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Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy

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Summary

Free trade areas (FTAs) are arrangements among two or more countries under which they agree to eliminate tariffs and nontariff barriers on trade in goods among themselves. However, each country maintains its own policies, including tariffs, on trade outside the region.

In the last few years, the United States has engaged or has proposed to engage in negotiations to establish bilateral and regional free trade arrangements with a number of trading partners. Such arrangements are not new in U.S. trade policy. The United States has had a free trade arrangement with Israel since 1985 and with Canada since 1989, which was expanded to include Mexico and became the North American Free Trade Agreement (NAFTA) effective in January 1994.

U.S. interest in bilateral and regional free trade arrangements surged, and the Bush Administration accelerated the pace of negotiations after the enactment of the Trade Promotion Authority in August 2002. U.S. participation in free trade agreements can occur only with the concurrence of Congress. In addition, FTAs affect the U.S. economy, with the impact varying across sectors.

The 112th Congress and the Obama Administration faced the question of whether and when to act on three FTAs pending from the Bush Administration—with Colombia, Panama, and South Korea. Although the Bush Administration signed these agreements, it and the leaders of the 110th Congress could not reach agreement on proceeding to enact them. No action was taken during the 111th Congress either.

After discussion with congressional leaders and negotiations with the governments of Colombia, Panama, and South Korea to assuage congressional concerns regarding treatment of union officials (Colombia), taxation regimes (Panama), and trade in autos (South Korea), President Obama submitted draft implementing legislation to Congress on October 3, 2011. The 112th Congress approved each of the bills in successive votes on October 12, along with legislation to renew an aspect of the Trade Adjustment Assistance (TAA) program. President Obama signed the bills into law on October 21, 2011.

In the meantime, on November 14, 2009, President Obama committed to work with the current and prospective members of the Trans-Pacific Strategic Economic Partnership Agreement (TPP). The TPP is a free trade agreement that includes nations on both sides of the Pacific. The TPP, which originally came into effect in 2006, currently includes Brunei, Chile, New Zealand, and Singapore. Besides the United States, Australia, Peru, and Vietnam have joined the negotiations. In addition, Canada, Japan, and Mexico have expressed interest in joining.

FTAs raise some important policy issues: Do FTAs serve or impede U.S. long-term national interests and trade policy objectives? Which type of an FTA arrangement meets U.S. national interests? What should U.S. criteria be in choosing FTA partners? Are FTAs a substitute for or a complement to U.S. commitments and interests in promoting a multilateral trading system via the World Trade Organization (WTO)? What effect will the expiration of TPA have on the future of FTAs as a trade policy strategy?

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In the last few years, the United States has considered bilateral and regional free trade areas (FTAs) with a number of trading partners. Such arrangements are not new in U.S. trade policy. The United States has had a free trade arrangement with Israel since 1985 and with Canada since 1989. The latter was suspended when the North American Free Trade Agreement (NAFTA) that included the United States, Canada, and Mexico went into effect in January 1994.

U.S. interest in bilateral and regional free trade arrangements surged, and the Bush Administration accelerated the pace of negotiations after the enactment of the Trade Promotion Authority in August 2002. U.S. participation in free trade agreements can occur only with the concurrence of Congress. In addition, FTAs affect the U.S. economy, with the impact varying across sectors.

The 112th Congress and the Obama Administration faced the question of whether and when to act on three pending FTAs—with Colombia, Panama, and South Korea. Although the Bush Administration signed these agreements, it and the leaders of the 110th Congress could not reach agreement on proceeding to enact them. No action was taken during the 111th Congress either. In addition, the Trade Promotion Authority (TPA) expired on July 1, 2007, meaning that any new FTAs agreed to would not likely receive expedited legislative consideration, unless the authority is renewed.

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This report will monitor pending and possible proposals for U.S. FTAs, relevant legislation and other congressional interest in U.S. FTAs.

What Are Free Trade Areas?

Free trade areas are part of the broad category of trade arrangements under which member-countries grant one another preferential treatment in trade. Preferential trade arrangements include the following:

- **free trade areas** (FTAs), under which member countries agree to eliminate tariffs and nontariff barriers on trade in goods within the FTA, but each country maintains its own trade policies, including tariffs on trade outside the region;
- **customs unions**, in which members conduct free trade among themselves and maintain common tariffs and other trade policies outside the arrangement;
- **common markets**, in which member countries go beyond a customs union by eliminating barriers to labor and capital flows across national borders within the market; and
- **economic unions**, where members merge their economies even further by establishing a common currency, and therefore a unified monetary policy, along with other common economic institutions. The European Union is the most significant example of a group of countries that has gone from a customs union to an economic union.[1]

The process of forming an FTA usually begins with discussions between trading partners to ascertain the feasibility of forming an FTA. If they agree to go forward, then the countries undertake negotiations on what the FTA would look like. At a minimum, participants in an FTA agree to eliminate tariffs and some other nontariff trade barriers and agree to do so over a specific time period. In addition, the partner countries usually agree on rules of origin, that is, a definition of what constitutes a product manufactured within the FTA and, therefore, one that is eligible to receive duty-free and other preferential trade treatment. Rules of origin prevent products from nonmembers entering an FTA market over the lowest tariff wall. Most FTAs also include procedures on the settlement of disputes arising among members and rules on the implementation of border controls, such as product safety certification and sanitary and phytosanitary requirements. Most recent FTAs contain rules on economic activities besides trade in goods, including foreign investment, intellectual property rights protection, treatment of labor and environment, and trade in services. The size and complexity of the FTA will largely reflect the size and complexity of the economic relations among the participating countries. U.S. FTAs with Israel and Jordan are relatively basic, while the NAFTA (the United States, Canada, and Mexico) is very complex.

Why Countries Form FTAs

Countries form free trade areas for a number of economic and political reasons. Most basically, by eliminating tariffs and some nontariff barriers, FTAs permit the products of FTA partners easier access to one another's markets. The 1989 FTA between the United States and Canada was formed arguably for this purpose. Developed countries have also formed FTAs with developing countries to encourage them toward trade and investment liberalization.

[1] Besides the arrangements described above under which member countries extend *reciprocal* preferential treatment, there are trade arrangements under which one party agrees to extend nonreciprocal preferential treatment to the imports of a country or group of countries unilaterally. Such arrangements involve primarily developed countries extending nonreciprocal preferential treatment to the imports from developing countries. For example, the United States employs the Generalized System of Preferences (GSP), the Andean Trade Preferences Act (ATPA), the Caribbean Basin Initiative (CBI), and the Africa Growth and Opportunity Act (AGOA). The main objective of these nonreciprocal arrangements is to encourage economic development in developing countries.

FTAs may be used to protect local exporters from losing out to foreign companies that might receive preferential treatment under other FTAs. For example, some supporters of the U.S.-Chile FTA argued that U.S. firms were at a disadvantage vis-à-vis their Canadian competitors whose exports face no Chilean tariffs under the Canada-Chile FTA. Slow progress in multilateral negotiations has been another impetus for FTAs. For example, when the 1986-1994 Uruguay Round negotiations got bogged down, the impetus for the United States, Mexico, and Canada to form NAFTA seemed to increase. Arguably the surge in FTA formation worldwide in the past few years has been a result of the difficulties encountered in launching and implementing the Doha Development Agenda round of negotiations in the WTO.

Political considerations are also a motivation to form FTAs. The United States formed FTAs with Israel and with Jordan to reaffirm American support of those countries and to strengthen relations with them.

FTAs in the Context of U.S. Trade Policy

Post-World War II trade policy under various presidential administrations has had several interrelated objectives. One has been to secure open markets for U.S. exports. A second has been to protect domestic producers from foreign unfair trade practices and from rapid surges in fairly traded imports. A third has been to control trade for foreign policy and national security reasons. A fourth objective has been to help foster global trade to promote world economic growth.

In fulfilling these objectives, U.S. political leaders have formed and conducted trade policy along three tracks. One track has been the use of multilateral negotiations to establish and develop a rules-based trading system. The United States was a major player in the development and signing of the General Agreement on Tariffs and Trade (GATT) in 1947. It was a leader in nine rounds of negotiations that have expanded the coverage of GATT and that led to the establishment in 1995 of the World Trade Organization (WTO), the body that administers the GATT and other multilateral trade agreements. The United States has continued this approach as a leader in the latest round–the Doha Development Agenda (DDA).

U.S. policymakers have used a second track which can be labeled the “unilateral” track. Under this approach, the United States threatens retaliation, usually in the form of restricting trade partners’ access to the vast U.S. market, in order to get the partner to open its markets to U.S. exports or to cease other offensive commercial practices and policies. The United States has employed this approach primarily against foreign practices not covered by GATT/WTO rules or because the multilateral dispute settlement process proved too slow and ineffective to meet U.S. needs. For several decades, especially in the 1970s and 1980s, the United States conducted its trade policy with Japan “unilaterally” to get Japan to amend domestic laws, regulations and practices that prevented U.S. exporters from securing what they considered to be a fair share of the Japanese market.

More and more, however, U.S. trade policy is becoming dominated by a third track—bilateral and regional negotiations to establish FTAs. The United States completed its first FTA with Israel in 1985 under President Reagan. It completed its second with Canada in 1989 under President Bush, whose Administration was involved in the process of expanding it to Mexico, a process that was completed by the Clinton Administration in 1993. However, even after the completion of NAFTA, it was still unclear whether bilateral and regional FTAs had become a fixture in U.S. foreign trade policymaking or anomalies to cement already strong economic relationships.

By 1994 it seemed apparent that FTAs were indeed becoming a fixture when the United States, under the Clinton Administration, led a group of trade ministers from 33 other Western Hemispheric countries in agreeing to work toward establishing a Free Trade Area of the Americas (FTAA) by 2005. In the same year, political leaders from the United States and other member-countries of the Asian-Pacific Economic Cooperation (APEC) forum signed a declaration in Bogor, Indonesia, to work toward free trade and investment in the region by 2010 for developed countries and by 2020 for all member-countries. Both of those efforts have flagged.

The pursuit of FTAs continued when, on June 6, 2000, President Clinton and Jordanian King Abdullah announced that their two countries would begin negotiations on establishing a free trade area. An agreement was quickly reached and was signed on October 24, 2001. Similarly, President Clinton and Singapore Prime Minister Goh Chok Tong announced, somewhat unexpectedly, on November 16, 2000, that their two nations would launch negotiations to complete a free trade agreement. And on December 6, 2000, the United States and Chile had started negotiations to establish an FTA. Chile had long been mentioned as a potential addition to NAFTA or as a partner in a stand-alone FTA.

In the meantime, many countries, including the other major trading powers, were actively negotiating free trade agreements. The WTO has reported that more than 200 FTAs are in force. For example, Canada formed an FTA with Chile as did Mexico. The EU has formed FTAs with a number of countries. Japan, which had shunned the use of FTAs, formed an FTA with Singapore and is exploring the possibility of forming an FTA with Korea, although those negotiations have been suspended.

The Bush Administration had affirmed the strategy of pursuing U.S. trade policy goals through the multilateral trade system but gave strong emphasis to building bilateral and regional trade ties through free trade agreements through a policy called a *competition in liberalization.*

The Bush Administration continued negotiations that the Clinton Administration initiated. At the end of 2002, the Bush Administration completed FTA negotiations with Chile and Singapore first begun by the Clinton Administration in 2000. The FTAs with Chile and Singapore entered into force on January 1, 2004.

Perhaps encouraged by the passage and enactment of legislation granting the President trade promotion authority (TPA), as contained in the Trade Act of 2002 (P.L. 107-210—signed into law on August 6, 2002), the Bush Administration moved ahead with a trade agenda that contained an unprecedented number of FTAs. In 2004, agreements with Australia and Morocco were signed, approved by Congress. The agreement with Australia entered into force on January 1, 2005, and the one with Morocco on January 1, 2006. An agreement with Central American countries and one with the Dominican Republic were also signed and combined into one agreement, the DR-CAFTA. The President sent Congress draft implementing legislation on June 23, 2005. The House and Senate passed the legislation (H.R. 3045) on July 27 and 28, 2005, respectively, and President Bush signed it into law on August 2, 2005 (P.L. 109-53). The agreement with El Salvador entered into force on March 1, 2006, with Honduras and Nicaragua on April 1, 2006, with Guatemala on July 1, 2006, with the Dominican Republic on March 1, 2007, and with Costa Rica on January 1, 2009.

An agreement with Bahrain was signed on September 14, 2004, for which Congress passed and the President signed implementing legislation (H.R. 4340/P.L. 109-169, January 11, 2006). The agreement entered into force on August 1, 2006. Congress passed and the President signed implementing legislation (P.L. 109-283) for an FTA with Oman, which entered into force on January 1, 2009. Under the Bush Administration, the United States signed FTAs with Colombia, Peru, Panama, and South Korea (see **Table 1**).[2] The House passed (285-132) on November 8, 2007, and the Senate passed on December 4, 2007, implementing legislation (H.R. 3688) for the U.S.-Peru FTA. The President signed the bill into law (P.L. 110-138) on December 14, 2007. The FTA entered into force on February 1, 2009.

After several months of negotiations, on May 10, 2007, congressional leaders and the Bush Administration reached an agreement on new policy priorities that are to be included in pending FTAs. These priorities included the enforcement of five core labor standards that are part of the International Labor Organization's Declaration on Fundamental Principles and Rights of Work, commitment to enforce seven multilateral environmental agreements to which FTA partners are parties; the availability affordable generic pharmaceuticals, port security, and foreign investor rights in investor-state disputes.

Obama Administration Policy and Recent Developments

President Obama and his Administration had expressed support for three pending FTAs from the Bush Administration—with Colombia, Panama, and South Korea—but with the understanding that some outstanding issues needed to be addressed. Specifically, regarding Colombia, critics, particularly labor unions, remain concerned about the treatment of union leaders and other labor activists. While supporters cited data showing that violence against union leaders had decreased, critics charged that the violence was still unacceptably high.[3] Regarding Panama, the primary concerns raised pertained to Panamanian tax policy, which, critics charged, allowed Panama to be a haven for companies and individuals to avoid taxes.[4]

The South Korean agreement was the most challenging case. Some Detroit-based car manufacturers, especially Ford and Chrysler, had opposed the agreement because, they asserted, the agreement did not adequately address South Korean barriers to auto imports. (GM had taken a neutral position on the KORUS FTA.) However, as a result of the modifications agreed to in December 2010, most of which pertain to autos, both Ford and Chrysler support approval of the KORUS FTA, as does the United Auto Workers (UAW) union. U.S.-based steel manufacturers have also opposed the agreement because, they argued, it would weaken U.S. trade remedy (antidumping, countervailing duty) laws. Other major labor unions, including the AFL-CIO oppose the agreement.[5]

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[2] The President submitted implementing legislation for the U.S.-Colombia Free Trade Agreement which was introduced in the 110th Congress (H.R. 5724/ S. 2830) on April 8, 2008. However, the House voted (H.Res. 1092) to make certain expedited procedures, including established deadlines under section 151 of the Trade Act of 1974, not applicable to the bill. The 110th Congress has taken no further action on the legislation.

[3] CRS Report RL34470, *The U.S.-Colombia Free Trade Agreement: Background and Issues*, by M. Angeles Villarreal

[4] CRS Report RL32540, *The U.S.-Panama Free Trade Agreement*, by J. F. Hornbeck

[5] CRS Report RL34330, *The U.S.-South Korea Free Trade Agreement (KORUS FTA): Provisions and Implications*, coordinated by William H. Cooper

The Administration has indicated that it is working with the relevant groups to work out solutions to issues with the Colombia and Panama FTAs. On April 6, 2011, the Obama Administration announced that Colombia had agreed to an "Action Plan Related to Labor Rights" laying out steps it was prepared to take to resolve the labor rights issues.[6] Panama and the United States came to a resolution on the tax transparency issue by agreeing to a Tax Information and Exchange Agreement (TIEA) TIEA, which Panama ratified on April 13, 2011. The TIEA permits either country to request information on most types of federal (U.S.) or national (Panama) taxes. To address the tax haven issue, Article 7 specifically allows for tax information exchange "under the existing Treaty on Mutual Legal Assistance in Criminal Matters," which covers money laundering among other illicit financial activities.

Eventually, President Obama submitted draft implementing legislation to Congress on October 3, 2011 for each of the FTAs. The 112th Congress approved each of the bills in successive votes on October 12, along with legislation to renew an aspect of the Trade Adjustment Assistance (TAA) program, and the President signed them into law on October 21, 2012. The U.S.-South Korean agreement entered into force on March 15, 2012 and the U.S. Colombia FTA entered into force on May 15, 2012. Entry into force of the U.S.- Panama FTA awaits further administrative action.

In the meantime, on November 14, 2009, President Obama committed to work with the current and prospective members of the Trans-Pacific Strategic Economic Partnership Agreement (TPP). The TPP is a free trade agreement that includes nations on both sides of the Pacific. The TPP, which originally came into effect in 2006, currently includes Brunei, Chile, New Zealand, and Singapore. Besides the United States, Australia, Peru, and Vietnam have also expressed interest in joining.[7]

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[6] For more information see, CRS Report RL34470, *The U.S.-Colombia Free Trade Agreement: Background and Issues*, by M. Angeles Villarreal.

[7] CRS Report R40502, *The Trans-Pacific Partnership Agreement*, by Ian F. Fergusson and Bruce Vaughn.

Table 1. U.S. Free Trade Agreements

	FTAs in Force
U.S.-Israel FTA	Implemented by P.L. 99-47 (June 11, 1985) Entered into force September 1, 1985.
U.S.-Canada FTA	Implemented by P.L. 100-449 (September 28, 1988). Entered into force January 1, 1989. Suspended with implementation of NAFTA.
North American Free Trade Agreement (NAFTA)	Implemented by P.L. 103-182 (December 8, 1993). Entered into force January 1, 1994.
U.S.-Jordan FTA	Implemented by P.L. 107-43 (September 28, 2001. Entered into force December 17, 2001.
U.S.-Singapore FTA	Implemented by P.L. 108-78 (September 3, 2003). Entered into force January 1, 2004.
U.S.-Chile FTA	Implemented by P.L. 108-77 (September 3, 2003). Entered into force January 1, 2004.
U.S.-Australia FTA	Implemented by P.L. 108-286 (August 3, 2004). Entered into force on January 1, 2005.
U.S.-Morocco FTA	Implemented by P.L. 108-302, August 17, 2004. Entered into force on January 1, 2006.
U.S.-Bahrain FTA	Implemented by P.L. 109-169, January 11, 2006. Entered into force on August 1, 2006.
U.S.-Dominican Republic-Central American FTA (DR-CAFTA)	President signed implementing bill (H.R. 3045) on August 2, 2005 (P.L. 109-53). Entered into force with El Salvador (March 1, 2006), Honduras and Nicaragua (April 1, 2006), Guatemala (July 1, 2006), the Dominican Republic (March 1, 2007), and Costa Rica (January 1, 2009).
U.S.-Oman FTA	President signed implementing bill on September 26, 2006 (P.L. 109-283). Entered into force on January 1, 2009.
U.S.-Peru FTA	Agreement with Peru signed April 12, 2006. President signed implementing bill (H.R. 3688) on December 14, 2007 (P.L. 110-138). Implemented on February 1, 2009.
U.S.-Colombia FTA	Agreement signed November 22, 2006. Congress approved implementing legislation (H.R. 3078) on October 21, 2011, and the President signed it into law on October 21, 2011 (P.L. 112-42). Entered into force on May 15, 2012.
U.S.-South Korea FTA	Agreement signed on June 30, 2007. Congress approved implementing legislation (H.R. 3080) on October 21, 2011, and the President signed it into law on October 21,2011 (P.L. 112-41). Entered into force on March 15, 2012.
	FTAs Under Negotiation or Completed
U.S.-Panama FTA	Agreement signed on June 28, 2007. Congress approved implementing legislation (H.R. 3079) on October 12, and the President signed it into law on October 21, 2011(P.L. 112-43).
Trans-Pacific Strategic Economic Partnership Agreement	Negotiations underway.

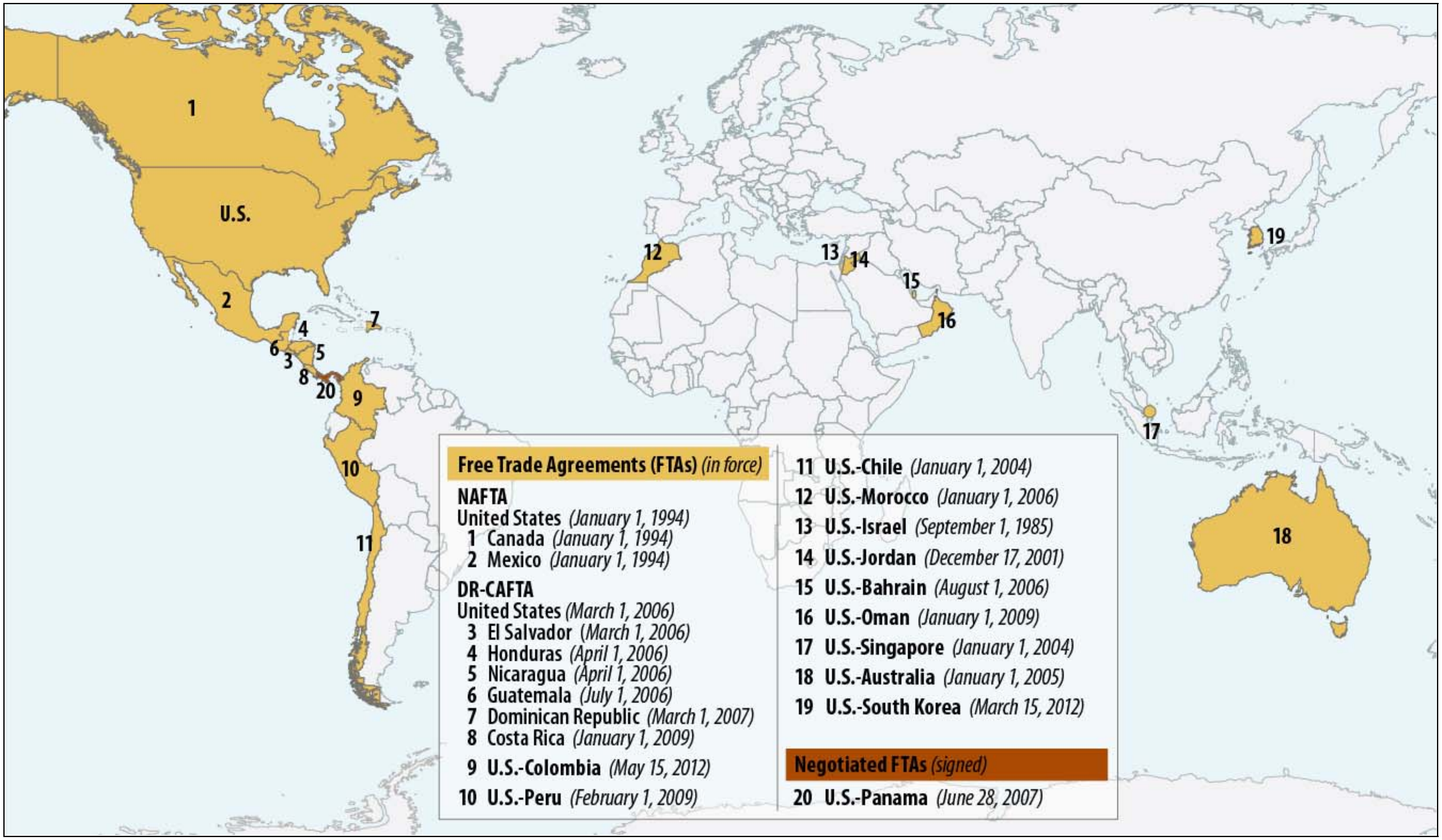

Figure 1. Free Trade Agreements

Source: CRS graphics from data in RL31356.

Economic Impact of FTAs

The surge in U.S. interest in FTAs and in the formation of FTAs worldwide raises the question of their impact on the countries included in an FTA and on the rest of the world. It is an issue that economists have long studied and debated. Interest in the issue has peaked at various times in the post-World War II period. The first time was the formation of the European Common Market. Interest has peaked again with the current trends in FTAs. The debate has relied largely on theory since empirical data are scarce save for the experience of the European Union. The debate has also divided economists between those who strongly oppose FTAs as an economically inefficient mechanism and those who support them as a means to build freer trade.

Economists usually base their analysis of the impact of FTAs on the concepts of *trade creation* and *trade diversion*. These concepts were first developed by economist Jacob Viner in 1950.[8] Viner focused his work on the economic effects of customs unions, but his conclusions have been largely applied to FTAs and other preferential trade arrangements. His analysis was also confined to static (one-time) effects of these arrangements.

Trade creation occurs when a member of an FTA replaces domestic production of a good with imports of the good from another member of the FTA, because the formation of the FTA has made it cheaper to import rather than produce domestically. The creation of the trade is said to improve economic welfare within the group because resources are being shifted to more efficient uses. Trade diversion occurs when a member of an FTA switches its import of a good from an efficient nonmember to a less efficient member because the removal of tariffs within the group and the continuation of tariffs on imports from nonmembers make it cheaper to do so. Trade diversion is said to reduce economic welfare because resources are being diverted from an efficient producer to a less efficient producer.

In most cases, it appears that FTAs lead to both trade diversion and trade creation with the net effects determined by the structure of the FTA. Therefore, even if two or more countries are moving toward freer trade among themselves in an FTA, the FTA could make those countries and the world as a whole worse off if the FTA diverts more trade than it creates, according to economic theory.[9] (See box below for illustrative examples of trade diversion and trade creation.)

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[8] Viner, Jacob. *The Customs Union Issue.* Carnegie Endowment for International Peace. 1950. New York.

[9] This conclusion is called the General Theory of the Second Best and was developed by economists Richard Lipsey and Kelvin Lancaster. Lipsey, Richard and Kelvin Lancaster. The General Theory of the Second Best. *Review of Economic Studies.* vol 24. p. 11-32. Cited and discussed in Lawrence, Robert Z. *International National Economies: Regionalism, Multilateralism, and Deeper Integration.* Brookings Institution. Washington, DC. 1996. p. 22.

Trade Creation or Trade Diversion?

Economist Robert Z. Lawrence has provided the following example to illustrate the difference between trade creation and trade diversion:

Assume that prior to implementing a free trade agreement with the United States, all television sets purchased in Mexico are subject to a tariff of 10%. Assume that Japan produces TVs under competitive conditions, which it sells at a cost of $100, but the United States could only produce such sets at $105. Initially, all TVs sold in Mexico and elsewhere would be Japanese. These would be imported at a price of $100 from Japan and sold to Mexican consumers for $110, with the additional $10 representing the tariff that would be paid by Mexican consumers to the Mexican government. Assume now that a free trade agreement is signed between Mexico and the United States which removes tariffs between Mexico and the United States but retains Mexican tariffs on other countries. Mexican consumers will now have a choice between buying American TVs, which will sell in Mexico at $105, or Japanese TVs, which will sell at $110. They will buy the U.S. TVs and be better off. However, the Mexican economy as a whole will be worse off. Before the agreement, Mexico bought TVs from Japan. Although consumers paid $110, $10 was just a transfer from Mexican consumers to the Mexican government. The economy as a whole, therefore, spent $100 per TV. After the agreement, however, Mexico is spending $105 per TV. TV prices in Mexico do not reflect their social opportunity costs. The impact of the agreement is to expand TV production in the United States, which is relatively less efficient, and to reduce it in Japan, which is relatively more efficient.

Of course, not all of the increased trade between partners will represent expansion from a less efficient source. Pure trade creation would also result. Assume in the example that initially Mexico could produce TV sets for $107. In this case, prior to the agreement Mexico would not have imported them from Japan, instead it would have supplied these TV sets domestically. In this case, Mexico would benefit from the agreement, which would allow it [to] pay only $105 per TV, although of course it would have done better by liberalizing fully and buying the sets from Japan.

Source: Lawrence, Robert Z. *International National Economies: Regionalism, Multilateralism, and Deeper Integration*. Brookings Institution. Washington. 1996. pp. 24-25.

Trade policymakers encounter circumstances much more complicated than those depicted in economic theory. Many functioning and proposed FTAs encompass more than two countries and involve a range of products, both goods and services, making it much more challenging to evaluate their economic impact. To provide an analytical framework, some economists have developed sets of conditions under which, they have concluded, an FTA would create more trade than it diverts. They state that trade creation is likely to exceed trade diversion—

- the larger the tariffs or other trade barriers among members before the FTA is formed;
- the lower the tariffs and other barriers in trade with nonmembers;
- the greater the number of countries included in the FTA;
- the more competitive or the less complementary the economies joining the FTA; and
- the closer the economic relationship among the members before the FTA was formed.[10]

Economists also have determined that, along with the immediate, static effects of trade diversion and creation, FTAs generate long-term dynamic effects that might include the following:

[10] Salvatore, Dominick. *International Economics.* Fifth Edition. Englewood Cliffs, NJ: Prentice-Hall, 1995, pp. 305-306.

- increased efficiency of production as producers face increased competition with the removal of trade barriers;
- economies of scale, that is decreased unit costs of production as producers can have larger production runs since the markets for their goods have been enlarged; and
- increased foreign investment from outside the FTA as firms seek to locate operations within the borders of the FTA to take advantage of the preferential trade arrangements.[11]

Until recently not many FTAs were in operation; therefore, available data on their impact have been limited to the experience of the formation of the European Common Market and subsequently the European Union. Most studies have concluded that the European Community has resulted in more trade creation than trade diversion. However, in some sectors, such as agriculture, the net effect has been trade diversion because the EU's Common Agricultural Policy raised barriers to agricultural trade outside the EU.[12]

FTAs and the WTO

A basic principle of the General Agreement on Tariffs and Trade (GATT) that is administered by the WTO is the most-favored nation (MFN) principle. Article I of GATT requires that "any advantage, favor, privilege, or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties." FTAs, by definition, violate the MFN principle, since products of FTA member countries are given preferential treatment over nonmember products. However, the original GATT signatories recognized that FTAs and customs unions, while violating the MFN principle, improve economic welfare of all members, if certain conditions are met to minimize trade diversion.

Article XXIV of the GATT requires that FTA members shall not erect higher or more restrictive tariff or nontariff barriers on trade with nonmembers than existed prior to the formation of the FTA. Furthermore, Article XXIV requires the elimination of tariffs and other trade restrictions be applied to "substantially all the trade between the constituent territories in products originating in such territories." In addition, Article XXIV stipulates that the elimination of duties and other trade restrictions on trade within the FTA to be accomplished "within a reasonable length of time," meaning a period of no longer than 10 years, according to the "Understanding of the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade" reached during the Uruguay Round. Member countries are required to report to the WTO their intention to form FTAs. In addition to Article XXIV, the "Enabling Clause," agreed to by GATT signatories in 1979, allows developing countries to form preferential trading arrangements without the conditions under Article XXIV.

Article V of the General Agreement on Trade in Services (GATS), the agreement that governs trade in services under the WTO, provides for the preferential treatment of trade in services

[11] Ibid, p.307.

[12] CRS Report 97-663. *Regional Trade Agreements: Implications for U.S. Trade Policy*, by George Holliday.

within FTAs or similar regional trading arrangements. Article V lays out requirements of substantial coverage of the elimination of trade restrictions and the prohibition on the *ex post facto* imposition of higher restrictions on services trade with nonmember countries.

The WTO formed the Committee on Regional Trade Agreements (CRTA) in 1996 to review pending and operating FTAs and customs unions to determine whether they conform to WTO rules under the GATT and the GATS. However, the rules are sufficiently ambiguous as to be subject to continuing debate within the CRTA. For example, the members have been unable to agree on what constitutes "substantially all trade" under Article XXIV (GATT) or "substantially all sectors" under Article V (GATS).[13] The number of FTAs and customs unions worldwide has increased at a rapid rate. As of July 2010, 474 FTAs and customs unions had been notified to the GATT/WTO. Some 283 FTAs and customs unions are in force. The remaining FTAs and customs unions were largely superseded by other agreements involving the same participants.[14]

Yet, none of the reports of notifications has been completed because CRTA members have not been able to reach a consensus on any of them. Nevertheless, the vast majority of the FTAs have gone into operation. For example, the CRTA has not completed its report on NAFTA, which went into effect in January 1994. The proliferation of FTAs and disagreements on rules have crippled the WTO review process and led WTO members to place review of the rules on regional agreements on the agenda of the Doha Development Agenda round. The Doha Ministerial Declaration, which established the agenda for the new round, states that the negotiations will strive at "clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements."

The Debate Over FTAs

The surge in the number of FTAs worldwide has been driving a spirited debate among experts, policymakers, and other observers over whether they promote or damage U.S. economic interests and the economic interests of the world at large. The differing views can be categorized into three main groups. One group consists of those who oppose FTAs because, they assert, FTAs undermine the development of the multilateral trading system and act as a "stumbling block" to global trade liberalization. A second group supports FTAs because, they believe, FTAs act as a "building block" to multilateral trade liberalization. The third category are those individuals and groups that are opposed to trade liberalization in general because they believe its impact on workers in import-sensitive sectors or on the environment is unacceptable, or because, they assert, it undermines U.S. sovereignty.

Among representatives of the first group of experts are international economists Jagdish Bhagwati and Anne O. Krueger, who have strongly advocated that the United States and other national governments should not pursue FTAs at the expense of multilateral negotiations in the WTO. Bhagwati has concluded that FTAs are by definition discriminatory and therefore trade diverting. He argues that tariffs remain high on many goods imported into developing countries and even on some labor-intensive goods (such as wearing apparel and agricultural products)

[13] The CRTA meets several times during the year.

[14] http://www.wto.org.

imported into developed countries. Consequently, he asserts, trade diversion will likely result when an FTA is formed.[15]

Both Bhagwati and Krueger cite the "rules of origin" and other conditions of an FTA's establishment for strong criticism. Bhagwati claims, for example, that the rules of origin in one FTA more than likely do not coincide with the rules of origin in many of the other FTAs. Furthermore, he argues, the schedule of implementation of the tariff reductions and other conditions for one FTA will not match the schedule of other FTAs. The incongruity of these regulations across FTAs has created what Bhagwati sees as a customs administration nightmare and calls the "spaghetti-bowl" phenomenon.[16]

In her criticism, Krueger claims that in order to meet the input thresholds of rules of origin requirements, producers in one FTA partner will be encouraged to purchase as many inputs as possible from other partner countries, even if a non-FTA member can produce and sell the inputs more cheaply and even if the tariff rate on inputs from non-FTA producers is zero. Importing inputs from within the FTA to meet the rules of origin threshold allows the producer to sell the final product within the FTA duty free. Under such circumstances imports of inputs are diverted from efficient producers outside the FTA to less efficient producers inside the FTA. A corollary to Krueger's conclusion is that the higher the threshold established in the rules of origin, the greater the chance that trade diversion will take place.[17]

A range of economists, policymakers, and other experts embrace a second view that FTAs can enhance trade and should be pursued. Economist Robert Z. Lawrence argues, for example, that recent FTAs involve much more economic integration than the elimination of tariffs. NAFTA, he points out, has led to the reduction in barriers on services trade, foreign investment, and other economic activities not covered by the GATT/WTO. In addition, under NAFTA, Mexico has affirmed its commitment to economic reform, making its economy more efficient. Lawrence asserts that the theory traditionally applied to FTAs (by Bhagwati, Krueger, and others) does not take into account these dynamic welfare enhancing characteristics of FTAs which he believes are likely to outweigh any trade diversion that results from the elimination of tariffs.[18]

A CATO Institute study by economist Edward L. Hudgins argues that while it may be preferable to liberalize trade multilaterally, countries should take any available avenue, including bilateral or regional FTAs, even if they lead to some trade diversion. Furthermore, Hudgins asserts that FTAs can be more efficient vehicles for addressing difficult trade barriers than the WTO, where the large membership requires compromise to the least common denominator to achieve consensus. FTAs have also have provided momentum for GATT/WTO members to move ahead with new trade rounds, he claims.[19]

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[15] Bhagwati, Jagdish. *The Wind of the Hundred Days: How Washington Mismanaged Globalization.* The MIT Press. Cambridge, MA. 2000. p. 240-245.

[16] Ibid.

[17] Krueger, Anne O. "Free Trade Agreements As Protectionist Devices: Rules of Origin," in Melvin, James R., James C. Moore, and Raymond Riezman (eds.). *Trade, Theory, and Econometrics: Essays in Honor of John C. Chipman.* Routledge Press. New York. 1999. pp. 91-101.

[18] Lawrence, Robert Z. *Regionalism, Multilateralism, and Deeper Integration: Changing Paradigms for Developing Countries.* in Mendoza, Miguel Rodriquez, Patrick Low, and Barbara Kotschwar (eds.). *Trade Rules in the Making.* Organization of American States/Brookings Institution Press. Washington, DC. 1999. p. 41-45.

[19] Hudgins, Edward. L. Regional and Multilateral Trade Agreements: Complementary Means to Open Markets. *Cato Journal*. Vol. 15. No. 23. Fall/Winter 1995/96.

Economist C. Fred Bergsten holds a position similar to the one expressed in the CATO study, that in lieu of multilateral trade negotiations, FTAs are the next best thing and promote global trade liberalization. Bergsten has advocated establishing U.S. FTAs with New Zealand and with South Korea. Economist Jeffrey Schott argues that some U.S. firms are being discriminated against because FTAs are rapidly forming in which the United States is not a participant; therefore, in his review, the United States must negotiate FTAs.[20]

Bergsten and others have also advocated structuring FTAs in a manner that could serve as building blocks of a global free trade system. Using the APEC plan as a model, Bergsten argues for an FTA based on "open regionalism," that is establishing the road map for free trade and investment in the Asian-Pacific region for 2010/2020 among the members but allowing other countries to join if they agree to accede to the conditions. In order to minimize trade diversion, he suggests that trade and investment could be implemented on an MFN principle, perhaps conditional MFN in order to limit the "free rider" effects. Other countries, and other regional groupings, Bergsten presumes, would be willing to accept the conditions having been enticed by the trade and investment opportunities until most of the membership of the WTO would be engaged in forming a free trade area.[21] A Heritage Foundation report draws up a similar proposal for a "Global Free Trade Association."[22]

A third group opposes FTAs but also trade liberalization or "globalization" in general. Included in this group are representatives of import-sensitive industries, for example labor unions, and representatives of social action groups such as some environmentalists, who question the wisdom of trade liberalization whether done through multilateral negotiations or through bilateral and regional trading arrangements. They assert that trade liberalization unfairly affects workers by exporting jobs to countries with lower wages and undermines the nation's ability to protect the environment by allowing companies to relocate to countries with less stringent environmental regulations.[23] For example, the United Auto Workers (UAW) union has stated the following position regarding the Free Trade Area of the Americas (FTAA):

> Such an agreement would provide broader protections for the rights of corporations, further undermine the ability of governments in the region to regulate their economies in the interests of their citizens and intensify the downward pressure on workers' incomes through competition for jobs and investments. All of this would take place in the absence of any counter-balancing protections for workers, consumers or the environment. This is why the UAW has consistently opposed the direction of these negotiations, the positions taken by the U.S. government, and worked closely with other organizations in the region to oppose the creation of an FTAA.[24]

[20] Schott, Jeffrey J. *Free Trade Agreements: The Cost of U.S. Nonparticipation.* Testimony before the Subcommittee on Trade. House Ways and Means Committee. March 29, 2001. http://www.iie.com.

[21] Bergsten, C. Fred. *Open Regionalism.* Working paper 97. Institute for International Economics. 1997.

[22] Hulsman, John C. and Aaron Schavey. *The Global Free Trade Association: A New Trade Agenda.* The Heritage Foundation Backgrounder No. 1441. May 16, 2001.

[23] For more information, see for example, the United Auto Workers positions on trade policy at http://www.uaw.com and the positions of Public Citizen's Global Trade Watch at http://www.citizen.org.

[24] http://www.uaw.com.

Conclusions and Implications for Congress

Free trade agreements are viewed by many as a significant trade policy vehicle for the United States and for other major trading nations. Over the last 10-15 years, the debate in U.S. trade policy has shifted from, "Should the United States form FTAs?" to "Should the United States form any more FTAs and, if so, with whom, when, and under what conditions?" Congress has a direct role in addressing those questions. Before any FTA can go into effect, Congress must review it as part of implementing legislation.

A number of questions regarding FTAs could arise as the Obama Administration pursues the TPP, and Congress oversees and evaluates overall U.S. trade policy strategy. One question pertains to the economic impact of an FTA. As with any trade liberalizing measure, an FTA can have positive effects on some sectors and adverse effects on others. An FTA may create trade for one sector of the U.S. economy but divert trade away from others. A Member of Congress is placed in the position of weighing the effects on his/her constituency versus the overall impact on the United States and other trading partners. Because conditions can differ radically from one FTA to another, the evaluation will likely differ in each case. Furthermore, Members might take into account not only the immediate static effects of FTAs but also the long-term, dynamic effects which could play an important role in evaluating their contribution to U.S. economy.

A second, broader question is whether bilateral and regional FTAs are the appropriate trade policy strategy to promote U.S. national interests. Economic specialists differ sharply on this question with some viewing the proliferation of FTAs as leading to confusion and serving as stumbling blocks to the development of a rules-based multilateral trading system. Other specialists consider FTAs as appropriate trade policy vehicles for promoting freer trade, as building blocks to a multilateral system and as necessary to protect U.S. interests against the FTAs that other countries are forming without the United States. Still others oppose trade liberalization in any form as counter to U.S. interests.

A third question is whether the Office of the United States Trade Representative and other trade policy agencies have sufficient time and human resources to negotiate a number of FTAs simultaneously while managing trade policy in the WTO and other fora. Others might find some U.S. interests being short-changed.

A fourth question is to what degree, if any, should non-trade concerns be included in FTAs? This issue has emerged in a number of completed and ongoing FTA negotiations.

A fifth overarching question is what criteria should the United States employ in determining which countries would make appropriate FTA partners. For example, to what degree should political factors be given weight over economic factors?

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