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NORTH AMERICAN FREE TRADE AGREEMENT

A Focus on the Substantive Issues

Statement of Allan I. Mendelowitz, Director
International Trade, Finance, and Competitiveness
General Government Division

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NORTH AMERICAN FREE TRADE AGREEMENT: A FOCUS ON THE SUBSTANTIVE ISSUES
SUMMARY OF STATEMENT BY ALLAN I. MENDELOWITZ, DIRECTOR INTERNATIONAL TRADE, FINANCE, AND COMPETITIVENESS

The North American Free Trade Agreement (NAFTA) represents a dramatic step in the process of North American economic integration. If ratified, it would create the largest free trade area in the world, with 360 million people and an annual gross national product over $6 trillion. However, NAFTA has engendered substantial controversy over its potential impact.

NAFTA's broad goal is to improve productivity and standards of living through the free flow of commerce in goods and services and investment capital throughout North America. Its potential effects include both the benefits that accrue from liberalization of trade and investment and the costs associated with anticipated adjustments. NAFTA proponents argue that the agreement would result in net benefits to all three countries. Opponents vigorously reject it, asserting it will adversely affect the U.S. labor market and the environment. Efforts to address these issues, both in NAFTA and in side agreements, have not satisfied all critics.

NAFTA, over a specific period, provides for removal of barriers to trade and establishes principles to protect North American investors from arbitrary interference by governments. While it eliminates tariffs and other measures that protect domestic industries, it provides longer phase-in periods for reducing barriers in certain trade-sensitive sectors, including agriculture, automotive products, energy, and textiles and apparel. It sets up systems to help implement the agreement and to resolve disputes. NAFTA also contains emergency safeguard provisions to restore protection temporarily for industries if imports cause or threaten to cause injury.

Most economic forecasters conclude that NAFTA will have small net macroeconomic and employment gains for the United States and Canada. This is because (1) the U.S.-Canada Free Trade Agreement has already resulted in low trade and investment barriers between the two countries, (2) Mexico currently has excellent access to the U.S. market with about 50 percent of Mexico's exports to the United States already entering duty free, and (3) Mexico's economy is only about 5 percent of U.S. gross national product. For the latter reason, relatively larger gains are projected for Mexico.

However, benefits gained will be accompanied by adjustment costs that may fall more heavily on certain sectors of the economy and labor force. Therefore, if NAFTA is ratified, Congress should ensure that an effective and well-funded adjustment program is in place to aid workers who bear the heaviest burden. The ultimate decision on NAFTA should come from a weighing of its broad-based benefits and its costs, as well as the potential adverse impact of its rejection.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to testify on major issues associated with the North American Free Trade Agreement, or NAFTA. My statement is based on our recently issued report (see app. item 1).

NAFTA, signed in December 1992 by the United States, Canada, and Mexico, is the latest step along the path of trade liberalization that has characterized trade and investment between the three countries for over a decade. The most important trade development between the United States and Canada is the U.S.-Canada Free Trade Agreement (CFTA), which was implemented in 1989. The most important developments in Mexico have resulted from its self-initiated efforts to liberalize and reform its economy. In addition, the United States and Mexico have negotiated a number of trade liberalization agreements, including the 1987 Bilateral Framework Agreement on Trade and Investment, which established routine consultations between the two countries on commercial issues.

NAFTA incorporates features designed to meet the main objectives of the three parties to the agreement. The agreement addresses traditional U.S. trade policy objectives, such as the general reduction of tariffs, the elimination of nontariff barriers to trade, and the creation of procedures to resolve disputes between parties to the agreement; it also covers new ground in the areas of intellectual property rights, services, investment, and government procurement. The NAFTA negotiation process also addressed nontraditional trade issues such as environment and labor standards, and workplace safety.

In addition, the agreement addresses Mexico's main objectives in the negotiations, such as locking in its self-initiated market-oriented reforms, increasing employment by attracting new investment, and gaining greater access to U.S. and Canadian markets. Canada's main objectives in joining NAFTA were to preserve, clarify, and strengthen the CFTA provisions and to ensure that Canada shares in the benefits that are expected to accrue from increased access to Mexico's traditionally closed economy.

NAFTA WILL REDUCE BARRIERS TO NORTH AMERICAN TRADE AND INVESTMENT

NAFTA is a significant step in the process of liberalizing North American trade and investment. To remove obstacles to trade in North America, NAFTA progressively eliminates almost all U.S.-Mexico tariffs over a 10-year period, with a small number of tariffs for trade-sensitive industries phased out over a 15-year period. Mexico-Canada tariffs are also phased out over a 10-year period. Tariff reduction schedules between the United States and Canada negotiated in CFTA are retained. In addition, NAFTA eliminates other barriers to trade such as import licensing requirements and Customs user fees. At the same time, NAFTA establishes the principle of national treatment for trade among the NAFTA countries, ensuring that NAFTA-origin products traded between NAFTA countries will receive treatment equal to similar domestic products.

NAFTA also guarantees service providers of the three countries equal treatment in the NAFTA area, including the right to invest and the right to sell services across borders. For example, in the area of financial services, NAFTA will enable U.S. banks and securities firms to establish full-service offices in Mexico for the first time in about 50 years.

In addition, NAFTA establishes five basic principles to protect foreign investors and their investments in the free trade area. These principles are (1) nondiscriminatory treatment, (2) freedom from performance requirements,[1] (3) free transfer of funds related to an investment, (4) expropriation only in conformity with international law, and (5) the right to seek international arbitration for a violation of the agreement's protections.

Despite these reductions in trade barriers, NAFTA will not bring about totally free trade. For example, Mexico reserved the right to prohibit foreign activity in its oil sector, Canada retained the right to protect certain culturally sensitive information industries, and the United States retained the right to maintain its domestic price supports and marketing orders for agricultural products. Marketing orders set quality standards for certain crops.

NAFTA HAS SPECIAL PROVISIONS FOR SENSITIVE ECONOMIC SECTORS

NAFTA has special provisions relating to the removal of barriers to trade and investment in certain specific sectors sensitive to the economic interests of each country. Examples of these special provisions follow.

-- Agriculture. Special agriculture provisions gradually phase out existing trade barriers over a maximum period of 15 years. This liberalization provides each country's agricultural sector with an opportunity to adjust to more competitive conditions. We have previously reported that increased liberalization of U.S.-Mexico agricultural trade will generally benefit the U.S. agriculture industry and that U.S. producer groups largely support increased trade liberalization (See app. items 24 and 25). NAFTA is generally expected to provide the U.S. agricultural sector

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[1]"Performance requirements" refers to government-mandated or approved activities that investors must undertake, usually as a condition of establishment or operation in a particular country.

with continued opportunities for export growth, particularly in sectors such as grains, certain fruits, dairy products, poultry, and meat. However, some U.S. fresh fruits and vegetables are likely to lose market share to the increased competition under NAFTA. While this competition would hurt producers, it could lead to lower prices for consumers. Special import protection provisions may be triggered if a particular industry is determined to be injured by imports.

-- <u>Automotive products</u>. Automotive products are currently the largest component of bilateral manufacturing trade between the United States and Canada and the United States and Mexico. NAFTA will increase U.S. and Canadian access to Mexico's traditionally protected automotive market. Specifically, NAFTA will eliminate over a 10-year transition period all barriers to trade in North American automotive goods and all investment restrictions in the automotive sector. CFTA will largely remain in effect for U.S.-Canadian trade. NAFTA also establishes a North American Automotive Standards Council to work toward harmonized standards. Stringent automotive rules of origin are designed to prevent non-NAFTA countries' products from enjoying NAFTA's preferential treatment.

-- <u>Energy</u>. NAFTA will provide substantive opportunities for new foreign investment in the areas of both electricity and petrochemicals in Mexico. NAFTA also increases opportunities in the area of government procurement by allowing North American firms to compete on a non-discriminatory basis for government contracts in selected energy markets. However, Mexico retains a reservation for its constitutional prohibition against foreign or private activity in oil exploration, production, and refining. Thus the potential gains to U.S. petroleum producers are limited, and Mexico's dilemma over how to raise sufficient capital for its energy sector is left unresolved.

-- <u>Textiles and apparel</u>. NAFTA will eliminate tariffs between the United States and Mexico, and between Canada and Mexico, either immediately or phased out over 10 years for products manufactured in North America that meet NAFTA rules of origin. Import duties between the United States and Canada will continue to be phased out on the schedule set forth under CFTA. NAFTA provides more strict and detailed rules of origin than CFTA. These rules define when textile or apparel goods traded among NAFTA countries qualify for preferential duty treatment. NAFTA also establishes a safeguard threshold for a NAFTA country to invoke emergency protection against imports that threaten or result in serious damage to the domestic industry. This safeguard threshold is lower for textiles and apparel than for other products.

NAFTA RULES WILL HELP IMPLEMENT THE AGREEMENT

CFTA created rules and mechanisms to facilitate implementation of the agreement that have been widely viewed as successful. NAFTA adopts and expands on these mechanisms. First, it provides for a Free Trade Commission to oversee the continual process of implementing the agreement and further liberalizing North American trade. This oversight includes the authority to supervise special working groups that clarify various aspects of the agreement and address unresolved issues. Second, when disputes arise among the parties concerning either unfair foreign trade practices or the interpretation and application of NAFTA itself, distinct settlement mechanisms can be applied to achieve a resolution through timely and impartial proceedings. However, at the insistence of the United States, each country will retain its laws regarding unfair foreign trade practices and may apply these laws to trade from a NAFTA partner.

NAFTA also includes comprehensive provisions for the protection and enforcement of intellectual property among the three countries. It requires each country to provide adequate and effective protection and enforcement of intellectual property rights through the provisions set out in the agreement and the substantive provisions in several international conventions dealing with various intellectual property issues.[2] NAFTA requires the parties to make every effort to accede to all of these conventions. This provision, in effect, will apply solely to Mexico, which is the only one of the three parties that has not acceded to all the conventions. According to U.S. government officials, NAFTA's incorporation of international conventions will provide a backdrop of long-standing interpretations of the minimum standards of protection that must be met by each party.

Finally, NAFTA will permit governments to impose temporary import protection, or safeguards, in cases where a domestic industry is determined to be injured or threatened by injury. Safeguards must be applied through fair and open administrative procedures, and compensation is to be provided for the affected countries.

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[2]These conventions include (1) the Geneva Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms (1971), (2) the Berne Convention for the Protection of Literary and Artistic Works (1971), (3) the Paris Convention for the Protection of Industrial Property (1967), and (4) the International Conventions for the Protection of New Varieties of Plants (1978 UPOV Convention and 1991 UPOV Convention).

CONCERN OVER NAFTA INCLUDES NONTRADE ISSUES

Debate over NAFTA has included factors outside the normal scope of trade negotiations, such as the environment and labor rights. Both the former and current U.S. administrations have acknowledged the importance of these factors by initiating parallel efforts, which address concerns over NAFTA's potential impact on the enforcement of environmental laws and labor rights and standards. Negotiations on these issues were concluded in September 1993. We have not yet assessed the resulting agreements.

Supporters of NAFTA argue that the agreement will enhance environmental protection by spurring economic growth in Mexico and thereby increasing the desire for, and ability to pay for, environmental protection. NAFTA is also expected to encourage trilateral cooperation on environmental issues. NAFTA critics argue that increased economic activity resulting from NAFTA will exacerbate existing environmental problems, particularly along the southern U.S. border. Nevertheless, both critics and supporters have widely recognized NAFTA as a landmark trade accord because it is the first to significantly address environmental issues. It has received qualified support from a number of environmental groups who wanted to see enforcement powers in a parallel environmental agreement. While such an agreement was recently concluded, some groups regard it as inadequate.[3]

Labor groups in the United States and Canada generally oppose NAFTA, while Mexican labor groups generally favor the agreement as a means for promoting economic growth and job creation in Mexico. The main concerns of the U.S. and Canadian labor groups are that free trade with Mexico will depress wages and will lower U.S. and Canadian standards for workers' rights, health, and safety. NAFTA does not directly address these issues, but a parallel agreement just negotiated is intended to establish oversight of labor standards and rights in the three countries.

Although NAFTA itself does not provide for open borders or the free movement of labor, there is considerable speculation over NAFTA's impact on Mexican migration to the United States. It is unclear what NAFTA's impact will be on illegal Mexican migration

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[3]On June 30, 1993, a U.S. district court judge ruled that the administration must prepare an environmental impact statement for NAFTA. The judge ruled in a suit filed by three environmental groups: Public Citizen, the Sierra Club, and Friends of the Earth. The administration has appealed this decision on an expedited basis, and the appeals ruling is expected to be issued in September.

to the United States in the short run. Whether or not NAFTA is implemented, illegal Mexican migration is expected to grow during the next decade due to Mexico's economic restructuring and its expanding working-age population. In the long run, however, most analysts predict that NAFTA will decrease illegal Mexican immigration to the United States by spurring economic growth in Mexico and creating jobs.

NAFTA'S POTENTIAL ECONOMIC IMPACTS

NAFTA incorporates a number of trade-offs designed to approach, over time, the fundamental goal of free trade and investment, ultimately providing net benefits to all parties to the agreement. Most studies predict that Mexico, due in large part to its smaller and less-developed economy, will gain most from the agreement, while the United States and Canada will enjoy better and more secure access to growing Mexican markets. These benefits do not come without a cost. It is clear that certain sectors of each country's economy will require restructuring to strengthen their competitiveness or to adjust to a diminished market position.

Assessing the impact of NAFTA presents a particular challenge for Congress, which, under the current rules, has to vote for or against the proposed implementing legislation without possibility of amendment. The breadth and complexity of the agreement make it difficult to readily sort out all of its potential effects. In addition, no set of analyses or studies in and of itself provides definitive estimates of these effects.

A considerable amount of research using a variety of economic models has been done on the effects NAFTA may have on the U.S. economy. There has been an ongoing debate over the assumptions used in these models as well as their general usefulness. Despite these weaknesses, a substantial majority of the studies reached a similar conclusion: limited net gains for the U.S. and Canadian economies if NAFTA is implemented. According to the U.S. International Trade Commission's (ITC) synthesis of a large number of economic studies, NAFTA would result in an increase in economic growth of less than one-half percent of gross national product (GNP) for these economies.[4] These projections are consistent with trade theory. The meagerness of this result was explained by (1) the currently low trade and investment barriers between the United States and Canada, allowing for generally free movement of goods and services; (2) the limited immediate gains from expanded exports to Mexico because of Mexico's small size relative to the U.S. economy (Mexico's GNP is only about 5

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[4]In general, these results from general equilibrium models should be interpreted as if NAFTA provisions were to be implemented all at once.

percent of U.S. GNP); and (3) Mexico's excellent access to the U.S. market, with about 50 percent of Mexico's exports to the United States already entering duty free. For Mexico, however, the ITC symposium reported an estimated benefit of up to 11 percent under the most optimistic scenario.

While the models project net employment gains as a result of NAFTA, the effects would not be evenly spread across the economy. Job dislocations are anticipated in certain affected industries, particularly among low-skilled workers. Opponents of NAFTA are concerned about the possible adverse effect the agreement could have on the job prospects of low-skilled laborers in the United States. Since Mexican workers are generally paid much lower wages, the potential for U.S. plant closures and relocations to Mexico could intensify wage competition in the United States and lead to lower real earnings for low-skilled U.S. workers. However, many analysts note that production relocations to Mexico or other developing countries will likely occur regardless of NAFTA's implementation, with accompanying dislocation of U.S. workers.

Liberalized trade is generally considered important to the future health of the U.S. economy, and thus it has long been U.S. policy to seek to remove trade barriers and promote "transparency" of trade rules. Disruption, adjustment, and change are inevitable in a dynamic economy, providing new opportunities for reallocating investment and employment that improve economic efficiency. These adjustments will occur, indeed are occurring, whether NAFTA is implemented or not. According to the Organization for Economic Cooperation and Development, attempts to refrain from adjustment are the real threat to employment. A healthy economy must have the ability to change and redirect economic resources and people to its most efficient and productive sectors in order to grow and create new employment.

The benefits realized by society as a whole from such change are accompanied by costs, however, some of which fall heavily on certain sectors of the economy and labor force. Consequently, trade liberalization without specific programs to help those who are injured means that the benefits are spread broadly across the economy, while certain groups bear a disproportionate share of the cost. Therefore, if NAFTA is ratified, policymakers should also consider making a strong commitment to an effective, well-funded worker adjustment assistance program to aid those who will most bear the burden of adjustment. In this regard, we identified problems with the two major federal programs to aid adjustment of workers who have lost their jobs -- Trade Adjustment Assistance (TAA) and Economic Dislocation and Worker Adjustment Assistance (EDWAA) (See app. item 11). Shortcomings in these programs included delays in providing assistance to participants, limitations in the services offered, and inadequacy in tailoring services to meet the specific needs of individual participants. Other analysts estimated that the programs were reaching only one-fifth of the individuals who were potentially eligible for services.

POTENTIAL IMPACTS FROM NAFTA REJECTION

Just as a decision to support NAFTA has to balance potential gains and losses, a decision to reject the agreement must do the same. Rejection of NAFTA may protect the economic interests of certain industries and workers in the short term. Presumably, CFTA would remain in effect to govern trade between the United States and Canada. However, rejection of NAFTA could result in changes in Mexico that would have adverse consequences for the United States. Mexico has recently undertaken action to open up its economy, and during this period the U.S. merchandise trade balance with Mexico has changed from a deficit to a sizable surplus. It is not clear whether these market-opening reforms could survive NAFTA rejection. A decision not to ratify NAFTA could also have adverse impacts on Mexico's financial markets. Additionally, Mexico's ongoing restructuring of its communal farm system may lead to increased illegal immigration into the United States should Mexico's economy not grow sufficiently to absorb the excess workers.

CONCLUSIONS

NAFTA presents a considerable challenge for Congress. The agreement will produce both benefits and costs, with some costs falling more directly on certain sectors of the economy and labor force. Unfortunately, the breadth and complexity of the agreement make it difficult to readily sort out all of its potential effects, and no set of analyses provides definitive estimates of its full impact.

NAFTA is expected to produce benefits at the macroeconomic level but at the expense of job dislocations in certain industries, particularly among low-skilled workers. An important consideration in this regard is the notable weaknesses we found in our analysis of the two major federal programs designed to aid adjustment of workers who have lost their jobs.

MATTER FOR CONGRESSIONAL CONSIDERATION

If Congress decides to ratify NAFTA, it should also ensure that an effective, well-funded worker adjustment assistance program is in place to facilitate the structural adjustment that may be needed in the workplace.

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Mr. Chairman and members of the Subcommittee, this concludes my prepared statement. I will be pleased to respond to any questions you may have.

RELATED GAO PRODUCTS

1. North American Free Trade Agreement: Assessment of Major Issues, Vol. 1 and 2, (GAO/GGD-93-137, Sept. 9, 1993).

2. U.S.-Mexico Trade: The Maquiladora Industry and U.S. Employment, (GAO/GGD-93-129, July 20, 1993).

3. International Investment: (GAO/GGD-93-53R, July 2, 1993).

4. NAFTA: Issues Related to Textile/Apparel and Auto and Auto Parts Industries (GAO/T-GGD-93-27, May 4, 1993).

5. U.S. Trade Data: Limitations of U.S. Statistics on Trade With Mexico (GAO/T-GGD-93-25, Apr. 28, 1993).

6. CFTA/NAFTA Agricultural Safeguards (GAO/GGD-93-14R, Mar. 18, 1993).

7. Pesticides: U.S. and Mexican Fruit and Vegetable Pesticide Programs Differ (GAO/T-RCED-93-9, Feb. 18, 1993).

8. U.S.-Canada Trade (GAO/GGD-93-10R, Dec. 12, 1992).

9. International Trade: Implementation of the U.S.-Canada Free Trade Agreement (GAO/GGD-93-21, Oct. 10, 1992).

10. North American Free Trade Agreement: U.S.-Mexican Trade and Investment Data (GAO/GGD-92-131, Sept. 25, 1992).

11. Dislocated Workers: Comparison of Assistance Programs (GAO/HRD-92-153 BR, Sept. 10, 1992).

12. U.S.-Mexico Trade: Assessment of Mexico's Environmental Controls for New Companies (GAO/GGD-92-113, Aug. 3, 1992).

13. Pesticides: Comparison of U.S. and Mexican Pesticide Standards and Enforcement (GAO/RCED-92-140, June 17, 1992).

14. U.S. Customs Service: Concerns About Coordination and Inspection Staffing on the Southwest Border (GAO/T-GGD-92-29, Apr. 8, 1992).

15. Mexican Oil: Issues Affecting Potential U.S. Trade and Investment (GAO/NSIAD-92-169, Mar. 18, 1992).

16. Hazardous Waste: Maquiladoras' Management of Hazardous Waste Hampered by Lack of Information (GAO/RCED-92-102, Feb. 27, 1992).

17. U.S.-Mexico Trade: Survey of U.S. Border Infrastructure Needs (GAO/NSIAD-92-56, Nov. 27, 1991).

18. U.S.-Mexico Trade: Concerns About the Adequacy of Border Infrastructure (GAO/NSIAD-91-228, May 16, 1991).

19. U.S.-Mexico Trade: Information on Environmental Regulations and Enforcement (GAO/NSIAD-91-227, May 13, 1991).

20. U.S.-Mexico Trade: Information on Wages, Fringe Benefits, and Workers' Rights (GAO/NSIAD-91-220, May 10, 1991).

21. U.S.-Mexico Energy: The U.S. Reaction to Recent Reforms in Mexico's Petrochemical Industry (GAO/NSIAD-91-212, May 3, 1991).

22. Occupational Safety and Health and Child Labor Policies of the United States and Mexico (GAO/T-HRD-91-22, Apr. 30, 1991).

23. U.S.-Mexico Trade: Some U.S. Wood Furniture Firms Relocated From Los Angeles Area to Mexico (GAO/NSIAD-91-191, Apr. 24, 1991).

24. U.S.-Mexico Trade: Impact of Liberalization in the Agricultural Sector (GAO/NSIAD-91-155, Mar. 29, 1991).

25. U.S.-Mexico Trade: Extent to Which Mexican Horticultural Exports Complement U.S. Production (GAO/NSIAD-91-94BR, Mar. 20, 1991).

26. Agricultural Trade: Government Support Calculations Under the U.S.-Canada Free Trade Agreement (GAO/RCED-90-210, Aug. 8, 1990).

27. U.S.-Mexico Trade: Trends and Impediments in Agricultural Trade (GAO/NSIAD-90-85BR, Jan. 12, 1990).

28. Canadian Power Imports: Update on Electricity Imports in the Northeast (GAO/RCED-89-51, Mar. 3, 1989).

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