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The Proposed U.S.-Panama Free Trade Agreement

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Summary

On April 26, 2004, the United States began negotiating a bilateral free trade agreement (FTA) with Panama. By building on the U.S.-Dominican Republic-Central America Free Trade Agreement (DR-CAFTA) text, the negotiations have moved quickly and many chapters are nearly completed. A fifth round is scheduled for October 18-22, 2004, after the inauguration of president-elect Martín Torrijos on Sept. 1, 2004. As with all free trade agreements, the FTA cannot enter into force until Congress passes implementing legislation and the President signs it into law.

Panama's economy is based largely on maritime and related service industries that developed around its transisthmian canal, once managed by the United States, but returned to Panama in 1999. Canal operations account for 7% of Panama's GDP, with the largest and fastest growing traffic volume generated along the U.S. East Coast-to-Asia trade route (especially U.S.-China). The canal's total economic impact, however, is far greater, supporting income and jobs in various services industries including warehousing, ship registry and repair, salvage operations, insurance, banking, and tourism.

Panama is a beneficiary of the Caribbean Basin Initiative's (CBI) unilateral trade preferences of the United States and is among the largest recipients of U.S. foreign direct investment in Latin America. Because of its historical economic dependence on the United States and the canal, Panama had not elected to pursue trade liberalization vigorously until 1997 when it joined the World Trade Organization. Opening the economy further to U.S. competition is a big step and will present more adjustment challenges. Panama seeks to solidify U.S. market access and investment benefits in an FTA. The incentive to negotiate is enhanced by the need to keep pace with other Latin American countries negotiating FTAs with the United States that may erode CBI preferences. For the United States, Panama has long had a military and commercial strategic importance, even as a small trading partner, and an FTA with Panama fits with broader U.S. trade policy.

The United States seeks to reduce tariffs and other barriers to U.S. industrial, agricultural, and consumer goods. Other important aspects of this agreement will be defining rules for services trade, investment, government procurement, and dispute resolution. Market access for agricultural goods has been difficult to negotiate given both countries have sensitive products. Textile and apparel issues are less critical given Panama's relatively small production. Labor and environmental advocates likely will challenge the relevant chapters in the FTA and Panama's record on these issues. Earlier agreements have passed congressional muster only after a majority of Members have been able to reconcile these provisions with the record of each country's labor laws and enforcement efforts. Panama has confidence in its labor rights record, but concerns have been raised in some reports. Panama may find it difficult to reach agreement on services, government procurement, and other areas where U.S. firms are highly competitive. This report will be update periodically.

Related information may be found in CRS Report RL30981, *Panama: Political and Economic Conditions and U.S. Relations*, by Mark P. Sullivan.

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On November 16, 2003, President George W. Bush formally notified Congress of his intention to negotiate a bilateral free trade agreement (FTA) with Panama. Negotiations commenced in April 2004 and four rounds have been completed. A fifth round is scheduled for October 18-22, 2004, after the inauguration of president-elect Martin Torrijos on September 1, 2004. The proposed U.S.-Panama FTA likely will be a stand-alone accord, meaning that unlike the U.S.-Dominican Republic FTA, it will not be linked to other regional FTAs like the U.S.-Central America Free Trade Agreement (CAFTA, now the DR-CAFTA), concluded in early 2004.[1] As with all free trade agreements, the U.S.-Panama FTA cannot enter into force until Congress passes implementing legislation and the President signs it into law. This report will be updated periodically.

Panama's Canal and Economic Relations with the United States

The United States and Panama have entered into many agreements over the past 150 years, the most prominent defining their relative stake in the famous canal the traverses the Central American isthmus and literally bisects Panamanian territory. (See **Figure 1**.) The canal has been a critical factor influencing Panamanian domestic and foreign affairs, and like earlier U.S.-Panama agreements, the FTA's significance is tied to a Panamanian economy that has formed largely around the canal.

Early U.S.-Panama Economic Relations

Since first explored by the Spanish at the turn of the sixteenth century, Panama has been prized for its unique geographic characteristic: the slender distance separating the Atlantic and Pacific Oceans. Because of the transit possibilities this presented (first for Peruvian gold and other colonial trade), Panama was a natural crossroads for the movement of commerce, a strategic value that grew as the world became ever more traveled and integrated. In fact, Panama's destiny became fused to its geography and, over time, to the vagaries of foreign interests that sought to take advantage of it, particularly the United States.

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[1] For a discussion of CAFTA and a deeper understanding of the regional economic implications of freer trade, see CRS Report RL31870, *The U.S.-Central America Free Trade Agreement (CAFTA): Challenges to Sub-Regional Integration*, by J. F. Hornbeck and CRS Report RL32322, *Central America and the Dominican Republic in the Context of the Free Trade Agreement (DR-CAFTA) with the United States*, K. Larry Storrs coordinator.

Figure 1. Map of Panama

Source: Map Resources. Adapted by CRS. (K.Yancey 7/27/04)

As a province of Colombia, Panama was swept to independence from Spain in 1821. By then, the United States and European powers openly coveted the prospect of an inter-oceanic connector. Well before construction of a canal could be realized, the United States displaced Britain as the dominant foreign influence, completing a cross-isthmian railroad in 1855. This project was driven by the westward expansion of the United States, which included an anticipated southern water route to the west coast. To secure this transit system, as well as the safety of goods and people using the it, the United States resorted to armed intervention in Panama some 14 times in the 19th century. By the time the United States sought permission to construct a canal, a clear precedent had been set for a U.S. presence in Panama that would be defended, if necessary.[2]

The initial U.S. effort to build a canal required a concession from Colombia allowing the United States to finish the bankrupt French project abandoned in 1889. In early 1903, the details were set down in a treaty ratified by the U.S. Senate, but unanimously rejected by the Colombian legislature. The United States responded by reaching out to the growing Panamanian successionist movement. In November 1903, in a quick and bloodless move facilitated by the indispensable aid of U.S. warships, Panama declared its independence from Colombia. Panama was immediately recognized by the United States as an independent state, and in return, signed the Hay-Bunau-Varilla Treaty, thereby conceding to the United States the rights to construct a canal and to control it "in perpetuity."[3]

The opening of the Panama Canal in 1914 led to U.S. dominance in the commercial and, at times, political life of Panama. Although both countries benefitted from its operations, the relationship was far from equal, which along with the perpetual U.S. presence, generated a nagging resentment, periodic protests, and sometimes violence over the tangible loss of national sovereignty. This tension remained a dominant feature of U.S.-Panamanian relations until the canal was ceded back to Panama in 1977 per the Panama Canal Treaty negotiated under President Jimmy Carter. Although tensions flared again in 1989 with the U.S. incursion into Panama to arrest chief of state General Manual Noriega on narcotics trafficking, arguably, the incursion proved to be a catalyst for the return of democracy. Perhaps not coincidently, Panama's decision to promote trade liberalization soon followed.[4]

The Canal and U.S. Trade Policy

The canal solidified Panama as a maritime economy and its return to Panamanian control raised expectations that Panama would enjoy greater economic benefits from its ownership. The canal operations by themselves account for approximately 7% of Panama's GDP, with the largest and fastest growing traffic

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[2] Conniff, Michael L. *Panama and the United States: The Forced Alliance*. Athens: the University of Georgia Press, second edition. 2001. pp. 30-35.

[3] Woodward, Ralph Lee. *Central America: A Nation Divided*. New York: Oxford University Press, third edition. 1999, pp.187-91 and ibid., pp. 63-70.

[4] Conniff, *Panama and the United States*, pp. 134-39 and CRS Report RL30981, *Panama: Political and Economic Conditions and U.S. Relations*, by Mark P. Sullivan, pp. 12-13.

volume generated along the U.S. East Coast-to-Asia trade route (especially U.S.-China). The canal's total economic impact, however, is far greater, supporting income and jobs in various services industries including warehousing, ship registry and repair, salvage operations, insurance, banking, and tourism. The two major ports at either end of the canal have been privatized and modernized, a portion of the canal (the Gaillard Cut) was widened in 2001, but Panama faces a difficult and expensive challenge to enhance the capacity of the entire canal to support much larger modern ships if it is to remain a global shipping hub in the 21st century.[5]

With transfer of the canal and its operations to Panama, the country also inherited a substantial amount of land and physical assets. The conversion of these assets to private use has been a boon to the Panamanian economy, but has entailed considerable costs as well. Privatization efforts eased the transformation of former U.S. government facilities to productive Panamanian use, which has included refurbishing the Panamanian railroad by Kansas City Southern Railways, transforming the former Albrook base airstrip into the Marcos Gelabert airport, and developing a foreign processing zone in the former Ft. Davis.[6]

At the start of the 21st century, the canal and close ties with the United States are still the defining features of Panama's economy, but they have also served to limit Panama's participation in regional integration efforts. Although part of the Central American Integration System, a broadly focused political arrangement, Panama has declined to join the Central American Common Market, relying instead on the canal and the large U.S. economy as its economic anchors. Panama adopted a fully dollarized monetary system and is a beneficiary country of U.S. unilateral trade preferences defined in the Caribbean Basin Initiative (CBI). So, it is no coincidence that Panama resisted becoming a more open economy, maintaining high tariffs and other barriers to trade. Only since joining the World Trade Organization (WTO) relatively recently in 1997 did tariff rates begin to decline, an important step in preparing for an FTA with the United States.

Panama's subregional independence and reliance on U.S. economic ties has suited the United States well in some ways, given its continuing interest in the Canal. An FTA with Panama may be seen as one way for the United States to support long-established commercial interests and deepen bilateral relations, particularly if recognized as a mutually negotiated pact with reasonably balanced political and economic outcomes. Although many ships have outgrown the canal, its locale and prospects for enlarging the passageway continue to reinforce Panama's historic, albeit diminished, importance for the United States as a strategic trade passage.

A bilateral FTA with Panama is also part of the Bush Administration's "competitive liberalization" trade strategy, in which negotiations are taking place on multilateral, regional, and bilateral levels. This multi-tiered negotiation strategy is predicated on an expectation that gains at one level of negotiation may encourage,

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[5] The Economist Intelligence Unit. *Panama: Country Profile 2003.* London, 2003. pp. 16-17 and U.S. Department of Energy. Energy Information Administration. *Panama: Country Analysis Briefs*. October 2003.

[6] Ibid.

if not compel, similar breakthroughs in other levels. Because of slow progress at the WTO and with the Free Trade Area of the Americas (FTAA), the United States has moved ahead aggressively with bilateral talks, of which the Panama FTA is a part. Some, however, have questioned the bilateral approach for the asymmetrical negotiation power the United States wields, the effects it may have on non-participating countries, and the one-sided trade system that is developing around the United States as opposed to a truly regional or multilateral system.

For Panama, the FTA may be seen as a way to reinforce its relatively new trade liberalization policy. This will require considerable adjustment, although Panama has already made some strides in transforming into a more open economy. The incentive to negotiate is enhanced by the need to keep pace with other Latin American countries negotiating FTAs with the United States that may erode CBI preferences.

Panamanian Trade Relations

Panama's recent economic trends have been mixed. This country of 3 million people has a stable, diversified economy and gross domestic product (GDP) rebounded from two years of tepid growth to expand by 4.1% in 2003 (see **Appendix 1** for basic macroeconomic data). Panama also has a higher per capita income than the Central American countries, with the exception of Costa Rica, but income distribution is highly skewed, poverty remains a nagging problem, especially among the indigenous population, and unemployment is high. These disparities could become more contentious issues in Panama as the country debates the costs and benefits of an FTA. Unlike any other Latin American country, fully 77% of Panama's GDP is in services, developed around the transportation and commerce generated by canal traffic and the Colón Free Zone (CFZ). Industry is the second most important sector, contributing 16% of GDP followed by agriculture at 7%. U.S. firms dominate the foreign presence in Panama, reinforcing arguments for a bilateral FTA as the next big step in U.S.-Panamanian relations.

Table 1. Panama's Current Account Balance

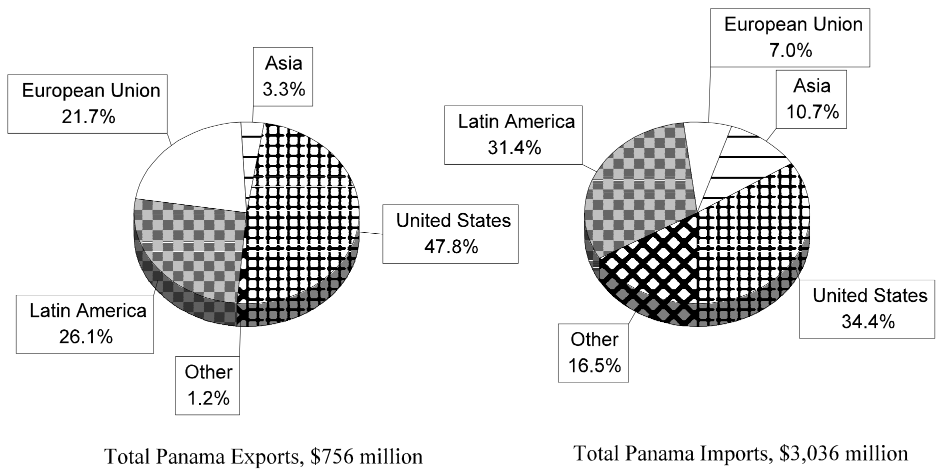
	2001	2002	2003
Balance on Merchandise Trade ($ million)	-696	-1037	-954
Balance on Services Trade ($ million)	899	979	1097
Current Account Balance (% of GDP)	-1.7	-0.9	-1.2

Data Source: United Nations Economic Commission on Latin America, *Preliminary Overview of the Economies of Latin America, 2003*. pp. 143-44.

Despite Panama's concentration in services, merchandise trade contributes much to economic output. Exports of goods and services compose 29% of GDP and Panama tends to run a sizeable trade deficit in goods, which is often balanced by a large services trade surplus. As seen in **Table 1**, Panama's merchandise trade deficits ranged from $700 million to $1 billion from 2001 to 2003. In each year, the merchandise deficit was offset by a services trade surplus of between $900 million to $1.1 billion. This feature is unique among Latin American countries.

The other distinct feature of Panama's trade regime is its Colón Free Zone, the largest free trade zone in the world, except for Hong Kong. Goods are imported, modified or repackaged, and re-exported without being subject to Panamanian customs regulations or duties, including income tax on earnings from re-exported sales. In addition, there are numerous government incentives for businesses to locate in the CFZ. Trade from the CFZ accounts for approximately 7% of net exports, but only 1% of the Panamanian employment.

Figure 2. Panama Direction of Trade, 2002



Source: CRS from IMF, *Direction of Trade Statistics*, June 2004. Does not include CFZ trade.

In 2002, nearly $5 billion worth of goods were imported into the CFZ, mostly from Hong Kong, where they were then re-exported to Latin America countries. The net effect was to add only $400 million to the Panamanian trade balance. CFZ trade is reported separately in Panama's trade statistics and is excluded in international comparisons of trade, such as in **Figure 2**. Most CFZ imports are luxury and other consumer goods, including electronic products and clothing.[7] The CFZ is a major distribution center for trade to the Latin American region, allowing businesses to base themselves in the canal area rather than in each individual country. The vast amount of commerce done in the CFZ, however, has also presented opportunities for illegal trading activities (narcotics and money laundering), piracy, and merchandise theft.[8]

Panama has many trading partners, but the United States has held the dominant position since before construction of the canal. Even today, as a single country it is a far larger trading partner than the world's major regions combined. The United

[7] American Chamber of Commerce in Panama. [http://panamcham.com] and EIU. *Panama: Country Profile 2003*, p, 32.

[8] U.S. Department of State. U.S. and Foreign Commercial Services. *Panama Country Commercial Guide FY 2004.* August 19, 2003. pp. 23-24 and 28.

States accounts for some 48% of Panamanian exports and 34% of its imports. The Latin American countries collectively are Panama's second largest trading partner, accounting for 26% of Panamanian exports and 31% of its imports. Panama runs a sizeable trade deficit with Latin America. The largest Latin American partners for exports and imports are Costa Rica, the Dominican Republic, and Mexico. Panama also imports significant quantities of oil from Venezuela and Ecuador. The European Union is the third largest trading partner, taking 22% of Panama's exports and providing 7% of its imports, but accounting for only a small portion of Panama's trade deficit. Asia accounts for only 3% of Panama's exports and 11% of its imports, dominated by trade with Japan.

U.S.-Panama Merchandise Trade

The value of U.S.-Panamanian merchandise trade is small. In 2003, the United States exported $1,848 million worth of goods and imported $301 million, producing a U.S. trade surplus of $1,547 million. Panama ranked as the 42nd largest export market for U.S. goods and only 92nd for imports. The United States has run a merchandise trade surplus with Panama for more than twenty years, in part due to the uneven growth of bilateral trade over the past 12 years. U.S. exports expanded by 73% over this time period, reflecting a 36% increase in refined oil in 2003. This is a large increase compared to U.S. export growth to the rest of Latin America, which expanded by only 48% excluding Mexico.[9] In addition to refined oil, the major U.S. exports, as seen in **Table 2**, are mostly capital- and technology-intensive manufactured products including aircraft, machinery, pharmaceuticals, and medical equipment. Cereals, mostly corn and wheat, round out the top seven U.S. exports.[10]

Table 2. U.S.-Panama Merchandise Trade, 2003

U.S. Exports	$ Value million	% of Total	U.S. Imports	$ Value million	% of Total
1. Oil	431.7	23.3%	1. Fish/Seafood:	101.8	33.8%
2. Aircraft	260.8	14.1%	2. Repaired Goods	66.1	21.9%
3. Machinery:	173.0	9.4%	3. Precious Metal	16.2	5.4%
- Office mach.	(36.3)		- gold		
- Computers	(32.7)				
- gas turbines	(9.1)				
4. Electrical mach.	135.9	7.4%	4. Oil (motor fuel)	14.3	4.8%
5. Pharmaceuticals	96.7	5.2%	5. Sugars	13.4	4.4%
6. Optical/Medical Equipment	62.9	3.4%	6. Coffee	12.3	4.1%
7. Cereals	56.1	3.0%	7. Elec. machinery	8.5	2.8%
8. Other	630.9	34.2%	8. Other	68.6	22.8%
Total	1,848.0	100.0%	Total	301.2	100.0%

Data Source: U.S. Department of Commerce.

[9] CRS Report 98-840 E, *U.S.-Latin American Trade: Recent Trends*, by J. F. Hornbeck.

[10] Services trade data are not available for smaller U.S. trading partners, including Panama.

Compared to export growth, the United States imports relatively little from Panama, accounting for the growing U.S. merchandise trade surplus. Most imports are primary products; fully one-third is seafood, mostly fresh fish and shrimp. Repaired goods are number two accounting for 22% of total imports from Panama.[11] Precious metal (mostly gold), crude and refined oil products, sugar, and coffee each account for between 4% and 5% of total imports. Unlike the Central American countries, U.S. sensitivities to textile/apparel trade may be less pronounced given the amount of this trade is relatively small. However, Panama's exports of some agricultural products, particularly sugar, is a sensitive issue.

U.S. Foreign Direct Investment

Panama has no formal restrictions on capital flows, does not discriminate between foreign and domestic investment, and maintains bilateral investment treaties with the United States and many European countries. Critics have pointed out, however, that the legal environment can be cumbersome and that Panama's relatively high labor costs (for the hemisphere) and inflexible labor laws can be a frustration if not an impediment to U.S. foreign direct investment (FDI).[12] Still, U.S. companies are well represented in Panama, including the largest container port facility in the region, multiple financial institutions, transportation firms, and manufacturing facilities from various sectors. Like other countries pursuing an FTA with the United States, Panama seeks closer ties for the continued FDI that may be generated from having a predictable economic relationship with a large trading partner.[13]

Table 3. U.S. Investment in Panama, Mexico, and Central America

($ millions)

Sector	1999	2000	2001	2002
Panama	33,143	30,758	25,170	20,003
Mexico	32,888	39,352	56,554	58,074
Central America	3,058	3,603	2,826	2,999

Data Source: U.S. Department of Commerce. Bureau of Economic Analysis. Available at the website at [http://www.bea.doc.gov/bea/di/usdlongcty.htm].
Data are stock of foreign direct investment (FDI) presented on a historical-cost basis.

U.S. FDI represents over a third of total FDI in Panama. **Table 3** compares U.S. FDI in Panama to other regional destinations. U.S. investment is much higher in Panama than in the five Central American countries combined, although it has declined in recent years, in part reflecting a tapering off of an extensive privatization effort in the late 1990s and an outflow of investment. Plans to widen and improve

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[11] Technically classified as "products of the United States when returned after having been exported, without having been advanced in value or improved in condition by any process."

[12] U.S. Department of State, *Panama Country Commercial Guide FY 2004*, August 19, 2003. pp. 30-31.

[13] Ibid., pp. 26.

the canal will provide an opportunity for large amounts of FDI in the future for many sectors, particularly for U.S. firms.

Status of Trade Negotiations

Panama approached the United States for a stand alone free trade agreement, eschewing any suggestion that it be linked to the DR-CAFTA. First and foremost, Panama wanted to maximize the FTA's potential to win U.S. congressional approval, leading to a strategy that emphasizes the historical and strategic U.S.-Panamanian relationship, while separating the negotiations from the DR-CAFTA accord, which are being slowed by congressional opposition over labor provisions. Panama's service economy, relatively small textile/apparel industry, and limited integration with the Central American economies also bolstered the case for separate negotiations.[14]

Negotiations are being conducted by numerous working groups, coordinated by the Chief Negotiators Group and including a non-negotiating group on trade capacity building. Four negotiation rounds have been completed, taking place on April 26-29, June 5-11, July 11-16, and August 9-12, 2004. The talks have relied on the text of the DR-CAFTA agreement as an overall framework for discussion, which has accelerated the process. Many chapters are reportedly nearly finished including market access, customs administration, services, transparency, and dispute resolution. The FTA may be completed after a fifth round, which is scheduled for October 18-22, 2004, following the inauguration of president-elect Martín Torrijos on September 1, 2004.

Trade Policy Issues

Proponents of the FTA argue that it supports foreign policy and economic interests of the United States. U.S. foreign policy strategy goals in the region include promoting democracy and the rule of law, fighting corruption, the narcotics trade, and money laundering, and encouraging regional economic integration. Proponents argue that the FTA is also expected to lend stability to Panama's increasingly open economy and benefit the commercial interests of both countries by promoting easier and more transparent movement of trade and investment, and helping increase commitments to related social issues such as environment and labor standards.[15]

The FTA has detractors as well who oppose it on various political and economic grounds. Protests have erupted at the University of Panama over the FTA, one demonstration apparently tied to numerous policy issues, and in part, perhaps an

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[14] Inside U.S. Trade. *Panama FTA Unlikely To Be Docked Into CAFTA as Talks Set to Begin*. April 23, 2004.

[15] USTR. Letter of Notification of Intent to Negotiate Panama FTA. November 18, 2004. Available at [http://www.ustr.gov].

unfocused statement of anti-Americanism.[16] Labor and environmental groups in the United States have also raised concerns over numerous bilateral FTAs and the extent to which they fail to support fully the enforcement of higher standards abroad. Import competing businesses in both countries have raised issues related to their vulnerability, particularly in the agricultural sector. The details, of course, are where the most difficult challenges emerge and there are numerous specific issues that may prove tough to conclude. Below, grouped by major negotiation groups, are selected issues that will have to be resolved for an FTA to be completed. They will be updated as the negotiations proceed.

Market Access

The market access working group is negotiating the tariff structures and rules of origin that would govern the movement of commercial, industrial, and agricultural goods. The text is expected to be similar the DR-CAFTA chapter and specific tariff schedules are being negotiated on a product-by-product basis defining the "staging categories" that prescribe the time that each country will be given to reduce tariff levels to zero. Tariffs on many industrial and commercial goods are expected to go to zero immediately, although none will be extended beyond ten years. Tariff phase-outs on sensitive products such as sugar, rice, dairy, pork, poultry, beef, tomatoes, among others, typically last more than ten years to accommodate either politically powerful interest groups or sectors deemed in need of more time to adjust to freer trade. Despite political pressure exerted in both countries, no goods are currently being considered for exclusion from tariff elimination. Rules of origin define which goods would be eligible for preferential treatment based on their regional content, with the intent of preventing transshipment of goods made from materials supplied by countries outside the agreement.

Panama acceded to the WTO in 1997, and part of its accession agreement included unilateral reduction of tariff levels. Panama's average tariff has fallen to 8%, but tariffs on agricultural products are higher, with some reaching the maximum permitted under Panama's commitments to the WTO. All imports are subject to a nondiscriminatory transfer (sales) tax of 5% and other fees, with exceptions for pharmaceuticals, foods, and school supplies. The WTO further encouraged Panama to amend its export subsidies (tax credits), but it has delayed a commitment to do so until 2005. The legislature is considering options for enacting an alternative form of subsidy after 2005 that will be WTO compatible. Panama uses tax exemptions to attract foreign investment in certain export-oriented industries, such as shrimp farming and tourism, and in "export processing zones," where imports of manufacturing inputs are duty free as long as they are transformed for re-export.[17]

Most U.S. imports from Panama enter duty free under the normal trade schedule or under the CBI, as amended (see **Appendix 3** for selected tariff rates). The big exceptions are sugar, which is subject to a tariff rate quota, and petroleum products.

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[16] Victoria, David Daniel. Suspendidas Indefinidamente Clases en la Universidad. *La Estrella de Panama*. June 11, 2004. p. 1.

[17] Office of the United States Trade Representative. *2004 National Trade Estimate Report on Foreign Trade Barriers*. Washington, D.C. March 31, 2004. p. 367-69.

By contrast, U.S. exports face sizable tariffs, with most falling in the range of 3-10%, plus the additional 5% transfer tax, which applies to domestic goods as well. Agricultural goods face very high out of quota tariffs to protect Panama's agriculture sector. Although agriculture is only 7% of GDP, it accounts for one quarter of total employment and so exerts considerable political influence, as in the United States. Panama actually raised tariffs in recent years on rice, pork, poultry, sugar, and especially milk, to help protect local producers. Panama's farming interests are pressing for continued protection in the FTA discussions, fearing that exports from subsidized U.S. production could easily overwhelm the Panamanian market. The United States would like to open these markets as soon as possible, but may have to make tradeoffs to accommodate concerns from U.S. farmers, such as sugar producers who lobby for maintaining a well-established quota system.[18]

Sanitary and phytosanitary (SPS) standards and certification measures are another important aspect of agricultural trade. Although understood as necessary to ensure the safety of agricultural imports, SPS standards can be cumbersome, and are often denounced as a veiled form of protectionism. Panama's SPS standards, on the whole, meet WTO standards. SPS issues, however, pose a concern for both countries. Panama requires that U.S. imports of poultry, beef, and pork come from processing plants that have been individually inspected by Panamanian officials. The inspection process has been drawn out at times and the United States seeks to work towards a system-wide certification process in the FTA negotiations.[19]

Services

Various services trade issues are negotiated separately including financial services, telecommunications, shipping, and e-commerce. Panama is known for its "open regulatory environment for services," but requires local licensing for many professionals who wish to practice in the country, which the United States would like to limit. Panama was the first country in Latin America to pass e-commerce legislation. It recognizes the legal standing of electronic transactions and provides for the creation of an oversight agency, but the regulatory framework has yet to be developed.[20] The United States is pressing for even greater transparency in regulatory procedures and U.S. business groups have identified services as a critical negotiating area given U.S. competitive advantages and the large services sector in Panama.

Maritime Issues. Cabotage is the transport of cargo or passengers in coastal waters, or between two points within a country, and is defined in U.S. law in the Jones Act and 1886 Passenger Vessel Services Act (PVSA). Under the PVSA, passenger vessels calling on more than one consecutive U.S. port must be U.S. flagged, crewed, and built. Foreign flag ships may call at a second U.S. port only after touching a designated "distant foreign port." Most Caribbean ports, including Panama, are designated "nearby foreign ports" and so do not qualify. Panama is a

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[18] EIU, *Panama: Country Profile 2003,* p. 27.

[19] USTR, *2004 Foreign Trade Barriers*, p. 367-68.

[20] Ibid., p. 370-71.

major flag of convenience and would like to have its status changed in the FTA to be designated a "distant foreign port," in expectation that it would increase cruise ship traffic linked to the U.S. market.[21]

In the United States, there would be winners and losers should a change to the PVSA be made. Winners could include cruise ship companies (many foreign owned and Panamanian flagged), who might generate more business with greater flexibility to call at U.S. ports. A second group would be U.S. port city businesses, which could gain from an increase in tourist trade from the additional cruise line traffic, in the same way that Panama might, if it were designated a "distant foreign port."

Opponents include U.S. shipbuilding interests, which have argued that they would "lose the only advantage they enjoy over foreign flag ships." Some Members of Congress have conveyed this concern to the USTR and added that passenger shipbuilding is a vital strategic interest for the United States for the movement of troops and supplies. Opponents also include organized labor, which represents various workers in shipping industries and views foreign operators as a threat to U.S. jobs.[22] Previous attempts to amend this act, even slightly, have met with strong congressional resistence, and the American-flag maritime industry has repeatedly lobbied against the inclusion of maritime issues in multilateral, regional, and bilateral free trade agreements, including in the U.S.-Panama FTA.[23]

Government Procurement and Intellectual Property Rights

These two areas are of particular interest to the United States and a bilateral FTA is seen as an opportunity to remedy many deficiencies in rules that limit the opportunities of U.S. companies, and to set the pace for standardized practice in the region. In the area of government procurement, Panamanian laws require transparency in the bidding process, a practice generally followed, but concerns have been raised by U.S. firms not only with respect to the bidding on contracts, but also the appeals process as well. Panama has not acceded to the WTO Government Procurement Agreement, which the United States would like to encourage in the FTA.[24] Government procurement is an important negotiation area for the United States given the prospects for large long-term investments to expand the canal and

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[21] Such a change would allow foreign flag cruise ships to leave one U.S. port, pass through Panama, where they could add or disembark passengers, and return to another U.S. port, which raises concerns over how significantly this might change the Caribbean and U.S. bi-coastal non-U.S.-flag cruise line traffic. Inside U.S. Trade. *Administration Is Warned Over Maritime Services in Panama FTA*. July 16, 2004.

[22] Inside U.S. Trade. *Administration Warned Over Maritime Services in Panama FTA* and Letters to USTR Robert Zoellick from Representatives Duncan Hunter and Ike Skelton, and Senators Trent Lott and John Breaux. July 16, 2004. [http://www.insidetrade.com]

[23] Letter from the Transportation Institute to USTR Robert Zoellick, June 10, 2004. Interestingly, the U.S. Chamber of Commerce in Panama, which represents a wide spectrum of U.S. commercial interests in the country, has listed flag protection as among the least important issues. See Panamcham. *Issues of Importance in the U.S.-Panama FTA Negotiations*, March 12, 2004. [http://www.panamcham.com/business_center/FTA.asp].

[24] USTR, *2004 Foreign Trade Barriers*, p. 368.

related facilities. Transparency in the bidding process for government contracts was listed as one of the most important issues by the U.S. Chamber of Commerce in Panama.[25]

The United States emphasizes intellectual property rights (IPR) protection in bilateral agreements, and seeks to have Panama's standards more closely approximate those of the United States. The USTR reports that Panama's IPR laws and legal institutional support have improved, with courts dedicated specifically to hear IPR cases. Panama has signed on to the World Intellectual Property Organization (WIPO) Copyright Treaty and Performances and Phonographs Treaty. The 1994 copyright law improved protection and increased the options to prosecute violators. The United States is negotiating to have Panama sign more IPR treaties as part of the FTA. Piracy violations are common, however, in part because Panama is such a large transshipment point, and the capacity to monitor violations is inadequate. Panama updated its patent law in 1996 and also has a law enforcing trademark protection.[26]

Investment

Panama has actively encouraged foreign direct investment, has a well-developed financial services industry to support the flow of capital, and is a regional financial center in its own right. U.S. firms are heavily invested in Panama relative to other Latin American countries. Panama already has a bilateral investment treaty with the United States and further guarantees of the free flow of transfers under a 1998 law. Although the Panamanian government has been responsive to U.S. foreign investment interests, concerns have arisen in particular cases involving investment in highly regulated industries. Resolution of these concerns apparently facilitated proceeding with the FTA negotiations.[27]

Although the privatization process has dwindled, there is much potential for further significant foreign investment in Panama, including the so-called reverted areas of the former canal zone and enhancements to the canal itself to meet 21st century shipping needs. This, in turn, could spur investment in related services industries. How government procurement and investment rules are treated in the FTA negotiations may have a big effect on the U.S. competitive position in Panama's investment future.

Labor and Environment

Labor and environmental provisions are contentious issues in trade agreements, and there is considerable disagreement in Congress and elsewhere over how aggressive language in trade agreements should be in accommodating these concerns.

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[25] Panamcham. *Issues of Importance in the U.S.-Panama FTA Negotiations*, March 12, 2004. [http://www.panamcham.com/business_center/FTA.asp].

[26] USTR, *2004 Foreign Trade Barriers*, pp. 369-70 and U.S. and Foreign Commercial Service, *Panama Country Commercial Guide FY2004*, pp. 28-29.

[27] USTR, *2004 Foreign Trade Barriers*, p. 370.

From an economic perspective, labor and environment advocates in the United States argue that developing countries may have an "unfair" competitive advantage because their lower standards are a basis for their lower costs, which in turn are reflected in lower prices for goods that compete with those produced in developed countries.[28] It follows from this argument that the difference in costs is an inducement to move U.S. investment and jobs abroad.

On the other hand, studies suggest that these cost differentials are usually not high enough to determine business location alone, and that productivity is the more important factor.[29] Further, many economists view trade liberalization as part of the overall development process that, in and off itself, can promote social development.[30] Developing countries are concerned with the loss of sovereignty should specific standards be defined in trade agreements, as well as, with the possibility that such provisions can be misused as a disguised form of protectionism.

Environmental Issues. For environment advocates, major goals include protecting and assuring strong enforcement of existing domestic environmental standards, ensuring that multilateral environmental agreements are not undermined by trade rules, promoting strong environmental initiatives to evaluate and raise environmental performance, developing a systematic program of capacity-building assistance, and assuring that environmental provisions in FTAs are subject to the same dispute resolution and enforcement mechanisms as are other aspects of the agreements.[31]

Environmental provisions in the U.S.-Panama FTA are likely to be similar to those in the DR-CAFTA. These emphasize: 1) encouraging high levels of environmental protection; 2) not failing "to enforce environmental laws," and 3) recognizing that it is inappropriate weaken or reduce protections as an

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[28] The difference is that the social costs associated with environmental degradation, pollution, poor working conditions, and low wages are not captured in the production process. Through legal and regulatory measures, developed countries require that businesses bear many of these costs, which are then reflected in the final (relatively higher) price of the good or service in the market place.

[29] See CRS Report 98-742 E, *Trade with Developing Countries: Effects on U.S. Workers*, by J.F. Hornbeck. September 2, 1998, pp 11-13. Productivity and wage levels are highly correlated, suggesting that lower productivity jobs gravitate toward countries with a relative abundance of low-skilled (and hence low-wage) workers. Rodrik, Dani. *Sense and Nonsense in the Globalization Debate*. Foreign Policy. Summer 1997. pp. 30-33.

[30] Some broader evidence suggests that FTAs have not "forced a race to the bottom of regulatory standards," but rather to the contrary, that policy convergence is affected more by countries agreeing to "norms of governance" via cooperation through international agreements. See Drezner, Daniel W. Globalization and Policy Convergence. *International Studies Review*. Vol. 3, Issue 1, Spring 2001. pp. 75 and 78.

[31] See [http://www.sierraclub.org/trade/fasttrack/letter.asp], *Principles for Environmentally Responsible Trade.* Another important issue for the United States is ensuring that its higher environmental standards defined in law and regulation not be compromised by challenges of protectionism. See CRS Report RS20904, *International Investor Protection: "Indirect Expropriation" Claims Under NAFTA Chapter 11*, by Robert Meltz.

encouragement for trade and investment. DR-CAFTA also provides for formal cooperation among governments on environmental issues and a dispute resolution mechanism.[32]

Advocates still raise the issue of the environmental effects of trade, particularly in developing countries that may have weak laws and lax enforcement mechanisms. Many of these same advocates, however, would agree that thus far trade agreements have not led to catastrophic pollution nor encouraged a "regulatory race to the bottom." There has also been a certain acknowledged degree of success in having environmental issues addressed in the body of FTAs, in side agreements on environmental cooperation, and through technical assistance programs, the latter of which developing countries can use to respond to specific problems. Advocates still note that much can be improved, such as tightening enforcement language and ensuring that the United States allocates financial resources to back up promises of technical assistance.[33]

As required under TPA, the USTR conducted an environmental review of the potential environmental effects possibly attributable to the FTA. It noted that Panama "faces a number of challenges in protecting its environment as it supports its economic and population growth." Deforestation, land degradation, loss of wildlife, threats to water quality and wetlands, among other problems are serious issues for Panama. The Panama canal also places severe water use requirements on the country. Panama has responded through the public policy process, establishing environmental standards in law and entering into international and U.S. bilateral environmental cooperation agreements.[34]

These issues were already factors in Panama's development process prior to the negotiation of the FTA. Thus, the environmental review maintains that the marginal effects of the FTA on environmental standards will be small, whether in terms of projected impacts on the United States or on Panama. The review argues that Panama's service-oriented economy and the small trade volume with the United States are unlikely to be greatly affected by the proposed FTA and so will change marginal production and trade little. The FTA, however, may have both positive and negative effects. The negative effects of pollution, environmental degradation, and endangering wildlife would come mostly from increased agricultural trade and production, which might be addressed with increased environmental oversight and policies. The positive effect of the FTA could include improvements in environmental standards that may be encouraged by the provisions of the agreement and the consultative and cooperation agreements attached to the FTA.[35]

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[32] U.S.-Dominican Republic Free Trade Agreement. Chapter 17. Environment.

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

[34] Office of the United States Trade Representative. *Interim Environmental Review: U.S.-Panama Free Trade Agreement.* June 2004. pp. 7-9.

[35] Ibid., pp. 15-20.

Labor Issues. Labor provisions are also likely to mirror provisions in the DR-CAFTA. At issue for the U.S. Congress has been the extent to which the dispute settlement provisions are effective in requiring countries to meet certain standards, and also to meet congressional trade negotiating objectives defined in Trade Promotion Authority (TPA) legislation. Labor advocates argue that the DR-CAFTA-like provisions are a step backward from those allowing for the suspension of trade benefits found in the U.S. unilateral trade arrangements like the Generalized System of Preferences (GSP) and CBI, which currently govern much of the U.S. trade with Latin America.

Specifically, there are three provisions in the DR-CAFTA given different weight: 1) the effective enforcement of domestic labor laws; 2) the reaffirmation of commitments to International Labor Organization (ILO) basic principles;[36] and 3) "non-derogation" from domestic standards (not weakening or reducing protections to encourage trade and investment). In previously negotiated bilateral agreements, such as the DR-CAFTA, failure to enforce domestic labor laws can be formally challenged in the dispute resolution process. In the case of the other two provisions, which are supported in principle, such recourse is not available and labor advocates argue that unless all three are enforceable, an FTA does not provide a meaningful trade discipline.[37]

In addition, for labor and environmental issues, the dispute resolution process in other FTAs has operated differently than for commercial issues. In the DR-CAFTA, for example, if a commercial dispute remains unsettled, the country faces the possibility of suspension of benefits under the FTA "of equivalent effect" (Article 20.16), resulting in the raising of tariffs or payment of a monetary assessment equal to 50% of what a dispute panel determines is "of equivalent effect." This article does not apply to the disputable labor (or environmental) provision. The difference is that the option for failing to resolve a labor dispute is a fine that would be capped at $15 million per year, with recourse to an equivalent dollar value of suspended benefits (higher tariffs) if the monetary assessment is not paid. The monetary assessment would also be paid by the government into a government fund and expended for "appropriate labor initiatives." Labor advocates argue that by capping the assessment at $15 million and having the assessment paid into a fund in the offending country, the labor provisions are rendered ineffective. The USTR argues that for small countries, such a fine would be significant relative to the dollar value of the trade benefits it would receive.[38]

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[36] The 1998 *Declaration on Fundamental Principles and Rights at Work* identifies four fundamental principles and rights: freedom of association and the right to bargain collectively; abolition of forced labor; equal opportunity and treatment in employment; and elimination of child labor. ILO. *Promoting Better Working Conditions: A Guide to the International Labor Standards System.* Washington, D.C. 2003. pp. 33-34.

[37] Lee, Thea M. Assistant Director for International Economics, AFL-CIO. *Comments on the Proposed U.S.-Central American Free Trade Agreement,* before the USTR Trade Policy Committee, November 19, 2002.

[38] Lee, op. cit., and Labor Advisory Committee Report.

From a congressional perspective, there is some debate over whether differences in the treatment of the three labor provisions fail to meet the principal negotiating objectives as outlined in TPA legislation, which is largely a matter of interpretation. Further, unlike environmental advocates, labor groups have not agreed that a proper balance has been more or less struck in previous agreements. Practical issues have also been raised. For example, support for core labor rights is one thing, but actually monitoring them, identifying violations, and resolving disputes in a uniform way would create immense measurement and interpretive challenges for dispute arbitration panels. This raises two thorny questions, the first being, if the core ILO labor standards are enforceable in a bilateral FTA, could the United States be challenged over failure of some firms to meet these standards? The second question addresses equity in practice. Would all countries be subject to the same standards irrespective of economic size and strategic importance?[39]

In recently passed bilateral FTAs, Congress has agreed to adopt the implementing legislation because a majority of Members have been reconciled to the labor issues by assurances that the labor laws of the countries in question cover basic ILO commitments and are being reasonably enforced. The exception so far has been the DR-CAFTA.

Panama has higher wage rates compared to the region and the Panamanian government believes existing labor laws and enforcement mechanisms are adequate. The U.S. Department of State has pointed out that some problems exist with restrictions on union formation, the wide use of temporary workers, the lack of labor rights in export processing zones, and the trafficking of women and children. Panama's government has criticized this report and it remains for Members of Congress to determine if Panama's labor conditions and laws merit supporting a bilateral FTA.[40]

Outlook

Negotiations are proceeding at a quick pace, with some expectation that they could be concluded in the fall after the new administration of president-elect Martín Torrijos takes office on September 1, 2004. The Torrijos administration representatives have been witnessing the trade discussions and may be prepared to continue negotiating expeditiously. Both Panama and the United States appear eager to move quickly. The FTA would be the next step of the U.S. regional building block strategy as well as support for Panama's broader trade liberalization policy.

Progress has apparently been made by working with key elements of the DR-CAFTA text. This appears to have accelerated dramatically the negotiation process.

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[39] These issues were explored in a report prepared by the National Academy of Sciences. A summary of the key issues is provided in: Moran, Theodore H. *Trade Agreements and Labor Standards*. The Brookings Institution. Policy Brief #133. May 2004.

[40] U.S. Department of State. *Panama: Country Report on Human Rights Practices - 2003.* Washington, D.C. February 25, 2004. pp. 13-16 and the Economist Intelligence Unit. *Country Report - Panama*. London, June 2004. p. 14.

As is typically the case, the most difficult issues will be dealt with last, including market access for agricultural goods and fine tuning language covering services issues. Maritime issues have yet to be discussed. Panama does not seem to have taken issue with the labor and environmental provisions, but they will likely receive criticism in the United States as have earlier FTAs. It is too early to know when or if the U.S.-Panama FTA can be completed, but given built-in statutory time tables for notifying the U.S. Congress and providing supporting documentation, its seems improbable that it could be ready for a vote in the 108^{th} Congress.

Appendix 1. Chronology of U.S. Panama FTA Negotiations

Date	Milestone
November 18, 2003	The USTR notifies Congress of President George W. Bush's intent to enter into negotiations on a free trade agreement (FTA) with the Republic of Panama.
April 26-29, 2004	First round of negotiations occurs in Panama City.
June 11-15, 2004	Second round of negotiations takes place in Los Angeles.
July 12-16, 2004	Third round of negotiations held in Panama City.
August 9-12, 2004	Fourth round of negotiations held in Tampa.
October 18-22, 2004	Fifth round of negotiations scheduled to be held in Panama City.

Appendix 2. Panama: Selected Economic Indicators

	1994	1996	1998	2000	2002	2003
GDP Growth (%)	3.1	2.7	4.6	2.6	0.8	4.1
Per Capita GDP Growth (%)	1.0	0.6	2.6	0.6	-1.1	1.1
Urban Unemploy Rate (%)	16.0	16.9	15.2	15.2	16.5	15.6
Inflation (%)	1.4	23	1.4	0.7	1.9	1.3
Current Account Balance (% of GDP)	0.2	-2.5	-10.9	-6.9	-0.9	-1.2
Terms of Trade (Indices, 1997=100)	106.5	98.0	99.9	96.5	96.0	94.0
Foreign Direct Investment ($ millions)*	402	416	1,203	267	204	214

Source: United Nations Economic Commission on Latin America and the Caribbean. *Preliminary Overview of the Economies of Latin American and the Caribbean, 2003.* pp. 140-58.
*Net investment = direct foreign investment in Panama minus Panamanian direct investment abroad.

Appendix 3. U.S.-Panama Tariff Rates for Selected Products

(% of total dollar value)

Major U.S. Exports*	% of Total	Tariff Rate	Major U.S. Imports*	% of Total	NTR Tariff Rate**	Free under CBI#
Oil (2710)	23.3	5%+	Fish/Seafood (0302)	33.8	Free	
Aircraft (8802)	14.1	10%	Repaired Goods (9801)	21.9	Free	
Machinery - ADP (8473) - computers (8471) - gas turbines(8411)	9.4 (2.0) (1.8) (0.5)	 3% 5% 3%	Precious Metals (7112) - gold/scrap	5.4	Free	
Electrical Machinery (8517)	7.4	5%	Oil (2710) - gasoline - crude	4.8	 .525/bbl .105/bbl	
Pharmaceuticals (3004)	5.2	Free	Sugar (1701) - raw cane	4.4	varies & TRQ	
Optical/Medical Instruments - cameras (9006) - parts (9009) - medical (9018)	3.4 (0.8) (0.7) (0.5)	10% 5% 15% 10%	Coffee	4.1	Free	
Cereals - corn (1005) - under quota - out of quota - mesline (1001) - rice (1006) - under quota - out of quota	3.0 (1.8) (1.0) (0.2)	 3% 58% Free 15% 103%	Electrical Machinery (8519-28) - sound reproducing	2.8	Free	Free
Other	34.2		Other	22.8		
Total	100%		Total	100%		

Data Source: U.S. Department of Commerce.

Note: all Panamanian imports are subject to a 5% transfer tax, which is also collected on domestic products. This tax is considered similar to a nondiscriminatory sales or value added tax (VAT) by the U.S. negotiators and apparently will not be eliminated as part of the FTA.

* By HTS number = Harmonized Tariff Schedule of the United States.

** NTR is the general or normal tariff rates (also known as most favored nation rates) applied to products not given preferential tariff treatment.

#CBI = Caribbean Basin Initiative, which provides unilateral preferential tariff treatment to selected Caribbean and Central American country products as codified most recently in the Caribbean Basin Trade Partnership Act (CBTPA). P.L. 106-200.

+ Tariffs on oil vary depending on end use. Discussions with U.S. Department of Commerce officials suggest most U.S. oil exports to Panama (for automotive use) face a 5% tariff. Some oil for maritime use has tariffs as high as 30%.

Sugar is subject to tariff rate quotas in which tariffs become high if imports exceed the quota.