
COTTON UPDATE – 26 October 2007

The Upland Cotton Compliance Panel Ruling

The Context

On 15 October 2007 the WTO compliance panel examining the US's efforts at bringing its legislation into line with the findings of the 2005 Appellate Body decision as confirmed by the WTO Membership through the Dispute Settlement Body made its findings. In short the panel has ruled that the US has failed to fully implement the earlier ruling both on domestic support and export subsidy programmes.

Note that this decision is currently only available to the parties (the US and Brazil) who are obliged under the WTO dispute settlement rules to keep the result confidential. None the less preliminary statements have been made by the parties to the press. The current report upholds the panel's preliminary report which was issued to the two parties in July 2007 for their comment before being finalised, which has now happened.

The public release of the decision is only expected to happen just before Christmas 2007. At this stage the US will have the opportunity to announce its likely decision to make an appeal. Speculatively the appeal will then be finalised by March 2008. Given the history of this case to date, that decision is also expected to go against the US. To this end the final stage would be an arbitration panel to decide the appropriate quantification of any retaliation that Brazil may wish to institute to make good any ongoing refusal by the US to amend its subsidies legislation. Brazil has indicated on an ongoing basis that their estimate is that this quantification would be in the order of US\$4 billion, being US\$3 billion attributable to prohibited export subsidies and US\$1 billion attributable to actionable domestic supports. An arbitration panel would theoretically take two months to complete, meaning that the matter will be finalised by the start of the 2008 summer. Recall that the initial request for consultations on cotton was made back in September 2002.

It would seem from USDA statements the US will indeed appeal the compliance decision. This would be done more as a method of delaying what now seems to be an inevitable result, rather than because the US believes that it realistically still has a chance of reversing a decision that has now been ruled upon 3 times by the WTO in the same way.

The Essence of the Complaint

Brazil requested the establishment of this compliance panel in August 2006. Technically this is an Article 21.5 panel in DSU parlance. In September 2006 the DSB agreed to try and refer the matter to the original panel that heard the dispute. This has not proven possible, and explains in part why this matter has royally breached the standard DSU timeframes for concluding the matter. The essence of the matters that the compliance panel is said to have dealt with stems from the following 3 broad categories of US subsidy programmes.

Firstly:

Production flexibility contract payments and direct payments are not green box measures, that is they do not fully comply to Annex 2 to the Agreement on Agriculture. These would not be illegal *per se*, but rather incorrectly classified.

Secondly:

Brazil experienced so-called 'serious prejudice' as the effect of the challenged price contingent domestic support subsidies (marketing loan program payments, market loss assistance payments, and counter-cyclical payments) caused significant price suppression in the world market for upland cotton and that the effect of the price contingent subsidies for the upland cotton in marketing years 1999 to 2002 constitutes a significant form of world market price suppression. The existence of the serious prejudice makes these measures illegal in their current form regardless of the correctness or otherwise of their box classification.

Thirdly:

The US's export credit guarantee programmes are prohibited export subsidies under the WTO subsidies (SCM) Agreement. In particular the US export credit guarantee programmes at issue (GSM 102 and SCGP) constitute a *per se* export subsidy within the meaning of item (j) of the Illustrative List of Export Subsidies in the SCM Agreement and should be removed. They are also unscheduled subsidies not reflected on the US's schedule of commitments.

After the initial ruling, the US eliminated part of its export credit guarantees and the Step 2 program that paid exporters and US cotton mills to buy cotton grown in

the US. However to date the US administration has not announced any specific initiative to address the domestic support programs deemed to have had a prejudicial impact to Brazil's trade interests. It is reported that in particular the compliance panel has found the US's countercyclical payments and marketing loan payments to cotton producers as trade distorting and that US legislative amendments that have been undertaken to date have not corrected the adverse effects of the subsidy programmes. It is essentially due to the fact that US efforts at reform have not prove adequate that the US is disappointed with the results. The following data taken from a recent paper "U.S. Farm Programs and African Cotton" (IPC Issue Brief 22 of February 2007) by Professor Daniel Sumner provides some indication of ongoing US spending levels on these subsidies:

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Direct payments	618 ^a	616	615	611
Counter Cyclical payments	1,312	392	1,375	1,376
Step 2 User Marketing payments	429	350	544	350
Marketing Loan Program benefits	871	168	1,842	1,257
Crop Insurance subsidy	277	279	79	-11
Total support (Sum)	3,508	1,805	4,455	3,582
Value of production	3,497	5,266	4,540	5,204
Quantity produced, (million lbs)	7,935	8,555	10,802	11,165

(Source: IPC form US government sources)

Note that in the present case the original panel's ruling on domestic subsidies is premised upon a claim of 'serious prejudice' which is evaluated by market effects independently of whether the US is within its Uruguay amber box (AMS) limits or not. In other words amber support *per se* is actionable if it causes adverse effects to the interests of other Members. This differs from the current AMS claim being prepared by Canada and Brazil which is based on a simple evaluation as to whether the US is within its AMS ceiling, an exceeding of which would be contrary to commitments despite any market effects. Export subsidies outside of scheduled levels are prohibited *per se* as they are deemed to be trade distorting.

Brazil's Response

The Brazilian Agriculture Minister Reinhold Stephanes indicated in the wake of the ruling that Brazil is considering leaving the actual retaliation that will likely be granted through the remainder of the process and settle for a so-called 'moral victory'. Retaliation would allow Brazil impose tariffs on goods imported from the US above MFN rates and to apply other sanctions such as deliberate infringements of US intellectual property rights. The problem is that these measures adversely affect other Brazilian sectors that have nothing to do with cotton. This is generally why it is preferred that Members comply with dispute rulings, as retaliation tries to match trade distortions with other, usually unrelated, retaliatory distortions. The other dynamic at play is the fact that the US is Brazil's biggest trading partner, hence the need to consider wider long term diplomatic relations on a wider front than just trade. This dynamic highlights the challenge of enforcing WTO trade rules and upholding the WTO's credibility from a systemic perspective.

This is the first time that Brazil has indicated that it may not actually enforce its retaliation rights. This decision is however not final, and Brazilian cotton sector players are likely to oppose this softening of the government's stance on this matter. Logically it is perceived as strange timing for Brazil to take this stance, with the standard thinking being that such a gesture should only be made, even if currently contemplated, only after the final ruling is made in June 2008. This being said the final decision would come from the Brazilian government and President Lula da Silva, so the retaliation is not yet completely off the table.

Africa's Comment

In West Africa the President of the African Cotton Producers Association, Francois Traoré, expressed satisfaction at the result, the underlying basis of which has long hampered West Africa's development interests in his opinion. He expressed the view that the ruling holds some form of moral suasion that could 'oblige' the international community to pressure the US to respect the ruling. While not part of the DSU process *per se*, this is certainly an externality that may come into play, most likely within the mix of the Doha agriculture negotiations.

It is reported that government officials in Burkina Faso are not overly optimistic about the prospects of their cotton industry in the immediate future. They also hope that at the Executive level US officials will feel embarrassed for always

being accusingly pointed at and they retain the hope that 'something can be done to implement the ruling'. They however fully recognise that the main hurdle remains with the US Congress under overwhelming pressure from the US cotton industry lobby. This view is backed by passage of the US's 2007 incarnation of the Farm Bill which thus far ignores any of the compliance panel corrective steps in setting US farm policy to 2012.

West Africa and Brazil continue to operate as allies showing a united front on the cotton trade matter. The Brazilian President, Lula da Silva, was visiting Burkina Faso when the news of the compliance panel's finding was released. Lula da Silva called on the WTO Membership to keep backing Burkina Faso, Benin, Chad and Mali (the C4 group). He expressed the view that Brazil and West Africa should continue to work together to protect their respective farmers from market distortions in order to regain competitiveness on the international cotton market.

The US Response

True to expectation, the US National Cotton Council (NCC) expressed 'disappointment' with the reported compliance panel decision. The NCC reaction is understandable when viewed from the context of their financial interest in retaining around US\$3 billion in government transfers to around 20-30 thousand cotton farmers. In this regard the NCC is of the view that the serious prejudice claims, now confirmed by 3 different WTO legal tribunals, are 'contrary to the facts in the world cotton market both then and now'. In the NCC view the US compliance steps to date, found to be insubstantial by the WTO, have had what they consider to be a significant impact on US cotton farmers in that cotton acreage is down 29% for 2007. Analysts have however commented that this is less due to a lack of US government support and more due to improved government support for bio-fuels and concomitant record prices for corn due to the bio-fuels boom.

None the less the NCC finds it 'incomprehensible' that the WTO panel could make a finding of serious prejudice against the US when the international cotton market is strong. They note that world prices are up, and that production outside of the US is at record levels. This leaves them 'to puzzle the basis of such a decision'. The actual position, as the NCC likely well understands, is not that puzzling due to the simple fact that the WTO compliance panel simply takes its cue from the initial case which covered the years 1999-2002 and their terms of reference have nothing to do with current market conditions. This being said the

latest WTO subsidy case being prepared by Brazil and Canada will cover the years 1999-2005, and based on initial analysis this case is also likely to come to the same finding as to the illegality of inter alia US cotton subsidies under international law.

The niceties of the actual factual position aside, the NCC is undeniably a powerful lobby in the US and even arguments with tenuous grounding in reality haven been able to significantly sway US law makers as both the passage of the 2007 Farm Bill and the US stance on cotton modalities in the Doha negotiations have shown.

The NCC's stated mission is to 'ensure the ability of the US cotton industry to compete effectively and profitably in the raw cotton, oilseed and U.S.-manufactured product markets at home and abroad'. We note that these aims make no reference to production based upon the ability of the US industry to produce under world market conditions. We recall that the first WTO cotton panel found as a factual reality, which the US was unable to refute, that in the absence of government assistance US cotton growers would earn an income less than their cost of production and thus following the basic logic of market economics, would cease to produce cotton. None the less the NCC is likely to continue to make sure that the US government ensures that US cotton interests are upheld at the expense of US international treaty commitments.

This view from the cotton industry is however not universally held in the US. There is a sound tranche of US based research that finds a continued price suppressing effect of US cotton subsidies on the world market price. A June 2007 study also confirms that earlier research is still valid. The study compiled by Oxfam was researched, inter alia, by leading US agricultural economist Professor Daniel A. Sumner. His work shows that:

- Lower world cotton prices harm millions of households and more than 10 million people across West Africa alone.
- The elimination of US cotton subsidies would result in an increase in the world price for cotton of between 6 and 14 percent.
- This increase would conservatively more than double the cotton prices in West Africa.

- The additional income per household would be sufficient to support food expenditure for an additional about one million households – in round terms, a million people.

Closing Observation

It is highly unlikely that any US compliance with the WTO compliance panel findings will be able to be divorced for the passage of the 2007 US Farm Bill. In this regard the US Congress has a responsibility to pass farm program legislation that complies with US commitments at the WTO. To this end it is noted that this can actually be done as was shown with the elimination of the cotton Step 2 provisions by US legislators in response to the initial cotton case ruling. However more far reaching statutory changes will be needed to eliminate the subsidised export credit guarantees, the main hindrance being the lingering 1% cap on user fees which still divorces the programme from market conditions. In addition changes to those programs deemed part of the actionable subsidy ruling, being countercyclical payments and marketing loan provisions, still urgently require legislative action. In addition, and ironically, the emerging Farm Bill (HR 2419) creates a 'new' cotton user payment of 4 cents per pound which is actually similar to the previously reformed Step 2 payment, effectively reversing the meager US compliance that has occurred to date.

Based upon the current passage of the 2007 Farm Bill this legislative necessity for reform US farm subsidies to align with WTO standards has proven to be completely absent thus far. Aside from the final conclusion of the cotton dispute in June 2008, the present dispute action by Canada and Brazil on US farm subsidies more generally probably holds the best chance of bringing further reform pressure to bear on the US.

IDEAS Centre offers policy advice services to developing and transition country governments in the areas of international trade, development and economic governance. In relation to the World Trade Organization (WTO), IDEAS Centre helps low-income countries defend their trade interests and thus use their WTO membership in a way that supports their development.

Our previous newsletters are posted on our website: www.ideascentre.ch

IDEAS Centre, 10, rue de l'Arquebuse, 1204 Geneva, Switzerland
T +41 22 807 17 40, F +41 22 807 17 41