

4. WTO Complaints by Brazil Against US Cotton Subsidies

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1. Introduction

On the 27th of September 2002, Brazil requested consultations with the Government of the United States in connection with US subsidisation of its domestic cotton industry. Zimbabwe, India and Argentina have submitted requests to join the consultations. Brazil itemises 12 types of measure which it considers to be inconsistent with the WTO obligations of the US, alleging that these are prohibited and actionable subsidies provided to US producers, users and exporters of upland cotton, which seriously prejudice the interests of Brazil. Brazil says that these subsidies result in significant price depression and price suppression in Brazilian and other markets, displacement or impediment of Brazilian cotton exports to third countries, and an increase in the US world share of the upland cotton market. Further, it says that these measures create mandatory conditions that will continue to suppress prices and foster US over-production that will continue to displace and impede Brazilian exports.

The immediate motivation for the Brazilian claim against US subsidies is the enactment this year of the 2002 Farm Act, which increases government payments to American agricultural producers. The 2002 Act modifies and expands existing programs under the 1996 Farm Act to ensure that the US government provides substantial income support to farmers, including cotton producers, into 2007. The increase in US subsidisation comes at an inopportune time, as negotiations under the Doha Development Agenda face difficult issues in regard to the liberalisation of trade in agricultural products. The increase in US support flies in the face of US commitments to progressively reduce subsidies, and undermines the confidence of developing countries which are reliant on such reduction commitments for improved access to the markets of developed nations.

The policy basis of the claim is clear. The legal situation is somewhat more complex, given the simultaneous application of the SCM and Agriculture Agreements of the WTO, and the 'peace clause', which requires Members to restrain from action against each other's agricultural subsidies until after the end of 2003.

By focusing on inequalities at the centre of global agricultural trade, the Brazilian challenge against US subsidies may have wider implications for the

Doha Agenda agriculture negotiations. The dispute will address the role of production subsidies and associated export dumping in driving down world prices, and their potential to undermine the trade prospects of developing countries where they would otherwise enjoy a comparative advantage. The questions are central to the economic well-being of many of the world's developing nations.

2. The challenged measures

Brazil requests consultations in regard to all US subsidisation of the US upland cotton industry. First, it refers generally to domestic support subsidies and export subsidies provided during 1999–2002, subsidies contingent on the use of US upland cotton, and all trade-distorting domestic support measures that are not 'green-box subsidies' under the WTO Agreement on Agriculture (see below), and are thus subject to reduction commitments.

Secondly, Brazil targets specific domestic support and export subsidies provided under a number of pieces of itemised US legislation, the primary one being the new *US Farm Security and Rural Investment Act of 2002* ('FSRIA' or '2002 Farm Act'), followed closely by its predecessor, the *1996 Federal Agriculture Improvement and Reform Act* ('FAIR Act' or the '1996 Farm Act'). The 2002 Farm Act supports farmers through three main commodity programs:

- direct income payments;
- 'counter-cyclical' payments that provide benefits whenever the effective price of the commodity is less than its 'target price'; and
- marketing assistance loans and loan deficiency payments.

Measures which provide for subsidies relating to crop disaster and insurance are identified under the Agricultural Risk Protection Act of 2000 and Brazil also challenges 'subsidies' provided under the Extraterritorial Income Exclusion Act of 2000, the Agricultural, Rural Development, Food and Drug Administration and Related Agencies Appropriations Acts of 1999, 2000, 2001 and 2002 and the Crop Year 2001 Agricultural Economic Assistance Act.

Targeted export measures include those under the Agricultural Trade Act of 1978 and the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ('ETI Act') and other programs which facilitate the export of US upland cotton. Export measures include export subsidies, exporter assistance, export credit guarantees, export and market access enhancement, and the 'Step 1 and Step 2' certificate programs under the 1996 Farm Act.

Lastly, Brazil includes a catch-all claim against any export or domestic subsidies provided under secondary legislation or administrative procedures and any measures, existing or future, that implement any of the measures previously listed.

3. The claim: serious prejudice

The claim of Brazil is a comprehensive one: that virtually all US cotton subsidies, in the form of domestic assistance, support for exports, and payments contingent on use of domestic goods, violate the WTO agreements on Agriculture and the SCM Agreement. The overarching assertion is that the challenged domestic and export subsidies are ‘actionable’ under the SCM Agreement because they have caused serious prejudice to the interests of Brazil, while export subsidies are *prima facie* prohibited by the SCM Agreement. Remedies for these complaints entitle Brazil to both countervailing duty action and dispute settlement proceedings under the SCM Agreement.

The catch is that each of these claims is subject to provisions of the Agreement on Agriculture which exempts agricultural subsidies from action by other Members until the end of 2003. Brazil claims that while both types of subsidies are maintained on agricultural products, neither conforms sufficiently to the requirements of the Agriculture Agreement to benefit from this ‘peace clause’.

Lastly, Brazil claims that government payments contingent on the use of domestic over imported cotton offend the WTO requirement on national treatment, which requires that imports be treated no less favourably than domestic products.

Actionable subsidies: ‘serious prejudice’

Brazil claims that the US has, through the use of subsidies, caused serious prejudice to its interests, in violation of Article 5(c) of the SCM Agreement. Both domestic support measures and export subsidies can be actionable under this head. Brazil argues firstly that all the relevant criteria have been met to demonstrate that the measures are in fact ‘subsidies’ under the Agreement, and then points to Article 6.3 of the SCM Agreement, which says that serious prejudice may arise where the effect of a subsidy is to displace or impede the imports or exports of the like product of another Member.

Brazil says that the US subsidies have caused serious prejudice by depressing or suppressing upland cotton prices in Brazil and displacing or impeding exports of Brazilian cotton in third country markets. It claims that the effect of the subsidies has been to increase the US world market share in upland cotton in 2001 as compared to the average market share during the 3 prior years, and this follows a consistent trend which has resulted in an overall increase of 23.3% (from 16.7 to 20.6 %) during the period from 1985 to 2001.

The actions or remedies available on grounds of ‘serious prejudice’¹ include a dispute settlement procedure which is new to the SCM Agreement², and the

¹ While ‘actionable subsidies’ also include those that cause ‘injury to the domestic industry’ or ‘nullification and impairment of benefits accruing under GATT 1994’, Brazil focuses here on ‘serious prejudice to the interests of another Member’.

² SCM Agreement, Article 7.

parallel Part V countervailing duty procedure, an elaboration of that set out in GATT Article VI. Imposition of countervailing duties requires a national investigation to demonstrate that the subsidies have caused injury to the domestic industry, a ground not pursued by Brazil in this proceeding.

4. The ‘peace clause’: exemption for agricultural subsidies

Even if Brazil is able to provide sufficient evidence to show that ‘serious prejudice’ has been caused, the whole SCM action could be thwarted if the US successfully invokes the requirement of ‘due restraint’ on challenges against agricultural subsidies set out in Article 13 of the Agreement on Agriculture. The SCM Agreement repeatedly subjects its provisions to those of the Agreement on Agriculture. Express references to Article 13 of the Agreement on Agriculture, which exempts agricultural subsidies from action under the SCM Agreement, can be found in Articles 5, 6.9 and 7.1; a more general caveat in relation to application of the Agriculture Agreement is set out in relation to the prohibition of export subsidies³, and, in the provision for countervailing duty actions⁴.

Under the Article 13 ‘peace clause’, Member states have agreed that until the end of 2003 they will not challenge each others’ agricultural subsidies, as long as the measures conform to the terms of the Agriculture Agreement. Separate provisions regarding conformity apply to domestic support measures⁵ and export subsidies⁶.

4.1 Domestic support measures

According to the peace clause, there are two bases on which domestic support measures for agricultural products will be exempt from actions under the SCM Agreement and the GATT. If the measures are ‘green box’ measures that conform to Annex 2 requirements, they are:

- non-actionable for the purposes of countervailing duties,
- exempt from challenge as ‘actionable’ subsidies causing injury, nullification and impairment or serious prejudice under GATT and the SCM Agreement, and
- exempt from ‘non-violation’ actions based on nullification and impairment of tariff concessions⁷.

³ Agreement on Agriculture, Article 3.

⁴ Ibid, Article 10.

⁵ Agreement on Agriculture, Article 13(a) and (b).

⁶ Ibid, Article 13(c).

⁷ Ibid, Article 13(a).

If the measures are ‘amber box’ trade-distorting measures and they are being reduced in accordance with Article 6 of the Agreement on Agriculture and the Member’s scheduled commitments⁸, then they are:

- exempt from countervailing duties unless there is a finding of injury,
- exempt from challenge as ‘actionable’ subsidies, *provided that* they don’t grant a specific commodity support in excess of ‘that decided during the 1992 marketing year, and
- exempt from ‘non-violation’ actions based on nullification and impairment of tariff concessions⁹.

These provisions raise two issues. The first is whether the subsidy in question is a green box measure which is not subject to reduction, or an ‘amber box’ measure which is considered trade-distorting and subject to reduction. The second is whether the amber box support for upland cotton exceeds that decided during the 1992 marketing year.

4.1.1 ‘Green’ or ‘amber’?

The two basic criteria for green box measures are that they must be funded through a government program that does not involve transfers from consumers, and may not have the ‘effect’ of providing price support to farmers. Green box also requires that eligibility for payments be determined in relation to a defined and fixed base period; and the amount of such payments in any year must not be related to the type or volume of production, market prices, or to input factors used in production, in any year after the base year. As a result, whether or not an income support program is truly ‘decoupled’ within the meaning of the Agreement on Agriculture can be a matter of debate and each of the challenged provisions will have to be addressed separately by a panel in order to make the appropriate determination.

- *Direct income payments* to farmers are the least coupled of the programs under the Farm Act 2002, but may influence production through wealth and investment effects. Provisions for updating base acreage and program yields may also have some influence on current production choices if farmers expect future legislation will again allow them to update these items for their farms¹⁰. Direct payments are calculated annually by way of a fixed payment rate for each crop for

⁸ Under the Agriculture Agreement, WTO Members are required to reduce their annual levels of amber box domestic support (‘aggregate measurement of support’ or ‘AMS’) by reference to a ‘Base Total AMS’ calculated for each Member over a specified period. Developed countries, including the United States, were required to reduce their total AMS by 20% during the period 1995 to 2000, while developing countries are committed to a reduction of 13.33% over the 10-year period from 1995 to 2004. US amber box domestic support is currently capped at a maximum US\$19.1 billion for about 2 million farmers (\$9,950 per farmer), as compared to US\$60 billion for the EU’s more than 7 million farmers (\$8,571 per farmer).

⁹ Ibid, Article 13(b).

¹⁰ *The 2002 Farm Act: Provisions and Implications for Commodity Markets*, Economic Research USDA, 2002, 17.

the entire life of the Act, and are in theory not affected by current production or by current market prices. Direct payments are based on 'historical' acreage and yields, although the new Act increases commodity rates and gives farmers an opportunity to upgrade the registration of their 'historical' acreage to reflect their current operations.

The 'decoupling' process was started under the 1996 Farm Act, to encourage farmers to respond to market forces and backed by a safety net in the form of a marketing loan and loan deficiency program. The 1996 Farm Act fixed total expenditure levels for each fiscal year and payment levels were allocated among contract commodities according to percentages specified in the Act. Eligible farmers obtained the annual payment by enrolling acreage in a 7-year 'production flexibility contract' that obliged the farmer to meet certain conservation compliance requirements. In exchange, farmers were largely freed from restrictions on what they could plant, giving rise to the name '*Freedom to Farm Bill*'¹¹.

Arguably, the 2002 Act 'recouples' subsidies to production by linking payments to recent output levels based on a 1998-2001 reference period and an updated registration of the acreage on which farmers' annual income payment is based. Direct payments are tied to acreage, so these benefits will be capitalised into farmland values, thereby increasing aggregate producer wealth. These payments may change production somewhat if the changes in wealth influence farmers' perception of the risks associated with production alternatives¹². The requirement that the acreage be subject to agricultural use, and the fact that direct payments are not available for fruits, vegetables and other crops may also influence production decisions for crops such as cotton.

- *Marketing assistance loans and loan deficiency payments* are linked to the volume of farm production and fall into the amber box category. Commodity loan programs allow cotton producers to receive a government loan at a commodity-specific rate per unit of production by pledging production as loan collateral. After harvest, a farmer may obtain a loan for all or part of the new commodity production.

¹¹ Ironically, the decoupling provisions of the 1996 Act were implemented during a period of near-record high prices, resulting in a significant increase in US domestic farm support over what would have been paid on the basis of the previous commodity-specific deficiency payments relative to current market prices. The policy change reflected in the Act ended abruptly with a sharp decline in market prices starting in 1998. US Congress responded by providing 'temporary' emergency bailouts over a four year period to compensate farmers in a total amount of about US\$ 30 billion over and above the domestic support payments provided for in the Act.

¹² *The 2002 Farm Act: Provisions and Implications for Commodity Markets*, Economic Research USDA, 2002, 17.

Alternatively, loan program benefits can be taken directly as loan deficiency payments. Farmers may choose to receive marketing loan benefits through direct loan deficiency payments when market prices are lower than commodity loan rates. This option allows the producer to receive the benefits of the marketing loan program without having to take out and subsequently repay a commodity loan. Commodity certificates can be purchased at the loan repayment rate for loan commodities. The certificates are available for producers to immediately exchange for crop collateral pledged to the Commodity Credit Corporation for a commodity loan. Under the 2002 Farm Act loan rates were increased for most eligible commodities and the program expanded to include others.

- The *counter-cyclical payments* were designed to replace and effectively lock-in 'temporary' emergency bailouts that were used to supplement payments under the *Farm Act of 1996* for the period 1998 to 2001. This new program provides price-dependent benefits for covered commodities, triggering payments whenever the effective world price for cotton is less than its target price, as established by the Act. Payments are based on historical area and yields and are not tied to current production of the covered commodity. Nevertheless, because they are linked to world prices, they may fall into the amber box.

4.1.2 *Support that 'exceeds that decided during 1992'*

Even if all of the challenged measures are 'amber box', they will be exempt under the peace clause as long as they are being reduced in accordance with the US commitments under the Agriculture Agreement, and do not exceed support for cotton as 'decided during the 1992 year'. The second question is therefore whether the support granted in facts exceeds that decided during the 1992 marketing year. Notably Brazil does not argue that the US has failed to comply with its aggregate reduction commitments under Article 6, nor that it has exceeded its Annual Bound Commitment level for any year. Instead it focuses on the level of specific commodity support and argues that because the subsidisation is 'excessive' the peace clause does not protect it. The argument is that the US cannot use Article 13 as a defence to the claim of serious prejudice, because the subsidies grant support to a particular commodity (upland cotton) in marketing years 1999-2002 'in excess of the support decided by the United States in the 1992 marketing year'.

The issues here relate to what figures are to be used to make this calculation. The legal merits of Brazil's assertion are difficult to assess, mainly because the legal criteria for exemption in Article 13(b)(ii) are themselves unclear. What does it mean that measures shall be exempt from SCM actions, provided

that they do not subsidise a specific commodity 'in excess of *that decided during the 1992 marketing year*'¹³? Is the intention of the provision to establish a high watermark for support, where individual commodities are concerned? If so, who is to have 'decided' the upper limit? Is it a total annual measurement of support that we are claiming is excessive, or an average measurement over some undefined period? Brazil has claimed that US subsidies over a 3 year period exceed 'support decided by the US during 1992'. The language of Article 13 is 'decided during', not 'provided during' the 1992 marketing year. If the cap is to reflect national commitments made during the 1992 year, why is there no reference to the Members' Schedules?

The identification of the correct measurement of support, 'decided during the 1992 marketing year' is crucial to Brazil's case. This is a matter for clarification of the panel and is itself a justifiable reason to pursue this case on behalf of developing states. Further, Brazil must have in hand sufficient evidence to show that US 'amber box' domestic support exceeds the established figure.

Brazil's claim on this point, whether or not it achieves the desired result, will have the immense benefit for all WTO Members, but especially for developing countries, of testing the language of the Agreement on Agriculture, and interpreting and clarifying it for the benefit of future negotiations and trade relations.

4.2 *Export subsidies*

Subsidies contingent on export performance, or on the use of domestic over imported goods, are prohibited generally by Article 3 of the SCM Agreement. Export subsidies are also 'actionable', along with measures of domestic support, under Articles 5 and 6. Brazil claims that payments provided to exporters of US upland cotton under the 'Step 2' program of the 1996 and 2002 Farm Acts are prohibited export subsidies and actionable under the SCM Agreement. It also asserts that US export credit guarantees, export and market access enhancement provided under the Agricultural Trade Act of 1978 and other programs are, as applied and as such, prohibited export subsidies, and actionable.

The questions raised by these claims are whether the challenged measures are export subsidies at all, and, if so, whether they conform sufficiently to the Agriculture Agreement reduction commitments to exempt them from action under the SCM Agreement and the GATT 1994.

4.2.1 *'Export subsidies'?*

Whether the challenged programs are export subsidies depends on whether

¹³ Agreement on Agriculture, Article 1 (b) (ii).

they are ‘subsidies contingent on export performance’, including those set out in Article 9 of the Agriculture Agreement¹⁴.

- *Step 2* payments are provided to both exporters of US cotton and to domestic mills using US cotton, with the alleged aim of bringing US internal prices into line with the international price¹⁵. Whether these payments are export subsidies does not turn on an indiscriminate application of benefits to both exporters and domestic users of cotton. If payments are contingent on export¹⁶, or contingent on the incorporation of cotton into exported products¹⁷, they are export subsidies subject to reduction commitments.
- The *Export Credit Guarantee Program* enables importers to borrow in dollars at US interest rates, and the lending bank can have the loans guaranteed by the US government. It is said to give American exporters a large advantage over rival exporters in countries with shortages of hard currency and high interest rates¹⁸. Exporters in developing countries will have difficulty in obtaining comparable levels of support. Brazil claims that this program as well as others amount to prohibited export subsidies.

4.2.2 *Conformity with export reduction commitments*

Even if the US export assistance programs amount to prohibited export subsidies, they may nevertheless be exempt from action by application of the ‘peace clause’. Article 13(c) says that so long as the export subsidies maintained on agricultural products conform to the reduction requirements in Part V of the Agriculture Agreement, they may be:

- subject to countervailing duties only upon a determination of injury or threat thereof¹⁹; and
- exempt from challenge as ‘actionable’ subsidies causing injury, nullification and impairment or serious prejudice²⁰.

Article 8 of Part V requires that each Member provide export subsidies only in accordance with the Agreement on Agriculture and the commitments specified in its Schedule.

¹⁴ Agreement on Agriculture, Article 1.

¹⁵ Oxfam, *Cultivating Poverty: The Impact of US Cotton Subsidies on Africa*, 2002, 15.

¹⁶ Agreement on Agriculture, Article 9.1(a).

¹⁷ Ibid, article 9.1(f).

¹⁸ Oxfam, *Cultivating Poverty: The Impact of US Cotton Subsidies on Africa*, 2002, 16.

¹⁹ In accordance with GATT 1994 Article VI, and Part V of the SCM Agreement

²⁰ Under GATT 1994 and the SCM Agreement.

5. Impact on Developing Countries

Third party participation

Countries from India, Africa and South America have expressed support for Brazil's WTO claim against the United States. According to the Oxfam Report, '*Cultivating Poverty: The Impact of US Cotton Subsidies on Africa*', Benin, Burkina Faso, Mali and Senegal are among those African countries most affected by the artificially low world cotton prices and who reportedly appealed to their governments and the West African Economic and Monetary Union (UEMOA)²¹ to file briefs in the WTO in support of the challenge. Previously, on 24 June 2002, the Ministers of Agriculture of UEMOA met in Abidjan (Cote d'Ivoire) to search for a common strategy for addressing the market crisis on cotton products.

Whatever informal complaints may have been registered, Zimbabwe is the only African state that has filed formal notice of its interest as a producer, supplier and exporter of cotton under the procedure provided by the WTO's dispute settlement rules. WTO Members had 10 days from the date of the circulation of Brazil's request for consultations with the US to notify the parties and the Dispute Settlement Body of their desire to be included in the consultations²². On 15 October 2002 Zimbabwe filed its request²³, followed by India²⁴ and Argentina²⁵ on the 18th and 22nd of October, respectively.

It is unlikely that the consultations will result in mutually agreeable solutions. If no agreement is reached, the dispute will likely go to the panel stage within 60 days. If so, Zimbabwe, Argentina and India will be able to participate as third parties to the dispute at both the panel and any subsequent Appellate Body proceedings. DSU Article 10.2 governs participation of third parties and states.

Effect of a successful challenge

A successful WTO challenge of the US subsidies could, in general terms, counter the current cotton market crisis and enable cotton producers outside the US to expand their market access opportunities. Over the last twenty years, under the influence of farm programs, yields in the US have risen more slowly than in those countries with dynamic cotton industries including Australia, Brazil, China and Turkey. US costs of production have also risen faster and the US is now an uncompetitive cotton producer dependent on continued government distortion of the cotton market to maintain its current share of world production. With world production costs falling, US competitiveness is

²¹ Comprising Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

²² Article 4.11 of the Dispute Settlement Understanding

²³ WT/DS267/2

²⁴ WT/DS267/3

²⁵ WT/DS267/4

set to fall further, and further perpetuating the reliance on government intervention for market survival. To the extent that Brazil's WTO claim results in effective reduction in US farm support programs, the competitiveness of developing country and other cotton industries will be enhanced.

Such enhancement is not likely, however, to be as dramatic or immediate as the affected countries might hope. The result of a positive finding that US subsidies exceed the maximum permitted level of support will simply require that the US bring its support programs back in line with its reduction commitments under the WTO Agreement on Agriculture. Perhaps as important is the fact that the case will provide the WTO Dispute Settlement Body with an opportunity to interpret and define certain aspects of the Agreement on Agriculture which will result in more future legal and practical certainty for all WTO Members and their agricultural producers. From that point, the parties will have to continue the ongoing negotiation of commitments under the Agreement on Agriculture to further reduce export and domestic subsidies. Countries must make the talks on agriculture and the problems of the cotton industry a priority in their negotiations within the WTO.

6. Conclusion

The US 2002 Farm Act has increased both domestic and export support for upland cotton, in apparent contradiction to the stated intentions of the US to liberalise trade in agricultural products during the Doha Agenda. Whether these particular measures on agricultural products technically violate the WTO depends firstly on whether they are amber box subsidies or prohibited export subsidies. If so, they will be subject to dispute settlement and countervailing duties remedies unless they are exempt from action by application of the due restraint or 'peace' clause in Article 13 of the Agreement on Agriculture. Until the end of 2003, they will be exempt if they are being reduced in accordance with the domestic and export subsidy reduction requirements of the Agriculture Agreement and the scheduled commitments of the US. Brazil argues that the US has no such defence, that domestic support for cotton is in excess of that decided by the US in 1992, and that the export subsidies do not comply with its reduction commitments.

In this case, the questions addressed by the WTO panel will, for the first time, focus on inequalities at the centre of global agricultural trade, with wider implications for the Doha Agenda agriculture negotiations and the expansion of the agricultural trade prospects for the developing world. Policy arguments in support of reduction and elimination of agricultural subsidies are persuasive from both a trade and development perspective. The road to that elimination is, however, by way of the negotiating table, at which Members' most vital interests remain at stake.