Free Trade and NAFTA
An Economic Overview

Both NAFTA and the recent GATT talks symbolize the international resurgence of free trade as a guiding economic principle. This overview of past agreements sheds light on the potential of free trade today. However, new technology may soon challenge contemporary notions of trade.

by Geoff Day

Nineteen ninety-three was a high water mark in the contentious field of free trade negotiations. In November, the North American Free Trade Agreement (NAFTA) was passed by the United States Congress after a bitter and divisive battle. In December, the latest round of the General Agreement on Tariffs and Trade (GATT) limped to a conclusion with a series of compromises and side agreements that have created a somewhat flawed deal, but a deal nonetheless.

Unique among economic concepts because of the intense debates that surround it, free trade remains a political litmus test for economists, politicians, labor leaders, and the general public alike. Fortunately for political pundits, the free trade debate remains complicated and inexact. The difficulty in predicting the future under a free trade regimen creates an atmosphere where nearly any point of view can be supported by questionable truths.

However, an understanding of the arguments for and against free trade, along with an overview of recent trade agreements, can clarify the confusion. Certainly, this debate is far more complex than Ross Perot’s “giant sucking sound” of American manufacturing jobs disappearing to Mexico.

The Case for Free Trade

What exactly are the economic theories behind free trade? Any graduate of Economics 101 will recall the supposed truism that “free trade is good” and Adam Smith’s “invisible hand” of the free market. An application of economic theories to the modern international economy illustrates several points.

The key argument for free trade is that improved efficiency increases economic output, to the benefit of all members of a free trade agreement. Efficiency expands because free trade, with its level playing field, allows countries to specialize in what they do best—what is often called “comparative advantage”. At the same time, inefficient or artificially competitive industries must adjust to survive.

The move to specialization and efficiency is not, in theory, a zero-sum game in which benefits accrued to one side represent losses to another. Nonetheless, during the NAFTA debate many critics argued that Mexico’s substantial gains would translate into corresponding losses for the U.S. and Canada. But experience from the European Union (EU) has shown that free trade leads to greater specialization among all countries and thus to higher efficiency in producing those goods. Invariably, total output after a free trade area is established shows growth for all trade members.

A second argument for the efficiency of free trade points out that tariffs, quotas, and other import restrictions create distortions in consumer choices. By applying tariffs to certain products and thereby raising prices, consumers make different choices.

“No doughnuts for them.”

-Dee Dee Myers, Press Secretary for President Clinton, in reference to the anti-NAFTA Congresspeople partaking of a White House breakfast the morning after the bill’s passage

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consumption choices than would be the case in a free trade environment. For example, in Japan, tariffs and other import restrictions on most agricultural items have imposed such exorbitant prices on fruit, rice and meat that standard western fare such as apples and oranges are treated as delicacies.

The extreme prices in these cases cause consumers to make what economists call “non-optimal consumption decisions” which cause an aggregate reduction in national welfare. Removing the tariffs would obviously have negative impacts on Japanese agricultural producers, but would allow consumers to make more efficient choices.

Arguments in defense of free trade also come from the political perspective. Recently, these arguments have gained increasing credence. The power of special interest groups, lobbyists, and Political Action Committees can overemphasize the importance of small groups of people or industries at the expense of the under-represented public.

For example, while the recent GATT negotiations legislated the end of any agriculture supply management systems, Canadian consumers have for decades paid prices nearly 50% higher than world levels for dairy, egg and poultry products. These costs were instituted in an effort to provide a stable price environment for some 37,000 farmers. Since these farmers can provide a cohesive lobbying front which is weakly opposed by unorganized consumer groups, the Canadian supply management system has survived far longer than it might have otherwise. Unfortunately, the concept of the greater public good and increased national welfare confronts a difficult foe in bankrupt farmers.

**The Case for Tariffs**

Economic and political arguments against free trade, and in support of tariffs, exist as well. First, the concept of an “optimal tariff” suggests that large economies, by virtue of their size and influence, can actually increase national welfare by imposing carefully calculated tariffs. However, such tariffs are generally consigned to the academic’s chalkboard since they are essentially impossible to implement, as they rely on an inordinately sophisticated understanding of both global and domestic economies.

The second argument against free trade regards tariffs as a remedy for domestic market failures. In economic terms, a market failure exists when a specific market behaves in a non-optimal manner: be it improperly allocated capital or inefficient labor markets. In such cases, it has been argued that carefully applied tariffs can resolve the market failures and increase national welfare. However, as in the case of an optimal tariff, such calculations are unrealistic in today’s complicated and interdependent international economy.

Unfortunately for economists, the world does not always behave like an economic model. As in most good things, there are hidden costs to free trade that were rarely if ever mentioned during the NAFTA debate or the recently concluded GATT talks. State Representative David E. Bonior (D) said in an anti-NAFTA speech before the bill was passed: “The working people who stand against this treaty don’t have degrees from Harvard. They don’t study economic models. And most of them have never heard of Adam Smith. To them, NAFTA isn’t just some economic theory. It’s real life.” National welfare cannot realistically be measured by a single statistic such as gross domestic product (GDP), and it must reflect life’s complexities.

As tariffs are removed over time, industries that previously were protected from foreign competition must either adapt or go out of business. In many cases, this means job losses. For example, the agricultural provisions of the latest GATT talks will cause significant problems for farmers in Europe, Japan, and Canada. While job gains from other industries will most likely provide a net increase in employment, the individuals that suffer the most are generally the ones least likely to find employment in a growth sector of the economy.

Free trade proponents tend to accentuate the positive and neglect the restructuring and retraining costs that accompany any free trade agreement. And the more significant the scope of the treaty, the higher the restructuring costs. Furthermore, most economists tend to downplay the significance of social costs when developing free trade models. “Economists might not approach with such ferocity, without any understanding of the human cost involved, the view that flux and labor turnover promote economic efficiency if they themselves were subject to the same flux,” commented Jagdish Bhagwati, a professor at Columbia University and free trade supporter.
A Modern History of Trade Agreements

Though economists have recognized the benefits of free trade since Adam Smith, the modern concept of global free trade was born during the Great Depression. Particularly important were the lessons of the United States after the passage of the Smoot-Hawley Act in 1930. By drastically increasing average tariffs on imports to 59%, the act effectively created a tariff wall around the United States, slaughtering imports and deepening an already serious recession.

By the time the U.S. government realized the seriousness of the problem and the need to cut tariffs, special interest groups and certain congressional districts had entrenched themselves against unilateral tariff cuts. The only solution left was to pursue bilateral trade agreements.

After successfully negotiating a series of bilateral deals with key American trade partners, tariffs in the U.S. fell to an average of 25% shortly after the end of World War II. However, the growth in international trade in the postwar era made bilateral trade agreements increasingly complicated. Thus was born the concept of multilateral negotiations under the auspices of GATT in 1947. Since that time, there have been eight significant multilateral trade discussions. The latest is known as the “Uruguay round,” named after the location of the initial negotiation sessions.

GATT governs the conduct of international trade through a series of rules. The signatory nations of any GATT treaty (of which there are now 117) agree to follow the regulations and amend domestic laws to conform to the treaties. There are several basic components to the GATT structure.

First, any new tariff must be offset by other tariff reductions to compensate trading partners. Second, export subsidies are forbidden except for certain agricultural products—an exception to be phased out as part of the Uruguay agreement. Third, import quotas cannot be imposed unless certain imports threaten “market disruption.” Finally, GATT encourages signatories to grant trading partners “most favored nation” (MFN) status, where bilateral tariff cuts—exclusive of regional trade deals—are extended to nations with MFN status.

While the central purpose of the GATT agreements has been to lower aggregate tariffs, they do not address non-tariff barriers (NTBs), which include voluntary export restraints, supply management organizations, and trade laws unfairly applied to foreign competitors. These NTBs are addressed through a process called tariffication, which quantifies their strength as an import barrier, allowing tariff reduction schedules to be applied and permitting domestic consumers and corporations to measure the true costs of import restrictions.

For example, the Canadian dairy, egg, and poultry supply management system will be dismantled as part of the Uruguay agreement, to be replaced by tariffs ranging from 182% on turkey to 351% for butter imports. While seemingly excessive, these tariffs can be gradually phased out over time to provide a transition period for farmers and a reliable progress indicator for aggregate tariff reductions.

The successful conclusion to the Uruguay round on December 15, 1993 is a landmark in reducing global trade barriers. The GATT will be transformed from a provisional agreement into a full international institution called the Multilateral Trade Organization, thus providing the basis for a trade dispute settlement mechanism. Furthermore, for the first time, cultural and service trade was included in the negotiations.

However, contentious issues such as cultural exports—which pitted France and the United States against each other in the final round of negotiations—remain to be addressed. Also, the United States appeared to have been successful in exempting taxation from the deal, thus allowing differential tax rates for foreign and domestic corporations—a thinly disguised NTB. Still, the benefits from the deal are likely to be significant, with the World Bank and OECD (the Organization of Economic Cooperation and Development) providing conservative estimates for increased annual worldwide output of some $200 to $275 billion annually.

Regional Trade Deals: NAFTA and CAFTA

While GATT addresses the issue of global trade, the rules specifically allow so-called regional trade deals, which are agreements among two or more nations to pursue free trade on a more aggressive scale than the globally binding GATT. Regional deals are generally among nations that share geographic proximity, and include the European Union, Canadian-American Free Trade Agreement (CAFTA), and most recently, NAFTA.

However, diligent free traders continue their opposition to regional trade deals in the fear that they will weaken GATT. To a certain extent, this is possible. A common pro-NAFTA argument proposed by the North American auto manufacturers during the debate was that the signing of the deal would keep Japanese auto producers out of the potentially lucrative Mexican market. Clearly, such sentiment contravenes the spirit of GATT and global free trade.

In broad terms, NAFTA will phase out nearly all trade barriers between Canada, the United States, and Mexico over a period of 15 years beginning January 1, 1994. By addressing
tariffs on nearly all manufactured items and including for the first time trade in services, agricultural products, and rules concerning taxation and intellectual property, NAFTA will create a free trade zone that includes some 375 million consumers—comparable in size to the European common market. Beyond straightforward tariff cuts, NAFTA will end current investment restrictions and will theoretically allow companies to operate in the same way regardless of location.

For the United States and Canada, NAFTA supersedes the 1988 CAFTA agreement that provided the model for NAFTA. As such, CAFTA can provide lessons regarding the new free trade alliance. While the CAFTA debate within Canada was every bit as contentious and emotional as the American NAFTA debate, free trade has started a significant process of economic restructuring within Canada for older industries that had traditionally enjoyed high levels of protection. This has allowed smaller, more nimble competitors to increase exports to the United States.

Certainly, free trade opponents continue to point to Canada’s persistently high unemployment levels—currently 11%—as evidence of CAFTA’s problems. But the fact remains that Canadian exports to the United States have risen by over 30% since 1991, a figure unimaginable without CAFTA.

But there are important differences between CAFTA and NAFTA, most notably the inclusion of intellectual property items, which was also a hot topic in the Uruguay round. Also included are new rules on transportation services. For example, while Canadian auto manufacturers will be rewarded with more secure access to American and Mexican markets, more stringent domestic content rules—which are already a source of trade friction for Japanese plants based in Canada—will be in place.

A key part of both CAFTA and NAFTA is the binding arbitration in cases of trade disputes. In effect, the trade tribunal initiated as part of CAFTA and composed of five members—two Canadian, two American, plus one other—gives the deal its teeth. For example, the tribunal recently ruled against the United States over punitive tariffs that had been imposed on Canadian softwood lumber. The panel’s decision forces the U.S. Commerce Department to reconsider the tariffs and reach a conclusion in accordance with the panel’s findings.

Both CAFTA and NAFTA are not without their faults, however. In particular, numerous concessions were made by Bill Clinton in order to ensure passage of the bill. These side deals included a development bank for the Mexican-American border, and agreements to assuage American wheat farmers near the Canadian border, wine producers in California, and citrus and vegetable farmers in Florida, to name just a few. As The Economist wrote, the arm-twisting to pass the deal was “a war of attrition where the chief weapon was pork.”

Finally, some industries will receive special protection under NAFTA. The Canadian culture industry, American airline and telecommunications sectors, and Mexican energy and railway industries all receive exemptions from key aspects of the deal.

**Next Steps for Free Trade**

The past year has been a hectic one for trade negotiators. The accomplishment of NAFTA, the GATT Uruguay round and other deals to cut tariffs and trade barriers is obvious: since GATT was established, average tariffs have fallen from 40% in 1947 to little over 5% today, and even less within regional trade deals such as CAFTA, NAFTA, and the European Union.

While the successful conclusions to NAFTA and GATT provide a significant step forward for free trade, there remains considerable work to be done. Such contentious international issues such as trade in culture, harmonized patent protection, and further progress in addressing trade in services remain. Moreover, as we embark into the information age, issues of intellectual property, copyright and information access loom ahead for future GATT and other trade discussions.

Also likely is the further development of regional trade alliances. Already, NAFTA’s expansion into Chile and other South and Central American countries has been predicted for the near future. Furthermore, the liberalization of former Eastern Bloc countries will no doubt mean further expansion for the European Union and its associated free trade zone, the European Free Trade Area (EFTA). Economic arguments will dictate that such growth will foster significant increase in global welfare. However, the social costs of unemployment, worker dislocation, and retraining must be considered in order to ease the pain in any move towards a truly international economy.

**Suggestions for Further Reading**


