Chapter III. The Content of DR-CAFTA: Implications for Market Access and Domestic Reforms

Abstract

This paper provides an abbreviated overview of the recently negotiated FTA between five Central American countries, the Dominican Republic, and the U.S. It evaluates whether provisions changed significantly market access and domestic regulations vis-à-vis the status quo in Central American countries. In market access, it finds that DR-CAFTA consolidates access terms gained by Central American nations through ongoing CBI preferences, eliminates remaining tariffs on a few sensitive goods in the U.S. and adds more flexibility to rules of origin, especially for the export of apparel. It also provides for a gradual opening of some sensitive agricultural markets in Central American economies, although long transition periods, safeguards and exemptions were obtained. The agreement includes chapters on services and some disciplines that most Central American countries had not included in previous trade negotiations, including intellectual property rights, government procurement, e-commerce, labor and environment. The inclusion of these new areas will exert an important lock-in effect of recent market-oriented reforms, and provide incentives to improve transparency and due process in public agencies. The multilateral application of the treaty’s disciplines among the Central American countries will also strengthen the regional integration process. In the case of Costa Rica, commitments will require significant legal changes that will allow private provision of some telecommunications and insurance services.
1. Introduction

After more than a decade of market reforms and significant advances in trade reforms, five nations of Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) embarked on negotiations for an FTA with the U.S. in early 2003. The outcome is DR-CAFTA, an agreement that was signed by the executive branches of all countries involved in August 2004 and is now in the midst of its ratification process in legislatures.¹

While the signature of an FTA with the U.S. is not a guaranteed path to sustained economic growth and prosperity, past experience suggests that it may play a fruitful role in two critical areas: improved market access and domestic reforms. The former is important because lowering trade barriers expands markets and increases trade flows that help resource allocation, specialization, economies of scale, technology transfer and overall economic dynamism. FTAs have also proven useful as a means of furthering policy and regulatory reforms in key areas and improving their credibility and permanence. For Central American nations, locking many of the reforms of recent years with an FTA that is costly to violate should generate a credibility effect that could boost investment levels.² Reforms that can have strong investment effects include trade liberalization, non discriminatory treatment of domestic and foreign investors, and removal of restrictions for private sector participation in most sectors of the economy.

This chapter presents an overview of the contents of the DR-CAFTA. While a detailed analysis of the final text and its implications falls outside of the scope of this chapter, it summarizes its most significant provisions and evaluates them from the point of view of their potential effect on market access, domestic regulations and institutions. The chapter attempts to provide preliminary answers to two sets of questions:

- **Expansion of market access**: Does the recently negotiated DR-CAFTA contain commitments to provide permanent and stable market access at least similar to that available to Central America exporters under CBI?³ Will it provide access to exports (i.e., relaxation of tariff and non tariff barriers, flexibilization of rules of origin) beyond that available to Central American countries under CBI provisions? Will it also remove trade barriers in the few remaining protected subsectors in Central America that have proven resistant to past efforts to reduce protection? A positive answer to this set of questions is likely to signify that DR-CAFTA would have the potential to increase trade flows, improve domestic resource allocation, and boost investment in new exporting ventures from Central America.

¹ As of this writing, DR-CAFTA has been formally ratified in El Salvador, Guatemala and Honduras.
² Trade agreements can effectively lock in domestic reforms if countries really value belonging to the agreement and if the credibility of the threat of action if rules are broken is high. From this point of view, a treaty with a developed country like the U.S. is likely to be most effective, as large trade flows are at stake.
³ There is some question whether the benchmark to evaluate market access commitments should be the unilateral preferences under CBI or an alternative such as U.S. most favored nation tariffs or tariff binding levels at the WTO. If a country were not to ratify DR-CAFTA, it is likely that its market access would be less favorable in relation to the existing CBI preferences, as has been relayed in press accounts of statements by members of the U.S. congress and officials of the executive branch.
• *Domestic reforms:* Do commitments included in the DR-CAFTA agreement effectively extend and/or lock-in the policy and regulatory reforms of recent years in Central American countries? Do they require significant additional changes? Do they require greater efforts in the enforcement of current regulations? A positive answer to this set of questions would suggest that DR-CAFTA will signal a strong commitment of Central American countries to consolidate and extend recent policy and regulatory reforms, and to their enforcement. While some countries in the region have already “locked in” some reforms through other international agreements, DR-CAFTA offers a chance for a higher credibility level of commitment that should yield a higher investment response.

This chapter is thus a summary of key commitments found in the DR-CAFTA text and deals with the topics of the agreement in the following order: market access in goods (agriculture, manufactures, apparel and textiles), services, other disciplines (i.e., investment protection, intellectual property rights, labor and environment, government procurement and other provisions) and the regional application of commitments. The main conclusions are drawn at the end.

2. Market access for goods

As a result of DR-CAFTA, duties affecting trade with the U.S. will be eliminated for virtually all goods. Due to strong sensitivities, some agricultural products were exempted from the eventual zero-duty status: sugar for entry into the U.S., white maize for entry into four Central American nations (El Salvador, Guatemala, Honduras and Nicaragua) and potatoes and onions into Costa Rica. While the bulk of tariffs will be removed upon implementation, some tariffs will be phased out gradually. Central America’s number of products with gradual phase-outs is significantly higher than that at the U.S. number.

**Agriculture**

CAFTA commitments in agriculture include the reciprocal elimination of all tariffs, with the only exceptions as described above. For Central American countries, this will consolidate the current access allowed under CBI legislation for Central American products and provide for some expansion of their zero duty access to a few new products that had been kept outside of the preferences. DR-CAFTA also includes reciprocal commitments from Central American countries to consolidate access to their agricultural markets to U.S. exports, eliminate tariff peaks and open further those sensitive sectors that still enjoy restrictions to imports.

**Market Access.** DR-CAFTA commits parties to eliminate tariffs for virtually all tariff lines, through tariff reductions, expansion of zero-tariff quotas and combinations of these two approaches. A separate schedule of commitments applies to each country, with El Salvador, Nicaragua...
Guatemala, Honduras and Nicaragua excluding white maize from tariff reduction obligations and Costa Rica excluding onions and potatoes.

Tariff Elimination. Tariffs are to be phased-out according to specific schedules negotiated on a product and country-specific basis (Table 1). Tariffs will be reduced within one of the following timeframes: immediate, 5 years, 10 years, 12 years or 15 years (18 years - 20 years for poultry parts, rice and dairy products). While most tariffs will be reduced in equal annual installments over the phase-out period, for specified sensitive products, tariff reductions will be back-loaded, with no cuts in the initial years of the phase-out period and larger cuts in the later years of the phase-out period. Central American producers obtained longer time periods for tariff phase outs as well as a greater share of the back-loaded phase out periods than the U.S.

**Table 1: Tariff Reduction Schedule for Sensitive Agricultural Products**

<table>
<thead>
<tr>
<th>Product</th>
<th>Guatemala</th>
<th>Honduras</th>
<th>El Salvador</th>
<th>Nicaragua</th>
<th>Costa Rica</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>IT (%)</td>
<td>PP (yrs)</td>
<td>GP (yrs)</td>
<td>IT (%)</td>
<td>PP (yrs)</td>
</tr>
<tr>
<td>Beef*</td>
<td>n/d</td>
<td>10</td>
<td>0</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Pork</td>
<td>15</td>
<td>15</td>
<td>0</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Poultry (leg quarters)</td>
<td>164.4</td>
<td>18</td>
<td>10</td>
<td>164.4</td>
<td>18</td>
</tr>
<tr>
<td>Dairy products</td>
<td>15</td>
<td>20</td>
<td>10</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Yellow maize</td>
<td>n/d</td>
<td>10</td>
<td>0</td>
<td>45</td>
<td>15</td>
</tr>
<tr>
<td>Beans</td>
<td>20</td>
<td>15</td>
<td>6</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Fresh potatoes</td>
<td>15</td>
<td>15</td>
<td>0</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Rice</td>
<td>29.2</td>
<td>18</td>
<td>10</td>
<td>40</td>
<td>18</td>
</tr>
<tr>
<td>Sorghum</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>15</td>
<td>15</td>
</tr>
</tbody>
</table>

* Beef products other than prime and choice cuts.

IT: initial tariff level; PP: phase-out period; GP: grace period; N/D: no data.

Tariff-Rate Quotas. For many sensitive products, immediate market access will be provided through the creation and gradual expansion of tariff-rate quotas (i.e., zero duty access for a specified quantity of imports). For example, Nicaragua will gradually increase TRQs in some sensitive U.S. products such as peanuts, peanut butter, beef and dairy products. Table 2 examines the TRQs obtained by Central America. For cases in which initial quotas account for relatively small shares of recent import volumes, significant changes in local market conditions should not be expected. For a few cases in which quotas are near 100 percent of local volumes or above, detailed analysis of specific commodity markets would be required that falls beyond the scope of this report. Such analysis would need to take into account the structure of the market, whether duty-free quota imports have been allowed in recent years (as in the case of several grains in El Salvador and Nicaragua) and whether performance requirements (see below) would apply in that market. Most quotas were agreed to grow at rates of between 2 percent and 5 percent, roughly at or below the rates of growth of the economies projected for the next decade.

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5 The exclusion of white maize was apparently motivated by the cultural importance and political sensitive of the crop, according to press accounts and interviews with negotiators.
### CHAPTER III. The Content of DR-CAFTA: Implications...

#### Table 2: Recent Imports (2003) vs. DR-CAFTA Quotas of Sensitive Agricultural Commodities

<table>
<thead>
<tr>
<th></th>
<th>Guatemala</th>
<th>Honduras</th>
<th>El Salvador</th>
<th>Nicaragua</th>
<th>Costa Rica</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Imports</td>
<td>Quota (% of local production)</td>
<td>Imports</td>
<td>Quota (% of local production)</td>
<td>Imports</td>
</tr>
<tr>
<td>Beef</td>
<td>9.5</td>
<td>15.0</td>
<td>3.2</td>
<td>No Quota</td>
<td>50.0</td>
</tr>
<tr>
<td>Pork</td>
<td>42.3</td>
<td>55.6</td>
<td>80.0</td>
<td>35.9</td>
<td>66.7</td>
</tr>
<tr>
<td>Poultry</td>
<td>18.7</td>
<td>21.3</td>
<td>7.5</td>
<td>84.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Potatoes</td>
<td>7.7</td>
<td>No Quota</td>
<td>110.5</td>
<td>0.0</td>
<td>233.3</td>
</tr>
<tr>
<td>Maize</td>
<td>59.4</td>
<td>87.3</td>
<td>65.3</td>
<td>84.4</td>
<td>63.8</td>
</tr>
<tr>
<td>Rice</td>
<td>275.6</td>
<td>84.0</td>
<td>1372.0</td>
<td>102.1</td>
<td>320.6</td>
</tr>
<tr>
<td>Milk</td>
<td>83.7</td>
<td>1.8</td>
<td>19.0</td>
<td>3.2</td>
<td>53.9</td>
</tr>
<tr>
<td>Butter</td>
<td>100.0</td>
<td>10.7</td>
<td>25.0</td>
<td>12.3</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Faostat (2004) and own calculations.

**Agricultural Safeguard.** DR-CAFTA includes a special agricultural safeguard to provide temporary protection against import surges of selected sensitive products. The safeguard is activated automatically if import quantities surpass pre-specified levels. If activated, an immediate tariff increase to pre-agreement (MFN) levels is allowed in the early years of implementation, and to gradually declining levels for the ulterior years. The agricultural safeguard cannot be in force for more than four years and can only be used once for most sensitive crops listed in the agreement during the transition period.6

**Sanitary and Phytosanitary Measures.** The parties agree to apply the science-based disciplines of the WTO Agreement on Sanitary and Phytosanitary (SPS) Measures. An SPS working group will expedite resolution of technical issues and contribute to the dissemination of the regulations and procedures applied in the U.S. but affecting agricultural and food products, which we believe can contribute to rural and national development in Central America. During negotiations, a working group on these matters aided Central Americans in resolving problems to meet standards required to enter the U.S. market and commitments were made for the continuation of technical assistance from U.S. sanitary and agriculture agencies.7

**Agricultural export subsidies.** Although much public attention was paid to large U.S. production and marketing subsidies during DR-CAFTA negotiations, no significant commitments were made by the U.S. in this area, consistent with its policy to negotiate this issue only in the context of global trade negotiations at the WTO. DR-CAFTA includes the

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6 The treaty specifies that these safeguards expire after tariff protection is phased out but allows for its extension, if all parties agree.

7 The U.S. is committed to resolve delays in food inspection procedures for meat and poultry products from Central America. Another example is the schedule that Honduras obtained from the U.S. for the resolution of sanitary issues that affect exports of poultry, dairy products, tomatoes and peppers, as well as technical assistance to strengthen institutions in the sanitary and phytosanitary area. Nicaragua is receiving help in solving sanitary and phytosanitary problems for exports of cheese, papaya, pitahaya, peppers and tomatoes. Costa Rica obtained guaranteed access of ornamental plants over eighteen inches in height, more flexible sanitary treatment for some of its flower exports. Progress was also made in the recognition of its poultry inspection system. These changes are expected to have significant impacts, e.g. in the case of Costa Rica’s ornamental plants, producers have estimated that this may increase their export earnings by 50 percent just by exporting taller rather than shorter plants.
commitment by all parties not to subsidize exports to each other’s market, except to compete with third party export subsidies.

Performance requirements. Imports of some sensitive products will be subject to performance requirements (e.g., agreements by importers to purchase a share of the local crop during the phase out period). This is the case of pork, rice, white and yellow corn in El Salvador, and rice in Costa Rica and Honduras.

Sugar. Although excluded from the final tariff elimination commitment by the U.S., DR-CAFTA includes a pledge to double the zero-tariff import quota of sugar from Central American nations, from 99,000 metric tons in the first year to about 140,000 over fifteen years (Table 3). While this keeps imports from the region below 1.7 percent of total U.S. consumption, it will provide greater revenues for Central American producers, who will be able to increase sales in the U.S., where import prices have been almost 200 percent above those prevailing elsewhere. The new market access will mean that Central American countries will double the share of current production that is exported to the U.S. from an average of less than 4 percent to about 8 percent.

Table 3: Sugar Imports to the U.S. from Central America

<table>
<thead>
<tr>
<th>Country</th>
<th>Avg. Imports 2000-2002</th>
<th>Additional Quotas Year 1</th>
<th>Year 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guatemala</td>
<td>58.9</td>
<td>32.0</td>
<td>49.8</td>
</tr>
<tr>
<td>El Salvador</td>
<td>30.5</td>
<td>24.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>17.8</td>
<td>22.0</td>
<td>28.2</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>15.8</td>
<td>13.0</td>
<td>15.8</td>
</tr>
<tr>
<td>Honduras</td>
<td>9.6</td>
<td>8.0</td>
<td>10.2</td>
</tr>
<tr>
<td>Total</td>
<td>132.6</td>
<td>99.0</td>
<td>140.0</td>
</tr>
</tbody>
</table>

Source: USTR.

Evaluation

In agriculture, DR-CAFTA provides significant gains in market access for all parties. It consolidates current CBI access to Central American exporters, introduces some flexibility to current non-tariff barriers and includes commitments to provide technical assistance in overcoming sanitary hurdles for nontraditional agricultural exports. The latter commitment is critically important for Central American producers interested in exporting into the U.S. market, as lack of adequate information and to effective procedures to remove these hurdles has been identified as a major obstacle to new exports in the past (Monge, Loria and González-Vega, 2003).

DR-CAFTA will also commit Central American countries to gradually eliminate remaining protection in products that had proven resistant to liberalization efforts in the past. Our

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8 Costa Rica’s quota includes 2,000 metric tons of organic sugar.
9 Article 3.15 of DR-CAFTA gives the U.S. the right to unilaterally compensate Central American exporters in lieu of allowing the quota obligations to enter duty free.
impression is that skillful negotiators on all sides achieved a delicate balance between pressures to prolong adjustment periods and provide safeguards for import-competing products and market access for Central America’s nontraditional agriculture. A comparison of the treatment afforded to Central American sensitive commodities with other U.S. free trade agreements suggests that they may have obtained comparatively the highest tariffs and longest periods, a likely result of the fact that agriculture accounts for a larger share of the economy and employment in Central America (Figure 1). This will benefit farmers and laborers engaged in the production of sensitive crops, but it will limit gains for consumers -- including the majority of the poor -- who will not see potentially more rapid declines in prices of key components of the food basket. While the exceptions granted in sugar, maize, potatoes and onions respond to strong political factors, they will impede trade and the most efficient deployment of resources in Central America and the U.S.

Figure 1: Weighted Tariffs for Sensitive Agricultural Items – U.S. FTAs: NAFTA, Chile and DR-CAFTA*

* Tariffs weighted by each sensitive item’s contribution to agricultural GDP.
Source: Tejada and Jaramillo (2005).

From the point of view of domestic reforms in Central American nations, DR-CAFTA provisions for the most part lock-in current agricultural trade policies, and in the future will

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10 See Arce and Jaramillo (2005) for a discussion of the significance of sensitive agricultural activities in rural employment and in the value added of overall agricultural output. They find that sensitive crops are very heterogenous on both counts. Corn (especially, white corn) is important for employment in Guatemala, Honduras and Nicaragua, but not too significant in El Salvador or Costa Rica. Beans are important in Honduras and Nicaragua, but of lesser relevance for employment and overall production elsewhere.
provide for greater liberalization by setting deadlines and firm commitments to move to freer trade for the bulk of agricultural goods.

On the issue of U.S. farm subsidies, it is unfortunate that no commitments were included in DR-CAFTA, as it is well known that these types of policies continue to create significant distortions in some key global markets (World Bank, 2002; Anderson, 2004). World Bank studies have shown that the elimination of these interventions would be favorable for the reduction of poverty on a global scale, mainly due to the positive effect on the income of farmers and farm laborers in countries with large exporting potential in activities such as grains, oilseeds, cotton and dairy products. However, these studies also warn that increasing food prices would represent welfare losses for consumers, and that food importing countries that have limited capacity to become exporters at low cost would lose from the removal of these subsidies (World Bank, 2002). Argentina and Brazil would be among the most likely winners in Latin America, while net food importers such as the small island nations of the Caribbean and some Central American countries would stand to lose from this policy change (De Ferrranti et al, 2005).

Manufactures

**Market access:** Commitments to include all manufactures in duty free commitments imply a consolidation and some improvement over CBI benefits for Central American countries. Tariffs will be eliminated for a few products that had been explicitly excluded from CBI preferences such as canned tuna, shoes, jewelry and hooks.

**Tariff elimination:** In contrast to agricultural goods, the vast majority of manufacturing tariffs will be eliminated upon entry into force of DR-CAFTA. There are some items that will undergo reductions in phase-out periods of 5 to 10 years. Once again, Central Americans placed more tariff lines in the gradual elimination categories, in response to considerations of so-called “asymmetries” between the U.S. and the developing countries of Central America. As a result, the U.S. will liberalize 99.8 percent of manufacturing products upon entry into force of DR-CAFTA, with only 19 Central American goods facing a 10 year gradual phase out of tariffs into the U.S. market. By contrast, about 80 percent of U.S. manufacturing exports will enter Central American countries duty free immediately. While 9 percent will be subject to a five year phase out, 9 percent to 10 years and 4 percent to a 12-15 year schedule. Transition periods were obtained by Central American negotiators for some sectors that asked for time to prepare for competition with the U.S. (e.g., beer, water, rum and wheat flour) as well as for some items that generate significant fiscal revenues (such as imports of vehicles for Honduras).

**Tariff-Rate Quotas.** Immediate market access for products included in phase-out categories is provided through the creation of tariff-rate quotas that grow in time.

**Rules of origin:** A large number of manufacturing products are subject to special rules of origin. While a careful evaluation of such provisions exceeds the scope of this chapter, DR-CAFTA takes, in general, a much more flexible approach than NAFTA (e.g., in the area of steel products, steel need not be produced in the region in order for the product to be a
qualifying good). Also, special provisions will allow for “co-production” arrangements, in which different stages of production of inputs or final goods can take place in the U.S. or Central American countries. The special case of apparel and textiles is treated separately, as complex rules of origin requirements have been the instrument of choice to maintain trade restrictions.

Safeguards: A safeguard provision is included to avoid the disruptive effects of sudden surges in imports. These safeguards can be invoked during the first 10 years of application of the treaty for manufactures (15 years for agricultural goods not subject to the special agricultural safeguard). The safeguard can be invoked as long as total imports of the product surpass current import levels by at least 3 percent, reinstating current tariff levels temporarily for up to four years.

Antidumping: DR-CAFTA allows countries to maintain their rights derived from the WTO’s Antidumping agreement. In addition, the U.S. vowed to continue to extend the preferential treatment afforded to Central American countries under CBI for antidumping investigations in the U.S.

Dealer agreements: DR-CAFTA includes commitments from four countries with existing dealer protection laws – Costa Rica, the Dominican Republic, El Salvador, and Honduras – to revise their legislation to eliminate compulsory exclusivity of distribution of imported products from the U.S.

Evaluation

DR-CAFTA consolidates and expands the access that Central American exporters enjoy today under CBI preferences for manufactures. From the point of view of Central American reforms, DR-CAFTA provisions for manufactures lock-in current trade policies and broaden them to apply to some sensitive items, after transition periods.

The elimination of all duties by all parties and the inclusion of products that had been excluded from CBI preferences should improve trade prospects and resource allocation. It is more difficult to evaluate the impact of the many sector-specific rules of origin. In some cases, these provisions are likely to continue to pose significant barriers of entry to the U.S. market, as has been shown by several Bank studies including “Lessons from NAFTA” (World Bank, 2005). In others, Central American negotiators obtained special treatment that should facilitate trade. Given the importance and complexity of the textile and apparel provisions, a review of changes in rules of origin is included below.

11 A special safeguard for the case of textile and apparel is also contemplated, although its use is restricted to the first five years after entry into force of the agreement.

12 Dealer protection laws have been a longstanding source of friction between U.S. exporters and some Central American nations, as they are perceived as locking foreign companies into costly exclusive and permanent relationships with local distributors, regardless of the latter’s performance. In some cases they have been used to ban imports of U.S. products when disputes have arisen with a local distributor, adding to perceived risks of trading in Central America.
Apparel and textiles ("Maquila")

In textiles and apparel, DR-CAFTA expands CBI treatment (as reflected in the Caribbean Basin Trade Partnership Act of 2000 known also as “NAFTA Parity”) by including some flexibility in the rules of origin that should allow zero duty entry to the U.S. for a broader set of products. A number of features of DR-CAFTA will facilitate goods to qualify for duty free treatment: unlimited use of regional inputs, flexible short supply lists, accumulation of origin with regional partners, exceptions for specific types of apparel, and temporary quotas for goods that do not need to meet strict rules of origin for Costa Rica and Nicaragua.

**Regional inputs.** DR-CAFTA provisions grant duty free treatment to apparel made from regional (knit or woven) fabric using yarn produced in the region (known as the yarn forward rule). This treatment contrasts with the latest CBI legislation (CBTPA approved in 2000) which had only allowed duty free and quota free treatment for goods made in Central America from U.S. inputs, and duty free entry for some goods that used regional fabrics and yarns but under quantitative restrictions.¹³

**Accumulation.** The treaty allows for the accumulation of origin from Mexico and Canada as well as the Central American parties to the agreement. This means that inputs from these countries will count as domestic inputs (those from Mexico and Canada subject to quantitative limits) for minimum content requirements.

**Short-supply.** A list of accepted “short-supply” inputs (those which can be sourced from third countries without losing the zero duty status) was expanded and the process to request inclusions of additional inputs to the list was streamlined.

**Exceptions for selected products.** Less restrictive rules of origin were negotiated for selected products such as bras, boxer shorts, pajamas and sleepwear, and textile luggage. For these products, the use of fabric made in third countries will be accepted as long as “substantial transformation” (i.e., cutting and sewing) takes place in a Central American country.

**De minimis.** The share of third party content that may be allowed in garments (known as the “de minimis” rule) was increased from the level currently applied under CBI (7 percent) to 10 percent in DR-CAFTA.

**Temporary quotas.** Two Central American countries obtained temporary quotas (known as TPLs) with less restrictive rules of origin. Nicaragua was awarded a temporary quota which exempts apparel exports from all rules of origin requirements.¹⁴ The quota amount is for 100 million square meters equivalent (about 75 percent of its current use of third party inputs) and will be in force for the first five years of the treaty, to be eliminated gradually during the following five years. Costa Rica also obtained a two year TPL for 500 thousand squared

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¹³ Only knit apparel was allowed under the regional inputs quota.
¹⁴ Press reports and interviews with negotiators revealed that the quota obtained by Nicaragua was awarded due to its low level of economic development and the incipient status of its maquila industry.
meter equivalent for woolen apparel that would enter the U.S. free from rules of origin restrictions at a tariff level equivalent to 50 percent of that applied for most favored nations.\textsuperscript{15}

In addition, liberalization commitments included in DR-CAFTA may be retroactive to January 1\textsuperscript{st} 2004 only for the case of textiles and apparel. This means that Central American exporters of these products will be able to obtain a refund for duties paid while DR-CAFTA is ratified by legislatures. The purpose of this concession is for Central American countries to begin to capitalize on DR-CAFTA immediately, attracting new investments and allowing some time for the industry to prepare for the upcoming end of the global textile quota regime in early 2005.

Of particular interest to the \textit{maquila} sector were the provisions related to export processing zones and duty drawbacks. DR-CAFTA provisions did not include commitments on significant changes to these instruments, aside from ratifying the need to comply with broader WTO obligations. For the higher income countries of Central America (Costa Rica, El Salvador and Guatemala), WTO pledges will require them to dismantle fiscal subsidies implicit in export processing schemes starting in 2009.

\textbf{Evaluation}

DR-CAFTA provisions on textile products effectively relax some of the current non tariff barriers implicit in rules of origin requirements that apparel and textile exports from Central America face under CBI. Once DR-CAFTA is ratified, Central American exporters will benefit from the most flexible set of market access conditions that any country enjoys into the U.S. for this sector. However, it should be said that access conditions are still restrictive in comparison to those granted in virtually all other sectors of manufacturing.

The new rules have been seen as a potential boom to regional suppliers of fabrics, yarns and other key inputs and may induce Central American exporters to forge new links with suppliers in Mexico and Canada. Given the dearth of regional supplies of textile inputs, DR-CAFTA provisions may contribute to attract the establishment of textile mills in the region. While all of this may favor exports of Central American apparel in the short run, it may also be extending implicitly the protection prevailing in U.S. markets to regional suppliers of inputs, which may not be necessarily competitive in world markets and could be subject to future adjustment costs in a sector where global liberalization trends are likely to continue. In the short run, the retroactive nature of the agreement and the flexibilization of rules of origin should allow firms based in Central American countries to gain an edge in a more competitive environment in the U.S. market as a result of the end of global quotas in 2005. In the medium and long run, strong competition and the likely erosion of trade preferences imply that countries will need to increase their productivity and rely on a sound overall investment climate to attract further investment in this sector.

\textsuperscript{15} This TPL could be extended beyond the original two years.
3. Services

In services, DR-CAFTA breaks new ground in the relationship between Central American countries and the U.S. since current CBI legislation did not contain significant commitments in most of the areas included in this chapter. In discussions and interviews with the authors of this report, policymakers and specialists from Central America have expressed optimism in the sense that these aspects of the treaty should boost the credibility of the reforms of recent years that opened provision of most services to private operators, including those from abroad.

DR-CAFTA includes commitments which apply to a long list of service sectors (exceptions are included in country-specific negative lists), including financial services, telecommunications, professional services, distribution, tourism, express delivery, computer and related services, audiovisual and entertainment, energy, transport, construction and engineering, advertising and environmental services. In addition, the agreement contains disciplines in the area of e-commerce, an area that most Central American countries had not included in previous FTAs. While a thorough evaluation of the implications for each one of these sectors is beyond the scope of this paper, this section provides a broad evaluation of implications for market access and domestic reform.

The commitments in services concentrate on securing the non-discrimination of firms from partner countries in market access and in the application of domestic regulations. Since all Central American countries and the U.S. currently grant broad non discrimination status between domestic and foreign firms for access to most domestic service markets, as well as non discrimination in their regulations, DR-CAFTA consolidates the status quo by locking-in the reforms undertaken in recent years to open sectors to private participation. Only for the notable case of Costa Rica, significant legislative reforms will be required in order to comply with obligations in the telecom and insurance markets (See Box 1).

In addition, DR-CAFTA spells out strong commitments to transparency in regulatory processes. Regulatory authorities are required to use open and transparent administrative procedures, consult with interested parties before issuing regulations, allow for comment periods for proposed rules, provide advance notice before the entry into force of new regulations, and publish all regulations. While several of these rules have been applied in Central American countries, for some countries and some service sectors, it will require significant upgrading in the process of consultation and application of regulatory decisions. However, these improvements in the transparency of regulations in Central American should contribute to strengthening the investment climate.

Some of the specific service sector commitments include:

- **Financial services (banking, insurance, securities):** Due to the complexities of the sector, a separate chapter in DR-CAFTA was negotiated to deal with financial services. The chapter centers on granting providers of these services non-discriminatory rights to establish branches, subsidiaries, and “sociedades anónimas” while preserving the right of domestic regulators to apply prudential measures to ensure the security and stability of the financial system. The chapter also includes provisions on transparency of domestic
regulatory regimes. U.S. based firms also gained the possibility of offering cross border services in areas such as financial information and data processing, and financial advisory services, while Central American mutual fund managers will be allowed to use foreign-based portfolio managers. For the case of insurance, Central American (except for Costa Rica) countries committed to allowing access through branches within four years. In addition, Central American countries opened their markets to U.S. based firms for the supply of insurance services on a cross border basis for a limited number of risks (e.g., reinsurance; reinsurance brokerage and marine, aviation and transport insurance).

- **Telecoms:** the agreement provides for non-discriminatory access for users to public telecom networks, providing the right to U.S. firms of interconnecting at nondiscriminatory, cost based rates (as in the Chile FTA). Commitments allow for current concession rights to private providers to continue until their expiration, such as Enitel in Nicaragua.

- **Professional services (architects, engineers, accountants):** An issue of debate during negotiations was temporary entry of professionals and procedures for assessing their qualifications. Some Central American nations pledged to remove some local residency requirements for the exercise of some services. The agreement includes reciprocal recognition of domestic procedures and institutions that grant degrees and authorization to exercise a profession.

- **E-commerce:** The agreement recognizes that services can be supplied through electronic means and binds the parties to uphold the non-discriminatory treatment of digital products (software, music, videos, text), not to impose customs duties on digital products and to cooperate on numerous policy areas related to e-commerce.

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16 The issue of the temporary entry of business employees was discussed during the negotiations but minimum annual visa numbers similar to those negotiated by the U.S. with Chile and Singapore were not agreed, due to strong opposition of these provisions in the U.S. Congress.
CHAPTER III. The Content of DR-CAFTA: Implications…

4. Other provisions

The remainder of the legal agreements of DR-CAFTA focus on commitments on disciplines that cover a wide range of issues, most of which Central American countries had not included in previous trade agreements. In this section we provide some summary observations of the content of each of them and evaluate them briefly for their potential for strengthening the credibility of domestic regulations.

**Investment protection**

DR-CAFTA grants reciprocal non-discriminatory rights to investors from signatory parties to establish, acquire and operate investments on an equal footing with local investors, unless specifically stated otherwise. The chapter deepens the commitments that Central American countries have made at the WTO and to one another in the area of investment protection. All forms of investment are protected under the agreement, including enterprises, debt, concessions, contracts and intellectual property. Investors receive protection under DR-CAFTA for due process as well as the right to receive a fair market value for property in the event of an expropriation. The agreement also includes impartial procedures for dispute settlement and explicit commitments to free and expeditious transfers of profits, subject to non-discriminatory domestic regulations on the financial sector and the protection of creditor rights.

**Evaluation**

This chapter of DR-CAFTA locks-in legal rights of U.S. investors which were already recognized by non-discrimination norms throughout Central America, and many of which had been locked in by Bilateral Investment Treaties that some of the countries had signed in

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**Box 1: Costa Rica’s commitments in telecoms and insurance**

Costa Rica did not open its telecommunications and insurance sectors to private competition in the 1990s, as most other countries in Latin America did, keeping both under the control of strong state-owned monopolies. An attempt to allow for competition in the provision of telecom services in the late 1990s was aborted due to strong public sentiment against the proposal. With DR-CAFTA, Costa Rica will commit to introduce competition to state agencies.

Telecommunications: Costa Rica pledged to undertake a partial and gradual opening of its telecom sector, specifically in three areas – private network services, Internet services, and wireless phone services. The process of opening will need to comply with the principles of “universality” and “solidarity” in the supply of these services, meaning that plans will need to be designed to facilitate inclusion of rural and disadvantaged segments of the population. Costa Rica committed to approve legislation for the modernization and strengthening of the local telecom company (originally by December 2004, although approval has been delayed), and to have in place modern regulatory norms and a regulatory authority by January 1st 2006. Private network services will be open to competition by January 1st 2006 while wireless services by January 1st 2007.

Insurance: Costa Rica also committed to allow private competition in its insurance market. The establishment of a modern regulatory framework, including a supervisory agency, is planned for 2007. The majority of the sector would be open by January 1st, 2008 with universal access to private providers in all lines of insurance by January 1st, 2011.
previous years with the U.S. Non discrimination, stable rules, and compensation for expropriation are important internationally recognized rights for investors. The consolidation of these rights should send a strong signal of improvement in the investment climate.

**Intellectual property rights**

DR-CAFTA provisions in the intellectual property rights chapter include commitments related to improving intellectual property rights (IPRs) protection and granting firms nondiscriminatory treatment. Three types of commitments are included. The first is the obligation to ratify a number of international agreements dealing with trademarks, patents, satellite TV, trademarks, newly developed plant varieties and other IPR issues. The second is the establishment of minimum standards for protection in the areas of brands, geographical indications, Internet domain names, author’s rights, satellite signals and patents – including the expansion of copyright protection from 50 to 70 years. The third is the application of procedures and resources for the enforcement of IPRs, including the criminalization of end user piracy. For the most part, commitments in this area imply obligations that apply generally, and not just to nationals of the signatory countries. Some of the key commitments include:

In the area of patents, significant obligations include the automatic extensions of patents in case of delays in processing of patenting submissions as well as non-disclosure of confidential and sensitive information used for patent purposes (i.e., test data and trade secrets) with terms of 5 years for pharmaceuticals and 10 years for chemicals. In the sensitive areas of pharmaceuticals, DR-CAFTA preserves the rights of governments to use compulsory licenses and parallel imports for pharmaceuticals, on any grounds (as provided by the TRIPS agreement) including for public health emergencies such as HIV-AIDS. In addition, no obligations were developed in relation to the patenting of diagnostic, therapeutic and surgical methods or for the recognition of patents for second uses of previously patented pharmaceutical products. However, difficult as it is to ascertain the overall costs and benefits of these IPR reforms, our view is that the previous two provisions should help reduce the risk of rising prices of medicines to deal with pressing public health concerns.

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18 The provisions protecting test data information for at least five years are perhaps the most ambiguous for us to evaluate a priori. On the one hand, allowing the use of test data for domestic production of medicines can reduce the prices of products not yet available in the U.S. On the other hand, there might be consumer and public-health gains to be had from restricting access to information that might lead to the production of products for yet unauthorized medicines. The existing empirical literature on IPRs is not detailed enough to answer this type of question.
CHAPTER III. The Content of DR-CAFTA: Implications…

Box 2: Controversies in protecting the rights of investors in FTAs

Some controversy has surrounded the chapters on investment protection in recent free trade agreements. While there is consensus that attracting investment and providing stable rules for investors are positive, critics hold that treaties give foreign investors excessive privileges. However, Central American countries have already incorporated these commitments in other FTAs and Bilateral Investment Treaties; hence, DR-CAFTA does not really impose “brand new” obligations to Central American countries. Some of the key controversies in this front include:

- **Investors’ rights and public interest.** Critics contend that FTAs extend rights to investors to use international arbitration panels to revoke local regulations, even if these are enacted for legitimate public interest objectives, including public health, safety and environmental protection. NAFTA’s Chapter 11 has been often criticized in this vein. DR-CAFTA’s Annex 10-C.4 (b) was drafted to address this issue by exempting most regulatory actions that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment from being deemed “indirect expropriations” – the source of most disputes in the NAFTA experience.

- **Dispute settlement.** Critics charge that the tribunals allowed under FTAs to resolve disputes allow investors to bypass domestic judiciary systems. However, the use of international panels has become commonplace for disputes with international investors, as local judiciaries have often been perceived as more easy to influence by domestic concerns. In response to criticism, newer FTAs (including DR-CAFTA) are including the creation of an appellate body to review decisions of individual panels.

- **Performance requirements.** Investments provisions explicitly prohibit governments from imposing requirements on foreign investment, such as commitments to export certain volumes, minimum usage of local inputs or compulsory technology transfer. Such requirements were commonplace in the past in many Latin American countries but were eliminated by the WTO’s Trade Related Investment Measures (TRIMs) agreement, which eliminates most performance requirements in the area of goods. DR-CAFTA introduces the prohibition of some performance requirements in services.

- **Destabilizing Capital Flows.** The U.S. has pressed in its FTAs for provisions that limit the ability of governments to curtail the movement of short-term capital flows. This has been subject to debate because speculative short-term outflows have been linked in the past to certain types of balance of payments crises. While the issue remains controversial, many studies suggest that monetary authorities should retain some powers to halt, even if temporarily, short term debt or investment flows to prevent herding behavior and macro destabilization. This issue has not been a strong concern in Central America, where significant flows of short term capital flows have not occurred.

Evaluation

DR-CAFTA commitments in the area of IPR are similar to those included in other recent U.S. free trade agreements and, similarly, go beyond several multilateral standards on intellectual property (Fink and Reichenmiller, 2005). These commitments will lock-in some recent upgrading to Central American IPR legislation but will also require significant modifications to legal frameworks, mainly through the adherence to a number of international treaties. Most importantly, DR-CAFTA will require more strict enforcement of IPR norms.

Enforcement of IPR might be important for two reasons. First, because complaints and disputes with holders of intellectual property rights (e.g., television broadcasters, owners of videos and compact disks, books) could send negative signals to investors about overall respect for the rule of law in the country and weakens the investment climate. Second,
because investors interested in development of important sectors (e.g., high technology, software, pharmaceuticals and agrochemicals) will look for environments where their rights are enforced in order to consider new ventures.\textsuperscript{19} With DR-CAFTA, non-compliance with IPR commitments will be subject to dispute settlement provisions which could eventually lead to monetary fines. Central American nations will need to improve their capacity to enforce IPR commitments, including substantial institutional strengthening of relevant agencies.

In controversial areas, such as the impact of more stringent standards (TRIPs plus) for protecting pharmaceutical patents, no methodologies have yet been developed to evaluate the welfare impacts of these types of commitments – especially if we consider gains from other aspects of the FTA. While greater IPR protection usually means restrictions on the use of generic drugs, the treaty seems to provide flexibility for governments to bypass the usual protections in order to protect public health, through compulsory licensing and the option of parallel imports.\textsuperscript{20}

\textbf{Labor and environment}

DR-CAFTA includes chapters on labor and environment, as mandated by the authorization given by the U.S. Congress to the executive branch. The inclusions of such provisions have generated heated public debate about whether they should be included in FTAs and whether they can be effectively used to improve standards in developing countries.\textsuperscript{21}

CAFTA commits all signatory countries to enforce current domestic labor and environmental laws and regulations. While respecting sovereign rights to modify its legislation in these areas, it bans the relaxation of labor or environmental regulations to encourage trade and investment. Obligations are subject to the dispute settlement provisions of the agreement and could eventually lead to monetary penalties (maximum of US$15m) which would then be used by the offending party to strengthen its enforcement capacity.\textsuperscript{22}

Parallel agreements were reached to establish a cooperative program to improve labor laws and enforcement, in cooperation with the International Labor Organization. The office of the U.S. Trade Representative has announced programs to build the capacity of Central American nations to monitor and enforce labor rights through specialized consultations and targeted

\textsuperscript{19} Fink and Maskus (2004) provide a comprehensive review of empirical evidence on the links between IPRs, trade, FDI and technology transfer.

\textsuperscript{20} Fink and Reichenmiller (2005) have highlighted the need to analyze further the difficulties that would be faced in granting compulsory licenses, related to regulatory permissions and test data exclusivity, as well as those associated with parallel imports.

\textsuperscript{21} Recent studies suggest that their inclusion is unnecessary as firms engaged in trade are those in which labor and environmental regulations tend to be followed (Stern, 2003).

\textsuperscript{22} For monetary penalties to be required, non-compliance needs to have an effect on trade or investment, and several stages of consultation and dialogue with labor and environmental authorities need to be exhausted before the dispute settlement rules can actually be activated. A contracting party will first need to require technical consultations in case of a complaint. If differences are not solved at that level, consultations can be elevated to the Environmental Affairs Council. If the complaint is not resolved at this level, the dispute resolution mechanisms can be activated, calling for arbitration by experts. If the panel of experts agrees with the complaint, governments can face monetary penalties for maximum of US$15m which would then be used by the offending party to strengthen its enforcement capacity.
training programs in the areas of child labor, public awareness of worker rights and labor inspection systems (USTR, 2004). DR-CAFTA includes an annex of Labor cooperation which defines cooperation priorities and financing. The U.S. committed $6.7 million for the first year to support to improve administrative capacity of the DR-CAFTA countries in labor matters.

The environmental chapter includes an environmental cooperation agreement that provides a framework for capacity building (including strengthening the capacity to develop, implement and enforce environmental laws) and establishes an Environmental Cooperation Commission. The agreement includes a commitment for frequent consultation mechanisms between the parties to evaluate compliance with DR-CAFTA obligations. The treaty goes beyond provisions included in the recent treaties between the U.S. and Chile and the U.S. and Singapore in allowing for a public submissions process to ensure that views of civil society are considered; envisions benchmarking of environmental cooperation activities and input from international organizations in evaluating progress; and enhances the mutual support of DR-CAFTA and multilateral environmental agreements (USTR, 2004). In addition, the agreement makes explicit reference to the right of member countries to protect and conserve genetic resources.\(^\text{23}\)

**Evaluation**

DR-CAFTA will in effect lock-in key features of current labor and environmental laws and regulations for the first time for most Central American countries through an international treaty.\(^\text{24}\) The obligations under DR-CAFTA are unlikely to require significant changes in current legislation but are likely to lead to pressures to upgrade enforcement, particularly in exporting sectors. While these sectors have been identified in the past as those in which labor and environmental regulations seem to be respected (Stern, 2003), overall institutional strengthening is likely to improve enforcement efforts in all areas of the economy. This should boost the investment climate by demonstrating a strong commitment to the rule of law. For the case of *maquilas*, labor provisions will be critical in addressing past criticism related to cases of violations of basic worker rights and should diminish pressure from sporadic international boycotts. Nonetheless, Central American countries will likely require resources and technical assistance to boost the enforcement of current norms, along the lines of the action plans included in the “White Book” drafted by Trade and Labor Ministers and supported by the ILO and other international organizations.

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\(^{23}\) See article 15.1.5.a of DR-CAFTA, which states that signatory parties understand that there are no contradictions with adherence to the 1991 UPOV treaty and the rights of countries with respect to protection and conservation of genetic resources.

\(^{24}\) Costa Rica included a parallel agreement on labor in its FTA discussions with Canada. The agreement also commits Costa Rica to uphold its legislation and prohibits relaxation to favor trade or investment. A parallel environmental agreement was also included with similar commitments.
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Government procurement and corruption

DR-CAFTA includes commitments for reciprocal non-discriminatory access of firms to public contracts, as well as commitments to improve transparency in procurement processes.25 The agreement gives access to Central American firms to markets for purchases by federal and state governments while U.S. firms gain access to bids on contracts from Central American government ministries, agencies and departments. Low value contracts are excluded and applicable thresholds vary by country. The agreement requires fair and transparent procurement procedures, such as advance notice of purchases and timely and effective bid review procedures. In addition, strict guidelines are spelled out for when governments can resort to procurement methods other than open bidding. Costa Rica will be able to keep its programs for bidding in favor of small and medium enterprises. DR-CAFTA commits signing parties to make bribery in government contracting a criminal offense.

Evaluation

DR-CAFTA locks in part of the reforms of recent years to government procurement norms. The importance of fair and transparent procedures in government procurement is self-evident. Despite substantial reforms in recent years, accusations of corruption, and lack of transparency in public purchases continue to plague Central American countries. DR-CAFTA will contribute to strengthening the trend towards the application of transparent and efficient procurement methods, and reducing avenues for corruption. It is likely to require some administrative changes in processes to boost transparency and reduce opportunities for corruption.

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25 Commitments do not apply to purchases financed by loans and donations, hiring of public sector employees or sales of companies under liquidation.
CHAPTER III. The Content of DR-CAFTA: Implications…

Box 3: DR-CAFTA and government procurement

DR-CAFTA requires that listed entities (e.g., central government agencies, autonomous enterprises, municipal governments) use specific procedures when the value of the procurement is above the agreed thresholds and commits governments to ensure the application of those procedures. The agreement contains basic disciplines on non-discrimination, transparency, and due process. These disciplines specifically refer to: Publication of notice of intended procurement, Time limits for the tendering process, Tender documentation, Technical specifications, Requirements and conditions for suppliers’ participation in procurement, Tendering procedures, Award of contracts, Information on awards, Non-disclosure of information.

DR-CAFTA also establishes the obligation of the Central American governments to have operational a domestic review and challenge mechanism. This is an impartial authority that acts to preserve the supplier’s opportunity to participate in procurement and to ensure that governments comply with their implementing measures. These measures require an effective procedure by which interested parties can bring complaints, initially, to the head of the procuring entity and, in the second instance, to the responsible manager in government for public procurement to take administrative remedies to correct violations of the regulations.

In addition DR-CAFTA incorporates specific commitments on non-discriminatory market access (foreign suppliers of goods and services must be allowed the same treatment as domestic suppliers). DR-CAFTA’s scope is limited to the entities listed in the agreement’s annexes, including entities at the central, local and decentralized level when applying national budget funds. For example, in the case of Honduras, the rules apply to 169 government entities:

**Honduran Entities subject to DR-CAFTA Requirements**

<table>
<thead>
<tr>
<th>Central level</th>
<th>Municipalities</th>
<th>Other Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>142</td>
<td>11</td>
</tr>
</tbody>
</table>

The agreement establishes that where the value of the procurement is estimated to equal or exceed agreed threshold levels DR-CAFTA rules shall be applied. DR-CAFTA allows higher thresholds for the Central American countries for the first three years of the agreement; thereafter, all DR-CAFTA countries, including the U.S., will have the same thresholds. For the specific case of Honduras, DR-CAFTA will require modifications in national legislation, as all these thresholds differ substantially from those currently valid.

**CAFTA’s Thresholds for Goods and Services by Level of Administration (US$)**

<table>
<thead>
<tr>
<th></th>
<th>Federal Level</th>
<th>Sub-Federal Level</th>
<th>Other Entities</th>
<th>For Construction Services. All levels</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Level</td>
<td>= $&gt;58,550</td>
<td>= $&gt;477,000</td>
<td>= $&gt;250,000</td>
<td>= $&gt;6,725,000</td>
</tr>
<tr>
<td></td>
<td>= $&gt;117,100 *</td>
<td>= $&gt;650,000 *</td>
<td>= $&gt;538,000 *</td>
<td>= $&gt;8,000,000 *</td>
</tr>
</tbody>
</table>

* For Central American Countries for a 3-year-period.
1 For specified U.S. entities

DR-CAFTA also incorporates a provision for “Ensuring Integrity in Procurement Practices.” This provision establishes that each party shall have and maintain systems that list each entity that is ineligible to participate in procurement because it has engaged in past fraudulent or other illegal actions. The agreement also provides for the exchange of this information with other DR-CAFTA members. To comply with this obligation, Central American countries will have to create a database of suppliers disqualified by national procuring entities.

**Source:** DR-CAFTA text and World Bank, Honduras CPAR (2004).
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Customs

DR-CAFTA includes obligations aimed at strengthening, improving and modernizing the operation of customs in order to facilitate trade among signatory parties. Provisions seek to facilitate customs procedures and reduce room for discretion. It includes rules of origin that are designed to be easier to administer. It also requires transparency, procedural certainty and efficiency in administering customs procedures, including DR-CAFTA rules of origin. Central American countries committed to a list of actions within three years to accomplish goals such as the publication of all norms and regulations in the Internet, the automatization of the clearance procedures, the electronic presentation of certificates of origin and the implementation of management and risk evaluation systems. All signatories also agreed to share information to combat illegal trans-shipment of goods. A program of technical assistance was agreed to support Central American countries in carrying out their commitments in this area.

Evaluation

Customs related issues have posed significant barriers to trade in Central America, due to complex and lengthy procedures, inefficiencies and opportunities for fraud and corruption. In many surveys conducted among private sector firms, complaints against customs procedures and officials usually top the list. The clarifications and simplifications of some procedures with respect to verifying rules of origin are of value but unlikely to be enough to end deep seated problems. Central American nations will need to push ahead with strong reforms (independent of DR-CAFTA) if they are to reap the full benefits of trade for development.

Dispute settlement

DR-CAFTA provides for all core obligations to be subject to a bilateral dispute settlement panel with high standards for openness and transparency. It includes monetary penalties to enforce commercial, labor and environmental obligations.

Evaluation

The dispute settlement section of any FTA is where key incentives are laid out for parties to get serious about compliance with provisions and strengthening domestic norms and institutions. DR-CAFTA sets appropriately high standards for openness and transparency in settlement procedures. While monetary penalties were included - a first for any FTA signed by Central American countries – they would only be used after long consultation periods and tests for non compliance. For Central American countries, having a reciprocal dispute settlement mechanism is a significant gain with respect to the CBI regime, in which no recourse was provided to unilateral actions by the U.S.

Trade capacity building

The agreement includes a Committee on Trade Capacity Building for the first time for any FTA involving the U.S. or any of the Central American nations. Also the creation of the
Institute for Trade Capacity Building, in New Orleans, which will focus on developing capacity for support programs for small and medium enterprises. In addition, a coalition of U.S. companies came together to support the creation and strengthening of trade capacity in Central America.

**Evaluation**

While it is too early to evaluate results of these provisions that have not been included in other U.S. free trade agreements, the Committee could be of use for the coordination of actions by donors, NGOs and the private sector for the improvement of institutional capacity, adjustment to new liberalization commitments and sensitive enforcement challenges.

**5. Provisions to deepen regional integration**

Central American countries took a momentous decision in making DR-CAFTA a treaty that would be applied multilaterally. Initially, it was thought that the treaty would be so markedly different to the norms that have governed trade among Central American Common Market members – aside from including many areas that are not included in that agreement – that it would only apply bilaterally between the U.S. and each Central American member, in what is known in the literature as the classic “hub-and-spoke” model. However, during negotiations it was agreed that the treaty’s commitments would be applied to trade and investment relations among all parties, including the Dominican Republic, as reflected in the agreement’s Article 1.1. This important decision should have great impact in a number of areas, most significantly in facilitating further trade and deepening regional integration efforts.

The multilateral application of DR-CAFTA will make more goods qualify for free trade between Central American countries than current norms.\(^{26}\) Under DR-CAFTA all goods made with inputs from any of the parties of the agreement will qualify as meeting the rules of origin – in the Central American Common Market regime, input accumulation was not possible and inputs from the U.S. or the D.R. could not count towards meeting origin rules. In addition, DR-CAFTA disciplines will allow free trade in goods produced in Export Processing Zones, as long as they meet origin requirements. As pointed out by González (2005), firms will enjoy an expanded set of input sourcing options when producing for exports to DR-CAFTA members, reducing the distortions that are created by the existence of multiple parallel FTAs. However, to avoid confusion, it may be important to modernize some of the existing Central American instruments which are not superseded by DR-CAFTA, in order to ensure that they are consistent with the treaty and more up to date with recent international trends.

In addition, DR-CAFTA will not contribute to the “spaghetti bowl” syndrome associated with the administration of multiple treaties, particularly costly in terms of the administration of multiple sets of complex rules of origin regulations. Instead, it is likely to foster an atmosphere conducive to finalizing steps for a Customs Union between CACM members, a task which only requires a few additional administrative steps to ensure that imports into the

\(^{26}\) Some of the arguments presented here draw from the excellent analysis of the application of DR-CAFTA among Central American countries and the Dominican Republic of González (2005).
region can stop only once at the port of entry into the region, and then proceed to move freely across the region’s borders.27

Multilateral application of DR-CAFTA also deepens regional integration efforts. The over forty years of history in such efforts among Central American nations had yielded a very advanced set of rules for trade in goods. Yet virtually no legal instruments exist for applying a common set of norms among Central American countries in the other areas of commitments included in DR-CAFTA.28 DR-CAFTA will now provide modern rules and disciplines for relations among Central American countries and the Dominican Republic in the areas of trade in services, investment protection, and government procurement – including financial services, telecoms and e-commerce.29 Moreover, it will allow the use of dispute settlement mechanisms in novel areas such as IPR, labor and environment. The new regional rules and disciplines are likely to strengthen regional ties and set the stage for even deeper integration efforts among Central American countries and the Dominican Republic in the future.

6. Conclusions

This chapter provides an overview of the recently negotiated DR-CAFTA, concentrating on the extent to which the agreement’s provisions would significantly change market access for Central American goods and services, and also on how far they could be expected to consolidate prior reforms and/or spur further domestic reforms in Central American countries. The overall assessment presented in the chapter is that, on both fronts, the answers are broadly positive, suggesting that DR-CAFTA should be expected to have a positive impact on trade flows and investment.

On market access, DR-CAFTA would consolidate and expand the current generous access that Central Americans currently enjoy to the U.S. market, while extending broadly reciprocal access for U.S. goods to their own markets. The benefits offered under the CBI would be locked in for Central American countries, and some additional permanent duty free access would be obtained for goods that had been previously exempted from CBI preferences. Other significant results would include the flexibilization of rules of origin for textiles and apparel, as well as commitments to help producers meet sanitary and phytosanitary standards required for the entry into the U.S. of promising non traditional agricultural exports. DR-CAFTA also includes reciprocal commitments on access to service markets, which consolidate domestic reforms that opened most of these markets to private participation in recent years.

Central American countries also agreed to grant reciprocal tariff-free access to their markets to U.S. products. Certain sensitive agricultural crops would be subject to extended transition periods (up to 20 years), in order to allow for gradual adjustment and to respond to domestic

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27 Arrangements would need to be made during the transition period to free trade for different tariff phase-out periods and for the specific country commitments that were made for tariff rate quotas in sensitive goods.
28 Negotiations in recent years among Central American countries had yielded general texts for draft treaties on Investment and Services and on Government Procurement. Detailed country-specific annexes were still under negotiation when DR-CAFTA discussions started.
29 In government procurement, Central American countries applied much stronger commitments to each other than they allowed with the U.S., by eliminating minimum thresholds or exemptions to any government agency in purchases of goods or services (González, 2005).
sensitivities. Central American countries secured access to flexible safeguard mechanisms to prevent sudden surges in imports or declines in prices.

Commitments embedded in DR-CAFTA would gradually erode current protection levels for various products that have retained high protection in Central American economies, during earlier efforts at easing trade restrictions in the past. The gradual decline expected in prices of basic food staples as a result should prove positive for the vast majority of Central Americans who are net consumers of such goods and whose welfare will be increased by lower prices. This said, not all sensitive products are included, in response to cultural and political factors, and these limitations – together with the agreement’s still excessively restrictive rules of origin for the entry of textile products to the U.S. – represent barriers to trade that will continue to foster some inefficiencies in the deployment of domestic resources both in the U.S. and Central America.

On the questions related to domestic reforms, DR-CAFTA commitments promise to lock in a number of the policy and regulatory changes implemented in recent years for the opening of competition in previously protected sectors (e.g., telecoms, financial services, energy) and the modernization of key norms and procedures in areas such as government procurement, intellectual property rights and the treatment of foreign investment, by locking in current levels of access of investors (and bidders) from the U.S.

Costa Rica is the only country that will be required to make significant legislative changes to adapt policies and regulations to its commitments under DR-CAFTA, allowing access to significant portions of its telecom and insurance markets. These reforms had been long postponed and should further foster the modernization, efficiency and competitiveness of these areas of the Costa Rican economy.

Aside from consolidating and spurring further reforms, the treaty should strengthen commitments to upgrade enforcement levels of domestic legislation. This represents a significant challenge in areas like labor, environment and intellectual property rights, which will require decisive efforts and resources to modernize and boost the capacity of public agencies. The net impact of these efforts should be positive, as investment is likely to be attracted to environments with effective institutions. However, while DR-CAFTA will put pressure on the modernization of these institutions, it will not by itself create such modernization. Countries will need strong independent plans of action and sufficient dedication of implementation capacity and resources.

The agreement includes cooperation accords to boost standards and enforcement levels in areas such as labor, environment, customs and other areas. It also offers proposals to develop further cooperation and “trade capacity building”, which should aid in the mobilization of human and financial resources required for key reforms and institutional actions required to implement the agreement and the broader developmental challenges.

Finally, a welcome side effect of the negotiation of DR-CAFTA has been the advancement of regional integration efforts. The decision to make the provisions of the agreement apply multilaterally among Central American countries and the Dominican Republic will deepen
regional integration efforts in the region and facilitate the creation of a Central American Customs Union.