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Brazil's WTO Case Against the U.S. Cotton Program

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Summary

U.S. and Brazilian trade negotiators reached agreement on June 17, 2010, on a "Framework agreement" regarding a World Trade Organization (WTO) dispute settlement case over U.S. cotton subsidies and GSM-102 agricultural export credit guarantees. The Framework agreement—which lays out a number of "steps and discussions"—represents a path forward toward the ultimate goal of reaching a negotiated solution to the dispute, while avoiding WTO-sanctioned trade retaliation by Brazil against U.S. goods and services. The Framework includes quarterly discussion on potential limits of trade-distorting U.S. cotton subsidies (recognizing that actual changes will not occur prior to the 2012 farm bill) and provides benchmarks for further changes to the GSM-102 program.

The so-called Brazil cotton case is a long-running WTO dispute settlement case (DS267) initiated by Brazil—a major cotton export competitor—in 2002 against specific provisions of the U.S. cotton program. In September 2004, a WTO dispute settlement panel found that certain U.S. agricultural support payments and guarantees—including (1) payments to cotton producers under the marketing loan and counter-cyclical programs, and (2) export credit guarantees under the GSM-102 program—were inconsistent with WTO commitments. In 2005, the United States made several changes to both its cotton and GSM-102 programs in an attempt to bring them into compliance with WTO recommendations. However, Brazil argued that the U.S. response was inadequate. A WTO compliance panel ruled against the United States in December 2007, and the ruling was upheld on appeal in June 2008.

In August 2009, a WTO arbitration panel—assigned to determine the appropriate level of retaliation—announced that Brazil's trade countermeasures against U.S. goods and services could include two components: (1) a fixed amount of $147.3 million for cotton payments, and (2) a variable amount based on GSM-102 program spending. The arbitrators also ruled that Brazil would be entitled to cross-retaliation if the overall retaliation amount exceeded a formula-based variable annual threshold. Cross-retaliation involves countermeasures in sectors outside of the trade in goods, most notably in the area of U.S. copyrights and patents.

Based on the arbitrators' formulas, using 2008 data, Brazil announced in December 2009 that it would impose trade retaliation against up to $829.3 million in U.S. goods, including $268.3 million in eligible cross-retaliatory countermeasures. In March 2010, Brazil released a list of 102 goods of U.S. origin that would be subject to import tariffs of up to 100%, followed by a preliminary list of U.S. patents and intellectual property rights that it could restrict. Brazil announced an April 6 deadline for imposing the tariffs, which led to intense negotiations between Brazil and the United States to find a mutual agreement and avoid the trade retaliation.

In early April, 2010, the United States offered a three-point proposal including establishment of a $147.3 million annual fund to provide technical assistance and capacity-building for Brazil's cotton sector, near-term modifications to the operation of the GSM-102 program, and special recognition for certain Brazilian beef imports into the United States. As a result, Brazil agreed to postpone the implementation of countermeasures until April 22. On April 20, the two parties signed a memorandum of understanding (MOU) that detailed the specifics of the $147.3 million fund. As a result, Brazil extended the suspension of trade retaliation until mid-June. The aforementioned "Framework agreement" is intended to delay any trade retaliation until after the 2012 farm bill, when potential changes to U.S. domestic cotton subsidies will be evaluated.

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Overview

This report provides a description and status report on Brazil's challenge to certain aspects of the U.S. cotton program under the rules of the World Trade Organization's (WTO's) dispute settlement process in case DS267.[1] The "Brazil cotton case" had its WTO origins in 2002 and has since evolved into a sprawling legal enterprise that is still ongoing as of mid-2010.

The report begins by summarizing the most recent developments in the case. It then provides a detailed history of the case in chronological phases. Readers interested in the current status of the dispute, and in particular details of the negotiations to reach a mutual settlement and avoid trade retaliation against U.S. goods and services, should proceed directly to the report section entitled "Phase V: Retaliation or Settlement?"

Report Phases

Along the way, this case has touched on many aspects of WTO legal procedure, including an initial WTO panel and appeal phase, a compliance dispute phase, and the ongoing retaliation phase. Because of the case's longevity and complicated legal twists and turns, this report seeks to keep the timeline clear and to footnote official reference documents. The report is broken into six separate components, each representing a different (and somewhat independent) phase of the case. These phases are followed by a summary of the potential role of Congress with respect to the WTO case rulings and their implications for U.S. cotton programs.

1. **Phase I**: Pre-case background on the U.S. cotton sector and its global context.
2. **Phase II**: Brazil's WTO dispute settlement case against U.S. cotton programs.
    a. Brazil's specific charges and the WTO panel's findings.
    b. WTO panel and Appellate Body (AB) recommendations.
    c. Implementation timeline for panel and AB recommendations.
3. **Phase III**: WTO compliance panel and AB review of U.S. compliance with dispute settlement panel's and AB's recommendations.
4. **Phase IV**: WTO arbitration of Brazil's request for retaliatory countermeasures.
5. **Phase V**: Retaliation or settlement.
6. **Phase VI**: Discussion of the potential policy implications of this WTO case for the U.S. cotton sector.
7. **Role of Congress**.

The report ends with a timetable of the WTO dispute settlement process (**Table 5**), to facilitate the reader's understanding of and access to the multifaceted legal procedures involved in the case's slow progression. However, the main thrust of this report is to provide an economic and policy perspective on case developments. For more on the legal aspects of WTO dispute

[1] Official WTO documents as cited in **Table 5** and throughout this report are available at http://docsonline.wto.org/ under a simple search using the specific "document symbol" cited, e.g., WT/DS267/1.

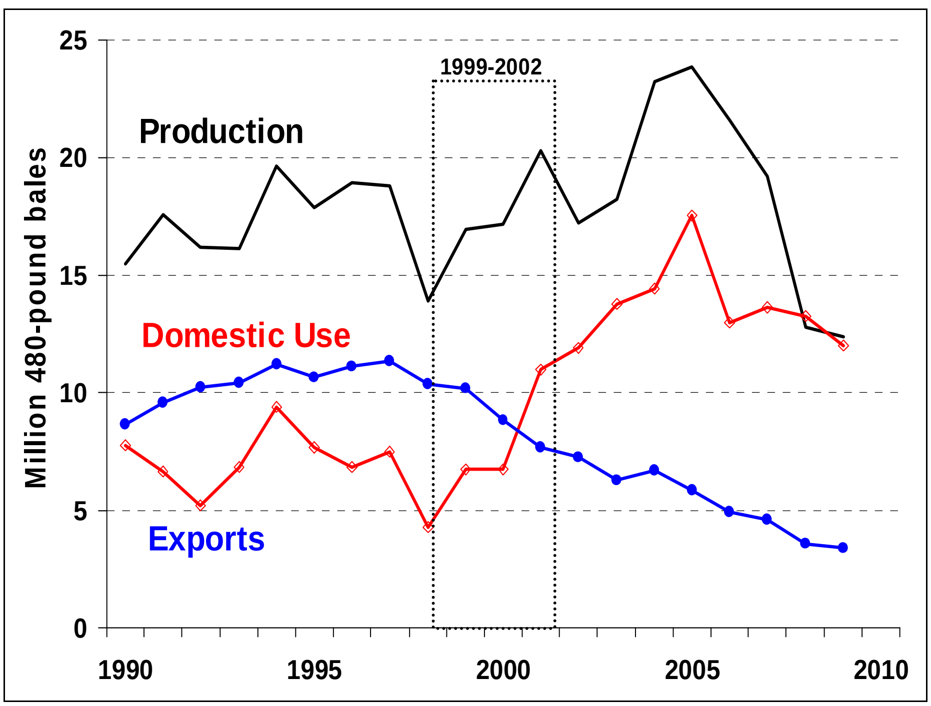
settlement cases in general, and the cotton case in particular, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

Phase I: Background on the U.S. Cotton Sector

The cotton industry is a major component of the U.S. agricultural sector. From 1991 to 2008 U.S. cash receipts from cotton production averaged $4.9 billion per year, while export sales averaged nearly $2.9 billion. Cotton is grown across the southern tier of states stretching from Virginia down through the Carolinas and into Georgia, then westward through a belt of contiguous states to California. Texas is the largest cotton-producing state, accounting for an average of 26% of U.S. production since 1990. In 2002, when Brazil first originated its WTO dispute settlement case against U.S. cotton programs, 17 states reported cotton production valued at over $20 million.

The United States is the third-largest producer of cotton in the world, behind China and India, and the world's largest cotton exporter. In the 1990s, U.S. exports accounted for 25% of world trade in cotton. However, since 2000 the United States has accounted for an increasing share of world trade (averaging 37%). U.S. exports as a share of domestic production have averaged nearly 70% since 2001, up from a 40% average during the early 1990s, due in large part to a decline in domestic mill use. (See **Figure 1**.) U.S. prominence in global markets coupled with large U.S. subsidy levels have directed international attention to U.S. cotton program outlays in recent years.

Figure 1. U.S. Cotton Production, Use, and Exports



Source: USDA, PSD database, February 11, 2010.

Domestic Program Support

Cotton is one of the principal U.S. program crops, along with wheat, rice, feed grains, soybeans, and peanuts. Traditionally, qualifying U.S. cotton producers were eligible for direct payments, counter-cyclical program (CCP) payments, marketing loan benefits, Step 2 payments, and other program benefits.[2] Since 2000, U.S. farm subsidies for cotton production have averaged $3.5 billion per year, while the harvest-time value of production has averaged $4.3 billion (**Table 1**).

Marketing loan program benefits and CCP payments are price-contingent in the sense that payments are determined by market prices falling below their respective price triggers (i.e., the loan rate and the adjusted target price). For upland cotton, the loan rate is set at $0.52 per pound and the target price is set at $0.71 per pound for calendar years 2010 through 2012 by the 2008 farm bill (P.L. 110-246). The target price is adjusted by subtracting the direct payment for upland cotton of $0.0667 per pound for calculating any CCP payment.

If the price triggers are set too far above market prices, they act as an incentive to encourage greater production (and exports) than what the market would otherwise demand. This results in lower prices than would exist in the absence of these programs. It is this "price effect" that was found by the WTO to cause adverse effects and serious prejudice in the international cotton market, as described below. Indeed, a comparison of relative support prices versus market prices for major U.S. program crops reveals that cotton producers receive payments under these programs far more routinely than do other crops.[3] This would suggest that cotton support prices are set too high relative to general cotton market conditions, as well as to other crop prices.

Export Credit Guarantee Programs

In 2002, at the time that Brazil first initiated the WTO case, the United States operated three principal export credit guarantee programs to facilitate the export of U.S. agricultural products (including but not limited to cotton). These were the GSM-102 program (which extended credit for periods ranging from 90 days to 3 years), the GSM-103 program (which extended credit for periods of more than 3 years, but not more than 10 years) and the Supplier Credit Guarantee Program (SCGP). The GSM-103 and SCGP programs were part of Brazil's original case; however, they both were eliminated by congressional action in 2008, as described below.

The GSM-102 export credit guarantee program (hereafter referred to as the GSM-102 program) is authorized under the Agricultural Trade Act of 1978 (7 USC Sec. 5622), as amended. The program, backed by USDA's Commodity Credit Corporation (CCC), guarantees the repayment of credit made available to finance export sales of agricultural commodities on credit terms between 90 days and 3 years. Typically, 98% of principal and a portion of interest are covered by a guarantee. To obtain a guarantee, an exporter has to pay a fee (or "premium") calculated on the basis of guaranteed value, according to a schedule of rates applicable to different credit terms and repayment intervals. At the time that Brazil initiated DS267, the fee was capped by law at 1% of the guaranteed value.

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[2] The Step 2 cotton-user payments program was ended on August 1, 2006, by P.L. 109-171. For a description of major farm programs, see CRS Report RL34594, *Farm Commodity Programs in the 2008 Farm Bill*, by Jim Monke.

[3] For more information, see CRS Report RL34053, *Measuring Equity in Farm Support Levels*, by Randy Schnepf.

Table 1. U.S. Upland Cotton Program Outlays and Harvest-Time Value of Production, FY1991-FY2010
($ millions)

Fiscal year[a]	Outlays: Cash[c]	Outlays: Non-Cash[d]	Outlays: Total	Value of production[b]
1991	382	13	395	5,076
1992	1,443	373	1,816	4,912
1993	2,239	572	2,810	4,274
1994	1,539	292	1,831	4,523
1995	99	3	101	6,795
1996	685	0	685	6,573
1997	561	0	561	6,410
1998	1,132	25	1,157	5,972
1999	1,882	230	2,112	4,122
2000	3,809	862	4,671	3,812
2001	1,868	381	2,249	4,257
2002	3,307	1,818	5,125	2,904
2003	2,889	689	3,578	3,676
2004	1,372	169	1,541	5,415
2005	4,245	1,458	5,703	4,643
2006	3,982	939	4,921	5,470
2007	2,592	973	3,565	4,819
2008[e]	1,604	398	2,002	5,468
2009[e]	3,191	na	3,191	3,014
2010[e]	2,472	na	2,472	3,424
Sum: 1991-2010	41,292	9,194	50,486	95,559
Average: 1991-1999	1,107	167	1,274	5,406
Average: 2000-2010	2,852	854	3,547	4,264

Source: USDA, Farm Service Agency (FSA), Budget Division, History of Budgetary Expenditures of the Commodity Credit Corporation, Books 3 (April 9, 2001) and 4 (July 15, 2003); and FSA Budget Table No. 35, Aug. 25, 2009, available at http://www.fsa.usda.gov/FSA/webapp?area=about&subject=landing&topic=bap-bu-cc.

Note: na = not available. Data are for program outlays within the reported fiscal year. Payments may be specific to cotton from several different crop or marketing year.

a. The fiscal year starts Oct. 1 and ends Sept. 30 of the following year. Fiscal year identification is with the second year. For example, FY1993 starts Oct. 1, 1992, and runs through Sept. 30, 1993.

b. Production is valued at harvest-time prices. Each production value is for the crop harvested during the crop year preceding the designated fiscal year.

c. Includes deficiency payments, production flexibility contract payments, loan deficiency payments, user market payments (Step 2), marketing loss payments, outlays from general loan operations, and other miscellaneous payments.

d. Includes loan repayment write-offs (otherwise referred to as producer marketing loan gains) and certificate sales proceeds/losses, both of which are treated as non-cash transactions.

e. USDA estimate, Table 35, "CCC Net Outlays by Commodity and Function," August 25, 2008, available at http://www.fsa.usda.gov/FSA/webapp?area=about&subject=landing&topic=bap-bu-cc; and USDA FY2010 Mid-Session Review, Commodity Estimates Book, August 25, 2009.

Phase II: Brazil's WTO Dispute Settlement Case Against the U.S. Cotton Program

In 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 certain features of the U.S. cotton program. Once initiated, a dispute settlement case follows a sequence of events designed to produce resolution of the dispute within a 12-15 month time frame. However, the WTO dispute settlement (DS) process that reviewed Brazil's charges against the U.S. cotton program has extended well beyond the hypothetical 15-month time frame. In this particular case, the initial WTO panel review took 17 months from the establishment of the panel in March 2003 to its final ruling in September 2004.

Furthermore, substantial additional time has since been added to the dispute settlement process—first, for an Appellate Body review of the initial ruling on appeal, then for a WTO compliance panel to review a dispute over U.S. compliance with the initial panel's ruling, and finally for an arbitrator to review a disagreement between Brazil and the United States over Brazil's proposed retaliation amounts. See **Table 5** for a timeline of the dispute settlement case and related events.

With respect to the initial dispute settlement case, it was broadly written and touched on almost every aspect of U.S. commodity programs, although the focus was on the six principal claims described below along with the WTO dispute settlement panel finding (of September 8, 2004) and Appellate Body (AB) ruling (of March 3, 2005).[4]

Brazil's Six Principal Claims Against U.S. Cotton Programs

Claim 1: Peace Clause Violation

Brazil claimed that the United States was no longer exempt from WTO dispute proceedings under the so-called "peace clause" (Article 13) of the WTO's Agreement on Agriculture (AA) because U.S. domestic and export subsidies to its cotton sector were in excess of its 1992 benchmark level.[5] Prior to its expiry in January of 2004, Article 13 exempted domestic support measures that complied with the AA's requirements from being challenged as illegal subsidies through dispute settlement proceedings, as long as the level of support for a commodity remained at or below the benchmark 1992 marketing year (MY) levels.[6] Brazil argued that U.S. cotton subsidies were about $2 billion in MY1992 compared with over $4 billion in MY2001. Therefore, Brazil argued that the United States was no longer in compliance with the requisite conditions and could no longer seek protection under the WTO's peace clause rule.

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[4] Ministry of Foreign Affairs [Ministério das Relações Exteriores], Brasilia; "Brazil-U.S.A. Dispute on Subsidies on Upland Cotton," translation from the original in Portuguese, Nota n° 248-18/06/2004; Distribuição 22 e 23.

[5] WTO, *The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations*, Cambridge Univ. Press, ©World Trade Organization 1999; hereafter referred to as *WTO Legal Texts*. Text of the Agreement on Agriculture is available online at http://www.wto.org/english/docs_e/legal_e/14-ag.pdf.

[6] USDA reports commodity program outlays on a fiscal year (FY) basis. (See **Table 1**.) However, marketing year data, not fiscal year, must be used in the WTO case. The U.S. cotton marketing year starts August 1 and ends July 31 of the following year, but identifies with the first year, such that MY1992 starts August 1, 1992, and ends July 31, 1993. The principal period in question, MY1999-MY2002, corresponds roughly with FY2000-FY2003.

In response, U.S. trade officials argued that WTO members agreed to the peace clause recognizing that agricultural subsidies could not be eliminated immediately and needed, under certain conditions, to be exempted from the Subsidies and Countervailing Measures (SCM) Agreement and GATT 1994 subsidies disciplines. As a result, U.S. officials argued that the words "exempt from actions" as used in Article 13 of the AA were of overarching importance and precluded not only the "taking of legal steps to ... obtain a remedy," as Brazil has argued, but also the "taking of legal steps to establish a claim."[7] Furthermore, U.S. trade officials argued that the immunity granted by the peace clause was still important, since even if a country was no longer in compliance with the peace clause, it was incumbent on the complaining party to prove there had been injury. (See "Claim 5: U.S. Subsidies Have Caused "Serious Prejudice",'" below.)

Finding 1

The panel found (and was upheld by the AB in finding) that Brazil had successfully discharged its burden to show that U.S. domestic cotton support measures during MY1999-MY2002 (which averaged $3.28 billion) were in excess of WTO commitments (of $2.0 billion) during MY1992. (See **Table 2**.) As a result, U.S. domestic cotton support measures lost the protection afforded by the "Peace Clause," which had shielded them from substantive challenges in the past. This occurred in part because, under Finding 2, Production Flexibility Contract and Direct Payment outlays were included with other commodity program outlays and evaluated against "peace clause" limits.

Table 2. Comparison of U.S. Domestic Cotton Support in Accordance with Article 13(b)(ii)

$ million	MY1992	MY1999	MY2000	MY2001	MY2002
Total	$ 2,012.7	$ 3,404.4	$ 2,429.3	$ 4,144.2	$ 3,140.3

Source: *United States—Subsidies on Upland Cotton*, "Report of the Panel," WTO, WT/DS267/R, Sept. 8, 2004; p. 157.

Claim 2: U.S. Direct Payments Do Not Qualify for Exemption from Reduction Commitments as Decoupled Income Support

Brazil claimed that two types of U.S. payments—production flexibility contract (PFC) payments made under the 1996 farm bill and direct payments (DP) made under the 2002 farm bill—failed to fully meet the conditions for decoupled income support in Annex 2 of the Agreement on Agriculture and should therefore be counted against the U.S. "Peace Clause" domestic support benchmark limit.

The United States considers both PFC and DP programs to be consistent with WTO language for exempt domestic support that has "no, or at most minimal, trade-distorting effects or effects on production."[8] As a result, the United States notifies both the PFC and DP outlays as "green box"

[7] *United States—Subsidies on Upland Cotton*, WT/DS267, "Initial Brief of the United States of America on the Question Posed by the Panel," June 13, 2003; available from the USTR website at http://www.ustr.gov/assets/Trade_Agreements/Monitoring_Enforcement/Dispute_Settlement/WTO/Dispute_Settlement_Listings/asset_upload_file376_5598.pdf.

[8] WTO, "Annex 2—Domestic Support: The Basis for Exemption from the Reduction Commitments," paragraphs 5 and (continued...)

where they are not subject to any limits. Furthermore, the United States argued strongly against including such "minimally distorting, non-commodity specific" payments in evaluating whether the United States has met or exceeded its "peace clause" limits.

Finding 2

The panel found (and was upheld by the AB in finding) that U.S. payments made under the PFC and DP programs, because of the prohibition on planting fruits, vegetables, and wild rice on covered program acreage,[9] do not qualify for the WTO's green box category of domestic spending. (The green box contains only non-distorting program payments and is not subject to any limit). Instead, they should be counted as domestic subsidies directly affecting cotton production (i.e., distorting) and be included with other commodity program outlays to evaluate whether the United States has met or exceeded its "peace clause" limits.

Claim 3: The Step 2 Program Functions as an Export Subsidy

Brazil argued that Step 2 payments made under the U.S. cotton program functioned as export subsidies and were inconsistent with U.S. WTO obligations regarding export subsidies as specified under the SCM Agreement.

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.[10] Step 2 payments were made to exporters and domestic mill users to compensate them for their purchase of higher priced U.S. upland cotton. Under the 2002 farm act, the Step 2 payment rate for the 2002-2005 marketing years was calculated as the difference between the price of U.S. upland cotton, delivered c.i.f. (cost, insurance, freight) in Northern Europe, and the average of the five lowest prices of upland cotton delivered c.i.f. Northern Europe from any source.[11]

The United States argued that Step 2 payments were part of its domestic support program since they were targeted to domestic cotton users as well as exporters. As a result, Step 2 payments were notified to the WTO as "amber" box (trade-distorting) domestic support payments and not as export subsidies. Consequently, U.S. trade officials contended that Step 2 payments were not subject to any limitations placed on export subsidies.

(...continued)

6, Agreement on Agriculture, *WTO Legal Texts*.

[9] For more information on these restrictions see USDA, Farm Service Agency, Fact Sheet, *Direct and Counter-Cyclical Payment Program Wild Rice, Fruit, and Vegetable Provisions,* February 2003, at http://www.fsa.usda.gov/pas/publications/facts/html/fav03.htm.

[10] The Step 2 cotton program was eliminated on August 1, 2006 (Sec. 1103, P.L. 109-171).

[11] Only prices for Middling (M) 1-3/32-inch upland cotton are used in the calculation. Also, certain price triggers must be met and held for a specified period of time before payments can be made. For information on the Step 2 program and other U.S. cotton program features, see USDA, ERS, "Cotton Briefing Room," at http://www.ers.usda.gov/Briefing/Cotton/.

Finding 3

In its finding, the panel considered Step 2 program payments to eligible 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.

The DS panel finding was upheld by the AB.

Claim 4: U.S. Export Credit Guarantees Function as Export Subsidies

Brazil argued that the U.S. GSM-102 program operated as a prohibited export subsidy under item (j) of Annex I of the Agreement on Subsidies and Countervailing Measures (SCM) because the premium rates (i.e., fees) charged to GSM-102 program beneficiaries were inadequate to cover the long-term operating costs of the program, thus imparting an implicit subsidy benefit.

Item (j) of Annex I identifies a prohibited export subsidy as:

> [t]he provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programs, of insurance or guarantee programs against increases in the cost of exported products or of exchange risk programs, at premium rates which are inadequate to cover the long term operating costs and losses of the programs.[12]

Brazil claimed that the favorable terms (i.e., the interest rate and time period that countries have to pay back the financing) provided under U.S. export credit guarantee programs—GSM-102, GSM-103, and the Supplier Credit Guarantee Program (SCGP)[13]—were effectively export subsidies inconsistent with the WTO's AA and SCM Agreements. Further, the subsidy effects of export credit guarantees applied not only to cotton, but to other eligible commodities.[14]

U.S. trade officials argued that the U.S. export credit guarantee programs were consistent with WTO obligations. Furthermore, the United States asserted that Article 10.2 of the AA reflected the deferral of disciplines on export credit guarantee programs contemplated by WTO members to the next WTO multilateral negotiating round—the Doha Round.

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[12] Item (j), Annex I, Agreement on Subsidies and Countervailing Measures, The Legal Texts, The Results of the Uruguay Round of Multilateral Trade Negotiations, World Trade Organization, Cambridge University Press©WTO1999.

[13] GSM-103 and SCGP were eliminated by the 2008 farm bill (P.L. 110-246; Sec. 3101(a)) upon its enactment on June 18, 2008. For information on the U.S. GSM-102 program, see USDA, Foreign Agricultural Service, "Export Credit Guarantee Programs," at http://www.fas.usda.gov/excredits/default.htm.

[14] For a list of commodities eligible for export credit guarantees see USDA, Foreign Agricultural Service, *USDA Amends Commodity Eligibility under Credit Guarantee Programs*, News Release, September 24, 2002; available at http://www.fas.usda.gov/scriptsw/PressRelease/pressrel_dout.asp?Entry=valid&PrNum=0346-02.

Finding 4

The panel found (and was upheld by the AB in finding) that U.S. export credit guarantees effectively functioned as export subsidies because the financial benefits returned by these programs failed to cover their long-run operating cost as specified by item (j) of the SCM. Furthermore, the panel found that this applied, not just to cotton, but to all commodities that benefit from U.S. commodity support programs and receive export credit guarantees. As a result, export credit guarantees for any recipient commodity were subject to previously scheduled export subsidy commitments for that commodity. This referred to those U.S. export subsidies under the Export Enhancement Program (EEP) and the Dairy Export Incentive Program (DEIP).[15] Under these criteria, export credit guarantees benefits extended to cotton and other "unscheduled" commodities (that are supported under U.S. agricultural programs) were found to be in violation of previous WTO commitments.[16] With respect to "scheduled" commodities, export credit guarantees extended to U.S. rice exports were found to be in violation of previous EEP volume commitments. The panel found (and was upheld by the AB) that "unscheduled" commodities not supported under U.S. agricultural programs, as well as scheduled agricultural products that remain within WTO commitments are exempt from actions under this dispute settlement case.

Claim 5: U.S. Subsidies Have Caused "Serious Prejudice"

Brazil argued that domestic farm subsidies provided to U.S. cotton growers contributed to significant overproduction and resulted in a surge in U.S. cotton exports, particularly during the 1999-2002 marketing years, when unusually large outlays were made under provisions of the U.S. cotton program (see **Table 1** and **Figure 1**). Brazil claimed that the resultant rise in U.S. exports led to three market conditions, each of which contributed to serious injury to Brazilian cotton exporters: (1) an increase in the U.S. share of the world upland cotton market; (2) a displacement of Brazilian upland cotton sales in third-country markets; and (3) a steep decline in world cotton prices (see **Figure 2** and **Figure 3**).[17]

In particular, Brazil claimed that injury to its economy due to low cotton prices, measured as the sum of individual negative impacts on income, foreign trade revenue, fiscal revenues, related services (transportation and ginning), and employment, exceeded $600 million in 2001 alone. Brazil asserted that injury under each of these three circumstances are in violation of the SCM Agreement.[18] In addition, Brazil argued that these same programs would be harmful (i.e., threatened serious prejudice) in future years.

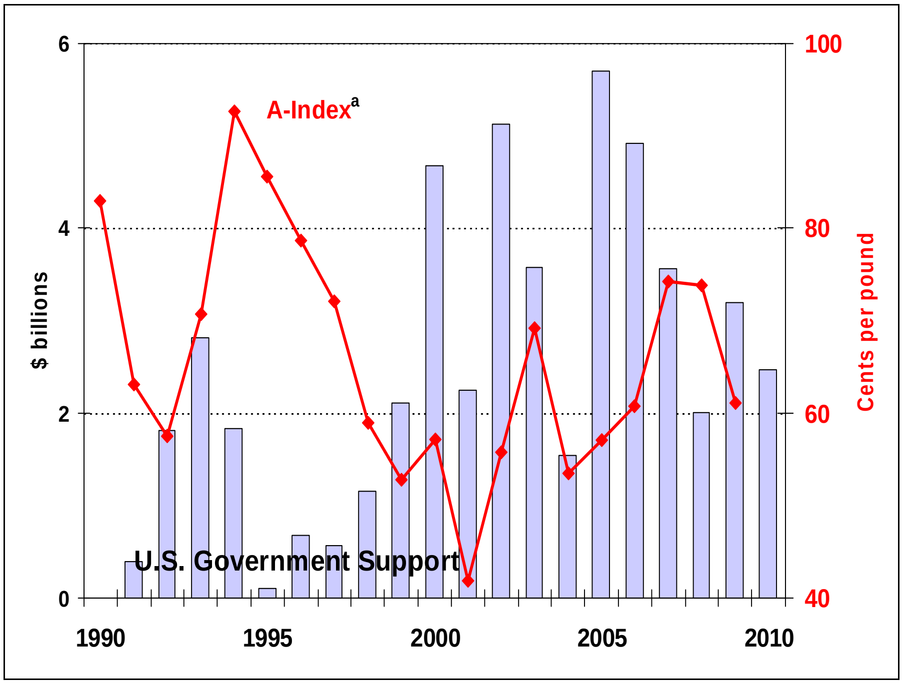
[15] The United States has scheduled export subsidy reduction commitments for the following thirteen commodities: wheat, coarse grains, rice, vegetable oils, butter and butter oil, skim milk powder, cheese, other milk products, bovine meat, pigmeat, poultry meat, live dairy cattle, and eggs.

[16] Those agricultural products which did not receive U.S. farm program support payments, but whose exports were otherwise assisted by export credit guarantee program are excluded from this case; WT/DS267/R, p. 348(d)(ii).

[17] Articles 5(c) and 6.3(b) of the Agreement on Subsidies and Countervailing Measures (SCM) deal with subsidies that result in adverse effects in other WTO-member countries. Brazil specifically identified Argentina, Bangladesh, Colombia, Germany, India, Indonesia, Italy, Portugal, Philippines, Slovenia, South Africa, South Korea, Switzerland, Thailand, and Turkey as the relevant third-country markets. WTO "Communication from Brazil," WT/DS267/9, March 21, 2003.

[18] Text of the Agreement on SCM is available online at http://www.wto.org/english/docs_e/legal_e/24-scm.pdf.

Figure 2. USDA Cotton Support, 1992 to 2010

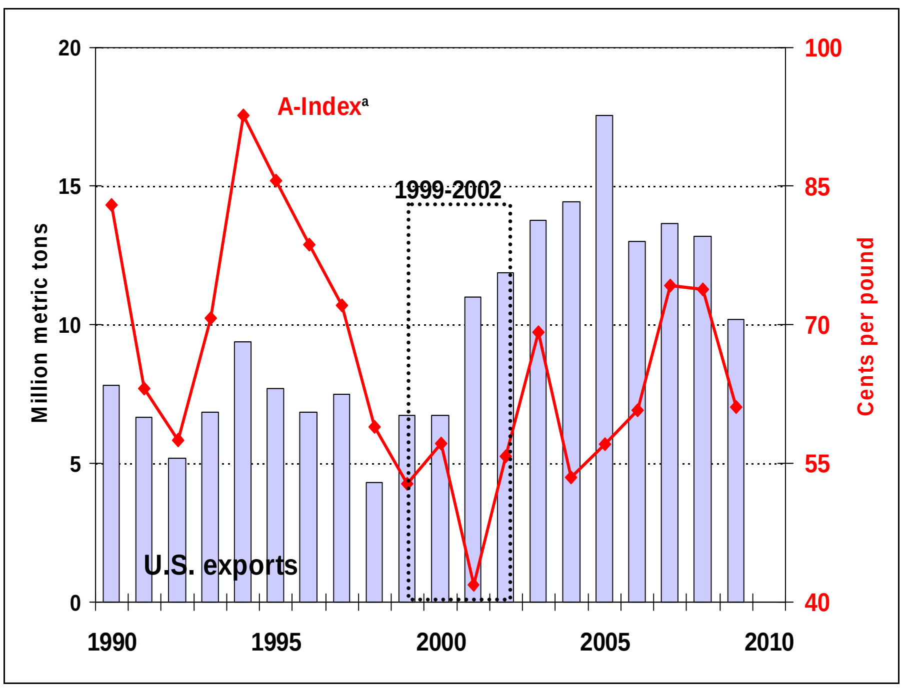


Source: USDA, FSA budget data (cash and non-cash support).

Note: Data for 2009 and 2010 are forecasts.

a. The A-index is an average of the five lowest priced types of 1-3/32 inch staple length cotton offered on the European market from 1990 through 2008, and in Far East markets in 2009.

Figure 3. U.S. Cotton Exports and International Cotton Price Index



Source: USDA, PSD online data base, August 12, 2009.

a. The A-index is an average of the five lowest priced types of 1-3/32 inch staple length cotton offered on the European market from 1990 through 2008, and in Far East markets in 2009.

U.S. trade officials argued that the subsidies provided to U.S. cotton growers have been within the allowable WTO limits and are consistent with U.S. WTO obligations. Furthermore, they argued that the decline in U.S. domestic use (due to declining U.S. competitiveness in textile and apparel production), rather than government support program outlays, contributed to larger U.S. raw cotton exports. In addition, they contended that international market forces—including weakness in world demand for cotton due to competing, low-priced synthetic fibers, and weak world economic growth—have played a larger role in determining the generally weak price level during the period in question, rather than U.S. export levels.

In evaluating this particular claim, the DS panel separated U.S. cotton support programs into two groups: those that are directly contingent on market price levels (i.e., loan deficiency payments, marketing loss assistance payments, counter-cyclical payments, and Step 2 payments), and those that are not (i.e., PFC and Direct Payments, and the federal crop insurance program).

Finding 5

The panel found (and was upheld by the AB in finding) that U.S. domestic support measures that are directly contingent on market price levels caused serious prejudice in terms of market price suppression for the period 1999 to 2002. However, U.S. domestic support measures that are not contingent on market price levels were not included in this finding as the panel could not find enough of a connection between the direct payments program and cotton planting decisions to declare the direct payments program a serious factor in price suppression.[19]

The panel also did not find in favor of Brazil's alleged serious prejudice in terms of an effect on international market share. Article 6.3 of the SCM lists several factors indicating serious prejudice; the panel only had to find one of the factors in violation to rule in Brazil's favor on the claim of serious prejudice during the 1999 to 2002 period.

With respect to Brazil's claim of a threat of serious prejudice going forward (2003 to 2007, the remaining life of the 2002 farm act), the panel stated in its final report that those "prohibited" subsidies that caused serious prejudice during the 1999-to-2002 period—namely, user marketing (Step 2) payments to exporters and domestic users; and export credit guarantees in respect of certain products under the GSM-102, GSM-103, and SCGP programs—must be withdrawn "without delay" pursuant to Article 4.7 of the SCM Agreement.[20] According to the panel, required withdrawal of the prohibited subsidies, within the time frame set by the panel, would curtail the future threat posed by U.S. cotton support programs. As a result, the panel stated that "it is not necessary or appropriate to address Brazil's claims of threat of serious prejudice."[21]

Claim 6: FSC-ETI Act of 2000 Acts as an Export Subsidy to Upland Cotton

Brazil claimed that the Foreign Sales Corporation Repeal and Extraterritorial Income Act of 2000 (ETI Act of 2000), by eliminating tax liabilities for U.S. upland cotton exporters who sell to foreign markets, constitutes an export subsidy and is inconsistent with U.S. export subsidy commitments for cotton.

[19] WT/DS267/R, paragraph 7.1307, p. 307.

[20] *Report of the Panel*, "United States—Subsidies on Upland Cotton," WTO, WT/DS267/R, para 7.1503, September 8, 2004, p. 345; hereafter referred to as WTO, WT/DS267/R.

[21] Ibid.

The United States asserted throughout the proceedings that Brazil failed to make any specific case with respect to the ETI Act of 2000 and U.S. upland cotton exports.

Finding 6

The panel concurred with the United States (and was upheld by the AB) in stating that Brazil failed to present any new arguments or evidence concerning effects upon upland cotton, but instead simply repeated the arguments that the European Union made in its WTO dispute settlement case with the United States (DS108).[22] As a result, the panel declined to further examine Brazil's claims on this particular issue.

Panel and Appellate Body Recommendations

The initial panel's final ruling was released publicly on September 8, 2004. The following month (October 18, 2004) the United States notified the WTO of its intent to appeal the panel's ruling. A WTO Appellate Body (AB) reviewed the legality of the case and issued its final report on March 3, 2005, upholding most of the initial panel's rulings. The policy recommendations that emerged from the panel and AB rulings are described below.

Prohibited Subsidies

The AB recommended that the United States withdraw those support programs identified as prohibited subsidies within six months of the date of adoption of the panel report by the Dispute Settlement Body (DSB) or by July 1, 2005 (whichever was earlier).[23] Since the DSB adopted the AB and panel reports on March 21, 2005, the relevant deadline for withdrawal was July 1, 2005. The list of prohibited subsidies subject to withdrawal "without delay" included the following.

Prohibited Export Subsidies

- Export credit guarantees under GSM-102, GSM-103, and SCGP that assist exports of upland cotton and other unscheduled agricultural products that are supported under government agricultural support programs.
- Export credit guarantees under GSM-102, GSM-103, and SCGP that assist exports of one scheduled agricultural product (rice), but in excess of the scheduled volume.
- Step 2 program payments to exporters of upland cotton.

Prohibited Import Substitution Subsidy

- Step 2 payments to domestic users of upland cotton.

[22] For more information on DS108, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

[23] Done in accordance with SCM, Article 4.7.

In contrast, unscheduled agricultural products not supported under government agricultural support programs and scheduled agricultural product exports that remain within their schedules were judged not to circumvent U.S. export commitments and therefore were not subject to trade remedy actions in this case.

Actionable Subsidies

The panel recommended that the United States take appropriate steps by September 21, 2005, to remove the adverse effects or to withdraw those U.S. subsidy measures singled out as price-contingent—marketing loan provisions, Step 2 payments, and CCP payments. These subsidies were identified as "actionable" subsidies that contributed adverse effects to the interests of Brazil during the marketing years 1999-2002.

It is noteworthy that the actionable subsidies remedy dealt with adverse effects that occurred during a historical time period and not future prejudice or injury. In support of this concept, the panel stated (in its original ruling on the "threat of serious prejudice" by actionable subsidies) that U.S. compliance with recommendations on prohibited subsidies—the Step 2 provisions and export credit guarantees—could so significantly transform the basket of measures in question that it was not necessary or appropriate to address Brazil's claims of threat of serious prejudice.[24] This appeared to leave open the possibility that removal of the prohibited subsidies might resolve the dispute under the actionable subsidies recommendation.

Implementation of Panel/Appellate Body Recommendations[25]

Following is a discussion of how the implementation phase was to unfold in accordance with WTO rules and how the actual implementation has unfolded.

In accordance with WTO rules, the evolution of the implementation phase depends on how both parties choose to respond to the different sequences of events as they unfold. In addition to the potential time tracks described below, the implementation phase also provides opportunities for the disputing parties to mutually resolve the dispute. If the United States failed to comply, Brazil could (upon visible evidence of noncompliance) request negotiations with the United States to determine mutually acceptable compensation (e.g., tariff reductions in areas of particular interest). Furthermore, if Brazil did not want to press ahead full force with imposing sanctions, there would be considerable opportunity to delay compliance steps.

The time track for compliance with panel and AB recommendations could diverge depending on whether the United States chose to respond separately to the rulings on prohibited subsidies and actionable subsidies. This is because prohibited subsidies are given expedited treatment under SCM, Article 4.12, which states that, "except for time-periods specifically prescribed in [SCM, Article 4], time-periods applicable under the DSU for the conduct of such disputes shall be half the time prescribed therein."

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[24] WTO, WT/DS267/R, para. 7.1503, p. 354.

[25] For details, see *Understanding the WTO: Settling Disputes*, "The Case Has Been Decided, What Next?" at http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm.

Prohibited Subsidies Potential Time Track

As a result of their expedited treatment, the AB recommended that the United States remove the prohibited export subsidies by July 1, 2005. Within 15 days after the AB and panel reports were adopted by the DSB (done on March 21, 2005),[26] the United States was expected to present an implementation plan to the DSB, although precedence suggests that such a plan could be as minimal as stating intentions to work with Congress to bring U.S. policies into compliance. This was indeed the case when, on April 20, the U.S. representative to the WTO announced that the United States intended to implement the recommendations and rulings of the DSB in a manner that respected U.S. WTO obligations.[27] The representative noted, however, that determining acceptable options would take a reasonable period of time and requested that Brazil be willing to consult on the potential timetable.

If, 10 days after the designated period (July 1, 2005) expires, no satisfactory compensation is agreed to, the complaining side (Brazil) may ask the DSB for permission to impose limited trade sanctions against the United States.[28] The trade sanctions are limited to a value equivalent to no more than the level of nullification or impairment of benefits. The DSB must grant this authorization within 15 days of expiry of the "reasonable" time period unless a consensus exists against the request.[29]

If the United States objects to the amount proposed by Brazil, the level of suspension would be arbitrated (by the original panel if available). Arbitration shall be completed within 30 days after the date of expiry of the designated period (July 1, 2005).[30] No trade sanctions are to be imposed during the arbitration period.

Once armed with the authority to impose trade sanctions, Brazil could 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) requested and received authorization to impose retaliatory measures against the United States on May 7, 2003.[31] However, the EC refrained from immediate action, stating that it would review U.S. actions for a period of time before proceeding. The EC eventually began imposing additional duties on U.S. products in March 2004.

Actionable Subsidies Potential Time Track

In contrast to the July 1, 2005, deadline, the removal of actionable subsidies was subject to a six-month period starting on the date of adoption of the AB and panel reports (March 21, 2005).[32] As

[26] Normally a 30-day period is given to respond (DSU, Article 21.3); however, this is halved under SCM, Article 4.12.

[27] U.S. Mission to the United Nations in Geneva, Press Release, "Statements by the U.S. Representative at the meeting of the WTO Dispute Settlement Body," April 20, 2005.

[28] Normally a 20-day period is given (DSU, Article 22.2); however, for disputes involving prohibited subsidies the prescribed time is halved (SCM, Article 4.12).

[29] Normally a 30-day period is given for authorization (DSU, Article 22.6); however, for disputes involving prohibited subsidies the prescribed time is halved (SCM, Article 4.12).

[30] Normally a 60-day period is given for arbitration (DSU, Article 22.6); however, for disputes involving prohibited subsidies the prescribed time is halved (SCM, Article 4.12).

[31] For more information on case DS108, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

[32] In accordance with SCM, Article 7.9.

a result, the panel recommended that, upon adoption of its final report, the United States take appropriate steps to remove the adverse effects or to withdraw those subsidies identified as contributing to serious prejudice to the interests of Brazil—marketing loan provisions, Step 2 payments, and CCP payments—by September 21, 2005. Thus, in every other respect, the timetable for actionable subsidies would follow the same sequence of events listed above for prohibited subsidies, but subject to the full time allotment for each event as described in the preceding footnotes rather than the "halved" time periods.

U.S. Compliance Actions

A spokesperson for the Office of the U.S. Trade Representative (USTR) expressed disappointment in the AB ruling, but also said that USTR would study the AB report carefully and work closely with Congress and U.S. farmers on its next steps.[33] However, U.S. officials said that they preferred to resolve the cotton case through trade negotiations in the WTO Doha Round rather than a separate settlement.[34] The National Cotton Council (NCC) of America—the principal national organization representing the interests of U.S. producers, ginners, warehousers, merchants, cottonseed processors/dealers, cooperatives and textile manufacturers—also expressed disappointment in the AB ruling, but stated that it would work with USTR and USDA to coordinate a response to the decision.[35]

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. The 1% cap on user fees for GSM-102, the primary export credit program, was cited by the DS panel as contributing to the subsidy component of the GSM program. Higher fees would ensure that the financial benefits returned by these programs would fully cover their long-run operating costs, and eliminate the subsidy component. USDA could not remove the cap administratively as it is required by statute (7 U.S.C. 5641). In addition, the CCC stopped accepting applications for payment guarantees under GSM-103.

On August 1, 2006, the Step 2 cotton program, which was authorized by the 2002 farm act (P.L. 107-171, Section 1207), was eliminated by a provision (Section 1103) in the Deficit Reduction Act of 2005 (P.L. 109-171).

On June 18, 2008, the date of enactment of the 2008 farm bill (P.L. 110-246), a provision (Sec. 3101(a)) in the Trade title (Title III) eliminated the GSM-103 and SCGP programs, and removed the 1% cap on fees that can be charged under the GSM-102 program. In addition, the same 2008 farm bill provision explicitly requires the Secretary of Agriculture, in carrying out the GSM-102 program, to "work with the industry to ensure, to the maximum extent practicable, that risk-based fees associated with the guarantees cover, but do not exceed, the operating costs and losses over the long-term."

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[33] *Inside U.S. Trade*, "Appellate Body Favors Brazil in Cotton Subsidies Challenge," Vol. 23, No.9, March 4, 2005.

[34] *Congressional Daily*, "Comply Quickly With WTO Ruling, Brazil Urges U.S." March 15, 2005.

[35] NCC, "NCC Statement on WTP Appellate Ruling," March 3, 2005; available at http://www.cotton.org/news/releases/2005/wtostatement.cfm.

However, the 2008 farm bill defined the "long-term" as a period of 10 or more years. While the WTO panel did not explicitly define its view of the "long-term," it clearly is less than 10 years and more likely is on the order of a period of two years—that is, a net loss in one year must be offset by a net gain in the following year.

At this point the Administration likely felt that sufficient program changes had been enacted to fully comply with the both the prohibited and actionable subsidies portions of the WTO ruling.

Phase III: WTO Compliance Panel Review and Ruling

This section describes Brazil's charges of noncompliance, the proposed retaliation, the beginning of WTO arbitration over the size and nature of the proposed retaliation, and a ruling by a WTO compliance panel reviewing whether the U.S. had fully complied with earlier recommendations.

Arbitration Requested, Then Suspended, Over Brazil's Proposed Retaliation Amounts

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. According to WTO rules, trade sanctions are limited to a value not to exceed the level of lost benefits. The $3 billion value corresponded to (1) Step 2 payments made in the then-most-recently-concluded marketing year (2004/2005) 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).[36] This amount was later pared back to $1.155 billion in annual retaliation to counter the prohibited subsidies based on Brazil's methodology applied to FY2006 data.[37] The United States objected to the amount of Brazil's proposed sanctions and requested WTO arbitration.[38] However, on August 18, 2005, the United States and Brazil reached a procedural agreement temporarily suspending arbitration proceedings concerning the prohibited subsidies.[39]

Then, 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 adverse effects to Brazil's trade interest. Brazil then requested authorization from the WTO to impose countermeasures valued at $1.037 billion as retaliation against the actionable programs. According to WTO rules, trade retaliation should take place within the sector where the violation occurred. In this case, retaliation would be restricted to punitive tariffs on U.S. goods entering Brazil. However, Brazil argued that limiting retaliation to the goods sector alone would have a more deleterious effect on the Brazilian economy (via higher

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

[37] Presented in Brazil's written submission to the WTO arbitration panel, January 13, 2009.

[38] 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.

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

input costs) and Brazilian consumers (via higher inflation) than on U.S. exporters due to the asymmetries between the two economies.[40] Instead, Brazil proposed to suspend tariff concessions as well as obligations under the WTO Agreement on Trade-Related Intellectual Property Rights (TRIPS) and the General Agreement on Trade in Services (GATS) in the amount of $1.307 billion until the United States withdrew the four domestic subsidies (counter-cyclical payments, market loss assistance payments, market loan program benefits, and Step 2 payments) or removed their adverse effects. This type of "cross-retaliation" has been permitted twice previously in WTO dispute settlement cases, so it is not without precedent. However, its impact is potentially very far-ranging and could include the protection of copyrights, trademarks, industrial designs, patents, and undisclosed information, as well as withdrawal of concessions in services related to communication, construction, distribution, finance, tourism, and transport.[41]

Once again, the United States objected to both the amount and nature of Brazil's proposed request and asked for WTO arbitration over the level of the proposed sanctions (October 18, 2005).[42] Again, the United States and Brazil reached a procedural agreement (December 7, 2005), thereby temporarily suspending further retaliation proceedings on the actionable subsidies.[43]

The suspensions were likely intended to permit policy reform to occur in a less confrontational forum under either the then-ongoing congressional debate on an extension or revision of U.S. farm legislation (as current farm law was set to expire in 2007) or the ongoing Doha negotiations.

Brazil Requests WTO 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 Doha Round of trade negotiations[44]—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, Brazil argued that U.S. program changes were insufficient and, on August 21, 2006, requested the establishment of a WTO compliance panel to review whether the United States had fully complied with panel and AB rulings.

Brazil identified below-market premium rates (i.e., user fees) charged to GSM-102 program beneficiaries as the primary reason that the revised GSM-102 program operated at a net loss and was still out of compliance with WTO rules. The WTO Compliance Panel (upheld on appeal) concurred with Brazil, after an examination of new evidence on GSM-102 operations for the 2006-2008 period showing that it continued to operate at a net loss. See **Table 3** for the most recent estimates of credit subsidies under CCC export credit guarantee programs.

[40] "U.S., Brazil Clash on Cotton Sanctions," International Center for Trade and Sustainable Development (ICTSD), *Bridges*, vol. 12, no. 6, January 2009.

[41] Ibid.

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

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

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

Table 3. Estimated Credit Subsidies on CCC Export Credit Guarantees

Fiscal Year	Budget Loss ($ millions)
2001	$1,410
2002	—
2003	$ 13
2004	$ 230
2005	$ 205
2006	$ 366
2007	$ 232
2008	$ 225
2009	$ 39
Average	**$ 302**

Source: President's FY2011Budget, *Analytic Perspectives*, "Special Topics," Table 22-3, "Re-estimates of credit subsidies on loans disbursed between 1992-2009," p. 366, available at http://www.whitehouse.gov/omb/budget/fy2011/assets/topics.pdf.

The GSM-102 premium rates were identified as below-market rates, in part, because they failed to fully account for the risk of non-payment or default for individual countries. There is no widely accepted international standard for determining country risk and assigning "market" premium rates. In its determination, the Compliance Panel used a list of "minimum premium rates" as reported in the Organization for Economic Cooperation and Development (OECD) *Arrangement on Officially Supported Export Credits.*[45] A comparison with premium rates charged under the GSM-102 program found the GSM-102 rates to be significantly below the OECD measures, suggesting that they were under-valued.

In addition, Brazil charged that U.S. farm programs continued to provide significant (and injurious) support to U.S. cotton producers (**Table 1** and **Table 4**).

WTO Compliance Panel Rules Against the United States

Following Brazil's request, the WTO's Dispute Settlement Body (DSB) agreed to establish a compliance panel to review U.S. farm program changes 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 had 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.

In February 2008, the United States appealed the compliance panel's ruling. On June 2, 2008, a WTO Appellate Body (AB) publicly released its final report upholding the compliance panel's

[45] For more information, see OECD, Trade and Agriculture Directorate, "Arrangement on Export Credits," at http://www.oecd.org/department/0,3355,en_2649_34171_1_1_1_1_1,00.html.

ruling that the United States had not fully complied with the March 2005 WTO ruling. The AB report was adopted by the WTO's Dispute Settlement Body on June 25, 2008.

Phase IV: WTO Arbitration of Brazil's Proposed Countermeasures

Brazil Requests Resumption of Arbitration

On August 25, 2008, Brazil requested a resumption of the arbitration proceedings to review its proposed retaliatory countermeasures. On October 1, 2008, Brazil and the United States agreed on the arbitration panelists, who then were to produce a ruling within 60 days. However, the arbitration review continued past the normally allotted 60 days and into 2009. During that period, both parties made written submissions to the WTO arbitrator stating their positions with respect to retaliation in this case.[46]

Brazil Alters Its Countermeasure Request

At a March 3, 2009, Dispute Settlement Body meeting, Brazil revised its total retaliation request to $2.5 billion, down from an earlier $3 billion request. Brazil's proposed sanctions total comprised both prohibited and actionable subsidy countermeasure components.

Under the prohibited subsidies arbitration case, Brazil was seeking two countermeasures:

1. a one-time countermeasure in relation to the Step 2 program of $350 million based on U.S. government payments made under the Step 2 program in marketing year 2005 (this corresponds roughly to the period that elapsed between the expiration of the prohibited subsidy compliance period on July 1, 2005, and the effective repeal of the Step 2 program by the U.S. Congress on August 1, 2006); and
2. annual countermeasures proportionate to the entire annual amount of GSM 102 export credit guarantees issued to all countries for export transactions involving unscheduled products—rice, pork, and poultry—valued at $1.155 billion during FY2006 (initially Brazil valued this countermeasure at $1.294 million) and composed of three parts:
    a. an interest rate subsidy component amounting to $234.7 million;
    b. the additional export sales obtained by the United States as a result of these discounts, including sales to creditworthy foreign obligors, referred to as marginal additionality and valued at $62.3 million; and
    c. the additional export sales to noncreditworthy foreign obligors, referred to as full additionality and valued at $855 million.

Under the actionable subsidies arbitration case, Brazil again asked for:

[46] *United States—Subsidies on Upland Cotton (WT/DS267)*, written submissions of the United States, December 9, 2008; and *United States—Subsidies on Upland Cotton (WT/DS267)*, written submission of Brazil, January 13, 2009.

3. annual countermeasures valued at $1.037 billion until the United States withdrew the relevant subsidies or removed their adverse effects (based on marketing year 2005 data, Brazil calculated the amount of adverse effects on the rest of the world at $3.335 billion, although it only requested countermeasures of $1.037 billion).

Under the combined prohibited and actionable subsidy cases, Brazil asked for:

4. the right to engage in cross-retaliation (i.e., countermeasures in sectors outside of the trade in goods, most notably in the area of U.S. copyrights and patents, as well as services), stating that retaliation in goods would not be practicable or effective due to limited trade in goods between Brazil and the United States.

The United States argued that it had removed the prohibited subsidy component of its export credit program via provision 3101(a) of the 2008 farm bill (P.L. 110-246). Furthermore, the United States argued that it had operated its remaining GSM-102 export credit program at "no net cost" to the government since 2005.[47] The United States asked the arbitrators to dismiss all claims related to prohibited subsidies since they currently operated at "no net cost" to the government. Furthermore, the United States argued that Brazil's prohibited-subsidy countermeasure request continued to include a program that no longer exists (i.e., Step 2). Finally, with respect to Brazil's actionable-subsidy countermeasure request, the United States pointed out that Brazil included a calculation for the entire global adverse effect, not just those adverse effects relevant to Brazil. According to U.S. calculations, the total effects of U.S. counter-cyclical payments and marketing loan payments on Brazil during the 2005-2007 period averaged $30.4 million per year.[48]

Arbitration Panel Ruling

On August 31, 2009, the arbitrator ruled on Brazil's arbitration requests in two separate reports.[49] The first report (WT/DS267/ARB/1) ruled on Brazil's retaliation requests regarding the prohibited subsidies—the Step 2 cotton program and the GSM 102 program (under certain conditions)—based on Article 4.11 of the SCM Agreement. The second report (WT/DS267/ARB/2) ruled on Brazil's retaliation requests regarding the actionable subsidies—market loss assistance payments, marketing loan benefits, counter-cyclical payments (CCP), and Step 2 payments—based on Article 7.9 of the SCM Agreement. The arbitrator's decisions are final and are not subject to appeal.

With respect to the four main countermeasure requests, the arbitrator issued four key findings, discussed below.

[47] *United States—Subsidies on Upland Cotton (WT/DS267)*, written submissions of the United States, December 9, 2008.

[48] Ibid., paragraph 312, p. 99.

[49] *United States—Subsidies on Upland Cotton: Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement*, WT/DS267/ARB/1, WTO, August 31, 2009; and *United States—Subsidies on Upland Cotton: Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 7.10 of the SCM Agreement*, WT/DS267/ARB/2, WTO, August 31, 2009.

First Finding

Brazil was not entitled to its request of a one-time $350 million retaliation award to compensate for previous Step 2 injury. In rejecting Brazil's request on this point the arbitrator stated that countermeasures are an exceptional temporary remedy, available only where compliance has not been achieved, and aimed at inducing such compliance, and that in fact the United States had fully (albeit belatedly) complied with the panel's recommendation to eliminate the Step 2 program.

Second Finding

With respect to Brazil's request for $1.155 billion in countermeasures related to the "prohibited" subsidies, the arbitrator found that Brazil was only entitled to retaliate for the effects of these subsidies on Brazilian products and not for their full effect on the rest of the world (ROW). The arbitrator used Brazil's share of world exports of those products receiving GSM 102 credit guarantees (estimated to be 11.7% in 2006) to apportion Brazil's share of the subsidy effect from the entire global market effect. With this revision to Brazil's formula, the arbitrator estimated the countermeasure at $147.4 million in FY2006—comprising an interest rate effect of $25.27 million, marginal additionality of $41.3 million, and full additionality of $80.8 million. Furthermore, the arbitrator ruled that the retaliatory amount accorded Brazil would vary each year (via formula) based on the total of exporter applications received by the U.S. government under the GSM 102 program for the most recently concluded fiscal year. The formula would consider an interest rate subsidy component and the trade displacement additionality (both full and marginal) of the subsidy component of GSM 102.

Third Finding

The arbitrator found that the amount of countermeasures specific to Brazil and commensurate with the degree and nature of adverse effects resulting from the actionable subsidies was fixed at an annual amount of $147.3 million. This figure was obtained, first, by a recalculation of the total adverse effects on the ROW resulting from the actionable subsidies, to an amount of $2.905 billion in the 2005 marketing year. The adverse effect was calculated as a price effect whereby it was determined that the world price of cotton would have been 9.38 cents per pound higher in the absence of U.S. marketing loan benefits and CCP payments, and that the lower world price resulted in both lost income effects in the ROW of $2.384 billion and reduced production effects of $521.5 billion, for a total of $2.905 billion. However, the WTO arbitrator determined that Brazil should be entitled to retaliation on only a specific portion of the $2.905 billion. The share apportioned to Brazil was based on Brazil's share of cotton production in the ROW in marketing year 2005, which equaled 5.1% or $147.3 million. Furthermore, the panel fixed Brazil's maximum annual retaliation with respect to the "actionable" U.S. subsidies at this same $147.3 million (in other words, this amount will not vary from year to year).

Thus, the overall annual permissible retaliation amount for 2006 was $294.7 billion. Furthermore, this amount varies annually, since it consists of both a fixed retaliatory amount in response to "actionable" U.S. subsidies, and a variable retaliatory amount in response to "prohibited" U.S. subsidies.

Fourth Finding

Finally, Brazil had requested the right to engage in cross-retaliation, that is, retaliatory countermeasures in sectors outside of the trade in goods, most notably in the area of intellectual property (IP) rights such as copyrights and patents. A key determinant in ruling on this request was Brazil's contention that there is insufficient trade in consumer goods with the United States to permit compensatory retaliatory action, and that a substantial portion of those imports were of critical importance to Brazil's economy such that punitive sanctions on them would harm Brazil's economy. However, the panel felt that a certain percentage of Brazil's imports of consumer goods originating from the United States should be eligible for countermeasures without causing harm to Brazil's economy because there was available to Brazil a sufficient amount of alternate sources of imports or of sufficiently close substitutes in consumption so as to avoid economic harm. As a result, the panel ruled that Brazil would be entitled to cross-retaliation, if (and only if) the overall retaliation amount (combining both the variable and fixed components) to which it would otherwise be entitled exceeds a variable annual threshold (described below). If the threshold is surpassed, then Brazil would be entitled to suspend certain obligations under the TRIPS Agreement and/or the GATS in the amount in excess of the threshold.

Threshold for Permitting Cross-Retaliation Countermeasures

For purposes of determining eligibility to apply cross-retaliation, the panel established an initial threshold amount of $409.7 million that could be subject to countermeasures without harming Brazil's economy based on the volume and composition of Brazil's imports of consumer goods in the year 2007. The amount of $409.7 million represents the sum of the value of those consumer goods imported by Brazil where the U.S. share is less than 20%, excluding books and automotive parts which are considered essential to Brazil's economy.

The threshold amount may vary from year to year according to the following formula:

$$T_{t+1} = T_t * (1 + g_{t+1}) \qquad \text{where } T_{2007} = \$409.7 \text{ million}$$

where

T_{t+1} = threshold value in year t+1

T_t = threshold value in year t

g_{t+1} = percentage change in the value of Brazil's total imports from the United States between years t and t+1.

Brazil's Reaction

Following the arbitration panel's ruling, Brazil claimed that applying the panel's countermeasure determination formulas to preliminary 2009 data would allow for $800 million in total retaliation, including both the fixed $147.3 million of actionable subsidy countermeasures and $650 million of prohibited subsidy countermeasures.[50] The $650 million figure resulted from expanded use of

[50] "WTO Arbitration Panel Decision Falls Short of Brazilian Demands," *Inside U.S. Trades' World Trade Online*, Daily News, August 31, 2009.

GSM 102 credit guarantees by the United States during the recent fiscal year—rising from $1.36 billion in FY2006 to $5.5 million in FY2009.[51] According to Brazil, using 2009 data to calculate the threshold for cross-retaliation would produce an amount of $460 million. If confirmed, these data would suggest that Brazil would be authorized to engage in cross-retaliation equal to $340 million (i.e., the difference between $800 million and $460 million) by suspending commitments it made under the WTO concerning the protection of intellectual property and services.

U.S. Reaction

USTR spokeswoman Carol Guthrie issued the following statement:[52]

> While we remain disappointed with the outcome of this dispute, we are pleased that the Arbitrators awarded Brazil far below the amount of countermeasures it asked for. In its first requests for countermeasures in the Cotton dispute, Brazil asked for more than $4 billion in annual countermeasures. During the arbitration proceedings, Brazil argued for more than $2 billion annually. Further, we are grateful that the Arbitrators denied Brazil's request for unlimited ability to suspend concessions on intellectual property or services. And we are pleased that the Arbitrators denied Brazil's request for an additional one-time $350 million in countermeasures in connection with the repealed Step 2 payment program for cotton.
>
> At this time, we do not know when or if Brazil will move to obtain final authorization to suspend concessions or when or if Brazil would act on any such authorization.
>
> The Administration will be actively consulting within the U.S. Government and with stakeholders on how to move forward.

U.S. industry groups, led by the National Cotton Council (NCC), argued that substantial changes had been made to the GSM 102 programs since the initial WTO dispute settlement panel issued its ruling in 2005 and that, as a consequence of those changes, the GSM 102 program now operates in a fully WTO-compliant manner.[53] Similarly, the NCC argued that changes under the 2008 farm bill (P.L. 110-246) to the marketing loan and CCP programs had made them more WTO-compliant. Finally, the NCC complained that the WTO arbitration ruling was based almost entirely on 2005 data, when U.S. cotton support programs were at their peak and the U.S. share of the world cotton market was near 40%, compared with about 12% today.[54]

As a result of these changed circumstances, the NCC and other U.S. farm groups publicly stated that USTR should seek the establishment of a new WTO compliance panel in order to prove that U.S. cotton subsidy programs and export credit programs no longer violate WTO rules. However, in accordance with WTO rules, even if the United States were to initiate such a new compliance panel, Brazil would be able to proceed with its WTO-authorized retaliation.

[51] The actual total is $5.9 billion including the $5.5 billion allowed under the 2008 farm bill plus $465 million in re-announcement of unutilized programs or cancelled guarantees from earlier in FY2009; available at http://www.fas.usda.gov/excredits/ecgp.asp.

[52] "USTR Statement on Awards in Brazil Cotton Dispute," U.S.T.R., August 31, 2009; available at http://www.ustr.gov/about-us/press-office/press-releases/2009/august/ustr-statement-awards-brazil-cotton-dispute.

[53] "WTO Arbitration Panel Ruling Fails to Recognize Changes to GSM Program; Punishes USA Despite Compliance with WTO," NCC news release, September 2, 2009; at http://www.cotton.org/.

[54] "NCC Statement—Arbitration Determination," NCC news release, August 31, 2009; at http://www.cotton.org/.

Phase V: Retaliation or Settlement?

The arbitrator's decisions were final and not subject to appeal, and Brazil had complete freedom to decide which products would be subject to retaliatory hikes in import tariffs and which IP and services rights could be targeted by supplementary countermeasures.[55] However, before Brazil could proceed with any retaliation, it first had to request the WTO Dispute Settlement Body to authorize its retaliation request in an amount, and with respect to types of trade, consistent with these decisions. Following the circulation of the arbitrator's decisions on August 31, 2009, Brazil accordingly submitted requests to the DSB to authorize the suspension of concessions or other obligations (WT/DS267/41 and WT/DS267/42).[56] Such approval is decided under reverse consensus, such that WTO members would have to decide by consensus (including Brazil voting against itself) to not allow Brazil to proceed.

On November 19, 2009, the DSB agreed to grant Brazil authorization to impose countermeasures consistent with the arbitrator's decisions.[57] WTO dispute settlement rules did not require that Brazil pursue its retaliation request or, if it did so, that it request authorization to retaliate by a given date. Other possible options included the negotiation of a settlement of the case before Brazil were to impose retaliatory measures or, as suggested by some, a request by the United States for a ruling by a new compliance panel that the objectionable elements of the prohibited subsidy have been eliminated.

Brazil Targets Goods and Services for Countermeasures

On December 21, 2009, Brazil announced that it was authorized by the WTO to impose trade retaliation against up to $829.3 million in U.S. goods in 2010 (based on 2008 U.S. trade data).[58] The countermeasure included a fixed annual amount of $147.3 million, reflecting the adverse effects from U.S. price-contingent subsidies (i.e., marketing loan benefits and counter-cyclical payments), and a balance related to the volume of U.S. export credit guarantees (found to operate as a prohibited export subsidy), which may vary annually. The WTO also established a threshold value (related to the value of Brazil's consumer goods imports from the United States) for determining the extent of permissible cross-retaliatory countermeasures. The threshold varies annually based on changes in Brazil's total imports from the United States, but is currently estimated at $561 million, yielding a remaining value of $268.3 million ($829.3 million - $561 million) in eligible cross-retaliatory countermeasures.

On March 10, 2010, Brazil released a final list of goods of U.S. origin valued at $561 million that would be subject to import tariffs within 30 days unless a last-minute agreement was reached.[59] The following week (March 15), Brazil released a preliminary list of U.S. patents and intellectual

[55] *BNA, International Trade Reporter*, "Brazil Says Entitled to Impose $829 Million in Annual Sanctions on U.S. in Cotton Case," December 24, 2009.

[56] Notes from the WTO DSB meeting of November 19, 2009, at http://www.wto.org/english/news_e/news09_e/dsb_19nov09_e.htm.

[57] The arbitrators' decisions are contained in official documents WT/DS267/ARB/1, WT/DS267/ARB/2 and Corr.1.

[58] *BNA, International Trade Reporter*, "Brazil Delays Final List of U.S. Goods to Be Sanctioned in WTO Cotton Dispute," December 24, 2009.

[59] "Brazil Releases List of U.S. Goods for Retaliation in Cotton Dispute," *Bridges Weekly Trade News Digest*, vol. 14, no. 9, March 10, 2010.

property rights it could restrict, barring a joint settlement.[60] The new measures—which were open to public comment for a period of 20 days and subject to public hearings—included the temporary suspension of U.S. patents on pharmaceuticals, chemicals, and biotechnology, and the restriction of copyrights in the music and audiovisual industry.[61]

Negotiations Seek Mutual Settlement

The United States and Brazil continued to seek a last-minute negotiated settlement to avoid the retaliatory measures. Brazil said that it would only apply sanctions if the United States refused to eliminate its cotton subsidies. The United States reiterated its intention to comply with the DSB's recommendations and rulings and therefore did not believe that it would be necessary for Brazil to exercise that authorization. The United States added that suspending concessions or obligations could present economic and other challenges for both Brazil and the United States.

Brazil indicated that it could accept a U.S. pledge to send a reform bill to Congress to alter the offending cotton program provisions, if Brazil were compensated for damages until the bill's approval. Some Brazilian leaders proposed compensation through U.S. investments into cotton research, as well as more U.S. imports of Brazilian beef, orange juice, and ethanol.[62] In contrast, some speculated that the United States could suspend the more than $2.5 billion in trade privileges that it offers Brazil under its Generalized System of Preferences (GSP).

Several U.S. trade associations—including the Brazil-U.S. Business Council, the National Association of Manufacturers, the U.S. Chamber of Commerce, the Council of the Americas, and the American Chamber of Commerce in Brazil, and others—voiced strong concerns that the U.S. government take every measure possible to avoid Brazil's imposition of trade retaliation.[63]

Steven Bipes, executive director of the Brazil-U.S. Business Council, argued that settlement of the dispute would likely have to occur in two stages:[64]

- the first stage would involve administrative action by the U.S. government on any number of several pending trade issues with Brazil as a gesture of good faith;
- the second stage would have to occur in the context of the 2012 farm bill, where Congress could make further substantive changes to U.S. cotton subsidies or to the GSM 102 export credit guarantee program.

Brazil and United States Sign Memorandum of Understanding

On April 1, 2010, Deputy U.S. Trade Representative (USTR) Miriam Sapiro and USDA Undersecretary for Farm and Foreign Agricultural Services Jim Miller met with Ambassador Antonio Patriota, Secretary General of Brazil's Ministry of External Relations, to discuss possible

[60] "U.S. Cotton Dispute—Public Consultations About Measures for the Suspension of Concessions or Obligations vis-à-vis the United States in the Area of Intellectual Property Rights," press release, Press Office of the Brazilian Ministry of External Relations, Brasilia, March 15, 2010.

[61] "Brazil Details Retaliation on U.S. Copyright, Patents," *Reuters*, March 15, 2010.

[62] Ibid.

[63] "Brazil Holds Off on Goods Retaliation List; U.S. Industries Press for Settlement," *Inside U.S. Trade*, Feb. 12, 2010.

[64] Ibid.

resolution of the dispute.[65] On April 5, 2010, the United States floated a proposal to Brazil on a negotiated settlement.[66] After reviewing the proposal, Brazil's Foreign Trade Council (CAMEX) approved a resolution that postponed until an initial deadline of April 22 the implementation of WTO-approved countermeasures by Brazil against U.S. imports. Key features of the U.S. proposal and the ongoing negotiations include the following:

- The United States will establish a fund in the amount of $147.3 million per year to provide technical assistance and capacity-building for Brazil's cotton sector. Under terms of a memorandum of understanding (MOU) signed by Brazil and the United States, the fund will continue until the passage of the next U.S. farm bill or a mutually agreed solution to the dispute, whichever is sooner. Also, the fund will be subject to transparency and auditing requirements, as well as a list of allowable uses specified in the MOU.[67]
- The United States agreed to make some near-term modifications to the operation of the GSM-102 Export Credit Guarantee Program, and to engage with the government of Brazil in technical discussions regarding further operation of the program. On April 6, 2010, USDA announced that it was cancelling unutilized balances from the GSM-102 program for FY2010, and that these balances would be re-announced under a new guarantee fee rate schedule announced on April 19, 2010.[68]
- The United States also agreed to publish a proposed rule by April 16, 2010, to recognize the state of Santa Catarina as free of foot-and-mouth disease, rinderpest, classical swine fever, African swine fever, and swine vesicular disease, based on World Organization for Animal Health guidelines, and to complete a risk evaluation that is currently underway and identify appropriate risk mitigation measures to determine whether fresh beef can be imported from Brazil while preventing the introduction of foot-and-mouth disease into the United States.

USDA will finance the annual "cotton" fund of $147.3 million using Commodity Credit Corporation (CCC) funds under the auspices of the CCC Charter Act (15 U.S.C. 714).[69] The CCC Charter Act contains language that allows USDA to use CCC funds to "export or cause to be exported ... agricultural commodities."[70]

In light of the conclusion of the MOU with Brazil (April 20), publication of the proposed rule on meat imports from Santa Catarina (April 16), and the above changes to the GSM-102 program, Brazil extended the ongoing negotiations for resolving the path forward by 60 days, to a second deadline in June 2010. Brazil said that it was still pursuing the full U.S. compliance with the

[65] "U.S., Brazil Agree Upon Path Toward Negotiated Solution of Cotton Dispute," *USDA News Release* No. 0168.10, April 6, 2010.

[66] "U.S. May Float Proposal in Cotton Dispute Today, CAMEX to Hold Meeting," *World Trade Online*, April 5, 2010.

[67] "U.S., Brazil Agree on Memorandum of Understanding As Part of Path Forward Toward Resolution of Cotton Dispute," *USTR Press Release*, April 21, 2010.

[68] Ibid.

[69] For more information, see "About the Commodity Credit Corporation," Farm Service Agency, USDA, available at http://www.apfo.usda.gov/FSA/webapp?area=about&subject=landing&topic=sao-cc.

[70] "USDA Determined CCC Charter Act Allows Funding of Brazil Cotton Deal," *World Trade Online*, Inside U.S. Trade, April 16, 2010.

WTO dispute settlement ruling, particularly as concerns U.S. cotton-specific farm program subsidies. However, any changes to farm programs would likely have to be made in the context of the 2012 farm bill.

Although the proposal succeeded in avoiding, at least temporarily, the imposition of harmful trade countermeasures including the suspension of copyright and patent protection, the U.S. proposal was met with both praise and criticism. Proponents of U.S. farm programs (and their incumbent support payments) were generally in favor of the ongoing negotiations and the U.S. proposal. In contrast, opponents and critics of U.S. farm programs were generally critical of the U.S. negotiating offer. In particular, the establishment of the $147.3 million annual fund to support Brazil's cotton sector was described as "subsidy payments to Brazil's cotton farmers needed to permit the continuation of subsidy payments to U.S. cotton farmers."[71]

Brazil and United States Reach Framework Agreement

On June 17, 2010, U.S. and Brazilian trade negotiators reached a "Framework agreement" for moving forward in the dispute settlement case.[72] The Framework agreement—which lays out a number of "steps and discussions"—represents a path forward toward the ultimate goal of reaching a negotiated solution to the dispute, while avoiding WTO-sanctioned trade retaliation by Brazil against U.S. goods and services.[73] The Framework agreement was formally accepted by Brazil's Foreign Trade Council of Ministers (CAMEX) on June 17, 2010.

The Framework agreement includes quarterly discussions on potential limits to trade-distorting U.S. cotton subsidies (recognizing that actual changes to cotton-specific subsidies require legislation by Congress and are not likely to happen outside of the 2012 farm bill debate).[74] Specifically, the agreement identifies parameters for a future annual limit on U.S. domestic support for upland cotton such that "[t]he level of the limit would be significantly lower than the average annual level of trade-distorting domestic support provided for upland cotton in the period MY 1999-2005."[75] Based on fiscal year data from **Table 1**, average annual upland cotton subsidies for the FY1999-FY2005 period averaged $3.568 billion.

In addition, the Framework agreement provides two sets of guided changes to the GSM-102 agricultural export credit guarantee program. First, the weighted-average length for a GSM-102 contract will be lowered to 16 months, down from the current average of about 20.5 months. Second, a set of benchmarks is established for implementing changes to GSM-102 contract premiums (i.e., the rates charged for each dollar of credit guarantee) contingent on performance. The current $5.5 billion in annual GSM-102 export credit guarantee value remains intact; however, the annual value is broken into two six-month tranches of $2.7 billion. Every six months an operational review (held each October and April) will determine how GSM-102 usage (i.e., the value of uncancelled guarantee value) for the preceding six-month period compares with the eligible $2.7 billion:

71 Michael Grunwald, "Why the U.S. Is Also Giving Brazilians Farm Subsidies," *Time*, April 9, 2010.

72 "Kirk Comments on Signing of Framework Regarding WTO Cotton Dispute," *USTR News Release*, June 25, 2010.

73 "CAMEX to Decide Today On Accepting Framework Cotton Deal," *World Trade Online,* Inside U.S. Trade, June 17, 2010.

74 "The Latest Brazil Cotton Compromise," *Washington Trade Daily*, vol. 19, no. 122, June 21, 2010.

75 "Framework for a Mutually Agreed Solution to the *Cotton* Dispute in the World Trade Organization (WT/DS267) Section I, June 17, 2010 (released publically on June 25, 2010), p. 1.

- if usage is greater than $1.3 billion, premiums increase by at least 11% of the simple average fee rate;
- if usage is not greater than $1.3 billion, then during the following six-month period, if usage exceeds $1.5 billion, premiums increase by at least 15% of the simple average fee rate; and
- if usage is below $0.8 billion, premiums could be decreased by an amount equal to half of the most recent premium increase.

Both parties to the dispute have said that a final mutually agreed solution would not be possible until after the 2012 farm bill, when the nature of any changes to U.S. domestic cotton subsidies has been made clear.

Phase VI: Potential Policy Implications of WTO Panel Ruling

The arbitration ruling in favor of Brazil's requested cross-retaliation countermeasure could raise the stakes in this particular dispute by expanding retaliation into TRIPS and the General Agreement on Trade in Services. 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.[76]

Trade experts have expressed concern that the panel findings could extend beyond cotton to other major field crops, particularly as concerns the potential limits on export credit guarantees. Some trade and market analysts, as well as legislators, have expressed concern that a broad finding against U.S. farm program provisions under the actionable subsidies ruling could necessitate legislative changes to the U.S. farm bill to bring existing program operations into compliance.[77]

Bringing GSM-102 into WTO Compliance

Brazil argued that the fees charged to users of GSM failed to cover the U.S. government's costs (whether a default on the credit or late or partial payment) associated with running the program. This charge was confirmed by the original WTO panel (based on U.S. historical data of GSM-102 program operations) and upheld on appeal. Thus, a key to bringing the GSM-102 program into compliance would be setting premium rates high enough to cover long-run program operating costs. By the WTO Compliance Panel's own measure, this could be achieved by adopting the minimum premium rates as reported in the OECD *Arrangement on Officially Supported Export Credits*. Further, the rates could be subject to a proviso that, should the GSM-102 program operate at a loss during any given year, then the fees would be adjusted higher by some amount to offset the loss in the subsequent year.

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

[77] For more information see, CRS Reports CRS Report RS22522, *Potential Challenges to U.S. Farm Subsidies in the WTO: A Brief Overview*, by Randy Schnepf, and CRS Report RS20840, *Agriculture in the WTO: Limits on Domestic Support*, by Randy Schnepf.

A review of the estimated credit subsidies on CCC export credit guarantees since 2001 suggests that an annual average of $302 million could be saved by adjusting fees upward to more fully cover operating costs. The program net losses have varied annually with changes in the rates of participation and default.

Bringing Price-Contingent Programs into WTO Compliance

The obvious adjustment needed to bring price-contingent cotton programs into compliance involves lowering the support prices (i.e., the loan rate and the target price) until they are more in line with market prices. Depending on the degree to which cotton price triggers are adjusted downward relative to market prices, the average payment rate will decline. By setting trigger prices at a moving average of market prices, payments could approach zero.

CCC outlays to cotton producers under the price-contingent market loan provisions (including loan deficiency payments, marketing loan gains, and certificate exchange gains) and the CCP program have, on average, accounted for about 42% of all CCC payments under these programs since 2003 (**Table 4**). During that period, cotton producers received an annual average of over $1.8 billion. Since 2007, cotton receipts have surged to a 66% share of total CCC outlays as high world commodity prices have raised prices for most other major U.S. program crops above their program price triggers.

Table 4. CCC Cotton Outlays under Marketing Loan Benefits and CCP Programs

($ millions)

Fiscal Year	Counter-cyclical Payments	Marketing Loan Benefits[a]	Total	% Share of Total CCC Outlays[b]
2003	$ 1,264	$ 891	$ 2,155	59.5%
2004	$ 217	$ 193	$ 409	24.8%
2005	$ 1,421	$ 1,840	$ 3,261	38.5%
2006	$ 1,410	$ 1,189	$ 2,600	25.1%
2007	$ 1,281	$ 1,118	$ 2,399	55.1%
2008	$ 267	$ 1	$ 268	73.2%
2009	$ 728	$ 885	$ 1,612	91.4%
7-year average	$ 941	$ 874	$ 1,815	41.6%

Source: USDA, Farm Service Agency, *CCC Budget Essentials*, "FY 2002 thru FY 2009 CCC Actual Payments" as of March 8, 2010, at http://www.fsa.usda.gov/FSA/webapp?area=about&subject=landing&topic=bap-bu-cc.

a. Sum of loan deficiency payments (LDPs), marketing loan gains, and certificates of exchange.

b. Cotton payments as a share of total USDA, Commodity Credit Corporation outlays for marketing loan benefits and CCP payments.

Direct Payments Classification

Concerns have also been expressed regarding the reclassification of PFC and direct payments away from non-trade-distorting green box support.[78] However, the panel finding that U.S. direct

[78] "Brazil Wins Key Points in Interim WTO Panel on U.S. Cotton Subsidies," *Inside U.S. Trade,* April 30, 2004.

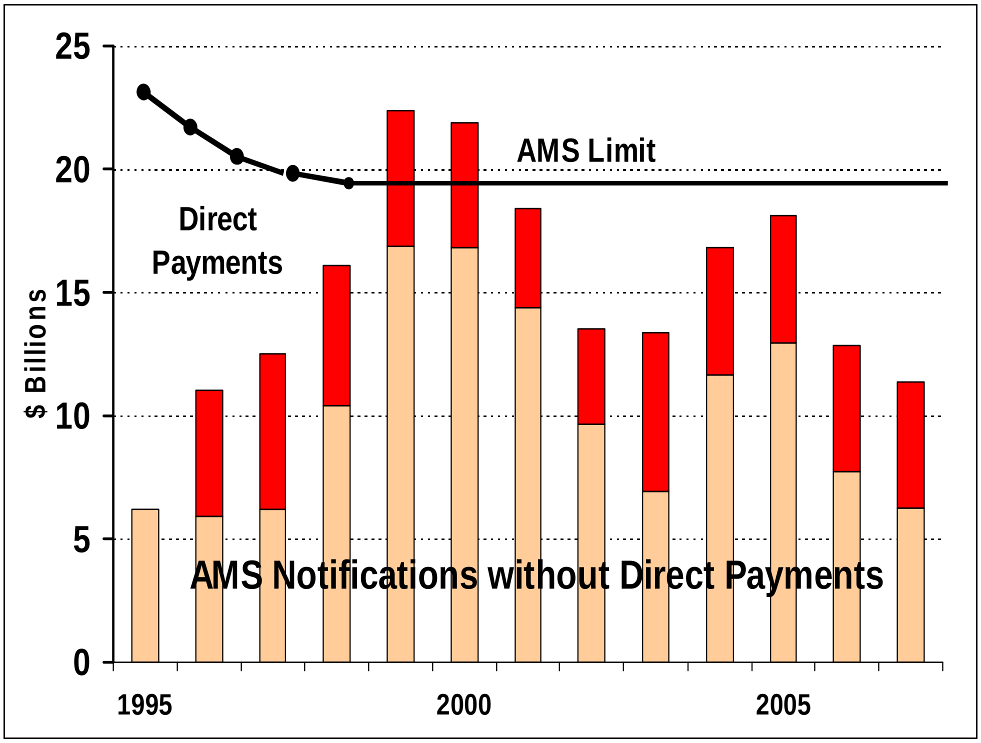
payments do not qualify for WTO exemptions from reduction commitments as fully decoupled income support (i.e., they are not green box compliant) appears to have no further consequences within the context of this case and does not involve any compliance measures. This is because direct payments were deemed "non-price contingent" and were evaluated strictly in terms of the Peace Clause violation.

The panel did not specifically reclassify U.S. PFC and DP payments as "amber box," nor did the panel recommend that the United States should notify such future payments as "amber box." This is a subtle but critical distinction because of the enormity of PFC and DP payments. During FY1996 to FY2007, PFC and DP payments averaged $5.2 billion per year and accounted for 33% of total U.S. farm program outlays. Shifting this amount to amber box could have important implications for future dispute settlement cases, as well as for the United States' ability to meet its WTO amber box commitments.

U.S. cotton industry and government officials are concerned that the specific finding on the apparent failure of U.S. "decoupled" payments to meet WTO green box criteria leaves such programs open to future charges, and that third countries may feel emboldened by knowing how a WTO panel is likely to rule on such matters. The European Union (EU) is also likely to be concerned about this finding since the EU's agricultural program (following agricultural policy reforms of June 2003) relies heavily on "decoupled" payments similar to the those of the U.S. program. These concerns appear to have merit, as both Canada and Brazil have initiated WTO dispute settlement proceedings against the United States charging that the United States has indeed incorrectly notified PFC and DP payments as green box and that their inclusion in the U.S. amber box results in the United States exceeding its WTO-agreed AMS spending limit on several occasions in recent years (**Figure 4**).[79]

[79] See CRS Report RL34351, *Brazil's and Canada's WTO Cases Against U.S. Agricultural Direct Payments*, by Randy Schnepf.

Figure 4. U.S. AMS Outlays, as Notified Without Direct Payments versus With Addition of Direct Payments



Source: 1995-2007 are U.S. WTO notifications.

Other Cotton-Related Trade Issues

Besides Brazil's WTO-initiated dispute settlement case (DS267), U.S. cotton subsidies are being challenged at the WTO on two additional fronts.

- First, the Doha Development Agenda negotiating round has substantial reductions in trade-distorting domestic program support as one of its principal modalities.[80] If realized, a new round of domestic spending limitations could potentially represent a "real" ceiling on U.S. commodity spending and could result in lower program outlays.
- Second, a consortium of four African cotton-producing countries—Benin, Burkina Faso, Chad, and Mali—has submitted a WTO proposal calling for a global agreement to end all production-related support for cotton growers of all WTO-member cotton producing nations.[81] In acknowledgment of the concerns of African cotton-producing countries, the United States—while not agreeing with the African proposal—worked with the African countries on a formulation in the initial agriculture framework (of July 31, 2004) of the WTO's ongoing Doha

[80] WTO, Doha Ministerial Declaration, WT/MIN(01)/DEC/1, November 20, 2001.

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

Round.[82] Although no specific cotton program concessions were mentioned in the framework, the United States committed "to achieve ambitious results expeditiously" under the framework. Further, it is notable that cotton is the only commodity singled out for special mention in the framework.

Role of Congress

Given the importance of cotton in the U.S. agricultural economy and the potential for WTO-imposed limitations on U.S. cotton program operations, Congress likely will be closely monitoring developments in the WTO cotton case and the Doha Round of trade negotiations. Both the Senate and House Agriculture Committees regularly hold hearings on agricultural trade negotiations. In addition to congressional hearings, Congress will likely be engaged in consultations with the Administration on the bilateral trade negotiations as well as the Doha Round of WTO trade negotiations. Such consultations will be a major vehicle for Members to express their views on this dispute and on the negotiating issues it raises.

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 would appear to have already complied with several of the AB's recommendation concerning "prohibited subsidies" through changes in the 2008 farm bill (P.L. 110-246; Sec. 3101(a)) by eliminating the Step 2, GSM-103, and SCGP programs, and by removing the fee cap on GSM-102 credit guarantees (i.e., by eliminating the "subsidy" component of export credit guarantees). In addition, by the same 2008 farm bill provision Congress requires that the Secretary of Agriculture, in carrying out the GSM-102 program, " work with the industry to ensure, to the maximum extent practicable, that risk-based fees associated with the guarantees cover, but do not exceed, the operating costs and losses over the long-term." However, a more explicit definition of "long-term" such as a two-year period would perhaps provide a stronger signal to the Secretary of Agriculture in regard to operating the GSM-102 program with no net losses.

Also, some questions remain as to what extent the 2008 farm bill has addressed the adverse effects charge related to price-contingent subsidies. Instead of eliminating or reducing program triggers, the 2008 farm bill appears to offer higher levels of price and income support that potentially could aggravate the perception (if not the reality) of adverse effects 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.[83] For example, the enacted 2008 farm bill:[84]

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[82] For more information, see CRS Report RS21905, *Agriculture in the WTO Doha Round: The Framework Agreement and Next Steps*, by Charles E. Hanrahan.

[83] 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.

[84] See CRS Report RL34696, *The 2008 Farm Bill: Major Provisions and Legislative Action*, coordinated by Renée (continued...)

- extends the counter-cyclical payments (CCP) program and current marketing loan provisions (Sections 1104 and 1201 of P.L. 110-246);
- raises both target prices and loan rates for several commodities, while only lowering (marginally) the target price for upland cotton (Sections 1104 and 1202);
- offers producers the choice (subject to a 30% reduction in marketing loan rates and in lieu of 100% of CCP and 20% of direct payments) of a revenue-based support option under the Average Crop Revenue Election program (ACRE, Section 1105) with potentially higher per-acre revenue guarantees for several crops than under the previous 2002 farm bill; and
- creates a new cotton-user payment of 4 cents per pound (Section 1207). 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 ultimately be subject to a WTO challenge, but would not be part of the current WTO cotton case.

Finally, the 2008 farm bill does not address the issue surrounding the disqualification of direct payments from the WTO's green box 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 75,000 acres in seven states (Section 1107). This retention of the status quo has important WTO implications for the AMS case being brought against the United States by both Canada and Brazil. The U.S. aggregate measure of support (AMS) has exceeded, on at least two occasions, its total WTO limit if direct payments are included in the AMS calculation (**Figure 4**).[85]

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 111th 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.

(...continued)

Johnson.

85 See CRS Report RL34351, *Brazil's and Canada's WTO Cases Against U.S. Agricultural Direct Payments*, by Randy Schnepf.

Table 5. Timeline: U.S.-Brazil WTO Dispute Settlement Case 267

Date	Event
Sept. 27, 2002	Brazil makes a formal "request for consultations" with the United States (WT/DS267/1).
Oct. 2002 to Jan. 2003	Brazil and United States hold three consultations to discuss dispute over U.S. cotton subsidies. The consultations are unsuccessful.
Feb. 7, 2003	Brazil's first request for the establishment of a dispute panel to rule on its complaint is vetoed by the United States (WT/DS267/7).
Mar. 18, 2003	Upon Brazil's second request, the WTO's Dispute Settlement Body (DSB) establishes a panel (WT/DS267/15).
May 19, 2003	Appointment of the panelists by the WTO Director-General. Once formed, a panel normally has six months to hold hearings and gather testimony before issuing its final report to both parties.
July 22, 2003	First meeting with DSB panel. Panel decides to review peace clause issue and Brazil's challenge to U.S. cotton subsidies separately.
Sept. 2003	The panel reverses an earlier procedural decision and states that it will decide both the peace clause issue and Brazil's challenge to U.S. cotton subsidies together.
Nov. 17, 2003	The panel chairman informs the DSB that the panel will not be able to complete its work in six months due to the complexity of the matter. An extension is announced (WT/DS267/16).
Apr. 26, 2004	The panel's interim report is released confidentially to the two parties. Both parties review the interim report and submit written comments by May 10, at which time they have three additional weeks to review each other's comments and respond. Although the report is released confidentially, news reports suggest at least a partial finding against the United States on each of the five major claims.[86]
June 18, 2004	The panel's final report is released confidentially to the two parties. News reports suggest that the final ruling varies little from the interim ruling against the United States.[87]
Sept. 8, 2004	After translation into English, French, and Portuguese, the final report is delivered to the WTO Dispute Settlement Body (DSB), as well as to the public (WT/DS267/R).
Oct. 18, 2004	The United States notifies its intention to appeal 14 specific points of the final report to the Appellate Body. The 14 points identify certain issues of law covered in the panel's final report and certain legal interpretations developed by the panel in the dispute. An appeal cannot reexamine existing evidence or examine new evidence (WT/DS267/17).
Nov. 16, 2004	Several additional countries file a third participant's submission, while others notify their intention to appear at the oral hearing.
Dec. 10, 2004	Due to the extent and complexity of issues under review, both the United States and Brazil agree to an extension to March 3, 2005, for circulation of the Appellate Body's (AB's) final report (WT/DS267/18).
Mar. 3, 2005	The AB issues its report upholding most of the panel's rulings (WT/DS267/ABR). Deadlines of July 1, 2005 for removal of prohibited subsidies, and Sept. 21, 2005, for removal of prejudicial effects from actionable subsidies are announced by AB.

[86] "Brazil Wins Key Points in Interim WTO Panel on U.S. Cotton Subsidies," *Inside U.S. Trade*, April 30, 2004; "WTO Panel Backs Brazil in Complaint Against U.S. Over Cotton Subsidies," *International Trade Reporter*, Vol. 21, No. 18, April 29, 2004; and "WTO Panel Reportedly Rules Direct Payments are Trade Distorting and Thus 'Amber Box,'" AgWeb.com, April 30, 2004.

[87] "WTO Ruling Against U.S. Cotton Subsidies is Not Limited to Cotton," AgWeb.com, June 29, 2004; and "WTO Issues Final Ruling Condemning U.S. Cotton Subsidies; U.S. Plans Appeal," *International Trade Reporter*, Vol. 21, No. 26, June 24, 2004.

Date	Event
Mar. 21, 2005	The DSB adopts the AB and panel reports, thus initiating a sequence of compliance deadlines (WT/DS267/20).
Apr. 20, 2005	The United States announces to the DSB that it intends to implement the recommendations and rulings of the DSB.
June 30, 2005	USDA announces temporary fix for its export credit guarantee programs, including adoption of risk-based fee structure for GSM-102 and cessation of use of GSM-103 program. In addition, USDA proposes legislation to Congress to repeal the Step 2 cotton program.
July 1, 2005	AB deadline for U.S. removal of prohibited subsidies expires.
July 4, 2005	Brazil requests authorization from WTO to impose $3 billion in retaliatory measures against prohibited U.S. subsidies (WT/DS267/21).
July 5, 2005	USDA proposes statutory changes be made by Congress: remove 1% fee cap on GSM-102 program and terminate GSM-103 program.
July 5, 2005	United States objects to the amount of Brazil's proposed sanctions on the prohibited subsidies and requests WTO arbitration (WT/DS267/23). Such arbitration shall be carried out by the original panel and completed within 60 days.
July 14, 2005	The DSB assigns role of arbitration on the prohibited-subsidy sanctions to the original panel (WT/DS267/24).
Aug. 17, 2005	Brazil and United States reach procedural agreement to temporarily suspend arbitration proceedings concerning the prohibited subsidies (WT/DS267/25).
Sept. 1, 2005	AB deadline for U.S. removal of prejudicial effects from actionable subsidies expires.
Oct. 6, 2005	Brazil requests authorization from WTO to impose $1 billion in retaliatory measures against actionable U.S. subsidies to offset their adverse effects (WT/DS267/26).
Oct. 17, 2005	United States objects to the amount of Brazil's proposed sanctions on the actionable subsidies and requests WTO arbitration (WT/DS267/27).
Oct. 18, 2005	The DSB assigns role of arbitration on the actionable-subsidy sanctions to the original panel (WT/DS267/28).
Nov. 21, 2005	Brazil and United States reach procedural agreement to temporarily suspend arbitration proceedings concerning the actionable subsidies (WT/DS267/29).
July 24, 2006	Doha round of WTO trade negotiations suspended indefinitely.[88]
Aug. 1, 2006	Step 2 cotton program eliminated (Sec. 1103, P.L. 109-171; Deficit Reduction Act of 2005).
Aug. 18, 2006	Brazil requests the establishment of a WTO compliance panel to review whether the United States has fully complied with the AB's ruling of March 3, 2005 (WT/DS267/30).
Sept. 28, 2006	The DSB agrees to establish a panel (WT/DS267/31). The panel members are announced on Oct. 25, 2006.
Jan. 9, 2007	The DSB announces that, because of particular circumstances, the compliance panel will not complete its work before July 2007.
July 27, 2007	The WTO compliance panel issues confidential interim ruling to Brazil and the United States. News reports suggest a ruling that the United States has not fully complied with the March 2005 ruling.[89]

[88] For more information, see CRS Report RL33144, *WTO Doha Round: The Agricultural Negotiations*, by Charles E. Hanrahan and Randy Schnepf.

[89] For example, see *Financial Times*, "Brazil Claims WTO Cotton Victory," July 27, 2007.

Date	Event
Oct. 15, 2007	The WTO compliance panel releases its confidential final report to the United States and Brazilian governments. News reports suggest a ruling that the United States had not fully complied with the March 2005 ruling.
Dec. 18, 2007	The WTO compliance panel issues its final ruling publicly (WT/DS267/RW), confirming earlier news reports that the panel has found that the United States is not in full compliance.
Feb. 12, 2008	The United States notifies its intention to appeal certain issues of law covered in the report of the WTO compliance panel (WT/DS267/33).
June 2, 2008	The Appellate Body (AB) issues its report upholding most of the compliance panel's rulings (WT/DS267/ABR).
June 18, 2008	2008 farm bill (P.L. 110-246) enacted, including a provision (3101(a)) that alters the U.S. export credit guarantee program by eliminating the GSM-103 and Supplier Credit Guarantee Programs, and the 1% cap on GSM-102 user fees.
June 25, 2008	The DSB adopts the compliance panel and AB reports.
Aug. 25, 2008	Brazil officially asks the chair of the DSB panel to resume the arbitration proceedings concerning proposed countermeasures for both the prohibited subsidies and the actionable subsidies rulings (WT/DS267/38 and WT/DS267/39).
Oct. 1, 2008	Brazil and the United States agree on the arbitration panelists (WT/DS267/24/Add.1 and WT/DS267/28/Add.1).
Dec. 9, 2008	U.S. written submission in arbitration proceedings.
Jan. 13, 2009	Brazil written submission in arbitration proceedings.
Aug. 31, 2009	WTO arbitrator releases a decision in two parts: WT/DS267/ARB/1, which rules on Brazil's retaliation requests regarding the prohibited subsidies, and WT/DS267/ARB/2, which rules on Brazil's retaliation requests regarding the actionable subsidies.
Nov. 19, 2009	DSB grants authorization to Brazil to impose countermeasures against the United States.
Dec. 21, 2009	Brazil announces authorization by WTO to impose trade retaliation in 2010 against $829.3 million in U.S. goods and services (based on 2008 data), including $268.3 million in cross-retaliation.
Feb. 10, 2010	Brazil's Chamber of Foreign Trade (CAMEX) releases a preliminary list identifying U.S. goods exports that would be subject to retaliatory duties.
March 10, 2010	Brazil announces that it will impose retaliatory tariffs worth $591 million on a list of 102 U.S. products. The new tariffs are set to take effect 30 days after their announcement.
March 15, 2010	Brazil announces a preliminary list of U.S. patents and intellectual property rights it could restrict unless both countries reach a settlement. The proposed measures are open to public comment for a period of 20 days and are still subject to public hearings.
April 1, 2010	U.S. negotiating team meets with Brazilian officials to discuss possible resolution of the dispute.
April 5, 2010	The United States floats a proposal to Brazil on a negotiated settlement. After reviewing the proposal, Brazil's Foreign Trade Council (CAMEX) approves a resolution that would postpone until April 22 the implementation of WTO-approved countermeasures by Brazil against U.S. imports.
April 6, 2010	USDA announces cancellation of unutilized GSM-102 balances for FY2010.
April 16, 2010	USDA publishes a proposed rule to recognize the Brazilian state of Santa Catarina as free of several virulent animal diseases, thus opening up the possibility of importation into the United States following 60-day comment period.
April 19, 2010	USDA announces new GSM-102 fee rates and re-announces the unutilized GSM-102 balances for FY2010.

Date	Event
April 20, 2010	Brazil and United States sign memorandum of understanding establishing a $147.3 million annual fund for technical assistance and capacity-building for Brazil's cotton sector.
June 17, 2010	Brazil and the United States reach a "Framework agreement" as interim solution detailing way forward to eventual mutual solution. Brazil's Council of Trade Ministers (CAMEX) approves the Framework to avoid retaliation.
June 21, 2010	Brazil's CAMEX publishes notice calling off trade retaliation pending successful implementation of the Framework agreement.
June 25, 2010	Framework agreement released publicly by the U.S. Trade Representative.

Source: Compiled by CRS from official WTO documents and news sources as cited.

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