What CAFTA Will Mean for Business and Trade in the Americas

By Chandri Navarro-Bowman and Melanie A. Frank

The U.S.–Dominican Republic–Central American Free Trade Agreement (DR-CAFTA or CAFTA), once fully implemented, will establish a free trade zone within seven signatory countries, including the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic. The agreement eliminates import tariffs on a significant number of manufactured and agricultural goods, provides open markets in areas such as government procurement and trade in services, and establishes enforcement rules in intellectual property, investment, labor, and the environment. One of the most important aspects will be drastic changes in customs procedures, which will become more transparent and predictable. Implementation of the agreement has been stalled for certain countries, and those gaps in implementation have created significant problems for producers and traders in Central America and the United States.

Status of Implementation

The original deadline for CAFTA implementation was January 1, 2006, but to date the United States has implemented the agreement with only four of the six countries: El Salvador, Honduras, Nicaragua, and most recently, Guatemala. The agreement now has the force of law between these parties.

Prospects for implementation with Costa Rica look good despite the fact that it has not yet ratified the agreement, a necessary step before implementation can proceed. The former president, Abel Pacheco, insisted that the unicameral legislative assembly enact his fiscal reform legislation before even debating CAFTA. Oscar Arias, who became president in May 2006, is a CAFTA supporter, however, and Costa Rica is expected to ratify the agreement in the near future.

Implementation of CAFTA in the Dominican Republic faces political resistance. In particular, Dominican farmers have pressured their government to negotiate compensation for them. At the same time, the United States has pressed the country to establish greater protection for intellectual property rights and to pass liberalizing government procurement legislation. These obstacles may delay implementation with the Dominican Republic for some time.

This fractured or "rolling implementation" is causing significant complications, as countries lose prior benefits under preference programs but cannot take full advantage of CAFTA benefits. Once a party implements CAFTA, it loses its duty-free benefits under the Generalized System of Preferences (GSP) and the Caribbean Basin Trade Partnership Act (CBTPA), which provide preferential import tariff treatment for goods that meet certain origin rules. This affects countries that have signed CAFTA and source their inputs from multiple countries in Central America because countries that have not implemented the agreement are considered nonparties. Products made in CAFTA countries that have implemented the agreement *with materials from* nonparty countries do not qualify for duty-free status under CAFTA or CBTPA. For purposes of that rule, it does not matter that current nonparties have negotiated CAFTA and will soon be parties.

Consequently, countries that implemented first are at a disadvantage to those who implement later. A stark example of this involves dyed thread. In March 2005, when the United States implemented CAFTA with El Salvador, apparel producers regularly sourced their thread from Honduras. Honduras did not implement the agreement until March 31, 2006. Thus, during the 13 months between March 1, 2005, and March 31, 2006, dyed thread from Honduras used in Salvadoran apparel was subject to tariffs between 8 and 32 percent. Prior to that time, such apparel from El Salvador had received duty-free treatment in the United States under CBTPA. In fact, much of the thread that comes through Central America is dyed or produced in the Dominican Republic or Costa Rica, where CAFTA is still awaiting final implementation. Consequently, a significant quantity of apparel that had previously been duty-free in the United States is now subject to duties. Obviously, this was not the intent of the agreement, and the U.S. trade representative (USTR) sought legislation to apply the duty-free status retroac-

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tively to cover all goods entered during the period of rolling implementation. This legislation was passed in August 2006; however, there was much confusion and disruption during the gap period, while companies were forced to start paying duties on goods that had previously received duty-free treatment.

Industry and government officials have noted that 99 percent of the problems with CAFTA involved textile and apparel imports. In a March 2006 interview with *Inside U.S. Trade*, a retail textile and apparel source stressed that this situation "is just one big 'don't do business in Central America' advertisement." The source warned that these complications were already causing trade to migrate from Central America to Asia. Indeed, in the first quarter of 2006, U.S. imports of CAFTA-region textiles were down by more than 15 percent from the same period in 2005. At the same time, other important industry issues were stalling implementation. For example, to pass CAFTA through Congress, USTR Rob Portman agreed to negotiate side agreements with the other parties to protect the U.S. pocketing industry. To secure greater protections for the lining and pocketing industries, the United States offered each country certain concessions, including specific changes to rules of origin. Other industries in the United States and Central America then sought similar protections, and any new changes would have to apply to all signatory countries.

Many agreed that new legislation was needed to fix these complex problems, but industry and congressional observers speculated that, with the upcoming November 2006 elections and remaining implementation issues, Congress would not pass any CAFTA amendments before 2007. However, in August 2006, Congress passed legislation that resolved most of the significant problems. Notably, Congress granted new proclamation authority to the president to make changes to the textile and apparel rules of origin, an authority that had been expressly omitted from the original implementing legislation. As a result of this legislative fix, in the coming months, companies who paid duties due to CAFTA implementation-related problems should have an opportunity to seek refunds of those amounts.

A similar issue exists with regard to Haiti and the Dominican Republic. Haiti is eligible for CBTPA duty-free treatment but is not a signatory to CAFTA. As a result, products originating in Haiti would continue to be eligible for CBTPA benefits, but upon implementation with the Dominican Republic those goods originating in the Dominican Republic containing inputs from Haiti would lose duty-free benefits. The Bush administration attempted to resolve the problem through a side letter to CAFTA in which the administration committed to work with Congress to amend the CBTPA to allow products jointly produced in a party and a CBTPA country to remain eligible for benefits. However, this has not yet happened. The CBTPA was not addressed in the August 2006 legislation, and this issue continues to present problems for producers who source inputs from Haiti or other nonparty CBTPA countries.

Overview of CAFTA

Once CAFTA is fully implemented, it will have a significant impact on trading practices between the United States and Central American countries. As a basic matter, CAFTA is intended to create a free trade zone for the signatory countries. The signatory countries have committed to eliminating tariffs on goods and services over a 20-year period. In addition, the agreement sets some ground rules on other issues, such as labor and environmental standards, intellectual property, government procurement, investment, trade in services, electronic commerce, sanitary and phytosanitary measures, and trade remedies. The parties also established major procedural changes, such as advancements in customs administration and transparency, capacity building, and dispute settlement procedures. Below are some of the key changes that will come from the agreement:

Tariff elimination. Duties on most industrial and consumer goods will be eliminated when CAFTA enters into force. Duties on other goods will be phased out over periods of up to ten years, although some agricultural goods will have longer periods for elimination of duties. In some cases, agriculture products may be subject to tariff rate quotas. The agreement provides that the parties may later agree to speed up tariff phase-outs on a product-specific basis, which would need to be negotiated by the signatories with likely involvement from industry. In addition, the agreement allows for temporary duty-free entry of certain items, such as professional equipment, display goods, and commercial samples.

Better customs procedures. Exporters and importers in the region often deal with inconsistent and unclear rules and arbitrary clearance procedures, which lead to delays in shipments and unnecessary costs. For example, in the past, U.S. exporters could not interact with Central American customs authorities prior to shipment. Under CAFTA, U.S. exporters will be able to obtain binding advance rulings on tariff classification, origin determinations, and other customs questions. In addition, governments must publish their customs laws on the Internet, and all customs fees on imports and exports will be limited to only the cost of services rendered. U.S. companies will have rights to regulatory and judicial review of customs decisions in Central American countries.

Another important change is that U.S. exporters will no longer be required to sell goods and services through a local dealer but instead be able to sell directly to mer-

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chants and consumers throughout the region, eliminating an inefficient cost of doing business.

Big advancements also will be made regarding customs treatment of express delivery services. Within one year of the effective date of CAFTA, Central American governments must provide a separate expedited procedure for express shipments, and such shipments will be able to clear customs prior to the arrival of the actual shipment. Most importantly, for the first time, the signatory countries will be required to clear express shipments from the port within *six hours* of submission of all necessary documents.

These customs-related obligations will phase in over three years. Already the countries are working together to harmonize documentation and procedures with electronic transmission of customs data and electronic payment of fees and tariffs.

Open markets for U.S. services. CAFTA will provide new access to sectors such as telecommunications, express delivery, computer services, energy, tourism, construction, transport, environmental, energy, financial services, and professional services.

Access to open and fair government procurement. As a result of CAFTA, Central American countries will be able to purchase U.S. goods, services, and technology in government procurement contracts without having to satisfy domestic sourcing requirements (and vice versa). Under the new rules, Central American governments must give advance public notice of all procurement opportunities. In addition, the agreement provides anti-corruption measures in government contracting so that all companies can be assured a fair and open process.

Investment. At the outset, CAFTA will establish specific protections for U.S. investors in the region. Parties will work further to develop an appellate mechanism for resolving investor-state disputes.

Labor rights and environmental protections. CAFTA requires merely that the signatory countries enforce their existing protections for workers and participate in arbitration over disputes. The U.S. administration sees this as key because in the past such rights were not always enforced. Critics argue that this mechanism provides a lower incentive to protect workers than CBTPA, under which duty-free access was tied to compliance with labor standards. There also will be a first-ever citizen participation process to resolve trade-related environmental issues. Under the agreement, citizens will be able to file a complaint with the CAFTA Secretariat if they find a party not in compliance.

Enforcement of intellectual property rights. CAFTA requires the parties to comply with a variety of international trade agreements regarding intellectual property (for example, World Intellectual Property Organization treaties, the World Trade Organization (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights, and WTO most-favored-nation provisions) within specified timetables. The agreement also sets out specific rules regarding protection of trademarks, copyrights, and patents and creates enforcement provisions that carry high monetary penalties for intellectual property violations.

Where Do We Go from Here?

Together, Central America and the Dominican Republic form the second largest U.S. export market in Latin America, surpassed only by Mexico. The region is the tenth largest U.S. export market in the world.

With its significant tariff reductions for manufactured products, CAFTA is intended to provide new market access opportunities for a number of U.S. sectors, including producers of chemicals, plastics, cosmetics, textiles, fertilizer, construction equipment and building supplies, information technology, medical equipment, industrial machinery, environmental technologies, electrical power generation and distribution equipment, and automotive parts and equipment. These market access commitments were negotiated to take advantage of the growing consumer markets for such products in Central America. For example, construction for tourism, housing, shopping, and industry are thriving in Central America. U.S. producers already are shipping these items to the region, and the demand for all of the products covered by CAFTA is expected to increase significantly. U.S. producers also will have new access to government procurement and services opportunities in Central America and will have protections over investments and intellectual property in the region.

Small and medium-sized U.S. companies will see particular benefits under CAFTA. The elimination of tariffs, new transparency in customs procedures, and reduction of regulatory red tape will open the door for more profitable, reliable exports to the region.

Markets for U.S. farmers and ranchers also will be expanded, as more than half of the current U.S. farm exports to Central America and the Dominican Republic will become duty-free immediately, a change affecting products such as high-quality cuts of beef, soybeans, cotton, wheat, fruits and vegetables, and processed food products. The American Farm Bureau Federation estimates that CAFTA could expand U.S. farm exports by $1.5 billion each year.

With respect to imports, consumer industries and retailers will continue to benefit from the free trade region with the certainty that a free trade agreement brings—duty-free treatment in perpetuity that is not subject to the political whims of future administrations and legislatures. However, most do not expect a significant increase in

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imports because many products from the region already have been subject to duty-free treatment under the GSP and CBTPA programs. To take advantage of the new CAFTA duty preferences, importers will need to be aware of the new documentation requirements including, for example, the very specific and sometimes complex "rules of origin." Importers also will have better assurance that they are buying from a region with enforceable labor laws and environmental protections. In addition, under CAFTA the United States will be granting refunds of duties paid for many textile goods that previously entered the United States from countries that have implemented the agreement. Importers who may be eligible for these refunds should act promptly in order to comply with U.S. regulatory deadlines. Further, for future shipments, U.S. import processing fees will be reduced in many cases. Producers and retailers alike should plan for these changes in duty rates and levels of trade.

Overall, CAFTA will change the landscape for trade between the United States and Central America as it creates increased transparency in customs procedures, eliminates corruption in customs regulation and in government contracts, allows for effective enforcement of intellectual property rights, and provides protections for U.S. investors in the region. U.S. and Central American businesses should take advantage of these changes. ✦

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