Is There a Democratic Deficit in the Free Trade Agreements?

What Local Governments Should Know

by Mildred Warner and Jennifer Gerbasi

The term "free trade" has as many definitions as there are interpreters. The United States Trade Representative (USTR) calls it an opportunity to gain access to markets worldwide for U.S. goods and services and to generate more quality and choice for the consumer. State and local governments are intimately involved in economic development and benefit from foreign markets. Some elected officials, however, are concerned that the free trade agreements, as currently drafted, fail to adequately protect our democratic traditions.

In 2002, Bill Moyers produced and wrote a documentary for PBS called "Trading Democracy" that outlined these fears. The states of California and Washington have convened trade oversight committees to interpret the impact of free trade on state and local government activities. They are concerned that everything from subsidies for local export programs to public health and environmental quality might be directly affected by the trade agreements. A group of states recently started a Forum on Democracy to study the impact of trade agreements on state authority.

Everyone wants to enjoy the benefits of larger markets and consumer choice. What is it about free trade that has state and local governments concerned?

STATE AND LOCAL GOVERNMENT AUTHORITY CHALLENGED BY FREE TRADE AGREEMENTS

In the past, trade treaties have focused on customs regulations and tariffs that are in the purview of the federal government. States and localities would only be concerned if the industry in question affected their economies. The new trade agreements, however, reach into nearly every aspect of government. Free trade goals focus on removing perceived barriers to the flow of money, services, and goods. Trade agreements don't regulate industry, they regulate government activity.

Many state and local government activities and regulations may be viewed as "nontariff barriers to trade." The free trade agreements seek to create a level playing field for foreign investors by eliminating local licensing, labeling, and contracting requirements; limiting purchasing criteria to quality and quantity considerations; and eliminating practices that favor public provision or domestic investors. Clearly, protectionist legislation would be contrary to the spirit of the trade agreements and a legitimate concern, but some analysts believe that harmonization of state and local laws for the sake of simplicity may come at the cost of local governments' ability to suit local needs and values.

Specifically, the new generation of free trade agreements presents these challenges to state and local governmental authority:

- Superior rights are granted to foreign investors.
- Private international tribunals replace public courts.
- Many public services may be subject to free trade provisions.
- Free trade goals conflict with government charters.
- Free trade agreements cause a democratic deficit.

FOREIGN INVESTORS GRANTED SUPERIOR RIGHTS

The new challenges to state and local government authority stem from the North American Free Trade Agreement, which came into force in 1994, and the World Trade Organization General Agreement on Trade in Services (GATS) signed in 1995. NAFTA's Chapter 11, which has been used as a template for other free trade agreements, creates special property rights for foreign investors. NAFTA expands the definition of "property" to include market share, market access, and future expected profits. This definition is important because it is used to value the loss to an investor, as well as the liability of government in a dispute.

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This treatment of property rights is the most striking example of the impact on state and local government. What is called "takings" legislation in the United States, based on the Constitution's Fifth Amendment protections against unlawful seizure of property, is called "expropriation" in the free trade agreements. NAFTA clearly states that compensation should be awarded by the federal government to foreign property owners when investments lose value due to regulation.

In the U.S. context, the government only pays compensation of fair market value if the value of the property, usually land, is lost nearly entirely (e.g., by eminent domain). Diminution of the value, which is called a partial takings, is not compensable in the United States (Eagle 2001).

Property owners, for example, are rarely compensated for lost development value due to zoning regulations. Under NAFTA, however, any loss of investment could trigger a challenge, even if the loss is due to regulation to protect public health.

For example, the Canadian company Methanex is challenging the United States because California banned the use of methyl tributyl ethanol (MTBE), an additive in gasoline that was banned because it was polluting groundwater. Methanex supplies a component of MTBE and sells 6 percent of its output in California, so the majority of the value of the company is unaffected by California's law. A United States investor would not be allowed to make such a claim because:

- The law affects all suppliers equally.
- Market share is not considered property.
- The law was passed to protect public health and water quality under the police powers of the state.
- Most of the company's property is unaffected, and many other uses and markets exist for the chemical component in question, namely, methane.

This standard legal framework stems directly from the Fifth Amendment but is no longer relevant for foreign investors under NAFTA. The Canadian manufacturer Methanex is claiming $970 million in damages against California in a private international tribunal. By contrast, state courts have awarded compensation of $50 million to California cities that have had their public water supplies contaminated by MTBE (Kay 2002).

INTERNATIONAL ARBITRATION REPLACES DOMESTIC COURTS

As seen in the Methanex case, this expansion in investor rights at the expense of state and local governments extends to the adjudication process. NAFTA gives a foreign investor the option to enforce the agreement by challenging host-country laws in an international tribunal rather than domestic courts (Chapter 18). Each

party (the host nation and the investor) selects an arbiter, and then the two agree on a third. The panel then selects the standard of law that will be applied. Generally, it is an international standard. Thus, for foreign investors, the domestic laws and court system can be circumvented.

An existing international commercial arbitration system was selected to hear the challenges, but the secrecy of these proceedings was not changed to accommodate the public character of the challenges. The federal government defends the case even if it is against a local law, but it isn't obligated to make the challenge, the witnesses, or even the outcome public knowledge. Both parties must agree to release information.

The federal defenders consult with whichever government entity passed the law, but states and localities have no access or input into the court proceedings unless the tribunal decides to accept written briefs. This lack of transparency and public access to a court system, particularly one that is challenging democratic legislation, concerns government officials and citizens alike.

The latest free trade agreement draft suggests that these investor rights could extend to domestic firms as well. The Free Trade Area of the Americas (FTAA), currently under negotiation, will include 34 countries in the Americas. While NAFTA allows foreign investors to sue a host-party nation, the FTAA draft includes a *domestic* investor's right to sue for performance requirements demanded by its own government. This would allow a U.S. citizen to circumvent the domestic courts by granting access to the international tribunal (FTAA Second Draft Agreement, Chapter on Investment, Article 1).

Congress, through the Trade Act of 2002, constrained the USTR from granting foreign investors rights greater than those of U.S. citizens. Giving citizens a new avenue to take state and local governments to international arbitrations as foreign investors was probably not a suggested tactic for reaching equal rights.

PUBLIC SERVICES SUBJECT TO FREE TRADE

In the January 2000 issue of *Public Management*, Bob Stumberg and Bill Schweke warned that economic development, government purchasing, consumer and environmental protection, and working conditions were some of the arenas that might be modified by the trade obligations.

Since then, the USTR has committed the United States to opening up to free trade the following: the insurance industry; such professions as law, accounting, and engineering; and environmental services, including testing, wastewater treatment, and solid waste removal. Each of these industries can only be regulated in accordance with the GATS, and it is highly likely that they will not be excluded from coverage by the FTAA unless asked by regulators and elected officials to do so.

The USTR seeks to liberalize banking, express delivery, and consumer sectors like the Internet or cable networks (USTR 2003). Listed services must treat foreign investors at least as well as domestic providers, including public providers. Many economic development policies, zoning regulations, and professional licensing and recycled-content laws would be subject to challenge under this new agreement (Stumberg and Schweke 2000). Limitations on the number of branches in an area, the size of stores, and store hours may conflict with the trade agreement as well as low interest loans, tax incentives, and economic development projects that aren't available to foreign investors.

The expansion of free trade rules to cover such traditional public services as water, sewer, environmental protection, and education could require the extension of public subsidies to foreign competitors. United Parcel Service, for example, is currently suing the Canadian Royal Post under NAFTA, claiming that it should have equal access to the Royal Post's package routes, as these constitute an unfair subsidy and thus a barrier to free trade.

Under NAFTA, most public service practices have not been challenged. The proposed expansion in services open to free trade under the FTAA and GATS could make such suits more common and wreak havoc on state and local budgets. Once a public service has been opened to free trade, the price for closing the market to foreign access is to pay the investors what they would have made had it remained open.

The USTR states that making this payment is as simple as reimbursing the disappointed investors for the change in market access. While this arrangement does seem procedurally simple, the valuation of these rights and the inability of public utilities and other services to bear this financial burden could be forbidding.

FREE TRADE GOALS CONFLICT WITH GOVERNMENT CHARTERS

Local and state governments are placed in the difficult position of wanting to benefit from foreign investment through expanded markets for their products and services. However, because of the way in which the agreements have been negotiated, local government's ability to function as the guardian for its constituents is being compromised, despite the fact that the primary charter of state and local government is to serve the needs of residents.

Any trade agreement that benefits foreign investors at the expense of the local population is therefore at odds with the traditional goals of state and local government. Free trade agreements substitute international standards for local democratic choice and give enhanced property rights (compensation for partial takings) to foreign investors.

The domestic legislative and court systems are undermined by the use of international arbitration panels that use international standards and ignore local laws and preferences (Grieder 2001). The framework that government actors work within is circumvented and replaced by agreements negotiated, implemented, and adjudicated by unelected administrative bodies unfamiliar with local conditions.

Against this backdrop, some local and state government actors and their representative associations have passed

resolutions trying to gain access to the free trade negotiation and dispute resolution processes. The majority, however, seem unaware of the breadth of the agreements and the impact they may have on state and local government procedures.

While a few states and several counties and municipalities have been actively communicating with the USTR, the U.S. negotiating group, the majority have not entered the debate at all. The most controversial element of NAFTA, Chapter 11 on investment, was never discussed on the floor of Congress or in the state legislatures.

The Western Governors Association, the National Conference of State Legislators, the National Association of Counties, the National Association of Attorneys General, and the National League of Cities have made public requests to the USTR and to Congress for clarification of or protection from the treaty obligations. These state and local representatives are not antitrade but question the necessity of surrendering traditional state and local powers. With few exceptions, these government associations are requesting more meaningful participation in both the negotiations and dispute resolution arenas.

State and local governments recognize the benefits of free trade, but they also recognize their obligations to protect the public well-being and to ensure democracy. This is why so many state and local governments are concerned.

ADDRESSING THE DEMOCRATIC DEFICIT

There are two issues that are key to the debate about the negotiations: transparency and representation. A democratic deficit in transparency is a common characteristic of the free trade negotiations and dispute resolution process. These agreements are written by nonelected officials (the USTR) and special-interest representatives, primarily from industry, who sit on 30 subcommittees.

Unlike domestic legislation, which requires strict adherence to the sunshine law, there is no such openness in trade negotiations. No record exists of how often each advisory panel meets with the USTR, who testifies, what they say, or how it has affected the drafting of the agreement text.

Because Congress has given the president trade promotion authority, members of Congress are limited to 90 days to review completed agreements and 20 hours of debate before deciding whether to vote the agreement up or down. Congress cannot modify the agreement in any manner. For the FTAA in particular, the brevity of this process makes it difficult to understand the influences that shaped the document during the 10 years it was being negotiated or to fully understand the impacts to current and future legislation.

Although NAFTA is finalized, the extension of free trade to public services proposed by FTAA is still under discussion. The USTR considers its approach to the negotiations innovative, allowing the draft agreements to be seen by the general public and government representatives. This approach, it says, permits unprecedented dialogue and transparency.

Without an effective mechanism for two-way communication, however, seeing the draft text doesn't ensure informed debate and public participation. Most of the text is under negotiation, so there is no way to tell which country or group has suggested the options for the final text. Because of this uncertainty, many in Congress are waiting for the final draft before review.

The government of each participating country is represented in the negotiations, but elected representatives are not the actors most intimately involved with this process. The USTR is made up of presidential appointees who coordinate advisory panels that consist mostly of industry representatives and a few civil-society groups. Congress requires that representatives from labor, environmental, and consumer groups be involved in the process.

Most of the seats, however, are filled with industry representatives who actually draft the text of the agreement. Members of the civil-society committees have complained that they do not meet often, and when they do, they are given written text on which to comment (House Energy and Commerce Committee 2003). Inquiries from citizens and nongovernmental organizations are seldom answered.

While the national government is primarily responsible for negotiating the agreements, state and local governments will be obligated to abide by them. This is why local and state governments, through their associations, are asking for greater representation in these debates. They also are asking for the governance mechanisms in these agreements to be consistent with established procedures under U.S. constitutional and case law.

This consistency should include respect for open government through a public legislative and judicial review process, direct representation of state and local government interests, respect for state and local courts systems, and acceptance of standard definitions of property and takings, as based in the U.S. legal tradition.

The Tenth Amendment of the Constitution reserves to the states all powers and duties not specifically given to the federal government. Treaties are a traditional arena for federal authority. These free trade agreements, however, are expanding into areas at the core of traditional state and local government authority (Greider 2001). Local governments' primary obligations are to ensure the public well-being and to provide the foundation for our democracy through broad public participation.

To meet these responsibilities, the

democratic deficit in these new free trade agreements must be rectified. State and local governments recognize the benefits of free trade, but they also recognize their obligations to protect the public well-being and to ensure democracy. This is why so many state and local governments are concerned.

For more information on the challenges to state and local authority under the free trade agreements, visit the Web site at http://government.cce.cornell.edu. This site includes descriptions of recent cases, the trade agreements, and resolutions passed by local government associations. **PM**

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