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U.S. Agricultural Policy Response to WTO Cotton Decision

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Summary

In March 2005, a World Trade Organization (WTO) appellate 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] To comply with the "prohibited subsidy" portion of the WTO ruling, U.S. Secretary of Agriculture Mike Johanns announced (July 5, 2005) that the Administration was sending proposed statutory changes to Congress 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. Congress complied with a portion of this request by including a provision in the Deficit Reduction Act of 2005 (P.L. 109-171; signed into law on Feb. 8, 2006) that calls for the elimination of Step 2 on Aug. 1, 2006. In light of this provision, and with the expectation that the additional proposed changes 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. Additional permanent modifications to U.S. farm programs may still be needed to fully comply with the "actionable subsidies" portion of the WTO ruling. Such changes ultimately would 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 Sept. 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

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

retaliation by Brazil against certain U.S. agricultural exports. 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]

WTO Panel's Recommendation

The WTO panel recommended that the United States withdraw those support programs identified as "prohibited" subsidies by July 1, 2005, and to remove the prejudicial effects of those programs identified as "actionable" subsidies by Sept. 21, 2005. Each of these subsidy types — prohibited and actionable — involves a different type of response and a different timetable for implementing that response.

Prohibited Subsidies. Two types of prohibited subsidies were identified by the WTO panel: 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);[3] and import substitution subsidies which refer to subsidies paid to domestic users to encourage the use of domestic products over imported products. Both Step 2 export payments and export credit guarantees were found to operate as prohibited export subsidies. Step 2 domestic user payments were found to operate as prohibited import substitution subsidies. 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]

Step 2 Program. 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.[5] 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.

Export Credit Guarantee Programs. USDA's export credit guarantee programs (GSM-102, GSM 103, and SCGP) underwrite credit extended by private U.S. banks to approved foreign banks for purchases of U.S. food and agricultural products by foreign buyers.[6] 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)

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

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

[4] For disputes involving prohibited subsidies, the prescribed time is halved. For more information on the implementation phase of WTO disputes, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne Grimmett.

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

[6] For information on these programs, see USDA, Foreign Agricultural Service, "Export Credit Guarantee Programs," at [http://www.fas.usda.gov/excredits/default.htm].

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 all three 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 export-subsidy aspect of export credit guarantees applies, not just to cotton, but to all recipient commodities that benefit from U.S. commodity support programs. 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. In contrast, 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. Any subsidy may be challenged in the WTO, i.e., it is "actionable," if it fulfills the WTO definition of a subsidy[7] and is alleged to cause adverse effects including serious prejudice to the interests of other WTO members. Such subsidies were previously afforded some protection under the so-called "peace clause" (Article 13) of the WTO's Agreement on Agriculture.[8]

Actionable U.S. subsidies were identified as contributing to serious prejudice to the interests of Brazil by depressing prices for cotton on the world market during the marketing years 1999-2002. Specifically, this involved those U.S. subsidy measures singled out as price-contingent (i.e., dependent on changes in current market prices), e.g., marketing loan provisions, Step 2 payments, market loss payments, and counter-cyclical payments.[9] 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.[10]

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 administratively, and how much response requires new legislation. The Administration has some 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.

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[7] As defined in Article 1 of the WTO's *Agreement on Subsidies and Countervailing Measures*.

[8] For more information, see CRS Report RL32571, *Background on the U.S.-Brazil WTO Cotton Subsidy Dispute*, by Randy Schnepf.

[9] For more information on these programs, see CRS Report RL33271, *Farm Commodity Programs: Direct Payments, Counter-Cyclical Payments, and Marketing Loans*.

[10] *Report of the Panel*, WTO, WT/DS267/R, para. 7.1503, p. 354.

In contrast, the Step 2 cotton program, which was authorized by the 2002 farm act (P.L. 107-171; Sect. 1207), would require new legislation to alter its implementation. In 2005, Congress responded by including a provision (Sec. 1103) in the Deficit Reduction Act of 2005 (P.L. 109-171) that calls for the elimination of Step 2 on Aug. 1, 2006.

On June 30, 2005, USDA announced a temporary fix that beginning July 1, the Commodity Credit Corporation (CCC) would use a risk-based fee structure for the GSM-102 and SCGP programs.[11] 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 were reallocated to the existing GSM-102 program for that country or region.

On July 5, 2005, USDA Secretary 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 (which has been subsequently accomplished by Sec. 1103 of P.L. 109-171); 2) removal of the 1% cap on fees that can be charged under the GSM-102 program; and 3) termination of the GSM-103 program.[12] According to Secretary Johanns the proposed changes were worked out in collaboration with U.S. industry groups. Furthermore, Secretary Johanns said that eliminating the 1% fee cap would make the Export Credit Guarantee Program more risk-based; terminating the GSM-103 program would reinforce the recent U.S. decision to stop using longer-term export credit guarantees, and that repealing the Step 2 program would remove both the prohibited export and import substitution subsidies while addressing issues related to the actionable subsidies (i.e., suppression of cotton prices in world markets).

The National Cotton Council (NCC) has been watching the U.S. policy response to this case very closely. 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. (This concern resulted in the delay in Step 2's removal until the end of the cotton marketing year on July 31, 2006). While the NCC has expressed interest in working with Congress in effecting a "fair and appropriate" response to the WTO case, in previous testimony to Congress the NCC leadership has also expressed 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.[13]

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[11] USDA press release No. 0238.05, June 30, 2005. For more information on the implementation of USDA's risk-based fee structure see [http://www.fas.usda.gov/excredits/default.htm].

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

[13] 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].

Brazil's Response

Prohibited Subsidies. Because prohibited export subsidies had not been removed by July 1, 2005, Brazil requested (July 4, 2005) authorization from the WTO to impose countermeasures against U.S. cotton subsidies valued at $3 billion. According to WTO rules, trade sanctions are limited to a value not to exceed the level of lost benefits. Brazil proposed to suspend tariff concessions as well as obligations under the WTO Agreement on Trade-Related Intellectual Property Rights and the General Agreement on Trade in Services until the United States withdrew the exports subsidies identified by the WTO, in an amount estimated at $3 billion corresponding to: (1) Step 2 payments made in the most recently concluded marketing year (2004/05), and (2) the total of exporter applications received under the three export credit guarantee programs, for all unscheduled commodities and for rice, for the most recent fiscal year (2004).[14] The United States objected to Brazil's proposed sanctions amount, and requested WTO arbitration (July 19, 2005; WT/DS267/24). However, the United States and Brazil reached a procedural agreement (Aug. 18, 2005; WT/DS267/25) temporarily suspending arbitration proceedings in so far as the prohibited subsidies are involved.

Actionable Subsidies. To date, the Administration has not announced any specific initiative to address the programs deemed to cause prejudicial impact to Brazil's trade interest. Because the prejudicial effects of the price-contingent actionable subsidies had not been removed by Sept. 21, 2005, Brazil requested authorization from the WTO to impose additional countermeasures valued at $1 billion as retaliation against the programs causing serious prejudice. Once again, the United States requested WTO arbitration (Oct 18, 2005; WT/DS267/27) over the level of the proposed sanctions. However, the United States and Brazil reached another procedural agreement (Dec. 7, 2005; WT/DS267/29) suspending further retaliation proceedings in so far as the actionable subsidies are involved.

Outlook. Brazil continues to undertake the procedural steps necessary to preserve its authority under the auspices of the WTO to retaliate in the event of noncompliance by the United States; although, Brazil has shown a willingness to permit the U.S. legislative process to make the changes needed to bring its farm programs into compliance with the WTO ruling, even if this process extends well beyond the deadlines established under the WTO dispute settlement ruling. The status of ongoing Doha Round multilateral trade negotiations — with both substantial concessions tabled by several of the major negotiating countries, e.g., the United States, the EU, and the Group of 20, and negotiating deadlines rapidly approaching — provides a further incentive to refrain from initiating trade sanctions. However, reportedly Brazil may soon restart one or both of the arbitration proceedings.[15]

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[14] For details, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*.

[15] BNA, *Daily Report for Executives*, "Brazil Set to Restart WTO Arbitration Request for Sanctions on U.S. Cotton," Jan. 10, 2006.

Potential Effects to U.S. Agriculture of Proposed Changes

Eliminating the Step 2 Program. The Step 2 program channeled $3 billion to the U.S. cotton industry during the 1996-2005 period.[16] According to the USDA's chief economist, Keith Collins, ending the Step 2 program would result in slightly lower domestic prices — by two to three cents per pound — and higher export prices for U.S. cotton.[17] But he also anticipated that declines in producer prices would be likely to trigger an increase in CCP to U.S. cotton farmers that would offset losses from lower prices. An analysis by the Food and Agricultural Policy Research Institute (FAPRI) found a -1.3¢ decline in U.S. farm price and a 0.4¢ rise in international prices due to the elimination of Step 2 payments.[18]

Changing GSM-102 and Terminating GSM-103. 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. Redesign of export credit guarantees (as discussed above) would likely have a small but negative effect on U.S. cotton exports, thus reinforcing the results of removing Step 2.

Role of Congress

Ultimately Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements. Passage of the budget reconciliation bill, S. 1932, the Deficit Reduction Act of 2005, includes a schedule for the elimination of the cotton Step 2 provisions. Further statutory changes will be needed to eliminate the alleged "subsidy" component of export credit guarantees as represented by the 1% cap on user fees. In addition, changes to those programs deemed part of the actionable subsidy ruling, i.e., CCP and marketing loan provision, would also necessitate legislative action. The legislation authorizing current farm programs is not set to expire until 2007. 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.[19]

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

[17] "More Cotton Program Changes," *Washington Trade Daily*, Vol.14, p. 131-132, Jul. 5- 6, 2005.

[18] FAPRI, *Potential Impacts on U.S. Agriculture of the U.S. October 2005 WTO Proposal*, FAPRI-UMC Report #16-05, December 15, 2005.

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