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NAFTA
An Assessment

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1

Overview and Scorecard

On 17 December 1992, the United States, Canada, and Mexico signed a historic trade accord. The North American Free Trade Agreement (NAFTA) is the most comprehensive free trade pact (short of a common market) ever negotiated between regional trading partners, and the first reciprocal free trade pact between a developing country and industrial countries. The NAFTA is scheduled to enter into force 1 January 1994, after ratification by the three legislatures.

In the United States, the process of formulating implementing legislation will begin in the new Congress, which convened in January 1993. Because the NAFTA was signed before fast-track provisions of US trade law expired, there is no statutory deadline for submitting implementing legislation. However, as a practical matter, given the 90 session days allowed for congressional action and the political calendar in Canada and Mexico, US implementing legislation must be submitted to Congress by summer 1993 if the NAFTA is to enter into force, as envisaged, in January 1994.

Delay in US ratification of the NAFTA could complicate the timetable of parallel efforts in Canada and, to a lesser extent, Mexico. In Canada, the Mulroney government must stand for election by late November 1993, so it will likely seek to approve the NAFTA in advance of US action to preclude the pact from becoming the focal point of the election, as the Canada-US Free Trade Agreement (FTA) was in 1988. In Mexico, the Salinas government has a longer tenure but would like the NAFTA to enter into force before the ruling party (PRI) nominates its candidate in summer 1994 to succeed Salinas in December 1994.

In this book, we summarize the central provisions of the NAFTA text, evaluate the economic impact of the agreement, and score the results against the recommendations of our earlier book (Hufbauer and Schott 1992a). This assessment is not intended as a legal guide or a negotiator's memoir. We leave those books to other authors. Our purpose is to provide a road map so that legislators, businessmen, labor leaders, and environmentalists can get a quick handle on the agreement.

Much of our analysis focuses on issues related to Mexico's participation in the pact, and in particular, the labor and environmental concerns that have dominated the US debate on NAFTA during the 1992 election and that will be a central theme in the ratification debate. Since the NAFTA incorporates much of the existing Canada-US FTA, we have limited our analysis of US-Canada issues to those areas where the NAFTA modifies or augments FTA provisions.

NAFTA Highlights

In essence, the NAFTA is a new, improved, and expanded version of the Canada-US FTA. In large part, the agreement involves commitments by Mexico to implement the degree of trade and investment liberalization promised between its northern neighbors in 1988. However, the NAFTA goes further by addressing unfinished business from the FTA, including protection of intellectual property rights, rules against distortions to investment (local-content and export performance requirements), and coverage of transportation services.

The NAFTA provides for the phased elimination of tariff and most nontariff barriers on regional trade within 10 years, although a few import-sensitive products will have a 15-year transition period. US-Canada bilateral tariffs will continue to be phased out according to the FTA schedule, that is, by January 1998. In addition, the NAFTA extends the innovative dispute settlement procedures of the FTA to Mexico (in return for a substantial revamping of Mexican trade laws that injects more transparency into the administrative process and brings Mexican antidumping and other procedures closer to those of the United States and Canada); contains precedent-setting rights and obligations regarding services and investment; and takes an important first step in addressing cross-border environmental issues.

The agreement contains notable commitments with regard to liberalization of trade and investment. First, the NAFTA establishes within 15 years free trade in agricultural products between the United States and Mexico. The accord immediately converts key US and Mexican agricultural restrictions into tariff-rate quotas and sets a maximum 15-year period for the phase-out of the over-quota tariffs—an impressive achievement considering the dismal track record of other trade talks in reducing long-standing farm trade barriers.

Second, the investment obligations of the NAFTA (and related dispute settlement provisions) accord national treatment to NAFTA investors, remove most performance requirements on investment in the region, and open up new investment opportunities in key Mexican sectors such as petrochemicals and financial services. The investment provisions provide a useful model for future GATT trade accords, despite the notable exceptions for primary energy and Canadian cultural industries.

Third, the pact sets important precedents for future regional and multilateral negotiations by substantially opening the financial services market in Mexico to US and Canadian participants by the year 2000 and by removing significant obstacles to land transportation and telecommunications services.

Finally, the NAFTA offers a schizophrenic result in textiles and apparel. On the one hand, the pact calls for the elimination of all tariffs and quotas on regional trade in textiles and apparel (except for a special US quota for Canadian apparel producers that do not meet the strict regional rules of origin). This is the first time in this heavily protected sector that imports from an important developing-country supplier have been significantly liberalized by the United States and Canada. However, the rules of origin established to qualify for duty-free treatment are highly restrictive. If not coupled with prospective GATT reforms, the cumulative result could be strongly trade diverting.

The NAFTA is a noteworthy achievement, but its implications for Mexico, Canada, and the United States should not be exaggerated. By widening the scope of the market and enlarging the range of available labor skills, the NAFTA enables North American firms and workers to compete more effectively against foreign producers both at home and in world markets. But the ability of the NAFTA partners to gain maximum benefits from the pact with minimum adjustment costs depends importantly on maintaining domestic economic policies that ensure growth. Firms will still look first and foremost at the macroeconomic climate in each country in setting their investment priorities.

Implications for Mexico, the United States, and Canada

For Mexico, the NAFTA reinforces the extensive market-oriented policy reforms implemented since 1985. These reforms have promoted real annual growth of 3 to 4 percent in the 1990s and a falling rate of inflation. The NAFTA portends a continuation of the fast pace of change in the Mexican economy by extending the reform process to sectors such as autos, textiles and apparel, finance, telecommunications, and land transportation. Mexican exporters will also benefit in two distinct ways: the relatively unfettered access to the US market that they already enjoy under various unilateral US programs will be sustained, and the few remaining US trade barriers will be liberalized.

The prospect of NAFTA implementation has already generated strong expectational effects, with capital inflows to Mexico estimated at about \$18 billion in 1992 (of which about \$5 billion was probably foreign direct investment).[1] These large inflows are the financial counterpart to the growing Mexican current account deficit generated by imports of machinery, equipment, and other capital goods—all essential ingredients for the sustained development of the Mexican economy.

However, a major cloud must be noted over Mexican skies: the government of Mexico seems determined to bring inflation down from its current rate of 10 to 15 percent to the US rate of 3 to 4 percent through stringent monetary policy, without permitting a significant devaluation of the peso. This approach could put the Mexican economy in a straitjacket, akin to the experience of the United Kingdom prior to the breakdown of the exchange rate mechanism in September 1992, and possibly compel Mexican policymakers to institute policies entailing high interest rates, low growth, and a burgeoning trade deficit for several years. Recognizing these risks, Mexico altered its exchange rate policy on 20 October 1992 and doubled the pace of permitted depreciation of the peso against the dollar from 2 percent to 4 percent per year (*Wall Street Journal*, 21 October 1992, A13). Further steps in this direction may be needed.

For the United States, the NAFTA reforms should enhance an already-important export market. US exports to Mexico have grown sharply since 1986 and now run at an annual rate of about \$42 billion. US suppliers of intermediates, capital goods, and high-technology products should continue to reap large benefits as prime suppliers of the growing Mexican market. Over time, the NAFTA should impel industrial reorganization along regional lines, with firms taking best advantage of each country's ability to produce components and assembled products and thus enhancing competitiveness in the global marketplace.

In addition, the NAFTA meets key US foreign policy objectives. The US debate often ignores the foreign policy dimension, blithely taking for granted that Mexican steps toward economic reform and political pluralism are irreversible. But Mexico's economic reforms are still vulnerable to political and financial shocks, and democratic reforms are still in their infancy. The NAFTA should anchor achievements already made in Mexico and reinforce efforts to promote economic growth and political pluralism in that country.

1. Investment has anticipated trade reforms in Mexico, just as it did in Europe after passage of the Single European Act in 1986, which presaged the internal market reforms of the EC 1992 process.

For Canada, the NAFTA reinforces, and in some cases strengthens, its FTA preferences in the US market. Canada achieved many of its specific objectives in the negotiations, such as clarifying the method used to calculate the regional content for autos and retaining the Canada-US FTA provision that exempts Canadian cultural industries from external competition. In addition, the NAFTA improves Canada's access to the Mexican market. Although Mexico is a relatively small export market for Canada (under $1 billion at present), the NAFTA will expand export opportunities for Canadian firms in several key sectors, such as financial services, automobiles, and government procurement.

NAFTA "Lowlights"

Despite its attractions, the NAFTA does contain warts and blemishes. For example, basic energy remains immune to free trade, progress on labor and environmental issues proceeds in half steps, and the accession clause is no more than a hortatory statement.

But the main area where the NAFTA is open to criticism is its enunciation of restrictive rules of origin. These arcane trade provisions have been aptly labeled "tools of discrimination": they are used to determine which goods qualify for preferential treatment under the NAFTA and to deny NAFTA benefits to those goods that contain significant foreign-sourced components.

Rules of origin are an integral part of all free trade pacts, but the NAFTA provisions pose two distinct dangers. First, to an undue extent, they penalize regional producers by forcing them to source from less efficient suppliers located in the region, thereby undercutting the global competitiveness of the buying firms. Second, the NAFTA rules could establish an unhappy precedent for other preferential trading pacts, which may choose to emulate the restrictive practices articulated in the NAFTA to the disadvantage of the original perpetrators.

The impact of rules of origin in limiting trade liberalization is suggested by comparing actual and hypothetical duty collections on US imports from Canada.[2] Based on 1991 data, duty collections from Canada will eventually drop to about 18 percent of the most-favored-nation (MFN) duty rates rather than the zero level that would occur without rules of origin. In other words, about 18 percent of US imports from Canada will not benefit from the FTA. Obviously, the stricter the rules of origin, the higher this residual percentage will be.

In general, the NAFTA adopts a standard rule that goods containing foreign components qualify for preferential treatment only if they un-

2. This exercise was carried out by Tom Dorsey (1992) of the Office of Management and Budget.

dergo a "substantial transformation" in the region that results in a change in tariff classification of the product. In addition, however, the NAFTA rules of origin for several key sectors have been encumbered by complex value-added tests and requirements that products not be contaminated by key components sourced abroad.

Our concerns about restrictive NAFTA rules of origin arise most prominently in two sectors: textiles and apparel, and autos. In textiles and apparel, the agreement establishes a triple transformation test that makes the already-protectionist rules of origin in the Canada-US FTA seem liberal by comparison. For most products, the NAFTA establishes a "yarn forward" rule, which requires an item to be produced from yarn made in a NAFTA country to qualify for regional preferences. The impact of this rule is somewhat softened, however, by the exemption of a small number of fabrics that only need pass a single transformation test to qualify for preferential treatment and by special quotas under which products that do not meet the origin requirements still qualify for preferential tariff treatment. The intense lobbying that prompted these restrictive NAFTA rules presages the industry's counterattack against the proposed global reform of the Multi-Fiber Arrangement in the Uruguay Round of GATT negotiations. The reform would phase out all quotas over 10 years.

For autos, the NAFTA adopts a "net cost" approach for origin calculations. By itself, this method is an administrative improvement.[3] However, the NAFTA value-added test (62.5 percent for autos, light trucks, engines, and transmissions; 60 percent for other vehicles and parts) is much higher than, and supersedes, the 50 percent requirement of the Canada-US FTA. Moreover, the NAFTA includes tracing requirements to ensure that the foreign component of engines, transmissions, and other specified parts is subtracted when determining whether a vehicle meets the new content requirements. Together these rules substantially raise the overall regional-content requirements for preferential trade in automotive products.

Foreign concern about the potentially adverse trade effects of these provisions will diminish if:

- The three NAFTA partners cut their MFN tariffs substantially in the Uruguay Round (thereby reducing the surviving margin of preference between the NAFTA zero rate tariffs and the MFN rate);
- The three countries move toward the adoption of a common external tariff, especially in autos, thereby mitigating the legitimate worries about potential transshipment of foreign components from one NAFTA partner to another.

3. The net-cost approach subtracts specified administrative expenses from the transaction price to determine the base for calculating the ratio of foreign to regional content.

In contrast to the textiles' and autos' rules of origin, a constructive precedent was set in the rule of origin for computers. The rule is relatively simple: computers qualify as a North American good if the circuit board is made in the region and is further transformed so as to change the tariff classification (e.g., from a circuit board to a partly assembled computer). In contrast to textiles and autos, the NAFTA establishes a common external tariff for computers and related products among the three countries: US and Canadian MFN tariffs (3.7 percent or 3.9 percent, depending on the product) will remain the same (subject to Uruguay Round cuts), but Mexico's external tariff will be reduced from rates of 10 and 20 percent, down to the US and Canadian levels over 10 years (annex 308.1).[4]

NAFTA Ratification: The Clinton Scenario

From the moment NAFTA negotiations were contemplated, US critics focused on environmental and labor provisions. These issues served as lightning rods for the congressional debate prior to the start of NAFTA talks in 1991. At that time, President Bush promised Congress to include environmental safeguards both in the agreement and in parallel bilateral initiatives with Mexico and to ensure that adequate programs address the adjustment needs of US workers dislocated by the NAFTA reforms.

While the NAFTA and the parallel US-Mexico side agreements arguably meet Bush's commitments, they clearly have not satisfied the critics. Even though the NAFTA is probably the "greenest" trade pact ever negotiated, the accord contains far less in terms of rules and enforcement than US environmental interests demanded. Similarly, the NAFTA drew sharp objections from US labor groups because it does not contain "hard" obligations in the area of workers' rights and related labor issues. In both cases, the critics complain that the consultative commissions are of the "meet and greet" variety, rather than forums for progressively upgrading standards and enforcement.

In October 1992 Governor Clinton delivered a major address in which he endorsed the NAFTA, rejected any renegotiation of the text, and enumerated important qualifications (Clinton 1992). With Clinton's election, these qualifications now provide a guide for the requirements for US ratification of the NAFTA.[5]

4. In addition, duty drawback benefits will be phased out over seven years for the maquiladoras, where most Mexican-made computers are produced (US Chamber of Commerce 1992, 32).

5. At a news conference held on 19 November 1992, President-elect Clinton affirmed that the NAFTA is a priority and that while "there are other things that have to be done before the treaty should be implemented by Congressional legislation," he looks forward to working with President Salinas to resolve the outstanding issues (*Washington Post*, 20 November 1992, p. A37).

In broad terms, Clinton sees NAFTA and other trade accords as part of a larger national economic strategy, including changes in the US tax system (i.e., investment tax credits), developing a "conversion plan" for the defense sector, and controlling health care costs. The NAFTA is accordingly regarded as a part of the overall US competitiveness strategy. Moreover, Clinton views the NAFTA as the first step toward developing stronger regional ties, as the United States "reaches down into the other market-oriented economies of Central and South America."

Clinton has enumerated five unilateral measures that the United States should enact in the context of NAFTA implementing legislation. The unilateral steps require worker adjustment assistance (training, health care benefits, income supports, and assistance to communities to create jobs); environmental funding (to ensure environmental cleanup and infrastructure investments in the United States); assistance to farmers (strict application of US pesticide requirements on food imports, plus help in shifting farmers to alternative crops); assurance that NAFTA "does not override the democratic process" (i.e., Clinton would give US citizens the right to challenge objectionable environmental practices in Mexico or Canada);[6] and assurance that foreign workers are not brought to the United States as strikebreakers.

In addition to these unilateral steps, Clinton stated his intention to negotiate three supplemental agreements that would be submitted to Congress in parallel with NAFTA implementing legislation. His proposal was ambiguous as to whether these pacts would be solely with Mexico or trilateral in nature. However, it clearly was motivated by political demands to strengthen US-Mexico provisions.

The first agreement would create an Environmental Protection Commission. The commission, which would be headed by Vice President Gore, would have "substantial powers and resources to prevent and clean up water pollution" and would "encourage the enforcement of the country's own environmental laws through education, training, and commitment of resources, and provide a forum to hear complaints" (Clinton 1992).

A second supplemental agreement would create a Labor Commission that would have powers similar to those of the environment commission to protect worker standards and safety. "It, too, should have extensive powers to educate, train, develop minimum standards, and have similar dispute resolution powers and remedies."

Finally, a supplemental safeguards agreement would be negotiated to deal with instances where "an unexpected and overwhelming surge" in imports from a partner country required temporary protection beyond that provided by the "snapback" clauses enumerated in the

6. This subject, of course, raises issues that could require negotiated commitments with US trading partners.

NAFTA text. The rationale for such a provision would be to provide an additional avenue for temporary import relief to deal with the aftershocks of regional integration. It does not encompass, however, the innovative safeguards mechanism that we advocated for sectors such as autos, textiles, and agriculture.

President Salinas has reacted positively, if not warmly, to these proposals. Indeed, he reportedly suggested that the agenda of these supplemental negotiations be expanded to include a special economic support fund for Mexican development (*Wall Street Journal*, 8 December 1992, A11).

In the relevant chapters that follow, we examine these proposed supplemental agreements in more detail. As with the completed NAFTA text, we offer recommendations regarding the scope and content of the prospective labor and environment pacts.

NAFTA Accomplishments: A Scorecard

In the remaining chapters of this assessment, we examine the accomplishments of NAFTA measured against the yardsticks set out in our 1992 book. When we drafted that book, we regarded our recommendations (which serve here as yardsticks) as the outer limits of what might be accomplished in a long process of integrating the economies of Canada, the United States, and Mexico. We have never viewed the NAFTA text as the final word on economic and social convergence within the huge North America market. Rather, we see the NAFTA as a very large first step, with the implication that further steps will be taken in later years.[7]

What follows are detailed assessments of the key provisions of the NAFTA text, both in terms of individual sectors and in terms of cross-cutting rules. Readers who want a succinct appraisal should turn to the appendix, which summarizes our recommendations, the main elements of the NAFTA text, and the contrast between recommendations and results. For readers who want a very short scorecard, in table 1.1 we have assigned grades for achievements in each area. In this scorecard, a gentleman's B indicates that the outcome just met our recommendations (which demand a high standard of accomplishment), an A indicates an outcome that surprised us for the exceptional progress made toward a free regional market, and a C indicates that the outcome was disappointing.

7. In a sense, the NAFTA for North America is akin to the Treaty of Rome, signed by European Community members in 1957. The parallel is far from exact, however, in that the Treaty of Rome announced as its destination a common market with a major institutional superstructure. By contrast, the NAFTA has as its destination a free trade area with little institutional superstructure.

Table 1.1 Scorecard: How NAFTA rates against the recommendations

NAFTA results	Grade
Market access by sector	
Energy	C+
Automobiles	B
Textiles and apparel	B+
Agriculture	A
Financial services	B+
Transportation	A
Telecommunications	B+
Trade rules	
Rules of origin[a]	C+
Safeguards[b]	C
Subsidies and dumping[c]	B
Dispute settlement[c]	A
Government procurement[d]	B+
New issues	
Investment	A–
Intellectual property	B
Environment	B
Labor adjustment[e]	A
Maquiladoras[d]	B
Average grade	B+

a. Rules of origin are discussed in chapter 1 and in the automobiles and textiles and apparel sections of chapter 3.
b. Safeguards are discussed in chapter 2.
c. Subsidies and dumping are discussed in the dispute settlement section of chapter 4.
d. Government procurement and maquiladoras are not addressed separately in the assessment but are included in the appendix.
e. Labor adjustment is discussed in chapter 2. The grade of A assumes that President Bush's proposed labor adjustment program, or a better program, is adopted.

The overall grade we assign the NAFTA text is a B+. In most subjects, the agreement met our recommendations. In several areas—such as investment, agriculture, transportation, dispute settlement, and labor adjustment—the NAFTA text exceeded our recommendations and receives an A. However, in some areas—energy and rules of origin—the agreement falls short and earns only a C.

2

Trade and Employment

In the United States, opposition to the NAFTA has focused on potential job losses and downward pressure on American wages. The root fear is that low Mexican wages and poor enforcement of Mexican labor standards will attract investment, deprive US workers of their jobs, and drive down US wages. NAFTA opponents point to the fact that average hourly compensation in Mexican manufacturing is only about 14 percent of the US figure: $2.17 in Mexico in 1991 versus $15.45 for the United States (US Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1991," Report 825, June 1992; Faux and Lee). In the third presidential debate, Ross Perot argued that equilibrium would not be reached between the United States and Mexico until Mexican wages rose to $7.50 an hour and US wages fell to $7.50 an hour (transcript of presidential debate, East Lansing, Michigan, 19 October 1992, excerpted in *New York Times*, 20 October 1992, A21).

Resurrection of the Pauper Labor Argument

The fears skillfully articulated in Perot's sound bites and by other NAFTA opponents basically amount to a restatement of the "pauper labor" argument: imports by a rich country from a poor country must inevitably reduce the standard of living in the rich country.[1] The best one-line

1. The "pauper labor" argument was reflected in the Tariff Act of 1922, which significantly

retort was offered by Ambassador Carla Hills: "If wages were the only factor, many developing countries would be economic superpowers" (remarks delivered at the Institute for International Economics, Washington, DC, 21 September 1992).

Ambassador Hills might well have noted that Puerto Rico has enjoyed free trade with the United States for decades. Yet a major gap still separates manufacturing wages in the United States and Puerto Rico. In 1987 the average payroll per production worker in Puerto Rican industry was only $11,170, compared with the US level of $20,540 *Statistical Abstract of the United States 1991*, tables 1305 and 1427). Nor has there been an outsize boom in Puerto Rican manufacturing jobs: between 1970 and 1990, employment in Puerto Rico only rose from 132,000 to 160,000 manufacturing workers, and these jobs actually fell as a share of the work force from over 17 percent to under 15 percent. If low wages were such a magnet for manufacturing activity, Puerto Rico should have gained more than 28,000 manufacturing jobs over two decades, and the proportion of the labor force engaged in manufacturing should have risen, not fallen *Statistical Abstract of the United States 1992*, table 1328).

More generally, while trade between developing and developed countries has mushroomed, differences in living standards are still very wide. Between 1975 and 1990, the dollar value of two-way trade between countries belonging to the Organization for Economic Cooperation and Development (OECD) and low-income countries tripled from $59 billion to $200 billion. Yet the per capita income gap between OECD countries and low-income countries actually increased over this period.[2] In 1975 the OECD-country average per capita GNP figure was $5,680 while the figure for low-income countries was $190 (OECD countries, 30 times higher); by 1990 the OECD country average reached $20,250 while the low-income country average was $350 (OECD countries, 58 times higher) (International Monetary Fund, *Direction of Trade Statistics, Yearbook 1981 and 1992*; The World Bank, *World Tables 1992*, 4–5).

Even in the highly successful instances of Hong Kong, Korea, and Singapore, a large gap still remains between wages paid to production workers and industrial-country wages. The total two-way trade of the three Asian "tigers" increased from $39 billion in 1975 to $475 billion by 1991 (International Monetary Fund, *Direction of Trade Statistics, Yearbook 1981 and 1992*). Yet in 1991 the average hourly compensation for production workers reached only $3.58 in Hong Kong, $4.32 in Korea, and

raised US tariffs after the First World War, and gave the president (acting on the advice of the Tariff Commission) the power to levy additional duties "to equalize costs of production" (the so-called "scientific tariff"). The pauper labor argument and the scientific tariff (which was seldom implemented) were attacked by, among others, Gottfried Haberler (1936, 251–53).

2. Low-income countries and OECD countries correspond to those listed in the World Bank's *World Tables 1992*, 684–85.

$4.38 in Singapore. These rates are still well below the hourly rates paid by their major trading partners: $15.45 in the United States, $14.41 in Japan, and $22.17 in Germany (US Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1991," Report 825, June 1992, 6).[3]

To be sure, real hourly compensation in the United States has grown by only 0.7 percent annually since 1973—far less, for example, than the 2.1 percent figure achieved in Japan (*Economic Report of the President 1992*, 95–96). But the dismal wage performance for the average US worker has little to do with imports from developing countries. Instead, it reflects larger forces in the US economy, especially low rates of investment, both in human training and in physical capital. The right policy response to poor US wage gains will not be found in trade barriers. Rather, the response requires broad-gauged policies that, among other things, ensure a much higher rate of investment, and far better work force skills (Competitiveness Policy Council, "First Annual Report to the President and the Congress: Building a Competitive America," 1 March 1992, and forthcoming report, March 1993).

The reason why the pauper labor argument misstates the connection between trade and wages is simple. On average, high US labor productivity pays for high US wages. The US worker earns high wages because of his high output, which in turn reflects his work skills, his complement of sophisticated capital equipment, and the highly articulated infrastructure of the US economy. In the future as in the past, average US wages will increase primarily as a result of US success in raising productivity, a task that requires research outlays, capital investment, and worker training—not the erection of barriers to developing-country exports.

These statements about average wage levels do not mean that wage rates are irrelevant to international competition. In some industries and in some products, US wages are higher than US productivity can justify when compared with the juxtaposition of Mexican wages and productivity, for example. Those activities will tend to migrate from the United States to Mexico. Illustrative of this is the Smith Corona typewriter factory that plans to relocate from Cortland, New York, to Mexico in 1993.[4] But in other industries and products, the reverse is true. For example, US workers can make cheaper and better heavy

3. All figures are translated at commercial market exchange rates.

4. In July 1992 Smith Corona announced that about 870 workers would be laid off. The highly publicized closure is the last step in the technological replacement of typewriters by electronic word processors and the relocation abroad of the remaining segments of the typewriter industry. Smith Corona also has a plant in Singapore but had kept the bulk of its operations in Cortland (*US News and World Report*, April 1982, 71; telephone conversation with David Verostko, Smith Corona headquarters, Cortland, NY, October 1992).

trucks and photocopy machines than Mexican workers.[5] In such activities, the NAFTA will prompt investment and jobs to migrate from Mexico to the United States.

NAFTA opponents often charge that US multinationals use the threat (or the actuality) of moving to Mexico as a hammer to beat down the wages of US workers. We do not know how often such tactics are used. But we would not vilify private firms that balance wage rates against labor productivity when selecting plant sites. Such calculations affect the choice between Los Angeles and Salt Lake City, just as they affect the choice between Cleveland and Guadalajara. Cost-minimizing decisions are the bedrock of an efficient economy. The fact that some US plants close, just as some Mexican plants close, should be read as evidence that the market system is working, not that it is failing. From the standpoint of the US economy as a whole, what counts is how many net jobs are created by NAFTA.

US Jobs Created and Dislocated

According to our estimates, the NAFTA will exert a modest but positive effect on the US labor market. By our estimates, the agreement—in conjunction with Mexican domestic economic reforms—will create about 170,000 net new US jobs in the foreseeable future (that number should be reached by 1995, five years after the NAFTA talks were first proposed) by comparison with the 1990 position (table 2.1).[6] Indeed, with a surging US trade balance with Mexico (a $6.8 billion trade surplus in 1992, compared with a $2.4 billion trade deficit in 1990), many new US jobs have already been created. If the NAFTA is rejected, we would expect the United States to experience job losses relative to the situation in 1992. The reason is that a rejection of NAFTA would probably cause capital to leave Mexico, in turn forcing Mexico to contract its imports, thereby slashing the growth of US exports and drastically shrinking the US trade surplus with Mexico.

Our job projections reflect a judgment that, with NAFTA, US exports to Mexico will continue to outstrip Mexican exports to the United States, leading to a US trade surplus with Mexico of about $7 billion to $9 billion annually by 1995. How long can this scenario last? The answer fundamentally depends on investor confidence in Mexico, Mexican growth, and the ratio between Mexican external debt and Mexican GDP.

5. See, for example, *Washington Post*, 13 December 1992, H1, for an account of how Xerox and its union have boosted productivity at the Webster, New York, plant, thereby averting relocation of the plant to Mexico.

6. We start the clock from a 1990 base because the prospect of the NAFTA generated expectational effects that resulted in sharp increases in bilateral trade and investment.

In this regard, the experience of South Korea is instructive (table 2.2). For 25 years, between 1957 and 1981, Korea ran current account deficits which, for successive five-year periods, averaged between 5.0 and 8.5 percent of GNP.[7] At the start of the Korean growth spurt, in the late 1950s, gross external debt was only 4 percent of Korean GNP. Over the next 25 years, as Korean GNP grew rapidly, Korean corporations began acquiring foreign assets. In combination, these various forces gradually pushed the Korean gross external debt ratio up to about 50 percent of GNP by 1982.[8]

While similarities may exist between the prolonged Korean growth spurt that started in the late 1950s and the Mexican growth spurt that started in the late 1980s, important differences must also be noted. Mexico has a much higher initial external debt ratio than Korea: 47 percent of Mexican GDP in 1990 versus 4 percent of Korean GDP in 1957. Moreover, Mexico has already experienced a severe debt crisis, so lenders may be more cautious. On the other hand, even with its dramatic reforms, Mexico is unlikely to grow as fast as Korea. In our view, Mexico might achieve an annual real growth rate of 4 to 5 percent over the next 25 years, whereas Korea sustained an average real growth rate of 8 percent between 1957 and 1981. These factors suggest that even a very successful Mexico would not long incur the magnitude of current account deficits that Korea experienced. However, with a slower rate of growth, Mexico will have less need (relative to its GNP) than Korea for foreign capital.

All in all, Mexican annual current account deficits in the vicinity of 3 percent of GNP should be consistent with a manageable external debt position. The 3 percent figure would translate into current account deficits of $10 billion to $15 billion annually in the 1990s and $13 billion to $19 billion in the following decade. These magnitudes are consistent with our scenario of a US merchandise trade surplus with Mexico of $7 billion to $9 billion annually throughout the 1990s and perhaps $9 billion to $12 billion annually in the following decade. This surplus would ensure the net creation of about 170,000 jobs in the US economy.

Other investigators have reached very different conclusions on the job impact of NAFTA. Conspicuous among NAFTA critics are the Economic Strategy Institute (Prestowitz and Cohen 1991), the Economic Policy Institute (Faux and Spriggs 1991; Faux and Lee), former Secretary of Labor Ray Marshall (1992), the Cuomo Commission on Competitiveness (1992), and Timothy Koechlin and Mehrene Larudee (1992, 19–32).

7. Until 1966 these deficits were largely financed by official aid, but beginning in 1967 private foreign investment and credits basically funded Korean trade deficits.

8. In 1984 Korea experienced a minor external debt crisis, which was quickly resolved.

Table 2.1 US jobs supported by exports to Mexico and dislocated by imports from Mexico, 1990 and future scenario, resulting from the impact of NAFTA and related reforms[a]

	Median weekly wage (*dollars*)	Base level (1990)		Scenario for the foreseeable future			
		Exports	Imports	Exports	Imports	Net job change vs. 1990	Percent of total US jobs
Merchandise trade (*billions of dollars*)	n.a.	*28.4*	*30.8*	*45.1*	*38.5*	n.a.	n.a.
Average weekly wage (*dollars*)	n.a.	*420*	*424*	*420*	*424*	n.a.	n.a.
Total jobs supported/displaced (thousands of workers)	n.a.	538.0	579.9	854.4	724.9	171.4	n.a.
Jobs, by type (thousands of workers, except where noted)							
Executive, administrative, managerial	*620*	59.1	67.3	93.9	84.1	17.9	0.12
Professional specialty	*634*	29.6	33.8	47.0	42.2	9.0	0.06
Technicians and related support	*508*	12.8	15.5	20.3	19.4	3.7	0.10
Sales	*418*	75.6	80.4	120.1	100.5	24.4	0.17
Administrative support, including clerical	*365*	61.1	67.5	97.0	84.4	19.1	0.10
Service	*280*	34.6	37.0	54.9	46.3	11.1	0.07
Precision, production, craft, repair	*483*	83.5	94.1	132.6	117.6	25.6	0.19
Machine operators, assemblers, inspectors	*336*	85.7	76.9	136.1	96.1	31.2	0.41
Transportation and material moving	*419*	30.6	35.9	48.6	44.9	9.0	0.18
Handlers, equipment cleaners, helpers, laborers	*305*	31.3	32.0	49.7	40.0	10.4	0.23
Farming, forestry, fishing	*263*	34.1	39.3	54.2	49.1	10.2	0.30

n.a. -- not applicable.

a. The assumptions behind the intermediate scenario for the foreseeable future are spelled out in the text. Basically, it was assumed that NAFTA and related Mexican reforms will boost US exports to Mexico by $16.7 billion over the levels otherwise obtained and boost US imports from Mexico by $7.7 billion. In this scenario, no allowance is made for normal trade growth in the absence of NAFTA and related reforms.

To obtain figures for jobs by occupational category supported by exports to Mexico in 1990, the Department of Commerce figures for direct and indirect jobs supported by exports to Mexico in 1990, by industry, were multiplied by coefficients representing the ratio of specific occupations within an industry to total jobs within that industry for the United States at large. For example, the figure for sales jobs supported by agricultural exports to Mexico was obtained by multiplying the total number of jobs (direct and indirect) supported by agricultural exports to Mexico by the ratio of sales jobs to total jobs in US agriculture as a whole.

To obtain figures for jobs by occupational category displaced by imports from Mexico in 1990, a parallel method was used. Department of Commerce figures for direct and indirect jobs in each industry supported by exports were multiplied by the ratio between US imports from Mexico and US exports to Mexico for the products of that particular industry. To make the calculation manageable, only the top 100 imports and exports were used in calculating these ratios. The top 100 imports and exports account for 96.8 percent of total US imports and 96.7 percent of total US exports to Mexico in 1990.

Numbers for total jobs by occupation supported by exports, or displaced by imports, in 1990 were obtained by summing the figures for each industry.

The average weekly wage for jobs supported by exports to Mexico in 1990 was obtained by taking a weighted average of the median wage for each occupational category, where the weights are the proportion of each occupational category supported by exports to the total number of jobs supported by exports. The same procedure was used to obtain the average wage associated with jobs displaced by imports. In these calculations, 1991 median wage figures were used.

The figures for jobs by occupation supported by exports or displaced by imports in the scenario was obtained by multiplying the respective 1990 figures by the ratio of scenario exports (or scenario imports) to base-year exports (or base-year imports). Average wages were calculated in the same way as those for 1990. This methodology does not allow for productivity growth either in terms of jobs or in terms of wages.

Sources: Data for total jobs, by industry, and supported by exports to Mexico in 1990 was obtained from the Office of the Chief Economist, Economics and Statistics Administration, US Department of Commerce, "U.S. Jobs Supported by U.S. Merchandise Exports to Mexico: Supplemental Report," May 1992. The coefficients representing the ratio of specific occupational categories within an industry to total jobs within that industry for the United States at large are derived from unpublished data for the year 1991, collected by the Bureau of Labor Statistics. The data for average weekly wages for the year 1991 for each occupation were obtained from Bureau of Labor Statistics, US Department of Labor.

Table 2.2 Korean GNP growth, current account deficit, and gross external debt, 1957–91

Year	Average real GNP growth (percent per year)	Average current account deficit (percent of GNP)[a]	Gross external debt (percent of GNP at beginning of period)[b]
1957–61	11.1	6.9	4.0
1962–66	7.9	6.7	3.8
1967–71	9.6	8.5	15.1
1972–76	9.2	5.7	33.9
1977–81	5.8	5.0	33.8
1982–86	9.8	0.8	52.0
1987–91	10.0	(2.8)	27.6

a. For these purposes, official aid is treated as a positive capital account item. Parentheses indicate a current account surplus.
b. Between 1957 and 1982, gross external debt increased as a percent of GNP, even though GNP was growing faster than the size of the current account deficit (as a percent of GNP), because Korean corporations and citizens were simultaneously acquiring foreign assets.

Sources: Il SaKong, *Korea in the World Economy*, Washington: Institute for International Economics, 1993; IMF, *International Financial Statistics*, various issues; OECD, *Financing and External Debt of Developing Countries*, 1990 Survey, Paris 1991.

The Cuomo Commission authored the most prominent criticism of NAFTA. Briefly, the commission was concerned that the NAFTA would have three adverse effects:

- it would shift new plant and equipment investment from the United States to Mexico;
- it would create "export platforms" by which multinational firms based in Japan and other countries would gain improved access to the US market;
- it would lead to more intense wage competition between US and Mexican workers.

The apprehension that, with NAFTA, Mexico will soon be sprinkled with export platforms was answered in a report issued by the Council of the Americas (US Council of the Mexico-US Business Committee 1992, chapter 3). Neither Japan nor other countries are clamoring to build export facilities in Mexico, and as our earlier calculations suggest, Mexico is likely to remain a large net importer from the United States for many years to come. Moreover, the tight rules of origin negotiated in some sectors, particularly autos and textiles and apparel, go a long way toward eliminating the attractions of Mexico as a place to assemble third-country components and to ship the finished goods to the United States and Canada.

We have already commented on wage competition between US and Mexican workers. The remaining issue raised by the Cuomo Commission is the potential shift of plant and equipment investment from the United States to Mexico. Among most NAFTA critics, including the Economic Strategy Institute and the Economic Policy Institute, this potential investment shift is the center point for scenarios of US job losses. A systematic exposition of the investment-shift and job-loss scenario was published by Koechlin and Larudee.

The key assumption they made is that increased investment flows from the United States will augment the capital stock in Mexico by an amount ranging from $31 billion to $53 billion between 1992 and 2000 and that these investment flows will cause an equivalent decrease in the US capital stock. From this key assumption, a very pessimistic scenario emerges. The United States loses 290,000 to 490,000 industrial jobs, while Mexico gains 400,000 to 680,000 industrial jobs.[9]

The assumption that larger investment in Mexico implies smaller investment in the United States (the substitution assumption) taps into a long debate on US foreign direct investment. In our view, the substitution assumption is based on an erroneous model of the international investment process. On balance, we think that investment by US firms in Mexico is a "good event" rather than a "bad event" for the United States. Foreign investment by US firms creates US jobs, both in the short run, by boosting US exports of capital goods, and in the long run, by establishing channels for the export of US intermediate components, replacement parts, and associated goods and services.[10] If US firms were to refrain from investing in Mexico, there is no reason to believe that the firms would invest in the United States instead (rather than, for example, Chile or Korea), nor is there any certainty that foreign multinational firms would not seize the investment opportunities in Mexico that were passed over by US firms. In any event, from a purely selfish US standpoint, the economic gains from additional investment and faster growth in Mexico are greater than the gains from corresponding activity in any other country (outside the US itself), since the Mexican propensity to import from the United States is among the highest in the world. On average, each Mexican imports $380 of US merchandise annually; by contrast, each Korean, with twice the per capita income, imports $360 of US merchandise annually.

There is another difficulty with the pessimistic scenario developed by Koechlin and Larudee: it ignores the dampening effect of a larger Mexican capital stock on illegal migration from Mexico to the United States. According to a computable general equilibrium model devised by Sher-

9. Koechlin and Larudee also forecast that between 0.8 million and 2.0 million Mexican rural jobs will be lost as a result of expanded US corn and bean exports to Mexico.

10. Early contributions to this debate were US International Trade Commission (1973, 645–72) and Bergsten, Horst, and Moran (1978). For a recent summary of the role of multinational firms in the international economy, see Hufbauer (1992, chapter 5).

man Robinson et al. (1992, 17), each 1 percent increase in the Mexican capital stock reduces the level of permanent migration from Mexico to the United States by about 44,000 workers. The Mexican capital stock in 1990 was probably about $500 billion,[11] so an increment of $31 billion to $53 billion owing to the NAFTA (the Koechlin and Larudee forecast) would augment the capital stock by between 6 and 10 percent. In turn, this would reduce permanent immigration by at least 260,000 workers from the levels that would otherwise be reached. Lower-skilled Americans who compete in the job market with immigrant Mexicans should welcome this by-product of Mexican prosperity.[12]

The Occupational Impact of NAFTA

Conflicting estimates of net jobs gained or lost in the intermediate term on account of NAFTA should be put in a broader perspective.[13] Over a period of 10 years or longer, total employment in the United States and the US merchandise trade balance with the world at large are essentially determined by macroeconomic conditions and policies: specifically, domestic and global business cycles, US fiscal and monetary policies, and the productivity of the US economy. Microeconomic events, such as defense conversion or NAFTA, will affect the distribution of employment throughout the economy, and perhaps the trade balance with individual countries, but they will not exert a perceptible long-run impact on overall employment levels or on the overall merchandise trade balance. In the long run, the impact of NAFTA will be offset by other changes in microeconomic policy or will be lost as noise in the background of macroeconomic events.

Nor will NAFTA make a significant addition to the large number of gross job displacements that occur annually in the dynamic US economy. For example, over the five years up to 1990, some 8.9 million workers reported that they had been displaced from their jobs, meaning that they had lost their jobs because of a plant closing, because the employer went out of business, or because they were laid off and not later recalled (Podgursky 1992, 19, table 1). By our calculations, a gross total of 316,000 US jobs will be created by NAFTA while a gross total of 145,000 US jobs

11. It is commonly assumed that the stock of reproducible capital is two to three times the level of GDP. In the United States in 1991, the estimate for the net stock of fixed reproducible private capital was $10.4 trillion while GDP was $5.7 trillion (*Survey of Current Business*, October 1992, 29).

12. One model suggests the return migration to Mexico could increase the wage rate for US rural and unskilled workers by between 1.8 and 5.7 percent (Hinojosa-Ojeda and Robinson 1991, 22–24 and table 8, scenarios 4B and 5B).

13. For a good summary of the broader economic perspective, see Alfred Reifman (1992).

will be dislocated.[14] Our estimate that 145,000 US jobs will be displaced works out to less than 2 percent of total displacements over five years. Even the far more pessimistic calculation of Koechlin and Larudee, namely that as many as 490,000 US workers will be displaced by NAFTA, works out to less than 6 percent of total displacements over five years.

Nevertheless, while the scale of NAFTA-related dislocations is small compared with economywide magnitudes, some US workers will inevitably lose their jobs. The volume of trade in both directions will rise dramatically, and increased two-way trade between the United States and Mexico will cause employment to shift within and between US industries. The challenge for the United States is to help such workers make the difficult transition to new jobs. In turn, this raises the question of whether the jobs created by NAFTA require very different skills from the jobs displaced by NAFTA. If this is the case, then on balance NAFTA would impose a heavier burden on some occupational categories than on others.

Because of the concern about the impact of NAFTA on US workers with different skill characteristics, it is worth taking a closer look at the likely impact by occupational category. Table 2.1 contains a breakdown, by occupational category, of US jobs "supported" in 1990 by exports to Mexico, and US jobs "dislocated" by imports from Mexico. These estimates rest on a number of assumptions that are summarized in the table notes.

Based on the 1990 composition of trade, the median weekly wage associated with US exports to Mexico and US imports from Mexico were practically the same: about $420 to $425 per week. This calculation is striking because it suggests that there is no overall tendency for US exports to Mexico to support high-skilled US jobs, nor for US imports from Mexico to displace low-skilled US jobs.

In our scenario for the foreseeable future, the impact of NAFTA and associated Mexican reforms is to increase US exports to Mexico by $16.7 billion and to increase US imports from Mexico by $7.7 billion.[15] For the purposes of this scenario, we ignore trade growth that would likely occur without NAFTA and Mexican domestic reforms. Based on this scenario,

14. We originally estimated that up to 112,000 workers would be dislocated by North American trade liberalization. In light of the latest Commerce Department coefficients of direct and indirect jobs per billion dollars of exports to Mexico (about 19,600 per billion dollars of exports) we have revised our earlier estimate upward to 145,000 jobs lost (US Department of Commerce 1992b).

15. A high-side estimate of trade diversion from all third countries as a result of NAFTA is about 35 percent of increased US imports from Mexico, or about $2.7 billion annually. The possibility of trade diversion is not factored into our job calculation, but it would increase the net number of US jobs created, since fewer US jobs would be dislocated owing to a smaller net increase in US imports (after making an allowance for diverted trade).

table 2.1 shows the number of US export jobs created, and the number of US import-competing jobs dislocated, by occupational category, assuming that the composition of trade by industry sector remains the same as in 1990. The important point to note is that the net job impact (by comparison with the 1990 position) is distributed fairly evenly across occupational categories. While all occupational categories show net job gains, relative to numbers employed in 1990 the net gains in the executive, professional, and administrative categories are actually smaller than for production workers and farmers.[16]

Long-Term Efficiency Benefits from NAFTA

Over the long term, the main impact of larger US-Mexican trade will be higher incomes made possible by greater efficiency and faster growth. Efficiency in both economies will be boosted by the tendency of each country to export those goods and services in which it has a comparative advantage. Faster growth will result from more intense competition among a larger number of firms in each segment of the market and from an expanded North American market that will enable each firm to realize economies of scale. In turn, this could result in an improved trade balance for North America with the rest of the world or better terms of trade for North America.[17]

Indirect evidence on the benefits of expanded trade is provided in a study by David Walters, Chief Economist in the Office of the US Trade Representative (1992a).[18] According to the Walters study, US direct and indirect private-sector jobs supported by nonagricultural exports to world markets pay wages that are about 16.7 percent higher than average nonagricultural jobs throughout the US economy. A parallel analysis by Walters for exports to Mexico (1992b) indicates that, on average, US jobs supported by nonagricultural exports to Mexico pay 12.2 percent more than average US nonagricultural jobs.[19]

It should be noted that, in his calculations, Walters compared the average wage of export-supported employment to the average wage of all employment; Walters made no comparison to the average wage of import-dislocated employment. Our calculations in table 2.1 suggest

16. It is worth noting that the INFORUM-CIMAT study directed by Clopper Almon reached similar results. In their TAB scenario, in which the US trade balance improves by about $6.3 billion (1990 dollars) five years after the NAFTA enters into force, the calculated increase in US craft worker, operative, nonfarm labor, and farm employment is 31,500 jobs, while the calculated increase in professional and managerial employment is only 9,100 jobs (Shiells and Shelburne 1992, tables 1 and 7).

17. Whether a more competitive North America translates into an improved trade balance or an appreciated currency (and hence better terms of trade) will depend on macroeconomic conditions in North America and other regions of the global economy.

18. The data used in this study are for 1990.

19. The data are for 1990.

that, in terms of bilateral US-Mexico trade, there is little difference in the average wage between export-supported and imported-dislocated jobs. These calculations accordingly suggest that US gains from NAFTA will result not from a shift in the occupational composition of the US work force but rather from greater efficiency within the traded goods sector and faster growth in the two economies.

One way to size up the efficiency benefits from trade liberalization is to examine the results of the hypothetical elimination of US trade barriers on a global basis for several highly protected industries. According to estimates made in the mid-1980s by the Institute for International Economics (Hufbauer, Berliner, and Elliott 1986, tables 1.2 and 1.4), if US import barriers on 31 highly protected industries had been eliminated, US imports would have increased by about $44.4 billion, and US efficiency gains would have been about $8.4 billion. These two numbers indicate that comparative-advantage gains from the elimination of trade barriers could be as large as 20 percent of trade expansion.[20] The industries in this sample were, however, subject to severe protection, a circumstance that overstates the size of possible efficiency gains relative to the volume of potential trade expansion in the North American context. Given the height of US and Mexican trade barriers prior to NAFTA, classic efficiency gains are likely to be in the range of 7.5 percent of two-way trade expansion.[21]

In addition to the classic efficiency benefits from harnessing comparative advantage, the larger number of firms in an expanded North American market should prompt all competitors to reduce their costs and to exploit economies of scale. This possibility has been widely discussed in the theoretical literature.[22]

In an unpublished study, the authors of this assessment have calculated the trade and growth gains for Latin American taken as a whole, based on a scenario of broad policy liberalization, including dramatic trade reform (Hufbauer and Schott 1992b, appendix B). The implication of our reform scenario is that, during 1990–2000, Latin American two-way trade would increase by $235 billion over the baseline level. The

20. A recalculation based on our unpublished analysis for the year 1990 suggests that the 20 percent ratio still applies for highly protected industries.

21. This calculation assumes that additional Mexican imports account for two-thirds of the total two-way trade expansion and that the efficiency gain on these imports is 10 percent of the incremental trade (reflecting an assumption that the pre-NAFTA level of Mexican tariff and nontariff barriers is on average 20 percent). The other one-third of the trade expansion is additional US imports from Mexico, where the efficiency gain is assumed to be 2.5 percent of the incremental trade (reflecting an assumption that the pre-NAFTA level of US tariff and nontariff barriers is on average 5 percent).

22. For a survey of the literature, see J. David Richardson (1989) and Hufbauer (1992, chapter 5). Also see McKinsey & Company (1992) for an indirect assessment of the impact of competition on productivity in a number of service-sector industries.

dynamic impact of trade gains, together with other reforms, would boost the region's GDP by $385 billion over the baseline level. The suggested ratio between induced GDP gains and trade expansion brought about by policy reform is an astonishing 1.65. This very high ratio is, of course, subject to estimation errors and assumes dramatic policy reforms. Even making liberal allowance for modeling errors and less-than-sweeping policy reforms, it seems plausible that trade liberalization could yield dynamic GDP gains of at least 50 percent of the resulting two-way trade expansion for the Mexican economy, which was highly protected in the late 1980s.

In round numbers, if two-way US-Mexico trade in the intermediate term expands by $25 billion on account of NAFTA, and if classic comparative-advantage benefits realized by both countries amount to just 7.5 percent of expanded trade, the annual efficiency gains would be about $1.9 billion. In addition, the growth gains from enhanced competition and larger markets might benefit the Mexican economy by as much as $12.5 billion annually. To an unknown extent, the larger and more competitive North American market would also confer dynamic gains on US producers.

Together, the efficiency benefits and growth stimulus of NAFTA could exceed $15 billion annually. Over the long term, this figure—not jobs gained or lost—is the true measure of the economic gain from the NAFTA agreement. Annual gains of $15 billion are equivalent to making an addition to the combined capital stock of the two nations of about $75 billion—not bad for government work.[23]

Migration

In keeping with our recommendations, the NAFTA text stayed well clear of the explosive issues raised by illegal immigration from Mexico to the United States. The NAFTA itself only addressed the entry of business and professional personnel.[24]

While the NAFTA itself is silent on illegal immigration, this issue is very much on the minds of Americans. Over the long term, Mexican prosperity is the only practical answer to the problem of illegal immigration. As explained in our 1992 book, the NAFTA is likely to lead over the long term to strong growth in Mexican per capita income (Hufbauer and Schott 1992a, chapter 3). Over three or four decades, Mexican per

23. The $75 billion figure assumes that capital invested in the US and Mexican economies yields a real social return of 20 percent per year.

24. Intracompany transferees will be allowed to enter if they have been with the company for at least one year out of the previous three years. In addition, 5,500 Mexican professionals will be allowed to enter the United States annually in addition to those admitted under global immigration limits (see NAFTA appendix 1603.D.4).

capita income might reach half the US level, and this gain would substantially ease and perhaps even eliminate pressures within Mexico to emigrate.

Nevertheless, Mexican immigration is likely to increase in the short run for reasons having nothing to do with NAFTA. A study by the National Commission for Employment Policy (1992, 6–7) indicates that between 4 million and 5 million legal and illegal Mexican immigrants will enter the United States during the 1990s, not taking into account the effects of the NAFTA. Most of these migrants will return to Mexico, but a fraction (perhaps 10 percent) will settle permanently in the United States (Martin 1992, 5).

All in all, it would be prudent to expect more rather than less immigration during the next five years. The overriding pressures to emigrate will come from rural displacement in Mexico stemming from land reforms, increased demand for farm and service-sector workers in the United States, and rapid efficiency gains in the Mexican industrial sector. Compared with these pressures, the incremental impact of NAFTA in the next five years will be small—perhaps an additional gross 100,000 migrants annually (National Commission for Employment Policy 1992, 6–7).[25]

One way to reconcile these various estimates is to speculate that, in the short run, NAFTA may marginally increase the gross number of illegal immigrants. However, in the longer run, NAFTA should help create the level of Mexican prosperity that will substantially reduce the gross level of illegal immigration.

Over time, emigration pressures will be offset by faster economic growth in Mexico, assisted and reinforced by the long-run effect of NAFTA in boosting Mexican productivity. The consulting firm CIEMEX-WEFA, for example, calculates that, over the 10-year period ending in 2002, the gross number of illegal immigrants could decrease by 600,000 on account of economic growth stimulated by NAFTA (CIEMEX-WEFA 1992, 15).[26]

The US federal government already provides about $1 billion annually to state and local governments to cope with extra social costs associated with immigrants (Philip L. Martin, letter to authors, 28 October 1992).[27]

25. Of the additional migrants, perhaps 10 percent, or 10,000 annually, would settle permanently in the United States.

26. The National Commission also projects a decrease in Mexican immigrants in the first decade of the 21st century (National Commission for Employment Policy 1992, 7).

27. A study by the Rand Corporation examined the impact on public services resulting from Mexican immigration, and noted *inter alia* that "California educators project they

About $600 million is spent annually on 13 programs for migrant and seasonal farm workers and their families. With the possibility of increased immigration in the short term, the federal government will probably have to augment these programs (Martin 1992, 12; National Commission for Employment Policy, letter to the president, 13 October 1992).

We do not believe that the United States should put large amounts of money into building steel barricades, digging concrete ditches, or placing electronic sensors along its 2,000-mile border with Mexico.[28] Such measures would be rightly characterized as rebuilding the Berlin Wall, brick by brick, in North America. Unless border controls were comprehensive and draconian, they would not stem the aggregate flow. However, they would prompt a larger fraction of migrants to settle permanently, knowing that reentry to the United States had become more difficult. Whatever the effect on immigration flows, border fortification measures would be sure to sour US relations with Mexico for a very long time.

US Labor Adjustment Programs

In its May 1991 Action Plan, the Bush administration promised to address labor's concerns about NAFTA both in the agreement itself and through a new US-Mexico Labor Commission. In her September 1992 testimony to Congress, US Labor Secretary Lynn Martin argued that labor's concerns would be addressed through three mechanisms: explicit NAFTA provisions, a formal binational cooperation program with Mexico, and President Bush's new job training program (Secretary of Labor Lynn Martin, testimony before the Senate Finance Committee, 10 September 1992, 2). These responses did not satisfy organized labor. Not surprisingly, candidate Clinton promised a bigger and better approach to labor adjustment. But even Clinton's approach will not satisfy those who are determined to take a negative view of the employment consequences of NAFTA.

Explicit NAFTA Provisions

According to Labor Secretary Martin, explicit NAFTA provisions that will smooth the transition for US workers include 15-year transition

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will need between $1.7 billion and $2.4 billion a year to give each immigrant adult an estimated 450 hours of schooling." To an unknown extent, additional taxes paid by immigrants offset some of these expenses (*The Washington Post*, 26 March 1991, A15).

28. The United States is helping Mexico police the Mexicans' southern border with Central America. This effort may retard the flow of Central Americans through Mexico to the United States.

periods for the most sensitive sectors, such as glassware, some footwear, ceramic tile, broomcorn brooms, some watches, and certain fruits and vegetables; improved safeguard mechanisms to protect sensitive industries against a flood of imports; and strict rules of origin to "ensure that the free-trade benefits of a NAFTA accrue to North American products and their workers" (Secretary of Labor Lynn Martin, testimony before the Senate Finance Committee, 10 September 1992, 5). Interestingly, only the United States and Canada obtained 15-year transition periods for particularly sensitive manufactured goods. Mexican tariffs on all manufactured products will be eliminated within 10 years.

The NAFTA contains several bilateral safeguard provisions applicable during the transition. The main bilateral safeguard mechanisms are contained in Article 801. During the transition period, a tariff "snapback" to the pre-NAFTA level is allowed for up to three years for most products, and up to four years for the most sensitive products, in cases where imports from a NAFTA partner are a substantial cause of serious injury or threaten serious injury.[29] This mechanism augments the Canada-US FTA safeguard provisions by allowing a safeguard action even if increased imports only threaten injury and by allowing up to four years of relief rather than three. The NAFTA also establishes special safeguards in the form of tariff rate quotas for sensitive agricultural products and a different causation test ("serious damage") for textiles and apparel.

In addition to the bilateral provisions of Article 801, the NAFTA's global safeguard provision (Article 802) allows for the imposition of tariffs or quotas on imports from NAFTA partners as part of a multilateral safeguard action brought by any NAFTA country. Following the FTA precedent, however, imports from a NAFTA partner must be "substantial" before its trade can be included in a global safeguards action.[30]

In designing long transition periods and special safeguard mechanisms, the negotiators gave ample attention to the adjustment consequences of free trade within North America. Under the NAFTA approach, some products will continue to enjoy protection for long periods, even though the concerned firms might have been able to adjust on a faster timetable to competition from other NAFTA countries. However, this flaw can be redressed if the NAFTA follows the US-Canada FTA approach and accelerates tariff cuts through subsequent negotiations.

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29. The current most-favored-nation (MFN) rates become the benchmark if, at the time of the snapback, the MFN rates are lower than the NAFTA rates (Article 801).

30. The NAFTA defines "substantial" differently from the US-Canada FTA. Imports from a NAFTA member is exempt from global safeguards unless that country "is among the top five suppliers of the good subject to the proceeding, measured in terms of import share during the most recent three-year period" (Article 802:2a). The FTA definition is 5 to 10 percent of total imports of the good.

Binational Cooperation

The Bush administration's second mechanism to meet labor concerns—binational cooperation—has resulted in a series of bilateral agreements to promote closer cooperation and joint action on a variety of labor issues. The initial memorandum of understanding with Mexico (signed in May 1991) has produced an array of comparative studies of labor conditions and laws in each country that are designed to provide the substantive basis for new bilateral programs.[31]

In September 1992 the United States and Mexico further expanded their cooperative efforts in this area by concluding a bilateral agreement establishing a new Consultative Commission on Labor Matters. This permanent body will implement a bilateral work program and consult on the enforcement of national labor laws and regulations. However, the agreement itself does not contain a joint enforcement mechanism ("Agreement . . . Regarding the Establishing of a Consultative Commission on Labor Matters," 14 September 1992, Article 3:1). In addition to the consultative commission, the two countries have agreed to develop improved standards in the areas of industrial hygiene and work place safety.

Job Training Program

The third, and most critical, of the Bush administration's efforts to address labor adjustment issues came in August 1992, when President Bush proposed a new worker adjustment program: Advancing Skills through Education and Training (ASETS). ASETS was designed to replace two existing adjustment programs, under the Economic Dislocation and Worker Adjustment Assistance Act (EDWAA) and the Trade Adjustment Assistance Act (TAA), with a single new program. The new program called for $10 billion in new funding over five years for training and adjustment assistance for displaced workers, of which $1.67 billion, or $335 million annually for five years, was earmarked (if needed) for workers displaced by the NAFTA.[32]

President Bush's plan easily beat our recommendation that the United States budget $1.2 billion over five years for NAFTA-related worker adjustment. Indeed, the Bush plan was much better and bolder than our proposals, since it subsumed NAFTA adjustment in the larger con-

31. See, for example, US Department of Labor and Mexican Secretariat of Labor and Social Welfare (1992a and b).

32. Up to an additional $335 million annually could be drawn from a discretionary fund, if required. The reserve-fund contingency implied an upper-level job-loss figure of about 300,000 workers over 10 years.

text of retraining workers, whatever the cause of dislocation. Further, as we had recommended, the bulk of the funding was scheduled for retraining rather than income maintenance, with vouchers issued for training at qualified private institutions in addition to federally run programs.

Clinton's Plan

Candidate Clinton said in his October 1992 speech that he would support the NAFTA as drafted but would negotiate a supplemental agreement to reinforce worker standards and safety (speech at North Carolina State University, 4 October 1992, 15). In addition, he promised a bigger and better approach to labor adjustment than that evinced in Bush administration programs.

To a large extent, Clinton's proposal for a supplemental pact on labor issues stems from concerns about the enforcement of national labor laws in Mexico. While specific objectives for such a pact have not yet been spelled out, we assume the supplemental negotiations would seek to establish commitments to the aggressive enforcement of national labor laws and regulations, monitoring of labor markets by a trinational commission, and dispute settlement provisions to encourage compliance. Such an agreement would subsume, but greatly expand upon, our recommendation that the NAFTA require trinational panels to issue biennial reports on labor market conditions (including immigration) in each country. In like fashion, it would sharply expand the responsibilities of the nascent US-Mexico Binational Commission, particularly with regard to enforcement mechanisms.

In essence, the commission should act as a roving spotlight. It should focus public attention both on inadequate enforcement and on labor standards that do not meet international norms. (It would thereby supplement the weak enforcement provisions of International Labor Organization conventions.[33]) To accomplish these tasks, the trinational commission would need to review the enforcement practices of national authorities, to send out field investigators, to hold public hearings, to publish reports, and to make recommendations to the NAFTA governments. Labor unions and industry associations should be able to file reports on the labor practices in any member country. In some respects, the procedures would parallel the special dispute settlement process for unfair trade laws under NAFTA chapter 19, in which NAFTA panels

33. It should be recalled that Mexico has signed more ILO conventions than the United States or Canada, so in some respects Mexico could complain that its northern neighbors have not met international norms. In addition, Canadian unions would be happy to use the Trinational Commission as a forum to criticize state "right to work" laws in the United States.

rule on whether national authorities have faithfully pursued their own trade laws and administrative procedures. In this case, the issue would be whether the national authority has enforced its own labor laws and regulations.

However, we do not think the commission should have the power to levy fines or award money damages against particular firms or industries. Such remedies should remain the responsibility of national agencies and courts. In most cases, we believe the glare of publicity should be sufficient to promote compliance. If this spotlight and subsequent government measures prove inadequate, the commission, acting on a petition from a NAFTA country, should be empowered to authorize trade remedies against firms or industries that show a persistent pattern of labor abuse.[34]

In sum, the supplemental agreement could make an important contribution to the enforcement of labor standards by using the trinational commission to expose offenders and by ultimately authorizing trade countermeasures if governments do not succeed in halting the abuses. We believe the negotiation of such a pact would reinforce the NAFTA provisions in this area and would be desirable for all three countries.

Clinton also proposed a supplementary agreement that would allow a NAFTA member to take action if there is an "unexpected and overwhelming surge in imports into either country which would dislocate a whole sector of the economy" (speech at North Carolina State University, Raleigh, NC, 4 October 1992, 16). The US sugar and citrus industries have been strong proponents of a supplementary agreement on safeguards. Both industries are concerned about the potential rapid growth in Mexican exports to the United States, especially if the NAFTA reforms are supplemented by GATT trade liberalization. Accordingly, they would like to retain the possibility of reinstating high tariffs and/or quotas to protect against import surges from Mexico both during and after the transition period.

Basically, the Clinton supplementary agreement on safeguards seems designed to address cases that have three characteristics: trade injury is serious, Canada and Mexico would escape global trade remedies because their exports to the United States are not "substantial," and the snapback provisions in Article 801 are inadequate to stem the import surge from NAFTA partners.

34. For trade remedies to be effective (and not give rise to spiraling countermeasures), the NAFTA parties would need to waive their GATT rights concerning the imposition of trade penalties for persistent labor abuse when the penalties are authorized by the Trinational Commission. In our view, the NAFTA commission, like a GATT dispute panel, should only authorize trade remedies in response to a petition from a member government. It should not become a court of original jurisdiction for labor unions, trade associations, or other petitioners.

A supplementary agreement, even if limited to these cases, would cause concern in Canada and Mexico. A major Canadian objective in the FTA was to contain the "sideswipe" risks of US actions under Section 201, and a supplementary agreement might threaten to undermine this objective. A possible solution is language that qualifies the circumstances in which Canadian and Mexican imports are excluded from global actions because they are not "substantial." In the case of an "unexpected and overwhelming surge" in a NAFTA country's imports (to use Clinton's language), the trajectory of import penetration as well as the level could be considered.

In addition to these supplementary agreements, Clinton promised to enact unilateral measures to facilitate labor adjustment within the United States. Clinton essentially pledged to reach more affected workers with better delivery systems than the Bush program. For example, farmers would be helped in the shift to alternative crops, and those farmers who do "lose out to competition should be just as eligible for transition assistance as workers in businesses" (speech at North Carolina State University, 4 October 1992, 13).

The dimensions of the Clinton labor training program remain to be spelled out, but a safe bet is that remedies for NAFTA-induced dislocation will eventually be part of a much larger program. As with the Bush proposals, the specific causes of worker dislocation may come to play a limited role in the availability of training, relocation, and income maintenance allowances. Instead, the program benefits will be geared to worker characteristics (e.g., the previous employment history of the worker, wage level, etc.) and features of the local labor market (e.g., the extent of unemployment in the area). Given mediocre US productivity performance over the past two decades, broad-gauged retraining programs make more sense than programs targeted on specific causes of worker dislocation. However, broad-based programs may not be in place by January 1994, when NAFTA implementation is supposed to start. Hence, as in the Bush program, Clinton should earmark money for NAFTA adjustment until a broader program has been adopted.

Finally, Clinton, Salinas, and Mulroney could make an important contribution to public acceptance of NAFTA by calling on their central banks and finance ministers to meet from time to time to review the macroeconomic situation in North America. In addition, when new fiscal, monetary, or exchange rate policies are adopted in one of the partner countries, the others should be consulted in advance. At a minimum, these meetings could help avert the tendency—so prominent in Canadian experience with the FTA—to blame the NAFTA for all plant closings, labor dislocation, and other bad economic tidings.