

Special Article

Canada's Subsidized Dairy Exports: The Issue of WTO Compliance

A World Trade Organization (WTO) compliance panel ruled against Canada in July in a dispute over the country's subsidized dairy exports—the first case before a WTO panel involving export subsidy provisions under the WTO-administered Agreement on Agriculture. Canada has already announced its intention to appeal the decision.

Under the Agreement on Agriculture, countries that employed agricultural export subsidies agreed to hold the volume of subsidized exports to specific levels. If Canada loses its appeal, a WTO arbitrator will determine the annual level of harm to the economies of the U.S. and New Zealand caused by the subsidized exports. Following that determination, both countries could increase tariffs on Canadian imports.

The panel's ruling was the latest development in a longstanding dispute. The ruling represents the third time since May 1999 that the WTO, in response to complaints from the U.S. and New Zealand, has found Canada's dairy export subsidies to be inconsistent with its WTO commitments.

Changes in Canadian Dairy Policy

The Canadian dairy sector has functioned under a complex supply management framework since the early 1970s. This framework consists of four elements: domestic production and marketing controls, import controls, administered pricing, and direct government payments to producers. Direct government payments are being gradually reduced and will be eliminated in 2002 in favor of higher administered prices.

Domestic production and marketing controls are intended to match supply with estimated demand at the administered price. Milk production is classified as either fluid (for table milk and cream) or industrial (for butter, cheese, milk powders, ice cream, yogurt, etc.). Fluid milk is generally consumed within the producing province, while industrial milk products move across provincial boundaries or are exported. Provincial marketing boards govern the production and marketing of fluid milk within their own borders. Marketing of industrial milk, on the other hand, is carried out under concurrent Federal and Provincial legislation.

Each year, the Canadian Milk Supply Management Committee forecasts demand for industrial milk and sets the national production target or Market Sharing Quota (MSQ). It then assigns a portion of the MSQ to each province based largely on historical shares. In contrast, each province sets its own production target or quota for fluid milk based on local demand. The two quotas—industrial and fluid—are then allocated by each provincial marketing board to its respective producers, according to its own policies and regional pooling agreements. Dairy quotas, which were initially distributed at no cost, are now auctioned on the



Agriculture and Agri-Food Canada, www.agr.gc.ca/science/

open market and have become an extremely valuable asset for producers.

Dairy imports are restricted through a system of tariff-rate quotas (TRQs). These allow imports of up to 5 percent of total domestic consumption to enter Canada at a low duty. Imports above these limits are subject to prohibitively high duties: as much as 299 percent for butter, 246 percent for cheese, and 202 percent for skim milk powder. These compare with duty levels in the U.S. ranging from 42 to 69 percent.

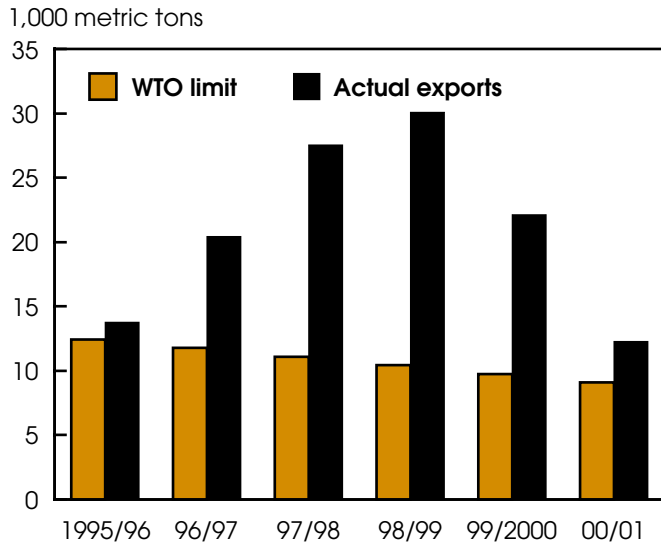
Milk production quotas combined with import restrictions allow Canada to maintain a protected domestic market and a system of administered prices. For industrial milk, the Canadian Dairy Commission (CDC) annually sets a target price based on cost-of-production surveys and other market considerations. The CDC supports the target price when necessary by purchasing butter and skim milk powder. Actual prices paid for industrial milk by processors are determined by provincial agreements, with reference to the target price, and depend on end use. The price paid by processors for fluid milk is generally higher than the price for industrial milk. Fluid milk prices are based on provincial cost-of-production estimates, subject to adjustments negotiated between marketing boards and processors to reflect market factors in addition to production costs.

Following implementation of the Agreement on Agriculture in 1995, Canada was not expected to increase dairy exports since its domestic prices were above world prices and its WTO commitments constrained the quantity of dairy products it could export with subsidies. However, in August 1995, Canada adjusted its national dairy policy by replacing export levies collected from producers with a new permit system that allowed Canadian

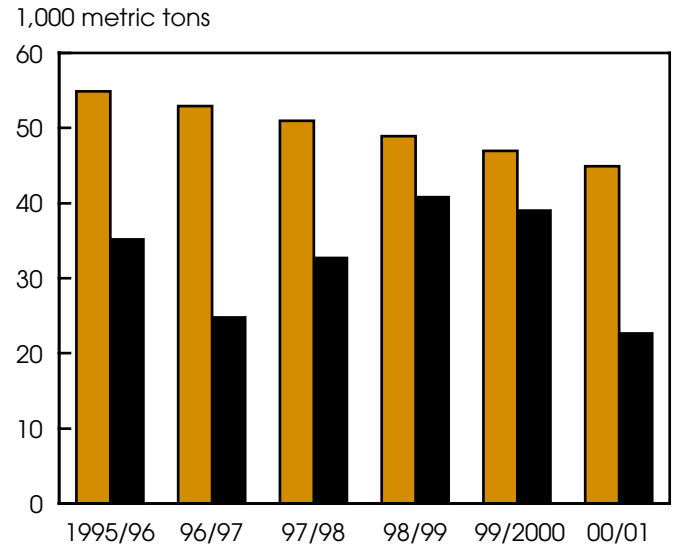
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Canadian Dairy Exports Frequently Exceeded WTO Limits for Subsidized Sales Since 1995/96

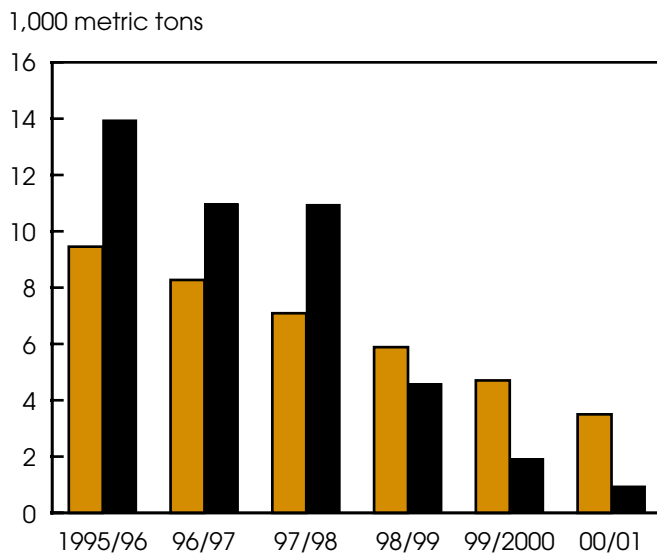
Cheese exports exceeded WTO limits every year



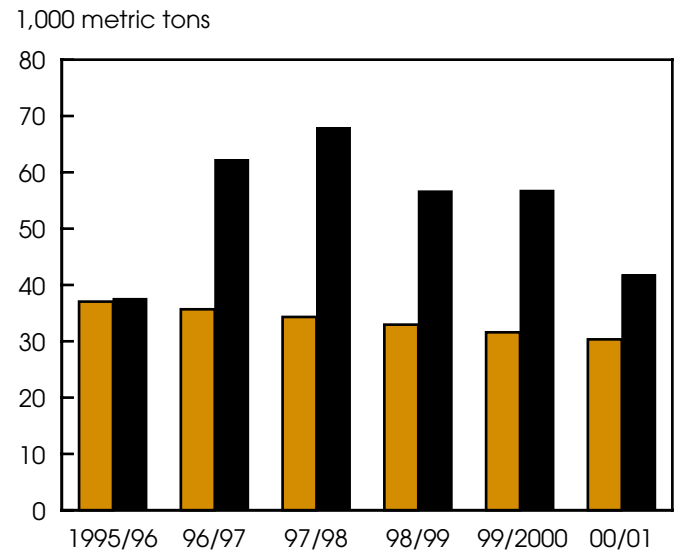
Skim milk powder exports have consistently been below WTO limits



Butter exports have been below WTO limits since 1998/99



Exports of other milk products exceeded WTO limits every year



August to July marketing year. Actual exports in 2000/01 are for three quarters only.
Sources: WTO Panel Report (WT/DS103/R, WT/DS113/R) and Statistics Canada.
Economic Research Service, USDA

processors to purchase surplus milk at discount for the exclusive use of manufacturing dairy products for export. Canada claimed the discount sales did not provide export subsidies and thus were acceptable under the Agreement on Agriculture. The U.S., joined by New Zealand, disagreed.

Canada's permit system provided for pricing five classes of milk based on processors' end use of the milk. Classes 1-4 covered milk used exclusively in the domestic market. Class 5 contained five "Special Milk Classes" (SMC). SMC 5(a) to 5(c) comprised milk in dairy products used as ingredients in other products mostly sold domestically. SMC 5(d) was primarily for milk used in dairy product exports to traditional markets. These traditional

Canada's Dairy Industry at a Glance

In the 1999/2000 marketing year (August to July), Canada had 20,600 dairy farms, producing 17.8 billion pounds of milk, compared with 84,260 farms producing 17.1 billion pounds in 1974/75. The average Canadian dairy farm has 54 cows, compared with 82 in the U.S.

Total Canadian milk production in 1999/2000 was down about 1 percent from the previous year. About 40 percent of milk production, or 7.1 billion pounds, was processed into table milk and cream, an increase of almost 1 percent over the previous year. The remaining 60 percent, or 10.7 billion pounds, was used in the production of dairy products, which decreased about 2.3 percent.

Processing at 270 plants across Canada resulted in \$8.5 billion (all currency in Canadian dollars: US\$1 = Can\$1.5) of processed dairy products in 1999. An estimated \$365 million of this production was exported, down from the 1998 peak of \$414 million. Exports in 2000 fell again to an estimated \$285 million.

Per capita milk consumption in Canada averaged 197 pounds in 1999, down from 215 pounds in 1990. Lower fat varieties such as skim and 1-percent milk continued to gain market share, accounting for 28.6 percent of all milk consumed in 1999, compared with 12.8 percent in 1990. Butter consumption closed the decade at 6.2 pounds per person, down from 11.8 pounds in 1990 but above the record-low 5.7 pounds in

1997. Ice cream consumption also decreased from 26.0 pounds to 22.6 pounds during the same period.

Canadian consumers did not abandon higher fat products entirely. Cheese consumption closed the decade at 23.8 lbs. per person, up 8 percent from 1990. Cream also enjoyed a surge in popularity, as consumption in 1999 reached 13.6 lbs. per person, up from 11.8 lbs. in 1990.

Dairy farming is the third-largest source of revenue in the Canadian agricultural sector, behind grains and red meats. In general, profitability of Canadian dairy farms was higher than for farms in other commodity sectors, with an operating margin of \$0.26 per dollar of revenue, up 1.1 cent from 1998. Dairy farm cash receipts increased about 2.6 percent in 2000, reaching \$4 billion, breaking the record set in the previous year. (In contrast, crop producers' receipts fell in 2000 for the third consecutive year, hitting a 6-year low.)

While Canadian dairy farmers have benefited from the comparative price and income stability associated with supply management, a portion of these gains has been capitalized in the value of the quota. As a result, the benefits of supply management tend to be greatest for those who were producing at the time the quotas were introduced in the early 1970s. During 2000, the market-clearing price for quota in Quebec (Canada's leading milk-producing province) ranged between \$24,000 and \$27,450 for the right to sell one kg (2.2 lbs.) of butterfat daily on the domestic market.

exports were included in determining national production quotas. SMC 5(e) was surplus milk not needed domestically and available for use in dairy products for export above the quantities destined for traditional markets.

The prices of 5(d) and 5(e) were negotiated between the CDC and processors on a transaction-by-transaction basis. Revenues from within-quota milk used for export were pooled across provinces with revenue from domestic sales. However, returns for milk produced in excess of quota and sold through 5(e) at discounted prices were not pooled with domestic market returns before being paid to individual producers.

Under the Agreement on Agriculture, Canada, like the U.S. and the European Union, had agreed to limit its subsidized exports. However, the permit system led to rapid expansion of exports of some dairy products, in excess of Canada's export subsidy limits. Butter exports grew from less than 1,000 metric tons in 1994/95 (August to July marketing year) to nearly 14,000 tons in 1995/96, the first year under the new program. In 1996/97 and 1997/98, butter exports averaged about 11,000 tons. Cheese exports increased steadily from about 12,000 tons in 1994/95 to 30,000 tons in 1998/99. Unlike butter and cheese, skim milk powder exports did not increase, nor did they exceed the permitted subsidy limits. Exports of other milk products from 1995/96 to 1999/2000 were above the agreed-to limits. For 2000/01, Canada

is limited to export subsidies on 3,500 tons of butter, 9,076 tons of cheese, 44,953 tons of skim milk powder, and 30,282 tons of other milk products.

What Constitutes an Export Subsidy?

In February 1998, after unsuccessful discussions with Canada to resolve the subsidy issue, the U.S. and New Zealand requested that a WTO compliance panel investigate Canada's dairy export practices. The U.S. maintained that Canada's system of special milk classes, which provided surplus milk at discounted prices to exporters, constituted an export subsidy and a violation of Canada's commitments under the Agreement on Agriculture. The U.S. also requested WTO review of Canada's restriction on commercial imports under its tariff-rate quota of 64,500 tons of fluid milk, claiming this also was a violation of its WTO commitment. Canada asserted that cross-border shoppers were already bringing in that amount, and that the commitment was thus being met without commercial imports.

In May 1999, a WTO compliance panel found that SMC 5(d) and 5(e) were financed by virtue of government action and constituted export subsidies within the Agreement on Agriculture definition. The panel noted the significant government involvement in the provision of milk to dairy product exporters at prices substantially below the levels otherwise available in Canada.

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Economics of Supply Management & Two-Tiered Price Schemes

In addition to being administratively complex, supply management tends to decrease incentives for farmers to improve technology and expand scale in order to reduce costs. It prevents efficient distribution of production and processing across countries, or across regions within a country. By introducing a wedge between domestic and world prices, supply management raises consumer prices, while requiring import restrictions to prevent an influx of lower priced foreign goods. Were it not for production quotas, surplus stocks would likely accumulate in the face of high domestic price supports. Occasional and inevitable surpluses still occur, but under pure supply management these are controlled through quota or stock adjustments or by subsidizing exports.

When a country is a net importer at the world price, supply management results in trade distortion. If supply management imposes no controls over the amount farmers produce, and if over-quota production is exported at a lower price, trade distortion increases. High domestic prices from supply management distort trade both by reducing consumption and providing some producers a solid base on which to expand output. Trade distortion continues whether or not the government is directly involved in allocating product between the domestic and export markets.

While producers played an important role in the provincial marketing boards, the panel found the boards acted under the explicit authority delegated to them by either the Federal or a provincial government. Accordingly, the panel presumed the boards to be an "agency" of one or more of Canada's governments. The panel also found that Canada's restriction on access to its tariff quota on fluid milk was inconsistent with the Agreement on Agriculture and recommended Canada open the quota to commercial imports.

Canada disputed the conclusions of the compliance panel and sought an Appellate Body review of the findings. The Appellate Body upheld the panel's determination that SMC 5(d) and 5(e) were export subsidies and thus contributed to a violation of Canada's export subsidy commitments. However, the Appellate Body overruled the panel's finding in the case of fluid milk and allowed Canada to continue restricting commercial imports of fluid milk in light of cross-border purchases by Canadian consumers. In October 1999, the WTO Dispute Settlement Body (DSB) adopted the Appellate Body report and requested Canada to bring its export subsidy practices into compliance with its WTO obligations.

Canada's Export Practices Remain in Dispute

After the Appellate Body ruling in 1999, the Canadian government consulted with its dairy industry and explored alternatives for complying with the WTO ruling. Some members of the industry interpreted the WTO decision as a narrow one that precluded government involvement in the export of dairy products,

How do two-tiered price schemes—based on parallel markets for domestic consumption and export at differentiated prices—result in expanded output? Under supply management, there will always be some producers with unused capacity. When high domestic prices cover producers' average total cost, those with the capacity to produce in excess of their quota limits will expand output as long as the export price covers the extra, or marginal, cost of additional production (primarily feed). If producers were not receiving sufficient revenue from domestic sales to cover their fixed costs (land, buildings, equipment, animals, etc.), the export price alone would have to cover the producer's average total cost (both fixed and variable costs) or eventually producers would go out of business.

Producers who can maximize profits by selling excess production into the commercial export market would probably be producing not for export but for the domestic returns they receive from the government policy of supply management. While some producers with quota and excess production capacity may view the export market as an attractive source of additional profits, it is unlikely to be attractive to producers who would have to take on additional fixed costs, such as a building, in order to increase production for export.

but permitted a two-tiered price system of higher milk prices for domestic use and discounted prices for export.

By August 2000, Canada began implementing revised procedures which it felt would comply with the panel's recommendations. While the revised procedures differed in many ways from the old, they still provided milk at discounted prices to processors, contingent on the verified export of the manufactured product.

Under the revised system, Canada retained and continued to export dairy products through SMC 5(d), while replacing the SMC 5(e) export subsidies with a procedure that encourages exporters to contract directly with producers. In several provinces, including Ontario and Quebec, an "auction" system was organized, administered by third-party companies appointed by the marketing boards. Exporters or processors post proposals on an electronic bulletin board with terms such as price, volume, and contract period. Producers bid on these contracts to supply milk. In British Columbia, Alberta, and Saskatchewan, provincial marketing boards provide processors or exporters with names of producers with whom they can negotiate directly for surplus milk.

In February 2001, Canada informed the DSB of its compliance with WTO rules. Shortly thereafter, the U.S. and New Zealand challenged Canada's revised system on the grounds that the changes did not go far enough in bringing its export subsidies into compliance with its WTO obligations. The U.S. maintained that Canada had simply replaced the SMC 5(e) export subsidies with a new export subsidy program offering discounted milk to

Canadian Dairy Production Is Small Compared with U.S., but Exports Are Important

	U.S.	Canada
Dairy cows (millions)	9.2	1.1
Dairy farms (number)	111,000	20,600
Average size (cows/farm)	82	54
Milk production (billion lbs.)	162.7	17.8
Used in manufacturing (%)	63	60
Used for fluid milk and other (%)	37	40
Products manufactured:		
Butter (million lbs.)	1,275	195
Cheese (million lbs.)	7,944	926
Consumption per capita:		
Fluid milk (lbs.)	218.0	197.0
Butter (lbs.)	4.8	6.2
Cheese (lbs.)	29.8	23.8
Exports:		
Butter (metric tons)	3,208	1,933
Cheese (metric tons)	38,341	22,110

1999 data. Cheese numbers exclude cottage and processed.
Sources: USDA, Agricultural Statistics 2001; Statistics Canada.
Economic Research Service, USDA

exporters. The new program continued to provide a subsidy to exporters roughly equal to the difference between the domestic market price and the discounted price.

In February 2001, the U.S. and New Zealand requested that a WTO compliance panel be convened to rule on the issue. Both countries also requested authorization to increase tariffs on Canadian agricultural products if the panel determines that Canada has not complied. Each agreed, however, to hold off on tariff increases until a WTO arbitrator confirms the level of trade harm suffered. Both the U.S. and New Zealand assert that their trade has been impaired by up to \$35 million annually. In July 2001, the compliance panel determined that Canada is subsidizing dairy exports at levels exceeding its committed-to limits. Canada has indicated its intention to appeal the panel's decision.

What the Future Holds

The next step in this longstanding dispute will involve Canada's appeal of the compliance panel's ruling. Canada will have 60 days from July 11 to prepare its appeal. The appeal, however, could delay the final outcome of the case until early 2002. While a ruling on the appeal is expected by November, a finding against Canada will have to be followed by a WTO arbitrator ruling on the level of harm suffered by each complainant's economy. The U.S. and New Zealand could then increase tariffs on Canadian imports until such time as the WTO confirms that Canada has made its dairy exports compliant with its WTO commitments.

For Canada's milk producers and dairy processors, the export market is crucial for expanding production and sales. With initiation of the Agreement on Agriculture, the Canadian dairy industry found itself in a potential supply/demand squeeze. Imports were set to increase as a result of expanding tariff-rate quotas, while the ability to subsidize exports was being curtailed. At the same time, the domestic market for dairy products was largely mature, with little growth expected. Unless the dairy industry could succeed in increasing "nonsubsidized" exports, production might have to be reduced or stocks left to accumulate. Considered essential was a two-tier price scheme that distinguishes between domestic and export markets, allowing milk producers to expand production or dispose of surplus milk without having to purchase additional quota, while permitting processors to compete on the world market.

The dairy panel case is significant not only as the first case brought before a WTO panel involving provisions of the Agreement on Agriculture related to export subsidies, but also because of its potential implications beyond trade in dairy products. With discussions underway in the WTO on further disciplining government policies regulating agricultural trade, the U.S. and New Zealand did not want a perceived circumvention of already existing disciplines to go unchallenged. Perhaps more importantly, if Canada loses its appeal, this case could discourage other countries from fashioning identical policies, while leaving countries with similar policies vulnerable to future WTO challenges. **AO**

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The WTO panel reports can be found at www.wto.org/english/tratop_e/dispu_e/distab_e.htm.

For more information on the WTO Agreement on Agriculture, see the **WTO briefing room** on the Economic Research Service website at www.ers.usda.gov/briefing/WTO

Featured on the WTO briefing room: Agricultural Policy Reform in the WTO—The Road Ahead
—the full report presenting ERS analysis of reform options for export subsidies and other trade-distorting policies