such as "jump teams," directed against quota fraud or violations of the rules of origin.[48] These officials told us that NAFTA jump teams' investigations of transshipment are intended to proceed more rapidly, and with shorter advance notice, than the method specified in NAFTA for conducting audits to verify the origin of a product.

Impact of the Agreement

According to the U.S. lead negotiator, NAFTA is beneficial for U.S. textile and apparel firms because (1) the strict rules of origin will ensure minimal import competition and (2) significant export opportunities will be available in the Mexican market. However, the U.S. Labor Policy Advisory Committee wrote in its report that NAFTA completely ignores the needs of U.S. textile and apparel workers and that it will encourage the export of U.S. apparel jobs.

According to this report, the U.S. government's "myopic" approach to the impact of trade on U.S. apparel jobs—as represented by NAFTA's provisions for textiles and apparel—has been accentuated in recent years through the

[46]Specifically, the committee is to devise a work program to develop uniform labeling requirements, for example, regarding pictograms and symbols, care instructions, fiber content information, and methods for attachment of labels.

[47]See chapter 2 on rules of origin and customs procedures.

[48]"Jump teams" consist of U.S. Customs officers who conduct announced visits to foreign countries to examine the production capabilities and production records of suspect textile/apparel factories. The jump teams work in cooperation with the foreign customs administration.

implementation of two specific U.S. trade programs. In the latter half of the 1980s, the U.S. government implemented special programs that liberalized U.S. quota treatment for apparel products assembled in specified Caribbean Basin Initiative (CBI) countries and Mexico (the special regime) from fabric parts formed and cut in the United States.[49] These programs were established, according to the report, as part of a Western Hemisphere strategy aimed at substituting Latin American apparel imports for those from Pacific Rim countries. However, the report states that U.S. government data show that U.S. apparel imports from Asia continue to grow along with those from Latin America, endangering U.S. apparel jobs.

According to the U.S. lead negotiator, with the implementation of NAFTA, Mexican apparel production is expected to replace rather than augment imports from Asia. This official noted that the U.S. apparel import market is currently dominated by Asian suppliers. However, three of these suppliers, Taiwan, South Korea, and Hong Kong, are becoming uncompetitive because of labor shortages and the concomitant rise in labor wages. U.S. textile and apparel negotiators have witnessed a shift of apparel manufacturing to Mexico and CBI countries that corresponds to the decline in U.S. imports of apparel from these three Asian countries. The Bush administration viewed these developments as beneficial to the U.S. economy because Mexican and/or Western Hemisphere firms are expected to buy yarn and fabric manufactured in the United States.

[49]The CBI program was launched by the U.S. government in 1983 to expand foreign and domestic investment in nontraditional sectors of the Caribbean Basin countries. The Caribbean Basin Economic Recovery Act, which provides duty-free entry into the United States for eligible products from the region, is the trade component of the CBI program. Apparel products are excluded from the list of eligible duty-free articles. However, the U.S. government established the "Special Access Program" for Caribbean Basin Economic Recovery Act countries in 1986. This program allows apparel items assembled in the Caribbean Basin from fabric parts formed and cut in the United States to receive liberalized quota treatment when entering the U.S. market. This program has allowed substantial growth in U.S. apparel imports from CBI countries.

Trade Rules

NAFTA's rules concerning the functioning of the agreement and the prevention and resolution of disputes are modeled after provisions in CFTA. Like CFTA, NAFTA will establish oversight and working groups to carry out the agreement, address unresolved issues, and undertake future negotiations to further liberalize trade. Also similar to CFTA, NAFTA has comprehensive measures to help governments in member countries prevent and resolve disputes concerning (1) the interpretation and application of NAFTA and (2) unfair trade practices. In both cases, if a dispute cannot be prevented or resolved through consultations, the interested parties will be able to employ impartial, independent panels to assist in dispute resolution. However, in accordance with the interests of the United States, each country will retain its existing domestic laws regarding unfair foreign trade practices and may apply these laws to a NAFTA partner.

NAFTA will require each country to provide adequate and effective protection and enforcement of intellectual property rights on the basis of national treatment, while ensuring that measures to enforce such rights do not themselves become barriers to legitimate trade. According to U.S. negotiators and several private sector advisory committee reports, NAFTA's intellectual property chapter represents the highest standards of protection and enforcement found in any multilateral agreement. However, NAFTA's cultural industries exception would allow Canada to exempt itself from all of the agreement's intellectual property obligations (except those deriving from its adherence to other international agreements).

NAFTA also contains provisions regarding member countries' imposition of (1) safeguards, which are temporary import barriers to protect domestic producers from serious injury by imports; and (2) standards-related measures. In particular, NAFTA emphasizes that member countries must follow transparent, fair, and well-defined procedures when implementing safeguards or standards-related measures.

NAFTA's Dispute Settlement Provisions

According to U.S. and Canadian officials, NAFTA's measures for preventing and settling disputes between the three governments over the agreement are comprehensive and build upon well-accepted provisions in CFTA. NAFTA reduces trade barriers and institutes common dispute settlement rules among member countries. These procedures lessen differences that can lead to disputes, according to a Canadian negotiator. NAFTA also prevents disputes by creating oversight and working groups to carry out the

agreement and to address unresolved issues, this Canadian official said. For disputes that cannot be prevented or resolved through consultations, NAFTA uses impartial, independent arbitration panels.

Among trade agreements, NAFTA stands alone in creating a system of arbitration for resolving investment disputes between foreign investors and host governments. It also calls on the three governments to promote arbitration and other alternative procedures to resolve private international commercial disputes. Increased use of private commercial arbitration could have the effect of reducing pressures on the three governments to become involved in otherwise purely private disputes, a U.S. trade official said.

NAFTA also addresses disputes over antidumping and countervailing duty determinations by federal government authorities in the three countries (see the following section).

Background

NAFTA builds upon CFTA to (1) reduce the frictions that can lead to disputes between governments; and (2) increase public perception of a fair and reciprocally balanced trade system, according to a Canadian negotiator. CFTA procedures to settle disputes between governments appeared to improve the bilateral environment for trade, according to a 1993 Congressional Research Service report.[1]

CFTA uses various procedures to prevent and settle disputes between governments. CFTA reduced tariff and nontariff trade barriers and resolved numerous outstanding bilateral trade issues. The result was the elimination of many stresses that could have led to disputes between the two governments, according to a Canadian trade negotiator. Various oversight and working groups now monitor the operation of CFTA in particular sectors and attempt to prevent and resolve disputes at the working level. When disputes do arise, CFTA emphasizes informal settlement through consultations. It also has an impartial and independent arbitration process to provide recommendations to the parties in order to resolve persistent disputes.

The Canada-United States Trade Commission oversees the further negotiation and elaboration of CFTA and resolves disputes concerning the interpretation and application of CFTA. Its principal representatives are the

[1] Arlene Wilson, The Canada-U.S. Free Trade Agreement: Lessons for the NAFTA, Congressional Research Service 93-153E (Washington, D.C.: The Library of Congress, Feb. 1993).

U.S. Trade Representative and the Canadian Minister for International Trade. The commission's oversight and management responsibilities have been instrumental in creating a cooperative, rules-based regime that successfully mitigates or avoids many potential disputes, according to a Canadian trade negotiator.

The United States and Canada have been satisfied with CFTA dispute settlement procedures, according to U.S. trade officials. A DOC official stated that in 4 years, only five disputes were not settled through consultations and were referred to dispute settlement panels. The relatively low use of CFTA dispute settlement panels may reflect the success of CFTA in preventing or resolving disputes at an early stage, according to the 1993 CRS study. Alternatively, fewer disputes may have occurred because CFTA reduced trade barriers and established nondiscriminatory rules for trade in many areas, the Congressional Research Service reports.

Negotiators' Objectives

Mexican, Canadian, and U.S. negotiators all wanted to create a NAFTA dispute resolution system that would be rapid, effective, and fair and that would produce results acceptable to all participants, according to a U.S. official. In addition, shared concerns regarding NAFTA and environmental and health issues were reflected in special procedures for resolving technical or scientific disputes involving these issues, this official said.

NAFTA Provisions for Resolving Disputes Between Governments Build Upon CFTA

NAFTA incorporates and enhances many CFTA techniques for preventing and settling disputes between governments. NAFTA continues CFTA reductions in trade barriers, relies to an increased extent on expert working groups to address potential disputes, and expands the application of dispute resolution procedures. According to legal analysts, NAFTA's comprehensive provisions allow governments flexibility in choosing an approach to prevent and resolve a dispute.

NAFTA helps to prevent disputes between governments by requiring each country to administer the rules of the agreement in a consistent, impartial, and reasonable manner, according to a Canadian negotiator. For example, the three countries are admonished to (1) publish in advance any measures they may adopt and (2) provide both individuals and other governments with a reasonable opportunity to comment on these measures. When these groups can register their concerns about changes to a country's measures, the problems may be resolved before the changes

are implemented and thereby avoid inciting disputes, according to a U.S. trade official.

Greater Role for Working Groups Under NAFTA

NAFTA's trilateral Trade Commission is closely modeled after the Canada-United States Trade Commission, but NAFTA working groups will have a greater role in dispute settlement. These working groups will provide comprehensive subject-area analysis for the various panels and committees. Such broad assistance by working groups was not available to the CFTA panels and committees which the NAFTA bodies replace. The NAFTA working groups cover five subject areas (rules of origin, customs, standards-related measures, trade and competition, and temporary entry by business persons), while the CFTA groups cover only two subject areas (agriculture and government subsidies).

NAFTA Expands Procedures to Resolve Disputes Between Governments

NAFTA's procedures for settling disputes between governments follow four steps outlined in CFTA. The steps are (1) consultations between disputing parties to resolve their disagreement at the staff level and, if needed, at the Trade Commission level; (2) referral of the dispute to a panel of independent experts; (3) dissemination of panel findings and recommendations; and (4) resolution of the dispute or retaliation by the complaining party. However, certain NAFTA procedures improve or expand CFTA procedures to settle disputes between governments. For example, (1) panel selection procedures are modified further to enhance the impartiality of dispute settlement panels; (2) coverage is extended to disputes over NAFTA's more comprehensive financial services provisions; and (3) special procedures are provided for resolving environmental, health, and safety disputes.

NAFTA Breaks New Ground in Addressing Private Disputes

NAFTA is unique among trade agreements because it (1) contains a comprehensive regime for settling disputes between foreign investors and host governments; and (2) promotes the use of arbitration and other forms of alternative dispute resolution for international commercial disputes between private parties in the free trade area, although it does not prescribe or establish arbitration procedures. International trade agreements have generally concentrated on removing government barriers to trade in goods and services. Disputes between private parties traditionally have been outside the scope of trade agreements.

Investor-State Dispute Settlement

NAFTA provides for consultations and binding arbitration to settle disputes between private foreign investors and host governments. Each NAFTA country shall provide that investor-state arbitration awards can be

enforced through its domestic courts. However, legal analysts say that NAFTA fails to set limits on (1) the time period for resolving investor-state disputes and (2) the disputants' ability to appeal arbitration decisions.

Trade agreements, such as CFTA, that treat investment issues have generally provided only for government-to-government dispute settlement. Private parties may petition their governments to initiate dispute settlement proceedings but do not have any direct rights under such agreements. Mexico and most Latin American countries require foreign investors to waive any right of diplomatic protection from their governments and to seek only remedies available under domestic law.

However, NAFTA goes beyond CFTA's scope by making investor-state disputes subject to binding arbitration for money damages. NAFTA emphasizes consultations and arbitration to resolve investor-state disputes. Consultations or negotiation are the first steps in handling these disputes. If a dispute is not resolved through consultations, the investor may then seek arbitration through a World Bank facility or through ad hoc proceedings under United Nations arbitration rules. NAFTA offers an effective means for resolving investor-state disputes without intercession by the investor's government, according to a USTR negotiator.

Each NAFTA country will enforce the awards granted by investor-state arbitration panels. Therefore, in cases where investor-state disputes have gone to arbitration, the investor can take the host government to court to force it to comply with an arbitration award, according to a U.S. official.

Nevertheless, some NAFTA experts criticize the agreement for failing to limit (1) time frames for settlement proceedings regarding investor-state disputes; and (2) disputants' ability to challenge arbitration decisions, a practice that has become routine under other agreements and that makes proceedings lengthy and expensive.

NAFTA Provisions for Private Commercial Disputes

NAFTA is the first U.S. trade agreement that treats the resolution of purely private international commercial disputes. In support of this provision, an advisory committee will report to the commission on alternative dispute resolution procedures in the free trade area. According to a U.S. official, these provisions were intended to encourage the development and use of alternative dispute resolution mechanisms. Successful use of these procedures could avoid complaints by private parties that they cannot obtain rapid, reliable, and fair adjudication of their disputes in local courts, a U.S. trade official said. NAFTA states that each country is to

facilitate the use of arbitration for international private commercial disputes, but does not prescribe or establish arbitration procedures. According to a U.S. official, to fulfill the U.S. obligation under this NAFTA provision, DOC may establish outreach programs to educate U.S. businesses on arbitration. These programs would include training on how to write arbitration clauses into commercial contracts and how to seek arbitration through private international forums, as well as providing information on other alternatives to litigation.

Promoting arbitration and other types of alternative dispute settlement for private commercial disputes is a new area to be treated in a trade agreement, according to a U.S. official. The advisory committee, if requested by the commission, may make recommendations with respect to the use of alternative dispute resolution in the free trade area.

NAFTA Rules Governing Unfair Trade Practices

Each NAFTA country has laws governing certain unfair foreign trade practices. According to U.S. officials, under these laws, the government investigates producers' claims that they have been injured by imports that are considered to be unfairly priced ("dumped") or subsidized by foreign governments. If dumping or subsidization and injury are found, the government may decide to impose duties that may increase the imports' price.

Chapter 19 of NAFTA will allow binational panels to be established to review a member government's administrative decision following an investigation of an unfair foreign trade practice. While this chapter is similar to its counterpart in CFTA, the parties attempted to craft several improvements for NAFTA. For example, NAFTA contains a set of due process procedures that all parties agreed are important in administering laws concerning unfair foreign trade practices. Also, NAFTA specifies the amendments required for each country to ensure that exporters receive the same rights and benefits in investigations of unfair foreign trade practices. In addition, new provisions are included to ensure the proper functioning of the binational panel review process.

Many Canadian government and business officials wanted the three countries to negotiate new rules on unfair foreign trade practices, according to a Canadian official. U.S. private sector advisory committees, however, opposed negotiating new rules in NAFTA and are satisfied with NAFTA's more limited provisions for reviewing decisions from members'

investigations of unfair trade practices. NAFTA will result in no significant changes to U.S. laws concerning foreign unfair trade practices.

Background

Each party to NAFTA has remedial laws that cover unfair foreign trade practices. In particular, each party has antidumping and countervailing duty laws designed to offset the unfair competitive advantage that can result from "dumping" and foreign government subsidies. Dumping occurs when foreign producers sell their goods in the United States at a less-than-fair-value price, i.e., at a price lower than the price they charge for similar goods in their home market, or at a price lower than the cost of production. Subsidies essentially allow foreign producers to operate at a lower cost than they would otherwise. As a result, foreign producers may sell their products at lower prices than their competitors from other countries.

Under U.S. antidumping/countervailing duty laws, a domestic industry may petition the administering authority (DOC) to initiate an investigation on the basis of sufficient evidence that dumped or subsidized imports from a foreign country are causing material injury to the domestic industry. As a result of its investigation, DOC may impose antidumping or countervailing duties on the dumped or subsidized imports. These duties are not punitive; they simply offset the margin of dumping or rate of subsidization determined by the administering authority.

In the United States, if a party wishes to appeal an administrative decision resulting from an unfair foreign trade investigation, it may petition for judicial review by the U.S. Court of International Trade.

Subsidies and dumping are extremely sensitive issues for the United States and Canada. U.S. business often views Canadian subsidies, which the United States claims are more extensive than U.S. subsidies, as unfair foreign trade practices, according to a 1993 Congressional Research Service study.[2] The Congressional Research Service reports that Canada argues that U.S. countervailing duty law is not always applied uniformly and is subject to political pressures. Consequently, it inhibits Canadian exports. As a compromise, CFTA established binational panel review of antidumping and countervailing duty cases as a temporary solution, while the countries were to negotiate new substantive rules on dumping and subsidies.

[2] Wilson, The Canada-U.S. Free Trade Agreement: Lessons for the NAFTA.

Specifically, CFTA permits the establishment, upon request, of a binational panel. This panel, which replaces the process of judicial review in the country that issued the decision, reviews the determination based on the administrative record. Review by the binational panel has earned the high regard of analysts in both countries. Though originally intended merely as a temporary measure until the two countries agreed on new substantive rules governing the use of subsidies, countervailing duties, and antidumping measures, it has become the de facto standard in lieu of new substantive rules.

CFTA binational review panels employ the same standard of review and substantive law as would the courts of the importing country. The panels, like the courts, determine if the contested antidumping/countervailing duty action is consistent with the antidumping/countervailing laws and regulations of the importing country. Even though CFTA binational panels operate much like the courts that they replace, one advantage of panel review over judicial review is that panel review proceeds on an expedited basis; panels are subject to extremely strict deadlines.

Observers in both the United States and Canada agree that CFTA binational review panels have been highly successful. A 1992 report by IIE says that in almost every case, the strict time limits of the process have been kept, and panels have not acted as rubber stamps for national regulators.[3] This report further notes that discussions between the two countries to negotiate new rules on subsidies and dumping have been effectively frozen pending the outcome of GATT's Uruguay Round.

Negotiators' Objectives

NAFTA negotiators wanted NAFTA to incorporate CFTA's successful provisions for reviewing antidumping and countervailing duty determinations. However, the disparity between the Mexican system and the Canadian and U.S. antidumping and countervailing duty regimes, and the need to harmonize them, was a substantial area of concern in negotiations.

Both the United States and Canada were concerned that Mexico's different legal system and traditions might impede the enforcement of NAFTA rules, according to the 1992 IIE report. The key concern involved Mexico's often opaque administrative procedures for investigations of unfair foreign trade practices, according to this study. Another concern was that Mexico's

[3]Gary Clyde Hufbauer and Jeffrey J. Schott, North American Free Trade: Issues and Recommendations (Washington, D.C.: Institute for International Economics, 1992).

investigations of unfair foreign trade practices did not always provide due process of law to exporters, a U.S. official added. Finally, Mexico does not currently provide for judicial review for U.S. exporters.

Therefore, if they were to adopt CFTA's system of binational panel review for NAFTA, the United States and Canada felt that Mexico's administrative and judicial review procedures must equal U.S. and Canadian standards, according to a U.S. official. That is, according to U.S. officials, NAFTA exporters should have the same rights in all member countries. These rights include the opportunity to defend themselves in investigations of unfair foreign trade practices and the right to appeal administrative decisions in the domestic judicial system.

The negotiators also sought assurances that unanticipated future procedural changes in any member country would not interfere with the operation of the binational panels, U.S. officials said. Such changes may occur in constitutional processes that prevent the formation or functioning of a binational panel. They may also occur in legal processes that may cause a country to deny effective judicial review of the basis for a decision on unfair foreign trade practices.

NAFTA Meets Negotiators' Objectives

The final NAFTA provisions generally satisfy the three countries' negotiating objectives, according to a U.S. official. NAFTA incorporates CFTA's system of binational panel review, with certain improvements. The problem of the differences among the legal systems of the three nations has been resolved essentially in favor of the more detailed and predictable U.S. and Canadian laws, according to a Canadian expert. The agreement will ensure that NAFTA exporters will have similar rights and benefits in member countries' investigations of unfair foreign trade practices, a U.S. official says. Finally, NAFTA includes provisions to ensure the proper functioning of binational panels.

NAFTA Is Modeled After CFTA, With Some Improvements

NAFTA is modeled after CFTA, with several practical improvements drawn from experience with CFTA. For example, NAFTA encourages the use of judges rather than trade practitioners as panelists. This system will (1) reduce the potential for conflicts of interest; and (2) underscore the requirement to use existing domestic laws and precedents, rather than a new body of case law, as the basis for decisions.

Like CFTA, the decisions of NAFTA binational panels may be appealed to an Extraordinary Challenge Committee. However, NAFTA makes this

committee a more practical instrument of review, according to DOC officials, by lengthening the committee's period of review to allow an in-depth examination of the panel's results. NAFTA also clarifies the committee's role by requiring it to examine the legal and factual conclusions of the binational panel.

NAFTA Sets Forth Due Process Procedures for Administering Unfair Foreign Trade Practice Laws

NAFTA sets forth due process procedures that all countries agreed are important in administering laws concerning unfair foreign trade practices, a U.S. official said. These procedures include announcing an investigation and its time frames in an official government journal, allowing involved parties reasonable access to information received by the investigating agency, and giving interested parties the opportunity to present facts and arguments and to comment on preliminary decisions.

Further, NAFTA sets forth the amendments necessary for each country to ensure that exporters receive equivalent rights and benefits in investigations of unfair foreign trade practices throughout the free trade area. In Mexico, these changes will, for the first time, allow interested parties full participation in the administrative process and the right to administrative and judicial review of determinations concerning unfair foreign trade practices. The changes are intended to be completed before NAFTA enters into force. However, according to a U.S. official, the United States and Canada will not significantly alter their laws concerning unfair foreign trade practices. They believe they already have made all the necessary adjustments for CFTA and that these changes are adequate to support NAFTA.

NAFTA Protects Binational Panel Review Process

NAFTA allays concerns about preventing changes in a country's procedures from interfering with the binational panel review process. NAFTA provides for consultations when a member country protests that the application of a partner's law has interfered with binational panel or judicial review. A special committee may be established if consultations do not remedy the problem. If the special committee review establishes that the application of law has been detrimental, country consultations will attempt to resolve the matter. Then, if a resolution is not reached within 60 days, the protesting country may suspend the operation of binational panels in its territory in retaliation.

Further Concerns Exist

Availability of Panelists

One of the issues that remains unresolved concerns Mexico's possible lack of experienced trade experts to serve on the binational panels, according to a U.S. official. However, a U.S. government attorney said that Mexico will create a special trade court with judges who are, or will become, experts in trade law. While the availability of experienced or practicing judges may be limited in the short term, judges will acquire experience and expertise in trade laws as a result of the long-term process of implementing NAFTA, the attorney said.

Private Sector Concerns

Many Canadians expressed strong reservations about incorporating CFTA's dispute resolution mechanism (the binational panel review) into NAFTA, according to a Canadian Chamber of Commerce official. U.S. private sector advisory committees stated that NAFTA's provisions on unfair foreign trade practice laws largely meet their negotiating objectives, although they have voiced certain concerns.

According to a Canadian official, Canadians may reason that incorporating CFTA's provisions for binational panel reviews into NAFTA would weaken the argument that the ultimate objective was to create new rules on government subsidy practices and dumping. However, a 1993 IIE study says that the three countries did commit to consider reform of subsidy and antidumping practices in the future.[4]

Private U.S. business advisers to the U.S. negotiators agree that NAFTA met their dispute settlement objectives. For example, NAFTA achieved one of their main goals of obtaining Mexico's agreement to meet the standards of comparable U.S. laws that ensure that investigations into unfair foreign trade practices follow fair and open procedures. However, the advisers voiced concerns over the lack of an "explicit and concise mechanism" in NAFTA to ensure that Mexico adopts the necessary changes to its laws and procedures.

In response, a DOC official said that the implementation of changes in Mexico will be a cooperative effort involving all three countries and that the changes will be carried out before NAFTA enters into force. Furthermore, the U.S. legislation implementing NAFTA most likely will condition U.S. approval of the treaty upon Mexico's passing legislation that fully supports NAFTA. Similar conditions on Canada were included in

[4]Gary Clyde Hufbauer and Jeffrey J. Schott, NAFTA: An Assessment (Washington, D.C.: Institute for International Economics, 1993).

the U.S. legislation implementing CFTA. The official also said that, should the application of one country's laws interfere with fair and effective judicial or binational panel review, NAFTA provides a sequence of steps for resolving the problem. These steps include consultations, special committee review, and suspension of the binational panel review process if problem resolution is delayed.

Intellectual Property

NAFTA's chapter on intellectual property represents the highest standards of protection and enforcement found in any multilateral agreement, according to U.S. negotiators and several private sector advisory committee reports. NAFTA requires each signatory to provide adequate and effective protection and enforcement of intellectual property rights on the basis of national treatment, while ensuring that measures to enforce such rights do not themselves become barriers to legitimate trade. The agreement sets out specific commitments regarding the protection of copyrights, patents, trademarks, and other intellectual property. The agreement also provides comprehensive procedures for the enforcement—both internally and at the border—of intellectual property rights, including provisions on injunctive relief, damages, and general due process issues.[5]

Background

Because technological advance is a major determinant of the growth of economic activity and living standards, governments have an interest in promoting innovative and creative work. Ensuring the right to intellectual property encourages the introduction of innovative products and creative works to the public. It does so by guaranteeing their originators a limited exclusive right, usually for a specified period of time, to whatever economic reward the market may provide for their creations. The three primary forms of intellectual property rights in worldwide use are copyrights, patents, and trademarks.

The United States and Canada do not have any bilateral agreements to protect intellectual property.[6] Despite the relative compatibility of legal regimes for the protection of intellectual property rights in both countries, CFTA did not include any provisions dealing with this issue except for two

[5]"Injunctive relief" refers to an order issued on behalf of a party that prevents another party from continuing to engage in specified activities. Such relief may be temporary (i.e., it applies during the pendency of a proceeding) or permanent.

[6]The U.S. government has established copyright regulations with many countries, including Canada and Mexico, through U.S. presidential proclamations.

articles in the chapter entitled "other provisions." These provisions required the two parties to (1) cooperate in the Uruguay Round of GATT's multilateral trade negotiations and in other international forums to improve protection of intellectual property and (2) compensate or otherwise protect copyright holders for retransmission of programs.

As with Canada, the United States does not have any bilateral agreement with Mexico on intellectual property rights. Discussions on intellectual property issues intensified in 1989 in the context of the "special 301" process of the 1988 Trade Act.[7] According to USTR, these discussions resulted from Mexico's realization that protecting intellectual property was in its own self interest, particularly as government officials promoted foreign investment in Mexico. In 1991, the Mexican Congress passed a completely new patent and trademark ("industrial property") law and enacted improvements to the country's copyright laws. Although the Mexican government's measures provide significantly improved intellectual property protection, certain issues were not addressed in the legislation. In addition, the U.S. private sector remains concerned about adequate enforcement of the new Mexican law.

Negotiators' Objectives

The United States had distinct objectives for negotiating NAFTA's intellectual property chapter with the Canadian and Mexican governments. For Canada, the U.S. government sought to eliminate (1) Canada's discrimination against U.S. "cultural industries" by discontinuing CFTA's cultural industries exemption[8] and (2) aspects of the Canadian government's compulsory licensing system that discriminate against some pharmaceutical products.[9] For Mexico, the U.S. government wanted to (1) lock in the intellectual property protection the Mexican government had passed in 1991; (2) expand the coverage to other areas, such as trade secrets, semiconductor chips, and plant varieties; and (3) obtain strict enforcement provisions. NAFTA provisions dealing with intellectual

[7]"Special 301" refers to section 1303 of the Omnibus Trade and Competitiveness Act of 1988. The provision requires USTR to identify countries that deny adequate protection for intellectual property rights, to negotiate with these countries to reach agreements for better protection, and to retaliate if deemed necessary.

[8]CFTA's "cultural industries" exemption allows either government to enact legislation, issue proclamations, or take other action having the force and effect of law, either directly or indirectly, which impedes the production, distribution, sale or exhibition of film, television programs, video recordings, or any other measure that would be inconsistent with the agreement but for this exemption.

[9]According to USTR, Canada's compulsory licensing provisions are discriminatory because drugs invented in Canada are exempt from some types of compulsory licensing, while drugs invented abroad are not.

property are set out in chapter 17 of the agreement. NAFTA negotiators built on the results achieved during the Uruguay Round of the GATT's Trade-Related Aspects of Intellectual Property Rights (TRIP) negotiations. As such, NAFTA's chapter on intellectual property incorporates the principles of national treatment, transparency of rules, adherence to international conventions, and adequate enforcement.

Nature and Scope of Obligations

NAFTA requires each country to provide adequate and effective protection and enforcement of intellectual property rights through the provisions set out in the chapter and the substantive provisions in several international conventions dealing with various intellectual property issues.[10] NAFTA requires the parties to make every effort to accede to all of these conventions. This provision, in effect, solely will apply to Mexico, which is the only one of the three parties that has not done so. According to U.S. government officials, NAFTA's incorporation of international conventions will provide a backdrop of long-standing interpretations of the minimum standards of protection that must be met by each party.

Under NAFTA, each country is to provide national treatment with regard to the protection and enforcement of all intellectual property rights, with certain limited exceptions. The agreement stipulates protection of at least 50 years for copyrights, 20 years from filing or 17 from the date of grant for patents, and 10 years (renewable) for trademarks. In addition, NAFTA permits a party to provide more extensive protection of intellectual property rights so long as the protection does not contravene provisions of the agreement. According to USTR, by reducing the threat of "piracy" (i.e., the unauthorized use of intellectual property) and establishing high levels of intellectual property protection, NAFTA provides additional incentives for U.S., Canadian, and Mexican inventors and authors to develop new technologies and products, thereby creating jobs and wealth.

NAFTA's Protection of Intellectual Property

According to U.S. negotiators and several private sector advisory committee reports, NAFTA's intellectual property chapter represents the highest standards of protection and enforcement found in any multilateral agreement. It covers all aspects of intellectual property. Specifically, NAFTA sets out obligations regarding the protection of copyrights, as well as

[10]These conventions include (1) the Geneva Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms (1971), (2) the Berne Convention for the Protection of Literary and Artistic Works (1971), (3) the Paris Convention for the Protection of Industrial Property (1967), and (4) the International Conventions for the Protection of New Varieties of Plants (1978 UPOV Convention and 1991 UPOV Convention).

sound recordings and satellite transmissions; patents, as well as plant breeders' rights; trademarks, as well as geographical indications; trade secrets; layout designs of integrated circuits; and industrial designs. According to the U.S. lead negotiator, some measures were included in NAFTA to protect certain intellectual property rights that are already legally protected by the three parties because the U.S. government regards NAFTA as a precedent-setting agreement (i.e., the United States would like to apply NAFTA's chapter on intellectual property to all countries).

NAFTA, according to this official, provides stronger protection than the GATT's TRIPS document in two areas dealing with copyrights and patents. First, under copyrights, NAFTA explicitly obligates each party to provide national treatment for all intellectual property rights, both current and future. This obligation means copyright protection accorded to "new" works and forms of expression by one NAFTA country will automatically come under the provisions of NAFTA, i.e., the agreement will not have to be amended. According to this official, intellectual property laws are by nature dynamic because they address new forms of expression that might be created through technological innovation. However, the TRIPS document explicitly does not provide comprehensive copyright protection for new forms of works.[11]

Second, NAFTA provides "pipeline protection" for pharmaceutical and agricultural chemical ("agrichemical") products.[12] Specifically, once the agreement is implemented, a NAFTA company will be able to obtain patent protection for these products from another signatory country for the unexpired term of patent protection provided by the company's home government as long as (1) the signatory country where protection is sought did not offer patent protection for pharmaceutical and agrichemical products before certain dates identified in NAFTA; (2) the product has not been marketed in that signatory country; and (3) the protection is requested. An official from the Department of Commerce told us that the three signatory countries currently provide protection for pharmaceutical and agrichemical products. Therefore, NAFTA's requirement for pipeline protection does not pertain to them. However, according to this official, future signatories to the agreement will be required to provide pipeline protection for pharmaceutical and agrichemical products if, prior

[11]Instead, according to a Commerce official, the TRIPs document incorporates the general obligation in Article 2(1) of the Berne Convention to "include every production in the literary, scientific and artistic domain whatever may be the mode or form of its expression..."

[12]"Pipeline protection" broadly refers to the protection accorded by a country for inventions, usually for pharmaceutical and agrichemical products, which already exist prior to that country's making patent protection available for such inventions.

to joining NAFTA, they were not previously offering protection for these products.[13] TRIPS, on the other hand, does not provide pipeline protection for pharmaceutical and agrichemical products. Instead, the proposed GATT agreement provides protection for such products based on patent applications filed after the agreement's entry into force.

Copyrights

Copyright laws protect literary, musical, and artistic works such as books, sound recordings, audiovisual works (e.g., movies), as well as computer programs, encrypted program-carrying satellite signals, and compilations of both individually protected and unprotected data and material (e.g., a database, such as Nexis, which is comprised of individually copyrighted works, or Lexis, which consists of material/data drawn mainly from public sources). Copyrights include the exclusive rights to reproduce, import, adapt, publicly communicate and distribute copies of original expressions of an idea in "any tangible medium of expression."

In the area of copyrights, NAFTA provides the terms of protection required by the Berne Convention, the preeminent international copyright treaty (i.e., the life of the author plus 50 years, or 50 years from first publication, as minima). NAFTA also obligates the parties to comply with all the provisions of this convention, with the exception of its requirement on moral rights.[14] According to the report of the IFAC for trade in intellectual property rights, the exclusion of moral rights from NAFTA was a major objective of U.S. industry. The intellectual property chapter also obligates each party to permit free and unhindered contractual transfers of rights and to safeguard the rights of transferees and other holders of rights to enjoy all the benefits of those rights, including the right to collect royalties. U.S. government officials told us that Mexican law does not recognize certain contractual transfers of copyrights. This nonrecognition has created problems associated with the payment of royalties. For example, past Mexican practices have limited the access of U.S. producers to royalties collected for the theatrical showing of U.S. movies in Mexico. Under NAFTA, the U.S. producer will be legally entitled to receive the royalties because the Mexican government will have to recognize

[13]For example, if (1) a U.S. company received U.S. patent protection for 17 years beginning on January 1, 1990, for a new drug it invented; and (2) a new member of NAFTA joined on January 1, 1996, (i.e., 2 years after NAFTA's date of entry into force) and that country were obligated to provide pipeline protection, the company could apply, within a limited amount of time, for patent protection of 11 years from the new member country, i.e., the unexpired term of the U.S. patent.

[14]Copyrights include the concepts of economic and moral rights. The former refers to an author's right to exploit, sell, rent, etc., a protected work, while the latter refers to an author's right to be identified as an author and to maintain the integrity of the protected work. Moral rights are not transferable but they may be waived. Unless they are waived, such rights may impede the purchaser's right to exploit fully a legally obtained copyright.

contractual transfers and other contractual agreements regarding copyrighted material, according to these U.S. officials.

According to the U.S. lead negotiator, a novel feature of NAFTA is its provisions for the protection of satellite transmissions and their copyrighted program content. Specifically, the agreement states that within 1 year from NAFTA's date of entry into force, each party will make it (1) a criminal offense to manufacture, import, sell, or lease decoding equipment without the authorization of the lawful distributor of an encrypted program-carrying satellite signal; and (2) a civil offense to receive, in connection with commercial activities, or further distribute, a signal that has been decoded without prior authorization.

In addition, NAFTA provides key rights for U.S. recording, motion pictures, and software interests. For example, NAFTA requires the signatories to

- establish a minimum term of 50 years for the protection of sound recordings and provide protection for existing sound recordings,
- protect computer programs as literary works and databases as compilations, and
- provide owners of computer programs and producers of sound recordings with the right to authorize or prohibit the rental of their products.

Patents

Patents protect inventions, giving the patent holder the right to exclude others, for a specified period, from making, using, or selling an invention. Patents give inventors the opportunity to obtain substantial economic benefits from licensing or exclusive exploitation of their discoveries for a limited time. In return, they must submit the details of their inventions for placement on the public record. This information can subsequently be used by others to advance further the "state of the art."

NAFTA protects inventions by requiring each party to do the following:

- They must allow product and process patents for virtually all types of inventions, including pharmaceuticals and agrichemicals.
- They must provide a term of protection for patents of at least 20 years from the date of filing or 17 years from the date of grant (terms equivalent to developed country standards).
- They must ensure patents are available and patent rights enjoyable without discrimination as to the field of technology, the territory of the party where the invention was made, and the importation or local production of a product. According to the U.S. lead negotiator, this

provision prohibits any special regime for particular product categories, which means Canada will have to eliminate its special compulsory licensing rules for products, most notably for pharmaceuticals.[15] In addition, according to a U.S. negotiator, this provision recognizes importation as satisfying the local-patent working requirement for compulsory licensing purposes.[16] Also, such recognition will provide a degree of job protection for some workers in the United States because U.S. companies will not be required to invest or manufacture in other NAFTA countries in order to maintain product patent protection.

- They must provide, as formerly mentioned, pipeline patent protection for pharmaceutical and agrichemical products already patented in another NAFTA country.
- They may grant compulsory patent licenses only under limited conditions. For example, any compulsory license must be nonexclusive, limited to the purpose for which it is authorized, compensated by adequate remuneration, and preceded by an attempt by the proposed user to obtain the license voluntarily on reasonable terms and conditions.
- They must provide for the protection of plant varieties through patents, an effective scheme of unique protection, or both. Therefore, plant breeders' rights are protected at a level consistent with international convention.

Under NAFTA, any of the countries may deny patent protection to a given technology if it is deemed necessary to prevent its commercial exploitation in order to (1) protect public order or morality or (2) prevent any harm to nature or the environment.

Trademarks

Trademarks help consumers to identify products known to be from a certain source and of a desired quality. Trademark protection allows producers to profit from their products' reputations. NAFTA defines trademarks as consisting of any sign, or any combination of signs, capable of distinguishing the goods or services of one person from those of another. These signs include personal names, designs, letters, numerals, colors, figurative elements, or the shape of goods or of their packaging. The agreement also defines trademarks to include service marks, thus requiring the parties to provide equal protection to these marks under national law.[17]

[15]In February 1993, Canada enacted a new patent law that, among other things, ends compulsory licensing of pharmaceuticals. According to USTR, the law is fully consistent with NAFTA.

[16]According to the U.S. negotiator, some governments require the compulsory licensing of a patent to a domestic firm, which will be allowed to copy and commercially exploit it.

[17]"Service marks" are marks that identify services and indicate the source of those services (e.g., TWA is considered a service mark for airline services).

In the area of trademarks, NAFTA

- strengthens protection for well-known trademarks and extends that protection to well-known service marks;
- requires each party to provide a system for the registration of trademarks;
- provides that the initial registration of a trademark will be for a minimum term of 10 years, indefinitely renewable for terms of no less than 10 years when conditions for renewal are met, and with use of a trademark required to maintain registration;
- prohibits encumbering the use of a trademark with special requirements, such as "trademark linking," which is a requirement that trademarks owned by foreigners must be used in conjunction with a trademark owned by a national in a party; and
- requires the parties to prevent the use of geographical indications in a manner that misleads the public as to the source of a product.[18]

Trade Secrets

Trade secrets are proprietary technical information used in industry or commerce. Trade secret protection can encompass a broad scope of manufacturing processes, testing, materials, and other know-how making up the most valuable resources a company has to license. Trade secret protection is regarded as being vital to the coverage of new technology, particularly high technology, where the commercial half-life of new products is often shorter than the time needed to process a patent application.

NAFTA represents the first major international regime that includes the protection of trade secrets or proprietary information. Specifically, NAFTA provides rules for protecting against (1) unauthorized third-party acquisition of trade secrets and (2) government disclosure of test data submitted by firms regarding the safety and efficacy of pharmaceutical and agrichemical products. This latter provision will require Mexico to provide a period of exclusivity (normally for a minimum of 5 years) for use of test data submitted for marketing approval for both pharmaceutical and agrichemical products that utilize new chemical entities.

Layout Designs of Semiconductor Integrated Circuits

Layout designs of semiconductor integrated circuits, also referred to as "mask works," are the patterns on the surface of a semiconductor chip. Because the designs of computer chips are easily copied, most developed countries have established a unique form of protection that combines

[18]NAFTA defines "geographical indications" as any indication that identifies a good as originating in the territory of a party or a region or locality in that territory, where a particular quality, reputation or other characteristic of the good is essentially attributable to its geographical origin. For example, Napa Valley is considered a geographical indication for wines.

copyright and patent principles. NAFTA requires the parties to protect mask works, both directly and in goods that incorporate them, at a level consistent with U.S. law, i.e., a minimum 10-year term of protection with a maximum term of 15 years. The agreement permits Mexico to delay implementation of the semiconductor layout-design provisions for up to 4 years after NAFTA's date of entry into force.

Industrial Designs

Industrial designs are the distinctive and aesthetic aspects of product style and packaging. For example, the bumper (including the front grille) of a car can be considered an industrial design because it possesses aesthetic and utilitarian qualities. NAFTA requires each party to provide for the protection of independently created industrial designs that are new or original for a term of at least 10 years, a level consistent with existing U.S. law.

NAFTA's Enforcement Provisions

Traditionally, according to a U.S. negotiator, the weakest aspect of intellectual property agreements has been their enforcement provisions. NAFTA, on the other hand, sets out detailed and extensive obligations regarding enforcement procedures and provides provisions on cooperation and technical assistance among the signatories. For example, the agreement requires each party to do the following:

- They must ensure civil judicial procedures, including provisions for general due process, for the enforcement of any intellectual property right. They must also provide that judicial authorities will be able to, among other things, order (1) injunctive measures against goods that involve the infringement of an intellectual property right and (2) the payment of damages adequate to compensate for injury suffered because of an infringement.
- They must apply criminal procedures and penalties in cases of infringement of intellectual property rights that involve willful trademark counterfeiting or copyright piracy on a commercial scale. Penalties shall include imprisonment or monetary fines.
- They must adopt procedures for the enforcement of intellectual property rights at the border. In implementing the requirements for border enforcement, Mexico is required to make every effort to comply as soon as possible, although it can take up to 3 years from NAFTA's date of signature (i.e., December 17, 1992). NAFTA includes safeguards to prevent abuse by each country's competent judicial and administrative authorities.

NAFTA's Cultural Industries Exemption

As noted in the investment chapter of this report, NAFTA, at the insistence of the Canadian government, incorporates CFTA's "carve out" provision for so-called "cultural industries" such as publishing, film, and music, as well as radio, television, and cable services. As such, NAFTA permits the parties to exempt themselves from the agreement's obligations (such as national treatment), including those in the services, investment, and intellectual property chapters, affecting cultural industries. Under this exemption, for example, the Canadian government could pass a law limiting the screen time of U.S. films to one night of the week and not be in violation of NAFTA. However, if the Canadian government were to undertake such measures, the United States would have the unilateral right, as it has under CFTA, to impose commensurate commercial retaliation against Canada without requiring bilateral consultations or necessitating use of the dispute settlement procedures. NAFTA's cultural industries exemption does not apply to obligations between the United States and Mexico.[19]

According to the report by the ISAC on services, U.S. pharmaceutical and computer software industries will benefit from NAFTA, but U.S. copyright-based industries such as film, video, sound recording, and publishing companies may be subject to market-access barriers, investment limitations, and discriminatory application of copyright laws in Canada. The U.S. lead negotiator told us that (1) the potential application of Canada's cultural industries exemption to intellectual property is the one major negative aspect of NAFTA's intellectual property chapter; but (2) the agreement's automatic retaliation provision should serve effectively to deter the Canadians from implementing any adverse measures affecting the intellectual property rights of the U.S. movie, recording, and/or publishing industries.

The Canadian government's exemption in NAFTA for cultural industries is the first such exclusion to appear in the context of a multilateral agreement on intellectual property. Specifically, Canada, without violating the agreement, could take broad exemptions from all NAFTA intellectual property obligations relating to cultural industries except those deriving from its adherence to other international agreements, such as the Berne Convention, according to a U.S. negotiator. Several private sector advisory committee reports state that committee members strongly oppose any use of "culture" as a possible excuse to deny adequate and effective levels of intellectual property protection and enforcement. One report, by the IFAC

[19]Mexico does, however, take some reservations that affect "cultural industries." For example, (1) 30 percent of the screen time of every Mexican theater, assessed on an annual basis, may be reserved for films produced by Mexicans; and (2) only Mexican nationals and Mexican enterprises may obtain a concession to operate a cable television system.

for trade in intellectual property rights, asserts that "the 'cultural industries' issue is an outgrowth of the arguably unique geographic and linguistic proximity of the United States and Canada. It is for that reason that our other trading partners should not view the exclusion as a precedent in future bilateral and multilateral intellectual property negotiations."

Emergency Actions Under NAFTA

NAFTA will permit governments to impose temporary import barriers on an emergency basis in order to protect domestic producers from serious injury by increasing imports from other NAFTA countries. Such safeguards are intended to be exceptional measures and, therefore, are to be used only when certain rigorous conditions are met. A period of import relief enables domestic producers and workers to better position themselves to compete when the import relief expires.

Each NAFTA country can protect an industry using import barriers sanctioned by GATT if imports cause, or threaten to cause, serious injury to the industry. The United States and Mexico, and Mexico and Canada, also can suspend NAFTA tariff reductions or restore pre-NAFTA tariffs if imports from each other cause or threaten serious injury to a domestic industry. In the United States, the government determines the extent to which a domestic industry has been injured, in part by investigating conditions such as unemployment and idle plant capacity, and their relationship to the imports in question.

NAFTA has special emergency protection provisions that apply to agricultural products and to textile and apparel products (see ch. 4 of this report).

U.S. officials say that NAFTA addresses their concern that emergency import protection be applied through fair and well-established administrative procedures. While this protection also was a concern of U.S. industry, their representatives say that other aspects of NAFTA's provisions fall short of their objectives. Experts predict that emergency protection will not be used extensively under NAFTA, because it is not always the easiest or most effective method of protection to obtain. Also, it simply may not be necessary.

Background

One of the basic tenets of the GATT trading system is that countries should be allowed to take temporary emergency action to restrict imports in

order to remedy serious injury caused by increased imports. The drafters of GATT recognized that a country would be more willing to enter into contractual obligations to reduce its trade barriers if it were allowed to temporarily reinstate them under certain circumstances. For example, if it were able to reimpose duties when and if imports of a particular product increased so greatly that the growth caused injury to one of its industries producing a competing product, a country might be more willing to sign an agreement to lower its trade barriers.

Both the United States and Canada have established "safeguard" procedures in domestic legislation to provide emergency relief to domestic industries injured by imports. A safeguard action generally takes the form of an increased duty or quota on the imported product that is causing or threatening the injury. However, a country using a safeguard procedure must compensate all affected exporting countries, through other trade concessions, or face the possibility of retaliation. For example, the exporting country may retaliate by imposing tariffs or restrictions of comparable value on imports of a product from the importing country (the country imposing the safeguard). The retaliation is aimed at affecting the importing country as much as the safeguard has affected the exporting country.

Negotiators' Objectives

According to one U.S. official, Mexican negotiators wanted NAFTA to duplicate the safeguard provisions of CFTA. This official said that CFTA created special bilateral safeguards to protect industries from unusual surges of imports that might result from the elimination or reduction of duties under the agreement. However, U.S. negotiators wanted to relax CFTA's injury standard for bilateral safeguards. They also wanted to ensure that NAFTA members would follow well-defined procedures for taking safeguard actions, this official said.

CFTA permits bilateral safeguards only if increased imports have in fact caused serious injury to a domestic industry. The United States wanted NAFTA's standards expanded to also allow bilateral safeguards when an industry is threatened by serious injury, which is consistent with U.S. trade law, a U.S. official said. However, the United States did not want NAFTA's standards to be so permissive that bilateral safeguards could be used arbitrarily as an unjustified form of protection.

Negotiators also sought to ensure that safeguard proceedings in each country would follow open and established administrative proceedings.

According to U.S. officials, the U.S. and Canadian procedures and authorities that implement safeguards are similar, so there was no need to establish rules of procedure for safeguards in CFTA. However, Mexico has no published or detailed rules governing safeguard proceedings, U.S. officials say. U.S. officials attribute this lack to the fact that since joining GATT in 1986, Mexico has not taken any safeguard actions. In addition, officials say that the Mexican administrative system is organized and operates on a very different basis from the United States and Canada. Therefore, U.S. negotiators wanted to ensure that comparable safeguard procedures would be administered in all three countries, a U.S. official said.

NAFTA Safeguards

Certain Exemptions From GATT Safeguards

NAFTA members will retain their domestic trade laws that enable them to use safeguards sanctioned by GATT. However, under certain conditions, the importing country must exempt its NAFTA partners from multilateral import restrictions. As an improvement upon CFTA, NAFTA specifies general rules for exemption from GATT safeguards, according to a U.S. official. NAFTA's rules are flexible enough to accommodate the three countries and any additional countries that later may join NAFTA, this official added.

Bilateral Safeguards

NAFTA allows temporary bilateral safeguards when increased imports from a partner cause, or threaten to cause, serious injury as a result of duty reductions under NAFTA. NAFTA's bilateral safeguards are intended to ease business and labor's adjustment to free trade. They should reduce the potential for dislocation of workers, according to a report by the former Bush administration.

NAFTA leaves in place CFTA's bilateral safeguard provisions for the United States and Canada and creates a separate bilateral safeguard between the United States and Mexico and between Canada and Mexico. The new bilateral safeguards can be used only once per product and, in most cases, for a maximum of 3 years during the 10-year transition period of NAFTA tariff reductions. After that, bilateral safeguards can only be used by mutual agreement.

NAFTA's bilateral safeguards improve upon CFTA's in two areas, according to U.S. government and industry representatives. First, CFTA bilateral safeguards can provide an industry with temporary import relief for a maximum of 3 years; however, NAFTA will allow an additional year of relief

for highly sensitive products. These products include corn and dry beans for Mexico and orange juice and sugar for the United States. Second, CFTA required an abrupt return to the originally scheduled tariff level upon termination of the safeguard; NAFTA will allow the phase-out schedule of the tariff to be recalibrated so that the effect on the industry will be more gradual.

NAFTA addresses U.S. government concerns that bilateral safeguards be used both to prevent and to remedy import injury, yet not be imposed arbitrarily or to impede trade. It ensures that the three countries follow comparable, open procedures for administering safeguard actions.

Like CFTA, NAFTA bilateral safeguards can be used temporarily to remedy injury caused by imports. However, NAFTA bilateral safeguards can also be used to prevent injury, in that they can be applied to protect an industry that is threatened by imports. Therefore, NAFTA will permit the United States to use bilateral safeguards against Mexican imports, even if increased imports only threaten serious injury.

According to the former Bush administration, NAFTA discourages using safeguards as an arbitrary form of protection. To do so, NAFTA requires the country using a safeguard to compensate all countries whose imports are affected. If no compensation is agreed upon, the affected countries may retaliate. To retaliate, the exporting country may take trade measures of equivalent effect to compensate for the trade effect of the safeguard.

NAFTA also prescribes the procedures that members must follow in administering safeguards. This process will help ensure that safeguards are not used arbitrarily, according to a report of the former Bush administration. Open and transparent procedures must be followed before safeguards are applied. For example, in all countries, determinations of serious injury or threat of injury will be entrusted to a competent investigating authority. In the United States, this authority is the ITC. The authority must (1) hold public hearings to allow all interested parties, both foreign and domestic, to present their views on the questions of injury, threat, and remedy; (2) gather and evaluate all relevant information in an objective manner in order to make a finding of injury; and (3) publish promptly its findings and conclusions on all aspects of the investigation, a U.S. official said.

Experts Question Whether NAFTA Safeguards Will Have Extensive Use

For several reasons, experts do not believe that safeguards will be used extensively in NAFTA. They say that safeguards are not easy to invoke, they sometimes are not effective in providing relief, and they may not be necessary.

Safeguards Are Deliberately Difficult to Invoke

Safeguards are intended to be exceptional measures and, therefore, are only used when certain rigorous conditions are met. These stringent procedures make safeguard applications less prevalent than other, relatively more simple methods of restricting imports. In the United States, an investigation by ITC determines whether increased imports are a substantial cause of serious injury, or threat thereof. If ITC makes an affirmative finding, it recommends to the President a level of relief to remedy the injury. The President may then provide import relief for the industry unless he determines that doing so is not in the national economic interest.

Other methods to restrict imports are easier to use than safeguards, a U.S. official said. For example, through bilateral negotiations, a country may agree voluntarily to limit its exports of a particular product. The restrictions on Japanese exports of automobiles to the United States during the 1980s, and the Multifiber Arrangement, a long-standing network of agreements governing world textile trade, exemplify this type of agreement.

Economic researchers have found that U.S. safeguard measures have not always been effective in preventing injury to domestic industries. For example, a study by research associates at the National Bureau of Economic Research reviewed several cases in which market responses prevented U.S. safeguards from remedying import injury.[20] Country-specific protection granted the U.S. color television and nonrubber footwear industries, for example, was rendered ineffective by an increase in imports from other countries that were not subject to U.S. import restrictions. Quality upgrading, modifications to the product in order to qualify for a different tariff classification, and shifts by consumers to substitute products have also caused U.S. trade protection to be ineffective in various cases.

Like CFTA, NAFTA probably will not cause dramatic changes in bilateral trade that could trigger safeguard actions, according to U.S. officials. CFTA

[20]R.E. Baldwin and R.K. Green, "The Effects of Protection on Domestic Output," Trade Policy Issues and Empirical Analysis, ed. Robert E. Baldwin (Chicago: The University of Chicago Press, 1988).

appears to have had a small effect on the volume of bilateral trade, according to the Congressional Research Service.[21] Experts attribute this situation to the fact that, before CFTA, U.S. bilateral trade with Canada was characterized by (1) relatively low average tariff rates and (2) a substantial share of trade already free of tariffs. In addition, CFTA's extended transition period for gradual reductions in bilateral tariffs on certain sensitive products may have helped prevent disruption, a U.S. official said. CFTA's small impact on trade may be the reason why the bilateral safeguard in that agreement has not been used since CFTA entered into force, experts say.

Because U.S.-Mexico bilateral trade has similar characteristics to U.S.-Canada trade before CFTA in terms of tariff profiles, and because the main provisions of CFTA and NAFTA are similar, experts predict that NAFTA also will have a fairly small effect on U.S.-Mexico trade in the short run. NAFTA allows extended periods for phasing out tariffs. These periods are even longer than CFTA for some products. Therefore, safeguard actions may not be necessary under NAFTA, if there is no significant disruption in bilateral trade, U.S. officials say.

U.S. Industry Representatives Express Unresolved Concerns

U.S. industry representatives believe that NAFTA's safeguards have several significant shortcomings. For example, they report that NAFTA's requirement that bilateral safeguards should be set "to the minimum extent necessary to remedy or prevent the injury" contradicts their recommendation for more liberal import relief. These representatives believe that NAFTA does not sufficiently address the concerns of industries that may need to use bilateral safeguards.

However, these U.S. industry representatives believe that NAFTA has certain limited improvements over CFTA that include (1) establishing specific procedures for members to administer emergency actions, (2) expanding CFTA standards so that safeguards may be used when serious injury is threatened, and (3) allowing extended import relief for highly import-sensitive products.

NAFTA's Provisions for Standards

Setting standards is crucial to providing regulations that protect people's health, safety, and environment. In international trade, harmonization of standards and transparency of their application becomes important to facilitating a free flow of trade. The difficulty NAFTA negotiators faced was

[21] Wilson, The Canada-U.S. Free Trade Agreement.

how to eliminate standards-related barriers to trade while ensuring that no country must compromise its standards under NAFTA.

NAFTA sets out "disciplines" regarding the use of standards-related measures in order to promote safety and to protect human, animal, and plant life and health; the environment; and consumers. Both the IFAC on standards and the U.S. Industry Policy Advisory Committee have issued reports supporting NAFTA and indicating that they find the NAFTA text relating to standards acceptable.[22]

Background

In international trade, having differing technical regulations and application procedures can create real or perceived nontariff trade barriers. In effect, these barriers discourage trade rather than promote the purpose of the standard. Moreover, if Mexico, Canada, and the United States maintain and enforce different regulations, additional costs will be imposed on producers and consumers. Under those circumstances, unique or specialized equipment or certification procedures may be required for otherwise identical products in each of the three countries. Transparency, or openness of information sharing, is important in developing and implementing standards, as it is the first step to improved trade flow.

There are two general types of standards, according to a Mexican negotiator: (1) SPS that relate to foods and food product safety; and (2) technical standards for industry, which are defined as specifications that products must meet in order to ensure an acceptable level of quality or safety. Technical standards consist primarily of occupational safety and health, labor, and environmental regulations.

Negotiators' Objectives

Regarding standards-setting, NAFTA negotiators representing Mexico, Canada, and the United States agreed to three basic objectives: (1) to ensure that standards are not used as disguised barriers to trade, (2) to work toward the enhancement and compatibility of these measures in the free trade area, and (3) to facilitate trade between the three countries. An additional U.S. negotiating objective was to encourage use of international standards as a basis for national standards, since this process will make NAFTA products more globally competitive, according to a U.S. negotiator.

[22]IFAC advises the Secretary of Commerce and USTR on trade matters. In particular, IFAC provides detailed policy and technical advice regarding the effect of standards, practices, and procedures on trade agreements. IPAC is part of the Industry Consultations Program, sponsored jointly by the DOC and USTR. IPAC provides industry perspectives to USTR and the Secretary of Commerce on bilateral, multilateral, and industry issues affecting U.S. international trade.

The United States also sought assurances in the negotiations that Mexico's participation in NAFTA would not infringe on each country's right to establish and enforce the standards it deems appropriate. According to a Mexican negotiator, Mexico's objectives in the negotiations were to (1) increase its competitiveness by achieving a comprehensive standards system of its own, using NAFTA as leverage to encourage Mexico's own industry to adopt it; and (2) ensure that the United States and Canada did not maintain or create standards-related barriers to trade.

According to a U.S. negotiator, the high level of comfort enjoyed by the United States and Canada in their respective standards regulations and procedures is not shared with Mexico. While Mexico's laws and standards are comparable to those in the United States and Canada, Canadian and U.S. negotiators were concerned about Mexico's lack of transparency in standards development and the effectiveness of and budgetary support for its enforcement activities. Enforcement problems in Mexico are due largely to inadequate funds and staff rather than to inadequate laws, according to a U.S. negotiator. Therefore, because NAFTA effectively suspends and supersedes the CFTA standards provisions, concerns over the addition of Mexico into NAFTA led Canadian and U.S. negotiators to push for a more substantive chapter on standards-related measures in NAFTA than was contained in CFTA. They hoped to ensure that NAFTA would be more explicit in the obligations placed on each party.

Trade in foods and food products between Mexico and the United States has often faced barriers arising from SPS health restrictions in both countries, according to a U.S. negotiator. According to a GAO report on U.S.-Mexico agricultural trade, producers in each of the three countries are generally able to meet the other countries' sanitary standards.[23] However, in some cases the prevalence of specific plant diseases and pests in Mexican production areas has led to a U.S. import prohibition against certain Mexican agricultural commodities.[24]

NAFTA's "Disciplines" on Standard Setting

NAFTA does not establish any specific standards. U.S. negotiators never considered creating specific standards for a number of reasons, including the following: (1) The United States had no interest in putting U.S.

[23] U.S.-Mexico Trade: Trends and Impediments in Agricultural Trade.

[24] These cases include, among others, Mediterranean and Mexican fruit flies, citrus canker, and seed weevil infestation in Mexican orchard crops; bovine tuberculosis, brucellosis, and fever tick in Mexican livestock and animal products; and traces of banned pesticides or higher-than-tolerable levels of pesticide residues in fruits and vegetables.

standards on the table, where they would be subject to negotiation; and (2) the staff and funding required to harmonize even a single standard were beyond the scope of the NAFTA negotiating team. NAFTA's standards chapter is only intended to establish a framework for the development and implementation of standards-related measures. The framework is meant to ensure that these measures are transparent and do not act as a disguised barrier to trade. The important responsibility for making existing North American standards compatible is left to trilateral working groups responsible for monitoring implementation of NAFTA.

NAFTA (1) maintains each country's right to adopt, apply, and enforce the standards-related measures it considers appropriate; (2) requires SPS measures to have a scientific basis and be based on a risk assessment appropriate to the circumstances; (3) prohibits discrimination in standards applied to imported versus domestic goods; (4) requires transparency in standards development; and (5) establishes a Committee on Standards-Related Measures.

Rights to Apply Appropriate Standards-Related Measures

NAFTA clearly states that each country (including states and localities) can set the standards-related measures it considers relevant, including those that result in a higher level of protection than achieved by international standards. In order to enhance NAFTA's global competitiveness, negotiators drafted language requiring each country to use international standards as a basis for its standards-related measures. While no country may adopt standards less stringent than international standards, each may adopt standards that are more stringent.

The negotiators made it clear in the NAFTA text that any effort to make standards or SPS measures equivalent between the countries should not entail the reduction of a country's chosen level of protection, i.e., countries will not "harmonize down." U.S. and Canadian negotiators insisted that every country retain the right to prohibit the entry of imports that do not meet the standards and specifications of the importing country. NAFTA recognizes that it is inappropriate for countries to lower environmental standards to attract investment.

Under NAFTA, no country is obligated to harmonize standards, and there are no penalties if a country chooses not to harmonize them, according to a U.S. negotiator. NAFTA will help facilitate and encourage harmonization of standards but will not guarantee it. Penalties are incurred only if one country discriminates against another in applying its standards.

Scientific Basis Required for SPS Provisions

While NAFTA allows each country to choose the level of standards protection it considers appropriate, NAFTA's SPS provisions require that all health and food safety measures have a scientific basis. NAFTA recognizes that different standards systems may lead to the same level of health protection. Thus, where it can be demonstrated to the satisfaction of the importing party that an exporting NAFTA country has an equivalent health or safety system, the importing NAFTA country must allow the product to enter. The burden of proof of discrimination lies with the accusing party. However, the importing NAFTA country is not required to accept the exporting NAFTA country's measures as equivalent if the importing country has a scientific basis for disagreeing over the safety of the product.

NAFTA requires that member countries accredit conforming laboratories in other NAFTA countries on a nondiscriminatory basis if these facilities meet accreditation requirements. Countries may prohibit access of goods to their domestic markets until the required approval is granted. According to a U.S. negotiator, the lack of certification for U.S. labs by Mexico and Canada has been a significant problem for U.S. labs.

Discrimination in Standards Applied to Imported Versus Domestic Goods Prohibited

According to a U.S. negotiator, the most important aspect of NAFTA's standards chapter is the establishment of equal treatment for each country's goods. NAFTA requires countries to apply the same standards to imported goods as are applied to domestic goods. Thus, NAFTA ensures that no country will discriminate against another country's goods by using its standards as a nontariff barrier.

Transparency of Standards Development Ensured

The negotiators ensured an open process for developing product standards. Application of these standards is required to be carried out in a manner that is timely, predictable, uniform, and nondiscriminatory. According to a DOC official, there have been problems at times when U.S. exports were stopped at the border because a new law passed in Mexico had not been made available beforehand to the exporter. According to the official, it is not clear to most outsiders how the standards development and conformity assessment systems really work in Mexico. The fact that Mexico maintains fewer statistics than the United States and Canada also points out differences in transparency. Among other provisions in NAFTA's section on transparency, U.S. suppliers and other interested persons are promised advance notice of potential changes in any standards.

Committee on Standards Established

NAFTA establishes a Committee on Standards-Related Measures to (1) monitor implementation of the agreement with regard to standards, (2) explore the extent to which harmonization of standards is possible,

and (3) work toward that goal. Subcommittees and working groups will be created to deal with specific topics of interest. NAFTA provides that these subcommittees and working groups may invite the participation of scientists and representatives of interested nongovernmental organizations from the three countries. According to a U.S. negotiator, the various working groups are the crux of the standards chapter because they will facilitate technical cooperation and development of product standards in specific areas.

Advisory Committees Support NAFTA Standards Measures

The IFAC on standards believes NAFTA will greatly benefit U.S. industry and the U.S. economy, according to its report.[25] The report also stated that NAFTA will provide for functional equity and reciprocity in all standards-related areas it covers. Furthermore, the IFAC on standards noted that several concepts go beyond internationally and regionally accepted processes and procedures, including those of GATT and CFTA. However, the IFAC report also states that the purposes of the Committee on Standards-Related Measures are extremely broad and are already addressed in numerous existing forums.

IPAC also reported that NAFTA will be beneficial to the U.S. economy. The proposed NAFTA provisions on standards and testing, including sanitary and phytosanitary measures, meet the principal and overall negotiating objectives of the United States and of U.S. industry, according to its report.[26]

[25]"Report of the Industry Functional Advisory Committee for Trade in Standards on the North American Free Trade Agreement," (Washington, D.C.: Sept. 8, 1992).

[26]"North American Free Trade Agreement: The Report of the Industry Policy Advisory Committee," (Washington, D.C.: Sept. 14, 1992).

NAFTA-Related Issues

Though NAFTA will likely have only a modest net effect on the U.S. economy, it has sparked controversy over issues not traditionally negotiated in trade agreements, such as its impact on the environment, enforcement of labor standards, and migration. Furthermore, the three countries' measures taken to address these issues, both in NAFTA and in side negotiations, have not yet satisfied critics of the agreement. NAFTA contains some provisions addressing environmental issues, while complex negotiations concluded in August 1993 addressed environmental protection and workers' rights and safety.

Supporters of the agreement argue that NAFTA will enhance environmental protection by spurring economic growth in Mexico, thereby providing increased funds for environmental protection. NAFTA is also expected to encourage trilateral cooperation on environmental issues. NAFTA critics argue that increased economic activity resulting from NAFTA will exacerbate existing environmental problems, particularly along the border. Nevertheless, both critics and supporters have widely recognized NAFTA as a landmark accord on environmental issues, and it has received widespread, though qualified, support. For example, while many environmental groups support NAFTA, they wanted strong enforcement powers in the parallel environmental agreement. Some critics believe the agreement negotiated is inadequate.

Labor groups in the United States and Canada generally oppose NAFTA, while Mexican labor groups generally favor the agreement as a means for economic growth and job creation in Mexico. The main concerns of the U.S. and Canadian labor groups are that free trade with Mexico will depress wages and will lower U.S. and Canadian standards for workers' rights, health, and safety. NAFTA does not directly address these issues, but the parallel agreement negotiated in August 1993 was intended to establish oversight of labor standards and rights in the three countries.

Although NAFTA itself does not provide for open borders or the free movement of labor, there is considerable speculation over NAFTA's impact on Mexican migration to the United States and Canada. Analysts predict an increase in Mexican migration to the United States in the short run, with or without NAFTA. During this period, the rate of worker displacement in Mexico may increase as a result of short-term restructuring of the Mexican economy. However, over the long run, NAFTA should alleviate migration pressures to the extent it spurs economic development and employment opportunities.

NAFTA's Rules Related to the Environment

Though NAFTA is expected to have only a modest net effect on the U.S. economy, controversy remains over traditionally non-trade-related issues, such as NAFTA's effect on the environment, employment, and immigration. The idea that the three NAFTA countries must work to develop and implement comparable environmental laws, standards, and enforcement has been a major thrust in the negotiations and in the development of parallel plans and programs. While Mexico's environmental legislation is structurally comparable to U.S. and Canadian laws, enforcement continues to be a problem due mainly to a lack of resources, not a lack of commitment, according to an Environmental Protection Agency (EPA) official.

NAFTA has been widely recognized as a landmark accord for handling environmental issues in a trade agreement. Several major environmental groups and IPACs generally believe that NAFTA is a good effort worthy of qualified support. However, they see the necessity for environmental safeguards. Environmental groups would like to see strong enforcement powers.

Background

Neither GATT nor CFTA was designed to address environmental concerns, according to a USTR negotiator. The significance of NAFTA's environmental provisions can be shown by comparing them to GATT. It was not until 1979 that the word "environment" was incorporated into GATT in the standards code (the Agreement on Technical Barriers to Trade), according to a University of Texas at Austin report.[1] This report stated that, although GATT permits a contracting party to depart from an international standard for environmental protection, cases ruled on by GATT gave little reliable guidance in clarifying the difference between environmental measures used as trade barriers and those with substantive environmental impacts.[2] According to a U.S. negotiator, NAFTA negotiators sought to place explicit provisions in the text that would draw on and elaborate on the proposed environmental language being considered in the Uruguay Round of GATT.

[1]Jan Gilbreath, Environment and NAFTA: Changing Our Approach to Trade Policy, University of Texas at Austin; American Conference Institute (Washington, D.C.: Dec. 2, 1992).

[2]The most highly visible and controversial GATT dispute settlement to date has been the ruling against U.S. restrictions on imported Mexican tuna because of incidental dolphin kills in excess of quotas established under the U.S. Marine Mammal Protection Act. Some environmental groups believe GATT tends to harmonize standards to the lowest international common denominator.

Environmental Concerns and Negotiators' Objectives

Concerns have been raised that a free trade agreement with Mexico may exacerbate environmental problems in Mexico and along the U.S. border, and weaken U.S. environmental health and safety standards.[3] Critics charge that Mexico's enforcement of its environmental laws has been too lax and that Mexico will provide a "pollution haven" for U.S. companies that want to escape environmental enforcement in the United States or Canada. Several major environmental groups generally believed, however, that NAFTA was worth supporting, as long as a strong parallel environmental agreement was signed. Some environmental groups continue to oppose NAFTA, asserting that the recent side agreement is inadequate.[4] A September 1992 report by one IPAC concluded that free trade can only be fair trade if environmental regulation and enforcement are comparable in all countries.

Supporters of NAFTA argue that only through economic integration will there be any real impetus for environmental cooperation between the United States, Mexico, and Canada. They say that economic growth expected under NAFTA will bring about increased environmental protection through the availability of added resources and cleaner technologies, as well as the greater public attention paid to environmental quality. This position is backed by two economic studies[5] concluding that as economic growth increases, resources become available to invest in pollution control, pollutants decrease, and prosperity encourages people to place a greater value on a cleaner environment.

According to an EPA official, NAFTA negotiators have attempted to ensure that increased trade and investment between the three countries will adequately protect the environment without creating barriers to trade. U.S. and Canadian negotiators insisted on an upward harmonization of standards. As for the Mexican negotiators, their objectives were to ensure that Mexico does not become a pollution haven as a result of NAFTA. All three countries wanted to ensure that environmental regulation and enforcement practices (or their lack) are not used as an unfair foreign trade barrier. EPA has even heralded NAFTA as the "greenest" trade

[3]Such environmental problems include water shortages; air and water pollution; and insufficient sewer, wastewater treatment, and hazardous waste facilities.

[4]On June 30, 1993, a U.S. district court judge ruled that the administration must prepare an environmental impact statement for NAFTA. The judge ruled in a suit filed by three environmental groups: Public Citizen, the Sierra Club, and Friends of the Earth. The administration has appealed this decision on an expedited basis, and the appeals ruling is expected to be issued in September.

[5]World Development Report, 1992, World Bank (Washington, D.C.: 1992); and Gene M. Grossman and Alan B. Krueger, Environmental Impacts of a North American Free Trade Agreement, a paper prepared for the conference on the U.S.-Mexico Free Trade Agreement, SECOFI (Mexico City: Oct. 8, 1991).

agreement ever negotiated. According to an EPA official, NAFTA's provisions will more than adequately protect the environment and high U.S. standards—objectives that the U.S. and Canadian negotiators sought to achieve.

Mexico's Actions to Strengthen Regulation and Enforcement

While lack of resources has been a problem for Mexico's environmental protection program, Mexico has been steadily strengthening its funding and staffing for environmental protection since 1989. Mexico's extensive air, water, and hazardous waste pollution problems are deep rooted and will require sustained long-term attention, according to an IIE report.[6]

Mexico passed its first comprehensive environmental law in 1988 and is in the process of developing the implementing regulations and technical norms that provide the basis for inspection and enforcement actions. According to a 1992 report by the administration, Mexico's laws and regulations are in many respects comparable to U.S. laws and regulations, and in some cases are even stricter. However, according to an August 1992 GAO report, while Mexico has shown increasing commitment to the environment, continued increases in staffing and funding are needed.[7] The report also indicates that improvements are needed to strengthen Mexico's environmental controls on new companies.

U.S. Environmental Review

In February 1992, then-President Bush released the findings of a 9-month U.S. government review of the environmental effects of NAFTA. The review's results and recommendations informed U.S. negotiators and helped shape the U.S. negotiating position. It concluded that NAFTA will enhance environmental protection by providing Mexico with additional resources to address current environmental problems. It also said that NAFTA will (1) ease environmental pressures on the border as free trade encourages economic development to occur further south; and (2) not encourage U.S. firms to relocate to Mexico for environmental reasons, because pollution abatement costs represent a small share of total production costs in most industries; moreover, those U.S. industries with high compliance costs generally have low tariffs, so NAFTA would give them little incentive to relocate to Mexico, according to the review.

[6]Hufbauer and Schott, NAFTA: An Assessment, p. 92.

[7]See U.S.-Mexico Trade: Assessment of Mexico's Environmental Controls for New Companies (GAO/GGD-92-113, Aug. 3, 1992).

NAFTA Provisions

NAFTA's Preamble declares the resolve of the three parties to "promote sustainable development." While there is no separate environmental chapter in NAFTA, environmental provisions are contained in several chapters, according to a September 1992 administration report.[8] The report identifies the environmental provisions included in other chapters of the NAFTA text, as discussed later in this chapter. In sanitary and phytosanitary measures, NAFTA maintains each country's right to maintain, adopt, and enforce any standard it deems appropriate—so long as the country's standards are applied equally to foreign and domestic products and are based on sound scientific methods. NAFTA also permits a country to ban all nonconforming imports. In standards-related measures, NAFTA encourages parties to harmonize their health, safety, and environmental standards to the highest common denominator and allows state and local governments to impose their own tougher environmental standards. NAFTA protects international environmental agreements, and these agreements are to prevail to the extent of any inconsistency.

In investment measures, the parties commit to preventing the lowering of environmental regulations or relaxing health, safety, or environmental standards in order to attract investment. Investment measures also permit each party to impose stringent environmental requirements to ensure that investment activity in its territory is undertaken in an environmentally sensitive manner. In dispute settlement, NAFTA promotes cooperation and harmonization by establishing a Committee on Sanitary and Phytosanitary Measures and a Committee on Standards-Related Measures: the burden of proof is placed on the party challenging an environmental measure. Finally, in land transportation measures, NAFTA establishes a subcommittee to harmonize regulations on emissions and environmental pollution levels and spill-prevention standards, among others.

Parallel Actions

The specific provisions in the NAFTA text are currently supplemented by the border plan. The United States has also negotiated a parallel agreement on the environment to supplement NAFTA in the areas of pollution prevention and abatement, inspector training, commitment to resources, and regulatory enforcement. This agreement builds on the North American Commission on the Environment (NACE). NACE was created in September 1992 by the heads of the Canadian, U.S., and Mexican environmental agencies to offer advice on regional environmental issues.

[8]Report of the Administration on The North American Free Trade Agreement and Actions Taken In Fulfillment of the May 1, 1991 Commitments (Washington, D.C.: U.S. Government Printing Office, Sept. 18, 1992).

Border Plan

Released in February 1992, the Integrated Environmental Plan for the U.S.-Mexico Border Areas (border plan) is a comprehensive, multiyear program of intensified U.S.-Mexican environmental cooperation undertaken as a parallel track to NAFTA for improving human health and the environment along the border, while sustaining economic development. The border plan is based on a review of the progress under the 1983 La Paz Agreement and provides for a more integrated bilateral effort to resolve environmental problems on the border.[9] The border plan establishes a Border Environmental Advisory Committee, composed of 24 members representing various areas of the border region, and utilizes joint initiatives in such areas as enforcement, air, water, hazardous waste, pollution prevention, and emergency response.

Concerns remain regarding adequate funding of the border plan. To carry out the border plan, Mexico has committed to a $460 million program for border cleanup during 1993-95. However, former President Bush's $379-million commitment for 1993-94 for border environmental programs had not been fully funded by the Congress, as of July 1993.

Views of Environmental Groups and Advisory Committees

Most major environmental groups generally support a NAFTA supplemented with strong parallel environmental agreements. They would like to see these agreements establish a NACE with meaningful responsibilities, adequate resources, and enforcement powers. Environmentalists are optimistic that President Clinton favors an institution with broader powers and responsibilities than described by the Bush administration. The issue of sovereignty, however, has made acceptance of such trinational enforcement powers difficult.

Although NAFTA makes reference to three major international environmental agreements,[10] concern has been raised that NAFTA does not make reference to the border plan nor NACE. According to one spokesperson from a leading environmental group, without formal linkage, the border plan will not provide effective, long-term environmental protection.

[9]The 1983 Border Environment Agreement (the La Paz Agreement) provides for bilateral cooperation in addressing environmental problems in the U.S.-Mexico border area and establishes a mechanism for action.

[10]The three major international environmental agreements are the Montreal Protocol on Substances that Deplete the Ozone Layer, the Convention on International Trade in Endangered Species, and the Basle Convention on the Control of Transboundary Movements of Hazardous Waste and Their Disposal. NAFTA parties agreed to uphold the principles outlined in each.

In their respective reports to the U.S. Congress, both the IPAC and the ACTPN concluded that NAFTA's provisions for the environment were adequate to protect the North American environment, as long as strong parallel agreements are negotiated. IPAC believes that NAFTA's environmental provisions meet the principal and overall negotiating objectives of the United States and of U.S. industry. IPAC recommended, however, that separate agreements should be negotiated with Mexico and Canada that would encourage the development of comparable environmental standards and enforcement throughout North America. ACTPN stated that the environmental negotiating objectives it had established as important to achieve in the negotiations were greatly exceeded by NAFTA. ACTPN also believes that initiatives to improve environmental standards and enforcement could best be achieved in parallel with NAFTA.

Labor Issues Under NAFTA

Labor issues have become a controversial aspect of the NAFTA debate, fueled by fear of potential deleterious economic effects of closer trade relationships between countries that are at different levels of economic development. Labor issues were not, however, originally intended to be specifically addressed in the agreement. After Members of Congress and U.S. labor groups voiced their concern over labor's absence in the negotiations, the Bush administration agreed to enter into parallel agreements with Mexico on labor issues of mutual interest. The present administration sought in further negotiations to expand the parallel agreements by creating a trinational commission with power to enforce labor rights and standards. Those negotiations culminated in an August 1993 agreement that would create such a commission. President Clinton stated that the agreement fulfilled his pledge to address NAFTA's shortfalls in the area of worker rights.

Labor groups in the three countries differ in their views on NAFTA. U.S. and Canadian labor groups generally oppose NAFTA due to their fear of job loss and diminished workplace standards. Mexico's labor organizations generally favor NAFTA due to its potential to increase investment and stimulate economic growth in Mexico.

Background

Labor, in the NAFTA context, involves several different types of issues. Two of these, the economic impact of NAFTA on the U.S. workforce and U.S. trade adjustment assistance for displaced workers, are discussed in

chapter 7 of this report. Other labor issues affecting the NAFTA debate include worker rights and workplace health and safety.

The Bush administration, in a report to the Congress, stated that Mexico has strong labor protections in its constitution and laws, as well as a forceful political commitment to promoting the rights and interests of its workers. It also stated that Mexico has enforcement problems, resulting largely from inadequate resources rather than inadequate laws.

In 1991 we reported that in two areas, occupational safety and health and child labor, the United States and Mexico have similar laws protecting workers.[11] We also reported that enforcement strategies differ between the two countries. Mexico places much more emphasis on negotiating workplace solutions to identified problems than on detecting violations and applying sanctions. The U.S. Department of Labor, while seeking to encourage voluntary compliance, also attempts to target inspections to likely violators and assess civil or criminal penalties sufficient to constitute a deterrent.

Negotiators' Objectives

Although labor issues have become paramount in the debate over NAFTA, they were not originally intended to be specifically addressed in the agreement. However, both the Congress and organized labor groups expressed concern that disparities between U.S. and Mexican labor standards could lead to a loss of jobs in the United States and the diminution of workplace standards. President Bush addressed these concerns in his Response to the Congress on May 1, 1991, which included his proposal to address labor-related issues in the process of NAFTA negotiations.

The administration's NAFTA labor response highlighted three specific areas within the negotiations expected to avert injurious effects or dislocation to U.S. labor: lengthy transition periods, rules of origin, and safeguards. The response stated that U.S. negotiators would seek a transition period, during which sensitive duties and other barriers would be phased out over a period of 10 years or possibly more. It further indicated that U.S. negotiators would seek to include safeguard provisions to respond to injurious increases in imports under NAFTA and to include measures such as the "snapback" provision found in CFTA to deal with temporary import

[11] Occupational Safety and Health and Child Labor Policies of the United States and Mexico (GAO/T-HRD-91-22, Apr. 30, 1991).

surges of agricultural products during the transition period.[12] Finally, the administration stated that it would seek strict rules of origin for products to ensure that Mexico would not become a platform for third-country exports to the United States.[13]

The Bush administration's proposal to address labor issues also set out its plan to facilitate bilateral cooperation between the United States and Mexico on labor issues through agreements parallel to NAFTA. The administration's proposal included the announcement of a Memorandum of Understanding (MOU) between the Department of Labor and Mexico's Secretariat of Labor and Social Welfare. The MOU, according to the proposal, provided a framework for mutual cooperation in areas such as health and safety measures; general working conditions, including labor standards and enforcement; resolution of labor conflicts; labor statistics; and other such areas of concern.[14]

Labor Issues in the Context of NAFTA

NAFTA includes provisions in the three areas that President Bush argued would help avert injurious impact to U.S. labor. NAFTA establishes a transition period for tariff phase-outs, which extends up to 15 years for some especially sensitive U.S. goods. The agreement also has specific chapters devoted to rules of origin and safeguard procedures. These issues are discussed elsewhere in this report.

U.S.-Mexico Bilateral Cooperation on Labor

Parallel track efforts to increase cooperation between the United States and Mexico have resulted in a series of studies undertaken by both governments and the formation of a new binational commission to facilitate future cooperative efforts.

NAFTA-related labor initiatives have been placed under the framework of existing bilateral efforts. The 1991 MOU falls under the auspices of the U.S.-Mexico Binational Commission. Labor officials note that while the 1991 MOU was a result of concern over labor issues in NAFTA, activities sponsored by the commission can continue without the implementation of NAFTA.

Principal initial activities under the MOU consisted of the preparation of comparative studies. An administration report states that these studies were necessary prerequisites to the identification of priorities for attention

[12]See chapter 5 for a discussion of snapback provisions.

[13]See chapter 2 for a discussion of NAFTA's rules of origin provisions.

[14]Mexico and Canada signed a similar bilateral MOU in May 1992.

and improvement.[15] The studies include reports on U.S. and Mexican workplace health and safety systems, labor law in both countries, child labor issues, and the activities of each country's informal economy.

The United States and Mexico also collaborated on a variety of labor issues of mutual interest. These activities included the following:

- The Occupational Health and Safety Administration (OSHA) sponsored technical assistance and training programs for Mexican officials to develop an improved workforce health enforcement program.
- OSHA allowed Mexico to use OSHA laboratories for specialized sample testing not currently available in Mexico.
- The U.S. Department of Labor's Bureau of Labor Statistics worked with Mexico's Secretariat of Labor and Social Welfare to improve the collection, analysis, and international comparability of social and economic data in Mexico.

Both Department of Labor and Secretariat of Labor and Social Welfare officials told us that the MOU activities had been particularly helpful to Mexico. They permitted Mexico to use existing expertise to improve workplace health and safety more rapidly and at lower cost than would have occurred without this assistance.

Based on the success of these initiatives, the United States and Mexico entered into a new agreement designed to formulate long-term strategies to address priority labor standards and enforcement issues. The new MOU, signed in September 1992, is an extension of the original MOU, and likewise falls under the auspices of the binational commission. The main feature of the new MOU is the creation of a new Consultative Commission on Labor Matters to establish an ongoing mechanism to manage and oversee cooperative activities. According to the Bush administration, the consultative commission would provide a permanent forum to promote the rights and interests of working people in both countries.

The 1992 MOU also created new, more action-oriented initiatives in two areas—industrial hygiene and workplace safety—according to a DOC official. The two countries agreed to work to upgrade their industrial hygiene programs by developing common approaches for such issues as permissible exposure limits for airborne contaminants and hazard communication standards. The two countries likewise agreed to seek

[15] Report of the Administration on The North American Free Trade Agreement and Actions Taken in Fulfillment of the May 1, 1991 Commitments (Washington, D.C.: Government Printing Office, Sept. 18, 1992).

opportunities for greater homogeneity of regulations in the workplace safety area, through cooperative initiatives designed to prevent accidents, avoid hazardous conditions, and assure compliance.

The New Administration's Approach to Labor Issues

During the 1992 campaign, then-Governor Clinton stated his general support for NAFTA, but indicated his desire to implement NAFTA in such a way as to minimize job and income loss for U.S. workers. He called for a trinational commission on worker standards and worker safety and health needs, stating that the commission should have extensive powers to educate, train, develop minimum standards, and facilitate enforcement of current laws.

Once elected, President Clinton indicated that he would negotiate a supplemental labor agreement with Canada and Mexico before submitting implementing legislation for NAFTA. These negotiations began in March 1993, and focused on both the creation of a North American Commission on Labor and the extent of enforcement power granted to it. One U.S. proposal included the possibility of providing the commission with power to levy trade sanctions against a NAFTA partner for failure to correct persistent and unjustifiable nonenforcement of its labor laws. A Mexican proposal rejected sanctions in favor of consultations among the parties for lax enforcement of labor laws and regulations with respect to health and safety in the workplace. These complex negotiations culminated in a number of agreements among the NAFTA countries in August 1993 after we had completed our work.

Organized Labor's Reaction to NAFTA

U.S. labor groups are generally opposed to NAFTA. The Labor Advisory Committee for Trade Negotiations and Trade Policy, in its September 1992 report on NAFTA, states that it believes NAFTA would encourage the transfer of U.S. production to Mexico and reduce domestic employment and wages. With regard to the parallel labor rights and standards activities undertaken since the 1991 MOU, the committee states that "they are without substance, and can only be described as political window dressing."[16] The American Federation of Labor and Congress of Industrial Organizations also opposes NAFTA as currently negotiated. It has called for the inclusion of measures in future negotiations that provide trade sanction enforcement powers for infractions of labor rights and workplace standards.

[16] Labor Advisory Committee on the North American Free Trade Agreement, The Labor Advisory Committee for Trade Negotiations and Trade Policy (Washington, D.C.: Sept. 16, 1992).

Canadian labor groups have similar concerns about NAFTA. Canadian labor groups believe that CFTA resulted in job losses and plant relocation to the United States, and they fear that this effect will be exacerbated with passage of NAFTA. In addition, Canadian labor groups are concerned about the differences between Canadian and Mexican labor standards. A senior official from the Canadian Labor Congress told us his organization fears the pressure to harmonize Canadian labor standards with Mexico's, which in his view are inferior to Canada's. This official stated that the Labor Congress would like to see minimum occupational safety and health standards as well as independent enforcement authority incorporated into NAFTA.

Mexico's labor groups generally do not have the same concerns over NAFTA as do their counterparts in the United States and Canada. A senior official for the Confederacion de Trabajadores de Mexico, the Mexican trade union confederation with close ties to the government, told us that the confederation is in favor of NAFTA because it will attract investment to Mexico. This investment will, in turn, lead to economic growth and improved opportunities for Mexican workers. He added that NAFTA is a commercial agreement and that labor issues should not be addressed in NAFTA but rather according to each country's laws and customs. Although these views represent the majority of Mexico's organized labor, according to U.S. embassy officials, some NAFTA opposition exists. One small labor organization, the Frente Autentico del Trabajo, has linked up with U.S. and Canadian groups to oppose NAFTA. Frente officials told us they are not opposed to free trade, but are opposed to NAFTA because it infringes on Mexican sovereignty, surrenders national resources, does not acknowledge social problems, and does not recognize the economic differences within Mexico.

Immigration Issues

NAFTA does not provide for open borders or the complete freedom of movement for labor among the participating countries. Whether or not NAFTA is implemented, illegal Mexican immigration is expected to grow during the next decade due to Mexico's economic restructuring and its expanding working-age population. However, it is unclear what NAFTA's impact will be in the short run on illegal Mexican migration to the United States. In the long run, illegal Mexican migration to the United States should decrease if the Mexican economy can provide the jobs needed by an expanding domestic workforce. The implementation of NAFTA is ultimately expected to accelerate Mexico's economic development, thus helping alleviate emigration pressures.

Background

The principal immigration issue raised by NAFTA is its potential impact on illegal Mexican migration to the United States, according to a recent Congressional Research Service report.[17] Mexico is the leading source of illegal immigration, accounting for 70 percent of the 1.7-million aliens legalized by the United States under a recent program for undocumented aliens who entered the country before 1982. In addition, more than 90 percent of deportable aliens apprehended annually by the Immigration and Naturalization Service (INS) are Mexicans.[18] According to a State Department official, there are three main factors that affect Mexican immigration to the United States: (1) the wage differential between the United States and Mexico, i.e., the "push-pull" factor; (2) population growth in Mexico; and (3) the ability of the Mexican economy to provide jobs.

In 1986, the U.S. Congress addressed the issue of illegal immigration in the Immigration Reform and Control Act. This law, among other things, provided for (1) employer sanctions for the employment of illegal aliens; (2) legalization of aliens who had lived illegally in the United States since before 1982; and (3) a program to grant temporary, and later permanent, resident status to eligible aliens who had performed seasonal agricultural services in the United States for certain prescribed periods of time. Employer sanctions were intended to address the "pull" factors attracting illegal migrants here by cutting off the economic magnet of employment, according to the Congressional Research Service report.

Negotiators' Objectives

The Bush administration, in a report delivered to the Congress in May 1991 as part of a request for an extension of fast-track authority for trade agreements, stated that it shared the concerns that some Members of Congress and the private sector expressed that a NAFTA not lead to increased immigration of foreign workers.[19] The report stated that NAFTA would not require changes to U.S. immigration laws, with the possible exception of technical changes to facilitate temporary entry of certain professionals and managers, as was done under CFTA.

[17] A North American Free Trade Agreement and Immigration, Congressional Research Service, Publication 93-62EPW (Washington, D.C.: The Library of Congress, Jan. 1993).

[18] According to the Congressional Research Service, although apprehensions of undocumented aliens by INS represent the best indication of the illegal flow of aliens to the United States, they are an imperfect measure since they also reflect INS enforcement priorities and multiple arrests of the same person.

[19] Response of the Administration to Issues Raised in Connection with the Negotiation of a North American Free Trade Agreement (Washington, D.C.: U.S. Government Printing Office, May 1991).

According to a senior USTR official involved with NAFTA negotiations, none of the parties to the agreement raised the topic of the free mobility of labor as an issue for negotiation. The official told us that the exclusion of this issue from NAFTA negotiations is not unique; the free mobility of labor has never been negotiated as part of any trade agreement to which the United States is a party, including the current and previous rounds of GATT negotiations and CFTA.

NAFTA and Immigration

NAFTA does not create a common market for the movement of labor, but it does include provisions on temporary entry of business professionals (see ch. 3 of our report). The agreement will allow the United States (1) to fully maintain its rights to protect the permanent employment base of its domestic labor force; (2) to implement its own immigration policies; and (3) to protect the security of its borders. According to a report issued by the Bush administration in September 1992, increased economic growth in Mexico is the ultimate solution to reducing migratory pressures.[20] The report concluded that NAFTA will raise Mexican wages and standards of living and thus decrease pressures for illegal immigration to the United States. This conclusion is consistent with the May 1991 report in which the administration presented the following quote attributed to President Salinas of Mexico: "[M]ore jobs will mean higher wages in Mexico, and this in turn will mean fewer migrants to the United States and Canada. We want to export goods, not people."

Impact of NAFTA on Mexican Immigration Flows to the United States

Determining future Mexican migration flows to the United States is problematic because of the numerous factors that must be considered, including the economic situations in both countries. Nonetheless, experts have reached several conclusions. With or without NAFTA, illegal Mexican migration to the United States is expected to increase during the next decade because of probable displacements resulting from Mexico's unilateral economic restructuring and the expansion of its working-age population. The short-run impact of NAFTA on illegal Mexican migration to the United States is unclear. In the long run, however, illegal Mexican migration to the United States should be less than it would be without NAFTA because implementation of the agreement is expected to accelerate Mexico's economic growth, thereby creating the jobs needed by an expanding domestic workforce.

[20] Report of the Administration on The North American Free Trade Agreement and Actions Taken in Fulfillment of the May 1, 1991 Commitments.

Migration Will Likely Increase in the Short Run Regardless of NAFTA

Recent studies indicate that, apart from NAFTA considerations, migration from Mexico to the United States will increase. For the remainder of this decade, rural Mexican migration, which plays a disproportionate role in migration to the United States, is not likely to slow because of three factors, according to one study we reviewed.[21] These factors include (1) the still-expanding, labor-intensive U.S. agricultural sector, which should continue to pull Mexican workers into the United States;[22] (2) the Mexican supply-push pressures that propelled rural Mexicans northward in the 1980s, which should remain high in the 1990s; and (3) the sophisticated networks that are in place bringing rural Mexicans legally and illegally into the United States.

An INS official told us that with or without NAFTA there will be an increase in illegal Mexican migration to the United States in the short run. This official stated that continued development along the U.S.-Mexico border, combined with an expanding working-age population in Mexico, will increase the pressures on Mexicans to enter the United States illegally to look for employment. Without sustainable growth in Mexico, illegal migration to the United States will not likely decrease in the foreseeable future.

A recent report by OTA also stresses the factor of Mexico's population structure.[23] Although the Mexican birthrate has fallen, the report notes that more than half of all Mexicans are under the age of 20, and the population is growing at a rate that will double every 30 years or so. Thus, even if fertility rates dropped to replacement levels, Mexico's population would continue to increase for several decades as young people entered their reproductive years. The report also notes that (1) unless unemployment and underemployment come down, and wages rise, pressures to emigrate could grow rather than diminish; and (2) it seems highly unlikely that Mexico's economy could expand fast enough by the year 2000 to absorb all new labor force entrants.

[21]Philip Martin, et al., National Commission for Employment Policy, The Employment Effects of the North American Free Trade Agreement: Recommendations and Background Studies, Special Report No. 33 (Washington, D.C.: Oct. 1992).

[22]However, a State Department official cited a November 1992 report by the Immigration Reform and Control Act Commission on Agricultural Workers that noted a U.S. oversupply of agricultural labor—much of it illegal. But, according to Martin, the Commission on Agricultural Workers also concluded that the U.S. fruit and vegetable industry will continue to expand in the 1990s regardless of NAFTA, and that even a stable U.S. agricultural labor market can be an important port of entry for immigrants.

[23]U.S.-Mexico Trade: Pulling Together or Pulling Apart?

In addition, Mexico's restructuring of the "ejido" (small communal farm) system is expected to greatly increase the speed of outmigration from the rural areas. In January 1992, the Salinas administration implemented a land reform program, aimed at improving productivity in the agriculture sector through changes in laws governing land ownership and use. According to immigration analyst Sherman Robinson, Mexico's unilateral agricultural restructuring measures will tend to drive subsistence farmers and low-productivity farm laborers out of this sector.[24] Some of these workers will migrate to the United States. It is important to note in this context that the Mexican government has undertaken or is planning to undertake measures to manage the restructuring of the ejido system. For example, an adjustment assistance program is being developed for displaced agricultural workers. In addition, the government has instituted programs aimed at keeping rural children in school, rather than having them drop out and move to the cities or the United States.

NAFTA's Impact on Migration in the Short Run Is Unclear

It is unclear whether NAFTA will increase migration flows from Mexico to the United States in the short run. A study performed by a bipartisan commission created under the Immigration Reform and Control Act to examine the conditions in Mexico and other Western Hemisphere countries that contribute to illegal migration to the United States, emphasized that expanded trade and development should be viewed as a long-term solution to this problem.[25] Although the study specifically recommended, among other things, the development of a North American free trade area, it found a major paradox in that "economic development in the short term stimulates migration by raising expectations and enhancing people's ability to migrate." According to some experts, NAFTA, by accelerating Mexico's economic restructuring, will increase in the short run the speed at which Mexican workers are displaced. Some of these displaced workers are expected to migrate to the United States.

However, some experts hold a different view on NAFTA's short-run impact on Mexican migration. According to a State Department official, Mexican migration to the United States may increase during this time period only if the restructuring of the Mexican economy (which, as noted, is ongoing with or without NAFTA) disproportionately affects agricultural workers.

[24]Sherman Robinson is an academic who is currently working for the Council of Economic Advisers and who has written a number of studies dealing with Mexican immigration. See, for example, Raul Hinojosa-Ojeda and Sherman Robinson, "Labor Issues in a North American Free Trade Area," North American Free Trade: Assessing the Impact (Washington, D.C.: The Brookings Institution, 1992).

[25]Unauthorized Migration: An Economic Development Response, Report of the Commission for the Study of International Migration and Cooperative Economic Development (Washington, D.C.: U.S. Government Printing Office, July 1990).

NAFTA provides for a 15-year phase-in period for complete trade liberalization (i.e., removal of all quotas and tariffs) in Mexico's most import-sensitive agricultural sectors. This lengthy transition period is intended, among other things, to allow marginal farmers displaced from their lands as a result of NAFTA to find jobs in a growing Mexican industrial sector, thus decreasing emigration pressures. However, according to Robinson, the Mexican government's unilateral agricultural restructuring measures will tend to cause subsistence farmers and low-productivity farm laborers to leave agriculture more quickly than the effects of NAFTA's gradual trade liberalization are realized. Thus, the likely increase in Mexican migration flows to the United States during the coming decade should not be viewed as NAFTA induced.

NAFTA May Decrease Mexican Migration in the Long Run

There is broad consensus among the reports we reviewed and the experts we spoke with that, without NAFTA, the United States will probably be confronted with a worsening of the problem of illegal Mexican migration. For example, Philip Martin concluded in his study that without a NAFTA-stimulated trade and investment boom in Mexico, the United States is likely to receive a large number of Mexican immigrants in the 1990s and another large flow in the first decade of the 21st century. NAFTA, on the other hand, can attract foreign investment and generate jobs in Mexico, and this situation should accelerate the country's economic development. This accelerated development, according to the study, can help to diminish the factors that increased Mexican migration to the United States in the 1980s.[26]

It is unclear how long it will take Mexico to attain its modernization goals. Robinson agrees with the view that even with NAFTA, there will be a period, possibly as long as 15 years, before Mexico's economic transformation results in the creation of enough jobs to greatly reduce emigration pressures. A report issued by ITC in February 1991 stated that "as wage differentials between the United States and Mexico narrow, the incentive for migration from Mexico to the United States will decline."[27] However, the report did not estimate how long it will take to narrow the wage gap to the extent necessary to decrease migration. Philip Martin believes that incomes and wages in the United States and Mexico do not need to be equalized in order to keep Mexicans at home. The experience of the European Community demonstrates that economic integration can prevent migration despite economic differences among nations. A NAFTA

[26]For example, according to Martin, if NAFTA encourages U.S. fruit and vegetable production or shoe making to shift to Mexico, there should be less of a U.S. demand-pull and a Mexican supply-push.

[27]The Likely Impact on the United States of a Free Trade Agreement With Mexico.

that (1) narrows the gap on unemployment and underemployment rates between the two nations to 2 to 1; (2) reduces the wage ratio to 4 or 5 to 1; and (3) causes wages to rise faster in Mexico than in the United States can drastically reduce migration for employment long before job opportunities and wages are completely equalized in the two countries, according to Martin.

Likely Economic Impacts of NAFTA

NAFTA has generated a heated public debate in the United States. In our review of about 20 studies assessing the probable economic effects of NAFTA, we found that proponents of the agreement point to the potential benefits of closer economic integration among the United States, Canada, and Mexico. These proponents note that economic gains are likely to be modest in the United States and Canada but substantial for Mexico.

On the other hand, opponents argue that NAFTA could intensify the problems of the ongoing integration of the U.S. and the Mexican economies. They are particularly concerned about the possible adverse effect NAFTA could have on the job prospects of unskilled laborers in the United States. Since Mexican workers are generally paid much lower wages, the potential for U.S. plant closures and relocations to Mexico could intensify wage competition in the United States and lead to lower real earnings for unskilled workers in the United States. And, as plants shut down, dislocated workers may not easily regain employment.

The United States has two major federal programs to help dislocated workers make the transition to new employment—the Trade Adjustment Assistance (TAA) program and the Economic Dislocation and Worker Adjustment Assistance (EDWAA) program. In addition, in August 1992, the Bush administration proposed a new worker adjustment program—Advancing Skills Through Education and Training Services —that would combine elements from TAA and EDWAA. President Clinton is also expected to propose a comprehensive program for dislocated workers. We believe that such a program is needed to correct the problems of existing programs and simplify the delivery of appropriate services to workers in a timely manner.

Most Models Predict Gains for All Three Countries

Overview of Studies' Analyses

Analysts of NAFTA's possible effects take three approaches: they use a general equilibrium model, a macroeconometric model, and/or informal analysis. Most of the studies we reviewed apply formal general equilibrium models that simulate the effects of policy changes associated with NAFTA and compare them to a base-year scenario without NAFTA to estimate

NAFTA's impact.[1] Two of these studies, DRI/McGraw-Hill (a macroeconometric forecasting firm) and the Clopper Almon study, use macroeconometric models to forecast the future economic environment with and without NAFTA. Both the general equilibrium models and the macroeconometric models are somewhat restricted by the features of their respective model structures. The third approach uses informal analyses that apply historical and extrapolated relations among economic variables to estimate NAFTA's impact.

The results of analyses from the general equilibrium models are sensitive to different assumptions made in the models. As assumptions change on the amount of future foreign investment in Mexico and the effect of that new investment on the United States, the estimated economic impacts differ. Similarly, the models are sensitive to assumptions regarding the existence of "increasing returns to scale" in production.[2] They are also sensitive to assumptions on the extent to which trade expansion will be achieved through displacing exports of nonmember countries to the NAFTA bloc (known as the "trade diversion effect"). In addition, the projected size of Mexican emigration to the United States would also significantly affect these models' assessments.

General equilibrium models in our survey have not incorporated all the important potential impacts of NAFTA on member countries' economies. For example, neither NAFTA's effect on the peso-dollar exchange rate nor Mexican dynamic productivity gains have been adequately accounted for or estimated. These models also do not estimate the amount of foreign capital inflow to Mexico due to NAFTA. Instead, some models assume an amount for total foreign capital inflow to Mexico. Estimating NAFTA's effect on the exchange rate without a good prediction of international capital flows would lead to unreliable results. Therefore, many policy analysts consider the contribution of these models to NAFTA policy debate as limited. They note that these models at their current state of development only provide a limited improvement over the reliability of predictions that can be drawn from simple international trade theory.[3]

[1]The studies included papers presented at the ITC symposium and at The Brookings Institution's conference in 1992; analyses requested by the National Commission for Employment Policy in 1992; and studies conducted at IIE, EPI, and ESI in 1992 (see app. I for a detailed discussion of each study).

[2]"Increasing returns to scale" refers to unit production cost savings due to output expansion. This concept is also known as the "economies of scale."

[3]OTA also shares this view. See U.S.-Mexico Trade: Pulling Together or Pulling Apart? For more detailed discussions of the models' limitations and conclusions that can be drawn from them, see Estimating the Effects of NAFTA: An Assessment of the Economic Models and Other Empirical Studies (Washington, D.C.: Congressional Budget Office, June 1993).

Modest Gains Anticipated for U.S. and Canadian Economies but Larger Gains for Mexico

Economists generally agree that, in theory, freer trade among the three nations would allow economic resources to be reallocated to better reflect each country's comparative advantage. In this scenario, relatively more efficient sectors within each country would potentially expand, and relatively less efficient sectors would contract. This shift would likely lead to higher national productivity and real income. In addition, jobs would be created in the expanding sectors but lost in the contracting ones. Regions would be affected unevenly as well.

In estimating the effects of freer trade, the general equilibrium models and macroeconometric models resulted in limited gains for the U.S. and Canadian economies if NAFTA is implemented. According to the ITC's symposium synthesis, NAFTA would result in additional economic growth of less than one-half percent of GNP for these economies.[4] This small result was explained by (1) the currently low trade and investment barriers between the United States and Canada, allowing for generally free movement of goods and services; and (2) the limited immediate gains from expanded exports to Mexico because of Mexico's small size relative to the U.S. economy. For Mexico, however, the ITC symposium reported an estimated benefit of up to 11 percent under the most optimistic scenario.

Due to NAFTA, Mexico's relatively small GNP is expected to increase more significantly than that of the United States or Canada. International investors are likely to have greater confidence in Mexico's improved economic and political stability;[5] a NAFTA agreement can make the liberalization of the Mexican economy less reversible. With increased confidence, foreign investment is likely to increase, accelerating Mexico's economic development and narrowing its gaps in technological know-how and labor productivity.

According to the ITC synthesis, derived mostly from general equilibrium models, aggregate gains in employment are likely to be less than 1 percent for the United States and Canada. On the other hand, Mexico is expected to post employment growth of up to 7 percent. As for the anticipated increase in average real wages, the ITC synthesis predicts less than 0.3 percent growth for the United States, less than 0.5 percent growth for Canada, but from 0.7 to 16.2 percent growth for Mexico.

[4]In general these results from general equilibrium models should be interpreted as if NAFTA provisions were implemented all at once.

[5]In addition, as a smaller developing country, Mexico would also have more opportunity than the United States or Canada to benefit from economies of scale, because some Mexican firms that produced mainly for the smaller domestic market in the past would be able to produce for the larger North American market under NAFTA.

Possible Adverse Impact on U.S. Economy

A few studies, such as those by EPI and ESI, say that the U.S. economy may not fare well with Mexican competition, especially if Mexico becomes an export platform for non-NAFTA countries trying to gain improved access to the U.S. market. And, U.S. unskilled labor may not adjust smoothly to dislocations. The two studies estimate that gross U.S. job dislocations will be in the range of one-half million to 1 million people. This estimate represents less than 1 percent of the U.S. labor force.

One study, using the Stolper-Samuelson theorem, estimates an annual income loss of $1,900 for U.S. unskilled labor.[6] However, other international trade experts point out that the theorem does not allow for economies of scale. The study also implicitly assumes that the Mexican economy will be as large as the U.S. economy, thus overstating the adverse impact on U.S. wages.

Proposals to Assist Dislocated U.S. Workers

The last 15 years have been difficult ones for the U.S. labor force. Average hourly compensation, adjusted for inflation, has been stagnant. While recognizing the advantages that increased trade may give the U.S. economy in general, workers in import-sensitive industries are suspicious of NAFTA's possible impact.

The United States has two major federal programs to aid the adjustment for workers who have lost their jobs: TAA helps workers dislocated because of increased imports, while EDWAA authorizes services to all dislocated workers, regardless of the reason for their job loss. The two programs offer similar services, including providing economic resources for training, job search, and placement assistance. In addition, individuals eligible for TAA can receive income support payments for up to 1 year after the expiration of their unemployment insurance. In 1990, 38,500 people received TAA-related benefits, at a cost of $150 million. In addition 288,000 workers received EDWAA benefits in that year, at a cost of $390 million.

GAO analysis of the two programs in 1992 revealed shortcomings that included delays in providing assistance to participants, limitations in the services offered, and inadequacy in tailoring services to meet the specific

[6]See Edward E. Leamer, "Wage Effects of a U.S. Mexican Free Trade Agreement" (unpublished paper, University of California-Los Angeles, 1992). The Stolper-Samuelson theorem predicts that freer trade would lower the real payment to factors used relatively more in the import-competing sectors (such as low-skilled labor in the United States) and increase the payments to factors used relatively more in the export sectors (such as capital in the United States). Due to competition among sectors within each country, these effects on productive factors will go beyond the sectors directly affected.

needs of individual participants.[7] Further, a study by two labor economists estimated that the programs were only reaching one-fifth of the individuals who were potentially eligible for services.[8] The economists were unsure whether the shortfall was due to inadequate funding or to perceptions that the two programs were unhelpful.

On August 24, 1992, then-President Bush, in response to congressional concern about NAFTA, proposed creating the Advanced Skills Through Education and Training Services program. Its goal was to combine elements from both TAA and EDWAA, and it was to have a funding level of $2 billion annually. This level was more than double the existing funding for worker adjustment assistance. Of the $2 billion, $335 million was specifically reserved for NAFTA-related worker displacement assistance, with an additional $335 million to be available if needed. President Clinton has requested more than $1.9 billion for EDWAA in fiscal year 1994 and is expected to propose a comprehensive program for dislocated workers.

We believe that a comprehensive dislocated worker assistance program is needed to correct the problems of existing worker displacement programs.[9] Further, we believe that combining the two programs should eliminate confusion about eligibility and simplify the delivery of services. However, program development efforts would be needed to resolve the remaining problems of tailoring services to the needs of individual workers and delivering those services in a timely manner.

Research by the Organization for Economic Cooperation and Development and others, concerning the best method of aiding dislocated workers, has found that services that assist workers in their job searches were the most useful. Assistance that is implemented early, ideally before workers have lost their jobs, had the greatest likelihood of success. Therefore, we believe that any new U.S. worker assistance program should keep these points in mind.

Liberalized trade is generally considered important to the long-run health of the U.S. economy, and thus it has long been U.S. policy to seek to remove trade barriers and promote "transparency" of trade rules. Disruption, adjustment, and change are inevitable in a dynamic economy, providing new opportunities for reallocating investment and employment

[7]See Dislocated Workers: Comparison of Programs (GAO/T-HRD-92-57, Sept. 10, 1992), and Dislocated Workers: Comparison of Assistance Programs (GAO/HRD-92-153BR, Sept. 10, 1992).

[8]Robert W. Bednarzik and Malcolm Lovell, U.S. Labor Market Adjustment Programs (Draft report presented to a meeting of the Competitiveness Policy Council, Jan. 7, 1992).

[9]See Dislocated Workers: Comparison of Programs.

that improve economic efficiency. These adjustments will occur, indeed are occurring, whether NAFTA is implemented or not. According to the Organization for Economic Cooperation and Development, attempts to refrain from adjustment are the real threat to employment. A healthy economy must have the ability to change and redirect economic resources and people to its most efficient and productive sectors in order to grow and create new employment.

The benefits realized by society as a whole from such change are accompanied by costs, however, some of which fall heavily on certain sectors of the economy and labor force. Consequently, trade liberalization without specific programs to help those that are injured means that the benefits are spread broadly across the economy, while certain groups bear a disproportionate share of the cost. Therefore, if NAFTA is ratified, policymakers should also consider making a strong commitment to an effective, well-funded worker adjustment assistance program to aid those who will most bear the burden of adjustment.

North American Free Trade Agreement's Economic Impacts

Historical Background

The United States and Canada have historically maintained close economic ties by engaging in trade across the border and investing in each other's economy. These ties have been further strengthened under the 1989 U.S.-Canada Free Trade Agreement (CFTA). In contrast, Mexico from time to time has pursued an inward-oriented economic policy under the influence of socialistic or nationalistic governments. Not until 1990 did Mexico favorably consider the idea of a free trade agreement with the United States. This change in attitude occurred after the Mexican government unilaterally liberalized its trade regime and economic system in response to its debt crisis of 1982.

Since Mexico's economic liberalization, bilateral trade with the United States has grown very rapidly. U.S. investment in Mexico has also increased substantially. A large share of these activities is related to Mexico's maquiladora program. Under the program, manufacturing plants were granted tariff exemptions by the Mexican government on imported equipment and material inputs. Maquiladoras also have benefited from special U.S. tariff provisions (currently sections 9802.00.60 and 9802.00.80 of the Harmonized Tariff Schedule).[1] These provisions allow goods to enter the United States with tariffs only on the foreign value added and not on the total value of goods made with U.S. components. Thus, U.S. made parts are permitted to reenter duty free after they have been processed into new products.

The tariff exemptions granted by both countries provide some incentive to integrate the economic activities of the two nations, i.e., to increase trade and coproduction among the two nations. However, the growth of maquiladora plants subsided somewhat during the years after the two oil shocks in the 1970s, and it has only regained impetus since the mid-1980s. These operations accounted for 46.3 percent of Mexican exports to the United States and 31.8 percent of Mexican imports from the United States in 1991. Many analysts believe that the North American Free Trade Agreement (NAFTA) will continue to intensify the trend toward economic integration brought about by the maquiladora phenomenon and Mexico's economic liberalization.

The maquiladora industries have provided a number of benefits to the Mexican economy. In addition to creating jobs, they have played a major role in earning the foreign currencies needed to make payment on

[1]The Harmonized Tariff Schedule's subheading 9802.00.60 sets forth tariff treatment for "certain metal of U.S. origin processed in a foreign location and returned to the United States for further processing." Subheading 9802.00.80 provides tariff treatment for "eligible imported goods that contain U.S.-made components."

Mexico's extensive foreign debt. Some believe that Mexico has also gained by having its workers trained by multinational corporations and by having access to and learning the new technologies that the foreign partners introduced.

Not all analysts agree about the costs and the benefits to the United States that result from this economic integration. Some argue that such integration, encouraged by the maquiladora program, helps U.S. industries cut production costs and increase competitiveness by moving some assembly operations to Mexico. They view this action as part of an inevitable trend toward globalization. Without this integration, analysts say, some operations would have to move to other countries or disband. They also believe that economic integration may help to save some high-skilled jobs in the United States, especially in sectors in which Mexico has not developed expertise.

However, organized labor has argued that such integration already has led to the loss of U.S. jobs, depressed U.S. wages, and provided an incentive for companies to evade U.S. health and safety standards. Labor has also maintained that the U.S. government is encouraging further job losses through its special tariff provisions.

Debate About NAFTA

Similar public debate has occurred over the likely impact of NAFTA. Proponents point to potential economic benefits from the largest single market (in terms of combined gross national product (GNP)) in the world to be formed under NAFTA. NAFTA may help export sectors that can withstand stronger competition from partner countries after further trade liberalization. It may also increase continental economic efficiency (i.e., the more efficient use of productive factors, including labor and capital, in the NAFTA bloc). The countries may also benefit from economies of scale, productivity gains, and strengthened competitiveness that could increase economic growth over the long run.

Opponents argue that accelerated economic integration under NAFTA may lead to a drastic shift in trade patterns and investment flows away from the United States to Mexico. They argue that this shift might mainly benefit Mexico while resulting in economic, social, and environmental problems for the United States.[2] The international academic community generally agrees that because Mexico is a developing nation, it will benefit

[2]This view was summarized in U.S. Employment Effects of a North American Free Trade Agreement: A Survey of Issues and Estimated Employment Effects, Bureau of International Labor Affairs, Department of Labor, Economic Discussion Paper 40 (Washington, D.C.: July 1992).

more from such an agreement than the United States. Moreover, opponents believe the liberalization of Mexican investment restrictions may attract a large inflow of foreign investment that might otherwise have gone to or stayed in the United States. Therefore, much of the current debate is focused on NAFTA's impacts on the U.S. economy, particularly on NAFTA's likely effects on U.S. wage rates and employment opportunities for less-skilled labor.

Economic Analyses Prepared at Various Stages of NAFTA Consideration

When the Bush administration requested an extension in May 1991 of "fast-track" authority to negotiate NAFTA, it cited three major economic analyses that addressed the possible benefits of a free trade agreement with Mexico: a 1991 International Trade Commission (ITC) study, a Clopper Almon study, and a KPMG Peat Marwick study. The Economic Policy Institute (EPI) and the Economic Strategy Institute (ESI) also released studies around that time. The latter studies have negative assessments of NAFTA's likely impact on the United States. Analyses released later, in 1992, include one study from the Institute for International Economics (IIE), several studies covered in an ITC symposium and a Brookings Institution conference, and three studies commissioned by the National Commission for Employment Policy. These studies are summarized in the following sections.

1991 ITC Study[3]

The 1991 ITC study provides qualitative analysis without formally quantifying the economic impacts. It draws upon partial equilibrium models of industrial sectors and a small Computable General Equilibrium (CGE) model to assess NAFTA's implications for U.S. workers.[4] Effects on workers are derived through effects on trade and output. The study also incorporates experts' opinions gained through interviews. It concludes that overall, a free trade agreement with Mexico would benefit the U.S. economy. However, it says that the benefits are likely to be small in the near to medium term, and a free trade agreement could cause some shifts in employment among sectors and occupations. It maintains that real income and wages of U.S. workers (high- and low-skilled combined) would gain moderately even though low-skilled workers' real income is

[3]The Likely Impact on the United States of a Free Trade Agreement with Mexico, U.S. ITC Publication 2353 (Washington, D.C.: Feb. 1991).

[4]A CGE model is a simplified representation of the economy that simultaneously determines prices and quantities in all sectors to satisfy equilibrium conditions. The use of CGE models involves the selection of a base year for analysis and assigning parameters for various economic behaviors (e.g., demand elasticities, production technology, and pricing principles). Results are generated using pre- and post-policy change specifications.

likely to fall.[5] According to the study, U.S. industries likely to gain include grains and oilseeds, electrical equipment, machinery, steel, and chemicals. Industries likely to lose are horticulture, tuna, and inexpensive household glassware.

Clopper Almon Study[6]

The Almon study utilizes two separate macroeconomic models (for the United States and for Mexico) linked through import share relations. These are multisectoral macro models estimated by an econometric method using historical data. Both models include more than 70 sectors. Econometric models have the merit of estimating economic relations with empirical data; however, they often do not emphasize the microeconomic equilibrium conditions that prevail in most CGE models. Therefore, they may be better suited to forecast short-term rather than long-term results. They are often useful in estimating near-term job losses since they allow for unemployment (disequilibrium) in the labor market.

The Almon study forecasts one scenario with a free trade agreement and another without such an agreement, for 1989 to the year 2000. The difference between results of these scenarios yields an estimate of NAFTA's impacts. Tariffs are assumed to be eliminated immediately, while some nontariff barriers are assumed to be gradually eliminated for major sectors in the scenario with a free trade agreement. The model incorporates neither large increases in capital inflows to Mexico that may result from its investment liberalization nor the possible productivity improvement brought about by these new inflows. While this study is useful in identifying the pattern of industrial impacts, its quantitative results are debatable due to the two omissions previously mentioned.

The Almon study estimates that trade liberalization eliminating tariff and nontariff barriers is likely to lead to a moderate increase in growth of U.S. GNP (0.09 percent after 5 years and 0.17 percent after 10 years) and some net increase in U.S. employment opportunities (44,500 jobs after 5 years and 63,200 jobs after 10 years). The study concludes that Mexican GNP will

[5]ITC has illustrated some plausible scenarios under which low-skilled workers' real income can increase.

[6]Industrial Effects of a Free Trade Agreement between Mexico and the U.S.A., an INFORUM report prepared for the U.S. Department of Labor, Bureau of International Labor Affairs (Clopper Almon, principal investigator) (Washington, D.C.: Sept. 1990).

decline slightly, due to a large increase in its bilateral trade deficit that is not offset by any increase in its foreign direct investment inflow.[7]

U.S. industries likely to gain (in terms of employment) from a free trade agreement identified in this study include agriculture, rubber and plastic products, computers, motor vehicles, electric appliances, metal products, communication machines, and metal working machines. Those likely to lose include apparel, construction, lumber, furniture, television, and radio.

KPMG Peat Marwick Study[8]

The KPMG Peat Marwick study uses two linked CGE models, each with 44 sectors for the economy (i.e., U.S. or Mexican). Taking 1988 as a base year, the study estimates the impacts of a free trade agreement on wages, income, rates of return to capital, exports, and imports for the base year. Tariffs and nontariff barriers are assumed to be eliminated in the scenarios with a free trade agreement. One scenario assumes no additional capital inflow to Mexico, and another scenario assumes an additional $25 billion of capital inflows to Mexico. The increase in capital inflows to Mexico is assumed to have caused no decrease in U.S. investment. Under both scenarios, the study concludes that a small benefit would accrue to the United States. U.S. real income would increase by 0.02 percent or 0.04 percent (depending on the scenario, with larger impacts associated with the scenario including additional capital inflow to Mexico), real wages would increase by 0.02 percent or 0.03 percent, and the real rate of return on capital would increase by 0.03 percent or 0.07 percent. Mexico would gain particularly from additional capital inflows. Its real income would grow from 0.32 percent to 4.64 percent. Full employment is assumed in most scenarios. The study also changes the full employment assumption in one experiment. If real wages are assumed to remain unchanged, the model estimates a job increase of 40,800 or 61,000 for the United States and 188,000 (0.85 percent of the labor force) or 1,460,000 (6.6 percent) for Mexico. U.S. exports to Mexico are estimated to increase at a faster rate than U.S. imports from Mexico in the scenario without additional capital inflows to Mexico. In the scenario with $25-billion

[7]In estimating the bilateral trade impacts of NAFTA, the study first computed the effects of tariff removals on average import prices of the two nations, then estimated the impacts on the total imports of each nation. The impacts on bilateral trade were then estimated with countries' import share data. Mexican imports from the United States are anticipated to increase relatively more than U.S. imports from Mexico due to two factors. First, Mexico has higher tariffs and nontariff trade barriers than the United States. Second, U.S. shares of Mexican imports are far greater than Mexican shares of U.S. imports.

[8]Analysis of Economic Effects of a Free Trade Area Between the United States and Mexico, KPMG Peat Marwick, Policy Economics Group (prepared for the U.S. Council of the Mexico-U.S. Business Committee) (Washington, D.C.: 1991).

additional capital inflows to Mexico, Mexican exports to the United States are expected to grow at twice the rate of its imports from the United States, and the United States would have a bilateral trade deficit of $20 billion or more. The study includes the effect of trade diversion.[9]

The study identifies machinery, motor vehicles and bodies, chemicals, and food products as "gaining" sectors, and sugar refining, fruits and vegetables, electronic components, computer equipment, apparel, construction, and household appliance sectors as losing industries in the United States.

EPI Study[10]

Both the EPI study and the ESI study have negative assessments of NAFTA's likely impact on the United States. They challenge the assumption that new investment in Mexico would not come at the expense of investment in the United States.

The EPI study reports the simulation result from a version of the CGE model developed by Raul Hinojosa-Ojeda and Robert K. McCleery. The model is a highly aggregated one covering only two countries, two commodities, and two types of labor (a high wage and a low wage). The model emphasizes the interaction of trade, migration, and capital flows between sectors in each country. It assumes full employment but estimates changes in U.S. job opportunities by measuring the changes in Mexican emigration to the United States. In a scenario that assumes a $44-billion increase in U.S. foreign direct investment to Mexico at the expense of U.S. domestic investment, 550,000 U.S. workers (about 0.45 percent of the workforce) are estimated to be dislocated. Since the model assumes they are rehired later at half of their previous pay, U.S. gross domestic product (GDP) is estimated to fall by $36 billion (about 0.6 percent of gross domestic product.

Limited by the assumption that only two countries exist in the world (i.e., Mexico and the United States), this version of the model does not include the trade or investment diversion effect. As a result, the model assumes

[9]"Trade diversion" refers to the situation in which imports from free trade agreement member countries increase, displacing (or substituting) imports from nonmember countries. As a result, increased imports from Mexico will not come on a one-to-one basis at the expense of U.S. domestic production.

[10]Jeff Faux and William Spriggs, U.S. Jobs and the Mexico Trade Proposal, Briefing Paper, Economic Policy Institute (Washington, D.C.: May 1991); William E. Spriggs, Potential Effects of Direct Foreign Investment Shifts Due to the Proposed U.S.-Mexico Free Trade Agreement, Economic Policy Institute testimony before the Subcommittee on Commerce, Consumer Protection, and Competitiveness, Committee on Energy and Commerce, U.S. House of Representatives, May 15, 1991.

that foreign investment in Mexico will increase at the expense of investment in the United States on a one-to-one basis.[11] These two assumptions tend to overstate the adverse impact on the U.S. economy. EPI released two more papers in the fall of 1992.[12] Similar problems prevail in these analyses, which do not use a formal general equilibrium model.

The EPI model is a highly aggregated one, with other simplifying assumptions, including perfect competition and "constant returns to scale."[13] It is not feasible for us to determine the validity of these assumptions. In addition, the model does not represent the real world in sufficient detail to provide a good estimation for policy debate.

ESI Study[14]

The ESI study emphasizes the potential increase of foreign investment in export-oriented industries of Mexico. It also emphasizes Mexico's potential role as an "export platform" by which Asian exporters may gain access to the U.S. market. The study questions many U.S. analysts' understanding of the Mexican economic system and the nature of its liberalization. It believes that certain aspects of Mexico's approach to development have been overlooked by U.S. analysts. For instance, Mexico may target strategic industries and encourage foreign investors to bring in higher technology and training for labor. More specifically, the study challenges the assumption that Mexico will continue to rely on U.S. investment and also on imported parts and materials from the United States. Also challenged is the assumption that Mexican productivity growth will not be a threat to the U.S. economy.

The ESI study estimates NAFTA's economic effects, using sectoral output-to-capital ratios. It estimates bilateral trade effects using historical market share data. Job impacts for the United States are computed with a jobs-per-billion-dollar exports ratio (a ratio of 30,000 jobs for each

[11]The EPI paper implies this result. However, McCleery presented a different version of the model in the ITC symposium later in February 1992. He assumed the investment diversion effect was only 50 percent (instead of one to one, 100 percent) in his later version.

[12]Robert A. Blecker and William E. Spriggs, "Manufacturing Employment in North America: Where the Jobs Have Gone," Briefing Paper, Economic Policy Institute (Washington, D.C.: Oct. 1992); and Robert A. Blecker and William E. Spriggs, "On Beyond NAFTA: Employment, Growth, and Income Distribution Effects of a Western Hemisphere Free Trade Area," Paper prepared for the Inter-American Development Bank and the U.N. Economic Commission for Latin America and the Caribbean Project, Fifth Colloquium (Washington, D.C.: Sept. 28-29, 1992).

[13]"Constant returns to scale" refers to a lack of production cost savings as output expands. In other words, unit production cost remains constant when the amount of production changes.

[14]Clyde V. Prestowitz, Jr., et al., The New North American Order, A Win-Win Strategy for U.S.-Mexican Trade, Economic Strategy Institute (Washington, D.C.: 1991).

$1 billion in exports is used, which is much larger than the latest estimate of 19,600 jobs for $1 billion in exports used by the Commerce Department).

The study creates two foreign investment scenarios: One assumes a 10-percent annual increase in foreign direct investment in Mexico leading to $25 billion in new foreign investment in export-oriented industries by 1999, and another assumes about an 18-percent annual increase in foreign investment, leading to $46 billion in new foreign investment in export-oriented industries. Based on the total investment value projected by Mexican analysts, ESI uses U.S. industry output-to-capital ratios to estimate Mexican output growth, then estimates the related Mexican export growth. The decline in the U.S. trade balance with Mexico would lead to job losses, estimated at 400,000 to 900,000.

This version of the ESI analysis is similar to that of EPI in one aspect—there is little allowance for the trade diversion effect. Seventy percent of the increase in Mexican production is assumed to be exported to the United States and to displace U.S. domestic production. The analysis does not allow for the possibility that Mexican imports of U.S. goods may increase rapidly after Mexican economic growth accelerates. Both of these assumptions tend to overstate the adverse impacts on the U.S. economy.

IIE Study[15]

The IIE study does not use a formal model for its estimation. Based on economic liberalization experiences of other developing countries, the IIE study extrapolates a scenario with a $9-billion improvement on U.S. bilateral trade balance with Mexico by 1995, and a net gain of 130,000 jobs.[16] This scenario includes a $20-billion annual gross capital inflow to Mexico. Part of this inflow (about $8 billion) is to cover the debt service requirement, and $12 billion is to finance the overall trade deficit caused by increased imports needed for consumption and investment.

Based on a World Bank study[17] that covered 31 episodes of economic liberalization experiences, the IIE study assumes that Mexican exports will

[15]Gary Clyde Hufbauer and Jeffrey J. Schott, North American Free Trade: Issues and Recommendations, Institute for International Economics (Washington, D.C.: 1992).

[16]The authors later revised these numbers in their 1993 book, NAFTA: An Assessment, also published by IIE. The revised net job gains for the United States are 171,0000 (with a 316,000-job increase and 145,000 dislocations) by 1995. Net improvement in the U.S. bilateral trade balance is estimated to be between $7 billion and $9 billion annually.

[17]Demetris Papageorgiou, Michael Michaely, and Armeane M. Choksi, eds., Liberalizing Foreign Trade: Lessons of Experience in the Developing World, the World Bank (Washington, D.C.: 1991).

grow at an 11.2-percent annual rate and Mexican GNP at a 6-percent rate. Mexican imports are assumed to be constrained by the sum of export earnings, remittances, and new capital flow net of debt service for the scenario with NAFTA. The scenario without NAFTA is described as encompassing no net capital inflow. Under both scenarios, Mexico is assumed to purchase 75 percent of its imports from the United States and sell 75 percent of its exports to the United States. Job impacts on the United States are estimated with a multiplier that relates jobs to billion dollars of net exports.[18] The study estimates the job gains for Mexico as 609,000, about 2 percent of its labor force. To estimate this, the study uses a job multiplier that is six times that used for the United States.[19]

The IIE study estimates larger benefits from NAFTA, since it has implicitly included the benefits due to Mexico's general economic liberalization. Its informal analysis may also capture the dynamic effects of accelerated economic development that are often omitted in a formal general equilibrium model.

The ITC Symposium

In February 1992, ITC held a symposium on the economic impacts of NAFTA estimated by 12 models.[20] Besides the Almon study and the KPMG study previously discussed, a version of the University of Michigan model was presented by Drusilla K. Brown. It emphasized the economies of scale and the terms-of-trade gains.[21] Also included was a model by David Cox and Richard Harris that focused primarily on the Canadian economy. Two models focused primarily on the Mexican economy. One, by Horacio E. Sobarzo, had a similar model structure to the one by Cox and Harris. It assumed imperfect competition and international capital mobility, and emphasized economies of scale. The other, by Leslie Young and Jose Romero, was a dynamic one that traced effects on Mexico over a 10-year period. It also emphasized the role of capital. A version of a dynamic model by Robert K. McCleery emphasized technology transfer and international capital mobility but assumed no emigration. Linda Hunter and associates presented a model on the automobile sector. Two other

[18] IIE used its own estimate of the multiplier as 14,500 jobs to $1 billion of exports for the results initially presented in the study, but later revised it with numbers estimated by the U.S. Department of Commerce.

[19] Proportional to the labor compensation rates of the two nations.

[20] "Economy-Wide Modeling of the Economic Implications of a FTA with Mexico and a NAFTA with Canada and Mexico" and Addendum to the Report, U.S. ITC Publications 2516 and 2508 (Washington, D.C.: May 1992).

[21] A "terms-of-trade" gain refers to an increase in the ratio of export to import prices. Such a gain implies that more imports can be exchanged for a given amount of exports.

models focused on the agricultural sector and were presented by Santiago Levy and Sweder van Wijnbergen and by Sherman Robinson and associates.

The ITC staff models included in the symposium experimented with three alternative measurements for nontariff trade barriers, expressed in tariff equivalents. It also experimented with two pricing principles and two alternative assumptions on returns to scale (i.e., either increasing or constant returns to scale).

The ITC staff models are static ones that do not consider changes in international capital flows or other dynamic effects. The overall trade balances of member countries are also assumed to remain fixed. Therefore, no interactions among exchange rates, capital flows, and trade flows are assumed. The models do allow for some unemployment. The wage rate is assumed to be rigid, and labor is assumed to be perfectly mobile among sectors but not internationally. In addition, labor is assumed to have been in excess supply in the base year for the analysis.[22]

The ITC staff models conclude that all three member countries can benefit substantially if nontariff barriers, such as import quotas, are also removed.[23] When increasing returns to scale and the contestable market pricing principle are assumed, the gains are the greatest. The "contestable market pricing principle" assumes that firms set prices at average costs to deter potential market entry by competitors. In contrast, the "Cournot pricing principle" assumes higher prices, with markups over marginal costs. The gains to producers are larger under the contestable market pricing assumption since such pricing can more effectively deter market entry, and economies of scale can be more fully realized under trade expansion.

The ITC staff models also provide some interesting sectoral results. When increasing returns to scale are assumed, output expands in 24 of the 26 sectors included in the models. The transport equipment sector would have the largest gain, due to demand expansion. Canadian output in nonagricultural sectors would achieve more significant gains than those for the United States. Mexico's agriculture sector would contract by 9 percent while the petroleum and the transport sectors would expand.

[22]This assumption about excess labor supply and the implied perfectly elastic labor supply are crucial in explaining the large gain from economies of scale in some ITC results.

[23]ITC estimates that removing nontariff barriers could add about a 1-percent onetime gain in the U.S. economy when constant returns to scale are assumed.

However, since the ITC staff models do not take into account changes in capital flows and related productivity gain dynamics in the Mexican economy, we believe these simulation results and other results from similar models should be interpreted with caution.

In general, the models presented at the symposium conclude that all three nations would gain from NAFTA. Benefits to the three nations include higher employment and real wage gains. Mexico would gain more than the other two nations, the models conclude, especially from technology transfer, larger buildup of skills, and increased access to specialized capital goods. It also would benefit from greater regional coproduction and an improved rate of innovation. In short, Mexico would accelerate its economic development. The United States would probably gain through intensified coproduction and the greater trade opportunities generated by trade liberalization and increased growth in the Mexican economy. The benefits to the Canadian economy would be similar to those for the United States, but to a lesser degree.

The ITC synthesis reported in 1993 concludes that the U.S. gain in GNP estimated by the various models would typically be less than 0.5 percent; the aggregate employment gain would be less than 1 percent; and the aggregate real wage increase would be less than 0.3 percent in general.[24] The wage impact for low-skilled workers would be mixed—some models estimated gains, some estimated losses, but all estimated impacts were less than 2 percent. The ITC analysis assumes foreign investment flows to Mexico would not be at the expense of investment in the United States.

As for NAFTA's impact on the Mexican economy, real Mexican GDP is estimated to gain from 0.1 percent to 11.4 percent after all NAFTA's effects are realized. The highest estimate is from the dynamic CGE model by McCleery. The model takes into account the technological progress that comes with increased capital inflows. The next highest growth is estimated from the dynamic model by Young and Romero. It assumes a 25-percent decline in the real interest rate in Mexico as investor confidence increases under NAFTA. This confidence is assumed to result in higher investment and growth. High growth is also estimated from a static model by Sobarzo that allows additional capital flows to Mexico and increasing returns to scale that are assumed to benefit the Mexican economy more than the U.S. and Canadian economies.

[24]"Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement," U.S. ITC Publication 2597 (Washington, D.C.: Jan. 1993).

With two exceptions, Mexico's aggregate employment increase is estimated to range from 0.1 percent to 6.6 percent, and Mexico's aggregate real wage increase to range from 0.7 percent to 16.2 percent. The speed of Mexican domestic liberalization in the agricultural sector would have strong implications for labor migration and emigration. Two agricultural studies agree that a phased-in liberalization would benefit both Mexico and the United States by slowing the migration flows within Mexico and across the border.

Only three studies covered by the symposium estimate NAFTA's possible impacts on Canada. Two studies (Brown and Cox-Harris) say that NAFTA's impact on Canadian real GDP would be less than 1 percent, and its impact on real wages would be less than 0.5 percent. The ITC's own model experiments showed real Canadian growth could be as high as 10.6 percent if increasing returns to scale were assumed throughout all manufacturing sectors. In the 1993 report, ITC's conclusion on Canada is more consistent with the other studies.

The Brookings Institution Conference

In April 1992, The Brookings Institution held a conference assessing research on NAFTA.[25] Six survey papers were presented, each concentrating on a particular subject: economywide modeling (by Drusilla K. Brown);, labor issues (by Raul Hinojosa Ojeda and Sherman Robinson); industry (by Sidney Weintraub); agriculture (by Tim Josling); international effects (by Carlos Alberto Primo Braga), and nontrade issues (by Robert A. Pastor).

The consensus that emerged from the conference reinforced the conclusions from the 1992 ITC symposium. That is, the direct economic effects of NAFTA will be a moderate gain for both Mexico and the United States. This conclusion is at odds with those in the U.S. public debate who support labor's concerns and worry about large-scale relocation of plants from the United States to Mexico. The conference's conclusion is based on the argument that trade barriers between Mexico and the United States have already been reduced to low levels and that economic integration has been ongoing. The conference also said that the potential adverse effect on certain U.S. sectors will be limited because a part of the increase in U.S. imports from Mexico will be offset by a decrease in U.S. imports from nonmember countries. (i.e., the trade diversion effect.)

[25]The Brookings Institution, North American Free Trade: Assessing the Impact, eds. Nora Lustig, Barry P. Bosworth, and Robert Z. Lawrence (Washington, D.C.: 1992).

At the conference, Carlos Bazdresch Parada pointed out three possible reasons to explain the apparent contradiction between the minimal economic impact of NAFTA expected by modeling researchers and the intensified political debates. First, he said, the expectation of impacts from NAFTA that fueled the public debates could be wrong. Second, the models may fail to capture the most important consequences of NAFTA. Third, the economic issues embodied in NAFTA may only be part of a process of deeper and wider integration between the two economies that is causing alarm. We believe these explanations have some validity.

The conference used results from CGE models to illustrate the potential effects of NAFTA on different sectors of the economies and discussed the sensitivity of results to various model assumptions. (We have already addressed some of these sensitivities in previous sections of this appendix.) The conference also pointed out that some of the CGE model results differ from the results predicted using a traditional trade theory. For example, the Stolper-Samuelson theorem predicts that the factor of production (such as labor) used relatively intensively in the import-competing sector will be hurt by trade liberalization. Thus, real wages for low-skilled labor in the United States will be lower, as predicted by the theorem. The conference noted that the theorem ignores the scale economies and the terms-of-trade gains with respect to nonmember countries.[26] Both have effects that can prevent a decline in real U.S. wages.

Standard trade theory predicts that liberalizing trade between the United States and Mexico should accelerate wage convergence, with real wages for low-skilled workers decreasing in the United States and rising in Mexico. However, Hinojosa-Ojeda and Robinson's review of labor impacts at the Brookings conference concluded that such wage convergence is likely to be small. When imperfect competition and economies of scale are considered, the wages of unskilled workers may rise in both nations. The review also pointed out that migration has a stronger impact on U.S. wages than NAFTA.

The development of the CGE models has not seemed to meet the accuracy expectations of some analysts who attended the Brookings conference. For example, Drusilla Brown emphasized that much work remains to be done, especially in the areas of saving and investment responses, effects on interest rates and exchange rates, and the behavior of multinational

[26]Edward E. Leamer's 1992 study was discussed. He applied the Stolper-Samuelson theorem in estimating a larger wage reduction for low-skilled U.S. labor: $1,900 annually. He appears to have assumed that the Mexican economy will be rather large in the future and can have a strong influence on U.S. prices of goods and services.

corporations. Timothy J. Kehoe stressed that CGE prediction results need to be verified with historical evidence afterwards. However, we believe such validation is very difficult to undertake.[27]

Robert Z. Lawrence noted that the current CGE models miss several important features of NAFTA, including the harmonization of Mexican institutional practices and investment rules with those that exist in the United States and the specific rule-of-origin requirements in NAFTA. Some of these omissions can help to explain why the models found NAFTA's effects to be so moderate.[28]

National Commission for Employment Policy Commissioned Studies

In 1992, the National Commission for Employment Policy, an independent agency established under the Job Training Partnership Act, sponsored three studies on the possible employment effects of NAFTA. These studies were done by a University of Michigan research team, DRI/McGraw-Hill, and Philip L. Martin of the University of California-Davis.[29] The first two studies emphasized the distributional impacts of jobs among sectors and locations; the third one studied migration (which we review in ch. 6 of this report). The Michigan study also estimated the distributional impacts among occupational groups.

The Michigan model used in the study is an extension of the CGE model constructed by Brown and Stern in 1989 to analyze the impact of the U.S.-Canada FTA. It included 34 nations (with the 31 countries outside the NAFTA bloc combined into one group), 23 tradable goods, and 6 nontradable goods. Each sector is either assumed to be perfectly

[27]CGE modeling adopts a "comparative statics" approach in comparing the base-year scenario to a simulated scenario with policy changes. To validate results empirically, one needs to quantify all other changes that occurred after the base year.

[28]Omitting the rule-of-origin requirement may not underestimate NAFTA's impacts. The rule-of-origin requirement has two economic effects: It may help to preserve some parts industries, such as auto parts, in NAFTA member countries that are not most efficient globally; and it may hinder other industries' capacity to find parts globally and achieve the lowest cost. Thus, the requirement may limit potential improvements in the industrial competitiveness of member countries, particularly for the more efficient sectors. Overall, the requirement's net effect on NAFTA countries' production could be either positive or negative. However, consumers' welfare would most likely be reduced in member countries.

[29]The Impact of the North American Free Trade Agreement on U.S. Regional and Sectoral Labor Markets, DRI/McGraw-Hill; Robert M. Stern, Alan V. Deardorff, and Drusilla K. Brown, A U.S.-Mexico-Canada Free Trade Agreement: Sectoral Employment Effects and Regional/Occupational Employment Realignments in the United States, Institute of Public Policy Studies, University of Michigan; and Philip L. Martin, NAFTA, Migration, and U.S. Labor Markets. These papers are collected in The Employment Effects of the North American Free Trade Agreement: Recommendations and Background Studies, National Commission for Employment Policy, Special Report No. 33 (Washington, D.C.: Oct. 1992).

competitive or monopolistically competitive, with free entry of firms to the market. The tradable goods are differentiated either by country of origin or by firm. Several scenarios are simulated—including one with a change in foreign direct investment in Mexico and two with increased emigration flows from Mexico.

The Michigan study estimated that all three NAFTA member countries would have moderate gains. Besides the benefits resulting from the better allocation of economic resources and the economies of scale, the model also accounts for gains in countries' terms of trade with nonmember countries.[30]

The Michigan study assumed full employment, balanced trade, and a rigid wage structure. It estimated the size of job displacement by adding job losses in contracting sectors over 10 years, without offsetting them by job gains in expanding sectors. The largest number of dislocations was estimated as 168,930, from a scenario assuming a 10-percent increase in Mexican capital stock and assuming that 5 percent of the Mexican labor force emigrated to the United States.

The National Commission for Employment Policy selected a slightly lower number, 166,500 job dislocations over 10 years, for policy discussion. This amount was estimated in a scenario that assumed no increase in foreign direct investment. The study also estimated an income loss due to dislocated workers of $80 million annually if an increase in emigration is considered.

The DRI study simulated a gradual and a nongradual scenario of trade liberalization between Mexico and the United States. These scenarios were then compared to the baseline forecast scenario in order to determine the impact of NAFTA up to the year 2000. The study used the econometric macro-modeling approach, most comparable to the Almon study. There is one major methodological difference between these two studies. Unlike the Almon study, which generated national impacts from sectoral impacts, the DRI approach used a top-down one that obtained national impacts from macro-model simulations and imposed the condition that sectoral impacts are summed to equal national impacts. The model included 25 sectors and 9 regions.

[30]Since tariffs are removed on imports from member countries but remain on imports from nonmember countries, exporters from nonmember countries may have to reduce prices in order to compete with member countries to maintain market shares. This situation implies that more imports from nonmember countries can be exchanged for a given amount of exports from the NAFTA bloc, i.e., a gain in terms of trade for the members.

DRI concluded that NAFTA would have a positive impact on both economies, with less than a 0.25-percent growth benefit for the U.S. economy and a slightly lower than 1-percent growth benefit for Mexico. It also found that gradual liberalization would be better for both nations. DRI noted that the short-term impact would differ from the long-term one across scenarios: nongradual liberalization would allow faster growth in Mexico only in the first 2 years and thereafter lead to an adverse effect on Mexico.[31] The study also estimated regional and industrial employment impacts. DRI estimated a cost for programs to assist dislocated workers as $834 million if the Trade Adjustment Assistance program and the Economic Dislocation and Worker Adjustment Assistance program remain separate, and $583 million if the two are combined.

The positive overall impacts of NAFTA as discussed in the DRI study are mainly driven by higher investment levels in both economies as the Mexican economy gains stability and its public enterprises are privatized. The U.S. economy is also expected to benefit from an export surplus with Mexico. DRI also assumed that the Federal Reserve would allow some increase in the money supply to accommodate the increase in GNP. It is unclear, however, how much increase in foreign capital to Mexico is assumed in the DRI simulation. It is also unclear if DRI has considered the potential displacement of imports from other nonmember countries in its analysis.

Summary

With the exception of a few U.S. policy analysis groups, the economic researchers in general agree that NAFTA would bring a small overall economic benefit to the U.S. and Canadian economies, and a larger benefit to the Mexican economy. The benefit to the Mexican economy would also come from dynamic growth brought about by a surge of foreign investment. The researchers also agree there will be job dislocations caused by a redistribution of economic activities among sectors and regions. Analysts are divided, however, on NAFTA's effect on real wages for low-skilled workers in the United States.

The results of the CGE models are sensitive to changes in economic assumptions underlying the models. Important assumptions include (1) the amount of increase in foreign capital inflow to Mexico, (2) the amount by which foreign capital inflows to Mexico displace the investment in the United States, (3) the extent of increasing returns to

[31] This result is due to the need for a drastic policy correction to cope with keener international competition. This correction could include a currency devaluation.

scale in production, (4) the extent to which Mexicans can acquire technology by working with foreign partners, (5) the extent by which trade increases at the expense of imports from nonmember nations, (6) the extent to which wage rates remain rigid in the U.S. labor market, and (7) the amount of Mexican emigration to the United States.

Overall, CGE models lead to more positive findings for the U.S. economy than the informal analyses provided by EPI or ESI. This result is due to the fact that CGE models are built on standard international trade theory. The standard trade theory holds that countries can benefit from freer trade opportunities, because as trade expands, resources are expected to be better allocated to reflect countries' comparative advantage. As trade barriers are removed or reduced, export sectors can grow and create job opportunities that can offset the contraction of import-competing sectors. Since export sectors are more efficient than import-competing sectors, this shift of resources can lead to higher national productivity and real income. In this standard trade theory, labor is assumed to be fully employed, with flexible wage rates. In order to calculate job losses, some CGE models estimate the change in immigration from Mexico as a measure of the change in U.S. job opportunities. Other models sum up job losses in contracting sectors without offsetting them with job gains in expanding sectors to measure job dislocations. Neither approach provides reliable estimates on job losses.

Certain analyses suggest that the labor market will not adjust to reallocate employment smoothly. These analyses' largest estimates are in the range of one-half million to 1-million job losses, or less than 1 percent of the U.S. labor force. As we have discussed, these numbers may provide an upper bound on potential job losses.

The general equilibrium models lead to a very moderate estimate of gains for the U.S. and Canadian economies—less than one-half percent of GNP. These results are small because of the low prevailing trade and investment barriers in these economies. The potential gain of these economies from expanded exports to Mexico is limited by the small size of the Mexican economy in the near and medium term.

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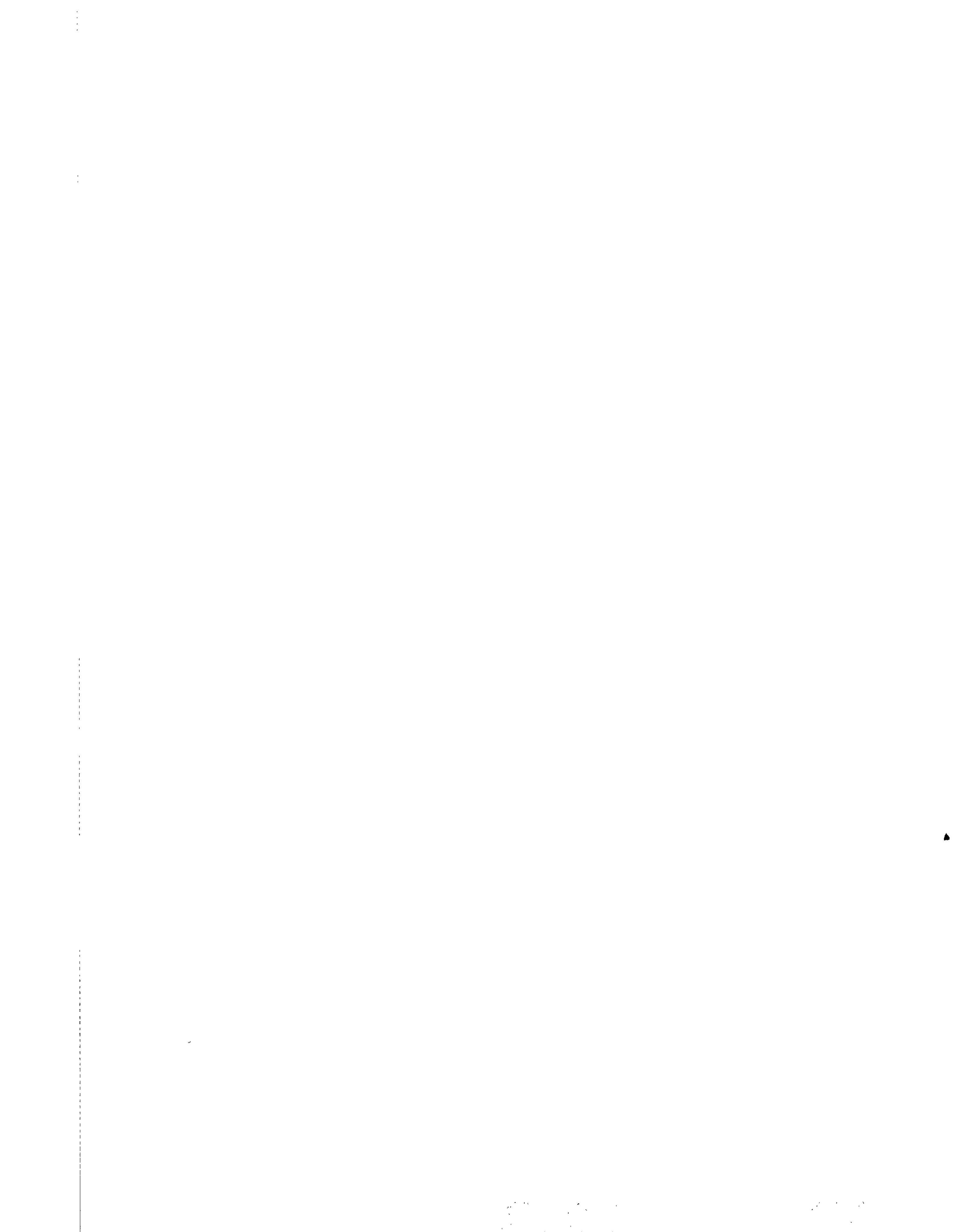

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