



## CRS Report for Congress

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

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### Summary

On June 2, 2008, a World Trade Organization (WTO) Appellate Body (AB) publicly released its final report upholding a December 2007 compliance panel ruling that the United States has not fully complied with a March 2005 WTO ruling against certain U.S. cotton support programs. This AB ruling was part of a prolonged dispute settlement case (DS267) originated by Brazil against certain aspects of the U.S. cotton program in September 2002.

The ruling against the United States could necessitate further U.S. farm program changes or, if no further changes are forthcoming, clear the way for Brazil to request WTO authorization for retaliatory trade sanctions. The AB ruling must first be adopted by the WTO's Dispute Settlement Body (within 30 days of the ruling's release); then the United States and Brazil will likely resume arbitration over the value of sanctions authority requested by Brazil (to be completed within 60 days).

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

### Introduction

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

## The WTO Dispute Settlement Panel's Recommendation

In their ruling against the United States, the WTO panel and the AB identified two subsidy types — prohibited and actionable. Each subsidy involves a different type of response and a different timetable for implementation.<sup>1</sup> Under the WTO's Agreement on Agriculture, prohibited subsidies are treated with greater urgency than actionable subsidies — in particular, they are given a shorter time frame for compliance.

**Prohibited Subsidies.** Two U.S. programs were found to operate as prohibited subsidies: Step 2 payments and export credit guarantees. Step 2 payments were part of special cotton marketing provisions authorized under U.S. farm program legislation to keep U.S. upland cotton competitive on the world market.<sup>2</sup> Step 2 payments were made to both exporters and domestic mill users to compensate them for their purchase of U.S. upland cotton, which tends to be priced higher than the world market price. Step 2 payments were deemed WTO-illegal because they were paid only to users of U.S. cotton (i.e., they discriminated against foreign cotton by encouraging the use of domestic products over imported products) and because they were unscheduled (i.e., export subsidies applied to commodities not listed on a country's WTO schedule or made in excess of the value listed on the schedule).<sup>3</sup>

USDA's export credit guarantee programs (GSM-102, GSM-103, and SCGP) underwrite credit extended by private U.S. banks to approved foreign banks for purchases of U.S. agricultural products by foreign buyers.<sup>4</sup> GSM-102 covers credit terms up to three years, while GSM-103 covered longer credit terms up to 10 years. The Supplier Credit Guarantee Program (SCGP) insured short-term, open account financing designed to make it easier for exporters to sell U.S. food products overseas. The WTO panel found that all three export credit programs effectively functioned as export subsidies because the financial benefits returned to the government by these programs failed to cover their long-run operating cost. Furthermore, the panel found that this export-subsidy aspect of export credit guarantees applies not just to cotton but to all recipient commodities that benefit from U.S. commodity support programs. In other words, so long as the credit guarantees act as an implicit export subsidy, only U.S. program crops that have export subsidies listed in their WTO country schedule are eligible for U.S. export credit guarantees. The AB recommended that the United States withdraw its "prohibited" subsidies by July 1, 2005.

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

<sup>2</sup> For more information on Step 2 payments, see CRS Report RL32442, *Cotton Production and Support in the United States*.

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

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

**Actionable Subsidies.** Any subsidy may be challenged in the WTO (i.e., is “actionable”) if it fulfills the WTO definition of a subsidy<sup>5</sup> and is alleged to cause adverse effects to the interests of other WTO members. In particular, price-contingent payments (i.e., payments dependent on changes in current market prices) — including marketing loan provisions, Step 2 payments, market loss payments, and counter-cyclical payments (CCP) — were identified as contributing to serious prejudice to the interests of Brazil by depressing prices for cotton on the world market during the marketing years 1999-2002. The panel recommended that the United States take appropriate steps to remove the prejudicial effects of “actionable” subsidies or to withdraw the subsidies entirely. The AB upheld the original panel’s recommendation and added a deadline of September 21, 2005, for their removal.

Such actionable subsidies were previously afforded some protection under the so-called “Peace Clause” (Article 13) of the WTO’s Agreement on Agriculture. However, the WTO panel reviewing the cotton case found that the United States was in violation of its Peace Clause spending limit such that Brazil’s dispute settlement case could proceed.<sup>6</sup> The panel ruled that neither production flexibility contract (PFC) payments under the 1996 farm bill nor direct payments (DP) under the 2002 farm bill qualify for the WTO’s green box exemption as decoupled payments due to a planting restriction on fruits, vegetables, and wild rice on program base acres. As a result, PFC and DP payments were counted against the U.S. Peace Clause limit. See the “Role of Congress” section at the end of this report for a discussion of related 2008 farm bill provisions.

## **U.S. Response to the Panel Ruling**

After losing its appeal, the United States announced that it intended to fully comply with the panel recommendations. In July 2005, USDA instituted a temporary fix for its export credit guarantee programs to make the fees charged by the programs more risk-based. Higher fees were needed to ensure that the financial returns of these programs fully cover their long-run operating costs, thereby eliminating their subsidy component. In addition, the CCC stopped accepting applications for payment guarantees under GSM-103. These efforts were formalized in the 2008 farm bill (P.L. 110-234, Sec. 3101), which eliminated the GSM-103 and SCGP programs and removed a 1% cap on fees that could be charged under the GSM-102 program. On August 1, 2006, the Step 2 cotton program, which was authorized by the 2002 farm act (P.L. 107-171, Sec. 1207), was eliminated by a provision (Sec. 1103) in the Deficit Reduction Act of 2005 (P.L. 109-171). The Administration likely felt that sufficient program changes had been enacted to fully comply with the “actionable subsidies” portion of the WTO ruling.

## **Brazil Seeks \$4 Billion in Retaliatory Trade Measures**

According to WTO rules, trade sanctions are limited to a value not to exceed the level of lost benefits. As the reform deadlines under the two different subsidy types

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<sup>5</sup> As defined in Article 1 of the WTO’s *Agreement on Subsidies and Countervailing Measures*.

<sup>6</sup> For more information on the Peace Clause and its role in this dispute, see CRS Report RL32571, *Background on the U.S.-Brazil WTO Cotton Subsidy Dispute*, by Randy Schnepf.

expired, Brazil first requested (July 4, 2005) authorization from the WTO to impose \$3 billion in countermeasures against the prohibited U.S. subsidies. This value corresponds to (1) Step 2 payments made in the then-most-recently-concluded marketing year (2004/2005) 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).<sup>7</sup> To achieve \$3 billion in retaliation, Brazil proposed to suspend tariff concessions as well as obligations under the WTO Agreement on Trade-Related Intellectual Property Rights and the General Agreement on Trade in Services. The United States objected to the amount of Brazil's proposed sanctions, and requested WTO arbitration. However, the United States and Brazil reached a procedural agreement temporarily suspending arbitration proceedings concerning the prohibited subsidies.

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

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 a Compliance Panel**

Initially Brazil showed a willingness to permit the U.S. legislative process — motivated by the 2007 expiration of U.S. farm programs and the prospects of a successful Doha Round of trade negotiations<sup>8</sup> — to bring U.S. farm programs into compliance with the WTO ruling, even if this process extended well beyond the deadlines established under the WTO dispute settlement ruling. However, on August 21, 2006, Brazil requested the establishment of a WTO compliance panel to review whether the United States had fully complied with the panel and AB rulings. On December 18, 2007, the WTO compliance panel released its final report ruling that the United States had not fully complied with the March 2005 WTO ruling against certain U.S. cotton support programs.

In February 2008, the United States appealed the compliance panel's ruling. In June 2008, a WTO Appellate Body (AB) publicly released its final report upholding the compliance panel's ruling that the United States had not fully complied with the March 2005 WTO ruling. The ruling against the United States could necessitate further U.S. farm program changes or, if no further changes are forthcoming, clear the way for Brazil to request WTO authorization for retaliatory trade sanctions. The AB report must first be

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<sup>7</sup> For details, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

<sup>8</sup> For more information on the status of Doha negotiations see, CRS Report RL33144, *WTO Doha Round: The Agricultural Negotiations*, by Charles Hanrahan and Randy Schenpf.

adopted by the WTO's Dispute Settlement Body (within 30 days of the ruling's release); then the United States and Brazil will likely resume arbitration over the value of sanctions authority requested by Brazil (to be completed within 60 days). 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.<sup>9</sup>

## Role of Congress

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

Ultimately, Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements. The United States would appear to have already complied with most, if not all, of the AB's recommendation concerning "prohibited subsidies" 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). However, some questions remain as to what extent the 2008 farm bill (P.L. 110-234) has addressed the serious prejudice 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 "serious prejudice" in the marketplace. Several of the proposed changes are specifically relevant to the Brazil cotton case, but also germane to the broader issue of program vulnerability to WTO challenge.<sup>10</sup> For example, the enacted 2008 farm bill:<sup>11</sup>

- extends the counter-cyclical payments (CCP) program and current marketing loan provisions (Sections 1104 and 1201 of P.L. 110-234);
- 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

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<sup>9</sup> For more information, see CRS Report RS21712, *The African Cotton Initiative and WTO Agriculture Negotiations*, by Charles Hanrahan.

<sup>10</sup> 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.

<sup>11</sup> See CRS Report RL33934, *Farm Bill Legislative Action in the 110th Congress*.

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 (P.L.110-234, Sec. 1107). This retention of the status quo has important WTO implications, as both Canada and Brazil have recently initiated WTO cases against the United States charging that the United States has exceeded its total limit for the aggregate measure of support (AMS) on several occasions in recent years if direct payments are included in the AMS calculation.<sup>12</sup>

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 110<sup>th</sup> Congress will likely continue to monitor developments in the WTO cotton case and the Doha negotiations, as well as the aftermath of the compliance panel's final ruling.

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<sup>12</sup> See CRS Report RL34351, *Brazil and Canada's WTO Cases Against U.S. Agricultural Support* by Randy Schnepf.