

# CRS Report for Congress

## The Proposed U.S.-Panama Free Trade Agreement

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# The Proposed U.S.-Panama Free Trade Agreement

## Summary

On June 28, 2007, the United States and Panama signed a free trade agreement (FTA) after two and half years and ten rounds of negotiations. Negotiations were formally concluded on December 16, 2006, with an understanding that further changes to labor, environment, and intellectual property rights (IPR) chapters would be made pursuant to detailed congressional input. These changes were agreed to in late June 2007, clearing the way for the proposed FTA's signing in time to be considered under Trade Promotion Authority (TPA), which expired on July 1, 2007. TPA allows Congress to consider trade implementing bills under expedited procedures.

The most visible changes include the adoption of enforceable labor standards, compulsory adherence to select multilateral environmental agreements (MEAs), and an easing of restrictions on developing country access to generic drugs. In each case, the proposed U.S.-Panama FTA goes beyond provisions in existing multilateral trade rules and even those contemplated in the Doha Development Round negotiations.

Panama is a small U.S. trade partner, but benefits from significant U.S. investment and unilateral trade preferences. These preferences would be replaced and made permanent by the reciprocal FTA. The FTA had to reconcile the needs of a relatively small developing country with those of a large developed one. For Panama, this meant addressing multiple trade liberalization goals, including expanding its globally competitive services sector, repositioning its much smaller manufacturing sector, and easing slowly into the international market its more protected and less competitive agricultural sector. For the United States, it meant building on a long-standing strategic military and commercial relationship, while accommodating the concerns of sensitive domestic sectors and industries.

The proposed U.S.-Panama FTA is a comprehensive agreement. Some 88% of U.S. commercial and industrial exports would become duty-free right away, with remaining tariffs phased out over a ten-year period. About 50% of U.S. farms exports to Panama would achieve duty-free status immediately. Tariffs and tariff rate quotas (TRQs) on select farm products are to be phased out by year 17 of the agreement. Panama and the United States agreed to a separate bilateral agreement on SPS issues that would recognize U.S. food safety inspection as equivalent to Panamanian standards, which would expedite entry of U.S. meat and poultry exports. The FTA also consummates understandings on services trade, telecommunications, government procurement, and intellectual property rights (particularly with respect to pharmaceutical products), while supporting trade capacity building.

Congress may take up implementing legislation this fall, but even with the recent changes to the FTA "template," FTAs remain a controversial issue. This report will be updated as congressional action and other developments warrant.

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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# The Proposed U.S.-Panama Free Trade Agreement

On June 28, 2007, representatives of the United States and Panama signed a free trade agreement (FTA) after two and half years and ten rounds of negotiations (see **Appendix 1** for a chronology of events). Negotiations were formally concluded on December 16, 2006, with an understanding that further changes to labor, environment, and intellectual property rights (IPR) chapters would be made pursuant to detailed congressional input. These changes were agreed to in late June 2007, clearing the way for the proposed FTA's signing in time to be considered under Trade Promotion Authority (TPA), which expired on July 1, 2007. TPA allows Congress to consider trade implementing bills under expedited procedures.<sup>1</sup>

The proposed U.S.-Panama FTA incorporates changes based on principles outlined in the "New Trade Policy for America,"<sup>2</sup> a bipartisan policy position crafted jointly by congressional leadership and the Bush Administration. First, the five basic labor rights defined in the United Nations International Labor Organization's (ILO) *Fundamental Principles and Rights at Work and its Follow-up (1998) Declaration* have been incorporated as unequivocal obligations, fully enforceable through the dispute settlement mechanism. Second, obligations to sign and adhere to numerous multilateral environmental agreements (MEAs) are now included. Third, pharmaceutical IPR provisions have been altered in ways that may hasten Panama's access to generic drugs. Congress may take up implementing legislation this fall,<sup>3</sup> but even with the recent changes to the FTA "template," FTAs remain a controversial issue. This report will be updated as events warrant.

## 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 ones defining their relative stake in the famous canal that traverses the Central American isthmus, bisecting 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.

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<sup>1</sup> For details, see CRS Report RL33743, *Trade Promotion Authority (TPA): Issues, Options, and Prospects for Renewal*, by J. F. Hornbeck and William C. Cooper.

<sup>2</sup> Released March 27, 2007 and available on the websites of the House Ways and Means Committee and the United States Trade Representative (USTR).

<sup>3</sup> Washington Trade Daily. *Democrats Say No to TPA*. July 2, 2007.

Figure 1. Map of Panama



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

## Early U.S.-Panama Economic Relations

Since first explored by the Spanish at the turn of the sixteenth century, interest in Panama has centered on 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 position 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.

Panama was swept to independence from Spain on November 28, 1821, becoming part of the Gran Colombia regional group. By this point, both the United States and Britain had openly coveted the prospect of an inter-oceanic connector. Well before construction of a canal could begin, the United States displaced Britain as the dominant foreign influence and completed 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 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 precedent had already been set to use military force for defense of U.S. interests in Panama.<sup>4</sup>

The initial U.S. effort to build a canal required a concession from Colombia allowing the United States to complete 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. On November 3, 1903, in a quick and bloodless move encouraged by the offshore presence of U.S. warships, Panama separated from Colombia. The United States immediately recognized Panama as an independent state, and in return, Panama signed the Hay-Bunau-Varilla Treaty, ceding to the United States the rights to construct a canal and to control it "in perpetuity."<sup>5</sup>

The Panama Canal opened in 1914, leading to U.S. dominance in the economic 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, frequent protests, and periodic 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 under terms defined in the Panama Canal Treaties signed by Presidents Jimmy Carter and Omar Torrijos. Although tensions flared again in 1989 when the U.S. military invaded Panama to arrest then-chief of state General Manuel Noriega on narcotics trafficking charges and for threatening U.S. personnel and property, the

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<sup>4</sup> Conniff, Michael L. *Panama and the United States: The Forced Alliance*. Athens: the University of Georgia Press, second edition. 2001. pp. 30-35.

<sup>5</sup> Woodward, Ralph Lee. *Central America: A Nation Divided*. New York: Oxford University Press, third edition. 1999, pp. 187-191 and *ibid.*, pp. 63-70.

incursion proved to be a catalyst for the return of democracy. Perhaps not coincidentally, Panama's decision to promote trade liberalization followed soon thereafter.<sup>6</sup>

## The Canal and U.S. Trade Policy

The canal solidified Panama as a maritime economy and its return to control by Panama raised expectations of greater economic benefits from its ownership. The canal operations by themselves account for approximately 6% 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). About one-third of all cargo passing through the canal has its origin or destination in the United States. 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 was widened in 2001, but Panama faces a difficult and expensive challenge to enhance the capacity of the entire canal to accommodate much larger post-Panamax ships.<sup>7</sup> Panama held a national referendum on the proposed \$5.25 billion expansion on October 22, 2006, which passed by a wide margin.

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 not without considerable costs and investment, 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 into residential housing, and developing a small foreign processing zone in the former Ft. Davis.<sup>8</sup>

The Panama-Pacific Special Economic Area (PPSEA) is perhaps the most ambitious of these projects. This public-private partnership, established in law, aspires to convert the former Howard Air Force Base into a "world class business center," with an emphasis on the export sector. Existing assets include housing and office buildings, a hospital, transportation infrastructure, fiberoptic cable network, an 8,500-foot runway, and four hangar facilities. The government offers businesses various fiscal incentives and a streamlined regulatory process. Firms are required to commit to state-of-the-art practices that include adopting internationally accepted environmental and labor standards.<sup>9</sup>

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<sup>6</sup> 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.

<sup>7</sup> 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; and [<http://www.pancanal.com>].

<sup>8</sup> *Ibid.*

<sup>9</sup> Government of Panama. *Panama-Pacific Special Economic Area Agency*.

With the assistance of the International Finance Corporation (IFC) of the World Bank, Panama is seeking a large global financing package to cover the initial investment needs. The project aims at developing various businesses including computer technology, cell phone manufacturing, international call centers (Dell already operates one on site), aeronautical industry support, and others that require a well-trained work force. The IFC supports this project not only for its prospects as a business venture, but because it is forward looking rather than relying on the “maquiladora” business model common in much of the region.<sup>10</sup>

At the start of the 21<sup>st</sup> century, the canal and close ties with the United States are still the defining features of Panama’s economy, but in the past these traits have hindered Panama’s participation in regional integration. 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 has always had a fully dollarized monetary system and is a beneficiary of U.S. unilateral trade preferences defined in the Caribbean Basin Economic Recovery Act (CBERA), the Caribbean Basin Trade Partnership Act (CBTPA), and the Generalized System of Preferences (GSP).<sup>11</sup> Under these circumstances, there has been little external incentive for Panama to become a more open economy. Only since joining the World Trade Organization (WTO) in 1997 did Panama begin to reduce tariff rates, an important step in preparing Panama for an FTA with the United States.

Panama’s subregional independence and reliance on U.S. economic ties has suited the United States as well, 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 accepted as a mutually beneficial 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 currently 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 on one level of negotiation may encourage, if not compel, similar breakthroughs on others. Because of slow progress in negotiations at the WTO Doha Round and the Free Trade Area of the Americas (FTAA), the United States has moved ahead aggressively with bilateral talks, of which the Panama FTA is one. Some, however, have questioned the bilateral

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<sup>10</sup> Ibid., and discussion with IFC official.

<sup>11</sup> Panama’s dollarized economy has been a cornerstone of its long-term economic stability. It has safeguarded Panama against exchange rate risk, currency mismatches, and speculative attacks experienced in other developing economies, and eliminated the monetizing of deficits, thereby reinforcing fiscal constraint and price stability. See Moreno-Villalaz, Juan Luis. Financial Integration and Dollarization: The Case of Panama. *Cato Journal*, Winter 2005. For more on trade preferences, see CRS Report RL33951, *U.S. Trade Policy and the Caribbean: From Trade Preferences to Free Trade Agreements*, by J. F. Hornbeck.



approach for the asymmetrical negotiation power the United States wields, the effects it may have on non-participating countries, and the one-sided trading system that is developing around a U.S. hub, as opposed to a truly regional or multilateral system.

For Panama, the proposed FTA may be seen as a way to reinforce its varied trade liberalization goals. The services sector is already globally competitive, but the manufacturing sector is small and agricultural remains protected and uncompetitive (see below). For Panama, the chief concern was crafting an FTA that would balance the need to pursue openness for services, export growth and promotion for manufacturing, and adjustment time for agriculture to become more competitive, while minimizing social displacement. The incentive to negotiate was perhaps also enhanced by the desire to keep pace with other Latin American countries that have or are negotiating FTAs with the United States.

## Panamanian Trade Relations

Panama is a country of 3.2 million people with a stable, diversified economy that has rebounded briskly from the 2001-2002 global economic downturn. Panama's gross domestic product (GDP) expanded by 4.2% in 2003, 7.6% in 2004, 6.9% in 2005, and 7.1% in 2006 (see **Appendix 2** for selected macroeconomic data). With the exception of Costa Rica, Panama has the highest per capita income in the Central American region, but income distribution is highly skewed, poverty remains a nagging problem, especially in rural areas, and unemployment is high, but declining. Unlike any other Latin American country, 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 17% to GDP followed by agriculture at 6%.<sup>12</sup>

### Structure and Direction of Panamanian Trade

Trade is an increasingly important part of this services-based economy. As seen in **Table 1**, Panama's balance of payments points to a sizeable trade deficit in goods compared to a large services trade surplus. Panama's merchandise trade deficits ranged from \$700 million to \$1.6 billion from 2001 to 2006. In each year, the merchandise deficit was offset by a services trade surplus of between \$900 million to \$1.7 billion, unusual for a Latin American economy.

**Table 1. Panama's Current Account Balance**

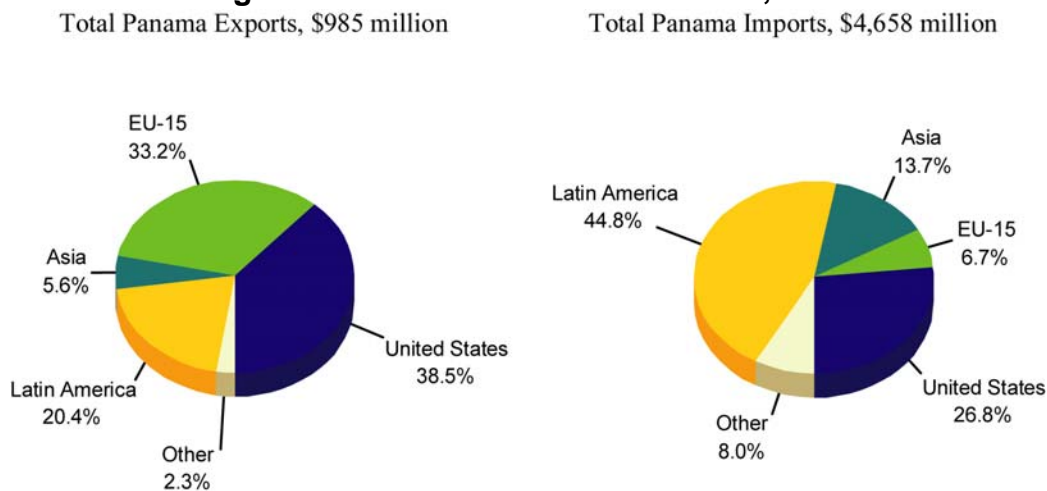
	2001	2002	2003	2004	2005	2006
Balance on Merchandise Trade (\$ million)	-696	-1,037	-1,113	-1,538	-1,316	-1,576
Balance on Services Trade (\$ million)	899	979	1,254	1,278	1,415	1,715

**Data Source:** United Nations Economic Commission on Latin America and the Caribbean (ECLAC). *Preliminary Overview of the Economies of Latin America and the Caribbean*, years 2003-2006.

<sup>12</sup> Republic of Panamá. Controller General's Office. 2005.

Overall, the current account deficit has remained relatively high in recent years due in part to the sharp rise in oil prices, which has also negatively affected Panama's inflation rate and terms of trade (**Appendix 2**). Panama places a strong emphasis on increasing exports as a driver of economic growth, pointing to the Panama Pacific Special Economic Area, Colón Free Zone (see below), and, to a lesser extent, the small export processing zones and nontraditional agricultural products as opportunities to execute this vision. As a global trader, it has completed FTAs with El Salvador (2002), Taiwan (2004), and Singapore (2005). In addition to the United States, it is negotiating FTAs with Guatemala, Nicaragua, Costa Rica, and Honduras. Panama nonetheless remains closely tied to the United States as its dominant trading partner, which as a single country is a larger trading partner than any of the world's major regions.

**Figure 2. Panama Direction of Trade, 2006**



Source: CRS from World Trade Atlas .

In 2006, the United States accounted for some 38.5% of Panamanian exports and 26.8% of its imports (see **Figure 2**). The European Union is the second largest export market with a 33.2% export share, but accounts for only 6.7% of Panamanian imports. The Latin American countries collectively are Panama's third largest export market with 20.4%, but has the largest import share at 44.8%.

Panama is one of the few Latin American countries with which the United States has a merchandise trade surplus, and although relatively small, it is by far the largest in the region. Panama runs a sizeable trade deficit with Latin America; its largest Latin American trade partners are Mexico, Costa Rica, and Brazil. Panama also imports significant quantities of oil from Peru, Venezuela, and Ecuador. Asia accounts for 5.6% of Panama's exports, but 13.7% of its imports, dominated by Japan, South Korea, and more recently, China.

**The Colón Free Zone.** A distinct feature of Panama's trade regime is the Colón Free Zone (CFZ), which with the exception of Hong Kong, is the largest duty free zone in the world. The vast trade volume that traverses the Panama Canal, multimodal transportation infrastructure, modern financial sector, and Panama's central location in the Americas make Colón a logical place for a duty free zone. It serves as a "one stop shop" for both Latin American buyers, and sellers from the rest

of the world, including Asia and the United States. Sellers operate showrooms targeted at small- and medium-sized buyers, who make wholesale purchases of goods for retail sale in their respective countries. Goods are typically repackaged in smaller lots, priced in the local market currency, and transferred to the purchasing country without incurring income, value added, or transfer taxes. Most CFZ trade is in electronics, clothing, jewelry, and other consumer goods.

Buyers benefit from the ability to purchase small lots, reduced travel to distant foreign countries, economies of scale that arise from consolidating lots for shipping, minimal transaction costs, vastly improved shipping times, and credit offered by sellers. The sellers benefit from reaching smaller Latin American markets in one location and reduced tax and transaction costs. Panama benefits from the 20,000 direct jobs the CFZ creates and the public revenue they generate. CFZ trade is reported as a separate component of Panama's trade statistics and only those goods entering the Panamanian economy are recorded as imports. In 2005, nearly \$5 billion worth of goods passed through the CFZ, with \$500 million added to the Panamanian trade balance.<sup>13</sup>

The CFZ is frequently associated with a number of illicit activities including money laundering, illegal transshipment, trademark and other intellectual property violations. In part, this is a reputation that Panama as a whole has been fighting since the military dictatorship, which was widely known for its flagrant disrespect of the law, if not outright corruption. Panama's proximity to Colombia and headquarters as a transshipment point helped fuel this perception.

The CFZ has attempted to counter this reputation. The zone itself is an enclosed commercial area, encircled by, and under the supervision of, customs and other law enforcement agencies of the Republic of Panama. In addition, both the Colón Free Zone User's Association and the CFZ Administration have a strict code of conduct and argue that illegal activity is also policed by individual companies because a bad reputation hurts those dedicated to making the CFZ a world class trading center. Even the accusation of an infraction can lead to a suspension of the license needed to operate in the zone. Cash accounts for only 10% of transactions and there is careful monitoring of all goods that move in and out of the zone through electronic tracking systems.<sup>14</sup>

## **U.S.-Panama Merchandise Trade**

U.S.-Panamanian merchandise trade is small.<sup>15</sup> In 2006, the United States exported \$2,706 million worth of goods and imported \$323 million, producing a U.S.

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<sup>13</sup> U.S. Department of Commerce. U.S. Commercial Services. *Doing Business In Panama: A Country Commercial Guide for U.S. Companies 2005*. April 7, 2005. p. 3 and author's interviews with CFZ representatives, September 21, 2005.

<sup>14</sup> Colón Free Zone User's Association. *Rules of Conduct for the Members of the Colón Free Zone Users' Association*, 1995; and author's interviews with representatives from agencies mentioned.

<sup>15</sup> Services trade data are not available for smaller U.S. trading partners, including Panama.

trade surplus of \$2,383 million, the largest in the Western Hemisphere. Still, Panama ranked as only the 45<sup>th</sup> largest export market for U.S. goods and 98<sup>th</sup> for imports. Major U.S. exports, as seen in **Table 2**, include oil and mostly capital- and technology-intensive manufactured goods such as aircraft, pharmaceuticals, machinery, medical equipment, and motor vehicles.

**Table 2. U.S.-Panama Merchandise Trade, 2006**  
(top ten U.S. exports and imports by \$ value)

U.S. Exports	\$ Value million	% of Total	U.S. Imports	\$ Value million	% of Total
1. Oil (not crude)	855.6	31.6%	1. Fish/Seafood:	101.9	26.9%
2. Machinery	291.8	10.8%	2. Repaired Goods	79.6	21.0%
- Computers	(65.1)				
- Office mach.	(41.8)				
3. Electrical mach.	183.6	6.8%	3. Gold	35.0	9.3%
4. Aircraft	166.1	6.2%	4. Crude Oil	32.3	8.6%
5. Pharmaceuticals	132.4	4.9%	5. Sugar (cane)	23.5	6.2%
6. Vehicles	93.4	3.5%	6. Edible Fruit	12.2	3.3%
7. Optical/Medical Equipment	93.4	3.5%	7. Coffee	11.8	3.1%
8. Perfume	77.3	2.9%	8. Electrical mach.	9.0	2.4%
9. Paper	67.2	2.5%	9. Aluminum	8.8	2.3%
10. Cereals	69.0	2.6%	10. Glass	5.2	1.4%
Other	676.9	24.7%	Other	59.0	15.4%
<b>Total</b>	<b>2,706.7</b>	<b>100.0%</b>	<b>Total</b>	<b>378.3</b>	<b>100.0%</b>

**Data Source:** U.S. Department of Commerce.

The United States imports relatively little from Panama, accounting for the growing U.S. merchandise trade surplus. Most imports are primary products; over one-quarter is seafood, mostly fresh fish and shrimp. Repaired goods are number two accounting for 22% of total imports from Panama.<sup>16</sup> Commodity trade includes crude oil, precious metal (mostly gold), fruit, sugar, and coffee, which together account for 30.5% of total imports. Unlike the Central American countries, where U.S. sensitivities to textile and apparel trade run high, Panama trades little in this sector. Panama's agricultural exports, particularly sugar, presented the more difficult negotiation issues.

## 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,

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<sup>16</sup> Technically classified in the Harmonized Tariff System (HTS) 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."

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).<sup>17</sup> 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 permanent rules-based trade relationship with a large trading partner.

**Table 3. U.S. Investment in Panama, Mexico, and Central America**  
(\$ millions)

Sector	2001	2002	2003	2004	2005
Panama	5,141	5,842	5,409	5,631	5,162
Mexico	52,544	56,303	59,851	63,502	71,423
Central America	2,994	3,199	2,333	2,857	3,230

**Data Source:** U.S. Department of Commerce. Bureau of Economic Analysis. International Economic Accounts. BEA website. 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. The amount of U.S. investment in Panama well exceeds that in the five Central American countries combined, although it is a small fraction of U.S. investment in Mexico. Plans to widen and improve the canal will likely provide an opportunity for some \$5 billion of investment in the canal itself, and perhaps related large amounts of FDI for other sectors of the economy with a significant U.S. presence.

## Summary of Trade Negotiations and the Proposed U.S.-Panama FTA<sup>18</sup>

Panama approached the United States for a stand-alone FTA, preferring to avoid a direct link to the U.S.-Dominican Republic-Central America Free Trade Agreement (CAFTA-DR).<sup>19</sup> Panama wanted to maximize an FTA's potential to win U.S. congressional approval by emphasizing the historical and strategic nature of the U.S.-Panamanian relationship, while separating the negotiations from the divisive CAFTA-DR accord. Panama's service economy, small textile and apparel industry, and limited integration with the Central American economies also bolstered the case

<sup>17</sup> U.S. Department of Commerce, *Doing Business in Panama*, pp. 3-4.

<sup>18</sup> This summary reflects information in the final text of the proposed FTA, released on July 2, 2007.

<sup>19</sup> For a discussion of the CAFTA-DR and a deeper understanding of the regional economic implications of freer trade, see CRS Report RL31870, *The Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR)*, by J. F. Hornbeck.

for separate negotiations.<sup>20</sup> Another unique feature of the FTA negotiations was the treatment of business issues with respect to the Panama Canal Area. Its status as an autonomous legal entity under the Panamanian Constitution required separate negotiations for government procurement, labor, investment, and other areas. The United States is the only country with which Panama has been willing to negotiate issues related to the canal area in an FTA.

The proposed agreement was completed in ten rounds of negotiation, concluding on December 16, 2006 and follows the text framework of earlier FTAs. It was signed on June 28, 2007 following some significant last minute changes to the labor, environment, and intellectual property rights chapters to accommodate new commitments agreed to by the USTR and bipartisan congressional leadership. Market access schedules, drawn from previous FTA templates, reflect U.S. and Panamanian interests, as do other market access provisions. Below is a more detailed discussion of the major negotiation areas and a description of the issues that have been of particular interest to Panama and the United States, including the U.S. Congress.

## Market Access

Market access (chapter 3 of the FTA) covers provisions that govern barriers to trade such as tariffs, quotas, safeguards, other nontariff barriers, and rules of origin (chapter 4). The proposed U.S.-Panama FTA would replace unilateral trade preferences provided to Panama under the Caribbean Basin Economic Recovery Act (CBERA), the Caribbean Basin Trade Partnership Act (CBTPA), and the Generalized System of Preferences (GSP), under which many imports from Panama enter the United States duty free along with those entering under the normal trade relations schedule (see **Appendix 3** for selected tariff rates). Panamanian agricultural products face some of the highest barriers, particularly sugar, which is subject to a tariff rate quota. U.S. exports face tariffs, with most falling in the range of 3-10%, plus the additional 5% transfer tax, which applies to domestic goods as well.

Market access provides for national treatment for traded goods of both parties, with a detailed schedule defining the progressive elimination of customs duties for manufactured and agricultural goods. There are eight staging categories that allowed each country to identify its most sensitive products for lengthier phase out of tariffs. The USTR reports that tariffs on 88% of industrial and commercial goods would go to zero immediately, with the remaining tariffs phased out over a ten-year period. Similarly, over half of U.S. farm exports would receive immediate duty free treatment.<sup>21</sup> Tariffs on some agricultural goods would remain in place longer, with some taking up to 16 years to be completely eliminated. Safeguards have been retained for many products only for the period of duty phase out, but antidumping and countervailing duties were not addressed, leaving these trade remedy laws fully operational, as required under TPA.

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<sup>20</sup> Inside U.S. Trade. *Panama FTA Unlikely To Be Docked Into CAFTA as Talks Set to Begin*. April 23, 2004.

<sup>21</sup> Office of the United States Trade Representative. *Free Trade with Panama: Summary of the Agreement*. January 2007.

Rules of origin define which goods would be eligible for duty-free treatment based on the country of origin of their content. Rules of origin are intended to prevent transshipment of goods made from materials originating in countries outside the agreement. They are particularly pertinent to apparel and textile trade. Apparel products made in Panama would be given duty-free treatment if they are made from U.S. or Panamanian fabric and yarns (the yarn forward rule).

**Agricultural Trade.** U.S. domestic agricultural support programs are not addressed in the proposed FTA, which focused on reducing tariffs, increasing quota levels, and cooperating more closely on sanitary and phytosanitary (SPS) rules and enforcement. Market access was particularly difficult for four highly protected products: pork; poultry; rice; and sugar. The United States was basically “offensive” on pork, poultry, and rice, expecting to open further Panama’s markets as soon as possible. It was “defensive” on sugar, attempting to limit increases in the sugar quota that might disrupt operations of the sugar program as defined in legislation. Panama’s position was the reverse, pressing to minimize increases in U.S. exports of pork, poultry, and rice, and to increase its U.S. sugar export quota.

In the United States, the sugar program reflects a historical commitment to protect the income of sugar beet, sugar cane, and sugar processing firms with below-prime-rate loans, limitations on sales in the domestic market, and tariff rate quotas (TRQs). TRQs restrict imports with prohibitively high tariffs on imports above a defined quota amount, as defined in WTO rules agreed to by the United States. In 2003, the above-quota tariff on sugar was 78%.<sup>22</sup> On average, Panama harvests only a quarter of the sugar produced by each of the five Central American countries, but it still plays a disproportionately important role in the agricultural sector. Sugar constitutes: 1) a third of Panama’s total agricultural exports, compared to less than 10% for the Central American countries, and; 2) 41% of agricultural exports to the United States. The U.S. market consumes 76% of Panamanian sugar exports, compared to less than 10% of sugar exports from Central America.

Given the dependence of sugar producers on the U.S. market, in part driven by Panama’s relatively high wage rates that make it cost prohibitive to produce for the world market, the Panamanians argued that even a relatively small quantitative increase in their portion of the U.S. sugar quota would have a large benefit for their industry. The U.S. sugar industry, however, continued to resist the inclusion of sugar in bilateral FTAs, arguing that the WTO is the forum for addressing domestic support programs and TRQs in the agricultural sector.

In Panama, pork, rice, and poultry were the most sensitive products. These are also protected by TRQs, with in-quota tariffs of 15% and out-of-quota tariffs rising to 74%, 103%, and 273%, respectively. Pork and poultry have a special issue related to the consumption of white versus dark meat. The United States consumes considerably more white meat than dark, leaving a disproportional amount of dark cuts for export, which face the highest tariffs. In Panama, as with much of the world,

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<sup>22</sup> The economic effect is to raise the price of sugar in the United States above the world price, increasing income to sugar-producing industries, but raising costs to sugar-using firms and consumers. CRS Report RL33541, *Sugar Policy Issues*, by Remy Jurenas.

dark meat is preferred. The concern revolves around U.S. producers willingness to sell dark meat cuts at a low price in foreign markets, putting downward pressure on prices and hurting domestic producers in those countries. The Panamanians argued that because of the relatively high profit margins on white meat in the United States, on a cost allocation basis, U.S. producers can actually afford to sell the dark meat at below cost. The cost accounting can be debated, but concerns over the price effect in the Panamanian market remained unchanged. Panama's rice industry, which supplies over 90% of the domestic demand, was also convinced that opening their market to U.S. subsidized rice would decimate their industry, which, because of its protection, sells rice considerably above the world price.

Panamanian agriculture represents only 6% of GDP, but 17% of employment. These numbers point to both an inherent inefficiency, due in part to protection, but also the strong role agriculture plays in supporting rural employment and social stability. Agriculture's 17% of national employment actually supports 40% of the country's population living in rural areas, most of whom exist at or below the poverty line. Given the potential to dislocate much of the poor in the country, the Panamanians argued that opening the agricultural sector too quickly to the large production capacity of the United States would have been highly detrimental to the social structure of the rural economy, leading to increased unemployment, poverty, and rural-urban migration. For these reasons, Panama wanted a slow transition to open markets in the agriculture sector, as well as, an increase in the sugar quota to boost employment. This would also buy time for Panama to develop its non-traditional export crops, such as melons, palm oil, and pineapples, which some view as the future of this sector.

The compromise struck in the proposed FTA would provide duty-free treatment for over half of U.S. farm exports to Panama including high quality beef, poultry products, soybeans, most fresh fruits, and a number of processed goods. Remaining tariffs would be phased out between 7 and 16 years after the FTA takes effect. Rice tariffs, which protect one of Panama's most sensitive products, would remain in place for the full 16 years, as would tariffs on pork, chicken leg quarters, dairy products, and corn, among others. These products would receive expanded quotas under the Panamanian tariff rate quota system. The United States agreed to give Panama an additional 7,000 metric tons of sugar imports in the first year under a three-tiered TRQ system, which would grow by 1% per year, capped eventually for some types of sugar. The American Sugar Alliance apparently has agreed not to come out against the agreement.<sup>23</sup>

Other protective measures for agriculture were negotiated. Whereas export subsidies, voluntary restraint agreements (VREs), and import licensing are generally prohibited, TRQs, safeguards, and a sugar compensation mechanism would be allowed. The sugar mechanism gives the United States the option to compensate Panamanian sugar producers in lieu of giving Panamanian their exports duty-free treatment. This provision might be used if the U.S. sugar program were threatened with disruption.

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<sup>23</sup> Inside U.S. Trade. *Panama FTA Offers Limited Sugar Access; Labor Changes Possible*. December 22, 2006.



**Sanitary and Phytosanitary Standards (SPS).** SPS was one of the most difficult issues to resolve. Although understood as necessary to ensure the safety of agricultural imports, SPS standards can be a burden, and are often denounced as a veiled form of protectionism. Panama's SPS standards, on the whole, are considered to be very high and meet WTO standards. The USTR, however, has long raised concerns over procedural transparency with respect to phytosanitary permits and also Panama's requirement that imports of poultry, beef, and pork, its most protected products, come from processing plants that have been individually inspected by Panamanian officials. The United States contends that this process has often been cumbersome, drawn out, and ultimately very costly to U.S. producers.<sup>24</sup>

The United States wanted Panama to recognize the USDA certification process as equivalent to Panamanian standards for the purpose of securing unimpeded entry of U.S. meat exports. This issue became highly controversial during the ninth round of negotiations, when U.S. negotiators proposed this agreement be put into a formal side letter. Panama responded by noting that the SPS chapter had already been closed, that its meat inspection standards are among the highest in the world, and that a last minute effort to change SPS provisions raised sovereignty issues in Panama by potentially requiring Panama to lower its standards in some cases.<sup>25</sup>

As part of the resolution, Panamanian officials visited the United States to review the food safety inspection system for meat and poultry and found that accepting the U.S. system would pose no sanitary threat to Panama. This understanding was formalized in a separate bilateral agreement between the two countries, along with a streamlined import documentation system. Signed on December 20, 2006, the agreement states that for meat, poultry, dairy, and other processed products, Panama agrees to accept U.S. sanitary, phytosanitary, and regulatory systems as equivalent to those of Panama and will no longer require individual plant inspections. Panama has since amended its laws accordingly.<sup>26</sup>

**Textiles and Apparel.** In general, textiles and apparel make for difficult market access negotiations, but Panama produces very little of these goods. The proposed FTA would provide immediate duty-free access for all textile and apparel goods, subject to rules of origin. The permanence of the provisions and more accommodating measures provide a benefit to the small Panamanian industry. Safeguard measures would allow duties to increase on imports in which a sudden increase in volume either threatens or actually harms U.S. producers. The text also provides for short supply lists of fabrics, yarns, and fibers that otherwise would face duties. The market access provisions were not the major apparel issue. Because

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<sup>24</sup> United States Trade Representative. *2007 National Trade Estimate Report on Foreign Trade Barriers*. Washington, D.C. March 2007. p. 452.

<sup>25</sup> Berrocal, Rafael E. Panamá Reconoce Sistema Sanitario de Estados Unidos. *Presna.com*. February 22, 2006 and *Inside U.S. Trade*. Dispute Over Agriculture Inspections Holding up U.S.-Panama FTA Talks. January 23, 2006. Also see USTR Press Release, February 13, 2006.

<sup>26</sup> *United States-Panama Agreement Regarding Certain Sanitary and Phytosanitary Measures and Technical Standards Affecting Trade in Agricultural Products*. December 20, 2006.

Panama is a huge transshipment point for international trade and has its own duty free zone, the main concern was to assure U.S. apparel producers that there would be effective customs cooperation to deter illegal transshipment of goods that do not meet rules of origin. There is an extensive provision on consultation, monitoring, and onsite visit procedures in support of adhering to the rules of origin.<sup>27</sup>

## Government Procurement

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.<sup>28</sup> Some of the concerns expressed were addressed in the 2006 amendments to the procurement law, which modernized (e.g., through the use of Internet procurement system) and made more transparent procurement regulations and government purchasing information. A separate administrative court for public contracting disputes was also created. These changes enhanced Panamanian laws that already require transparency in the bidding process. Panama has not acceded to the WTO Government Procurement Agreement, which the United States has encouraged.<sup>29</sup>

Government procurement takes on a greater importance when considered in light of the proposed expansion of the Panama canal and related prospects for large long-term investments. The Panama Canal Authority (PCA) operates independently of the national government and Panama required separate negotiation apart from the regular government procurement chapter. Panama negotiated to maintain the canal authority dispute settlement system within the proposed FTA, as well as to keep small business set aside provisions for Panamanian firms. In addition, for 12 years after the agreement takes effect, Panama may set aside contracts let by the PCA to Panamanian firms subject to clear notice of intent to do so and limitations on the size of contracts. The text otherwise addresses U.S. concerns over nondiscriminatory, fair, nondiscriminatory, and open government procurement procedures for all national government authorities. Like the PCA, subnational governments (e.g. states and municipalities) are not required to uphold the government procurement provisions, but those willing to do so appear in an appendix of the proposed FTA.

## 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 signed a bilateral investment treaty with the United States in 1991, the first in the region, which includes investor-state provisions 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,

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<sup>27</sup> Inside U.S. Trade. *U.S. Panama FTA Includes Restrictive Textile Rules of Origin*. January 5, 2007 and USTR, *Free Trade with Panama*, p. 2.

<sup>28</sup> Panamcham. *Issues of Importance in the U.S.-Panama FTA Negotiations*, March 12, 2004. [[http://www.panamcham.com/business\\_center/FTA.asp](http://www.panamcham.com/business_center/FTA.asp)].

<sup>29</sup> USTR, *2007 Foreign Trade Barriers*, p. 503.

concerns have arisen in particular cases involving investment in highly regulated industries. Resolution of these concerns facilitated proceeding with the proposed FTA and there is potential for further significant foreign investment in Panama, including the canal expansion and reverted areas of the former canal zone.<sup>30</sup>

The text provides for clear and enforceable rules for foreign investments, which is largely accomplished by “standard” language (identical to the CAFTA-DR) requiring national and most-favored-nation (nondiscriminatory) treatment. It further clarifies rules on expropriation and compensation, investor-state dispute settlement, and the expeditious free flow of payments and transfers related to investments, with certain exceptions in cases subject to legal proceedings (e.g., bankruptcy, insolvency, criminal activity). Transparent and impartial dispute settlement procedures provide recourse to investors.

Two investment issues stand out. First, an investor-state provision, controversial during the CAFTA-DR debate, but commonly used in U.S. bilateral investment treaties (BITs) and in earlier FTAs, has been included. It allows investors alleging a breach in investment obligations to seek binding arbitration against the state through the dispute settlement mechanism defined in the Investment Chapter. U.S. investors have long supported the inclusion of investor-state rules to ensure that they have recourse in countries that may not adequately protect the rights of foreign investors. Since bilateral investment treaties are usually made with developing countries that have little foreign investment in the United States, it was not anticipated that these provisions would be applied in the United States. This changed under NAFTA, when investor-state provisions gave rise to numerous “indirect expropriation” claims against subnational (state) governments in the United States, Mexico, and Canada over environmental and other regulations.<sup>31</sup>

Although none of the claims filed against the United States has prevailed, Congress instructed in TPA legislation that future trade agreements ensure “that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors.” In response, Annex 10-B of the proposed U.S.-Panama FTA states that “except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.” This provision, along with one that allows for early elimination of “frivolous” suits, is intended to address congressional concerns.

Second, Annex 10-F of the proposed FTA seeks to reserve certain rights with respect to disputes filed under Section - B of the investment chapter that may affect the Panama Canal Authority (PCA). First, it clarifies that Panama has sole authority over the canal and its operations, and should a claim be made against the PCA, the

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<sup>30</sup> Ibid., p. 475.

<sup>31</sup> Indirect expropriation refers to regulatory and other actions that can adversely affect a business or property owner in a way that is “tantamount to expropriation.” This issue and many cases are discussed in CRS Report RL31638, *Foreign Investor Protection Under NAFTA Chapter 11*, by Robert Meltz.

dispute tribunal “may not order attachment or enjoin the application of a measure that has been adopted or maintained by the Panama Canal Authority in pursuance of...” its responsibility for the canal. Second, a claim arising from acts of the PCA that alleges a breach of the investment agreement must first be made to the PCA, where it will have three months to respond before the claim may be made to the dispute settlement panel under the proposed FTA.

## Services

Services trade was negotiated in multiple chapters and include financial services, shipping, telecommunications, professional services, and e-commerce. Panama is a service-based economy, has many competitive services industries, and is known for its “open regulatory environment for services.” Panama does require local licensing for many professionals to practice in the country, which the United States wanted to change. 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. The United States pressed for even greater transparency in regulatory procedures and U.S. business groups identified services as a critical negotiating area given U.S. competitive advantages and the large services sector in Panama.<sup>32</sup>

Equal ability to compete in retail trade, express delivery, and financial services, including insurance and portfolio management, was negotiated in the proposed FTA, an issue of primary importance to the United States. In particular, restrictions on investment in retail trade and access to contracts let by the Panama Canal Authority were either eliminated or reduced. Greater access to other professional services and transparency in licensing and other accreditation were clarified. In reducing restrictions in these areas, U.S. firms would be better able to compete in the largest sector of the Panamanian economy, the one most likely to grow with canal expansion and increased merchandise trade through the canal. Panama wanted greater transparency in the U.S. state-level financial services regulatory system to help ease the possible opening of Panamanian banks in select U.S. states. The United States government argued, however, that it was unable to make commitments on state-level financial services regulatory matters.

## Intellectual Property Rights

Clarifying intellectual property rights (IPR) was a major U.S. priority, in particular by having Panama’s standards approximate more closely those of the United States and by securing Panama’s commitment to join an array of international agreements related to IPR protection. The most contentious IPR issues revolved around loosening restrictions on data exclusivity with respect to the approval process of new pharmaceutical products (see below).

The USTR reports that Panama’s IPR laws and institutional support have improved with the creation of courts dedicated specifically to IPR cases. Panama updated its patent law in 1996 and has a law governing trademark protection.

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<sup>32</sup> USTR, *2007 Foreign Trade Barriers*, pp. 455-456.

Panama 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 continues to encourage Panama to accede to additional IPR treaties, as now required in the proposed FTA, and to remain vigilant in its antipiracy commitment, a primary concern given the large amount of goods that are shipped through the Canal Free Zone.<sup>33</sup>

IPR provisions in the proposed FTA exceed those in the WTO. They provide that all businesses receive equal treatment and that Panama ratify or accede to various international IP agreements. Trademark registration is better enforced through a transparent online process and special system to resolve disputes over internet domain issues, among other requirements. Copyright provisions clarify use of digital materials (exceeding TRIPS standards) including rights over temporary copies of works on computers (music, videos, software, text), sole author rights for making their work available online, extended terms of protection for copyrighted materials, strong anti-circumvention provisions to prohibit tampering with technologies, the requirement that governments use only legitimate computer software, the prohibition of unauthorized receipt or distribution of encrypted satellite signals, and rules for liability of internet service providers for copyright infringement. Patents and trade secrets rules conform more closely with U.S. norms. End-user piracy is criminalized and all parties are required to authorize the seizure, forfeiture, and destruction of counterfeit and pirated goods. The text also mandates statutory damages for abuse of copyrighted material.<sup>34</sup>

**Pharmaceutical Data Exclusivity.** A debate emerged during the CAFTA-DR negotiations over IPR provisions because they were construed to be a potential barrier to the more timely entry of generic drugs into developing country markets. The primary issue involved the data exclusivity term. To bring a patented drug to market, a drug company must demonstrate through clinical trials that the drug is both safe and effective, a time consuming and costly process. Under U.S. law, the data used to establish these claims are protected from use by generic manufacturers to certify their own products for a period of five years from the time the patented drug is approved for use in a country's market, the so-called data exclusivity term. In the CAFTA-DR debate, this provision became controversial when the Guatemala legislature changed its laws, adopting WTO language that would have limited data protection to five years from the time a drug is brought to market in the first country (e.g., the United States), rather than from the later time that it might be introduced in a second country (e.g., Guatemala).

This issue was partially resolved in the CAFTA-DR with a side agreement stating that "obligations" under the IPR chapter do not affect a country's ability "to take necessary measures [e.g., compulsory licensing for generic drugs] to protect public health by promoting access to medicines for all," in particular those needed to combat epidemics such as HIV/AIDS, tuberculosis, and malaria, among others. Critics, however, wanted the side agreement to include an explicit exception to the

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<sup>33</sup> USTR, *2007 Foreign Trade Barriers*, p. 454.

<sup>34</sup> U.S.-Panama FTA, Chapter 15.

data protection requirement for cases where compulsory licencing under the WTO rules might be invoked.<sup>35</sup>

For the proposed U.S.-Panama FTA, congressional input changed the language to reflect this latter concern. The new text provides that if a company files to bring to market a new drug in a second country (e.g., Panama) after making an initial filing in the first country (e.g., the United States), and Panama approves the drug within six months of that filing, the data exclusivity term begins at the time the drug is approved in the United States, not Panama. This provision is intended to encourage both drug companies and governments to engage in the approval process as efficiently as possible, thereby speeding the entry of generic drugs into developing countries (Panama). Because the six-month rule potentially reduces the data exclusivity term in Panama, drug companies are encouraged to file as soon as feasible to maximize the time their data may be protected in Panama after getting market approval. Because countries must approve within the sixth-month rule to benefit from it, they are encouraged to put in place an efficient drug certification process.

In addition, there is language in the IPR chapter stating that in the case of epidemics, a waiver from the data exclusivity laws would be allowed. In the past, the WTO public health provisions have allowed for compulsory licensing, circumventing patents in public health emergencies, but in the case of the U.S.-Panama FTA, the waiver is extended to the data exclusivity term, as well. Among other issues, the FTA also eliminates patent restoration, or allowing for the retroactive application of patents in cases where the approval of a patent extends beyond some legal- or regulatory-determined standard period of time.

Public health advocates have long pushed for changing international rules that would potentially hasten the introduction of lower cost generic equivalents into developing countries, particularly to address public health emergencies. The revised IPR chapter supports this goal. Pharmaceutical companies, however, argued against these changes because they bear the full cost of this option through lost revenue to the earlier introduction of generic competition, revenue expected to offset the high costs of research and development that allows new drugs to be properly tested and approved in the first place. Also, in developing countries with less than robust patent laws, data exclusivity is often the only recourse drug companies have to provide some protection of their investment, and so changing the terms of the data exclusivity term has a direct financial cost.

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<sup>35</sup> U.S. Congress. House of Representatives. Committee on Ways and Means. *Dominican Republic-Central America-United States Free Trade Agreement Implementation Act*. H.Rept. 109-182. pp. 50-51. The side agreement is available at [<http://www.ustr.gov>] and for a summary of the debate, see Brevetti, Rosella. CAFTA Opponents Blast U.S. Stance on Guatemalan Data Protection Law. *International Trade Reporter*. BNA, Inc. March 10, 2005. See also: CRS Report RS21609, *The WTO, Intellectual Property Rights, and the Access to Medicines Controversy*, by Ian F. Fergusson.

## Labor and Environment

Labor and environment provisions have been highly contentious issues in trade agreements, with considerable disagreement in Congress and elsewhere over how aggressive language in trade agreements should be in accommodating these concerns. An important aspect of the proposed U.S.-Panama FTA is that it adopts new standards for both the labor and environment chapters that reflect a bipartisan understanding as developed by congressional leadership and the USTR in the “New Trade Policy for America.”

The debate over labor and environment standards reflect differences in both economic and political perspectives. From an economic perspective, labor and environment advocates in the United States have argued that developing country firms 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.<sup>36</sup> It follows from this argument that the difference in costs may be an inducement to move U.S. investment and jobs abroad. In addition, critics have also argued that trade agreements should not support a status quo in production standards that leads to unacceptable working conditions and severe environmental degradation.

On the other hand, some studies have suggested that cost differentials are usually not high enough to determine business location alone, and that productivity is the more important factor.<sup>37</sup> Further, many economists view trade liberalization as part of the overall development process that, in and of itself, can promote improved social and economic conditions in the long run.<sup>38</sup> 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.

**Labor Issues.** Preliminary drafts of the U.S.-Panama FTA adopted the CAFTA-DR labor chapter language verbatim. Many Members of Congress and

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<sup>36</sup> The difference is that in most developing countries, the social costs associated with environmental degradation, pollution, and poor working conditions may not be captured in the market price of goods (so-called *external* costs). Through legal and regulatory measures, developed countries require that businesses correct for many of these social costs, thereby *internalizing* them to the business, where they are then reflected in the final (relatively higher) price of the good in the market place.

<sup>37</sup> See CRS Report 98-742, *Trade with Developing Countries: Effects on U.S. Workers*, by J.F. Hornbeck. September 2, 1998. 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.

<sup>38</sup> 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.

others objected to four key aspects of this language. First, it emphasized that a country must effectively “enforce its own labor laws,” rather than define specific labor standards to be codified and enforced. Second, this was the only provision in the agreement subject to the FTA’s labor dispute resolution process. Third, labor (and environment) provisions had their own dispute settlement process separate from the process used for commercial and other disputes that might arise with respect to the FTA. Critics argued the labor dispute mechanism was inferior for many reasons. Fourth, for other commitments in the labor chapter, language requiring that the Parties to the agreement “strive to ensure” that basic labor principles as defined in the International Labor Organization (ILO) *Fundamental Principles and Rights at Work and its Follow-up (1998) Declaration* was an inadequate commitment and unenforceable.

In short, there existed a basic criticism that the labor provisions in the bilateral FTAs did not reflect the intent of Congress in defining labor negotiating objectives in Trade Promotion Authority (TPA) legislation, were a step backward in U.S. policy on this issue that conditions trade benefits on meeting basic ILO labor commitments as defined in the Caribbean Basin Initiative (CBI) and the Generalized System of Preferences (GSP), and were effectively meaningless without a credible enforcement mechanism.<sup>39</sup>

Although supporters of the CAFTA-DR model prevailed in earlier agreements, a new bipartisan consensus emerged with the 110<sup>th</sup> Congressional leadership that led to a significantly changed model for bilateral FTA labor chapters. The principles of this change, as defined in the “New Trade Policy for America,” were incorporated into the labor chapters for proposed U.S. bilateral FTAs with Panama (and Peru). The major changes from the CAFTA-DR model state that each country:

1. shall adopt and maintain in its statutes, regulations and practices as rights, the five core ILO labor principles: a) freedom of association; b) the effective recognition of the right to collective bargaining; c) the elimination of all forms of compulsory or forced labor; d) the effective abolition of child labor and, for purposes of this Agreement, a prohibition on the worst forms of child labor; and, e) the elimination of discrimination in respect of employment and occupation;
2. not waive or otherwise derogate from, or offer to do so, in a manner affecting trade or investment between the countries in implementing the above commitment;
3. shall not fail to effectively enforce its labor in accordance with the above commitment and that each party retains the right to the reasonable exercise of

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<sup>39</sup> U.S.-Panama Free Trade Agreement. *Report of the Labor Advisory Committee for Trade Negotiations and Trade Policy (LAC)*. April 25, 2007. pp. 3-7, and U.S. Congress. House of Representatives. Committee on Ways and Means. *Dominican Republic-Central America-United States Free Trade Agreement Implementation Act*. H.Rept. 109-182. pp. 47-50.



discretion in using resources to achieve this goal, provided the exercise of such discretion is not inconsistent with the obligations of the chapter; and,

4. will be required to use the dispute settlement process defined for the entire agreement (rather than a separate process for labor disputes as defined in the CAFTA-DR).

The change in language is intended to make commitments to ILO basic principles under the proposed FTA binding and enforceable to the same extent as all other disputes, including the recourse to trade sanctions. The rest of the labor chapter conforms largely to commitments in previous bilateral FTAs that include procedural guarantees of transparency and fairness in the use of tribunals to enforce a Party's labor laws and institutional arrangements that include creation of a joint Labor Affairs Council to oversee implementation and review of commitments made in the Labor Chapter. These commitments include establishing a Labor Cooperation and Capacity Building Mechanism.

**Panama's Labor Conditions.** Panama has higher wage rates, stronger labor laws, and fewer impediments to union formation compared to many countries in the region. The business community, including U.S. firms operating in Panama, argue that the labor laws are too generous with respect to firing or downsizing the labor force, which can actually encourage unintended responses by business, such as extended use of temporary workers. In 1970, Panama created the Tripartite Council on Union Freedom and Participation in Economic and Social Development with representatives from the government, labor, and business. Its primary function is to oversee that worker rights are being observed in Panama.

The U.S. Department of State has pointed out that Panama's labor laws guarantee all five of the ILO basic principles. In general, major violations have not been found. Nonetheless, concerns still exist over the widespread use of temporary workers in the general and child labor in the informal sector and rural areas, particularly during harvest times. Lax enforcement of health and safety standards was also cited as a problem.<sup>40</sup>

The Colón Free Zone and the small export processing zones are all subject to national labor laws. The Panama Canal Area presents a unique issue. Although the Canal Zone has separate statutes governing labor, they tend to be more generous with respect to workers' rights and compensation, and jobs in the Canal Zone are highly coveted. Workers may organize and exercise their rights to collective bargaining, but the prohibition on striking goes to Panama's commitments under the Panama Canal Treaties, which stipulate that the canal must be operated without interruption.<sup>41</sup>

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<sup>40</sup> U.S. Department of State. *Panama: Country Report on Human Rights Practices - 2006*. Washington, D.C. March 6, 2007, the Economist Intelligence Unit. *Country Report - Panama*. London, June 2004. p. 14, and American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). *Panama: Labor Rights and Child Labor Reports*. Washington, D.C. August 9, 2004. p. 3.

<sup>41</sup> Panama Legislative Assembly. *Law No. 19* — "Whereby the Panama Canal Authority is (continued...)"

**Environmental Issues.** Major environmental goals in FTAs 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 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.<sup>42</sup>

Advocates raise the issue of the environmental effects of trade, particularly in developing countries that may have weak laws and lax enforcement mechanisms. Some of these same advocates, however, have indicated 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 and many Members of Congress still note that much can be improved, such as clarifying obligations, tightening enforcement language, and ensuring that the United States allocates financial resources to back up promises of technical assistance.<sup>43</sup>

As with the proposed FTA labor chapter, revisions made pursuant to ideas outlined in the “New Trade Policy for America,” reflect a bipartisan sense of that although the text recognizes sovereign rights and responsibilities with respect to the management of natural resources, that trade and environmental policies should be mutually supportive and dedicated to the objective of sustainable development. The new language, therefore, strengthens the commitments to environmental obligations and their enforcement, requiring that each country:

1. adopt, maintain, and implement laws, regulations, and other measures to fulfill their obligations under selected multilateral environmental agreements (MEAs) listed in Annex 18.2;
2. shall not fail to effectively enforce environmental laws and regulations, including those adopted as signatories to the MEAs;
3. shall not waive or otherwise derogate from, or offer thereto, from such laws (replacing the “strive to ensure” with “shall not”);

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<sup>41</sup> (...continued)

*Organized.*” Chapter V — Personnel Administration and Labor Relations. June 11, 1997.

<sup>42</sup> 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 RL31638, *International Investor Protection: “Indirect Expropriation” Claims Under NAFTA Chapter 11*, by Robert Meltz.

<sup>43</sup> See Audley, John. *Environment and Trade: The Linchpin to Successful CAFTA Negotiations?* Carnegie Endowment for International Peace. Washington, D.C. July 2003.

4. adopt a commitment to policies that will promote conservation and sustainable use of biological diversity;
5. subject disputes to the FTA's overall dispute settlement mechanism rather than a mechanism developed solely to deal with labor and environmental disagreements that was used in previous FTAs; and,
6. meet obligations for formal cooperation among governments on environmental issues and use of the consultation and dispute resolution mechanism in a way that is transparent and involves public input.<sup>44</sup>

As required under TPA, the USTR conducted an environmental review of the potential environmental effects possibly attributable to the proposed 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, and 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.<sup>45</sup> These issues were already factors in Panama's development process prior to the negotiation of the proposed FTA. Thus, the environmental review maintains that the marginal effects of the proposed FTA on environmental standards would be small, whether in terms of projected impacts on the United States or on Panama.

The environmental review further notes 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 proposed FTA.<sup>46</sup> Panama's environmental regulatory agency (Autoridad Nacional de Ambiente — ANAM) points out that Panama is increasingly using environmental impact studies, but realizes it has enforcement capacity issues that may require time to remedy, which could be accommodated in the FTA.

## **Trade Capacity Building**

The proposed FTA would create a Committee on Trade Capacity Building (TCB), designed to assist Panama with the transition to freer trade with the United

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<sup>44</sup> U.S.-Panama FTA, Chapter 17, The Environment.

<sup>45</sup> Office of the United States Trade Representative. *Interim Environmental Review: U.S.-Panama Free Trade Agreement*. June 2004. pp. 7-9.

<sup>46</sup> *Ibid.*, pp. 15-20.

States. In general, the committee's mission includes providing technical assistance and coordinating financing to accelerate the transition period in expectation of increasing the gains of trade while minimizing the adjustment costs. The TCB Committee would help coordinate technical assistance provided by U.S., regional, and multilateral agencies in helping Panama meet its obligations under the FTA.

Panama prioritized TCB needs in its national trade capacity building strategy. The overriding goal is to formulate a strategy that would allow Panama to assume all the commitments under the proposed FTA, in the context of meeting the country's development needs. The National TCB Strategy places strong emphasis on sectoral adjustment strategies, recognizing that some industries are already competitive by international standards (e.g., financial services), whereas others will need considerable assistance when faced with increased competition from the United States (e.g., agriculture). Emphasis is also placed on supporting existing and potentially new micro, small, and medium-sized businesses, which may need the most assistance and constitute a significant portion of the Panamanian economy, as well as government capacity to administer trade-related activities.<sup>47</sup>

The major goals identified include inter-sectoral coordination, increasing exports to the United States, enhancing the investment climate, better integrating education and innovation into the business community, and improving government trade facilitation (processing imports and exports.) The strategy identifies 18 action plans covering major trade and trade-related issues, ranging from market access and rules of origin, to labor, environment, transparency, and trade agreement administration. In each case, the status of Panama's commitments under the proposed FTA is identified along with action items that may need to be pursued to improve capacity in the respective area. Successfully implementing the strategy, however, would require resources and coordinated assistance among international and U.S. agencies.

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<sup>47</sup> Government of Panama. Ministry of Trade and Industry. *Panama's National Strategy for Trade Capacity Building (TCB) in Light of the Free Trade Agreement with the United States*. Panama, March 4, 2005. pp. 20-23.

## Outlook

The proposed U.S.-Panama FTA cannot take effect without congressional passage of an implementing bill. The U.S. Congress appears poised to consider such a bill this fall, a considerable challenge given the increased complexity of FTAs. Unlike earlier (pre-1960s) FTAs that focused mainly on tariff reduction, Congress faces weighing the implications that newly proposed FTAs have on foreign economic and domestic policy considerations, including trade-related issues with broad social implications in such areas as worker standards, environmental regulation, and public health.

The debate over proposed FTAs is frequently contentious because of this increased complexity (not to mention the political ramifications) and concerns over the negative effects of globalization that have increased substantially in a post-CAFTA environment. To address some of these concerns, the proposed U.S.-Panama FTA, in addition to supporting U.S. commercial and economic interests, incorporates significant changes initiated by the Democrats and ultimately agreed to by congressional leadership as part of a bipartisan congressional understanding arrived at with the Bush Administration.

The most visible of these changes include the adoption of enforceable labor standards, compulsory adherence to select multilateral environmental agreements (MEAs), and an easing of restrictions to developing country access to generic drugs. In each of these cases, the proposed U.S.-Panama FTA goes beyond provisions in existing multilateral trade rules and even those contemplated in the Doha Round. In this case, along with the broader arguments both for and against FTAs, Congress perhaps now faces an even more difficult choice given that the recent changes to this proposed FTA may set a precedent in U.S. trade policy. As significant as these changes are, perhaps portending a shift in U.S. trade policy, it is still not clear that they are sufficient to ease the concerns many Members have over free trade agreements.

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

<b>Date</b>	<b>Milestone</b>
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 takes place in Panama City.
December 6-10, 2004	Sixth round of negotiations held in Washington, DC.
January 10-15, 2005	Seventh round of negotiations held in Washington, DC.
Jan. 31-Feb. 6, 2005	Eighth round of negotiations occurs in Washington, DC.
Jan. 17-20, 2006	Ninth round of negotiations held in Washington, DC.
Dec. 16, 2006	Tenth and final round of negotiations concludes in Washington, D.C. Chapters on labor and environment left open.
March 27, 2007	Bipartisan "New Trade Policy for America" released.
March 30, 2007	President Bush formally notifies Congress of his intention to sign the proposed U.S.-Panama FTA.
April 27, 2007	USTR transmits to the White House and Congress 27 trade advisory reports on the U.S.-Panama FTA.
June 29, 2007	The United States and Panama sign a free trade agreement at the Organization of American States in Washington, D.C.
July 2, 2007	USTR releases final text of proposed U.S.-Panama FTA.

## Appendix 2. Panama: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006
GDP Growth (%)	2.7	0.6	2.2	4.2	7.5	6.9	7.5
Per Capita GDP Growth (%)	0.8	-1.3	0.4	2.3	5.6	5.1	5.7
Urban Unemploy. Rate (%)	15.2	17.0	16.5	15.9	14.1	12.1	10.4
Inflation (%)	0.7	0.0	1.9	1.5	1.5	3.4	2.0
Current Acct. Bal. (% GDP)	-5.8	-1.4	-0.8	-3.9	-7.5	-5.0	-4.2
Terms of Trade (2000=100)	100.0	102.7	101.6	97.2	95.3	93.5	90.8
Foreign Direct Invest. (\$ mil)*	624	467	99	771	1,004	1,027	2,500

**Source:** United Nations Economic Commission on Latin America and the Caribbean. *Preliminary Overview of the Economies of Latin American and the Caribbean, 2006*. December 2006.

\*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 <sup>a</sup>	% of Total	Tariff Rate	Major U.S. Imports <sup>a</sup>	% of Total	NTR Tariff Rate <sup>b</sup>	Free under CBI <sup>c</sup>
Oil (2710)	31.6	5% <sup>d</sup>	Fish/Seafood (0302)	26.9	Free	
Aircraft (8802)	6.2	10%	Repaired Goods (9801)	21.0	Free	
Machinery	10.8	3-5%	Precious Metals (7112) - gold/scrap	9.3	Free	
Electrical Machinery (8517)	6.8	5%	Crude oil (2710)	8.6		Free under CBTPA
Pharmaceuticals (3004)	4.9	Free	Sugar (1701) - under quota - over quota (avg. 2003)	6.2	0 78%	
Optical/Medical Instruments	3.5	10%	Coffee	3.1	Free	
Cereals - corn (1005) - under quota - over quota - mesline (1001) - rice (1006) - under quota - over quota	2.8 (1.8)   (1.0) (0.2)	3% 58% Free 15% 103%	Fruit - bananas - papaya - watermelon	3.3		Free under CBI and GSP
Other	33.4		Other	21.6		
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 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 provides unilateral preferential tariff treatment to select Caribbean and Central American country products. Petroleum enters duty free under the Caribbean Basin Trade Partnership Act (CBTPA – P.L. 106-200), a related program.
- 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%.