Canadian Dairy Export Subsidies and the WTO Appellate Decision: Dairy Market Expansion in Limbo

A Special Report

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SPECIAL REPORT

Canadian Dairy Export Subsidies and the WTO Appellate Decision: Dairy Market Expansion in Limbo

The dairy industry in Canada was turned on its ear by the release of the WTO decision last fall that Canada's Special Milk Classes constitute an export subsidy. Dairy processors fear the loss of established export markets. At the same time, the decision threatens the role of supply management authorities as the sole marketers of farmers' milk. Will farmers market milk for export directly to processors? What consequences could renewed marketing board involvement in exports have in the international trade arena? The industry is preparing for conflict as it reorients itself in the international market. That conflict is embedded in proposals made by some of the milk marketing agencies and by some processor members of the National Dairy Council (NDCC).

Because of the immediate importance of this case and the issues it spawns, the George Morris Centre is releasing this special report. It addresses the following topics:
- The nature of the challenges to the Special Milk Classes scheme
- The WTO decision
- Implications for the dairy industry
- Marketing boards' proposal for export pricing reform
- NDCC proposal for export pricing reform
- Evaluation of the alternatives

Challenges to Canada's Export Milk Pricing System

In late 1997, the United States and New Zealand initiated a challenge of Canada's milk classification scheme before the World Trade Organization (WTO) Dispute Settlement Board (DSB). The US and New Zealand claimed that the Special Milk Classes scheme operated by the Canadian Dairy Commission (CDC) and provincial marketing boards had sufficient involvement by federal and provincial governments to constitute "government action" under the 1994 Agreement on Agriculture. The US and New Zealand also claimed that under the Canadian milk pricing scheme, classes 5(d) and 5(e) used to price milk for the export market constituted an export subsidy.

Specifically, the US and New Zealand claimed that classes 5(d) and (e) embody a "payment-in-kind" to processors in the form of below cost milk, and that class 5 (d) and (e) milk is priced to processors at a lower price than any alternative sources, satisfying the definition of an export subsidy under Article 9.1(a) of the Agreement on Agriculture. The US and New Zealand also alleged that milk sold under classes 5(d) and 5(e) constituted a payment in kind financed by virtue of government action, and thus an export subsidy under Article 9.1(c). Pursuant to the claims that the Special Milk Classes scheme was an export subsidy, the US and New Zealand claimed that Canada had violated provisions of the Agreement on Agriculture relating to the use of export subsidies. The complainants argued that through the Special Milk Classes scheme,

- Canada exceeded permitted levels of subsidized exports (contrary to Article 3.3),

- Canada exceeded subsidized exports on cheese, butter, and other dairy products (contrary to Article 10.1),
- Canada undertook new export subsidies (contrary to Article 8).

The essential economic content of the challenge relates to pooling of milk over domestic and export milk classes. The complainants identified the Special Milk Classes scheme as an implicit export subsidy because it uses revenue from higher valued domestic milk classes (Class 1-4) as a means to subsidize below-cost sales of milk to the export market (Class 5 (d) and (e)) through class pooling. Because the higher priced domestic market is maintained through the regulatory actions of federal and provincial supply management agencies, the Americans and Kiwis alleged that the implicit export subsidy was illegal.

The WTO Decisions

The initial decision on the export subsidy case was released by the DSB in May, 1999. The DSB found that Canada was unable to meet its burden of proof in demonstrating that the Import for Re-export program provided milk for export on equivalent terms as Class 5 (d) and (e). They also found that CDC product sales through Class 5 conferred a guaranteed margin to processors. As such, the DSB found that the Special Milk Classes scheme satisfied the definition of an export subsidy under Article 9.1(a). Because the CDC and provincial marketing boards were either direct government agencies or were under the direct supervision of a government regulatory body, the DSB found that the Special Milk Classes scheme was an export subsidy as defined under Article 9.1(c). With the finding that Class 5(d) and (e) pricing constitutes an export subsidy, the DSB sided with the complainants on their arguments stemming from illegal uses of export subsidies.

Canada appealed the decision in Summer 1999 on the grounds that the DSB was unjustified in declaring the payment-in-kind an export subsidy, and that marketing boards were incorrectly identified as government agencies. In its final decision in October, 1999, the WTO appellate body overturned the previous ruling that the payment-in-kind constitutes a subsidy under Article 9.1(a). However, the appellate body upheld the remaining findings that had been appealed by Canada, including the findings that the CDC and provincial marketing boards are government agencies, and that Special Classes 5(d) and (e) are financed by virtue of government action. It reinterpreted Article 9.1(c) as including payments-in-kind. As a result of this decision, Canada agreed to bring the export milk pricing system into compliance by August 1/2000, with all required legislative changes to be implemented by December 31, 2000.

Implications For the Dairy Industry

The WTO decision has a number of implications for the dairy industry:

- The most immediate impact is a reduction in milk available to processors for export through Class 5(d) and (e). As a consequence of the WTO decision, Canada faces a steep reduction in the volume of cheese, butter, skim milk powder, and other products that can be exported through the existing system. The gravity of the situation is illustrated in the Table 1 below which shows Canada's committed levels of subsidized exports and actual dairy product exports. Under the current marketing system, future exports would have to comply with the WTO mandated levels, which would be a harsh adjustment, particularly in the cheese and other products categories.

- In turn, this means that Canadian dairy processors will be unable to supply export markets that they have in recent years. Exports are of increasing importance to the Canadian dairy industry. Figure 1 below shows that since the Agreement on Agriculture was concluded in 1994, Canadian dairy processors have been successful in expanding export markets for higher valued dairy products. In particular, exports of cheddar and specialty cheeses have grown steadily, while the lower valued butter and processed cheese categories have been relatively flat. These exports are in addition to the SMP exports that control the structural surplus in Canada.

- Apart from Italian and specialty cheeses[1], the Canadian market for processed dairy products is largely mature and bottled milk has been yielding market share to soft drinks in the beverage market for years. Figure 2 below illustrates this- variety cheese is about the only manufactured product showing significant increases in domestic disappearance. Thus, the export market provides the dairy industry with a very important source of growth given that domestic demand is stagnant.

- On the other hand, because of Canada's minimum access commitments for dairy products (negotiated in the Uruguay Round and in bilateral trade agreements), dairy product imports will penetrate the Canadian market to an increasing extent in the future. So, while the dispute decision means that exports will decline, the minimum access commitments mean imports will increase if there is not a pro-active response to the decision.

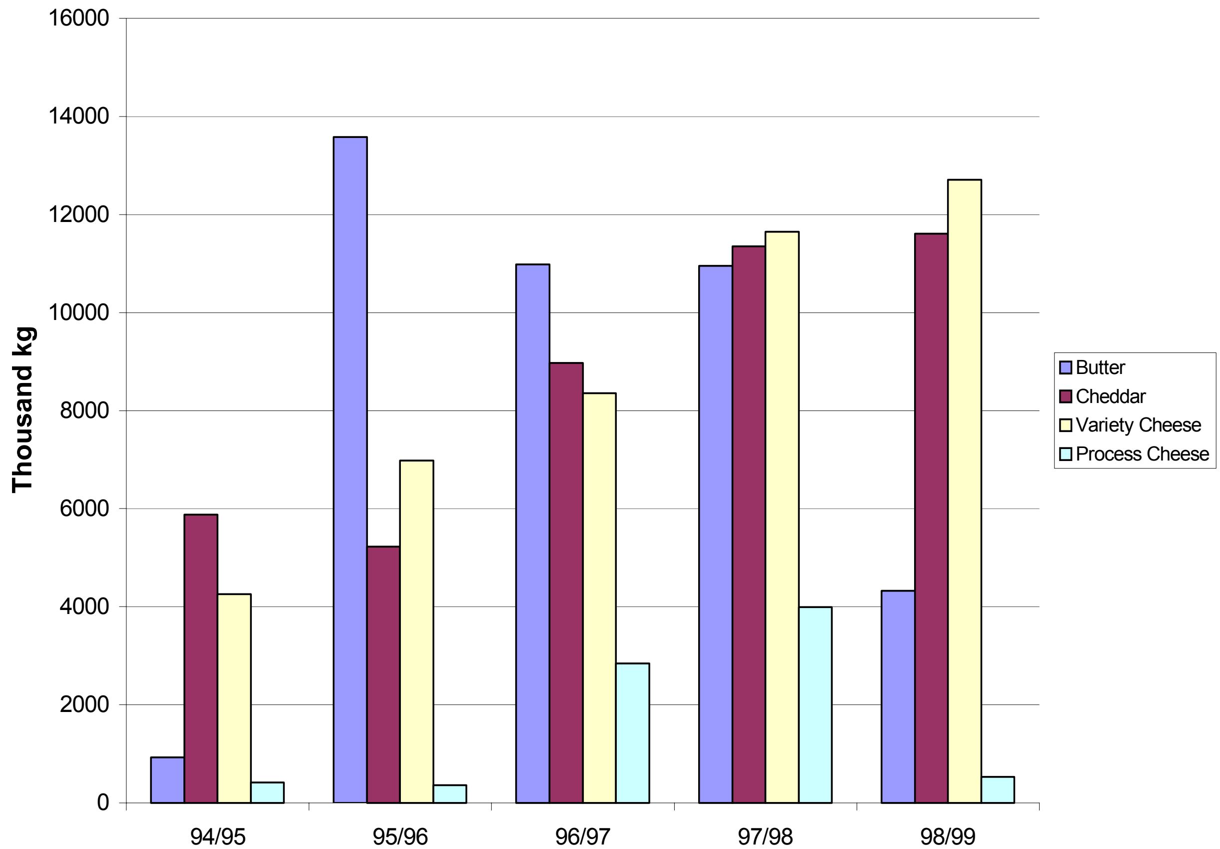
[1]Yogurt (not shown in Figure 2) is also a growing market for the Canadian dairy industry

Table 1
Committed Subsidized Export Levels and Actual Exports, 1995/96 - 2000/01 (thousand kg)

Product	Dairy Year*	WTO Commitment Level**	Actual Exports***
Butter	1995/96	9,464	13,956
	1996/97	8,271	10,987
	1997/98	7,079	10,894
	1998/99	5,886	4,327
	1999/00	4,693	-
	2000/01	3,500	-
Cheese	1995/96	12,448	13,751
	1996/97	11,773	20,409
	1997/98	11,099	27,397
	1998/99	10,424	26,027
	1999/00	9,750	-
	2000/01	9,076	-
Skim Milk Powder	1995/96	54,910	35,252
	1996/97	52,919	24,888
	1997/98	50,927	29,886
	1998/99	48,936	40,728
	1999/00	46,944	-
	2000/01	44,953	-
Other Milk Products	1995/96	36,990	37,573
	1996/97	35,649	62,146
	1997/98	34,307	71,023
	1998/99	32,966	46,630
	1999/00	31,624	-
	2000/01	30,282	-

* Dairy year August1- July 31
** Source: 1994 Agreement on Agriculture, WTO
*** Source: Statistics Canada

Figure 1
Canadian Exports of Selected Dairy Products, 1994/95-1998/99*

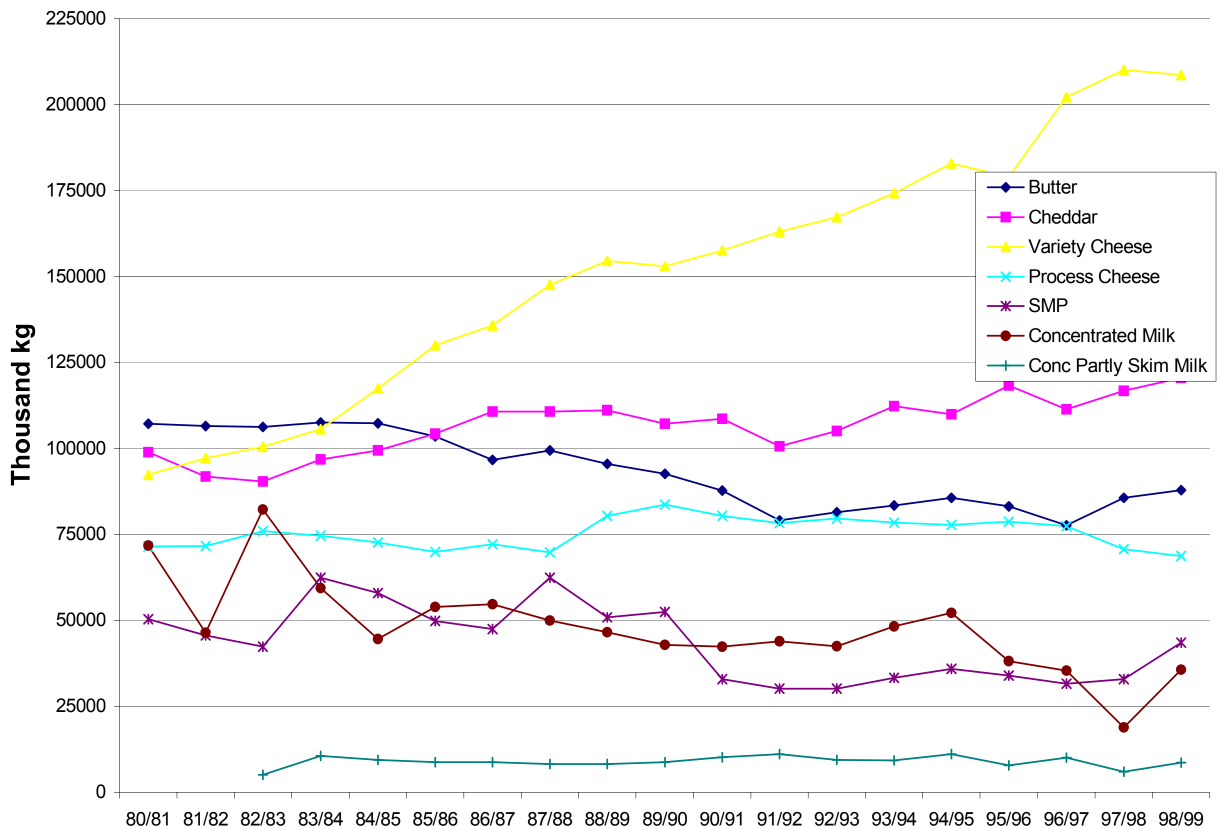


Source: Statistics Canada
* Dairy Year August 1- July 31

- The import effects may be intensified if Canadian tariffs decrease and imports made from much lower cost milk increase as a result of a new WTO Round. Canadian processors will feel intense pressure in the domestic market; unless Canadian processors are successful in establishing export markets abroad, this pressure from imports into the domestic market will shrink the dairy industry.

Pressures on processors mean dairy farmers will inevitably be impacted by the WTO decision. Milk production has been increasing steadily over the last number of years; between 1995 and 1999 Canadian milk production increased about 4%. This increase has been fuelled by generally positive profitability conditions for farmers. The best indication of this is milk quota values, which have increased sharply. Milk production and quota price increases are largely the result of the fact that farmers have a market for their milk. Table 2 below shows that the Special Milk

Figure 2 Domestic Disappearance of Dairy Products, 1980/81 - 1998/99*



Source: Statistics Canada
*Dairy Year August 1- July 31

Classes scheme (Class 5) has been an important part of that market. In particular, the export classes 5 (d) and (e) are the majority of the milk in the special class. Farmers will not be happy if

Table 2 Percentage of Milk Marketed in Special Classes in Canada, by Dairy Year

	Class 5	Class 5 (d) and (e)
1997-98	15.3%	10.8%
1998-99	12.4%	8.1%
1999-2000*	15.7%	10.5%
Simple Average	**14.5%**	**9.8%**

Source: Canadian Dairy Information Centre

*August-November
they lose much of the almost 10% of their market which goes to exports.

However, the WTO did not say that Canada is not allowed to ship milk for export; it only said that the CDC and provincial marketing boards could not do it on farmers' behalf. The WTO found that these supply management authorities are "government agencies", and that by using Special Classes 5(d) and (e) "exports are financed by virtue of government action". In fact, the implication of the ruling is two-fold. Firstly, the provision of export milk to processors at discount prices financed through pooling or other means coordinated by government action constitutes an export subsidy. Secondly, a government agency (marketing board) cannot determine export levels or otherwise direct milk to export.

This second implication of the WTO ruling has profound consequences for the CDC and provincial marketing boards. For almost 30 years, the CDC held the mandate to plan industrial milk marketing and marketing boards have been the monopoly purchasers of farmers' milk. This role in milk marketing is entrenched in provincial legislation and in the Canadian Dairy Commission Act. However, according to the WTO decision, if dairy exports occur through the Canadian Dairy Commission or provincial boards, they are subsidized exports that face the limits negotiated in the Uruguay Round. If this were to happen, Canada would fill its limit of subsidized exports quite quickly; dairy exports would fall drastically.

This brings into question an institution that has long remained sacred- the exclusivity of marketing boards as the sole purchasers of farmers' milk. Continued involvement of the CDC and marketing boards in export sales would result in fewer exports because of the WTO limits on subsidized exports. The consequence would be greater difficulty for processors in sourcing milk used in products destined for export and a loss of markets for farmers' milk. But what if farmers sold milk directly to processors, without CDC/marketing board involvement? If this were to occur, it would circumvent the WTO difficulties in marketing milk for export. No one could claim that export levels or financing occurred "by virtue of government action", or that the pooling of an export milk class with the domestic classes comprises an export subsidy. What's more, there would be no supply management on the export milk. This would be of substantial benefit to farmers wishing to expand but concerned about high quota costs, and would provide expanding volumes of milk to processors for export products. However, this all works against 30 years of tradition and layers of legislation establishing the absolute authority of marketing boards in Canadian milk marketing.

Marketing Boards' Proposal for Export Pricing Reform

Marketing boards are justifiably concerned about the situation. Export marketing allows them to maintain the stable domestic marketing conditions touted as one of the primary benefits of supply management. Losing control over export marketing, it is claimed, would make it more difficult to control the milk supply because the "sleeve" (discretionary milk quantity) would be lost. There is also an important precedent at stake; if marketing boards lose control over *some* of the milk supply, is it possible they might lose more control in the future? These concerns are surely weighing on marketing board leaders.

Milk marketing boards wish to retain involvement in export milk marketing. The proposal for export pricing reform forwarded by the marketing boards involves processors submitting bids and farmers submitting offers to a bulletin board operated by the marketing board. The marketing board would put buyers in touch with sellers by performing a brokerage function. Milk for export would thus be sold on contracts negotiated between farmers and processors. The milk sold through this process would be the "first out of the tank"- farmers would not be able to export residual milk after quota has been filled. Quota volume would be filled after contractual sales have been made. The milk sold on contract would face standard licensing and transportation levies; the promotion levy would not be charged.

NDCC Members' Proposals

Members of the National Dairy Council of Canada (NDCC) also have an important stake in export milk pricing. The NDCC represents dairy processors, many of whom serve export markets. What's at stake for the processors is the possible loss of export markets if subsidized exports are brought back in line with Uruguay Round commitments. The NDCC does not believe the loss of export markets is an option for the dairy industry[2].

In an attempt to retain and expand dairy export markets, the NDCC members have proposed an alternative system for facilitating dairy exports. The NDCC favours export milk pricing reform that would be decentralized from marketing board control. Under their proposal, milk would be procured directly from farmers by processors through contracts. Like the marketing boards' proposal, the contracted milk would be the first out of the tank. All milk and components would be exported, subject to the same audit and reporting procedures as domestic milk.

Export Milk Pricing Alternatives: An Evaluation

Who should handle milk for export? The answer to this question hinges critically on two questions: (1) does the "brokerage" function of the bulletin board scheme proposed by marketing boards confer a benefit (i.e. is it an export subsidy), and (2) will the milk utilization audit and reporting system be sufficient to keep domestic and export markets segregated?
The marketing boards are counting on the bulletin board scheme not being counted as conferring any benefit (export subsidy). If marketing board coordination of exports is declared an export subsidy, dairy product exports will be forced to conform with agreed upon limits which are much lower than recent export levels, and dairy farmers will lose a significant market for their milk. In the coming debate, the marketing boards will likely argue that the domestic and export markets cannot be maintained as separate unless marketing boards coordinate because the reporting system cannot guarantee segregation of domestic milk from export milk; this would undermine

[2] Speech by Kempton Matte, NDCC President and CEO, Dairy Farmers of Canada Annual Policy Conference, January 25, 2000

the supply management system in the domestic market.

If processors purchase milk directly from farmers, as the NDCC members advocate, there is no fear of the system being declared an export subsidy. The implication is that there would be no supply management on export milk, because there is no WTO cap on unsubsidized dairy product exports. This would allow processors to retain and expand export markets and source export milk much more easily. It would also provide producers with a market for which no quota is required- at a time when prohibitively high quota prices (as much as $20,000 per cow) are a big issue for many producers. The onus would be placed on processors to handle milk for export in such a way that they can prove it is not infiltrating the domestic market. Direct movement of export milk would place additional pressure on the supply management system domestically through the loss of the "sleeve" to account for unanticipated market conditions.

So what are the chances that the brokerage function performed by marketing boards would be declared an export subsidy? Probably pretty good, when you consider that all that has to be shown is that there is a benefit conferred by it. Brokers in many other commodities make a very good living, so it only stands to reason that it has value. Marketing boards have unique access to all the dairy producers in a province, so the brokerage service they provide to a processor would be particularly good, compared to the cost that would be incurred by the processor to perform its own procurement function. Initial indications from US trade officials and an American dairy processors' organization are that there would be objections to marketing board involvement; even Canadian trade officials say that board-run price mechanisms would not be defensible[3].

And what of the reporting system for milk utilization, is it up to it? The system currently reports utilization of 16 different milk classes, 14 of which are domestic. Processors are responsible for component testing and reporting utilization of milk in these classes, on both a hectolitre and a component basis, and are subject to periodic audit. It is difficult to believe that if procurement of producer milk for export were given to processors, this system would necessarily break down and lead to export milk in the domestic market. In fact, there would be one less class of milk to report if processors procured directly. And, the only real difference in the two proposals is that in one, the pricing function would be direct between a processor and a farm, while in the other it would be between the Board and a farmer. After that, both require documentation and audit. If one system can be audited, so can the other.

Implications

If you come to the conclusion that marketing board involvement in export sales of milk confers a benefit, and that it would be possible to maintain separate domestic and export markets for milk without marketing board involvement in exports, then the best option for the dairy industry is to allow processors to procure export milk directly from farmers. The alternative is a loss of export

[3] "New Dairy War Looms With US Industry", *National Post*, February 4, 2000

markets- virtually the only growing market Canada has- which will hurt dairy processors and dairy farmers. This seems like a big sacrifice to make to protect the marketing board hegemony.