TPP and Canada’s dairy sector: How reducing protection can increase rents

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Backdrop: Canada’s High P Dairy Industry

• Canada’s dairy sector somewhat unique in world dairy mkt: its domestic prices are high
  – Compared to the US, CDN prices are between 60% and 90% higher than US prices for the more high-volume products, depending on the XR (2015 prices)
    • At a PPP exchange rate of 1CAD=USD0.85, average CDN farm milk prices are 89% higher than average US farm milk prices
    • Translating into US dollars per hundredweight (cwt), CDN farm milk prices are US$30/cwt vs. US farm milk price of $16/cwt

• This differential protected by Canada’s high over-TRQ tariffs of 200-250 percent, and
• Supported by low TRQ levels (~3% CDN consumption) and domestic marketing quotas (farm level) that restrict total milk supply to the estimated demand at those relatively high prices
Contentious area in trade negotiations

- Would-be milk product exporter countries (e.g., US, New Zealand)
  - Attracted by such large price differences, indicating highly profitable export prices, and/or
  - The prospect of gaining new access to a market roughly the size of California
- This became key issue in TPP negotiations, where US and NZ argued strongly for full removal or substantial reduction in Canada’s over-TRQ tariffs and/or substantial increase in TRQ levels
  - Some lobbyists called for complete removal of both
- Also represented a key domino in trade benefits within a TPP for the US and NZ, allowing them to offer lower protection/benefits to other TPP partners
Policy change options for TPP?

• Basically, only these two instruments that can be changed as part of dairy product trade negotiations:
  – Reduce over-TRQ (Tariff Rate Quota) tariffs
    • With tariffs currently at 200-250%, much scope for reduction (esp. with much ‘water’)
    • In theory, could make some imports competitive with domestic products, leading to possibility of increased imports and lower domestic prices
  – Increase TRQs themselves
    • Would certainly increase imports; effect on domestic prices is unclear, depending on response of domestic industry in terms of domestic production quotas
Early expectations?

• On basis of history of Canada’s trade negotiating positions over 25 yrs, the most likely concession Canada would offer is to expand TRQs
  – Canada has strenuously avoided reducing over-TRQ tariff levels; this position supported strongly/chosen by industry
  – URAA result: setting of TRQs with high over-quota tariffs
  – Doha Rd negotiations converged on only TRQ increase
  – CETA negotiations yielded this outcome

• Canada’s over-TRQ tariffs have much water (i.e., excess protection where tariffs are higher than needed to keep out imports)
  – Appears that moderate tariff reductions could occur with no change in imports for most years and world prices
  – But even moderate reduction strongly resisted by industry
Acceptable to trading partners?

• This (my) expectation (only TRQ increase) was not held by TPP partners

• NZ was clear; a TPP agreement with Canada required substantial opening up of dairy trade

• After early information of Canada-EU Trade Agreement that EU accepted an increase in Canada’s cheese TRQ of some 10-15,000 tons, the US dairy lobby gave an equally strong reply:

  “U.S. dairy industry representatives this week said the new cheese market access that Canada reportedly agreed to give the European Union under a bilateral free trade agreement falls far short of what U.S. dairy producers are seeking to obtain from Canada in the Trans-Pacific Partnership (TPP) negotiations...” (Oct 25, 2013, Inside US Trade’s World Trade Online)
Actual TPP Results

• Headline Result:
  – An increase in Canada’s milk product TRQs by 3.25 percent of domestic consumption

• Additional less publicized results for Canada
  – No change in over-TRQ tariff rates
  – Small increased TRQ access to US dairy market
  – Elimination of tariff on MPI, milk protein isolates
  – Phase-out of tariffs on dried whey

• These latter two categories are part of category of non-fat milk solids, still relatively small, but outside system of TRQs and the 3.25% increases above, so now with no tariff or quota limits
How to interpret 3.25% TRQ increase

• What is existing TRQ level as % of consumption, with disaggregated data by main dairy products
• TRQs by product category using 2011 consumption data

- Butter 3.5%
- Cheese 4.2%
- Yogurt 0.1%
- Creams 0.1%
- Ice Cream 0.5%
- Fluid Milk 2.4%
General effects of 3.25% TRQ increase

• Overall, existing TRQs are roughly equivalent to 3 percent of aggregate consumption
• The TPP agreement will double the level of import access to the domestic market
• We do not yet know how this increase will be allocated across product categories
  – It does appear that it includes fluid milk
  – It also adds to the TRQ increase (on cheese) given to the EU in the CETA (not yet ratified), equal to roughly 1.5% of all milk product consumption
  – It is also unclear how much will be given to importer countries vs. to Canadian importers (rent distribution?)
More analytical detail effect of TPP

• To consider the industry-wide effect of TRQ increases on the Canadian dairy sector we look at a S-D model

• An increased TRQ is inframarginal and exogenous; it does not itself alter consumption decisions or the supply curve within Canada (assuming imports and domestic products are close substitutes)

• It will satisfy part of domestic demand and shift out the domestic supply curve in an industry S-D diagram; the increase in TRQ is shown as T shifting to T’ (in red)

• Two alternative scenarios are shown:
  – One, domestic supply is cut back to offset the increased TRQ (S, Q, P, MC)
  – Second, domestic supply is unchanged (S’, Q*, P*, MC*)
Illustration of Effect of Increased TRQ on milk prices, quota levels
What effect on CDN Industry? 2

• Case 1: there is no change in total market supply, no change in demand or supply curves, and therefore, no change in the price
  – The only change: domestic milk quotas are cut back by the full amount of the increased TRQ
  – It is worth emphasizing, no change in domestic $P$ (this is the domestic milk price, not product price)

• Case 2: there is no change in the domestic quota, but total milk quantity increases to $Q^*$ with the increased TRQ, so price falls to $P^*$, and the domestic supply curve is shifted to $S'$
Which result will occur, Case 1 or 2?

• This is an industry decision
• However in past, the industry quite predictable in cutting back domestic quotas to offset any changes in imports to protect domestic price
• Is this optimal in purely economic terms for the industry?
  – A monopolist, facing a decreased demand for domestic milk (which is what happens with an increase in imports via the TRQ), would both cut both quantity and price
  – But this assumes a starting point of maximum industry profit; If, as is likely, the industry through the constraints on its pricing was at a lower price than a pure unregulated cartel’s price, it is optimal to cut quota levels as they always choose to do
• In any case, we assume the industry follows past practice, keeps prices constant and reduces domestic quotas
More on the increased TRQ

• So we assume Case 1, that domestic quotas will be cut back, kg for kg, with the increased TRQs

• This will result in no change in domestic prices, to consumers or producers

• It will mean that producers choose to reduce their quotas, by roughly the 3.25%

• This will be phased in, over 5 years

• What will this mean to average producer, aside from the 0.65%/yr during the phase-in period?
  – A farmer’s industrial milk component of his/her quota already fluctuates from year to year with normal fluctuations in demand
-3.25% vs. past fluctuations in MSQ?

- Industrial milk quota (MSQ) fluctuates each year in line with expected changes in market demand.
- Over the past 13 years, from dairy years 1999/2000 to 2011/2012, the average change in aggregate Canada-wide MSQ was +0.8 percent.
- In 5 of those 13 years, quotas were reduced on average by 1.4% (range -0.1 to -4.0%).
- Compare to 5 yr phased-in 3.25% cut (0.65%/yr).
- Average market growth is likely to cover this cut; on average it will be highly difficult to notice.
Implications for quota values

• Because aggregate quota levels will fall, and milk prices will not, there will be changes in the private market for domestic quota

• Supply is reduced, while demand is unchanged (no change in milk prices), pushing up quota prices
  – Marginal rents will rise, discounted into higher stock prices

• Another reason for quota values to rise concerns policy risk. With the TPP agreement in place, it is likely that perceived policy risk will fall, further raising quota values

• This is exactly what happened in the years following the URAA, when quota prices rose substantially due heavily to reduced policy risk; After the TPP with the increase in TRQ, quota values are doubly likely to rise
Conclusion re TRQ increase

• On the basis of the 3.25% TRQ increase, and predictable endogenous reduction in domestic quota levels, we can assess the TPP impact on the dairy sector

• In an environment when many, including some negotiators, had predicted significant changes to Canada’s supply management system, the industry dodged a bullet

• Not only did it avoid serious harm, it almost certainly will end up with an increase in the total value of farm-held quotas

• Because there is no other trade agreement on the horizon, the window is likely closed for some time on further major reform of the regime. This is why perceived policy risk by quota holders and buyer is most likely to fall, and raise the industry’s total wealth.
Government compensation for TRQ increase

- With recognition of possible damage to the industry from the TRQ increase, particularly in the final weeks of a federal election campaign, a compensation package was offered
  - Whether the industry was actually damaged or not (clearly from the foregoing I would argue not), is beside the point, especially in an election campaign (analogous to grape sector compensation after the CUSTA was signed)
- The compensation package was generous: $4.3 billion for both dairy and poultry sectors
- It features a price guarantee for quota values: if quotas are sold in some time period below some reference point price, compensation will be paid
- It also features an income guarantee, that if incomes fall below some reference level, payments will also be made
- This will also have an effect on quota prices, further raising them
- To sum: I believe that for three separate reasons quota values will rise
  - If this is correct, the Minister of Finance will be relieved to hear that the quota price guarantee likely will never have to pay out.
Milk Protein Isolates 1

• An less obvious result of the TPP agreement is the reduction in tariffs on milk protein isolates for TPP member countries (and EU)
  – Why not covered by TRQs? They were classed as protein rather than dairy products and then in NAFTA, US and Mexico not bound by this TRQ

• The import into Canada in this category has grown by 76 percent, 2007 to 2014; 22% more in 2015 to Sep (17,000 tons) [but this category includes all protein sources >85% protein by weight, so HS 35.04 is not only MCI]

• On protein equivalent basis, MCI is ~3X skim milk powder; so “imports” equiv to 50,000 tons, and CDC surplus removal of skim was 61,000 tons

• MCI is not all of this 50,000 tons equiv. but it apparently dominates
  – This surplus removal accounts for ~ 8 percent of all skim milk produced in Canada, giving one measure of the size of the longstanding (i.e., “structural”) surplus problem of Canada’s milk policy
Milk Protein Isolates 2

• What makes this product important is that as a milk protein it exacerbates Canada’s surplus non-fat solids problem, maybe 70-80% of CDC’s existing surplus disposal (offsetting it to a high degree)

• As Hedley et al have pointed out, this problem can no longer be solved by exports after the WTO milk exports case against Canada by the US and NZ

• What is needed is some reduction in prices of nonfat solids, which is now being seriously discussed, and possibly addressed, by the provinces and the CDC
  – The policy challenge here is to reduce the export subsidy component on skim at the margin while providing a firewall to keep high-priced domestic product consumption (domestic rents) unchanged

• TPP adds potential to increase these imports by adding NZ and Australia to potential sources, along with EU (CETA)
Summary

• The TPP will increase the dairy TRQ of 3.25% of total consumption, or in annual phased-in terms, 0.65%/yr
  – Almost certainly will result in reduction in domestic quotas to preserve existing farm milk prices
  – This is a much smaller result than was anticipated
  – Will almost certainly result in increased quota values for several reasons
    – By this TPP component itself, industry becomes more profitable
• On top of this, compensation package announced will further benefit the industry, in part by further raising quota values
• But also worth noting TPP tariff removal on certain concentrated protein sources may exacerbate the existing non-fat solids surplus in Canada, pushing the dairy sector to resolve this surplus problem more seriously, and quickly