United States – Subsidies on Upland Cotton **(WT/DS267)**

Arbitration under Article 22.6 of the DSU and Article 7.10 of the SCM Agreement

Oral Statement of the United States

March 3, 2009

1. Today, the Arbitrator will consider the second of Brazil's requests for countermeasures, its request for countermeasures with respect to marketing loan and countercyclical payments.

2. Brazil claims that Brazilian producers are adversely affected by excess U.S. cotton production. But, the U.S. cotton market has changed dramatically over the last several years. These changes directly contradict the basis for Brazil's claims. This calls for an examination of the type of data that has been found relevant in previous proceedings relating to Brazil's serious prejudice claims. For example, part of the analysis of the original and compliance proceedings was to look at planted acreage. However, U.S. planted acreage has fallen in each year since 2005, and in 2008 was 35% lower than in 2005. The U.S. Department of Agriculture projects planted acreage for 2009 at 8.4 million acres – 14% lower than 2008 and 41% below 2005.[1] As graphically illustrated in the table in Exhibit US-114, U.S. production has fallen dramatically since 2005, and the U.S. share of world production continues to shrink.

3. The original and compliance proceedings also found it relevant to examine cotton base acreage in relation to planted acres. Here too, the decline in planted acreage has produced a dramatic divergence between base acreage and planted acreage. At 8.4 million acres, planted

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[1] USDA Long-term Projections, February 2009.

area would only equal about 46% of base acres for upland cotton. This huge divergence does not suggest that cotton subsidies are keeping acres in cotton production, and certainly does not support Brazil's contention that expectations of base updating encouraged cotton planting. The decline in planted area, shown relative to base acres, is also shown in Exhibit US-114.

4. The compliance proceeding in particular expressed concern that the payments permitted U.S. cotton farms to cover long-term costs and resulted in cotton farms staying in business that otherwise would have to exit cotton farming. In fact, according to the just-released U.S. Census of Agriculture, the number of cotton farms has declined dramatically.[2] Exhibit US-115 shows that the total number of cotton farms has dropped from 33,640 farms in 1997 to 18,286 farms in 2007 – a 46% decline. Consolidation has continued with smaller, less efficient, higher cost farms exiting at a more rapid pace than large farms. In 1997, 10% of farms accounted for 40% of cotton acres. In 2007, 17% of farms accounted for 54% of cotton acres. The number of farms with 250 acres or less fell by over 60%. The U.S. cotton sector has undergone rapid and significant structural change over the past decade.

5. In these proceedings, we are considering what adverse effects there may be on Brazil's interests in the world cotton market as a result of the U.S. measures at issue. As a result, the market situation is not only relevant to these proceedings, it informs them. The DSB's recommendations and rulings are that the United States has not removed the adverse effects from

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[2] Exhibit US-115.

marketing loan payments and counter-cyclical payments. But the Arbitrator is now called upon to quantify what are the adverse effects on Brazil's interests. And the data above suggest that the payments have not maintained U.S. cotton acreage at anything close to historic levels. Rather, U.S. cotton planted acreage has declined precipitously, and a significant proportion of U.S. cotton farmers have exited cotton farming. These data are not consistent with large effects on U.S. production.

6. Brazil has requested more than one billion dollars in annual countermeasures for marketing loan and countercyclical payments. Although the WTO has twice considered these payments and the question of whether they result in significant price suppression, this is the first time that the extent of such price suppression must be measured.

7. As with Brazil's request for countermeasures on GSM-102, a special and additional rule of the SCM Agreement applies for this request. The rule applies only for actionable subsidies and is set out in Article 7.9 of the SCM Agreement, as follows: countermeasures must be "commensurate with the degree and nature of the adverse effects determined to exist."

8. The United States has detailed, through its written submission and its responses to the Arbitrator's questions, how Brazil's proposed countermeasures for marketing loan and countercyclical payments are far in excess of what would be commensurate with the adverse effects on Brazil of these payments. Consequently, Brazil's proposal far exceeds what is permitted under the SCM Agreement. If the modeling and legal errors in Brazil's approach are

corrected, any countermeasures for marketing loan and countercyclical payments would be less than $30.4 million, at an average, calculated for MY2005-2007.

9. The United States will not repeat all of these arguments here. Rather, we will highlight why – through legal errors and errors in the economic modeling – Brazil's proposal is so high. First, the United States will discuss the errors in the economic modeling, as this serves as the basis for the calculation of the total effects of marketing loan and countercyclical payments. Second, the United States will review the legal errors in Brazil's approach – specifically, the failure to limit the proposed countermeasures to the adverse effects on Brazil, and the failure to limit the proposed countermeasures to the portion of the effects of marketing loan and countercyclical payments that result in the WTO inconsistency that is the subject of the DSB recommendations and rulings.

10. Understanding and correcting these errors is all the more important because, unlike prior proceedings, the Arbitrator is asked to attach a number to the alleged significant price suppression caused by marketing loan and countercyclical payments. Before, the question of significant price suppression could be answered in one word: either "yes" or "no." But the question for the Arbitrator is different, and more challenging.

11. For the economic modeling, the United States believes the correct way to model the impact of the removal of marketing loans and countercyclical payments is using long run elasticities to allow for full adjustment to the policy change. But even Brazil's short run analysis,

if one were to accept that approach, uses the wrong parameters, including the short run elasticities, the overstated coupling factor for countercyclical payments, the representation of price expectations, and the period for analysis. Without correcting for these errors, the results of the model far exceed any plausible effects of marketing loan and countercyclical payments. Brazil's total effects is more than $3 billion, which is equal to about 60 percent of the value of U.S. cotton in 2005. With the long run parameters and other changes the United States describes, the maximum annual global effects over MY2005-2007 average about $460 million, less than one-sixth Brazil's total impact.

12. Brazil's choice of elasticities is the most important factor contributing to the exaggerated estimates of effects. Brazil has stated that the elasticities used in its model should be "customized" to suit the issue at hand, both for its prohibited subsidies model as well as its serious prejudice model. This statement comes close to saying that Brazil is picking elasticities to fit a preconceived outcome. Brazil justifies the particular elasticities used in its serious prejudice model based on the specific counterfactual it defines – the announced, anticipated, complete, and permanent removal of the marketing loan and countercyclical payment program. The correct question before the Arbitrator is not withdrawal of payments and any consequent price effects in the short term (the adjustment period to the policy change), but rather the situation that would have prevailed in the absence of marketing loan and countercyclical payments, as if the payments had never existed. That counterfactual provides the ceiling for the price effects that these payments could have caused.

13. To help justify its selection of elasticities, Brazil has assembled a lengthy collection of economic studies that contain supply and demand elasticities for U.S. and world cotton. One set of studies provided by Brazil relies on various elasticities to perform analytical experiments with respect to changes in government policies. Brazil takes the opportunity to remind the Arbitrator (in its response to Question 5) – for practically every study reviewed – that the study did not expressly state that the change in policies are expected to be permanent and whether the change was anticipated. The United States notes that practically all of the studies were undertaken in the context of the on-going WTO Doha negotiations, where governments have been negotiating for years the reduction in domestic subsidies, among other items. The studies examined the hypothetical impacts of a change in government policy that would result from a multilateral trade agreement. Brazil would have one believe that a national government would be able to negotiate for years, reach an international agreement, remove domestic subsidies without telling anyone in the country, and then perhaps a year or two later, reinstate all the subsidies. This "warning flag" is no warning at all, but a red herring designed to throw one off the track and provide unwarranted support for Brazil's arbitrary choices of elasticities.

14. Brazil justifies a very high supply elasticity based on the conjecture of the announced, anticipated, complete, and permanent removal of two U.S. support programs. Brazil cites two studies where the cotton supply elasticities are higher than Brazil's choice. Obviously, Brazil supports these studies.[3] Both studies evaluated responses on Normal Flex Acres (NFA) from

[3] Brazil's Response to Arbitrator Questions, 13 February, 2009, paras. 19 - 22.

1991-1995, which is a subset of total area devoted to the crop, where planting flexibility was allowed. Crop choices on these acres were made at the margin and would be expected to be much more responsive than the full acreage base. Those acres could adjust more easily without limitations or restrictions imposed by rotational constraints, agronomic factors, and fixed asset or infrastructure investments. All of these factors mean the responsiveness of the total acreage to price is much less than the marginal NFA acres. Thus, these studies do not support such a large U.S. supply elasticity for a short-run analysis.

15. In contrast to the overstated U.S. supply elasticity, Brazil uses a small elasticity for the rest of world supply: it argues the supply response is indirect for the rest of the world because there is imperfect and slack price transmission. Brazil asserts that the rest of world supply response "is less pronounced," which therefore justifies a low supply elasticity.[4] Again, Brazil leans toward selecting an elasticity that supports a preconceived outcome. But if producers in some other parts of the world are not subsidized, their only source of income is the price they receive from cotton. So the change of price has a direct effect on these farmers.

16. Brazil also argues that rest of the world producers would not begin to adjust until they were confident that the higher prices were permanent. Brazil has provided no support to the notion that U.S. farmers have better knowledge about the true permanency of a government policy change. And indeed, Brazil has shown in this dispute that U.S. legislation, regulations,

[4] Brazil Methodology Paper, para. 103.

and program information is readily available and highly transparent.

17. As further justification for a low supply response for the rest of the world, Brazil argues that most of the non-U.S. suppliers are in developing countries and it would be difficult for them to increase production from year to year. To buttress this argument, Brazil submits two new studies that look at rural farm households in developing countries.[5] The United States acknowledges that some smaller developing countries, especially the Sub-Saharan African suppliers, may face challenges to increasing production. But many do not face such daunting constraints. China, India and Pakistan – which accounted for more than 70% of rest of world production in 2007 – are more easily able to expand production. As an FAO study states:

> "In some major producing countries, notably China, India and Pakistan, cotton planting area accounts for only 2-4 percent of total agricultural land, which permits production expansion significantly with small changes in relative prices (high supply response). Also, the domination of small size farms in cotton production in these countries allows them to respond to any price movement in a massive way. In particular, if prices of other agricultural crops remain unchanged, a significant increase in cotton price would induce significant shift of land from other crops to cotton, and swiftly so (i.e. even in the short run)."[6]

[5] Brazil's Response to Arbitrator Questions, 13 February, 2009, paras. 19 - 22.

[6] Exhibit US-61.

18. In fact, using a single rest-of-world supply elasticity is problematic, as Brazil has pointed out. In its response to Arbitrator Question 5, Brazil called the supply elasticity choice of Goreux unrealistic since he used a uniform elasticity for all countries. Brazil, in essence has done the same by lumping all producers, excluding the United States, into the rest of the world. Brazil further compounds what it considers to be a fault, with improperly weighting the elasticity towards the smaller producers. In short, Brazil's justification for low rest of world supply elasticity does not hold.

19. Brazil also chooses a low number for U.S. and rest of world demand elasticities. Brazil claims these should be low because cotton represents a small cost share to the final apparel or textile item, and so demand is inelastic. But that is not at all clear. As the FAO study points out, ". . . the demand for cotton is from cotton mills, where cotton accounts for nearly 70 percent of total production cost, which means that changes in cotton prices should have considerable effect on the mill consumption decision."[7] The FAO study goes on to say that mills determine the mix of fibers in making yarn and with the high degree of substitution between fiber types, the elasticity of demand should be larger.

20. However, should the Arbitrator opt for a short-run analysis, the United States believes it is important to account for stocks. The FAO study agrees. "Even though they are relatively significant, cotton stocks have not generally been modeled in PE or GE frameworks. Cotton

[7] Exhibit US-61.

stocks levels have a similar pattern to production levels, but proportional change in stocks year to year are significantly greater." The FAO study goes on to say that "[w]hile it would be safe to ignore stocks if it can be assumed that in the short run they do not vary, this is not the case in reality. In the long term, however, the static assumption may be appropriate."[8] Whereas Brazil ignored the stock issue, the United States adjusted the FAPRI short-run demand elasticities to account for stocks.

21. If the Arbitrator corrects Brazil's elasticity choices, the amount of total effects in the simulation model will fall dramatically. But other corrections – CCP coupling factor, price expectations and time period – are also needed for the modeling to approach a reasonable estimate of total effects of marketing loan and countercyclical payments.

22. With respect to the coupling factor, there is no universal agreement on the extent to which CCPs directly impact planting decisions. But, the U. S. coupling factor accurately, and conservatively, reflects the available literature. The few studies that have looked at the relationship between CCP and production have generally found a small production effect from CCPs (although it should be noted that these findings are not cotton-specific).

23. Brazil has used a coupling factor of 0.4. Because of the modest effects of CCP indicated by the literature, the United States believes 0.4 overstates the relationship – and exaggerates the

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[8] Exhibit US-61.

overall effects in the model. The coupling factor should be smaller, simply because farmers holding base acres do not need to plant any cotton to get the payment. This has been borne out by the large gap between base and planted acres. As part of their argument for this overstated coupling factor, Brazil claims that farmers expected the next farm bill (now the 2008 Farm Bill) would allow for base acreage updating as had occurred in the 2002 farm bill. Brazil, however, never provided any evidence that farmers *actually* had the expectation of base acre updating for the new farm bill.[9] And the sharp decline in planted acres strongly suggests farmers did not anticipate base updating.

24. The United States instead has proposed a coupling factor of 0.25. The United States believes that even this level probably overstates the effect of CCPs on production, but proposed it as a reasonable choice for the Arbitrators, since it was used by independent researchers at FAPRI for its modeling purposes.

25. Regarding the modeling of expected prices, the United States agrees with Brazil that farmers rely on multiple sources to form their individual expectations of the likely market prices at harvest time. But in Brazil's model, there can be only one proxy for the price expectation. Whereas Brazil chose lagged price (previous year's market price) as its price expectation, the United States uses the futures price as the price expectation.

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[9] *US–Upland Cotton (Panel)*, para. 7.405.

26. As both parties stated in their responses to question 61, the lagged price is not known at the time of planting. That is, as Brazil acknowledges, the lagged price incorporates prices that are not realized until after the planting decision period has ended; thus, the previous year's price is not available to farmers at the time planting decisions are made. [10] By contrast, farmers are aware of futures prices at the time of planting. The futures price reflects all available information to date about the current cotton market and likely conditions at the future delivery date. Futures prices are observable by farmers during the planting decision period, incorporate the actual price expectations of farmers entering into futures contracts, and readily reflect overall price expectations. Even if the futures price historically does not predict the realized market season prices with great accuracy, the futures price is still a better price expectation proxy because it incorporates more of the information that farmers rely on to make planting decisions.

27. Regarding the time period for analysis, the United States believes that it is appropriate to use a three year average to account for year to year variation in market conditions that is typical in agricultural products.

28. By contrast, Brazil's choice of a single-year baseline does not account for anomalous years, such as MY2005, in which the U.S. production was the highest in the last decade. Since MY2005, U.S. production has been declining every year. Because of the forward-looking nature of countermeasures, the estimated effects based on this single year would be applied, by Brazil's

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[10] Brazil Responses to Questions from Arbitrators, para. 89.

methodology, no matter what the usual variation in payments and effects from year to year may be.

29. The use of a range of years is also important in this particular dispute because of the nature of the subsidy, in that it varies from year to year. Taking into account several years is one way for the Arbitrator to be more certain that the amount of any countermeasures is commensurate with the nature and degree of the adverse effects of these payments.

30. Finally, the United States would also like to comment on Brazil's claim that the Arbitrator should consider continuing effects of marketing loan and countercyclical payments, and its proposed calculation for such effects in the Response to Question 36 from the Arbitrator. Brazil has provided no actual evidence of any continuing effects, and the data on planted acreage, number of farms, and small farms exiting all suggest that continuing effects are not occurring.

31. Brazil's response is flawed. Interestingly, in their earlier submission to the Arbitrator, Brazil claimed that Mr. Sumner's model could not be used to calculate continuing effects, but Brazil nonetheless has used it for this purpose.[11] Brazil's approach, however, does not provide an estimate of the continuing effects of payments in MY1999, because Brazil basically has removed the same payment repeatedly in hypothetical subsequent years that are identical to the original year. In each subsequent year, as a result of the elasticities used, the response by market

[11] Written Submission of Brazil, para. 391.

participants actually increased.

32. The United States has reviewed the modeling errors that produce Brazil's large result for total effects of marketing loan and countercyclical payments, and will now review two of the key legal errors that premise Brazil's enormous request for countermeasures. Both of these are discussed in the U.S. written submission and responses to the Arbitrators' questions.

33. The most significant legal error in terms of number is Brazil's decision to include all the worldwide effects of marketing loan and countercyclical payments in its calculation, without regard to whether the payments adversely affect Brazil. But, in order to meet the standard of Article 7.9 of the SCM Agreement, the countermeasures must be limited to the adverse effects on Brazil.

34. Brazil's attempt to obtain authorization for countermeasures for adverse effects on other Members and even non-WTO Members has a dramatic effect on the amount of proposed countermeasures. The total effects produced by Brazil's approach total more than $3.335 billion. If the actual effects on Brazil are isolated, leaving all Brazil's other errors in Brazil's model untouched, the effects plummet to only $134.3 million – approximately one-twenty-fifth of Brazil's claimed amount.

35. The DSU provides a way for a WTO Member to take action where that Member considers benefits to it are being impaired. It does not provide for a Member to bring disputes or

suspend concessions on behalf of all Members. Nor does the DSU provide a mechanism for a Member to impose countermeasures for the effects on non-WTO Members (indeed, a WTO Member would not have an obligation under the WTO with respect to the effects of its subsidies on non-Members). Each Member retains its individual rights. Brazil's approach, where it would essentially be taking countermeasures on behalf of the entire world, including non-WTO Members, would fly in the face of this principle.

36. In this particular instance, there is a finding of adverse effects under Article 5(c) of the SCM Agreement. This article specifically reinforces the fact that Brazil cannot suspend concessions on behalf of all Members.

37. The findings of the original and compliance panel conform to the Member-specific limitation in Article 5(c) of the SCM Agreement. The compliance panel concluded that:

> ". . .the effect of marketing loan and counter-cyclical payments provided to US upland cotton producers pursuant to the FSRI Act of 2002 is significant price suppression within the meaning of Article 6.3(c) of the SCM Agreement in the world market for upland cotton constituting "present" serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement." [12]

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[12] *US--Upland Cotton (panel)*, para. 15.1(a).

38. Similarly, the original panel stated:

> ". . . the effect of the mandatory price-contingent United States subsidy measures – marketing loan programme payments, user marketing (Step 2) payments, MLA payments, and CCP payments – is significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement." [13]

39. Brazil argues that these statements support their position, as if a finding of price suppression in the world market is equivalent or coextensive with the finding of adverse effects to the interests of Brazil. But this is not so.

40. The conclusion, in fact, of the original panel and the compliance panel simply tracks the separate questions of Articles 5(c) and 6.3(c). Article 6.3(c) provides one basis for a finding of "adverse effects," which is significant price suppression. Whether the price suppression is measured in the world market, a regional market, or a national market, it is used for the same purpose: for the finding under Article 5(c) of adverse effects to the interests of the Member bringing a claim to dispute settlement. The use of a "world market" or a "world price" for the finding on price suppression does not change the scope of Article 5(c).

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[13] *US--Upland Cotton (panel)*, para. 8.1(g)(i).

41. The next legal error is Brazil's decision to request countermeasures without taking into account the fact that the finding of the compliance panel under 6.3(c) is not of "price suppression" alone, but of "significant price suppression." Price suppression to a certain point is not inconsistent with the WTO – only when it passes a certain point where it becomes significant to the complaining Member is it an issue under Article 5 of the SCM Agreement.

42. Given the enormous level of countermeasures that Brazil has requested, even a small adjustment can cause a very large effect on possible countermeasures. Such an adjustment is essential. Without such an adjustment (for example, if countermeasures were imposed for all of the effects of marketing loan and countercyclical payments), it would be as if the obligation of the SCM Agreement were only to withdraw the subsidy. It is not. Because some subsidies are permitted, Members may comply, under Article 7.8 of the SCM Agreement, by eliminating adverse effects, and only the adverse effects can be the basis for countermeasures. To be clear, Members may either withdraw subsidies or remove the adverse effects.

43. Finally, the United States recalls the discussion regarding cross-sectoral suspension of concessions from its opening statement in the arbitration under Article 4.10 of the SCM Agreement and 22.6 of the DSU. This discussion also applies in this arbitration, and the United States hereby incorporates this discussion by reference. In addition, the United States notes that the fact of large levels of U.S. exports does not support Brazil's claim that suspension of concessions within the goods sector would not be effective. Brazil's claim is based on the proposed $1 billion in countermeasures, but, as described above, the correct amount is closer to

$30 million, if any. Brazil has not claimed that it considers it not practicable and effective to limit its suspension of concessions to goods in that amount. Moreover, the standard for the amount of countermeasures under Article 7.9 is related to the adverse effects caused by the subsidy, regardless of the size of the economy of the Member providing the subsidy. (Similarly, the standard of "appropriate" / "not disproportionate" countermeasures under Article 4.10 of the SCM Agreement does not change by the size of the economies of the Members concerned.) Brazil's contention would convert cross-retaliation into the rule, not an exceptional instrument, whenever a relatively smaller economy, even one the size of Brazil's, brings an action.

44. In conclusion, Brazil's proposed countermeasures far exceed what would be commensurate with the adverse effects on Brazil caused by significant price suppression. Brazil's modeling choices exaggerate the total effect of removal of marketing loan and countercyclical payments, and Brazil fails to relate the proposed countermeasures to the effect on Brazil or the degree to which marketing loan and countercyclical payments cause significant price suppression.