

A NEW TRADE POLICY for the UNITED STATES

Lessons from Latin America



Woodrow Wilson
International
Center
for Scholars

Latin American Program

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INTRODUCTION

JOSÉ RAÚL PERALES

The 2008 presidential campaign took place in the context of growing U.S. trade deficits and acrimonious battles for congressional approval of pending free trade agreements (FTAs). The Obama campaign argued that a new, fairer trade policy was necessary to make up for the increasing loss of manufacturing and other American jobs being outsourced abroad. The model of competitive liberalization through FTAs, promoted since the early years of the Bush administration, was seriously criticized. In the midst of a heated campaign, Obama spoke about renegotiating the North American Free Trade Agreement (NAFTA) and freezing new negotiations, with the notable exception of the Doha Round of the World Trade Organization (WTO).

Official pronouncements about trade policy may have changed since the days of the campaign, but many politicians seem to have little appetite for initiatives that promise further trade liberalization or openness. Indeed, trade policy remains one of the most controversial themes on the complicated economic agenda of the Obama administration. In spite of political compromises negotiated in the Peru FTA between Democrats and Republicans over sensitive topics like labor and the environment, FTAs with Colombia, Panama, and South Korea have yet to be ratified by Congress. In some ways, free trade agreements have become almost synonymous with an economic model that has come under fire, especially as the financial crisis of 2008 began spreading through the real economy. Moreover, as the Obama administration launched major policy initiatives—including health reform, cap-and-trade emissions legislation, an economic stimulus package, and an overhaul of financial regulation—trade’s divisiveness as an issue had the potential to threaten the political coalitions required to advance the administration’s multiple economic objectives.¹

Political divisions in the United States over trade policy are certainly not new, as *Stephen Lande* argues in this report. However, in the context of the worst economic crisis to hit the United States and the global economy in over 70 years, these divisions create additional obstacles to crafting a new trade policy that not only addresses the concerns expressed by the Obama team throughout the campaign, but also that reflect U.S. interests and challenges with respect to the global economy.

Herein lies an important test for the Obama administration. Even though the role of foreign trade in the economic recovery remains clouded in political debate and controversy, the United States must resume active engagement in the international trading system and address a number of new challenges and scenarios. There is pessimism about concluding the Doha Round of negotiations of the World Trade Organization, even though the World Bank predicts that a deal would not only pump an additional US \$160 billion in global income, but also would serve to strengthen the rules-based global trading system at a time of increasing threats of protectionism and unfair trade practices among advanced and developing countries. In spite of generalized apprehensions about new trade agreements in the United States, trade giants such as the European Union, China, Korea, Brazil, and India are expanding their FTA networks and thus gaining new unrestricted access to a variety of markets.

As U.S. trade officials and politicians evaluate the merits of reform and of moving forward with a new trade agenda, Latin America's experience with FTAs may offer lessons that can inform the debate in Washington. This is the argument advanced in this report. The Western Hemisphere has the world's most extensive network of free trade agreements involving developing and developed trading partners, particularly the United States. Latin America is no stranger to political and social controversy over free trade agreements, particularly in terms of their potential effects on local agricultural and manufacturing producers, their consequences for small and medium-sized businesses, and their impact on incomes and poverty. Because of its extensive experience of free trade with the United States, the region provides a rich environment in which to examine propositions about the effects of free trade and free trade agreements (especially U.S.-sponsored agreements) on a whole range of issues, including trade patterns, competitiveness, poverty reduction, and development.

The papers contained in this report address some of the most important questions regarding FTAs and U.S. trade policy, either from a Latin American perspective or using Latin America as a test case. The papers examine the politics of free trade agreements in countries like Costa Rica and Nicaragua, and what renegotiation of their FTAs would entail; labor, environmental, and poverty reduction issues in trade agreements; the effects of free trade on competitiveness; and how to make Latin America's FTA network develop into a stronger tool for economic development.

Authors in this report make recommendations regarding things that “work” and things that “don't work” in the current U.S.- Latin America trade regime. Latin Americans have little interest in renegotiating existing FTAs, especially in light of the political costs many governments incurred in getting these agreements approved by their respective legislatures (or, in the case of Costa Rica, by popular referendum). According to *Anabel González* and *Mario Arana*, resources and efforts should rather concentrate on optimizing existing FTAs so that trade can become the engine of growth that its supporters envision. Moreover, for trade to be an effective tool for poverty reduction, as *Paolo Giordano* explains, it ought to be embedded in a long-term economic development strategy that is tailored to the needs of each country, including the adjustment concerns of losers from trade. Failure to do so would only exacerbate political tensions and growing region-wide discontent with globalization.

Approaches to contentious issues such as labor and the environment would also benefit from reviewing Latin America's experiences. On labor, current U.S. free trade agreements place a heavy emphasis on countries' enforcement of their own laws, while an intense political debate has been brewing over the convergence of such laws with internationally-recognized standards. Yet labor provisions in most FTAs (NAFTA being an important exception) are linked to the dispute resolution mechanism contained in the agreement. This approach places litigation at the center of labor protection efforts but leaves unaddressed many labor-related issues that can emerge as a result of increased commercial openness and economic integration as FTAs become fully implemented. According to *Isabel Studer*, the current approach ought to be modified in favor of more forward-looking strategies that take stock of labor complementarities across national boundaries, like training programs, labor mobility, and human capital investments.

The environmental provisions of FTAs present a different set of difficulties. Environmentally responsible investments and trade involve costs that companies and markets do not automatically integrate into their pricing mechanisms. According to *Kevin Gallagher*, governments can help the private sector internalize these costs through a series of measures involving technology transfers, investment rules, and information sharing. In terms of FTAs and trade policy, Gallagher emphasizes the need for a combination of enforcement (through trade-related monitoring and sanctioning mechanisms) and inducements (like financing investments in sustainable agriculture and technological upgrading) in order to give environmental protection a more central role in U.S. trade policy.

NOTES

1. Claude Barfield and Philip I. Levy, “In Search of an Obama Trade Policy,” *AEI Outlook Series*, August 5, 2009, www.aei.org.

THE ROAD TO FREE TRADE WITH THE UNITED STATES: MAKING TRADE WORK FOR FAMILIES IN THE AMERICAS

ANABEL GONZÁLEZ¹

The road to free trade between the United States and Central America has been a long and winding one. Central American countries first proposed a version of free trade with the United States in 1993 out of a desire to build on the benefits of the Caribbean Basin Initiative (CBI), as well as from concern for the potential negative impacts NAFTA could have on trade and investment flows into the region. It would take fifteen years for this initiative to bear fruit, with the Central America-Dominican Republic Free Trade Agreement (CAFTA-DR) coming into full effect with the joining of Costa Rica in January of 2009, the last Central American country to join.

There have been many challenges within this progression. First, obvious asymmetries in size and level of development made the process a major challenge for Central American countries. Second, the negotiation of CAFTA-DR was very complex from a substantive perspective, as it involved a large and diverse set of issues that were eventually addressed within the full 22 chapters of the final agreement. Third, the negotiation process was multidimensional, involving not only the domestic and international dimensions typical within international relations, but also a third dimension that was a result of the unique nature of the proceedings. This third dimension was the aspect of group negotiation between Central American countries regarding common or joint positions with the United States. And finally, constraints imposed by the U.S. congressional mandate, the importance of precedence, and the competing domestic forces that shape U.S. policy resulted in a negotiation process that was difficult and occasionally contentious, even though the United States was bargaining with relatively small countries.

¹This article was written by Minister González in the capacity of her personal character and does not reflect the official position of the Government of Costa Rica.

Despite the difficulties, negotiations with the United States were both necessary and beneficial for Central America for two key reasons. First, the United States is the most important trading partner and one of the most significant investors in the region. The importance of this for Central America is clear: trade is important for the region as a means towards development, growth, and integration into the world economy. Second, although Caribbean Basin Initiative had been quite beneficial, the region was looking for a reciprocal, more stable relationship based on a scheme of rights and obligations rather than unilateral concessions.

CAFTA-DR was signed in August 2004 by the United States, the Dominican Republic, El Salvador, Guatemala, Honduras, Costa Rica, and Nicaragua. Thus began the difficult process of implementation and entry into force of the agreement. From the technical perspective, the drafting, consultation, and discussion of the legislation and regulations necessary to implement the agreement proved to be quite complex, most notably in the area of intellectual property. Signatories to the agreement had to produce up to 13 pieces of legislation in order to conform to CAFTA-DR. They also had to set up or strengthen their institutional capacity to apply its provisions.

Another challenge was, of course, political. Legislative approval and implementation of the agreement proved to be quite controversial in all countries, including the United States. Nonetheless, such approval was gradually obtained and the agreement first came into force between the United States and El Salvador in March of 2006, with the other signatory countries following shortly thereafter. However, things proved to be much more complicated for Costa Rica, where CAFTA-DR turned into the most difficult political exercise of the past 50 years. Paradoxically, the most important U.S. trade and investment partner in the region—which arguably had the greatest capacity to take advantage of CAFTA-DR’s opportunities—had to go through an excruciating political process that lasted more than four years. Ultimately, it led to the first draft law ever being submitted to a referendum in Costa Rica, in which 60 percent of registered voters decided its fate. CAFTA-DR finally came into force for Costa Rica in January 2009, and the agreement—particularly components related to the opening of the telecom and insurance markets—would become symbols of the political and economic direction that the country would take in the years ahead.

Just when things seemed set on a predictable course and Central American countries were beginning to take advantage of CAFTA-DR, the region was hit hard by external economic conditions. The first challenges were increases in the prices of food and fuel in 2007 and 2008, followed by the global economic crisis and the resulting negative impact on employment, investment, production and trade. As a result of these economic realities, some of the expected benefits from CAFTA-DR will undoubtedly take longer to materialize than originally estimated.

A NEW LOOK AT U.S. TRADE POLICY?

When confronted with the question of whether changes in CAFTA-DR will or should be sought, the viewpoint from Central America is that the existing agreement is adequate. This viewpoint is buttressed by the perception that revisiting trade agreements during times of economic distress within an atmosphere of enhanced protectionist sentiments is not a good idea, certainly not for the smaller players.

What is necessary, however, is for Latin American countries to move beyond their initial skepticism. They must seize the moment and work to influence the new administration in Washington in an attempt to refine and reorient the course of U.S. trade policy as a means of crafting a new, common agenda. At the same time, by understanding where its FTA trade partners are coming from, the United States must move early to dismiss fears of protectionism, to increase comfort levels and to build a positive atmosphere. However, some initial actions have not gone in the right direction.

The United States' rationale for investing in a reinvigorated trade policy in Latin America is clear. Open markets are creating a middle class in the region whose success comes from market-based opportunity, not government intervention. This is essential not only to reduce poverty and inequality—where there have been great strides made in recent years—but also to foster political stability and support for democracy. Now is the time to act so that these gains are not erased by the global economic crisis and resulting protectionist policies. U.S. FTA partners are or could be readily available to forge a new successful partnership at a relatively low cost which could help the Obama administration project a new image to the world while creating opportunities at home and abroad. The partnership

should encompass other issues relevant to the region as well, but trade and investment is one important pillar within this alliance. President Obama has called for trade to work better for American families; what is truly necessary is for trade to work better for families in all of the Americas.

A PLAN FOR REVITALIZING THE U.S. TRADE AGENDA IN THE REGION

Through various FTAs (encompassing agreements in force with Canada, Mexico, Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, the Dominican Republic, Peru, and Chile) the United States has a solid and extensive platform in place for the conduct of trade and investment in the Americas. This existing platform should be the starting point to build a more enduring economic engagement, one which would allow firms in North, Central, and South America to take advantage of greater scale economies thereby enhancing their ability to compete in global markets. This platform can and should be improved and revitalized through a new trade policy jointly developed and implemented by all partner countries that would aim to complete the following six recommendations:

- *Extend the current platform by finalizing pending FTAs and provide for its potential expansion.* This would require first and foremost approval by the U.S. Congress of the FTAs with Panama and Colombia so as to complete the missing pieces of the core legal infrastructure. This would send a very important signal to the region, and there would be no need to enter into new agreements for some time. However, the door should be left open in case other countries, perhaps in the Caribbean, would want to tie into this scheme.
- *Make the FTA platform fully operational.* Many of the FTAs that are part of this platform have come into force only recently. Countries have had to struggle to implement many of the provisions of these FTAs through adoption of major legislative and institutional reforms. Most Latin American countries, however, continue to face challenges derived from the application of the FTA provisions in areas such as customs administration, intellectual property, telecom, labor, or environmental issues. These countries would benefit

from enhanced technical assistance not only to make the FTA fully operational in these areas, but also to devise additional measures that respond directly to broader competitive and institutional challenges, as such, making these measures sustainable over time. Full implementation of FTAs is also in the direct interest of the United States as it promotes compliance, facilitates surveillance, and minimizes trade frictions in a more efficient manner than dispute settlement.

- *Integrate all of the pieces of the FTA platform into a unified whole.* Most of the 12 countries in the region that have trade agreements with the United States also have trade agreements with each other, which shows their strong commitment to free trade. At the same time, however, these overlapping agreements create a complex web of differing tariff treatments, trade rules, and dispute settlement mechanisms that result in inefficiencies and a lack of transparency and predictability. Since the United States is the most important trading partner for most of these countries, it is the most logical candidate to promote convergence of the various agreements in a way that would allow countries to move from a hub-and-spoke model, where all of them are hubs and spokes at the same time, to one that promotes full integration among all. This is a process that could be organized in stages, with the FTAs to which the United States is a party serving as the point or points of departure for this effort.
- *Expand the universe of those who benefit from the FTA platform while minimizing transitional costs.* Trade is a powerful growth engine that can spur individuals, families, and whole communities out of poverty circles by opening new and better employment and entrepreneurial opportunities, by increasing productivity, and by promoting the transfer of technology and sound business practices. However, in order to unleash, maximize, and expand the potential of trade for the benefit of all, countries must work to address a number of supply-side constraints that range from improving inadequate transportation and communication infrastructure to providing credit for trade financing. Countries also need to invest in those areas that ensure equality of opportunity, most notably in education for all citizens

and the early introduction of technologies. This suggests a very important role for “aid-for-trade.” The United States has already embraced this concept, but placing trade capacity building efforts at the center of U.S. trade relations with Latin American countries would further consolidate and expand the role of the United States as a partner in the developmental efforts of the region.

- *Strengthen the foundations on which the FTA platform is based.* The FTA platform must rest on the foundation of a solid rules-based trading system. Thus, the continued commitment of the United States and of its FTA partners to the World Trade Organization is essential. In order to strengthen this foundation, countries should conclude the Doha Round negotiations as soon as possible. This is important for three reasons. First, it would send a strong signal that the United States maintains a commitment to multilateralism and open markets, which is key at times of increased protectionist pressures. Second, the Doha Round addresses some issues that are not adequately dealt with in the FTAs but that nevertheless have an important impact on trade, such as agriculture subsidies. And third, by concluding the Doha Round, countries would be in a better position to address other issues that are also very important and for which multilateral cooperation is essential, such as energy security and climate change.

A CONTROVERSIAL ISSUE: LABOR STANDARDS

One particular issue of apparent importance to the Obama administration is likely to be controversial in the region, namely, that of revisiting existing agreements with a view to strengthening provisions on labor standards. Concerns about this issue in the region are multifaceted. On the one hand, countries fear that protectionist interests may block hard-fought access to the U.S. market. On the other hand, for most countries in the region the process of negotiating, approving, and implementing the FTA with the United States was extremely challenging, and they are simply not ready to go through such a process again any time soon. It is not a matter of lack of will; rather, to do so would risk unsettling a balance that was delicately achieved, opening a “Pandora’s box” of requests for renegotiation from

domestic special interest groups that may spin out of control both in the United States and in Latin America. Furthermore, anti-globalization, nationalist, and populist political forces in the United States and in the region would try to use such a process to advance their own anti-trade objectives, further complicating the political landscape in the area. In any case, the issue itself seems to be primarily of a domestic nature within the United States. Building trust among FTA partners regarding U.S. intentions is a necessary first step if any policy proposal in this area is to succeed. If anything, such a proposal would need to be clearly circumscribed, should have no adverse effect on trade, and should be implemented without reopening existing agreements.

SEIZING THE OPPORTUNITY

President Obama begins his presidency as a well-respected and admired leader in the region and perhaps the most popular since John F. Kennedy. Perceived of as an internationalist who will work with others to achieve common goals, people south of the border have high hopes for him as well. As trade is a key issue for many Latin American countries, a review and possible revision of U.S. trade policy provides President Obama with the opportunity to confirm that he stands ready to lead the revitalization of the United States in partnership with the region. Such an opportunity must be seized.

A NEW TRADE POLICY IN THE UNITED STATES? A CENTRAL AMERICAN PERSPECTIVE ON FREE TRADE

MARIO ARANA

INTRODUCTION

The negotiation of second generation free trade agreements with the United States traditionally included disciplines for the free trade of goods as well as rules on investment, services, and intellectual property rights. However, in the most recent trade agreements negotiated by the United States, the enforcement of labor and environmental standards has been added to the mix. This was a result of a bipartisan consensus led by Democrats in the U.S. Congress in order to support recent agreements negotiated with Latin American countries. Critics of this approach argue that these so called “blue and green” issues have no place in free trade agreements, and should be addressed in other forums.

The competitive liberalization paradigm of the George W. Bush administration has not been replaced by an alternative paradigm. The Bush administration had taken a strategy that relied upon the premise that one-on-one or regional negotiations with Latin America would press others to enter negotiations and, as a result, facilitate multilateral negotiations overall. However, one contrary view takes the stance that existing trade agreements should be renegotiated as the United States experiences increasing labor employment instability as a result of globalization. Alternatively, the view also exists that there should be a hiatus on any new bilateral or regional trade negotiations as reassessments are made of the overall trade strategy.

It is clear that organized labor strongly influences the views of Democrats in Congress—perhaps even more strongly than corporate America—especially within the context of a recent presidential election. Nevertheless, the Obama administration has not excluded asking for a new Trade Promotion Authority (TPA) or a fast track mandate from the U.S. Congress. At the same time, there is a recent call to avoid protectionist practices in the face of the current

world recession. Nevertheless, the renegotiation of trade agreements has faced not only rejection by countries that could be affected, but the new administration has for all practical purposes played down the issue, and more recently has stated that those negotiations will not be reopened. Yet, there seem to be discussions in which agreements not yet sent to Congress could see their labor and environmental components revisited, and as such may yet be supported by the Obama administration.

So, in the face of a backlash against free trade, are there any lessons to be learned from the experience of the negotiation and implementation of the free trade agreement between the United States and Central America? How should we Latin Americans and Central Americans who have played a leading role in trade liberalization view this debate, given the fact that we have taken risks in guiding our countries down the road to free trade? And can we be sure that the best interests of consumers, and especially the poor, are being served? Until now, the basic staples that form a large part of the diet of impoverished sectors of Latin and Central American society have received a high degree of protection. Under the free trade agreement with the United States, in only 10, 15, or 20 years time at most, those preferences should be removed. Staples such as rice, beef, dairy, cooking oil, beans, sorghum, and other sensitive goods will not have protective tariffs, and this will directly affect the poorest of the poor.

At the same time, inefficient producers of over protected basic staples stand to face greater competition. These producers must become more competitive and develop alternative sources of income or else face hardship and dislocation when full liberalization takes place. In this sense, does free trade represent an appropriate option for the improvement of the overall well being of our societies? And, if that is the case, how do we prevail without disregarding the sensibilities and political realities of today?

THE OBJECTIVES OF CAFTA-DR FROM A CENTRAL AMERICAN AND U.S. PERSPECTIVE

In this context, it is worthwhile to briefly review the motivations and objectives of the two sides as they entered into negotiations for a free trade agreement and examine some of the outcomes of the negotiations. Central America had several key objectives in mind as it decided to negotiate a free trade agreement with the United States. A central one was

the consolidation, expansion, and permanence of the Caribbean Basin Initiative (CBI) Trade Preference System, which was subject to periodic revisions and approval by the U.S. Congress. The CAFTA-DR allowed for these objectives, adding predictability, security and transparency to the region's exports and preferred access to the U. S. market. Furthermore, these preferences were multilateralized among signatories and made permanent within the free trade agreement.

A second key objective was the diversification of Central America's exports. With the definition of clear and predictable rules and greater access to the U.S. market, it was expected that the agreement would motivate the diversification of the region's exports as well as the growth of non-traditional productive sectors vital to the region's economic growth.

A third key objective was for the region to become a privileged export platform to the world's largest market as a means of attracting foreign direct investment (FDI). Preferred access to the U.S. market was expected to be a platform through which Central American countries could attract FDI from third countries wishing to benefit from this increased access.

In addition, the trade agreement would bring improved import conditions. Lower costs of inputs, raw materials, and capital goods produced elsewhere were necessary for lowering the costs of production of goods while making the Central American economies more competitive. The agreement also aimed at eliminating non-tariff barriers (NTB) to regional trade with the United States. CAFTA-DR negotiations resulted in a reduction of NTBs between the United States and the countries of the region, and the formation of a structure that would eliminate the risk of future barriers. These measures were crafted to ensure a free flow of the region's exports to the United States.

From the perspective of the United States there were several key motivations and objectives. The free trade agreement with Central America was part of the so called competitive liberalization strategy of the Bush administration, through which Washington expected that Latin American countries would warm up to the Free Trade of the Americas Initiative, or better yet, facilitate negotiations within the World Trade Organization (WTO). Given the fact that the trade concessions of the Caribbean Basin Initiative were for the most part one sided, another interest for the United States was the leveling of the playing field with Central America. And there were still important tariffs and non tariff barriers to free trade that the United States faced in the region.

More importantly for the United States, national security was at the forefront of the political agenda, and it was believed that free trade negotiations with Central America could contribute to strengthening U.S. national security, even if that was not openly advocated. The hope was that free trade would support economic development and would contain migration flows, among other collateral benefits, that could reduce threats from hostile political currents in the region.

RESULTS OF THE CAFTA-DR NEGOTIATIONS IN THE CASE OF NICARAGUA FROM A MARKET ACCESS PERSPECTIVE

The following serve as examples of market access negotiation results for Nicaragua. Relatively similar asymmetrical agreements were achieved between the United States and the other Central American countries. Within CAFTA-DR negotiations, Nicaragua obtained:

- Consolidation and inclusion of 100 percent of Nicaraguan products within the CBI into CAFTA and free access to other products outside the CBI (e.g. tuna and shoes)
- Immediate access to the United States for 100 percent of existing exports from Nicaragua, plus additional access through export contingents to the U.S. market
- Free and immediate access for 100 percent of Nicaraguan goods
- A 100 million meter TPL (trade preference levels) quota for textiles/clothing
- Free access for more than 95 percent of U.S. tariff headings
- Free access for 68 percent of current agricultural trade and free access through contingents for the rest of the agricultural sector

In exchange, Nicaragua granted the United States:

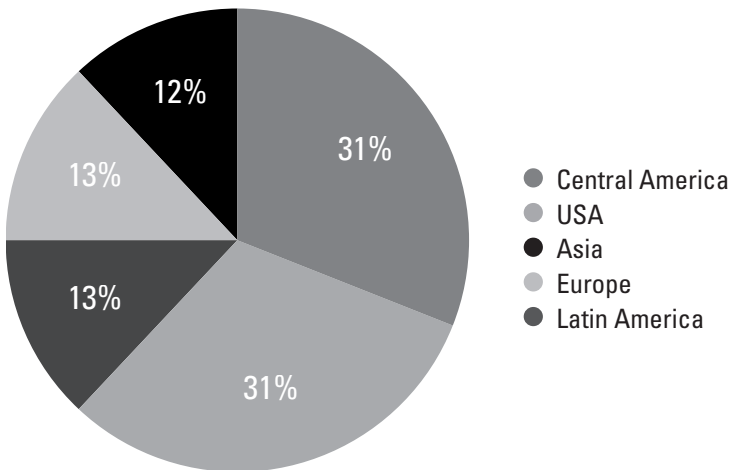
- Immediate access for 80 percent of U.S. industrial exports to Nicaragua
- Free access for 55 percent of current agricultural trade with the United States, plus additional access through import contingents for 25 percent of current agricultural imports
- Access equivalent to a value of 5 percent of current trade through contingents of milk, pork, and corn

- As a whole, including additional access, Nicaragua granted immediate access for 85 percent of current trade levels at the time of negotiation with the United States

RESULTS FOR CENTRAL AMERICA, NICARAGUA, AND THE UNITED STATES IN THE FIRST YEARS OF THE CAFTA-DR IMPLEMENTATION (2005–2008)

Judging by the evolution of economic and trade relations over the last few years, Central America has indeed benefited from an increase in exports to the U.S. market, which represents the destination for over 30 percent of the regions total exports. Exports from Central America to the United States increased from US \$19.2 billion in 2005 to US \$27.2 billion in 2008, a substantial increase within the initial years of the trade agreement. During this same time period, imports from the United States to Central America increased from US \$35 billion in 2005 to US \$53.6 billion in 2008. As the United States represents 40 percent of imports to Central America, the trade balance has favored the former player. In fact, Central America's trade deficit had grown to over US \$26 billion by 2008 and is only expected to increase in the future.

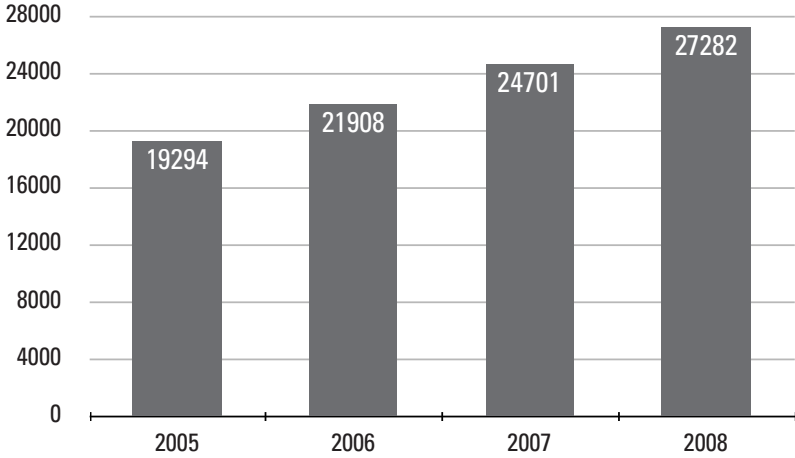
Geographical Distribution of the Central America's Exports



Source: Central American Integration System (SIECA)

Central America's Exports (including free trade zones)

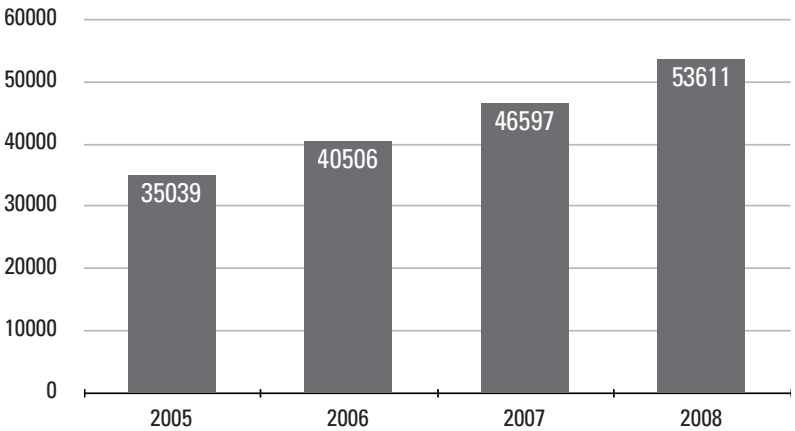
Millions of Dollars



Source: Executive Secretary of the Central American Monetary Council (SECMCA)

Central America's Imports (including free trade zones)

Millions of Dollars



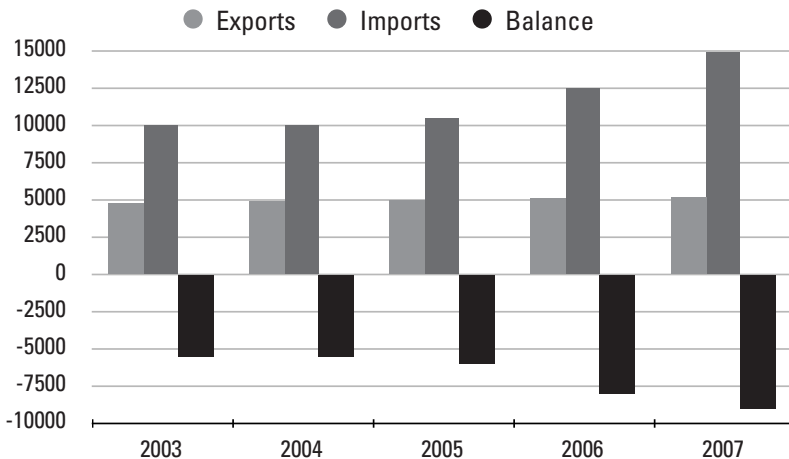
Source: Executive Secretary of the Central American Monetary Council (SECMCA)

In regards to Nicaragua, an examination of the first three years of CAFTA-DR shows that the agreement has produced positive effects for trade and investment, though Nicaragua has not taken full advantage of the benefits. Imports from the United States grew 37 percent by the third year of implementation, benefiting consumers as well as producers, and Nicaraguan exports to the United States grew 29 percent from 2006 to 2008 (excluding free trade zones). However, the commercial balance continued to favor the United States. This would be a similar trend in Central America as a whole.

CAFTA-DR complements other Central American Free Trade Agreements such as the one with Mexico, and more importantly, the Central American Common Market. A positive effect of the trade agreement with the United States has been a steady rise in intra-regional trade. In fact, in the case of Nicaragua exports to the Central American region have exceeded those to the United States in the last three years, going from US \$355 million in 2006 to US \$497 million in 2008 (a 40 percent increase). And the trade balance with Honduras and El Salvador has favored Nicaragua.

Central America’s Commercial Balance with the United States

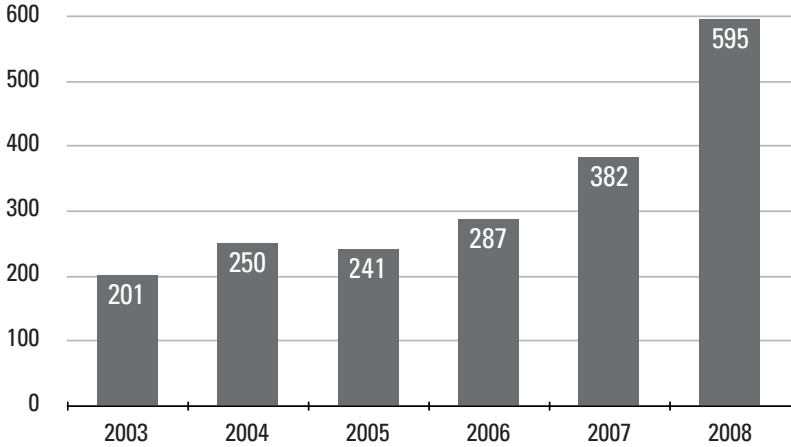
Millions of Dollars



Source: Central American Integration System (SIECA)

Net Foreign Direct Investment In Nicaragua

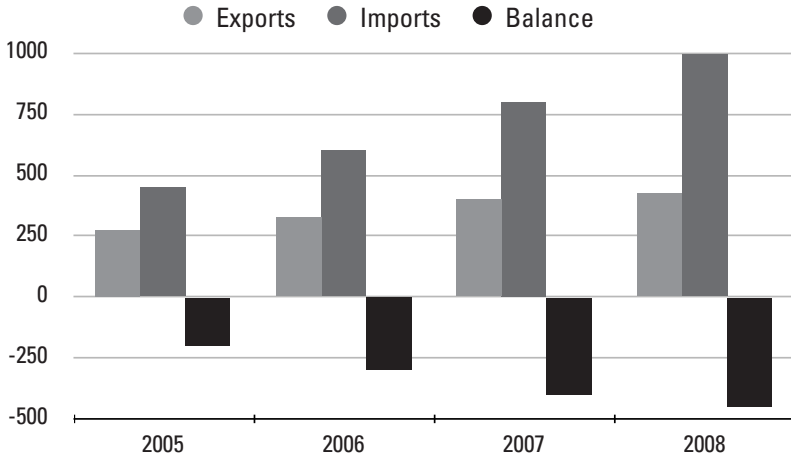
Millions of Dollars



Source: Central Bank of Nicaragua (BCN)

Nicaragua's Commercial Balance with the United States

Millions of Dollars

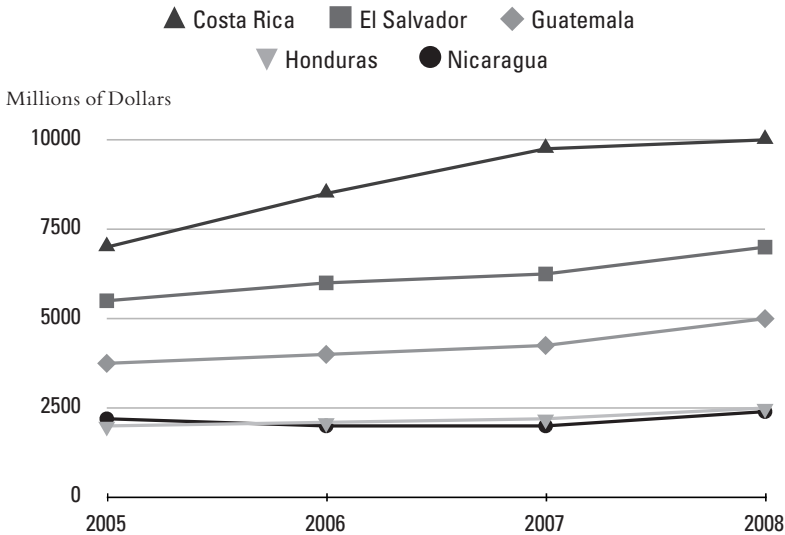


Source: Central Bank of Nicaragua (BCN)

In the case of foreign direct investment, there has been a marked increase in the first years after the signing of the agreement, although Nicaragua still shows the lowest level among the CAFTA-DR countries. The average yearly FDI has gone from US \$250 million of new investment before the agreement to US \$350 million after the agreement, reaching US \$600 million in 2008. Investment from Venezuela, Canada, and the United States in energy generation explains this recent increase. Overall, while Nicaragua needs to increase efforts to promote FDI linked to productive and export activities, Central America as a whole has seen an increase in terms of FDI after implementing CAFTA-DR.

At present, the bulk of export-related FDI is concentrated under the free trade zone regime in textile and apparel, while FDI in agriculture, mining, fishing, and industry has been limited. Yet the improved business climate resulting from the CAFTA-DR has led to new foreign direct investment in communications, finance, and agriculture from various countries such as the United States and Mexico, as well as among Central American countries. Most of this can be explained by the externalities of the agreement, even if it is not representative of investment in export oriented activities aimed at trading with the United States.

Central American's Exports: A perspective for each country



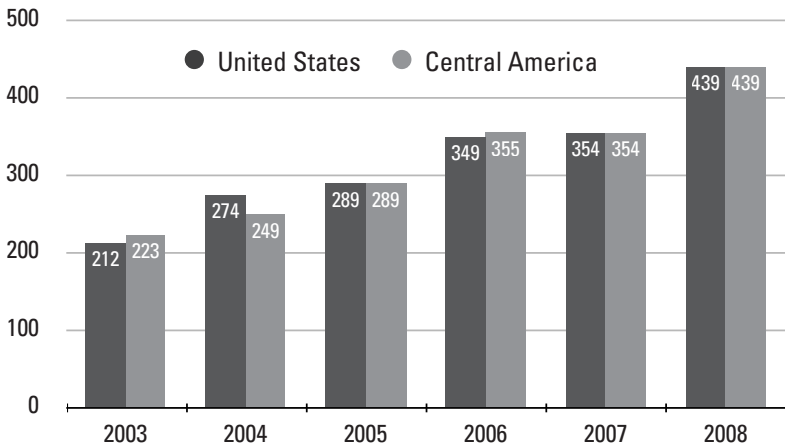
Source: Executive Secretary of the Central American Monetary Council (SECMCA)

In spite of these achievements, there are of course major shortcomings to overcome. Nicaragua still faces limitations that hinder its capacity for taking full advantage of the CAFTA-DR. It must deal with weaknesses in productive chains, improve productive infrastructure, address institutional issues related to the agreement’s complementary agenda (e.g., establishment of the Pro-Competencia Institute, which was created by law but has not been put into effect due to budgetary constraints), and reinforce quality control systems and health standards. As a result of these impediments, Nicaraguan exports are still centered in 50 enterprises. As such, small and medium-size businesses need technical and financial support to gain access to the opportunities opened by CAFTA-DR.

But the bottom line is that even though direct foreign investment may have played in favor of Nicaragua, in terms of trade the United States has enjoyed a favorable balance. A similar picture applies to the Central American region overall, even Mexico. So, it is a great paradox that countries in trade agreements with the United States—though without favorable trade balances—are blamed for problems such as the U.S. deficit with China and the potential loss of U.S. jobs. In this line of thought, the emphasis on environmental and labor standards in trade agreements is supposed

Central American’s Exports: A perspective for each country

Millions of Dollars



Source: Executive Secretary of the Central American Monetary Council (SECMCA)

to level the field so that U.S. jobs will not be lost to other countries, as presumably unfair competition is prevented when labor and environmental standards are enforced in developing economies.

A Nicaraguan tripartite commission made up of labor, businesses, and government representatives adopted a common strategy when the issue of labor standards was addressed in the negotiation of the agreement. In terms of the defense of labor rights there exists in Central America a very progressive legal framework, even more advanced than in the United States. The difficulty lies in the enforcement of labor and environmental standards. All actors in the negotiation agreed that labor and environmental laws and the capacity to enforce them in the region needed to be strengthened. If this issue becomes a limitation to other agreements in Latin America, Central American countries will benefit in the short term from privileged access to the U.S. market. But, in the medium to long term, there will be little increase in overall efficiency and competitiveness if the agenda for free trade does not continue making headway throughout the region.

To use these arguments to reopen negotiations with Central America would shift the careful balance that was reached when the negotiations were completed back in 2003. This would bring unforeseen consequences, and as a result protectionism could prevail over liberalization. Thankfully, within the context of the international economic crisis, recent surveys are beginning to show a more positive attitude in the United States towards free trade. Still, there is the need to retake the Doha agenda, which is important for developing countries in terms of market access for agricultural goods, but even more significantly, it will allow these countries to deal with the implications of agricultural subsidies.

Nevertheless, the reasons behind the current dilemmas confronting free trade within the United States are political and related to perceived concerns about trade-offs on employment opportunities and depressed wages for impoverished social sectors. While it might be true that free trade tends to depress wages of lower income groups in the United States, there are other benefits that offset this impact. For example, market access and the weight of exports within the U.S. economy today explain a significant portion of economic growth as well as employment generation.

At the same time, as investment opportunities and lower production costs open up in other countries, part of the argument regarding the negative impact on employment associated with free trade is misplaced. For instance, in a

normal year (before the current recession), the U.S. economy was creating 17 million jobs while destroying 15 million, for a net gain of 2 million new jobs. It is important to realize that this process certainly causes major dislocations and should not be taken lightly, but the impact of free trade is only a small part of the perpetual transformation that capitalist economies undergo. So the point is, while trade is positive overall, it requires attention from a political and social point of view. Hopefully a more educated understanding of the benefits and consequences of trade and an avoidance of simplistic populist perspectives and counterproductive policies will increase the well being of potential partner economies. The strengthening of proper safety nets would go a long way in countries such as the United States to better address the dislocations that come from free trade, and more so to address the dislocations resulting from the perpetual transformation of capitalist economies.

Taking into account the dislocations that are caused by trade and economic change, the United States and its trade partners should work on an agenda that addresses the political and social implications of free trade so that they may enjoy the benefits of having more satisfied consumers and more competitive economies. It should be admitted that the backlash against free trade has valid concerns, but these concerns should not be allowed to derail the potential benefits of free trade. Partner countries in the Americas must work together so that these concerns are addressed. Safety nets, dealing with dislocations and investment in job creation are all part of the agenda that countries and governments need to aggressively work on in the future.

CONCLUSIONS

International free trade is inspired by the principles of comparative advantage popularized by the writings of the classical economist David Ricardo. Under this principle it is logical to expect that investments will go to the countries where there are efficiencies to be gained. While there are winners and losers, countries and regions stand to develop a higher standard of living through trade. However, it is clear that productive and social dislocations will take place in the process. The difference is that advanced economies such as the United States enjoy the protection of a reliable safety net, while this is not the case for developing economies. On the other hand, advanced and developing economies alike should invest in educating the

population on the implications of free trade, so that populist arguments that do not really address the correct options for development are overcome. The negotiations of Doha need to continue moving forward, and there is a need to continue the promotion of free trade with interested Latin American countries. In the end, we all stand to benefit from efficiency, specialization, and competitiveness over all.

TRADE AGREEMENTS AND CONTEMPORARY U.S. POLITICS

STEPHEN LANDE

Within the CAFTA-DR and U.S.-Peru trade negotiations, one of the great difficulties Latin American negotiators faced was political buffering from domestic interests, most of which were not ready to accept the strict discipline demanded by U.S. negotiators. Negotiators were also buffeted by those they negotiated with. One can imagine the challenge of negotiating with a country with a population 30 to 100 times larger, Gross national product (GNP) differentials of even greater proportions, and on top of all this, is the only remaining world superpower. Worsening the situation for Latin American negotiators was the fact that U.S. negotiators worked from a set template known as a “gold plated” model from which deviation is difficult if not impossible. This template is based largely on the presupposition that foreign governments will adopt U.S. laws, which often differ significantly from those within Latin America.

The Central American and Andean negotiators managed this buffering through a number of tools, many of which were developed during the negotiations themselves. The negotiating teams were able to come to agreements that proved acceptable to their domestic political process by refusing to be rushed into an agreement, by focusing on details, making judicious use of flexibilities allowed by phase-in periods, and by gaining a detailed knowledge of U.S. deviations from their own free trade model.

Although there was some domestic resistance to a few provisions such as patent protection for pharmaceuticals and the opening of markets to the highly subsidized agricultural goods from developed countries, on the whole, the approval process went smoothly. In fact the only exception was Costa Rica. However, here the problem was principally caused by two issues: an extremely cumbersome approval process which was unique in allowing minority views to be expressed, and a very close election in which the free trade agreement (FTA) was an issue.

Within the agreements, U.S. negotiators gave up little and the U.S. “gold-plated” template was largely accepted by its partners. The United States had already been providing duty-free treatment to the vast majority of imports from its trading partners under preferential systems, and it was simply called to bind duties that were largely already at zero. Furthermore, few domestic laws had to be modified and those that did were subject only to minor changes. On the other hand Central American and Andean FTA partners had to eliminate duties that were often in high single or double digit levels. They also had to revise a great number of laws to comply with the U.S. model. Yet surprisingly the approval process proved in general to be more difficult in the United States than in the Central American and Andean regions.

To understand the reason for this difficulty, one must understand the U.S. political process. As with the North American Free Trade Agreement (NAFTA) 12 years earlier, the approval challenge had little to do with the trade agreements themselves. Rather, the challenge was largely caused by domestic politics. For most of the post-war period the United States had a bipartisan trade policy. Democratic administrations were responsible for the reversal of the excessive duties of the Smoot Hawley Tariff Act, which was credited with deepening the depression of the 1930s. The Democrats gained approval for multilateralism with the approval of the General Agreement on Tariffs and Trade (GATT) in 1947. The Kennedy Round of GATT (1964–1967) became the first of a series of comprehensive negotiations moving beyond tariffs, and the Tokyo Round (1973–1979) was approved with a lopsided vote in which only 14 of the 525 members of the U.S. Congress opposed its passage. This bipartisan approach began to erode during the Reagan-H. W. Bush administration and fell apart completely during the W. Bush administration. Unfortunately, later agreements paid the price with the long delay and narrow vote in favor of CAFTA-DR, the long delay and additional negotiations for the approval of U.S.-Peru FTA, and the continuing delay and uncertain future of U.S. FTAs with Colombia, Korea, and Panama.

The major issue that has made passage of recent FTAs difficult is the difference between Democrats and Republicans regarding the treatment of labor issues. Until recently labor issues did not impinge on multilateral trade negotiations; they simply were not covered. Even FTAs with Canada and Israel did not involve labor issues given the high standard of living in these countries.

However, the issue of labor arose with a vengeance during the NAFTA negotiations. This was the first U.S. FTA negotiation with a country which had significantly lower wages than those existing in the United States. Until NAFTA, the United States provided duty-free treatment to developing countries under unilateral preference programs. Unlike FTAs, these programs did not require binding commitments. Duty-free treatment could be withdrawn unilaterally by the United States, and one justification for its withdrawal could be violation of labor rights. Regardless of how the provision was expressed, U.S. labor was being asked to replace unilateral duty-free treatment—which could be withdrawn by the United States at will—with a binding commitment which subjected any removal to dispute settlement.

Complicating the situation was a disagreement between Democrats and Republicans over the terms of the labor provision in the FTAs. The Democrats favored a continuation of the definition of labor rights incorporated in U.S. preference programs. This definition provided that duty-free treatment could be withdrawn if any country violated internationally recognized labor rights. Republicans felt that this definition was too strict since foreign countries could bring complaints against U.S. labor practices as well. They argued that the test should be a simpler one: whether a country was enforcing its labor laws as they applied to exports in general and export zones specifically.

A second disagreement was over the appropriate sanction against violations of the labor provisions. The Democrats favored treating labor violations as any other violations with the right to retaliate by withdrawing concessions on products. They argued that since concessions could be withdrawn for a violation of market access or intellectual property rights (IPR) commitments, the same sanctions should be available for a violation of labor rights. The Republicans were not willing to provide such a strict penalty for labor violations and argued for further mediation. First, under NAFTA, not all labor violations were subject to sanctions. Second, there were more opportunities to work out a mutually acceptable solution. Thirdly, if a violation was established under dispute settlement and it was a violation covered by sanctions, the sanction could be a fine as opposed to a withdrawal of concessions.

Many felt that the major purpose of the Republican strategy was domestic politics. It was claimed that the Republican House leader Tom Delay and the Republican Chairman of the House Committee on Ways and

Means Bill Thomas agreed on this strategy to embarrass Democrat incumbents in marginal districts. In general, business supported FTAs and labor opposed them. By insisting on a provision that labor could not accept, Democrats were faced with an inevitable choice. They either would lose the support of their business constituents by voting against the agreement or that of their labor constituents by voting for the agreement. The strategy worked as the number of pro-trade Democrats declined in the late nineties and early years of the first decade of the twenty-first century. During this period the Republicans were able to solidify their majorities.

There was little that countries negotiating with the United States could do to resolve this internal situation. The CAFTA-DR countries sent a clear signal that they could live with either the Democratic or Republican formulations for labor. In fact, the leaders of the pro-labor Democrats in the House, Sandy Levin and Xavier Becerra, made a commitment to a group of Central American ministers that they would support CAFTA-DR if an acceptable formulation was developed. When United States Trade Representative (USTR) Robert Zoellick got wind of the offer, he abruptly reminded the ministers that there was only one USTR in the U.S. government and it was inappropriate to negotiate with anyone else. The offer came to naught.

Republican majorities were sufficiently strong during the beginning of the second term of the Bush administration (2005–2009) to pass CAFTA-DR without changing the basic labor provisions. However by the time the Peru, Colombia, Panama, and Korea FTAs were ready to be passed, the Democrats were back in the majority. USTR Susan Schwab realized that there was no way that there was no way that the FTAs could pass during the remaining time in the Bush administration. The result was the compromise of May 2007 in which labor provisions were successfully strengthened.

Peru passed with a significant proportion of Democratic votes although still not a majority of House Democrats. However, there was too much baggage and political shenanigans to allow the other agreements to pass. Colombia was bogged down by a long history of labor violence and alleged impunity for perpetrators. Korea became a victim of the precipitous decline of the U.S. auto industry. Peru may have been passed if the Bush administration did not insist that Colombia had to pass first simply because it was negotiated first. In point of fact, the Bush administration thought that they could use support for Panama as a way to gain support for Colombia.

Regardless of what happens, CAFTA-DR and the U.S.-Peru FTA have been passed by the U.S. Congress and are being implemented. The Obama administration appears willing to try to develop a more bipartisan trade policy, though it may have little choice if it wishes to see any of the three pending agreements passed or any new initiatives considered. Speaker Nancy Pelosi has announced that no agreement will be brought up for Congressional consideration without support from a majority of House Democrats. Even if a majority acquiesces there will be strong Democratic opposition which can only be offset with strong Republican support. However, one cannot predict what will happen until one knows the composition and attitudes of the Obama trade team, the Democratic House caucus, the Republican House leadership, and foreign trading partners.

FREE AND FAIR TRADE FOR ALL: THE ECONOMIC FOUNDATIONS OF A PRO-POOR TRADE AGENDA IN THE AMERICAS

PAOLO GIORDANO

INTRODUCTION

One of the fundamental tenets of international trade theory is that in the long-term an international division of labor based on free trade and specialization according to comparative advantages is a win-win proposition for all, countries and individuals. Yet if that was simply the case, trade negotiations would not be necessary. Navigating the world economy is indeed more complex than suggested by standard theory.

As John Maynard Keynes bluntly put it, in the long term we are all dead.² And, as Jagdish Bhagwati recently pointed out, free trade agreements are not about free trade so much as they are about regulating residual restrictions to the movement of goods and services.³ So in essence, trade liberalization—especially in the context of negotiated, preferential, and reciprocal free trade agreements—has distributive consequences in the short term, which have important political economy implications.

In Latin America, of particular salience is the distributive impact of trade integration on the poor, which constitute a large share of the population and are the most vulnerable to the consequences of liberalization. Uncertainty about the asymmetric distributive effects of free trade has created some anxiety, which in turn has been eroding a longstanding consensus for trade integration. *Latinobarómetro* polls indicate that support for trade integration in Latin America has declined from a peak of 88 percent in 1998 to 75 percent as of 2005.⁴

These attitudes are mirrored in developed countries, as evidenced in a German–Marshall Fund survey about trade attitudes in the United States and Europe. According to recent data, if a trade agreement is to be signed with a poor country an overwhelming majority of the population expresses support for trade. When asked if the poor country would benefit from free trade, there is also a majority that believes so, although less so than in the

previous question. When asked if they would agree to provide assistance to poor countries in the context of the negotiation of a free trade agreement, again a majority of respondents say that aid-for-trade is a necessary complement to trade liberalization.⁵

In short, representative surveys of popular opinion suggest that people at different income levels support trade integration, but there is also a widespread consensus on the need to adopt measures that guarantee that everyone in society will benefit from it, particularly the poor. As stated eloquently by President Obama: “This is the moment for trade that is free and fair for all.”⁶

Against this backdrop, this short essay summarizes the evidence on the nexus between trade and poverty reduction in Latin America and discusses the implications for the trade integration agenda of the Western Hemisphere.

TRADE AND POVERTY, AN ELUSIVE CONNECTION

As a starting point, it is crucial to clarify the analytical framework used to understand the likely impact of trade on poverty. Both terms need to be defined precisely as there is some confusion about what they imply. They also need to be clearly separated from concepts that are apparent, yet misleading. In fact, depending on the definition of the terms, one finds evidence to support a variety of contrasting causal relationships.

For instance, free trade cannot be equated with globalization at large, since the latter includes the movement of capital, migration, and information, which have distributive implications on their own. Similarly, it is very different to consider only trade in goods and services or to include in the analysis the technological change that goes along with enhanced trade and foreign direct investment. More technically, the specific measure of each variable is not neutral and leads to different policy implications. For example, trade openness refers to a multidimensional outcome only partially controlled by governments, while trade policy measures such as the removal of tariff or non-tariff barriers are under the control of public authorities.

By the same token, poverty is not synonymous with inequality; poverty reduction can be associated with both rising and falling inequality. As with

the definitions of trade, it is crucial to separate relative and absolute measures of poverty or global and local measures of inequality. All these issues elicit different consequences on the trade and poverty nexus. To ignore the necessity of clarification is to guarantee a dialogue of the deaf.

THE CHANNELS OF TRANSMISSION IN TRADE THEORY

Once the key variables are carefully defined, it is possible to track the three main channels that link trade liberalization with poverty reduction. First, trade liberalization causes a change in relative prices, which in turn affect the consumption possibilities of poor households. Second, on the production side, changes in relative prices determine the incentives for investment, employment, and wages in the sectors in which the poor are employed. And third, the erosion of public revenues originating from trade taxes has an impact on governmental capacity to balance the effects of trade liberalization.

According to standard trade theory, it is likely that these three channels lead to pro-poor outcomes. This is particularly so in the case of trade-creating North-South agreements in which poor countries producing labor intensive goods conduct trade with developed economies that have a comparative advantage in capital-intensive goods.

However, many assumptions underlying the standard theory do not hold in the case of Latin America. Thus trade agreements' effects differ from theoretical predictions for three main reasons. First, Latin American markets are characterized by imperfect market structures such as oligopolies or monopolies in which consumers are prevented from benefiting from the price reductions resulting from trade liberalization. Likewise, many poor households live in subsistence economies or reside in regions not well connected to global markets. In these cases, price changes at the border will affect poverty in remote areas.

Second, on the employment side, labor immobility and unemployment persists throughout the continent. While some skills are readily transferable from one sector to the other, the poor may not have the capacity to adjust to a trade liberalization shock for lack of flexibility, human capital, or other structural factors. Likewise, in a situation of unemployment, additional demand for labor-intensive exports does not necessarily result in higher

wages at the bottom of the salary scale. The existence of large pockets of informality also prevents the labor market from functioning as predicted by traditional trade theory.

Finally, Latin America and the Caribbean's public budgets rely heavily on tariffs as a source of income, and governments have serious difficulty in forgoing or replacing them. Hence there is a critical lack of resources to compensate for the negative distributional effects of trade liberalization.

THE STANDARD TRADE THEORY DOES NOT TELL THE WHOLE STORY

Beyond the widespread existence of market failures sketched above, three additional reasons make standard trade theory a limited instrument to fully assess the effects of trade liberalization on poverty. First, in some Latin American countries, the structure of trade protection has been biased towards labor-intensive industries. Across-the-board trade liberalization has entailed significant adjustment costs in these sectors, with adverse income effects on the poor employed therein.

Second, free trade was paralleled by skill-biased technological change, which in turn placed a premium on skilled labor and in particular workers at the top of the salary scale. In the presence of skill-bias, free trade increased wages for the most educated and wealthier workers while the poorer segments of the labor force were penalized. Indeed, skill-biased technological change, in itself independent from trade liberalization, goes to some length in explaining wage inequality following trade liberalization episodes in the region.

Finally, the most compelling argument against the applicability of standard trade theory in Latin America is that most predictions are based on a two country model: a rich country with comparative advantage in capital or technology-intensive goods, and a poor country with comparative advantage in labor-intensive goods. However, what happens when a third country like China comes into the picture? The question of which is the labor-intensive country or region arises: is it China or Latin America? When Latin America was opening up to globalization, so was China. All of the predictions indicating that Latin America would gain from specialization in labor-intensive industries were incomplete, since the region does not have a comparative advantage in labor-intensive industries once countries such as China emerge as global trade powerhouses.

EMPIRICAL EVIDENCE ON THE TRADE AND POVERTY NEXUS

Since standard trade theory is not sufficient to assess the impact of trade liberalization on poverty, it is necessary to review the empirical evidence on the trade and poverty nexus.⁷ Some studies have attempted to disentangle *ex-post* the complex forces at work in past liberalization episodes, while others try to predict them *ex-ante*.

Ex-post evidence

Macro-level cross-country evidence indicates a positive but small link between trade, growth, and poverty reduction. The policy implication of this finding is quite straightforward: protectionism is certainly not a pro-poor policy response as it has a proven regressive impact on growth and thereby on development. Nevertheless, trade can lead to widening inequality. This most likely happens when trade liberalization is accompanied by skill-biased technological change, foreign direct investment penetration, and capital account opening. According to the literature, it is therefore crucial to adopt proactive complementary and compensatory policies to accompany trade liberalization as a means of guaranteeing a more pro-poor and equitable outcome.

Ex-ante predictions

The preferred instruments to gauge *ex-ante* the impact of trade liberalization on poverty are the so-called Computable General Equilibrium (CGE) models. According to one comprehensive CGE assessment of the trade liberalization options available to Latin American countries, poverty could be reduced substantially through trade.⁸ However, CGE simulations are often based on extreme scenarios in which trade protection is eliminated across-the-board in every country. Unfortunately these “big bang” scenarios are quite unlikely in a world in which trade agreements are defined by negotiators who act according to mercantilist interests. The poverty effects may therefore be overstated.

One alternative solution is to study “realistic” scenarios like those actually negotiated in recent preferential trade agreements such as the CAFTA-DR or the U.S.-Peru FTA, or those determined by policy outcomes such as the loss of Andean Trade Promotion and Drug Eradication

Act (ATPDEA) preferences in the case of Bolivia.⁹ According to these simulations, negotiating a trade agreement has a moderate and positive impact on GDP, which in turn leads to small poverty reduction effects. The results are lower than those obtained with “big bang” simulations, but put forward figures that should not be overlooked.

Analyzing real negotiated scenarios allows analysts and policymakers to consider trade agreements as dynamic micro-economic transformation processes. A complete tariff phase-out schedule may last over 20 years, and trade liberalization of the most sensitive products is often backlogged. Understanding the dynamics of the free trade adjustment process is crucial to designing and timing the implementation of complementary and compensatory policies at the macro and sectoral level. For example, such a dynamic analysis reveals that Central American countries only have a few years left before they feel the pressure originating from competing industries which will soon gain market access in the context of the CAFTA-DR.

CONCLUDING REMARKS

This brief non-technical discussion of the pro-poor effects of trade liberalization on poverty reduction points to four policy implications. First, within an environment in which mounting public anxiety is fueling a backlash against trade integration, it is crucial to adopt a long term perspective and sustain momentum for the opening of markets. As the impacts of free trade agreements materialize in the long run, negotiation, implementation and adjustment costs often arise in the short and medium term. This is relevant because policymakers tend to focus on the negotiation and ratification of agreements. Therefore, it is crucial to set up institutions with a mandate to follow up with what is needed to capitalize on the opportunities that those agreements can create.

Secondly, policy design should be the result of significant research on countries’ particular dynamic comparative advantages and vulnerability profiles. The effects of trade on poverty are indirect and highly-country specific. There is no one-size-fits-all measure for a trade adjustment package. Trade adjustment reforms should therefore be mainstreamed into the overall national development strategy and be based on extensive and inclusive national dialogues.

Third, trade adjustment inevitably creates winners and losers, and some groups or sectors will be able to transition from losers to winners, but often they can do so only if assisted by some form of complementary policy package aimed at facilitating the transition to freer trade. Potential winners can benefit from enhanced competition and improved market access, but the existence of market failures may justify government support to help them take full advantage of international markets. Likewise, it is crucial to acknowledge the existence of potential net losers which need to be compensated with economic and social policies.

Finally, complementary and compensatory policies are the essence of aid-for-trade and a pro-poor trade adjustment agenda. When hemispheric free trade fervor was in full swing during the 1990s and early 2000s the short term adjustment costs of trade integration may have been neglected. As such, a renewed agenda of hemispheric trade integration should capitalize on past experience and place emphasis on the welfare-improving potential of an open free trade regime, as well as on the need to design and finance pro-active public policies that guarantee fair distribution of trade gains.

NOTES

1. This essay draws heavily on the presentation given by Paolo Giordano at the workshop “A New Trade Policy for the United States? Lessons from Latin America,” held at the Woodrow Wilson International Center for Scholars, Washington, D.C., March 27th, 2009.

2. Keynes, John Maynard (1936). “The General Theory of Employment, Interest and Money.” Macmillan *Cambridge University Press*, for the Royal Economic Society.

3. Bhagwati, Jagdish (2008). “Termites in the Trading System – How Preferential Agreements Undermine Free Trade.” *Oxford University Press*.

4. See Latinobarómetro (2009), “América Latina mira al mundo: la economía y la política de las relaciones internacionales.” *Corporación Latinobarómetro*.

5. GMF (2007). “Perspectives on Trade and Poverty Reduction.” *The German Marshall Fund of the United States*.

6. “This is the moment when we must build on the wealth that open markets have created, and share its benefits more equitably. Trade has been a cornerstone of our growth and global development. But we will not be able to sustain this growth if it favors the few, and not the many. Together, we must forge trade that truly rewards the work that creates wealth, with meaningful protections for our people and our planet. This is the moment for trade that is free and fair for all.” See, Barack Obama (2008) “Change We Can Believe In.” Speech in Berlin, p.268, Jul 24, 2008.

7. See Paolo Giordano and Victoria Florez (2009), “The trade and poverty nexus in Latin America,” in *Trade and Poverty in Latin America*, *Inter-American Development Bank*.

8. See Vos, R., Ganuza, E., Moreley, S. and Robinson, S. (2006), “Who Gains from Free Trade? Export-led Growth, Inequality and Poverty in Latin America.” *Routledge*. This study reports potential reductions of the poverty incidence up to 7 percent in the case of a comprehensive hemispheric trade agreement.

9. See Giordano, P., Mendez-Parra, M. and Watanuki, M. (2007), “Andean Countries at a Crossroads: Evaluating Pro-Poor Trade Integration Options,” presented at the GTAP Tenth Anniversary Conference “Assessing the Foundations of Global Economic Analysis”, Purdue University, West Lafayette, June 7-9; and Giordano, P., and Watanuki, M. (2008), “Evaluating the impact of trade agreement for Central America: Does trade integration improve poverty and inequality?,” presented at the GTAP Eleventh Annual Conference “Future of Global Economic Analysis,” Helsinki, Finland, June 12–14. These studies suggest a reduction of the poverty rates of about one half of a percentage point in the case of the agreements of Peru, Colombia and Central America with the U.S., and an increase of the poverty rate of about the same magnitude when Bolivia loses preferential access to the U.S. market.

LABOR STANDARDS AND FREE TRADE: LESSONS FROM NORTH AMERICA

ISABEL STUDER NOGUEZ

During his fight for the Democratic nomination for the U.S. presidency, Barack Obama promised to seek the inclusion of labor and environmental standards within the text of the North American Free Trade Agreement (NAFTA). Indeed, NAFTA is the only bilateral trade agreement recently signed by the United States that does not include complete environmental and labor chapters directly linked to the treaty's dispute resolution mechanisms. Obama's promise revived a debate that took place 15 years ago regarding the existence of a legitimate link between trade, the environment, and labor.

Well before NAFTA, the United States had already required countries receiving preferential access to the U.S. market to implement internationally recognized worker rights. This was the case of preferential market access agreements signed in the 1970s and 1980s, such as the General System of Preferences, the Caribbean Basin Initiative and the Andean Trade Preference Act. But the controversy that has emerged since the United States proposed the introduction of labor standards in the North American trade regime has been about whether the implementation and enforcement of globally accepted labor standards should be explicitly linked to trade. More specifically, the discussion has centered on what form the institutional mechanisms for monitoring and implementing these rights should take. Since the inclusion of labor provisions in the NAFTA labor side agreement, the United States has progressively introduced more stringent labor requirements in the free trade agreements (FTAs) signed with other countries.¹

The North American Agreement for Labor Cooperation (NAALC)—the labor side agreement of NAFTA—contains different enforcement procedures than does the main agreement, and places limits on monetary enforcement assessments as well as threatening the suspension of benefits due to noncompliance. More recent agreements have fully enforceable commitments in order to maintain the labor laws and practices according

to international regulations, to prohibit them from lowering their labor standards, to limit prosecutorial or enforcement discretion in five basic core labor standards, and to apply the same dispute settlement mechanisms or penalties for other FTA obligations.

One problem with the introduction of international labor standards into trade agreements is that such standards are considered eminently domestic issues unrelated to trade. Also, there is a broad scope for how those standards are implemented nationally and how they contrast with rules more universally applicable such as intellectual property rights. The question remains, then, whether the inclusion of fully enforceable labor standards in trade agreements has achieved the objectives sought by U.S. labor organizations. Many of the free trade agreements that include labor dispute resolution mechanisms are too recent to provide a definite answer to the question, and other agreements have not even been ratified by the U.S. Congress. And since enforceable labor commitments in the NAALC are limited, most analysts have discarded the North American experience as a valid to respond to such a question.

However, although most critiques against the NAALC have focused on the “weakness of the enforcement mechanisms,” I argue that the real failure was the agreement’s institutional shortcomings. These shortcomings have inhibited the creation of a North American regime aimed at defending universally recognized labor values across the region. From this perspective, the objectives of U.S. labor organizations to boost improved compliance with labor standards have not been achieved. Instead, the NAALC model draws largely from the conflictive, litigious approach that characterizes U.S. industrial relations. Labor organizations, particularly from the United States, have placed emphasis on dispute resolution mechanisms as a key element in achieving effective enforcement of labor laws. This has marginalized the role that the Commission for Labor Cooperation (CLC) could have played in the process of developing policies that address shared labor problems in North America.

I argue that linking labor enforcement provisions to NAFTA’s dispute resolution mechanisms could further inhibit the development of a collaborative regional agenda on labor issues, including capacities for improved compliance with labor standards throughout the region. The litigious, conflictive model that has been utilized by labor and trade has prevented the three North American countries from taking advantage of opportunities

for cooperation that arise from geographic proximity, shared resources, a context of high economic integration, and the complementarities of labor markets and demographic dynamics.

CORE ELEMENTS OF NAALC

While NAFTA does not make the same type of commitments regarding labor standards as it does for the environment, its preamble does include explicit objectives such as the creation of new employment opportunities, improved working conditions, improved living standards, and the commitment to “protect, enhance and enforce basic workers’ rights.” The NAALC establishes an ambitious list of goals to improve working conditions in the region, yet the only firm commitment the three countries make is to promote adequate enforcement of domestically established labor standards. The agreement does not constitute supranational legislation or jurisdiction nor does it intend to harmonize social standards in the three countries. However, it instituted a public petition mechanism that allows any Canadian, U.S., or Mexican citizen to file a complaint against its own government for failure to effectively enforce *national* labor regulations (Article 16.3). While the environmental agreement established similar provisions as well as the Joint Public Advisory Committee (JPAC), which is a permanent channel of representation for non-governmental stakeholders within the Commission for Environmental Cooperation (CEC), no similar arrangement was conceived for the NAALC.

The environmental side agreement grants the CEC’s secretariat the power to act independently of State representatives (the Council of Ministers) in the administration of Articles 14 and 15, thus granting an element of “supranationalism” that is absent in the NAALC. In the latter it is the National Administrative Offices (NAOs) which have the mandate to receive citizens’ complaints regarding another country’s failure to enforce its domestic labor laws. The secretariat of the CLC also bears responsibilities such as assisting the Council of Ministers, conducting research, and supporting cooperative activities. Compared with the CEC, the CLC’s secretariat is nonetheless much more limited in its functions and resources compared to the CEC. The CLC’s research functions have been unduly constrained by the NAOs and its staff size considerably reduced—from 15 to 3 in the last four years.

The NAALC introduces regulations that establish a torturous process that has never been—and most likely never will be—implemented, which ultimately can lead to the use of trade sanctions where “a persistent pattern” of ignoring labor law is found (Part V). Trade sanctions, the “teeth” or “red meat” that were requested by the anti-NAFTA groups were the most controversial aspects of the agreement and the cause of political stalemate that has endured to this date. While such sanctions were seen as the only means through which labor groups could effectively impede the potential deterioration of labor standards in the region, they were perceived by the Mexican and Canadian governments as blunt protectionism.

Fifteen years after its implementation, there is no clear demonstration of the worsening of labor conditions due to NAFTA.² It is, however, apparent that the side agreement has contributed only marginally to improved labor conditions and a more effective enforcement of labor legislation in the region. What has become evident is that the “innovative” regulations of the NAFTA side agreement (the citizens’ submission processes and the introduction of “teeth”) have been a source of significant tension within the CLC and among the governments of the three countries. More specifically, the political stalemate over the use of trade sanctions to ensure the effectiveness of the side agreement marginalized the role that the CLC could have played as a relevant forum in the process of developing environmental and labor policies in North America.

FAILURE BY DESIGN

The linkage of trade, labor, and the environment is based on a fundamental political/conceptual disagreement between the Mexican government and civil society groups (particularly from the United States) who rallied against NAFTA at the time of the treaty’s negotiation. Being the first free trade agreement that the United States signed with a developing country, the opposition from U.S. unions was particularly fierce.³ Anti-NAFTA groups argued that in a context of free trade the lack of enforcement of environmental and labor laws could confer on non-compliant parties an illegitimate competitive advantage. The Mexican government saw in these arguments—as well as similar arguments coming from environmental NGOs—protectionist interests at play.⁴ This being the case, the Mexican government accepted the side agreements as a *sine qua non*

condition for the ratification of NAFTA by the U.S. Congress. It did so, however, without acceding to all the demands of civil society.

And thus a hybrid institutional framework that implicitly harbors two contradictory and irreconcilable paradigms permeates the NAAEC and the NAALC: one confrontational or litigious and dictated by trade sanctions and the citizen submissions' process; and the other, a more cooperative, inter-governmental approach. The incipient "supranational aspects" embedded in the NAAEC that center on citizens' petitions, the limited role of the CEC secretariat, and the potential use of trade sanctions have generated high expectations in the civil society as effective processes to enforce national environmental laws.⁵ These expectations were incommensurate with the institutional and financial resources granted to the CEC and the CLC.

The political victory for both NAFTA supporters and opponents was thus pyrrhic. The confrontational focus was intended to serve the interests of NAFTA opponents, but the trade sanctions were a "death letter" at birth. The dispute resolution mechanisms were designed to fail and have in fact proven too cumbersome to be implemented. The concessions made by the Mexican government over the side agreements were insufficient to garner the unions' and NGOs support for the negotiated outcome. This was particularly true for the NAALC. As Hufbauer and Schott argue, "labor advocates did not favor NAFTA with or without a side agreement."⁶ Organized labor in the United States denounced the NAALC "as inadequate" and the approval of NAFTA "was tarnished because critics were able to disrupt trade liberalization efforts for the rest of the 1990s by claiming that NAFTA had made inadequate progress on labor issues."⁷ The cooperative aspects contained in the NAALC are more promising than the "dispute resolution mechanisms" as means of addressing common regional problems. Yet they have been compromised by the strong emphasis that the anti-NAFTA groups have placed on the litigious elements of the agreements as a pre-condition to accept the deepening of integration in North America.

A LITIGIOUS APPROACH

The original proposal contemplated the creation of an independent CLC secretariat with the power to investigate citizens' petitions as well as potential remedies such as trade sanctions for non-enforcement of labor laws. However, both the U.S. business community and the governments of

Mexico and Canada voiced strong opposition against ceding authority in labor issues to any “supranational” institution. In particular, the Mexican government resisted any enforcement mechanism that could be used to restrict trade or compromise national sovereignty through the review of domestic labor laws. U.S. businesses and even some labor groups were also resistant to the idea of a strong international labor institution for North America.⁸

The National Administrative Offices located within the labor ministry of each country became responsible for the citizen’s complaints.⁹ Enforcement questions were handled bilaterally, which confirmed the suspicion that the side agreements only sought the monitoring of Mexico. Between Mexico and the United States, fines and suspension of trade benefits are the potential enforcement mechanisms and trade sanctions do not apply to Canada, though Canadian courts may impose fines. The fact that the NAALC was imposed as a means to monitor Mexico has also inhibited Mexico’s commitment to fully engage in developing the potential of the agreement.

Mirroring the NAAEC, Part V of the NAALC provides a mechanism for resolution of disputes over persistent non-enforcement of select labor standards, thus giving non-governmental organizations (NGOs) a leading—though limited—role in building the North American regime. The side agreement identifies 11 labor principles and divides them into three tiers, with enforcement remedies differing in each of these tiers. The majority of labor standards are protected only by low levels of enforcement, which do not involve any penalization for non-compliance.¹⁰ The first three principles of the NAALC relate to the most basic or enabling rights of organizing (freedom of association, collective bargaining and the right to strike), and are limited to NAO review and ministerial oversight. This is the only mechanism that so far has been utilized in response to the 36 citizens’ complaints that have so far been filed under the NAALC.¹¹

The Evaluation Committee of Experts (ECE) makes up the intermediate level of enforcement. The ECE convenes a panel of non-governmental experts to make recommendations, and was conceived to function regarding five labor principles: the prohibition of forced labor, equal pay for equal work, non-discrimination in employment, workers’ compensation in case of injury or illness, and protection of migrant workers. The only NAALC remedy with enforcement “teeth” is the one that applies to minimum wage, child labor, and occupational safety. A panel of experts

has the authority to establish an action plan, to levy fines, and even invoke a loss of tariff preferences if a plan that is proposed to remedy enforcement problems is not implemented.

The use of the citizens' petition mechanism has been limited in NAALC, even if compared to the number of petitions filed under NAAEC. As expected, Mexico has been the target of the majority of the citizens' petitions, with 23 of the 36 citizens' petitions filed since 1994; followed by the United States, with 11 cases, and only 2 against Canada. The majority of those complaints (25) invoke "enabling" rights that refer to collective bargaining, freedom of association and the right to strike. Twelve, sought protection of freedom of association, while the other 13 included the protection of freedom of association as a claim connected to rights to occupational health, non-gender based discrimination, minimal employment standards, child labor prevention, collective bargaining, and the ability to strike.¹²

In the initial years "labor advocates saw the NAALC as a vehicle for highlighting the suppression of independent unions in Mexico and the poor conditions in *maquiladoras* owned by U.S. firms."¹³ Only a few of these complaints reached ministerial consultations, and the results were commitments to implement educational activities such as public seminars, forums, conferences, experts' reports, meetings, and exchange of information regarding national legislation. Some petitions have achieved a certain level of success. This was the case in which a cross-national advocacy coalition challenged the pregnancy test used in different *maquiladora* plants for new female recruits. The public submission procedure of the NAALC led employers to cease such practices. However, as Teague has argued, "no systemic change has been triggered to labor market governance in Mexico due to NAALC related activity. The main impact has been the 'shaming' of some companies with labor practices that would not be considered distinguished."¹⁴

By the late 1990s, more sophisticated networks of groups filed complaints regarding occupational health, discrimination and safety which are the areas where the NAALC contemplates the possibility of going beyond ministerial consultations. When the submissions "involved more discrete protective rights," the institutional response was more welcoming.¹⁵ Ministerial consultations were held and led to the establishment of educational programs on occupational health and safety in the work place, migrant worker's rights and exchange of information among the three offices.

More recent submissions have been related to “structural deficiencies” in labor market governance, and each included the participation of broader networks of civil society organizations (the number of complainants signing one petition was anywhere from 12 to 55). The complaints started to demand interpretation of local laws (state government employees and migrant workers in the United States, or Mexico’s effort to reform its labor law) through the lens of international labor standards, thus attempting to broaden the scope of the NAALC despite the fact that it is meant to promote only the enforcement of domestic laws.¹⁶ The institutional response to all of these submissions have been “slow and convoluted.”¹⁷

Much of the criticism against the NAALC has focused on the institutional and procedural shortcomings of the agreement, particularly the low potential for sanctions. However, as Rambois et al have argued, the critique that the NAALC is a “toothless instrument” is too simplistic.¹⁸ First, the NAALC does not have even the incipient elements of supranationalism found in NAAEC, as the authority that is vested in the former agreement preserves national sovereignty. The NAOs, which have the power to review labor law issues in the other NAFTA members, are embedded in national institutions.¹⁹ Also, NAOs have virtually no political incentive to take the process of public submissions to their ultimate consequence— trade disputes.²⁰

A more significant problem is the NAALC’s bias in favor of conflict, heavily influenced by the U.S. industrial relations model. While complainants perceive the NAALC as a quasi-judicial instrument with concrete results, it is rather a political instrument which often becomes a supplement to other routes such as legal proceedings at the national level, political channels, and public campaigns meant to put political pressure on governments by internationalizing sensitive national labor issues. As in the case of NAAEC, the petition process aims to “embarrass” governments that fail to comply with their own legislation. Also, disputes become internationalized when public communications are submitted to NAOs outside of the country where the alleged violation is taking place. This can then provoke automatic resistance from the accused government, which will refute allegations of territorial breaches of labor principles in its territory.

The conflictive nature of the NAALC explains a great deal of the existing tensions within the organization. It also explains the North American labor ministries’ lack of political engagement in the CLC’s affairs, and the dominant role that the NAOs have played overall. The secretariat

played a more active research agenda in the early years of the agreement's implementation, but it has subsided recently as it has withered under the dominant role that the NAOs play. The ministers have met only a few times since NAALC and have signed as few as eight resolutions since 1994.

In addition, none of the party members to NAALC, least of all the United States, are prepared to accept an international regulatory body with powers to enforce changes in national labor laws. In stark contrast with environmental issues, there is a body of international law that protects universally accepted core labor principles. In 1995 the United Nations Social Summit in Copenhagen declared four categories of core labor principles and rights: freedom of association and collective bargaining, the elimination of forced labor, the elimination of child labor and the elimination of discrimination in respect to employment and occupation. These core international labor standards, which were enshrined in the International Labor Organization's (ILO) Declaration of Fundamental Principles and Rights at Work, are globally accepted as such. The ILO has historically held the responsibility of monitoring international labor standards, and has adopted 183 conventions to cover a wide range of labor rights and standards.

All three NAFTA countries adhere to the ILO's Declaration of Principles, which are the benchmark against which actions in other countries are evaluated. Despite this, the United States may not be interested in pursuing the enforcement of labor principles enshrined in the NAALC. Although they are less detailed and specific than the ILO Conventions (the United States has only signed two of the eight core Conventions, while Mexico and Canada have signed all eight), the latter could be used as definitions for the NAALC principles and could elicit challenges to a number of U.S. labor laws.²¹

As Elliot has argued, so far the evidence on the effectiveness of sanctions demonstrates "that trade measures could be designed to contribute to improved compliance with labor standards *in discrete situations*, while also guarding against protectionist abuse."²² She concluded, however, that the ILO, not the WTO or the FTAs, should have the principal role in promoting and enforcing international labor standards generally. Furthermore, the fact that until recently there have been no requirements in U.S. bilateral free trade agreements that national laws be consistent with the core labor standards as defined by the ILO has undermined the prospects for an international consensus on key labor standards.²³

While U.S. unions want to contain the forces of globalization triggered by free trade, they also oppose the adoption of international standards and prefer to maintain their domestic prerogatives. According to Teague, “the strong domestic orientation of organized labor has contributed to the under-testing of the consultation and dispute resolution machinery of NAALC. Thus compounding the undoubted cumbersome and convoluted procedures of NAALC is a process of self-blockage on the part of organized labor.”²⁴ Indeed, the low level of involvement of unions is shocking, considering that they are the ones who carry considerable political weight in their own countries and could give the NAALC the legitimacy and effectiveness that has thus far been missing. One reason for this lies in the corporatist nature of the Mexican labor union organizations, particularly the CTM, which are frequently the focus of complaints against Mexico. Large North American unions such as the Canadian Labor Congress and the AFL-CIO have persisted with their basic criticism of the NAALC “as toothless and ineffectual.”²⁵ As one author has concluded in regards to union involvement, “the organization in the United States that is best placed to give the NAALC real political clout is not involved at all in the NAALC regime.”²⁶ It is no coincidence that the citizens’ submission process has been tested mostly by Mexican independent unions (which tend to be small) or labor rights activist groups that have a strong international orientation.²⁷

A COOPERATIVE APPROACH FOR THE FUTURE

While the CLC was given very limited resources and powers for monitoring the national enforcement of labor standards, the very existence of administrative and judicial enforcement procedures has had a preemptive effect on the willingness of the three countries to use the institutional structures to advance a cooperative agenda. Although cooperation is not an aspect normally highlighted in regards to the NAALC, the agreement grants the NAOs with the responsibility to initiate international cooperative activities on labor market affairs, including seminars, training courses, technical assistance, as well as the sharing of best practices regarding occupational health and safety and employment promotion. These activities also promote social participation between union, business, and NGO representatives. Close to 100 such activities were developed between 1994 and 2007, the great majority of which have focused on occupational health and safety.²⁸

Developing public goods in transnational labor markets could be a better way of securing decent work conditions and higher living standards for workers than the imposition of prohibitive rules. It is doubtful that trade sanctions are the proper tool to ensure the enforceability of labor standards, much less to foster labor cooperation. It is not just trade that affects labor conditions, but also business cycles, technological change, and macroeconomic policies.²⁹ A trade agreement alone cannot supersede the asymmetries that exist in North American labor markets, nor decades of domestic political compromise over labor legislation. Trade agreements do increase competitive pressures in the labor markets and do create labor market distortions, as evidence by the significant migration of Mexicans to the United States during the past 15 years.

The protectionist stance taken by U.S. unions against NAFTA has not helped much to improve labor conditions in Mexico, nor in the region.³⁰ Rather than hard law or trade sanctions, soft law can be used as an effective tool for regulation. Organized labor could devise innovative measures to test the international channels connecting each national labor market in North America. As Elliot has argued, labor activists should shift their attention from sanctions to enforcing standards in trade agreements as a means of pressuring governments raise labor standards and provide the financial resources necessary to implement them.³¹ Training programs, labor mobility, and immigration reform present areas of opportunity where unions could help boost labor rights throughout North America and take advantage of the lessons learned from NAALC and NAFTA.

More forward-looking proposals that unveil the potential for exploiting market and social complementarities between the North American countries could provide a rationale for new trilateral approaches. This could be a regional strategy that places a number of internationally accepted core labor values at the center of a North American cooperative strategy, such as minimum wage, child labor, and occupational safety. Another promising area is for the three countries to heavily invest in human capital in order to ensure a competitive work force and a sustained capacity to generate well-paid jobs in North America. Given the huge investments that emerging economies such as China and India are making in this strategic area, the United States may see its lead in science and technological development narrow in the medium term. The educational underperformance of impoverished racial and ethnic minorities in the

United States takes place at a time when a technologically sophisticated and globally competitive economy demands increasingly higher level of skills from all workers. The competitive risks of the North American labor market could be exacerbated by an aging population both in the United States and Canada. Mexico's demographics could become a positive element but only if there is a regional plan to invest in the human capital throughout the region.

Unfortunately, options to modify NAFTA and its side agreements are virtually non-existent, largely because environmental and labor organizations and the Mexican government prefer to maintain minimum gains achieved through the side agreements. Opening NAFTA could also unlock a "Pandora's box" of protectionist forces, which are particularly strong at a time of economic crisis. Mexico and Canada may end up accepting the original Obama proposal to include language which promises to enforce environmental/labor legislation within the text of the free trade agreements for the sake of expediency. But that proposal would not translate into improved labor conditions in the region. A more positive route would be to strengthen the intergovernmental cooperative agenda, which has proven to be the most successful effort of the labor and environmental agenda of the NAFTA side agreements. In the best case scenario the three countries may decide to strengthen their cooperation agenda outside of the NAFTA framework.

NOTES

1. For a detailed comparison of how the United States modified the NAFTA model in the free trade agreements negotiated in the last 15 years, see May Jane Bolle, "Overview of Labor Enforcement Issues in Free Trade Agreements," Congressional Research Report for Congress, Washington, DC, Library of Congress, February 29, 2008.

2. While the literature on NAFTA effects on labor and the environment is vast, see Scott Vaughan, *The State of the Art*, Montreal: Institute for Research and Public Policy, 2003; Carolyn L. Deere and Daniel C. Esty, ed. *Greening the America: NAFTA's Lessons for Hemispheric Trade*, Cambridge, MA: MIT, 2002; Gary C. Hufbauer and Jeffrey Schott, chapters on Labor and on the Environment, in *NAFTA revisited: achievements and challenges*, Washington, DC: Peterson Institute for International Economics, 2005, pp. 79–198; Kim Ann Elliot and Richard B. Freeman, *Can Labor Standards Improve Under Globalization?*, (Washington, DC: The Peterson Institute for International Economics, 2003).

3. For a detailed account of the labor and environment negotiations see Barbara Hogenboom, *Mexico and the NAFTA Environment Debate*, Amsterdam: International Books, 1998; Fredrick Mayer, “Negotiating the NAFTA: Political Lessons for the FTAA” in Deere and Esty, pp. 97–116; Fredrick Mayer, *Interpreting NAFTA. The Science and Art of Political Analysis*, New York: Columbia University Press, 1998; and Hufbauer and Schott, *Op. cit.*

4. Mexico’s experience in the tuna embargo case played a significant role in shaping Mexico’s positions regarding the linkage of trade and environment, see Gustavo Alanís y Ana Karina González, “No Room for the Environment: the NAFTA Negotiations and the Mexican Perspective on Trade and the Environment,” in Deere and Esty, pp. 41–60.

5. These high expectations even prevailed in the more limited provisions found in the NAALC. A statement by Human Rights Watch regarding the NAALC as “the most ambitious link between labor rights and trade ever implemented,” illustrates well this point. As quoted in Ian Thomas Macdonald, “NAFTA and the Emergence of continental Labor Cooperation,” *The American Review of Canadian Studies*, Vol. 33, (Summer 2003), p. 180.

6. Hufbauer and Schott, *Op. cit.*, p. 122.

7. *Ibid.*

8. Hufbauer and Schott, *Op. cit.*, 121–2; Mayer, 1998, *Op. cit.*

9. In addition, any party may request ministerial consultations with another party regarding any matter within the scope of the agreement. One NAO can request consultations with another NAO regarding labor law, labor law administration and labor market conditions. Hufbauer and Schott, *Op. cit.*, p. 122.

10. Rainer Dombois, Erhard Hornberger and Jens Winter, “Transnational labor regulation in NAFTA — a Problem of Institutional Design? The case of the North American Agreement on Labor Cooperation between the USA, Mexico and Canada,” (paper presented at the 13th World Congress of the International Industrial Relations Association, Berlin, 2003).

11. For a detailed account of the petitions, see Ruth Buchanan and Rusby Chaparro, “International Institutions and Transnational Advocacy: The case of the North American Agreement on Labor Cooperation,” *Comparative Research in Law and Political Economy (CLPE)*, Research Paper, Vol. 04 No. 05 (2008), p. 20.

12. *Ibid.*

13. *Ibid.*

14. Hall 2000 as quoted in Teague, *Op. cit.*, p. 436.

15. Buchanan and Chaparro, *Op. cit.*, p. 21.

16. *Ibid.*, p. 22.

17. *Ibid.*, p. 23.

18. Dombois, Hornberger and Winter, *Op. cit.*

19. The NAOs can also set their own operation rules, thus creating an additional level of complexity for those filing a citizens’ complaint.

20. On this issue see also Hufbauer and Schott, *Op. cit.*, p. 122.

21. In fact, the United States has ratified only 2 core ILO conventions (105, on the abolition of forced labor and 182, on the worst forms of child labor). By contrast, other countries in the Western Hemisphere have ratified about 44 of the ILO's 180 conventions and 7 of the 8 core conventions. On this issue see Elliot and Freeman, *Op. cit.*, p. 96.

22. Anne Elliott, "Labor Standards and the Free Trade Area of the Americas," Working Paper No. 03-7, Washington, DC: Institute for International Economics, August 2003, p.2.

23. Elliot, *Op. cit.*, p. 15.

24. Teague, *Op. cit.*, p. 444.

25. See Rambois, et. al., *Op. cit.*

26. A number of studies have praised the formation of transnational alliances between labor organizations as unintended consequences of the citizens' petition process in the NAALC, but most of them accept that such collaboration between organized labor in the three participating countries of NAFTA has not taken place in the context of the NAALC. See Tamara Kay, "Labor Transnationalism and Global Governance: The Impact of NAFTA on Transnational Labor Relationships in North America," *American Journal of Sociology*, Vol. III, Number 3, November 2005: pp. 715-756; and Ian MacDonald, *Op. cit.*

27. Teague, *Op. cit.*, p. 443.

28. For a total of 44 in occupational health and safety matters; labor markets, 10; minimum working conditions, 9; freedom of association, 9; work discrimination, 7; migrant workers' rights, 6; child labor, 2; and others, 10.

29. Rambois, et. al. *Op. cit.*

30. On the labor unions' transnational collaboration, see MacDonald, *Op. cit.*, pp. 183-188; on the limits on this cooperation to create a regional labor regime in North America, see Teague, *Op. cit.*, pp. 442-444.

31. Elliot, *Op. cit.*, p. 20.

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.¹

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.² 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.³ 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 tribunals⁴
- 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.⁵

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.⁶

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.⁷

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.⁸ 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.⁹

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.¹⁰

The North American Development Bank (NADBANK) was originally proposed by prominent economists Albert Fishlow, Sherman Robinson, and Raul Hinojosa-Ojeda.¹¹ 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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