TRADE LAW BRIEF

Making Trade Law Simple

Brazil-US Upland Cotton Dispute

What Does it Augur for Agricultural Subsidies?

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Brazil won a landmark case at the World Trade Organisation (WTO) that spells the beginning of the end of rich countries' subsidy payments to their farmers. Brazil's case is the first to challenge the rich world's farm subsidies. Further, the US subsidies on cotton exports depressed world prices thereby limiting the earnings of cotton farmers and adversely impacting their livelihoods in Brazil and other developing countries. The case has set a valuable precedent for the developing countries to rise against the wealthy nation's domestic agricultural subsidies.

What was the Dispute?

The complainant, Brazil, argued that the subsidies amounting to US$12.9bn paid to the US farmers growing upland cotton during the 1999-2002 period, and others mandated through to 2007 by the latest US Farm Bill, violated the WTO rules. Such subsidies increased the production of high-cost US upland cotton, increased its export, and suppressed the prices in the US, the World and Brazil. This resulted in the US having a more than equitable share of world export trade. The dispute, therefore, had both legal and economic components.

Specifically, Brazil contended that the US cotton subsidy programmes caused 'serious prejudice' to the interests of Brazil, contravening Article 5(c) of the Subsidies and Countervailing Measures (SCM) Agreement. The SCM Agreement provides that no Member should cause adverse effects to the interests of other Members, i.e serious prejudice to the interest of another Member. Brazil further argued that the US cotton Step 2 programme and US export credit guarantee programmes for all commodities were 'prohibited' subsidies under Article 3 of the SCM Agreement.

The Panel ruled largely in favour of Brazil. It charged the US for practicing trade distorting measures like marketing loans, market loss assistance, and counter-cyclical payments and for wrongly classifying direct payments on cotton, another type of domestic support subsidy, into the green box. The Panel also judged that the US domestic support measures caused 'serious prejudice' to Brazilian interests. It asked the US to withdraw these subsidies entirely, or take appropriate steps to negate its adverse effects.

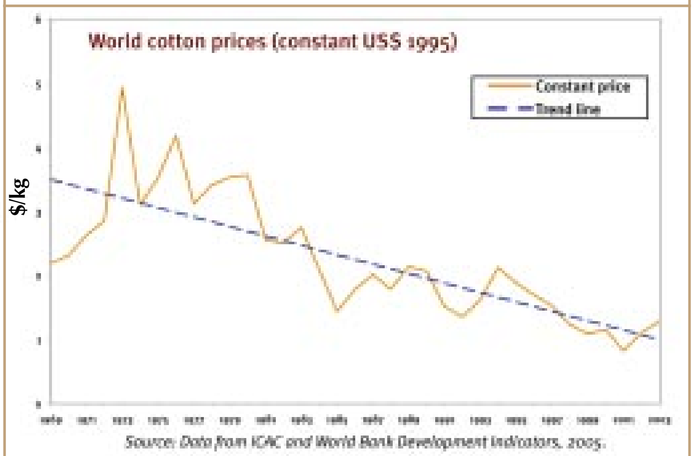
Following this adverse decision, the US appealed before the Appellate Body (AB) of the WTO on October 18, 2004. In reply, Brazil also made many 'conditional' appeals.

Appellate Body's Verdict

The AB issued its report on March 3, 2005, upholding the Panel's ruling on all major points of the dispute. It upheld that the subsidies challenged by Brazil do not qualify for exemption from WTO challenges under the 'peace clause' of the Agreement on Agriculture (AoA), though it modified somewhat the Panel's decision regarding this aspect.

With respect to 'serious prejudice', the AB upheld the Panel's finding that the challenged

Box 1: World Cotton Prices



The US is the biggest exporter, but only the second-biggest producer next to China. Both US and China produce over 45 percent of all the cotton grown in the world, and their huge subsidies distort the market by sharply depressing world prices. The graph above shows the detrimental effect on world prices for the past few years.

Source: Ian Gillson, Trade: How cotton subsidies harm Africa, Policy Brief, Annual Report 2005, Overseas Development Institute, http://www.odi.org.uk/annual_report/ar2005/page10_trade.pdf

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price-contingent subsidies, i.e. marketing loan programme payments, user marketing (Step 2) payments, market loss assistance payments, and counter-cyclical payments, caused significant price suppression within the meaning of Article 6.3(c) of the SCM Agreement, which provides that serious prejudice ... arise where the effect of the subsidy is 'significant price suppression ... in the same market'.

As regards user-marketing (Step 2) payments, the AB backed the Panel's findings that Step 2 payments to domestic users of US upland cotton are subsidies contingent on the use of domestic over imported goods that are inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement. Whereas the Step 2 payments to exporters of US upland cotton are subsidies contingent upon export performance within the meaning of Article 9.1(a) of the AoA, they are inconsistent with Articles 3.3 and 8 of AoA and Articles 3.1(a) and 3.2 of the SCM Agreement. Article 3.1(a) prohibits 'subsidies contingent in law or in fact, ... upon export performance, including those illustrated in Annex I' (the Illustrative List of Export Subsidies appears at the end of the SCM Agreement) and Article 3.2 provides that a Member shall not 'grant or maintain' prohibited subsidies.

The AB upheld the Panel's findings that the export credit guarantee programmes at issue are export subsidies for purposes of Article 3.1(a) of the SCM Agreement and are inconsistent with Articles 3.1(a) and 3.2 of the Agreement. Further, the AB maintained that the Panel did not err in exercising judicial economy in respect to Brazil's allegation that the US export credit guarantee programmes are prohibited export subsidies, under Article 3.1(a) of the SCM Agreement, because they confer 'benefit' within the meaning of Article 1.1 of that Agreement.

The possible consequence of such an interpretation by AB might discourage the grant in aid to agriculture and at the same time put pressure on rich nations to reduce their current support as part of the ongoing Doha Round negotiations.

Who Won and Who Lost?

Brazil largely won the case. But the victory is not limited to Brazil alone, it is a triumph for 10 million poor African farmers whose livelihoods are affected by unfair competition. The US was unsuccessful in convincing the AB and now has to bring its cotton subsidies in line with the global trade rules. It ought to quickly reform its programmes and thus bring an end to dumping cheap cotton onto the world markets that threaten the livelihoods of poor farmers in the developing world. Both the International Monetary Fund (IMF)/World Bank (WB) and Oxfam estimate that the end of US cotton subsidies would lead to a rise in world prices by at least 25 percent

The ruling will surely affect the US farmers, as the US, in complying with the ruling, will now be forced to reform its national farm programmes. It will now have to cut over US$3bn a year in payments to nearly 25,000 cotton farmers. Thus, the US programmes will affect the major facets of its agricultural policy.

Fresh Challenges

The US and other rich countries are now on the verge of facing fresh challenges to support their farmers. This ruling on cotton subsidies has opened a Pandora's box of WTO challenges on other similar US subsidies elsewhere as more efficient producers in developing countries are losing out because of the rich countries' subsidies. Disputes are rising to question the legality of

Box 2: Elimination of Agriculture Subsidies – A Controversial Discussion

Jagdish Bhagwati, an economist at Columbia University and author of the book *'In Defense of Globalisation'*, wrote recently in the *Far Eastern Economic Review* that the agricultural subsidies are certainly undesirable. But the claim that removing them will help the poorest countries is 'dangerous nonsense' and a 'pernicious' fallacy since most poor countries are net importers of agricultural goods. Though subsidies depress the price of agricultural products on world markets, its repeal will benefit exporters but hurt importers.

Economists Alberto Vales and Alex McCalla have shown that as many as 45 least developed countries (LDCs), out of 49, are net food importers; and as many as 33 are net importers of all agricultural products together. As prices rise with the removal of subsidies, surely the importers will be harmed, not helped, except in the singular cases where the importers switch to becoming significant exporters.

In a paper published in 2003, Stephen Tokarick of the IMF, estimated by how much the repeal of subsidies benefit. He reckoned that, if the Organisation for Economic Cooperation and Development (OECD) countries were to scrap their subsidies (but keep their tariffs), Brazil and Argentina, both strong agricultural exporters, would gain. But the rest of Latin America would lose US$559mn a year. India would benefit a bit, but the rest of South Asia would be US$164mn worse off. Sub-Saharan Africa (SSA) would lose US$420mn, while North Africa and the Middle East would face a cost of US$2.9bn.

On the other hand, trade experts identify that with the same argument all the developed countries should maintain industrial subsidies, where 45 LDC are net industrial products importers too.

These trade experts believe that when the prices of the agricultural commodities and food products achieve the real market price without subsidies the price may increase, but at the same time, this situation would stimulate the apparition of new competitors in the production of these products. The new biotechnological products expand the agricultural frontiers to other regions including LDCs. This is a new opportunity for the developing countries to reduce poverty. In extreme cases, even when the LDCs do not have any possibility to produce food products, the international community can support the aid without distorting the market.

The debate on the elimination of agricultural subsidies is ever widening with commentators on either sides, or even the same side finding both positives and negatives in their arguments. Time will tell which side will prove to be the most beneficial to all.

Source: Punch-up over handouts, Economics Focus, The Economist, 23 March 2005, http://www.economist.com/research/articlesBySubject/displayStory.cfm?story_ID=3786899&subjectid=478044

huge amount of annual subsidies that support farmers of grain, sugar, soy bean, oilseed, wheat, corn and dairy farmers of the rich nations.

- ***EU's Sugar Subsidies:*** The WTO dispute panel found that the EU sugar subsidies violate global trade rules. The complaint, which Brazil filed in August 2003 along with Australia and Thailand, argued that the EU illegally dumped millions of tonnes of subsidised sugar on the world market, driving down prices for their producers.

  This ruling, just like the cotton decision, confirms that there are distortions in international agricultural markets.
- ***American Rice Subsidies:*** Uruguay has recently decided to file a legal complaint against the American rice subsidies at the WTO, built on the precedent of the cotton and sugar cases.

  Uruguay, the world's seventh biggest rice exporter, is determined to argue that US support to its rice farmers makes it harder for its own exports to compete. The US is the world's third largest rice exporter. With costs higher than many of its big competitors, its rice sector is one of the largest recipients of US farm subsidies, receiving about US$1.5bn a year. Some of the payments to farmers are similar to those ruled illegal in the WTO cotton case.
- ***American Soy Subsidies:*** Brazilian soy bean growers are considering pushing their government to bring another dispute before the WTO challenging US subsidies to soy beans. It is believed that soy beans were exported from the US at an average price of 10 percent below their cost of production in 2003.

Retaliation by Brazil

The US was given time till July 1, 2005, which was further extended till September 2005, to comply with the ruling, requiring steep cut in government subsidies. Though the US claims that it has taken steps towards complying with the ruling, Brazil rejects the same. Brazil has now decided to ask authorities within the WTO to allow Brazil to impose retaliatory trade measures.

Trade sanctions could be in the form of higher tariffs on US imports or allowing Brazilian manufacturers to break the US patents. However, the request for permission to retaliate does not necessarily mean that Brazil will actually go ahead with sanctions.

A delay in reforming the US subsidy programme will not only lead to retaliation from the Brazil, but will also jeopardise the entire round of WTO negotiations.

Significance of the Ruling on the Doha Round

Cotton became a major item on the WTO negotiation agenda ever since the Cancun Ministerial conference. The WTO Director-General, Dr Supachai Panitchpakdi, was himself facilitating the talks on cotton. The economies of African countries (Chad, Burkina Faso, Mali and Benin), which brought this issue to the negotiating table at Cancun, are heavily dependent on cotton.

At the recently concluded Hong Kong Ministerial, developed countries, including the US, have agreed to remove export subsidies on cotton by 2006. Further, it has been agreed that duty and quota-free market access would be provided to cotton exports from the LDCs. However, this result may be inadequate since domestic cotton subsidies, such as the US export credit guarantee system, would remain in place.

Box 3: US Special Farm Benefits

Direct Payments. Most cotton farmers benefit from direct payments under the 2002 Farm Act. These payments are based on the value of production and yields during a previous production period. On this basis, the US Government insists that its support is 'decoupled' from production, and is therefore eligible for the Green Box. In addition, the 2002 Farm Act prohibits direct payments on land used for cultivating fruits, vegetables, and other crops. This encourages the farmers to grow crops eligible for support, including cotton. For these reasons, there is a serious doubt whether the direct payments to US cotton farmers are properly within the Green Box.

Counter-cyclical Payments. These were introduced under the 2002 Farm Act, and replace the 'emergency market loss payments' provided by the US to cotton farmers during 1998-2001. This subsidy is designed to increase payments to farmers during periods of low world prices, thus enhancing production at the very time it should be declining. On this basis, the US cotton farmers received US$1.1bn in subsidies from this programme in 2002-03. As these payments are based on the market price falling to a certain level, they fall into the Amber Box.

Loan Deficiency Payments and Marketing Loan Gains. These payments are triggered when world prices fall below US$0.52 per pound. The further world prices fall below that level, the more they increase. Because they are linked to the volume of farm production, they fall into the Amber Box.

Step 2 Subsidies. These payments aim to keep the US export prices in line with low-cost competitors. They are provided both to exporters of US cotton and to domestic mills using US cotton, the aim being to eliminate any difference between the US internal prices and the international price. Total export subsidisation under this heading was around US$197mn in 2001.

The Export Credit Guarantee Programme (ECGP). The ECGP provided US$398mn funding in the fiscal year 2001. Under the programme, importers can borrow in dollars at US interest rates, and banks lending to them have the loans guaranteed by the US Government. This gives American exporters an enormous advantage over rival exporters in countries with shortages of hard currency and high interest rates.

US Crop Revenue and Insurance Programme. This covers over 90 percent of cotton acreage and protects farmers against crop loss caused by adverse weather or other conditions. It effectively takes away a large share of risks of farming. These programmes are part of the Amber Box for cotton producers. However, because they are applied to all crops, they are permissible, as long as they do not exceed five percent of the total value of production.

Source: Oxfam Briefing Paper, Cultivating Poverty: The Impact of U.S. Cotton Subsidies on Africa, September 2002, http://www.oxfam.org/eng/pdfs/pp020925_cotton.pdf

Livelihood Aspects

For African LDC's, cotton is extremely important. It is the foundation of their rural community, providing the major, and in some cases the only, source of income for many inhabitants. It is a vital source of foreign exchange, investment, and economic growth. It facilitates building houses, hospitals, schools etc. and occupies a pivotal role in the livelihoods of its poor. A couple of years ago, when exports of cotton increased in value, production expanded in these countries, raising village incomes.

Also being a low cost producer of cotton, it would have been highly competitive if markets were not distorted by massive subsidies. Cotton production in the region had multiplied by five to six times and about 95 percent was exported. But the collapse in the cotton price in the world market has threatened the very existence of these communities. The rich countries, by providing huge amount of subsidies, have raised the living standards of thousands of their people above the poverty line and at the same time increased the poverty of millions of Africans.

Now not only the 10 million cotton farmers in West Africa suffer from these trade-distorting subsidies but also the manufacturers of substitutable synthetic fibers. About 70 percent of them are in developing countries, and are suffering from having to compete with a crop whose market price is not freely determined. Similar is the case with silkworm farmers and flax-growers. Demand for linen and silk is depressed by the artificially low price of cotton.

However, this recent ruling by WTO would bring a change in the fortunes. This ruling against the US is not only a political victory but it also brings financial gain for Africa's small farmers, among others. The removal of US cotton subsidies would counter the global price distortions caused by overproduction and export subsidies, thus allowing African cotton farmers to compete fairly and secure a higher price for their cotton.

Box 4: WTO Cotton Sub-committee – The HK Draft Ministerial Declaration

Under paragraphs 11 and 12 of the Draft Declaration, the Members reaffirmed their commitment to ensure working towards an explicit decision on cotton within the negotiations on agriculture and through the Sub-Committee on cotton "ambitiously, expeditiously and specifically".

The Members agreed to:

- Eliminate all forms of export subsidies for cotton by the developed countries by 2006; and
- Give duty and quota-free access by developed countries for cotton exports from least developed countries from the commencement of the implementation period.

With regard to the development assistance aspects, the Declaration urges the development community to scale up cotton-specific assistance. It calls for intensification of consultative efforts with bilateral donors and with multilateral and regional institutions, with emphasis on improved coherence, coordination and enhanced implementation and to explore the possibility of establishing through such institutions a mechanism to deal with income declines in the cotton sector. It also urges the Members to promote and support South-South Cooperation, including the transfer of technology.

The Declaration makes a special reference to the domestic reform efforts by African cotton producers aimed at enhancing productivity and efficiency and encourages them to deepen this process.

Source: WTO WT/MIN(5)/W/3Rev.2 dated December 18, 2005

Conclusion

The significance of this ruling cannot be underestimated. The final outcome of this dispute at the WTO has highlighted the need for new approaches to agriculture trade. As discussed, this decision, together with the recent decision in the EU sugar subsidies case, in all probability will create an impact on the ongoing agriculture negotiations to a greater extent. It has been established that developed countries are adhering to trade distorting measures, and are not abiding by the rules that they themselves devised during the Uruguay Round.

Now it is for the developed as well as the developing countries to seriously ponder over what would be best in their own interests, especially in view of the likely rise in number of similar disputes at the WTO. Though there is an urgent need for restructuring the rich countries' domestic support towards agriculture, cutting down altogether the agriculture subsidies rapidly could harm both parties.

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