Regime Change in Canadian Dairy Policy: A Cautionary Tale

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The Issue

2018 is turning out to be a time of tension, and potentially high drama in Canadian trade policy. There has been a rapid escalation of tensions into what may prove to be a trade war between the US and Canada (and between the US and others) over the US use of Section 232 tariffs, while Canada is in negotiations with the US and Mexico on renewal of NAFTA (since July 2017). Consistent with the Mexican presidential elections and US Congressional mid-term elections, NAFTA renewal negotiations appear to have fallen back into stock taking and planning. However, this has not impacted the rhetoric, and the US continues to threaten further escalation under Section 232 tariffs, or otherwise. While mostly directed at China, further escalation may be seen as a tool through which to leverage NAFTA renegotiation with Canada.

In this regard, the US has particularly directed its comments at Canadian dairy. US President Trump has decried 270 percent tariffs he says that Canada charges on dairy imports from the US. More recently, US Undersecretary for Agricultural Trade Ted McKinney was quoted as saying
"You [Canada]… decided to dump dried milk powder on the world market at half to two-thirds of world price … Not fair. Not fair"[1]

This could present the motivation for Canada to accommodate US demands for major changes in Canadian dairy policy. Reportedly, the US has requested the removal of milk Class 7, along with a phase out of supply management over 10 years. The Government of Canada has expressed its commitment to defend supply management; yet, it cannot ignore the high stakes to other segments in the event of an impasse over Canadian dairy policy. Moreover, the need to placate and constantly defend dairy policy in foreign relations is an obligation for the federal government; the 11th hour short strokes toward a renegotiated NAFTA agreement could provide just the crisis that could release the government from this burden. Concessions to the US on dairy could be seen by some as an opportunity to provide President Trump with a quick win.

However plausible, this would be naïve. The dichotomy portrayed between a protected dairy market with a coddled dairy industry versus US free traders south of the border and elsewhere is a false one, and would leave Canada exposed to competition with others who are anything but free traders. The real question then is what Canada's fallback position is if it were to make major concessions that weakened or somehow eliminated supply management.

The purpose of this policy note is to consider the context and implications of Canada making major changes in its dairy policy as an element in concluding a new NAFTA agreement.

What the US Wants

Media outlets reported on requests that the US had made of Canada with respect to dairy under NAFTA renegotiation round in mid-October 2017. The requests made of Canada reported at that time were the following:

[1] https://nationalpost.com/news/politics/canadas-dairy-industry-is-stumbling-block-to-nafta-deal-not-trump-or-mexico-top-u-s-trade-official

- Increased transparency regarding the operation of milk supply management
- Elimination of milk Class 3(d), Class 5, and Class 7
- US prior agreement to any changes in milk supply management
- A phase-out of supply management through elimination of supply control/quotas in dairy, poultry, and eggs within 10 years
- Increased dairy market access of 5% per year leading to open access for the US within 10 years
- Apparently more specific US requests regarding Canadian dairy market access, to be clarified. One media outlet reported that the US had requested access for 400,000 tonnes of fluid milk (vs. 55,000 tonnes agreed to in the original TPP agreement).

These requests from the US should be interpreted with some caution, as they were made prior to the Senate confirmation of the lead US agricultural trade negotiator; some requests were rejected out of hand by Canada as unworkable. However, with Greg Doud now confirmed as US lead agricultural trade negotiator it can be anticipated that the US will now press its demands further, and press for a Canadian response.

Canada's Agenda

Canada's agenda with regard to the dairy industry appears essentially defensive- give up as little as possible. However, the reality is somewhat more nuanced. The operation of milk supply management is impacted by a number of factors inherently linked to trade policy:
- Structural surplus of skim milk
- Canada's WTO obligations on export subsidies, and associated caps on dairy exports
- Nairobi Declaration on export subsidies
- Market access already provided for dairy products by Canada in recent trade agreements

In establishing a quota to match production with Canada's butterfat requirements, the associated production of skim milk significantly exceeds domestic demand. The persistent problem of domestic skim surpluses, coupled with WTO limits on subsidized exports (and elimination by January 2021 under the Nairobi Declaration) has generated protracted problems in the past in getting the market to clear in skim milk. Canada inherently hits its cap on subsidized exports of skim milk powder on the basis of outlay. This has pushed Canada toward other means of skim surplus removal, such as the marketing of skim milk powder in the feed market at exceptionally low prices, and periodic waste dumping of surplus product that had no market.

Canada views exports of skim product made from Class 7 milk as non-subsidized and hence outside the WTO limitation on subsidized exports. The Nairobi Declaration, made as part of the WTO-Doha Round in late 2015, commits countries to eliminate subsidized exports. As a signatory, Canada was given a reprieve to fully comply, with certain conditions, until 2021. However, after 2020 Canada will be entirely out of the market for dairy exports, with the exception of products it declares as free of subsidy. At this time, the only products that would satisfy this condition are skim products made from milk in Class 7.

Class 7 was established as a mechanism to allow the Canadian skim market to clear, by providing for pricing at a competitive world price, in either domestic or export markets. Without this mechanism, and with Canada bound by subsidized export caps on products made from skim milk- with subsidized exports soon to be eliminated entirely- the structural surplus of skim had reached the point that it could overwhelm the supply management system. Absent Class 7, the supply management system has evolved to a point at which it has flipped from being bound by a butterfat quota to being *de facto* bound by an implicit skim quota. If Class 7 were suddenly removed, the implication would be a mass reduction in the butterfat quota triggered by the need to bring the skim market into balance based largely (and completely- as of 2021) on the domestic market. A major reduction in production quota and complete loss of any access to exports would immediately sour the climate for processing investment, and strand assets recently invested in dairy processing. Producer pricing of skim would deteriorate.

Thus, Class 7 is a critical matter for Canada, as it enables market clearing in the skim market, and provides the prospect of market access for dairy exports beyond 2020. Without this mechanism, it is unclear how the supply management element of Canadian dairy policy could continue to function, as it would involve some combination of massive quota cuts to facilitate the skim market clearing in Canada coupled with major butter imports, or large-scale dumping of skim milk.

So Class 7 is much more than a trade irritant identified by the US, which could be closed off through a NAFTA trade concession, with the system re-setting back to pre-Class 7 levels. There is no point of traction that would allow the system to revert to a stable past. At current levels of butterfat demand, the removal of Class 7 would begin the process of sequential butterfat quota reductions that could lead to collapse in the system.

Another aspect constraining the Canadian agenda is that Canada has already committed itself to major increases in domestic market access for cheese. Under the Comprehensive Economic and Trade Agreement (CETA) with the EU, Canada allowed for increased TRQ access granted to the EU of almost 18,000 tonnes of cheese, phased in by 2022. This compares with pre-CETA TRQ access of 20,411 tonnes, so it represents a sharp increase. Secondly, Canada committed itself to dairy market access concessions amounting to approximately 3.25% of the Canadian market under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This access will be phased in, but it is generally front-loaded such that its effects will be felt shortly after its coming into force.

Canada's default position would likely be to offer increased market access to the US in renegotiation of NAFTA; but with so much dairy market access already committed, Canada is constrained in doing so.

Canadian Dairy Policy in Context

Canadian dairy policy has much in common with dairy policy in the US.

- Both Canada and the US operate end-use classified pricing systems.
- Both Canada and the US have mandatory price/revenue pooling across the end use classes.
- Both Canada and the US employ a markup on fluid end-use classes which has the effect of supporting the blend price paid to farmers relative to the class prices for milk used in dairy manufacturing. In both countries, the fluid milk market is essentially mature, but also highly price inelastic- meaning that fluid milk price increases do not reduce volume demanded by much, but add significant revenues to the pool.
- Both Canada and the US maintain significant barriers to imports. Canada uses a combination of tariff-rate quotas (TRQs) and very high over-quota ad valorem (percentage) tariffs. The US employs these in combination with special safeguards. While the matter is complex, both countries' border measures have sharply limited dairy imports in excess of TRQ levels.

The major differentiating points of Canadian and US dairy policy are that (1) Canada limits the milk supply (and thus the supply response to pooling) with quotas, while the US does not, and (2) Canada is bound by subsidized export caps- with subsidized exports soon to be eliminated entirely.

More generally, the world dairy markets are some of the most distorted markets in agricultural trade. All of the major dairy exporters have been suffering from over production, with stocks building in the EU (powders, cheese) and the US (cheese). World prices of most dairy products have languished at relatively low levels since 2015.

Alternative policy instruments intended to stabilize the dairy industry appear not to be working. Daily dairy industry news throughout 2017-18 has reported on malaise in the dairy industries in the US, EU, New Zealand, and Australia, with producers exiting the industry due to soft market conditions.

The US is in the late stages of its 2018 Farm Bill process, with a House Farm Bill just passed that stands to replace the Margin Protection Program with a more robust Dairy Risk Management Program[2]. The EU removed its supply controls in 2015; in the intervening period production in many member states has increased, stock holding as a means to support prices has increased, and the EU is searching for some way to bring the milk supply back under control. A recent EU Parliamentary study found that 70 percent or more of the income for EU dairy farmers comes from the "whole farm payment", not from dairy farming, allowing exports at far below remunerative prices for dairy producers[3]. New Zealand pricing and exports are controlled almost entirely by Fonterra. The issue of Fonterra acting as a *de facto* state trading enterprise is an ongoing irritant raised by the US.

These issues are not Canadian issues, and Canada cannot be a significant contributor to them- they exist among much larger dairy producing countries that do not regulate or limit output and/or actively support their dairy industries, and would have existed regardless of Canada.

Implications for the Evolving Canadian Position

The Canadian position is not as precarious as the reported US demands, or the "with-or-without" supply management contrast would make it appear. In particular, with the observation that developed countries broadly distort their dairy markets, and by extension the export market, it would be irresponsible for Canada to simply capitulate to the US demands. Doing so would simply put Canada on a highly tilted playing field in favour of others, and open it to the economic malaise they have been engulfed in.

At this critical juncture, Canada should consider- if not milk supply management, then what? The newspaper op-ed writers demanding that supply management be ended to "stop the ripoff" completely fail to address this problem. To the extent that the US presents itself as a free-trader, its institutions and trade barriers belie this view. In fact, the US and Canadian systems are closely analogous in many ways, with Class 7 representing a shift in the Canadian system to be more like the US system.

There is also a certain irony in the US demands of Canada on dairy. By requesting a phase out of supply management (or removal of Class 7, which will cause the drowning of the milk supply management system

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[2] https://agriculture.house.gov/uploadedfiles/agriculture_and_nutrition_act_of_2018.pdf

[3] Ihle, Rico, Liesbeth Dries, Roel Jongeneel, Thomas Venus, Justus Wesseler, 2017. RESEARCH FOR AGRI COMMITTEE - THE EU CATTLE SECTOR: CHALLENGES AND OPPORTUNITIES - MILK AND MEAT. Study for the European Parliament. IP/B/AGRI/IC/2016-014. February 2017. Available at: http://www.europarl.europa.eu/RegData/etudes/STUD/2017/585911/IPOL_STU(2017)585911_EN.pdf

and ultimately generate the same result), the US will push Canada toward a dairy policy even more like the their own, to a much greater degree and faster than would occur otherwise. Left without effective supply controls, periodic milk surpluses, lower prices, and increased exports can be expected in Canada, requiring deficiency payments or some other form of stabilization assistance. But if this were to occur, Canada could expect the immediate threat of countervail or other trade action from the US (and perhaps others) in response. Thus the irony, and a form of entrapment- in the US request for Canada to conform with even more of a US-style dairy policy, Canada would open itself to the threat of future attack from the US in the form of a trade dispute.

Moreover, in an environment such as this, Canada could become more of an international export competitor. As Bozic has recently argued,[4] the US "should be careful what it asks for". Canada is a rival export supplier of grain-fed beef to the US, based largely on feed cost advantages; with both the US and Canada operating a grain-fed dairy industry, why would the dairy situation be that much different?

Rather, the Canadian position in NAFTA could consider the ongoing need for progressive dairy policy changes, within a supply managed framework. This includes consideration of how Canada will operate in the post-2020 environment without market access for subsidized exports, and how the supply managed system can be reformed to facilitate non-subsidized exports.

In a typical year, a high proportion of Canada's most distorting domestic support notified to the WTO is market price support for dairy. It must be anticipated that in the future, the agenda for reductions in domestic support will require agreement from WTO members, notably developed countries like Canada, to further reduce their most distorting support. Shifts in Canadian dairy policy can be made in advance to blunt the pain of adjustments from such a future agreement.

Canada needs an environment that facilitates ongoing investment in dairy farms and dairy processing- these can be facilitated through prudent policy adjustments that make milk supply management more market and growth oriented.

Finally, the significance of Class 7 in the current state of Canada's dairy policy and milk supply management must be underscored. Class 7 simply cannot be carved out, with the rest of the system somehow remaining intact. The implications of Class 7 concession are of major reductions in producers' milk quotas, an effective freeze on future dairy processing investments, and threat to some existing processing investments. A robust future supply management system cannot continue without it.

Milk production and processing of milk generate economic activity, not supply management itself. However, failures in the supply management system that lead to reductions in quotas- whether gradual, or sudden and catastrophic- are losses in economic activity.

The risk that Canada may face is that its desire to protect the dairy industry creates an impasse in NAFTA talks, and when left with most other issues already settled, is forced to capitulate to many of the US demands on Canadian dairy to finalize the agreement. In doing so, it would fall victim to the art of the deal.

But this is really a false dichotomy. It appears as though relatively few issues have actually been resolved. Capitulation on supply management or concession of Class 7 will not save NAFTA. The difficult and much more important issues remain like Chapter 19 dispute resolution, the sunset clause,

[4] http://www.thebullvine.com/news/professor-blames-full-fat-trend-for-dairy-trade-spat/#

issues of origin in the automotive sector, and Chapter 11 investor-state dispute resolution.

Without taking on vastly greater fiscal liability and industry investment losses, Canada has no good alternative to milk supply management- and this needs to be clearly understood. In so doing, it should equally be realized that milk supply management is robust and is capable of significant evolution, needed to address the known, sobering challenges it already faces.