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Econ 370

Honors Contract Essay

## Free Trade Agreements and Implications

### **Introduction**

The 2016 U.S. Presidential Election saw battle on many issues from immigration to the rising costs of college tuition, but perhaps none were more hotly debated than trade. Countless debates were carried out by experts, economists, political scientists, politicians, and lawyers to no end.

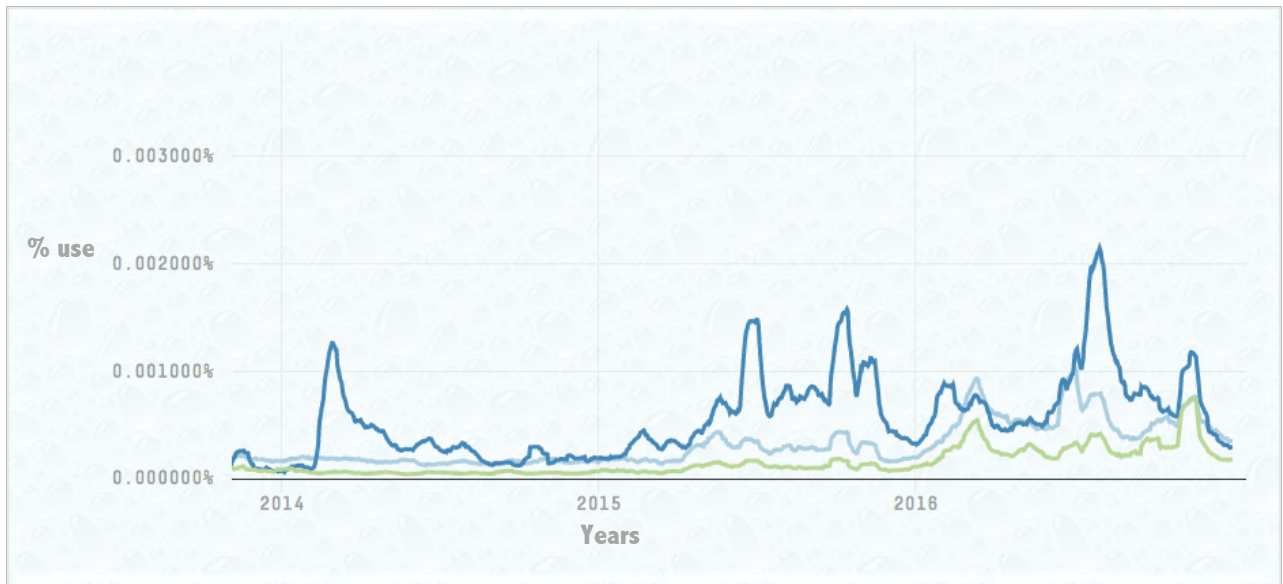
The most prominent voice of all was the republican nominee for President, Donald Trump, who often tweeted about the horrors of trade, "...NAFTA, the worst economic deal in U.S. History."

(1) In fact, there are a dozen other tweets saying similar things corroborating Trump's overall disgust with free trade deals. What's more, Trump just about single handedly made trade a relevant issue when prior to 2015 (when most candidates announced their campaign) it had been an issue that political analysts brushed off. You can see the stark increase in trade rhetoric from 2015 onward in Figure 1.0 from data collected on Reddit, a popular online forum (4). The phrase "free trade" is in light blue, "TPP" is in dark blue, and "NAFTA" is in green. Still, Trump didn't only tear apart NAFTA; public enemy No. 1 was the TPP (still being voted on during the campaign season) of which he had this to say, "Many republicans support TPP. They are stupid." (2).

However, while this debate may seem one sided, his showering of hate for free trade deals comes at strong odds with the longtime overall opinion of economists. According to the University of

Chicago Initiative on Global Markets, 95% of economists agree that the U.S. is better off for having signed NAFTA (3), and freer trade improves productive efficiency and choices for

Figure 1.0



consumers. This conflict in opinion was the fulcrum of the war that was waged over the campaign season. But, despite dozens of experts and officials touting the benefits of trade, Trump's polling numbers steadily increased until, finally, he won the republican nomination (a party that has historically supported free trade deals) and then the presidency of the United States. To an outsider this may seem very odd, but there's a reason Trump was able to secure votes from important swing states despite directly conflicting with experts. He appealed to many disgruntled Americans who have watched what appeared to be good jobs move overseas in the past 8 years. In addition, some U.S. towns that were once economically sound are now overgrown and succumb to widespread poverty and crime after local manufacturing plant shutdowns. For example, Tim Ryan, the U.S. representative for Youngtown, Ohio (a hard-hit Rust Belt town) says, "NAFTA is like the logo for economic inequality, deindustrialization

and lack of economic investment in the United States. (5)” Naturally, this disconnect in ideas raises some questions. If free trade and NAFTA brings prosperity to Americans why did the candidate who’s tough on trade win the election for President? How can it be that so many people are upset with trade? Who really sees the gains from trade? How bad are we harmed by not trading? Unfortunately, these are no simple questions and they require a requisite knowledge of free trade agreements and, the effects on countries.

### **NAFTA and TPP**

NAFTA was signed by the U.S. in 1993 to truly open a North American supply chain and increase trade between its member countries (Mexico, Canada, and the U.S.). All barriers to trade were set to be taken down by 2008. The key industries removing duties were textiles, apparel, automotive, agricultural, and some service related sectors. Other provisions put regulation on investment, government procurement, and intellectual property. More than 20 years after these provisions were put into effect, the estimates of NAFTA’s degree of overall contribution to the U.S. GDP and jobs is still up for discussion. However most agree that the effect was positive. The reason why the degree is still unknown is because it had such a small effect in total. U.S. imports/ exports only count as a fraction of our GDP, and trade with Mexico and Canada is estimated to make up less than a twentieth of our production. However particular sectors have seen benefit as trade in the auto sector has grown to almost eight times what it was pre-NAFTA (12). Another benefit is the creation of an international supply chain between Canada, Mexico, and the U.S. (Wharton). This cuts down on costs for large multinational firms and allows them to take advantage of each country’s specializations. Perhaps the most important benefit of NAFTA is seen by everyone. Trade lowers prices of consumer goods. According to

The Economist, “Excluding food and energy, prices of goods have fallen every year since NAFTA. This effect disproportionately helps low wage workers since consumer goods take up a larger percentage of their income (7).

The Trans-Pacific Partnership was a proposed agreement between 12 member countries mostly in the Asia (but not including China) and the U.S. The member countries were: the U.S., Japan, Canada, Australia, Mexico, Malaysia, Singapore, Chile, Vietnam, Peru, New Zealand, and Brunei. The elimination of trade barriers was set to be completed by 2030 with barriers coming down for agriculture goods, textiles, apparel, and many other goods and services. But, the TPP unlike some trade agreements of the past goes far beyond removing trade barriers. In the official U.S. summary of the document it’s stated that these reforms include, “issues related to the Internet and the digital economy, the participation of state-owned enterprises in international trade and investment, the ability of small businesses to take advantage of trade agreements, and other topics.” Some of the other topics dealt include intellectual property, government procurement, investment, labor conditions, and the environment. The hope with this sweeping document was to not only setup a trading relationship, but also setup standards for an international marketplace (11).

However, on January 23<sup>rd</sup>, 2017 President Trump signed a memorandum withdrawing the U.S. from the TPP (9). Many economists saw this as a major blow to American welfare, and in fact one report estimated every year the TPP is delayed would be a \$94 billion loss to the U.S. (10). This comes as no surprise after perusing the many analyses prepared to put out a projection on the overall impact of the TPP. Real GDP growth was expected to be 0.15-0.5% above trend by

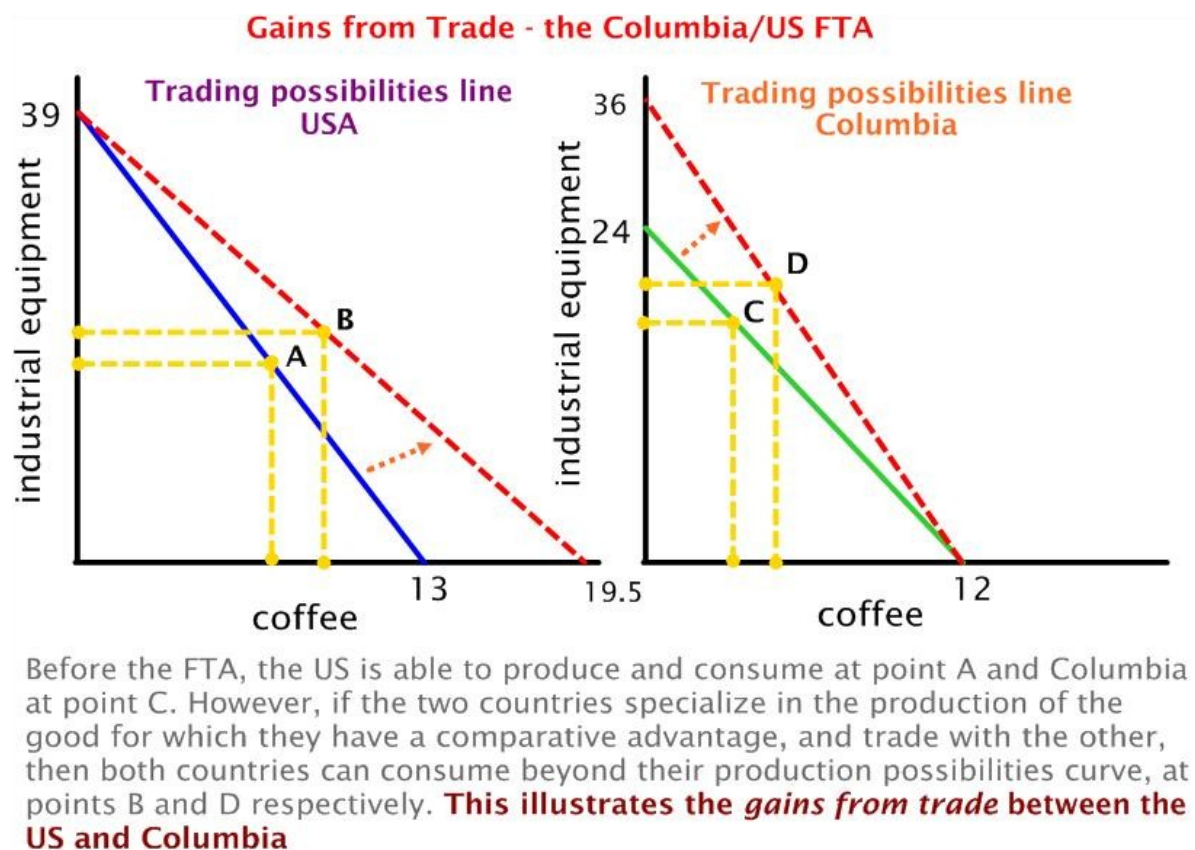
2032, and real income would have been 0.23% above baseline projections (10). Overall the consensus is that growth from the TPP was inevitable. In fact, while studies varied greatly on jobs projections, some projected creation of over 400 thousand jobs by 2030 (10).

## **Economic Implications**

Free trade agreements come in various sizes and each have different guidelines mostly dependent upon the countries in question. Still, the overall goal is to reduce or eliminate tariffs between the countries on some or all goods and services traded between the two countries. NAFTA is a regional trade agreement, which means that the parties involved are limited and usually geographically close by. Perhaps even more popular though are multilateral trade agreements like the TPP which is an agreement between many countries. These sweeping contracts, while difficult to compose, simplify things for member countries since any tariff one country receives, all must receive, and vis-versa. To keep things fair between members of differing regional trade agreements rules of origin must be placed to make sure that tariffs are respected. These rules just make sure that an outsider A can't effectively bypass a tariff set by country C by selling to a country B in a regional trade agreement with country C and has low or no tariff on a good from country A. This can be very confusing which is why destinations and origins must be tracked and managed well for trade. Inside these arduous agreements are mostly specifications on timing of tariff reductions and specific industries that will see tariff changes. Following the main pieces of the trade agreements are passages on labor and intellectual property. IP must be protected for firms to be incentivized to do business across borders, so specification is made in accordance with domestic rules. Labor, however; presents a much larger problem because the main objective of labor agreements is to increase working standards, in foreign countries especially.

This is more of a political move out of goodwill than proper economic reasoning, since low labor standards are the driver behind cheap low skill labor for many countries and the key to their comparative advantage. This idea is confirmed by the theory behind the Heckscher-Ohlin model, which shows how some countries can specialize in and thus export low skill labor and vis versa.

Figure 2.0



Still the more pressing concepts to understand about free trade are its economic implications.

The reason 95% of economists support free trade is that countless models show that there are gains to trading. There is a lot of economic change when moving from tariff based trade to free trade. The benefits consumers can expect to receive are lower prices, wider selection, gains in

efficiency for the entire economy from increased competition, better commercial relations, and access to more technology. The Ricardian and Specific Factor models of trade show increases in a country's possible consumption when compared to a closed economy. The basic idea behind this, is due to specialization in what a country's good at. This specialization in what you're good at is called using your comparative advantage. Once this has been achieved, worldwide production increases as resources are used more efficiently within each country. This idea is further expressed in Figure 2.0. However, while there is an overall economic gain, it should be noted that there are losers in these models too. It cannot be expected that *every* firm producing a certain good will stop making that good on realization that they aren't in a comparative advantage industry. Even more, workers are not the only people with stake in industries as there are capital owners of land, shoes, computers, etc. Determining winners and losers greatly depends on specific situations and foreign competition. Still, these conclusions while backed by data should be taken with a grain of salt specifically because most are made under key assumptions and very simplified models. In the real world, there are limitless varying factors playing into macroeconomic trends some of which are surely unpredictable and uncontrollable like political and social factors. Still it is known that trade has three main cons: potential job loss in certain sectors, potential lower wages, and concentrated adjustment costs. What makes things worse is that these costs are often delivered with much greater rapidity than the gains seen from trade, which are often spread over a decade. Since there are large pros and cons and an almost completely unpredictable whole economy at work, it's hard to know exactly what will happen. The main thing to keep in mind is that there will be changes to the economy in many ways and experts in the field believe that these changes net a more positive economy for society.

Changes aren't exclusive to member countries; in fact, many other countries outside of trade agreements can be hurt by them. Gain or loss of trade as a result of an agreement is referred to as trade creation/ diversion. Creation happens when two countries that have just come into an agreement with each other start trading a good or service they weren't previously because of the agreement. Diversion is then the opposite of this or when countries stop trading because of a trade agreement. These interactions reveal some of the only inefficient behavior of trade deals. This is because a country might have been previously trading with the most efficient producer of a certain good, but not continue to after a trade deal where lower tariffs made them switch to trading with a member country. Of course, this could be avoided in a world with no tariffs. Politically the implications to this play a very complex role. If a country you're currently trading with knows you intend to sign an agreement that will cease further trading will be against this deal and then perhaps engage in inefficient behavior to block the deal by lobbying.

## **Conclusion**

So, with such high praise for the TPP and NAFTA, why do hundreds of thousands, if not, millions of Americans (in the Trump camp) hate free trade agreements? The answer lies in concentrated losses. Overall economies benefit from imports and exports, but, as mentioned before, while macroeconomic trends see gains there are many structural adjustments to industry within the U.S. This means that many may lose their jobs, but new jobs are created elsewhere. For example, in the first years after NAFTA many automotive jobs were displaced, but overall the employment in the industry grew by 14.1% due to auto parts imports (5). According to the Economic Policy Institute more than 680 thousand U.S. jobs were displaced due to Mexican trade as of 2010 (8). However, it's important to give this number perspective. The Economist

says, “Between 2000 to 2007 Americans left 5m jobs a month and started 5.1m new ones.” This shows that trade effects truly are a drop in the bucket compared to macroeconomic trends. The churn of American jobs is huge and only 8% of U.S. jobs are even at mercy to be affected by trade (10). What’s more important is *who* was displaced. In fact, the lowest skilled workers tend to move to similarly vulnerable jobs and repeat a dangerous cycle (7). The hardest hit states (in terms of displaced jobs) were Michigan, Indiana, Kentucky, and Ohio. The clear majority of these jobs were manufacturing related (8). Now it’s clear to see that while trade creates net positives for the economy there are winners and there are losers. In addition, it was estimated that trade with poor countries decreased lower skilled worker’s wages by 10% in 2011 (7).

One look at Trump’s victory map combined with the information already shared can tell you, at the very least, a significant contribution to his win. Trump carried almost every Midwestern state, and some by a large margin. In fact, the hardest hit states for displaced jobs overwhelming voted for Trump (13). The truth is that the benefits of trade are widespread, slow, and almost invisible. While the damage from trade is often rapid, significant, and concentrated geographically (7). Still, the penalties are far more than Economists had predicted until recently. According to a study in the MIT Press on the effects of NAFTA, “A high school dropout living in an apparel and footwear-dependent small town in South Carolina, even if she is employed in the nontraded sector such as in a diner, where she would appear to be immune to trade shocks, would see substantially lower wage growth from 1990 to 2000 than if she were in, for example, College Park Maryland, which has few NAFTA-vulnerable jobs,” (14). The implications of this statement are far reaching. This raises questions about trade increasing inequality in wages, and perhaps disenfranchising a group of Americans. In this increasingly complex problem there is

even more to understand. The damage that people often cite as being caused by trade is often more related to growth in automation taking over manufacturing jobs (7). While there are programs to combat the structural changes of trade and displaced workers like the TAA (Trade Adjustment Assistance) program, they are, “woefully inadequate” according to the Economist (7).

Overall, I believe that trade should not be feared as the gains to productivity and growth to our economy are real and measurable. Still, trade needs to be respected and structural adjustments need to be respected more. Otherwise workers in the U.S. will feel disenfranchised and be encouraged to come to hate it. I think we’ve witnessed fear mongering that was propelled by the disenfranchisement of many Americans, and those that weren’t directly affected saw the damage done to cities they grew up in, knew someone in, or presided in themselves. While trade affects only a portion of our economy I think it’s nothing to be taken lightly, and the proper due diligence must be taken, not only by our leaders, but by us as citizens of this country to correctly adjust.

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