THINKING OUTSIDE THE "BOXES"

A (POSSIBLY) SIMPLER STRATEGY FOR ADVANCING MULTILATERAL REGULATION OF FARM SUBSIDIES

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Introduction

Trade negotiators are trying to take the next step in a long-term process of disciplining farm subsidies. Aside from the obvious political difficulties, their task is complicated by the fact that they are working within an inherited and seemingly cumbersome system based on color-coded "boxes" and scheduled numerical subsidy limits.

Working inside the current paradigm, they may be able to produce by the end of this month a number-less "framework" for agriculture negotiations and thereby keep the Doha Development Agenda's ("DDA's") engine humming. But even if they do, I expect they will have trouble afterwards -- not because there is no basis for a win-win agreement to reduce subsidization, but because the scheme itself is not the most sensible one.

Whatever they may do, or fail to do, in Geneva this month, negotiators should not treat the box system as holy writ. If/when further impasses occur over farm subsidies, they should remain open-minded about trying to move ahead under a different, simpler paradigm with which they are already well-familiar: the *Agreement on Subsidies and Countervailing Measures* ("ASCM") scheme under which some subsidies are "prohibited," but *all* subsidies, no matter how labeled, are actionable if they can be shown to cause adverse trade effects.

The Situation Today

With the "Peace Clause" having expired and a new *Agreement on Agriculture* ("AoA") still on the drawing board, all agriculture subsidies (export and domestic) are:

- "prohibited" -- challengeable without any showing of adverse effects -- to the extent they exceed any numerical commitments scheduled by the bestowing Member;[1] and

- actionable even within those limitations, to the extent that a complaining Member can demonstrate adverse trade effects in one of the forms set out in ASCM Part III.[2]

[1] Many Members have scheduled numerical limits on export subsidies and on domestic subsidies classified in the "amber" and "blue" boxes (aid linked to output levels, and to output limitations, respectively), and on an "aggregate measure of support."

[2] Mainly this means "serious prejudice" to a Member's trade interests, which can take the form of lost exports, significant price undercutting, or an increase in the world market share of the subsidizing Member in a "particular subsidized primary product or commodity."

Thus, the WTO's two subsidy control regimes (agricultural and industrial) now have, if only temporarily, a single set of rules for actionable subsidies -- the ASCM rules. But they still differ in how they delineate a category of "prohibited" subsidies; in agriculture, a prohibited subsidy is defined as one exceeding scheduled quantitative (aggregate or box-specific) commitments, whereas on the industrial side, a prohibited subsidy is defined as one contingent on exportation or on import substitution.

Negotiators are feverishly working on the "framework" for a new AoA which would remove the current overlap between these two subsidy control regimes and reinstate the near-complete separation that prevailed from 1994-2003. They reckon that the best way to take the next step in disciplining farm subsidies lies with the box system and scheduled quantitative limits on various normative categories of aid.

If they can complete their self-appointed task using this scheme, and achieve a meaningful advance in control of farm subsidies, then they deserve nothing but thanks and congratulations. But if they stall again, it may be time to consider whether the scheme itself is making their task unnecessarily difficult.

Before providing some details, I should emphasize that this month's (July 2004) problem in the agriculture talks lies elsewhere. The box system applies to -- and may complicate the final resolution of -- two of the three "pillars" of the agriculture talks, export competition and domestic support. But by most accounts the hardest issue at the present "framework" stage is the third pillar, market access. Negotiators have dropped many hints that by using suitably general language and no numbers, they can agree on a framework for the subsidy issues; they have given no such hints where market access is concerned. And of course there are difficult sectoral issues in agriculture which require at least some immediate attention, including the cotton and sugar items providing an entry point for our discussion here today. My suggestions regarding the subsidy control issues are made with an eye on finishing the DDA agriculture talks, not restarting them this month.

Demerits of the Box System

1. It ignores years of learning about the best way to separate troublesome from "benign" domestic subsidies -- the injury ("adverse effects") test. The key question in designing a control regime for domestic subsidies is identifying which ones can trigger remedial/offsetting action. The AoA's amber, blue and green boxes group subsidy programs according to *assumptions* about how significantly they are likely to distort output, prices and trade. A more sensible approach, grounded in experience and economics rather than assumptions, is to make domestic subsidies of all types actionable to the extent that they are shown to have adverse trade effects -- not to rely on what a subsidy is called, or what it ostensibly aims to encourage the recipient to do, or what color box the subsidizing government thinks it belongs in. Actionability should depend on a fact-based examination, available upon the request of an aggrieved party.

Some regard it as draconian to use an injury test to sort subsidies; to them, it seems obvious that subsidies bearing labels like "environmental" belong in a separate class, exempt and immune whether or not they can be shown to distort trade. This instinct is not unknown on the industrial side, where it gave rise to a 5-year experiment with "green lighting" certain normative categories of aid under the ASCM (Articles 8-9 which were in force from 1995-2000). The current state of ASCM rules -- which use the trade effects test as the unique mechanism for sorting subsidies -- reflects an important "lesson learned" with respect to effective techniques for regulating subsidies. (The lesson is bolstered by the EC's ongoing and visible difficulty in managing its internal state aid regime, which likewise exempts various normative categories of aid.)

The injury/trade effects approach has proved to be more realistic and durable precisely because it is economic and not normative. The ASCM's injury-based remedy is far from perfect, but it rests on a sound premise. Namely, subsidies are neither good nor bad; they should be actionable when they cause economic harm to someone else, and ignored (as a trade policy matter) otherwise. Only the injury test sorts subsidies in this fashion. Attempts to immunize certain categories of domestic subsidies from case by case examination under the injury test -- and that is ultimately what the box system does -- fly in the face of basic economic realities, most notably the fungibility of money.

2. It wrongly assumes that subsidies which are *unlikely* to distort trade are *incapable* of distorting trade, and therefore need not be subject to case by case examination. The *US - Upland Cotton* panel decision seems to have refuted this assumption. But the broader question is whether there is a legitimate need to green light any category of farm subsidy. Aid which truly has no injurious effects will never be successfully challenged under the injury test anyway.

3. It may result in wasted negotiating resources, or at least less-transparent negotiations. For example, the daily trade press dutifully reports on debates, even at the current "framework" stage, over whether particular countries should be permitted to "reclassify" certain existing subsidies into the Blue Box, or whether the parameters previously assigned to the Blue Box should be stretched this way or that. The significance of these struggles is far from obvious in the absence of information about what reduction commitments will be scheduled for the subsidies in question, and (perhaps more importantly) what cross-cutting obligations will be undertaken to refrain from causing injury through domestic subsidies of all hues.

4. It places too much faith in the concept of "decoupling." The box system's defenders argue that it encourages governments to shift their domestic subsidies from more to less pernicious varieties -- mainly by "decoupling." "Coupled" subsidies are those most obviously connected to increased production, the simplest case being a per-unit-of-output cash grant. "Decoupled" subsidy programs give something of value to recipients without regard to what they have been doing, and with no restrictions on how they will use the proceeds. This creates the theoretical possibility that they will use the subsidy to buy high-tech stocks or invest in mutual funds -- *i.e.*, might do something other than increase their production of farm goods already in oversupply.

That is the theory. The reality, as experience on the industrial side has shown, is that while untied domestic subsidies may not affect production in exactly the same way as per-unit-of-output subsidies, the difference is one of degree. Anyone who has spent time looking at untied domestic subsidies in industrial sectors like steel can confirm that they do, indeed, significantly influence output.

Moreover, even granting that "decoupled is better," reforms often fail to achieve *effective* decoupling. One problem is implicit governmental expectations about what recipients will do with the aid they receive, which ties into beneficiaries' interest in repeatedly obtaining subsidies. Consider the case of aid payments that are based on the crop in which the recipient's land was planted during a recent representative period: if the recipient has reason to suspect that future benefits will be lower to the extent subsidies already disbursed are put to "other" uses, then he may remain fully planted for that reason and there may be no effective decoupling. Or, consider debt relief -- on the industrial side, probably the most heavily-used type of "untied" domestic subsidy over the last 40 years. For calculation purposes, debt relief is normally treated like a grant -- there being little difference between excusing a debt and granting the debtor an identical amount of money to retire the debt. A simple cash grant is the ultimate "decoupled" subsidy. But is debt relief "decoupled?" Does it yield fresh cash usable outside the recipient's main area of business? Industrial subsidy cases have shown that debt relief which enables companies to stave off bankruptcy keeps them operating, and therefore does indeed have a significant impact on production (hence also prices, *etc*.). Disaster relief programs in agriculture may operate similarly, allowing continued production by enterprises which otherwise would be forced to exit the business.

5. It is not even the best means of defining a category of prohibited subsidies. The box system's demerits relative to ASCM scheme are clearest in the case of domestic/actionable subsidies. But the "prohibited" category is also a key part of a subsidy control regime. As noted above, in agriculture, a prohibited subsidy is defined as one exceeding scheduled quantitative (aggregate or box-specific) commitments, whereas on the industrial side, a prohibited subsidy is one contingent on exportation or on import substitution. Which approach is preferable?

The ASCM approach has presented some challenges -- most notably in applying, in various contexts, the notion that a facially unrestricted subsidy can be "de facto" contingent on export performance. But that difficulty seems to have been largely surmounted. Meanwhile, the AoA approach (1) seems to invite disputes over what does and does not "count" toward the fulfillment of a scheduled limitation (again, see *US -- Upland Cotton*); (2) invites further disputes by requiring mathematical calculations which few normal humans can understand, *e.g.*, how to calculate total subsidization which is partly in grant form and partly in other forms such as soft loans or under-priced insurance policies; (3) seems to invite compliance problems in the case of aid delivered through entitlement-type schemes, with amounts that vary from year to year based on weather or market conditions and thus are unknowable at the time legislative authority is conveyed; (4) specifically countenances a certain, scheduled amount of export-contingent subsidization (although the agriculture negotiators may, with the EU having finally relented, take care of that problem over time); and (5) does not accord "prohibited" status

to subsidies contingent on the use of domestic over imported goods (although this may be less important as a practical matter in agriculture than on the industrial side).

A Possible Synthesis

If negotiators believe that using scheduled numerical limits -- whether aggregate, box-specific, or both -- is an important technique for disciplining farm subsidies, they need not abandon it. Indeed, such limitations could provide an additional "ratchet," or source of discipline, *complementary* to the discipline resulting from an overall obligation not to cause adverse effects through subsidization.

From this perspective, the policy question can be restated as simply whether there really needs to be any "green light" category of farm subsidies, exempt from examination under the adverse effects standard? Do WTO Members really have so little faith in the accuracy of the assumptions underlying the "green box" designation that they are unwilling to see that assumption tested through case-by-case economic analysis? Or, might they finally be ready to agree that while free to provide all the domestic subsidies they want, they will face WTO remedies if they cause each other economic harm? And if not now, when?