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First Annual Conference

NAFTA, Environmental Regulations and Firm Strategies :

An Update with Chapter 11 Cases

by

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To be presented at the Toronto Conference of November 16-18 2000 on "Strengthening Canada's Environmental Community through International Regime Reform : Twenty First Century Challenges", Munk Centre for International Studies, University of Toronto

This paper is based on Chapter 7 of Alan M. Rugman, John Kirton and Julie A. Soloway, Environmental Regulations and Corporate Strategy: A NAFTA Perspective. (Oxford: Oxford University Press, 1999.)

NAFTA, Environmental Regulations and Firm Strategies

Abstract

The North American Free Trade Agreement (NAFTA) provides a unique laboratory to investigate the corporate strategies of multinational enterprises (MNEs) as they respond to a new political regime of trans-border environmental regulations. The NAFTA is the first international trade and investment agreement to incorporate such environmental laws and standards. As the new environmental and trade regime of NAFTA emerges we find that the potential set of relevant strategies for firms has expanded. We call this new NAFTA political regime a situation of "complex institutional responsiveness". In this paper we first present the conditions for complex institutional responsiveness and then consider, from the firm's viewpoint, both corporate strategies and political strategies under such conditions. An update discusses the chapter 11 cases as they affect firm strategies.

Key words: complex institutional responsiveness; environmental regulations; NAFTA.

Introduction

Traditionally, environmental regulatory barriers have posed a specific set of threats which restrict the strategies of firms engaged in international business. The classic threat is from foreign environmental regulations that deny access to the large, lucrative export markets. Such regulatory barriers have been particularly formidable when they moved to ever higher levels, were backed by powerful coalitions of protectionist industries and environmental groups in the foreign market, and administered by a trade dispute system in large national governments over which outside firms from smaller countries had little control. In such situations the time and expense of litigation and lobbying, even with the full support of one's home government, could be an enormous competitive disadvantage for a firm. The major alternative response, available primarily to those large firms with vast resources and long time horizons, was to produce at home to meet the stringent regulations in the large, Vogel-type 'California' export market (Vogel 1995), calculating that these high and ever rising regulations would keep one's competitors, foreign and domestic, at bay.

Today, however, firms face a much more complex situation. Environmental regulations are proliferating at the local, national and international levels. They are expanding from product to production/processing and distribution/disposal phases, and intensifying conflict among industries in different sectors. At the same time, the advent of internationally-integrated production systems is making such local and national regulatory borders increasingly costly, as firms build a larger base enabling them to compete on a fully global scale. This is true even as the rise of multinational production and international business alliances allows firms more readily to produce and exert influence within once closed foreign markets. Finally, to help manage these new intersections of opening markets and compounding environmental regulations, there has arisen a new array of trade liberalization agreements, the first of which is

NAFTA, with new rules for trade-environment integration and new institutions to ensure that the values of both environmental protectors and trade liberalizers are simultaneously enhanced.

This more complex regulatory and competitive environment, and the array of international institutions which govern it, presents firms with new obstacles and opportunities in their response to business challenges abroad. This paper outlines the expanded array of corporate and political strategies which firms now have available in this complex institutional environment, and identifies how firms at different stages of internationalization are best able to benefit from particular instruments within this menu. This paper thus begins by identifying the key factors that have changed the regulatory, business, and international institutional environment facing firms – the new conditions of complex institutional responsiveness. It then discusses the new corporate strategies firms now have available, and the new repertoire of political strategies that the new institutional complexity opens for them. It concludes by analyzing which of these new corporate and political strategies are likely to be most appealing to, and hence adopted by, firms, from domestic producers through to transnational firms at different levels of internationalization. This work provides an analytical foundation for the NAFTA case studies which Rugman, Kirton and Soloway (1999) report on in detail. In this paper we discuss several of these cases in passing. Further details of these cases appear in Vogel and Rugman (1997) and in Rugman and Soloway (1998).

Complex Institutional Responsiveness

Traditionally, all but the largest firms operating as monopolies or oligopolies in relatively closed markets have needed to be responsive to challenges from competing firms and their home governments abroad. But now, virtually all firms have been forced to respond to such international competition. The widespread demise of closed regimes, along with major multilateral and regional trade liberalization during the 1990s, has opened up a world market. In seeking to enhance their competitiveness in this far more international arena, firms face new complexities in regulatory, production and international institutional conditions.

The first set of complexities arises from the behind-the border defenses of environmental regulations and standards, which the reduction of border tariffs and quotas have rendered more visible and valuable as protectionist devices. The recent era of rising environmental consciousness has added new complexity to the traditional environmental regulatory barriers firms face in foreign markets, and at home as well. Mass public concern with environmental protection has fueled ever more stringent and rapidly changing regulations, with more flexible enforcement schedules, tradeoffs between target levels and deadlines, compliance assistance for firms, and, under the precautionary principle, more flexible standards for scientific proof. Subnational governments have begun to adopt a rapidly changing array of local regulations, fragmenting such previously large markets as the United States and raising the costs of producing for sale across it. A new generation of multilateral environmental agreements has established an additional set of regulations at the international level, and often incorporated trade restrictive measures to enforce compliance with them.

At all levels, from the local to the international, regulation has come to focus not only on the characteristic of products entering a market but on the methods by which they are produced, processed, distributed and disposed of anywhere in the world and all along the value chain. The traditional focus on product characteristics has thus been joined, in a cradle-to-grave vision, by regulatory action over the entire product cycle, from production and processing methods, to waste reduction and product disposability. Firm reputations and liabilities can now be strongly affected by the practices of their suppliers and partners. And the emergence of a total systems approach to environmental protectionism has intensified the clash among once separated industries, such as autos and oil, about who could and should best bear the additional environmentally enhancing costs. This maze of multilevel, rapidly changing, ever more stringent, and far-reaching regulation imposes major costs on those firms unable to respond before their competitors to the harsh demands of this new environmental regulatory world.

Accompanying these developments in the arena of environmental regulation are similarly far reaching changes in the world of international business. The advent of internationally integrated production and just-in-time inventory processes means firms need to be able to import and export freely and without interruption across international boundaries. This requirement compounds the costs which even minor regulatory detours or delays can impose, and simultaneously generates new incentives for convergent or at least compatible environmental regulations across jurisdictions. The result is a new corporate 'intervulnerability,' as the production systems of even large firms in large countries can be crippled if they are denied, by environmental regulatory action on a local or national basis, the irreplaceable critical inputs from abroad they need to maintain production and market share. Moreover, the expansion in multinational enterprise and international business alliances has further increased the cost of national regulatory protectionism and reinforced these pressure for compatible production standards (Dunning 1993; Rugman 1996). Finally, the advent of competition on a global scale, often from firms of much larger size, has underscored the need for a large protected home (or now multi-country regional market) to amortize fixed costs and build the required minimum scale.

Governing this clash between the world of more complex environmental regulations and global competitive pressures over the past decade is a third new development - the advent of potent international institutions with trade and environment responsibilities. Even those as lightly institutionalized as the Canada-U.S. Free Trade Agreement (FTA), provide a new international centre, beyond national trade law systems, where firms can make a case that they have been denied market access by unjustifiable environmental regulatory protectionism. When, as with NAFTA, such institutions are accompanied by strong powers, institutions and organizations that embrace both trade and the environment, they can provide a common forum and reference point for trade-environment communities to interact and their conflicts to be settled, managed, or event protected. And if, as in NAFTA, they provide for the direct participation of firms and environmental groups, as well as governments, from all participating countries, they can foster the development of complex transnational coalitions, and an emergent sense of common interests *vis-a- vis* the outside world.

Corporate Strategic Responses

The more heavily and innovatively regulated, internationalized and institutionalized world of the 1990s presents firms not only with complex new obstacles. It also offers them new opportunities, in both their corporate and political strategies, to circumvent potential barrier and increase their competitiveness on a larger scale. Of initial interest are the vastly expanded array of corporate responses that firms, following a strict business logic, can now employ.

Traditional Corporate Strategies

Traditionally, firms facing the classic challenge of environmental regulatory protectionism in their major export market abroad have had a limited array of often unsuccessful strategies to employ. The first, often instinctive response, was to secure from the foreign regulatory authority a certificate of equivalency or another form of *ad hoc* exemption for a specific shipment or product. Such a response of *ad hoc* exemptionalism was tried unsuccessfully by

Lactel, at an early stage of the UHT case, Rugman, Kirton and Soloway (1997), Vogel and Rugman (1997).

A second response, attractive when the foreign regulations were fully prohibitive for market entry, was to withdraw to the domestic market and seek replacement customers at home. Such a strategy of domestic withdrawal was an appealing second best option for smaller firms with a large domestic market, and for firms with products at early stages of the product cycle where domestic demand could be expected to rapidly expand.

A third response, attractive to firms which wished to preserve their export market, was to pay the incremental cost of the foreign regulation, hoping that by expanding production through foreign sales they could lower their unit costs and restore net profitability in their foreign sale. Such a response was attractive where the cost of the foreign regulation was modest rather than prohibitive, potentially transitory (while undergoing further scientific testing, for example), and where the export market was rapidly growing and serviced by few competing firms at home or abroad. In sunrise sectors, where the regulation stemmed from early government regulatory authority backed by few national producing industries and allied NGOs, such a strategy could prove to be a successful one over the longer run. This strategy was followed on the part of the U.S. beer producers in the Ontario beer case. Rather than withdraw from the Ontario market, they simply 'endured' the additional 10 cent cost per can, while negotiating a whole host of additional access issues with the Ontario government, Rugman and Soloway (1998).

A fourth strategy was to alter one's product or even production standard to meet the foreign regulation of the moment. This was an attractive option where the costs of the adaptation was low (perhaps restricted to a single low value input), where firms were installing new capacity in a product line dedicated to the export market and segmented from the rest of the firms production capacity, and when the foreign market offered high profitability, a high percentage of the firms sales, and confidence that the existing regulation would last for a long time (over the course of which incremental costs of adjustment could be amortized). Such a strategy of product/production alteration was evident in the case of New Brunswick blueberries, where the Canadian producer switched from the use of the pesticide dimenethoate to that of higher cost but still affordable imidian, in an effort to meet the U.S. regulation, Rugman and Soloway (1998).

A fifth strategy was to shift to the production of alternative, even closely allied products, that did not face the specific regulatory restriction. This was particularly attractive when the abandoned product, relative to the alternative, was a mature, low value added product whose market share might be in a state of long term decline. It was also attractive when the foreign regulatory barrier was highly product specific, and difficult to change or expand. This strategy of product alternatives was employed, successfully for a few years, by Canadian producers in the softwood lumber case, as they circumvented restrictions on their exports of 2x4's to the U.S. market by drilling holes in them to create a new product for unrestricted export - drilled studs.

A sixth traditional strategy was market diversification - shifting sales to an alternative export market where the regulatory barrier did not exist. This was particularly attractive to mature export capable firms able easily to overcome barriers of distance and language, to seek new customers in less or differently regulated markets. It was a real option when these alternative export markets were not likely to rapidly raise their regulations, or do so in a way that was different than that of the firms' home government. The diversion of newsprint exports from California to Asia was a strategy considered on the part of the B.C. forestry firms when they were denied access from the California market, Vogel and Rugman (1997).

These traditional strategies were essentially reactive rather than proactive - they responded to the introduction by foreign governments of new or different environmental regulations. Although they depended on a calculation of how those and related regulations were likely to change in the foreign government, in other export markets and at home, the dominant assumption was that a foreign government would act without catalysing a sequence of strategic moves by other players. This would include other governments with regulatory powers, and firms and NGOs wishing to adopt or circumvent successful techniques. These traditional strategies are thus poorly suited to the new world of rapidly changing environmental regulation and strategic regulatory protectionism, extensive internationalization of business, and strong international institutions to constrain national regulations and create international regulations of their own.

New Corporate Strategies

Conditions of complex institutional responsiveness offer a much broader array of strategies. These strategies take account both of the new regulatory, competitive and institutional processes at work, and the dynamic pace of technology which lies behind. They require firms to plan proactively over long time horizons, to calculate the second and subsequent order responses to their moves, and to consider the reactions of multiple actors, including firms, governments, NGOs, and international institutions, operating at home and abroad.

The first of these new strategies, developed in the work of Porter (1990), is to readily accept and produce at home to the highest environmental standards in one's domestic market, in order to have the unique first mover advantage in export markets which are calculated to be moving to ever higher levels of environmental regulation (Porter and van der Linde 1995).

Such a strategy, however, is available only to relatively large firms who can afford the initial additional costs, who have long time horizons, who can use their green production as an advantage at home among consumers to capture the domestic market and secure the required scale, and who have a large unfragmented national market to allow the minimum required scale (Rugman 1995). They are also appealing when the level rather than the form of regulation is at issue, when there is a single future standard that is probable and widely accepted, when regulations rise by a unilinear rather than leapfrogging process, and when technology forcing innovation is likely.

The second strategy, suggested in the work of David Vogel, goes beyond producing to high levels at home to prepare for an uncertain future market abroad to directly produce to meet the high environmental regulations prevailing in the largest export market (Vogel 1995). This is the strategy that takes advantage of the 'California effect', under which German automotive producers at home and abroad met the higher environmental standards in their large California market, confident that the environmentally pioneering California regulations would eventually be adopted throughout the United States and in key markets around the world. Such a strategy offers strong first mover advantages in a word where markets, and higher environmental regulations, are becoming global. It involves significant risks, however, when several subfederal jurisdictions and countries are seeking to become the global environmental pioneer and when their differing regulatory approaches threaten to fragment the prospective global and existing national marketplace. Such uncertainty can be compounded, as under NAFTA, when the easy trade and investment access to jurisdictions with lower levels of environmental regulation and enforcement create a fear that there may not be a future upward movement, but rather a regulatory chill that freezes the current regime or even a regulatory race to the bottom.

A third strategy is to move production facilities closer geographically to an export market, in order to minimize the transportation costs, and to better absorb the temporary border delays that environmental regulations sometimes cause. This strategy is attractive to home-based exporters from countries such as Canada and Mexico *vis-a-vis* the United States, where a firm's home country is contiguous to the major export market and to the major consumers within it. Its logic is seen in the many operations that have opened and expanded, both before and after NAFTA, in the *maquiladoras* along Mexico's northern border. It was a potential strategy available to Canadian newsprint producers faced with the task of transporting recycled newsprint from major urban centres in California and elsewhere in the United States back for recycling in Canada (Rugman 1995). It has similar potential in cases, such as for U.S. producers in the Ontario beer case, where transport costs imposed by recycling schemes constitute a significant cost of doing business. It is also attractive where just-in-time inventory methods are in use, and where there are additional advantages, for learning and marketing purposes, in being geographically proximate to customers.

A fourth strategy is to transform oneself from a home-based exporter into a domestic producer, by abandoning the newly closed export market and selling one's product as an input to another domestic producer whose products are free to enter the foreign market. This is the strategy pursued by Canada's leading steel producer, Stelco, when its steel exports to the United States were hit with a succession of antidumping duties. It diverted its product to supplying Canadian auto parts manufactures such as Magna who were free to ship to the United States. Here U.S. protectionist action had the unintended effect of inducing a successful 'further processing' industrial strategy in Canada, Rugman and Anderson (1997).

A fifth strategy is to transform oneself from a home-based exporter into a home-base multinational enterprise by opening production facilities in the country whose market is now closed to exports by the environmental regulation. NAFTA's investment guarantees allow firms to adopt this strategy with much greater assurance than before. This strategy is attractive in cases, such as the recycling cases, where geographic proximity is an advantage, and where the costs of a greenfield or takeover investment, including those of regulatory compliance, are not onerous. The process fostered by the use of this strategy is the opposite of the widespread fear of regulatory refugees closing facilities in high cost environmental sanctuaries for relocation in pollution havens where environmental regulations and thus business costs are lower. Under this strategy firms move, but to jurisdictions with higher environmental regulations. It is likely to be most evident where countries employ environmental regulations that are easy and inexpensive for domestic firms, but difficult and costly for foreign firms, to meet.

A sixth strategy is when firms from both the importing and exporting country make an agreement regarding minimum prices in exchange for the withdrawal of antidumping actions or harassment through discriminatory environmental regulation. Such agreements exist outside the NAFTA institutional process. This has been especially prevalent in the agriculture sector, where in the case of Mexican tomatoes exports to Florida, such an agreement was made. The Florida tomato producers agreed to withdraw their antidumping actions and cease harassment over environmental and packaging standards in exchange for voluntary export quotas and minimum price floors on the part of the Mexican tomato producers.

Strategic Political Responses

In addition to their business-based strategies, firms have long possessed a repertoire of political strategies to employ in combating environmental regulatory protectionism abroad. On occasion, they have been able to mobilize the power of governments, and those who influence government action, to shape the content and application of regulations to their advantage, rather than just comply with those regulations. As with their corporate strategies, their array of available political strategies has been significantly expanded by the advent of the conditions under which complex institutional responsiveness can flourish.

Traditional Political Instruments

Traditionally, the first response of firms faced with regulatory protectionism has been litigation. This requires mobilizing the power of one's home government to take up one's case and be an advocate in the national trade law system of the country imposing the regulation. For example, in the UHT case, Lactel mobilized the home, Canadian government at the official and diplomatic level to help it secure a certificate of equivalency for its product, Rugman and Soloway (1998). This is essentially a passive strategy, in which the firm and its government are responding to the procedures and schedule of the foreign national trade law system. As the experience of Lactel in the UHT milk case illustrates, the strategy of litigation, even when successful, can take so long, and involve such expense, that serious competitive damage is done. More costly still is the fear, born by repeated experiences of such 'process protectionism' against the firms' products, that future exports will be blocked to the point that the firm is deterred from pursuing future exports, Vogel and Rugman (1997).

A second political strategy is lobbying, with the aim of inducing the foreign government to allow such discretion as its national trade law system exists to provide at least an exemption in such a case. Such a claim can often best be made by one's home government, as an exercise in 'exemptionalism'(Kawasaki 1998; Cuff and Granastein 1972) . Firms can reinforce their capacity to pursue such a strategy by retaining local legal counsel with political access in the foreign country, or by maintaining permanent corporate representation in the foreign capital (Gotlieb 1984). Here home-based MNEs have an advantage over home-based exporters in that they can employ their host country managers to gather intelligence about, and intervene as nationals in the legal and related political processes of the regulating government.

A third, more active strategy is coalition-building - constructing and activating a broad coalition of interest groups within the regulating country and in third countries to secure a modification or suspension of the objectionable regulation. For example, in the softwood lumber case, and earlier related cases such as shakes and shingles (Rugman and Anderson 1987), Canadian firms mobilized the U.S. consumers' interests. This included the U.S. Homebuilders Associations (to whom the product was sold), those financing the U.S. housing purchases, and consumers wishing to purchase homes. All of these groups had a vested interest in the low input prices and easy availability of Canadian lumber. Reciprocally, in the Ontario Beer case, Alcan (as a Canadian supplier to U.S. firms exporting their beer in aluminum cans into the Ontario market), was mobilized against the Ontario environmental regulation, Vogel and Rugman (1997). Transnational MNEs, with a presence in many countries, are often best positioned to employ this strategy as they can more easily mobilize third party governments to join an intervention against the regulating government.

A fourth strategy is high-level diplomacy. This involves mobilizing one's home government, at the leader, ministerial or senior official level, to pursue the case on an intergovernmental basis, and perhaps link it to other issues in an overall bilateral relationship. Such a strategy is reinforced by the finding that in the Canada-U.S. relationship, Canada tends to prevail in issues dealt with at the Summit level and linked to the overall state of the relationship (Nye 1974). Such a strategy can be pursued as a matter of segmented problem solving in the special relationship, an approach pursued with the joint Canada-U.S. study by agricultural officials in 1995 in the UHT case. Or it can be done as a matter of pure intergovernmental bargaining. For example, in the softwood lumber case, following its failed arbitration through the FTA, including two Extraordinary Challenge Committees, the two national governments negotiated outside the trade law system to arrive at the 1996 Softwood Lumber Agreement with its own dispute settlement procedures, Rugman and Anderson (1997).

A fifth strategy, attractive when the foreign government will not easily adjust, is subsidization - seeking a subsidy from one's home government to meet the cost of the foreign environmental regulation. This strategy is a variant of that employed by the Canadian government in August 1971 to help defend Canadian industry affected by the U.S. government's unilateral imposition of a 10% surcharge on all dutiable goods entering the United States (Sakurada 1998). It does raise the danger that such 'generally available' subsidies will trigger further countervailing duty action by the regulating governments. This is especially true in the case of the United States, where such duties are imposed on the gross amount of the foreign subsidy rather than the net difference between foreign subsidies and U.S. subsidies to its home firms (Rugman and Anderson 1987, 1997). However the successful use of environmental subsidies, for example, by the Alberta government to its beef processing industry, and the opening to legitimize green subsidies in the WTO and modern regional trade agreements, can make this an appealing strategy. This is especially true when the size of the required subsidies is not large, when one's home government has an available fiscal surplus, and where there is a legitimate case for infant industry, automatically sunsetted subsidization (as with a one-time grant for environmental facilities for new plant construction).

A sixth strategy is retaliation - having one's home government impose mirror image regulatory restrictions of equal or greater magnitude on the imports from the country practicing the initial regulatory protectionism. This use of this strategy is evident in evident in the counter-retaliations over potato inspections along the Maine-New Brunswick border and in countless other similar cases between the United States and Canada, Rugman and Soloway (1998). It is likely to be efficacious when the counter-retaliation is carefully targeted against politically consequential constituencies in the other country, or where the market share of the imports and thus leverage of the retaliating country is larger than that that of its rival.

A seventh strategy is one of convergent national adjustment, that is, where firms intervene with their home government to adjust its national regulations unilaterally to correspond with those of a major foreign government to which the firms exports. This is essentially a strategy of acquiescence, based on a calculation that a single international regulatory regime regardless of content is more beneficial through the reduction of transaction costs than nationally diverse systems of whatever character. This strategy stands in contrast to Porter (1990) production, where a firm seeks high home government regulation in advance of those foreign markets, and in contrast to Vogel (1995) where a firm seeks to meet foreign government standards in advance of its own home government. Convergent national adjustment represents the most rapid way of securing simultaneously an identity of foreign and home standards. Convergent national adjustment was the strategy pursued by Canadian auto manufacturers in demanding that the Canadian government change its regulations with respect to MMT in gasoline to conform to the United States standard which did not allow MMT, Rugman and Soloway (1998). This strategy rationally appeals to MNCs for whom international transaction costs can constitute a primarily regulatory barrier.

Whatever strategy, or blend and sequence of such traditional strategies is employed, all are heavily dependent for their use and success on the willingness of one's home government to take up the case of a single firm, to pursue it effectively with a foreign government and within a foreign country. Such dependence on one's home government can be a problem. At home, a firm might be too small and politically inconsequential to secure home government support, by virtue of its size, number of employees, regional location (where the governing party does not have a strong support base), campaign contribution record, or image and status as not being a national champion. Firms may not be able to mobilize sector-wide coalitions of other firms at home if the latter perceive that they can secure a competitive advantage from avoiding collective action (e.g. if they are less dependent upon exports to the regulating country's market). Domestic public opinion may make it difficult for a national government to vigorously pursue a national firm's cause, as indicated by the case of aboriginal leghold traps or Canada's east coast seal hunt (the conduct of which offended domestic animal rights and environmental groups).

Looking abroad, a government may have limited leverage with a much larger foreign government, particularly at times of cool overall relations. And the interests of a particular firm might be traded off for higher political issues or to maintain good overall relations with a foreign government.

New Political Instruments

The new political instruments and strategies available under complex institutional responsiveness circumvent many of these obstacles. They are far less dependent for their use and success on the will, skill, and size of a firm's home national government. They still involve political action, but focus more directly on using other political forums and actors, particular those of and opened by the new array of international institutions. Whereas the old strategies, (rooted in mobilization by national governments) contain a bias toward entering into and escalating intergovernmental conflict, the new strategies (based in international institutions), begin with the rules-based third party treatment of firm-government conflict and contain a built in bias towards ever stronger forms of transborder co-operative action. They begin with the settlement of conflicts, and move into conflict management and prevention and ultimately into common action against larger outside challenges.

The first of these new political strategies is International Dispute Settlement. This involves taking one's dispute directly to the new NAFTA network of dispute settlement mechanisms. Like their FTA predecessors they offer a rules-governed international forum with specific mechanisms for antidumping and countervailing duties cases (Chapter 19), and for general disputes (Chapter 20). Yet unlike the FTA they also offer, under Chapter 11, two mechanisms for investment disputes, and under the NAAEC, three mechanisms (Chapter 13, 14-15 and Part 5), for dealing with environmental disputes. Most innovatively, two of these six mechanisms - NAFTA's Chapter 11 and NAAEC's Article 14-15– allow firms direct access to initiate and pursue cases, without involving their home government. The NAAEC's Article 13 enables firms to lobby the CEC Secretariat directly to initiative an investigation. The early widespread use of Chapter 11 for environmental cases, and that environmental cases constitute virtually all of the Chapter 11 cases to date, plus the absence of environmentally related cases among those dealt with by the more FTA-like Chapter 19 and 20 mechanisms shows the importance of this right of direct firm access. Further, the widespread use of NAAEC's Article 13 and 14-15 cases, and the lack of any action under Part 5 (which requires government to government action) underscores the point. Firms, and their competitors are no longer hostages to home governments. They can now move to redress national and local environmental regulatory protectionism directly at the international level.

The second of the new political strategies is dispute management and prevention. The mandate and the work of the NAFTA institutions and the CEC provide an incentive and capacity to deal with disputes before they automatically proceed to expensive and visible litigation through dispute settlement. Through the role of the ministerial councils and their subordinate official-level institutions and stand-alone Secretariats, disputes can be politically managed in ways that prevent them from escalating into major intergovernmental conflicts, or from arousing domestic political pressures that would further impede transborder trade. These institutions also have the power to act to prevent such disputes from arising in the first place. This capacity has proven its value already, specifically in regard to major regulatory protectionist issues relating to safety, notably in the U.S.-Mexican trucking area. The role of the NAFTA Co-ordinators, and since 1998, the NAFTA Deputy Ministers forum, has substantially reinforced this capacity for dispute management and prevention.

A third strategy, which extends the impetus for dispute prevention from conflict avoidance into the realm of actual co-operation, is the use of the NAFTA institutions for communication and capacity-building. Through the NAFTA institution, firms can learn about the regulations, certification procedures and accreditation, and regulatory development systems in other countries. Firms also have a NAFTA guaranteed right to comment on draft regulations and thus shape their content. NAFTA's institutions encourage firms to build regulatory capacity in partner countries, thereby ensuing that foreign regulations are similar to home country ones in the consistency and predictability of their application. Such capacity building can also aid foreign suppliers and the general business infrastructure. In both cases, the development of personal networks with those in partner's national regulatory systems can do much to alleviate misunderstanding, build trust and lower the costs of commerce.

A fourth strategy is regulatory convergence - using the NAFTA institutions to have national and local regulations move over time to become more compatible or similar. There are many ways this harmonization process can take place, from mutual recognition of national standards, through minimum standards and procedures (such as accrediting test labs in the other country), to the negotiation and acceptance of common standards (Esty and Gerardin

1997). Such a process is easier to undertake and complete in areas of new regulatory activity, where no partner country has existing regulations and the interests that lie behind. It can vary in the level of the common standards aimed at (high versus low), the dynamics of movement (negotiated versus incremental; hegemonic versus mutual adjustment), the form (labeling, product, process or disposal standards), the scope (regional versus multilateral) and the speed (including differential phase-ins).

A fifth strategy, facilitated by the NAFTA institutions, is to form transnational coalitions to secure the convergent regulations one favours. Because the NAFTA institutions bring together firms, ENGOs and other stakeholders from all participating countries in their work, they ease the task of assembling transnational coalitions to overcome national obstacles backed by weaker, national firm coalitions. Broader coalitions can also widen the range of benefits available. Over time, this process can lead firms and their governments to redefine their interests, and to formulate business strategies in fully regional terms.

A sixth strategy is to engage in multilaterally-oriented coalition-building. This involves constructing coalitions across all communities and countries within the region to create a stronger North American constituency, aimed at securing the broader multilateral standards that favour North American industry interests. This strategy has been evident in the activities of firms in the chemicals industry.

A seventh and final strategy is to engage in regional harmonization, with or without a multilateral orientation, outside of the NAFTA institutions or even non-NAFTA intergovernmental forums. Such international, voluntary, private sector, standardization can be seen in the activities of the automotive industry, for whom the work of the relevant NAFTA institutions is distinctly secondary. It can also be seen, outside of the environmental domain, in the activity of the North American steel industry, where (in 1998) 48 steel firms have formed a region-wide association and have begun to act against the threat of low cost steel flowing into North America from currency-weak Asia and Russia.

The Impact of the NAFTA Institutions on Firm Behaviour

An expanded array of corporate and political strategies available under conditions of NAFTA's complex institutional responsiveness has been documented. Which are those likely to be, under rational calculation, most appealing to different types of firms? The advent of free trade agreements such as NAFTA, with strong trade and investment liberalization provisions, plus a thick network of institutions for shaping regulations and managing disputes, offers firms a new arsenal of opportunities and instruments to maintain and enhance competitiveness. These environmentally-related institutions have thus far operated effectively to facilitate the access of Canadian and Mexican firms to the U.S. market, and that of U.S. firms to their partner's markets. They have also served to augment the ability of North American firms to penetrate global markets, and to enhance the North American environment at the same time. But among the many new instruments the NAFTA regime offer, how do domestic firms, home-based exporters, home-based MNEs and transnational MNEs choose those particular instruments most appropriate to their overall size and operational scope? The basic rationale for particular instruments to be employed by these different types of firms is as follows.

In the first instance, domestic firms can take advantage of the new NAFTA institutional network in several ways. Most directly, small domestic firms can benefit from the direct contracting practices of the CEC itself. The CEC has allocated its modest budget with strict attention to equal disbursements among the three member government contributors, often through the formula of contracting enterprises from the three countries to work together on a particular project. Such certification by an international organization and development of a network of affiliates in the other two NAFTA countries, even at a very modest level, increases the export readiness of small domestic firms, helps to transform them into home based exporters, and gives them an international network of firms with which they might supply or form co-operative alliances in the future. For small, domestic firms such a lowering of transaction costs and provision of a *de facto* guarantee of international governmental approval can be of considerable value.

The work of the NAFTA institutions more generally, particularly through its involvement of firms, has a substantial effect in bringing larger domestic firms and home-based exporters into contact, not merely with foreign distributors and customers, but with similar firms or potential competitors. From such concentrated contact can flow a greater sense of export opportunities, familiarity with local regulations, and the identification of local lobbying affiliates. It can also breed the trust and information required to forge larger strategic alliances that can help transform such firms into home-based MNEs, facilitate the sharing of industry best practices (including the adoption of environmental management systems), and foster a shared interest in working toward region wide regulatory convergence.

NAFTA can assist home-based exporters in another way. Such trade agreements, by opening vastly larger markets with different, and in the case of Mexico at times less stringent, regulations give formerly domestic producers and their home country much larger markets for their existing products, and thus the resources and skills to meet the intensifying regulatory demands from abroad. At a minimum, NAFTA’s trade liberalization provisions mean firms could find new markets abroad (Mexico) where their products meet the regulatory requirements, and thus insulate themselves from and reinforce their ability to compete with regulatory protectionism in a single large market such as the United States. NAFTA thus offers home-based exporters fully focused on the United States the strategy of export diversification.

NAFTA's trade liberalization provisions, and its innovative guarantees for foreign direct investment make it easier for firms to move production abroad, to service the former export markets, and the former home market. NAFTA thus gives home-based exporters the option of becoming home based MNEs, at least on a regional scale. They can move existing and new production to lower cost jurisdictions such as Mexico to offset the higher costs of meeting the regulations required to export into the U.S. market. Or they can move into the U.S. market itself, and thereby better learn about and lobby for the national and subnational regulations they can meet. In doing so, they place, as NAFTA's critics correctly identify, a market-based check on excessive enthusiasm for national environmental regulatory protectionism, especially the form that could harm firms in the global marketplace.

In addition, the NAFTA Agreements' environmental provisions and institutional mechanisms give firms a much enhanced array of possibilities. High and costly environmental regulations at home can force firms to look for investment locations abroad, where other production costs could be higher, distance from high value markets greater, and access to those markets more uncertain. In such a situation, of particular interest to experienced home-based exporters with several foreign markets and to home-based MNEs are those CEC programs directly focused on corporate contributions to environmental enhancement, notably the development and spread of voluntary environmental management systems such as ISO 14000, and support for pooling environmental technologies of proven value in Mexico to enhance their export into the Americas as a whole. Their participation with ENGOs in such for a can also lead to shared interests both in sustainable development opportunities, or in green protectionism at a regional rather than the national or subnational level where baptist-bootlegger coalitions predominantly form.

By far the most important impact of the NAFTA institutions, especially for the home-based MNEs that dominate North American trade and investment, is their work in: 1) constraining the emergence and use of green protectionist regulations by national, subfederal and local governments within the NAFTA community; 2) facilitating regulatory convergence across the region; and 3) fostering a single North American regional voice to combat such protectionism in external regions such as the E.U. and build a broader, more open multilateral regime.

A substantial number of the environmentally-related trade disputes in the region (affecting domestic firms, home based exporters and home-based MNEs), especially prior to NAFTA, arose from state and provincial regulations (Vogel and Rugman 1997). While such cases have thus far concentrated on agricultural and natural resource industries, pressures for state-level automotive emission standards (beyond California) and automotive inspection and maintenance programs threaten to bring such subfederal regulatory escalation and proliferation to the manufacturing industries at the heart of the NAFTA economy.

For home-based exporters and MNEs it is often the uniformity, stability and form rather than the level of regulation which is the central interest. Although MNEs are conventionally thought to be in favour of regulatory diversity across countries (so that they can exploit their comparative advantage by relocating to produce for export to global markets from the locations where their costs are the lowest) in practice it is costly to shift production to such locations. Moreover the high degree of intracorporate trade and management integration provides further incentives for firms to favour stable or slowly changing uniformity over rapidly changing diversity.

The NAFTA regime and institutions, in practice, have not led to a downward harmonization that have forced subfederal entities to reduce their environmental standards, where they are higher than the national or international norm (Kirton 1998; Orbuch and Singer 1995). Although allegations of a deterrent 'chill effect' persist (by which the NAFTA disciplines and institutions prevent subfederal entities from further increases and thus differentiation in their environmental regulations), the record of dispute settlement thus far suggests the incentives are otherwise. For while the CEC has acted against subfederal jurisdictions (such as British Columbia) for the alleged non-enforcement of existing environmental regulations, the NAFTA dispute settlement mechanisms have not yet moved against those seeking to set environmental regulations higher (apart from the MMT case in process against the Canadian federal government). In the British Columbia case, which is really a case concerning government-owned B.C. Hydro, it may be a public utility whose commercial interests are harmed, to the benefit of its private sector competitors. The NAFTA institutions and the CEC thus assist home-based exporters and MNEs with their most costly market access problem of subfederal regulatory proliferation, with little cost to existing levels of regulatory protection and some benefit against those states and provinces tempted to relax environmental enforcement.

It is here that the NAFTA institutions, implementing the NAFTA rules on standards, have been most effective. By bringing NAFTA disciplines to many areas of state and provincial regulatory activity, while restricting the direct participation of state and provincial officials in them, the NAFTA institutions in their composition and practice create a bias in favour of standards that are trade friendly, national and regional in application (Orbuch and Singer 1995).

More generally, the NAFTA rules and institutions have assisted home-based exporters and MNEs from NAFTA's two smaller countries with the major threat they face, namely loss of market access to the United States. With unilateral environmental regulatory action by the national government of the United States, entrenched in a Vogel (1995) type 'baptist-bootlegger' coalition, there is the threat of denial of access to the large and vital U.S. market to firms who must export their products there to survive. The most analytically clear instances arise where the U.S. government has embedded in its national laws trade sanctions against foreign firms allegedly not abiding by the practices prescribed in U.S. regulations.

These cases follow a standard pattern, in which, first, U.S. environmentalists seek and secure a higher U.S. environmental standard (or support an international one). Second, U.S. industry resists its imposition on U.S. industry (or demands its imposition on external competitors from foreign countries). Thirdly, a 'green and greedy' coalition is formed to secure unilateral trade sanctions as an enforcement mechanism. Fourthly, the industry proceeds with its environmental partners to seek the internationalization of this standard (DeSombre 1995). Such a process, which might be termed the 'Washington effect', explained earlier in the chapter, as distinct from the 'California effect' (Vogel 1995), opens up two major strategies for foreign firms. The first is proactively forging alliances with U.S. firms in the first stage to prevent such national environmental regulations from coming into force (or doing so in such a way that exempts Canadian firms from its application) and thus provides privileged access into the U.S. market.

The second is to pre-emptively create an international standard (at or near the higher U.S. level or acceptable to the dominant U.S. industry-environmental-government alliance) before the damaging threat of unilateral sanctions emerges. The presence of a three country regional forum, in which the U.S. government feels comfortable, and with effective institutions to devise, implement and enforce such standards, is a major asset, particularly to home-based exporters in Canada and Mexico. It helps to speed up the second strategy, given the slowness of the broad multilateral process and the latter's anti-environmental bias arising from the large number of developing countries exercising a drag effect.

At the firm level, the high degree of intrafirm integration between Canada and the United States provides MNEs with a strong incentive to eliminate potential trade sanctions that might impede their production systems. At the same time, the presence of a sanctionist regime (through fines, trade penalties or domestic court action), has an impact in inhibiting U.S. firms from lowering the effective environmental regulatory burden in their prized domestic market and reaping the rewards which may ensue. It is thus a victory for Canadian and Mexican domestic firms subject to U.S. import competition, and home based exporters (competing against domestic U.S. rivals in the U.S. market) at the expense of their U.S. equivalents, while having an essentially neutral effect on U.S., Canadian and Mexican home-based MNEs.

Looking ahead, the greatest value of NAFTA's environmentally-related institutions will come in altering the interests of their governments and firms, and enhancing their capacity to advance common North American interests in broader multilateral forums. The trend toward broadly multilateral standardization will primarily benefit U.S. MNEs whose broadly dispersed international markets and production create an overwhelming interest in a single, high level environmental standard worldwide. The trend toward a regional caucus and common North American standards, distinct from that of the rest of the world, will primarily benefit Canadian and Mexican MNEs and exporters, as their major markets and production sites are primarily located in the United States and North America itself. It is even possible that regionally distinct standards (perhaps extended from the NAFTA three to Chile and Latin America) will be the domain in which the largest convergence of industry and environmental interests is found.

Conclusions

As firms operate in a more complex environmental regulatory system, they are faced with numerous challenges and opportunities. Firms at all levels need to take account of the new environment for complex institutional responsiveness, that is, careful strategic planning is required in order to navigate around these challenges and make the most of these competitive opportunities. Traditional corporate and political strategies available prior to the advent of the major multilateral and regional trade liberalization initiatives are no longer the most effective course of action. They tend to be reactive rather than proactive, and fail to take account of the realities in which firms must operate today where business is internationalized, environmental regulation is rapidly changing and a new international institutional structure exists.

Conditions of complex institutional responsiveness offer a much broader array of both corporate and political strategies, which take account of the new regulatory, competitive and institutional processes at work. In the case of NAFTA, its new set of international institutions charged with trade and environment responsibilities has provided multiple opportunities for firms which they are beginning to utilize. The NAFTA institutions have had particular success in constraining the emergence of 'green' protection at all levels of regulation, facilitating regulatory convergence, and developing a North American 'voice' to combat protection beyond its borders and influence the development of standards in international bodies. In the future, sectors where there is a high degree of both region-wide integration and institutional-based regulatory convergence will be best poised to take advantage of the new environment for complex institutional responsiveness.

The array of corporate and political strategies discussed in this paper can be generalized beyond the North American experience. The shifts from traditional to new corporate and political strategies are relevant for firms operating under the GATT/WTO, the E.U., FTAA, and to some extent APEC. Where the conditions for complex institutional responsiveness are present (as they are embodied in NAFTA), there is a rational incentive on the part of firms to use the new, rather than old, strategies of complex institutional responsiveness. Complex institutional responsiveness is not the fate of North American and European firms only. Rather, it is expected that the conditions of complex institutional responsiveness will develop and gain momentum over time. And thus one can expect that firms will embrace these strategies as new institutions develop, as environmental concern becomes more pressing and the conduct of business becomes ever more international.

Update: Corporate Strategy and Chapter 11 of NAFTA

The small number of Chapter 11 cases over the first seven years of NAFTA suggest that firm strategies are not being affected by the chapter 11 provisions.

Table 1 lists the fourteen Chapter 11 investor-state dispute settlement cases that have arisen under NAFTA's investment provisions. These are cases where individual investors can seek compensation against government for a discriminatory trade-related environmental measure. The most famous of these cases is the Canadian government's 1997 ban on trade in MMT, a gasoline additive produced by US-based Ethyl Corporation.

The NGOs have totally misrepresented the Ethyl MMT case, which was an example of the choice of the wrong policy tool by Canada's then Environment Minister, Sheila Copps. She chose, with Bill C-29, to ban international and interprovincial trade in MMT but not its production in Canada. The ban on interprovincial trade violated Canada's Agreement on Internal Trade and the ban on international trade was at variance with the NAFTA-based principle of national treatment. Ethyl Canada was denied national treatment as Sheila Copps banned its foreign-made MMT but not (potential) domestic production. Instead of introducing a trade-related environmental barrier to foreign business, Sheila Copps should have banned all production of MMT, domestic as well as foreign. Then the discriminatory treatment of Ethyl would have been avoided and the chapter 11 investor-state dispute settlement procedures would have been redundant.

The first Chapter 11 case involving Mexico was the Desona case. In this, the US company argued that a Mexican municipal government cancelled its contract to collect municipal waste, develop a landfill and build a new power plant. The NAFTA arbitration panel threw out this claim by Desona.

In contrast, US company Metalclad was awarded US$16.7 million in damages for denial of permission to build a new hazardous waste facility in Mexico. The dispute settlement tribunal ruled that there was expropriation and denial of national treatment to Metalclad.

A Canadian company, Methanex, is currently claiming that California's ban on MTBE (a methanol-based product to reduce carbon monoxide emissions) has denied it profits of US$970 million. It will probably lose the case as the Californian ban on MTBE did not violate national treatment, Hufbauer et al (2000) p.14.

Table 1 also reports a total of 28 citizen and NGO cases under Articles 14 and 15 of the NAAEC. In these 28 cases, Mexico was the defendant in 11; Canada in 9 and the United States in 8. Of the 28 cases, the CEC Secretariat considered that 7 cases were unwarranted, another was withdrawn, and 11 were under consideration in mid 2000. Only 2 factual records had been published by the CEC by mid 2000. In the Cozumel Pier case the Mexican government eventually declared Cozumel Island a protected natural area. The CEC has also published a record which found against Canada in the British Columbia hydroelectric dam case, and is preparing one in the Tijuana smelter case. There is no evidence to date that these Article 14 and 15 cases have either promoted or denied better environmental practices in

NAFTA countries, although in Cozumel and British Columbia hydroelectric, the efforts of NGOs were largely successful.

Table 1 here

Given the thousands of firms involved, either directly of indirectly, in NAFTA-based trade and investment, the obvious conclusion is that the economic effect of chapter 11 is trivial. Recent data in Rugman (2000) suggests that US$500 billion of trade is conducted between the three NAFTA partners. Of this, the total volume of trade subject to chapter 11 is, indeed, trivial, as it is under 0.01 percent. The total value of the eight environmentally-related chapter 11 cases is US$1.7 billion, but actual and potential settlements run well under this, Hufbauer et al (2000). For example, the Ethyl Corporation MMT claim of US$250 million was actually settled for only US$13 million; the Desona claim was for only US$20 million, and was lost; Metalclad was awarded US$16.7 million of the US$90 million claimed. All of these are, indeed, trivial amounts when compared to the total volume of NAFTA-based trade.

In other words, while some trade lawyers and misinformed NGOs may become excited by Chapter 11, from the viewpoint of the managers who actually conduct NAFTA trade and investment, it is not on their radar screen. Thus, as a business school professor, my remarks on the economic strategic management aspects of Chapter 11 are brief; they do not matter.

Table 1:

Numbers of Environmental Dispute Cases under NAFTA, 1994-2000

	Chapter 11 Cases	NAAEC Article 14.15 cases
1994	0	
1995	1	2
1996	4	3
1997	0	8
1998	6	6
1999	2	3
2000 †	1	6
Total	14*	28

* of which, eight are environmentally related

† first 6 months of 2000

Sources: Gary Hufbauer, et al (2000) ; Howard Mann and Konrad von Moltke (1999)

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