

# **Mexico's Struggle for Economic Development and the Relationship with the US**

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# 1. Introduction

Mexico is the 15th largest economy in the world and the second largest in Latin America. However, its growth rate is quite low for a major world economy and the need for government intervention is ever-increasing as it struggles to keep up with other developing countries in terms of growth. The presence of organized crime has hindered the economic opportunities given to the youth whilst the waves of migrants coming in from countries like Nicaragua, El Salvador, and Guatemala seeking asylum in the US, but getting stuck in Mexico, have created a huge informal sector in the country limiting growth. In this report, we seek to study Mexico's struggle for economic development and its relationship with the United States.

## 2. Discussion

### 2.1 Informal Sector

#### 2.1.1 Introduction

While studying Mexico's struggle for Economic Development, we first need to analyze the informal sector. The informal sector of an economy is defined as the part of an economy that is neither taxed nor monitored by any form of government.

When explaining informality, there are two dimensions. The first is the nature of economic units. When a unit is dedicated to the production of goods and/or services for the market and operates using household resources without keeping basic accounting records, we can say that the unit is used in an informal setting. The second informal dimension is the labor perspective: all employment that is not subject to labor law or an institutional framework can be called informal employment.

Informal employment usually decreases in periods of economic growth. However, following the global financial crisis of 2008, informal employment as a percentage of total employment always remained high despite economic growth.

#### 2.1.2 Case of Mexico

Over the last 20 years, the Mexican economy has faced sluggish growth. The economy grew by 2.6% which did not absorb the increase in the labor force. The global financial crisis in 2008 worsened growth and resulted in many workers losing their jobs. However, despite this economic slowdown, the Mexican labor market had relatively low open unemployment. This is because there was high informal employment; many workers who lost their jobs resorted to jobs in the informal sector. During a crisis like this, job creation is slow and hence, people stay put with their informal jobs. Moreover, people always fear the occurrence of another crisis, so in order to avoid losing their formal jobs, workers prefer staying with their informal jobs and avoiding uncertainty. As of the last quarter of 2022, the share of employment in the informal sector in Mexico was 55.2%.

When we look into the numbers, we see that informal employment varies by state. States with a less developed labor market have higher informal employment. Oaxaca consistently has the highest rate of informal employment (81.2%) while Nuevo Leon has the lowest (39.5%).

### 2.1.3 How it affects growth

Now how does the informal economy affect growth? Firstly, since informal jobs are untaxed, the government does not receive revenue from people working informally. As a result, government spending does not increase which indirectly creates stagnant economic growth. Furthermore, firms in the informal sector have difficulty obtaining credit from domestic sources and hence cannot raise enough capital to expand output. Due to this, many small and medium-sized enterprises remain small, and due to this, the country's ability to move forward is severely limited. Moreover, when workers transition from an informal to a formal setting, they get the adequate training required in order to be able to carry out their job smoothly. However, when workers choose to remain in the informal job, they do not gain new skills and as a result of their unskilled labor, the average productivity does not increase and growth remains stagnant

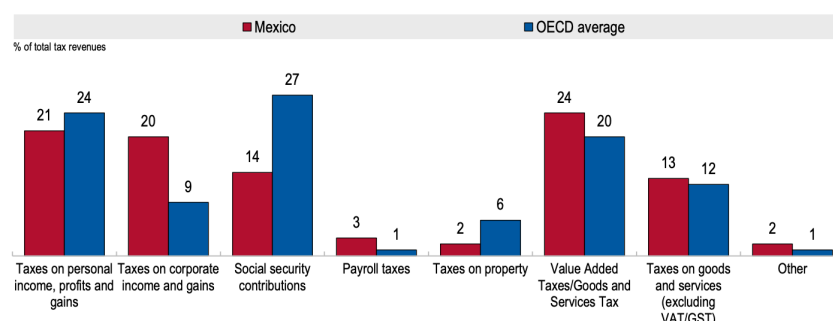
## 2.2 Role of Government

Given the abundance of natural resources and the large population, rich in diversity, the underperformance and striking poverty of Mexico comes as a surprise. This paradox highlights how the role of the government is crucial for economic development. Where there is a market imperfection, where basic requirements for individuals are not met, there stands government intervention and policies.

### 2.2.1 Taxation

Taxation plays a central role in sustainable development and growth, through resource allocation. It is necessary to consider and understand their tax capacities as well as the mobilization of domestic resources. Data suggests that the tax-to-GDP ratio is significantly lower than the average OECD country, in 2021 was even ranked as the OECD country with the lowest tax-to-GDP ratio. This ratio determines how inefficiently the government can direct its economic resources and achieve sustainable economic growth. According to the World Bank, a good ratio consists of 15%, while Mexico's was between 11% and 17.8% in the years 2000 and 2021, hence just above the threshold advised to assure economic growth and poverty reduction in the long term.

Analyzing the tax structure, as a general trend, the government heavily taxes income and profit on capital gains as well as goods and services. This drastically influences the job market and the composition of formal enterprises in the country.



[Tax structure compared to the OECD average, 2020]

### 2.2.2 Social development

Another complementary crucial aspect of economic development is social development, improving human welfare can be an effective investment for growth. A critical point for Mexico is the collection of social security contributions, which relies on registered employers and workers, hence the dominance of the informal sector would explain why such a low percentage of contributions is recorded in the country. Mexico has undertaken reforms to implement social protection programs and to enlarge the population base benefitting from these, just to mention the most relevant ones *Oportunidades*, *Seguro Popular*. These programs, although proven to be working, can still be considered imperfect. The reason is that these programs work as parallel entities without any formal coordination thus creating inefficiency. In addition, the lack of coverage for the new and more vulnerable population compromises the efficacy of these social security programs.

### 2.2.3 Regulation of trade

Another field vital to economic development is trade, before 1994 the government was promoting a protectionist economic model. Signing the North America Free Trade Agreement, *NAFTA*, meant embracing free trade that benefitted economic growth due to the lack of trade barriers with one of the main trading partners, the US. This translated to a rise in demand for manufactured products and attracted foreign direct investment into the pockets of Mexico. This first experience could represent a prime example of potential trade collaboration and the deriving benefits for emerging markets.

In terms of expected positive effects on wages and living standards, the free-trade land did not live up to expectations. The reasons are different, just to mention a few major financial crises and growing competition from China that reduced Mexico's advantages in exporting manufactured goods.

## 2.3 Trade

Over the past forty years, Mexico has shifted from being a relatively closed economy to becoming one of the economies that most engage in international trade. Mexico's opening process began with the country's entry into GATT (General Agreement on Tariffs and Trade) in 1986 and continued with the signing of free trade agreements with 50 countries, including NAFTA in 1994. According to the 2021 WTO statistical review, Mexico was the 11th biggest exporter and the 13th biggest importer worldwide in 2021 reaching 418 billion of merchandise trade. (Source)

In 2021 Mexico's most significant exports included motor vehicles, computers, delivery trucks, and crude petroleum, amounting to a total value of 474 billion dollars. On the other hand, the country's primary imports consisted of refined petroleum, motor vehicles and their parts and accessories, office machine parts, integrated circuits, and petroleum gas. Both for imports and exports the United States, Canada, and China stood out as Mexico's primary trading partners. It is worth noting that the United States holds a much more significant position as a business partner for Mexico than any other country. Indeed, the U.S. alone accounts for an overwhelming 70% of Mexico's total exports, while Canada, the second-largest importer of Mexican products, only receives 3% of the country's total exports.

### 2.3.1 Trade relationships with the US

The trade share represents the most immediate and clear evidence of the US and Mexico economic synergy. The economies of the two countries are tightly integrated with the

exchanges of goods, services, capital, and people happening at unprecedented rates. Two-way trade between the United States and Mexico totaled USD 725.7 billion in 2021, positioning Mexico as the second-largest overall U.S. trading partner after China. Though the geographical and inevitable cultural proximity has fostered close economic ties over the years, bilateral economic integration had a fast growth since the implementation of NAFTA. The United States and Mexico have forged a unique economic partnership that is characterized by cooperation rather than competition and that sets Mexico apart from the US trade relationship with other countries. The unique nature of bilateral trade between the United States and Mexico is exemplified by the Maquiladora program. Maquiladoras are US-owned factories in Mexico that operate with special tariff programs, allowing for duty-free entry of raw materials. The Mexican government established the Maquiladora program in 1964 to reduce unemployment and boost industrial growth. Today there are almost 3000 maquiladora companies operating in Mexico, representing 55% of Mexico's manufacturing exports. Although the Maquiladora program was successful in its objectives, it has been recognized as a source of labor exploitation. American border and migrant policies together with an increased military presence at the border, compound the issue, as the high demand for employment in these facilities from migrants who failed to cross the US border often results in extremely low wages.

Over the last two decades, China has been a silent third player shaping the trade relationship between the US and Mexico. When it joined the WTO in 2001, many Mexican maquiladoras closed and relocated to China due to its lower labor costs. However, especially in recent years and following political tensions, China has become the most threatening source of competition for the U.S. economy. Therefore, due to geographical proximity and a number of key complementarities, economic cooperation between Mexico and the US is one of the best ways for the United States to improve its global competitiveness.

### **3. Conclusion**

While Mexico's features suggest the potential for economic development, the dominance of the informal sector and poverty levels indicate the need for government intervention and policies to promote growth. In fact, fiscal policy requires improvement, as the tax-to-GDP ratio remains below the recommended threshold for economic growth and poverty reduction. Social development is also hindered by the informal sector which limits the collection of social security contributions. In the context of an internal economy facing these challenges, trade has become a critical sector; the signing of NAFTA provided benefits for economic growth by transitioning Mexico to a more open economy regime. While the economic relationship between Mexico and the US has been beneficial for Mexican growth, it has also created a strong dependency between the countries that makes Mexico vulnerable to any economic shocks or policy changes in the US. The Maquiladora program has been successful in promoting employment and boosting industrial growth but has revealed issues in relation to labor exploitation. This further highlights the need for strong social and economic policies towards the reduction of the informal sector and in support of the booming trade sector, so that Mexico can fully realize its economic potential.

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