

*United States – Subsidies on Upland Cotton*

(WT/DS267)

**Executive Summary of the Opening Statement  
of the United States of America  
at the Second Session of the First Meeting  
of the Panel with the Parties**

October 20, 2003

1. **Brazil's Analysis Fails to Establish to Whom Certain Payments Go and Whether Certain Payments May Properly Be Attributed to Exported Upland Cotton.** One of the fundamental elements of Brazil's claims is that Brazil needs to identify the "subsidized product" that is causing the serious prejudice that Brazil claims its interests are suffering.<sup>1</sup> Brazil has not even explained, however, what is the "subsidized product" for each of the types of subsidies from which it claims serious prejudice. Brazil appears to assume that the "subsidized product" is upland cotton in the form traded on the world market. Yet many of the subsidies at issue are paid to producers of cotton. Cotton is processed and sold before being traded. Brazil has made no showing of how the subsidy to the producer can be assumed to pass through to the exporter.
2. Brazil's panel request identifies the challenged measures as "subsidies provided to US producers, users, and/or exporters of upland cotton." However, it is for Brazil as the complaining party to establish who are the recipients of the subsidies and that the subsidies are properly attributed to upland cotton. Brazil's failure to do so means that it has not carried its burden in demonstrating that cotton is subsidized for purposes of considering adverse effects.
3. In the Peace Clause portion of this dispute, the United States has discussed at length certain decoupled payments that are not linked to production of upland cotton. With respect to these decoupled payments, Brazil has failed to demonstrate who the recipients of these payments are in connection with any exported upland cotton. Brazil simply presumes that every upland cotton producer is an upland cotton base acreage holder and receives a decoupled payment. Brazil has brought forward no facts to demonstrate that this is the case.
4. Even if Brazil had brought forward evidence that the recipients of these payments were upland cotton producers, that would not be enough. Brazil would still need to allocate these payments, which Brazil concedes are not linked to current production of upland cotton, over total production on a recipient's farm.<sup>2</sup>
5. Thus, Brazil assumes that the subsidies<sup>3</sup> at issue are received by someone currently producing cotton, based simply on the fact that the subsidy is based on past production of cotton. Brazil has not explained how this makes upland cotton currently for sale on the export market the

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<sup>1</sup> For example, for purposes of a claim under Article 6.3(c) of the Subsidies Agreement, the "effect of the subsidy" must be "significant price undercutting" or "significant price suppression, price depression, or lost sales" caused by "the subsidized product." Similarly, under Article 6.3(d) "the effect of the subsidy" must be an increase in world market share "in a particular *subsidized primary product or commodity*."

<sup>2</sup> Subsidies Agreement, Annex IV, paras. 1-3 (We note the context provided by Annex IV of the Subsidies Agreement, which explained the calculation of the ad valorem subsidization of a product under the now-defunct Article 6.1(a) of the Subsidies Agreement. This Annex provided that (among other conditions), unless "the subsidy is tied to the production or sale of a given product," the overall rate of subsidization of a "product" is found by taking the amount of the subsidy over the "total value of the recipient firm's sales in the most recent 12-month period.").

<sup>3</sup> Brazil purports to include export credit guarantees under the GSM-102 program within its actionable subsidy claims. However, Brazil has merely alleged the quantities of export credit guarantees benefitting cotton and the value of exports. Brazil has nowhere presented evidence on any alleged subsidy rate resulting from this program nor the amount of the subsidy. Therefore, Brazil again has not provided any evidence with respect to the amount of the subsidy alleged to be provided by U.S. export credit guarantees.

“subsidized product” with respect to these payments. Brazil has failed to demonstrate that the recipients of the subsidies are involved in current cotton production, nor has it demonstrated how much of the subsidy, even under Brazil’s approach, should be allocated to other products produced by the recipient, such as corn or soybeans.

**6. Brazil Has Not Established that U.S. Subsidies Have Suppressed or Depressed Prices in the Same Market.** As noted above, Brazil has in fact not even demonstrated the subsidized product for each of the subsidies it challenges or the size of the subsidies to exported upland cotton. However, without relieving Brazil of its burden on these issues, we note that even Brazil’s overly simplified approach does not suffice to demonstrate causation. U.S. subsidies largely resulted from low market prices, not the other way around.

7. This is nowhere more evident than in marketing year 2001, a year with historically low market prices. Brazil has failed to explain that market signals (futures prices) at the time when planting decisions were taken by U.S. producers suggested prices would remain high. Thus, the large marketing loan payments ultimately made in marketing year 2001 do not demonstrate that marketing year 2001 payments had the effect of increasing U.S. production. Brazil’s expert acknowledges this very point, but Brazil has not presented in its further submission *any* information on “the expectations about production incentives that growers hold at the time they make their planting decisions,” information on which its own expert has stated “cotton plantings depend.” Thus, Brazil’s simple explanation of the conditions in marketing years 1999 through 2002 ignores “the basic economic principles” its own expert says are relevant in this case.

**8. The Sumner Model Presented by Brazil Is Inadequately Explained, Inappropriately Applied for a Retrospective Analysis, and Apparently Uses Faulty Assumptions and Estimations.** In presenting this reaction to Brazil’s expert’s analysis, the United States notes that the use of a simulation model to explore the counter-factual of removal of U.S. subsidies cannot be made without answers to previous questions on the subsidized product and size of the subsidies. That is, the use of a simulation model cannot relieve Brazil of its burden of arguing the elements necessary to establish its claims. This critique of Dr. Sumner’s analysis is made to show that Brazil’s approach is fundamentally flawed in all aspects.

9. Since Brazil has not provided access to the model itself, one cannot say with certainty how the modeling affects the results.<sup>4</sup> Nonetheless, based on what has been presented in Annex

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<sup>4</sup> The report provided by Brazil as Annex I to its further submission does not provide the model itself, including detailed specifications of the equations used therein. As a result, Brazil is essentially asking the Panel and the United States to accept Dr. Sumner’s results on faith alone. The United States points out why Brazil’s expert’s approach is inappropriate for a retrospective analysis of the effect of U.S. subsidies. Even were Brazil’s expert’s approach appropriate, however, Brazil has failed to provide sufficient evidence to allow the Panel to fully understand and evaluate that model. Thus, quite apart from flaws identified by the United States, Brazil’s reliance on Dr. Sumner’s inadequately explained results, evident throughout Brazil’s latest submission, further demonstrates that Brazil has not established a *prima facie* case that U.S. subsidies have the effects complained of.

I, Brazil's analysis appears flawed in several respects and as a result, the conclusions drawn are biased and misleading. While the modeling approach used is well accepted for forward-looking projections, using a baseline model to simulate counterfactual outcomes over the historical period 1999-2002 is problematic because of the implicit assumption of perfect foresight by producers of actual conditions in the historical year. This potentially overstates the effects of the program because the model assumes outcomes that were unanticipated by producers when they made their planting decisions. Also, it is not clear to what extent actual observed data enter into the solution process. The difference is not merely conceptual: the choice of values can potentially affect the reported results.

10. Brazil's use of lagged prices as a proxy for expected prices is also problematic. Recent studies have criticized the use of lagged variables as substitutes for expectations, and numerous papers use the futures price for next year's crop as the best proxy for expected price. The use of futures prices in a multi-commodity modeling framework for extended time projection is cumbersome. Nonetheless, the use of lagged prices as a modeling convenience does not preclude the possibility of bias. In those years where there are large shocks, lagged prices are poor predictors of expected price. Futures prices, by contrast, are more efficient because they are based on more current information.<sup>5</sup>

11. Brazil's expert's estimates of U.S. program impacts after marketing year 2001 are further inflated by his choice of a low-price baseline for the counter-factual comparison.<sup>6</sup> The low-price baseline exaggerates the 2003-07 results and ensures projections of significant marketing loan payments throughout 2003-07.

12. The economic literature on decoupled payments acknowledges the programs may have some impact on production, and that those impacts depend in part on farmer's expectations. However, the research concludes that the impact appears negligible. Brazil's expert, on the other hand, uses a stylized logic to come up with the estimates for the impact of production flexibility contract (PFC) payments that have neither empirical nor theoretical grounding. It is widely accepted that these programs have whole farm impacts rather than crop specific impacts. Furthermore, the impact is much smaller than Brazil has estimated; the whole farm impact is, at

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<sup>5</sup> Consider as an example the 2002 crop year. In Brazil's analysis, area response to the removal of the cotton loan program results in a 36-percent reduction in U.S. planted area—the largest single effect for any of the years considered in his analysis. Based on lagged prices, price expectations for 2002 were 29.8 cents per pound, a 40 percent reduction from 2001 levels. Yet, the futures market data suggests a far smaller reduction in expected price. December futures prices taken as an average in February 2002 averaged 42.18 cents per pound, a 28 percent drop from year earlier levels. Based on Brazil's range of supply response elasticities of 0.36 to 0.47, a decline of this magnitude would suggest a drop in acreage of 10 to 13 percent from the preceding year. In fact, actual U.S. cotton acreage dropped 12 percent (from 15.5 million acres in 2001 to 13.7 million acres in 2002) suggesting acreage levels entirely consistent with world market conditions and price expectations.

<sup>6</sup> Brazil's expert's estimate for the 2002 A-Index is 51 cents, compared with 54 cents in FAPRI's March 2003 baseline, and an actual price of 56 cents. For 2003, Brazil's expert's A-Index is estimated again at 51 cents, whereas FAPRI's baseline has a 58.4 cent forecast; as of September 15, 2003, the A-Index is at 65.5 cents.

its upper estimate, perhaps one-quarter to one-fifth the impact Brazil's expert cites for cotton alone.

13. Brazil argues that market loss assistance (MLA) payments have a larger effect on area than do PFC payments, despite the fact that MLA payments were paid on the identical payment base as the PFC payments. Supplemental legislation authorizing each of these MLA payments was passed several months after planting for the crop year in question had occurred. Brazil asserts that producers had expectations about MLA payments at the time of planting. However, if producers had expectations of payment, then they also knew that they would be eligible to receive such a payment whether or not they planted cotton. Indeed, they could choose not to plant any crop at all and still be eligible for the payment.

14. Brazil argues that counter-cyclical payments “clearly provide more production incentive than the market loss or the direct payments,” yet offers no empirical evidence to justify such a claim. The claim, as well as Brazil's expert's treatment of decoupled payments in general, is particularly puzzling given a recent paper by Brazil's expert in which he concludes that the 2002 farm bill would have a minimal effect on cotton area and world prices. Brazil's expert also remarked that: “The impacts of the FSRIA will be hard to isolate amid the normal flux of world markets.”<sup>7</sup> We agree with Dr. Sumner's previously *published* conclusions on these points.

15. Crop insurance subsidies are generally available for most crop producers and hence do not give a specific advantage to one crop over another. Thus, their effects are not commodity specific, and have no or minimal impacts on cotton markets. Moreover, crop insurance purchases by cotton growers have generally been at lower coverage levels than for other row crops. Over 2002-03, roughly 90 percent of cotton acreage insured was at coverage levels at 70 percent or less, consistent with the criterion under paragraph 8(a) of Annex 2 of the Agreement on Agriculture. This suggests that even if one were to consider cotton crop insurance subsidies as crop specific, over 90 percent of insured cotton area would be exempt as having no or minimal trade-distorting effects.

16. Lastly, while some studies like the ones cited by Brazil have suggested crop insurance subsidies may have a slight effect on acreage, the effects on production are less clear. Recent studies suggest that farms with more insurance tend to use less inputs like fertilizer and pesticides and vice versa. This demonstrates a potential moral hazard problem with crop insurance: a negative effect on yields, which may well offset any marginal effects on crop area.

17. The size of Step 2 payments under Brazil's baseline appears to be biased upwards, in part, due to the low-price baseline discussed earlier. Brazil's results are inconsistent with other

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<sup>7</sup> Sumner, D.A. “Implications of the US Farm Bill of 2002 for Agricultural Trade Negotiations.” Australian Journal of Agricultural and Resource Economics. 47(2003): 99-123, at 114. (See Exhibit US-56)

analyses of Step 2.<sup>8</sup> Thus, contrary to the results of Brazil's expert's model, the benefits of Step 2 payments would appear to largely accrue to the producer, with only negligible effects on world markets. While Brazil's model documentation is lacking, one explanation for the difference may be a more price responsive acreage equation by Brazil.

18. While Brazil has presented a modeling framework that is conventional, much of how Brazil's expert has modeled U.S. farm payments can be considered "unconventional." Thus, the analysis presented by Brazil in Annex I is not "conservative", but rather produces results that are inconsistent with a wider body of academic research.

19. **Additional Legal Arguments.** With respect to price suppression or depression under Article 6.3(c) of the Subsidies Agreement, Brazil believes that it is the effect on the producers of the complaining Member that must be "significant." We find it implausible that the Subsidies Agreement was intended to create multiple standards for panels to apply: that is, what may be "significant" to one Member's producers may be "insignificant" to another's. Context for rejecting Brazil's approach can be found in Article 15.2 of the Subsidies Agreement, which sets out for countervailing duty purposes the same effects found in Article 6.3. This text makes it even more clear that the analysis is whether the level of price suppression or depression itself is "significant."<sup>9</sup> Brazil has not suggested that the analysis under Articles 15.2 and 6.3(c) should be different.

20. With respect to GATT 1994 Article XVI:3, Brazil appears to assume that it may advance a claim under this provision on all challenged U.S. subsidies. However, Article XVI:3 only applies to export subsidies. Therefore, as Brazil has predicated its claim under Article XVI:3 on evidence relating to all challenged U.S. subsidies and not only those subsidies it alleges are export subsidies, Brazil has failed to establish a *prima facie* case on its claims.

21. Finally, with respect to Brazil's claims of a threat of serious prejudice, the United States notes Brazil's failure to present recent market and futures price data, which belie the notion that there is a clearly demonstrated and imminent likelihood of future serious prejudice. In fact, prices are currently above the level at which the marketing loan program confers any benefit on U.S. upland cotton producers and are expected to remain so. If there is not a "clearly demonstrated and imminent likelihood" of serious prejudice in marketing year 2003, it follows that there cannot be a threat of serious prejudice for marketing years 2004-07, either.

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<sup>8</sup> In Brazil's baseline, Step 2 payments average 5.6 cents per pound over the 2003-07 period, elimination of Step 2 payments raises world prices by an average of 1.6 cents, while farm prices fall by 2.5 cents per pound. These alleged effects are higher than those found by others. For example, in 1999, when Congress was debating whether to reauthorize Step 2 subsidies, the FAPRI analyzed the effects of reauthorization for the Senate Committee on Agriculture, Nutrition and Forestry. Their analysis estimated an average Step 2 payment of 5.3 cents per pound, resulting in an increase of the U.S. spot price by 4 cents and a fall in the world cotton price of less than 0.5 cents.

<sup>9</sup> Subsidies Agreement, Article 15.2 ("With regard to the effect of subsidized imports on prices, the investigating authorities shall consider whether . . . the effect of such imports is otherwise to depress prices *to a significant degree* or to prevent price increases, which otherwise would have occurred, *to a significant degree*.").