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The WTO Cotton Case and US Domestic Policy

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Once in a while, an event comes along that portends to reshape agricultural policy. Brazil's complaint in the World Trade Organization (WTO) against the United States on domestic support for cotton, export credit guarantees, and export subsidies could be one such event. (For background on the WTO, the dispute resolution process, and the specifics of the cotton case, see the Economic Research Service, http://www.ers.usda.gov/briefing/wto/, and Mercier, 2004). The initial ruling, however, was a mixed bag. The WTO dispute resolution panel did rule in favor of Brazil on most key points, and the appellate body report, released March 3, 2005, mostly confirmed the initial panel's rulings. The result of both could have serious implications for US farm policy.

The cotton case, or Dispute Settlement (DS) 267, has received considerable national and international attention. Whereas most agricultural issues (with the exception of bovine spongiform encephalopathy [BSE]) are, at best, relegated to the business section of the newspaper, the cotton case has been front-page news. Many popular press publications, including *The New York Times* and *The Wall Street Journal*, have made the case that the US government has exploited subsistence farmers around the world by lavishing subsidies on US cotton farmers. US cotton interests and some farm organizations have countered that as the 2002 farm bill was being developed, assurances were given to US policy makers that the farm bill provisions were compliant with WTO rules. In the world of international trade policy, however, nothing is assured. Many provisions within agreements are subject to interpretation. Here, we attempt to draw out the key complaints, findings, and economic arguments underlying the case and explore some implications for future directions in US farm policy.

The Key Complaints

To be successful, Brazil first had to establish that US subsidies exceeded agreed-upon limitations set in 1992. Brazil successfully argued that US production flexibility contract payments (PFCPs) and direct payments (DPs) were not eligible to be classified in the non-trade-distorting Green Box category due to planting restrictions on fruits and vegetables. The 1996 and 2002 Farm Bills restrict planting of fruits and vegetables on base acres,[1] which, the Brazilians argued, effectively ties direct payments to current production. The WTO panel ruled in favor of Brazil on this point, meaning that PFCPs and DPs were counted as Amber Box for this case. This finding, along with several others, meant that the United States had exceeded agreed-upon 1992 subsidy limits and was not entitled to Peace Clause protection, thus opening the door for Brazil to argue the remainder of its complaints. However, more importantly, this seemingly innocuous technical point may have more major long-run implications for US policy, which we discuss later in this article.

Brazil challenged four primary components of US agricultural policy. First, US domestic support for cotton causes "serious prejudice"[2] to Brazilian producers by depressing or suppressing the world price of cotton and results in a larger US share of the world cotton market. Second, US export credit guarantees are an export subsidy. Third, the Step 2 payments are both an export subsidy and an import substitution policy.[3] Finally, tax credits/deferrals given for cotton to US exporters amount to an export sub-

1. *Specifically, planting fruits and vegetables on base acres affects payments.*
2. *Serious prejudice occurs when a subsidy (a) displaces or impedes exports or imports, (b) results in significant price undercutting, suppression, or lost sales, or (c) results in an increase in the subsidizing country's market share.*

sidy. The United States attempted to limit the scope of the complaint to cotton, but Brazil successfully argued to include all other commodities in the argument related to export credit programs as well.

Ultimately, many of Brazil's claims hinged on the assertion that US cotton policies bestow excessive subsidies and depress world prices. This claim is important from a public relations perspective, because it is consistent with claims made by international watchdog groups (such as Oxfam and others) that US farm policy depresses world prices and has had significant adverse consequences for subsistence farmers in developing and less developed countries, where approximately 75% of the world's cotton is grown.[4] The United States provided some evidence that cotton prices actually increased by nearly 100% from 2001 to 2003, which hardly makes for good evidence of price depression. Further, a study by Texas Tech University in January 2004, using a world textile/cotton model, concluded that the elimination of all cotton subsidies by the United States will cause a short-term international cotton price increase of only 2.14% and that the price effects of such policy will quickly dissipate as other countries increase their production (Pan, Mohanty, Ethridge, & Fadiga, 2005).

Key Findings

Given the Peace Clause determination mentioned above, the WTO panel ruled on each claim in Brazil's case.[5] First, the panel found that export credit guarantees were export subsidies. For unscheduled commodities such as cotton and soybeans, these export subsidies are prohibited and must be removed. For scheduled commodities such as rice, the panel found that export credit guarantees were subsidies; inclusion of these in subsidy calculations meant that the United States had exceeded subsidy limits in several of the years in question. Despite this finding, however, the panel found that guarantees for both scheduled and unscheduled commodities did not constitute circumvention of US WTO reduction commitments. Additionally, the panel found that Brazil had failed to establish that tax credits to exporters were export subsidies.

Most importantly, the WTO panel found that key elements of the 1996 and 2002 farm programs, such as the marketing loan, countercyclical payments, market loss assistance, and Step 2, caused significant price suppression and serious prejudice to Brazil over the 1999–2002 period. However, the panel failed to find compelling evidence that US support programs would cause serious prejudice over the 2003–2007 period. Conversely, the panel found that other support programs, such as production flexibility contract payments, direct payments, and crop insurance, did not cause serious prejudice to Brazil. Interestingly, the panel did not rule on the issue of market share, because it could not agree on a sufficient definition of market share.

Step 2 payments to domestic users of cotton were ruled to be subsidies that favor the use of US cotton over imported goods. Step 2 payments to exporters are subsides contingent upon export performance and are therefore inconsistent with WTO rules. The Step 2 provisions must be modified or eliminated by July 1, 2005 for the United States to comply with obligations in the WTO. The Step 2 program has long been a popular tool in the US cotton program. However, from the WTO ruling one can clearly see that the Step 2 program has been successfully targeted by Brazil and must be significantly changed to remain in compliance.

In sum, the WTO panel found sufficient evidence to call for an immediate end to export credit guarantees (in their present form) and the Step 2 payments. The panel further found that these subsidies, or the effects of these subsidies, caused serious prejudice to Brazil and must be eliminated. Interestingly, however, the panel did not provide an indication of the *degree* of serious prejudice (i.e., the magnitude of the economic damage). Thus, the original ruling suggests that there are many issues related to US domestic agricultural

3. *The Step 2 payment is part of a three-step competitiveness program for US cotton. Because US cotton is often higher priced than world market prices, the Step 2 program paid the difference between world prices and US prices to both exporters and domestic users (we are, of course, simplifying the mechanics). The contention is that this program allowed exporters to sell cotton at prices consistent with world market prices and allowed domestic users to purchase US cotton at world market prices.*
4. *This amount is the percentage of world production outside of the United States, Australia, and the European Union.*
5. *The panel ruled on all major points except for the issue of increased market share. The lack of a ruling on increased market share is immaterial because it was ultimately not necessary for Brazil's case. There were numerous rulings and findings in the case, but we focus on the key elements here for clarity.*

policy that are to be considered in the future if the United States wishes to remain in compliance with WTO rules.

Both the United States and Brazil appealed different parts of the decision, but the appellate findings, released on March 3, 2005, upheld most of the relevant points in the initial panel's findings. Although some provisions of US farm policy will need to be changed in order to comply with the rulings, the implications for other program components are less clear—the panel provided no real guidance as to *what* must be changed or *how* it must be changed to be in compliance.

Policy Options and Consequences

There are a number of options available to the United States as a result of this decision. First, the United States can bring farm policy into full compliance with the rulings of the WTO. This approach requires some modification of the export credit guarantee and Step 2 programs by July 1, 2005, with other programs to be addressed in the near future. If Brazil is satisfied with the July 1 outcome, the process will end. However, if Brazil believes the United States has not complied with the ruling, Brazil can request the formation of a compliance panel, which will reexamine the steps taken by the United States. Thus, whatever is done by the United States must be accepted by Brazil and is subject to WTO review.

Second, the United States can partially comply by modifying some policies and compensating Brazil for maintaining other selected policies. The United States could comply with part of the ruling—Step 2 and export credit guarantee modifications, for example—but arbitrate with Brazil over compensation for marketing loan payments and countercyclical payments. This option would no doubt cause some countries to be less than satisfied, might undermine the effectiveness of the WTO, and could delay or derail progress in the Doha round of WTO negotiations currently underway. Brazil could impose tariffs, not necessarily on cotton or agricultural products, in amounts consistent with damages caused by the US policies.[6] Brazil is not obligated to place tariffs and must gain approval from the WTO for products and tariff rates. Although the WTO encourages that like products be dutied, this suggestion is not a requirement—possibly opening the door to industrial goods.

Finally, the United States could opt not to comply at all with the decision, in which case Brazil will be allowed to retaliate by imposing punitive tariffs on Brazilian imports of US products. Although this approach would reduce some US exports, imposing punitive tariffs would also raise the cost of imports to Brazilian consumers. More important, however, this option would almost certainly undermine the effectiveness of the WTO, reduce the ability of the United States to lead trade liberalization efforts, and stall or completely negate progress in Doha. If the United States took the position of complete noncompliance, Brazil would be more likely to seek compensation, because Brazil would view the US position as inflexible (not to mention illegal according to WTO rules).

Is Compliance the Likely Outcome?

There are at least three reasons for the United States to comply with the WTO rulings. First, as stated above, compliance sends a clear signal that the United States still intends to lead the trade liberalization agenda, thus providing substantial support to the Doha Development Agenda in the WTO negotiations. In fact, cursory observation of past WTO cases involving the United States suggests that the United States tends to comply with WTO rulings. Second, with respect to the Peace Clause determination, the United States is vulnerable to further litigation in cotton now that it has been established that subsidy reduction commitments were exceeded.[7] Although compliance will not completely insulate US farm programs from further litigation, compliance may make arguments of serious prejudice violations less valid

6. *Given the WTO panel's reluctance to provide an estimate of the economic damages in its initial ruling, these would have to be determined before tariffs could be placed. This begs the question of just how large the damages actually are. If one takes the Pan et al. (2005) study at face value, it would appear that the economic damages are relatively small (around 3%).*

7. *It should be noted that because the Peace Clause expired in 2003, all countries can now move straight to arguments about serious prejudice in other commodities without establishing Peace Clause violations first. The critical element here is that because the WTO panel deemed many US programs as trade distorting, they may have set a precedent that encourages other countries to seek remedy in the WTO. That process is very expensive, however, which may limit the number of suits brought against the United States.*

and nearly moot in multilateral negotiations.

Perhaps a more compelling reason is the potential for retaliatory tariffs. Figure 1 shows that cotton is the largest US agricultural export to Brazil. Of course, Brazil may choose to place tariffs on US cotton if compliance is not offered. However, as Figure 2 shows, agriculture is only a small portion of overall exports to Brazil, and Brazil is not obliged to place tariffs on cotton. In computers, for example, even a small tariff on this high-volume, low-margin industry could significantly damage US sales.

Brazil likely does not want to increase consumer prices by placing tariffs on key consumer goods. Moreover, political pressure from potentially affected industries in the United States will likely mount as well. Thus, US compliance seems the most likely course of action.

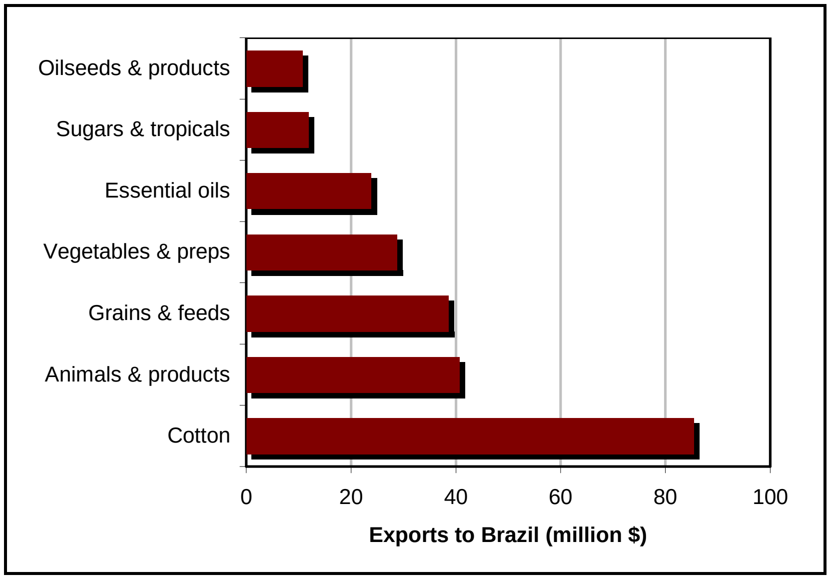

Figure 1. US agricultural exports to Brazil, 2004.

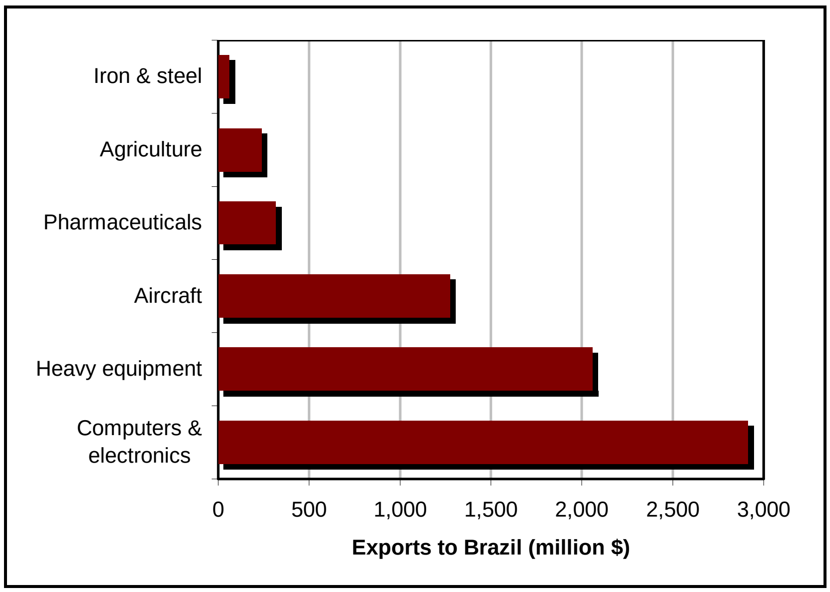

Figure 2. US product exports to Brazil, 2004.

Conclusions

The WTO case has focused attention and debate on the future direction of US farm policy. Although budgetary pressures have been mounting, Congress has so far not taken action to reduce the overall level of support to US agriculture, but farm program payments are seen as vulnerable nonetheless (Conley, 2005). At the same time, some farm groups (such as the National Corn Growers Association) have signaled a desire to move from supporting farm incomes to providing incentives for value-added product production (Tolman, 2005). The budgetary path in the short run is uncertain, but the WTO decision has provided ammunition for proponents of farm subsidy reductions and has provided longer-term political cover for politicians who would like to reduce farm support for budgetary or other reasons.

The WTO decision will not likely lead to a reduction in the overall level of farm program payments by itself, but may lead to a diversion out of traditional commodity payments into programs that can be deemed non-trade-distorting. If the United States is successful in arguing for a continuation of the Blue Box program in the Doha Development Agenda of trade negotiations and can move programs such as the PFCPs and countercyclical payments into that category, it will solve the short-term problem of Amber Box subsidy limit violations. However, any negotiated reductions in the aggregate measure of support (AMS) in the Doha Round will necessarily lead to overall reductions in total support. Any AMS reduction does not derive directly from the cotton case, but the findings of the cotton case certainly draw direct attention to the level of domestic support in the United States.

One clear signal sent by the results of DS 267 is that safety-net programs employing countercyclical components are under close scrutiny and likely to be unacceptable in the future. If this is the case, the countercyclical programs could be challenged by other countries and for other crops, even if these programs are modified and survive. This finding also raises the question of whether countercyclical payments will be allowed in the new Blue Box being negotiated in the Doha Development Agenda noted above.

The WTO looms large in the next fall bill debate. Although some farm groups are attempting to downplay the potential impact of the WTO cotton ruling on the future of farm policy, one must question how Congress will be able to ignore compliance issues and the costs of noncompliance as a new farm policy is formulated. Clearly, export subsidies will have to be eliminated, and export programs of any kind will be closely scrutinized to ensure compliance. More important is the fate of farm program payments. The US Trade Representative has clearly linked reductions in domestic support to market access to developing country markets in the Doha negotiations. Given that the United States is currently at or near agreed-upon subsidy limits in the current WTO, any additional reductions in the AMS negotiated through the Doha Round will necessitate overall reductions in farm program payments. Thus, discussion of which "box" payments go into may become only an interesting sideline discussion, with the more relevant issue being the total payments received by farmers.

US farm policy is formed in a dynamic setting. Agriculture is becoming an ever-shrinking share of the US federal budget; demographic trends make the population further removed from the farm and rural life. As international problems and goals consume more time and money, agriculture will increasingly become the residual claimant for federal resources. Agriculture may increasingly become the carrot for the United States to use in trade negotiations, because agriculture is a larger relative share of the economy of developing and less developed countries.

Although US agricultural tariffs are already among the world's lowest, its trade-distorting domestic farm support ranks near the top, along with the European Union and Japan. The farm programs of all three countries may be targets of challenge in the future. A successful conclusion to the Doha Round would likely mitigate this outcome, whereas failure in Doha will almost certainly ensure a future fraught with litigation.

For More Information

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