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UPGRADING NAFTA TO MEET NEW TRADE AND SECURITY CHALLENGES

Washington, DC—The United States, Canada, and Mexico should upgrade their NAFTA partnership to deal with fresh challenges to trade and security, according to a new study by Institute senior fellows Gary Clyde Hufbauer and Jeffrey J. Schott. Their main proposals are that “NAFTA II” should include

- *the adoption of a common external tariff* by the three countries, thereby converting the North American free trade area into a North American customs union, to expand trade further and reduce the considerable distortions generated by NAFTA’s current rules of origin;
- *an agreement to use the greatly strengthened dispute settlement mechanisms in the World Trade Organization (WTO)*, which were not available when NAFTA was instituted, to address future conflicts over antidumping (AD) and countervailing duty (CVD) cases;
- *deeper energy cooperation* in the areas of infrastructure planning and regulation with Canada and fresh Mexican initiatives to mitigate severe energy shortfalls, which are hampering Mexican growth;
- *common visa standards* for non-NAFTA visitors and immigrants;
- *updated labor and environmental provisions* in line with other recent US free trade agreements, with a spotlight on core labor standards; and
- *substantial expansion of the capital of the North American Development Bank* to address environmental and other infrastructure needs.

NAFTA Revisited: Achievements and Challenges provides a comprehensive assessment of NAFTA's performance since its entry into force in 1994, comparing actual experience with both the objectives of the agreement's supporters and the charges of its critics. The authors assess the overall economic gains to all three countries; the results in key sectors such as autos, agriculture, and energy; and the operation of the dispute settlement, labor, and environmental provisions. In addition, they examine the fresh challenges presented by globalization in general, competition from China, and the post-9/11 threat of terrorism. The authors recommend ways to expand trade and investment opportunities among the three partner countries and to address the social and environmental problems faced by all three.

Hufbauer and Schott conclude that the trade pact has been a substantial but not unqualified success. Overall, NAFTA achieved what it was designed to do, albeit not everything that exuberant politicians promised. Whatever politicians might have said in 1993, NAFTA was not designed to limit illegal immigration nor do more than scratch the surface on long-standing labor and environmental problems. High-profile failures involving softwood lumber, trucking, and sugar mar an otherwise solid record of achievement in promoting regional trade and investment.

During its first decade, trade among the NAFTA partners doubled and now exceeds \$700 billion annually (see table 1.2). Intraregional investment is extensive; US foreign direct investment in Mexico was valued at almost \$67 billion at year-end 2004, up from \$17 billion in 1994 (see table 1.6). Integration of the three economies has advanced—though the gains have been distributed unevenly and mask adjustment problems afflicting some workers and firms in each country.

Most trade disputes have been well managed. Concerns that NAFTA Chapter 11 investor-state cases would undermine environmental regulations have proved exaggerated. To date, 39 cases have been brought under Chapter 11 and 10 decisions rendered; total arbitral awards to date have totaled only \$35 million, a small fraction of the initial claims (see table 4.4).

However, the NAFTA footprint is limited in important respects. Key economic and social issues were deliberately excluded from the pact. Particularly overlooked were

obstacles to US-Canada agricultural trade, problems related to migration from Mexico, barriers to energy trade and investment, and strong disciplines on AD and CVDs.

The NAFTA partners now face an increasingly competitive and security-conscious global environment. Hufbauer and Schott offer proposals for addressing long-standing impediments to regional trade and investment and for dealing with new security concerns that were not on the radar screen of the original draftsmen. Their recommendations cover enhancement of NAFTA's core provisions on trade and investment, resolution of ancient disputes on softwood lumber (with Canada) and sugar (with Mexico), new initiatives in the politically sensitive but strategically vital energy sector, and practical approaches to deal with crucial but sensitive components of the North American partnership: migration, labor, and environment, particularly in the US-Mexico border region.

Deepening the Trade Bargain

By adopting a NAFTA common external tariff, the partners would promote commerce among themselves, while reducing distortions generated by NAFTA rules of origin. The same beneficial results would flow from better consultation and cooperation on domestic regulatory policies, particularly in the area of food safety. In addition, leaders in the three countries should make it their priority to resolve trade disputes that have festered so long, and so bitterly, that they are eroding all relationships in North America. These disputes include, first and foremost, softwood lumber and sugar but extend to trucking, wheat, corn, tomatoes, and other products.

NAFTA has a Chapter 19 panel arbitration mechanism for judging each country's administrative disposition of AD and CVD determinations involving the other partners. This was a vital part of the overall NAFTA bargain, as both Canadian and Mexican firms had a checkered history (before NAFTA) in their dealings with US administrative agencies. Since NAFTA, however, the WTO dispute settlement process has been greatly strengthened. Hufbauer and Schott argue that the NAFTA partners should agree to use the WTO process to address their future AD and CVD disputes, since—unlike NAFTA Chapter 19 panels—WTO panels operate against a common standard that applies to all three countries (and all other WTO members as well). The most serious problem with

the WTO system for reviewing AD and CVD disputes is that, unlike NAFTA, it does not lead to the refund of duties that were wrongfully assessed in the first place. However, this defect could be corrected by a NAFTA agreement that stipulates refunds in appropriate WTO cases between the NAFTA parties.

Expanding NAFTA Energy Production

The United States will not achieve energy independence in the foreseeable future, given existing sources and reserves of fossil fuel, but it can strengthen energy security by working cooperatively with its immediate neighbors. The United States and Canada have largely integrated their energy markets but could deepen cooperation in the areas of infrastructure planning and regulation. For its own sake, and for the sake of North America, Mexico should pursue tax and energy policies that will generate domestic revenues that, in turn, are devoted to oil and gas production and electricity generation. Energy reforms are needed first and foremost to provide a strong foundation for Mexican economic growth. In so doing, Mexico would contribute to North American energy security and thus to the long-term health of the North American economy—on which Mexico is so dependent.

Travel and Immigration Controls

Ottawa, Washington, and Mexico City should forge common visa standards for non-NAFTA visitors and immigrants. This goal is highly significant from a security standpoint, and North America needs a shared system for excluding non-NAFTA nationals who pose a security threat. As well, NAFTA partners should create a special force to handle all third-country immigration controls at the individual's first airport of entry into NAFTA space. Common document and biometric identification standards should be applied.

Likewise, the partners should create a more efficient system for handling legitimate travelers among the three NAFTA countries. The Smart Border accord negotiated between Canada and the United States contains useful elements: high-tech

identity cards for permanent residents, using biometric identifiers, and preclearance programs for frequent travelers, known as INSPASS at airports and CANPASS (dedicated commuter lanes) at land borders. The same system should be extended to cover visitors arriving from Mexico.

Finally, and most difficult, the United States and Mexico need to devise new policies for improving the life chances of some 10 million illegal Mexican immigrants who have built permanent homes and livelihoods in the United States and for regulating the illegal inflow, numbering some 400,000 Mexicans annually. Hufbauer and Schott propose a modified amnesty program for illegal immigrants who have lived and worked in the United States for a considerable period yet who are deprived of important economic and social rights that go with citizenship. The authors also propose a sharp expansion of temporary work visas, coupled with more rigorous control of the border, by both US and Mexican immigration patrols. While these proposals are no “silver bullet” for one of the most difficult social problems facing both countries (and especially the border states), they are an improvement over the current array of “don’t ask, don’t tell, don’t care” policies.

Labor and Environmental Issues

The NAFTA labor and environmental side agreements were not designed with enough ambition to make substantial progress in addressing labor and environmental problems that have been decades in the making. In both areas, NAFTA should be updated to incorporate new provisions developed in recent US free trade pacts. The labor side agreement should be recast to focus attention on a very short list of core labor standards.

In addition, the authors recommend substantial financial commitments to underpin existing and new initiatives. The North American Development Bank (NADBank) is woefully underfunded, and Mexican municipalities are starved of revenues. The NADBank’s capital base should be increased incrementally from \$4.5 billion to \$10 billion. Instead of a 50-50 split between the United States and Mexico, the funding should be 75-25.

For its part, the Mexican federal government should assist municipalities to levy and collect property taxes and dedicate the revenues to environmentally sound infrastructure improvement—basic needs like water, sanitation, and paved roads. NADBank loans for municipal environmental projects should be conditioned on meaningful local tax efforts. Since US contributions to NADBank would increase by more than \$5 billion under this proposal, and since substantial new funds would be directed to Mexican communities, Mexico should reciprocate by adopting tax reforms and infrastructure investments that improve regional transport networks and enhance border security.

Conclusion

Hufbauer and Schott argue that a healthy dose of enlightened self-interest will go far toward crafting policy responses that promote North American economic prosperity and enhanced security.

- If the United States moves to rationalize its own immigration laws, it will be the primary beneficiary of a more secure border and a more accountable workforce. If the United States resolves outstanding trade disputes, it will lower costs to American producers and consumers and vastly improve the atmosphere for North American cooperation.
- In Canada, improved border security measures will protect against disruptions in US-Canada trade—a matter of growing concern for firms already producing in Canada, as well as those considering additional investments. Canada, like the United States and Mexico, can only benefit from the rapid resolution of long-standing trade disputes.
- Mexican energy reforms will stimulate new investment in oil and gas field development, and power generation and transmission, which in turn will provide Mexican homes and industries with more reliable sources of energy. Allaying energy shortages will spur investment in the manufacturing and technology sectors, which are critical to Mexico’s development strategy.

In sum, Hufbauer and Schott conclude that it would make economic sense for many of their proposals to be implemented on a unilateral basis. In the real world of give-and-take politics, however, reforms may be possible only in the context of a fresh round of NAFTA negotiations.

About the Authors

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About the Institute

The Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is devoted to global economic policy issues. Its staff of about 50 focus on macroeconomic topics, international money and finance, trade and related social issues, and international investment, and cover all key regions—especially Europe, Asia, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site.

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Table 1.2 US merchandise trade with NAFTA partners, 1989–2004
(billions of US dollars)

Partner	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Percent change, 1989–		2000–04
																	2004	2004	
Canada																			
Exports	78.3	83.0	85.1	90.2	100.2	114.3	126.0	132.6	150.1	154.2	163.9	176.4	163.7	160.8	169.5	187.7	139.8	87.4	6.4
Imports	88.2	91.4	91.1	98.5	110.9	128.9	145.1	156.5	168.1	174.8	198.3	229.2	217.0	210.6	224.2	255.9	190.1	130.7	11.7
Total	166.5	174.3	176.3	188.7	211.1	243.2	271.1	289.1	318.2	329.0	362.2	405.6	380.7	371.4	393.6	443.6	166.5	110.1	9.4
Balance	-9.9	-8.4	-6.0	-8.3	-10.7	-14.7	-19.1	-23.9	-17.9	-20.7	-34.4	-52.8	-53.2	-49.8	-54.7	-68.2			
Mexico																			
Exports	25.0	28.4	33.3	40.6	41.6	50.8	46.3	56.8	71.4	79.0	87.0	111.7	101.5	97.5	97.5	110.8	343.7	166.1	-0.8
Imports	27.2	30.2	31.2	35.2	39.9	49.5	61.7	73.0	85.9	94.7	109.7	135.9	131.4	134.7	138.1	155.8	473.3	290.3	14.7
Total	52.2	58.6	64.5	75.8	81.6	100.3	108.0	129.8	157.3	173.7	196.8	247.6	232.9	232.3	235.5	266.6	411.2	226.9	7.7
Balance	-2.2	-1.8	2.1	5.4	1.7	1.3	-15.4	-16.2	-14.5	-15.7	-22.7	-24.2	-29.9	-37.2	-40.6	-45.1			
World																			
Exports	363.8	393.0	421.9	447.5	464.9	512.4	583.0	622.8	687.6	680.5	692.8	780.4	731.0	693.3	723.7	816.5	124.5	75.7	4.6
Imports	473.4	473.4	496.0	488.8	532.1	580.5	663.8	743.5	870.2	913.9	1,024.8	1,216.9	1,142.0	1,163.5	1,259.4	1,469.5	210.4	176.2	20.8
Total	837.2	866.4	917.9	936.3	997.0	1,092.9	1,246.9	1,366.3	1,557.8	1,594.4	1,717.6	1,997.3	1,873.0	1,856.8	1,983.1	2,286.0	173.1	129.3	14.5
Balance	-109.6	-80.4	-74.1	-41.3	-67.2	-68.1	-80.8	-120.7	-182.6	-233.4	-331.9	-436.5	-410.9	-470.3	-535.7	-652.9			
NAFTA																			
Exports	103.2	111.3	118.4	130.8	141.8	165.1	172.3	189.3	221.5	233.2	251.0	288.2	265.2	258.3	266.9	298.5	189.1	110.5	3.6
Imports	115.4	121.5	122.3	133.7	150.9	178.4	206.8	229.5	253.9	269.6	308.0	365.1	348.4	345.3	362.2	411.8	256.8	173.0	12.8
Total	218.6	232.9	240.8	264.4	292.7	343.5	379.2	418.8	475.4	502.7	559.0	653.3	613.6	603.7	629.2	710.3	224.9	142.7	8.7
Balance	-12.2	-10.2	-3.9	-2.9	-9.1	-13.3	-34.5	-40.1	-32.4	-36.4	-57.1	-77.0	-83.2	-87.0	-95.3	-113.3			
Non-NAFTA																			
Exports	260.5	281.6	303.4	316.7	323.0	347.3	410.7	433.5	466.1	447.3	441.9	492.3	465.8	434.9	456.8	518.1	98.8	60.4	5.2
Imports	358.0	351.9	373.7	355.2	381.2	402.0	457.0	514.0	616.3	644.3	716.7	851.8	793.6	818.2	897.2	1,057.7	195.4	177.5	24.2
Total	618.5	633.5	677.1	671.9	704.2	749.4	867.7	947.5	1,082.4	1,091.6	1,158.6	1,344.0	1,259.3	1,253.2	1,354.0	1,575.8	154.8	123.8	17.2
Balance	-97.5	-70.2	-70.3	-58.5	-58.2	-54.7	-46.3	-80.5	-150.2	-197.0	-274.9	-359.5	-327.8	-383.3	-440.4	-539.6			

Source: USITC Interactive Tariff and Trade Dataweb, <http://dataweb.usitc.gov> (accessed on March 15, 2005).

Table 1.6 US outward direct investment position (stock) at year-end, NAFTA and world (historical cost basis, billions of US dollars)

Sector	Canada		Mexico		World	
	1994	2003	1994	2003	1994	2003
Mining ^a	10.4	24.3	.1	.4	67.6	98.7
Utilities	n.a.	1.0	n.a.	.7	n.a.	26.9
Manufacturing						
Food	4.0	4.3	2.7	1.7	24.9	22.7
Chemicals	5.8	13.1	2.3	4.0	47.9	90.3
Primary and fabricated metals	2.2	4.1	n.a.	n.a.	9.8	23.0
Machinery	2.1	3.1	n.a.	1.1	25.0	21.4
Computer and electronic products	n.a.	5.3	n.a.	1.8	n.a.	57.6
Electrical equipment, appliances, and components	1.1	1.5	.9	.9	19.6	9.7
Transportation equipment	9.4	17.9	1.8	n.a.	28.0	45.4
Total	34.0	74.9	10.1	20.1	201.0	378.0
Wholesale trade	6.9	12.7	1.3	2.0	59.0	140.6
Information	n.a.	2.2	n.a.	1.2	n.a.	47.5
Depository institutions	.9	2.7	n.a.	16.9	27.4	63.7
Finance (except depository institutions) and insurance	13.0	34.2	2.2	7.2	195.9	299.8
Professional, scientific, and technical services	3.3	2.0	.4	.4	27.0	40.6
Other industries	5.8	38.5	n.a.	12.6	35.0	693.1
All industries	74.2	192.4	17.0	61.5	612.9	1,788.9

n.a. = not available

a. Values for 1994 are petroleum only.

Notes: Starting in 1999, the Bureau of Economic Analysis (BEA) updated its categorization for FDI abroad. Some investment may have shifted categories as a result of reclassification.

Source: BEA (2004b).

Table 4.4 Comparison of settled Chapter 11 claims and arbitral awards

Case	Amount claimed (millions of dollars)	Amount awarded ^a (millions of dollars)
Ethyl Corporation	250.0	13.0
Metalclad Corporation	90.0	16.7
Azinian	17.0	—
Marvin Feldman	50.0	1.0
USA Waste ^b	60.0	—
S. D. Myers	20.0	3.9
Pope & Talbot ^c	507.6	0.5
Mondev	16.0	—
ADF Group Inc.	90.0	—
Methanex Corporation	970.0	4.0
Total	2,070.6	39.0

— = No award on costs made; each side pays its own expenses plus half the costs and expenses of the tribunal proceedings.

a. Tribunal awards plus interest. Three cases (Sun Belt, Ketcham, and Trammel Crow) that were withdrawn before the commencement of arbitration are not included.

b. USA Waste is counted twice as it was submitted twice.

c. Based on claims that the Canadian government violated five Chapter 11 obligations: Articles 1102, 1103, 1105, 1106, and 1110.

Sources: US State Department, Office of the Legal Adviser, 2004, www.state.gov/s/l/c3439.htm; Canada Department of Foreign Affairs and International Trade, 2004; Todd Weiler, www.naftalaw.org, 2004.