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THE FUTURE OF NORTH AMERICAN ECONOMIC INTEGRATION

The Future of North American Economic Integration

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Abstract: The United States-Mexico-Canada Agreement (USMCA) will modestly set back economic integration. The new pact is part-TPP, part-original NAFTA, and also includes some protectionist measures that will likely have a small negative impact on the U.S. economy and hurt the Mexican auto sector compared to NAFTA. Nevertheless, the pact has a big plus: thanks to the name change and the buy-in from U.S. Congressional Democrats, the USMCA has mitigated much of the political opposition that complicated North American trade and investment relations. Our paper enumerates the problems created by USMCA before examining the opportunities to work together now that the stigma of the old NAFTA has been removed.

The second part of the paper examines opportunities created by the new, more cooperative, political atmosphere within North America. Priority should be given to cooperation on energy, including renewables and carbon emission standards. In addition, the USMCA partners should expand NADBank programs and substantially increase its capital. Infrastructure investment also should be a priority, although regional cooperation could be complicated by Buy American procurement requirements and new U.S. tax policies. Considering the Cold War that is likely to continue between the United States and China, Mexico and Canada must decide how to play their own China cards, recognizing the implications that export controls have on relations with the European Union and other important trading partners.

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1. Introduction

The North American Free Trade Agreement (NAFTA) died on July 1, 2020, scorned in the United States throughout its 25-year existence and unloved by politicians in all three member countries. NAFTA did not deserve its bad reputation and provided substantial economic benefits for all three countries, delivered through huge expansions in regional trade and investment. Moreover, NAFTA provided the template for dozens of bilateral FTAs with other trading partners that each country negotiated separately over the past two decades.

But NAFTA was designed for the 20th century and needed updating. Unable to reopen the original deal without risking its unraveling, political leaders in the three countries largely skirted needed NAFTA reforms and limited changes to decisions by trade ministers, virtually unnoticed by their legislatures, to adjust rules of origin to promote interregional trade and investment at the expense of global linkages. In the political realm, more attention was paid to stiff labor and environmental rules foisted on Mexico.

However, NAFTA economic reform was substantially achieved indirectly through the negotiation of the Trans-Pacific Partnership (TPP). Mexico and Canada joined the U.S.-led negotiations in late 2012 and the three countries completed a comprehensive update of their North American pact in the context of modernizing trade relations in the broader Asia-Pacific region. NAFTA reform was essentially realized through the TPP - but then not implemented due to U.S. withdrawal from the agreement at the start of the Trump administration in January 2017. [1]

Efforts at NAFTA reform soon revived but President Donald Trump demanded that the talks reflect his priorities, or he would pull the United States out. After 15 months of negotiation between the three partners, the revised deal was signed on November 30, 2018. After additional modifications to the pact were made to secure U.S. congressional support, the pact was ratified by the national legislatures and entered into force on July 1, 2020.

In the United States, the new pact is titled the United States-Mexico-Canada Agreement or USMCA; in Mexico it is the T-MEC or Treaty between Mexico, the United States, and Canada; and in Canada it is the Canada-United States-Mexico Agreement or CUSMA. Fittingly, the new pact is no longer called a "Free Trade Agreement." Words matter. The pact is not like past FTAs; with few exceptions, it does not introduce new liberalization of trade and investment but rather imposes restrictions that limit commercial relations compared to the NAFTA era (e.g., on access to bidding on U.S. government contracts) in an effort to serve U.S. protectionist interests. Canadian and Mexican officials accepted this biased orientation under duress but also in the misguided hope that it would bolster foreign investment in their auto sectors.

The USMCA clearly reflects its NAFTA parentage. Much of the new agreement is drawn from the old agreement. Negotiators also borrowed generously from and improved upon TPP provisions to update and augment obligations in areas such as digital trade, environment, currency practices, and labor. Modernization required little change in the current policies of the three countries since the provisions largely reflect U.S. practice as well as obligations that Canada and Mexico have implemented pursuant to their participation in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

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1 Fortunately, Mexico and Canada implemented a slightly revised TPP, renamed the Comprehensive and Progressive Agreement for TPP (CPTPP) which entered into force at the end of 2018.

On balance, the new trade pact will modestly set back economic integration. Peterson Institute analyses (Lovely and Schott, 2019) and the assessment of the USMCA by the U.S. International Trade Commission (USITC, 2019) indicate that USMCA will have a slightly negative impact on the U.S. economy and hurt the Mexican auto sector compared to NAFTA.

Nevertheless, the pact has one big plus: thanks to the name change and the buy-in from U.S. Congressional Democrats, the USMCA has mitigated much of the U.S. political opposition that threatened to abrogate the pact and clouded North American trade and investment relations. Put another way, the new pact reduces the insurance premia on investments in Mexico by lowering the risk that border restrictions will be reinstalled. But as we have seen with the response to the COVID-19 pandemic, with immigration across the U.S.-Mexico border, and with steel and aluminum tariffs imposed for spurious national security reasons, trade obligations can be easily circumvented by new restrictions.

Moreover, even though the new pact improves the climate for investment in Mexico by removing Trump's threat to dissolve NAFTA, that "gain" is offset to some extent by the increased uncertainty arising from the new review/termination clause that could be activated after 16 years. That prospect might constrain investment in large plants that serve two or three countries. Compared to the pre-Trump era, the USMCA does little to boost investor confidence in any of the three markets. If Mexico wants to improve its attractiveness to foreign investors, it needs to get its own economic house in order.

It is worrisome the North American partners only have a brief honeymoon before their regional relationship faces new challenges. To ensure increased growth and shared prosperity throughout North America, the three trade partners quickly need to take advantage of opportunities created by the new, more cooperative, political atmosphere to strengthen regional economic integration.

An early goal should be a supplementary agreement that no restrictions on medical exports – masks, PPE, ventilators, vaccines, treatments – will be applied between the USMCA partners. In numerous other areas the three partner countries can also work together to promote shared prosperity. At the same time, there are areas where the three countries will need to manage their differences, particularly to deter nationalist policies that hinder North American trade and investment flows. In that regard, this paper starts with two sectors that account for a significant share of interregional trade: autos and energy. The new pact is likely to hurt the former and help the latter, though recent Mexican energy policies could counter the cooperative intent of the new accord.

2. Auto Trade

USMCA takes a giant (and most unfortunate) step into the realm of managed trade, with strict rules of origin that discourage auto parts from third countries (Asia, Europe, South America), and quotas on autos assembled in Mexico and Canada that are sold in the U.S. market. The quotas will not bind for several years, but the concept of managed trade is now firmly established. In a last-minute tweak, U.S. officials demanded the inclusion of a "melted and poured" provision for steel used in auto production to protect U.S. steelmakers. Again, implementation is delayed – here, for seven years – but the managed-trade precedent is there.

Rules of origin (ROOs) matter. The United States has recently issued controversial implementing regulations that detail how domestic content requirements are to be calculated for cars and trucks to qualify for USMCA tariff preferences in order to satisfy the new and more demanding North American sourcing requirements. As we predicted long before the USMCA deal was struck, the cost of producing vehicles in North America will go up as supply chains are broken or readjusted to fit more stringent sourcing requirements. It will not take much additional cost to convince companies to import passenger-vehicles produced in Asia and Europe to the dominant U.S. auto market and simply pay the small 2.5% U.S. car tariff instead of producing in North America.

However, trucks are a different matter since the alternative to USMCA preferences is payment of a 25% U.S. tariff, which deters most foreign trucks from competing with U.S.-based production. Vehicle manufacturers got whip-sawed by the new U.S. content regulations, which will require them to make far more substantial changes in their supply chains for trucks than previously expected. Mexican producers thought they could comply with the new rules with some easy workarounds and by substituting parts made in Mexico for those imported from Asia and Europe. And Mexican officials thought the foreign companies would relocate parts' plants in Mexico to serve growing production and exports to the United States. Both were thus sanguine about the stricter regional content rules. Now they are stuck with complying with the new rules and losing part of their truck business or shifting production to U.S.-based plants.

This is a big deal for Mexico. In 2019, Mexico exported about USD 38 billion worth of trucks, buses, and special purpose vehicles to the United States (U.S. Census Bureau, 2020). Expect those numbers to go down once the market returns to normal after the COVID-19 pandemic. The USITC study, which did not take account of the new U.S. auto content regulations, reaches a similar downbeat forecast (p. 89):

> For small cars, mid- and full-size cars, and multi-passenger vehicles (MPVs), the absolute increase in U.S. and Mexican production costs for some models (both absolute and relative to production costs outside North America) would lead to three types of reductions. The cost increase would cause a reduction in (1) U.S. production, (2) U.S. exports to Canada and Mexico, and (3) U.S. imports from Mexico (table 3.8). The new ROOs would also lead to an increase in U.S. imports from outside North America.

3. Energy Policy

Energy is a central feature of North American commerce. In 2019, three-way energy trade reached USD 160 billion, some 14% of total three-way merchandise trade (table 1). As well, in 2019, the stock of U.S. direct investment in the Canadian energy sector was USD 11 billion, and in Mexico USD 11 billion, too. When oil security was a hot political issue in the 1980s, the United States-Canada Free Trade Agreement called for non-discriminatory access to supplies. This provision was carried into NAFTA, and then into the USMCA. While Mexico retains, in Chapter 8, the right to change its constitution and laws, USMCA requires Mexico not take measures with respect to the Chapter 14 Investment Chapter that are more restrictive than existing obligations in Mexico's trade agreements that have already entered into effect, such as the CPTPP.

Table 1. Trilateral merchandise trade in 2019 (USD billion)

	Trade in goods	Trade in energy goods	Trade in agricultural goods	Trade in auto and parts
U.S. exports to Canada	292.6	85.5	26.7	62
U.S. imports from Canada	319.4	24.7	26.8	59.8
U.S. exports to Mexico	256.6	13.1	18.3	37.1
U.S. imports from Mexico	358	37.4	31.6	136.6
Mexico exports to Canada	14.1	0.002	0.8	5.5
Mexico imports from Canada	9.8	0.4	1.7	1.6
NAFTA total	1,240.7	160.7	104.2	301

Note: Energy goods (HS27), agricultural goods (HS1-4, 7-13, 15-22,33) and auto and parts (HS87)
Source: U.S. Census Bureau and Trademap.org using UNCTAD database

With newfound abundance of oil and gas, energy security is no longer the hot topic. Instead, political focus has moved to energy commerce and carbon emissions, two closely related issues. Between the United States and Canada, energy trade and investment are substantially free, but U.S. environmental concerns and the threat to boycott Alberta's oil sands have delayed pipeline construction. Between the United States and Mexico, energy trade is also substantially free, but new Mexican regulatory policies could erect significant obstacles to bilateral flows of trade and investment.

A letter from the American Petroleum Institute (API) to U.S. officials detailed the gambits deployed by Petróleos Mexicanos (PEMEX), the Mexican government-owned energy giant, to keep near monopoly control (API, 2020). Barriers include roadblocks to American companies seeking permits for new or rebranded gas stations, energy storage facilities, and liquefied natural gas terminals (Macchiarola, 2020). Delays are now routine for permits that are supposed to be granted within 90 days. To make matters worse, on July 1, 2020 – the day the USMCA entered into force – the Mexican government required American companies to maintain five days' worth of fuel storage, a

Catch-22 rule since PEMEX owns the lion's share of storage and Mexican officials have blocked U.S. firms from building storage.

PEMEX clearly has much at stake. Today, it owns roughly 30% of all fuel stations in Mexico (Meana, 2020). PEMEX officials have vowed to nearly double the company's drilling activity, even as the vast majority of oil and gas firms have pulled back on exploration and production (Kimani, 2020).

American firms also have much at stake. Mexico is the number one export market for U.S. finished motor gasoline, pipeline natural gas, and total refined products. In 2019, for example, the United States sent nearly two thirds of its gas exports, nearly 5 trillion cubic feet, to Mexico and Canada. PEMEX's bid to maintain a near monopoly is no excuse for official discrimination against U.S. and other foreign firms.

Under USMCA rules, American companies that entered the Mexican market after that nation's 2013 Energy Reforms should receive protections from the kind of discrimination detailed by the API. Using the USMCA framework, American investors can seek redress using the investor-state dispute settlement (ISDS) system, a mechanism built to adjudicate claims of discrimination against foreign investors (Clemente, 2020, April 19).

4. Carbon Emissions

Global warming calls for coordinated action by all three federal governments and their subnational units. This should be a priority for the Biden Administration. Conceivably it could seek penalties against countries that do not meet their carbon commitments. Economists have long urged that the best way forward is through carbon taxes or tradeable emission permits –as in the European Union (EU). While neither approach is yet broadly favored in North America, a market-based scheme might gain legislative favor if funds raised from taxes or permit sales are dedicated to popular purposes, such as infrastructure projects. In any event, agreement should be reached between Canada, Mexico, and the United States on acceptable ranges for tax bases and rates or for permit allocations. The last thing North America needs is cumbersome border taxes within the region to offset national differences in carbon taxation or emission permits.

If, as seems likely, carbon emissions are limited through assorted regulatory measures, the three partners should negotiate metrics for recognizing substantially equivalent measures, again to avoid bedeviling commerce with border restrictions. Meanwhile, with Joe Biden in the White House, North America should adopt a common front for enforcing Paris Accord commitments. A good starting point would be a moratorium on climate-related border measures for the simple but powerful reason that the dominant shares of carbon and methane emissions come from power generation, motor vehicles, farming, and oil and gas extraction. Industrial production contributes about a fifth of greenhouse gas emissions in the United States. This is not trivial, but border measures triggered by emissions associated with specific imports will cause international ill-will and would not address the other four-fifths of emissions. Instead, a more appropriate approach would call out countries that seriously fail in their overall commitments and impose broad financial penalties.

5. NADBank Reform and Expansion

The North American Development Bank (NADBank) was created as a companion to the labor and environmental side agreements, which the Clinton administration negotiated to address critical issues left out of the original NAFTA signed in December 1992. The NADBank aimed to propel needed infrastructure in the U.S.-Mexico border region, with prospective investments in southern Texas designed to secure U.S. political support for approving NAFTA in 1993.

The NADBank has operated as an investment bank with a charter permitting a variety of financial instruments including grants, direct loans, and credit enhancements. It can mobilize resources to invest in environmental and employment development projects in the United States and Mexico—Canada was not included. The United States and Mexico agreed to contribute equally to the USD 3 billion capitalization of the NADBank, with 90% of resources for projects along the U.S.-Mexico border, certified by the Border Environmental Cooperation Commission (BECC). The NADBank and the BECC were merged in late 2017. The Community Adjustment and Investment Program (CAIP) was set up to allocate the remaining 10% of resources on employment generating projects in the most impacted non-border communities in both countries.

The CAIP component of the NADBank operated separately in the United States and Mexico. The funds were to be used with a focus on communities adversely affected by increased international trade. The goal was to go beyond trade adjustment assistance (TAA) for workers and help communities mobilize comprehensive investment responses for new employment creation. The projects would include support for technical assistance and planning that could help integrate worker re-training with loans in non-border communities. One U.S. approach was to leverage CAIP funding by collaborating with the Small Business Administration (SBA) and other lending programs, such as the U.S. Department of Agriculture Rural Development Administration (RDA).

The NADBank developed eligibility criteria for the CAIP to identify counties with strong NAFTA-related impacts. Eligible counties had to have active TAA programs and unemployment rates higher than the national average. CAIP resources were additionally used to subsidize fees to apply for SBA and RDA loans likely to generate employment in the designated counties. There was also a smaller program for Direct Credit and Technical Assistance Grants for projects that generated sustainable jobs in eligible communities.

The Mexican CAIP program was not able to achieve the programmatic robustness of the U.S. CAIP. There was no mechanism for leveraging CAIP funding with other government resources in Mexico. Instead it worked through philanthropic partnerships with organizations focused on community employment and financial empowerment in impoverished high-migration-sending regions.

After a long set up period in the 1990s, the NADBank enjoyed a successful record. Its investment projects had very positive impacts along the border and showed NADBank to be a viable instrument for leveraging private and public resources for infrastructure investment at low cost to the government. The NADBank is now well regarded both by Wall Street rating agencies – its bonds currently have an Aa1 negative Moody's rating– and by environmentalist groups.

As of June 30, 2020, the NADBank had contracted a total of USD 3 billion in loans across 267 projects worth USD 10.1 billion since its inception. These projects have produced tangible results, such as an increase in wastewater treatment coverage along the border from 21% in 1995 to 87% in 2012, water savings estimated at 371,000 acre-feet per year (enough to provide drinking water to four million people), solid waste projects enabling proper management of 1550 tons of waste per day, and renewable energy projects that help avoid the release of 2.1 million metric tons per year of greenhouse gases.

Where it operated, the CAIP was successful in integrating community development and TAA programs. In addition, the U.S. CAIP Federal Agency Program which subsidized fees through SBA and RDA loans was able to generate substantial employment in designated CAIP counties. Limited funding and strict eligibility requirements, however, restricted its scope. It was required to operate only in high NAFTA-TAA impacted areas with higher unemployment rates than the national average. This restriction limited CAIP access to only 30% of the total NAFTA-impacted TAA eligible workers and only 27% of TAA eligible counties. Even with these limitations, CAIP resources were able to generate approximately 10-21% of re-employment of TAA eligible workers in CAIP communities.

CAIP resources made the most impact in the most vulnerable of CAIP-eligible counties in the United States which have higher poverty rates, higher shares of manufacturing employment, as well as higher concentrations of Latino and Black trade exposed workers. Further comparative analysis of the CAIP eligible counties indicates that CAIP criteria focused resources on counties with highly vulnerable socio-economic characteristics compared to all TAA certified counties (Hinojosa-Ojeda et al., 2021).

Mexico could significantly benefit from the application of the type of CAIP community-focused technical assistance and adjustment investments that have been deployed in the United States. NADBank's Mexican CAIP should continue expanding its focus on improving financial services to poor communities and people by marshalling remittances for local development projects in poor regions. Adjustment assistance will be very important in southern Mexico where poverty is higher and out-migration to the rest of the country and the United States is significant. Mexico's urban-rural duality will likely continue without a significant Mexican development strategy to reduce regional inequalities.

On the U.S. side, the largest failing of NADBank/CAIP was the restrictive eligibility requirements for CAIP operations and the requirement that only 10% of its resources could be used for operations beyond the border region. These requirements should be liberalized so that NADBank can effectively operate in all regions where trade adjustments are required.

Even though the NADBank has accomplished important goals, the scale of its operations was much smaller than what was needed. From day one, the NADBank has been under-capitalized. The success of the NADBank and the CAIP programs as institutions indicates that the scale of their operations should be greatly expanded, especially given the wider agenda of climate change impacts across North America. Regional trade will continue to expand under the new USMCA agreement and there will be increasing need for the NADBank and CAIP.

With broad political support enjoyed by the newly negotiated USMCA, the NADBank should look to expand its capital base to USD 10 billion and broaden the potential beneficiaries beyond those along the U.S.-Mexico border. As well, the NADBank could address challenges beyond what was originally identified as water, wastewater, and sanitation to include broader sustainable energy issues, as well as expand operations in communities in the interiors of both the United States and Mexico.

Another proposal is to expand NADBank operations to include Canada. The resources contributed by Canada and the United States combined would be significantly more than what is expected to be provided by Mexico. The three countries together would support a strong focus on accelerated environmental investments. Canada would also be a potential beneficiary of expanded programs.

6. North America and China

Even with Joe Biden in the White House, the U.S. Cold War against China will continue. As a major difference with the Trump Administration, Biden will try harder to recruit like-minded countries to join the United States in calling for Chinese reforms. Biden will certainly seek to include Canada and Mexico, along with European and Asian allies.

Whether the Cold War becomes more intense during the Biden Administration will depend on President Xi Jinping's actions. His premature termination of the "one country, two systems" model for Hong Kong triggered global alarms. If Xi follows with a more aggressive posture towards the South China Sea or Taiwan, that will enlarge the military component of what has been, so far, largely an economic Cold War. Even if Xi tamps down Chinese territorial ambitions, the United States will continue to tighten restrictions on technology, trade, investment, and finance that might directly or indirectly benefit Chinese military endeavors. Among targets of U.S. ire, Huawei, ZTE, TikTok, and WeChat are prominently excluded from the U.S. market as sellers of 5G technology, buyers of electronic components, or sponsors of internet apps that allegedly enable Chinese spies. During the Biden Administration, additional targets are almost certain, and China will likely respond in kind.

Mexico and Canada must decide how to play their own China cards, recognizing the implications that trade and investment controls have not only on relations with China but also with the European Union and other important trading partners. Mexico has already decided to counter Chinese competition in manufacturing and, for that reason, might be amenable to joining U.S. efforts to de-couple North American high-tech industries from Chinese buyers or sellers. But historically Mexico has seldom subscribed to U.S. geopolitical goals. Mexico was not a U.S. ally in the First or Second World Wars, or the Soviet Cold War. Mexico never broke diplomatic relations with Cuba, nor did it join a multitude of economic sanctions against U.S. adversaries. Moreover, Mexico will want continued access to Chinese markets and Chinese capital. In short, Mexico faces a tricky balancing act in response to U.S.-China confrontation that could last decades – keeping on good terms with Washington while not completely cutting itself off from Beijing.

Unlike Mexico, Canada has been a staunch U.S. military ally for more than a century, joining forces with the United States in nearly every war. While Ottawa harbors doubts about Beijing's ambitions, Canadians are less inclined to see spies in every piece of Chinese tech hardware or software. But if Ottawa chooses to do business as usual with China, Canada will likely become a target of U.S. national security controls on trade and investment and might jeopardize its alliance with Washington.[2] All things considered, Ottawa will probably choose to stand within the U.S. ring fence. That choice will limit commercial opportunities in China and could limit Canada's high-tech trade with Europe and Canada's CPTPP partners unless those countries also join the U.S. ring fence. In any event, by following Washington's lead, Canada would buy an exclusion from U.S. security controls – a significant benefit.

2 The extradition case of Ms. Meng Wanzhou of Huawei is already putting this relationship to the test.

7. Infrastructure Frictions and Related Barriers

7.1 Hard infrastructure

Even with the USMCA, border frictions still bedevil North American integration. Most visible are infrastructure bottlenecks – congested conditions at key border crossings. These will reappear in a few years once COVID-19 is controlled. The goal should be to establish maximum clearance times, say one hour, and the partners should commit to build the necessary bridges and roads on a shared basis, and expedite documentation, to meet the goal.

Fortunately, a priority for the Biden Administration will be major, multi-year, infrastructure legislation, largely paid with federal funds. A price tag of USD 1 trillion was mentioned during the Trump Administration (Leonard and Wingrove, 2020, June 15). A program that size will have ample room for the U.S. side of border roads and bridges. The key question is whether Canada and Mexico will provide ample funds for their side of the border. For Mexico, an expanded North American Development Bank may help.

Also, Mexico and the United States should support infrastructure investment that encourages renewable energy production and distribution in both countries. In the near term, continued growth in natural gas production and trade will make a major contribution to reduced carbon emissions as coal-fired power plants are phased out. Coherent regulatory policies for wind and solar, and expanded interconnections between gas pipelines and electric grids, will boost energy security and spur profitable new investment in Mexico and the southwestern U.S. states.

7.2 Digital flows

Less visible, but no less important, are frictions that impede e-commerce and data flows. Unlike China, Russia, and a few other countries, governments in North America do not censor digital news or information. Pathways are open for transformative changes in retail sales, education, health, law, finance, and other areas through digital networks. These pathways will be major growth poles in the decade ahead.

But Canada has toyed with the idea of a digital services tax (DST) along the French model: a percentage of revenues earned by firms like Facebook and Google arguably attributed to Canadian users. This idea conflicts with existing bilateral tax treaties and is stoutly opposed by Congressional Democrats as well as Republicans (Hufbauer, 2020). Quebec and Saskatchewan already have introduced taxes on digital services and British Columbia intends to do so in April 2021 (Taxamo, 2020). To avoid new North American frictions, the three countries should put a hold on the imposition of new taxes and develop instead a coherent strategy to ensure that tax policies do not create barriers to regional trade.

Other frictions lie in wait for e-commerce and data flows. Most worrisome are requirements – now common around the world – of data localization. The core feature is a requirement that all personal and business data

gathered within a country should be stored on servers physically located in that country and, as an additional restriction, should not be transmitted to servers in another country. These requirements go well beyond the needs of personal privacy and add substantial costs to the operation of digital platforms. China already imposes such requirements. A recent ruling by the European Court of Justice that the EU-U.S. Privacy Shield fails to protect European data privacy when companies transfer data to the United States, could compel the European Union to follow the Chinese example (InfoCURIA, 2020). Meanwhile, the USMCA prohibits member countries from imposing data localization requirements and restricting data flows. If Canada and Mexico go down the EU path, it would violate the North American pact. However, in October 2020, Mexico floated regulations that could impede the use of cloud services from U.S. providers and require a certain amount of data localization. This bears watching.

Modeled on U.S. Section 230 of the Communications Decency Act, the online liability provision in the USMCA protects digital platforms, such as Facebook, YouTube, and Twitter, from legal liability for false, fraudulent, or infringing statements posted by users. Without protection, the platforms would face a barrage of claims (Legal Information Institute, 2020). However, as a practical matter, the platforms increasingly take down offending material when given notice. The USMCA protects the platforms from being sued when they eliminate such materials in "good faith". This provision will apply to Mexico in three years, starting July 1, 2023.

7.3 *De minimis* thresholds

Problematic for North America are the low *de minimis* thresholds – about USD 100 per package – applied by Mexico and Canada. Parcels below the threshold are free of customs duties, value added taxes and retail sales taxes. Above the Mexican and Canadian thresholds, however, the hassle of collecting customs duties and taxes severely reduces small parcel imports. By contrast, the U.S. *de minimis* threshold is USD 800 and small parcel imports are a major item. The United States could lower its statutory threshold to the Mexican and Canadian thresholds, consistent with the USMCA, if it so decides. Mexico and Canada harbor fears that, if they raise their *de minimis* thresholds to approach the U.S. level, too much tax revenue will be lost, and their retail stores will be swamped by U.S. e-commerce firms. Given these concerns, agreements providing both higher *de minimis* thresholds and simplified taxation should be reached, allowing e-commerce to flourish but preserving tax revenues on retail sales and not affording an undue tax advantage to e-commerce imports.

7.4 Biden's Tax Plans

During the presidential campaign, Biden released a plan to impose new business taxes to discourage offshoring of U.S. jobs, particularly manufacturing jobs. Biden's proposals are problematical, not only because they would hurt U.S.-based multinational corporations competing with foreign multinational corporations (MNCs) but also because they would pose difficult choices for business taxation in Canada and Mexico (Biden, 2020a). Alongside the tax plan, other leading Democrats have proposed massive subsidies for U.S. tech industries. As well, those might challenge Canada and Mexico (Peterson and Davidson 2020, July16).

The story line underlying Biden's tax plan revives the "runaway plant" theme that inspired the 1972 Burke-Hartke tax bill.[3] That bill, which never became law, sought to deny MNCs a credit against U.S. tax obligations for income taxes paid to foreign countries. But making multinational corporations with overseas production into a villain is misplaced. Research by Moran and Oldenski (2016) shows that U.S.-based MNCs create more American jobs, do more investment, sell more exports, and conduct more Research and Development (R&D) than their homebody counterparts.

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3 More information about the 1972 Burke-Hartke tax bill: https://history.state.gov/historicaldocuments/frus1969-76v04/d264.

Biden's plan has two components: offshoring tax penalties and tax credits for bringing jobs home. Both have implications for Mexico and Canada.

7.4.1 Offshoring tax penalties

Unless modified, the offshoring penalties in Biden's plan would directly target U.S.-based MNCs doing business in Canada and Mexico. The penalties reflect the tax doctrine known as "capital export neutrality" (CEN): namely, that a U.S.-based MNC should pay the same tax rate on profits earned abroad as on profits earned at home. CEN tax doctrine was widespread 50 years ago, not only in the United States but also other advanced countries. Since then, CEN has been abandoned by nearly all jurisdictions, including Canada, Mexico, and finally the United States in the 2017 Tax Cut and Jobs Act (TCJA).[4] The core argument against CEN is that each country should gather tax on income clearly derived from production in that country, and that other countries should not tax that income.[5] Biden's plan would, in some respects, go beyond CEN and tax the foreign profits of MNCs at higher rates than their domestic profits.

Under Biden's plan, the basic corporate tax rate would be lifted from the 21% TCJA rate to 28%. Biden's new 28% rate would put U.S. corporations well above tax rates now prevailing in Ireland, the United Kingdom, Sweden, and other countries that have enacted lower rates to stimulate business and lure MNCs. Biden would also add a 10% tax penalty – an additional 2.8 percentage points – to the basic 28% rate if a U.S.-based MNC produced goods or services abroad and sold them back into the U.S. market. This provision would clearly discourage U.S. production in Canada and Mexico, as well as other foreign countries. Moreover, the Biden plan would establish a minimum 21% tax on all MNC profits earned abroad, no matter where the goods and services are sold, and without any of the existing or new tax credits sprinkled across the Internal Revenue Code.

The main problem with Biden's plan is that it would disadvantage U.S.-based MNCs in competition with foreign-based MNCs. For example, multinationals based in France, Germany, or Japan, that produce competitive goods and services would be able to sell in the U.S. market unburdened by the Biden tax. Moreover, the Biden plan would deny otherwise allowable deductions for U.S. MNC production abroad if the overseas jobs could plausibly have been offered to American workers. For example, if an automobile transmission made in Mexico, or an electric car made in Canada, could have been made in the United States, deductions for U.S. R&D underlying the design of the transmission or the whole car would have been denied.

7.4.2 Tax credits for doing business in America

Biden's plan proposes 10% "advanceable" credits (probably meaning refundable, even if the firm owes no tax) to encourage five enumerated modes of business behavior:

- Investing in a closed or closing facility;
- Retooling for advanced manufacturing;
- Incurring expenses for reshoring production;
- Expanding facilities to grow employment;
- Enlarging the manufacturing wage bill.

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4 More information about the 2017 Tax Cut and Jobs Act: https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf.
5 Current international tax debates largely focus on the right to tax "mobile income", such as trademark, patent, and trade secret royalties, that have no strong connection to a particular jurisdiction.

Fitting a firm's outlays into one of the favored categories will attract high-paid legal and accounting talent. With taxpayer creativity, the new credits will offset a good portion of the revenue gain that might be anticipated from raising the basic corporate rate from 21% to 28%.

A more serious problem for the USMCA is that, if the Biden plan is enacted, with its obvious goal of luring foreign jobs back to American territory, Canada and Mexico will need to consider their own tax responses, given their close trade and investment ties to the United States and the prospective impact on North American integration. When the U.S. Congress debates the new tax law, Canada and Mexico should seek a "North American carveout", not only for the tax penalties mentioned above but also for some of the new tax credits. In particular, the reshoring credit should not be available for shutting down production in Canada or Mexico.

When the U.S. Congress has thrashed out details of Biden's tax plan, Canada and Mexico might sensibly choose to align their own business tax codes closer to U.S. practice. They might consider offering refundable business tax credits for activity that parallels some of the eligible categories in the new U.S. tax code. They should not enact new discriminatory taxes on U.S. digital firms such as Facebook or Google, as noted previously.

Biden's campaign declarations hinted at new industrial subsidies but did not spell out target activities – though likely candidates would be artificial intelligence, cyber, quantum computing, 5G communications, and other areas of Chinese technical prowess (Biden, 2020b). It is not certain those subsidies will be enacted nor whether they will impact industries, like electric autos, where Canada and Mexico might expect to compete. However, both countries should be watchful. If their firms cannot participate in new U.S. subsidies, Ottawa and Mexico City might consider launching their own programs.

7.4.3 Made in America

Biden repeated his "Made in America" promises 29 times in a campaign document. Moreover, he committed to close loopholes that allow foreign content to creep into American made goods purchased by the federal government. Like Trump, Biden holds a special affection for manufacturing jobs, for iron and steel melted and poured on American soil, and for the merchant marine as a carrier of goods between U.S. ports. The claim of generating well-paid employment is central to the argument for spending taxpayer dollars solely on American goods. None of this is good news for U.S. trade with Mexico and Canada. Nor is it good news for taxpayers and consumers. Unfortunately, three-quarters of Americans polled support the concept of "Buy America".

The Government Procurement Agreement (GPA), hosted in the World Trade Organization (WTO), and the erstwhile NAFTA, both promised reciprocal opening of national government procurement. The difference in government procurement between NAFTA and USMCA is that the government procurement chapter under USMCA does not apply to the United States and Canada like it did under NAFTA. In this area, North American integration has taken a step backwards and Canada and Mexico could see further retractions as U.S. legislation claws back rights to bid on U.S. federal contracts.

Table 2 illustrates the potential benefits of opening government procurement to foreign competition. The table summarizes federal, state/provincial, and local government procurement statistics for the United States, Canada, and Mexico. Import percentages for procurement in the year 2014 (latest available) are compared with overall import percentages. In percentage terms, imports for procurement are less than half overall imports – reflecting the widespread application of buy national requirements. The fourth row reports the observed level of

procurement imports and the fifth row calculates what procurement imports would have been in 2017 if they had exhibited the same percentage as overall imports. We take these calculations as rough estimates of procurement imports in the absence of nearly all buy national requirements – in other words, an almost free trade regime for procurement.

The final row in table 2 uses a computable partial equilibrium (CPE) model, explained elsewhere, to calculate the *ad valorem* equivalent (AVE) tariff of buy national requirements in each country (Hufbauer and Elliott, 1994). The calculation asks what tariff rate would reduce the hypothetical almost free trade level of procurement in 2017 to the observed level. As an example, U.S. hypothetical procurement would be USD 203.6 billion, while the observed level was just USD 135.9 billion. The CPE model suggests that Buy American requirements equate to a 26% *ad valorem* tariff which explains the U.S. import shortfall for government procurement. Parallel calculations suggest the *ad valorem* tariff equivalent of Canadian procurement restrictions is 36%, and of Mexican procurement restrictions 38%.

Table 2. Government procurement in six countries

		United States	Canada	European Union	Japan	South Korea	Mexico
Imports of goods and services as	% of government procurement (2014)	7.5	14.7	8.3	8.8	10.1	16.8
Imports of goods and services as	% of GDP (2017)	15	33.6	42.7	16.8	36.2	39.5
Total value of government procurement	USD billion (2017)	1809	227	2921	858	260	119
Observed level of procurement imports	USD billion (2017)	136	33	242	75	26	20
Free trade level of procurement imports	USD billion (2017)	204	57	935	108	71	35
Observed level of domestic procurement	USD billion (2017)	1674	193	2679	783	234	99
Estimated markup on domestic production	%	5.6	7.4	17.6	5	13.2	7.8
Estimated ad valorem equivalent tariff rate	%	26	36.2	116.8	22.8	75.9	38.1

Note: Figure 7 (page 35) in U.S. Government Accountability Office (2019); World Bank's World Development Indicator database; OECD Government at a Glance database (2019) and authors' calculation.

Arithmetic leads to the startling conclusion that the U.S. taxpayer cost was USD 250,000 for each job "saved" by Buy America in the domestic procurement industry. We put "saved" in quotation marks because buy national requirements essentially shuffle jobs from other sectors of the economy, including exports, to the procurement sector. The shuffling takes a toll on economic efficiency, which shows up in elevated price tags on everything from computers to bridges. On balance, Buy America creates no new jobs, but it preserves jobs in domestic firms that supply government needs, often at a high cost to taxpayers. Although Buy America may be political winner in U.S. elections, it is an economic loser. Canadian and Mexican buy national procurement rules no doubt impose similarly high costs on their taxpayers.

Given the popular resurgence of mercantilism, it would be too much to ask a Biden Administration to embrace broad free trade in government procurement. But it might not be too much to consider a "Made in North America" agenda for central government procurement, covering the United States, Canada, and Mexico. Judging from estimates in table 2, Canada and Mexico embrace buy national policies to a greater extent than the United States. In other words, each USMCA partner would expand its exports from more open procurement and as well benefit its taxpayers. A trial pact lasting six years should be negotiated for liberalization within North America, ambitiously covering almost all federal procurement. Actual cross-border procurement could then be closely monitored, and at the end of six years the pact could be extended if the three parties were satisfied.

8. Concluding Remarks

By no means is the USMCA a path-breaking agreement. In important ways, it retrogresses from the NAFTA. Yet, the new agreement paves the way for closer North American economic integration, thanks to ending 25 years of U.S. political antagonism to NAFTA. The USMCA also sets the stage for contentious disputes over Mexico's labor and environmental policies – issues we do not discuss. The disputes will create political friction, a regrettable by-product. At the same time, the USMCA should prompt the three partners to adopt policies that reduce economic friction and spur trade and investment. As a starter, the partners should avoid new policies that do further harm to the auto sector, particularly large trucks and pickups.

Cooperation on energy, including renewables and carbon emission standards, should be a priority. Mexico and the United States should support infrastructure investment that encourages the growth of renewable energy production and its distribution in both countries and sustains the growth in natural gas trade. Ensuring coherent regulatory policies for wind and solar, and expanding interconnections between the electric grids, would boost both energy security and provide inducements for new investment in Mexico and the southwestern U.S. states.

Similarly, the North American partners should bolster the NADBank –at least tripling its capital and removing restrictions on its scope of operations. Canada should be encouraged to participate as well. Hard and soft infrastructure linking Mexico, Canada, and the United States all need upgrading. Hard infrastructure will cost hundreds of billions of dollars, mostly public money. Soft infrastructure – meaning digital links – will be developed with private funding, provided Mexico and Canada do not engage in data localization or overly strict privacy

requirements. Agreements will need to be forged that reconcile Mexican and Canadian fears of lost tax revenue and excessive dominance by U.S. tech firms with the promise of digital trade.

Mexico and Canada will need to devise creative economic and political policies to cope with what looks like an era of U.S. de-coupling from supply chains, investment, and technical flows with China.

The Biden Administration promises business tax and government procurement changes that could adversely but unintentionally impact Mexico and Canada. To avoid harmful sideswipes, both countries will need to work closely with the U.S. administration in the early months of 2021 to avoid new obstacles to North American economic integration.

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