

U.S. JOBS AND THE MEXICO TRADE PROPOSAL

by Jeff Faux and William Spriggs

In his May 1 letter to the Democratic leadership, George Bush said that “economic studies show that a free trade agreement would create jobs and promote growth in the United States.”

But the studies cited by the President and other proponents at best show only **insignificant** gains in employment from a Free Trade Agreement (**FTA**), ranging from zero to 64,000 jobs over a ten-year period. Additions to the Gross Domestic Product (GDP) are projected to be 0.04 to 0.06 percent of GDP. However, even such modest estimates are based on unrealistic and inconsistent assumptions, such as: 1) full employment -- which assumes away **all job** losses! 2) no shift in investment from the high wage U.S. to the low wage Mexico.

This report shows that **with** more sensible but still conservative assumptions, the same sort of economic models cited by the Administration produce estimates of U.S. job dislocations of 550,000 jobs after ten years and a loss to U.S. GDP of \$36 billion.

* * *

In attempting to make sense out of the various claims made for the job impact of an **FTA**, two points should be kept in mind:

1. The decision on fast track is not a decision on the principle of free trade, nor on liberalizing the flow of commerce between the U.S. and

Mexico. It is a decision on the Bush Administration's particular version, which we already know has the following characteristics:

- it is an agreement on trade and investment liberalization only;
- debt relief is "off the table";
- adjustment assistance to U.S. workers and questions of labor and environmental standards will not be regarded as part of the treaty and if treated at all will only be as a reluctant political concession by the Administration.

2. No one *can predict the outcome of the Bush proposal with any accuracy*. Economists have a hard enough time making relatively easy predictions--such as interest rates in six months--much less the complex long-term interactions between the U.S. and Mexico that would flow from this unprecedented arrangement.

Thus, the decision on fast track requires a judgement on the risks of *this particular proposal*, specifically: how do the *potential job gains compare with the potential job losses?*

THE ADMINISTRATION'S NUMBERS

In making its case, the Administration's May 1 submission to the Congress cites three studies. A close look at these studies show that the estimated benefits are so small as to be statistically insignificant and therefore in any practical sense they do not support the claims that the President and the other Administration spokespeople make for them.

We examine each of these studies:

1. The **Clopper Almon-~~INFORUM-CIMAT~~** study, *Industrial Effects of a Free Trade Agreement between Mexico and the USA, completed in*

September, 1990 for the Department of Labor, with a January 1991 update. **This** study predicts that, as a result of a free trade agreement, after five years GNP in the U.S. will increase by \$1.7 billion (in 1977 dollars, or \$3.1 billion in 1988 dollars). The tiny increase in GNP is almost meaningless since it is **smaller** than the statistical error embedded in the compilation of the GNP! The study claims a job gain of **64,200** by the year 2000. This job change is so small that the unemployment rate would be virtually unchanged (it goes down by less than **five** one hundredths of one percent.) As in the case of the “gains” in GNP, the job increases projected are smaller than the standard error for measuring U.S. employment, and for all practical purposes reflect a zero increase in jobs from an **FTA**.

2. The **Peat-Marwick study, commissioned by the U.S. Council of the Mexico-U.S. Business Committee, February 1991.** The study assumes that Mexico will receive additional capital as a result of the **FTA, but not from U.S. investors.** It claims real income would increase by only 0.04 percent. The model “assumes” full employment, and thus there are no changes in U.S. employment levels at all. Again, the income results are small and the job conclusions meaningless.

3. The U.S. **International Trade Commission report, The Likely Impact on the United States of a Free Trade Agreement with Mexico, February 1991.** **This** study asserts a general belief that an **FTA** will bring unspecified benefits to the U.S. economy. But the study **quantifies** neither benefits nor costs. It gives no numbers on overall job or income gains or losses. The report does note **that** “Unskilled workers in **the** United States would suffer a slight decline in **real** income, but U.S. skilled workers and owners of capital services would **benefit** more from lower prices and thus enjoy increased real income” (ITC, page 2-6). When the Economic Policy Institute asked for the data on how many workers were defined as unskilled, the answer the **ITC staff** gave was **73** percent of the U.S. work force. This conclusion was later disowned in a letter from Commissioner Anne E. Brunsdale, to Congressman Dan **Rostenkowski**, in which she claimed that the **ITC** had located “new” estimates of “elasticities” for

Mexican imports which now indicate that lower-wage U.S. workers would have a wage **increase** of 0.011 percent! Even if we take the new found elasticities at face value,¹ it results in a number that is so small that in a statistical sense it represents no growth at all.

These studies thus give no support to the President's claim that "a free trade agreement would create jobs and promote growth in the U.S."

Still, some proponents have used these results as proof that an FTA will not damage the U.S. economy, i.e., it will be "harmless." But **all** three of these studies suffer from fundamental flaws, inherent in the statistical models themselves, which make it impossible for them to say whether or not the FTA will cause a loss of jobs and income to U.S. workers.

1. None of the three studies addresses the concern that the FTA will create incentives for U.S. **firms** to shift investment in production facilities, and therefore jobs, to Mexico. **The** reports assume that **there will be no such shift. The** assumption is arbitrary. It defies not only common sense, but the experience of the continuous shifting of investment to the Mexican **Maquiladora** sector. This **extraordinary** omission is underscored by warnings, scattered throughout the **ITC** report, that if U.S. investment in Mexico does increase substantially, job and income losses will be much higher than they have guessed and will extend to those U.S. industries that the **ITC** now assumes will be gainers **from** the FTA, such as automobiles and machinery. For example. the study hints that the Big Three U.S. auto makers are likely to invest significantly in Mexico. But because the Big Three's actual intentions are today "unknown," the report refuses to consider the potential impact of increased investments on U.S. employment. Likewise, the machinery and equipment industry is presumed to be a winner **from** the FTA. Yet,

¹ There are good reasons to suspect these elasticities. For instance among the results relied upon is the implication that when the price for some basic industrial products--like copper plates and wires-- drops, demand falls.

the **ITC** admits: “In the long run, and assuming that an **FTA** does not result in the equalization of wages and health, safety, and environmental standards, U.S. **firms** may accelerate the process of producing more **finished** machinery and equipment in Mexico.” Since the study explicitly concludes that wages **will not equalize** (ITC Report pp. 2-5, 6) the implication is that there *will* be a shift of investment, and therefore, jobs.

2. Both the **ITC** model and the Peat-Marwick study *assume full employment*. This means that by *definition*, there can be no *net job losses*. The models do allow for job shifts between industries, but there are no adjustment costs for workers or companies. Job changes are assumed to take place instantly.

3. All studies assume that U.S.-made components and inputs will continue to be employed supplying *Maquiladora* plants, even though the **tariff** advantage that now holds would be terminated. In other words, there will be zero purchases from Japan, Europe, or other Pacific rim sources, nor any relocation of the component manufacturing to Mexico.

FACTORING IN INVESTMENT

Of **all** of the limitations of the models above, the absence of an equation allowing investment to move freely is the most damaging. The assumption of **full** employment, **while** misleading, **still allows** the policy **analyst** to study the degree of worker “dislocation”--that is the number of people who would lose their present jobs and would have to find new ones, possibly at lower wages, or be permanently unemployed.

The shift of investment however, is key to the analysis of the possible effects on U.S. jobs. As everyone in the debate acknowledges, U.S.-Mexico trade has already been largely **liberalized**. Indeed, that is a reason why the **ITC**

study **tells** us there **will** be so few gains for U.S. exports as a result of the agreement.

Mexican restrictions on investment have also been liberalized, although some restrictions remain--particularly in the critical oil and other **extractive** industries. But as a previous Economic Policy Institute study ("Fast Track - Fast **Shuffle**") points out:

Multinational corporations are reluctant to make the massive **long-term** investment in plant and equipment needed to take full advantage of cheaper costs in Mexico because of concern over the political climate. Specifically, they fear a return of popular hostility to foreign investment and the threat of nationalization. Their solution is to put the rights of foreign investors into an international treaty that any future Mexican government would find difficult or impossible to change. As the **ITC** report notes: 'by codifying liberal trade and investment policies in an international agreement ... a U.S.-Mexico **FTA** would increase the confidence of investors in **Mexico's** economy.'

Thus, the attraction of Mexico for U.S. manufacturers is not Mexico's small consumer economy, it is the labor force of almost 30 million willing to work for wages that average one seventh of ours in Mexican manufacturing and one fourteenth in the **Maquiladoras**. These wage differentials, contrary to the assertions in the President's May 1 submission are not due to lower productivity. For example, Walter Mead, in a EPI study, found that though a Mexican Ford engine plant was 80 percent as **efficient** as a U.S. plant, workers were paid 6 percent of U.S. wages. (Walter Russell Mead, **The Low-Wage Challenge to Global Growth: The Labor Cost-Productivity Imbalance in Newly Industrialized Countries**, Economic Policy Institute, 199 1.)

Of course, no one knows precisely how much investment will be shifted. Spokespeople for corporations that are lobbying for the **FTA** are obviously not

going to tell the Congress of their intentions. But, despite the inherent limitations of all modeling, we can get closer to the impact of capital mobility by removing the restriction on capital movements in the models. A more realistic model would examine the effect of allowing capital to move freely from the **U.S. to Mexico.**

Accordingly, the Economic Policy Institute asked University of California at Berkeley economist Dr. Raul Hinojosa-Ojeda to modify the standard model of U.S.-Mexico relations he has developed with **economist** Dr. Robert McCleery to allow for a modest shift of capital **between the U.S. and Mexico.** The equation introduced into the model reduced the risk premia for U.S. investors investing in Mexico by 10 percent as a result of the **FTA.** Given that all economic analysts think the **FTA** will increase U.S. investor confidence in Mexico, this is a rather conservative assumption.

The **Hinojosa-McCleery** model is similar to that of the **ITC** and **Peat Marwick** in that it is a “Computable General Equilibrium” model. The **Hinojosa-McCleery** model is unique in that it encompasses the interaction of trade, migration, and capital flows between sectors in each country. But, like the other models, it too assumes full employment. In fact, run without the adjusted capital investment equation, it generates an even larger gain for the U.S. from an **FTA** than the studies cited by the Administration. **(This is due to certain assumptions it makes about migration.)** A complete description of the model is given in Raul **Hinojosa-Ojeda** and Robert **K. McCleery**, “U.S.-Mexico Interdependence, Social Pacts and Policy Alternatives: A Computable General Equilibrium Approach” [***Estudios Economicos, Vol. 5 (Number 2, 1990 forthcoming)***].

Two scenarios were simulated by the model. The **first**, a “status quo” projection, assumed a continuation of the historic differential in the return on capital between the U.S. and Mexico. Interest rates are assumed to be stable, oil prices rise to reach their 1982 level by the year 2000, Mexico is able to receive **\$4.5 billion (nominal) in new lending per year to maintain its debt**

payments, the Immigration Reform and Control Act (IRCA) of 1986 is assumed to work -- in that costs to migrants rise by twenty percent and wages for undocumented workers fall by ten percent.

The second scenario has the same assumptions, except investors are allowed to be more confident in Mexico as a result of a free trade agreement, Free trade is modelled as an elimination of tariffs between the two countries over 10 years beginning in 1992. The differential in returns to capital between the U.S. and Mexico is allowed to fall by two percent the first year of the agreement, and one percent each additional year until the year 2000, for a ten percent overall decline in the risk premia.

This scenario results in a movement of \$44 billion in capital from the U.S. to Mexico over the decade. As a consequence, the U.S. loses 550,000 jobs and the U.S. Gross Domestic Product falls by \$36 billion. Because the model assumes full employment, these workers are reemployed, but with a 50 percent wage cut.

The loss of jobs because of direct foreign investment shifts is not a unique finding of this model. For example, Norman Glickman, the director of urban policy research at Rutgers University and Douglas Woodward, professor economics at the University of South Carolina in their book, *The New Competitors* (New York: Basic Book, 1989) found that between 1977 and 1986 U.S. companies* investments abroad stimulated the creation of 588,000 jobs, but caused the loss of 3.3 million *American jobs*. They calculated a net loss of 2.7 million jobs. So the finding of a loss of 550,00 jobs projected by the Hinojosa-McCleery model is certainly in line with our experience.

CONCLUSION

Economic models cannot predict the future. They can, however, clarify the risks of perspective policies. In the case of the proposed U.S. - **Mexico** trade agreement, an examination of the models tells us:

1. The Administration and the proponents have vastly overstated the benefits and ignored obvious costs.

2. Even a modestly more realistic assumption of a slight decrease in the risks of investing in Mexico results in substantial loss of jobs and incomes for U.S. workers.

It should be further noted that other risks have not been addressed. These include, for example, the dangers of encouraging U.S. financial institutions. themselves **burdened** with excessive debt, to expand their investments in an unstable Mexican economy that could plunge once again into a debt crisis. The result could be a massive claim on the U.S. Treasury and the Federal Reserve Bank to bail out Mexico in order to save U.S. **financial** institutions.

So far, neither this nor any **other** possible economic risks have been addressed by the Administration in its rush to a treaty. Under these circumstances, agreeing to fast track could put the nation in economic peril.

(Note: for a more comprehensive analysis of the proposed U.S. - **Mexico** trade agreement see: Jeff Faux and Richard Rothstein, "Fast **Track**, Fast **Shuffle: The Economic** Consequences of **the Administration's Proposed Trade Agreement with Mexico**," Economic Policy Institute Briefing Paper, March, 1991).

May 1991