Options for Supply Management in Canada Under Trade Liberalization

Rick Barichello, John Cranfield, and Karl Meilke

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Introduction

• Doha Development Agenda (DDA) negotiations will have some implications for Canada’s Supply Management (SM) sector but likely to be small
• Important question facing industry, government in our view:
  – Should SM system be realigned to deal with new DDA rules, or should more fundamental changes be undertaken to position industry better for post-DDA world, 2021 and beyond?
  – If no action taken before 2021, significant over-quota tariff cuts could result in sharp price drops
  – Now have 15 year window of adjustment
Introduction 2

• In this paper we illustrate kind of changes DDA may require
• Also point to some options for adjustment to leave industry better positioned to compete in 2021 and into future
• Reasonable for governments to consider providing adjustment assistance
  – We discuss some different types of assistance, highlighting strengths and weaknesses
  – We are not proponents of any one approach; identification of options and program design characteristics is important activity
Background Notes

• 2004: supply management commodities accounted for 20 percent (C$7.4 billion) of farm cash receipts (C$36.5 billion), same as in early 1970s
• Adjustments to future trade policies made more difficult by currently high quota values
• 1981 Quota value: $4.4 B (3.5% of all non-quota assets)
• 2004 Quota value: $24.8 B (12.2% of non-quota assets)
  – Growth rate 1981-1995: 6.4%/year (nominal)
  – Growth rate 1995-2004: 10.0%/year nominal (8.1%/yr real)
Current Situation

• URA apparently convinced farmers rents in milk production assured for 10-15 yrs, lowering their perceived discount rate. Coupled with falling real interest rates, quota values exploded
  – In Ontario, dairy farmer with 100 cows has $2.5 M invested in quota
• Led by increase in quota values, equity levels have grown, particularly since 1995 and for larger (sales > $500,000) farms
• Debt levels grew even faster, more than doubling 1995-2002
  – In 2002 for these larger farms, debt/non-quota equity > 1 for Alberta, Ontario, Quebec (1.1, 1.1, 1.2, respectively)
DDA Proposals

- Export competition:
  - Elimination of export subsidies would require elimination of butter, skim milk powder, and cheese exports
  - This accounts for 2-3% of Canada’s domestic consumption
- Domestic support
  - Some cuts likely due to product-specific AMS limits
  - This may change CoP-based open-ended pricing used in milk; prices may need to be negotiated with processors, as in poultry
- Market Access
  - Minimum access commitments likely to be specified as percent of recent consumption. Current levels: butter 3.7%; cheese 5.5%; other dairy products range from 0.2% (ice cream) to >20% (buttermilk powder). Percentages higher in eggs, broilers, due to use of supplemental import permits
DDA Proposals: sensitive commodities

• Market Access, cont.: Tariff cutting
  – Special and sensitive products facing lower tariff cuts; Canada likely to specify its supply managed commodities as sensitive
  – “Sensitive commodities”: Likely to be subject to some maximum proportion of tariff lines
    • 1% (US proposal) vs. 8% (EU proposal)
  – Canada’s supply managed commodities covered by at least 5% of total ag tariff lines
  – If mid-way compromise between US and EU, Canada may be able to specify most of its overquota tariff lines as sensitive
DDA Proposals: OverTRQ tariffs, TRQs

• Over-TRQ tariffs will be cut somewhat and TRQs will be increased, subject to some trade-off between the two

• Water in tariffs?
  – With over-TRQ tariffs in 200-300 percent range, must be much higher than tariff that would just make imports competitive
  – Estimates: 50-70 percent cut in chicken tariffs, and 100 percent cut in egg tariffs, would still keep out most imports
  – Dairy products: 50 percent to keep out (US) raw milk, higher tariffs to keep out non-US industrial products; more work needed

• If 30-50% tariff cuts assumed to provide protection from imports for most commodities, then SM industries will face minimum access increases of 50-70 percent, with specified minima of 5-7% of domestic consumption

• Add about-to-be-prohibited export subsidies, forcing dairy exports to zero. Result: 7-10% TRQ increase
Likely Trade Policy Changes

• Increases in TRQs:
  – Decrease in domestic marketing quota, up to 10%
  – Incomes will fall due to reduction in domestic quota

• Reduction in over-TRQ tariffs:
  – Reduction from existing tariffs likely in 30-50% range; no effect on farm prices, incomes
  – If reduction were to exceed existing water in tariff, this would result in some price and income decline

• Domestic support disciplines
  – Possibly future milk price increases smaller than in past
Options for Adjustment Assistance

• Looking ahead, beyond DDA to anticipate more significant change following future round
• Precedent for Assistance to make adjustment

Four Basic Cases considered
  1. Assistance based on book value/historical quota cost
  2. Australian dairy reform
  3. Two-quota option
  4. Full quota buyout
Precedent for Assistance

- Some arguments made against assistance (e.g., such risks already anticipated and built in to quota prices, quota values more than doubled since URA in 1995)
- But strong argument that role exists for government to encourage adjustment to lower farm prices
- Also ample precedents for adjustment assistance of various kinds
- Within Canada
  - WGTA/Crow freight rate removal, $1.6 B, 1996
  - Transition assistance to grape growers in Ontario and BC when CUSTA signed
    - Payments to replant to modern (higher quality) wine grape varieties ($8000/acre)
Other Precedents

- **Tobacco in Canada (Ontario):**
  - Payments ($88 million) to retire basic production quota permanently; affected ~1000 producers
  - Domestic reform, not trade policy change

- **US Peanut Reform**
  - Domestic reform, not trade policy change
  - Payments to retire quota equivalent to 70% of past average of “rental value” of quota (infinite stream discounted @5%)

- **US Tobacco Reform**
  - Payments equivalent to 57-66% of past rental value

- **Australian Milk Reform, June 2000**
  - Average payments of A$165,000 per farm
  - Level meant to cover costs of lower (fluid) prices for three years, explicitly to encourage adjustment for continuing farms
1. Assistance paid on book value

- Family of options to pay adjustment assistance based on quota (capital) value
- This one based not on current market value but on historical or book value, which is lower
- Rationale/argument:
  - Person who bought quota years ago, or was given it, has received many years of benefits and “needs” less assistance
  - Recent purchaser may still have debt to service and hence “needs” assistance more
- Additional advantage:
  - Likely to be less expensive form of assistance
- Difficulty:
  - Perceived inequity of not providing payments to cover capital gains
2. Australian Dairy Model

- Full and immediate reform after 9 months notice
- Rapid and significant decline in fluid milk prices plus some subsidy removal
- Assistance based on lost income from reforms
  - 3 yrs worth, not full PV of loss
- Focus on encouraging adjustment of farms, not equity-based income support
- Known schedule of payments
- Financed by consumers via increased milk prices for 10 yrs, no contribution from government (consumers were beneficiaries but half consumer benefits postponed 10 yrs)
Applying Australian Model to Canada

- Administratively feasible via well developed milk revenue pooling arrangements
- In Canada, losses would occur on all dairy products, not just fluid milk
- Allows lower payments than would occur with full quota buyout
- Could allow for government financing as well as consumer via contributions to price pool
- Flexibility in this approach, in terms of size of payments and incidence of payment burden
3. Two-Quota Option

- Introduce new quota: cheaper but ties production covered to lower prices
  - E.g., Lower price may be world price+30% tariff (45c vs 65c)
- *Trade-in scheme*: sell old quota to govt and buy new quota; use farmers’ offers to sell, bids to buy
- *Voluntary*: farmers who are unable or do not want to produce at lower prices, don’t have to participate
- *Incremental*: can buy only small proportion of output; aggregate trade-in volume dependent on government budget and planned adjustment period
- *Feasible*: one price to consumers via pooling of returns
- *Expensive*: virtually full quota buyout from buying high priced old quota; small offset from sales of new quota
- *Flexible*: allows cost to be spread out over as lengthy a time period as budget and trade agreements permit
Attraction of new quota to producers?

• Opportunity to leave behind risks of current policy with ad hoc quota cutbacks and uncertain future price declines
• Advantage of locking in current high prices of quota which many farmers think are unsustainable
• Allows chance to get out equity from old quota assets yet still stay in farming
• Can be done incrementally or not at all
• Could be offered to entering farmers who cannot afford current high cost of quota but who can produce at lower price
4. Full Quota Buyout

- Easy to do administratively
- Politically attractive to producers
- Very costly: C$25 B
  - Compare to WGTA buyout to all wheat farmers of less than C$2 B total
- How long can buyout be stretched out in time?
  - Probably not long if begun only in response to finalized trade agreement
  - Cost could be spread out if introduced well in advance
- Feasible budget-wise if buyout only introduced in response to finalized trade agreement? (i.e., with time-concentrated expense)
Conclusions

- Two likely main changes from Doha: (a) TRQ increase, (b) Decrease in over-TRQ tariffs but without domestic price effects
- Precedents for some form of longer term adjustment assistance
- Many options for designing scheme, with guidance from cases examined above: variables to consider:
  - Size of assistance payments;
  - Time pattern of payments (how spread out over time)
  - Incidence of financing costs between government and consumers
  - Voluntary schemes vs. across the board payments to all
  - Same payments to all producers vs. differential assistance based on some criteria (e.g., historical quota price vs current market value)
  - Options for new quota type
  - Administrative ease