

WTO Consistency of U.S. and New Zealand Agricultural Practices

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Grey, Clark, Shih and Associates, Limited have prepared a Report on the WTO consistency of U.S. and New Zealand agricultural programs and practices. In conducting this review, Grey, Clark, Shih and Associates, Limited determined that both the United States and New Zealand have failed to notify recent information related to all aspects of their agricultural production and their agricultural support programs. Therefore, the review was conducted on the basis of the best and most current information available. On the basis of this information, this Report concludes that both the United States and New Zealand have introduced and maintain programs which are not consistent with their WTO obligations or which exceed their bound subsidy reduction commitments.

With respect to the United States, this review concludes and demonstrates that the United States:-

- fails to notify all of its domestic support programs;
- provides domestic support to its agricultural producers in excess of its bound WTO commitment levels; and
- provides export subsidies to support the export sale of its agricultural products in excess of its bound WTO commitment levels.

With respect to New Zealand, this review concludes that demonstrates that:-

- New Zealand provides export subsidies to support its shipments of dairy products.

The analysis and findings in this Report demonstrate that the United States and New Zealand have violated their WTO obligations with the result that their agricultural products, and exports, have an unfair competitive advantage in the world market.

The specific programs and practices which could be the focus of the requested dispute settlement challenge are addressed, in detail, in the four Annexes of this Report. The first Annex reviews U.S. Domestic Support Programs, including U.S. irrigation programs. The Second Annex reviews U.S. Export Subsidy Programs. The Third Annex reviews export subsidies provided by New Zealand to support the export sale of dairy products. The Fourth Annex reviews Article 9.1(c) export subsidies provided by the United States and New Zealand to support the export sale of a range of agricultural products. Each of these Annexes is a stand-alone review and analysis of the programs covered in the particular Annex. Each Annex reviews these programs in light of WTO obligations and concludes that the U.S. and New Zealand have violated those obligations. A brief description of each Annex follows at the end of this Executive Summary.

Annex A Domestic Support Programs

The United States provides substantial domestic subsidies to support its agricultural production. The U.S. Aggregate Measure of Support (AMS) commitment enables the United States to provide up to, but not more than, USD \$19.1 billion per year consistent with its international obligations. However, this report concludes that, in fact, the United States provides support that greatly exceeds its WTO limits.

The United States violates its WTO AMS commitments in two manners. First, the U.S. provides support which it claims is not subject to reduction commitments on the basis that the support is properly classified as “green box” support or that the level of support is protected by the *de minimis* exceptions. “Green box” support covers support that does not support prices or distort trade. *De minimis* support includes both product-specific support, where the

support is less than 5% of the value specific basic agricultural product (eg., if the support provided to product X does not exceed 5% of the total value of production of product X for the year that the support is provided, the support is considered *de minimis* and is not counted in total AMS). Non-product-specific support, which is less than 5% of the total value of agricultural production. These exemptions from domestic support reduction commitments are set out in Article 6 and Annex 2 to the *Agreement on Agriculture*.

Despite U.S. claims that these types of support are properly excluded from its AMS, it is far from clear that these U.S. programs are properly entitled to be excluded. Rather, the facts establish that the USA provides massive trade and price-distorting support that cannot justifiably be excluded from its AMS. Further, the generous support provided by the United States appears to surpass the *de minimis* threshold. Consequently, in both cases, it is concluded that the USA has improperly characterized its support as being either “green” or being protected by the *de minimis* rules. Therefore, this support must be counted within the U.S. AMS. Failure to include this support, and to notify this support to the WTO, is a clear breach of U.S. WTO obligations.

The most recent U.S. notification to the WTO covers domestic support provided in 1999. This notification was made to the WTO in February 2003. In this notification, the United States reported total domestic subsidies in the order of USD \$16.1 billion. The “green box” and *de minimis* support not accounted for by the United States would certainly push total U.S. domestic support over the USD \$19.1 billion limit. E.U. Agriculture Commissioner Franz Fischler, commenting on the *de minimis* loophole, noted that the U.S. relied on the *de minimis* exception in 1998 to avoid reporting approximately \$8 billion in domestic support. The addition of this support alone would result in domestic support provided in excess of the USD \$19.1 billion AMS ceiling by more than 25 per cent. This is a clear breach of a reasonable *de minimis* or negligibility concept.

Second, the USA has failed to include specific, and substantial, domestic support programs in its AMS by not including the massive benefits of its irrigation programs. While the USA has notified monies expended to build the infrastructure required for its irrigation programs to the

WTO as non-product-specific support, the USA has failed to notify support in the form of water for irrigation provided to agricultural producers at below market rates. The benefits provided to USA producers through the approximately 130 irrigation projects are massive.

The irrigation projects are primarily located in eleven Western States. The projects were introduced as a means of enabling and promoting agricultural production in the western desert regions. Agricultural producers in these regions are heavily dependent on government financed and supported irrigation schemes. Without these irrigation projects, agricultural production would either not exist in these regions or would be severely curtailed.

The value of the subsidy provided through water for irrigation is determined on the basis of benchmarks that compare the water rates charged by U.S. irrigation authorities (which are government entities) for agricultural use to the water rates charged by U.S. irrigation authorities for non-agricultural use. These comparisons demonstrate that the same irrigation authority charges agricultural users significantly less than non-agricultural users for the same water. The difference between these two rates, which provides a clear benefit to agricultural users, is a subsidy to the agricultural producer provided by the government entity.

Considering the total volume of water provided by irrigation authorities to agricultural producers at below their own non-agricultural use rates, it is clear that the total unreported subsidy provided by the United States to support agricultural production is massive and, when added to the substantial domestic support already provided under the U.S. Farm Bill Programs, clearly pushes U.S. domestic support well beyond the limits in its AMS.

The irrigation subsidies, provided in the form of low-cost water, cannot be excluded from the U.S. AMS. Without the water provided through the irrigation infrastructure, agricultural production in the eleven western states would be severely restricted. Consequently, the provision of subsidized water is trade-distorting because, without this subsidy, there would be little or no production and certainly far less production than currently exists. As a trade-distorting subsidy, the U.S. is required to notify the value of the subsidy and to include the subsidy in its AMS. The U.S. has failed to meet this clear WTO obligation.

Although the value of the subsidy provided to agricultural producers in the form of water sold at below market rates has not been notified to the WTO by the USA, this Report reviews water rates charged by irrigation districts in California. Based on the value of the below-market water provided to agricultural producers relative to the costs charged to non-agricultural users, the value of the irrigation subsidy provided to U.S. producers through the 130 projects is well in excess of USD \$10 billion per year and may well be in the range of USD \$25 to \$30 billion per year.

In considering the domestic support provided to agricultural producers through the provision of water for irrigation at below market rates, we recognize that only water drawn from its natural state will be subject to the rules and obligations in the trade agreements. Water in its natural state is neither a good nor a service and is not subject to trade obligations.

Furthermore, Government cannot be compelled, by trade obligations, to allow water to be drawn from its natural state. The extraction of natural resources is the step that must be taken to convert the natural resource into a good or service for purposes of the WTO. Government cannot be compelled to take this step. However, once government voluntarily allows natural resources to be extracted for commercial purposes, the resulting goods or services will enter the flow of commerce and be subject to trade disciplines. In the present case, the water at issue is a good or service for purposes of the WTO because the United States Government voluntarily decided to allow this water to be drawn from its natural state for use to support agricultural production. This decision, and the subsequent act of drawing the water from its natural state for irrigation or other commercial purpose, converted that water into a good or service for purposes of the WTO.

The USA has failed properly to account for and report its domestic support. The USA has improperly sought to exclude programs from its AMS on the basis that they are “green” or that they are *de minimis*. The USA has also failed fully to account for its domestic support programs, as evidenced by its failure to notify its continuing financial support to producers through water for irrigation provided at below-market rates. The value of these support programs must be taken into consideration in determining the U.S. AMS. Once this support

is properly included in the AMS calculation, it becomes clear that the USA is in serious breach of its WTO obligations by providing domestic support in excess of its AMS bindings.

Annex B USA Export Subsidy Programs

The U.S. provides generous export subsidies to support the shipment of U.S. agricultural products. The U.S. is permitted to provide support up to the volume and value bindings set out in its Schedule to the *Agreement on Agriculture*. However, this Report establishes that the U.S. has, and continues, to provide support in excess of those limits.

The USA maintains five distinct types of export subsidies;

1. Programs, including the Export Enhancement Program and the Dairy Export Incentive Program, which the United States admits are export subsidy programs subject to its WTO commitments. The USA has provided subsidies under these programs that are virtually at the limit of its WTO commitments.
2. Export credit guarantee programs and market promotion programs that support USA agricultural exports. The USA does not admit that these programs provide export subsidies and has not reported the value of these benefits against its WTO commitment levels.
3. California's dairy pricing system that confers an export subsidy on specific dairy products sold into the international market.
4. *De facto* export subsidies which take the form of domestic subsidies provided to support production of agricultural commodities that are historically produced well in excess of U.S. needs and are intended for sale in substantial volumes on the international market. For example,

the majority of U.S. domestic support is provided to commodities, such as soybeans, that are primarily produced for export either as soybeans or as further processed products. The domestic support provided to this historically export-oriented product is clearly intended to support the sale of these products in the international market and has been recognized as such by the U.S. International Trade Commission. The clear result is that these subsidies, that are structured as domestic subsidies, are provided to support the production and sale of these products for export. Similar situations exist with respect to grains such as corn and wheat. These subsidies must be considered *de facto* export subsidies.

5. Article 9.1(c) export subsidies made in the form of payments by third parties on the export of agricultural products that are financed by virtue of governmental action. Through its generous domestic support programs, the U.S. allows third parties to sell commodities on the export market at prices that are well below total average industry cost of production. This Report has reviewed corn, wheat, barley, sorghum, soybeans and oats. The total export subsidy provided through these third party payments is calculated by taking the difference between export price and total average industry cost of production and multiplying that amount by total exports. Based on this calculation, through Article 9.1(c) export subsidies made in 2001, the U.S. has exceeded its WTO export subsidy commitments for these products by approximately USD \$3.82 billion.

Although the U.S. has only admitted that its Export Enhancement Program and its Dairy Export Incentive Program are export subsidy programs, the support provided through the other export subsidy programs listed above must also be counted against the volume and value limits in the USA Schedule. The total value of U.S. export subsidy commitments is currently set at USD \$520.1 million.

The Article 9.1(c) export subsidies set out above, which relate to some agricultural commodities, alone clearly exceed total U.S. export subsidy commitments by a substantial amount. When all of these export subsidy programs are properly considered and counted against the USA Schedule, it is clear that the USA has provided substantial export subsidies that exceed its WTO commitments by approximately USD \$13 billion.

Annex C New Zealand Export Subsidy Programs

New Zealand, through the *Dairy Industry Restructuring Act 1999* has reorganized its dairy industry by merging the New Zealand Dairy Board, the New Zealand Dairy Group and Kiwi Co-operative Dairies to form Fonterra Cooperative Group Limited (Fonterra) to replace the New Zealand Dairy Board. Through Fonterra, New Zealand provides export subsidies to support the sale of New Zealand dairy products.

Fonterra was established to be a *de facto* state trading enterprise and single desk exporter of New Zealand dairy products. Fonterra was established as a *de facto* export monopoly because it was an export-oriented company and was intended to continue as an export-oriented company. To ensure that Fonterra would have the greatest ability to sell onto the export market, the New Zealand Government granted it exclusive access to (restricted) higher value markets for dairy products through export licenses issued to it by the New Zealand Government.

To ensure that Fonterra could be established, the merger exempted from the requirement for Commerce Commission review which would have considered the competition aspects of the merger and which would have almost certainly rejected the proposal. Fonterra's constitution requires that all dairy producers supplying Fonterra must be shareholders in the corporation and must supply all of their production to Fonterra for sale. As a result, Fonterra has effectively captured virtually all New Zealand dairy production. This action has been supported and condoned by the New Zealand Government.

To ensure that Fonterra continues to benefit from as many advantages as possible, the New Zealand Government continues to assist Fonterra, including taking positive steps to initiate a dialogue between Fonterra and the Australian dairy industry.

The combination of controlling virtually all New Zealand dairy production and holding the exclusive right to access high value markets and continued support from the New Zealand Government has allowed Fonterra to cross subsidize exports of dairy products. Using the revenues generated in the high value markets, Fonterra can sell into other more competitive export markets at lower prices. The lower prices offered by Fonterra are made possible by profits that it realizes from its sales into the more remunerative protected markets. As a result, the lower prices that it offers into the other markets are made possible through export subsidies.

Fonterra provides an export subsidy to support the sale of its dairy products onto the low-value markets on the following basis,

- i) the sale of milk at below market rates constitutes a “financial contribution” for purposes of SCM Article 1.1(a)(1)(iii);
- ii) as a state trading enterprise, Fonterra is a government body so that the financial contribution is made by government for purposes of SCM Article 1.1(a)(1);
- iii) as the purchaser receives the milk at below-market rates, it receives a benefit for purposes of SCM Article 1.1(b); and
- iv) as the below-market rates are specifically tied to the sale of dairy products into specific export markets, the subsidy is made contingent on export performance for purposes of SCM Article 3.1.

Therefore, the practice of selling New Zealand dairy products onto low-value markets through Fonterra confers an export subsidy inconsistent with the obligations set out in the SCM Agreement.

Although it may be tempting to argue that Fonterra is merely a price taker, the evidence demonstrates that this is not the case. In the six month period ending November 2002, Fonterra deliberately chose to liquidate its inventory at a loss. As a result, Fonterra drove international prices down 30% and, despite increasing its total sales by 40%, made those sales at a loss. These facts clearly demonstrate that Fonterra is a price setter, not a price taker, and that it chooses to sell into particular markets at below market rates. These sales clearly provide a benefit to the recipient and clearly constitute export subsidies for purposes of the *WTO Agreement on Agriculture* and the *WTO Subsidies and Countervailing Measures Agreement*.

New Zealand may not provide export subsidies to support the export of New Zealand dairy products. This is because New Zealand's WTO obligations do not envisage any volume of subsidized agricultural products or any value of export subsidy applied to support those agricultural exports. Consequently, any export subsidies provided by New Zealand through Fonterra are provided in breach of, and inconsistently with, its WTO obligations.

Annex D Article 9.1(c) Export Subsidy Programs

Article 9.1 of the *Agreement on Agriculture* deems a number of specific practices to be export subsidies subject to each WTO Member's volume and value limitations and reduction commitments. Article 9.1(c) provides that practices meeting the following criteria are deemed to be export subsidies,

“payments on the export of an agricultural product that are financed by virtue of government action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived.”

Based on the Appellate Body's interpretation of Article 9.1(c) in *Canada – Dairy Exports*, a “payment” is made if there is a transfer of economic resources from a third party to a

purchaser. This transfer can take the form of the sale of agricultural products by the third party to the purchaser at less than the relevant industry's total average cost of production. For example, the sale of corn by U.S. third parties at a price below total industry average cost of production constitutes a "payment" by the third party to the purchaser in an amount equal to the difference between the export price and the total industry average cost of production. This amount represents the value of economic resources transferred to the purchaser by the third party on the export sale of that corn.

A "payment" is "financed by virtue of governmental action" if government enables the third party to make the "payment". There is no requirement that the government, directly or indirectly, make payments to the third party. There is no requirement that the government take steps to compel the third party to make the "payment". It is sufficient that government allows the third party to offset its losses on the export sale so that sales on the export market, or its sales of inputs to be used in export production, at prices below total average industry cost of production is an available alternative to the third party.

That the "payments" be made "on the export" of the agricultural product simply requires that the "payment" made by the third party and "financed by virtue of governmental action" be provided when the agricultural product at issue is exported. An interpretation of Article 9.1(c) on the basis of the rules set out in the *Vienna Convention on the Law of Treaties* clearly demonstrates that export contingency is not required to establish an export subsidy in this case. Rather, Article 9.1(c) describes an export subsidy practice that merely requires that the payment at issue be made when the subsidized product is exported. Whether or not the same payment is made on the domestic sale of the subsidized product is not relevant in a consideration of Article 9.1(c).

As noted above, the United States maintains generous domestic support and export subsidy programs. These programs allow third parties in the USA to sell onto the world market or to provide inputs to U.S. exporters at prices below total industry average cost of production because they effectively offset the losses that would otherwise be incurred by the third party.

Article 9.1(c) export subsidies are also provided to support the export sale of New Zealand dairy products. Fonterra, New Zealand's *de facto* export monopoly, makes "payments" "on the export" of dairy products because Fonterra sells these dairy products at prices below total industry average cost of production. These "payments" are "financed by virtue of governmental action" because Fonterra has been granted the exclusive right to access high value export markets by the New Zealand Government. As a result of this delegation of exclusive rights, Fonterra must be treated as government for purposes of the *Agreement on Agriculture*.

This allows Fonterra to mitigate any losses on its below total industry average cost of production sales into lower value markets through its more remunerative sales into the higher value markets. The result is that "payments" are made "on the export" of these dairy products to these markets and these "payments" are "financed by virtue of governmental action." In these circumstances, it is clear that New Zealand, through sales by Fonterra, also provides Article 9.1(c) export subsidies.

The fact that New Zealand, through Fonterra, makes payments on the export of dairy products has been made abundantly clear by recent Fonterra actions. In the six month period ending November 2002, Fonterra deliberately chose to liquidate its inventory at a loss. These sales, made on the world market, drove down international prices by 30% . As these sales were made at a loss, it is evident that Fonterra chose to make a payment on the export of these products financed by virtue of governmental action thereby meeting the requirements of Article 9.1(c).

In both cases, U.S. and New Zealand third parties provide Article 9.1(c) export subsidies in support of agricultural shipments. These export subsidies are not only generous but, with respect to USA practices, are massive. A review of U.S. exports of corn, wheat, barley, sorghum, soybeans and oats based on USDA data indicates that these products are sold into the world market at prices below total industry average cost of production. This "payment" is "financed by virtue of governmental action" that primarily takes the form of the generous domestic subsidies provided by the United States to support the production of these crops.

As a result, the total “payments” made “on the export” of these products made in 2001 was approximately USD \$3.82 billion in excess of U.S. export subsidy commitments.

These Article 9.1(c) export subsidies must be counted against U.S. and New Zealand export subsidy commitments. With respect to the U.S., the value of these export subsidies, and the volume of supported products, clearly exceeds U.S. WTO bindings, particularly when added to the other export subsidies provided by the U.S.

Because New Zealand does not have the ability to provide any export subsidies in support of its agricultural shipments, these Article 9.1(c) export subsidies clearly exceed New Zealand’s WTO commitment levels. In both cases, the provision of Article 9.1(c) export subsidies results in the USA and New Zealand having violated their WTO obligations.

Neither the U.S. nor New Zealand can successfully defend against an Article 9.1(c) challenge on the basis that the underlying support is provided to the third party in a WTO consistent manner. For example, the U.S. could not successfully argue that support to its third parties provided consistent with its domestic support obligations could not “finance” a “payment” by the U.S. third party. Even if the domestic support provided to the third party is fully consistent with U.S. WTO obligations concerning domestic support (which is not the case), this would not justify providing this support in a manner that violated U.S. export subsidy commitments. The Appellate Body, in *Canada – Dairy Exports*, has concluded that domestic support obligations are distinguishable from export subsidy commitments so that consistency with one cannot and does not justify a violation of the other. Therefore, the provision of domestic support in a manner that fully conforms to WTO obligations cannot justify the provision of that support in a manner that violates export subsidy commitments.

Conclusion

This Report demonstrates that the United States and New Zealand maintain measures that violate WTO obligations and that support the production and sale of agricultural products.

The United States provides domestic support and export subsidies that greatly exceed the bound limits in its Schedule to the *Agreement on Agriculture*. By providing support and export subsidies in excess of its bound limits, the United States has violated its WTO obligations.

New Zealand continues to provide export subsidies on the sale of dairy products into particular markets at prices below prevailing market prices. As New Zealand does not have the right to provide any amount of export subsidies to support its agricultural shipments, the export subsidies provided by Fonterra to support the export sale of dairy products violates New Zealand's WTO obligations.

As a result of interpretation of Article 9.1(c) of the *Agreement on Agriculture*, both the United States and New Zealand provide an additional range of export subsidies. In light of the export subsidies already provided by both countries, and the restrictions on export subsidies set out in their respective Schedules, the Article 9.1(c) export subsidies provided by the United States and New Zealand violate WTO obligations.