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**International Agricultural Trade and Policy Center**

**THE COTTON AND SUGAR SUBSIDIES DECISIONS: WTO'S  
DISPUTE SETTLEMENT SYSTEM REBALANCES THE  
AGREEMENT ON AGRICULTURE**

By

**Stephen J. Powell & Andrew Schmitz**

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**Institute of Food and Agricultural Sciences**

## **INTERNATIONAL AGRICULTURAL TRADE AND POLICY CENTER**

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- Serve as a nation-wide resource for research on public policy issues concerning specialty crops.
- Disseminate research results to, and interact with, policymakers; research, business, industry, and resource groups; and state, federal, and international agencies to facilitate the policy debate on specialty crop issues.

**The Cotton and Sugar Subsidies Decisions: WTO's Dispute Settlement System Rebalances  
the Agreement on Agriculture**

Stephen J. Powell and Andrew Schmitz

July 10, 2005

# The Cotton and Sugar Subsidies Decisions: WTO's Dispute Settlement System Rebalances the Agreement on Agriculture

Stephen J. Powell and Andrew Schmitz<sup>1</sup>

## I. Introduction

As far back as Ricardo's shattering insight as to comparative advantage in 1817, agriculture has enjoyed special favor in trade.<sup>2</sup> The unique place of farming was so well established by the time the 1947 General Agreement on Tariffs and Trade (GATT) was negotiated that GATT's tight disciplines on government interference with free trade not only exempted government protections to growers, but in fact were drafted to be fully consistent with the agricultural policies of the major signatories.<sup>3</sup> While it would be an exaggeration to argue that GATT's first half century was without impact on agricultural benefits, the sector at any rate took center stage during negotiations to create the World Trade Organization (WTO), because by the time these talks began in 1986, subsidy-induced overproduction had led to widespread displacement of efficient producers from their traditional markets.<sup>4</sup> Many felt this result was far from realization of David Ricardo's compelling economic case for the smallest possible government intervention.<sup>5</sup>

While widely hailed for bringing agriculture – at last – under the GATT/WTO umbrella, 1995's Agreement on Agriculture more than lived up to the promise of Article 20 that “substantial . . . reductions in support and protection resulting in fundamental reform is an ongoing process.” Both as to export subsidies – those contingent upon export performance and thus with the most direct impact on export prices and trade – and the remaining domestic subsidies, the Agriculture Agreement's ambitions are so modest that many experts believed its generous exemptions and undefined terms rarely would permit successful reining in by dispute settlement panels of the

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<sup>2</sup>Melaku G. Desta, *THE LAW OF INTERNATIONAL TRADE IN AGRICULTURAL PRODUCTS* 6 (Kluwer 2002).

<sup>3</sup>Terence P. Stewart, *I The Uruguay Round: A Negotiating History* 134 (Kluwer 1993).

<sup>4</sup>Paul C. Rosenthal & Lynn E. Duffy, *Reforming Global Trade in Agriculture* 146 (ch. 5 in *The World Trade Organization*, Amer. Bar Assoc., Terence P. Stewart, ed.).

<sup>5</sup>See Alan O. Sykes, Jr., “Comparative Advantage and the Normative Economics of International Trade Policy,” 1 *J. Int'l Econ. L.* 57 (1998).

nearly \$1 billion a day developed nations provide to their farmers.<sup>6</sup>

Two decisions issued by WTO dispute settlement panels on September 8, 2004, belie that prediction. Brazil, an agricultural superpower in its own right, was a complainant in both cases. In the first case, a Panel found U.S. subsidies to upland cotton were sufficiently in excess of those granted by the United States during the baseline 1992 marketing year to be actionable under the Subsidies Agreement despite the protection of the “Peace Clause” of the Agreement on Agriculture.<sup>7</sup> The *Cotton* Panel went on to find that these subsidies caused serious prejudice to Brazil’s cotton growers within the meaning of the Subsidies Agreement. In the second case, which involved the EU’s Common Agricultural Policy, a Panel held that the European Union had exceeded in both the amount of exports and the level of subsidies its agreed commitments on sugar.<sup>8</sup>

Not only is *Cotton* notable as the first WTO decision to find that domestic farm support caused injury, but the report is important because it also concluded that serious prejudice – and thus a WTO violation – was shown by the size and nature of the government benefits to the cotton industry on the ground that they caused world prices to be suppressed. U.S. cotton producers received \$13.1 billion<sup>9</sup> in subsidies during the examined period of 1999 to 2003 for a crop valued at \$13.94 billion in those four years. The Panel’s conclusions, which have been upheld by the WTO’s Appellate Body,<sup>10</sup> will have significant impact on agricultural policies for specialty and program crops of the United States, Europe, and Japan.<sup>11</sup> The *Sugar* Panel’s finding that below-cost exports of an agricultural product may, even in the absence of “direct” export subsidies, show export subsidization if there is close linkage of domestic support programs with these exports makes the U.S. rice, corn, soybeans, and other commodities programs vulnerable to dispute challenge.

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<sup>6</sup>N.Y. Times Apr. 28, 2004.

<sup>7</sup>*United States – Subsidies on Upland Cotton*, Report of the Panel, WT/DS267/R (Sept. 8, 2004), *appealed by the United States* at Meeting of WTO Dispute Settlement Body (Oct. 18, 2004) (hereinafter *Cotton Panel Report*).

<sup>8</sup>*European Communities – Export Subsidies on Sugar*, Reports of the Panels, WT/DS265/R, WT/DS266/R, & WT/DS283/R (Oct. 15, 2004) (unofficial reports issued to the Parties Sept. 8, 2004)(hereinafter *Sugar Panel Report*), *aff’d*, Report of the Appellate Body, WT/DS265/AB/R, WT/DS266/AD/R, & WT/DS283/AB/R (Apr. 28, 2005)(hereinafter *Sugar AB Report*).

<sup>9</sup>In terms of the effect of cotton policy on U.S. producers, the dollar amounts of the transfer referred to by the Panel are not the true gain for U.S. producers. Using standard cost benefit criteria, the gain in producer welfare from cotton price supports for 2002 was in the neighborhood of roughly \$1.5 billion, while the amount for 2003 was much less at \$595 million. (Fred Rossi, Andrew Schmitz, & Troy G. Schmitz, “The Multiplicative Effect of Water Subsidies and Support Payments: The Case of US Cotton,” J. INT’L AG. TRADE & DEV.(forthcoming 2005). These estimates are based on the standard cost-benefit framework outlined in Richard E. Just, , Darrell L. Hueth, & Andrew Schmitz, THE WELFARE ECONOMICS OF PUBLIC POLICY: A PRACTICAL APPROACH TO PROJECT AND POLICY EVALUATION 688 (Edward Elgar Pub. 2005).

<sup>10</sup>*United States—Subsidies on Upland Cotton*, Reports of the Appellate Body, WT/DS265/AB/R, WT/DS266/AB/R, & WT/DS267/AB/R (adopted Mar. 21, 2005)(hereinafter *Cotton AB Report*).

<sup>11</sup>See “Final Cotton Decision Could Have Major Impact on U.S. Farm Policies,” Inside U.S. Trade (June 25, 2004).

This paper will analyze the major holdings of the *Sugar* and *Cotton* decisions from both a legal and an economic perspective, assess the WTO implications of those holdings on other crops and on Doha Round agriculture negotiations, and examine the effects on other U.S. exports of the failure of the United States to implement the decisions separate from Doha Round negotiations.

## II. U.S.—Cotton Subsidies

### a. U.S. Cotton Support Programs as Non-Exempt Subsidies

The WTO Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) creates strong prohibitions on export and import-substitution subsidies (prohibited or “red light”) and on domestic subsidies that injure competing industries (actionable or “yellow light”). Recognizing the place agriculture continues to occupy under trade rules, in the case of both types of government programs, the Subsidies Agreement defers to the Agriculture Agreement.<sup>12</sup> Export subsidies and import-substitution subsidies are prohibited “except as provided in the Agreement on Agriculture.” As to domestic subsidies, normally actionable either through WTO disputes or national countervailing duty investigations, an exception is made for “subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture,” the so-called “Peace Clause” that exempted for the first nine years of implementation of the Agreement agricultural subsidies provided consistently with the Agreement’s terms. The Panel’s first task, then, was to evaluate whether U.S. Government benefits to cotton production and export met the Agriculture Agreement’s requirements. If so, the strictures of the Subsidies Agreement that govern state aid to all other products would not be relevant.

### b. Domestic Support

The Panel began with two programs the United States claimed—with apparent acquiescence by other farm country delegations during the Uruguay Round—were classic “green box” subsidies under Article 13(a) of the Agriculture Agreement—entirely exempt from reduction commitments because their receipt was unrelated to whether the farmer planted cotton, and thus have insignificant impact on cotton trade. To qualify as green box subsidies, the benefit program must meet several criteria. The first and “fundamental” requirement is that they have “no, or at most, minimal trade-distorting effects or effects on production.” Such subsidies must provide support solely from publicly funded government programs that do not involve transfers from consumers. Moreover, support must be decoupled from both prices and production and the program must meet the specific policy conditions set out by Annex 2 as to 12 different kinds of potentially eligible benefits, such as agricultural research, crop disaster assistance, income insurance, regional assistance, environmental programs, farmer retirement, and income support.<sup>13</sup> Even if the program meets all these conditions, a WTO Member may not claim green box status unless it

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<sup>12</sup>WTO Agreement on Subsidies and Countervailing Measures arts. 3.1 and 5.

<sup>13</sup>Agreement on Agriculture Annex 2.

has notified the WTO of the program.<sup>14</sup>

Green box status carries important benefits to the granting government. Green box programs are neither subject to reduction commitments nor need be counted in a Member's Aggregate Measurement of Support in base or subsequent years, which allows green box payments to grow without affecting the Member's overall reduction commitment. Most importantly, green box subsidies were exempt during the implementation period (1995-2003) from both national countervailing duty investigations and WTO dispute settlement challenges.<sup>15</sup>

The two claimed green box subsidies, production flexibility contract payments (PFC) and their 2002 successor, direct payments (DP), provide support to producers of upland cotton and other commodities based on historical acreage and yields in order to support farming flexibility and certainty. Neither depends on current prices. To fall into the green box, direct payments to producers must be decoupled not only from prices, but payment amounts also must not be "related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period."<sup>16</sup> The Panel noted first that "in general," payment amounts were not related to production volume or type, because program eligibility did not rely on actual production.

However, the Panel did not stop at this finding. Noting that although the producer had some flexibility because payments were not affected if the grower planted no crop at all, in fact the majority of producers did plant their acreage and the programs provided that payments would be reduced if recipients planted fruits and vegetables, melons, tree nuts, or wild rice.<sup>17</sup> Given that fruits and vegetables and the other listed crops clearly are "types" of production, the fact that producers who planted any of the "prohibited" crops would find their payments reduced was enough to convince the Panel that payments were not entirely decoupled from production.

The Panel's evaluation did not rely on actual use of the land by payment recipients, but on the hypothetical "monetary incentive for payment recipients not to produce the prohibited crops," which the Panel found could be significant in certain parts of the country.<sup>18</sup> In other words, even though the Panel acknowledged that the amount the producer received would not be affected in any way if the producer planted cotton, no matter how few or how many acres were grown, it found that flexibility and direct payments were coupled to production because a given farmer might grow a listed crop.<sup>19</sup> Planting cotton would seem by far the most likely alternative for a

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<sup>14</sup>Agreement on Agriculture art. 18.2 & 18.3.

<sup>15</sup>WTO Agreement on Subsidies and Countervailing Measures arts. 3.1 and 5.

<sup>16</sup>Agreement on Agriculture ¶ 6(b) of Annex 2.

<sup>17</sup>*Cotton Panel Report, supra* note 7, at ¶¶ 7.385 and 7.388.

<sup>18</sup>The Panel cited USDA data showing that 22 percent of farm income in the 17 states producing upland cotton came from the prohibited crops and that this figure was 70 percent in California, a major cotton producing state. *Cotton Panel Report, supra* note 7, at ¶ 7.386.

<sup>19</sup>The United States cogently argued that, under this reasoning, a WTO Member could not even prohibit planting of opium poppy or other illegal crops, much less environmentally damaging production or unapproved biotech varieties. The Panel stated this issue was not before it. *Cotton Panel Report, supra* note 7, at ¶¶ 7.360 & 7.373. The Appellate Body curtly rejoined that there is nothing to suggest that the



cotton producer, particularly one concerned that future support programs might be based on recent planting records.<sup>20</sup>

The Panel's finding that PFC and DP payments are coupled with production is thus not only theoretical, because it is not based on actual use of the land, but it also relies on testimony by an official of the National Cotton Council that does not support the Panel's reasoning.<sup>21</sup> Disqualifying the entire program from green box treatment for the potential that certain payments could be reduced is a broad reading of Annex 2's conditions, a step back from the reality of farm production, and a short-circuiting of the analytical process demanded by the treaty's terms. The PFC and DP programs thus failed the green box test and had to be considered with other domestic support under the "blue" or "amber" boxes of Article 13(b).<sup>22</sup>

To be exempt from the Subsidies Agreement under Article 13(b) of the Agriculture Agreement's Peace Clause, non-green domestic support measures provided "during the implementation period"<sup>23</sup> must "not grant support to a specific commodity in excess of that decided during the 1992 marketing year." In comparing the annual amounts provided from 1999 to 2002 by

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term "production" in paragraph 6 refers to anything other than "lawful" production, suggesting that the United States could decouple payments from production by making the growing of fruits and vegetables illegal. *Cotton AB Report, supra* note 10, at ¶ 340.

<sup>20</sup>The Appellate Body actually turned the likelihood that a cotton farmer would grow cotton, which should have supported the U.S. position that the prohibition of certain crops had "no, or at most minimal, trade-distorting effects or effects on production" (the first requirement of Annex 2), into a point found to undercut the U.S. position. Noting the Panel's finding that the "overwhelming majority" of cotton payment recipients continue to produce a permitted crop, the Appellate Body concluded that the U.S. prohibited list caused production of permitted crops to increase, rather than simply having negative effects on the listed crops. *Cotton AB Report, supra* note 10, at ¶ 329. Despite the theoretical possibility of the Appellate Body's conjecture, the more reasonable conclusion, in light of the actual evidence of record, is that the prohibited list had no effect on cotton production, as the United States argued. The conclusion of the Appellate Body in this respect is even more troubling in view of its later citation to data showing a strong positive correlation between farmers receiving direct payments and farmers who currently grow cotton. *Cotton AB Report, supra* note 10, at ¶ 376.

<sup>21</sup>In Note 511, the Panel seems to interpret the statement by then Council Executive Committee Chairman Robert McLendon to the House Committee on Agriculture that "I don't think we have a lot of farmers getting their payments and not working the land" as meaning that producers are constrained in the type of crops they can plant by the programs at issue. See *Cotton Panel Report, supra* note 7, at ¶ 7.386.

<sup>22</sup>In general, "blue box" subsidies are payments tied to output, acreage, or animal numbers that also require output limits, such as production quotas or land set-asides. For example, paying a rancher \$10 for every head of cattle not raised would be a classic blue box subsidy. Like green box payments, blue box programs are entirely exempt from reduction commitments, although no claim is made that such subsidies are without trade-distorting effects. Any subsidy that does not fit into the green or blue boxes automatically becomes an "amber" subsidy, such as price support payments. Non-*de minimis* amber box payments are subject to reduction commitments. See Raj Bhala, "World Agricultural Trade in Purgatory: The Uruguay Round Agriculture Agreement and Its Implications for the Doha Round," 79 N.D.L.REV. 693, 794-797 (2003).

<sup>23</sup>Evidence provided to the Panel by the parties covered only 1999 through 2002, and the Panel used this segment of the 1995 to 2003 "implementation period" to compare with MY1992. *Cotton Panel Report* ¶ 7.538.

programs that “clearly and explicitly specified” cotton as a commodity to which they grant support”<sup>24</sup> with the amount “decided”<sup>25</sup> during the 1992 marketing year,” the Panel prepared Table 1:

**Table 1: Comparison of support in accordance with Article 13(b)(ii)**

Million Dollars	MY1992	MY1999	MY2000	MY2001	MY2002
Marketing loan programme	866	1761	636	2609	897.8
User marketing (step 2)	102.7	165.8	260	144.8	72.4
Deficiency payments	1017.4	0	0	0	0
PFC payments	0	616	574.9	473.5	436
MLA payments	0	613	612	654	0
DP payments	0	0	0	0	181
CCP payments	0	0	0	0	1309
Crop insurance payments	26.6	169.6	161.7	262.9	194.1
Cottonseed payments	0	79	184.7	0	50
<b>TOTAL</b>	2012.7	3404.4	2429.3	4144.2	3140.3

The Panel concluded from its calculations that the aggregate non-green box support during MY1992 was exceeded in each of the implementation period years under review and thus that the Peace Clause exempted none of these programs from the Subsidies Agreement.<sup>26</sup> As shown in the table, the United States exceeded the \$2 billion in MY1992 subsidies during MY1999-2003 by between \$417 million and \$2.1 billion. The PFC/DP payments accounted for \$473 million to \$616 million of the excess. The United States argued that these programs, which were not in effect during the base year MY1992,<sup>27</sup> were exempt green box subsidies, but the Panel concluded they must be counted in the reduction commitment because they were not entirely decoupled from production. By far the largest program was marketing loans, which seeks to minimize potential loan forfeitures by providing interim financing to eligible producers and

<sup>24</sup>The other programs were the PFC and DP programs previously found not to qualify for green box treatment, plus user marketing (Step 2) payments, the marketing loan program, counter cyclical payments, and marketing loan assistance payments. *Cotton Panel Report* ¶ 7.518. The Panel rejected U.S. arguments that the measures to be counted during the implementation period should include only “product-specific” payments, which would exclude the four programs that provide planting flexibility because they contain no requirement to produce. The Panel noted that the U.S. interpretation would treat several billion dollars in subsidies as not supporting any commodity at all. *Cotton Report* ¶¶ 7.519-7.520. The Appellate Body agreed with the United States that only payments to current producers of cotton should be counted as “product-specific” payments, which would have been a great victory, but for the fact indicated *supra* note 20 that virtually all farmers with cotton base acres receiving payments also are current producers of cotton.

<sup>25</sup>The Panel found this “curious usage,” as compared with amounts actually granted, to mean the particular payments decided upon during MY1992. even if distributed at a later time. *Cotton Panel Report* ¶¶ 7.434 and 7.452.

<sup>26</sup>*Cotton Panel Report* ¶¶ 7.597 and 7.608.

<sup>27</sup>Of course, any program brought into effect after MY1992 will be in excess of that provided for that program during the base year.

whose payments were substantially larger than the base year in all but MY2000 and accounted for \$32 million to \$1.74 billion of the excess in the three other comparison years.

c. Export Subsidies and Import-Substitution Subsidies

As noted, export subsidies (those conditioned on export of the product) and import-substitution subsidies (eligibility is met by purchasing a domestic product rather than an imported one) for agricultural products are prohibited by the Subsidies Agreement “except as provided in the Agreement on Agriculture.” Article 8 of that Agreement prohibits export subsidies that exceed the reduction commitment specified for a particular product by the particular Member, as well as any export subsidies for products not listed in the Member’s schedule. The United States has no scheduled commitment for upland cotton, so the Agriculture Agreement prohibits any U.S. export subsidy provided for cotton . The only U.S. argument, then, was that the programs at issue were not, in fact, export subsidies. The Panel first looked at user marketing (Step 2) payments, a special marketing loan provision for upland cotton that provides marketing certificates or cash payments to domestic users and exporters of eligible cotton when market conditions result in U.S. cotton pricing benchmarks being exceeded. In essence, Step 2 payments are used to compensate U.S. cotton exporters and millers for their purchase of higher-priced U.S. cotton.

In looking at Step 2 payments to cotton exporters, the Panel used the broader definition of export subsidies in the Subsidies Agreement to find that such payments indeed were conditioned upon export of the product, despite U.S. arguments that payments also could be made to domestic users under the same program and that Step 2 must be examined as a whole as a benefit to cotton “users,” not with respect to any particular payment. In the Panel’s view, payments in one set of circumstances may not be ignored just because payments in other discrete segments of the program are not conditioned on export.<sup>28</sup>

As to Step 2 payments to domestic users of cotton, the Panel determined this segment of the program constituted an import-substitution subsidy, also prohibited under the Subsidies Agreement, because “the measure explicitly requires the use of domestically produced upland cotton as a pre-condition for receipt of the payments.”<sup>29</sup> Because the Agriculture Agreement’s Peace Clause does not even attempt to protect import-substitution subsidies from action under the Subsidies Agreement, Step 2 payments to domestic users are illegal under that Agreement.<sup>30</sup>

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<sup>28</sup>*Cotton Panel Report* ¶¶ 7.700, 7.708, & 7.720. The Panel looked to the Appellate Body’s decision during the implementation phase of the case involving U.S. export taxes (ETI), which grants a tax exemption in two situations, one conditioned on exportation and one not necessarily so. “Our conclusion that the ETI measure grants subsidies that are export contingent in the first set of circumstances is not affected by the fact that the subsidy can also be obtained in the second set of circumstances.” *United States—Tax Treatment for “Foreign Sales Corporations”—Recourse to Article 21.5 of the DSU by the European Communities*, Report of the Appellate Body, WT/DS108/AB/RW at ¶ 119 (adopted Jan. 29, 2002).

<sup>29</sup>*Cotton Panel Report*, *supra* note 7, at ¶ 7.1085.

<sup>30</sup>*Cotton Panel Report*, *supra* note 7, at ¶¶ 7.1050 & 7.1097.

The Panel next turned to the three export credit guarantee programs (GSM 102, GSM 103, and the Supplier Credit Guarantee Program), which aim to increase exports of agricultural commodities to compete against foreign agricultural exports by guaranteeing the repayment of credit extended to finance export sales. The first U.S. argument was that negotiators had made clear in Article 10.2 that no present disciplines existed as to export credit guarantees for agricultural products. In Article 10.2,

“Members undertake to work toward the development of internationally agreed disciplines to govern the provision of export credits, export credit guarantees or insurance programmes and, after agreement on such disciplines, to provide export credits, export credit guarantees or insurance programmes only in conformity therewith.”

In an unusual dissenting opinion, one Member of the Appellate Body agreed with the U.S. argument that Article 10.2 “suggests that it was believed [by the drafters] that such measures would not be subject to any disciplines until such time as disciplines were internationally agreed upon pursuant to Article 10.2.”<sup>31</sup> The majority disagreed, noting that Article 10.2 does not expressly exempt such export subsidies from the disciplines of Article 10.1, which prohibits application of subsidies not listed in Article 9 in a manner that circumvents the Article 9 commitments. The majority pointed to other exemptions identified by the Panel in the Subsidies Agreement and the General Agreement on Trade in Services which the Members had explicitly carved out, pending further multilateral negotiations. No such explicit exemption for export credits had been made in Article 10.2.<sup>32</sup>

Looking again to the Subsidies Agreement for guidance as to when export credit guarantees should be considered a prohibited export subsidy, the Panel noted that the test was whether premiums charged under the export credit guarantee programs were adequate to cover long-term operating costs and losses.<sup>33</sup> The principal argument was over the treatment of rescheduled debt, but the parties did not disagree that losses for the programs, for which dairy cattle also are eligible, were at least \$630 million in the past decade, and thus these programs had operated as prohibited export subsidies during 1999-2002.

The Panel thus found that the GSM 102, GSM 103, and Supplier Credit Guarantee Programs are prohibited export subsidies. Significantly for other crops, the Panel’s finding in this respect is not limited to cotton, despite U.S. arguments that Brazil’s claim reached only export guarantees for cotton.<sup>34</sup>

The final subjects of the Panel’s analysis were user marketing (Step 2) payments to domestic

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<sup>31</sup> *Cotton AB Report*, *supra* note 10, at ¶ 638.

<sup>32</sup> *Cotton AB Report*, *supra* note 10, at ¶ 610.

<sup>33</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.763, relying on Item (j) in Annex I to the Subsidies Agreement.

<sup>34</sup> *Cotton Panel Report*, *supra* note 7, at ¶¶ 7.55, 7.69, 7.764, & 7.869.

users, which as noted the Panel previously had found to be import substitution subsidies within the meaning of Article 3 of the Subsidies Agreement. Noting that the Agriculture Agreement's Peace Clause made no mention of import substitution subsidies, the Panel concluded that these types of subsidies were not shielded from the disciplines of the Subsidies Agreement.<sup>35</sup>

As export credit guarantees, the GSM 102/103 and the Supplier Credit Guarantee Programs are prohibited by the Subsidies Agreement. The user marketing (Step 2) payment to exporters is also a prohibited export subsidy and its payment to domestic users was found to be an import substitution subsidy, also a prohibited subsidy.

As to each of these programs found to be prohibited, the Panel, in accordance with Article 4.7 of the Subsidies Agreement, recommended that the programs be withdrawn "without delay," which the Panel specified in these circumstances to be no later than July 1, 2005.<sup>36</sup>

#### d. Serious Prejudice

Having found both export and domestic U.S. cotton support programs not immunized by the Agriculture Agreement, the Panel reached Brazil's claim that U.S. cotton subsidies violate Article 5 of the Subsidies Agreement, which provides that "No Member should cause, through the use of any subsidy . . . , adverse effects to the interests of other Members, i.e., . . . serious prejudice . . ." Article 6.3(c) defines "serious prejudice" to include the case where "the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market." Brazil alleged that U.S. subsidies caused serious prejudice to Brazil's interests during the 1999-2002 marketing years by significantly suppressing upland cotton prices in the Brazilian, world, and U.S. markets.<sup>37</sup> The Panel began its inquiry by finding that Brazilian and U.S. upland cotton compete "in the same market," which Article 6.3(c) does not limit geographically and can mean a world market where, as here, conditions of competition for sales from both countries are similar.<sup>38</sup> This initial finding laid the foundation for the Panel's examination of world cotton prices as the measure of serious prejudice by satisfying the first of the conditions set by Article 6.3(c):

- The subsidized product—U.S. cotton—and a like product<sup>39</sup> of another Member—Brazilian cotton—compete in the same market;
- Price suppression exists;
- The price suppression is significant; and
- The significant price suppression is through the effect of the subsidy.

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<sup>35</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1050.

<sup>36</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 8.3.

<sup>37</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1108.

<sup>38</sup> *Cotton Panel Report*, *supra* note 7, at ¶¶ 7.1240 & 7.1248. The Appellate Body agreed without significant further analysis. *Cotton AB Report*, *supra* note 10, at ¶ 405.

<sup>39</sup> The Panel quickly disposed of squabbles about whether the competing cotton products were "like," concluding that the "subsidized product" and the "like product of another Member" was, in both instances, upland cotton lint. *Cotton Panel Report*, *supra* note 7, at ¶ 7.1221.

e. Price Suppression

The Panel found three factors relevant to its determination whether price suppression (which it defined to mean that prices either are prevented or inhibited from rising, i.e., prices do not increase when otherwise they would have<sup>40</sup>) had occurred: (a) the relative magnitude of U.S. production and exports in the world upland cotton market; (b) general price trends; and (c) the nature of the subsidies at issue, in particular whether they have discernible price suppressive effects.<sup>41</sup> As to the first factor, the Panel noted that because the United States held a substantial proportion of world production (about 20% during MY1996-2002)<sup>42</sup> and export markets (from a 23% to 40% world share during this period) for upland cotton, it exercised “substantial proportionate influence on prices in the world market.”<sup>43</sup>

Turning to global price trends, the Panel first, in the words of National Cotton Council CEO Dr. Mark Lange, “dismissed the outlandish economic model results offered by Brazil’s economic expert,”<sup>44</sup> which had found that *but for* U.S. cotton subsidies, world cotton prices would have been 12.6 per cent (6.5 cents per pound) higher during MY1999-2002.<sup>45</sup> As Dr. Lange noted, the Brazilian results had been undermined in recent studies by Texas Tech and by FAO, both of which found minimal U.S. impacts on world prices. The Panel observed that Brazil’s and 13 other studies submitted by the United States and third parties had reached the common sense conclusion that removal of certain U.S. subsidies would lead to a change in world prices and “attributed to them the evidentiary weight we deemed appropriate.”<sup>46</sup> Using a chart submitted by the parties at the Panel’s request based on a composite of price sources, the Panel noted a “broad decline in the overall level of these price trends from 1996 to January 2002, with intermittent peaks and valleys,” but a clear decline during that period and an increase after the period.<sup>47</sup> To determine whether these prices were suppressed, the Panel looked to subsidies that are price-suppressive by nature.

The Panel noted that four of the subsidies were directly linked to world market prices (the marketing loan program, Step 2 user marketing payments, marketing loss assistance payments, and counter-cyclical payments). Under the marketing loan program, which seeks to minimize loan forfeitures by providing interim financing, the Panel concluded from its chart of subsidy

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<sup>40</sup> *Cotton Panel Report, supra* note 7, at ¶ 7.1277.

<sup>41</sup> *Cotton Panel Report, supra* note 7, at ¶ 7.1280.

<sup>42</sup> Although the United States argued that only serious prejudice in 2002, the last year for which complete data were available, was relevant, the Panel found that given its examination of subsidies over a period of time, “a recent historical period ... provides a more robust basis for a serious prejudice evaluation than merely paying attention to developments in a single recent year”, especially because “the market may well already be distorted in a given year due to subsidies.” *Cotton Panel Report* ¶ 7.1199.

<sup>43</sup> *Cotton Panel Report, supra* note 7, at ¶¶ 7.1281-7.1285.

<sup>44</sup> Quoted in “National Cotton Council Disagrees with WTO Ruling Against U.S. Subsidies,” Inside U.S. Trade (Sept. 8, 2004).

<sup>45</sup> *Cotton Panel Report, supra* note 7, at ¶¶ 7.1202 and 7.1205.

<sup>46</sup> *Cotton Panel Report, supra* note 7, at ¶¶ 7.1212 and 7.1215.

<sup>47</sup> *Cotton Panel Report, supra* note 7, at ¶ 7.1288.

payments that the further the “world price drops, the greater the extent to which United States upland cotton producers’ revenue is insulated from the decline, numbing United States production decisions from world market signals” and thus “enhancing production and trade-distorting effects.”<sup>48</sup> Having earlier concluded that it need not quantify the subsidies at issue because it was not engaged in a countervailing duty review,<sup>49</sup> the Panel pointed to information in the record that marketing loan subsidies over the period were in a “very large amount.”<sup>50</sup>

The same descriptor was used for the user marketing (Step 2) program, whose payments to exporters increased demand for U.S. cotton and whose payments to producers raised the price they received and thus stimulated production. In the case of payments both to exporters and to producers, the amount of the subsidy is directly linked to world market prices and thus “affects the world market generally.”<sup>51</sup> Similar findings were made as to the remaining price-contingent MLA and counter-cyclical payments.<sup>52</sup>

In a signal of the importance the Panel would continuously accord to the price-contingent nature of a subsidy and its relation to world prices, it found that the remaining subsidies – direct payments, crop insurance,<sup>53</sup> and production flexibility contract payments – while they enhance producer wealth and lower risk aversion, nonetheless should not be aggregated with price-contingent subsidies because they are “more directed at income support” and “their price-suppression effects are not as easily discernible as” the four programs it had decided to aggregate.<sup>54</sup> Noting that “neither party ... disputes the proposition that suppressed world prices may follow from an increased supply being infused on the world market,” that the world cotton price from MY1998 to MY2002 fell about 30 per cent from its 1980 to 1998 average, and that U.S. and world market prices are closely linked, the Panel found that price suppression had indeed occurred in the “same” world market within the meaning of Subsidies Agreement Article 6.3(c).<sup>55</sup>

#### f. Significance of the Price Suppression

Recall that Subsidies Agreement Article 6.3(c)’s definition of serious prejudice is met only if the price suppression is “significant,” another undefined term which the Panel treated in a possibly-oversimplified manner as meaning “important, notable, or consequential.” In an analysis reminiscent of its examination of whether price suppression existed in the first place, the Panel

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<sup>48</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1294.

<sup>49</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1179.

<sup>50</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1297.

<sup>51</sup> *Cotton Panel Report*, *supra* note 7, at ¶ 7.1300.

<sup>52</sup> Market loss assistance comprises *ad hoc* emergency and supplementary assistance provided to producers in order to make up for losses sustained as a result of recent low commodity prices. Counter-cyclical payments provide support to producers based on historical acreage and yields. *Cotton Panel Report*, *supra* note 7, at ¶¶ 7.216 & 7.223.

<sup>53</sup> Crop insurance protects against losses caused by natural disasters or market fluctuations. *Cotton Panel Report*, *supra* note 7, at ¶ 7.227.

<sup>54</sup> *Cotton Panel Report*, *supra* note 7, at ¶¶ 7.1305 and 7.1307.

<sup>55</sup> *Cotton Panel Report* ¶¶ 7.1309-7.1312.

returned to the same elements it had considered decisive for that element, that is, the relative magnitude of U.S. production and exports, the overall price trends in the world market, the price-contingent nature of the four programs, and the “readily available evidence of the order of magnitude of the subsidies.” In effect, the Panel’s single finding of price suppression sufficed as well for its pivotal conclusion that Brazilian producers faced “significant” suppression of world prices. Without citing to or likely using any economic data, the Panel opined that “a relatively small . . . suppression of prices could be significant” for a widely traded commodity such as upland cotton, because profit margins may be narrow, sales likely are price sensitive, and the market is large.<sup>56</sup> Thus the Panel turned “a relatively small” price effect into significant price suppression. And even this modest finding it makes by reasoning in the negative: “we are certainly not, by any means, looking at an insignificant or unimportant world price phenomenon.”<sup>57</sup>

g. Causal Link Between Subsidies and Price Suppression

Having found several domestic and export subsidies to violate the Subsidies Agreement, as well as significant price suppression in the world market for cotton, the Panel next examined whether the price suppression was caused by the subsidies, essentially of course an attribution exercise. While the Panel did not find in the Subsidies Agreement articles in question the need to separate effects “to a precise degree,” as would have been required under the Anti-Dumping or Safeguards Agreements,<sup>58</sup> the Panel nonetheless examined other potential reasons for the significant suppression of world cotton prices in finding a causal link based on four factors.

As it had in finding price suppression, and its significance, the Panel cited the substantial proportionate influence that the United States exerts in the world cotton market, and the fact that four of the support programs were linked directly to world market prices.<sup>59</sup> This latter factor was so important to the Panel, as it had been several times before, that it refused to aggregate the remaining subsidies that were not price-tied. Third, the Panel found a temporal coincidence between the subsidies and suppressed world prices. Over the same period that the subsidies were being granted, U.S. cotton producers generated large supplies while their revenue – and world market prices – declined. Even taking account of lower production from the 1998 drought and higher yields from 2001, the connection between price suppression and the increase in U.S. exports is clear.<sup>60</sup> Finally, the Panel found that production costs and revenues were not convergent, indicating that cotton producers would not have been economically capable of remaining in the market but for the subsidies.<sup>61</sup>

As to U.S. arguments that the strong U.S. dollar has had an inverse effect on the world price of cotton, which is traded internationally in U.S. dollars, the Panel noted that the U.S. share of the

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<sup>56</sup> *Cotton Panel Report* ¶ 7.1332.

<sup>57</sup> *Cotton Panel Report* ¶ 7.1332.

<sup>58</sup> *Cotton Panel Report* ¶ 7.1344.

<sup>59</sup> *Cotton Panel Report* ¶¶ 7.13248 and 7.1349.

<sup>60</sup> *Cotton Panel Report* ¶ 7.1352.

<sup>61</sup> *Cotton Panel Report* ¶ 7.1353.



export market rose dramatically at the same time the dollar appreciated during MY1999-2001, because U.S. cotton producer revenue is effectively sheltered from currency and price developments. As to China's release of millions of bales of government stocks at low prices between 1999 and 2001, while the Panel agreed that this event inevitably would exert downward pressure on world prices, it noted that U.S. exports were much larger than China's over this period and that China's action had no actual effect either on U.S. production or on its exports, which were maintained or increased over the period.<sup>62</sup> The meaning of the Panel's findings in this section is clearly that the U.S. effect on the market simply overshadowed the non-subsidy effects, and causation was thus established.

This discussion, however, cannot in any sense constitute an examination that would ensure that suppression caused by these other factors is not attributed to U.S. cotton subsidies, which the Panel seems to concede it must, on some level, conclude, else it would have no need at all to look at other potential causes. Article 6.3(c) requires a finding that "the effect of the subsidy is a significant price . . . suppression." The standard for finding injury in a countervailing duty examination in Article 15.5 is the same: "it must be demonstrated that the subsidized imports are, through the effects of subsidies, causing injury . . ." While Article 6.3(c) does not explicitly follow this test with the caution that "injuries caused by . . . other factors must not be attributed to the subsidized imports," as does Article 15.5, it is difficult to imagine any finding of injury that does not, to some degree, separate out these other potential causes. The Appellate Body seems to agree, as noted in the *Japanese Hot-Rolled Steel* case:

"If the injurious effects of the dumped imports are not appropriately separated and distinguished from the injurious effects of the other factors, the authorities will be unable to conclude that the injury they ascribe to dumped imports is actually caused by those imports, rather than by the other factors. Thus, in the absence of such separation and distinction of the different injurious effects, the investigating authorities would have no rational basis to conclude that the dumped imports are indeed causing the injury which, under the *Anti-Dumping Agreement*, justifies the imposition of anti-dumping duties."<sup>63</sup>

The Appellate Body's analysis here relies not on the non-attribution language of Article 15.5, but on reason. The Panel in *Cotton* did not look at the effect of subsidies by other countries on price suppression. In our view, these other subsidies clearly also suppress world cotton prices, and would continue to do so even without the U.S. cotton program. No economic model or data have yet sorted out the various contributions to this condition of price suppression. The Panel here adds no knowledge to this blank slate.

#### h. Panel's Use of Economic Data

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<sup>62</sup> *Cotton Panel Report* ¶¶ 7.1360-7.1361.

<sup>63</sup> *United States – Anti-Dumping Measures on Certain Hot-Rolled Steel Products from Japan*, WTO/DS184/AB/R ¶ 223 (Jul. 24, 2001).

Brazil's challenge relies heavily on the work of Daniel Sumner, an agricultural economist from the University of California at Davis, who found that, for the period 1999-2002, U.S. cotton subsidies caused world prices to drop roughly by 15 percent. Another study, the so-called Texas model, which covered only 2003,<sup>64</sup> showed that U.S. cotton subsidies caused less than a five percent drop in world prices. Part of this difference can be explained by the high world cotton price in 2003.

Other studies also show that the U.S. cotton policy causes world cotton prices to fall. Work by Schmitz, Schmitz, and Dumas<sup>65</sup> shows that, for certain time periods prior to 2000, world cotton prices were negatively impacted by at least 10 percent as a result of U.S. cotton policy. The cotton model developed here at the University of Florida, which included water subsidies, found that for the period 2002 world cotton prices were impacted by approximately 14 percent because of the U.S. farm program. For 2003, the impact was much less at about six percent.<sup>66</sup> One important feature of this work is the debate over the extent to which the U.S. cotton policy is decoupled. The 14 percent estimate is based on the assumption that U.S. producers use the U.S. cotton target price for production decisions. However, many argue that part of the cotton program is decoupled because U.S. producers use the loan rate for decision making rather than the target price. The work at the University of Florida shows that, for the latter, world cotton prices are negatively impacted by somewhere between six and seven percent for 2002.<sup>67</sup>

In summary, all of the economic models of which we are aware show that U.S. cotton policy has a negative impact on world cotton prices. However, the magnitude of the price impact varies among studies for reasons including the choice of base year, the incorporation of water subsidies, and the degree to which the U.S. cotton policy is assumed to be decoupled.

While the above models show the price impact from the U.S. cotton policy, we are unaware of any study that analyzes the extent of subsidies used by importing and exporting competing cotton producers and how these subsidies affect world cotton prices. Even in the absence of the U.S. cotton policy, world cotton prices may well be highly distorted in view of the use of worldwide subsidies either explicit or implicit. As a result, statements made concerning price suppression in the absence of U.S. cotton policy should be interpreted with caution because, even without U.S. cotton policy, cotton prices may well be below those under free trade due to worldwide cotton subsidies. In this case, price suppression can exist even in the absence of the U.S. cotton policy.

What use did the Panel make of economic data? While the empirical results from formal modeling discussed above may be consistent with the Panel's ruling, the Panel does not use any

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<sup>64</sup>Neither model included the impact of water subsidies.

<sup>65</sup>Schmitz, Troy G., Andrew Schmitz, and Chris Dumas. "Gains from Trade, Inefficiency of Government Programs, and the Net Economic Effects of Trading." *Journal of Political Economy* 105, 3 (1997): 637-647.

<sup>66</sup>Rossi, Fred, Andrew Schmitz, and Troy G. Schmitz. "The Multiplicative Effect of Water Subsidies and Support Payments: The Case of US Cotton," *J. INT'L AG. TRADE & DEV.*(forthcoming, 2005).

<sup>67</sup>Andrew Schmitz, Fred Rossi, & Troy G. Schmitz, "U.S. Cotton Subsidies under Decoupling" (submitted to *J. INT'L AG. TRADE & DEV.* 2005).

one specific model on which to hang its results. This may have been due to a number of factors, including the point raised above, that the formal economic model cited says very little about price suppression in the absence of U.S. farm programs. The Panel appears to rely more heavily on the fact that U.S. cotton subsidies were large and the United States was a major player in the world cotton market. In addition, the Panel relied heavily on other economic data, especially the U.S. Department of Agriculture's published cost of production data for cotton produced in the United States. These data clearly show that, in the absence of price supports, U.S. cotton production could not be sustained at current levels.

### III. Doha Round Outlook

The United States repeatedly has stated that it believes some of the issues addressed by the Panel would better be handled in the ongoing Doha Round talks on agriculture. Brazil as often has voiced disapproval with the notion of addressing these issues through negotiations rather than by timely implementation of the Panel ruling by the United States.<sup>68</sup> Of course, the United States opposes paying the price demanded by the Panel without extracting some compensation in return, particularly from Europe. The EU, however, whose views on agriculture are formidable in the WTO, is unlikely to be supportive of the U.S. approach, because the EU decided at least in theory last year to decouple from production over time most Common Agricultural Policy (CAP) payments, so the decision could have minimal impact on the CAP in the longer term.<sup>69</sup> After their central role in collapse of the September 2003 WTO Ministerial Conference in Cancun, cotton subsidies have been targeted expressly by WTO Members in their August 1, 2004, decision to activate anew the Doha Round negotiations. As to agriculture, despite the U.S. proposal to handle cotton as part of the overall negotiations, the decision states:

“The General Council recognizes the importance of cotton for a certain number of countries and its vital importance for developing countries, especially LDCs. It will be addressed ambitiously, expeditiously, and specifically within the agriculture negotiations.”<sup>70</sup>

The WTO offers elaborate financial penalties to coerce compliance with Panel rulings. If the losing Member fails within a reasonable period of time to bring its laws into compliance with the Panel's findings (or those of the Appellate Body following an appeal, as in this case), the winning Member may retaliate by imposing prohibitive tariffs on imports from the losing country in the amount of the trade lost as a result of the WTO-inconsistent measure.<sup>71</sup> While

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<sup>68</sup>“WTO Issues Landmark Ruling Against U.S. Cotton Subsidies,” WTO Reporter Sept. 9, 2004, p. 4 (BNA).

<sup>69</sup>“EU Official Sees No Threat to Farm Subsidies from WTO Ruling on Cotton,” WTO Reporter June 24, 2004 (BNA).

<sup>70</sup>See Terence P. Stewart, “The Ongoing Global Trade Talks Latest Decision – An Initial Assessment” at 2 (Aug. 9, 2004), on file with authors.

<sup>71</sup>WTO Understanding on Rules and Procedures Governing the Settlement of Disputes art. 22. For example, since July 1999, the United States and Canada have imposed increased tariffs on a number of imported products from Europe in the amount of US\$ 117 million and CDN\$11 million per year

these counter blows do not immediately benefit the industry harmed by the violating measure (here, Brazil's cotton producers), strong political pressure from the innocent exporters now suffering from high tariffs often will cause the losing Member to implement the Panel's recommendations. Brazil's course of action thus will bring strong pressure on the U. S. Congress to make changes to the last three years of the latest farm bill, the Farm Security and Rural Investment Act of 2002. That push will come from industries threatened by Brazil's ability to impose offsetting tariffs on U.S. exports to compensate for the WTO-inconsistent cotton subsidies.

The Peace Clause expired in any event at the end of 2003, so additional payments until termination of the current farm bill in 2007 will be subject to national CVD investigations as well as WTO dispute settlement system challenges based not only on which of the amber, blue, or green boxes the Agriculture Agreement would place them in, but based on whether they meet the definition of a "subsidy" and have adverse trade effects within the meaning of the Subsidies Agreement,<sup>72</sup> unless the Agriculture Agreement is amended as part of the Doha Round of multilateral negotiations.<sup>73</sup> One may speculate whether the Congress was aware of this exposure when it passed the 2002 farm bill, as well as whether the Congressional committees could have foreseen the *Cotton Panel's* interpretation of the Peace Clause's outer boundaries.<sup>74</sup>

The Panel's decision not to quantify non-exempt subsidies made even less reviewable and more subjective its conclusion that price suppression existed in the first place and even more so that it was "significant." By this approach, the Panel also avoided the need to specify what economic data underlie its conclusions. To a certain degree, of course, all subsidies have market-insulating effects, which make the question of degree – which the Panel discounts – critical in the serious

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following the EC's failure to revise its ban on hormone-fed beef in accordance with the WTO Appellate Body Report in *EC – Measures Concerning Meat and Meat Products (Hormones)*, WTO/DS26 & 48/AB/R (adopted Feb. 13, 1998). See "EU requests WTO to confirm that there is no justification for US/Canada to continue to apply sanctions," EC Press Release (Nov. 8, 2004), available at [http://europa.eu.int/comm/trade/issues/respectrules/dispute/pr081104\\_en.htm](http://europa.eu.int/comm/trade/issues/respectrules/dispute/pr081104_en.htm).

<sup>72</sup>John R. Magnus, *The Evils of a Long Peace: Legal Consequences of a WTO "Peace Clause" Expiry and Practical Issues for New Litigation Over Farm Subsidies*, at n. 2 (quoting testimony of then U.S. Trade Representative Charlene Barshefsky as to expiration of the Peace Clause) & 8, Presentation to Global Business Dialogue (Dec. 4, 2003), copy on file with author.

<sup>73</sup>Stewart, *supra* note 71, at 5.

<sup>74</sup>The Deputy U.S. Trade Representative told the Dispute Settlement Body upon its adoption of the *Cotton AB Report* that the 2002 U.S. farm bill was written to be consistent with the Peace Clause, at least as U.S.T.R. then understood its meaning: "Again, we wonder whether Members are well served by a Peace Clause interpretation that could not have been known to any Member designing its support programs . . . ." "Statements of U.S. Ambassador Linnet Deily at the Meeting of the WTO Dispute Settlement Body (Mar. 21, 2005), available at <http://www.us-mission.ch/Press2005/0321DSB.htm>. The "front-loaded" U.S. system for gauging compliance with its international obligations, which begins and ends with initial amendment of federal laws the Administration and the Congress believe to be in derogation of the new commitment, but denies the courts any but the most incidental role in ongoing enforcement, makes particularly difficult implementation of emerging interpretations of those obligations by dispute settlement panels. See John R. Magnus, Naviin Joneja, & David Yocis, "What Do All Those Adverse WTO Decisions Mean?," presentation at INTERNATIONAL TRADE LAW UPDATE 2003 (Geo. Univ. L. Ctr.), on file with authors.

prejudice equation. The Appellate Body readily concedes this point by its statement that “[t]he magnitude of the subsidy is an important factor in this analysis [of price effects],” but is unwilling to do more than scold the Panel by saying it “could have been more explicit and specified what it meant by ‘very large amounts.’”<sup>75</sup> By this wink and a nod approach, the Appellate Body signaled that it was unwilling to disturb the Panel’s ultimate finding of significant price suppression.<sup>76</sup> The authors find in this regal forbearance as to such a striking and consequential deficiency by the Panel an example of the Appellate Body’s occasional foray into the policy sphere, an incursion into the legislative arena that at times seems irresistible, perhaps unavoidable, for the court of last resort in any judicial regime. What the Panel and the Appellate Body have overlooked in their efforts to hasten reduction of farm subsidies is that their failure to devise a quantitative standard for serious prejudice leaves WTO Members completely without guidance on how to bring their agricultural support programs into WTO compliance. The authors agree with the decisions that *Cotton* is not a countervailing duty case, which would have required agreement on a precise rate of subsidization. In fact, the lack of quantification in effect tells Members to do nothing, because further dispute settlement litigation will be required before any rule may emerge that is capable of implementation.

The Panel took several such short cuts, including its finding that any potential reduction in PFC or DP payments through planting of listed crops automatically excludes the entirety of both programs from green box treatment. Actually reviewing the extent of such payment reductions may have revealed that the likelihood of the planting of listed crops was insignificant enough for the Panel to regard as *de minimis* for purposes of the production-decoupling requirement of the Agriculture Agreement for direct payments to farmers. One may also question the Panel’s ready conclusion that the simple prohibition of planting of certain crops, for example, to reduce agricultural overproduction—a goal both the Agriculture and Subsidies Agreement would applaud—disqualifies a direct payment program from the green box on the basis of this indirect, even incidental, “coupling” with production.

The most striking use of short cuts, and likely the element of the Panel’s analysis that will have the most far-reaching effects, is the ease with which the Panel was able to find price suppression, the key element in its determination that U.S. cotton programs caused serious injury to Brazil’s cotton growers. The Panel quickly found that marketing loan payments, counter-cyclical payments, and Step 2 payments were inherently price-suppressive because the amount of payments was directly linked to world prices. As the world price fell, payments increased, with

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<sup>75</sup>*Cotton AB Report, supra* note 10, at ¶ 461.

<sup>76</sup>The Appellate Body lacks the power of national courts to remand the case to the Panel for correction of errors. It may but reverse, modify, or uphold a panel. WTO Understanding on Rules and Procedures Governing the Settlement of Disputes, art. 17.13. Reversing the Panel on this critical step of the analysis would have required Brazil to begin its complaint anew. For example, Brazil claimed on appeal that the Panel erred in finding that U.S. export credit guarantee programs circumvented U.S. export subsidy commitments only for rice, and not for the 12 other commodities eligible for such credits, including pig and poultry meat. The Appellate Body found that the Panel had not actually analyzed the 12 other commodities, so reversed the Panel’s finding as to them. However, lacking a factual basis to make any findings of its own (“complete the analysis”), the Appellate Body could give Brazil no further relief, leaving Brazil in the same position as if it had not appealed this point.

the effect of erasing market signals that ordinarily would result in decreasing production. Despite some 330 pages devoted to findings and conclusions, that is the essence of the Panel's analysis. This brevity most certainly would not have been countenanced by the Appellate Body if it had been performed by the U.S. International Trade Commission in determining injury,<sup>77</sup> and is all the more surprising in light of the abundance of relevant information on the record to which the Panel repeatedly cites,<sup>78</sup> yet refuses to use to underpin its conclusion. The lack of a quantitative standard was most apparent in this aspect of its decision. Without explicitly accepting any of the estimates submitted by the parties, the Panel relied on the relative magnitude of U.S. production and exports – “we are certainly not, by any means, looking at an insignificant or unimportant world price phenomenon.” U.S. trade authorities agree with the observation of the authors that the superficial analysis of both the Panel and Appellate Body in this respect would never have survived WTO dispute panel analysis if performed by national authorities.<sup>79</sup>

We may properly disagree with the Panel's refusal to develop, and the Appellate Body's refusal to require, a quantitative standard for determining whether the effect of such subsidies was “significant.” In effect, the Panel collapsed the game-determining search for the significance of price suppression into the examination of its very existence, because the Panel used precisely the same factors to reach both conclusions. On the other hand, it is more difficult to find fault with the Panel's conclusion that price-based support programs most directly affect world prices. Income support programs tied to neutral non-price criteria, while they may also increase production to levels that growers could not have sustained without the subsidy, are unlikely to have such easily discernible effects on prices. Payments that rise or fall with cotton prices undeniably insulate producers from market signals, regardless of the merit of the program's benchmarks.

We should also keep in mind that the Subsidies Agreement does not require, as the *Cotton* cases vividly demonstrate, proof that subsidies resulted in a decrease in world prices. As noted, price suppression, one of the triggers of a “serious prejudice” finding along with the more familiar price undercutting or depression, requires a finding that prices were not rising as fast as they would have risen absent the subsidies. A panel can find price suppression even if prices generally are in an upward trend, which is not the familiar situation we imagine for proof of injury. In addition, by contrast to a finding of price undercutting, the standards for making this “but for” determination are greatly more subjective and dependent on the opinion of the panel members.

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<sup>77</sup> See, e.g., *United States – Safeguard Measures on Imports of Fresh, Chilled, or Frozen Lamb Meat from New Zealand and Australia*, WT/DS177 & 178/AB/R ¶¶ 162 *et seq.* (adopted May 16, 2001), and *United States – Anti-Dumping Measures on Certain Hot-Rolled Steel Products from Japan*, WTO/DS184/AB/R ¶¶ 223 *et seq.* (Jul. 24, 2001).

<sup>78</sup> For example, *Cotton Panel Report*, *supra* note 7, at ¶¶ 7.1297, 7.1300, 7.1306, and 7.1308.

<sup>79</sup> *United States – Subsidies on Upland Cotton*, Notification of an Appeal by the United States, WTO/DS267/17, at 4 (Oct. 20, 2004); “WTO Formally Backs Cotton Ruling: U.S. Slams Appellate Body Analysis,” *WTO Reporter* 2 (BNA Mar. 22, 2005).

We agree with Brazil's statement to the WTO during adoption of the *Cotton* cases that the ruling has an "obvious and important impact" on Doha Round agriculture negotiations.<sup>80</sup> Inclusion of the relatively new direct payments program in the blue, instead of green, box will completely undercut U.S. Doha Round plans for the "new" blue box. The United States intended that the expanded blue box outlined in the July 2004 Framework<sup>81</sup> would contain its counter-cyclical payments, the program that succeeded the market loss assistance payments the United States had notified to the WTO as amber box subsidies. Counter-cyclical payments are directly linked to current prices, but are decoupled from production.<sup>82</sup> This intended movement of counter-cyclical payments to the blue box, which is not subject to reduction commitments, although a cap would limit the new blue box, is perhaps the most controversial proposal in the July 2004 Framework, because it would preserve for the United States a major component of its farm policy. The United States would be required to make substantial adjustments to stay within its lowered amber box ceiling, but counter-cyclical payments would nonetheless continue.<sup>83</sup> However, the new blue box for the United States has no room for the \$4 billion to \$5 billion in direct payments, because it will be filled entirely by an expected \$10 billion in counter-cyclical payments.

The *Cotton* case thus substantially changes the starting positions of the developed country and developing country negotiators by blurring the distinctions between the "boxes" that were clear to the agriculture negotiators during the Uruguay Round. At a minimum, negotiators will be at pains to avoid by more precise drafting the technical traps used to advantage by Brazil in the *Cotton* and *Sugar* cases.

#### IV. Application to Other Crops

Not only is cotton highly supported through farm programs, but so are commodities such as rice and wheat. These programs are heavily sustained by government subsidies, minimum price controls, and other market interventions. Japan as well props up the price of domestic rice through a variety of government subsidies and other market controls.

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<sup>80</sup>"WTO Formally Backs Cotton Ruling," *supra* note 38, at 4.

<sup>81</sup>Decision Adopted by the General Council on 1 August 2004, WT/L/579, at Annex A para. 13 (Aug. 2, 2004)(hereinafter July 2004 Framework). The first bullet in paragraph 13 refers to the production-limiting programs that are the subject of the current art. 6.5 of the Agreement on Agriculture. The second bullet would create a new blue box for "direct payments that do not require production if such payments are based on fixed and unchanging bases and yields; or livestock payments made on a fixed and unchanging number of head; and such payments are made on 85% or less of a fixed and unchanging base level of production. Counter-cyclical payments, under planned reductions, would fit this second bulleted description.

<sup>82</sup>As explained in *Cotton Panel Report*, *supra* note 7, at ¶ 7.225, counter-cyclical payments depend on historical acreage and yields with the amount calculated as the difference between the legislation's target price for a commodity and an average current price.

<sup>83</sup>See Stewart, "The Ongoing Global Trade Talks Latest Decision – An Initial Assessment," *supra* note 71, at 4; discussions with U.S. Department of Agriculture negotiators, notes on file with authors (Apr. 15, 2005).

To put cotton in perspective with other program crops, consider Table 2. Under the 2002 U.S. Farm Bill, loan rates and target prices were set for major U.S. commodities. Since that time, market prices have been significantly below target prices. In addition, at times market prices have even been below the loan rate. Both countercyclical and loan deficiency payments have been sizeable. This is true not only for cotton. Clearly U. S. producers are selling commodities such as cotton and corn at prices under the full cost of production. Often the United States is dumping in its export markets.<sup>84</sup> When examining the market prices over time with the data in Table 2, it is clear why more WTO dispute cases will occur in the future. Cotton is hardly any different from soybeans or corn or the other commodities listed.

Table 2. Selected U.S. Agricultural Commodity Loan Rates and Target Prices, 2002.<sup>85</sup>

<b>Crop</b>	<b>Loan Rate</b>	<b>Target Price</b>
Corn (\$/bushel)	1.98	2.60
Sorghum (\$/bushel)	1.98	2.54
Wheat (\$/bushel)	2.80	3.86
Upland Cotton (\$/pound)	0.52	0.72
Rice (\$/hundredweight)	6.50	10.50
Barley (\$/bushel)	1.88	2.21
Oats (\$/bushel)	1.35	1.40
Soybeans (\$/bushel)	5.00	5.80
Minor Oilseeds (\$/pound)	0.096	0.10

Any support program for any crop that limits planting of alternative crops, such as the PFC and DP payments, is vulnerable to challenge under the Panel's reasoning that such a limitation constitutes a tie to production. DP payments are available under the same restrictions for rice, soybeans, wheat, corn, and other crops, which makes payments to producers of these commodities vulnerable.<sup>86</sup> More importantly to specialty agriculture, if DP or similar green box support programs cannot lawfully discourage planting of alternative crops (because, for example, domestic demand is being met by existing production), downward price pressure increasingly will be exerted on fruit and vegetable, tree nut, melon, and wild rice production.<sup>87</sup>

The United States will be under strong pressure to repeal its agricultural export credit guarantee programs long before Doha Round negotiations would require this result, and in fact has already

<sup>84</sup>Andrew Schmitz & Richard Gray. "Distorted Agricultural Trade: Who Wants Free Trade Anyway?" in IMPROVING AGRICULTURAL TRADE PERFORMANCE UNDER THE GATT 163-180 (T. Becker, R. Gray, & A. Schmitz, eds. Wissenschaftsverlag Vauk Kiel KG 1992).

<sup>85</sup>See Bruce A. Babcock, 3 IOWA AG. REVIEW 8 (2002).

<sup>86</sup>Because the Appellate Body and Panel found that DP payments are not price-dependent and thus should not be considered in the price suppression analysis, the vulnerability of DP payments for other crops would seem to be limited to the inclusion of the DP program in the U.S. non-green box reduction commitments. See text at *supra* note 54.

<sup>87</sup>The authors are beholden to Stanford University Food Research Professor Timothy Josling for highlighting this implication.



offered both regulatory and legislative amendments to accomplish this result.<sup>88</sup> This pressure also will have direct effect on the many other crops eligible for such guarantees, including the hog and poultry meats that were of such concern to Brazil, because the WTO ruling that these programs are prohibited export subsidies was not limited to export guarantees for cotton. Rice, corn, oilseeds, wheat, and soybeans also receive substantial export credit subsidies.<sup>89</sup>

The United States was unsuccessful in convincing the Appellate Body that conditioning the amount of a payment on the production undertaken by the producer, which is not the case under DP, is different from banning a DP recipient from producing certain crops, which is what DP does. The Appellate Body concluded that “[d]ecoupling of payments from production under paragraph 6(b) can only be ensured if the payments are not related to . . . either a positive requirement to produce certain crops or a negative requirement not to produce certain crops or a combination of both positive and negative requirements on production of crops.”<sup>90</sup>

Rumors abound of another case being considered by Brazilian growers, based on the reasoning of the *Cotton* case, against the U.S. soybean industry, which is expected to receive \$3.25 billion in subsidies if President Bush’s 2006 budget is adopted, an amount that rivals receipts by upland cotton producers from 1999 to 2003. Much of this possible increase would consist of direct payments and crop insurance subsidies, which are not tied to prices and thus not considered by the *Cotton* panels’ reasoning to contribute to serious prejudice. Marketing loans, counter-cyclical payments, and loan deficiency payments may be substantially greater than past years unless recent favorable pricing trends continue.<sup>91</sup> Dairy and rice are often mentioned by Brazilian officials as subsidized U.S. programs especially vulnerable as a result of the Appellate Body’s upholding all the findings of the *Cotton Panel Report*.<sup>92</sup>

## V. EC—Sugar Subsidies

### a. Relevant Provisions of EC sugar regime and the Agreement on Agriculture

The EC sugar regime establishes production quotas for two categories of sugar, labeled “A sugar” and “B sugar.” These production quotas, which are divided among the EC’s many sugar producers based on prior production levels after the quotas are allocated to individual Member States, are the maximum amounts of sugar that may be sold within the EC in a given year. Producers must export any surplus amounts, designated “C sugar.” If a producer cannot

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<sup>88</sup>“USDA Releases Administration Proposal to Comply with WTO Decision on Cotton,” Int’l Trade Reporter 1 (BNA Jul. 7, 2005); “USDA Announces Steps to Bring U.S. Into Compliance with WTO Cotton Ruling,” Int’l Trade Reporter 10 (BNA Jul. 7, 2005).

<sup>89</sup>“WTO Appellate Body Upholds Ruling Against U.S. Subsidy Programs for Cotton,” WTO Reporter 1 (BNA Mar. 4, 2005).

<sup>90</sup>*Cotton AB Report*, *supra* note 10, at ¶ 325.

<sup>91</sup>“American Soy Group Downplays Prospects of Brazil WTO Complaint on U.S. Subsidies,” WTO Reporter 1-3 (BNA Feb. 22, 2005).

<sup>92</sup>“WTO Appellate Body Upholds Ruling Against U.S. Subsidy Programs for Cotton,” *supra* note 39, at 3.

establish that it exported any amount produced above its “A sugar” and “B sugar” quotas, the producer will be charged penalties.<sup>93</sup> The production quotas also establish the maximum quantities of sugar that may receive domestic price supports. Domestic prices for A and B sugar are supported by a combination of minimum prices, supply management, import restrictions, and by requiring Member State agencies to intervene in the market to purchase A and B sugar at prices that ensure a “fair income” for sugar-beet and sugar-cane producers.

The EC also provides direct export subsidies (called “refunds” by the EC law) for A and B sugar. The amount of the export refund is the amount by which the EC internal market price exceeds the world market price.<sup>94</sup> Even though C sugar must be exported, C sugar does not receive direct export subsidies. EC sugar producers may purchase sugar beets below the minimum price set for A and B sugar beets if they use the beets for C sugar production. The prices for C sugar beets generally are about 60 percent of the prices for A and B sugar beets.<sup>95</sup>

The EC has entered into trade agreements, among others, with former colonies of EC Member States in Africa, the Caribbean, and the Pacific (the ACP/EC Partnership Agreement). This Agreement obligates the EC to import about 1.29 million metric tons of sugar from these countries. The EC also has signed a preferential agreement that requires importation of an additional 10,000 tons from India. The minimum price system applies to these imports. In addition, the EC grants EC sugar producers export refunds, at the same level as those for A and B quota sugar, on export amounts equivalent to the imports of ACP/India origin sugar.<sup>96</sup>

Article 9.2 of the WTO Agreement on Agriculture requires an approximate one-third reduction of existing export subsidies on agricultural commodities. Each WTO Member providing such subsidies has set out its reduction commitments on a product-by-product basis in a schedule of commitments. These schedules became binding provisions by their incorporation by reference in the Agreement. Articles 3 and 8 prohibit Members from providing export subsidies except as permitted both by the Agreement and in the particular Member’s commitment schedule. Article 3.3 establishes a two-part test by its requirement that “a Member shall not provide export subsidies . . . in excess of the budgetary outlay and quantity commitment levels” which it has set with respect to agricultural products in a certain part of its Schedule.

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<sup>93</sup>In the alternative, producers may carry C sugar over to the following marketing year in an amount up to 20 percent of the producer’s A sugar quota. Andrew Schmitz, “The European Union’s High-Priced Sugar-Support Regime,” chap. 15 in *SUGAR AND RELATED SWEETENER MARKETS: INTERNATIONAL PERSPECTIVES* 205 (Andrew Schmitz et al. eds., CABI Pub. 2002).

<sup>94</sup>Council Regulation (EC) No. 1260/2001 (Jun. 19, 2001) carries forward the 1968 Common Organization for Sugar. See *Sugar Panel Report*, *supra* note 8, at ¶¶ 3.1, 3.4, 3.8, & 3.11. The Panel noted that a significant complication in appraising the WTO compliance of the sugar regime was that generally producers of A, B, and C sugar are the same enterprises and these products are produced on the same production lines. The categories are created by the legal regime and do not necessarily reflect physical differences in the sugar.

<sup>95</sup>*Sugar Panel Report*, *supra* note 8, at ¶ 3.8.

<sup>96</sup>*Sugar Panel Report*, *supra* note 8, at ¶¶ 3.7, 3.14, 7.117, & 7.234. For a more detailed description of the EU’s sugar regime, see Andrew Schmitz, *supra* note 92, at 193-213.

Article 3.3 also provides that the types of export subsidies subject to reduction commitments are those detailed in Article 9.1. Of relevance here, the subsidies subject to reduction commitments include direct subsidies to producers “contingent on export performance” (Article 9.1(a)), and “payments on the export of an agricultural product that are financed by virtue of government action” (Article 9.1(c)).

In the relevant section of its reduction commitment schedule, the EC limits its export subsidies on sugar to 1,273,500 tons and 499.1 million euros. Footnote 1 to this commitment states: “Does not include exports of sugar of ACP and Indian origin on which the Community is not making any reduction commitments. The average of export in the period 1986 to 1990 amount to 1.6 mio t.” Brazil, Thailand, and Australia alleged that the EC had exceeded its reduction commitments in each year since 1995, including in the 2001-2002 marketing year by exporting upwards of 4 million tons of subsidized C sugar.<sup>97</sup>

b. Determination of EC export subsidy reduction commitment levels

Before reaching the questions whether the EC had exceeded its volume and budgetary commitment as to sugar, the Panel first had to decide precisely what was the EC’s export subsidy commitment for sugar. The EC argued that its volume limitation for sugar exports was not solely the 1.273 million tons listed in the main part of its schedule, but in addition the 1.6 million tons identified in Footnote 1, which the EC said was intended to expand its commitment.

The Panel rejected the EC’s claim on two grounds. The Panel first noted that the very words used do not, giving the terms their ordinary meaning, accomplish what the EC says they do, namely, “make(s) it clear that *exports* [equivalent to] the quantity of ACP/India sugar *imported* shall not be counted against the commitments made on the base period levels.”<sup>98</sup> The Footnote literally attempts to exempt sugar of ACP/India *origin* from the EC’s *export* subsidy commitments, which makes little sense. The EC’s reading of the sentence, the Panel essentially found, did not comport with the words it used.<sup>99</sup> More importantly, the Panel found that Footnote 1 has no legal value because it does not meet the requirements of Article 3.3, which prohibits export subsidies in excess of the budgetary and quantity commitments specified in a Member’s schedule. Footnote 1 does not even attempt to specify a budgetary commitment as to ACP/India sugar. Without this aspect of the commitment, a complainant could never prove a violation of Article 3.3 and the EC thus cannot point to Footnote 1 as part of its specified commitment.<sup>100</sup>

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<sup>97</sup> *Sugar Panel Report, supra* note 8, at ¶¶ 3.13 & 7.1.

<sup>98</sup> The EC noted that it was well-known to all parties at the time the Agreement on Agriculture was concluded that the EC did not grant export refunds on the re-export of sugar of ACP/Indian origin, but rather to an exported quantity of A or B sugar equivalent to such imports. *Sugar Panel Report, supra* note 8, at ¶ 7.117.

<sup>99</sup> *Sugar Panel Report, supra* note 8, at ¶¶ 7.168-7.169 & 7.180.

<sup>100</sup> *Sugar Panel Report, supra* note 8, at ¶¶ 7.137-7.138. The Panel also took account of the inconsistency of the EC’s statements to the Committee on Agriculture and the Panel and the inconsistency between the information contained in its notifications and its assertions before the Panel.

c. Whether the EC subsidized its non-quota sugar exports

The importance of listing in a Member's schedule both the quantity limits and the budgetary outlay become clear in light of the analysis by the Appellate Body in the 2001 *Canada—Dairy* case of the elements of proof of a violation of Article 3.3. The first element is that the challenged Member has exported an agricultural product in excess of its quantity commitment level. However, simply proving exportation of the product in excessive quantities does not establish a violation. In addition, the Member must have granted export subsidies with respect to these excessive quantities.<sup>101</sup>

To make export subsidies more difficult to grant, even if specified in a Member's schedule, drafters of the Agreement on Agriculture added a procedural rule that simplifies proof of a violation of Article 3.3. This rule reverses the burden of proof to establish in the first instance the elements of the violation. Normally, complainants Brazil, Thailand, and Australia in this case would have the burden of coming forward with the evidence of both the EC's exceeding its quantity limits on sugar exports and of the EC's subsidizing these excessive exports of sugar. Article 10.3 of the Agreement reverses that burden as to the second element. The complaining Member must prove only the first element of the violation, that the EC exceeded its sugar export quota in a given year. Article 10.3 then shifts the burden to the EC to prove that it did not grant an export subsidy on the excess exports.<sup>102</sup> Having lost its argument concerning the quantity level of its sugar commitment, the EC found Article 10.3 impossible to overcome.

Complainants had no difficulty in establishing the first element of an Article 3.3 violation. The EC itself had reported to the WTO sugar exports of 4.097 million tons in the 2001/2002 marketing year, some 2.82 million tons in excess of the EC's commitment level.<sup>103</sup> Article 10.3

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The Panel concluded that the Footnote has never been treated by the members of the Committee on Agriculture, or by the European Communities, as a "commitment" specified in the European Communities Schedule. Although the Panel treated this 1.6 millions tons of exported sugar separately from C sugar in the remainder of its report, the Panel continually referred to this amount as "what the European Communities considers to be ACP/India equivalent sugar." *Id.* at ¶ 7.237.

<sup>101</sup>*Canada—Measures Affecting the Importation of Milk and the Exportation of Dairy Products—Recourse to Article 21.5 of the DSU by New Zealand and the United States*, Appellate Body Report, WT/DS103 & 113/AB/RW, at para. 70 (adopted Dec. 18, 2001). As the Appellate Body stated in its review of the *Sugar Panel Report*, "[a] commitment on budgetary outlay alone provides little predictability on export quantities, while a commitment on quantity alone could lead to subsidized exports taking place that would otherwise have not taken place but for the budgetary support." *Sugar AB Report, supra* note 8, at ¶ 197.

<sup>102</sup>*Sugar Panel Report, supra* note 8, at ¶ 7.34.

<sup>103</sup>*Sugar Panel Report, supra* note 8, at ¶ 7.230. Note that the EC exceeded even the expanded commitment level it had urged on the Panel by almost a million and a quarter tons. Proving the expanded level would have value to the EC nonetheless, because the level of retaliation would thereby have been reduced under Article 22.4 of the WTO Understanding on the Settlement of Disputes (the level of the suspension of concessions . . . shall be equivalent to the level of nullification or impairment).

means that the EC is presumed to have granted WTO-inconsistent subsidies to this excess amount and it is up to the EC to establish the contrary.<sup>104</sup>

i. ACP/India Equivalent Sugar

The EC admitted that exports by EC producers of sugar equivalent in amount to the quantity of imports of ACP/India sugar received the same level of export refunds as did A and B quota sugar that were exported. The Panel quickly found that these export subsidies were subject to reduction commitments under Article 9.1(a) of the Agreement on Agriculture as “the provision by governments or their agencies of direct subsidies . . . to producers of an agricultural product . . . contingent on export performance.” Refunds were made only on exports, the payments were made by the government, and were paid directly to EC sugar producers.<sup>105</sup>

ii. C Sugar

The question of subsidization of C sugar is not so clear. Recall that C sugar is not eligible for direct export refunds. C sugar also may not be sold on the EC domestic market, with that market’s minimum price supports. Complainants alleged that C sugar, nonetheless, is cross subsidized by the domestic and export subsidies for A and B quota sugar, as well as by the ability of sugar producers to purchase C sugar beets below the cost of their production, because these “payments” constitute a transfer of financial resources to the same producers that make and export C sugar. Complainants argue that both of these types of payments are, in fact, export subsidies, because producers must export C sugar. As noted below, the Panel agreed with both arguments.

1) Below-cost sales of C sugar beets

Article 9.1(c) of the Agreement on Agriculture, the provision complainants alleged the EC violated by its indirect subsidies on C sugar, requires reduction commitments for “payments on the export of an agricultural product that are financed by virtue of government action.” The Panel first decided that the ability of sugar producers to purchase C sugar beets below their cost of production was a payment in kind to producers within the meaning of Article 9.1(c), because producers were receiving an input to C sugar below its “proper value.” The Panel determined that the “proper value” is the beet’s total average cost of production, because the beet producer is transferring economic resources to the sugar producer/exporter if the sale is below total cost.<sup>106</sup> Thus, a “payment” has been made within the meaning of Article 9.1(c).

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<sup>104</sup> *Canada—Dairy*, *supra* note 39, at ¶¶ 72-74. As the Panel later notes, Article 10.3 establishes a *prima facie* case that the excess is subsidized, that is, evidence that requires a panel to rule in favor of the complaining party in the absence of effective rebuttal. *EC—Sugar Subsidies*, *supra* note 8, at ¶ 7.236.

<sup>105</sup> *Sugar Panel Report*, *supra* note 8, at ¶ 7.238.

<sup>106</sup> *Sugar Panel Report*, *supra* note 8, at ¶ 7.258.

Was the payment made “on the export of an agricultural product?” Complainants alleged that C beets may be used only to produce C sugar, which in turn must be exported. This linkage was enough to convince the Panel that payments by way of below-cost C beets was made “on the export,” which the Panel interpreted to mean “in connection with the export” of C sugar.<sup>107</sup> The Panel then turned to the third part of the Article 9.1(c) test, whether the payment in kind through below-cost sales of C sugar beets to C sugar producers on the export of C sugar was a payment “financed by virtue of governmental action.”

Although the Panel did not say as much, it appears that the EC foundered on the reverse burden of proof as to this part of the Article 9.1(c) test. The Appellate Body in *Canada—Dairy* had found that Article 9.1(c) requires a “demonstrable link” and a “clear nexus” between the payment and the “government action.” The Panel found close EC involvement in the sale of C sugar beets from the EC’s control of the price of A and B sugar beets, the prescription of a framework for beet and sugar producers to negotiate the price of C sugar beets, and the dependence of the price of C sugar beets on the export price of C sugar. The EC countered that the Council Regulation does not regulate the price of C sugar beets and that beet farmers grow other crops, any one of which could be cross-subsidizing the beet farmer’s ability to sell its C sugar beets below their total production cost. The EC’s involvement in the sale of C sugar beets did not meet, the EC claimed, the “causal link” test.<sup>108</sup>

The Panel was unconvinced. The EC, it said,

“controls virtually every aspect of domestic beet and sugar supply and management. In particular, the EC Regulation fixes the price of A and B beet that renders it highly remunerative to farmers/growers of C beet. Government action also controls the supply of A and B beet (and sugar) through quotas. . . . In sum, the European Communities controls both the supply and the price of sugar in the internal market. This controlling governmental action is ‘indispensable’ to the transfer of resources from consumers and tax payers to sugar producers for A and B quota sugar and, through them, to growers of A and B quota beet.”<sup>109</sup>

The Panel seemed to be especially influenced by the fact that large numbers of EC farmers continue over the years to engage in the production of C sugar beets. As the Appellate Body noted in upholding the Panel’s reasoning, “[i]n our view, the continued production of such large volumes of over-quota beet, at prices well below its cost of production, could not take place but for governmental action.”<sup>110</sup> Article 10.3 was important in this regard, in our view, because the Panel too easily discounted the EC’s explanation of cross-subsidization from other crops as inadequate to overcome the presumption of illegal subsidization.<sup>111</sup>

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<sup>107</sup> *Sugar Panel Report*, *supra* note 8, at ¶ 7.277.

<sup>108</sup> *Sugar Panel Report*, *supra* note 8, at ¶ 7.283-7.285.

<sup>109</sup> *Sugar Panel Report*, *supra* note 8, at ¶¶ 7.291.

<sup>110</sup> *Sugar AB Report*, *supra* note 8, at ¶ 248.

<sup>111</sup> *Sugar Panel Report*, *supra* note 8, at ¶¶ 7.286-7.287.

## 2) Cross-subsidies from domestic supports for A and B sugar

The Panel went on to consider the final element of the complainants' argument, that is, that the high domestic prices for A and B sugar served as cross subsidies on the export of C sugar, allowing EC sugar producers to sell C sugar below fixed costs. As the Panel explained, despite the absence of direct export subsidies for C sugar, producers are able to recover a portion of their fixed costs on export by spill over of revenues from sales of A and B sugar. The Panel on this claim put most of its determinations with respect to below-cost purchases of C sugar beets to further use. First, the Panel determined that the cross-subsidization constituted a "payment" within the meaning of Article 9.1(c):

“[T]he relatively high EC administered domestic market (above-intervention) prices for A and B quota sugar allow the sugar producers to recover fixed costs and to sell exported C sugar over average variable costs but below the average total cost of production. Sugar is sugar whether or not produced under an EC created designation of A, B or C sugar. A, B or C sugar are part of the same line of production and thus to the extent that the fixed costs of A, B or C are largely paid for by the profits made on sales of A and B sugar, the EC sugar regime provides the advantage which allows EC sugar producers to produce and export C sugar at below total cost of production. For the Panel this cross-subsidization constitutes a payment in the form of a transfer of financial resources.”<sup>112</sup>

Before the Appellate Body, the EC argued that the "payments" identified by the Panel are not "payments" within the meaning of Article 9.1(c), because they constitute only an "internal allocation" of the sugar producer's resources and do not provide the sugar producer with new additional resources. Any "payment" resulting from the transfer of financial resources by sugar beet farmers, the EC contended, was merely a "notational" one by sugar producers in their account books. The Appellate Body, agreeing with the Panel, was unconvinced: "In the light of the enormous difference between the price of C sugar and its average total cost of production [the Panel had found that the price did not 'even remotely' cover costs<sup>113</sup>], we do not see how the 'payment' identified by the Panel was 'purely notational'." <sup>114</sup>

The Panel emphasized, as it had with respect to the purchase of the C sugar beet inputs, that C sugar must be exported: "Because of that legal requirement, advantages, payments or subsidies to C sugar, that must be exported, are subsidies 'on the export' of that product." <sup>115</sup>

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<sup>112</sup>*Sugar Panel Report, supra* note 8, at ¶¶ 7.310 & 7.321.

<sup>113</sup>*Sugar Panel Report, supra* note 8, at ¶ 7.301.

<sup>114</sup>*Sugar AB Report, supra* note 8, at ¶¶ 262-265.

<sup>115</sup>*Sugar Panel Report, supra* note 8, at ¶ 7.321.

Regarding the final element of the Article 9.1(c) test, that is, whether the sugar is “financed by virtue of governmental action,” the Panel again referred to the broad EC governmental action of regulating the domestic sugar market:

“The higher revenue sales for quota sugar in the internal market effectively finances some or all of the fixed costs of C sugar. C sugar is cross-subsidized through direct subsidies, price support mechanisms and related mechanisms for quota sugar, all of which are regulatory instruments of the EC sugar regime.”<sup>116</sup>

d. Relevance of CVD Attribution Rules

The concept of cross subsidization is well known to purveyors of national countervailing duty (CVD) laws that offset through border taxes the competitive advantages of imports benefiting from government subsidies. In the technical jargon of CVD cases, the question for a recurring subsidy such as the EC’s sugar support regime is whether a government subsidy should be “attributed” to a particular product or whether the benefit of the subsidy should be spread over all production of a company. Subsidies that are “tied” to a particular product or to a particular market will be attributed only to that product or that market. Otherwise, the general rule is that, in the words of the U.S. Department of Commerce regulation, “[t]he Secretary will attribute a domestic subsidy to all products sold by a firm, including products that are exported.”<sup>117</sup> The Panel did not employ the expertise gained by national authorities in CVD cases, instead relying on an interpretation of the literal language of Article 9.1(c) of the Agreement on Agriculture and a common sense explanation of the realities of farming as a business.<sup>118</sup>

We may ask how national CVD authorities, at least those in the United States, would have attributed these subsidies. The EC system is specific about the product beneficiaries of each of its subsidies. Export refunds are available for A sugar, B sugar, and for an amount of exported sugar equivalent to ACP/India imports. C sugar is explicitly not eligible for such export refunds. The EC sets minimum prices for A and B sugar, as well as for imported ACP/India sugar. No price support is provided for C sugar, because it may not legally be sold within the Community (except as a carry-forward to the next year’s A and B sugar quotas).

“Tying” rules are arcane, especially in light of the need to guard against potential circumvention of the CVD law by knowledgeable subsidizing governments. Tying rules attempt to make

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<sup>116</sup>*Sugar Panel Report, supra* note 8, at ¶ 7.326. Dr. Schmitz has elsewhere written that EC exports are “cross subsidized in the European Union by . . . excess profits earned on the A-quota and B-quota production of sugar.” Andrew Schmitz, *supra* note 92, at 196.

<sup>117</sup>19 C.F.R. § 351.525 (2004).

<sup>118</sup>The Panel also chose as a matter of judicial economy not to reach claims that the EC sugar regime also violated the Subsidies Agreement, finding the claims undeveloped and not ready for examination. *Sugar Panel Report, supra* note 8, at ¶ 7.386: “Complainants have not set forth their claims under Article 3 of the *SCM Agreement* in quite as clear and unambiguous a manner as under the *Agreement on Agriculture*. . . . The Panel considers that the important questions presented under the *SCM Agreement* in this dispute would be best decided in a case where they have been further argued by the parties.”



practical sense of the basic theoretical economic proposition that money is fungible, that a dollar given by the government for the ostensible purpose of paying a firm's dairy plant electricity bill means that a dollar is freed to spend on painting the firm's horse barn.<sup>119</sup> Some tying rules are essential to calculate a per-unit rate of subsidization in a CVD investigation. Perhaps the rough justice meted out by the *Sugar* Panel was technically acceptable in a WTO case for which quantification is unnecessary. However, addressing the intricacies of tying and fungibility brings with it useful lessons that could have made the Panel's analysis tighter and more credible. The Panel's treatment of the entire EC sugar regime as untied subsidies would bear close scrutiny if the issue arose in a CVD investigation.<sup>120</sup>

e. Application to Tariffs and other import restrictions

The EC's final lament to the Panel was that the Panel's attribution of the benefit from any governmental intervention in the commodity marketplace to be "by virtue of government action" under Article 9 of the Agreement on Agriculture would extend that Agreement's strict export subsidy rules far beyond the types of government programs intended by the drafters. Under this reasoning, a government's high tariff, or its limitation of imports because of a safeguard action to protect against the effects of temporary surges in imports, or even its exchange rate policy could have the incidental effect of "financing" export sales at a loss. In essence, the EC believes, the Panel has held that when a company exports an agricultural product below its total cost of production—a common practice for agricultural exports—a panel may find export subsidization "by virtue of government action" under Article 9 of the Agreement on Agriculture if the government provides a high degree of support for the commodity.<sup>121</sup>

One aspect of the Panel's response would seem to be incorrect on its face. The Panel cites to the Appellate Body's statement in *Canada—Dairy* to the effect that Article 9 reaches a broad range of government activities as potentially supporting a claim that the benefits from customs duties, for example, could be considered payments on the export of an agricultural product by virtue of government intervention.<sup>122</sup> The authors are confident the Appellate Body had in mind no such sweeping inclusion of government measures that do not sound in subsidization.<sup>123</sup> If indeed that result was the Appellate Body's meaning, then every WTO Member's agricultural programs are subject to challenge for their tariffs, safeguard restrictions, even their food safety rules, none of which previously has been considered fodder for the support provisions of the Agreement on Agriculture or for the subsidy disciplines of the Subsidies Agreement.

On the other hand, the Panel is applying a straightforward causation standard to find the below-cost sale of C sugar beets by sugar beet farmers to be "by virtue of government action." The

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<sup>119</sup>As John Magnus of TRADEWINS LLC puts it (*supra* n. 1), fungibility tells us what is possible, while tying tells us what is likely.

<sup>120</sup>See, e.g., *Bethlehem Steel Corp. v. U.S.*, 162 F.Supp.2d 639 (Ct. Int'l Trade 2001).

<sup>121</sup>*Sugar Panel Report*, *supra* note 8, at ¶ 7.311.

<sup>122</sup>*Sugar Panel Report*, *supra* note 8, at ¶ 7.313.

<sup>123</sup>The Appellate Body did not find occasion to clarify this portion of the Panel's decision. See *Sugar AB Report*, *supra* note 8, at ¶ 259.

combination of government interventions in the sugar beet market led directly to that result, even though the EC issued no directives or even encouragement to beet farmers to transfer economic resources to EC sugar producers.<sup>124</sup> By comparison, some trade experts believed the Subsidies Agreement had set up a similar causation standard for transfers of economic resources by private actors. The Subsidies Agreement provides that the government will be considered to have made a “financial contribution” (a required element of a subsidy) if the government “entrusts or directs” a private body to transfer funds.<sup>125</sup> However, two Panels recently have effectively read this indirect means of subsidization out of the Subsidies Agreement by finding that the language requires “affirmative acts of delegation or command.”<sup>126</sup> The EC’s substantial involvement in sugar beet production would not likely have met the Subsidies Agreement test.

f. Determination of export subsidy under Article 9

As noted, under attribution rules for CVD investigations, authorities could have concluded that the high prices set for sale within the Communities of limited quantities of A and B sugar should be attributed to sales of A, B, and C sugar. They might also have reached the opposite result, depending on whether authorities viewed the domestic benefits to be “tied” solely to A and B sugar. What attribution rules will not do, however, is convert domestic subsidies into export subsidies. That is, untied domestic subsidies may be attributed to export sales, but they remain domestic subsidies for purposes of the other provisions of the Subsidies Agreement.<sup>127</sup> To find the EC in violation of Article 3.3 of the Agreement on Agriculture, the Panel was required to find that the subsidies on C sugar, and on the 1.6 millions tons of sugar exported under the rubric of ACP/Indian sugar, were export subsidies under Article 9 of the Agreement on Agriculture.

Article 1(e) of the Agreement on Agriculture defines “export subsidies” to mean “subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement. This tighter test, identical to that under Article 3 of the Subsidies Agreement, is repeated in Article 9(a), which identifies “direct subsidies, including payments-in-kind,” as one of the export subsidies subject to reduction commitments. As stated by the Department of Commerce Regulations, “the Secretary will consider a subsidy to be contingent upon export

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<sup>124</sup>See *Canada—Measures Affecting the Importation of Milk and the Exportation of Dairy Products—Recourse to Article 21.5 of the DSU by New Zealand and the United States*, Report of the Appellate Body, WT/DS103&113/AB/RW (adopted Dec. 18, 2001).

<sup>125</sup>Subsidies Agreement art. 1.1(a)(1)(iv).

<sup>126</sup>*Korea—Measures Affecting Trade in Commercial Vessels*, Report of the Panel, WT/DS273/R at ¶ 7.407 (Mar. 7, 2005); *United States—Countervailing Duty Investigations on Dynamic Random Access Memory (DRAMs) from Korea*, Report of the Panel, WT/DS296/R at ¶ 7.77 (Feb. 21, 2005). The Appellate Body’s reversal of the DRAMS Panel on the narrow grounds that “the Panel failed to consider that pieces of evidence, especially circumstantial evidence, might become more significant when viewed in their totality” does not undercut this conclusion. *United States—Countervailing Duty Investigations on Dynamic Random Access Memory (DRAMs) from Korea*, Report of the Appellate Body, WT/DS296/AB/R at ¶ 158 (Jun. 27, 2005).

<sup>127</sup>For example, Article 3 of the Subsidies Agreement declares that subsidies contingent on export performance are prohibited and other articles provide a fast track to elimination of those kinds of subsidies, which are considered especially trade distorting.

performance if the provision of the subsidy is, in law or in fact, tied to actual or anticipated exportation or export earnings, alone or as one of two or more conditions.”<sup>128</sup> The fact that a company receiving a government benefit happens to export some or even all of its production in a given year will not convert that benefit into an export subsidy if the benefit is not explicitly tied to export performance as a condition of its issuance.

The Panel applied the Article 9.1(a) test to exports of what the EC considered to be equivalent to ACP/India origin imports, 1.6 million tons of sugar exports. These export refunds were indeed “direct subsidies” and eligibility was based solely on whether the sugar was exported, thus clearly meeting the contingency test of Article 9.1(a).

Article 9.1(c), on the other hand, does not contain a contingency test, at least not in those words. The paragraph labels as an export subsidy “payments *on the export* of an agricultural product that are financed by virtue of government action.” The Panel explicitly decided not to apply to this paragraph the tighter “contingency” test of Articles 1(e) and 9.1(a) of the Agreement on Agriculture, that the subsidy must be “contingent” upon export performance. The Panel stated that the EC’s argument that Article 1(e) requires a contingency test “misinterprets” the Agreement. While the EC price support program “as a whole is de facto contingent upon C sugar being exported” (apparently thus meeting the contingency test of Article 1(e)), Article 9.1(c) requires only that the particular payment in question be “on the export,” which the Panel interpreted to mean, “in connection with” the export.<sup>129</sup> Apparently, the Appellate Body’s view was that the Panel need not even have found the “program as a whole” to be contingent, de facto or otherwise, upon export performance: “Article 9.1 sets forth a list of practices that, by definition, involve export subsidies. In other words, a measure falling within Article 9.1 is deemed to be an export subsidy within the meaning of Article 1(e) of the *Agreement on Agriculture*.”<sup>130</sup>

As to below-cost sales of C sugar beets to sugar processors, the Panel found “the very close link” between production of C sugar and production of C sugar beets, as well as the fact that C sugar must be exported as meeting the lesser standard of Article 9.1(c) that the government payments (here, in kind) were “on the export” of C sugar.<sup>131</sup>

As to the cross subsidization of C sugar by high prices of domestic sales of A and B sugar, the Panel concluded that the advantages it had found attributable to C sugar were “on the export” of that sugar because C sugar was required to be exported. The EC had argued that whatever advantages a sugar producer received from the sugar regime would exist whether or not the

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<sup>128</sup>19 C.F.R. §351.514(a)(2004).

<sup>129</sup>*Sugar Panel Report*, *supra* note 8, at ¶ 7.273. The only case the Panel could find relevant to its interpretation was a reading of the term, “on importation,” by a Panel in *India—Measures Affecting the Automotive Sector*, WT/DS146/R, WT/DS175/R and Corr. 1, at ¶ 7.257 (adopted Apr. 5, 2002), which read the term as meaning “with regard to” or “in connection with,” which would encompass measures that relate both directly and indirectly to importation.

<sup>130</sup>*Sugar AB Report*, *supra* note 8, at ¶ 269.

<sup>131</sup>*Sugar Panel Report*, *supra* note 8, at ¶ 7.276.

producer exported anything. The Panel found that this meant only that benefits were not “contingent on” export performance, not that the payments had not been made “on the export,” that is, in connection with exportation.<sup>132</sup>

The EC would appear to have a point. As the United States argued as third party,<sup>133</sup> the panel has expanded the definition of export subsidy beyond, at least in not making receipt of the benefit “contingent” on exportation, what was agreed in Article 3 of the Subsidies Agreement. The United States believes the same meaning was intended for Article 9.1(c) of the Agreement on Agriculture, despite the fact that the “contingency” test was not explicitly included. Would the cross subsidization of C sugar meet the contingency test? As the EC noted, EC sugar producers receive no additional “payment” from the EC if they export a large amount or no C sugar. On the other hand, if, as the Panel found, sugar producers are able to sell C sugar above fixed costs, each sale covers the marginal costs of producing the sugar, thereby maintaining customer relationships, scale efficiencies, and assurance to beet suppliers of a reliable outlet for their production.

In any event, the finding that the high prices for A quota and B quota sugar cross subsidize C sugar exports substantially complicates the EC’s task of bringing its sugar regime into compliance with its reduction commitments under the Agreement on Agriculture. If the 4 million tons of C sugar exports benefit from export subsidies, either these exports must be eliminated or the subsidization of them must be ended. The former approach will put the EU in breach of its agreements with ACP countries and with India. The latter will be difficult, if possible at all, without elimination of domestic support for A and B quota sugar, because the *Sugar* opinions leave the EC with little guidance as to what level of domestic support would end C sugar cross-subsidization. As in the *Cotton* case, the lack of quantification by dispute panels has left the losing WTO Member in a position of not knowing how to bring its subsidy program into compliance.

g. Application to U.S. Crops

EU sugar policy is generally regarded as providing to its growers some of the highest sugar price supports in the world, either direct or indirect. EU sugar policy distorts both world production and sugar prices.<sup>134</sup> In its absence, world sugar prices would rise significantly. EU sugar producers receive benefits from support which includes, as the Panel correctly notes, cross-price subsidization for C sugar from A and B sugar. Many analysts would concur with the economics upon which the Panel based its decision.

In contrast to the European Union, U.S. sugar policy consists of mostly tariff-rate quotas, which support producer prices above the so-called world dumping market price. Although EC sugar

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<sup>132</sup> *Sugar Panel Report*, *supra* note 8, at ¶ 7.317 and 7.321.

<sup>133</sup> “WTO Issues Final Decision Finding EU Sugar Subsidies Exceed Quotas,” WTO Reporter, at 4 (Sep. 9, 2004).

<sup>134</sup> Andrew Schmitz, *supra* note 92, at 193.

policy provides far greater support than does that of the United States, this difference is irrelevant, because U.S. sugar exports are minimal.<sup>135</sup> On the other hand, U.S. program commodities such as rice, soybeans, and corn are exported at prices below fully allocated cost of production and benefit from a high degree of government support.<sup>136</sup> If the Panel's straightforward causation test is applied to U.S. rice policy, this situation may be sufficient to establish prohibited export subsidization for rice. The "very close link" between the domestic U.S. support program and below-cost exports would place, for example, the U.S. rice policy within the decision's ambit.

The Appellate Body took pains to rebut the EC's argument that the cross-subsidization finding "blurs the distinction between domestic support and export subsidies," a crucial distinction under both the Agreement on Agriculture and the Subsidies Agreement. Noting that its "interpretation is based on the specific facts and circumstances of this dispute," that is, that C sugar must be exported, the Appellate Body protested that its decision indeed respects this important boundary.<sup>137</sup> U.S. commodity producers may take some comfort in this qualification by the Appellate Body.

We noted earlier that the Panel suggested that even high tariffs could be considered a form of government subsidization. While we disagree,<sup>138</sup> many U.S. commodities are protected by high tariffs as well as quota restrictions and could thus be vulnerable to the *Sugar* Panel's reasoning.

## VI. Conclusions

We have presented two interesting cases where Brazil challenged, through the WTO, the U.S. cotton policy and the EU sugar policy. Both have very different implications for U.S. farm policy. U.S. sugar programs are unlikely to be affected because sugar is not exported and does not receive direct domestic subsidies. However, the implications for cotton and other commodities that receive direct government subsidies are far reaching and may lead to additional challenges before the WTO. These decisions pose serious threats to U.S. farm policy in its current form and substantially change the balance of concessions and obligations as the Doha Round renegotiation of the Agreement on Agriculture enters the critical stage of exchanging offers.

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<sup>135</sup>Id.

<sup>136</sup>See Table 2, *supra* text at note 85.

<sup>137</sup>*Sugar AB Report*, *supra* note 8, at ¶¶ 281-282.

<sup>138</sup>See text *supra*, at note 112.