TRANSFORMATION OF THE MEXICAN MAQUILADORA INDUSTRY: THE DRIVING FORCE BEHIND THE CREATION OF A NAFTA REGIONAL ECONOMY

David W. Eaton*

The Mexican maquiladora (maquila) industry is the cornerstone for the creation of a North American regional economy. A maquila is an assembly or manufacturing facility located in Mexico in which the United States (U.S.), Asian, or European companies prepare goods for American consumers utilizing Mexico's inexpensive labor force, geographic proximity to the U.S., and temporary importation (TI) programs. Assimilation of the maquilas into modern integrated production schedules establishes links between Mexico and the U.S. that will facilitate the eventual creation of a unified regional economy. Gradually, the integration process will expand southward into the interior of Mexico, carrying with it new business opportunities and increased bilateral cooperation.

Temporary importation programs allow foreign manufacturing firms to import, without taxation, raw materials, parts, and components (inputs) to their subsidiary maquila in Mexico free of import duties. Once inputs are in Mexico, they are incorporated into finished products that are exported to the U.S. Because of TI programs, the Mexican government does not impose duties on the inputs shipped to maquilas when they enter Mexico. Likewise, when products leave maquilas and enter the U.S., U.S. customs authorities apply duties only to the value added by the Mexican labor during the manufacturing or assembly process. Eventually, the North American Free Trade Agreement (NAFTA)[1] will eliminate the majority of import/export duties between the U.S. and Mexico taking with it the utility of TI programs. Therefore, there is a common misunderstanding that the maquila industry will lose its utility when the NAFTA eliminates import duties between the U.S. and Mexico. However, this Commentary will establish that despite restriction of TI programs caused by the NAFTA, future investments in maquilas will be undertaken to take advantage of low labor costs, geographic proximity to the U.S., and the benefits of preferential treatment under the NAFTA.

Since the creation of the maquila industry in 1965, the most important benefit offered to foreign manufacturers has been the temporary importation of

---

* David W. Eaton is a Project Director for the National Law Center for Inter-American Free Trade. The author is also a full professor of law in the Instutito Technological y de Estadios Superiores de Monterrey (ITESM) in Monterrey, Mexico and serves as Deputy Director for the Centro Juridico para el Comericio Interamericano (Centro JURICI) at the ITESM. He thanks Dr. Boris Kozolchyk and David A. Gantz for their support and guidance. He also thanks Brett Rose for his indispensable critical editing and research support.

1. North American Free Trade Agreement, Dec. 17, 1992, Can.-Mex.-U.S., 32 I.L.M. 289 (1993).

inputs from foreign sources. The TI program was designed so that maquilas would avoid the payment of duties on inputs used in the assembly of final products destined for the U.S. consumer market. The NAFTA will eventually eliminate the majority of import duties between the U.S. and Mexico. Despite the fact that TI programs will be severely restricted under the NAFTA, four important benefits offered by maquilas will continue to create incentives to invest in twin plants. First, maquilas are afforded facilitated customs procedures that are not granted to Mexican domestic industries. For example, maquilas are permitted to file consolidated importation documents for inputs from foreign sources and are not forced to comply with restrictive standards such as product labeling requirements or phytosanitary certificates. Second, maquilas do not have to pay Mexico's value-added tax (IVA) on inputs used in assembly or manufacturing processes. Third, the NAFTA will not eliminate all import duties between member countries until the year 2008. Whether a product is eligible for duty free entry into Mexico depends on the specific tariff classification of the good. Hence, in cases where inputs are still subject to import duties between the years 2001 and 2008, TI programs offered under the maquila system will offer important benefits. Fourth, after the year 2001, maquila products exported to markets outside North America will not be affected by the NAFTA. Given the constraint of TI programs under the NAFTA, it is logical to believe the maquila regimen will lose much of its value after the year 2001. Nevertheless, the maquila regimen will continue to offer important benefits which will create incentives for investments in this sector.

NAFTA Article 303 will limit Mexico's ability to grant "duty drawbacks" for taxes paid on inputs from non-North American sources, subjecting Asian inputs to higher taxes than intermediate goods from North America. Under the NAFTA's "rules of origin," goods are only granted preferential treatment under the Treaty if the majority of a product's content is of North American origin. Maquilas will be able to continue to use TI programs until the year 2001, at which point inputs from sources outside the U.S., Canada, and Mexico (North America) will be subject to taxation by Mexican authorities. Consequently, large U.S. and Asian manufacturers will invest in maquilas and sub-maquilas in order to qualify under the NAFTA's rules of origin and duty drawback provisions.

The maquila industry is one of the most important sources of foreign direct investment (FDI) in Mexico, making it one of the most important industries for economic recovery. In an effort to overcome economic difficulties caused by the 1994 peso devaluation, Mexico has embarked on an aggressive campaign to attract substantial quantities of FDI. This policy is in response to Mexico's over-dependence on international portfolio investment prior to the 1994 peso crisis. Generally, portfolio investments consist of the infusion of money from foreign sources into the stocks and bonds markets in a country. In contrast, FDI calls for the actual establishment of assembly or manufacturing facilities in a country. With the advent of electronic banking, international portfolio capital is highly mobile and can span the globe in a matter of seconds. As a result, emerging global economies such as Mexico, which have become over-dependent on portfolio investments, are exposed to a sudden flight of capital from their financial systems. In 1994 international investors lost confidence in the Mexican economy after a drastic devaluation of the peso led to the abrupt exit of large quantities of portfolio investments. The devaluation of the peso and the sudden extraction of money from Mexico's financial markets catapulted the country into one of its worst economic recessions on record. In an effort to rejuvenate its economy in a stable fashion, the Mexican government is aggressively attracting FDI. FDI is also needed to create jobs and build a much needed infrastructure in Mexico. Because the maquila industry is one of the most important sources of FDI in Mexico, it is key to the stable recovery of the Mexican economy.

The establishment of maquila operations requires that investors have confidence in the future of Mexico. Unlike portfolio investments, the parent company of a maquila cannot quickly liquidate their investment in times of social unrest or financial crisis. Mexico is competing with several emerging global economies for a finite pool of international FDI. Thus, policies and institutions must be implemented to effectively meet the needs of international investors. One of the primary needs of investors is a transparent legal environment providing for clear regulatory requirements.

Transparency refers to clearly established rules and procedures required by investors before they will commit money. In the context of attracting FDI, transparency is designed to protect two important stakeholders. First, clear investment rules must be established in Mexico to protect investors. Transparent legal requirements protect foreigners from the subjective application of Mexican investment laws. Second, transparent procedures, such as public right to know laws, must be established to afford citizens' groups the right to participate in decisions about possible investments in their communities. In general, Mexico needs to create more open and accessible investment rules in order to protect the previously mentioned stakeholders.

Social stability is also an important requirement for foreign companies planning to establish maquilas in Mexico. Anti-government movements, high crime rates, and general social discontent are counterproductive to efforts to attract FDI. Investor's require stability in Mexico because social unrest can disrupt business activities and make any FDI venture risky. Mexico needs to solve its political and social problems peacefully if it is to satisfy concerns about the country in international circles. A favorable climate for foreign investment in maquilas will continue provided that Mexico maintains its current process of economic liberalization and democratic reforms.

The maquila industry is one of the most profitable industries in Mexico. However, to facilitate the continued growth of the industry, improvements are needed in transportation, environmental, and social infrastructure. Improving transportation infrastructure throughout Mexico is paramount to fueling competitive exportation of maquila products, establishing twin plants in the Mexican interior, and promoting the sale of maquila products in large cities like Mexico City. Second, environmental infrastructure improvements must be undertaken to properly treat maquilas' waste water discharges and industrial hazardous waste. The maquilas and the government should work together to provide solutions to horrendous environmental conditions in border communities that are plagued by poor drinking water and clandestine hazardous waste dumps. Finally, social infrastructure must be improved to elevate the quality of life of maquila workers. Specifically, maquilas must consider the long-term benefits of improving schools, employee housing, and electrical power generation facilities. By improving social infrastructure, maquilas ensure sustainable development in their communities.

New legal mechanisms for project financing and asset-based lending must be developed to provide capital for large infrastructure projects and start-up loans for businesses affiliated with the maquila industry. Mexican law makes it difficult for state and municipal governments to acquire financing in foreign currencies, which in turn makes it difficult for local governments to obtain international financing for infrastructure projects such as waste water treatment plants. Also, Mexico's constrictive lending laws impede the ability of small to mid-size businesses to acquire financing. The lack of financing severely limits Mexican participation in maquilas and lucrative maquila supplier markets. Thus, legal reforms designed to promote project financing and asset-based lending in Mexico must be developed.

In summary, the NAFTA will eliminate some of the traditional benefits offered under the maquila system. Nevertheless, the traditional benefits of twin plants, combined with new structural advantages created by the NAFTA, create a situation in which the maquila industry will still retain a comparative advantage over other industries in Mexico. In the future, the maquila industry will continue to play an important role in the development of a NAFTA regional economy. Integrated production techniques currently used in the maquila industry will gradually be transferred to Mexican domestic companies further linking Mexico to the new global economy. Maquilas are one of the primary engines driving Mexico's economic recovery through the attraction of FDI. To increase FDI, Mexico needs to create an environment conducive to investment. Finally, maquilas offer opportunities for greater bilateral understanding through personal and professional cross-border contacts necessitated by the day-to-day operation of a twin plant.