Lessons from the Canada-U.S. Free-Trade Agreement

Mexico, Other Regional Agreements, and the GATT System

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The Canada-U.S. Free-Trade Agreement of 1989 is a milestone in U.S. trade policy. When initially conceived, a preferential agreement between the United States and its largest trading partner raised concerns about the continued commitment of the U.S. to multilateralism. These concerns have been assuaged by U.S. efforts in the Uruguay round, in large part because the objectives of the United States in pursuing the agreement with Canada are quite similar to its goals in supporting the General Agreement on Tariffs and Trade (GATT). Ultimately, however, the implications of the agreement for U.S. trade policy are too complex to be cast simply in terms of bilateralism versus multilateralism.

The free-trade agreement offers important lessons about the difficulties of achieving meaningful progress in contemporary trade negotiations—both in bilateral agreements and in multilateral negotiations. Recent trade talks have increasingly focused on complex nontariff issues such as subsidies, services, and foreign investment. In these areas the free-trade agreement provides evidence of the constraints under which negotiators operate. In addressing subsidies and foreign investment, further trade liberalization often requires that an extranational authority penetrate into areas of policy that have traditionally been firmly within the domains of national governments.

Now the possible addition of Mexico to a North American free-trade agreement raises new issues. Although the Canada-U.S. free-trade agreement offers a starting point for U.S. (and probably Canadian) negotiations with Mexico, there are important reasons to expect that a trade pact with our southern neighbor, at least initially, will be more limited and far more complex. In addition, while our agreement with Canada is consistent with GATT and could contribute to further multilateral progress, a pact with Mexico will need to be carefully crafted to achieve similar results.

Finally, the current trend in North America and

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in Europe to fashion regional trade compacts must not be allowed to stultify trade worldwide. Vigilance will be required to guard against agreements that eliminate some barriers only to raise others against perceived "outsiders."

Lessons from the Canada-U.S. Free-Trade Talks

Two important lessons can be drawn from efforts by the United States and Canada to establish a free-trade agreement. First, politically potent special interests, faced with falling tariffs, worked hard to retain traditional protection. As a result, some tariffs were replaced with nontariff barriers directed against countries outside the agreement. Second, although the United States and Canada share many important legal and historical traditions, addressing nontariff barriers that reach deep into domestic prerogatives was extremely difficult. These lessons can be better understood by examining more closely the free-trade agreement and the process from which it evolved.

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Reducing Tariffs. At the outset of the negotiations between the United States and Canada, high tariffs impeded bilateral trade in textiles, apparel, furniture, appliances, petrochemicals, plastics, and some metal, paper, and fish products. Policy analysts initially considered excluding some especially sensitive sectors from tariff cuts, but both sides agreed early on that the best way to sell free trade in the face of significant pockets of domestic opposition was to eliminate tariffs across the board. If even one industry were excluded, special pleading would become contagious, and the whole process could easily unravel.

Particularly troublesome industries for the negotiators included apparel, automotive products, and fruits and vegetables. And though tariffs were lowered, negotiators found other, less transparent devices through which to protect some of the more politically sensitive sectors.

Some products were subjected to "rules of origin" that specify the shares of total value that must be of American or Canadian origin. For new cars and trucks crossing the U.S.-Canada border to receive duty-free treatment, for example, third-country components must account for no more than 50 percent of their value. These rules actually increase discrimination against foreign parts suppliers over what existed under the Automotive Agreement of 1965, which first established limited bilateral duty-free trade between the United States and Canada.

Similarly, the free-trade agreement imposes annual quotas on the amount of offshore fabric that may be incorporated into apparel qualifying for duty-free status. In addition, Canada retained the right to reimpose seasonal tariffs on fruits and vegetables as needed until 2008.

As tariffs were lowered, jointly implemented nontariff barriers were erected against third countries to maintain the protection for selected politically potent industries. Hints of a similar trend are also appearing as Europe moves toward 1992. Once protective structures such as these are created, they often become addictive and increasingly discriminatory. A free-trade agreement study group has already recommended raising the U.S.-Canadian automotive content requirements from 50 to 60 percent, for example. Furthermore, by replacing tariff with nontariff barriers, future efforts at liberalization are almost certainly made more difficult.

Nontariff Barriers. Nontariff barriers continue to create the most significant impediments to progress in liberalizing trade—either across individual borders or around the world. Efforts to control nontariff barriers require increased harmonization of domestic policies, practices, and regulations. Matters such as health and safety standards, educational requirements for professionals, the protection of intellectual property, and the regulation of banking reach deeply into national prerogatives.

For Canadians who already feel that their country is excessively influenced by U.S. culture and fads, such policy harmonization poses sovereignty issues. Similarly, it was a major breakthrough for the U.S. Congress to accept even limited Canadian oversight of trade actions taken by the U.S. International Trade Commission and the Department of Commerce. In pursuing the ideal of a free-trade

agreement, policymakers often face difficult choices between ceding control over domestic economic and social policies and impeding trade liberalization that could raise overall standards of living.

Despite these problems, the free-trade agreement achieved some important breakthroughs in the area of nontariff barriers. The agreement includes precedent-setting provisions for services, foreign investment, and energy, and it establishes binational review of U.S. and Canadian decisions to levy countervailing duties on subsidized or unfairly priced imports in bilateral trade.

In other important areas, however, the negotiators reached no more than a standstill. The agreement's primary contribution in many cases was to set goals for long-term, issue-by-issue, sector-by-sector negotiations in areas that include a broad range of subsidies, product standards, government procurement practices, definitions of dumping and predatory pricing, agricultural trade, and the (de)regulation of financial services.

Canada's views about how government and business should interact are closer to those of the United States than are the views of any other major trading partner. Thus, examining the limitations and points of disagreement in the free-trade agreement may help define the parameters of future negotiations with Mexico and other countries.

Subsidies. Subsidies are clearly among the knottiest problems in trade negotiations today. The United States would like to achieve greater international discipline on subsidies by establishing constraints on their use by GATT signatories. U.S. negotiators argue that this would then allow the United States to rely less on countervailing duties to counteract subsidized imports. For their part, Canada and our other trading partners believe that the United States is overly aggressive in its use of countervailing duties. They would like to limit the availability of such a remedy without subjecting what are viewed as internal policy decisions to increased international control.

Like it or not, Canada (and to an even greater extent, the European Community and Japan) sees the interplay between competitiveness and government intervention in a way fundamentally different from the view of the Bush administration and many members of Congress. There is in fact a divergence of views about the definition of a subsidy. When does government support for R&D cross the line from the support of intellectual infrastructure and become unfair industry targeting?

In the free-trade negotiations the United States and Canada failed to reach an agreement on these issues, and further negotiations were suspended until after conclusion of the Uruguay round. Indications are that future agreements (both bilateral and multilateral) will create three categories of subsidies—prohibited, permissible, and actionable. This last category would continue to be legal, but subsidies so categorized would be subject to countervailing duties when they were found to cause injury.

Particularly troublesome in the free-trade agreement negotiations were issues raised by state and regional assistance in both Canada and the United States. Industrial revenue bonds, the U.S. Economic Development Administration, the Chrysler and Lockheed bailouts, and state-sponsored financial and technical incentives designed to attract new business are examples of such activities in this country. National governments can easily funnel industry aid through regional agencies and thereby distort cross-border trade. And although such programs often provide benefits to the communities and industries to which they are directed, they can also have negative effects on contiguous regions, states, or countries. Finally, there is the continuing issue of the competitive benefits bestowed by U.S. defense procurement policies on our computer, electronics, and aviation sectors.

Thus, Canadian and U.S. negotiators reached an impasse. U.S. officials are reluctant to place all regional development programs on a bilateral list of permitted subsidies, although Canadian officials are under political pressure to achieve just such an exemption. Nor does the United States want such activities fully prohibited since many in Congress are reluctant to give up their freedom to provide targeted aid or to constrain the activities of the states. Indeed, Canadian veterans of the free-trade negotiations maintain that in the end it was U.S. reluctance to discipline its own activities that nixed chances for a deal on subsidies.

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does not want Canada or its other trading partners to give up all their subsidies because the United States would then have to do the same. Rather the United States seems to want other nations to restrict themselves to a similar level and scope of activity as that pursued here.

Given such constraints, neither the Uruguay round negotiations nor the free-trade agreement can be expected to come up with long lists of clearly prohibited or clearly allowed subsidies, although future agreements between the United States and Canada are expected to embody more comprehensive rules than do the agreements enforced through GATT. In both bilateral and multilateral negotiations, divergent national perceptions and political constraints make the lowest common denominators very low indeed.

As a result, countervailing duties will remain the primary means for combating injury to domestic

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industries. In responding to industrial targeting and government support for R&D, punitive duties will often be weapons with limited effect at best and self-defeating instruments at worst. Many of the medium-term benefits reaped by foreign competitors emerge from new or improved products, and much of the long-term damage to U.S. firms is inflicted in offshore markets.

Services. The free-trade agreement chapter regarding treatment of business services indicates just how laborious progress in this new area of international negotiations will be. In U.S.-Canadian talks, the divisive issue of the short-term movement of nonprofessional workers, a critical concern of developing countries, is not at play. Furthermore, similar legal, regulatory, and economic institutions make the harmonization of domestic policies a manageable problem. Nevertheless, the free-trade agreement only manages a moratorium on new discriminatory practices.

"You can't imagine, amigo, how heavy my load is!"

In essence, Canada and the United States have agreed that when shaping new regulations, they will afford one another's service providers national treatment, right of establishment, and equal access to local distribution systems. Industry-by-industry talks are being planned to eliminate existing violations of these principles.

Investment. In the area of foreign investment, the United States achieved much of what it sought in the free-trade agreement, even though the final agreement seems somewhat lopsided. Once foreign subsidiaries are established, the agreement guarantees U.S. (Canadian) firms in Canada (the United States) national treatment under tax laws, antitrust laws, and business regulations. The agreement also bans foreign firm performance requirements, particularly export goals and domestic purchasing requirements, that directly affect trade.

Canada does, however, retain the right to screen U.S. acquisitions of its 100 largest industrial corporations. In contrast, should the United States begin screening foreign acquisitions of commercial enterprises, Canadian purchases would be exempt,

regardless of the size of the companies involved. Canada simply does not believe that it can offer the same freedom of access to U.S. investors as Canadian investors enjoy in the United States.

In addition, the agreement makes no mention of R&D-related performance requirements for foreign investors. These were a favorite tool of Canadian industrial policymakers through the mid-1980s, and Canadian officials interpret the omission as sanctioning technology-related performance requirements. The U.S. Congress disagrees, but U.S. efforts to negotiate restrictions on these practices will encounter the same kinds of problems as efforts to eliminate Canadian regional subsidies and the screening of U.S. acquisitions.

Energy. The agreement guarantees the United States access to Canadian oil, gas, coal, and electricity at the prices paid by Canadians under comparable commercial circumstances. Export embargoes, export taxes, and practices raising export prices above domestic prices are prohibited. In the event of shortages, available supplies will be shared equitably among U.S. and Canadian consumers. Nevertheless, Ottawa and the provinces enjoy considerable latitude in setting the pace of development of Canada's energy resources, and the pace of development will largely determine Canada's long-term export capabilities.

Finally, the asymmetrical treatment accorded investment holds here as well. The agreement allows Canada to continue to limit U.S. ownership in the Canadian oil and gas industry, but the United States may not impose similar limits on Canadian interests.

The free-trade agreement has generated interest in similar trade agreements between the United States and Mexico, several Latin American countries, and several Asian-Pacific nations. However desirable such arrangements may be, it is important to understand and anticipate probable impediments before we begin. The agreement with Canada is of considerable scope and depth. Producing it required intense micropolicy coordination. Japan, the emerging industrial powers of Asia, and the Latin American countries are all nations whose economic institutions, laws, and cultures differ significantly from those of the United States and Canada. This greatly diminishes the prospects for an agreement of the kind signed by the United States and Canada. Still, the lessons learned from the process that led to the agreement with Canada can provide important guides for future trade negotiations with Mexico and the rest of the world.

Prospects for a Mexico-U.S. Agreement

In February 1990 Mexican President Carlos Salinas de Gortari raised the possibility of a Mexico-U.S. free-trade agreement with President Bush, and in September Bush advised Congress that the administration intends to proceed with such talks.

Formal negotiations will likely commence in 1991, and Canada has asked to join the talks. Although the Canada-U.S. agreement will provide negotiators with a point of departure, it is unlikely that a pact with Mexico will achieve the same scope of economic integration as that accomplished by the United States and Canada—at least not initially. The wide disparities between U.S. and Mexican economic, legal, and cultural institutions, the political legacy of Mexico's Revolution, and the sensibilities of some in Congress regarding Mexican electoral processes will constrain negotiators.

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Despite these difficulties, the United States has a major political and security stake in Mexico's economic success, and the success of economic reforms in Mexico is critically dependent on expanding access to U.S. markets. These factors may provide the political resolve to overcome several difficult obstacles. Through recent reforms, President Salinas has already indicated his willingness to bring Mexican institutions into closer conformity with U.S. norms.

In any trade negotiations with Mexico, it would clearly serve U.S. interests to obtain long-term guarantees regarding the treatment of American investment. The Mexican government has already moved to liberalize access to the Mexican markets by U.S. investors, but a wide-open investment regime seems unlikely because of constitutional restrictions.

Similarly, if U.S. petrochemical producers are not to be put at an unfair disadvantage, trade talks would need to include assurances regarding Mexico's intent to pursue market-based energy pricing and supply strategies. Such assurances may emerge as a precondition for unfettered Mexican access to U.S. markets for petrochemicals and primary

plastic products. But energy policy is a highly emotional issue in Mexico, and leftist politicians could invoke the warrant of the Mexican Revolution if President Salinas offers significant concessions.

High on Mexico's want list are likely to be across-the-board elimination of tariffs and import restraints, the free movement of labor as part of any deal on services, and dispute-settlement procedures similar to those enjoyed by Canada under the free-trade agreement to control the U.S. appetite for countervailing duties, voluntary export restraints, and other tools of managed trade. Unfortunately, none of these demands is likely to sit well with entrenched interests in the United States.

Mexico's low wages could devastate some U.S. industries, and that fear will fuel political pressures to remove apparel, footwear, steel, and certain fruits and vegetables from consideration. Furthermore, the specter of Mexican construction workers, janitors, and other service personnel moving freely across the border will generate fierce opposition among U.S. unions. Finally, with respect to dispute settlement, the United States and Canada have very similar laws regarding subsidies and import measures that Mexico does not fully share. The recent vintage of GATT-consistent laws in Mexico and the limited experience of Mexican judges and lawyers in trade disputes will make it difficult for Congress to accept binational decisionmaking.

Compromises by the United States and Mexico involving phased policy harmonization and increasing market access should be used to finesse difficult questions involving energy, investment, and direct competition with the United States' more vulnerable mature industries.

Coming up with a deal that both leaders can sell at home will require each to achieve concessions from the other on delicate issues such as these. Presidents Bush and Salinas both have strong incentives to be creative. Salinas hopes to achieve lasting market-oriented reforms, and Bush hopes to avoid the security consequences of Mexican political upheaval.

A comprehensive agreement is possible by 1994, and the experience gained in negotiating the Canada-U.S. free-trade agreement will help. Compromises involving phased policy harmonization and increasing market access should be used to finesse difficult questions involving energy, investment, and direct competition with the United States' more vulnerable mature industries.

In the area of energy, for example, it may be possible to negotiate a pricing agreement without opening Mexico's oil and gas sector to direct U.S. investment. Mexican production capacity is currently constrained by Pemex's lack of capital. An attractive agreement from Mexico's perspective might include a trust fund from which Mexican producers could draw to expand capacity. Withdrawals could then be repaid with future petroleum deliveries.

Recent Mexican initiatives in automobiles and other industries indicate that a range of creative solutions is possible where foreign investment is concerned. Finally, in sensitive mature sectors such as apparel and steel, tariffs could be lifted subject to temporary reinstatement any year in which Mexico's share of the U.S. market grew more rapidly than some specified percentage.

This kind of managed liberalization is certainly not optimal. Although probably necessary, it could be quite complicated and messy. The trade agreement could become hamstrung by safeguards and lead to permanently managed trade and investment rather than to a true free-trade pact. Or the United States could lose sight of the preferred long-term goal—a trade agreement that gradually leads to the full integration of the two economies. A quick political fix in the form of a hastily prepared, limited pact could ultimately preempt a more comprehensive agreement.

The key will be to establish well-defined time lines that keep the process moving in the direction of an agreement consistent with the free-trade agreement with Canada and with GATT through the phased elimination of transitional mechanisms. As the Mexican and U.S. economies respond to expanding market opportunities, as Mexican wages rise, and as U.S. labor markets adjust, an agreement similar to the agreement with Canada could emerge.

Bilateral and Regional Agreements and the GATT System

Although regional agreements can offer important benefits, multilateral liberalization best promotes growth. In this context, four sets of questions should be asked when new regional agreements are proposed.

- Does the agreement increase barriers to trade with nonmember countries?

• Does the agreement approach nontariff issues in ways consistent with subsequent progress under GATT?

• Does the agreement foster stronger economies better able to cope with adjustments and to participate in future multilateral liberalization?

• Do the member countries avoid concessions that would preclude broader liberalization under GATT? Does the agreement avoid creating any disincentives for participation in GATT negotiations?

Generally, the Canada-U.S. free-trade agreement stands up well. Despite automotive and apparel content requirements, the Canada-U.S. agreement does not increase protection toward third countries overall. Its provisions are GATT-consistent, its processes are compatible with approaches discussed in the Uruguay round, and the agreement will strengthen both economies (although Canada can expect to gain more than the United States).

A Mexico-U.S. or Mexico-U.S.-Canada agreement, structured to become consistent with the Canada-U.S. agreement in the long term, could stand up too. An agreement involving Mexico need not raise barriers to third-country imports, and it could be fashioned to respect existing and emerging GATT disciplines. By attracting more capital and technology to Mexico, such an agreement would help to ensure the durability and extension of economic reforms and would thereby strengthen the Mexican economy and its capacity to participate in GATT.

In the long run the fuller integration of the Mexican and U.S. economies could prove to be a dynamic force for growth in the United States as well. Mexico could play a role in North America similar to the one played by Italy in Europe in the 1980s. As such, an agreement with Mexico need not create disincentives for the United States to seek additional multilateral progress.

But there are risks. Duty-free trade with Mexico could force Washington to further curtail trade with countries outside North America if increased competitive pressures on U.S. apparel, steel, and other mature industries create additional protectionist sentiment. Although the specific provisions of an agreement with Mexico might not indicate an immediate increase in restrictions, these could materialize through, for example, tighter voluntary export restraints.

This brings to the foreground several dangers associated with a succession of bilateral agreements with Latin American countries. The creation of a Western hemisphere trading system would increase adjustment pressures facing mature industries in the United States. The United States could seek to avoid such adjustments by limiting imports from other sources, thereby straining U.S. trade relations with Asian and European countries. Conversely, the United States could accept these adjustments, but this process could so tax the U.S. political capacity to accept market disruptions that the United States would be unable to offer countries outside the Western hemisphere meaningful concessions in other areas of GATT negotiations.

Additionally, approaches to nontariff issues will inevitably vary with the business institutions, legal traditions, and cultures of participants engaged in regional accords. Expanding U.S.-, EC-, and Japanese-centered trading blocs would almost certainly differ in their approaches on some important issues. Taken together, these variations could impose significant impediments to multilateral progress. In the end it may not be possible to build a workable set of multilateral rules from a collection of regional agreements.

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A Mexico-U.S. or Mexico-U.S.-Canada free-trade agreement designed to become increasingly compatible with the Canada-U.S. free-trade agreement could avoid these pitfalls. But there may be real limits to how far we can push regional solutions to trade problems without constraining prospects for multilateral progress.

Selected Readings

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