Institutions and Trade: An Examination of the U.S. States and Mexico

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Motivation

- Trade between Mexico & the U.S. is **"YUGE"!**
- Mexico was 2nd largest goods export market for U.S. in 2017 (1-Canada) (USTR).
- And 2nd largest supplier of goods imports into U.S. (1-China)
- U.S. goods exports to Mexico totaled $243 billion in 2017, almost doubling since the end of the last recession.

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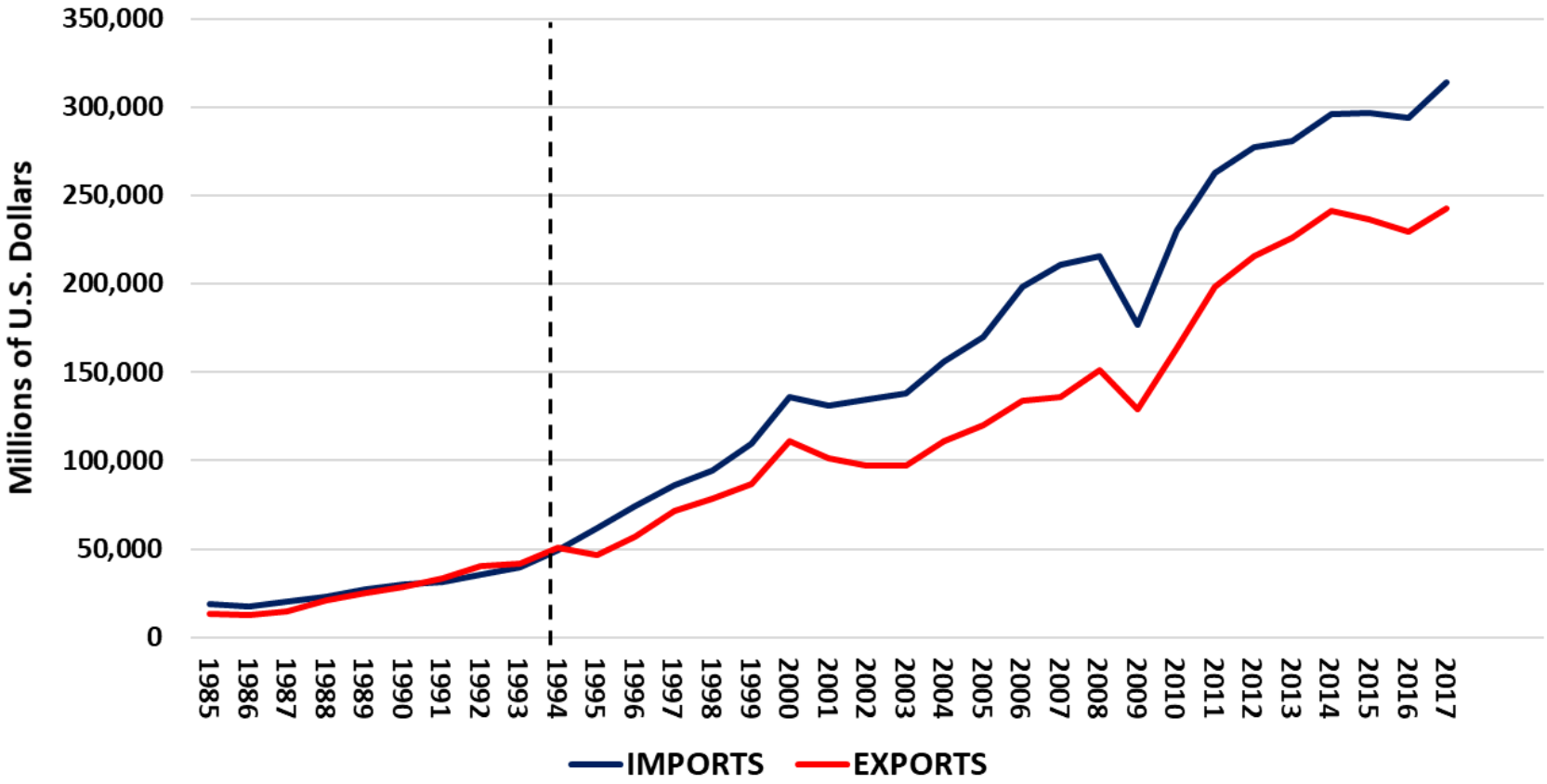
U.S. Trade in Goods with Mexico



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Motivation

- NAFTA has helped facilitate trade, but Trump wants to “renegotiate.”
- Given that context, a better understanding of the character of trade relations between the U.S. and Mexico would be helpful in this debate.

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Methodology

- We examine how differences in institutional quality – across the U.S. states and between the U.S. states and Mexico – affect trade relationships.
- Our measure of institutional quality: state "economic freedom" scores from the Fraser Institute's *Economic Freedom of North America (EFNA).*
  - *Available at www.freetheworld.com*
- An offshoot of Fraser's *Economic Freedom of the World (EFW)*, developed about 30 years ago by Nobel Laureate Milton Friedman and others.

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What is "economic freedom"?

- "Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others."
- Most recent *EFW* rankings:
  - U.S. & Canada: 11th (tied)
  - Guatemala: 23rd
  - Panama: 30th
  - Mexico: 76th
  - Venezuela: 159th (last place)

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Motivation

- A large literature has found a positive relationship between “economic freedom” and a wide variety of positive economic outcomes (e.g., standard of living, GDP growth, etc.).
- We examine it’s relationship with trade volume.
  - We are the first to investigate this at the state level.
- Higher volumes of trade may be one of the channels through which those other better economic outcomes are achieved.
- We will also investigate that relationship between trade and broader measures of prosperity.

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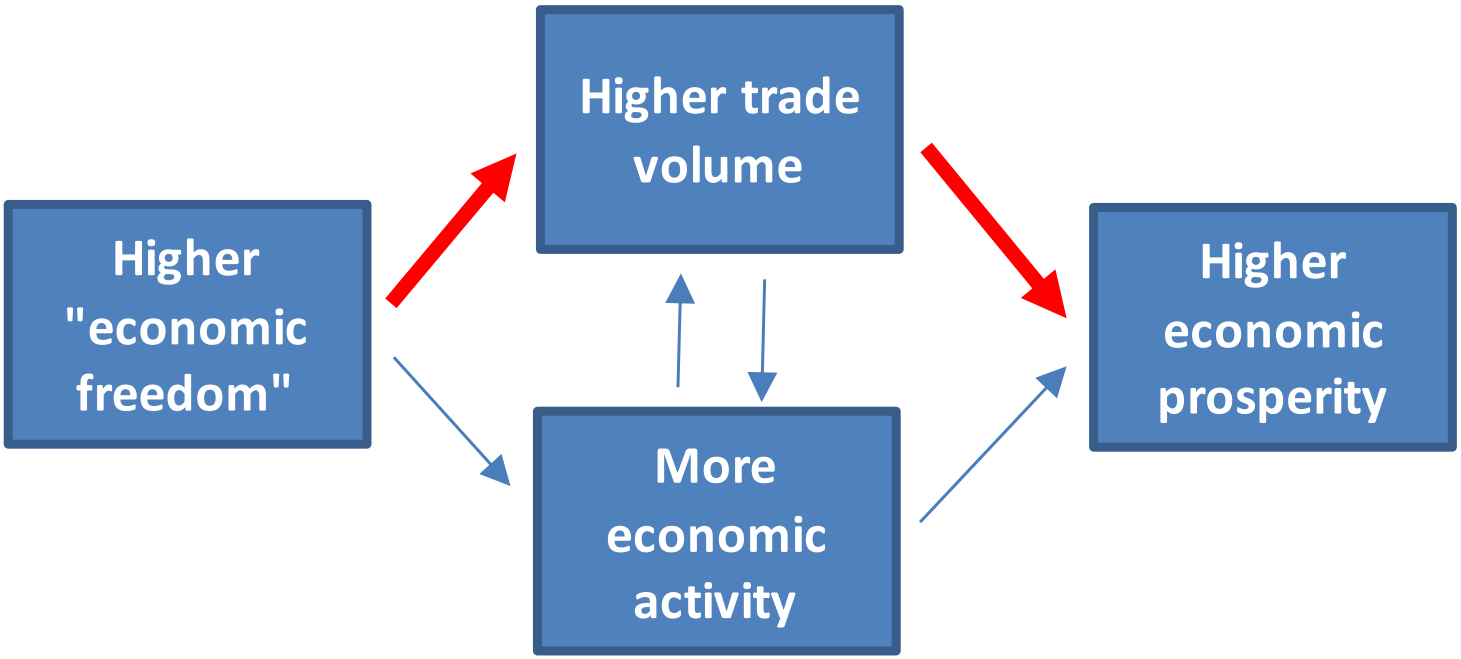
Methodology

- Most research in this area examines trade between nations.
- Barriers between nations are higher and vary substantially across countries.
- Looking at states allows us better to isolate the impact of economic freedom on trade.
- The noise that exists in cross-country panel studies is much less in the state-to-state context.

Multi-faceted relationships



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Preliminary Findings

- Unsurprisingly, GDP is positively related to trade
- Areas that share a common border are more likely to trade with one another.
- Economic freedom is a facilitator of trade
  - Government spending doesn't seem to matter, but areas with friendlier tax structures and fewer labor market restrictions tend to trade more.
- Borders matter – even within the US!
  - Strong border effect for states
  - Surprisingly, larger border effect for states than for the international border
  - Implicit barriers might be more important than explicit barriers

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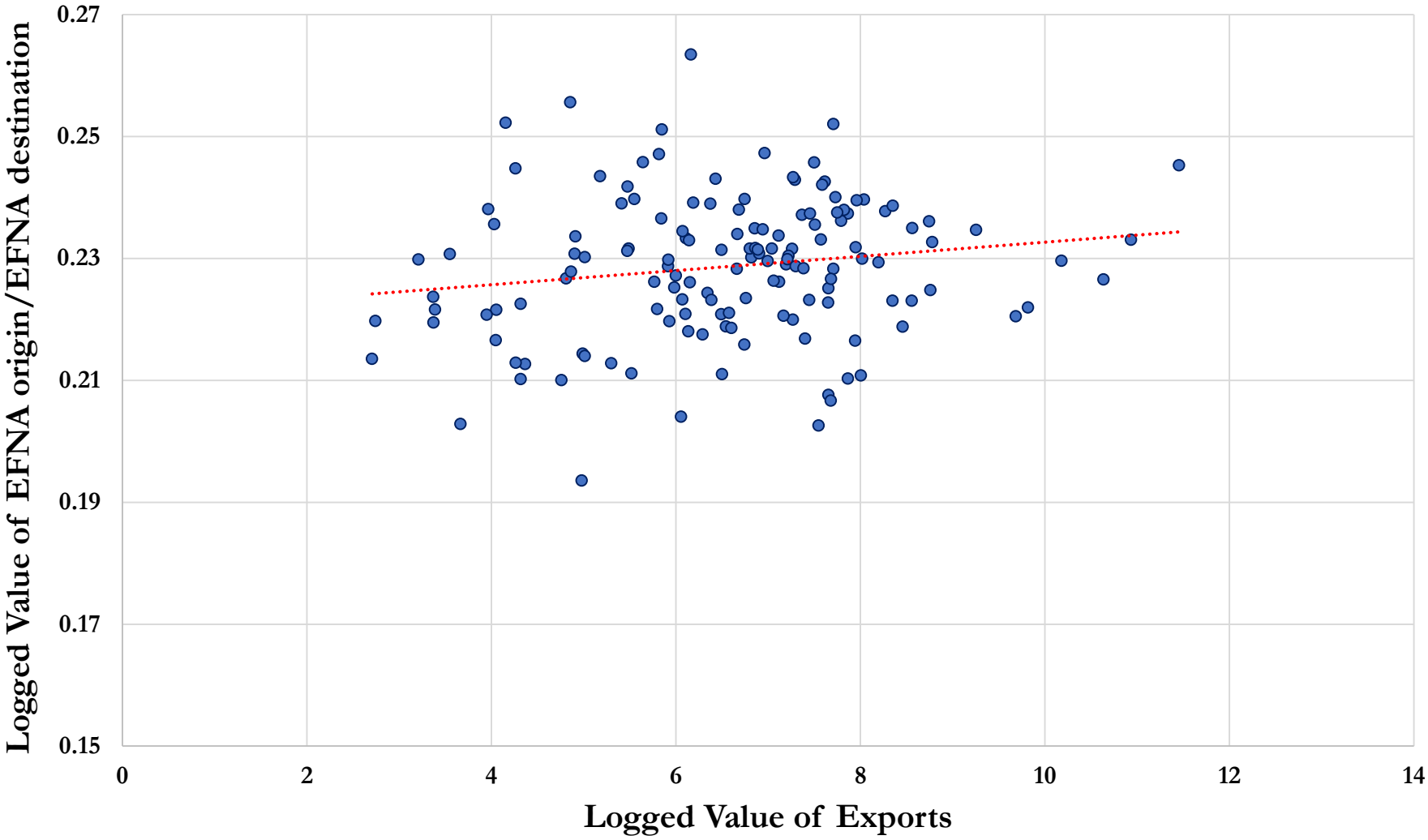
Relationship Between Economic Freedom and Export Activity



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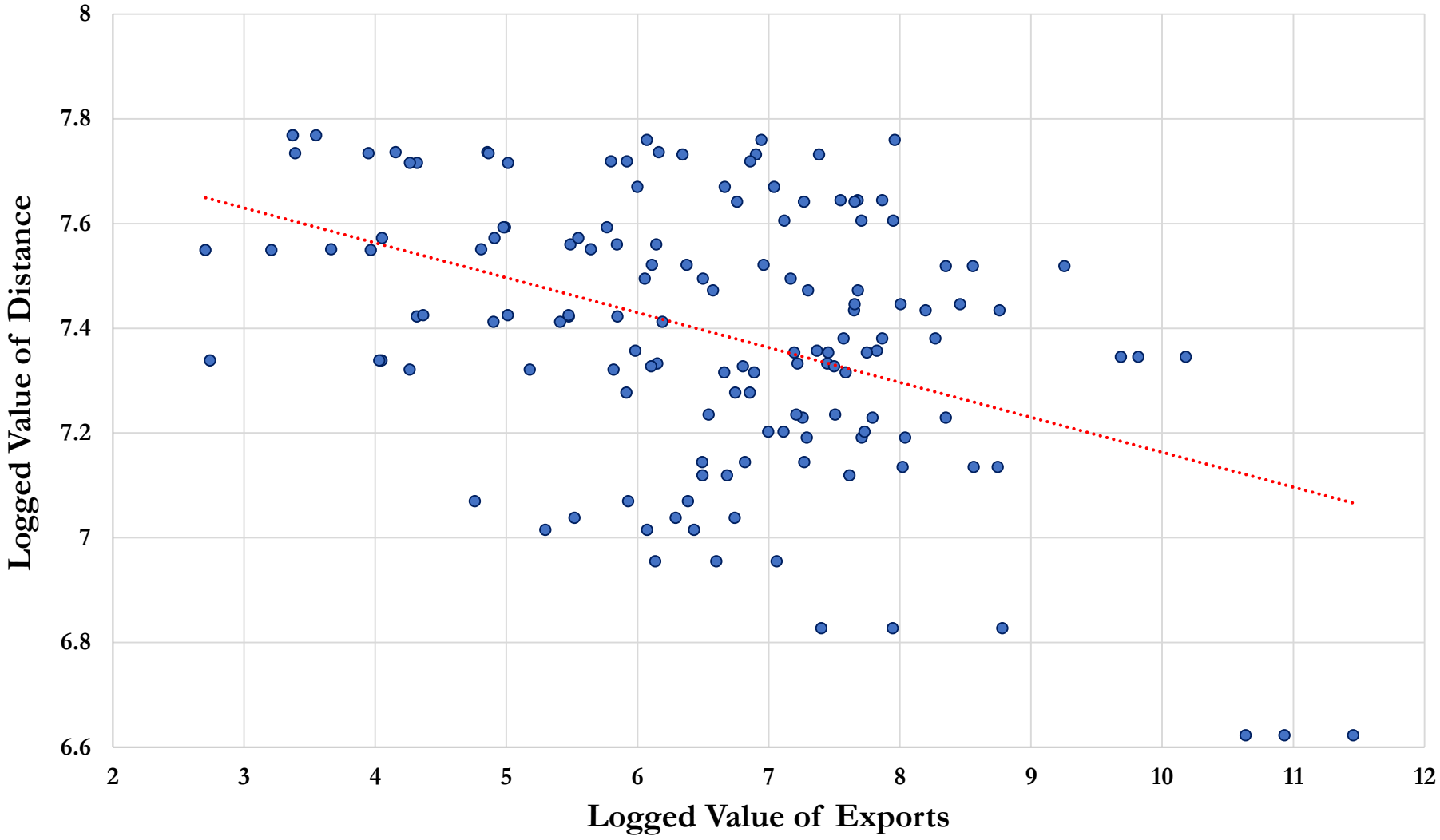
Relationship Between Distance and Export Activity



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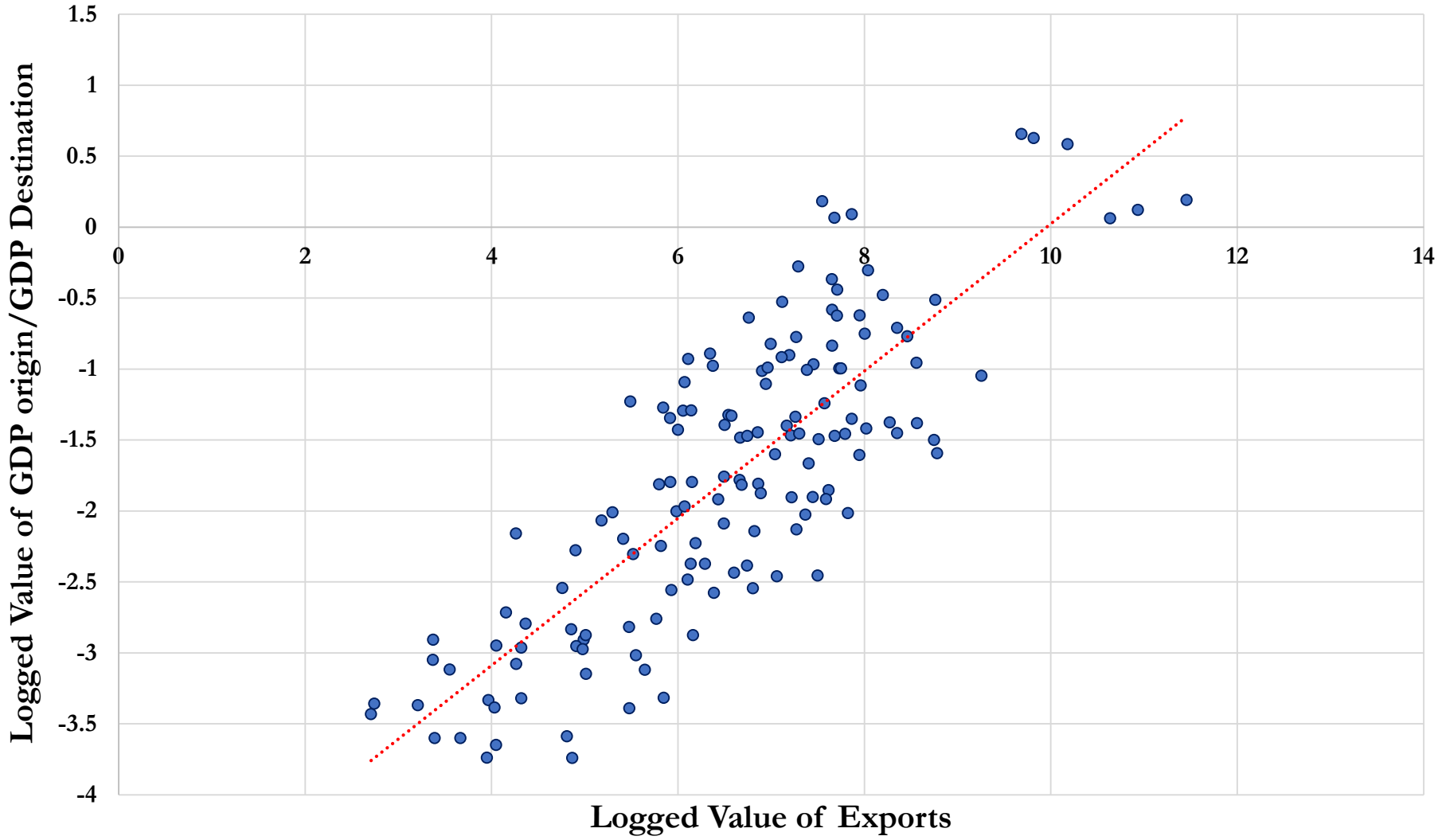
Relationship Between Exports and GDP



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Conclusion

- States that place fewer restrictions on economic activity tend to produce a higher volume of trade with other jurisdictions.
- States that engage in a higher volume of trade tend to have higher levels of GDP, which ultimately means higher standards of living.
- Residents in states (and countries) that place restrictions on trade will tend to see lower standards of living, meaning they are poorer than they would otherwise be.

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