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Potential Challenges to U.S. Farm Subsidies in the WTO: A Brief Overview

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Summary

This report examines U.S. commodity subsidy programs against an emerging set of criteria that test their potential vulnerability to challenge in the World Trade Organization. The criteria are whether the subsidies cause adverse effects contributing to serious prejudice under the Agreement on Subsidies and Countervailing Measures (SCM), Articles 5 and 6.3. When measured against these criteria, available evidence suggests that all major U.S. subsidy program crops, particularly crops receiving benefits under both the counter-cyclical payments program and marketing loan provisions are potentially vulnerable to dispute settlement challenges. If such challenges occur and are successful, the WTO remedy likely would imply either elimination, alteration, or amendment by Congress of the programs in question to remove their adverse effects. Alternately, in light of an adverse ruling the United States could choose to make compensatory payments (under agreement with the challenging country) to offset the alleged injury. In spite of U.S. vulnerability, there are reasons why challenges may rarely be filed. Disputes are economically and diplomatically costly, and a lost challenge can help to legitimize the disputed program. This report, which will be updated, is an abridged version of CRS Report RL33697, *Potential Challenges to U.S. Farm Subsidies in the WTO*. Citations to sources appear in that report.

The World Trade Organization's (WTO's) 149 members have agreed to a set of trading rules, including constraints on domestic subsidies and a process for challenging violations. Now, the combination of three relatively recent events — (1) the expiration of the WTO Peace Clause on January 1, 2004; (2) Brazil's successful challenge of certain provisions of the U.S. cotton program in a WTO dispute settlement proceeding (upheld on appeal in March 2005); and (3) the indefinite suspension of the Doha Round of WTO trade negotiations in July 2006 — have raised concerns that U.S. farm programs could be subject to a new wave of WTO dispute settlement challenges.

The Peace Clause had provided protection for actionable subsidies provided they met certain compliance conditions. Now an agricultural subsidy may be challenged under claims of "adverse effects" in agricultural markets — even if the subsidy remains within specified spending limits. The potential list of actionable subsidies includes export subsidies, amber box, blue box, green box, and *de minimis* domestic support measures. (See CRS Report RL32916, *Agriculture in the WTO: Policy Commitments Made Under the Agreement on Agriculture*, for an explanation of these categories). In particular, the "serious prejudice" claim of the Agreement on Subsidies and Countervailing Measures (SCM), Article 5(c), according to expert opinion, is a lower threshold for achieving successful challenges than the injury requirement under a countervailing duty claim.

If challenges are successful, the WTO remedy likely would imply either elimination, alteration, or amendment by Congress of the programs in question to remove their adverse effects. Since most governing provisions over U.S. farm programs are statutory, new legislation could be required to implement even minor changes to achieve compliance. Alternately, in light of an adverse ruling the United States could choose to make compensatory payments (under agreement with the challenging country) to offset the alleged injury. USDA Secretary Johanns has stated that one of his primary objectives for the 2007 farm bill is to make U.S. farm programs "beyond challenge." This objective was translated into specifics in the Administration's *2007 Farm Bill Proposals*.

Nevertheless, some trade specialists argue that numerous new WTO challenges of U.S. farm support are unlikely. They contend that challenges require intense effort, the financial costs are high, and the broader geopolitical consequences may far outweigh any potential trade gains. Few developing countries have the needed resources for a challenge. In addition, there is the inherent risk that, if the challenge fails, the effort could legitimize those very programs targeted for discipline. However, in January 2007, Canada requested consultations with the United States under the auspices of the WTO (case DS357) to discuss three explicit charges against U.S. farm programs: that corn subsidies have caused serious prejudice to Canadian producers in the form of market price suppression; that the export credit guarantee program operates as an illegal export subsidy; and that fixed direct payments are not green box compliant and should be counted as amber box payments, putting the United States in violation of its $19.1 billion amber box spending limit in six of the past eight years.

Measuring Vulnerability

Based on precedent from WTO past decisions, several criteria are important in establishing the existence of adverse effects contributing to serious prejudice: (1) the subsidies constitute a substantial share of farmer returns or cover a substantial share of production costs; (2) the subsidized commodity is important to world markets because it forms a large share of either world production or world trade; and (3) there is a causal relationship between the subsidy and adverse effects in the relevant market.

A WTO challenge, under SCM Articles 5 and 6.3, is most likely to focus on those programs that are production- and trade-distorting (i.e., amber box) or that have been exempted from the amber box under the blue box, *de minimis*, or green box criteria, but can be shown to cause adverse effects in certain markets. To identify commodities that are potentially vulnerable to WTO challenges, USDA data are used to measure the level of subsidy dependence. Then, those commodities identified as depending heavily on government subsidies are evaluated in terms of the potential for the subsidies to be linked to adverse effects in international commodity markets.

How Important Are Farm Subsidies Relative to the Commodity's Market Returns? When U.S. program crops (i.e., commodities receiving mandatory federal support) are ranked by the level of subsidy as a share of cash receipts (over the past 10 years beginning with 1996), all of the "covered commodities," with the exception of some minor oilseeds, received subsidy payments amounting to more than 10% of marketplace cash receipts.

Table 1. Subsidy Payments as Share of Cash Receipts, Average FY1996-FY2005

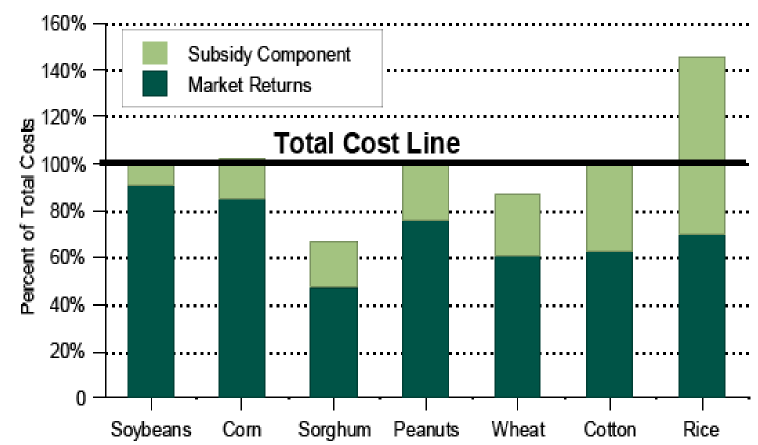
Commodity	Subsidy as Share of Cash Receipts	Commodity	Subsidy as Share of Cash Receipts
Rice	72%	Sunflower Seed	21%
Upland Cotton	58%	Canola	20%
Sorghum	45%	Flaxseed	13%
Wheat	34%	Dry Peas	12%
Barley	30%	Peanuts	11%
Corn	25%	Soybeans	10%
Oats	25%		

Source: Subsidies include commodity support payments and crop insurance indemnity payments in excess of farmer-paid premiums. Calculations were made by CRS from USDA data.

The averages understate the situation because challenges in the WTO likely would specify the years when the subsidies were at their highest levels relative to market revenues. In FY2000, for example, rice and cotton subsidy payments amounted to 174% of cash receipts, and sorghum, wheat, and corn payments were respectively 110%, 101%, and 66% of cash receipts, according to USDA data.

How Important Are Farm Subsidies Relative to the Commodity's Costs of Production? On average, for the crops receiving the most program support per unit, market revenue has covered operating costs but not total costs of production. It is only with the subsidies that these commodities cover their total cost, and even this was not accomplished for sorghum and wheat. In the most extreme case, market revenue for rice amounted to 70% of total costs, but with the addition of subsidies the total revenue amounted to 146% of total costs.

Figure 1. Revenue Components as Share of Total Costs



Source: Calculated by CRS from USDA data.

These comparisons suggest that only with the aid of subsidies is a substantial portion of U.S. production made economically sustainable. Unanswered is the question of whether production would decline without the subsidies. Some (and possibly a substantial) portion of the lost production from high-cost farms that would leave the sector in the absence of subsidies would be offset by increased production from low-cost farms that would likely expand their operations. Nonetheless, the substantial contribution of subsidies toward covering otherwise unmet production costs implies a high chance for adverse rulings for any of the major covered commodities.

Which Programs Provide Most of the Farm Subsidies for the Commodity? Direct payments, the 2002 farm bill successor to production flexibility contract payments, are, on average, the largest and most constant commodity subsidy payments. Counter-cyclical payments and marketing loan program payments, as well as milk income loss payments, have the greatest variation and are large, by design, in years when market prices are low. The cotton user marketing program, commonly called the Step 2 program, has been terminated by a change in the law subsequent to the WTO cotton ruling, and expenditures will drop to zero in FY2007. There are purchase programs for milk and sugar to remove supplies from the market when prices fall below mandated support levels, but federal costs are comparatively low because price support largely is achieved through import restrictions. Crop insurance is another sizable and growing direct subsidy program, benefitting primarily the major crops but other crops as well. **Table 2** provides detailed expenditure data for the major subsidy programs.

Some WTO members, including the EU, have argued that benefits from U.S. marketing loan provisions should be classified as prohibited export subsidies. They contend that these subsidies "effectively behave like an export subsidy." However, under SCM Article 3 an export subsidy must be based specifically on export performance or upon use of domestic over imported goods: "The mere fact that a subsidy is granted to enterprises that export shall not for that reason alone be considered to be an export subsidy..." The United States maintains that all of its farm programs operate within the framework of U.S. commitments to the WTO and are therefore in compliance. Furthermore, no WTO member has challenged the benefits obtained by U.S. producers under the marketing loan provisions as prohibited subsidies.

Federal crop insurance costs have grown in recent years because the level of subsidy on each policy has increased and the pool of subsidized commodities and production locations has grown. Since FY2002, government net outlays (including premium subsidies and government loss-sharing and delivery costs) have averaged more than $3 billion annually. Future growth (according to a January 2006 report by the Food and Agriculture Policy Research Institute (FAPRI)), is expected to raise net outlays to over $4 billion by 2008 and $4.6 billion by 2015. This higher expenditure level could bring the crop insurance program under greater scrutiny from trade competitors.

While crop insurance is available widely, 68% of the subsidy over the FY2002-FY2006 period went to five crops — corn (20%), wheat (18%), soybeans (16%), cotton (9%), and sorghum (6%) — and fully 75% of the total crop insurance coverage went to the program crops, while the remaining 25% went to the non-program crops. When total premiums (including farmer and federal contributions) are compared to indemnity payments, the loss ratio was 1.09, giving the overall appearance of being actuarially sound. However, if the federal premium subsidy is excluded, the loss ratio is 2.70 (indemnities were 2.7 times higher than farmer premium payments).

Table 2. Commodity Subsidy Outlays, by Program, FY2002-FY2007F

Program	FY02	FY03	FY04	FY05	FY06E	FY07F
			$ Million			
Direct Payments Program [a]	3,968	3,857	5,278	5,235	4,949	4,170
Counter-Cyclical Payments Program		1,743	809	2,772	3,975	3,147
Marketing Loan Program	5,987	4,752	1,047	5,608	5,693	402
Loan Deficiency Payments	*5,345*	*693*	*461*	*3,856*	*4,576*	*351*
Commodity Certificate Gains	*0*	*3,869*	*268*	*1,520*	*1,106*	*32*
Marketing Loan Gains	*642*	*190*	*318*	*232*	*11*	*19*
Milk Income Loss Contract	0	1,796	221	9	515	600
Cotton User Marketing Program	182	455	363	582	312	0
Total CCC Commodity Payments	16,124	17,355	8,765	19,814	21,137	8,721
Dairy price support program	622	698	74	(30)	88	145
Sugar price support program	(130)	(84)	61	(86)	0	0
Total Commodity Purchase Operations	492	614	135	(116)	88	145
Crop Insurance Indemnities in Excess of Farmer-Paid Premiums [b]	1,772	2,892	1,871	1,500	750	na
Total Commodity-Specific Support	18,388	20,861	10,771	21,198	21,975	8,866

Source: Data are from USDA, FSA, CCC Net Outlays by Commodity and Function, July 11, 2006. Outlays for FY2006 and FY2007 are budget forecasts.
a. Direct payment outlays for FY2002 include funds for the predecessor contract payments program.
b. There are additional federal costs for crop insurance delivery and administration not included in these calculations. However, those costs benefit the providers and not directly the farmers.

How Important Are U.S. Production and Trade for Subsidized Commodities Relative to World Markets? The most heavily subsidized commodities (with the exception of milk) also are this nation's largest agricultural exports. Not only do exports provide a market for a large proportion of U.S. production, these exports are a large proportion of the entire world's exports. During the 2002 to 2005 period, U.S. cotton accounted for 20% of world production and 40% of world trade. Similarly, U.S. rice accounted for 2% of world production and 13% of world trade; U.S. wheat was 9% of world production and 25% of world trade; U.S. sorghum averaged 18% of world production and 83% of world trade; and soybeans averaged 38% of world production and 44% of world trade.

Do U.S. Farm Subsidies Cause Adverse Effects in the Marketplace? Several economic studies have investigated the causality linkage between U.S. agricultural policy support and the adverse market effects identified in SCM Article 6.3 (i.e., lost market share, quantity displacement, and suppression of market prices). In general, these studies support the idea that U.S. (and other developed country) agricultural support programs negatively influence international market prices and tend to disadvantage third-country trade of non-subsidized "like" products. (The longer version of this report, CRS Report RL33697, summarizes these studies.)

WTO Remedies

The remedy to a successful WTO legal challenge of a subsidy program depends on the nature of the subsidy — prohibited versus actionable — and on the recommendation of the panel hearing the case. Prohibited subsidies must be withdrawn without delay (SCM Article 4.7) according to a time period specified by the panel in its recommendation. If withdrawal is not accomplished within the specified time frame, then the Dispute Settlement Body (DSB) shall grant authorization to the complaining member to take appropriate retaliatory countermeasures (SCM Article 4.10).

With respect to actionable subsidies, the remedy is to remove the subsidy's adverse effects or withdraw the subsidy (SCM Article 7.8). The subsidizing party is given some leeway in deciding how to remove the adverse effect. Options could include eliminating the subsidy program, reducing the subsidy amounts, reducing the linkage between the subsidy and the adverse effects (e.g., decoupling), or making some sort of mutually acceptable compensatory payment. Furthermore, if the recommendation is not followed within six months of the adoption of the panel report (or the Appellate Body report on appeal), then the DSB shall grant the complaining member authority to take appropriate retaliatory countermeasures commensurate with the degree and nature of the adverse effects determined to exist (SCM Article 7.9). An arbitrator may be asked to determine whether proposed countermeasures are commensurate.

Conclusions

When measured against WTO criteria, all major U.S. subsidized crops (both "covered commodities" and "loan commodities") appear potentially vulnerable to WTO legal challenges. Furthermore, several commodities may be more vulnerable to challenges because of impacts in specific export markets (rather than on a global basis) or in sub-product domestic and export markets. Another important concern is the potential for certain U.S. farm programs (e.g., foreign market development programs) to be ruled prohibited subsidies when subject to detailed analysis by a WTO Panel.

A review of recent economic analyses suggests that a partial U.S. policy reform (such as the U.S. Doha-Round Proposal to reduce U.S. amber box spending by 60%) would provide only a modest reduction in adverse effects in international markets. This happens because the United States plays such a large role in world commodity markets. As a result, U.S. subsidy programs would appear vulnerable to WTO challenge under SCM Article 5 and 6.3 following even such a policy reform.

The most clear method for decreasing exposure to WTO legal challenges is through extensive decoupling (i.e., remove the linkage between payments and producer or consumer behavior). Such decoupling would sever the causality linkage necessary to accomplish a successful WTO challenge. Several options for decoupling have been considered or discussed as part of the ongoing 2007 farm bill debate. These include fully decoupled direct payments, whole-farm revenue-insurance-type programs, and conservation or "green" payments. The attraction of these alternatives is their likely qualification as green box programs. The costs thus would fall outside the WTO's aggregate measures of support (AMS) spending limits.