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'Brazil Cotton' Makes Trade Retaliation Operational

Law360, New York (November 10, 2009) -- In an arbitration panel decision handed down on Aug. 31, 2009, the World Trade Organization clarified how and to what extent the industries of a WTO-member government may be targeted for countermeasures when the government has provided WTO-illegal subsidies.

Brazil had been seeking $2.68 billion in countermeasures, threatening to "cross-retaliate" by targeting U.S. intellectual property rights and service businesses. However, the panel awarded only $294.7 million for fiscal year 2006.

The decision has interesting policy implications, particularly in relation to the pending WTO dispute settlement proceeding between Airbus and Boeing.

For the first time, an arbitration panel has agreed that WTO countermeasures for subsidies can and should take into account lost sales and other subsidy effects — a critical factor in markets where a small illegal subsidy can tip the balance for a multimillion dollar sale.

On the other hand, the panel found that there can be no countermeasures when a subsidy has been revoked, even if revocation took place well after the WTO deadline for action.

By clarifying the rules for cross-retaliation, the panel has made cross-retaliation more feasible — but important limits remain on cross-retaliation against services or intellectual property, as explained below.

Background

Brazil launched a WTO challenge against the United States on Sept. 27, 2002, under the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement) regarding U.S. export credit guarantees, marketing payments, marketing loans, counter-cyclical payments and other subsidies benefiting the U.S. cotton industry.

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On March 21, 2005, the WTO adopted panel and Appellate Body reports that found some of the subsidies at issue violated SCM provisions: Specifically, export credit guarantee programs and aspects of the so-called Step 2 cotton payments program were found to be export subsidies.

Under SCM Article 4.7, the United States was obligated to withdraw these measures "without delay" — interpreted in this instance as July 1, 2005 — or face countermeasures against its exports.

Also, various price-based payments to cotton producers, such as counter-cyclical payments, marketing loans, marketing payments and market loss assistance were found to cause "serious prejudice" to Brazil under SCM Article 5(c), and thus the United States was obligated to "take appropriate steps to remove the adverse effects or ... withdraw the subsidy" or face countermeasures against its exports. The deadline for such actions was six months from the date of adoption.

The United States did not repeal the Step 2 program until Aug. 1, 2006. The United States did amend one of the export credit guarantee programs, and it ended payments under the others; however, it continued its marketing loans and counter-cyclical payments to cotton producers with no substantive change. Brazil then requested the establishment of a WTO panel on Aug. 18, 2006, regarding the U.S. failure to comply.

The Appellate Body eventually confirmed that the remaining export credit guarantee program was still a prohibited subsidy and that the changes to the other programs had not removed the adverse effects.

The June 20, 2008, adoption of the decisions in the compliance proceeding set the stage for Brazil to move to the next stage — settling the size of the countermeasures that it would be authorized to take against U.S. trade.

The SCM Agreement allows the WTO to authorize countermeasures against a failure to comply with obligations regarding subsidies. This possibility of trade retaliation underscores the binding nature of SCM obligations. The prevailing party must announce the amount and target of its proposed countermeasures. The noncomplying party can then appeal to an arbitrator.

In this case, Brazil sought authorization for countermeasures against $1.037 billion in trade for the "serious prejudice" subsidies, plus $350 million for U.S. failure to repeal the Step 2 program on time, plus $1.294 billion for the export credit guarantee program.

The United States disputed the amount and argued that Brazil's proposal to retaliate against U.S. services and intellectual property rights was impermissible. The arbitration panel issued two separate reports for the "serious prejudice" subsidies and for the export subsidies.

Countermeasures Amount: Delayed Compliance

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The arbitration panel considered Brazil's request for countermeasures equal to payments under the Step 2 program for the 13 months between the compliance deadline and the date the program was actually repealed. The panel in the compliance proceeding had refused to rule on the legality of this program, deeming it moot.

The arbitration panel ruled that the purpose of countermeasures is to induce compliance and that because the United States had complied, and there was no "multilateral determination" of violation for the 13 months, no countermeasures could be authorized for this program.

On the other hand, the arbitration panel rejected a U.S. argument that there could be no countermeasures for the "serious prejudice" subsidies (marketing loans and counter-cyclical payments) because the 2002 Farm Bill had expired.

For these programs, the compliance panel had made a determination that the United States had failed to comply, and the arbitration panel had to accept that ruling. Moreover, the arbitration panel noted, the facts indicated that these subsidy programs were simply continuing under a new legal basis.

Countermeasures Amount: Subsidies Causing 'Serious Prejudice'

The Brazil Cotton case was the first to apply the SCM Agreement's rules disciplining subsidies that cause "serious prejudice" through "adverse effects" on another WTO member, and the first to determine the appropriate level of countermeasures for such subsidies.

Brazil presented a counterfactual econometric simulation of the global impact of eliminating marketing loans and counter-cyclical payments, including income losses on actual cotton production plus the value of cotton production foregone due to suppressed world prices.

The arbitration panel found that it could only consider the effects on Brazil. The panel also adjusted some of the parameters in Brazil's model, reran it to produce a revised amount, applied Brazil's global share of cotton production in marketing year 2005 (5.1 percent), and came up with a figure of $147.8 million.

Countermeasures Amount: Lost Sales

In asking for $1.294 billion in countermeasures for the export credit guarantee program, Brazil focused on both the amount of the interest rate subsidy (interest-rate discounts secured by creditworthy and noncreditworthy buyers), and the export sales gained by U.S. sellers as a result of these discounts.

In a departure from earlier cases, the arbitration panel agreed that countermeasures should take into consideration the effect of the subsidy.

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It calculated the trade-distorting impact on Brazilian producers and exporters of the interest rate subsidy, and export credit guarantees issued to creditworthy and noncreditworthy buyers, including both the impact on Brazil's domestic market and the impact on Brazilian sales in world markets (using Brazil's 11.7 percent share of world trade in GSM-102 products). This total came to $147 million for FY 2006.

The panel's shift from the subsidy's amount to its effect is particularly relevant in the aircraft and other capital goods markets.

If two competitors offer export financing at the floor rates authorized by Organisation for Economic Co-operation and Development (OECD) and WTO rules, and then one of the competitors' rates dips below by a small amount, that competitor can capture a contract worth millions with a small illegal subsidy. The panel has recognized that there are situations when countermeasures equal to the amount of the subsidy may not be enough.

The panel also limited Brazil to countermeasures for damage to its own trade. This will substantially reduce the incentive for a country to litigate alone, but it avoids the result, criticized in the WTO's Foreign Sales Corporation case, that one member takes countermeasures for all.

'Cross-Retaliation'

The WTO Agreement includes agreements on trade in goods (e.g., the SCM Agreement), the General Agreement on Trade in Services (the GATS Agreement), and the Agreement on Trade-Related Aspects of Trade in Goods (the TRIPS Agreement).

Under the WTO dispute settlement rules, a violation of one of these agreement areas can only trigger suspension of concessions or obligations in the same area, unless such suspension is not practicable or effective — in which case, "cross-retaliation" (trade retaliation in one of the other areas) is permissible. The arbitration panel in Brazil Cotton found that these rules also apply to the special SCM Agreement subsidies enforcement procedures.

In the Brazil Cotton case, Brazil argued that it would not be practicable or effective for it to take countermeasures against imports of capital goods, intermediate goods, inputs or some specific consumer goods, because switching suppliers for these goods would be difficult or costly.

Brazil argued it had a low capacity to retaliate against imports of U.S.-origin goods, and therefore would have to be authorized to also cross-retaliate against U.S. exports in the services and intellectual property rights (such as pharmaceuticals or software) sectors.

The panel agreed that retaliation in a sector would not be "practicable" if it is not available for application in practice and suited for being used in this case; and that it would not be "effective" if such retaliation would cause more harm to the retaliating

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party than to the target. It also agreed to consider the revised $294.8 million total amount in assessing whether this countermeasure would be practicable and effective.

The arbitration panel examined the factual situation of Brazilian imports of goods from the United States. It agreed with Brazil's argument that it was not practicable or effective for Brazil to seek countermeasures against imports of capital goods (including computers), intermediate goods, inputs, books or the automotive sector.

The panel also found that the cost to Brazil of countermeasures would not be excessive for a product if alternative sources were available — that is, if the U.S. share of imports of a tariff line was less than 20 percent.

(The 20 percent criterion makes it more possible for countries with diversified import sources to cross-retaliate; on the other hand, it makes it more difficult to cross-retaliate against large countries or groupings like the EU, which have larger import shares.)

The panel rejected Brazil's argument that nongoods targets should be generally permitted simply because such countermeasures would be more persuasive.

Adding it all up, the panel determined that Brazil had a countermeasure capacity of $409.7 million in trade in goods in 2007. Because the $294.8 million in total countermeasures is well under that level, Brazil must limit its countermeasures to trade in goods for now.

On an ongoing basis, Brazil must update the total level of countermeasures that it would be entitled to each year and adjust the threshold for the change in its imports from the United States. If the countermeasure amount exceeds the updated threshold, Brazil can cross-retaliate.

In a March 31 press release, Brazil issued its own estimates that the adjusted threshold will be around $460 million in 2009, and that total authorized countermeasures could reach $800 million for 2009. Use of GSM-102 export financing increased greatly during the financial crisis.

Limits to Cross-Retaliation

The arbitration panel added an important reminder regarding how difficult it can be to retaliate against intellectual property rights — referencing a discussion of TRIPS retaliation in an earlier WTO dispute involving Ecuador.

The difficulty flows from the selectiveness of WTO-authorized retaliation, and from the nature of rights under the TRIPS Agreement, which requires a WTO-member country such as Brazil to provide a minimum level of IP rights to nationals (natural or legal persons) of other members such as the United States.

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If, for example, the holder of a patent is a company organized in the Netherlands Antilles, the right-holder benefits from the TRIPS obligations owed to the Netherlands even if the right holder is owned or controlled by a U.S. company.

Authorized retaliation cannot impair the rights of WTO members that did not violate the WTO rules. Even if the WTO authorizes Brazil to suspend TRIPS obligations for U.S. nationals, this decision would not give Brazil the right to suspend its TRIPS obligations for nationals of other WTO members.

If a product embodying intellectual property (such as a sound recording or a piece of software) involves IP rights of non-U.S. right holders, Brazil is still obligated under the TRIPS Agreement to provide protection to the non-U.S. right holders' rights.

WTO actions also cannot change Brazil's obligations under other treaties, including World Intellectual Property Organization (WIPO) intellectual property treaties.

Moreover, intellectual property rights are territorial in nature. Therefore, even if the WTO authorizes Brazil to deny TRIPS rights benefiting an IP right holder in Brazil, this denial is only valid in Brazilian territory, and the right holder retains the ability to enforce its rights in other WTO members' territories.

And other members remain obligated under TRIPS to provide border enforcement against infringing goods, including those produced in Brazil.

Conclusion

The arbitration panel in the Brazil Cotton case significantly clarified the types and amount of countermeasures that a WTO member may take in response to another member not eliminating WTO-inconsistent subsidies.

Most notable are the panel's decision that countermeasures can be based on the effect of a subsidy, rather than its amount, and its analysis of when cross-retaliation is allowed.

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