POLICY BRIEF

Institutions, Trade & Economic Prosperity: An Examination of the U.S. and Mexican States

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STATEMENT OF ISSUE

Canada, the U.S. and Mexico, due in large part to the liberal trade environment created through NAFTA, comprise one of the world's largest free trade areas, and contain about one-third of the world's GDP. Nearly all tariffs were eliminated between the three countries as a result of NAFTA. Trade in goods between the U.S. and Mexico has more than tripled since then. We explore what effect institutions have on both interstate trade and cross-border trade, and also what impact the national border has on these trade relationships. We also examine the relationship between trade volume and economic prosperity. Because individual states differ, understanding subnational trade flows can help us gain a clearer picture of both the determinants and consequences of trade between the nations. By utilizing state-level data, we are in the unique position of being able to understand both subnational relationships and the micro-determinants of national relationships.

KEY FINDINGS

- Trade is a more important determinant of prosperity for the importing state than for the exporting state.
- Our findings show that international trade does not hinder inter-state trade for U.S. states that lie across the U.S.-Mexico border.
- U.S. states are significantly less likely to trade with Mexican states with whom they share a border, than with states within the U.S.
- Analysis of U.S. and Mexican states indicates the following:
  - States with greater economic freedom tend to engage in more trade with other states.
  - States that engage in more trade with other states tend to have greater economic prosperity.
  - States that have greater economic freedom tend to have greater prosperity.

POLICY RECOMMENDATIONS

- Reducing national barriers to trade between the U.S. and Mexico should be beneficial to both countries' economies.
- The new North American trade agreement, USMCA, contains trade restrictions that should be reconsidered, such as country-of-origin rules, which will raise the cost of producing automobiles in North America, and the restrictions on negotiating freetrade agreements with "non-market"economies outside of North America.
- While most trade policy is determined at the national level, individual states can improve the health of their economies by reducing government restrictions on economic freedom.
- Labor market freedom was found to be particularly strongly, and positively, associated with trade volume, so reducing labor market-restrictions such as minimum wages and occupational licensing restrictions may be especially beneficial.
- Implement policies that promote a freer economy, such as income tax reductions and slower spending growth.

SOURCES AND FULL PAPER

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