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NAFTA: Economic Effects on the United States After Five Years

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Summary

The main economic benefit of the North American Free Trade Agreement (NAFTA) is that, over time, it is expected to increase productivity and incomes in the United States, Mexico and Canada. In the near term, some reallocation of resources occurs within each country, generating gains for some producers and workers and costs for others. Since the Mexican and Canadian economies are small relative to the U.S. economy, both the long-term benefits and short-term adjustment costs of the NAFTA to the United States are expected to be small. The data suggest that NAFTA has had a positive, but small, effect on U.S. trade with Mexico and that U.S. direct investment in Mexico remains very small relative to total U.S. investment abroad. The number of workers displaced by import competition with Canada and Mexico or production shifts to those countries is estimated to be very small compared with total U.S. employment. This report will be updated annually.

The NAFTA has been in effect since January 1, 1994. Some anecdotal evidence suggests that the NAFTA has been highly beneficial to the United States, while other accounts imply that import competition from Mexico has led to substantial U.S. unemployment. Neither of these claims are supported by the available evidence. This report begins with a brief discussion of the benefits and adjustment costs of free trade, followed by empirical evidence suggesting that, over time, trade is beneficial to all countries. The discussion then focuses on the NAFTA's effect on the United States, given the relatively small size of the Mexican economy and the data which show the NAFTA's effects, in the aggregate, to be very small.

Why Trade Matters

The basic economic argument for international trade is that nations can, by producing more efficiently, expand the amount of goods and services they produce and consume. By importing goods that are relatively costly to produce domestically and exchanging them for exports which it can produce most efficiently, it is argued that each country can produce and consume more goods with trade than in isolation. That is, by specializing in producing those goods and services in which each country has a comparative advantage, productivity is improved for all countries. Moreover, by providing access to a larger market, free trade may allow some industries to take advantage of "economies of scale;" plants can specialize in producing fewer product lines at lower costs. The economy can be thought of as a pie; trade expands the size of the pie. Importantly, all countries gain; one country's gains are not another country's losses.

Free trade also can enhance the investment climate, improve the rate of technological development, stimulate firms to become more competitive, and raise the economy's rate of growth. Consumers, in particular, benefit considerably from lower prices and a wider choice of products. These dynamic gains are often of greater long-term significance than the benefits of comparative advantage.

Nevertheless, as countries engage in trade, labor and capital may have to shift from one industry to another. As resources are reallocated from an industry whose costs are relatively high to one whose costs are relatively low, some jobs disappear and others are created. This process occurs regularly and necessarily in a market economy, with or without foreign trade, and ultimately results in a rising living standard. *Importantly, trade does not affect the total number of jobs in the economy, but it may affect the composition of jobs.*

Trade may also affect the distribution of income within an economy. By increasing the demand for those products which are produced most efficiently, wages for workers and the reward to capital that produce those products tend to rise. Similarly, demand for the products produced least efficiently falls, reducing wages of workers and the return to capital in those industries.

Empirical evidence suggests that international trade, when restricted, inhibits economic growth and, when liberalized, stimulates economic growth. Economists believe, for example, that the Smoot-Hawley tariff (which raised tariffs to an all-time high in 1930) led to retaliatory trade restrictions by other countries, which served to deepen and lengthen the worldwide depression of the 1930s.

In contrast, the post-World War II process of trade liberalization under the auspices of the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO), has been accompanied by a large increase in world output (GDP) and an even larger growth of world trade. Recent experience of the developing countries supports the hypothesis that trade liberalization is associated with higher economic growth. Those developing countries which liberalized trade, such as Hong Kong and Singapore, grew much faster than those that restricted trade, such as Nigeria and Ghana.[1]

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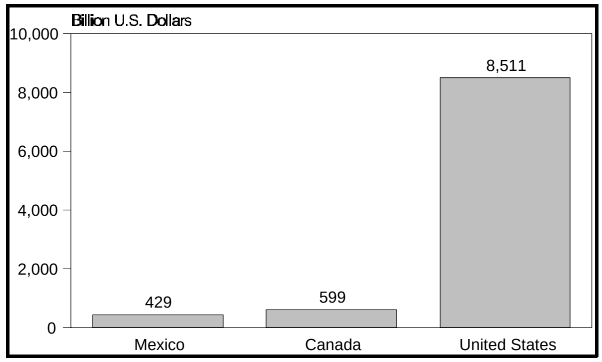
[1]The Theory and Practice of Free Trade. *Federal Reserve Bank of Dallas Economic Review*. Fourth Quarter, 1993. p. 4. Of course, other factors, such as education levels, political stability, and access to technology, are also important.

Magnitude of NAFTA's Effect on the United States

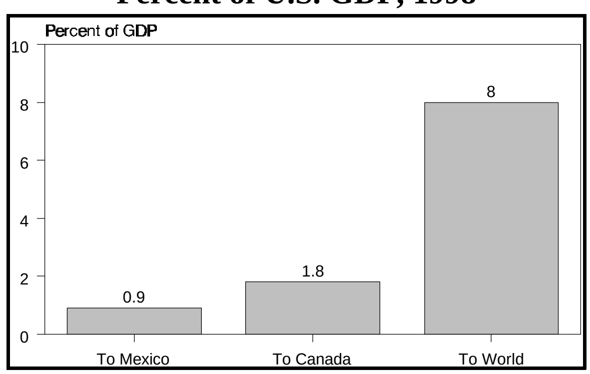
Figure 1. Gross Domestic Product 1998



There are several reasons why NAFTA's effect on the U.S. economy would be expected to be small. First, the U.S. economy is very large relative to that of Canada and Mexico. Mexico's GDP in 1998 of $429 billion was only 5% that of the United States (see figure 1). Expressed another way, the Mexican economy is roughly the size of the economy of New Jersey or the Los Angeles metropolitan area. Even Canada's 1998 GDP of $599 billion was only 7% of U.S. GDP.

Another way of looking at it is to examine U.S. trade with Mexico and Canada. Even though Mexico is the second largest U.S. export market, U.S. exports to Mexico were less than 1% of U.S. GDP in 1998 (see figure 2). U.S. exports to Canada (the largest U.S. trading partner) were 1.8% of U.S. GDP. Even if the NAFTA substantially increased trade flows, they would still be relatively small in relation to U.S. GDP.

Figure 2. U.S. Merchandise Exports as a Percent of U.S. GDP, 1998



Second, tariffs were already low or nonexistent between the three countries when the NAFTA went into effect and have continued to decline. Under the Canada-U.S. Free Trade Agreement, which was superceded by the NAFTA, some tariffs were eliminated on January 1, 1989, and the rest phased out over 5 or 10 years. By January 1, 1999, virtually all U.S.-Canadian tariffs had been eliminated.

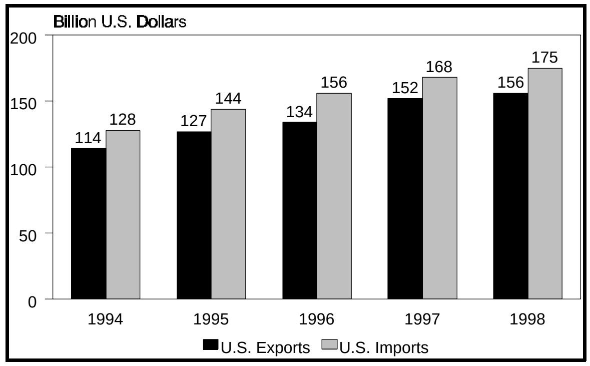
When the NAFTA went into force, half of U.S. exports to Mexico became duty-free, with the remaining half phased out over 5, 10, or 15 years. By January 1, 1999, the average Mexican tariff on U.S. products had declined from 10% to 1.68%, while the average U.S. tariff on Mexican products had declined from 4% to 0.46%.[2]

[2]Office of the United States Trade Representative. *1999 Trade Policy Agenda and 1998 Annual Report of the President of the United States on the Trade Agreements Program*. Washington, 1999. p. 159.

The Evidence So Far

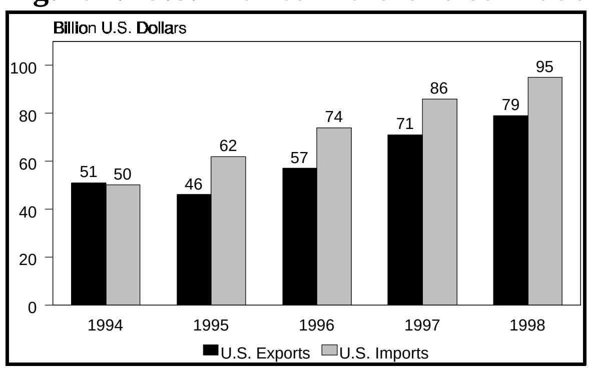
Trade. U.S. trade with Canada and Mexico has increased since 1994, as shown in figures 3 and 4. Between 1994 and 1998, U.S. exports to Mexico and Canada combined grew by about 42%, while U.S. imports from both countries increased 51%. The U.S. trade deficit with Mexico and Canada combined fluctuated from $33 billion in 1995 to $39 billion in 1996, $31 billion in 1997 and $34 billion in 1998. It accounted for 15% of the total U.S. merchandise trade deficit in 1998.

Figure 3. U.S.-Canada Merchandise Trade



However, the trade data reflect much more than the effects of the NAFTA. Although not shown in figures 3 and 4, U.S. trade with Canada and Mexico was increasing before 1994, suggested that some of the post-NAFTA trade increases are a continuation of an ongoing trend. Moreover, in the short-run, exports and imports and the trade deficit are strongly influenced by exchange rate changes and the level of economic activity in each country. For example, in 1998, the robust U.S. economy and the relatively high U.S. dollar vis-a-vis the Canadian dollar and Mexican peso likely were important causes of the increased U.S. trade deficit with both countries in 1998.

Figure 4. U.S.-Mexico Merchandise Trade



Section 512 of the NAFTA Implementation Act (P.L.103-182) required the President to provide a comprehensive assessment of the operation and effects of NAFTA to the Congress by July 1, 1997. The main findings of this report, which covers the first three years of NAFTA (1994 through 1996) were:[3]

- NAFTA had a modest positive effect on U.S. net exports, income, investment and jobs supported by exports.
- U.S. suppliers saw their share of Mexico's import market grow from 69% to 75%. Mexican suppliers increased their share of U.S. imports from 7% to 9%.

[3]President of the United States. *Study on the Operation and Effects of the North American Free Trade Agreement*. July 1997, p. ii, iv, v, and vi.

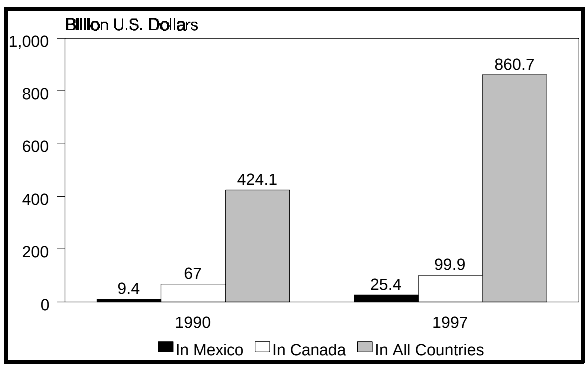
- The U.S. share of Mexico's import market increased the most in the following sectors: textiles, transport equipment, and electronic goods and appliances. Under the NAFTA, Mexico's tariffs declined substantially in these three sectors, stimulating increased U.S. exports.

- In apparel, the U.S. share of imports from Mexico (which have a high U.S content) grew from 4.4% to 9.6%, while the share from China, Hong Kong, Taiwan and Korea fell. U.S. apparel imports from Mexico apparently displaced apparel imports from the Far East.

Investment. During the NAFTA debate, much concern was expressed that U.S. firms might relocate plants to Mexico to take advantage of its low wages. Others argued that wages are only one factor in the decision to invest abroad. In particular, productivity in most industries in Mexico is lower than in the United States, and Mexico's transportation and infrastructure are not as well developed as those of the United States.

The available data suggest that U.S. direct investment in Mexico[4] is currently small relative to total U.S. direct investment abroad. In 1997 (the latest data available), the U.S. direct investment position (the cumulative amount, or the stock) in Mexico was $25.4 billion, only 3.0% of the U.S. direct investment position in all countries of $860.7 billion (figure 5). Even the U.S. direct investment position in Canada is only 11.6% of the total U.S. direct investment position abroad.

Figure 5. U.S. Direct Investment Abroad, 1990 and 1997



Furthermore, the amount of new investment in Mexico is relatively low. Looking at investment *flows*, U.S. direct investment in Mexico was $3.0 billion in 1995, $2.7 billion in 1996, and $5.9 billion in 1997. By comparison, U.S. domestic investment in U.S. plant and equipment was $864.9 billion in 1997.[5] In other words, U.S. investment in Mexico was less than 1% of all U.S. domestic investment in plant and equipment in 1997. This suggests that even if the NAFTA directly caused all these investment flows, the NAFTA's effect is very small.

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[4]Direct investment is defined as the ownership or control, directly or indirectly, by one person (individual, partnership, etc.) of 10% or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise.

[5]U.S. Department of Commerce. *Survey of Current Business*, Vol. 78, No. 7, July 1998, p. D-2.

Employment. As noted earlier, the NAFTA may cause some workers to gain jobs and others to lose them as the economy reallocates its resources. Since it takes time to shift resources, and since some resources are not easily adaptable to other types of production, some industries and workers will find it difficult to adjust. At the same time, other industries would benefit from increased demand, creating new jobs.

The implementing legislation for the NAFTA (P.L. 103-182) included a Transitional Adjustment Assistance (TAA) program, which provides employment services, training, income support, and job search and relocation allowances to eligible workers.[6] To receive benefits, workers must be certified by the U.S. Secretary of the Labor as having lost their jobs (or been threatened with job loss) by increased import competition from Mexico or Canada or by production shifts to Mexico or Canada.

One by-product of the TAA program is that it provides data on the estimated number of workers covered by certification. It is important to emphasize that the number of workers covered by certification is not the same as the number of jobs lost as a result of NAFTA. Some of the workers covered by certification were never laid off from their jobs, while some displaced workers may not have applied for assistance. Nevertheless, since the TAA numbers are the only available data, they provide an indication of the magnitude of the adjustment costs of NAFTA.

In the 5 years ending December 31, 1998, 350,011 workers were covered by certification, of which about 34% were in the apparel and electronics industries.[7] The 350,011 workers covered by certification is relatively small — about three-tenths of a percent of total U.S. employment of 132.5 million at the end of December 1998. From another perspective, the average number of jobs created *per month* between March 1991 (when the current economic expansion began) and December 1998 has been about 165,000. Moreover, since mid-1994, the U.S. economy has been near, if not above, what most economists consider to be full-employment, suggesting that displaced workers may have found jobs elsewhere or dropped out of the labor force.

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[6]For a fuller discussion, see CRS Report 94-52 EPW, *Adjustment Assistance for Workers Dislocated by the North American Free Trade Agreement*, by James R. Storey (Updated September 10, 1998).

[7]U.S. Department of Labor. Office of Trade Adjustment Assistance. See also CRS Report 98-782 E, *NAFTA: Estimates of Job Effects and Industry Trade Trends After 4 ½ Years*, by (name red acted).