Promoting Prosperity Through A U.S.-Mexico Free Trade Area

By Edward L. Hudgins, Ph.D.

During the last decade the debt crisis in less developed countries and the threat of increased trade protectionism were the two most serious international economic problems. The spark that set off the crisis was the default of the Mexican government in August 1982. The crisis developed and was fueled, in Mexico as well as in other debtor countries, in part by trade protectionism. Restrictions on imports meant low productivity for Mexican industries and massive government subsidies to state-owned enterprises that tried to make up, in an extremely inefficient manner, for lost imports. The result was massive government borrowing. In addition, trade restrictions in developed countries, including the United States, closed markets for goods from Mexico and other debtor countries.

Now, Mexican President Carlos Salinas de Gortari has asked the U.S. to open talks on a Free Trade Area (FTA) between the two countries. The Bush Administration not only has wisely accepted this offer but has suggested a Western Hemisphere FTA. It is appropriate that with his FTA request, President Salinas will help deal with his country's debt and trade problems, and take a giant step in assuring Mexico's future economic growth and prosperity. Further, an FTA will create jobs in Mexico, reducing in part the exodus of Mexicans to the U.S. Finally, it will force Mexicans to invest only in their most productive industries. Less money will be wasted on inefficient enterprises hiding behind a wall of protection.

Incentives for Others. The U.S. also will gain from such an FTA with Mexico. More American goods and services will be sold in Mexico. American consumers will have greater free access to Mexican products. Further, a U.S.-Mexico FTA will create greater incentives for other countries to seek bilateral open markets with the U.S. The Israel and Canada FTAs with the U.S. have created pressures for more free trade. An FTA with Mexico will bring us one step closer to complete open markets in North America, the Western Hemisphere, and perhaps throughout the world.

President Salinas showed wisdom and courage in seeking a Free Trade Area with the U.S. The Bush Administration has been equally wise in offering to negotiate FTAs with any country in the Hemisphere that seeks one. The Administration should extend this offer to Asian countries such as the Republic of China on Taiwan and Singapore. And if Congress wishes to help the U.S. and these other countries, it will give these arrangements their full support.

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America's Interests in Mexico

The history of U.S.-Mexican political and economic relations has been troubled. The last century saw war over territory and U.S. military intervention in Mexico. A major goal of the Mexican Revolution of 1910 was to reduce what was perceived by Mexicans as excessive American investments and thus excessive political influence in their country. Mexico nationalized most foreign enterprises and set strict limits on foreign investments. In general, foreigners generally were allowed to own only 49 percent of a business. This meant that the Mexican government often had to provide investment capital for industries and thus often had to borrow money or inflate the currency. Further, Mexico erected trade barriers to foster the development of its domestic industries. This resulted in inefficient industries, since they did not have to compete in world markets, and low levels of economic output. Many industries were owned by the government and required heavy subsidies to meet expenses. This meant more borrowing or currency inflation by the Mexican government. Thus, Mexico's trade protection was a major contributing factor to the debt crisis.

But the problem has not only been on Mexico's side of the border. American trade protection for products such as textiles and apparel products robbed Mexico of markets for its goods. And in general, trade protection in developed countries has harmed the poorer countries. A February 1989 study by the U.S. Agency for International Development on "Development and the National Interest" found that all the foreign aid given by richer countries does not quite cover the damage done by their protectionist policies to less developed countries.

Yet despite past troubled relations, with the exception of the Soviet Union, no country is of greater importance to the U.S. than Mexico. Its 80 million people and two-thousand-mile border with the U.S. mean that Mexico's problems are America's problems.

The U.S. has a three-fold interest in an economically prosperous Mexico. First, a poverty-stricken Mexico is likely to be politically unstable. The rise of an anti-American, pro-communist regime South of the Border would be a major security disaster for the U.S. A prosperous Mexico likely would be politically stable and friendly to America.

Second, America has a humanitarian interest in seeing the elimination the destitution that is characteristic of the lives of too many Mexicans. The average Mexican has only about one-tenth the annual income of an American.

Third, an economically prosperous Mexico is better able to purchase American products and to supply goods to the U.S. market.

U.S.-Mexico Trade Relations

The U.S. and Mexico already have a close economic relationship. The U.S. is Mexico's principal trading partner, last year absorbing some $25 billion, or about 60 percent, of Mexico's exports and providing $27.2 billion, or 65 percent, of Mexico's imports. America's third largest trading partner after Canada and Japan, Mexico receives 6 percent of U.S. exports and sells America 6 percent of its imports.

In recent years Mexico has taken major steps away from its closed market policies of the past. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT), the international arrangement meant to foster open markets. As a result of this move, Mexico has cut import tariffs from a high of 100 percent on some items to a maximum today of 20 percent. Most tariffs are far below this level, averaging about 9 percent.

Further, Mexico has eliminated most import licenses. In addition, a special framework agreement signed with the U.S. in 1987 establishes joint working groups to deal with trade differences. Now Mexico is taking an even bolder step by seeking a Free Trade Area (FTA) with the U.S.

The Free Trade Area Approach

Most trade between over 90 of the non-communist countries is governed by the GATT. The basic principle of the GATT is most favored nation (MFN) status. All GATT members agree that the lowest tariff rate charged on any given product will be charged to all other GATT members, even if their tariffs on this product are higher or lower than this amount. This makes international trade easier, since each country has one set of tariffs for all other GATT members. It also prevents trade wars in which tariffs on some given items are raised on a particular country but not on others.

Over the last decade, however, the GATT has been less able to cover non-tariff trade barriers. The current round of GATT negotiations, scheduled to end this year, will try to deal with some of these problems. Further, America's trade deficit has led to increased protectionism by the U.S. and trade tensions with other countries.

An FTA moves beyond the GATT and allows two countries to remove all tariffs and many non-tariff trade barriers, such as quotas or licensing requirements for domestic goods that discriminate against imports. Restrictions on foreign investments also could be eliminated. An FTA differs from a customs union in which the member countries have a uniform set of tariffs and trade laws applying to non-members. In an FTA, each member keeps its own set of trade regulations for non-members. An FTA also differs from a common market. In addition to uniform trade laws towards non-members, workers in a common market are free to move between member countries.

The U.S. currently is phasing in over ten-year periods FTAs with Israel, which was approved in 1985, and with Canada, which took effect in 1989. The debates in the U.S. and these countries over FTAs brought out many of the advantages of this sort of arrangement. An FTA is bilateral. Both sides open their markets. It is therefore a "fair" trade. Both sides benefit. There is not a "winner" or a "loser." Both countries win. By allowing goods and services to be produced by the most efficient companies in member countries, FTAs help raise the GNP in both countries.

Critics' Errors. Some critics maintain that an FTA will work only between countries at similar levels of economic development and with similar social and political institutions such as the U.S. and Canada. FTAs between developed and less developed countries such as the U.S. and Mexico, they argue, would not benefit both countries.

The arguments specifically against a U.S.-Mexico FTA on both sides of the Rio Grande illustrate the errors of both groups of critics. Some Mexicans fear that opened markets will mean that the U.S., with a GNP of $5.5 trillion, would completely dominate Mexico's $150 billion economy. They assume that Mexican industries will be unable to compete with rich and technologically advanced American firms. Mexican businesses, they maintain, will shut down in the face of U.S. imports.

Ironically, American critics complain that an FTA with Mexico would doom many U.S. firms that would be unable to compete with the low wages available to Mexican enterprises. Further, they fear that as American investments move to Mexico and more American factories are established there, Americans will lose jobs.

Complementary Economies. Both U.S. and Mexican critics are wrong. The economies of the U.S. and Mexico complement one another. Some American firms need access to inexpensive Mexican labor in order to lower their costs and remain competitive. Mexico needs American capital and technology to get its economy growing again. Both countries will gain jobs and additional GNP.

A preview of the FTA benefits is found in the special U.S.-Mexico arrangement popularly known as the *maquiladora* system. Under this program, which gained momentum in the last decade, U.S. firms can establish wholly owned factories in Mexico, typically near the U.S.-Mexican border. Permitting Americans to own factories outright is an exception to the usual Mexican limit of 49 percent foreign ownership. The owners can import, duty-free, capital equipment, components, and raw materials for their operations. The final products must be exported. The U.S. for its part, gives special tariff breaks to imports manufactured from American-made components.

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.

100,000 U.S. Jobs. This *maquiladora* system employs an estimated 350,000 Mexicans. Some 100,000 Americans work at jobs in the U.S. to supply these facilities. Without the *maquiladora* option, the U.S. probably would not "win" 350,000 jobs from Mexico. More than likely, the U.S. firms would move offshore entirely, perhaps to Asia, would contract their operations in the U.S., or would shut down. The U.S. might well lose all 100,000 jobs. In 1988 the U.S. Department of Labor estimated that if America removed special tariff treatment for items manufactured overseas out of U.S. components, a key to the *maquiladora* trade, America would lose $2.6 billion in GNP and 76,000 jobs.[1]

A recent survey by Grupo Bermudez of Ciudad Juarez, Mexico, found that 20,743 American enterprises in 49 states plus the District of Columbia supply components to *maquiladora* plants in just one Mexican city, Ciudad Juarez, which is across the border from El Paso, Texas. These suppliers generally are located in the Northeast and North Central in-

1 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.

dustrial U.S. states. 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]

The Benefits for the U.S.

An FTA with Mexico promises a number of economic benefits to the U.S. First and foremost, opened markets would mean that American enterprises could sell more products South of the Border. Under the *maquiladora* arrangement, goods produced in American factories in Mexico must be re-exported and thus do not enter the Mexican economy. Products that the U.S. could sell would include telecommunications equipment, computers, machine tools, mining and construction equipment, electrical production and generating machinery, and food processing and packaging equipment.

If an FTA includes the elimination of U.S. import quotas, the American consumer would benefit from increased access to certain Mexican textile and apparel products among other goods.

The U.S. also could be getting in on the ground floor of a new, fast growing economy. The FTA proposal is only one of the major changes made by President Salinas in his attempt to radically reform the Mexican economy. With the help of the FTA as well as other reforms, Mexico could become a fast growing economy, another South Korea or Thailand.

The Benefits for Mexico

Mexico, in a sense, has the most to gain from an FTA since its economy is in far worse shape than is America's. Opened markets would give Mexican companies access to less expensive, high quality capital goods. This would go a long way to helping Mexico increase its economic productivity and modernize its industries and infrastructure. In the end, purchasing power and higher living standards are a result of turning out the most goods and services per input of labor, capital, materials, energy, and equipment. Mexican prosperity thus is tied to Mexican productivity.

If an FTA removes restriction on foreign investments in Mexico, as it should, then Mexico would, in the long term, receive much needed capital invested in existing enterprises or in new ones. Free movement of capital should be an essential part of a U.S.-Mexican FTA.

An FTA also would give Mexican consumers access to certain American consumer products. In many less developed countries, governments try to limit imports to items deemed essential to production. This is a mistake. Economic reforms in less developed countries ultimately should offer individuals the opportunity to profit from their own efforts. Individuals work and seek better ways to serve the market demands of their fellow citizens not for the good of the state, but for their own good and that of their families. A salary means nothing if an individual has no access to the goods and services that makes his

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.

or her life better. Therefore a market opened to all products is an essential element for generating economic growth.

And important point must be kept in mind about free trade. Generally, "countries" do not trade with one another. Individuals do. For both Mexicans and Americans, a free trade area simply reestablishes the right of individuals to dispose of their property as they see fit, to buy and sell based on mutual agreement.

Creating Opportunities. An FTA also would create incentives for Mexicans to invest in enterprises that are truly competitive and to remove support from enterprises that can only survive behind a wall of protection. It will become more costly for Mexicans to keep open inefficient enterprises if they are subject to competition from imports. The Mexican government will find itself increasingly unable to supply the larger subsidies needed to keep state enterprises in operation.

An FTA will give Mexico free access to the U.S. market for its goods. This will create opportunities in many industries and will, in the long-term, more than offset the burdens of economic adjustment.

Finally, an FTA will give Mexicans an incentive to stay and work in their own country rather than flee to the U.S. It is often said that Mexico either will export to the U.S. its goods or its people. And despite what is commonly believed, Mexico, not America, will gain from slower immigration into the U.S. The Mexicans going North are the most energetic and entrepreneurial, the ones that are willing to act and take risks to better their lives. These are just the sort of individuals that Mexico should want to keep.

Fallacies About Free Trade

In both Mexico and the U.S., policy makers and the public as well hold a number of mistaken beliefs about free trade. Many Mexicans, for example, worry that increased economic integration with American could result in undue influence over their politics. This concern is the result of the unfortunate history of U.S. intervention in Mexico. But in today's world, such influence is of less concern. For example, Canada feels free to oppose the U.S. on foreign policy matters even though Americans have $90 billion in direct and indirect investments in Canada, own many businesses in Canada completely, and purchase the majority of Canadian exports. During the Vietnam War, for example, Canada accepted American draft dodgers with impunity.

Some critics of free trade on both sides of the border are concerned that wages in Mexico will remain low with greater American ownership of productive Mexican assets. Yet even now in the *maquiladora* factories, foreign owners have manpower shortages and attempt to attract workers with special benefits and bonuses. Mexican government wage guidelines are more responsible for keeping wages low.

Further, the only permanent solution to low wages is higher productivity. The Asian countries of Hong Kong, South Korea, Singapore, and the Republic of China on Taiwan begun in such a situation but produced themselves to higher wages and living standards.

Momentum for Worldwide Open Markets

Beyond the immediate economic benefits to the U.S. and Mexico, and FTA would create additional incentives for more open markets worldwide. In 1985 an opponent of free trade perhaps made the case best in favor of such arrangements. Testifying before Congress on an FTA with Israel, Stephen Koplan of the AFL-CIO said:

> If agreement can be reached and Congress approves, it would be the first such free trade arrangement in U.S. history. Its establishment would make future requests from other countries for free-trade areas much more difficult to refuse. The economic and political rationale given by the Administration for establishing a free-trade area with Israel will be cited as precedent by many other countries in the world. Is this initiative the start of the process where similar negotiations will soon commence with South Korea, the Philippines, or the European Economic Community?

While this FTA opponent got the countries wrong, he correctly identified the momentum set up by FTAs. The U.S.-Israel FTA illustrates this point. Shortly before Israel and the U.S. entered FTA negotiations, Israel established substantial trade liberalization with the European Community. Without an FTA, U.S. products entering Israel subject to tariffs would have competed at a disadvantage against European goods subject to lower tariffs. Thus, the incentive for the U.S. was not to close its markets to Israeli goods in retaliation but rather to open Israel's market further to U.S. goods, in this case through an FTA.

Japan's Concern. The FTA's potential dynamics were evident during then-Japanese Prime Minister Yasuhiro Nakasone's 1986 visit to Canada shortly after Washington and Ottawa announced their intention to open free trade talks. While publicly Nakasone expressed no reservations about the pact, behind the scenes Japanese officials were concerned about the effects of such an FTA on sales of Japanese goods competing with U.S. goods in Canada. As Mexico began its trade liberalization with the U.S., the Japanese began to take a much greater interest in that market.

A year or two ago I had a conversation with business representatives from the Caribbean. They expressed some concern that if the U.S. established an FTA with the Mexico before establishing one with the Caribbean, that investments might go to Mexico rather than to the Caribbean.

All of these examples illustrate the incentives created by FTAs for non-member countries to seek similar arrangements, countries competing to be the next to establish FTAs with the U.S. This interest is spreading in this Hemisphere. Several years ago Uruguay asked the U.S. about what an FTA would involve. Unfortunately, at that time the U.S. said that Uruguay's major exports, apparel products and agricultural goods, would probably be excluded. An opportunity to demonstrate the U.S. commitment to open markets was missed. Recently, when asked about an open trading arrangement in North America and converting the Caribbean Basin Initiative into an FTA, Jamaican Prime Minister Michael Manley said he thought it would be inevitable. Argentina recently hinted that it might be interested in an FTA. Chile has made a similar suggestion.

Invitation to All. The idea of a North American FTA including Mexico, Canada, the Caribbean, and Central America has been discussed for some years. Now President Bush has showed true leadership and imagination by offering to negotiate a Western Hemisphere FTA. This proposal deserves the strongest support from Congress and from any citizen of this Hemisphere who wishes to give all people the opportunity for economic prosperity. The Administration, moreover, should extend the same free trade invitation to any Asian country that wishes such an arrangement. Currently, the Republic of China on Taiwan and Singapore are seeking FTAs with the U.S.

The goal of U.S. trade policy should be open markets in the U.S. and with all of our trading partners. FTAs are an important tool in any free trade strategy. The U.S. therefore should offer to negotiate FTAs with any country that wishes to remove its own barriers to American imports in exchange for open U.S. markets.

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