

## **The WTO's Cotton Subsidies Decision: The Agreement on Agriculture Takes a Bite Out of U.S. Agricultural Policy**

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### Introduction

As far back as Ricardo's shattering insight as to comparative advantage in 1817, agriculture has enjoyed special favor in trade.<sup>2</sup> The unique place of farming was so well established by the time the 1947 General Agreement on Tariffs and Trade (GATT) was negotiated that GATT's tight disciplines on government interference with free trade not only exempted government protections to growers, but in fact were drafted to be fully consistent with the agricultural policies of the major signatories.<sup>3</sup> While it would be an exaggeration to argue that GATT's first half century was without impact on agricultural benefits, the sector at any rate took center stage during negotiations to create the World Trade Organization (WTO), because by the time these talks began in 1986, subsidy-induced overproduction had led to widespread displacement of efficient producers from their traditional markets,<sup>4</sup> Many felt this result was far from realization of David Ricardo's compelling economic case for the smallest possible government intervention.<sup>5</sup>

While widely hailed for bringing agriculture – at last – under the GATT/WTO umbrella, 1995's Agreement on Agriculture more than lived up to the promise of Article 20 that “substantial ... reductions in support and protection resulting in fundamental reform is an ongoing process.” Both as to export subsidies – those contingent upon export performance and thus with the most direct impact on export prices and trade – and the remaining domestic subsidies, the Agriculture Agreement's ambitions are so modest

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<sup>2</sup> Melaku G. Desta, *THE LAW OF INTERNATIONAL TRADE IN AGRICULTURAL PRODUCTS* 6 (Kluwer 2002).

<sup>3</sup> Terence P. Stewart, *I The Uruguay Round: A Negotiating History* 134 (Kluwer 1993).

<sup>4</sup> Paul C. Rosenthal & Lynn E. Duffy, *Reforming Global Trade in Agriculture* 146 (ch. 5 in *The World Trade Organization*, Amer. Bar Assoc., Terence P. Stewart, ed.).

<sup>5</sup> See Alan O. Sykes, Jr., “Comparative Advantage and the Normative Economics of International Trade Policy,” 1 *J. Int'l Econ. L.* 57 (1998).

that many experts believed its generous exemptions and undefined terms rarely would permit successful reining in by dispute settlement panels of the nearly \$1 billion a day developed nations provide to their farmers.<sup>6</sup>

Two decisions issued by WTO dispute settlement panels on September 8, 2004, belie that prediction. In the first, a Panel reviewing the EU's Common Agricultural Policy held that the European Union had exceeded in both the amount of exports and the level of subsidies its agreed commitments on sugar.<sup>7</sup> In the other, a Panel found U.S. subsidies to upland cotton were sufficiently in excess of U.S. commitments under the Agriculture Agreement to be actionable under the Subsidies Agreement despite the protection of the "Peace Clause" of the Agreement on Agriculture. The *Cotton* Panel went on to find that these subsidies caused serious prejudice to world cotton growers within the meaning of the Subsidies Agreement.<sup>8</sup> Brazil, an agricultural superpower in its own right, was a complainant in both cases.

Not only is *Cotton* notable as the first WTO decision to find that domestic farm support caused injury, but the report is important because it also concluded that serious prejudice – and thus a WTO violation – was shown by the size and nature of the government benefits to the cotton industry in excess of Agriculture Agreement ceilings on the ground that they caused world prices to be suppressed. U.S. cotton producers received \$13.1 billion<sup>9</sup> in subsidies during the examined period of 1999 to 2003 for a crop valued at \$13.94 billion in those four years. The Panel's conclusions, if upheld by the WTO's Appellate Body, will have significant impact on agricultural policies for specialty and program crops of the United States, Europe, and Japan.<sup>10</sup>

### U.S. Cotton Support Programs as Non-Exempt Subsidies

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<sup>6</sup> N.Y. Times Apr. 28, 2004.

<sup>7</sup> *European Communities – Export Subsidies on Sugar*, Reports of the Panels, WT/DS265/R, WT/DS266/R, & WT/DS283/R (Oct. 15, 2004)(unofficial reports issued to the Parties Sept. 8, 2004).

<sup>8</sup> *United States – Subsidies on Upland Cotton*, Report of the Panel, WT/DS267/R (Sept. 8, 2004), *appealed by the United States* at Meeting of WTO Dispute Settlement Body (Oct. 18, 2004), at [http://www.wto.org/english/news\\_e/news04\\_e/dsb\\_18oct04\\_e.htm](http://www.wto.org/english/news_e/news04_e/dsb_18oct04_e.htm) (*Cotton Report*).

<sup>9</sup>In terms of the effect of cotton policy on U.S. producers, the dollar amounts of the transfer referred to by the Panel are not the true gain for U.S. producers. Using standard cost benefit criteria, the gain in producer welfare from cotton price supports for 2002 was in the neighborhood of roughly \$1.5 billion, while the amount for 2003 was much less at \$595 million.

<sup>10</sup> See "Final Cotton Decision Could Have Major Impact on U.S. Farm Policies," Inside U.S. Trade (June 25, 2004). Brazil must file its expected appeal by November 8, 2004, and the Appellate Body is to rule within 90 days thereafter, WTO Understanding on Rules and Procedures Governing the Settlement of Disputes arts. 16.4 and 17.5 (1994).

The WTO Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) creates strong prohibitions on export and import-substitution subsidies (prohibited or “red light”) and on domestic subsidies that injure competing industries (actionable or “yellow light”). Recognizing the place agriculture continues to occupy under trade rules, in the case of both types of government programs, the Subsidies Agreement defers to the Agriculture Agreement.<sup>11</sup> Export subsidies and import-substitution subsidies are prohibited “except as provided in the Agreement on Agriculture,” and domestic subsidies are actionable either through WTO disputes or national countervailing duty investigations, except for “subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture,” the so-called “Peace Clause” that exempted for the first nine years of implementation of the Agreement agricultural subsidies provided consistently with the Agreement’s terms. The Panel’s first task, then, was to evaluate whether U.S. Government benefits to cotton production and export met the Agriculture Agreement’s requirements. If so, the strictures of the Subsidies Agreement that govern state aid to all other products would not be relevant.

### Domestic Support

The Panel began with two programs the United States claimed were “green box” subsidies under Article 13(a) of the Agriculture Agreement – entirely exempt from reduction commitments because they have insignificant impact on trade. To qualify as green box subsidies, the benefit program must meet several criteria. The first and “fundamental” requirement is that they have “no, or at most, minimal trade-distorting effects or effects on production.” Such subsidies must provide support solely from publicly-funded government programs that do not involve transfers from consumers. Moreover, support must be decoupled from both prices and production and the program must meet the specific policy conditions set out by Annex 2 as to 12 different kinds of potentially eligible benefits, such as agricultural research, crop disaster assistance, income insurance, regional assistance, environmental programs, farmer retirement, and income support.<sup>12</sup> Even if the program meets all these conditions, a WTO Member may not claim green box status unless it has notified the WTO of the program, including any new or modified measure.<sup>13</sup>

Green box status carries important benefits to the granting government. Green box programs are neither subject to reduction commitments nor need be counted in a Member’s Aggregate Measurement of Support in base or subsequent years, which allows green box payments to grow without affecting the Member’s overall reduction

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<sup>11</sup> WTO Agreement on Subsidies and Countervailing Measures arts. 3.1 and 5.

<sup>12</sup> Agreement on Agriculture Annex 2.

<sup>13</sup> Agreement on Agriculture art. 18.2 & 18.3.

commitment. Most importantly, green box subsidies were exempt during the implementation period from both national countervailing duty investigations and WTO dispute settlement challenges.<sup>14</sup>

The two claimed green box subsidies, production flexibility contract payments (PFC) and their 2002 successor, direct payments (DP), provide support to producers of upland cotton and other commodities based on historical acreage and yields in order to support farming flexibility and certainty. Neither depends on current prices. To fall into the green box, direct payments to producers must be decoupled not only from prices, but payment amounts also must not be “related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.”<sup>15</sup> The Panel noted first that “in general,” payment amounts were not related to production volume or type, because program eligibility did not rely on actual production.

However, the Panel did not stop at this finding. Noting that although the producer had some flexibility because payments were not affected if no crop was planted, in fact the majority of producers did plant their acreage, and the programs provided that payments would be reduced if recipients planted fruits and vegetables, melons, tree nuts, or wild rice.<sup>16</sup> Given that fruits and vegetables and the other listed crops clearly are “types” of production, the fact that producers who planted any of the “prohibited” crops would find their payments reduced was enough to convince the Panel that payments were not entirely decoupled from production, in short, that the programs were in fact “related to” production.

The Panel’s evaluation did not rely on actual use of the land, but on the hypothetical “monetary incentive for payment recipients not to produce the prohibited crops,” which the Panel found could be significant in certain parts of the country.<sup>17</sup> In other words, even though the Panel acknowledged that the amount the producer received would not be affected in any way if the producer planted cotton, no matter how few or how many acres were grown, it found that flexibility and direct payments were coupled to production because a given farmer might grow a listed crop.<sup>18</sup> Planting cotton would

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<sup>14</sup>WTO Agreement on Subsidies and Countervailing Measures arts. 3.1 and 5.

<sup>15</sup>Agreement on Agriculture ¶ 6(b) of Annex 2.

<sup>16</sup>*Cotton Report* ¶¶ 7.385 and 7.388.

<sup>17</sup>*Cotton Report* ¶ 7.386.

<sup>18</sup>The United States cogently argued that, under this reasoning, a WTO Member could not even prohibit planting of opium poppy or other illegal crops, much less environmentally damaging production or unapproved biotech varieties. The Panel stated this issue was not before it. *Cotton Report* ¶¶ 7.360 & 7.373.

seem by far the most likely alternative for a cotton producer, particularly one concerned that future support programs might be based on more recent planting records.

The Panel's finding that PFC and DP payments are coupled with production is thus not only theoretical, because it is not based on actual use of the land, but it also relies on testimony by an official of the National Cotton Council that does not support the Panel's reasoning.<sup>19</sup> In our view, disqualifying the entire program from green box treatment for the potential that certain payments could be reduced is a broad reading of Annex 2's conditions, a step back from the reality of farm production, and a short-circuiting of the analytical process demanded by the treaty's terms. Under the Panel's reasoning, the PFC and DP programs thus failed the green box test and had to be considered with other domestic support under the "blue" or "amber" boxes of Article 13(b).<sup>20</sup>

To be exempt from the Subsidies Agreement under Article 13(b) of the Agriculture Agreement's Peace Clause, non-green domestic support measures provided "during the implementation period"<sup>21</sup> must "not grant support to a specific commodity in excess of that decided during the 1992 marketing year." In comparing the annual amounts provided from 1999 to 2002 by programs that "clearly and explicitly specified" cotton as a commodity to which they grant support<sup>22</sup> with the amount "decided"<sup>23</sup> during the 1992

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<sup>19</sup>In Note 511, the Panel seems to interpret the statement by then Council Executive Committee Chairman Robert McLendon to the House Committee on Agriculture that "I don't think we have a lot of farmers getting their payments and not working the land" as meaning that producers are constrained in the type of crops they can plant by the programs at issue. See *Cotton Report* at ¶ 7.386.

<sup>20</sup> In general, "blue box" subsidies are payments tied to output, acreage, or animal numbers that also require output limits, such as production quotas or land set-asides. For example, paying a rancher \$10 for every head of cattle not raised would be a classic blue box subsidy. Like green box payments, blue box programs are entirely exempt from reduction commitments, although no claim is made that such subsidies are without trade-distorting effects. Any subsidy that does not fit into the green or blue boxes automatically becomes an "amber" subsidy, such as price support payments. Non-*de minimis* amber box payments are subject to reduction commitments. See Raj Bhala, "World Agricultural Trade in Purgatory: The Uruguay Round Agriculture Agreement and Its Implications for the Doha Round," 79 N.D.L.REV. 693, 794-797 (2003).

<sup>21</sup> Evidence provided to the Panel by the parties covered only 1999 through 2002, and the Panel used this segment of the 1995 to 2004 "implementation period" to compare with MY1992. *Cotton Report* ¶ 7.538.

<sup>22</sup> The other programs were the PFC and DP programs previously found not to qualify for green box treatment, plus user marketing (Step 2) payments, the marketing loan program, counter cyclical payments, and marketing loan assistance payments. *Cotton Report* ¶ 7.518. The Panel curtly rejected U.S. arguments that the measures to be counted during the implementation period should include only "product-specific" payments, which would exclude the four programs that provide planting flexibility because they contain no requirement to produce. The Panel noted that the U.S. interpretation would treat several billion dollars in subsidies as not supporting any commodity at all. *Cotton Report* ¶¶ 7.519-7.520.

marketing year,” the Panel prepared Table 2:

**Table 2: Comparison of support in accordance with Article 13(b)(ii)**

<b>\$ million</b>	<b>MY1992</b>	<b>MY1999</b>	<b>MY2000</b>	<b>MY2001</b>	<b>MY2002</b>
Marketing loan programme	866	1761	636	2609	897.8
User marketing (step 2)	102.7	165.8	260	144.8	72.4
Deficiency payments	1017.4	0	0	0	0
PFC payments	0	616	574.9	473.5	436
MLA payments	0	613	612	654	0
DP payments	0	0	0	0	181
CCP payments	0	0	0	0	1309
Crop insurance payments	26.6	169.6	161.7	262.9	194.1
Cottonseed payments	0	79	184.7	0	50
<b>TOTAL</b>	2012.7	3404.4	2429.3	4144.2	3140.3

The Panel concluded from its calculations that the aggregate non-green box support during MY1992 was exceeded in each of the implementation period years under review and thus that none of these programs is exempted by the Peace Clause from the Subsidies Agreement.<sup>24</sup> As shown in the table, the \$2 billion in MY1992 subsidies were exceeded by MY1999-2003 subsidies in a range of \$2.4 billion to \$4.1 billion. The PFC/DP payments accounted for \$473 million to \$616 million of the excess. These programs, which were not in effect during the base year MY1992,<sup>25</sup> were argued by the United States to be exempt green box subsidies, but the Panel concluded they must be counted in the reduction commitment because they were not entirely decoupled from production. By far the largest program was marketing loans, which seeks to minimize potential loan forfeitures by providing interim financing to eligible producers and whose payments were substantially larger than the base year in all but MY2000 and accounted for \$32 million to \$1.74 billion of the excess in the three other comparison years.

#### Export Subsidies and Import-Substitution Subsidies

As noted, export subsidies (those conditioned on export of the product) and import-substitution subsidies (eligibility is met by purchasing a domestic product rather than an imported one) for agricultural products are prohibited by the Subsidies Agreement “except as provided in the Agreement on Agriculture.” Article 8 of that Agreement

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<sup>23</sup> The Panel found this “curious usage,” as compared with amounts actually granted, to mean the particular payments decided upon during MY1992. *Cotton Report* ¶¶ 7.434 and 7.452.

<sup>24</sup> *Cotton Report* ¶¶ 7.597 and 7.608.

<sup>25</sup> It goes without saying that any program brought into effect after MY1992 will, by definition, be in excess of that provided for that program during the base year.

prohibits export subsidies that exceed the reduction commitment specified for a particular product by the particular Member, as well as any export subsidies for products not listed in the Member's schedule. The United States has no scheduled commitment for upland cotton, so any U.S. export subsidy provided for cotton is by definition prohibited by the Agriculture Agreement. The only U.S. argument, then, was that the programs at issue were not, in fact, export subsidies. The Panel first looked at user marketing (Step 2) payments, a special marketing loan provision for upland cotton that provides marketing certificates or cash payments domestic users and exporters of eligible cotton when market conditions result in U.S. cotton pricing benchmarks being exceeded. In essence, Step 2 payments are used to compensate U.S. cotton exporters and millers for their purchase of higher-priced U.S. cotton.

In looking at Step 2 payments to cotton exporters, the Panel used the broader definition of export subsidies in the Subsidies Agreement to find that such payments indeed were conditioned upon export of the product, despite U.S. arguments that payments also could be made to domestic users under the same program and that Step 2 must be examined as a whole as a benefit to cotton "users," not with respect to any particular payment. In the Panel's view, payments in one set of circumstances may not be ignored just because payments in other discrete segments of the program are not conditioned on export.<sup>26</sup>

As to Step 2 payments to domestic users of cotton, the Panel determined this segment of the program constituted an import-substitution subsidy, also prohibited under the Subsidies Agreement, because "the measure explicitly requires the use of domestically produced upland cotton as a pre-condition for receipt of the payments."<sup>27</sup> Because the Agriculture Agreement's Peace Clause does not even attempt to protect import-substitution subsidies from action under the Subsidies Agreement, Step 2 payments to domestic users are illegal under that Agreement.<sup>28</sup>

The Panel next turned to export credit guarantee programs (GSM 102, GSM 103, and the Supplier Credit Guarantee Program), which aim to increase exports of agricultural commodities to compete against foreign agricultural exports by guaranteeing the repayment of credit extended to finance export sales. Looking again to the Subsidies Agreement for guidance, the Panel examined whether premiums charged under these programs were adequate to cover long-term operating costs and losses.<sup>29</sup> The principal

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<sup>26</sup> *Cotton Report* ¶¶ 7.700, 7.708, & 7.720.

<sup>27</sup> *Cotton Report* ¶ 7.1085.

<sup>28</sup> *Cotton Report* ¶¶ 7.1050 & 7.1097.

<sup>29</sup> *Cotton Report* ¶ 7.763, relying on Item (j) in Annex I to the Subsidies Agreement. The Panel rejected the U.S. contention that Article 10.2 of the Agriculture Agreement, which binds Members to work

argument was over the treatment of rescheduled debt, but the parties did not disagree that losses for the programs, which include dairy cattle, were at least \$630 million in the past decade, and thus these programs had operated as prohibited export subsidies during 1999-2002.

Significantly for other crops, the Panel's finding in this respect is not limited to cotton, despite U.S. arguments that Brazil's claim reached only export guarantees for cotton.<sup>30</sup>

The final subjects of the Panel's analysis were user marketing (Step 2) payments to domestic users, which as noted the Panel previously had found to be import substitution subsidies within the meaning of Article 3 of the Subsidies Agreement. Noting that the Agriculture Agreement's Peace Clause made no mention of import substitution subsidies, the Panel concluded that these types of subsidies were not shielded from the disciplines of the Subsidies Agreement.<sup>31</sup>

As export credit guarantees, the GSM 102/103 and the Supplier Credit Guarantee Programs are prohibited by the Subsidies Agreement. The user marketing (Step 2) payments to exporters is also a prohibited export subsidy and its payments to domestic users was found to be an import substitution subsidy, also a prohibited subsidy. As to each of these programs found to be prohibited, the Panel, in accordance with Article 4.7 of the Subsidies Agreement, the Panel recommended that the programs be withdrawn "without delay," which the Panel specified in these circumstances to be no later than July 1, 2005.<sup>32</sup>

### Serious Prejudice

Having found both export and domestic U.S. cotton support programs not immunized by the Agriculture Agreement, the Panel reached Brazil's claim that U.S. cotton subsidies violate Article 5 of the Subsidies Agreement, which provides that "No Member should cause, through the use of any subsidy ..., adverse effects to the interests of other Members, i.e., ... serious prejudice ...." Article 6.3(c) defines "serious prejudice" to include the case where "the effect of the subsidy is a significant price undercutting by

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toward development of internationally agreed disciplines to govern export credit guarantees, meant that export credit guarantee programs were not disciplined by the Agreement's present terms at all. The Panel noted that the Subsidies Agreement's definition of export subsidies, which explicitly includes export credit guarantees, was intended by the Agriculture Agreement's drafters to be used to define export subsidies and that the Agreement's drafters did not carve out an exception for such programs. *Cotton Report* ¶ 7.911.

<sup>30</sup> *Cotton Report* ¶¶ 7.55, 7.69, 7.764, & 7.869.

<sup>31</sup> *Cotton Report* ¶ 7.1050.

<sup>32</sup> *Cotton Report* ¶ 8.3.



the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market.” Brazil alleged that U.S. subsidies caused serious prejudice to Brazil’s interests during the 1999-2002 marketing years by significantly suppressing upland cotton prices in the Brazilian, world, and U.S. markets.<sup>33</sup> The Panel began its inquiry by finding that Brazilian and U.S. upland cotton compete “in the same market,” which Article 6.3(c) does not limit geographically and can mean a world market where, as here, conditions of competition for sales from both countries are similar.<sup>34</sup> This initial finding laid the foundation for the Panel’s examination of world cotton prices as the measure of serious prejudice by satisfying the first of four conditions set by Article 6.3(c): (1) in the same market as the subsidized product – U.S. cotton – and a like product of another Member– Brazilian cotton,<sup>35</sup> (2) the effect of the subsidy is (3) significant (4) price suppression.

### Price Suppression

The Panel found three factors relevant to its determination whether price suppression (which it defined to mean that prices either are prevented or inhibited from rising, i.e., prices do not increase when otherwise they would have<sup>36</sup>) had occurred: (a) the relative magnitude of U.S. production and exports in the world upland cotton market; (b) general price trends; and (c) the nature of the subsidies at issue, in particular whether they have discernible price suppressive effects.<sup>37</sup> As to the first factor, the Panel noted that because the United States held a substantial proportion of world production (about 20% during MY1996-2002)<sup>38</sup> and export markets (from a 23% to 40% world share during this period) for upland cotton, it exercised “substantial proportionate influence on prices in the world market.”<sup>39</sup>

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<sup>33</sup> *Cotton Report* ¶ 7.1108.

<sup>34</sup> *Cotton Report* ¶¶ 7.1240 and 7.1248.

<sup>35</sup> The Panel quickly disposed of squabbles regarding the “like product,” concluding that the “subsidized product” and the “like product of another Member” was, in both instances, upland cotton lint. *Cotton Report* ¶7.1221.

<sup>36</sup> *Cotton Report* ¶ 7.1277.

<sup>37</sup> *Cotton Report* ¶ 7.1280.

<sup>38</sup> Although the United States argued that only serious prejudice in 2002, the last year for which complete data were available, was relevant, the Panel found that given its examination of subsidies over a period of time, “a recent historical period ... provides a more robust basis for a serious prejudice evaluation than merely paying attention to developments in a single recent year”, especially because “the market may well already be distorted in a given year due to subsidies.” *Cotton Report* ¶ 7.1199.

<sup>39</sup> *Cotton Report* ¶¶ 7.1281-7.1285.

Turning to global price trends, the Panel first, in the words of National Cotton Council CEO Dr. Mark Lange, “dismissed the outlandish economic model results offered by Brazil’s economic expert,”<sup>40</sup> which had found that *but for* U.S. cotton subsidies, world cotton prices would have been 12.6 per cent (6.5 cents per pound) higher during MY1999-2002.<sup>41</sup> As Dr. Lange noted, the Brazilian results had been undermined in recent studies by Texas Tech and by FAO, both of which found minimal U.S. impacts on world prices. The Panel observed that Brazil’s and 13 other studies submitted by the United States and third parties had reached the common sense conclusion that removal of certain U.S. subsidies would lead to a change in world prices and “attributed to them the evidentiary weight we deemed appropriate.”<sup>42</sup> Using a chart submitted by the parties at the Panel’s request based on a composite of price sources, the Panel noted a “broad decline in the overall level of these price trends from 1996 to January 2002, with intermittent peaks and valleys,” but a clear decline during that period and an increase after the period.<sup>43</sup> To determine whether these prices were suppressed, the Panel looked to subsidies that are price-suppressive by nature.

The Panel noted that four of the subsidies were directly linked to world market prices (the marketing loan program, Step 2 user marketing payments, marketing loss assistance payments, and counter-cyclical payments). Under the marketing loan program, which seeks to minimize loan forfeitures by providing interim financing, the Panel concluded from its chart of subsidy payments that the further the “world price drops, the greater the extent to which United States upland cotton producers’ revenue is insulated from the decline, numbing United States production decisions from world market signals” and thus “enhancing production and trade-distorting effects.”<sup>44</sup> Having earlier concluded that it need not quantify the subsidies at issue because it was not engaged in a countervailing duty review,<sup>45</sup> the Panel pointed to information in the record that marketing loan subsidies over the period were in a “very large amount.”<sup>46</sup>

The same descriptor was used for the user marketing (Step 2) program, whose

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<sup>40</sup> Quoted in “National Cotton Council Disagrees with WTO Ruling Against U.S. Subsidies,” Inside U.S. Trade (Sept. 8, 2004).

<sup>41</sup> *Cotton Report* ¶¶ 7.1202 and 7.1205.

<sup>42</sup> *Cotton Report* ¶¶ 7.1212 and 7.1215.

<sup>43</sup> *Cotton Report* ¶ 7.1288.

<sup>44</sup> *Cotton Report* ¶ 7.1294.

<sup>45</sup> *Cotton Report* ¶ 7.1179.

<sup>46</sup> *Cotton Report* ¶ 7.1297.

payments to exporters increased demand for U.S. cotton and whose payments to producers raised the price they received and thus stimulated production. In the case of payments both to exporters and producers, the amount of the subsidy is directly linked to world market prices and thus “affects the world market generally.”<sup>47</sup> Similar findings were made as to the remaining price-contingent MLA and counter-cyclical payments.<sup>48</sup>

In a signal of the importance the Panel would continuously accord to the price-contingent nature of a subsidy and its relation to world prices, it found that the remaining subsidies – direct payments, crop insurance,<sup>49</sup> and production flexibility contract payments – while they enhance producer wealth and lower risk aversion, nonetheless should not be aggregated with price-contingent subsidies because they are “more directed at income support” and “their price-suppression effects are not as easily discernible as” the four programs it had decided to aggregate.<sup>50</sup> Noting that “neither party ... disputes the proposition that suppressed world prices may follow from an increased supply being infused on the world market,” that the world cotton price from MY1998 to MY2002 fell about 30 per cent from its 1980 to 1998 average, and that U.S. and world market prices are closely linked, the Panel found that price suppression had indeed occurred in the “same” world market within the meaning of Subsidies Agreement Article 6.3(c).<sup>51</sup>

### Significance of the Price Suppression

Recall that Subsidies Agreement Article 6.3(c)’s definition of serious prejudice is met only if the price suppression is “significant,” another undefined term which the Panel treated in a possibly-oversimplified manner as meaning “important, notable, or consequential.” In an analysis reminiscent of its examination of whether price suppression existed in the first place, the Panel returned to the same elements it had considered decisive for that element, that is, the relative magnitude of U.S. production and exports, the overall price trends in the world market, the price-contingent nature of the four programs, and the “readily available evidence of the order of magnitude of the subsidies.” In effect, the Panel’s single finding of price suppression sufficed as well for

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<sup>47</sup> *Cotton Report* ¶ 7.1300.

<sup>48</sup>Market loss assistance are *ad hoc* emergency and supplementary assistance provided to producers in order to make up for losses sustained as a result of recent low commodity prices. Counter-cyclical payments provide support to producers based on historical acreage and yields. *Cotton Report* ¶¶ 7.216 & 7.223.

<sup>49</sup>Crop insurance protects against losses caused by natural disasters or market fluctuations. *Cotton Report* ¶ 7.227.

<sup>50</sup> *Cotton Report* ¶¶ 7.1305 and 7.1307.

<sup>51</sup> *Cotton Report* ¶¶ 7.1309-7.1312.

its pivotal conclusion that Brazilian producers faced “significant” suppression of world prices. Without citing to or likely using any economic data, the Panel opined that “a relatively small . . . suppression of prices could be significant” for a widely traded commodity such as upland cotton, because profit margins may be narrow, sales likely are price sensitive, and the market is large.<sup>52</sup> Thus the Panel turns “a relatively small” price effect into significant price suppression. And even this modest finding it makes by reasoning in the negative: “we are certainly not, by any means, looking at an insignificant or unimportant world price phenomenon.”<sup>53</sup>

### Causal Link Between Subsidies and Price Suppression

Having found several domestic and export subsidies to violate the Subsidies Agreement, as well as significant price suppression in the world market for cotton, the Panel next examined whether the price suppression was caused by the subsidies, essentially of course an attribution exercise. While the Panel did not find in the Subsidies Agreement articles in question the need to separate effects “to a precise degree,” as would have been required under the Anti-Dumping or Safeguards Agreements,<sup>54</sup> the Panel nonetheless found a causal link based on four factors.

As it had in finding price suppression, and its significance, the Panel cited the substantial proportionate influence that the United States exerts in the world cotton market, and the fact that four of the support programs were linked directly to world market prices.<sup>55</sup> This latter factor was so important to the Panel, as it had been several times before, that it refused to aggregate the remaining subsidies that were not price-tied. Third, the Panel found a temporal coincidence between the subsidies and suppressed world prices. Over the same period that the subsidies were being granted, U.S. cotton producers generated large supplies while their revenue – and world market prices – declined. Even taking account of lower production from the 1998 drought and higher yields from 2001, the connection between price suppression and the increase in U.S. exports is clear.<sup>56</sup> Finally, the Panel found that production costs and revenues were not convergent, indicating that cotton producers would not have been economically capable of remaining in the market but for the subsidies.<sup>57</sup>

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<sup>52</sup> *Cotton Report* ¶ 7.1332.

<sup>53</sup> *Cotton Report* ¶ 7.1332.

<sup>54</sup> *Cotton Report* ¶ 7.1344.

<sup>55</sup> *Cotton Report* ¶¶ 7.13248 and 7.1349.

<sup>56</sup> *Cotton Report* ¶ 7.1352.

<sup>57</sup> *Cotton Report* ¶ 7.1353.

As to U.S. arguments that the strong U.S. dollar has had an inverse effect on the world price of cotton, which is traded internationally in U.S. dollars, the Panel noted that the U.S. share of the export market rose dramatically at the same time the dollar appreciated during MY1999-2001, because U.S. cotton producer revenue is effectively sheltered from currency and price developments. As to China's release of millions of bales of government stocks at low prices between 1999 and 2001, while the Panel agreed that this event inevitably would exert downward pressure on world prices, it noted that U.S. exports were much larger than China's over this period and that China's action had no actual effect either on U.S. production or on its exports, which were maintained or increased over the period.<sup>58</sup> The meaning of the Panel's findings in this section are clearly that the U.S. effect on the market simply overshadowed the non-subsidy effects, and causation was thus established.

### Panel's Use of Economic Data

Brazil's challenge relies heavily on the work of Daniel Sumner, an agricultural economist from the University of California at Davis, who found that, for the period 1999-2002, U.S. cotton subsidies caused world prices to drop roughly by 18 percent. Sumner's economic model did not include the additional effect on world prices of U.S. water subsidies. Another study, the so-called Texas model, which covered only 2003 and also did not include water subsidies, showed that U.S. cotton subsidies caused less than a five percent drop in world prices. The cotton model developed here at the University of Florida, which included water subsidies, found that for the period 2002 world cotton prices were impacted by approximately 14 percent as a result of the U.S. farm program. For 2003, the impact was much less at about six percent.<sup>59</sup>

Our economic analysis suggests that U.S. cotton subsidies are trade-distorting, which supports the claim made by Brazil. Inexplicably, however, it appears that the Panel did not use the results from formal economic modeling, but instead seems to rely on U.S. Department of Agriculture published cost of production data for cotton produced in the United States. These data clearly show that, in the absence of price supports, U.S. cotton production could not be sustained at current levels. As noted, the Panel provides little or no basis for its conclusions either that U.S. cotton subsidies caused price suppression or that such suppression was significant.

### Implications for Specialty Agriculture

The United States immediately signaled not only that it will appeal, but that if

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<sup>58</sup> *Cotton Report ¶¶ 7.1360-7.1361.*

<sup>59</sup>"The Multiplicative Effect of Water Subsidies and Support Payments: The Case of US Cotton" (Rossi, Schmitz, and Schmitz, 2004)

unsuccessful, it believes that some of the issues addressed by the Panel would better be handled in the ongoing Doha Round talks on agriculture. Brazil quickly voiced disapproval with the notion of handling these issues through negotiations rather than by timely implementation of the Panel ruling by the United States.<sup>60</sup> Of course the United States opposes paying the price demanded by the Panel without extracting some compensation in return, particularly from Europe. The EU, however, whose views on agriculture are formidable in the WTO, is unlikely to be supportive of the U.S. approach, because the EU decided at least in theory last year to decouple from production over time most Common Agricultural Policy payments, so the decision could have minimal impact on the CAP in the longer term.<sup>61</sup> After their central role in collapse of the September 2003 WTO Ministerial Conference in Cancun, cotton subsidies have been targeted expressly by WTO Members in their August 1, 2004, decision to activate anew the Doha Round negotiations. As to agriculture, despite the U.S. proposal to handle cotton as part of the overall negotiations, the decision states:

“The General Council recognizes the importance of cotton for a certain number of countries and its vital importance for developing countries, especially LDCs. It will be addressed ambitiously, expeditiously, and specifically within the agriculture negotiations.”<sup>62</sup>

The WTO offers elaborate financial penalties to coerce compliance with Panel rulings. If the losing Member fails within a reasonable period of time to bring its laws into compliance with the Panel’s findings (or those of the Appellate Body following an appeal, as in this case), the winning Member may retaliate by imposing prohibitive tariffs on imports from the losing country in the amount of the trade lost as a result of the WTO-inconsistent measure.<sup>63</sup> While these counter blows do not immediately benefit the industry harmed by the violating measure (here, Brazil’s cotton producers), strong political pressure from the innocent exporters now suffering from high tariffs often will

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<sup>60</sup> “WTO Issues Landmark Ruling Against U.S. Cotton Subsidies,” WTO Reporter Sept. 9, 2004, p. 4 (BNA).

<sup>61</sup> “EU Official Sees No Threat to Farm Subsidies from WTO Ruling on Cotton,” WTO Reporter June 24, 2004 (BNA).

<sup>62</sup> See Terence P. Stewart, “The Ongoing Global Trade Talks Latest Decision – An Initial Assessment” at 2 (Aug. 9, 2004), on file with author.

<sup>63</sup> WTO Understanding on Rules and Procedures Governing the Settlement of Disputes art. 22. For example, since July 1999, the United States and Canada have imposed increased tariffs on a number of imported products from Europe in the amount of US\$ 117 million and CDN\$11 per year following the EC’s failure to revise its ban on hormone-fed beef in accordance with the WTO Appellate Body Report in *EC – Measures Concerning Meat and Meat Products (Hormones)*, WTO/DS26 & 48/AB/R (adopted Feb. 13, 1998). See “EU requests WTO to confirm that there is no justification for US/Canada to continue to apply sanctions,” EC Press Release (Nov. 8, 2004), available at [http://europa.eu.int/comm/trade/issues/respectrules/dispute/pr081104\\_en.htm](http://europa.eu.int/comm/trade/issues/respectrules/dispute/pr081104_en.htm).

cause the losing Member to implement the Panel's recommendations. Brazil's course of action thus will bring strong pressure on the U. S. Congress to make changes to the last three years of the latest farm bill, the Farm Security and Rural Investment Act of 2002. That push, if the Panel is substantially upheld by the WTO Appellate Body, will come from industries threatened by the EU's ability to impose offsetting tariffs on U.S. exports to compensate for the WTO-inconsistent cotton subsidies.

The Peace Clause expired in any event at the end of 2003, so additional payments until the expiration of the farm bill in 2007 will be subject to national CVD investigations as well as WTO dispute settlement system challenges based not on which of the amber, blue, or green boxes the Agriculture Agreement would place them in, but based on whether they meet the definition of a "subsidy" and have adverse trade effects within the meaning of the Subsidies Agreement,<sup>64</sup> at least until such time as the Agriculture Agreement is amended as part of the Doha Round of multilateral negotiations.<sup>65</sup> One may speculate whether the Congress was aware of this exposure when it passed the 2002 farm bill, as well as whether the Congressional committees could have foreseen the Cotton Panel's interpretation of the Peace Clause's outer boundaries.

The Panel's decision not to quantify non-exempt subsidies made even less reviewable and more subjective its conclusion that price suppression existed in the first place and even more so that it was "significant." By this approach, the Panel also avoided the need to specify what economic data, if any, underlie its conclusions. **The authors are aware of no present economic model or data that would [necessarily] [directly] support this "but for" test.** To a certain degree, of course, all subsidies have market insulating effects, which makes the question of degree – which the Panel discounts – critical in the serious prejudice equation. The Panel took several such short cuts, including its finding that any potential reduction in PFC or DP payments through planting of listed crops automatically excludes the entirety of both programs from green box treatment. Actually reviewing the extent of such payment reductions may have revealed that the planting of listed crops was insignificant enough to be regarded as *de minimis* for purposes of the production decoupling requirement of the Agriculture Agreement for direct payments to farmers. One may also question the Panel's ready conclusion that the simple prohibition of planting of certain crops, for example, to reduce agricultural overproduction, a goal both the Agriculture and Subsidies Agreement would seem to applaud, should disqualify a direct payment program from the green box on the basis of this indirect, even incidental, "coupling" with production.

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<sup>64</sup> John R. Magnus, *The Evils of a Long Peace: Legal Consequences of a WTO "Peace Clause" Expiry and Practical Issues for New Litigation Over Farm Subsidies*, at n. 2 (quoting testimony of then U.S. Trade Representative Charlene Barshefsky as to expiration of the Peace Clause) & 8, Presentation to Global Business Dialogue (Dec. 4, 2003), copy on file with author.

<sup>65</sup> Stewart, *supra* note 56, at 5.

The most striking use of short cuts, and likely the element of the Panel's analysis that if upheld will have the most far-reaching effects, is the ease with which the Panel was able to find price suppression, the key element in its determination that U.S. cotton programs caused serious injury to Brazil's cotton growers. The Panel quickly found that marketing loan payments, counter-cyclical payments, and Step 2 payments were inherently price-suppressive because the amount of payments was directly linked to world prices. As the world price fell, payments increased, with the effect of erasing market signals that ordinarily would result in decreasing production. Despite some 330 pages devoted to findings and conclusions, that is the essence of the Panel's analysis. This brevity most certainly would not have been countenanced by the Appellate Body if it had been performed by the U.S. International Trade Commission in determining injury<sup>66</sup> and is all the more surprising in light of the abundance of relevant information on the record to which the Panel repeatedly cites,<sup>67</sup> yet refuses to use to underpin its conclusion. The lack of a quantitative standard was most apparent in this aspect of its decision. Without explicitly accepting any of the estimates submitted by the parties, the Panel relied on the relative magnitude of U.S. production and exports – “we are certainly not, by any means, looking at an insignificant or unimportant world price phenomenon.” The U.S. appeal keys in on this lack of “basic rationale behind its findings.”<sup>68</sup>

We may properly disagree with the Panel's refusal to develop a quantitative standard for determining whether the effect of such subsidies was “significant” and, in effect for collapsing the game-determining search for the significance of price suppression into the examination of its very existence, because the Panel used precisely the same factors to reach both conclusions. On the other hand, it is more difficult to find fault with the Panel's conclusion that price-based support programs most directly impact world prices. Income support programs tied to neutral non-price criteria, while they may also increase production to levels that could not have been sustained without the subsidy, are unlikely to have such easily discernible effects on prices. Payments that rise or fall with cotton prices undeniably insulate producers from market signals, regardless of the merit of the program's benchmarks.

We should also keep in mind that the Subsidies Agreement does not, as this case vividly demonstrates, require proof that subsidies resulted in a *decrease* in world prices.

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<sup>66</sup> See, e.g., *United States – Safeguard Measures on Imports of Fresh, Chilled, or Frozen Lamb Meat from New Zealand and Australia*, WT/DS177 & 178/AB/R ¶¶ 162 *et seq.* (adopted May 16, 2001), and *United States – Anti-Dumping Measures on Certain Hot-Rolled Steel Products from Japan*, WTO/DS184/AB/R ¶¶ 223 *et seq.* (Jul. 24, 2001).

<sup>67</sup> For example, *Cotton Report* ¶¶ 7.1297, 7.1300, 7.1306, and 7.1308.

<sup>68</sup> *United States – Subsidies on Upland Cotton*, Notification of an Appeal by the United States, WTO/DS267/17, at 4 (Oct. 20, 2004).



As noted, price suppression, one of the triggers of a “serious prejudice” finding along with the more familiar price undercutting or depression, requires a finding that prices were not rising as fast as they would have risen absent the subsidies. Price suppression can be found even if prices generally are in an upward trend, which is not the familiar situation we imagine for proof of injury. And in contrast to a finding of price undercutting, the standards for making this “but for” determination are greatly more subjective and dependent on the opinion of the panel members. As noted, the authors know of no existing economic model or data that [directly] [independently][necessarily] would support the Panel’s reasoning as to price suppression.

Unless the Appellate Body disagrees, the United States will be under strong pressure to repeal its agricultural export credit guarantee programs by July 2005, long before Doha Round negotiations would require such result. This will have direct effect on any other crop eligible for such guarantees, because the Panel’s finding was not limited to export guarantees for cotton.

Any support program for any crop that limits planting of alternative crops, such as the PFC and DP payments, is vulnerable to challenge under the Panel’s reasoning that such a limitation constitutes a tie to production. DP payments are available under the same restrictions for rice, soybeans, wheat, corn, and other crops, which makes payments to producers of these commodities vulnerable if the Panel’s reasoning here stands. More importantly to specialty agriculture, if DP or similar green box support cannot discourage planting of alternative crops (because, for example, domestic demand is being met by existing production), downward price pressure increasingly will be exerted on fruit and vegetable, tree nut, melon, and wild rice production.<sup>69</sup> The United States will attempt to convince the Appellate Body that conditioning the amount of a payment on the production undertaken by the producer, which is not the case under DP, is not the same thing as banning a DP recipient from producing certain crops, which is what DP does.

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<sup>69</sup>The authors are beholden to Stanford University Food Research Professor Timothy Josling for highlighting this implication.