INTRODUCTION

If the United States–Mexico–Canada Agreement (USMCA) is ultimately approved by the three parties and enters into force, this modified and modernized version of NAFTA\(^1\) will continue to govern most economic relationships in North America, including nearly $1.2 trillion in annual trade of goods and services, for at least 16 years. The USMCA preserves the bulk of the NAFTA structures that permit North American manufacturers to compete effectively with their counterparts in Europe and Asia in North American and foreign markets.

The most likely alternative—termination of NAFTA by the Trump administration—would have been far worse for the three economies and might have created a constitutional crisis in the United States between the president and Congress. The chilling effect on investment and new hiring generated by almost two years of uncertainty over NAFTA’s future will also be resolved once the USMCA goes into force, perhaps as soon as January 1, 2020.

Those in Canada and Mexico who rightly viewed the negotiations first and foremost as a damage-limiting exercise can take comfort that in the case of Canada, the NAFTA cultural industries exception was preserved, the trade dispute settlement mechanism survived, and Canada was required to reduce its restrictions on milk product imports and accept higher pharmaceutical prices to only a limited degree. For Mexico, despite attacks on its auto industry, under the new rules the industry will probably survive mostly intact and may actually expand (see below); labor obligations permitting independent unions will assist Mexico’s new president, Andrés Manuel López Obrador, in increasing Mexican wages and reducing inequality; and most other industrial and agricultural sectors will be relatively unaffected. Most significantly, both Mexico and Canada preserve their access to the U.S. market, on which more than 75% of their exports depend.

Given that NAFTA was negotiated in 1991–92, it is obvious that many changes have occurred affecting regional and global trade in the ensuing 25 years. The USMCA consists of 34 chapters compared to 22 in NAFTA, plus numerous annexes and side letters.\(^2\) The new subject matter includes small and medium-sized enterprises, state-owned enterprises, corruption, e-commerce, data localization, and general regulatory practices, some of which may set the standard for future trade agreements concluded by the three parties. Significant economic or political changes to NAFTA include rules governing the automotive trade, dispute settlement, intellectual property, and agriculture.

As with NAFTA, compliance with USMCA rules will create significant administrative burdens for enterprises in all three countries,
prevailed against U.S. pressures, forcing the United States to compromise. These divisions are mine and do not necessarily reflect those of other observers. Subsequent reports in this series will explore major features of the USMCA in much greater detail, including questions relating to its ultimate approval by Congress.

**Positive Changes in the USMCA Compared to NAFTA**

While there has been much, often justified, criticism of the USMCA as a retreat from open regional trade, particularly in the automotive sector and (in my view) the area of dispute settlement, this does not change the fact that the twenty-five-year-old NAFTA was badly in need of modernization to deal with many new areas, such as data and e-commerce, and improve coverage of areas such as labor, the environment, and small and medium-sized enterprises.

**Modernization of NAFTA**

The USMCA updates or adds to NAFTA (and to later U.S. FTAs): coverage of customs and customs procedures, state-owned enterprises, competition policy, small and medium-sized enterprises, corruption, good regulatory practices, technical barriers to trade, sanitary and phytosanitary standards, and various industry-specific standards. The most important modernizations for American businesses, particularly financial institutions and high-tech enterprises, are probably those that prohibit localization requirements for data storage and that govern e-commerce. For North American business and labor, the most significant benefit of the USMCA is that it continues NAFTA in a manner that will largely preserve the competitiveness of North American supply chains, intraregional trade, and high-level manufacturing, innovation, and services with major competitors, China and the European Union.

Many of the USMCA innovations reflect the Trans-Pacific Partnership (TPP) text that the Obama administration concluded (along with Canada and Mexico) that was rejected in January 2018 by the Trump administration. Democrats in the House may, as a condition of supporting the agreement, demand changes in the text, most likely to strengthen the enforcement of the labor and environmental provisions (which are already considerably more robust than those in the NAFTA “side” agreements). This conditional support by key Democrats last occurred in 2011, when the new Republican House majority and some Democrats supported the passage of free trade agreements (FTAs) with Colombia, Panama, and South Korea (five years after their conclusion by George W. Bush’s administration) only after the Obama administration reopened negotiations with those countries to make changes demanded by industry and labor groups. Also, Trump’s renewed threat to terminate NAFTA as a means of convincing Congress to pass the UMSCA could, if implemented, backfire by strengthening Congressional opposition, particularly among Democrats. Still, if used judiciously it might help to avoid extended delays in congressional action once the agreement is formally sent to Congress.

This report provides an introduction and overview to the USMCA, focusing on the most significant changes. The discussion is divided into three major sections, addressing positive and negative changes, and a few key areas where Canada and Mexico
A major objective of the TPP, which will enter into force in modified form as the “Comprehensive and Progressive TPP” (CPTPP) on January 1, 2019, for most of the remaining eleven parties, was to set new standards for future trade agreements worldwide. The incorporation of many TPP provisions in the USMCA suggests that some Trump administration officials are mindful of the desirable precedential effects of incorporating provisions developed in regional trade agreements.

Enhanced Labor and Environmental Protections

Improved protections for labor and the environment have been incorporated in every free trade agreement concluded by the United States since NAFTA, beginning in 2003 with the agreements with Australia, Chile, and Singapore. The principal objective of NAFTA critics during this period was to ensure that future FTAs would incorporate labor and environmental protections in the body of the agreement, rather than in supplemental agreements as with the NAFTA “side” agreements, so as to ensure that violation of those provisions would be subject to the same dispute settlement mechanism and trade sanctions as violations of the trade obligations. However, due to the intransigence the Bush administration, this was not achieved until a group of late Bush administration agreements with Colombia, Panama, Peru, and South Korea were amended at the demand of the Democratic Congress in 2007.

The USMCA labor provisions focus on supporting independent unions in Mexico on the assumption that more effective unions will mean higher wages and greater purchasing power for Mexican workers. One additional, presumably added at the initiative of Canada, requires the implementation of policies against “employment discrimination on the basis of sex, including with regard to pregnancy, sexual harassment, sexual orientation, gender identity, and caregiving responsibilities.” The sexual orientation and gender identity requirements have created opposition among some conservative Republican members of Congress, resulting in the addition of a footnote that effectively (if awkwardly) makes these requirements inapplicable to the United States.

The environmental provisions draw heavily on the TPP environmental chapter, which addresses conservation in such areas as fisheries subsidies, shark finning, invasive species, and cooperation on marine litter and air quality. Importantly, a side agreement on environmental cooperation preserves the Commission for Environmental Cooperation created under NAFTA’s North American Agreement on Environmental Cooperation.

Currency Manipulation

For the first time in a trade agreement, the USMCA incorporates measures to guard against currency manipulation. While the importance of incorporating such safeguards in the USMCA is limited given that neither Canada nor Mexico have been accused of currency manipulation in the past, the U.S. negotiators—very wisely in my view—saw the USMCA negotiations as an opportunity to develop language that could be incorporated in future trade agreements, such as those contemplated with the European Union, Japan, and the United Kingdom. The relatively limited reach of the provisions likely reflects the reluctance of the U.S. Department of Treasury to address currency issues in trade agreements.

Agriculture

Press reports on the negotiations between Canada and the United States suggest that the most difficult issues to resolve were Canada’s insistence on maintaining the NAFTA dispute settlement mechanism for reviewing unfair trade practice actions (see below), and U.S. demands for improved access to the Canadian dairy market. The United States achieved a modest opening for milk solids exports, comprising about 3.6% of the Canadian market. In addition, cheese exporters to Mexico preserved a lucrative export market for their branded products, including protection against EU efforts in a pending trade agreement with Mexico to limit the usage of certain product names to EU suppliers. More importantly, the

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United States, Mexico, and Canada preserve a vibrant, mutually beneficial series of trade relationships. American farmers and food processors will continue to enjoy access to their first (Canada) and third (Mexico) largest export markets. Mexico was also successful in preserving access to the U.S. market for winter fruits and vegetables, defeating a Trump administration demand for new trade remedies that could have diminished such access. Today, the principal threat to North American agricultural trade is in Canadian and Mexican retaliation for U.S. tariffs on imported steel and aluminum, which has caused U.S. agricultural exports to both markets to decline since June 2018.

**THE DOWNSIDES OF THE USMCA**

As indicated above, it is likely that the areas that have been most severely criticized in the USMCA, the automotive rules of origin and rules about dispute settlement, have overshadowed the positive aspects of the agreement. Still, these two areas are not the only ones that represent steps backward in the long evolution of U.S. FTAs since NAFTA.

**Automotive Rules of Origin and Related Restrictions**
The most controversial area of the USMCA negotiations was the auto and auto parts sector. The United States initially made a series of harsh demands, including raising the total North American content requirements from 62.5% to 85%, of which 50% would have had to have been U.S. content. These were not surprisingly rejected out of hand by Mexico and Canada. Compromises were ultimately reached in the negotiations between the United States and Mexico that took place in July and August 2018, although the U.S. continued to focus on increasing U.S. content, indirectly if not directly.

Most of the changes will be phased in over a three-year period beginning with the implementation of the USMCA. The most controversial area of the USMCA negotiations was the auto and auto parts sector. First, the North American “regional value content” required for NAFTA was raised from 62.5% to 75%. Second, 70% of the steel and aluminum used in auto production must come from North American sources. Third, 40% of the product value of autos and 45% of trucks must be made in facilities where workers are paid at least $16 per hour, meaning that except for research and development and some engineering, only facilities located in the United States or Canada would qualify.

For Canada, the $16 per hour requirement is no more a bar than in the United States, given the similar wage costs in Canada. For Mexico, it is a much more serious challenge since typical auto industry wages in Mexico are approximately $3.60-$3.90 per hour (attributable by some studies in part to lack of union support for workers). This means that most of that 40% to 45% of auto content must be produced in the United States or Canada. Still, some high-wage Mexican employees, such as engineering, research and development, and management personnel, are paid up to $22 per hour and may be counted toward the total, perhaps encouraging auto manufacturers to undertake more research and development in Mexico. Mexican officials estimate that about 70% of Mexican auto production already would meet the 75% regional value content requirements. Those vehicles that do not qualify for the USMCA rules of origin would be eligible for the current most-favored nation (MFN) duty of 2.5%, if the applied MFN rate remains the same. This is also true for the MFN rates on auto parts.

Vehicles that would have met the NAFTA rules of origin but not the USMCA rules would continue to benefit from the current MFN duties, but only up to 1.6 million vehicles per year. Such imports would be feasible for autos at the 2.5% MFN tariff but not for small trucks, where the U.S. tariff is 25%. The USMCA side letters effectively establish a tariff-rate quota for both Mexican and Canadian vehicles if the United States imposes “national security” tariffs on autos and auto parts. Under the USMCA, 2.6 million passenger vehicles per year and a quantity of auto parts ($32.4 billion from Canada and $108 billion from Mexico), as well as light trucks from both countries, would be excluded from the “national security” measures if applied elsewhere. All such
Chapter 14 of the USMCA, except for “legacy” claims under NAFTA Chapter 11 (which would survive for a period of three years), significantly reduces the protection for most investors in Mexico, primarily by depriving them of the right to pursue actions against the Mexican government in ISDS for denial of “fair and equitable treatment” or indirect expropriation. In addition, the new provisions do not apply to establishment claims (prior to the actual investment), and they impose a 30-month period for exhaustion of local remedies before international arbitration can be sought.

The full ISDS protections, including the frequently cited denial of fair and equitable treatment and indirect expropriation, remain only for investors in Mexico that have concluded contracts with the government or government entities in oil and gas, infrastructure projects, power generation, transportation, and telecommunications.

Given the importance for Mexico in attracting foreign investment to the hydrocarbons sector, the preservation of ISDS for that sector will probably afford potential investors a greater level of confidence when they invest in long-term projects. For investors in the relatively unprotected sectors, questions arise as to whether there will be a substantial impact on investment levels, given the relatively few ISDS actions (less than 20 in 25 years) against Mexico.

The situation with Canada is different; ISDS claims will not be permitted at all between the United States and Canada after the legacy period. Disputes between Canadian investors and the Mexican government and vice-versa would be covered by the CPTPP once it enters into force, presumably January 1, 2019.

With Canada, which has the dubious honor of being the most frequent NAFTA respondent, one may speculate that many government lawyers and other officials are wary of defending ISDS cases in a country where the national courts have a well-deserved reputation for competence and independence.
Hydrocarbon Sector Investment in Mexico

Many, if not all, trade agreements are subject to retrospective criticism about what was not accomplished. NAFTA was criticized for permitting Mexico to retain its long-time government monopoly over hydrocarbons and electric power generation. Some observers had hoped that the USMCA would instead guarantee the same opportunities for private foreign investors in those sectors as are provided by Mexico’s 2013 legal and constitutional reforms. Key elements of the reforms overwhelmingly approved by Mexico’s congress included procedures to permit and govern investment in service and other profit-sharing contracts in hydrocarbon development, as well as in refining, transport, storage, natural gas processing, and petrochemical sectors.

However, the USMCA does not incorporate these reforms. Rather, in language that was presumably insisted upon by López Obrador’s representatives in the negotiations, Mexico explicitly retains the right to change its hydrocarbon laws and constitutional provisions at any time. Thus, in the event that López Obrador decides to re-establish a national petroleum monopoly, it would not be a violation of the USMCA (although it is conceivable that Mexico might incur liability to some investors under the provisions discussed earlier).

Sixteen-year Sunset Clause

The USMCA’s sunset clause is the process calling for a review six years after the agreement enters into force, with termination ten years thereafter if there is no agreement on extending it. The best thing that can be said about this clause is that it is far better than the original U.S. government proposal, which was a five-year sunset provision. Such a short period of time would have resulted in great uncertainty for investors in all three countries—probably the reason the Trump administration proposed it in the first place—and it was roundly criticized by all stakeholders. Sixteen years is long enough to cover the useful lives of most investment outside the extractive industries and should have relatively little impact on investment decisions in North America.

Ten-year Term for Biologic Drug Protection Will Drive up Costs in Mexico and Canada

While the United States was unable to negotiate a ten-year period for biologic drug patent protection in the TPP (effectively eight years), Canada and Mexico both agreed on ten years in the USMCA. Other intellectual property sections of the USMCA are very similar to those in the TPP, providing for enhanced protection against generic producers of agricultural chemicals and pharmaceutical products. While U.S. law provides for a twelve-year term, such lengthy protection is generally opposed elsewhere, including in Canada and Mexico, because it increases the costs of such drugs, most of which accrue to national government healthcare systems.

Prohibition of Mexico or Canada from Concluding an FTA with a Nonmarket Economy (e.g., China)

Another unique provision apparently insisted upon by the Trump administration is designed to give the United States the option of withdrawing from the USMCA with six months’ notice if either Canada or Mexico were to negotiate a trade agreement with a nonmarket economy (NME). However, any country with a free trade agreement at the time of signing the USMCA is excluded. Thus Vietnam, which is a party to the existing CPTPP along with Canada and Mexico, is excluded from the prohibition.

Steel and Aluminum Tariffs

The U.S. section 232 tariffs, which are independent of both NAFTA and the USMCA, have resulted in the imposition of “national security” tariffs on steel and aluminum imported from most countries. These tariffs will remain in place under the USMCA as of early December 2018, as will the Canadian and Mexican retaliatory tariffs mentioned earlier. Before the tariffs, Canada was the largest source of both steel and aluminum imports into the United States, and Mexico was fourth largest in terms of steel imports. Given that possible future U.S. national security tariffs on autos and auto parts are addressed in the two USMCA side letters mentioned earlier, it is surprising...
to some observers that these steel and aluminum tariffs have not been addressed. They will likely remain a major problem in U.S.–Canada and U.S.–Mexico relations unless they are removed or some sort of settlement is reached.

**PRESERVING OTHER KEY ASPECTS OF NAFTA**

The fact that the USMCA carried over the bulk of NAFTA was undoubtedly critical to obtaining Canada’s last-minute inclusion in the agreement. In addition to the general preservation of the duty-free, tariff-free trade established under NAFTA, as well as very limited changes to the NAFTA rules of origin that NAFTA stakeholders have learned to live with over the past twenty-five years, several specific areas of NAFTA that were retained in the USMCA are notable.

**Review of Dumping and Subsidies Trade Determinations**

Despite strong initial Trump administration opposition, the NAFTA mechanism (Chapter 19) for reviewing dumping or illegal subsidization by binational panels instead of domestic federal courts was preserved without significant changes.\(^5\) While the September 30 draft of the USMCA initially applied the mechanism only between the United States and Canada, with Mexico having agreed to its elimination, the USMCA was soon revised to expand the mechanism to Mexico as well. For Canada, Chapter 19 was a red line, given that it was material—the “crown jewel” with “iconic significance”—in Canadian approval of the 1988 U.S.–Canada Free Trade Agreement, as well as NAFTA five years later.\(^5\)

**Canadian Cultural Industries Exception**

The other redline issue was Canada’s “cultural industries” exception, which was also incorporated in the United States–Canada FTA, NAFTA, and now into the USMCA.\(^5\) The exception, which applies only to Canada, reflects long-standing Canadian concerns “of having its indigenous cultural expression drowned in a flood of U.S. films, television programs, sound recordings, books, and magazines.”\(^5\) Given that most of Canada’s citizens live within 100 miles of the U.S. border and some 94% of films and 75% of TV programs shown in Canada originate in the United States as of 2010, these concerns do not seem unreasonable if exercised responsibly, even if restrictions on such media would otherwise technically violate free trade principles.

**State-to-state Dispute Settlement**

Another area of strong interest to Canada and Mexico given the enormous disparities between the size of their economies and the United States, as well as their dependence on the United States as their major export market, was the preservation of a strong state–to–state dispute settlement mechanism. This aspect of NAFTA was targeted for curtailment by the United States, which had proposed making compliance with dispute settlement panel rulings voluntary.\(^5\) Canada and Mexico ultimately prevailed, and the NAFTA provisions were carried over to the USMCA with minimal changes.

**Government Procurement**

The United States also attacked NAFTA’s government procurement provisions during the negotiations. Initially, the United States demanded that government procurement be reciprocal on a dollar–for–dollar basis, i.e., Canadian and Mexican enterprises would benefit from sales to U.S. government entities only to the extent that the Canadian and Mexican governments made purchases from U.S. enterprises.\(^5\) This approach was impractical given that the U.S. economy and population are many times the size of the other economies. The risks for Canada were not severe given that both the United States and Canada are parties to the WTO’s

Still, if the major threat to the U.S. economy in the future is China, a robust North American economy, which will be preserved by the USMCA, becomes critical.
government procurement agreement, but Mexico is not. The USMCA provisions make minor changes, but in general the NAFTA provisions are carried over.58

CONCLUDING OBSERVATIONS

The Trump administration’s broader trade policies (such as massive tariffs on imports from China and on most steel and aluminum imports regardless of source) will affect intra-North American trade as well as trade with other parts of the world, particularly if tariffs or quotas are imposed on imports of autos and auto parts from Europe and Asia, and particularly if the trade war with China continues or escalates. Mexico could benefit from a higher North American content requirement for auto production if some current Chinese production is shifted to Mexico. Still, if the major threat to the U.S. economy in the future is China, a robust North American economy, which will be preserved by the USMCA, becomes critical.

Given that the effective implementation of the USMCA will require close coordination among the United States, Mexico, and Canada for the indefinite future, it is too soon to tell if the personal attacks by Trump on Canadian Prime Minister Justin Trudeau will have a lasting negative effect on the United States’ closest ally and largest trading partner. Similarly, Trump and López Obrador effectively began with a clean slate on December 1, 2018, sharing an opportunity to establish cordial relations that will facilitate the successful implementation of the USMCA—or the opposite.

ENDNOTES


5. USMCA, chs. 7, 9, 11, 12, 21, 22, 25, 27, and 28.

6. USMCA, ch. 19.


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12. USMCA, art. 23.9.

13. USMCA, art. 23.9, fn. 13.


16. USMCA, ch. 33.


28. USMCA, annex 2–C, para. 5.

30. See NAFTA, annex A–300; appendix to annex 4–B.
31. Australia refused to accept ISDS in that agreement but did so in the TPP and the CPTPP fifteen years later.
34. USMCA, annex 14–C.
35. USCMA, annex 14–D.
36. USCMA, annex 14–D.
37. USMCA, annex 14–E, para 6(b).
38. See USMCA, annexes 14–D and 14–E (not applicable to Canada).
39. CPTPP, ch. 9; but see CPTPP text, annex, para. 2 (suspending certain investment related provisions of the TPP).
40. NAFTA, ch. 6.
43. USMCA, ch. 8.
44. USMCA, art. 34.7.
45. TPP, art. 18.51 (deleted from the Comprehensive and Progressive TPP concluded by the remaining eleven TPP Parties in 2018).
47. USMCA, ch. 20, subsections B (agricultural chemicals) and C (pharmaceutical products).
48. USCMA, art. 32.10.
50. NAFTA, ch. 19; USMCA, ch.10, sec. D.
52. USCMA, art. 32.6; NAFTA, annex 2106 (incorporating relevant provisions of the U.S.–Canada FTA).
55. See NAFTA, ch. 20; USMCA ch. 31.