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U.S. Agricultural Policy Response to WTO Cotton Decision

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Summary

On March 3, 2005, a World Trade Organization (WTO) Dispute Appeals Panel ruled against the United States in a dispute settlement case (DS267) brought by Brazil against certain aspects of the U.S. cotton program.[1] The United States was given a July 1, 2005, deadline to bring certain cotton programs into compliance with WTO rules. On July 5, 2005, U.S. Secretary of Agriculture Mike Johanns announced that the Administration was sending proposed statutory changes to Congress to comply with the WTO case including elimination of the Step 2 cotton program, removal of a 1% cap on fees charged under the GSM-102 export credit guarantee program, and termination of the GSM-103 export credit guarantee program. In light of USDA's proposed changes, and with the expectation that they will be fully implemented in an expeditious manner, Brazil has temporarily suspended its pursuit of WTO-sanctioned retaliatory trade measures against U.S. agricultural products. The U.S. National Cotton Council (NCC) has announced its opposition to the removal of the Step 2 cotton program. Modifications to or the elimination of the programs as suggested by USDA, ultimately will be decided by Congress. This report will be updated as events warrant.

Background

In late 2002, Brazil initiated a WTO dispute settlement case against specific provisions of the U.S. cotton program. On September 8, 2004, a WTO dispute settlement panel released its ruling on the case, finding against the United States on several key issues. On March 3, 2005, the WTO panel's ruling was upheld on appeal. On March 21, 2005, the panel reports were adopted by the WTO membership, initiating a sequence of events, under WTO dispute settlement rules, whereby the United States is expected to bring its policies into line with the panel's recommendations or negotiate a mutually acceptable settlement with Brazil. U.S. failure to comply could result in WTO-sanctioned trade retaliation by Brazil against certain U.S. agricultural exports.

[1] For a detailed discussion of the U.S.-Brazil WTO dispute settlement case see CRS Report RL32571, *U.S.-Brazil Cotton Subsidy Dispute*.

The U.S. response to the WTO cotton ruling is being watched closely by developing countries, particularly by a consortium of four African cotton-producing countries which has submitted its own proposal to the WTO calling for a global agreement to end all production-related support for cotton growers of all WTO-member countries.[2] In addition, other WTO members are likely to evaluate the U.S. response as an indicator of whether the United States is prepared to make substantial cuts in market-distorting agricultural subsidies as part of the Doha Round of WTO trade negotiations.[3]

WTO Panel's Recommendation

In its final report, the WTO panel recommended that the United States withdraw those support programs identified as "prohibited" subsidies by July 1, 2005, and bring into compliance those programs identified as "actionable" subsidies with no deadline given. Each of these subsidy types — prohibited and actionable — involve a different type of response and a different timetable for implementing that response. Under the WTO's Agreement on Agriculture, prohibited subsidies are treated with greater urgency than actionable subsidies — in particular, they are given a shorter time frame for compliance.[4]

Prohibited Subsidies. Prohibited export subsidies refer to unscheduled export subsidies (i.e., subsidies applied to commodities not listed on a country's WTO schedule or made in excess of the value listed on the schedule).[5] Prohibited import substitution subsidies refer to subsidies paid to domestic users to encourage the use of domestic products over imported products.

Step 2 User Payments. Step 2 payments are part of special cotton marketing provisions authorized under U.S. farm program legislation to keep U.S. upland cotton competitive on the world market.[6] Step 2 payments are made to exporters and domestic mill users to compensate them for their purchase of U.S. upland cotton which tends to be priced higher than the world market price. In its finding, the panel considered Step 2 program payments to exporters separately from payments to domestic users. Payments to exporters were found to be "contingent upon export performance" and therefore qualified as prohibited export subsidies in violation of WTO commitments. Payments to domestic users were found to be "contingent on the use of domestic over imported goods" and therefore qualified as prohibited import substitution subsidies.

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[2] For more information, see CRS Report RS21712, *The African Cotton Initiative and WTO Agriculture Negotiations*.

[3] "U.S. Proposes to Abolish Cotton Subsidy Scheme," *Financial Times*, July 5, 2005.

[4] For disputes involving prohibited subsidies, the prescribed time is halved (WTO, Agreement on Subsidies and Countervailing Measures, Article 4.12).

[5] For more information, see CRS Report RL32916, *Agriculture in the WTO: Policy Commitments Made Under the Agreement on Agriculture*.

[6] For more information on Step 2 payments, see CRS Report RL32442, *Cotton Production and Support in the United States*.

Export Credit Guarantees.[7] USDA's export credit guarantee programs (GSM-102 and GSM 103) underwrite credit extended by private U.S. banks to approved foreign banks for purchases of U.S. food and agricultural products by foreign buyers. GSM-102 covers credit terms up to three years, while GSM-103 covers longer credit terms up to 10 years. The Supplier Credit Guarantee Program (SCGP) insures short-term, open account financing designed to make it easier for exporters to sell U.S. food products overseas.

The WTO panel found that the GSM-102, GSM-103, and SCGP export credit programs effectively functioned as export subsidies because the financial benefits returned to the government by these programs failed to cover their long-run operating cost. Furthermore, the panel found that this applies, not just to cotton, but to all recipient commodities that benefit from U.S. commodity support programs. As a result, the WTO panel ruled that export credit guarantees for any such recipient commodity are limited by previously scheduled WTO export subsidy commitments. If a commodity that benefits from program payments is unscheduled (i.e., not listed on a country's WTO schedule) then, according to the WTO panel, it is not eligible for U.S. export credit guarantees so long as the credit guarantees continue to function as an implicit export subsidy. With respect to the WTO case, the panel ruled that the subsidized export of scheduled agricultural products that remain within their export subsidy schedules do not circumvent U.S. export commitments and are not subject to trade remedy actions.

Actionable Subsidies. The panel also issued recommendations concerning "actionable" subsidies identified as contributing to serious prejudice to the interests of Brazil during the marketing years 1999-2002. Specifically, this involved those U.S. subsidy measures — marketing loan provisions, Step 2 payments, and Counter Cyclical Payments — singled out as price-contingent (i.e., dependent on changes in current market prices). The panel recommended that, upon adoption of its final report, the United States take appropriate steps to remove the adverse effects or to withdraw the subsidies.

However, it is noteworthy that the actionable subsidies remedy dealt with serious prejudice and injury that occurred during a historical time period (1999-2002) and not current or future prejudice or injury. In support of this concept, the panel stated that U.S. compliance with recommendations on prohibited subsidies — i.e., the Step 2 provisions and export credit guarantees — could so significantly transform the basket of policy measures currently in question that it is not necessary or appropriate to address Brazil's claims of threat of serious prejudice.[8] Thus, it appears that removal of the prohibited subsidies may by sufficient to resolve the actionable subsidies recommendation.

U.S. Response

With respect to implementing changes to the "prohibited subsidies," the Administration is limited to how much response can be accomplished through altering the program's operation and how much response requires new legislation. The Step 2 cotton

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[7] For information on these programs, see CRS Report IB98006, *Agricultural Export and Food Aid Programs*; or USDA, Foreign Agricultural Service, "Export Credit Guarantee Programs," at [http://www.fas.usda.gov/excredits/default.htm].

[8] *Report of the Panel*, "United States — Subsidies on Upland Cotton," WTO, WT/DS267/R, para. 7.1503, p. 354.

program was authorized by the 2002 farm act (P.L. 107-171; Sect. 1207) and would necessitate new legislation to remove or alter its implementation. The Administration has more discretion over the implementation of the export credit guarantee program, since it may choose simply not to operate the program or to provide credit only for WTO scheduled commodities. However, if the Administration intends to use export credit guarantees for the current list of supported commodities in otherwise unrestricted amounts, then some statutory changes will be needed to eliminate the alleged "subsidy" component of export credit guarantees. This is because user fees for GSM-102, the primary export credit program, are capped at 1% of the value of the export product. Higher fees are needed to ensure that the financial benefits returned by these programs fully cover their long-run operating costs; thereby eliminating their subsidy component.

On June 30, 2005, USDA announced that beginning July 1, the Commodity Credit Corporation (CCC) would use a risk-based fee structure for the GSM-102 and SCGP programs. As a result, fee rates are now based on the country risk that CCC is undertaking, as well as the repayment term and frequency under the guarantee. The new structure responds to a key finding by the WTO that the fees charged by the programs should be risk based. In addition, the CCC stopped accepting applications for payment guarantees under GSM-103. Any remaining country and regional allocations for GSM-103 coverage under FY2005 program announcements was reallocated to the existing GSM-102 program for that country or region.

On July 5, 2005, U.S. Secretary of Agriculture, Mike Johanns, announced that the Administration was sending three proposed statutory changes to Congress to comply with the WTO case: 1) elimination of the Step 2 program; 2) removal of the 1% cap on fees that can be charged under the GSM-102 export credit program; and 3) termination of the GSM-103 program.[9] According to Secretary Johanns the proposed changes were worked out in collaboration with U.S. industry groups. Furthermore, Secretary Johanns said that repealing the Step 2 program would remove both the prohibited export subsidies and import substitution subsidies that the WTO cited and address issues related to suppression of cotton prices in world markets; eliminating the 1% fee cap would make the Export Credit Guarantee Program more risk-based; and terminating the GSM-103 program (which extends credit for up to 10 years) would reinforce the recent U.S. decision to stop using longer-term export credit guarantees.

Brazil's Response

What is Permissible? In accordance with WTO dispute settlement rules, upon visible evidence of U.S. noncompliance by the July 1, 2005 deadline, Brazil could request negotiations with the United States to determine mutually acceptable compensation (e.g., tariff reductions in areas of particular interest). If, 10 days after the designated period expires, no satisfactory compensation is agreed to, Brazil may ask the WTO for permission to impose limited trade sanctions against the United States. The trade sanctions are limited to a value equivalent not to exceed the level of lost benefits. The DSB must grant this authorization within 15 days of the expiry of the "reasonable" time period unless there is a consensus against the request. If the United States objects to the amount proposed by Brazil, the level of suspension would be arbitrated (by the original

[9] USDA press release No. 0242.05, July 5, 2005.

panel if available). Arbitration shall be completed within 30 days after the date of expiry of the designated period (July 1, 2005). No trade sanctions are to be imposed during the arbitration period.

What will Brazil Do? According to Brazil news media sources, on July 4, 2005, Brazil sent an official request to the WTO seeking authorization to retaliate against U.S. cotton subsidies. Brazil claims that the preliminary steps of June 30 concerning U.S. export credit program modification were insufficient to comply with the WTO panel recommendation.[10] News reports suggested that Brazil was seeking authority for trade retaliation valued at $2.905 billion. However, on July 5, 2005, a spokesperson for the U.S. Trade Representative (USTR) announced that the United States and Brazil had reached a procedural agreement suspending further retaliation proceedings in the WTO cotton dispute.[11] Brazilian news media stated that Brazil will defer its right for sanctions until year's end, under the condition that the White House convince Congress to change the programs in question. "We have the intention and the desire that the United States fulfill the WTO decisions, but we reserve our right to retaliate in case we have to use it," said Brazilian Foreign Minister Celso Amorim. A Brazilian government spokesman said that the retaliation could be applied to imported U.S. goods, but could also be placed on services and intellectual property.[12]

Once armed with the authority to impose trade sanctions, Brazil may still choose to wait. A precedent for this occurred under the WTO Dispute Settlement case (DS108) involving the U.S. Foreign Sales Corporation statute. Under DS108, the European Communities (EC) received authorization to impose retaliatory measures against the United States on May 7, 2003.[13] However, the EC did not begin imposing additional duties on U.S. products until March 2004.

Potential Effects to U.S. Agriculture of Proposed Changes

Eliminating the Step 2 Program. According to the USDA's chief economist, Keith Collins, ending the Step 2 program would have some impact on U.S. cotton markets.[14] The Step 2 program has channeled nearly $3 billion to the U.S. cotton industry since 1996.[15] Collins said that the removal of Step 2 would result in slightly lower domestic prices — by two to three cents per pound — and higher export prices for U.S.

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[10] This story appeared in several Brazilian news sources as reported by the U.S. Embassy, Brasilia, Public Affairs Press Summary for July 5, 2005.

[11] USTR, News Release 2005-38; July 5, 2005.

[12] Brazilian newspapers *O Estado de S. Paulo*- B6; *Valor Econômico*- A1, A4; *Folha de S. Paulo*- B9; *O Globo*- 22; and *Jornal do Brasil*-A19 as reported by the U.S. Embassy, Brasilia, Public Affairs Press Summary for July 6, 2005.

[13] For more information, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne Grimmett.

[14] "More Cotton Program Changes," *Washington Trade Daily*, Vol.14, pp. 131 and 132, July 5-6, 2005.

[15] USDA, Farm Service Agency, Table 35-CCC, *Net Outlays by Commodity & Function*; available at [http://www.fsa.usda.gov/dam/bud/bud1.htm].

cotton. But he also anticipated that declines in producer prices would be likely to trigger an increase in counter-cyclical payments (CCP) to U.S. cotton farmers that would offset losses from lower prices.[16] Hence, some of the budgetary savings from eliminating Step 2 would be negated by the required additional outlays for commodity price support.

The National Cotton Council (NCC) announced its opposition to the immediate elimination of cotton's Step 2 program as proposed by USDA.[17] The NCC is an industry group representing cotton producers, ginners, warehousers, merchants, cottonseed processors/dealers, cooperatives and textile manufacturers. NCC chairman Woods Eastland expressed concern that the program not be changed in the middle of the marketing year when it could have disruptive effects on cotton producers and users alike. Eastland expressed the NCC's interest in working with Congress in effecting a "fair and appropriate" response to the WTO case. However, in previous testimony to Congress the NCC leadership has expressed a consistent interest in participating in the WTO's rules-based international trading system and in maintaining an effective U.S. cotton program that complies with WTO rules.[18]

Changing GSM-102 and Terminating GSM-103. Export credit guarantees underwrite, on average, about 6-8% of U.S. agricultural exports.[19] Removal of export credit guarantees on cotton would, in general, reinforce the results discussed for the removal of Step 2 although by a likely smaller margin, since the share of U.S. cotton exports supported with export credit guarantees is fairly small. In FY2004, about 11% of U.S. cotton exports were facilitated with export credit guarantees — FY2004 U.S. cotton exports were valued at $4,511 million of which $480 million were facilitated with GSM-102 export credit guarantees and another $8 million relied on SCGP guarantees.

Role of Congress

Ultimately Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements. However, Congress is not bound to necessarily accept the modifications to or the elimination of the cotton programs as suggested by USDA. Senate Agriculture Committee Chairman Saxby Chambliss has said that he would review the administration's proposal and work with industry and the Administration to identify the appropriate legislative solution for complying with the WTO ruling.[20]

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[16] For more information on the CCP, see CRS Report RS21779, *Farm Commodity Programs: Direct Payments, Counter-Cyclical Payments, and Marketing Loans* by Jim Monke.

[17] NCC news release, "NCC Opposes Administration's Step 2 Cotton Program Proposal," July 6, 2005; available at [http://www.cotton.org/news/releases/2005/step2proposal.cfm].

[18] Statement of Woody Anderson, then-chairman, National Cotton Council, before the U.S. Congress, House Committee on Agriculture, May 19, 2004; available at [http://agriculture.house.gov/hearings/108/10829.pdf].

[19] For more information, see CRS Report RL32278 *Trends in U.S. Agricultural Export Credit Guarantee Programs and P.L. 480, Title I, FY1992-2002* by Carol Canada.

[20] "USDA Calls for Repeal of Cotton Subsidy to Achieve WTO Compliance," *Inside U.S. Trade*, July 8, 2005.