

# PROSPECTS FOR US-MEXICO TRADE: WILL THE PROPOSED TRADE AGREEMENTS WITH THE PACIFIC BASIN (TPP) AND EUROPE (TTIP) ENHANCE OR UNDERMINE NAFTA?

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## I. Introduction

NAFTA is in its 20<sup>th</sup> year as one of the most successful free trade agreements (FTAs) in terms of trade growth, with more than \$1.075 billion in trilateral during 2013; in October total monthly trade reached \$100 million for the first time. Despite its controversies and continued opposition from labor and environmental groups, NAFTA has had a profound economic impact on the nations of North America.

For political reasons, NAFTA has been virtually impossible to amend despite two decades of refinement in the legal structures of the international trading system and the increasing importance of new disciplines such as e-commerce, trade facilitation, energy and telecommunications. Under such circumstances, if NAFTA is to be updated it will likely be indirectly, through more modern agreements to which the NAFTA Parties are also parties. Two major routes may offer such a result:

- The Trans-Pacific Partnership (TPP)—where Canada, Mexico and the United States are among the 12 negotiating parties (including Australia, Brunei, Chile, Japan, Malaysia, New Zealand, Peru, Singapore and Vietnam)
- The Transatlantic Trade and Investment Partnership (TTIP)—where the US is the only North American Party, but where Canada and the EU have negotiated a parallel agreements and Mexico has a 2001 “economic partnership agreement” with the EU, the latter of which will likely have to be revised.

These agreements, if both are concluded and enter into force, would provide the United States with largely unfettered access to approximately two-thirds of the global economy, according to U.S. Trade Representative Michael Froman. Given the gloomy prospects for major trade liberalization through the WTO in Geneva, the economic significance for the United States (as well as its NAFTA Partners) of these new agreements is difficult to over-estimate.

As a general rule, NAFTA commerce expands if the U.S. economy grows stronger, since Canada and Mexico each send more than 70% of their exports to the United States, a percentage that may fall slightly if there is greater trade with the EU and the TPP nations. With the TPP, as with any subsequent FTA (e.g., CAFTA-DR or the Mexico-Japan FTA), there is always the risk of trade diversion, for example, with the United States increasing apparel imports from Vietnam or even auto imports from Japan, all at the expense of Mexico. However, given that the three

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NAFTA nations already have exports that compete well in third-country markets, the removal of trade barriers through the TPP, particularly if Japan is forced to reduce its barriers to agricultural imports, should on balance benefit all three. The extent to which the TTIP indirectly benefits Canada and Mexico as well depends in part on rationalizing the rules of origin on the EU side and whether the current EU economic partnership agreement with Mexico is updated.

Other agreements to which the three NAFTA governments are Parties may also result in indirect changes in NAFTA obligations if they effectively supersede current NAFTA obligations. For example, the Trade in Services Agreement (TISA) is currently under negotiation as a “plurilateral” agreement under WTO auspices among approximately fifty WTO Member countries, including Canada, the United States and Mexico. These negotiations, if successful, could effectively expand services market access among the parties beyond the levels authorized under NAFTA Chapters 12-14 in a context where the major developing country members such as Brazil, Russia, India and China (BRICs) and a few other developing countries are effectively blocking a multilateral approach. Other multilateral negotiations that may effectively expand trade within North America as well as elsewhere include an agreement under the WTO or the Asia Pacific Economic Forum (APEC) reducing tariffs on green technology goods and Mexican adherence to a revised Information Technology Agreement. However, this paper is confined to the TPP and TTIP.

The TPP and the TTIP are the only two major Obama Administration initiatives to expand U.S. exports through regional trade agreements. Both are important matters for the Administration. After the 2010 Congressional elections the Administration re-evaluated the policies that had given the negotiation of trade agreements (including the Doha Round accords) relatively low priority, and took the necessary steps to obtain Congressional approval of three long-pending FTAs with Colombia, Panama and South Korea. The president also ramped up efforts to conclude the TPP negotiations and appointed in mid-2013 a close adviser, Michael Froman, to be U.S. Trade Representative. The TTIP is a more recent phenomenon, an FTA which is supported by majorities in Congress and many in the EU, as well as by both the Obama Administration and the EU Commission. In some ways it may be less controversial with U.S. labor interests than the TPP, since wages in the two jurisdictions are more or less equal.

## **II. Where should NAFTA be Modified or Enhanced?**

As noted earlier, NAFTA has been very successful in stimulating North American trade. Still, there are a number of areas in which NAFTA could be improved (depending upon the point of view of the interests affected). Among the most important are the following:

- Coordination of climate change and energy policies, in a context where Mexico has recently changed its Constitution and laws to encourage foreign investment and technology transfer in oil and gas; Canada is greatly expanding its petroleum production through tar sands development; and the United States, because of increased oil exploration and natural gas fracking is rapidly becoming self-sufficient;

- Investor-state dispute settlement, where subsequent U.S. and Canadian FTAs have adjusted the balance between investor rights and the host government’s ability to avoid the

treatment of non-discriminatory changes in environmental and public health regulations as indirect expropriations requiring compensation;

- Rules of origin, including the currently highly restrictive rules relating to textiles and apparel, and certain chemicals;
- Preservation of labor rights and enforcement of rules protecting the environment, the inclusion of which in newer trade agreements is effectively a condition precedent to Congressional approval;
- Protection of intellectual property beyond the requirements of the WTO's Agreement on Trade Related Intellectual Property (TRIPS) with the "TRIPS-Plus" provisions affording greater protection to confidential pharmaceutical and agricultural chemical test data and extended periods of patent protection where approval is unreasonably delayed
- Inclusion of disciplines relating to national regulation and taxation of e-commerce
- Addressing unbalanced competition by state-owned enterprises (SOEs) with private firms and other anti-trust issues to level the playing field (although probably not to the extent of covering Pemex and the Corporación Federal de Electricidad).

All could be affected by the TPP and TTIP agreements if they are completed.

### **III. The Trans-Pacific Partnership**

After more than three years the challenges to completing the TPP negotiations remain daunting, complicated inter alia by the entry of Mexico and Canada late in 2012 and even more so by Japan in 2013. But the TPP has always been an extraordinary ambitious undertaking. The TPP's 29 chapters would cover the full range of the existing "wide and deep" U.S. FTAs beginning with NAFTA, including not only trade in goods (including agriculture), trade in services, government procurement, investor protection, TRIPS-Plus, labor, environment and mandatory dispute settlement. TPP also addresses e-commerce and areas of importance for increasingly globalized manufacturing, disciplines for SOEs along with supply chain management, regulatory coherence and trade facilitation. Many of these raise concerns with individual TPP partners who may oppose certain U.S. proposals as a matter of principle (e.g., enforceability of labor and environmental obligations under mandatory dispute settlement mechanisms) or simply have different ideas about scope and coverage, as with SOE disciplines. Added to the mix are some of the more traditional aspects of U.S. protectionism, such as tariff-quotas on sugar, high footwear tariffs and the insistence on strict rules of origin ("yarn forward") for apparel imports (primarily affecting Vietnam). Should the Obama Administration under pressure from stakeholders and Congress decide that it is politically essential to preserve such protection for stagnant or dying U.S. industries in the TPP there will likely be a cost in terms of sacrificing increased market access on services and other potential benefits for more modern and competitive U.S. exporters.

Additional complexities result from the potential conflicts between the TPP and earlier regional trade agreements. The 12 TPP partners have more than 40 bilateral or multiple party

FTAs among them, the most recent an Australia—Japan FTA concluded April 7 and a Canada—Japan FTA concluded in March. Among the 11 other TPP Parties, the United States already has FTAs with Australia, Canada, Chile, Mexico, Peru and Singapore. Avoiding further exacerbation of Professor Jagdish Bhagwati’s “spaghetti bowl” in the region will be one of the ongoing challenges of TPP implementation, particularly if the negotiators do not provide clear rules for determining when provisions of the newer agreement supersede those of existing ones.

While the TPP appears to enjoy a very modest level of bipartisan support in the U.S. Congress, the Administration and USTR’s negotiators are facing the usual range of important U.S. interest groups. These include but are not limited to various agricultural producers, including those representing dairy products, beef and sugar; organized labor in general, with concerns about moving jobs offshore; the textile, apparel and footwear industries; advocates for stronger, enforceable environmental provisions; those supporting or opposing “TRIPS-Plus” protections for pharmaceutical and agricultural chemical producers; and differing groups seeking greater or reduced protection for foreign investors.

Many of these differences have surfaced again after a bill seeking renewal of Trade Promotion Authority (TPA or “fast-track”) was introduced in Congress in January 2014. The Democratic Party leadership, in the persons of House Minority Leader Nancy Pelosi and Senate Majority Leader Harry Reid, have told the president that they have no interest in moving the TPA legislation forward before the November 2014 elections, and President Obama has been unable or unwilling to challenge their position. This means that at best TPA could be enacted in the “lame duck” session after the elections, but more likely in the first quarter of 2015, meaning that the TPP, despite any entreaties that the President may make when he visits Asia late in April, cannot effectively be concluded until the other 11 Parties have the assurance that once the agreement is concluded the agreement will not be modified or unduly delayed by Congress. Since 1974 the United States has achieved this guarantee only through the fast-track legislation.

With the inclusion of Japan and its relatively closed economy in agriculture and autos both the rewards of success and the risks of failure for the United States have escalated. The potential trade and other economic benefits of a free trade agreement encompassing 12 nations with an aggregate GDP of in excess of \$26 trillion are staggering. Japan’s entry might also eventually convince some of the more recalcitrant Asian WTO Members to become more serious about salvaging some elements of the defunct Doha Development Round in Geneva and in any event is likely to encourage additional TPP participation in the Pacific Rim, likely including Costa Rica, Korea, Thailand and perhaps Taiwan. (While China is said to be welcome in the TPP if it is willing to adhere to all the TPP disciplines few believe that China would sign on in the foreseeable future.)

Still, parallel bilateral negotiations between the United States and Japan have made relatively little progress in more than a year, with Japan still insisting that its protective tariffs on imports of certain agricultural products be phased out only over a lengthy period. (These negotiations if successful could of course provide better agricultural market access for Canada and Mexico as well as the United States and the other TPP partners.) Some in Congress have suggested that the United States might have to move forward in the TPP without Japan’s

participation. Issues exist as well with Canada (the supply management system for dairy products) and Mexico (protection for textile producers) which raise significant internal political challenges. Among other partners, Vietnam has focused almost exclusively on apparel rules of origin while Australia remains concerned about investor-state dispute settlement and its long-held objective of increasing sugar exports to the United States. Singapore and Malaysia have expressed concerns about new constraints on SOEs.

More generally, significant further delays in concluding the TPP could lead to the pact unraveling as some negotiating partners turn their attention to other trade negotiations, such as the “Regional Cooperative Economic Partnership” (RCEP) which if successfully concluded—a big “if”—would bring together Australia, China, India, Japan, New Zealand, South Korea and the 10 ASEAN nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam). None of the negotiating parties wishes the TPP to go the way of the Free Trade Agreement of the Americas (FTAA) which after a promising launch in December 1994 and apparent progress in negotiations over four or five years was abandoned in 2003.

Significantly for the United States, failure to close the TPP deal would do severe damage to United States’ “pivot” toward strengthening its economic, political and security interests in Asia, at a level far beyond the failure of the FTAA in the Western Hemisphere, and given China what would be perceived as a major victory. Among consequences would almost certainly be an acceleration of the RCEP negotiations and other regional trade initiatives in Asia that include China but exclude the United States, and the reluctant conclusion on the part of many Asian nations that the United States is not really committed to reinforcing its economic presence in the region. This suggests that serious efforts to reach a successful conclusion to the negotiations must continue, even if the United States is required to make more compromises than it has in earlier FTAs, even if another year or more is required for conclusion of the negotiations and even if President Obama is required to expend significant political capital to obtain fast-track legislation, assure the negotiations reach a successful conclusion and obtain the approval of the TPP by Congress.

#### **IV. Transatlantic Trade and Investment Partnership**

The TTIP negotiations have had a slow start, and are underway only since late 2013. Although as of April 2014 they have not progressed beyond the “throat-clearing” stage (according to USTR Froman), the TTIP may ultimately succeed in significant part because such an agreement is one of few available alternatives to the EU and United States for major trade expansion between two giant but stagnant economies. Despite the “success” of the Bali WTO Ministerial Meeting in December 2013 in reaching agreement on trade facilitation and some food security and related agricultural trade issues, few observers believe that other pending Doha Round agreements (such as those relating to services, agricultural market access and agricultural subsidies) can be salvaged. Officials in both the United States and the EU are concerned about China’s rising economic (as well as military) power and realize that their future security depends on strengthening their currently stagnant economies. Some officials in both the EU and the

United States fear that their economies may be condemned to chronic slow growth, better than the 20-year Japanese period of no growth but sharing some of the same characteristics.

The TTIP thus carries the considerable allure of expanding an economic partnership that accounts for almost 50% of global output, a trillion dollars in annual trade (about the same as NAFTA), \$4 trillion in investment and 13 million jobs, all according to the EU Commission. A new FTA between the two leading economic players in the world, with a combined population of over 800 million persons, promises significant stimulus to economic growth; the U.S. Chamber of Commerce suggests that current bilateral trade could increase by over 20% if the TTIP were to be completed and implemented.

Despite this potential, the negotiations face mind-boggling complexities; they will focus more on building regulatory and standards compatibility, with mutual recognition of regulatory procedures, and other non-tariff barriers. While tariffs are already very low on both sides of the Atlantic, averaging less than 4% on a trade-weighted basis, high tariffs remain on some agricultural products, footwear, textiles and apparel.

Perhaps the most significant unanswered question is not whether there will be a TTIP but how “broad and deep” it will ultimately be:

- Will it have extensive coverage of agriculture, reducing tariffs and non-tariff restrictions?
- To what extent will it apply to financial services (which the US is resisting) and to professional services, both of which are deemed very important to the EU, and to domain names as for certain cheeses and hams), advocated by the EU but widely resisted in the United States?
- Will TTIP include a system to encourage regulatory coherence and consistency through consultation and uniform laws where appropriate, along with mutual recognition of regulatory determinations? For example, can duplicate testing in the two jurisdictions of electrical equipment, pharmaceutical products and chemicals be reduced or eliminated?
- Will effective protection of foreign investment, similar to that in the TPP and recent U.S. FTAs, be incorporated, despite well-regarded legal systems in the United States and in most EU jurisdictions, given that investment disputes inevitably arise?
- To what extent will TTIP incorporate improved disciplines for sanitary and phytosanitary measures and technical barriers to trade, long a source of contention between the two Parties, e.g., with hormones used to fatten cattle and GMOs?
- Will trade facilitation obligations go beyond the scope of the Bali accord, given that access by U.S. exporters to some EU Member state markets is better than others?
- To what extent will the TTIP result in broad expansion of services market access, including legal and other professional services?
- As noted above will all or almost all tariffs be eliminated?

- Will the rules of origin enhance or inhibit U.S. producers' ability to take advantage of lowered tariffs and removal of non-tariff barriers?

The alternative is a much more modest undertaking with the Parties settling for reduction of the already low tariffs, plus some reduction of agricultural trade barriers and non-tariff barriers, leaving more ambitious changes for the future. A shallower, narrower FTA is far easier to conclude given the important political and economic groups in most jurisdictions that fear increasing competition from imports but would create many fewer economic benefits for the Parties and be viewed as a failure by other WTO Members who are closely following the TPP negotiations.

In fact, there is a great deal of protectionism in both jurisdictions:

- Agriculture generally (dairy, sugar, wine, some grains, beef and pork) is traditional subsidized and sensitive
  - Administrative agencies (Commission, SEC, FTC, others) are resistant to change and are extremely jealous of their prerogatives
  - Any manufacturing that is not largely automated, particularly in nations with low productivity, such as France and Italy, is vulnerable (and opposed) to lower tariffs
  - Despite the WTO's Government Procurement Agreement, "Buy American" and "Buy European" legislation and regulations continue to exist, particularly at the state levels in the United States (where State participation in the Government Procurement Agreement disciplines is voluntary and NAFTA's GPA Chapter 10 does not apply at all to state or provincial entities)

In recent years, leaders in both jurisdictions have in my view shown a notable lack of political will to make the tough decisions that every rational person knows are necessary to sustain medium and longer term economic growth, and this may carry over to the TTIP negotiations.

## **V. The Impact on NAFTA**

The changes brought about by the TPP could include the following (some of which will not be welcomed by certain stakeholders):

- In investment, broader limits on treating non-discriminatory national regulation, particularly in the environmental and public health areas, as regulatory takings subject to compensation.
- Some simplification of rules or origin, particularly with regard to textiles and apparel (an area of importance to Mexico, the United States and Vietnam among other negotiating parties), but also a problem if the NAFTA rules do not meet the rules of origin under a U.S.-EU agreement
- Bringing disputes over labor rights and expanded environmental protection under the same dispute settlement mechanism, and with the same trade penalties as with trade disputes

- Expanding intellectual property protection to include “TRIPS-Plus” elements found in more recent U.S. FTAs
- Addressing state owned enterprises other and anti-competition issues
- Incorporating modern disciplines with regard to regulation of e-commerce

Views as to the desirability of such modifications may differ depending on NAFTA Party and stakeholder interest, which may not be parallel. The three NAFTA governments, for example, are all interested in narrowing the scope of investor-state actions in the areas of regulatory takings and where alleged violations of “fair and equitable treatment” are raised. Labor interests may be mollified if violations of international core labor standards are subject to mandatory dispute settlement under the TPP (although the other 11 negotiating parties, including Mexico and Canada, are opposed).

While the TTIP impacts on NAFTA would be more diffuse, they could also be important, and possibly more negative than positive. The TTIP will not directly modify NAFTA because only the US and EU would be parties. The EU-Mexico Economic Partnership, Political Cooperation and Cooperation Agreement (MEPA) is now thirteen years old; the “Comprehensive Economic and Trade Agreement” (CETA) was concluded “in principle” between the EU and Canada in October 2013; and the negotiations for the TTIP have only begun. Thus, the three NAFTA nations could have potentially conflicting FTA obligations among the three EU bilateral agreements while in contrast, the 28 EU nations negotiate as a bloc through the Commission. Thus, the issues arise in economic relations among the EU Members as a group but with the three NAFTA nations individually.

Several potential areas of conflict exist including investment, electronic commerce and privacy issues, but the most significant is likely with manufactured goods rules of origin. So-called “preferential rules of origin” are designed to assure that a particular good does not receive duty-free treatment under the FTA unless the good “originates” in one or more of the countries that are party to the agreement. For example, under NAFTA a television assembled in Mexico will not qualify for duty-free entry into the U.S. and Canada unless certain components are manufactured within the region rather than imported from other sources, such as China.

One of the best examples of the manner in which rules of origin may cause the NAFTA countries individually to lose benefits from the trade agreements with the EU is with automobiles. The North American auto industry (including not only the U.S. “Big Three” but also such transplants as Honda, Nissan and Toyota) is broadly integrated, with most producers assembling finished autos as well as sourcing parts in all three countries. In order to be traded duty free in NAFTA, an automobile must have 62.5% regional value content (net cost method), but whether that 62.5% is made up of content from Canada, the US or Mexico is immaterial. In practice, very few vehicles assembled in any one of the North American nations lack substantial content from the other two.

It is clearly in the interest of each of the three NAFTA Parties to be able to export autos made in its territory to the EU member nations under the respective FTAs free of the EU’s

customs duty. But what happens when the EU has separate rules of origin in agreements with Mexico, Canada and the United States? The CETA is an indication of the types of conflicts that may arise later when the TTIP rules of origin are negotiated. Under the CETA (as reported to date; the texts have not been released), a Canadian auto must contain 50% Canadian content to enter the EU duty free, rising to 55% after 7 years. (100,000 vehicles per year are exempt, with only a 20% Canadian content requirement. This would be a ten-fold increase in current Canadian auto exports to Europe, amounting to less than 10,000 units annually.)

Under present North American manufacturing practices, it is unlikely that any motor vehicle made in Canada contains 50-55% Canadian and EU content, although almost all of them contain 62.5% or more North American content. Should the TTIP incorporate similar restrictions requiring 50-55% US and EU content, it is possible that a few vehicle models assembled in the United States would meet the requirements, but most would not. For example, a Ford assembled in Dearborn, Michigan, may incorporate a transmission manufactured in Hermosillo, Mexico and other parts produced in Windsor, Ontario. Auto and auto parts trade accounts for some 20% of total NAFTA merchandise trade, with several parts crossing the borders multiple times before appearing in finished vehicles.

This is in contrast to the situation in the EU, where a Fiat assembled in Italy using parts and subassemblies sourced from Germany, Spain and Poland (to suggest a hypothetical example) would be much more likely to qualify for duty-free entry into the United States (or Canada or Mexico).

Some have suggested, optimistically, that if the TTIP moves toward completion some accommodation will be made by the Commission for this situation, but it is not yet clear whether the “fix” would apply only to the automotive industry or to the other industries in which production among the three NAFTA nations has been integrated. Nor has there been any indication as to whether such arrangements would be extended to Mexico in a series of amendments to the existing EU—Mexico FTA, which almost certainly would be demanded by Mexico should the TTIP be completed. Ideally, the three EU FTAs would treat “originating” vehicles meeting the NAFTA rules origin as automatically meeting EU rules as well and thus subject to duty-free entry into all EU Member nations. For example, if Fiat/Chrysler wants to export minivans (most of which are assembled in Windsor, Ontario) to Europe, those imports into the EU should be duty-free as long as they meet the NAFTA rules.

This problem is not unique to the TTIP. The three NAFTA partners have concluded individual FTAs with Chile, Mexico and Canada’s in 1996 and the U.S. FTA in 2003. Instances have been reported in which a good (not typically autos) made in the United States has been exported to Chile, but failed to meet the US-Chile FTA rules of origin because it did not contain sufficient U.S. (as distinct from North American) content.

In retrospect, it would have been far preferable for the EU to be negotiating as a group with the NAFTA nations (even though there is no central authority such as the Commission to be responsible for such negotiations). For a variety of political reasons this was not feasible, but from the point of North American industrial sectors that are extensively integrated, including

autos and auto parts and some machinery, the individual approach unfortunate. In the absence of a single FTA between EU and the NAFTA Parties every effort should be made the U.S. negotiators, in consultation with their counterparts in Canada and Mexico, to eliminate to the extent feasible problems relating to rules of origin, so as to avoid undue restrictions on potentially hundreds of millions of dollars/Euros of affected trade.

Because of the low tariffs in the United States, the EU and Canada, and much lower tariffs today in Mexico than was the case 20 years ago, many of the most significant barriers to trade among the NAFTA and EU nations relate more to regulatory coordination and coherence, along with mutual recognition of regulatory procedures and address anti-competition challenges. Unfortunately, the EU—Mexico FTA and NAFTA do not deal significantly with such issues at any significant level, and there is no assurance that the approaches in the Canada-EU agreement and the TTIP will be parallel or even consistent with each other.

While among NAFTA Parties Mexico maintains its competitive advantages in some trade with the EU due to lower wage costs despite high energy costs and other dis-incentives, distortion between the United States and Canada in their competition for exports to the EU is potentially greater. As noted earlier, Canada will likely be disadvantaged in terms of its auto exports where the EU imposes high national content requirements in the rules of origin, since the Canada's auto industry is less able to produce vehicles without heavy reliance on parts and components from Mexico and the United States. It is conceivable that if the EU and the United States agree to rules of origin providing for relatively high national content, intra-NAFTA trade in auto parts could actually decrease if more component production is brought back to the United States from Mexico.

## **VI. Conclusion**

The negotiation and conclusion by the United States of the TPP and TTIP offers both rewards and risks for NAFTA and NAFTA trade in the future. Changes in NAFTA chapters relating, inter alia, to investment, rules of origin and intellectual property could reward the governments (investment), pharmaceutical and agricultural chemical producers (intellectual property) and NAFTA manufacturers (rules of origin) but adversely affect foreign investors (investment) and textile and apparel producers (rules of origin). Rules of origin in the TTIP, the CETA and MEPA, to the extent they fail to recognize the integrated nature of the NAFTA market could put the NAFTA exporters at a significant competitive disadvantage vis a vis competitors in the European Union. The overall impact will clearly not be known for several years, but will bear careful watching by stakeholders in the NAFTA nations.

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