# TWO YEARS AFTER NAFTA:

## A Free Market Critique and Assessment

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## EXECUTIVE SUMMARY

The debate over the North American Free Trade Agreement (NAFTA) was characterized as a clash between free trade and protectionism. However, close inspection of the NAFTA proposal revealed not genuine free trade, but a managed trade agreement designed to create a North American trade bloc. Despite the free trade rhetoric behind NAFTA, the treaty itself is a mixture of trade-liberalizing and trade-restrictive elements. For this reason, opposition to the agreement came from a most unlikely source: free market advocates. For free traders — even those who supported the treaty as an incremental step toward freer world trade — the practical experience of managed trade under NAFTA warrants careful scrutiny.

Genuine free trade consists merely of the unilateral lowering of trade barriers such as tariffs, bureaucratic regulations, and administrative penalties. "Free trade" through government negotiations, on the other hand, conditions the opening of markets on reciprocal actions by other countries. Negotiations lead to managed trade agreements, in which mercantilist governments attempt to balance their imports with greater exports. The result is a greater impediment to open markets.

The formation of NAFTA has caused respected free-trade scholars, such as Columbia professor Jagdish Bhagwati, to question the wisdom and the theoretical basis of regional free trade agreements.

- When trade barriers are lowered for members of a trade bloc, they are raised in a relative sense for non-members, causing offsetting trade and investment diversion.

- Regional trade blocs are a futile attempt to protect domestic industries through administratively arbitrary "rules of origin," trade barriers applied against foreign products and components.

- The bureaucracies which implement trade agreement rules are ripe for manipulation and capture by special interests.

- The explosion of preferential trade compacts makes trade increasingly confusing and risks the fragmentation of world trade into competing defensive blocs.

- Preferential trade agreements can be used to incorporate interventionist government policies — such as labor, environmental and other social standards for trade.

The theoretical free market objections to trade blocs have been confirmed by the experience of NAFTA. The treaty's first two years have been characterized by the typical hallmarks of excessive government: mercantilist planning, environmental controls, industrial policy subsidies, and bailout guarantees.

The North American industrial policy of "production-sharing" anticipated that Mexico would purchase large quantities of U.S. exports. Yet central planning did not produce the results that were scripted under NAFTA: economic growth south of the border, transformation of Mexico into a consumer's paradise, and the creation of millions of U.S. export-related jobs.

NAFTA also promotes the export of U.S.-style environmental regulations south of the border. NAFTA created a North American Commission on Environmental Cooperation (CEC), headquartered in Montreal, which is now in the process of harmonizing regional environmental standards related to pollution prevention, energy efficiency, climate change, habitat protection, and environmental law enforcement. A variety of new Mexican laws are being patterned after U.S. laws in the areas of hazardous waste, transportation, forestry, fisheries, soil, and water standards. Bureaucratic regulations punish consumers, stifle competition and create trade barriers. The potential long term consequences of NAFTA's environmental provisions were demonstrated by the filing of several petitions with the NAFTA environmental commission seeking to tighten enforcement of environmental laws. NAFTA threatens to undermine national sovereignty by internationalizing domestic environmental policies.

NAFTA has failed to correct distortions of the market caused by subsidies for domestic producers and exporters. An array of export promotion programs, foreign aid giveaways, and industrial policies continue under NAFTA at the North American Development Bank, the Export Import Bank, and the World Bank.

NAFTA played an integral role in the devaluation of the peso and subsequent Mexico bailout. A NAFTA financial side agreement called the North American Financial Group (NAFG) propped up the peso at an artificially high foreign exchange value. NAFTA helped to conceal Mexico's financial condition, heightened investment losses, and undermined market discipline when the peso finally crashed. NAFTA's peso bailout fund would later form the basis for a much larger bailout of Mexico's foreign debt obligations. NAFTA has distorted trade by destabilizing currency markets, subsidizing investment and banking interests, and generating regionalized inflation.

The free trade hope with NAFTA has been that, despite its flaws, one regional free trade agreement will beget others, producing a gradual expansion of economic liberalism and relatively unrestrained commerce. Yet every increase in cross-border exchange encouraged by NAFTA has been accompanied by a rise in bureaucratic restrictions on international commerce. The treaty did not simply lower tariff barriers between the member countries, it erected new barriers to outside parties and created a new bureaucracy capable of entangling trade policy in a morass of environmental and social concerns. The NAFTA experience should prompt a serious reexamination of negotiated trade agreements by the free trade community.

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**by James M. Sheehan**

The debate over whether the U.S. should ratify the North American Free Trade Agreement (NAFTA) gripped the nation for well over a year. The Republican Congressional leadership found itself allied with a Democratic White House in support of ratification, along with mainline environmental groups, organized business interests, and most of the "free trade" community.

The NAFTA juggernaut was opposed by an equally broad alliance ranging across the political spectrum — populists, labor unions, and consumer/environmental activists. The NAFTA opposition coalesced around a leadership trio of Patrick Buchanan, Ross Perot, and Ralph Nader. These strange bed-fellows articulated a variety of worries about the treaty, including its possible threats to the U.S. economy, its favoritism to powerful corporate and political insiders, and its transfer of power to supra-national government entities. The NAFTA opponents were roundly condemned as isolationists, protectionists, and xenophobes.

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However, additional opposition to the agreement came from a most unlikely source: free market advocates.[1] For such critics, the 2,000-page treaty looked more like a blueprint for bigger, more centralized government than for trade liberalization. Close inspection of the NAFTA proposal revealed not genuine free trade, but a managed trade agreement designed to create a North American trade bloc. These fears about NAFTA were seemingly validated in the following *Washington Post* news analysis appearing just prior to the treaty's ratification:

> When NAFTA was first proposed, critics in all three countries claimed that its hidden agenda was the development of a European-style common market. Didn't Europe also start out with a limited free trade area? And, given the Brussels precedent, wouldn't this mean ceding some measure of sovereignty to unelected bureaucrats? Even worse, wouldn't this lead to liberalization and collaborative policymaking in many other sensitive areas, from monetary policy and immigration to labor and environmental law?
>
> NAFTA's defenders said no. They argued that the agreement is designed to dismantle tariff barriers, not build a new regulatory bureaucracy. NAFTA, declared one congressional backer, "is a trade agreement, not an act of economic union."

> Yet the critics were essentially right. NAFTA lays the foundation for a continental common market, as many of its architects privately acknowledge. Part of this foundation, inevitably, is bureaucratic: The agreement creates a variety of continental institutions — ranging from trade dispute panels to labor and environmental commissions — that are, in aggregate, an embryonic NAFTA government. Border environmental and public works problems are being addressed by new regulatory bodies, and new financial mechanisms are being developed within the NAFTA framework. . .[2]

Two years after ratification of the treaty, it is evident that much of what the *Washington Post* anticipated is well under way. While the news media depicted NAFTA proponents as "free traders" and opponents as "protectionists," both pro- and anti-NAFTA arguments were simply variants of the same managed trade philosophy. Despite the free-trade rhetoric in support of the treaty, NAFTA itself comprises a mixture of trade-liberalizing and trade-restrictive elements. As a study by the Federal Reserve Bank of Dallas observes, "[NAFTA] may be seen as part of a dialectical progression in which shifting protectionist and free-trade interests compete to synthesize a new trade policy. . .NAFTA liberalizes trade on some fronts and increases protectionism on others."[3]

*NAFTA liberalizes trade on some fronts and increases protectionism on others.*

For free traders — even those who supported the treaty as an incremental step toward freer world trade — the practical experience of managed trade under NAFTA appears to be a setback for economic liberalization.

## THE FREE TRADE CASE AGAINST FREE TRADE AGREEMENTS

Since NAFTA's most prominent opponents advocated protectionism, it was naturally assumed that the treaty represented protectionism's polar opposite: free trade. This misperception persists to this day, as the Clinton administration tries to extend NAFTA to other countries in Latin America. Unfortunately, the national debate over NAFTA generated enormous confusion about economics and the purpose of international trade.

Genuine free trade consists merely of the lowering of trade barriers, including tariffs, bureaucratic regulations, and administrative penalties. It can be pursued unilaterally, without concern for whether other countries adopt free trade first. A free trade policy is the recognition that governments do not trade with each other; it is individual businessmen or consumers who voluntarily exchange goods and services with each other.

Ideological free traders have frequently extolled the benefits of unilateral free trade and the deficiencies of trade negotiations. The Cato Institute's Brink Lindsey argued that free trade through government negotiations is based on the same mercantilist premise that underlies protectionism, "and in practice, its accomplishments in opening markets and keeping them open have been modest to marginal."[4] The trade negotiation strategy is to condition the reduction of trade barriers on equivalent reductions in other countries: the U.S. agrees to allow more "harmful" imports on the condition that other countries promise to increase "beneficial" American exports. The concept of reciprocity is a justification for retaining differential trade barriers against imports, and is by its very nature antithetical to free trade.

*Free trade through government negotiations is based on the same mercantilist premise that underlies protectionism.*

As a trilateral, managed-trade agreement, NAFTA is conceptually far away from the free trade ideal — at most a third-best option behind unilateral trade barrier reductions and the multilateral trade liberalization efforts of the General Agreement on Tariffs and Trade (GATT). Cato's Lindsey indicated that tentative support for NAFTA, given its flaws, was easier than a futile effort to "redefine the battle lines" over a finished treaty.[5]

However, the formation of NAFTA, and its potential expansion southward, have caused respected free-trade scholars to question the wisdom of regional free trade agreements. Columbia University professor and noted trade expert Jagdish Bhagwati has provided the most comprehensive outline of the theoretical deficiencies of bilateral/trilateral free trade agreements.[6]

• **When trade barriers are lowered for members of a trade bloc, they are raised in a relative sense for non-members.** Regional trade areas are inherently preferential and discriminatory. Tariffs, anti-dumping and anti-subsidy measures, for example, are more predictable and transparent for trade agreement partners than for non-partners. Why should the central government favor trade with Mexicans and Canadians over trade with Swiss, Czechs, or Taiwanese?

• **The increasing number and complexity of preferential trading blocs makes trade confusing and cumbersome.** There are a myriad of overlapping trade agreements: Mexico has one with the U.S., and others with Costa Rica and Chile; Israel has one with the European Union, and another with the U.S. A recent proposal outlines a Trans-Atlantic Free Trade Agreement between the European Union and the U.S. Sorting out the differences in what each agreement requires can be a daunting and expensive task for importers and exporters.

*The concept of reciprocity is a justification for retaining differential trade barriers against imports.*

• **The bureaucracies which implement trade agreements are ripe for manipulation and capture by special interests.** Preferential agreements employ discriminatory "rules of origin" to determine which goods are afforded special tariff treatment. Under NAFTA, complex rules have been devised to determine the percentage of domestic content for a wide range of imports, including textiles and apparel, automotive products, and consumer electronics. Trade bureaucracies attempt to determine with some precision the national identity of traded products in order to apply higher tariffs to foreign goods than originating goods. As trade-distorting devices, rules of origin discriminate against more efficient producers outside the bloc. Therefore, consumers must pay higher costs for items in the protected North American market.

*Protectionism is merely transferred from the national to the regional or bloc-wide level.*

• **Attempting to promote national or regional industries through trade agreements is futile because traded products have no precise nationality.** As inputs are diversified through globalization of the international economy, defining the "true" national origin of traded goods is purely arbitrary. Proponents of free trade areas overlook the insights of economist Jacob Viner, who developed the classic free trade critique of trade alliances, and Austrian trade theorist Gottfried Haberler, who championed the principle of non-discrimination.

• **A preferential trade bloc tends to create trade internally at the expense of trade with countries outside the bloc.** Though a preferential trade area may appear to expand trade, in the aggregate trade is simply diverted as intra-bloc trade displaces more efficient trade flows. Trade preferences in NAFTA induce North American producers to source from less efficient suppliers in the trade bloc, rather than the most efficient suppliers in non-member countries. Consequently, NAFTA promotes a misallocation of resources.[7] Trade diversion is aggravated by the selective use of trade barriers, such as anti-dumping actions, by members of a preferential trade bloc against non-members.[8] Protectionism is merely transferred from the national to the regional or bloc-wide level.

NAFTA's mercantilist qualities were proclaimed quite openly by some of the treaty's proponents. President Clinton claimed the treaty would prevent a flood of imports: "Without NAFTA, Mexico could well become an export platform, allowing more products from Japan and Europe into America."[9] Edward Hudgins, an economist for the Republican Conference during the congressional debate, promoted NAFTA as a bludgeon with which to force Japan to open its own market: "Japan clearly exercises certain unfair trade practices that prevent American firms from selling as much as they might in overseas markets. The biggest stick the U.S. has to open Japanese markets without igniting a destructive trade war is to enter into alternative trade relationships, such as free trade areas (FTAs)."[10]

*Trade diversion creates new interest groups who would oppose broader trade liberalization and true free trade.*

• **Trade blocs may produce investment diversion through preferential access to export markets.** Since Mexico has preferential access to the largest market in the world, foreign investment may be skewed toward Mexico and away from other markets.

• **Preferential trade blocs undermine broader free trade objectives.** A potential consequence of NAFTA will be the formation of retaliatory, defensive trading compacts and the fragmentation of world trade into competing blocs. There has been speculation about an East Asian trade bloc centered around ASEAN, including Japan. Malaysia is keenly interested in forming a defensive bloc, as it has specialized in low-wage production for the Japanese multinationals.

*NAFTA implies that lax enforcement of environmental standards is an unfair trade practice akin to below-cost dumping, which may be countervailed through trade sanctions.*

The Brookings Institution's Anne Krueger points out that trade diversion creates new interest groups who would oppose broader trade liberalization and true free trade.[11] There is a desire amongst U.S. exporters to preserve Mexico as America's preferential export market, to the exclusion of Japan, East Asia, and Europe. Exporters have political economy incentives to lobby for reciprocal trade agreements in their favor, rather than push for broader trade liberalization which spreads the benefits amongst their competition.

• **Preferential trade agreements can incorporate extraneous social policies unrelated to trade.** In NAFTA, the U.S. was able to use its force as a superpower to place unreasonable demands on a weaker developing country — labor and environmental side agreements. The inclusion of these extraneous issues facilitates the capture of trade policy by special interests that aim to increase trade barriers rather than reduce them. NAFTA implies that lax enforcement of environmental standards is an unfair trade practice akin to below-cost dumping, which may be countervailed through trade sanctions. Forcing U.S.-style environmental standards on Mexico would erode that country's comparative advantage. As a condition of trade, Mexico must meet the environmental expectations set in the U.S. Thus Mexico must allocate its resources to promote its close political relationship to the U.S., rather than to promote environmental priorities more appropriate for Mexico's current economic situation.

## THE FAILURE OF TRADE PLANNING IN NORTH AMERICA

The theoretical free market objections to trade blocs are confirmed by the experience of NAFTA. The management of trade policy under the treaty has been symptomatic of a mercantilistic, trade planning mentality. In scheming to induce Mexicans to buy more U.S. exports, the government has restricted the freedom of exchange both internally and externally.

*NAFTA promotes North American producers at the expense of more efficient Asian competition.*

The aftermath of the peso devaluation in 1995 brought an important aspect of NAFTA to light. A chief purpose of the treaty is to provide official government support for an industrial strategy known as "production-sharing" (or co-production), which entails the manufacturing of labor-intensive intermediate goods in Mexico for export to the U.S. The strategy of production-sharing is similar to the centrally-planned industrial policy commonly practiced in Japan, which conducts labor-intensive production-sharing throughout the Pacific Rim.

NAFTA provides various incentives for subsidiaries of U.S.-based corporations to locate assembly facilities in Mexico as the preferred producer of goods for the U.S. market.[12] Such incentives are intended to divert capital investment away from Asia, where market conditions are competitive with Mexico for labor-intensive production. Rep. David Dreier (R-CA), a leading NAFTA champion in Congress, illustrated Bhagwati's fear of competing trade blocs when he proclaimed that "NAFTA provides U.S. firms significant advantages over their competitors from Europe and Asia. . .[spurring] continued expansion of U.S.-Mexican production partnerships."[13] But if the U.S. policy is free trade, why does NAFTA force the consumer to buy from less competitive domestic firms? Evidently, NAFTA promotes North American producers at the expense of more efficient Asian competition.

Another relevant question is: if production-sharing partnerships are profitable, why must they be located in Mexico and not Asia? Shouldn't private businesses decide where to do business, free from government interference? There is a very good reason why U.S. politicians granted privileged access to the vast U.S. market. They expected NAFTA to generate the Mexican economic growth necessary to create and nurture a viable middle class consumer market for U.S. exports. The transformation of Mexico into a consumer's paradise was scripted under NAFTA to create millions of U.S. jobs associated with exports of consumer goods. The treaty's proponents had predicted U.S. exports would grow by 10 to 15 percent annually,[14] and that the U.S. bilateral trade surplus with Mexico would grow as well. U.S. Trade Representative Mickey Kantor predicted 200,000 new U.S. jobs and a $9 billion trade surplus in 1995 alone.[15]

*Politicians routinely proclaim that NAFTA creates U.S. jobs, but do not to identify tangible benefits to consumers, who should benefit the most from free trade.*

However, the belief that NAFTA could generate this process presumes that government knows how to fine-tune aspects of production, imports, and exports better than the market. Such blind faith has been NAFTA's downfall in its first two years. The vaunted export growth expected from NAFTA did not materialize. Because of the devaluation of the peso from 3.5 to as low as 8 per dollar, exports collapsed 11.9 percent between January and June of 1995 (compared to a year earlier).[16] U.S. exports of consumer goods have taken the worst hit, as prices have doubled in peso terms, and the U.S. trade deficit with Mexico is expected to reach between $10 and $15 billion by year's end.[17]

In fact, it is now widely acknowledged that Mexico's consumption binge over several years was fueled by excessive borrowing, spendthrift government policies, and an overvalued peso — all products of the desperate attempt to get NAFTA ratified in 1993.[18] The consumption binge was financed by precarious short-term debt instruments and foreign capital flows which have subsequently vanished. These factors combined to produce a massive but unsustainable current account deficit in 1994, and helped precipitate the peso devaluation.[19] The bitter austerity program imposed by the Zedillo government to address the financial crisis has left the country poorer and more indebted than before.[20] Mexico's pubic sector offshore debt exceeds $100 billion.[21]

Like all export promotion schemes, incentives for production-sharing were crafted to promote the interests of politically-favored producers, not consumers. Consequently, politicians routinely proclaim that NAFTA creates U.S. jobs, but do not to identify tangible benefits to consumers, who should benefit the most from free trade. The Commerce Department claims that NAFTA created over 100,000 jobs in 1994, using a multiplier that correlates exports to jobs created.[22]

The problem with this calculation is its application in reverse — if true, then imports must necessarily destroy the same number of jobs, as protectionists claim. Also implicit in the obsession with jobs is the mercantilist assumption that exports are inherently good and imports are bad for the U.S. economy. Rep. Dreier falls into this trap, defending NAFTA as an anti-import measure because imports from Mexico "simply take the place of imports from some third country."[23] Restricting foreign trade to North America is supposed to guarantee that jobs created through exports will offset the jobs lost because of imports.

*Raw materials and other components sourced from outside the NAFTA region are facing greater trade barriers than ever before.*

The peso collapse did advance one NAFTA objective by accelerating the trend toward production-sharing with Mexico, and hence, trade diversion. Maquiladoras, the border production-sharing facilities, benefited tremendously from the collapse of the peso's purchasing power. Multinational firms producing auto parts, textiles, and electronics now have a greater incentive to locate export-assembly operations south of the border.[24] Zenith Electronics, for example, elected to source picture tubes in Mexico instead of the Far East as a result of the lower peso.[25]

While the weak peso caused Mexico's imports of consumer goods to collapse by 41 percent in 1995, imports of intermediate goods for re-export (production-sharing) have grown by roughly 5 percent, in part because NAFTA's rules of origin and other trade barriers are having their intended effect.[26] With almost a one-third growth in exports since the devaluation, Mexico's trade deficit with the U.S. turned into a surplus in a few short months.[27] Mexico now generates more hard currency from maquiladora co-production than from petroleum exports and tourism.[28] Foreign direct investment in maquiladora-type assembly operations should continue to rise as Mexican assets have become much cheaper in the aftermath of the 1995 financial collapse.[29]

Bhagwati reasoned that preferential trade blocs would lead to greater protectionism against outsiders, as has happened in the European Community.[30] The reasoning holds true for NAFTA as well. Devaluation itself is a form of protectionism, and NAFTA's regional content rules create perverse incentives for devaluation as a means of promoting domestic industries.[31] The competitive effect of the peso devaluation is the equivalent of a 50 percent tariff on U.S. products, more than offsetting the decline in Mexico's 10 percent average tariff under NAFTA. Though NAFTA was supposed to lend credibility to Mexico's economic reforms and prevent it from succumbing to protectionism, if anything the reverse has happened.

The Zedillo regime's austerity program included a desperate effort to reverse Mexico's trade deficit by curbing imports and promoting exports. Raw materials and other components sourced from outside the NAFTA region are facing greater trade barriers than ever before:[32]

*NAFTA rules-of-origin are being vigorously enforced against Asian imports, harming U.S. retailers*

- Mexico City has begun applying domestic content rules, anti-dumping probes, agricultural and health inspections, and environmental standards to imports.[33] President Ernesto Zedillo claimed such measures were necessary to combat predatory pricing from Asian importers.[34]

- Mexico raised tariffs and applied import quotas for a variety of apparel, confectionery goods, and leather imports from all countries which do not offer reciprocal market access to Mexican products through preferential trade agreements such as NAFTA.[35]
- The Mexican Commerce Ministry (Secofi) announced 1,300 new technical standards, or *normas*, under the 1995 National Normalization Program. More than 30 bureaucratic committees and working groups developed regulations covering product labeling, energy efficiency and electronics standards, manufacturing and telecommunications standards, health rules for meat and dairy products, and phytosanitary standards for agricultural products. Similar standards issued in 1994 were such an obstruction to U.S. exports that they were listed in the U.S. Trade Representative's National Trade Estimate Report as unfair non-tariff trade barriers.[36]

Mexican protectionism has had ripple effects for trading partners in the U.S. NAFTA rules-of-origin are being vigorously enforced against Asian imports, ironically harming U.S. retailers which were once fixtures of the pro-NAFTA lobby, such as J.C. Penney, Wal-Mart, K-Mart, and Sears. "Buy-NAFTA" rules mean a virtual embargo on the Taiwanese, Chinese and Hong Kong-made products sold through their Mexican outlets. "The Mexicans are fighting us with the full force of all the protectionist tools they can muster," protests the National Retail Federation.[37] Though in the past Mexico could not compete in textiles and apparel because of inferior quality, under NAFTA Mexico has begun to rival China as a leading exporter of these products.[38] U.S. government subsidies may have helped this process along by providing $23 million in loan guarantees for Mexico to purchase textile dyeing equipment in 1994.[39]

Importers and exporters polled by the Canadian Chamber of Commerce report serious bottlenecks constraining intra-NAFTA trade, particularly for small businesses.[40] One half of respondents complained of delays caused by harmonized tariff classifications, rules of origin, and ambiguous paperwork requirements arising from the treaty. Problems are the worst at Mexico's border, where Canadian firms indicate that 23 percent of their shipments are delayed more than a day. According to economist Jan Herin, paperwork costs associated with domestic content rules add between 3 and 5 percent to the cost of a product.[41] In addition, Mexico requires all imports to be processed through licensed customs brokers at the border, a process which can entail three separate truck transfers.[42] These trade barriers will exacerbate trade diversion in exactly the way predicted by the free market critique of preferential trade agreements.

*Organized labor has sought new alliances with environmentalists.*

## THE GREENING OF AMERICAN TRADE

> *"[NAFTA] raises the cost of production to Mexico by requiring greater investments in labor and in the environment."*
> *— President Bill Clinton, October 20, 1993.*

According to a study by the Federal Reserve Bank of Dallas, "while NAFTA opens trade, NAFTA-related agreements open broader opportunities to protectionists to reduce trade through appeals against environmental and workplace enforcement in areas with little direct effect on the international exchange of goods and services."[43] As protectionism diminishes in U.S. industries, organized labor has sought new alliances with environmentalists, as "some U.S. manufacturers profess to find new forms of unfairness among their competitors."[44]

*The merging of trade and environmental policies under NAFTA may usher in a new era of cooperative environmental regulation within the region.*

NAFTA's hostility to the free market extends to its environmental provisions, which imply that Mexico's less-restrictive environmental standards are an unfair trading practice. "Fair" trade can only be guaranteed through raising Mexico's enforcement of EPA-style regulations and standards. The merging of trade and environmental policies under NAFTA may usher in a new era of cooperative environmental regulation within the region as the U.S. exports its brand of command-and-control regulation south of the border.

NAFTA created a North American Commission on Environmental Cooperation (CEC), headquartered in Montreal, to facilitate harmonization of environmental standards. Its continental environment workplan includes the total elimination of lead, cadmium, mercury, and other organic chemicals and metals from the North American economy.[45] Action plans are under consideration for the elimination of PCBs, and the pesticide DDT.[46]

A jumble of NAFTA, Mexican, and American border bureaucrats are preparing a "five-year plan" to address water quality, air quality, and hazardous waste issues.[47] NAFTA governments are in the process of enacting cooperative regulations regarding pollution prevention, energy efficiency, climate change, habitat protection, and environmental law enforcement. The CEC will conduct ecosystem mapping and will produce a State of the North American Environment Report focusing on air monitoring, ecological modeling, and biodiversity.[48] NAFTA authorities intend to harmonize information-gathering procedures for numerous pollutants in order to take a complete pollutant release inventory of all emissions in North America.[49] In an attempt to internationalize the National Environmental Policy Act (NEPA), the CEC is developing a NAFTA environmental impact assessment mechanism to regulate economic development across borders.[50]

*NAFTA will likely contribute to the concentration of production in the hands of a small number of politically-protected firms.*

Upward harmonization of regulations is progressing in several areas:

- Mexico's laws are being patterned after U.S. laws in the areas of transportation, forestry, fisheries, soil, and water standards.[51]

- In advance of NAFTA harmonization meetings, Mexico's transport ministry published 125 pages of regulations classifying hundreds of important industrial materials as officially "hazardous" under the United Nations guidelines. Other rules were issued covering vehicle emission standards, engine manufacturing requirements, and fuel standards in preparation for the NAFTA harmonization of weights and transport regulations.[52]

- NAFTA officials drafted harmonized rules through a Land Transportation Standards Subcommittee.[53] Reports were translated from Spanish to English to French and back again, and the NAFTA-crats settled on the official definition of a "NAFTA truck."

- Raising its standards to U.S. levels, Mexico enacted a "Emergency Response Guidebook," which classifies transported materials according to "U.N. Recommendations on the Transport of Dangerous Goods." Mexican environmental authorities declare that "We are going to work closely with the [U.S.] EPA to standardize what we mean by waste."[54] This is the agenda of the United Nations Environment Program Governing Council and the Basel Convention, written into the NAFTA text, which forbids free trade in materials considered "hazardous" by international bureaucrats.[55]

U.S.-style hazardous waste regulations would be very costly because Mexico has only two waste confinement sites in the entire country.[56] In the U.S., hazardous waste regulations impose burdensome regulations on the production and use of consumer and industrial goods, including plastics, machinery, textiles, metals, paints and fuels, and cleaners.[57] However, even the EPA has admitted that "the definitions of 'solid waste' and 'hazardous waste' are exceedingly difficult to understand even for the most experienced staff."[58]

Environmental regulations by their very nature are anti-competitive, often protecting domestic businesses from foreign importers. Within the U.S. market, regulations have a cartelizing effect, conferring advantages on large businesses over their smaller competition.[59] Because small businesses cannot easily absorb compliance costs, regulatory requirements create "artificial economies of scale."[60] Consequently, NAFTA will likely contribute to the concentration of production in the hands of a small number of politically-protected firms.

*By stifling competition and raising production costs, bureaucratic regulations punish the consumer and prevent businesses from competing efficiently.*

Harmonization is particularly costly for Mexican entrepreneurs, small businesses, and consumers. For small and medium-sized firms "unfamiliar with the regulations...it's going to be a tough time," complains a Mexico City sales manager.[61] Demand for pollution control equipment stands at approximately $1.5 billion in 1994, but is expected to double over the next few years because of government restrictions.[62] To offset increased business spending on pollution control equipment under NAFTA, Mexico's Confederation of Industrial Chambers is calling for tax relief.[63] Harmonization of an assortment of vehicle emissions standards, engine manufacturing requirements, and fuel standards is expected to drive up the operational costs of Mexican motor carriers to U.S. levels. One California state official claims that the Mexicans have no choice: "They will have to change to meet our requirements, or they will not be allowed in California."[64]

By undermining regulatory competition between countries, harmonization erodes Mexico's comparative advantage, and the whole purpose of free trade. By stifling competition and raising production costs, bureaucratic regulations punish the consumer and prevent businesses from competing efficiently. By acting as a trade barrier, harmonized environmental regulations exacerbate the problem of trade diversion. Because the remedy for non-enforcement of environmental laws is trade sanctions, the trade-environmental process is ripe for capture by special interests seeking to close markets and undermine free exchange.

Mexican regulations, made comparable to U.S. standards, are proving to be significant barriers to trade.

- Eight separate government agencies are responsible for inspecting perishables at the border, causing substantial delays at

*Environmental groups are able to focus international attention on environmental standards through NAFTA.*

crossings where as many as 1,000 trucks per day must pass. According to agricultural producers, the Mexican distribution system is so plagued by inefficiency and delay that 35 percent of Mexico's perishable items are destroyed by spoilage.[65]

- Mexican officials have forced each truckload of U.S. beef into cold storage in order to enforce Spanish-language labelling rules and food inspection laws.[66] The U.S. Meat Export Federation protests that "the Mexican cattlemen are trying to stifle imports" by using inspections as new trade barriers. But Mexican officials responded that the barriers are fully justified under NAFTA: "Now we need to put together normal measures for nations that do trade — safety standards, health standards."[67]

- A variety of government-imposed customs fees are being used as non-tariff barriers, reports the Border Trade Alliance, a coalition of border area businesses. When the U.S. imposed a $30 fee for phytosanitary certificates, Mexico countered with a $32 phytosanitary fee of its own. The Alliance claims that NAFTA is becoming a "fee-trade agreement" in which tariffs are merely being replaced with fees that are just as costly.[68]

That NAFTA has not produced free trade is becoming clear. An El Paso customs broker tells the *New York Times* that NAFTA is more accurately called "a managed trade agreement" or a "preferred trade agreement."[69]

## THE INTERNATIONALIZATION OF ENVIRONMENTAL POLICY

*"There's something about international pressure that makes it hard for a government to ignore an environmental problem."*

The potential long term consequences of NAFTA's environmental agreements were demonstrated in the filing of several petitions with the NAFTA environmental commission in 1995.[70] The bureaucracy's first investigation focused on a polluted reservoir near Mexico City, where 40,000 birds were killed by raw sewage.[71] The CEC recommended greater public works spending to clean up the water and provide waste treatment. The petition demonstrates that environmental groups are able to focus international attention on environmental standards through NAFTA. According to the National Audubon Society: "There's something about international pressure that makes it hard for a government to ignore an environmental problem."[72] Yet because Mexico is bankrupt, it will likely borrow additional funds from the U.S. to finance spending programs.

Subsequent NAFTA petitions attempted to bring the environmental policies of the U.S. under international pressure. The subjects of these challenges included proposed EPA appropriations legislation, a temporary moratorium on the listing of species under the Endangered Species Act, and legislation to allow the salvage of damaged timber in national forests.[73] A future NAFTA challenge is expected from a Canadian environmental group to compel the EPA to enforce toxic waste rules against General Motors.[74]

*Environmentalists may have better luck in influencing U.S. environmental regulation by focusing the CEC's attention on the enforcement of existing laws.*

The environmental lobby's attempt to internationalize domestic disputes poses a unique threat to U.S. environmental sovereignty. Charles Alan Raul, an attorney with the firm of Beveridge and Diamond, points out that NAFTA could undermine delicate checks and balances in the federal government as it adds international litigation to the tangled web of domestic litigation which already complicates environmental policy. Though environmental groups ostensibly demanded NAFTA's environmental agreements to induce enforcement of Mexican laws, "it did not take long to confirm that the United States, not Mexico, was the groups' prime target," writes Raul.[75]

Few predicted the brazenness with which environmental activists would pursue their agenda using NAFTA. "The U.S. can't go back on its word to enforce our [environmental] laws," declared the National Wildlife Federation. The subject matter of the NAFTA petitions demonstrates the folly of including extraneous environmental policies in trade agreements. Should an environmental dispute be arbitrated by the CEC, the likely remedy would be trade sanctions of some kind. Ironically, enactment of such sanctions could violate the terms of GATT, and would clearly represent a setback for free trade.

If anything, the environmental lobby has been overly ambitious, especially given the current political environment. Environmentalists were unable to enlist the executive branch in a resort to NAFTA to thwart environmental proposals by the newly-Republican Congress. The CEC elected not to pursue the complaint regarding enforcement of the Endangered Species Act, declining to second-guess the will of elected lawmakers.[76] Additionally, members of Congress acted to prevent the intervention of NAFTA into domestic environmental policy disputes. The prospect of a NAFTA petition challenging timber salvage legislation so alarmed several Republican legislators that they issued a warning to the White House. In a letter to President Clinton from the entire Idaho congressional delegation, Senator Larry Craig, Senator Dirk Kempthorne, Rep. Helen Chenoweth and Mike Crapo, expressed their serious misgivings about the environmentalists' NAFTA appeals:

*An array of export promotion programs, foreign aid giveaways, and industrial policies continue unabated with NAFTA.*

> We are concerned by the precedent which may be set by this [NAFTA] claim. Should the [CEC] accept the argument, the result of NAFTA will be that the United States cannot even modify its environmental protection laws. If this is the case, no industry will be exempt from intense scrutiny, and no law will be passed without the risk of committing this nation to a long and costly international approval process. . .We cannot allow [NAFTA to be used] so that our nation's ability to make laws and develop policies is subject to approval by an unelected, tri-national panel.[77]

*The Eximbank's exposure in Mexico is by far the largest.*

The environmental lobby, which endorsed NAFTA because of its environmental provisions, has thus far failed to use NAFTA successfully to obstruct environmental reforms passed by Congress and signed by the President. It appears that the ultimate defense against use of NAFTA to strengthen environmental laws, in the short term at least, is a Republican-controlled Congress. Environmentalists may have better luck in influencing U.S. environmental regulation by focusing the CEC's attention on the enforcement of existing laws. Preventing lax enforcement is more the intended function of NAFTA's environmental agreements. Routinely, environmental laws — such as the Clean Water Act, Clean Air Act, and Resource Conservation and Recovery Act — are not enforced to the letter, or are selectively enforced by executive agencies.[78]

## INDUSTRY SUBSIDIES AND FOREIGN AID

An important means by which governments distort and interfere with free trade is the provision of subsidies to domestic producers. As noted above, NAFTA must be seen in the context of the overall production-sharing objective: to maintain Mexico as a targeted market for exclusive U.S. investment and export sales. True free trade, or even marginally freer trade within a region, would do away with subsidies. Yet an array of export promotion programs, foreign aid giveaways, and industrial policies continue unabated with NAFTA. The interaction of Washington bureaucrats, Mexican economic planners, and politically-favored export industries defines the NAFTA strategy for controlling U.S.-Mexico economic integration. It was not widely advertised that the NAFTA scheme would be financed by transfers of wealth from U.S. taxpayers to the Mexican central government, Mexican consumers, and profitable American exporters.

*In addition to export promotion, there is a sizable foreign aid component to NAFTA.*

Despite the Clinton administration's free trade rhetoric associated with NAFTA, Mexico was targeted as one of the Commerce Department's priority export promotion markets in its National Export Strategy.[79] Commerce Secretary Ron Brown led trade missions to Mexico in which he personally brokered business deals for corporate chieftains. Federal assistance has benefited exporters of medical equipment, construction, autos, auto parts, environmental technologies and agricultural products. According to the Commerce Department, the Export Mexico trade assistance program was implemented "to take advantage of the opportunities offered by the North American Free Trade Agreement."[80]

Other efforts to get Mexico to buy more U.S. exports include the loans and guarantees of the Export-Import Bank of the U.S. A high proportion of its operations are concentrated in Mexico. The agency provided Mexico with over $250 million in loan guarantees in 1994, and accumulated $656 million in gross loans outstanding and $5.58 billion in exposure to off-balance sheet credit risk.[81] The Eximbank's exposure in Mexico is by far the largest; Mexico commands more than twice the financial commitments of the Eximbank's second largest client, Venezuela.[82]

The political component of such aid cannot be ignored; many of the same interests which lobbied stridently for NAFTA also benefited from federal export subsidies, including multinational firms like Caterpillar and AT&T.[83] The highly political nature of subsidized lending is underscored by the fact that Eximbank subsidies are steered by chairman Kenneth Brody, a former senior partner at the most prominent financial house operating in Mexico, Goldman Sachs. This firm, whose former chairman is now Secretary of the Treasury, is also said to be a major beneficiary of the Mexico bailout.

In addition to export promotion, there is a sizable foreign aid component to NAFTA. As part of the implementation of the treaty, the U.S. and Mexican governments set up the North American Development Bank, along with a Border Environmental Cooperation Commission, to facilitate border infrastructure development, environmentally "sustainable development," and community adjustment to NAFTA. The NADBank is expected to finance $3 billion in loans and guarantees and to leverage up to $8 billion in projects. As with many public sector loans, NADBank projects will be vulnerable to currency risk. Within Mexico, a project generating revenue in local currency will find it difficult to service dollar-denominated debt in the event of further devaluation of the peso.[84]

*Overconfidence in the peso was perhaps generated by the recurring foreign exchange interventions of the U.S. Treasury to counteract Mexico's economic and political turmoil.*

The NADBank enters an already crowded field of multilateral aid for Mexican development, including the World Bank, International Monetary Fund, and the Inter-American Development Bank — all heavily subsidized by the U.S. taxpayer. Mexico is the World Bank's second largest client, having borrowed $2.4 billion in fiscal 1995.[85] Internal World Bank data reveals a one-third failure rate for the more than $23 billion in cumulative loans to Mexico over more than four decades.[86] As in the 1980s, when it bankrolled Mexico's enrollment in GATT, the Bank recently lent almost $1 billion to help the government make policy adjustments for the North American Free Trade Agreement. The Bank plans to lend as much as $1.8 billion for environmental projects in Mexico.[87]

Some of NAFTA's expensive border environmental commitments are proving too costly in the wake of Mexico's financial crisis.[88] Construction of many sewage-treatment projects has ground to a halt because the Mexican government lacks funds. Without promised Mexican support, the projects may not move forward without external assistance from the U.S. Deteriorating conditions will likely fuel demands for more U.S. foreign aid to support NAFTA-related spending.

Proposals for government-to-government assistance are often rationalized by claims that foreign aid creates American jobs. Indeed, some foreign aid returns back to the U.S. in the form of procurement contracts for U.S.

firms. However, this is simply a justification for corporate welfare. The same jobs could be created more efficiently by transferring taxpayer dollars directly to the corporations. On net, no jobs are created by foreign aid transfers. In reality, economic opportunities are wasted because sound financial principles have been compromised by NAFTA's political imperatives for "green" lending. However, little economic development has occurred in Mexico as a result of many decades of foreign aid, even without its environmental component.

## THE PESO DEBACLE

While President Clinton was lobbying for NAFTA he made the unfortunate prediction: "I believe that you have to just say that the peso would become stronger if NAFTA passes because it would strengthen the Mexican economy."[89]

*The principal flaw of a bailout guarantee is that it causes moral hazard, encouraging excessive risk-taking by investors.*

White House sentiments in the run-up to NAFTA reflected a conventional wisdom so solid that detractors were severely ostracized. For example, early warnings of an inevitable currency devaluation by financial writer Christopher Whalen, publisher of *The Mexico Report*, were harshly ridiculed.[90] "Those of us who have become obscenely wealthy by investing in Mexico find [Whalen] rather naive," charged Hudson Institute economist Alan Reynolds, "nobody understands [Mexico] less." Repudiating Whalen's cautions, supply-sider Jude Wanniski proclaimed that "[Mexico's] debt pyramid is built on honor and integrity, and is as solid as the pyramids of Egypt."[91]

Overconfidence in the peso was perhaps generated by the recurring foreign exchange interventions of the U.S. Treasury to counteract Mexico's economic and political turmoil.[92] Such interventions would continue as a result of NAFTA, as the 1993 NAFTA implementing legislation vaguely implied:[93]

> There are close bilateral consultations [between the U.S. and Mexico] on a range of issues which include macroeconomic policies and, as appropriate, exchange rate policies. The NAFTA strengthens the institutional relationships among the United States, Mexico, and Canada...the NAFTA should increase the prospects for non-inflationary growth in the U.S. and Mexican economies and thus also improve the prospects for a more stable exchange rate between our currencies.

Secret currency swap lines had been created in November 1993 to prevent speculation against the peso.[94] The temporary arrangement was later formalized in a NAFTA side agreement establishing the North American Financial Group (NAFG) and a $6 billion peso bailout fund.[95] A *Washington Post* editorial hailed the arrangement as an intermediate step towards European-style currency links, while others speculated that it presaged cooperative social programs at the department level.[96] However, exchange rates determined politically, instead of by the market, are tremendously destabilizing and distortive of trade. NAFTA's exchange rate manipulation undermined countless cross-border investments, contracts, and trading relationships entered into based on the reasonable expectation of a peso valued at roughly 3.5 per dollar. Though the nominal purpose of the peso bailout fund was to "stabilize" exchange rates, according to Walker Todd, a former assistant general counsel of the Federal Reserve Bank of Cleveland, the only possible use of the Treasury's credit lines "was to finance the flight from the peso of Mexico's governing elites and their compatriots in the international financial system."[97]

*The Clinton administration hopes to extend NAFTA to the rest of Latin America, starting with Chile.*

The principal flaw of a bailout guarantee is that it causes moral hazard, encouraging excessive risk-taking by investors exacerbating crises when they occur. The NAFTA safety net induced Americans into undertaking extremely high-risk investment activity, short-term portfolio investments which were used to finance Mexico's reckless borrowing and spending patterns.[98] The Mexican regime used its dollar reserves to peg the peso at an artificial, significantly overvalued exchange rate with the dollar. The highly inflationary monetary policies of Mexico's central bank had created the illusion of a prosperous economy worthy of U.S. investment. Through NAFTA's trade-management institutions, Mexico's economic and exchange rate policies were coordinated with the U.S. government. Top U.S. officials, from the Treasury Secretary to the president himself, publicly extolled and applauded those policies. The unpleasant truth is that Mexico's special relationship to the U.S. under NAFTA helped to conceal that country's true financial condition, heightened losses for American investors who were unaware of the inherent risks, and undermined the ability of markets to discipline inept economic planning by selling pesos.[99]

Just as misguided NAFTA managers contributed to the root causes of peso instability, they compounded error by organizing a massive, $50 billion bailout of Mexican debt obligations with the International Monetary Fund. The U.S. bailout continued a pattern of smaller U.S. loans and guarantees following peso devaluations in 1982 and again in 1988.[100] Though Mexico reportedly tried to activate its credit lines with the U.S. Treasury in early January 1995, the financial meltdown exceeded the size of NAFTA swap lines, and the bailout became that much larger.[101]

*The treaty's free trade proponents would never admit this, but NAFTA's underlying thrust is toward managed trade and investment.*

The escalation of bailout commitments prompted Sidney Weintraub, director of the U.S.-Mexico Project at the University of Texas, to ask: "Has NAFTA turned out to be more all-embracing than we expected? Yes, once you have a partner of that nature, you have to come to the rescue in a way you wouldn't have earlier. The two countries, like it or not, are deeply intertwined."[102] The merger apparently includes the powers to distort free trade by manipulating foreign exchange markets, subsidizing investment and banking interests, and generating regionalized inflation through effectively linked currencies.

*The grafting of environmental policy onto NAFTA has led to special interest demands that similar provisions be replicated in other trade agreements.*

## HEMISPHERIC NAFTA?

The Clinton administration hopes to extend NAFTA to the rest of Latin America, starting with Chile. Several other countries which have expressed a desire to join, such as Argentina, Colombia, and Venezuela, did not meet pre-conditions necessary to join NAFTA, including minimum environmental standards. Chile's application may also get bogged down for this reason.[103] Thus far, Congress has refused to grant the president fast-track negotiating authority which includes labor and environmental standards in trade.[104] Nevertheless, under a recent national environmental law the Chilean government has imposed new regulations and environmental impact assessment requirements to prove its worthiness of NAFTA entry.[105] Chile's Finance Minister Eduardo Aninat declared, "We're not at all insensitive on these issues. We're very sensitive and dynamic in approaching [environmental] values."[106]

The December 1994 Summit of the Americas unveiled a blueprint for a hemispheric trade bloc called the Free Trade Agreement of the Americas (FTAA). This blueprint commits the trade bloc to "sustainable development" through environmental regulations and controls, curtailments of energy use, and compliance with the Earth Summit's Agenda 21 and global climate change treaties. The Summit's action plan calls for environmental restrictions in forestry, agriculture, and wetlands, as well as conservation of biodiversity through ecosystem management.[107] The FTAA would resuscitate the long-dormant Organization of American States as a regional bureaucracy to administer the grand hemispheric plan and to promote observance of international labor, human rights, and environmental treaties. The Americas plan anticipates over $10 billion per year in foreign aid from the World Bank and Inter-American Development Bank, with special emphasis on environmental spending.[108]

## ASSESSMENT AND CONCLUSIONS

The public debate over NAFTA was "free trade" versus "protectionism," but reality was more nuanced. The reality is that NAFTA, a managed trade bloc, is free trade in name only. The *New Republic*'s John B. Judis, no free trader himself, was one of the few to note this fact:

> NAFTA is not really about free trade. It does remove trade and investment barriers among the United States, Canada, and Mexico, but it retains and erects (in the form of 'rules of origin') barriers between the three countries and the rest of the world. Appearances aside, NAFTA is a prudent step toward creating a regional trading bloc. . .The treaty's free trade proponents would never admit this, but NAFTA's underlying thrust is toward managed trade and investment.

Many free traders hoped that NAFTA would be an incremental step toward freer commerce, in no small part because the most vocal opponents of NAFTA were protectionists, and defeat of the treaty would be seen as a defeat for free trade principles. The important question is: what are NAFTA's long-term implications for economic liberty and the freedom of international commerce?

Even as a pragmatic compromise, NAFTA did not live up to its billing — many trade barriers remain, while still others were raised. NAFTA's first two years have been characterized by the typical hallmarks of excessive government: mercantilist planning, environmental controls, industrial policy subsidies, and bailout guarantees. The treaty did not simply lower tariff barriers between the member countries, it erected new barriers to outside parties and created a new bureaucracy capable of entangling trade policy in a morass of environmental and social concerns. The grafting of environmental policy onto NAFTA has led to special interest demands that similar provisions be replicated in other trade agreements, including the World Trade Organization of the GATT.

The free trade hope with NAFTA has been that, despite its flaws, one regional free trade agreement will beget others, producing a gradual expansion of economic liberalism and relatively unrestrained commerce. Yet NAFTA's record to date suggests that this is wishful thinking. Every increase in cross-border exchange encouraged by NAFTA has been accompanied by a rise in bureaucratic restrictions on international commerce. Though tariffs have been cut and the volume of U.S.-Mexico trade has increased, NAFTA has been a disappointment for those who value free enterprise.

Genuine free trade does not require negotiations, thousands of pages of text, and mischievous side agreements. In light of the NAFTA experience, supporters of open markets should recall the 1993 advice of the Cato Institute's Brink Lindsey: "Forget about a new round of GATT talks, as well as extending NAFTA farther south. Instead free-traders should invest their energies and political capital in fighting trade barriers here at home."[109] With a reform-minded Congress in place, freedom of trade stands a much better chance without another NAFTA or treaties of its ilk.

## ABOUT THE AUTHOR

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