COUNCIL *on* FOREIGN RELATIONS

Backgrounder

NAFTA and the USMCA: Weighing the Impact of North American Trade

President Trump reached a deal with Canada and Mexico to restructure the North American Free Trade Agreement, hoping a new trilateral accord will reinvigorate the U.S. manufacturing sector.

WRITTEN BY
Andrew Chatzky, James McBride, *and* Mohammed Aly Sergie

UPDATED
Last updated July 1, 2020 8:00 am (EST)

Summary

NAFTA was a landmark trade deal between Canada, Mexico, and the United States that took effect in 1994.

It contributed to an explosion of trade between the three countries and the integration of their economies, but was criticized in the United States for contributing to job losses and outsourcing.

President Trump called NAFTA the “worst trade deal ever made” and renegotiated it as the USMCA.

The North American Free Trade Agreement (NAFTA) was a three-country accord negotiated by the governments of Canada, Mexico, and the United States that entered into force in January 1994. NAFTA eliminated most tariffs on products traded between the three countries, with a major focus on liberalizing trade in agriculture, textiles, and automobile manufacturing. The deal also sought to protect intellectual property, establish dispute resolution mechanisms, and, through side agreements, implement labor and environmental safeguards.

NAFTA fundamentally reshaped North American economic relations, driving unprecedented integration between the developed economies of Canada and the United States and Mexico's developing one. In the United States, NAFTA originally enjoyed bipartisan backing; it was negotiated by Republican President George H.W. Bush, passed by a Democratic-controlled Congress, and was implemented under Democratic President Bill Clinton. Regional trade tripled under the agreement, and cross-border investment among the three countries also grew significantly.

Yet NAFTA was a perennial target in the broader debate over free trade. President Donald J. Trump says it undermined U.S. jobs and manufacturing, and in December 2019, his administration completed an updated version of the pact with Canada and Mexico, now known as the U.S.-Mexico-Canada Agreement (USMCA). The USMCA won broad bipartisan support on Capitol Hill and entered into force on July 1, 2020.

How did NAFTA fit into the broader debate over trade policy?

When negotiations for NAFTA began in 1991, the goal for all three countries was the integration of Mexico with the developed, high-wage economies of the United States and Canada. The hope was that freer trade would bring stronger and steadier economic growth to Mexico, by providing new jobs and opportunities for its growing workforce and discouraging illegal migration. For the United States and Canada, Mexico was seen both as a promising market for exports and as a lower-cost investment location that could enhance the competitiveness of U.S. and Canadian companies.

The United States had already completed a free trade agreement (FTA) with Canada in 1988, but the addition of a less-developed country such as Mexico was unprecedented. Opponents of NAFTA seized on the wage differentials with Mexico, which had a per capita income just 30 percent [PDF] that of the United States. U.S. presidential candidate Ross Perot argued in 1992 that trade liberalization would lead to a "giant sucking sound" of U.S. jobs fleeing across the border. Supporters such as Presidents Bush and Clinton countered that the agreement would create hundreds of thousands of new jobs a year, while Mexican President Carlos Salinas de Gortari saw it as an opportunity to modernize the Mexican economy so that it would "export goods, not people."

NAFTA also ushered in a new era of FTAs, which proliferated as the World Trade Organization's (WTO) global trade talks stagnated, and it pioneered the incorporation of labor and environmental provisions, which have become progressively more comprehensive [PDF] in subsequent FTAs. The USMCA achieved stronger enforcement mechanisms for labor provisions than the original deal, leading the AFL-CIO, the largest collection of U.S. labor unions, to support the pact—a rare endorsement from a group that heavily criticized NAFTA.

Who Pays for Tariffs?

4 min

Economists largely agree that NAFTA benefited North America's economies. Regional trade increased sharply [PDF] over the treaty's first two decades, from roughly $290 billion in 1993 to more than $1.1 trillion in 2016. Cross-border investment also surged, with U.S. foreign direct investment (FDI) stock in Mexico increasing in that period from $15 billion to more than $100 billion. But experts also say that it has proven difficult to tease out the deal's direct effects from other factors, including rapid technological change and expanded trade with countries such as China. Meanwhile, debate persists regarding NAFTA's effect on employment and wages. Some workers and industries faced painful disruptions as they lost market share due to increased competition, while others gained from the new market opportunities that were created.

How did NAFTA affect the U.S. economy?

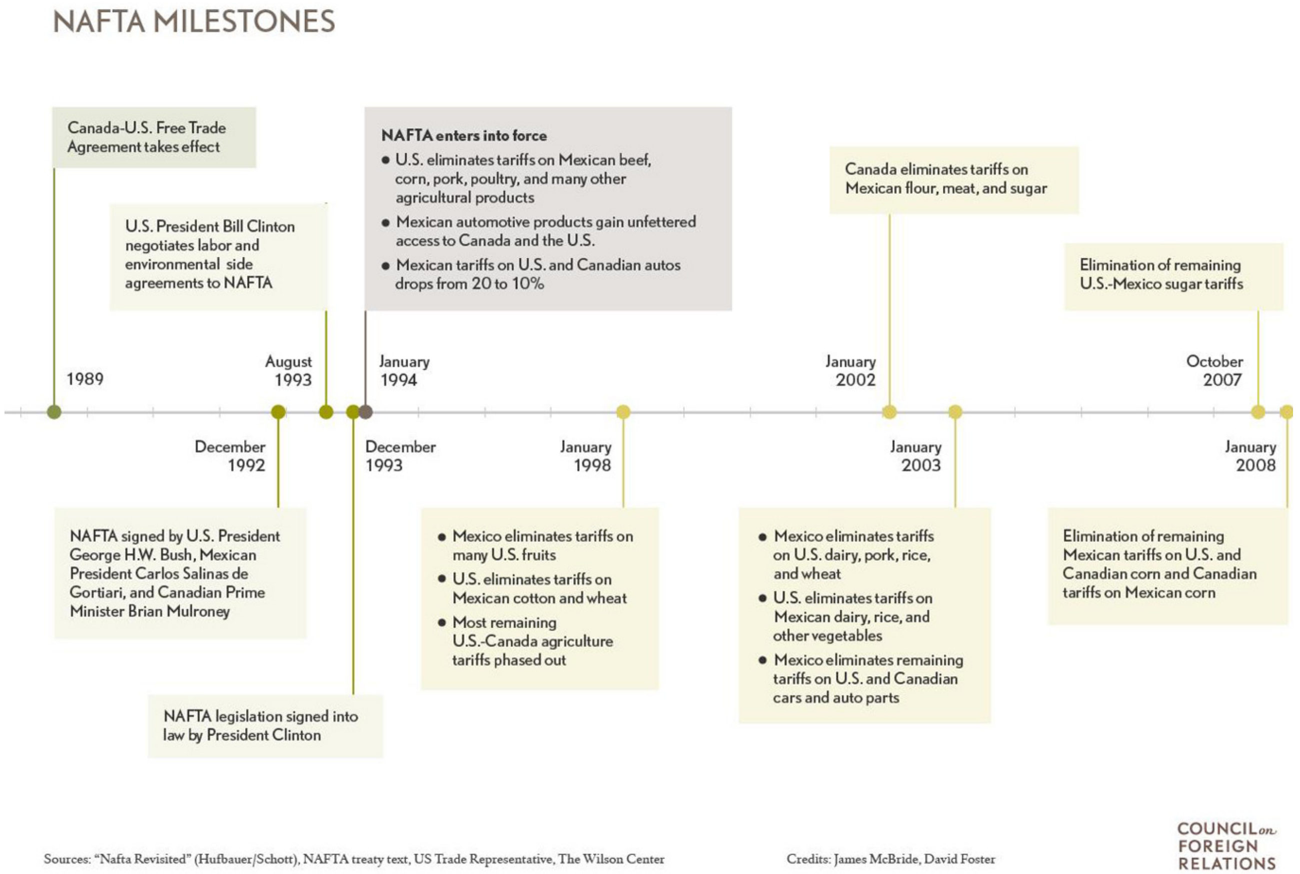
In the years since NAFTA, trade between the United States and its North American neighbors more than tripled, growing more rapidly than U.S. trade with the rest of the world. Canada and Mexico are the two largest destinations for U.S. exports, accounting for more than one-third of the total. Most estimates conclude [PDF] that the deal increased U.S. gross domestic product (GDP) by less than 0.5 percent, an addition of up to $80 billion to the U.S. economy upon full implementation, or several billion dollars of added growth per year.

Such upsides of trade often escape notice, because although the costs are highly concentrated in specific industries such as auto manufacturing, the benefits of a deal such as NAFTA are distributed widely across society. NAFTA supporters estimate that some fourteen million U.S. jobs rely on trade with Canada or Mexico, and that the nearly two hundred thousand export-related jobs created annually by the pact pay 15 to 20 percent more on average than the jobs that were lost.

On the other hand, critics of the deal argue that it was to blame for job losses and wage stagnation in the United States, driven by low-wage competition, companies moving production to Mexico to lower costs, and a widening trade deficit. The Center for Economic and Policy Research's (CEPR) Dean Baker and the Economic Policy Institute's Robert Scott argue that the surge of imports after NAFTA caused a loss of up to six hundred thousand U.S. jobs over two decades, though they admit that some of this import growth would likely have happened even without NAFTA.

Many workers and labor leaders blame trade agreements such as NAFTA for the decline in U.S. manufacturing jobs. The U.S. auto sector lost some 350,000 jobs since 1994—a third of the industry—while Mexican auto sector employment spiked from 120,000 to 550,000 workers.

But other economists, including Gary Clyde Hufbauer and Cathleen Cimino-Isaacs of the Peterson Institute for International Economics (PIIE), have emphasized that increased trade produces overall gains for the U.S. economy. Some jobs are lost due to imports, but others are created, and consumers benefit significantly from falling prices and often improved quality of goods. Their 2014 PIIE study of NAFTA's effects found a net loss of about fifteen thousand jobs per year due to the pact—but gains of roughly $450,000 for each job lost, in the form of higher productivity and lower consumer prices.



Additionally, many economists assert that the recent troubles of U.S. manufacturing have little to do with NAFTA, arguing that domestic manufacturing was under stress decades before the treaty. Research by David Autor, David Dorn, and Gordon Hanson published in 2016 [PDF] found that competition with China has had a much bigger negative impact on U.S. jobs since 2001, when China joined the WTO. Hanson, an economist and trade expert at the University of California, San Diego (UCSD), says that the steepest decline in manufacturing jobs—seventeen million to eleven million between 2000 and 2010—is mostly attributable to trade with China and underlying technological changes. "China is at the top of the list in terms of the employment impacts that we found since 2000, with technology second, and NAFTA far less important," he says.

In fact, NAFTA helped the U.S. auto sector compete with China, says Hanson. By contributing to the development of cross-border supply chains, NAFTA lowered costs, increased productivity, and improved U.S. competitiveness. This meant shedding some jobs in the United States as positions moved to Mexico, he says, but without the pact, even more could have been lost. “Because Mexico is so close, you can have a regional industry cluster where goods can go back and forth. The manufacturing industries in the three countries can be very integrated,” Hanson says. These linkages, which have given U.S. automakers an advantage over China, would be much more difficult to achieve without NAFTA’s tariff reductions and protections for intellectual property.

CFR’s Edward Alden says that anxiety over trade deals has grown because wages haven’t kept pace with labor productivity while income inequality has risen. To some extent, he says, trade deals have hastened the pace of these changes in that they have “reinforced the globalization of the American economy.”

How did it affect the Mexican economy?

NAFTA boosted Mexican farm exports to the United States, which have tripled since the pact’s implementation. Hundreds of thousands of auto manufacturing jobs have also been created in the country, and most studies have found [PDF] that the agreement increased productivity and lowered consumer prices in Mexico.

The pact catalyzed Mexico’s transition from one of the world’s most protectionist economies to one of the most open to trade. Mexico had reduced many of its trade barriers upon joining the General Agreement on Tariffs and Trade (GATT), the precursor to the WTO, in 1986, but still had a pre-NAFTA average tariff level [PDF] of 10 percent.

Mexican policymakers saw NAFTA as an opportunity to both accelerate and lock in these hard-won reforms of the Mexican economy. In addition to liberalizing trade, Mexico’s leaders reduced public debt, introduced a balanced-budget rule, stabilized inflation, and built up the country’s foreign reserves. So although Mexico was hard hit [PDF] by the 2008 financial crisis due to its dependence on exports to the U.S.

market—the next year, Mexican exports to the United States fell 17 percent and its economy contracted by over 6 percent—its economy bounced back relatively quickly, returning to growth in 2010.

But Mexico's NAFTA experience suffered from disparities between the promises of some of its supporters—that the pact would deliver rapid growth, raise wages, and reduce emigration—and the deal's outcomes. Between 1993 and 2013, a period when Latin America was undergoing a major economic expansion, Mexico's economy grew at an average rate of just 1.3 percent yearly. Poverty remains at the same levels as in 1994. And the expected convergence of U.S. and Mexican wages didn't happen, with Mexico's per capita income rising at an average of just 1.2 percent annually in that period—far slower than Latin American countries such as Brazil, Chile, and Peru.

Unemployment also rose, which some economists have blamed on NAFTA for exposing Mexican farmers, especially corn producers, to competition from heavily subsidized U.S. agriculture. A study led by CEPR economist Mark Weisbrot estimated that NAFTA put almost two million small-scale Mexican farmers [PDF] out of work, in turn driving illegal migration to the United States. (Migration to the United States, both legal and illegal, more than doubled after 1994, peaking in 2007. The flow reversed after 2008, as more Mexican-born immigrants began leaving the United States than arriving.)

Many analysts explain these divergent outcomes by pointing to the "two-speed" nature of Mexico's economy, in which NAFTA drove the growth of foreign investment, high-tech manufacturing, and rising wages in the industrial north, while the largely agrarian south remained detached from this new economy. University of Pennsylvania economist Mauro Guillen has argued that Mexico's rising inequality stemmed from NAFTA-oriented workers in the north gaining much higher wages from trade-related activity.

Ultimately, many experts say, Mexico's recent economic performance has been affected by non-NAFTA factors. The 1994 devaluation of the peso drove Mexican exports, while competition with China's low-cost manufacturing sector [PDF] likely depressed growth. Unrelated public policies, such as land reform, made it easier for farmers to sell their land and emigrate. UCSD's Hanson has argued [PDF] that Mexico's struggles have largely domestic causes: poorly developed credit markets, a large and low-productivity informal sector, and dysfunctional regulation.

What was the impact on Canada?

Canada saw strong gains in cross-border investment in the NAFTA era: Since 1993, U.S. and Mexican investments in Canada have tripled. U.S. investment, which accounts for more than half of Canada's FDI stock, grew from [PDF] $70 billion in 1993 to more than $368 billion in 2013.

However, the most consequential aspect for Canada—opening its economy to the United States, by far Canada's largest trading partner—predated NAFTA, with 1989 entry into force of the Canada-U.S. Free Trade Agreement (CUSFTA). Overall Canada-U.S. trade increased rapidly in the wake of Canada's trade liberalization. Post-NAFTA, Canadian exports to the United States grew from [PDF] $110 billion to $346 billion; imports from the United States grew by almost the same amount.

Agriculture, in particular, saw a boost. Canada is the leading importer of U.S. agricultural products, and Canadian agricultural trade with the United States has more than tripled since 1994, as did Canada's total agriculture exports to NAFTA partners.

Neither the worst fears of Canada's trade opponents—that opening to trade would gut the country's manufacturing sector—nor the highest hopes of NAFTA's advocates—that it would spark a rapid increase in productivity—came to pass. Canadian manufacturing employment held steady, but the productivity gap between the Canadian and U.S. economies wasn't closed: by 2017, Canada's labor productivity remained at 72 percent [PDF] of U.S. levels.

Overall, Canada became more dependent on trade with the United States, relying on its southern neighbor for 75 percent of its exports. Other high-income countries tend to be much more diversified, rarely relying on a single partner for more than 20 percent. U.S. presidents have long shared warm relationships with Canadian prime ministers, but

Trump has not hesitated to use this dependence as leverage. In the course of USMCA talks, he threatened new tariffs on Canadian auto parts if Ottawa did not agree to trade concessions.

What's next for North American trade?

NAFTA was long a political target. In 2008, then presidential candidate Barack Obama responded to widespread trade skepticism among the Democratic base by promising to renegotiate NAFTA to include tougher labor and environmental standards. The Obama administration sought to address the issues with NAFTA in negotiations for the Trans-Pacific Partnership, a massive trade deal with eleven other countries including Canada and Mexico. The TPP was deeply unpopular—Hillary Clinton ultimately came out against the deal during her 2016 presidential run—and President Trump withdrew the United States from the TPP in one of his first acts in office.

During the 2016 presidential campaign, both Trump and Senator Bernie Sanders, an independent, criticized NAFTA for bringing U.S. job losses. After entering office, Trump opened renegotiations to get a "better deal" for the United States. Trade remains a hot-button issue, with candidates in the 2020 race divided over whether to support the USMCA.

Much of the debate among policy experts has centered on how to mitigate the negative effects of deals such as NAFTA, including whether to compensate workers who lose their jobs or provide retraining programs to help them transition to new industries. Experts say programs such as the U.S. Trade Adjustment Assistance (TAA), which helps workers pay for education or training to find new jobs, could help quell anger directed at trade liberalization.

Many economists argue that current TAA funding levels are far from sufficient to address the increase in trade-related job losses. "There are pockets that have felt lots of pain," says Hanson. "The existence of those pockets highlights our policy failures in helping regions and individuals adjust to the impact of globalization."

Eschewing these policy proposals, Trump instead made good on his campaign promise to renegotiate NAFTA. He used tariffs as bargaining leverage throughout the process, applying import tariffs on steel and aluminum in early 2018 and threatening to do the same with automobiles. Trump's demands included more access to Canada's highly protected dairy market, better labor protections, dispute resolution reform, and new rules for digital commerce.

In late 2019, the Trump administration won support from congressional Democrats for the USMCA after agreeing to incorporate stronger labor enforcement. In the updated pact, the parties settled on a number of changes: Rules of origin for the auto industry were tightened, requiring 75 percent of each vehicle to originate in the member countries, up from 62.5 percent; and new labor stipulations were added, requiring 40 percent of each vehicle to come from factories paying at least $16 per hour. A proposed expansion of intellectual property protections for U.S. pharmaceuticals—long a red line for U.S. trade negotiators—was sacrificed. The USMCA also significantly scales back the controversial investor-state dispute settlement mechanism, eliminating it entirely with Canada and limiting it to certain sectors with Mexico, including oil and gas and telecommunications.

As part of the deal, Canada agreed to allow more access to its dairy market and won several concessions in return. The USMCA will keep the Chapter 19 dispute panel, which Canada relies on to shield it from U.S. trade remedies. It also avoided a proposed five-year sunset clause, instead using a sixteen-year time frame with a review after six years.

In early 2020, the U.S. Congress approved the USMCA with large bipartisan majorities in both chambers, and the deal entered into force on July 1. Yet some critics have complained that the new rules of origin and minimum wage requirements are onerous and amount to government-managed trade. CFR's Alden was more sanguine, saying the administration can take credit for restoring bipartisanship to U.S. trade policy. He warns, however, that "if this new hybrid of Trumpian nationalism and Democratic progressivism is what it now takes to do trade deals with the United States, there may be very few takers."

Recommended Resources

This 2017 Congressional Research Service report [PDF] explains the history of NAFTA and its effects over twenty years.

Economists David Autor, David Dorn, and Gordon Hanson weigh the impacts of trade with China and Mexico on the U.S. labor market in this 2016 paper [PDF] for the National Bureau of Economic Research.

In *Foreign Affairs*, former U.S. Trade Representative Carla Hills explains the economic upsides of NAFTA from the U.S. perspective. The issue also includes essays on views from Mexico and Canada.

The *Economist* examines NAFTA's progress after two decades in this 2014 report.

This 2014 analysis from the University of Pennsylvania's Wharton School evaluates the costs and benefits of NAFTA for the U.S. and Mexican economies.

Claims on both side of the NAFTA debate have been overblown, argue experts in this 2014 report [PDF] by the Peterson Institute for International Economics.