WTO Appellate Body rules against USA in the Cotton Dispute Case

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In a recent ruling of significance for the evolving agricultural trade regime, a WTO Appellate Body (AB) has supported all major findings of an earlier WTO panel report which concluded that US cotton subsidies were in violation of WTO rules. At issue are 'product flexibility contracts' (PFC), 'direct payments' (DP), 'export credit guarantees' and 'step 2 marketing payments'. In a report dated March 3 2005, the Appellate Body has confirmed that certain US subsidies given to cotton farmers, such as 'product flexibility contracts' (PFC) and 'direct payments' (DP) are production and trade-distorting in nature and therefore cannot be categorized as permissible 'decoupled payments.' The AB has also supported the conclusion of the Panel Report that 'export credit guarantees' and 'step 2 marketing payments' offered to US cotton producers are prohibited export subsidies and they should be abolished with immediate effect.

In its recommendation the Appellate Body has directed the Dispute Settlement Body to request the United States to bring its measures, found to be inconsistent with the Agreement on Agriculture and the Subsidies and Countervailing Measures Agreement, into conformity with USA's obligations under those Agreements. This verdict by the WTO Appellate Body is the culmination of an ongoing dispute between USA and a number of developing countries, including Brazil, about subsidies given by US to its cotton farmers. Estimates by Brazil indicate that in 2002-03, USA has given US $4.8 billion as subsidies to the cotton sector and according to these estimates, resultant overproduction and dumping of cotton by developed countries have driven cotton prices down to a very low level and thereby has negatively affected cotton exporting countries from the developing world.

Export Support Programmes That Came Under Scrutiny

Production flexibility contract ('PFC') payments, which were replaced in 2002 by direct payments, provided support to owners or producers, based on historical acreage and yields for seven commodities, including cotton.

The 'step 2' programme pays US cotton producers the difference between the domestic cotton price and the world market price to ensure that their cotton can be sold profitably in international markets

Export credit guarantee programmes enable US exporters to offer more attractive financial packages to buyers than those offered by commercial institutions. Because this confers an advantage, the difference between commercial terms and those offered under ECGs is considered an export subsidy. Taken together, US export credit guarantees constitute by far the largest agricultural export credit programme in the world, with a minimum of $5.5 billion per year allocated under the 2002 Farm Bill. Over the past decade, ECGs have financed exports worth nearly $34 billion.

Source: Dumping: the Beginning of the End? Implications of the Ruling in the Brazil/US Cotton Dispute., Oxfam Briefing Paper.

If one recalls, one of the highlights of the Cancun Ministerial meet was a debate about how high subsidies given to cotton farmers by developed countries are adversely affecting cotton exporters from some West African countries. Benin, Burkina Faso, Chad and Mali pointed out that as a result of subsidies given to cotton in richer countries, exports of these four West African countries have suffered. They argued that subsidies given to farmers in developed countries induce overproduction of cotton in those countries. This surplus cotton is dumped in the

international market at an artificially cheap rate. Excess supply of cotton is driving down the prices in the international market. Data show that between 1997 and 2002, international prices of cotton have declined by 39 percent and cotton prices in 2002 were at a 30 year low. Declining international prices of cotton and increasingly lower price realization from cotton exports is hurting cotton exporters from developing countries. The problem is more acute for Benin, Burkina Faso, Chad and Mali because cotton is the main cash crop as well as the most important source of export revenue for these four countries. Based on the discussions in the Ministerial, the WTO issued a draft ministerial declaration which, in its paragraph 27, included some proposals about the cotton initiative. However, the draft ministerial text ignored the concerns of developing countries and closely reflected the US approach towards the cotton sector. The draft did not include any firm commitment on reducing domestic and export subsidies for cotton. It was also imprecise and vague about the treatment of US domestic and export subsidies for the cotton sector. Due to the failure of the Cancun Ministerial, no constructive ministerial declaration was finalized and the draft proposal which contained the controversial paragraph on cotton initiative was rejected. It is notable here that in the "framework" text of the so-called July package it has been declared that cotton will be addressed "ambitiously, expeditiously and specifically" within the agriculture negotiations. A sub-committee has been formed to work on "all trade-distorting policies affecting the sector", in all three key areas of the agriculture talks — the "three pillars of market access, domestic support, and export competition".

As a parallel initiative, in September 2002, the Government of Brazil disputed the legal status of such subsidies under WTO and requested consultations with the Government of the United States about prohibited and actionable subsidies provided to producers, users and exporters of upland cotton in USA. Consultations were held on 3, 4 and 19 December 2002 and on 17 January 2003, but failed to settle the dispute. Subsequently, Brazil filed a case against US cotton subsidies under the Dispute Settlement mechanism of WTO in February 2003.

In its submission to the WTO (WT/DS267/R), Brazil argued that at the core of this case are $12.9 billion of US subsidies for upland cotton for the years 1999-2002. According to Brazil, these subsidies increase and maintain the production of high-cost US upland cotton, increase US cotton exports, suppress US, world and Brazilian prices and lead to the United States having a more than equitable share of world export trade. Brazil has also established that the US subsidies between 1999 and 2002 caused significant price suppression of cotton in the international market. Brazil alleged that these US subsidies are inconsistent with various provisions of the Agreement on Agriculture (AoA), the Agreement on Subsidies and Countervailing Measures (SCM) and the GATT.

The submission of Brazil also highlighted some interesting facts. The submission showed that in spite of steady decline of prices of cotton over the last few years, US planted acreage of cotton has increased. The paper argued that without the US subsidies, many US upland cotton producers would have to switch to crops providing a higher market return or take marginal land out of production. Estimates published in the submission show that without subsidies, US acreage and production of cotton would fall considerably. In addition to falling US production, the removal of US subsidies would also result in significant reductions in US exports contributing to increased world prices. Calculations show that for the period 1999-2002, in absence of subsidies, US exports of cotton would fall from the annual actual average exports of 8.62 million bales by

41.2 per cent to 5.07 million bales. This reduction of 3.55 million bales represents 13.4 per cent of the total average world export market between 1999 and 2002. The paper argues that given the relatively inelastic demand for upland cotton, the 13.4 per cent decrease in the supply of cotton to the world export market would have led to an increase of cotton prices in the international market.

A Panel was established on 18 March 2003 to consider claims by Brazil regarding various support measures given by USA to its cotton sector that allegedly constituted actionable subsidies. The WTO Panel report on this dispute, which was issued on 8 September 2004, ruled mostly in favour of Brazil and recommended that prohibited US subsidies are to be withdrawn "without delay". The Panel came to the conclusion that US payments to farmers, under Product Flexibility Contract (PFC) and Direct Payments (DP) are trade distorting domestic supports. The panel also ruled that 'export credit guarantees' and 'step 2 marketing payments'[1] given by US to its cotton producers were prohibited export subsidies and had to be withdrawn "without delay", that is, at the latest within six months of the date of adoption of the panel report or by 1 July 2005. The ‘Conclusion and Recommendations’ section of this Panel report is given in the Appendix.

On 18 October 2004, the United States notified the DSB of its intention to appeal against some of the conclusions reached by the Panel. The USA appealed to the WTO Dispute Settlement Body and in its submission to the WTO (WT/DS267/17, dated 20 October 2004) sought a "review by the Appellate Body of the Panel's legal conclusion that certain U.S. decoupled income support measures - that is, production flexibility contract payments under the Federal Agricultural Improvement and Reform Act of 1996 ("1996 Act"), direct payments under the Farm Security and Rural Investment Act of 2002 ("2002 Act"), and "the legislative and regulatory provisions which establish and maintain the [direct payments] programme" - are not exempt from actions under Article 13(a) of the Agreement on Agriculture."

As mentioned before, the Appellate body ruled mostly in favour of Brazil and upheld all the major conclusions of the earlier Panel Report. Taken together, the recommendations and conclusions of the AB and the Panel Report can have far reaching implications for future trade disputes. Apart from giving a much tighter interpretation of permissible agricultural subsidies (blue and green box subsidies), it appears that a long standing question whether agricultural subsidies should be dealt with under the SCM agreement has also been resolved. The Panel report has made it clear that the SCM is applicable to agricultural products and the obligations under the SCM run parallel to the AoA provisions. This is an important verdict as the expiry of the Peace Clause[2]will allow many countries to initiate countervailing measures against subsidized agricultural exports. It is also worth highlighting here that this ruling is the first ever to target domestic agricultural subsidies in the WTO.

The WTO verdict against USA has been received with cautious optimism. The Bridges Weekly newsletter points out that while West African cotton producing countries Benin, Burkina Faso, Chad and Mali welcomed the ruling and urged the US to implement the decision in time for the WTO's Hong Kong Ministerial Conference, Oxfam, has expressed concern over statements by US government officials that say that no major reforms may be needed to comply with the cotton ruling. It remains to be seen what actual steps USA will take to comply with the WTO ruling, but

the verdict has paved the way for more actions against other agricultural products like sugar and tobacco which also receive heavy subsidy in developed countries.

APPENDIX

UNITED STATES - SUBSIDIES ON UPLAND COTTON

Report of the Panel

I. CONCLUSIONS AND RECOMMENDATIONS

1.1 In light of the findings above, we conclude as follows:

(a) Article 13 of the Agreement on Agriculture is not in the nature of an affirmative defence;

(b) PFC payments, DP payments, and the legislative and regulatory provisions which establish and maintain the DP programme, do not satisfy the condition in paragraph (a) of Article 13 of the Agreement on Agriculture;

(c) United States domestic support measures considered in Section VII:D of this report grant support to a specific commodity in excess of that decided during the 1992 marketing year and, therefore, do not satisfy the conditions in paragraph (b) of Article 13 of the Agreement on Agriculture and, therefore, are not exempt from actions based on paragraph 1 of Article XVI of the GATT 1994 or Articles 5 and 6 of the SCM Agreement;

(d) concerning United States export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programmes:

(i) in respect of exports of upland cotton and other unscheduled agricultural products supported under the programmes[3], and in respect of one scheduled product (rice):

- United States export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programmes are export subsidies applied in a manner which results in circumvention of United States' export subsidy commitments, within the meaning of Article 10.1 of the Agreement on Agriculture and they are therefore inconsistent with Article 8 of the Agreement on Agriculture;

- as they do not conform fully to the provisions of Part V of the Agreement on Agriculture, they do not satisfy the condition in paragraph (c) of Article 13 of the Agreement on Agriculture and, therefore, are not exempt from actions based on Article XVI of the GATT 1994 or Articles 3, 5 and 6 of the SCM Agreement;

- United States export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programmes are provided by the United States government at premium rates which are inadequate to cover long-term operating costs and losses of the programmes within the meaning of item (j) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement, and

therefore constitute per se export subsidies prohibited by Articles 3.1(a) and 3.2 of the SCM Agreement.

(ii) however, in respect of exports of unscheduled agricultural products not supported under the programmes[4]and other scheduled agricultural products:

- the United States has established that export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programmes have not been applied in manner which either results in, or which threatens to lead to, circumvention of United States export subsidy commitments within the meaning of Article 10.1 and that they therefore are not inconsistent with Article 8 of the Agreement on Agriculture;

- in these circumstances, and as Brazil has also not made a prima facie case before this Panel that the programmes do not conform fully to the provisions of Part V of the Agreement on Agriculture, this Panel must treat them as if they are exempt from actions based on Article XVI of the GATT 1994 and Article 3 of the SCM Agreement in this dispute.

(e) concerning section 1207(a) of the FSRI Act of 2002 providing for user marketing (Step 2) payments to exporters of upland cotton:

(i) section 1207(a) of the FSRI Act of 2002 providing for user marketing (Step 2) payments to exporters of upland cotton is an export subsidy, listed in Article 9.1(a) of the Agreement on Agriculture, provided in respect of upland cotton, an unscheduled product. It is, therefore, inconsistent with the United States' obligations under Articles 3.3 and 8 of the Agreement on Agriculture;

(ii) as it does not conform fully to the provisions of Part V of the Agreement on Agriculture, it does not satisfy the condition in paragraph (c) of Article 13 of the Agreement on Agriculture and, therefore, is not exempt from actions based on Article XVI of the GATT 1994 or Articles 3, 5 and 6 of the SCM Agreement;

(iii) section 1207(a) of the FSRI Act of 2002 providing for user marketing (Step 2) payments to exporters of upland cotton is an export subsidy prohibited by Articles 3.1(a) and 3.2 of the SCM Agreement.

(f) concerning section 1207(a) of the FSRI Act of 2002 providing for user marketing (Step 2) payments to domestic users of upland cotton: it is an import substitution subsidy prohibited by Articles 3.1(b) and 3.2 of the SCM Agreement;

(g) concerning serious prejudice to the interests of Brazil:

(i) the effect of the mandatory price-contingent United States subsidy measures - marketing loan programme payments, user marketing (Step 2) payments, MLA payments and CCP payments -- is significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement;

(ii) however, Brazil has not established that:

- the effect of PFC payments, DP payments and crop insurance payments is significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement; or

- the effect of the United States subsidy measures listed in paragraph 7.1107 of Section VII:G of this report is an increase in the United States' world market share within the meaning of Article 6.3(d) of the SCM Agreement constituting serious prejudice within the meaning of Article 5(c) of the SCM Agreement.

(h) concerning the ETI Act of 2000:

(i) Brazil has not made a prima facie case before this Panel that the ETI Act of 2000 and alleged export subsidies provided thereunder are inconsistent with Articles 10.1 and 8 of the Agreement on Agriculture in respect of upland cotton;

(ii) with respect to the condition in Article 13(c)(ii) of the Agreement on Agriculture, as Brazil has also not made a prima facie case before this Panel that they do not conform fully to the provisions of Part V of the Agreement on Agriculture in respect of upland cotton, this Panel must treat them as if they are exempt from actions based on Article XVI of the GATT 1994 and Article 3 of the SCM Agreement in this dispute.

1.2 Under Article 3.8 of the DSU, in cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered prima facie to constitute a case of nullification or impairment. We conclude that, to the extent that the United States has acted inconsistently with the covered agreements, it has nullified or impaired benefits accruing to Brazil under these agreements.

1.3 In light of these conclusions:
(a) we recommend pursuant to Article 19.1 of the DSU that the United States bring its measures listed in paragraphs 8.1(d)(i) and 8.1(e) above into conformity with the Agreement on Agriculture;

(b) as required by Article 4.7 of the SCM Agreement, we recommend that the United States withdraw the prohibited subsidies in paragraphs 8.1(d)(i) and 8.1(e) above without delay. The time-period we specify must be consistent with the requirement that the subsidy be withdrawn "without delay". In any event, this is at the latest within six months of the date of adoption of the Panel report by the Dispute Settlement Body or 1 July 2005 (whichever is earlier);

(c) pursuant to Article 4.7 of the SCM Agreement, we recommend that the United States withdraw the prohibited subsidy in paragraph 8.1(f) above without delay and, in any event, at the latest within six months of the date of adoption of the Panel report by the Dispute Settlement Body or 1 July 2005 (whichever is earlier); and

(d) we recall that, in respect of the subsidies subject to our conclusion in paragraph 8.1(g)(i) above, pursuant to Article 7.8 of the SCM Agreement:
"7.8 Where a panel report or an Appellate Body report is adopted in which it is determined that any subsidy has resulted in adverse effects to the interests of another Member within the meaning of Article 5, the Member granting or maintaining such subsidy shall take appropriate steps to remove the adverse effects or shall withdraw the subsidy."

Accordingly, upon adoption of this report, the United States is under an obligation to "take appropriate steps to remove the adverse effects or ... withdraw the subsidy".

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[1] Under the 'step 2' programme, US cotton producers are paid the difference between the domestic cotton price and the world market price to ensure that their cotton can be sold profitably in foreign markets.

[2] The Agreement on Agriculture contained a “due restraint clause” or “peace clause”. Peace Clause states that permissible domestic subsidies cannot be subject to countervailing duties during the implementation period, and that other ("amber") domestic support and export subsidies are subject to Countervailing (CV) action only if a determination of injury or threat thereof is established as per the Subsidies and Countervailing Measures agreement. The ‘Peace Clause’ provided special immunity to subsidy providers in AoA. However, the Peace Clause has expired in 2004.

[3] As indicated supra, Section VII:E, paragraph 7.875, referring to Exhibit BRA-73, to the extent they are within our terms of reference and within the product scope of the Agreement on Agriculture.

[4] i.e. unscheduled agricultural products, to the extent they are within our terms of reference and within the product scope of the Agreement on Agriculture, other than those indicated supra, Section VII:E, paragraph 7.875.