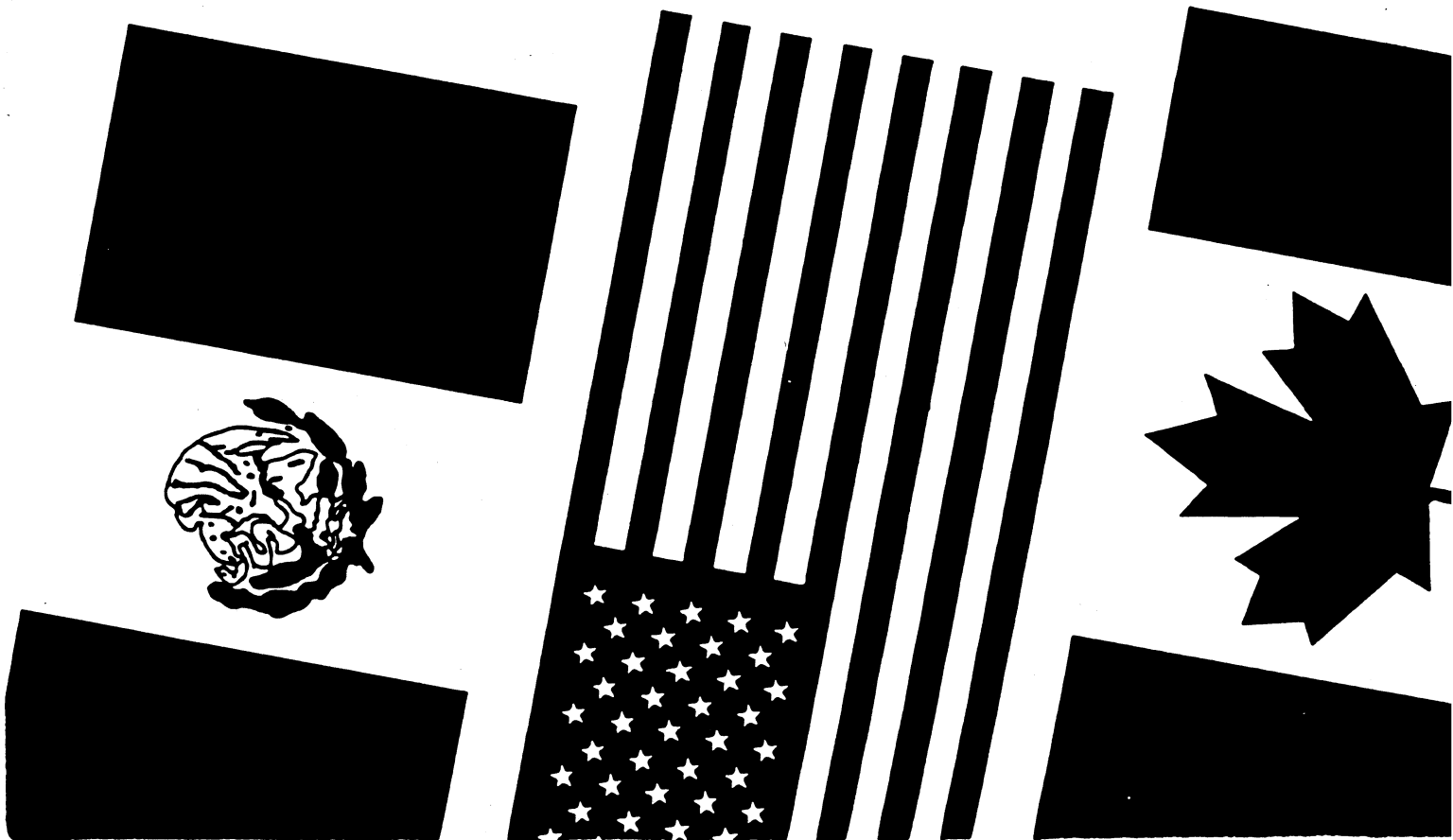


Potential Impact on the U.S. Economy and Selected Industries of the North American Free-Trade Agreement

Report to the Committee on Ways and Means of the United States House
of Representatives and the Committee on Finance of the United States
Senate on Investigation No. 332-337 Under Section 332 of the
Tariff Act of 1930



Executive Summary



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**POTENTIAL IMPACT ON THE U.S. ECONOMY AND SELECTED INDUSTRIES
OF THE NORTH AMERICAN FREE-TRADE AGREEMENT**

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PREFACE

Following receipt on September 23, 1992, of a request from the House Committee on Ways and Means and the Senate Committee on Finance (appendix A), the U.S. International Trade Commission instituted investigation No. 332-337 under section 332(g) of the Tariff Act of 1930 (19 U.S.C. 1332(g)) on October 23, 1992. The purpose of this report is to analyze the short- and long-term costs and benefits of the North American Free-Trade Agreement (NAFTA) for the U.S. economy, focusing on important industrial, energy, agricultural, and service sectors.

Copies of the notice of the investigation were posted in the Office of the Secretary, U.S. International Trade Commission, Washington, DC 20436, and the notice was published in the Federal Register (57 F.R. 49192) on October 30, 1992. An amendment to the scope of the investigation was published in the Federal Register (57 F.R. 54856) on November 20, 1992. The Commission held a public hearing in connection with the investigation on November 17-19, 1992. All persons were allowed to appear by counsel or in person, to present information, and to be heard. In addition, interested parties were invited to submit written statements concerning the investigation.

The information and analysis in this report are for the purpose of this report only. Nothing in this report should be construed to indicate how the Commission would find in an investigation conducted under other statutory authority covering the same or similar matter.

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EXECUTIVE SUMMARY

This report examines (1) the overall economic effects of the North American Free-Trade Agreement (NAFTA) on the economies of the United States, Mexico, and Canada; (2) the key NAFTA provisions and related legal changes for the United States, Mexico, and Canada that may significantly affect individual sectors; and (3) the short- and long-term impact of NAFTA on important industrial, energy, agricultural, and service sectors of the U.S. economy. The report also summarizes recent economic developments in Mexico that, in conjunction with NAFTA, are likely to affect the potential for U.S. investment and market access in Mexico.

Since the mid-1980s, Mexico has been opening its economy to foreign competition by liberalizing its trade and investment policies, privatizing many state-owned or -controlled economic sectors, and reducing subsidies. NAFTA will remove many remaining barriers to trade and investment and will help to ensure that Mexico's recent economic reforms remain in place, thus paving the way for greater economic integration among the three countries.

Under NAFTA, the United States and Canada will gain greater access to the Mexican market, which currently is the fastest growing major export market for U.S. goods and services. Second, NAFTA will create investment opportunities that will facilitate trade among the member countries in many sectors and that may reduce impediments to future trade growth. Third, NAFTA will lead to a more predictable business environment, reducing risks associated with investment and other business decisions. Fourth, NAFTA will improve the competitive position of certain U.S. sectors in North American and global markets. Finally, NAFTA is an important step towards free trade throughout the hemisphere. However, as noted below, NAFTA is also likely to affect certain U.S. sectors adversely.

NAFTA incorporates on a trilateral basis most of the provisions of the existing United States-Canada Free-Trade Agreement (CFTA) and in many instances expands upon those provisions. Because both the United States and Canada already have implemented CFTA, the principal effects of NAFTA on U.S. economic sectors will result from changes in United States-Mexico trade and investment. Mexico will be required to make many more legal changes than either the United States or Canada to implement NAFTA.

Trade and investment within North America are important to all these nations. The United States and Canada are each other's major trading partner and Mexico is the United States' third-largest partner after Canada and Japan. In 1991, Canada accounted for 19 percent of U.S. merchandise trade, Japan 15 percent, and Mexico 7 percent. The United States is Mexico's largest trading partner and source of foreign direct investment (FDI), accounting for almost 70 percent of total Mexican trade in 1991 and 61 percent of Mexico's cumulative FDI by value as of June 1992. Mexico is likely to benefit substantially more from NAFTA than either the United States or Canada because its gross domestic product (GDP) is only 5 percent of U.S. GDP, its economy historically has been closed, and trade with the United States is relatively more important to its economy.

Economic Trends in Mexico

- Mexico's ongoing market-oriented reforms have spurred foreign investment and trade, leading to higher growth for the nation's economy overall. Austerity measures have reduced inflation from triple-digit levels as recently as 1987 to an estimated 11 percent in 1992. Following economic stagnation during 1982-88, the Mexican economy grew by an annual average rate of nearly 4 percent during 1989-91. In 1992, however, economic growth in Mexico is expected to slow to 2.7 percent. FDI in Mexico in 1991 rose by 81 percent over the 1990 level, and foreign portfolio investment roughly quadrupled in both 1990 and 1991. During the first half of 1992, FDI rose by 13 percent over the 1991 period, whereas foreign portfolio investment fell by 3 percent.
- Mexican exports grew by 19 percent during 1989-91, and imports rose by 50 percent. During January-July 1992, Mexican exports rose only 1 percent over the 1991 period, whereas imports accelerated 29 percent. The growth in Mexican imports is largely due to increased purchases of capital goods to support Mexico's modernization of its manufacturing base and infrastructure. The United States supplies two-thirds of Mexico's total imports, and capital goods are a leading U.S. export to Mexico. Since 1989 the Mexican trade deficit has widened and reached \$11.4 billion in January-July 1992, surpassing the deficit for all of 1991.
- Remaining economic challenges for Mexico include financing its growing trade deficit, alleviating the shortage of highly skilled workers, and expediting improvement of the highway system, electricity, and telecommunications. The Government has recently launched efforts to modernize infrastructure in conjunction with private participation, as well as to improve education, productivity, and product quality.
- Mexico's regulatory reforms have been accompanied by efforts to address environmental issues. While Mexican environmental laws and regulations are in many instances comparable to those in the United States, concern remains about Mexico's enforcement of such laws and regulations. The Mexican Government has stated its commitment to stricter enforcement and has recently taken additional actions toward this end.

Likely Impact of NAFTA on Member Economies

- Empirical evaluations generally conclude that NAFTA is likely to produce net aggregate gains for each of the member countries in both the short term (within 1 year) and long term (after complete phase-in of NAFTA). Estimated long-term gains in U.S. and Canadian real GDP are 0.5 percent or less. Projected long-term gains in Mexican real GDP range from 0.1 to 11.4 percent.
- Projected long-term gains in aggregate employment are less than 1 percent for the United States and Canada but up to almost 7 percent for Mexico. Expected increases in average real wages are 0.3 percent or

less for the United States, 0.5 percent or less for Canada, and 0.7 to 16.2 percent for Mexico. Although the evidence on the direction of real wage effects for low-skilled and high-skilled U.S. workers is mixed, the preponderance of evidence indicates an almost indiscernible effect on U.S. wage rates for both low-skilled and high-skilled workers.

- NAFTA is expected to expand U.S.-Mexican trade substantially. Estimated gains in U.S. exports to Mexico range from 5.2 to 27.1 percent. Projected increases in U.S. imports from Mexico range from 3.4 to 15.4 percent.
- NAFTA is expected to provide further impetus for increased FDI in Mexico. Analysts disagree over the likely origin and magnitude of the expected increase in FDI, but generally agree that such investment flows will provide Mexico with greater benefits than will the reduction in trade barriers.
- NAFTA is expected to have minimal additional effects on trade and investment between the United States and Canada, because the majority of NAFTA's provisions have already been implemented under CFTA. Canadian gains under NAFTA are expected to be small, reflecting the existing CFTA and the low level of trade and investment flows between Mexico and Canada.
- Mexico's improved access to advanced technology could lead to a long-term increase in Mexico's rate of economic growth (i.e., dynamic gains). The United States and Canada, as longstanding participants in a global open trading regime, may not realize substantial dynamic gains from NAFTA, but will most likely benefit from market opportunities created by economic growth in Mexico.
- NAFTA's impact on the United States will vary from region to region. Various economic studies suggest that the border region will benefit substantially under NAFTA. The sector analyses in this report suggest that the effects on U.S. industries in other regions will range from beneficial to adverse.
- Based on the sectors covered in this report where regional effects were identified, regions more likely to be affected by long-term production and employment changes as a result of NAFTA are the Midwest, the South, and the West. Industries in these regions likely to experience gains are machine tools, bearings, industrial machinery, steel mill products, pharmaceuticals, textiles, grains and oilseeds, cotton, lumber and wood products, and automotive parts. Industries in these regions likely to experience losses are automobiles, apparel, flat glass, certain household glassware, major household appliances, shrimp, peanuts, certain fresh and frozen vegetables, citrus juice, and fresh-cut roses. Likely production and employment effects for U.S. industries in other regions are noted in chapter 2 of this report.

Key NAFTA Provisions Affecting U.S. Trade and Investment

- The key NAFTA provisions affecting U.S.-Mexican investment and trade include the removal of tariffs and quotas, the imposition of strict and transparent rules of origin, and the limitation on duty drawback. NAFTA also will require changes in Mexican law or the maintenance of recent Mexican reforms to ensure removal of many restrictions on FDI, stronger intellectual property protection, and a more open services market and government procurement process for U.S. firms.
- NAFTA prohibits the adoption of new customs duties on qualifying goods and contains a schedule of staged duty reductions for each party, divided into four general staging categories plus a category for goods remaining free of duty. The staged duty reductions affecting U.S. trade with Mexico are approximately as follows (based on a percentage distribution of 1990 trade):

<u>Category</u>	<u>U.S. imports from Mexico</u>	<u>U.S. exports to Mexico</u>
A (free on implementation)	53.8	31.0
B (free within 5 years)	8.5	17.4
C (free within 10 years)	23.1	31.8
C+ (free within 15 years)	.7	1.4
D (currently free)	13.9	17.9

Note.--U.S. imports from Mexico in category D are principally those imports entered under duty-free most-favored-nation rates. It should be noted that there are duty-free imports from Mexico under other tariff provisions, such as the Generalized System of Preferences and those relating to production sharing programs. In total, about 45 percent of U.S. imports from Mexico enter duty-free. For further discussion of the data, see appendix F of this report.

- NAFTA rules of origin are intended to ensure that the benefits of tariff reductions will accrue principally to the NAFTA parties and to provide incentives for North American production and sourcing. Comparing CFTA to NAFTA, to qualify as a North American product under NAFTA a number of industrial sectors would be subject to stricter and more detailed change in tariff classification rules, higher and more stringent value-content requirements, and rules requiring that certain subassemblies be produced in North America. These sectors include automotive goods, computers and other electronic equipment, machine tools, steel mill products, textiles and apparel, major household appliances, industrial machinery, and bearings.
- The limitation on duty drawback will contribute to the establishment of an integrated North American market by discouraging the creation of "export platforms" in one NAFTA country to serve markets in another

NAFTA country. The NAFTA limitation is intended to ensure that when non-North American components and raw materials are imported into North America, they will be subject to ordinary customs duties without regard to whether such imports are consumed in the country of importation or shipped to another NAFTA country.

- In most cases NAFTA will require that each country's federal government procurement process for covered goods be opened further on a nondiscriminatory basis to suppliers from the other NAFTA nations. The elimination of most domestic procurement preferences and the requirement for transparent procedures represent the first legal obligations for open competition in the Mexican Government's procurement market, since Mexico, unlike the United States and Canada, is not a signatory to the General Agreement on Tariffs and Trade (GATT) Agreement on Government Procurement.

Likely Impact on U.S. Industrial Sectors

- The United States in 1991 recorded a favorable balance of trade with Mexico in the industrial sectors covered in this report, with U.S. exports to Mexico of \$16.8 billion exceeding U.S. imports from Mexico by \$1.1 billion. U.S. tariffs on Mexican goods average 3 percent in nominal terms, whereas Mexican tariffs on U.S. products average 10 percent. However, the effective tariffs for bilateral trade are lower because of the maquiladora arrangement and other special customs programs. In addition to tariffs, restrictions such as U.S. quotas on textiles and apparel and Mexican domestic content and investment requirements have acted as barriers to trade and investment.
- The United States in 1991 posted a trade surplus with Canada in the covered industrial sectors, with U.S. exports to Canada of \$46.8 billion exceeding U.S. imports from Canada by \$2.8 billion. Tariffs on all products except selected agricultural goods traded between the United States and Canada are already being phased out under CFTA, and no major nontariff restrictions remain.
- The United States accounts for a large portion of total FDI in Mexico's industrial sectors, primarily under the maquiladora program (which involves the processing or assembly of U.S. components in Mexico for export to the United States). Under NAFTA, U.S. investment in Mexico is expected to increase between 6 and 15 percent in major household appliances; and computers, computer components, and electronics in the short term, and in bearings and pharmaceuticals in the long term. Long-term increases in U.S. investment to Mexico of 16 percent or more are anticipated for autos and automotive parts; computers, computer components, and electronics; major household appliances; and apparel. Some of the expected growth in U.S. investment in sectors such as apparel and computers, computer components, and electronic equipment is likely to represent a shift in investment from East Asia and other developing countries to Mexico.

- NAFTA is likely to result in short- and long-term increases in U.S. trade with Mexico in all industrial sectors covered. Long-term increases of between 6 and 15 percent are expected in U.S. trade in the following sectors (in some broad sectors both imports and exports are expected to increase):

U.S. exports

bearings
machine tools
steel mill products
pharmaceuticals
industrial machinery
chemicals
major household appliances

U.S. imports

bearings
household glassware
steel mill products

- Long-term increases of 16 percent or more are likely as a result of NAFTA in the following sectors:

U.S. exports

autos and automotive parts
computers, computer components,
and electronics
textiles and apparel
ceramic tile
household glassware

U.S. imports

autos and automotive parts
computers, computer components,
and electronics
textiles and apparel
ceramic tile
major household appliances

- Many sectors of U.S. industry are much larger and more technologically advanced than their Mexican counterparts, giving U.S. producers a competitive advantage. However, U.S. producers are at a substantial disadvantage with Mexican firms in terms of wage rates, although this disparity is offset in part by lower productivity and rising costs in Mexico associated with financing, transportation, and infrastructure.
- U.S. production and employment gains of between 1 and 5 percent in the long term are likely in industrial machinery, and in computers, computer components, and electronics; gains of less than 1 percent are likely in machine tools, bearings, textiles, pharmaceuticals, steel mill products, and chemicals. The automotive parts industry is expected to gain 6 to 15 percent in production and less than 5 percent in employment in the long term.
- U.S. production and employment losses of less than 5 percent are likely in apparel in both the short and long term. Losses between 6 and 15 percent in the long term could occur in major household appliances, flat glass, and certain segments of household glassware and ceramic tile. Although the automotive products sector is likely to be virtually unaffected by NAFTA in the short term, automobile production and employment likely will decline in the long term by less than 5 percent.

- NAFTA is expected to have a small but positive effect on the ability of many U.S. industrial sectors to compete in both North American and global markets. In particular, the agreement is expected to boost the ability of the U.S. bearings and textile industries to compete in North America, and to benefit certain major U.S. apparel firms in competing with East Asian products in the United States and Mexico. For the majority of U.S. apparel firms, however, and for the household glassware industry, the elimination of quotas and/or duties is likely to generate added competition in the U.S. market by Mexican producers.

Likely Impact on U.S. Energy Sectors

- U.S. trade with Mexico in energy products was marked by a deficit of \$4.6 billion in 1991. Currently, the opportunities for U.S. trade and investment in Mexican energy sectors are very limited. Virtually all aspects of investment, production, and distribution are reserved to the State. Although U.S. companies provide a significant amount of the services procured by the Mexican parastatals--Petroleos Mexicanos (PEMEX) and Comision Federal de Electricidad (CFE)--current procurement procedures tend to favor Mexican suppliers.
- The U.S. trade deficit with Canada in energy products was \$8.6 billion in 1991. The Canadian energy sectors are relatively open to U.S. trade and investment. The energy provisions of NAFTA are virtually identical to those of CFTA and, thus, are not likely to have any added effect on U.S.-Canadian energy trade and investment.
- NAFTA recognizes Mexico's constitutional reservation of State ownership and control of most of its energy industry, including ownership of subsoil resources, investment in exploration and production, control of services related to energy products, and distribution of these products in Mexico. Because Mexico is not bound by most of the energy provisions in NAFTA, there is only minimal potential for increased energy trade and investment between the United States and Mexico as a result of NAFTA. Little or no increase in U.S. production and employment is likely.
- NAFTA does provide, however, some increased opportunities for U.S. service providers to contract with PEMEX and CFE. The agreement's government procurement provisions will permit foreign firms to bid on 50 percent of PEMEX and CFE contracts immediately on a non-discriminatory basis and the percentage will increase to 100 percent of such contracts after 9 years, subject to some specific exceptions.
- NAFTA will also permit private U.S. and Canadian investment in the production of most petrochemicals and in certain electricity generating facilities (self-generation, cogeneration, and independent power plants), although public sale of electricity remains prohibited.

Likely Impact on U.S. Agricultural Sectors

- In the agricultural sectors, U.S. trade with Mexico generated a surplus of \$53 million in 1991. Currently, about 40 percent of Mexican agricultural goods enter the United States duty-free and the remaining products are dutiable at an average rate of 8 percent ad valorem. U.S. agricultural exports to Mexico are subject to year-round and seasonal tariffs of 10 percent or more. In addition to tariffs, the United States maintains quotas on certain agricultural imports from Mexico, and Mexico requires import licenses for U.S. agricultural products. U.S. health and sanitary requirements reportedly have slowed the trade flow from Mexico in certain products.
- Canada is the only significant agricultural trading partner with which the United States has a trade deficit in the sector. In 1991 the U.S. trade deficit with Canada in the agricultural sector totaled \$239 million; in addition, in lumber and wood products the United States posted a much greater trade deficit with Canada of \$2.4 billion.
- The most significant NAFTA provisions affecting trade in agriculture relate to market access. In part, these provisions provide for tariffication of nontariff barriers and the subsequent elimination of these and existing tariffs. The agreement provides different arrangements for the treatment of agricultural trade between the United States and Mexico and between Canada and Mexico. Because of these differences and the existence of CFTA, NAFTA has no practical effect on tariffs and on most nontariff barriers applicable to U.S.-Canadian trade in agricultural products.
- U.S. investment in Mexican agriculture is small compared with investment in manufacturing and services. However, it is expected to increase in the long term by 6 to 15 percent for poultry and fish processing; investment is likely to increase between 6 and 15 percent in the short term and by 16 percent or more in the long term for citrus products, grains and oilseeds, and alcoholic beverages. U.S. investment in domestic fresh-cut roses is expected to decline between 6 and 15 percent in both the short and long term as a result of added Mexican investment in its domestic industry and anticipated increases in U.S. imports from Mexico.
- NAFTA's effect on U.S. agricultural trade is likely to be relatively small compared with current sector production. NAFTA is likely to result in long-term increases of 6 to 15 percent in U.S. exports to Mexico of alcoholic beverages and canned sardines and in U.S. imports of Mexican citrus juices (especially frozen concentrated orange juice) and fresh-cut roses. Long-term increases of 16 percent or more are likely in U.S. exports to Mexico of grains and oilseeds, deciduous fruits, poultry, swine and pork, beef offals, fresh citrus, and certain cut flowers (including high-quality roses).
- NAFTA is likely to have little or no impact on most agricultural sectors examined in this report. Sectors likely to experience production and

employment gains of 1 to 5 percent in the long term include fisheries and grains and oilseeds. Production and employment losses of less than 5 percent in the short or long term are expected in citrus juice, shrimp, certain fresh and frozen vegetables, peanuts, and fresh-cut flowers (including fresh-cut roses).

- NAFTA is not likely to affect the overall ability of U.S. agriculture to compete globally. Certain U.S. agricultural sectors are likely to be more cost competitive in the North American market over time, including grains and oilseeds, deciduous fruit, poultry, certain livestock and meat, alcoholic beverages, cotton, and dairy products. Removal of U.S. tariffs under NAFTA is expected to result in a slight decline in the U.S. share of the North American market for citrus juice, certain frozen vegetables, noncitrus fruits (e.g., grapes, melons, and strawberries), and fresh-cut roses.
- NAFTA's impact on trade in agricultural goods subject to U.S. quotas will likely vary. U.S. sugar imports from Mexico and sugar exports to Mexico will depend on whether or not Mexico eventually becomes a net surplus producer of sugar. For goods subject to section 22 quotas (cotton, dairy products, peanuts, and sugar-containing articles), NAFTA will likely have little or no effect on the level of U.S. imports from Mexico. For U.S. exports to Mexico, NAFTA will likely result in little or no increase in sugar-containing articles and in long-term gains of 16 percent or more in cotton and dairy products (especially nonfat dry milk), and less than 5 percent in peanuts.

Likely Impact on U.S. Service Sectors

- U.S. services sales to Mexico of approximately \$8 billion represent a very small fraction of the industries' \$257 billion in worldwide sales. Restrictions prevented U.S. companies in most service sectors from providing services to Mexico directly through a local establishment and in many cases from providing services on a cross-border basis.
- CFTA enabled U.S. service providers to increase their already significant investment and participation in the Canadian services market. U.S.-Canadian services trade and investment are not expected to change appreciably under NAFTA. The principal exception is in construction and related services, for which Canada has agreed to go beyond CFTA obligations to open its federal government procurement of these services to U.S. providers over a 10-year period.
- The benefits and obligations provided to Mexico under NAFTA are similar to those contained in CFTA. NAFTA is expected to create opportunities in Mexico for U.S. service providers, either through increasing cross-border trade or by investing in or establishing Mexican enterprises. U.S. investment is expected to increase by 6 to 15 percent in Mexico's telecommunications and banking services sectors in the long term. A similar increase is expected in U.S. investment in Mexican transportation services in the short term and is likely to exceed 16

percent in the long term. Mexican investment in the transportation services industry is anticipated to increase between 6 and 15 percent, concentrated in the U.S. border States.

- Removal of Mexico's restrictions on foreign equity ownership in the insurance market is likely to result in an expansion of U.S. investment in this market by 16 percent or more in both the short and long term. However, cross-border trade in insurance services will remain small and largely unaffected by NAFTA because of different regulatory practices in each country (at the state or province level) requiring that insurance transactions be conducted only by formally licensed companies or subsidiaries (not branches) within a given jurisdiction.
- U.S. receipts from sales to Mexico of telecommunication, transportation, construction and engineering, and banking services are likely to increase in the long term between 6 and 15 percent as a result of NAFTA. Specialized environmental engineering services will offer potential growth opportunities for U.S. firms. U.S. payments to Mexico for transportation, engineering, and construction services are expected to rise by 5 percent or less in both the short and long term, with the increases accruing primarily to border areas.
- U.S. operations and employment in most services sectors covered in this report are expected to increase relatively little in the short term and by less than 5 percent in the long term as a result of NAFTA. The principal exception is transportation services where U.S. firms are currently unable to provide cross-border services with Mexico. The U.S. sector is expected to show gains of 6 to 15 percent from the opening of Mexico's market for trucking and rail services under NAFTA, expected infrastructure improvements, and an overall increased demand for transportation services generated by NAFTA.
- Greater access to Mexican markets is expected to result in a small but positive increase in the ability of most U.S. services to compete in North America and globally as the result of the experience gained in a developing market and the potential gateway to further trade in Latin America. In addition, the increase in U.S. investment and trade in services in Mexico under NAFTA will benefit other sectors, as better trucking and rail services and increased efficiency of Mexican banks facilitate merchandise trade flows between the United States and Mexico. Such indirect benefits from NAFTA may affect service sectors in the United States more than will direct benefits from tariff removal only.

