

North American Free Trade Agreement (1992)

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A. Introduction

- 1 The North American Free Trade Agreement ('NAFTA') establishes a free trade area comprised of the territories of Canada, Mexico, and the US ('the Parties'). The NAFTA entered into force on 1 January 1994. As between Canada and the US, it is the successor to the Canada–US Free Trade Agreement ('CUSFTA') that entered into force on 1 January 1989, which is suspended so long as the NAFTA remains in effect. Negotiation of the NAFTA was initiated during the US presidency of George HW Bush at the suggestion of President Carlos Salinas of Mexico. This was during a period in which Mexico was undergoing a transition from State ownership to private ownership of key industries, as well as more generally opening the economy to imports and foreign investment. From the standpoint of the Mexican government, the NAFTA was an important element in a broader transition from a closed to an open market economy. The US had long sought to establish more favourable investment and trading terms with Mexico, and the proposal for a free trade agreement was consistent with expressed US interests. Two-way trade between Canada and the US far exceeded trade between Canada and Mexico, and the CUSFTA already promised to liberalize trade between Canada and its major trading partner. Nonetheless, Canada's participation in the negotiations allowed it to revisit some important subject matter and to otherwise remain engaged in a broader US plan for an eventual hemispheric → *Free Trade Area of the Americas (FTAA)*.

B. Background

- 2 The political underpinnings of the NAFTA are significantly different than those of the European Union ('EU'), and the differences are reflected in the characteristics of the institutions and terms of these two prominent regional arrangements. The project for → *European integration* was initiated following World War II. In addition to promoting the rapid rebuilding and integration of European economies, the architects of European integration sought to establish a framework for political cooperation that would reduce prospects for future regional conflict. The Treaty of Rome (Treaty Establishing the European Economic Community [signed 15 March 1957, entered into force 1 January 1958] 294 UNTS 17) placed significant legislative power in the hands of the Council of Ministers, and created a permanent judicial institution, the European Court of Justice, with substantial powers in relation to Member States (→ *European [Economic] Community*; → *European Communities, Court of Justice [ECJ] and Court of First Instance [CFI]*). The Treaty of Rome embodied the idea of free movement of persons throughout the Community, and established a common commercial policy. These key features of the European Economic Community were intended to bring the people of Europe closer together economically and politically.
- 3 The prospect of enhanced political integration did not motivate any of the NAFTA Parties. There was no internal or external pressure for a framework to prevent future military conflict. There was no political constituency in the US that sought to facilitate free movement of Mexican nationals. To the contrary, one of the political 'selling points' of the NAFTA was that, by helping to stimulate economic development in Mexico, it would reduce pressures for northward migration. As a consequence of this overall political dynamic, and taking into account constitutional concerns that might have arisen in all of the Parties from a 'deeper' integration proposal, the decision-making institutions of the NAFTA are weak and relatively nonintrusive—an analogy might be drawn to the initial post-World War II attitude of Great Britain toward the European Community project, and to Britain's first preference for a regional European trading arrangement that did not include a significant level of political integration (→ *European Free Trade Association [EFTA]*). The Agreement liberalizes trade in services and addresses in a limited way the movement of professional service providers, but it does not provide for the free movement of persons among the territories of the Parties.
- 4 There was significant political opposition in the US to the negotiation of the NAFTA, particularly from organized labour and environmental groups. Labour unions argued that further opening the US market to exports from Mexico

would encourage US businesses to relocate manufacturing plants and jobs in Mexico to take advantage of lower labour costs and weaker regulation. Environmental groups argued along the same lines, but emphasized that weak Mexican environmental standards and enforcement would effectively turn that country into a haven for engaging in environmentally unsound manufacturing practices, which would in turn create pressure to 'ratchet down' US environmental protections to equalize the playing field. Labour unions found an unlikely ally in a wealthy Texas entrepreneur, Ross Perot, who as a 'third-party' candidate for the US presidency in 1992 based his campaign on the loss of domestic jobs that would result from the NAFTA. The votes that Ross Perot garnered in the November 1992 presidential election arguably influenced the outcome of the Bush–Clinton contest. Perot's campaign certainly increased the general public's attention to the NAFTA. It is fair to say that no US trade initiative before or after has generated the level of domestic political attention as was manifest during the NAFTA debate. By the time the → *Uruguay Round* results were brought before the US Congress in 1994, the country had fairly well exhausted its interest in trade policy, and the → *World Trade Organization (WTO)* congressional approval process generated far less public interest.

- 5 President William Jefferson ('Bill') Clinton entered office subsequent to the signing of the NAFTA by the Parties on 17 December 1992, but prior to US congressional approval of the NAFTA. His Democratic Party was traditionally supported by labour unions, and was friendlier to environmental protection interests than the Republican opposition. Labour unions and environmentalists largely opposed the NAFTA that had been drafted by the GHW Bush Administration, placing the newly elected President Clinton in the awkward position of relying on Republican congressional support for approval of the agreement, while also needing to attract at least a modest Democratic constituency. To accomplish this, the Clinton administration negotiated two 'side agreements' to the NAFTA. These are the → *North American Agreement on Environmental Cooperation (1993)* ('NAAEC') and the → *North American Agreement on Labor Cooperation (1993)* ('NAALC'). As the Republicans would not support strong environmental and labour protections, the side agreements were essentially 'soft'. Yet their conclusion was enough to satisfy a sufficient number of Democratic congressional representatives so as to permit approval of the NAFTA. Immediately prior to the congressional vote there was considerable uncertainty as to whether the NAFTA would be approved by the US House of Representatives, but in November 1993 the agreement was in fact approved by a comfortable margin (234–200 votes in the House of Representatives and 61–38 votes in the traditionally more free-trade supportive Senate).
- 6 The NAFTA follows the customary 'free trade area' agreement model described in Art. XXIV → *General Agreement on Tariffs and Trade (1947 and 1994)* ('GATT'; UNTS 187 and 1867 UNTS 190). The NAFTA is structured to reduce or eliminate tariffs and quotas on trade in goods between the Parties. The NAFTA extends to liberalization of trade in services, as now covered by Art. V → *General Agreement on Trade in Services (1994)* ('GATS'; 1869 UNTS 183). In addition, the NAFTA provides for liberalization of restrictions on foreign direct investment ('FDI'), and establishes protection against → *nationalization* or → *expropriation*. The NAFTA is thus broader in terms of regulating economic activity than the classical 'free trade area' agreement as described in the GATT 1947 (→ *Free Trade Areas*).

C. Content and Purpose of the Agreement

- 7 In a 'free trade area' the members reduce or eliminate tariffs and quotas as between themselves, but do not establish a common outer tariff wall. This is the structure of the NAFTA, in which tariffs and quotas are effectively eliminated for trade in goods between the three Parties. However, each Party maintains its own schedule of tariffs applicable to goods from third countries, so that the tariff rate applicable to an imported product may differ depending on whether the importing country is Canada, Mexico, or the US. In order to avoid tariff rate 'shopping' by exporters to the NAFTA countries, the agreement establishes complex → *rules of origin* that limit tariff-free transit among the NAFTA Parties to goods that originate within the territory of the NAFTA, or which undergo a specified level of 'transformation' within the NAFTA territory. The level of regional transformation that would be required to qualify for tariff-free transit was one of the most controversial subjects of the NAFTA negotiations, particularly as this affected the automotive, textiles, and computer sectors. The NAFTA includes both general rules regarding 'regional transformation'—which involves movement among specified tariff schedule headings (and subheadings)—and rules applicable to specific sectors. For an automobile to qualify as a regionally transformed good, 65% of the content of the automobile, including the labour component, must have been produced within a NAFTA Party. This represented an increase from the 50% level for automobiles under the CUSFTA, and this increase was the subject of considerable concern in Japan. It is interesting to note that Japanese manufacturers substantially increased their direct investment in automobile manufacturing plants in the NAFTA territory, particularly in the US, following entry into force of the NAFTA.
- 8 Tariffs and quotas among the three NAFTA Parties were scheduled for elimination immediately, and over 5, 10, and 15 year time frames. The vast preponderance of tariff reduction would be completed by the 10th year. In fact, the Parties have implemented several rounds of accelerated tariff reductions. Tariff and quota reduction with respect to agricultural products was essentially subject to bilateral agreement between the Parties. Most of the products for which the 15 year

time tariff reduction period applies are in the agriculture sector. As between the US and Mexico there is essentially a complete programme of tariff elimination in the agricultural sector. The US and Canada preserved their CUSFTA agriculture commitments, continuing to reserve in the NAFTA a few agricultural products against tariff elimination. Part of the NAFTA process for eliminating restrictions in the agricultural sector involved the 'tariffication' of quotas, which involves converting the trade effect of quantitative limitations on agricultural imports into tariff rates. In some cases the result takes the form of 'tariff-rate quotas' ('TRQs') that increase once a certain quantity of goods has crossed the border. The 1994 GATT Uruguay Round Agreement on Agriculture similarly provided for tariffication of quotas (WTO Agreement on Agriculture [signed 15 April 1994, entered into force 1 January 1995] 1867 UNTS 410). That certain agricultural tariffs would require a relatively long phase-out is logical because such tariffs—particularly those that were converted from restrictive quotas—would be higher than for other products, and also because certain parts of the agricultural sector involve politically sensitive producing regions and groups. There have been a few serious disputes regarding implementation of the tariff elimination commitments in the agricultural sector (see → *North American Free Trade Agreement, Dispute Settlement*). However, in the final analysis, the NAFTA provides for nearly complete elimination of tariffs and quotas on trade between the Parties by the end of the 15 year reduction period.

- 9 The NAFTA imposed significant limitations on duty drawback or remission schemes between the Parties, which had already been eliminated between Canada and the US in the CUSFTA. This would effectively eliminate most of the trade-rule incentives attached to Mexico's well-known Maquiladora programme. Under that programme, importation into designated areas of Mexico of parts or components for the purpose of local assembly and export (usually to the US) would qualify for refund or drawback of tariffs otherwise paid to Mexico. US exports of parts or components to Mexico also enjoyed preferential treatment upon re-entry into the US. The benefits of the Maquiladora programme also were enjoyed by European and Japanese exporters of parts and components intended for assembly in Mexico and export to the US. Since US exporters would enjoy duty-free export and import for NAFTA-origin goods, only European, Japanese, and other third country users of Maquiladora facilities would suffer from the NAFTA's elimination of this duty drawback scheme. This helps to explain why both the European Union and Japan were anxious to conclude free trade agreements with Mexico following entry into force of the NAFTA. With new free trade areas ('FTAs'), exporters from these countries would also enjoy duty-free importation into Mexico.
- 10 The NAFTA broadly liberalizes trade in services (Chapter 12) among the Parties and their nationals by incorporating a general rule of 'national treatment' (→ *National Treatment, Principle*). However, the NAFTA also permits the Parties to maintain exceptions from national treatment by listing regulatory restrictions in annexes to the agreement. When the NAFTA was concluded, the Parties agreed that sub-federal units, ie, states and provinces, could retain nonconforming measures pending adoption of annexed lists of such nonconforming measures. Subsequently, by agreement of the trade ministers, the Parties dispensed with the inclusion of annexed lists of nonconforming sub-federal measures, allowing them to remain in effect. The NAFTA excludes a few important sectors from services liberalization coverage, including air and maritime transport, and basic voice telecommunications. Telecommunications service liberalization was subsequently agreed to under the WTO GATS system. Cross-border trucking services were scheduled to be liberalized over a six-year period. However, public safety and labour concerns in the US have blocked the later stages of implementation of trucking liberalization. Mexico initiated a NAFTA Chapter 20 dispute settlement proceeding against the US because of the latter's failure to implement the cross-border trucking agreement, and was largely successful (*Cross-Border Trucking Services USA-MEX-1998-2008-01*). So far, however, this has not resulted in removal of the impediments.
- 11 The NAFTA liberalization of telecommunications (Chapter 13) and financial services (Chapter 14) are addressed by rules complementary to the general chapter on services. Although the NAFTA did not open the basic voice telephone market, it did open the value-added services market. Chapter 13 includes rules on non-discriminatory access to telecommunications transport networks. The financial services chapter included limitations on foreign banking penetration of the Mexican market during a 10 year transition period, subject to certain limited extensions. The financial services chapter includes rules regarding the types of juridical entities that may be established by foreign owners (eg, branch banking is limited).
- 12 Nationals of third countries may take advantage of the services liberalization rules of the NAFTA provided that they establish a commercial presence within the NAFTA territory. From a practical standpoint, the services market of the NAFTA is open to nationals and enterprises of third countries. This is consistent with Art. V.6 GATS.
- 13 Investment liberalization (Chapter 11) is accomplished through the adoption of a 'national treatment' standard. Investors and investments of NAFTA Party nationals are to be treated the same way as investors and investments of 'local' nationals. As with the services liberalization, the NAFTA investment chapter includes annexed exceptions from national treatment which the Parties are permitted to maintain. The NAFTA investment chapter essentially provides the

customary international law standard of protection against nationalization or expropriation. What is added, in particular, is a third-party dispute settlement mechanism, using either the facilities of the → *International Centre for Settlement of Investment Disputes (ICSID)* or the → *United Nations Commission on International Trade Law (UNCITRAL)* arbitration rules, for disputes between private investors of a Party and a host government. Several such proceedings have been conducted. It may be briefly noted here that Chapter 11 investor-State dispute settlement has addressed issues that may not have been contemplated by NAFTA's trade negotiators such as whether US courts meet international standards of due process, or the manner in which US states regulate the environment. This has led to some discussion of limiting the scope of Chapter 11 dispute settlement. Third country nationals may take advantage of the NAFTA investment chapter rules, assuming they are doing business within the NAFTA territory.

- 14 The NAFTA includes Chapter 17 on intellectual property ('IP'). This chapter was negotiated contemporaneously with the WTO → *Agreement on Trade-Related Aspects of Intellectual Property Rights (1994)* ('TRIPS'; 1869 UNTS 299) and for the most part incorporates the same terms. There are, however, some material differences. The NAFTA includes a provision (Art. 1711 (5) and 1711 (6)) regarding the protection of regulatory data submitted in connection with the approval of pharmaceutical and agricultural chemical products that is more restrictive than the equivalent provision in the TRIPS Agreement (Art. 39 (3)). The NAFTA provision effectively requires the grant of marketing exclusivity for a reasonable period, normally five years. In addition, the NAFTA IP chapter obligated Mexico to provide 'pipeline' protection for pharmaceutical patents previously granted in the US or Canada with respect to products not previously placed on the market in Mexico (Art. 1709 (4)). This 'pipeline' provision applied only to patents granted in the Parties and was one of the factors that induced TRIPS negotiators from third countries to insist upon a most-favoured-nation undertaking in the TRIPS Agreement (→ *Most-Favoured-Nation Clause*). Canada effectively agreed to eliminate its 'license of right' system of compulsory licenses for pharmaceuticals as a consequence of the NAFTA IP chapter, although it was equally under pressure to do so in the TRIPS negotiations. In the audiovisual services sector, Mexico made a number of reservations regarding market access, such as requiring that a certain percentage television broadcast time be reserved for Mexican nationals.
- 15 The NAFTA rules on antidumping ('AD') and countervailing duties ('CVD') require the Parties to comply with their own domestic legislation on these subjects. The question whether a Party, in fact, has properly applied its own AD/CVD law is subject to dispute settlement under Chapter 19 (see below para. 20).

D. Institutional Structure and Domestic Implementation

- 16 The main decision-making institution of the NAFTA is the Free Trade Commission ('FTC') comprised of the trade ministers of the respective Parties. The FTC is required to meet at least annually. The FTC has rather limited powers which extend to overseeing implementation of the agreement, appointing dispute settlement panels and making recommendations to the Parties. The FTC may negotiate conditions of accession with third countries, but it is not authorized to adopt accession agreements. The trade minister of a country typically has some significant authority to make adjustments to trade policy execution, and the three NAFTA Party trade ministers acting together, on the basis of their inherent authority, have some significant governance power that is more or less independent of NAFTA provisions.
- 17 The NAFTA establishes a Secretariat, but this is merely a clearinghouse for information. The power and authority of the NAFTA decision-making institutions is not in any measure comparable to the power and authority of the decision-making institutions of the European Union. The NAFTA FTC does not have the authority to adopt 'secondary legislation' on behalf of the Parties, as do the Council of Ministers and Parliament in the EU. There is no NAFTA institution comparable to the European Commission with a charter to implement and to enforce the agreement. While there is a NAFTA dispute settlement mechanism, it is not in the nature of the ECJ with the power to issue rulings directly in the law of the Parties, except in the limited case of antidumping and countervailing duty determinations. The relative lack of power and authority placed in the central NAFTA institutions consciously reflects that none of the NAFTA Parties was seeking 'deep integration' of political and social institutions on the North American continent.
- 18 The NAFTA does not provide for a common external trade policy among the Parties. Each remains free to conduct its own foreign trade policy, provided that the policy does not violate the terms of the NAFTA. Since adoption of the NAFTA, the US has negotiated a substantial number of free trade agreements with other countries, including, for example, Jordan, Australia, Singapore, Chile, Morocco, and Central America (Central America-Dominican Republic-United States Free Trade Agreement ['CAFTA-DR']). Mexico has concluded a wide-ranging free trade agreement with the European Union (European Union-Mexico Free Trade Agreement [signed 23 March 2000, entered into force 1 July 2000] (2000) OJ L276/45), and free trade agreements with other countries, including, for example, Japan. Canada is in the process of negotiating a number of bilateral free trade agreements.

- 19 The NAFTA includes a panel dispute settlement mechanism (Chapter 20) for intergovernmental disputes under the agreement. A NAFTA Chapter 20 dispute settlement panel makes a determination and recommendation to the FTC regarding the subject matter of the dispute. The Parties should endeavour to resolve the matter based on the panel findings. The Party whose measures are inconsistent with the agreement is expected to bring its measures into compliance. If it does not do so, the complaining Party is entitled to withdraw equivalent concessions. There is no appellate mechanism in Chapter 20 dispute settlement.
- 20 The NAFTA contains a separate dispute settlement mechanism (Chapter 19) for antidumping and countervailing duty claims (this mechanism is also described in the NAFTA Dispute Settlement). Panels under this mechanism make determinations regarding whether a Party has properly applied its AD/CVD laws. The decisions of the NAFTA Chapter 19 panels are binding on the administrative authorities of the country making the determination. They are subject to a limited extraordinary challenge based on allegations of misconduct of the panellists. The Chapter 19 dispute settlement mechanism has been fairly heavily used.
- 21 As noted earlier, there are two side agreements to the NAFTA; these are the NAAEC and the NAALC. Each of these agreements includes a statement of principles regarding the policies the Parties should follow in the respective areas of governance, though the respective principles are not established as binding norms. Each side agreement establishes a governing body (the NAAEC Commission on Environmental Cooperation and the NAALC Commission for Labor Cooperation) that plays principally an advisory role. Neither has the authority to adopt legislation for the Parties. Each of the side agreements contains its own dispute settlement mechanism, though these are rather limited affairs.
- 22 When it adopted the NAFTA Implementation Act, the US Congress expressly denied self-executing or direct effect of the agreement in US law. The agreement is precluded from having direct effect in Canada as a matter of constitutional interpretation. It appears that direct application of the NAFTA is permitted as a matter of Mexican constitutional law (as noted in a Chapter 19 panel report).

E. Concluding Assessment

- 23 The rapid increase over the past decade of imports into the US from China, and the outsourcing of US jobs to India, has shifted the focus of the US public away from the NAFTA and toward Asia. Mexico is grappling with internal economic and political difficulties that likewise divert attention from external trade. Nonetheless, the NAFTA remains the subject of some political controversy as labour unions in the US continue to stand in opposition, and some NGOs assert that the NAFTA has harmed the interests of Mexico's less affluent farm operators. Yet regardless of the changeable political environment, the geographical proximity of the NAFTA Parties and the substantial cross-border movement of persons between them virtually assure that this legal framework for trade relations will remain important.

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