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The Dominican Republic-Central America-United States Free Trade Agreement (DR-CAFTA)

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Summary

On May 28, 2004, the United States, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua signed the U.S.-Central America Free Trade Agreement (CAFTA). On August 5, 2004, the Dominican Republic, having completed separate negotiations with the United States, was added to the agreement in a subsequent signing by all parties. The new agreement was titled the Dominican Republic-Central America-United States Free Trade Agreement, or the DR-CAFTA. Since negotiations began in January 2003, it has been a complicated and controversial agreement, becoming more so in September 2004, when the Dominican Republic passed a revenue bill that included a 25% tax on beverages that contain high-fructose corn syrup. With this breech of the proposed DR-CAFTA, the USTR recommended that the Dominican Republic be excluded from the implementing legislation unless this tax is changed. Some Members of Congress have come out against this option.

The DR-CAFTA was negotiated, in part, as a regional agreement in which all parties would be subject to the "the same set of obligations and commitments," but with each country defining its own separate schedules for market access on a bilateral basis. The DR-CAFTA is a comprehensive and reciprocal trade agreement, which distinguishes it from the unilateral preferential trade arrangement between the United States and these countries as part of the Caribbean Basin Initiative (CBI). It defines detailed rules that would govern market access of goods, services trade, government procurement, intellectual property, investment, labor, and environment.

Under the DR-CAFTA, more than 80% of U.S. consumer and industrial exports and over half of U.S. farm exports to Central America would become duty-free immediately. For the DR-CAFTA countries, 100% of non-textile and non-agricultural goods would enter the United States duty free immediately. Many goods would have tariffs phased out incrementally so that duty-free treatment is reached in 5, 10, 15, or 20 years from the time the agreement takes effect. Duty-free treatment would be delayed longest for the most sensitive products, and in some cases, the tariff reductions would not begin until 7 or 12 years into the agreement. To address asymmetrical development and transition issues, the DR-CAFTA specifies rules for transitional safeguards, tariff rate quotas (TRQs), and trade capacity building.

The DR-CAFTA is controversial. Supporters see it as part of a policy foundation supportive of both improved interregional trade, as well as long-term social, political, and economic development. Concerns remain in all participating countries, however, over the negative effects on certain import-competing sectors and their workers. Labor rights issues in some DR-CAFTA countries have caused organized labor to come out against the agreement, despite arguments that trade contributes to long-term economic growth, poverty reduction, and development. All these economic issues, however, are necessarily balanced against the politics of trade, which makes the outcome of the DR-CAFTA uncertain.

Contents

Why Trade More Freely? 1

The Impetus for a DR-CAFTA 4

The Quest for Central American Integration 8

U.S. Trade Relations with Central America and the Dominican Republic 11
- U.S.-Central America Trade 11
  - U.S. Imports 13
  - U.S. Exports 15
- U.S.-Dominican Republic Trade 16
- U.S. Foreign Direct Investment 17

Review of the DR-CAFTA 17
- Market Access 18
  - Textiles and Apparel 19
  - Agriculture 20
- Investment and Services 22
- Government Procurement and Intellectual Property Rights 23
- Labor and Environment 25
  - Environmental Issues 26
  - Labor Issues 27
- Dispute Resolution and Institutional Issues 31
- Trade Capacity Building 31

Outlook 32

Appendix 1. Chronology of DR-CAFTA Negotiations 34

Appendix 2. Selected Economic Indicators 35

Appendix 3. U.S. Merchandise Trade with DR-CAFTA Countries 36

List of Figures

Figure 1. Central America's Direction of Merchandise Trade, 2002 12

List of Tables

Table 1. Central American Exports as % of GDP 10
Table 2. Top Eight U.S. Merchandise Imports from Central America, 2003 . . . 13
Table 3. Top Eight U.S. Merchandise Exports to Central America, 2003 15
Table 4. U.S.-Dominican Republic Merchandise Trade, 2003 16
Table 5. U.S. Foreign Direct Investment (FDI) in DR-CAFTA Countries 17

The Dominican Republic-Central America-United States Free Trade Agreement

On May 28, 2004, the United States Trade Representative (USTR) Robert B. Zoellick and trade ministers from Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua signed the U.S.-Central America Free Trade Agreement (CAFTA), formally concluding the negotiations. On August 5, 2004, the Dominican Republic, having completed separate negotiations with the United States, was added to the agreement in a subsequent signing by all parties. The new agreement was titled the Dominican Republic-Central America-United States Free Trade Agreement and is referred to as the DR-CAFTA (see **Appendix 1**, Chronology of Negotiations).

Since negotiations commenced in January 2003, the DR-CAFTA has been a complicated and controversial agreement. It became more so in September 2004, when the Dominican Republic passed a revenue bill that included a 25% tax on beverages that contain high-fructose corn syrup. The USTR considers this a breech of the Dominican Republic's World Trade Organization (WTO) commitments, as well as those in the proposed DR-CAFTA, and has recommended that the Dominican Republic be excluded from the implementing legislation unless this tax is changed. Some Members of Congress have come out against this option.

Enacting the agreement requires that the U.S. Congress pass implementing legislation and that parallel action be undertaken in the legislatures of the other countries. El Salvador was the first to act, ratifying the agreement on December 17, 2004. As required under Trade Promotion Authority (TPA) legislation (P.L. 107-210), the Bush Administration has sent supporting materials to Congress. There is no time limit for introducing implementing legislation and it may happen early in the 109th Congress if the Bush Administration and congressional leadership agree to do so. Given the latest controversy, and opposition from some labor and commercial interests, the future of the DR-CAFTA in Congress is far from clear. This update provides background and analysis on the DR-CAFTA, including a section on U.S. trade and investment with the Dominican Republic, and will be updated.

Why Trade More Freely?

Countries trade because it is in their national economic interest to do so, a proposition long supported by theory and practice. Comparative advantage has been recognized for nearly 200 years as a core principle explaining the efficiency gains that can come from trade among countries by virtue of their fundamental differences. It states that countries can improve their overall economic welfare by producing those goods at which they are relatively more efficient, while trading for the rest. Intra-industry trade is the other major insight that explains trade patterns. Larger markets

allow for benefits from exchange among countries to occur based on specialized production, product differentiation, and economies of scale. Many Latin American countries have liberalized trade policies recognizing the contribution that trade (and related investment) can have on economic growth and development. As an important caveat, trade is at best only part of a broad development agenda, which must also include promotion of political freedom, macroeconomic stability, sound institutions, and adequate levels of savings and investment, among many other factors.[1]

Comparative advantage provides the rationale for U.S.-Central American (and Dominican Republic) trade in agriculture, textiles, apparel, and capital goods. Intra-industry trade (e.g. goods within the same harmonized tariff system (HTS) code number) is based on specialized production, but in this case relies in large part on differences in wages, skills, and productivity.[2] Certain specialized jobs have developed in Central America (and other developing countries), where they frequently reside in production sharing (maquiladora) facilities. Economists have come to refer to such specialized production as "breaking up the value added chain" and it accounts for why products (and particularly parts thereof) as diverse as automobiles, computers, and apparel are often made or assembled in Central America and other countries in partnership with U.S. firms.[3] This relationship, discussed in more detail later, provides the basis for much of the labor policy debate on the DR-CAFTA, and FTAs more generally.[4]

Measuring the benefits of freer trade is another difficult issue. There is a tendency to count exports, imports, and the oft-misrepresented importance of the trade balance as indicators of the fruits of trade. This approach often gives undue weight to exports at the expense of understanding benefits from imports, where the

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[1] The role of trade is summarized well in: Rodrik, Dani. *The New Global Economy and Developing Countries: Making Openness Work*. The Overseas Development Council, Washington, D.C. 1999. p. 137 and Bouzas, Roberto and Saul Keifman. Making Trade Liberalization Work. *After the Washington Consensus: Restarting Growth and Reform in Latin America*. Kuczynski, Pedro-Pablo and John Williamson, eds. Institution for International Economics. Washington, D.C. March, 2003. pp. 158, 165-67.

[2] This case differs from the standard intra-industry case between two developed countries in which goods, such as automobiles, are exchanged based on product differentiation and economies of scale and where differences in wage levels are not a central factor.

[3] For the theoretical foundation, see Krugman, Paul. Growing World Trade: Causes and Consequences, in *Brookings Papers on Economic Activity (1)*, William C. Brainard and George L Perry, eds. 1995. pp. 327-76 and for the case in Central America, see Hufbauer, Gary, Barbara Kotschwar, and John Wilson. *Trade and Standards: A Look at Central America*. Institute for International Economics and the World Bank. 2002. pp. 992-96.

[4] Note that this trend has not been a driving force in the aggregate unemployment rate of the United States, but does affect the distribution of employment among sectors of the economy. It is also important to emphasize here that wage levels are only part of the issue. Lower wages correlate closely with lower productivity, hence an abundance of low-skilled (low productivity) workers attracts these types of jobs. For an overview of the methodology of measuring the effects of changes in trade policy, see Rivera, Sandra A. Key Methods for Quantifying the Effects of Trade Liberalization. *International Economic Review*. United States International Trade Commission. January/February 2003.

gains from trade are better understood by their contribution to increased consumer selection, lower priced goods, and improved productivity. For example, high-tech intermediate goods imported from developed countries are the basis for future, more sophisticated, production in developing countries. In developed countries, imports from developing countries, whether final goods for consumers or inputs for manufacturing enterprises, reduce costs and contribute to productivity and economic welfare. For all countries, exports are the means for paying for these imports and their attendant benefits.

Three caveats related to negotiating FTAs are important. First, the discussion of costs and benefits generally assumes that FTAs are executed and implemented in a multilateral setting. In fact, given the slow pace of World Trade Organization (WTO) negotiations, many countries are pursuing preferential arrangements, that is, regional and bilateral agreements like the DR-CAFTA. Latin America is full of them and depending on how they are defined, they may actually be trade distorting if they promote trade diversion. This occurs when trade is redirected to countries within a limited agreement that does not take into account countries outside the agreement, some of which may be more efficient producers. Preferential trade agreements are also cumbersome to manage, requiring extensive rules of origin, and economists disagree over whether FTAs help or hinder the movement toward greater multilateral trade liberalization.[5]

Second, trade, much like technology, is a force that changes economies. It increases opportunities for internationally competitive sectors and challenges import competing firms to become more efficient or do something else. This fact gives rise to the policy debate over adjustment strategies, because while consumers and export sector workers benefit, some industries, workers, and communities are hurt. Economists generally argue that it is far less costly for society to rely on various types of trade adjustment assistance than opt for selective protectionism, the frequent and forcefully argued choice of trade-affected industries. The public policy difficulty is that both options have costs and benefits, but result in different distributional outcomes.[6] Because trade agreements raise difficult political choices for legislators in all countries, many of whom represent both potential winners and losers, FTA provisions are typically limited in scope (so continue to protect partially or completely certain products, industries, or sectors) and are phased in over time (typically up to 15-20 years for very sensitive products).

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[5] U.S. businesses operating in Latin America have had to interpret a difficult road map when dealing with multiple arrangements defined in the Caribbean Basin Trade Partnership Act, the Andean Trade Preference Act, and the North American Free Trade Agreement. Each distorts investment decisions in the region and can have a countervailing influence on the others. Adding the many Latin American FTAs only makes the situation more confusing.

[6] Importantly, when a staple, such as underwear, is produced abroad and sold in the United States as a lower-priced import compared to a domestically produced good, it is equivalent to an increase in real income for the U.S. consumer. This can be significant for low-wage workers in the United States. The same idea holds true for industrial products and business consumers. So, there is a "trade off" in the trade policy decision between keeping certain jobs through protection and losing the income gains, or keeping the income gains and losing certain jobs. One public policy response has been to pass trade adjustment assistance legislation to help firms and workers transition more quickly to new opportunities.

Third, there are clearly implications in the trade negotiation process for smaller countries' bargaining leverage when they choose to negotiate with a large country in a bilateral rather than multilateral setting. Both Chile and the Central American countries realized early in the process that there were negotiating issues over which they would be able to exert little or no leverage. Both agreements deal little with trade remedies (e.g. antidumping and subsidies) and resolving agriculture issues also has been limited, given the politically sensitive nature of this issue.

The Impetus for a DR-CAFTA

The United States was motivated by both external events and broader strategic interests in deciding to negotiate preferential trade agreements with Central America and the Dominican Republic. With the proliferation of regional agreements around the world, trade negotiations have become a tactical issue of picking off gains where they are perceived relative to what other countries are doing. It was repeatedly argued by the U.S. business community, for example, that the U.S.-Chile agreement was necessary to equalize treatment of U.S. businesses competing with Canadian firms that already enjoyed preferential treatment with Chile. The case was made for Central America as well, which has trade agreements with Canada and Mexico, each with firms that compete with U.S. businesses in the region. Delays with WTO and Free Trade Area of the Americas (FTAA) negotiations only reinforce this attitude.

In the context of regional trade agreements, history, geographic proximity, and economic complementarities also make the DR-CAFTA an apparently logical step.[7] At least three cautionary notes, however, bear keeping in mind. First, because of a historical pattern of U.S. political, military, and corporate intervention in the region, a sense of disparity in power between the two partners lingers and carried over to the trade negotiations themselves. Second, intra-Central American squabbles and instability have at times disrupted regional integration and especially foreign trade relations. Third, it is easy to raise expectations of the effects of trade agreements on broader social, economic, and political reform.

Economic fundamentals have shaped Central American trade relations. From the early days of independence, agricultural exports were the centerpiece of Central American economic growth. The British controlled primary export production (coffee, bananas, sugar, and beef) until about 1850, when U.S. interests won over. This continued until the 1980s when passage of the Caribbean Basin Economic Recovery Act (CBERA — P.L. 98-67) began to transform the Central American and Dominican economies. By becoming eligible for unilateral preferential tariff treatment as part of the Caribbean Basin Initiative (CBI), U.S. investment fostered growth in light manufacturing, primarily apparel.[8]

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[7] For an excellent economic history of the region, see Woodward, Ralph Lee Jr. *Central America: A Nation Divided.* New York: Oxford University Press, third edition, 1999.

[8] This legislation was extended and amended twice, most recently by the Caribbean Basin Trade Partnership Act (CBTPA — P.L. 106-200, Title II), which further eased restrictions on apparel imports from the Central American countries.

The U.S.-Central American/Dominican Republic economic relationship changed dramatically under the CBI, creating an environment in which businesses forged strategic partnerships in the increasingly complex world of textile and garment manufacturing. From 1974 until 1995, rules restricting trade in apparel between developed and developing countries (mostly quotas) were set out in the Multifiber Arrangement (MFA). Its successor, the WTO sponsored Agreement on Textiles and Clothing (ATC) served as a transitional agreement that oversaw the reduction and elimination of quotas on January 1, 2005.[9] The CBI preferential arrangements were defined under this system, which the United States created to help foster Caribbean economic development, as well as, to assist U.S. industry in responding to competition from similar production-sharing arrangements in Asia that were taking a toll on U.S. production and employment in the textile and apparel industries.

U.S. textile and particularly apparel industries have been hit hard by foreign competition, resulting in a total job loss of over 540,000 employees from 1998-2002.[10] The textile industry (e.g., thread, yarns, cloth) has remained marginally competitive through use of sophisticated production technologies. The apparel manufacturing industry (e.g., shirts, pants, undergarments) by contrast, is highly labor intensive, and in striving to reduce costs, has moved production offshore to lower-wage countries. As part of this process, and with the added incentive of CBI benefits, U.S. firms invested in Central American and Caribbean countries to develop assembly businesses that use mostly U.S. textiles as inputs. This strategy created a mutually beneficial pact and in 2002, some 56% of U.S. apparel and textile imports from Central America was assembled from U.S. materials, compared to less than 1% for imports from China.[11] Although this was a controversial move because of the reliance on foreign low-wage workers to the detriment of some U.S. employment, many economists argue that the alternative would have been an even greater loss of textile and garment jobs to Asian countries that use no U.S. inputs.[12]

With the removal of textile and apparel quotas in January 2005, the trade picture changed. The DR-CAFTA countries were already losing U.S. market share, which from 1997 to 2002 declined from 11.7% to 9.4%. Over the same time period, China's market share increased from 9.1% to 13.0%. Given that U.S. textile and apparel imports from DR-CAFTA countries are heavily concentrated in products previously covered by quotas, the dominance of China and other low-cost Asian producers is likely to continue. DR-CAFTA producers are less competitive on a pure cost basis because of the lower labor costs in Asia, the requirement to use more

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[9] See CRS Report RL31723, *Textile and Apparel Trade Issues*, by Bernard A. Gelb.

[10] United States International Trade Commission (USITC). *The Economic Effects of Significant U.S. Import Restraints*. Publication 3701. Washington, D.C. June 2004. p. 60.

[11] USITC. Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. November 2003. p. 22 and B-1-4.

[12] Chacón, Francisco. International Trade in Textile and Garments: Global Restructuring of Sources of Supply in the United States in the 1990s. *Integration and Trade*, Vol. 4, No. 11, May-August 2000. Inter-American Development Bank, Washington, D.C. and United States International Trade Commission. Production-Sharing Update: Developments in 2002. *Industry Trade and Technology Review*. November 2003. p. 12.

expensive U.S. inputs, and the additional administrative costs associated with U.S. preferential trade requirements.[13]

Low-cost labor, however, is not the only or even the most important factor driving competitiveness. Studies suggest that the economic and social networks that developed between U.S. and Central American firms effectively created a comparative advantage for the region in apparel exporting that has held up even with the entry of China in the market. This relationship was made possible by the proximity of production, operational efficiencies, and quick turn around times for meeting increasingly shortened deadlines demanded of large retailers.[14] In a post-quota trading world, these advantages allow a certain portion of textile and apparel production to remain in the DR-CAFTA countries, but DR-CAFTA country representatives have emphasized that the passage of the free trade agreement is a critical component for maintaining this strategy.[15]

Broader geopolitical and strategic concerns also sparked interest by all parties in pursuing the DR-CAFTA. Proponents expect the DR-CAFTA to reinforce stability in general by providing institutional structures that will undergird gains made in democracy, the rule of law, and efforts to fight terrorism, organized crime, and drug trafficking. The DR-CAFTA may also be a way to expand support for U.S. positions in the FTAA, and given that the January 2005 completion date has slipped, may also help rationalize the system of disparate preferential trade agreements that currently define Western Hemisphere trade relations.

Critics of the DR-CAFTA point to equally broad themes, such as the pervasive social and economic inequality in much of the region, and so support labor and environment provisions as important negotiating objectives. There is concern, for example, over the adequacy of working conditions and enforcement of labor laws in the DR-CAFTA countries. The DR-CAFTA countries argue that the agreement is one of many forces that can have a positive effect in raising labor standards, although it is not sufficient to accomplish this goal on its own.

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[13] United States International Trade Commission. *Textiles and Apparel: Assessment of the Competitiveness of Certain Foreign Suppliers to the U.S. Market.* USITC Publication 3671. Washington, D.C. January 2004. pp. 1-12, 3-22, and 3-33-35. On December 13, 2004, the U.S. Department of Commerce published rules that would impose safeguard measures and restrict apparel imports from China in 2005, despite the removal of quotas. This may provide some cushion to DR-CAFTA apparel producers. See Rugaber, Christopher S. Textiles: CITA to Restrict Imports of 'Embargoed' Goods from China, Others in Early 2005. BNA, Inc. *International Trade Reporter*. December 16, 2004.

[14] A more subtle distinction made by one economist notes that, "How comparative advantage is created matters. Low-wage foreign competition arising from an abundance of workers is different from competition that is created by foreign labor practices that violate norms at home. Low wages that result from demography or history are very different from low wages that result from government repression of unions." See Rodrik, Dani. "Sense and Nonsense in the Globalization Debate." *Foreign Policy*. Summer 1997. p. 28.

[15] USITC, Textiles and Apparel, pp. 3-33, 4-2-4. Gereffi, Gary. The Transformation of the North American Apparel Industry: Is NAFTA a Curse or a Blessing? *Integration and Trade*. Vol. 4, No. 11. May-August 2000. Inter-American Development Bank. pp. 56-57.

Strategic justifications may have helped get the process going, but ultimately it is fair to ask what each country expects to gain commercially from the detailed agreement that has emerged. The dollar value of U.S. trade with Central America makes the region the United States' third largest Latin American trading partner, right behind Brazil, although a distant third from Mexico. Although firms engaged in this trade may find its effects significant, total DR-CAFTA trade in 2003 represented only 1.6% of U.S. foreign commerce, and so can be expected to have only a small macroeconomic effect.

For the United States, an FTA is a more balanced trade arrangement than the unilateral preferences provided in the CBI. Market access issues (e.g., tariff rates, quotas, rules of origin) were core negotiating areas. Although Central American and Dominican tariffs are already relatively low, they can be reduced further. In particular, U.S. business interests want equal or better treatment than that afforded to exports from Canada and Mexico based on their FTAs with Central American countries. Permanent and clarified trade rules would also support the joint production arrangements already in place between U.S. firms and those in the region. Finally, as highlighted in the negotiations with Chile, a bilateral agreement offers the United States a chance to address other trade barriers that affect some of its most competitive industries. This includes clarifying rules for the treatment of intellectual property, foreign investment, government procurement, e-commerce, and services.

From the Central American and Dominican perspectives, reducing barriers to the U.S. market (especially for textile and agricultural products) was cause enough to proceed. The DR-CAFTA would also make permanent U.S. benefits given under the CBI legislation, but which requires periodic reauthorization by Congress. This could increase U.S. foreign direct investment (FDI) that defined the maquiladora relationship and which supports the region's export driven development strategy. The DR-CAFTA countries also faced important vulnerabilities, such as the possibility that U.S. agricultural exports of key staples, such as corn and rice, might overwhelm their small markets, causing huge displacement issues. Sensitivity to these and other key industry sectors were addressed in the extended tariff phase-out and safeguard schedules, and as a matter of development policy, by DR-CAFTA country efforts to diversify the agricultural sector into non-traditional exports.[16]

Finally, two factors pointed to significant negotiation challenges. The first was the need for better Central American integration. Individually, the Central American countries may be too small to justify a U.S. bilateral agreement by themselves, and also trade has been hampered within the subregion by cumbersome customs and other rules. For the DR-CAFTA to work well, the United States needed some

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[16] The DR-CAFTA countries have begun new exports projects in areas such as miniature vegetables, cut flowers, cable manufacturing, among others, in expectation that moving beyond subsistence agriculture and textile manufacturing is critical to achieve economic diversification and development. What distinguishes this effort from the earlier agricultural export model is the emphasis on integrating small producers into the export system. The idea is not only to tap into naturally small production capabilities, but to help bring social development to areas that previously were not integrated into the agricultural export development model. It is still a relatively small effort and its widespread application has yet to be fully realized, but the DR-CAFTA countries see the FTA as supporting this strategy.

assurance that goods could flow efficiently within the region. Second, much was made of the difference in negotiating capacity between Central America and the United States. U.S. and multilateral offers to assist these countries in developing such capacity were viewed as generous, but also a little self-serving, which required a sensitive approach to the whole negotiation process.

The Quest for Central American Integration

Because the Central American countries had to negotiate together, cooperation was paramount. This is no small technical point; although the Central American Common Market (CACM) has been in place for four decades, historically the member countries have struggled to define unified positions in trade, a natural consequence of trying to reconcile diverse national interests and economic capabilities. The fact that Costa Rica took longer to conclude an agreement makes the point.[17]

Since the Spanish colonial period, Central America has been an agricultural exporting area, which by the modern period became concentrated in five major commodities: bananas; coffee; sugar; beef; and cotton (in the 1960s and 1970s). The socioeconomic balance that emerged from this trade regime was far from egalitarian. Economic gains have been uneven. Concentrated land ownership led to highly skewed patterns of income and wealth. Although underlying inequality was an inherent part of colonial Central American society, the modern, foreign-dominated agricultural export model did little to change this reality. The resulting highly stratified socioeconomic structure fostered social discontent and political unrest, leading directly, and perhaps unavoidably, to the turbulent 1970s and 1980s (see **Appendix 2** for a comparison of economic data among the five countries).[18]

There are important implications of this development pattern for regional integration. The emphasis Central American leaders placed on economic integration rested largely on expectations that the gains from economic growth and development would be shared, at least among countries, if not within them. The CACM lowered and equalized external tariffs, expanded the internal market, and helped diversify production and modernize economic activity. Economic analysis of the first two decades of the CACM points to both static and dynamic gains from trade. Benefits arose from more open domestic policies as well as foreign investment and technology transfer that accompanied trade. One study found that some of these gains were shared broadly, as seen in lower prices and a greater selection of goods. Economic integration, however, was not realistically expected to change the underlying social and economic stratification that had dominated for centuries. What the CACM did

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[17] This is not to suggest that all five countries were expected to strike the exact same bargain with the United States in all cases, but that there was agreement among them regarding the agreement's framework.

[18] Woodward, *Central America: A Nation Divided*, p. 299. For a discussion on the effects of the agricultural export model from a historical basis, see Brockett, Charles D. *Land, Power, and Poverty: Agrarian Transformation and Political Conflict in Central America*. Boulder. Westview Press, second edition, 1998. See especially pp. 93-94.

accomplish was to address, in part, the lack of opportunity that defined small closed economies, presumably without introducing new distortions in trade relations.[19]

These gains were widely applauded in the first decade and *intraregional* trade grew eight-fold from 1960 to 1968, when it peaked at 24% of total Central American trade. After that, the CACM struggled to unify the region. Unequal growth patterns undermined the common market because of disappointment over efforts to achieve its unwritten, but widely accepted goal of "balanced development." Historical inequalities among the five countries, most evident between the two extremes of a relatively wealthy Costa Rica and a far poorer Honduras, gave rise to chronic balance of payments problems. As economic growth in Honduras continued to lag behind the rest, it pressured the common market members to find a policy solution to the growing disparity in economic performance.[20]

Unequal economic performance gave way to heated political debate and eventually military conflict. The "Soccer War" between El Salvador and Honduras, begun during the 1969 World Cup playoffs, was a major setback for the CACM because the heart of this conflict was economic, arising out of long-term tensions over land disputes and immigration pressures. The hostilities, although short-lived, had lasting economic effects, with Honduras pulling out of the CACM and suspending trade with El Salvador for over a decade. Despite these setbacks, economic analysis strongly suggested that where reduced restrictions to trade were allowed to operate, net welfare gains could be found for all countries, even if not shared equally. Nonetheless, economic and social inequality delayed realization of deeper integration and continued to spark turmoil.[21]

The 1980s led off with the fall of the Somoza dictatorship in Nicaragua, civil war in El Salvador, the 1982 Latin American debt crisis, and military repression in other parts of Central America. Between a growing political mistrust and the collapse of economic fundamentals, intraregional trade was halved by 1986, falling to 15% of total trade. Policies meant to correct the foreign debt buildup and balance of payments problems resulted in increased non-tariff barriers, reducing trade growth throughout the region. Over time Central America moved away from low value-added primary-goods exports, and through this diversification process, there emerged a renewed sense that the region would be served better by engaging the world as a bloc, rather than individually.

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[19] Cline, William R. and Enrique Delgado, eds. *Economic Integration in Central America*. Washington, D.C. The Brookings Institution, 1978. pp. 405-10.

[20] Ibid., pp. 30-45 and Carl, Beverly M. *Trade and the Developing World in the 21st Century*. New York, Transnational Publishers, Inc, 2001. p. 106.

[21] Cline and Delgado, op.cit., pp. 22-23, 39-41, 110-15, and 296-300. Honduras actually raised its tariffs for all CACM members and then proceeded to negotiate more limited bilateral agreements with individual CACM countries, except for El Salvador. The Central American Bank for Economic Integration took responsibility for providing resources to address uneven development. Interestingly, Honduras had the highest level of outstanding loans (relative to total economic output) in the first two decades, but this failed to keep hostilities at bay.

As with most of Latin America, it took more than a decade for Central America to recover economically from the 1980s downturn (see **Appendix 2**). In the1990s, there was a return to democratic government and other institution building that lay the groundwork for economic growth and development. A revived commitment to deeper integration was codified in the 1991 Protocol of Tegucigalpa that established the Central American Integration System, which operates as a regional umbrella organization and includes Panama. Since then, most Central American countries have experienced noticeable increases in trade as a percentage of economic activity (see **Table 1**), although at levels that still leave much room for growth, especially for countries with small internal markets.

Table 1. Central American Exports as % of GDP

Country	1991 Exports/GDP	2001 Exports/GDP
Costa Rica	22.8	31.0
El Salvador	11.3	20.8
Guatemala	12.8	14.2
Honduras	26.7	31.7
Nicaragua	21.4	32.6

Data Source: IMF, *International Financial Statistics*, and Central Banks of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

In 1993, the Protocol of Guatemala modified commitments of the original CACM treaty, calling for deeper economic and political cooperation. This took form in policies such as establishing a new common external tariff (CET) with a floor of zero and a cap of 15%. This and other rules, however, were phased in at the discretion of each country, so the prospects for deeper integration rests on a foundation of flexibility that has served to unify the member countries by recognizing their varying abilities to implement the agreement's provisions.[22]

This flexibility has been useful in the CACM's earlier trade negotiations with both Chile and the Dominican Republic. Individual countries, however, are also pursuing bilateral agreements with various Latin American countries, again pointing to the fluid nature of the CACM, but also blurring the distinction between the CACM operating as a free trade area rather than a customs union with a well-defined and fully observed common external tariff. This system raises a number of potential legal confusions for international firms wishing to trade or operate in one or more of the Central American countries.[23]

Such a concern has not been lost on the CACM countries. On March 24, 2002, they signed a plan of action to move forward on integration issues including tariff harmonization, reducing non-tariff barriers, finalizing dispute settlement procedures, and developing a common foreign trade policy. This process was not completed, but

[22] Inter-American Development Bank. *Integration and Trade in the Americas: Periodic Note*. Washington, D.C. December 2000. pp. 34-35.

[23] Ibid., p. 35-36 and Carl, op. cit., pp. 110-11.

the continuing commitment to regional integration was effectively subsumed by the DR-CAFTA.[24]

U.S. Trade Relations with Central America and the Dominican Republic

"Docking" the Dominican Republic FTA to CAFTA added the largest of what would be six trading partners covered by the DR-CAFTA agreement. U.S. exports to the Dominican Republic are nearly 25% greater than Costa Rica's, the largest U.S. trading partner in Central America. What made the process feasible was the Dominican Republic's willingness to accept the basic framework and rules of CAFTA, while negotiating market access and some other issues bilaterally, as was done with each of the five Central American republics. In addition, the Dominican Republic's economy and export regime are, in many ways, similar to those of Central America. U.S.-Dominican Republic trade has been added to this report and is discussed in more detail separately.

U.S.-Central America Trade

Because of its huge size and geographical proximity, the U.S. market is a natural destination for Central American exports. Merchandise trade with the United States has dominated Central America's foreign commerce for 150 years, and as seen in **Figure 1**, remains in that role today. The United States is by far the largest of Central America's trading partners, accounting for some 57% of its exports and 41% of its imports. The rest of Latin America collectively is the next largest trading partner, accounting for 19% of Central America's exports and 28% of its imports. The European Union and Asia together account for about 17% of Central American exports and 19% of imports.

This distribution is not uniform throughout the region. Honduras, for example, exports 70% of its merchandise goods to the United States, compared to 45% for Costa Rica. Honduras also has the highest import percentage from the United States at 55% compared to Nicaragua's 24%, which is the lowest. Total trade (exports plus imports) with the United States is also somewhat uneven country by country. Costa Rica accounts for one-third of total Central American trade with the United States, whereas Nicaragua amounts to only 7% of the total. Guatemala, Honduras, and El Salvador account for 25%, 22%, and 12% respectively.

Trade volume with the United States varies among countries, but in most cases the trend has been one of growth at a rate higher than the average for U.S. trade with the world. Over the past six years, U.S. exports to Central America grew by 29.2% (22.1% including the Dominican Republic), compared to 6.1% with the world and 5.2% with Latin America as a whole (see **Appendix 3** for the data). U.S. imports from Central America increased by 34.1% (23.1% including the Dominican

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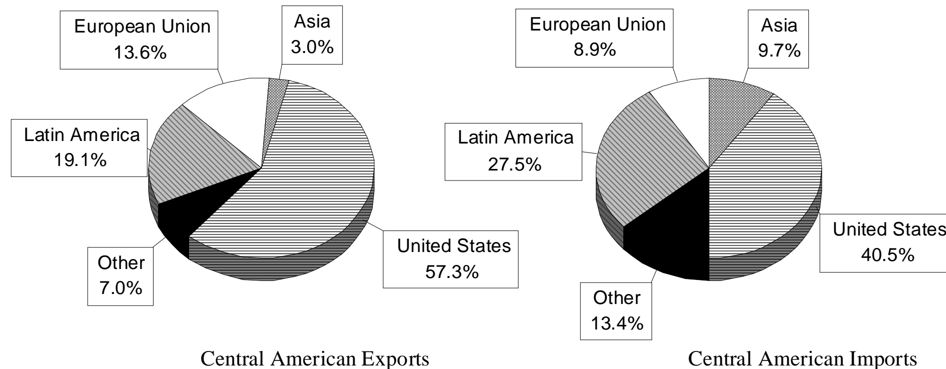
[24] Inter-American Development Bank. *Institute for Integration of Latin America and the Caribbean. Monthly Newsletter*. April 2002.

Figure 1. Central America's Direction of Merchandise Trade, 2002



Data Source: IMF, *Direction of Trade Statistics*, September 2003.

Republic) over the same time period, compared to 38.1% from the world and 49.7% from Latin America. Importantly, in 2003 some 80% of imports from Central America and the Dominican Republic entered the United States duty free under either normal trade relations (NTR) status or the CBI or GSP programs.[25]

For 2003, although trade growth varied among the five countries, U.S. export growth to Central America far exceeded average export growth to the world. U.S. merchandise exports to the world expanded by 4.4%, whereas exports to Central America grew by 10.4% (7.0% including the Dominican Republic), with all five countries experiencing solid growth. U.S. imports from Central America, by contrast, grew at a much smaller rate than average import growth from the world. U.S. imports from the world advanced by 8.4% in 2003, compared to 4.6% from the Central American countries (5.2% including the Dominican Republic), all of which experienced growth in the U.S. market over the last year.[26]

As these trends suggest, the United States tends to run small merchandise trade deficits with all the Central American countries and the Dominican Republic. In part, this is the nature of a production-sharing trade relationship, where parts and materials are sent abroad for value-added processing and then returned to the United

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[25] United States International Trade Commission. *U.S.-Central America-Dominican Republic Free Trade Agreement: Potential Economywide and Selected Sectoral Effects.* USITC Publication 3717. August 2004. p. 7.

[26] Calculations are made from trade data compiled by the U.S. Department of Commerce. Merchandise trade data have a two-month lag time from the time the goods enter the country until they are reported. Services trade data have a much longer lag time and are not readily available for many small U.S. trading partners, such as the Central American countries.

States. Importantly, when services trade is added to the trade balance, the United States tends to run trade surpluses with all these countries. This trend, too, is indicative of the basic relationship between the United States, a service-based economy, and developing countries.[27]

U.S. Imports. The major U.S. imports from Central America fall into three main categories: fruit (mostly bananas) and coffee; apparel; and integrated circuits. These three distinct categories, for various reasons, are not traded uniformly by the five countries (see **Table 2**). First, Central America has traditionally exported bananas and coffee, which is dominated by Costa Rica and Guatemala. Coffee has actually declined for all countries except Costa Rica and constitutes only 3.2% of U.S. imports from the region. This reflects the competitive nature of trade in coffee, which is grown in vast quantities by Brazil, Colombia, and countries in Africa as well. Banana trade has also declined in importance and accounts for only 5.4% of U.S. imports from Central America.

Table 2. Top Eight U.S. Merchandise Imports from Central America, 2003

($ millions)

Product and HTS Number	Total	C.R.	Hon	Guat	El Sal	Nic
Total U.S. Imports	12,407	3,362	3,312	2,945	2,019	769
Knit Apparel (61)	4,737	309	1,887	1,076	1,318	147
Woven Apparel (62)	2,388	282	680	686	403	337
Edible Fruit & Nuts (08) -Bananas (0803)	1,022 (655)	519 (273)	150 (111)	337 (259)	1 (0)	15 (11)
Electrical Machinery (85) -Integrated circuits (8542)	975 (623)	814 (623)	98 (0)	2 (0)	34 (0)	39 (0)
Optical/Med. Equip. (90)	489	480	0	9	0	0
Spices, Coffee, Tea (09) -Coffee (0901)	453 (446)	126 (125)	26 (24)	216 (213)	45 (45)	40 (39)
Fish and Seafood (03)	293	69	124	21	19	70
Mineral Fuel, Oil (27)	181	4	0	177	6	0
Other	1,869	759	347	421	193	121
Top 8 Imports as % of Total	82.3	70.8	89.5	83.3	89.4	81.4

Data Source: U.S. Department of Commerce.
#HTS = Harmonized Tariff Schedule

Second, apparel has become the primary export good for all countries except Costa Rica and accounts for nearly 60% of total U.S. imports from Central America. Because of the CBTPA benefits, some 56% of textiles and apparel imported from the six DR-CAFTA countries in 2002 was assembled from U.S. fabric (from U.S. yarns).

[27] This trend is not disputed, but the U.S. Department of Commerce does not disaggregate bilateral services trade data for the Central American countries. Estimates are provided in some of the Country Commercial Guides produced by the U.S. Department of Commerce based on foreign country reporting.

Of that amount, the Dominican Republic had 33% of the total followed by Honduras with 30%, El Salvador with 18%, Costa Rica with 9%, Guatemala with 8%, and Nicaragua with 2%. Under the CBTPA, these countries may engage in greater value-added operations such as cutting and dyeing, which has allowed them to remain somewhat competitive with low-cost Asian exports. These restrictions would be further relaxed under the DR-CAFTA.[28] The USITC points out that the DR-CAFTA countries have been losing market share to Asia since at least 1997, and the DR-CAFTA is seen as a way to help abate this trend.[29]

Third, Costa Rica attracted $500 million in foreign direct investment for a computer chip assembly and testing plant, which has become its major export generator. This investment was augmented by an additional $110 million in October 2003 for the production line of "chipsets" for personal computers. In 2003, U.S. imports of integrated circuits grew by 39% in dollar terms and constituted 18% of total imports from Costa Rica. Similar growth may be seen in imports of Costa Rica's medical equipment, another indicator of its relatively sophisticated production capabilities. Costa Rica is the fastest growing and most diversified trader in Central America, which explains, in part, why it has outpaced its neighbors on the development path and has been the leading advocate of the DR-CAFTA.[30]

The DR-CAFTA is intended to build on these trends, support export diversification, and provide a long-term stable trade environment that will increase U.S. foreign investment in the region. Evidence is already seen in alternative agricultural exports such as cut flowers and miniature vegetables (in multiple DR-CAFTA countries), as well as developing maquiladora operations to supply coil wrapped cables for the automotive sector (Honduras) and adapting apparel cutting technology to supply insulation for aircraft engines (Costa Rica).

Many non-apparel items that the United States imports from Central America face minimal or no tariffs. Bananas, coffee, oil, most fish products, and Costa Rica's integrated circuits and medical equipment enter duty free. Some enter the United States under preferential arrangements, but the majority is free of duty under normal (most favored nation — MFN) tariff rates. Apparel was technically excluded from preferential treatment under CBI, but under a special access program (SAP), eligible Central American apparel exports receive preferential treatment under production-sharing arrangements (Chapter 98 of the Harmonized Tariff System — HTS). This arrangement was extended under the Caribbean Basin Trade Partnership Act (CBTPA) in October 2000 (P.L. 106-200), which allows duty-free and quota-free treatment of apparel imports if assembled in the Central American countries from

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[28] United States International Trade Commission. Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. November 2003. pp. 13, 22, B1-4.

[29] USITC, *Textiles and Apparel*, p. 1-12.

[30] Hufbauer, Kotschwar, and Wilson, op. cit., p. 1003.

fabrics made in the United States made of U.S. yarns, whether the fabrics were cut to shape in the United States or Central America.[31]

U.S. Exports. As seen in **Table 3**, the major U.S. exports to Central America include electrical machinery, apparel, plastic, yarns, and fabric.

Table 3. Top Eight U.S. Merchandise Exports to Central America, 2003

($ millions)

Product and HTS Number[#]	Total	Costa Rica	Hon	Guat	El Sal	Nic
Total U.S. Exports	10,859	3,414	2,845	2,274	1,824	503
Elec Machinery (85) -Integrated circuits (8542)	1,659 (999)	1,237 (997)	84 (0)	177 (1)	111 (1)	51 (0)
Knit Apparel (61)	821	103	423	36	252	8
Machinery (84) -Office Mach. Parts (8473) -Computer Parts (8471)	993 (175) (139)	307 (76) (48)	224 (23) (13)	220 (47) (33)	195 (20) (35)	48 (11) (9)
Knit/Crocheted Fabric (60)	663	34	340	16	266	8
Plastic (39)	574	256	81	147	79	11
Cotton Yarn (52)	570	13	307	165	74	11
Woven Apparel (62)	501	141	254	37	33	36
Cereals (10) -Corn (1005) -Wheat and Meslin (1001) -Rice (1006)	447 (196) (162) (87)	109 (57) (34) (17)	77 (29) (27) (20)	107 (54) (44) (9)	104 (47) (39) (17)	50 (8) (18) (23)
Other	4,631	1,214	1,055	1,369	710	280
Top 8 Exports as % of Total	57.4	64.4	63.0	40.0	61.1	44.3

Data Source: U.S. Department of Commerce. [#]HTS = Harmonized Tariff Schedule

Many of these goods are processed in some form and re-exported back to the United States under production-sharing arrangements. For example, nearly 60% of electrical machinery exports to Central America is integrated circuits going to Costa Rica for processing and re-export. The same may be said for fabric and yarns that are exported to all countries, sewn and otherwise assembled, and re-exported back to the United States. Some of these goods are consumed in the DR-CAFTA countries along with capital goods (machinery and parts) and agricultural products.

The same distinctions seen in U.S. import trade are evident in U.S. exports. In 2003, 73% of knit and woven apparel and 80% of knit, cotton, and yarn fabric went to Honduras and El Salvador. Although the United States exports machinery and parts to all five countries, electrical machinery and particularly integrated circuits, are

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[31] For the technical details of this arrangement, see CRS Issue Brief IB95050, *Caribbean Basin Interim Trade Program: CBI/NAFTA Parity*, by Vladimir N. Pregelj.

sent to Costa Rica. All five countries import U.S. cereals and some, such as corn and rice, are among the more import sensitive products for the DR-CAFTA countries.[32]

The significant aspects of this trade structure are that it reflects: 1) the continued historical trend of (largely duty-free) regional dependence on the large U.S. market as an important aspect of trade and development policy; 2) a deepening economic integration; and 3) growing U.S. direct investment over the long run.

U.S.-Dominican Republic Trade

The Dominican Republic is the 26th largest U.S. export market (5th in the Western Hemisphere) and ranks as the 38th largest import country (7th in the Western Hemisphere). More so than any of the Central American countries, Dominican trade is dominated by the United States (see **Table 4** for details).

Table 4. U.S.-Dominican Republic Merchandise Trade, 2003

U.S. Exports (by product and HTS Number*)	$ millions	U.S. Imports (by product and HTS Number*)	$ millions
Electrical Machinery (85)	431	Woven Apparel (62)	1,241
Oil (not crude) (27)	366	Knit Apparel (61)	858
Knit Apparel (61)	344	Medical Instruments (90)	450
Cotton Yarn, Fabric (52)	248	Electrical Machinery (85)	377
Plastic (39)	243	PreciousStones/Jewelry (71)	277
Woven Apparel (62)	235	Tobacco (24)	208
Machinery (84)	212	Footwear (64)	138
PreciousStones/Jewelry (71)	195	Plastic (39)	120
Other	1,940	Other	786
Total	4,214	Total	4,455
Top 8 Exports as % of Total	54%	Top 8 Imports as % of Total	82%

Data Source: U.S. Department of Commerce. #HTS = Harmonized Tariff Schedule

The United States absorbs 85% of its exports, with 10% going to other developed countries and only 5% entering developing countries. The Dominican Republic imports 49% of its merchandise goods from the United States, 17% from other developed economies, and 34% from various developing countries. Although the largest of the DR-CAFTA trading partners, U.S. exports actually declined by nearly 1% in 2003 because of a severe recession in the Dominican Republic.

The joint-production arrangements of U.S.-Dominican trade are evident in apparel and jewelry-making industries, as seen in **Table 4**. Apparel and textiles constitute 20% of U.S. exports and 50% of U.S. imports. Other significant U.S. exports include various types of machinery, refined oil products, and plastic. Other

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[32] USITC, Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. July 2002. pp. 39-42, B1-4

important U.S. imports include medical instruments, electrical machinery, tobacco, and plastic. In many ways, the structure of the U.S.-Dominican trade is similar to that of U.S.-CAFTA trade, and hence the economic logic of "docking" it to the Central American agreement.

U.S. Foreign Direct Investment

The DR-CAFTA countries also benefit from foreign direct investment (FDI) as part of the trade relationship with the United States, which is the largest foreign investor in all six countries. To the extent that an FTA can be considered a stabilizing factor in economic relationships, it is expected to encourage more FDI and thereby promote longer term economic growth and development. U.S. FDI in the CAFTA countries is presented in **Table 5**.

Table 5. U.S. Foreign Direct Investment (FDI) in DR-CAFTA Countries

($ millions)

Country	1999	2000	2001	2002	2003
Costa Rica	1,493	1,716	1,835	1,802	1,831
El Salvador	621	540	464	684	779
Guatemala	478	835	311	303	294
Honduras	347	399	227	181	270
Nicaragua	119	140	157	250	261
Total Central America	3,058	3,630	2,994	3,220	3,435
Dominican Republic	968	1,143	1,116	983	860
Total CAFTA	4,026	4,773	4,110	4,203	4,295

Data Source: U.S. Department of Commerce. Bureau of Economic Analysis. Available at [http://www.bea.doc.gov/bea/di/usdlongcty.htm]. Data are stock of FDI on a historical-cost basis.

The trends suggest that U.S. direct investment in the area is relatively small and has grown erratically in recent years. Some countries have fared better than others and net foreign investment may increase or decrease because of both economic and political trends, as well as opportunities in other parts of the world that can affect business decisions. Investment patterns have been skewed toward Costa Rica, which has over half of U.S. FDI in Central America. The stock of FDI has declined since 1999 in El Salvador, Guatemala, Honduras, and the Dominican Republic.

Review of the DR-CAFTA

The CAFTA negotiations concluded on March 15, 2004. USTR Robert B. Zoellick and the five Central American trade ministers signed CAFTA on May 28, 2004, followed by a second signing of the DR-CAFTA with all seven countries on August 5, 2004. The DR-CAFTA is a controversial agreement and implementing legislation necessary to enact the agreement was not introduced in the 108th Congress, but is expected for the 109th Congress.

One aspect of the congressional debate over trade agreements focuses on their potential economic effects on the United States. Assessing these effects falls to the United States International Trade Commission (USITC), which released its congressionally-mandated report in August 2004. It provides quantitative and qualitative estimates of the DR-CAFTA effects on the U.S. economy as a whole and for selected sectors. Overall, the "welfare value" or aggregate effect on U.S. consumers and households of trade liberalization under the DR-CAFTA, assuming it would be fully implemented on January 1, 2005, was estimated to be approximately $166 million (less than 0.01% of GDP) for each year the agreement is in effect.[33]

With respect to trade flows, the reduction of relatively higher tariff rates on U.S. goods is expected to provide a greater effect on U.S. exports than to imports from the region. The USITC model estimates that if the DR-CAFTA is fully implemented, U.S. exports to the DR-CAFTA countries would increase by $2.7 billion or 15%, while imports would increase by $2.8 billion, or 12%. The effect on aggregate U.S. output and employment is expected to be minimal. The largest sector increases were estimated to occur for U.S. grains (0.29% for output and 0.31% for employment) and the greatest decrease to occur for sugar manufacturing (-2.0% for both output and employment).[34] These estimates are in line with expectations prior to the negotiations that the marginal effects of the DR-CAFTA would be small, but positive for the U.S. economy as a whole given the DR-CAFTA countries had small and already largely open economies.

The rest of this section briefly summarizes the major negotiation issues and references the ITC's conclusions with respect to each major issue area, where applicable. Emphasis is given to those sectors expected to be most affected by the agreement.

Market Access

Market access covers provisions that eliminate or reduce barriers to trade such as tariffs, quotas, safeguards, and rules of origin, which define goods eligible for tariff preferences based on their regional content. For the DR-CAFTA countries, the FTA would consolidate and make permanent preferential market access currently provided under the Caribbean Basin Trade Partnership Act (CBTPA) and the Generalized System of Preferences (GSP). For the United States, DR-CAFTA would change the trade arrangement with Central America from one based largely on unilateral trade preferences to a bilateral FTA, making U.S. exports more competitive. Agriculture and textile/apparel goods, Central America's major exports, were the most important and difficult market access issues to resolve.

The annex to chapter 3 details the tariff elimination "staging categories." Each traded good falls into one of eight different categories defining the time period over

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[33] USITC, *U.S.-Central America-Dominican Republic Free Trade Agreement,* p. 64. The study reviews literature on the DR-CAFTA and makes estimates of the economywide and sectoral effects of trade liberalization under DR-CAFTA based on a computable general equilibrium (CGE) model. For details, see pages xiv, 2, and Appendix D.

[34] Ibid., pp. xxii and 64-70.

which duties will be eliminated, with duty-free treatment delayed for the most sensitive goods as defined by each country. For manufactured goods, duties on 80% of U.S. exports would be eliminated immediately, with the rest phased out over a period of up to 10 years.[35] For agricultural goods, duties on over 50% of U.S. exports would be eliminated immediately, with the rest phased out over a period of up to 20 years. In some cases, duty-free treatment does not begin for 7 or 12 years. For the DR-CAFTA countries, 100% of non-textile and non-agricultural goods would enter the United States duty free immediately.[36] Safeguards are retained for many products over the period of duty phase out, but antidumping and countervailing duties were not addressed in the DR-CAFTA, leaving all U.S. and other country laws fully enforceable as required under TPA.

Textiles and Apparel. The DR-CAFTA would remove all duties on textile and apparel imports that qualify under the agreement's rules of origin, retroactive to January 1, 2004. Special safeguard measures are included. The permanence of the provisions and the more accommodating rules of origin and administrative guidelines may allow for a marginal increase in apparel imports from the region. These provisions are intended to address the decline in textile and apparel imports from the region over the past five years, most of which have been displaced by Asian products, despite the enhanced preferential treatment that Congress afforded to Central American and Dominican imports under CBTPA.[37]

Central American and Dominican apparel has been entering the United States duty free for years provided it is assembled from U.S. materials under the so-called "yarn forward" rule, in which the production process beginning with the yarn (not the fiber) must be done in a country covered by the agreement. Under the cumulation rule, DR-CAFTA would allow duty-free treatment to be extended selectively, and on a limited basis, to eligible products made from NAFTA-partner materials, a new step toward integrating apparel manufacturing in the region. Duty-free treatment would also be extended to goods with limited amounts of material from third countries. Although these rules were widely supported, some textile producers registered concern that they are overly restrictive and therefore limited in their intended effect of helping the region compete (by lowering costs) in the U.S. market against Asian imports. U.S. and DR-CAFTA firms that produce for the U.S. market wanted as much flexibility as possible to use fabrics from third countries.

There are exceptions to the yarn forward rule for certain products, and tariff preference levels (TPLs) were allowed for select products from Nicaragua and Costa Rica. These provisions were challenged because of their special treatment by those countries that did not receive similar consideration, as well as some U.S. textile manufacturing interests, which argued that they would hurt U.S. exports. There was also considerable debate over the expansion from the CBTPA of the "short-supply"

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[35] Ibid, p. 25.

[36] Office of United States Trade Representative. *Free Trade with Central America: Summary of the U.S.-Central America Free Trade Agreement*. p. 1. Hereafter cited as the *CAFTA Summary*. It may be found at [http://www.ustr.gov].

[37] USITC, *U.S.-Central American-Dominican Free Trade Agreement*, pp. 28-29.

list. This is the list of goods given duty-free access if made from fabrics that are determined to be in "short supply" in the United States. The DR-CAFTA may also increase slightly U.S. exports of textiles, but on balance, the USITC study estimated that it "will likely have a negligible impact on U.S. production or employment."[38]

Agriculture. Domestic support programs were not addressed in the DR-CAFTA, but strides were made to reduce tariffs and increase quota levels, the most costly trade-distorting policies. The DR-CAFTA would also provide generous transition schedules to all countries with sensitive agricultural products, with the option to use safeguard measures during that period.[39] Agricultural products have the most generous tariff phase-out schedules, with up to 20 years for some products (e.g. rice and dairy). This approach acknowledges that countries dependent on small farms require time to accommodate the structural adjustment process taking place as their agricultural sectors attempt to transform themselves from dependence on subsistence farming to value-added agribusiness operations, and away from agriculture in general to manufacturing and services.[40] All agricultural trade would eventually become duty-free except for sugar imported by the United States, fresh potatoes and onions imported by Costa Rica, and white corn imported by the other Central American countries. Over half of current U.S. farm exports to Central America would become duty free immediately, including high quality cuts of beef, cotton, wheat, soybeans, certain fruits, and vegetables, processed food products, and wine.[41]

Many other transitional provisions exist. Agricultural products would be subject to tariff-rate quotas, or limits on the quantity of imports that can enter the United States before a higher tariff is applied. The phased reduction in agriculture protection also includes the transitional use of price- and volume-triggered safeguards, or applying temporarily an additional duty on products that are being imported in quantities deemed a threat to the domestic industry.[42] Export subsidies would be

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[38] Inside U.S. Trade. *CAFTA Textile Rules Pave Way for Increase in Foreign Fabric Use.* December 19, 2003 and Press Release. *NTA Denounces CAFTA as Threat to U.S. Textile Industry*. December 18, 2003 and USTR, CAFTA Summary, p. 2 and USITC, *U.S.-Central American-Dominican Republic FTA*, p. 30-32. Nicaragua received special preferential treatment for certain "non-originating apparel goods"(Annex 3.27) and Costa Rica received limited special treatment for certain wool apparel goods (Annex 3.28).

[39] For more details, including sanitary and phytosantiary (SPS) provisions, see CRS Report RL32110, *Agricultural Trade in a U.S.-Central American Free Trade Agreement (CAFTA)*, by Remy Jurenas.

[40] Salazar-Xirinachs, Jose M. and Jaime Granados. The US-Central America Free Trade Agreement: Opportunities and Challenges. In: Schott, Jeffrey J. ed. *Free Trade Agreements: US Strategies and Priorities*. Washington, D.C. Institute for International Economics. 2004. pp. 245-46.

[41] U.S. Sugar Industry Group. *Press Release: Mexican and US Sugar Industries Jointly Oppose CAFTA Sugar Provisions*. December 18, 2003.

[42] For example, in the case of beef, the Central American countries have agreed to the immediate elimination of tariffs on U.S. prime and choice cuts, but have a 15-year tariff phase-out on other products, with a backloaded schedule (no tariff reductions in the early

(continued...)

eliminated except when responding to third party export subsidies. The United States would be able to impose a sugar price mechanism to compensate sugar exports in lieu of according duty-free treatment.

Sugar was perhaps the most controversial and complex of agricultural issues in the negotiations. The U.S. conceded to slight numerical increases in sugar quotas for all six countries. Sugar and sugar-containing products imported under the U.S. quota system enter the United States duty-free, but exports above the quota face prohibitive tariffs (more than doubling the price). Raw sugar receives the largest quota by volume, 28% of the total U.S. sugar quota for the world was filled by the DR-CAFTA countries in 2003, and was the major issue for this agreement. The U.S. market accounts for only 14% of the region's sugar exports, representing less than 10% of the region's sugar production.[43]

The DR-CAFTA would raise the U.S. quota by an amount equal to 35% of the current quota in year one, rising to 50% by year 15, after which the quota would increase each year slightly in perpetuity. This may seem large, but the USITC notes that the initial increase amounts to only 1% of U.S. production and consumption of raw sugar in 2003, and that the overall effects of the sugar provisions may be small. Two studies done by the USITC and Louisiana State University estimated that the sugar provisions could result in a decline in sugar prices of 1% (USITC) and 4.6% (LSU), with perhaps largely offsetting employment effects in the sugar producing and sugar-containing product industries.[44]

For the United States, increasing grain exports was an important goal given it is the largest grain exporter in the world. Wheat is not grown in the DR-CAFTA countries and there is already largely free trade in this commodity. Staples for the DR-CAFTA countries, such as rice and white corn, remain protected and there is a complicated system for phasing out TRQs on U.S. exports over a 15-20 year period. U.S. exports of corn and rice will increase slowly due to the highly restrictive TRQs and special safeguard measures. The USITC estimates that changes in the quantity of exports from the United States will be small at first and rise by perhaps 20% by the end of the TRQ phase-out period. The USITC suggests that the long-run effect would be small (1.2% of total U.S. grain exports), but notes that the "potential increase in grains exports offers significant market opportunities for U.S. white and yellow corn growers and U.S. rice growers."[45] Despite the lengthy transition period, concerns remain over the potentially harmful effects to Central America of further opening its markets to U.S. subsidized agriculture.[46]

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[42] (...continued)
years) and a safeguard. The United States has a 26% out-of-quota tariff on beef that will be phased out over 15 years, with the quota schedule defined for each country.

[43] USITC, *U.S.-Central American-Dominican Free Trade Agreement*, p. 35.

[44] Ibid., pp. 38-40.

[45] Ibid., pp. 43-47.

[46] Oxfam International. *A Raw Deal for Rice Under DR-CAFTA*. Briefing Paper #68. 2004.

Investment and Services

In 2003, the United States' stock of foreign direct investment (FDI) in the DR-CAFTA countries was $4.3 billion, which represents only 1.4% of U.S. FDI in Latin America and the Caribbean. Some 43% of the FDI in DR-CAFTA countries went to Costa Rica, followed by the Dominican Republic with 20%. The United States has advocated clear and enforceable rules for foreign investment in all trade agreements, which is largely accomplished by "standard" language requiring national and most-favored-nation (nondiscriminatory) treatment. The DR-CAFTA would clarify rules on expropriation and compensation, investor-state dispute settlement, and the expedient free flow of payments and transfers related to investments, with certain exceptions in cases subject to legal proceedings (e.g. bankruptcy, insolvency, criminal activity). Transparent and impartial dispute settlement procedures would provide recourse to investors, all issues defined in TPA and of importance to U.S. investors because of their disparity in treatment among the six DR-CAFTA countries.

Two investment issues stand out. First, an investor-state provision, common in U.S. bilateral investment treaties and used in earlier FTAs, has been included. It would allow investors alleging a breach in investment obligations to seek binding arbitration with the state directly, as opposed to pursuing a slower and more cumbersome path involving a state-to-state process. This has raised questions in the past over the possibility of disputes brought against the United States, particularly under NAFTA, but U.S. foreign investors advocated the inclusion of such rules given the large amount of U.S. foreign direct investment abroad relative to the small amount of investment from the DR-CAFTA countries. On balance, U.S. foreign investors support the investment provisions for the enhanced protections given them in developing countries like those in Central America, which may lead to increased investment flows from the United States to these countries.[47]

Second, the DR-CAFTA countries requested greater flexibility in the treatment of certain sovereign debt. Annex 10-A allows sovereign debt owed to the United States that has been suspended and rescheduled not to be held subject to the dispute settlement provisions in investment chapter, with the exception that it be given national and MFN treatment. Annex 10-E extends from six months to one year the amount of time required before a U.S. investor may seek arbitration related to sovereign debt with a maturity of less than one year. Both provisions are intended, in the event of a financial crisis, to keep the DR-CAFTA from interfering in any sovereign debt restructuring process, and are viewed by the U.S. Treasury as an accommodation to Central American interests.

The United States is the largest services exporter in the world, and not surprising, services trade presented a number of hurdles given that the Central American countries have adopted few commitments of the WTO's General Agreement on Trade in Services (GATS). There are also many industry-specific barriers that exist, such as: barriers to foreign insurance companies in Guatemala; "heavy" regulation licensing of foreign professionals in Honduras; local partner requirements in some financial services in Nicaragua; and numerous services

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[47] USITC, *U.S.-Central America-Dominican Republic Free Trade Agreement*, pp. 90-91.

monopolies in Costa Rica (insurance and telecommunications).[48] The DR-CAFTA would provide broader market access and greater regulatory transparency for most industries including telecommunications, insurance, financial services, distribution services, computer and business technology services, tourism, and others. Banks and insurance firms would have full rights to establish subsidiaries, joint ventures, and branches. Regulation of service industries is required to be transparent and applied on an equal basis and e-commerce rules are clearly defined, a critical component of delivering services.[49]

Overall, the USITC suggests that the DR-CAFTA would have little effect on U.S. services imports because the market is already open. New opportunities would materialize, however, for U.S. firms to expand into Central America. In particular, Costa Rica agreed to the eventual opening of its state-run telecommunications and insurance industries, where there has been strong political resistence to deregulation.[50] Unlike the other countries, doing so would constitute a major structural adjustment for the Costa Rican economy, have implications for Costa Rican social policy, and require amending the constitution, all of which, the Costa Ricans argued, would be difficult for their legislature to support without concrete tradeoffs in other areas, such as agriculture and textiles. These issues were resolved in two week-long discussions held in January 2004 and their detailed commitments are presented in the relevant chapters of the DR-CAFTA.

Government Procurement and Intellectual Property Rights

These two areas were also of particular interest to the United States. The DR-CAFTA was seen as an opportunity to remedy many deficiencies and move toward strong enforcement of standardized practice in the region. None of the DR-CAFTA countries is a signatory to the WTO Agreement on Government Procurement and allegations against the various purchasing processes vary from dissatisfaction with less than transparent and cumbersome procedures in Costa Rica to outright corruption in Guatemala. El Salvador and Nicaragua passed new government procurement laws in 2000 and Honduras followed in 2001, and in general, there have been improvements in all countries in dealing with project bidding, although transparency issues remain.[51] In part, this is due to a lack of incentives given that many of these countries would not be able to compete in the U.S. government procurement market.[52]

The DR-CAFTA would grant non-discriminatory rights to bid on contracts from Central American ministries, agencies, and departments, with the exception of "low-value contracts" and other exceptions. It would also call for procurement procedures

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[48] USTR. *2004 National Trade Estimate Report on Foreign Trade Barriers.* Washington, D.C. 2004.

[49] USTR, *CAFTA Summary*, p. 2-3.

[50] Salazar-Xirinachs and Granados, op.cit., p. 260.

[51] USTR, *2004 National Trade Estimate Report on Foreign Trade Barriers*.

[52] Salazar-Xirinachs and Granados, op.cit., p. 253.

to be transparent and fair, including clear advance notices of purchases and effective review. Specific schedules detailing exceptions and limitations were written by each country, covering such diverse issues as the sale of firearms to supplying school lunch programs. In addition, each country provided a list of subnational governments (e.g. states and municipalities) that would adhere to the GP provisions. The DR-CAFTA would also make clear that bribery is a criminal offense under the laws of all countries, and in general, was supported by U.S. businesses interested in doing or expanding opportunities in the region.[53]

All Central American countries are revising, or have revised, their intellectual property rights (IPR) laws and are closing in on complying with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). That said, all countries are subject to criticism for falling short on either clarifying or enforcing penalties for noncompliance and in some cases have simply not adopted reforms that many U.S. industries (e.g., sound and video recordings, pharmaceuticals, book publishing, computer software) consider necessary to protect their intellectual property. Piracy, incomplete or inadequate legal protection, and enforcement capacity remain problems and ongoing concerns exist across the range of IPR issues of patents, trademarks, and copyrights, covering print, electronic, and other media.[54]

The IPR provisions in the DR-CAFTA would provide that U.S. and DR-CAFTA businesses receive equal treatment in all areas and that the CAFTA countries ratify or accede to various international IP agreements. Trademarks would benefit from a transparent on-line registration process and special system to resolve disputes over internet domain issues, among other benefits. Copyright provisions would clarify use of digital materials (exceeding TRIPS standards) including rights over temporary copies of works on computers (music, videos, software, text), sole author rights for making their work available on-line, extended terms of protection for copyrighted materials, strong anti-circumvention provisions to prohibit tampering with technologies, the requirement that governments use only legitimate computer software, the prohibition of unauthorized receipt or distribution of encrypted satellite signals, and rules for liability of internet service providers for copyright infringement. Patents and trade secrets rules would conform more closely with U.S. norms. End-user piracy would be criminalized and all parties would be required to authorize the seizure, forfeiture, and destruction of counterfeit and pirated goods. The DR-CAFTA would also mandate statutory damages for copyrighted material.[55]

For many countries, these commitments would require significant changes in law, which may prove politically challenging where there is no tradition of strong IPR protection. There is concern that strict IPR provisions may impede technology transfer to the DR-CAFTA countries. Pharmaceutical products is one high profile case, pitting the social concern for making drugs available at an "appropriate price" (branded versus generic) against the needs of the industry to recover the high costs of research and navigating the regulatory process. Lack of rules governing the

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[53] USTR, *CAFTA Summary*, p. 5.

[54] Ibid and *2004 National Trade Estimate Report on Foreign Trade Barriers*.

[55] Ibid., p. 4-5.

protection of firm and industry research data released for marketing approval has also raised concerns from the pharmaceuticals and agricultural chemicals industries.

The DR-CAFTA goes a long way toward meeting U.S. business IPR protection needs and the USITC suggests that many industries will benefit from higher revenue if the new standards can be enforced.[56] Even if laws are changed to conform to the DR-CAFTA commitments, however, enforcement issues will likely remain and technical assistance may be needed to help develop the necessary capabilities.

Labor and Environment

Perhaps the greatest challenge to the DR-CAFTA arises from the environment and labor chapters, which complicate the trade negotiation process by moving it beyond purely commercial issues into the realm of social policy. Although it has become widely accepted that social issues can be affected by trade liberalization, there is considerable disagreement over how aggressive language in trade agreements should be in accommodating this concern. Should trade agreements require all countries to meet specific core standards, or is this approach too stringent? Is a trade agreement the best, or even a good enforcement mechanism for social policy that usually is the purview of domestic laws and regulation?

From an economic perspective, labor and environment advocates in the United States argue that developing countries may have an "unfair" competitive advantage because their lower standards are the basis for their lower costs, which in turn are reflected in lower prices for goods that compete with those produced in developed countries.[57] It follows from this argument that the difference in costs is an enticement to move U.S. investment and jobs abroad. On the other hand, studies also suggest that these cost differentials are usually not high enough to determine business location alone, and that productivity remains the primary decision factor.[58] Further, many economists view trade liberalization as part of the overall development process that, in and off itself, can promote social change.[59] Developing countries are also concerned with sovereignty issues related to specifying standards in trade agreements

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[56] USITC, *U.S.-Central America-Dominican Republic Free Trade Agreement*, p. 101.

[57] The difference is that in most developing countries, the social costs associated with environmental degradation, pollution, and poor working conditions may not be captured in the market price (so-called *external* costs). Through legal and regulatory measures, developed countries require that businesses correct for many of these social problems, thereby *internalizing* these costs to the business, where they are then reflected in the final (relatively higher) price of the good or service in the market place.

[58] See CRS Report 98-742 E, *Trade with Developing Countries: Effects on U.S. Workers*, by J.F. Hornbeck. September 2, 1998, pp 11-13. Productivity and wage levels are, however, highly correlated. See Rodrik, *Sense and Nonsense in the Globalization Debate*, pp. 30-33.

[59] In addition to the external costs addressed in this section, it is interesting to note that there is some broader evidence that FTAs have not "forced a race to the bottom of regulatory standards," but rather to the contrary, that policy convergence is affected more by countries agreeing to "norms of governance" via cooperation through international agreements. See Drezner, Daniel W. Globalization and Policy Convergence. *International Studies Review*. Vol. 3, Issue 1, Spring 2001. pp. 75 and 78.

and the possibility that such provisions can be misused as a disguised form of protectionism.

Environmental Issues. For environmental advocates, major goals include protecting and assuring strong enforcement of existing domestic environmental standards, ensuring that multilateral environmental agreements are not undermined by trade rules, promoting strong environmental initiatives to evaluate and raise environmental performance, developing a systematic program of capacity-building assistance, and assuring that environmental provisions in FTAs are subject to the same dispute resolution and enforcement mechanisms as are other aspects of the agreements.[60]

The USTR summary states that congressional objectives on environmental issues have been met in the proposed DR-CAFTA agreement. It includes language requiring all countries to enforce their laws and regulations and also creates an environmental cooperation agreement with a framework for establishing a cooperation commission and a process to conduct capacity building. All parties would agree to commit to establish high levels of environmental protection and to open proceedings in the administration and enforcement of laws and regulations.[61]

The environmental provisions are not the most contentious issues in the DR-CAFTA. Advocates still raise the issue of the environmental effects of trade, particularly in developing countries that may have weak laws and lax enforcement mechanisms. Many of these same advocates, however, have conceded that trade agreements have not led to catastrophic pollution problems nor encouraged a "regulatory race to the bottom." In fact, there has also been a certain acknowledged degree of success, by having environmental issues addressed in the body of FTAs, in side agreements on environmental cooperation, and through technical assistance programs, the latter of which developing countries can use to respond to specific problems. Advocates still note that much can be improved, such as tightening enforcement language and ensuring that the United States allocates financial resources to back up promises of technical assistance, particularly in the case of Central America, where commitment to "public accountability" is questioned in some cases.[62]

The Trade and Environment Policy Advisory Committee supports most of the environment provisions in the DR-CAFTA and particularly the enhanced public participation process negotiated by the State Department in a environmental

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[60] See [http://www.sierraclub.org/trade/fasttrack/letter.asp], *Principles for Environmentally Responsible Trade.* Another important issue for the United States is ensuring that its higher environmental standards defined in law and regulation not be compromised by challenges of protectionism. See CRS Report RS20904, *International Investor Protection: "Indirect Expropriation" Claims Under NAFTA Chapter 11*, by Robert Meltz.

[61] For more details on congressional interest in environmental provisions in trade agreements, see CRS Report RS21326, *Trade Promotion Authority: Environment Related Provisions in P.L. 107-210*, by Mary Tiemann.

[62] See Audley, John. *Environment and Trade: The Linchpin to Successful CAFTA Negotiations?* Carnegie Endowment for International Peace. Washington, D.C. July 2003.

cooperation side agreement. The dispute settlement provisions, effectively the same rules governing labor disputes, were accepted as striking the "proper balance." The advisory committee still raised a number of specific environmental concerns, and questioned whether the DR-CAFTA would be able to meet congressional objectives on capacity building without concrete funding for the program.[63]

Labor Issues. Arguably, the most contentious issue in the DR-CAFTA is the labor chapter. Two broad themes have emerged. First, the extent to which the DR-CAFTA countries have adequate labor laws and enforcement mechanisms, and second, whether the DR-CAFTA meets the technical negotiation objectives defined by Congress in TPA.

Labor Laws and Enforcement. Labor advocates argue that some, if not all, DR-CAFTA countries lack adequate protection for workers' rights in their labor codes and that even where such rights are spelled out, enforcement mechanisms are woefully inadequate. The standards to which these countries are being held are the core labor principles as defined by the United Nations International Labor Organization (ILO). These are defined in the ILO's *1998 Declaration on Fundamental Principles and Rights at Work* as: 1) the freedom of association and the effective recognition of the right to collective bargaining; 2) the elimination of all forms of forced or compulsory labor; 3) the effective abolition of child labor; and 4) the elimination of discrimination in respect of employment and occupation.

To counter these accusations, the Central American countries requested that the ILO conduct a study of their labor laws. The final report is subject to interpretation, but appears to suggest that the core ILO principles are guaranteed in all the countries, either through constitutional or statutory measures.[64] Labor advocates have argued that there is still a need to clarify or change laws in some countries for them to comply with these principles. There is little disagreement, however, that enforcement of labor laws and rights is a problem in many DR-CAFTA countries and that unionization is not widespread.

Proposing that the DR-CAFTA be the document that enforces ILO principles raises a number of questions. First, if the ILO lacks the power to enforce its own principles, is such a burden reasonable to expect of a trade agreement? Second, as far as the labor provisions go in the DR-CAFTA, are they not part of a multiple effort to raise standards that includes the ILO, domestic labor laws, and the market itself? In the last case, to protect the reputation of brand names from being associated with "sweatshop" production, corporate social responsibility has taken on new life as large apparel retailers have begun insisting on higher uniform labor standards from all their suppliers, while also realizing that worker productivity, not absolute lowest cost, is

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[63] Trade and Environment Policy Advisory Committee on the Central American Free Trade Agreement. *The U.S.-Central American Free Trade Agreement*. March 12, 2004.

[64] United Nations. International Labor Organization. *Fundamental Principles and Rights at Work: A Labour Law Study: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua*. Geneva, 2003.

the key to remaining globally competitive.[65] In some cases, international firms may be setting higher labor standards in Central America than domestic firms, suggesting that trade and foreign investment can support the development process.

There are historical and cultural factors at work, as well, that limit the influence of unions as understood in the United States. For example, in subsistence agrarian economies, whole families tend to work the agricultural plot. Changing this social structure overnight is not feasible, even if it runs against ILO child labor principles. Also, worker organizations have developed differently in Latin America for many reasons. Solidarity and industry associations provide lines of communication from employees to management, define working rules and conditions collectively, and have promoted worker' benefits such as defined work days, vacation time, pay scales, and the provision for credit unions and subsidized cafeterias. In some countries, unions have poor reputations among workers for their corruption and inefficacy.[66] If there is a problem with these well-meaning alternatives, it is that they exist mostly at the pleasure of the firm and lack the strict bargaining power of a traditional union.

Finally, many DR-CAFTA countries have admitted to lacking the financial resources and technical expertise to enforce good labor practices, a problem that will also take time and resources to overcome. This is an area where the DR-CAFTA might be used to assist countries financially and with technical assistance to achieve higher enforcement standards. In fact, as part of the 2005 omnibus appropriations bill (H.R. 4818), a request was made for $20 million to help DR-CAFTA countries improve their capacity to enforce their labor laws, an approach that could be implemented through the labor Cooperation and Capacity Building Mechanism, if the DR-CAFTA is implemented.[67]

Labor Provisions and TPA. Irrespective of a particular country's capacity to legislate and enforce labor standards, there are concerns over the way the labor chapter was written in the DR-CAFTA. From a technical perspective, the USTR, in its summary of the DR-CAFTA labor provisions, makes three important claims with respect to the agreement. First, that it fully meets the labor objectives set out by Congress in the Trade Promotion Act of 2002 and makes labor obligations a part of the core text of the trade agreement. Second, that it includes unprecedented provisions that commit DR-CAFTA countries to provide workers with improved access to procedures that protect their rights. Third, that it goes beyond Chile and Singapore FTAs through a 3-part cooperative approach to improve working conditions by: 1) ensuring effective enforcement of existing labor laws; 2) working with the ILO to improve existing labor laws and enforcement; and 3) building local capacity to improve workers rights.

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[65] For an example, see The Gap, Inc. *2003 Social Responsibility Report*. This report may be found at [http://www.gapinc.com/social_resp/social_resp.htm]. For a review of the report, see Liedtke, Michael. Gap Acknowledges Labor Violations. *The Washington Post*. May 13, 2004, p. E6.

[66] Ver Beek, Kurt Alan. Maquiladoras: Exploitation or Emancipation? An Overview of the Situation of Maquiladora Workers in Honduras. *World Development*, 2001.

[67] Norton, Stephen, J. CAFTA Puts Labor Money on the Table. *CQ Weekly*. December 4, 2004. p. 2832.

U.S. labor advocates charge to the contrary, that "The labor provisions of the DR-CAFTA will not protect the core rights of workers in any of the six countries participating in the agreement."[68] The crux of the critique centers on the dispute settlement provisions and the extent to which they are effective in requiring countries to meet certain standards, and also to meet congressional trade negotiating objectives defined in TPA. Labor advocates argue that they are a step backward from the provisions allowing for the suspension of trade benefits found in the GSP and CBI, which currently govern much of the U.S. trade with Latin America. Specifically, there are three provisions given different weight in the DR-CAFTA: 1) the effective enforcement of domestic labor laws; 2) the reaffirmation of commitments to ILO basic principles; and 3) "non-derogation" from domestic standards (not weakening or reducing protections to encourage trade and investment).[69]

Failure to enforce domestic labor laws can be formally challenged in the dispute resolution process as defined in the DR-CAFTA. In the case of the other two provisions, which are supported in principle, such recourse is not available (Articles 16.2 and 16.6). The USTR points to cooperative mechanisms for improving workers' rights in the FTA, but labor advocates argue that unless all three are enforceable, the DR-CAFTA does not provide a meaningful trade discipline.[70]

In addition, for labor (and environmental) issues, the dispute resolution process operates differently than for commercial issues. If a commercial dispute remains unsettled, the country faces the possibility of a suspension of benefits "of equivalent effect" (Article 20.16), resulting in the raising of tariffs, or payment of a monetary assessment equal to 50% of what a dispute panel determines is "of equivalent effect." This article does not apply to the disputable labor provision. The difference is that the option for failing to resolve a labor dispute is a monetary assessment, which would be capped at $15 million per year, with recourse to an equivalent dollar value of suspended benefits (higher tariffs) if the monetary assessment is not paid. The monetary assessment would also be paid into a fund and expended for "appropriate labor initiatives." Labor advocates argue that by capping the assessment at $15 million and having the assessment paid into a fund in the offending country, the labor provisions are rendered largely ineffective. The USTR argues that for small countries, such a fine would be significant relative to the dollar value of the trade benefits it would receive.[71]

From a congressional perspective, there is the question of whether differences in the treatment of the three labor provisions in some way fail to meet the principal negotiating objectives as outlined in TPA legislation. Although the three provisions

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[68] Labor Advisory Committee for Trade Negotiations and Trade Policy (LAC). *The U.S.-Central America Free Trade Agreement*. March 19, 2004. p. 1.

[69] Ibid, p. 6 and Lee, Thea M. Assistant Director for International Economics, AFL-CIO. *Comments on the Proposed U.S.-Central American Free Trade Agreement*, before the USTR Trade Policy Committee, November 19, 2002.

[70] For the Department of State reports on human rights, including labor rights, see [http://www.state.gov/g/drl/rls/hrrpt/2003].

[71] Lee, op. cit., and Labor Advisory Committee Report.

are not accorded the exact same treatment in the DR-CAFTA, neither are they in the TPA language. Section 2102(b)(11) of the Trade Act of 2002 (TPA) states that among the principal labor negotiation objectives is the provision "*to ensure that a party* to a trade agreement with the United States *does not fail to effectively enforce* the environmental or *labor laws*." This may be contrasted with the apparently weaker objective "*to strengthen the capacity* of United States trading partners *to promote respect for core labor standards,*" and, in Sec. 2102(a)(1)(7) to "*strive to ensure* that *they do not weaken or reduce the protections afforded in* domestic environmental and *labor laws* as an encouragement for trade."

Although the TPA provisions seem to differ with respect to treatment of these three labor provisions, under the dispute resolution provision (sec. 2102(b)(12)(G)), a principal negotiating objective also listed is "to seek provisions that treat United States principal negotiating objectives equally" with respect to the ability to resort to dispute settlement, the availability of equivalent procedures, and the availability of equivalent remedies. Whereas the labor groups have argued that this is not the case with labor and commercial disputes, the USTR has responded that this standard has been met since both commercial and labor disputes are subject to monetary assessments and suspension of benefits. The dispute settlement procedures do operate slightly differently, however, and it may be a matter of interpretation as to whether there is a problem in their meeting congressional negotiating objectives.[72]

Practical issues have also been raised. For example, support for core labor rights is one thing, but actually monitoring them, identifying violations, and resolving disputes in a uniform way would create immense measurement and interpretive challenges for dispute arbitration panels.[73] This raises two other thorny questions. The first question is whether the United States can logically insist that the DR-CAFTA require all countries to meet core ILO standards as the proper benchmark for support of labor rights given it has ratified only two ILO conventions? The second question addresses equity in practice. Would all countries entering into a bilateral FTA with the United States be subject to the same standards? The Central American countries have argued that given the precedence for U.S. acceptance of FTAs with Jordan, Singapore, Morocco, and Bahrain (not yet ratified), the DR-CAFTA is being held to different standards than other FTAs made with countries whose labor standards could be easily challenged. The difficult question for policymakers is deciding whether the DR-CAFTA, as negotiated, can be seen as one of many factors that influence positive social change in the workplace, or whether it falls so short of doing so that it should not be implemented.

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[72] It should also be noted that under the principal negotiating objectives with respect to labor is the provision: 1) "to recognize that parties to a trade agreement retain the right to exercise discretion" in investigating and prosecuting compliance matters; 2) that "a country is effectively enforcing its laws" if its reflects reasonable action as being taken; and 3) "no retaliation may be authorized based on the exercise of these rights or the right to establish domestic labor standards." Sec. 2102(b)(11)(B).

[73] These issues were explored in a report prepared by the National Academy of Sciences. A summary of the key issues is provided in: Moran, Theodore H. *Trade Agreements and Labor Standards*. The Brookings Institution. Policy Brief #133. May 2004.

Dispute Resolution and Institutional Issues

This negotiation group focused on numerous aspects that define how the trade agreement will operate, particularly with respect to rules governing procedures for dispute resolution. Dispute resolution is modeled on previous FTAs, in which disagreements are intended to be resolved cooperatively via a consultative process. If this approach is not successful, the process moves to the establishment of the Free Trade Commission of cabinet-level representatives, and finally an arbitral panel. Arbitral panels are intended to broker mutually acceptable resolutions, including providing for compensation, if appropriate. If a mutually-agreed solution is not found, the complaining party may resort to a suspension of benefits of equivalent effect. This may also be challenged, and final resolution, as well as how the suspension of benefits are to be administered are set out in guidelines. Resolving labor and environmental disputes would be slightly different (see previous section). All dispute resolution procedures are defined in Chapter 20. Administrative and other technical matters (e.g. transparency issues) of trade agreement implementation were also addressed by this working group.

Trade Capacity Building

Even before detailed discussions began on CAFTA, the Central American countries expressed a strong apprehension of being overwhelmed by the resources and experience that the United States could muster to negotiate and later comply with liberalized trade rules. Hence, the need for trade capacity building, which, now that the negotiation process is over, may be classified into three distinct areas beyond trade negotiation capabilities. First, the ability to identify priorities, including where the major adjustment costs (losers) are expected to be and how to respond to them. Second, the ability to develop resources to implement the agreement, including institutional, financial, and analytical resources. Third, the capacity to benefit from CAFTA.[74] The agreement would create a permanent Committee on Trade Capacity Building to continue work begun in the negotiation process, and recommendations in the agreement call for one of its first priorities to be customs administration.

The third category, however, is arguably the most challenging. Also referred to as "supply side" capacity, it refers to the ability of a business to: compete in a larger market; learn how to export and use imports (as inputs) more to its advantage; tap into global finance; navigate customs and trade logistics problems; and in other ways make the transition from local producer to international player.[75] This will be a difficult challenge for many Central American firms, particularly if barriers to world trade are reduced outside the U.S.-Central American relationship (WTO/FTAA) putting increasing pressure on marginally productive businesses. The joint-production relationship already established in textiles and garments suggests that certain firms have already developed some expertise in meeting these challenges.

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[74] This typology of capacity issues was developed by Bernard Hoekman of the World Bank. Earlier versions of this report mentioned a fourth area, trade negotiation capacity.

[75] Ibid.

From the outset of negotiations, the United States advocated assisting the Central American countries. Each Central American country prepared a National Action Plan based on a review of its "trade-related" needs. Assistance is being provided by the United States, private groups (corporate and non-government organizations — NGOs), and five international organizations (the Inter-American Development Bank — IDB, Central American Bank for Economic Integration — CABEI, United Nations Economic Commission on Latin America and the Caribbean — ECLAC, Organization of American States — OAS, and the World Bank).[76] In the view of many, what is lacking is an adequate commitment for financial and institutional support in the years to come.

Outlook

The DR-CAFTA negotiations moved quickly and were concluded by the anticipated year-end 2003 deadline, with the exception of a slight delay with Costa Rica and the later addition of the Dominican Republic. A final version of the agreement was signed on May 28, 2004. The DR-CAFTA, by the very nature of being a negotiated agreement, is a compromise, a second best solution that defines more the limits each country is willing to accept in furthering freer trade, rather than a referendum on free trade itself. It is, nonetheless, a comprehensive and innovative agreement, melding the interests of the United States with those of six developing countries that vary significantly among themselves. This makes it a historic effort, which must now be judged by the legislatures of the participating countries as to whether it, on balance, leads to a positive outcome.

As the USITC study suggests, implementing the DR-CAFTA would have a small effect on the U.S. economy as a whole. In fact, it represents more of a marginal rather than wholesale change from the existing U.S. trade arrangement with the region. It would build on long-established trade partnerships, but would also change the framework from the CBI unilateral preferential arrangement to a negotiated bilateral agreement. These altered terms would provide the United States with greater access for vital sectors of its economy, but have also allowed the Central American countries greater say in how controversial provisions, such as labor rights enforcement, would work. In the end, supporters hope that the DR-CAFTA can be part of a policy foundation supportive of both improved interregional trade and long-term social, political, and economic development.

The United States has both commercial and broader development/strategic interests at stake, which sometimes seem at odds with each other. U.S. commercial interests reflect both mercantilist (protect import-competing sectors) and free trade (support exporting and import-using sectors) sentiments. Their respective positions on free trade stem from their economic interests, raising one of the basic difficulties with any congressional trade vote. The U.S. Congress has also supported opening U.S. markets to the DR-CAFTA countries to promote development and stability in

[76] Details of the program and the Central American National Action Plans may be found at the USTR website: [http://www.ustr.gov].

the region, most recently in 2000 with the vote to implement the Caribbean Basin Trade Partnership Act. The DR-CAFTA builds on this rationale, as well.

Labor is one of the major issues that threatens to derail ratification of the DR-CAFTA, which also points to the challenge of reconciling commercial and development policy goals. Criticism that the labor provisions are inadequate emanate either from a concern that the lower standards provide an unfair commercial advantage, or from a humanitarian concern. From a development perspective, evidence continues to mount, however, that trade contributes to economic growth and thereby poverty reduction.[77] In the case of the DR-CAFTA countries, this means that by relaxing restrictions on the imports for which they have a comparative advantage, such as agriculture (especially non-traditional value-added products), textiles, and apparel, the United States is assisting with these countries' development agenda, and that along with specific provisions related to labor and environment, could provide benefits of a greater magnitude than those currently given through aid.[78]

The economic arguments for trade, however, are necessarily tempered by politics and the fate of the DR-CAFTA is far from certain. Whether the U.S. Congress decides to support the FTA or not, one thing is clear. The status quo will not be an option given the many trade agreements emerging in the Western Hemisphere. In such a dynamic policy and negotiating environment, the decision on the DR-CAFTA will send a strong message one way or the other to Central America and the Dominican Republic.

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[77] Reducing rich-country protectionism is a critical goal defined by a study aimed at highlighting policies that may affect social development and equity in Latin America. See Birdsall, Nancy, Augusto de la Torre, and Rachel Menezes. *Washington Contentious: Economic Policies for Social Equity in Latin America.* Carnegie Endowment for International Peace and Inter-American Dialogue. Washington, D.C. 2001. pp. 65-66. A more recent and rigorous case is made in: Cline, William R. *Trade Policy and Global Poverty*. Institute for International Economics, Washington, D.C. June 2004. pp. 25-27, 270-71, and 278-79. The author makes the interesting point, that "Global free trade is found to raise the median real wage for unskilled labor in developing countries by 5%." p. 279.

[78] Ibid., p. 285.

Appendix 1. Chronology of DR-CAFTA Negotiations

Date	Milestone
January 16, 2002	President George W. Bush announces his intention to explore a free trade agreement (FTA) with Central America.
August 6, 2002	President Bush signs the Trade Act of 2002 (P.L.107-210), which includes Trade Promotion Authority (TPA).
October 1, 2002	President Bush, as required under TPA, formally notifies Congress of his intention to negotiate a U.S.-Central America Free Trade Agreement (CAFTA) with Guatemala, El Salvador, Honduras, Costa Rica, and Nicaragua.
November 19, 2002	USTR holds public hearings, accepting written and oral testimony on CAFTA.
January 27, 2003	The first of nine negotiation rounds begins in San Jose, Costa Rica.
August 4, 2003	USTR Zoellick formally notifies Congress of intent to negotiate an FTA with the Dominican Republic.
December 17, 2003	CAFTA negotiations concluded in Washington, D.C. Costa Rica decides not to accept the agreement pending further discussion on telecommunications, insurance, agriculture, and textile market access issues.
January 5-9, 2004	Costa Rica and the United States hold first round of bilateral discussions on CAFTA.
January 12-16, 2004	First round of negotiations with Dominican Republic held.
January 19-24, 2004	Costa Rica and United States hold second round of bilateral discussions on CAFTA.
January 25, 2004	Costa Rica and United States agree to CAFTA provisions.
January 28, 2004	USTR releases draft version of CAFTA to public.
February 20, 2004	President Bush formally notifies Congress of his intention to sign CAFTA.
March 15, 2004	The United States and the Dominican Republic conclude a bilateral FTA and the USTR announces it will be "docked" to CAFTA.
March 24, 2004	President Bush formally notifies Congress of his intention to sign the U.S.-Dominican Republic FTA.
April 9, 2004	USTR releases draft text of the FTA with the Dominican Republic.
May 28, 2004	The USTR and trade ministers from the Central American countries sign CAFTA in Washington, D.C.
August 5, 2004	The USTR and trade ministers from the Dominican Republic and Central America sign the DR-CAFTA agreement in Washington, D.C.
December 17, 2004	The Salvadoran legislature ratifies the DR-CAFTA by a vote of 49 to 35.

Appendix 2. Selected Economic Indicators

(year 2003 data, except where otherwise indicated)

	Costa Rica	El Salvador	Guat-emala	Hon-duras	Nicar-agua	Dom. Rep.
GDP ($ billions)	17.5	14.7	24.0	6.8	2.7	20.5
GDP Growth (%)	5.0	2.2	2.4	1.5	2.3	-1.3
GDP Growth 1980-1990 (%)*	3.0	0.2	0.8	2.7	-1.9	3.1
GDP Growth 1990-2002 (%)*	4.9	4.3	4.0	3.1	4.3	6.0
PPP Per Capita Gross National Income**	8,560	4,190	4,030	2,540	2,350	6,270
Inflation (%)	9.3	2.8	5.5	9.8	6.1	28.0
Current Account Balance (% of GDP)	-5.9	-4.5	-4.3	-7.6	-17.6	4.5
Pop. Below $1 per day (%)***	2.0	31.1	16.0	23.8	45.1	<2.0
Human Development Index (HDI) Rank#	42	105	119	115	121	94

Sources: World Bank, *World Development Indicators 2004*, pp. 14-15, 54-55, and 178-83, United Nations, *Human Development Report, 2003*, and IMF website.
* Average annual percent growth.
** Gross national income (GNI) converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over the GNI as a U.S. dollar has in the United States. GNI, formerly represented as GNP by the World Bank, is a different, but similar measure as GDP. Data are for year 2002.
*** Percentage of population living on $1 per day or less, most recent survey year.
# HDI is a composite measure (education, income, and life expectancy) of average achievement in human development. A lower ranking is better: e.g. United States (7), Italy (21), and South Korea (30). The 2003 report reflects data for year 2001.

Appendix 3. U.S. Merchandise Trade with DR-CAFTA Countries

($ millions)

Country	1998	1999	2000	2001	2002	2003	% Change 2002-2003	% Change 1998-2003
U.S. Exports								
Costa Rica	2,296	2,381	2,460	2,502	3,117	3,414	9.5%	48.7%
Honduras	2,318	2,370	2,584	2,416	2,571	2,844	10.6%	22.7%
Guatemala	1,938	1,812	1,901	1,870	2,044	2,274	11.3%	17.3%
El Salvador	1,514	1,519	1,780	1,760	1,665	1,824	9.6%	20.5%
Nicaragua	336	374	379	443	437	503	15.1%	49.7%
Dominican Rep	3,944	4,100	4,473	4,398	4,250	4,214	-0.8%	6.8%
Total CAFTA	12,346	12,556	13,577	13,389	14,084	15,073	7.0%	22.1%
Mexico	78,772	86,909	111,349	101,296	97,470	97,457	0.0%	23.7%
LAC*	63,396	55,153	59,283	58,157	51,551	52,036	0.9%	-17.9%
Latin America	142,168	142,062	170,632	159,453	149,021	149,493	0.3%	5.2%
World	682,138	695,797	781,918	729,100	693,103	723,743	4.4%	6.1%
U.S. Imports								
Costa Rica	2,745	3,968	3,539	2,886	3,142	3,362	7.0%	22.5%
Honduras	2,544	2,713	3,090	3,127	3,261	3,312	1.6%	30.2%
Guatemala	2,072	2,265	2,607	2,589	2,796	2,945	5.3%	42.1%
El Salvador	1,438	1,605	1,933	1,880	1,982	2,019	1.9%	40.4%
Nicaragua	453	495	589	604	679	769	13.3%	69.8%
Dominican Rep	4,441	4,287	4,383	4,183	4,169	4,455	6.9%	0.3%
Total CAFTA	13,693	15,333	16,141	15,269	16,029	16,862	5.2%	23.1%
Mexico	94,629	109,721	135,926	131,338	134,616	138,073	2.6%	45.9%
LAC*	50,266	58,464	73,348	67,370	69,503	78,857	13.5%	56.9%
Latin America	144,895	168,185	209,274	198,708	204,119	216,930	6.3%	49.7%
World	911,896	1,024,618	1,218,022	1,140,999	1,161,366	1,259,396	8.4%	38.1%
U.S. Balance of Trade								
Costa Rica	-449	-1,587	-1,079	-384	-25	52		
Honduras	-226	-343	-506	-711	-690	-468		
Guatemala	-134	-453	-706	-719	-752	-671		
El Salvador	76	-86	-153	-120	-317	-195		
Nicaragua	-117	-121	-210	-161	-242	-266		
Dominican Rep	-497	-187	90	215	81	-241		
Total CAFTA	-1,347	-2,777	-2,564	-1,880	-1,945	-1,789		
Mexico	-15,857	-22,812	-24,577	-30,042	-37,146	-40,616		
LAC*	13,130	-3,311	-14,065	-9,213	-17,952	-26,821		
Latin America	-2,727	-26,124	-38,642	-39,256	-55,103	-67,437		
World	-229,758	-328,821	-436,104	-411,899	-468,263	-535,653		

Source: Table created by CRS from U.S. Department of Commerce data.
* Latin America and the Caribbean, except Mexico.