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Brazil's WTO Case Against the U.S. Cotton Program: A Brief Overview

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Summary

On December 18, 2007, a World Trade Organization (WTO) compliance panel publicly released its final report concerning U.S. compliance with a negative ruling in a dispute settlement case (DS267) brought by Brazil against certain aspects of the U.S. cotton program. The panel's ruling confirmed an earlier (July 27, 2007) interim ruling that the United States has not fully complied with a March 2005 WTO ruling against certain U.S. cotton support programs. A U.S. appeal (if it so chooses) must occur before the compliance panel's ruling is adopted by the Dispute Settlement Body (i.e., within 60 days of the ruling's release). The ruling against the United States (barring a successful U.S. appeal) could necessitate further U.S. farm program changes or, if no further changes are forthcoming, clear the way for Brazil to request WTO authorization for retaliatory trade sanctions. Both the Senate- and House-passed versions of the 2007 farm bill (H.R. 2419) contain provisions to bring the export credit program into compliance; however, neither version appears to address the serious prejudice charge related to price-contingent subsidies.

This report provides a brief overview of Brazil's case against the U.S. cotton program, the evolution and current status of the case, and the potential role for Congress. For a detailed discussion of the U.S.-Brazil WTO dispute settlement case, see CRS Report RL32571, *Brazil's WTO Case Against the U.S. Cotton Program*, by Randy Schnepf. This report will be updated as events warrant.

Introduction

The United States is the world's largest cotton exporter. During the 2001-2003 period, U.S. cotton exports accounted for 40% of world trade, while U.S. cotton subsidies averaged $3 billion per year. In late 2002, Brazil — a major cotton export competitor — expressed its growing concerns about U.S. cotton subsidies by initiating a WTO dispute settlement case (DS267) against specific provisions of the U.S. cotton program. On September 8, 2004, a WTO dispute settlement panel ruled against the United States on several key issues (discussed below). This ruling was appealed by the United States, and on March 3, 2005, a WTO Appellate Body (AB) upheld the panel's ruling.

In both instances the panel and the AB issued decisions against certain aspects of U.S. cotton programs with recommendations that the offending programs either be removed or be altered so as to remove their adverse effects. After losing its appeal, the United States responded to the AB ruling by removing its Step 2 cotton program and by adjusting its export credit programs. Brazil argued that these changes were insufficient and on August 21, 2006, requested a WTO compliance panel to review the matter.

The WTO Dispute Settlement Panel's Recommendation

In their ruling against the United States, the WTO panel and the AB identified two subsidy types — prohibited and actionable (described below). Each subsidy involves a different type of response and a different timetable for implementation.[1] 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. For example, the AB recommended that the United States withdraw "prohibited" subsidies by July 1, 2005, and that it remove the prejudicial effects of "actionable" subsidies by September 21, 2005.

Prohibited Subsidies. Two programs were found to operate as prohibited subsidies: Step 2 payments and export credit guarantees. Step 2 payments were part of special cotton marketing provisions authorized under U.S. farm program legislation to keep U.S. upland cotton competitive on the world market.[2] Step 2 payments were made to both 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. Step 2 payments were deemed illegal because they were paid only to users of U.S. cotton (i.e., they discriminated against foreign cotton by encouraging the use of domestic products over imported products) and because they were unscheduled (i.e., export subsidies applied to commodities not listed on a country's WTO schedule or made in excess of the value listed on the schedule).[3]

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.[4] GSM-102 covers credit terms up to three years, while GSM-103 covered longer credit terms up to 10 years. The Supplier Credit Guarantee Program (SCGP) insured 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

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[1] For disputes involving prohibited (or WTO-illegal) subsidies, the prescribed remedy compliance time is halved. For more information on WTO disputes, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne Grimmett.

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

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

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

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. In other words, so long as the credit guarantees act as an implicit export subsidy, only U.S. program crops that have scheduled export subsidies are eligible for U.S. export credit guarantees.

Actionable Subsidies. Any subsidy may be challenged in the WTO (i.e., is "actionable") if it fulfills the WTO definition of a subsidy[5] and is alleged to cause adverse effects to the interests of other WTO members. In particular, price-contingent payments (i.e., payments dependent on changes in current market prices) — including marketing loan provisions, Step 2 payments, market loss payments, and counter-cyclical payments — 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. The panel recommended that the United States take appropriate steps to remove the adverse effects of these subsidies or to withdraw the subsidies entirely.[6]

Such subsidies were previously afforded some protection under the so-called "Peace Clause" (Article 13) of the WTO's Agreement on Agriculture. However, the WTO panel reviewing the U.S. cotton case found that the United States was in violation of its Peace Clause spending limit such that Brazil's dispute settlement case could proceed.[7] The panel ruled that neither production flexibility contract (PFC) payments under the 1996 farm bill nor direct payments (DP) under the 2002 farm bill qualify for the WTO's green box AMS exemption as decoupled payments due to the planting restriction on fruits, vegetables, and wild rice on program base acres. As a result, PFC and DP payments were counted against the U.S. Peace Clause limit.

U.S. Response to the DS Panel Ruling

On July 1, 2005, USDA instituted a temporary fix for its export credit guarantee programs, whereby the Commodity Credit Corporation (CCC) would use a risk-based fee structure for the GSM-102 and SCGP programs. The new structure responded to a key finding by the WTO that the fees charged by the programs should be risk-based. User fees for GSM-102, the primary export credit program, presently are capped at 1% of the value of the export product (7 U.S.C. 5641). 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. In addition, the CCC stopped accepting applications for payment guarantees under GSM-103. Furthermore, both the Senate- and House-passed versions of the 2007 farm bill (H.R. 2419) contain provisions to eliminate the GSM-103 and SCGP programs, and to remove the 1% cap on fees that can be charged under the GSM-102 program.[8]

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

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

[7] For more information on the Peace Clause and its role in this dispute, see CRS Report RL32571, *Background on the U.S.-Brazil WTO Cotton Subsidy Dispute*, by Randy Schnepf.

[8] Section 3002, Title III, of the House-passed H.R. 2419 (July 27, 2007); and Section 3101, Title III, of the Senate version of H.R. 2419 as passed (Dec. 14, 2007) with amendments.

On August 1, 2006, the Step 2 cotton program, which was authorized by the 2002 farm act (P.L. 107-171; Sect. 1207), was eliminated by a provision (Sec. 1103) in the Deficit Reduction Act of 2005 (P.L. 109-171). The Administration likely felt that sufficient program changes had been enacted to fully comply with the "actionable subsidies" portion of the WTO ruling. Furthermore, it is likely that the Administration deemed that Congress would have the opportunity to make further adjustments, if needed, when it passed new farm legislation in 2007 (as current farm law was set to expire in 2007).

Brazil Seeks $4 Billion in Retaliatory Trade Measures

According to WTO rules, trade sanctions are limited to a value not to exceed the level of lost benefits. As the reform deadlines under the two different subsidy types expired, Brazil first requested (July 4, 2005) authorization from the WTO to impose $3 billion in countermeasures against the prohibited U.S. subsidies. This value corresponds to (1) Step 2 payments made in the then-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 then-most-recent fiscal year (2004).[9] To achieve $3 billion in retaliation, 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. The United States objected to the amount of Brazil's proposed sanctions, and requested WTO arbitration.[10] However, the United States and Brazil reached a procedural agreement temporarily suspending arbitration proceedings concerning the prohibited subsidies.[11]

Second, as the September 21, 2005, deadline to address the actionable subsidy ruling expired, Brazil charged that the United States had neither taken nor announced any specific initiative for the price-contingent programs deemed to cause prejudicial impact to Brazil's trade interest. Brazil then requested authorization from the WTO to impose countermeasures valued at $1 billion as retaliation against the actionable programs. Once again, the United States requested WTO arbitration over the level of the proposed sanctions.[12] Again, the United States and Brazil reached a procedural agreement, thereby temporarily suspending further retaliation proceedings on the actionable subsidies.[13]

Brazil Requests a Compliance Panel

Initially Brazil showed a willingness to permit the U.S. legislative process — motivated by the 2007 expiration of U.S. farm programs and the prospects of a successful

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

[10] WTO official document WT/DS267/24, July 19, 2005. Official WTO documents are accessible online at [http://docsonline.wto.org/gen_search.asp?searchmode=simple].

[11] WT/DS267/25, August 18, 2005.

[12] WT/DS267/27, October 18, 2005.

[13] WT/DS267/29, December 7, 2005.

Doha Round of trade negotiations[14] — to bring U.S. farm programs into compliance with the WTO ruling, even if this process extended well beyond the deadlines established under the WTO dispute settlement ruling. However, on August 21, 2006, Brazil submitted a request for a WTO compliance panel to review whether the United States had fully complied with panel and AB rulings. The WTO's Dispute Settlement Body (DSB) agreed to establish a compliance panel at the September 28, 2006, DSB meeting. On July 27, 2007, the compliance panel released a confidential interim ruling to the two countries that the United States has not fully complied with the March 2005 WTO ruling against certain U.S. cotton support programs. On October 15, 2007, the compliance panel's final report was released confidentially to the U.S. and Brazilian governments and, two months later on December 18, 2007, it was released publicly. The panel's final ruling confirmed the earlier interim ruling against the United States.

If the United States appeals the compliance panel's ruling, it must do so before the compliance panel's ruling is adopted by the DSB (i.e., within 60 days of its release). If appealed, an Appellate Body decision would not be likely until mid-2008. The ruling against the United States (barring a successful U.S. appeal) could necessitate further U.S. farm program changes or, if no further changes are forthcoming, clear the way for Brazil to request WTO authorization for retaliatory trade sanctions. First, however, Brazil would likely ask the WTO arbitration panel to resume its work, with a decision within 60 days, according to the U.S.-Brazil agreement on prohibited subsidies. U.S. failure to comply with any decision could result in WTO-sanctioned trade retaliation by Brazil against the United States. 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 that 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.[15]

Role of Congress

When confronted with a negative WTO dispute settlement ruling, a country has essentially five options to choose from: eliminate the subsidy; reduce the subsidy to diminish its adverse effect; revise the program function to reduce the linkage between the subsidy and the adverse effect (referred to as decoupling); pay a mutually acceptable compensatory payment to offset the adverse effects of the subsidy; or suffer the consequences of trade retaliation.

Ultimately, Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements. The United States has already complied with at least a portion of the AB's recommendation by eliminating the Step 2 program. In addition, proposed provisions in the pending House and Senate farm bills would bring the export credit program into compliance with WTO rules by eliminating the "subsidy" component of export credit guarantees. However, neither the House- nor the Senate-passed version of H.R. 2419 appears to address the serious prejudice charge related to price-contingent subsidies. Instead, both the House and Senate

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[14] For more information and an update on the status of Doha negotiations see, CRS Report RL33144, *WTO Doha Round: The Agricultural Negotiations*, by Charles Hanrahan and Randy Schenpf.

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

versions of H.R. 2419 appear to offer higher levels of price and income support that could potentially aggravate the perception (if not the reality) of "serious prejudice" in the marketplace. Several of the proposed changes are specifically relevant to the Brazil cotton case, but also germane to the broader issue of program vulnerability to WTO challenge.[16] For example, both House and Senate farm bill versions would:[17]

- extend current marketing loan provisions and the CCP program;
- raise both loan rates and target prices for several commodities, while only lowering (marginally) the target price for upland cotton;
- offer producers the choice of revenue-based support options in lieu of CCP (which includes significantly higher per-acre revenue guarantees for cotton than under the current 2002 farm bill);
- change the world price used by USDA to determine cotton marketing loan repayment rates from a Northern European price to a Far Eastern price, which presumably would result in larger payments under the provisions of the program; and
- create a new cotton-user payment of 4 cents per pound. (This payment appears similar to the WTO-illegal Step 2 payment except that cotton from all origins (not just domestic sources) is eligible for the payment. Since the United States imports very little cotton, most payments would still likely go to domestically sourced cotton. As a result, this subtle technical loophole might be subject to a WTO challenge if it survives the congressional legislative process and emerges as part of a new farm bill.)

Finally, both pending farm bill versions fail to address the issue surrounding the disqualification of direct payments from WTO's green box AMS exclusion as decoupled payments due to the planting restriction on fruits, vegetables, and wild rice on program base acres. Instead, direct payments are extended with no change to the current planting restriction (except for a small pilot program on 10,000 acres in Indiana). This glaring retention of the status quo has important WTO implications, as both Canada and Brazil have recently initiated WTO cases against the United States charging that the United States has exceeded its total AMS limit on several occasion in recent years if direct payments are included in the AMS calculation.[18]

Additional uncertainty arises from the ongoing Doha Round of trade negotiations, where a successful conclusion could potentially mitigate or end Brazil's interest in continuing its case against the U.S. farm programs. Both agriculture committees (House and Senate) of the 110th Congress will likely continue to monitor developments in the WTO cotton case and the Doha negotiations, as well as the aftermath of the compliance panel's final ruling.

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[16] For more information on this issue, see CRS Report RS22522, *Potential Challenges to U.S. Farm Subsidies in the WTO: A Brief Overview*, by Randy Schnepf and Jasper Womach.

[17] See CRS Report RL33934, *Farm Bill Legislative Action in the 110th Congress*.

[18] See CRS Report RS22724, *Canada's WTO Case Against U.S. Agricultural Support: A Brief Overview*, and CRS Report RL22728, *Brazil's WTO Case Against U.S. Agricultural Support: A Brief Overview*, both by Randy Schnepf.