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# **REFORMING U.S. FTAs FOR ENVIRONMENTAL PROTECTION: LESSONS FROM MEXICO AND BEYOND**

**KEVIN P. GALLAGHER**

## **INTRODUCTION**

U.S. President Barack Obama and U.S. Trade Representative Ronald Kirk have consistently stated their commitment to strengthening the environmental provisions of U.S. trade and investment agreements. More specifically, the U.S. will look to “repair” the free trade agreements (FTAs) negotiated by former President George W. Bush as well as the North American Free Trade Agreement (NAFTA) ratified under President William J. Clinton, and create a template for future FTAs. This short essay examines the relationship between trade and the environment and draws from past trade agreements as a means of putting forth recommendations as to what role environmental issues should play within future FTAs.

## **TRADE AND ENVIRONMENT**

Trade and trade agreements can have positive and negative impacts on the environment. These impacts are usually grouped in four categories: scale, composition, technique, and regulatory effects. In addition, with respect to the environment the “winners and losers” within trade agreements do not always align with the winners and losers from the standard model of goods trade.<sup>1</sup>

Scale effects occur when liberalization causes an expansion of economic activity. If the nature of that activity is unchanged but the scale is growing, then pollution and resource depletion will increase along with output. Composition effects occur when increased trade leads nations to specialize in the sectors in which they enjoy a comparative advantage. When comparative advantage is derived from differences in environmental stringency, then the composition effect of trade will exacerbate existing environmental problems in the countries with relatively lax regulations.

Race-to-the-bottom discussions are perfectly plausible in economic theory. The Hecksher-Ohlin (H-O) theory in trade economics postulates that nations will gain a comparative advantage in those industries where they are factor abundant. Applying the H-O theory to pollution then, it could be argued that a country with less stringent environmental standards would be factor abundant in the ability to pollute. Therefore, trade liberalization between a developed and a developing nation in which the developed nation has more stringent regulations may lead to an expansion in pollution-intensive economic activity in the developing country with the weaker regulations.

Technique effects, or changes in resource extraction and production technologies, can potentially lead to a decline in pollution per unit of output for two reasons. First, the liberalization of trade and investment may encourage multinational corporations to transfer cleaner technologies to developing countries. Second, if economic liberalization increases income levels, the newly affluent citizens may demand a cleaner environment.

From an economic perspective, when liberalization occurs and nations trade where they have a comparative advantage, the winners are those sectors which can now export more of their goods or services. Theoretically, this will not only cause expansion of exports but also of employment and wages in relevant sectors as well. The losers of liberalization are those sectors that will find it harder to face an inflow of newly competitive imports. In those sectors one would expect a contraction of business, layoffs, and wage reductions. If the gains to the export sector outweigh the losses to the import sector, the net gains are positive. This leaves the possibilities that the winners can compensate the losers and/or that the gains from trade can be used to stimulate proper growth.

Being an economic winner does not negate the possibility of being an environmental winner as well. First, this can occur if trade liberalization causes a compositional shift toward less environmentally degrading forms of economic activity. Second, there is also the possibility of environmental improvements in relatively environmentally destructive sectors if those sectors attract large amounts of investment from firms that transfer state-of-the-art environmental technologies to the exporting sector.

## OVERARCHING PRINCIPLES AND GOALS FOR REFORM

For markets to work more efficiently, both positive and negative externalities need to be incorporated into pricing mechanisms resulting from FTAs. Given that externalities are not included within the decisions of private actors in the marketplace, governments are necessary as “second-best” options for correcting market failures. FTAs should afford appropriate policy space for governments to provide the necessary incentives to internalize externalities in the least trade restrictive manner. Four overarching principles and/or rights should guide these goals:

- *Polluter pays principle*, in which those responsible for pollution pay for the external environmental costs of production
- *Precautionary principle*, which states that policies should account for uncertainty by taking steps to avoid outcomes that could cause irreversible damage in the future
- *Access and benefit sharing*, in which profits derived from the use of biological and/or genetic resources are shared with the original providers, and in which original providers are ensured access to the resources in question
- *Right to know*, which is the responsibility of producers and governments to share scientific and environmental information with their populations

In order to repair FTAs and provide a new template for trade and environmental policy as a means of enhancing environmental sustainability for the United States and its trading partners, it will be necessary to revisit some of the core components of FTAs and revise the environmental chapters therein.

## INSTRUMENT, POLICY, AND PROVISION RECOMMENDATIONS

### *Investment Rules*

Although FTAs did not cause an influx of foreign investors intent on exploiting Mexico’s weaker environmental standards, many foreign investors are not model environmental firms. Under NAFTA, some firms brought strict environmental standards with them while others were quite lax and

not in compliance with Mexican law.<sup>2</sup> Furthermore, in all three NAFTA countries foreign firms challenged environmental laws claiming that such laws were “tantamount to expropriation,” or that such laws were in violation of the “minimum standards of treatment” accorded to foreign investors under NAFTA.<sup>3</sup> A reformed investment regime must provide all three governments the policy space to internalize environmental externalities in all firms within its borders, regardless of their national origin. In addition, governments and citizens should have a right to know about the environmental performance and history of all firms operating within their economies. Five general improvements are needed to repair the investment chapter of NAFTA:

- Negotiate an “interpretive note” to reinforce recent NAFTA cases that affirm that indirect expropriation and minimum standard of treatment rules cannot trump genuine environmental regulations that internalize externalities. This could be accomplished by formally recognizing the “Methanex” and “Glamis” rulings under NAFTA tribunals<sup>4</sup>
- Require environmental impact statements by foreign investors before locating in a country
- Preserve the ability of governments to conduct “pre-establishment screening” whereby possible investors are screened for their environmental record and other priorities
- Grant governments General Agreement on Tariffs and Trade (GATT) Article XX- like exceptions to use selective performance requirements to ensure that foreign firms are transferring environmental technologies and practices
- Establish “right-to-know” provisions whereby citizens and governments have access to information regarding an investor’s environmental performance

Many of these provisions have precedent within recent NAFTA cases as well as within the World Trade Organization (WTO) and the United States’ Preferential Trade Agreements under NAFTA. NAFTA investment tribunals in the Methanex and Glamis cases both affirmed that nations have the policy space for *bona fide* environmental laws. Under the WTO, foreign investors are granted no greater treatment than domestic investors and rules on indirect expropriation are absent. The “OECD Guidelines

for Multinational Enterprises” which were signed separately by Mexico, Canada, and the United States, recognize the need for right-to-know provisions and environmental impact statements in foreign firms.<sup>5</sup>

### ***Intellectual Property Rights***

Reinvigorated FTAs will need to have an intellectual property rights regime that recognizes the different levels of development among its parties while ensuring that all parties can put in place systems of innovation and technology/product development within an environmentally sustainable manner. Under U.S. FTAs in the hemisphere, there has been an incentive for private multinational firms located primarily in the United States to monopolize domestic and traditional knowledge and exclude constituents from the benefits of innovation and new product development. There are also increasing concerns that the current intellectual property regime will prohibit nations from developing or deploying new clean technologies for climate-friendly development. With respect to the environment, a new intellectual property template would include the following:

- Require patent applicants to disclose the source and country of origin of genetic and biological resources
- Require patent applicants to show evidence of prior informed consent and a commitment to fair and equitable sharing of benefits from patents that entail the use of genetic or biological resources
- Ensure that intellectual property rules facilitate the transfer of clean technologies, and grant parties equal opportunities to develop new clean technologies
- Re-affirm the right to exclude plants and animals from patent protection and to utilize *sui generis* systems of protection for plant varieties

Again, many of these provisions have precedent in the World Trade Organization and United States’ Preferential Trade Agreements that have come after NAFTA and elsewhere. Article 27.3(b) of the Trade Related Intellectual Property agreement in the WTO grants countries the flexibilities to exclude plant and animals from patent protection and grants nations the flexibility to use *sui generis* systems of protection of plant varieties, as

does the current NAFTA provisions on intellectual property. In the U.S.–Peru Free Trade Agreement and in the draft of the U.S.–Colombia Free Trade Agreement, both parties agreed to a “side letter” whereby prior informed consent and access and benefit sharing for genetic resources are covered. Making commitments regarding access and benefit sharing part of the intellectual property chapter of NAFTA would make such provisions more enforceable and help alleviate some of the concerns over bio-prospecting and bio-piracy in Mexico.<sup>6</sup>

Intellectual property rules and clean technology transfer and development are relatively new concerns that have not been largely debated during earlier negotiations. Nevertheless, these issues are beginning to become primary concerns under the WTO. Key among those concerns are the extent to which developing countries like Mexico will have to pay monopoly prices to install already expensive clean energy technologies and/or face insurmountable obstacles if they choose to develop indigenous clean energy technologies to adapt to and combat global climate change.<sup>7</sup>

### ***Services***

Most U.S. FTAs do not extend even limited environmental coverage to the services sector as can be found for the goods sector. The ongoing case concerning Mexican trucks is emblematic of how services provisions under U.S. FTAs can run head-to-head with environmental policy. Services chapters may also collide with future efforts to deploy renewable energy and global climate change mitigation. To reform services provisions in future FTAs, policy-makers should provide GATT Article XX- like exceptions for trade in services. For measures that regulate services, FTAs could provide exceptions that are necessary to protect public morals, life, health, and conservation of exhaustible resources. Compared to goods trade, NAFTA and other FTAs do not provide parallel exceptions to national treatment for measures that relate to cross-border services. Without such exceptions for health and environmental policy, a trade dispute based on services chapters can undermine the exceptions for measures that regulate goods.

## **ENVIRONMENT PROVISIONS**

The inclusion of environmental provisions within NAFTA was a landmark event. However, while many post-NAFTA agreements have gone on to

have more enforcement power and a larger scope than NAFTA, most do not contain some of NAFTA's innovations.

On the one hand, the side agreement and the institutions surrounding it fostered an unprecedented level of tri-national environmental diplomacy and cooperation among parties to the agreement. NAFTA's environmental agreement, "The North American Agreement on Environmental Cooperation," created a North American Commission for Environmental Cooperation (CEC) that is in part overseen by a transparent and representative public advisory committee. One concrete achievement stemming from these efforts has been the establishment of a "Pollutant Release and Transfer Registry" law in Mexico that is broader in scope than similar laws in the United States and Canada.<sup>8</sup> The CEC also boasts a "citizen submission" process whereby third parties can file claims identifying where they see violations of environmental laws in the three countries. This process has given rise to interesting fact finding missions that have publicized coastal pollution and the genetic contamination of corn. CEC has also hosted (but no longer does) innovative funding mechanisms for communities and small businesses to help them monitor and comply with environmental law. Finally, another collateral NAFTA institution of relevance to the environment was the creation of the North American Development Bank (NADBANK) and the Border Environmental Cooperation Commission. These institutions fund and monitor water and sanitation projects in the U.S.-Mexico border region.

However, post-NAFTA agreements have taken one step forward and two steps back, as most FTAs brought about by the United States after NAFTA have not created a comparable environmental commission overseen by a public advisory group. What's more, when citizen submissions processes do exist, they are not as strong. Five general improvements are needed to strengthen environmental chapters within U.S. FTAs:

- Environmental provisions should be subject to the same enforcement and dispute resolution as commercial parts of agreements
- Require parties to maintain, improve, and effectively enforce a set of basic environmental laws and regulations
- Re-affirm and expand upon the precedence of the list of Multilateral Environmental Agreements (MEAs) that parties are to implement

- Commit to gradually harmonizing environmental standards
- Create and fund collateral environmental commissions

The North American Commission for Environmental Cooperation has been praised by environmental organizations as well as independent assessments for its role in sparking tri-national initiatives on the environment in areas such as pollutant release and transfer registries. It has also been praised for its tri-partite nature which grants civil society an advisory role on how the organization works. Most important, the commission has a “citizen submissions” process whereby non-governmental organizations can allege failures to effectively enforce environmental laws. Such allegations can be followed up by the commission in the form of “factual records,” which have been shown to shame violators into compliance.<sup>9</sup>

While the commission has been criticized for its lack of information and data gathering as well as its limited mandate for enforceability, it is necessary to keep in mind that the commission has been provided a paltry US \$9 million budget, and as such has not been able to change the course of environmental events in North America. In the NAFTA context this commission needs to be reinvigorated and used as a template for new FTAs.

## **RENEWED ENVIRONMENTAL AND DEVELOPMENT INSTITUTIONS**

In order for the expanded role of environmental issues under NAFTA to be accepted and function properly, it is necessary to strengthen the existing mechanisms for financing environmental initiatives in the region. As it stands, funding for environmental improvements in Mexico has been on the decline since the implementation of NAFTA. If the environmental provisions of NAFTA are seen as an unfunded mandate there will be great reluctance on the part of the Mexican government to enforce those provisions. Indeed, there is some evidence that such perceptions persisted when NAFTA was signed, partly explaining why the environmental record under NAFTA has been poor in Mexico.<sup>10</sup>

The North American Development Bank (NADBANK) was originally proposed by prominent economists Albert Fishlow, Sherman Robinson, and Raul Hinojosa-Ojeda.<sup>11</sup> The idea was that the institution would serve as a regional development and adjustment assistance bank to help harmonize

development in North America. NADBANK was indeed established under NAFTA, but ultimately only to address environmental problems at the U.S.-Mexico border. The organization was plagued by difficulties and was reformed by the Bush and Fox administrations in 2001. However, these reforms only served to strengthen its mandate regarding U.S.-Mexico border environmental issues.

A revitalized NADBANK would revert to the form in which it was originally proposed, that of a development bank and adjustment assistance facilitator modeled after the structural funds of European economic integration and Brazil's national development bank (BNDES). To that end, the NADBANK would have to be recapitalized by NAFTA governments and have the capacity to sell bonds and take equity stakes in order to raise funds as needed. The tasks that a revitalized NADBANK would have in relation to the environment within the three NAFTA countries would include:

- Support of small scale, sustainable agriculture initiatives
- Provision of loans for small and medium-sized enterprises (SMEs) for innovation and compliance with environmental regulations
- Provision of loans and financing support for public infrastructure, renewable energy development, and environmental cleanup projects
- Support for public-private partnerships for environment-related research, and development activities
- Development and maintenance of an active research team that examines issues related to development and the environment within NAFTA countries as well as examining bank activities

While such an institution is NAFTA-specific, similar operations could be overseen under other FTAs in the hemisphere by the Inter-American Development Bank or the newly formed Bank of the South.

## CONCLUSION

This short essay has identified the major limitations of U.S. FTAs as regards the environment. What is interesting to note is that the remedies to these limitations have been addressed piecemeal in more recent agreements. This essay collects these numerous improvements from the U.S.

FTAs, and elsewhere, as a means of putting forth a comprehensive set of recommendations for reform regarding trade and the environment under future U.S. FTAs.

## NOTES

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## **Latin American Program**

Woodrow Wilson International Center for Scholars  
1300 Pennsylvania Ave., NW  
Washington, DC 20004

Tel. (202) 691-4030

Fax (202) 691-4076

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