



Mexico—The Sick Man of NAFTA

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In the memorable debate between then-Vice President Al Gore and failed presidential candidate Ross Perot over the North American Free Trade Agreement (NAFTA) in November 1993, Perot offered up perhaps the most famous quip of the night. Mexico, he argued, was a poor choice for a trading partner, because “people who don’t make anything can’t buy anything.”¹ In the nearly ten years since that debate, many of Perot’s criticisms of NAFTA have been discredited: trade has soared between Mexico and North America (although not to the degree that some NAFTA proponents had hoped); on a net basis few jobs have been lost in the United States because of the free trade pact; and U.S. companies have not decamped to Mexico so as to avoid stricter U.S. labor and environmental regulations. But that callous remark about Mexicans not making anything and therefore not buying anything from the United States has proven depressingly correct. Most NAFTA boosters at the time dismissed Perot’s comments, promising that the agreement would usher in a wave of economic modernization in Mexico that would improve the productivity of Mexico’s workers, raise living standards, and create a much wealthier nation of consumers ready and able to buy American-made goods. Since NAFTA went into effect on January 1, 1994, however, economic growth in Mexico has averaged just 2.7 percent per year, exactly the same rate of economic growth as in the decade prior to NAFTA’s birth. Moreover, the number of Mexican workers has increased by roughly 2.8 percent a year over the last ten years, meaning

that workers’ incomes have actually fallen since the agreement went into effect. At least on this one count, Ross Perot was correct: Mexicans have not become the prosperous consumers of North American goods that so many NAFTA supporters expected.

The failure of NAFTA to improve the lives and incomes of ordinary Mexicans presents a serious challenge to policymakers on both sides of the U.S.-Mexico border. The perceived shortcomings of neoliberal economic policy have already taken their toll on bilateral relations, as a sluggish Mexican economy has put President Vicente Fox Quesada—a vocal proponent of NAFTA and neoliberal reforms, including privatizing state enterprises, creating a more flexible labor market, and signing more free trade agreements—on the defensive, which in turn has helped create an environment in which he must burnish his nationalist credentials for domestic consumption. These pressures became all too apparent in the debate over U.N. approval for the war in Iraq, when the normally supportive Fox refused to back the United States in the Security Council, despite President Bush’s entreaties. The failure of NAFTA to fulfill its promise of widespread Mexican prosperity has also meant continued illegal immigration into the United States, of both unskilled and skilled workers. This has contributed to tense bilateral relations, as Washington’s concerns about terrorists crossing the porous U.S.-Mexico border arose just as President Fox began pressing for more relaxed border controls. Economic sluggishness in Mexico has also contributed to the trade in illegal

drugs, one more point of friction between the two countries.

The Productivity Morass

Perhaps the greatest disappointment to the proponents of NAFTA after more than a decade of deregulation, privatization, and lower tariff barriers has been the stubbornly low level of productivity gains in Mexico. Simply put, labor productivity is in many ways the overwhelming determinant of improvements in living standards. But the hoped-for productivity miracle in Mexico has not materialized. Mexican labor productivity, by some measures, has actually declined since the beginning of the 1990s, whereas productivity in the United States—already a developed nation with presumably fewer opportunities for easy gains in this area—has risen by a third since 1990. The widening of the productivity gap, when all predictions were that the gap would narrow, is probably the most fundamental issue that policymakers in both Mexico and the United States must address, as the failure of Mexico's labor force to post productivity improvements undercuts the very rationale for NAFTA, especially from the perspective of Mexican workers.

To understand the productivity problem, one first has to grasp the magnitude of Mexico's dependence on growth in the labor force to drive growth in the overall economy. In 1970, 43.6 percent of Mexico's pool of potential workers (technically, all Mexicans 12 years old and older) were actually in the labor force, either working or actively seeking work. The vast majority of working-age individuals not in the labor force were women. (While these women may well have been working long hours, household labor did not technically contribute to Mexico's GDP.) Over the next three decades, however, the work force participation rates of Mexican women soared, with most of the shift out of the home and into the work force occurring in the 1990s, when the Peso Crisis of 1994–95 (a crippling episode of

currency devaluation, followed by a 7 percent decline in GDP and a 20 percent decline in workers' wages) forced economically inactive Mexicans to seek work. In 1991, women represented just 26 percent of the total labor force; by 2000, they represented a full 45 percent of all workers. This surge in the number of women seeking and finding work pushed the overall labor force participation rate to 56.3 percent of the population of working-age Mexicans by 2000.

While Mexican women were entering the labor force in unprecedented numbers in the late twentieth century, Mexico was also enjoying an unprecedented demographic boom in the overall population and, more importantly, in the number of working-age people. Only 50.8 percent of the population was 15 years old or older in 1970, but by 2000, a full 67.4 percent of Mexicans were 15 or older. During this period, Mexico's population also doubled, rising from 50.7 million in 1970 to 110.3 million in 2000. Thus, with women entering the work force, the surge in the working-age population, and the increase in the overall population, the size of the labor force has more than tripled over the last three decades, from 11.2 million workers, to 37.3 million workers at the end of 2000.

Comparing the growth in the labor force to the growth in the Mexican economy over the last three decades—the labor force rose by over 230 percent, GDP rose by just 220 percent—it is clear that productivity growth has been depressingly low. Thus, Mexican workers appear to be less productive today than they were in 1970.² This calculation could possibly overstate the problem to some degree; it is possible that the average number of hours each Mexican worker spent on the job declined somewhat over the last three decades (which would mean that workers were able to produce more per hour worked), but the lack of reliable data on the work week leaves this hypothesis difficult to test. Even assuming that the work week has grown shorter for

the average Mexican worker over the last few decades, there would have to have been a 45 percent reduction—from, say, 40 hours a week to just 22 hours a week—for Mexican productivity to have kept pace with productivity growth in the United States. To put that hypothesis into perspective, changes in labor patterns in the United States since 1970, including a significant rise in female work force participation, have only decreased the average work week by about 2.5 hours, from 37 hours in 1970 to 34.5 hours in 2000. The more probable conclusion is that Mexican labor productivity has significantly lagged productivity in the United States.

The fact that productivity growth has remained so stubbornly low in Mexico comes as a surprise to those NAFTA boosters, both in Mexico and in the United States, who argued that a common market would invite a wave of foreign investment in Mexico and with that investment would come a transfer of technology and skills that would propel the Mexican economy—and the productivity of its work force—into the twenty-first century. To be sure, NAFTA has at least partially fulfilled its promise in certain geographical regions and in select sectors of the economy. The manufacturing sectors around Monterrey, in the northeast, and Puebla, a few hours south of Mexico City, for instance, have become relatively sophisticated over the last 15 years, due in large part to foreign investment and loans, and productivity in these regions has risen as a result. However, much of the rest of the Mexican economy has stalled or even regressed in terms of worker productivity. The state-controlled petroleum and electricity sectors, major components of the Mexican economy, are notorious for their inefficiency. Tourism, a labor-intensive sector where productivity gains are difficult to achieve, has grown in relation to the overall economy, dragging down productivity growth as more and more workers enter the low-value-added hotel and restaurant industries. The *maqui-*

ladora (manufactured goods assembly) industry is another sector where growth has been relatively high but productivity gains have been low. Built along the U.S.-Mexico border to rapidly assemble parts—often U.S. or Asian-made—into finished products like household appliances or consumer electronics, these factories are by definition low-value-added operations that depend on cheap labor, not skilled workers.

By far the worst culprit in Mexico's sluggish labor productivity picture, however, has been the dramatic increase in the number of marginal workers in the informal sector. This increase is difficult to quantify, but most Mexicans will agree that the number of irregular street vendors, for example, is substantially higher today than it was 20 years ago. While these workers may be marginal, they are still members of the labor force, and their chronic lack of skills dilutes the productivity gains experienced in the dynamic sectors of the economy.

Yet another driver of low productivity growth has been Mexico's proximity to the United States, the very factor that NAFTA boosters argued would usher in an era of high productivity growth and rising living standards, as North American companies sought to benefit from Mexico's lower labor costs. As NAFTA's promises have failed to materialize, however, this proximity has led to a brain drain of relatively high-skilled Mexican workers who cross the border in search of better labor opportunities in the United States. To be sure, the porous border has also let lower-skilled Mexican workers seek work in the United States: the majority of Mexican immigrants to the United States have not completed high school. Still, roughly 1.2 million Mexican immigrants in the United States have completed some education after high school, a staggering figure when one considers that only 5.2 million Mexicans have completed any postsecondary education. This means that Mexico has lost roughly 20 percent of its most educated workers to the U.S. job market.

This last point presents a serious dilemma for policymakers looking for solutions to the problem of sluggish productivity growth. The most obvious public policy solution would be to increase Mexico's stock of human capital through increased funding for education. While increased investment in education could well result in higher levels of average educational attainment, it is by no means clear that those better educated graduates would not take their skills to the United States in search of more attractive labor opportunities. This is not to argue that investment in education would not yield some positive returns in terms of productivity growth, but so long as other conditions (poor infrastructure, labor market rigidities, institutional and regulatory deficiencies, etc.) militate against an improved economic picture, Mexican policymakers cannot be sure that better educated Mexicans will mean a better educated and more productive labor force.

Mexico's Structural Challenges

Mexico's inability to generate significant labor productivity gains—and its corollary inability to generate substantial improvement in income levels and overall development—cannot be blamed entirely on the brain drain into the United States. Mexico faces a number of mounting structural problems, including a growing social security crisis, a poor long-term outlook for the petroleum sector, chronic underinvestment in the electricity sector, and an overwhelmed health care system, that will bring further economic disappointment—to Mexicans as well as to U.S. policymakers and foreign investors—unless they can be addressed. In fact, given the array of pressing structural problems facing Mexico, the productivity and income growth outlook over the next decade could be even more disappointing than that of the last three decades.

The first, and potentially most explosive, of these structural issues is Mexico's looming social security crisis, which has

been growing on two fronts, with rising deficits in public-sector workers' pension plans and growing demand for health care spending. Mexico faces chronic and rising deficits in the State Workers' Institute for Social Security and Services (ISSSTE), the pension system that covers most of Mexico's public-sector workers. Largely a product of the oil-rich boom years of the 1970s, when the long-ruling PRI party extended generous benefits to government workers in order to secure their electoral support, the ISSSTE is fast becoming one of the most expensive items in an otherwise underfunded government budget. Under current ISSSTE rules, government pensioners have the right to draw 100 percent of their last 12 months of salary upon retirement. With the average worker retiring at age 56 and the average life expectancy beyond retirement at about 22 years, this guarantee imposes a significant burden on the government budget. The pay-as-you-go system's generous benefits were set up at a time when the age pyramid of Mexico's government workers was heavy at the bottom, with many young public-sector workers supporting relatively few pensioners. Now, however, the system covers only 2 million active public-sector workers while providing benefits for 400,000 retirees: a dependency ratio of 5:1. The dependency ratio, which was 20:1 just 20 years ago,³ is projected to shrink to 2:1 by 2020,⁴ meaning the pension contributions of just two government workers will have to be stretched to cover the generous pension benefits of one retiree. Because the federal government is committed to covering any deficits in the ISSSTE pension system, the worsening dependency ratio will mean rapidly increasing costs for Mexico's taxpayers (and its lenders).

Just a few years ago, the prospects for reform of the pension system—and a reduction in the long-term burden the system would impose on Mexico's fiscal accounts—appeared much brighter. Mexico, under former president Ernesto Zedillo, successfully

enacted important reforms to the pay-as-you-go private-sector pension system, transforming it from a defined benefit plan with serious actuarial deficits to a defined contribution plan with greatly reduced actuarial deficits. However, President Zedillo did not follow through with similar reforms with respect to ISSSTE, largely for fear of alienating the powerful public-sector unions. The Zedillo government dropped the issue when it realized that the PRI would face stiff competition in the 2000 presidential election.

Zedillo's decision to soft-pedal ISSSTE reform was not enough to help the PRI hold on to the presidency, however, and in 2000 Vicente Fox Quesada, who ran on a platform of wholesale reform, was elected. As the leader of the center-right PAN party, President Fox is much less beholden to the interests of Mexico's public-sector workers than his predecessors, although he has apparently decided that the political costs of tackling ISSSTE reform would be too great. Fox would prefer to stress other structural reforms—particularly the partial privatization and deregulation of the electricity sector that would benefit constituents in his electoral base in the more heavily industrialized north. In truth, reforming ISSSTE would be extremely difficult for any Mexican president since Mexico's three-party system virtually guarantees that no president can muster an outright electoral majority. Reform of the ISSSTE would require congressional approval, but no one party is likely to control an outright majority in either chamber of Congress, even after this summer's elections. Reform would have to be initiated by President Fox's party, but the centrist and the leftist parties, looking ahead to the 2006 presidential elections, could easily form an alliance to block reform. What this means is that Mexico's taxpayers, or the foreign and domestic lenders who cover Mexico's deficits, will be forced to finance a pension fund deficit that is projected to rise from roughly 0.3 percent of GDP (approximately \$2 billion) today to 1.4 percent of

projected GDP 20 years from now. This will drain funds away from the investments in education and infrastructure that Mexico needs to make in order to jump-start worker productivity.

The second half of Mexico's social security crisis derives from the government's role as the provider of most health care services. The problems in the Mexican Social Security Institute (IMSS) stem from two sources: the fact that the costs for health care services will continue to rise above the inflation rate, and the dismal state of IMSS facilities and equipment, and the corresponding need for significant investment to ward off further deterioration of services. Rapidly increasing health care costs are a problem everywhere, but in Mexico's case the problem has been compounded by a sharp rise in those covered under the IMSS health plan. Since 1974, the number of persons eligible for IMSS health services has risen by 350 percent; however, during this same period the number of hospital beds in the system increased by only 20 percent.⁵ The physical condition of IMSS facilities has also deteriorated, with 40 percent of all of Mexico's primary care hospitals judged to be either in immediate need of significant repairs so as not to compromise services, or so dilapidated that they require constant and expensive maintenance. The problem of unreliable or seriously outdated medical equipment in IMSS facilities has also grown more acute in recent years, with the IMSS health service estimating that it needs some \$600 million (0.1 percent of GDP) to replace broken equipment, and considerably more to modernize its equipment. All of this comes against the backdrop of Fox administration budgets that have seen drastic cuts in health care investment spending in order to offset rising expenditures elsewhere. The 2001 budget cut spending for building new hospitals, upgrading existing facilities, and purchasing new equipment by 70 percent, to just 0.02 percent of GDP, and the 2002 budget slashed them to zero, a level not seen even during the worst days of the

Peso Crisis, when a steep recession forced broad cuts in government spending.

The political costs of allowing the health system to continue to deteriorate as the demands of an aging population for services increase will be hard to ignore, and this is likely to be an important issue in the 2006 presidential elections. The fact remains, however, that rehabilitating the system will require considerable government expenditures, and there are no obvious new revenue sources that can be tapped. If the federal government diverts resources that might otherwise go toward other pressing long-term needs, like investing in education and infrastructure to the health care system, it will undercut productivity growth. And so the vicious cycle continues.

If only Mexico could produce more oil, or produce it more efficiently, it is often argued, there would be plenty of money to finance the investments Mexico needs to make in order to modernize. Unfortunately, PEMEX, the government-owned oil and gas monopoly, is no longer the goose that lays the golden eggs. Mexico's long-term oil outlook is grim; proven and probable hydrocarbon reserves will be depleted in 35 years at current production levels. Oil and natural gas reserves have been steadily declining since 1984. After exponential growth in the 1970s and early 1980s, oil production was flat from 1984 to 1989, and has grown at an average annual rate of just 1.8 percent since 1990. This picture could change if there were major new discoveries, but the Fox administration, which is hamstrung by the lack of private investment in the hydrocarbon sector, has called only for enough exploration to maintain hydrocarbon reserves at current levels. Therefore, unless there is a permanent increase in oil prices in real dollar terms, oil revenues will inevitably fall, as a percentage of GDP, as Mexico's economy grows but production remains more or less stable.

To offset stagnant oil revenues, the Mexican government will have to find a way to

broaden its tax base, but there is no political appetite for tax reform that would sufficiently offset sluggish oil revenues. One of President Fox's top priorities upon entering office was to broaden the sales tax base. But Mexico's divided Congress could not agree to the politically unpopular measure, and the long-term prospects for Fox's vision of fiscal reform now appear bleak.

Yet another structural deficiency Mexico must address is its seriously outdated and inefficient electricity sector. Mexico's constitution grants the state the exclusive control of the electricity system, from generation through distribution. This state monopoly has resulted in a persistent lack of investment in generation capacity because the government has either been unwilling or unable to mount the borrowing campaign necessary to bring the system up to date. By the government's own account, the electricity sector will require \$100 billion in new investment over the next decade in order to meet growing demand. President Fox's reform initiative to amend the constitution to allow the private sector to participate in the generation and distribution of electricity has been stalled in Congress since last year, however, and unless Fox's party is able to gain a significant number of seats in this summer's congressional elections, it is unlikely that Congress will agree to liberalize the electricity sector before the 2006 general elections.

If Congress does not approve the liberalization of the sector, the federal government will have to devote scarce public-sector resources to maintaining and upgrading the system. It is unlikely to be able to come up with the required \$100 billion, but even partial funding will drain resources from other critical areas. And the country will still be left with an inadequate electricity grid, yet another disincentive to investment.

A Recipe for Growth

The recipe for rapid productivity growth in Mexico is not especially complicated: a mix-

ture of increased (and more efficient) spending on education and physical infrastructure, deregulation and legal reform, and an intensified battle against corruption.

But this is all much easier said than done. Perhaps Mexico's greatest triumph in the aftermath of the Peso Crisis of 1994–95 was to have put its fiscal house in order by reducing spending in real terms, and a long record of fiscal restraint has earned Mexico investment grade ratings of Baa2 from Moody's and BBB from S&P, which allow many U.S. and European pension funds and insurance companies to invest in Mexican debt. A loosening of the fiscal reins now in the form of a wave of new education and infrastructure spending could threaten those ratings, especially if those new expenditures were not offset by politically unpopular budget cuts. A loss of investment grade ratings would entail higher borrowing costs and, potentially, a host of other economic ills that could undermine the government's ability to sustain higher investment spending.

With Mexico's options for increased spending limited, the Fox administration and Congress must undertake reforms that, however politically contentious they may be, could lead to increased, and more equally distributed, economic growth down the road. The outdated electrical system—a strong disincentive to potential new investments in manufacturing—must be opened up to private investment. The public-sector pension plan must be restructured, with pensions reduced and the minimum retirement age raised for new retirees. Bureaucratic red tape should also be addressed; one recent study showed that manufacturers looking to open a facility in China must complete only 22 bureaucratic steps to begin operations, whereas in Mexico the same firm would have to clear 359 bureaucratic hurdles.⁶ Finally, Mexican labor relations should be made more transparent so as to encourage companies to invest in the country. The process by which union delegates

are chosen must be made more democratic so as to avoid union bosses who represent the interests of neither the workers nor the company. The specialized labor courts, which scare away potential foreign investors wary of judicial corruption, should be integrated into the existing judicial system.

Even if Congress were to approve all of these structural reforms—an unlikely scenario, given the current political divisions—Mexico would still have considerable unmet investment needs for which there will be no funds available so long as the country pursues its International Monetary Fund–endorsed fiscal policies. Therefore, the United States should provide targeted foreign aid for Mexican education and infrastructure spending. Last year, Mexico spent just \$1.1 billion on school construction and only \$1.3 billion on capital investment in communications and transportation. A modest annual U.S. aid package of \$1.2 billion would allow the Mexican government to boost spending in these critical areas by 50 percent. To mollify the persistent critics of NAFTA and foreign aid—both from the right and the left—in the U.S. Congress, such an aid package could be tied to the approval by the Mexican Congress of the structural reforms outlined above, reforms which would have obvious benefits for U.S. companies investing in Mexico.

A sizeable aid package directed at increasing Mexican labor productivity would be in the clear self-interest of the United States, which spends billions on policing the Mexican border against illegal immigrants and drug smugglers, and on education and health care for Mexican immigrants. Helping Mexico deal with its economic problems would make far more sense than the border controls that have proven so costly, both in financial and human terms. More importantly, U.S. companies are unable to exploit a potentially vast Mexican consumer base, because a lack of economic development has stunted the growth in Mexican wages. Faster growth in Mexican wages could be a

boon to U.S. exporters at a time when sluggish or nonexistent growth in Japan and the European Union has led to tepid demand in our traditional export markets. Finally, such a foreign aid package would be aimed directly at the problem for which NAFTA is so often blamed: income inequality. Whether or not the criticism of NAFTA as an engine of inequality is fair, a U.S. aid package targeted at building and upgrading Mexico's schools and roads could address the problem of anti-American Mexican nationalism, reflected in the popular pressure on President Fox to pursue an independent foreign policy during the debate over the Iraq War, and help improve bilateral relations over the long term.

Unfortunately, the likelihood of such a happy combination of U.S. aid and Mexican reform is slim at best, given the current political climate on both sides of the border. For the United States to offer such a package—and for the divided Mexican Congress to accept its terms and approve the required structural reforms—would require a change of heart in both Washington and Mexico City. The Bush administration would have to relax its skepticism about foreign aid that is not directly tied to strategic or domestic political interests, as with aid to Turkey or the African AIDS relief package. The administration would have to sell such aid as benefiting U.S. companies, which would be able to capitalize on a richer Mexican consumer. In Mexico, the political factions that consider themselves to be the defenders of the populist revolution of 1910 would have to abandon their vision of public control of the electricity grid as a cornerstone of national sovereignty, and in cooperating on social security reform they would have to be willing to alienate public-sector workers. Such a change of heart is not unthinkable—similar political realities existed when Mexico began to liberalize its economy in the late 1980s, and again when the private-sector social security regime was restructured following the Peso Crisis—but President

Fox, or his successor, will have to be able to convince the general public that the welfare of the nation depends on reform.

Yet U.S. aid and Mexican reform could be a winning combination for both sides. In the short term, a successful structural reform agenda would improve investor sentiment, reducing the interest rates at which the government, Mexican corporations, and Mexican consumers could borrow. Over the long term, Mexico would continue to benefit from higher economic growth and rising incomes, while the United States would experience more manageable migration flows from Mexico and, more importantly, a more dynamic Mexican consumer market for U.S. exports. One thing is clear: until Mexico's problem of low productivity growth is tackled, Ross Perot's assessment of Mexico's economic potential will continue to ring true. ●

Notes

1. "Gore, Perot Challenge Each Other on NAFTA Money, Facts," Bloomberg News wire, November 19, 1993.

2. Mexico's official productivity data do not stretch back to 1970, and even then they are limited to only certain workers and are therefore not comparable to productivity data for the United States or other developed nations. See Christian Stracke, "Mexico Debt Sustainability—The Bumpy Road to Single-A," November 24, 2002, at www.creditsights.com/marketing/headlines/0211/004355.htm.

3. See Interamerican Development Bank, "Health and Social Security Reform for Government Workers," mimeo, August 2002.

4. See International Monetary Fund, "Mexico: Selected Issues," Country Report No. 02/238, October 2002, p. 80.

5. See IMSS, "Informe al Ejecutivo Federal y al Congreso de la Unión sobre la Situación Financiera y los Riesgos del Instituto Mexicano del Seguro Social," mimeo, June 2002.

6. Consejo Mexicano de la Industria Maquiladora de Exportación, as reported in *Reforma*, May 23, 2003.