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This presentation discusses the economic rationale behind supply management and why agriculture, especially dairy, is different than other sectors of the economy, such as natural resources.

The economic rationale is then illustrated with empirical data, using the example of the U.S.

Various criticisms found in recent Think Tank reports, such as reduced consumption, higher prices, effects on incentives and others are discussed before concluding

At a Glance

- The aim of this paper is to initiate a constructive dialogue among stakeholders in the industry that will enable the Canadian dairy value chain to improve its efficiency.
- Canada is not unique; characteristics of the dairy sector, notably coordination problems, have led many countries to intervene in their dairy industries to varying degrees.
- Supply management currently faces important internal and external pressures including access to quota, structural surpluses, the use of dairy ingredients and international trade negotiations.
- We propose three specific strategies to help stakeholders address some identified pressures: adapt provincial and regional structures to national ones, change processor's incentive in order to reduce solid non-fat surplus and identify export opportunities.

Since its inception in the Canadian agricultural policy landscape, supply management in the dairy sector has generated a great deal of debate. The system essentially limits the supply of dairy products to meet demand at a price based on cost of production and restricts imports of dairy products into Canada. Critics of supply management have argued that it should be dismantled in order to favour economies of scale, competitiveness and to reap the benefits from trade in Canada's dairy sector. Supporters contend that it reduces price volatility, increase farmers' benefits and lowers transaction costs – thereby ensuring that processors and consumers (taxpayers) are not worse off.

It is also important to note that numerous supporters of supply management recognize that the current system requires some changes to enable it to operate more efficiently. In fact, since its inception some forty years ago, supply management has evolved considerably. These facts, combined with the pressure on supply management created by factors such as the ongoing global trade discussions and the growing use of non-dairy substitutes imply that this is an appropriate time to move the discussion on Canadian dairy supply management forward.

This paper's objective is to enhance the debate on Canadian dairy supply management with facts and suggestions aimed at initiating a constructive dialogue among stakeholders in the industry that will enable the Canadian dairy value chain to better prepare for the changes that are on the horizon.

There is no doubt that changes to supply management may be difficult to achieve, especially from a political point of view. Nevertheless, our assessment is that dairy supply management needs to become more flexible and efficient. We are not recommending the dismantling of supply management. As a result, our recommendations might not satisfy some opponents of the system. However, one needs to recognize that while some stakeholders in the dairy supply chain are asking for changes, few are demanding a complete dismantling. Empirical evidences from recent world events (the 2009 dairy crisis), stress the need for the coordination of supply in the dairy sector. It appears to us that supply management can be a legitimate coordination tool.

Canada is not the only country that regulates its dairy industry

A combination of the fixed resources present in the dairy industry, the significant lags between the time a decision is made in response to market signals and the time it takes to alter production, the perishability of the product and the short run incentive of producers to increase production in order to maintain revenues when price are declining have led many other countries to intervene in their dairy industries to varying degrees.

Canada implemented a supply management program for the dairy industry in the early 1970s and has, therefore, significant intervention in its dairy sector with production quotas, import restrictions and a support price based on the cost of production. By its nature, Canada's dairy supply management is oriented towards the domestic market. Therefore, Canada does not export to a great degree and is a marginal player in international market. Supply is matched with demand at negotiated prices based on cost of production and price volatility is kept to a minimum.

The United States and Europe both intervene heavily in their respective dairy industries with a combination of price supports, subsidies, purchases of surpluses, import restrictions and export subsidies. New Zealand and Australian dairy sectors benefit from a production structure that makes them among the lowest cost producers in the world. The two countries are also major players on the international market. In fact, contrary to the vast majority of countries, their domestic consumption is much less important than their exports. Dairy sectors in both countries were also deregulated and receive little government support. However, free market does not completely rule New Zealand's industry since it has a co-operative processor that controls almost entirely the domestic market as well as New Zealand's exports. On the other hand, Australia does not have a single buyer and seller for dairy and this might explain why the Australian dairy sector has struggled since total deregulation in 2000, especially compared with the situation in New Zealand.

Canada's supply management system has enabled dairy farmers to avoid the dairy crisis that other countries faced in 2008-2009. Canadian dairy farmers have also benefitted from higher prices than most of their counterparts in other countries, as well as from lower price volatility. Moreover, the direct costs for governments in Canada are minimal compared with the situation in the United States and the EU. However, these advantages of supply management must be weighed against some of the disadvantages including the fact that dairy prices are, at least at some point in time, higher in Canada compared with the United States. This represents a cost born by consumers that is not captured in the direct cost of supply management. However, similar costs are born by taxpayers in the EU and the U.S. systems.

Internal and External Pressures

Supply management currently faces important internal and external pressures including access to quota, structural surpluses, the use of dairy ingredients and international trade negotiations.

In the past few years, dairy farmers have encountered increased difficulties in obtaining additional quota in part because the rate of exit of farmers from the industry has slowed down, as has the move towards greater consolidation. These developments have sharply increased the cost of acquiring quota. In response to this rising quota price, a price cap has been implemented in numerous provinces. Once the cap is reached, quota is allocated on a demand basis with the result that only small quantities can be acquired over time by a single producer. Thus, it reduces dairy farmers' capability to reap the benefit from economies of scale. If this situation persists in the long run, it has the potential to affect the competitiveness of the whole dairy value chain.

Technological development in dairy processing has increased to the point where dairy ingredients can be substituted for milk in order to increase yield. These dairy ingredients were, for the most part, not produced in Canada and were imported free of tariffs at low prices. At the same time, this development contributed to an increase in solids non-fat (SNF) structural surplus inherent in the Canadian system. The main issue now is how to transform the roughly 60 million kg of SNF (issued from our structural surplus) from a dead weight cost to a return for the industry.

The most important external pressure that dairy supply management faces in Canada is bilateral and regional trade talks. The recent trade agreement with Europe is a good example with a significant new access to our cheese market. At this point, dairy farmers seems ill equipped to compete against European and Americans farmers that benefit from significant subsidies.

An Open Dialogue is needed to initiate changes

The challenges to supply management discussed above imply that, going forward, a constructive dialogue among stakeholders is crucial. Unfortunately, to date, this type of discussion has been difficult and the debate has often been dominated by rhetoric on both sides. To further support suggestions for change to the system, five points of view often presented to oppose supply management are discussed. This analysis sets the stage for some strategic suggestions to improve the effectiveness of the Canadian dairy sector going forward.

Issue1: Because of supply management, consumption of dairy products is declining in Canada.

It is a fact that milk consumption is declining in Canada. However, this is not unique to Canada and could be associated with a change in the mix of dairy products consumed by the public, which is influenced by income, demographics, culture and other factors. It is hard to blame supply management for a trend that is taking place throughout the developed world.

Issue 2: Retail dairy product prices more expensive in Canada

Statistical evidence suggests that dairy prices in Canada are less volatile compared with other countries. Although no exhaustive statistical analyses were performed, a spot survey of supermarkets indicates that in February 2011, dairy product prices were higher in Canada than in the United States. It should be noted that price differential between countries might also be affected by differences in processing and distribution structure, as well as by direct and indirect subsidies to dairy production in the US.

Issue 3: Supply management generates little incentive to reduce costs at the farm

Empirical evidence seems to indicate that dairy farmers in Canada currently have less incentive to lower costs compared with dairy farmers in non-supply managed countries like the United States.

Issue 4: Supply management is detrimental to dairy processors

It could be argued that supply management limits competition thereby making it easier for processors to operate effectively in Canada. Nevertheless, processors face constraints such a regional allocation of milk, which can result in sub-optimal use of their capital investment as well as limiting growth of value-added dairy products.

Issue 5: Canada is missing out on exports, especially on dairy consumption growth in developing countries

Critics of supply management contend that the system prevents dairy farmers in Canada from taking advantage of export opportunities because it is geared towards the domestic market. However, what some of the critics overlook is the fact that it will always be difficult for Canada to compete on international markets with dairy farmers from New Zealand and Australia, for instance. The cost structure for farmers from these countries is lower because of extensive pasture-based production and minimal investment in infrastructure compared to Canada.

While the opportunity to export commodity dairy products on the international market may be limited, there may be potential for products like higher value-added cheeses, especially to the U.S. market.

Strategies Going Forward

An understanding of the challenges and the evidence regarding some of the commonly held views on supply management have led us to put forward some strategies for the industry to consider going forward that would hopefully improve the efficiency of supply management.

We suggest the following strategies:

- <u>To adapt provincial and regional structures to a national market:</u>
    - The creation of a national board,
    - The creation of a national pool with a national allocation of milk on demand;
    - The creation of a national centralized quota exchange for partial share of the MSQ.

- <u>To change processors incentives toward SNF surplus:</u>
    - The creation of a mechanism to share the cost of SNF surpluses between producers and processors over and above a certain level of surplus;
    - To reduce processors margins for butter-powder and/or to create one for dairy ingredients;
    - To change class pricing so that the use of Canadian dairy ingredients would not be priced at class 3a but would be more competitive with the price of potential substitutes.

- <u>To see Canadian dairy exports differently:</u>
    - To identify and explore ways to exploit value added export markets where Canada might have a competitive advantage;
    - To coordinate and facilitate, in the short run, the effort of smaller fine cheese producers to penetrate the fine cheese market in the U.S., which is currently mostly deserved by French imports.

- <u>To increase dairy farmers' revenues through an increase in pool price and volumes,</u> instead of an increase in regular milk classes (class 1 to 4). This could be achieved through different combinations of the previous suggestions and has the potential to limit the increase in farm the price differential between Canada and other countries.

For a complete version of this discussion paper :
http://www.cirano.qc.ca/pdf/publication/2011DT-01.pdf