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ESSAY

THE NORTH AMERICAN FREE TRADE AGREEMENT AND UNITED STATES EMPLOYMENT

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I. INTRODUCTION

This essay addresses the North American Free Trade Agreement (NAFTA) and its potential effects on employment in the United States.[1] Before reviewing the details of the agreement, it is worth putting the NAFTA in context.

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1. Because this article was drafted at approximately the same time as the release of the 2000+ page text of the North American Free Trade Agreement, much of the analysis is based on the summaries and descriptions of the various sections of the NAFTA that were provided by the Office of the United States Trade Representative and the United States Department of Commerce Office of Mexico. It should also be noted that the authors of this article work with

Trade is critical to the health of the United States economy. With the expansion of international commerce, the United States economy has become increasingly dependent on the global competitiveness of United States firms. Since the mid-1980s, when the dollar began returning to traditional levels after several years of overvaluation, United States firms have been competing quite successfully. In fact, in 1991 the United States surpassed Germany as the world's largest exporter by selling abroad over $422 billion in industrial and agricultural products and over $164 billion in services.

The recent trade performance of the United States has had a significant impact on employment levels. Between 1986 and 1990, the rise in United States merchandise exports to all foreign markets created jobs that account for one-quarter of the growth in United States civilian employment during that period. In 1986, 5 million United States jobs *were supported by* merchandise exports. Currently, more than 7.5 million United States citizens owe their jobs to such exports. The jobs issue is not only one of quantity but also of quality. United States workers in export-related jobs earn 17% more than the average worker in the United States.

At the same time international commerce has become more important for the United States, it has become more important for Asia and Europe, and countries in those regions are undertaking initiatives that will increase their competitiveness and challenge the United States position in the world market. The European Community (EC) is progressing with its 1992 market harmonization program. Moreover, the political changes in Eastern Europe have opened large labor markets which will allow EC industries to increase their efficiency through regional production sharing. Co-production is already a way of life in the Pacific Rim. Integrated manufacturing has allowed Japan and its neighbors to maintain and expand market shares not only in Asia and Europe but also in North America. In the long run, these global changes will slow United States job growth unless the United States responds with initiatives to boost its own competitiveness.

Although the transformation of global commerce created the need for a free trade agreement, the timing of the negotiations for the NAFTA depended in large measure on Mexico itself. In recent years, Mexico has substantially increased international access to its market.

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the Commercial Section of the United States Embassy in Mexico, and thus the analysis presented herein focuses on the United States-Mexico axis of North American free trade.

In 1986, Mexico acceded to the General Agreement on Tariffs and Trade (GATT), accepting a tariff ceiling of 50%; previously, Mexico's duty ceiling had been 100%. Mexico has gone beyond its GATT obligations, reducing its tariffs to a current maximum rate of 25%. In addition, Mexico has eliminated import licenses for most products.

Impressive domestic reforms have accompanied Mexico's international trade policies. Mexico has, for example, streamlined its parastatal sector through privatization and disincorporation. In 1982, there were 1,155 parastatal enterprises. The present number of parastatals has dropped to just over 200. Mexico has also renegotiated its foreign debt obligations and has lifted many restrictions on foreign investment.

These domestic and international policies have revitalized the Mexican market. Mexico's gross domestic product (GDP) grew by 4% last year, exceeding the rate of population growth for the third straight year. The inflation rate for 1991 was 18.8%, and approached single digits in 1992. By contrast, inflation was nearly 160% in 1987. In 1982, the public sector deficit reached 17% of GDP, whereas in 1992 the Mexican government expected a small surplus.

Mexico's economic reforms have also had positive effects on United States producers. United States exports to Mexico have nearly tripled since 1987, increasing from $14.6 billion to a projected $42 billion for 1992. Using the United States Department of Commerce's estimate that every additional billion dollars of United States exports to Mexico supports 19,600 new United States jobs, the expansion of exports to Mexico over the 5 years period ending in 1992 led to the creation of more than 500,000 United States jobs.

Thus, with respect to United States employment, there were two major reasons for beginning negotiations for the North American Free Trade Agreement. First, the NAFTA would provide an improved and expanded regional trade and investment base which would boost the global competitiveness of both United States products and the United States work force vis-à-vis other regions in the world. Second, further trade liberalization with Mexico would maintain Mexico as a premier growth market for United States exports and for the jobs those exports support.

II. Investment

The NAFTA will eliminate conditions that currently encourage or require United States firms to invest south of the border. High trade barriers, for example, have led United States companies to establish affiliates in Mexico in order to sell to that market. A study by the Stern Group shows that 70% of the sales of United States majority-owned affiliates in Mexico goes to the domestic market. When the NAFTA eliminates Mexico's tariff and non-tariff barriers, avoiding trade restrictions will cease to be a motivation for United States manufacturers to move to Mexico. Other provisions in the NAFTA will dismantle Mexico's local content and export performance requirements. Both of these requirements have created regulatory inducements, not market incentives, for United States suppliers to locate in Mexico. These changes portend a return of jobs to the United States.

With or without the NAFTA, however, international market forces are compelling some United States firms to invest overseas. For these firms, off-shore joint production is the only way to ensure survival and maintain at least part of their United States employment base in the face of growing global competition. To be competitive, these United States firms must maximize their regional resources in much the same way that Japanese and Southeast Asian firms are doing.

The NAFTA will guarantee that the full range of North America's continental resources are tapped. By establishing the principle of nondiscrimination for investors, the NAFTA will give United States companies the confidence they need to draw on complementary resources in neighboring economies. The NAFTA will also provide a series of investor rights, including the right to repatriate profits and capital, which will increase the security of United States investments in Mexico.

A dispute settlement mechanism will ensure enforcement of the NAFTA's investment rules. If Mexico violates those rules and a United States investor suffers monetary damages as a result, the dispute settlement mechanism will allow the investor to seek restitution through binding international arbitration. Over the long term, the NAFTA's investment rules and dispute settlement mechanism will foster a commercial climate in North America in which United States investors will be able to utilize continental integrated production when it makes competitive sense.

Beyond boosting global competitiveness, joint production with Mexico confers another benefit on United States producers and workers. When firms locate in Mexico—as opposed to Asia or Eastern Europe—they buy parts and intermediate goods from the United States. The United States International Trade Commission reports that United States content in production-shared imports from Mexico exceeded 50% in 1990; on average, United States content in production-shared imports from countries outside of North America was 13%. Furthermore, for every dollar earned, Mexicans spend over four times more than Asians and over twenty times more than Eastern Europeans on goods made by United States workers. Given these statistics, it is notable that, in expectation of the NAFTA, a number of United States firms are considering moving production facilities to Mexico from other parts of the world.

The NAFTA will also boost investment in Mexico from sources outside of the United States. The prospect of the NAFTA and the progressive reforms of the Salinas administration have already had two effects: (1) the return of Mexican capital to its home country; and (2) new interest in Mexico among European and other foreign investors. These trends will spur long-term economic growth in Mexico. As the former United States Trade Representative, Ambassador Carla Hills, said in testimony to the United States Congress regarding the NAFTA: "Economic growth will not only make Mexico a better customer, but also a stronger and more stable neighbor, easing pressures for illegal immigration. The lesson of history is clear: if opportunities do not go to the people, people will go to the opportunities."

III. Trade in Services

The NAFTA will establish free trade in services; for the United States, this is important for two reasons. First, Mexico's market for services is expanding rapidly, nearly doubling in size since 1987. Second, because United States service providers are among the world's most competitive, access to Mexico's service contacts will greatly benefit firms in the United States. In fact, United States service companies already are effectively competing south of the border. Between 1987 and 1991, our services exports to Mexico increased by 137%, reaching $8.3 billion in 1991.

The NAFTA will liberalize trade in virtually all types of services, including but not limited to: accounting, advertising, architecture, broadcasting, construction, consulting, engineering, enhanced telecommunications, environmental services, health care management, land transport, legal services, and tourism. Under the NAFTA, these services will enjoy the principle of nondiscrimination. Furthermore, the NAFTA's provisions relating to cross-border trade in services and temporary entry for business persons will allow United States firms to provide services in Mexico without relocating operations and employees from the United States. Another notable provision is that, within two years following implementation of the NAFTA, nationality and permanent residency requirements will no longer influence the licensing and certification of professional service providers.[2]

Following implementation of the NAFTA, for the first time in over fifty years United States banking, securities, insurance, and finance firms will be allowed to establish wholly-owned subsidiaries in Mexico and will receive the same treatment as local firms. Although commercial banks still will face some size limits after the NAFTA is fully implemented, the NAFTA will significantly improve access to Mexico for all United States financial services providers. For example, the NAFTA will eliminate within 6 years all of Mexico's equity and market share restrictions on insurance, thus completely liberalizing access to what is estimated to be a $3.5 billion insurance market.

Moreover, the NAFTA not only will increase access to existing financial markets in Mexico but also will open *new* financial markets. On the day the NAFTA goes into effect United States limited-scope financial institutions will be allowed to establish in Mexico. Once established, these institutions will be providing services in what is an untapped market. At the present time, for example, there are not any limited-scope financial institutions in Mexico providing consumer or household finance.

United States firms and workers will also benefit from new access to land transport services. Currently, United States trucks are not allowed to carry cargo into Mexico. Thus, United States truckers must transfer their payloads at the border to Mexican carriers. This system has resulted in delays for United States exporters and extra costs for Mexican importers; it also has reduced work opportunities for United States truckers. Two years after the NAFTA goes into effect, however, United States truckers will be permitted to deliver to the Mexican states which border the United States. Four years later, United States truckers will have cross-border access to all of Mexico. With over 90% of United States-Mexico trade shipped by land, and with trade flows increasing at an unprecedented rate, the liberalization of land-transport services will greatly benefit United States exporters and truckers.

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2. Annexes to the Services Chapter outline special provisions relating to the licensing and certification of engineers and legal consultants.

As Mexico continues to modernize, its market for enhanced telecommunications services is growing dramatically. The NAFTA will liberalize trade in these services. Specifically, the NAFTA will eliminate Mexico's investment and service restrictions on United States providers of electronic data interfaces, on-line data bases, and managed network services, among other enhanced services. The NAFTA also stipulates that the cross-border provision of enhanced telecommunication services, such as data processing, will be unrestricted. Additionally, the NAFTA will protect United States firms from anticompetitive practices by telecommunications monopolies in other NAFTA markets, and it will ensure access to and use of public networks in other NAFTA markets.

IV. Trade in Goods

Significant barriers impede United States merchandise exports to Mexico. Mexico's average tariff on United States products is two and one-half times higher than the average United States tariff on Mexican goods. In addition, many non-tariff barriers in Mexico block United States exports. The NAFTA will establish free trade in goods between the United States and Mexico. Within fifteen years of the date that the NAFTA enters into force, there will be no tariffs on United States-Mexico trade. The vast majority of United States exports, however, will enter Mexico duty-free well before the end of the fifteen-year period. In fact, the only United States exports to Mexico falling into the fifteen-year category are a few agricultural products.

Nearly one-half of all United States manufactured exports to Mexico will enjoy immediate duty-free access to the Mexican market. Within 5 years, approximately 65% of United States industrial and agricultural exports to Mexico will enter duty-free; many of these goods currently face 10 to 25% tariffs. When these duties are removed, some of America's most competitive products will compete on a level playing field for the first time, allowing United States exporters to increase significantly their shares of the Mexican market.

The NAFTA will also eliminate non-tariff barriers which impede United States merchandise exports to Mexico. The NAFTA will immediately eliminate restrictive import-licensing requirements for many products, including agricultural goods and pharmaceutical inputs. Additionally, the NAFTA will improve access to government procurement, immediately opening to United States suppliers 50% of Mexico's national petroleum (PEMEX) and electricity (CFE) companies' major procurement. This percentage will increase in steps over a ten-year phase-in period. At the end of this period, United States suppliers will have access to all of PEMEX and CFE's major procurement under transparent and competitive bidding rules.[3]

The NAFTA contains provisions which will ensure that United States goods and services exports shall not face unfair or discriminatory standards upon entering Mexico, and the agreement will establish nondiscriminatory procedures for allowing United States standards testing facilities to apply for accreditation in other NAFTA countries. The NAFTA also will allow United States companies to participate directly in the development of new standards in Mexico and Canada on the same basis as domestic firms in those countries. Under the NAFTA, the United States will retain the right to establish and enforce its own product standards, including those relating to the protection of human, animal, and plant life.

V. Protecting United States Industries/Workers

For several reasons, establishing free trade with Mexico is a step implying minimal adjustment pressures for the United States. First, the United States already is very close to one-way free trade with Mexico. The average United States tariff for all Mexican products is currently only 4% on a trade-weighted basis, and approximately 50% of Mexico's exports enter the United States duty-free under the Generalized System of Preferences program or other beneficiary programs. Second, the Mexican economy is quite small relative to the United States economy. In fact, the gross domestic product of Mexico is smaller than the economy of the Los Angeles, California five-county area.

The United States NAFTA negotiators, however, were not satisfied with seeking minimal adjustments for the United States at the *aggregate* level. Instead, these negotiators sought an agreement that would maximize commercial opportunities while minimizing adjustment costs at the *industry-specific* level. To reach this goal, the United States NAFTA negotiators consulted extensively with the private sector and the United States Congress to allow for consideration of the

3. After the transition period, Mexico will retain a small set-aside for national suppliers. Similarly, the United States will retain a set-aside for United States small businesses.

ways in which continental free trade would potentially adversely affect particular industries.

The NAFTA's provisions will be phased in over varying time periods to account for the sensitivities of different industries. For example, goods that will enter the United States duty-free from Mexico ten or five years following implementation of NAFTA reflect, respectively, progressively lower levels of import sensitivity. Furthermore, the most protected and traditionally sensitive United States sectors—including certain rubber footwear, household glassware, ceramic tiles, canned tuna, orange juice, asparagus, broccoli, cucumbers, and cantaloupe—will not face duty-free competition from Mexican producers until fifteen years after the NAFTA goes into effect. In contrast, Mexico negotiated for itself a much smaller range of goods in the fifteen-year tariff phase-out category.

The structure of the tariff phase-outs will allow import sensitive industries in the United States to prepare for free trade. Nevertheless, if tariff reductions result in serious injury—or even the threat of serious injury—to an industry, the NAFTA provides a safeguard mechanism for reinstating temporarily pre-NAFTA tariff rates. Here, the NAFTA clearly improves on the United States-Canada Free Trade Agreement (CFTA). Under the CFTA, eligibility for tariff "snapback" is based on proving that serious injury has already occurred. Under the NAFTA, proving the *threat* of serious injury will be sufficient. Another improvement is the length of the snap-back period. Under the NAFTA, United States firms in highly import sensitive sectors will be able to seek a four-year reprieve from the tariff elimination schedule, whereas the CFTA's safeguard mechanism allows for a maximum of only three years of relief. Additionally, it should be noted that the administration of President Clinton has called for a supplemental agreement outside of the NAFTA to further address the issue of import surges.

United States workers will also be protected by the NAFTA's rules of origin, which define the conditions under which a good will qualify as North American for the purposes of the NAFTA's market access measures. The rules of origin are based on the principles that goods will have to contain substantial North American content to receive duty-free treatment. Components originating in a non-NAFTA county will have to undergo significant processing in North America for the finished product to qualify for NAFTA benefits. These rules of origin will provide a strong incentive to source intermediate goods in North America, and United States firms are the continent's most competitive suppliers of such goods.

Finally, the United States government will be able to protect United States industries and workers through a government-to-government dispute settlement procedure.[4] The NAFTA provides that disputes between NAFTA countries will be resolved within eight months by an impartial international panel and that the losing country will have to comply with the panel's recommendations. Noncompliance without acceptable compensation will be grounds for the winning country to seek trade concessions through retaliatory measures.

VI. Industry Example: Automotive Sector

Examining the NAFTA's impact on the United States auto industry will illustrate some of the concepts discussed above. The auto industry provides a particularly important example because auto trade accounts for 21% of total United States-Mexico trade and is the largest single component of this bilateral, commercial relationship.

Mexico has the fastest growing auto market in the Western Hemisphere. This market growth and the Mexican government's limited measures to liberalize auto trade led to a tripling of United States auto parts exports to Mexico between 1986 and 1991: from $1.8 billion to $5.4 billion. The rapid expansion of auto parts exports transformed a $1.1 billion auto parts trade deficit with Mexico in 1986 into a small surplus just 5 years later. In terms of employment, the number of United States jobs supported by motor vehicle equipment and parts exports to Mexico more than quintupled between 1983 and 1990.

United States auto exports to Mexico have increased despite Mexico's significant remaining barriers to trade and investment in that sector. By substantially reducing or eliminating these barriers, the NAFTA will create additional export opportunities for the United States auto industry and will increase the job security of United States auto workers.

The NAFTA will eliminate tariffs on automotive goods made in North America.[5] The resulting duty-free auto trade will greatly bene-

4. This dispute settlement mechanism is different from the investor-host country dispute settlement mechanism mentioned in Section II of this article.

5. As defined by the NAFTA's rules of origin for auto trade. See below.

fit the United States. While the United states now levies only a 2.5% tariff on passenger automobile imports, Mexico currently levies a 20% tariff on such imports. The NAFTA will immediately reduce Mexico's tariffs on automobiles to 10% and will completely remove the tariffs over 10 years. The NAFTA will also eliminate tariffs on 75% by value of Mexico's auto parts imports from the United States within 5 years; tariffs on the remaining 25% will be eliminated within 10 years.

The NAFTA will gradually eliminate Mexico's Auto Decree over ten years. Under the Auto Decree, firms investing in Mexico's automotive sector currently must comply with a trade-balancing requirement: for every dollar of automobile imports, companies must export two dollars of automotive goods. This requirement not only encourages the purchase of parts from Mexican suppliers and severely limits United States exports to Mexico, but it also provides an artificial incentive to export to the United States. Without the trade-balancing requirement, auto manufacturers in Mexico would source more parts from United States suppliers and would export less to the United States market.

When the NAFTA goes into effect, auto manufacturers in Mexico will need to generate only eighty cents of exports for every dollar of imports. The amount of exports necessary for balancing imports will decline every year, eventually reaching fifty-five cents per dollar in the tenth year. After that point, Mexico's trade-balancing requirement will be abolished.

The NAFTA will also gradually eliminate the Auto Decree's local content rule. This rule currently states that a car or light truck made in Mexico for sale in the domestic market must incorporate parts and labor from certain local suppliers accounting for at least 36% of the vehicle's value. In forcing auto manufacturers to buy from firms in Mexico, this local content rule legislates against parts imports from the United States and encourages United States parts manufacturers to locate in Mexico so their parts will qualify as "local." Under the NAFTA, these incentives will disappear as the local-content requirement is reduced immediately to 34%, and then to 29%, over a 10-year period, after which point the national value-added rule will be eradicated.[6]

6. For certain manufacturers, the NAFTA's provisions for gradually eliminating Mex-

The NAFTA's rules of origin with respect to auto trade will protect United States jobs. To qualify for preferential tariff treatment under the NAFTA, cars and light trucks will have to contain at least 62.5% North American content. This percentage requirement will be implemented in two successive 4-year phases: it will rise from 50 to 56% after the first 4-year period, increasing to 62.5% after the second 4-year period. The rules of origin for trade in motor vehicles also provide for "deep tracing" of imported components, which will allow customs officials to make an accurate assessment of a vehicle's true content. The 62.5% rule combined with the tracing system will ensure that non-NAFTA auto producers will not be able to use Mexico or Canada as export platforms or pass-through points.

VII. LABOR AND ENVIRONMENTAL CONSIDERATIONS

Some critics of the NAFTA argue that weak labor and environmental standards in Mexico provide incentives for United States firms to move operations and jobs south of the border. Even if the critics' allegations about standards were true, overall productivity—not compliance with labor and environmental standards—is the underlying determinant in an investment decision, and United States workers are estimated to be five times more productive than Mexican workers.

Standards in Mexico, however, do not differ significantly from those in the United States. In 1991, Mexico became an observer member of the Organization for Economic Cooperation and Development's Labor and Employment Committee, and committed itself to adhering to the OECD's labor standards; the United States is a full member of the OECD Committee. The United States Occupational Safety and Health Administration (OSHA) and its Mexican counterpart agency recently published a study which shows that the United States and Mexico have comparable legal frameworks for addressing workplace hazards. Furthermore, in 1988, Mexico passed a broad environmental law modeled on United States environmental law. In some respects, Mexico's 1988 law is more exacting than United States environmental law.

The challenge in the realm of labor and environmental standards concerns resources. Without the technologies and capital for enforc-

ico's local-content rule are more flexible regarding the percentage of content required for compliance during the ten-year transition period.

ing its standards, Mexico will face difficulties in achieving desirable levels of compliance. In an effort to identify resources, leaders from both sides of the border initiated a series of discussions which parallelled, but were separate from, the NAFTA negotiations. Although the NAFTA discussions are complete, the talks with respect to labor and environmental standards continue.

The labor talks have been fruitful. In September of 1992, the United States and Mexico signed a bilateral agreement creating a Consultative Commission on Labor Matters, which will serve as a permanent forum for improving labor standards. The Commission will build on earlier cooperative successes. The United States Department of Labor (DOL) has assisted its Mexican counterpart (STPS) in developing hygiene testing laboratories and in training STPS officials in areas of OSHA expertise. The DOL has worked closely with STPS to improve maquiladora operators' understanding of, and compliance with, Mexican labor standards. The two agencies have also cooperated in producing joint studies on a range of issues, including labor law, labor relations, child labor, and the informal economy. These studies are initial steps in the upward harmonization of labor standards.

The bilateral talks on environmental issues have also been productive. The most visible result has been the Integrated Plan for the Border Environment, which commits hundreds of millions of dollars through 1994 to projects that will enhance environmental infrastructure in the United States-Mexico border region. Another result of the parallel talks was the creation of the United States-Mexico Environmental Business Committee, which is co-chaired by this article's coauthor, Roger W. Wallace. This bilateral committee is drawing on the resourcefulness of the private sector to facilitate the cross-border flow of environmental technologies. As Mexico's access to environmental technologies improves, it will become easier for the government of Mexico to obtain compliance with environmental standards.

These cooperative bilateral efforts on labor and environmental matters should be considered with several other trends. First, the administration of President Clinton has called for supplemental agreements outside the NAFTA to further ensure progress in addressing labor and environmental matters involving Mexico. Second, President Salinas and his administration are committed not only to improving the Mexican economy but also the quality of life for Mexico's citizens. With this latter goal in mind, the Salinas Administration has taken a number of steps to increase compliance, including quadrupling the number of border environmental inspectors and shutting down a record number of environmentally unsafe plants. Moreover, with international attention focusing on Mexico, noncompliance will act as stumbling block for Mexican leaders who want to bring their country into the league of developed nations. The convergence of bilateral cooperation, domestic leadership, and international attention will continue to boost standards compliance in Mexico.

VIII. CONCLUSION

The North American Free Trade Agreement will bring into effect conditions that will create new opportunities for United States firms and workers; simultaneously, the agreement will protect United States workers by ensuring that the benefits of continental free trade remain in North America and by structuring the transition to free trade over fifteen years.

In 1882, the United States negotiated a free trade agreement with Mexico; the implementing legislation, however, failed to pass the United States Congress. Today, as we make up our minds about the North American Free Trade Agreement, the stakes are higher than they were over a century ago. The United States is more dependent on international trade than ever before. At the same time, America faces increasing competition from different geographic regions in which countries are using freer trade to unleash their economic potential. These changes strongly indicate that the United States should embrace continental free trade—combined with a domestic agenda that encourages growth in United States competitiveness—to help meet the challenges and opportunities of global commerce.