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Mexico is deeply concerned about the impact of two economic changes promoted by US President Donald Trump's administration: the tax reform approved by the US Congress at the end of 2017, and the possibility that the US will follow through with its threat to withdraw from the North American Free Trade Agreement (NAFTA).

A major worry is that the sharp reduction of corporate tax rates offered by the new law, which amounts to US$1.5 trillion over 10 years, could encourage US companies to invest in the US rather than in Mexico.

A possible response by the Mexican government would be to enact its own tax reforms to discourage capital flight.

However, Mexico has very little room to maneuver in this area, according to Alicia Bárcena, executive secretary of the Economic Commission for Latin America and the Caribbean (ECLAC).

"Mexico has limited fiscal space because its rate is very low, while tax evasion and avoidance are high," Bárcena said at a press conference in Mexico City in December. The corporate tax rate in Mexico is 30%, while the US tax reform would bring the same rate in the US to about 21% from the previous level of 35%.

Bárcena said that Mexico should probably wait before making any decision on lowering corporate taxes, and suggested that the real tax rate for the US could increase because US states might increase taxes. She also pointed out that other factors come into play when US corporations decide whether to retain or make new investments in Mexico, including "location, resources, work force, [and] value chains."

Mexico considers options

The Mexican finance ministry (Secretaría de Hacienda y Crédito Público, SHCP) has left open the possibility of lowering the business tax, (impuesto sobre la renta, ISR) in response to the changes in the US tax rate.

In a document published in December, the finance ministry said changes to the ISR are very much a consideration, but that a lower tax would not be pursued if it would increase the deficit.

"Given that we have no margin to increase our public debt, we will rule out a reduction of the corporate ISR that produces a higher deficit," said the SHCP.

Another concern raised by the finance ministry is the regressive nature of a reduction in the ISR, which would primarily benefit the wealthier taxpayers.

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Still, the SHCP indicated that it was ready to consider any other changes to the tax code. “There will be an assessment of whether modifications should be made to Mexico’s fiscal framework,” the document said.

Some private analysts see very little direct impact from the US tax reform on financial investments in Mexico.

Gabriel Casillas, a columnist for the daily business newspaperEl Financiero, believes that tax incentives approved by the Peña Nieto administration in 2017 to encourage Mexicans to repatriate capital will help the economy and perhaps send a signal to foreign entities that it is advantageous to keep their capital in Mexico (SourceMex, Aug. 2, 2017). “Many of our funds, including pensions, are already exempt from the ISR, and those that are not exempt pay a very low rate of between 4.9% and 15%,” he wrote.

Casillas said he does not foresee a massive repatriation of US operations back to the home country in the short term. “In the medium term, the incentives to invest in Mexico might decline, and the next presidential administration would have to consider some type of tax reform.”

US could withdraw from NAFTA

A bigger uncertainty for the Mexican economy is the US threat that it might withdraw from NAFTA. US, Mexican, and Canadian negotiators have remained far apart during several rounds of negotiations, launched in August, to modify the trilateral agreement that went into effect in 1994.

US President Donald Trump’s administration, which blames NAFTA for a loss of jobs in the US and for the wide deficit with its two North American partners, is seeking changes in the accord that would make it less attractive for US companies to relocate to Mexico (SourceMex, Aug. 23, 2017).

Negotiators have managed to reach agreement in some minor areas, but for the most part, the US position remains distant from the stance adopted by Mexico and Canada (SourceMex, Oct. 18, 2017).

US negotiators have put forth several proposals that are not acceptable to Mexico and Canada, including a plan to establish rules of origin that would require minimum levels of US content for autos; a sunset clause that would terminate the agreement if it is not renegotiated every five years; and an end to Chapter 19, the provision in NAFTA’s disputes mechanism that allows for an alternative binational panel to review domestic courts’ determinations on antidumping and countervailing duty cases.

Trump has encountered some resistance from the US auto industry and from members of the US Congress whose districts include major operations for US automakers. In mid-November, more than 70 Republican and Democrat House members wrote US Trade Representative Robert Lighthizer to express their concerns about the rules-of-origin proposal, which they said would undercut the competitiveness of the auto industry in North America and jeopardize NAFTA if rejected by Canada and Mexico.]

“Either outcome would adversely affect the US auto industry—reducing sales, production, and exports, and harming US workers in the process,” the lawmakers told Lighthizer.

The letter was written on behalf of a coalition of auto industry trade associations representing nearly all major vehicle manufacturers, as well as dealers and parts suppliers.

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The unwillingness of Mexico and Canada to make major concessions to the US has created great frustrations for the Trump government. In an interview with Reuters, a US source close to the White House quoted Trump as saying “I want out” as the talks drag on with little sign of progress.

The three countries are scheduled to meet for a sixth round of negotiations in Montreal on Jan. 23-28. On Jan. 9, Mexico’s economy secretary, Ildefonso Guajardo, said these talks could be decisive to resolve the disagreements that have hampered the negotiations.

However, Guajardo warned that Trump’s threats to withdraw the US from NAFTA should not be taken lightly. He has said that Mexico will not negotiate under duress and will leave the table if the US initiates the withdrawal process.

Two Canadian government sources told Reuters on Jan. 10 that they believe the Trump government is ready to consider withdrawing from NAFTA if it does not perceive that sufficient progress is occurring at the talks.

“The [Canadian] government is increasingly sure about this ... it is now planning for Trump to announce a withdrawal,” one of the sources said.

The comments from Canadian officials had a negative effect on the Canadian and Mexican financial markets. The Canadian dollar fell to its lowest level of the year against the US dollar following the comments. The Mexican currency weakened to 19.41 pesos per US$1.00, compared with 19.16 per US $1.00 earlier in the day.

Even as Trump insists that he is watching over the best interests of the US private sector, a segment of US business is greatly concerned about the possibility that the US would abandon the accord.

Thomas J. Donohue, president of the US Chamber of Commerce, said his organization has supported the Trump administration’s tax reforms and reductions in regulations but opposes a withdrawal from NAFTA, because such a move would have a negative effect on US growth.

“A major mistake in Washington—such as withdrawal from NAFTA or defaulting on our debt—would undermine our growth,” he said during his annual speech on the state of American business on Jan. 10.

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