6-2008

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Author Manuscript
This is a pre-publication author manuscript of the final, published article.

Recommended Citation

Malliaris, Anastasios G.; Kondonassis, Alexander J.; and Paraskevopoulos, Chris. NAFTA: Past, Present and Future. The Journal of Economic Asymmetries, 5, 1: 13-23, 2008. Retrieved from Loyola eCommons, School of Business: Faculty Publications and Other Works, http://dx.doi.org/10.1016/j.jeca.2008.01.002

NAFTA: PAST, PRESENT AND FUTURE

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Abstract. The North American Free Trade Agreement (NAFTA) – an extension of the Free Trade Agreement (FTA) between Canada and USA to include Mexico – went into effect on January 1, 1994, primarily as an agreement to eliminate restrictions on trade and investment over the course of twelve years. NAFTA is a trade agreement and after twelve years remains as such with limited prospects, if any, of widening or deepening the integration process. Despite its narrow scope, the agreement became, from the start, controversial – and continues to be so – not only for trade and investment matters but for a whole host of other related issues. The other related issues include: the dispute settlement mechanism and side agreements on labor and environmental issues.

JEL Classification: F03, F15, F31

Keywords: North American Free Trade Agreement, NAFTA, Canada, Mexico, United States, trade, investment, agricultural integration, monetary integration.

1. Introduction

"Put simply, NAFTA has been neither the disaster its opponents predicted nor the savior hailed by its supporters" Audley J, (2003, p. 7)

The North American Free Trade Agreement (NAFTA) – an extension of the Free Trade Agreement (FTA) between Canada and USA to include Mexico – went into effect on January 1, 1994, primarily as an agreement to eliminate restrictions on trade and investment over the course of twelve years. NAFTA is a trade agreement and after thirteen years remains as such with limited prospects, if any, of widening or deepening the integration process.

Despite its narrow scope, the agreement became, from the start, controversial – and continues to be so – not only for trade and investment matters but for a whole host of other related issues. The other related issues include: the dispute settlement mechanism, membership enlargement, monetary integration, and side agreements on labor and environmental issues.

As NAFTA moves into its second decade, these issues require more urgent attention especially as the long-term effects of the treaty, anticipated or not, is slowly emerging. In this study we provide a retrospective assessment and evaluation of NAFTA thirteen years later and raise some of the issues that require immediate attention as we look to the future. Accordingly, in Section 1 we contrast NAFTA with the European Union (EU), in Section 2 we discuss the recent trend towards bilateralism, in Section 3 we look critically at NAFTA thirteen years later, and in the last section we raise some of the challenges affecting the future of NAFTA.

2. NAFTA and the EU

At the time, NAFTA was a unique case of integration in the world as it involved the integration of a developing county with two industrial ones. The per capita income of the US was six times that of Mexico. Whereas, in contrast, the per capita income of Germany – wealthiest – was twice that of Greece –poorest – among the EU 15.

NAFTA, unlike the European Union, is a trilateral agreement. NAFTA is structured as three bilateral agreements, one between Canada and the United States, a second between Mexico and the United States, and a third between Canada and Mexico. The first accord is CFTA, which took effect on January 1, 1989, and is subsumed by NAFTA. The second and third agreements are found in NAFTA itself.

Today, more than a decade later, NAFTA has not enlarged its membership to include other countries in the Americas. Since its inception, however, there have been several efforts to expand free trade agreements – at a multilateral level – in the Americas. But unlike the EU, which has established an elaborate legal process and criteria – albeit bureaucratic and sometimes intrusive – for the accession of new members, the NAFTA accession clause – article 2204 – provides no such clear guidance and criteria. It leaves it up to the individual members.

According to Robert A. Pastor (2004, p. 124):

> *"Although NAFTA fueled the train of continental integration, it did not provide conductors to guide it".*
>
> *"No clause in the agreement established a mechanism to anticipate or respond to market failures. Whereas the EU has created too many intrusive institutions, North America made the opposite mistake: it created almost none"*

In fact, in the absence of clear criteria in the Agreement, the candidate country must be willing and able to accept the conditions of the so-called Washington Consensus, a term coined by John Williamson which includes reducing fiscal deficits, tax reform, exchange and interest rate reform, privatization, FDI, deregulation, etc.

Chile tried without success to become part of NAFTA. Instead all three NAFTA countries opted to sign separate bilateral agreements with Chile. For sometime now there is a preference for bilateral over multilateral agreements. In all three countries there are a number of bilateral free trade agreements. This attitude, according to Pastor, has been largely deliberate. He points out that "Integration has usually taken the form of dual bilateralism – U.S.-Mexican and U.S.-Canadian – rather than a continental partnership." We will elaborate on this issue in the next section.

It is important to remember that unlike the EU, NAFTA was designed as a trade agreement with no political dimension or vision attached. The treaty was solely based on unlocking the economic benefits within the three trading countries of North American. NAFTA was more of an experiment in international trade and economic theory but on no account did include the political aspiration of the EU. This fundamental difference casts a shadow over NAFTA's achievements so far and its future development.

3. NAFTA and Rising Bilateralism

The World Bank (2005) reports that there is a proliferation of regional trade agreements (RTAs) that now surpasses 200, a six-fold increase in the last twenty years. This covers more than one-third of world trade and "… is fundamentally altering the world trade landscape." The World Bank report notices that the EU and United States are the most prominent players in this proliferation process. This includes reciprocal treaties such as NAFTA, the EU-Mediterranean Bilateral Agreement, and South-South agreements like MERCOSUR.

Moreover, according to Francois Bourguignon (2004)

> *"Since Cancun, it can be observed that major economies in North America and in Europe have redoubled efforts to seek bilateral and regional trade agreements. The U.S. has recently signed a trade agreement with Chile, and has a trade agreement with Central America. The EU is presently negotiating with MERCOSUR. And then the question arises whether these agreements complement the effort to achieve a pro-development WTO round, or do they stand in the way and threaten to derail these negotiations in WTO. We need to address this question."*

The report argues that agreements leading to open regionalism – that is, deeper integration of trade as a result of low external tariffs, increased services competition, and efforts to reduce cross-border and customs delays costs – are effective as part of a larger trade strategy to promote growth. Such regional agreements can complement a strategy that, on the one hand, includes autonomous liberalization to promote productivity gains and, on the other hand, leverages domestic reforms to enhance market access. Although regional agreements can prove beneficial to member countries, they can have adverse effects on excluded countries. Lowering of border barriers around the world is crucial to minimizing these effects. It is hoped that future agreement by all countries in the World Trade Organization on global trade issues will reduce the risk of trade diversion associated with regional agreements and will decrease trade losses of countries excluded from agreements.

The report also says that key ingredients of RTAs that promote development include low external border barriers, promotion of new cross-border competition, nonrestrictive rules of origin, few sectoral and product exemptions, and more open services markets. Effective RTAs can help reduce regional political tensions, exploit economies of scale in infrastructure provision, and lead to joint programs to improve border crossings. However, Richard Newfarmer, Economic Adviser in the Bank's Trade Department and lead author of GEP (2005) states that

> *"Neither North-South bilateral agreements nor South-South arrangements get universally high marks," "U.S. and EU bilateral agreements often fall short of full free trade because they exclude sensitive products, commonly agriculture, or they adopt restrictive rules of origin that effectively deny market access. South-South agreements are sometimes more liberal in goods trade, but rarely expand competition in services and often lag in implementation. And few agreements seize the opportunity to provide for temporary movement of workers."*

William R. Cline (2004), in a comprehensive study published by the Center for Global Development and the Institute for International Economics argues that the elimination of tariffs and other protective barriers globally would:

- lift at least 500 million of people out of poverty over 15 years
- create long-term economic benefits to developing countries of $200 billion per year, and
- liberalization of agriculture would account for about half of the total gains for both developing and industrial countries. (Cline, 2004)

Notwithstanding the above, the World Bank report concludes: "… regional trade agreements offer benefits to developing countries provided that these trade agreements do not occur behind a wall of protection or behind an increased role of protection."

However, some strongly argue against the bilateral trend currently pursued by the U.S and the E.U. Jeffrey Schott (2004), in a major study by the Institute for International Economics, proposes that "The United States should recast its trade negotiating priorities to pursue fewer but bigger deals." (Schott, 2004). He argues that "big stakes" FTAs yield the largest payoff for US firms, workers, and farmers, while also providing strong support for ongoing WTO negotiations. As such, we believe the U.S. needs to refocus its efforts away from bilateralism in the interest of more comprehensive and multilateral trade agreements.

4. NAFTA after Thirteen Years: A Critical Assessment

It has been thirteen years since the implementation of NAFTA and the controversy over its value continues. The promises of the proponents of NAFTA – that it would create hundreds of thousands of new jobs, raise the standards of living of USA, Mexico, and Canada, improve the environment and boost the development of Mexico – are questionable. The opponents of NAFTA argue that jobs have been lost, domestic policy making has been undermined, and environmental and health conditions have suffered. Why such disparity of views? The proponents of NAFTA have apparently built their position on the assumptions that free trade is good for every country and that privatization is largely the answer to development. Powerful organizations such as the World Bank and the International Monetary Fund have been among the proponents of this view. The opponents to NAFTA argue that the market and free trade alone are not necessarily the best ways to economic development, sustainability, and social justice. Furthermore, they argue that the questionable results from NAFTA mitigate against its expansion into more countries in Latin America.

One of the problems with NAFTA is that integration was tried among countries of such disparate levels of development. For instance, gross national income per capita for Mexico, Canada, and the USA was $7,310, $32,600, and $43,740 in 2005 respectively; that is, Mexico's gross national income per capita was one sixth of that of the USA. Because of NAFTA there was an assumption that Mexican agriculture would be modernized and become more productive, but NAFTA provided no financial assistance to this end. Since 1958 the European Union has provided under the common agricultural policy large amounts of financial assistance to old and new members in support of their agriculture. New members whose income levels were low became eligible to receive structural funds for economic development in an effort to move the European Union members toward social and economic cohesion. A more specific look into developments in the three NAFTA countries in recent years shows briefly the following.

NAFTA and the US Case. In the case of the US a small trade surplus with Mexico before NAFTA has become a large trade deficit after NAFTA. The US trade deficit with Canada has increased fivefold. It is estimated that about half a million US jobs have been lost due to NAFTA. Many workers who lost high paying jobs in manufacturing have moved into service jobs with considerably lower wages. The US had a total trade deficit of $436 billion in 2002 of which 20% was with its NAFTA partners.

It is also argued that NAFTA is an investment agreement which grants foreign investors a new set of rights to encourage relocation abroad of businesses. US farmers were told that NAFTA would provide access of US agricultural exports to Mexico and Canada and would improve the status of US farmers. The experience of farmers after NAFTA shows that 38,000 US small farms have been eliminated and farm income has gone down. However, agribusiness profits are up.

NAFTA had a minimal effect on the wage level and widening disparity between skilled and unskilled labor in the U.S. But Sandra Polaski observes a decoupling in productivity growth from wage growth in the U.S which, she argues, can partly be attributed to NAFTA because workers bargaining position had been weakened. (Polaski, 2006)

NAFTA and Canada. Canada has experienced a large increase in its exports to the USA but not as large an increase as in its imports from the USA. Canada's real per capita growth averaged an increase of 1.6% per year during the period 1989-2002. Productivity growth averaged 2% per year for the 1994-2002 period while wages rose by an annual rate of .4% per year (Foster and Dillion). This suggests that employers, not workers, benefited from the higher output per hour. Between 1995 and 2001 unemployment averaged 8.6% per year. Many of the jobs created during NAFTA have been part-time, insecure jobs with few benefits. A study of the labor market in Canada found that under NAFTA part-time workers, mostly women, earn about two-thirds the wages of full-time workers and less than 20% receive benefits. In 1996 11.6% of employed workers held temporary jobs.

There were 2400 fewer jobs in the agri-food processing industry in 2002 than in 1988. Some 16% of Canadian farmers have been forced off the land. The National Farmers Union said in 2002 that free-trade agreements may increase trade but they alter the relative size and market power of the players. "Free trade helps Cargill and Monsanto, not farmers."

According to Polaski, Canada has experienced an increase in productivity since the signing of NAFTA. However, this growth in productivity has not translated into an equivalent growth in wages.

Increase in productivity has substantially exceeded growth in wages both in the manufacturing and nonmanufacturing sectors. (Polaski, 2006)

She goes on to say that income inequality in Canada has been trending upward for the past decade with only the richest 20 percent of households experiencing an increase in real income. The rest experienced a sharp decline in real income in the early years of the treaty followed by a slight recovery. However, the recovery was not strong enough to overcome the initial decline.

NAFTA and Mexico. Concerning Mexico the argument advanced was that NAFTA would help raise the standard of living and make it closer to its partners in NAFTA. Thirteen years later more than 1.5 million farm jobs have been destroyed as cheap US corn came into Mexico reducing prices received by Mexican farmers by 70%. As a result rural workers have moved into Mexico's urban areas where under-employment has kept wages low. The average wage paid to Mexico's main factory workers dropped from $5 per day to $4.

When NAFTA got started about 8 million of Mexico's people were involved in agriculture (about ¼ of the active labor force). By 2003 this number had fallen to 6.5 million. Most of Mexico's agricultural economy, was comprised of small plots of land (ejidos) given to Mexico's farmers through land reform that took place in Mexico's post-revolution era in 1917. But NAFTA asserted that land could be owned by foreigners. It allowed plots of land to be sold. It also permitted creditors to seize land. Farm programs that provided price guarantees, low interest rates, and subsidies were eliminated.

Desperation among farmers has stimulated a social movement under the name "The Countryside Can't Take It Anymore" leading to national protests in 2002 and 2003. After ten years, increased investment and exports have not translated into the promised benefits.

Data show that foreign direct investment in Mexico increased from the annual average in 1986-93 of $3.46 billion to $24.73 billion in 2001. Exports of Mexico ranked 54th in 2002. Per capita income increased by 9% during the NAFTA years, but this is less than 1/3 of the increases in the 1960s and 1970s.

Increased investment and exports have not had a broad impact. Specific rules of NAFTA limited regulation of foreign investors in terms of the impact on the Mexican economy. Mexico became an easy in, easy out, investment country. About 1/3 of the 800,000 manufacturing jobs created under NAFTA have disappeared because companies have gone to cheaper labor markets such as China, Malaysia, and Guatemala.

The environment and public health not only have not improved but industrialization on the border has increased toxic dumping and water contamination. The environmental infrastructures in Mexico have not kept pace with increases in pollution as a result of the rapid growth in trade. NAFTA has proven unable to address these problems.

5. Summarizing the Main Problems with NAFTA

All the indications are that Mexico has not greatly benefited from NAFTA. Exports have not been an engine of growth. Exports are concentrated in a few companies with few connections to local production. Their export production has not created more employment. Foreign investment has not created much employment either because much of it represents the acquisition of companies. Sandra Polaski, in her testimony to the senate finance committee, points out the surprising weak job creation in Mexico which operated at less than full employment level, a result that does not sit well from the perspective of economic and trade theories. As a result, some call into question the value of NAFTA and argue that NAFTA represents a model not to be imitated. Market forces may not solely be relied on to produce development. A national plan to establish conditions conducive to each country's development is needed.

With regard to Canada, University of Toronto Professor Stephen Clarkson declares that NAFTA is essentially a "Supra-Constitution." It empowers some actors and dis-empowers civil-society organizations and citizens who look to the state to resolve their problems. Corporations enjoy and exploit their rights under NAFTA. What is needed is an enhanced NAFTA accord which goes beyond the silent integration of markets and deals with the social dimensions of development, that is, environment, labor, energy, services, and transport. This sort of project, something close to the European model, is not likely to receive much support among businesses and the respective parliaments of the NAFTA partners.

Many economists argue that trade liberalization has contributed to income inequality in the US in recent years. Trade liberalization has helped increase corporate profits and the income of highly educated workers at the expense of less educated workers. Estimates state that trade liberalization has cost 75% of US non-college workers an amount equal to 12.2% of their current wages. In 1973 the real hourly wage for high-school graduates peaked at $13.36 a level to which they had still not returned by 2001. On the other hand, US corporate profits rose by 88% in the 1990s and CEO pay by 463% (Lawrence, Berstein and Boushy, 2003).

6. Future Prospects for NAFTA

The empirical evidence gathered thus far lends little support for the value of NAFTA in its current structure as a trade agreement to eliminate restriction on trade and investment among its members. The empirical data challenge the economic rationale behind NAFTA which advocates that free trade on its own will promote economic efficiency and growth. In a paper that examines the history and fate of regional economic integration attempts, A.G Malliaris and A.J Kondonassis show that “Integration agreements that did not progress beyond trade aspects eventually faded away” and “Regional economic integrations schemes that went beyond free trade to monetary union, often resulted in full political unions.” (Malliaris and Kondonasis, 1996, p. 33)

In light of these historical cases, will NAFTA eventually “fade away” or is the prospect for further economic integration, including monetary integration? Will the trend towards bilateralism outlined above lead to the demise of NAFTA or will this trend ultimately strengthen NAFTA by offering pathways to more comprehensive multilateral agreements? These are some of the questions on which the future of NAFTA depends. Where does the current debate stand on these issues?

On the monetary front, there has been little development in the past thirteen years. But as NAFTA moves into its second decade, the issue remains in the background and debate continues on whether or not a further economic integration is possible or desirable. With the European template in sight, monetary union of NAFTA appears as the natural progression and extension of the trading treaty. However, the issue doesn’t seem to attract much attention and is quietly debated in the academic circles and among business leaders with no apparent rush.

With the exception of two periods – namely, the 1994-1995 peso crisis and the latter part of the 1990’s when the Canadian dollar weakened against the dollar – none of the members has been in a hurry to push the monetary integration issue. Mexico and Canada fully understand that pursuing further integration at this stage would likely occur on U.S. terms and conditions. This means mirroring the U.S. institutional, financial, and regulatory approach in NAFTA. From the U.S. perspective, further integration at this stage may be met with political resistance as people are still anxious and unconvinced that the trade agreement, let alone a monetary union, has been in the best interests of the U.S.

Although the debate has not reached the desk of policy makers, all members of the treaty recognize the benefit of monetary integration of some sort. The direction of any further economic integration is unclear with some arguing for a dollarization approach in which Mexico and Canada would adopt the U.S. dollar as their official currency while others argues for a full monetary union that mirrors that of European Union. Neither approach is a clear winner. Proponents of dollarization argue that given the dominant role of the United States in NAFTA, dollarization is the most reasonable and likely outcome of any monetary integration of the region. Furthermore, NAFTA shouldn’t be compared with the EU as a model for monetary integration since the two treaties are fundamentally different. For starters, none of the EU members carries the weight and dominance that the United States has in NAFTA. But more importantly, the monetary union of the EU members is a product of a wider political agreement between its members. NAFTA, in contrast, was drafted as a trading agreement with no political dimensions or aspirations. Since NAFTA lacks the political dimension on which the EU was built, the best approach to monetary integration is, perhaps by default, dollarization.

The other important issue that confronts NAFTA is the rise in bilateral trade agreements and away from comprehensive multilateral agreements. We can only hope that the trend towards bilateral agreements, which tend to be less cumbersome and easier to accomplish, is not a rejection of the multilateral approach. Since the greatest payoff for the U.S. lies in a comprehensive multilateral agreement, we hope that numerous but smaller agreements, as they mature, will pave the ground for larger and more comprehensive agreement.

It is clear from this debate that NAFTA is in need of redefinition of its identity and restructuring of it current purpose to go beyond trade for the treaty to have future prospect.

7. NAFTA: the Second Decade

Looking ahead to the prospects of economic integration in the Americas, here are some of the issues that we believe need to be addressed, with deliberate speed, in the second decade:

1. NAFTA is a trade agreement and after ten years remains as such, but is limited. It falls short of a full free trade agreement because it includes many exclusions that effectively deny market access. Although the prospects of removing these exclusions, and widening or deepening the integration process are limited, it is imperative that the three countries move towards a common external tariff.

2. Despite its narrow scope, the agreement became, from the start, controversial - and it will continue to be so - not only for trade and investment matters but for a whole host of other related issues. The other related issues include: the dispute settlement mechanism and side agreements on labor and environmental issues.

Accordingly, the impact on the environment, migration, the Mexican democracy and NAFTA's dispute settlement mechanism will dominate public debate. Although political pressure for corrective action, some within the next ten years, is – in our view – expected, we believe political pressure on immigration and outsourcing will be more immediate.

In short, what is needed is a NAFTA plus accord which goes beyond the silent integration of markets and deals with social dimensions of development, e.g., environment, labor, energy, services, transport.

3. NAFTA and North American economic integration is at a crossroads as it faces an immediate challenge. The fallout from 911 threatens to seriously undermine North American integration. According to Hufbauer and Schott (2004):

> *"After Sept. 11, 2001, the United States imposed new security measures that made it costly and cumbersome to move goods and people across borders. They created a zone of uncertainty around Canada and Mexico. The threat of another terrorist attack risks a new round of onerous controls on cross-border flows. Clearly, joint action by the three NAFTA partners is essential to minimize that danger" (Hufbauer and Schott, 2004)*

4. The blackout of August 2003 that left 50 million people without electricity raises serious concerns over the adequacy of the regional electric grids. This highlights the urgency of energy issues that NAFTA failed to address.

5. A 34-country free trade arrangement through the newly proposed 'Free Trade Areas of the Americas' (FTAA) is planned to be signed no later than December 2005. The Trade Negotiating Committee (TNC) presented the third draft of the Agreement in November 2003 at the Miami Ministerial Conference. The FTAA draft is based on NAFTA provisions on trade and investment, and on the GATS provisions on services under the WTO. Not surprisingly, the FTAA has been controversial from the start, not only for trade and investment matters, but for a whole host of other related issues that were bitterly debated over NAFTA.

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