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Trade Note 16

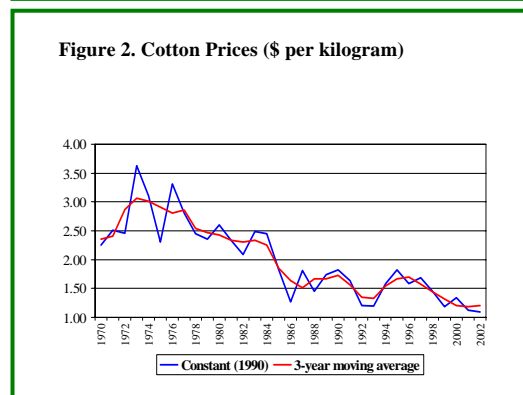
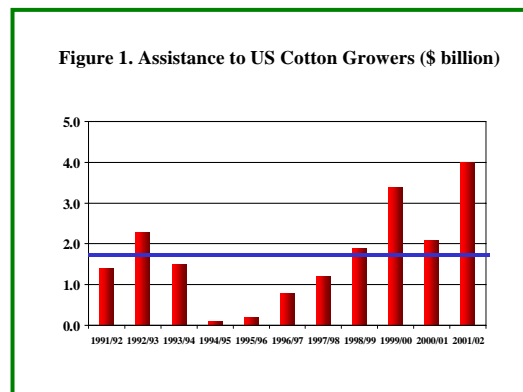
## Brazil vs. US: Cotton Subsidies and Implications for Development

On September 27, 2002 Brazil requested consultations with the US regarding prohibitive and actionable subsidies provided to US cotton producers. On March 18, 2003, the Dispute Settlement Body (DSB) of the WTO established a Panel, with standard terms of reference. On April 26, 2004 the WTO issued an interim ruling in favor of Brazil. A final ruling—to be made public sometime in August 2004—is likely to be very similar to the interim ruling. This note examines the nature and likely implications of the ruling.

### The Nature of the Dispute

The Brazil/US cotton dispute consists of legal and economic components. In legal terms, Brazil claimed that the US cotton program was inconsistent with US obligations under the WTO rules. In economic terms, Brazil had to show that US cotton subsidies caused serious prejudice, i.e., considerable financial loss to its cotton industry.

Specifically, Brazil argued that certain aspects of US cotton subsidies are inconsistent with various provisions of the Agreement on Subsidies and Countervailing Measures (SCM Agreement), the Agreement on Agriculture, and GATT 1994. These Agreements set limits on subsidies equal to the amount prevailing in 1992. Brazil claimed that (i) during the four marketing years 1999-2002 the US provided domestic support to cotton that was in excess of the 1992 limit. These subsidies caused serious prejudice to the interest of Brazil under the SCM Agreement (see figure 1



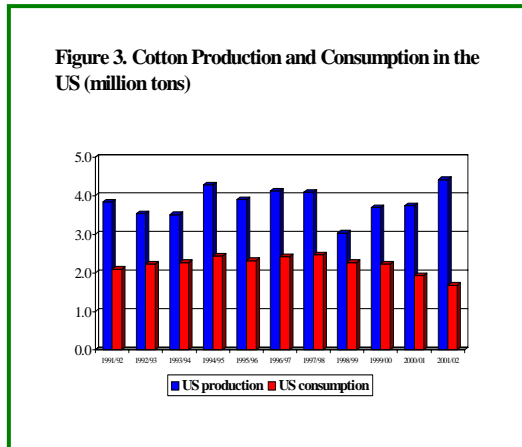
for the level of the US subsidies) and (ii) the export subsidies (i.e., export credit guarantees, step-2 payments) are in violation of the Agreement on Agriculture.

Thus, US cotton subsidies “caused serious prejudice to the interests of Brazil” because of a “significant price depression and price suppression” of cotton in the world market (see figure 2 for the world price of cotton). Brazil made its case by utilizing the econometric model developed by FAPRI, which showed that the US subsidies induced a 41% increase in US cotton exports, hence reducing the world price of cotton by 12.6%. Based on these figures, the estimated injury suffered by Brazil was estimated at about \$600 million for the marketing year 2001 alone.



## Global Balance of the Cotton Market

The US is the world's second largest cotton producer (4 million tons in 2003/04, see figure 3) and consumer (2 million tons) after China (5 million production and 7 million tons consumption) and the largest cotton exporter (2 million tons). During the 2003/04 marketing year, Brazil was the 5<sup>th</sup> largest cotton producer (1 million tons) and 6<sup>th</sup> largest cotton consumer (0.8 million tons). World cotton production and consumption are 20.3 and 21.2 million tons, respectively (see table 1). During 1999-2002, Brazil's cotton production and consumption were approximately equal. It is worth noting that in two of the four seasons of interest (1999-2002) Brazil was a net cotton importer.



## Cotton Subsidies

The US is the largest supporter of cotton (in terms of absolute level of support), followed by China and the EU. US cotton subsidies take mainly the form of domestic support. Support to the US cotton sector averaged \$2.2 billion during 1997-2002 (see table 2). The US cotton program is very complicated and changes when new *Farm Bills* are introduced every 5-6 years. The three relevant *Farm Bills* for this case were introduced in 1990, 1996, and 2002.

The main channels of US domestic support are direct payments (known as production flexibility contracts under the 1996 *Farm Bill*), marketing loan program payments (through the loan rate mechanism), crop insurance, subsidies to domestic mills (through the so-called "Step-2" program), and emergency payments. They are also known as marketing loss assistance payments that were introduced in 1998 to compensate for the loss of income due to low commodity prices but became "permanent"—now called countercyclical payments—under the 2002 *Farm Bill*.

Direct payments are based on historical enrolled areas of cotton. They were introduced with the 1996 *Farm Bill* in order to compensate for the "losses" resulting from the elimination of deficiency payments (which were tied to production of specific commodities). Marketing loan program payments (or coupled payments) are designed to compensate cotton growers from the difference between the adjusted world price and the loan rate when the latter exceeds the former. User (Step-2) market payments are made to eligible cotton exporters and domestic end users of cotton when domestic US prices exceed North Europe c.i.f prices by a certain level and the world price is within a certain level of the base loan rate. The objective of the Step-2 payment is to bridge the gap between higher US domestic prices and world prices so that US exporters and mills maintain their competitiveness.

## Implications of the Ruling

This is the first case to focus on agricultural subsidies in a North-South dimension—another similar case is the Australia-Brazil-Thailand against the EU's subsidies on sugar, currently under examination. The ruling was issued against the background of the ongoing critical agriculture negotiations, the expiration of the Peace clause, the more assertive stance taken by the so called G-20



	1960	1970	1980	1990	1999	2000	2001	2002	2003
<b>Production</b>									
China	1,372	1,995	2,707	4,508	3,830	4,417	5,324	4,916	4,870
US	3,147	2,219	2,422	3,376	3,694	3,742	4,420	3,747	3,975
India	1,012	909	1,322	1,989	2,650	2,380	2,686	2,312	2,831
Pakistan	306	543	714	1,638	1,911	1,816	1,783	1,736	1,734
Brazil	425	549	623	717	700	939	766	848	1,121
<b>World</b>	<b>10,201</b>	<b>11,740</b>	<b>13,831</b>	<b>18,970</b>	<b>19,070</b>	<b>19,439</b>	<b>21,475</b>	<b>19,295</b>	<b>20,325</b>
<b>Consumption</b>									
China	1,481	2,016	3,300	4,225	4,700	5,200	5,700	6,500	7,000
India	1,006	1,076	1,371	1,958	2,939	2,924	2,910	2,914	2,873
Pakistan	245	429	461	1,343	1,700	1,764	1,855	2,042	2,100
US	1,803	1,786	1,083	1,885	2,230	1,929	1,676	1,583	1,350
Turkey	109	184	293	557	1,483	1,150	1,300	1,310	1,300
Brazil	272	296	566	723	852	873	830	760	800
<b>World</b>	<b>10,231</b>	<b>12,173</b>	<b>14,215</b>	<b>18,585</b>	<b>19,610</b>	<b>19,842</b>	<b>20,278</b>	<b>21,150</b>	<b>21,117</b>

Source: ICAC, *Cotton Review of the World Situation*, various issues.  
Note: Years refer to marketing years (August through July).

	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
Coupled payments	3	0	28	535	1,613	563	2,507	248
PFC/DP	0	599	597	637	614	575	474	914
Emergency/CCP	0	0	0	316	613	613	524	1,264
Insurance	180	157	148	151	170	162	236	194
Step-2	34	3	390	308	422	236	196	na
<b>Total</b>	<b>217</b>	<b>759</b>	<b>1,163</b>	<b>1,946</b>	<b>3,432</b>	<b>2,148</b>	<b>3,964</b>	<b>2,620</b>

Notes: PFC denotes production flexibility contracts, DP denotes direct payments, and CCP denotes counter-cyclical payments.

group as well as the Sectoral Initiative on Cotton by the four West African Countries (Chad, Benin, Burkina Faso, and Mali). Although the interim ruling is subject to changes, it has numerous implications for the Doha Development Agenda and the developing countries.

Because it is the first WTO ruling in which a developing country challenges an OECD farm subsidy program, it may set a precedent. If more cases like that follow, there may be a shift on the focus of WTO's activities from negotiation to litigation.

The ruling also coincided with the expiration of the peace clause (i.e. Article 13 of the Agreement on Agriculture) which imposed some restraint on act WTO cases against members using trade-distorting subsidies and market support programs. The peace clause essentially said that if domestic support was lower than the level applied in 1992, it could not be challenged in WTO. Now that the peace clause has expired the ruling may open "the floodgates" for other domestic subsidy cases that prior to 2003 were "protected" under the peace clause.

It should be noted that although the ruling is often discussed in the context of the peace clause, in fact, it was not in response to the expiration of the peace clause. In other words, if the peace clause were to expire in 2013 instead of 2003, the Brazil/US cotton case would have proceeded in the same way.

Because this dispute may be just the tip of the iceberg of potential upcoming cases, a way to avoid a significant increase in these disputes is to entail trade-distorting subsidies through progress in the Doha Development Agenda. The ruling strengthens the position of many developing countries regarding their claims that OECD subsidies depress world prices. Benin and Chad, two LDCs and proponents of the Sectoral Initiative on Cotton, were involved in the proceedings of this case as third parties.

### Next Steps

This is an interim ruling. The final ruling is most likely to be released sometime in August 2004. The US has already publicly



stated that it will appeal, adding at least another 3 months to the process before the Panel and Appellate Body Reports are formally adopted by the Dispute Settlement Body. If the interim ruling is maintained at the conclusion of the WTO dispute settlement process, the US will be required to remove the adverse effects causing the serious prejudice and/or withdraw the subsidies fairly quickly under the stringent compliance rules of the SCM Agreement. Depending on the steps taken by the US (along with Brazil's response), it could add years until the process is completed. The US may attempt to protract the case until the next *Farm Bill*—due in 2007.

If the US loses the appeal and does not remove the subsidies, WTO rules call for the parties to negotiate compensation on an MFN basis until subsidies become WTO-compliant. In case that compensation cannot be agreed, then Brazil is likely to ask the DSB to authorize suspension of concessions, i.e. retaliation through imposition of countervailing duties equivalent to the value of trade that was over the period before the resolution of the case, i.e. \$600 million.

Whatever the eventual outcome, the case underscores the importance of reducing ag-

ricultural subsidies and border protection, both as a measure to promote development and a measure to avoid further strain in the already fragile dispute resolution institutions governing world trade. The opportunity of the Doha Agenda assumes a new urgency.

### Further Reading

Baffes, John. 2004. "Cotton: Market Setting, Trade Policies, and Issues." *Policy Research Working Paper*, no. 3218, February. The World Bank, Washington, DC ([www.econ.worldbank.org](http://www.econ.worldbank.org)).

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*This Trade Note was written by John Baffes, Sr. Agricultural Economist in the Development Research Group. The author would like to thank Carlos Braga, Uri Dadush, Harry de Gorter, John Nash, and Richard Newfarmer for comments and suggestions. This Trade Note can be downloaded at <http://www.worldbank.org/trade>.*