CAFTA: Few Benefits, Many Costs

By Vincent McElhinny | January 29, 2004, revised February 20, 2004

The U.S.-Central American Free Trade Agreement (CAFTA) is the first subregional trade agreement of its kind. Trade between the U.S. and Central America is about $13.4 billion per year.[1] The U.S. is the region's most important trading partner, about 40-50% of Central American exports go to the United States. CAFTA is the first agreement between such highly asymmetric trading partners. The agreement will not take effect until the U.S. Congress signals its approval—which is by no means certain.

Finalized in late January, CAFTA includes Guatemala, Honduras, El Salvador, and Nicaragua. During the final week of negotiations in last January, Costa Rica withdrew from the trade agreement in the face of continuing U.S. demands that it open its telecommunications and insurance sectors to U.S. investors. The negotiations, which had been scheduled to end in December 2003, were extended into 2004 in an attempt to resolve differences with Costa Rica. After realizing that Guatemala had negotiated terms that were inferior to its neighbors, Guatemalan negotiators also returned to Washington in January to correct these imbalances, hoping in the words of lead negotiator Guido Rodas, that the agreement was not "carved in stone."

Although progress toward the liberalization of 80% of all goods and services had been made prior to the Washington round, major disputes threatened the outcome of CAFTA in the areas of agriculture, textiles and apparel, and labor & environmental rules. Other issues of significance included the absence of a major new offer of trade capacity building assistance and a weakened foundation of regional integration and democracy after a year of secretive and divisive negotiations.

In nearly every major area of concern to the development potential of the region, the Central Americans ended up ceding tremendous ground from their initial proposals. Moreover, the façade of regional unity disintegrated under the onslaught of a relentless U.S. strategy of ultimatums, which were followed by divide-and-conquer bilateral negotiations over the most sensitive products. Consistent with their previous performances in Cancún and Miami, the U.S. remained relatively inflexible on these and most other important Central American demands. In the end, the four Central American nations settled for third- and fourth-best arrangements that have little to offer but much to threaten the long-term development needs of Central America.

The CAFTA negotiations have reached the end of the negotiation stage without the support of any empirical research to suggest that the benefits of a trade agreement will outweigh the costs. In the end, CAFTA is shaping up to be a slightly expanded Caribbean Basin Trade Protection Act (CBTPA), which provides greater security to investors and will likely increase exports—mirroring the NAFTA results. Also like NAFTA, the Central American trade agreement fails to offer much hope to the working poor of the region.

Asymmetric Trading Partners

- *The combined GDP of Central America is 0.5% that of the United States.*
- *The per capita income of Central America in 2000 was $1,822—19 times smaller than the U.S. at $34,637.*
- *Wage differentials for U.S. and Central American workers in comparable jobs are about 15:1.*
- *Agriculture contributes only 2% to the GDP of the U.S.; it contributes on average 17% to the GDP in Central America, and as high as 32% in Nicaragua.*
- *About 35-45% of the labor force in Central America is employed in agricultural activities, in comparison with only 2% in the United States.*
- *Central America accounts for only around 1% of total U.S. trade.*
- *Over 45% of Central American imports originate from the U.S. and over 50% of exports go to the U.S., 90% of which already receive duty free access under the Caribbean Basin Trade Partnership Act (CBTPA). The U.S. ranks number two in the 2003 Growth Competitiveness Index (behind Finland), while El Salvador ranks 48, Costa Rica ranks 51, and Guatemala, Nicaragua, and Honduras rank 89, 90, and 94 out of 102 countries.*
- *The U.S. is the primary destination for Central American migration, which has increased steadily to a flow of approximately 250,000 persons per year.*

1. Labor Rights: The Office of the U.S. Trade Representative (USTR) claims that CAFTA will provide discipline and incentives for the Central Americans to improve compliance with the five core labor standards of the International Labor Organization (ILO). Initial proposals included going beyond the U.S.-Chile Free Trade Agreement by demanding reforms in current labor laws and linking market access to independently verifiable compliance with improved laws. The U.S. declined to insist on either demand. A parallel Council on Labor Issues will be established to provide advice on the linkage between labor laws and trade. An internationally funded program of regional coopera-

Key Points

- *The U.S. has exerted tremendous pressure on the Central Americans to accept a trade agreement at any cost.*
- *Central American unity collapsed, and common bargaining positions fragmented into bilateral negotiations.*
- *CAFTA will be the first agreement between such highly asymmetric trading partners.*

tion will be established to assist Central American governments to follow through on promised strategies to comply with ILO standards by stepping up inspections, encouraging free association and bargaining rights, addressing long-standing violations, and meeting all established indicators. However, the persistence of pervasive labor violations under current laws leaves great doubt about the lack of leverage to improve current practices. Instead of clear and firm conditions within CAFTA for the improvements necessary for ILO compliance, the U.S. has watered down its labor demands by accepting as a baseline compliance with current national labor laws and not linking market access to improvement of labor practice.

The absence of a single functioning collective bargaining unit in the Central American maquila sector—employing some 350,000 workers—calls into question this U.S. faith in existing regional labor laws. A maximum penalty in the form of a $15 million fine for recurrent labor violations was also strenuously resisted by Central American governments. However, regional business leaders were assuaged by the U.S. assurance that a penalty will be assessed only against governments—not the businesses themselves—if there is a pattern of labor rights violations. However, it is likely that such violations will be tolerated over a long period. Instead of penalties, good-faith cooperation programs, intended to strengthen national Labor ministries, will be emphasized. What the USTR pronounced as "groundbreaking and comprehensive" the AFL-CIO denounced as labor provisions that are weaker than existing labor protections under the Generalized System of Preferences (GSP).

2. Agriculture: This most difficult area of negotiations rewarded the Central Americans with relatively little new market access and placed hundreds of thousands of small producers at almost certain risk of displacement from dumping of subsidized U.S. agricultural exports. The significance of the sector cannot be understated. Agricultural trade between the U.S. and Central America reached $3 billion in 2001, with the U.S. exporting twice as much as what it imports from the region, resulting in a Central American agricultural trade deficit of $975 million with the United States. Agriculture employs some 4.5 million Central Americans (35-45% % of the workforce) compared with about 3.5 million in the U.S. (less than 2 % of the American workforce). Major Central American agricultural exports include: bananas, coffee, shrimp, sugar, pineapples, vegetables, live plants, and flowers. Processed food accounts for a relatively small percentage of exports (1.4%) as does beef (0.6%).

As Central American countries have unilaterally liberalized their economies over the past decade, agriculture has been devastated by declining terms of trade, lack of investment, and the dumping of subsidized U.S. grains. The rural sector is and will continue to be the primary platform for migration to the United States. As the negotiations were being designed, the major producer federations demanded a separate chapter for agriculture, which U.S. negotiators rejected. Several producer federations then demanded that sensitive agricultural crops (such as basic grains, dairy, and pork) be exempt from CAFTA until the U.S. eliminated unfair agricultural subsidies. The U.S. refused to include any exemptions. The Central Americans then retreated to demands for special and differential treatment of agriculture, in terms of significantly greater market access for sugar, pork, poultry, beef, and various fruits and vegetables as well as preserving high tariffs and long liberalization periods for sensitive agricultural products. In the end, the U.S. offered—and the Central Americans accepted—relatively little significant new market access in these sectors. U.S. trade negotiators permitted a 15-20 year maximum liberalization period for several crops, with a one-time safeguard mechanism that triggers only after considerable damage is done.

At one point midway through the negotiations, the U.S. even withdrew certain market access benefits that were in place for Central America under CBTPA, stating that Central America would have to "earn" these privileges again. Sugar was considered a "big winner," but new market access represents only about 4.4% of current regional production, which will not generate significant numbers of new jobs over the next 15 years. About a million local corn and rice producers were left vulnerable to continued importation of subsidized U.S. grains, with little additional protection. Without significant assistance and in light of the Mexican experience of facilitating the U.S. dumping of surplus grains, most producers in sensitive sectors feel threatened by this deal. When push came to shove, Central American countries abandoned a collective bargaining strategy in the key agricultural subsectors and resorted to bilateral negotiations with the U.S. to take what they could get. The signal to Central American farmers was to prepare themselves for the journey north as part of a new wave of emigration.

3. Textiles and Rules of Origin: Textile and garment trade (as well as other assembly industries) represent the fastest growing part of trade between the U.S. and Central America.[2] CAFTA provides an expansion of CBTPA benefits by allowing duty-free access to textiles and garments using regional inputs, and selective use of nonregional, non-U.S. inputs. The garment and textile sector in Central America employs 350,000 people and has the potential for the forward and backward linkages necessary to stimulate higher value-added manufacturing in the future. CAFTA will permit the continuation of export processing zone incentives until 2009, a brief reprieve from certain devastation unless the maquila industry becomes able to compete with cheaper Asian imports with some type of economic reconversion. To do so, the sector requires the incentives to induce this

type of transformation. The textile and maquila producers demanded a flexible rule of origin to allow sourcing from countries that do not enjoy preferential trading rights with the United States. These proposals included "trade preference levels" for Asian inputs, but only Nicaragua was able to negotiate a modest quota of 100 million square meters—80% of what it already uses—and this will disappear in five years. The U.S. agreed to a more flexible rule of origin for three clothing items (bras, pajamas, and boxer shorts) but for all else insisted on a strict rule of origin that allows only sourcing for undersupplied items during a short time period from those few countries that have trade agreements with the United States.

4. Trade Capacity Building Assistance (TCBA): Perhaps one of the most significant surprises of the final round of the CAFTA negotiations was the absence of any announcement of a significantly larger package of TCBA for Central America. TCBA was largely absent from the final speeches by the CAFTA political leaders—a notable reversal from the high profile announcements at the outset of negotiations. In the 1980s, when the U.S. created the Caribbean Basin Initiative to promote the expansion of export processing zones (EPZ) in the region and offer an economic lifeboat to governments under siege from revolutionary insurgencies, the U.S. policy was "Trade Not Aid." This simply meant that the U.S. was shifting assistance increasingly away from the state and toward the private sector. By 1993, the U.S. had obligated $1.3 billion to private sector-led EPZ expansion.[3]

The prospect of CAFTA exposed the fact that the deregulation and dismantling of the Central American state in the 1990s—which was largely the result of the initiatives of Washington and the international financial institutions—left considerable institutional weaknesses in areas necessary for the implementation of a trade agreement. To sweeten the CAFTA deal, soften opponents to CAFTA in the U.S. Congress, and rebuild key state regulatory functions, the U.S. has announced significant reprogrammed assistance for Central America.

Trade capacity building assistance (TCBA) is focused in three areas: 1) to strengthen the negotiating capacity of the five country governments, 2) to fortify the institutions responsible for CAFTA implementation, and 3) to address costs associated with the adjustment consequences of CAFTA.[4] A total of $67 million in nonreimbursable trade capacity assistance was promised for the region in 2003, and some $91 million in 2004. The Inter-American Development Bank has approved some $319 million in lending in recent years for TCBA in the region, much of it in the form of structural adjustment loans that provide cash in return for further liberalization reforms. For the U.S. Agency for International Development (USAID), TCBA now represents almost 25% of its annual commitment to the region. The bulk of USAID projects are targeted at financing the adjustments associated with trade liberalization, what USAID refers to as "economic responsiveness." Most of the TCBA on the table has been directed at negotiating capacity (with questionable utility) and the most immediate regulatory and policy reforms associated with the implementation of the trade agreement. Much less has been invested in productive reconversion or the needs of displaced producers, even though some have estimated that these adjustment needs are close to $500 million per year or more.

5. Consolidation of Central American Democracy and Economic Integration: While CAFTA was initially offered as a means for strengthening the process of economic integration and democratization among the five negotiating countries, the secrecy of the negotiating process and the U.S. divide-and-conquer bargaining strategy may have left regional relations more frayed than ever. Central Americans were unable to harmonize a common external tariff for many products, and were forced to essentially abandon their goal of full harmonization by 2004. A Central American customs union, a fundamental prerequisite for regional integration, was supposed to go into effect on January 1, 2004 but has been postponed. A number of other fundamental laws and regulations are far from being harmonized within the Central American Common Market.

Key Problems

- *Washington's insistence on a confidentiality agreement to exclude civil society deepened the democratic deficit and heightened suspicions among the Central Americans—likely setting back authentic regional integration for years.*
- *Without promise of significant economic assistance and anticipating the U.S. dumping of surplus grains, most producers in sensitive sectors feel threatened by this deal.*
- *What the USTR pronounced as "groundbreaking and comprehensive," the AFL-CIO denounced as labor provisions that are weaker than existing labor protections.*

Deepening Division, Not Integration

In the final days of the last negotiating round, the Central American unity collapsed, and common bargaining positions fragmented into bilateral negotiations on key products such as rice, poultry, pork, dairy, and sugar as well as in services and garment trade preference levels. By pitting one country against the other, the U.S. succeeded in negotiating differential parallel bilateral agreements on sensitive products that forced Central Americans to lower their expectations. In response to U.S. insistence that its insurance and telecommunications sectors be opened up to private sector competition, Costa Rica resisted, in January ceded to most of the U.S. demands, while the other four negotiators settled for less than satisfactory deals.

U.S. bilateral deal-making and heavy-handedness on Costa Rican services deepened divisions in the region among and within countries. After less than a year to negotiate an agreement, most Central Americans still know little about CAFTA's details and feel largely excluded from the negotiation process.

The weakness of the Central American bargaining front was also evident in the divisions within key regional producer federations, which had lost significant influence by the final round. The U.S. insistence on a confidentiality agreement to exclude civil society, while at the same time funding pro-CAFTA propaganda in the region, has contributed to deepening the democratic deficit and heightening suspicions among the Central Americans, which will most likely set back authentic regional integration for years.

Given the recent challenges to the U.S. trade agenda at the WTO negotiations in Cancún and the Free Trade Area of the Americas (FTAA) negotiations in Miami, the U.S. has exerted tremendous pressure on the Central Americans to accept a trade agreement at any cost. Despite the hold-out by Costa Rica, U.S. Trade Representative Robert Zoellick left no doubt about the prospect of any gains that might be had by Costa Rica in delaying the process. "We are advancing with the four countries [El Salvador, Guatemala, Honduras, and Nicaragua]," he said, "and hope that Costa Rica joins us soon, but we are not going to wait."

In the first week of 2004, the USTR returned to the unfinished CAFTA business with the CA-4 countries, and pending legal issues have largely been resolved. The USTR resumed negotiations with Costa Rica on January 5 and reached an agreement on Jan. 26 to allow docking of Costa Rica into CAFTA. By holding out, the Costa Ricans were able to postpone opening up its insurance market until 2008, and won modestly preferable terms on several sensitive products, including trade preference levels for apparel. The USTR announced that after the legal review of the text, they anticipate sending a signed CAFTA to the U.S. Congress by late April or early May 2004. However, some question remains whether the USTR will wait until after the November 2004 elections to submit CAFTA legislation to Congress.

Congressional opponents of CAFTA (both Democrat and Republican) have argued that the president does not currently have the votes to pass CAFTA, and how this situation changes is one key factor in determining whether a vote is called prior to the elections. The Republican leadership will be assessing the opposition to CAFTA in the coming months. Elections in El Salvador in March 2004 may also have some bearing on the timing. A third factor is the completion of market access negotiations with the Dominican Republic by late March in order to "dock" that country into the CAFTA agreement by April. For this last reason, April may be the soonest that CAFTA can be introduced to the Congress, putting it on track for a congressional vote prior to the August recess and in advance of the 2004 party conventions.

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Endnotes

1 SIECA database at www.sieca.org.gt. Exports plus imports, if only the value added of assembled goods are included. This figure is significantly lower than the U.S. Trade Representative (USTR) estimate of $20 billion per year, which is inflated by the maquila sector exports.

2 The apparel industry uses the figure of $7 billion in Central American exports in 2002, 64% of total exports. See www.americanapparel.org.

3 See Barbara Briggs, "Aiding and Abetting Corporate Flight: U.S. AID and the Caribbean Basin," *Multinational Monitor*, January 1993. In the 1983 *Kissinger Report* that served as the intellectual rationale for the CBI, it was argued that trade liberalization would require some $20 billion in additional investment over eight years.

4 Latin America received $100 million in TCBA in 2001, $140 million in 2002. The U.S. Agency for International Development (USAID) funds over 70% of U.S. TCBA. For more information, see http://www.usaid.gov/economic_growth/egat/eg/tech-trade/ or http://qesdb.cdie.org/tcb/index.html.

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