NAFTA and Free Trade: An Ecological Economics Perspective

A May 2018 brief by Eric Miller in support of economic literacy for a green economy

Canada has signed many free trade agreements, including the North American Free Trade Agreement (NAFTA). In theory, free trade on the basis of comparative advantage will be mutually beneficial to all trading countries, even if one of them has an absolute advantage in producing all tradable things. In practice, many factors challenge the application of comparative advantage, when considering its requirements and costs. Modern free trade agreements affect much more than the trade of goods and services. Ecological economists tend to be critical of the current model of free trade that empowers marketplaces and restricts some powers of governments. Alternative models of global trade are needed to help conserve resources, reduce pollution, and promote more public goods.

Canada has signed many agreements

About one third of total production in Canada in a year is exported to the rest of the world. Conversely, about a third of everything consumed in Canada is imported from the rest of the world. This exchange, and other aspects of the Canadian economy, are directly or indirectly governed by trade agreements.

Canada has signed 61 free trade and investment agreements with other countries, according to the website of Global Affairs Canada. Another 30 are being negotiated or explored. Most agreements are relatively recent, with only a quarter in effect prior to the year 2000.

Some agreements are with individual countries, while others are with multiple countries. Some of these countries are economically similar to Canada, while others have different marketplaces and levels of economic outcomes.

One well-known agreement is NAFTA – the North American Free Trade Agreement. This agreement governs most trade between Canada, the United States of America, and Mexico.

Modern free trade agreements are much broader than reducing tariffs and restrictions on the movement of goods and services. Agreements typically expand protections for intellectual property and investor rights, establish extra-judicial dispute settlement mechanisms, and mandate specific norms such as reciprocal and non-discriminatory treatment by governments. The environmental implications of these intentions are complicated and controversial.

Free trade advocates are enthused about comparative advantage

Anyone who has taken an introductory economics course will have been taught the principle of “comparative advantage”. This concept was derived in the early 1800s when there were also debates about whether international trade should be enhanced, or further restricted through limits on imports or tariffs that apply a cost onto each traded unit.

For any two countries that can each produce the same two goods, comparative advantage is the relative advantage that one of the countries *will* have in the production of one of the goods. Even if one country can produce both goods more cheaply, each country will be able to produce one of the goods more productively on a *relative* basis.

If each country only produces the good for which it has a comparative advantage, and trades its surplus production with the other country, then more goods will have been produced overall. Under this arrangement, free trade will yield mutually beneficial results even if one country has an absolute advantage in producing all the tradable units.

Free trade on the basis of comparative advantage could increase total production, and therefore increase total income. A more recent theory proposes that increased incomes will eventually lead to environmental improvements. This theory and its general application is controversial. Nevertheless, free trade enthusiasts often combine this theory with the principle of comparative advantage to propose that free trade is good for the environment.

Many factors challenge the application of comparative advantage

Textbooks today still use an example of comparative advantage from David Ricardo in 1817. His example was about England and Portugal being able to each produce cloth and wine, with Portugal being able to produce both more cheaply. If England were to specialize in producing only cloth, and Portugal only wine, and if each freely trade with each other, there could be more total product than a trade-less alternative.

Nevertheless, this arrangement, and any other possible arrangement based upon the same theory, could prove to be disappointing when various costs and requirements are also considered.

Market economies are not planned, so the transition towards each country's economy having fewer sectors may be difficult and often resisted. Even if this transition were to be successful, there would be significant costs to re-purpose all the workers and machines from one sector to another. Workers would need to be retrained, potentially moved, and provided with some sort of transitional income support to be able to purchase the traded goods. Comparative advantage is applied with an assumption that people and machines would not migrate to the other country. The more they are able to migrate, the less mutually beneficial the free trade relationship will be.

Comparative advantage is maximized when redundant sectors are eliminated. This could lessen economic resilience in trading countries if there are no easy substitutes for an imported good that unexpectedly fails, with no remaining supplier in the home country.

If traded goods cost more to transport than if they were produced domestically, this would reduce the mutual gains from trade. These costs, and other costs (including unpaid environmental costs) and risks would need to be considered with the gains from comparative advantage, in order to estimate the net gains from trade being freer than it is today.

Ecological economists are generally critical of modern free trade

Ecological economists focus on relationships between the economy and environment, with the goals of sustaining the regenerative capacity of the biosphere while maximizing human wellbeing that is equitable and efficiently attained.

While ecological economists understand the principle of comparative advantage, they are mindful of its requirements and therefore skeptical about its significance. They are also concerned that many aspects of modern free trade agreements could frustrate the pursuit of a greener economy.

Free trade agreements aim to grow the market economy, restrict the powers of government, and avoid precautionary public policy. In contrast, ecological economists are interested in directing and in some cases constraining the market economy, using the powers of government, and applying the "precautionary principle" as defined by conventions and laws.

Ecological economists are keen for governments to reduce "market failures" by reshaping marketplaces to make it less advantageous for producers and consumers to shift costs and burdens onto others, including the environment. This can be achieved by making producers and consumers pay for the pollution they create and the resources they deplete. Otherwise markets will fail to adequately conserve resources and minimize pollution, which undermine sustainability.

High levels of health and safety standards and a fair wage need to be mandated so that markets can help to maximize human wellbeing, in a just and efficient way.

If health and environmental standards are dissimilar between trading partners, free trade could amplify market failures. Production would grow in the jurisdiction that has more market failures. The government of that jurisdiction might be dissuaded from applying health and environmental standards to remedy the market failures, out of concern that this might reduce its trade advantage.

In Canada and other countries with a significant amount of international trade, market failures need to be reduced at home and abroad concurrently, in order to be successful. This is a typical objective of multilateral environmental agreements, which often conflict with the intent of free trade. Some environmental agreements have deliberately prohibited certain types of trade or production. More recently, the 2016 Paris Agreement will require significant governmental efforts to reshape marketplaces and global flows of trade and investment.

Modern free trade agreements affect much more than the trade of goods

Many critics of modern trade agreements refer to them as “so-called free trade” since so much of their content is beyond the free trade of goods. Since the 1990s, the scope of free trade agreements have expanded to include services and also to contain provisions that protect investment.

Investment provisions intend to treat foreign investment equally to domestic investment. A typical agreement will forbid governments from showing any preference for domestic over foreign investors. Agreements aim to forbid governments from limiting how much land or other natural resources and other capital, including existing businesses, can be purchased or owned by non-residents and non-resident corporations. Provisions also include prohibitions on performance requirements for investors.

Governments are less able to mandate eco-labelling, and are not allowed to restrict products that were made using processes that are illegal in the importing country. For example, a country would be in violation of free trade if it banned the import of unsustainably harvested timber from unrestricted logging that is destroying rainforests. It could only restrict timber imports if those products were conclusively found to be necessary to protect human or animal health or plant life in the importing country.

Modern agreements have tended to setup trade tribunals to resolve disputes from foreign investors and traders, rather than relying upon domestic courts. This sidesteps many provisions enshrined in the domestic court system such as high levels of transparency, allowing intervenors, and considering trade laws in the context of other laws and policies.

Modern trade agreements tend to strengthen intellectual property rights, which amounts to making the potentially free public good of information a higher priced private good. Longer and stronger patents and other forms of intellectual property will raise the cost of using environmental innovations, which can lessen their adoption even if they flow across borders without tariffs.

NAFTA contains some unique and controversial provisions

The North American Free Trade Agreement includes typical broad provisions related to trade and investment. The agreement also includes a preamble that aims to “strengthen the development and enforcement of environmental laws and regulations”. The agreement also includes some controversial provisions.

NAFTA contains a proportionality clause that requires Canada to maintain its current share of energy exports to the United States, even if Canadians experience shortages or were to deliberately constrain certain forms of energy that have high environmental costs.

The text of NAFTA defines water as a “tradeable good” and as a “service” and can be considered as an “investment”. This has created some worry that water policy could be subject to very broad provisions that could make it difficult for governments to respond to future scarcities by treating water as a common pool resource and not a market good.

NAFTA’s investment provisions include a right to be compensated for actions that could be perceived as tantamount to expropriation. This has been interpreted by trade tribunals as including lost potential profits. Foreign investors have sued Canadian governments for damages from environmental decisions that harmed their investments, including a moratorium on fracking in Quebec, a conservation decision from an environmental assessment panel, and a ban on a compound that was a suspected neurotoxin.

New models of trade could promote greener economies

The Government of Canada has keenly promoted the current model of free trade. The government has also tended to support multilateral environmental agreements. Canada ought to integrate these considerations to advocate for new models of trade that promote greener economies. Regardless of the government’s intentions, Canadian non-governmental organizations have played active roles in critiquing the existing trade model and providing alternatives.

One idea is to use trade to uphold compliance with multilateral environmental agreements. Countries have signed many agreements that usually lack built-in mechanisms to fine or dis-incentivize non-compliance. Perhaps countries could be permitted to use trade sanctions or countervailing tariffs against trading partners that are not fulfilling their measureable obligations under international environmental agreements.

One idea that is gaining traction is to allow for eco-tariffs such as border carbon adjustments. As countries work to internalize the costs of greenhouse gas emissions, there’s a concern about carbon leakage, if domestic reductions in emissions are offset by increased emissions elsewhere in the world. One remedy would be to levy a border tax or require importers to surrender a quantity of carbon permits in jurisdictions that use a permitting system.

Perhaps trade agreements should be retooled to allow for process or production standards. Perhaps trade agreements could be retooled to promote information and labelling requirements to inform the marketplace about production processes.

There are already many voluntary non-governmental initiatives in this realm, such as the fair trade certification system. Voluntary initiatives are limited, but so too are governments; if governments were to mandate labelling or a specific certification system now, this would tend to be in contravention of existing trade and investment agreements.

All of these ideas would be in addition to other principles that are not inherently environmental, but could still help to promote greener economies. This includes: a different model for resolving trade and investment disputes, re-thinking regulatory takings as if they're tantamount to expropriation, and re-thinking the conventional treatment of public goods and services as if they are market goods.

New models of trade would benefit from new complementary global agreements, such as a commitments to reduce environmentally harmful subsidies, since this can be difficult for one trade-dependent jurisdiction to do alone. A new approach to global reserve currencies and exchange rates could help to protect countries against speculative finance that can unjustly undermine the terms of trade. And global efforts are needed to develop protocols to protect against tax avoidance, including global rules for how income and profits and losses are attributed to different jurisdictions.

These measures would allow governments to more easily conserve resources, reduce pollution, and provide more public goods.

An ecological economic approach to international trade agreements would differ from the current approach. Greener agreements would mandate process or production standards, or allow for eco-tariffs to compensate for different levels of standards that are easily measured, such as emission fees or caps. Greener agreements would support efforts to promote labelling and chain of custody to better inform marketplaces. Greener agreements would have principles that are better synchronized with the goals of multilateral environmental agreements. Greener agreements would be more selective about the types of trade and investment that are to be promoted, and which should be curtailed. Greener trade and investment agreements would benefit from other complementary efforts, such as global commitments to: reduce subsidies that accelerate environmental depletion, coordinate efforts to incorporate the costs of pollution into prices, remedy foreign exchange issues, combat international tax avoidance, and enhance the governance of common pool resources and the capacity of governments to provide public goods.

This brief is authored by Eric Miller, an independent consulting economist. This publication is supported by the Ivey Foundation, as part of a broader Economic Literacy Project managed by the Sustainability Network.