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Gary C. Hufbauer

Yee Wong

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SECURITY AND THE ECONOMY IN THE NORTH AMERICAN CONTEXT: THE ROAD AHEAD FOR NAFTA

Gary C. Hufbauer and Yee Wong†
U.S. Speaker

The North American Free Trade Agreement (NAFTA), implemented in January 1994, broke new ground in the crowded field of free trade agreements (FTAs): it was the first major FTA between a developing country (Mexico) and developed countries (the United States and Canada). NAFTA confronted skeptics at its inception and still faces many today. Nevertheless, the agreement contributed to a sharp expansion of trade and investment between the United States and Mexico. Two-way US-Mexico trade expanded from $79 billion in 1993 to $220 billion in 2002, growth of 178 percent, about 2.75 times faster than US trade with non-NAFTA countries.¹

NAFTA was instrumental in boosting foreign direct investment (FDI) in Mexico as well, both directly by removing barriers on ownership, and indirectly by eliminating tariffs on industrial components. The investment surge in fact started before NAFTA was implemented. During the period 1990 to 2001, the US FDI stock placed in Mexico increased from $10 billion to $56 billion, helping to make Mexico the host of more FDI ($116 billion from all countries) than all developing countries except China ($395 billion total) and Brazil ($219 billion total).²

For both Canada and Mexico, proximity to the United States dominates economic and political life, ensuring that agreements with the United States are a central priority. The post 9/11, post-Iraq challenge for NAFTA partners is to advance their agendas of economic integration when US attention is

† Gary Clyde Hufbauer is the Reginald Jones Senior Fellow at the Institute for International Economics. Yee Wong is a Research Assistant at the Institute for International Economics.

¹ Before NAFTA, Mexico was the third-largest market for US exports and the third-largest supplier of US imports. By 2001, it was second in both categories. The CBO estimates that NAFTA increased US merchandise exports to Mexico by amounts ranging from 2.2 percent ($1.1 billion) in 1994 to 11.3 percent ($10.3 billion) in 2001. The same study estimates that NAFTA increased US merchandise imports from Mexico by amounts ranging from 1.9 percent ($0.9 billion) in 1994 to 7.7 percent ($9.4 billion) in 2001. In our view, these estimates underestimate the impact of NAFTA.

² US FDI is a much larger factor in Mexico than either China or Brazil. In 2001, China hosted $11 billion and Brazil hosted $35 billion in FDI stock from the United States, respectively. See Department of Commerce, Bureau of Economic Analysis (2003); UNCTAD, United Nations World Investment Report, (2003).
centered on the Middle East, and when Canada and Mexico harbor reservations about the broader doctrine of military pre-emption.\(^3\) Since the United States is both less motivated and more distracted, advancing the NAFTA agenda will depend on joint Canadian and Mexican initiatives. Their proposals should be ambitious enough to inspire visionary leadership, but flexible enough to accommodate the political realities of North America.

In the short term, NAFTA will probably advance furthest in areas that have security overtones. Energy and migration are two topics that clearly qualify. Longer-term NAFTA projects should include improvements to the dispute settlement systems, joint financial regulation, and more open services sectors. Sensitive agriculture questions, over trade in corn, beans, sugar, lumber and wheat, will need to be thrashed out on an issue-by-issue basis.

**BORDER SECURITY**

Canada and Mexico are the first and second largest trading partners for the United States. Consequently they are not only the largest source of US merchandise imports but also the leading export market for most US states.\(^4\) In 2002, two-way US-Canada merchandise trade reached $370 billion, while US-Mexico trade totaled $220 billion. Much of this trade originates in, or is destined for, establishments owned by US investors in Canada and Mexico. These commercial flows are highly sensitive to cross-border congestion, which can increase sharply in a security alert. Some 75 percent of bilateral US-Canadian merchandise trade moves through five border crossings: one in British Columbia and four in Ontario. Border closures are estimated to cost Canada $25,000 per minute in lost production.\(^5\) Two or three additional border shutdowns, of the sort that occurred after September 11, could have a telling impact on business plans to establish new plants in Canada.\(^6\) The same is true for Mexico.

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\(^3\) In the UN debate, both Canada and Mexico signaled disagreement with US military action against Iraq. Differences with US foreign policy decisions have already had spillover effects in trade policy vis-à-vis other countries. When Chile voted against the UN resolution, to cite the most prominent example, signatures on the US-Chile FTA were delayed for one month. The implicit signal from Washington is that open opposition by NAFTA partners to US security policy could delay closer economic relations in North America.


To improve the management of the US-Canadian border (8,890 kilometers) and the US-Mexican border (3,326 kilometers), the United States negotiated with Canada the "Smart Borders" plan and with Mexico the "Border Partnership Action Plan." These have alleviated border delays. The US Homeland Security Department plans to implement a high-tech entry/exit system during 2003 at airports and seaports, and at the 50 largest land entry points during 2004. Canada similarly implemented measures to improve border patrols, and has spent almost $180 million to purchase new security technology and hire critical personnel. Mexico has helped improve border security by sharing information about visa screening, by enhancing cargo-security, and by expanding the use of the SENTRI program that provides pre-clearance passes for low-risk travelers along the southern border.

After September 11, joint US-Canada initiatives were packaged to facilitate personal travel and cross-border merchandise trade. NEXUS, coordinated by US and Canadian customs and immigration agencies, enables faster border crossings for low-risk travelers. The FAST program was established to expedite customs clearance for cargo.

As an intermediate goal, the authorities should encourage all multiple-entry US-Canada and US-Mexico travelers to obtain NEXUS passes. Likewise FAST ports of entry and enrolment centers should seek to accommodate around 80 percent of merchandise trade at both borders, compared to around 15 percent of US-Canada trade today. The first secure fast lane in El Paso/Juarez should be accompanied by additional fast crossings along the US-Mexico border.

MIGRATION AND IMMIGRATION

The NAFTA migration story has two major dimensions: one is the relationship between security and bilateral border crossings; the other concerns illegal migration of Mexican workers into the United States. Unfortunately the perception has taken root in the US public that the
US-Canada border is porous. The US concern is that Canada’s general immigration policies are less demanding, allowing people to enter who may have been denied entry into the United States. Canada’s comparatively liberal treatment of refugee claimants also fosters the perception that dangerous persons might enter the United States through Canada.

US-Mexico migration problems are not new. Since NAFTA was implemented in 1994, the number of unauthorized Mexicans living in the United States has almost doubled from about 2.5 million in 1995 to about 4.5 million in 2000, representing an annual increase of 400,000 a year. Conditions endured by many Mexicans working in the United States, and desperate attempts to cross the border, are both sensitive political issues in Mexico. Before and after September 11, President Fox has tried to engage the Bush Administration on immigration issues. Fox made his task more difficult by opposing US military action in Iraq.

Stepping away from the North American scene, the European Union (EU) provides an example for achieving a coherent immigration policy in a free trade area. The founding Treaty of Paris (1957) guaranteed free movement of labor, but for several decades this was a paper pledge. The EU took concrete steps to develop Community rules on residency and work permit rights in the Schengen Agreement (1985) and later under the Maastricht Treaty (1992).

In a similar spirit, NAFTA is beginning to configure its internal border checks so as to distinguish between citizens of NAFTA countries and non-NAFTA nationals. Canada and the United States have already implemented high-tech identity cards for permanent residents and pre-clearance programs for frequent travelers, known as INSPASS at airports.

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12 This concern is based on the December 1999 episode of Ahmed Ressam, who attempted to cross the British Columbia-Washington state border with bombs destined for US millennium celebrations.
13 After the U.S. Department of Homeland Security required all male visitors from a list of 25 mostly Arab and Muslim countries to register with the US government, the Canadian government was flooded with refugee claims. In 2002, a third of the 45,000 asylum seekers in Canada entered via the United States.
14 US-Mexico migration is part of a larger worldwide trend. According to one estimate, the number of migrants worldwide is around 175 million persons, representing about three percent of the world population. See, Philip Martin, Mexican-US Migration, reprinted in Gary Clyde Hufbauer and Jeffrey J. Schott. Forthcoming. NAFTA: A Ten-Year Appraisal, WASHINGTON DC: INSTITUTE FOR INTERNATIONAL ECONOMICS.
15 Fox’s position reflected overwhelming public sentiment in Mexico. While this was understood in the Bush White House, the divergence on security policy did not foster closer relations.
and CANPASS at land borders. Similar passes should be extended to cover visitors arriving from Mexico. Other initiatives should include common rules for crossing external borders, and harmonization of rules for visas and entry.

Immigration policies are distinctly different between the United States and Canada. Canada’s point system is designed to choose skilled immigrants (60 percent), whereas US immigration policy favors family reunification (64 percent). In Mexico, immigration legislation has gradually liberalized the entry of certain categories of foreigners, particularly to facilitate the entry of business visitors, investors, technicians and professionals. Given their deep-seated differences, the NAFTA partners are not likely to agree on common immigration criteria for many decades. Indeed, within Europe, each member country still determines its own policy with respect to extra-EU immigrants.

The more immediate and sensitive issue is migrant workers, especially illegal immigrants. Mexico is ranked first and Canada fourth as source countries for illegal immigration into the United States. The pattern of flows is dominated by demography and structural differences among NAFTA partners. The biggest flows are between Mexico and the United States. Mexico’s labor force is young (average age 27), whereas the US labor force is older (average age 39). The wage differential between the United States and Mexico is about eight or nine to one. Given the wage and age differences between the United States and Mexico, it is not surprising that many Mexicans seek work in the north.

It might seem that the migration pressures will be unrelenting for decades to come. However, Philip Martin (2003) has outlined demographic and economic reasons why Mexico-US migration pressures should fall between

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16 While the NEXUS program facilitates pre-clearance for low-risk travelers along land borders, the INSPASS program acts as an airport EZ-pass that scans hands to confirm that travelers are citizens with no criminal background. The INSPASS automated immigration inspection system takes about 20 seconds. Similarly, the CANPASS program extends pre-clearance of low-risk persons traveling by air, boat, or through land border crossings. In May 2003, the United States and Canada announced the CANPASS-Air (limited to Canadians only) and NEXUS-Air projects, which use high-tech iris scanners at airports to expedite the customs process for low-risk travelers.

17 Relative to its population size, Canada also offers more generous, skill-based permanent residency, and ultimately citizenship, than the United States. See, Peter Rekai, Peter, US and Canadian Immigration Policies: Marching Together to Different Tunes, TORONTO: CD HOWE INSTITUTE COMMENTARY, No. 171, THE BORDER PAPERS, Nov. 2002.


19 The wage differential in agriculture is huge. In 2000, the daily wage for farm work in Mexico was $3.60 compared to the US average of $66.32. See, Steven Zahniser and Florencino Trevino, Hired Farm Labor: Comparing the US and Mexico, USDA AG. OUTLOOK, Jan.-Feb. 2001; Also see, “Open Border” Report, PBS NEWSHOUR, Aug. 25, 2000.
2005 and 2010. Martin explains that, as the rate of new Mexican entrants to the labor force drops by 50 percent between 1996 and 2010, with proper policies sustained economic growth should create enough new jobs to hold the great majority of new workers in Mexico.

Mexican demographics and economics may work according to Martin’s model. Nevertheless, an immigration accord now would create mutual benefits. First and foremost, an accord would ameliorate some of the tensions and perhaps avert greater fortification of the 3,326 km US-Mexican border. Second, estimates suggest three-fourths of all new US jobs in the coming decade will be in the services and retail industry, where there is considerable demand for relatively low skilled labor. Some of these jobs can be filled by Mexicans. 20

Martin proposes that a US-Mexico immigration accord should feature pilot guest worker programs that offer temporary work permits. 21 This is similar to the recommendation of Hufbauer and Vega-Casanovas (2003). According to Martin’s plan, a US employer could initiate a guest worker visa. In turn, visa holders would be refunded part of their Social Security and Unemployment Insurance payments once the worker returned to Mexico and surrendered the visa. 22

Also calling for urgent attention is the status of the 4.5 million unauthorized Mexicans who already live and work in the United States. We do not have a magic solution. The foundation for our tentative recommendations is the proposition that these people have made permanent homes in the United States and they are not going to pick up their lives and return to Mexico. Under appropriate circumstances, therefore, they should be granted residence permits with eligibility for citizenship. The circumstances we envisage have two components – a threshold relating to the total number of illegal crossings, and standards for individual applicants. Provided that both governments certify that illegal crossings are less than, say, 100,000 annually, then Mexican residents living in the United States for five years or more, with no criminal record, would be eligible for residence permits and eventual citizenship. 23

In addition to these measures to expand the flow of legal migrant workers across the border and regularize the status of those living in the United

20 Orrenius and Viard, supra note 18.
21 Martin, supra note 14.
22 For information about reforming the current US H-2A and H-2B programs, adapting the US L-1 visa option, and seasonal agricultural guest worker programs, refer to Martin (2003). In the US Congress, the House International Relations Committee proposed linking an immigration accord with the opening of PEMEX, Mexico’s state-run oil company. But Mexican President Fox quickly rejected the proposal. Dow Jones (2003); SourceMex (2003).
23 Hufbauer and Vega-Casanovas, supra note 4.
States, we recommend a joint border patrol program operated by Mexico and the United States to stem the surge of illegal migrants looking for work in the United States. This joint patrol program would help keep the number of illegal crossings below the agreed threshold.

ENERGY

The collapse of the Northeast power grid in August 2003, depriving 50 million people of electricity for a couple of days, was not attributable to shortcomings in North American energy integration. But it forced attention on weak infrastructure. This wake-up call should, among other results, spur more attention on NAFTA’s role in ensuring reliable energy supplies.

The creation of the North American Energy Working Group in 2001 was a first step towards better energy cooperation within NAFTA. Just as the European Union drafted its Energy Charter in 1998, NAFTA can start by building on the Energy Working Group to integrate the North American energy market. All three NAFTA partners have a stake in this enterprise. Mexico needs to step up production not only for its own needs, but also to take advantage of its export opportunities. Canada, even more than Mexico, can benefit from exporting greater quantities of oil and gas to the United States.24

The United States has security reasons for diversifying its energy supplies away from the Middle East. The United States already buys 32 percent of its oil from Canada and Mexico, but key suppliers outside of North America are decidedly less stable in their internal politics. These include major producer countries such as Algeria, Angola, Indonesia, Nigeria, Saudi Arabia, and Venezuela.25 The United States has an interest in promoting a North American energy agreement because the multilateral sharing mechanisms contemplated under the International Energy Agency (IEA) could easily break down in an energy crisis. The problem with the IEA is that the interests of major energy importers – the United States, Europe, Japan and

24 Canada’s Athabasca tar sands are often promoted as a useful check on OPEC. Technical problems of getting oil from rock, the high water usage, the high costs of producing and transporting oil from the sands, and the difficulty complying with the Kyoto Protocol, makes Athabasca a long shot in rivaling Saudi Arabia in oil. Nevertheless, the tar sands have value as energy insurance. There’s oil in them tar sands! - Exploiting Canada’s tar sands, THE ECONOMIST, June 28, 2003, available at 2003 WL 58583044.

China — will diverge sharply in the event of prolonged energy shortage. Moreover, demand has grown rapidly in countries outside the IEA, causing the agency to lose the critical mass necessary for managing a future shortfall.

While the United States is a net importer from its NAFTA partners, there is considerable two-way trade. In 2002, when the United States imported $113 billion of energy from the world, it imported $31 billion of energy products from Canada and $11.3 from Mexico. In the same year, the United States sold $5 billion of energy products to Canada (out of total Canadian energy imports of $11 billion) and $3 billion to Mexico (virtually the total of Mexican energy imports).

In 2001, Canada supplied about 12 percent of total US energy consumption and Mexico supplied 3 percent. Canadian exports of natural gas to the United States (which account for more than 90 percent of total US imports) provide about 15 percent of US gas consumption.\(^\text{26}\) But Canadian exports are slowing as Canadian domestic demand rises.\(^\text{27}\) Meanwhile, facing electricity brownouts and oil and gas shortages, Mexico has the most acute energy needs in North America to accommodate its industrialization and urbanization.

Given that coal production is significantly constrained by environmental concerns, we focus on the dynamics of North American natural gas and oil energy supplies. For environmental reasons, natural gas is strongly favored over oil. Nearly all the electric plants built since 1998 in the United States are run by gas, and Canada already supplies 30 percent of California's demand for natural gas.\(^\text{28}\)

In 2002, the US Senate proposed an oil and natural gas pipeline from the Arctic to the lower 48 states. The Alaskan pipeline would be a step forwards in developing a unified North American energy market. The problem is that the Canadian government rejects the erstwhile US Senate proposal for a more expensive “southern route” from northern Alaska to Chicago that would be heavily subsidized by the US government. The Senate preferred the southern route because a greater percentage of the line would go through the United States, creating more jobs for union workers. The alternate “northern route”


\(^{27}\) Under Kyoto as written, Canada cannot export clean energy products, namely hydropower and natural gas, to the United States to compensate for a 60 million ton gap in greenhouse emissions. Jeff Rubin and Peter Buchanan, *Kyoto Discord: Who Bears the Cost?*, CIBC WORLD MARKETS OCCASIONAL REPORT, No. 36, Nov. 20, 2002.

\(^{28}\) In the first half of 2003, when natural gas prices rose sharply, stored supplies of gas fell to the lowest levels since 1976. Bradley and Watkins *supra* note 26.
provides access to significant Canadian gas reserves, is more direct, and would cost $2 billion less to build than the southern route.\footnote{Canada has several objections to the southern route. For one, it would bypass the McKenzie Valley, where there is access to significant proven Canadian reserves. Canada also prefers to limit government participation in building the pipeline but US proposals for a southern route would be supported by heavy subsidies. Finally, the Canadian government objects to the southern route because it assumes that Canada would serve as a land bridge for Alaskan gas. Bradley and Watkins, supra note 26.} The northern pipeline, preferred by Canada, would run southeast underwater into the Northwest Territories, collect gas in the McKenzie Valley and Alberta, and then run through British Columbia on its way to Chicago. In June 2003, Imperial Oil signed an agreement with aboriginals, energy companies and pipeline builders to begin planning for the very early stages of building the northern pipeline.\footnote{TransCanada Pipelines Limited agreed to lend about $55 million to the Aboriginal Pipeline Group for preliminary work on an arctic gas pipeline through Mackenzie Valley. The deal also gives TransCanada an option to buy five percent of the Imperial Oil’s share of the pipeline. For information about the latest progress on the northern artic pipeline. CBC NEWS (2003).}

Very likely neither the “southern” nor “northern” route will be economically viable to the private sector without public support. In the interests of North American energy cooperation, the United States and Canada should pursue a jointly subsidized pipeline, with public costs shared on a 50-50 basis. A pipeline contract should include a reasonable mix of construction workers from the NAFTA region, and the pipe and other materials should be procured by competitive tender with a limited NAFTA preference of, say, ten percent.

Another avenue for North American energy cooperation is to expand Canada-US regional electricity markets and grid networks, while supporting greater private participation in Mexico’s electricity sector. Canadian provinces should participate to a greater extent, in regional transmission organizations (RTOs). Hydro-Quebec, for example, has long profited from electricity exports to New England and New York. British Columbia Hydro is now doing the same, with connections to a grid serving the US Northwest and California, extending into Mexico.\footnote{Interconnected north-south electricity grids also provide opportunity for seasonal diversity. British Columbia Hydro’s winter peak complements California’s summer peak, allowing B.C. Hydro to export during the summer when it has surplus-generating capacity.}

Progress with Mexico on energy questions will be more difficult. There are two key obstacles: one is the popular Mexican resistance to amend the constitutional prohibition against foreign participation in the energy sector. The other is the job security of Pemex and CFE workers.\footnote{Pemex and CFE are both overstaffed to a huge degree, and unless assurances of job security (or early retirement at full pay) are provided, opening the Mexican energy sector will
difficult front for making headway is electricity. In 2001, President Fox attempted to reform Mexico’s energy laws by allowing CFE to buy increased amounts of electricity from private sources. Fox also proposed changes to the Mexican Constitution to allow private electricity generators to sell directly to consumers. These are steps in the right direction, but they are small. Mexico should consider a long-term comprehensive transition to a competitive, electricity market with no restrictions on ownership. At the same time, Mexico should provide generous early retirement and severance packages to CFE workers who are laid off. Successful reform of electricity could then serve as a prototype for eventual private participation in Mexican oil and gas sectors.

TRADE INTEGRATION

A “strategic bargain” that deepens NAFTA relationships should further enhance trade integration, even though this has been the spearhead for NAFTA. In the next phase, NAFTA members should adopt a common external tariff (CET) on non-agricultural products, a new approach on antidumping remedies, and make continued progress on agricultural disputes.

Common External Tariff

By harmonizing their national tariff rates towards a CET, NAFTA countries will minimize differences in the MFN (most-favored-nation) tariffs applied on imports from third countries. In turn, that will eliminate a major rationale for protective rules of origin. While external MFN tariff

be nearly impossible.

33 The Fox administration’s new energy reform proposals would encourage new investment as private sector projects traditionally had to compete with subsidized electricity provided by the CFE. New Horizons in US-Mexico Relations, US-MEXICO BINATIONAL COUNCIL, (Sept. 2001).

34 The genesis of the strategic bargain is explained by Dobson, supra note 5, who coined the term “Big Idea.” See, Danielle Goldfarb, The Road to a Canada-US Customs Union: Step-by-Step or in a Single Bound? TORONTO: CD HOWE INSTITUTE COMMENTARY, No. 184, THE BORDER PAPERS, June 2003, for an exposition of the CET. In our view, agriculture protection is both too disparate and too sensitive for common external tariffs in the near term.

35 The CET goal could be reached by a NAFTA accord that all countries would implement the lowest rate applied by a NAFTA member, for each tariff line within a decade. In the course of multilateral WTO negotiations, any NAFTA member could, of course, reduce its tariffs at a faster pace.

36 Rules of origin are justified as a means of preventing “trade deflection,” namely the practice of routing imports through the lowest tariff country in an FTA. Unstated is the intentional protective effect of rules of origin. Despite this intent, it is our hope that rules of origin would be waived for tariff-free trade within NAFTA, provided that the exporting
schedules might converge only gradually and some rules of origin might linger for many years, these changes would be instrumental to eradicate residual commercial borders that still separate Canada, the United States and Mexico.

Trade remedies

In the NAFTA negotiations, Canada and Mexico were eager to rein in US antidumping (AD) and countervailing duty (CVD) actions. They did not succeed in changing US law, but they did establish a tri-national dispute settlement system. The dispute settlement provisions do not stop US firms from filing unfair trade cases against Canada and Mexico (and vice versa). However, under NAFTA, national AD and CVD actions can be vetted, after the national agency makes it determination, by impartial NAFTA panels. Some 85 cases have been handled under Chapter 19 (the dispute system for AD and CVD actions). Except for lumber and wheat, the dispute settlement process has resolved cases with little fanfare.

One way to improve the trade remedy atmosphere within NAFTA would be an accord excludes, by mutual agreement, designated sectors from recourse to AD or CVD remedies. Excluded sectors would be determined by industry consultations. For the excluded sectors, safeguard remedies would still be available, but not AD and CVD duties.

Agriculture

Agricultural trade prospered under NAFTA. US agricultural exports to NAFTA partners increased by 60 percent during the period 1993 to 2000, from $8.9 billion to $14.2 billion, a period when US agricultural exports to the world expanded by only 10 percent. NAFTA agricultural gains were
most significant in US-Mexico agricultural trade: US agricultural trade with Mexico nearly doubled between 1993 and 2000.\textsuperscript{40}

By contrast to the US-Canada FTA, which largely excluded agriculture, Mexico and the United States took far-reaching steps towards complete liberalization of agricultural trade in NAFTA. As of January 2003, most tariffs have been phased out. About 90 percent of tariff lines on US agricultural products entering Mexico are now less than 2 percent.\textsuperscript{41} However, liberalization for sensitive products was back-loaded.\textsuperscript{42} Mexican tariffs on corn and dry beans phase-out over a 15-year period, and the United States insisted on an equally long period for orange juice and sugar. Given these restraints, in 2000, just eight commodities, some of them minor agricultural products, represented 55 percent of the value of US-Mexico agricultural trade: beer, coffee, tomatoes, cattle, peppers, cucumbers, grapes, cauliflower and broccoli.

NAFTA members are advocating deep agricultural liberalization in the WTO. The risk is that Doha Round agricultural negotiations will not make much progress, either on farm subsidies or market access.\textsuperscript{43} Whatever progress is made in the WTO, NAFTA will still face its own agricultural battles. To illustrate the challenges for NAFTA, we mention two US-Canadian agricultural battles: softwood lumber and wheat.

\textsuperscript{40} US agricultural exports to Mexico increased from $3.6 billion in 1993 to $6.5 billion in 2000, while US agricultural imports from Mexico increased from $2.7 billion in 1993 to $5.1 billion in 2000. Much of the growth was associated with US FDI in highly processed foods. US FDI in the Mexican food processing industry doubled since NAFTA was ratified, from $2.3 billion in 1993 to $5.3 billion in 1999. See, Steven Zahniser and John Link, \textit{The Effects of NAFTA on Agriculture and the Rural Economy}, USDA AGRICULTURAL OUTLOOK, July 2002; Rosanna Mentzer Morrison, ed., \textit{Food Review: Global Food Trade}, USDA ERS FOOD REVIEW, Vol. 24, No. 3, Dec. 2001.

\textsuperscript{41} Based on estimates provided by the Mexican Embassy in Washington, D.C. (2002).

\textsuperscript{42} US tariffs on wheat, tobacco, cheese, evaporated milk and other products were eliminated on January 1, 2003. Mexico will eliminate tariffs on imports of corn and dry beans by January 1, 2008. The United States will end tariffs on Mexico exports of winter vegetables by January 2008. The United States has already eliminated tariffs on Mexican exports of corn, barley, pork and poultry. See, \textit{Outlook Report 2002}, US DEPT. OF AG. ECONOMIC RESEARCH SERVICE.

\textsuperscript{43} Illustrating the difficulty of reducing subsidies, the US Farm Act committed the United States to high subsidies through 2008, and the EU has stated that Common Agricultural Policy (CAP) budget will be frozen until 2013 to accommodate new country members. In 2002, to placate irate Mexican farmers, President Fox promised to give $1.3 billion in new farm subsidies. See, David Luhnow, \textit{Mexican Farmers Rage at the Trade Pact, but the Enemy Is Within}, THE WALL ST. J., March 5, 2003, at A13.
Softwood Lumber

While lumber is not usually considered an agricultural commodity, the softwood lumber dispute has elements in common with other agricultural disputes: significant government regulation coupled with public subsidies. For all the success of the Chapter 19 process, its most glaring failure and NAFTA’s continuing largest trade dispute involves softwood lumber (SWL). The economic stakes are huge. In 2001, Canadian softwood lumber accounted for one-third of the US market and represented $6.5 billion of exports annually. The long-running dispute can be traced to different forest resource management practices. In the United States, timber prices are determined by private contracts or auctions, in which either the US Forest Service or private landowners sell the cutting rights. In Canada, most timber is located on crown (public) lands, and provinces control the crown forests. The control of forests is used to ensure adequate timber supplies to local mills, thereby stabilizing employment in mill towns. While the US Forest Service incurs ancillary costs (such as road maintenance) for harvesting timber on public lands, Canada’s provincial governments shift all forest management costs to producers. In exchange, stumpage rights are sold at favorable terms on long-term contracts.

One consequence is a series of trade disputes stretching back to 1982. The US lumber industry has brought a series of CVD and AD cases; the US government has imposed penalty duties; and in response the Canadian government has challenged the duties in the GATT and NAFTA. These cross-border differences are accentuated by the virtual absence, until recently, of cross-border investment in the lumber industry. Pragmatic solutions to the dispute will likely include auction-based provincial timber sales, open to all bidders, for at least a portion of stumpage rights. When

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44 Ironically, the adverse economic consequences of the SWL dispute have made the Canadian lumber industry more efficient. According to The Economist, average costs (including US penalty duties) at Canadian mills have been reduced by an estimated $65 per thousand board feet of lumber (still representing a 20 to 35 percent tax on US consumption of lumber). As a result, Canadian mills can maintain their market share in the United States despite their lower profits. Brink Lindsey, Mark A. Goombridge, and Prakash Loungani, Nailing the Homeowner: The Economic Impact of Trade Protection of the Softwood Lumber Industry, CATO INSTITUTE, July 6, 2000.

Canada implements market-based lumber pricing measures, the United States will probably scale down its penalty duties on Canadian lumber exports.46

Wheat

The US-Canada dispute over wheat could be a harbinger of disputes over other agricultural products both in US-Canada and US-Mexico trade. The key issues in wheat revolve around differences in marketing systems and the political influence of major producers both in the United States and Canada. The economic stakes are significant. The United States is the world's leading wheat exporter with an annual value of exports around $3.6 billion in 2002; by comparison, the Canadian Wheat Board's (CWB) annual exports were about $2.1 billion in 2002.47 A point of bilateral contention is the type of agricultural subsidy. Whereas the United States subsidizes wheat exports, the Canadian government subsidizes the CWB.48 Large private US grain companies, such as Cargill and Bunge, buy most of the US crop, and sell wheat around the world.49 In Canada, the CWB acquires virtually all wheat and barley, and (like its private competitors) sells on a global basis.

In agricultural trade, the United States emphasizes private markets (although farm incomes are substantially augmented by public subsidies). By comparison, the CWB is a state trading agency that makes most marketing decisions, provides quality assurance, and maintains an efficient grain handling system. US proposals to dismantle the CWB are indirectly raised in the draft Doha agriculture text and directly raised under the WTO dispute settlement mechanism. But they are not likely to break the current impasse between Canada and the United States.50 As the US government

47 In 1999, US wheat exports represent about 27 percent of total world exports, while the CWB supplied about 18 percent of the world wheat and barley exports.
50 Beginning in 1993, under the Canada-US Free Trade Agreement, Chapter 18 dispute settlement process, the United States requested a binational panel review of CWB wheat practices. Following a short-lived US-Canada Memorandum of Understanding on Grains
admits, even after a state trading enterprise like the Australian Wheat Board has been abandoned, monopoly trading practices in wheat will likely persist. Rather than getting rid of CWB, a political compromise might require the CWB to adopt transparent wheat prices in exchange for the elimination of US export subsidies in wheat.

INSTITUTIONAL DEPTH

A comparison between NAFTA and EU institutions illustrates how North America’s future will be distinct from Europe’s. Brussels is the headquarters for most EU institutions (however, the European Central Bank is headquartered in Frankfurt and the European Parliament has chambers both in Strasbourg and Brussels). EU institutions employ 19,000 persons and dispose very large budgets. By contrast, NAFTA deliberately scattered its institutions throughout North America -- Montreal, San Antonio, Mexico City, Ottawa, and Washington, DC, and they are modest in scope, with total employment under 1,000 persons.

NAFTA governments have no desire to create supra-national institutions modeled along EU lines. Given that limitation, NAFTA can still advance integration through efforts that address income disparities and foster joint policy coordination. As the EU Cohesion Fund (1994) was used to help integrate poorer countries, NAFTA can similarly enlarge its funding for the North American Development Bank (NADBank). NADBank’s capital base should be increased from $4.5 billion to $10 billion. Recognizing disparities in income, funding should be based on a 75-25 split between the United States and Mexico, rather than 50-50.

In the near term, a common currency is not a realistic goal. This is in contrast to the EU. As the North American economies become more integrated, the case for a single currency will grow stronger. But the predominance of the US economy in the region — accounting for almost 90 percent of North American GDP — makes the US government reluctant to share control over monetary policy with Canada and Mexico. On the other hand, if Mexico and Canada dollarize with no sharing of monetary control or central bank earnings, they will surrender an important symbol of sovereignty and lose seignorage to boot.

(1994), the United States finally in 2003 filed formal charges against the CWB in the WTO.

51 United States, Australia Discuss Farm Programs, Medicines in First Round of Free Trade Talks, BUREAU OF NATIONAL AFFAIRS (BNA) INTERNATIONAL TRADE REPORTER, Vol. 20, No. 13, March 27, 2003.

52 As a comparison, in 1999, the European Structural Funds program budget was 195 billion Euros, representing 1.27 percent of the EU’s GDP. Robert A. Pastor, Toward a North American Community. WASHINGTON, DC: INSTITUTE FOR INTERNATIONAL ECONOMICS (2001).
Our view is that NAFTA members should deepen their institutional relations through a different track – by welcoming each other’s officials as non-voting observers on the boards of important agencies. US agencies we propose for consideration are the US Occupational Safety and Health Administration (OSHA), the Food and Drug Administration (FDA), the International Trade Commission (ITC), the Federal Reserve Board, together with their Canadian and Mexican counterparts. This low-key, but still significant step, would establish a basis for closer cooperation in a number of functional areas.

CONCLUSION

If the United States views NAFTA solely as a trade and investment arrangement, and not the first large step towards deeper integration, much of the potential for North American economic and social life will be lost. Pastor (2002) persuasively argues that a major shortcoming of NAFTA, so far as Mexico is concerned, is the absence of funding mechanisms to promote development. He contends that the United States should make Mexico’s development an explicit priority, both for its own sake and to make progress on issues that are important to the United States, especially drug trafficking and illegal immigration.

The NAFTA partners took concrete steps to secure the safety of trade and travel after September 11. NEXUS and FAST initiatives should now be extended. Energy should be added to the agenda, with high-level policy coordination between the United States, Canada and Mexico. NAFTA should foster the opening of Mexico’s electricity sector, the United States and Canada should agree upon a jointly acceptable pipeline route.

Commonly agreed immigration policies should be a long-term objective. As NAFTA partners work towards harmonizing visa rules, the United States and Mexico can tackle the sensitive issue of illegal immigration. A US-Mexico immigration accord can make progress by offering temporary work permits for guest workers and extending permanent residency to 4.5 million undocumented Mexicans living and working in the United States, both conditioned on a reduction in the annual number of border apprehensions.

53 Counterpart governmental bodies in Canada and Mexico include: Canadian Center for Occupational Health and Safety (CCOHS), the Bank of Canada, Canadian Trade Facilitation Office, Canadian International Trade Tribunal (CITT), Mexican Secretariat of Labor and Social Welfare, Health Canada, Mexican Ministry of Health, Federal Commission for Protection from Sanitary Risks (COFEPRIS), Mexican Ministry of Economy (SECOFI), and the Banco de Mexico.
On the trade front, NAFTA can move towards a common external tariff for non-agricultural products. They can deal with trade remedies by agreement that trouble-free sectors will only be subject to safeguards, not countervailing or antidumping duties. They can continue to work through the long list of agricultural disputes.

Short of creating supra-national institutions, the NAFTA members can deepen their institutional ties by inviting each other’s officials as non-voting members on key agencies, such as the EPA and the Fed.