



# USMCA

UNITED STATES MEXICO CANADA

# FORWARD

# 2022

BUILDING A MORE COMPETITIVE,  
INCLUSIVE, AND SUSTAINABLE  
NORTH AMERICAN ECONOMY

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## ACKNOWLEDGEMENT

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The editors would like to thank Brookings President John R. Allen, Brookings Trustee Paul Desmarais, and Brookings International Advisory Council member Pablo González for their vision and foundational support for the USMCA initiative. The Brookings Institution is a nonprofit organization devoted to independent research and policy solutions. Its mission is to conduct

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# FORWARD

**JOHN R. ALLEN**

President of Brookings  
Institution

**PAUL DESMARAIS JR.**

Chairman of Power  
Corporation of Canada

**PABLO GONZALEZ,**

CEO of Kimberly-Clark Mexico

In January 2021, Brookings launched the USMCA initiative. Created as a multiyear project, the USMCA initiative focuses on key developments, identifying how the trade agreement could create a more competitive, inclusive, and sustainable North American economy. Following USMCA-related issues, such as labor rights and environmental commitments, the initiative utilizes Brookings' reputation as a world-class non-partisan public policy research organization to identify the many ways USMCA can strengthen and deepen North American economic relations.

At the moment, the USMCA has support from all three of its members' governments: The U.S., Mexico, and Canada. However, the overwhelming political support should not be taken for granted or considered as an immediate measure of success. Rather, policymakers and thought leaders would be wise to approach the trade agreement as something nascent, requiring consistent time and attention. To succeed, all three nations will need to take measures to deepen their economic relationships, create opportunities for the middle class and labor, as well as address the effects of climate change. If handled properly, the USMCA could serve as a paragon of how like-minded democratic nations can uphold respect for fair competition and trade and commitment to the rule of law—despite the rise of near-peer competition with countries like China.

The Brookings USMCA initiative has started to create a roadmap for such a success. Over the course of 2021, Brookings convened a series of roundtables and engagements with government officials, key stakeholders from industry, and civil society. In September last year, the initiative released a policy brief that identified key priorities for building a more competitive, inclusive, and sustainable North American economy. Now, we are proud to launch this flagship report as the first in an annual series that will examine the USMCA's actions over the course of the previous year, providing an assessment for areas of progress as well as identifying areas for improvement.

With contributions by experts from the U.S., Canada, and Mexico, this year's report dedicates one chapter to each of the five policy priorities outlined in the September 2021 policy brief: (1) increasing North American competitiveness with a particular focus on Mexico; (2) building more resilient supply chains; (3) expanding use of data and digital technologies and aligning on appropriate regulation for a digital economy; (4) strengthening labor standards; and (5) cooperating on climate change, including on issues of clean technology.



**WE BELIEVE THAT BY PROVIDING INDEPENDENT, WORLD CLASS ANALYSES THAT IDENTIFY OPPORTUNITIES AND ARTICULATE COMPLEX DOMESTIC REALITIES, THE BROOKINGS USMCA INITIATIVE WILL BE AN ESSENTIAL RESOURCE FOR POLICYMAKERS AND LEADERS. ”**

In addition, senior government officials, union representatives, business leaders, and academics have contributed “Viewpoints,” or essays, that discuss USMCA priorities and challenges from a range of perspectives. They include viewpoints from U.S. Trade Representative Katherine Tai, Canada’s Trade Minister Mary Ng, and Mexico’s Secretary of the Economy Tatiana Clouthier, as well as AFL-CIO President Liz Shuler, Unifor President Jerry Dias, and more.

Despite their different perspectives, two key messages emerged from these viewpoints. The first is that all stakeholders across North America see the USMCA as an important opportunity for the region. The second is that many see USMCA as a turning point in North America for a less contested relationship than was the case under its predecessor, the 1993 North American Free Trade Agreement (NAFTA). At the same time, the report also illustrates how important it is for all governments to implement their USMCA commitments. From this perspective, efforts by President Obrador to change Mexico’s energy market and the

proposed EV tax credits in the U.S. are of particular concern because they are likely inconsistent with USMCA commitments, would undermine confidence in the USMCA as a stable framework for trilateral trade and investment, and in the case of Mexico, would undercut the government’s ability to achieve its climate goals.

Recognizing this kind of constant push and pull between policies, the Brookings USMCA initiative is an important growing resource. Alongside this report, the initiative plans to launch a number of other products, including a USMCA Trade Tracker, which will be an online resource dedicated to providing comprehensive data on the trade and investment flows across North America and serve as a go-to-source on USMCA meetings and disputes. We believe that by providing independent, world class analyses that identify opportunities and articulate complex domestic realities, the Brookings USMCA initiative will be an essential resource for policymakers and leaders that will help deepen the mutually beneficial cooperation between the U.S., Mexico, and Canada.

# LETTER FROM THE EDITORS

## JOSHUA P. MELTZER

Senior Fellow in  
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## BRAHIMA S. COULIBALY

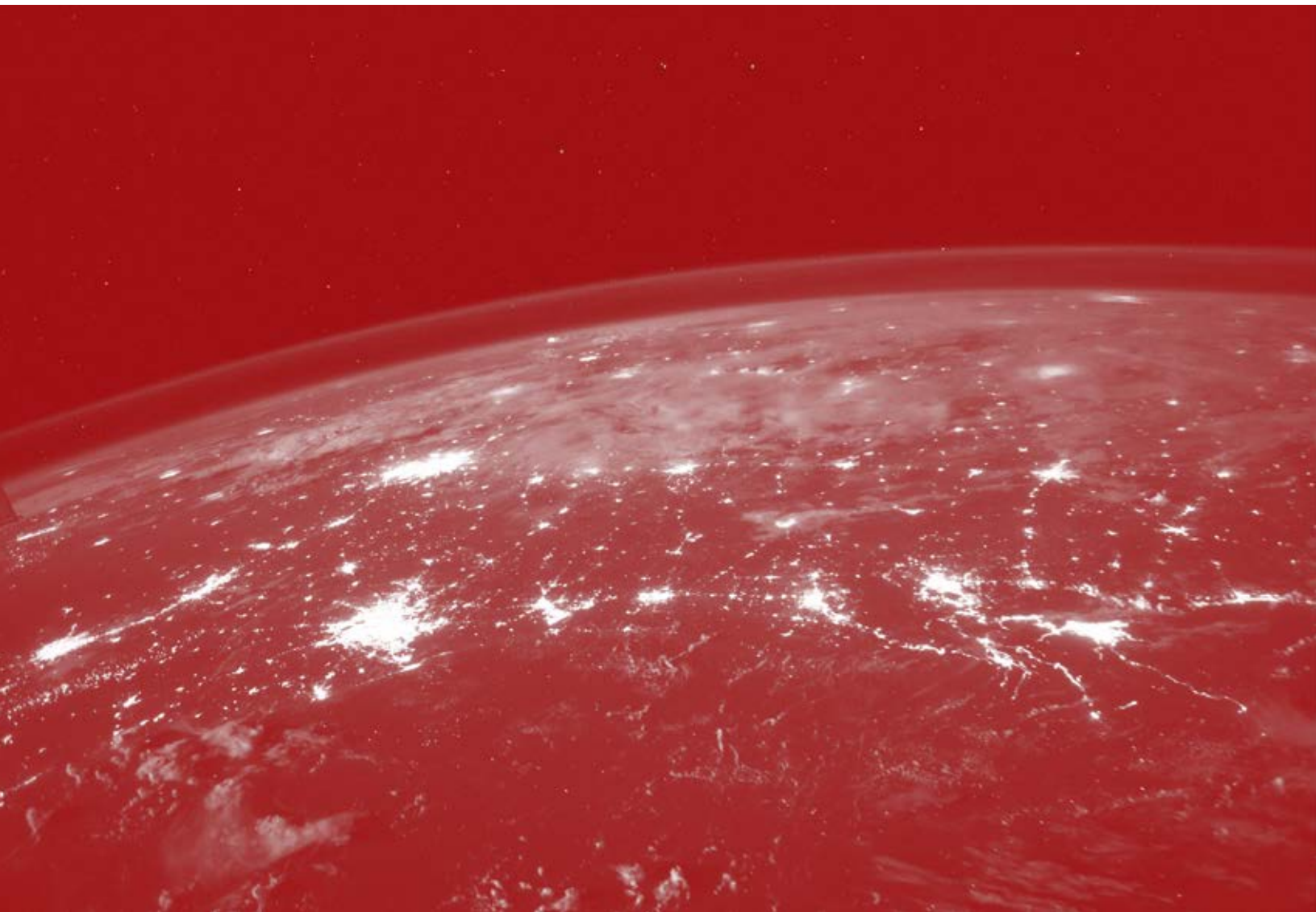
Vice President and Director  
of the Global Economy  
and Development program  
at Brookings Institution

Less than two years ago the United States, Mexico, and Canada signed a historic agreement to build a more competitive, inclusive, and sustainable North American economy. The United States–Mexico–Canada Agreement (USMCA) is arguably the most significant trade agreement that any of the partner countries has signed since the World Trade Organization was created in 1995. Beyond a traditional trade agreement, the USMCA provides an economic template to realize the potential of an integrated, competitive North American market while avoiding the political tensions that surrounded the now defunct North American Free Trade Agreement (NAFTA). Even though the USMCA received broad support from various stakeholders in all three countries, its success is not preordained.

Notably, implementation of the agreement will prove challenging. By tracking progress and proposing solutions to overcome obstacles, the **Brookings USMCA initiative** aims to contribute to the success of the agreement, including during the joint review and extension of USMCA in 2026. In this spirit, we are pleased to launch the inaugural flagship Brookings report *USMCA Forward 2022: Building a more competitive, inclusive, and sustainable North American economy*. This report identifies five main priority areas: **improving North American economic competitiveness, strengthening supply chains, expanding digital trade, improving**

**labor conditions and wages; and supporting the transition to low-carbon economic growth.** With contributions from experts and thought leaders from Canada, Mexico, and the U.S., the five chapters capture the most pressing issues within these priority areas. These theme-based chapters are complemented by shorter policy-focused viewpoints of leaders from government, business, unions, and academia. This includes viewpoints from Canadian Trade Minister Mary Ng, Mexican Secretary of Economy Tatiana Clouthier, United States Trade Representative Katherine Tai, AFL-CIO President Liz Shuler, Unifor President Jerry Dias, and business leaders from the Business Council of Canada, Business Roundtable of Mexico, and the U.S. Business Roundtable. We also feature perspectives from notable academics in this field and former lead trade negotiators for NAFTA.

These viewpoints, together with the chapter analyses, provide a comprehensive view of the potential benefit of the USMCA for the three countries. A common observation and starting point for thinking about USMCA opportunities is the strong political support it received in all three countries. In addition to the bipartisan support in the U.S. Congress (89 to 10 in the Senate), the USMCA passed Canada's House of Commons (275 to 28) and Mexico's upper chamber (114 to 4) resoundingly. But as Brookings President John R. Allen, Brookings Trustee Paul



©Photo credit: NASA

Desmarais Jr, and Brookings International Advisory Council member Pablo Gonzalez note in the Forward to this report, realizing the agreement’s full potential will require sustained commitment and leadership across government, industry, and civil society.

The following themes emerge in this report: First, USMCA is a pathway towards even greater levels of cooperation and dialogue among the three countries to address pressing collective challenges such as the COVID-19 pandemic, climate change, and strengthening North American competitiveness. As former U.S. Trade

Representative and lead U.S. trade negotiator for NAFTA, Carla Hills points out in her viewpoint, NAFTA not only ushered in an era of increased trade and investment, through collective leadership of government, industry, and civil society, it also led to strengthened cooperation in areas such as border security, environmental protection, and intelligence sharing. The space that USMCA creates to deepen cooperation across a range of issues will require renewed commitments to a vision for what the three countries can achieve together. The meeting of President Biden, President Obrador, and Prime Minister Trudeau at the so-

called “three amigos” summit in November 2021 – who had not met in five years – is an important first step to reinvigorating leader level contact and signaling the renewed importance and opportunities of North American cooperation and leadership. As the leaders stated, “we are closely bound by history, culture, a shared environment, and economic and family ties, and strongly believe that by strengthening our partnership we will be able to respond to a widening range of global challenges.”

**All three trade representatives, in their respective viewpoints, also underscore the importance of cooperation and the USMCA in effectively addressing common challenges.** Canadian Trade Minister Ng highlights how opportunities to utilize supply chains and manufacturing capacity across the U.S., Mexico, and Canada enabled the rapid development of an innovative air filtration system that reduces COVID particles using high heat. This is just one example of how trilateral cooperation enabled by USMCA can be used to address pressing common challenges. As Minister Ng notes, “We have the best shot at tackling even the most pressing global challenges when we engage our collective strength, resilience, and innovation.” Similarly, Mexico’s Secretary of Economy Tatiana

Clouthier emphasizes the need for closer cooperation and deeper integration – and more coordination and more dialogue. United States Trade Representative Tai calls USMCA “the cornerstone of North America’s economic future” and concludes with the observation that “it will be critical for the United States, Mexico, and Canada to continue our close cooperation to ensure that USMCA remains a living agreement that delivers inclusive economic growth and broadens our collective prosperity.”

The chapters on strengthening North American competitiveness and building more resilient supply chains provide additional contextual analyses to these viewpoints. Luis de la Calle in his chapter on competitiveness describes the two main drivers of economic integration in North America: The regulatory environment and technological advancement. De la Calle shows how implementation of USMCA can be a catalyst for improving competitiveness in the burgeoning field of health and medical innovation. This includes leveraging the region’s talent and collaborating with federal and state governments, academia, research centers, and the private sector. As he notes, North America’s competition with other regions of the world is for technological leadership, and success in this area requires

“**THE SPACE THAT USMCA CREATES TO DEEPEN COOPERATION ACROSS A RANGE OF ISSUES WILL REQUIRE RENEWED COMMITMENTS TO A VISION FOR WHAT THE THREE COUNTRIES CAN ACHIEVE TOGETHER.**”



the participation of many skilled players.

In the chapter on building more resilient supply chains, David Dollar offers insight into the extent in which Mexico can be an alternative destination for Chinese-based manufacturing and supply chains. He concludes that **trade pacts like USMCA have the potential to improve the region's investment climate; however, complimentary policies that address weaknesses in areas such as logistics and human capital will be crucial for Mexico to fulfill its potential as a manufacturing hub.** In fact, Dollar notes that China has been an increasingly important source of inputs into North American supply chains. One suggestion here is that it may be more fruitful to focus on integrating North American manufacturing into Asian supply chains rather than displacing China.

Building a digital North America is another focus of the report that speaks to the opportunities USMCA presents. USMCA includes a set of commitments on digital trade that were largely absent in NAFTA and are the most comprehensive digital trade commitments globally. Patrick Leblond explains how the three North American countries can realize the full potential of digital technologies and ensure the region's economy remains integrated as it digitalizes. For Leblond, cooperation on digital trade would allow North America to become a global leader in the digital economy, particularly in the development of new technologies like artificial intelligence, blockchain, and quantum computing.

A second key theme in the report is the importance of the USMCA's labor and environment chapters. Indeed, this is one area where USMCA made important progress on NAFTA. Inclusion of these labor and environment chapters in USMCA was central to building bipartisan political support for the agreement. The agreement's enforceable labor provisions and stronger labor standards were key reasons why the AFL-CIO, the largest federation of unions, supported USMCA – the first time the organization has supported a major trade agreement in 20 years. Jerry Dias, President

of Unifor, Canada's largest private-sector labor union, also emphasizes the importance of USMCA labor provisions for improving worker conditions. Demonstrating that these chapters can yield results will also be needed to ensure that USMCA can deliver more inclusive and sustainable outcomes from international trade and investment and sustain broad political support for USMCA going forward. In this respect, the U.S.' use of the agreement's rapid enforcement mechanism in 2021 to address breaches of USMCA labor standards at facilities in Mexico signaled U.S. adherence to these new USMCA labor commitments. It particularly demonstrated the effectiveness of the innovative rapid enforcement mechanism. In the labor chapter, Santiago Levy provides an important analysis of the extent in which the USMCA labor commitments can help increase Mexican wages. He concludes that, in addition to the commitments, reform of Mexico's labor market regulations will also be needed in order to significantly increase Mexican wages. In the absence of such reform, USMCA could lead to small wage increases in firms engaged in trade with the U.S., but with limited impact on overall wages in Mexico.

The opportunities for USMCA to help address climate change is the subject of the chapter by James Bacchus. Bacchus points out that the goals of increasing competitiveness and addressing climate change are not in conflict, but are in fact, complimentary. This includes leveraging USMCA to eliminate tariffs on environmental goods and services that can be used to address climate impacts. These policies would also increase the competitiveness of North American industry, enhance coordination of research and development in clean energy across the countries, and integrate better the North American energy market – while developing common standards and regulations that reduce emissions along supply chains.

A third theme that emerges from this report is the need for the three North American governments to fully implement and comply with their USMCA commitments. As the business leaders in their viewpoint note, “Full implementation and enforcement

of USMCA will sustain broad political and stakeholder support for the agreement.” Ambassador Tai in her viewpoint also notes that “full implementation and enforcement of the USMCA are top priorities for the Biden–Harris Administration and a key component of a worker–centric trade policy.” Over the last year there were notable demonstrations of the effectiveness of USMCA dispute resolution mechanisms. This included success in using the agreement’s rapid enforcement mechanism to strengthen worker outcomes at plants in Mexico, and the U.S. won the first state–state dispute with respect to Canada’s allocation of dairy tariff–rate quotas. These positive outcomes are however clouded by developments in Mexico and the U.S. that threaten to overshadow this otherwise positive momentum. Meghan O’ Sullivan and Lourdes Melgar in their viewpoints outline efforts by President Obrador to reform Mexico’s power sector in ways that are potentially inconsistent with Mexico’s USMCA commitments. They note that these reforms would lead to increased use of carbon intensive energy sources, undermining Mexico’s ability to meet its commitment under the Paris Climate Accords, a point that James Bacchus also makes in his chapter. Prioritizing electricity from the state–run utility CFE over private sources of energy would also lead to less investment in Mexico, increased energy costs, and reduction in economic competitiveness.

The second area of concern is the proposed U.S. tax credit for Electric Vehicles (EV) manufactured in the U.S. and with union labor. As Secretary Clouthier notes in her contribution to this report, such a tax would “reduce the ability of U.S. manufacturing to produce with its most important trade partners, at a very high cost to the U.S., and to North America.” In his viewpoint, John Weekes observes that the proposed EV tax credit, on top of the tariffs President Trump imposed on Canadian steel and aluminum imports for national security purposes, has shaken Canada’s trust in the stability of its North American partnership.

USMCA represents a new opportunity for Canada, Mexico, and the U.S. to build an economic partnership that addresses common challenges and improves worker outcomes. Success will require strong political leadership and sustained engagement by all stakeholders. The Brookings USMCA initiative stands ready to support these efforts with world class analyses and convenings. Over the course of the year, we will continue to monitor the USMCA, including through a new **USMCA Tracker**, forward–looking research, timely commentaries, and convenings.

## ENDNOTES

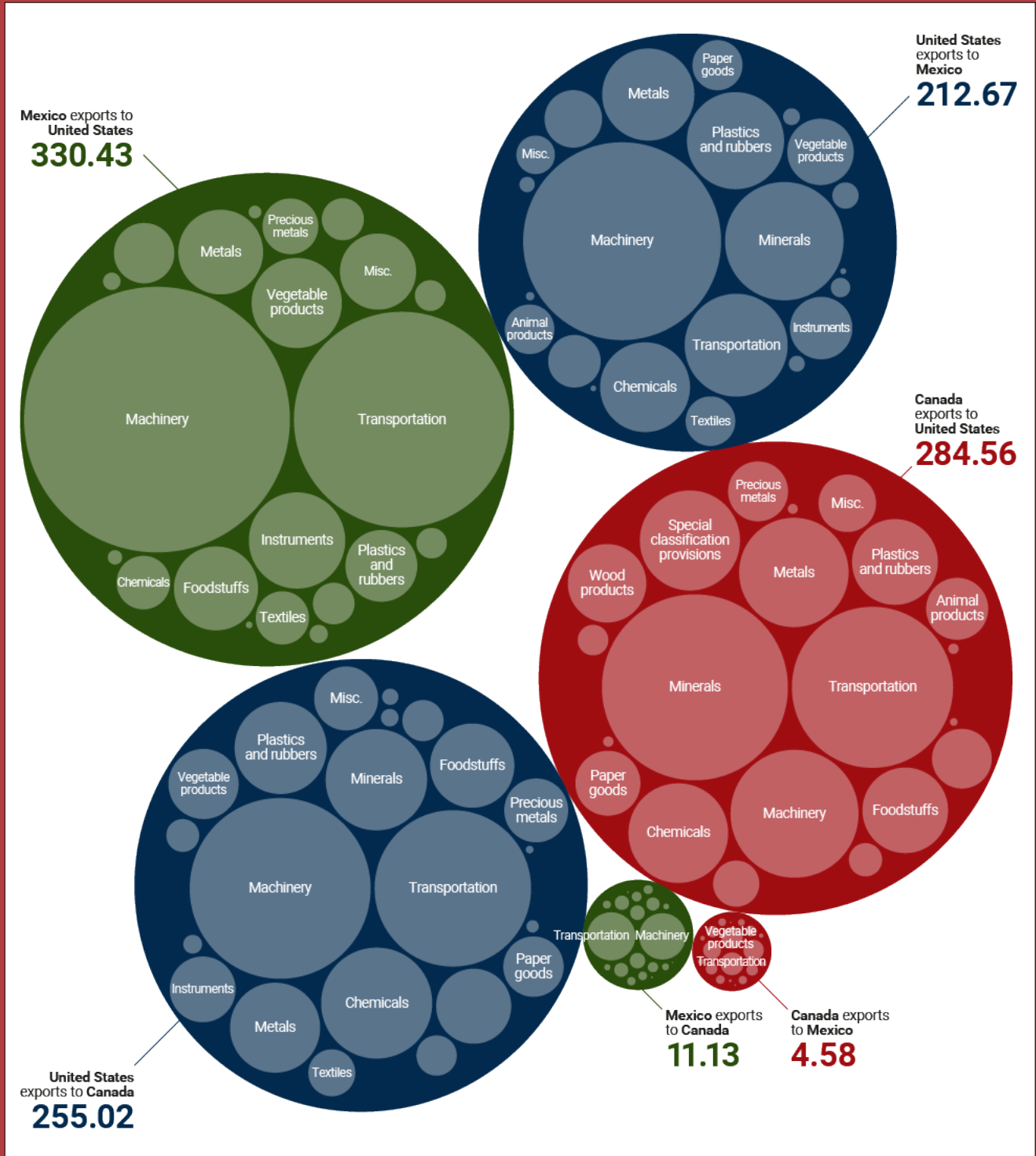
1 See “[Developing a roadmap for USMCA success](#)” for more on these priority areas.



**GRAPH 1**

**Goods Trade in North America during 2020 (in billions of dollars)**

Trade in similar products between the U.S. and Mexico and the U.S. and Canada highlights the role of supply chains and opportunities for specialization.



Source: UN Comtrade Database (2022).



Mary  
Ng

Canada's Minister of International  
Trade, Export Promotion, Small  
Business and Economic Development

# Canada's vision for a resilient North American trade relationship

When the COVID-19 pandemic swept across the world two years ago, it catapulted us into one of the most difficult periods in modern memory, irrevocably changing lives and livelihoods around the globe. While we are not out of the woods yet, and face renewed difficulties with emerging variants, we have begun to look forward to how we might rebuild the prosperity of our nations and create even more durable economies moving forward.

One thing is certain, we will be better off moving forward and were better able to address the pandemic, thanks to the vibrant, unique trilateral trade relationship between Canada, the United States, and Mexico. Allow me to share just one striking example: Houston-based company Integrated Viral Protection (IVP).

IVP leaped to the fore a few weeks into the pandemic, with an innovative air filtration system. But they couldn't produce this new system alone. That's where our North American Free Trade Agreement (CUSMA) came in. Together with three manufacturing companies – the United States' Dust Free, Canada's Engineering CPR, and Mexico's Instalaciones y Especialidades Metalicas – IVP launched a transcontinental partnership to create the award-winning Biodefense Indoor Air Protection System that traps the COVID-19 virus using high heat.

While CUSMA has helped lift the weight of this particular crisis, it was created to address many broader issues. Whether it's climate change or maintaining North America's competitive advantage, we have the

best shot at tackling even the most pressing global challenges when we engage our collective strength, resilience, and innovation. When we look to recovery – one which has sustainability and inclusivity at its core – we will be better equipped to support our workers, businesses, and communities by leveraging the opportunities provided through CUSMA.

Thanks to CUSMA, those who have been hardest hit by the pandemic – our nations' small and medium-sized businesses, women, and underrepresented communities – are better positioned to benefit from international trade. On top of this, CUSMA incorporates strong labor and environmental obligations, which will be crucial to our long-term competitiveness.



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Importantly, its clear dispute settlement mechanisms will help hold us accountable.

What's more, CUSMA and the stability it yields for our North American economic partnership — where US\$110 million in trilateral trade still happens every hour — uniquely positions our industries to leverage our strengths and collaborate, especially in the fast-growing sectors of the future such as critical minerals and clean-tech, and make real, collective progress to tackle climate change. Whether it's building electric vehicles or developing world-leading clean hydrogen technologies, our cross-border collaboration can make us a hub for innovation to in turn, export to, and compete with the world.

Bolstering our deeply integrated supply chains, and decades-long collaboration through CUSMA, will reinforce our domestic economic security and ensure that the prosperity that flows from international trade begins here, with our North American partnership, and continues to benefit our businesses, industries, people, and communities.

Of course, in any partnership, differences will arise, as they have recently with proposed protectionist measures in both the U.S. and Mexico. But we've been here before, and navigating these differences can make our trilateral relationship stronger. Time and again we have met conflict with goodwill and faith and used the mechanisms negotiated between us to maintain rules-based trade.

And thanks to this careful work, our companies, workers, and their families are better able to feel secure in their futures.

As is the case with fighting COVID-19, our nations will not be able to achieve long-term growth and prosperity without working together. So, let's lean into our strengths, resources, and unique trilateral relationship to strengthen the bridges between our countries and improve the well-being of our peoples and economies.



## Tatiana Clouthier

Secretary of Economy of Mexico

# Mexico's priorities for USCMA in 2022

On July 1, 2020, North America opened a new era of integration, which built on the North American Free Trade Agreement and was renewed to include a deeper and wider integration that puts people at the center of our region.

The new USMCA enables Mexico to deepen its productive integration in North America and benefit from the opportunities it offers to promote trade and investment, which are essential to our economic growth, job creation and above all, to help us reduce long-term regional and income inequalities.

Mexico belongs to North America, and its economy has become intertwined with the United States and Canada's economy as we trade and produce together for our regional market and the world. Today, the U.S. and Canada are Mexico's first and fifth largest

trading partner, respectively, while the U.S. is the number one foreign investor and Canada ranks third. Likewise, in 2021, Mexico has been the U.S.' number one trading partner and Canada's third. These numbers reflect that our nations have built an integrated production platform in a diverse number of industries including automobiles, electronics, household appliances, medical devices, machinery, and equipment, among others, as well as in agriculture, which allows the three to complement each other and ensure food security in the region.

The COVID-19 pandemic has posed unforeseen challenges to our regional integration as a result of confinements and disruptions in supply chains and put tremendous pressure on all walks of life. The pandemic made us realize how integrated we have become, how dependent on each other we have

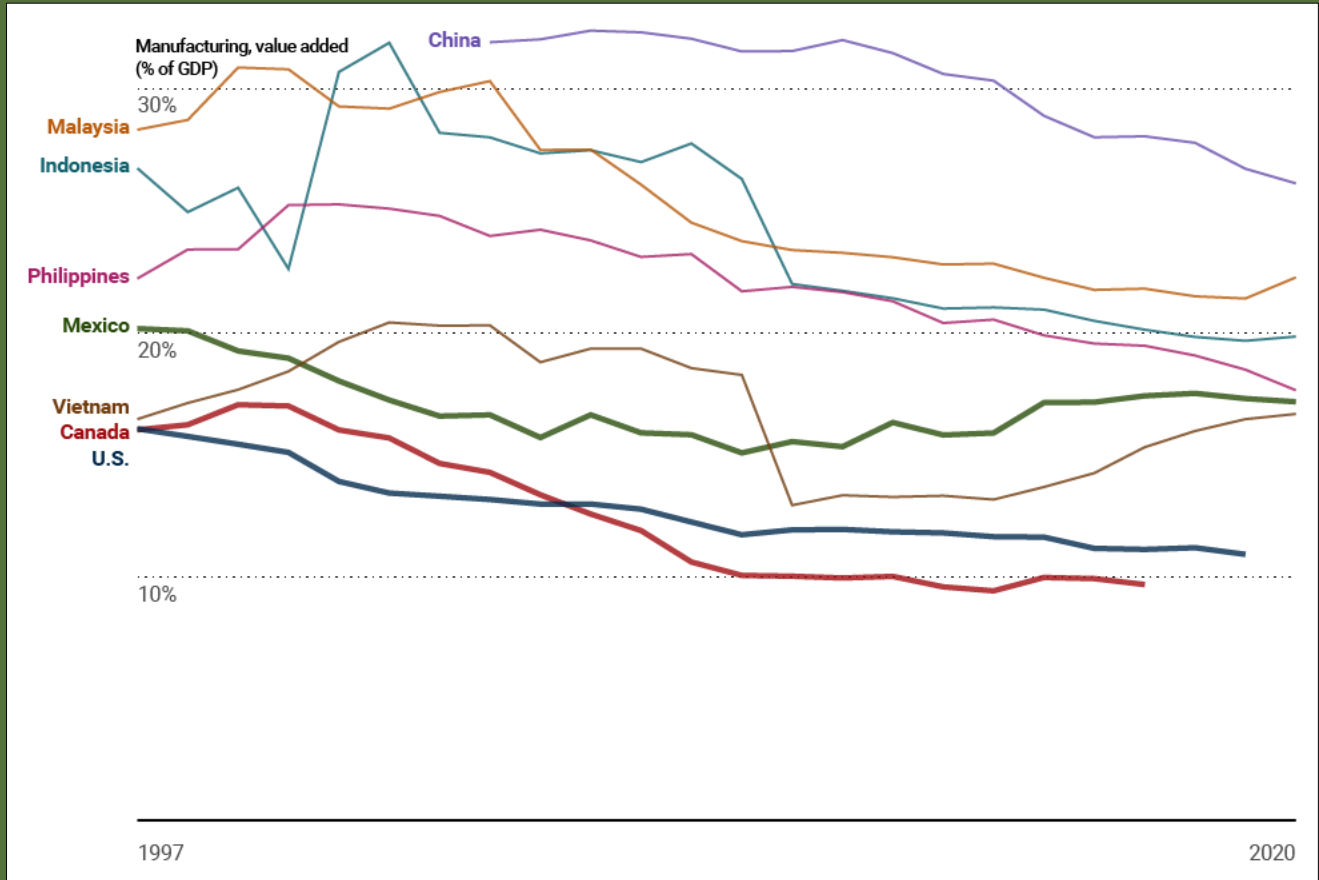
grown, and the urgency to work together in a coordinated fashion to overcome this major challenge.

The pandemic, however, has also unleashed protectionist trends as an apparently easy way out to reduce the vulnerabilities of supply chains and build more resilient economies. However, this is a wrong premise for the world and certainly for North America. Protectionism is an ill-advised trade policy at this moment. Today, we need closer collaboration and deeper integration, more coordination and more dialogue. The region does not need unilateral solutions or isolationist measures. This is why Mexico voiced its deep concern about a recent protectionist proposal introduced in the U.S. Congress that wrongly aims at diverting electric vehicle production to the U.S. by offering discriminatory tax incentives.

**GRAPH 2**

**Manufacturing value added as a share of GDP in North America and select Asian economies, 2020**

Mexico is the only country increasing manufacturing as a share of GDP over the last 15 years.



Source: World Bank Development Indicators (2020).

Such policy proposal is deeply troubling because it directly contradicts the spirit of the USMCA as it intends to divert investment and production of these types of vehicles to the U.S. while it would in fact disarticulate the North American automobile supply chain. Such a move would have dramatic consequences not only for the Mexican auto industry but also for the U.S. since it would reduce the ability of U.S. manufacturing to produce with its most important

trading partners, at a very high cost to the U.S. and to North America. The way for North America to be competitive vis-à-vis other regions is by deepening our integration, not by isolating our economies.

Our USMCA partnership provides the ideal framework to enhance cooperation to face current and future challenges and ensure that North America remains as one of the most dynamic and competitive regions in the world.

In 2022, Mexico will continue to work with its North American partners to build a strong, resilient, and competitive region. In this way, we will make sure that we offer the prosperity that our people deserve.





**Katherine  
Tai**

**United States Trade  
Representative**

# USMCA Priorities for the United States in 2022

The USMCA is the cornerstone of North America's economic future and a reflection of the ongoing evolution of trade policy in response to contemporary challenges. This agreement, revised with landmark protections for workers and the environment coupled with new and enhanced enforcement tools, came after an intensive renegotiation process with Canada and Mexico involving a broad range of stakeholders on both sides.

Sustained bipartisan engagement here in the United States led to a final, renegotiated USMCA that secured robust levels of support in Congress not seen since the North American Free Trade Agreement (NAFTA). Dozens of groups, including the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), the U.S. Chamber of Commerce, the NETWORK Lobby for Catholic Social

Justice, and state and local leaders across the country ultimately endorsed the new agreement.

**The overwhelming support for the USMCA creates a strong foundation for the Agreement's durability. Full implementation and enforcement of the USMCA are top priorities for the Biden-Harris Administration, and a key component of a worker-centric trade policy.**

**The Agreement reflects the United States' commitment to raising wages and empowering workers, and it recognizes that workers and producers are central to creating more productive and competitive North American economies.**

The labor and environmental obligations, the strongest of any trade agreement, are fully enforceable through new tools and mechanisms that we actively

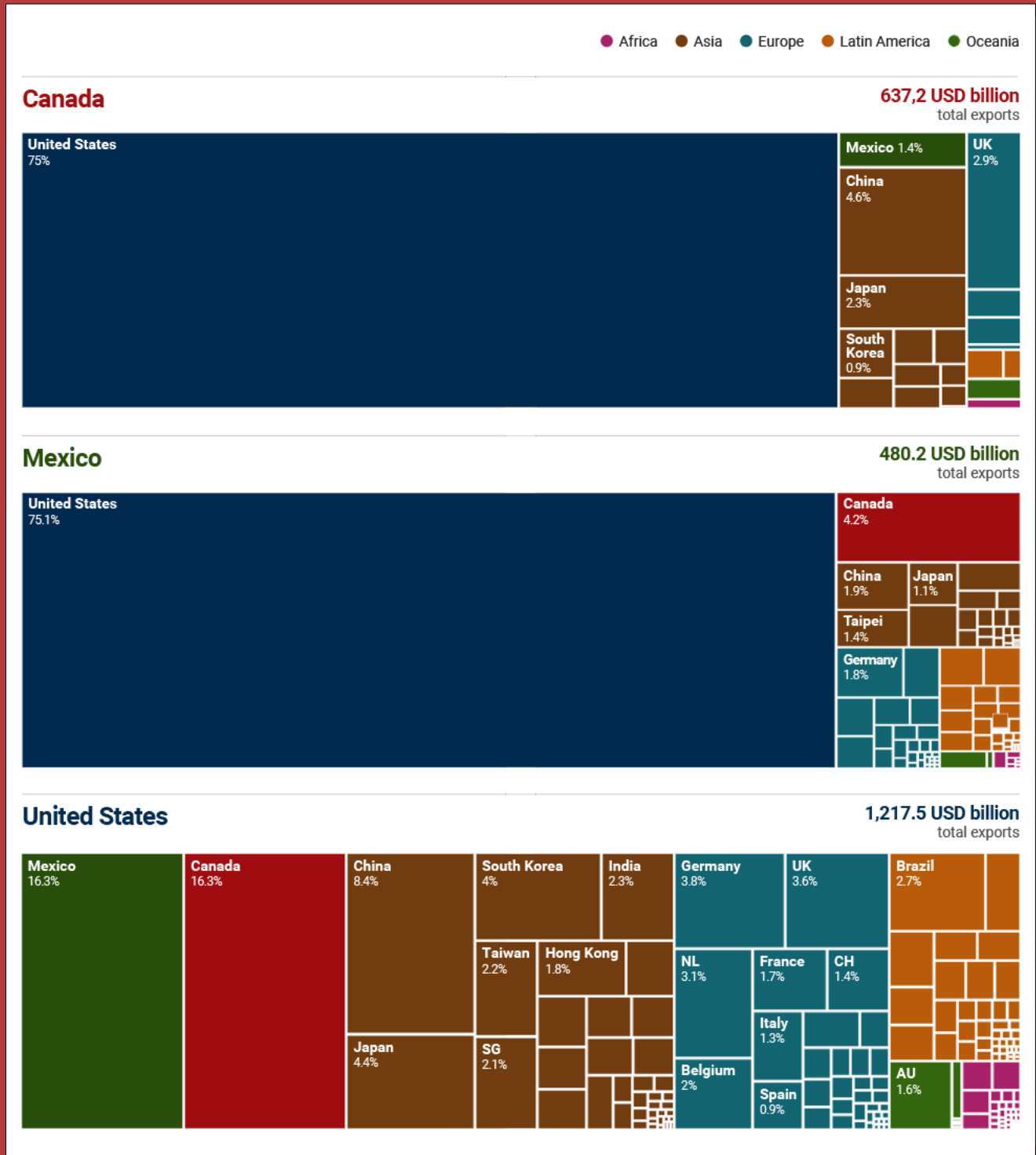
employed in 2021. These include the obligation to identify and ban imports of goods produced with forced labor. This demonstrates North America's leadership to eliminate this practice from our supply chains as a moral imperative and a term of fair economic competition.

The groundbreaking Rapid Response Mechanism gives the United States the opportunity to proactively support Mexico's domestic labor justice reform efforts and empower workers in Mexico and the United States at the same time. In May 2021, the United States self-initiated a labor enforcement action under a trade agreement for the first time in history. We resolved another matter that led to severance and back pay for Mexican workers and a commitment to neutrality in future union elections.

**GRAPH 3**

**Where do North American exports go to? (2021)**

Canada and Mexico are the largest export markets for the U.S. —twice that of China. The U.S. is an even more important destination for Canadian and Mexican exports.



Sources: The Observatory of Economic Complexity (2022); Statistics Canada Table 12-10-0011-01 (2022).

“ THE USMCA WILL HELP NORTH AMERICA MEET THE CHALLENGES OF THE 21ST CENTURY AND FACILITATE A ROBUST AND JUST PANDEMIC RECOVERY. ”







©Photo credit: Reuters

Our actions are aimed at driving a race to the top in trade and raising regional labor standards. But our commitment to workers and producers does not stop with the Rapid Response Mechanism.

Earlier this year, the United States prevailed in the first dispute settlement panel under the Agreement that reviewed whether Canada's allocation of its dairy tariff-rate quotas undermined the ability of American exporters to sell a wide range of dairy products to Canadian consumers. Delivering on this historic win will ensure that American dairy farmers get the full benefit of the USMCA to market and sell their products in Canada – a promise critical to securing the support of agricultural and rural stakeholders for the USMCA.

Importantly, the USMCA will help North America meet the challenges of the 21<sup>st</sup> century and facilitate a robust and just pandemic recovery. The critical changes to the intellectual property provisions will help promote access to affordable medicine for all. The Agreement's conservation commitments will also contribute to North America's sustainability and resilience efforts.

The Agreement also confronts the non-market practices of countries outside the region that force our workers and businesses to compete on an uneven playing field. All three countries agreed to important provisions regarding state-owned enterprises and currency manipulation. We also committed to combatting efforts to undermine existing antidumping, countervailing duty, and safeguards measures.

In approving the USMCA, Congress delivered on a vision for ongoing implementation and monitoring of the Agreement's terms. The \$180 million authorized over four years will support Mexico's labor reforms through technical assistance and enhancing United States' efforts to monitor and enforce the agreement's environmental obligations. This funding has already led to stronger intelligence sharing and increased capacity to combat illegal take and trade in flora and fauna. It also supported new collaboration with Mexico and Canada on sustainable forest management, sustainable fisheries management, and conservation of marine species.

There is a lot to celebrate as we approach the USMCA's second anniversary, but the work of implementation is just beginning. We must use the new tools in the Agreement to effectively resolve our trade disputes and uphold the commitments made to each other. In 2022, we will work together to support regional workforce development and small and medium-sized enterprises (SMEs) while identifying ways to increase the resiliency of our supply chains, combat forced labor, protect the environment, and address the harm from state-owned enterprises.

The Biden-Harris Administration is committed to using the USMCA as a model for how trade agreements can put workers and their interests first. In the coming years, it will be critical for the United States, Mexico, and Canada to continue our close cooperation to ensure the USMCA remains a living agreement that delivers inclusive economic growth and broadens our collective prosperity.

# A TRULY COMPETITIVE NORTH AMERICA



**LUIS F. DE LA CALLE**

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In this chapter, the role of federal and state governments, academia, research centers, and the private sector in furthering competitiveness in North America is analyzed by means of outlining the challenges and opportunities of the health sector. Increasingly, in the age of the knowledge economy, competitiveness hinges upon creating an environment conducive to maximizing the synopsis among different actors, such as needed in health, but also in other sophisticated sectors. In the end, North America's competition with other regions of the world is for technological leadership, and success requires the participation of many players.

The United States–Mexico–Canada Agreement (USMCA) modernized the North American Free Trade Agreement (NAFTA) by incorporating areas such as digital trade, state-owned enterprises, labor, environment, small- and medium-sized firms, competitiveness, anticorruption, good regulatory practices, and a functioning dispute resolution system.

While NAFTA was successful first in manufacturing and then in agriculture—and USMCA will further those gains, with the potential exception of the auto sector in light of the too strict rules of origin and in the context of transition to electric/electronic vehicle—the future economic success of North America will depend on deeper regional integration. This will require not only the effective implementation of the current agreement, a commitment from the three federal governments to adhere to the obligations, and respect for the arbitration rulings, but also the commitment of the larger North American community, including

state governments, trade unions, university systems, the private sector, think tanks, and non-governmental organizations.

With most traditional trade barriers (e.g., import duties) eliminated in the region long ago and relatively low most favored nation duties for the rest of the world—further economic integration will be contingent on the regulatory environment and technological advancement in North America. Economic value creation increasingly depends on the level of complexity of production processes and the number of linkages between each economic sector. This emphasizes interdependence of many economic factors along the value chain: Design and intellectual property, sourcing of top-quality materials at competitive prices worldwide, availability of multiple types of inputs and technologies, branding, logistics, and sales. This applies to many sectors including high-tech, energy, autos and auto parts (electronic, not only electric, and no longer internal combustion), avionics,



©Photo credit: National Cancer Institute

machine tools, medical devices, molecular biology, and others.

China's success stems precisely from its regional competitive environment where the availability of sourcing is very rich. North America is already competitive in many sectors<sup>2</sup>, but the challenge is to deepen competitiveness by improving conditions for innovation that happen in a decentralized fashion (for political reasons China is moving in the opposite direction), with a regulatory environment conducive to competition of standards and not just convergence, and by exploiting the region's significant advantages in terms of developing and attracting talent, and having a diversified and potentially cleaner energy matrix and capital markets able to finance long-term endeavors. In a technologically complex world, success hinges upon, in part, the ability to interact with a myriad of economic agents and diverse sources of innovation. Only a flexible, decentralized regulatory environment fosters such conditions. Longer-term richness and flexibility ought to be North America's main advantages over a centralized and more rigid system such as China's.

Mexico has the potential to play a significant role in the production processes of most of these sectors, but it would require a significant shift (if not 180 degrees turn) in policy areas related to logistics, energy, research and development, and rule of law. USMCA can be a catalyst for these developments. For example, Mexico could support the regional health sector—one of the largest (and growing) sector in most economies—with the USMCA driving deeper integration and improving competitiveness in this area. Similar arguments could be made for other sectors as well.

### **The health sector and its role in strengthening competitiveness**

Healthcare is not only the largest (and growing) sector in most economies, but also one of the more complex. It involves a long value chain with complicated links that can be capital intensive (when research and development are required). It also entails sophisticated manufacturing and strict quality and sanitary controls, while being labor intensive, particularly mid- and downstream in the provision of healthcare. Most of the time, policy analysts focus on the sector's costs as it impacts government budgets. However, healthcare is also a significant area for value added creation and jobs for the region.

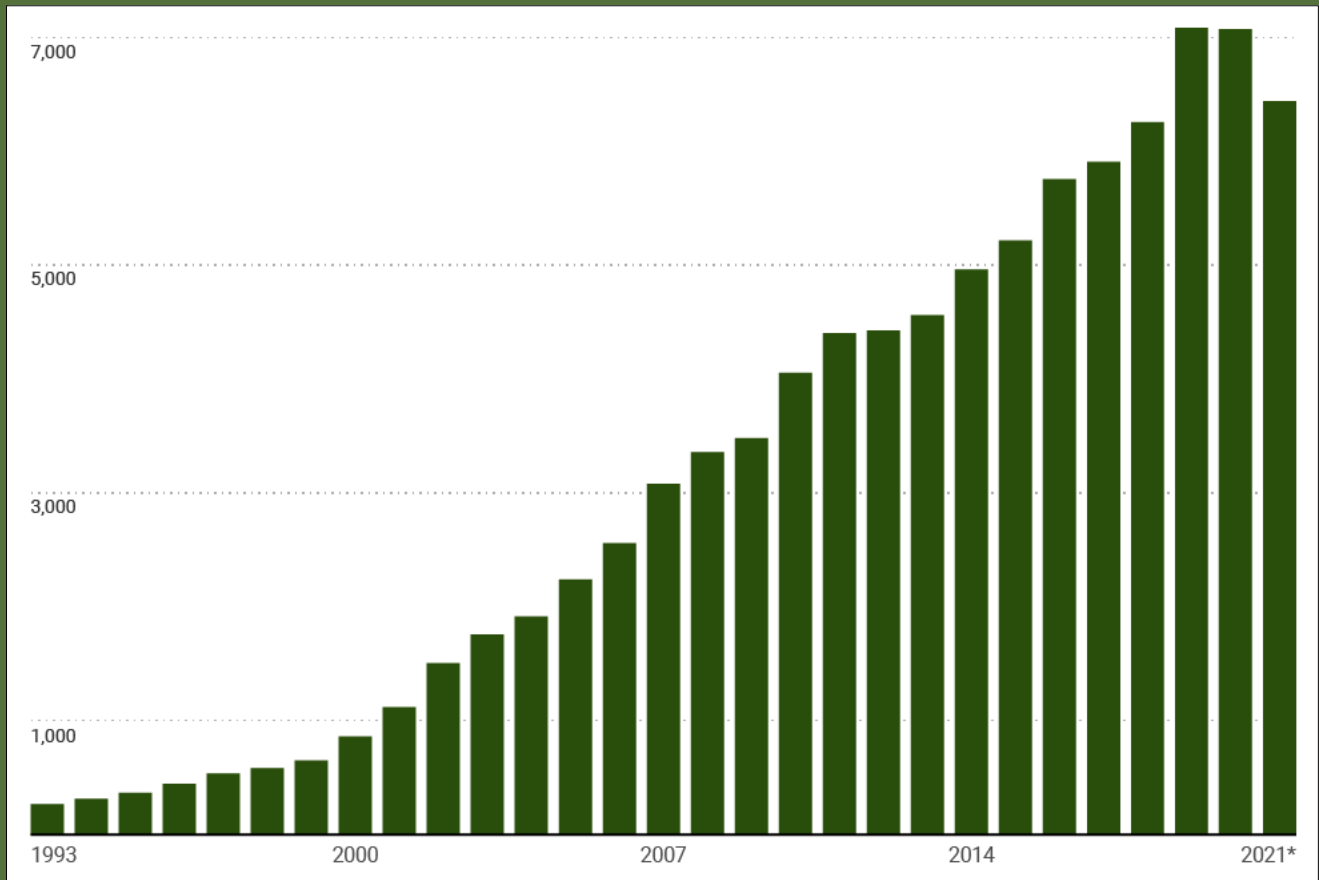
**“NORTH AMERICA IS ALREADY COMPETITIVE IN MANY SECTORS, BUT THE CHALLENGE IS TO DEEPEN COMPETITIVENESS BY IMPROVING CONDITIONS FOR INNOVATION THAT HAPPEN IN A DECENTRALIZED FASHION.”**

Traditionally, most trade agreements, including USMCA, are silent in terms of the health sector due to the mostly local nature of its services. However, the COVID-19 pandemic has made clear the interdependence of healthcare across borders, and also the risk of relying only on one or two sourcing countries. For this reason, there is now a conscious effort by policymakers to ensure sourcing diversification in the health sector and leverage its potential for strengthening competitiveness.

As Graph 4 shows, Mexico is already one of the largest suppliers of medical devices and medication to the U.S. (competing head-to-head with China): Surgical clothing, scalpels, stents, orthopedic gear, dental equipment, and many others. The COVID-19 pandemic has proven Mexico is a reliable supplier of these essential products; nearshoring and diversification of supplier risk mean more production will be done in the region.

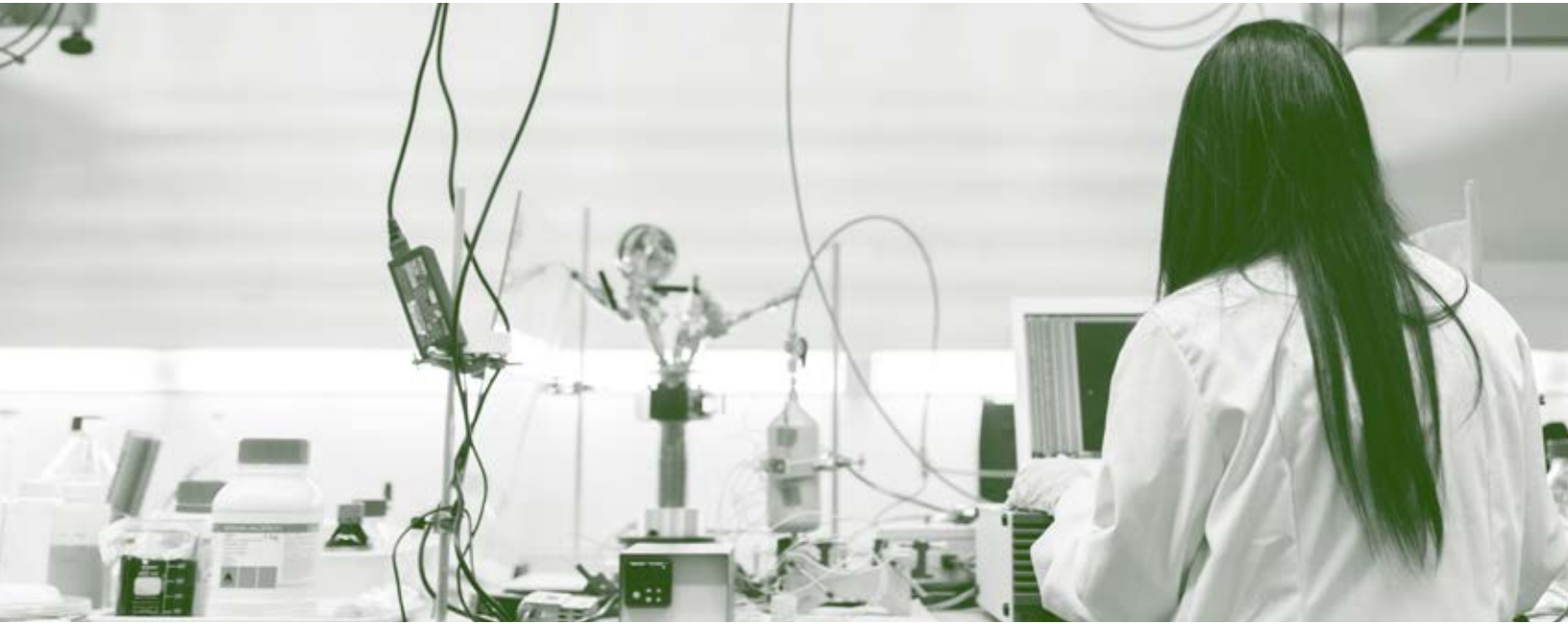
Furthermore, Mexico increased nearly 10 percentage points its market share of these exports to the U.S. between 2001 and September 2021 (from 20 to 28 percent), as the following graphs show:

**GRAPH 4** Mexico's exports of medical, surgical, dental, or veterinary sciences devices to the U.S. (1993-2021), in millions of dollars



\*January-September  
\*Source: U.S. International Trade Commission (2021).





© Photo credit: ThisisEngineering RAEng

Mexico increased nearly 10 percentage points its market share of medical devices and medications in the U.S. between 2001 and 2021

from  
20%  
to  
28%

Graph 5 illustrates Mexico’s potential to continue the upward trend, but to fully benefit, it needs to develop competitive production of key inputs of medical devices, such as specialized steels and aluminum, resins and plastics, and glass and fiber glass (all these are natural gas intensive and North America is the most competitive region in the world for this essential input), and increase investment in research and development (R&D). Medical devices, pharmaceuticals, and molecular biology are similar to advanced manufacturing in that they thrive in an environment that promotes innovation through applied R&D and where multiple linkages between industrial and services sectors are present. Moreover, this is consistent with the aim to strengthen supply chains in North America and the promotion of nearshoring to diversify exposure to Chinese risk.<sup>3</sup>

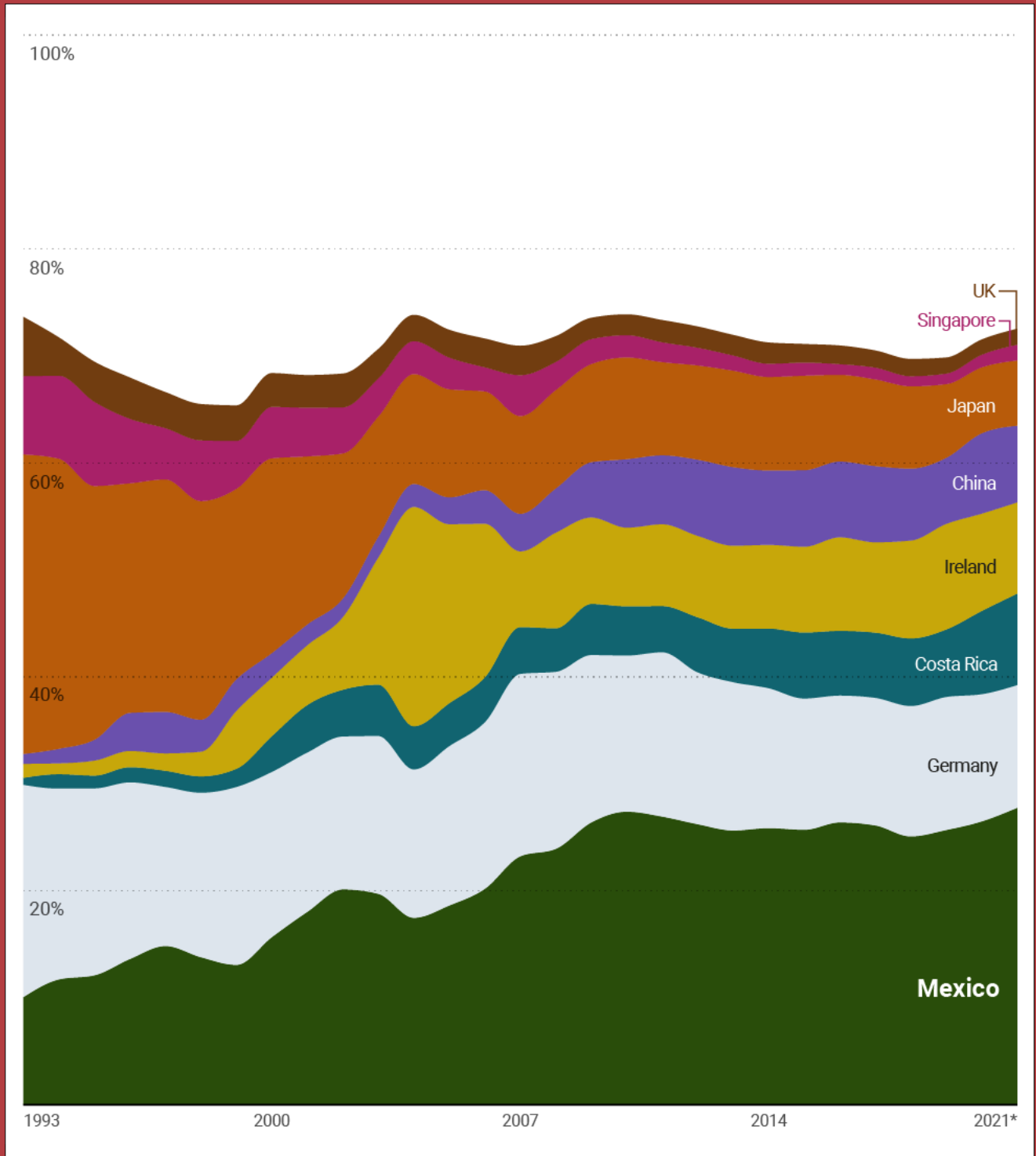
Proper implementation of USMCA can provide the framework that allows regional integration to deepen and support the health sector’s success. **Participation of multiple actors** will play an important part: Federal governments (as regulators and resource providers) but also state governments (as healthcare providers in hospitals, promoters of investment, catalysts for regulatory

compliance, source of talent through universities and community colleges), private sector investment, research centers, and think tanks. In this manner, deepening North American integration in the larger health sector depends on the participation of many decentralized actors, while USMCA serves as a framework that allows the integration to deepen. The same would apply to other sectors (including agriculture and food) as well.

**Good regulatory practices** are important parts of the sector’s success in the region. Chapter 28 of USMCA provides disciplines for consultation and regulatory review, information quality, early planning, plain language use, transparency in the development of regulations, advisory expert groups, regulatory impact assessment, and compatibility and cooperation. While these rules for a proper regulatory framework are important, promoting compliance at the firm level, particularly for small- and medium-size firms, can be useful. Otherwise, significant obstacles, in terms of accessing high quality inputs and ensuring best manufacturing practices, regulatory applications, insurance protection, and others can become insurmountable.

**GRAPH 5**

**Market share of U.S. imports of medical, surgical, dental, or veterinary sciences devices in % (1993-2021)**



\*January-September  
Source: U.S. International Trade Commission (2021).

It is in this realm that state governments can assist local manufacturers in obtaining necessary certifications, particularly cross border ones. For example, pharmaceuticals from the state of Jalisco, where many such companies are established, could be supported by the state regulatory compliance promotion office. It could help with obtaining certification from COFEPRIS, a department within the Mexican Secretariat of Health responsible for the importation of medical devices and relevant permits or, even better, from the Federal Drug Administration (FDA).

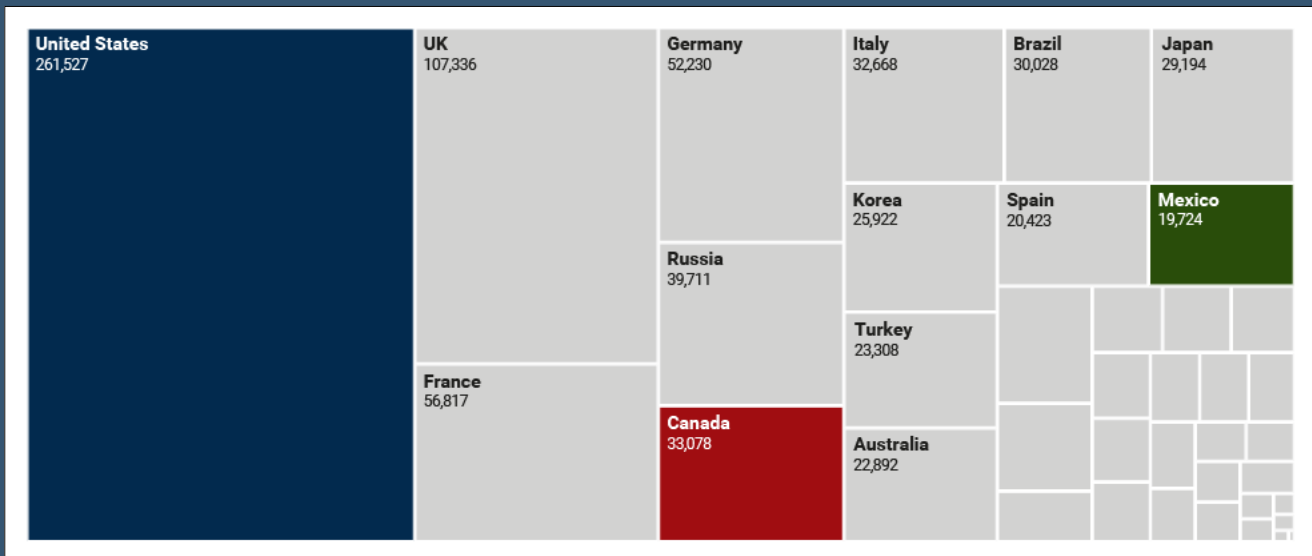
Furthermore, state authorities could help fund the establishment of laboratories to test for human, animal, and plant sanitary compliance. The lack of testing laboratory capacity can often be a barrier to participating in international trade.

On the pharmaceutical front, moving from manufacturing to the development of innovative medication means a long-term and significant commitment to research. A good place to start is to set up a joint scheme with the three USMCA members so

that state healthcare systems can more fully participate in phases two and three of clinical trials. For this, partnering with networks of state hospitals is key. COVID-19 has made it clear that the institutional capacity to carry out phases two and three in clinical trials is necessary to participate in the most profitable links of the health sector value chain. A conscientious effort by state governments can make the difference so that investing in adequate institutional capacity happens.

It is in the downstream that the larger positive impact on jobs can be obtained and where Mexico can derive significant benefits. Patient care is, by its nature, labor intensive and requires a qualified labor force. The U.S. and Canada have a critical shortage of doctors, nurses, and health assistants for hospitals, clinics, retirement homes, and home care services. USMCA provides the necessary framework to mutually recognize professional degrees and issue temporary entry visas for cross-border service provision. The issuance of professional temporary entry visas under the NAFTA and now USMCA (so called TN

**GRAPH 6** Graduates per field in natural sciences, mathematics, and statistics, OECD countries + Russia and Brazil (2019)



Source: Organisation for Economic Co-operation and Development (2019).



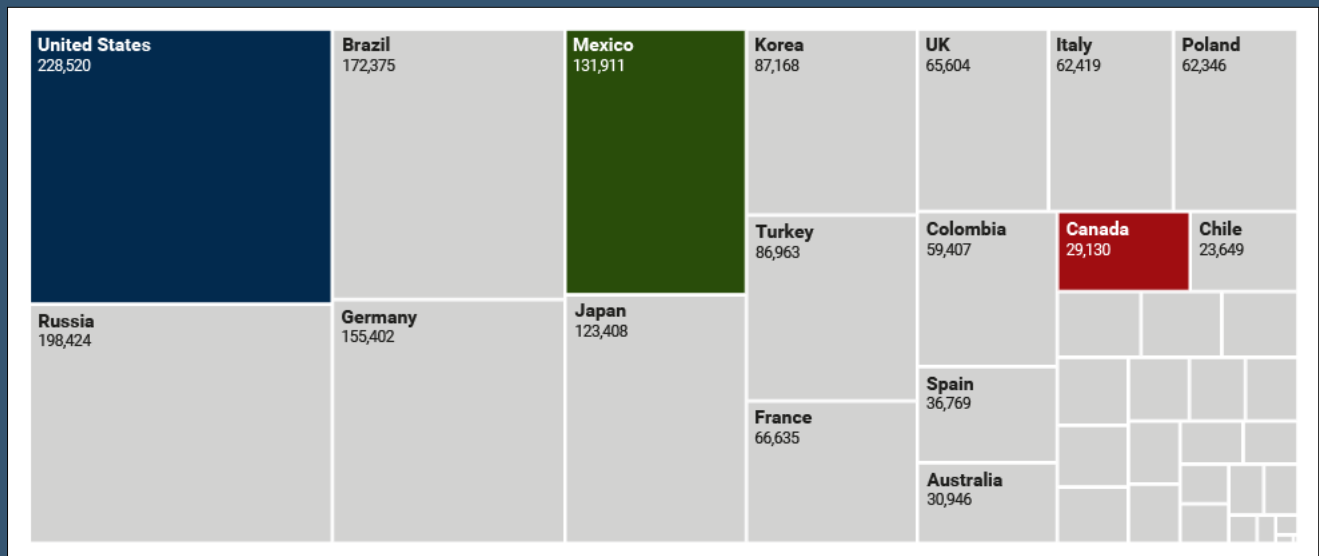
in the U.S.) has been more successful than most realize.<sup>4</sup> According to the Report from the Visa Office,<sup>5</sup> in 2015 there were 13,093 NAFTA TN visas issued. By 2019, that number had escalated to 21,193 (38.2 percent more). Although COVID-19 diminished the numbers by 2021, the trend will undoubtedly continue.

Mexico is already graduating many skilled professionals compared to other countries. The following two graphs show the absolute number of graduates in natural sciences, mathematics, and statistics, as well as engineering, manufacturing, and construction. In natural sciences and mathematics, Mexico has significant room to grow (Graph 6), while it leads (Graph 7) in engineering, manufacturing, and construction (not surprisingly, given NAFTA).

For the health sector, the number of Mexican graduates is also already significant, but insufficient for the expansion that can be envisioned, as shown in Graph 8. Mexico’s healthcare workforce should aim to reach at least the levels of Brazil in the next five years.

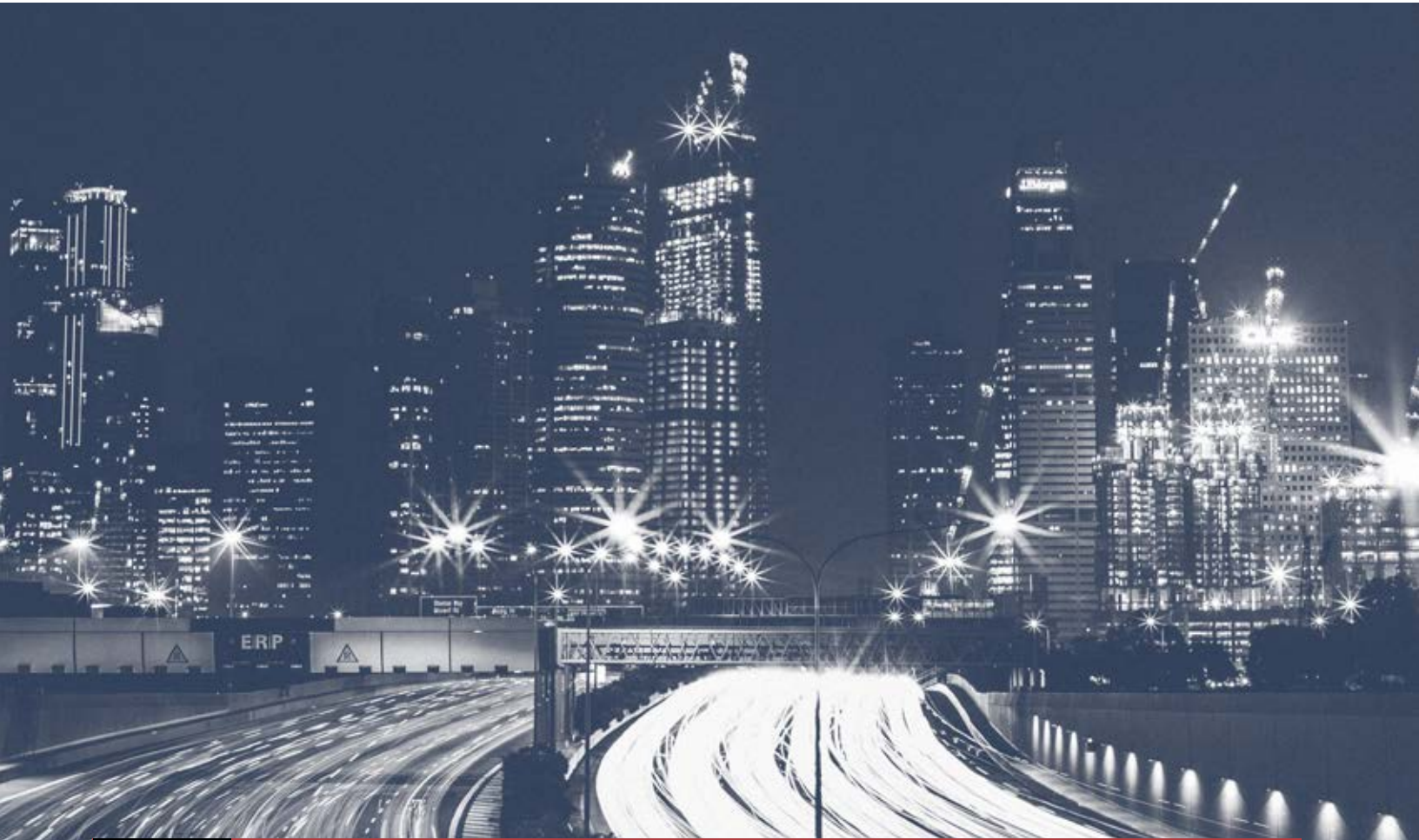
However, to really take advantage of the opportunities from more integration and use of talent in healthcare, much more needs to be done, especially at the state level. The principal constraint is on the supply side. Mexico has the young cohorts that could potentially participate, but they lack the proper training and certification to do so. A concerted effort to enroll healthcare students (especially nurses) in professional training courses, to make sure they become proficient in English and partner with key counterparts in the U.S. and Canada, are essential. The role of state governments is crucial in terms of strengthening career training for nurses in universities, as well as technical and vocational schools, for other health-related trades. Some state governments in Mexico could undertake this effort, while California, Texas, and other U.S. states could participate with large student exchange programs. The resulting “bilateral” students could be more easily certified to work in both countries.

**GRAPH 7** Graduates per field in engineering, manufacturing, and construction, OECD countries + Russia and Brazil (2019)



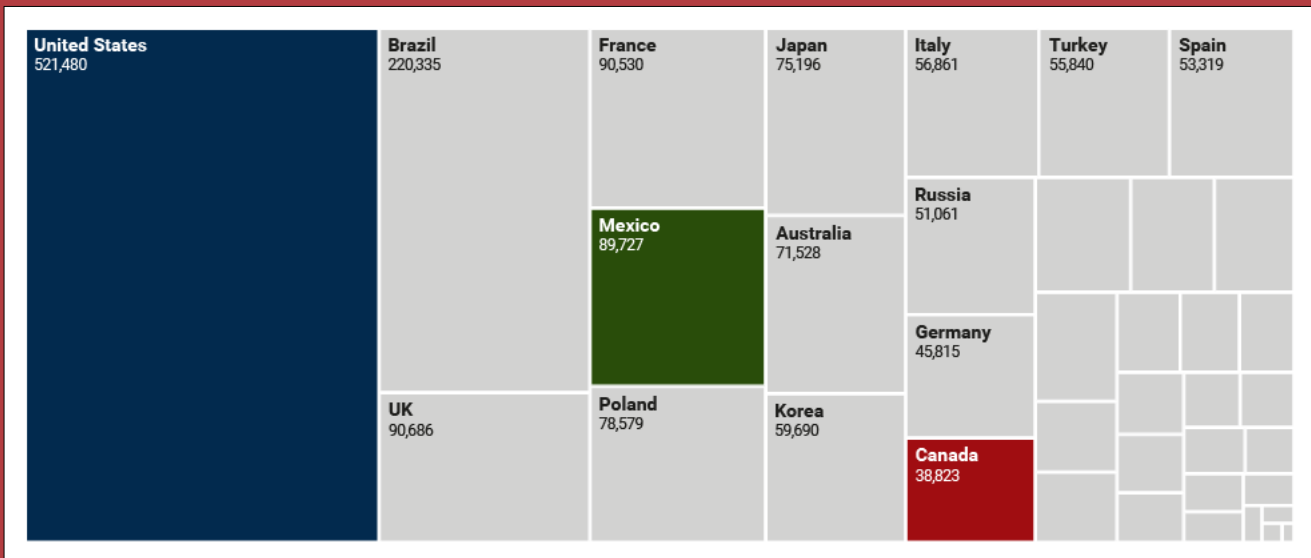
Source: Organisation for Economic Co-operation and Development (2019).

©Photo credit: Thaddaeus Lim



**GRAPH 8**

**Graduates per field in health and welfare, OECD countries + Russia and Brazil (2019)**



Source: Organisation for Economic Co-operation and Development (2019).

There is a strong demand for these types of experience and training, so that qualified candidates can be binationally certified and more easily find jobs or obtain visas. On the visa front, an important improvement may be to issue multiple and not only temporary entry visas so that healthcare personnel can spend part of the year overseas and the rest back home.

Some in Mexico may object to the idea of “exporting” health sector talent to the U.S. and Canada; they may fear the country may lose nurses and other health professionals who are not easy to replace. The concern is even more acute in the absence of an ambitious program to significantly increase their numbers. The fear, however, is unfounded. The number of health professionals is not fixed. Moreover, a constant stream of trained personnel would generate significant revenues as compensation in the sector is higher than average wages and much higher than wages in manufacturing in the country.

Furthermore, the expansion of health training and facilities could support the growth of medical tourism, so that a growing number of patients are treated in the country. Mexico has significant comparative advantage for medical tourism, for both short- and long-term care: A young trainable labor force, year-round welcoming weather, a large network of airports (more than 30) that serve directly from the U.S., same time zones, and well-known hospitality service. Medical tourism in Mexico is already happening: Deambulatory in border towns such as Tijuana and Juarez, that serve patients from California and Texas, and hospitalization in Mexico City, Monterrey, Guadalajara, and Leon.

For future growth, the opportunity lies on developing adequate urban planning, environmentally sustainable water and water treatment, universities with qualified healthcare programs, and hospitals specializing in relevant branches of medicine. Fonatur, the Mexican agency responsible for developing a number of tourism destinations, including Cancún, Ixtapa, and Nuevo Vallarta, could be in charge of selecting the sites for this purpose.

Fonatur has experience designing attractive and sustainable destinations and could develop clusters of hospitals, universities, hotels, and entertainment facilities, as well as residential areas for healthcare and hospitality personnel. These clusters could become an important attraction for not only patients from North America (including Mexico) and other countries, but for talent and jobs. In terms of suitable locations, Fonatur has land already reserved south of Mazatlán, and locations near Acapulco and the San Pedro development next to Tecate at the border with California could be suitable. Digital technology can also play a role through remote surgery, connected medical devices, and electronic patient files.

In the past, insurance coverage and Medicare reimbursement were seen as prerequisites for securing investments in medical tourism, making it difficult for this industry to thrive in Mexico. A better approach may be to illustrate the industry’s potential for providing high quality healthcare services at competitive prices, to then become attractive for insurers. The growing community of U.S. nationals—currently at two million and considered the largest in the world—that reside almost permanently in Mexico could become a large market for this industry.

A fully integrated and competitive healthcare industry in Mexico would allow it to compete in an industry where innovation and technology play significant roles. USMCA membership offers Mexico a comparative advantage in this area, but it is insufficient. Realizing its full potential requires complementary efforts by many actors: Federal and state governments, regulators, universities, think tanks, NGOs, and private sector investment. Deepening integration in other complex sectors need an integrated vision as well.

## ENDNOTES

- 1 Compared to most other trade agreements, Article 303 of NAFTA and USMCA limits drawback and duty remission programs to incentivize use of regional components; a consequence of this article is to encourage lowering of MFN duties on intermediate goods.
- 2 According to U.S. Census figures several sectors have experienced significant value-added growth during 2009-2019 in the US, such as motor vehicles bodies and trailers, magnetic and optical media, industrial machinery, household appliances, electrical equipment and components, ships and boats, while Mexico and Canada are clearly competitive in the US as they are its second and third largest suppliers. FY2019AnnualReport/FY19AnnualReport-TableXVI-B.pdf
- 3 The White House, February 24, 2021, Executive Order on America's Supply Chains. Available at: <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/02/24/executive-order-on-americas-supply-chains/> See also The White House, June 2021, Building Resilient Supply Chains, Revitalizing American Manufacturing, and Fostering Broad-based Growth. 100-day Reviews under Executive Order 14017. Available at: <https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf>.
- 4 See, for instance, "Legal Migration and Free Trade in the NAFTA Era: Beyond Migration Rhetoric", by Miguel Ángel Jiménez, Mexico Institute Wilson Center and Comexi. <https://www.wilsoncenter.org/publication/legal-migration-and-free-trade-the-nafta-era-beyond-migration-rhetoric>
- 5 Visa Office Nonimmigrant visas issued by classification (including border crossing cards) 2019 Report, US. Department of State, Bureau of Consular Affairs <https://travel.state.gov/content/dam/visas/Statistics/AnnualReports/>

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# North American business leaders' perspectives on USMCA opportunities and challenges

We are less than two years into a modernized North American trade agreement and already the United States-Mexico-Canada-Agreement (USMCA) boasts some early successes in facilitating North American economic competitiveness and resolving disputes. Despite the ongoing pandemic and border closures, merchandise, including food and consumer goods, has continued to flow to the benefit of all three countries. In addition, the digital economy has matured, with growing partnerships across North America. For the first time in 20 years, a North American State-to-State Dispute Settlement Mechanism has been used successfully. The updated consultation and enforcement mechanism in USMCA can help

resolve differences. Moreover, the greater certainty and predictability provided by the agreement can incentivize further investments to enhance innovation, sustainability, and resilience across North America.

The business communities in all three countries welcome these early gains, but the hard work lies ahead: We must ensure USMCA generates an enduring positive impact on the economies of all our countries to benefit workers, businesses, and customers.

Our countries face many headwinds, including economic recovery, climate change, rapidly changing technologies, and the need for greater economic security and resiliency. Fully



implementing and enforcing USMCA can help North American leaders tackle these opportunities and challenges together.

In support of a more coordinated North American economy, business leaders were pleased to see the release of bilateral frameworks in 2021: The Roadmap for a Renewed U.S.-Canada Partnership and the U.S.-Mexico High-Level Economic Dialogue. In addition, we welcomed

early efforts to enhance cooperation and coordination through the first North American Leaders Summit in more than five years.

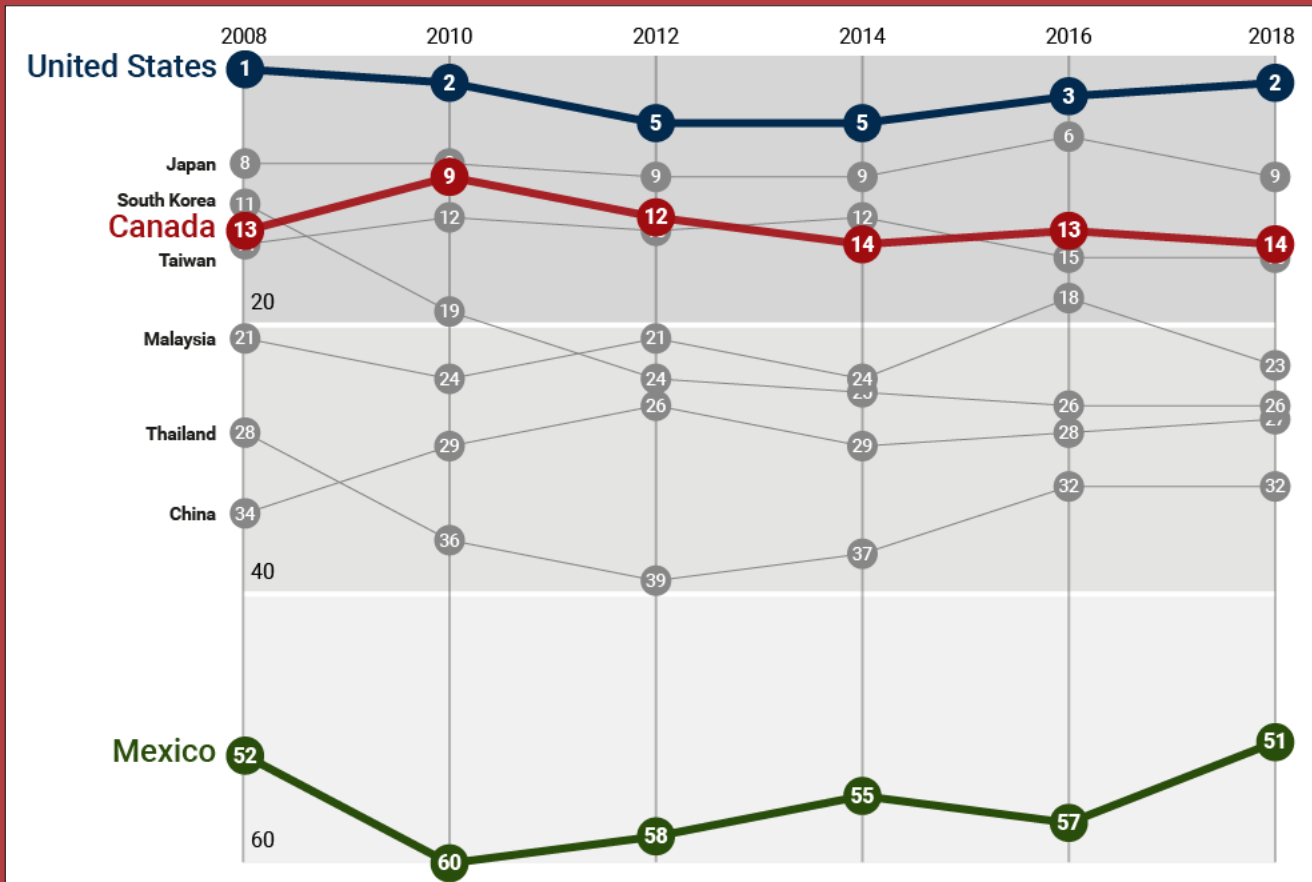
These engagements send the right signal that the future of the North American economy depends on working together at the highest levels to translate the promise of USMCA into results for citizens across the region.

Full implementation and enforcement of USMCA will sustain broad political and stakeholder support for the agreement. Our governments, business stakeholders, and civil society all invested considerable effort, supported the negotiations, and made compromises to reach this historic framework. Yet we are seeing some significant and worrying examples of our three countries developing policies that clearly undermine

GRAPH 9

Global Competitiveness Index rankings in North America and select Asian economies, 2008-2018

Mexico competitiveness is lagging in North America, but also globally.

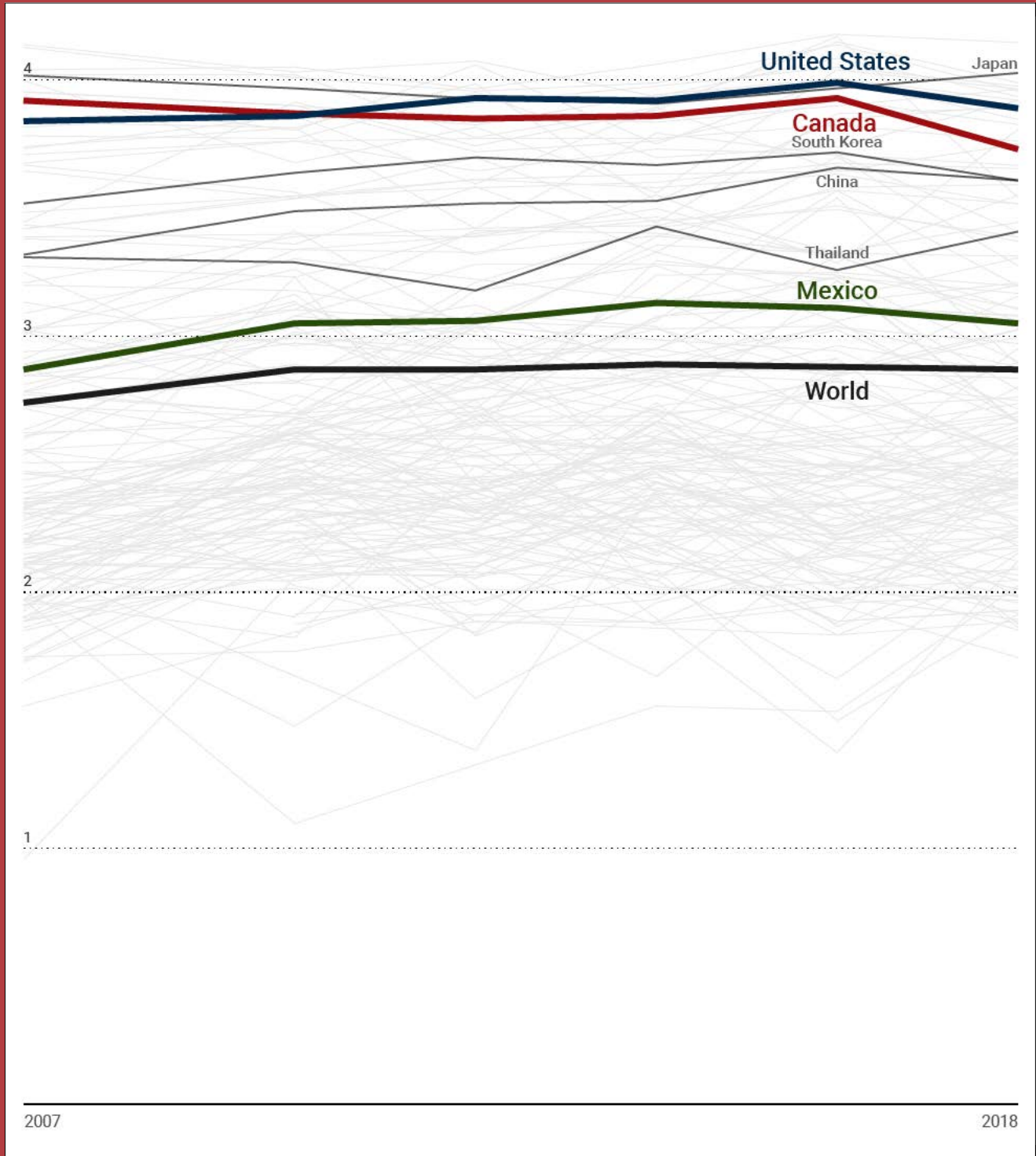


Source: World Economic Forum, Global Competitiveness Index (2007-2018).

**GRAPH 10**

**Logistics Performance Index in North America and select economies, 2012-2018**

Logistics is an enabler of supply chains, highlighting the need for the U.S., Canada, and Mexico to reverse the downward trend to remain globally competitive.



Source: World Bank's Logistics Performance Index (2012-2018).

the objectives and commitments embodied in the agreement. We urge our governments to focus on the opportunity that North America presents to boost our mutual competitiveness and commit to resolving pressing policy challenges by demonstrating shared commitment to USMCA and its provisions.

Finally, we call on all three governments to fully harness the USMCA's various committees, including the innovative USMCA Competitiveness Committee, to enhance supply chain resiliency and drive sustainability and innovation in the region.

Through USMCA, we have an unprecedented opportunity to strengthen North American supply chains and improve our competitiveness. The private sector stands ready to partner on the development and implementation of an ambitious USCMA and North American agenda to empower our businesses and workers to better compete in the world.

“

**THE BUSINESS COMMUNITIES IN ALL THREE COUNTRIES WELCOME THESE EARLY GAINS, BUT THE HARD WORK LIES AHEAD: WE MUST ENSURE USMCA GENERATES AN ENDURING POSITIVE IMPACT ON THE ECONOMIES OF ALL OUR COUNTRIES TO BENEFIT WORKERS, BUSINESSES, AND CUSTOMERS.**

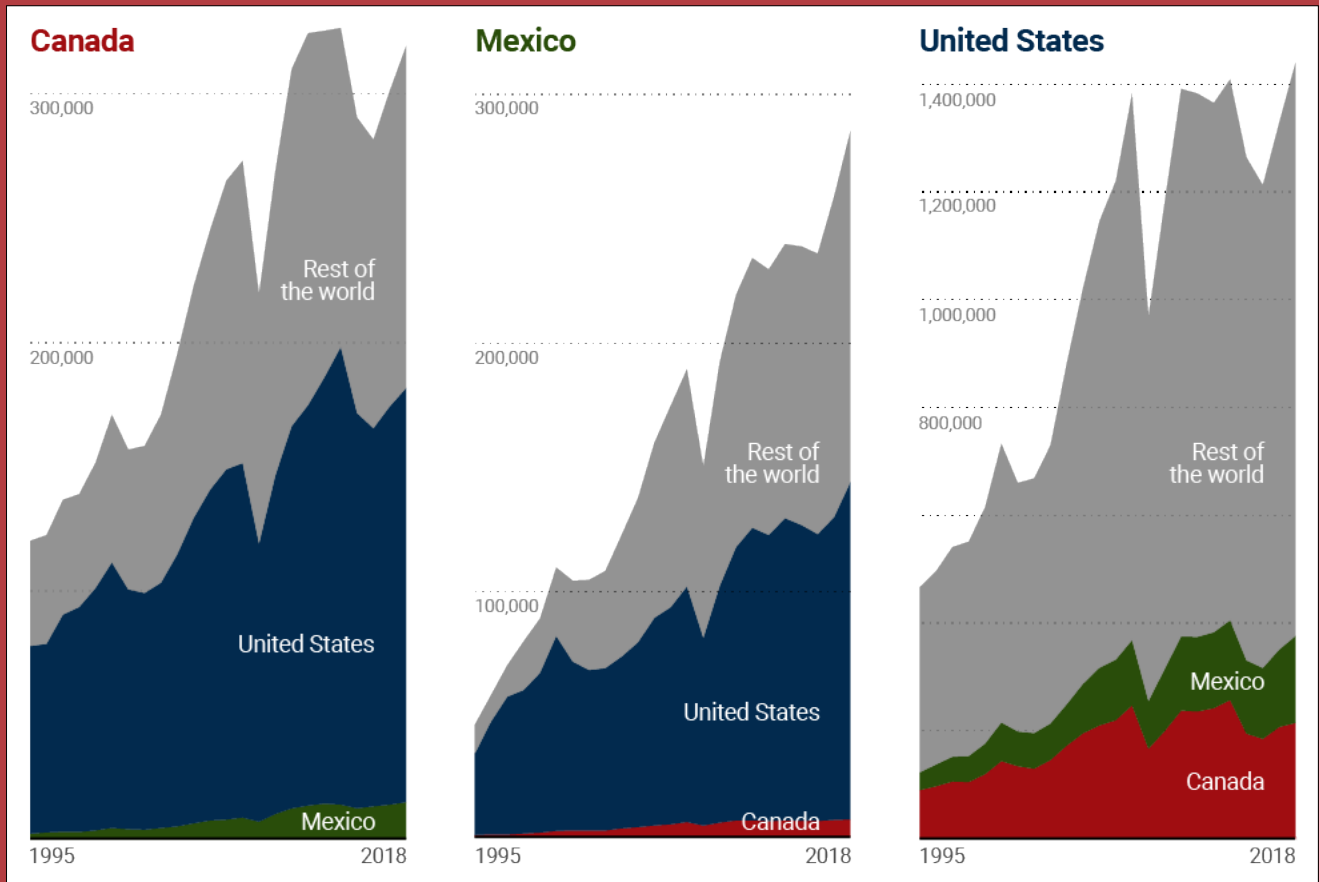
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**GRAPH 11** Trade in intermediate goods and services in North America

The importance of supply chains means growing trade in intermediate inputs among North American partners and globally.



Source: OECD Trade in Value Added (2021).

# MEXICO'S EVOLVING ROLE IN GLOBAL SUPPLY CHAINS



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The events of 2018-2020 have highlighted the risks of extended global supply chains, especially ones that rely on one or more key inputs produced in only one or a small number of locations. This turbulent period has included the U.S.-China trade war in which export controls were imposed on hi-tech inputs and a 25 percent tariff levied on many ordinary products traded between the U.S. and China. The COVID-19 pandemic has also been a huge shock that has disrupted supply and demand patterns all over the world. There also seem to be an increasing number of local environmental disasters tied to climate change affecting supply chains, notably, floods in Thailand, China, and Germany; wildfires across the American West; and deep freeze in Texas.

In response to the growing awareness of risks, the vast majority of firms are trying to build more resilience into their supply chains. Furthermore, the infrastructure bill should strengthen America's role as a producer by reducing transport and power bottlenecks. The effort to improve resilience, however, does not take all firms in a similar direction. The total volume of imports into the U.S. keeps increasing, both from China and other countries, suggesting that there is no general move to reshore, though it is likely to happen to some extent in semi-conductors and other hi-tech sectors owing to U.S. government incentives. Beyond those specific products, there was a big surge in demand for consumer durables in the U.S. as a result of the pandemic, and much of this was met by imports from Asia. Resilience may come from changes such as holding more inventories or diversifying suppliers to several locations abroad, rather than shortening value chains.

The extension of the free-trade agreement of North America, now named the United States-Mexico-Canada Agreement (USMCA) coincided with these shocks, coming into effect July 1, 2020. The agreement provides strong incentives for integrated production among these three economies, compared to no agreement, but only modestly increased incentives compared to the previous NAFTA. The main change was increasing the required share of content for autos that must come from within USMCA in order to qualify for tariff-free trade. There was also a new requirement that effectively limited Mexico's share of automobile value added by requiring that a certain amount of value added come from high-wage locations. In that sense the agreement is a mixed blessing for encouraging Mexico's role in manufacturing value chains. But leaving aside autos, for example in the all-important electronics sector, the incentives to involve Mexico in supply chains is modestly strengthened.



©Photo credit: Maksym Kaharlytskyi

A number of commentators have noted the potential for a shift of some supply chains from China to Mexico to be a critical part of the Biden administration's technology policy. Meltzer (2021), for example, argues that:

*The importance of resilient supply chains has also been made abundantly clear in light of the impact of COVID-19, and as competition with China exposes vulnerabilities to relying on Chinese supply chains. The Biden administration has ordered a review of U.S. supply chains, with the objective of decreasing American dependence on Chinese production of critical inputs. Integrated North American supply chains could provide a viable alternative to Chinese manufacturing and allow some critical industries to move production closer to home.*

Similarly, Finley et al. (2021) argue that Mexico's proximity plus the updated trade agreement put it in a good position to strengthen its role in supply chains. At the other end of the spectrum, Schott (2021) is skeptical about Mexico's potential, given its investment climate weaknesses: "intrusive Mexican business regulations, inadequate and irregular power supplies, and clogged road and rail networks." The State Department's 2021 assessment of Mexico's investment climate likewise notes that "uncertainty about contract enforcement, insecurity, informality, and corruption continue to hinder sustained Mexican economic growth."

The objective of this chapter is to examine some of the key factors that will determine how much Mexico advances as a manufacturing location deeply involved in supply chains and what policies would enhance this shift. The next section details the startling fact that value chains are deeply embedded in East Asia for good reasons – of scale and diversity of the economy. It will not be easy to displace China from value chains, as it produces about 30 percent of global manufacturing value added. Also, Mexico is integrated to some extent with the East Asian value chains. So, from Mexico's point of view, its manufacturing sector is more likely to thrive if it remains connected to Asia,

for example, through new trade agreements. Cutting East Asia out of supply chains is mostly unrealistic. There may be particular military items where it is important to have a closed North American supply chain, but this will be expensive and should be limited to products of clear military importance.

The other main section of the chapter looks at a number of investment climate indicators for Mexico and East Asian economies. At this point China has higher manufacturing wages than Mexico, so production is not attracted there by lower labor costs. Rather, China has a number of investment climate advantages: Excellent ports and logistics, as well as outstanding human capital. Mexico compares unfavorably not just to China but to the large economies in Southeast Asia. Those economies have three times as much manufacturing value added as Mexico. Firms that are looking to diversify out of China are likely to look first to ASEAN countries. Mexico would need to address its weaknesses in logistics and human capital in order to attract more investment and deeper involvement in supply chains.

### **Established supply chains are incredibly complex**

The global supply chains that have developed in the modern era of globalization are incredibly complex. In the decade from 2000 to 2010 supply chains lengthened for most products and became highly international, with two-thirds of world trade crossing at least two borders during the production process (*Global Value Chain Development Report 2021*). Since 2010 there has been stagnation in the length of value chains, but no observed shortening so far. Modern input-output tables enable us to trace out value chains for individual industries. Graph 12 shows the chain for China's exports of ICT equipment coming from multinational companies (MNCs) in 2016 and illustrates several points. Each observation is a country-industry pair, for example, China's steel production or U.S. financial services, that meets a threshold of contribution to the final product. The size of the bubble is the amount of value added contributed to the final output, while the vertical axis indicates the productivity of the country-industry pair.



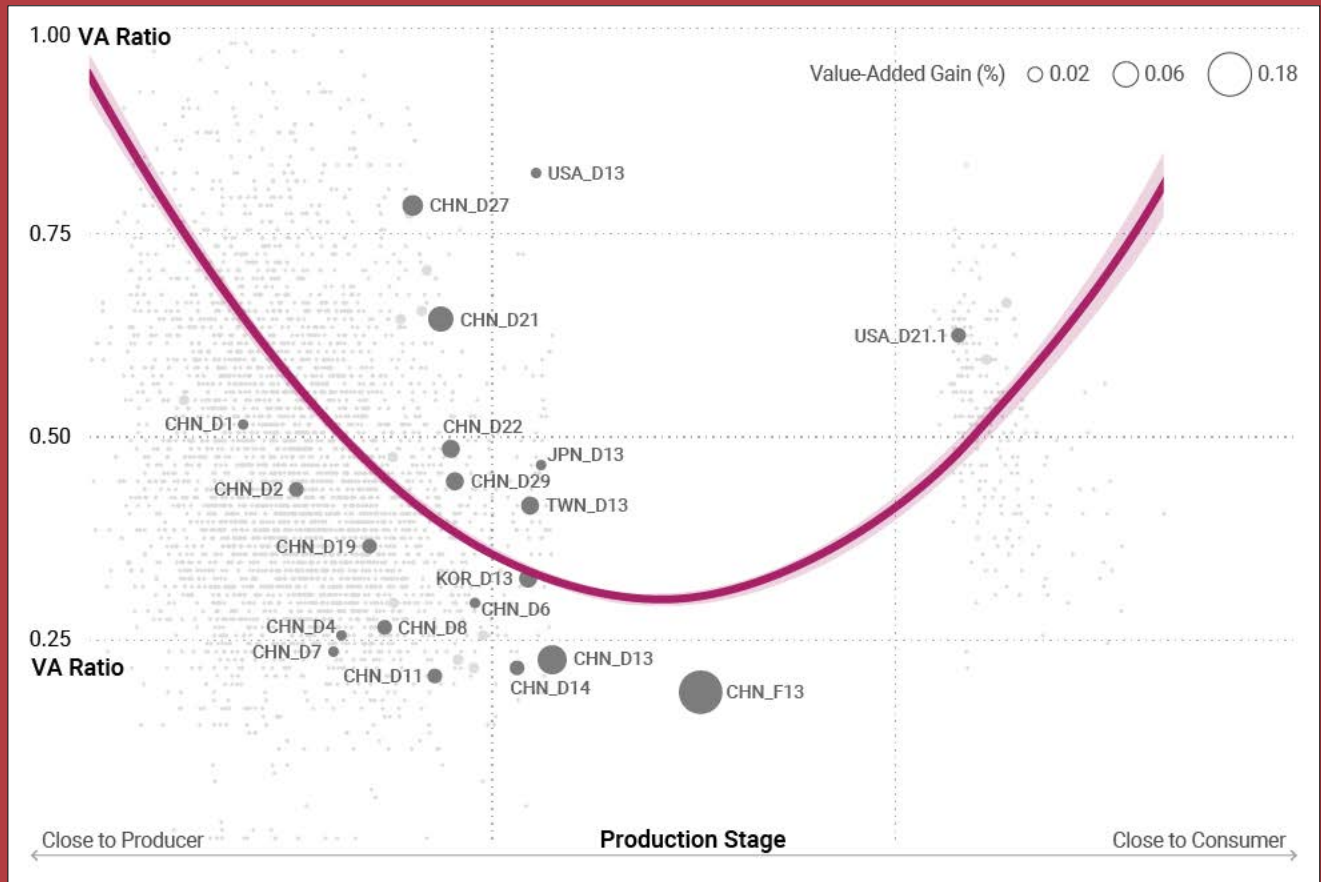
A second point is that many industries have this characteristic “smile curve” with high value added inputs early in the production process (design, finance, software, hi-tech inputs), then low-value-added assembly, and finally high-value inputs as products are transported and marketed.

A third observation is that there are dozens of industries making contributions to ICT production. Finally, while the number of inputs makes it hard to read all the observations, close inspection reveals that there are a large number of upstream contributions from Chinese industries such as finance, steel, glass, and others. This is an important change over the past decade. China used to be involved

primarily as a low-wage assembler, but now many of the upstream inputs come from China as well. Also, many upstream inputs come from nearby Asian partners such as Japan, Korea, Malaysia, or Thailand.

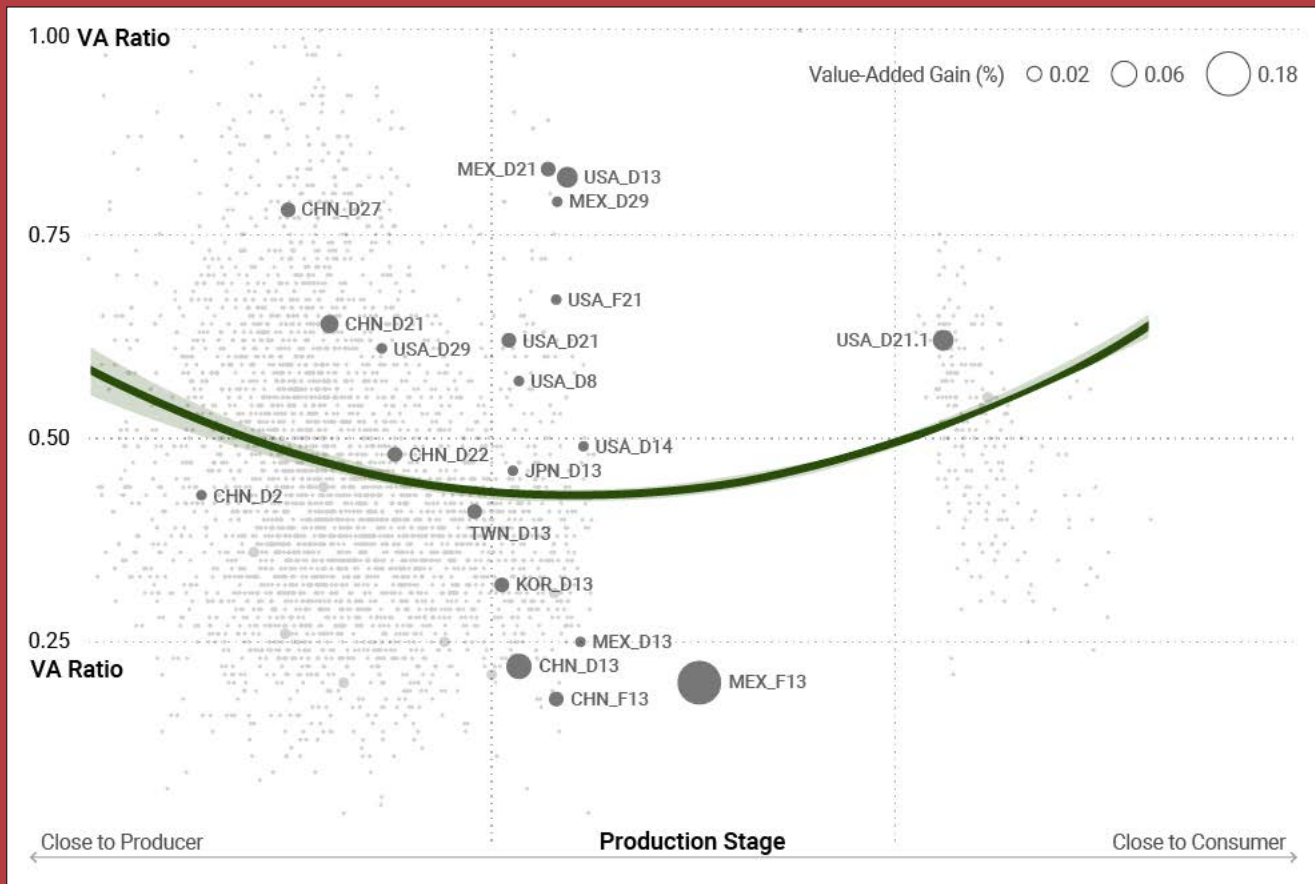
Mexico is a significant exporter of ICT equipment as well. Graph 13 shows the analogous value chain for MNC exports of ICT products from Mexico in 2016. The value-added bubble for the Mexican ICT industry is significantly smaller than the one for China, indicating that the latter is a much larger player in this sector. But otherwise the supply chain for Mexican exports is surprisingly similar to the supply chain for Chinese exports. In particular, there are a large

**GRAPH 12** Smile curve of MNCs exporting ICT products from China, 2016



Source: World Trade Organization's Global Value Chain Development Report (2021).

**GRAPH 13** Smile curve of MNCs exporting ICT products from Mexico, 2016



Source: World Trade Organization's Global Value Chain Development Report (2021).

number of different Chinese imports that contribute upstream to Mexican production. There are also contributions from the other Asian economies such as Japan, Korea, Malaysia, and Thailand. One immediate conclusion: Simply switching purchases from MNCs in China to ones in Mexico would not really reduce dependence on Chinese production because of this dominant role of China in producing intermediate inputs.

One factor to keep in mind then is the sheer scale of China's manufacturing sector. Graph 14 shows manufacturing value added in Mexico, 2020, compared to China and other Asian economies. China's output was 20 times

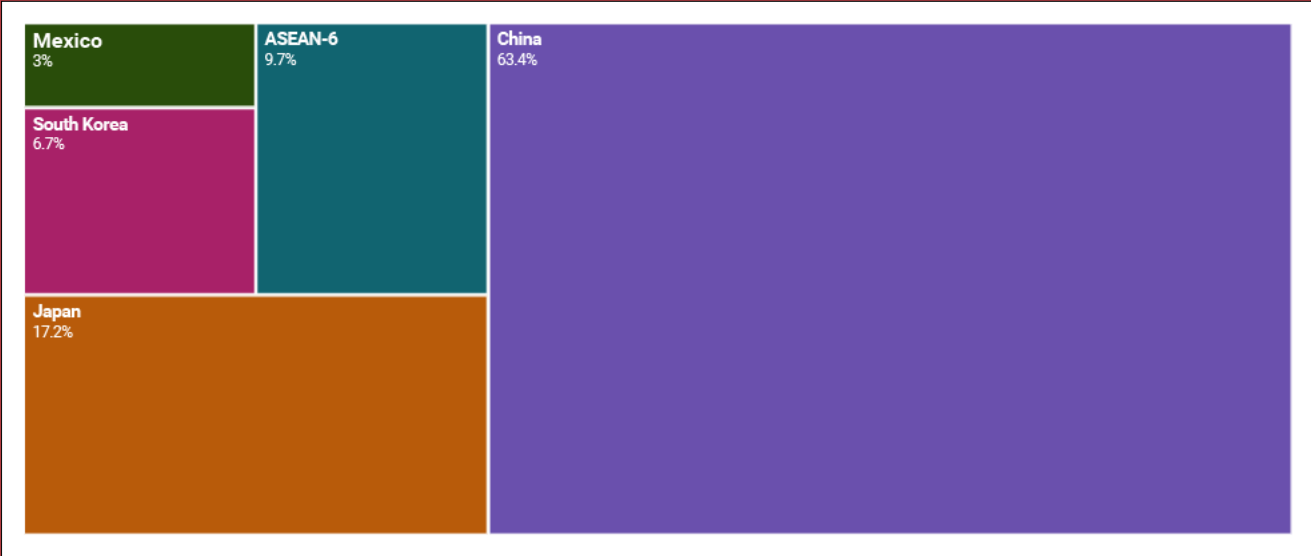
larger than Mexico's. The manufacturing value added of the six large ASEAN economies was three times Mexico's output. Given this ecology of firms in East Asia, it would be very hard to dislodge existing supply chains. Also, keep in mind that most of the manufacturing production is consumed in Asia. China, in particular, is much less export dependent than in the past. It is the largest producer of manufactures, but also the largest consumer. Many U.S. firms refer to their strategy as "in China for China," meaning that a large share of their production in China is sold in the domestic market. For this type of investment, relocating out of China makes no sense.



©Photo credit: Sid Suratia



**GRAPH 14** Relative manufacturing size, Mexico and East Asia, 2020



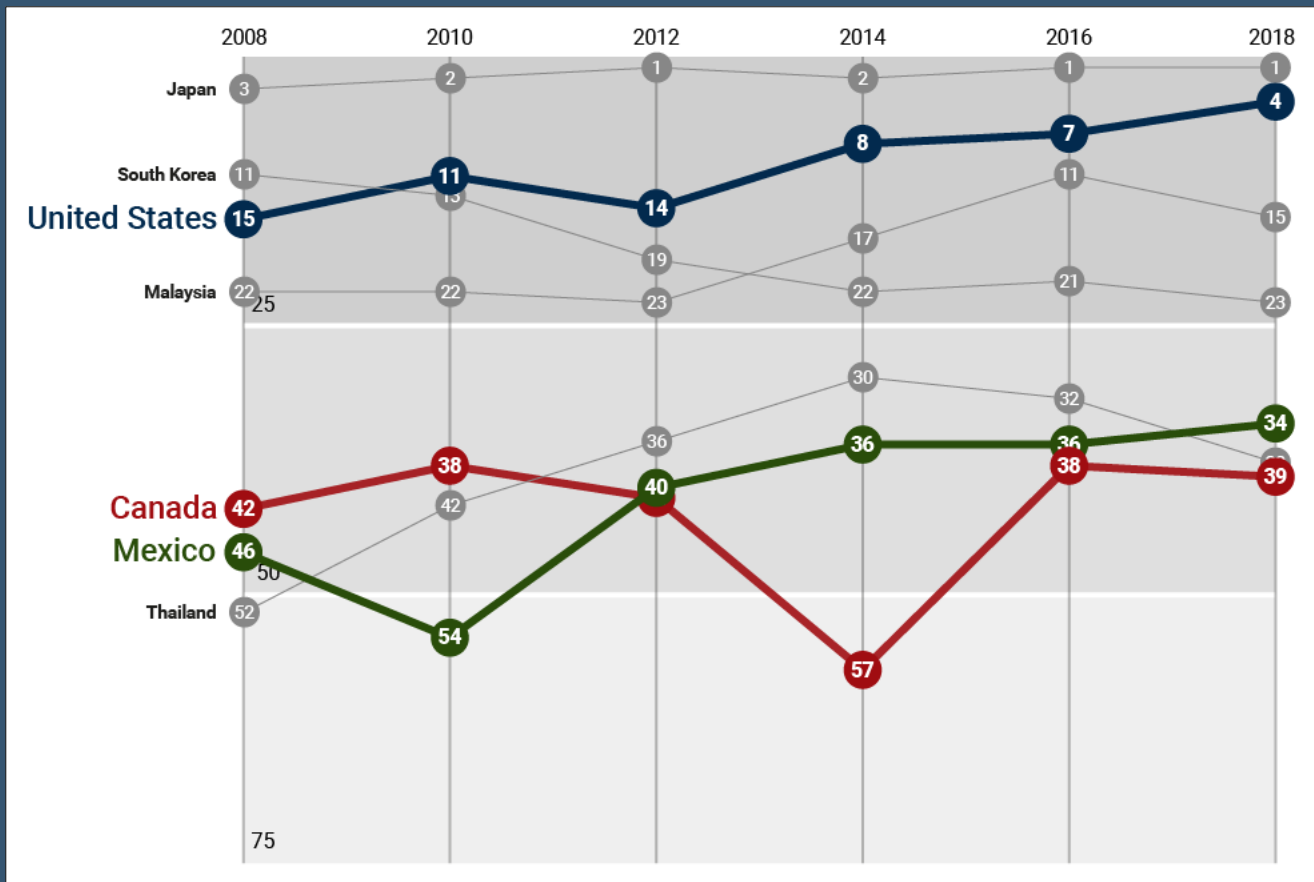
Source: World Bank's World Development Indicators (2020).

“SIMPLY SWITCHING PURCHASES FROM MNCs IN CHINA TO ONES IN MEXICO WOULD NOT REALLY REDUCE DEPENDENCE ON CHINESE PRODUCTION BECAUSE OF THIS DOMINANT ROLE OF CHINA IN PRODUCING INTERMEDIATE INPUTS.”

**GRAPH 15**

**Global Value Chains in North America**

According to the Global Value Chain Index, U.S. companies are present at all stages in the value chain. Mexico and Canadian companies are also expanding along the value chain but more is needed for the region to compete globally across the value chain.



Source: World Economic Forum, Global Competitiveness Index, 2007-2018 (2021).

## Investment climate varies across countries

The fact that so much manufacturing production ended up in East Asia, China especially, is not a coincidence. China was known initially for low wages, but wages are low throughout the developing world. Other factors turn out to be as, or more, important. Table 1 presents a number of investment climate indicators for Mexico and China, as well as Japan and Korea, and the six large economies in ASEAN (Indonesia, Malaysia, Vietnam, Thailand, Philippines, and Singapore). The countries are listed in increasing order of per capita GDP (measured at PPP) because these indicators tend to rise with development level, and it is useful to look at one's ranking relative to peers.

The indicators are: Logistics Performance Index, which indicates how well ports and other infrastructure function to move goods in and out; Intellectual Property Rights Protection Index because the MNCs that manage value chains bring their brands and technology and need it to be protected; PISA test score for math indicates how well a country is developing basic human capital; and the tertiary school enrollment rate signals upgrading of the labor force for the future.

Mexico's logistics performance only better than the Philippines and is well behind China or Thailand, even though the three are at similar stages of development. On the IPR index, Mexico is behind China or Malaysia.

This is especially important for bringing in hi-tech value chains. China's PISA scores for math are off the chart. An important footnote is that the Chinese testing is only done in Beijing, Shanghai, Zhejiang, and Jiangsu, but these coastal locations have several hundred million people, and they are where much of the hi-tech production takes place. Finally, China's tertiary enrollment rate, at 58 percent, is more similar to rich countries than to other developing ones.

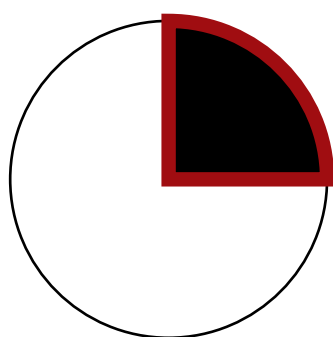
## Conclusions and policy recommendations

The USMCA trade pact provides incentives for integrated North American production. This could be paired with industrial policy interventions to consolidate production for some specific products, which would also be smoothed by the infrastructure bill. But to promote this as a wide-ranging program aimed at dislodging supply chains from China would be expensive and would probably fail. The Regional Comprehensive Economic Partnership among ASEAN, China, Japan, Korea, Australia, and New Zealand will provide similar incentives for integrated production in the Asia-Pacific. Furthermore, that region starts as the dominant player in world manufactures and with investment climate advantages in terms of logistics, infrastructure, and human capital.

China's application to join the Trans-Pacific Partnership is important. This is a deeper agreement than RCEP and would do even more to cement Asia-Pacific value chains. Mexico, as a member of CPTPP, would benefit from the pact's expansion to large new partners such as China, Indonesia, and Korea. CPTPP could become the foundation for Asia-Pacific supply chains. The U.S. is the odd man out in the Asia-Pacific and it would take significant changes in attitudes towards trade by both U.S. political parties to turn that around.

From Mexico's point of view, the potential benefits of investment climate improvements are enhanced by new trade pacts such as USMCA and TPP. Key issues are logistics, infrastructure, property rights protection, and greater investment in schooling at all levels. These are all in Mexico's interest regardless of its trade status; they become even more important in an integrated Asia-Pacific economy. The U.S. has a similar agenda of infrastructure and human capital renewal. That agenda of renewal would be enhanced by deeper trade agreements with the Asia-Pacific.

This turbulent period has included the U.S.-China trade war in which export controls were imposed on hi-tech inputs and a



**25%**

tariff levied on many ordinary products traded between the U.S. and China.

**TABLE 1. Investment climate indicators, Mexico and East Asia**

|             | Logistics Performance Index (1-5) | Intellectual Property Rights Index (1-7) | Tertiary School Enrollment Rate (%gross) | Programme for International Student Assessment (PISA) Math Mean Score |
|-------------|-----------------------------------|--|--|---|
|             | 2018                              | 2016                                     | 2019                                     | 2018  |
| China       | 3.61                              | 3.97                                     | 58.4                                     | 591 <sup>2</sup>  |
| Indonesia   | 3.15                              | 4.26                                     | 36.3                                     | 379   |
| Japan       | 4.03                              | 6.07                                     | 64.1                                     | 527   |
| Korea       | 3.61                              | 4.16                                     | 98.4                                     | 526   |
| Malaysia    | 3.22                              | 5.42                                     | 43.1                                     | 440   |
| Mexico      | 3.05                              | 3.80                                     | 42.8                                     | 409   |
| Philippines | 2.90                              | 3.89                                     | 35.5                                     | 353   |
| Singapore   | 4.00                              | 6.20                                     | 91.1                                     | 564   |
| Thailand    | 3.41                              | 3.20                                     | n.a.                                     | 419   |
| Vietnam     | 3.27                              | 3.62                                     | 28.6                                     | 496   |

**Source:** The data for LPI are from the "World Development Indicators," 2018, the World Bank. The data for IPR are from the "Global Information Technology Report 2016," 2016, the World Economic Forum. The data for Tertiary School Enrollment Rate are from "World Development Indicators," 2019, the World Bank. The data for PISA Math Mean Score are from the "PISA 2018 Results," 2018, the Organisation for Economic Co-operation and Development.

## ENDNOTES

- 1 <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/02/24/executive-order-on-americas-supply-chains/>  
 2 The data for China only includes Beijing, Shanghai, Zhejiang, and Jiangsu.

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## John Weekes

Former Canadian diplomat and chief negotiator for the NAFTA

# Making the USMCA work requires careful political commitment: It's not happening yet

The new USMCA offers an exciting opportunity to create a stronger and more prosperous North America while strengthening the economies of each of its three partners. On November 18, 2021 at the first meeting in five years, the North American leaders set the right tone in their joint statement proclaiming, “We are closely bound by history, culture, a shared environment, and economic and family ties, and strongly believe that by strengthening our partnership we will be able to respond to a widening range of global challenges.” The preamble to the USMCA itself sets out lofty aspirations including a promise to “enhance and promote the competitiveness of regional exports and firms in global markets, and conditions of fair competition in the region.” Unfortunately, serious fissures have developed beneath the surface that could disrupt the entire agreement.

The last few years provided a bruising experience to the then NAFTA partners. President Trump’s declaration—that he would “tear up NAFTA” unless it was rebalanced in favor of the U.S.—created an investment chill over Canada and Mexico. Alleging that Mexican and Canadian imports of steel and aluminum were a threat to the national security of the U.S., President Trump slapped punitive duties on these products under Section 232 of the Trade Expansion Act of 1962. To Canada, a staunch American ally for over a century, this action was both insulting and economically harmful.

To better understand Canada’s reaction, we must recall that in 1988 many Canadians believed that it was a mistake for Canada to enter a free trade agreement with the U.S. They argued that it risked undermining Canadian sovereignty

and would leave Canada more vulnerable to American trade actions, which were often politically motivated. Canadian supporters of free trade argued that the rules of the trade agreement would protect Canada from unfounded and egregious trade actions from the U.S. In a closely fought national election, the issue of free trade became an important political issue. Supporters of free trade eventually won out, and Canada joined the U.S. in a bilateral free trade agreement (FTA) and became an important partner in constructing the NAFTA a few years later.

For 25 years NAFTA benefitted businesses in all three countries. Indeed, many smart companies, their workers, and even whole sectors prospered by using this opportunity to rationalize production to benefit from the relative



comparative advantage of different regions in North America. Trade increased dramatically and there were major economic benefits for each of the three partners. However, there were also several problems: Political neglect of the agreement, no real effort to adapt it to changing times, and a serious failure to explain its benefits to the broader community.

Today, Canadians are troubled by an emerging pattern of American behavior whereby the U.S. is restricting imports of traditional manufactured and resource products (many of them Canadian, ranging from automotive products to softwood lumber), while calling for more open trade and strengthened rules for high technology products where the U.S. has a comparative advantage and strong domestic support for open competition.

These developments leave many Canadians wondering if they can build a secure economic future with a partner focused increasingly on going it alone—taking Canada for granted and seemingly being enamored by managed trade. In addition, Canadians are worried that the U.S. is guarding the American economy through unilateral trade remedy tools rather than with rules enshrined in international agreements. Concern about Chinese competition may lie behind some of these measures, but they often hit other countries more severely than China; this was the case when Canada was subjected to the Section 232 steel tariffs.

Canadians have been startled by recent American moves in the automotive sector, an area where Canada and the U.S. pioneered free trade with the Canada-U.S. Auto Pact of 1965. In this particular sector the three North American countries—if they work together—could become the

global powerhouse of the new electric, high-tech, automobile industry. Proposals to provide discriminatory tax incentives for American purchasers of vehicles built entirely in the U.S. would stack the deck against investments in Canada and Mexico. Moreover, the Biden administration is set on pushing an egregious interpretation of the automotive rules of origin, invented by the then U.S. Trade Representative Robert Lighthizer. This would make it much more difficult for automobiles made in Canada or Mexico to meet the test to qualify for free trade treatment.

Of course, it is not just the U.S. that needs to act to make the USMCA a success. A new course is needed. To realize the full aspirations of the USMCA, all three partners need to stop fighting each other and figure out a way to collectively win—at home and globally. This will require the U.S., Mexico, and Canada to work together.



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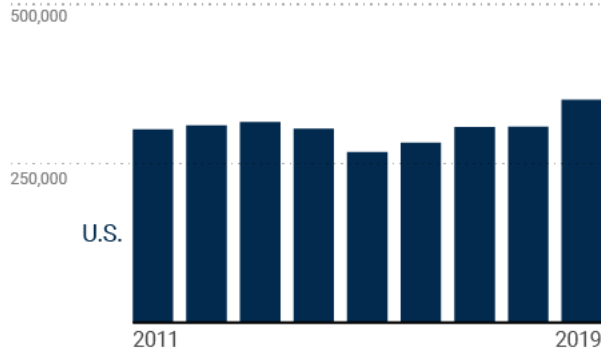


**GRAPH 16**

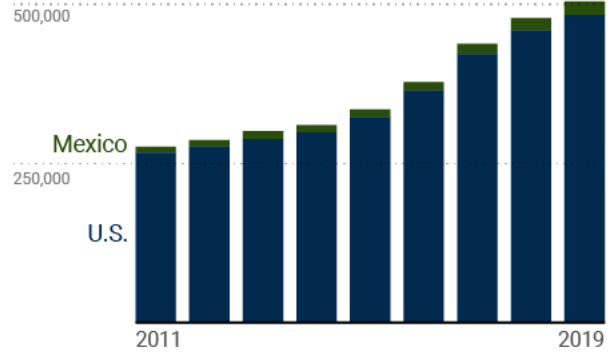
**Inward and outward FDI in North America (in billions of dollars)**

The U.S. is the largest recipient of FDI from Mexico and Canada and the largest source of FDI in North America.

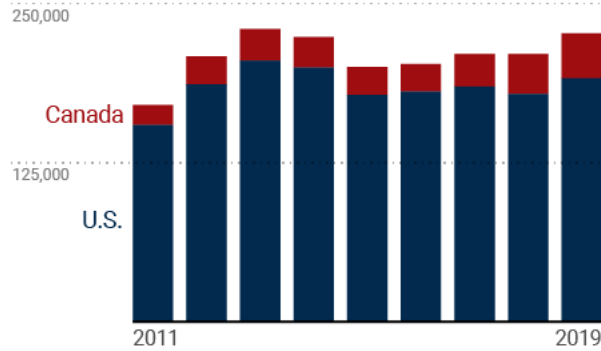
**Canada** inward FDI Stocks



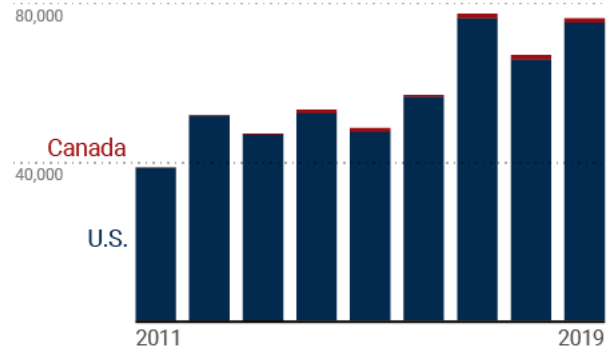
**Canada** outward FDI Stocks



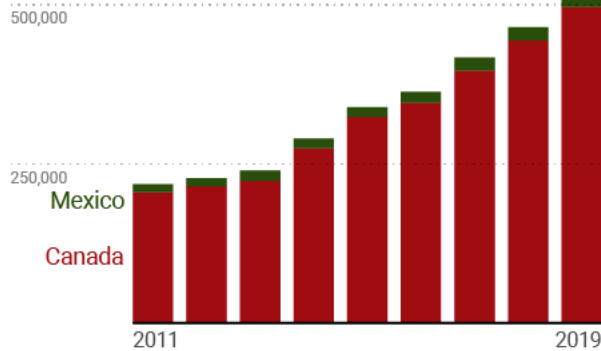
**Mexico** inward FDI Stocks



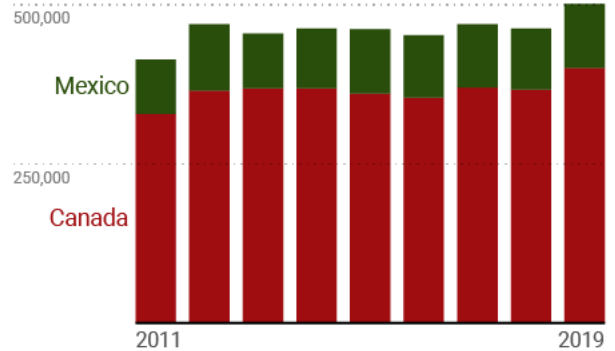
**Mexico** outward FDI Stocks



**United States** inward FDI Stocks



**United States** outward FDI Stocks



Source: OECD Stats & Inward FDI by partner country (2019).

# THE USMCA AND DIGITAL TRADE IN NORTH AMERICA



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Data and the digital economy are ever more present in business and public policy discussions, domestically as well as internationally.<sup>1</sup> The USMCA contains one of the most ambitious digital trade chapters of any free trade agreement (FTA), which provides an important building block towards a more digitally-integrated North America. The November 2021 North American Leaders Summit underscored the digital economy's importance, calling on the three governments—U.S., Mexico, and Canada—to cooperate to ensure a safe, secure, and reliable cyber ecosystem in North America.<sup>2</sup>




©Photo credit: Reuters

Digital trade between the three North American economies is difficult to assess because of a lack of adequate statistics; however, the available data indicate that it is significant and that it represents a growth opportunity. According to UNCTAD (2021b, 11), the U.S. imported \$318 billion worth of digitally delivered services in 2020.<sup>3</sup> Canada's share of those imports is estimated to be around 7.5 percent.<sup>4</sup> For U.S. exports of digitally delivered services, we can estimate Canada's market share to be less than two percent.<sup>5</sup> It seems reasonable to assume that the percentages are smaller for digitally delivered services between Mexico and the U.S.

There is more to digital trade than digitally-delivered services; there are also digitally ordered goods and services.<sup>6</sup> Unfortunately, North American cross-border trade data is not available for such transactions, although it is safe to assume that the majority of online sales are domestic in nature. For instance, in 2016, the McKinsey Global Institute estimated that 12 percent of all goods traded across borders were the result of digital trade (Manyika et al. 2016). For its part, UNCTAD estimates that 91 percent of online

sales worldwide between businesses and consumers (B2C) in 2019 were domestic in nature (UNCTAD 2021a, 5).<sup>7</sup>

Trade in digitally ordered goods and services between the three North American economies could be worth as much as \$250 billion. After all, the U.S. is the largest, by far, digital market in the world, with \$9.5 trillion in total—B2C and business to business (B2B)—online sales (of goods and services) in 2019 (UNCTAD 2021a, 4). As for Canada, total online sales amounted to C\$336 billion in 2019 (Statistics Canada 2021), placing it just short of the top 10 in the world. With \$31 billion in B2C online sales in 2019, Mexico came in 14th place in the world, only a few spots behind Canada (UNCTAD 2021a, 5). Assuming that B2B online sales represent at least 80 percent of total online sales for Mexico, we can estimate the latter's B2B digital market to be over \$200 billion. So, in total, we are talking about ten trillion dollars in online sales for North America. If we assume that about ten percent of digitally ordered goods and services are internationally traded, then this means that about \$1 trillion of such goods and services would be traded internationally. Given that



**“ THE USMCA CHAPTER 19 ON DIGITAL TRADE SHOULD FORM THE BASIS FOR THE THREE NORTH AMERICAN PARTNERS TO COOPERATE IN DEVELOPING AND INTEGRATING THEIR DIGITAL MARKETS BECAUSE IT ADDRESSES THE KEY ELEMENTS NECESSARY FOR DIGITAL TRADE TO FLOURISH IN NORTH AMERICA. ”**

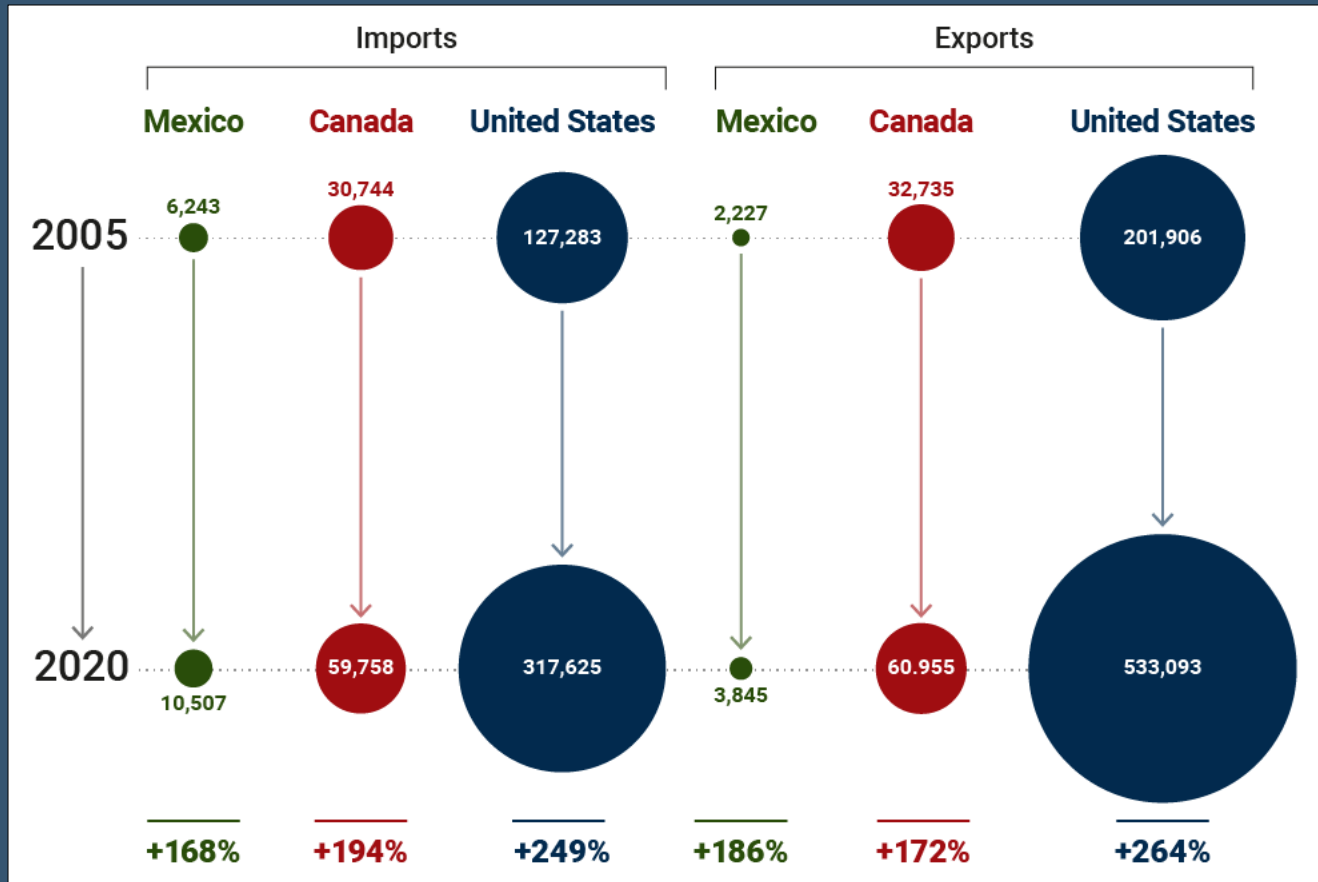
about 25 percent of the three North American economies' total trade in goods and services takes place in North America, then we can reasonably estimate that about one quarter of total digitally ordered goods and services in North America would be traded between Canada, Mexico, and the U.S.

Digital trade is about digitally ordered goods and services as well as digitally delivered services, but it is also about the application of digital technologies in supply chains. Big data analytics, artificial intelligence, blockchain, robotic process automation, and the Internet of things (IoT) are increasingly being used (or considered) by businesses to improve different aspects of their supply chains: Demand planning, sourcing, warehouse and inventory management, transportation, and distribution operations (Hartley and Sawaya 2019; Seyedghorban et al. 2020). The more businesses in North America make good use of these technologies for making their operations more efficient and resilient, the more we are likely to see digital trade taking place across the three North American economies. So, how should Canada, Mexico, and the U.S. realize the full potential of digital technologies and ensure that the North American economy remains integrated as it digitalizes?

The USMCA Chapter 19 on digital trade should form the basis for the three North American partners to cooperate in developing and integrating their digital markets because it addresses the key elements necessary for digital trade to flourish in North America.

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**GRAPH 17** Trade in digitally-delivered services (DDS), in millions of U.S. dollars (2005-2020)  
 Growth in DDS highlights the importance and opportunities from digital trade in the region.



Source: United Nations Conference on Trade and Development Database (2020).

The chapter is the most advanced among existing free trade agreements (FTAs) in terms of liberalizing digital trade between its members (Haji and Leblond forthcoming; Meltzer 2019a). To that end, it prohibits the imposition of custom duties on digital transactions, although it allows domestic taxes on digital trade as long as they do not discriminate against firms from other USMCA parties. It also does not allow restrictions of cross-border data transfers, including for personal data.<sup>8</sup> Similarly, it prohibits any requirement to locate computing facilities in a member state as a condition of doing business in that jurisdiction, except for contracts with governments.<sup>9</sup> Finally, it forbids requiring the transfer or access to the

source code of software (including algorithms that are part of a source code) as a condition for selling or using that software in a member state's territory.

In addition to prohibiting potential barriers to digital trade (with some exceptions), the USMCA's Chapter 19 encourages or requires several endeavors that facilitate or encourage digital trade. For instance, it recognizes electronic signatures and encourages the parties to work together to convert the paper-based administration of cross-border commerce into an electronic one. It also requires that the parties have consumer protection legislation and regulations in place for online commercial



activities and work together to protect consumers in digital trade transactions. This includes adopting or maintaining measures to limit unsolicited electronic commercial communications, which means that consent must be obtained beforehand. Similarly, it mandates the adoption of legislation and regulations to protect individuals' right to privacy with respect to their personal data; however, it cannot be done in a manner that discriminates against firms offering digitally enabled goods and services from the other parties. In support of digital competition, the chapter explicitly recognizes that consumers must not only have access to the internet and its information, but also have choice with respect to service providers and online applications. It also recognizes that "facilitating public access to and use of government information fosters economic and social development, competitiveness, and innovation" and, therefore, it commits the parties to making such information available digitally and easily accessible. Finally, in recognition of the fact that cybersecurity can "undermine confidence in digital trade," the chapter enjoins the USMCA's three members to have capabilities to prevent and respond to cybersecurity incidents and adopt a risk-based approach in addressing cybersecurity threats, especially in working with businesses.

To achieve the above, the USMCA's Chapter 19 calls upon Canada, Mexico, and the U.S. to cooperate to "exchange information and share experiences on regulations, policies, enforcement and compliance relating to digital trade." It also specifically commits them to cooperate closely (by strengthening existing collaboration mechanisms) in cybersecurity matters so as "to identify and mitigate malicious intrusions or dissemination of malicious code that affect electronic networks, and use those mechanisms to swiftly address cybersecurity incidents, as well as for the sharing of information for awareness and best practices." Another area where Chapter 19 enjoins the parties to cooperate is on expanding and facilitating access to government information and data "with a view to enhancing and generating business opportunities, especially for SMEs." The USMCA's three members are to cooperate

not only among each other within North America but also internationally. They are expected to "actively participate in regional and multilateral fora to promote the development of digital trade," including with respect to the interoperability of privacy regimes and "the development of mechanisms to assist users in submitting cross-border complaints regarding personal information protection."

The USMCA digital trade chapter enjoins the North American partners to establish "a forum" to formalize their cooperation on the above-mentioned matters and, therefore, more effectively implement the USMCA's digital trade provisions and objectives. Such a forum (we could call it the North American Digital Trade Council) would allow the three USMCA member states to exchange information, coordinate (domestic and international) policy actions, and negotiate the removal of obstacles to digital trade across their borders. The creation of such a permanent forum should be a priority for Canada, Mexico, and the U.S. as a building block for more intensive cooperation on digital trade opportunities.<sup>10</sup> To produce effective cooperation, a North American Digital Trade Council would need to be under the responsibility of specific federal minister/secretaries from the three USMCA countries with dedicated human and financial resources from three federal departments: Department of Commerce (U.S.), Innovation, Science and Economic Development (Canada), and Secretaría de Economía (Mexico). There should be regular meetings of the dedicated government officials and the latter should engage closely with relevant stakeholders from all three countries, including subnational governments (provinces and states).<sup>11</sup> Once the USMCA's digital trade cooperation forum is set up, it should address a number of priority issues to ensure digital trade's development in North America.

To begin with, Canada, Mexico, and the U.S. should cooperate closely to build an integrated fast, reliable, secure, and inclusive digital infrastructure throughout North America. Currently, Internet access outside urban areas (and in urban areas too, because of digital "redlining") is expensive





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and inadequate in all three countries, which makes it difficult, if not impossible, for people and enterprises to take part in digital trade (Cave et al. 2018; Koch 2020; Rachfal 2021). 5G may be arriving in large urban centers in Canada and the U.S., but rural communities are often living in a 3G, if not slower, world. Closing this “digital divide” is key to ensure everyone can take equal part in the digital economy and conduct digital trade (Chakravorti 2021; Weeden and Kelly 2021). The Canadian and U.S. governments, for instance, have both committed billions of dollars to support the development of such digital infrastructure. For example, as part of the recently signed \$1.2 trillion U.S. Infrastructure Investment and Jobs Act, \$65 billion is allocated to fixing the digital divide (Reardon 2021). It is, however, important that such infrastructure spending not be associated with protectionist “buy local” measures, which lead to higher costs.<sup>12</sup> It is also important that the North American digital infrastructure is accessible by any business across the three economies and that it interconnects easily across borders, which is what the USMCA’s Chapter 18 on telecommunications is meant to ensure.<sup>13</sup>

Payments are another important piece of the digital trade infrastructure puzzle (World Economic Forum 2020b). Paying for goods and services that are digitally ordered—B2B as well as B2C—across North American borders is generally expensive. Whether payment is done through credit cards, wire transfers, or payment platforms such as PayPal, there is a significant cost per transaction, often for both sides of the transaction (McKinsey & Company 2018).<sup>14</sup> Reducing payment-related transaction costs would help stimulate digital trade across North America’s borders, especially for small and medium-sized enterprises (SMEs) and consumers. This requires cooperation by Canada, Mexico, and the U.S. to ensure greater interoperability between national clearing and settlement systems as well as interoperability between payment service providers, including adequate oversight by financial system supervisors. The USMCA’s chapter (17) on financial services should serve as a basis for such cooperation on easier and cheaper cross-border payments.<sup>15</sup>

The third priority for a North American Digital Trade Council should be to ensure that data (personal, business, and, where relevant, government) can flow freely across North America’s borders in support of digital trade; however, this requires a high degree of trust (for individuals, businesses, and governments) surrounding the collection, processing, and use of data in all three USMCA countries. The agreement’s provisions on consumer protection, privacy, cybersecurity, and unsolicited electronic commercial communications are meant to achieve a trusting environment for cross-border data flows in particular and digital trade in general. To create such an environment throughout North America so that data (and trade) can flow freely across borders, policymakers must cooperate closely to develop and enforce common, high-quality privacy protection standards and regulations, as Leblond and Aaronson (2019) and Meltzer (2019b) argue. Otherwise, federal and/or subnational governments in the three North American partners risk adopting laws and regulations to protect individuals, businesses, and governments that pose obstacles to cross-border data flows and digital trade. And it is not clear that the USMCA’s provisions are sufficient to prevent such national or subnational obstacles to cross-border digital trade from being implemented (Leblond 2021a). In years to come, such cooperation within a North American Digital Trade Council will be crucial as Canada and Mexico revise, and the U.S. establishes, federal privacy/data protection laws. Coordination with provincial and state governments will also be important since they (in Canada and the U.S.) have been active in promulgating such laws in recent years. Canada, Mexico, and the U.S. should also make use of their close cooperation at the North American level to push for “free data flow with trust” at the international level (Leblond 2021b; Leblond and Aaronson 2019; Meltzer 2019).<sup>16</sup>

The same kind of close cooperation within a North American Digital Trade Council should also take place when it comes to digital platform regulation, to prevent national laws being at odds with the USMCA’s provisions. For example, even if the U.S.

As part of the recently signed

**\$1.2  
trillion**

U.S. Infrastructure  
Investment and Jobs Act,

**\$65  
billion**

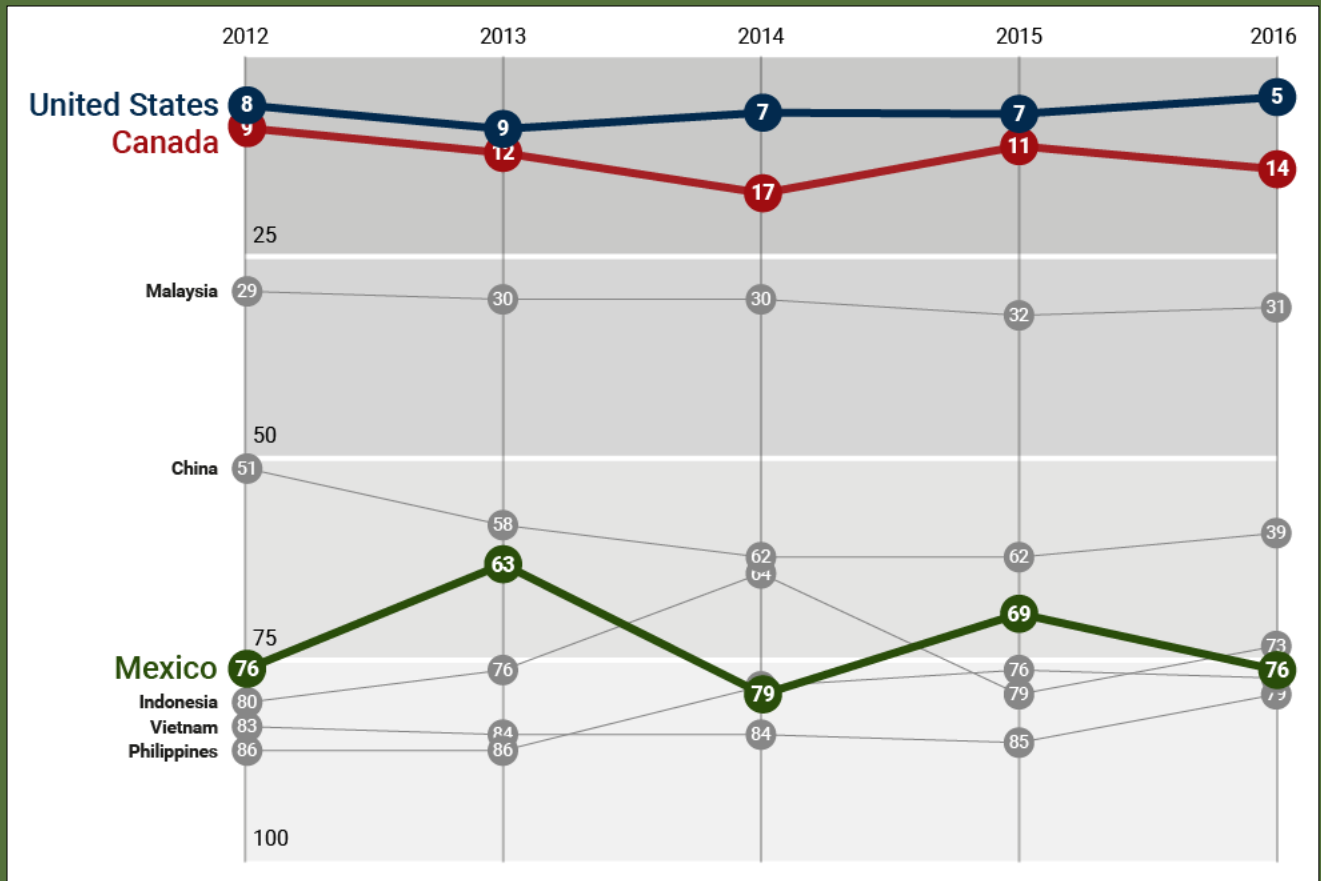
is allocated to fixing the  
digital divide (Reardon 2021).

©Photo credit: Reuters



**GRAPH 18** Network Readiness Index rankings in North America and select Asian economies, 2008-2018

Growing importance of ICT for competitiveness and digital trade underscores the need for Mexico to do more to be globally competitive.



Source: Network Readiness Index, 2012-2016.



federal government were to get rid of Section 230 of the Communications Decency Act, the USMCA's Article 19.17 (Interactive Computer Services) would allow service providers based in Canada and Mexico to avoid any liability for third-party information on their platforms with respect to American consumers. In such a case, and with Canada and Mexico also adopting laws making platforms legally liable for third-party content (e.g., misinformation), we want to avoid a situation where Meta's main platforms (Facebook, Instagram, WhatsApp) would serve U.S. customers from Canada or Mexico while they would serve Canadian and Mexican customers from the U.S. The three North American partners would then have to cooperate to remove Article 19.17 from the USMCA in a future mandated review of the agreement.

In addition to data protection, platform governance, and cybersecurity, the USMCA member states should also coordinate their efforts in the development and regulation of new digital technologies like artificial intelligence, blockchain, and quantum computing. Such cooperation would prevent

duplication of efforts and protectionist actions (e.g., subsidies) in the pursuit of national industrial policies, which are gaining in popularity across North America. A North American Digital Trade Council could lead on cooperative efforts focused on science, technology, and innovation, thereby allowing joint statements for cooperation in these domains, such as the recent one between Canada and the U.S., to become a reality.<sup>17</sup>

The USMCA's chapter on digital trade offers a strong basis for Canada, Mexico, and the U.S. to cooperate closely to facilitate and promote the development of digital trade in North America and beyond through an integrated digital infrastructure, common or interoperable standards and regulations, the development of new digital technologies, and their application throughout firms' and sectors' entire supply chains. Such cooperation, thanks to a North American Digital Trade Council, would allow for North America to become a global leader in the digital economy.

## ENDNOTES

- 1 <https://www.commerce.gov/news/press-releases/2021/09/us-eu-trade-and-technology-council-inaugural-joint-statement>.
- 2 <https://pm.gc.ca/en/news/backgrounders/2021/11/18/joint-statement-north-american-leaders>.
- 3 Digitally delivered services are defined as services that are delivered remotely to foreigners over information and communications technology (ICT) networks. Statistics Canada and the United Nations Conference on Trade and Development (UNCTAD) follow this definition, which is based on a framework developed by the Organization for Economic Cooperation and Development (OECD), the World Trade Organization (WTO), and the International Monetary Fund (IMF) (2020). According to the OECD-WTO-IMF framework for measuring digital trade, goods cannot be delivered in digital form, only services can: "by this definition, digital equivalents of goods—such as e-books or digital software—would be considered as the delivery of a licence to use the product and not physical ownership of the product" (Nair 2021, 14).
- 4 In a survey of Canadian enterprises conducted in 2018, Statistics Canada (2020b) found that a maximum share of 82 percent of "in-scope" (i.e., within the scope of the survey) exports to the United States were digitally delivered. According to the U.S. Bureau of Economic Analysis (<https://www.bea.gov/sites/default/files/2021-09/trad-geo-time-series-0721.xlsx>), U.S. imports of services from Canada amounted to \$29.3 billion in 2020. Therefore, we can estimate that a maximum of \$24 billion (i.e., 82 percent) of those imports would have been digitally delivered. This amount represents 7.5 percent of all digitally delivered services imported into the U.S. in 2020.
- 5 Total Canadian imports of digitally delivered services are estimated to be C\$13.2 billion for 2019 (Statistics Canada 2021) while total U.S. exports of such services are reported to be \$533 billion for 2020 (UNCTAD 2021b, 11). If we assume a 20 percent growth rate for digitally delivered services imported into Canada for 2020 with 70 percent of those imports coming from the U.S. and an average exchange rate of \$0.75 for C\$1, then Canada would account for only 1.6 percent of U.S. exports of digitally delivered services in 2020. To compare, Canada's share of total U.S. exports of services was 7.6 percent in 2020, based on data from the U.S. Bureau of Economic Analysis.
- 6 The OECD et al. (2020) define digital trade as "all trade that is digitally ordered and/or digitally delivered", whereby digitally ordered trade corresponds to "[t]he international sale or purchase of a good or service, conducted over computer networks by methods specifically designed for the purpose of receiving or placing orders."
- 7 No data are available for business-to-business (B2B) online sales.
- 8 Exceptions are allowed for a "legitimate public policy objective" as long as they are applied in a manner that is not protectionist in nature.
- 9 Chapter 19 does not apply to government procurement.
- 10 The existence of such a forum does not guarantee success, as demonstrated by the North American Competitiveness Council's failure and the US-Canada Regulatory Cooperation Council's limited effectiveness.
- 11 The responsible ministers should meet at least once a year to review the Council's activities and provide guidance for future work, to ensure that it maintains its momentum and effectiveness over time.
- 12 In principle, the USMCA's chapter 13 on government procurement should prevent the implementation of such discriminatory measures when federal funds are used to finance digital infrastructure contracts above a certain threshold value, but only between Mexico and the U.S. since chapter 13 does not apply between Canada and the U.S., which instead rely on the WTO Agreement on Government Procurement. In practice, it remains uncertain how effective government procurement provisions are in preventing the use of "buy local" (Onur Tas et al. 2019; Rickard and Kono 2014).

- 13 USMCA articles 18.3 ensures that any enterprise of another party has “access to and use of any public telecommunications network or service, including leased circuits, offered in its territory or across its borders, on reasonable and non-discriminatory terms and conditions.” Article 18.4 ensures that the supplier of public telecommunications services of a party can interconnect with the suppliers of another party at reasonable rates, negotiate roaming agreements with such suppliers, and provide “number portability without impairment to quality and reliability, on a timely basis, and on reasonable and non-discriminatory terms and conditions.”
- 14 Cross-border payment transactions usually charge both the payer and payee administrative fees for sending and receiving funds, respectively. The payer or payee is also charged a commission or premium for converting one currency into another.
- 15 USMCA article 17.15 states: “Under terms and conditions that accord national treatment, each Party shall grant financial institutions of another Party established in its territory access to payment and clearing systems operated by public entities, and to official funding and refinancing facilities available in the normal course of ordinary business.”
- 16 At the 2019 annual meeting of the World Economic Forum in Davos, Switzerland, former Japanese Prime Minister, Shinzo Abe, gave a speech in which he invited leaders to build an international order for “data free flow with trust” (World Economic Forum 2020a). In June 2019, at the G20 leaders’ summit in Osaka, Japan, 24 countries signed the Osaka Declaration on the Digital Economy ([http://www.g20.utoronto.ca/2019/osaka\\_declaration\\_on\\_digital\\_economy\\_e.pdf](http://www.g20.utoronto.ca/2019/osaka_declaration_on_digital_economy_e.pdf)), which launched the “Osaka Track” for negotiating an agreement on “trade-related aspects of electronic commerce” at the WTO.
- 17 <https://www.canada.ca/en/innovation-science-economic-development/news/2021/11/joint-statement-to-leaders-from-canadas-minister-of-innovation-science-and-industry-and-the-united-states-director-of-the-white-house-office-of-sci.html>.

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## Carla A. Hills

**Former U.S. Trade Representative  
and lead negotiator for NAFTA**

The North American Free Trade Agreement (NAFTA) that was negotiated during President George H.W. Bush's administration, approved by Congress during President Clinton's administration, and took effect in 1994 achieved broader market openings than any prior trade agreements. It eliminated tariffs on all industrial products and most agricultural goods. It was the first trade agreement to open a broad range of services, remove substantial barriers to investment, and protect copyrights, patents, and trade secrets. It was also the first comprehensive trade agreement to join a developing economy with highly developed economies, creating a huge market—accounting for roughly \$22 trillion and 493 million consumers today.

Canada and Mexico are currently America's two largest export markets. Our inter-regional trade is up six-fold since the agreement took effect. One-third of our total global trade is with our two NAFTA partners. Today 80 percent of world trade is conducted through global supply chains, and the NAFTA created one of the most vibrant chains. Roughly 14

million jobs depend on our trade and investment with our two neighbors.

The vibrancy of our economic bonds created by NAFTA strengthened our overall relationships with our neighbors leading to enhanced cooperation on a range of security issues, the sharing of intelligence, and improved border procedures. The three leaders began to hold yearly summits to discuss areas of potential cooperation. They created the North American Competitive Council comprised of senior representatives from the private sector of each country to provide recommendations on actions the trio could take to strengthen regional competitiveness. In addition, state and local officials began to reach across borders to meet with their counterparts to address issues that would benefit their cities and states.

In recent years, these interactions have sharply declined. This past November, President Biden hosted the North American Leaders' Summit (sometimes called the "Three Amigos Summit") for the first time in five years. The North American Competitive Council has not met in more than a decade. To deal with today's

# Lessons learned from the NAFTA

challenges, whether it be climate, pandemics, migration, employment, border efficiency, or security, it is critical that we work with our neighbors and strengthen our trilateral relationships. Indeed, we need to take a page from the early post-NAFTA period to strengthen our economic and political relationships not only regionally but also globally.

That will require domestic political support. It is ironic, that as the economic benefits generated by the NAFTA have developed, public support for open trade has waned and concerns regarding globalization have grown. Many are skeptical about whether trade puts their job at risk. Few Americans know the benefits that we have derived from the NAFTA and could secure with future trade agreements. Again, the collaboration established in the early post-NAFTA period with our businesses, universities, mayors, and governors, could help correct the knowledge gap and importantly assist with programs to train our workers to secure and excel in 21<sup>st</sup> century jobs. Many proposals have been made, but the collaboration needed to make them work has been lacking.

# NAFTA-USMCA AND WAGES IN MEXICO



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The North American Free Trade Agreement (NAFTA) represented a significant step towards the integration of the three economies of that region. Launched in 1994, it superseded a previous agreement between Canada and the U.S., so the substantive change was the incorporation of Mexico, a country with a relatively lower average per capita income. NAFTA made significant advances in trade and foreign investment regulations but excluded any binding provisions on immigration or the free movement of labor (other than commitments to enforce pre-existing legislation). Indeed, the expectation was that trade in goods would in part substitute for trade in factors, particularly labor, so that the agreement would narrow wage differences between Mexico and its two northern partners.<sup>2</sup>



©Photo credit: Reuters

Assessing the impact of NAFTA on wages in Mexico is complex because they respond to many circumstances, not all related to trade. Ideally, one would like to perform a “counterfactual exercise” to identify what wages would have been without NAFTA keeping constant all other factors.<sup>3</sup> This exercise is not attempted here. Rather, this note focuses on some features of Mexico’s labor market that, in our view, have been insufficiently considered in previous analyses.

In our assessment we find that:

- Despite NAFTA, average wages in Mexico did not increase from their pre-NAFTA levels, although in its absence they would have been marginally lower.
- So long as Mexico’s current domestic regulations remain—particularly those pertaining to labor and social insurance—it is unlikely that the U.S.–Mexico–Canada Agreement (USMCA), the trade pact that superseded NAFTA in 2019, will lead to higher average wages.

- If the USMCA increases labor costs significantly in the USMCA-related segment of the economy, aggregate productivity in Mexico may suffer.

## Wages in Mexico

The black line in Graph 19 shows the average real urban hourly wage between 1990 and 2019.<sup>4</sup> In this and the next graph (Graph 20), the first dashed vertical line marks the beginning of NAFTA, the second the 1994–1995 financial crisis, and the third the change in employment survey from Encuesta Nacional de Empleo Urbano (ENEU) to the Encuesta Nacional de Ocupación y Empleo (ENOE).

After an initial upward trend starting in 1990, there is a sharp drop in 1995 associated with the financial crisis. This is followed by a gradual recovery, with the net result in 2019, the real average urban wage is practically the same as in 1990. This is a puzzling result for two reasons: Mexico recovered macroeconomic stability quickly after the

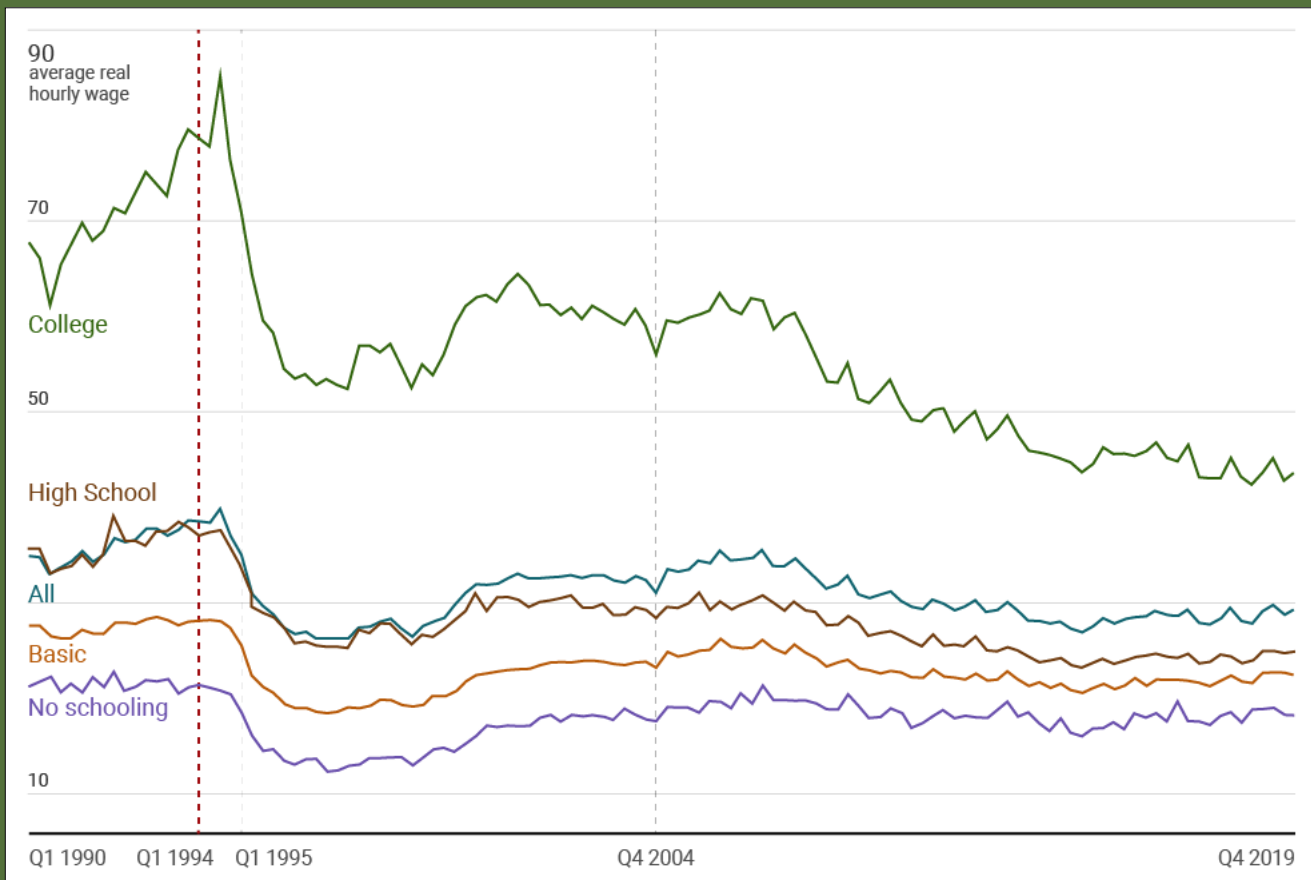
1995 crisis and average years of schooling increased by 47 percent from 1990 to 2019 (from 6.6 to 9.7 years). Since workers with more schooling earn higher wages, one would expect that as average years of schooling increase, so would the average wage, more so in a context of macroeconomic stability and increased trade and investment flows with Canada and the U.S.

The reason this did not occur is displayed in the colored lines in the same graph, separating workers into four schooling categories.<sup>5</sup> Wages for workers with college education have fallen in absolute terms, and have remained constant for those with

fewer or no years of schooling. Wages of workers with more schooling fell because their supply outpaced their demand and this, together with the fact that their share in total employment increases over time, pulls the average down. This is partly compensated by the fact that the share of employment by workers with little or no schooling moved in the opposite direction, resulting in a stagnant average.<sup>6</sup>

Graph 20 uses the same data as Graph 19 but shows median rather than average wages, showing that the wage distribution is not symmetric. The average mean wage is higher than the average median wage (also in black),

**GRAPH 19** Median and average urban wages in Mexico



Source: author's calculations based on ENEU and ENOE for localities with 100,000+ inhabitants.

indicating that a few high-income workers pull the average mean wage over the average median wage. Over time fluctuations are more nuanced than those shown in Graph 19, but the basic result stands: For the period captured in the graphs, the average median wage was constant, with a downward trend for those with college education.

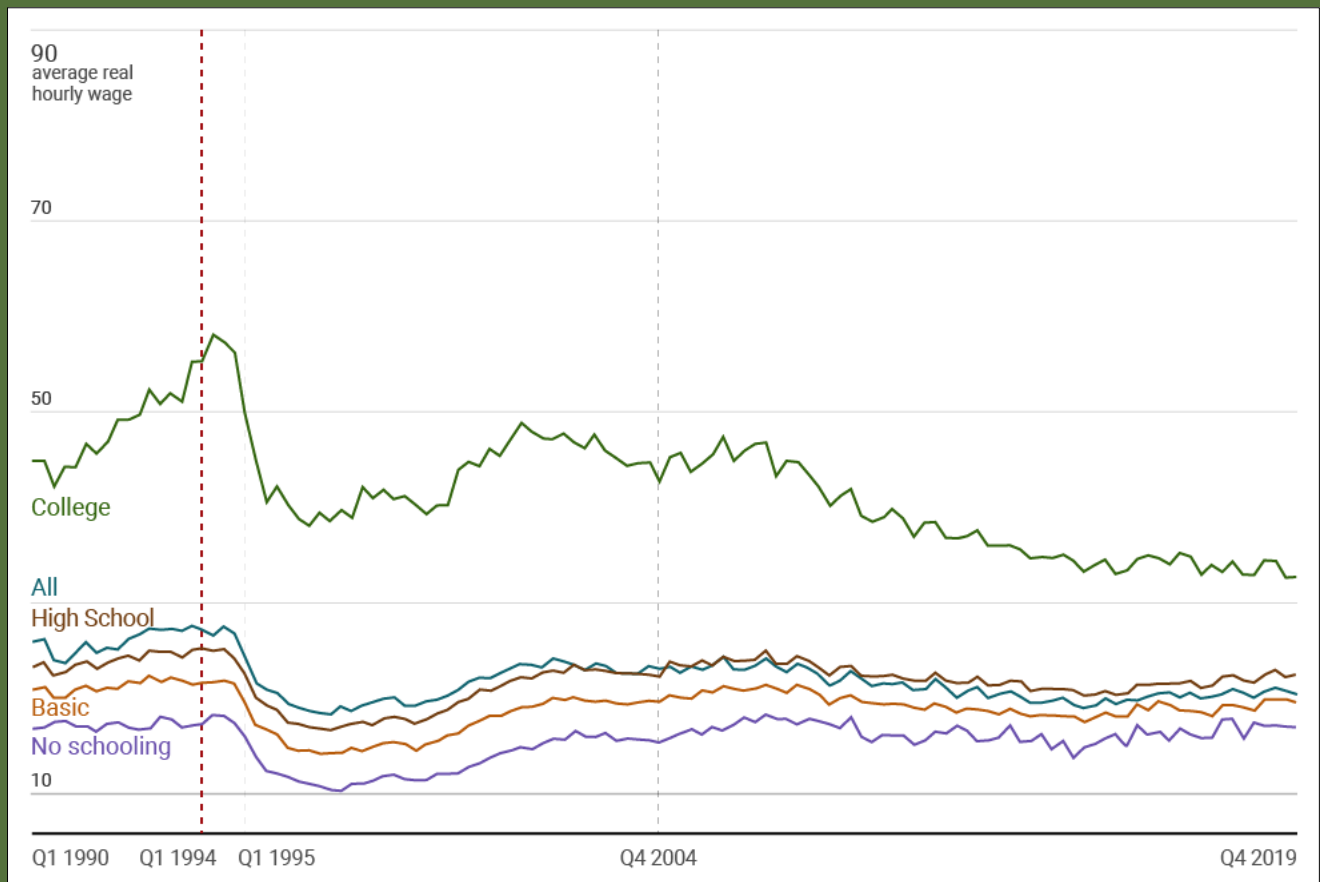
### Impact of NAFTA on wages in Mexico

How are Graphs 19 and 20 related to NAFTA? Unfortunately, the employment surveys contain little information regarding the firms where workers are employed. Table 2

remedies this, combining information on workers from the ENOE with information on firms from the 2018 Economic Census, the last one available.<sup>7</sup> The first two columns show measures of employment and schooling from the ENOE, for localities of the same size as those considered in the Census regardless of whether economic activity occurs in a fixed premise or not. As a result, it provides a more complete description of Mexico’s urban labor market than the Census which, despite its name, excludes part of urban economic activity.

The next four columns show measures of employment and schooling from the Census

**GRAPH 20** Median wages in Mexico, 1990-2019



Source: author's calculations based on ENEU and ENOE for localities with 100,000+ inhabitants.



and other variables not collected in the ENOE. The first refers to the whole Census and the last three to alternative measures of economic activity associated with NAFTA: All firms in manufacturing (M1); all firms that export (M2); and all firms with a foreign nexus (M3). The first measure assumes that all firms in manufacturing export to Canada or the U.S. or compete with imports from those countries in the domestic market. The second measure captures exports to all countries but is a good proxy of those going to Canada and the U.S., since around 85 percent of them have that destination. The third captures firm exposure to the rest of the world. More precisely, it measures whether the firm “participates in integrated processes through contracts or economic collaboration programs with firms located in other countries” (Census questionnaire,

our translation). It also overestimates the importance of NAFTA since the question refers to all countries, and although in this case there is little information to judge by how much, it is safe to assume that most links occur with Mexico’s two northern neighbors.

None of these measures are fully satisfactory. M2 and M3 are probably too narrow since they exclude firms that produce inputs for exporting firms or focus only on firms with contractual arrangements with foreign ones. On the other hand, M1 is probably too broad since it assumes that all manufacturing firms compete with Canadian or U.S. firms. Considered jointly, however, they are a reasonable first-order approximation to the relative importance of economic activity associated with NAFTA.

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“ WHILE NAFTA HAS HAD A SMALL POSITIVE EFFECT ON URBAN WAGES IN MEXICO, IT HAS NOT BEEN SUFFICIENTLY POWERFUL TO OFFSET OTHER FORCES THAT KEEP LABOR EARNINGS LOW. ”

**TABLE 2. Measures of economic activity associated with NAFTA, 2018**

|  | EAP <sup>1</sup> | EAP without public sector workers <sup>1</sup> | Economic Census | M1: manufactures | M2: exporting firms <sup>2</sup> | M3: firms with foreign nexus <sup>2</sup> |
|--|------------------|--|-----------------|------------------|----------------------------------|---|
| <b>1. Employment (L)<sup>3</sup></b>           | 42.1             | 37.8   | 27.1            | 6.5              | 3.5                              | 1.7                                       |
| <b>2. Schooling<sup>4</sup></b>                | 1.8              | 2.0  | 2.4             | 2.5              | 1.8                              | 2.2                                       |
| no schooling                                   | 47.9             | 51.3   | 41.8            | 54.2             | 46.8                             | 48.2                                      |
| 9 years  | 23.7             | 24.5   | 33.3            | 28.4             | 31.3                             | 31.0                                      |
| 12 years                                       | 26.6             | 22.2   | 22.5            | 14.8             | 20.1                             | 18.6                                      |
| 16 years                                       | 50.6             | 47.0   | 59.9            | 70.3             | 76.0                             | 77.0                                      |
| <b>3. Composition of L<sup>4</sup></b>         | 24.6             | 27.1   | 22.8            | 11.8             | 0.1                              | 0.1                                       |
| salaried                                       | 24.8             | 25.8   | 17.3            | 17.9             | 23.9                             | 22.9                                      |
| owners/family <sup>5</sup>                     |                  |  |                 |                  |                                  |   |
| other  |                  |  |                 |                  |                                  |   |
| <b>4. Capital stock/L<sup>6</sup></b>          | N.A.             | N.A.   | 426.9           | 456.8            | 1,123.0                          | 804.0                                     |
| <b>5. Value added/L<sup>6</sup></b>            | N.A.             | N.A.   | 367.9           | 491.8            | 862.8                            | 546.7                                     |
| <b>6. Number of establishments<sup>7</sup></b> | N.A.             | N.A.   | 4,800.2         | 579.8            | 12.1                             | 7.8                                       |
| <b>7. Average size<sup>8</sup></b>             | N.A.             | N.A.   | 5.7             | 11.2             | 292.3                            | 212.6                                     |
| <b>8. Average wage<sup>9</sup></b>             | N.A.             | N.A.   | 102.2           | 121.2            | 143.0                            | 135.8                                     |

**Source:** author's calculations with data from the ENOE and the Economic Census.

1) Economically active population in localities with 2,500 or more inhabitants from ENOE 2018.IV; 2) To/with all countries, including "maquila" exports; 3) millions of workers; 4) shares of total employment; 5) includes self-employment; 6) thousands of pesos of 2018 per worker; 7) thousands; 8) workers per establishment; 9) total wages and salaries over salaried employment in thousands of pesos of 2018 per year; N.A. = not available.

Consider the first block in Table 2. Line 1 shows that there were 42.1 million urban workers in 2018. However, the Census only captures 27.1 million, or 64 percent (72 percent excluding public sector workers). The difference is explained by the fact that 10.7 million urban workers carry out their activities in the streets and are therefore not included in the Census. Note that by any of the three measures used, NAFTA-related employment is not large: 15 percent of all urban employment in the case of M1, 8 percent for M2, and 4 percent for M3.

Line 2 provides information on schooling. Workers with 12 or more years of schooling represent 50 percent of the whole urban labor force (47 percent excluding public sector workers) but 55 percent of that

captured in the Census. This share is lower for M1, 43 percent, but very similar for the two other measures of NAFTA-related activities, 51 percent for M2 and 50 percent for M3. Note that the share of workers with 16 or more years of education is lower in all three measures compared to the whole urban labor force, with or without public sector employees. These figures suggest that all in all, NAFTA-related activities are not more intensive in educated workers than all other urban activities.

On the other hand, line 3 shows that the composition of employment varies substantially between the ENOE, the whole Census, and NAFTA-related activities. In the ENOE, excluding public sector employment, salaried workers—who are paid salaries and

wages—account for less than half of the labor force, 47 percent. The second largest share, 27 percent, is accounted for by workers who run their own business or work for a family enterprise and are remunerated through profit-sharing or other arrangements.<sup>8</sup> These shares reflect the critical role played by self-employment and small family firms in Mexico. The contrast with the composition of employment captured in the Census is large. The share of salaried employment increases to 60 percent for the whole Census, and to between 70 to 77 percent depending on the measure used of NAFTA-related employment. In parallel, the share of owner/family firm employment falls, and is almost negligible for M2 and M3.

Consider now the second block: Lines 4 and 5 show that regardless of the measure used, NAFTA-related employment occurs in more capital-intensive firms and has higher labor productivity, as measured by value added per worker. Note that the differences are particularly large when we use M2 and M3. Differences in firm size are also quite sharp.

Finally, line 8 in the third block compares the average wage between the whole Census and NAFTA-related activities. The measure is very rough but is the only one that can be constructed with the Census data.<sup>9</sup> The differences are notable: 19 percent higher for M1, 40 percent for M2 and 35 percent for M3, and that, *prima facie*, they cannot be attributed to differences in schooling. That said, it should be noted that unfortunately the information on workers' characteristics in the Census is very rough and only refers to years of schooling. As a result, one cannot discern the extent to which the difference in average wages reflects differences in other dimension of human capital not captured in the Census (e.g., experience, on-the-job learning) or the fact that firms in NAFTA-related activities capture rents, which they shared with their workers in the form of higher wages. What is clear is that wages in NAFTA-related activities are higher than in the rest of urban economic activities and therefore raise the average urban wage.

Altogether, the picture that emerges from Table 2 is that NAFTA-related activities, particularly when measured by M2 or M3, are markedly different from those captured in the ENOE or even the whole Census. While they are not more intensive in workers with more years of schooling, they occur in substantially larger and more capital-intensive firms, with a different salaried/non-salaried employment composition and with higher average wages for salaried workers. That said, only a tiny share of all firms is directly engaged in NAFTA-related activities, 0.003 percent in the case of M2 and 0.002 percent in the case of M3, and even though these firms are 37 to 51 times larger, they nonetheless directly employ a small share of urban workers (8 percent in M2 and 4 percent in M3). These conclusions hold under the more generous M1 measure of NAFTA-related activities, although the differences are not as sharp, including in average wages.

We do not attempt here to estimate wages in the no-NAFTA scenario, although the discussion suggests that results would be more disappointing than those shown in Graphs 19 and 20.<sup>10</sup> We conclude that while NAFTA has had a small positive effect on urban wages in Mexico, it has not been sufficiently powerful to offset other forces that keep labor earnings low. In particular, the forces that have over time depressed the earnings of workers with more years of schooling; NAFTA has helped but clearly far from enough.<sup>11</sup>

### **A few remarks on labor regulations in Mexico**

Mexican labor institutions are very different from Canada and the U.S. First, labor and social security laws in Mexico make a critical distinction between salaried and non-salaried workers. The former have a relationship of dependency and subordination with respect to a boss/firm in exchange for a wage. The latter work for themselves or for firms but are not paid wages because they are engaged under contractual arrangements that do not imply subordinated labor. Second, only salaried

workers are covered by minimum wage regulations, can form unions, and have the right to strike for better benefits and working conditions. Third, only firms and salaried workers are obligated to contribute to social security programs which, as opposed to Canada and the U.S., include various types of pensions, health insurance, housing, and daycare services. Finally, salaried workers do not have unemployment insurance; rather, they are protected from the loss of employment by stringent job stability regulations. These considerations matter greatly since most of the labor provisions in NAFTA and now USMCA, apply only to salaried labor.

The functioning of the associated institutions is also different. For many reasons, salaried workers in Mexico undervalue the benefits of social security programs, so that there is an implicit tax on salaried employment. In parallel, non-salaried workers have access to some social benefits that, while not exactly equivalent to those for salaried ones, are free (Levy, 2008, 2019). The implicit tax on salaried employment, combined with stringent job stability regulations, on one hand, and the implicit subsidy to non-salaried employment, on the other, have two effects. First, they induce firms hiring salaried workers to evade labor and social insurance regulations, a situation that is facilitated by their imperfect enforcement. Second, they induce firms to elude these regulations through non-salaried contractual arrangements and promote self-employment. The result is that the labor market is segmented into two groups of workers: Salaried ones employed by firms that comply with the relevant labor and social insurance regulations, henceforth called “formal.” The rest are categorized as “informal,” a heterogenous group made up of salaried workers hired by firms that do not comply with the relevant regulations, self-employed and domestic workers and, very importantly, workers associated with firms without salaried contractual agreements.

The segmentation of the labor market is reflected in the structure of Mexico’s firms, which also divide into formal and informal depending on whether they hire



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salaried workers and comply with labor and social insurances laws or not. Importantly, firms can be informal without breaking these laws if they engage with workers without salaried contractual arrangements. These distinctions matter greatly. In 2018, 90 percent of all firms captured in the Economic Census were informal, 65 percent legally so. Informal firms, legal and illegal, are substantially smaller than formal ones (as measured by the number of workers), less capital intensive, controlling for size demand relatively fewer workers with more years of schooling, and on average have lower productivity than formal ones (Levy, 2018).

The formal-informal dichotomy, a central feature of Mexico's economy and a critical determinant of labor market outcomes, has been resilient to increases in the years of schooling of the labor force and to structural changes in output markets, as exemplified by NAFTA. In 2005, the first year of the ENOE, the urban labor informality rate was 58 percent, not that different from the one observed at the end of 2019, 56 percent. In the same period, the firm informality rate increased from 84 percent in 1998 to 90 percent in 2018.<sup>12</sup> The dichotomy needs to be seen as a deeply engrained structural feature of Mexico—a feature that is hard to rationalize with arguments about insufficient investments in human capital or lack of integration into the world economy. After a quarter of a century since NAFTA, there are two relevant lessons for the USMCA:

- It is difficult to change the labor market through reforms to output markets, particularly when many other regulations that bear on the labor market tend to deepen the formal-informal dichotomy (Levy, 2018).
- So long as this dichotomy persists, it will be difficult for wages to increase, because it is associated with low productivity and a depressed demand for workers with more years of schooling (Levy, 2018; Levy and López-Calva; 2020, Bobba, Flabbi and Levy, 2021).

### **A few remarks on the potential impact of USMCA on wages in Mexico**

As opposed to NAFTA, the USMCA did imply reforms to Mexico's labor law. These reforms, carried out in 2019, strengthened the mechanisms allowing salaried workers to decide on the unions that represent them and improved enforcement of pre-existing regulations (De Buen and Leycegui, 2021). Importantly, the USMCA included the right by Canadian or U.S. firms to request investigation of non-compliance by Mexico and when appropriate, the imposition of trade-related remedies. However, it did not change the underlying labor and social insurance architecture; in particular, the asymmetry in the treatment of salaried and non-salaried workers with respect to social insurance, nor job stability regulations for salaried workers. It also did not change the scope of social insurance or the functioning of the associated institutions.

By developing new mechanisms to exercise the rights of salaried workers and enhancing the credibility of sanctions in cases of non-compliance, the USMCA strengthened their bargaining power—particularly of those employed by USMCA-related firms. In principle, this will likely raise the labor costs of Mexican firms exporting to Canada and the U.S. or competing in the domestic market with imports from those countries. It is difficult to quantify the magnitude of this effect as it depends on the extent of pre-USMCA violations of salaried labor regulations and the effectiveness of the inspection-cum-sanction provisions. However, the direction is clear: All else equal, production in Mexico for the North American market will be less attractive because labor costs will be higher. Differently put, Mexico will lose some of its competitiveness vis-à-vis Canada and the U.S.<sup>13</sup>

Will the USMCA increase the average wage in Mexico? We consider two scenarios. But before discussing them, we point out that both ignore any changes in the world economy that independently of the USMCA, could improve Mexico's comparative advantages (e.g., re-design of regional



sourcing patterns triggered by competition between China and the U.S.). The first scenario assumes that the labor provisions of the USMCA are enforced mostly on USMCA-related firms in Mexico and that these firms enjoy rents, so that they can absorb higher labor costs without changing their demand for labor. In this case, the average wage will increase since it is the weighted average of wages in the USMCA-related segment of the economy and the rest (where the weights are the share of employment in each), and since by assumption the composition of employment does not change (implying no change in wages or labor earnings in the non-USMCA-related segment of the economy). That said, recall from Table 2 that the share of employment in the USMCA-related segment is small so that the increase in the average wage is bound to be small.

The second scenario allows for changes in the composition of employment. If wages or labor costs in USMCA-related firms increase substantially, firm rents will be exhausted, and these firms will adjust employment levels. This can also occur if investments in Mexico become less profitable vis-a-vis Canada and the U.S. because production costs in Mexico increase in response to other provisions in the USMCA like those related to rules of origin.<sup>44</sup> The result is that USMCA-related employment falls and, concomitantly, the supply of labor to the non-USMCA segment of the economy increases. Ignoring outward migration or open unemployment, the change in the average wage is now ambiguous, as the increase in

the USMCA-related segment is offset by a wage decrease in the rest of the economy and by the lower share of employment in the USMCA-related segment. But even if the change is positive, its magnitude will be smaller than in the first scenario, which already suggested that any wage increase would be fairly small.

Critically, the labor provisions of the USMCA do not change the underlying productivity of firms or workers in Mexico. In the first scenario, they only redistribute rents from firms to workers in the USMCA-related segment of the economy without impacting resource allocation. However, in the second scenario these provisions do change resource allocation, and they do so in the direction of increasing resources to the non-USMCA-related segment of the economy—the segment which, as shown in Table 2, has lower productivity. Differently put, from the point of view of productivity, in this scenario the labor provisions of the USMCA are doing exactly the opposite of what is needed.

Critically as well, note that the likelihood of the second scenario is proportional to the impact of the USMCA labor provisions on labor costs in USMCA-related firms: The greater it is, the greater the shift in resource allocation. Paradoxically, the “success” of the USMCA labor provisions—assuming this is interpreted as an increase in labor costs to USMCA-related firms in Mexico—may end up lowering aggregate productivity in Mexico, making it more difficult to sustain a higher average economy-wide wage.

**“ PARADOXICALLY, THE “SUCCESS” OF THE USMCA LABOR PROVISIONS—ASSUMING THIS IS INTERPRETED AS AN INCREASE IN LABOR COSTS TO USMCA-RELATED FIRMS IN MEXICO—MAY END UP LOWERING AGGREGATE PRODUCTIVITY IN MEXICO, MAKING IT MORE DIFFICULT TO SUSTAIN A HIGHER AVERAGE ECONOMY-WIDE WAGE. ”**

This brings us to the crux of the matter. The average rate of growth of total factor productivity in Mexico between 1990 and 2017—a period spanning NAFTA—was (-) 0.43 percent (Fernández-Arias, 2021). Over this period the productivity gap between Mexico and the U.S. widened despite NAFTA. Or to put it differently, NAFTA did not result in productivity convergence between Mexico and its northern neighbors.<sup>15</sup>

The average wage in Mexico will increase when the productivity of all of Mexico’s economy increases, not only that of its relatively small USMCA-related segment. The average wage will increase when, across the economy, low productivity firms exit the market, high productivity firms grow, and entering firms are more productive than incumbents—something that, at least

through 2013, had not occurred (Levy, 2018). The average wage will increase when higher productivity formal firms that are more intensive in workers with more years of schooling are not undercut by lower productivity informal firms. NAFTA was unable to improve overall firm dynamics in Mexico, not because of deficiencies in the agreement itself, but because the forces offsetting it were more powerful. Graphs 19 and 20 illustrate this unfortunate fact. Unless these forces change in Mexico, it is difficult to foresee that the USMCA will produce a different outcome. Labor provisions in the USMCA may help tighten the enforcement of regulations pertaining to salaried labor in a subset of firms in Mexico and redistribute some rents from firms to workers. However, these issues are far removed from the roots of Mexico’s productivity problem.

**ENDNOTES**

- 1 We thank Manuel Ramos Francia for very useful comments and suggestions.
- 2 Standard trade theory specifies that since relative to the US and Canada, Mexico is the labor-abundant country, NAFTA should result in higher wages in Mexico.
- 3 Various papers attempt to identify the impact of NAFTA on wages and employment in Mexico; see, for instance, Hanson (2003), Esquivel and Rodríguez-López (2003), Robertson (2007), Chiquiar (2008), Vázquez (2013) and Trachtenberg (2018).
- 4 The graph refers to salaried and non-salaried workers aged 18 to 65 working 20 or more hours a week in localities with 100,000 or more inhabitants. The expression “wage” also denotes the equivalent earnings of non-salaried workers. Wages are expressed in prices of 2008. Mexico’s employment survey changed in 2005, making it necessary to join the Encuesta Nacional de Empleo Urbano, ENEU (1990-2004), with the Encuesta Nacional de Ocupación y Empleo, ENOE (2005-2019). Both are quarterly household-based surveys, but the ENEU only samples localities with 100,000 or more inhabitants while the ENOE samples the whole country. To make them comparable, in graphs 19 and 20 we restrict the ENOE to localities with 100,000+ inhabitants. In both surveys, worker’s earnings are measured in pesos and in ranges of the minimum wage but in some cases the peso value is missing. In these cases, we extrapolate its value with the average peso earnings of workers in the same range of the minimum wage.
- 5 No schooling, 9 years of schooling (basic education), 12 years (high school) and 16 years (college). Both ENEU and ENOE provide more granular information on schooling, but we chose these categories to make them comparable with the ones used in the Economic Census; see Table 2.
- 6 In 1990, the shares of workers in localities with 100,000 or more inhabitants with no schooling, 6, 9 and 12 years of schooling were 3.8%, 68.3%, 10.4% and 17.5%, respectively. In 2019 they were 1.1%, 42.4%, 24.7% and 31.8%.
- 7 The Census captures information about all establishments in a fixed premise (i.e., with walls and a roof) regardless of ownership structure or registration with various authorities in urban areas, defined in the Census as localities with 2,500 or more inhabitants. Workers and establishments carrying out activities in the streets are excluded.
- 8 Other type of workers refers to those associated with firms through non-salaried contractual arrangements different from family-type ones, like sub-contracting, who are paid through honorariums or other mechanisms for which there is no information in the Census.
- 9 Wages are best measured with the ENOE, but one cannot identify NAFTA-related activities in it.
- 10 If we mechanically impute the average wage of workers in the Census to workers in NAFTA-related activities, the average would be 1% lower for the case of M2, and less for the other two measures.
- 11 The fall in the returns to education implicit in Graphs 19 and 20 lowers the incentives to invest in schooling in Mexico, as discussed in Bobba, Flabbi and Levy (2021). Thus, one can argue that in the absence of NAFTA there would have been fewer investments in schooling, a positive aspect of NAFTA that sometimes goes unnoticed. Importantly, there is little empirical evidence to support the proposition that the fall in the returns to schooling has been caused by a reduction in the quality of education (Levy, 2018).
- 12 The urban labor informality rate refers to localities with 2,500+ inhabitants, which for the reasons already cited cannot be obtained from ENEU. Focusing only on localities with 100,000+ inhabitants, the labor informality rate was 49.30% in 1990 and 49.28% in 2019. On the other hand, the firm informality rate is calculated from the Economic Census, which is only available every 5 years. However, for technical reasons the 1993 Census cannot be compared with the subsequent ones.
- 13 Of course, USMCA-related firms in Mexico can offset higher costs of salaried labor through labor-saving technologies or productivity gains in their production processes, so that the translation from higher labor costs to lower exports need not be automatic; much depends as well on the behavior of wages in Canada and the US. That said, note that these technical changes and innovations would likely reduce the share of employment in USMCA-related activities, particularly if they occur in very relevant ones like automobile production and auto parts.
- 14 USMCA-related firms in Mexico could try to preserve their rents and market share lobbying for looser monetary policy and a lower real exchange rate. We ignore these issues here.
- 15 Various reforms to increase total factor productivity were carried out after NAFTA. However, their impact was fully offset by less-visible changes in tax and social insurance policies that negatively affected the performance of firms and workers in the labor market, and by the persistence of distortions in sectors producing non-tradable goods and of an environment where contracts are enforced imperfectly (Levy, 2018).

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President of AFL-CIO

# The USMCA and the way forward for trade policy

The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) advocates every day for a global economy that benefits working people in every country, safeguards a livable planet, and bolsters democracy. But this isn't possible without a fairer global trade model. Signed into law on Jan. 29, 2020, the United States–Mexico–Canada Agreement (USMCA) is such a model, and the first major trade agreement the AFL-CIO has supported in nearly 20 years.

As president of the AFL-CIO, I am often asked how we came to support the USMCA after opposing the original North American Free Trade Agreement (NAFTA) and many subsequent trade deals.

To simplify it, NAFTA was written without real input from working people or their unions. Consequently, labor standards were relegated to an unenforceable side agreement. The USMCA, on the other hand, contains strong and enforceable labor provisions—the result of a sustained, authentic dialogue we helped shape.

Critically, as a precondition for the agreement, the USMCA required Mexico to adopt a package of labor law reforms designed to strengthen workers' virtually nonexistent rights to organize independent trade unions and bargain collectively. Together, these reforms seek to address Mexico's corrupt system of "protection contracts," where employers sign bogus collective bargaining agreements with

illegitimate, undemocratic trade unions that serve the companies' interests. Over the past several decades, the protection contract system has played a fundamental role in keeping Mexican workers' wages artificially low, encouraging offshoring of jobs from the United States and dragging down wages and standards across North America.

Given the real-life harm the protection contract system has caused workers across borders, the USMCA contains a new rapid-response enforcement mechanism that allows the U.S. government to bring trade enforcement cases directly against private employers in Mexico accused of denying workers their fundamental human rights of freedom of association



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and collective bargaining. Under the new mechanism, Mexican facilities found to be violating workers' rights must take effective corrective actions or face significant financial penalties, including, for repeat offenders, potential loss of access to the U.S. market. The Biden–Harris administration already has used the mechanism twice, resulting in rapid settlements that advanced workers' rights.

The USMCA raised the bar on other important labor standards as well. For example, it requires all three countries to adopt and implement bans on the import of goods made with forced labor. In addition, it contains strong rules of origin, particularly in the auto sector, which will require companies to use more North American content in

order to qualify for tariff reductions under the agreement. All of these commitments are backed up by an array of monitoring and enforcement mechanisms to ensure all trade partners live up to the terms of the deal.

More broadly, the USMCA eliminated various special interest giveaways to multinational corporations, including excessive patent protections that would have made prescription drugs even more expensive for North American workers. In addition, it greatly restricts access to investor-state dispute settlement (ISDS), which corporations have used to challenge basic environmental, public health, and labor protections in all three countries.

Despite these advances, the USMCA is far from perfect. By itself, it will not end outsourcing, growing economic inequality or climate change. However, it represents a major improvement over NAFTA and points the way toward a more balanced, worker-centered trade model capable of delivering broad-based economic growth that advances workers' rights.





Jerry  
Dias

National President of Unifor

# Bold labor provisions a bright light under new North American trade pact



In the midst of a horrific pandemic, the USMCA's coming into force flew almost entirely under the radar.

It is indicative, perhaps, of a change in the mindset of North America's political economy. Our world looks different today than it did during the blustery presidency of Donald Trump. Today, the entire precept of globalization is facing heavy criticism, and for good reason: Footloose capital built more profitable, but highly vulnerable, global supply chains.

Despite being a largely status quo agreement, the USMCA managed to break new ground by rewriting the labor conditions of trade.



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For the first time ever, workers in North America—the collateral damage of “rationalized” continental supply chains—have tools to meaningfully deal with abhorrent worker conditions; the same conditions, ironically, that manifested because of free trade.

Unlike NAFTA, which treated workers' rights as a “nice-to-have” (but strictly voluntary), the USMCA brings labor protections into the core text of the agreement. As a result, governments can now file formal disputes in order to resolve alleged violations like other provisions in the deal.

Emboldened by this change in approach, the Centro de Derechos de los Migrantes (CDM), an NGO promoting migrant labor rights, filed a first petition in March of 2021. The petition claims Mexican women faced systemic discrimination in hiring and employment conditions—a violation of USMCA's labor provisions.

Added to these new labor protections is a brand new complaint system, known as the Rapid Response Labour Mechanism. This provision targets the most egregious violations of workers' rights, including the denial of free and fair collective bargaining with severe penalties for corporate rule breakers—up to and including a total ban on cross-border exports. This bolsters labor reform efforts introduced by the Mexican government in 2019.

This new trade provision is proving to be, at least so far, more than just words on paper. In 2021, the U.S. government twice invoked the

mechanism to address serious allegations of vote tampering and worker intimidation at U.S.-owned auto plants in Mexico, including a massive General Motors truck complex in Silao. The added pressure placed on firms to maintain decent and fair labor standards, under threat of trade sanction, is emboldening Mexican workers to organize in defense of their rights, mounting legitimate challenges to Mexico's deeply corrupt and illegitimate “protection” unions.

These are still early days in new North American trade relations, and it is difficult to foretell how effective, or resilient, this surge in labor activism will be.

Strong progressive, political alignment between President Biden, Prime Minister Trudeau, and President Obrador in support of trade union freedoms is unique and positive—but also potentially transitory. A rash of America-first economic policies, under President Biden's Build Back Better plan, also threatens to upend any political goodwill built up in post-Trump North America.

Under USMCA, new approaches to labor are reason for hope. The question heading into 2022 is whether mobilizing around the rights of workers can transcend the antecedents of profit-driven free trade policy, in a post-pandemic North America.

# USING THE USMCA FOR CLIMATE ACTION



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When the renegotiated NAFTA was put to a vote in late 2020 and early 2021 in the U.S. Congress, some Democrats refused to vote for the revised agreement because it includes no specific provisions that address climate change.<sup>2</sup> Without question, the revised agreement should have addressed climate change specifically. U.S. Trade Representative Katherine Tai has rightly described this as a “glaring omission.” Even so, the new USMCA does include provisions that can be used to address some aspects of climate change and can set the stage for doing so more comprehensively and more effectively in future improvements in the treaty.

Although the side letters on the environment and labor in the original NAFTA were left on the side in 1993 and not included in the first formal trade agreement among Canada, Mexico, and the United States, those letters were nevertheless the first accords on the environment and labor ever to accompany an international trade agreement. This was an accomplishment in and of itself, and there was hope at the time that the mechanisms established by those letters would advance environmental and labor protections and would also presage the true integration of environmental and labor concerns into the NAFTA and other trade agreements in the future.

To say the least, this did not happen nearly quickly enough. More than a quarter of a century later, the NAFTA was renegotiated and rebranded as the USMCA, the House passed it at the end of 2019, and the Senate in January 2020. In this revision, the environment and labor provisions of the original NAFTA side letters were enhanced and were at last included in the main text of the agreement, making those provisions enforceable for the first time through revised arrangements for dispute settlement.

Despite these enhancements, with respect to protection of the environment, the situation now is not that much better since the original NAFTA took effect in 1994. Environmental provisions in the new USMCA are more than they were before, but they are less than they ought to be. In the long term, the challenge is to transform the USMCA into an agreement that truly addresses the many links between trade and the environment. Yet, in the near term, the challenge for those who seek effective environmental action is to make the most of the strengthened provisions. Equally, it is to find ways to fight climate change through the agreement despite the unfortunate fact that climate change is nowhere mentioned in the agreement.

How do we address this climate challenge?

As Joshua Meltzer has pointed out, “While USMCA has been criticized for failing to explicitly include climate change

commitments, there are a number of provisions that support climate action.”<sup>3</sup> For example, the environmental chapter of the USMCA – Chapter 24 – includes requirements for maintaining the effective enforcement of environmental laws and maintaining procedures for assessing the environmental impacts of proposed projects that “may cause significant effects on the environment.”<sup>4</sup> Although the language in these obligations could and should have been more demanding of the three USMCA countries, these obligations do exist.

In addition, Chapter 24 incorporates seven multilateral environmental agreements (MEAs) – making them enforceable through USMCA dispute settlement.<sup>5</sup> This list of MEAs does not include the United Nations Framework Convention on Climate Change or the Paris Agreement. It should. Yet, enforcement of the agreements already on this list includes various actions on other aspects of sustainable development. These relate to such matters as air quality, ozone layer depletion, marine ship pollution, wetlands protection, and the protection of endangered species.<sup>6</sup> Thus, although the listed MEAs do not deal with climate change directly, they do help to diminish some of the impacts of climate change on the environment.

Furthermore, Chapter 24 of the USMCA also includes provisions aimed at protecting biodiversity; preventing the introduction of invasive alien species; maintaining marine wild capture fisheries; furthering sustainable fisheries management; disciplining fisheries subsidies; conserving whales and other marine species; combating illegal, unreported, and unregulated fishing; combating all other kinds of illegal wildlife trade; and ensuring sustainable forest management, including by acting against illegal logging.<sup>7</sup> Admittedly, all of these provisions could and should have been tougher, but they are all improvements to the original agreement. Here, too, while these provisions do not deal directly with addressing climate change, they can be employed positively to ease some of the impacts of climate change and also to enhance climate adaptation.



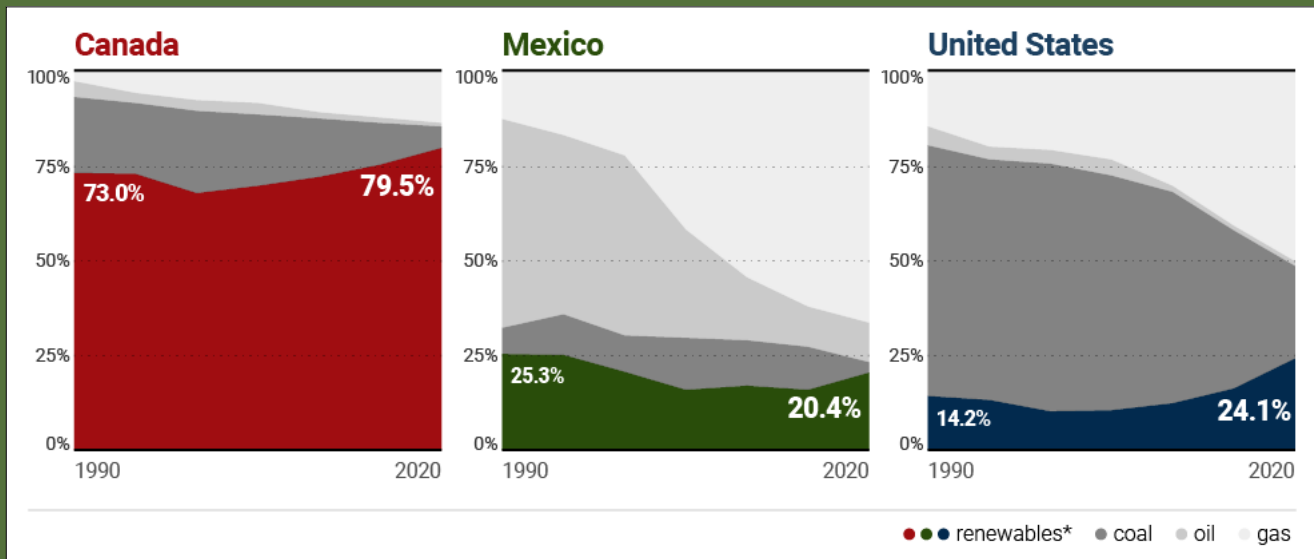
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**GRAPH 21**

**Share of energy sources in electricity generation**

Since 1990, growth in renewable energy in the U.S. is a standout, whereas renewable energy as a share of Mexico's power sector has declined overall, with some recent gains. Expanding U.S. electricity trade with Canada is one way to further increase the share of renewable energy in the U.S. energy mix.



Source: IEA Energy and Carbon Tracker (2020).

\*Electricity and heat derived from solar, wind, ocean, hydropower, biomass, geothermal resources, and biofuels and hydrogen derived from renewable resources.



The opportunities provided by the USMCA can be used to improve the competitiveness of each of the three USMCA countries and of the entire North American region while also furthering climate change mitigation and adaptation as well as other goals for sustainable development. For example: One provision in Article 24 states that “the Parties shall strive to facilitate and promote trade and investment in environmental goods and services.”<sup>8</sup> By eliminating tariffs and “potential non-tariff barriers” to that trade, North America can become a more integrated and globally competitive market while also selling to other countries – especially to developing countries – more of the environmental goods and services they much need. Examples of these goods are wind turbines, water treatment filters, solar water heaters, ultraviolet disinfection and desalination equipment, recycling equipment, air and water quality monitors, and LED lights and industrial automation systems. As envisaged in the USMCA,<sup>9</sup> the three USMCA parties can also cooperate in the World Trade Organization (WTO) to bring a successful conclusion to the negotiations on eliminating tariffs on environmental goods that have continued in the WTO for twenty years.<sup>10</sup>

This cooperation should also include efforts to further integrate the North American energy market and to turn that market more quickly toward clean means of producing and distributing carbon-free renewable energy. For instance, in keeping with the recognition in Chapter 11 of the USMCA that “mechanisms exist to support greater regulatory alignment and to eliminate unnecessary technical barriers to trade in the region,” the three countries could facilitate the greater alignment of standards and technical regulations aimed at reducing greenhouse gas emissions from their regional supply chains.<sup>11</sup> For example, agreement on common climate-friendly standards on batteries and steel production could improve overall efficiency while also speeding and spreading the reduction of carbon emissions within the region without raising competitive border issues among the three countries on carbon-related trade.

Importantly, the three USMCA parties could also coordinate their research and development on clean energy and on regionwide encouragement of innovative investments in clean energy. Annex 12-D of the USMCA envisages cooperation “on energy performance standards and related test procedures in order to facilitate trade among the Parties and advance energy efficiency....”<sup>12</sup> The stated aim in the agreement is harmonization of energy performance standards and test procedures.<sup>13</sup> Because the energy markets of the three USMCA countries are significantly and increasingly integrated, the emissions-reducing impact of regulatory and other plans to reduce greenhouse gas emissions in the United States would be increased if the three parties to the USMCA chose to pursue their goals for energy efficiency and energy-related climate action together.

A looming obstacle to regional energy cooperation is the pending electricity legislation in Mexico that would reverse recent moves toward privatization and modernization of the Mexican energy market and turn it back toward the self-defeating and heavily carbon-emitting state direction of the past.<sup>14</sup> This legislation could violate USMCA treaty obligations by discriminating against private electricity generators and foreign investors in favor of state-owned enterprises.<sup>15</sup> Moreover, because those state-owned enterprises are overwhelmingly dependent on fossil fuels and have done little to reduce their fossil fuel emissions, this reversal by the Mexican government would run counter to keeping the ambitious promises of carbon emissions cuts Mexico has made under the Paris Agreement.<sup>16</sup>

Historically, Mexico has been sensitive about, and has always taken great pride in, its sovereignty over its energy resources. Mexico’s “direct, inalienable, and imprescriptible ownership” of its hydrocarbons is specifically acknowledged in the USMCA.<sup>17</sup> Clearly reserved in the USMCA is Mexico’s “sovereign right to reform its Constitution and its domestic legislation,” including those constitutional provisions and laws relating to hydrocarbons.<sup>18</sup> In reliance

The parties to the USMCA can be helpful in spurring such multilateral action by the

# 164 WTO Members

by working together to establish a common regional approach to shaping and taking such measures in North America

on these treaty provisions, President Andres Manuel Lopez Obrador of Mexico is giving renewed expression to the Mexican national concern about its oil and gas resources. He is trying to reverse reforms made by his predecessor that opened the state-dominated Mexican energy market to both domestic and foreign competition from the private sector. Furthermore, he is proposing additional restrictions on the lawful reach of the private sector in energy production, distribution, and sales in Mexico.<sup>19</sup>

The Mexican president's proposed reforms, however, are not as legally straightforward under the USMCA as he insists. As Inu Manak and Alfredo Carrillo Obregon of the Cato Institute have explained, depending on how the proposed Mexican energy bill is implemented, "it is possible that it could violate a number of provisions of the USMCA, and both state-to-state and investor-state dispute procedures are available. Notably, legacy investments are still covered under the scaled back investor-state dispute settlement rules for three years after entry into force; and for new investments, the oil and gas and power generation sectors are still covered for investor-state disputes related to covered government contracts. While Canada does not have recourse to ISDS against Mexico under USMCA, it could pursue a claim under the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), to which Mexico is also a party."<sup>20</sup>

Because of its discriminatory nature – and because of the insecurity it would instill in foreign direct investments in the Mexican energy market – this proposed energy bill would hinder new private investment, both foreign and domestic alike, in Mexican energy production and electricity generation, including in clean energy.<sup>21</sup> Mexico cannot afford to lose such investment, especially if it hopes to meet its climate pledges.<sup>22</sup> Instead of pushing this proposed legislation, which faces hurdles under Mexican law, the Mexican government should instead be seeking more foreign direct investment from the U.S., Canada, and elsewhere. It should be soliciting and welcoming technical assistance and financing from its USMCA partners that

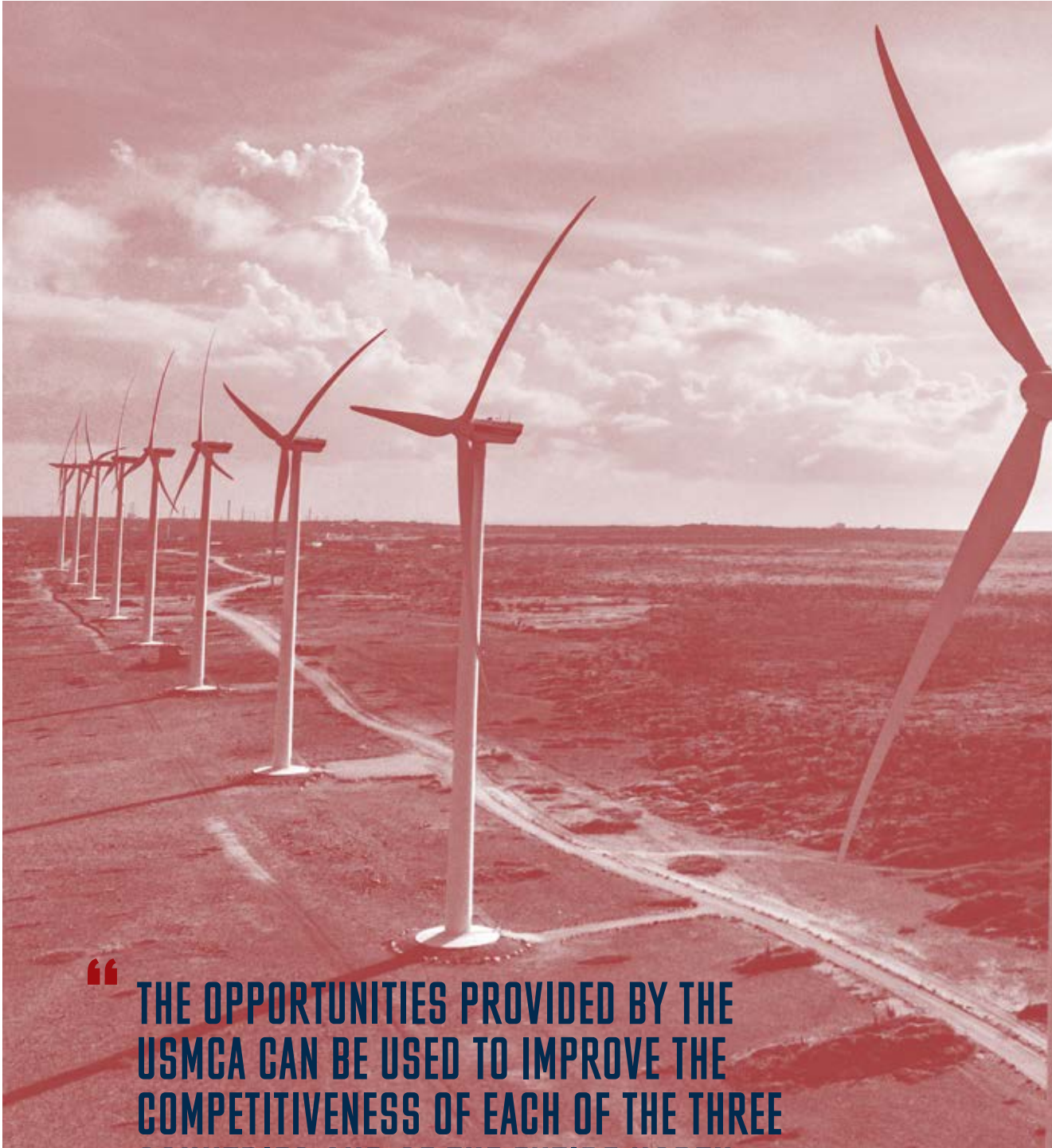
would help increase energy efficiency and reduce emissions.<sup>23</sup> For their part, the U.S. and Canada should not wait on entreaties from Mexico before making such offers, which could be conditioned on a retreat by Mexico from the proposed legislation.

There is also an opportunity for the three USMCA parties to cooperate in a common approach to the new and rapidly spreading phenomenon of climate-related trade restrictions. The U.S. and the EU have announced that they will impose tariffs or other trade restrictions on imports of "dirty" steel and aluminum.<sup>24</sup> This follows the recent proposal by the EU to impose climate-related trade restrictions on imports of carbon-intensive products in a new "carbon border adjustment mechanism."<sup>25</sup> These restrictions are not scheduled to take effect for another few years. However, the U.S. and the EU are enlisting other countries in their steel and aluminum plan; and the U.S., Canada, Japan, and other countries are considering new trade-limiting climate legislation akin to the EU CBAM. At this point, Canada is probably farther along toward enacting such legislation than either the U.S. or Japan; but this could change.<sup>26</sup>

The countries planning and contemplating these trade-restrictive climate measures say they are doing this to help them take actions to limit greenhouse gas emissions domestically, and to help inspire more ambitious climate actions throughout the world. They claim they are motivated by the urgency of the accelerating pace of climate change and the growing evidence of the economic and environmental devastation that it causes. For the most part, this seems to be true. And yet such measures can also be pretexts for green protectionism, imposing new restrictions on imports – often from developing countries – that are motivated more by a desire for trade protection than by a commitment to climate action.

These actions are being taken outside the legal framework of the WTO, which risks further undermining the efficacy and the centrality of the WTO-based multilateral trading system. At the same time, they raise legal issues under international trade law

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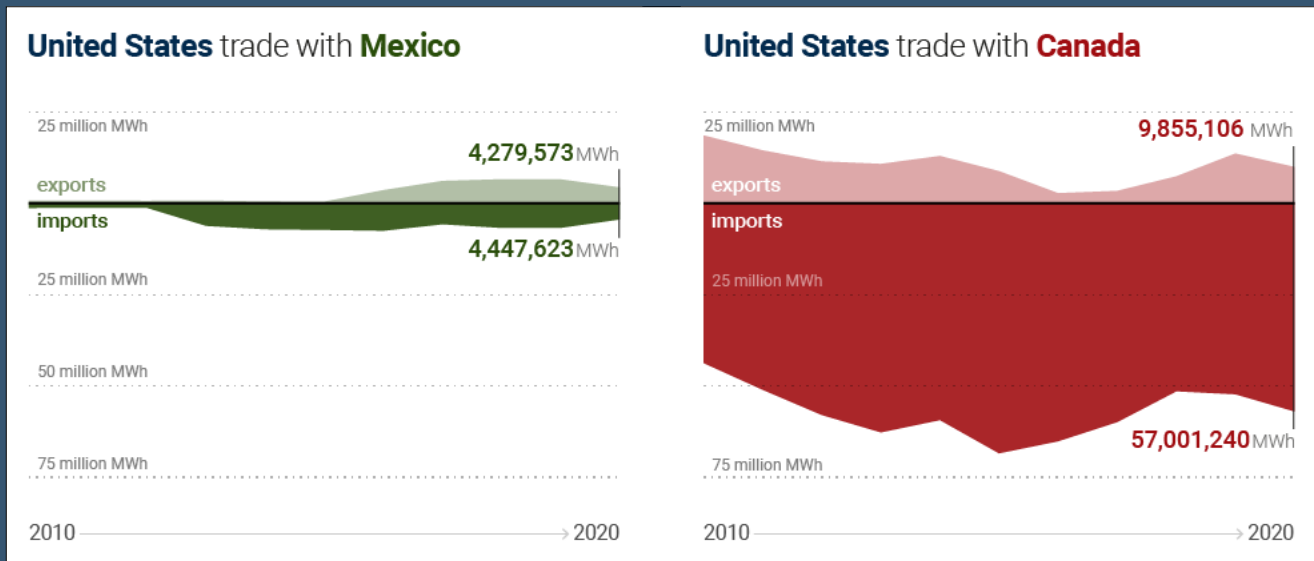


**“ THE OPPORTUNITIES PROVIDED BY THE USMCA CAN BE USED TO IMPROVE THE COMPETITIVENESS OF EACH OF THE THREE COUNTRIES AND OF THE ENTIRE NORTH AMERICAN REGION WHILE ALSO FURTHERING CLIMATE CHANGE MITIGATION AND ADAPTATION. ”**

**GRAPH 22**

**Electricity trade in North America (in Megawatthours), 2010-2020**

Huge U.S. imports of electricity from Canada is an opportunity to help decarbonize U.S. electricity.



Source: U.S. Energy Information Administration (2016-2020).

that could result in highly contentious WTO trade disputes that could transform the WTO’s trade judges into climate judges.<sup>27</sup> At the core of these legal concerns is the failure thus far of the trade and climate regimes to grapple with how and where the line should be drawn to distinguish between trade-restrictive measures that are ostensibly climate measures but are in fact purely protectionist, and legitimate climate response measures that have a mix of economic and climate motives.

This line should be drawn globally through multilateral action by the WTO. The parties to the USMCA can be helpful in spurring such multilateral action by the 164 WTO members by working together to establish a common regional approach to shaping and taking such measures in North America. Tackling climate change should not build barriers to trade in North America but should be a driver for addressing climate change. If done consistently with their WTO obligations, a common regional approach could take the form of a climate “club.”<sup>28</sup> The three USMCA

countries can then work within the WTO to employ their own experience in building on this regional approach by forging a common multilateral approach. In so doing, they could help prevent a global climate trade war that could have harmful global economic effects far exceeding those of the bilateral trade confrontation between the U.S. and China.<sup>29</sup>

The key to all these climate-related actions under the USMCA, will be cooperation. Regional cooperation under the USMCA must, from now on, see the economy and the environment as one. Going forward, regional economic integration in North America must also be regional environmental integration. Although the phrase “climate change” does not appear in the USMCA, the Agreement can, nevertheless, become a useful tool for taking affirmative actions to mitigate and adapt to climate change between now and some later date when specific and stronger provisions on climate change are added to the treaty.



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# Mexico's energy counter-reform could derail the prospects for a prosperous North America



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North America has the potential to become a global energy powerhouse. The region is endowed with an abundance of diverse energy resources and has developed increasingly interdependent energy markets. In this decade, North America could become energy self-sufficient, a net exporter of crude oil and natural gas, and a dynamic producer of renewable energy sources and critical minerals to support the transition to a low-carbon economy. The entering into force of the USMCA provides a sound institutional framework to further support trilateral integration from which to build a post-COVID recovery process that is fair and sustainable. However, the effective cooperation between the U.S., Mexico, and Canada could be strained as partners diverge on goals and vision; specifically, the

proposal to overhaul Mexico's energy policy could derail the effort to partner on combating climate change and developing clean technology solutions.

On September 30, 2021, President Andrés Manuel López Obrador submitted to the Mexican Congress an *Initiative to Reform the Mexican Constitution on Energy Matters*. The initiative aims to nationalize the energy and the mining sectors, return to a dual monopoly model for hydrocarbons and electricity, and establish government control throughout the supply chain of the energy transition process, including science, research and development, and investment.

The initiative is most explicit regarding the power sector: Existing electricity power generation



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contracts and permits would be canceled; the independent system operator would become a part of national utility company, Comisión Federal de Electricidad (CFE); the Energy Secretariat would absorb the autonomous regulatory bodies; and state-owned enterprises would become government entities.

The initiative would bestow unlimited power to CFE: It would run the electricity sector, be its arbiter and regulator, establish transmission and distribution tariffs and electricity rates, and drive the pace and shape of the energy transition. Furthermore, CFE would have the authority to determine which previous contracts and permits are legal and define the terms for buying from “recognized” private producers. The initiative would take effect retroactively, as it would cancel out all contracts and permits, and seriously undermine the rule of law in Mexico.

Moreover, the initiative would adversely affect Mexico’s renewable energy development. It would cancel Clean Energy Certificates that support the deployment of clean-energy projects, modify the cost-based rules of the electricity market in favor of inefficient CFE plants,

“ **IN THIS DECADE, NORTH AMERICA COULD BECOME ENERGY SELF-SUFFICIENT, A NET EXPORTER OF CRUDE OIL AND NATURAL GAS, AND A DYNAMIC PRODUCER OF RENEWABLE ENERGY SOURCES AND CRITICAL MINERALS TO SUPPORT THE TRANSITION TO A LOW-CARBON ECONOMY.** ”

and block combined-cycles and renewable-based private production, which generates at a lower cost than CFE. A central aim of the initiative is to ensure that CFE burns in its plants the fuel-oil PEMEX produces in its inefficient refining process for which there is no market. Scientists in Mexico and the U.S. have warned that emissions will increase. A recent study by NREL concludes that under different implementation scenarios CO<sub>2</sub> emissions could go up between 26.1 percent and 65.2 percent, whereas total production costs would go up between 31.7 percent and 52.5 percent, seriously undermining Mexico's competitiveness.

Already, Mexico's compliance with its Paris Climate Agreement commitments is deemed "highly insufficient," and it is assumed that the country will not reach the

goal of generating 35 percent of its electricity from clean-energy sources by 2024. The initiative would put Mexico on a new high-carbon trajectory, setting it apart from its North American partners.

The implications of the energy reform are profound. If approved in its terms and implemented, Mexico's competitiveness would be compromised as electricity rates would rise and blackouts increase due to supply shortages, putting at risk Mexico's economic recovery. Investments would not flow into Mexico given the lack of secure supply of clean energy. Companies with net-zero commitments are likely to move operations across the border. The loss of revenue from existing investments and indirect expropriation of plants would have a rippling effect beyond the energy

sector for years to come. Mexico would lose a golden opportunity to attract investments in the dynamic supply chain of clean energies.

The bill is currently under consideration by the Mexican Congress. If approved in its current terms, Mexico will de facto forsake its trade and climate agreements. Mexico would be in violation of its free-trade agreements, including Chapters 2, 11, 14, 22, and 24 of USMCA. A major blow to North American integration and recovery.



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# Mexico's energy reforms: A blow to realizing the most competitive and dynamic region in the world

In late 2017, Mexico made headlines as Italian company Enel bid what was then a world-record low price for renewable energy in the country's third such energy auction. This development was possible due to the historical and sweeping energy reforms passed with broad support in Mexico in 2013. Then-President Enrique Peña Nieto had succeeded where previous Mexican presidents had failed, reversing decades of resource nationalism and overhauling the energy sector through constitutional reforms that gave the private sector a larger role and advantaged renewable energy in Mexico's economy. The 2017 auction seemed to indicate Mexico's bright future not only as a

conventional oil producer, but also as a clean energy power.

Just four years later, Mexico and its policymakers are contemplating energy reforms, which would reverse these gains. Mexico's Congress will soon debate a constitutional amendment supported by current President Andrés Manuel López Obrador that was deemed necessary after Mexican courts challenged the legitimacy of earlier legislation. The president is seeking to restore the dominance of the state in Mexico's energy sector and, in his view, minimize corruption and level the playing field between the state and private companies.<sup>1</sup> The proposed constitutional amendment would shift control of the power sector

back to the state-run utility, the Federal Electricity Commission (CFE), and move now-independent energy regulators back under the auspices of the state. Under the new rules, CFE would have at least 54 percent of the power market and would no longer have to dispatch the lowest cost power first, but instead would prioritize its own power generation. These changes are proposed in the context of a broader push to favor state-run companies, including Mexico's oil behemoth Pemex, in the energy sector.

The implications of this constitutional "counter reform," if successful, are serious and wide-ranging – and go well beyond Mexico's domestic arena. First, such





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“  
**THE PROPOSED ENERGY REFORMS WOULD BE A SIGNIFICANT SETBACK TO THE ASPIRATIONS OF THE AGREEMENT AND ENTAIL OPPORTUNITY COSTS TO ALL.**  
”

changes would destabilize Mexico’s renewable energy sector and the ability of Mexico to meet its already too-modest climate goals. The prioritization of power produced by CFE over that of private companies is effectively a move to favor fossil fuels over renewable energy. CFE primarily generates power from hydro, nuclear, natural gas, and fuel oil. Most of Mexico’s green power is produced by the private sector, which means that it would be dispatched

last, despite being cheaper. The prospects of Mexico meeting its climate targets – which the Obrador government declined to revise to be more ambitious at Glasgow – would move from dim to nil as renewable energy suffered this major setback. Mexico’s 2012 General Law on Climate Change currently commits the country to generating at least 35 percent of its power with clean technologies by 2024 and to reduce emissions by 30 percent by

2020 and 50 percent by 2050 when compared to 2000.<sup>2</sup> Yet, a 2021 study done by the U.S. Department of Energy’s National Renewable Energy Laboratory (NREL) assessed that similar changes to those being advocated today would increase Mexico’s carbon emissions by 26-65 percent.<sup>3</sup>

The proposed constitutional reform would also harm Mexican competitiveness and economic



growth. The surge in wind and solar power generation in Mexico since former President Nieto's 2013-2014 energy reforms has been a boon to manufacturing given the importance of energy costs to such industries.<sup>4</sup> CFE's power, which will now be dispatched first, will in most cases be more expensive than the renewable energy generated by the private sector. The same study by the NREL expected a dominant role for CFE in Mexico's power sector would increase electricity generation costs by 32-54 percent and boost the possibility of power outages by 8-35 percent.<sup>5</sup> Moreover, large companies that have been securing power directly from private power plants—many of them relying on renewable sources—would no longer be able to do so and would be forced to turn to the more expensive, less clean power provided by CFE. Higher cost power would make Mexico far less attractive to companies and investors looking for a competitive alternative to basing operations in China amidst increasing tensions between Beijing and the West. Moreover, international companies committed to their own “net-zero” carbon goals would be less interested in establishing operations in a place that would worsen or not improve their carbon footprints.

Finally, the proposed constitutional reforms are almost certain to create greater friction in Mexico's relationship with the U.S. and Canada. Most significantly, they are viewed by some to be in violation of the USMCA, in which signatories committed not to favor domestic companies at the expense of foreign investors. The trade pact provides remedies to foreign energy investors in Mexico when fair market competition is undermined; Bloomberg calculates that the reforms would jeopardize more than \$22 billion of foreign-owned solar, wind, and other renewable-energy installations.<sup>6</sup>

The trade pact does not mention the United Nations Framework Convention on Climate Change nor the Paris Agreement in the list of agreements to which signatories committed to maintain laws or regulations to fulfill such obligations. But the USMCA does affirm each country's “commitment to implement the multilateral environmental agreements to which it is a party,”<sup>7</sup> and the reforms would clearly hamper Mexico's ability to do this. In addition to these potential violations of USMCA, the proposed energy reforms would be a significant setback to the aspirations of the agreement and entail opportunity costs to all by preventing the three

countries from deepening their trade and other forms of cooperation related to climate. The vision of the continent being “the most competitive and dynamic region in the world”<sup>8</sup> as articulated by the leaders of the U.S., Canada, and Mexico in 2014 would be hard to realize if Mexico moves determinedly away from the private sector and renewable energy.

The American and Canadian governments have both the grounds and a responsibility to urge Mexican policymakers to oppose this constitutional amendment and the general direction of President Obrador's energy reforms.

The push to restore the primacy of the state and, as a result, the role of fossil fuels in Mexico's economy has implications for climate, competitiveness, and cooperation that are of direct interest and importance to Mexico's northern neighbors. Both the Biden and Trudeau governments appear to have made this clear to the Obrador administration. Now that the action is shifting to the Mexican Congress with an April 2022 debate and vote looming, so too should the diplomacy of Washington and Ottawa. The implications for the continent's prosperity, competitiveness, and climate are all at stake.

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