CANADA'S DAIRY INDUSTRY: CAN SUPPLY MANAGEMENT SURVIVE AN OPEN TRADE ENVIRONMENT?

Mike Gifford

The Doha Round of global trade talks comes to an important juncture in December as trade and agriculture ministers meet in Hong Kong. Agricultural subsidies have long been a sore point between the United States and Europe, while for Canada the most politically sensitive issue is supply management in dairy and poultry. Canada's dairy and poultry farmers want supply management maintained at current levels, which subsidize production while slapping prohibitive tariffs on imports. But it is not a very realisitic position for Canada and other countries at the negotiating table. "While the general incidence of agricultural export subsidies has declined significantly since the end of the Uruguay Round, trade in dairy products remains heavily distorted by export subsidies," writes Mike Gifford, who was Canada's lead agricultural negotiator during the entire Uruguay Round. He concludes: "It is clear that the dairy sector will not be excluded from the Doha Round results. It is equally clear that Canada will have to open its market to the same extent as other developed countries."

Le cycle de Doha sur les échanges mondiaux franchira en décembre un important tournant avec la rencontre à Hong-Kong des ministres de l'Agriculture et du Commerce. Entre les États-Unis et l'Europe, les subventions agricoles constituent de longue date une question sensible. Pour le Canada, c'est plutôt la gestion des approvisionnements dans l'industrie laitière et avicole qui pose problème. Les fermiers canadiens souhaitent le maintien des approvisionnements à leurs niveaux actuels, lesquels permettent de subventionner la production tout en imposant des tarifs prohibitifs sur les importations. Mais cette position n'est guère tenable, ni pour le Canada ni pour certains autres pays participant aux négociations. « Si l'incidence globale des subventions aux exportations agricoles s'est considérablement amoindrie depuis la fin du cycle de l'Uruguay, celles-ci n'en continuent pas moins d'altérer fortement le commerce des produits laitiers », écrit Mike Gifford, principal négociateur canadien durant tout le cycle de l'Uruguay. « Il est clair que le secteur laitier ne sera pas exclu des résultats de Doha, conclut-il, mais il est tout aussi clair que le Canada devra ouvrir son marché dans la même mesure que d'autres pays développés. »

Four years ago the World Trade Organization (WTO) launched negotiations to further reduce global trade barriers. In December 2005 in Hong Kong, Canada's trade and agriculture ministers will join ministers from 148 countries to provide the political impetus necessary to push these highly complex negotiations into their final stages. On the table will be the modalities — the changes in trade rules and how and by how much to reduce trade barriers — for concluding the negotiations. Under this scenario the negotiations will conclude by late 2006 or early 2007, with the new rules and reductions in trade barriers starting to be implemented in 2008. While full agreement may not be reached in Hong Kong, it is nevertheless possible to discern the general outline of the likely results in agriculture.

Trade in agriculture is the pivot point around which the negotiations will succeed or fail. Many countries, including the United States and the European Union, will face difficult decisions. For Canada, the dairy and poultry sectors are the most difficult because the more successful the negotiations, the greater the adjustment implications for these supply managed sectors, which, in the case of dairy, have been operating under supply controls for almost 40 years. Canada's dairy and poultry farmers are calling for Canada to walk away from the negotiations unless the current system of supply management can continue largely unchanged. All major political parties support Canada's supply management system. The dilemma for the government is that Canada cannot walk away from the negotiations, which cover international trade in all goods and services. Moreover, successful negotiations will bring major benefits to Canada's grain, oilseed, beef, and pork farmers, who depend upon export markets. It is time for a serious dialogue on the adjustments the dairy and poultry sectors are likely to face as a result of the negotiations, and how best to meet them.

We need a more informed understanding of the consequences of the likely results and to explore the adjustment options that are available to meet a changed global trading environment. This article concentrates on the dairy sector, which is the most politically sensitive, given its concentration in Quebec and Ontario, and which potentially faces the most significant changes.

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The national supply management system controls the production and marketing of milk by assigning individual production quotas to dairy farmers. The provincial governments, through their provincial milk-marketing boards, set the prices for milk, which vary depending upon end use. Over 60 percent of milk is used for the manufacture of dairy products, the remainder is consumed as fluid milk. A federal price-support program for butter and skim milk powder further underpins dairy product prices. Dairy farmers are largely insulated from import competition by prohibitively high import tariffs, except for a limited quantity, equivalent to roughly 3 percent of Canadian consumption, which enters at low tariffs. Supply management originated in the 1960s, when a national consensus emerged among dairy farmers and federal and provincial governments that "orderly marketing" was the best way to counteract chronically low prices and a highly distorted world market for dairy products. The poultry and egg sectors quickly followed the example of dairy. Attempts to extend supply management to other agricultural sectors, notably pork, failed because farmers decided that it was better to be a part of an integrated North American livestock economy, and that supply controls were not appropriate for sectors with an export growth orientation.

Although the international trade rules of the then General Agreement on Tariffs and Trade (GATT) allowed countries to impose an import quota to support supply management of primary products (e.g., milk), Canada's ability to shield dairy products from import competition through import quotas began to shrink, and then disappeared. First, in a dispute with the United States, the GATT decided that import quotas could not be applied to milk products, specifically ice cream and yogurt. Then, in the Uruguay Round of multilateral trade negotiations, which concluded in the mid-1990s, import quotas were abolished and, together with other forms of non-tariff import protection, converted into tariffs — tariffication. Canada's dairy farmers aggressively lobbied the federal government to oppose tariffication and, if necessary, walk away from the negotiations. This position ignored the fact that the Uruguay Round agricultural package was clearly in the interests of the 75 percent of the Canadian agricultural economy that was not under supply management. Thus, no one was surprised when Canada signalled in the very last days of the negotiations that it too would, reluctantly, support tariffication.

The current round of multilateral trade negotiations, dubbed the Doha Round after the capital of Qatar where they were launched, is the ninth in a series that began over 50 years ago. Until the Uruguay Round, agriculture was largely left out of multilateral trade negotiations, on the grounds that it was too sensitive to deal with for too many countries. The Uruguay Round made important progress in bringing agricultural trade under strengthened and more effective global trade rules and disciplines. The mandate for the Doha Round is to build upon this progress by seeking the elimination of export subsidies, making substantial reductions in trade-distorting domestic support, and significantly improving access to global markets. At this juncture it is possible to anticipate with a fair degree of precision what is likely to emerge under each of these headings and assess the impact on the dairy sector.

There is consensus to phase out agricultural export subsidies. While the general incidence of agricultural export subsidies has declined significantly since the end of the Uruguay Round, trade in dairy products remains heavily distorted by export subsidies. The end of export subsidies will strengthen world dairy prices, which are already forecast by the OECD to be firm as compared to the depressed prices of the 1990s. There

Farmers demonstrate in front of Quebec's National Assembly, illustrating the politically sensitive nature of reforming Canada's supply management regime in the dairy and poultry segments. Even so, Mike Gifford writes, it will impossible to exclude the dairy sector from any agreement on agriculture at next month's crucial WTO ministerial meeting in Hong Kong.

will be new rules to prevent the use of export credit sales and food aid disguised as export subsidies.

Trade-distorting domestic support is likely to be reduced by at least 60 to 70 percent, combined with a cap on the level of domestic support on specific products at some historical average. The effect will be to limit increases in federal dairy product price supports, linked to a cost-of-production formula, and could well require rollbacks.

The market access outcome will be the most difficult issue to resolve. Tariffs above 100 percent are expected to be reduced by at least 60 percent. Virtually all Canadian dairy tariffs are two-stage tariffs, with a small quota imported over a relatively low tariff. The protective tariff for imports that exceed the quota is generally in the prohibitive 200 to 300 percent range. A 60 percent cut would reduce the main Canadian dairy tariffs to between 80 and 120 percent. However, WTO members will have the option of designating some products as "sensitive," as Canada will certainly do for dairy products, and reducing the over-quota tariffs by less than the agreed amount, provided they expand the size of the quota that is subject to a low tariff rate.

One possible scenario would have quota expansion proportional to the reduction in the formula tariff cut. For example, if the agreed tariff cut was 60 percent, a designated "sensitive" product could choose to accept a tariff cut of say only 30 percent and increase the quota by 50 percent. It is also reasonable to assume that the minimum size of any "nonsensitive" quota would be increased to at least 5 percent of consumption in a recent base period. In fact, this is what the dairy farmers have indicated they are willing to do, provided other developed countries do the same. However, they strongly oppose any reduction in the over-quota tariffs. Given that Canada's quotas currently represent less than 3 percent of consumption, the Doha Round result could end up permitting dairy imports to account for between 7 and 10 percent of consumption, with over-quota tariffs still in the 140 to 200 percent range.

Canadian dairy exports made from Canadian milk will have to be phased out in accordance with the elimination of export subsidies, unless Canada can demonstrate that its system of export dairy pricing no longer constitutes an indirect export subsidy. Under current trade rules, pricing export milk at below domestic milk constitutes an export subsidy if, as a result of government action, the export price is below the average cost of production. Apart from minor quantities of high-priced specialty cheeses (e.g., aged Canadian cheddar), it is unlikely that Canada will be able to export bulk dairy products made from Canadian milk once the export subsidy prohibition is implemented. However, it will still be possible to export processed food products containing Canadian milk, provided the milk is priced the same for both the domestic and export markets.

Currently Canada's trade distorting domestic support is defined as the difference between the domestic support prices powder and the corresponding world prices (the so-called "price wedge"), multiplied by the domestic production of these products. If there is a cap on product-specific support, Canada will not be able to continue to increase support prices in line with increases in the cost of production or for other reasons.

The progressive loss of exports, together with the expansion of import quotas, will mean that Canadian dairy farmers will not be able to retain more than 90 percent of the domestic market. As international dairy prices should strengthen as a result of the negotiations and given the forecast relatively robust fundamentals of the international dairy market, it is anticipated that over-quota tariffs will protect the market, even if they are progressively reduced by one-third.

While the main dairy products will retain significant protection, this is not the case for products not covered by the current system of quotas, for example, sugar/butter-oil blends used to manufacture lower quality ice cream. Canada's dairy industry would continue to be vulnerable to unrestricted import competition and loss of market share. However, since many of these products come from Europe, which heavily subsidizes dairy (and sugar) exports, the phase-out of export subsidies should help to moderate this source of unrestricted competition.

If Canadian dairy farmers lose domestic market share so will dairy processors, possibly leading to the closure of some of the less efficient plants. Some of these pressures, particularly with respect to plants processing milk for fluid use, could be moderated through a reciprocal agreement with the United States to permit cross-border trade. Currently, the complex web of national/subnational regulations governing milk marketing in both countries effectively prevents cross-border commercial shipments of milk for fluid consumption.

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International dairy product prices have long been among the most distorted prices in international trade. Throughout the post-Second World War period, extremely high import barriers and the widespread use of export subsidies and other forms of export assistance have characterized the international market. Surplus disposal programs by most of the developed countries have extended and accentuated price fluctuations in the residual international market. This has resulted in volatile and often abnormally depressed international prices.

However, the recent joint OECD/FAO Medium Term International Dairy Outlook suggests the international dairy market over the next 10 years will be relatively firm, mainly as a result of strong demand growth in a number of developing countries, particularly for whole milk powder. Thus, over the next decade, demand rather than supply is expected to be the dominant market fundamental. Prices will still continue to fluctuate but they are expected be more in keeping with the trend line of recent years, as opposed to that of the 1990s. This outlook assumes no changes in existing dairy and trade policies.

A Doha Round result, which would progressively phase out dairy export subsidies over a 5- to 10-year period, expand market access, and cap trade, distorting domestic support, would reinforce demand-generated international price pressures. Although low-cost producers like New Zealand and Australia will expand production, global demand pressures are expected to dominate exportable supplies. International butter and skim milk powder prices are both expected to fluctuate in the US$2,000-US$3,000/metric tonne (MT) range (f.o.b. Northern Europe), as opposed to lows in the order of US$1,000-US$1,100/MT as recently as mid-2002.

Canadian over-quota dairy tariffs are currently 299 percent for butter and 202 percent for skim milk powder. (Other dairy products have over-quota tariffs ranging from 200 to 300 percent.) Current Canadian support prices for butter and skim milk powder are C$6,870/MT and C$5,728/MT respectively.

Under this scenario, and assuming international butter prices toward the low end of the estimated range at $2,000/MT, a one-third reduction in Canada's 299 percent tariff on butter would have the following impacts:

- at a 90-cent Canadian dollar, the landed tariff paid price would be $6,882/MT
- at an 80-cent dollar, the price would be at $7,750/MT
- at a 70-cent dollar, the price would be $8,866/MT

There would be similar impacts on cheese, skim milk powder and other dairy products. In each case, the tariff-paid price would remain above Canadian support prices.

In practice, the actual tariff structure provides even more protection than the simple ad valorem rate suggests. All over-quota tariffs are in fact "compound" tariffs, which contain a minimum specific rate as well as the ad valorem rate. Thus, in the case of butter the actual tariff is 299 percent on the f.o.b. value, but not less than C$4,000/MT. The specific tariffs are only triggered when international prices are low. For example, the current specific tariff on butter would be triggered only when international prices fell below US$1,200/MT under the 90-cent Canadian dollar exchange rate.

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The foregoing analysis suggests that even with a 90 cent Canadian dollar, a reduction of one-third in Canadian over-quota tariffs would not undercut current Canadian prices provided international dairy prices do not fall significantly below current levels. A good Doha Round result, combined with continued strong income growth in developing countries, should result in international prices that are higher than current levels.

In rough terms, the results of the negotiations could lead to a reduction over the next decade in domestic production of milk to about 90 percent of domestic consumption, requiring a corresponding reduction in the allocation of production quotas to individual farmers. The reduction in the national production quota could be achieved by a government-mandated pro rata reduction in individual production quotas or through a voluntary quota buy-back program whereby the federal or the federal and provincial governments purchase sufficient quota to balance supply with market requirements. A voluntary program could be operated on a bid basis, where individual producers are invited to indicate at what price they would be willing to sell their quota to the government(s). Presumably, the producers most likely to take advantage of such a program would be the higher-cost producers and those who were thinking of retiring from dairy farming.

Any national quota-reduction program will require delicate negotiations between the federal government and the provinces, since quota is created and defined by the provinces and not the federal government. In this regard it should be noted that any quota buyout program will need to ensure that the expected benefits are not nullified by subsequent unilateral provincial decisions to increase quota.

The Canadian Dairy Commission's ability to continue to set dairy product prices according to a cost-of-production formula, and, from time to time, other considerations, would no longer be possible. In the future, milk prices will likely have to be determined by negotiations between provincial milk marketing boards and dairy processors, rather than by either the federal or provincial governments. This would parallel the pricing arrangements already in place for chickens and turkeys. In a provincial milk marketing board/dairy processor price negotiation, classified milk pricing according to end use could still continue, but the negotiated prices would reflect supply and demand factors. Such a move to market prices implies more price variability, since it is difficult to adjust milk supply in the shorter term.

The effect on the value of production quotas is difficult to quantify. Much will depend on how surplus production quota is removed from the system and on the level of the negotiated milk prices, which will still be protected by high over-quota tariffs. The Doha Round results are unlikely to materially affect the price of fluid milk. Where they will impact more is on the price of storable dairy products and dairy ingredients used in food processing.

Currently, the value of dairy production quotas is estimated to be in excess of $20 billion. Put another way, it now costs a dairy producer in excess of $25,000 to purchase enough quota to cover the milk production of one cow. For a new entrant, this would mean spending about $2.5 million to purchase the quota for a herd of 100 dairy cows. While a few of the older producers may have originally acquired quota at little or no cost, younger producers have incurred major purchase obligations. With current quota values, it typically takes a producer 8 to 10 years to pay back a quota purchase. However, 50 percent of the value of the quota is treated as a depreciable asset, so some of the estimated value has already been written off. In these circumstances, it would seem appropriate to provide some, but not necessarily full, compensation in the event of a significant decline in quota values. However, it is far from clear to what extent quota values will in fact decline. Much will depend on the information producers have on how the Canadian dairy industry will adjust to the post-Doha Round reality and their confidence in the maintenance of at least a modified form of supply management for the foreseeable future.

Production quota values are the capitalized value of the benefits of the current supply management system. A binding cap on trade-distorting dairy support could result in some rollback of existing price support levels, which will be directly reflected in quota values. However, there will still be upward price pressures by those producers who want to purchase more quota to expand their operations so as to obtain the economies of scale. Even though there is considerable uncertainty as to future equilibrium quota values, early announcements of the government's commitment to introduce appropriate adjustment/compensation programs would be desirable. In this regard, how the European Union proposes to reform its sugar policy is informative. These reforms would reduce support prices by 39 percent over two years and compensate producers for 60 percent of the price cut by providing decoupled direct income payments. Sugar production quotas would continue until at least 2014-15.

In Canada the price of quota varies from province to province, mainly for scale-of-operation reasons at both the farm and dairy processor levels. This fact suggests that the development of alternative quota reduction approaches will need to carefully consider the regional implications.

At this juncture there is nothing in the anticipated Doha Round results that would prevent the Canadian dairy industry from evolving to take advantage of the countervailing power benefits of single-desk selling when negotiating prices with a handful of dairy processors (three firms — Agropur, Parmalat, and Saputo — purchase 70 percent of the milk produced in Canada).

Changes in Canada's import regime will also have implications for Canadian dairy processors and food processing firms using dairy ingredients. If dairy processors lose domestic market share, the only way to maintain production at efficient volumes will be to export. Given the phase-out of export subsidies, this means that increased dairy product exports using two-price milk are not an option. One possible solution would be to import more milk and other dairy products for processing and re-export. This import-for-re-export trade is already occurring and would need to increase if the dairy-processing sector is to avoid being downsized. A similar argument can be made to ensure that food-processing exporters continue to have access to imported dairy ingredients at competitive prices.

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In order to facilitate a smooth transition, a dairy adjustment package could include

- A voluntary quota buy-back program that would allow the national production quota to decline as imports progressively increase to fill the expanded TRQ access (if the voluntary program was deemed too expensive, a mandatory pro rata quota reduction would be required — this could be accompanied by a one-time compensation payment)
- Assurance that the production quota system would be continued for at least the next 10 years
- Continued access to the national direct income stabilization payment program would help moderate income fluctuations
- A program to guarantee outstanding loans used to purchase production quota
- Assurance that during the transition period emergency import safeguards will be triggered if the over-quota tariff is not high enough to prevent imports from entering Canada
- Assurance that dairy processors would continue to have unrestricted access to imported milk and dairy products used to manufacture food products for export

Some observers might object to governments buying back quota at market value, arguing that if compensation is to be offered, it should be at some fraction of the estimated "loss." If a voluntary buy-back is judged to be "too rich," then the other main alternative would appear to be a combination of a mandatory pro rata quota reduction and a one-time compensation payment. Clearly, the magnitude of any compensation will be a highly sensitive issue involving political as well as economic considerations.

These adjustments could be accommodated without destroying the fundamental elements common to all the supply managed sectors, i.e., production controls and single-desk marketing. A reasonably soft landing is conditional on the development of an adjustment assistance package before the WTO results start to be implemented.

For dairy farmers, the crucial question is whether the present system of supply management can survive the implementation of a Doha Round result permitting high, albeit reduced, levels of over-quota tariffs. The likely price for avoiding much steeper cuts in over-quota dairy tariffs is allowing imports to account for up to 10 percent of domestic consumption, as compared to less than 3 percent today. In addition, Canada's dairy pricing flexibility is expected to be constrained by the new disciplines on product-specific trade-distorting domestic support, and exports will progressively decline as the export subsidy prohibition is phased in.

Helping to offset these downward pressures on prices and domestic market share will be the upward pressure effects on international market prices of expanded global access, the phase-out of export subsidies, and the capping and/or reduction in the most trade-distorting forms of domestic support. These dairy-trade-reform effects are expected to reinforce an already relatively strong international dairy-market forecast for the coming decade.

A Doha Round result along the lines described means that domestic milk production will decline to accommodate more imports, but most of the key features of the current supply-management system would continue for the foreseeable future. The principal impacts will be phased reductions in the national production quota as imports progressively increase to about 10 percent of domestic consumption; a cap on administered price increases; and a reduction in dairy-product exports.

Unfortunately, there is a real risk that the dairy-farmer leadership will prefer, as they did in the Uruguay Round, to delay acknowledging the realities until the end of the negotiations. The Doha Round results will have a far greater impact on domestic policy options than the Uruguay Round. In the absence of a plan, dairy farmers will face considerable uncertainty as to whether to buy or sell production quotas. Delaying discussion of how to adapt to a new external environment will only make any necessary changes more difficult and increase the costs of adjustment. Delay will marginalize Canada from the crucial endgame decisions as the negotiations draw to a close. The inevitable price of being the last country to join a consensus is having little or no influence in putting the final package together. For medium-size and smaller countries, being the last to get on board usually means having to accept what others have already negotiated. Accommodations are much easier to negotiate when a country signals earlier in the negotiations that it is prepared to be part of the solution. When the overall agricultural package is clearly in the interest of the holdout country, it is very difficult to credibly argue that walking away from the negotiation is a real option.

The politics of supply management in Canada are extraordinarily sensitive, but no more so than the politics faced by other countries for their sensitive products, for example sugar in the United States or rice in Japan. It is clear that the dairy sector will not be excluded from the Doha Round results. It is equally clear that Canada will have to open its market to the same extent as other developed countries. Canada's trade and agriculture ministers need a viable negotiating position in Hong Kong, and Canadian dairy farmers and processors need some assurances regarding the future of supply management and the value of their investments. These imperatives do not need to be mutually exclusive.

Mike Gifford was Canada's chief agricultural negotiator in the 1986-94 GATT Uruguay Round of multilateral trade negotiations as well as in the negotiations for the Canada–US Free Trade Agreement and the NAFTA. Bill Dymond contributed to this article.