The Broken Promise of NAFTA

by Joseph Stiglitz

The celebrations of the North American Free Trade Agreement's 10th anniversary are far more muted than those involved in its creation might have hoped. In the United States, NAFTA has failed to fulfill the most dire warnings of its opponents and the most fervent expectations of its supporters. In Mexico, however, the treaty remains controversial and even harmful – as do America's efforts to liberalize trade throughout the hemisphere.

There is some good news. In America, the "giant sucking sound of jobs being pulled out of this country" that **Ross Perot** predicted never quite materialized. The first six years of NAFTA saw unemployment in the U.S. fall to new lows. (Of course, to most economists there was little basis for Mr. Perot's worries in the first place. Maintaining full employment is the concern of monetary and fiscal policy, not of trade policy.) NAFTA has brought some benefits to Mexico as well; it was trade with America, fueled by NAFTA – not the bailout of Wall Street lenders – that was responsible for Mexico's quick recovery after the financial crisis of December 1994.

But while Mexico benefited in the early days, especially with exports from factories near the U.S. border, those benefits have waned, both with the weakening of the American economy and intense competition from China. Meanwhile, poor Mexican corn farmers face an uphill battle competing with highly-subsidized American corn, while relatively better-off Mexican city dwellers benefit from lower corn prices. And as all but one of Mexico's major banks have been sold to foreign banks, local small- and medium-sized enterprises –

Hidden in NAFTA was a new set of rights – for business – that potentially weakened democracy throughout North America.

NAFTA: A Success Story to be Proud Of

by Jack Mintz

Analysts often view trade agreements like the proverbial glass of water – half full for the optimists, and half empty for the pessimists. Not so with NAFTA. Despite some rough edges, I believe the agreement can be deemed an unqualified success across the board, with the glass about nine-tenths full. By my count, this earns NAFTA a grade of A+, and Canadian, Mexican and U.S. negotiators should receive awards for their efforts.

From the Canadian perspective, after the Canada-U.S. Free Trade Agreement came into force in 1989, the decade between 1988 and 1997 turned out to be one of the worst periods of economic growth for our country. Canada's per capita income hardly grew during these years, falling to the fourth-lowest of all OECD countries. It would be easy to put the blame for this on the Free Trade Agreement and its successor, NAFTA. This is a mistake.

A myriad of other problems – unrelated to trade agreements – beset the Canadian economy during this period. Canadian governments had to significantly retrench due to the fiscal mismanagement of the 1970s and 1980s, when program expenditures grew sharply along with taxes, deficits and public debt. Further, our high-price inflation was at long last countered by stringent monetary policy, leading to high interest rates and a high dollar in 1989, followed by recession in 1990. Painful adjustments in fiscal and monetary policy were needed, and since 1997, Canadians have been reaping the benefits from these policies as Canada's economic performance has improved substantially.

If anything, the two trade agreements were the bright stars of policy decision-making since the late 1980s. Canadian businesses – while still not the most productive in the world – are at least more competitive internationally now. Canadian exports have climbed to two-fifths from 25 per cent of GDP back in 1988. More importantly, many Canadian businesses have become multinational. Canada is now a net exporter in foreign direct investment, and technological receipts – once in deficit – are now in surplus. Even industries that were expected to be pulverized by free trade – such as textiles, apparel and wine – have been successful in achieving economies of scale and better product variety. Economic studies indicate that Canadian companies were generally net job creators as a result of the free trade agreements adopted in recent years.

Those who criticize NAFTA have suggested that our improved export performance has been a result of a low Canadian dollar – but they forget that the price of our currency reflects various economic factors, including commodity prices

particularly in non-export sectors like small retail – worry about access to credit.

Growth in Mexico over the past 10 years has been a bleak one per cent on a per capita basis – better than in much of the rest of Latin America, but far poorer than earlier in the century. From 1948 to 1973, Mexico grew at an average annual rate of 3.2 per cent per capita. (By contrast, in the 10 years of NAFTA, even with the East Asian crisis, Korean growth averaged 4.3 per cent and China's 7 per cent in per capita terms.)

And while the hope was that NAFTA would reduce income disparities between the U.S. and its southern neighbor, in fact they have grown – by 10.6 percent in the last decade. Meanwhile, there has been disappointing progress in reducing poverty in Mexico, where real wages have been falling at the rate of 0.2 per cent a year.

These outcomes should not have come as a surprise. NAFTA does give Mexico a slight advantage over other trading partners. But with its low tax base, low investment in education and technology, and high inequality, Mexico would have a hard time competing with a dynamic China. NAFTA enhanced Mexico's ability to supply American manufacturing firms with low-cost parts, but it did not make Mexico into an independently-productive economy.

When President **Bill Clinton** first asked the Council of Economic Advisers about the economic importance of NAFTA, early in his administration, our response was that potential geopolitical benefits were far more important than the economic benefits. (Similarly, the European Union, for all of the economic benefits that it has brought, is mainly a political project.)

America perhaps stood more to gain economically than Mexico, but the concrete gains were likely to be small on both sides. Tariff rates on both sides were already very low, with Mexico's tariffs being slightly higher than America's, and NAFTA would not eliminate important non-tariff barriers. The disparity in income across the Mexican border is among the largest anywhere, and the resulting migration pressure was enormous. Doing what little America could do to enhance growth in Mexico would be good for Mexico, and good for America; and it was the right thing to do for our neighbor to the south.

Unfortunately, much of the goodwill that the U.S. might have expected has been squandered. First, America attempted to use barriers to keep out Mexican products that began to make inroads in our markets – from tomatoes to avocados to trucks to brooms. Despite the impressive efforts of workers' rights groups, efforts to ease the life of immigrants have stalled. Recent moves in California to prevent illegal immigrants from receiving driver's licenses and medical care have been a depressing sign that conditions for Mexican immigrants in the U.S. are getting worse.

Of course, NAFTA was a far more modest project than the European Union. It did not envision the free movement of labor, though that would have had a far larger effect on regional output than the free movement of capital, on which it focused. It

(which were declining until very recently), Canada-U.S. interest rate differentials, and ultimately, productivity. Recently, the shift away from the U.S. currency has led to a rising Canadian dollar, but compared to two decades ago, many Canadian businesses have been shielded from its effects as they have diversified their activities internationally, as well enjoying higher world prices for commodities and some products (like steel).

In the United States, NAFTA has been a success story as well. The U.S. economy during the 1990s was one of the fastest-growing large economies of the world, with significant gains in productivity. While this success was not solely due to NAFTA, the increased trade among the three partners provided many U.S. businesses with opportunities to improve their efficiency by taking advantage of a much larger North American market.

Mexico's story is more mixed, but it remains generally positive. Again, one cannot look at trade agreements in isolation to interpret data – one has to also look at other factors that explain growth. Mexico was already changing prior to NAFTA, with trade liberalization followed by privatizations. NAFTA provided a base for Mexico to attract new investments, improve efficiencies and raise productivity. After the financial destabilization of 1995 (unrelated to NAFTA), the Mexican economy had its best growth spurt of the past two decades – 5.5 per cent per year between 1996 and 2001. After NAFTA, for the first time, Mexican manufacturing employment grew 2.5 per cent per year, interrupted only in 2001 by the effects of the U.S. recession. The auto industry was its clearest winner, with exports jumping substantially during the 1990-2000 period. Electrical and electronic goods, textiles, traditional manufacturing (food and beverages) and services also sharply increased in size due to improved access to the North American market.

> The idea of free trade is to remove barriers that prohibit economies from specializing in those products that are relatively cheaper to produce.

The one Mexican industry that did not fare as well was agriculture, out of which employees were expected to be absorbed by other growing industries. Sugar businesses – many inefficiently operated prior to NAFTA – were particularly hard hit. A worsening agricultural industry and the growth of manufacturing and services has led to increased regional inequality between northern and southern states in Mexico. Infrastructure expenditures in the north have not kept up with the expanding economy, in part reflecting a continuing problem of fiscal imbalances among federal and state governments. A highly centralized

did not envision a common set of economic regulations, or even a common currency. But hidden in NAFTA was a new set of rights – for business – that potentially weakened democracy throughout North America.

Under NAFTA, if foreign investors believe they are being harmed by regulations (no matter how well justified), they may sue for damages in special tribunals without the transparency afforded by normal judicial proceedings. If successful, they receive direct compensation from the federal government. Environmental, health and safety regulations have been attacked and put into jeopardy. To date, suits with claims in excess of US$13 billion have been filed.

While many of the cases are still pending, it is clear that there was not a full and open debate of the consequences of NAFTA before passage. Conservatives have long sought to receive compensation for regulations that hurt them, and American courts and Congress have usually rejected these attempts. Now businesses may have accomplished indirectly, through treaty, what they could not get more openly through the democratic political process.

Meanwhile, those harmed by the actions of the foreign firms, for instance by what they do to the environment, do not have comparable protections of appealing to an international tribunal and receiving compensation. The concern is that NAFTA will stifle regulation, no matter how important for the environment, health or safety.

All of this has important implications for the proposed Free Trade Area of the Americas, and for countries thinking of signing onto bilateral trade agreements with the United States. Signing a free trade agreement is neither an easy nor an assured road to prosperity. The U.S. has said it does not want agriculture or non-tariff barriers to be on the table in these talks. But while it refuses to give in on these points, it wants Latin American countries to compromise their national sovereignties and to agree to investor "protections".

In fact, the U.S. has been demanding that countries fully liberalize their capital markets just as the International Monetary Fund has finally found that such liberalization promotes neither growth nor stability in developing countries. Unfortunately, many of the smaller and weaker countries will probably agree in the quixotic hope that by linking themselves to America, they will partake of America's prosperity.

In the long run, while particular special-interest groups may benefit from such an unfair trade treaty, America's national interests – in having stable and prosperous neighbors – are not well served. Already, the manner in which the U.S. is bullying the weaker countries of Central and South America into accepting its terms is generating enormous resentment.

If these trade agreements do no better for them than NAFTA has done for Mexico, then both peace and prosperity in the hemisphere will be at risk.

Dr. Joseph Stiglitz is a professor of economics and finance at Columbia University. He is the co-founder and executive director of the Initiative for Policy Dialogue, a global network of economists and social scientists based at Columbia. His most recent book, *The Roaring Nineties*, was published last fall by W.W. Norton.

---

country, Mexico has been shifting expenditure responsibilities to its states, but not revenue fields. At the same time, the central government has faced its own fiscal pressures and attempted a tax reform that has failed to reach its objectives.

The idea of free trade is to remove barriers that prohibit economies in specializing in those products that are relatively cheaper to produce. As the world economy discovered with shrinking world trade in the depression years of the 1930s, increased world trade creates gains for all economies. In other words, free trade is not a zero-sum, but instead a positive-sum game in which all countries can do better than they can without it.

Some of the horrors raised by critics of free trade simply have not occurred. Several investor-protection cases (which require governments to compensate companies that are adversely affected by protectionist policies and are appropriate in maintaining a level playing field) have by and far been limited in application and, when applied, usually result from governments making bad decisions in the first place.

A good example is the case of fuel-additive MMT in Canada. When Environment Minister **Sheila Copps** did not feel she had a strong enough case to prohibit domestic and imported production of MMT on environmental grounds, she used a trade restriction to prohibit it. Further, much to the dismay of the critics, governments have had no difficulty in raising revenue to spend on public goods and services – in fact, tax levels as a proportion of GDP have generally increased in all three countries since 1994. Statutory corporate income tax rates have fallen, but this is more a result of countering profit-shifting at the international level rather than attracting capital. Governments have also scaled back tax incentives for investment, and in Mexico and Canada, corporate income taxes as a proportion of GDP have actually increased in the past decade and a half.

All of this is not to say that NAFTA has been perfect. Trade agreements do not apply to all industries – and some, like agriculture, have remained protected. Instead of following the EU's lead and ridding ourselves of anti-dumping laws – using competition policy to ensure competitiveness in markets – the three countries have maintained their distinctive trade protection laws where warranted. And labour mobility, while improved, is still regulated across the borders.

NAFTA's future success will require further improvements to economic integration in North America. More could be done to reduce regulatory and tax barriers to encourage a freer flow of capital and labour within the continent. However, U.S. anti-free trade sentiment has grown – mainly due to trade with Asia rather than Mexico or Canada – so any attempt at removing more barriers to trade and factor flows will be challenge. As Canadians, we should not accept this as an outcome. We know that we have much to offer to the U.S. and Mexico, and we should overcome the Luddites who still think free trade doesn't work – because it does.

Jack Mintz is the Deloitte & Touche LLP Professor of Taxation, at the Rotman School of Management and president and CEO of the C. D. Howe Institute.