AMERICAN PHOENIX
TRADE ADVISORY SERVICES PLLC
FORGING A NEW CONSENSUS ON TRADE.

EXECUTIVE SUMMARY

August 1, 2017

In the past year, the backlash against globalization has expressed itself through Brexit, the withdrawal of the U.S. from the Trans-Pacific Partnership, and the launch of NAFTA renegotiations. It is clear from the discussions that significant segments of the population do not feel that globalization is working for them.

Both economic theory and empirical evidence support the argument that trade *overall* is beneficial. But theory and practice also support the argument that trade exacerbates inequality.

Modernizing trade agreements is not just about recognizing that we now live in a digital age. It is also about rethinking the terms of these agreements, and making our trade policy more inclusive.

The following principles are designed to modernize policy to achieve that goal:

1. Less is sometimes more.

2. Labor and environment rules not only need to be included but strengthened.

3. Rules of origin need to be tightened – intelligently.

4. Digital trade is vital, but we must be thoughtful about it.

5. Investor-State Dispute Settlement in trade agreements is an anachronism.

6. We need a competitiveness policy.

7. Visionary businesses must lead the charge for a new, more inclusive trade policy.

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These views are elaborated below.

THE NAFTA RENEGOTIATION:
SEVEN WAYS TO MODERNIZE TRADE POLICY

Mistrust of government and business – the very entities that make our trade policy -- is one of the enduring legacies of the financial crisis. Couple that mistrust with the targeted, devastating effects of trade to certain segments of the population, and the backlash against globalization is not hard to understand.

There now seems to be a new consensus that trade agreements must be modernized. The NAFTA renegotiation is the first step in this direction. However, modernization can take one of two forms. It can continue the past practice of focusing on business and simply update the agreement to provide benefits for new industries, such as digital trade. Alternatively, modernization can recognize the inequality inherent in the approach to date, and seek better balance. Below are seven principles designed to promote the latter.

LESS IS SOMETIMES MORE.

The reflexive reaction to the concept of modernizing trade agreements is to expand them.

Less, however, can be more.

As a nation, we have decreasing confidence in the way panels have interpreted provisions in our trade agreements. The latest example is the controversy over the panel decision *In the Matter of Guatemala – Issues Relating to the Obligations under Article 16.2.1(a) of the CAFTA-DR.*, where the United States lost its case against Guatemala over labor rights – despite having proven that Guatemala hasn't lived up to its promises.

Given these concerns, we should reevaluate whether it is a good idea to expand the jurisdiction of the very panels we believe are interpreting the agreements incorrectly. As it is, the Trump Administration is seeking to eliminate the special mechanism that governs unfair trade disputes.

Other reasons to ask ourselves if increasing the girth of these agreements is the best policy:

- *We aren't just plaintiffs – we're also defendants*. We tend to design trade agreements with an overly-optimistic view that we will be attacking other countries' laws, rather than defending on our own. That approach was certainly true, for example, when we were designing the WTO dispute settlement system. Yet we more frequently find ourselves defending our own laws than we had anticipated.

The WTO has been particularly aggressive in striking down our unfair trade laws – despite the fact that preserving them has been a major negotiating priority for the United States since before the GATT was created in 1947. That priority led to the exceptionally strong language in Article VI of the GATT that dumping is to be "condemned."[1] The United States has been, and remains, the global market of last resort. That means other countries will use all available tools to improve their access to our markets, including filing seemingly meritless disputes at the WTO that nevertheless end up succeeding.

In that context, the push for enforceable "WTO-plus" sanitary and phytosanitary rules might be a case of "be careful what you wish for." If our trading partners choose to challenge our laws, we cannot guarantee that those laws won't be found inconsistent with our trade commitments. We can certainly argue that we won't be forced to change those laws, but that argument will ring hollow in the wake of, for example, the repeal of the Country of Origin Labeling law. It may be that big business can absorb an influx of invasive species; but it is less clear that our independent farmers can. During the debate around the NAFTA renegotiation, we have heard over and over again that agriculture has been a big winner. The mantra, including from the agriculture community, is to do no harm. Why risk it?

Similarly, on currency manipulation, rather than having a set of rules that a panel might or might not interpret in a way we consider sound, why not include language affirming our ability to use our countervailing duty laws to address the problem? That approach has the benefit of preserving our ability to tackle currency manipulation -- unilaterally.

- *Provisions don't just restrict other governments – they restrict ours*. Little discussed is the push to include provisions for the purpose of hamstringing *Congress'* flexibility. During the negotiation of the Trans-Pacific Partnership, one of the stumbling blocks was the length of protection for biologic medicines. The U.S. industry pushed for 12 years – the same amount of time as provided for in current U.S. law. Meanwhile, there was a simultaneous debate in the United States about whether the 12-year period should be reduced to seven. Had TPP required 12 years, and entered into force, then any ongoing effort to reduce the U.S. term of protection would have been met with the argument that we'd be in violation of the very provisions we insisted on including in TPP.

  For this reason, highly prescriptive provisions are seen as incursions on sovereignty, and may explain why, during the trade debates of 2015, the Members of the Freedom Caucus were more aligned with Progressives than with other Republicans.

[1] Terry Stewart, *The GATT Uruguay Round: A Negotiating History,* at 1405.

- *Sometimes we're wrong*. We also do not have perfect information, and in our zeal to establish rules for everything, we include provisions that turn out to be ill-advised. As an example: at one point, we considered it a foregone conclusion that capital controls should be prohibited, and thus we began to proscribe them in our trade agreements. Then the financial crisis occurred, and we learned that capital controls can be valid and useful. In recognition of that fact, prohibitions on capital controls were not included in the Trans-Pacific Partnership. But they live on in, for example, the U.S.-Korea trade agreement.[2] We leave too little room to revisit policies that over time become anachronistic.[3]

  Even as to tariffs we have been too idealistic. At the GATT (now WTO), other countries often negotiated a bound rate – the maximum tariff they can impose on imports of a particular good. However, they also have a separate applied rate – the rate they intend to actually impose. The applied rate cannot be higher than the bound rate, but it can be lower. The wriggle room between the two provides policy flexibility for countries to raise their applied rates if the need arises. The United States, by contrast, did not negotiate a lower applied rate, and we thus have no wriggle room. Perhaps our manufacturing base would have fared better, and the backlash against globalization less severe, if we had allowed ourselves more flexibility.

The very fact that NAFTA is being renegotiated after two decades highlights the comparative permanency of the rules in these agreements. They cannot be changed unless the parties all agree. As the scope and detail of agreements grow, these agreements become inflexible, outdated contracts that do not easily respond to the evolution of trade priorities. Instead of taking every regulatory grievance, big or small, and shoehorning it into a trade agreement, we should ask ourselves if it would be better to return to the days when these agreements provided a more general framework of rules under which trade is conducted. Businesses prefer zero risk, to be sure. But the effort to eliminate risk has led to excessively prescriptive agreements that tie regulators' hands and encourage the feeling that these agreements are the product of crony capitalism.

LABOR AND ENVIRONMENT RULES NOT ONLY NEED TO BE INCLUDED BUT STRENGTHENED.

The NAFTA renegotiation highlights how the thinking behind trade policy can evolve. In 1994, labor and environmental provisions were considered inappropriate subjects for a trade agreement at all, let alone to be backed up with binding dispute settlement.

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[2] *See* Article 11.7, https://ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file587_12710.pdf

[3] Indeed, the question of whether total liberalization of trade in financial services has been good policy remains an area that has not been adequately explored. One of the upshots of *This Time is Different,* the famous work exploring centuries of financial crises, is that a rapid influx of capital leads to bubbles that eventually burst – and ensuing crises. It is worth examining whether the financial crises of the late 1990s were in any way linked to trade liberalization in financial services after implementation of WTO commitments. Perhaps not – but the issue should be examined.

Just over a decade later, in 2007, a new consensus emerged, and today Republicans and Democrats alike support enforceable labor and environmental provisions.

However, a disparity remains. To prove a claim under the labor and environmental chapters, the complaining party must demonstrate that the breach affected trade or investment between the parties. At first blush, that condition makes sense. After all, the provisions are part of a trade agreement. But the trade nexus is not applied in other chapters. Take the TPP intellectual property chapter, for example. The chapter requires parties to impose penalties, including *criminal* penalties,[4] for violations of intellectual property rights – whether or not a cross-border transaction is involved.

As it turns out, that condition is pivotal. The United States failed to make its case in the *Guatemala* dispute not because Guatemala complied with the substantive labor rights provisions of the agreement – the panel found otherwise - but because the United States did not prove that Guatemala's breaches occurred in a manner affecting trade or investment between the parties.[5]

Labor and environment provisions aren't included in these agreements because they're "social" issues – they're included because they're *economic* issues. They directly affect the competitiveness of U.S. workers, businesses, goods, and services. It only makes sense that these provisions be subject to the same dispute settlement standards as other provisions in the agreement.

Lastly, these provisions must be enforced. There are breaches of existing trade agreements that would clear the hurdle that proved problematic in *Guatemala.* For example, there are substantiated allegations that Peru is in breach of its obligations under our bilateral trade agreement, particularly with respect to illegal harvesting and export of timber. A shipment of such merchandise made its way to the Port of Houston, where the U.S. government detained it – certainly that ought to meet the requirement that the breach occurred in a manner affecting trade. Yet no dispute has been brought against the Peruvian government to compel compliance.

RULES OF ORIGIN NEED TO BE TIGHTENED – INTELLIGENTLY.

When people talk about rules of origin, they often focus on sensitive products, such as autos, or textiles and apparel.

What people don't talk about is the rules of origin for goods that *aren't* sensitive. Those rules are *even weaker.* President Trump has been dismissed as wrongheaded

[4] *See,* e.g., Article 18.77.

[5] *In the Matter of Guatemala – Issues Relating to the Obligations under Article 16.2.1(a) of the CAFTA-DR,* http://trade.gov/industry/tas/Guatemala%20%20%E2%80%93%20Obligations%20Under%20Article%2016-2-1(a)%20of%20the%20CAFTA-DR%20%20June%2014%202017.pdf, pp. 50 et seq; pp. 156, 167-170.

for claiming that China had a backdoor to TPP. The truth is that China has had a backdoor *to all of our trade agreements in the past two decades*, via weak rules of origin for non-sensitive goods.[6]

Tightening these rules is even more important now that we have binding labor and environmental rules in our trade agreements. These rules are only binding on the parties to the agreement, not to third countries such as China. At present, Korea – a trade agreement partner – is required to meet labor and environmental standards as a condition of enhanced access to our markets, but China is not. If we want to establish the rules of the road for trade, which was a commonly-invoked argument in favor of TPP, why not start by tightening up our rules of origin?

At the same time, we have to be realistic. The United States has comparatively low tariffs on most products. If we require 100% regional content, then companies may not bother using the agreement, and pay the tariff instead, as Professor Helper explained.[7] That certainly won't incentivize American production.

Little work has been done to identify optimal rules of origin. Rather than rushing to complete a renegotiation in a short period of time, negotiators would be well-served to spend some time devising a process for identifying more optimal rules of origin that would drive sourcing in the region.

In this vein, calls for eliminating duty drawback restrictions are at odds with the goal of incentivizing regional sourcing. Advocates for eliminating these restrictions themselves state that the upshot of the drawback restrictions is to encourage manufacturing to move from non-NAFTA parties to NAFTA parties. In that context, it seems the drawback rules are fulfilling their intended goal.

DIGITAL TRADE IS IMPORTANT, BUT WE MUST BE THOUGHTFUL ABOUT IT.

Much of the emphasis on modernizing NAFTA has focused on digital trade, including issues around forced localization and cross-border data flows. Indeed, digital trade – not manufacturing – was the first sector listed in the letter Ambassador Lighthizer sent to Congress notifying the NAFTA renegotiation.[8]

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[6] Rules of origin are technically complex. Many rules do not involve a percentage content requirement but rather depend on whether an appropriate shift has occurred from one classification in the Harmonized Tariff Schedule to another. A rule of origin permitting a shift from one subheading to another is considered a lenient rule of origin that facilitates a much greater amount of third-party content than a rule requiring a change from one chapter to another. A perusal of the NAFTA rules origin highlights that many of these lenient rules exist today.

[7] Further, if the rate applicable to all our trading partners (the "MFN" rate) is zero, then a lenient rule of origin is not problematic. However, if the MFN rate is positive, then lenient rules of origin create a free-rider problem.

[8] https://ustr.gov/sites/default/files/files/Press/Releases/NAFTA%20Notification.pdf

There is no need to repeat the discussion here. A few points, however, are raised less often, if at all:

- Are we at risk of repeating the mistakes we made with manufacturing? We were pioneers in manufacturing and assumed that open markets would always operate to our benefit. As manufacturing shifted abroad, we have been left with few tools to replace the lost jobs, and the frustration stemming from job loss has fueled the backlash against globalization.

- Are there legitimate reasons to require data localization? As one example, Chinese companies listed on U.S. stock exchanges must allow U.S. audit inspectors to examine the company's audit workpapers. The Chinese don't allow those inspectors to do so. The United States could reasonably require the workpapers to be kept here, rather than in China.

- What will we do with 3D printing? There is little discussion about additive manufacturing, including what appropriate rules of origin might be in such circumstances.

Although the Administration has indicated it believes it can wrap up the negotiations quickly, previous Administrations have had similar ambitions, only to be frustrated by the exponential complexity of modern trade negotiations and the inability of the United States to dictate terms.

If indeed the parties want to claim victory before Mexico's election season begins in earnest, then they may choose to conclude a digital update to NAFTA – one that would not necessarily require implementing legislation in the United States. If so, then the Administration's NAFTA modernization would be of the kind that simply follows the previous line, rather than fundamentally improving the balance in favor of those who have lost more than they have won from globalization.

INVESTOR-STATE DISPUTE SETTLEMENT IN TRADE AGREEMENTS IS AN ANACHRONISM.

Investor-state dispute settlement may have made a certain amount of sense when it was initially included in investment treaties. Those treaties had no other mechanism to resolve conflicts, and the risk of expropriation in some countries was real.

The world, however, has changed. Today, the excesses of ISDS are a common point of discussion. One of the witnesses at the hearing characterized ISDS as an important mechanism to keep countries honest. Unfortunately, threats to use ISDS to keep a country "honest" are in too many instances threats to prevent a country from regulating in the public interest.

Indeed, even companies that don't have deep pockets now reportedly benefit from "angel" investors who will fund the litigation: hedge funds have gotten into the business of financing claims as investment vehicles, subsidizing claimants who might not otherwise have the means to wage a battle of attrition against a foreign sovereign government.[9]

The debate has reached the point where the pro-trade Economist is scratching its head:

> If you wanted to convince the public that international trade agreements are a way to let multinational companies get rich at the expense of ordinary people, this is what you would do: give foreign firms a special right to apply to a secretive tribunal of highly paid corporate lawyers for compensation whenever a government passes a law to, say, discourage smoking, protect the environment or prevent a nuclear catastrophe. Yet that is precisely what thousands of trade and investment treaties over the past half century have done, through a process known as "investor-state dispute settlement", or ISDS.[10]

In fact, the Economist went so far as to advocate that we should simply rely on state-to-state dispute settlement to solve these types of conflicts.[11] And that is the main reason ISDS in trade agreements makes little sense. These agreements already have dispute settlement mechanisms, and thus it is not necessary to give investors special access.

Labor unions and environmental groups oppose ISDS – as does the Cato Institute.[12] The AFL-CIO and the Cato Institute do not consistently share policy positions; yet they agree that ISDS should not be part of our trade agreements.

WE NEED A COMPETITIVENESS POLICY.

Important as it is to have labor and environmental provisions, and to recalibrate the rules of origin, these provisions will not, by themselves, bring jobs back to the United States. The labor and environmental rules would dissuade race-to-the-bottom offshoring, but they won't necessarily lead companies to onshore in the United States.

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[9] http://www.nakedcapitalism.com/2017/04/investor-state-dispute-settlement-isds-suits-become-favored-hedge-fund-investment.html

[10] *The Arbitration Game,* October 11th, 2014, https://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration

[11] *A Better Way to Arbitrate,* October 11, 2014. https://www.economist.com/news/leaders/21623674-protections-foreign-investors-are-not-horror-critics-claim-they-could-be-improved

[12] Dan Ikenson, *A Compromise to Advance the Trade Agenda: Purge Negotiations of Investor-State Dispute Settlement*, https://www.cato.org/publications/free-trade-bulletin/compromise-advance-trade-agenda-purge-negotiations-investor-state

Rules of origin incentivize *regional* sourcing, but that sourcing could be in Mexico or Canada – not necessarily the United States.

When many think of trade agreements, they assume that Trade Adjustment Assistance addresses any job losses under our agreements. TAA is an excellent program for helping workers from an individual factory retrain to become something else – a nurse, for example, or a software programmer. But TAA was never intended to address the kind of crippling job loss that has ravaged the Midwest as entire supply chains have been offshored, or to replace the textile and apparel industry that once flourished in North Carolina. As a country, we made the decision to open our markets. But, as a country, we have no answer for the consequences that have been visited on entire regional economies.

It doesn't have to be that way. In light of German workers' ability to weather the financial crisis comparatively well, there are new questions about whether we should explore Germany's apprenticeship system, or something similar. Other ideas include reexamining the way we evaluate foreign investment, and to consider it in light of its effect on competitiveness.

There are reasons other than trade agreements to take a look at how we can improve our competitiveness. There's no need to debate whether trade or automation causes more job loss – they both do, and right now we have a solution for neither.

VISIONARY BUSINESSES WILL LEAD THE CHARGE FOR A NEW, MORE INCLUSIVE TRADE POLICY.

Businesses that like trade agreements and want more of them should be concerned that, absent major changes in process and substance, the opposition that sank TPP may sink future agreements as well. The financial crisis fundamentally changed the way Americans view both government and big business. Polls indicate that people trust business and elected officials *least*.[13] Yet our trade policies have to date been predominantly created by collaboration between government and big business.

The fight over TPP, and the Brexit vote, represent a watershed, the embodiment of the frustration that the middle and working class have had with global economic policy. The response to this frustration can be, as it has been, to dismiss opponents as unfamiliar with even the most basic principles of "Econ 101." But this response is facile. Paul Krugman didn't win a Nobel Prize in Economics on the basis of freshman trade theory, where variables are suspended and information and markets are presumed to be perfect. Economists such as David Autor at MIT are challenging the assumptions that traditional approaches have been accurate predictors of economic change:

[13] *See, e.g.,* http://www.pewresearch.org/fact-tank/2016/10/18/most-americans-trust-the-military-and-scientists-to-act-in-the-publics-interest/

> I think if we had realized how traumatic the pace of change would have been we would have at a minimum had much better policies in place. [14]

Advocates of trade must be at the forefront of seeking a more inclusive approach to our policy. At the hearing, Mr. Linebarger of Cummins stood out, expressly supporting not just enforceable labor and environmental standards, but actual enforcement of those standards. At the same time, those are policies that have been in place since 2007. In light of the backlash against globalization, it seems clear that still more must be done.

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American Phoenix has submitted these comments on its own behalf.

[14] http://freakonomics.com/podcast/china-eat-americas-jobs/