Texas Conservative Coalition Research Institute

The Importance of NAFTA and Free Trade to Texas

A Policy White Paper

October 2017

"Few ideas have been as widely accepted by economists and as roundly rejected by many other people as the doctrine of free international trade."[1]

[1] Bob McTeer, "David Ricardo: Theory of Free International Trade," Economic Insights, Federal Reserve Bank of Dallas, Vol. 9, No. 2; online at: https://www.dallasfed.org/assets/documents/research/ei/ei0402.pdf

Background: Free Trade in Theory and Practice

Free trade between nations is one of the foundational concepts of modern economics. In the 19th century, British economist David Ricardo demonstrated in the clearest possible terms how unfettered trade between nations benefits both countries:

> Ricardo demonstrated that for two nations without input factor mobility, specialization and trade could result in increased total output and lower costs than if each nation tried to produce in isolation. Since Ricardo's exposition, the distinction between absolute and comparative advantage has been taught as one of the field's most brilliant insights. Nations will export not only what they have an absolute advantage in producing, but also what they have a comparative cost edge in producing.[2]

Ricardo's realization that comparative advantage (when a country is *relatively* more efficient at producing certain items, or, perhaps more accurately, relatively *less inefficient* at producing those items) allows all countries to benefit from free trade, was groundbreaking because it showed that a country benefits from free trade even if it does not have an absolute advantage (in terms of efficiency) in producing the goods it exports. This broke from the orthodoxy espoused by luminaries such as Adam Smith:

> [According to Smith] if Japan produced cars, computers, food and clothing more efficiently than the US, Japan would export all these goods to the US. The US would run a large trade deficit with Japan [and] the US would likely be hurt by this trade deficit, since American jobs would be lost to Japan.
>
> But for Ricardo there was no problem if one country was less efficient at producing everything. Trade, he contended, depended on comparative advantage, or relative efficiency, rather than on absolute efficiencies … through specialization each country would gain from international trade.[3]

Ricardo illustrated his point with simple numerical examples[4] and yet, as former Dallas Fed President Bob McTeer notes, "few ideas have been as widely accepted by economists and as roundly rejected by

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[2] *Ibid.*

[3] Steven Pressman, "50 Major Economists," 3rd Edition, Routledge (2013).

[4] "Suppose both Japan and the US each produce either one car one ton of rice in any given year. In Japan, one agricultural worker can produce two tons of rice in a year, and one manufacturing worker can produce three cars in one year. For both rice production and automobile manufacturing Japanese workers are absolutely more productive than American workers. However, Japanese workers are absolutely more productive than American workers. However, Japanese workers are relatively more efficient at producing cars and US workers are relatively less inefficient at producing rice. Japanese workers are three times more efficient in manufacturing cars, US workers are only half as efficient as the Japanese when it comes to growing rice.

What Ricardo demonstrated is that both the US and Japan would gain from specializing in what each does better at making, and then trading with each other. The argument runs as follows. Suppose the US has 200 workers and Japan has 100 workers, and that workers are divided equally between car production and rice production in each country. The US then produces 100 cars and 100 tons of rice, while Japan produces 150 cars and 100 tons of rice for the year. Combined output for both countries is 250 cars and 200 tons of rice.

many other people as the doctrine of free international trade … Today, world trade agreements are under increasing attack. Many people are deeply concerned about such issues as outsourcing and the physical location—and relocation—of firms doing business across national borders."[5]

In last year's presidential election campaign, Republican nominee Donald Trump made free trade deals (notably the North American Free Trade Agreement or NAFTA, and the Trans-Pacific Partnership or TPP) a centerpiece of his campaign. Statements such as "we are killing ourselves with trade pacts that are no good for us and no good for our workers,"[6] and "since China joined the WTO, Americans have witnessed the closure of more than 50,000 factories and the loss of tens of millions of jobs,"[7] became hallmarks of the Trump campaign. Similarly, Democratic nominee Hillary Clinton affirmed her position, attesting that "I will stop any trade deal that kills jobs or holds down wages, including the Trans-Pacific Partnership … I'll oppose it now, I'll oppose it after the election and I'll oppose it as president."[8] But these critiques of free trade and free trade agreements miss the mark.

Overseas trade is a two-way street

Since the advent of NAFTA in 1994, trade with Canada and Mexico has risen by 350 percent to $1.2 *trillion* per year. This trade supports 14 million jobs in the United States, 5 million of which are directly attributable to NAFTA, according to a comprehensive study completed by the U.S. Chamber.[9] Texas in particular benefits from this trade, with 387,000 jobs supported directly by exports to Canada and Mexico.[10]

Texas exported about $95 billion worth of products to Mexico in 2015, representing 37 percent of total state exports and an increase of 30 percent since 2010. Texas' second largest export destination is Canada at $25 billion in 2015. In total, according to the U.S. Department of Commerce:

> The United States currently has free trade agreements in force with 20 countries, which accounted for $155.5 billion (62 percent) of Texas's exports in 2015. Since 2005, exports from

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Now consider what happens when Japan specializes in car production and the US specializes in rice production. In Japan, 100 workers make 300 cars; in the US, 200 workers produce 200 tons of rice. World output has gone up by 50 automobile due to specialization. Many people will be better off because more cars get produced."
Steven Pressman, "50 Major Economists," 3rd Edition, Routledge (2013).

[5] Bob McTeer, "David Ricardo: Theory of Free International Trade," Economic Insights, Federal Reserve Bank of Dallas, Vol. 9, No. 2; online at: https://www.dallasfed.org/assets/documents/research/ei/ei0402.pdf

[6] Guian McKee, "This is What Trump and Sanders get wrong about free trade," The Washington Post, May 17, 2016; online at: https://www.washingtonpost.com/news/monkey-cage/wp/2016/05/17/this-is-what-trump-and-sanders-get-wrong-about-free-trade/

[7] https://www.donaldjtrump.com/positions/us-china-trade-reform [accessed October, 2016]

[8] Amber Phillips, "How progressives are putting Hillary Clinton in a tough spot on trade (again)," The Washington Post, August 14, 2016; online at: https://www.washingtonpost.com/news/the-fix/wp/2016/08/14/how-progressives-are-putting-hillary-clinton-in-a-tough-spot-on-trade-again/

[9] U.S. Chamber of Commerce, "NAFTA Triumphant: Assessing Two Decades of Gains in Trade, Grwoth, and Jobs," (2012); online at: https://www.uschamber.com/sites/default/files/legacy/reports/1112_INTL_NAFTA_20Years.pdf

[10] Ibid.

> Texas to these markets grew by 93 percent, with NAFTA, Colombia, Korea, CAFTA-DR, and Panama showing the largest dollar growth during this period.[11]

Trade between Texas and Mexico should also continue to grow as the Mexican economy continues to expand and develop. In recent years Mexico has grown its economy at a relatively impressive rate and consistently outperformed projections.

Pantheon Macroeconomics recently noted that "the Mexican economy is still growing at a healthy pace, thanks to solid domestic demand, offsetting the hit from lower oil prices,"[12] while Mexico's deputy finance minister also noted that "in a complex, volatile environment, the Mexican economy is growing more than in the same period a year ago, at a faster pace than in the first half of this year and above analyst estimates."[13] The Heritage Foundation's Index of Economic Freedom rates the Mexican economy quite highly in a number of trade-related areas, and reports that "Mexico has reduced tariff and non-tariff barriers both unilaterally and through trade agreements … The financial sector has become more competitive and open in spite of the challenging global environment. Banking remains relatively stable, and foreign participation has grown rapidly."[14]

Trade with Canada and Mexico is also far more balanced from a U.S. perspective than it is with many other countries. In 2015, for example, the U.S. ran a $367 billion trade deficit with China (61 percent of total trade with China) and a $155 billion deficit with the European Union (22 percent of all E.U. trade), but only a $66 billion deficit with Mexico (11 percent of total trade with Mexico).[15] This type of mutually beneficial trade with a growing and developing economy should continue.

In fact, trade deficits – situations in which a country imports a greater value than it exports – do not cost jobs. Most developed countries have a large physical trade deficit, because they consume more raw materials than they produce. In fact, rising trade deficits correlate with falling unemployment rates, and trade deficits may even signal global investor confidence in the United States and rising purchasing power among domestic consumers. Indeed, a 2016 *National Review* piece explains that:

> Deficits don't happen because the wily Japanese juke us on trade policy. They happen because intelligent people holding a fistful of dollars very often decide to forgo the consumption of American consumer goods in order to invest in American assets.
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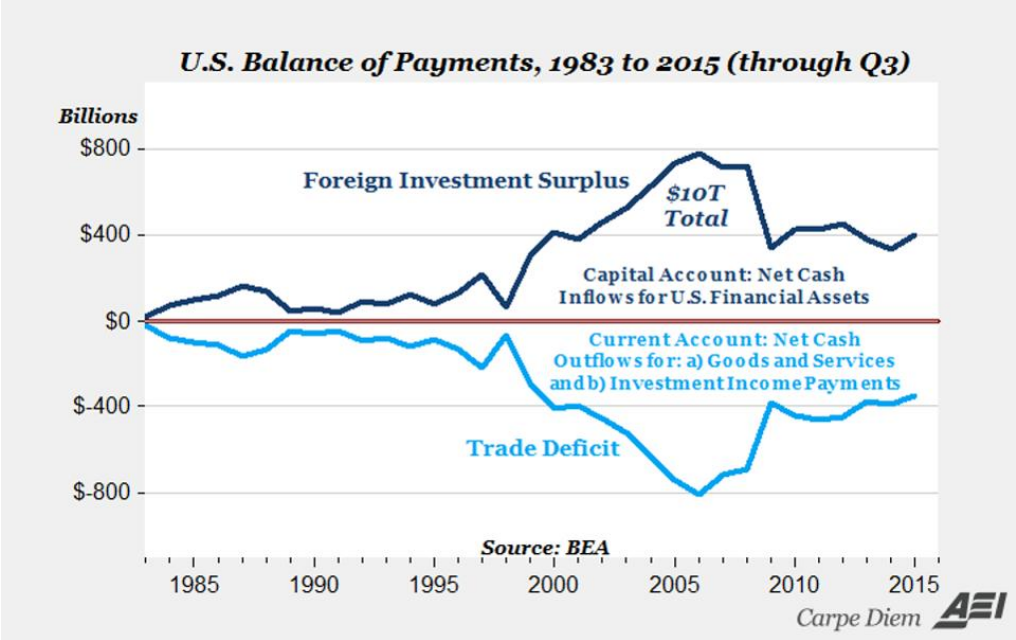
> In economics terms, what this means is that the trade deficit is a mirror image of the capital surplus. A capital surplus isn't necessarily an unalloyed good (everything in economics is about

[11] Ibid.
[12] Brendan Case, "Mexico GDP Growth Beats All Forecasts as Pickup Accelerates," November 20, 2015, Bloomberg.com; online at: http://www.bloomberg.com/news/articles/2015-11-20/mexico-gdp-growth-beats-forecasts-as-economic-pickup-accelerates
[13] Ibid.
[14] Heritage Foundation, 2017 Index of Economic Freedom; online at: http://www.heritage.org/index/country/mexico
[15] U.S. Census Bureau, U.S. Trade in Goods by Country; online at: https://www.census.gov/foreign-trade/balance/index.html

tradeoffs), but it is a pretty nice thing to have around if you are, say, an entrepreneur looking to build a new facility in Houston or Jacksonville and looking for some investors to stake you.[16]

The following chart illustrates the trade deficit/capital investment surplus perfectly:



Source: American Enterprise Institute

Manufacturing facilities have been moving locations for decades

It must also be noted that even trade with countries where the U.S. runs a significant trade deficit is similarly beneficial. As the Cato Institute has noted:

> There is no connection between trade deficits and industrial decline. From 1992 and 1997, the U.S. trade deficit almost tripled, while at the same time U.S. industrial production increased by 24 percent and manufacturing output by 27 percent. Trade deficits do not cost jobs. In fact rising trade deficits correlate with falling unemployment rates. Far from being a drag on economic growth, the U.S. economy has actually grown faster in years in which the trade deficit has been rising than in years in which the deficit has shrunk. Trade deficits may even be good news for the economy because they signal global investor confidence in the United States and rising purchasing power among domestic consumers. What matters to the economy is not the difference between imports and exports but the extent to which Americans are free to benefit from the efficiencies, opportunities and consumer choice created in an economy open to world trade.[17]

[16] "We Do Not Have a Trade Deficit," Kevin D. Williamson, National Review, December 7, 2016: http://www.nationalreview.com/article/442828/donald-trump-trade-deficit-ignorance-and-misunderstanding

[17] Daniel Griswold, "America's Maligned and Misunderstood Trade Deficit," Cato Institute, April 20, 1998; online at: http://www.cato.org/publications/trade-policy-analysis/americas-maligned-misunderstood-trade-deficit

At its core, trade is essentially a key element of competition between businesses and industries in different countries. Corporations frequently move their facilities within the United States in order to take advantage of a better business or tax climate, or a more skilled workforce in one state or another. Similarly, businesses may seek to locate their manufacturing facilities or corporate headquarters in the country where it is most advantageous for them to do so. This simply underscores the competitive nature of the global economy and that every nation must strive for the most competitive tax and regulatory structure that it can achieve, combined with a competitive labor market that can provide the skilled workforce that businesses require. Consider the following analysis of Carrier Air Conditioning, which has been frequently attacked by Donald Trump for its decision to relocate two of its Indiana manufacturing facilities to Mexico:

> Carrier has been moving factories since it was founded more than a century ago. Engineer Willis Carrier invented the first functional air conditioner in 1902. His employer, the Buffalo Forge Manufacturing Co. in Buffalo, created Carrier Air Conditioning as a subsidiary. Carrier became an independent company in 1915. Between 1918 and 1921, it moved its headquarters, research laboratory and production facilities to a technologically advanced plant in Newark. After a series of mergers, Carrier moved again, consolidating its operations at a 30-acre site in Syracuse, N.Y., in 1931 … During the 1950s and 1960s, it opened production facilities in locations around the United States that had low labor costs, including one in Indianapolis and others in the South. Beginning in the 1980s, the corporation began a global expansion strategy that involved acquiring foreign air-conditioning manufacturers. As early as 1990, almost half of Carrier's production took place overseas. In 2004, Carrier closed its Syracuse manufacturing facility and offices.[18]

The central point is that free trade and free trade agreements do not cause the loss of manufacturing jobs. Global and national economic trends shift over time and successful businesses respond accordingly, hence textile factories fled labor unions in New England in the 1920s, the auto industry left Detroit starting in the 1950s, and the steel industry largely vacated Pittsburgh starting in the 1970s. There are many factors that explain these shifts. The author of the Carrier analysis, Guian McKee of the University of Virginia, explained the factors that led Carrier to move so many times in the course of its (highly successful) existence thusly: "proximity to new markets; the need for modernized facilities; evading unions; and local and state tax incentives. But one factor has been constant: the pursuit of low-cost labor."[19]

There are many factors that can cause labor costs to rise, but is also worth noting that numerous other factors, including improvements in manufacturing productivity and shifts in the *types* of products being manufactured that create the impression that manufacturing output or employment is declining.[20] The

[18] Guian McKee, "This is What Trump and Sanders get wrong about free trade," The Washington Post, May 17, 2016; online at: https://www.washingtonpost.com/news/monkey-cage/wp/2016/05/17/this-is-what-trump-and-sanders-get-wrong-about-free-trade/

[19] Ibid.

[20] Tim Worstall, "The Myth of the Decline of UK Manufacturing," June 22, 2011, Forbes.com; online at: http://www.forbes.com/sites/timworstall/2011/06/22/the-myth-of-the-decline-of-uk-manufacturing/#5157532149ba

data underscore this point. Analyzing U.S. manufacturing output and employment since 1972, the Federal Reserve Bank of St. Louis notes that:

> As a year-over-year percent change, the level of manufacturing has generally grown. (One striking exception is during the recent recession.) The *number of employees* working in manufacturing is a different story, however. It has sometimes grown, but it has nearly always grown less than the growth in manufacturing. This suggests that growth in manufacturing does not equal growth in manufacturing *jobs*. What's the explanation? A prime candidate is productivity growth. Another is that the sectoral mix has shifted toward industries with higher value added, such as computers and electronics.[21]

Furthermore, a recent study by Ball State University attributed 90 percent of manufacturing job losses in the U.S. to productivity gains, noting that "had we kept 2000-levels of productivity and applied them to 2010 levels of production, we would have required 20.9 million manufacturing workers. Instead, we employed only 12.1 million."[22]

Overbearing federal taxes and regulations are the real drag on the economy

To the extent that U.S. corporations locate manufacturing facilities overseas, labor costs are likely a primary contributor. These costs come in many forms, ranging from direct impositions such as minimum wage requirements, to indirect costs attributable to business taxes and regulations. These factors must also be balanced against the relative size of the welfare state in the United States, and how ready access to unemployment assistance and other government transfer payments negatively impacts labor market participation. On this point, writing in *National Review,* Scott Lincicome notes that:

> Total non-farm job openings, for example, are at their highest point on record (including well over a million unfilled jobs in "blue collar" fields such as manufacturing, construction, and transportation) and continue to outpace hirings. Workers have recently appeared more willing to quit their jobs and seek others, but the civilian labor-force-participation rate has hovered near its lowest point (62.5 percent) since the late 1970s—a problem caused in part by the fact that workers have become less likely to move to areas with better employment opportunities, choosing instead to remain in places hit hard by the Great Recession and to drop out of the labor force entirely.[23]

In April 2016, the Mercatus Center at George Mason University released an extensive report on the cost to the economy of federal regulations. The report concludes that from 1977 to 2012, federal regulations reduced the United States' rate of economic growth by 0.8 percent annually. Put another way, if the cost of compliance with federal regulations had remained at the 1980 level through 2012, the U.S.

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[21] Federal Reserve Bank of St. Louis, "Manufacturing is growing, even when manufacturing jobs are not," December 18, 2014; online at: https://fredblog.stlouisfed.org/2014/12/manufacturing-is-growing-even-when-manufacturing-jobs-are-not/

[22] Scott Lincicome, "The Truth About Trade," *National Review*, April 11, 2016.

[23] *Ibid.*

economy would have been 25 percent larger than it actually was. In real terms, that amounts to $4 trillion of lost economic growth[24], or about $13,000 per capita. The report's authors concluded that:

> The buildup of regulations over time leads to duplicative, obsolete, conflicting, and even contradictory rules, and the multiplicity of regulatory constraints complicates and distorts the decision-making processes of firms operating in the economy. Firms respond to both individual regulations and regulatory accumulation by altering their plans for research and development, for expansion, and for updating equipment and processes … the deterrent effect that intervention can have on knowledge growth and accumulation can induce considerable deceleration to an economy's growth rate. Our results suggest that regulation has been a considerable drag on economic growth in the United States.[25]

It is important to remember that federal regulations affect different states differently. The cost of federal regulation to Texas is the 6th highest in the nation, which translates to an impact that is 29% higher than nation as a whole.[26] This is due primarily to Texas' relatively high levels of production of petrochemical products, oil and gas extraction, as well as electric power generation & transmission, and even auto manufacturing. According the Mercatus Center's analysis, the federal Environmental Protection Agency (EPA) is by far the federal agency with the most significant regulatory impact on Texas. And, as Governor Greg Abbott noted in a November 2011 column addressing newly proposed EPA regulations:

> Regulatory overreach by the EPA creates economic uncertainty and discourages employers from expanding their businesses, which exacerbates unemployment and stifles job creation. These draconian new federal regulations will require Texas employers to spend millions of dollars on regulatory compliance – rather than new employees – and threaten project delays, factory closures and job losses.[27]

A dire example of these overreaching regulations is the 2010 moratorium on deep water offshore oil drilling on the Outer Continental Shelf, including in the Gulf of Mexico. Although a preliminary injunction and, ultimately, a stay were issued against the moratorium, litigation is ongoing leading to significant regulatory uncertainty and damage to employment along the Gulf Coast. Reports indicate that:

> As a result of decreases in investment due to the moratorium, total U.S. employment is estimated to have been reduced by 72,000 jobs in 2010 and approximately 90,000 jobs in 2011 … Since April 2010, 11 drilling rigs left the Gulf for Brazil, Egypt or Angola, generating more than an estimated $21 billion in investments in those countries. More than 130 offshore drilling projects have been

[24] Coffey, McLaughlin, & Peretto, "The Cumulative Cost of Regulations," Mercatus Center, April 26, 2016; online at: http://mercatus.org/publication/cumulative-cost-regulations
[25] *Ibid.*
[26] "The Impact of Federal Regulation on the 50 States," Quantgov.org; online at: http://regdata.org/50states/texas/
[27] Greg Abbott, "Economic Impact of Federal Regulations," November 2011; online at: https://www.texasattorneygeneral.gov/agency/weeklyag/2011/1111regulations.pdf

delayed by almost a year and half, since the moratorium, compared with 46 projects being delayed pre-moratorium."[28]

This one example of a poorly-conceived regulatory action illustrates the broader point that every regulation has an impact on jobs, investment, and economic growth. The National Association of Manufacturers estimates that the annual cost of complying with federal regulations is $2 trillion, which translates to $233,182 for the average U.S. business, or 21 percent of payroll.[29] Combine these costs with the third-highest corporate tax rate in the world (behind only Chad and the United Arab Emirates), and the United States has created conspicuous disincentives for job creation and investment compared with almost every other country with which it trades.

In such an environment, it would be sensible for the U.S. to make it easier for workers to adjust to the changing landscape of manufacturing employment. But, in fact, the federal tax code works in the opposite direction. The business deduction for work-related education, for example, "permits a worker to deduct education and training expenses from his taxable income, but only if they relate to his current job."[30] As Scott Lincicome again points out, "thus, a textile-factory worker can get a tax benefit for new training on the latest garment machine, but he cannot get the same benefit for night classes to become a certified IT specialist. Such a system discourages workers in dying fields from preparing themselves for a new career."[31]

Combine these types of disincentives with the 11th-highest minimum wage among developed (OECD) countries, a workforce that is highly regulated through robust occupational licensing schemes, numerous employment protection laws, and the rejection of "right to work" legislation in 24 of the 50 states, and it is clear that, at a minimum, depressed employment growth can be attributed to multiple factors that can be solved through federal and state level regulatory and tax reform. In David Ricardo's terms, these factors certainly hinder the extent to which the U.S. can develop a "comparative advantage" in the manufacture of product. And even where such an advantage exists, it is certainly reduced significantly by these regulatory and tax burdens. Reforming these areas would make the entire economy more competitive and would put U.S. businesses on a more level playing field with our trading partners.

Conclusion: The Future of NAFTA

On October 11, NAFTA renegotiations will recommence between the U.S., Mexico, and Canada. The free trade agreement has come under a lot of criticism, not least from President Trump, who repeatedly links NAFTA to American job losses and trade deficits with Mexico. U.S. Trade Representative Robert Lighthizer notified Congress that the President intended to initiate negotiations with Canada and Mexico

[28] Pierre Bertrand, "Gulf Oil Drilling Moratorium, 'Permitorium' to Cost Nation $24B, Industry Says," International Business Times, January 11, 2012; online: http://www.ibtimes.com/gulf-oil-drilling-moratorium-permitorium-cost-nation-24b-industry-says-394336

[29] National Association of Manufacturers, "The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business," (2012); online at: http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Executive-Summary.pdf

[30] Scott Lincicome, "The Truth About Trade," *National Review*, April 11, 2016.

[31] Ibid.

to modify NAFTA, noting that among the needed changes are new provisions to address intellectual property rights, regulatory practices, state-owned enterprises, and customs procedures.[32]

Lighthizer pledged that the Trump Administration would work closely with Congress to review elements of NAFTA and address the challenges to U.S. consumers, businesses, farmers, ranchers, and workers in an increasingly global economy.[33] Texas provides nearly half of all U.S. meat and poultry exports to Mexico. Texas farmers and ranchers have tremendously expanded their businesses thanks to NAFTA. Senators John Cornyn (R-Texas) and Senator Ted Cruz (R-Texas) have noted that agricultural product standards and classifications have varied among the three countries, resulting in non-tariff barriers that make trade more costly, which should be addressed in renegotiating NAFTA.[34]

The two Texas senators have also noted that the Mexican oil and gas sector has opened up to foreign investment, and the U.S. and particularly Texas have the expertise and the capital to take full advantage of this new market. However, the transition created regulatory barriers that are preventing the U.S. energy industry from reaching its full investment potential, which should be addressed in renegotiation.[35] Finally, the Texas senators note that digital trade was in its infancy when NAFTA was enacted; and that NAFTA should be updated to better reflect protections for intellectual property rights.[36]

These are all issues that should be addressed during the ongoing NAFTA renegotiation process. NAFTA should be viewed as vehicle through which to expand trade between the U.S., Canada, and Mexico, not as a threat to economic opportunity, and certainly not as the root cause of any of the economic woes being encountered in the U.S. or abroad.

[32] "Trump Administration Announces Intent to Renegotiate the North American Free Trade Agreement," Office of the U.S. Trade Representative, May 18, 2017. Online at: https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/may/ustr-trump-administration-announces
[33] Ibid.
[34] "Sens. Cornyn and Cruz: It's time to modernize NAFTA and Texas knows how," Dallas Morning News, June 13, 2016. Online at: https://www.dallasnews.com/opinion/commentary/2017/06/13/sens-cornyn-cruz-time-modernize-nafta-texas-knows
[35] *Ibid.*
[36] *Ibid.*