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Strong and Competitive:

The American Economy in the Free Trade Era

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The conventional wisdom about free trade is wrong. Free trade is beneficial to the country, though the painful economic dislocations caused as we adjust to this new system often makes it more difficult for us to see the bigger picture.

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Free trade has never been popular. Despite being persuasively argued for over 200 years, it remains a hard sell, particularly in the United States as our economy works its way through a significant restructuring, brought on in part by free trade agreements. An April 2008 poll by the Pew Research Center showed that 48% of Americans believe free trade agreements have been bad for the U.S., while only 35% believed they are good for the country.[1] The Democratic presidential candidates reflected this uncertainty. Barack Obama said he would "fix NAFTA so that it works for American workers,"[2] while Hillary Clinton worried that "American workers in service industries are increasingly competing against low-wage counterparts around the world."[3] And perhaps no one has been as publicly vocal about free trade as CNN anchor Lou Dobbs, who for years has been criticizing the "exporting of America."[4]

This conventional wisdom about free trade is wrong. Free trade is beneficial to the country, though the painful economic dislocations caused as we adjust to this new system often makes it more difficult for us to see the bigger picture. In this first part of a three-part series on free trade, I will explain how free trade between countries is no different than free trade between cities or states, provide data showing that the U.S. economy has not weakened in the free trade era and that there are more jobs in the U.S. than ever before, and explain how the reduction in manufacturing jobs is not evidence of a disappearing manufacturing sector, but of increased productivity. Because free markets enhance our material well-being, it is important to continue supporting free trade among all nations.

THE ARGUMENT FOR FREE TRADE

The value of free trade is based on the idea of the division of labor, the same simple idea on which Henry Ford based his assembly lines. Ford recognized that the division of labor increases productivity, allowing us to make more goods at less cost. This in turn makes those goods more affordable, which increases our material well-being, our wealth, by allowing us to own more goods. The system was not developed by Ford of course; it is a very old idea, first expressed clearly in Adam Smith's *magnum opus*, *The Wealth of Nations*, which opens with this example about making pins:

> [A] workman not educated to this business… could scarce, perhaps, with his utmost industry, make one pin in a day, and certainly could not make twenty. But in the way in which this business is now carried on… One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on, is a peculiar business, to whiten the pin is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations…I have seen a small manufactory of this kind where only ten men were employed. [But] they could, when exerted themselves, make among them about…forty-eight thousand pins in a day.[5]

Consider the productivity increase Smith discusses here—from perhaps 20 pins per person per day to 4,800 pins per person per day—more than a 20,000% increase in pin production! But it's not just that more pins are produced. The important thing is that *the cost of producing each pin is reduced*. Therefore, pins become more affordable. Assume that the pins considered here are sewing pins, used by seamstresses. Because the seamstresses' costs are reduced, they can in turn reduce the price they charge for clothes, and clothes also become more affordable. In this way the division of labor increases wealth—not just for the manufacturer, but for the *consumers*. Since *everyone is a consumer*, the division of labor benefits everyone.

There is no logical boundary to this principle. Labor can be divided within a factory, between factories within a city, between factories in different regions, and between factories in different countries. Each extension of the division, if it lowers costs, benefits the people at the end of the economic chain: the consumers.

Free Trade among Families, Towns, States and Countries

Many have little difficulty applying the idea of a division of labor within a factory or even within a state, but balk at applying it across national boundaries; however, *all* political boundaries are artificial as far as economics is concerned. If it makes sense to buy something made in another town because it is less expensive, the same goes for purchasing goods manufactured in other countries. As Adam Smith said:

> "What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom."[6]

We can demonstrate this beginning with examples wholly contained within the boundaries of the United States, then expand the idea to examples that cross international borders.

First, consider a division of labor between towns as discussed in Todd Buchholz's *New Ideas from Dead Economists*:

> [The] division of labor can take place among towns, not just among workers in a factory. Particular towns can specialize, just as particular individuals can. Boise may produce wheat, while Boston produces computers.[7]

Clearly, Boise has some real advantages over Boston when it comes to wheat production. The cost of land around Boston would make it economically inefficient to grow wheat; the owners of the land can make a lot more money building houses, office buildings, and shopping centers. Boston, on the other hand, has clear advantages over Boise when it comes to producing computers. Although Boise's technology sector has developed substantially since Buchholz wrote the preceding passage, it simply cannot command the density of intellectual infrastructure that Boston can. It would be as foolish for Boston to refuse to import wheat and grow its own as it would be for Boise to try to provide all its own technology needs.

Now consider two examples of the international division of labor, the first from Adam Smith, and the second a contemporary example.

> By means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine can be made of them at about thirty times the expence for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland?[8]

Even today, with much more advanced technology, Scotland imports most of its wine, rather than produce it itself. The resources saved by not producing its own wine are invested in more productive uses, where they are more beneficial to the Scottish economy.

Our final example is closer to home. While sugar cane is grown in the United States, the Dominican Republic produces sugar cane much more cheaply because its climate is better suited to it. It would make sense, then, for the U.S. to import sugar cane rather than produce it domestically. Yet in actuality the U.S. violates economic wisdom in this case—it has traditionally placed tariffs and quotas on imported cane sugar from the Dominican Republic and other Central American countries,[9] costing U.S. consumers as much as $2 billion[†] per year.[10] While this preserves some jobs in the sugar industry, those jobs do not come free: high sugar costs in the U.S.—fully two to three times the world average—have cost the American candy industry dearly. Ohio's Spangler Candy Company estimates that it pays an extra $16,000 *per day* for sugar because of the tariffs,[11] and thousands of jobs in the candy-making industry have left the country because sugar can be purchased more cheaply elsewhere.[12]

The American Experience—the United States as the World's First Free Trade Zone

One of the most important but little noticed provisions of the U.S. Constitution is the Interstate Commerce Clause, in section 8 of Article 1, which gives Congress authority over commerce among the states. The crucial effect of that clause is that *states cannot create trade barriers against each other*. While we take this for granted today, it was not always the case. Under the Articles of Confederation, in effect from 1777 to 1789, the U.S. was not a single country, but a confederation of thirteen separate countries in a "firm league of friendship," each retained "its sovereignty, freedom, and independence." If limited trade between countries is beneficial, the United States should have prospered at that time, because the states enforced tariffs and other business restrictions against each other (including each state having its own money, which could not be used in other states). Virginia went so far as to declare that any ship that did not pay duties to Virginia could be seized by any person, a law that wasn't directed against European countries, "but at the cargoes of Pennsylvania, Maryland, and Massachusetts."[13] These impediments to commerce strangled economic development, and the acrimony they created between states led to threats of war. It is no wonder, then, that James Madison said, "Most of our political evils may be traced to our commercial ones."[14]

Today it is as likely that jobs shift from one state to another as it is that they are sometimes shifted from one country to another, yet there is no outcry against free trade within the U.S. and no complaints that, for example, Michigan is being unfairly harmed because General Motors located a truck factory in Indiana instead of in Detroit. So what changes when we talk about trade between countries, rather than states? Clearly there is a stronger sense of us against them, but that is not a strong economic argument—autoworkers in Michigan are equally out of jobs if the factory is moved to Indiana as if it is moved to Mexico, so why should they feel better about one than the other? The standard response is that in the former case the jobs are still *domestic* jobs, while in the latter case the jobs are in *other countries*. Let's explore the jobs argument more carefully.

Free Trade, Jobs, and Wealth

The hardest issue for most people to understand is that the effects of free trade should not be judged by the effects on jobs. Because the material well-being of nearly everyone is wholly dependent on having a well-paying job and free trade *does* cause some jobs to move out of country, the focus on jobs is quite understandable. But as the sugar tariff example showed, keeping production in the country may save jobs in one industry while costing as many or more jobs in those industries that have to pay higher prices. And of course the end result is that consumers pay higher prices and consequently have less disposable income left over with which to buy other goods and services, supporting more jobs in other industries.

Another real-world example is the steel tariffs instituted by President George W. Bush in 2002. The goal was to protect jobs in the steel producing industry from the competition of low-cost imported steel by putting tariffs on those imports that would increase their cost.[‡] The problem is that steel *using* industries in the U.S. employ about 40 times as many people as the steel *producing* industries, and whatever steel-producing jobs were saved came at the cost of 45,000 – 75,000 steel-using jobs.[15]

[‡] The tariffs ranged from 13% to 30%, and were levied on ten steel products: tin mill steel, flat steel (including cold-rolled, plate-rolled, and coated sheet steel), hot-rolled bar and cold-finished bar, carbon and alloy fittings and flanges for auto production, stainless rod, construction rebar, and slab steel.

These indirect effects of tariffs are often overlooked because job losses are usually more dispersed than jobs saved. French economist Federic Bastiat called this the distinction between "What is Seen and What is Not Seen," and said:

> There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen*.[16]

It is easy to see the jobs that are saved by a tariff that protects a specific industry, but if the higher prices that result force us to spend less on other goods and services, it is hard to see just where jobs are lost. While some of us may eat out less often, others will forgo buying a new computer, decide not to buy new carpet for their living room, or cut back on their vacation spending. Because each consumer responds differently, the job losses caused by restrictions on free trade are more diffuse and harder to see. But if we are concerned with the overall benefits for the whole country, the *unseen* effects of protections cannot be ignored.

Despite the focus on jobs here, it is important to point out that the real economic well-being of a country is not measured by jobs but by the quantity of goods and services consumers can afford. Jobs are simply a means, whereas the goods and services are the end—the real measure of wealth. Here is a simple thought experiment to help clarify this idea:

> Would you rather be a millionaire in a country where a cup of coffee cost $100,000, or penniless in a country where everything was free?

The millionaire will be broke after his tenth cup of coffee, but the penniless person will still have all his needs met. Obviously this is not a realistic example, but it highlights an important truth—quantity of goods and services are wealth, not quantities of dollars.[§] This is why inflation is such a problem—if your income increases but prices rise more rapidly, you are actually worse off, despite receiving bigger paychecks. For most people this is intuitive, because we have all experienced the shock of seeing big price increases (most recently, of course, in the price of gasoline).

What is harder for people to grasp is that you can actually be better off with a reduced income *if* prices decline even more than your paycheck does. In reality, it is rare for prices to decrease,[**] but if the price of something rises at less than the rate of inflation it actually becomes less expensive in real dollar terms. This is what free trade—whether between cities, states, or countries—does. By shifting production to places that are more cost-effective it keeps prices down, effectively reducing them, so people can afford to buy more.

ANALYSIS OF THE U.S. ECONOMY SINCE THE RATIFICATION OF NAFTA

While the logic of the preceding argument is strong, it must be backed up by data. In this section I will present data on the U.S. economy since the North American Free Trade Agreement (NAFTA) went into effect on January 1, 1994. First I will show the overall growth in the United States' Gross Domestic Product (GDP, which is the total economic output of the U.S.), then will focus on the change in the total number of jobs in the United States, and finish by focusing on the manufacturing sector.

GDP and Job Growth

In contrast to those who claim that free trade is destroying the American economy, economic data reveals that the U.S. economy has been strong since the implantation of NAFTA. Figure 1 shows the percentage change in GDP for the years 1980-2007, which allows us to compare the 14 years prior to NAFTA with the 14 years following its implementation. Looking past the great variability in economic growth, we find a very slight upward trend (as noted by the dotted horizontal trend line), showing economic growth has been slightly better since NAFTA than before it. Specifically, the average annual growth in GDP in the 14 years before NAFTA was 2.74%, compared to 3.13% since then.

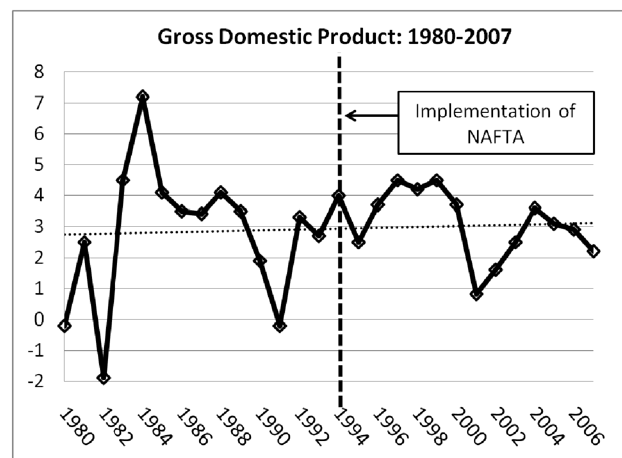

Figure 1: Percent change in GDP from previous year, 1980-2007. Source: Bureau of Economic Analysis

[§]This is well demonstrated by a promotion run by an Oregon radio station in the 1990s. The winner of the grand prize would become a millionaire...in Mexican Pesos.

[**]Except on technological goods, which generally begin with very high price tags, and then become cheaper.

This does not mean that NAFTA is the cause of that increase. Not only is the difference very small (less than ½ of 1 percentage point per year), but there have been other economic changes during that time. But it does show that NAFTA has not diminished the U.S.'s economic growth.

Some might suspect that this economic growth has obscured severe job losses. During his 1992 presidential bid, Ross Perot claimed that ratification of NAFTA would result in a "giant sucking sound,"[17] as U.S. jobs fled south to Mexico. This remains the common wisdom about free trade. Critics speak of millions of jobs lost,[18] and any forthright assessment must agree that *specific jobs are lost*. But as painful as the loss of specific jobs is to those who have lost them, the *total number of jobs* in the American economy is much more important. There are several reasons why we should focus on the total number of jobs rather than looking only at job losses.

First, as discussed previously, it is easy to ignore the jobs that tariffs destroy by forcing consumers to pay higher prices. If George Bush had not implemented steel tariffs, thousands of jobs in the steel industry would have been lost to foreign competition. Those job losses would have been highly visible, but nobody would have noticed the jobs saved in the steel-using industries because they already existed, and situations that do not change are rarely noticed. Likewise with sugar tariffs, thousands of sugar producing jobs would be lost, but tens of thousands of other jobs could be regained. Critics of free trade tend to focus only on jobs that are lost to foreign competition and ignore the fact that letting those jobs go frequently results in a net gain in jobs.

Second, in any given year in the U.S., *millions of specific jobs are destroyed simply by the normal working of the marketplace*, but millions of other jobs are created to replace them. The free market does not create a stable economic structure, but as Joseph Schumpeter argued, is in a constant state of change:

> [A] capitalist economy is not and cannot be stationary. Nor is it merely expanding in a steady manner. It is incessantly being revolutionized *from within* by new enterprise, i.e., by the intrusion of new commodities or new methods of production or new commercial opportunities… Economic progress, in capitalist society, means turmoil.[19]

This job churn is so great that "almost one job in five is destroyed or created every year."[20] Companies downsize, restructure, and close money-losing operations, but new jobs are constantly created as well, so the real question is whether there is a net loss or a net gain.

Given this perpetual economic turmoil, we should look critically at whether the supposed job losses of free trade are really that significant. We can look at jobs in two ways: by the unemployment rate and by the total number of jobs in the U.S. The total number of jobs in the U.S.—the labor force—from 1980 to 2007 is shown in Figure 2. From being under 100 million in 1980, it has grown to 146 million in 2007, an increase of 40 million jobs. 25 million of those jobs have been created since NAFTA went into effect. These dramatic increases contradict the claim that free trade in general, and NAFTA specifically, have harmed the economy by destroying jobs.

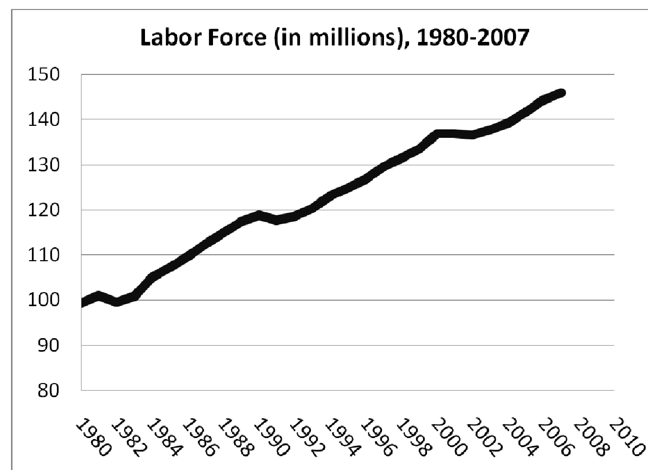

Figure 2: U.S. Civilian Labor Force, 1980-2007.
Source: Bureau of Labor Statistics

Of course the labor force is, in part, determined by the size of the U.S. population; in theory it is possible that the labor force could grow, but not as fast as the population, leaving more people unemployed. But as Figure 3 shows, there is an unmistakable downward trend in unemployment since 1980 (as revealed by the downward sloping dotted line). Unemployment is *not getting worse*—instead the unemployment figures are *better* than they were during the boom of the 1980s, before NAFTA.

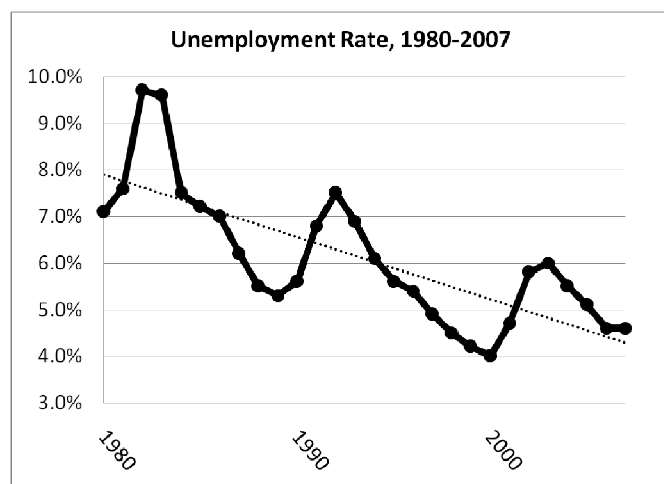

Figure 3: Unemployment Rate, 1980-2007.
Source: Bureau of Labor Statistics

Again, the cause of the declining unemployment rate is not NAFTA. Rather it is a combination of the economic deregulation of the Carter and Reagan presidencies and the Federal Reserve Board's careful use of monetary policy to strike a balance between high unemployment and high inflation. But clearly free trade has not caused a net decrease in unemployment.

Barack Obama recently claimed that NAFTA has cost America 1 million jobs.[21] Although the accuracy of this claim has been disputed,[22] let's take it at face value and consider what it means. With more than 146 million jobs in the U.S. economy, 1 million jobs would be approximately 2/3 of 1 percent of all jobs. In April 2008 the unemployment rate was 5%, with roughly 7 million people unemployed. Another 1 million unemployed would increase the unemployment rate to around 5.7%—still *below the last 30 years' average unemployment rate of 6.1%.* But even that is an exaggeration, because it assumes all 1 million jobs were lost in one year. Instead, the 1 million jobs would have been spread across the past 14 years, which works out to an average of less than 72,000 jobs per year, or less than 5/100th of 1% of the U.S. job market. And those 72,000 jobs per year that are alleged to have been destroyed by NAFTA must be set against the net gain of 1.75 million jobs per year since 1994, when NAFTA went into effect. If 1 million jobs have indeed been lost to NAFTA—and again it's worth pointing out that the claim has been disputed—the negative impact on the U.S. is at best, very small. The conclusion is, *even as the supply of labor has increased by nearly half, the percentage of unemployed workers has declined.*

Changes in the Manufacturing Sector since Ratification of NAFTA

Another concern about free trade focuses primarily on manufacturing. News stories about manufacturers outsourcing jobs are particularly common, along with claims that the U.S. is simply not competitive against low-wage manufacturers in developing countries. As a consequence, America's manufacturing sector is supposedly "hollowing out" as our industrial base declines. Data, however, does not support these claims of industrial decline. On the contrary, the value of our manufacturing output has nearly doubled since 1987,[††] from $866 billion in 1986 to almost $1.6 *trillion* in 2007. [NOTE: This is in *constant dollars*, it discounts for inflation, so inflation is *not* a contributor to these figures, as noted in the footnote—this is a *real dollar* doubling in manufacturing output]

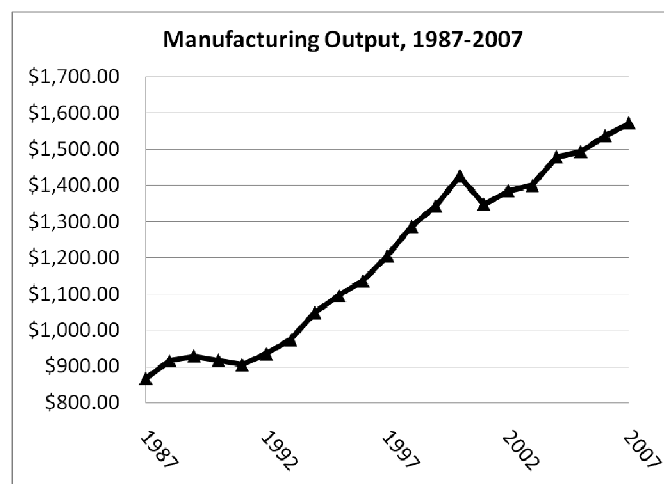

Figure 3: Manufacturing Output in Billions of Chained 2000 dollars. Source: Bureau of Economic Analysis.

It is true that *total employment* in manufacturing has declined by roughly 25%, as seen in Figure 4. The U.S. has over 3.5 million *fewer* manufacturing jobs than it did in 1980. This is in part due to free trade, and the low-wage competition it allows, but free trade is only one part of the story. Much of the decrease in manufacturing jobs is a consequence of *increased productivity* in U.S. manufacturing, which allows us to produce nearly twice as much value with one quarter less labor. Between 1990 and 2000, the average annual growth rate in U.S. manufacturing productivity was 4%, a greater rate of productivity growth

[††]1987 is the earliest year for which the Bureau of Economic Analysis has this data available in constant dollars. Again, the data discounts inflation, and is shown in billions of chained 2000 dollars.

than experienced in the period from 1950-1973 or 1973-1990, and higher than all G7 countries‡‡ except France, during the same time period.[23] While people worry about the lost jobs in manufacturing, keep in mind that the effect of greater productivity is to allow us to *produce more for less*, which allows us to *have more*, to increase our material well-being.

Figure 4: Manufacturing Employment, 1980-2007, in Millions of Production Workers. Source: Bureau of Labor Statistics

CONCLUSION

It is commonly assumed that free trade is destroying the American economy, particularly the manufacturing sector. But a close look at what's really happening shows that the economy has been strong in the free trade era, despite occasional downturns. Total employment is up significantly, and unemployment has been lower than in the two decades before NAFTA was implemented. Although manufacturing employment has declined, improvements in productivity have resulted in greater total manufacturing output than ever before.

There is no doubt that the dislocations of the adjustment to free trade have been very difficult for those who have lost their jobs. These job losses, however, are only a fraction of the total annual jobs that are destroyed in such a large and dynamic economy. Indeed there is nothing special about a job lost to international competition compared to a job lost because of productivity increases or domestic competition. Whatever the cause, the person affected is out of a job due to the normal turbulence of a market economy. It would be foolish to pass laws protecting specific jobs from domestic competition or outlawing productivity increases because they may eliminate some jobs, and in the same way it does not make sense to protect jobs from international competition.

The winners are the American consumers; that is, all of us. The relentless competitive pressures of a free market economy work to drive costs down, making goods and services more affordable, thus enhancing our material well-being. The greatest beneficiaries are actually the poorer people. For example, the end of restrictions on textile imports has reduced the price of clothing, making it easier for poorer people to give their children good shoes and winter coats. Quotas and tariffs on the import of foreign cars long protected the U.S. auto industry from competition, resulting in cars that were both more expensive and of lower quality than what was available from Japan.§§ If free trade actually did result in a decrease of jobs, so that American consumers couldn't afford to buy goods and services, then there would be reason for concern. But as we have seen, there has been no net loss of jobs.

Those who demand that we protect their jobs from competition are in effect demanding that consumers be required by law to give them more money. But in the end, how does it help the economy if we just take the money from the consumer and give it to the laborer? There is no more money to go around as a result, the dollars just have a new owner, and the overall wealth of the country is not increased one iota. If the transfer of wealth was from the rich to the poor, there might be some justification for it. But the reality is, the poor are hit the hardest, and the extra money they have to pay for goods and services goes to middle class workers. Restrictions on free trade cause a regressive transfer of wealth, and there is no justification for that. ◆

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‡‡The G7 includes the U.S., Canada, France, Germany, Italy, the United Kingdom and Japan.

§§To get around these tariffs, the Japanese automakers began building factories in the U.S., where there competition did force the U.S. automakers to produce higher quality cars for the American public.

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