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

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Summary

The United States Trade Representative (USTR) and trade ministers from Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic signed the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR) on August 5, 2004. Nearly one year later, it faced a contentious debate and close vote in both houses of the U.S. Congress. The Senate passed implementing legislation 54 to 45 on June 30, 2005, with the House following in kind 217 to 215 on July 28, 2005. President Bush signed the legislation into law on August 2, 2005 (P.L. 109-53, 119 Stat. 462). The United States implemented the agreement on a rolling basis as countries brought their laws and regulations into conformity with the obligations of the agreement. El Salvador was the first country to implement the agreement on March 1, 2006. Costa Rica was the last, implementing the agreement on January 1, 2009, after a lengthy procedural delay and national referendum.

The CAFTA-DR is a regional agreement with all parties subject to "the same set of obligations and commitments," but with each country defining its own market access schedule with the United States. It is a reciprocal trade agreement, replacing U.S. unilateral preferential trade treatment extended to these countries under the Caribbean Basin Economic Recovery Act (CBERA), the Caribbean Basin Trade Partnership Act (CBTPA), and the Generalized System of Preferences (GSP). It liberalizes trade in goods, services, government procurement, intellectual property, and investment, and addresses labor and environment issues. Most commercial and farm goods attain duty-free status immediately. Remaining trade will have tariffs phased out incrementally over five to twenty years. Duty-free treatment will be delayed longest for the most sensitive agricultural products. To address asymmetrical development and transition issues, the CAFTA-DR specifies rules for transitional safeguards, tariff rate quotas, and trade capacity building.

The CAFTA-DR is not expected to have a large effect on the U.S. economy as a whole given the relatively small size of the Central American economies and the fact that most U.S. imports from the region had already been entering duty free under normal trade relations or CBI and GSP preferential arrangements. Adjustments will be slightly more difficult for some sectors, but none are expected to be severe. 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 wanted better trade adjustment and capacity building policies to address the potentially negative effects on certain import-competing sectors and their workers. They also argued that the labor, intellectual property rights, and investment provisions in the CAFTA-DR needed strengthening. This report discusses negotiation issues and evolution of the CAFTA-DR agreement from the time negotiations commenced on January 27, 2003 until its implementation by the last country on January 1, 2009. It will not be updated.

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On August 5, 2004, the United States Trade Representative (USTR) and trade ministers from Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic signed the Dominican Republic-Central America-United States Free Trade Agreement (the CAFTA-DR; see **Appendix A**, Chronology of Negotiations). The CAFTA-DR is a regional trade agreement with all parties subject to "the same set of obligations and commitments," but with each country defining its own market access schedule with the United States. It is a comprehensive and reciprocal trade agreement, replacing U.S. unilateral preferential trade treatment extended to these countries under the Caribbean Basin Economic Recovery Act (CBERA), the Caribbean Basin Trade Partnership Act (CBTPA), and the Generalized System of Preferences (GSP).

The U.S. Congress did not consider implementing legislation for nearly a year after the CAFTA-DR was signed because it was so controversial. On June 30, 2005, however, the Senate passed S. 1307 by a vote of 54 to 45. The House followed on July 28, 2005, passing H.R. 3045 by a vote of 217 to 215. President Bush signed the bill into law on August 2, 2005 (P.L. 109-53, 119 Stat. 462). El Salvador, Honduras, Guatemala, the Dominican Republic, and Nicaragua also ratified the agreement, in that order. The CAFTA-DR was expected to enter into force on January 1, 2006, but none of the ratifying countries had completed the legal and regulatory measures needed to comply with the agreement. The USTR announced that the CAFTA-DR would take effect on a rolling basis when countries fulfilled these obligations. It entered into force on March 1, 2006 and was implemented for El Salvador, Honduras, Nicaragua, Guatemala, and the Dominican Republic within the next year.

In Costa Rica, CAFTA-DR was highly controversial because it required major restructuring of public sector monopolies over electricity, insurance, and telecommunications. Public sector unions were at the center of this concern, but small farmers and other workers also voiced opposition. Oscar Arias won a slim presidential victory in 2006 on a pro-CAFTA platform, but opposition in the National Assembly was able to delay consideration of the agreement. In the end, the Electoral Tribunal ruled in favor of a petition to hold a national referendum on the CAFTA-DR. On October 7, 2007, with a 60% participation rate, the people of Costa Rica voted 51.6% to 48.4% in favor of CAFTA-DR. Following passage of 14 implementing bills in the Costa Rican National Assembly, the United States implemented the agreement with Costa Rica on January 1, 2009. This report discusses negotiation issues and evolution of the CAFTA-DR agreement from the time negotiations commenced on January 27, 2003 until its implementation by the last country on January 1, 2009. It will not be updated.

U.S. Congressional Action

The CAFTA-DR was the most controversial free trade agreement (FTA) vote since the North American Free Trade Agreement (NAFTA) implementing legislation was passed in 1993. Many lawmakers were uncomfortable with the agreement as written, particularly the labor provisions, treatment of certain sensitive industries (sugar and textiles), investor-state relations, pharmaceutical data protection, and basic sovereignty issues. It was also caught up in an overarching congressional controversy over how trade negotiation objectives should be defined in

FTAs based on the Trade Promotion Authority (TPA) framework, as well as, concern by some Members over the perceived ineffectiveness of the executive-legislative consultation process.[1]

These issues were raised repeatedly in "mock markups" of draft implementing bills held by the Senate Finance and House Ways and Means Committees on 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 have extended the trade adjustment assistance program to cover workers in 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 CAFTA-DR countries and the United States to build capacity on labor issues," and a provision requiring monitoring of CAFTA-DR's 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. It included a new Section 403, the House amendment requiring that the Administration transmit biennial reports on progress made in implementing the labor provisions, including the Labor Cooperation and Capacity Building Mechanism. It also called for monitoring 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 CAFTA-DR countries. 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.

The Senate Finance Committee acted 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 June 30, 2005, where, following 20 hours of floor debate, S. 1307 passed 54 to 45. H.R. 3045 did not come before the House until July 28, 2005, where, following two hours of debate, it narrowly passed 217 to 215. On the same day, the Senate voted 56 to 44 to substitute H.R. 3045 for S. 1307, a necessary procedural vote to comply with the constitutional requirement that revenue bills originate in the House. President Bush signed H.R. 3045 into law on August 2, 2005 (P.L. 109-53, 119 Stat. 462).

Passage in the Senate was by a slimmer margin than with earlier trade agreements and required accommodation outside the implementing legislation to labor, textile, and sugar interests. In a letter from USTR Rob Portman to Senator Jeff Bingaman, the Administration promised to allocate $40 million of fiscal 2006 foreign operations appropriations 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 funding International Labor Organization (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.

In another letter, Secretary of Agriculture Mike Johanns assured Senator Saxby Chambliss and Representative Bob Goodlatte, the respective agriculture committee chairs, that the

[1] On TPA, see CRS Report RL33743, *Trade Promotion Authority (TPA): Issues, Options, and Prospects for Renewal*, by (name redacted) and (name redacted).

Administration would not allow the CAFTA-DR to interfere with the operation of the sugar program as defined in the Farm Security and Rural Investment Act of 2002 (the Farm Bill) through FY2007, when it expires. In particular, he promised to take steps should additional sugar imports due to the CAFTA-DR, NAFTA, and other trade agreements jeopardize the sugar program operations by exceeding the import trigger threshold. Should this occur, the U.S. Secretary of Agriculture agreed to preclude entry of additional sugar imports into the domestic sweetener market by either making direct payments to exporters or using agricultural commodities to purchase sugar to be used for nonfood use (ethanol production).

Separately, for the textile and apparel issues, promises were made to: (1) change the rules of origin to require that all pocketings and linings come from the CAFTA-DR countries (rather than third party countries like China); (2) negotiate a new stricter customs enforcement agreement with Mexico before the CAFTA-DR cumulation rules take effect allowing Mexican inputs to be used in CAFTA-DR textile and apparel products; and (3) require Nicaragua to increase use of U.S. fabric to qualify as duty-free under their tariff preference levels.

Other accommodations were made to win House support of H.R. 3045, including passage in the House on July 27, 2005, of the U.S. Trade Rights Enforcement Act (H.R. 3283). This bill would allow greater recourse to pursue trade complaints against China and other non-market economies. Not all interest groups, however, could be appeased. Despite efforts to win over all groups, the sugar industry and some textile groups chose not to support the bill and strong Democratic opposition remained over a number of other issues that may prove to be enduring challenges to future trade agreements, if crafted from the CAFTA-DR framework.

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.[2]

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.,

[2] 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, DC. 1999. p. 137, and Bouzas, Roberto and Saul Keifman. Making Trade Liberalization Work. *After the Washington Consensus: Restarting Growth and Reform in Latin America*. Kuczynski, Pedro-Pablo and (name redacted), eds. Inst itution for International Economics. Washington, DC. March, 2003. pp. 158, 165-67.

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.[3] 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.[4] This relationship, discussed in more detail later, provides the basis for much of the labor policy debate on the CAFTA-DR, and FTAs more generally.[5]

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 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 CAFTA-DR. 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.[6]

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[3] 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.

[4] 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.

[5] 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.

[6] 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.

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.[7] The public policy difficulty is that both options have costs and benefits, but result in different distributional outcomes.[8] 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 a long period of time (typically up to 15-20 years for very sensitive products).

Third, there are 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, for example, do not address antidumping and subsidies, reflecting an ongoing congressional concern, and negotiations on certain agriculture issues were also limited, given the politically sensitive nature of this issue.

The Impetus for a CAFTA-DR

The United States was motivated by both commercial and broader foreign economic policy interests in deciding to negotiate preferential trade agreements with Central America and the Dominican Republic. Geopolitical and strategic concerns also sparked interest by all parties in pursuing the CAFTA-DR. Proponents expected the CAFTA-DR to reinforce regional stability by providing institutional structures that can undergird gains made in democracy, the rule of law, and efforts to fight terrorism, organized crime, and drug trafficking. The CAFTA-DR may also be a way to expand support for U.S. positions in the Free Trade Area of the Americas (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 CAFTA-DR pointed to equally broad themes, such as the pervasive social and economic inequality in much of the region, and so supported strong labor and environment provisions as important negotiating objectives. There was concern, for example, over the adequacy of working conditions and enforcement of labor laws in the CAFTA-DR countries. The

[7] 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, DC.: Institute for International Economics, 2005. pp. 313-41.

[8] It is important to note that 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.

CAFTA-DR countries argued 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, the first FTA after NAFTA, 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 reinforced this attitude.

In the context of regional trade agreements, history, geographic proximity, and economic complementarities also made the CAFTA-DR an apparently logical step.[9] 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 trend continued until the 1980s and passage of the Caribbean Basin Initiative (CBI).[10] By becoming eligible for unilateral preferential tariff treatment, U.S. investment increased in the region, fostering growth in Central American export sectors.

A major change to the CBI relationship occurred with passage of the Caribbean Basin Trade Partnership Act of 2000 (P.L. 106-200). In response to repeated concerns over trade benefits negotiated with Mexico under NAFTA, Congress passed essentially NAFTA-equivalent treatment for the CBI countries. CBTPA targeted preferences on textile, apparel, and other high-volume export goods not covered under the original CBI legislation. The benefits were extended temporarily for a period ending September 30, 2008, or until a beneficiary country enters into an FTA with the United States.[11]

The U.S.-Central American/Dominican Republic economic relationship changed importantly under the CBTPA, creating an environment in which businesses forged strategic partnerships in the increasingly complex world of textile and garment manufacturing. From 1974 until 1995, global rules restricting trade in apparel between developed and developing countries (mostly quotas) were set out in the Multifiber Arrangement (MFA) and its successor, the WTO-sponsored Agreement on Textiles and Clothing (ATC), which served as a transitional arrangement to a quota-free system begun on January 1, 2005. In this context, the CBTPA preferences provided an import benefit for the region's export sectors.[12]

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

[9] 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.

[10] The Caribbean Basin Economic Recovery Act (CBERA – P.L. 98-67).

[11] Extended to September 30, 2010 in P.L. 110-246, sec. 15408.

[12] For more on the evolution of these trade preference arrangements, see CRS Report RL33951, *U.S. Trade Policy and the Caribbean: From Trade Preferences to Free Trade Agreements*, by (name redacted).

industries. 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.

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 back to the United States—a mutually beneficial strategy. 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 apparel 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 argued that the alternative would have been an even greater and more rapid loss of textile and garment jobs to Asian competitors that use no U.S. inputs.[15]

With the removal of textile and apparel quotas in January 2005, the trade picture changed again. The CAFTA-DR 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 CAFTA-DR countries are heavily concentrated in products previously covered by quotas, the dominance of China and other low-cost Asian producers is likely to continue. CAFTA-DR producers are less competitive on a pure cost basis because of their higher labor costs relative to some countries in Asia, the CBTPA 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.[17] Studies suggest that the economic and social networks that developed between U.S. and Central American firms effectively created a niche market in the region for certain apparel that has held up even with the growing presence 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 by large retailers. In a post-quota trading world, these advantages may allow a certain portion of textile and apparel production to remain in the CAFTA-DR countries. Although CAFTA-DR country representatives have

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

[14] USITC. Production-Sharing Update: Developments in 2001. *Industry Trade and Technology Review*. November 2003. pp. 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.

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

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 B** for economic data) and although firms engaged in this trade may find its effects significant, total CAFTA-DR 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 were already relatively low, they were reduced further. In particular, U.S. business interests wanted 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 also supported the joint production arrangements already in place between U.S. firms and those in the region. Finally, a bilateral agreement offered the United States a chance to deepen other trade commitments that affect some of its most competitive industries, including 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 CAFTA-DR also made permanent and expanded U.S. benefits given under the CBTPA legislation, but which require reauthorization by Congress. Permanence in trade rules is an enticement for U.S. foreign direct investment (FDI), which in turn can support the region's export driven development strategy.

The CAFTA-DR 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 matter of development policy, by CAFTA-DR country efforts to diversify the agricultural sector into non-traditional exports and non-farm employment.[19]

Finally, there were two significant negotiation challenges. The first was the need for better Central American integration as part of CAFTA-DR, which historically has been hampered. Having multiple trade rules and rules of origin in a small sub-region would complicate the trade picture. For the CAFTA-DR to work well, the United States needed assurance that goods would

[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] The CAFTA-DR 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 CAFTA-DR countries see the FTA as supporting this strategy.

flow efficiently within the region, which will be a significant benefit of 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.

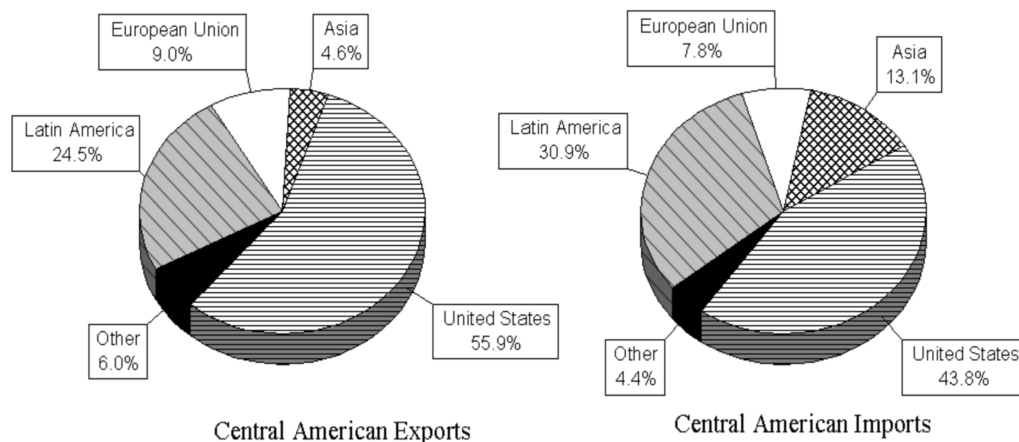
U.S. Trade Relations with Central America and the Dominican Republic

"Docking" the Dominican Republic FTA to CAFTA added the largest of six trading partners covered by the CAFTA-DR 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 an earlier version of 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.

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



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

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 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.

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 C** 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.[20]

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 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.[21]

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 1**). 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,

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[20] 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.

[21] 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.

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

Table 1. 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)	1,037	490	172	359	0	14
-Bananas (0803)	(657)	(245)	(129)	(273)	(0)	(11)
Electrical Mach. (85)	983	719	172	1	18	73
-Integrated circuits 8542	(489)	(489)	(0)	(0)	(0)	(0)
Optical/Med. Equip. (90)	492	480	0	12	0	0
Spices, Coffee, Tea (09)	512	150	45	216	49	52
-Coffee (0901)	(504)	(148)	(43)	(213)	(49)	(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.

Note: HTS = Harmonized Tariff Schedule

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 CAFTA-DR 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 selectively competitive with low-cost Asian exports. These restrictions are further relaxed under the CAFTA-DR.[22] The USITC points out that the CAFTA-DR countries have been losing market share to Asia since at least 1997, and the CAFTA-DR is seen as a way to help abate this trend.[23]

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

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

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

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.[24]

The CAFTA-DR 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 CAFTA-DR 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. Rules on U.S. apparel imports were enhanced and made permanent under CAFTA-DR.

U.S. Exports

As seen in **Table 2**, 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 CAFTA-DR countries along with capital goods (machinery and parts) and agricultural products.

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 CAFTA-DR countries because they are staple crops and grown by small, often subsistence farmers.[25]

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.

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

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

Table 2. 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)	1,698	1,092	175	206	157	68
-Integrated circuits 8542	(828)	(822)	(0)	(5)	(1)	(0)
Machinery (84)	1,031	301	205	256	205	69
-Office Mach. Pts (8473)	(207)	(68)	(26)	(62)	(32)	(19)
-Computer Parts (8471)	(136)	(43)	(20)	(32)	(26)	(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)	559	156	92	118	125	68
-Corn (1005)	(242)	(71)	(31)	(65)	(64)	(10)
-Wheat and Meslin 1001	(167)	(38)	(28)	(34)	(46)	(21)
-Rice (1006)	(149)	(46)	(33)	(18)	(16)	(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.

Note: HTS = Harmonized Tariff Schedule

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 3** for bilateral trade data.)

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 CAFTA-DR trading partners, U.S. exports grew by only 1.6% in 2004 as the Dominican Republic continued to recover from a severe recession.

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.

Table 3. 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 Yarn, 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.

Note: HTS = Harmonized Tariff Schedule

U.S. Foreign Direct Investment

The CAFTA-DR 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 4**.

Table 4. U.S. Foreign Direct Investment (FDI) in CAFTA-DR 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-DR	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 stagnated or 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.

Review of the CAFTA-DR

One aspect of the congressional debate over trade agreements focused 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 CAFTA-DR effects on the U.S. economy as a whole and for selected sectors. Overall, it found that the "welfare value" or aggregate effect on U.S. consumers and households of trade liberalization under the CAFTA-DR would be approximately $166 million (less than 0.01% of GDP) for each year the agreement is in effect.[26]

With respect to trade flows, the reduction of relatively higher tariff rates on U.S. goods is expected to increase U.S. exports more than imports with the region. The USITC model estimates that when the CAFTA-DR is fully implemented, U.S. exports to the CAFTA-DR countries will increase by $2.7 billion or 15%, while imports will increase by $2.8 billion, or 12%. The effect of this trade growth on aggregate U.S. output and employment is estimated 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).[27] These estimates are in line with expectations voiced prior to the negotiations that the marginal effects of the CAFTA-DR would be small, but positive for the U.S. economy as a whole, given the CAFTA-DR 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 and issues expected to be most affected by the agreement, or that generated the most contentious policy debate.

Market Access

Market access refers to 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. CAFTA-DR replaces and enhances in a permanent agreement U.S. preferential market access extended unilaterally under the Caribbean Basin Economic Recover Act (CBERA), the Caribbean Basin Trade Partnership Act (CBTPA), and the Generalized System of Preferences (GSP), which require periodic congressional reauthorization (except CBERA). Agriculture and textile/apparel goods, Central America's major exports, were the most important and difficult market access issues to resolve.

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

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

Each traded good falls into one of eight tariff elimination "staging categories," which define the time period over which customs duties will be eliminated. Each country negotiated a list of its most sensitive products for which duty-free treatment is delayed. For manufactured goods, duties on 80% of U.S. exports were eliminated immediately, with the rest phased out over a period of up to 10 years.[28] For agricultural goods, duties on over 50% of U.S. exports were 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 will not begin for 7 or 12 years after the agreement takes effect. For the CAFTA-DR countries, 100% of non-textile and non-agricultural goods enter the United States duty free immediately.[29] Safeguards are retained for many products over the period of duty phase out, but antidumping and countervailing duties were not addressed in the CAFTA-DR, leaving all U.S. and other country trade remedy laws fully enforceable, as required under Trade Promotion Authority (TPA).

Textiles and Apparel

The CAFTA-DR has less restrictive provisions governing textile and apparel imports than those in the CBTPA. It removes all duties on textile and apparel imports that qualify under the agreement's rules of origin, retroactive to January 1, 2004, and allows 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 generate 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.[30]

Central American and Dominican apparel has been entering the United States duty free for years, if it is assembled from U.S. yarn and fabric under the so-called "yarn forward" rule. The difference from the CBTPA is that duty-free access applies to textiles and garments assembled from components made in either the CAFTA-DR countries or the United States, rather than just the United States.[31] Exceptions to this rule include an enhanced "cumulation rule," which allows duty-free treatment for a limited quantity of woven apparel assembled from components made in Canada and Mexico, to help U.S. textile firms invested in these countries. In addition, there are exceptions for specified products (affecting less than 10% of trade), goods with limited amounts of material from third countries, and for tariff preference levels (TPLs) given to a few imports from Nicaragua and Costa Rica.

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 CAFTA-DR firms that produce for the U.S. market wanted as much flexibility as possible to use fabrics from third countries. Others feared, however, that they are too generous and that if customs procedures are not well implemented, they could harm U.S. producers by increasing opportunities for the illegal transshipment of fabrics or goods originating from outside the region, such as China. There was

[28] Ibid., p. 25.

[29] 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.

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

[31] See: CRS Report RS22150, *DR-CAFTA, Textiles, and Apparel*, by (name redacted).

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 CAFTA-DR 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."[32]

Concerns raised by certain sectors of the textile and apparel industry required assurances from the Bush Administration before support would be given to the CAFTA-DR. Promises were made to: (1) change the rules of origin for textiles and apparel to require that all pocketings and linings come from the CAFTA-DR countries (rather than third party countries like China); (2) negotiate a new stricter customs enforcement agreement with Mexico before the CAFTA-DR cumulation rules take effect allowing Mexican inputs to be used in CAFTA-DR textile and apparel products; and (3) require Nicaragua to increase use of U.S. fabric to qualify as duty-free under their tariff preference levels. These assurances are not part of the formal CAFTA-DR, but have been implemented nonetheless.[33]

Agriculture

Domestic support programs were not addressed in the CAFTA-DR, which focused on reducing tariffs and increasing quota levels, the most costly trade-distorting policies. Average applied tariffs on agricultural goods by most CAFTA-DR 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.[34] 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 they will require time to make the transition to freer trade.[35]

All agricultural trade eventually becomes 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 will continue to be subject to quotas that will increase, after a certain period, by approximately 2% each year in perpetuity, with no decrease in the size of the above-quota tariff.[36] Over half of current U.S. farm exports to Central America became duty free upon implementation, including high quality cuts of beef, cotton, wheat, soybeans, certain fruits and vegetables, processed food products, and wine.

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[32] 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).

[33] Washington Trade Daily, *Tide Rising for CAFTA—Portman*, July 26, 2005.

[34] For more details, including sanitary and phytosantiary (SPS) provisions, see CRS Report RL32110, *Agriculture in the U.S.-Dominican Republic-Central American Free Trade Agreement (DR-CAFTA)*, by (name redacted).

[35] 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.

[36] CRS Report RL32110, *Agriculture in the U.S.-Dominican Republic-Central American Free Trade Agreement (DR-CAFTA)*, by (name redacted).

Many other transitional provisions exist. Agricultural products are 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.[37] Export subsidies are eliminated except when responding to third party export subsidies.

Sugar was the most controversial agricultural issue to resolve and U.S. sugar growers and processors were vehement opponents of the agreement to the end. The U.S. agreed 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. Raw sugar receives the largest quota by volume, 28% of the total U.S. sugar quota for the world was filled by the CAFTA-DR countries in 2003, and was a 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.[38]

The CAFTA-DR raises 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 increases 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.[39] The United States may 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 was defining precisely how this mechanism will work.

Nonetheless, the sugar producing industry remained unsatisfied with these provisions. The Bush Administration responded in a letter from Secretary of Agriculture Mike Johanns to Senator Saxby Chambliss and Representative Bob Goodlatte, the respective agriculture committee chairs, assuring the industry that the CAFTA-DR would not be allowed to interfere with the operation of the sugar program as defined in the Farm Security and Rural Investment Act of 2002 (the Farm Bill). In particular, he agreed to act should additional sugar imports due to the CAFTA-DR, NAFTA, and other trade agreements cause the import trigger threshold of 1.532 million short tons per year to be exceeded and threaten the sugar program operations. The U.S. Secretary of Agriculture agreed that in such a case, he would preclude entry of additional sugar imports into the domestic sweetener market by either making direct payments to exporters or using agricultural commodities to purchase sugar to be used for nonfood use (ethanol production). This offer also proved inadequate to bring about sugar industry support for the CAFTA-DR.

Increasing grain exports was another important goal for the United States. Wheat is not grown in the CAFTA-DR countries and there is already largely free trade in this commodity. Staples for the

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[37] 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.

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

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

CAFTA-DR 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 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 may 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."[40]

Despite the lengthy transition period toward freer trade under the CAFTA-DR, 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.[41] Three recent studies, however, agree that overall, increased agricultural trade can also 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 an increase in family income. Because subsistence farmers' produce generally does not reach the market, they are unlikely to be affected greatly by changes in market prices.[42]

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 CAFTA-DR, there is also a critical need for increased investment in transportation and communications infrastructure, education, and more fully developed financial services. These measures 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 may remain vulnerable to the negative effects of freer trade.[43]

Investment

In 2003, the United States' stock of foreign direct investment (FDI) in the CAFTA-DR 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 CAFTA-DR countries went to Costa Rica, followed by the Dominican Republic with 20%. The United States has advocated clear and enforceable rules for foreign investment in all trade agreements, which is largely accomplished by "standard" language requiring national and most-favored-nation (nondiscriminatory) treatment. The CAFTA-DR clarifies 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

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

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

[42] 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.

[43] Ibid.

cases subject to legal proceedings (e.g., bankruptcy, insolvency, criminal activity). Transparent and impartial dispute settlement procedures provide recourse to investors.

Two investment issues stood out. First, an investor-state provision, common in U.S. bilateral investment treaties (BITs) and used in earlier FTAs, was included. It allows investors alleging a breach in investment obligations to seek binding arbitration against the state through the dispute settlement mechanism 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, such a provision was thought unlikely to be used in the United States. Circumstances changed, however, under NAFTA when Canada used investor-state provisions to raise "indirect expropriation" claims against U.S. state environmental regulations.[44]

Although none of the claims filed against the United States has prevailed, Congress instructed in TPA legislation 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 CAFTA-DR 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 another that allow for early elimination of "frivolous" suits were intended to address congressional concerns, but there is uncertainty about how well the changes will operate.

Second, the CAFTA-DR 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 CAFTA-DR from interfering in any sovereign debt restructuring process, and are viewed by the U.S. Treasury as an accommodation to Central American interests.

Services

The United States is the largest services exporter in the world and 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 were also many industry-specific barriers that existed, 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).[45] The CAFTA-DR provides broader market access and greater regulatory transparency for most industries including telecommunications, insurance,

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[44] 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 (name redacted).

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

financial services, distribution services, computer and business technology services, tourism, and others. Banks and insurance firms 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.[46]

The USITC suggests that the CAFTA-DR likely will have little effect on U.S. services imports because the market is already largely open. It does anticipate 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 resistance to privatization and deregulation.[47] Unlike the other countries, doing so constitutes a major structural adjustment for the Costa Rican economy, has implications for Costa Rican social policy, and required amending domestic laws, all of which was difficult for their legislature to support if they did not receive concrete tradeoffs in other areas, such as agriculture and textiles. Negotiators resolved these issues in two week-long discussions held in January 2004 and their detailed commitments are presented in the relevant chapters of the CAFTA-DR. Because of this continued sensitivity, however, the CAFTA-DR was delayed until after a national referendum supported moving ahead with the agreement.

Government Procurement

None of the CAFTA-DR 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.[48] Some analysts believe this is due in part to a lack of incentives given that many of these countries will not be able to compete in the U.S. government procurement market.[49]

The CAFTA-DR grants 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 also calls 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 agree to adhere to the government procurement provisions. The CAFTA-DR also makes 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.[50]

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

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

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

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

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

Intellectual Property Rights

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.[51]

The IPR provisions in the CAFTA-DR go beyond those in the WTO. They provide that all businesses receive equal treatment and that the CAFTA-DR countries ratify or accede to various international IP agreements. Trademark holders benefit from a transparent online registration process and special system to resolve disputes over internet domain issues, among other improvements. Copyright provisions 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 online, 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 conform more closely with U.S. norms. End-user piracy is criminalized and all parties are required to authorize the seizure, forfeiture, and destruction of counterfeit and pirated goods. The CAFTA-DR also mandates statutory damages for abuse of copyrighted material.[52]

The CAFTA-DR 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 CAFTA-DR commitments, however, enforcement problems will likely continue and technical assistance may be needed to help develop the necessary capabilities.[53]

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 CAFTA-DR. This provision 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).

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

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

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

The USTR argued that this change was a breach of the CAFTA-DR commitments and threatened to delay implementing legislation until the law was changed. Guatemala reversed the data protection law, to the disappointment of many who argued that the CAFTA-DR 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 will be further inhibited by this provision. An August 5, 2004 side agreement among all signatories further clarifies that "obligations" under Chapter 15 of the CAFTA-DR do not affect a country's ability "to take necessary measures [e.g., compulsory licensing for generic drugs] 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, however, would have preferred that the side agreement include an explicit exception to the data protection requirement for cases where compulsory licensing under the WTO rules might be invoked.[54]

Labor and Environment

Perhaps the greatest challenge to the CAFTA-DR arose over concerns about the labor and environment chapters. It has become widely accepted that labor and environment provisions should be part of modern trade agreements. There is considerable 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.[55] 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, economists have argued that developing countries have a comparative advantage in labor costs consistent with the free trade model and studies suggest that these cost differentials are usually not high enough to determine business location alone—productivity remains the primary decision factor.[56] Further, many economists view trade liberalization as part of the overall development process that, in and off itself, can promote social change.[57] Developing countries are also

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[54] U.S. Congress. House of Representatives. Committee on Ways and Means. *Dominican Republic-Central America-United States Free Trade Agreement Implementation Act*. H.Rept. 109-182. pp. 50-51. 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 (name redacted).

[55] 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.

[56] 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 (name redacted). Productivity and wage levels are, however, highly correlated. See Rodrik, *Sense and Nonsense in the Globalization Debate*, pp. 30-33.

[57] 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.

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.

Labor Issues

The labor chapter proved to be the biggest point of contention in the CAFTA-DR debate, divided largely along party lines. The opening paragraph of the 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* as: (1) the freedom of association and the effective recognition of the right to collective bargaining; (2) the elimination of all forms of forced or compulsory labor; (3) the effective abolition of child labor; and (4) the elimination of discrimination in respect of employment and occupation.[58] Disagreement revolved around three issues. First, whether the CAFTA-DR countries had laws that complied with ILO basic principles. Second, the ability of these countries' to enforce their laws. Third, and most importantly, capacity of the CAFTA-DR Labor Chapter to compel legal compliance and enforcement of ILO fundamental principles.

CAFTA-DR Labor Laws and Enforcement

The Central American countries entered the debate early when they requested the ILO to 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 argument as to whether the CAFTA-DR countries guarantee core ILO principles.[59] Some interpreted the report to affirm that the CAFTA-DR countries' laws comply with internationally recognized labor standards. In response, Democratic Members of the House Ways and Means Committee pointed out deficiencies in many of their laws in a letter sent to the USTR's office. It identified 20 Central American laws that 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.[60]

In April 2005, with the assistance of the Inter-American Development Bank, the CAFTA-DR country ministers of trade and labor released a study of their countries' shortfalls in meeting and enforcing core labor principles. Although it documented that all countries had 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.[61]

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[58] Article 16.8 of the Labor Chapter also has 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."

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

[60] 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.

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

The debate over the adequacy of labor laws was not resolved to the satisfaction of any party, but there was little disagreement that labor law enforcement is an ongoing problem and that unionization is not widespread. The CAFTA-DR countries have admitted in their own report that many lack the financial resources and technical expertise to enforce adequately good labor practices, a problem that will also take time and resources to overcome.

Labor Provisions in TPA and the CAFTA-DR

The Labor Chapter in the CAFTA-DR defines certain labor standards for all member countries and the dispute settlement mechanism for arbitrating formal complaints against noncompliance. It closely follows language set out in Trade Promotion Authority (TPA) legislation on the principal negotiating objectives of the United States with respect to labor.[62] The USTR made note of this fact and further argued that the chapter goes beyond earlier FTAs through a Labor Cooperation and Capacity Building Mechanism that will support a mutual approach to improve working conditions in CAFTA-DR countries 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.

Critics charged, however, that the CAFTA-DR labor provisions were too weak because they give different weight to the following three provisions: (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).[63] The first provision, failure to enforce domestic labor laws, can be formally challenged in the dispute resolution process as defined in the CAFTA-DR. Dispute resolution is not available for the other two provisions, although they are supported in principle (Articles 16.2 and 16.6).

There was also concern over the differences between labor and other dispute settlement provisions. 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 is 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 is paid into a fund operated by the country in question and is to be expended for "appropriate labor initiatives."

An Enforceable Labor Chapter

U.S. labor advocates have charged that "the labor provisions of the CAFTA-DR will not protect the core rights of workers in any of the six countries participating in the agreement."[64] Many

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[62] The 2002 TPA vote itself was highly contentious in large part because of the disagreement over how the principal negotiating objectives with respect to labor were defined.

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

[64] LAC, ibid., p. 1.

Members of Congress concurred, believing that the "enforce your own laws" standard, as well as the limited dispute settlement provisions, would be ineffective at compelling countries to meet basic ILO standards. It was also argued that they are a step backward from the provisions allowing for the suspension of trade benefits found in U.S. unilateral preferential trade arrangements, such as the Caribbean Basin Initiative (CBI) and the Generalized System of Preferences (GSP). In these, the United States has the option to suspend trade benefits (reimpose tariffs) if a country does not comply with provisions of the agreement, including the labor section. Democrats cited a number of examples, including CAFTA-DR countries, where sanctions, or threats thereof, compelled changes in labor laws.[65] Further, capping the assessment in a labor dispute at $15 million and having the assessment paid into a fund in the offending country was seen as a largely ineffective mechanism for compliance.

Supporters of the Labor Chapter argued that the agreement encourages countries to improve their laws, making the "enforce your own laws" a meaningful standard, that the CBI option for trade sanctions is less appealing in a reciprocal free trade agreement where the United States is also subject to the discipline, and further, that trade sanctions are a "blunt" instrument, punishing all export workers whose products would come under the sanctions, potentially worsening their situation rather than improving it. It was also argued that sanctions have not been a widely used tool over the lives of the CBI and GSP programs, and to the contrary, that an annual $15 million fine per violation is a potentially significant deterrent for the CAFTA-DR countries. Finally, technical assistance, cooperation, and transparency were presented as more effective tools in the long run to bring about change in Central America.[66]

Only time will tell if the CAFTA-DR labor provisions provide support and possibly effective punitive responses to encourage deeper labor rights reforms in Central America. These provisions are similar to those found in other FTAs for which Congress passed implementing legislation, including Chile, Singapore, Morocco, and Australia (Jordan's labor provisions were different in some places). Many Members may have accepted that those countries had adequate labor laws, even if there were enforcement or other concerns. This perception was clearly lacking for the CAFTA-DR countries, despite efforts to make transparent their deficiencies and to correct some laws and enforcement problems. Hence, broader support was never reached in Congress over the adequacy of these provisions in the CAFTA-DR.[67]

Environmental Issues

Major goals included 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.[68]

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[65] See U.S. Congress. House of Representatives. Committee on Ways and Means. *Dominican Republic-Central America-United States Free Trade Agreement Implementation Act*. H.Rept. 109-182. pp. 47-50.

[66] Ibid., pp. 4-6. See also: Gresser, Edward. *The Progressive Case for CAFTA*. Progressive Policy Institute. Policy Brief. July 2005. pp. 4-6.

[67] Indeed, incorporating mandatory adherence to the ILO basic principles would later become standard language for the Peru, Panama, and Colombia bilateral FTAs.

[68] See http://www.sierraclub.org/trade/fasttrack/letter.asp, *Principles for Environmentally Responsible Trade.* Another (continued...)

The USTR argued that congressional objectives on environmental issues have been met in the proposed CAFTA-DR 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 agree to commit to establish high levels of environmental protection and to open proceedings in the administration and enforcement of laws and regulations.[69]

Advocates raised 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 were not the most contentious issues in the CAFTA-DR. 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 noted 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.[70]

The Trade and Environment Policy Advisory Committee supported most of the environment provisions in the CAFTA-DR and particularly the enhanced public participation process negotiated by the State Department in a 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 CAFTA-DR would be able to meet congressional objectives on capacity building without concrete funding for the program.[71] 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.

Dispute Resolution and Institutional Issues

The dispute resolution chapter was 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

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(...continued)

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 (name redacted).

[69] For more details on congressional interest in environmental provisions in trade agreements, see CRS Report RS21326, *Trade Promotion Authority: Environment Related Provisions of P.L. 107-210*, by (name redacted).

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

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

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 result 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 will be handled slightly differently (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 CAFTA-DR, the Central American countries were apprehensive over the possibility of being overwhelmed by the resource and experience advantage that the United States had to negotiate and comply with liberalized trade rules. Hence, the need for trade capacity building, which may be classified into three distinct areas beyond trade negotiation capabilities. First, the ability to identify priorities, including where the major adjustment costs (losers) are expected to be and how to respond to them. Second, the ability to develop resources to implement the agreement, including institutional, financial, and analytical resources. Third, the capacity to benefit from the CAFTA-DR.[72] The agreement created 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. 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.[73] 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).

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[72] 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.

[73] Ibid.

The CAFTA-DR includes a Committee on Trade Capacity Building to coordinate these types of activities. U.S. inter-agency funding in support of CAFTA-DR 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. This is also true for the trade capacity building efforts in specific non-commercial areas, such as enforcing labor and environmental commitments.

Appendix A. Chronology of CAFTA-DR 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 on CAFTA.
January 27, 2003	The first of nine 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 conclude in Washington, DC. Costa Rica requests further negotiation 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 CAFTA-DR agreement in Washington, D.C.
December 17, 2004	Salvadoran legislature ratifies the CAFTA-DR 49 to 35.
March 3, 2005	Honduran legislature ratifies the CAFTA-DR 100 to 28.
March 10, 2005	Guatemalan legislature ratifies the CAFTA-DR 126-12.
April 13, 2005	Senate Finance Committee holds hearing on CAFTA-DR.
April 21, 2005	House Ways and Means Committee holds hearing on CAFTA-DR.
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.

Date	Milestone
June 23, 2005	President Bush sends final text and required supporting documents of the CAFTA-DR 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, 25 to 16.
June 30, 2005	S. 1307 agreed to in the Senate, 54 to 45.
July 25, 2005	H.R. 3045 reported by the House Committee on Ways and Means (H.Rept. 109-182).
July 26, 2005	House Committee on Rules provides a closed rule for consideration of H.R. 3045 under which debate is limited to two hours and all points of order against consideration of H.R. 3045 are waived (H.Rept. 109-186).
July 28, 2005	H.R. 3045 agreed to in the House, 217 to 215.
July 28, 2005	Senate agrees to substitute H.R. 3045 for S. 1307, 56 to 44.
August 2, 2005	President Bush signs H.R. 3045 into law (P.L. 109-53; 119 Stat. 462)
September 6, 2005	Dominican Republic ratifies CAFTA-DR. Chamber of Deputies passes bill 118 to 4, Senate passed bill 27 to 3 on August 26.
October 9, 2005	Nicaraguan General Assembly ratifies CAFTA-DR by a vote of 49 to 37.
March 1, 2006	The United States implements CAFTA-DR for El Salvador.
April 1, 2006	The United States implements CAFTA-DR for Honduras and Nicaragua.
July 1, 2006	The United States implements CAFTA-DR for Guatemala.
March 1, 2007	The United States implements CAFTA-DR for the Dominican Republic.
October 7, 2007	Costa Rica referendum supports CAFTA-DR 51.6% to 48.4%.
January 1, 2009	The United States implements CAFTA-DR for Costa Rica.

Appendix B. 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 (%)[a]	3.0	0.2	0.8	2.7	-1.9	3.1
GDP Growth 1990-2002 (%)[a]	4.9	4.3	4.0	3.1	4.3	6.0
PPP Per Capita Gross National Income[b]	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 (%)[c]	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.

Note: 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.

a. Average annual percent growth.

b. 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.

c. Percentage of population living on $1 per day or less, most recent survey year.

Appendix C. U.S. Merchandise Trade with CAFTA-DR 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[a]	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[a]	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		

Country	1999	2000	2001	2002	2003	2004	% Change 2003-2004	% Change 1999-2004
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[a]	-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.

a. Latin America and the Caribbean, except Mexico.

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