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# THE WTO AGRICULTURE NEGOTIATIONS: POTENTIAL IMPLICATIONS FOR COTTON

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# WTO LITIGATION AND NEGOTIATION: POTENTIAL IMPLICATIONS FOR COTTON

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U.S. farm programs for cotton have become front and center in the World Trade Organization (WTO), caught in the crosshairs of litigation and negotiation. Although cotton has been a significant part of U.S. agriculture for over two centuries, cotton currently accounts for only about 2 percent of U.S. farm cash receipts and about 6 percent of U.S. agricultural exports. Just how did U.S. cotton come to occupy center stage at the WTO and what are the implications for cotton programs as a result of the combination of dispute settlement and agricultural negotiations?

## Cotton and WTO Litigation

The seminal event leading to the current focus on U.S. cotton programs in the WTO negotiations was Brazil's successful challenge to many of those programs through the WTO dispute settlement process. Starting in the late 1990s, as world prices for many commodities fell to very low levels and payments under U.S. farm programs began to increase, the Brazilian government began seriously questioning U.S. subsidy levels. Initially, Brazil focused its interest on U.S. soybean subsidies, which had increased to unprecedented levels in 1999-2001. But following the collapse of world cotton prices in the 2001 marketing year, Brazil switched gears and on February 6, 2003, requested the establishment of a WTO dispute settlement panel to investigate its myriad claims against U.S. farm programs affecting upland cotton.

### What the Panel Concluded

In September, 2004, the panel found in favor of most of Brazil's claims. The U.S. appealed the decision to the WTO's Appellate Body, which generally affirmed the panel's decisions. On March 21, 2005 the WTO cotton panel was adopted by the Dispute Settlement Body. Brazil's claims and the panel findings can be classified into three main categories.[1]

Export Credit Guarantee Programs. With respect to Export Credit Guarantee Programs (GSM-102 and GSM-103) and the Supplier Credit Guarantee Program (SCGP), the panel ruled that these programs constituted an export subsidy, because, among other things, program fees (premia) did not cover long-term operating costs and losses. (This part of Brazil's challenge was not limited to cotton, but rather extended to all commodities.) Under WTO rules, the U.S. is only allowed to use export subsidies for 13 notified commodities, mainly wheat and dairy products.[2] Cotton is not a notified commodity and therefore is not eligible to use export subsidies. Thus, in WTO parlance, the export credit guarantee programs for cotton (and certain other commodities) are prohibited export subsidies, and the subsidies were to be eliminated no later than July 1, 2005.

Step 2. The second key finding concerned the Step 2 program, which makes payments to domestic cotton users and exporters, based on the difference between U.S. and world prices. The panel found that the program was both a prohibited import substitution subsidy and a prohibited export subsidy. Similar to the export credit guarantee programs, these prohibited subsidies were to be eliminated no later than July 1, 2005.

Serious Prejudice. The third component of the panel's findings concerned whether U.S. domestic farm programs for upland cotton contributed to "serious prejudice." The panel found that "price-based" U.S. domestic support measures – marketing loan payments, Step 2 payments, market loss assistance payments (no longer used), and counter-cyclical payments – caused serious prejudice in the sense of significant price suppression or depression in world cotton markets in 1999-2002. To comply with the panel ruling, the U.S. is required to withdraw the subsidies or remove the adverse effects of the subsidies. Under WTO rules, September 21, 2005 was the earliest date Brazil could seek to arbitrate whether any actions the U.S. took constituted compliance, or seek countermeasures (retaliation), if the U.S. had taken no actions.

Implementation of Panel Findings for Compliance

The specific timelines for compliance set in motion a series of steps by both Brazil and the United States. On *prohibited export subsidies*, Brazil first sought authorization to retaliate in the amount of $3 billion, estimated as the recent value of Step 2 payments and the value of exporter registrations under the export credit guarantee programs. To address the findings on prohibited export subsidies, the USDA announced on June 30, 2005 that it would use a risk-based fee structure for GSM-102 and the SCGP, and would eliminate the highest risk countries from the programs altogether. USDA also announced it would no longer accept applications for the GSM-103 program. At the same time, the Administration submitted proposed legislation to the Congress that would repeal the current cap of one percent on program fees for GSM-102 and the SGCP, repeal the authority for the GSM-103 program, and repeal the Step 2 program. Based on these actions, Brazil and the U.S. reached an agreement on July 5, 2005 that effectively provides more time for the U.S. to implement the panel rulings. The agreement also requires that Brazil must successfully challenge the U.S. actions before continuing with retaliation.

The process on the *serious prejudice* finding has unfolded in a similar but not identical manner. The compliance period ended on September 21, 2005. On October 6, Brazil requested authorization to retaliate in the annual amount of $1.037 billion, until such time as the U.S. withdraws the subsidies or removes their adverse effects. The U.S. objected to Brazil's request and the matter was referred to arbitration, under WTO rules. On November 21, the U.S. and Brazil agreed to suspend the arbitration proceedings until either party requests their resumption. Under this agreement, Brazil does not have to request a compliance panel to examine any U.S. actions; that is, Brazil can move straight to a request for retaliation.

Congress included the Administration's request to eliminate Step 2 in its budget reconciliation legislation, a process that began in the spring of 2005. After much parliamentary maneuvering, final Congressional approval for the budget reconciliation bill occurred on February 1, 2006. Step 2 will be eliminated as of August 1, 2006. The Administration proposals to eliminate the one-percent fee cap and the GSM-103 program were not included because of Senate rules.

Under the terms of the Brazil-U.S. agreement on prohibited subsidies, a panel would have to review U.S. changes to the export credit guarantee programs to determine whether the changes constitute compliance with the panel findings. The elimination of Step 2 would address not only prohibited subsidies but also serious prejudice, as it is one of the principal components of that finding. Whether a WTO panel would deem this action sufficient to address the serious prejudice finding is not answerable. There is no WTO precedent that offers guidance or insight as to what actions are appropriate for compliance with a serious prejudice finding.

## Cotton in the WTO Negotiations

Even as the WTO cotton case was heightening attention on U.S. cotton subsidies, cotton wandered onto center stage at the WTO Doha negotiations as well. Certainly, the U.S. has advocated sharp reductions in trade-distorting domestic and export subsidies, both of which have direct implications for U.S. cotton programs. But as the negotiations have progressed, cotton has been singled out for discrete treatment in ways totally unexpected.

### The U.S. Proposal on Domestic Support

Leading up to the WTO Ministerial in December, 2005 in Hong Kong, on October 10 the U.S. unveiled a bold new proposal on agriculture with the aim of invigorating the negotiations. The proposal's linchpin calls for a 60-percent reduction in trade-distorting amber box subsidies, as measured by the Aggregate Measurement of Support (AMS). Under the U.S. proposal, the current annual AMS limit of $19.1 billion would be reduced to $7.6 billion over some period of time. The U.S. AMS averaged $16 billion annually during1999-2001, a high-water mark because of low world and domestic prices. The U.S. proposal also called for product-specific caps based on the 1999-01 AMS.

Support under the marketing loan program, including that for cotton, is an amber-box subsidy and accounted for about 50 percent of the average 1999-01 AMS. The cotton AMS averaged $2.1 billion during this period. Estimates for 2005 suggest an AMS of around $14 billion and a cotton AMS of about $2 billion. Most of the cotton AMS is accounted for by the marketing loan program and Step 2; direct payments and counter-cyclical payments (or the prior Market Loss Assistance payments) are not counted as support to cotton, even though the WTO cotton panel attributed support to cotton from those programs.

The U.S. proposal also calls for a "blue box" category, where partially decoupled payments would be capped at 2.5 percent of the value of production. U.S. counter-cyclical payments would fall under this category. Assuming a 1999-01 value of agricultural production of about $200 billion means blue box expenditures could not exceed $5 billion. Counter-cyclical payments for cotton have been at their maximum of almost $1.4 billion 3 out of the past 4 years (estimated for 2005/06). In addition to the overall 2.5% cap, many other WTO members have called for some sort of product cap or limitation on blue box payments.

Cotton Initiatives in the WTO

Emboldened by Brazil's challenge to U.S. cotton programs and encouraged by the "development" moniker of the WTO negotiations – with substantial assistance by key NGOs like Oxfam – four West African countries (C-4) proposed the creation of a Cotton Sub-Committee at the 2003 WTO Cancun Ministerial to address their specific concerns as cotton exporting countries. The July 2004 Framework Agreement called for cotton issues to be addressed "ambitiously, expeditiously, and specifically" in the agricultural negotiations. To that end, the Cotton Sub-Committee was established in November 2004 to address both trade and development aspects of cotton.

The Sub-Committee met throughout 2005, and the African countries made numerous proposals, calling for, among other things, the complete elimination of distorting domestic support and export subsidies for cotton, and compensation for losses due to such previous subsidization, before the end of 2005. In addition, separate consultations have occurred on the development aspects with the aim of boosting productivity and efficiency in the cotton sectors in developing countries. Several new programs and initiatives were announced in the fall of 2005, with additional funding from both developed WTO members and international organizations.

Cotton issues remained paramount at the Hong Kong Ministerial in December, 2005. The final Declaration called for developed countries to eliminate all forms of export subsidies for cotton in 2006, and to provide duty-free, quota-free access for cotton exports from least developed countries from the commencement of the implementation period. Members also agreed that "the negotiating objective is to reduce trade-distorting domestic supports for cotton more ambitiously and more quickly than the general formula that is ultimately agreed." The United States has already worked toward fulfilling the pledge on export subsidies through the legislation to eliminate Step 2, as well changing the export credit guarantee programs.

Timeline for WTO Processes

There are multiple timelines and deadlines at play in the dispute settlement process and the negotiations. The dispute settlement process on prohibited subsidies (Step 2 and GSM programs) could run 6-9 months from the time Brazil requests a com- pliance panel. For the serious prejudice claims, if there is no compliance panel, the arbitration process could be even quicker, but it is not clear how Brazil will proceed.

The Hong Kong Ministerial established several dates for the Doha negotiations – April 30, 2006 for establishing modalities and July 31, 2006 for the submission of comprehensive draft schedules. In addition, completing the negotiations this year is important in order to meet the timelines for U.S. implementation of any agreement contained in the U.S. Trade Promotion Authority, which governs Congressional procedures for implementing trade agreements.

## Potential Economic Effects of Cotton Reform

In tandem with the litigation and negotiation issues on cotton, economists have weighed in with numerous analyses of trade reform of cotton. Some early analysis was done for advocacy purposes, including several studies done in the context of the C-4 complaints about cotton subsidies, as well as the analysis submitted by Brazil as part of its WTO complaint. These early analyses aimed directly at the effect of U.S. cotton subsidies on world markets.

It is not possible to review all those studies here; the FAO has done an excellent review, noting that results are highly dependent on the assumptions and type of model. Of the studies that FAO reviewed, the price impacts of removing all subsidies and tariffs on cotton ranged from 3-15 percent.

The FAO estimated that the most likely price impact of *complete* liberalization of cotton tariffs and subsidies would be in a range of 3 to 5 percent. World price effects are small because of the low initial level of distortion. Global tariffs on cotton are low, and the main source of distortion is domestic subsidies, primarily U.S. and EU subsidies. Under complete reform, world cotton output and trade falls 2 percent. U.S. cotton production and exports fall 14 percent, while C-4 production increases about 2 percent and exports about 4 percent. These base estimates vary in different scenarios, depending on key assumptions about supply and demand elasticities, the nature of subsidies, and China's cotton policies.

The Food and Agricultural Policy Research Institute (FAPRI) has provided a useful illustration of the possible effects of the U.S. proposal on cotton in an analysis published last December. Using its stochastic baseline to produce a range of outcomes, FAPRI analysts calculated what support levels for the major commodities would need to be such that the proposed AMS limits would be exceeded only 5 percent of the time. To reach this outcome, target prices for grains, oilseeds and cotton would have to be reduced 7 percent by 2011 (67.3 cents for cotton); loan rates would be reduced 11 percent by 2011 (46.3 cents for cotton).

The analysis examined three scenarios – unilateral liberalization, multilateral liberalization, and multilateral liberalization plus compensation. For cotton, world prices increase about 2 percent on average over the projection period (2007/08-2014/15) and world trade declines by about one percent. For all three scenarios, U.S. cotton area falls about 4 percent, farm prices rise slightly, and exports decline 4-5 percent, but net returns fall as a sharp decline in government payments is not fully compensated by an increase in market receipts. African (not just C-4) cotton production is basically unchanged and exports grow about one percent. Brazil's production increases on average about 2 percent and exports increase by about 3 percent.

The conclusion from the FAO review and other mainstream studies is that even complete liberalization of cotton tariffs and subsidies will not result in large global price or trade effects. Results from some early studies that showed price effects as high as 30 and even 70 percent now appear as outliers based on dubious assumptions or inappropriate parameters. But several studies conclude that U.S. cotton subsidies are the main source of distortion in world cotton markets. Thus, much of the economic analysis, even if flawed, has reinforced the unprecedented international focus on U.S. farm programs for cotton.

## Conclusions

U.S. subsidies for cotton are under intense scrutiny as a result of Brazil's successful challenge of U.S. cotton programs as well as a major thrust of the Doha Development Agenda to reduce trade-distorting domestic support. The combination of the WTO panel, a concerted push by NGOs and the media, and numerous economic analyses highlighting U.S. cotton subsidies has resulted in U.S. cotton being singled out in the WTO negotiations, as evidenced by the formation of the Cotton Sub-Committee and specific commitments for cotton in the Hong Kong Ministerial. U.S. cotton programs are already looking at change as Step 2 will be eliminated on July 31, 2006. With a new farm bill possible in 2007, the combination of the WTO compliance process, a WTO agreement that reduces trade-distorting domestic support, and the WTO cotton-specific initiatives mean further changes in cotton programs are in prospect.

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[1] The cotton panel addressed other issues relating to U.S. farm programs, but only those programs directly implicated as a result of the findings on prohibited export subsidies and serious prejudice are discussed here.
[2] A notified commodity means a WTO member included that commodity in its official schedule of commitments, such that export subsidies can be used as permitted by the Uruguay Round Agreement on Agriculture.

<u>References</u>

For information on the Brazil WTO cotton panel, go to:
http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm.

To see U.S. briefs presented in the Brazil cotton panel, go to:
http://www.ustr.gov/Trade_Agreements/Monitoring_Enforcement/Dispute_Settlement/WTO/Dispute_Settlement_Index_-_Pending.html

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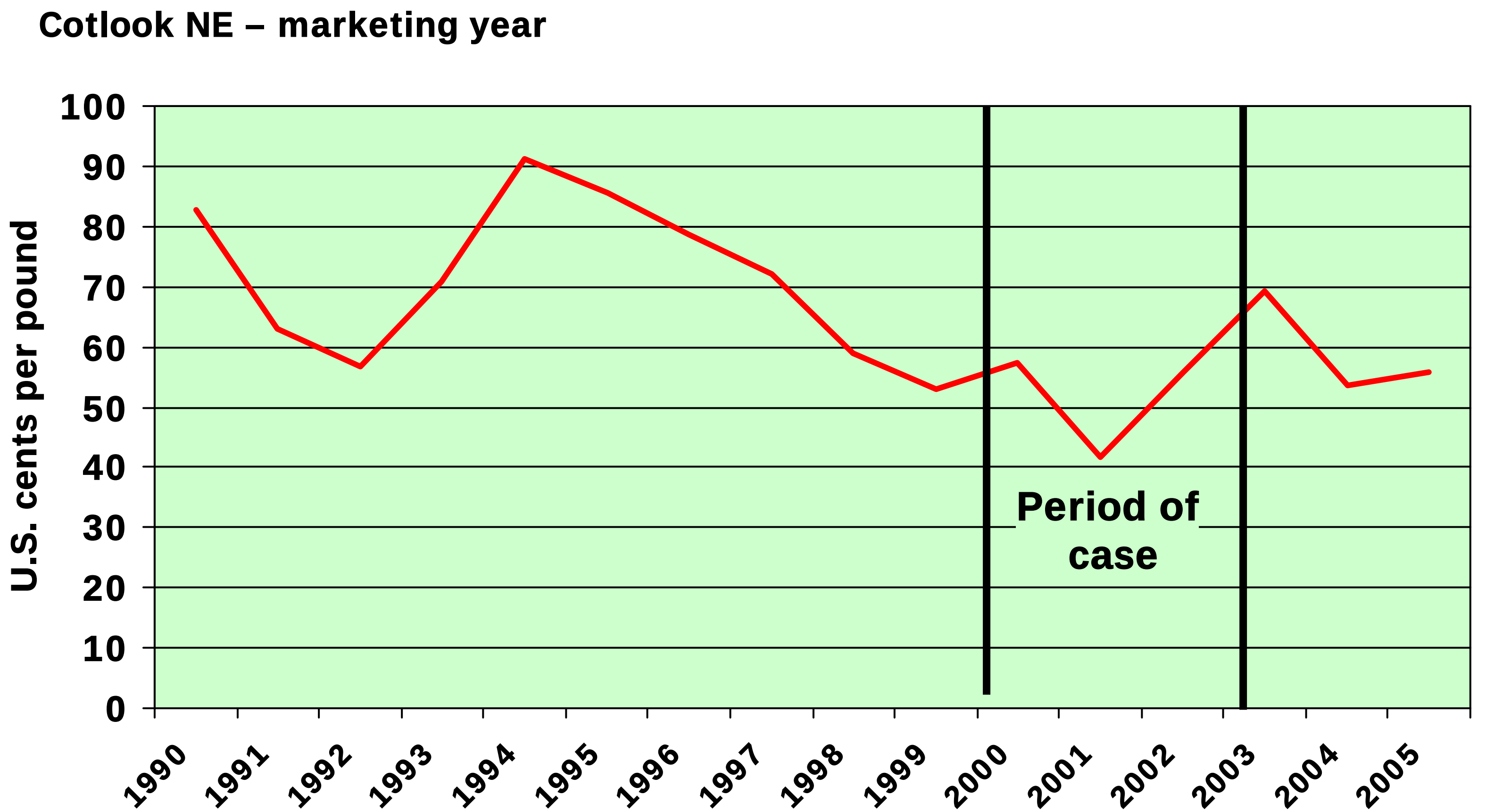
# Why Cotton?

- Starting in late 1990s falling commodity prices, increasing U.S. subsidies
- Growing Brazil frustration → looked to soybeans first
- 2001 cotton price collapse →Brazil switches to cotton for WTO challenge
- Crucial role of media, NGO's, economic analysis, timing of WTO negotiations

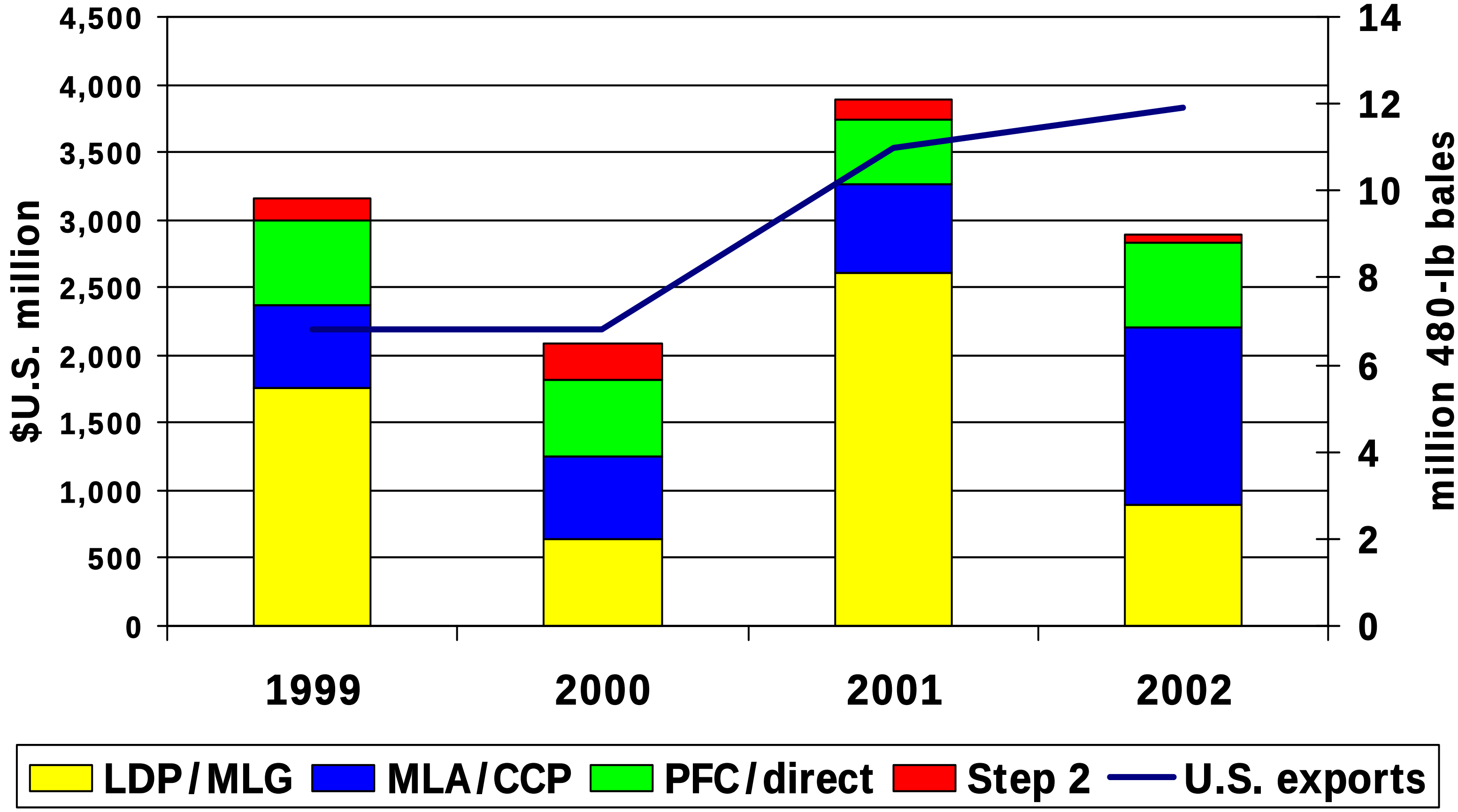
# What Caused World Cotton Prices to Fall?



# U.S. Cotton Under the WTO Gun

- **Brazil challenged all aspects of U.S. cotton programs (Feb 2003-March 2005)**
- **<u>Step 2</u>: prohibited export subsidy, import substitution subsidy**
- **<u>Export credit guarantees</u> (GSM/SCGP): prohibited export subsidies for cotton & other unscheduled commodities**
- **<u>Serious prejudice</u>: Marketing loans, MLA/CCPs, Step 2**

# Brazil's Views Largely Prevailed



# Compliance Process

- **Eliminate *prohibited subsidies* by 7/1/05**
- **U.S. adjusted GSM/SCGP, July 2005**
- **Step 2 eliminated as of July 31, 2006**
- **Brazil requests $3 billion in retaliation; WTO compliance panel is likely**
- **Address *serious prejudice* by 9/21/05**
- **Brazil requested $1 billion in retaliation; process suspended; compliance panel or arbitration**

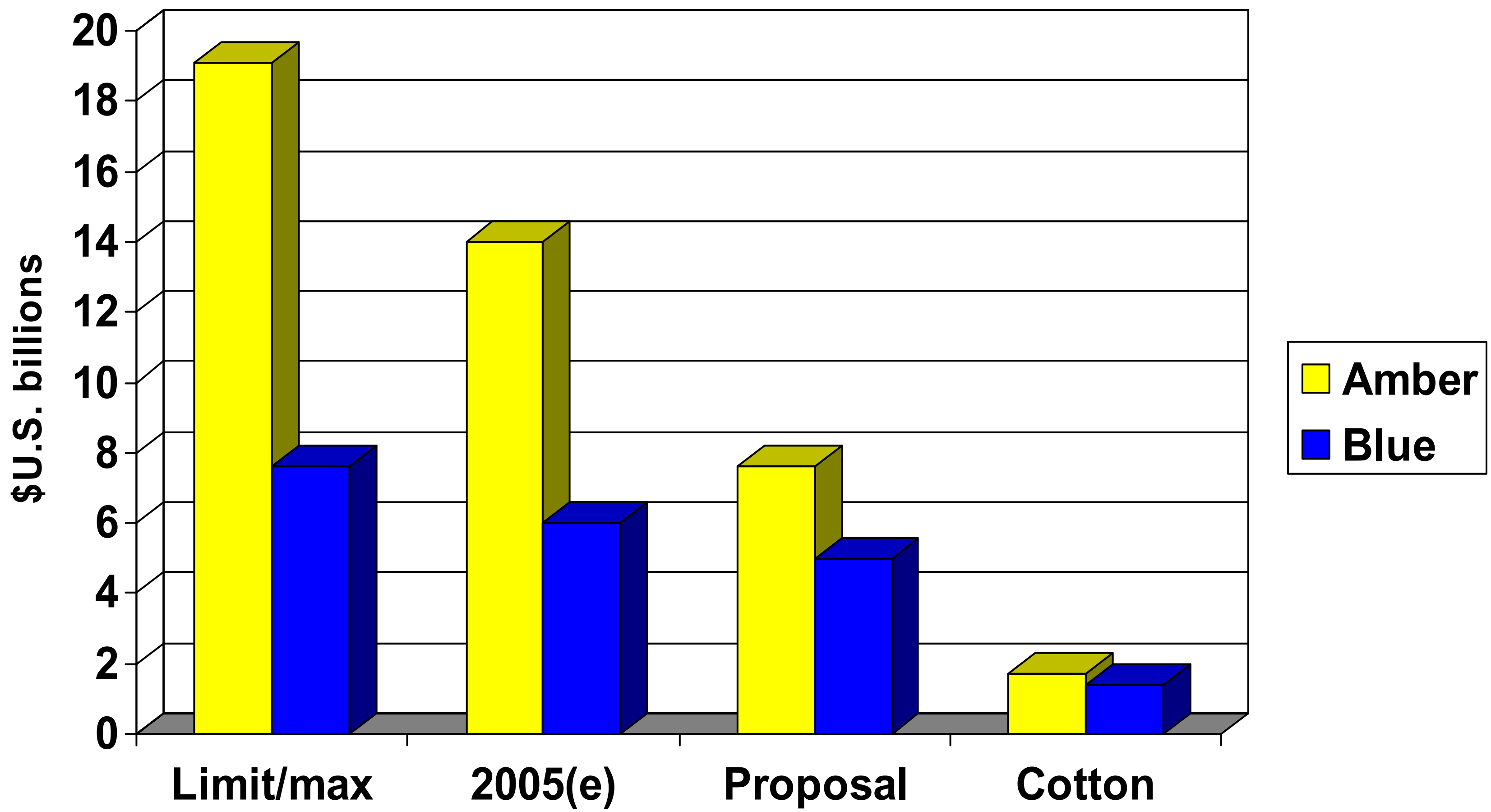
# Cotton Stands Out in the WTO

- Prodding by C-4, media coverage, 2003 Cancun Ministerial collapse
- July 2004 Framework: cotton to be treated *ambitiously, expeditiously, specifically*
- C-4 – eliminate cotton subsidies, compen-sation from subsidizers, development assistance for cotton sectors
- Cotton Subcommittee formed Nov. 2004
- Cotton singled out at Hong Kong – eliminate export subsidies in 2006; DFQF for LDC exports, development assistance

# U.S. WTO Proposal

- Amber box: cut AMS by 60% over 5 years (marketing loans, price support)
- Product specific AMS caps: 1999-01 base
- Product and non-product specific *de minimis*: cut by 50%, from 5% to 2.5% of current value of production
- Blue box: cap at 2.5% of base period value of production (CCPs)
- Green box: no substantial changes, no cap

# What Could U.S. Proposal Mean?



# WTO Timelines

- Litigation:
  - 6-9 months for compliance panel (prohibited subsidies)
  - quicker if straight to arbitration (serious prejudice)
- Negotiation:
  - April 30 for modalities
  - July 31 for schedules
- Legislation: U.S. TPA expires July 1, 2007

# Economic Analysis Plays a Role

- Early analysis of cotton showed large world price, production, trade effects; focus on U.S. subsidies
- FAO review – world price effects of 3-15%; average around 3-5%
- Low border measures; main effect from U.S. and EU subsidy elimination
- U.S. production, exports fall 14% (FAO)

# Analysis of U.S. Proposal

- FAPRI analysis of U.S. proposal – need to lower U.S. support prices
- 11% for loan rates; 7% for target prices
- U.S. cotton area falls about 4%, exports fall 4-5%
- Producer returns (cash receipts + gov't payments) show sharpest drop
- World prices ↑ 2%; world trade ↓ 1%

# Prospects for Change?

- Global effects of eliminating cotton subsidies initially greatly exaggerated
- U.S. subsidies identified as key distorting element
- Litigation: has resulted in some changes in U.S. programs
- Negotiation: WTO agreement suggests more program changes likely