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Implications of European Policy Reforms on the U.S. Dairy Industry

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The U.S. has contended for years now that European Union (EU) agricultural policy is inherently unfair and negatively impacts world markets. This issue was highlighted recently by U.S. dairy farmers at the U.S. International Trade Commission hearing (December 2003) on milk protein imports. It was contended that EU casein subsidies and export restitution payments provided the EU with an unfair trade advantage that resulted in increased U.S. imports of milk protein concentrate (MPC). This theme was the cornerstone of the U.S. position at the Uruguay Round Agreement that created the World Trade Organization (WTO). The U.S. and other countries argued that the Common Agriculture Policy (CAP) adversely affected global market prices for dairy products such as butter, cheese, and skim milk powder.

Since the WTO agreement the U.S. has had its share of expensive agricultural programs. The 2002 Farm Bill introduced new income support programs including direct payments and counter-cyclical payments for major program crops. For dairy, the Milk Income Loss Contract Program was created. This program provides targeted counter cyclical payments to small dairy farms. And the dairy price support program continues even though it represents an Amber Box policy under the WTO. Amber Box programs adversely affect markets and are subject to cuts under the current WTO negotiation. In addition, the U.S. used foreign donation programs and casein production subsidies in order to reduce excessive stocks of surplus skim milk powder.

The fact is the EU has made significant reforms to the CAP. In the case of dairy programs, this will mean the EU will be far ahead of the U.S. in the current round of negotiations of the WTO, the so-called Doha Round. These changes and their implications for the U.S. dairy industry will be explored below.

EU Dairy Programs

The EU dairy program consists of a production quota for milk, import protection, an intervention program that supports the price of skim milk powder and butter, and export refunds which are used to market surplus dairy products.

The milk quota was created in the early 1980s in response to a growing milk supply. Each EU country received a quota on milk production and butterfat. The quota year begins April 1 and ends March 31 of the following year. In addition to production quotas, the EU has import quotas that limit the volume of dairy products that can enter the EU. These import quotas are mainly country specific and allow a limited amount of imports at relatively low tariffs. Import quotas are also available under the Market Access Agreement of the GATT (non country specific). Any quantity over the quota levels faces stiff tariffs that were negotiated in the last WTO.

The EU also has a number of domestic or internal programs designed to support farm milk prices. Domestic support begins with the intervention system. This program was designed to provide a safety net for minimum prices of skim milk powder and butter. Because of growing purchases of excess inventory, the EU limited the amount of product that could enter intervention as well as the months of the year that product can enter. Only 109,000 mt of skim milk powder and 60,000 mt of butter can enter into the EU intervention program during the months March through September (to be reduced annually by 10,000 tons to just 30,000 mt by 2008). In addition to the intervention program, the EU has an array of consumption subsidies on products such as butter used in pastry and ice cream, and skim milk for calf feed. The EU also has a subsidy on casein production (which will likely face continued reductions in the future).

The EU has surprisingly few direct regulations on milk pricing. It can be argued that minimum pricing for butter and skim milk powder can indirectly affect all EU prices at the farm, processing, and retail levels. But with the exception of the intervention prices, most prices for dairy products in the EU are not regulated and are allowed to "float" with internal market conditions. Thus market prices for products like yogurt and cheese, for example, don't face regulated minimum prices for milk ingredient costs or for wholesale market prices. As a result, farmers are paid a formula price that is based on how their milk company markets their products. Each milk company looks at the portfolio of products they sell and estimates what they can afford to pay farmers. Of course these companies must compete with each other for milk supplies and the milk quotas available from each producer. Thus there is no minimum manufacturing price or regulated blend price as in the U.S.

One of the problems with the EU system is that it has created a surplus of butter and skim milk powder. The most pressing problem is excess butterfat production in the EU. Demand for butterfat has declined in the EU due to consumer preferences for low fat products. The EU has used export subsidies to direct surpluses onto the world market. They use an export refund system to bridge the gap between high internal prices and lower world market prices. This created much discord during the Uruguay Round because export subsidies act to depress world market prices and made them more volatile.

CAP Reform

The dairy portion of the CAP cost roughly $2 billion euros in 2003. Due to decoupling the overall cost of the dairy portion of the CAP will fall to $1 billion euros. But major reforms in the EU are underway to reduce the cost of the CAP even further. While it appears that the EU is mending its ways with regard to trade distorting policies, there are a number of logical factors that are forcing the EU to make significant reforms to the CAP. First, agriculture today contributes very little to EU employment. That of course wasn't the case after World War II when agricultural employment was important. Second, the cost of the CAP has become burdensome, particularly since 10 new countries have now joined the EU. These new countries, all in Eastern Europe, are expected to be net recipients of CAP payments which will further create a budget crisis. And finally, the EU is attempting to better position itself in the current WTO round. Their strategy is to make major reforms on export refunds and domestic spending. In this way they may hope to avoid major concessions on import protection issues (called market access) since they are obviously having less adverse effects on global markets. It is in effect a well thought out strategy.

The EU has already phased in major reductions in both the amount of product that can enter the intervention system and the intervention prices themselves (see Table 1). This is intended to directly lower internal market prices for all dairy products. It is shocking to think that lower internal prices for dairy products has now become a major goal of CAP reform. Casein production subsidies will also likely be phased out over time. These subsidies were $1500 per mt just a few years ago and are now $450 per mt. And the EU has agreed in the WTO negotiations to eventually eliminate all export refunds. If domestic prices for dairy products declines there will be less need for export refunds.

These changes will cause economic hardships for EU dairy farmers. EU politicians have made the decision to create new direct payments to help offset some of the price reductions. These payments are decoupled and linked to environmental programs. That means they are outside Amber Box spending programs and have no direct relation to the level of milk production. In addition, these new payments will be off the EU books and placed on individual national budgets. Thus this strategy will likely be viewed positively in the current WTO negotiations. Estimates are that for the current year these direct payments will only offset 55 percent of the reduction in EU farm milk prices. In addition, under these changes, the cost of EU dairy programs will actually grow from $1-$2 billion euros a year to $6 billion euros. While it will cost EU taxpayers more, the nature of the payments will be more amenable to WTO watchers.

Implications of CAP Reform

There are a number of implications of CAP reform:

- Domestic EU prices for dairy products will fall
- EU processors will focus more on value-added processing in order to offset lower market prices
- EU dairy farmers will become fewer and larger over time
- The EU dairy industry will become more globally efficient
- Exports of surplus dairy products will disappear, creating less EU presence in global markets

EU CAP reform is startling in its degree of change. Market prices will be lower, there will be fewer dairy farmers, and export refunds and production subsidies will disappear. The EU will be in an excellent position to argue in the current WTO that they are making real commitments towards lower spending on domestic programs and export subsidies. They will use this argument effectively to avoid major commitments to increasing EU market access. Currently the EU has greater import protection than does the U.S. when it comes to dairy products.

While the EU has taken an aggressive well thought out strategy towards the WTO, the U.S. dairy industry in contrast is completely unprepared. The MILC payment program and the price support program are clearly areas where the U.S. will likely have to make significant reductions in the WTO since these programs represent Amber Box spending. The U.S. may trade off the MILC payment program in the upcoming Farm Bill because of budget pressures and because it is controversial among dairy producers. But the U.S. dairy industry is committed to continuing the price support program and is even discussing production subsidies for the production of dried milk proteins (including casein and milk protein concentrates).

In addition to these programs, the U.S. is being criticized for the use of expanded export subsidy programs. The U.S. government used foreign donation programs in order to remove surplus skim milk production from storage under the dairy price support program and export these products abroad. These “free” exports likely competed with commercial sales from countries like New Zealand who rely on unsubsidized exports. In addition, the USDA has accepted some limited offers to sell surplus skim milk powder to domestic U.S. processors willing to produce casein. This clearly represents a production subsidy since the purchase price is lower than the domestic market price of skim milk.

Conclusions

It is likely that the U.S. dairy industry will face significant criticism and will have major changes forced upon her if an agreement is reached in the Doha Round. The EU has already made significant market reforms and will be viewed favorably as a leader of market reform. Since implementation of the Uruguay Round the U.S. has only increased spending on agricultural programs and has made no efforts to reform or phase out the dairy price support program. Unless some significant reforms are made in the upcoming Farm Bill, the U.S. dairy industry may find itself outmaneuvered by the EU on issues of domestic market reform and elimination of export refunds.

Table 1. Proposed Reductions in the European Union Dairy Intervention Program

Marketing Year	Skim Milk Powder		Butter	
	% drop in price	MT	% drop in price	MT
2004	-5	109,000	-7	60,000
2005	-5	109,000	-7	50,000
2006	-5	109,000	-7	40,000
2007	0	109,000	-4	30,000