Free Trade—Real Results Versus Unreal Expectations

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This year the Canada-US Free Trade Agreement (FTA) celebrated its 10th anniversary. The first tariff cuts took place ten years ago and this year saw the end of its 10-year transition period. Its terms are now fully implemented. Measured against the predictions of disaster by some of its most severe critics, the FTA must be seen as a massive success. Measured against the prediction made by many of its more enthusiastic supporters that it would be a universal panacea for all of Canada's ills, it must be seen as a failure. Measured against reasonable expectations, it is a significant success.

A first step toward a reasoned assessment comes with the realisation that the FTA was not a wholly new initiative. Instead, it represented a continuation of a long-standing policy of trade liberalisation pursued by all Canadian governments since the 1930s.

The National Policy

In 1854, Canada signed the Reciprocal Trade Treaty with the United States, which introduced free trade in a wide range of primary products. For a variety of reasons, the United States abrogated the treaty in 1866. Several subsequent Canadian attempts to restore freer trade with the United States failed and the efforts languished.

Partly in response to the failure to liberalise trade with the United States, Sir John A Macdonald instituted his National Policy in 1879. This policy placed high tariffs on imported manufactured goods in order to protect the home market. Foreign firms built "tariff factories" in Canada to serve the local market, thus assisting central Canada's industrialisation.

In 1911, the two countries negotiated a substantial bilateral reduction of tariffs, but before the agreement could be ratified, a Canadian election intervened and the pro-free-trade Liberal government was resoundingly defeated.

In the late 1920s and early 1930s, largely in response to the Great Depression, tariffs were pushed to alarmingly high levels by almost all countries. Each country tried to raise employment by restricting its imports, only to find that its exports were falling as other countries adopted similar policies. The result was a greatly diminished volume of trade and income, with no increase in employment. As a small trading nation, Canada was profoundly hurt by this bout of world protectionism. From that time on, Canadian policymakers have recognised Canada's overriding interest in keeping world markets as open as possible.

Canadian Policy Turns Outward

The first steps in Canada's slow march toward trade liberalisation occurred in the late 1930s when Canada and the United States signed two trade-liberalising treaties. The first was in response to a US initiative. Alarmed by the rising tide of protectionism, the Roosevelt administration negotiated several trade-liberalising treaties with individual countries. Tariff reductions were negotiated bilaterally and then extended to other countries on a most-favoured-nation basis. The second treaty was negotiated in 1937 at Canada's initiative. These treaties made significant cuts in both countries' very high tariffs.

In 1948, a free-trade agreement with the United States was discussed at some length but the private discussions were broken off without any public debate when Prime Minister Mackenzie King turned against the proposal.

In the same year, Canada became a founding member of the General Agreement on Tariffs and Trade (GATT), committing the country to a policy of progressive trade liberalisation. Over the next 40 years, the GATT rolled back tariffs among developed countries from the high levels that ruled in 1945 to the much lower levels that ruled in the mid 1980s. By 1985, tariff rates averaged less than 5% in the United States and about 10% in Canada. The CD Howe Institute estimated that by 1985 Canada had removed approximately 80% of the trade barriers that it had in place in 1934!

The Canadian economy underwent major structural adjustments to these tariff cuts, particularly as a result of the Kennedy and Tokyo rounds of the GATT

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negotiations. In almost every industrial classification old jobs were lost and new ones created, while Canadian imports and exports both increased dramatically. These big changes took place without major public debate and without significant outcry over any perceived massive economic dislocation. It appeared that, by 1980, Canadian industry had grown up and was able to compete internationally without heavy tariff protection.

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Growing Problems in the World Trade Regime

By the early 1980s, the world multilateral trading system was under growing stress. The GATT Secretariat wrote of the "increasing difficulty, not only in furthering trade liberalisation, but also in safeguarding previously negotiated levels of market access". World-trade-law experts Gerard and Victoria Curzon were even more outspoken:

> "[The GATT] is now incapable of halting daily violations of its most innocuous rules, let alone defending its basic principles. Evidence of breakdown is everywhere… [A]n undeclared trade war is in progress."

Most important from Canada's point of view, protectionist sentiment was rising in the United States, the country that had been the moral leader in the postwar movement toward trade liberalisation. There were several causes of this US turnaround. Here I mention two of the most important.

The first were the very large US budget deficits in the early years of the Reagan administration. The link between the so-called twin deficits shows that a domestic budget deficit leads to a deficit on the current account in the balance of payments. The budget deficit raises interest rates as funds are sought to finance the growing public debt. The high interest rates attract foreign capital and when foreign investors buy US dollars they bid up its value on the foreign-exchange market. The result is a deficit on current account because US imports grow and US exports languish. This mechanism, which takes a good hour to explain properly to graduate students well versed in economic analysis, is little understood outside the economics profession. It was thus far easier for legislators to look at the trade deficit in isolation, blaming it on a failure of US exporters and unfair competition from foreign firms selling into the US market.

Their view was exacerbated by a series of spectacular failures of US firms to compete with their Japanese rivals in such products as automobiles, TVs and micro chips. It is a matter of debate how much these competitive failures contributed to the trade deficit, but they were visible and dramatic and they fed the widespread belief that the United States was losing its ability to compete. It seems almost quaint today, but in 1985, when the US automobile industry was hard pressed and had been saved only by extraordinary restrictions on imports of Japanese cars, the Japanese competitive menace and the corresponding US competitive failure seemed all too real to US policymakers.

GATT commitments prevented an increase in tariffs and, as a result, an evolving array of US non-tariff barriers (NTBs) was developed. Two of the most worrisome were countervailing and antidumping duties. Countervailing duties are meant to create a level playing field, neutralising the effects of any subsidy given by foreign governments to firms selling into the United States. This sounds well and good on paper except for two major drawbacks. First, the administration of these "safeguards" was often arbitrary and stacked against foreign firms. Second, US subsidies were not taken into account, and as a result foreign firms selling into the US market sometimes faced countervailing duties against the subsidies they received although their US competitors received larger subsidies from US sources.

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Anti-dumping duties are meant to offset predatory pricing by foreign firms who sell at a loss in order to wipe out domestic competition. As they have evolved over the years, however, they now can be levied against any firm selling below its "full allocated cost"—that is, costs of production plus full overheads. Since competition often leads firms to sell at a profit over direct costs of production but at a price which does not cover some notional allocation of overheads, most firms are vulnerable to claims of dumping much of the time.

A second major US change was to take the initiation of investigations leading to countervailing and anti-dumping duties out of the hands of the administration and into the hands of private firms. Instead of being an instrument of national geopolitical policy, these measures became instruments of competitive policy wielded by US firms who could initiate an investigation more or less on command. Not surprisingly, Canadian policymakers were alarmed.

The Canadian Response

Vitally concerned with the growing crisis in the world trading system, many Canadian observers surveyed Canada's policy options. The arguments for Canada's seeking an FTA with the United States were both defensive and offensive. The defensive reason was that the best defence against rising US protectionism was to act bilaterally to eliminate all tariffs and to contain the use of non-tariff barriers. Supporters pointed to the well-established principle of international law that: *Small countries have more to gain from imposing the rule of law than do large countries who can expect to be the winners in an unregulated game involving naked power.*

The offensive arguments for an FTA were that the Canadian economy had matured and was ready to compete openly in world competition. The infant-industry stage had been passed when Canadian firms successfully weathered the removal of 80% of their tariff protection, and it was time to remove the last 20%—at least on trade with our major trading partner. This would allow successful Canadian industries further access to the US market—improved access that would generate employment to replace the employment lost when less successful industries declined. After all, Canadian industries had already quietly adjusted to several rounds of multilateral tariff cuts, so there was no reason to think that they could not adjust to the final round in which tariffs were eliminated on most trade.

More broadly, an FTA was seen as part of a policy package of liberalising the entire Canadian economy, exposing it more fully to market forces. Among other things, crown corporations were privatised, subsidies were reduced, unemployment insurance was reformed, and the manufacturers' sales tax was replaced by the GST. All of these were in line with the global movement to concentrate government into its areas of core competence. The private sector was seen as the best creator of wealth while the government was the provider of public goods, environmental protection and a universal safety net.

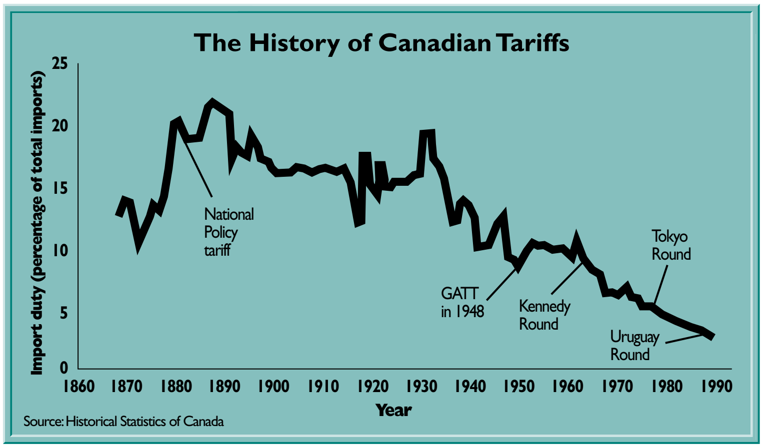
Seen in these ways, the FTA was a major step toward completion of the government's 40-year-old trade liberalisation policy and a part of its new market-orientation policy. Had the tariff reductions been part of a new GATT round and extended to all countries, the cuts would probably have proceeded unnoticed, as had all previous GATT-negotiated reductions.

Unreasonable Expectations

But the fact that the new round of tariff reductions was to be restricted to the United States caused the proposal to become a centre of public debate. Both opponents and supporters were led to make increasingly extreme predictions that created unreasonable expectations—expectations of disaster among many opponents and expectations of unrealistically high benefits among some supporters.

Wildly extreme fears were quickly aroused by the opposition's rhetoric: Canadian industry would be wiped out by US competition; Canadian firms would flee to the United States; US firms would take over Canada; employment would fall drastically; Canadians would lose control over their resources; we would be forced to sell water and oil to the United States, to adopt US management of our hospitals and, according to Canadian author Margaret Atwood's testimony to a Senate committee, to adopt US gun laws. According to Liberal leader John Turner and publisher-critic Mel Hurtig, the very existence of the country was at stake. Here is a sample of Hurtig's prose, drawn from his book *The Betrayal of Canada*:

> "The single most important overall impact of the Free Trade Agreement is already clear—a big decline in the standard of living of Canadians. And the future will be much worse. The less obvious result is as certain as the fact that you are now reading these words—the destruction and disappearance of our country."



Many of the opponents knew nothing of the history of Canadian trade policy and assumed that the FTA was a new initiative. Few saw any need to explain why the disasters they predicted from removing most of the last 20% of Canadian protection had not ensued when Canada removed the first 80% between 1935 and 1985.

Hurtig's kind of nonsense is refuted by the fact that, 10 years after the FTA, the country is still here and prospering, rated by international judges as one of the best places in the world in which to live. We have our problems but they are largely domestic, related to Quebec, taxes, and, until recently, budget deficits. But these problems are not caused by any inability to compete with the Americans, or any FTA-unleashed loss of Canadian sovereignty and identity.

I put the point this way in a convocation address at Carleton University in 1988. After analysing the major differences between social, cultural and political attitudes of Americans and Canadians, I went on to conclude that the decision as to whether or not to have an FTA with the United States should be based on:

> "... the real economic and political issues that are at stake, not on the mistaken belief that the Canadian identity, of which we are justly proud, is so skin-deep that it will not survive eating one more McDonald's hamburger, watching one more instalment of "Dallas" or doing five percent more trade with the Americans. Do your country, and your national identity, the honour it deserves by understanding that it *is* more than skin-deep ... and that whatever sensible or misguided policies we follow in the future, our identity as Canadians will be around for quite some time."

For their part, proponents, many of whom were trade-policy experts, were clearer from the outset about the more limited gains and adjustment costs that free trade with the United States would bring. But in the great heat of the debate, many proponents promised too much. On the political level, Prime Minister Mulroney promised "Jobs, jobs and more jobs" in spite of the fact that trade liberalisation is about replacing low quality jobs with higher quality ones, not about creating more jobs overall. Others promised a rapid convergence to US productivity levels and to US living standards.

Reasonable Results

None of the dire predictions of the opponents came to pass. As with all previous Canadian tariff cuts, the adjustments, although painful for a few years, were followed by more employment (not caused by the FTA), more investment (to some extent caused by the FTA), no US confiscation of Canadian water and petroleum (because such action was not covered by the treaty) and no unplanned loss of sovereignty (exactly as was to be expected). For example, in the first two years of the FTA total Canadian employment rose by 200,000, only to fall in the third year as the world sunk into the most serious recession since the Great Depression of the 1930s. Not surprisingly, the opponents blamed the loss of employment during the recession on the FTA instead of on a world-wide recession, and a highly restrictive Canadian monetary policy that resulted in both an unusually high spread between Canadian and US interest rates and a severely overvalued Canadian dollar.

Nor were the extreme predictions of some supporters borne out. In particular, Canadian productivity, wages and living standards did not appear to converge on the higher US levels. The failure of these extreme predictions has created among some observers the mistaken impression that the FTA was a failure.

Yet, measured against the reasonable expectations that proponents expressed in their more sober publications (including three books and numerous pamphlets of my own) and not their platform rhetoric, the FTA has been a substantial success.

Here is a short list of some of its major accomplishments:

- Canadian exports have expanded greatly from around 25% of Canadian GDP to close to 40%, proving that Canadian industry was ready to compete on equal terms both with the Americans and the rest of the world.
- Canada had an export-led recovery from the deep world-wide recession of the early 1990s. The US economy recovered when domestic demand recovered; Canada recovered when exports to the United States rose dramatically.
- Significant adjustment occurred as inefficient areas of production contracted and efficient areas expanded.
- According to Canadian economist Daniel Trefler, the FTA lowered prices to consumers by between one and two percent—a significant accomplishment that refuted predictions of disaster, but well below many unreasonable expectations of massive consumer gains.
- Canada got a dispute-settlement mechanism that, by and large, has worked well. Dozens of disputes have been settled by international panels that, except in a very few cases, did not split along national lines. The rule of law has helped to keep all of these disputes from escalating into trade wars and has made Canada a secure base for firms wishing to serve the North American market. (Two disputes that do threaten trade wars, softwood lumber and "culture" are both outside of the Agreement—softwood lumber because it was subject to a special agreement reached just before the FTA came into force and "culture" because it was excluded under the terms of the Agreement.)
- Canada has been protected against the upsurge of US projectionist sentiment. It is hard to calculate how much this is worth but the security of access to the US market is obviously worth quite a bit to Canadian firms. Also, many attempted trade restrictions have been thwarted by the dispute-settlement mechanism, while an unknown number that would have been tried had the mechanism not been in place have never seen the light of day.
- An increasing amount of foreign direct investment entered Canada over the first years of the FTA but Canadian direct investment in the United States did not rise greatly. Both facts indicate a willingness of firms to locate in Canada to serve the whole North American market if costs and other economic calculations justified that decision.

Finally, it should be noted that the productivity comparisons are still open to debate. Canadian trade specialist, Daniel Trefler, writing in *The Canadian Journal of Economics*, argues that most existing comparisons have used non-comparable data. Canadian figures refer to real GDP in manufacturing per hour worked while US figures refer to net value added, which excludes such purchased inputs as energy and raw materials. He also argues that the growing trend toward part-time work in Canada, not matched in the United States, biases comparisons of productivity per worker. When he measures output comparably, labour inputs as hours instead of numbers of workers, and controls for other influences, he finds large gains in Canadian productivity statistically associated with tariff reductions. He estimates that for all industries the FTA raised productivity between 0.4% and 0.8% per year over an 8-year period. For the industries that had highest pre-FTA tariffs, and hence were most impacted by the FTA, he estimates an effect of between 1.6% and 2.9% per year over the same period. As Trefler observes these are "enormous numbers".

In my opinion, they are too big to be taken at face value. For example, we do not know how much of the measured increase resulted from the closing of the least efficient operations (which raises the average productivity of the whole group) and how much came from a genuine increase in efficiency of those who survived. But at very least, Trefler's work shows that the last word has not yet been said on the productivity effects of the FTA. The best existing estimates now suggest that the productivity effects were positive and significant. Productivity pessimists will have to think again!

Conclusion

The FTA was a far less dramatic policy initiative than its critics claimed. In trade policy, it continued, and nearly completed, the process of reducing trade barriers that began in the 1930s. In broader economic policy, it was part of a package of reforms that increased the degree of openness of the Canadian economy to market forces. On both counts, it was a marked success—as well as making Canadian access to the US market more secure than ever before.

It was a failure only in that it failed to fulfil both the dire predictions of disaster promoted by its many opponents and the more extreme claims made by some of its supporters. Looking back on the massive debates that surrounded the FTA, we can only be thankful that the similar Canadian policies of trade liberalisation from 1935 to 1985 never came into the spotlight of public debate. One such divisive debate per lifetime is surely enough! We can be thankful that the debate is behind us and that we can now direct our attention to the very real issues that seriously affect Canadians, such as the international effects of Canadian political uncertainty, and our high taxes relative to those in the United States. ◆