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Status of the WTO Brazil-U.S. Cotton Case

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Summary

The so-called "Brazil cotton case" is a long-running World Trade Organization (WTO) dispute settlement case (DS267) initiated by Brazil—a major cotton export competitor—in 2002 against specific provisions of the U.S. cotton program. In September 2004, a WTO dispute settlement panel ruled that (1) certain U.S. agricultural support payments for cotton distorted international agricultural markets and should be either withdrawn or modified to end the market distortions; and (2) U.S. Step-2 payments and agricultural export credit guarantees for cotton and other unscheduled commodities were prohibited subsidies under WTO rules and should be withdrawn.

In 2005, the United States made several changes to both its cotton and export credit guarantee programs in an attempt to bring them into compliance with WTO recommendations; however, Brazil argued that the U.S. response was inadequate. A WTO compliance panel ruled in Brazil's favor and was upheld on appeal. The United States made additional changes to the export credit program in the 2008 farm bill, but Brazil found the overall level of changes to fall short of the WTO ruling. The threat of retaliation led Brazil and the United States to negotiate a temporary agreement (June 17, 2010) to avoid trade retaliation. Key aspects of the agreement included (1) U.S. payments of $147.3 million annually to the "Brazilian Cotton Institute" to provide technical assistance and capacity-building for Brazil's cotton sector; (2) modifications to the operation of the GSM 102 program coupled with a semi-annual review of whether U.S. GSM 102 program implementation satisfies certain performance benchmarks; and (3) regular discussions on potential limits of trade-distorting U.S. cotton subsidies—with the understanding that the WTO cotton dispute would be resolved definitively within the context of the next U.S. farm bill.

In this regard, the 2014 farm bill (P.L. 113-79) includes several substantive changes to both U.S. cotton support programs and the export credit guarantee program. These changes have resulted in cotton being singled out and treated differently from all other U.S. program crops. Cotton no longer has access to the price and income support programs offered for other program crops, but instead will rely on a within-year, market-based insurance guarantee—referred to as the Stacked Income Protection Program or STAX—as its primary support measure. Under this new cotton program, producers would have to pay into the program in order to participate, a loss (albeit at the county level) would have to occur before an indemnity payment would be made, and the sum of program indemnity payments under STAX and any other crop insurance policy would be prohibited from exceeding the value of the insured crop to minimize any production incentive.

Under STAX, cotton will eventually have no safety net against multiple-year low returns, an unlikely outcome without the WTO ruling in the U.S.-Brazil cotton case. In addition, U.S. export credit guarantee programs have been substantially reformed, including a shortened tenor (i.e., contract length) of only 24 months—down from 36 months—and increased user fees to ensure that the program's operating costs are fully covered by fees so as to avoid any implicit subsidy. New farm legislative language also includes expanded flexibility for USDA to negotiate with Brazil concerning the compliance of export credit guarantee implementation.

While a new farm bill might address issues related to the WTO Brazil-U.S. cotton case from a U.S. perspective, Brazil still retains substantial authority in making a final determination regarding the compliance with WTO recommendations of any policy changes to U.S. cotton support programs. The two sides are expected to continue negotiations to resolve this case.

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Introduction

This report provides a description and status report on Brazil's challenge to certain aspects of the U.S. cotton program under the rules of the World Trade Organization's (WTO's) dispute settlement process in case DS267.[1]

The "Brazil-U.S. cotton case" had its WTO origins in 2002 and has since evolved into a sprawling legal dispute that is still ongoing as of early 2014. For a detailed description of the case's origin and progress through the WTO dispute settlement process to the point in April 2011 when Brazil and the United States reached a temporary agreement to avoid trade retaliation (referred to as the U.S.-Brazil framework agreement), readers may refer to archived CRS Report RL32571, *Brazil's WTO Case Against the U.S. Cotton Program*.

This report focuses on developments in the cotton case since 2011; in particular, on three aspects of the WTO cotton case:

- the nature and calculation of Brazil's authority to retaliate (in an **Appendix**);
- changes to U.S. agricultural policy that have occurred as a direct result of the WTO cotton case; and
- the current status of efforts to resolve the WTO trade dispute.

Each of these case aspects remains highly germane to U.S. farm policy and programs, as Brazil still retains the WTO-granted authority to impose millions of dollars of trade retaliation against U.S. goods and services. In addition, with the world closely watching the resolution of the Brazil-U.S. cotton case, the final terms and circumstances of such a resolution—were it to occur—could serve either as catalyst or as precedent for future trade disputes related to the agricultural sector, and/or as progenitor of new, more restrictive WTO rules for domestic cotton support programs.

Brief Historical Overview of the WTO Case

The so-called "Brazil-U.S. cotton case" is a long-running WTO dispute settlement case (DS267) initiated by Brazil—a major cotton export competitor—in 2002 against specific provisions of the U.S. cotton program. Brazil charged that U.S. cotton programs were depressing international cotton prices and thus artificially and unfairly reducing the quantity and value of Brazil's cotton exports, causing economic harm to Brazil's domestic cotton sector.

Dispute Settlement and Arbitration

In September 2004, after nearly a year-long period of hearings and review, a WTO dispute settlement panel found that certain U.S. agricultural support payments and guarantees were inconsistent with WTO commitments and resulted in market distortions that depressed international cotton prices, as asserted by Brazil. In addition, certain U.S. agricultural export programs were found to be illegal under WTO rules. As a result, U.S. support programs were

[1] For an official WTO summary and documents related to the cotton case, DS267, see WTO's case reference site at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm.

found to violate two different types of WTO rules and thus required two different types of responses from the United States to remedy the inconsistencies.

First, actionable subsidies were those subsidies identified as having distorted normal market conditions and resulted in adverse effects to Brazil. The WTO panel recommended that the United States take appropriate steps by September 21, 2005, to remove the adverse effects or to withdraw the subsidy measures singled out as price-contingent—marketing loan provisions, market loss assistance payments, Step 2 (domestic user marketing) payments,[2] and counter-cyclical program (CCP) payments.[3] It is noteworthy that the panel found that certain other U.S. domestic support programs—direct payments and crop insurance payments—did not cause serious prejudice and consequent adverse effects.

Second, prohibited subsidies were those subsidies deemed illegal under WTO rules. The panel identified export credit guarantee programs—GSM 102, GSM 103, and the Supplier Credit Guarantee Program (SCGP)[4]—that assisted cotton and other "unscheduled" agricultural products entering international markets, and Step 2 payments to exporters of upland cotton. The WTO panel recommended that the United States withdraw these programs by July 1, 2005.

In 2005, the United States made several changes to both its cotton farm support programs and export credit guarantee programs in an attempt to bring them into compliance with WTO recommendations. However, Brazil argued that the U.S. response was inadequate and requested authority to impose $3 billion in retaliation against prohibited U.S. subsidies. Retaliation generally takes the form of higher tariffs, above WTO bound levels.

The United States objected to Brazil's requested retaliation amount and called for WTO arbitration; however, arbitration was mutually suspended in July 2006. Shortly thereafter (August 2006), Brazil requested a WTO compliance panel to review whether the United States had brought its cotton programs into compliance with the original WTO panel ruling. In December 2007, a WTO compliance panel ruled in favor of Brazil's noncompliance charge against the United States, and the ruling was upheld on appeal in June 2008.

WTO Authorizes Retaliation Authority for Brazil

In August 2008, Brazil requested resumption of arbitration over its proposed retaliation value of $3 billion. In August 2009, the WTO arbitration panel announced that Brazil's trade countermeasures against U.S. goods and services could include two components:[5]

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[2] Step 2 payments were part of special cotton marketing provisions authorized under U.S. farm program legislation to keep U.S. upland cotton competitive on the world market. Step 2 payments were made to exporters and domestic mill users to compensate them for their purchase of higher-priced U.S. upland cotton. Under the 2002 farm act, the Step 2 payment rate for the 2002-2005 marketing years was calculated as the difference between the price of U.S. upland cotton, delivered c.i.f. (cost, insurance, freight) in Northern Europe, and the average of the five lowest prices of upland cotton delivered c.i.f. in Northern Europe from any source. The Step 2 cotton program was eliminated on August 1, 2006 (§1103, P.L. 109-171).

[3] For a description of U.S. farm programs, see CRS Report RL34594, *Farm Commodity Programs in the 2008 Farm Bill*.

[4] GSM-103 and SCGP were eliminated by the 2008 farm bill (P.L. 110-246; §3101(a)) upon its enactment on June 18, 2008. For information on the U.S. GSM 102 program, see USDA, Foreign Agricultural Service, "Export Credit Guarantee Programs," at http://www.fas.usda.gov/excredits/default.htm.

[5] For details, see the **Appendix**, "Brazil's Trade Retaliation Authority Explained."

- a fixed annual amount of $147.3 million in response to the actionable subsidies (i.e., market-distorting U.S. cotton program payments), and
- a variable formula-derived retaliation amount based on annual spending made under the U.S. GSM 102 program in response to the prohibited subsidies.

According to WTO rules, trade retaliation should take place within the sector where the violation occurred. In this case, retaliation normally would be restricted to punitive tariffs on U.S. goods entering Brazil. However, Brazil argued that limiting retaliation to the goods sector alone would have a more deleterious effect on the Brazilian economy (via higher input costs) and Brazilian consumers (via higher inflation) than on U.S. exporters due to the asymmetries between the two economies.[6] Instead, Brazil proposed to suspend tariff concessions as well as obligations under the WTO Agreement on Trade-Related Intellectual Property Rights (TRIPS) and the General Agreement on Trade in Services (GATS).

In response to Brazil's concerns regarding applying retaliation entirely in the goods sector based on trade between the two countries, the arbitrators ruled that Brazil would be entitled to cross-retaliation if the overall retaliation amount exceeded a formula-based, variable annual threshold—different from the earlier formula used for calculating the total annual retaliation.[7] Cross-retaliation involves countermeasures in sectors outside of the trade in goods—for example, in the area of U.S. copyrights, patents, and other intellectual property rights (IPR). Based on the arbitrators' formulas, using 2008 data, Brazil announced in December 2009 that it would impose trade retaliation for the year starting on April 6, 2010, against up to $829.3 million in U.S. goods, including $268.3 million in eligible cross-retaliatory countermeasures.

Temporary Suspension of Retaliation

The threat of sanctions led to intense negotiations between Brazil and the United States to find a mutual agreement and avoid trade retaliation. While U.S. exporters were anxious about losing trade with the emerging Brazilian domestic market, Brazil's domestic manufacturing and business sectors were concerned that trade retaliation in the form of higher tariffs could be counter-productive if it resulted in restricting access by domestic industry to key inputs.

Memorandum of Understanding

In April 2010, the two parties agreed to a memorandum of understanding (MOU) that spelled out certain actions which, if undertaken by the United States, would lead to a temporary suspension of Brazil's threatened retaliation.[8] These actions included (1) the annual payment by the United States of $147.3 million (or $12.275 million per month) to Brazil for a fund to be used for certain authorized activities—primarily to provide technical assistance and capacity-building for Brazil's cotton sector, but explicitly excluding research—and (2) the United States working jointly with Brazil "on an understanding that is mutually satisfactory that will provide a framework for

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[6] "U.S., Brazil Clash on Cotton Sanctions," International Center for Trade and Sustainable Development (ICTSD), *Bridges*, vol. 12, no. 6, January 2009.

[7] For details, see the **Appendix**, "Brazil's Trade Retaliation Authority Explained."

[8] Joint Brazil-U.S. communication, "Memorandum of Understanding Between the Government of the United States of America and the Government of the Federative Republic of Brazil Regarding a Fund for Technical Assistance and Capacity Building With Respect to the Cotton Dispute (WT/DS267) in the WTO," April 2010.

reaching a mutually agreed solution to the cotton dispute." The joint work period would start on April 22, 2010, and last for 60 days, during which Brazil would not impose countermeasures.[9]

Framework Agreement for a Mutually Agreed Solution

On June 17, 2010, U.S. and Brazilian trade negotiators concluded the *Framework for a Mutually Agreed Solution to the Cotton Dispute in the WTO*.[10] The "Framework Agreement," which laid out a number of "steps and discussions," represented a path forward toward the ultimate goal of reaching a negotiated solution to the dispute, while avoiding WTO-sanctioned trade retaliation by Brazil against U.S. goods and services and possibly intellectual property rights (IPR). As a result, Brazil suspended trade retaliation pending U.S. compliance with the Framework Agreement measures. The four major aspects of the Framework Agreement are as follows.

1. Discussions towards a mutually agreed solution would have as a basis an annual limit on trade-distorting U.S. domestic cotton support as measured by the following criteria:
    a. the limit would be significantly less than the average annual level of trade-distorting support provided to upland cotton during the 1999 to 2005 period;
    b. the extent to which any domestic support program counts against the limit would depend on its degree of trade-distortion; and
    c. green box (i.e., minimally or non-trade distorting) support measures would not be counted against the limit.
2. The United States would undertake some near-term modifications to the operation of the GSM 102 program, and would convene with Brazil for a semi-annual review of whether U.S. GSM 102 program implementation satisfies certain performance benchmarks. If benchmarks were not being met, the United States would adjust operating fees to bring the program into line with the benchmarks.
3. Brazil and the United States would meet for quarterly discussions and information exchanges regarding potential limits of trade-distorting U.S. cotton subsidies (recognizing that actual changes would not occur prior to the next farm bill).
4. Upon enactment of the 2014 farm bill, the parties would consult with a view to determining, with respect to measures of domestic support for cotton and the GSM 102 program, whether a mutually agreed solution to the WTO cotton dispute (WT/DS267) had been reached.

These U.S. commitments were intended to delay any trade retaliation until after the 2014 farm bill, when potential changes to U.S. cotton programs would be evaluated. See the section "U.S. Policy Changes in Response to the Cotton Case," below, for a discussion of the changes made in the enacted 2014 farm bill (P.L. 113-79).

[9] Ibid.

[10] WTO, *WT/DS267/45*, August 31, 2010.

U.S. Policy Changes in Response to the Cotton Case

Since 2005, the United States has made several changes to both its cotton and export credit guarantee programs in an attempt to bring them into compliance with WTO recommendations. This includes both changes made prior to the 2014 farm bill and changes made as part of the 2014 farm bill (P.L. 113-79).

U.S. Program Changes Prior to the 2014 Farm Bill

Because the price and income support programs contained in omnibus farm bills could only be modified or removed by an act of Congress—and such changes generally only occur within the context of a new farm bill[11]—the Administration had been limited in its ability to respond to the WTO panel recommendations, but instead resorted to using whatever flexibility existed in implementing such programs. However, in the interim years between farm bills, Congress took steps of its own by including relevant amendments to non-farm-bill legislation to address several of the outstanding case-related issues.

Eliminated Step 2 program

In order to address the issue of actionable subsidies in the Brazil-U.S. cotton case, the Step 2 cotton program was eliminated by a provision (§1103) in the Deficit Reduction Act of 2005 (P.L. 109-171) on August 1, 2006. From 1991 through 2006, nearly $3.9 billion in payments were made under the Step 2 cotton program.

Modified or Eliminated Export Credit Guarantee Programs

In order to address the issue of export credit guarantees containing an implicit export subsidy prohibited under WTO rules—that is, the idea that benefits returned under the program are insufficient to cover the operating costs and losses of program implementation—several steps were taken by both USDA and Congress.

On July 1, 2005, USDA instituted a temporary fix whereby the Commodity Credit Corporation (CCC) would use a risk-based fee structure for export credit guarantee programs—GSM 102 and SCGP. Higher program participation fees would help to ensure that the financial benefits returned by these programs fully cover their long-run operating costs, and thus would eliminate the subsidy component. USDA adopted the risk-based fee structure since a 1% fee cap was required by statute (7 U.S.C. 5641) and could not be removed administratively. In addition, the CCC stopped accepting applications for payment guarantees under GSM 103—a long-term credit guarantee program covering periods of from 3 to 10 years.

On June 18, 2008, the date of enactment of the 2008 farm bill (P.L. 110-246), a provision (§3101(a)) in the Trade title (Title III) eliminated both the GSM 103 and SCGP programs, and removed the 1% cap on fees that could be charged under the GSM 102 program.

[11] CRS Report RS22131, *What Is the Farm Bill?*

In addition, the same 2008 farm bill provision explicitly required the Secretary of Agriculture, in carrying out the GSM 102 program, to "work with the industry to ensure, to the maximum extent practicable, that risk-based fees associated with the guarantees cover, but do not exceed, the operating costs and losses over the long-term." However, the 2008 farm bill defined the "long-term" as a period of 10 or more years. While the WTO panel did not explicitly define its view of the "long-term," it clearly is less than 10 years and more likely is on the order of a period of two years[12]—that is, a net loss in one year must be offset by a net gain in the following year.

These alterations to the GSM 102 program have contributed to the recent drop in Brazil's retaliatory rights, as mentioned earlier.[13] This is in spite of the fact that total usage of the GSM 102 program has actually increased in recent years. In particular, two additional changes to GSM 102 operation made in 2010 are also helping to drive down Brazil's retaliation rights. First, USDA blocked Brazilian banks from being able to enjoy the loan guarantees for the financing of U.S. agricultural exports. Second, USDA disqualified Brazil as an export destination for third-country banks seeking such loan guarantees.

The WTO formula for calculating annual retaliatory authority assumes that GSM 102-backed loans by Brazilian banks to importers in Brazil have a particularly negative impact on Brazilian agricultural producers. As a result, the existence of such loans prior to 2010 had the effect of driving up Brazil's retaliatory rights by a significant amount, as those measures were meant to counteract the harm done to Brazilian agricultural producers.[14] These alterations have had the effect of driving down Brazil's retaliation rights since 2010.

Cash Payments to a Brazil Cotton Fund

Under the April 2010 Brazil-U.S. memorandum of understanding, the United States was to make payments to a Brazilian cotton fund of $12.275 million every month, for a total of $147.3 million annually.[15] Money from the fund was to be used for certain authorized activities to aid the development of Brazil's cotton sector—primarily technical assistance and capacity building, but specifically excluding research—and for international cooperation in the cotton sector with developing countries.[16]

Although the Framework Agreement and its monthly payments succeeded in avoiding, at least temporarily, the imposition of harmful trade countermeasures, the U.S. proposal was met with both praise and criticism. During 2011, several amendments were introduced in the House that would have eliminated or banned the payments to Brazil; however, none of these amendments was enacted.[17]

In September 2013, USDA—claiming that the effects of the federal budget sequestration process were at play—reduced the monthly payment to Brazil by an amount equal to 5% of the annual

[12] Annex J, paragraph 3(a), of the "2008 Revised Draft Modalities" sets 180 days as the maximum repayment terms for an export credit guarantee contract.

[13] For details, see the **Appendix**, "Brazil's Trade Retaliation Authority Explained."

[14] Ibid.

[15] Brazil subsequently established the Brazil Cotton Institute to manage the fund.

[16] Section IV of the MOU between Brazil and the United States, lists the authorized activities.

[17] See CRS Report RL32571, *Brazil's WTO Case Against the U.S. Cotton Program*.

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total (i.e., $7.365 million out of $147.3 million), leaving a payment of just $4.9 million.[18] In October, USDA completely stopped the payments. By October 2013, the United States had already made cumulative payments to Brazil's cotton fund of nearly $496 million (assuming that payments started in May 2010, the month after the memorandum of understanding was agreed to). In addressing the cessation of payments, Agriculture Secretary Tom Vilsack claimed without elaboration that the U.S. government lost the authority on October 1, 2013, to continue making payments to Brazil, in part because funding for said payments had been explicitly excluded from the President's 2014 budget proposal.[19]

Still Not Enough

In summary, by 2008 Congress had passed legislation to permanently eliminate the Step 2 program as well as the GSM 103 and SCGP export credit guarantee programs. By late 2010, the United States was making monthly payments of $12.275 million to Brazil's cotton fund, and was meeting twice a year to discuss and modify GSM 102 program operations and quarterly to discuss potential market distortions under then-current U.S. cotton support programs. As a result, the United States argued that the basket of potentially distorting programs in question had been so transformed as to render moot the issue of adverse effects or threat of serious prejudice.

However, Brazil continued to argue that the U.S. policy response was inadequate. In an attempt to definitively resolve the cotton dispute, and in accordance with the June 2010 Framework Agreement, Congress proposed a complete revamping of the then-existing cotton price and income support programs and replacement of most of them with an insurance-like program (described below) as part of the 2014 farm bill.

Policy Changes Made in the 2014 Farm Bill (P.L. 113-79)

The National Cotton Council played an active role in helping to design the new cotton support program to ensure that it addressed the WTO cotton case's outstanding issues. As a result, both the Senate-passed (S. 954) and House-passed (H.R. 2642) farm bill proposals were in agreement over proposed changes, and conferees adopted the new program in the final bill (P.L. 113-79).

These changes have resulted in cotton being singled out and treated differently from all other U.S. program crops. U.S. cotton no longer has access to the price and income support programs offered for other program crops, but instead will rely on a within-year, market-based insurance guarantee as its primary support measure. Under the new cotton program, producers have to pay into the program in order to participate, a loss (albeit at the county level) has to occur before a payment is made, and the sum of program payments is prohibited from exceeding the value of the crop insured in order to minimize any potential incentive. Because the program price guarantee is based on within-year prices, cotton will eventually have no safety net against multiple-year low returns, an unlikely outcome without the WTO ruling in the U.S.-Brazil cotton case.[20]

[18] *Inside U.S. Trade,* "U.S. Cuts Cotton Payment, Leading Brazil To Gear Up For Retaliation," October 3, 2013.

[19] *Inside U.S. Trade,* "Experts: Vilsack Claim On Brazil Payment Authority Expiration Is Untrue," August 15, 2013.

[20] Carl Zulauf, "2014 Farm Bill Farm Safety Net: Summary and Brief Thoughts," http://farmdocdaily.illinois.edu/, January 30, 2014.

The major cotton-related provisions in the enacted 2014 farm bill are briefly described here (the related 2014 farm bill provision is cited in brackets for easy reference).[21]

1. **Current cotton support programs are repealed.** The price and income support programs direct payments (DP), counter-cyclical program (CCP), and Average Crop Revenue Election (ACRE) available under the 2008 farm law are repealed ***[§1101, §1102, §1103].*** This represents a significant concession for the U.S. cotton sector. Under the direct payment program, national average direct payments of $6.67/hundredweight (cwt.) or $39.82/acre (using the national yield of 597 lbs./acre) were made annually to cotton base acres irrespective of market conditions. Since 1996, owners of upland cotton base acres have received over $10 billion in direct payments. Similarly, owners of upland cotton base acres have received nearly $7.6 billion in CCP payments since their origin in FY2003.
2. **Cotton is ineligible for most new price and income support programs.** Cotton is not eligible for coverage under the following new price and income programs: Price Loss Coverage (PLC), Agricultural Risk Coverage (ARC) ***[§1111(6)]***; and the shallow-loss insurance program Supplemental Coverage Option (SCO) ***[§11003(C)(iv)]***. As a result, cotton producers do not benefit from yield and base updating available to other program crops under these programs.
3. **Reduced marketing loan program benefits for cotton.** Marketing loan benefits continue for all major program crops, including upland cotton, but at a reduced marketing loan rate for upland cotton. The new marketing loan rate for upland cotton is to be calculated as the simple average of the adjusted world price for the two preceding marketing years within a range of 45 cents/lb. to 52 cents/lb. (down from a fixed 52 cents/lb. in the 2008 farm bill) ***[§1202(a)(6)]***. Farm prices for upland cotton have been above 60 cents/lb. since December 2009. Thus, the cotton market would have to experience a substantial collapse in prices before any benefits would be received under the reduced cotton marketing loan program.
4. **Stacked Income Protection Plan (STAX)**. The 2014 farm bill handles upland cotton separately from the other major program crops. In lieu of the farm revenue programs available to program crops—PLC, ARC, and SCO—upland cotton producers are eligible for a stand-alone, county-based revenue insurance policy called the Stacked Income Protection Plan (STAX). Producers can purchase this policy in addition to their individual crop insurance policy or as a stand-alone policy ***[§11017]***.
    a. STAX covers county-wide revenue losses of greater than 10% but not more than 30% of expected county revenue, offered in 5% increments. In other words, a loss of at least 10% must occur at the county level (and relative to the county-level guarantee) before any indemnity is made under STAX.
    b. Total indemnity payments received—including both STAX and other crop insurance—cannot exceed the total insured value of the crop.
    c. Participating producers must pay 20% of the STAX policy premium, while the federal government pays the remaining 80% share. The government

[21] For details see CRS Report R43076, *The 2014 Farm Bill (P.L. 113-79): Summary and Side-by-Side.*

subsidy rate of 80% for STAX is more generous than for other insurance products, but is viewed by U.S. interests as a partial offset for the other program benefits sacrificed to obtain STAX. In addition, this is unlike all previous cotton support programs over the past eight decades when producers did not have to pay to participate. Under STAX, producers must pay to participate.

d. Premiums are based on the risk of loss and the value of the insured crop. As a result, when crop prices move higher the cost of premiums also rises.

e. In years where no loss or STAX indemnity is incurred, cotton producers will still be required to make premium payments under the program, thus incurring costs with no offsetting monetary benefits (although producers would implicitly benefit from the reduced risk of loss).

f. Under STAX, the expected price used in determining the program's revenue guarantee is based on market conditions. STAX only provides within-year protection. The initial price guarantee is determined in February based on the price of harvest-time futures contract, although a Harvest Revenue Option allows the expected price to be replaced by the actual harvest-time price, if higher than the initial guarantee. In other words, the price component of the revenue guarantee moves up and down from year to year with market conditions—a recommendation of the WTO panel. Thus, as mentioned earlier, under STAX, cotton will eventually have no safety net against multiple-year low returns.

g. Because it is designed as an insurance product, STAX (like all other crop insurance programs) is not subject to a cap on individual payments. However, the restriction that combined STAX and crop insurance indemnities may not exceed the insured value of the crop is itself a type of payment limitation.

h. The STAX payment rate multiplier of 120% available to producers seeking higher per-acre protection is poorly understood by casual observers. Brazil has expressed dismay over this program feature. However, it simply allows producers to improve their risk management coverage relative to the county average. The restriction on total STAX plus crop insurance indemnities not exceeding the value of the insured crop dampens the potential for abnormal production incentives and subsequent market distortion.

5. **Temporary Upland Cotton Transition Payments**. Cotton producers will be given special transition payments in 2014 and possibly 2015 ***[§1119]*** in light of the repeal of Direct Payments; the ineligibility of cotton producers for PLC, ARC, or SCO; reduced marketing loan benefits; and the delayed implementation of STAX. However, the transition payments are only a partial offset to the previous benefits under DP, CCP, and the reduced marketing loan program benefits. In 2014, an estimated transition assistance rate of $53.73/acre will be made on 60% of cotton base acres in existence in the 2013 crop year (i.e., a national average DP equivalency of $32.24/acre); in 2015, if STAX is yet unavailable, the same transition payment will be made on 36.5% of base (i.e., a national average DP equivalency of $19.61/acre).

6. **Brazil Cotton Institute spending concessions**. The 2014 farm bill allows for funds that have already been disbursed to Brazil's special cotton fund created under the 2010 memorandum of understanding to be used for agricultural

research in Brazil, provided that it is conducted in collaboration with USDA or a college, university, or research foundation located in the United States ***[§1615]***.

7. **Additional changes made to the GSM 102 program**. The maximum contract length (i.e., tenor) was capped at 24 months, down from 36 months under the 2008 farm bill ***[§3101(a)(1)]***; and USDA was given additional flexibility to negotiate with Brazil on GSM 102 use in order to ensure compliance with the WTO cotton case recommendations ***[§3101(a)(5)E]***.

Some additional provisions related to the U.S. cotton sector, but unrelated to the WTO cotton case, were also extended in the 2014 farm bill (P.L. 113-79), including payment of upland cotton storage costs, but at reduced rates (down 10%) ***[§1204(g)]***, and special marketing provisions to help keep the U.S. upland cotton spinning industry competitive. These include a special import quota ***[§1207(a)]*** and a limited global import quota ***[§1207(b)]*** when certain market price conditions are met.[22] Domestic users of upland cotton (from all sources, regardless of origin) are eligible for an economic adjustment assistance (EEA) payment of 3 cents/lb.[23] ***[§1207(c)]***.

Is a Permanent Resolution in the Offing?

In accordance with the Framework Agreement, officials from Brazil and the United States will meet to review and evaluate these changes and to attempt to finalize a solution to this long-running WTO dispute case. At first glance, it would appear that upland cotton's treatment under the 2014 farm bill falls within the WTO criteria of causing minimal distortion in domestic and international markets. The principal cotton support program is now the insurance-like STAX program. A key finding of the original WTO panel hearing the cotton case was that crop insurance payments did not cause serious prejudice to Brazil's interests because Brazil was unable to show a necessary causal link between crop insurance programs and significant price suppression—such a link was established for Step 2 payments, market loss assistance payments, marketing loan program payments, and counter-cyclical payments.

Market Forces Likely to Play Dominant Role in Cotton Markets

It is unclear to what extent the expected net indemnity (i.e., expected indemnity minus the producer-paid, 20%-share of the premium) might provide an incentive for greater cotton area to be planted than would occur in the absence of STAX. This would have to be determined by empirical analysis, but it is likely that relative returns from other program crops will play a much larger role in producer planting decisions than the size of the federal premium subsidy under STAX (**Figure 1**). Furthermore, total indemnity payments under both STAX and any other cotton-specific crop insurance are prohibited from exceeding the value of the insured crop, thus further minimizing any potential production incentive.

Market forces have already played a large role in allocating resources away from cotton and toward other crops. Since 2006 the rapid rise in prices of corn and other feed grain and oilseed

[22] Both of these temporary TRQ programs are notified in the U.S. country schedule to the WTO and thus are WTO compliant. For more information on these programs see "Special Program Provisions for Upland Cotton," at http://www.ers.usda.gov/topics/crops/cotton-wool/policy/special-program-provisions.aspx.

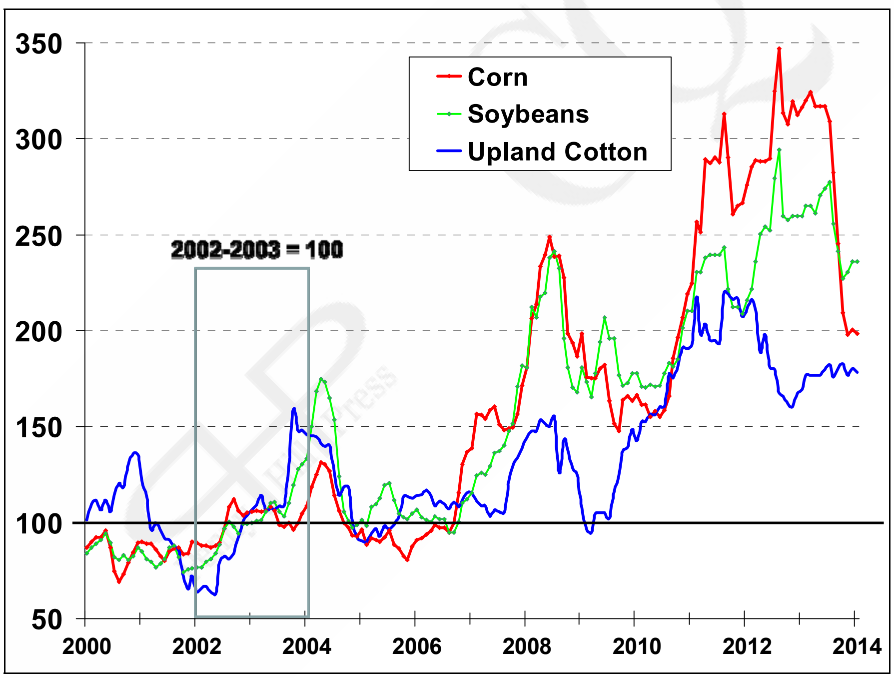
[23] Since cotton from any source qualifies a user for payment under the EEA program there is no discriminatory treatment of imported cotton and the EEA program is WTO compliant.

crops has pulled area away from upland cotton (**Figure 2**) while contributing to lower levels of government support payments (**Figure 3**).

Globalization and the search for low-cost, unskilled labor markets have contributed to the steady decline of the U.S. textile sector and domestic mill use of U.S. upland cotton in recent decades (**Figure 4**). As this phenomenon has played out it has coincided with increasing U.S. costs of production to impair upland cotton's relative competitiveness against other program crops.

The rapid decline of corn and feed grain prices of 2013—due in part to a return to normal weather conditions and trend yields after two years of poor weather and below-trend yields, but also reflecting a plateauing of corn-for-ethanol demand as fuel markets reached the ethanol blend wall—could encourage some acres to return to cotton in 2014 based on regional comparative advantage. However, it has been suggested that any increase in cotton plantings in 2014 will more likely reflect relative market conditions than government program incentive.[24]

Figure 1. Farm Price Gains for Corn and Soybeans Have Surpassed Those for Upland Cotton Since the 2002-2003 Period

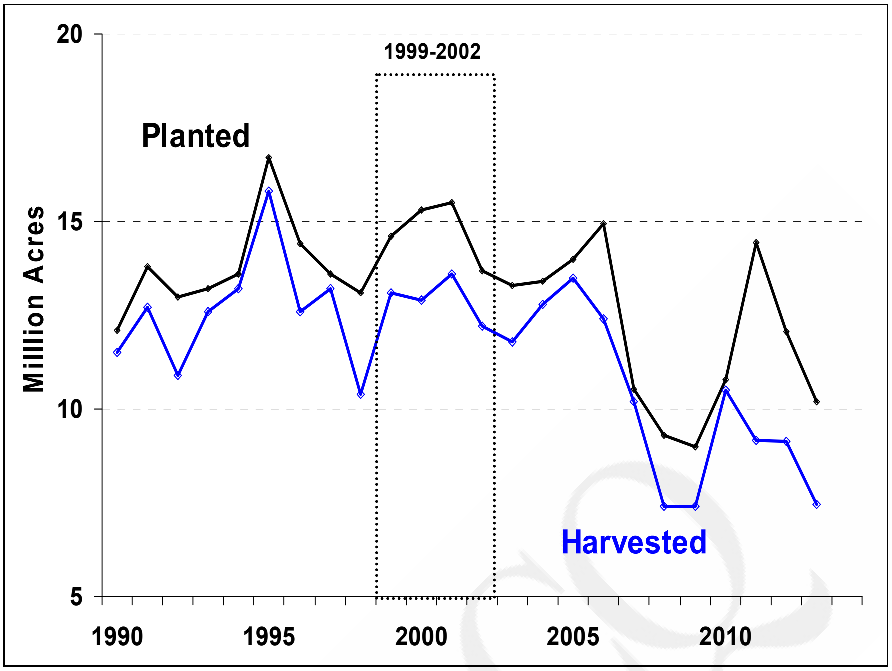


Source: USDA, National Agricultural Statistics Service, *Agricultural Prices*, calculations made by CRS.

Notes: Monthly farm-prices received are set to an index of 2002-2003 = 100 to facilitate comparisons.

[24] Gary Adams, Shawn Boyd, and Michelle Huffman. *The Economic Outlook for U.S. Cotton 2014*, National Cotton Council, February 2014.

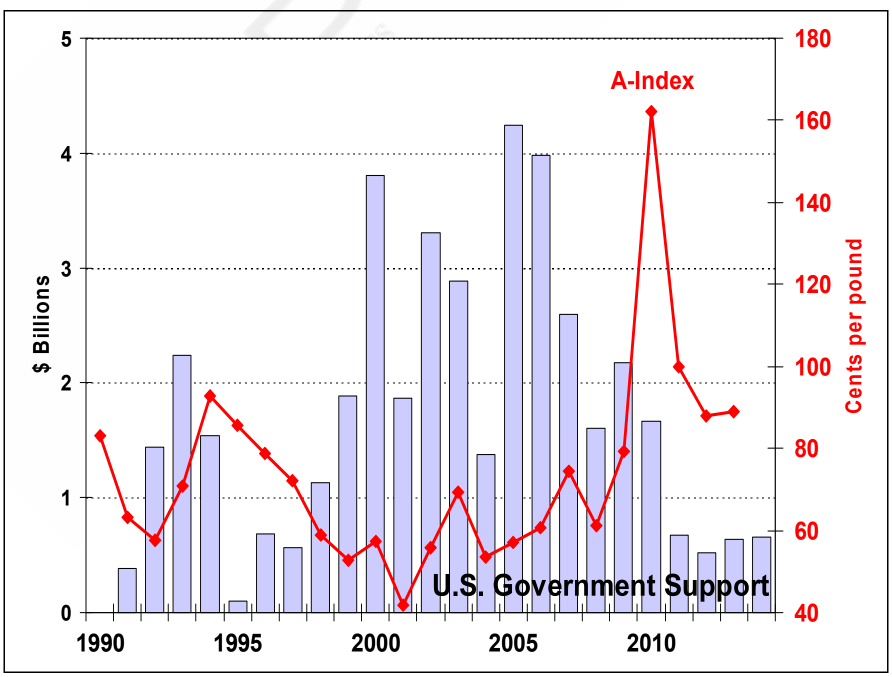
Figure 2. U.S. Upland Cotton Area Has Trended Lower Since the Mid-1990s



Source: USDA, PSD database, January 10, 2014.

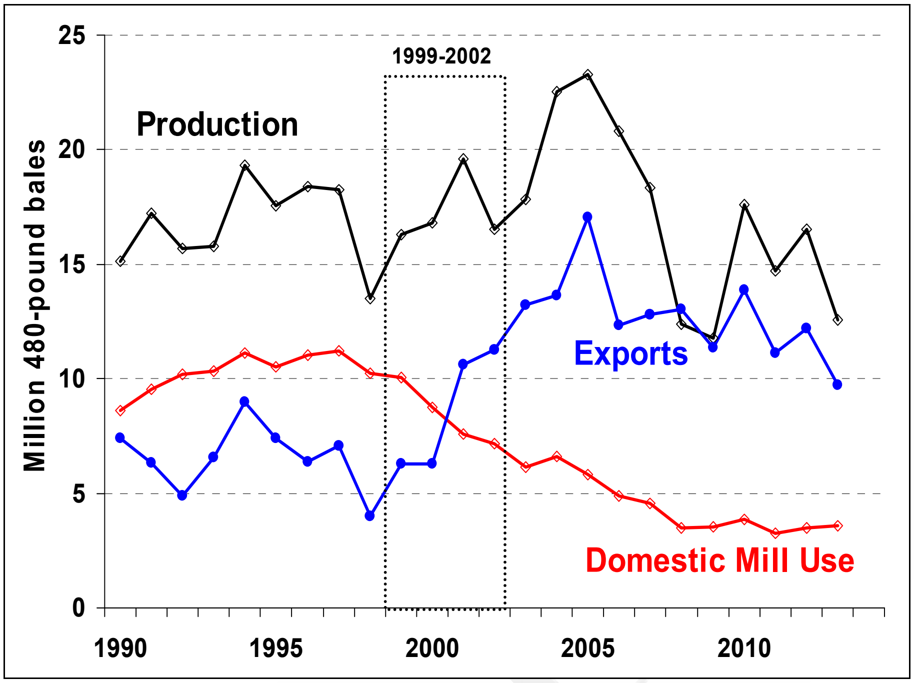
Notes: The WTO Brazil-U.S. cotton case (DS267) was initiated in 2003 and focused its initial data analysis on the 1999-2002 period.

Figure 3. CCC Net Outlays to Upland Cotton Have Declined Substantially Since 2006 While International Market Prices Have Trended Higher



Source: CCC Net Outlays: USDA, Farm Service Agency, Mid-Session Review, President's Budget 2014, Table 35; A-Index is from USDA, Economic Research Service, Cotton and Wool Outlook Reports.

Figure 4. Since 2005, the U.S. Cotton Sector Has Experienced Declining Production and Exports, While Mill Use Has Declined Steadily Since 1997



Source: USDA, PSD database, January 10, 2014.

Conclusion

While changes to U.S. cotton support programs made in the 2014 farm bill (P.L. 113-79) might address issues related to the WTO Brazil-U.S. cotton case from a U.S. perspective, and while the Framework Agreement calls for a mutual solution, under the WTO case ruling Brazil still retains substantial authority in making a final determination as to whether these recent U.S. policy changes are deemed sufficient to meet the conditions and/or terms of the agreement. However, Brazil will have to carefully weigh the costs in terms of potential geopolitical capital lost and additional time and resources spent vis-à-vis the benefits of continued pursuit of any remaining policy gains that it perceives as potentially achievable. If Brazil were to pursue further retaliation, some wonder if U.S. commercial interests would perceive Brazil's intentions as "piling on" rather than fair treatment.

As mentioned earlier, the U.S. cotton sector already has been singled out and treated differently from all other U.S. program crop sectors. Cotton no longer has access to the price and income support programs offered other program crops, but instead will rely on a within-year, market-based insurance guarantee as its primary support measure. As a result, cotton will eventually have no safety net against multiple-year low returns. In addition, U.S. export credit guarantee programs have been substantially reformed as a direct result of WTO cotton case ruling.

Both U.S. and Brazilian commercial interests appear ready to see this case come to a satisfactory resolution. According to news media, the Brazilian government is preparing a report on the 2014 farm bill to be presented soon to CAMEX, a group of Brazilian ministers that is responsible for deciding whether to retaliate in the cotton case.[25]

If the United States were to disagree with Brazil's interpretation of whether U.S. policy changes were sufficient, the United States likely would have to introduce a new dispute settlement case to the WTO or, alternately, reach some kind of new understanding with Brazil to avoid retaliation.

In addition to the implications for U.S. cotton policy, the heightened attention surrounding the WTO Brazil-U.S. cotton case has served to single out cotton for special treatment within ongoing WTO trade negotiations. A final resolution to the cotton case could have an important bearing on how cotton and other domestic support programs are treated in future WTO trade negotiations or in future dispute settlement cases.

[25] *World Trade Online*, "Brazil's Foreign Minister Meets With Froman on Bilateral Cotton Dispute," Jan. 30, 2014.

Appendix. Brazil's Trade Retaliation Authority Explained

As stated earlier, a WTO arbitration panel announced that Brazil's trade countermeasures against U.S. goods and services could include two components—a fixed amount and a variable amount. Each of these components is described in more detail here.[26]

Fixed Component

The fixed annual amount of $147.3 million was based on Brazil's share (5.1%) of the calculated global market price effect resulting from the international price-depressing nature of U.S. cotton programs. This calculation was undertaken using U.S. and international market data for the 2005 marketing year. The analysis found that, in the absence of U.S. marketing loan benefits, Step 2 payments, and counter-cyclical payments to U.S. cotton producers, the world price of cotton would have been 9.38 cents per pound higher, and that the estimated worldwide losses for both trade and production effects were $2.9 billion. Since Brazil's share of world cotton production (excluding the United States) at that time was 5.1%, this same share of the global loss was assigned to Brazil as the fixed payment.

Formula-Based Variable Component

An annual, variable retaliatory amount was included to account for U.S. agricultural exports made under the GSM 102 program. Furthermore, the WTO arbitrator ruled that the retaliatory amount accorded Brazil would vary each year based on the total of exporter applications received by the U.S. government under the GSM 102 program for the most recently concluded fiscal year—the formula would consider an interest rate subsidy component and a component to reflect any measurable trade displacement—referred to as "additionality." The WTO arbitrator used Brazil's share of world trade of those products receiving GSM 102 credit guarantees (estimated at 11.7% in 2006) to apportion Brazil's share of the estimated global subsidy effect of GSM 102.

Since the authority for cross-retaliation was based on the value of trade in goods between Brazil and the United States, annual changes in the value of trade in goods need to be considered in order to ascertain a fair value for cross-retaliation. For purposes of determining eligibility to apply cross-retaliation, the panel established an initial threshold amount of $409.7 million that could be subject to countermeasures without harming Brazil's economy based on the volume and composition of Brazil's imports of consumer goods in 2007. The amount of $409.7 million represents the sum of the value of those consumer goods imported by Brazil where the U.S. share is less than 20%, excluding books and automotive parts, which are considered essential to Brazil's economy.

The threshold amount may vary from year to year according to the following formula:

$$T_{t+1} = T_t * (1 + g_{t+1}) \qquad \text{where } T_{2007} = \$409.7 \text{ million}$$

[26] All official WTO documents related to the Dispute Settlement Case DS267 are available at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm

where

T_{t+1} = threshold value in year t+1
T_t = threshold value in year t
g_{t+1} = percentage change in the value of Brazil's total imports from the United States between years t and t+1.

Estimated Retaliation Authority Based on Recent Data

Both U.S. policy changes and trade flows have altered the formula calculations in the United States' favor in recent years. USDA has made several changes in how it implements the GSM 102 program (described below), while the changing nature of U.S.-Brazil trade flows is working to severely restrict both the amount and the nature of the retaliatory rights to which Brazil is entitled. Based on 2011 data, it was estimated that Brazil was entitled to roughly $500 million in total retaliation.[27] This compares with retaliation authority estimates of $829 million using 2008 data and $1 billion using data from 2009.

Not only has the total retaliation authority declined in recent years, but so too has the authority for cross-retaliation. For instance, using 2008 data, about $269 million of the $829 million in total retaliation could be applied in cross-retaliation. Similarly, Brazil enjoyed cross-retaliation rights of about $550 million out of $1 billion total retaliation using 2009 data.[28] In sharp contrast, estimates for 2011 indicate that the cross-retaliation threshold would be higher than the total retaliation value of $500 million, meaning that Brazil would have no ability to engage in cross-retaliation.

The fact that Brazil is not entitled to any cross-retaliation when 2011 data are used depends heavily on the value of U.S. exports in goods to Brazil, which have skyrocketed over the last several years. According to U.S. Census Bureau export data, which are somewhat less precise than the Brazilian import data used for the retaliation calculations, U.S. exports to Brazil totaled about $26.1 billion in 2009, but climbed in 2010 to $35.4 billion, and to $42.9 billion in 2011.[29] This surge partly reflects the fact that the U.S. dollar had depreciated vis-a-vis Brazil's currency, making U.S. exports more attractive to Brazilian consumers.

If recent developments are limiting the amount and nature of Brazil's retaliatory rights, that could mean that Brazil has less ability going forward to use retaliation as leverage to encourage the United States to bring its cotton programs into compliance with its WTO obligations, or that the potential costs—in terms of time, resources, and political capital—in pursuing whatever further changes might be achieved in addition to the already substantial number of concessions made by the U.S. cotton sector may no longer represent sufficient return on the investment.

[27] *Inside U.S. Trade*, "GSM-102 Tweaks, Recent Data Limit Brazil's WTO Cotton Retaliation Rights", June 21, 2012.
[28] Ibid.
[29] Ibid.

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