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Dairy production: the costs of supply management in Canada

International talks at the World Trade Organization (WTO) in July 2004 drew attention to the "supply management" model in agriculture. This model was first applied in Australia in the 1920s to protect farmers' incomes against economic swings and lower prices for their products as well as to increase their power in relation to buyers. Supply management, which is held out today as an indispensable element of Canadian agricultural policy, is in reality a needlessly costly system, particularly where dairy production is concerned.

The dairy sector in Canada — including both fluid milk for direct consumption (39% of overall production) and industrial milk for processing (61% of production)[1] — was the first area run along supply management lines at the national level, with creation of the Canadian Dairy Commission in 1966.[2] The commission's functions include among other things setting a "target" price for milk to serve as a reference and heading the Canadian Milk Supply Management Committee, the key body determining the level of industrial milk production through quotas at the federal level.

The supply management system is based on provincial boards and agencies with government-granted monopoly powers to supervise fluid milk production and distribute quotas among the various individual producers in each province.

A costly burden for consumers

Canada's supply management system in farm products relies essentially on two major forms of government involvement in agricultural markets. First, it involves setting up planning and administrative control over the pricing and marketing of an agricultural product as well as the quantities offered, largely through the imposition of quotas. Second, supply management also relies on customs tariffs that are set high enough to keep foreign products out.

Through such measures, the government eventually ensures a captive market for Canadian farmers. Artificially high domestic prices correspond in reality to an implicit tax that governments have authorized farmers to impose on consumers. These prices are sometimes completely disconnected from world markets. For example, estimates from the Organization for Economic Cooperation and Development (OECD)[3] found that Canadian milk prices have been two to three times higher than world prices since 1986 (see Graph 1).

The OECD has evaluated overall public assistance to agriculture around the world since the mid-1980s. It uses

1 See "Dairy Industry Profile," Agriculture and Agri-Food Canada, 2004, available at http://www.dairyinfo.gc.ca/cdiccdindustprof.htm.

2 For the history of involvement in the dairy sector, see the official site of the Canadian Dairy Commission, http://www.cdc-ccl.gc.ca/cdc/main_e.asp?catid=663&page=1760.

3 OECD, Table 2.6: Milk, Market price support and consumer price support (Canada), 2004, available at http://www.oecd.org/dataoecd/33/18/32360855.xls.

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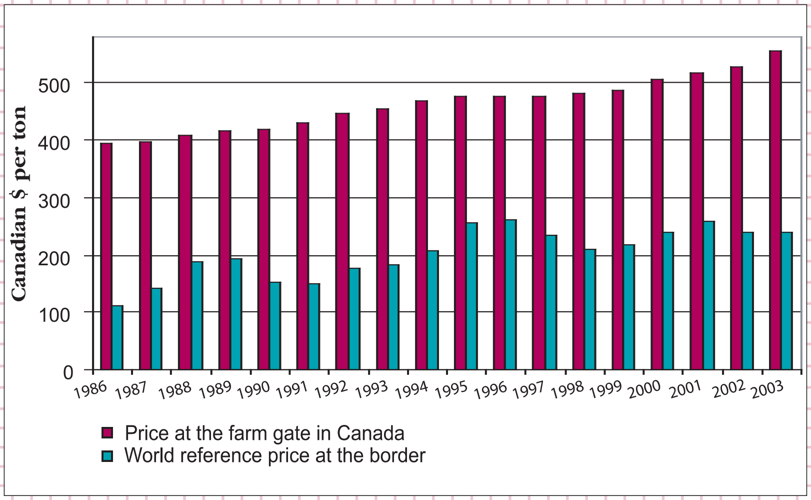
Graph 1

Comparison of domestic milk prices with world prices



Source : OCDE (2004)

its Consumer Support Estimate (CSE) indicator[4] to measure the assistance provided to Canadian producers through supply management. The OECD estimates this support to Canadian dairy producers at $2.7 billion in 2003, equal to more than 60% of the value of total dairy production that year.

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Entire milk-using industries, such as food processing and the restaurant trade, have to support the costs of supply management. In some cases, since they are obliged to pay higher prices for their milk and dairy product inputs, companies are less competitive than foreign rivals that are not required to pay Canadian prices.

As a form of compensation for these penalizing effects of supply management and to help affected industries become more competitive, government authorities have created additional regulations providing for lower preferential prices depending on the final use of the milk. To maintain their competitiveness in relation to their U.S. rivals and to keep them from moving their production outside the country, Canadian makers of frozen pizzas are entitled to pay lower prices for their cheese, which in turn is made from milk billed at a lower price. On the other hand, Canadian pizza restaurants, which are in direct competition with these firms and go after the same consumers, do not have access to these preferential measures and pay higher prices.[5] Supply management thus creates further distortions in the economy.

Finally, the costs of the supply management system are reflected in retail prices, to a more or less considerable degree depending on the product. These costs are ultimately financed by income transfers from consumers to Canadian farmers, who also receive subsidies from taxpayers. Consumers are thus obliged to pay more for their milk and their dairy products than they would without supply management. This has no doubt contributed (along with changes in food habits toward drinks other than milk) to a drop of nearly 15% in per capita milk consumption in Canada between 1986 and 2003 (see Graph 2).

A rigid model for farmers

The supply management system relies on the establishment of quotas for various products, which is equivalent to issuing rights to sell a certain quantity at administratively set prices. These quotas were initially distributed free of charge but later changed hands on centralized exchanges in the case of milk, becoming increasingly expensive. An average of more than $22,000 was required to make use of a cow and sell its milk in Canada in 2002.[6] In 2003, according to Statistics Canada,[7] quotas amounted to an average of nearly $1.1 million per dairy farm and a total of almost $17.6 billion for all dairy farming operations in Canada. This represents close to half the entire permanent long-term asset base of milk producers.

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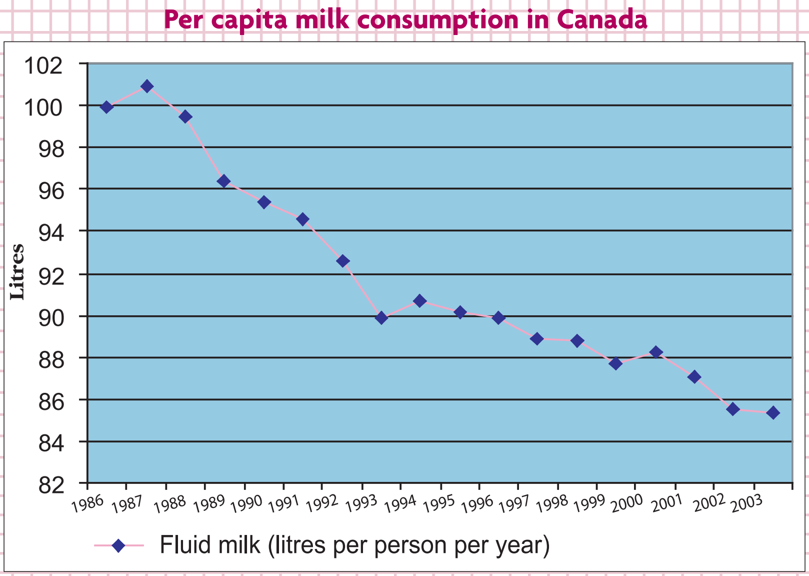
[4] The CSE measures the support provided by consumers at the farm gate. Unlike the Producer Support Estimates (PSE), it does not include subsidies financed by taxpayers. Calculations are based on the difference between prices at the farm gate and effective world prices at the border (corresponding to the New Zealand price). Even though some analysts challenge the OECD's methodology, its approach is justified when studying the situation of a particular country such as Canada, regardless of the agricultural policies that may apply in other countries. See M. Doyon, D.-M. Gouin, N. Pillat, "Analyse critique du concept d'estimation du soutien au producteur. Application au secteur laitier," *Économie rurale* 272, Nov.-Dec. 2002, pp. 74-87. Also see OECD, "Agricultural Support: How is it Measured and What does it Mean?," *The OECD Observer*, September 2004, pp. 5-6, available at http://www.oecd.org/dataoecd/63/8/32035391.pdf.

[5] Owen Lippert, "The Perfect Food in a Perfect Mess: The Cost of Milk in Canada," Fraser Institute, November 2001, p. 40, available at http://www.fraserinstitute.ca/admin/books/files/PPS52-milk.pdf.

[6] Dairy Farmers of Canada, *Dairy Facts and Figures*, 2002, p. 68, available at http://www.dairyinfo.gc.ca/pdf_files/ff2003_e.pdf.

[7] Statistics Canada, *Farm Financial Survey*, December 2004, available at http://www.statcan.ca/cgi-bin/downpub/listpub.cgi?catno=21F0008XIB2004001 (additional data obtained by the author upon request).

Graph 2



Source: Statistics Canada, Table 002-0019: Per capita consumption of major food groups, annual data (2004).

To set up a dairy farm, almost as much would have to be spent on quotas as on the assets truly required for milk production, such as animals, land, buildings, farm machinery and equipment.

It is obvious that quotas have become a barrier to entry for anyone wishing to start a new operation in this sector. The paradox is that farmers already in the market have no interest in ending the system of quotas, whose high value does nothing to facilitate reforms. Quotas constitute an "asset" that farmers can sell and that is often used to guarantee loans from financial institutions. Abolishing supply management would result in quotas losing their entire value, posing serious problems for farmers and their creditors.

Supply management also forms an obstacle to entrepreneurial activity and to adapting production to economic conditions. Efficient farmers who might wish, for instance, to raise their production cannot do so because they are not authorized to exceed their quotas. Instead of trying to win market share to the benefit of consumers through various strategies in areas such as pricing, quality, product differentiation, advertising, service, or forms of marketing, Canadian farms under supply management have to devote an increasing share of their resources to covering the cost of quotas.

From a geographic standpoint, evolution of the system is blocked. It is very difficult to modify the proportion of quotas that each province receives. This rigidity is a source of conflict between provinces and of added uncertainty for farmers. Because of quotas, it is impossible to take advantage of more favourable production conditions in different parts of Canada if and when they arise.

Awkward trade relationships

The supply management system involves strict control over imports and access by Canadian consumers to foreign products. As noted by OECD agriculture director Stefan Tangermann, "In fact, support provided by consumers through artificially high prices for farm produce is just as trade distorting" as a system of direct subsidies.[8] Customs tariffs, applied to all imports beyond a certain authorized limit, reach prohibitive levels of over 200% — for example 245.5% for cheeses and 298.5% for butter[9] — for farm products under supply management.

For this reason, the supply management system was at the centre of the latest WTO talks in the summer of 2004 in Geneva. A lowering of customs tariffs was discussed by the various parties and will be brought up again at future negotiations to give foreign products access to various domestic markets. If this occurs, supply management and the quota system will no longer be able to play an effective role, because it will be difficult to "capture" consumers.

Canada has already been condemned by the WTO for price-fixing practices in the dairy sector, ruled as equivalent to export subsidies.

The Canadian system is also a source of conflict with certain trade partners. Canada has already been condemned by the WTO after actions taken by New Zealand and the United States going back to 1998 for price-fixing practices in the dairy sector, ruled as equivalent to export subsidies. Given that the system is coming under increasing pressure and that it will no doubt have to be reformed sooner or later, it would be useful to look to experiences abroad for insight. In this regard, New Zealand and Australia can serve as examples.

[8] Stefan Tangermann, "Farming support: the truth behind the numbers," OECD, 2004, available at http://www.oecdobserver.org/news/fullstory.php/aid/1223/Farming_support:_the_truth.html.

[9] Canada Border Services Agency, Customs Tariff, Dairy products, available at http://www.cbsa-asfc.gc.ca/general/publications/tariff2004/ch04ne.pdf.

Reforms in New Zealand and Australia

New Zealand provides an excellent example of deregulation in the domestic agricultural market. In 1984, the New Zealand government eliminated nearly all agricultural subsidies, which went as high as 40% of farmers' incomes. This was followed by deregulation of the domestic market, with elimination of the legal monopoly protection enjoyed by the various marketing boards (with the exception of the board handling kiwi exports to countries other than Australia).

In 2000, a reform of Australian laws governing the dairy industry provided for an overhaul of the supply management system. To compensate farmers for losses due to the elimination of quotas and to lower prices, public programs were set up on a temporary basis, financed in part by a tax on Australian milk consumption applicable until 2008.

New Zealand and Australia were among the OECD countries with the lowest agricultural supports in 2003.

New Zealand and Australia were among the OECD countries with the lowest agricultural supports in 2003. Income transfers to dairy producers through domestic price support is inexistent. In New Zealand, following an easier than expected adaptation, reform of the agriculture sector resulted in a significant return to organic farming and to a more diversified product range, with stronger export capability at world prices. The farm sector's share of New Zealand's GDP rose from 14.2% in 1986-87 to 16.6% in 1999-2000, and during that period agriculture experienced the greatest productivity gains of any economic sector.[10]

Conclusion

The Canadian supply management system is equivalent to the establishment of a government-supported cartel for the marketing of farm products. Through customs tariffs, administered prices and quotas, it seeks to protect producers to the detriment of consumers and of food producing industries that have become captive to it. But supply management also penalizes the producers themselves, who no longer have any control over the prices they charge or the quantities they produce and who are forced to pay high costs for unproductive assets such as quotas. Moreover, when they start exporting they are likely to be subjected to sanctions by our trading partners. It is time for Canada to re-examine the supply management system and to return to a domestic agricultural market, in which farmers can run their business as they understand it by deciding on prices, quantities, and forms of marketing, to the benefit of consumers who will then have a real choice among competing products.

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[10] Federated Farmers of New Zealand, "Life after Subsidies," 2002, p. 1, available at http://www.fedfarm.org.nz/issues/documents/LifeAfterSubsidiesAug02.pdf.