U.S. - MEXICO FOUNDATION

SUMMARY

ENHANCING MEXICO'S COMPETITIVENESS THROUGH FISCAL POLICY RECOMMENDATIONS

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EXECUTIVE SUMMARY

Nearshoring is gaining prominence due to trade tensions, disruptions in supply chains, and political instability, offering a wide range of benefits.

Nearshoring is the practice of relocating business activities or processes to a nearby or geographically closer location, typically in neighboring countries or regions, rather than distant offshore destinations.[1] The practice has gained prominence due to several geopolitical and economic factors. By reallocating certain processes or activities, firms can benefit from enhanced supply chain control, market expansion, efficiency optimization, resource acquisition, and strategic asset utilization.

Nearshoring practices are attractive for host countries due to their impact on Foreign Direct Investment (FDI), economic growth, and job creation.

This practice presents a mutually beneficial scenario where companies gain cost advantages and market proximity, while host countries experience economic growth, job opportunities, and technology transfer. For example, it is estimated that nearshoring can help Mexico add an additional 3% to its GDP in the next five years.[2] Countries will seek and compete to attract nearshoring by offering incentives like tax benefits, specialized economic zones, skilled labor forces, robust intellectual property regimes, and strategic trade policies.

Several factors have enhanced the attractiveness of Mexico as a nearshoring destination of U.S. activities, mainly those relocating from Asian economies.

The imposition of tariffs on China by the United States in 2018 prompted certain enterprises to explore alternative markets to alleviate expenses. The United States-Mexico-Canada Agreement heightened the demand for a higher regional value content in goods to qualify as North American-made. Maritime transportation costs resulted in transportation expenses surging over fivefold. Lastly, the onset of the conflict in Ukraine curtailed the supply of raw materials, obliging global businesses to seek out alternative

[1] Fernández-Miguel, A. et al. 2022. Disruption in Resource-Intensive Supply Chains: Reshoring and Nearshoring as Strategies to Enable Them to Become More Resilient and Sustainable.
[2] Deloitte. July, 2023. Nearshoring in Mexico.

suppliers.[3] However, despite Mexico's strategic position and economic integration with North America, the country has only absorbed a relatively small share of that lost by China.[4]

Countries that aim to attract nearshoring should meet macroeconomic stability, tax incentives, skilled labor availability, infrastructure quality, and law enforcement.

Desirable destinations possess well-established development frameworks, including robust, well-developed transportation networks, ports, and telecommunications, enhancing supply chain resilience. Moreover, transparent and stable governance, R&D investment, intellectual property protection, and strong institutions are crucial for reducing uncertainties in nearshoring decisions. In this regard, high-income countries have demonstrated more effective attracting and retaining investment.[5] Mexico can still improve its performance on key institutional and labor elements, including using more tax incentives to drive economic growth.

In 2022, Mexico occupied the 30th position out of 38 countries on the International Tax Competitiveness Index.

Amongst the 38 countries, the U.S. ranked 22nd, falling below Japan, above Slovenia, and only eight positions ahead of Mexico. Mexico outshines the U.S. with its highly competitive property tax, securing a notable ninth rank globally in this tax category.

Interestingly, the U.S. displays its least competitive aspect in this tax category. Mexico's favorable tax system offers an opportunity to formulate a tax incentive strategy, allowing U.S. investors to explore the benefits of property-related factors in their offshore and nearshoring decisions.

Mexico's FDI potential from the U.S. is promising; however, it should also consider diversifying its trade partners, mainly focusing on Europe.

Despite Mexico's success in becoming the first U.S. trade partner as of June 2023, displacing China, 14 out of more than 51 countries engaged in investment activities in Mexico have shown a consistent decline in FDI over the past decade. Seven of these 14 countries are from Europe. It's worth noting that despite the rise in U.S. FDI in Mexico, the amount is on par with

[3] Ibid
[4] Deloitte. July, 2023. Nearshoring in Mexico.
[5] International Monetary Fund. Foreign Direct Investment in Developing Countries. Finance & Development.

the newly acquired FDI by Texas in 2022. Texas is the second-largest recipient of FDI in the U.S., showcasing the economic potential that individual U.S. states have compared to an economy the size of Mexico.

States within the U.S. could pose competition for FDI in Mexican bordering and manufacturing regions, especially in the automotive sector.

The U.S. has consistently ranked as the number one worldwide FDI destination, with the participation of manufacturing accounting for $5.3 billion or 65% of 2022 Greenfield investment expenditures. This is mainly driven by the computer and electronic products sector, which contributed $1.8 billion. California, New York, and Texas emerge as the dominant FDI beneficiaries, collectively contributing 46% of the entire new FDI influx in the U.S. These three states exhibit numerous commendable practices, such as a skilled workforce, robust infrastructure, efficient connectivity, and strategic location.[6] For example, the U.S. has implemented tax incentives to encourage reshoring the electric vehicle battery supply chain, leading to increased job creation and enhanced supply chain resilience.[7] Mexico will introduce a range of tax incentives for nearshoring, including those aimed at benefiting specific sectors such as pharmaceuticals, aerospace, electronics, and microprocessors. It will be necessary to analyze the impact these incentives have in the long term and whether they can compete with states in the United States.

When contrasted with alternative nearshoring locations, Mexico offers certain incentives and continues to have the potential to explore innovative tax schemes.

Northern and Eastern Europe, particularly in regions such as the Baltics and the Balkans, have emerged as alluring nearshoring prospects for Western European nations. This trend is exemplified by Lithuania, which boasts advantageous tax rates, Special Economic Zones, and a robust Intellectual Property Regime, solidifying its appeal as a prime destination. Similarly, with a significant manufacturing trade partnership with the U.S., Pakistan has established Special Technology Zones and strategic trade policies targeting the growing electric vehicle market, accentuating the evolving landscape of nearshoring. In this context, Mexico could consider

[6] Investment Monitor. July, 2022. The big three march on: How Texas, New York and California dominate US FDI.
[7] Rocky Mountain Institute. May, 2023. The EV Battery Supply Explained.

exploring tax incentives that align with the dynamic global economy, mainly centered around innovation and technological advancement.

In October 2023, the Mexican Government introduced new tax incentives to boost investments in response to nearshoring activities. These tax incentives are aimed at companies contemplating relocating within Mexico, specifically focusing on ten critical sectors, including electronics, semiconductors, batteries, engines, and pharmaceuticals, among others. These incentives encompass accelerated investment deductions and an additional deduction for worker training expenses.

In addition, it has been identified that Mexico could enhance its competitiveness as a nearshoring destination by exploring the adoption of the following recommendations oriented to its fiscal framework:

1. Review the Interest Deduction Limit
2. Repeal Deduction Limits on Worker Payments
3. Reduce the Time Frame to Return Credit Balances of Contributions
4. Explicitly include a Research and Development (R&D) deduction within authorized deductions

It will be interesting to assess how tax incentives aimed at attracting nearshoring will be applied in all states and municipalities in Mexico. However, given that the recommendations outlined earlier are geared towards encouraging nearshoring activities, they can bring about significant changes in the country's economic landscape and contribute to Mexico's fiscal sustainability, economic prosperity, and the overall well-being of its population.

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