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U.S.-MEXICAN ECONOMIC TIES

INTRODUCTION

Mexico's economic health is of great concern to the United States. Not only is Mexico the third largest U.S. trading partner (after Canada and Japan), but economic hardship in Mexico could trigger political and social unrest that would have immediate repercussions north of the Rio Grande.

In the past decade, Mexico has suffered serious economic problems. Billions of dollars in oil revenues were squandered by the government on money-losing state-owned industries and higher salaries or graft for political elites. Nationalizations, culminating with the seizure of private banks in 1982, triggered capital flight, with Mexicans sending billions of dollars out of their country. Other flawed economic policies discouraged productive enterprise. Heavy foreign borrowing and misallocated funds, meanwhile, led to a huge foreign debt; Mexico now owes $108 billion and has difficulty paying even the interest on it. Economic output and living standards have declined.

Mexico at last has begun taking steps to deal with the causes of these economic problems. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT), the international arrangement meant to foster open markets. As a result of membership, Mexico has cut import tariffs and

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This is the eleventh in a series of Heritage studies on Mexico. It was preceded by *Backgrounder* No. 688, "The Security Component of U.S.-Mexico Relations" (January 26, 1989); *Backgrounder* No. 679, "A Review of 150 Years of U.S.-Mexican Relations" (October 31, 1988); *Backgrounder* No. 638, "Evolution of Mexican Foreign Policy" (March 11, 1988); *Backgrounder* No. 611, "Privatization in Mexico: Robust Rhetoric, Anemic Reality" (October 22, 1987); *Backgrounder* No. 595, "Keys to Understanding Mexico: The PAN's Growth as a Real Opposition" (July 29, 1987); *Backgrounder* No. 588, "Deja Vu of Policy Failure: The New $14 Billion Mexican Debt Bailout" (June 25, 1987); *Backgrounder* No. 583, "For Mexico's Ailing Economy, Time Runs Short" (June 4, 1987); *Backgrounder* No. 581, "Mexico's Many Faces" (May 19, 1987); *Backgrounder* No. 575, "Mexico: The Key Players" (April 4, 1987); and *Backgrounder* No. 573, "Keys to Understanding Mexico: Challenges to the Ruling PRI" (April 7, 1987). Future papers will examine other aspects of Mexican policy and development.

eliminated most import licenses. A special framework agreement signed in 1987 between the U.S. and Mexico establishes joint working groups to deal with trade differences. Mexico also has begun to privatize state-owned enterprises.

Triggering an Economic Boom. The most promising development has been the expansion of the so-called *maquiladora* program. Launched in 1965, the program allows foreign businesses to set up factories in Mexico, free of the general Mexican prohibitions on such enterprises, as long as the products of those factories are exported. Special U.S. tariff reductions for overseas production of goods using American components have encouraged two-way trade, with the U.S. providing inputs for *maquiladora* factories and Mexico returning finished products to the U.S. This arrangement as has triggered an economic boom in the border areas. Since 1982, employment in the special in-bond plants in Mexico has risen from 122,000 to 350,000. And around 100,000 Americans are employed supplying these plants.

The U.S. and Mexico should continue to build on the momentum of Mexican economic reform. Among the top priorities, the U.S. should continue to negotiate with Mexico to liberalize trade between the two countries. The long-term goal should be a U.S.-Mexican free trade area in which both countries remove all tariff and most nontariff barriers. In aiming for this, the U.S. should take care not to pressure Mexico; this could backfire in traditionally protectionist Mexico. The U.S. also must avoid new protectionist measures against Mexico.

Relaxing Regulations. To speed cross-border commerce, more U.S. customs inspectors should be assigned to Mexican border. In addition, U.S. officials should point out to their Mexican counterparts that labor shortages in *maquiladora* factories are due in part to poor public transportation for potential workers in border cities. Relaxing government regulations on this sector would allow even more Mexicans to find work in border factories.

By encouraging such reforms, to the benefit of both countries, the Bush Administration can build on the success of the *maquiladora* system and help solve the economic problems of Mexico, making it a model for other less developed countries.

THE *MAQUILADORA* PROGRAM

In 1987 the U.S. sold Mexicans $14.6 billion in goods and services while importing $20 billion worth. It is estimated that in 1988 the U.S. sold about $20 billion worth of goods and services to Mexico while purchasing $22 billion. The U.S. is Mexico's largest source of imports and largest market for its exports. Approximately two-thirds of all Mexico's exports are sent to the U.S.

Yet U.S.-Mexican trade and investment relations have had a difficult history. A central theme of the bloody 1910 Mexican Revolution was resentment among Mexicans of perceived American economic domination.

In the 1930s, the government of Mexico nationalized foreign-owned oil fields, mainly the property of American and British investors. And today, foreign majority ownership of any Mexican business generally is prohibited. The so-called "49 percent-51 percent" rule means that while foreigners can invest in Mexico, they cannot own controlling shares of a company.

Exception to Protectionism. The one major exception to Mexico's protectionist policy has become in recent years a major success story benefiting both the U.S. and Mexico. It is the Border Industrialization Program, popularly known as the *maquiladora* program. It was established by Mexico in 1965 to stimulate economic development in the then-stagnant northern part of the country. In 1972, the program was extended to the entire country, although the vast majority of facilities under this program are still in the border areas.

Under the *maquiladora* system, 100 percent foreign-owned production facilities can be established in Mexico if their output is exported. Machinery, raw materials, and semi-finished components can be imported for these factories duty-free. A special bond is posted by the businesses, which promise to re-export the finished products from these factories.

This "in-bond" system encourages foreign firms to invest in Mexico to take advantage of the country's lower wage rates. The average wage for *maquiladora* factory workers in 1987 was about $1.07 per hour. With Mexico's lower cost of living, however, this wage has drawn many Mexicans to the border factories and created many jobs.

U.S. Tariff Break. U.S. law encourages these factories to make use of U.S. raw materials and components. Under Items 806.3 and 807 of the U.S. Tariff Schedule,[1] products made overseas from American parts and components can be imported back into the U.S. with tariffs paid only on the value added to the product by foreign labor. Thus, if $100 of U.S. parts are shipped to Mexico for assembly in a *maquiladora* plant, and the value of the finished product reexported to the U.S. is $125, American tariffs are paid only on the additional $25.

While a wide range of items are produced in the *maquiladora* plants, most factories assemble semi-finished components. Example: the parts of a motor are assembled and the finished product shipped back to the parent company in the U.S. for direct sale to the consumer. Example: the carburetor for an engine is assembled in Mexico and returned to the parent company in the U.S. for inclusion in an automobile assembled in Detroit. Example: electronic components are assembled in Mexico then sold and shipped to another U.S. enterprise for inclusion in a computer.

1 The numbers of these titles are being changed due to a recent international tariff agreement accepted by the U.S.

HOW THE SYSTEM BENEFITS MEXICANS

The *maquiladora* system's most obvious benefit for economically troubled Mexico has been in job creation. By the first half of 1988 there were 1,333 plants under Mexico's in-bond system, a 125 percent increase since 1982. These facilities employ 350,000 Mexicans, a 187 percent increase over the 122,000 working in these facilities in 1982. The annual growth rate in employment in *maquiladora* plants averaged 15 percent between 1978 and 1987. Most remarkable of all, by mid-1988, this system accounted for 13 percent of all manufacturing jobs in Mexico.

The *maquiladora* program also has helped ease Mexico's debt burden. It is expected that the program will generate $2 billion in foreign exchange for Mexico. The in-bond system is ahead of tourism and second only to oil as a source of foreign exchange.

Fostering Responsibility and Pride. The *maquiladora* system has contributed other valuable, though less tangible, benefits to Mexican society. Since many of the lower-level workers in these facilities come from poor rural backgrounds, foreign employees often teach workers not only how to carry out their jobs but also the basic skills needed to succeed in an industrialized, urban environment. Elementary sanitation and hygiene, for instance, often are included in basic instruction.

Similarly, the social habits of working with others and taking responsibility and pride in the work product are emphasized. In some *maquiladora* plants, for example, workers are organized into sections and their productivity measured. This not only helps management to run the factory better but encourages workers to do better by allowing them to take pride in their own progress. In a electrical component plant visited by The Heritage Foundation, workers on the assembly line check the quality of the work at various stages of the production process. This not only allows them to correct mistakes but teaches them that their own efforts make a difference. Group leaders are designated in some plants and meet regularly to review and improve factory performance.

Emphasizing Individual Efforts. In one plant, a visitor sees no signs on the walls, customary in the U.S., warning workers to wear safety glasses, to keep the plant clean, and in general to observe the rules of the factory. Management explains that this is intentional. Initial employee training emphasizes that each worker is responsible for the safety and cleanliness of the factory. Pride in their factory and peer pressure have had positive results. A factory visitor sees neat work areas. There is no trash in sight. The employee cafeteria is clean. The *maquiladora* factories compare favorably with their U.S. or Asian counterparts.

While many factories in Mexico provide special salary supplements to defray the cost of transportation and meals during the workday, some *maquiladora* factories prefer to pay reasonable wage rates and to help workers learn to budget their funds. Management explains that this is an attempt to get away from the paternalistic practices of the Mexican government and industries that discourage people from taking greater responsibility for their own lives.

Workers in the *maquiladora* plants appear to be in good spirits and on friendly terms with their supervisors and management personnel. The firms often provide some form of counseling to workers having difficulties dealing with a factory job as well as family responsibilities. In addition, some factories hold free night classes for workers who wish to improve their reading and grammar.

Since the *maquiladora* factories must train certain workers in higher skilled jobs, like machine maintenance workers or quality control supervisors, many Mexicans improve their skills beyond the basic level. Opportunities for promotion exist in most factories. Other avenues of advancement are open as well. Since most of the *maquiladora* factories are concentrated in border cities, workers who improve their skills can seek better employment opportunities at the highest paying plants. Moreover, foreign firms usually have men and women working together, often in the same jobs and sometimes with women supervising men. This has helped to break down some of the gender barriers in this traditionally male oriented society.

HOW THE SYSTEM CREATES JOBS FOR AMERICANS

U.S. businesses were slow to take advantage of the *maquiladora* system. Yet by the mid-1970s, inflation in the U.S. and competition from companies in Asia using cheap labor encouraged American firms to set up operations in Mexico. With the devaluation of the Mexican peso in the 1980s, American businesses accelerated their expansion into border factories. Today, about 80 percent of the facilities under the *maquiladora* program are owned by Americans.

Some American observers complain that by attracting U.S. investment and plants to Mexico, the *maquiladora* system costs American jobs. They are wrong. Studies show that the in-bond system creates jobs for Americans and makes American businesses more competitive. The U.S. Department of Commerce estimates that in 1987 over 100,000 Americans were supplying the *maquiladora* plants. Over $4 billion in U.S. products were exported to in-bond facilities south of the border.

Suppliers in 49 U.S. States. A recent survey by Grupo Bermudez of Ciudad Juarez, Mexico, confirms this. It finds that 20,743 American enterprises in 49 states plus the District of Columbia supply components to *maquiladora* plants in just one Mexican city, Cuidad Juarez, which is across the border from El Paso, Texas. These suppliers generally are located in the Northeast and North Central industrial U.S. states. Illinois has 5,561 suppliers, the largest number in any one state. The other top ten suppliers for Juarez are Texas with 4,911 suppliers, Ohio with 932, Michigan with 920, California with 882, New York with 784, Pennsylvania with 667, Indiana with 614, New Jersey with 530 and Wisconsin with 527.[2]

Studies on the net economic impact of the system show major benefits for the U.S. A 1988 U.S. Department of Labor study, for example, found that if the U.S. were to eliminate the special tariff treatment of items manufactured overseas from America components, a key to the *maquiladora* trade, America would lose $2.6 billion in gross national product and 76,000 jobs.[3]

Some American critics of the *maquiladora* program complain that the Japanese are taking advantage of the system in order to sell their goods in the U.S. market. Yet only 34 out of over 1,300 *maquiladora* facilities are owned by Japanese citizens. Special U.S. tariff concessions, moreover, apply only to the percentage of a product made from U.S. components. A product made of Japanese parts in Mexico would not be subject to lower U.S. tariffs. In any case, it is not to America's economic disadvantage for foreigners to provide goods to U.S. consumers.

Making America Competitive

The lower cost of Mexican labor allows American businesses to be more price-competitive. Many U.S. firms now are able to maintain operations in the U.S., designing and constructing components, and perhaps doing final assembly work, on products put together in *maquiladora* plants. The 1,933-mile border allows for far greater and easier return of components and finished products to the U.S. market than if such products come from Asia. Moreover, good product quality control is a notable characteristic of the *maquiladora* facilities. Because it is more costly and time consuming to ship defective parts back to the U.S. than between facilities within the U.S., Mexican plants have adopted high quality control standards to remain attractive.

The trading regime established by the special Mexican in-bond factory program, and by the special U.S. tariffs for products made with American components, helps both countries. One country does not "win" while the other "loses." Both countries generate more jobs and higher national income due to this system.

Keeping Up With Economic Expansion

Ironically, one of the problems experienced by in-bond factories in Mexico is shortages of employees. This may seem strange in a country with at least 15 percent unemployment and with declining living standards. This is due in

2 William L. Mitchell and Lucinda Vargas, "Economic Impact of the *Maquiladora* Industry in Juarez, Mexico on El Paso, Texas and Other Sections of the United States," Grupo Bermudez, Ciudad Juarez, Mexico, 1987.
3 Greg Schoepfle and Jorge Perez-Lopez, *U.S. Employment Impact of TSUS 806.30 and 807.00 Provisions and Mexican* Maquiladoras*: A Survey of Issues and Estimates*, Economic Discussion Paper No. 29, Bureau of International Labor Affairs, U.S. Department of Labor, August 1988.

large part to the inability of many Mexican border cities to provide the services and infrastructure needed by workers.

Coping with Transportation and Housing Shortages. Because of deficiencies in public transportation, for example, *maquiladora* workers often must spend a long time traveling to and from work every day. In America, businesses facing these problems often provide shuttle buses for employees. In Mexico this is illegal. The government and unions exercise a tight monopoly over the transportation sector. In many less developed countries, "informal" unlicensed buses spring up to meet public demands and they are tolerated by government officials. But in Mexico the otherwise inefficient government is generally effective in stamping out such activities that threaten the power of transportation special interests.

Housing shortages pose another serious problem in border areas, making it hard for workers to move in and take jobs in *maquiladora* plants. The capital shortage in Mexico makes investment in housing difficult. While the Mexican government requires all employers to pay into a Employee Housing Fund, administered from Mexico City, housing allowances for workers are distributed through a lottery system. Thus, while *maquiladora* factories in Juarez, for instance, account for 65 percent of the contributions of firms from that city, workers in the Juarez *maquiladora* plants receive only 2 percent of that city's housing funds.

Another problem effecting cross-border *maquiladora* trade is the pace of U.S. customs checks. Trucks going to the U.S. must wait for hours and sometimes an entire day to be inspected before they can enter the U.S.

THE INCREASING PACE OF REFORM

The success of the *maquiladora* program has been followed in recent years by other significant Mexican trade liberalization measures. One of the most important was Mexico's decision in 1986 to join the General Agreement on Tariffs and Trade (GATT). Established in 1947 to set rules to promote international commerce, the GATT currently has over 90 members and associates from the non-Soviet bloc. In a series of negotiating rounds the GATT has lowered the tariff levels of members nations. The current round, which began in 1986 in Uruguay, seeks to deal with nontariff barriers.

As a member of the GATT, Mexico already has eliminated most of its import license requirements, replacing them with less restrictive tariffs. Further, Mexico has lowered its maximum tariff rates from over 100 percent on some goods to 20 percent.

In November 1987, the U.S. and Mexico signed an understanding "Concerning a Framework of Principles and Procedures for Consultations Regarding Trade and Investment Relations." This agreement could prove to be a breakthrough in economic relations between the two countries, which historically have been strained. The accord establishes procedures for regular U.S.-Mexican consultations and for the quick resolution of trade disputes. It also sets up regular working group meetings to deal with specific trade problems in the sectors of textile, agricultural, steel and electronic products, investment, technology transfer, and intellectual property rights. Four series of meetings were held last year and agreements reached in the areas of steel, textiles, alcoholic beverages and seeds.

THE NEXT STEP: A U.S.-MEXICO FREE TRADE AREA?

In 1985 the U.S. negotiated a Free Trade Area (FTA) agreement with Israel. In 1988 a similar agreement was adopted by the U.S. and Canada. Under an FTA, the signatory countries remove all tariffs and most nontariff barriers affecting each other's goods. Each country, however, keeps its own trade regulations on imports from other countries.

Many U.S. policy makers have expressed interest in a North American FTA, which would include the U.S., Canada, Mexico, and the noncommunist Caribbean and Central American countries. Advocates of this proposal point out that FTAs help the economies of all countries involved. The removal of trade-distorting restrictions allows resources such as labor and capital to be directed to sectors in which each country holds competitive advantages. Businesses in each country can sell their goods in the other's market, unhindered by trade barriers. The result: new jobs are created and national income rises in all the participating countries.

Helping Mexico Pay Its Foreign Debt. The U.S. and Mexico both would benefit from an FTA. Not only would jobs be created on both sides of the Rio Grande, but the economic growth triggered by an FTA would help Mexico pay its foreign debt and raise its low living standards. This would contribute to the social and political stability of the country.

Apparently many Mexicans, however, balk at an FTA with the U.S. The Mexican protectionist tradition and fear of foreigners is especially strong among union leaders and in the radical leftist faction of the Institutional Revolutionary Party, which has ruled Mexico for nearly 60 years. This faction is now challenging the policies of Mexico's new President Carlos Salinas de Gortari.

Competing Against Entrenched Myths. Mexicans, moreover, still generally do not understand the benefits of free trade. They fear, it seems, opening up their market to the American Colossus, whose $5 trillion gross national product dwarfs Mexico's $150 billion. Most Mexicans still assume that they cannot compete with rich and technologically sophisticated American enterprises. This is ironic, for so many Americans complain that it is impossible for American enterprises to compete with the low wages available to Mexican businesses. Both sets of critics are mistaken, as the *maquiladora* program has proved, but the myths are deeply entrenched.

Even among those Mexican who favor more liberal trade with the U.S., there is a feeling that other economic reforms must come first if Mexican businesses are to take advantage of open U.S. markets. Thus, while a

U.S.-Mexico Free Trade Area should be a goal of both countries, the U.S. must take care not to push too hard for such an agreement.

RECOMMENDATIONS

The *maquiladora* system has proved that free trade is profitable for all participants. Mexico, moreover, has taken further important steps to liberalize trade and should be congratulated for its efforts. While future steps depend in large part on Mexico, the U.S. can pursue policies to encourage more open markets. Among them:

1) Continue the sectoral trade liberalization talks under the Framework Agreement. The Framework Agreement of 1987 has led to a series of meetings to deal with U.S.-Mexican trade disputes. The Bush Administration should emphasize the importance of these meetings in resolving obstacles to freer trade with Mexico, and it should see them as helping to prepare the ground for an eventual U.S.-Mexico Free Trade Area. However, due to the sensitive political nature of trade in Mexico, the U.S. should not push too aggressively for an Free Trade Area in the near future.

2) Defend Items 806.3 and 807 of the Tariff Schedule against congressional attacks. Many American labor unions and liberals in Congress argue, incorrectly, that the special tariff breaks for products manufactured overseas with U.S. components cost American jobs. Since Tariff Schedule Items 806.3 and 807 actually create jobs for Americans, and since these provisions are central to the success of the *maquiladora* program, the Bush Administration should resist attempts by congressional protectionists to change them.

3) Do not use trade disputes with Mexico as an excuse for protectionist actions as a means of placating Congress. U.S.-Mexican trade issues should be given high-level attention by the Bush Administration and "tough-on-trade" rhetoric should be kept to the minimum. The U.S. should remember the prevailing economic ideology in Mexico, and the turbulent history of U.S.-Mexican trade relations, and avoid confrontation that will only revive protectionist sentiments in Mexico.

4) Increase the number of customs inspectors processing cross border trade. Free trade requires the speedy flow of goods; this is possible only if customs inspection is quick and simple. The trade generated by the *maquiladora* system in Mexico has been so great that U.S. customs officers have great difficulty keeping up with the volume of border crossings. More inspectors should be assigned to border crossings.

5) Urge Mexico to improve border infrastructure such as public transportation and housing by allowing private competition. U.S.-Mexican discussions of debt problems often center on broad economic policy. Yet Mexico could help create thousands of jobs for its own citizens, and help itself growth out of its debt morass, by improving transportation and housing in border areas. The Mexican government has declared this to be a high priority. American officials should point out that improving transportation does not always mean increased government expenditures. Mexico could spur improved services, for instance, by relaxing controls on private transit services.

CONCLUSION

The U.S. and Mexico are tied by mutual economic interests. While the history of relations between the two countries has not always been smooth, the debt crisis has encouraged many Mexicans to seek freer trade, with the U.S. in particular, as an element in a general program of economic reform. The special *maquiladora* factories, in combination with special U.S. tariff breaks for goods manufactured overseas with U.S. components, have demonstrated that such improved trade benefits both countries.

Pursuing Market Reforms. Economic growth in less developed countries is in America's national interest. This is especially true for Mexico, America's populous southern neighbor. Prosperous countries are better able to meet the basic human needs of their people, to purchase more American goods, and to resist communist subversion. A free market provides incentives and opportunities for individuals to profit through their own productive efforts. Economic expansion results. To achieve these goals, therefore, Mexico must pursue market reforms, including privatization, that is, returning government enterprises to the people, removing regulations that deter business and job formation, opening the economy to foreign investments, and free trade.

Mexico's only chance to deal with its economic problems is through such free market economic reforms. Free trade is one of the most important elements of such a reform program. The government of Mexico, in the face of pressure at home for even greater restrictions on economic freedom, has pushed ahead with reforms. The U.S. should continue to support this policy, making it an example for all debtor countries.

Edward L. Hudgins, Ph.D.
Director, Center for International
Economic Growth