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

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Summary

On August 5, 2004, the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic signed the Dominican Republic-Central America-United States Free Trade Agreement, or the DR-CAFTA. El Salvador, Honduras, and Guatemala have ratified the agreement; the rest have not. In the United States, following "mock markups" of draft implementing legislation by the House Ways and Means and Senate Finance Committees, the Bush Administration sent final legislation to Congress where identical bills were introduced jointly and referred to the House Ways and Means and Senate Finance Committees. Congressional consideration of the implementing bill is being done under expedited procedures as defined in Trade Promotion Authority (TPA). The Senate passed S. 1307 on July 1, 2005, and the House Ways and Means Committee favorably reported out H.R. 3045 on June 30. It awaits floor action by the House.

The DR-CAFTA was negotiated 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. It 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), as amended. It liberalizes trade in goods, services, government procurement, intellectual property, investment, and addresses labor and environment issues. Most commercial and farm goods attain duty-free status immediately. Remaining trade would have tariffs phased out incrementally over five to twenty years. Duty-free treatment would be delayed longest for the most sensitive agricultural products. To address asymmetrical development and transition issues, the DR-CAFTA specifies rules for transitional safeguards, tariff rate quotas, and trade capacity building.

The DR-CAFTA is not expected to have a large effect on the U.S. economy as a whole, but would be more of an incremental change from existing trade arrangements. Some sectors and groups, however, would be affected more than others. Supporters see it as part of a policy foundation supportive of both improved intraregional trade, as well as, long-term social, political, and economic development in an area of strategic importance to the United States. Opponents point to the need for better trade adjustment and capacity building policies to address the potential negative effects on certain import-competing sectors and their workers. In light of the region's poor labor standards in some cases, the perception of inadequate labor laws, and widely accepted lax enforcement, opponents also argue that the labor provisions in the DR-CAFTA need strengthening. In a broader perspective, this controversial agreement raises questions about the logic of pursuing bilateral FTAs given the inherent conflicts associated with the TPA legislation and effects of trade liberalization with developing countries. This report will be updated.

For more on individual country perspectives, see CRS Report RL32322, *Central America and the Dominican Republic in the Context of the Free Trade Agreement (DR-CAFTA) with the United States*, coordinated by K. Larry Storrs.

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

On May 28, 2004, the United States Trade Representative (USTR) and trade ministers from 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 and is referred to as either the DR-CAFTA or the CAFTA-DR (see **Appendix 1**, Chronology of Negotiations).[1] Three countries have ratified the DR-CAFTA: El Salvador on December 17, 2004; Honduras on March 3, 2005; and Guatemala on March 10, 2005. In the United States, implementing legislation was introduced jointly in the House and the Senate on June 23, 2005, where it was passed by the Senate on July 1, but awaits floor action by the House. This report provides an analysis of the DR-CAFTA and will be updated.

Congressional Action

The DR-CAFTA is arguably the most controversial trade vote that Congress has faced since the North American Free Trade Agreement (NAFTA) implementing legislation was passed in 1993. Many lawmakers are uncomfortable with the agreement as written, particularly with respect to the labor provisions, treatment of certain sensitive industries (sugar and textiles), and to a lesser degree, investor-state, pharmaceutical data protection, and basic sovereignty issues. It has also been caught up in an overarching congressional controversy over how trade negotiation objectives are defined in Trade Promotion Authority (TPA) and concern by some Members over the perceived ineffectiveness of the executive-legislative consultation process.

These issues were raised repeatedly in "mock markups" of draft implementing bills held by the Senate Finance and House Ways and Means Committees June 14 and 15, 2005, respectively. The Senate Finance Committee voted 11-9 to approve the draft legislation, with one non-binding amendment that would extend the trade adjustment assistance program for workers to cover services industries. The House Ways and Means Committee voted 25-16 for approval of the draft legislation, also adding a non-binding amendment with "a requirement that the Administration report on activities conducted by the DR-CAFTA countries and the United States to build capacity on labor issues" and a provision requiring monitoring of DR-CAFTA's

[1] For detailed information on country issues, see CRS Report RL32322, *Central America and the Dominican Republic in the Context of the Free Trade Agreement (DR-CAFTA) with the United States*, coordinated by K. Larry Storrs.

effects on U.S. services industries. A "mock conference" was not held, to the expressed consternation of some Members.

The Bush Administration sent the final implementing bill to Congress on June 23, 2005. Under TPA procedures, identical bills were introduced jointly as H.R. 3045 and S. 1307 and referred to the House Ways and Means and Senate Finance Committees. Each committee technically has 45 legislative days to report the bill, after which it would be automatically discharged. Because of the bill's revenue provisions, under the Constitution, the Senate must pass the House bill. Hence, with respect to reporting the bill, the Senate Finance Committee had the longer of either 45 days from the time the bill was introduced in the Senate or 15 days from the time it receives the House bill. After a committee reports the bill or it is discharged, each house then has 15 legislative days to conduct limited debate and vote on it, up or down. The DR-CAFTA enters into force if the United States and at least one other signatory country pass implementing legislation into law.[2]

In fact, the Senate chose to act first, favorably reporting out S. 1307 by voice vote on June 29, 2005. The House Ways and Means Committee followed suit, reporting favorably by a vote of 25 to 16 on June 30, 2005. The measure came before the full Senate on July 1, 2005, where following 20 hours of floor debate, S. 1307 passed 54 to 45. The House could not schedule a vote before the July 4 recess and is expected to take up the measure later in the month.

Passage in the Senate was by a slimmer margin than with earlier trade agreements and was apparently secured by accommodating labor, sugar, and textile interests. Of the suggested amendments made during the mock markups, only required reporting on labor issues was added to the final implementing bill. Specifically, section 403 mandates that the Administration transmit biennial reports on progress made in implementing the labor provisions of the agreement, as well as the Labor Cooperation and Capacity Building Mechanism defined in annex 16.5. Progress in meeting the challenges outlined in the so-called White Paper on labor produced by the vice ministers of trade and labor of the DR-CAFTA countries is also to be monitored.

Commitments to support labor and rural development were also made outside the final implementing legislation. In a letter from USTR Rob Portman to Senator Jeff Bingaman, the Administration promised to allocate the $40 million for foreign operations appropriations for fiscal 2006 earmarked for "labor and environmental enforcement capacity building assistance," and to continue to request this level of funding in budgets for fiscal years 2007 through 2009. Some $3 million is to be used for supporting ILO reporting on progress in labor law enforcement and working conditions in these countries. An additional $10 million annual commitment for five years was made for transitional rural assistance for El Salvador, Guatemala, and the Dominican Republic, or until these countries can qualify for anticipated assistance from the U.S. Millennium Challenge Corporation.

[2] For more on how trade implementing legislation moves through Congress, see CRS Report RL32011, *Trade Agreements: Procedures for Congressional Approval and Implementation*, by Vladimir Pregelj.

In a letter from Secretary of Agriculture Mike Johanns to Senators Saxby Chambliss and Bob Goodlatte, the Administration provided assurance that the DR-CAFTA would not interfere with the operation of the sugar program as defined in the Farm Security and Rural Investment Act of 2002 (the Farm Bill) through calendar year 2007, when it expires. In particular, the promise provides that should additional sugar imports due to the DR-CAFTA cause the import trigger threshold of 1.532 million short tons per year be exceeded, the U.S. Secretary of Agriculture would preclude entry of additional sugar imports into the domestic sweetner market by either making direct payments to exporters or using agricultural commodities to purchase sugar from exporters to be used for nonfood use (ethanol production).

Separately, for the textile and apparel issues, promises were reported that include: 1) an attempt to change the rules of origin for textiles and apparel to require use of U.S.-made pocketings and linings; 2) negotiation of a customs enforcement agreement with Mexico before the DR-CAFTA cumulation rules take effect allowing Mexican inputs to be used in DR-CAFTA textile and apparel products; and 3) an agreement with Nicaragua that would limit its special textile and apparel tariff preference levels to only currently non-qualifying items.

These compromises apparently were sufficient to allow passage of S. 1307 in the Senate, but it is not clear this will be the case in the House. The sugar industry responded that the commitments made addressed only short-term concerns and so were inadequate. Some Members arguing for the inclusion of fully enforceable international labor standards also expressed dissatisfaction with the Administration's offer. The textile and apparel industry remained split, despite promised changes.

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, in which the benefits from exchange among countries 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 make to economic growth and development. As an important caveat, trade is at best only part of a broad development agenda, and is no substitute for the promotion of political freedom, macroeconomic stability, sound institutions, and the need for complementary social and economic policies.[3]

[3] 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*

(continued...)

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.[4] 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.[5] 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.[6]

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 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 implemented in a multilateral

[3] (...continued)
Latin America. Kuczynski, Pedro-Pablo and John Williamson, eds. Institution for International Economics. Washington, D.C. March, 2003. pp. 158, 165-67.

[4] This 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.

[5] 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.

[6] 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 a 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.

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 as to whether FTAs help or hinder the movement toward multilateral trade liberalization.[7]

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.[8] The public policy difficulty is that both options have costs and benefits, but result in different distributional outcomes.[9] 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).

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

[7] 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.

[8] For a recent and accessible treatment of this subject, see Kletzer, Lori G. and Howard Rosen. Easing the Adjustment Burden on US Workers. In: Bergsten, C. Fred., ed. *The United States and the World Economy*. Washington, D.C.: Institute for International Economics, 2005. pp. 313-41.

[9] 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.

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 commercial and broader strategic interests in deciding to negotiate preferential trade agreements with Central America and the Dominican Republic. Geopolitical and strategic concerns sparked interest by all parties in pursuing the DR-CAFTA. Proponents expect the DR-CAFTA to reinforce regional stability 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 strong 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.

With the proliferation of regional agreements around the world, trade negotiations have also 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.[10] Economic fundamentals shaped a trade relationship based on exports of traditional agricultural products, and later apparel. 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), as part of the Caribbean Basin Initiative (CBI), began to transform the Central American and Dominican economies. By becoming eligible for unilateral preferential tariff treatment, U.S. investment fostered growth in light manufacturing,

[10] 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.

primarily apparel.[11] Most Central American exports grew, albeit unequally, as a percentage of economic output, particularly after the turbulent 1980s (see **Table 1**).

Table 1. Central American Exports of Goods and Services/GDP

Country	1980	1985	1990	1995	2003
Costa Rica	26.5	30.7	34.2	37.6	46.8
El Salvador	34.2	22.3	18.6	21.6	26.7
Guatemala	22.2	18.5	19.7	19.3	16.2
Honduras	36.2	25.1	37.2	43.7	38.8
Nicaragua	24.2	14.8	25.7	31.8	24.1

Data Source: IMF, *International Financial Statistics Yearbooks 2002 and 2004* and Costa Rican Ministry of Foreign Trade.

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 elimination of quotas on January 1, 2005. It was under this system that the CBI preferential arrangements were defined, and amended in the Caribbean Basin Trade Partnership Act (CBTPA) of 2000. The CBTPA expanded, through FY2008, preferential treatment for select apparel imports and coincided with a large increase in U.S. domestic exports of fiber, yarn and fabric to the region. The United States created the CBI/CBTPA to foster Caribbean economic development and 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.[12]

Still, 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.[13] The textile industry (e.g., fiber, yarns, fabric) 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.

[11] This legislation was extended and amended twice, most recently in 2000 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.

[12] See CRS Report RL31723, *Textile and Apparel Trade Issues*, and CRS Report RL32895, *Textile Exports to Trade Preference Regions*, p. 2, by Bernard A. Gelb.

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

As defined in the CBTPA, U.S. firms, through subsidiary or contractual arrangements, are required to use mostly U.S. textiles as inputs to products that are assembled and exported to the United States. 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.[14] 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.[15]

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 expensive U.S. inputs, and the additional administrative costs associated with U.S. preferential trade requirements.[16]

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.[17] In a post-

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

[15] 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.

[16] 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.

[17] 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

(continued...)

quota trading world, these advantages may allow a certain portion of textile and apparel production to remain in the DR-CAFTA countries. Although DR-CAFTA country representatives have emphasized that the passage of the free trade agreement is a critical component for maintaining this strategy, it is not certain that it can counter the long-term trend in market share loss to Asia.[18]

Strategic considerations were important, 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, but a far distant third from Mexico. Still, these are small economies (see **Appendix 2** for economic data) and although firms engaged in this trade may find its effects significant, total DR-CAFTA trade in 2004 represented only 1.5% 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/CBTPA. 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, a bilateral agreement offers the United States a chance to deepen other trade commitments that affect some of its most competitive industries. This includes rules covering 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 and expands U.S. benefits given under the CBTPA legislation, but which require periodic reauthorization by Congress.[19] This could increase U.S. foreign direct investment (FDI) that defines 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. Sensitivity to these and other key industry sectors were addressed in the extended tariff phase-out and safeguard schedules, and as a

[17] (...continued)
that result from government repression of unions." See Rodrik, Dani. "Sense and Nonsense in the Globalization Debate." *Foreign Policy*. Summer 1997. p. 28.

[18] 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.

[19] To date, Congress has reauthorized and often expanded every U.S. trade preference program upon expiration.

matter of development policy, by DR-CAFTA country efforts to diversify the agricultural sector into non-traditional exports and non-farm employment.[20]

Finally, there were two 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 assurance that goods could flow efficiently within the region, which would be a significant benefit to the agreement. Second, there was a 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 sensitivity in the negotiation process.

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. Total U.S. trade with the Dominican Republic in 2004 was one-third greater than with either Costa Rica or Honduras, which tie as the next 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 was added to this report and is discussed in more detail separately.

U.S.-Central America Trade

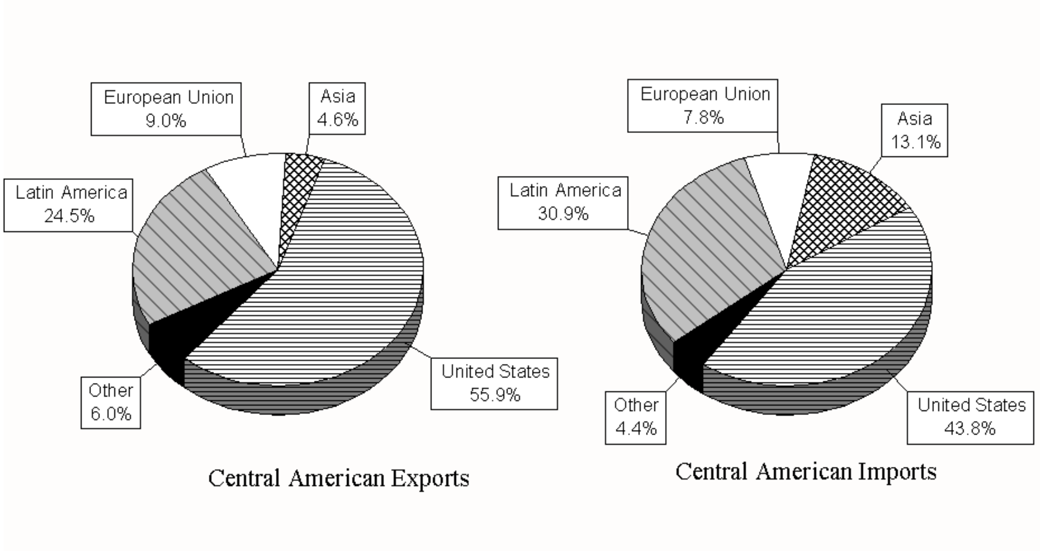
Because of its huge size and geographical proximity, the U.S. market is a natural destination for Central American exports. Merchandise trade with the United States has dominated Central America's foreign commerce for 150 years, and as seen in **Figure 1**, remains in that role today.

The United States is by far the largest of Central America's trading partners, accounting for some 56% of its exports and 44% of its imports. The rest of Latin America collectively is the next largest trading partner, accounting for 25% of

[20] 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.

Central America's exports and 31% of its imports. The European Union and Asia together account for about 14% of Central American exports and 21% of imports.

Figure 1. Central America's Direction of Merchandise Trade, 2003



Data Source: IMF, *Direction of Trade Statistics, 2004 Yearbook.*

This distribution is not uniform throughout the region. Honduras, for example, exports 67% of its merchandise goods to the United States, compared to 44% for Costa Rica. Honduras also has the highest import percentage from the United States at 53% compared to Nicaragua's 25%, which is the lowest. Total trade (exports plus imports) with the United States is also somewhat uneven country by country. Costa Rica accounts for 30% of total Central American trade with the United States, whereas Nicaragua amounts to only 5% of the total. Guatemala, Honduras, and El Salvador account for 25%, 22%, and 18% 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 five years, U.S. exports to Central America grew by 34.7% (25.3% including the Dominican Republic), compared to 17.6% with the world and 21.2% with Latin America as a whole (see **Appendix 3** for the data). U.S. imports from Central America increased by 19.3% (15.4% including the Dominican Republic) over the same time period, compared to 43.4% from the world and 51.4% 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.[21]

For 2004, although trade growth varied among the five countries, U.S. export growth to Central America doubled average export growth to the world, with all five countries experiencing solid growth. U.S. imports from Central America, by

[21] 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.

contrast, grew by less than half that of average import growth from the world. 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 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.[22]

U.S. Imports. Nearly three-quarters of 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**).

Table 2. Top Eight U.S. Merchandise Imports from Central America, 2004

($ millions)

Product and HTS Number	Total	C.R.	Hon	Guat	El Sal	Nic
Total U.S. Imports	13,172	3,333	3,641	3,155	2,033	991
Knit Apparel (61)	5,108	253	2,013	1,261	1,364	216
Woven Apparel (62)	2,415	265	729	686	357	379
Edible Fruit & Nuts (08) -Bananas (0803)	1,037 (657)	490 (245)	172 (129)	359 (273)	0 (0)	14 (11)
Electrical Mach. (85) -Integrated circuits 8542	983 (489)	719 (489)	172 (0)	1 (0)	18 (0)	73 (0)
Optical/Med. Equip. (90)	492	480	0	12	0	0
Spices, Coffee, Tea (09) -Coffee (0901)	512 (504)	150 (148)	45 (43)	216 (213)	49 (49)	52 (52)
Fish and Seafood (03)	293	60	133	22	6	74
Mineral Fuel, Oil (27)	186	0	0	180	6	0
Other	2,146	916	377	418	233	183
Top 8 as % of Total	83.7%	72.5%	89.6%	86.8%	88.5%	81.5%

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

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 3.8% of U.S. imports from the region. This reflects the competitive nature of trade in coffee, which is grown in vast

[22] This trend is not disputed, but the U.S. Department of Commerce does not disaggregate U.S. bilateral services trade data with 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.

quantities by Brazil, Colombia, and countries in Africa as well. Banana trade has also declined in importance and accounts for only 5.0% of U.S. imports from Central America.

Second, knit and woven apparel has become the primary export goods for all countries except Costa Rica and accounts for nearly 57% 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). 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.[23] 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.[24]

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 2004, U.S. imports of integrated circuits constituted 18% of total imports from Costa Rica. Similar importance may be seen in the 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.[25]

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-

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

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

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

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 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.[26]

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

Table 3. Top Eight U.S. Merchandise Exports to Central America, 2004

($ millions)

Product and HTS Number[#]	Total	Costa Rica	Hon	Guat	El Sal	Nic
Total U.S. Exports	11,388	3,304	3,077	2,548	1,868	592
Elec Machinery (85) -Integrated circuits 8542	1,698 (828)	1,092 (822)	175 (0)	206 (5)	157 (1)	68 (0)
Machinery (84) -Office Mach. Pts (8473) -Computer Parts (8471)	1,031 (207) (136)	301 (68) (43)	205 (26) (20)	256 (62) (32)	205 (32) (26)	69 (19) (10)
Cotton Yarn, Fabric (52)	780	18	412	241	84	23
Mineral Fuel (27)	712	93	239	313	57	10
Knit/Crocheted Fabric 60	688	38	351	24	272	3
Plastic (39)	657	253	123	181	87	13
Knit Apparel (61)	624	101	312	33	176	2
Cereals (10) -Corn (1005) -Wheat and Meslin 1001 -Rice (1006)	559 (242) (167) (149)	156 (71) (38) (46)	92 (31) (28) (33)	118 (65) (34) (18)	125 (64) (46) (16)	68 (10) (21) (37)
Other	4,639	1,252	1,168	1,176	705	336
Top 8 as % of Total	59.3%	62.1%	62.0%	53.8%	62.3%	43.2%

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

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

Similar trends for U.S. import trade are evident in U.S. exports. In 2004, 78% of knit apparel and 76% 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 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 because they are staple crops and grown by small, often subsistence farmers.[27]

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 28th largest U.S. export market (6th in Latin America) and ranks as the 41st largest import country (8th in Latin America). More so than any of the Central American countries, Dominican trade is dominated by the United States (see **Table 4** for bilateral trade data.)

Table 4. U.S.-Dominican Republic Merchandise Trade, 2004

U.S. Exports (by product and HTS Number*)	$ millions	U.S. Imports (by product and HTS Number*)	$ millions
Electrical Machinery (85)	529	Woven Apparel (62)	1,147
Knit Apparel (27)	379	Knit Apparel (61)	889
Cotton Yar, Fabric (52)	301	Medical Instruments (90)	417
Oil (not crude) (27)	291	Electrical Machinery (85)	393
Plastic (39)	235	Precious Stones/Jewelry(71)	341
Machinery (84)	230	Tobacco (24)	227
Precious Stones/Jewelry(71)	219	Iron and Steal (73)	161
Cereals (10)	185	Footwear (64)	137
Other	1,974	Other	816
Total	4,343	Total	4,528
Top 8 Exports as % of Total	54.5%	Top 8 Imports as % of Total	82.0%

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

The United States absorbs 80% of its exports, with 12% going to other developed countries and only 8% entering developing countries. The Dominican Republic imports 50% of its merchandise goods from the United States, 13% from other developed economies, and 37% from various developing countries. Although the largest of the DR-CAFTA trading partners, U.S. exports grew by only 1.6% in 2004 as the Dominican Republic continued to recover from a severe recession.

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

The joint-production arrangements are evident in apparel and jewelry-making industries. Apparel and textiles constitute 16% of U.S. exports and 48% of U.S. imports. Other significant U.S. exports include various types of machinery, refined oil products, and plastic. Other 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

One aspect of the congressional debate over trade agreements focuses on their potential economic effects on the United States. Congress mandated that the United States International Trade Commission (USITC) assess these effects and it released its final report in August 2004. This report 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, would be approximately $166 million (less than 0.01% of GDP) for each year the agreement is in effect.[28]

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 were 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).[29] These estimates are in line with expectations made 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 govern 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 and expand 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.

Each traded good falls into one of eight tariff elimination "staging categories," which define the time period over which customs duties would be eliminated. Each country negotiated a list of its most sensitive products for which duty-free treatment would be delayed. For manufactured goods, duties on 80% of U.S. exports would

[28] 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.

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

be eliminated immediately, with the rest phased out over a period of up to 10 years.[30] 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 is "back loaded" and would not begin for 7 or 12 years after the agreement takes effect. For the DR-CAFTA countries, 100% of non-textile and non-agricultural goods would enter the United States duty free immediately.[31] 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 have less restrictive provisions governing textile and apparel imports than currently in force under the CBTPA. It would remove all duties on textile and apparel imports that qualify under the agreement's rules of origin, retroactive to January 1, 2004 and allow for special safeguard measures during the duty phase-out period. 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 U.S. market share of 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 the CBTPA.[32]

Much Central American and Dominican apparel has been entering the United States duty free for several years, if it is assembled from U.S. yarn and fabric under the so-called "yarn forward" rule. The key difference from the CBTPA is that duty-free access would apply to textiles and garments assembled from components made in either the DR-CAFTA countries or the United States, rather than just the United States.[33] Among other enhanced benefits, the "cumulation rule" would allow duty-free treatment to be extended on a limited quantity basis to woven apparel made from components made in Canada and Mexico, 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. Others fear, however, that they are too generous and that if customs procedures are not well implemented, they could harm U.S. producers by increasing

[30] Ibid., p. 25.

[31] 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].

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

[33] See CRS Report RS22150, *DR-CAFTA: Textiles and Apparel*, by Bernard A. Gelb. p. 4.

opportunities for the illegal transshipment of fabrics or goods made in ineligible countries, such as China.

There are exceptions to the yarn forward rule for certain products (affecting less than 10% of trade) and tariff preference levels (TPLs) were allowed for a few imports from Nicaragua and Costa Rica. Because of this special treatment, countries that did not receive such consideration challenged these provisions, as did some U.S. textile manufacturing interests, which argued that they would hurt U.S. producers. There was also considerable debate over the expansion from the CBTPA of the "short-supply" list. This is the list of goods given duty-free access if made from materials that are determined to be commercially in "short supply" in the United States. The DR-CAFTA may also increase U.S. exports of textiles, which have risen significantly under CBTPA. On balance, however, the USITC study estimated that it "will likely have a negligible impact on U.S. production or employment."[34]

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. Average applied tariffs on agricultural goods by most DR-CAFTA countries are relatively low, ranging from 7% to 23%. Most agricultural imports face no tariff in the United States. For all countries, the pressing challenge was negotiating tariff rate quotas (TRQs — see below) for their most sensitive products.[35] 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 the agricultural sectors bear most of the trade adjustment costs and that it takes time for rural economies to make the transition to freer trade.[36]

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. These goods would continue to be subject to quotas that would increase, after a certain period, by approximately 2% each year in perpetuity, with no decrease in the size of the above-quota tariff.[37] Over half of current U.S. farm exports to Central America would

[34] CRS Report RL32895, *Textile Exports to Trade Preference Regions*, p. 2, by Bernard A. Gelb. 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).

[35] 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.

[36] 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.

[37] CRS Report RL32110, p. 5.

become duty free immediately, including high quality cuts of beef, cotton, wheat, soybeans, certain fruits, and vegetables, processed food products, and wine.

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 very high tariff is applied. The phased reduction in agriculture protection also includes the transitional use of volume-triggered safeguards, or applying an additional duty temporarily on products that are being imported in quantities deemed a threat to the domestic industry.[38] Export subsidies would be eliminated except when responding to third party export subsidies.

Sugar was perhaps the most controversial and complex of agricultural issues to resolve and U.S. sugar growers and processors are vehement opponents of the agreement. 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 (nearly 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.[39]

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.[40] The United States would be able to impose a sugar price mechanism to compensate Central American sugar exporters in lieu of according them duty-free treatment, but a key issue for some Members of Congress is defining precisely how this mechanism would work.

Increasing grain exports was an important goal for the United States. 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, however, remain protected and there is a complicated system for phasing out TRQs on U.S. exports over a 15-20 year period. As with sugar imports to the United States, U.S. exports of corn and rice will increase slowly due to the highly restrictive TRQs

[38] 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 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.

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

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

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."[41]

Despite the lengthy transition period toward freer trade under the DR-CAFTA, concerns remain over the potentially harmful effects to Central America, particularly to the small commercial and subsistence farmers, of further opening its markets to U.S. agriculture.[42] Three recent studies, however, agree that overall, increased agricultural trade can be one source of Central American rural development. In addition to increasing Central American agricultural exports, the majority of households are net consumers of agricultural goods, and so stand to gain from lower prices, the equivalent to a increase in family income. Because subsistence farmers' produce generally does not reach the market, it would not likely be affected greatly by changes in market prices.[43]

Still, for the minority of rural net producers of agricultural goods, economists also agree that adjustment policies are essential, beginning with targeted income assistance. For rural areas to benefit fully from the DR-CAFTA, there is also a critical need for increased investment in transportation and communications infrastructure, education, and more fully developed financial services. This would improve agricultural productivity, help transition workers toward alternative crops or non-farm employment, and integrate the rural economy more fully with the national and international economy. Without concerted effort in adjustment assistance, the poorest segments of rural Central America would remain vulnerable to the effects of freer trade.[44]

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

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

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

[43] Todd, Jessica, Paul Winters, and Diego Arias. *CAFTA and the Rural Economies of Central America: A Conceptual Framework for Policy and Program Recommendation*. Inter-American Development Bank. Washington, D.C. December 2004. pp. 43-50, Mason, Andrew D. *Ensuring that the Poor Benefit from CAFTA: Policy Approaches to Managing the Economic Transition*. Draft of Chapter 5 in forthcoming book. The World Bank. Washington, D.C. March 25, 2005. pp. 25-26, 35, and Arce, Carlos and Carlos Felipe Jaramillo. *El CAFTA y la Agriclutura Centroamericana*. Paper presented at the World Bank Regional Conference on International Trade and Rural Economic Development, Guatemala. February 21-22, 2005. p. 17.

[44] Ibid.

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 expeditious 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.

Two investment issues stand out. First, an investor-state provision, common in U.S. bilateral investment treaties (BITs) and used in earlier FTAs, has been included. It would allow investors alleging a breach in investment obligations to seek binding arbitration against the state directly, using the dispute settlement panel defined in the Investment chapter. U.S. investors have long supported the inclusion of investor-state rules to ensure that they have recourse in countries that do not adequately protect the rights of foreign investors. Since bilateral investment treaties are usually made with developing countries that have little foreign investment in the United States, it was not anticipated that these provisions would greatly affect the United States. This changed under NAFTA where investor-state provisions gave rise to numerous "indirect expropriation" claims against subnational (state) governments in the United States, Mexico, and Canada over environmental and other regulations.[45]

Although none on these claims has prevailed in the United States, Congress instructed in TPA that future trade agreements ensure "that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors." In response, Annex 10-C of the DR-CAFTA states that "except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations." This provision, and one that would allow for early elimination of "frivolous" suits, is intended to address congressional concerns, but there is uncertainty about how well the changes would operate.

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.

[45] Indirect expropriation refers to regulatory and other actions that can adversely affect a business or property owner in a way that is "tantamount to expropriation." This issue and many cases are discussed in CRS Report RL31638, *Foreign Investor Protection Under NAFTA Chapter 11*, by Robert Meltz. See pp. 3-5, and 11.

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 monopolies in Costa Rica (insurance and telecommunications).[46] 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.[47]

The USITC suggests that the DR-CAFTA would have little effect on U.S. services imports because the market is already open and sees opportunities 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 privatization and deregulation.[48] 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 domestic laws, 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. Because of this continued sensitivity, however, a vote on ratifying the DR-CAFTA is highly controversial in the Costa Rican Congress.

Government Procurement and Intellectual Property Rights

These two areas were also of particular interest to the United States, with the DR-CAFTA seen as an opportunity to remedy deficiencies and encourage enforcement of standardized practice in the region. None of the DR-CAFTA countries is a signatory to the WTO Agreement on Government Procurement and complaints against purchasing processes vary from dissatisfaction with opaque and cumbersome procedures in Costa Rica to outright corruption in Guatemala. El Salvador, Nicaragua, and Honduras passed new government procurement laws in 2000/01, and in general, there have been improvements in all countries in dealing with project bidding, although transparency issues remain.[49] Some analysts believe

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

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

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

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

this is due in part to a lack of incentives given that many of these countries would not be able to compete in the U.S. government procurement market.[50]

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 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. In general, the provisions are supported by U.S. businesses interested in doing or expanding opportunities in the region.[51]

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 of 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.[52]

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 DR-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 abuse of copyrighted material.[53]

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

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

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

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

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. 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.[54]

Pharmaceutical Data Protection. To bring a patented drug to market, a drug company must demonstrate through clinical trials that the drug is safe and effective. Under U.S. patent law, the data used to establish these claims are protected from use by generic manufacturers for five years from the time the drug is introduced in a country's market. Similar language was adopted in the IPR chapter of the DR-CAFTA. This issue became controversial in November 2004 when the Guatemala legislature changed its laws, adopting World Trade Organization (WTO) language that would have limited data protection to five years from the time a drug is brought to market in the first country (e.g. the United States), rather than from the presumably later time that it might be introduced in a second country (e.g. Guatemala).

The USTR insisted that this change was a breach of the DR-CAFTA commitments and threatened to delay implementing legislation until the law was changed. Guatemala chose to reverse the data protection law, to the disappointment of many who argued that the DR-CAFTA provisions could delay access to future generic drugs. Given that data protection and patent protection often run concurrently, however, it is debatable whether the introduction of future generic drugs would be further inhibited by this provision.

An August 5, 2004 side agreement among all signatories further clarifies that data protection obligations under the DR-CAFTA do not affect a country's ability "to take measures [e.g. compulsory licensing for generic drugs] necessary to protect public health by promoting access to medicines for all," in particular those needed to combat epidemics such as HIV/AIDS, tuberculosis, and malaria, among others. Critics contend that the side agreement still does not provide an explicit exception to the data protection requirement for cases where compulsory licencing under the WTO rules is invoked, and others even challenge the entire WTO provision as inadequate.[55]

Labor and Environment

Perhaps the greatest challenge to the DR-CAFTA arises from the environment and labor chapters. It has become widely accepted that environmental and labor provisions should be part of modern trade agreements. There is considerable

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

[55] The legal issue is complicated and perhaps subject to interpretation as to whether the five-year data exclusivity could, under some circumstances, limit access to generic drugs beyond the patent period. The side agreement is available at [http://www.ustr.gov] and for a summary of the debate, see Brevetti, Rosella. CAFTA Opponents Blast U.S. Stance on Guatemalan Data Protection Law. *International Trade Reporter*. BNA, Inc. March 10, 2005. See also: CRS Report RS21609, *The WTO, Intellectual Property Rights, and the Access to Medicines Controversy*, by Ian F. Fergusson.

disagreement, however, over how aggressive language in trade agreements should be in addressing these issues.

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.[56] 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, others have argued that developing countries have a comparative advantage in labor costs consistent with the free trade model, and in any case, studies suggest that these cost differentials are usually not high enough to determine business location alone — productivity remains the primary decision factor.[57] Further, many economists view trade liberalization as part of the overall development process that, in and off itself, can promote social change.[58] Developing countries are also concerned with sovereignty issues related to specifying standards in trade agreements and the possibility that they can be misused as a disguised form of protectionism.

Environmental Issues. 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 agreement.[59]

[56] 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, or are external to, the market price (so-called *external* costs). Through legal, regulatory, and tax measures, developed countries require that businesses correct, or pay 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.

[57] See Stern, Robert M. Labor Standards and Trade. In: Bronckers, Marco and Reinhard Quick, eds. *New Directions in International Economic Law: Essays in Honor of John H. Jackson*. The Hague: Kluwer Law International. 2000. pp. 427-28 and 436 and CRS Report 98-742, *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.

[58] 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 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.

[59] 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 RL31638, *Foreign Investor Protection Under NAFTA Chapter 11*, by Robert Meltz.

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.[60]

Advocates raise the issue of the environmental effects of trade, particularly in developing countries that may have weak laws and lax enforcement mechanisms, but the environmental provisions are not the most contentious issues in the DR-CAFTA. Many of these same advocates 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.[61]

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 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.[62] In response, the seven countries signed a supplemental Environmental Cooperation Agreement (ECA) on February 18, 2005. It calls for a new unit to be established in the Secretariat for Central American Integration to administer public submissions or complaints made on enforcement issues. The ECA is intended to address both short- and long-term environmental goals, including providing for a monitoring process, but does not address concerns over funding for the implementation of environmental initiatives.

Labor Issues. Arguably, the most contentious issue in the DR-CAFTA is the labor chapter. Two broad themes have emerged given that labor standards in many of these countries can be weak. First, the extent to which the DR-CAFTA countries

[60] 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.

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

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

have adequate labor laws and enforcement mechanisms, and second, whether the DR-CAFTA meets the negotiation objectives defined by Congress in TPA.

Labor Laws and Enforcement. Labor advocates argue that some 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 first paragraph of the Labor Chapter states that all parties reaffirm their commitments under the United Nations International Labor Organization (ILO). These are defined in the ILO's *1998 Declaration on Fundamental Principles and Rights at Work*: 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.[63]

In response, the Central American countries requested that the ILO conduct a study of their labor laws. The final 2003 report is subject to interpretation and has been used to bolster both sides of the issue of whether the DR-CAFTA countries guarantee the core ILO principles.[64] Those concerned with the adequacy of labor laws have argued that there is still a need to clarify or change laws in some countries for them to comply fully with these principles. This argument was further pressed by several Members of the House Ways and Means Committee in a publicized letter to the USTR's office. It pointed to 20 examples in which Central American laws fail to meet core ILO principles, all cases related to freedom of association or collective bargaining as opposed to discrimination, compulsory labor, or child labor.[65]

At the same time, with the assistance of the Inter-American Development Bank, the DR-CAFTA country ministers of trade and labor released a study of their countries' shortfalls in meeting and enforcing core labor principles. Although all countries have made recent changes to their labor laws, there was clear recognition for the need to harmonize some laws better with ILO principles, as well as address enforcement of key infractions such as employment discrimination (pregnancy testing), abuses in free trade zones (application of labor laws), and the need to dedicate more resources to enforcement.[66]

The debate over the adequacy of labor laws continues, but there is little disagreement that labor law enforcement is a problem and that unionization is not

[63] Article 16.8 of the Labor Chapter also includes a list of internationally recognized labor rights that includes all of these rights plus "acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health."

[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.

[65] Letter to the Honorable Peter Allgeier. April 4, 2005. If Honduras and Guatemala are eliminated, concerns in this letter would focus on the use of solidarity associations, onerous strike requirements, and inadequate protection against anti-union discrimination.

[66] Minister of Trade and Labor. *The Labor Dimension in Central America and the Dominican Republic. Building on Progress: Strengthening Compliance and Enhancing Capacity*. April 2005.

widespread. The DR-CAFTA countries have admitted in their own report that they lack 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 could be used to assist countries financially with technical assistance to achieve higher enforcement standards through the Labor Cooperation and Capacity Building Mechanism, defined in annex 16.5. As a side note, the DR-CAFTA is a reciprocal agreement and although most concerns about enforcement are directed at the region, the United States is not without its own critics in this matter.[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, makes three 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.

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 critique centers on the dispute settlement provisions and the extent to which they are effective in requiring countries to meet certain standards. It is argued 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]

The first provision, failure to enforce domestic labor laws, can be formally challenged in the dispute resolution process as defined in the DR-CAFTA. Such recourse is not available for the other two provisions, although they are supported in principle (Articles 16.2 and 16.6). The USTR points to cooperative mechanisms for

[67] Bensusán, Graciela. Labor Regulations and Trade Union Convergence in North America. In Weintraub, Sidney, ed. *NAFTA's Impact on North America: The First Decade*. Washington, D.C.: CSIS Press. 2004. p. 145.

[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.

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 (fine) 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 paid by the country, which would be capped at $15 million per year, per violation, with recourse to an equivalent dollar value of suspended benefits (higher tariffs) if the fine is not paid. The fine would also be paid into a fund and expended for "appropriate labor initiatives." Those supporting stronger labor provisions 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 levied annually for each violation would be significant relative to the dollar value of the trade benefits they 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 are not accorded the 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 less stringent objectives "*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."

The TPA provisions seem to differ with respect to treatment of these three labor provisions, and under the dispute resolution provision (sec. 2102(b)(12)(G)), one objective 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. Critics argue that this is not the case with labor and commercial disputes, but the USTR contends that this standard has been met since both commercial and labor disputes are subject to fines and suspension of benefits. Since the dispute settlement procedures do not operate identically, it may be a matter of interpretation as to whether there is a problem in their meeting congressional negotiating objectives.[72]

[70] Ibid. 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.

[72] It should also be noted that under the principal negotiating objectives in TPA with respect

(continued...)

The DR-CAFTA labor provisions contain many of the same controversial provisions found in earlier FTAs for which Congress passed implementing legislation, including Chile, Singapore, Morocco, Australia (Jordan's labor provisions were different in some places.) Many Members may have accepted that these countries had adequate labor laws, even if there were enforcement or other concerns. This perception is clearly lacking for the DR-CAFTA countries, despite efforts to make transparent their deficiencies and to correct some laws and enforcement problems. A challenge for policymakers is deciding whether the labor chapter in DR-CAFTA is sufficient to support this next FTA, requires amending in the text, or could be improved sufficiently in a side agreement or letter, if it is to be ratified.

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 the DR-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,

[72] (...continued)
to labor is a limiting provision that is reflected almost verbatim in Article 16.2 of the DR-CAFTA: 1) "to recognize that parties to a trade agreement retain the right to exercise discretion with respect to investigatory, prosecutorial, regulatory, and compliance matters and to make decisions regarding the allocation of resources to enforcement with respect to other labor [or environmental] matters determined to have higher priorities," 2) that "a country is effectively enforcing its laws if a course of action or inaction reflects a reasonable exercise of such discretion;" and 3) "no retaliation may be authorized based on the exercise of these rights or the right to establish domestic labor standards." P.L. 107-210, sec. 2102(b)(11)(B).

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 the DR-CAFTA.[73] 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.[74] 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.

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 government through the U.S. Trade and Development Agency, Agency for International Development, and the Department of State, among others; 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).[75]

The DR-CAFTA includes a Committee on Trade Capacity Building to coordinate these types of activities. U.S. inter-agency funding in support of DR-CAFTA trade capacity building peaked as the agreement came to completion, including $20 million for labor and environmental technical assistance in the FY2005 budget. Maintaining formal support for these programs, including ongoing financial commitments, is one challenge supporters of these programs emphasize.

Outlook

Although the DR-CAFTA implementing legislation passed the Senate, it appeared to require last minute accommodation to sugar, textile, and labor interests.

[73] 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.

[74] Ibid.

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

This took the form of various promises to protect sugar and textile interests and increase monitoring of labor rights in DR-CAFTA countries, while supplying additional funding to help with labor rights enforcement capacity building in the region. It is far from clear that such assurances will be sufficient to garner needed support in the House and as the vote approaches; discussions along those lines may well continue and the DR-CAFTA, whether implemented or not, may have broad repercussions for future U.S. trade policy.

Interestingly, despite the lengthy and contentious debate, the DR-CAFTA is not expected to have a large effect on the U.S. economy as a whole. In fact, it represents more of a marginal rather than wholesale change from the existing unilateral (CBI/CBTPA) trade arrangement in place. Nor is it necessarily a referendum on free trade, but rather a compromise agreement attempting to meld the diverse interests of the United States with those of six developing countries. Yet, from the outset it has been highly controversial, centered on myriad issues discussed in this report, which together also raise some important broader questions with respect to the economics of U.S. trade policy with developing countries.

First, the ongoing debate over labor and environmental standards reflects a fundamental congressional disagreement over the trade negotiating objectives as defined in the equally controversial TPA legislation. No real consensus emerged as seen in the very slim margin of victory for the TPA legislation in 2002. This lack of consensus foreshadowed future problems with FTA implementing bills that were crafted in the image of TPA. Without a stronger (bipartisan) consensus on trade policy objectives (and the congressional consultation process), future FTAs may share the similar fate of a close vote and uncertainty of passage. This is a concern developing countries contemplating expending the resources to negotiate an FTA with the United States may consider more seriously in the future and one Congress may be expected to debate at length if and when TPA reauthorization is contemplated after it expires in June 2007.

Second, U.S. free trade agreements with developing countries carry different challenges than those with developed countries, especially in the hotly debated areas of employment outcomes and effects on lower income groups. Technological advances will continue to nudge employment opportunities in the United States toward the high-skill end of the job market. Trade with developing countries, given their abundance of low-skilled workers, will complement this trend, but together, both point to the need for U.S. (trade) adjustment assistance programs to help the low-skilled portion of the labor market, which faces the most competition from developing country trade.

Regarding developing countries, lessons from recent economic case studies suggest that hoped-for gains in economic growth and poverty reduction from trade liberalization will not happen automatically. Complementary policies in developing countries are required to facilitate labor mobility, speed resolution of other transition problems, and offset the negative income effects that some groups face.[76] Trade

[76] A rigorous case is made in: Cline, William R. *Trade Policy and Global Poverty*. Institute (continued...)

capacity building can help address this concern, but it may require long-term dedicated funding. On the positive side, access to the U.S. market may be particularly helpful for lower-income households in both Central America and the United States given that Central America's comparative advantage, simply stated, is in relatively inexpensive food and clothes, which make up a sizable proportion of U.S. lower-income household budgets.[77]

Third, U.S. trade policy has relatively recently emphasized bilateral agreements, a trend that may be at a crossroads. Congress has, in general, supported trade liberalizing legislation, but the uncertain fate of the DR-CAFTA suggests this case could be different. Clearly, the United States is able to expedite its trade agenda in less unwieldy bilateral agreements than in the consensus-driven multilateral realm. But should Congress decide not to support the DR-CAFTA, the bilateral approach may be called seriously into question, particularly given the small amount of trade that has so far been affected, at least since NAFTA.

Fourth, the United States in recent bilateral agreements has made headway in areas that so far have proved elusive in the multilateral rounds. This includes negotiating deeper comprehensive agreements (e.g. services trade, investment, intellectual property rights), improving the labor chapter beyond previous FTAs (even if still lacking the flexibility to deny trade benefits unilaterally as available under the CBI or GSP), and limiting commitments to reduce protection of sensitive goods (e.g. sugar). If the bilateral approach stalls or collapses, there seems to be little alternative to the multilateral route. Although many economists have expressed strong preference for the multilateral approach in any case, it points the United States back to a negotiating arena where many developing countries are enjoying a strengthening collective leverage targeted at, among other issues, reducing agriculture protection in developed countries and resisting inclusion of any labor provisions in WTO rules.

[76] (...continued)
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. 279-85. This point is further supported by new research using multiple case studies. See Harrison, Ann. *Globalization and Poverty*. Draft Chapter 1. April 11, 2005. pp. 4-8.

[77] 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. See also: Center for Global Development. *Global Trade, Jobs, and Labor Standards*. [http://www.cgdev.org]. Mason, *Ensuring that the Poor can Benefit from CAFTA*, p. 35, Arce and Jaramillo, *El CAFTA y la Agricultura Centroamericano*, p. 17, Todd, Winters, and Arias, *CAFTA and the Rural Economies of Central America*, pp. 43 and 50, and Harrison, *Globalization and Poverty*, pp. 42-43.

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	Salvadoran legislature ratifies the DR-CAFTA 49 to 35.
March 3, 2005	Honduran legislature ratifies the DR-CAFTA 100 to 28.

Date	Milestone
March 10, 2005	Guatemalan legislature ratifies the DR-CAFTA 126-12.
April 13, 2005	Senate Finance Committee holds hearing on implementing DR-CAFTA.
April 21, 2005	House Ways and Means Committee holds hearing on implementing DR-CAFTA.
June 14, 2005	Senate Finance Committee holds “mock markup” on draft implementing legislation and informally approves it 11 to 9, with one non-binding amendment.
June 15, 2005	House Ways and Means Committee holds “mock markup” on draft implementing legislation, informally approving it 25 to 16 with one non-binding amendment.
June 23, 2005	President Bush sends final text and required supporting documents of the DR-CAFTA implementing bill to Congress.
June 23, 2005	Identical legislation is introduced in the House and Senate as H.R. 3045 and S. 1307.
June 29, 2005	Senate Finance Committee orders S. 1307 favorably reported by voice vote, with no written report.
June 30, 2005	House Ways and Means Committee orders H.R. 3045 favorably reported by a roll call vote of 25 to 16.
June 30, 2005	S. 1307 agreed to in the Senate, 54 to 45.

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	1999	2000	2001	2002	2003	2004	% Change 2003-2004	% Change 1999-2004
U.S. Exports								
Costa Rica	2,381	2,460	2,502	3,117	3,414	3,304	-3.2%	38.8%
Honduras	2,370	2,584	2,416	2,571	2,826	3,077	8.9%	29.8%
Guatemala	1,812	1,901	1,870	2,044	2,263	2,548	12.6%	40.6%
El Salvador	1,519	1,780	1,760	1,664	1,821	1,868	2.6%	23.0%
Nicaragua	374	379	443	437	502	592	17.9%	58.3%
Dominican Rep	4,100	4,473	4,398	4,250	4,205	4,343	3.3%	5.9%
Total CAFTA	12,556	13,577	13,389	14,083	15,031	15,732	4.7%	25.3%
Mexico	86,909	111,349	101,296	97,470	97,412	110,775	13.7%	27.5%
LAC*	55,153	59,283	58,157	51,551	51,946	61,426	18.3%	11.4%
Latin America	142,062	170,632	159,453	149,021	149,358	172,201	15.3%	21.2%
World	695,797	781,918	729,100	693,103	724,771	817,936	12.9%	17.6%
U.S. Imports								
Costa Rica	3,968	3,539	2,886	3,142	3,364	3,333	-0.9%	-16.0%
Honduras	2,713	3,090	3,127	3,261	3,313	3,641	9.9%	34.2%
Guatemala	2,265	2,607	2,589	2,796	2,947	3,155	7.1%	39.3%
El Salvador	1,605	1,933	1,880	1,982	2,020	2,053	1.6%	27.9%
Nicaragua	495	589	604	679	770	991	28.7%	100.2%
Dominican Rep	4,287	4,383	4,183	4,169	4,455	4,528	1.6%	5.6%
Total CAFTA	15,333	16,141	15,269	16,029	16,869	17,701	4.9%	15.4%
Mexico	109,721	135,926	131,338	134,616	138,060	155,843	12.9%	42.0%
LAC*	58,464	73,348	67,370	69,503	78,829	98,749	25.3%	68.9%
Latin America	168,185	209,274	198,708	204,119	216,889	254,592	17.4%	51.4%
World	1,024,618	1,218,022	1,140,999	1,161,366	1,257,121	1,469,671	16.9%	43.4%
U.S. Balance of Trade								
Costa Rica	-1,587	-1,079	-384	-25	50	-29		
Honduras	-343	-506	-711	-690	-487	-564		
Guatemala	-453	-706	-719	-752	-684	-607		
El Salvador	-86	-153	-120	-318	-199	-185		
Nicaragua	-121	-210	-161	-243	-268	-399		
Dominican Rep	-187	90	215	81	-250	-185		
Total CAFTA	-2,777	-2,564	-1,880	-1,947	-1,838	-1,969		
Mexico	-22,812	-24,577	-30,042	-37,146	-40,648	-45,068		
LAC*	-3,311	-14,065	-9,213	-17,952	-26,883	-37,323		
Latin America	-26,124	-38,642	-39,256	-55,098	-67,531	-82,391		
World	-328,821	-436,104	-411,899	-468,263	-532,350	-651,735		

Source: Table created by CRS from U.S. Department of Commerce data.

* Latin America and the Caribbean, except Mexico.