

that the major benefit will come from the liberalization of the few areas that still require import permits, fundamentally in the agricultural sector. Likewise, phytosanitary rules, quarantine restrictions and protection of national production, are other restrictions which when eliminated will ease the functioning of agroindustrial maquiladoras whose activity is increasingly important in Mexico.

From the point of view of the United States, tariff liberalization will imply for the maquiladora industry an important promotion of the procurement of Mexican raw materials which will be imported duty-free. Currently, the United States applies import duties to Mexican added value on products which enter its territory, except in the case of imports which qualify under the General System of Preferences. In these terms, the greater the contents of materials with American origin, the smaller the impact of the import tax. In contrast, the greater the contents of Mexican raw materials, the higher the import taxes. The aforementioned American General System of Preferences has been an instrument which has benefited maquiladoras which are exempt from all kinds of import taxes.<sup>38</sup>

The elimination of tariffs on imports from the United States will be greatly beneficial for the maquiladora industry and particularly for the Mexican

38 Maquiladora enterprises have benefited the most with the American General System of Preferences. The majority of imports exempted through this avenue belong to maquiladora exports.

industry which can compete with other suppliers of raw materials to the maquiladoras. Currently, over 90% of the raw materials used by maquiladoras are supplied by non Mexican markets because of tariff reasons, degree of trust worthiness of supply, quality standards and required technologies.<sup>39</sup>

On the other hand, it is important to emphasize, that according to the import rules used by the maquiladora industry, tariffs 9802.00.60 and 9802.00.80, are justified in so far as American raw materials which return as part of the final product have not been submitted to a transformation process which does not allow their custom identification. If raw materials were substantially transformed, the United States applies an import tax on the total value of the final product. In these cases, tariff liberalization will be a decisive factor for the promotion of maquiladoras whose industrial process implies an important transformation degree or whose product does not qualify under the General System of Preferences.

To conclude, the liberalization of tariff and non-tariff barriers will promote and spawn important additional advantages for the maquiladora industry.

### *B. Currency exchange control rules*

Little has been said regarding the effect that the Free Trade Agreement would entail in the subject-

<sup>39</sup> Pg. 1-5. The Likely Impact on the United States of a Free Trade Agreement with Mexico. *Idem.* Ant.

matter of currency exchange rules. It is convenient to recall that under the terms of the Decree for Exchange Control and its Complementary Rules, maquiladora enterprises are subject to the controlled market rules regarding payment of operative expenses incurred in Mexico.<sup>40</sup> Even in the cases in which the maquiladora obtains a maquila program to cover its idle capacity, its obligation will be even stricter because they will have to register currency sale commitments.<sup>41</sup>

In purely economic terms it seems logical to conclude that the signing of a Free Trade Agreement and the transfer of currency—an immediate effect of it—is a sufficient motive to eliminate the exchange control measures currently in force in Mexico.

We must not forget that the maquiladora industry is the second generating source of currency for Mexico.<sup>42</sup> Said source stems from the sales which the maquiladoras carry out to pay for their domestic operative expenses. Eliminating exchange controls would imply that the Mexican government would cease to hold this industry captive and, therefore the benefit of acquiring currency which Mexico requires to face its international commitments, at preferen-

40 Article 5 of the Exchange Control Decree published in the Official Gazette of the Federation on December 13, 1982.

41 By registering currency sale commitments (CSC), there is an obligation to sell all revenue produced by the exports at the controlled exchange rate to the Mexican Banking system. In the case of 100% maquiladora enterprises, only the operation cost is sold, and therefore the profit margin is not subject to exchange controls.

42 Pg.1-5. The Likely Impact on the United States of a Free Trade Agreement with Mexico. *Idem. Ant.*

tial rates, would be reduced.<sup>43</sup> However, exchange in a free trade market will open up a valve for the entry of currency due to the exchange of goods and services and investments which would be stimulated immediately. It is possible that the generation of currency created by a free trade area as well as investments will surpass the official income of currency which currently is generated in the controlled exchange market.

It is believed that, if not immediately, surely in the medium term, exchange control rules must be eliminated, otherwise, investment would be discouraged and the philosophy and guiding principles of the Free Trade Agreement would not be accomplished.

Regarding the maquiladora industry, the elimination of the controlled exchange market would be one more incentive for the manufacturing of goods in Mexico. Indeed, while operating in free markets, the maquiladoras will obtain more pesos to operate in Mexico. However, upon suspension of the exchange market it is expected that the exchange rate will be pegged, and thus, exchange profits or losses will become a transitory phenomenon until a uniform rate is achieved. In the long term, exchange variations will disappear as was the case in Mexico before the 13th of December of 1982, when the Exchange Control Decree was enacted. Mexico will have to carefully analyze its trade balance and exchange accounting, and the macroeconomic implications which are ex-

<sup>43</sup> As represented by currency purchases at the controlled exchange rate and the difference which exists between said exchange rate and the free market rates.

pected in light of the application of the free trade agreement, in order to make a final decision regarding the elimination of exchange controls.

### *C. Tax provisions*

Differences in the tax regime structure and treatment between the countries involved in free trade are of great importance in order to achieve a harmonic system in the international arena.

Currently, tax systems in Mexico, the United States and Canada are different in their fundamental principles. Regarding income tax, Mexico establishes as the main tax connection point the residence of tax payers.<sup>44</sup> In the United States, on the other hand, the fundamental connection is the nationality of people.<sup>45</sup> However, both countries recognize the existence of income sources for non-residents. On the other hand, regarding complementary taxes, Mexico has adopted a tax on assets, which is a tax that does not exist in the United States. The Value Added Tax functions differently than the sales tax in force in different states in the US, although in both cases the tax is paid by consumers. The tax system in place in the different states in America is much more important than in Mexico where the federal tax system is dominant. These differences in tax systems are an example of the economic philosophies in countries with contrasting needs and origins.

<sup>44</sup> Article 1 of the Income Tax Law.

<sup>45</sup> However, the residence principle is applied in the cases of foreigners when they have a permanent residence in the United States or they comply with the requirements established in the law.

The latter not only suggests, but in fact requires, an adaptation of the tax systems to establish congruency in the economic interaction within the free trade area. It is important to note that the United States has never signed a Convention for the elimination of international tax sources with Latin American countries. Mexico will be the very first Latin American country with which the United States will initiate negotiations for the signing of a double taxation Convention.<sup>46</sup>

Currently, maquiladoras have been acknowledged as expense sources, not as profit sources. This consideration is based on the fact that traditionally maquiladoras have been exporting industries and the benefit which they have produced in Mexico is the generation of jobs and currency. There are no legal provisions in the Mexican tax laws which expressly acknowledge the maquiladora industry as expense sources.<sup>47</sup>

With the opportunities currently available for the sale of maquiladora products in Mexico, the concept of "expense source" is losing its strength. In so far as the maquiladora penetrates the domestic market offering its products and services, the legal tax rules applicable to profit margins in terms of free competition become binding.

46 According to an article published in the Wall Street Journal, "Tax Report" column, January 23, 1991. In this respect it is convenient to point out that Mexico and the United States already have a Tax Information Exchange Agreement.

47 Article 64 of the Income Tax Law does not make distinctions and clearly indicates that the operations registered at cost or without profit are subject to the possible determination of presumptive income on the part of the tax authorities. However, it is a reiterated policy of the Mexican Tax authority to consider maquiladoras as expense sources, not profit sources.

In a free trade market it is expected that the maquiladoras will sell their products in Mexico without restrictions as is the case with domestic enterprises. Under these conditions, it is considered that maquiladoras will benefit from the free trade agreement and become regular taxpayers in the country. Thus, a negative effect of the free trade agreement for the maquiladora industry will be its assimilation to Mexico's domestic industry for tax effects. This phenomenon has already occurred in a primary and relative fashion with the establishment of the 2% tax on enterprise assets which is also applied uniformly to all enterprises established in Mexico.<sup>48</sup>

Although assimilation of maquiladoras with the domestic industries will entail tax considerations for the maquiladoras, there are also worldwide tax consolidation mechanisms in place, as well as international tax crediting schemes and, more importantly, great expectations for the signing of a tax convention which will eliminate double international taxation. If this latter convention becomes a reality, maquiladoras will not be at a disadvantage, economically or taxwise.

Regarding rules on income sources for non-resident tax payers in Mexico, in case double taxation is not addressed by an international treaty, the problems

<sup>48</sup> However, inventories, machinery and equipment which are transferred by the main office of an enterprise to their maquiladoras, are exempted from the tax under the terms of rule 132 of the Tax provisions for 1991, published in the Official Gazette of the Federation on March 15, 1991.

which derive from it will have to be reviewed so as to not discourage investment, financing and transfer of capitals between the free trade countries. The concepts of interest payment and other capital product withholdings, of dividends distribution,<sup>49</sup> and royalties for the transfer of technology, will have to be modified due to their highly chilling effect on trade and international investment.

#### *D. Foreign investment restrictions*

As we underscored in the point regarding the analysis of the foreign investment rules for the maquiladora industry, traditionally it has been exempt from the restrictive rules contained mainly in the Law to Promote Mexican Investment and to Regulate Foreign Investment.

The aforesaid conclusion is correct in so far as the maquiladora industry is considered an export industry.<sup>50</sup> However, the penetration of the maquiladora industry in the domestic market, and the rules on exemption from the foreign investment restrictions have their limits. As an example we have the maquiladora automotive parts industry which obtains a permit to sell in Mexico. In this case, is it

49 In the area of distribution of dividends to non-resident stockholders, the Mexican Income Tax Law only contemplates tax withholding if the amounts distributed as dividends have not been subjected to tax payment at the corporate level. The distribution of resulting dividends from net profits after taxes is exempt from withholding.

50 The new Regulations of the Foreign Investment Law, in Article 6, provide for the possibility of keeping up to 100% of capital of Mexican enterprises in the hands of foreigners as long as said enterprises are classified as exporting enterprises.



justifiable that the maquiladora with 100% foreign investment compete with non maquiladora enterprises from the same industry restricted by the Foreign Investment Law to a maximum 40% foreign investment? Which prevails, the Bylaw of the Foreign Investment Law or Article 5, Paragraph C of said law?

There are other cases of maquiladoras which operate in industrial areas that are limited in the levels of participation for foreign investment.<sup>51</sup> Actually, the legal interpretation which presents an acknowledged promotion of the maquiladora industry adopted by the officials of the Ministry of Commerce and Industrial Promotion, has established that the maquiladora industry is clearly an exception to the restrictions placed on foreign investment, justifying the existence of the cases which we have mentioned above. However, this favorable criterion for the maquiladoras assumes, as an indispensable premise, that we are dealing with a wholly exporting industry. Indeed, in the case of the automotive parts maquiladoras, the permits for their sale in Mexico are restricted and submitted to internal consultations by the competent authorities.<sup>52</sup>

The aforementioned problem will become more important when the Free Trade Agreement is enforced because one of its effects will be the liberalization of sale permits in Mexico. Maquiladoras benefited with the Agreement will be able to sell their products in Mexico

51 As an example we can quote Article 46 of the Federal Fire Arms and Explosives Law, which limits maximum foreign participation to 49% in enterprises dedicated to the manufacturing of explosives.

52 As a policy set down by the Ministry of Commerce and Industrial Promotion, in the automotive parts industry, maquiladoras can only sell up to 20 % of their production in Mexico.

without restrictions. Under the latter premises, the assimilation of the maquiladora industry to the domestic industry will imply the surfacing of restrictions on foreign investment for maquiladoras. However, because it is believed that the Free Trade Agreement will also eliminate, to the maximum possible, restrictions on foreign investment, in the final analysis, all enterprises benefited with the free trade agreement will be able to operate without investment barriers or limitations in the orientation of markets.

If this double phenomenon occurs, if maquiladoras are allowed the indiscriminate sale of products in Mexico, and on the other hand, restrictions on foreign investment are eliminated, the maquiladora industry will enjoy an important benefit in its activities in Mexico. In this respect, Mexico must give the treatment of assimilation of nationals to investors who are benefited with the Free Trade Agreement under the terms of Article 6 of the Foreign Investment Law, as is the case with the Free Trade Agreement between the United States and Canada.<sup>53</sup> However, said assimilation acknowledges limitations according to the barriers and the fundamental exceptions contained in the Federal Mexican Constitution.<sup>54</sup>

53 Article 1402 of the US-Canada Agreement.

54 Articles 27 and 28 of the Federal Constitution.

### *E. Sales rules in Mexico*

This subject-matter was mentioned in the previous headings, therefore, we will only make some additional comments.

According to the rules currently in force, maquiladora industries can sell, within Mexico, up to 50% of their additional production, if and when they have a positive individual currency balance.<sup>55</sup> Currently, enterprises which obtain a sale permit in Mexico, must pay import taxes related with merchandise and components which they require for the manufacturing of the products which will be sold in Mexico.

With the approaching Free Trade Agreement and the liberalization of import tariffs, maquiladora industries can sell their products in Mexico without any restrictions and without the payment of the import taxes aforementioned. This effect of free trade will be greatly beneficial for maquiladora enterprises which qualify under the terms of the agreement.

### *F. Rules on real estate property in Mexico*

Regarding the legal provisions which govern the acquisition and disposition restrictions of real es-

<sup>55</sup> Articles 20 to 23 of the Decree for the Promotion and Operation of the Export Maquiladora Industry. Positive currency balance implies that maquiladoras are only allowed to sell production units manufactured with import raw materials whose value does not exceed the amount of currency that said enterprises have sold at the controlled exchange rate during the year preceding the sale request, and as long as said unit total does not exceed 50% of the maquiladoras' total production during the same period.

tate property, we must refer to article 27, Section 1, of the Federal Constitution. In what is known as the prohibited zone, 50 kilometres along coasts, and 100 kilometres along Mexican borders, foreigners cannot acquire real estate property. Although the scope and effects of this Constitutional provision have been questioned,<sup>56</sup> regulatory provision<sup>57</sup> and the interpretation of Mexican authorities is to apply the restriction on Mexican corporations which have or may have the participation of foreign investment.

We must not forget that the largest number of maquiladora industries are established along the border strip between the United States and Mexico, which explains why maquiladoras which invest in their own industrial plants have to do so through trusts in the prohibited zone contemplated under the Law to Promote Mexican Investment and to Regulate Foreign Investment.<sup>58</sup>

Maquiladoras established in Mexican territory, outside the prohibited area are not subject to the aforementioned restrictions and therefore can acquire direct title of real estate property.

It remains unclear what the interpretation of the Constitutional limitation will be under the Free Trade Agreement. In case foreign investments are

56 The subject is discussed in pg. 400. *Derecho Internacional Privado*. Carlos Arellano Garcia. Ed. Porrúa. Mexico. Distrito Federal.

57 Provisions in the Organic Law of Clause One, Article 27 of the Federal Constitution and the Foreign Investment Law.

58 Articles 18 to 22 of the Foreign Investment Law. The extension of the 30 to 60 year life period for trusts is contained in the Bylaw of said Law.

given the national treatment, maquiladoras could be allowed to acquire full title to their real estate located in the border strip with the United States. The apparently absolute restrictions contained in the Federal Constitution has already been reduced or weakened by the Foreign Investment Law, and its Bylaw, through the use of trusts for tourist and industrial activities.<sup>59</sup>

### 3. *Economic principles and legal aspects*

The central part of this study is to define precisely what will be the outcome of the combination of economic principles and legal aspects which are expected to result from the free trade agreement with respect to the export maquiladora industry.

If the aforesaid outlook materializes, it is expected that the maquiladora industry with investors from countries benefited with the agreement and those from other countries which invest and manufacture in the free trade area and comply with the rules of origin, will undergo a transformation to become domestic industries with export activity. The phenomenon can be seen from two converging points of view, namely: integration and adaptation of the maquiladora industry to the domestic industry, or, participation of the domestic industry in the benefits expected with free trade, and which the maquiladora industry has enjoyed since its establishment. With the elimination of tariff and non-

<sup>59</sup> Article 19 of the Foreign Investment Law extends and defines the concept of industrial and tourism activities regarding the establishment of this type of trusts.

tariff barriers to foreign trade, the concept of maquila as a preferential industry will vanish because the domestic industry will share those same benefits.

Adaptation of the domestic industry and assimilation to the national industry will depend upon the union of the premises underscored in this study, evolution of the cost of manual labor in Mexico, and the interest that maquiladoras have in participating in the domestic market selling their products and services in Mexico.

If the cost of manual labor increases and Mexico ceases to enjoy a competitive world-wide edge, that sector of the maquiladora industry which only has an interest in the aforementioned reduced cost benefit, will desert and relocate in other countries which can sustain said competitiveness. Under these circumstances, the tendency will be towards the disappearance of the maquiladora industry as such in Mexico. The other maquila sector interested in assimilating to the national industry, in participating in the domestic market and in the export markets of third countries will seek to be treated as maquiladora industry and will enjoy the same benefits as the domestic industry. Of course it should be pointed out that for this phenomenon to occur it is indispensable for Mexico, its industry and its population to attain certain levels of productivity, technology and quality in the manufacturing, and of qualification in different activities and services. These are the long term goals sought with the free trade agreement. The degree of integration between the countries which are benefited with free trade

will also be a determining factor to produce the quoted phenomena. Increase in exchangeable goods in the free trade area and the equilibrium of prices of said goods will serve as guidelines so that these goals are realized.

On the other hand, in case the international competitiveness of the cost of manual labor is sustained by Mexico, the maquiladora industry will also become assimilated to the national industry in so far as restrictions on foreign investment disappear and the conditioning aforementioned postulates occur with regard to that sector of the maquiladora industry which is only interested in profiting from cheap manual labor in Mexico. In case foreign investment restrictions subsist as well as competitiveness of the cost of manual labor, the maquila program, as a privileged industrial sector will survive.

The transformation and adaptation period of the maquiladora industry into a domestic industry will be gradual and will take several years, the implementation of the Free Trade Agreement, the liberalization of tariff and non-tariff barriers and the phenomenon of the equilibrium of prices and costs of production do not appear immediately. During this transformation stage more than a maquiladora industry we will be speaking of a co-production and co-investment industry established in Mexico.

The aforesaid conclusions, I wish to insist, will occur in the maquiladoras with investors from the countries participating in the Free Trade Agreement. The phenomena which will be presented regarding the maquiladoras with investment from third countries, like the European, Japanese and

Taiwanese cases, will remain unchanged as long as the cost of manual labor in Mexico is competitive. However, it is expected that these investors will want to benefit indirectly from the Free Trade Agreement in order to qualify under the rules of origin as domestic manufacturing enterprises. As the standard of living improves in Mexico and with it the cost of manual labor, Mexico will cease to be a maquiladora country and therefore the maquiladoras of those third countries which do not qualify to enjoy the benefits of the North American free trade will have to relocate in other countries.

## VI. RULES OF ORIGIN OF MERCHANDISE

The rules of origin of products will undoubtedly be one of the subjects which will focus attention during the negotiation of the North American free trade agreement. Regarding the maquiladora industry, or what in the future will be the activity of industrial joint production and investment, the definition of these rules will be of great importance.

For the maquiladora industries with investors from countries which are not parties to the Free Trade Agreement, these rules will be transcendental to determine if they will benefit from tariff liberalization. The major concern for the United States and Canada is the possible interference of Japanese, and other maquiladoras, which, through Mexico will carry out activities to assemble or introduce their products in the latter consumer markets. There are already cases in the United States of maquiladoras which have achieved a penetration of their products at market prices which are in-



ferior to those which are considered as reasonable in said country.<sup>60</sup>

The rules of origin contained in the Free Trade Agreement between the United States and Canada represent an important model for the new trilateral Agreement. In general terms, merchandise is considered as originating in the territory of one of the countries party to the agreement, and therefore subject to its benefits, when they have been manufactured entirely in one or both of the territories of the signatory countries. This of course, assumes that the manufacture or production has been carried out with raw materials and components coming from any one of the countries which is a member of the free trade area.<sup>61</sup> When the merchandise is manufactured with foreign raw materials from countries which are non-members of the treaty, the resulting merchandise will only benefit if submitted to a substantial transformation in any one of the member countries which warrants a modification of the tariff classification according to the General Harmonized Tariff System.<sup>62</sup>

Additionally, goods are considered as originating in one of the member countries if they have been transformed in said countries and sent to another party country, whether or not said transformation changes the classification of the Harmonized Tariff System, as long

60 As an example we can quote the case of maquiladoras which have imported television kinescopes with Japanese and Korean components.

61 Article 301. General Rules.

62 Article 4-a of Interpretation Annex 301.2. This rule allows merchandise from one of the party countries to be considered as complying with the rule of origin when a value added of 50% of domestic materials is accumulated coupled with the direct assembly cost in one of the signatory countries.

as they comply with the rules of the Interpretation annex.<sup>63</sup>

Merchandise will not be considered as originating in one of the countries party to the treaty solely because they were packaged in one of the member countries, underwent dissolution processes or it is discovered that the transformation process in one of the countries part of the treaty has been carried out in a fraudulent fashion in order to evade or escape the rules of origin established by the treaty.<sup>64</sup> The parts, or accessories of the merchandise are considered as accessory to the merchandise to which they are tied and therefore will have the same origin as long as their number and value is what normally corresponds to them.<sup>65</sup>

In pass-through cases, the rules provide that merchandise will be deemed as coming from one of the party countries when said merchandise is delivered directly to the territory of the other contracting party, and if they come from third countries they will conserve their origin only when said merchandise has not entered the trade flow of the third country and does not undergo any transformation other than the simple embarkment or disembarkment, transportation and inspection operations, and as long as shipping documentation shows as place of origin and destiny the territories of the countries which are a party to the Free Trade Agreement.<sup>66</sup>

63 Article 301.2.

64 Article 301.3.

65 Article 301.4.

66 Article 302.

Regarding certain industries and trading activities, the Free Trade Agreement between the United States and Canada establishes specific rules to approve or exclude merchandise origin.

Only when the conditions for the certification of origin are met, will the remittances of merchandise between party countries be duty-free or receive the aforementioned benefits of the Free Trade Agreement.

These rules allow us to have a pretty good idea as to the contents of the multilateral agreement between Mexico, the United States and Canada. It is quite probable that similar rules will be incorporated. Of course there will be certain rules of exception for industries in those countries.

Regarding the Mexican maquiladora industry, the rules of origin will be of great importance to define the benefits that will probably substitute Mexican imports under classifications 9802.00.60, and 9802.00.80, and those contained in the American General Preference System.

The rule of origin defined in Articles 3 and 4-A of Annex 301.2 of the Interpretations of the Agreement between the United States and Canada transferred to the Mexican maquiladora industry warrants a special reference. According to this rule, when industrial transformation activity is carried in one of the countries which is a party to the agreement with raw materials and components originating in third countries, it is not sufficient to achieve a change in tariff classifications according to the Harmonized Tariff System, therefore it is considered that said merchandise did not originate in the country party to the Agreement. However, the merchandise is deemed to have originated in the country party to the treaty, under the same hypothesis, as

long as the value of raw materials and complementary components originating in any one of the countries party to the Agreement, plus the direct cost of production, make up at least 50% of the merchandise's value at the moment they exported to the other signatory countries. If this rule is adopted in the trilateral Agreement, the maquiladoras with investors from third countries, such as the Japanese, will try to use the rule of origin in order to obtain a penetration of their products in the consumer markets of the United States and Canada. It is expected that the latter countries will seek to abandon the rule of origin contained in Article 4 of Annex 301.2 of the Interpretations of their Agreement, or establish requirements for the integration of materials and manual labor in excess of the 50% rule explained.

Maquiladora enterprises will take great care in defining their operative frameworks under the rules of origin that are contained in the final text of the agreement for the North American market. In this respect, although it is estimated that the rules of tariffs 9802.00.60 and 9802.00.80, will be kept in force in the United States, the future of the General System of Preferences of said country is uncertain regarding Mexican exports.

## VII. SENSITIVE BRANCHES OF THE MAQUILADORA INDUSTRY

There are certain industrial branches with a high concentration of maquiladora enterprises for which the Free Trade Agreement with the United States and Canada entails special considerations.

### 1. *Textile industry*

The textile industry is considered, worldwide, as one of the most important areas in the domestic economy. This sector is considered highly sensitive and therefore there has been a tendency to establish barriers to international trade.<sup>67</sup>

Internationally, and based on the GATT, several countries signed the Agreement Regarding International Trade of Textiles, in Geneva, Switzerland, on December 20, 1973. This agreement is known as the Multifibre Agreement. It establishes the restriction bases in international textiles trade, representing a principle of exception to the most favored nation clause given the fact that it allows restrictions to the import of textile products in certain fibres.<sup>68</sup>

Currently, approximately 43 countries are signatories of the Multifibre Agreement and their international trade represents 48% of the world's textile trade; the remaining 52% is carried out between countries outside the Agreement, as well as among these and other non-party countries.<sup>69</sup>

67 The Bilateral US-Mexico Convention in the subject-matter of Textiles. Publication of the Ministry of Commerce and Industrial Promotion.

68 Pg. 4-39. The Likely Impact on the United States of a Free Trade Agreement with Mexico. *Idem. Ant.*

69 Pg.5. The Bilateral U.S.- Mexico Convention in the subject- matter of Textiles. *Idem. Ant.*

Regarding textile trade between Mexico and the United States, the latter country has imposed more restrictions to imports from the former, concretely with regard to the establishment of non-tariff barriers like import quotas. However, in the past years and due to the high participation of the maquiladora industry which uses mainly American raw materials, the United States have reduced their existing restrictions. Mexico and the United States have entered, under cover of the Multifibre Agreement, into five specific agreements,<sup>70</sup> the last of which entered into force in January of 1988, and will expire on December, 1991. The five aforementioned agreements have established the interregional textile trade rules between our countries and have fixed barriers on Mexican imports. The textile agreement in force with the United States underwent an important amendment on April 20, 1990, with the establishment of an increased liberalization of textile quotas and the creation of a so-called special regime which allows the specific allocation of quotas for the importation of products manufactured with raw materials of American origin. The sector most favored with this special regime has been the Mexican maquiladora industry.

70 Which cover the following periods: 1) Bilateral Agreement on Trade in Cotton Textile Products between Mexico and the US/ May 1st, 1967 to April 30th 1971; 2) Bilateral Agreement on Trade in Cotton Textile Products between Mexico and the US/ May 1st of 1971 to April 30, 1975; 3) Bilateral Agreement on Trade in Cotton, Wool and Artificial and Synthetic Fibres, Textile Products between Mexico and the US/ May 1st of 1975 to April 30, 1978; 4) Bilateral Agreement on Trade in Cotton, Wool, and Artificial and Synthetic Fibres Textile Products between Mexico and the US/ May 1st of 1978 to December 31st of 1981. This Convention was extended four times until December 31, 1987; 5) US-Mexico Bilateral Agreement on Textiles/ January 1st of 1988 to December 31st of 1991.

The Mexican textile industry has surged in recent times with an average growth of 19% in imports to the United States, during the last five years.<sup>71</sup> It is important to underscore that the international trade of textiles between Mexico and the United States is accounted for mainly by the maquiladora industry established in Mexico. Because a large amount of raw materials and components from the United States are used, the impact of imports with Mexican raw materials in reality has been minimal, representing barely 6% of the sector's imports in said country.<sup>72</sup>

It is important to state that rules of origin and certification of textile products will have a special importance in the multilateral agreement which is approaching.

The free trade agreement will have as a mission the elimination of tariff and non-tariff trade barriers in textiles. This will not happen immediately but will occur in a process of adaptation and a gradual period of liberalization, probably lasting ten years as occurred in the Agreement between the United States and Canada. It is held that the bulk of textile trade will be concentrated as has been the case up to now in the maquiladora industry or in what in the future will be known as international joint production and investment. On the other hand, there will exist an added incentive for the integration of Mexican raw materials and components, as import quotas are liberated and

71 Pg. 4-38. *The Likely Impact on the United States of a Free Trade Agreement with Mexico. Idem. Ant.*

72 Pg. 4-38. *Idem. Ant.*

Mexican producers achieve greater quality in their products and acquire modern technology. Thus, the Free Trade Agreement represents an important incentive for the maquiladora industry.

## 2. *Automobile industry*

The automobile and the auto parts sectors are yet another industry which are classified as sensitive. In this case, Mexico has been the country which has established the most restrictions, both in its rules for foreign investment, as well as in other rules regarding national contents and positive balance of currency.

The Mexican automobile industry, although a small scale supplier for the United States and Canada, is growing rapidly. Concretely in the area of automotive parts, Mexico is the United States' third partner and a very important potential partner for Canada. In 1989, Mexico exported a third of its automobile production, a total of 641,000 units. These exports were sent mostly to the United States and to Canada.<sup>73</sup>

Mexico has established control rules applicable to direct foreign investment in the plants of terminal automobile industries and of automotive parts. Concretely, the Law to Promote Mexican Investment and to Regulate Foreign Investment limits foreign participation to 40% of the capital of Mexican enterprises.<sup>74</sup> The Decree on the Promotion and

<sup>73</sup> Pg. 4-17. *Idem.* Ant.

<sup>74</sup> Article 5 of the Foreign Investment Law.



Modernization of the Automobile Industry, although ratifying the restriction, softens it in the case of auto part enterprises, by permitting the pyramiding of foreign investment through the use of holding companies.<sup>75</sup> Regarding the maquiladora industry, it is feasible to maintain up to 100% foreign investment, albeit the possibility of selling their products in the country is reduced to a maximum 20% of its excess production.

The Decree for the Promotion and Modernization of the Automobile Industry also provides additional conditions regarding a positive balance of currency, forcing assembly plants located in Mexico as well as automotive parts enterprises to attain a higher level of domestic contents. The possibility of importing foreign vehicles to Mexico is restricted and can only be carried out through terminal auto industry plants or their authorized dealers.

Despite the latter considerations, Mexico has gradually decreased its restrictions, to the extent of authorizing a majority participation of foreign investment via what the Bylaw of the Foreign Investment Law defines as "temporary investment".<sup>76</sup>

<sup>75</sup> Article 6 of the Decree for the Promotion and Modernization of the Automotive Maquiladora Industry published in the Official Gazette of the Federation on December 11, 1989.

<sup>76</sup> According to the terms of Articles 23 to 26 of the Bylaw of the Foreign Investment Law, temporary investment consists in the authorization which can be obtained for the majority participation of foreign investment for a period of no more than 20 years through trusts in the cases of enterprises with cash flow problems or extreme financial unbalance and which require considerable investments to recover. Covered by these rules are investments in the mining, secondary petrochemical and automotive industries, among others.

It is important to mention that approximately 50% of the United States' imports coming from the Mexican automobile industry are carried out through the maquiladora industry under classifications 9802.00.60 and 9802.00.80, of the General System of Preferences.<sup>77</sup> Thus, participation of the maquiladora industry in this industrial sector is highly important.

Pressures exerted by Mexican legal provisions on the automobile industry have resulted in a growing participation from the maquiladora industry in the increased level of national contents. Increasingly, we witness the phenomenon of maquiladora enterprises that sell their products and transfer their inventories to terminal enterprises so that these can increase their domestic contents.

It is expected that the Free Trade Agreement will produce positive effects for the automobile industry in general. However, the level of the cost of manual labor in Mexico, and the decision to establish important foreign investments in Mexico will be two factors which will have to be carefully analyzed. The rules of origin will also have special importance because special care will be taken regarding the penetration of oriental firms. Uncertainty and doubts remain regarding the position to be taken by the Japanese and German plants currently established and operating in Mexico. Naturally, in the latter two cases, as is the case with the two oriental

<sup>77</sup> Pg. 4-19. The Likely Impact on the United States of a Free Trade Agreement with Mexico. *Idem.* Ant.

plants located in the United States and Canada, there will have to be special negotiations. The existing automobile agreements between the United States and Canada will definitely be a reference parameter in the negotiations with Mexico.

### 3. *Electronics industry*

After the liberalization of non-tariff restrictions that Mexico had in place before 1985, there has been an increase in foreign electronic imports in Mexico. The local industry has severely felt the negative effects derived from this situation.

Regarding the American market, there is a very limited importation of electronic products manufactured with Mexican materials. Actually, most imports of this type come from the maquiladora industry of the corresponding sector. Currently, it is estimated that approximately 348 maquiladoras of the sector, together with the automotive part maquiladoras, from the maquiladora industry group which generates the highest degree of Mexican value-added.<sup>78</sup> In this area, the percentage of non Mexican raw materials and components which are incorporated to the products is about 95%.

Regarding foreign investment, despite generic limitations maintained by the Foreign Investment Law, its Bylaw enacted on May, 1989, allows majority foreign investment as long as the conditions established in Article 5 are met.<sup>79</sup>

<sup>78</sup> Pg. 4-25. *Idem.* Ant.

<sup>79</sup> Among the requirements established are the need to finance investments with foreign resources, location in industrial development areas, maintaining a positive currency balance, generating employment and importing modern technologies.

Once again, electronics' imports have benefited with tariffs 9802.00.60 and 9802.00.80, and the American General System of Preferences. With the liberalization of free trade with the United States and Canada it is expected that imports to Mexico will increase and that those which are directed to other countries will be maintained. The maquiladora industry will sustain its leading role in this sector in so far as the cost of manual labor is kept at a competitive level or, the demand from the direct consumer market justifies its presence in the country.

The rules of origin will have special meaning for the United States due to the aforementioned precedent third country penetration of the American consumer market through the Mexican export maquiladora industry.

#### 4. *Agroindustry*

Regarding agriculture, Mexico is the second supplier of agricultural products to the United States and Canada. In addition, Mexico is the USs' third market for agricultural products after Japan and the Soviet Union.<sup>80</sup> This means that there will be a greater potential for trade exchange resulting from the establishment of a trilateral Free Trade Agreement. However, the involved countries must be prepared to negotiate and liberalize non-tariff restrictions which exist in the sector, such as previous import permits, and quarantine and phytosanitary rules.

<sup>80</sup> Pg. 4-3. The Likely Impact on the United States of a Free Trade Agreement with Mexico. *Idem.* Ant.

The United States is worried by the impact of free trade due to the low level of the cost of manual labor in Mexico, a circumstance which will definitely affect the producers of certain garden products and fruits in the United States. There is great opposition from the potentially affected sectors to the signing of an Free Trade Agreement with Mexico.

Regarding the maquiladora industry, it was stated above that in the past years agroindustrial maquiladoras have proliferated to take advantage of the reduced costs of manual labor. Originally, Mexican authorities established certain requirements for these maquiladoras in order to allow their "temporary importations" of seeds, chemical products, fertilizers and packaging materials. They have also been required to carry out an "industrial processing" of the products and not only the purchase and packaging of the products to be exported. The constitutional limitations for the purchase, administration and direct harvesting of lands have limited their growth.<sup>81</sup> However, operations through trusts and leasing have served as legal vehicles for these maquiladoras.

With the Free Trade Agreement and the gradual elimination of non-tariff barriers in this sector, it is expected that Mexico will greatly increase its exports to its northern neighbors. Foreign investment will also play an important role in the development of farm industries.

<sup>81</sup> When they are sought through business corporations through shares. Clause IV of Article 27 of the Constitution.

### 5. *Transportation*

Although strictly speaking it is not possible to talk of maquiladoras in the transportation sector, we will endeavor to highlight the importance of this industry for maquiladora enterprises, especially those located on the border strip between Mexico and the United States.

Traditionally, there has been an unbalance regarding transportation opportunities on both sides of the border, especially with regard to transborder movement. Mexico has in the past been more restrictive than the United States.

According to the Foreign Investment Law, transportation on federal roads is restricted to enterprises which are 100% Mexican.<sup>82</sup>

In both countries there are very powerful investors in the sector although the quality of infrastructure and equipment which is available in the United States and in Canada is not comparable with Mexico's.

The United States allow the entry of Mexican equipment, including trailers within the border trade areas. There are restrictions for the entry of said equipment to interstate highways and other roads. The importation of foreign equipment is restricted because according to the Customs Law only the temporary importation of trailers is allowed.<sup>83</sup> Before the last

82 Article 4, section b) second part of the Foreign Investment Law.

83 Article 75 of the Customs Law. The importation of traction engine trailers was only allowed for up to three months between April and August of 1990, according to tax provisions in force at the time.

provisions issued by the Ministry of Communications and Transportation were enacted, the entry of traction engine trailers to Mexican territory including the border areas, was banned. The maquiladora enterprises had to contract the equipment exchange with Mexican teamsters, because their vehicles could not be imported. Near the end of 1990, with amendments to the transportation provisions in Mexico, this situation has changed and the entry of their vehicles to border cities is now permitted, and therefore a balance in transportation industry interests is achieved.

With the Free Trade Agreement, there will be a need to negotiate an agreement to establish conditions of operation for international transportation. As there are no constitutional restrictions in Mexico in this respect, there will be ample freedom to negotiate the diverse and difficult aspects related with this industry. There will be problems related with the safety of the equipment, with operation and driving licenses, with migratory facilities, with international insurance coverage, with the definition of transborder responsibilities, and of course, with the difficult subject-matter of foreign investment in transportation enterprises.

For the maquiladora industry, the effects that the Free Trade Agreement generates in the transportation area, will most likely benefit it because it will be able to use its own equipment, thus sidestepping costly exchange services.