Testimony before the International Trade Committee

Senate Foreign Relations Committee

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The politically correct position on the left in the United States is that the North American Free Trade Agreement has been a failure. The argument is that Mexican economic growth has been disappointing even as the United States has had a bilateral trade deficit with Mexico in the 12 years that the agreement has been in effect. The reasoning is simple: because these developments occurred after NAFTA came into existence on January 1, 1994, the adverse economic effects must have been caused by NAFTA. I will give comments on Canada later; U.S.-Canada free trade began in 1989, and free trade between these two countries has not been controversial.

At its core, NAFTA was a trade agreement; or a trade and investment agreement. The objective was to increase trade between the member countries and encourage foreign investment into Mexico to stimulate production for Mexico's exports. Focusing for the moment on U.S.-Mexico relations, these two goals were amply achieved. Mexican merchandise exports to the United States from 1993 (the year before NAFTA) to 2005 grew by 400 percent (in current dollars), and U.S. exports to Mexico over the same period grew by 245 percent. Foreign direct investment into Mexico averaged about $3 billion a year in the five years before 1993 and has averaged $12 billion a year ever since.

Some of this trade and investment growth probably would have occurred in any event, but econometric analysis shows that NAFTA added an extra dimension to the growth.

Mexico's real GDP growth from 1994 to 2005 has averaged 2.8 a year, which is inadequate to create enough jobs for new entrants into the labor force. Looking at the other two NAFTA partners the average GDP growth over the same time was 3.4 percent a year for Canada and for the United States 3.2 percent a year. This lack of job-creation has surely stimulated emigration to the United States. It is hard to argue, as those who oppose NAFTA have essentially done, that Mexico's net export growth reduced job creation. Common sense demands that we look for more rational reasons for the inadequate level of GDP growth necessary for creating enough jobs. The reasons are not hard to find—and they have to do with inadequate economic policies in Mexico. It has been evident for some time that Mexico has deep structural problems. Tax collections have been about 11 percent of GDP, compared with, say, the 18 percent of GDP at the federal level in the United States. (The figure in the United States is about 35 percent when state tax revenue is added; Mexican states, by contrast, collect little revenue directly.) Tax reform is sorely needed.

In order to meet budgetary needs, the Mexican federal government levies taxes of about 6 percent of GDP on Petróleos Mexicanos (Pemex), the state oil company; and this, in turn, has left Pemex with too few financial resources for exploration and development. This is a serious issue in that without new finds, and at current rates of production, Mexico has only about 10 years of proven oil reserves. Mexico already must import natural gas and petroleum products. The budgetary shortage is somewhat mitigated today because of high prices for oil exports; but this has not led to government reduction in the taxes it imposes on Pemex.

Mexico’s educational structure at primary and secondary levels is inadequate. The labor system is inflexible; the high cost of dismissing workers has led to a structure of part-time hiring precisely to avoid these dismissal costs, as well as to a large informal economy that is about 40 percent of the total labor force. Investment is impeded by an uncertain justice system. I have seen no reliable calculation of the cost in GDP of these structural faults, but my estimate is that this may be as high as 2 percentage points a year. NAFTA by itself cannot be expected to compensate for these large domestic problems.

Mexico does have a law in effect to promote competition, but in practice major monopolies and oligopolies are permitted to flourish. These exist for oil, natural gas, communications, and other activities. Examples abound of government procurement contracts rigged in favor of chosen companies and not determined by unbiased bidding. Such actions also have a deleterious effect on GDP growth.

Mexico, in recent years, has had stringent fiscal and monetary policy. Some Mexican analysts advocated larger fiscal deficits and looser monetary policy in order to raise economic growth. Less rigorous financial policies, however, might have stimulated inflation; this is now only about 3 percent a year. Mexico’s new president, Felipe Calderón, inherits a sound financial structure, and this is one of his main assets.

Calderón also must deal with one of the most unequal societies in the world in terms of income and opportunity distribution. About 40 percent of the population lives in poverty. The recent election showed that Mexican society is sharply divided, with about 35 percent of voters each for the center right and center left. The new president faces a complex social situation. The income disparities coincide with the country's geography: the northern states benefited from increased economic activity with the United States, while the southern states did not. NAFTA exacerbated the north-south division, but the reality has existed for a long time.

The north-south disparity is not an artifact of NAFTA; it is a shortcoming of national economic and social policy of Mexico. I believe that the two richer countries of NAFTA, the United States and Canada, should provide aid to help Mexico's less-developed regions, conditioned by Mexico's own efforts to help these regions, along the lines practiced in the European Union. The development disparities in Mexico—in personal income and regionally—are a source of great potential instability that could affect the United States. Indeed, it does affect the United States right now in immigration flows from less-developed regions in Mexico.

Analysts have criticized NAFTA's agricultural provisions. The criticism deals mainly with farming in south-central and southern Mexico, a region that has little irrigation and must rely on uncertain rainfall for harvest outcomes. The farm owners and farm workers in these regions are able to subsist, but not much more, and need government help. One indicator of rural poverty is that Mexico's rural areas contain more than 20 percent of the population and contribute perhaps 6 to 7 percent of national GDP. The hope of the Mexican drafters of NAFTA was that overall Mexican growth would create enough jobs in urban areas to receive impoverished immigrants from rural areas. Economic growth and job-creation was insufficient to accomplish this. Much of the emigration from rural areas bypassed Mexican cities and ended up instead in the United States.

There are now calls from Mexican political figures of just about all persuasions to alter the terms of NAFTA as they pertain to corn, a Mexican staple. Under NAFTA, the import tariff for corn was supposed to phase out gradually over15 years—to reach zero in 2008. My recommendation is to negotiate a side agreement to NAFTA (that is, not to open all of NAFTA's agricultural provisions to re-negotiation, as President Vicente Fox has suggested), to alter the time for elimination of Mexico's corn tariffs. The United States subsidizes corn and that is a further argument the Mexicans make for giving them some flexibility on corn. Terms for the export of U.S. poultry to Mexico were revised a few years ago to resolve a bilateral trade problem.

NAFTA did not cause the rural problem, other than to set an arbitrary deadline. The rural population in Mexico has long been impoverished and opportunities in the *campo* were horrible long before NAFTA. The only long-term hope for most subsistence farmers and *jornaleros* (landless peasant workers) is to immigrate to places where opportunities are greater.

As an economist I focused on NAFTA's economic effects. U.S.-Mexican political relations also changed after NAFTA came into being. Mexican politicians today rarely use anti-Americanism to curry favor with the electorate. Mexican universities have set up many new centers to study the United States and Canada since NAFTA came into effect, and U.S. universities have done the same to study Mexico. Business people from both countries have developed closer relations, as have government officials. Environmental groups now cooperate across the border in ways they did not earlier. Bilateral problems have not disappeared, but they are now amenable to constructive discussion.

I will close with a word on Canada. Its economic growth rates have been satisfactory, about 3.4 percent a year over the last 13 years. Canada also has a trade surplus with the United States. Who doesn't? The issue of sovereignty loomed high when the decision had to be made in Canada on entry into free trade with the United States, and the election of 1988 focused on that issue. The Progressive Conservatives under Prime Minister Brian Mulroney won that election and the Canada-U.S. Free Trade Agreement went into effect. The connection between free trade and sovereignty has hardly been made since in Canada.