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February 2004

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### Keywords

Federal, key workplace documents, Catherwood, ILR, NAFTA, U.S., Canada, Mexico, Latin America, economy, growth, productivity, employment, wages, immigration.

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Received through the CRS Web

## NAFTA at Ten: Lessons from Recent Studies

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### Summary

On January 1, 2004, the North American Free Trade Agreement (NAFTA) completed its tenth year and most of its provisions are now implemented. NAFTA is a free trade agreement (FTA) that effectively added Mexico to the U.S.-Canada FTA completed in 1989. Its anniversary has sparked numerous evaluations, which are particularly relevant as the United States pursues free trade agreements with multiple Latin American countries. Most studies found that NAFTA's effects on the U.S. and Mexican economies to be modest at most. This report provides an analytical summary of the economic lessons reached in support of Congress's role in the trade policy process. It will be updated as needed.

### Introduction

Free trade agreements are supposed to enhance the welfare of participating countries, so evaluating their effects is a valuable exercise. NAFTA is particularly relevant to the bilateral trade agreements being considered by the United States today because it was the first trade agreement in a non-multilateral setting between a developing and two developed countries. As such, it is important to note that this report focuses on U.S.-Mexico issues, not because Canada is unimportant, but because the U.S.-Canadian free trade agreement predates NAFTA, is less controversial in the eyes of most trade critics, and is less relevant (because it entails trade between two developed economies) to the pending trade agreements with Latin America. Further, because trade between Canada and Mexico remains very small, the trilateral trade agenda is still only emerging, although there is growing interest in analyzing immigration, security, and other issues within this trilateral framework.

This report evaluates four studies produced by the Congressional Budget Office (CBO), the World Bank, the Carnegie Endowment for International Peace, and the United States International Trade Commission (USITC). These assessments of NAFTA, by and large, are analytical in nature, use established methodologies, caveat their own work to reflect limitations of the research, and draw on academic rather than special interest research. The details of their methodologies are not reproduced here, but it is important to note that they faced similar research challenges. These include: 1) isolating the effects

of NAFTA from many other economic policies and forces at play; 2) using sufficiently long time-frames to separate out pre- and post-NAFTA trends and effects; and 3) comparing NAFTA over time and across countries to provide relative measures of the importance of any observed or inferred change.<sup>1</sup>

The lessons outlined below reflect conclusions of the reports, but not all addressed each of the issues. When analyses overlap, agreements and differences are identified, and other sources are cited when needed to clarify or expand on a certain theme. Conclusions regarding NAFTA's effects are not drawn relative to expectations espoused prior to its implementation. For political and other reasons, many of the claims made about NAFTA in the early 1990s, both good and bad, were less than credible. Details below provide a sense of NAFTA's economic success or failure relative to its effect on trade, investment, economic growth, productivity, employment, wages, and immigration.

## Trade and Investment Effects

NAFTA is a broad agreement, but improved market access, including tariff reductions on merchandise trade, was the major U.S. goal. After ten years, most tariffs have gone to zero, except for some very sensitive (mostly agricultural) goods that have limited protection for up to 15 years. Clearly, U.S.-Mexico trade and investment have grown sharply over the past decade. From 1994 to 2003, U.S. exports to Mexico rose 91%, compared to 41% to the world. U.S. imports increased by 179%, compared to 89% from the world. This surge, however, began prior to NAFTA, so the question is, how much of the post-1994 growth can be attributed to NAFTA?

**NAFTA had a modest effect on U.S.-Mexico trade growth.** The CBO, World Bank, and USITC approached the problem differently, but all found that NAFTA had a modest effect on U.S.-Mexico trade growth. The CBO model of U.S.-Mexico trade estimated that 85% of the U.S. export growth and 91% of U.S. import growth would have occurred without NAFTA. Although the effect was modest, it accelerated over time, accounting for a 2% marginal growth of U.S. exports and imports in 1994 up to 11% and 8% marginal growth of U.S. exports and imports in 2001. As a percentage of economic activity, the increased trade was more pronounced for Mexico than the United States. Separately, the World Bank makes the point that NAFTA has reinforced existing trends in trade growth and estimates that Mexico's global exports would have been 25% lower without NAFTA.<sup>2</sup>

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<sup>1</sup> Lederman, Daneil, William F. Maloney, and Luis Servén. *Lessons From NAFTA for Latin America and the Caribbean Countries: A Summary of Research Findings*. The World Bank, Washington, D.C. December 2003, Audley, John J., Demetrios G. Papademetriou, Sandra Polaski, and Scott Vaughan. *NAFTA's Promise and Reality: Lessons from Mexico for the Hemisphere*. Carnegie Endowment for International Peace, Washington, D.C. 2004, and United States International Trade Commission. *The Impact of Trade Agreements: Effect of the Tokyo Round, U.S.-Israel FTA, U.S.-Canada FTA, NAFTA, and the Uruguay Round on the U.S. Economy*. Publication 3621. Washington, D.C. August 2003. The Congressional Budget Office. *The Effects of NAFTA on U.S.-Mexican Trade and GDP*. Washington, D.C. May 2003.

<sup>2</sup> CBO, pp. 17-19, World Bank, p. v, 298, and 307, and USITC, p. 66.

The USITC analyzed tariff preferences by sector to isolate the effects of NAFTA on U.S.-Mexico trade. It estimated that NAFTA tariff preferences accounted for one-third of the growth in U.S. import shares from Mexico (higher among textile and apparel goods) and 13% of growth of U.S. exports to Mexico. The remaining growth in trade would have occurred anyway, and was influenced more by factors such as the 1994 peso devaluation and existing preferences provided Mexico under the Generalized System of Preferences (GSP) and production-sharing (maquiladora) programs. The U.S. benefit from NAFTA may also be seen in Mexico's response to the 1994 peso crisis, which was to raise tariffs against non-NAFTA partners. (In another report, the USITC noted that there was also an increased variety of goods traded and a rise in the average price of Mexican imports, suggesting new and upgraded goods being imported from Mexico.)<sup>3</sup>

**There is little evidence of trade diversion.** A key concern of trade analysts is whether an FTA results in trade shifting from nonmember countries to members of a trade agreement because the tariff preferences have allowed them to become the lower-cost producers. This has the effect of switching trade from more to less efficient trading partners. The World Bank Study found no significant evidence of trade diversion in NAFTA, particularly with respect to textile and apparel producers in neighboring Central America and the Caribbean.<sup>4</sup> This is consistent with a majority of studies done earlier.

**NAFTA did not cause the widening U.S. trade deficit with Mexico.** From 1994 to 2002, the U.S. trade deficit with Mexico grew from -\$1.4 to -\$37.1 billion. These studies found that trade deficits are largely macroeconomic phenomena, in this case predominantly attributed to the respective business cycles in Mexico and the United States. Strong U.S. growth in the 1990s combined with Mexico's deep recession caused by the December 1994 peso crisis (devaluation) were the main factors cited for the large deficits. Importantly, none of the studies attributed the peso crisis to NAFTA, but to structural misalignments in the Mexican economy combined with political events.<sup>5</sup>

**NAFTA helped increase bilateral foreign direct investment (FDI).**<sup>6</sup> From 1994 to 2002, U.S. FDI in Mexico rose from \$16.1 billion to \$58.1 billion, or 259%. Mexican FDI in the U.S. increased 244% to \$7.9 billion, albeit from the much smaller base of \$2.3 billion. FDI in Mexico (mostly U.S.) grew on average from 1.1% of GDP in 1980-93 to 3.0% in 1994-2001. The World Bank noted that NAFTA was one of numerous factors directing FDI and estimated that it led to a 40% annual increase in FDI to Mexico, without diverting FDI from other countries. The CBO and USITC studies basically agreed, finding that NAFTA's investment and trade liberalization worked together to reduce risk and improve profitability, and so observed that NAFTA helped to increase total investment flows to Mexico.

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<sup>3</sup> USITC, pp. 302-04, 308, 313. Hillberry, Russell H., and Christine A. McDaniel. *A Decomposition of North American Trade Growth Since NAFTA*. USITC. Washington, D.C. Working Paper No. 2002-12-A.

<sup>4</sup> World Bank, pp. xvii-xviii and 298.

<sup>5</sup> CBO, p. 20 and USITC, p. 49. The Carnegie Endowment study (Polaski, p. 14) does state that the tariff cuts, "resulted in a shift from a net trade deficit with the United States before NAFTA to a substantial net trade surplus in 2002" without citing evidence for it.

<sup>6</sup> World Bank, p. v, 155, and 366, CBO, p. 4, USITC, p. 158.

## Domestic Economic Effects

The various studies reached different conclusions with respect to the macroeconomic effects of NAFTA. Choice of methodology and depth of research varied and likely explain many of the differences.

**NAFTA slightly increased growth in output and productivity.** The CBO study, which had a limited model for estimating the trade effects on GDP, found that NAFTA increased annual GDP growth in the United States by no more than .04%, and for Mexico, no more than .8%. Similarly, the USITC cited other literature suggesting that U.S. GDP could grow by an additional 0.1% to 0.5% once NAFTA is fully implemented. The World Bank study, which undertook a more elaborate modeling effort, concluded that Mexico's economic performance was similar to the rest of Latin America prior to NAFTA. After NAFTA went into effect, Mexico's per capita GDP converged increasingly toward that of the United States, although a large discrepancy still exists. Estimates of the rate of convergence suggest that without NAFTA, Mexico's per capita GDP growth would have been 4-5% lower by 2002.<sup>7</sup> The World Bank also suggested that NAFTA contributed to "a substantially faster rate of productivity convergence than in previous years." For example, Mexican manufacturers were able to halve the time needed to adapt U.S. technological innovation. The Carnegie study also notes that productivity rose dramatically after NAFTA in both the United States and Mexico and suggests NAFTA "likely played a significant role."<sup>8</sup>

**NAFTA had little or no impact on aggregate employment.** NAFTA is at the heart of a long-standing debate over the employment effects of trade because of fears that trade with developing countries causes U.S. job losses and that trade deficits equate to higher unemployment. None of the reports attributed changes in aggregate U.S. or Mexican employment levels to NAFTA, but the author of the first chapter of the Carnegie study suggests that changing the assumptions of a USITC model would allow for a net gain in U.S. employment over the past decade of between zero and 270,000 jobs, a small increase. For Mexico, it concludes that "the sum of the effects of the trade pact to date has not been a strong net gain in overall employment." The second chapter (different author) argues for zero net growth in U.S. jobs. The USITC study demonstrates, contrary to some popular opinion, that U.S. trade deficits tend to occur during periods of low unemployment, and "vice versa." This evidence supports well-established economic theory that would suggest both the U.S. trade deficit with Mexico and U.S. employment levels over the past decade were responding to economic growth, not each other.<sup>9</sup>

**NAFTA contributed to employment shifts among sectors.** The Carnegie report observes a shift in Mexican employment away from agriculture toward services and manufacturing. It attempts to correlate this shift with NAFTA-induced trade balances in agriculture (deficit) and manufacturing (surplus) goods, but concludes that it is impossible

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<sup>7</sup> CBO, p. 22, USITC, p. 32, and World Bank, p. 27-28.

<sup>8</sup> World Bank, p. 5 and 28 and Carnegie Endowment, (Polaski, pp. 24 and 33). The USITC summary of the literature on productivity and trade cited numerous studies supporting the claim that trade liberalization enhances productivity. pp. 100-13.

<sup>9</sup> Carnegie Endowment, (Polaski, p. 20 and 28, Papademetriou, p. 39), USITC, p. 49

to establish precisely how much of the jobs shift can be attributed to NAFTA. The World Bank points to productivity growth in irrigated agricultural lands and the lack of opportunity in subsistence agriculture as alternative reasons for these shifts. In the United States, employees who lost jobs because of NAFTA are eligible for NAFTA trade adjustment assistance. The Carnegie report notes that at the end of 2003, some 525,000 workers have been certified under this program, heavily concentrated in manufacturing, especially apparel. Over a period of ten years, this represents a small portion of the aggregate work force, many of whom are already re-employed. Nonetheless, it is among the most salient adjustment issues related to trade, along with the possible need for a larger “social safety net.” The USITC and World Bank also show that structural shifts in both countries had been affecting long-term employment patterns as well.<sup>10</sup>

**NAFTA has had a small effect on real wages.** The USITC, in summarizing the vast literature on the observed rising U.S. income gap between more-skilled and less-skilled workers, suggests that while estimates varied, trade in general has contributed to no more than 10-20% of the wage gap. Economists generally consider the wage-gap problem to be a function of skill-based technological change that causes an employment bias toward more highly educated or trained workers. Increased trade of intermediate goods using outsourcing or production-sharing arrangements has also been linked in recent research. For Mexico, the Carnegie Endowment and the World Bank note that real wages are lower than when NAFTA began, but conclude that it was not the cause. Decomposing the trend shows that Mexico experienced a 25% fall in real wages after the 1994 peso crisis. Real wages began a steady recovery in 1997 and are approaching 1994 levels. Interestingly, the World Bank study showed that those Mexican states tied to FDI, exports, and maquilas had higher and faster-growing wages than other states.<sup>11</sup>

**Immigration patterns were not affected by NAFTA.** The long-term trend in legal and unauthorized worker migration from Mexico to the United States continued and accelerated after NAFTA was implemented. The trade agreement, however, was found to be largely irrelevant. The Carnegie Endowment study points to many factors that outweigh any effect an FTA can have on migration patterns. Mexican workers have been drawn to the United States by big wage differentials and the high demand for low-skilled workers. They have been encouraged to leave Mexico by the burgeoning work force that cannot be absorbed and the strong migration networks in place. Periodic financial crises (1982, 1986, 1994) exacerbate the problem. These cause huge losses in formal sector jobs, large declines in real wages relative to those in the United States, and failing confidence in the Mexican economy, all of which encourage emigration. The World Bank found that Mexican emigrants had higher levels of education and earned more than non-emigrants and so migration may have contributed to Mexico’s growing wage gap.<sup>12</sup>

**NAFTA has a minor role in Mexico’s rural-urban migration.** The first chapter of the Carnegie Endowment study argues that the observed trend of migration

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<sup>10</sup> Carnegie Endowment, (Polaski, p. 20-28), World Bank, p. xv, xxv, 183-85, and USITC, p. 41-45. On U.S. sectoral issues related to textiles, see: Rhodes, Karl. *Global Gain, Local Pain. Regional Focus*. Federal Reserve Bank of Richmond. Winter 2004. pp. 12-18.

<sup>11</sup> USITC, p. 67-68, 114, 125, World Bank, pp. vi-vii, Carnegie Endowment, (Polaski, p. 24-25).

<sup>12</sup> Carnegie Endowment, (Papademetriou pp. 40-41 and 50-53) and World Bank, pp. 174-80.

from rural areas of Mexico to urban centers, along with the attendant problems of unemployment, family disruption, and poverty, is directly the result of agricultural liberalization linked to NAFTA. This is contradicted by a second chapter (different author) that argues such migration patterns have been in place since 1960 when over 50% of the workforce was agricultural compared to 36% in 1980 to less than 25% in 1995. NAFTA appears at most to have affected at the margin an established trend that economists long have argued is common in the development process of most countries.<sup>13</sup>

## Outlook

The four studies discussed above point to three broad themes. First, by most aggregate measurements, NAFTA has had only a modest, but positive, effect on the U.S. and Mexican economies and tends to reinforce long-term trends already evident by its inception. This is in keeping with what is widely understood about trade and trade agreements; they work at the margin of economies and their effect can be easily confused with much more powerful factors such as long-term structural change and short-term volatility (e.g. financial crises). Such confusion is seen in the reluctance of many supporters and opponents of NAFTA to engage in a more nuanced debate on trade.

Second, adjustment problems related to trade liberalization present the greatest challenge to policy makers. For export firms and sectors, the adjustment is positive and provides evidence of the winners from trade. For import competing sectors, displacement can have devastating effects on communities and raises the question of whether to fight freer trade or attempt to adjust to it as part of the larger global integration process. The World Bank report argues that trade agreements can do more by improving distorting rules of origin, taking on the hard tasks of antidumping and countervailing duty measures, and tackling adjustment problems. The Carnegie Endowment study argues that trade agreements should address trade-related adjustment issues through longer tariff reduction schedules, use of special safeguards, removal of agricultural subsidies, and provision for regionally funded trade adjustment assistance and social safety net programs.<sup>14</sup>

Third, two studies address a common call for better integration of trade policy into a country's overall development program by coordinating and supporting it with domestic reforms. The Carnegie study argues for more attention to agricultural, environmental, immigration, tax, and labor rights protection policies, among others. The World Bank study prioritizes institutional reform (especially rule of law and anti-corruption efforts), educational development (to promote technology transfer), other innovation supporting policies, and labor reform that facilitates employment transition among industries and sectors.<sup>15</sup> In the end, these reports do not provide easy answers to trade-related policy problems, but do attempt to explain how the gains from trade may be enhanced by understanding and responding better to the adjustment challenges all countries face.<sup>16</sup>

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<sup>13</sup> Carnegie Endowment, (Polaski, pp. 17-23 and Papademetriou, pp. 46-47, 51-52).

<sup>14</sup> Carnegie Endowment, pp. 7-8 and World Bank, pp. v, xiv, xxiv, xxv.

<sup>15</sup> Carnegie Endowment, pp. 7-8 and World Bank, pp. v, viii, ix, xxiv, xxv.

<sup>16</sup> Themes developed here can be found in academic literature. See: Chambers, Edward J. and Peter H. Smith, eds. *NAFTA in the New Millennium*. University of California Press. 2002.