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## STATES, PROVINCES, AND CROSS-BORDER INTERNATIONAL TRADE

*Matthew Schaefer\**

I know I must be back in academia and out of government, not because I am talking on trade. I am still talking on trade. But there is no scent of tear gas. I do want to say that my views today are my own. I am here in my individual capacity, and not as a representative of the White House, where I was last year. I want to thank Henry for having me back.

When I visited here in 1997, I talked about the need to bind sub-federal actors like states and provinces to international obligations.<sup>1</sup> States and provinces are large economic actors. If you took a list of the largest nations and then compared state and provincial Gross National Products (GNPs) with those, you would find that there were more than thirty states that would rank in the top fifty nations in terms of GNP. You will probably find at least two, three, or four provinces that would rank in the top fifty as well. So it is clear for economic welfare reasons that there is a need to bind sub-federal governments like states and provinces to international trade agreement obligations. Indeed, as trade agreements have been extended into the non-tariff barrier area, new topics like services and investment, and so-called linkage topics like environment and labor, where states exercise significant regulatory and enforcement powers, the need to bind sub-federal governments becomes all the more clear. In the North American Free Trade Agreement (NAFTA) and in the World Trade Organization (WTO), we have applied obligations to states and provinces, but we have used a variety of techniques to protect the measures that were inconsistent with these agreements. So we have a ways to go. In fact, you could argue that most of the obligations in these trade agreements, at least in the new areas like services and investment, are stand-still obligations. They only prevent new protectionism. They do not scale back the existing protectionism that is maintained by states and provinces. For instance, there was grandfathering of laws, both within the GATS (General Agreement on Trade in Services) and the NAFTA services and investment chapters.

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\* Schaefer bio.

<sup>1</sup> Matthew Schaefer, *Searching for Pareto Gains in the Relationship Between Free Trade and Federalism: Revisiting the NAFTA, Eyeing the FTAA*, 23 CAN.-U.S. L.J. 441-488 (1997).

In between my two prior stints to the Canada-U.S. Law Institute, I went down to New Mexico to complain about state investment attraction subsidy wars, the same type of issues that the Canadians have among their own provinces.<sup>2</sup> The Canadians tried to handle this problem through the internal trade agreement. Well, none of the legal barriers to these state investment attraction wars is effective. There are state constitution prohibitions that arguably would cover such conduct. Those have not proved to be effective. Dormant commerce clause constraints have not proven effective. In fact, international trade agreement constraints have not proven effective either. Again, there is a need for further constraints on states and provinces. The task is not done; rather it has only just begun.

In 1998, I came back to the Canada-U.S. border to say that we need to protect federalism. In other words, as we constrain states and provinces we must be aware of measures that somehow reflect values of federalism.<sup>3</sup> I suggest to you that beggar-thy-neighbor type policies and other inefficient type policies have nothing to do with the values of federalism. In fact, federalism divides power between central and sub-central governments to end some of these beggar-thy-neighbor policies.

It is important to realize that the U.S. federal government, unlike the Canadian federal government, has full constitutional powers to bind the states. You Canadians have more legal difficulties. Our difficulties are not legal. They are not constitutional. It is clear that recent Supreme Court federalist jurisprudence indicates the Supreme Court is giving greater respect to states' rights. You see that in cases like *Lopez*,<sup>4</sup> which struck down a federal enactment barring possession of guns in a school zone. Nothing in *Lopez* or any other recent Supreme Court federalism jurisprudence takes away from the federal government's powers to bind the states to international trade agreement obligations. Nonetheless, we in the United States have our own complications binding states to international obligations. Our complications are political, not constitutional or legal.

The political constraints can be severe, and you saw that during the negotiation of NAFTA. That is the reason why techniques like grandfathering of existing inconsistent legislation were used. That is why states were only bound to the government procurement agreement on a voluntary basis. Both were caused by the political constraints on the federal

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<sup>2</sup> Matthew Schaefer, *State Investment Attraction Subsidy Wars Resulting From a Prisoner's Dilemma: The Inadequacy of State Constitutional Solutions and the Appropriateness of a Federal Legislative Response*, 28 NEW MEXICO L. REV. 303-342 (1998).

<sup>3</sup> Matthew Schaefer, *The "Grey Areas" and "Yellow Zones" of Split Sovereignty Exposed by Globalization*, 24 CAN.-U.S. L.J. 35-72 (1998).

<sup>4</sup> U.S. v. Lopez, 514 US 549 (1995)

government using the full extent of its constitutional powers to bind the states and eliminate state protectionist activity.

Before I began that venture I had gone to Washington, D.C. to speak on a topic more directly related to today.<sup>5</sup> We are talking about management and resolution of disputes. Currently under the NAFTA<sup>6</sup> Chapter 20, the general dispute settlement mechanism, and the WTO dispute settlement mechanisms, only national governments can bring claims against governmental behavior in another nation. Private actors have no ability to bring claims at the international level.

Chapter 11 is an exception that was discussed yesterday, and we will talk about that a little bit. But in the general dispute settlement mechanism from NAFTA Chapter 20 and the WTO, it is a state-to-state, government-to-government dispute settlement mechanism. One of the things that is frequently mentioned in academic circles is the possibility of having private causes of action in domestic courts. This would de-politicize enforcement of international trade agreement obligations.

One of the problems is that we would have a chilling effect on the negotiation of new obligations that we need. I just mentioned that we have only just begun limiting state and provincial protectionism. We have exempted from coverage existing elements of protectionism affecting services and investments. So we are going to need, either for constitutional reasons in Canada or political reasons in the United States, to get some form of state consent to curb further these protectionist practices and services in investment and government procurement areas. Having private causes of action available against the states and provinces may have a chilling effect on the creation and extension of the rules to existing elements of protectionism.

While we are on this topic of dispute resolution and management, it is not only the rules that are important, but it is compliance with the rules that is important. If the rules bind states and provinces, but they are bad actors and do not comply, we do not get the welfare-enhancing effects of the limits the rules seek to put on their protectionism. Dispute resolution, management, and obtaining compliance also depends on having states and provinces believe the process is fair, and that they are involved in the process. In fact, compliance will become higher with a greater degree of awareness and cooperation. Even here in the United States, although the federal government

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<sup>5</sup> Matthew Schaefer, *Are Private Remedies in Domestic Courts Essential for International Trade Agreements to Perform Constitutional Functions with Respect to Sub-Federal Governments?* 17 NW. J. INT'L L. & BUS. 609-652 (1997).

<sup>6</sup> North American Free Trade Agreement Between the Government of Canada, the Government of Mexico, and the Government of the U.S., Dec. 17, 1992, Can. T.S. 1994 No. 2, 32 I.L.M. 289 (entered into force Jan. 1, 1994), [hereafter NAFTA].

has the constitutional legal powers to bring the states into compliance, there are political constraints on exercising that power.

We ought to be seeking greater awareness among states; greater cooperation so that violations do not happen in the first place. We are going to see that when we look at some recent disputes that this is happening. I should also say we should be worried when we start carving away at existing protectionism in states and provinces, and not just future enactments. Compliance is going to become more difficult. Right now there are not a lot of cases involving sub-federal non-compliance with NAFTA or the WTO. It is largely because these agreements act only as a constraint on future protectionism and future enactments. These agreements do not try to carve away a lot of the existing protectionism. So compliance is only going to increase in importance as we strengthen the substantive rules.

Where are we in terms of cooperation on disputes, both between Canada and the United States, when it comes to state and provincial measures, and internally, within Canada and the United States, between federal governments and state and provincial governments? There is a two-level dynamic there. In the 1992 GATT *Beer II* case,<sup>7</sup> which many of you may be familiar with, a GATT dispute settlement panel struck down thirty-nine or forty states measures regarding the marketing and taxation of alcoholic beverages. This case had an equivalent effect on states as had the *Tuna-Dolphin* dispute, which occurred at about the same time, upon the environmental community.<sup>8</sup> It really woke states up, just like the *Tuna-Dolphin* dispute woke up the environmental community.

Unfortunately, just like *Tuna-Dolphin* led to some unnecessary hysteria in the environmental community, there was also some unnecessary hysteria created among state governments as a result of the GATT *Beer II* decision. For instance, some groups prepared a laundry list of state laws that would be subject to challenge; including ninety-three California measures that would be subject to challenge under the WTO agreements. These lists were published without any reflection of what reservations were carved out in the agreements or what the obligations actually required.

Now, I cannot complain too much about this hysteria, because in part it paid my rent and food for two years. So I do not want to say that all hysteria is bad, but it should be limited.

As a result of the *Beer II* decision, states felt they had not received sufficient involvement in the case. A Texas state official from went to Geneva with federal government officials regarding *Beer II*. In general, they

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<sup>7</sup> United States – Measures Affecting Alcoholic and Malt Beverages, (1991-92), 39S B.I.S.D. 206.

<sup>8</sup> United States – Restrictions on Imports of Tuna, (1991-92), 39S B.I.S.D. 155.

felt their involvement throughout the process was sufficient. In both the NAFTA implementing act and the Uruguay Round implementing act, states acquired rights to be involved at every stage of the dispute settlement process, at least internally.

The United States Trade Representative (USTR) was unwilling to guarantee that states would be involved in the actual negotiations to try and solve disputes because the USTR saw that as a sole or exclusive federal responsibility of the negotiation function. We will see that despite the fact that they did not want to make legal commitments guaranteeing state's rights involvement in consultations, the USTR has included the states. This an important point.

I know that in Canada there is no statutory mechanism for cooperation. But in the United States we have a statutory dispute mechanism for cooperation among states and the federal government as well as regarding foreign countries challenging state measures. But as important as the statutory provisions or institutions that create rights are, the changes in cultures and attitudes are equally important. I do believe the USTR is more aware today of the need for the benefits of cooperating and coordinating with states on dispute settlement cases than they were in 1992, when demands for state involvement in dispute settlement cases were viewed as trying somehow to corrupt trade agreements. This was not true however; governors' support for NAFTA was critical to its passage. Forty-two of fifty governors supported NAFTA. State demands for involvement in cases concerning their laws had nothing to do with being anti-NAFTA. It had to do with the need to coordinate if disputes arose involving state measures.

Let us take a look at types of recent disputes and label the states' activities that have led to challenges against state laws, or against provincial laws.

I will call case number 1 the case of the retaliating state. North Dakota was upset with the flow of wheat into the United States. They were upset with the inability to get into the Canadian market and to use the rail system to get U.S. wheat out to the West Coast. There were a variety of actions taken by wheat producers along the border in 1998. Canada and the United States reached an agreement under which Canada would allow shipment of U.S. wheat on Canadian rail lines. But there were continued problems in North Dakota, Montana, and the northern plains that led the North Dakota legislature to pass a bill that would have made it a misdemeanor to transport into North Dakota any wheat that did not have a certificate saying that the wheat did not contain trace amounts of certain chemicals that were not registered for use in growing wheat here in the United States.

There was a great degree of cooperation in the response to this North Dakota bill. It never reached the panel stage. Canada requested consultations under NAFTA. The U.S. government coordinated quite closely with North Dakota, and the governor of North Dakota vetoed the bill because of concerns that it conflicted with international obligations. The lesson to be learned from this case is the need to avoid the enactment of laws in the first place before it gets to the panel stage, before you have to talk about the repeal of laws. It is better to cut them off beforehand.

In fact, there has been significant coordination among the federal government and the states in avoidance mechanisms. This is very important. It has also happened in sanctions laws, laws that would sanction Burma similar to the Massachusetts Burma law.<sup>9</sup> Cooperation between the U.S. federal government and state governments led states to cease work on such legislation before it was enacted. So the case of the retaliating state is a lesson in the need for avoidance.

Let us turn to the taxing state unaware of unintended consequences. Michigan was going to impose, retroactive taxes on a wide range of Canadian companies that previously subject to Michigan tax. Once again, there was a great degree of cooperation among the Canadian government as well as the state and federal governments here in the United States to solve the problem. In this case it may have been problematic bringing claims under international trade agreements for the activities. In cases where the violation of a trade agreement is less clear, to avoid unintended harms and effects, the cooperation and coordination led to solution. The lesson here is that there might be a need to develop early warning mechanisms between the two countries, so that the consequences for U.S./Canadian trade relations can be taken into account regarding a measure.

As our third type of state, I bring up the case of the aggrieved state. Minnesota challenged Ontario regulations that would not allow for someone to keep fish that they caught if they did not stay overnight in Ontario, or otherwise spend money on Ontario tourism. This had a negative affect on Minnesota fishing guides who were taking their clients beyond Minnesota waters into Canadian waters for the capture of fish, but who wanted to stay at Minnesota resorts rather than Canadian resorts. Once again, consultations were requested under NAFTA. The case never even reached the dispute settlement stage because Ontario, in negotiations with the Canadian federal government, the state of Minnesota, and the U.S. federal government, agreed to remove the measure. The importance here is that the federal government worked with the state of Minnesota, not in defending a measure that was

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<sup>9</sup> Mass. Gen. Laws Ch. 7 § 22G (1998).

being challenged, but to get rid of an offending measure in a province. It proves to states the benefits of NAFTA even when it comes to a measure impacting a particular state, and that the federal government is willing to work with the state. I think that is quite important.

Let me turn to my last example, the case of the environmental regulating state. Here I am talking about the Chapter 11 case that has been brought against California because they have enacted a proposed ban against the use of MTBE in gasoline.<sup>10</sup> MTBE is put in gasoline for purposes of the Clean Air Act. It is used as an oxygenate and it is also an anti-smog additive.<sup>11</sup> Unfortunately, if it leaks into groundwater, it has been known to cause a bad odor and smell in water. There are further studies being done on whether that bad odor and smell actually lead to health consequences.<sup>12</sup> So there is a lot of concern over it.

Here I would have to agree with Dan Price that we are going to have to wait and see. We should not be jumping into changes to Chapter 11 simply because there are claims being brought. You have to look at the justifications for the claims; the actual state measures involved. The fact that a lot of claims are being brought under Chapter 11 does not mean a lot of claims are going to be successful. Even if there are a few losses regarding state measures, that alone is not reason for change. Again, you have to look at the state measures and the justifications for the state measures. We should not be jumping into any changes to Chapter 11.

We should let some experience and practice develop here. The other interesting thing about this case is that the Canadian company not only brought a Chapter 11 action, but they also brought an action under the North American Agreement on Environmental Cooperation,<sup>13</sup> the so-called NAFTA side environmental agreement, arguing that the only reason California enacted the MTBE ban was that they were not properly enforcing their fuel tank storage leakage laws that prevent leakage in the fuel storage tanks. It is an interesting case where state law, or state practices, have been challenged under two separate agreements.

What are the lessons? The USTR has a growing awareness of the need to cooperate with states, particularly in the first instance, to avoid the enactment of state laws leading to a dispute settlement case and potentially become

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<sup>10</sup> MTBE, Methyl Tertiary-Butyl Ether, is a controversial gasoline additive meant to reduce air pollution.

<sup>11</sup> See BNA, *Canadian Company Seeks \$97 Million in Damages for California Ban on MTBE*, 16 INT'L TRADE REP. 1058 (1999).

<sup>12</sup> See Ryan W. Herrick, *MTBE or Not To Be?: Clean Air, Dirty Water, and Common Law*, 30 MCGEORGE L. REV. 1325 (1999).

<sup>13</sup> 42 U.S.C. § 7401 (1998).



highly politicized. Cooperation on these types of disputes has been quite good. I do not want to leave you with the impression that the picture is all rosy. The lumber dispute is still out there, which we will hear about. *Beer II* is still out there, although it is fairly commercially insignificant. We are going to have disputes. We do have 500 billion dollars in trade between the two nations. It is not surprising that we have disputes from time to time. I do think there is an encouraging trend in recent disputes to resolve and manage them even before they get to formal dispute settlement processes.

I will leave on a broader picture. Last night, we talked about the 40,000 protesters in Seattle and the need to accommodate them. I am not sure that you will ever convince the 40,000 people in Seattle that the WTO or NAFTA are good for America. But what we do need to worry about is the impact that the 40,000 protesters are having on general public opinion and the states. State support was critical for NAFTA, and the one fear I have is that we will get a losing case in either the *Loewen* case,<sup>14</sup> this case challenging the Mississippi Court ruling, or this California MTBE case.<sup>15</sup> I am afraid that these groups will try to co-opt the states and injure state support for trade liberalization and trade agreements. We have to engage in further transparency, and respond to the legitimate concerns of these groups. But ultimately, the goal should not be to win over the 40,000 in the streets of Seattle. Heck, there are 76,000 people who come out every Saturday in Lincoln, Nebraska; primarily young college students who know exactly what they want, a Nebraska football victory, and they get very little press coverage. They are only on the sports page, and even then, we spend most of our time talking about the actual participants, not what the fans did outside. So let us not overreact and give too much weight to these folks, but we ought to respond to their legitimate concerns with openness and transparency. That would help assure general public support and the continued support of the states for trade liberalization.

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<sup>14</sup> *Loewen Group, Inc. v. United States*, Notice of Claim, Oct. 31, 1998. See also Harmonization Project, Briefing Paper, *Loewen Group, Inc. v. United States* (visited July 28, 2000) <<http://www.harmonizationalert.org/NAFTA/loewen.htm>>.

<sup>15</sup> MTBE, or Methyl Tertiary-Butyl Ether is a gasoline additive. Methanex Corp., a Vancouver-based company that manufactures Methanol, one of the raw materials in MTBE, filed a notice of intent to arbitrate against the United States on June 15, 1999, after Governor Gray Davis of California banned the use of MTBE because it is thought to be a carcinogen. See Samrat Ganguly, *The Investor-State Dispute Mechanism (ISDM) and A Sovereign's Power to Protect Public Health*, 38 COLUM. J. TRANSNAT'L L. 113 (1999).