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People Prosper from Trade: NAFTA & TEXAS

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Key Points

- Free trade is the ability of individuals to meet in a marketplace and mutually benefit from voluntary exchange.
- People have flourished from increased trade and job creation across the country since NAFTA, and this increased market exposure has helped to diversify Texas' economy.
- Any renegotiation of NAFTA should be toward freer trade, along with making the U.S. and Texas economies more globally competitive so Texans and all Americans can prosper.

Executive Summary

The 1994 North American Free Trade Agreement (NAFTA) is a trilateral trade deal between the U.S., Mexico, and Canada designed to reduce transaction costs among Americans, Mexicans, and Canadians. Critics argue that NAFTA is a bad trade deal that impoverishes Americans by giving an unfair advantage to people in other countries. They have pushed to renegotiate NAFTA in the spirit of "fair trade" to reduce trade deficits and bring jobs back to the U.S. However, research shows NAFTA has positively contributed to increased U.S. economic activity and job creation.

The U.S. Chamber of Commerce notes trade among individuals in these countries supports a net 14 million U.S. jobs with increased trade after NAFTA contributing to 5 million of those jobs (9). These economic benefits occurred directly by reducing the cost of doing business with a broader market, and indirectly by lowering prices of goods and services that contribute to people having more purchasing power to satisfy their desires. A 2017 Gallup poll shows the public understands these benefits as 72 percent of Americans believe foreign trade increases economic opportunity. This support across the political spectrum is on the rise since 2011, with 80 percent of Democrats, 71 percent of independents, and 66 percent of Republicans now favoring foreign trade. These Gallup data suggest the economic benefits are widely understood wherein individuals voluntarily trading mutually prosper.

Before NAFTA, the U.S. and Canada traded with few trade barriers because of the 1987 Canada-U.S. Free Trade Agreement (CUSFTA). NAFTA primarily provided these two countries an institutional framework that further reduced trade restrictions. However, trade barriers plagued exchanges between the U.S. and Mexico. NAFTA eliminated roughly half of all tariffs, with most trade barriers phased out within 15 years. As the largest multinational trade deal, NAFTA was touted as having the potential for lowering business costs among member countries resulting in more economic output and job creation.

Texas is a major trading player among NAFTA member countries that would rank as the 10th largest economy if it were an independent country (Selby). In addition, Texas' proximity to Mexico could heighten the costs and benefits of the agreement. Texans have benefited from NAFTA as greater demand for exports and cheaper goods from imports have allowed opportunities to diversify away from the dominant energy sector over time, fostering more prosperity.

We recommend any renegotiation of NAFTA be toward freer trade. This includes reducing trade barriers within domestic rules of law that secure private property rights and remove protectionist measures picking industry winners and losers. In addition, domestic policies should be advanced in Austin and D.C. that support

more globally competitive economies so Texans and all Americans can flourish.

Economics of Free Trade

Free trade is the ability of individuals to meet in a marketplace and mutually benefit from voluntary exchange. As Americans benefit domestically within this framework, so can individuals in different countries. Within the framework of international trade, there is a place for government to be involved, but that involvement should be focused on ensuring cross-border enforcement of contracts (i.e., property rights), not imposing tariffs, quotas, or labor or environmental regulations on those trading. This focus also allows governments to engage one another in "free trade" agreements in order to remove existing barriers to trade.

Mercantilism ruled the day for centuries with the economic rationale that nations derive wealth from accumulating profitable balances (e.g., gold and silver) through trade surpluses with other countries. However, history proved that countries with trade surpluses had an increase in their gold stock, putting upward pressure on prices as money flowed into the economy. Higher prices reduced domestic purchasing power and left those countries less globally competitive and poorer in the process. Smith introduced the concept of absolute advantage in the 18th century, revolutionizing the way people thought about trade (I.1). Specifically, he explained there could be benefits from trade when one person could produce more of something in a given period than another, leading to division of labor and ultimately specialization. The resulting increased productivity from trade along with the accumulation of capital contributed to an increase in the wealth of nations. This explanation and historical evidence led to the demise of mercantilism. However, there was something missing in Smith's work, because if an individual or a country could produce more of everything in a certain period, then the person could be self-sufficient and not trade (i.e., autarky). In autarky, a person would reduce her satisfaction because practically every moment is spent sacrificing without reaping the benefits of that sacrifice, contributing to less wealth creation over time. Ricardo followed Smith with the concept of comparative advantage in the 19th century to avoid the inherent problems with absolute advantage (Chapter 7). A comparative advantage exists when people are relatively more productive at producing one good in a given period than a trading partner, resulting in the trading partner being relatively more productive at producing another good. This outcome allows individuals in trading countries to specialize in production of particular goods while having access to foreign markets to sell their products and purchase other goods. Consequently, exchange among individuals with a comparative advantage, or even a competitive advantage that also accounts for costs and quality of products, in member countries of a trade agreement supports more income growth than protectionist trade policy (Frankel and Romer, 394-395).

> Exchange among individuals with a comparative advantage or even a competitive advantage supports more income growth than protectionist trade policy does.

The structure of a free trade agreement matters as erected barriers to competition can hinder the growth and increase the volatility of member countries' economies (Edwards; Edwards and Ginn; Hartman). Potential economic and employment uncertainty from international trade gives Americans reason to question NAFTA and other trade agreements. Some Americans argue for "fair trade" because they associate international trade with specific job losses, which they deem unfair. While free trade agreements may not create net new jobs immediately as some industries fail to compete, lower trade costs support greater economic activity among industries able to compete, which initially reallocates the job mix, then increases the rate and net job creation over time (Cañas, 19). This is an example of the economic benefits of trade being often diffuse while the costs are acute. Ultimately, though, trade agreements benefit people by lowering prices, opening up previously inaccessible markets, and creating new opportunities to flourish.

Examining NAFTA

From its genesis, NAFTA has been politically controversial. Critics of NAFTA predicted an exodus of economic activity and jobs, which was famously echoed by the U.S. presidential candidate Perot, who predicted in 1992 that there would be a "giant sucking sound" as income and jobs left. Protectionists claim that perverse effects of trade deficits with member countries provide reason to renegotiate the agreement (Lawder and Wroughton).

In fact, the opposite occurred. The U.S. economy expanded, and more jobs were created after NAFTA.The U.S. Chamber of Commerce estimates trade among people in these three countries supports 14 million U.S. jobs with 5 million of those jobs related to the boost in trade since NAFTA (9).

Critics of free trade often point to trade deficits as a reason to oppose trade agreements, but trade deficits and surpluses are only one side of the trade equation. People benefit from trade regardless of whether there is a trade deficit or surplus. The value exchanged among individuals internationally is called "balance of payments," which includes the current account of goods and services and the capital account of financial assets. Stein expands on the balance of payments:

> *Because the current account and the capital account add up to the total account, which is necessarily balanced, a deficit in the current account is always accompanied by an equal surplus in the capital account, and vice versa. A deficit or surplus in the current account cannot be explained or evaluated without simultaneous explanation and evaluation of an equal surplus or deficit in the capital account.*

Given the identity in the balance of payments, the U.S. current account (trade) deficit of $566 billion in 2017 essentially equals its capital account (trade) surplus. Alternatively, the current account deficit, with imports of $2.895 trillion exceeding exports of $2.329 trillion, provides the total value of trade of $5.224 trillion as Americans trade with individuals worldwide (Census Bureau 2018a, 3). However, the current account trade deficit is often interpreted as a weakness for the American economy because of declining competitiveness or unfair trade agreements. Moreover, the Bureau of Economic Analysis' calculation of gross domestic product (GDP) as the sum of expenditures, specifically consumption, investment, government spending, and exports minus imports is misleading (2015). This calculation notes that a current account trade deficit reduces economic activity because dollars leave the country; however, this is based on the flawed logic of mercantilism above along with the fact those dollars return in the form of capital investment.

> Competition from foreign markets may get the blame, but job losses are often the result of domestic policies that raise costs of doing business.

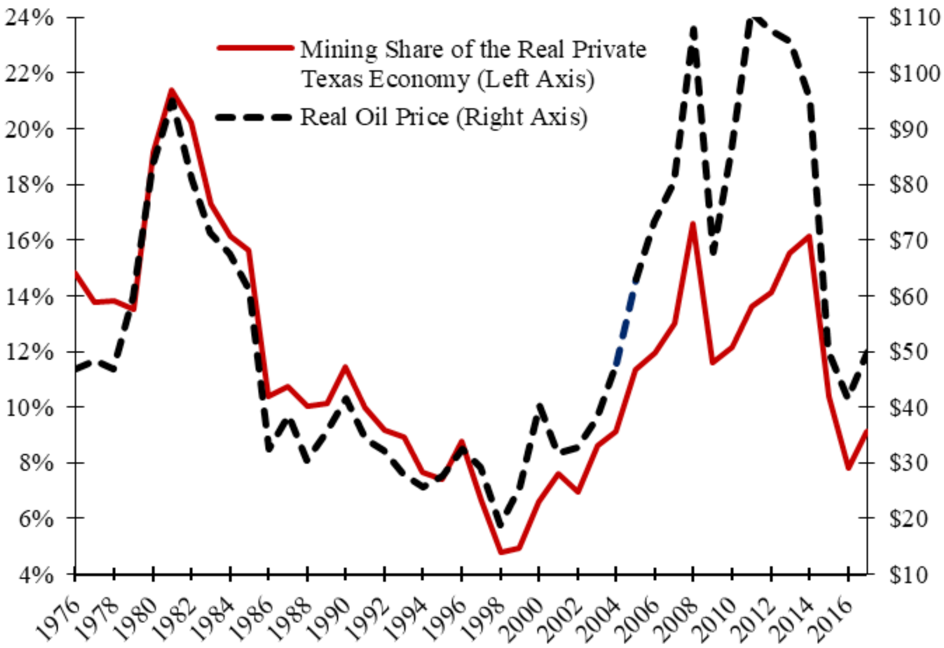
Some point to job losses in the auto manufacturing sector as an example of the cost to American auto workers from NAFTA, as lower prices of capital and labor in Mexico reduced America's competitive advantage (Hufbauer et al., 9-10). However, Ferguson and Villarreal conclude that NAFTA has had positive effects on the countries involved by increasing regional trade and by supporting foreign investment (11-12). In addition, Hufbauer and Cimino-Isaacs highlight gains in productivity and lower consumer prices after NAFTA. Scholars assert that the job losses in the manufacturing sector would likely have happened even in the absence of the agreement, primarily from China's manufacturing growth and the advent of efficiency-improving technologies (Autor et al.; Cocco). While this has been a boon to American auto consumers, some auto manufacturing workers were displaced. However, the same Mexican market that allowed for the reallocation of auto manufacturing opened up markets for the American petroleum industry, which has experienced a rapid increase in exports of gasoline to Mexico (EIA 2018a). Essentially, Mexicans are relatively more productive at producing cars than Americans while Americans more efficiently produce gasoline—an example of comparative advantage. As a result, both industries can produce more of their respective product and make both products more accessible to domestic and international populations, growing the economic pie and creating more net jobs over time. In fact, real (inflation-adjusted) GDP, even with its biased calculation against imports as the U.S. has long run a current account trade deficit, has increased since 1994 by $7.2 trillion, or 73 percent, to $17.1 trillion in 2017, and nonfarm employment has increased by 32.2 million, or 28 percent, to 146.6 million in that period. Not quite the "giant sucking sound" that Perot and others feared.

Although some auto manufacturing companies have suffered job displacement because of high-tax-and-spend policies and large unions, other auto manufacturing companies like Toyota flourished by moving to right-to-work states with pro-growth policies like Texas. Competition from foreign markets may get the blame, but the results of job losses are often dependent on domestic policies, at the state and federal levels, that raise costs of doing business. Moreover, individuals who lose their job have learned skills from on-the-job training that allow them opportunities to find work elsewhere.

NAFTA and Texas

Texas' proximity to Mexico and the volume of trade with NAFTA member countries provide a case study for the economic effects of the trade agreement. Texas marked its 16th straight year as the leader in exports nationwide in 2017, benefiting from trade with its two largest trading partners, Mexico and Canada (Aldeen). Considering all its foreign trading partners in 2017, Texas exports were $264.1 billion, or 17.1 percent of total U.S. exports, and imports were $263.3 billion, or 11.2 percent of total U.S. imports,

Figure 1. Texas economy's relationship with oil prices changed soon after NAFTA (2017 $)



Notes: Data are inflation-adjusted where appropriate, with 2017 as the base year, and are from the U.S. Bureau of Economic Analysis and Energy Information Administration.

for a trade surplus of $800 million (Census Bureau 2018b). Texas' top trading partner was Mexico with exports of $97.3 billion, or 36.8 percent of total exports, and with imports of $89.8 billion, or 34.1 percent of total imports, resulting in a $7.5 billion trade surplus for Texas. Trade with Canada represented the second highest exports of $22.8 billion, or 8.6 percent total exports, and third highest imports of $18.3 billion, or 6.9 percent of total imports, for a $4.5 billion trade surplus.[1] NAFTA contributes to a $12 billion trade surplus in a $1.7 trillion economy (Bureau of Economic Analysis 2017). However, instead of simply evaluating a trade surplus as positive or negative, consider that the balance of payments allows for people worldwide to benefit from total foreign trade with Texas of $527.4 billion.

Did NAFTA Contribute to Economic Diversification or a "Giant Sucking Sound" from Texas?

Figure 1 shows the real oil price and the mining sector's (dominated by oil and gas activity) share of the private economy from 1976 to 2017. These two variables provide an indication of the diversification of Texas' economy over time.

The mining share of Texas' private economy averaged 13.7 percent pre-NAFTA and 10.1 percent after. The real oil price averaged $52 per barrel with a compound annual average decline of 3.2 percent before 1994 and $58 per barrel after with a comparable average increase of 2.9 percent. Each period's highs for these variables were in 1981 with the mining share of 21.4 percent and real oil price of $95 per barrel while in 2008 the mining share was only 16.1 percent with a real oil price of $108 per barrel. The correlation between these two variables was 7.2 percent for the entire period. However, there is a stark difference between the two periods, as the correlations were 27.7 percent pre-NAFTA and only 7.2 percent thereafter, indicating economic diversification.

Regarding economic diversification, Ginn and Roach found that Texas' economy was more resilient to oil price fluctuations after NAFTA as lower-cost trade with Canadians and Mexicans incentivized broader market dynamics. However, as Texas' economy diversified to look more like other states, with expansions in sectors like technology, telecommunications, health care, and financial services outpacing the mining sector's over time (Koech and Wynne, 18), it tended to be more dependent on the rest of the U.S. economy. For example, employment in Texas now swings less with the oil and gas market and more with activity in the business and financial services sector (Dhaliwal et al.). While this can be beneficial, it also means that Texas may be more susceptible to business cycles in other states and national policy changes.

Texas has not had a net decline in job creation or economic activity since NAFTA, negating the fear of a "giant sucking sound." Texas' private economy expanded at a compound annual rate of 2.5 percent pre-NAFTA compared with 3.5 percent post-NAFTA, for an increase of $824 billion in the real private economic output. In addition, civilian employment increased, on net, by 1.3 million jobs for a compound annual growth rate of 2.8 percent in the earlier period while it increased by a net 4.1 million jobs for a rate of 1.7 percent after. The U.S. Department of Commerce notes that 11.5 million gross jobs were supported by U.S. exports in 2015, with 10 percent of those in Texas. Additionally, these data account for only part of the job creation supported by foreign trade. Imports often result in lower prices, higher

1 China is Texas' third highest trading partner in exports of $16.3 billion, or 6.2 percent of total exports, and second highest trading partner in imports of $42.7 billion, or 16.2 percent of total imports, for a $26.4 billion trade deficit.

productivity, and more business investment allowing people to have more money in their pocket, higher wages, and more job opportunities. In short, a focus on reducing trade deficits is not likely to be the best use of resources to make an economy more competitive. Estimating the potential cost to Texas if each NAFTA country substantially raised barriers to trade, Francois and Baughman find that Texas could lose almost 309,000 jobs within five years, which is equivalent to losing at least one year of recent job creation (20).

The data suggest Texans have prospered from freer trade with Canadians and Mexicans. However, foreign trade is not the only factor responsible for this prosperity. Pro-growth policies in Texas have also provided the institutional framework for Texans to thrive and for businesses to do business (Ginn; Peacock). The Fraser Institute's reports on economic freedom, which compare states and countries based on areas such as government spending, taxes, and regulation, rank Texas as the second best U.S. state (Stansel et al., 7) and the U.S. as 11th worldwide (Gwartney et al., 7). Over 230 scholarly articles by independent researchers have used the work by Stansel et al. to examine economic freedom at the state level, while more than 400 articles have done the same with the work by Gwartney et al. at the national level. The vast majority of this research finds that areas economically free from excessive government intervention generally experience positive outcomes, including more economic prosperity. States with the fastest economic growth, like Texas, have similar limited governmental institutions with relatively low taxes, limited spending growth, and sensible regulation that support entrepreneurial success (Stansel and Tuszynski).

NAFTA and Energy

NAFTA has contributed to America's resurgence in energy production. Its importance is highlighted by the fact that in 2017, 47 percent of petroleum imports (10.1 million barrels per day) into the U.S. came from Canada (40 percent), and Mexico (7 percent). Moreover, the U.S. exported 30 percent of petroleum exports (6.3 million barrels per day) to Mexico (17 percent) and Canada (13 percent)—the top two consuming nations (EIA 2018b). Although many in favor of protectionist economic policy favor full energy independence, crude oil imports allow America to run its refineries at their full capacity to create more valuable petroleum products that are consumed domestically and exported internationally. Again, the value of NAFTA stands out here, with the potential for North America to soon achieve liquid fuel self-sufficiency (API, 2).

Through maintaining and improving the energy provisions in NAFTA, the U.S. has the opportunity to further expand its energy dominance while also benefiting exporting countries. For example, the energy chapter of NAFTA is unlike other chapters (SICE, Chapter 6), as it was written in the context of Mexico's completely nationalized energy sector. Mexico had long maintained state control of natural resources, including natural gas, coal, and oil, resulting in only one petroleum company—the 75-year-old state-run Pemex. NAFTA currently is written to accommodate this past reality. For instance, Mexico can limit exploration, drilling, and refining of crude oil and natural gas. It can fully control the trade, transportation, and distribution of crude oil, natural gas, petrochemicals, and products made with petrochemicals. NAFTA also states that private investment in these resources can only be performed if the Mexican government permits a contract (SICE, Annex 602.3).

As with most government-created monopolies, Pemex has been plagued by corruption and inefficiency, ultimately forgoing risks and prospects for sub-surface resources. However, Vietor and Sheldahl-Thomason note that these issues led to a surprising move in 2013 to gradually privatize the energy sector (4). Constitutional changes were fully in place by 2014 with the goal of improving efficiency of Pemex, reduce corruption, and allow foreign investment, prospecting, and exploration in Mexico's energy sector. Increased production of Mexico's crude oil and natural gas often results in more business for refineries in Texas and elsewhere in the U.S., contributing to greater economic activity and job creation. However, there is no guarantee these economic benefits will continue.

While there could be benefits of renegotiating NAFTA to better represent the realities of privatization of Mexico's energy sector by agreeing to enhance private property rights, exit from NAFTA might nullify the opportunities and economic gains made from trade. For example, a new Mexican president could nationalize the energy sector again, meaning that U.S. oil and gas companies could lose their capital there. An amendment to NAFTA's energy chapter that protects private property rights for oil and gas companies would be a win for energy companies and people.

Thanks to NAFTA, proximity, and profit motives, Texas refineries have become intertwined with Mexico's energy sector. In 2016, Texas exported $37.1 billion in petroleum and coal products (second only to computer and electronic products of $47.1 billion), with much of it going to Mexico and Canada (Kreutzer). Matthews notes that the U.S. energy sector had a positive trade surplus with Mexico of $11.5 billion in 2016. Although the U.S. is the leading producer of petroleum in the world, America uses six million barrels more of oil and related products per day than we produce. Canadian producers satisfy three million barrels a day of that demand, with Mexico sending about 688,000 barrels of oil per day. When this industry grows, Texas and America prosper. For example, Texas created 26 percent of all U.S. civilian jobs with only 9 percent of the U.S. population from December 2007 to December 2017, that is from the beginning of the last U.S. recession and amid the shale revolution. (Bureau of Labor Statistics).

Sammon estimates that NAFTA already supports about 8 percent of the U.S. economy and 9.8 million energy jobs. Although it is difficult to predict the future, the positive effects of NAFTA could expand if the agreement was modernized toward freer trade, along with fewer energy-related restrictions in Mexico and increased protection of private property rights to reduce political uncertainty.

Freer Trade and Economic Competitiveness

Free trade brings tremendous economic benefits to all involved. But it can expose the harm caused by anticompetitive domestic regulations. Policymakers should consider the evidence of increased economic prosperity from foreign trade agreements, despite their imperfections, and focus on reducing government regulation on the American economy to allow domestic businesses to be more competitive, domestically and globally.

Policymakers should focus on reducing government regulation on the American economy to allow domestic businesses to be more competitive.

Such policy changes include rolling back needless regulations, cutting taxes, and restraining government spending that drives higher taxes and funds regulatory bureaucracies. The Trump administration and Congress took valuable steps in this direction regarding tax and regulatory reforms in 2017, but there is more work to do regarding restraining government spending, without which the benefits of reform will not last. Similar policy choices should also be made in Texas. These steps will help both increase economic competitiveness in a global economy and stop pointing the finger at foreign countries when domestic policies are the cause of the problem.

Moreover, any renegotiation of NAFTA or other trade agreements should be toward freer trade without government privilege to private businesses. This should also include expanding free trade agreements with other countries to lower exchange costs so more people worldwide can improve their standard of living. As we go down this path toward trade liberalization, it is worth reiterating that free trade does not necessarily initially create a net number of new jobs, and often the economic benefits are diffuse while the tradeoffs can be acute. Ultimately, though, free trade benefits everyone by lowering the general price level, opening up previously inaccessible markets, and creating new industries that provide more opportunities for people to flourish.

Conclusion

Americans trade with the rest of the world for the same reasons that they trade with each other. They trade because it allows them to satisfy their desires while focusing their efforts on what they do best, which in turn raises productivity, incomes, and standards of living. A free enterprise system in which government institutions preserve liberty best supports individual prosperity, even between countries.

Renegotiating NAFTA could serve as a valuable opportunity to promote prosperity, but only by reducing trade barriers and government privilege so individuals in different countries can mutually benefit. In addition, the U.S. can help keep businesses from fleeing and support more job creation at home by cutting excessive government spending, ensuring a pro-growth tax system, and rolling back onerous regulations. The same is true for Texas. By effectively restraining government spending, Texas can lower tax and regulatory burdens to provide an economic environment most conducive to business investment and hiring.

NAFTA renegotiation, if desired, should focus on modernizing the agreement to reflect the many changes that have taken place in industries, and to consider the creation of new industries, since it was originally signed into law decades ago. The energy sector is a great example of an area where modernization may be necessary. However, a successful renegotiation of NAFTA should ultimately respect the tenets of free trade, by focusing on removing barriers to trade, instead of erecting them. This includes reducing trade barriers within domestic rules of law that secure private property rights and remove protectionist measures picking industry winners and losers.

There is much at stake with the outcome of renegotiating NAFTA. Economic growth, standards of living, and successes of many businesses lie in the balance. If the focus is on the principles of freedom and liberty, the outcome of an improved NAFTA will be to let people prosper, whether they are Texans, Americans, Mexicans, or Canadians.

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About Texas Public Policy Foundation

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