MAPI Economic Report

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The North American Free Trade Agreement

The NAFTA Debate: Generating More and Better Jobs or Protecting Existing Jobs?

On or about November 17, the Congress is scheduled to vote on whether to approve or disapprove the North American Free Trade Agreement (NAFTA). The agreement is supported by the Clinton Administration and has strong bipartisan backing. The bill also has strong opposition, however, much of it coming from traditional Democratic sources of support: organized labor, some environmental groups, the National Association for the Advancement of Colored People (NAACP), and consumer groups such as Ralph Nader's Public Citizen. These opponents of NAFTA have been joined by the more populist elements of the right, most vocally Ross Perot and Patrick Buchanan. NAFTA is expected to pass easily in the Senate. The outcome in the House of Representatives is less certain and will depend largely upon the amount of support the Administration receives from its own party.

NAFTA's opponents have been strident in their claims that passage of NAFTA will result in the widespread movement of U.S. jobs to Mexico. The most popular champion of this argument has been Ross Perot's book, *Save Your Job, Save Our Country*.[1] This book lacks any plausible evidence on the likely effect of NAFTA on employment in the United States as well as credible analyses to support its conclusions. As an attempt to influence public opinion on this important issue, however, the book may prove successful. The book displays many of the traits that by now characterize Mr. Perot's involvement in politics: it is put together quickly, relies on catchy phrases rather than careful analysis to convince, questions the motives of those who disagree with it, and uses incomplete and/or misleading statements of fact.

The consensus among economists is that NAFTA will benefit the U.S. economy over both the short- and long-term, but that the benefit will be relatively small—the gross domestic product (GDP) of Mexico is only 5 percent of the output of the U.S. economy. Lower tariffs will help stimulate U.S. exports to Mexico and reduce the need for U.S. companies to locate plants in Mexico in order to penetrate the Mexican market. NAFTA also will raise the living standards of Mexican people. A stronger Mexican economy in the long run will help expand markets for U.S. manufacturers and reduce the pressure on illegal immigration into the United States from Mexico.

The growth of a larger free trade market will pose problems, of course, for some industries and for some groups of workers. Industries with a high proportion of low-skilled workers will experience competition from low-wage Mexican labor. This will result in some unemployment in these particular industries and will accelerate the need for capital and labor to move from these industries to higher value-added activities. Nevertheless, the consensus among most economic studies is that while some workers will experience unemployment as lower wage, lower skilled jobs move to Mexico, expanded trade in North America as a result of NAFTA will generate more new and better paying jobs. Ross Perot does not debate this consensus: he dismisses it.

[1]Ross Perot with Pat Choate, *Save Your Job, Save Our Country: Why NAFTA Must be Stopped—Now!*, Hyperion, 1993.

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This report analyzes the most significant criticisms of NAFTA. It summarizes the consensus of economists on the likely effects of NAFTA on employment, investment, exports and immigration. Finally, it examines the debate about NAFTA in the context of the relationship between the U.S. economy and the rest of the world. The report concludes that passage of NAFTA is strongly in the general economic interest of this country, although perhaps more for the indirect effects it will bring about than for its direct effects.

Flaws in the Perot Argument

There are a number of factual and logical errors in Ross Perot's book which give a distorted picture of NAFTA. These errors include:

- Mr. Perot frequently attributes broad social problems to the passage of NAFTA. No one contests the fact that Mexico faces serious problems such as environmental degradation, poverty, and weak democratic institutions. The book, however, often seeks to give the impression that these problems are partly caused by trade with the United States. A more plausible analysis is that the type of openness which NAFTA encourages is likely to lead to economic and political changes to address these issues.
- The book ignores instances in which the U.S. negotiators have attempted to ameliorate potential problems. These include transition periods to give U.S. industries time to adjust to increased competition as well as separate side agreements on labor issues and the environment. The book expressly assumes that NAFTA provisions on worker qualifications, the environment, and food safety will not be enforced and are therefore worthless.
- The book completely ignores the cost of existing barriers against U.S. exports to Mexico. It therefore gives little credit to the negotiators for attempting to lower them and discounts the potential for expanded exports. Instead, it focuses solely on the fact that in some cases the barriers would not be completely eliminated and in other cases long transition periods would be allowed. It does not mention the exemptions and transition periods that U.S. negotiators have insisted on in return.
- The book has a difficult time deciding whether foreign investment is good or bad. It faults NAFTA for making U.S. investment in Mexico easier, implicitly assuming that investment abroad harms the United States. It also faults the agreement for opening up certain sectors of the U.S. economy to Mexican investors, thereby implying that this unfairly benefits Mexico.
- Perhaps most importantly, the book completely ignores the benefits to consumers and industry of obtaining cheaper goods from Mexico. If U.S. manufacturers are likely to move production to Mexico in order to lower production costs, then U.S. buyers, whether they are consumers purchasing final products or manufacturers seeking inputs, will benefit from lower prices. Additionally, U.S. companies moving abroad, many of which are partly owned by large pension funds holding the retirement income of millions of U.S. workers, should benefit from higher profits. These effects should at least partly offset the cost of those jobs that are lost. Nowhere does one find any mention of this offsetting benefit.
- Mr. Perot exaggerates the importance of Mexico's economy in relation to our own. Both net investment in Mexico and the corresponding benefits from higher exports and profits are likely to be relatively minor, given the fact that Mexico's economy is only 5 percent the size of ours. There is a real limit to the amount of investment and economic growth Mexico can sustain without inflation. Even before this limit is reached, a variety of offsetting factors such as exchange rate adjustments, lower economic returns, and higher wages in Mexico will act to moderate the initial effects.
- The book implicitly assumes that negotiators could have gotten more and given up less if only they had been wiser and more patriotic. In his final recommendations, Mr. Perot assures readers that such an agreement can be reached by presenting Mexico with a take-it-or-leave-it deal.[2] The only explanation he offers as to why Mexico would accept such a deal is the vast attractiveness of U.S. markets, which already are relatively open. The problem is that this sort of all-or-nothing approach to negotiations usually leaves consumers and exporters with nothing.

The Real Effects of NAFTA

There is no shortage of economic studies of NAFTA. None claims to give a definitive answer regarding NAFTA's effect on the U.S. economy. The ultimate impact will be determined over time by the decisions of millions of consumers and businesses in the United States and abroad. Predicting these decisions requires broad assumptions about how people act and about the future economic climate in which decisions will be made. While Ross Perot correctly points out some of the problems with these studies, he offers no better alternative for estimating the likely impact.

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[2] *Ibid.*, pp. 101-110.

This report looks at two studies issued by the Congressional Budget Office (CBO) and one study issued by the General Accounting Office (GAO).[3] These studies summarize the results of over 20 economic papers on the impact of NAFTA on jobs, trade, investment, and immigration. These studies conclude that, despite differences between various models, there is broad agreement that NAFTA will increase jobs, expand American exports, and broaden investment opportunities for U.S. investors. This conclusion completely contradicts the assertions of Mr. Perot.

Job Creation

Given the current climate of slow economic growth and business restructuring, the final verdict on NAFTA is likely to depend on whether or not it is perceived as a job creator. On this the consensus is definite: NAFTA would have a net positive, if marginal, effect on job creation in the United States. The CBO study concludes:

> In the short run, as long as production in the United States remains below potential and unemployment is high, the improved trade with Mexico is likely to increase both production and employment in the United States. . . . Over [the] longer period, the improved trade would probably increase real income in the United States, with both higher real wages on average and higher profits. These effects, however, would be very small relative to the size of the U.S. economy.[4]

CBO also concludes that some jobs would be lost: ". . . even though NAFTA would increase total employment in the United States, some U.S. workers would lose their jobs. The total number of jobs lost would probably be well under half a million, spread over at least a decade."[5] The Perot book seizes on this quote and misrepresents it as an estimate of net rather than gross job loss.[6] When asked why the book failed to mention CBO's estimate of net job creation, co-author Choate explained, "I believe the displacement. I don't believe the gain."[7]

In order to gain the maximum amount of attention, Perot cites 5.9 million jobs as being "at risk."[8] This figure includes American jobs in 75 manufacturing industries with moderate to good growth, low- to mid-technology operations, and a labor component of 20 percent or more of the cost of goods sold. Many of these jobs are in industries such as sonar equipment, aerospace, medical equipment, and telecommunications,[9] industries in which the United States has a large comparative advantage. While the Perot book admits that not all of these jobs will be lost, it claims that "millions" will be lost and that few if any jobs will be created.[10] This figure is several times higher than even the most pessimistic economic study on NAFTA.

The Perot study cleverly confuses NAFTA with the broader issue of the impact that increased competition and technological progress have had on the availability of low-skill, high-wage jobs in this country. It encourages readers to believe that the loss of these jobs can be significantly slowed by defeating NAFTA. Technological innovation and increases in worker productivity have made it possible for U.S. industry to maintain manufacturing output with fewer jobs. A similar experience occurred in agriculture over the past century, leading to a dramatic decline in the number of farmers needed to produce the nation's food supply.[11] The existence of foreign competition creates pressure on manufacturers to adopt new technology in order to remain competitive. It is this technological innovation and industrial restructuring, not competition from lower wage countries, that has resulted in most of the loss of specific jobs over the past decade.

The Perot study is correct when it states that the existence of low-wage labor overseas represents a potential threat to at least some American jobs. However, it exaggerates this threat and gives the misleading impression that this threat can be avoided by trade policy. In the vast majority of cases where foreign corporations set up companies overseas, they do so because international competition for overseas

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[3]Congressional Budget Office, *A Budgetary and Economic Analysis of the North American Free Trade Agreement*, CBO Study, July 1993; Congressional Budget Office, "Estimating the Effects of NAFTA: An Assessment of the Economic Models and Other Empirical Studies," CBO Paper, June 1993; General Accounting Office, *North American Free Trade Agreement: Assessment of Major Issues, Volume 2*, September 1993.

[4]*A Budgetary and Economic Analysis of NAFTA*, p. 24.

[5]*Ibid.*, p. xv.

[6]*Save Your Job, Save Our Country*, p. 66.

[7]"Critics of Perot's New Book on Nafta Charge Co-Authors Twist or Omit Some Crucial Facts," *The Wall Street Journal*, August 27, 1993, p. A8.

[8]*Save Your Job, Save Our Country*, pp. 53-57.

[9]U.S. Trade Representative, *Correcting the Record: Response of the Office of the U.S. Trade Representative to the Perot/Choate NAFTA Book*, September 2, 1993 (manuscript available from the U.S. Trade Representative's Office, Washington, DC), p. 28.

[10]*Save Your Job, Save Our Country*, pp. 66-67.

[11]For an excellent expansion of this argument, see MAPI Economic Report ER-260, *The Missing Ingredient in the Economic Expansion—New Jobs*, March 31, 1993.

markets increasingly requires manufacturers to be near their customers. This explains why Japanese and German auto manufacturers have moved production facilities here. In many industries it is becoming increasingly difficult for U.S. manufacturers to compete in foreign markets when their production facilities are located half a world away.

When it comes to producing for the American market, the Perot argument overstates the importance of lower wages in determining the location of production plants. Wages increasingly represent a smaller and smaller share of total production costs. Other factors such as worker training, government policy, proximity of suppliers, and transportation costs can easily outweigh the availability of a lower wage work force.

Finally, the presence of large numbers of low-wage workers abroad is something that the United States can do little to change. Any attempt to erect import barriers in order to protect American workers from competition abroad is likely to reduce exports and raise the cost of living. Rather than seeking to isolate ourselves from the rest of the world, the nation would do better if U.S. industry concentrated on moving into high value-added production of goods and services in which the United States has a comparative advantage.

Effects on Foreign Investment

Perot's book accuses NAFTA of being little more than a scheme to "protect the investment of U.S. companies that build factories in Mexico."[12] It strongly insinuates that NAFTA will attract large amounts of foreign investment to Mexico and that U.S. investment in Mexico reduces domestic production.

Most studies have shown that passage of NAFTA is likely to increase foreign investment in Mexico. This investment is unlikely to affect U.S. domestic investment.[13] World capital markets are becoming increasingly integrated. Whoever invests in Mexico, whether it is Americans, Japanese, or Mexicans themselves, can borrow the necessary funds from anywhere in the world. Moreover, the fact that someone builds a plant in Mexico does not mean that the plant would otherwise have been built in the United States. It is more likely that investment in Mexico would lead to additional investment in the United States.

Even if investment in Mexico represented a threat to the U.S. economy, defeating NAFTA would do little to stop it. Investment funds from the United States and other developed countries have gone into several other countries, including Argentina and Chile, once their governments have committed to stable macroeconomic policies. It is true that investors regard NAFTA as a guarantee that the Mexican government will not revert to the closed-door policies of the 1970s. It is these policies, not NAFTA, that ultimately attract investment. Almost all of the investment guarantees contained in NAFTA are policies that the Mexican government can implement unilaterally. As long as these policies are implemented, foreign investment is likely to grow, even should NAFTA be defeated.

U.S. Exports

The beneficial effect of NAFTA on real income in Mexico and on the free flow of capital in North America should boost U.S. exports for several reasons. First, rising incomes in Mexico will increase the demand for U.S. consumer durable goods. Second, investment requires not just funds, but also capital goods to build the infrastructure and plants and equipment needed to begin production. Factors such as geographical proximity, NAFTA's preferential tariffs, and the presence of world-class manufacturers make it likely that the United States will benefit disproportionately from this demand for capital inputs.

In addition, increased U.S. investment in Mexico will raise the demand for Mexican currency. This will cause the peso to appreciate, making Mexico's exports more expensive and lowering the price of U.S. products in Mexico. Again, preferential tariffs will put the United States in a better position than other non-Mexican producers to take advantage of this relative price decrease. The CBO believes that passage of NAFTA will cause Mexico's trade balance to worsen over the next several decades as it concentrates on importing investment rather than goods.[14]

Finally, over the long term, increased investment will boost the standard of living in Mexico. At the end of 10 years, CBO expects NAFTA to add 6 percent to 12 percent to Mexico's GDP.[15] People with higher incomes purchase more and, once again, the United States will be in the best position to take advantage of these new markets.

Immigration

High per-capita income in the United States creates a strong incentive for foreign individuals to seek immigrant status in the United States. The number of applicants is typically far in excess of the approximately three-quarter million positions made

[12] *Save Your Job, Save Our Country*, pp. 11-12.

[13] *A Budgetary and Economic Analysis of the North American Free Trade Agreement*, pp. 25-26.

[14] *Ibid.*, pp. 23-24.

[15] *Ibid.*, p. 22.

available annually. As a result, a large number of immigrants try to enter the United States illegally. Because of its proximity to the United States a very high proportion of the illegal immigration comes from Mexico. The differences in U.S. and Mexican income levels, the existence of very liberal eligibility requirements for welfare programs in a number of states, and the unique nationality laws which give anyone born in the United States legal citizenship has attracted a large flow of illegal immigrants across the U.S. border with Mexico.

Illegal immigration imposes substantial costs on local communities even though illegal immigrants supply labor for many low-skilled jobs. In periods of slow employment growth, the large influx of illegal workers and their families poses a serious economic and social problem for many states. The opponents of NAFTA have capitalized on this serious issue by claiming that its passage will dramatically increase illegal immigration into the United States.

Reform of U.S. immigration laws together with tighter eligibility criteria for government programs are necessary to reduce the flow of illegal immigrants. In the long run, NAFTA will contribute to stronger economic growth in Mexico. As living standards rise in Mexico, one of the major sources of pressure for illegal immigration will be reduced somewhat. Consequently, those affected adversely by illegal immigration from Mexico should support the passage of NAFTA.

Can NAFTA Pass?

NAFTA's passage in the Senate is virtually assured. Its chances in the House are very uncertain and, in the end, they will depend upon whether the Clinton Administration is willing to make NAFTA a major priority and to fight hard for its passage.

A large majority of Democrats in the House are expected to vote against NAFTA. Passage requires that the Administration convince a sufficient number of them to vote for it. Even though a majority of House members are privately in favor of NAFTA, a large proportion of them think that voting for NAFTA is politically risky: the political pressure favoring narrow, existing interests that are threatened by competition is always more vocal than the pressure from more diverse groups that benefit from it; it jeopardizes political contributions from interests that have traditionally supported Democratic campaigns; and it invites opposition from the more vocal elements of the left wing of the party.

In this climate, voting for NAFTA makes little sense unless NAFTA is expected to pass. If the Democratic House members believe that NAFTA is likely to be defeated, they will have little incentive to incur the political costs of voting for it. If, however, they see that the Administration is totally committed to its passage and is working hard to accomplish that end, the politics of NAFTA shift from not being feasible to a question of which members will be called upon to cast the difficult vote and what they will get in return. Once this shift is accomplished, passage of NAFTA becomes not only possible but likely.

Unfortunately, that shift has not yet occurred. NAFTA's prospects are slowly improving to the point where the odds of its passage are slightly over 50 percent. It would be too optimistic to say that passage is likely. For that to be the case, the proponents of NAFTA will have to make a more concerted effort to explain its benefits to both the Congress and the public.

Ultimately, how one views the overall effect of trade agreements such as NAFTA depends upon one's view of the underlying forces that drive the economy and trade. Unfortunately, economic philosophies are not subject to absolute proofs. They can, however, be at least partially judged by the relative success of economies that have followed them.

Many opponents of NAFTA have never met a trade agreement they liked. For example, labor unions tend to view any U.S. imports as a threat to U.S. production. Foreign investment in the United States is often viewed as a threat to national sovereignty, while U.S. investment abroad moves jobs overseas. This philosophy regards economic prosperity as equivalent to the preservation of existing manufacturing jobs and believes that these positions can be maintained indefinitely against cheaper imports. Because this view does not trust the market to create new and better jobs, it is unwilling to jeopardize existing jobs in one industry in return for expanded opportunities in other industries. Opponents of NAFTA claim that allowing consumers to save money by buying less expensive goods from abroad undermines the economy rather than strengthens it. Trade agreements, according to those who share this philosophy, should be all-or-nothing deals in which negotiators ensure that other nations remove their unfair barriers to U.S. exports, while still protecting American jobs from unfair overseas competition. The fact that U.S. actions might provoke retaliation is usually discounted since the United States can retaliate back.

Those who favor free trade recognize that all economic changes involve both costs and benefits; none is either totally positive or totally negative. In a world of mixed results, companies and nations are better off concentrating their resources in areas in which they have a relative advantage over others. The best way of discovering these areas is to let market forces, rather than the government, drive resources toward them. Proponents of this view believe that income growth in other countries

represents a net benefit to the United States rather than a threat. Their fear of increased imports does not outweigh their expectation of expanded exports. They believe that allowing consumers and businesses to purchase the best products at the lowest prices benefits the economy. They also place greater faith in the economy's ability to create good jobs by taking advantage of new opportunities. While they recognize the transitional cost of job dislocation, they believe the net benefits from trade are strongly positive. Protection almost always is wasteful since it reduces net consumer welfare, increases government subsidies, and provokes retaliation and the loss of export markets, all to keep jobs in uncompetitive positions. Rather than focusing on specific jobs, those who believe in free trade prefer that the focus be on worker training and education.

MAPI's Position on NAFTA

MAPI supports the passage of NAFTA since the reduction of tariffs and the expansion of trade in North America will ensure the growth of employment and income in the United States and in the economies of the other parties to the agreement.

Although virtually every study has concluded that the benefits of NAFTA will be positive, NAFTA's limitations also should be kept in mind. For Mexico, NAFTA represents a welcome vote of confidence in its efforts to bring economic prosperity to its people. U.S. barriers to trade from Mexico are already low, however. Mexico's rate of economic growth will continue to depend largely on its government's continued adherence to economic competition, macroeconomic stability, and political openness. It is these policies, not the prospect of NAFTA itself, that have produced most of Mexico's success so far. Continuation of these policies will be the single most important determinant of Mexico's economic prosperity.

For similar reasons, the defeat of NAFTA will be a chimerical victory for the opponents of open trade. By failing to recognize and prepare for the forces that continue to push international markets toward competition and innovation, they will have missed an opportunity to use NAFTA to obtain better programs for worker retraining and relocation. Once the debate on NAFTA is finished, the same structural forces that have broken the link between output and jobs in manufacturing will remain. However, the political environment will be less amenable to the consideration of programs to ease the personal costs of the shift of manufacturing jobs among industries.

Should NAFTA be defeated, many of the problems its opponents fear most are likely to become even more severe. Without NAFTA, illegal immigration from Mexico will be higher than otherwise, U.S. exports will suffer, and U.S. investment will be more likely to end up in East Asia. Meanwhile, increases in worker productivity and the restructuring of industry will require more rapid labor market adjustment as worldwide competition continues to increase.

In the United States, support for NAFTA should be tempered by recalling that its benefits pale in comparison to those awaiting a successful conclusion of the negotiations on the General Agreement on Tariffs and Trade (GATT). These negotiations have limped along for years and now face perhaps their final deadline on December 15. The cost of a failure to achieve a GATT agreement far outweighs the impact of NAFTA. Yet NAFTA's defeat would signal other nations that the Congress is unlikely to approve any trade agreement they might agree to. Conversely, passage of NAFTA should not cause supporters of free trade to lose sight of the work that remains to be done.

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