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NAFTA and the USMCA: A History

Introduction

On October 30, 2018, Vox uploaded a Youtube video titled “NAFTA, explained by a toy car”. In it, the narrator provides a brief history of the North American Free Trade Agreement and its successor - the United States-Mexico-Canada Agreement. The benefits for America have been diverse, argues Vox, with the average American seeing prices come down and purchasing power rise. This is especially visible in the auto industry, where the real price of new cars has risen by only 7 percent since 1994. The price of almost all other goods has increased by 86 percent in that same span.

Yet, NAFTA has come under fire by many, including politicians on both sides of the aisle. President Trump, before renegotiating the agreement, labeled NAFTA as “the worst deal, one of the worst deals our country has ever made, from an economic standpoint … one of the worst deals, ever.” Similarly, Barack Obama proclaimed “NAFTA was a mistake.” The pact’s opponents have suggested it has fattened international corporate pockets at the expense of honest, hard-working American citizens.

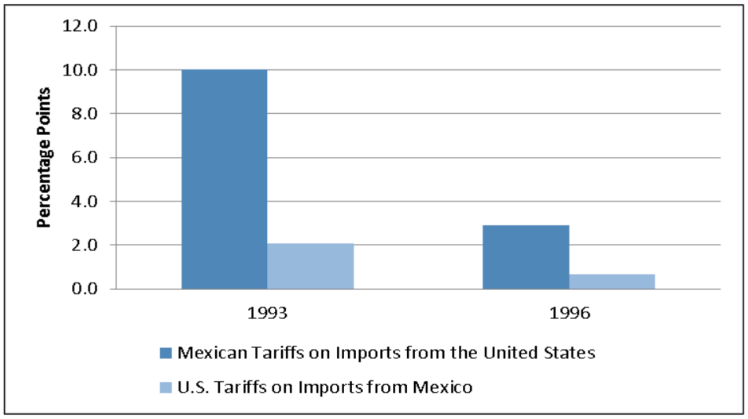
How true are such claims? Has NAFTA benefited America and its partner countries, or has it merely exacerbated the economic reality of its vulnerable citizens? The goal of this paper is to analyze the origins of NAFTA, US-centered trade patterns, welfare consequences for the respective countries, and where the USMCA will go from here.

NAFTA - Origin and Provisions

NAFTA came into effect on January 1, 1994. Per the source text, the deal’s objectives were to “eliminate barriers to trade...facilitate the cross-border movement of, goods and services...promote conditions of fair competition in the free trade area...increase substantially investment opportunities...provide adequate and effective protection and enforcement of intellectual property rights…[and] establish a framework for further trilateral, regional and multilateral cooperation”. (NAFTA, 1994)

The deal originally faced support across national governments, as each country believed it would gain from expanded opportunities. For Mexico, the hope was that less restricted trade would dramatically increase economic growth, promote democratic institutions, and reduce illegal immigration. For Canada and the United States, the gains lied in access to cheaper labor and a new export market. With its establishment, NAFTA created the world's largest free trade zone, linking 444 million people and catalyzing the production of $17 trillion worth of goods and services.

Figure 1. Average Applied Tariff Levels in Mexico and the United States (1993 and 1996)

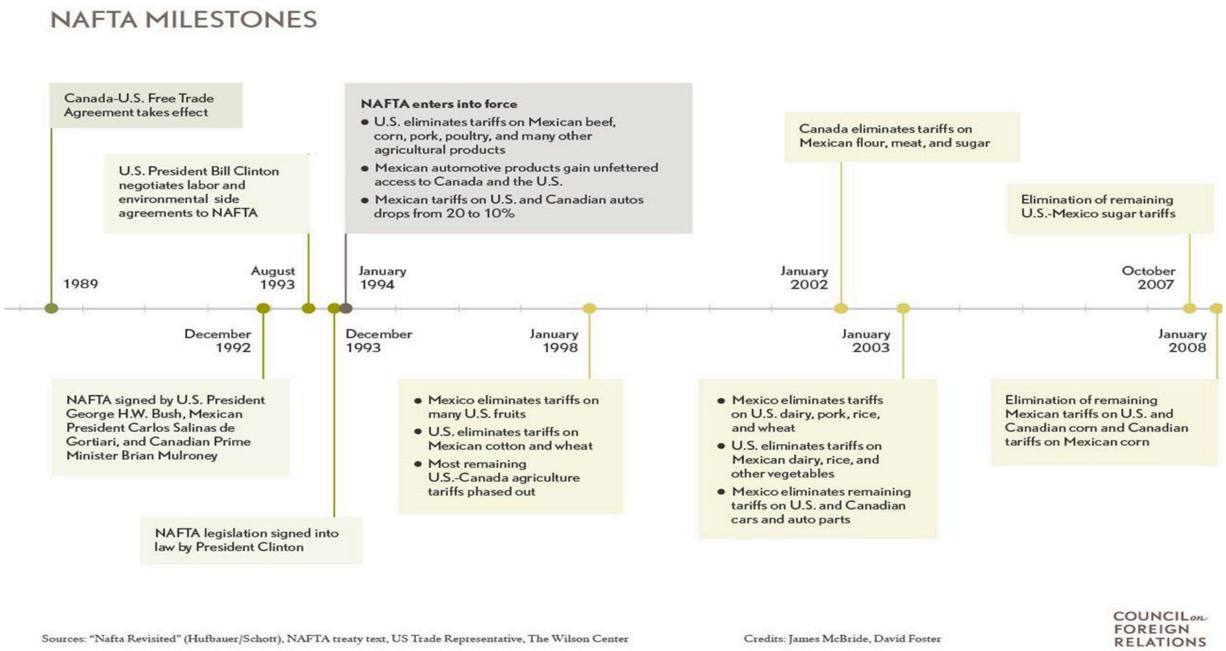


At the time of its signing, the deal extended the bilateral trade agreement between the US and Canada (CFTA) and brought trade liberalization to Mexico. As depicted in Figure 1, import tariffs were more costly in Mexico than in the US at the time. While Canada featured a 0.37% import tariff rate on US goods in 1993, Mexico's hovered at 10%. As such, an immediate removal of tariffs on 70% of US imports from Mexico and 50% of Mexican imports from the US was instituted. Other barriers to trade were gradually reduced over the next 15 years, including import licensing, investment restrictions, and import substitution policies.

The textiles, apparel, automotive, and agricultural industries were most significantly affected by trade liberalization. Pre-NAFTA, "65% of U.S. apparel imports from Mexico entered duty-free and quota-free, and the remaining 35% faced an average tariff rate of 17.9%. Mexico's average tariff on US textile and apparel products was 16%, with duties as high as 20% on some products." With regard to the automotive industry, "the United States assessed the following tariffs on imports from Mexico: 2.5% on automobiles, 25% on light-duty trucks, and a trade-weighted average of 3.1% for automotive parts. Mexican tariffs on US and Canadian automotive products were as follows: 20% on automobiles and light trucks, and 10%-20% on auto parts." Similarly, agriculture was heavily restricted "prior to NAFTA…[A]pproximately one-fourth of US agricultural exports to Mexico (by value) were subjected to restrictive import licensing requirements." (Villarreal & Fergusson, 2017)

Services trade was also liberalized through NAFTA, with "the agreement grant[ing] services providers certain rights concerning non-discriminatory treatment, cross-border sales and entry, investment, and access to information." In addition, NAFTA incorporated other measures, such as provisions regarding foreign investment, intellectual property (IP) rights, dispute settlement procedures, government procurement, and regulations concerning labor and environmental sustainability. (Villarreal & Fergusson, 2017)

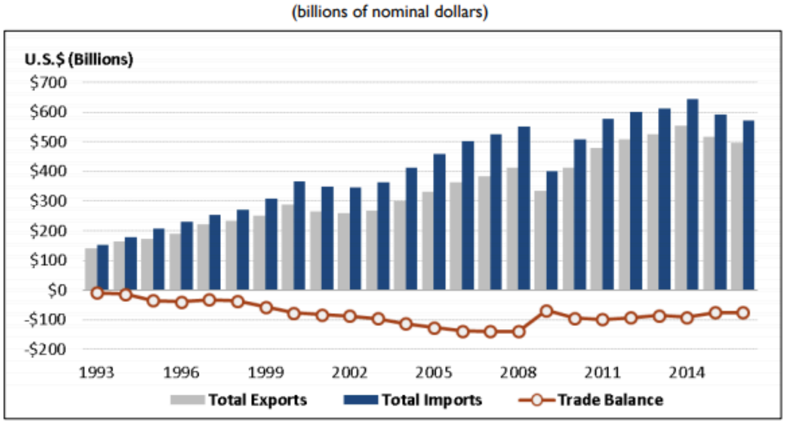
With foreign investment, "NAFTA removed significant investment barriers, ensured basic protections for NAFTA investors, and provided a mechanism for the settlement of disputes between investors and a NAFTA country." And with IP rights, NAFTA set out specific enforceable commitments by NAFTA parties regarding the protection of copyrights, patents, trademarks, and trade secrets." (Villarreal & Fergusson, 2017) Below is a timeline featuring the gradual reduction in tariffs thanks to NAFTA.



NAFTA - Trade Patterns

US trade has more than tripled with Mexico and Canada since 1994, rising faster than trade with the rest of the world. In fact, "in 2011, trilateral trade among NAFTA partners reached the $1 trillion threshold. In 2016, Canada was the leading market for US exports, while Mexico ranked second. The two countries accounted for 34% of total US exports in 2016. In imports, Canada and Mexico ranked second and third, respectively, as suppliers of US imports in 2016. The two countries accounted for 26% of US imports." (Villarreal & Fergusson, 2017)

Figure 2. U.S. Merchandise Trade with NAFTA Partners: 1993-2016
(billions of nominal dollars)

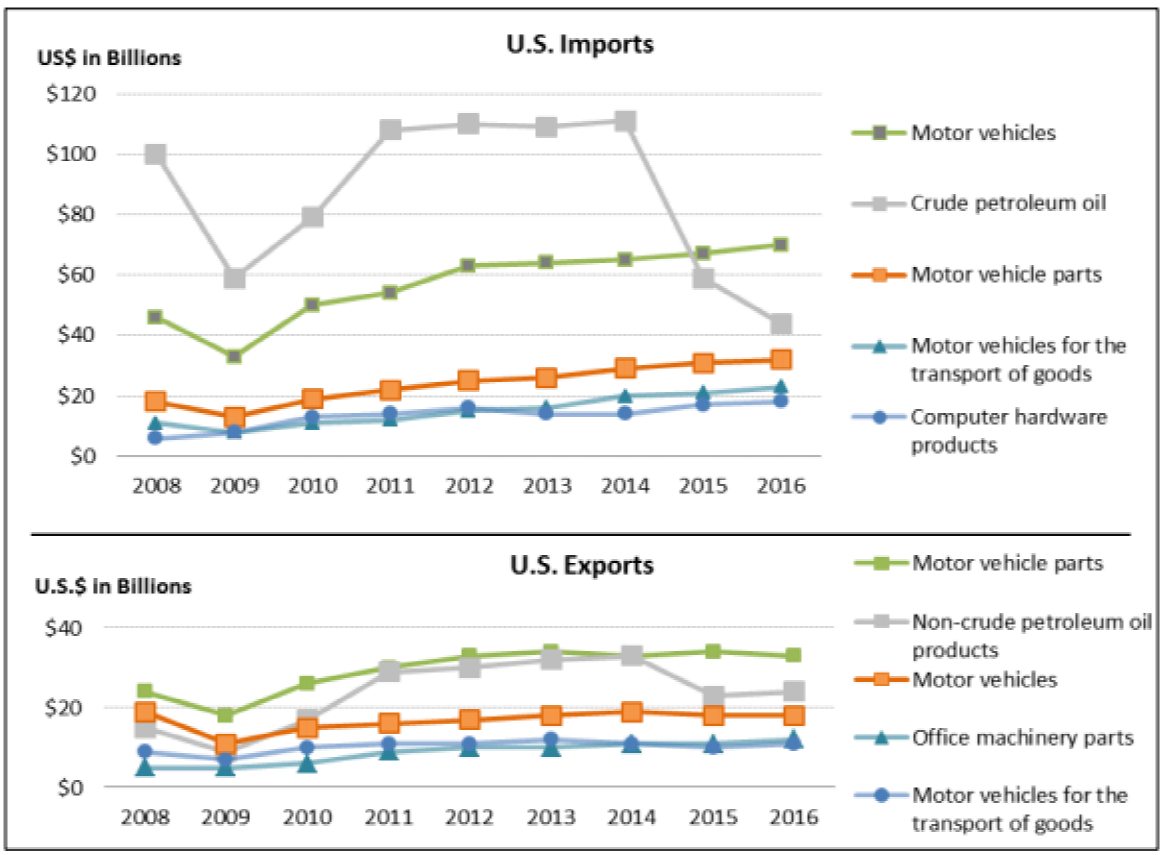


Source: Compiled by CRS using trade data from the U.S. International Trade Commission's Interactive Tariff and Trade Data Web, at http://dataweb.usitc.gov.

Bilaterally, US-Canada trade more than doubled after the CFTA and further flourished under NAFTA. Total trade went from $166.5 billion in 1993 to $362.2 billion in 2004 to $600.6 billion in 2008. US-Mexico trade has similarly exploded, with US exports to Mexico increasing by 455% and US imports increasing by 637%.

It is difficult to evaluate how important NAFTA was in orchestrating these levels of trade. Other factors, such as each country's domestic economic growth, have likely played a significant role as well. Nevertheless, companies across country borders have utilized access to more markets to their advantage. "Many economists and other observers have credited NAFTA with helping US manufacturing industries, especially the US auto industry, become more globally competitive through greater...economic integration and the development of supply chains." As these supply chains have developed, companies have capitalized on improved efficiency and economies of scale. (Villarreal & Fergusson, 2017)

Figure 4. Top Five U.S. Import and Export Items to and from NAFTA Partners
(billions of nominal dollars)



Source: Compiled by CRS using trade data from the USITC at http://dataweb.usitc.gov.

<u>NAFTA - Consequences for the US</u>

Trade with Mexico and Canada traditionally amounts to less than 5% of US GDP.. As such, it is difficult to ascertain the precise costs and benefits of NAFTA to the US populace. However, econometric studies over the past 25 years have uncovered a net overall benefit from

NAFTA. According to a 2003 report by the Congressional Budget Office (CBO), NAFTA contributes a few billion dollars each year to US GDP. Though a modest figure overall, many sectors have improved their efficiency and lowered prices as a result. This is especially apparent in the automotive industry, where companies (such as Ford) are able to source different parts of their vehicles in different countries to keep prices low. A report by the US International Trade Commission in 2016 found results consistent with the CBO report. That is, NAFTA has led to “a substantial increase in trade volumes for all three countries; a small increase in US welfare; and little to no change in US aggregate employment.” (USITC, 2016)

An independent analysis conducted by economists Lorenzo Caliendo and Fernando Parro reinforces these findings. By utilizing a modified Ricardian model factoring in “sectoral heterogeneity, intermediate goods and sector linkages”, economic benefits become visible. (Caliendo & Parro, 2014). Per their findings, US terms of trade has risen slightly in the past 25 years, along with trade volume and real wages. The table below provides measurements for all 3 countries.

Table 2. Welfare effects from NAFTA’s tariff reductions

Country	Welfare			
	Total	Terms of trade	Volume of Trade	Real wages
Mexico	1.31%	-0.41%	1.72%	1.72%
Canada	-0.06%	-0.11%	0.04%	0.32%
U.S.	0.08%	0.04%	0.04%	0.11%

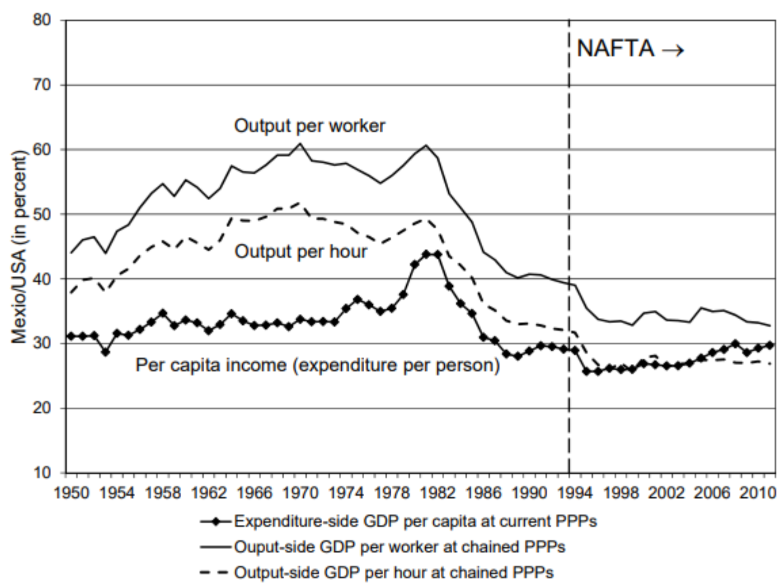
The record regarding employment in import-competitive industries is more mixed. According to the Peterson Institute for International Economics, nearly 200,000 export-related jobs are created every year by NAFTA. “Since NAFTA’s enactment, fewer than 5 percent of US workers who have lost jobs from sizable layoffs (such as when large plants close down) can be attributed to rising imports from Mexico….and almost the same number of new jobs has been created annually by rising US exports to Mexico...The net annual job losses are perhaps in the low tens of thousands, about 15,000. For every net job lost..the gains to the US economy were about $450,000...globalization payoffs derive from investment as well as trade…[F]or every 100 jobs US manufacturing multinational corporations created in Mexican plants, nearly 250 jobs were added in their US operations.”

However, some economists dispute this conclusion completely. Instead of the pact creating jobs, NAFTA has actually pushed jobs away from the United States. This is particularly evident in lower-skilled industries. Robert Scott of the Economic Policy Institute writes that as many as 682,900 jobs were lost on net. “U.S. trade deficits with Mexico as of 2010 displaced production that could have supported 682,900 U.S. jobs; given the pre-NAFTA trade surplus, all of those jobs have been lost or displaced since NAFTA. This estimate of 682,900 net jobs displaced takes into account the additional jobs created by exports to Mexico.” (Scott, 2011)

Others economists fall somewhere in the middle. A net jobs loss was indeed recorded. But these jobs were not lost due to competition with Mexico and Canada, argues economist Gordon Hanson. Rather, they disappeared due to technological automation and increased competition with China. Without NAFTA, even more jobs would be lost. NAFTA lowered costs, increased productivity, and improved American competitiveness. Though some were injured financially, things could have been even worse.

<u>NAFTA - Consequences for Mexico</u>

Mexican President Carlos Salinas de Gortari “famously declared that NAFTA would transform his country into a first-world nation and that it would enable Mexico to ‘export goods not people’.” Unfortunately, according to economist Robert Blecker, “these optimistic forecasts were never realized...there has been no convergence between Mexico and the United States since NAFTA went into effect...On the contrary, as of the last year for which data are available (2011), Mexico’s relative per capita income was no higher than it was in the early 1990s...and its relative labor productivity...was lower than in the pre-NAFTA years. Even more distressingly, by 2011 all the convergence that Mexico had achieved between 1950 and 1980 had been completely reversed; its labor productivity was a smaller percentage of the U.S. level (by either measure) than in 1950, and its per capita income was about the same percentage as in 1950 (around 30 percent in PPP terms).” (Blecker, 2014)



Blecker paints a bleak picture, but he only tells part of the story. A study done by the World Bank found contrasting results. NAFTA has indeed been a net benefit to the Mexican economy, as it’s increased Mexican firm productivity and welfare. In addition, US investment in Mexico has increased by over 600% since 1993. As such, the discrepancy between the graph here and the table above can be evaluated through the lens of Mexico’s “two-speed” economy. For the sectors involved with technology, manufacturing, and the like, gains have been strong. But for industries such as agriculture, NAFTA has been harmful due to cheap competition in the US and Canada.

Just as with the United States, it is extraordinarily difficult to separate the signal from the noise when parsing economic data. NAFTA did not end up engendering wage convergence as some hoped, but it is unfair to expect such a result in the first place. Mexico has experienced a host of domestic economic issues since 1994, including the Peso Crisis and the 2008 recession. In addition, many industries still face high levels of regulation that distort efficient allocations of resources. In the long run, improvements in education, industrial policies, and manufacturing would do more to spur wage convergence than free trade. In addition, some economists argue that “neither Mexico nor the United States adopted complementary policies after NAFTA that could have promoted a more successful regional integration effort…[O]ther developments, such as increased security along the US-Mexico border…[and] terrorist attacks have made it much more difficult for the movement of goods and services across the border.” (Villarreal & Fergusson, 2017) Below is a figure representing the various channels through which trade affects an economy.

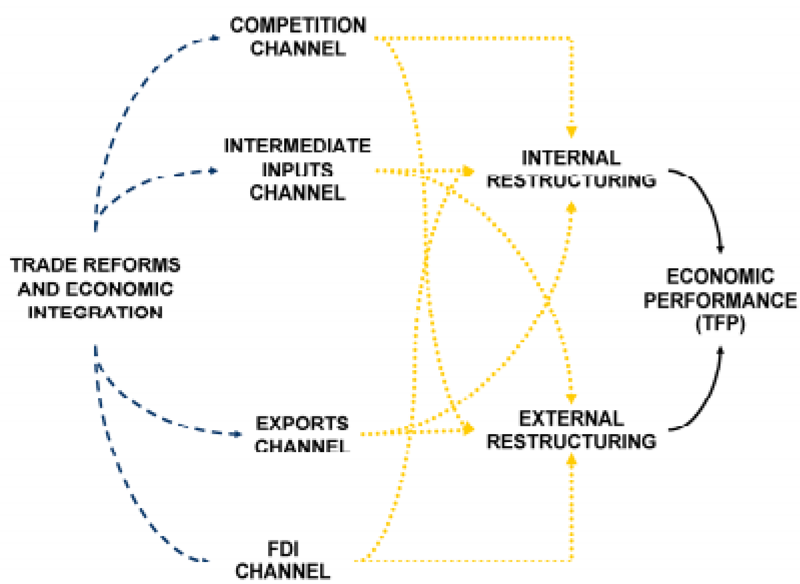


Figure 1: Trade-Productivity Linkages: Conceptual Framework

NAFTA - Consequences for Canada

Because Canada was already engaged in free trade with the United States, its benefits from NAFTA were less pronounced. Nevertheless, cross-border investment has surged since 1993. US investment into Canadian industry grew by over 500% and now accounts for over half of its FDI stock. Agriculture, in particular, gained from the pact. Canada is now the leading importer of US agricultural products, and one of the largest exporters of agricultural products to the United States.

“From the Canadian perspective, the important consequences of the [Free Trade Agreement] may have been what did not happen...many of the fears of opening up trade...did not come to pass. Canada did not become an economic appendage or ‘51st state’...it did not lose control over its water or energy resources; its manufacturing sector was not gutted from the agreement…However, some hopes….that it would be a catalyst for greater productivity in Canadian industry, also have not come to pass.” (Villarreal & Fergusson, 2017) To this day, a productivity gap persists. For every $1 created by an American firm over a given amount of time, only $0.73 are produced by an equivalent Canadian firm during that span.

USMCA - Changes to NAFTA

In August 2018, the Trump administration struck a deal to “modernize” NAFTA with the Mexican and Canadian governments. The USMCA - as it’s labeled - preserves NAFTA in its current state. However, a couple changes are worth noting. With regard to the auto industry, rules of origin tightened. 75% of vehicles sold in America, Canada, and Mexico must now originate in these countries - up from 62.5%. In addition, 40-45% of automobile parts must be produced by workers receiving wages of $16 per hour. With regard to agriculture, the United States gained access to an increased portion of the Canadian dairy market. And with regard to IP, copyrights now extend 70 years beyond the life of their author - up from 50 years. Perhaps most importantly, governments’ abilities to impose tariffs via loopholes were eliminated. The deal is scheduled to expire after 16 years.

Conclusion

When it comes to economic upheaval, NAFTA has been a source of controversy since its inception. Proponents of the deal have often spoken of the miraculous effects of free trade. Increased trade volume, higher foreign investment, greater amounts of jobs, lower consumer prices, and general prosperity have been touted as just some of the benefits of economic integration. Meanwhile, critics have turned their attention to its costs. Lost jobs, worse product quality, lower wages, and the like have become familiar talking points in politics today.

In the end, who is correct? The answer is not black and white. NAFTA’s critics have consistently been incorrect about wages, investment, welfare, and product quality. The countries in aggregate are better off today than they likely would have been without a pact. But the deal’s proponents often forget that reorienting entire economies leads to tradeoffs. There are generally winners and losers in free trade, and the winners gain diffusely while the losers are harmed acutely. The case of North American free trade has played out no differently.

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