USMCA: A Marginal NAFTA Upgrade at a High Cost

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On the campaign trail, Donald Trump vowed to strengthen enforcement of existing trade rules and negotiate better trade deals than his predecessors had. With his national security tariffs on steel and aluminum, his safeguard tariffs on washing machines and solar components, his broad trade war with China, and the looming specter of new barriers for automobile imports, President Trump has delivered—for better or worse—on the first promise. On the second, he has little to show.

On Sept. 30, 2018, American, Mexican, and Canadian negotiators reached a deal to replace the North American Free Trade Agreement (NAFTA), which President Trump had described as "the worst trade deal ever negotiated." Two months later, Trump and his Mexican and Canadian counterparts signed the "United States-Mexico-Canada Agreement" (USMCA), which modernizes—and revises in ways both good and bad—the 25-year old NAFTA. But before the USMCA can enter into force, it must be approved by the legislatures of all three countries. This will be a heavy lift.

Whether the U.S. Congress passes the implementing legislation, which will be introduced by the administration after an assessment of the deal is published by the U.S. International Trade Commission on or around April 19, remained an open question at press time. But considering the controversial substance of the agreement, the vitriolic nature of America's partisan politics, and the fact that the presidential primary election season is rapidly approaching, prospects for passage before the November 2020 elections are no better than 50-50, and fading.

Why did the president choose to renegotiate NAFTA? How does the USMCA compare to the original NAFTA? How does it compare to other important benchmarks? Why are its prospects for congressional approval so uncertain? And what will happen if it doesn't pass?

Have We been Losing at Trade?

American presidents of both major parties from Franklin D. Roosevelt through Ronald Reagan to Barack Obama considered trade a mutually beneficial endeavor, essential to global economic growth and prosperity, and integral to promoting peace among nations. President Donald Trump doesn't share this perspective. He sees trade as a zero-sum competition between Team America and foreign teams—a win-lose proposition—where exports are America's points, imports are the foreign teams' points, and the trade account is the scoreboard. To Trump, perennial U.S. trade deficits mean that the United States has been losing at trade for decades, and it has been losing because it has negotiated bad trade deals.

It is in that context that the president deemed NAFTA a failure and set out to revise its provisions to tilt the playing field in favor of U.S. producers. But that is an ahistorical view. After NAFTA came into effect in 1994, nearly all tariffs among the three countries were eliminated, many non-tariff barriers were reduced, and trade and investment flourished.

Between 1993 (the last year before NAFTA went into force) and 2016, total U.S. trade in goods and services with Canada and Mexico increased more than 125 percent in real terms, reaching over $1 trillion in 2016. During the same period, foreign direct investment in the United States from Canada and Mexico increased from $41.6 billion to $285.6 billion.

NAFTA certainly enabled more cross-border final goods trade, but it also facilitated the development of a globally competitive North American production platform, most consequentially in the auto sector. Today, 40 cents of every dollar of goods imported from Mexico and 25 cents of every dollar of goods imported from Canada can be attributed to U.S. inputs of labor and material—U.S. value added.

Much has been made over the years since Ross Perot's 1992 description of a "giant sucking sound" of jobs and investment being drawn south of the border from the United States. But like the trade and investment data, the employment figures don't support that claim either. U.S. manufacturing employment peaked in the United States in 1979 at 19.43 million workers. Between 1979 and 1993 (the last year before NAFTA took effect), manufacturing employment shrunk by 2.66 million jobs. In the next 14-year period (between 1993 and 2007), when NAFTA was in effect, employment in the manufacturing sector decreased by 2.89 million—effectively, no significant change in the trajectory. And over the first six years of NAFTA, the U.S. economy added 540,000 manufacturing jobs. This is not to suggest that NAFTA should be credited with creating those jobs, but that those who blame NAFTA for manufacturing job decline need to account for these countervailing facts.

Changing the Rules

As a "Perot-ist" on NAFTA, President Trump aimed to change the so-called "rules of origin" in a way that would strongly encourage manufacturers to invest more, produce more, and create more jobs in the United States. A trade agreement's rules of origin establish the minimum level of regional value a product must contain to qualify for the agreement's preferential terms.

For both autos and apparel, those thresholds were increased in the USMCA. There is even a requirement that a minimum of 40 percent of the value of auto production be produced by workers earning at least $16 per hour. These production restrictions likely will hurt more than they help. The reduced capacity for automakers in North America to make use of the most efficient supply chains, using inputs from within and outside of North America as requirements and economic conditions would dictate, is likely to make regional producers less competitive relative to producers in countries where there are fewer restrictions on sourcing. The more rigid rules of origin translate into higher regional production costs, which will encourage automakers, apparel producers, and other manufacturers to forego the costs of complying with these rules in favor of using non-qualifying inputs or producing outside the region altogether, and paying the non-preferential tariff rates upon entry into the United States. That would mean less investment and more divestment from the region, which is what happens when origin rules are too onerous.

Although the USMCA does not raise tariffs over the rates effective under NAFTA, it does have the distinction of being the first U.S. trade agreement that doesn't include any significant new U.S. market-opening provisions. That's a notable missed opportunity. In 2017, U.S. consumers spent $4.1 trillion on goods with imports totaling $2.3 trillion (57 percent). In contrast, U.S. consumers spent $9.2 trillion on services, only $550 billion (six percent) of which were imported. What this wide disparity in import penetration—six percent for services versus 57 percent for goods—suggests is that the United States maintains significant barriers to trade in services.

The USMCA does nothing to reduce barriers to services trade. Instead, it reaffirms bans on foreign competition in maritime shipping, commercial air services, and trucking services. Transportation costs comprise a significant share of the prices Americans pay for goods purchased on Amazon and at brick and mortar establishments. Meanwhile, commercial air travel is a significant cost of doing business for companies across all industries, and it accounts for an important share of consumer spending. The absence of foreign competition across our transportation services industries—as well as in our education, health care, professional services industries—suggests that the USMCA could have been much more liberalizing.

Opening the Market

The U.S. market is generally open to foreign investment already, but investment restrictions persist in certain industries, including financial services, commercial air services, communications, and mining. The USMCA provides no significant new access to foreign investors in the United States.

Likewise, the USMCA does close to nothing to open any wider U.S. government procurement spending to bids from Canadian and Mexican companies. That's a huge missed opportunity because under the various "Buy American" provisions, foreign firms and foreign products are limited in competing for the estimated $1.7 trillion of annual U.S. federal and state government procurement spending. This, of course, drives up the cost of every government project and ensures that taxpayers get the smallest bang for their buck. In light of the president's interest in advancing a major infrastructure bill—maybe in the neighborhood of $1 trillion—this is a problem that should concern us all.

Despite backsliding in some areas and missed opportunities in others, the USMCA isn't all bad. Most goods trade will continue to be tariff-free (the NAFTA status quo) under the new agreement, and barriers to certain agricultural products will be reduced, as well. The agreement establishes needed new rules in the realm of digital trade, including prohibitions of data transmission taxes and data localization requirements.

The USMCA is a marginal improvement over NAFTA—better in some areas, worse in others, about the same in most. Relative to the existing NAFTA, there are pros and cons. Though there is greater liberalization in goods trade, it is marginally to imperceptibly so. Taking into consideration the negative changes, especially to the rules of origin, it's not obvious that USMCA is much of an upgrade from NAFTA. But it's possible—even probable—that some of the less directly liberalizing, technical and procedural provisions, such as those governing "Digital Trade," "Customs and Trade Facilitation," "State-Owned Enterprises" and others, utilized in ways not completely apparent now, could lead to lower trade costs down the road.

The only real certainty is that the USMCA is better than a U.S. withdrawal from NAFTA without a replacement agreement. But that couldn't happen, right?

Congress's Battle

The Democratic takeover of the House of Representatives raises doubts about the feasibility of passing the USMCA implementing legislation. The irony in all of this is that U.S. Trade Representative Robert Lighthizer was explicit about his intention to make the agreement one that would have bipartisan appeal. He went out of his way to incorporate provisions Democrats have long sought in trade agreements, including more rigorous labor and environmental provisions, and other measures presumed to dissuade outsourcing. But Democrats have some substantive concerns over the question of whether those beefed-up labor and environmental provisions will be enforced. They may insist on having the agreement reopened to include more rigorous language in this regard or they may seek concessions from Trump in other policy areas.

House Speaker Nancy Pelosi could also exercise her prerogative to take the agreement off the fast track (as she did with the U.S.-Colombia FTA in 2007), if she asserts that the administration deviated from its statutory obligations under the Trade Promotion Authority legislation. That would essentially foreclose consideration of the deal until she's no longer speaker or until negotiations with Canada and Mexico are re-opened.

But substantive opposition to the USMCA's provisions from the House majority party is only one part of the problem. Another is that Democrats have used NAFTA as a wedge issue for 25 years and are unlikely to know how to position themselves on the trade question if they join Republicans in support of the USMCA. Even though a majority of voters who affiliate with the Democratic Party support trade and free trade agreements, Democratic leadership in Washington is wary of ceding its capacity to showcase the party's opposition to trade agreements when wooing voters in the Rust Belt.

Meanwhile, Democrats may not want to give Trump something that could amount to a political victory. Aversion to that outcome will only increase as pressure builds for House investigations and possibly impeachment proceedings, and as the calendar closes in on 2020.

In the final analysis, if USMCA doesn't pass and the existing NAFTA remains in force, the downside won't be all that substantial because the new deal is only slightly better than the existing one. However, NAFTA remaining in force is an uncertainty, as Trump has been threatening to issue the USMCA implementing legislation and the NAFTA withdrawal notification on the same day to compel Congress to act quickly.

It's not clear why Trump thinks that his provoking a crisis would compel Democrats to act on the USMCA. It's more likely that Trump would bear the brunt of the blame for the dissolution of the integrated North American economy.

The USMCA is far from the ideal free trade agreement, but an agreement pursued with trade deficit reduction and supply chain repatriation as its main objectives was never going to be an exemplar of trade liberalization. For the sake of restoring some predictability to the North American business environment, it would be wise of policymakers to find a way to implement the agreement as quickly as possible.

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