Country Intervention Indexes

An Alternative to PSEs in Trade Negotiations

— by John Pender —

The need for reform of national policies affecting agricultural trade has become abundantly clear. In 1987, the United States and the European Community (EC) spent over $50 billion to subsidize agricultural production and exports; more than the annual income of over half of the world's nations. Nevertheless, farmers were going out of business in large numbers and world market prices remained depressed as competitors engaged in a costly trade war.

It has become increasingly apparent that significant reforms are needed, not only of trade policies, but also of the domestic policies that drive the system towards surplus production and trade subsidies and restrictions. For the first time, domestic agricultural policies are on the negotiating table in the General Agreement on Tariffs and Trade (GATT).

Producer Subsidy Equivalents

An important issue is how to measure progress toward policy reform. One measure—the Producer Subsidy Equivalent (PSE)—has been proposed as the basis for negotiating a new GATT agreement. The PSE is an estimate of the effect of government policy on gross producer returns, usually expressed as a percentage of producer revenues for a particular commodity.

The PSE is a broader measure of producer support than the Nominal Rate of Protection (NRP), which measures the difference between domestic and world prices, since the PSE is intended to reflect all policies affecting producers of a given commodity. PSE estimates, as presently calculated, add the estimated value of border measures (determined by the difference between domestic and world prices times the quantity of domestic production) to the budgetary cost of other policies. This sum is expressed as a percentage of total producer revenue.

The PSE approach has several attractive features from the standpoint of GATT negotiations. PSEs are relatively easy to measure, simple to express, and facilitate comparison of vastly different policy measures affecting many commodities in different countries. Most importantly, they could be used to facilitate an agreement in broad terms to reduce the level of intervention, without requiring all nations to agree on what specific policy changes will be made to comply with the agreement. Each nation would have flexibility to determine policy changes consistent with the constraints imposed by the agreement.

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Despite these features, there are a number of problems with the PSE approach. Many of these are technical issues concerning the appropriate reference prices to use, the policies to include in PSE estimates, etc. Underlying many of these issues is a fundamental problem with the PSE approach. *PSEs attempt to measure the benefits nations provide to their agricultural sectors via government policies.* The agricultural trade problem has not arisen because nations bestow benefits on their own producers; it arises because *domestic policies impose costs on other nations.* It is the costs caused by such policies that have led to the counter productive spiral of policy responses and trade interventions that are disrupting agricultural trade.

Consequently, PSEs, as they are currently being measured to the Organization for Economic Cooperation and Development (OECD) are ill suited to the task of trade negotiations. Proposals to modify PSE calculations such as excluding certain payments or policies judged to have relatively small or benign effects on trade would improve the measure. But they may not solve the underlying problem.

The nature of PSEs leads to the risk that an agreement might be reached in the GATT to reduce PSE levels but that nations would do so in ways that did not reduce the trade distorting effects of their policies. Careful refinement of PSE measures could help to reduce this risk, but achieving agreement on such changes may prove difficult.

An Alternative to PSEs

An alternative to PSEs is for negotiators to focus on the costs of agricultural policies on foreign nations rather than on the benefits to domestic farmers. This suggestion will undoubtedly be met by criticisms that the estimated "costs" of one nation's policies on other nations are very difficult to measure and likely to be the source of considerable disagreement among negotiating parties. One can imagine endless disputes arising over the definition of "costs" and the methods and parameters used to quantify those costs.

Fortunately, the problem may not be as intractable as it first appears. The primary need is to develop a *process* for measuring costs that negotiators and their constituents agree is fair and will adequately reflect their concerns about the costs imposed by other nations' policies. It may be possible to use such an approach, *even if all nations do not agree to a single measurement technique or model.* What is important is that they agree to a process that they feel will yield a fair result.

An example of such a process is when two children have a candy bar to divide. The appropriate rule is: one divides; the other chooses. Thus, regardless of who divides the candy bar, it is abundantly clear that the process is fair. If one child should divide the bar into two unequal parts, that child runs the risk of being left with the smallest part.

The challenge, then, is to design an

◆ Producer Subsidy Equivalent (PSEs) attempt to measure the benefits governments provide to their domestic agricultural sectors, whereas the concern in trade negotiations is the cost domestic policies impose on other nations. As a result, there are significant problems in using PSEs as a basis for GATT negotiations. An alternative approach, based on the concept of measuring the cost of policies on other nations, would be to construct Country Intervention Indices (CII) that would be the basis for proportionate reductions in intervention by all nations. The CII for any country would be constructed by other countries. CIIs can provide sufficient flexibility to facilitate negotiations while assuring that the domestic policy changes made following an agreement serve the goal of reducing the harm trading nations are doing to each other.

approach whereby all parties expect the result to be fair and that the approach provides opportunities for the parties to assure that it is fair. This problem is simplified if negotiating parties can agree in advance that cuts in intervention (or trade distortion) from present levels will be made proportionately by all parties.

For example, suppose all countries agree to cut intervention, however measured, by 50 percent over five years. Since all reductions would be proportionate, there would be no issue of whose policies are the worst or who is taking the deepest cut. Thus, there would be no need to have a common scale of measurement for all countries. An "intervention index," with a current value of 100 for each country, would suffice.

Similarly, questions about how to weigh policies affecting different commodities against each other could be avoided if nations further agree to proportionate reductions in intervention for all commodities. In this case, each country would start with an intervention index of 100 for each commodity.

Now the problem is reduced to construction of an intervention index for each country (and commodity, if negotiators choose proportionate reductions for each commodity). Borrowing from the candy bar analogy, *each nation's intervention index would be constructed by other nations.*

In a bilateral negotiation, the solution is simple; each nation would construct an intervention index for the other nation. The index would reflect the perceived relative impact of the other nation's policies. Suppose the United States and the EC are negotiating changes in each other's policies that relate to wheat. The EC would construct the index of U.S. intervention. The index would include those U.S. programs that the EC considers most onerous. For example, the EC constructed index of U.S. intervention might assign two points for every dollar's worth of export subsidies, one point for every dollar's worth of deficiency payments, and zero points for every dollar's worth of crop insurance subsidies. The United States would then be able to reduce the index by reducing export subsidies or deficiency payments, although reducing export subsidies would have more effect on the index than an equal dollar reduction in deficiency payments.

Similarly, the United States would construct an index of EC intervention.

Each side would be free to include or exclude whatever policies it chose and to be as analytical or as subjective in constructing the index as it wishes. There would be one proviso. The method for computing the index must be explicit so that changes in the index can be translated into policy changes. In turn, the United States would have complete flexibility in deciding how to change its policies in order to reduce the U.S. index of intervention by some agreed amount. The EC would have similar flexibility in achieving the agreed reduction in the EC index of intervention.

Two Advantages

There are two major advantages of this approach. First, it forces nations to *reveal their preferences* concerning other nations' policies. A major goal for any negotiation is to discover combinations that benefit all parties. With the proposed approach, each side would have an incentive to explicitly express its preferences in constructing the index, and that information would allow the other side to attempt to identify mutually acceptable policy changes.

Suppose the EC is most concerned about U.S. export subsidies, is moderately concerned about deficiency payments, and not at all concerned about crop insurance payments to wheat producers. If this were the case, the EC would have an incentive to include both the U.S. export enhancement subsidies and deficiency payments in the U.S. intervention index but to exclude crop insurance payments. Furthermore, it would be in the interest of the EC to assign greater weight to export enhancement subsidies than to deficiency payments. If it didn't, the United States could get as much "credit" for reducing deficiency payments by one dollar as it would for reducing export enhancement subsidies by one dollar, even though the EC prefers the latter.

The EC could include only export enhancement subsidies in the U.S. intervention index. However, this approach by the EC would reduce the burden on the United States, since a 50-percent reduction would be required *only* of the export enhancement program whereas with a more broadly defined index, a 50-percent reduction in both export subsidies and deficiency payments might be achieved.

Consequently, it would be in the EC's interest to include all of the policies (and only those policies) that concern it, and to assign weights to each policy consistent with its level of concern about each.

The EC could even provide negative points for U.S. supply control efforts as an inducement for the United States to continue such programs, although the United States would not be required to do so. The United States would make similar choices in constructing an index for EC policy.

The second major advantage of this approach is that it allows nations flexibility in deciding how to change their policies. This is a major attraction of using an aggregate measure in trade negotiations. Most trade negotiations do not have the authority to assure specific changes in domestic policies; these normally require legislative action. Thus the described approach may assist the negotiators in crafting an international agreement acceptable to their respective governments while the same time preventing nations from having so much flexibility that they are able to circumvent the intent of an agreement.

Multilateral Negotiations

In multilateral negotiations, more than one nation may be involved in constructing indices for any country. They may disagree about which policies to include in the index and about their relative weights. This may not be a major obstacle, however. The EC and the Cairns Group, for example, are likely to have similar views about which U.S. wheat policies are of greatest concern, beginning with the Export Enhancement Program. Similarly, the United States and the Cairns Group likely could reach agreement about which EC policies are most onerous. And, not all countries would necessarily want to be heavily involved in constructing the indices. Japan, for example, might not have a strong interest in altering U.S. or EC wheat policies, and thus might defer to other nations in the process.