# What the Record Shows About Integration in Capital and Labor Markets

## Cross-Border Integration of Capital Markets on the Rise

Recent growth in foreign direct investment (FDI) indicates that progress achieved in unifying the North American market has been more successful than a simple analysis of integration based upon trade data would suggest. Post-CUSTA/NAFTA expansion of intra-member FDI has tripled in value, while intra-member trade has doubled (U.S. Department of Commerce). The growth in intra-member FDI reflects the success of CUSTA and NAFTA in reducing impediments to cross-border investment by providing for the equal treatment of domestic and foreign investors and by locking in reforms of the 1980s that liberalized the Mexican economy.

FDI is a powerful force for change. It provides the recipient with resources which, when combined with relatively abundant domestic factor inputs, increase output and productivity. In the North American food processing industry, FDI has transferred cutting-edge technology embodied in capital and managerial knowledge. These developments have had positive impacts on local production and productivity. For example, U.S. investment in the Canadian grain-processing industry has enabled all the major players in the Canadian market to exploit scale economies (Wilson and Dahl).

The inception of CUSTA and NAFTA coincided with significant growth in the flow of U.S. food processing FDI to Canada and Mexico.[10] U.S. investment in Canada (Mexico) rose from $1.8 billion to $5 billion ($2.3 billion to $5.3 billion) between 1988 (1993) and 1999. The reliance upon FDI to access foreign markets is particularly strong for U.S. food processing firms. Sales from Canadian and Mexican affiliates of U.S. companies are about three times the level of U.S. processed food exports to these countries (Bolling et al.).

Common sense might dictate that increased FDI would curtail imports of processed foods due to expansion of local production, but this has not happened on an aggregate basis. U.S. exports of processed foods to both Canada and Mexico increased substantially at the same time that U.S. food processing FDI to both countries rose. Figure 6 highlights the sharp rise in both FDI and exports after CUSTA and NAFTA.

Applied analysis shows that U.S. FDI in the Canadian and Mexican food processing industries complements, rather than substitutes for, additional U.S. agricultural exports to these countries. Using a dynamic model that accounts for the interrelationship between U.S. FDI and U.S. exports to Canada and Mexico, Jerardo and Bolling ascertained that U.S. FDI and U.S. exports rise and fall together in the processed food economies of both Canada and Mexico. They also discovered that complementarity in these FDI-export relationships deepened post-CUSTA/NAFTA. In the U.S.-Mexican case, Mexican demand for processed intermediate inputs from the United States increases with U.S. investment in Mexican food processing. Product specialization explains FDI-export complementarities in the U.S.-Canadian case.

## Big Challenges and Opportunities in the Labor Market

Growth in the number of Mexicans crossing the border into the United States points to increased integration of the U.S. and Mexican labor markets (University of California, Davis-a).[11] One in 25 Mexicans crossed the northern border in the 1990s.[12] The rapid expansion of Mexican emigration has swelled the U.S. Hispanic population. According to the International Office for Migration, there were 7.5 million Mexicans living in the United States in 1998, a fourfold increase from 20 years earlier (The Economist, 2/23/02).

Employment of Mexican labor in the United States is beneficial to both countries. Mexican migrants have led to lower production costs in meatpacking plants and on produce farms. Foreigners working in the United States often provide a substantial source of income to their families back home. Remittances by

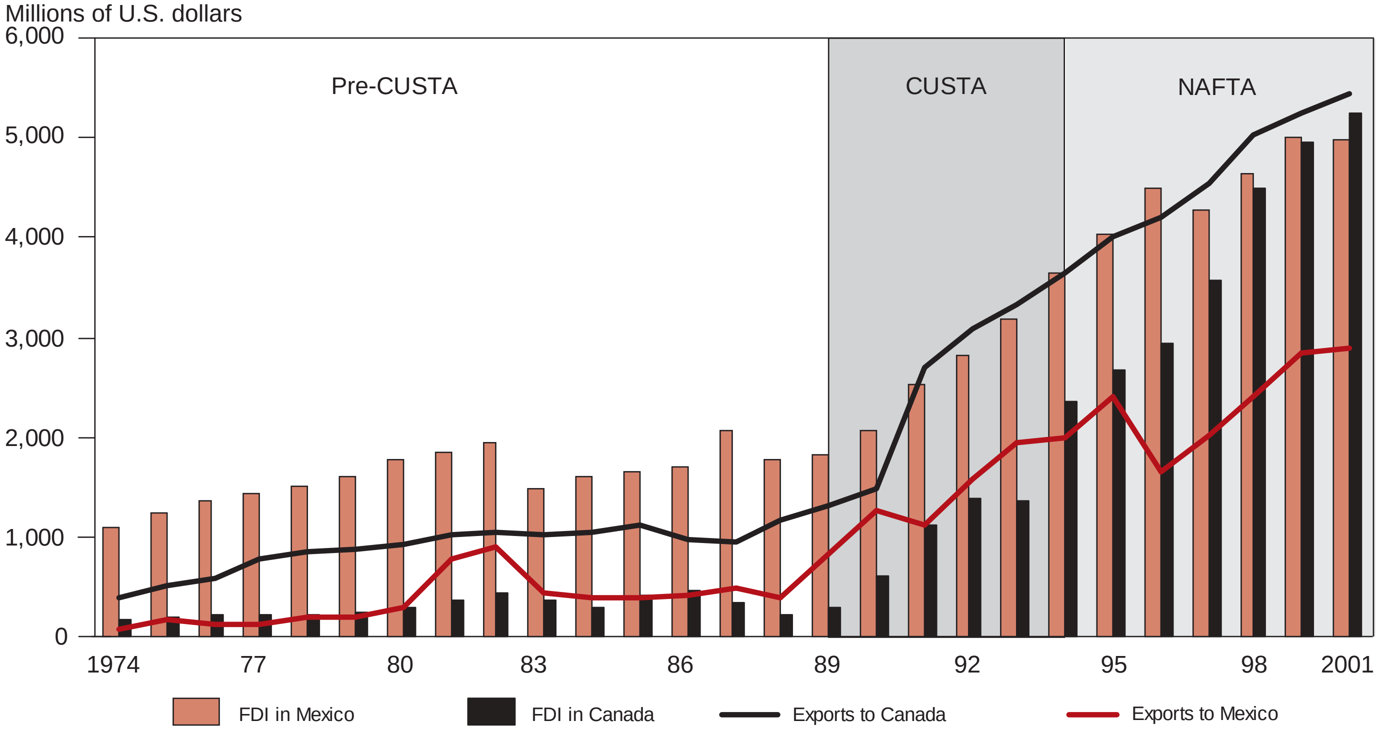
[10] It should be pointed out, however, that growth in U.S. processed-foods FDI and exports to Mexico first took off in the late 1980s, prior to the formation of NAFTA.

[11] Analyses of the degree of integration in labor markets can be revealed via national wage rates and by movement of labor across country borders. Given the difficulty of securing information on wage rates for comparably skilled labor, emphasis here is placed on the movement of labor.

[12] Sidney Weintraub, scholar from the Center for Strategic and International Studies, Washington, DC, from the NAAMI symposium proceedings.

Figure 6

**U.S. exports of processed food to Canada and Mexico move up in tandem with U.S. foreign directinvestment in food manufacturing**




Source: U.S. Department of Commerce, Bureau of Economic Analysis. *Survey of Current Business* and USDA FATUS.

Mexican migrants totaled $11 billion in 2002, up from $700 million in 1980 (The Economist, 1/25/03; University of California, Davis-b), and are now much larger than both private investment and the money provided by the multilateral development banks.[13] Conditions in rural Mexico would arguably be significantly worse if Mexican migrants were not able to find gainful employment in the United States.

Despite the increase in the supply of low-wage foreign labor in the United States, there is a growing debate among American citizenry about the desirability of immigration (Drucker). This debate stems from problems of illegal immigration, cultural assimilation, the stress put upon educational, health, and other social services in the United States, and the adverse effect on wages earned by relatively unskilled U.S. laborers.

The U.S. Immigration Reform and Control Act (IRCA) of 1986 was established to rectify problems of illegal entry and employment of unauthorized workers. To accommodate agricultural interests, this legislation contained two programs for farm labor. The Special Agricultural Worker (SAW) program provides a mechanism for foreign workers to become legal immigrants. The guest-worker program permits U.S. farmers to employ unauthorized laborers.

Recently, a U.S.-Mexican working group on migration was created to address the concerns of both U.S. farmers and foreign workers. At its first meeting in the summer of 2001, the group explored the concept of "earned legalization," a novel idea, that, if implemented would enable the U.S.-Mexican labor market to function more efficiently (Martin).[14] Only unauthorized foreigners who have worked in the United States would be eligible for earned legalization. These workers would have to continue working in the United States to maintain their temporary legal status before qualifying to become legal immigrants. Earned legalization would provide guarantees to U.S. farmers that newly legalized workers could not immediately leave agriculture before seeking employment elsewhere in the U.S. economy. It would also assure foreign workers that they could eventually become legal immigrants and seek nonfarm jobs.

[13] *Ibid.*

[14] After consulting with national legislatures, border states, communities, and other stakeholders, this binational working group is to make specific recommendations aimed at alleviating migration concerns.

Relatively skilled workers in each NAFTA country have been the major beneficiaries of increased market integration in North America as their real wages have increased most (Feenstra and Hanson). The educated labor forces in the United States and Canada have been able to harness information technologies that cause firms to switch production towards areas that are biased in favor of skilled workers. Moreover, increased competition from low-wage Mexico has induced domestic resources in the United States and Canada to shift further towards industries which use skilled labor relatively intensively, enabling better exploitation of comparative advantages.

The well-educated labor force in Mexico has also benefited from the enlarged North American market. This has occurred primarily because of increased U.S. and Canadian direct investment and outsourcing by "Northern" multinational corporations into Mexico. Feenstra and Hanson provide empirical evidence that the expanded flow of capital from "North" to "South" has resulted in increased manufacturing production in Mexico. They point out that "activities outsourced to the South are, from the North's perspective, ones that use relatively large amounts of unskilled labor, but, from the South's perspective, are ones for which the reverse is true." The result is an increase in the relative demand for skilled labor in both regions, which, in turn, causes the relative wage of skilled labor to rise in all three countries. Examples abound in North America. For instance, vegetable processing, such as the cutting and freezing of broccoli, the transformation of cotton into apparel, and other manufacturing processes employing semi-skilled workers, used to take place in the United States. Now, these industries are thriving in Mexico. Moreover, many displaced U.S. workers have found higher paying jobs in other sectors.

While many workers have reaped gains from the integration of North American agriculture, other have not. For example, Mexican grain and livestock producers have incurred net financial losses. By 1998-99, real net income for these producers had declined 45 percent from levels achieved just prior to NAFTA (Salcedo-Baco).

A number of options are available to facilitate needed labor adjustments. One option is the development of retraining programs that enable displaced workers to again become productive. In the United States, the Trade Adjustment Assistance program was created in 1962 to ease the adjustment burden in the domestic apparel industry. This program assists U.S. workers who lose their jobs or whose hours of work and wages are reduced as a result of international trade. More specifically, it provides displaced workers with opportunities to engage in long-term training while receiving temporary income support.[15] Similar kinds of targeted programs could be developed in Mexico and Canada, facilitating the transition of temporarily disenfranchised workers to higher income employment.

Another option is the creation of "degressive-wage insurance," which would provide assistance to any worker dislocated from employment for whatever reason (Hufbauer). Under this concept, if a worker loses a job because a firm goes out of business or closes a plant, that worker would be eligible for supplementary income payments after finding a new job. The supplementary payment could cover a portion of the difference between the worker's old and new wage. Ideally, the portion would decrease over time (say, 3 years), to circumvent future problems of entitlement.

Economic logic provides a rationale for assisting those whose income falls because their skills are in less demand after national markets become more open and economically integrated. Two important impacts of more open markets enable society to compensate those workers so that net benefits are never negative. One is that as demand for domestic resources changes in response to increased economic openness, the returns to the abundant factor in each country rise while the returns to the scarce factor in each country fall.[16] The other is that changes in the pattern of trade raise domestic income in the aggregate. These two impacts provide policymakers with justification to redistribute income in such a way as to not make anyone worse off. If done well, redistribution can create additional gains by increasing the productivity of labor that had been economically disenfranchised through market integration. The acquisition of needed skills enables workers to secure higher wage jobs that become available as integration takes place.

[15] U.S. workers in North Carolina displaced from their textile jobs due to NAFTA can obtain $2,500 for retraining. They also qualify for extended unemployment insurance for a period up to 2 years following loss in employment (Hamrick et al.).

[16] Stolper-Samuelson theorem.