

NAFTA REVISITED

Jeffrey Schott and Gary Hufbauer

From the Peterson Institute in Washington, leading American trade policy authorities Jeffrey Schott and Gary Hufbauer consider the results under the North American Free Trade Agreement among Canada, the US and Mexico since 1994. "NAFTA was and is foremost a commercial agreement and in commercial terms the pact is a great success," they write. "Between 1993 and 2006, trilateral merchandise trade rose almost three-fold, now exceeding \$800 billion annually." On the jobs front, "US employment rose from 110 million in 1993 to 144 million in 2006 and in Canada from 13 to 16 million," although "NAFTA is no more than a blip on the US employment picture." They conclude: "NAFTA succeeded in advancing economic integration and the goals agreed to in the pact — though not in reaching the inflated promises of politicians when the agreement entered into force."

Jeffrey Schott et Gary Hufbauer, experts en politique commerciale rattachés au Peterson Institute à Washington, analysent les résultats obtenus en vertu de l'Accord de libre-échange nord-américain par le Canada, les États-Unis et le Mexique depuis 1994. « L'ALENA était et reste avant tout une entente commerciale et elle constitue à cet égard une grande réussite », estiment-ils. « De 1993 à 2006, le commerce trilatéral de marchandises a presque triplé pour dépasser aujourd'hui les 800 milliards de dollars annuels. » Et le nombre d'emplois a augmenté de 110 à 144 millions aux États-Unis et de 13 à 16 millions au Canada. « L'ALENA, concluent-ils, a fait progresser l'intégration économique et les objectifs convenus par ses signataires, sans toutefois remplir les promesses exorbitantes faites par les politiciens lors de son entrée en vigueur. »



At the end of 2006, the North American Free Trade Agreement (NAFTA) covered a combined economy of more than \$14 trillion and a population of about 435 million people. Throughout its duration, NAFTA has been hailed by some and derided by others. Proponents laud the pact's contribution to regional trade and investment, and argue for an acceleration of the integration process. Critics focus on NAFTA's impact on wages and jobs because of growing competition and immigration; some fear that increased cooperation will lead to a loss of sovereignty. Labour unions continue to attack trade pacts using their old rallying cry, "No More NAFTAs."

In the presidential pre-primaries in 2007, the leading Democratic contenders (Hillary Clinton, Barack Obama and John Edwards) all voiced skepticism about trade pacts and globalization, echoing the anti-NAFTA rhetoric of the past. Thirteen years after NAFTA entered into force, the political debate remains confused and divisive. Why confused? Much of what was promised from NAFTA could never be achieved solely through a free trade deal; much of what has occurred since NAFTA cannot be attributed to the agreement. Trade agreements create opportunities; they don't guarantee results.

Why divisive? The fractious NAFTA ratification debate has had lingering effects in Washington, as evidenced by dwindling Democratic support for major trade bills over the past decade in response to constituent pressures and in retaliation for the highly partisan tactics of the Republican leadership during the period 1994-2006.

Ironically, NAFTA critics devote less attention to the pact's most glaring shortcomings. Energy and border security have captured the political spotlight, yet minimal progress has been achieved on both files. Additionally, Mexican GDP growth has averaged only 3 percent per annum since 1993. The record for 2006 and 2007 might reach 4 percent, still well below Mexico's potential and a far cry from Asian growth rates. The Mexican political system has not delivered the tax and energy reforms that would generate new resources to fund investments in physical infrastructure, social services and education. Mexico has neither roused the drug lords nor eradicated the corruption mentality. These factors have limited Mexico's ability to take full advantage of NAFTA, and indeed have put Mexican industries at a competitive disadvantage, particularly against Chinese firms.

Meanwhile, the Canadian dollar has strengthened from \$US 0.77 in 1993, and a low of \$US 0.63 in 2002, to a robust \$US 0.95 in July 2007. The Canadian pay packet now buys almost 50 percent more in US dollar terms than it did in 2002. However, the good fortunes of the Canadian economy owe much to the global resource boom and little to NAFTA.

A trade agreement can be assessed against many standards. We apply a

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straightforward test: how well did the three countries meet the objectives set out in NAFTA Article 102, namely to

- Promote trade and investment
- Increase employment and improve working conditions and living standards
- Manage trade relations and disputes
- Strengthen and enforce labour and environmental laws and regulations
- Cooperate in regional and multi-lateral trade forums

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While NAFTA is comprehensive compared to other trade agreements, in some areas its footprint is small. For example, NAFTA has no rules on subsidies, nor on anti-dumping or countervailing duties; its side pacts on labour and the environment are limited in scope and not backed by meaningful funds; and Mexico avoided significant obligations in the energy sector.

In addition, NAFTA lacks the medicinal powers to cure important ills of North America, including high levels of illegal immigration and trafficking of illegal drugs, slow progress on environmental problems, growing income disparities (particularly within Mexico) and weak growth in real wages. Some of these problems are cor-

relates of economic integration and higher incomes, though NAFTA is only a small part of the story.

NAFTA was and is foremost a commercial agreement, and in commercial terms the pact is a great success. Between 1993 and 2006, trilateral merchandise trade rose almost three-fold, now exceeding \$800 billion annually (figure 1). US-Mexico trade has expanded at a particularly rapid clip, much faster than US merchandise trade with the world.

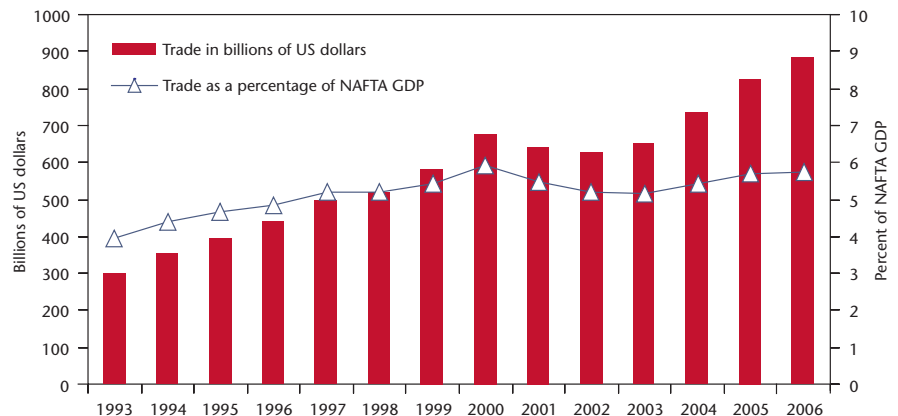
Average annual growth in US-Canada trade did not change significantly after NAFTA: the growth burst in US-Canada trade followed the Canada-US FTA, which entered into force in 1989. On the other hand, Canada-Mexico trade increased rapidly, albeit from a tiny base. Much of NAFTA commerce is concentrated in autos and parts, and energy, which together account for a third of regional trade. By contrast, cross-border services trade flows (not including remittances to Mexico) have grown at a more measured pace. The explanation probably lies in the high level of openness between Canada and the United States pre-NAFTA, and the delayed effect of NAFTA on US-Mexico services trade.

One of the key Mexican objectives in NAFTA was to increase foreign direct investment (FDI), and here again the pact has had a positive impact. The stock of FDI in Mexico from all sources has increased more than four-fold since 1993. The real spurt has come from European, Asian and Canadian investment, not the United States, as NAFTA — buttressed by the peso crisis of 1994-95 — prodded Mexico to adopt broad-based reform of its investment policies.

Canadian FDI flows to and from the United States have consistently increased, but the US share of total FDI flows into Canada has steadily decreased. The investment story in Canada is dominated by three themes: energy and other natural resources; the entry of Asian and European firms; and a winding down of US plants that were established to jump the pre-Canada-US FTA tariff wall. Only the third theme can be attributed to free trade pacts.

NAFTA's first decade coincided with an extended period of strong US economic growth — with positive knock-on effects for its neighbours. Total employment was up in all three countries. US employment rose from 110 million in 1993 to 144 million in 2006 and in Canada from 13 million to 16 million. Jobs in the formal sector in

FIGURE 1. TRILATERAL MERCHANDISE TRADE BETWEEN THE US, CANADA AND MEXICO, IN BILLIONS OF US DOLLARS AND PERCENTAGE OF NAFTA GDP



Source: IMF Direction of Trade Statistics — July 2007. Figures represent the sum of exports from each NAFTA partner to the other two countries.

Mexico increased from 33 million to 44 million. But not every worker or community benefited, and national trade adjustment programs for hard-hit workers and communities remain meager.

On an annual basis, depending on who is counting, NAFTA-related job losses in the United States ranged between 60,000 and 190,000. Since the total number of US jobs *increased* substantially during NAFTA's first decade, even the top

In the grand scheme of economic forces, NAFTA is no more than a blip on the US employment picture. Formal employment in northern Mexico has clearly benefited from NAFTA. In Canada, the strong dollar has taken a sharp toll on manufacturing jobs in Quebec and Ontario, which also feel pressure from the energy boom that has shifted jobs to the western provinces.

number for annual job losses — running at about 1.9 million over a decade — is small compared to the number of jobs “created,” and represents a fraction of 1 percent of jobs “lost” through turnover in the dynamic US economy over a decade. In the grand scheme of economic forces, NAFTA is no more than a blip on the US employment picture. Formal employment in northern Mexico has clearly benefited from NAFTA. In Canada, the strong dollar has taken a sharp toll on manufacturing jobs in Quebec and Ontario, which also feel pressure from the energy boom that has shifted jobs to the western provinces.

What about wages? Some NAFTA critics — echoing the theories of Stolper and Samuelson — charge that trade pacts drive down wages of unskilled workers. In *NAFTA Revisited*, we examined the relationship of trade and wages in the NAFTA context and could not detect a material difference in US wage rates between states and industries with a large volume of US imports from Mexico and those with a small volume. By far the most important channel by which Mexico influences US wages is immigration, legal and illegal. Immigration is a direct result of geographic proximity; it is not driven by NAFTA.

NAFTA incorporated six dispute settlement processes to manage and expedite the resolution of disputes among the three countries. The six processes are Chapter 11 (investment), Chapter 14 (financial services), Chapter 19 (anti-dumping and countervailing duties), Chapter 20 (functioning of the agreement), the NAALC (labour), and the NAAEC (environment). Apart from Chapter 19, some of the other dispute

processes contain procedures that are intentionally cumbersome and rely heavily on consultation rather than litigation (notably the side pacts on labour and the environment).

In general, the dispute settlement process has worked relatively well in cases where the NAFTA obligations were clearly defined (including most Chapter 19 cases involving the *ex post* review of national anti-dumping and countervailing duty determinations), but poorly in big cases where domestic politics blocked treaty compliance (notably, US-Mexico trucking, Canada-US softwood lumber and US-Mexico sugar and HFCS). With the exception of US-Mexico trucking, however, even the big cases (softwood lumber, sugar and HFCS) are being resolved with large helpings of political grease.

While anti-dumping and countervailing cases are by far the most numerous, the most controversial dispute provisions cover investor-state disputes under Chapter 11. When NAFTA was signed, the Chapter 11 provisions were relatively uncontroversial; in fact, NAFTA arbitration was hailed as an improvement over national courts. In practice, however, rules regarding “indirect expropriation” under Article 1110 and requirements for minimum

legal standards under Article 1105 have fostered a broader range of litigation than originally envisaged.

NAFTA critics assert that Chapter 11 tribunals are riding roughshod over state and local environmental standards. There is no basis for this assertion: total awards to date are less than \$100 million — a small fraction of the overblown claims of business plaintiffs and a tiny amount compared to three-way FDI within NAFTA, now amounting to almost \$900 billion.

The North American Agreements on Labor Cooperation and on Environmental Cooperation were negotiated and appended to the NAFTA in 1993 at the behest of President Clinton to encourage US congressional ratification of the pact. These side agreements announced three specific objectives: monitor implementation of national laws and regulations pertaining to labour and the environment, provide resources for joint initiatives to promote better labour and environmental practices, and establish forums for consultations and dispute resolution. In practice, however, the two side agreements have furthered only marginal improvements in labour and environmental conditions.

Although NAFTA itself has not expanded beyond the three original members, its provisions have served as precedents for bilateral FTAs between the United States and other countries. The basic NAFTA model has been subsequently refined. Most notably, labour and environmental obligations have been moved from side agreements into treaty text. The shift was conspicuous in the case of US FTAs negotiated with Central America, the Dominican Republic, Panama, Peru and Colombia. In response to sovereignty concerns, investor-state dispute settlement provisions (Chapter 11) have been modified; however, nothing akin to Chapter 19 arbitration exists in post-NAFTA agreements.

Indirectly, NAFTA played a role in facilitating the liberalization of world trade. The agreement helped provide the final push to the completion of the Uruguay Round, which was signed in April 1994. In the wake of NAFTA, Mexico has become a world leader in bilateral FTAs, compiling agreements with more than 30 countries, including pacts with the European Union in 2002 and Japan in 2004. Canada and the United States have also negotiated several new FTA pacts. These post-NAFTA pacts usually contain provisions on the liberalization of services trade that go far beyond the accomplishments of the WTO General Agreement on Trade in Services (GATS).

NAFTA was state of the art when negotiated in the early 1990s. Fifteen years later, the pact could benefit from renovation, for three reasons:

- Important items were excluded from NAFTA coverage (including some farm products, energy investment in Mexico, rules on subsidies and dumping, and migration).
- Several NAFTA provisions were poorly constructed and should be recast (including rules of origin, labour and environmental side accords, and some dispute settlement procedures and definitions).
- New conditions have emerged that were not on the radar screen of the original NAFTA draftsmen — importantly security concerns and electronic commerce.

In other words, despite a decade of progress, the three NAFTA partners still have a lot of work. Melding the security and economic objectives of the three countries will require large doses of political will and diplomatic skill.

To take full advantage of NAFTA's opportunities, Mexico must invest heavily to redress its own energy shortages, and to upgrade its roads, ports,

telecommunications networks and public services. Doing so would create better opportunities for economic development in the poorer regions of southern Mexico and would curb the "Mexico cost" that weighs heavily on the international competitiveness of Mexican industries.

Canada has fewer shortcomings. While the country is still riding on a natural resource boom, however, the government should reform the corporate tax system (one of the world's most burdensome) and invest heavily in hard and soft infrastructure to better integrate Canadian merchandise and people

The US-Mexico trucking dispute is another lingering disagreement. The North American trucking sector was to have been fully liberalized in January 2000, but the United States repeatedly appealed to safety and environmental issues to prevent the entry of Mexican trucks. The real issue, of course, was opposition from the Teamsters union. The consequence was the creation of a highly inefficient "commercial zone" at the border which requires the use of drayage trucks to link US and Mexican long-haul trucks.

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The United States needs to streamline its security measures for cargo and travellers on both the northern and southern borders. Closer cooperation on security initiatives is essential to ensure efficient flows of goods and people. Resolving the trucking dispute with Mexico will be an essential component of the larger security agenda.

The NAFTA partners now face an increasingly competitive and security-conscious world. To enhance the global competitiveness of North America, the Regulatory Cooperation Framework was created in 2006 to reduce redundant testing and promote compatibility of regulations. The Intellectual Property

Action Strategy targets counterfeiting and piracy. While the Montebello Summit, held in August 2007, confirmed progress in both areas, these are modest achievements. We recommend bolder progress in three concrete areas.

First, by adopting a NAFTA common external tariff, the partners could promote commerce among themselves while reducing distortions generated by NAFTA rules of origin. (Since 2005, three rounds of reforms on rules of origin have already facilitated an estimated \$130 billion in trilateral trade). Second, the NAFTA partners need a higher level of cooperation on domestic regulatory standards, particularly in the area of food safety. Third, leaders in the three countries should direct their ministers to ensure that longstanding trade disputes are resolved. The most prominent disputes involve softwood lumber, sugar and trucking. All three are on track toward resolution; what leaders must do is ensure that the disputes don't jump off their tracks.

The softwood lumber dispute originated between Canada and the United States in the early 1980s and has gone through several rounds of litigation and conciliation. In April 2006, after decisions by NAFTA and WTO panels that favoured Canada, the two countries reached an agreement to settle the latest round. The United States promised to return 80 percent of duties levied while Canada promised to restrict its exports if prices dropped too far. A year later, however, the United States has launched arbitration proceedings claiming that Canada is not carrying out its end of the bargain. When the arbitration reaches its conclusion, the decision must be then faithfully observed by both countries.

While the original sugar side letter to NAFTA significantly limited Mexican shipments, all restrictions on

the US sugar market are scheduled to be lifted on January 1, 2008. It appears that the United States will comply by converting additional imports of Mexican cane sugar into subsidized ethanol. As part of this convoluted bargain, Mexico should eliminate its tax on US corn sweeteners. Leaders need to ensure that these interlocking steps happen on schedule.

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In February 2007, the United States and Mexico finally agreed on a pilot program that allows 100 trucking companies based in Mexico to make deliveries in the United States, and 100 US companies to do business in Mexico. However, in July 2007, the US House of Representatives approved an amendment that would postpone implementation until October 2008. President Bush needs to stand firm against these delaying tactics.

Since September 11, 2001, and especially since the Iraq war began in 2003, crude oil prices have soared, and US policy-makers have rediscovered their latent concerns over the adequacy of regional energy supplies. Development of oil and gas fields, as well as construction of new energy distribution channels, has likewise become a high priority — though for somewhat different reasons — in both Canada and Mexico. Three important problems continue to fester.

First, the region is not producing enough oil and gas, given its vast reserves. Coupled with a sharp decline in spare production capacity world-

wide, North America is now more vulnerable to volatile energy price swings.

Second, inadequate investment in new refineries has created supply bottlenecks for refined products. Here again, new NAFTA projects could insure against supply disruptions elsewhere in the world.

Third, the blackout that deprived 50 million Americans and Canadians of electricity in August 2003 underscored the problems of aging electrical transmission systems. The regulatory reforms needed to spur new infrastructure investment have long been debated; reforms usually run afoul of state or provincial rules. Federal preemption may be the only answer.

The NAFTA partners will not achieve energy independence in the foreseeable future, given existing sources and reserves of fossil fuel, but they can strengthen the region’s energy security by working together. At the Montebello summit, all three countries expressed the desire to investigate ways to cooperate on national auto fuel efficiency standards. The Canadian province of Alberta

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expects to invest \$100 billion to develop its gas reserves and oil sands over the next decade, and much of the new energy will be sold to the US market.

South of the US border, it’s a different story. Mexico is an energy-rich country with energy shortages. Current policies impede the development of Mexican oil and gas resources and prevent adequate investment in power generation and distribution. The Mexican government drains revenue from the state-owned petroleum company Pemex to cover its own budget needs, and the Mexican constitution forecloses foreign investment in energy production or distribution.

Both problems are well understood by President Calderon, and possibly he will mobilize the political force necessary to make a dent in the energy picture during the second half of his six-year term in office.

Tremendous numbers of Mexicans and Canadians cross the US border each year: most legally for commercial reasons, employment or tourism; some, including an estimated 400,000 Mexicans, illegally. There is a clear *security* imperative to better monitor and control these flows; at the same time, there is an *economic* imperative to maintain unfettered access for legitimate purposes. The Security and Prosperity Partnership launched in 2005 aims to achieve a balance between the two goals. The need for increased cooperation and mutually acceptable inspection protocols was reiterated by the US, Canadian and Mexican leaders at the Montebello summit.

US legislation to enhance security by scanning all containers entering the United States awaits congressional approval in the fall of 2007. The ship-

ping industry warns that the bill as drafted would severely increase congestion in cargo handling systems. The costs of installing and monitoring scanners will be high. Non-compliance would effectively stop all shipments from an offending country to the United States. Whatever the international resolution may be, the top priority for NAFTA is to ensure that shipments within North America move smoothly — through compliance at the point of origin and through sophisticated tracking of trucks, railcars, cargo planes and ships as they haul merchandise across the land, air and sea borders.

Ottawa, Washington and Mexico City should forge common visa and biometric standards for non-NAFTA visitors and immigrants. This goal is highly significant from a security standpoint, and North America needs a shared system for excluding non-NAFTA nationals who pose a security threat. As well, NAFTA partners should create a special force to handle all third-country

third idea has gained political traction and funding in the United States. While the whole package does not add up to “silver bullet,” it would vastly improve the current array of “don’t ask, don’t tell, don’t care” policies.

The NAFTA labor and environmental side agreements were not designed with enough ambition to

can provide the political impetus to craft successful policies. When the United States moves to rationalize its own immigration law, it will be the primary beneficiary of a more secure border and a more accountable workforce. In Canada, improved border security measures will protect against disruptions in US-Canada trade — a matter of growing concern for firms already producing in

Canada, as well as those considering additional investments. Mexican energy reforms will boost industrial production by stimulating new investment in oil and gas field development, power generation, and transmission, which in turn will

provide Mexican homes and factories with more reliable sources of energy.

In other words, it would make economic sense for many of our proposals to be implemented on a unilateral basis. But in the real world of give-and-take politics, these reforms may be possible only in the context of a fresh round of NAFTA negotiations.

Given increasingly tough global competition and global security threats, the three countries need a more integrated response from North American leaders. So far, leaders have allowed the North American agenda to slip further down on their priority lists. While NAFTA encouraged broader structural reform, it left the hard task of reaping the opportunities to each government. As evidenced at the recent Montebello summit, the three countries are not yet fully committed to the task.

This piece is updated from an article with the same title that appeared in the Melbourne Review (Jeffrey Schott and Gary Hufbauer, “Nafta Revisited,” the Melbourne Review, May 2006, volume 2, number 1). The authors are senior fellows at the Peterson Institute for International Economics in Washington. They were assisted by Claire Brunel, a research assistant at the Institute. Opinions expressed are the views of the authors, and not necessarily the views of the Peterson Institute or its staff.

The recent Montebello summit clearly identified the pressing need for an integrated approach to climate change and energy security, while reducing barriers to the development of new and clean technologies. The energy science and technology agreement, signed in July 2007, aims to promote progress in those technologies.

immigration controls at the individual’s first airport of entry into NAFTA space.

Likewise, the partners should create a more efficient system for handling legitimate travellers. The US-Canada Smart Border accord contains useful elements: high-tech identity cards for permanent residents, biometric identifiers and pre-clearance programs for frequent travellers, known as INSPASS at airports and CANPASS at land borders. The same system should be extended to cover visitors arriving from Mexico.

Finally, and most difficult, the United States and Mexico need to devise new policies for improving the life chances of some 10 million illegal Mexican immigrants who have built permanent homes and livelihoods in the United States, and for regulating the illegal inflow numbering some 400,000 Mexicans annually. In 2007, President Bush sponsored legislation that tracked suggestions offered by ourselves and other observers; unfortunately, the President’s proposals ran into a brick wall of Republican opposition. Still the ideas make sense: first, a modified amnesty program for illegal immigrants who have lived and worked in the United States for a considerable period free of encounters with the law; second, a sharp expansion of temporary work visas; and third, more rigorous control of the border. Unfortunately, only the

address labour and environmental problems that have been decades in the making. For labour, we recommend that NAFTA institutions should concentrate their attention on basic standards relating to workplace conditions, child labour, and forced labour.

For the environment, we recommend substantial financial commitments to underpin existing and new initiatives. The North American Development Bank (NADBank) is woefully under-funded, and Mexican municipalities are starved of revenues. The NADBank’s capital base should be increased incrementally from \$4.5 billion to \$10 billion. Instead of a 50-50 split between the United States and Mexico, the funding should be 75-25. For its part, the Mexican federal government should assist municipalities to levy and collect property taxes and dedicate the revenues to environmentally sound infrastructure improvement — basic needs like water, sanitation and paved roads.

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In large measure, our North American agenda is about enlightened self-interest. An international agreement