Testimony before the House Ways and Means Subcommittee on Trade Hearing on Modernization of the North American Free Trade Agreement (NAFTA)

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Thank you for the opportunity to testify today. As an economist with supply chains as my primary research focus, and as a long-time Ohio resident, I have followed the implementation of NAFTA for many years.

As an economist, I believe that increased competition has many benefits, for example allowing companies with better products to grow and profit by better serving consumers. While increased trade in general has the potential to make everyone better off, this has not been the case with NAFTA, as President Trump and others have noted.

Economic studies have found only small overall increases in welfare for the U.S., Canada, or Mexico as a result of the agreement.[1] While some groups have benefited, especially large corporations, others have lost ground. A careful study by Hakobyan and McLaren (2016) shows that NAFTA has caused significantly slower wage growth in both U.S. industries and regions affected by tariff reductions in the agreement. The slower wage growth affected not just manufacturing workers, but also service workers, as those who lost manufacturing jobs tried to find new jobs in sectors like restaurants and retail, even as loss of these good-paying jobs reduced demand for such services. In Mexico as well, wages have stagnated even as productivity has increased; overall real wages rose just 2.3% between 1994 and 2012 (Weisbrot et. al, 2014). Mexican manufacturing wages remain well under 20% of US manufacturing wages (Blecker, 2014).

Appropriately designed, trade deals can set rules so that everyone shares in the resulting gains. For instance, we should negotiate trade deals to ensure competition is based on technology and innovation — rather than on other nations' willingness to exploit workers or the environment. However, NAFTA's current rules allow companies to compete based on who can exploit workers or the environment more, undercutting firms that would like to compete on innovation.

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[1] Romalis (2007) found no net benefit of NAFTA for aggregate welfare in the US; Caliendo and Parro (2015) find very small increases in aggregate welfare for each NAFTA country.

In my testimony, I will discuss four ways in which the agreement could be improved: increasing worker protections, increasing environmental protections, eliminating or reforming special courts for foreign investors, and strengthening supply chains. I will address the first three briefly, and then discuss supply chains in somewhat more detail.

If implemented, these changes would go a long way toward making the agreement work for ordinary citizens not just in the US, but in Mexico and Canada as well.

1. **Increasing worker protections.** As discussed above, a strong argument can be made that NAFTA has contributed to the reduced bargaining power experienced by workers in both the US and Mexico. Poorly designed rules can aggravate inequities. Under NAFTA, for example, the worst penalty that can be imposed for sweatshop conditions is that countries can call for "consultations" with the offending country's labor ministers — consultations with no enforcement mechanisms. As discussed below, investors have far stronger protections available to them. Several groups have made detailed recommendations about how to ensure that workers share in gains from trade, including the AFL-CIO (2017) and the Roosevelt Institute (Tucker, 2017).[2]

2. **Increasing environmental protections**. Like the worker protections, environmental protections in NAFTA are vague and contained in a side agreement with no enforcement provisions. As a result, the post-NAFTA period has been characterized by environmental issues such as deforestation, increased use of fossil fuels, and environmentally-destructive mining. Leading environmental groups (in addition to the sources above) have provided detailed recommendations for improvement. (350.org et. al, 2017)

3. **Reform or eliminate special courts for investors.** Firms' decisions to leave the U.S. are eased by provisions in trade agreements such as NAFTA, which set up special courts in which firms can challenge government policies that affect their investments. These "investor-state dispute settlement" (ISDS) mechanisms undermine national sovereignty. ISDS also undercuts the U.S. advantage in having a reliable legal system by helping ensure companies against potential expropriation by countries with weaker institutions. Countries have lost lawsuits over policies ranging from financial stabilization to environmental clean-up and even criminal prosecutions. (Hamby, 2016; Tucker 2017.)

[2] More recent trade agreements have gone beyond NAFTA in creating enforceable labor standards, but recent evidence suggests that even these do not go far enough to truly create equity between worker and investor interests. For example, last month, an arbitral panel released the first ever ruling under the labor rights provisions of the U.S.-Central America Free Trade Agreement (CAFTA). While siding with the U.S. that Guatemala had violated workers' rights, the panel found that it did not do so in a manner sufficiently affecting cross-border trade. This trade nexus requirement - also included in the proposed Trans-Pacific Partnership - is difficult to meet and limits the utility of these provisions for working families. Negotiators should consider a simpler formulation that makes clear high labor standards must be enforced (and enforceable under NAFTA) across the economy as a whole (Tucker 2017).

More generally, institutions of global governance should focus less on facilitating multinationals' ability to pit countries against each other to win investment and more on genuinely global issues. For example, international trade agreements should tackle issues of international tax evasion and on promoting cross-border collaboration on environmental issues that cross national boundaries.

4. **Strengthening US supply chains.** Many arguments against making changes to NAFTA are based on a fear that any change would weaken U.S. supply chains. For example, Amiti, Freund, and Bodine-Smith (2017) argue: "Some critics of NAFTA are concerned about the bilateral trade deficit and have proposed stricter rules of origin (ROO), which would make it more cumbersome for firms to access the zero tariff rates they are entitled to under NAFTA. We argue that measures that make it costlier for US firms to import will also hurt US exports because much of US-Mexican trade is part of global supply chains."

For example, these analysts point to the auto industry, where U.S.- produced components comprise 40 percent of the value of products imported into the United States from Mexico. In contrast, for goods imported from China, only 4 percent of their value is from U.S. content (Wilson, 2011). If NAFTA re-negotiation meant that trade barriers with Mexico were raised, labor-intensive production steps (like assembly of instrument panels) might move to China. Losing access to cheap nearby labor could mean that work currently done in the US (e.g., production of gauges for instrument panels) might move to Asia as well.

However, analysis such as this assumes that individual companies alone optimize their supply chains, and that no market failures exist.[3] The analysis also relies on the key assumption that Mexican (and Canadian) supply chains complement US supply chains and do not substitute for them. Moran and Oldenski (2014) appears to support this complementarity assumption, finding that when firms increase their Mexican employment, they also increase their US employment. However, much more research is needed to be sure of this result. Their data looks only at employment by a focal firm, not at suppliers. It is plausible that when a firm expands in Mexico, it expands its Mexican supply base more than it would if it expanded in the US. Also, it is not clear that their technique separates cyclical changes (e.g., when the business cycle is favorable, firms expand in all their locations) from trends (e.g., a gradual hollowing out of US supply chains).

U.S. supply chains are largely domestic. Eighty-five percent of U.S. exports are composed of U.S.-made parts; domestic content of overall U.S. production is similarly high (Mahoney and Helper,

[3] In contrast, as discussed below, where there are benefits to clusters of firms, the impact of each firm's location and investment decisions spills over to affect other firms in the industry (Mahoney and Helper, 2017).

2017).[4] The threat to manufacturing jobs comes less from the globalization of supply chains than from the movement of large chunks of whole industries abroad.

In many cases, this process begins when manufacturers move labor-intensive components or assembly overseas. Before too long, they do the same for higher-tech operations as well. For example, U.S. personal computer manufacturers started by offshoring the assembly of printed circuit boards, then moved complete product assembly overseas, then supply-chain management, and, finally, design and innovation (Pisano and Shih, 2009).

To prevent this atrophy of capabilities, it is important to identify clusters of industries that are at tipping points, and bolster these eco-systems. For example, it may be that the North American auto parts cluster is approaching such a tipping point. Since NAFTA came into force in 1994, Canada has lost four auto assembly plants and the US has lost ten, even as Mexico has gained eight plants.[5] As more auto assembly occurs in Mexico, more suppliers will find that costs of shipping and of coordinating engineering changes fall, as critical mass is reached. These firms may thus find it profitable to re-locate to Mexico from the U.S. and Canada; as each firm moves, it creates additional reasons for other firms in the network to leave as well (agglomeration economies). The North American industry could benefit from careful examination and management of these trends, assurance that changes are based on fair competition (not unfair practices), and that dislocation is managed and investment in fuel-efficient, innovative vehicles is promoted.

Supply Chain Recommendations

A concern for US supply chains should not foreclose re-negotiation of NAFTA. Instead, promoting the vibrancy of US supply chains would greatly benefit from actions such as the following:

1. Better data and analysis about the health of US supply chains. US statistical agencies are doing a great deal of creative work (despite tight budgets) to improve our understanding of global value chains.[6] However, there are several key steps that should be taken, requiring modest additional resources;[7]

    a. Greater funding of input-output tables. Currently, estimated relationships underlie much of this analysis, data limitations preclude computing many of these statistics for service sector supply chains. Moreover, the domestic content figure assumes “import

[4] See also Fetzer and Strasser (2015), Nicholson and Noonan (2017); Helper and Krueger (2017).
[5] United Auto Workers (2017).
[6] See Fetzer and Strasser (2015) as one example among many.
[7] Taken together, the US statistical agencies spend only 3 cents per American per year. (Powers and Beede, 2014).

proportionality," (e.g., that if 40% of a broad category of steel is imported, that each industry using that steel imports exactly 40% of it).

b. Analysis of the extent to which foreign suppliers are complements or substitutes for domestic suppliers. The Moran and Oldenski analysis could be improved by using customs data to track imports by a particular firm through the tiers of the supply chain. This would allow us to understand the circumstances under which firms add or subtract domestic employment when they expand abroad or use foreign suppliers. It is very rare to trace a product through the supply chain. However, the Customs-Trade Partnership Against Terrorism is beginning to collect such data (Homeland Security, 2015); it would be useful to use this for statistical purposes. (Note that as tracking technologies such as RFID spread throughout the chain, the costs fall of collecting such data and of monitoring that only suppliers with good conduct are used (Mahoney and Helper, 2017).

2. Convening of stakeholders (including business, unions, consumers, environmental groups) across the US, Mexico, and Canada to develop industry-specific strategies and responses.

3. Non-trade policies to strengthen supply chains within the US. US manufacturing supply chains are characterized by a heavy presence of small, isolated firms (40% of manufacturing workers are in firms of fewer than 500 employees). These firms struggle to do the innovation on which the main source of US comparative advantage is based. Strengthening US supply chains could include more robust efforts at training workers and managers, efforts to promote sourcing based on total cost of ownership (including costs of poor quality and missed delivery), promoting collaborative relationships with suppliers, continued funding for the Manufacturing Extension Partnership. See Mahoney and Helper (2017); Helper and Krueger (2016) for more analysis and recommendations.

4. Reviewing NAFTA rules of origin. Rules of origin should be revisited to determine how they could better promote development of tri-national clusters including robust US participation. The process of review should be undertaken carefully. If rules of origin are too weak, other nations can share in the gains from the agreement without taking on the disciplines contained in it. On the other hand, if rules of origin are too strict, firms will forgo NAFTA benefits, import instead under most-favored nation rates at the World Trade Organization, and perhaps weaken clusters. Also, to the extent production moves from low-wage nations (such as China) to North America, production may well go to Mexico, not the US or Canada. Thus, the impact of this policy on US employment and wages depends critically on the policies suggested above regarding stronger labor and environmental rights.

A thoughtful renegotiation of NAFTA could make good on the promise of a prosperous, sustainable North American continent, and should be conducted in an open, inclusive manner. The key step is to put the interests of American workers and communities ahead of the profits of multinational corporations.

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