CBO TESTIMONY

Statement of
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before the
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Committee on Ways and Means
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NOTICE

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Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee to discuss the results of the Congressional Budget Office's (CBO's) recent study, *A Budgetary and Economic Analysis of the North American Free Trade Agreement*. The study analyzes the major effects of the proposed agreement and its probable impact on the U.S. economy and the federal budget. It is not a cost or revenue estimate of the legislation that the Congress will be asked to vote on to carry out the North American Free Trade Agreement (NAFTA), although it provides a basis on which CBO can make those estimates.

My statement reviews the following three conclusions of the CBO study:

- o NAFTA would provide net economic gains for all three countries. In particular, the net effect on the U.S. economy, although very small, would be positive.

- o NAFTA would cause some reallocation of resources within and among the United States, Mexico, and Canada, but should not cause a massive relocation of U.S. manufacturing plants and jobs to Mexico.

- NAFTA would impose some direct costs on the U.S. budget, but these costs would be insignificant compared with NAFTA's broader economic effects.

AN ECONOMIC OVERVIEW OF NAFTA

The North American Free Trade Agreement provides rules and guidelines for dismantling trade barriers and creating a free-trade area encompassing the United States, Mexico, and Canada. In addition, NAFTA provides for the substantially free flow of capital among the three parties to the agreement, and for some mobility of labor in the form of rules governing the temporary entry of businesspeople. Because the most significant aspect of the agreement is the addition of Mexico to the existing Canadian-U.S. free-trade area, most analyses, including CBO's, focus on interactions between the U.S. and Mexican economies.

Each of the countries participating in NAFTA would realize net economic gains. The agreement would carry Mexico further along in its strategy of promoting economic development by opening markets and encouraging foreign investment. This strategy has already led to economic

growth and higher wages in Mexico. A rising standard of living in Mexico, based on greater economic efficiency and open trade, would also help raise the standard of living in this country as Mexico imports additional agricultural products, manufactured goods, and services from the United States.

On balance, U.S. consumers, workers, and investors would benefit from the provisions of the agreement. U.S. consumers would benefit from lower prices; U.S. workers would benefit from a net increase in jobs and income; and U.S. investors would benefit from new investment opportunities in both Mexico and the United States. The United States would also be helped by changes in Mexico that, over the long run, are likely to reduce illegal immigration and improve U.S.-Mexican relations. For example, the agreement could eventually relieve pressure for illegal immigration into the United States by supporting the growth of jobs and income in Mexico.

A thorough review of the myriad changes brought about by NAFTA, and of their interactions, leads to the conclusion that the net effect on the U.S. economy, although very small, would be positive. (The largest changes introduced by NAFTA would be those related to Mexico. Given the small size of the Mexican economy--less than 5 percent of U.S. gross domestic product--one can reasonably conclude that the impact of the agreement on the United States would be modest.) But the view that the net effect on the

United States would be positive should not obscure the painful adjustments and losses that some U.S. workers, firms, and communities would undoubtedly experience. Net economic gains cannot be achieved, however, unless such adjustments are made--labor and capital must be shifted from less profitable to more profitable uses.

Contrary to some commonly expressed concerns, the reallocation of resources in this country would not be massive. The United States should not fear that NAFTA would cause a wholesale relocation of its manufacturing plants and jobs to Mexico to take advantage of the lower average wage there. Labor costs are only one of a number of factors that influence where firms locate their plants. The United States will retain its economic strengths, and Mexico, even after additional development and reform of its markets, will still have some drawbacks. Indeed, some U.S.-owned firms now operating plants in Mexico may relocate to the United States if access to the Mexican market from U.S. production sites improves.

With or without NAFTA, low-skilled workers in the United States will continue to face competition from low-wage workers in other countries. The failure of Mexico to continue with its economic reform strategy, or of the United States to approve NAFTA, would not offer much of a reprieve for these workers, nor would the success of NAFTA greatly affect their fortunes. Without NAFTA, a few of those workers might be granted temporary relief,

but technological change and the competitive forces that drive the U.S. economy (as well as larger flows of migrants across the border) would continue to apply pressure. And more important, workers and firms that now depend on trade with Mexico could find themselves in jeopardy if NAFTA were not carried out.

GROWTH IN MEXICO AND ITS BENEFIT TO THE U.S. ECONOMY

In the mid-1980s, Mexico adopted an outward-looking and market-oriented development strategy that broke with the past by emphasizing deregulation and privatization and reducing restrictions on foreign trade and investment. The potential success of that strategy and the potential benefits of NAFTA are interrelated issues. The growth of the Mexican economy depends critically on the ability of Mexico to attract and productively absorb foreign capital. NAFTA is expected to play a significant role in this pursuit. The agreement would make investment in Mexico more attractive for U.S. investors (because of its investment provisions) and would reduce doubts that U.S. and other foreign investors may have about the permanency of Mexico's economic reforms; that is, it would help lock in those reforms and so would reduce the risk involved in investment.

At the same time, the success of NAFTA, for both Mexico and the United States, largely depends on whether Mexico continues to pursue policies that enable it to achieve a sustainable increase in economic growth. That is, Mexico must proceed on its current path of reform. The effort will not be easy for the Mexican government. Such policies have already caused and will continue to cause worker dislocations and painful adjustments for a large segment of the Mexican population.

Mexico's more liberal investment policies will encourage additional investment in its physical capital, which over time should greatly improve its standard of living. Much of this physical capital will be exported to Mexico from the United States; 90 percent of the $11 billion in capital goods imported by Mexico in 1991 came from the United States. Illustrative simulations, based on the experiences of other countries that have successfully liberalized their trade, suggest that after 20 years NAFTA could raise real output in Mexico by as much as 6 percent to 12 percent.

To achieve this higher level of output, Mexico must attract foreign financial capital of about $15 billion a year for 10 years or more. The potential flow of capital from the United States to Mexico would not represent a significant net draw on the pool of resources available for investment in the United States. The yearly amounts that might come from the United States are very small in relation to U.S. capital markets, and the

United States would also be in a better position to attract capital from the rest of the world. Thus, the extra demand for investment in Mexico would amount to only a small draw on U.S. capital markets. And in time, this investment would generate interest and dividend income for U.S. investors.

On balance, capital flows into Mexico imply more jobs and more income for the United States. The logic of this is compelling. In economic terms, capital flows to Mexico are the financing for Mexico's trade deficit. When capital moves from the United States into Mexico, both Mexican imports and U.S. exports must rise to balance each country's external accounts. In fact, it is likely that some of the capital entering Mexico would take the form of direct investment by U.S. corporations and that those corporations would equip plants in Mexico from their normal U.S. suppliers. But even if the links between capital flows and exports were not so direct--if, for example, some of the capital flows to Mexico financed imports of consumer goods--U.S. exporters would still benefit.

This point is crucial. When capital flows to Mexico, it does not cost U.S. jobs; for a considerable period it actually adds to U.S. jobs by increasing U.S. exports. That process has already begun as a result of Mexico's steps toward liberalizing and stabilizing its economy and in anticipation of NAFTA. U.S. exports of merchandise to Mexico increased from $12.4 billion in 1986 to $40.6 billion in 1992, shifting our bilateral trade deficit to a surplus of

nearly $5 billion. CBO's estimate, using both the experience of other countries and model simulations, is that capital flows are likely to continue for 10 to 15 years, and U.S. exports and jobs will benefit throughout the entire period.

EFFECTS ON INDUSTRIES, AGRICULTURE, AND EMPLOYMENT IN THE UNITED STATES

Estimates of the overall benefits of NAFTA mask its effects on individual industries and commodity groups. In some cases, NAFTA would boost production and employment in the United States because of improvements in efficiency or better access to the Mexican market. In other cases, however, U.S. operations would contract in favor of less costly imports. Although these individual effects would be fairly small when viewed against totals, they could be large to those who gain from the agreement and especially to those who are hurt by it.

It is inevitable that freer trade with Mexico would create winners and losers, largely because the Mexican and U.S. economies have different competitive strengths. But by encouraging each country to produce and trade the types of goods and services that draw on those strengths (for example, a relatively large pool of low-wage labor in Mexico and a relatively large pool of capital and skilled labor in the United States), NAFTA would promote

overall gains in both countries. The benefits of lower prices would spread to all consumers; workers and firms in expanding industries would also gain, but some costs would be visibly concentrated on workers and firms displaced by foreign competition and on the communities in which they are located.

CBO's review of a selected group of traded goods indicates that U.S. industries making intensive use of capital and skilled labor--particularly those that now face substantial barriers to trade with Mexico--would benefit from NAFTA. Conversely, U.S. industries making intensive use of low-wage labor--particularly those that are now protected by substantial tariffs or import restrictions--would probably be placed at a disadvantage. In the automobile industry, for example, NAFTA would be more likely to help than to hurt U.S. firms and workers, as a group. In part, that industry would benefit because most of the barriers to be removed by NAFTA are imposed by Mexico against imports of U.S. goods. In the apparel industry, however, NAFTA would introduce additional competitive pressure because the industry employs a relatively large number of low-wage workers.

In agriculture, too, NAFTA would encourage each country to draw on its competitive strengths. For the United States, the overall effect would be modest and positive. For specific groups of commodities, however, the results would vary. U.S. producers of grains, oilseeds, and some animal products

would benefit from the agreement, but U.S. producers of some horticultural products would face additional competition.

Differences in market conditions, such as those that affect costs of production, influence decisions about firm and plant location. To the extent that NAFTA allows freer investment in Mexico and enables U.S. investors in Mexico to benefit from those differences, the agreement may have some effect on the location of manufacturing. Some groups have voiced concern that firms operating in the United States will be at a competitive disadvantage because firms operating in Mexico will face lower costs for controlling pollution. These groups suggest that U.S. firms will move to Mexico as a result. Most analysts, however, conclude that differences in the costs of pollution control should not cause widespread movement of U.S. manufacturing facilities to Mexico, mainly because such costs are a small portion of most firms' total expenses. Moreover, economic growth in Mexico should eventually lead to better enforcement of environmental regulations in that country, thus eliminating the difference in those costs.

Although CBO does not anticipate a large movement of U.S. operations, some U.S. firms that depend on low-wage labor may migrate south of the border to take advantage of Mexico's low-wage labor and liberalized investment climate. Owners of such firms would benefit from NAFTA, but their workers would not. NAFTA would create opportunities for new

employment, but the jobs created may not match the training or geographic location of the displaced workers. Although recent studies indicate that job gains could ultimately exceed job losses by 35,000 to 170,000, no provision in NAFTA can possibly guarantee that the workers who are displaced will be the ones who find the new jobs. Moreover, even those people who do find new employment could take several months to do so, resulting in substantial transition costs for them. If retraining or relocating is necessary, those costs would be even higher. A key issue is whether existing programs--unemployment insurance, Economic Dislocation and Worker Adjustment Assistance, and Trade Adjustment Assistance--are sufficient and appropriate to handle the needs of workers displaced by NAFTA.

A review of available information about the potential effects of NAFTA on workers in the United States indicates that even though the agreement would increase total employment in this country, some U.S. workers would lose their jobs. The gross number of jobs that could be lost would probably be well under half a million, spread over at least a decade. Viewed as part of a larger, dynamic labor market in which nearly 20 million workers were displaced during the 1980s, the effects of NAFTA appear relatively small.

Judging by the experience of workers who lost their jobs over the past decade, the consequences for some of those who are displaced could be

serious. (Half of the workers who lost their jobs in the 1980s were either not working or were making less than 80 percent of their previous earnings one to three years later.) Although existing programs--particularly unemployment insurance--would provide a basic safety net, many of the displaced workers would run out of benefits before they found new jobs.

EFFECTS ON THE FEDERAL BUDGET

As the Congress considers legislation to carry out NAFTA, one element to be reviewed will be the agreement's impact on the federal budget. Overall, this impact would be slight, not only in absolute terms, but in relation to the total budget. NAFTA could affect the federal budget directly in four ways: by reducing revenues from tariffs, changing outlays for agricultural programs, increasing expenditures for displaced workers, and increasing pressure for spending on infrastructure and environmental cleanup along the U.S.-Mexican border.

Reducing Revenues from Tariffs

Reduced tariffs on imports from Mexico could result in revenue losses of about $2.5 billion over five years. In 1991, tariffs on imports from Mexico

amounted to nearly $0.6 billion. About 50 percent of the total value of imports from Mexico was duty free; of those duty-free imports, one-quarter entered the country under the Generalized System of Preferences program.

Changing Outlays for Agricultural Programs

The agreement would probably have little effect on the cost of U.S. commodity programs and the cost of programs to promote exports of U.S. farm products. If U.S. exports of grains, oilseeds, and related products to Mexico increase, the cost of U.S. programs for those commodities could fall. If Mexico uses credit backed by U.S. programs that provide credit guarantees to finance those exports, the cost of the guarantee programs could rise.

Increasing Expenditures for Displaced Workers

Increased expenditures for workers who may lose their jobs because of NAFTA could result in additional budgetary costs. The Administration has indicated its intention to submit legislation that would address the needs of all displaced workers regardless of the reasons they lost their jobs. No estimate is available of how much of the increased funding would be

attributable to NAFTA. Any legislation to expand aid for displaced workers would be subject to the constraints of the Budget Enforcement Act.

Increasing Pressure for Spending on Infrastructure and Environmental Cleanup

Pressing environmental problems and the lack of adequate infrastructure along the U.S.-Mexican border create another set of potential budgetary expenditures related to NAFTA, although these problems predate the agreement and would continue to create pressure for spending even without it. In 1992, the United States and Mexico issued an integrated plan for the border area (known as the Border Plan) to deal with common problems involving resources and the environment. Federal funding for projects included in the Border Plan or any new programs is subject to annual appropriations that are limited by the caps in the Budget Enforcement Act.

CONCLUSIONS

If the North American Free Trade Agreement is carried out, the resulting economic gains for the United States, although fairly small, would be large enough to outweigh the budgetary and private-sector costs that could follow in its path. Contrary to some commonly expressed concerns, NAFTA would

have relatively little impact on U.S. jobs and the location of manufacturing. On balance, NAFTA would boost U.S. employment, but economic analysis cannot answer the question of how the losses that may be felt by some people should be weighed against the gains experienced by most. Temporary income support and aid in finding new employment are measures that can help compensate the losers, if they can be identified.