THE NAFTA

What's In, What's Out, What's Next

Richard G. Lipsey
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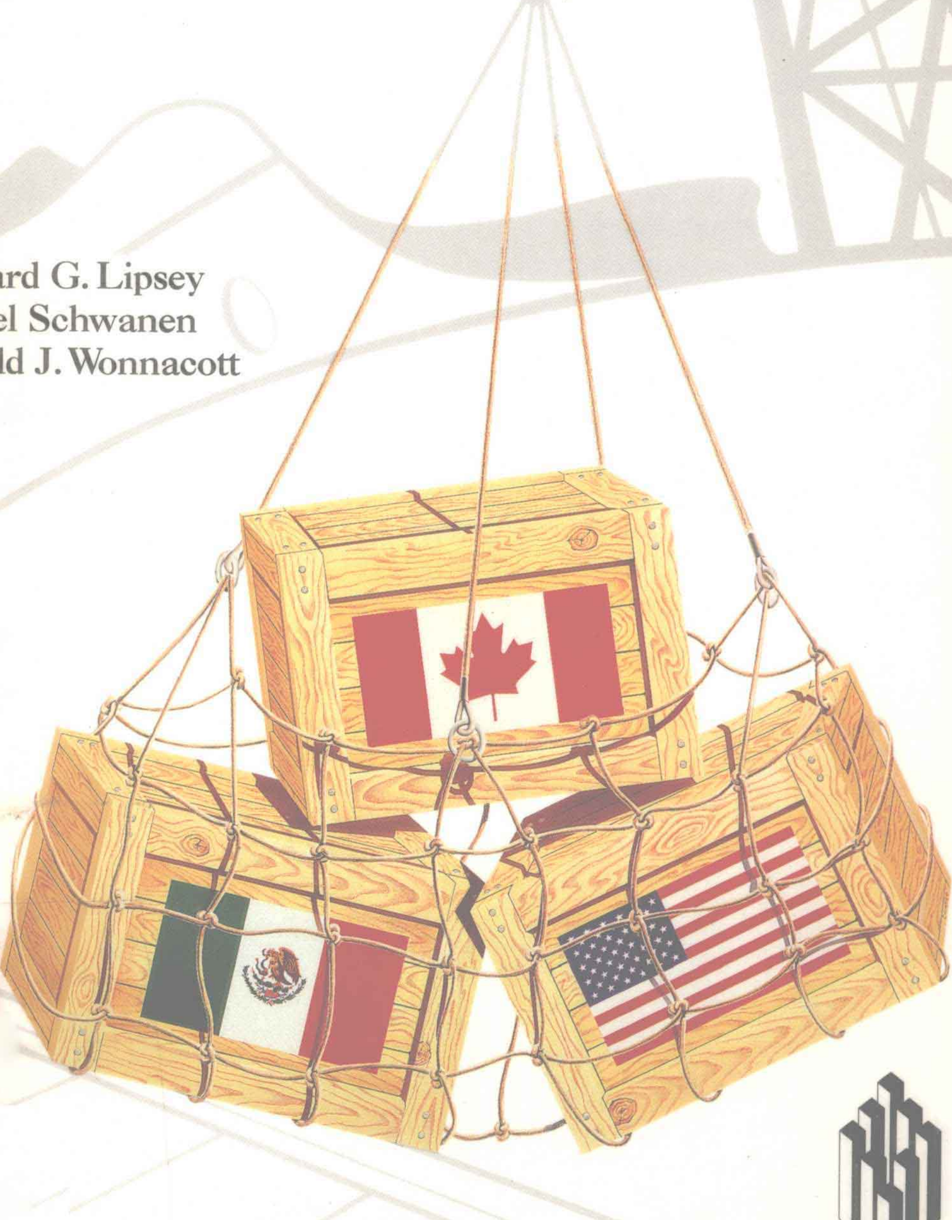

C.D. Howe Institute

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Foreword

These are times of continuing rapid change in the world trading environment, as global trade patterns are being reshaped by technological progress and investment flows. At the same time, protectionist threats continue to grow, as national leaders remain under constant pressure from noncompetitive forces in their respective political arenas.

While we can rejoice at the successful completion of the most recent round of trade negotiations under the GATT, it is clear that the evolution of up-to-date and detailed multilateral trading rules tends to lag, sometimes severely, the challenges posed by protectionist threats. Thus, for close trading partners, regional trade agreements can help to bridge the gap until the multilateral process catches up.

It was in this context that, on January 1, 1994, Canada, Mexico, and the United States implemented the North American Free Trade Agreement (NAFTA). The effects of this lengthy and complex document on the climate in which Canadian firms conduct international business will be felt for decades, as they and the governments under which they operate adapt to its provisions. Other countries are likely to seek to join the newly constituted free trade area, and the NAFTA's innovations will influence the future direction of multilateral trade negotiations.

Many Canadians, however, are unfamiliar with the NAFTA's provisions. Others remain fearful of Canada's place in a comprehensive trade agreement with one country, the United States, that is so much bigger, and another, Mexico, that is clearly poorer but hoping to close that gap by attracting investments from other parts of the world. Canadians remain unconvinced, despite the fact that smaller economic partners in trade agreements tend to benefit from them by virtue of being less subject to the protectionist vagaries of the larger international market.

This study, by three of Canada's leading trade policy experts, is meant to help nonexperts familiarize themselves with the content of the deal, and also to point out what is *not* in it. In so doing, the study debunks some of the myths, both economic and political, surrounding the NAFTA. The authors root the agreement in past Canadian trade policy, describe the provisions of the agreement under five broad headings, and assess its likely impact on the economy and on Canada's sovereignty.

The authors conclude that many of the concerns expressed about the NAFTA are not grounded in the letter of the agreement itself or in previous experience with trade agreements. On the contrary, they say, with all its imperfections, the NAFTA is a useful set of rules that allows smaller trading nations, such as Canada and Mexico, to expand their markets in the face of global protectionist tendencies.

This being said, the NAFTA is not a panacea for all the trade problems Canada is experiencing with the United States or other partners in the hemisphere. Too often, access to markets remains painfully restricted, but many of the deal's provisions are a useful base from which to secure further opening.

The C.D. Howe Institute's aim in presenting studies such as this is to raise the level of public debate on issues of national interest by presenting diverse points of view — whether or not it agrees with them — in publications that are well researched and well grounded. The Institute hopes that, in so doing, it will give Canadians much to think about, including the information they require to exercise their responsibilities as citizens.

This volume was copy edited by Darlene Zeleny and desktop published by Brenda Palmer. The analysis and opinions presented in the study are the responsibility of the authors and do not necessarily reflect the view of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

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Richard G. Lipsey,
Daniel Schwanen,
Ronald J. Wonnacott

Introduction

The North American Free Trade Agreement (NAFTA) is a historic agreement among Canada, the United States, and Mexico to liberalize their trade. The pact was agreed to in principle in August 1992 and signed in December 1992. Parallel accords on environmental and labor standards were reached in August 1993, and the NAFTA took effect on January 1, 1994.

This book surveys the policy context in which the NAFTA is being implemented, and assesses its impact on Canada's economy and policymaking. The study's unique feature is its core section: a guide, for nonspecialists, to the agreement itself. It includes a description of the NAFTA's provisions in summary form, and a view of their significance in the context of the General Agreement on Tariffs and Trade (GATT), the bilateral Canada-US Free Trade Agreement (FTA), and Canada's trade policy objectives.

Part 1 of the book, consisting of Chapters 1–3, is the Overview. In Chapter 1, we summarize the economic structure and performance of the three NAFTA countries, and paint a picture of recent global trade and investment trends. Chapter 2 puts the NAFTA in the context of Canada's trade policy agenda. Chapter 3 is an outline of the agreement itself, particularly in relation to the existing Canada-US FTA.

The detailed description of the NAFTA provided in Part 2 (Chapters 4–8) covers provisions affecting trade in goods (Chapter 4); services, investment, and related issues (Chapter 5); government procurement (Chapter 6); environmental and labor standards (Chapter 7); and dispute settlement (Chapter 8). Each chapter is divided into four sections: what the NAFTA says; how it differs from the FTA and the GATT; the significance of its provisions; and the concerns, if any, that we or other analysts have about the provisions.

Readers who are not interested in the detailed description of the NAFTA that constitutes Part 2 can skip to Part 3, which surveys the

NAFTA's impact on Canada. Chapter 9 assesses whether Canada achieved its negotiating objectives with the NAFTA, and Chapter 10 surveys what we know about the likely economic impact of the deal. To complete Part 3, Chapter 11 addresses the issue of whether the agreement imposes unacceptable constraints on the policies of Canadian governments, a frequent criticism of this and other trade deals.

In broad terms, we conclude that the NAFTA will have a positive impact on Canada. Our assessment is that Canada's participation in the agreement is consistent with the need to improve its position in a changing global economy, but that the agreement does not constitute a radical departure from traditional Canadian trade policy. The NAFTA is expected to have a small positive impact on the Canadian economy as long as Canada remains party to the agreement. Nonparticipation would have meant losses for Canadians, and locating investment in Canada would have become less attractive relative to locating in the United States.

The NAFTA opens up new avenues for Canadian exporters. Most will benefit from clearer rules of access to the US market and better dispute avoidance mechanisms than those that were in place under the FTA. Businesses in specific sectors — notably services, energy, and all sectors affected by restrictive government procurement policies — will gain better access to the United States and Mexico. The FTA's dispute settlement mechanism, which has proved beneficial to Canadian exporters, has been incorporated into the NAFTA, with some modifications, on a permanent basis.

Because of certain tradeoffs contained in the NAFTA, however, not all of its provisions represent gains for Canada. In particular, the NAFTA may make it more difficult in the long run for non-North American car producers and for clothing manufacturers located in Canada to penetrate the US market. Moreover, modifications to the dispute settlement regime that seem small on the surface may in some, but probably not many, cases make it less likely that the dispute settlement panels will decide in favor of Canadian exporters.

While Canada may not have achieved all its negotiating objectives, neither did Mexico or the United States, the two economies that will be most affected by the NAFTA. Overall, the NAFTA preserves the principle of "national treatment," whereby each country remains free to adopt and enforce the standards and measures it considers necessary to achieve economic, social, and environmental well-being. In the light of this fact, one can reject the view that the deal will compel Canada to harmonize its economic and social policies with those of its neighbors to the south.

It is also clear, however, that the NAFTA is by no means a panacea for Canada's trade problems. This is mainly because producers in each country remain vulnerable to the possibility that the other countries will impose antidumping and countervailing duties. The recently concluded Uruguay Round of the GATT, while enhancing the positive effects of the NAFTA in a number of areas, will provide only useful first steps toward a significant improvement in this area. Consequently, much work remains to be done to provide Canadian-based producers with even more secure access to the US and other major markets. In this respect, it is important that Canada actively pursue negotiations with the United States on a bilateral subsidies and dumping code, which the Canadian government made a precondition for implementing the NAFTA. The small chance that these negotiations will result in substantial complementary agreements that will enhance the benefits of the NAFTA and its precursor agreement, the Canada-US FTA, must be exploited.

Contents

Part I

Overview

Chapter 1

The Global Context

Current Global Trends in Trade and Investment

Trade

The freeing of international trade has been one of the engines of postwar economic expansion, particularly since the first successful negotiations toward a General Agreement on Tariffs and Trade (GATT) in 1947. The industrialized countries today export and import substantially more as a proportion of their output than they did 40 years ago. In fact, during the past four decades this rising trend has continued essentially uninterrupted, and has recently been spurred by rapid growth in services trade, in addition to merchandise trade.

Building on their access to major markets in Europe and North America, many countries that would have been considered as developing only 30 years ago have now joined the ranks of the industrialized. Chief among them are Japan and the "newly industrialized" countries (NICs) of Southeast Asia. If not for the remaining barriers to trade throughout the world — for example, in textiles and agricultural products — many more countries could have enjoyed rapid development.

However, the industrialized countries in general, and the United States in particular, have made it more difficult for the NICs and other would-be exporters to their markets to emulate Japan's strategy of export-led growth. Since the 1980s, they have increasingly made accepting imports conditional on rules pertaining to government subsidies, openness in financial markets, respect for intellectual property, and transparent regulations in the domestic market of the exporting country — rules with which Japan, in an earlier period, did not have to contend. The industrialized countries also enhanced their trade remedy arsenal during the 1980s, notably with the growth of managed trade measures that are not covered by the GATT (such as so-called voluntary export restraints) and with their declared intention of unilaterally enforcing a "level playing field" on countries that penetrate their markets.

Analysts may disagree on how the threatened rise in unilateralism might affect global trade, but it is certain to make the "Japan Inc." model, as it applied to external trade relations, a thing of the past. Judging by the demands for greater openness that the United States and Europe placed on countries such as South Korea and Taiwan during the 1980s (not to mention the pressures they put on Japan itself),[1] it is unlikely that any other country will be able to follow Japan's example in the future. The negotiations toward a North American Free Trade Agreement (NAFTA) clearly took place within this context of increased debate over the impact of policies affecting trade, both directly and indirectly.

Investment and the Transnational Corporation

Although international trade in goods and services continued to grow through the 1980s, the most important development in cross-border exchanges during that decade was the growth of international investment flows. While all such investment flows have implications for the conduct of economic policy, foreign direct investment (FDI) — as opposed to portfolio investments or short-term capital flows — is of particular importance in terms of future trade flows and the conduct of trade policy.

1 These pressures by the United States on Japan were renewed in early 1994, following the conclusion of the Uruguay Round of the GATT. The United States complains that Japan maintains informal barriers to trade, such as the rules that govern its retail sector. See "US Launches New Japan Assault," *Financial Post*, January 26, 1994, p. 11.

FDI can come in the form of either the greenfield establishment of a new business in a given country by nonresidents or the acquisition by foreign interests of a controlling equity share in a domestic enterprise. Although many less-developed countries with low labor costs have increasingly liberalized their rules on foreign direct investment, most FDI flows during the 1980s were, in fact, toward North America and Europe. There are many reasons for this, including the type of investments being made (acquisitions of existing businesses have dwarfed greenfield investments) and the fact that successful investment in new ventures requires a lot more than low labor costs.

Indeed, a main reason for FDI in Europe and North America is that these are the richest markets overall. Proximity to one's market is often important to winning customers in that market — not only because of low transport costs, but also because of factors such as the need to maintain close contact with customers of sophisticated products. In addition, in contrast to the less-developed countries, developed countries can offer large pools of skilled labor. They also have the supporting infrastructure — telecommunications, transportation, support services for business — that is a key requirement for competing in the global economy. Thus, the importance of wage differentials has been greatly exaggerated as a factor influencing FDI for a number of manufacturing and service industries.[2]

Competition for Foreign Investment and the Market for Unskilled Labor

The expansion of FDI has in turn spurred new growth areas in international trade, as suggested by the high level of intrafirm trade in North America and the recent flow of trade following Japanese investment in Southeast Asia. Both free trade and FDI allow produc-

2 In a recent survey of top managers at Canada's 1,000 largest companies, labor costs ranked behind availability of skilled employees, the exchange rate, quality of infrastructure, and market access in a list of factors affecting competitiveness. See "Lower Tax Rates Not Lower Wages Top NAFTA Lure Survey Shows," *Toronto Star*, May 3, 1993, p. C1.