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NEW CHALLENGES FOR THE *MAQUILADORAS*:

Legal and Policy Implications of NAFTA Article 303 for United States-Mexico Trade[†]

DAVID A. GANTZ[*]

I. INTRODUCTION

The North American Free Trade Agreement (NAFTA) [1], which entered into force on January 1, 1994, has greatly stimulated the expansion of trade within North America. In particular, the phased elimination of tariff barriers for trade in goods that "originate" in North America, along with provisions that facilitate and protect foreign investment, have encouraged an increase in total regional trade from about $350 billion in 1993 to $670 billion in 1999, a 91 percent increase over the six-year period.[2] Such increases in intra-regional trade, although perhaps at a slower rate, are likely to continue during the first decade of the Twenty-first Century. Foreign investment also continues to increase, to an estimated $13.2 billion in 2000, up from $11.6 billion

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1. North American Free Trade Agreement, Dec. 17, 1992, U.S. - Can. - Mex., 32 I.L.M. 289 (chs. 1-9); 32 I.L.M. 605 (chs. 10-22) [hereinafter NAFTA].

2. *See* U.S Census Bureau, *U.S. Trade Balance with Canada* (2001), http://www.census.gov/ foreign-trade/balance/c1220.html (last visited Mar. 1, 2002); U.S. Census Bureau, *U.S. Trade Balance with Mexico* (2001), http://www.census.gov/foreign-trade/balance/c2010.html (last visited Mar. 1, 2002); Mexican Secretariat of Economy, *Mexico's Integration to the World Economy: Mexico-Canada Trade*, *at* http://www.nafta-mexico.org/trade/Mexico_s_trade/Mexico_s_Integration_to_the_Wo/ performamexico_s_integration_to_the_wo.html (last visited Mar.1, 2002).

in 1999.[3] In 2000, the United States accounted for about $9 billion worth and Canada, about $500 million;[4] NAFTA sources thus represented about 72 percent of Mexico's total foreign investment.[5]

However, major changes affecting intra-NAFTA trade have recently taken place, on January 1, 2001, as mandated by NAFTA's Chapter 3.[6] These changes constitute the most significant modifications of the NAFTA trading system since 1994, and have major implications for future trade, particularly exports from Mexico to the United States and Canada under the *Maquiladora* (border industries) system[7], and investment in Mexico designed to produce finished goods for export to the United States and Canadian markets.

Until 2001, if materials, parts and components imported into one NAFTA country (e.g., Mexico) from outside North America were made into finished goods, and the finished products were then exported to the United States or Canada, Mexico was not required to collect normal "most favored nation" (MFN) import duties on the non-NAFTA materials, parts and components.[8] Yet, on January 1, 2001, as required by Annex 303.7, Article 303 of NAFTA was implemented, sharply limiting such duty waiver or remission.[9] Mexico is now required to collect MFN duties (frequently in the 12-18% range or higher) on non-NAFTA parts and components that are in excess of the import duties

3. *See* Mexican Secretariat of Economy, *Mexico Attracts Record Levels of Investment* (2001), *available at* http://www.naftaworks.org/Publications/nletters/NW2001/nw2001.html (last visited Mar. 1, 2002).

4. *See* Mexican Secretariat of Economy, *Mexico Attracts Record Levels of Investment* (2001), *available at* http://www.naftaworks.org/Publications/nletters/NW2001/nw2001.html (last visited Mar. 1, 2002).

5. *See id.* Factors contributing to the strong investment performance, in addition to NAFTA, include a 6.9 percent GDP growth rate and the peaceful transfer of political power to Vincente Fox in 2000.

6. *See* NAFTA, *supra* note 1, at Annex 303.7.

7. There are other export-oriented regimes in Mexican law, such as the *Pitex, Altex* and *Ecex* regimes. All are affected in essentially the same manner as the *Maquiladora* program, and are not discussed in detail in this article. The *Pitex* regime, for example, permits an existing Mexican manufacturer to set aside a specific production unit, or create a subsidiary, for exports. *See* Pitex Decree, *Diario Oficial* [hereinafter *D.O.*] May 5, 1990, as amended *D.O.* May 11, 1995 and *D.O.* Nov. 11, 1998.

8. NAFTA, *supra* note 1, at art. 303. Duty remission was not permitted for imports of color picture tubes over 14 inches in diagonal measurement. NAFTA, *supra* note 1, at art. 303, para. 8; *and* NAFTA, *supra* note 1, at Annex 303.8.

9. NAFTA, *supra* note 1, at Annex 303.7 (Effective Dates for the Application of Article 303). A government may forego duties on imported materials, parts and components in several different ways. The optimal situation for the manufacturer is a complete waiver of the duties, so that they never have to be paid. However, some systems provide for remission or "drawback" of duties paid, so that it may be several months or longer before the duty amounts paid at the time of importation are recovered. *See* NAFTA, *supra* note 1, at art. 303, para. 5.

assessed on the finished goods entering the U.S. or Canada.[10] However there are exceptions for those industries covered by Mexico's new special sector programs (PROSEC) or where products are imported under the provisions of one of Mexico's many other free trade agreements. (There are also limited exceptions for goods entered under bond for transportation or imported and exported under the same condition, as for testing, cleaning, repacking, etc., for duty-free shops.[11]) Also, under Article 304, existing duty waiver programs tied to export performance are eliminated.[12]

In most instances, U.S. or Canadian duties on Mexican (NAFTA) originating finished goods now or within a very few years will be zero; as of 1999, tariffs had been eliminated on 80 percent of all tariff items in intra-regional trade.[13] Consequently, most non-NAFTA parts and components imported into Mexico became fully dutiable as of January 1, 2001, again except— and this is a very broad except— where special sector programs provide otherwise.[14] (For U.S. –Canada trade, such duty remission on non-NAFTA parts and components was limited after January 1, 1996.)[15]

The impact of these changes will be most pronounced on sourcing patterns for Mexican manufacturers exporting to the United States and Canada, particularly for the many *"maquiladoras"*[16] that are currently purchasing some parts and components or raw materials from outside the NAFTA region. United States and Canadian producers are also subject to the restrictions, but U.S. industry is much more self-sufficient than Mexico's, and U.S. most-favored-nation import duties on most imported parts and components are zero or near-zero.[17] In Mexico, in contrast, import duties on parts and components are in the 12-18

10. Materials, parts and components originating in one NAFTA country and exported to another for production there are not affected. Finished goods exported outside the NAFTA region will also continue to benefit from duty remission programs. *See* NAFTA, *supra,* note 1 at art. 303; *see also* NAFTA, *supra* note 1, at Annex 303.7.

11. NAFTA, *supra* note 1, at art. 303, para. 6.

12. *Id.* at art. 304, paras. 1-2; *and id.* at Annex 304.1-2.

13. *See* NAFTA Tariff Elimination Schedule, *available at* http://naid.sppsr.ucla.edu/NAFTA96/ TBL3_7.html (last visited Mar. 1, 2002).

14. NAFTA, *supra* note 1, at Annex 302.2. Under the NAFTA tariff schedules, most duties are eliminated immediately or in phases ending January 1, 1998 (five years), or January 1, 2003 (ten years). *See generally,* NAFTA, *supra* note 1. It is estimated that as of 1999, 80 percent of items in the tariff schedules traded duty free between Mexico and the United States. *See* Country Commercial Guides FY 1999: Mexico, Chapter VI-Trade Regulations and Standards, http://www.state.gov/www/about_state/business/com_guides/1999/wha/mexico99_06.html (last visited Mar. 1, 2002).

15. NAFTA *supra* note 1, at Annex 303.7.

16. A *maquilero* (or *maquiladora)* is defined as "one who measures or takes dues for grinding corn." CASSELL'S SPANISH DICTIONARY 547 (1968). The term as used today no longer connotes any relationship to grain milling.

17. *See generally* NAFTA *supra* note 1.

percent *ad valorem* range, and only about 3.2% of the parts and components used by the *maquiladoras* are sourced in Mexico.[18]

The more than 3,700 *maquiladoras* licensed under Mexican law[19] produce finished goods primarily for export or components for use in the production of exported goods. Of all the industrial sectors, the *maquiladora* sector is the most dynamic in the Mexican economy. At it's peak, the sector employed nearly 1.3 million persons, 28 percent of Mexican manufacturing employment in 1999, the nation's largest single source of foreign exchange, recently surpassing petroleum and far outdistancing tourism.[20] Although *maquiladoras* are concentrated in electronics, transportation (including autos and auto parts) and textiles, they involve a variety of manufacturing activities.[21] *Maquiladoras* were responsible for a total export value of nearly $80 billion in 2000. Approximately 20 percent represents Mexican value added, while the remainder consists of imported parts and components.[22] The impact on the United States is particularly significant, given the fact that about 80% of the *maquiladoras* are U.S. owned and the United States exports billions of dollars of parts and components to Mexico for assembly there, probably over $45 billion worth in 2000, representing directly at least one million U.S. jobs.[23]

However, the changes that occurred on January 1, 2001 also impact upon United States importers (other than those whose products use only North American materials), and governmental institutions involved in or regulating intra-NAFTA trade including the United

18. *In-Bond Industry / Industria Maquiladora 2001* (CNIME/Consejo Nacional de la Industria Maquiladora de Exportación, AC/Nat'l Maquila Ass'n, Mex., D.F., Mex.), Nov.-Mar. 2001, at 13.

19. *See Maquila Overview, at* http://www.maquilaportal.com/Visitors_Site/nav21.htm (last visited Mar. 1, 2002) (presenting an overview of the history of maquiladoras with statistics from 1994 to April 2001).

20. *See* Lucinda Vargas, *The Binational Importance of the Maquiladora Industry*, SOUTHWEST ECONOMY, Nov./Dec. 1999, at 2 [hereinafter Vargas, *Binational Importance*], *available at* http://www.dallasfed.org/htm/pubs/pdfs/swe/swe99_6.pdf (last visited Sept. 24, 2001); Lucinda Vargas, *Maquiladoras 2000: Still Growing,* EL PASO BUSINESS FRONTIER, Issue 3 2000, at 2 [hereinafter Vargas, *Maquiladoras 2000*], *available at* http://www.dallasfed.org/htm/pubs/pdfs/busfront/300.pdf (last visited Sept. 24, 2001).

21. These three sectors account for almost 75 percent of total employment and 80 percent of production. *See* Vargas, *Maquiladoras 2000, supra* note 20.

22. *In-Bond Industry / Industria Maquiladora 2001, supra* note 18, at 17.

23. Exact figures are difficult to estimate, but of the total imports of *maquiladoras* in 2000 (about $62 billion), it is likely that at least $45 billion are from U.S. sources, given that total exports of all kinds from China, Japan, Korea, Taiwan, Hong Kong and Singapore, including machinery and equipment, consumer goods and all other products, are only $18 billion. *See In-Bond Industry / Industria Maquiladora 2001, supra* note 18, at 17; Secretariat of Economy, Comercio Total de Mexico (2000). Using U.S. Department of Commerce estimates that $1 billion worth of exports is responsible for 20,000 jobs, the parts and components destined for the *maquiladoras* represent 900,000 jobs.

States Customs Service (USCS).[24] Among the major legal, economic and policy issues raised by the changes are the following: Are Mexico's new regimes for manufacturing operations legal under NAFTA and the World Trade Organization agreements?

If Mexico assesses import duties on non-NAFTA origin raw materials, parts and components, thereby increasing the manufacturing costs of the finished product, will a significant number of the producers move their facilities elsewhere in Latin America, or to Asia, with adverse employment and investment implications for Mexico (and the United States)?

Alternatively, if duty-free importation of non-NAFTA parts and components is permitted to continue under the new special sector program, will that practice discourage investment in production of parts and components in Mexico, keeping the Mexican materials content of *maquiladora*- produced goods at the current 2-3 percent levels,[25] and foregoing new jobs and technology transfer?

If *maquiladora* employment declines significantly, or even increases more slowly, where will Mexican workers ready to enter the work force find jobs (legally or illegally) except in the United States?

With the many changes taking place in the world economy, will the value of Mexico's preferential access to the United States and Canadian markets under NAFTA be reduced to the point where it is no longer a substantial incentive to new Mexican investment and job creation?

It is easier to ask most of these questions at the present time than to answer them, in part because the NAFTA mandated changes are so recent. Assessment is also complicated by the fact that the implementation of NAFTA continues to take place simultaneously with other, global trade-liberalization measures. These may reduce the effect of the tariff advantages Mexico enjoys in the United States and Canadian markets under NAFTA. For example, the tariff reductions resulting from the "Uruguay Round" of the General Agreement on Tariffs and Trade (GATT) negotiations resulted in a reduction of average tariffs imposed by developed countries by 45 percent, from 5.5 to 3 percent, and by 28 percent for developing countries, from 14.9 to 10.7 percent.[26] While U.S. tariffs remain high in some areas, such as textiles and apparel, footwear, chemicals, small trucks, color picture tubes, the reduction or elimination of world-wide tariffs has reduced the level of tariff preference that can be offered by the United States, Canada, the European Union, Japan and other developed countries in

24. *See* North American Free Trade Agreement Implementation Act, 19 U.S.C. §§ 3301, 3331-3333.

25. *In-Bond Industry / Industria Maquiladora 2001*, *supra* note 18.

26. RAJ BHALA & KEVIN KENNEDY, WORLD TRADE LAW: THE GATT-WTO SYSTEM, REGIONAL ARRANGEMENTS, AND U.S. LAW 84-85 (1998).

free trade areas.[27]

Also, preferential access to the United States market for manufactured goods from developing nations world-wide, and particularly in the Caribbean Basin, Andean nations and Africa, has been expanded in recent years. Other trade developments such as the impending membership of China in the World Trade Organization,[28] and the entry into force on July 1, 2000 of a free trade agreement between Mexico and the European Union,[29] will necessarily affect investment in and trade with Mexico as well.

Investment and production in Mexico– entirely apart from customs issues– is significantly affected by the strength of the U.S. economy. A weakening U.S. economy may cause production cutbacks, worker layoffs and even plant closing regardless of changes in the NAFTA customs regime, or in circumstances where the NAFTA changes are the "straw that breaks the camel's back" in the ongoing corporate analysis of costs and benefits of doing business in Mexico.

Whether these changes in the longer run will offset the advantages of producing goods in Mexico for the United States market– convenience of shipping and travel, a favorable investment regime, political stability, among others– remains to be seen.

In Part II, this article reviews the operations of the *maquiladora* system, historically and under the early NAFTA period, 1994-2000. In Part III, I analyze the Article 303 changes and their impact on the *maquiladora* system, along with the contemporary external factors, including WTO tariff reductions, China's entry into the WTO, and the Mexico - European Union Free Trade Agreement, that are most likely to affect *maquiladora*-based U.S. trade with and investment in Mexico. Finally, in Part IV, I present a necessarily preliminary assessment of the impact of these developments. Throughout, I focus primarily on Mexican production and investment in Mexico, although I briefly discuss other aspects of the NAFTA trading relationship.

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27. However, NAFTA preferences can be a substantial incentive for many Canadian and United States producers because Mexican tariff rates still average about 10 percent. The success of global tariff reduction, as well as NAFTA, also reduces the significance of other special programs, such as the "9802" duty waiver for the U.S. origin components used to assemble finished goods abroad for export to the United States.

28. *See* Emma Jane Kirby, *China enters WTO fold* (Sept. 17, 2001), *at* http://news.bbc.co.uk/ hi/english/business/newsid_1548000/1548866.stm (last visited Mar. 1, 2002).

29. *See EU congratulates Mexico on watershed vote* (July 3, 2000) *at* http://news.bbc.co.uk/ hi/english/world/americas/newsid_817000/817334.stm (last visited Mar. 1, 2002).

II. THE MAQUILADORA SYSTEM AND ITS INTERACTION WITH NAFTA, 1965-2000

NAFTA for Mexico is a job, investment, technology and export generating "machine." For the United States, it is a means to improve global competitiveness by utilizing low-cost labor where necessary in a convenient location while maintaining a high U.S. content in manufactured goods. It also is designed to give United States exporters preferential access to the Mexican market, which remains protected by relatively high (10-15%) most-favored-nation tariffs on most imports from outside North America. Thus, despite the terminology, for the United States, Canada and Mexico, NAFTA is functionally less a free trade agreement, than a *preferential* trade agreement, designed to give preferential access to each other's markets, even if regional trade replaces imports from outside North America that are lower priced and better quality.[30] Although "import substitution" as a national policy has been frowned upon for decades, to some extent NAFTA is a regional import substitution mechanism, with some of the same potential for distorting global trade.[31] However, the traditional concerns relating to imports substitution policies followed by relatively small economies probably do not apply to NAFTA. The incorporation of two small economies, Canada and Mexico, into the huge United States' economy means that Mexico and Canada now enjoy much greater economies of scale. A very significant vehicle for achieving Mexico's objectives under NAFTA has been the *maquiladora* system.

A. The Maquiladora *System in Mexico*

The idea of using relatively inexpensive Mexican labor to assemble goods destined for the U.S. and other export markets pre-dates NAFTA by almost 30 years.[32] The *maquiladora* program is an evolution of a cooperative approach between Mexico and the United States. It is

30. It nevertheless appears to qualify as a *free* trade agreement under Article XXIV of the GATT 1994, in its permitted derogation from global "MFN" treatment. *See* RAJ BHALA & KEVIN KENNEDY, *supra* note 26, at 163-69 (Lexis Law Pub., 1998).

31. Ironically, the proliferation of regional free trade areas is in part a result of developing countries' rejection of national import substitution models, where high cost, inefficient domestic producers are protected by high tariff walls and quotas or other non-tariff barriers that dominated economic policies of the 1960s and 1970s. The move toward market liberalization by countries such as Mexico, stimulated the negotiation of regional trading blocs, such as NAFTA. *See* JEFFREY A. FRANKEL, REGIONAL TRADING BLOCS IN THE WORLD ECONOMIC SYSTEM 7-11 (Inst. Int'l Econs. 1997). Of course, free trade agreements may lead to greater regional economic activity that stimulates global as well as intra-regional trade, creating as well as diverting trade. *Id.* at 109-110.

32. *See* Maria Plumtree, Note & Comment, *Maquiladoras and Women Workers: The Marginalization of Women in Mexico as a Means to Economic Development*, 6 SW. J. L. & TRADE AM. 177, 178 (1999).

designed to give American companies the nearby low-cost labor they require to remain competitive in the world market, and to generate vitally needed jobs for an ever-growing Mexican population. For the United States, the *maquiladora* program permits U.S. firms to locate labor-intensive operations in Mexico, thereby achieving lower labor costs in a highly competitive global market.[33] How did this all come about?

1. The Significance of Population Pressures

For demographic reasons, perhaps the greatest challenge facing any Mexican government is job creation. Despite the success of population control measures initiated in the early 1970's, Mexico has one of the most rapid population growth rates in the world, and it is not expected to level off for another generation.[34] Consequently, this means that every year the government and private industry must create some 1,000,000 new jobs to avoid increasing unemployment and the economic and social problems that would follow. For a nation that had a population of 48 million in 1970[35] and approximately 100 million by January 2000,[36] this is a daunting requirement. (In comparison, for most of the 1990's, during a period of unprecedented economic growth, the United States created approximately one and a half million new jobs per year[37] with a population almost three times greater than Mexico and an economy 20 times larger.)

Even in very good economic times and with effective economic incentives, to create over a million new jobs annually is a serious challenge. Under the best of circumstances in the past, only about 900,000-1,000,000 jobs have been created annually in Mexico.[38] If this process does not continue, the new members of the labor force each year will be added to the rolls of the unemployed, or to the numbers migrating (both legally and illegally) northward.[39]

33. *See* Vargas, *Binational Importance*, *supra* note 20, at 1.

34. "[T]he population [of Mexico] has quintupled since 1940, and will continue to surge at about 1 million people a year for nearly three decades. . .many forecasters predict that slowing fertility rates will mean that the country's population will virtually stop growing by 2045." Sam Dillon, *Smaller Families to Bring Big Change in Mexico*, N. Y. TIMES, June 8, 1999, *available at* http://www.uwmc.uwc.edu/geography/demotrans/mexpop.htm (last visited Sept. 26, 2001).

35. *See id.*

36. *See County Navigator–Population Facts*, *available at* http://www.os-connect.com/pop/ p2.asp?sort= 1970 (last visited Mar. 2, 2002).

37. *See* COUNCIL ON COMPETITIVENESS, *America's Competitive Resurgence: What Drove U.S. Prosperity*, *in* U.S. COMPETITIVENESS 2001: STRENGTHS, VULNERABILITIES AND LONG-TERM PRIORITIES 11, *at* http://www.compete.org/pdf/Section_1.pdf (last visited Mar. 3, 2002).

38. *See* Dillon, *supra* note 34.

39. *Id.*

All Mexican presidents since Gustavo Díaz Ordaz (1964-1970) have focused on job creation, with more or less success.[40] It is almost inevitable that this continuing need to create employment will dominate the economic policies of future Mexican governments.

2. From the Bracero Program to the *Maquiladoras*

Between 1942 and 1964, some of the pressure created by Mexico's growing population was absorbed by the *"Bracero"* program, under which Mexican farm laborers were permitted to work regularly in the United States, primarily in Texas and California.[41] The program was initiated to address a shortage of U.S. citizen agricultural workers during the labor crisis created in the United States by World War II.[42] While the *Bracero* program was broadly criticized at its peak as being exploitative of Mexican labor[43] and a mechanism to avoid unionization, higher wages and better working conditions for American agricultural laborers, it met the principal goal of providing work to thousands of Mexican citizens and offsetting labor shortages in the U.S. during the 1940's.

By the early 1960's, however, the *Bracero* program was becoming politically unacceptable in the United States.[44] It was under attack because of the perceived exploitation of Mexican workers laboring in poor working conditions, as well as concerns that immigrants were taking low wage jobs away from U.S. citizens in the border states (Arizona, California, New Mexico, and Texas).[45] César Chavez and other organizers were being heard in Washington as well as in the Central Valley of California. In 1963, President Kennedy decided to terminate the program, which ended during the Johnson administration in December 1964.[46] However, President Johnson, like

40. *See* Gerhard Rempel, *Post-War Mexico, available at* http://mars.wnec.edu/~grempel/courses/ world/lectures/postwarmexico.html (last visited Mar. 3, 2002).

41. Howard R. Rosenberg, *Snapshots in a Farm Labor Tradition,* 3 LAB. MGMT. DEC. 1 (1993), *available at* http://are.berkeley.edu/APMP/pubs/lmd/html/winterspring_93/snapshots.html (last visited Mar. 1, 2002).

42. Gordon H. Hanson & Antonio Spilimbergo, *Mexican Migration and U.S. Policy Options, in Immigration in U.S.-Mexican Relations: A Report of the U.S.-Mexican Relations Forum* (Jan. 1998), *at* http://www. iadialog.org.immigrat.html (last visited Sept. 19, 2001).

43. Kitty Calavita, *U.S. Immigration Policy: Contradictions and Projections for the Future,* 2 IND. J. GLOBAL LEGAL STUD. 143, 146 (1994).

44. *See id.*

45. KITTY CALAVITA, INSIDE THE STATE: THE BRACERO PROGRAM, IMMIGRATION, AND THE I.N.S. 141 (Routledge , 1992).

46. RICHARD B. CRAIG, THE BRACERO PROGRAM: INTEREST GROUPS AND FOREIGN POLICY 197 (U. of Tex. Press, 1971).

his Mexican counterpart President Díaz Ordaz, was well aware that the *Bracero* program had provided an important safety valve for Mexican population growth.[47] They realized that elimination of the program without providing an alternative source of work for the affected Mexican citizens would most likely lead to an increase in Mexican illegal immigration to the United States.[48]

As a result, the Mexican and United States governments, with input from the private sector from both countries, created a new mechanism to meet the needs of both countries: the *maquiladora* system. The creation of the *maquiladora* program required the close political and technical cooperation and coordination of both nations.[49]

3. Basic Concepts of the *Maquiladora* System

For this new program to be successful from Mexico's point of view, it had to meet a number of potentially conflicting objectives. While Mexico desperately needed to attract new investment that would generate manufacturing jobs, the Mexican government also did not want to disturb the politically powerful industrial oligarchy that benefitted from the protection that high tariffs and a variety of non-tariffs barriers provided against foreign competition. Mexico's industrial base in 1964 was characterized by high-cost, mediocre quality production that survived only because Mexican consumers had no other choices. (Competition within the Mexican economic system began approximately 20 years later, during the de la Madrid administration in 1985).[50] Throughout this time, the Mexican government was not inclined to abrogate Mexico's highly exclusionary foreign investment restrictions, even when President de la Madrid began to liberalize trade in the 1980's. A good example of this is the 1973 Mexican Foreign Investment Law, which was not modified even informally until 1989.[51] This law effectively required federal government approval of every foreign investment based on a highly subjective list of factors, required the use of a portion of Mexican materials and components, and in most instances limited foreign ownership to a minority 49 percent share.[52]

The solution for Mexico was to institute a job-creating

47. *See* Calavita, *supra* note 43, at 167.

48. *Id.*

49. DONALD W. BAERRENSEN, THE BORDER INDUSTRIALIZATION PROGRAM OF MEXICO 3 (1971).

50. *See* Kurt Kroese, *Integration of the Maquiladora Program and NAFTA: A Proposal to Protect Mexico's Economy in* TOWARD SEAMLESS BORDERS: MAKING FREE TRADE WORK IN THE AMERICAS 168, 186 (Boris Kozolchyk, ed., 1993).

51. *See* Chiang-feng Lin, *Investment in Mexico: A Springboard Toward the NAFTA Market - An Asian Perspective*, 22 N.C. J. INT'L L. & COM. REG. 73, 96 (1996).

52. *See* Law on the Promotion of Mexican Investment and the Regulation of Foreign Investment, Art. 5, May 8, 1993, 12 I.L.M. 643, 644 (1973).

industrialization program that would focus on production only for export, located in isolated border regions, generate new jobs and attract new technology to Mexico. This original concept was particularly attractive because many of the former *Bracero* workers had remained in the northern border regions, rather than returning to the interior of Mexico.[53] The *maquiladora* program over time has created many incentives, including the possibility of 100 percent foreign ownership and freedom from many government restrictions then applicable to other foreign investors.[54] Most significantly, firms that qualified for the program would be permitted to import machinery and equipment duty free on a "temporary" basis for the life of the plant.[55] They could also avoid payment of the steep Mexican import tariffs on raw materials, parts and components if these inputs were utilized to produce goods for export. Exemption was granted from the value-added tax and effectively, until 1994, from corporate income taxes.[56] This meant that such firms (the vast majority of which were American-owned) could set up a factory in the border area and import all or most of their equipment, avoiding most normal taxes as long as they produced for export. The only major limitation was on sales in the domestic market. Initially, such sales were prohibited. However, in 1989 *maquiladoras* were permitted to sell in the Mexican market up to 50 percent of the prior year's export sales.[57] Then and now, Mexican import duties are normally payable on parts and components used in the manufacturing of finished goods for the Mexican domestic market, and such transactions are subject to the value-added tax (IVA).[58]

4. U.S. Cooperation: Item 807.00, TSUS, and Other Benefits

U.S. government programs which were seen as encouraging U.S. firms to move their manufacturing operations (and accompanying jobs) offshore could not reasonably be expected to be any more popular than the *Bracero* program. Fortunately for the *maquiladora* program in Mexico, U.S. customs laws already contained a mechanism that served the *maquiladora* concept well when combined with the other advantages of Mexican production for U.S. firms.

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53. *See* Ignacio Ibarra, *Maquiladora Impact*, Ariz. Daily Star, Sep. 16, 1991, at 1B (detailing the growth of Nogales, Sonora, from a population of approximately 50,000 to over 250,000 between 1970 and 1990).

54. *See* JAY M. JESSUP AND MAGGIE L. JESSUP, DOING BUSINESS IN MEXICO 84-86 (1992).

55. *Decreto para el Fomento y Operación de la Industria Maquilado,* Art. 20, *D.O.*, Dec. 22, 1989 [hereinafter the "1989 Decree"].

56. *See* Mauricio Monroy, *Harmonizing the Mexican Tax System with the Goals of the North American Free Trade Agreement*, 35 SAN DIEGO L. REV.739, 753 (1998).

57. 1989 Decree, *supra* note 55.

58. *Id.* at 4, art. 23.

Although the concept was politically unpopular with some, many U.S. producers realized by the early 1960's that they could not compete in world markets against products that were highly price-competitive when using relatively high-cost U.S. labor in labor-intensive industrial production. The search for lower labor costs in such industries as footwear and textiles was not new. In the immediate post-World War II period, most of the U.S. textile industry moved from New England to the South to pursue find lower wages and escape organized labor.[59] It was obvious to many U.S. economic policy-makers that if movement toward lower-cost labor markets for assembly were inevitable, a system which would help to assure that such offshore production would contain a high U.S. content was far preferable to the alternatives. Also, a low-cost labor manufacturing base adjacent to U.S. territory would provide other economic advantages, such as use of the new Interstate highway system (to deliver parts and components and return finished products) and U.S. communications, enhanced control over exported technology, and convenience for U.S. management.

The TSUS 807.00/HTS 9802 programs dating from 1930[60], although never limited exclusively to Mexico, met many of these economic policy objectives. Where U.S. components exported in condition ready for export are re-imported as finished products into the United States, U.S. duties are payable only on the value added abroad.[61] These benefits are available only where the U.S. components have not lost their physical identity and their value has not been enhanced abroad except by assembly and operations incidental to the assembly process. Similar treatment applies to textile and apparel goods where all fabric components are wholly cut and formed in the United States.[62]

Before the advent of the "Generalized System of Preferences" in 1974, United States import duties on finished goods imported from Mexico and other developing countries were, in some instances, substantial. The prospect of avoiding duties on the U.S. component portion of a foreign product was thus a powerful economic incentive. Item 807 also encouraged U.S.-owned factories in Mexico to use U.S. origin parts and components, and over the years probably discouraged many firms from moving their production to Asia, where use of American made components would have been much less attractive because of transport costs.[63] The limitation of item 807 treatment to

59. Paul Krugman, *Some Chaotic Thoughts on Regional Dynamics*, *at* http://web.mit.edu/ krugman/www/temin.html (last visited Mar. 1, 2002).

60. Tariff Act of 1930, 19 U.S.C. § 1202 (1994) (the Tariff Schedules of the United States (TSUS) were replaced by the Harmonized Tariff Schedules of the United States (HTSUS or HTS) in 1988).

61. U.S. INT'L TRADE COMM'N, HARMONIZED TARIFF SCHEDULES OF THE UNITED STATES, PUB. NO. 3378, at 9802.00.80 (2001).

62. *Id.* at 9802.00.90.

63. DEP'T OF THE TREASURY, U.S. CUSTOMS SERV., IMPORT REQUIREMENTS ON

goods "assembled" abroad using U.S. components also helped to ensure that most of the high value-added processes would remain in the United States, and that only the final assembly operation would move to Mexico.[64] Otherwise, a Mexican operation exporting goods to the United states would be considered by USCS to be engaging in "manufacturing" rather than "assembly", and would lose the 807 tariff benefits.[65]

B. *The Essential NAFTA Scheme: Preferential, Duty-Free Trade*

The core of NAFTA's incentives for trade in manufactured goods is comprised of four elements: (1) elimination of tariffs for "originating" goods that are traded within the region; (2) rules of origin that, in most instances require a high North American content (through the source of materials or a significant manufacturing process) in order for goods to qualify as NAFTA originating for preferential tariff treatment;[66] (3) elimination, after January 1, 2001, of duty remission on non-NAFTA originating materials, parts and components, encouraging the use of North American inputs;[67] and (4) for textiles and apparel, automobiles, agricultural products and others, reduction or elimination of quantitative restrictions.[68]

An important non-trade element, extensive protection for foreign investors under NAFTA's Chapter 11, including the elimination of most restrictions on foreign ownership of Mexican companies and of the requirement for government approval of investment in most sectors,[69] is discussed in part C, below.

None of these trade benefits are guaranteed exclusively for NAFTA members, except those relating to investment. For example, Canada provides similar benefits for trade with Chile,[70] and the United States, for trade with Israel.[71] Mexico has separate free trade agreements with Chile, Colombia and Venezuela, Costa Rica, Bolivia, Nicaragua and Israel, among others.[72] Mexico concluded an agreement with the

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ARTICLES ASSEMBLED ABROAD FROM U.S. COMPONENTS (ITEM 807.00), CUSTOM INFORMATION SERIES C:79-1, at 22 (1978).

64. *Id.* at 2.

65. *Id.* at 1.

66. *See* NAFTA, *supra* note 1, at arts. 302, 401.

67. *See* NAFTA, *supra* note 1, at arts. 401, 402.

68. *Id.* at ch. 3.

69. *See id.* at ch. 11.

70. *Canada and Chile Reach Free Trade Agreement; Highlights of the Canada-Chile Free Trade Agreement*, Nov. 14, 1996, Pub. No. 209, CAN. DEP'T OF FOREIGN AFFAIRS AND INT'L TRADE, *available at* http://www.dfait-maeci.gc.ca/ (last visited September 29, 2001).

71. *See* Overview and Compilation of U.S. Trade Statutes, 1977 ed. 213 (Committee on Ways and Means, 105th Cong., 1st Sess., Jun. 25, 1977).

72. *MEXICO'S INTERNATIONAL TRADE*, MEXICAN TRADE OFFICE SECOFI-NAFTA (Ottawa, Canada), *at* http://www.nafta-mexico.org/trade/Mexico_s_trade/mexico_s_trade.html (Mexico-Chile: effective Jan. 1,

European Union that entered into force July 1, 2000,[73] which could potentially be quite significant. An FTA with Guatemala, El Salvador and Honduras entered into force March 15, 2001.[74] A commission is even being formed to study an FTA between Mexico and Japan,[75] although Japan's closed agricultural market will make negotiating such an agreement very difficult, despite the current inability of Japanese industry to compete in the Mexican market with the preferential tariff treatment afforded to Canada, the United States and now the nations of the European Union.[76]

NAFTA, like every so-called "free" trade agreement, cotemplates the elimination of customs duties on intra-regional trade. Under NAFTA, tariffs on U.S. –Mexico trade are fully eliminated no later than January 1, 2008 (fifteen years after NAFTA's entry into force), but the vast majority of tariffs will be eliminated by January 1, 2003.[77] While many tariffs were eliminated immediately upon the enactment of NAFTA, others are eliminated at five, ten or fifteen year intervals. In addition, there are many variations on the general approach to tariff elimination. The actual tariff elimination schedule for each product is determined from the importing party's NAFTA Tariff Schedule.[78] U.S. – Canada trade became fully duty-free, except for some agricultural products, as of January 1, 1998, in accordance with the ten year phase-out schedule in the U.S. –Canada FTA that was not altered by NAFTA.[79]

NAFTA's rules of origin are designed to avoid Mexico's becoming an "export platform" for final assembly of non-North American parts and components. Accordingly, for a product to qualify as NAFTA originating, a significant North American content must normally be demonstrated, either through a tariff shift, the inclusion of major components or materials produced in North America, or through demonstrating a high (50-60 percent) "regional value content."[80] For

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1992; Mexico-Columbia-Venezuela (G-3): effective Jan. 1, 1995; Mexico-Costa Rica: effective Jan. 1, 1995; Mexico-Bolivia: effective Jan. 1, 1995; Mexico-Nicaragua: effective July 1, 1998).

73. *Id.*

74. Marcos Aleman, *Central America Joins Mexico in Plan*, ASSOCIATED PRESS, June. 16, 2001, *at* 2001 WL 22916204; *But see Honduras Postpones Implementation of Mexico Trade Deal,* CORPORATE MEXICO, May 2, 2001, *at* 2001 WL 3331756 (Honduras delayed implementation).

75. Toshio Aritake, *Bilateral Agreements: Japan, Mexico to Begin Study Commission on Free Trade Accord, but Timing Uncertain,* INT'L TRADE DAILY, Jun. 19, 2001.

76. *Id.*

77. *See* NAFTA, *supra* note 1, at art. 302, Annex 302.2; *See also* NAFTA Tariff Elimination Schedule, *supra* note 13 (it is estimated that as of 2003, duties on 92 percent of the tariff schedule items comprising U.S.-Mexico trade will have been eliminated).

78. *See* NAFTA, *supra* note 1, at Annex 302.2, § 3.

79. *Id.* at §§ 4-9.

80. *See* NAFTA, *supra* note 1, at arts. 401, 402; *see also id.* at Annex 401.

example, a large screen color television does not qualify for NAFTA treatment unless the picture tube is of North American origin.[81] Most apparel must be made from fabric that satisfies the "yarn forward" rule to be of North American origin,[82] meaning that the yarn, the fabric and the apparel itself are all produced in North America. Automobiles will ultimately be required to have 62.5 percent regional value based on "net cost" calculations that track the country of origin as well as major parts of principal assemblies such as engines and transmissions.[83]

However, for many products, such as, for example, bathtubs, it is sufficient that production involve a major manufacturing process –often the equivalent of "substantial transformation"- to confer regional origin.[84] Where a complete tariff shift would otherwise be required –all materials, parts and components must be classified under a tariff heading different than the finished product. Under NAFTA there is a *de minimis* exception: if no more than seven percent of the value of the product fails to undergo a tariff shift, the product may nevertheless qualify for NAFTA treatment.[85]

Under the system, it is immaterial whether the materials, parts and components, and manufacturing operations, take place in Mexico, the United States or Canada. The objective is to favor production not only of finished goods but of imputs within North America, not in any particular NAFTA nation, although Mexico's significantly lower wages have in many respects favored Mexico for finished goods production, and to a lesser extent for input production as well.

Even though duty remission on non-NAFTA components conditioned on export performance was permitted until January 1, 2000, there has been a strong incentive in many industries to purchase NAFTA-originating parts and components. For example, if an auto manufacturer is seeking to demonstrate that 62.5 percent of the net cost is North American, the manufacturer is better off using disk brake assemblies made in the United States rather than brakes made in Korea. The latter will not count toward the 62.5 percent regional content. Even if the rule of origin is a tariff shift, use of a North American component rather than a non-NAFTA component may reduce the total value of non-originating material below the seven percent *de minimis* threshold, and thus permit a claim of NAFTA origin and the duty benefits associated therewith.

81. *Id.*, at Annex 401 (Since January 1, 1999, the printed circuit boards (item 8528.10.bb) must also be of North American origin).

82. *See id.* at Annex 401, ch. 62.

83. *Id.* at art. 403 (5) (a); *See also id.* at Annex 403.1.

84. HARMONIZED TARIFF SCHEDULES OF THE UNITED STATES, *supra* note 61, item 2507, 6910 (the clay or Kaolin enters under item 2507, while the finished bathtub is classified under item 6910).

85. *See* NAFTA, *supra* note 1, at art. 405.

As of January 1, 2001, use of non-NAFTA parts and components resulted in a double "whammy." The cost of non-NAFTA components do not count toward a percentage regional value added, as has been the situation since the beginning. In addition, Mexican import duties at the "most favored nation" rate will have to be paid on all imported parts and components to the extent that these duties are less than the duties on the finished products when imported into the United States or Canada. They can no longer be forgiven through the current duty remission program, although the effect may be similar to the old system if the affected manufacturing sector is subject to one of the new special sector "PROS-EC" programs, or if the imported parts and components are imported from one of the many other nations with which Mexico has a free trade agreement. The impact on manufacturing costs of Mexican MFN import duties on imported parts and materials could be substantial, even ruinous, because most of the duties are 12-18 percent *ad valorem*.[86]

In 1993, the year just prior to NAFTA, Mexico was the most significant beneficiary of the U.S. GSP program.[87] Under NAFTA, all goods that entered the U.S. duty-free under the "general system of preferences" (GSP) became duty-free under NAFTA as of January 1, 1994, with an important proviso.[88] Beginning in January 1, 1994, NAFTA rather than GSP rules applied.[89] In some instances, this shift was probably beneficial, since a 35 percent Mexican value added – difficult to achieve if the principal Mexican value added is labor costs – was no longer required in all cases.[90] In other cases, NAFTA rules of origin may be more stringent, as where the regional value added must be 50 percent or 60 percent depending on the calculation methodology.[91] Anecdotal evidence suggests that the volume of GSP imports that lost duty-free treatment as a result of application of the NAFTA rules of origin was probably small.

While most U.S. imports are not subject to quotas or other quantitative restraints, the U.S. will continue to impose quotas on many textile and apparel imports until they are eliminated January 1, 2005 (and replaced with tariffs) under the WTO Agreement on Textiles and Clothing, as noted earlier. However, NAFTA provides special treatment for Mexican and Canadian textiles. Not only are NAFTA origin textiles admitted under preferential duty rates, but non-

86. *See id.* at art. 303.

87. RALPH FOLSOM & MICHAEL GORDON, INTERNATIONAL BUSINESS TRANSACTIONS § 4.15 (1995).

88. *Id.* at § 4.22.

89. *Id.*

90. *Id.* at § 4.14.

91. *See* NAFTA, *supra* note 1, at art. 402 (defining the "net cost" method and the "transaction value" method of calculation regional value content).

originating textiles are also admitted under preferential conditions.[92] Likewise, quantitative restrictions on such products as sugar are reduced or eliminated under NAFTA.[93]

C. *Protection and Encouragement of Foreign Investment*

Central to the NAFTA objective of trade and job creation was the task of making Mexico's investment climate more attractive to U.S., Canadian and other foreign investors. As noted earlier, Mexico's market opening and liberalization policies, beginning in 1985, included major reforms in restrictive investment laws. These reforms helped to encourage a significant increase in direct foreign investment well before January 1, 1994. However, for some investors, investment in any foreign country –including but not limited to Mexico –requires a high level of protection against arbitrary host government action such as expropriation. Investors are also aware that reforms made by national legislation are subject to political winds and changes in government. In contrast, investment protection rules embodied in a binding international agreement, such as NAFTA, are much less susceptible to arbitrary or unexpected abrogation.[94]

Chapter 11 of NAFTA embodies a series of investment protections similar to those found in the more than 40 bilateral investment treaties the United States has concluded with developing nations in Latin America, Asia and Africa.[95] Under Chapter 11, covered investors ("investors of another party") enjoy a series of basic protections. Investors include NAFTA citizens, individual or corporate, and the term "investment" is defined broadly.[96] Investors receive national treatment or most favored nation treatment for their investments, whichever is better, and must generally receive treatment that is consistent with international law and is "fair and equitable."[97] Performance requirements (obligations to purchase materials locally or export a certain portion of production, such as the former requirements of the *maquiladora* program) are abolished, by January 1, 2001 or before.[98]

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92. *See id.* at Annex 300-B.

93. *Id.* at ch. 7, art. 703 (note that market access in agricultural products is treated separately for U.S.-Mexico trade and Canada-Mexico trade). .

94. México: Foreign Investment Act of 1993, Dec. 27, 1993, 33 I.L.M. 207 (Mexico implemented its obligations under NAFTA).

95. Eleanor Robert Lewis, *The United States Bilateral Investment Treaty Program: Protection for U.S. Investors Overseas,* in THE COMMERCE DEPARTMENT SPEAKS ON INTERNATIONAL TRADE AND INVESTMENT 127 (Ginger Lew, ed., 1994).

96. *See* NAFTA, *supra* note 1, at art. 1139 (in the case of a corporation, it enjoys the protections regardless of ultimate ownership if the company is organized under the laws of one of the NAFTA members and operates a business in one of the NAFTA countries).

97. *Id.* at arts. 1105, 1102, 1103.

98. *See* NAFTA, *supra* note 1, at Annex I-Mexico (NAFTA requires the elimination of so-called performance requirements for foreign investments by NAFTA investors in

Also, limitations on choice of management by nationality are eliminated and currency convertibility and corporate transfers are guaranteed.[99] Expropriation or nationalization is permitted only under limited conditions and with the payment of fair compensation, as required under international law.[100] Disputes between foreign investors and host governments are subject to binding international arbitration, usually under the "Additional Facility" rules of the World Bank's International Centre for the Settlement of Investment Disputes (ICSID) or the arbitral rules of the United Nations Commission on International Trade Law (UNCITRAL).[101]

Chapter 11 covers all foreign investments except those subject to specific reservation under one of the NAFTA annexes. Moreover, it provides for a phase-out of host government approval for investments in non-reserved sectors up to relatively high and increasing limits, $75 million for Mexico during the period January 1, 2000 – January 1, 2003, ultimately increasing to $150 million after nine years.[102] For most manufacturing operations, there are no reservations.

III. THE MAQUILADORA SYSTEM, 2001 AND BEYOND

The restrictions on duty drawback and duty remission programs that became effective January 1, 2001, are likely to have a more significant impact on the *maquiladora* system, and thus on U.S. - Mexican trade and investment, than have any other changes since NAFTA became effective in 1994, and perhaps since the creation of the *maquiladora* system in 1965. Significantly, Mexico's responses to these changes, to maintain current *maquiladora* operations and at the same time encourage further direct foreign investment and new employment, are constrained by Mexico's obligations under the World Trade

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another NAFTA member nations. Prior to 1994, one of the most significant performance requirements was the limitation on *maquiladora* sales in the Mexican domestic market. Under NAFTA, as of 1994, *maquiladoras* were permitted to sell in the domestic market a volume equal to as much as 50 percent of the preceding year's export sales. This percentage increased by five percent each succeeding years, i.e., 55 percent in 1995, 60 percent in 1996, etc., with the limitation eliminated as of January 1, 2001. Initially, this change probably had little impact on domestic sales, particularly of consumer products, because of the deep recession following the December 1994 currency crisis); *But see* Gloria Arizaga, *Repunta Consumo: Crece 11.2% en Enero (Consumption Rises: 11.2% in January)*, EL ECONOMISTA, http://wwweconomista.com.mx (March 23, 2000) (as of early 2000, there is anecdotal evidence that in some sectors, such as consumer electronics, domestic sales are increasing).

99. *See* NAFTA, *supra* note 1, at arts. 1106, 1107, 1109.

100. *Id.* at art. 1110.

101. *Id.* at art. 1120; *See* David A. Gantz, *Reconciling Environmental Protection and Investor Rights Under Chapter 11 of NAFTA*, 31 ENVTL. L. REP. 10646 (2001) (for a discussion of certain aspects of investor - state litigation under Chapter 11).

102. *See* NAFTA, *supra* note 1, at Annex I-Mexico.

Organization Agreement on Subsidies and Countervailing Measures, as well as by the provisions of NAFTA.

Ironically, the elimination of duty waivers mandated by Article 303 is designed in part to deal with a situation that probably does not occur very often today. If U.S. and Mexican factories are both producing widgets for sale in the United States market, there is an element of unfairness if the Mexican factory pays no import duties on non-NAFTA parts and components, while the U.S. competitor must pay such import duties on the parts and components that *she* imports (since the finished products are not exported but instead are consumed in the United States). This gives the U.S. producer higher materials costs by the amount of the U.S. duties on the imported materials. Of course, the other major objective of Article 303— encouraging substitution of regional parts and component production for non-NAFTA inputs—remains valid.

However, if the Mexican producer exporting to the United States is competing with a Chinese producer also exporting to the United States, the elimination of duty waivers for Mexico favors the Chinese producer. The latter will continue to enjoy the duty waiver in his home country for non-Chinese parts and components (and lower wages), although the finished product from China may be subject to U.S. import duties while the Mexican product will not.

A. Limitations on Duty Remission for Non-NAFTA Parts and Components

NAFTA, Article 303(1), limits duty remission of Mexican import duties on non-NAFTA parts and components to the lesser of the Mexican import duties on the parts and components, or the U.S. (or Canadian) duties on the finished products. Significantly, the limits do not apply to parts and components originating elsewhere in the NAFTA region; such imports continue to receive duty referral or remission to the extent regular duties have not already been eliminated among the NAFTA parties. Antidumping and countervailing duties imposed by NAFTA nations on non-NAFTA products must be assessed upon the entry of the goods and cannot be remitted.[103] However, Mexico has interpreted its laws to preclude assessment against the *maquiladoras* of antidumping duties originally imposed prior to January 1, 2001, on the *maquiladoras,*[104] on the apparent grounds that such interests did not have an opportunity to participate in the administrative process that

103. *See* NAFTA, *supra* note 1, at art. 303(2)(a).

104. Customs Law (Ley Aduanera), art. 2(X), (amended 2000), *available at* http://www.mexicolaw.com/CustomsLawDemo/Article1-9.htm (last visited September 10, 2001).

led to assessment of the dumping duties.[105]

Separately, Article 304(1) precludes the initiation of new duty waiver programs if the benefits are conditioned on performance requirements,[106] such as exporting a given percentage of production. Under Article 304(2), and Annex 304.2, Mexican duty waivers tied to performance (export) requirements must be eliminated January 1, 2000.[107] *However, to the extent that duty waiver programs are not conditioned on performance requirements, they arguably remain legal under NAFTA.*

To illustrate the impact of the change on Mexican manufacturers, consider the production of a Mexican widget that is exported to the United States. The widget, in this example, uses Asian parts valued at $30 subject to a 10 percent Mexican duty, or $3.00. The finished product has a transaction value[108] of $100 when imported into the United States. U.S. duties on the widget are five percent ($5.00). Prior to January 1, 2001, the Mexican duty of $3.00 would have been deferred or remitted, regardless of any duty owing on the finished widget when imported into the United States. After January 1, the situation is as follows:

a) If there remains a U.S. duty of five percent ($5.00) on the widget, the Mexican authorities are permitted to remit the entire $3.00 Mexican duty on imported parts could be remitted.

b) If the U.S. duty is two percent ($2.00), only $2.00 of the $3.00 in total Mexican duties could be remitted.

c) If the U.S. duty is zero— the predominant situation— no Mexican duty could be remitted.

The effect of this limitation on duty remissions is an increase in the manufacturing (materials) costs for Mexican widgets by $3.00, if the U.S. duty on the finished product is zero, unless of course that widget parts and components are purchased in North America, entitled to special sector treatment or enjoy duty free entry under one of Mexico's other free trade agreements. If widgets are a competitive product worldwide, the effective increase in manufacturing costs - $3.00 or three percent in this example – could eliminate profit. The increased cost may cause Mexican widget makers to shift their operations to the United States, or, more likely, to other nations (presumably in Asia) where overall manufacturing costs are lower than in Mexico.

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105. *Id.*

106. *See* NAFTA, *supra* note 1, at art. 304(1).

107. *Id.* at art. 304(2); *See also id.* at Annex 304.2.

108. Tariff Act of 1930, 19 U.S.C.A. §1401a(b) (1994) (the "transaction value" is the price actually paid or payable for the goods when sold for export to the U.S., subject to certain adjustments. Normally, it is used when the transaction is between importer and exporter that are unrelated parties).

There are certain industries that are currently more dependent on non-NAFTA sources than others. The electronics and auto parts industries are among those that are most seriously affected. For that reason, and because investment and employment in these sectors are huge, the Mexican government took steps, discussed in detail *infra*, to reduce the impact of additional materials costs on these and other key industries.

The impending limitations on duty remissions under Article 303, along with rules of origin encouraging a high level of regional content as with the 62.5 percent for automobiles, have had an impact on Mexico long before they became effective.[109] Anticipation of the elimination of duty remission programs encouraged many producers, particularly in the electronics and automobile sectors, to develop local (Mexican or United States) sources for parts previously imported from outside region.[110] For example, in the electronics sector, a television producer's factory is typically surrounded by other, satellite, factories either independent or owned by related parties, that are producing key components for the Mexican production of televisions.[111] This anticipatory phenomenon has most likely been among the strong incentives for new direct foreign investment in Mexico since the mid-1990s, as the drafters of NAFTA presumably intended.

B. Elimination of Duty Remission on Imported Machinery and Equipment

The 2001 changes under Articles 303 and 304 apply not only to non-NAFTA parts and components imports, but also to non-NAFTA-origin machinery and equipment imported by the *maquiladoras* to produce goods in Mexico.[112] Direct foreign investment in Mexico in recent years has averaged approximately $9-$10 billion per year,[113] although probably only about 20-25% of that goes into *maquiladora* manufacturing.[114] Much of this investment has most likely been used to

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109. *See* NAFTA, *supra* note 1, at art. 303(2)(a).

110. *Id.*

111. For example, Daewoo Electronics de Mexico, S.A. de C.V., which was established in 1991 in San Luis, Sonora, encouraged the establishment of a subsidiary of Daewoo Components Co., Ltd. in 1996. That new factory in the same industrial park produced deflection yokes, tuners and coils for Daewoo Electronics. Moreover, several unrelated Korean firms are located within a few hundred feet and produce condensers and other electric parts.

112. NAFTA, *supra* note 1,at arts. 303, 304.

113. *Focus on Mexico*, *at* http://www.eslfocus.com/nationsfolder/fomexico/infoonmex5.html (last visited Mar. 8, 2002).

114. *In-Bond Industry/Industria Maquiladora 2001*, *supra* note 18, at 26 (estimating $2 billion in 1999 and again in 2000).

purchase machinery and equipment for industrial production.[115] Under the prior *maquiladora* rules, machinery and equipment could be "temporarily" imported with the duty deferred under the condition that it be used in valid *maquiladora* operations.[116] In the event that the machinery was re-exported when it was no longer needed or operations cease, there was effectively no duty.

As of January 1, 2001, Mexican authorities could no longer provide such deferral. Rather, Mexican import duties are now payable upon importation of the machinery and equipment, at the duty rate applicable in Mexico to imports from the affected countries.[117] The duty rate will be the "most favored nation" duty for most non-NAFTA suppliers, unless the machinery is covered by one of the special sector ("PROSEC") programs at a zero or reduced (usually 5%) rate or is from a country with which Mexico has a free trade agreement.[118] However, the *maquiladoras* will continue to import the machinery on a temporary basis, because in doing so they will avoid paying the value added taxes of 10%.[119]

Because many industrial companies, including some *maquiladoras*, depend on machine tools and other equipment imported from Asia, particularly Japan, Korea, Taiwan and China, the impact on future *maquiladora* investment and operations is also likely to be considerable for sectors not protected by a special decree. For machinery and equipment imported before December 29, 2000, the term for temporary imports of machinery and equipment has been fixed at five years or the term for depreciation under the Mexican Income Tax Law,[120] whichever term is longer. It appears that machinery and equipment that has been temporarily imported[121] in the past, and is still within its useful life (usually 10 years under Mexican law) will not be subject to any duties if such machinery and equipment has been used in the *maquiladora* program.

115. Camilla Castellanos, *Foreign Interest*, *at* http://www.mexconnect.com/mex_/travel/bzm/ bzmtop50-99.html (last visited Mar. 8, 2002).

116. Decreto para el Fomento y Operación de la Industria Maquiladora de Exportación [Decree for the Encouragement and Development of the Export-maquiladora Industry], art. 8(II) and (III), June 1, 1998 (Mex.), *available at* http://www.naftaworks.org/downdof/1998/jun01-1.htm (last visited Sept. 8, 2001).

117. Customs Law, *supra* note 104, at art. 110.

118. Ley del Impuesto al Valor Agregado [Value Added Tax Law], arts. 1, 2, 29 *et seq.*, *available at* http://www.sat.gob.mx/AGJI/ACAC97/Legis_2000/Leyes_Fiscales/Ley_Imp_ValorAgregado/ Marco_LeyImp_ValorAgregado.htm (last visited Sept. 8, 2000).

119. *Id.*

120. Ley de Impuesto Sobre la Renta, art. 99, D.O., Dec. 30, 1980 (Mex.).

121. Customs Law, *supra* note 104, at arts. 109-10.

C. Other Limitations Imposed by the WTO and NAFTA

As previously discussed, the pre-2001 *maquiladora* benefits were conditioned on exporting a certain portion of production; these requirements are being phased out under NAFTA as of January 1, 2001, and cannot legally be extended. Such export requirements for obtaining government benefits – such as duty-free entry of machinery and equipment for exporters but not for other Mexican producers – will in the future be a violation of Mexico's obligations under the WTO Agreement on Subsidies and Countervailing Measures. The SCM Agreement prohibits, *inter alia*, "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance. . ."[122] Under the Agreement, duty remission on machinery and equipment when conditioned on export of the finished products would thus be a violation. (There is an exception for duties and for value added taxes on parts and components that are incorporated in finished products that are then exported; by agreement they are not considered actionable export subsidies.)[123]

These restrictions were not applicable to Mexico immediately upon the entry into force of the SCM Agreement on January 1, 1995.[124] Under the SCM Agreement, Mexico, as a developing nation, generally has an eight-year period – until January 1, 2003 – to eliminate export subsidies.[125] However, during that interim period, Mexico may not increase the level of export subsidies.[126] Given the increased friction between developing country and developed country members of the WTO as demonstrated at the meeting in Seattle in November 1999,[127] it is possible that Mexico and other developing nations may seek and

122. WTO Agreement on Subsidies and Countervailing Measures [hereinafter "Subsidies Agreement"], art. 3.1(a), *available at* http://www.wto.org/english/docs_e/legal_e/24-scm.pdf (last visited Mar. 1, 2002).

123. *Id.* at Annex I(i).

124. *Id.* at art. 27.2(b). However, under Act 27.4, existing subsidy links may not be increased.

125. *Id.*

126. Interestingly, in sectors where Mexico has earlier reached export competitiveness, defined as 3.25 percent of total world trade for two consecutive years, the covered export subsidies for those sectors must be phased out within two additional years, subject to certain limitations. Based on this standard, it is arguable that Mexico was obligated to phase out duty free entry of machinery and equipment used for production of color televisions, automobiles and some textiles earlier than 2003. WTO Subsidies Agreement, *supra* note 122, at arts. 27.3-27.6. Mexico has probably accounted for well over 3.25 percent of total world trade in each of these categories – four digit HS headings – for some time. Apparently, these issues have not been raised with Mexico – not even by the U.S. Government – perhaps because most of the benefits of the *maquiladora* program accrue to U.S. owned firms.

127. *WTO Meeting Brings No Progress on Reducing Agricultural Export Subsidies*, ON THE PLATE, Dec. 1999, *at* http://www.consumeralert.org/pubs/OnthePlate/OTPDEC99.htm (last visited Mar. 8, 2002).

receive a further deferral of their obligations under the Agreement beyond 2003.

As noted earlier, one of the benefits guaranteed to foreign investors under NAFTA is a prohibition of performance requirements.[128] In addition to the Article 304 prohibition on tying customs duty waivers to performance requirements (minimum export percentages), NAFTA Article 1106 provides as follows:

> 1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory: (a) to export a given level or percentage of goods or services. . .[129]

The limitations on domestic sales as a percentage of total sales by *maquiladoras* were phased out over seven years, under NAFTA's Annex I, as of January 1, 2001.[130] The provision of Articles 304 and 1106 effectively make it illegal under NAFTA for the Mexican government from imposing new export requirements on Mexican factories owned by U.S. or Canadian investors, as a condition, for example, to obtaining lower duties on imports of non-NAFTA parts and components or machinery and equipment, or in the case of Article 1106, to obtain other benefits.[131] There is thus an issue of whether the new PROSEC decrees are in effect (if not technically) export requirements and a violation of both NAFTA and WTO provisions. If in fact the sectoral programs, as discussed below, effectively benefit both exporters and producers for the domestic market, Mexico will be able to argue with considerable validity that the PROSEC programs are consistent with Mexico's NAFTA and WTO obligations.

Also, to the extent that the new *maquiladora* decree retains export requirements in order for investors to qualify for the benefits of the decree, this would appear to be a violation of NAFTA, Article 1106. Thus, the provisions that limit "temporary" imports of materials to firms that have annual export sales of $500,000 or 10% of total invoicing, and imports of machinery and equipment for temporary purposes to firms that demonstrate that 30% of their invoice value is for export,[132] are of questionable validity. Of course, if the firm does not

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128. NAFTA, *supra* note 1, at art. 1106.

129. *Id.*

130. *Id.* at Annex I.

131. *Id.* at arts. 304, 1106.

132. Decreto para el Fomento y Operación de la Industria Maquiladora de Exportación, D.O., June 1, 1998 (Mex.); Decreto que reforma al diverso para el Fomento y Operación de la Industria Maquiladora de Exportación, D.O., Nov. 13, 1998 (Mex.); Decreto que reforma al diverso para el Fomento y Operación de la Industria Maquiladora

wish to export any portion of its production it probably has no economic incentive to participate in the *maquiladora* program.

At the same time, with both NAFTA and the SCM Agreement, the issue is not simply one of the substantive violation, but a practical question: who will complain? Since an estimated 80-90 percent of the *maquiladora* firms are U.S. owned,[133] the United States is unlikely to object—other than on grounds of principle—to the Mexican authorities about such violations unless the *maquiladora* industry objects. As long as most *maquiladora* production is exported, objections are likely to be rare or non-existent.

There is, of course, nothing in NAFTA or the WTO agreements that prevents Mexico from reducing its MFN duties on non-NAFTA machinery and equipment to zero. However, a general reduction on such machinery and equipment would benefit not only PROSEC program beneficiaries but other Mexican producers as well, and would affect goods produced for the Mexican market as well as those made for export. A general duty reduction could also have significant fiscal effects in terms of loss of customs duty income for the Mexican government, and discourage investment in production of parts and components in Mexico (and in the United States and Canada). The principal advantages of MFN duty reduction would be administrative; it would avoid the additional layer of regulation that the special sector program imposes, for government officials and *maquiladoras* alike.

D. Protecting the Maquiladoras *Consistently with NAFTA / WTO Requirements*

It has been quite obvious to Mexican government officials and to *maquiladora* owners and operators that while the NAFTA provisions discussed above provide a powerful incentive for *maquiladoras* to replace non-NAFTA sources with NAFTA sources of materials, there are some parts and components that simply cannot currently be produced in Mexico at competitive prices, in adequate quantities and with acceptable quality. The industries and the government would have both faced a difficult situation if Mexico had simply adhered to the NAFTA requirements, without further action, and as of January 1, 2001, begun charging MFN duties typically between 12-18 percent *ad*

de Exportación, D.O., Dec. 31, 2000 (Mex.); and Decreto que reforma al diverso para el Fomento y Operación de la Industria Maquiladora de Exportación, art. 4 A, paras. I, II, D.O., Dec. 31, 2000 (Mex.) [hereinafter referred to in consolidated form as *Maquiladora* Decree].

133. Dignity in Labour, *Facts on the Maquiladoras*, *at* http://www.citinv.it/associazioni/CNMS/ archivio/lavoro/maquiladoras.html (last visited Sept. 8, 2001) (suggesting that 90 percent were U.S. owned, but this may have declined somewhat given the influx of Asian and European investment in the post-1994 period).

valorem except for textiles where the rates may be considerably higher.[134] Manufacturing costs would have increased by the amount of the Mexican import duties. Under such circumstances, many Mexican manufacturers would have concluded that production of goods in Mexico for the U.S. market no longer made sense.

This result is unattractive for both the NAFTA governments and their stakeholders. In most instances, manufacturers have no interest in shifting otherwise profitable facilities elsewhere, and the Mexican government has no interest in creating unemployment in the border region as a result of closed factories. Presumably, the United States Government shares both objectives because most of the *maquiladora* firms are U.S. owned and an increase in Mexican unemployment rates would presumably encourage emigration to the United States. A shift of Mexican production to Asia would most likely reduce the U.S. parts and components content of the finished goods significantly, indirectly reducing U.S. manufacturing jobs as well.

Mexico has initially addressed the problem through two separate mechanisms, the new *maquiladora* and *Pitex* decrees, and the new special sector programs. Legislation (decrees) enacted in October and December 2000 created a new system which no longer ties *maquiladora* benefits (or similar *Pitex* benefits) to export performance. This analysis provides brief overview of a very complex series of legal changes, including but not limited to major modifications in the *Maquiladora*[135] and *Pitex*[136] decrees, the Mexican Customs Law[137], various subsidiary customs laws and, most importantly, the new sectoral promotion programs.[138]

134. A textile producer in Nogales, Sonora, told the author during a plant visit in September 2000 that one of his product lines was dependent on a particular fabric commonly imported from the Far East. The fabric, after January 1, 2001, will be subject to Mexican import duties in the 25-30 percent range. He can find no NAFTA supplier of the fabric at a competitive price, and thus may be forced to discontinue the product line in Mexico if the fabric is not covered by the special sector program.

135. *See generally Maquiladora* Decree, *supra* note 132.

136. Decreto que establece Programas de Importación Temporal para Producir Artículos de Exportación, D.O., May 3, 1990 (Mex.); Decreto que reforma al diverso que establece Programas de Importación Temporal para Producir Artículos de Exportación, D.O., May 11, 1995 (Mex.); Decreto que reforma al diverso que establece Programas de Importación Temporal para Producir Artículos de Exportación, D.O., November 13, 1998 (Mex.); Decreto que reforma al diverso que establece Programas de Importación Temporal para Producir Artículos de Exportación, D.O. October 30, 2000; and Decreto que reforma al diverso que establece Programas de Importación Temporal para Producir Artículos de Exportación, D.O., December 31, 2000 [hereinafter referred to in consolidated form as *Pitex* Decree].

137. *See generally* Customs Law, *supra* note 104.

138. Decree Establishing Various Sector Promotion Programs, D.O. Dec. 31, 2000 as amended D.O. Mar. 1, 2001 (Mex.) [hereinafter PROSEC Decree]. Earlier versions, now repealed, are found at D.O. Nov. 14, 1998, D.O. May 9, 2000 and D.O. Oct. 30, 2000.

1. Modified Rules for *Maquiladora* Operations

The changeover to the new system (for parts and components that do not meet NAFTA origin requirements) effectively began November 20, 2000, in anticipation of the NAFTA restrictions that were effective January 1, 2001, due to the normal lead time between importation of parts and components and exportation of the finished products.[139] Certain transitory provisions dealing with imports during November and December 2000, and many other technical changes in the operational requirements are not germane to this discussion. However, it should be noted that parts and components imported after November 20, 2000, were subject to treatment under the new law if the finished goods are exported after January 1, 2001, when the PROSEC decree becomes effective.[140]

The most important aspect of the new *maquiladora* system relate to the major change. As noted earlier, Mexican duties will be paid on parts and components imported from non-NAFTA sources, unless one of the special sector programs applies. They can no longer be waived as an export condition. Although as noted earlier some *maquiladora* benefits are still related to export performance,[141] there is less emphasis that in the past on exporting a high percentage of the finished goods produced by *maquiladoras*.

In most other respects basic *maquiladora* operating practices are not significantly changed, except with regard to relatively minor administrative requirements and the possibly significant administrative burdens of operating under a second, overlapping regime, the special sector (PROSEC) program. Most importantly, *maquiladora* assembly operations which are dependent entirely on U.S. parts and components are essentially unaffected by the 2001 changes insofar as their materials are concerned. Article 303 does not apply to those parts and components. Yet, many U.S. *maquiladoras* have and will continue to import non-NAFTA origin machinery and equipment, and are thus affected in that way.

Also, manufacturing sectors that involve goods that are wholly obtained or produced entirely in the territory of one or more of the parties,[142] will not be affected in so far as materials inputs are

139. *See id.* at Preamble, Transitory Arts. 1, 4.

140. *See* PROSEC Decree, *supra* note 138, at Transitory Article 4.

141. *See Maquiladora* Decree, *supra* note 132, at art. 4 A. Permission to import raw materials and containers temporarily, saving the value added tax and allowing the deferral of payment of any duties on the materials until 60 days after the finished product has been exported, is available only to firms that have annual foreign sales that exceed US$500,000 or 10% of total sales. Permission to import machinery, tools and related items is limited to firms for which foreign sales represent at least 30% of total sales.

142. NAFTA, *supra* note 1, at arts. 401, 415.

concerned. These include most mineral products, fisheries products, agricultural crops and livestock, as well as certain wood products, pottery, etc., because they do not incorporate inputs from outside the NAFTA region. Even if there are minor non-NAFTA inputs in processed foods and furniture, they are likely to be well below the seven percent *de minimis* level provided in NAFTA.[143] Of course, imported machinery and equipment purchases from non-NAFTA sources will be impacted, particularly in the mining and agriculture sectors. As a result those and some other sectors are included in the PROSEC programs with regard to capital equipment.

Even where Mexican duties on parts and components are payable, continued use of the *maquiladora* form of doing business in Mexico will be essential for most operators. The system continues to offer clear advantages over alternative ways of doing business in Mexico. Existing and future investments will continue to benefit from factors that have been traditionally linked to *maquiladora* operations. These include lower labor costs, geographic proximity to the United States and its excellent transportation infrastructure, the option for managerial personnel to live in the United States while operating a business in the border region of Mexico, and Mexico's relative political stability. However, there are also other specific trade-related advantages to operating as a *maquiladora*.

Under the revised *maquiladora* system, payment of duties where there is no special sector exemption is deferred for two months following the exportation of the finished goods,[144] which may mean 4-6 months from the date of importation of the materials into Mexico. For many companies, this is a significant cost consideration and alone might justify operating as a *maquiladora*. The *maquiladora* regime continues to grant an additional benefit, in that *maquiladoras* do not have to pay the Mexican value added tax (IVA) on components used in assembly or manufacturing processes (temporary importations),[145] or on machinery and equipment imports even when the latter are dutiable. Under NAFTA, Mexican entities may import goods definitively at a reduced tariff rate, but they normally are required to pay the applicable value added tax. The IVA is variable, but typically it amounts to 10 percent of all sales of goods and services within Mexico.[146]

Although they are required to comply with applicable customs regulations and procedures,[147] *maquiladoras* also enjoy more favorable customs procedures than that afforded Mexican companies in general.

143. *Id.* at art. 405.

144. *Maquiladora* Decree, *supra* note 132, at art. 8 B; *see also* NAFTA, *supra* note 1, at art. 303(5).

145. Value Added Tax Law, *supra* note 118, at arts. 29 *et seq.*

146. *Id.*

147. Customs Law, *supra* note 104, at arts. 35 *et seq.*

The *maquiladora* program requires companies to comply with applicable customs regulations, while facilitating customs procedures.[148] *Maquiladoras* are allowed to file consolidated importation documents (*pedimento consolidado*),[149] rather than filing a *pedimento* with each customs entry. The consolidated document covers several entries during a specified period of time. The consolidated system makes the process more expeditious, by avoiding the additional paperwork and filing required for each single customs crossing.

Additionally, *maquiladoras* are not under an obligation to comply with detailed marking requirements. Most products have to bear a label with Spanish information in compliance with Mexican labeling standards. Temporary imports carried out by *maquiladoras*, on the other hand, include packaging materials, labels and brochures necessary to complement the basic production program.[150]

Among other factors, it appears that firms that commonly export goods to non-NAFTA countries will want to continue operations as a *maquiladora*. Only Mexican exports to the United States and Canada are subject to the January 1, 2001 changes. Exports to other markets will continue to enjoy the duty deferral and duty-drawback provisions on imported parts and components indefinitely, and on machinery and equipment until Mexico's WTO obligations preclude it in 2003. (If machinery and equipment is used to produce both for NAFTA and non-NAFTA export markets, the goods will presumably have to meet the NAFTA imposed limitations on duty remission or drawback.)

There is also a perception that *maquiladoras* are treated more favorably than some other sectors of Mexican industry, due to their tremendous importance to the Mexican economy. The Secretariat of Economy (SECON) (formerly SECOFI) is the primary government agency responsible within the Mexican Government for regulating foreign trade.[151] The author's impression is that SECON has traditionally been viewed by companies as a more favorable, flexible and business-oriented entity, in contrast with other governmental agencies such as the Secretariat of Finance and Public Credit (SHCP).[152]

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148. *Id.*

149. *Id.* at art. 37 ("Exporters of merchandise may file at customs through a customs agent or attorney a single customs request covering several operations of the same exporter. Such a request shall be called a 'consolidated request.' *Maquiladoras* and companies with export programs authorized by the Ministry of Commerce and Industrial Development may also elect to file for customs dispatch of merchandise through a consolidated customs request for import.").

150. *Maquiladora* Decree, *supra* note 132, at art. 8.

151. The scope of SECON's mission and authority is set forth in the *Ley Orgánica de la Administración Pública Federal* [Organic Law of the Federal Public Administration], art. 34, D.O. Dec. 29, 1976, as amended (Mex.).

152. Author's discussions with various *maquiladora* and their attorneys during January 2000-March 2001.

SECON's participation begins with the granting of the relevant operating permits (i.e. the establishment of the *maquiladora*) and continues with monitoring and enforcement.[153] Maquiladoras are required to submit an annual report to SECON detailing their import and export operations and domestic sales.[154] The *Maquiladora* Decree also requires *maquiladoras* to provide any information requested by SECON or SHCP and to cooperate with them in carrying out program compliance efforts.[155]

2. Special Sector Program (PROSEC)

The second and more innovative mechanism to address the impact of the Article 303 changes in Mexico is an import duty reduction program applicable only to specific industry sectors (*programas de promoción sectoral*). The essence of the PROSEC program is to provide Mexican importers of the parts and components used to manufacture specific finished products, with zero or reduced (usually 5%) duties on certain of the non-NAFTA parts and components.[156] In order to achieve compliance with NAFTA and WTO rules, the PROSEC programs are applicable to all manufacturers of the specified products, regardless of whether production is for export or domestic consumption, and regardless of whether the manufacturing operation is carried on under the rules of the *Maquiladora* or *Pitex* programs.[157]

An initial PROSEC decree issued in November 1998 covered only the electronics and electrical sectors.[158] It was replaced with broader PROSEC decrees issued in May 2000 and again in October 2000.[159] All of these earlier decrees were superseded by a December 31, 2000, PROSEC decree, which remains in force, after amendment of the covered tariff category list on March 1, 2001.[160] The December 31 decree, like the earlier ones, notes the need to "increase the competitiveness of the domestic production sector in international markets," to obtain raw materials and machinery that are "critical" for some industries, and to do so in a manner consistent with Mexico's NAFTA and WTO

153. PROSEC Decree, *supra* note 138, at arts. 6, 8.
154. *Maquiladora* Decree, *supra* note 132, at art. 13.
155. *Id.*
156. *PROSEC - Program of Sectoral Promotion*, *at* http://www.mexicanlaws.com/PROSEC.htm (last visited Sept. 12, 2001) (stating that a company can import the goods and materials utilized in their production and pay duties of 0%- 5%).
157. *Id.*
158. PROSEC Decree, D.O. Nov. 14, 1998 (repealed).
159. PROSEC Decree, D.O. May 9, 2000, D.O. Oct.20, 2000; *see also* PROSEC Decree, D.O. Dec. 31, 2000 and, *supra note* 138, at Transitory art. 3.
160. PROSEC Decree, *supra* note 138. These amendments added only certain items to the lists of those subject to duty free or reduced duty treatment, and deleted a few.

obligations.[161]

Once a manufacturer has completed the necessary registration process, it is eligible for PROSEC treatment if a) the finished product falls within one of the tariff categories listed in the decree, and b) the particular imported parts and components originating outside of North America are specifically listed in the decree as well.[162] There is an exception to the category-by-category treatment of parts and components. The Mexican Customs Law now provides under Rule 8 that all of the parts and components necessary to produce certain finished products may be imported under a single "basket" customs category, rather than under the individual tariff classifications, usually at a zero rate, once the finished product is granted the necessary approvals.[163]

Thus, Article 3 of the PROSEC decree provides a list of product sectors that are covered by the decree.[164] The direct producer of the finished product, or one of the "indirect" producers (those who make intermediate goods used to produce one of the listed finished products) is authorized to import any of the materials, parts and components listed in Article 5.[165]

The December 31, 2000, PROSEC decree, which remains in force, covers twenty-two sectors: furniture; toys; sports equipment; footwear; mining and metallurgy; capital goods; agricultural machinery; automotive and auto parts; textiles and apparel; chocolate; candy and similar products; coffee; and a miscellaneous "basket" of products.[166] According to SECON, the PROSEC decree covers approximately 5500 raw materials, parts and components, machinery and equipment tariff categories, of which about two thirds relate to inputs for the electrical

161. *Id.*, at preambular paragraphs.

162. *Maquiladora* Decree, *supra* note 132, at Transitory art. 2.

163. *See* Tariff Schedule of Mexico, Chapter 98, "Imports of Parts for the Fabrication of Products Produced by Businesses Which Have Complied with the Requirements Established for Operations Specified under Rule 8 of the Law of General Duties on Imports," *available at* http://www.apectariff.org/tdb.cgi/6e616674612063656e746572ff3039333532/mx/Mexico.zip (last visited Mar. 1, 2002).

164. PROSEC Decree, *supra* note 138, at art. 3.

165. *Id.* at art. 166.

166. Under Article 4, subsection 10 of the PROSEC Decree, *supra* note 138, the miscellaneous programs include: office or school supplies; buckets and pails; trunks, suitcases, purses, jewelry boxes and other plastic or textile materials; account books, notebooks, etc.; binders, folders, etc.; interchangeable hand tools; certain electric motors; separators of classifiers of ferrous materials or parts; drawing or mechanical calculating instruments; wrist watches, pocket watches, clocks, etc.; instrument panel clocks for vehicles, aircraft, spacecraft, etc.; other clocks; time apparatus for measuring, recording or otherwise indicating intervals of time, time switches, etc.; and cigarette lighters, pocket and table lighters.

and electronic industries.[167] The March 1 decree added 1,047 items to the list and removed 37 items (the latter all in the electronics sector).[168]

The electronics industry was the first to be subject to a PROSEC decree, in November 1998.[169] Apparently after extensive negotiations with firms in the electronics/electrical industry, the Mexican government issued the Electronics/Electrical Industry Decree[170] which would have eliminated or reduced Mexican import duties not only on parts and components, but also on machinery and equipment which cannot reasonably be obtained from North American sources. It is not surprising that the electronics industry was addressed first, it accounts for almost 50 percent of total *maquiladora* production and a third of *maquiladora* employment.[171] It is also a highly competitive industry world wide, with Mexican production facing intense competition from other sources, particularly in Asia. Most of the Mexican electronics producers are owned by Asian or European firms,[172] which may reduce the perceived advantages of operating in North America, particularly if excess production capacity is currently available in Asian facilities. Thus, in this industry, the risks to Mexico of production shifts to lower-labor cost areas of Asia are very real.

Mexico's MFN duty rates are *not* being reduced or eliminated across the board, and remain applicable to all other importers, except those covered by the specific decrees. The PROSEC decree, in itself a special series of tariff rates (including zero), is specific in its coverage, and to some extent reflects careful choices by SECON after negotiations with the affected industries. In theory, at least, a balance should be sought between avoiding additional costs to manufacturers for non-NAFTA inputs not easily available in Mexico, and permitting extensive imports of non-originating goods that could be found in Mexico or elsewhere in North America. Mexican Officials are presumably aware that duty-free entry of parts and components used to produce goods for the domestic market will result in lost customs revenues, but they nonetheless are liberally granting requests to include additional items for duty-free entry under the PROSEC Program.[173] Also, whether a good is classified under one of the favored

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167. Rocio Ruiz Chavez, Seminar on Application of Article 303 of NAFTA, at 8-9 (Mar. 22, 2001)(copy on file with author).

168. *See* Jorge Caballero Matamoros, Seminar on Application of Article 303 of NAFTA, at 6 (Mar. 22, 2001) (copy on file with author).

169. *See generally* Decreto Que Establece Diversos Programas de Promoción Sectorial *available at* http://www.naftaworks.org/downdof/1998/nov14-1.htm

170. The November 1998 version, *D.O.* Nov. 14, 1998, has been superseded by the *PROSEC* Decree, *supra* note 138.

171. Lucinda Vargas, *Maquiladoras 2000*, *supra* note 20, at 2.

172. Among the largest are Phillips (Netherlands), Thomson, S.A. (France), Daewoo, Samsung and LG Electronics (Korea) and Sony, Matsushita and Sanyo (Japan).

173. Telephone interview with Lic. Isabel Sanchez, an attorney in Ciudad Juarez, Jun.

categories, or under a category that is not listed, will make a tremendous difference with regard to duties paid by the importers and revenues collected by Mexican customs authorities. Among other things, *maquiladoras*, their lawyers and Mexican customs officials will be paying much more attention to classification and valuation determinations than in the past, when virtually all parts and components imports, regardless of classification, were duty-free if made by *maquiladoras* or *Pitex*.

The fine-tuning of the PROSEC program is an on-going process. Between the first November 1998 decree and the December 2000 decree, the number of covered sectors increased from two (electronics and electrical industries) to more than 20.[174] The list of covered parts and components is also dynamic. As noted earlier, in March 1, 2001, two months after the new program went into effect, the Mexican government published an extensive list of additional items subject to reduced duty or duty-free treatment under the PROSEC decree.[175] Additional such decrees are almost inevitable. As official SECON guidance states: "The programs are flexible because import duty levels and products included can be modified."[176]

Initially, at least, it appears that SECON is being very liberal in its treatment of requests for the addition of additional tariff items to the PROSEC lists of parts, components and machinery subject to 5% or zero tariffs.[177] In many instances, producers covered by the PROSEC Decree are being authorized under Rule 8 to import all of the materials, parts and components under a single "basket" tariff category, an approach which vastly simplifies the customs and bookkeeping requirements.[178] There appear to be fewer situations in which a request is refused, and there is no evidence that the views of Mexican producers of parts and

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19, 2001 (transcript on file with author).

174. *See* discussion *supra* at notes 158-166 and accompanying text.

175. *See* PITEX Decree *supra* note 136.

176. *See A Practical Guide to Mexico's Maquila 2001 Program,* at http://www.naftaworks.org (last visited Mar. 1, 2002).

177. Sanchez Interview, *supra* note 173.

178. *Id.* Under this "Rule 8," the Mexican authorities have the ability to permit a particular importer to import all non-NAFTA parts and components under a single tariff category at a single duty rate, often zero. For example, under Rule 8 and item 9802.00.02 of the Mexican Tariff Schedules, a producer of electronic goods such as televisions which has qualified for the PROSEC program may import all of the 400 plus electronic components used in television production under that single tariff category, rather than the dozens of different categories under which the individual components would have to be classified. Whether this provision will be used temporarily to permit certain *maquiladoras* to import all non-NAFTA parts and components duty free under the PROSEC program until the ministries can determine which such parts and components, if any, can be reasonably sourced in Mexico, or used permanently, remains to be seen. *See also* NAT'L LAW CTR. FOR INTER-AM. FREE TRADE, THE IMPACT OF THE 2001 NAFTA CHANGES: REPORT TO THE U.S. CUSTOMS SERVICE 63—64 (2001).

components who would logically oppose duty-free imports from outside the region are being considered. This may well reflect the fact that the Mexican authorities are reluctant to take any steps that would cause a further reduction of *maquiladora* employment beyond that resulting from the softening of the U.S. economy,[179] i.e., by encouraging finished goods *maquiladoras* to shift their production currently in Mexico to other, possibly lower cost, venues. In any event, for those finished goods producers whose materials, parts and components are subject to PROSEC decree coverage, production costs and general competitiveness are not significantly changed from what it was prior to January 1, 2001, despite some additional administrative requirements resulting from operations under the PROSEC system.

A more difficult question is the extent to which Mexican authorities in the future will be prepared to *remove* items from the PROSEC listings if and when they are persuaded that adequate supplies exist in North America, a process that will be essential to increasing direct foreign investment in parts and components producers in Mexico, and to treating United States and Canadian parts suppliers fairly. The PROSEC decree itself provides duty free or reduced duty treatment for most items on a semi-permanent basis, for a year with automatic renewals, unless and until the Mexican authorities decide to revoke them.[180] The transitory nature of the PROSEC benefits gives the Mexican government, at least in theory, the opportunity to discontinue PROSEC benefits for parts and components that are reasonably available in Mexico or elsewhere in North America, and there is anecdotal evidence that after a full review more items available in Mexico are being removed from the PROSEC lists. In fact, in the March, 2001 PROSEC decree, 1047 tariff items were added to duty-free or reduced duty coverage, and 37 tariff items, all in the electronics sector, were excluded from special sector treatment.[181] The intensity of the lobbying before the Mexican government authorities between the major manufacturers— who will favor continued access to non-NAFTA sources of parts and components— and present or future investors in Mexican parts and components production facilities (or United States facilities), is probably difficult to overestimate. The enormous challenge to Mexican authorities is equally obvious.

Even though the PROSEC program and the *maquiladora* programs are legally distinct, it can reasonably be expected that the

179. Interview with Lic. Isabel Sanchez, *supra* note 176.

180. *See* Memorandum of Meeting Between Secretariat of Economy and CNIME et al., (Feb. 2001), discussing loss of PROSEC benefits (5% duties in this case) for television tuners and other major consumer electronics parts and components, and options to avoid that loss (on file with author).

181. *See* Secretaria de Economia, Where is the Maquiladora Industry? Nov. 1, 2001 (Power Point presentation), at 18 [hereinafter SECON].

maquiladoras will be the primary beneficiaries of the PROSEC program, raising questions as to whether the new regime is in fact NAFTA and WTO legal. Mexican officials have argued that the sectoral programs are NAFTA and WTO legal because the duty reduction or elimination on imported parts and components or machinery and equipment are not tied to exports.[182] There are no illegal performance requirements, and the benefits apply to goods that are definitively imported as well as to those that may be used in the production of exported products. All producers, not just *maquiladoras,* may benefit. As of November 2001, 2,963 firms had registered for PROSEC benefits and about 12% of those were companies that do not export.[183] The longer term persuasiveness of these arguments depends in part on whether non-*maquiladora* and non-*Pitex* Mexican firms apply for and benefit from the PROSEC program, and on the extent to which sales in the domestic market of finished products covered by the PROSEC decree actually benefit from the reduced or zero duties on listed parts and components.

Finally, one of the campaign promises of President Vincente Fox was to alleviate the heavy administrative burdens of doing business in Mexico. The new system, imposing the PROSEC requirements on top of the modified requirements for *maquladoras* is in this respect a step in the opposite direction. The Fox Administration, as noted earlier, might have simply reduced Mexico's MFN duties for important parts and components, an approach which would have vastly simplified the administrative requirements for Mexican business. However, such an approach would have made it difficult for Mexican authorities to continue attracting investment by parts and components suppliers, since many could not compete with cheaper Asian imports if the latter enter Mexico duty free under MFN duties. In addition, the potential revenue loss from permitting producers for the domestic market to avoid duties on imported parts and components would have been permanent.

The Mexican dilemma can be illustrated by a simple example (based on an actual situation). An Asian manufacturer of color picture tubes for televisions has invested over $200 million in Mexican production facilities, and employs over 1,500 persons. The producer is considering production in Mexico (for the first time) of 13-inch picture tubes. The current MFN duty on 13-inch picture tubes in 15%, but under the PROSEC decree Mexican television manufacturers may currently import such picture tubes from outside North America duty free. If the Mexican picture tube producer goes ahead with production of 13 inch picture tubes, what is the likelihood that Mexican

182. *See generally* PROSEC Decree, *supra* note 138.
183. *See* SECON, *supra* note 181.

government authorities will elminate the PROSEC eligibility of imports of similar tubes at some future date.

The Mexican government is thus in a "Catch-22" situation. If it revokes duty free entry, the picture tube producer will increase its investment and employment in Mexico. However, if the use of somewhat more expensive Mexican picture tubes in place of Asian source picture tubes increases the effective manufacturing cost of 13 inch televisions in Mexico (about 50% of which is the picture tube), the television producers may move their television production to China, Malaysia or elsewhere in Asia, where picture tube and labor costs are lower. This is particularly likely with regard to small televisions, since the U.S. MFN duty on such television imports is zero, as it now is with video cassette recorders and computer monitors as well.[184]

IV. IMPACT OF REGIONAL AND GLOBAL CHANGES

The 2001 Maquiladora changes are occurring at a time of other major changes in tariff levels potentially affecting *maquiladora* operations. The most significant of these are noted below.

A. Tariff Reductions on U.S. Imports

As a result of the Uruguay Round tariff negotiations,[185] the United States agreed to eliminate its MFN duties on hundreds of items, including pharmaceutical products, toys and many consumer electronic products, and to reduce duties to lower levels on other products.[186] These tariff elimination and reduction obligations were phased in over five years, so that the affected products became duty-fee or subject to the lower Uruguay Round duties on January 1, 1999.[187] Overall, the trade-weighted average tariff in the United States is under four percent,[188] despite continued high tariffs on footwear and apparel, some chemicals, small trucks and other products. Moreover, anecdotal evidence has suggested that when U.S. import duties are in the range of

184. *See* tariff items 8521.10-90 (VCRs); 8471(computer monitors); 8528.12.12 (small screen televisions); 8528.12.24 (large screen televisions). Harmonized Tariff Schedule of the United States (2001), Supp.1, Rev. 1, *available at* http://www.usitc.gov/taffairs.htm (last visited Mar. 1, 2002).

185. Final Act Embodying the Results of the Uruguay Round of Multinational Trade Negotiations, Apr. 15, 1994, *available at* http://www.wto.org/english/docs_e/legal_e/final_e.htm#finalact (last visited Mar.1, 2002) (the WTO website contains all documents produced as a result of the Uruguay Round of Multilateral Trade Negotiations)[hereinafter Final Act].

186. *Id.*

187. Final Act, *supra* note 185.

188. Barriers to Latin American and Caribbean Exports in the U.S. Market 1998-1999, U.N. Economic Commission for Latin America and the Caribbean 3 (1999) *available at* http://www.eclacwash.org/public.html (last visited Mar. 10, 2002).

three percent or less some importers will pay the duties rather than try to qualify for NAFTA treatment, given the risk of additional duties, interest and penalties if subsequent NAFTA audits deny NAFTA treatment.

The 1997 Information Technology Agreement (ITA) resulted in the elimination of U.S. and Canadian tariffs (and those of many other U.S. trading partners, although not Mexico) on a variety of computer and other high-technology products, fully effective in most instances on January 1, 2000.[189] Negotiations on an expanded ("ITA-II") began in 1997 but have not been concluded.[190]

The United States also provides benefits under the Generalized System of Preferences to developing countries worldwide[191], to the countries of Central America and the Caribbean (except Cuba) under the Caribbean Basin Initiative (CBI),[192] and the Andean nations through the Andean Trade Preferences Act.[193] In the latter two cases, U.S. market access approaches that of NAFTA. The Trade and Development Act of 2000 provides duty-free entry of textiles and apparel for many products from Africa.[194] The CBI, in particular, makes such countries as the Dominican Republic, Costa Rica and Jamaica a viable alternative to Mexico for supplying the U.S. market. When and if a "Free Trade Agreement of the Americas" is concluded and implemented among the United States, Canada, Mexico and up to 30 other Western Hemisphere nations, this will further reduce the tariff advantages of producing manufactured goods for the United States and Canadian markets in Mexico, although it may well make Mexican manufacturers more competitive in other Latin American markets, such as Brazil.[195] The same is true if the United States is successful in completing the negotiations of free trade agreements with Chile and Singapore, now underway, and in negotiating an agreement with the Central American nations, as proposed by President Bush.[196]

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189. WTO, *Information Technology Agreement - Introduction*, *at* http://www.wto.org/english/ tratop_e/inftec_e/itaintro_e.htm (last visited Sept. 10, 2001)(The Information Technology Agreement became effective April 1, 1999).

190. *Id.*

191. Generalized System of Preferences Act, 19 U.S.C. §§ 2461-66 (2000).

192. Caribbean Basin Economic Recovery Act, 19 U.S.C. §§ 2701-07 (2000).

193. Andean Trade Preference Act, 19 U.S.C. §§ 3201-3206 (2000)(due to expire Dec. 4, 2001 unless extended).

194. Trade and Development Act of 2000, Pub. L. No. 106-200, 114 Stat. 251 (codified in scattered sections of 19 U.S.C.).

195. *See* Miami Summit of the Americas Declaration of Principles, *available at* http://www.ftaa-alca.org/ministerials/miami_e.asp; *see also* Miami Summit of the Americas Plan of Action, *available at* http://www.ftaa-alca.org/ministerials/plan_e.asp.

196. *See* Rosella Brevetti, *Bilateral Negotiations: Chile's Ambassador Says FTA Talks will Cover TPA-Sensitive Issues*, INT'L TRADE DAILY (BNA), Mar. 8, 2002, at d4 (reporting on "substantial" progress in the negotiations); Chris Rugaber, *Bilateral Negotiations: US-Singapore FTA to Include E-Commerce Chapter; Labor, Environmental Issues Remain,*

While a new "Round" of GATT/WTO tariff reductions has only begun and may take many years to conclude, the Asia Pacific Economic Cooperation forum (APEC) committed some time ago to another round of industrial tariff reductions without specifying any date.[197] Initially, it was anticipated that chemicals, energy products, environmental products, jewelry, medical and scientific equipment, toys, and possibly fisheries and forest products would be set for "zero to zero" tariff reductions. Nevertheless, it is expected that eventually - perhaps five to eight years from now as part of the new round of WTO negotiations - U.S. MFN duties on a significant new group of products will be subject to further reductions and eventually, become zero.[198]

Such changes will ultimately make NAFTA origin for United States imports increasingly irrelevant, at least for some products. For example, as noted earlier, it no longer matters to small screen color television producers in Mexico whether all of the printed circuit boards, including the tuners, are of North American origin, in order to qualify for NAFTA treatment.[199] The same is true with computer monitors and video-cassette recorders. Of course, this is not true for United States exports to Mexico, since Mexican most-favored-nation duties remain high, averaging over 10% for imports from non-NAFTA countries.[200]

B. WTO Membership for China and Impact on U.S. Textile Imports from Mexico

China is a new member of the World Trade Organization, having been approved by the membership in November 2001.[201] With China,

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INT'L TRADE DAILY (BNA), Mar. 18, 2002, at d5 (predicting that negotiations would be completed by mid-year); Rosella Brevetti, *International Agreements: Untied States to Explore FTA with Central America, Bush Says*, INT'L TRADE DAILY, Jan. 17, 2002, at d2.

197. *See* APEC 9th Ministerial Mtng., Annex to the Ministers' Joint Statement, Nov. 22, 1997, *available at* http://www.apecsec.org.sg/virtualib/minismtg/mtgmin97.html (last visited Mar. 2, 2002).

198. *See* DOHA WTO Ministerial, *Ministerial Declaration*, at para. 16, WT/Min(01)/Dec/1 (Nov. 14, 2001), *available at* http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm (last visited Mar. 2, 2002).

199. If the televisions meet the diagonal measurement limitations (34.29 cm., or 13.5 inches, under legislation enacted in June 1999), and undergo a manufacturing or assembly process in Mexico, they will enter the United States duty free under the MFN rates. *See* item 8528.12.84. Harmonized Tariff Schedule of the United States (2001), Supp.1, Rev. 1, *available at* http://www.usitc.gov/taffairs.htm (last visited Mar. 1, 2002).

200. A study by Enrique Dussel Peters of the National Autonomous University of Mexico estimates that the rate paid on "definitive" imports– those not imported under duty waiver programs– was 10.38%. *See* John Rieger, *Going Easy on the Rest*, Bus. Mex., 3437 (Mar. 1, 2001) *available at* 2001 WL 7670895 (quoting Peters).

201. *See* WTO, WTO Ministerial Conference approves China's accession, Press/252 (Nov. 10, 2001), *available at* http://www.wto.org/english/news_e/pres01_e/pr252_e.htm; *see also* Washington File, Press and Culture Section, U.S. Embassy, Bucharest, Rom, Transcript:

there is always the possibility that political or security issues, such as the diplomatic incident concerning the American "spy" aircraft that landed in China March 31 after a collision with a Chinese fighter plane, will interfere with China's embrace of economic and commercial globalization, and the United States' willingness to encourage such efforts.[202]

Now that China is a WTO member, it will enjoy various WTO benefits, including the requirement in the WTO Agreement on Textiles that all textile quotas be phased out by 2004. Given the significantly lower labor costs in China compared to Mexico, it is reasonable to assume that some textile producers, at least, will determine that despite tariffs, high shipping costs, delivery delays, political uncertainties and the like it is more economical to produce certain textiles and apparel in China than in Mexico. With some textiles, Mexican sources are either much more expensive than Asian sources, or supplies are limited. If the Mexican government prevents continued duty-free or reduced duty imports of such materials, through the PROSEC program, it may adversely affect textile production by the maquiladoras in the future, although current policy appears to favor inclusion of many textile items under PROSEC.

C. *Other Mexican Free Trade Agreements*

In addition to normal Mexican MFN duty rates (and exceptions to these rates), Mexico has a number of other special rates, in some cases including zero, through free trade agreements with a variety of Latin American nations and Israel.[203] Mexico has also concluded an agreement with the European Union (EU) that became effective July 1, 2000. While, few *maquiladoras* are likely importing large quantities of materials, parts and components from these other Latin American nations,[204] a larger number are probably importing machinery and

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USTR Zoellick, Agric. Sec. Veneman on WTO Talks (Nov. 13, 2001), *available at* http://www.usembassy.ro/USIS/Washington-File/200/01-11-13/eur235.htm (last visited Mar. 2, 2002).

202. *See* David E. Sanger, *Collision with China: The Overview; Bush is Demanding a 'Prompt' Return of Plane and Crew,* N.Y. TIMES, Apr. 3, 2001, at A1.

203. Miguel Diaz, *Mexico: Free Trade Agreements Anyone?*, U. S. – MEX. CHAMBER OF COM., Jan. 2001, *available at* http://www.usmcoc.org/nafta_MexFTAs.html (last visited Sept. 14, 2001)(This paper is part of the United State-Mexico Chamber of Commerce's NAFTA Forum series, which considers general trade issues and sector-specific concerns between the two nations); Mexico & Israel Sign a Free Trade Agreement, U. S. – MEX. CHAMBER OF COM., Sept, 2000, *available at* http://www.usmcoc.org/nafta_MexIsra.html, (last visited Sept. 14, 2001)(This paper is part of the United State-Mexico Chamber of Commerce's NAFTA Forum series, which considers general trade issues and sector-specific concerns between the two nations).

204. For example, it is assumed that the Volkswagen and Mercedes-Benz auto and truck factories in Mexico import some components, machinery and equipment from

equipment and components from EU nations. Duty free treatment under these agreements will eliminate most of the complexities of the special decrees for those who enjoy the tariff reduction benefits under the FTAs. In 2000, Mexico's total trade with Central and South America was only 3% of its trade with Canada and Mexico, and its total trade with the European Union nations is only 7% of North American trade.[205] However, given the relatively high most-favored-nation duties for most of Latin America, there is at least a potential for significant increases in bilateral trade there, as well as with the European Union.

1. FTA with the European Union

The FTA with the European Union is likely to be Mexico's most important FTA other than NAFTA. The European Union is the largest common market in the world, made up of over 370 million people.[206] The EU is in the process of expansion. Its current membership of 15 will be expanded to 20 or more within the next several years, and the EU will then have a population approaching 500 million.[207]

There are significant differences between the European integration process and more modest free trade agreements such as NAFTA. Since the onset of free trade agreements, many analysts have tried to compare that process to the European Union. Both systems seek to establish trade preferences. However, they have different scopes and purposes. In many respects, the process of European economic and now political integration is best compared to the experience of the United States in the few decades after 1789.[208]

The FTA between the EU and Mexico responds to a predominantly economic purpose. The purposes of the EU, in contrast, are much broader. While the European Communities initially had a primarily economic focus as well, from the outset the purposes of the European Union were also political. This essential difference is clear in the following features that characterize the EU, as opposed to the FTA.

The FTA between Mexico and the EU forms part of recent efforts by the Mexican Government to liberalize trade. In 1986, Mexico became a

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Germany.

205. Secretaria de Economia, Subsecretria de Negociaciones Comerciales Internacionales, *Comercio Total de Mexico*, for 2000, http://www.naftaworks.org (visited Mar. 14, 2001).

206. *European Union in Brief*, European Union in the U.S., *at* http://www.eurunion.org/profile/brief.htm (last visited Mar. 1, 2002).

207. Colin Jones, *Knocking on the EU's Door: Members of East European Countries*, THE BANKER, May 1998, at 43.

208. *See generally* Manfred Zuleg, *What Holds a Nation Together? Cohesion and Democracy in the United States of America and the European Union*, 45 AM. J. COMP. L. 505, 512 (1997).

member of the General Agreement on Tariffs and Trade (GATT),[209] and in 1994 it entered the Organization for Economic Cooperation and Development (OECD).[210] Mexico has also strengthened its trading position through regional agreements, including the NAFTA, as noted earlier. The significance of NAFTA and its impact on the trading relationship with Mexico attracted the keen interest of the EU. Trade between Mexico and the EU has been seriously affected by NAFTA. Despite the fact that the EU is Mexico's second-largest trading partner, its trade only represents six percent of Mexico's foreign trade.[211] Mexico's trade with the U.S. has expanded and constitutes 80 percent of its total foreign trade.[212]

The downward trend in Mexico - EU trade has been largely responsible for an EU decision to reinvigorate the trading relationship between Mexico and the EU.[213] In December 1997, both parties signed an economic cooperation agreement.[214] After several years of discussions, the FTA was concluded and became effective in July of 2000.[215] The FTA provides for a bilateral, progressive and reciprocal liberalization of tariff and non-tariff barriers to trade in goods, under the framework of Article XXIV of GATT 1994.[216] The Agreement further establishes other objectives, such as the opening of government procurement markets of the parties; establishment of cooperation agreements in the field of competition; consultation mechanisms on intellectual property matters, and establishment of dispute settlement mechanisms.[217] In addition, there is a separate regulation on trade in

209. Stuart Auerbach, *GATT Voting on Mexico's Membership*, WASH. POST, July 16, 1986, at G1.

210. Robin Wright, *U.S. Urges OECD to Broaden its Focus, Mandate; Relations: At Annual Meeting in Paris, Mexico Becomes the Group's First New Member in 20 Years*, LOS ANGELES TIMES, June 9, 1994, at part D, p. 2, col. 3.

211. Michael McClintock, *Sunrise Mexico; Sunset NAFTA-Centric FTAA - What Next and Why?*, 7 SW. J. OF L. & TRADE AM. 1, 72 n. 434 (2000).

212. *Id.*

213. *See* Joel Millman and Geoff Winestock, *EU and Mexico Reach Free-Trade Pact*, WALL ST. J., Nov. 26, 1999, *available at* 1999 WL-WSJ 24923416.

214. Global Agreement, Dec. 8, 1997, Mex. - E.C., *available at* http://economia-brusselas.gob.mx/english/html/body_global.htm (last visited Sept. 15, 2001); Interim Agreement, Dec. 8, 1997, Mex. - E.C., *available at* http://economia-brusselas.gob.mx/english/html/body_interim.htm (last visited Sept. 15, 2001); Final Act, Dec. 8, 1997, Mex. - E.C., *available at* http://economia-brusselas.gob.mx/english/html/body_final_act.htm (last visited Sept. 15, 2001).

215. EUROPA, *Entry into Force of EU-Mexico Free Trade Agreement Signals Start of New Era in Europe's Relations with Mexico*, *at* http://www.europa.eu.int/ comm./trade/ bilateral/mexico/
ftapr_en.htm (last visited Sept. 15, 2001).

216. Decision 2/2000 of the EC-Mexico Joint Council, Mar. 23, 2000, art. 1(a), Eur. Union-Mex., *available at* http://europa.eu.int/comm/trade/pdf/en2_decision_goods.pdf [hereinafter FTA].

217. *Id.* at art. 1(b-e).

services.

The process will involve a transitional period, not to exceed ten years,[218] during which existing customs duties on imports and exports are to be eliminated, and no new customs duties will be introduced.[219] Certain customs duties will be eliminated as soon as the FTA enters into force, whereas others will be eliminated in successive stages, following a schedule agreed to by the parties.[220]

The schedule is not the same for both parties. In general, the Agreement requires the EU to liberalize its market earlier than Mexico.[221] Mexican goods get duty-free status four years earlier than EU goods.[222] When the Agreement enters into force, approximately 47.6 percent of EU exports of manufactured goods to Mexico will immediately become duty-free, with the following subsequent increments: 5.1 percent by 2003; 5.6 percent by 2005; and the remaining 41.7 percent by 2007.[223] In contrast, 82 percent of Mexican exports of manufactured goods to the EU will be duty-free upon the Agreement's entry into force, with a subsequent phase-in of the remaining 18 percent by 2003.[224] In the automobile sector, Mexico has agreed to shorter timetables to reduce its tariffs, so as to achieve full liberalization by the year 2003.[225]

The gradual elimination of duties is also supplemented by specific provisions covering rules of origin.[226] By virtue of these provisions, EU-harmonized rules of origin will apply to most industrial goods. (This encompasses approximately 90 percent of the rules.) In certain areas (for example, the automotive sector), a compromise was reached so that Mexican companies would have time to adapt to European standards.[227]

The FTA further prohibits the imposition of non-tariff restrictions, such as quantitative restrictions, discriminatory or unfavorable provisions, except under exceptional circumstances (safeguard and shortage clauses).[228] In order to comply with these provisions,

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218. FTA, *supra* note 216, at art. 2.

219. *Id.* at art. 3(3-4).

220. *See generally id.* at tit. II, arts. 5-10.

221. *Compare id.* at tit. II, art. 5 *with id.* at tit. II, art. 6.

222. *See Subsecretaria de Negociaciones Comerciales Internacionales, Avances de la Negociacion Comercial Mexico – UE, Rondas de Negociacion, at* http://www.economia-snci.gob.mx/Negociaci_n/ Uni_n_Europea/Avances_neg/avances_neg.htm (last visited Aug. 31, 2001).

223. *Id.*

224. *Id.*

225. FTA, Annex II § C 2.1(iv), *available at* http://europa.eu.int/comm/trade/pdf/en2_annex_2.pdf (*last visited* Oct. 14, 2001).

226. *See generally* FTA, Annex III, tit. II, art. 2(1-2), *available at* http://europa.eu.int/comm/trade/ pdf/en2_annex_3.pdf (*last visited* Mar. 1, 2002).

227. *See generally* FTA, Annex II, § C.

228. *See id.* at tit. II, arts. 11–16.

arrangements have been made to ensure cooperation between Mexican and EU customs authorities. This cooperation will take place through the exchange of information, the organization of training programs and technical assistance mechanisms, the streamlining of customs documents, the simplification of inspection procedures and formalities and, in general, the improvement of working methods, transparency and efficiency.[229]

Like NAFTA, the FTA includes provisions restricting duty remission programs,[230] again designed to avoid the "export platform" problem. The FTA provisions, effective January 1, 2003,[231] differ significantly from Article 303 of NAFTA. Most importantly, an exporter may elect to opt out of preferential treatment for its finished products, paying the EU MFN duties on the finished product but continuing to receive a duty exemption from parts and components imported from non-EU sources into Mexico. Nor is there a complex "lesser of the two" rule for calculating Mexican duty liability. These provisions would, of course, affect only exports to the EU; EU owned *maquiladoras* exporting to the United States or Canada are subject to Article 303. For EU companies with manufacturing subsidiaries in Mexico that focused on exports to the United States and Canada, the FTA may provide significant relief from Article 303 changes, to the extent that parts and components are sourced from the EU.

The overall impact of the FTA with the EU on U.S. manufactured *exports* to Mexico is quite difficult to assess, but there will undoubtedly be some sectors in which Canadian and U.S. producers will lose their competitive edge in the Mexican market vis a vis European producers. This may occur relatively quickly given the extent to which EU exports to Mexico become duty free over the six years, as noted above. For example, prior to July 1, 2000, a Caterpillar tractor for agricultural use made in the United States entered Mexico duty-free as of January 1, 1994, while Mexico's most-favored-nation tariff remained at 15%.[232] A similar tractor made by Volvo in Sweden was subject to the 15% duty until July 1, 2000, when it was reduced to 10% under the FTA with the EU,[233] and will presumably be zero within a few years.

2. Mexican FTAs in Latin America

Mexico's regional international trade negotiations formally began

229. *See* FTA, at art. 17.
230. *See id.* at Annex III, tit. IV, art. 14.
231. *Id.* at art. 14, para. 7.
232. NAFTA, *supra* note 1, at Annex 302.2(1)(a).
233. *See* SECON Website, listing for item 8701.90.11, http://www.economia-snci.gob.mx/aracom /cgi/aracomcgi/foxisapi.dll/aracom.ssnci.Aracom (last visited Jun. 20, 2001).

in August 1980 with the *Treaty of Montevideo*, which created the Latin American Integration Association (ALADI).[234] This 11-member commercial alliance (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela) sought to create a regional system of economic preferences within Latin America.[235] During the 1990's, Mexico concluded seven free trade agreements in addition to NAFTA: the "Group of Three" (G-3) Agreement with Colombia and Venezuela in 1994;[236] the Mexico-Bolivia FTA in 1994;[237] the Mexico-Costa Rica FTA in 1994;[238] the Mexico-Nicaragua FTA in 1997;[239] the Mexico-Chile FTA in 1991, and expanded in 1998;[240] the Mexico-Israel FTA in 2000;[241] and the FTA with the Triangle of the North (Guatemala-Honduras-El Salvador, effective March 15, 2001).[242] Currently, almost 90 percent of Mexican exports are destined for the countries covered in these agreements, including Canada and the U.S. under NAFTA.[243] Additionally, Mexico and MERCOSUR have recently announced – perhaps optimistically -- that

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234. Treaty of Montevideo Establishing the Latin American Integration Association, Aug. 12, 1980, 20 I.L.M. 672 (entered into force Mar. 18, 1981).

235. *See id.* at ch. I, art. 1.

236. Decreto de promulgacíón del Tratado de Libre Comercio entre los Estados Unidos Mexicanos, la República de Colombia y la República de Venezuela, June 3, 1994, Mex.-Colom.-Venez., D.O., 9 de enero de 1995 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/tlcg3.pdf (last visited Mar. 1, 2002).

237. Decreto de promulgación del Tratado de Libre Comercio entre los Estados Unidos Mexicanos y la República de Bolivia, Sept. 10, 1994, Mex.-Bol., D.O., 11 de enero de 1995 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/Tlcbol.pdf (last visited Mar. 1, 2002).

238. Decreto de promulgacion del Tratado de Libre Comercio entre los Estados Unidos Mexicanos y la República de Costa Rica, Apr. 5, 1994, Mex.-Costa Rica, D.O., 10 de enero de 1995 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/tlccr.pdf (last visited Oct. 14, 2001).

239. Decreto de promulgacion del Tratado de Libre Comercio entre el Gobierno de los Estados Unidos Mexicanos y el Gobierno de la República de Nicaragua, Dec. 18, 1997, Mex.-Nicar., D.O., 1 de julio de 1998 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/TLCNIC.pdf (last visited Mar. 1, 2002).

240. Decreto promulgatorio del Tratado de Libre Comercio entre la República de Chile y los Estados Unidos Mexicanos, Apr. 16, 1998, Chile-Mex., D.O., 28 de julio de 1999 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/tlcchile1.pdf (last visited Mar. 1, 2002).

241. Decreto promulgatorio del Tratado de Libre Comercio entre los Estados Unidos Mexicanos el Estado de Israel, Apr. 10, 2000, Mex.-Isr., D.O., 28 de junio de 2000 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/isra1.pdf (last visited Mar. 1, 2002).

242. Decreto promulgatorio del Tratado de Libre Comercio entre los Estados Unidos Mexicanos y las Repúblicas de El Salvador, Guatemala y Honduras, June 29, 2000, Mex.-El Sal.-Guat.-Hond., D.O., 14 de marzo de 2001 (Mex.), *available at* http://www.economia-snci.gob.mx/Tratados/pdfs/TLC-Triangulo.pdf (last visited Mar. 1, 2002).

243. Yadira Mena, *Mexico Negociador Multilateral con Vision Bilateral* [*Mexico: Multilateral Negotiator with a Bilateral Perspective*], EL ECONOMISTA, Aug. 14, 1998, *available at* http://www.economista. com. mx (last visited Aug. 28, 2001).

Mexico would become an associate member of MERCOSUR by 2004.[244]

Modeled to some extent after NAFTA, the above-mentioned free trade agreements resemble one another in non-tariff content and structure. They all include the liberalization of goods and services, regulate intellectual property rights, include rules of origin, provide investor protection and create dispute settlement mechanisms, although language, terms and coverage vary considerably. Mexico's shift to a more open economy has not always been favorably perceived in Latin America, particularly by Brazil.[245] Since the ultimate objective of ALADI is to form a *Latin American Common Market*, its members were initially displeased with Mexico's engagement in NAFTA. However, NAFTA gradually revealed the implicit "bridging" opportunities. After all, North America constitutes the largest consumer of goods and services in the Americas.

Moreover, the demand for increased trade and investment flows has led to a proliferation of bilateral and trilateral free trade agreements in the Western Hemisphere. These negotiations have focused on Mexico (and to a lesser extent, on the Southern Cone Common Market or Mercosur) for several reasons. Mexico is Latin America's largest exporter and second largest market (after Brazil),[246] with preferential access to the United States and Canada. Peripheral economies seeking to secure commercial ties with the North American alliance can do so by engaging Mexico in bilateral and multilateral free trade agreements. Most of the agreements were proposed before the conclusion of NAFTA, due to concerns that joining or affiliating with the trade bloc would be more difficult after NAFTA's ratification. Mexico apparently seeks to make full use of its NAFTA membership in becoming the north-south commercial bridge and can justifiably claim a leadership role in the free trade movement, a result that undoubtedly has political as well as economic benefits for Mexico.

D. *The Economic Slowdown in the United States*

One of the most important influences on production decisions in Mexico, largely independent of the Article 303 changes, is the impact of a slowdown in the United States economy. In the short term, this may have been more significant than all other factors put together, given that roughly 80 percent of Mexico's manufactured goods are exported to

244. *See* John Nagel, *Mercosur: Mercosur Invites Mexico to Join Hemispheric Trade Bloc by 2004*, INT'L TRADE DAILY (BNA), Sept. 8, 2000.

245. *See* Karen Hansen-Kuhn, *Free Trade Agreement of the Americas*, 1 FOREIGN POLICY IN FOCUS 27, Dec. 1996, *available at* http://www.foreignpolicy-infocus.org/pdf/vol1/27ifftaa.pdf (last visited Mar. 1, 2002).

246. *Mexico: US $25bn Plan Launched to Help Close the North-South Divide*, COUNTRYWISE PUBL'G LTD COUNTRY MKT REP., Apr. 4, 2001, at 1.

the United States.[247] Because of the particularly sharp downtown in high technology products and services in the United States, cutbacks in production at Mexican suppliers are almost inevitable, and during 2001 there was a reduction in the *maquiladora* growth rate by three percent. At least 11 percent of the workforce was laid off and perhaps as much as 33 percent.[248] It is also possible that the U.S. economic slowdown, in combination with additional manufacturing costs as a result of Article 303 and other competitive factors, has encouraged factory closings which would not have otherwise have taken place, and resulted in postponement of expansion plans for existing operations and investment in new facilities.

There have been signs of this trend in the electronics sector, even though its manufacturers in Mexico appear to have been well covered by the PROSEC decree, that is, most of their non-NAFTA parts and components are permitted duty free entry. Such Mexican firms as Daewoo Electronics (consumer electronics), Sony Corporation (consumer electronics), Acer Communications (computers), Sanyo Electronics (consumer electronics), ALPS (keyboards), and SAFT America (cell phone batteries) announced plans in early 2001 to curtail production, consolidate factories, reduce employment, suspend operations or initiate a combination of such changes.[249]

IV. THE RESULTS OF IMPLEMENTING ARTICLE 303

Given the recent nature of the Article 303 changes, it is too early for a fully accurate analysis of the impacts. The reader is therefore warned that these comments are more in the nature of speculation and identification of likely trends.

A. Changes of Limited Significance for Many Sectors?

For most significant manufacturing sectors, such as electronics, automotive, and the others covered by the PROSEC system, the Mexican duty liability of the *maquiladoras* on non-NAFTA parts and components may not be significantly higher than in the past under the full duty remission system, *assuming that the PROSEC program will continue to apply to all or most of the parts and components that were being imported from outside the region prior to January 1, 2001.* As

247. *See* SUBSECRETARIA DE NEGOCIACIONES COMERCIALES INTERNACIONALES, *Comercio Total de México*, *at* http:www.naftaworks.org/formas/2000/jl00mxct.pdf (last visited Sept. 4, 2001).

248. SECON, *supra* note 181, at 8 (reporting an 11% decline in employment); Geri Smith, *Mexico's Wagon is Hitched to a Falling Star*, BUS. WK., Oct. 1, 2001, at 88 (reporting 500,000 layoffs, or a third of the total work work force).

249. COMMUNICATION FROM RICARDO RODRIGUEZ, OF KPMG TIJUANA, MEXICO, MAR. 14, 2001, REPORTING ON PUBLIC ANNOUNCEMENTS OF ELECTRONICS INDUSTRY PLANS.

noted earlier, this inclusive policy has been followed by Mexican authorities in implementing the new rules, although there are signs that Mexican authorities are reviewing PROSEC coverage more carefully in recent months. The automobile industry, with its 62.5% regional value added[250] and integrated production in North America is likely to be one of the least likely to consider production elsewhere. Even if not all import items are covered by PROSEC, those who produce for the domestic market as well as for export may be better off. They will effectively receive duty waivers (or very low duties) on parts and components used to produce the goods for sale in Mexico, which will lower manufacturing costs for the Mexican domestic market significantly. (In the past, those parts and components were fully subject to Mexican MFN duties.) For these firms, the major costs of the new regime may be the additional administrative burdens.

However, at the present time it is impossible to predict with any certainty which items that currently enjoy PROSEC treatment will remain eligible for duty-free or reduced duty entry for the longer term. Clearly, such uncertainties, which are virtually inevitable in light of the Mexican government's challenges as discussed under Part B, *infra*, will remain for at least the foreseeable future, for virtually all sectors which currently enjoy PROSEC coverage.

For sectors that are not covered the outlook is much more pessimistic. A *maquiladora* that is dependent on imported parts and components for its production that suddenly finds its materials costs increasing by 10-15 percent or more will probably not be likely to survive operating in Mexico, particularly if there are other options available.

B. Balancing Finished Product Maquiladora *Health Against New Investment in Parts and Components Production*

Ideally, the Mexican government, in consultation with producers of both finished goods and parts and components, will in implementing the PROSEC system distinguish carefully between parts and components that can be produced in North America in adequate quantities, at world competitive prices and quality, and those which cannot be. This is probably the greatest challenge of the Article 303 changes, in the future, recognizing that the current practice of simply granting all requests for PROSEC treatment as the economy strengthens and Mexican authorities gain more experience in implementing the PROSEC program. In the longer term, if Mexican authorities err on the side of an overly inclusive PROSEC program, they will deprive Mexico of the investment and jobs that would come from new and existing parts

250. NAFTA, *supra* note 1, at art. 403(5)(a) (tariff in effect as of Jan. 1, 2002).

and components producers. This would frustrate one of Mexico's major objectives under NAFTA and probably engender criticism by the United States if the ability of U.S. parts and components producers to sell in the Mexican market is compromised by overly generous waiver of normal import duties by Mexico under the PROSEC program.

On the other hand, if Mexican authorities unduly restrict the availability of duty-free or reduced duty imports under the PROSEC program, they will increase manufacturing costs in Mexico to the point where some producers, particularly in the electronics and textile sectors, shift new and/or existing production to Asia or to other low labor cost nations in the Western Hemisphere. Thus, fine tuning of the PROSEC system's coverage is vitally important in maintaining one of the principal benefits of NAFTA for Mexico, hopefully on an objective basis as freely as possible from threats from finished product or parts and components producers/investors, existing and prospective.

C. The Legal Issues

In terms of Mexico's international legal obligations under NAFTA and the WTO, the complex approach taken by Mexico with modifying its trade laws and initiating the PROSEC program appears to present at least a colorable case for compliance, with a few possible exceptions. As noted earlier, the PROSEC program is consistent with Article 303 in that the duty benefits are not tied to exports. Also, the program is not an export subsidy under current WTO rules (applicable to Mexico as of January 1, 2003), at least to the extent that in practice, as well as written, PROSEC is made available to producers who are selling finished goods in the domestic market.[251]

The potential weaknesses in Mexico's new regime are four. First, there is the legal argument that the PROSEC program is not tied to exports, and thus not violative of Mexico's NAFTA and WTO obligations. However, the connection is obvious; the December 31, 2001, *Maquiladora* Decree notes that "with the objective of increasing their competitiveness, the businesses shall be able to enjoy simultaneously the benefits of the Sectoral Promotion Program and of the Export Maquiladora Program."[252] Also, there is the strong possibility that the benefits will in operation disproportionately favor members of the export-oriented *maquiladora* industry, even if those are nominally available to all producers of specified goods. This could occur as a result of a weak Mexican domestic market, the lack of competitiveness of Mexican firms producing largely for the domestic market, or administrative actions that make it difficult for non-exports

251. As of Nov. 1, 2001, of 2,963 PROSEC registrations, 348, or 12%, were for firms not connected with export programs. SECON, *supra* note 181, at 18.

252. *Maquiladora* Decree, *supra* note 132, at sixth preambular paragraph.

to enjoy the full benefits of the PROSEC program. There will be those who will argue, perhaps not persuasively, that the new *maquiladora* - PROSEC program is simply the old system with new clothing, and that the new system is thus inconsistent with NAFTA and WTO rules. And, as noted above, certain provisions of the *Maquiladora Decree* tie the systems benefits to exports in apparent violation of Article 1106 of NAFTA.

Secondly, there is at least a theoretical legal question whether PROSEC's lower duty rates for the twenty-two industrial sectors, but not for others, could be considered an actionable subsidy under the WTO Agreement on Subsidies and Countervailing Measures. This turns on whether the subsidy is considered "specific" to an industry or group of industries, or, rather, is generally available[253] to all Mexican producers that wish to register for the program. The PROSEC program is available to twenty-two industry sectors, but it is not available to other sectors, and eligibility is specifically limited to producers of certain listed products.[254] On the other hand, the system establishes "objective criteria" governing eligibility and the amount of the subsidy (duty-free or reduced duty treatment for imported parts and components),[255] and a strong argument can also be made that the twenty-two sectors represent such a large portion of the manufacturing economy that the benefits are "generally available" and thus not actionable under the SCM Agreement.

Third, as noted earlier, the revised *maquiladora* program still incorporates limited ties between eligibility for other *maquiladora* benefits and export requirements (exports of $500,000 or 10% of total invoicing, 30% for benefits for machinery and equipment[256]). These elements are probably inconsistent, not with Article 303, but with the anti-performance requirements obligations (barring virtually any tie of export performance to the establishment or operation of a foreign-owned Mexican business) of Article 1106 and with Annex I of NAFTA. (The latter requires the phasing out of any export requirements for the *maquiladoras* by January 1, 2001.[257])

Another, in the author's view weaker, argument for NAFTA inconsistency can be made against Mexico's decision not to charge antidumping duties to *maquiladora* importers based on dumping orders issued prior to January 1, 2001, despite a specific NAFTA provision to

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253. *See* SCM Agreement, *supra* note 122, at art. 2.

254. *See* DIRECCIÓN GENERAL DE SERVICIOS AL COMERCIO EXTERIOR DE SECOFI, Programas de Promoción Sectorial (PROSEC), *available at* http:www.secofi-dgsce.gob.mx/avisoimp2.htm (last visited Mar. 4, 2002).

255. *See* Subsidies Agreement, *supra* note 122, at art. 2, ¶2.1(a)-(b).

256. *Maquiladora* Decree, *supra* note 132, at art. 4-A, paras. I-II.

257. *See* NAFTA, supra note 1, at Annex I.

the contrary.[258] The Mexican decision was made on grounds that the maquiladoras did not have the right to participate in the administrative and judicial proceedings that resulted in the imposition of those duties, and thus to protect their interest. In support of that position, it is notable that the NAFTA bar is to antidumping and countervailing duties that are "applied pursuant to a Party's domestic law. . ."[259] If Mexican law does not permit applying the antidumping duties in such circumstances, neither the U.S. or Canada is in a strong position to object.

With regard to all of these legal questions, it is again important to point out that the likelihood of a legal challenge by the United States or Canadian governments is remote, given that the *maquiladora* beneficiaries of the new *maquiladora*/PROSEC system are overwhelming U.S. (and to a much lesser extent, Canadian) owned firms, and the U.S. consumer.

D. Effects of Other Factors

What is the likely effect of decreasing U.S. customs duties on finished products from non-NAFTA countries, making the NAFTA duty benefits for some products, such as most consumer electronics and computer products, largely irrelevant? There is likely in time to be some shifting of some production, particularly in the electronics sector, to China or other lower cost markets, where wages and some other costs are lower, and there is less red tape and are more tax benefits.[260] The major Asian owned electronics firms operating in Ciudad Juarez, San Luis, Mexicali and Tijuana already have production facilities in many other countries, so that cost increases in Mexico may encourage other manufacturing options. One of the risks of creating a preferential trading scheme such as NAFTA, where tariff rates may be in conflict with global comparative advantage, is that over time as global tariffs are reduced the value of the preferences also declines. This is inevitable unless one believes that the trends of the past fifty-four years are likely to be reversed, although it will undoubtedly be many years before Mexican external tariffs are reduced to the negligible range. Thus, United States and Canadian exporters to Mexico will continue to benefit from Mexico's low NAFTA tariffs, at least with nations that do not yet have free trade agreements with Mexico, even if Mexican producers exporting to the United States do not.

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258. *See* NAFTA, *supra* note 1, at art. 303(2)(a) (specifically precluding waiver of antidumping or countervailing duties).

259. *Id.*

260. Geri Smith, *Is the Magic Starting to Fade for Manufacturing in Mexico?*, BUS. WK., Aug. 6, 2001, *available at* http://www.businessweek.com/magazine/content/01_32/b3744085.htm (last visited Mar. 5, 2002); *see also* SECON, *supra* note 181.

In terms of Mexican manufacturing and investment, as indicated earlier, there are many benefits to serving the U.S. market from Mexico rather than Asia or even the Caribbean beyond tariff differentials and low labor costs. These include not only legal protection of investment under NAFTA and relative political stability, but the convenience of truck transportation and access to the Interstate highway system in the United States, the ability to meet "just in time" delivery obligations to customers and, particularly for smaller American firms, the language, cultural and travel disadvantages of operating in Asia. (The major obstacles to doing business in Mexico, such as corruption, drug-related and other crime, limited access to credit, significant defects in the legal and educational systems and border congestion, are present in most of the alternatives, in Asia and elsewhere.) It seems unlikely that those firms with established operations, particularly American-owned firms, would pull up stakes in large numbers, unless they already have unused capacity elsewhere in the world or there is a major increase in manufacturing costs in Mexico, an avoidable problem for most industries covered by the PROSEC program. It is even less likely that in an economic downturn that a firm currently producing in Mexico would engage in the costs and risks of establishing a new plant making the same product somewhere else, particularly at a time when political uncertainties in China and Indonesia cannot be ignored.

For smaller American firms, there may be Caribbean or Central American locales, particularly in the textile and apparel sectors, that are viable compromises between Asia and Mexico. Duty waiver for imported parts and components is still available, and access to the U.S. market under the expanded Caribbean Basin Initiative is available on NAFTA-like tariff treatment, even if restrictions still apply to some textiles and other import sensitive goods, and transportation to the United States may be less convenient.

China's WTO accession and the elimination of textile quotas in a few more years is probably more significant, particularly if Mexico is unwilling or unable to give Mexican producers full relief from the high Mexican duties on textile products. Even with high tariffs, Chinese labor costs for textiles and apparel are well below those in Mexico, and the attraction of lower cost Chinese production may be irresistible for some. At the same time, the Chinese regulatory framework for trade and foreign investment is neither simple nor friendly, particularly for smaller companies.[261] Travel and transportation to and from the United States is time-consuming and expensive, and the costs involved in shipping U.S. origin parts and components to China may be prohibitive.

The overall impact of Mexico's other free trade agreements on Mexico exports to the United States and investment in Mexican

261. *See* Shai Oster, *Nothing Ventured*, ASIA WEEK, July 27, 2001, at 57.

facilities is difficult to assess, although it appears that the impact will be largely positive. The FTA facilitates efforts by EU firms, such as Volkswagen, to maintain a low cost production base for the U.S. market.[262] It is also difficult to tell whether new European investment is a result of the FTA, of other competitive factors, or both, although early anecdotal evidence suggests that the focus of that investment is on production for the U.S. market.[263] The number of European firms who will shift production to Mexico for the United States and Canadian markets, presumably those that import parts and components from Europe, is difficult to estimate. In time, the ability of Mexico-located firms to enjoy duty free access to many other Latin American markets could become significant, particularly if Mexico is able to conclude an FTA with MERCOSUR, and thereby gain access to the huge Brazilian market.[264] For some U.S. exporters to Mexico, the loss of preferential tariff access to the Mexican market vis-à-vis the European Union nations will have an adverse impact on their competitiveness.

From Mexico's point of view, the increased viability of Mexican production for EU markets (and the markets of other Mexican FTA partners as well as for the United States and Canada) is also important.[265] Some economists believe that there is room for considerable growth in this sector,[266] although whether Mexican factories can compete with facilities in Eastern Europe for the EU market remain to be seen. Certainly, the fact that there is now a United Kingdom consulate in Monterrey, Mexico, and EU investment in Mexico is increasing, are positive sign.[267]

The impact of many of these factors may well be exacerbated, or masked, by the economic downturn in the United States, which as noted earlier has been at least partially responsible for reductions in production and employment in the Mexican electronics sector. The fact that the electronic sector, more than most others, has been relatively well-protected by duty free treatment afforded under the PROSEC

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262. *See* Chris Kraul, *EU Pact Should Boost Mexico's Auto Industry*, L.A. TIMES, Dec. 1, 1999, at A1.

263. *See* Fieri Smith, *Is the Magic Starting to Fade?* BUSINESS WEEK., Aug. 6, 2001, at 43. For example, Philips Electronics is constructing a color picture tube factory at a cost of $225 million, and several other Dutch companies (packaging, brewers' vats) are also investing with an eye toward sales in the United States and Canada.

264. Brazil's economy is twenty-two percent larger than Mexico's, but its foreign sector is only slightly more than a third the size of Mexico's. *See* CIA – The World Factbook 2000 – Brazil, *available at* http://www.odci.gov/cia/publications/factbook/geos/br.html (last visited Mar. 4, 2002), *and* CIA – The World Factbook 2000 – Mexico, http://www.odci.gov/cia/publications/factbook/geos/ mx.html (last visited Mar. 4, 2002).

265. Adrian Croft, *Mexico's Fox Vows to Step Up Trade With Europe*, REUTERS, Jan. 26, 2001, *available at* http://www.naftaworks.org/papers/2001/davos.htm (last visited Sept. 7, 2001).

266. Vargas, *Maquiladoras 2000*, *supra* note 21, at 3.

267. *See* Millman, *supra* note 263, at A9.

decrees, and is still cutting back suggests that even where these changes are attributed to Article 303 there are other factors at play.

United States' owned *maquiladoras*, as noted earlier, are less likely to move, at least in the short and medium term (1-3 years) because of the strong interdependence between Mexican production and U.S. produced parts and components, often from related companies. With an estimated $45 billion in parts and components exports to Mexico, this is a significant sector of the United States economy, representing around 40% of total U.S. exports to Mexico.[268] In addition, any significant downturn in the Mexican economy, as in December 1994, could greatly reduce United States' finished goods exports to Mexico.

V. CONCLUSION

Notwithstanding some delays on the part of Mexican authorities and a good deal of confusion for industry personnel and government officials alike, Mexico has managed to replace its export-oriented *maquiladora* legal structure with a new system combining *maquiladora* benefits with special sector programs designed to keep *maquiladora* production competitive in the United States and Canadian markets. These new structures are in their major features largely compliant with the requirements of NAFTA and the WTO agreements, despite some arguable exceptions noted earlier. However, the international legal questions, despite their fascination for law professors, are clearly not the most important ones.

In fact, the future may bring problems. In the immediate future, Mexican authorities are in a "Catch-22" situation: if they give favored sectors (autos, electronics, textiles) near blanket duty waivers under the PROSEC program as currently appears to be the practice, they may discourage investment in Mexican parts and components production, and injure some U.S. producers of parts and components exported to Mexico. If they deny PROSEC protection for important parts and components, the finished product manufacturers may shift their production to lower operating cost sites, further exacerbating an unemployment problem among the *maquiladoras* and possibly discouraging new investment in production of finished products. The uncertaintly for the *maquiladoras* is not helpful.

Mexico's competitive advantages as a manufacturing platform for the United States market are adversely affected to some extent by factors both within and without the Mexico and NAFTA, ranging from

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268. *See In-Bond Industry/Industria Maquiladora 2001*, *supra* note 18; *see also* U.S. CENSUS BUREAU, *U.S. Trade Balance with Mexico*, *available at* http://www.census.gov/foreign-trade/balance/c2010.html (visited Mar. 2, 2002) (stating U.S. exports to Mexico were $111.349 million in 2000).

the U.S. recession to lower U.S. MFN tariffs to increasing attractiveness of production elsewhere in Latin America, the Caribbean and Asia, as well as the complexities of doing business, all as discussed earlier. The general advantages of Mexican production, proximity to the United States and its highway system, reasonable wage costs, a complex but generally pro-business investment environment, cordial relations between the United States and Mexican governments, relative political stability and an increasingly democratic system, a language spoken by 30 million Americans, and NAFTA's investment protections and guaranteed tariff elimination, remain. Nevertheless, the outlook for continued robust growth of the United States-Mexico trade and investment, fueled in the past in significant part by the growth of the *maquiladora* sector, is inevitably somewhat cloudier than it has been in recent years.