Session Two
THE PUBLIC CHOICE/POLITICAL ECONOMY OF A DEAL

THE POLITICAL ECONOMY OF NORTH AMERICAN FREE TRADE: A PUBLIC CHOICE APPROACH

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I. INTRODUCTION

The issue of a North American free trade agreement (NAFTA) appeared on the public policy agenda with considerable suddenness. When the Canada-U.S. Free Trade Agreement (FTA) was signed in 1987, few in the signatory countries anticipated that one of its spinoff effects would be Mexican interest in free trade with the United States. The almost immediate prominence of the NAFTA question reflects different policy priorities and responses across the three countries. Common to all three, however, is awareness of changing global patterns of trade and investment and the importance of global competitiveness.

Greater trade liberalization has characterized recent policy in Canada, the U.S. and Mexico, although protection remains for some key industries. This liberalization is most marked in Mexico where President Salinas has adopted a series of market driven policies designed to promote economic growth. State interests in a NAFTA not only are market driven, but also include concerns about immigration, drugs and democratic

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reforms in Mexico. Nonetheless, current policy responses to the challenges of globalization both in North America and Europe are being influenced by an understanding of the economics of production that facilitate bloc formation.

Whenever a major policy change is under consideration, it is useful to examine the determinants of the existing policy and why and how individuals are being led to initiate change. Kudrle (1985) provides a public choice framework, based on four factors, within which we can look at the motives pressuring the three states towards a strategic alliance through a NAFTA. By examining the way individuals are stimulated by their environments and how these stimuli interact with domestic interests, we can gain some insight into the relative ease or difficulty with which policy changes can be made.

The first of Kudrle's four factors, *ideological consonance*, addresses the congruence between the policy proposal and the general value orientation of particular groups or countries. Given fundamental national values of prosperity, autonomy and security, the question here is the extent to which the policy change is consonant with general public attitudes or some broadly defined national interest. In terms of a NAFTA, we focus on the degree to which such a strategic alliance fits with the general goals of the states concerned. The second factor, *issue transparency*, identifies the way in which the affected parties comprehend the policy choice. With respect to a NAFTA, issue transparency deals with the distribution and comprehension of information concerning the possible outcome of the talks. Individual leaders may play significant roles in reducing information-gathering costs and in linking poorly understood policies to ideological views or group interests. The question for a NAFTA is the extent to which the public is aware of the NAFTA initiative and understands the likely outcomes. The third factor is the *distribution of perceived benefits and costs* from the new policy option. Public choice theory tells us that if the benefits are concentrated while the costs are diffused over the population, policies are more likely to be lobbied and supported; thus we examine the likely winners and losers and their relative bargaining power in each country. The fourth factor influencing the politics of policy formation is the *institutional context* within which policies are developed. Domestic as well as bilateral institutions, which can either promote or deter policy change, will affect the probable success of the NAFTA initiative.

Clearly, these four factors are not mutually exclusive and interact with each other (a problem with many such methodologies); nevertheless, we believe the Kudrle categories can be heuristically useful in explaining why a NAFTA so quickly became a significant policy issue in all three states in North America.

II. IDEOLOGICAL CONSONANCE: NATIONAL INTERESTS AND A NAFTA

The fit between NAFTA as a strategic alliance and the goals of the three states varies among the North American economies. A general national interest can be understood in three areas: prosperity, autonomy and security, so that state policies designed to enhance all three can be deemed ideologically consonant.

Frustration with the difficulties of attaining multilateral trade agreements amongst so many members on a wide range of issues has prompted many states to seek solutions to their individual and collective economic interests outside the global trading system. Regional trading arrangements, which provide many of the advantages of the multilateral trading system and may be easier to negotiate, are but one of these strategies. Many states are moving to ensure a position for themselves within regional blocs: the United States by negotiating the FTA with Canada and both of these countries in deciding to negotiate a NAFTA with Mexico; the European Community (EC) by intensifying the integration process through the reduction of border controls and the mutual recognition of national legislation; the EC and the members of the European Free Trade Association (EFTA) by agreeing to create a free trade area from the Arctic to the Adriatic; and Japan by establishing subsidiaries in East Asian countries as well as in the other two blocs.

In the current global economy, all three countries in North America have an interest in creating a trading unit which will enhance their economic opportunities. From the U.S. perspective, NAFTA is a policy that addresses current national interests in the United States as reflected in its fear of declining hegemony and competitiveness. A free trade area in North America would create a market larger than that of the EC (of the 12) and would secure U.S. access to low-cost Mexican labour inputs and Canadian resources. Moreover, a NAFTA would allow the U.S. to point to its continuing commitment to trade liberalization, even if the proliferation of regional trading blocs might subsequently make progress in multilateral trade discussions more difficult. The U.S. has applauded President Salinas' liberalization of trade and investment; a free trade agreement would make a Mexican return to restrictive investment regulations and an interventionist state more difficult. An expanding Mexican economy would mean enhanced opportunities for American producers of capital equipment and other manufactured goods. To the extent that the provisions of the agreement restrict the U.S. Congress from making protectionist laws against Canadian and Mexican firms, some loss of autonomy is involved. In terms of security, a more prosperous southern neighbour would ease the border immigration problem and perhaps relieve pressures on U.S. banks with Mexican debts in their portfolios. In short, for the U.S. a NAFTA offers prosperity and the possibility of enhanced economic security with minimal loss of autonomy.

At an ideological level, concerns about both economic adjustment and constraints on sovereignty, as well as very weak economic links, made the NAFTA choice for Mexico and Canada more complex. The shared economic dependence of both countries on the United States engendered certain parallels in the way they decided free trade with the U.S. was essential for their long-term economic prosperity. The U.S. is the most important trading partner for both Canada and Mexico, absorbing some 70% of Canadian and approximately 67% of Mexican exports. Both countries are highly trade-dependent, with 20% of Mexican GNP accounted for by trade in 1985; for Canada the comparable figure is close to 30%. Therefore securing and expanding access to the U.S. market was paramount for both countries.

In Mexico's NAFTA calculations, the need for investment is as important as secure market access. A free trade agreement might both attract back Mexican capital and lure new foreign investment. Although it is now clear President Salinas' worries that the opening of Eastern Europe might deprive Mexico of investment were unfounded (Ostry, 1991: 14), it remains true that Mexico requires considerable capital inflows to create jobs, improve its infrastructure and bring it up to the standards of the poorer developed market economies.

While all three signatories to a NAFTA anticipate economic gains, the burden of adjustment falls mainly on the smaller partners. The adjustment costs for Mexico in particular will be heavy, given the less efficient character of its manufacturing and its protected agricultural sector. Canada, already trying to adjust to the FTA, will confront a second round of adjustment to a lower-cost partner. Although Canada and Mexico did increase their formal economic contacts at the end of the 1980s, Canada neither wanted nor encouraged Mexico to approach the United States to open trade talks. Indeed, Canada may have misjudged the consonance of its interests in freer trade with those of the United States: Canada clearly focussed solely on the FTA and appeared rather surprised by the quick U.S. move to consider other bilateral agreements. Recognition of the potential costs of a series of U.S. hub-and-spoke arrangements, rather than any deep interest in a wider free trade arrangement, brought Canada to the NAFTA table (see Wonnacott, 1990 and Molot, 1991).

One of the major ideological problems for Mexico in any closer relationship with the U.S. is sovereignty. Fear about loss of autonomy was one reason Canada has been reluctant to establish institutional linkages with the U.S. to manage the bilateral relationship.[2] Participation in any free trade agreement means some diminution of sovereignty, for example, the surrender of control over certain tools of economic policy such as tariffs and non-tariff barriers. The FTA includes provisions with respect to investment, energy and financial services that make it something more than a simple free trade agreement. A NAFTA likely will contain similar clauses, thereby restricting Mexico's ability to regulate certain kinds of economic activities.

Many Mexican analysts, like their Canadian counterparts in the late 1980s, worry about a more formal relationship with a political economy of the strength of the U.S. Some feel that the free trade discussions are being rushed and question the long-term implications of an agreement on Mexican political reform and sovereignty (Cardenas, 1990). Given the economic asymmetries between Mexico and the U.S., a NAFTA might well perpetuate dependency (Weintraub, 1990c:17). Like Canada, Mexico has shied away from formal links with its larger neighbour. In the words of one analyst of Mexico-U.S. relations: "Mexico's traditional political culture viewed U.S. proximity as a curse, not as an opportunity. Bilateral cooperation was limited. . . Mexican leaders

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[2]Interestingly, there has also been an historic U.S. reluctance to create international institutions that might limit sovereignty. Witness the Senate's rejection of the proposed International Trade Organization in the late 1940s.

did not wish to be accused of consorting with the enemy" (Baer, 1991: 138). Ideological consonance is clearly more muted in Mexico and Canada than in the U.S. In the end, for both Mexico and Canada, considerations of prosperity — the importance of unfettered access to their largest market — won out over suspicions about formal ties (Cameron, 1991; Vega, 1991).

III. THE TRANSPARENCY OF A NAFTA

Awareness of NAFTA as a trade policy issue differs across Canada, the U.S. and Mexico. The issue unquestionably has greater salience in the U.S. and Mexico than in Canada. The feasibility of a U.S.-Mexican free trade agreement had been floated as an occasional policy trial balloon by analysts of U.S.-Mexican relations.[3] President Salinas indicated Mexico's interest in a formal U.S.-Mexico trade accord when, in June 1990, he approached the U.S. to negotiate a free trade agreement. For Salinas and members of his administration the move toward formal trade ties with the U.S. demonstrated their understanding of the realities of Mexico's economic position: though trade with the rest of Latin America is attractive in theory, in reality there is little prospect of it. Opportunities for Mexican trade with Europe and East Asia are similarly limited. Secure access to its largest market was therefore far more significant than trade diversification (Baer, 1991: 134). President Bush saw U.S.-Mexico free trade as one answer to immediate U.S. concerns about Mexican economic stability. It also coincided nicely with his "Enterprise for the Americas Initiative" launched at the end of June 1990. Thus, for both Mexico and the U.S. the personal commitment of the two presidents gives free trade high visibility, especially among politicians and various industry stakeholders.

In Canada, in contrast, although the NAFTA issue was debated by academics and industry association officials, it was put on the domestic political agenda only very reluctantly. Canadians were preoccupied with domestic constitutional problems and many were still debating the benefits to Canada of the FTA. In the end, the Mulroney government decided Canada had to participate in discussions which would shape the rules of trade and investment in North America. Official Canadian enthusiasm for a NAFTA did not approach that for the FTA, however.

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[3]Interest in the possibility of a North American economic unit does go back some time. U.S. Senate Resolution 165, introduced in 1979, called on the President to "enter into negotiations with the Government of the United Mexican States and the Government of the Republic [sic] of Canada to establish a North American Continental Trade Commission" (Cohn, 1985: 9-10).

IV. MATERIAL INTERESTS AND A NAFTA

The calculus of winners and losers and their relative political importance structures the politics of policy formation. Different interest groups in all three countries have been developing positions based on their understanding of how a NAFTA will affect them. Here we briefly review the attitudes of the various stakeholders across the three countries.

In terms of perceived winners and losers, in the United States the prospect of a NAFTA has generated uncertainties and the debate over its wisdom continues. U.S. multinationals (MNEs) that have already benefited from the corporate rationalization U.S. tariff provisions 806 and 807 facilitated stand to benefit still further both from a NAFTA and from the further liberalization of the Mexican economy that such an agreement would promote. As Ostry argues, multinationals see the GATT as having only limited relevance to their increasingly global operations. For reasons of practicality, MNEs are demonstrating a preference for regionalism or bilateralism (Ostry, 1990: 3-4). Among the MNEs different stances are taken with respect to the precise contents of a NAFTA; for example, the U.S. "Big Three" auto makers have demanded high local content requirements, and a long phase-in of a NAFTA agreement. For many American corporations Mexico offers opportunities similar to those which Eastern Europe provides the European Community — a large and expanding market and cheap labour (Morici, 1991).[4]

Smaller U.S. corporations, those who provide inputs to the MNEs across a variety of industries, most notably auto parts, and those who manufacture commodities that would face competition from similar Mexican goods, for example, makers of glass dishes, textiles, garments and accessories, are less sanguine about a NAFTA. Politicians from the rustbelt states, reflecting constituent fears, have questioned the negotiation of a free trade agreement with Mexico. Some segments of the steel industry worry about their ability to compete. U.S. fruit and vegetable growers, already facing competition from cheaper Mexican products, fear a free trade agreement will make their position economically untenable.[5]

U.S. labour is unalterably opposed to free trade with Mexico, whatever its form. Pointing to jobs lost as a result of corporate relocation to Mexico, U.S. labour formed an alliance with religious and environmental groups to publicize working conditions in

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[4]Companies under pressure to keep costs down may do all of their manufacturing work in Mexico, rather than just assemble components. Increased operations in Mexico could benefit U.S. companies that supply parts and equipment, including plastics, dyes and packing used in Mexican factories (*New York Times*, November 11, 1990: F12).

[5]U.S. food processors have already begun to move some of their vegetable-packing plants to Mexico to take advantage of both cheaper produce and lower wage rates. Some U.S. farmers, unable to compete, now farm in Mexico (*Business Week*, February 25, 1991: 70-71).

the *maquiladoras* and campaign against a NAFTA.[6] Although this opposition failed to prevent Congressional approval of the fast-track negotiation authority, questions raised about environmental standards in Mexico generated sufficient concern that the White House complied with a request from senior members of Congress that talks on environmental issues take place in parallel with the NAFTA negotiations.

There are fewer societal and state pressures promoting Canadian participation in NAFTA talks. That business is more ambivalent about a NAFTA is not surprising, given the limited character of Canada-Mexico trade. There is also considerable concern about competition with Mexican goods for the U.S. market. The 1990-91 recession and the loss of tens of thousands of manufacturing jobs, have made segments of Canadian business ambivalent about the FTA itself, let alone a broader agreement. Nonetheless, Canadian MNEs, the Chamber of Commerce, the Canadian Manufacturers Association and the Automotive Parts Manufacturers Association all believe that Canada cannot permit others to determine the North American trade regime; in their view Canada must participate in the NAFTA negotiations.[7] Industries already finding adjustment to the FTA difficult — e.g., furniture, shoes, and garments — are concerned about another trade agreement. Labour cites job losses that followed upon the FTA and, like its U.S. counterpart, fears competition with lower-paid Mexican workers would simply worsen its position.[8]

The broad consensus in Mexico in favour of free trade with the United States is based on the expectation that it will bring the country out of its economic crisis and promote economic stability. Large corporations and many smaller ones support the free trade initiative. Most have already accommodated to the pressures of adjustment required by Mexican accession to the GATT in 1986; for them a NAFTA would secure the Salinas reforms and ensure the continued outward-looking nature of the Mexican economy. Some groups still press for a return to higher tariffs, though in the view of Weintraub (1990b: 119) they are "fighting a rearguard action". Among the sectors that are less certain about free trade are chemicals, textiles, and some small and medium-sized

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[6]Labour, environmental, and religious groups have formed a Coalition for Justice in the *Maquiladoras* and have proposed a voluntary code of conduct for U.S. MNEs with *maquila* investments, which includes fair wages, freedom to organize unions, health and safety protection, and pollution controls (*Globe and Mail*, February 13, 1991: B3).

[7]A survey of CMA members showed that almost 90% favoured Canadian participation in the NAFTA talks. About 46% viewed trade liberalization with Mexico as an opportunity and 29% viewed it as a threat. Of the latter, 75% still felt that Canada should participate in the talks (SCEAIT 1990-59: 23-4).

[8]The Canadian Labour Congress listed some 36 companies, including GM, Ford, GE, Northern Telecom, Black and Decker, Campbell Soup, IBM and Motorola, which have closed facilities in Canada. The CLC argued that while it is impossible to trace plant closures and layoffs in Canada to job creation in Mexico, all of these firms have invested heavily in the *maquiladoras* (SCEAIT 1990-59: 6).

businesses; also hesitant are those that have traditionally been under state control, such as oil, railways and electricity (SCEAIT 1990-66: 12). Finally, and in ironic parallel with the fears of southern U.S. agricultural states, there is concern that more efficient midwest U.S. grain producers would swamp their less efficient Mexican counterparts, thereby reinforcing Mexican dependence on U.S. corn, wheat, and beans.

V. THE INSTITUTIONAL CONTEXT OF A NAFTA

The institutional structures involved in setting up a NAFTA would be more complicated than those developed under the FTA. The limited structures created by the FTA provide mechanisms for consultations, dispute settlement, and bilateral review of proposed legislation. The decisions reached through the dispute resolution process eventually will provide a body of case law, thereby promoting the convergence of U.S. and Canadian trade laws and practices (Schott, 1989). Similar legal systems and a common tradition of judicial review of administrative action have facilitated the implementation of the FTA dispute-settlement provisions (Lowenfeld, 1990: v). So far, the dispute-settlement mechanisms have functioned relatively smoothly and the panel decisions have not reflected national voting patterns (Lowenfeld, 1990: 10). The FTA arrangements, which were of great importance to Canada, do provide some leverage over U.S. administered trade policy, and hence some protection against U.S. unilateralism.

What is needed to administer a three-party agreement may well be more complicated institutionally than the structures established under the FTA. Any supranational institution will have to overcome traditional U.S. suspicion about the ceding of sovereignty to supranational bodies. While the U.S. and Mexico have signed bilateral accords, the formal structures linking the two economies are not well developed. If a NAFTA generates more extensive trilateral institutional arrangements, the two smaller parties should benefit, since to some extent this protects them *vis à vis* nonmembers. However, trilateralizing the FTA institutional mechanisms for a NAFTA may be difficult (Hart, 1990; Schott, 1989) given the different legal traditions and income levels between Mexico and its northern neighbours. The institutional structures in Mexico for a trilateral NAFTA remain to be developed. In addition, Canadian influence in trilateral dispute resolutions would be less compared to the FTA, creating problems where disputes are bilateral rather than trilateral.

VI. CONCLUSIONS

This paper has used a public choice approach to analyze the NAFTA policy formation process. It has focussed on: how NAFTA fits with fundamental national interests; how well NAFTA is understood by societal actors in the three economies; the likely configuration of gainers and losers from a NAFTA; and the institutional mechanisms that are involved in the NAFTA issue. There are always difficulties in applying a particular approach to the analysis of complicated political processes and the use of Kudrle's public choice model is no exception. In particular, we are sensitive to the interactive character of the four factors and their varying importance across the three countries involved in the NAFTA talks. Nevertheless, the approach allowed us to dissect some of the complexities of the NAFTA process and to analyze why this policy issue is currently high on the political agenda.

Our public choice approach to NAFTA policy formation leads us to conclude that the issue is less complex in the U.S. than in the other two countries: NAFTA has a long history in terms of visibility and thus is well understood by U.S. state and nonstate actors, is congruent with overall U.S. national interests, is heavily supported by U.S. MNEs and fits to some degree with U.S. institutional interests. On the other hand, the NAFTA issue is less well understood by Canadians; excluding MNEs seeking to rationalize production on a trilateral basis, the initiative does not have a clearly identifiable constituency. Canada's purpose at the table is more to protect its interests in the U.S. market, a defensive purpose, than to try to engineer competitive advantage. A NAFTA may in the long run strengthen Canadian competitiveness; however, this is not the major purpose behind Canadian pressures for trilateralization of North American trade linkages.

For Mexico, the movement to a NAFTA deepens institutional linkages between Mexico and the U.S. and affirms Mexico's commitment, initiated with GATT membership, to a more open trading system. While a NAFTA clearly has negative impacts on Mexican sovereignty it should benefit the two other national interests of prosperity and security. As Canada has traded off some loss of sovereignty under the FTA in return for secure access to the U.S. market (and therefore the prospect of greater prosperity), so, too, is Mexico launched on this road. While the adjustment costs are likely to be large, Mexico being the least advantaged of the three economies, it also has the most to gain, particularly from foreign investment.

We therefore conclude that for the U.S. the NAFTA strategy serves a variety of national and international purposes. From Canada and Mexico, by contrast, we see mainly recognition that the current global economic environment leaves them with few options except that of strategic alliance within a North American free trade area.

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