

## GLOBAL ECONOMIC GOVERNANCE INITIATIVE

# Small Gains & Big Risks:

## Evaluating the Proposed United States-Mexico-Canada Agreement

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It is no surprise that calls to renegotiate the North American Free Trade Agreement (NAFTA) from some candidates in both US political parties resonated with so many Americans. Numerous studies have documented the negative effects of NAFTA on certain groups, regions, and the environment in the US, Mexico and Canada. President Trump can be credited with renegotiating NAFTA, yet according to the evidence reviewed in this policy brief, the resulting United States-Mexico-Canada Agreement (USMCA, 2018) will not restore innovation, industrial jobs, worker rights and living wages; nor will it provide the protections for affordable health care and the environment that have been on the decline since the original NAFTA went into force.

The US International Trade Commission (USITC, 2019) projects that the USMCA will bring small and skewed economic gains in the US, including:

- A one-time increase in GDP of only three and a half tenths of one percent (0.35%) six years after the agreement goes into force;
- A one-time increase in total employment of a small fraction of one percent (0.12%) six years after the agreement goes into force, mainly in low-paid service sector jobs;
- A one-time wage increase of about a quarter of one percent (0.27%) on average after 6 years. Slightly larger wage increases would go to higher educated workers than to workers without college degrees, pushing the latter further down the income ladder.

Alongside those small gains, the USMCA will bring heightened social, health and environmental risks including:

- Weak enforcement and dispute resolution procedures for the protection of labor rights and the environment;

- A loophole whereby US oil and gas companies with Mexican government contracts can still sue the Mexican government directly (under NAFTA's rules) if it adopts higher environmental and public health standards. Meanwhile, the agreement does not address or even mention climate change;
- Special protections for large pharmaceutical and digital firms that will increase their monopoly power, raise health care costs and threaten privacy and the ability to regulate harmful content on the internet.

The renegotiated NAFTA is a far cry from what the evidence suggests is needed and what citizens, workers and environmentalists across America were hoping for. Unless the agreement is revised to shift the balance in favor of workers, households and communities in North America and the global commons, it should be rejected in favor of an agreement that prioritizes shared and sustainable prosperity.

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## **The impact of the original NAFTA 1.0 on the US**

Studies of NAFTA by US congressional researchers have consistently concluded that the effect of the agreement on overall US gross domestic product (GDP) was likely very small—"probably no more than a few billion dollars, or a few hundredths of a percent" (CBO, 2003). A study prepared by the Congressional Research Service as the US began to re-negotiate NAFTA in 2017 concluded that the "net overall

effect of NAFTA on the US economy appears to have been relatively modest, primarily because trade with Canada and Mexico accounts for a small percentage of US GDP. However, there were adjustment costs for workers and firms as the three countries adjusted to more open trade and investment" (Villarreal and Fergusson, 2017: 2). Economists from Yale University, the National Bureau of Economic Research, and the Federal Reserve conclude that at most NAFTA spurred a one-time bump in US growth by a mere eight one-hundredths of one percent (Caliendo and Parro, 2015)

If there was so little effect overall, why is the agreement still so controversial? It is precisely because trade creates winners and losers—something long recognized by trade economists—as economies adjust to different costs of production in trading partner countries. The losers may be as numerous as, or even more numerous than, the winners, especially in the short-to-medium term. NAFTA was the first trade agreement that eliminated tariffs between relatively high wage economies (US and Canada) and a low wage developing country (Mexico). Further, NAFTA and subsequent US free trade agreements created new protections for cross-border investment, along with robust mechanisms for investors to assert their claims against governments and it offered guaranteed access for the goods and services produced by those investments back into the lucrative US market.

These pro-investor measures created additional incentives for firms to move their operations to Mexico to take advantage of low wages and permissive regulation. Thus, beyond immediate winners and losers among sectors and workers directly affected by trade opening, these agreements strengthened investors' bargaining power and weakened labor's, thus setting up workers for continuing losses in the future. Investors can and did move production to lower cost locations, eliminating jobs in the US and creating them in Mexico and other low wage countries or threatening to leave in order to depress wages in the US (Bronfenbrenner, 1997).

While it has traditionally been difficult to measure the actual impact of trade agreements on jobs and wages due to the multiple factors affecting labor markets, new research methods and better data have more recently produced robust estimates of these effects. For example, a study that looks at the effects of NAFTA by measuring each industry's vulnerability to Mexican imports and each locality's dependence on vulnerable industries finds that wage growth was dramatically lower for blue collar workers in the most affected industries and localities, with negative spillover effects on service-sector workers in those localities as well (McLaren and Hakobyan, 2016). The study shows that those losses were concentrated in vulnerable towns and counties in Georgia, North Carolina, South Carolina and Indiana among other states. Another study using different methodology finds that at the state-wide level, the hardest-hit states in terms of jobs displaced as a share of total state employment were Michigan, Indiana, Kentucky and Ohio (Scott, 2011). What small gains did accrue from the agreement flowed to large firms and wealthy households in the US (Scott, 2003). At a time of increasing inequality, with particularly harsh effects in some regions, the impact of NAFTA continues to be felt and raises important questions about the potential effects of USMCA.

Losses in the United States have not been Mexico's gain. While trade increased significantly for Mexico, per capita economic growth has hardly budged and environmental conditions have worsened (Zepeda et al., 2009). Indeed, new research shows that NAFTA shifted pollution-intensive manufacturing to Mexico and more than two million Mexicans working in farming lost their livelihoods to cheap imports of agricultural products from the US (Cherniwchan, 2017). What is more, according to a World Bank study, wage disparity increased in Mexico as a result of NAFTA (Lederman et al., 2004).

## Does the USMCA Set a New Path?

President Trump criticized NAFTA's shortfalls and has delivered a renegotiated agreement. While it includes some minor improvements, it is largely a NAFTA 2.0 that will bring very small economic benefits, accentuate inequality and put downward pressure on regulation for health, privacy and the environment.

To put this agreement into a broader context, the trade and investment regime designed after World War II was meant to be a rules-based system that could underpin both prosperity and peace, supporting widespread growth and development while avoiding the beggar-thy-neighbor policies that contributed to two world wars. Over time, however, special interest groups and neoliberal governments have shaped trade agreements to primarily serve the interest of large global corporations.<sup>1</sup> Gradually a new ideology redefined governments' domestic regulations on social welfare and the environment as barriers to trade (Rodrik, 2018; Slobodian, 2018). Instead of viewing trade as a tool to improve economic efficiency for the purpose of increasing living standards, trade expansion was now presented as an end in itself.

A trade regime suitable for 21<sup>st</sup> century challenges will need to support and not undermine inclusive economies, just societies, participatory politics and a sustainable future. It will need to boost productive investment, beginning with a strong public footprint in clean transport and energy systems to establish low carbon growth paths; transform food production for a growing global population; and address problems of pollution and environmental degradation more generally. It will need to support and not undermine the expansion of social protection to shield workers and communities from economic shocks and will need to favor economic activities that place a premium

<sup>1</sup> The United Nations estimates that the top one percent of exporting corporations accounts for 57 percent of global exports (UNCTAD, 2018: 53).

on nurturing human welfare rather than corporate profits. It will need to regulate the movement of capital and design effective financing institutions with longer time horizons attentive to social returns and promote accelerated investments in research, development and technological adaptation. It must devise a new generation of intellectual property and licensing rules that ensure affordable access to medicine and cutting edge technologies. And it must ensure that investors' interests are not allowed to undermine regulation for the public good (Gallagher and Kozul-Wright, 2019; Stiglitz et al., 2015).

## Small and Skewed Economic Gains

Does USMCA meet these challenges? President Trump's new version of NAFTA does not come close to such ambition. By the US government's own account (USITC, 2019), the USMCA will yield a one-time increase of three and a half tenths of one percent in GDP (0.35%) six years after the agreement goes into force. A study published by the IMF estimates that Canada and Mexico would each have a very slight welfare gain while the US would have a slight decline and that the overall effects on the three countries' GDP would be negligible (Burfisher et al 2019). Moreover, the types of models used by the USITC and the IMF have long been criticized for overestimating benefits while ignoring costs (Taylor and Von Arnim, 2006; Ackerman and Gallagher, 2008; Capaldo, 2015). For instance, the USITC assumes that stringent new protections for data companies and cross-border services will increase GDP because they will "reduce policy uncertainty" by freezing current regulations or preventing new regulation (USITC, 2019 Chapter 2). In fact, without the positive value attributed to these increased protections for certain industries, USITC finds that the overall impact of USMCA on US GDP, employment and wages will be negative. Most of the benefits from these new protections would go to firms in specific sectors, such as ITC firms, digital platforms and biotechnology companies, which tend to be monopolistic and/or to seek rents. The USITC overlooks the impact of more industry concentration on higher prices, which reduce wages' purchasing power, and on the ability of governments to regulate in the public interest.

The USITC projects that US employment will hardly increase under the deal, even with the positive value it spuriously assigns to reduced regulatory space. The effect on employment would be a one-time increase in total employment of a small fraction of one percent (0.12%), or 176,000 jobs after six years when the US economy has completely adjusted to the agreement. This one-time addition is about the same as the number of jobs that are created by the US economy monthly in a year of moderate growth. About 70% of the jobs would be in the service sector and most would go to workers with no college education, meaning that most of the new jobs are likely to be low paid.

The report estimates that wages would increase on average by about a quarter of one percent (0.27%) after six years, or seven cents per hour based on the current US average hourly wage of \$27.70. Slightly larger wage increases would go to higher educated workers than to workers without college degrees, increasing inequality. In an economy where wages have stagnated for decades except for the high paid (Silver, 2018), USMCA would hardly move the needle and even then the slight move would be in the wrong direction. Furthermore, the wage projections are inflated by the assumption that the labor market in all participating economies is permanently tight due to full employment in all sectors, an obviously unrealistic assumption.

## A good deal for workers?

As a result of the unequal distributive effects of NAFTA and other trade agreements, there has been pressure from some members of Congress, trade unions and civil society to include strong

protections for labor rights in all trade agreements. In this respect, the USMCA labor chapter continues the trend in US trade negotiations over the last 25 years to expand the scope of the parties' commitments to protect labor rights, in keeping with recent evidence indicating that progressive labor market regulation promotes employment, industrial upgrading and growth (Heimberger, 2019; Storm and Capaldo, 2018). However the agreement does nothing to strengthen overall enforcement of labor rights, meaning that even seeming improvements in the commitments will have little impact in practice. The weakness of enforcement mechanisms available in the trade agreements to hold parties to their labor commitments is compounded by the observable reluctance of the US and other governments to pursue enforcement of the labor terms of agreements. Both of those shortcomings were strikingly demonstrated by the failure of the US to prevail in the only labor case it has ever taken to arbitration, one that addressed egregious and widespread violations of labor rights in Guatemala (Polaski, 2017). Despite acknowledging that violations occurred, the arbitrators declined to hold Guatemala responsible for violating its obligations under the trade agreement and did not impose any sanctions.

The USMCA enforcement procedure replicates the flaws in earlier US labor chapters. It continues to include loopholes such as requiring that violations of the labor commitments occur "in a manner affecting trade or investment" and through "a sustained or recurring course of action or inaction" in order to be considered in breach of the treaty. In the USMCA footnotes are added to define these terms. The footnotes related to "in a manner affecting trade or investment" appear to narrow that loophole although they do not eliminate it. The footnotes related to "a sustained or recurring course of action or inaction" appear to leave a broad loophole in place. These limitations—which are applied to labor and environmental provisions but not to corporate investment or intellectual property rights, for example—should be eliminated.

The process for initiating arbitration under the dispute settlement mechanism appears to allow any one country to stall the establishment of a panel indefinitely (USMCA Article 31.5, 31.6). This actually makes the USMCA enforcement process even weaker compared to NAFTA and other existing US trade agreements. Given that violations of the labor commitments would constitute violations of human rights and inflict economic damage on the weaker party (labor), the agreement should establish an appeals body that has a public interest mandate and qualifications, rather than allowing flawed private arbitral decisions to stand, as happened in the case of US versus Guatemala. These shortcomings should be corrected and in addition affected parties such as workers and trade unions should be given stronger standing to participate fully in any arbitral proceeding and the process should be public and transparent. However even if these changes are made to the dispute settlement mechanism, it is unlikely to provide timely relief for workers whose rights have been violated.

The USMCA also includes an annex to the labor chapter that commits the Mexican government to a series of reforms that would strengthen workers' rights to organize and bargain collectively. These commitments are appropriate and welcome, given that previous Mexican governments had for decades pursued an aggressive strategy of wage repression. They did this both by keeping the minimum wage extremely low and by limiting trade union's bargaining rights and recognizing "protection contracts" negotiated without the knowledge of the workers.<sup>2</sup>

2 By some accounts, average unit labor costs in manufacturing in Mexico today are 30 per cent lower than in China. See for example North American Production Sharing, Inc. (NAPS), "Mexico vs. China

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The Mexican legislature recently adopted a major reform that appears to be consistent with the commitments made in the annex, although there are reports that it could be further amended in coming sessions. However even if a robust reform survives, its implementation will require dismantling the current flawed administrative system and creating an entirely new system of administrative bodies and labor courts, which will be time consuming and costly to establish and to staff. Success will depend on political will and resources. The current Mexican government is favorable toward workers' interests, as demonstrated not only by the legal reform but also by a sharp increase in minimum wages (a 16 per cent national increase and a doubling of the minimum wage in the higher cost-of-living border region) as one of its first acts. But even with a continued pro-worker policy orientation, the damage of the previous low-wage strategy will take years to reverse, as acknowledged by Mexican officials. Previous experience with trade agreements also indicates that reforms that are promised before the agreement is ratified are often not delivered once the vote has taken place. This suggests that a vote on USMCA would be premature before new enforcement bodies are established and operating to the benefit of Mexican workers.

Given the flaws in the dispute settlement mechanism, as well as the uncertainty over Mexican reforms, a more promising approach to enforcement of labor rights should be added to the agreement, along the lines of a proposal from Senators Ron Wyden and Sherrod Brown. They propose a bilateral agreement between the US and Mexico that would allow the two governments to audit and inspect facilities suspected of violating labor standards.<sup>3</sup> If violations were found, the government of the importing country would have the right to deny entry to the goods produced in that establishment under the preferential tariff terms of USMCA. This is a more direct and timely approach to enforcement and focuses on specific firms that engage in violations. The ability to investigate and sanction only violators rather than a whole sector or entire economy is a strong advantage of the approach. In addition to its efficiency it has the potential to create substantial deterrent effects, as other firms observe the effective enforcement of the labor chapter. The Mexican Ambassador to the US recently said that Mexico could agree to such an arrangement if it were reciprocal, allowing inspections of worker rights violations in either country (Politico, 2019). Such an approach has precedents. For example the US-Peru free trade agreement allows the US to block imports of illegally logged timber because they violate commitments to sound forestry practices; and the World Trade Organization allows governments to deny entry of goods from any country that were made with prison or forced labor. Goods suspected of violations of intellectual property rights can be stopped at the border and destroyed if a violation is proved, thus creating incentives for importers to observe the rules. And with respect to the Mexican Ambassador's demand, again there is precedent: during the original bracero program that brought Mexican farm workers into the US during World War II, the US agreed that the Mexican government could send in labor inspectors to ensure that the workers were not exploited on US farms (Gamboa, 1990).

The Wyden-Brown proposal should be strengthened to deny entry to goods produced in violation of labor standards, rather than simply charging higher tariffs, which would weaken the desired deterrent effect. It should be clear that inspections can also be conducted in upstream establishments that feed inputs to those producing exported goods. Value chain data indicate that final assembly before export makes a relatively minor contribution to the manufacturing process (Banga, 2013; UNCTAD, 2013; Kummritz and Quast, 2016). This means that assembly establishments (formally the exporters) may adopt USMCA labor standards without much impact on export prices. Limiting

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Manufacturing: How the Two Countries Compare" Available at: <https://napsintl.com/manufacturing-in-mexico/mexico-vs-china-manufacturing-comparison/>; China Economic Review, "Chinese wages higher than Brazil, Mexico", February 2017." Available at: <https://chinaeconomicreview.com/chinese-wages-higher-brazil-mexico/>  
3 There is no logical reason why this should not be a trilateral agreement involving Canada as well.

inspections and enforcement to these establishments does not prevent violations along the manufacturing process nor does it prevent firms to lower standards upstream in order to recoup any competitiveness lost in the final assembly stage – a form of “social arbitrage.” The Wyden-Brown proposal should also assign stakeholders, such as workers’ unions and civil society groups, a strong recognized role in identifying violations of the USMCA labor rights commitments and require government response within strict time limits. It would be further strengthened by adding a legal right for stakeholders to compel action by the governments through national courts.<sup>4</sup> This would address the problem of lack of political will to pursue action against labor rights violators, as demonstrated by the US reluctance to use the dispute settlement mechanisms over the 25 years that such obligations have been part of trade agreements, beginning with NAFTA.

## Social, Health and Environmental Risks

The USMCA is the latest in a series of agreements that promote a global race to bottom in labor costs and government regulation while establishing stronger legal protection for large firms and wealthy households through the strengthening of corporate intellectual property rights, the deregulation of financial flows and the weakening of social and environmental protections. This trend has been shown to drive up inequality and have deflationary effects on the global economy (UNCTAD, 2018).

As noted above, most of the benefits of USMCA are likely to be concentrated in a few sectors, including ITC, digital platforms and biotechnology, as the result of the agreement’s new protections for cross-border flows of data and restrictions against data localization as well as its extension and locking in of patent protection for biologic medicines for long periods. This will tend to increase economic distortions and inequality, giving the main rewards to these sectors and firms rather than to the public or the broader economy—real costs whose impacts are not taken into account in the USITC report.

The agreement will restrict the right of the parties—including the US government—to adopt new regulations that would protect the public interest. For example, the digital trade chapter would prevent the US from instituting new requirements that US individuals’ personal and financial data must be kept in the US to protect it from malign or less secure handling abroad. Articles 19.11 and 19.12 should be eliminated or significantly revised to provide policy space for future action. The chapter also appears to restrict the future ability of the US to increase regulation of harmful content on digital platforms by limiting the liability of internet service providers for disseminating such content. Article 19.17(2) should be eliminated. At a time when the public and policy makers are becoming more aware of the dangers as well as the benefits of the digital environment, it is inappropriate to use the backdoor of a trade agreement to constrain governments from enacting new laws and regulations to protect public interests from the distortions created by these concentrated and networked firms. The USITC report acknowledges that “the United States, Canada, and Mexico have yet to establish many types of regulations potentially governing

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<sup>4</sup> This could require amending Article 31.21 of the agreement, which reads: “No Party shall provide for a right of action under its law against another Party on the ground that a measure of that other Party is inconsistent with this Agreement and Article 25.3 (4), which reads: “Nothing in this Chapter shall be construed to empower a Party’s authorities to undertake labor law enforcement activities in the territory of another Party.”

international data transfers” (USITC, 2019) and the same is true of platforms’ liability for harmful content.

USMCA intellectual property protections would also constrain the US (as well as Canada and Mexico) from future efforts to reduce prescription drug prices by locking in the number of years biologic companies can avoid competition based on their test data. In general, stronger intellectual property protections produce rents (profits generated by a privileged position in the market, perhaps

legally sanctioned, rather than by competitive advantage) for the corporations that hold them, rather than for individual inventors. They reduce the incentive for new research by allowing firms to collect rents from prior breakthroughs for longer periods. Article 20.49 should be eliminated or the period of protection should be substantially reduced.<sup>5</sup>

It is worth noting again that these changes and similar provisions that restrict policy space for the US and other governments are identified by the USITC report as the main source of gains from the agreement, based on the claim that reducing policy uncertainty will lead to greater investment. However, evidence indicates that investment responds most strongly to growth prospects (Jorgenson, 1971; Chirinko, 1993; Stockhammer, 2004) rather than to anticipation of regulatory behavior; and recent increases in profits have not led to increasing investment around the world (UNCTAD 2016,

Chapter 5). The effects of reduced policy uncertainty are fundamentally a benefit to the profitability of firms and private capital—but at the expense of government policy space and public preferences in terms of privacy, security, access to affordable medicines and other public and social goods. It is a clear reflection of the fact that trade policy as practiced by the US (and many other countries) is a form of mercantilism in which USTR bargains for the interests of leading sectors of the economy and the key firms in those sectors. The system of advisory committees in fact can be seen as open acknowledgement that the policy is one of managed trade to the benefit of politically influential sectors and firms, rather than pursuit of any idealized notion of free trade.

The USMCA fails to even mention climate change, despite the fact that the WTO and the United Nations have shown that trade agreements increase carbon dioxide emissions and that North American emissions from fossil fuels are the second largest of any region in the world (Tamiotti et al., 2009). Furthermore, in Chapter 24 on Environment, the Trump administration eliminates provisions found in the original NAFTA that parties to the agreement should heed commitments under Multilateral Environmental Agreements even if they conflict with NAFTA rules.

Perhaps the one significant improvement of the USMCA over the original NAFTA is the elimination of the investor-state dispute settlement mechanism (ISDS) between the United States and Canada and for Mexican investors in the US.<sup>6</sup> The existing ISDS in NAFTA effectively protects profit expectations by allowing private firms to challenge government regulations before tribunals of private-sector arbitrators who can order governments to pay investors unlimited compensation for deemed violations of NAFTA’s investor protections. The mechanism remains in place under USMCA for US investors in Mexico but introduces limitations that would apply to most cases,

<sup>5</sup> A similar logic applies to Article 20.45, protection of agricultural chemicals.

<sup>6</sup> Canadian investors retain the right to bring ISDS arbitration claims against the Mexican government under CPTPP.

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including the requirement that claimants first exhaust domestic legal remedies, restrictions on investors' substantive rights and restrictions on the application of critical clauses such as Minimum Standard of Treatment. However, an annex to Chapter 14 of the proposed USMCA creates a loophole whereby US corporations with Mexican government contracts in the oil and gas, power generation, telecommunications and transport sectors would still be able to use the old, expansive ISDS regime to challenge environmental, health and other protections in Mexico.

## Conclusion

The text of USMCA requires significant amendments before it can be deemed a good deal for the US and North America. Given the negligible or even negative overall economic impact of the deal found in the USITC and IMF studies cited above, it is clear that the main effect of USMCA will be not growth but redistribution, with more rights and rents going to certain favored firms and sectors including digital platforms and other technology firms and biologic firms. The touted strengthening of the labor chapter will be meaningless without very significant additional enforcement procedures.

Unless the agreement is revised to shift the balance in favor of workers, households and communities in North America and the global commons it should be rejected in favor of a more values-driven agreement that supports and promotes shared prosperity and wellbeing. US trade and investment policy needs a more fundamental reset so as to reflect the universal values that the US and other nations have committed to under the UN Charter, the UN's Social Development Goals for 2030, the International Labor Organization's Declaration on Fundamental Principles and Rights at Work and the Paris Climate Accord. A values-driven trading regime must prioritize the role of global public goods that are needed to deliver human welfare and a healthy planet, promote cooperation and collective actions to bring fairness and balance to market outcomes, coordinate policy initiatives to mitigate common risks and ensure that no nation's pursuit of these broader goals infringes on the ability of other nations to pursue them.

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*The Global Economic Governance Initiative (GEGI) is a research initiative at Boston University's Global Development Policy Center.*

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