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Background on the U.S.-Brazil WTO Cotton Subsidy Dispute

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Summary

In late 2002, Brazil initiated a World Trade Organization (WTO) dispute settlement case (DS267) against specific provisions of the U.S. cotton program. On September 8, 2004, a WTO dispute settlement (DS) panel ruled against the United States on several key issues in case DS267. On October 18, 2004, the United States appealed the case to the WTO's Appellate Body (AB) which, on March 3, 2005, confirmed the earlier DS panel findings against U.S. cotton programs.

Key findings include the following: (1) U.S. domestic cotton subsidies have exceeded WTO commitments of the 1992 benchmark year, thereby losing the protection afforded by the "Peace Clause," which shielded them from substantive challenges; (2) the two major types of direct payments made under U.S. farm programs — Production Flexibility Contract payments of the 1996 Farm Act and the Direct Payments of the 2002 Farm Act — do not qualify for WTO exemptions from reduction commitments as fully decoupled income support and should therefore count against the "Peace Clause" limits; (3) Step-2 program payments are prohibited subsidies; (4) U.S. export credit guarantees are effectively export subsidies, making them subject to previously notified export subsidy commitments; and (5) U.S. domestic support measures that are "contingent on market prices" have resulted in excess cotton production and exports that, in turn, have caused low international prices and have resulted in "serious prejudice" to Brazil.

What happens next? On March 21, 2005, the AB and panel reports were adopted by the WTO membership, initiating a sequence of events, under WTO dispute settlement rules, whereby the United States will bring its policies into line with the panel's recommendations or negotiate a mutually acceptable settlement with Brazil. First, the panel recommended that all "prohibited" U.S. export subsidies (i.e., Step 2 payments and exports of unscheduled commodities — including cotton — made with GSM export credit guarantees) must be withdrawn by July 1, 2005. Second, as concerns a ruling on "actionable" subsidies under a finding of serious prejudice caused by "price contingent" subsidies (e.g., loan deficiency payments, marketing loss assistance payments, counter-cyclical payments, and Step-2 payments), the United States is under an obligation to "take appropriate steps to remove the adverse effects or withdraw the subsidy."

It is noteworthy that the panel finding that U.S. direct 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.

This report provides background to the dispute, as well as details of the WTO dispute settlement case. It will not be updated. For information on the U.S. response to panel recommendations and their implications for the U.S. cotton sector, see CRS Report RS22187, *U.S. Agricultural Policy Response to WTO Cotton Decision*.

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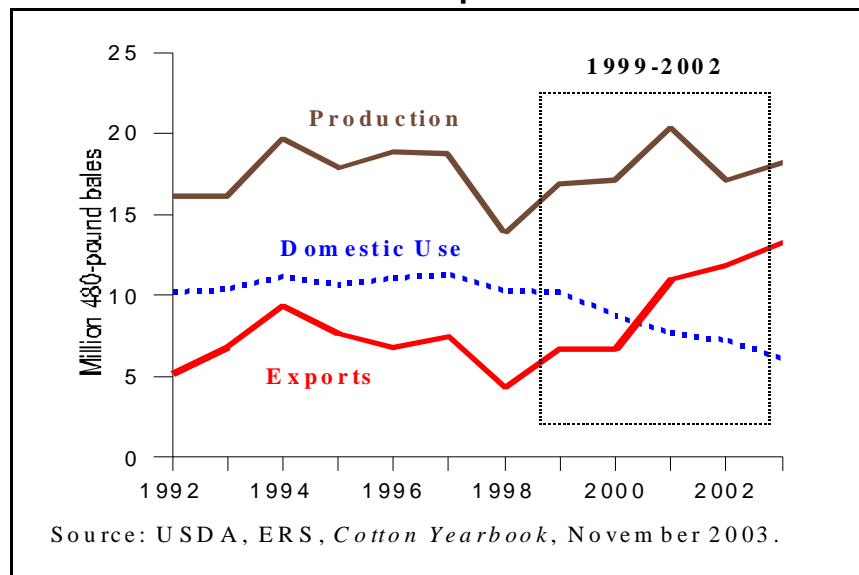
Background on the U.S.-Brazil WTO Cotton Subsidy Dispute

Background on the U.S. Cotton Sector

The cotton industry is a major component of the U.S. agricultural sector. From 1997 to 2002, U.S. cash receipts from cotton production averaged \$4.6 billion per year, while export sales averaged over \$2.1 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 stretching to California. Texas is the largest cotton-producing state, accounting for an average of 26% of U.S. production since 1993. In 2002, 17 states reported cotton production valued at over \$10 million.

Cotton is one of the principal U.S. program crops, along with wheat, rice, feed grains, soybeans, and peanuts. Qualifying U.S. cotton producers are eligible for direct payments, counter-cyclical payments, loan deficiency payments, Step-2 payments, and other program benefits.¹ From FY1991 to FY2004, U.S. farm subsidies for cotton production averaged \$1.7 billion per year. (See **Table 1**.)

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



The United States is the second-largest producer of cotton in the world. In recent years, the United States has been exporting an increasing share of its annual

¹ For more details on U.S. cotton program operations, see CRS Report RL32442, *Cotton Production and Support in the United States*, June 24, 2004.

production, due in large part to a decline in domestic mill use. (See **Figure 1.**) U.S. exports as a share of production have averaged 59% since 2001, up from a 42% average during the early 1990s.

The United States is the world's largest cotton exporter. During the 2001-03 period, U.S. exports accounted for 40% of world trade, on average. Large U.S. subsidy levels coupled with U.S. prominence in global markets have directed much international attention to U.S. cotton program outlays in recent years.

Table 1. U.S. Upland Cotton Program Outlays, FY1991-FY2005^a

| Fiscal year ^b | Total Outlays (\$ million) ^c |
|--------------------------|--|
| 1991 | 382 |
| 1992 | 1,443 |
| 1993 | 2,239 |
| 1994 | 1,539 |
| 1995 | 99 |
| 1996 | 685 |
| 1997 | 561 |
| 1998 | 1,132 |
| 1999 | 1,882 |
| 2000 | 3,809 |
| 2001 | 1,868 |
| 2002 | 3,307 |
| 2003 | 2,889 |
| 2004 | 1,372 |
| 2005 ^d | 4,721 |
| Sum: 1991-2004 | 23,026 |
| Average: 1991-2004 | 1,658 |
| Average: 2000-2003 | 2,968 |

Source: USDA, Farm Service Agency, Budget Division, *History of Budgetary Expenditures of the Commodity Credit Corporation*, Books 3 (April 9, 2001) and 4 (July 15, 2003), and Table 35 — CCC Net Outlays by Commodity and Function, available at [<http://www.fsa.usda.gov/dam/bud/bud1.htm>].

^a Data are for outlays within the reported fiscal year. Payments may be specific to cotton from several different crop or marketing years.

^b 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.

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

^d USDA estimate, Table 35, "CCC Net Outlays by Commodity and Function," downloaded on March 4, 2005, available at [<http://www.fsa.usda.gov/dam/bud/bud1.htm>].

Sequence of Events in WTO Case DS267

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.² 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. (See **Table 2** for a timeline of the dispute settlement case.)

Table 2. Timeline: U.S.-Brazil WTO Dispute Settlement Case 267

| Date | Event |
|------------------------|---|
| Sept. 27, 2002 | Brazil made a formal “request for consultations” with the United States. |
| Oct. 2002 to Jan. 2003 | Brazil and the United States held three consultations to discuss the dispute over U.S. cotton subsidies. The consultations were 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. |
| Mar. 18, 2003 | Upon Brazil’s second request, the WTO’s Dispute Settlement Body (DSB) established a panel at its meeting on March 18, 2003. |
| 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 22-24, 2003 | First meeting with the DSB panel. The panel decides to review the peace clause issue and Brazil’s challenge to U.S. cotton subsidies separately. |
| Sept. 2003 | The panel reversed an earlier procedural decision and stated that it would decide both the peace clause issue and Brazil’s challenge to U.S. cotton subsidies together. |
| Nov. 17, 2003 | The panel chairman informed the DSB that the panel would not be able to complete its work in six months due to the complexity of the matter. An extension was announced. |
| April 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 was released confidentially, news reports suggested at least a partial finding against the United States on each of the five major claims. ³ |

² *United States — Subsidies on Upland Cotton*, WT/DS267 (WTO Dispute Settlement Case 267). Documentation is available at [http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm].

³ “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 (continued...)”

| Date | Event |
|---|---|
| June 18, 2004 | The panel's final report is released confidentially to the two parties. News reports suggested that the final ruling varied little from the interim ruling against the United States. ⁴ |
| 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. ⁵ |
| Oct. 18, 2004 | The United States notified 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. ⁶ An appeal cannot reexamine existing evidence or examine new evidence. |
| Nov. 16, 2004 | Several additional countries filed a third participant's submission, while others notified 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 agreed to an extension to March 3, 2005, for circulation of the Appellate Body's (AB's) final report. |
| Mar. 3, 2005 | The Appellate Body issued its report upholding most of the panel's rulings. ⁷ |
| Mar. 21, 2005 | The DSB adopted the AB and panel reports, thus initiating a sequence of compliance deadlines. |
| Compliance procedures are discussed in a later section. For information on U.S. compliance actions and their implications for the U.S. cotton sector, see CRS Report RS22187, <i>U.S. Agricultural Policy Response to WTO Cotton Decision</i> . | |

Arguments in the U.S.-Brazil WTO Cotton Case

Brazil's case was broadly written and touched on almost every aspect of U.S. commodity programs, although the focus has been on six principal claims (see

³ (...continued)

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.

⁴ "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.

⁵ *United States — Subsidies on Upland Cotton*, "Report of the Panel," WTO, WT/DS267/R, Sept. 8, 2004; available at [http://www.wto.org/english/tratop_e/dispu_e/267r_a_e.pdf].

⁶ The U.S. appeal notification may be obtained by searching for WT/DS267/17 using the WTO online documents search engine at [http://docsonline.wto.org/gen_home.asp?language=1&_=1].

⁷ *United States — Subsidies on Upland Cotton*, AB-2004-5, "Report of the Appellate Body," WTO, WT/DS267/AB/R, March 3, 2005; available at [http://www.wto.org/english/tratop_e/dispu_e/267abr_e.doc].

below).⁸ Each of Brazil's main claims is presented here along with the WTO dispute settlement panel finding and Appellate Body (AB) ruling.

Claim 1: Peace Clause Violation. Brazil claimed that the United States is 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 are in excess of its WTO commitments.⁹ Article 13 exempts domestic support measures that comply 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 remains at or below the benchmark 1992 marketing year (MY) levels. Brazil argued that U.S. cotton subsidies were about \$2 billion in MY1992 compared with over \$4 billion in MY2001.¹⁰ 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.

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 are 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.”¹¹ 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 has been injury. (See “Claim 5,” below.)

Finding 1. The panel found (and was upheld by the AB) 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

⁸ Ministry of Foreign Affairs [Ministério das Relações Exteriores], Brasília; “Brazil-U.S.A. Dispute on Subsidies on Upland Cotton,” translation from the original in Portuguese, Nota nº 248-18/06/2004; Distribuição 22 e 23.

⁹ 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].

¹⁰ 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 Aug. 1 and ends July 31 of the following year, but identifies with the first year, such that MY1992 starts Aug. 1, 1992, and ends July 31, 1993. The principal period in question, MY1999-MY2002, corresponds roughly with FY2000-FY2003.

¹¹ *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].

of WTO commitments (of \$2.0 billion) during MY1992. (See **Table 3**.) As a result, U.S. domestic cotton support measures lose the protection afforded by the “Peace Clause” which has shielded them from substantive challenges in the past. This occurs in part because, under Finding 2, Production Flexibility Contract and Direct Payment outlays are included with other commodity program outlays and evaluated against “peace clause” limits.

Table 3. 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 — fail to fully meet the conditions for decoupled income support in Annex 2 of the Agreement on Agriculture and should therefore count 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.”¹² As a result, the United States notifies both the PFC and DP outlays as “green box” 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) 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,¹³ 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.

¹² WTO, “Annex 2 — Domestic Support: The Basis for Exemption from the Reduction Commitments,” Agreement on Agriculture, *WTO Legal Texts*, p. 48.

¹³ 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>].

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

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

Step-2 payments are part of special cotton marketing provisions authorized under U.S. farm program legislation to keep U.S. upland cotton competitive on the world market. Step-2 payments are 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 is 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.¹⁴

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

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 Appellate Body.

Claim 4: U.S. Export Credit Guarantees Function as Export Subsidies. 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 — GSM102, GSM103, and the Supplier Credit Guarantee Program (SCGP)¹⁵ — are effectively export subsidies inconsistent with the WTO’s

¹⁴ 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/>].

¹⁵ For information on U.S. export credit programs, see USDA, Foreign Agricultural Service (FAS), “Export Credit Guarantee Programs,” at [<http://www.fas.usda.gov/excredits/default.htm>].

AA and SCM Agreements. Further, the subsidy effects of export credit guarantees apply not only to cotton, but to other eligible commodities.¹⁶

U.S. trade officials argued that the U.S. export credit guarantee programs are 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.

Finding 4. The panel found (and was upheld by the AB) 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.¹⁷ Furthermore, the panel found that this applies, 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 are subject to previously scheduled export subsidy commitments for that commodity. This refers to those U.S. export subsidies under the Export Enhancement Program (EEP).¹⁸ Under these criteria, export credit guarantees benefits extended to cotton and other “unscheduled” commodities (that are supported under U.S. agricultural programs) are found to be in violation of previous WTO commitments. 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 the 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

¹⁶ 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, Sept. 24, 2002; available at [http://www.fas.usda.gov/scripts/PressRelease/pressrel_dout.asp?Entry=valid&PrNum=0346-02].

¹⁷ Found to violate Annex I(j) of the SCM, *WTO Legal Texts*, p. 267, which identifies as an export subsidy, “The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.”

¹⁸ 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. For more information on the EEP program, see CRS Issue Brief IB98006, *Agricultural Export and Food Aid Programs*, Foreign Agricultural Service, USDA, at [<http://www.fas.usda.gov/excredits/eep.html>].

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: (i) by increasing the U.S. share of the world upland cotton market; (ii) by displacing or impeding Brazilian upland cotton sales in third-country markets; and (iii) by contributing to a steep decline in world cotton prices (see **Figure 2**).¹⁹ In particular, Brazil claims 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 asserts that injury under each of these three circumstances are in violation of the SCM Agreement.²⁰ In addition, Brazil argued that these same programs would be harmful (i.e., threatened serious prejudice) in future years.

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. For example, see **Figure 3** for a visibly strong correlation between China cotton imports and the international cotton “A-index.”

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 (loan deficiency payments, marketing loss assistance payments, counter-cyclical payments, and Step-2 payments), and those that are not (PFC and Direct Payments, and the federal crop insurance program).

Finding 5. The panel found (and was upheld by the AB) 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. 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.

¹⁹ 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.

²⁰ Text of the Agreement on SCM is available online at [http://www.wto.org/english/docs_e/legal_e/24-scm.pdf].

Figure 2. U.S. Cotton Exports and International Cotton Price Index

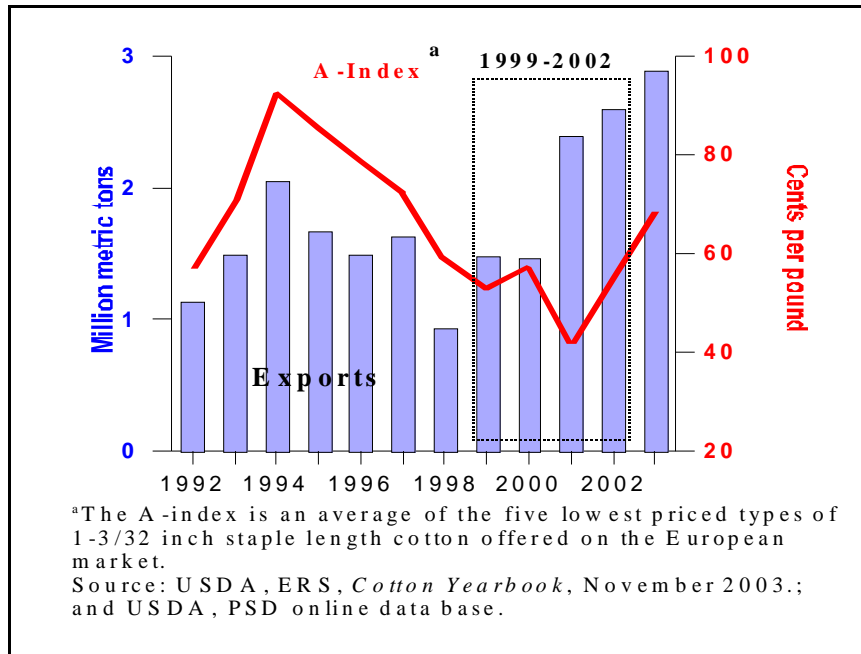
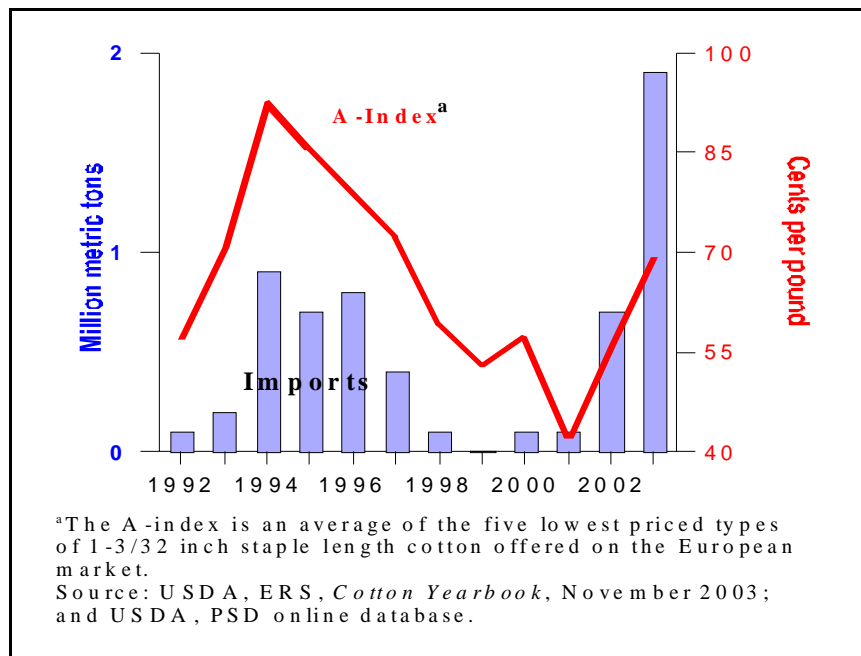


Figure 3. China Cotton Imports and International Cotton Price Index



With respect to Brazil’s claim of a threat of serious prejudice going forward (i.e., 2003 to 2007 — the remaining life of the 2002 farm act), the panel stated in its final report that those “prohibited” subsidies that cause the 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.²¹ 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...”²²

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.

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).²³ As a result, the panel declined to further examine Brazil’s claims on this particular issue.

Panel Recommendations

Prohibited Subsidies. In its final report, the panel recommends 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 is earlier).²⁴ Since the DSB adopted the AB and panel reports on March 21, 2005, the relevant deadline for withdrawal of prohibited subsidies is July 1, 2005. The list of prohibited subsidies subject to withdrawal “without delay” includes:

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; and
- Step-2 program payments to exporters of upland cotton.

²¹ *Report of the Panel*, “United States — Subsidies on Upland Cotton,” WTO, WT/DS267/R, para 7.1503, Sept. 8, 2004, p. 345.

²² *Ibid.*

²³ For more information on DS108, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases* by Jeanne Grimmer.

²⁴ Done in accordance with SCM, Article 4.7.

Prohibited Import Substitution Subsidy.

- Step-2 payments to domestic users of upland cotton.

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

Actionable Subsidies. The panel also issued recommendations concerning the “actionable” subsidies identified as contributing to serious prejudice to the interests of Brazil during the marketing years 1999-2002. Specifically, this involves those U.S. subsidy measures singled out as price-contingent — marketing loan provisions, Step-2 payments, and CCP payments. The panel recommended that, upon adoption of its final report, the United States take appropriate steps to remove the adverse effects or to withdraw the subsidies.

However, it is noteworthy that the actionable subsidies remedy is dealing with serious prejudice and injury 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 — i.e., the Step-2 provisions and export credit guarantees — could so significantly transform the basket of measures currently in question that it is not necessary or appropriate to address Brazil’s claims of threat of serious prejudice.²⁵ This appears to leave open the possibility that removal of the prohibited subsidies may resolve the dispute under the actionable subsidies recommendation.

Implementation Phase²⁶

Following is a discussion of how the implementation phase could potentially unfold in accordance with WTO dispute settlement rules. However, this report does not discuss how the implementation phase unfolded and the nature and effects of U.S. compliance decisions. Eventual U.S. compliance actions and their implications for the U.S. cotton sector are covered in CRS Report RS22187, *U.S. Agricultural Policy Response to WTO Cotton Decision*.

The evolution of the implementation phase depends on how both parties choose to respond to the different sequence 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. Furthermore, if the complaining country does not want to press ahead full force with imposing sanctions, there is considerable opportunity to delay compliance steps.

²⁵ *Report of the Panel*, “United States — Subsidies on Upland Cotton,” WTO, WT/DS267/R, para. 7.1503, p. 354.

²⁶ 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].

From this point forward, the time track may diverge depending on whether the United States chooses 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.”

Prohibited Subsidies Potential Time Track. The panel has recommended that the United States remove the prohibited export subsidies listed above by July 1, 2005. If the United States fails 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). The first scheduled event was scheduled to occur within 15 days after the AB and panel reports were adopted by the DSB (done on March 21, 2005).²⁷ During this period the United States is 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.²⁸ 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.²⁹ 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.³⁰

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).³¹ 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,

²⁷ Normally a 30-day period is given to respond (DSU, Article 21.3); however, this is halved under SCM, Article 4.12.

²⁸ 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.

²⁹ 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).

³⁰ 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).

³¹ 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).

the European Communities (EC) requested and received authorization to impose retaliatory measures against the United States on May 7, 2003.³² 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. The panel recommends 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. In contrast to the July 1, 2005 deadline, the removal of actionable subsidies is subject to a six-month period starting on the date of adoption of the AB and panel reports (March 21, 2005) — i.e., September 21, 2005.³³ At that point, in the absence of mutual agreement on compensation and if the United States has not fully complied with the recommendation, then 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.

Preliminary U.S. Government and Industry Response. 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.³⁴ However, U.S. officials have said that they prefer to resolve the cotton case through trade negotiations in the WTO Doha Round rather than a separate settlement.³⁵

The National Cotton Council (NCC) of America — the principal national organization representing the interests of U.S. producers, ginner, warehouse, merchants, cottonseed processors/dealers, cooperatives and textile manufacturers — also expressed disappointment in the AB ruling, but has stated that it would work with USTR and USDA to coordinate a response to the decision.³⁶

Potential Implications of WTO Panel Ruling

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 program provisions of the U.S. cotton program such as the mandatory Step-2 provisions could necessitate legislative

³² For more information, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne Grimmett.

³³ In accordance with SCM, Article 7.9.

³⁴ *Inside U.S. Trade*, “Appellate Body Favors Brazil in Cotton Subsidies Challenge,” Vol. 23, No.9, March 4, 2005.

³⁵ *Congressional Daily*, “Comply Quickly With WTO Ruling, Brazil Urges U.S.” March 15, 2005.

³⁶ NCC, “NCC Statement on WTP Appellate Ruling,” March 3, 2005; available at [<http://www.cotton.org/news/releases/2005/wtostatement.cfm>].

changes to bring existing program operations into compliance; and that such potential program changes could necessitate that the U.S. farm bill be reopened well before its scheduled expiration in 2007. The July 1, 2005, deadline for removal of prohibited export subsidies including Step 2 payments and export credit guarantees appears to increase the likelihood of that possibility.

Concerns have also been expressed regarding the reclassification of PFC and Direct Payments away from non-trade-distorting green box support.³⁷ However, the panel finding that U.S. direct 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 FY2000 to FY2003, PFC and DP payments averaged nearly \$5 billion per year and accounted for 32% of total U.S. agricultural 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.

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.³⁸ 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

³⁷ “Brazil Wins Key Points in Interim WTO Panel on U.S. Cotton Subsidies,” *Inside U.S. Trade*, April 30, 2004.

³⁸ WTO, Doha Ministerial Declaration, WT/MIN(01)/DEC/1, Nov. 20, 2001.

proposal calling for a global agreement to end all production-related support for cotton growers of all WTO-member cotton producing nations.³⁹ 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 recently completed agriculture framework (July 31, 2004) of the WTO's ongoing Doha Round.⁴⁰ 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 as the U.S. seeks to bring its programs into compliance with the WTO Appellate Body ruling and recommendations. The July 1, 2005, deadline for removal of prohibited export subsidies including Step 2 payments and export credit guarantees appears to increase the likelihood of that some sort of legislative change may be needed to bring existing program operations into compliance.

The House Committee on Agriculture regularly holds hearings on agricultural trade negotiations.⁴¹ Last year two such hearings were held (April 28 and May 19, 2004). Among the trade issues discussed during these hearings, both U.S. Trade Representative Zoellick and Woody Anderson, chairman of the National Cotton Council, provided testimony on and responded to questions regarding the U.S.-Brazil WTO cotton case.

In his testimony to the House Committee on Agriculture, May 19, 2004, Mr. Anderson expressed his support for the WTO negotiations stating that “[a] rational, rules-based international trading system is superior to the alternative. We will do our part, working with this committee and the administration, to maintain an effective U.S. cotton program that complies with WTO rules.”⁴² However, he also expressed his concern that U.S. programs such as the export credit guarantees and decoupled direct payments — programs that he felt were clearly exempted from reduction

³⁹ For more information, see CRS Report RS21712, *The African Cotton Initiative and WTO Agriculture Negotiations*.

⁴⁰ For more information, see CRS Report RS21905, *Agriculture in the WTO Doha Round: The Framework Agreement and Next Steps*.

⁴¹ House of Representatives, 108th Congress, Committee on Agriculture, *Agricultural Trade Negotiations*, Serial No. 108-29; available at [<http://agriculture.house.gov/hearings/108/10829.pdf>].

⁴² Statement of Woody Anderson, chairman, National Cotton Council, before the Committee on Agriculture, U.S. House of Representatives, May 19, 2004; available at [<http://agriculture.house.gov/hearings/108/10829.pdf>].

commitments under the Uruguay Round Agreement — might fail to withstand challenges under the WTO dispute settlement process.

In addition to congressional hearings, under fast track or Trade Promotion Authority (TPA) legislation, Congress will be engaged in consultations with the Administration on negotiations of the Free Trade Agreement for the Americas (FTAA) and the agriculture negotiations in the WTO. Such consultations will be a major vehicle for Members to express their views on this dispute and on the negotiating issues it raises. Ultimately Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements.