

# CRS Report for Congress

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## NAFTA: Related Environmental Issues and Initiatives

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Specialist in Environmental Policy  
Resources, Science, and Industry Division

### Summary

The North American Free Trade Agreement (NAFTA) includes several environment-related provisions, that while limited, were unprecedented for their inclusion in a trade agreement. However, further environmental (and labor) assurances were needed to secure passage of NAFTA, and ultimately, the negotiating parties agreed to a side accord that promotes cooperation on environmental matters and includes provisions to address a party's failure to enforce environmental laws. Additionally, the United States and Mexico entered into the Border Environmental Cooperation Agreement (BECA), which authorized the establishment of the Border Environment Cooperation Commission (BECC) and the North American Development Bank (NADB) to help border communities finance environmental infrastructure projects.

In the 108<sup>th</sup> Congress, NAFTA's environmental provisions and related institutions have continued to receive attention. A key issue has concerned the effectiveness of the NADB and the BECC, and especially the Bank's ability to finance projects. Enacted on April 5, 2004, P.L. 108-215 (H.R. 254) authorizes several operational reforms to the NADB. Other issues involve the environmental impact of NAFTA, and the effect that NAFTA and its environmental side agreement have had on the negotiation of other U.S. trade agreements, including the U.S.-Central America Free Trade Agreement (CAFTA) and U.S.-Chile FTA. This report briefly reviews NAFTA's environmental provisions, associated agreements, and related issues and congressional actions. It will be updated.

### NAFTA Environmental Issues and Provisions

Environmental issues emerged early in NAFTA negotiations, and linkages between trade and environmental issues were reflected in the outcome of these negotiations more so than in any previous trade talks. While not a new issue, the question of whether a country's stricter environmental measures could be found to pose non-tariff trade barriers received an unprecedented level of attention during the NAFTA debate. Additionally, the question was raised whether a country's weaker environmental protection measures or their ineffective enforcement would create a competitive advantage and provide an added incentive for businesses to relocate production to the least regulated country. A related

concern was that expected NAFTA-driven industrialization and population growth in the U.S.-Mexico border region would worsen the severe pollution problems already present. Although trade officials argued that environment was not a customary trade matter and that NAFTA talks were not the best forum for resolving these issues, the level of concern over environmental issues in Congress prompted NAFTA negotiators to respond to them.

Ultimately, the NAFTA parties included language to conditionally protect a party's stricter environmental, health, and safety standards for products and produce (provided that, among other things, such measures are scientifically based). NAFTA also includes hortatory language to discourage parties from lowering standards to encourage investment. Other NAFTA provisions encourage upward harmonization of standards and encourage parties to integrate environmental protection and sustainable development into economic decision-making. NAFTA's standards provisions do not affect a country's ability to determine its levels of environmental protection for manufacturing and other process standards (such as water pollution controls and resource harvesting practices).

NAFTA set a precedent in addressing its relationship to multilateral environmental agreements (MEAs). It identifies three trade-related MEAs that may take precedence over NAFTA if implementation conflicts arise, provided that the MEA is implemented in the least NAFTA-inconsistent manner. The listed agreements include the Montreal Protocol on Substances that Deplete the Ozone Layer; the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal; and the Convention on International Trade in Endangered Species. U.S.-Mexico and U.S.-Canada bilateral waste-trade agreements also are included, and the parties may agree to add others.

Despite the inclusion of the above provisions, some in Congress remained concerned that NAFTA's effect on environmental laws could be unpredictable. For example, an issue during the debate on renewing trade promotion authority concerned the effect that NAFTA may have on state and federal environmental laws, because some investors have challenged environmental measures as constituting a form of expropriation for purposes of the NAFTA investment chapter. These provisions allow companies to challenge, and potentially be compensated for, governmental measures that are viewed as harming their investments. At least 20 cases have been filed, including 6 against the United States, one of which involves California's ban on methyl tertiary butyl ether (MTBE) in gasoline.

Environmental concerns persisted after completion of the NAFTA text. To facilitate NAFTA passage, two related agreements were negotiated, which are discussed below.

## **North American Agreement on Environmental Cooperation**

A matter not addressed in the NAFTA text was whether lax enforcement of environmental laws in Mexico would provide an added incentive for U.S. industries to relocate, and thus increase U.S. job losses, and increase border-area pollution. Many in Congress called for side agreements that included an enforcement mechanism to address failures to enforce environmental (and labor) laws. Opponents of a side agreement argued that NAFTA-related economic growth would increase Mexico's resources available for environmental protection, and that NAFTA would increase environmental cooperation in North America. Nonetheless, congressional support for NAFTA remained uncertain.

In 1993, the three NAFTA governments adopted the North American Agreement on Environmental Cooperation (NAAEC), which includes dispute settlement provisions to address a party's failure to enforce environmental laws. The side accord's objectives cover a range of goals, including avoiding the creation of trade distortions or new trade barriers; enhancing compliance with, and enforcement of, environmental laws and regulations; and fostering environmental protection and pollution prevention.

The side agreement created the North American Commission for Environmental Cooperation (NACEC) which includes a Council, a Joint Advisory Committee, and an independent Secretariat. The Council consists of cabinet-level representatives of the parties and has key responsibilities regarding the side agreement's dispute settlement provisions. The Joint Advisory Committee advises the Council and is comprised of nongovernmental groups. The Secretariat's duties include preparing reports and serving as a point of inquiry for public concerns about NAFTA's possible environmental effects. The NACEC's major goal is to broaden environmental cooperation among the parties. It provides a forum for the parties to consider ways to address environmental issues, and provides an avenue for dispute settlement panels to obtain environmental expertise.

Perhaps most notable is the side agreement's dispute settlement process that, as a last resort, may impose monetary assessments and sanctions to address a party's failure to enforce its environmental laws. To invoke the dispute settlement process, a complaint must concern a party's persistent, systematic failure to enforce its laws, and the alleged failure must be trade-related or involve competing goods or services. Only the NAFTA parties can initiate a NAAEC dispute settlement proceeding, and none have done so. However, the Secretariat may consider a submission from any person or nongovernmental organization asserting that a party is failing to enforce its environmental law, and may request that party to respond. The Secretariat may prepare a factual record and submit it to the Council for its consideration. Since 1995, 47 citizen submissions have been filed, and 9 factual records have been finalized and made publicly available.

## **U.S.-Mexico Border Environment Cooperation Agreement**

Throughout the NAFTA debate, many proponents and opponents noted the need to identify funding sources for financing environmental improvements in the border area. Much of the pollution there had been attributed to the effects of unregulated industrial development and related population growth associated with Mexico's maquiladora program, and both governments anticipated that NAFTA could further concentrate economic activity in the border region, and that existing environmental conditions would worsen without a binational effort to address infrastructure needs. The Administration estimated that \$8 billion would be required to address needs for sewage treatment, drinking water, and municipal solid waste infrastructure projects along the border over the next decade and that NAFTA-related industrialization would create additional needs.<sup>1</sup> For many in Congress, support for NAFTA was partially contingent on the identification of a mechanism for financing border environmental projects.

In October 1993, the United States and Mexico agreed to a new institutional structure to promote border environmental cleanup. The Border Environmental

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<sup>1</sup> U.S. Congress. House. Committee on Banking, Finance, and Urban Affairs. *United States-Mexican Border Environment Agreement*. Hearings, 103d Cong., 2d Sess. Oct. 27, 1993.

Cooperation Agreement authorized the establishment of the North American Development Bank (NADB) and the Border Environment Cooperation Commission (BECC) to assist border communities in financing environmental infrastructure projects. The agreement noted the need for environmental infrastructure, especially in the areas of water pollution, wastewater treatment, and municipal solid waste.

The BECC is directed to help border states and communities coordinate, design, and mobilize financing for environmental infrastructure projects, and to certify projects for financing. The NADB evaluates the financial feasibility of BECC-certified projects and provides financing as appropriate. Public involvement is fostered through representation on the BECC Board of Directors and Advisory Council, and through a public comment process on proposed projects.

The NADB was designed to generate between \$2 billion and \$3 billion in loans or guarantees for financing environmental projects on either side of the border. (Ten percent of the NADB's resources may be used for NAFTA-related community adjustment and investment projects.) To leverage financing, the United States and Mexico each contributed \$225 million over four years, for a total of \$450 million in paid-in capital. The NADB is authorized to make only market-rate loans, however, and this has been a major obstacle to the Bank's ability to finance projects in low-income border communities.

Despite the creation of the NADB to provide financing for border environmental infrastructure projects, grants from the Environmental Protection Agency (EPA) have accounted for the vast majority of funding provided through the Bank. In 1997, the NADB entered into an agreement with EPA, under which EPA contributes much of its annual border infrastructure appropriation to the Border Environment Infrastructure Fund (BEIF). (Over the past decade, Congress regularly has provided EPA with \$75 million or \$50 million each year for border water and wastewater projects.) The NADB established the BEIF to use EPA grant resources for drinking water and wastewater projects to make the projects affordable for border communities. The NADB develops financing packages using its loan and guaranty programs, EPA grants, and other sources. EPA grant funds may be used for BECC-approved projects on either side of the border.

As of June 30, 2004, the NADB had approved 22 loans worth a total of \$97.1 million, and had fully disbursed 9 loans. Overall, the NADB had authorized \$662.4 million in grants and/or loans to partially finance 80 infrastructure projects estimated to cost a total of \$2.26 billion. In addition to the 22 loans, this assistance included \$490 million in EPA grants that had been committed for 52 water and wastewater projects.<sup>2</sup>

Because of the low activity level of the NADB, and because most infrastructure funding for NADB projects has been provided through EPA grants rather than NADB financing, considerable interest emerged in recent years for reforming the NADB. Both federal governments, the border states, and other interested parties discussed possible reforms for these institutions, including changes in institutional structure, types of financial assistance provided, and types of projects eligible for assistance.

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<sup>2</sup> For more information on NADB and BECC functions and accomplishments, see *BECC/NADB Joint Status Report*, June 30, 2004, at [<http://www.cocef.org>].

In 2000, the NADB established a Low Interest Rate Lending Facility using part of its paid-in capital to provide lower-than-market rate loans to communities. In 2001, President Bush and President Fox directed a binational working group to develop recommendations to strengthen the performance of the NADB and the BECC. In 2002, both Presidents accepted the working group's recommendations and directed their respective administrations to work with their legislatures to effectuate them. The recommendations include maintaining the focus on environmental infrastructure projects; giving the NADB more flexibility to make grants and below-market-rate loans to finance projects; and expanding the geographic scope of BECC/NADB operations to include the area in Mexico within 300 kilometers of the border. In August 2002, the NADB Board of Directors approved creation of a Water Conservation Investment Fund to finance water conservation projects. As discussed below, H.R. 254 (P.L. 108-215), enacted in April 2004, authorizes several operational reforms to the NADB. Corresponding legislation was approved by the Mexican legislature in 2003.

## Assessing NAFTA's Environmental Impacts

The NAFTA Implementation Act directed the President to report to Congress in 1997 on the effects of NAFTA and implementation of the side agreements. The resulting study concluded that it was premature to assess any environmental effects of NAFTA and difficult to determine whether further environmental degradation at the U.S.-Mexico border was due to NAFTA or other economic development and events. More recent studies have attributed increased border pollution and other environmental impacts to NAFTA, although the studies generally identify a number of other contributing factors. A March 2001 NAAEC study, *North American Trade and Transportation Corridors: Environmental Impacts and Mitigation*, concluded that air pollution from increased freight traffic in NAFTA transportation corridors is significant and could double or quadruple by 2020.<sup>3</sup> Relatedly, the number of assembly factories in Mexico near the border grew from 2,114 in 1993 to 3,182 in 2003, while employment at these plants more than doubled to 1.07 million.<sup>4</sup> A report by EPA in 2000, *Protecting the Environment of the U.S.-Mexico Border Area*, noted that the concentration of industry and people at the border was exacerbating pollution and health problems, and that many border cities expected to experience serious water constraints by 2005. A NAAEC committee recently completed a ten-year review of the environmental side agreement, and concluded that the NAAEC has facilitated trilateral environmental cooperation and capacity building overall, and specifically has fostered environmental progress in Mexico.

## Congressional Activity and Issues

In the 107<sup>th</sup> Congress, the environment-related provisions of NAFTA and its side accord received attention during consideration of trade promotion authority legislation

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<sup>3</sup> The NACEC has an ongoing program assessing the positive and negative environmental impacts of NAFTA on specific sectors, as well as projects assessing various environment matters. These studies and reports can be found at [<http://www.cec.org/trio/index.cfm?varlan=english>].

<sup>4</sup> In 2001, the number of maquiladora plants reached 3,684 with 1,202 employees. The decline of 502 plants by late 2003 has been attributed to a decline in the U.S. economy and movement of plants to China and elsewhere for lower labor costs. (See, for example: Randall Sherman, "Has Outsourcing to China Gone Too Far?" *MexicoNow*, v. 2 no. 7, Nov.-Dec. 2003. p. 42-45.)

and the U.S.-Jordan Free Trade Agreement (FTA); both adapted environmental provisions from the NAAEC and NAFTA.<sup>5</sup> Some in Congress expressed particular concern regarding the effect that NAFTA-like investment provisions may have on domestic environmental protection efforts, because various investors have challenged environmental measures as constituting a form of expropriation under the NAFTA investment chapter.<sup>6</sup> Also in the 107<sup>th</sup> Congress, the House passed H.R. 5400 to authorize changes in NADB and BECC operations, with a goal of increasing these institutions' effectiveness.

In the 108<sup>th</sup> Congress, efforts to reform the BECC and NADB continued, and in April 2004, the President signed into law P.L. 108-215 (H.R. 254, H.Rept. 108-17). This law authorizes the President to agree to a change in the NADB's charter to permit the Bank to make below-market-rate loans and a limited amount of grants in order to increase the number of projects these institutions support. It directs the U.S. members of the NADB board of directors generally to oppose project proposals if grants account for more than 50% of the project financing or if a project is not financed in part by loans. The law also authorizes extending the operational area of the BECC/NADB on the Mexican side of the border from 100 kilometers to 300 kilometers. It requires an annual report to Congress, and includes a sense of the Congress relating to U.S. support for water conservation projects. In other legislation, the conference report to H.R. 6, the Energy Bill (Section 146) would amend NAFTA implementing legislation to direct U.S. NADB board members to encourage the Bank to finance infrastructure projects related to clean energy and energy conservation.

Interest in the 108<sup>th</sup> Congress also has continued regarding the implications of NAFTA and the NAAEC for new trade agreements. The U.S.-Chile and U.S.-Singapore FTAs both include an obligation for parties to enforce their environmental laws, and make this obligation subject to dispute settlement procedures. Moreover, both agreements include environmental cooperation and capacity-building provisions. The U.S.-Chile FTA further calls for parties to negotiate a U.S.-Chile Environmental Cooperation Agreement. The U.S.-Central America FTA (CAFTA), which the President has signed but which requires implementing legislation, includes similar provisions and also adapts the NAAEC provisions that allow citizens to file submissions concerning a party's failure to effectively enforce its environmental laws.

While welcoming the heightened consideration of environmental matters since the NAFTA debate, some Members of Congress and environmental groups remain concerned that the provisions in the current TPA law and in recently negotiated trade agreements may not be sufficient to safeguard legitimate environmental measures from challenges, particularly those involving investor-state disputes. Consequently, while the debate over whether environmental matters should be a part of trade negotiations generally has been settled, the debate over how to address such issues is likely to continue. The effect of the environment-related provisions in recent U.S. bilateral trade agreements, and thus the shape of the debate, may become clearer with the ongoing implementation of NAFTA and subsequent agreements that have incorporated NAFTA and NAAEC-like provisions.

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<sup>5</sup> For more information, see CRS Report RS21326, *Trade Promotion Authority: Environment Related Provisions of P.L. 107-210*, and CRS Report RS20999, *U.S.-Jordan Free Trade Agreement: Analysis of Environmental Provisions.*

<sup>6</sup> For a discussion of this issue and pending cases, see CRS Report RL31638, *Foreign Investor Protection Under NAFTA Chapter 11*, by (name redacted).

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