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Can Canada's Supply Managed Dairy Industry Survive the Doha Round?

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1.0 Background

Let me start by explaining why I decided to write a paper on whether Canada's supply managed dairy industry can survive the more open and less distorted international trading environment which is expected to emerge from the current round of WTO negotiations.

- My first concern is that while there are only a few weeks left before the Hong Kong WTO ministerial meeting, (which is expected to decide on how and by how much agricultural trade barriers and distortions are to be reduced), there is, as yet, no meaningful public discussion on how Canada's supply managed dairy, poultry and egg industries are going to adjust to a Doha Round result which will inevitably involve a reduction in Canada's over quota tariffs.

- My second concern is that the supply managed sectors have backed the federal government into an impossible corner by insisting that any reduction in the over quota tariffs will inevitably mean the end of supply management and the government should therefore walk away from the negotiations if over quota tariffs are to be reduced. This position ignores the interests of the 75 percent of Canadian agriculture which is not supply managed and the rest of the economy which have important stakes in a successful Doha Round result.

- My third concern is that Canadian negotiators will be unable to effectively pursue Canada's agricultural trade interests if they are forced to take untenable positions which results in Canada being marginalized as the negotiations enter their most critical phase. It is important to note that I say this as a former trade negotiator.

I should emphasize at the outset that I recognize that supply management is a policy which is supported by all of the major political parties in Canada. Given this reality I am not concerned about whether there are better alternative marketing systems. My only concern is to stimulate a debate on whether, and if so how, supply management can adapt to a Doha Round outcome which is increasingly likely to result in the elimination of export subsidies, achieve substantial reductions in trade distorting domestic support and substantially increase market access for all commodities. I repeat - all commodities.

2.0 Supply Management in Canada

I focus on the dairy sector because it is the largest and most politically sensitive supply managed sector, given that over 80 percent of the dairy farms are located in Quebec and Ontario. It is also the supply managed sector which potentially faces the most significant changes to the status quo, as I will explain later.

The current supply management system emerged from a situation in the 1960's of chronically depressed prices and highly distorted international markets. It is often forgotten that, prior to supply management, Canada was a net dairy exporter. However, as world markets began to close and export subsidies became the norm, a national consensus emerged that it was best to circle the wagons and concentrate henceforth on servicing the domestic market by matching supply with identified demand. This was achieved through the delegation of federal and provincial powers which permitted provincial milk marketing boards to control production, pricing and marketing on the basis of individual farm production quotas and single desk selling. Currently, the federal government underpins the system by maintaining support prices for butter and skim milk powder and providing import protection through a system of tariff rate quotas. Because the over quota tariffs are prohibitively high, the import system acts as an import quota, with the permitted import volumes entering over low tariffs. Within quota imports are equivalent to about 3 percent of consumption – roughly the same access as provided by the European Union and the United States.

You will recall that in the Uruguay Round all agricultural import quotas, variable import levies and other similar non-tariff measures were required to be converted to tariffs. There was also a requirement to provide access for a specified volume at low tariffs and to reduce the protective over quota tariffs by a minimum of 15 percent. The end result was the current system of tariff rate quotas.

3.0 The Doha Development Agenda

The Uruguay Round architecture of tackling agricultural trade reform through the three interrelated pillars of market access, domestic support and export assistance is being replicated in the Doha Round negotiations. It is already clear that very substantial results are on the table for export assistance and domestic support. Less clear, is how and by how much market access will be improved. However, even in this most difficult part of the negotiations, it is possible to discern the likely negotiating approaches and to get some idea of the probable order of magnitudes.

At this juncture there is already clear evidence that the final Doha Round result will include the elimination of export subsidies and improved disciplines on export credits and food aid. It also appears evident that there will be substantial reductions in trade distorting domestic support, likely in the order of 60 percent or more, with product specific caps on the most trade distorting forms of domestic support.

While more speculative, it is also possible to suggest what a market access result will include. Tariffs over 100 percent will face the deepest formula cuts, perhaps 60 percent or more, and there appears to be growing support for a tariff cap in the order of 100 percent. However, it is accepted that a small number of self-designated “sensitive” products will be excluded from the general tariff formula and countries will have the option of a smaller reduction in the over quota tariff in exchange for a proportional increase in the size of the within quota volumes for these commodities. However, even the most sensitive products will be required to make a minimum reduction in over quota tariffs. Given that most Canadian dairy tariffs are in the 200-300 percent range there appears little doubt that Canada will choose to designate these tariffs as sensitive.

I have assumed for illustrative purposes that the minimum reduction on the over quota tariff of a sensitive commodity will be one-third and that tariff rate quotas will have to be expanded in proportion to the deviation from the formula tariff reduction. This suggests that Canada will end-up having to provide market access equivalent to 7-10 percent of consumption, as compared to about 3 percent to-day. However, when you add the fact that Canada will also face the loss of most of its dairy exports because of the phased elimination of export subsidies, then it becomes clear that imports are more likely to be closer to 10 rather than 7 percent of consumption.

4.0 Implications of the Doha Round for Canada's Dairy Industry

What then are the implications for the Canadian dairy industry of a Doha Round result which approximates the scenario just described? The main positive impact will be the upward pressure on world prices resulting from the global increase in dairy access, the elimination of export subsidies and the capping of the most trade distorting forms of domestic support. These price strengthening effects will reinforce an already relatively firm market price forecast for the next decade that was recently prepared on a joint basis by the OECD and FAO. This market strength is mainly attributed to continued strong demand growth in the developing countries.

I have already referred to some of the main negative effects of a potential Doha Round agreement. To repeat, these include: 1) the loss of nearly all Canadian dairy exports made from Canadian milk as export subsidies are phased-out; 2) if there is a cap on product specific trade distorting support, Canada will not be able to continue to increase support prices in line with cost of production increases or for other reasons; and 3) Canada's share of the domestic market will decline to around 90 percent of consumption as imports increase and exports decline. This will affect dairy processors as well as milk producers.

Some of the more clear-cut effects arising out of the likely Doha Round results have already been described but less clear are the impacts on Canadian market prices and on the value of production quotas. Our best judgment is that while domestic milk prices will not be able to increase for the foreseeable future, it should be possible to maintain prices around current levels. The main reason for believing that prices will not fall drastically is the fact that even with a reduction of one-third in current over quota tariffs and assuming a 90 cent Canadian dollar imports would still not undercut current Canadian support price levels for butter. This view is based on my analysis of domestic and import prices given a relatively firm international price outlook. A substantial Doha Round result would only reinforce what is already forecast to be a demand driven international market.

If what I have described is agreed to be a reasonable scenario, what then are the adjustment options available to the Canadian dairy industry? A reduction in domestic market share and loss of most exports will necessitate a corresponding reduction in production quotas which could be achieved by a government mandated pro rata reduction in individual production quotas or through some form of voluntary quota buy-back program. Presumably the producers most likely to take advantage of a quota buy-back program would be the higher cost producers and those who are already thinking of retirement. Any national production quota reduction program would require delicate negotiations between the federal and provincial government because quota is created and defined by the provinces, not the federal government.

As explained earlier, there is little likelihood that the Canadian Dairy Commission will be able to continue to increase support prices. Therefore, in the future, milk prices will likely have to be determined by negotiations between the provincial milk marketing boards and dairy processors. This would parallel the pricing arrangement already in place for chickens and turkeys. There would appear to be no reason why the current system of end-use pricing could not continue under a negotiated price regime.

The effect of a phased implementation of the Doha Round results, over 5-10 years, on the value of dairy production quotas is difficult to quantify. Much will depend on how surplus quota is removed, the level of negotiated prices and the assurances the federal and provincial governments provide about the future of supply management. Currently the value of dairy production quotas is estimated to be in excess of $20 billion. Put another way it now costs a dairy farmer in excess of $25,000 to buy the quota for one cow and it typically takes 8-10 years to pay back any bank loan. Given the amounts at stake, there is little doubt that the main concern of any dairy producer is the potential impact of the Doha Round results on quota values.

Production quota values reflect the capitalized value of the benefits of the current supply management system. Much of the increase in quota values reflects the reality of more efficient producers wanting to buy more quota to achieve economies of scale. These pressures will continue even if market prices remain stagnant or decline somewhat. It appears evident that the uncertainty regarding future production quota values is an issue which must be directly addressed in any adjustment package. In this regard, it is interesting how the European Union Commission is proposing to reform its sugar policy. 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 2014-2015. I am not suggesting that Canada should copy the specifics of the European Union approach; instead I suggest that a clear plan and guarantees about the future of supply controls should go a long way towards preventing precipitous declines in quota values in a Canadian context.

There is nothing in the anticipated results of the Doha Round which would prevent the continuation of single desk marketing. It is understandable why in a negotiated price scenario dairy farmers would want to continue to market collectively when dealing with a handful of dairy processors (three firm's purchase 70 percent of the milk in Canada).

So far our analysis has concentrated on the implications for dairy farmers. However, any adjustment package must also address the impacts on the dairy processor and food processing sectors. Clearly, the loss of export markets and a reduced domestic market share will impact negatively. At a minimum it would appear necessary to ensure that the existing import for processing and re-export program continue and that food processors who must compete with duty free imports from the United States continue to have access to imported ingredients at competitive prices.

What should an adjustment package look like? The following elements could be considered:

- A voluntary production quota buy-back program, possibly operated on a bid-basis whereby individual producers are invited to indicate at what price they would be willing to sell their quota to the government(s). If a voluntary buy-back program was deemed to be too expensive then a mandatory pro-rata quota reduction accompanied by a one-time compensation payment would appear to be the main alternative.

- Assurance that the production quota system would continue for at least the next 10 years.

- Continued access to any national direct income stabilization program, given that negotiated pricing could result in more income variability.

- A program to guarantee outstanding loans used to purchase production quota.

- Assurance that during the implementation period emergency import safeguards will be triggered if the over-quota tariffs do not prevent imports.

- Assurance that dairy and other food processors will continue to have unrestricted access to imported milk and dairy products used to manufacture food products for export.

6.0 Conclusions

In conclusion, I contend that it is possible for Canada to agree to something more than an insignificant reduction in over quota tariffs without destroying the fundamental elements that are common to all supply managed sectors, i.e. production controls and single desk marketing. I further suggest that it should be possible to develop an adjustment package which will facilitate a smooth adoption of the likely Doha Round results.

Unfortunately, there is a real risk that the dairy farmer leadership will prefer, as they did in the Uruguay Round, to delay until the very last moment acknowledging the realities of the negotiations. This would be very unfortunate. Delaying discussion of how to adapt until after the end of negotiations in late 2006 or early 2007 will only make any necessary changes more difficult and more costly. Delay will marginalize Canada from the end-game 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 sized and smaller countries being the last to get on-board usually means having to accept with little, or more likely no change 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 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 others for their sensitive products, for example, sugar in the United States, sugar and dairy in the European Union, and rice in Japan or Korea. It is clear that Canada will have to open its market for sensitive products to the same extent as other developed countries – no more, but certainly no less. 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 but time is fast running out. Stakeholders need to start a dialogue now – not 12 months from now.