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Does Canada Need to Dismantle Supply Management In the Trans-Pacific Partnership?

SPECIAL REPORT

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1. Introduction

With the recent news that Canada is being formally invited to join the Trans Pacific Partnership (TPP), media coverage has once again focused on dairy, egg, and poultry supply management. It is asserted by some that now it is clear that we must rid ourselves of this expensive and antiquated system. For example, Martha Hall Findlay recently challenged her fellow politicians to summon the "courage" to dismantle supply management, because retaining it denies many more (and larger) industries the benefits from Canada entering new trade agreements[1]. If this were correct, then we should expect a coming clash over supply management that will rival the conflict over the Canadian Wheat Board in intensity, perhaps many times over.

With so little known about how the TPP negotiations may proceed, it is remarkable how unequivocal some have been in asserting that Canada will simply need to give up supply management. This demonstrates a broad lack of understanding of supply management systems, and the real trade issues surrounding it.

The purpose of this paper is to provide an overview of what marketing boards in supply management do and to assess how it is that dismantling them would help Canada in its participation in the TPP. It concludes with some ideas as to what the real issues will be for Canada in the TPP and how the policy dialogue could better proceed.

2. What do Marketing Boards and Supply Management Agencies Really Do?

Supply management for milk, eggs, and poultry authorizes producer agencies to regulate a range of elements in their respective markets. This is carried out by provincial marketing boards and their affiliated national agencies; these in turn are enabled by provincial and federal legislation. The first element regulated under supply management is price. Supply management agencies establish a target price that "ought to be" for their respective farm products. This is done slightly differently across supply managed products. In milk supply management, the cost of production calculated by marketing boards is a component of the pricing target, but other considerations such as strength of demand and competition from substitutes are given consideration. Poultry and egg supply management relies more directly on a cost of production formula to establish a target price. As has been widely noted, the effect of these price controls is to increase the prices received by farmers in supply managed products in comparison to comparable world market prices.

Secondly, supply management agencies are involved in setting the quantity that will be sold in the market. This is done through a survey of demands from processors and downstream market segments, monitoring of product storage stocks, and other considerations. Importantly, unlike a conventional free market, levels of price and quantity are set largely independently from one another.

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[1] Martha Hall Findlay "Politicians need courage to dismantle supply management", *Globe and Mail* Thursday, Jun. 21 2012

Supply management agencies also conduct a range of other activities, such as establishing product quality standards, product promotion, administering quotas to individual farmers, allocating the farm product to processors, and conducting research in support of their products. Under milk supply management, agencies are also involved in charging different prices for milk based on its end use; for example, milk sold to a fluid milk plant for dairy beverages is charged a higher price than milk sold to a cheese plant. Milk marketing boards then pay the farmers the weighted average of all these end use prices. In other words, the farmers receive a price that is pooled among these end uses. This does not occur in poultry supply management. Under egg supply management, eggs are sold at a lower price to for use in food manufacturing than they are as table eggs for retail sale; the difference in prices is financed by a levy charged to egg farmers.

Supply management agencies also oversee the functioning of the domestic market. For example, the Canadian Dairy Commission (CDC) monitors (and purchases) stocks of butter and skim milk powder at administratively set prices to facilitate the clearing of markets; in setting these prices, the CDC establishes a production cost allowance for butter and skim milk processing. CDC operations frequently involve exports of surplus product to support the farm level milk price. Similarly, there are exports of chicken and turkey to support domestic market functions at administered prices.

The supply management agencies themselves are empowered by coordinated legislation and regulations at both the federal and provincial level. Marketing boards are accountable to government supervisory agencies at the provincial level. At the national level, the Farm Products Council of Canada, a federal government body, oversees supply management in poultry and eggs. The Canadian Dairy Commission, also a federal government body, has an supervisory role in the dairy industry.

Finally, supply management agencies do work with customers to segment and develop markets. Under milk supply management, programs are in place that allocate milk to encourage new product development in an attempt to develop new markets. In both dairy and poultry, programs exist that allow processors to import products that are re-exported to improve capacity utilization in processing. Supply management agencies also fund promotions and other initiatives with retailers to increase product sales.

3. What Don’t Marketing Boards and Supply Management Agencies Do?

Canada has trade barriers to imports in place for supply managed products. These control imports; without import controls supply management systems would be rendered ineffective. Without any barriers to trade, a marketing board attempting to increase farm prices by reducing the supply would be subject to imports which would undermine the domestic supply controls intended to increase prices. With no import controls a supply management system would require producers to limit production subject to quota with little impact on price; a very unsatisfactory result for the producers involved.

Marketing boards and supply management agencies are not directly involved in establishing or maintaining barriers to trade. This is accomplished via a system of tariffs and tariff-rate quotas

(TRQ's) administered by the federal Department of Foreign Affairs and International Trade (DFAIT). The tariffs protecting supply managed products in Canada are exceptionally high, for example:

- Butter 299%
- SMP 201%
- Cheese 246%
- Hatching eggs 238%
- Chicken 238-246%
- Turkey 155-165%
- Eggs 164%

Tariff-rate quotas establish a volume of imports that can enter the country at zero or nominal tariff. These are quite limited for supply managed products. For example, in turkey the TRQ is 3.5% of a trailing measure of national consumption. Chicken has a somewhat higher TRQ access level at 7.5% of a trailing measure of consumption. For dairy products, the TRQ is set at an absolute amount. For example, the TRQ for cheese is just over 20,000 tonnes; to put this in context, Statistics Canada reports 2010 national cheese consumption at about 472,000 tonnes.

Marketing boards do not regulate the price of consumer products charged by retailers or the wholesale prices that processors charge retailers or the food service industry. Strictly speaking, the effects of supply management on pricing are limited to the farm product[2]; the competitive environment beyond the farm gate determines the result in terms of wholesale and retail pricing. Logic would suggest that the effect of supply management in increasing the price of the farm product would correspondingly increase the price of associated food products. However this is complicated by current retail competitive practices (e.g. "loss leader" pricing of certain food products).

4. What Are the Interests of Other Countries in Supply Management?

Canada's trading partners, especially some of those who are current members of TPP, have long been critical of supply management. How should we understand their opposition to the Canadian system? Which elements of what marketing boards do are they opposed to? As observed above, marketing boards act to support prices and regulate quantities supplied. In the case of milk supply management, marketing boards also regulate pricing according to end use and blend prices across end uses in establishing the milk prices received by farmers.

Similar elements of farm product marketing occur in the countries that have been opposed to Canada's supply management system. For example, US dairy policy acts to support farm milk prices using a support price scheme. Price pools are commonly used in the US for milk and horticultural products through Federal Marketing Orders. Price pools have also existed in the New Zealand and Australian dairy industries. Quotas have been elements of European dairy policy, as well as regulated marketing in the California dairy industry. Under the US Senate version of the 2012 Farm Bill, a new dairy policy is proposed that involves elements of supply management.

[2] The exception to this is the manufacturing cost allowance established by the CDC, described above

Thus, it is unlikely to be some ideological bias against the operations of dairy, egg, and poultry marketing boards in Canada that draws the opposition of some existing members of the TPP. This leaves only one element of the system- barriers that unduly restrict trade. The average Most Favored Nation tariff on agricultural products following the 1994 Agreement on Agriculture was 62%; for dairy products it is about 85%, poultry 70-80%, and eggs about 65% (USDA ERS).

Table 4.1 considers the tariffs Canada has in place on selected supply managed products versus two key existing members of TPP, Australia and the US. The table shows a rather stark contrast. Australia has tariff-free access on butter, skim milk powder, chicken, and turkey, and a tariff of $Aus 1.22/kg on processed cheese. The US has material tariffs on all of the products listed in the table. Most US tariffs are a constant per unit, with the exception of processed cheese which has and *ad valorem* tariff ranging from 6.4% to 20%. Canada has both *ad valorem* tariffs and minimum unit tariff levels. There are factors of magnitude higher on comparable products than that for either the US or Australia.

Table 4.1 Sample Tariff Comparisons on Products that are Supply Managed in Canada, Existing TPP Members vs. Canada; Over Access Commitment

Tariff Code and Product	Australia	US	Canada
040510 Butter	0	$US .123/kg	298.5% >$Can 4.00/kg
040630 Processed Cheese	$Aus 1.22/kg	6.4% - 20%	245.5% >$Can 4.34/kg
040210 Skim Milk Powder	0	$US .033 - .865/kg	201.5% >$Can 2.01/kg
020714 Chicken cuts, frozen	0	$US .176/kg	238% > $Can 6.45/kg
020727 Turkey cuts, frozen	0	$US .176/kg	154.5% > $Can 4.51/kg
040700 Whole eggs	0[3]	$US .028/dozen	163.5% > $Can .799/dozen
040891 Dried Eggs	0	$US .476/kg	$Can 6.12/kg

Source: International Customs Tariffs Bureau

In the past, the US and New Zealand have been very interested in how Canada exports supply managed products- notably dairy products. In a World Trade Organization (WTO) case brought against Canada in the late 1990's, the US and New Zealand opposed classified milk prices used in dairy exports[4]; the US and New Zealand prevailed. Following the WTO dairy export decision, Canada agreed to restrain its dairy exports to levels upon in the 1994 Agreement on Agriculture as "subsidized exports". This is in place today.

Thus, with past export disputes settled, the principal point of difference between Canada and the existing members of TPP must be the barriers to trade that Canada has in place for supply managed products, not the actual operations of marketing boards and supply management. Indeed, much of what supply management agencies do is emulated elsewhere in the very countries that have raised concerns with Canada's supply management system. Understanding that it is not the supply management system in and of itself that is the issue for Canada in TPP,

[3] Australia does not import shell eggs on the basis of domestic health and safety criteria; see http://www.daff.gov.au/__data/assets/pdf_file/0004/182452/eggs.pdf
[4] For a summary of the case , see http://www.wto.org/english/res_e/booksp_e/dispu_summary06_e.pdf

but rather the barriers to trade that Canada has in place for supply managed products, has profound implications.

5. Conclusions

Once we understand what supply management agencies really do, it should become evident that our potential trading partners are unlikely to care about their operations very much, *per se*, in terms of Canada joining TPP. We should not expect other countries to request that milk marketing boards change the way a milk marketing board does pooling calculations, or to be upset about the methodology used in a poultry supply management cost of production formula, or how the farm products are allocated to plants in this or that supply managed system. What they care about are barriers to trade- TRQ's and tariffs. It is evident that our existing tariffs are very high compared with others; Canada's prospective TPP partners who have already gone through the process of reducing their barriers to trade quite rationally expect that we should lower ours. Whether we were to increase or decrease production quotas or domestic prices in the course of reducing access barriers is likely to be much less significant to them.

Perhaps the best way to see this is to consider the likely response if Canada agreed to completely dismantle supply management systems, but not change its existing trade barriers. This could create significant domestic market and policy upheavals, but no material change from the perspective of our trading partners. The Canadian domestic market and domestic policy would change, but the trade barriers protecting it would remain unchanged; a very unsatisfying result for some of the existing members of TPP.

More fundamentally, not only is the issue of dismantling supply management motivated by prospective trade agreements misplaced, it focuses on the agenda of others, rather than on what Canadians want and are able to negotiate and obtain from trade agreements like TPP. Any discussion of reducing protection on supply managed products should reference the gains to Canada expected from doing so. For all of the concerns that have been identified about supply management, acknowledging that the beneficiaries are greatly benefitted from the current levels of protection, there needs to be a case made for the benefits to the country from reducing protection. If there were really no prospective gains for Canada under TPP then it couldn't be in the national interest to reduce current levels of protection- it would just benefit others at our expense. Rather, there are significant expected benefits to Canada from TPP- these should be measured against the values reduced levels of protection in supply managed industries.

The implications of this are the following. First, it really makes no sense to assert that "supply management must be dismantled" for Canada to enter TPP. If our partners don't really care much about what marketing boards do (because what they care about is barriers to trade in supply managed products) then why would we force producers and their governments through a wrenching process of scrapping a system that has been in place for up to forty years? From a practical perspective, the very notion of "dismantling" supply management is daunting, as the system is based on a nexus of producer-provincial-federal agreements. Domestic adjustment to a situation in which supply management has been dismantled must fit in with financial, legal, and regional/sectoral considerations in Canada. For example, some regions have processing facilities in dairy, poultry and eggs primarily due to regulations enacted under supply management.

Provincial governments, which have much (if not the most) of the regulatory authority under supply management, might act vigorously to defend their provincial interests in plants, jobs, and economic activity if discussion of dismantling the system occurred. Much of current discussion blithely assumes away the costs of this process and adjustments in addressing these issues. Moreover, this is unlikely to be either *necessary* (since our partners won't care much) nor *sufficient* to satisfy the criteria (which is yet to be articulated) laid out by our TPP partners, unless material reduction in trade barriers are offered.

Secondly, supply management could remain even with reductions in barriers to trade under TPP, although this is a matter of degree. Reduced trade barriers would discipline the manner in which marketing boards do their pricing; the notion of controlling domestic supply using production quota could remain. For example, pricing might need to be significantly reduced to meet the competition from imports on selected products. Canadian supply managed industries could choose to price competitively with imports; the decision would be up to the industries affected.

It would be naïve to suppose that reducing trade barriers might not create painful adjustments in the system and in supply managed industries, especially if the negotiated changes in access were very large or implemented very suddenly. A reduction in prices to meet imports could be expected to dampen quota values in supply management, and therefore a portion of farmers' wealth. But it would also be naïve to suppose that supply management systems are static and unchanging; with regard to pricing and other elements the system is always evolving, and pressure on pricing already exists. There exists the robustness and flexibility within the supply management model to adjust to lower levels of protection and to lower prices.

Conversely, if protection were reduced very aggressively, there could be a desire on behalf of supply managed industries themselves (along with others) to dismantle supply management systems; this becomes a function of marketplace realities along with the degree of reduction in trade barriers. For example, at lower prices, farmers might no longer be willing to restrict the volume they supply. Market imbalances could also cause shifts in preference for supply management. In poultry for example, a reduction in protection could result in a dramatic increase in imports of white breast meat. However, when poultry is slaughtered and processed domestically, white breast meat is produced in a fixed proportion with dark meat, all under the same volume measure of quota. Thus, due to fact that domestic production of white meat is intrinsically connected to dark meat production, each kilogram of breast meat imported displaces a disproportionate amount of total poultry meat in a quota-bound system. Supply management agencies would need to be attuned to these issues, and be prepared to make major changes in how they operate, including potentially dismantling the supply management system itself. But this is not assured, nor implied right now, because it is very much dependent upon the extent of reduction in trade barriers, which Canada is in a position to negotiate.

Third, with barriers to trade properly recognized as the issue of focus, adjustment could be much less disruptive compared with the removal of the overall supply management system. This is true in a variety of ways. Reductions in trade barriers could be phased in to cushion adjustment. The mix of tariffs reduced and TRQ's increased will be negotiated; this can be done strategically, as in past trade negotiations, for example to give more access on products for which we have less processing capacity, and to retain more protection where we have more capacity. As we reduce barriers to trade as part of our entry to TPP, the costs of entering the agreement will be more transparent in comparison with the benefits of liberalization.

Moreover, focusing in on trade barriers as the issue it could provide an opportunity to re-engage issues of Canadian exports of supply managed products, especially dairy. If we agree to reduce our barriers to trade in supply managed products, Canada can quite rationally expect a reduction in its barriers to export in supply managed products within the TPP group of countries. This could allow Canada to escape the dairy export box it is currently in. To neglect the export side of trade barriers would be to invite imports of product, without some offsetting consideration of growth through exports in those products.

Finally, by focusing on barriers to trade, the dialogue could assume a much richer set of dimensions than simply "with or without" supply management. Each tariff and TRQ level will be negotiated, so that what can actually occur is an adjustment portfolio across tariff lines, rather than an abrupt change from dismantling supply management. It would also allow us to more closely follow the US experience as it discusses it agricultural policies (notably dairy) with the current TPP members.

In summary, the assertion that we must, or should, dismantle supply management as part of Canada's entry into the TPP is misplaced. Other members of TPP simply have little incentive to care whether we do or don't market dairy, eggs, and poultry using a supply management system; they care about the barriers to trade they face in supply managed products with Canada. What insisting that we dismantle supply management does do open up unnecessary conflict among regions, governments, supply management agencies, and create a distraction from the real issue- which is how we can best negotiate the levels of trade barriers within TPP. The key will be reducing barriers that unduly restrict trade in supply managed products, and the prospect exists for this to be done strategically to mitigate a harsh adjustment.

Dismantling supply management is not the relevant dialogue regarding Canada's involvement in TPP. The relevant dialogue relates to how and to what extent Canada can or should be willing to reduce trade barriers in supply managed products, given the totality of Canadian interests in the TPP. The debate about the future of supply management and its advantages and disadvantages is a matter of domestic policy, framed by Canada's foreign/trade policy pressures and interests, including TPP. The serious discussion as to whether or how Canada wishes to alter, retain, or dismantle supply management in the various products should occur later as the implications of external factors regarding trade become better understood, and as Canada's preferences in doing so are better understood.

References

Profiles of Tariffs in Global Agricultural Markets/ AER-796 USDA Economic Research Service, 2007