

U.S. Farm Policy and WTO Compliance

Daniel A. Sumner*

* Director, University of California Agricultural Issues Center; Frank H. Buck, Jr. Professor, Department of Agricultural and Resource Economics, University of California, Davis; and member of the Giannini Foundation. Sumner has also been an economic expert for Brazil in the WTO upland cotton case discussed below. Paper prepared for American Enterprise Institute (AEI) project, Agricultural Policy for the 2007 Farm Bill and Beyond, directed by Bruce Gardner and Daniel A. Sumner. The views expressed here are the author's own and are not to be attributed to any organization with which he is affiliated.

Overview

Farm policy participants and commentators consistently rank compliance with World Trade Organization (WTO) commitments as among the most important drivers for change in the 2007 Farm Bill. For example, the U.S. Department of Agriculture (USDA) position paper on risk management evaluates every policy option it considers in the context of WTO implication, and considers those obligations in the context of WTO dispute settlement.¹ Likewise in response to requests from members of Congress, the Congressional Research Service has advised Congress on the implications of WTO agreements and rules for the 2007 Farm Bill.²

This is a new development. Before 2003, there was little serious consideration of compliance with WTO obligations in setting U.S. farm policy.³ The successful challenge of the U.S. upland cotton program by Brazil in a wide-ranging WTO dispute disrupted the complacency with which many viewed the U.S. ability to satisfy its WTO obligations in agriculture. While largely specific to upland cotton, the detailed rulings in that case suggested that other U.S. farm subsidy programs and the aggregate measure of support provided by U.S. programs might also be vulnerable to challenge under the agreements that the United States had signed creating the WTO at the completion of the Uruguay Round of WTO negotiations.

The United States was the leader in bringing agriculture under the full WTO umbrella and strengthening of the WTO dispute resolution process. These accomplishments promise to yield important economic benefits for the United States and U.S. agriculture for decades to come. However, seeming U.S. violations of its obligations, and apparent unwillingness to play by the rules it created, undermine the credibility of the WTO and of the United States. To be sure, not every farm program violates the text of the WTO agreements and the United States must defend its policies against unwarranted legal challenge. Nonetheless, it is also important to recognize that transparent contradictions between rhetoric and action harm the strong U.S. agricultural interests in opening markets and reducing subsidies globally. There are times when full, immediate, and forthcoming compliance and policy adjustment in anticipation of WTO disputes will reap significant strategic gains. The United States should consider unilaterally eliminating or altering its agriculture subsidy programs to preclude future WTO challenges and secure the benefits of freer trade for its farmers. The 2007 Farm Bill can be the vehicle to achieve all these ends.

Background, Objectives, and Outline. The United States was an original “contracting party” of the General Agreement on Tariffs and Trade (GATT) in 1947, but has seemed to maintain ambivalence about agricultural trade policy since long before that date.⁴ Back at

¹ USDA, “2007 Farm Bill Theme Paper: Risk Management” (May 2006).
<http://www.usda.gov/documents/Farmbill07riskmgmtrev.doc>.

² See, for example, Schnepf (2005); Schnepf and Womack (2006).

³ The so-called GATT trigger in the 2002 Farm Bill will be discussed below.

⁴ For a history of U.S. farm policies from 1790 to 1950, see Benedict (1953).

the time the GATT was created, D. Gale Johnson noted the “inconsistency” between U.S. agricultural policy and trade policy in general (Johnson 1950). Agriculture was never “left out of the GATT,” but with so many exceptions and special treatments, agricultural trade was not subject to the same multilateral liberalizing thrust that affected other merchandise trade until the WTO was formed by the Uruguay round agreements of 1994 (Sumner and Tangermann 2002; Josling 2007). The 1994 Agreements accomplished three important innovations. They provided a systematic framework and began the gradual process of broad-based agricultural liberalization. They also brought agricultural trade formally under the trade rules that applied to other merchandise trade, except where explicit exceptions were stated. And, they created a much more robust and effective dispute settlement process.

This study explores the potential for inconsistency between U.S. farm policies and the WTO agreements that the United States has signed. It then evaluates policy alternatives for responding to potential inconsistencies. The main objective is to examine how the 2007 Farm Bill may be framed to reduce rather than to increase potential inconsistencies between U.S. farm policies and WTO obligations.

Before turning to alternatives for the 2007 Farm Bill, the paper briefly reviews the applicable WTO agreements and obligations. One cannot evaluate how the Farm Bill may conflict with international obligations without appreciating what those obligations are. Further, since WTO disputes play a prominent role in this story, the dispute settlement process warrants attention. The paper then outlines some main features of existing U.S. farm programs that have raised consistency questions.

Much of the current concern about the implications of the WTO for the 2007 Farm Bill hinges on the results of the recent dispute concerning U.S. upland cotton programs. The rulings in the upland cotton case provide clarification of how WTO panels and the WTO Appellate Body have interpreted the relevant WTO provisions and U.S. programs. The rulings in this case suggest how the Dispute Settlement Body (DSB) may interpret U.S. policies in light of WTO obligations. Of course, it is impossible to prejudge any case yet to be filed, but we may be able to gain insight into those parts of U.S. policy that may be most vulnerable to challenge, and what conditions increase such vulnerability.

This paper argues that the United States has a strong interest in reducing potential WTO inconsistencies and conflicts and may wish to bring its programs into compliance without waiting for legal challenge. That leads to considering policy options that can achieve secure WTO compliance.

In part, this paper extends my 2005 analysis of conflicts between U.S. farm policies and WTO obligations (Sumner 2005b). In addition, I draw upon the very useful recent summary of the issues by Schnepf and Womack (2006) in a Congressional Research Service report to Congress. I also draw on the companion American Enterprise Institute study of Josling (2007) that reviews bilateral and multilateral agreements and negotiations undertaken by the United States.

WTO Agreements, Compliance, and Dispute Settlement

The World Trade Organization (WTO) has one main objective and two roles. The objective is to open markets and facilitate trade. The WTO is the “only international

⁵ Since the WTO is a voluntary group of nations (and groups of nations such as the European Union), any nation that does not subscribe to these objectives is welcome to remain outside the WTO. Over the past two decades, however, most nations have decided that joining the WTO was in their interests.⁶

One role of the WTO is to facilitate negotiation of agreements among nations to lower barriers to trade. Over the past 60 years, there have been nine WTO negotiating "rounds." The Uruguay Round established the WTO and the set of agreements that are currently governing multilateral trade. Achieving agreement in the ninth round, the Doha Development Agenda, remains illusive (Josling 2007). Economists have often talked about the WTO (or GATT before that) in terms of the negotiations of new agreements. The WTO remains crucially relevant, even if success in negotiations seems remote. The Agreements themselves are the core of the WTO; even without a new agreement on the near term horizon, the existing agreements remain in force.

The second role of the WTO is to administer the current multilateral trade agreements, which comprise the set of promises or contracts that nations have made with one another. The major part of administering the WTO agreements is facilitating compliance by members to the agreements. The WTO Web site notes, "Dispute settlement is the central pillar of the multilateral trading system, and the WTO's unique contribution to the stability of the global economy. Without a means of settling disputes, the rules-based system would be less effective because the rules could not be enforced."⁷

The Dispute Settlement Process. Before the Uruguay Round agreement of 1994, the dispute settlement system had fundamental flaws. The most egregious of those flaws was that any member could block the resolution of the dispute by simply voting to disallow the GATT from assembling a panel to consider the question. Then, if a member did not agree with the rulings of a GATT panel, it could simply block the adoption of that panel decision. In effect, the accused served on the jury, and the verdict had to be unanimous. Not only that, with no clearly specified, enforceable timetables, even the process of investigating and resolving cases could be unending. The process was thoroughly overhauled with the creation of the WTO in 1994.

Under the WTO dispute settlement process, parties must first engage in formal consultations to try to resolve the dispute issue. Only if such consultations fail to reach a mutually acceptable resolution does the WTO dispute settlement body consider appointing a panel to investigate and rule on an issue. The WTO dispute resolution panels are comprised of three individuals with expertise in trade law and trade policy who are citizens of WTO members that are not parties to the case. These individuals, with the assistance of

⁵ See the WTO Web site, "The WTO in Brief."
http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm.

⁶ There was a gradual increase in the numbers of nations that subscribed to the WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), before the WTO was launched in 1994.

⁷ WTO Web site, "WTO Legal Texts: Subsidies and Countervailing Measures."
http://www.wto.org/english/docs_e/legal_e/legal_e.htm.

the WTO staff, guide the development and presentation of evidence and make decisions based on the facts, analysis, and applicable WTO rules.

The panels operate within very tight time schedules. After the consultations have been held and a panel is appointed, the panel has only six months to gather the needed information from the parties, including receiving formal written submissions and oral testimony, and issue its report to the parties. In all, this stage takes less than one year. If the case is appealed, the appellate body process takes another three months. That means that even in complex cases with an appeal, the WTO dispute settlement process will be completed in less than one and one half years—except in unusually complex and strongly contested disputes, where delays are allowed at each step.

The Dispute Settlement Body (DSB) has authority to specify remedies to settle the dispute; however, the WTO does not have any authority to require members to comply with WTO rulings and implement trade policy changes as directed by the DSB. If members do not comply with rulings, they are expected to provide compensation to the offended member. The most that the WTO can do is authorize the offended party to withdraw trade concessions that had previously been provided to the losing party of the dispute. In practical terms, this typically means that a member is given authorization to raise tariffs against a certain amount of trade from the offending member. Other measures are not precluded, but they are required to be commensurate with the hardship caused by the offending policy.

If the offending member undertakes some measures to bring its policies in line with the DSB decisions, but in the view of the offended member the adjustments are insufficient, a panel may be required to adjudicate this dispute over compliance. This compliance process is scheduled for six months and an appeal is allowed at this stage too.

The dispute settlement process operates within quite reasonable time schedules. The time schedule for settling a WTO dispute is far shorter than the time needed to resolve a comparable contract dispute in the courts of the United States. The United States was a strong advocate for a more effective dispute settlement process and gains from a trading system based on well-defined and enforceable rules.

However, because the WTO cannot compel policy changes in sovereign members, those that do not wish to adopt the rulings of the DSB may make alternative compensation, including accepting retaliation. The ultimate leverage to encourage a member to implement with the rulings of the DSB derives from three sources: first, the disapproval of the other WTO members and a loss of credibility that sours trade relations broadly; second, a concern for weakening the WTO as an effective institution; and third, the negative consequences of a sanctioned trade retaliation.

The WTO Agreement on Subsidies and Countervailing Measures. The most important source of potential conflicts between U.S. farm programs and the WTO agreements is likely to be the agreement on subsidies and countervailing measures (SCM). Thus this paper considers this agreement first, and then turns to the agreement on agriculture.

Subsidies liable for dispute settlement actions must be “specific” in the sense that they apply to a limited scope of the overall commerce of a member. The WTO agreement

creates two categories of such subsidies: prohibited subsidies and “actionable” subsidies.⁸ Members found to use prohibited subsidies must remove them immediately, or as soon as is practical. Prohibited subsidies come in two forms. The first are export subsidies, which are defined and illustrated with a list of many of the most common types of export subsidies, including export credit guarantees and “producer-financed” export subsidies. Exception to the prohibition of export subsidies is provided only for those agricultural exports subsidies that were listed for reduction commitments as a part of implementing the agreement on agriculture. The second form of prohibited subsidies are local content subsidies, which are those contingent on the use of the domestic product over imported goods. For example, local content subsidies include payments to domestic buyers contingent on purchasing a domestic product when purchases of an imported substitute are not eligible for the payment. These export subsidies and local content subsidies are prohibited because they are expressly designed to affect trade, and thus are presumed to have adverse effects on other WTO members.

Before any ruling may be taken against “actionable” subsidies, the complaining member must show that such subsidies have an “adverse effect” on the complaining members. Adverse effects come in three forms. First is injury to a domestic industry from subsidized imports into the home market. Such injury claims are the basis for countervailing duty actions undertaken by domestic agencies, such as the U.S. International Trade Commission (ITC), and are subject to review by the WTO. Second, “serious prejudice” occurs in either the home market of the subsidizing member or in third country markets, including the world market, when subsidies cause displacement of imports or exports, lower prices, lost sales, or an increase in market share of the subsidizing member. Third, nullification or impairment occurs when benefits expected from the WTO agreement are hampered through failure to implement the agreement or in other ways.

Serious prejudice is the most important of the adverse effects in considering agricultural subsidies and was a major issue in the U.S. upland cotton case. Serious prejudice may arise in cases of: displacing or impeding imports into the market of the subsidizing member; displacing or impeding exports of another member into a third market; price undercutting, price suppression, or price depression or lost sales; or an increase in world market share by the subsidizing member.

The WTO Agriculture Agreement. The Agriculture Agreement of 1994 has been often reviewed (Sumner and Tangermann 2002; Josling 2007). The discussion that follows highlights only a few points about subsidy programs that are particularly important in the context of potential WTO disputes over U.S. farm policy.

As noted, export subsidies are generally banned under WTO rules. An exception was made for pre-existing agricultural export subsidies. Under the Agriculture Agreement, members were required to list their agricultural export subsidies and reduce them over specified time. This was among the most straightforward of obligations in the Agriculture Agreement. There was also a provision to discuss further export credit guarantees and

⁸ This section is derived from material provided in the subsidies and countervailing measures section of the WTO Web site.

issues of food aid as export subsidies, but there was no explicit language exempting these programs from the export subsidy rules.

Provisions concerning domestic support in the Agriculture Agreement are inordinately complex and difficult to interpret. Domestic support is separated into three categories. The first category includes those programs that are at most minimally trade distorting. Domestic support that falls into this category, known informally as the "Green Box," is not subject to reduction commitments. A second category includes those programs that would be generally considered more than minimally trade distorting, but which include specified limits on production so as to mitigate the trade distorting effects. These "Blue Box" programs are also exempt from reduction commitments.

The policies that are considered to be more than minimally trade distorting and for which there are not sufficient production controls are known informally as "Amber Box" programs. The measures associated with these programs are subject to inclusion in an "aggregate measure of support," for which there are reduction commitments and specified buffer limits. However, even for Amber Box programs, an exception is provided for *de minimis* support, which is defined for wealthy WTO member countries as the 5 percent of the value of commodity production for commodity-specific programs, or in the case of the aggregate of programs that apply broadly, 5 percent of the value of all agricultural production. Reduction commitments apply to the remaining Amber Box support. Notice that the reduction commitments and limits on the aggregate measure of support apply only to a subset of agricultural subsidies, and that there are no limits that apply to subsidy for individual commodities. For the United States, the aggregate measure of support that has applied since 2001 totals \$19.1 billion.

The Agriculture Agreement provides ample detail about what constitutes more than minimally distorting support, but within that detail there seem to be unavoidable ambiguities that require further clarification or adjudication. Upon implementation of the WTO agreement in 1994, members were required to list the categories in which they placed their agricultural policies. This self-declaration generally went unchallenged at the time, but these classifications are now under additional scrutiny. In January 2007, Canada and a dozen additional countries challenged the U.S. compliance with its aggregate measure of support commitments. This challenge is based in part on an interpretation of what constitutes Green Box programs from findings of the WTO upland cotton dispute.

Finally, the so-called "peace clause," Article 13 within the WTO 1994 Agriculture Agreement, provided that members would avoid bringing certain kinds of trade disputes over agricultural subsidies until the Agriculture Agreement had been in place for 10 years. One exception to this general period of "peace" was when support for a commodity had increased since the base period 1992. Among other provisions, the peace clause states that agricultural subsidy policies that complied with the agreement on agriculture would be exempt from serious prejudice claims, "provided that such measures do not grant support to a specific commodity in excess of that decided during the 1992 marketing year."⁹ The

⁹ WTO Web site, "WTO Legal Texts: Subsidies and Countervailing Measures." http://www.wto.org/english/docs_e/legal_e/legal_e.htm.

peace clause has now expired, which exposes more commodity programs to subsidy cases brought under the SCM agreement.

U.S. Farm Policies in Relation to WTO Obligations

This section focuses on where specific U.S. commodity programs and other policies might be inconsistent with WTO rules of the SCM Agreement or the Agriculture Agreement. The whole variety of individual programs is not examined here.¹⁰ Rather, the discussion considers some categories of policies to examine their potential inconsistencies with the agreements and focuses on some leading commodities.

Prohibited Subsidies. Potential prohibited subsidies include either export programs that may have been left off the lists provided by the United States under the Agriculture Agreement or export subsidies provided in excess of that allowed under the Agriculture Agreement. As detailed below in the discussion of the upland cotton case, the United States continues to maintain export credit guarantees that may be inconsistent with the rulings of the WTO upland cotton panel. The United States also has special export provisions under certain marketing orders, including those for almonds and raisins. Dairy products may be exported under the Dairy Export Incentive Program, which was listed and reduced in compliance with Agriculture Agreement rules. In addition, the National Milk Producers Federation recently created a producer-financed export subsidy program, under the Cooperatives Working Together umbrella. This program is operated and financed by dairy cooperatives, not by the federal government. However, agricultural cooperatives themselves operate under government provisions, including those derived from the Capper-Volstead Act. The export subsidy provisions of the Agriculture Agreement and the SCM agreement discuss explicitly the potential for "producer-financed" export subsidies to be included as prohibited subsidies if there is significant government participation or support for the program. The cooperative export program will certainly be examined carefully by international legal experts.

Dairy product exports also benefit from price discrimination under state and federal milk marketing orders that lowers the price of exportable and import-competing commodities relative to much less tradable beverage milk products (for more description of these programs, see Balagtas 2007). The U.S. programs listed are not necessarily in violation of WTO export rules, but they are vulnerable to challenge.

Potential prohibited subsidies under local content rules might include the operation of government purchase programs, for example in the operation of price supports. In general, an imported product must be treated no differently from a domestic product once it enters the local market. Hence government purchase programs would be expected to make no distinction between domestically produced agricultural commodities and those that have been imported. For example, if the government undertakes to purchase cheese to support the price of dairy products, imported cheese would be eligible for purchase under the same terms as domestic cheese and government specification could not be arbitrarily set to disadvantage imports. Again, as far as I know, these programs have not been

¹⁰ For description and analysis of major U.S. programs, see Westcott, Young, and Price (2002).

challenged, and there have been no WTO cases to clarify their vulnerability (Sumner 2005b).

Other Subsidies. The principal commodity support programs of the United States qualify as subsidies under the provisions of the WTO SCM agreement. They are operated by the government and transfer income to producers. Hence their potential inconsistency with WTO rules hinges on whether or not these programs cause adverse effects to the interests of other WTO members. Rather than consider all possible adverse effects, this discussion focuses specifically on the issue of serious prejudice.

The United States provides direct payments, countercyclical program payments, and marketing loan benefits for crop program participants (Babcock 2007). The United States also provides dairy producers with Milk Income Loss Contract (MILC) payments whenever prices go below a specified threshold (Balagtas 2007). Crop insurance subsidies and disaster payments (Glauber 2007) and low interest rate loans provide additional benefits all in a more widespread basis. Other programs, including irrigation subsidies, grazing fee subsidies on public land, and credit programs, provide support to a variety of crop and livestock commodities. Subsidies for environmentally friendly practices, such as the Environmental Quality Improvement Program (EQIP) and the Conservation Security Program (CSP), also subsidize production by lowering costs of environmental compliance and sometimes by providing payments that require no additional practices or investments than the farmer would have undertaken anyway (Claasen 2002; Antle 2007; Kuminoff 2007).

These programs all have the potential to stimulate production and, under appropriate market conditions, may contribute to serious prejudice by increasing exports of the subsidized products, reducing exports of competing products of other WTO members, or depressing the market price of the subsidized products. Whether such effects are large enough to be considered "serious" prejudice depends on the specific nature of the programs and the product markets.

The Potential for Serious Prejudice Actions. The model developed in the appendix to Sumner (2005b) shows how subsidy and market data along with several economic parameters determine the magnitude of the production and price effects of U.S. agricultural subsidy programs. Serious prejudice depends on the following key data and parameters. This information is therefore relevant to determining whether a U.S. commodity program is vulnerable to a serious prejudice challenge.

a. The elasticity of supply for the subsidized commodity in the United States. The more that U.S. production responds to the incentives created by subsidy programs, the larger are the market price and quantity effects of those programs and the more likely is serious prejudice. The counterfactual question to consider is: what would the U.S. production have been, but for the subsidy program? Therefore, this parameter measures the response in production to a reduction in expected per unit revenue that is tied directly to the production of the crop, where lower expected price (or subsidy revenue per unit) means lower output. As with any

other supply analysis, the relevant per unit revenue is that anticipated by producers at each of the times at which key production decisions are made.

For trade disputes, one typically considers response to a change in one subsidy program assuming the other programs remain in place. So, for example, if subsidies for corn were challenged, the analysis would consider the effects of the corn programs, holding constant the subsidies for soybeans and other crops. This is clearly different from the supply analysis that applied to a farm bill where supply impacts of changing all the relevant programs are typically considered at the same time (Lin and others 2000).

b. The per unit subsidy amounts expected to be provided under each challenged program. The effect of a subsidy obviously depends on the amount of subsidy. The larger is the total subsidy rate, the larger the price and quantity effects and the more likely is the serious prejudice. Again, it is not the actual ex post subsidy that matters in determining price impacts, but instead the subsidy expected at the time production decisions are made. Actual subsidy rates matter because they provide an indication of expected subsidies.

c. The degree to which each of the challenged support programs provides an incentive to produce relative to the incentive to produce created by market price. The more that support programs provide a production incentive, the larger are the production and price effects and the more likely is the serious prejudice. This parameter allows us to scale the total subsidy amount to put it on the same basis as market price. For example, direct payments—which do not require production of the subject commodity, but are instead tied to the historical base production—provide less production incentive than marketing loans benefits that are paid on all current production. Considerable research has discussed the production incentives created by different program specifications.¹¹ Some programs, such as direct payments, would have a relative incentive parameter of less than 1.0. Other programs, such as marketing loans, which may reduce the risk of loss from producing the subsidized commodity, may have a relative incentive parameter greater than 1.0.

d. The share of production of the United States in the relevant market for the subsidized commodity. The larger is the share of U.S. subsidized production in the relevant market, the bigger are the price and quantity impacts and the more likely is serious prejudice. In some cases, the relevant share may be the U.S. world production share. In other cases, the share of U.S. exports in total consumption in a specific local or regional market may be more relevant.

e. The elasticity of supply of the subject commodity outside the United States in response to the change in the market price induced by the elimination of the subsidy program. The larger is this supply response, the smaller is the market price impact and the smaller is the likelihood of finding significant price suppression. However, the larger is the supply response of the complaining member, the larger are the quantity displacements. There are two influences of the supply response of foreign producers to the market price effect

¹¹ See Sumner (2003, 2005b); Alston (2007); and studies cited there for a summary, but this literature is expanding rapidly.

caused by U.S. subsidies. The first effect is the price transmission between the market price affected directly by a U.S. policy change and the local internal market price faced by foreign farmers. The second effect is the supply response by producers to increases in the internal per unit market revenue that they face. Note that this supply response is related to an increase in production incentives.

f. The elasticity of demand for the subsidized commodity in the United States.

g. The elasticity of demand for the subsidized commodity outside the United States.

h. The share of the U.S. market and other relevant markets in the relevant demand. These three parameters may be discussed together. The larger are the demand elasticities the smaller is the price potential for price effects of the subsidy and the less likely is serious prejudice. The shares are used to weight each demand elasticity to create the overall demand elasticity.

Each of these parameters enters into equations (shown, for example, in the appendix to Sumner 2005b) that determine the likely price and quantity impacts of U.S. subsidies. These parameters were also important to assessing the likely price suppression that contributed to the WTO findings of serious prejudice for cotton that are discussed below.

The Potential for Exceeding AMS Commitments. The Farm Security and Rural Improvement (FSRI) Act of 2002 included a so-called GATT trigger provision that required the Secretary of Agriculture to adjust farm subsidies whenever estimates indicated that support would exceed that allowable under the Uruguay Round agreements. However, no practical way to implement this trigger was included in the law. Moreover, since the United States has not reported its relevant subsidy calculations to the WTO for any year after 2001, this provision of the law remains toothless. In fact, the failure of the United States and other members to report subsidy classifications and calculations points to the general ineffectiveness of the domestic support regime of the Agriculture Agreement. There are no positive incentives to report on a timely basis. Sumner (2005b) and Schnepf and Womack (2006) present evidence that, under interpretations that apply after the upland cotton case, the United States has been out of compliance with its AMS obligations in several recent years.

In January 2007, Canada filed a request for consultations with the United States in a dispute that included the contention that the United States has exceeded its AMS obligations. "...the Government of Canada believes that total U.S. trade-distorting domestic support, specifically, the Total Aggregate Measurement of Support (Total AMS), exceeds the United States' corresponding WTO commitment levels for certain years." Consequently, for these years, Canada's position is that the United States is not in compliance with certain provisions of the WTO Agreement on Agriculture.¹² Canada goes on to note:

¹² Canada, Department of Foreign Affairs and International Trade, News Release No. 2, January 2, 2007. "Canada Requests WTO Consultations on U.S. Agricultural Subsidies."

“The majority of U.S. support programs affecting the production and exportation of agricultural products, including corn, emanate from U.S. Farm Bill programming. Canada believes that many of these Farm Bill programs, which include price-based support programs, are trade-distorting and need reform. The U.S. Congress will soon begin to draft a new Farm Bill, which will be the foundation of U.S. domestic support programs for the next five years. As such, it has the unique opportunity to ensure that the United States is in full compliance with its WTO obligations and can contribute to a more level playing field for international trade in agriculture.”

Canada was joined in its request for consultation by a dozen additional WTO members, including the EU, Australia, and Thailand.

The Upland Cotton Case

A better understanding of the upland cotton case is useful in order to appreciate how future WTO claims against U.S. programs might proceed. Each potential case depends on facts and analysis relevant to that market situation and on the specific WTO provisions. However, as noted, many observers think the cotton case provides guidance about future litigation and indications of how the 2007 Farm Bill can be adjusted to reduce the potential for successful challenges (see, for example, Schnepf and Womack 2006).

The Process. The upland cotton case followed the time schedule laid out above for complex disputes. (An abbreviated time line of the cotton case is presented in appendix A.) The consultations took place in late 2002. After they failed to settle the issues, a panel was formed the spring of 2003. The panel met with the parties three times in the summer and fall of 2003, with exchanges of written briefs and written responses to panel questions extending from June 2003 to February 2004. The panel submitted its report in the spring of 2004, which was released publicly in September 2004. The appeal was heard in December 2004. The final decision by appellate body of the Dispute Settlement Board (DSB) was released in March 2005. The final report of the DSB was similar to the findings of the panel and included instructions for the United States to remove the prohibited subsidies by July 1, 2005 and to bring the subsidies causing serious prejudice in line within a few months after that.

The United States took a few actions in 2005 and eliminated the Step 2 program, which included prohibited subsidies, in July 2006. The United States claimed that its actions were sufficient to comply with the instructions of the DSB. Brazil asked for a panel to review the U.S. compliance. The compliance panel formed in the fall of 2006, met with the parties in February 2007, and is expected to issue its report in May or June 2007, with appeals expected to the rulings of the panel. The appeal process would be complete in fall 2007, with a final report expected by the end of 2007. At that point, either the United States would have to comply with DSB instructions or the United States would be found out of compliance and Brazil would be authorized to take compensation measures.

The Peace Clause. Before considering whether the U.S. programs caused serious prejudice, the panel faced a preliminary legal issue. Under the peace clause of Article 13 of the Agriculture Agreement, Brazil could not pursue its serious prejudice claims unless it first showed that U.S. support for cotton was higher during the period at issue than it had been in 1992. The peace clause was set to expire in 2004, but since Brazil had filed its case while the peace clause was still operative, the case would have been tossed out without a finding in favor of Brazil on this point. One problem was that no clear definition of what constituted support for a commodity is included in the WTO legal text. Given the complexity of U.S. programs and the changes in the form of support under the 1996 Farm Bill, the parties argued for different interpretations.

The panel ruled that U.S. support for cotton during the later years was higher than in 1992, and in so ruling, it gave concrete legal interpretation to the term “support for a specific commodity.” In particular, the panel found that some of the programs that the United States has claimed were decoupled and therefore not commodity support (such as the direct payment program) or were broadly available to many commodities and were therefore not support for a specific commodity (such as the countercyclical program payments and crop insurance subsidies) were part of the overall U.S. support for cotton.

Ironically, the United States could have simply accepted that the peace clause did not apply to the cotton case—in which case the WTO panel would not have needed to rule on an interpretation of the term “support for a specific commodity.” Instead, by forcing the panel to rule, the WTO panel and appellate body are now on record as deciding that the U.S. direct payment program is support for specific commodities and is therefore more than minimally trade-distorting. In particular, the WTO panel pointed to the conflict between the direct payment provision that payment recipients were restricted from planting base land to fruits, vegetables, melons, tree nuts, or wild rice. The Agriculture Agreement states that in order to be considered at most minimally trade distorting, “the amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.” The panel noted that a list of restricted crops had the same effect as a list of acceptable crops and was clearly ruled out by the language excluding from the Green Box payments related to the “type” of production.

This ruling has implications for how WTO members classify their subsidy programs in reporting domestic support totals. Therefore the ruling affects commodities other than cotton. In particular, if direct payments are considered part of the AMS, it seems that the United States has exceeded its AMS limits in the past and may likely exceed its AMS limits in the future.¹³ Furthermore, the WTO panel ruled that some countercyclical program payments were support for cotton. However, this should not be interpreted to mean that these payment must be included in production-specific support rather than the category of support for agriculture in general, which has been excluded from reduction commitments under the 5 percent *de minimis* exemption discussed above.

Prohibited Subsidies and Serious Prejudice. The WTO panel ruled that both parts of the Step 2 user payment program for cotton were prohibited subsidies. The payments to export

¹³See Hart (2005); Schnepf and Womack (2006); Sumner (2005b).

buyers were an export subsidy, while the payments to domestic buyers of U.S. cotton were a prohibited local content subsidy. The Step 2 user program was unique to cotton, but as noted above, the WTO provisions at issue may apply to other commodities. The panel also ruled that export credit guarantees provided for cotton and other commodities such as grains and oilseeds also constituted prohibited export subsidies. The DSB instructed the United States to remove the prohibited programs by July 1, 2005.

Finally, the WTO panel found that those U.S. programs whose benefits varied with the market price of cotton—including the Step 2 user payments, marketing loan program benefits, and countercyclical program payments—suppressed the world price of cotton and caused “serious prejudice” to the interests of Brazil. The panel did not specify a quantitative threshold of price suppression required to qualify as serious prejudice. But for a variety of reasons, it found that the impacts of U.S. cotton were sufficient to exceed that threshold. The data and parameters listed above were among the information used by the panel. The panel noted the costs of cotton production in the United States relative to market price as indication that quantity supplied would fall without the subsidies. It also noted the large market share of the United States and the magnitude of cotton subsidies as a share of total revenue.¹⁴ Based on the rulings of the panel and the appellate body, the DSB instructed the United States to withdraw the programs or remove the significant price suppression that they cause by October 2005.

As the first WTO dispute over domestic farm subsidy programs, the rulings in the upland cotton case have clarified the agreement provisions for current and future negotiations. The rulings also suggest that other subsidy policies of the United States and other WTO members may also be out of compliance, and that additional cases may be brought. Finally, because it was a very high-profile “win” by a developing country over one of the large, rich farm subsidizers, the cotton case is likely to re-energize developing countries in the WTO and sustain their participation in the system. In general, this is a positive development for the United States because the U.S. benefits from enforceable trade rules and the movement toward more open markets for agriculture, as well as for other goods and services.¹⁵

Changes in WTO Rules to Facilitate More Effective Agricultural Compliance

Some important adjustments to WTO rules and procedures would make them more effective. The United States could urge some WTO changes at the same time that the United States adjusts its farm programs to meet WTO compliance concerns. The WTO Agriculture Agreement established capacious limits for domestic support for agricultural

¹⁴ As cited by Schnepf and Womack (2006, p. 40), the panel stated, “we observed that the simulations were prepared by experts and explained to the panel by experts. The outcomes of the simulations are consistent with the general proposition that subsidies bestowed by member governments have the potential to distort production and trade and the elimination of subsidies would tend to reduce ‘artificial’ incentives for production in the subsidized Member. This is one of the underlying rationales for the establishment of the subsidy disciplines in the SCM agreement.” (Quoted from (WTO 2004)]] para. 7.1207.)

¹⁵ For more on the upland cotton case, see Schnepf and Womack (2006); Schnepf (2005); Sumner (2005a, 2005b), as well as the panel report (WTO 2004) and the appellate body report (WTO 2005).

commodities. The overall AMS commitments are based on the high subsidy period of the late 1980s; apply only to the aggregate of support—not to each commodity individually; and allow exclusions of *de minimis* support from the AMS calculations. Furthermore, the domestic support part of the Agriculture Agreement has been implemented with no ex ante notification of how support would be classified and with no incentive for timely notification. Therefore, the AMS commitments have become essentially irrelevant. The most recent AMS notifications by the United States apply to 2001, before the 2002 Farm Bill programs were created. For example, the United States has yet to declare officially how the countercyclical program payments would be classified. The current system provides no incentive for timely notification and every incentive to delay notification until after programs are no longer operative. In this situation it is difficult for WTO members to challenge AMS calculations; other members must do the calculations themselves and argue that the challenged member exceeded their limits. That seems to be the approach that Canada is taking, but that case is in the very early stages.

WTO members concerned with the domestic support programs of other members must naturally turn to provisions outside the Agriculture Agreement. One way to help remedy the failure of the AMS commitment regime is to institute new commitments (or expectations) to report preliminary or approximate AMS results as soon as preliminary data become available and to report final AMS calculations as soon as final data become available. Furthermore, the members must have an effective mechanism for challenging these notifications. In an effective system, members could be expected to report the proposed AMS classification of programs at the time they are initially legislated or implemented. Clearly members cannot report the actual amount of price-contingent domestic support until after all payments for the year have been made, but reporting how they planned to measure and classify support provided by a program would allow other members the opportunity to prepare for the notifications. Furthermore, a mechanism to allow challenges to the initial classification of support programs would allow members using domestic support to know in advance how the other members would regard their programs. Under this plan, members with potential challenges could raise classification issues and have them adjudicated before the offending programs had affected markets.

For either the timely AMS notifications or the ex ante classifications to be effective in curbing violations, the WTO dispute settlement body must have an effective mechanism to indicate policy adjustments required when reclassification indicates that AMS totals are or would be out of line with commitments. Such a procedure must be on an expedited schedule to be effective.

If the United States decides to adjust its programs to comply with its WTO commitments, it could then take a lead role in proposing a reinterpretation of the Agriculture Agreement to provide for early ex ante reporting of AMS classifications and an opportunity to challenge those notifications. Such changes need not await a full renewal of the full Doha WTO negotiations. This plan would allow the United States to review and challenge notification of trading partners for programs that are unlikely to be significant enough in world markets to warrant challenge under subsidy or countervail rules. Reliance on serious prejudice (or material injury, as used in countervail cases) means that small countries or minor producers are practically exempt from sanction, even if their collective

effects on markets may be large. Effective use of AMS rules would begin to redress this imbalance in favor of small countries and would be an advantage to the United States. Furthermore, since many WTO members are concerned with the failure of the United States to comply with WTO rules, a proposal along these lines from the United States may be broadly welcomed.

The Likelihood of Additional Litigation

Regular news reports and reports from trade insiders suggest that many countries have considered bringing cases against U.S. farm programs following the broad outline of the upland cotton serious prejudice case. A number of cases have been discussed dealing with U.S. commodities such as rice, wheat, corn, and sorghum. For example, Uruguay has discussed a case concerning long grain rice in the Latin American market, and Mexico has discussed a sorghum case.

In 2005 after the cotton ruling was announced, Canadian corn producers asked the Government of Canada to bring a WTO serious prejudice case on U.S. corn subsidies. Given hesitation by the Canadian government to pursue such a case, in 2005 and early 2006, the corn growers instead brought a countervail case under Canadian trade remedy law. The Canadian government found that U.S. corn was indeed subsidized and sold in Canada at less than fair market value. However, the Canadian International Trade Tribunal ruled that recent increases in corn imports to Canada had been caused by exchange rate movements, not by changes in subsidy rates. Of course, a serious prejudice case would not hinge on explanations of current movements in trade flows, and the Canadian International Trade Tribunal did not rule on whether U.S. subsidized corn had depressed the price of corn in Canada, which would likely be a key issue in a serious prejudice case.

When Canada finally requested consultations in anticipation of proceeding against the U.S. corn subsidy programs in 2007, the serious prejudice issues raised paralleled those brought in the cotton case. Canada focuses on data from corn marketing year 2005, which ended on July 31, 2006. The 2006 marketing year would provide much less opportunity to win a case because the ethanol demand boom has caused corn prices to rise so much that few if any price contingent subsidies are expected for the 2006 marketing year.

Sumner (2005b) documents potentially significant price suppression caused by U.S. programs for wheat, corn, and rice. Based on price and subsidy conditions in marketing year 2005 and on a set of example supply and demand elasticities and other parameters, that analysis shows that the U.S. corn program suppressed world prices by approximately 10 percent. The world price impacts for the U.S. wheat program were about 7 percent and world price impacts for the U.S. rice program were about 5 percent. These numbers are illustrative and clearly depend on the underlying market conditions and parameters. The impacts are larger for corn because, in the base year considered, corn subsidies were large and the United States supplies 40 percent of world corn production. Although rice subsidies are also often high, the U.S. market share for rice is much smaller than that for corn or wheat. As a result, the impacts of subsidies are likely to be smaller, except in specific markets where the U.S. share may be particularly large.

The results presented in Sumner (2005b) are illustrative of impacts using the data and parameters applicable for a recent base year, treating that year as typical. Those estimates may not be representative of impacts of other market price conditions. For example, if the price of corn were to remain so high that marketing loan benefits and countercyclical payments for corn remain negligible, then prospects for a successful serious prejudice case against U.S. corn subsidies would be small. Sumner (2005b) explained that given the subsidies and market conditions for soybeans from 2002 through 2006, the impact of the soybean programs on world soybean prices were relatively small. Under those conditions it would be difficult to claim that the U.S. soybean programs were suppressing world prices significantly.

World market prices for program crops other than cotton are projected to remain very high for the next several years (USDA 2007; FAPRI 2007). Under those projections, the effects of current farm programs on market conditions would be low and vulnerability to successful serious prejudice claims would be low as well. The structure of the programs themselves does not lead to serious prejudice; the market facts must be considered as well. Of course, that same point applies to the impacts of the programs on program budget costs, allocative inefficiencies, and distributional effects that apply in a domestic evaluation of the programs. That is, with high market prices, price-contingent subsidies have little effect.

But farm prices have a history of being quite variable, and many high price periods in the past have been short-lived (the late 1970s and the mid-1990s come to mind). The reason to adjust the farm programs in light of potential WTO challenges despite high projected prices is to assure that cases are not filed as soon as prices fall back to normal. Just as farm subsidy advocates argue for keeping the programs in place—just in case prices decline, from the view of avoiding WTO challenges, it makes sense to modify programs now for the same reason.

Implications of WTO Rules for Change in U.S. Farm Policy

Litigation over U.S. farm subsidy programs remains probable and this potential is appropriately playing a significant role in discussions about the design of the 2007 Farm Bill. The United States has been a leader in the global trade community since the first GATT agreement in 1947. United States was the key driver to bringing agriculture under the full WTO umbrella in 1994 and led the strengthening of the dispute resolution process with the formation of the WTO. These developments now mean that agricultural policies are subject to the same compliance constraints that apply to government policies that affect international trade in other parts of the economy. On balance, these developments promise net economic benefits for the United States and U.S. agriculture.

Some farm policy leaders have discounted the prospects for or importance of WTO challenges to U.S. farm programs.¹⁶ They suggest that compliance with WTO agreements

¹⁶ As recently reported, "...during an October 30th campaign stop in North Platte, Nebraska, incoming House Ag Committee Chairman Collin Peterson stressed that the next farm bill will look a lot like the current version. He said, at worst, potential WTO legal challenges would just keep USDA lawyers in business. 'If they want to sue us like they did on cotton,' Peterson said, 'We've got a lot of lawyers, and we can probably

is unimportant or that programs can be adjusted ex post if they are found out of compliance. The Secretary of Agriculture, among others, has argued that this is the wrong approach and it is in the interest of the United States to use the 2007 Farm Bill to bring U.S. program into line before there are further disputes.¹⁷ There are several issues to consider and several reasons for using the 2007 Farm Bill to make the needed adjustments to assure compliance.

The WTO Agreement on Subsidies and Countervailing Measures is designed explicitly to deal with government support that has significant impacts in specific markets of importance to other WTO members. These are the sorts of issues that the aggregate limits in the agreement on agriculture are unlikely to address.

If the 2007 Farm Bill maintains or enhances the subsidy elements of the current programs, international competitors are likely to bring WTO dispute settlement cases against U.S. farm programs in the future. As noted, one response is to ignore the likelihood of litigation and to deal with WTO cases on an ad hoc basis as they arise. It is possible, of course, that few cases will be filed and that the United States may prevail in some of those that are filed. The main domestic difficulty of this response is that it leaves commodity producers with considerable uncertainty about whether the farm programs will remain in force. Furthermore, when programs are challenged in the WTO, the remedies imposed may be less palatable than the initial policies that would have been adopted to avoid litigation.

Failure to comply with WTO rules also damages the reputation of the United States as a leader in international trade. The United States has been a major beneficiary from the rules-based system of trade under the GATT and the WTO in part because the United States has been a leader in developing the agreements. If the United States is seen to ignore its international obligations, its leadership role will likely be forfeited. Furthermore, the process of defending itself in trade litigation damages the reputation of the United States, in ways that are similar to how defending against lawsuits from customers damages the reputation of marketing firms. Most firms decide it makes more sense to protect the reputation of the firm by avoiding law suits from customers, even if they are able to prevail in much of the litigation.

In WTO and bilateral free trade negotiations, the position of the United States is stronger if the United States has a reputation of complying with the existing agreements. Conversely, if trade partners perceive that the United States does not comply with its WTO domestic support obligations, other members have little incentive to reduce and bind their import barriers, for which compliance is almost automatic. In fact, the main trade-off in current WTO agricultural negotiations is the exchange of binding reductions in domestic subsidies applied by the United States for additional binding market opening in other countries. But, if countries do not expect the United States to comply with its domestic support obligations, there is simply no reason for them to reduce their border barriers as a part of such a bargain. This is a major concern for producers of commodities that do not

keep them out of mischief working on that stuff.” Quoted in Peter Shinn, “WTO Challenges to Farm Bill Don’t Worry Peterson,” *Brownfield Ag Network*, Nov. 15, 2006.

¹⁷. USDA, “2007 Farm Bill Theme Paper: Risk Management” (May).
<http://www.usda.gov/documents/Farmbill07riskmgmtrev.doc>.

now receive benefits of commodity programs and have had their market access improvements blocked by the U.S. insistence to protect its subsidy programs rather than push harder to open markets.

Finally, for the United States to remain out of compliance with its WTO obligations damages the organization itself. Evidence is clear that the WTO has improved economic growth around the world and in the United States. The WTO has also provided a mechanism to involve nations such as China, and now Russia, more thoroughly within the global economic system. The international economic and political interests of the United States are for the maintenance of a strong World Trade Organization.

Concluding Remarks

The United States should consider unilaterally eliminating or altering its agriculture subsidy programs to preclude future WTO challenges and secure the benefits of freer trade for its farmers. The 2007 Farm Bill can be the vehicle to achieve all these ends.

Given high projected commodity prices, 2007 is an ideal year to deal with long-term inconsistencies of U.S. farm programs with WTO agreements. Eliminating the marketing loan and countercyclical programs for grains, oilseeds, and cotton, the price support for sugar, and the price support and MILC program for dairy would remove the largest impediments to meeting WTO obligations. These programs stimulate production and affect markets—arguably in violation of the WTO. Short of program elimination, reducing loan rates and target prices enough that these programs are unlikely to affect production significantly would reduce the likelihood of successful challenge against these programs. But, the underlying rationale of these programs, to offset low market prices for producers, is fundamentally at odds with the principles that the United States has urged on the WTO.

The direct payment programs for grains, oilseeds, and cotton may also cause WTO problems. Like the countercyclical programs, these programs allow considerable planting flexibility and do not tie payments to commodity prices. However, they do restrict what can be grown on program land and provide additional incentives to maintain area and enhance yields. Thus these programs, too, are not immune from WTO challenge. A simple way to meet the current WTO ruling is to remove the planting restrictions for payment base land. However, that would not respond to the other production incentives imbedded within the direct payment program. Here again, eliminating the program is the simplest way to assure compliance with the letter and spirit of WTO obligations. That would also remove the objections raised by traditional growers of the “restricted crops” that they would face unfair competition and lower market prices if growers receiving direct payment and countercyclical payments were allowed to plant their crops on payment-eligible land.

In contrast, payments to farmers for environmental objectives may pose fewer WTO concerns if they are developed carefully. The general rule is that such programs face WTO limits only if they stimulate production. So for example, programs that pay farmers on a per acre basis for production of a specific crop so long as they meet minimal environmental standards would stimulate production of the crop. Such programs are not prohibited by the WTO, but they would contribute to distorting international markets and

to the aggregate measure of support. The WTO rules for considering environmental programs as only minimally trade distorting allow for support that pays for environmental benefits supplied by the farm without overcompensating the grower.

Compliance with WTO obligations constrains U.S. farm subsidies, but these obligations are consistent with the interest of the United States for an agricultural sector that responds more to market signals than to government subsidy. Using the 2007 Farm Bill to move vigorously in this direction would avoid international conflict and provide strategic trade policy gains for the United States and U.S. agriculture.

Appendix 1. Time Line of the WTO Dispute over U.S. Upland Cotton Subsidies

Year	Month	Activity
2002	Sept.	Brazil requests consultations with the United States regarding U.S. upland cotton subsidies.
2003	Feb.	Brazil requests the establishment of a panel. At U.S. request, the Dispute Settlement Board (DSB) defers the establishment of a panel.
	July– Dec.	Panel meets three times in Geneva with parties to review each aspect of the case.
2004	May	Panel completes its report and submits to the parties.
	Sept.	The panel report is circulated to the members of the WTO.
	Oct.	The United States notifies its intention to appeal certain issues of law and legal interpretations developed by the panel.
	Dec.	The Appellate Body (AB) meets with the parties.

**Appendix 1. Timeline of the WTO Dispute over U.S. Upland Cotton Subsidies
(continued)**

Year	Month	Activity
2005	March	The AB report is circulated to WTO members. The DSB adopts the AB report and the panel report, as modified by the AB.
	July	The reasonable period of time to comply expires with respect to the prohibited subsidies. Brazil asks the DSB for authorization to take countermeasures. The United States issues its objection to Brazil's request. The DSB refers the matter to arbitration.
	Sept.	The reasonable period of time with regard to actionable subsidies expires.
	Oct.	Brazil requests the DSB for authorization to take countermeasures. The United States submits its objections to Brazil's request. The DSB refers the matter raised by the United States to arbitration.
2006	Aug.	Brazil requests the establishment of a compliance panel to examine whether the United States has complied with the earlier rulings.
	Oct.	Compliance panel formed with one original member and two new members; original time schedule delayed.
2007	Feb.	Compliance panel meets with the parties and third parties for oral presentations and questions.
	~May	Report expected from the compliance panel.
	Summer 2007	Appeals expected to compliance panel decision.
	Fall 2007	Appellate body meeting expected and final ruling on compliance.

Source: WTO Summary of the Cotton Dispute.
http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds267_e.htm.

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