

# CRS Report for Congress

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## U.S. Agricultural Policy Response to WTO Cotton Decision

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### Summary

In a dispute settlement case (DS267) brought by Brazil against certain aspects of the U.S. cotton program, a WTO Appellate Body (AB) recommended in March 2005 that the United States remove certain “prohibited subsidies” by July 21, 2005, and remove the adverse effects resulting from certain “actionable subsidies” by September 21, 2005. When the United States failed to meet these deadlines, Brazil claimed the right to retaliate against \$3 billion in U.S. exports to Brazil based on the prohibited subsidies, and proposed \$1 billion in retaliation based on the actionable subsidies. The United States objected to these retaliation amounts and requested WTO arbitration on the matter. However, in mid-2005 the United States and Brazil reached a procedural agreement to temporarily suspend retaliation proceedings.

On August 21, 2006, Brazil submitted a request for a WTO compliance panel to review whether the United States has fully complied with panel and AB rulings. The United States blocked the WTO’s Dispute Settlement Body (DSB) from approving Brazil’s request on August 31, 2006; however, Brazil is expected to make a second request (which the United States will be unable to block) at the DSB meeting set for September 28, 2006. If a compliance panel finds that the United States has not fully complied with the AB rulings, Brazil could ask the WTO arbitration panel to resume its work. Although the United States has already complied with a portion of the AB’s recommendation by eliminating the Step 2 program (August 1, 2006), additional permanent modifications to U.S. farm programs may still be needed to fully comply with the WTO ruling on “actionable subsidies.” 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. exports accounted for 40% of world trade, on average, while government domestic subsidies averaged \$3 billion per year. In late 2002, Brazil — a major cotton export competitor — expressed its growing concerns about U.S. cotton subsidies by initiating a WTO dispute settlement case (DS267) against specific provisions of the U.S.

cotton program. On September 8, 2004, a WTO dispute settlement panel ruled against the United States on several key issues (WT/DS267/R). On March 3, 2005, a WTO Appellate Body (AB) upheld the panel's ruling on appeal (WT/DS267/AB/R). On March 21, 2005, the panel and AB reports were adopted by the WTO membership, initiating a sequence of events, under WTO dispute settlement rules, whereby the United States is expected to bring its policies into line with the panel's recommendations or negotiate a mutually acceptable settlement with Brazil.<sup>1</sup>

## The WTO Dispute Settlement Panel's Recommendation

In their ruling against the United States, the WTO panel and AB recommended that the United States withdraw those support programs identified as "prohibited" subsidies within six months of adoption of the panel's and AB's reports by the WTO membership or by July 1, 2005, whichever was earlier; and that it remove the prejudicial effects of those programs identified as "actionable" subsidies by September 21, 2005. Each of these subsidy types — prohibited and actionable — involves a different type of response and a different timetable for implementing that response.<sup>2</sup>

**Prohibited Subsidies.** Two types of prohibited subsidies were identified by the WTO panel: unscheduled export subsidies (i.e., subsidies applied to commodities not listed on a country's WTO schedule or made in excess of the value listed on the schedule);<sup>3</sup> and import substitution subsidies, which refers to subsidies paid to domestic users to encourage the use of domestic products over imported products. Both Step 2 export payments and export credit guarantees were found to operate as prohibited export subsidies. Step 2 domestic user payments were found to operate as prohibited import substitution subsidies. Under the WTO's Agreement on Agriculture, prohibited subsidies are treated with greater urgency than actionable subsidies — in particular, they are given a shorter time frame for compliance.

**Step 2 Program.** 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>4</sup> Step 2 payments were made to exporters and domestic mill users to compensate them for their purchase of U.S. upland cotton, which tends to be priced higher than the world market price.

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

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<sup>1</sup> For a detailed discussion of the U.S.-Brazil WTO dispute settlement case, see CRS Report RL32571, *Background on the U.S.-Brazil WTO Cotton Subsidy Dispute*, by Randy Schnepf.

<sup>2</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>3</sup> For more information, see CRS Report RL32916, *Agriculture in the WTO: Policy Commitments Made Under the Agreement on Agriculture*, by Randy Schnepf.

<sup>4</sup> For more information on Step 2 payments, see CRS Report RL32442, *Cotton Production and Support in the United States*, by Jasper Womach.

buyers.<sup>5</sup> GSM-102 covers credit terms up to three years, while GSM-103 covers longer credit terms up to 10 years. The Supplier Credit Guarantee Program (SCGP) insures short-term, open account financing designed to make it easier for exporters to sell U.S. food products overseas. The WTO panel found that all three export credit programs effectively functioned as export subsidies because the financial benefits returned to the government by these programs failed to cover their long-run operating cost. Furthermore, the panel found that this export-subsidy aspect of export credit guarantees applies not just to cotton but to all recipient commodities that benefit from U.S. commodity support programs. In other words, so long as the credit guarantees act as an implicit export subsidy, only U.S. program crops that have scheduled export subsidies (in accordance with the U.S. WTO country schedule) are eligible for U.S. export credit guarantees.<sup>6</sup>

**Actionable Subsidies.** Any subsidy may be challenged in the WTO (i.e., is “actionable”) if it fulfills the WTO definition of a subsidy<sup>7</sup> and is alleged to cause adverse effects to the interests of other WTO members. Actionable U.S. subsidies were identified as contributing to serious prejudice to the interests of Brazil by depressing prices for cotton on the world market during the marketing years 1999-2002. Specifically, this involved those U.S. subsidy measures singled out as price-contingent (i.e., dependent on changes in current market prices) — marketing loan provisions, Step 2 payments, market loss payments, and counter-cyclical payments.<sup>8</sup> The panel recommended that, upon adoption of its final report, the United States take appropriate steps to remove the adverse effects of these subsidies or to withdraw the subsidies entirely.<sup>9</sup> Such subsidies were previously afforded some protection under the so-called “peace clause” (Article 13) of the WTO’s Agreement on Agriculture.<sup>10</sup>

## Brazil’s Response

**Prohibited Subsidies.** Because the prohibited export subsidies had not been removed by July 1, 2005, Brazil requested (July 4, 2005) authorization from the WTO to impose countermeasures against U.S. cotton subsidies. According to WTO rules, trade sanctions are limited to a value not to exceed the level of lost benefits. Brazil proposed to suspend tariff concessions as well as obligations under the WTO Agreement on Trade-Related Intellectual Property Rights and the General Agreement on Trade in Services until the United States withdrew the exports subsidies identified by the WTO, in an amount estimated at \$3 billion, corresponding to (1) Step 2 payments made in the most recently concluded marketing year (2004/05) and (2) the total of exporter applications received

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<sup>5</sup> For information on these programs, see USDA, Foreign Agricultural Service, “Export Credit Guarantee Programs,” at [<http://www.fas.usda.gov/excredits/default.htm>].

<sup>6</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>7</sup> As defined in Article 1 of the WTO’s *Agreement on Subsidies and Countervailing Measures*.

<sup>8</sup> For more information on these programs, see CRS Report RL33271, *Farm Commodity Programs: Direct Payments, Counter-Cyclical Payments, and Marketing Loans*, by Jim Monke.

<sup>9</sup> *Report of the Panel*, WTO, WT/DS267/R, para. 7.1503, p. 354.

<sup>10</sup> For more information, see CRS Report RL32571, *Background on the U.S.-Brazil WTO Cotton Subsidy Dispute*, by Randy Schnepf.

under the three export credit guarantee programs, for all unscheduled commodities and for rice, for the most recent fiscal year (2004).<sup>11</sup> The United States objected to the amount of Brazil's proposed sanctions, and requested WTO arbitration (July 19, 2005; WT/DS267/24). However, the United States and Brazil reached a procedural agreement (Aug. 18, 2005; WT/DS267/25) temporarily suspending arbitration proceedings insofar as the prohibited subsidies are involved.

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

## U.S. Response

With respect to the "prohibited subsidies," the Step 2 cotton program, which was authorized by the 2002 farm act (P.L. 107-171; Sect. 1207), was eliminated on August 1, 2006, by a provision (Sec. 1103) in the Deficit Reduction Act of 2005 (P.L. 109-171). As for export credit guarantees, user fees for GSM-102, the primary export credit program, presently are capped at 1% of the value of the export product. Higher fees are needed to ensure that the financial benefits returned by these programs fully cover their long-run operating costs; thereby eliminating their subsidy component. On July 1, 2005, USDA instituted a temporary fix whereby the Commodity Credit Corporation (CCC) would use a risk-based fee structure for the GSM-102 and SCGP programs.<sup>12</sup> The new structure responds to a key finding by the WTO that the fees charged by the programs should be risk-based. In addition, the CCC stopped accepting applications for payment guarantees under GSM-103. On July 5, 2005, USDA Secretary Johanns proposed that Congress implement statutory changes to comply with the prohibited subsidy ruling that included the removal of the 1% cap on fees that can be charged under the GSM-102 program and termination of the GSM-103 program.<sup>13</sup> According to Secretary Johanns the proposed changes were worked out in collaboration with U.S. industry groups.

Additional permanent modifications to U.S. farm programs may still be needed to fully comply with the "actionable subsidies" portion of the WTO ruling. The National Cotton Council (NCC) has been watching the U.S. policy response to this case very closely. The NCC is an industry group representing cotton producers, ginneries, warehousemen, merchants, cottonseed processors/dealers, cooperatives and textile

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<sup>11</sup> For details, see CRS Report RL32014, *WTO Dispute Settlement: Status of U.S. Compliance in Pending Cases*, by Jeanne J. Grimmett.

<sup>12</sup> USDA press release No. 0238.05, June 30, 2005. For more information on the implementation of USDA's risk-based fee structure, see [<http://www.fas.usda.gov/excredits/default.htm>].

<sup>13</sup> USDA press release No. 0242.05, July 5, 2005.

manufacturers. While the NCC has expressed interest in working with Congress in effecting a “fair and appropriate” response to the WTO case, in previous testimony to Congress the NCC leadership has also expressed interest in participating in the WTO’s rules-based international trading system and in maintaining an effective U.S. cotton program that complies with WTO rules.<sup>14</sup>

## Recent Developments

Brazil continues to undertake the procedural steps necessary to preserve its authority under the auspices of the WTO to retaliate in the event of noncompliance by the United States. However, Brazil has shown a willingness to permit the U.S. legislative process to make the changes needed to bring its farm programs into compliance with the WTO ruling, even if this process extends well beyond the deadlines established under the WTO dispute settlement ruling. For example, Brazil agreed to suspend retaliation arbitration for both the prohibited and actionable subsidy cases, partly because the U.S. proposal to eliminate the Step 2 cotton program signaled U.S. intentions to fully remove the prohibited subsidies, and partly due to the expectation that further changes to the actionable subsidy component of the U.S. cotton program would be reached as part of a negotiated solution under the Doha Round of WTO trade negotiations and that such changes would then be incorporated as part of the next U.S. farm bill.

In July 2006, the Doha Round talks were suspended indefinitely. Shortly thereafter, on August 21, 2006, Brazil submitted a request for a WTO compliance panel to review whether the United States has fully complied with panel and AB rulings. The United States blocked the WTO’s Dispute Settlement Body (DSB) from approving Brazil’s request on August 31, 2006; however, Brazil is expected to make a second request (which the United States will be unable to block) at the DSB meeting set for September 28, 2006. Under Article 21.5 of the Understanding on Rules and Procedures Governing the Settlement of Procedures, a compliance panel would have 90 days to reach a decision with the possibility of requesting an extension. A decision by the compliance panel could also be appealed and the AB also would have 90 days to reach a decision. If the compliance panel found that the United States has not fully complied with the AB rulings, Brazil could ask the WTO arbitration panel to resume its work, with a decision within 60 days, according to the U.S.-Brazil agreement on prohibited subsidies.<sup>15</sup>

U.S. failure to comply could result in WTO-sanctioned trade retaliation by Brazil against the United States. The U.S. response to the WTO cotton ruling is being watched closely by developing countries, particularly by a consortium of four African cotton-producing countries that has submitted its own proposal to the WTO calling for a global

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<sup>14</sup> Statement of Woody Anderson, then-chairman, National Cotton Council, before the U.S. Congress, House Committee on Agriculture, May 19, 2004; available at [<http://agriculture.house.gov/hearings/108/10829.pdf>].

<sup>15</sup> “Brazil to Ask for WTO Cotton Compliance Panel in September,” *Inside U.S. Trade*, Aug. 18, 2006; available at [<http://www.insidetrade.com>].

agreement to end all production-related support for cotton growers of all WTO-member countries.<sup>16</sup>

## Potential Effects to U.S. Agriculture of Proposed Changes

**Eliminating the Step 2 Program.** The Step 2 program channeled \$3 billion to the U.S. cotton industry during the 1996-2005 period.<sup>17</sup> In July 2005, USDA's chief economist, Keith Collins, suggested that ending the Step 2 program would result in slightly lower domestic prices — by two to three cents per pound — and higher export prices for U.S. cotton.<sup>18</sup> But he also anticipated that declines in producer prices would be likely to trigger an increase in counter-cyclical payments (CCP) to U.S. cotton farmers that would offset losses from lower prices. A December 2005 analysis by the Food and Agricultural Policy Research Institute (FAPRI) found a -1.3¢ decline in U.S. farm price and a 0.4¢ rise in international prices due to the elimination of Step 2 payments.<sup>19</sup>

**Changing GSM-102 and Terminating GSM-103.** In FY2004, about 11% of U.S. cotton exports were facilitated with export credit guarantees — FY2004 U.S. cotton exports were valued at \$4.5 billion, of which \$480 million were facilitated with GSM-102 export credit guarantees and another \$8 million relied on SCGP guarantees. Redesign of export credit guarantees (as discussed above) would likely have a small but negative effect on U.S. cotton exports, thus reinforcing the results of removing Step 2.

## Role of Congress

Ultimately, Congress is responsible for passing farm program legislation that complies with U.S. commitments in international trade agreements. The Step 2 program has already been permanently eliminated by a provision in the Deficit Reduction Act of 2005 (Sec. 1103, P.L. 109-171). Further statutory changes could be needed to eliminate the “subsidy” component of export credit guarantees as represented by the 1% cap on user fees. In addition, changes to those programs, specific to cotton, deemed part of the actionable subsidy ruling (i.e., CCP and marketing loan provision) would also necessitate legislative action. The legislation authorizing current farm programs is not set to expire until 2007. Senate Agriculture Committee Chairman Saxby Chambliss has said that he would review the Administration's proposal and work with industry and the Administration to identify the appropriate legislative solution for complying with the WTO ruling.<sup>20</sup>

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<sup>16</sup> For more information, see CRS Report RS21712, *The African Cotton Initiative and WTO Agriculture Negotiations*, by Charles Hanrahan.

<sup>17</sup> USDA, Farm Service Agency, Table 35-CCC, *Net Outlays by Commodity & Function*; available at [<http://www.fsa.usda.gov/dam/bud/bud1.htm>].

<sup>18</sup> “More Cotton Program Changes,” *Washington Trade Daily*, Vol.14, p. 131-132, Jul. 5-6, 2005.

<sup>19</sup> FAPRI, *Potential Impacts on U.S. Agriculture of the U.S. October 2005 WTO Proposal*, FAPRI-UMC Report #16-05, December 15, 2005.

<sup>20</sup> “USDA Calls for Repeal of Cotton Subsidy to Achieve WTO Compliance,” *Inside U.S. Trade*, July 8, 2005.