



AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
<http://ageconsearch.umn.edu>
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

The NAFTA Panel on Dairy and Poultry: What Will They Decide?

by

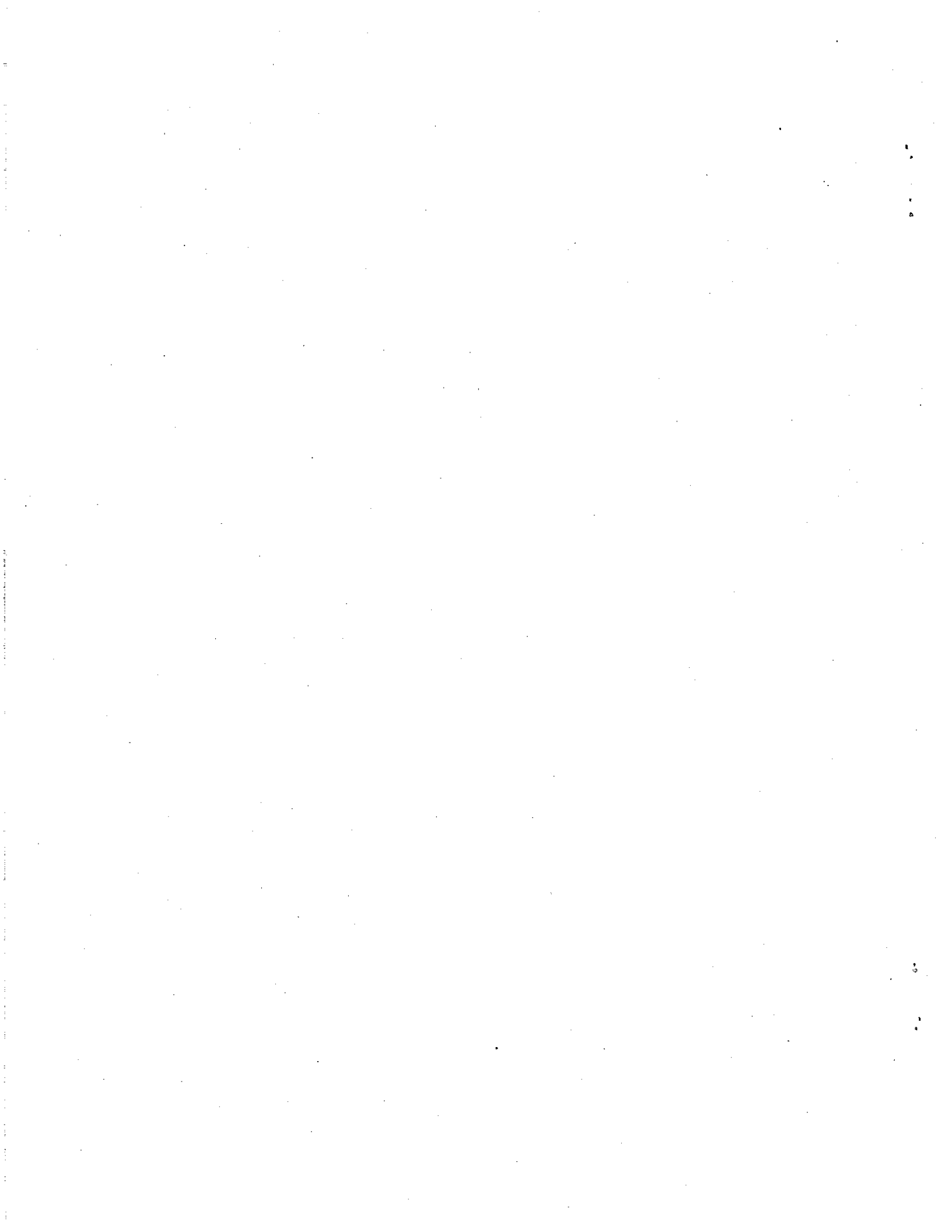
Karl D. Meilke
Professor
Department of Agricultural Economics and Business
University of Guelph
Guelph, Ontario
N1G 2W1

DISCUSSION PAPER DP95/03

October 1995

This paper is scheduled to appear in the November 1995 issue of *Policy Options*. Helpful comments on an early draft of this paper were received from T.K. Warley and Larry Martin but the author is solely responsible for any errors. Financial support for this project was provided by the Social Science and Humanities Research Council. This paper reflects the policy situation as of September 10, 1995.

DISCUSSION PAPERS ARE PUBLISHED WITHOUT FORMAL REVIEW WITHIN THE
DEPARTMENT OF AGRICULTURAL ECONOMICS AND BUSINESS



THE NAFTA PANEL ON DAIRY AND POULTRY: WHAT WILL THEY DECIDE?

Since the signing of the Canada-United States Free Trade Agreement(FTA) there have been a number of trade disputes involving agricultural products. In most of these cases, the disputes have been settled using the procedures outlined in Chapter 19 of the FTA. Chapter 19 deals with anti-dumping and countervailing duty cases, or more generally "unfair" trading practices. While the results of the various panel decisions have not been entirely satisfactory to representatives of either country, most observers would agree that they represent an improvement over the national appeal processes which they replaced.

The current dispute is the first case that will be heard under Chapter 20 of the North American Free Trade Agreement(NAFTA). It addresses Canada's right to replace import quotas with permanent tariffs on its supply managed commodities (dairy, eggs and poultry). Border measures are required to protect the formula determined prices of these commodities, which are typically well above world market levels. Further, farm production is controlled using production quotas, so that output approximately equals domestic demand at the formula determined prices. Although not a "formal" part of the dispute, the panel ruling will also affect the tariffs the United States has applied to Canadian exports of dairy products, sugar, peanuts and processed products containing these ingredients.

Chapter 20 is designed to deal with the institutional arrangements and the interpretation of the NAFTA. While economics and economic arguments play a key role in Chapter 19 hearings, economics will not play an important role in the Chapter 20 dispute. The argument is essentially a legal issue that will be determined on legal grounds. The decision of the NAFTA panel will, however, no matter what its finding, have decisive economic effects on the production and patterns of trade of the commodities under discussion.

HOW WE GOT INTO THIS DISPUTE?

The origins of this dispute trace back to the negotiation of the FTA and the Uruguay Round Agreement on Agriculture (IATRC; Warley). It was clear throughout the FTA negotiations that agriculture would be a difficult sector to negotiate. Both the United States and Canada had sensitive commodity sectors and policies that neither country wanted to liberalize in the bilateral negotiations. Further, given the emotionally charged nature of the free trade debate, it was important for the FTA's supporters to be able to argue that no essential element of domestic agricultural policy was threatened by the bilateral accord. Consequently, in the FTA, Canada insisted on maintaining its then GATT-legal import quotas for dairy, eggs and poultry products. In return, Canada increased its global import quotas for these products to insure that its imports would not drop from the then current import levels. The import quotas ranged from about 2 percent of domestic production for turkey to 7.5 percent of domestic production for chicken. In a similar fashion, the United States retained its 1955 waiver from GATT rules which allowed it to impose import quotas, if imports interfered with its domestic agricultural programs

When NAFTA was negotiated, Canada again insisted on maintaining its right to impose import quotas on its supply managed products¹. As a result, Canada entered into separate bilateral agreements with the United States and Mexico for agriculture. The provisions of the FTA continue to apply to Canada-United States agricultural trade and a separate set of provisions govern Canada-Mexico agricultural trade.

One of Canada's major goals in negotiating agri-food trade during the Uruguay Round was to maintain its import quotas on the primary products under supply management, and to establish that import quotas could be used to protect the processed products using the supply controlled raw products as ingredients. This was a key issue, because the legality of import quotas on processed agricultural products was in serious doubt following GATT panel rulings against the import quotas imposed on a wide variety of products in Japan and against Canada's import quotas on yogourt and ice cream. Canada's negotiating position would have required a rewriting of GATT Article XI to make it more trade restrictive - expanding the conditions under which import quotas - were legal.

Early in the GATT negotiations Canada had some support for its position on Article XI from several high-cost agricultural importers. However, following the tabling of the *Draft Text on Agriculture*, in December 1991, by Arthur Dunkel (Director General of the GATT), which called for the conversion of all non-tariff border measures into tariffs, Canada's negotiating position was in serious difficulty. In fact, many countries found Canada's negotiating position, which

¹ Meilke, von Massow and van Duren provides a discussion of the issues going into the NAFTA negotiations.

called for the liberalization of trade in those commodities where it has a major export interest and increased protection for its supply managed commodities, hypocritical. Over the remaining two years of the GATT negotiations Canada's arguments for a strengthened Article XI continued to lose support until it was left alone, at the end of the negotiations, in arguing for a permanent exception from converting import quotas into tariffs.

In ratifying the Uruguay Round Agreement Canada agreed to the conversion of all non-tariff barriers into import tariffs, a process termed "tariffication". Most observers agree that this was one of the major achievements of the Uruguay Round, as it brought agricultural trade under rules similar to those governing trade in manufactured products. The Uruguay Round eliminated permanent import quotas, restrictive import licensing practices, variable import levies and other gray area trade measures that have long hampered efforts to liberalize trade in agricultural products. Further, all tariffs, including the ones created through the tariffication process must be reduced by a minimum of 15 percent and on average by 36 percent, over the next six years. In addition, minimum access commitments were established.

Many countries in order to meet, but not exceed, their minimum access commitments have replaced their non-tariff border measures with tariff rate quotas. A tariff rate quota allows a specified quantity of product (the within-quota amount) into a country at minimal or modest tariffs; while quantities above this amount face much higher tariffs. This is the route that Canada followed. Table 1 shows the within and the over-quota tariffs for selected supply managed products. To meet its tariff reduction requirements Canada chose to reduce the within-quota tariff rates by 57 percent and the over-quota rates by 15 percent.

Canada's over-quota tariffs are huge, ranging from 182 percent for turkey to 351 percent for butter. These tariffs are high enough to keep out over-quota imports for the life of the Uruguay Round agreement. It is these tariffs, created through the tariffication process, to which the United States objects.

Table 1: Canada's Tariffs for Selected Commodities¹

<i>Commodity</i>	<i>Within-Quota Tariff</i>	<i>Over-Quota Tariff</i>
Milk	17.5%	283.8%, but not < \$0.406/liter
Butter	\$0.2646/kg	351.4%, but not < \$4.709/kg
Cheddar Cheese	\$0.0661/kg	289.0%, but not < \$4.149/kg
Skim Milk Powder	\$0.0772/kg	237.2%, but not < \$2.360/kg
Yogourt	15%	279.5%, but not < \$0.549/kg
Ice Cream	15.5%	326.0%, but not < \$1.360/kg
Chicken	12.5%, but not < \$0.11/kg	280.4%, but not < \$1.960/kg
Turkey	12.5%, but not < \$0.11/kg	182.0%, but not < \$2.295/kg
Eggs	\$0.035/dozen	192.3%, but not < \$0.94/dozen

1/ These tariffs are effective August 1, 1995. Over the next six years the within-quota tariffs will be reduced by 57% and the over-quota tariffs by 15%.

As soon as comprehensive tariffication became the most likely outcome of the Uruguay Round negotiations it was clear that a crucial issue was the legal status of the tariffs that would replace import quotas at the Canada-United States border. One option was to negotiate this issue with the United States bilaterally, folding the outcome of these discussions into the Uruguay Round agreement. Given the importance of this issue to Canada, why was this not done?

Two interrelated answers capture the most obvious possibilities. First, Canada may have felt it was on solid legal ground given Article 302 of the

NAFTA. Hence, discussions on this issue were simply unnecessary. However, as will be explained, Canada's legal case is less compelling for the tariffs that apply to yogurt and ice cream than they are for the other supply managed commodities.

The second reason for not negotiating the status of Canada-United States trade in supply managed and derivative products, during the Uruguay Round, had to do with Canada's overall negotiating position. Canada's attempt to save and strengthen Article XI was clearly doomed to failure many months before the end of the negotiations. However, in the fall proceeding the final agreement, the federal government was taken to task by the supply management producers lobby when its chief agricultural negotiator suggested that Canada's position was in some jeopardy. Hence, it was politically impossible for Canada's negotiators to clarify the situation with the United States without giving the appearance of having given up on Canada's long held negotiating position, in Geneva. This was true even though at the final hour Canada agreed to comprehensive tariffication. Canada's supply managed industries signed-on to the agreement only when it became clear that the proposed over-quota tariff rates would be prohibitive and that the minimum access commitments would not be onerous, essentially guaranteeing the status quo for the next six years.

The United States also had a stake in clarifying the rules governing Canada-United States agricultural trade prior to the end of the Uruguay Round. Their imports of Canadian sugar, peanuts and products containing these ingredients are also protected by high tariffs. These are politically sensitive products in the United States and they would like to avoid a flood of imports from Canada. Hence, there was room for some horse trading. Even if it the United

States wasn't willing to negotiate a deal acceptable to Canada, walking away, was always an option. It is difficult to see where Canada had anything to lose in raising the issue, unless our legal position was considered iron clad.

Between December 1993 and October 1994, representatives from the two countries met several times in an attempt to resolve the tariff dispute as well as problems in the grain sector. All to no avail. Hence, whatever its merits the opportunity to clarify the rules governing Canada-United States trade during and immediately after the Uruguay Round was lost and both countries will have to live with the consequences.

THE LEGALITIES

The key provisions of the NAFTA which will guide the resolution of the current dispute are: Article 302: *Tariff Elimination and Annex 702.1 : International Obligations*; as well as Article 401: *Schedule C*, the time table for tariff elimination from the FTA. These read as follows:

Article 302: Except as otherwise provided in this Agreement, no Party may increase any existing customs duty, or adopt any customs duty, on an originating good.

Annex 702.1: Unless otherwise specifically provided in this Chapter, the Parties retain their rights and obligations with respect to agricultural, food, beverage and certain related goods under the General Agreement on Tariffs and Trade (GATT) and agreements negotiated under the GATT, including their rights and obligations under GATT Article XI.

fluid milk would also be in noncompliance. It is even possible that the panel could find Canada is in compliance with NAFTA for its raw agricultural products, that are supply controlled, but not for the processed products made from poultry, eggs and milk.

A finding that Canada is in partial compliance with its NAFTA obligations would cause nearly as much havoc in the industry as a finding of non-compliance. Supply management could no longer exist in its current form if the tariffs on all processed products were removed. Canadian processed products would have to be competitively priced - which implies competitively priced raw products - or they would be imported.

If tariffs are removed on only yogurt and ice cream the dairy industry could respond in one of two ways. It could abandon these markets to imported products. However, yogurt and ice cream account for about 11 percent of total industrial milk sales and this is an expanding market segment. Alternatively, Canada could lower the price of milk used to make ice cream and yogurt, by changing the current discriminatory pricing system. This would lower overall raw milk prices, assuming the price of milk for other uses wasn't increased, but make processing these products from domestic milk sources possible. However, a pricing scheme of this type might be open to challenge in the World Trade Organization, where the multiple pricing policy could be deemed an export subsidy.

Hence, any finding by the NAFTA panel, other than total exoneration for Canada, has potentially serious ramifications for our supply managed industries.

THE ECONOMICS

How serious would an open border with the United States be for Canada? The exact impacts depend on exchange rates, processing efficiency and raw product market prices in both countries. However, there is no doubt that Canadian prices for the supply managed commodities are considerably higher than in the United States. Surprisingly, this does not mean that Canadian producers could not compete at these lower prices. Canada's raw product cost structure has been shifted sharply upward by the existence of expensive production quotas. For producers who have bought production quota these are real costs and a quick move to lower output prices would put many relatively efficient producers, saddled with high quota costs, out of business along with many less efficient producers. These hardships could be minimized by a slow phased removal of protection and/or the provision of compensation. Finally, one should not lose sight of the benefits which would flow to Canadian consumers following trade liberalization and the potential benefits to Canadian agri-food firms from more open access to the United States market.

THE POLITICS

While it is expected that the NAFTA panel decision will "decide" the dairy and poultry dispute, this is unlikely. It will simply judge if Canada's tariffs are in conformity or non-conformity with the NAFTA. Following this, Canada and the United States will be left - again - to negotiate a solution. Unfortunately, a finding against Canada has the potential to escalate into a wider trade war. Why?

Canada has the option of not implementing the panel findings. If so, the United States can retaliate by removing trade benefits of equivalent effect. This would spread the trade dispute beyond the supply managed commodities, since there is little scope for retaliation by the United States in these sectors. However, this is the worst case scenario and not a likely outcome. Recall, an adverse panel report for Canada also has implications for the United States dairy, sugar and peanut industries. The United States is also interested in finding a way to control Canadian grain shipments into the United States. Although higher grain prices have moved this issue off of the front burner.

An adverse ruling for Canada is likely to lead to some form of a negotiated multi-commodity settlement, but the panel ruling will determine which country has the upper hand in the negotiations. Dr. Larry Martin, Director of Economic Research for the George Morris Centre, an agricultural policy think-tank, argues that Canada should use the time before the panel report to negotiate a phased reduction of all remaining tariffs between the two nations as well as the removal of a significant number of United States technical barriers to trade (Martin). However, both sides appear to be entrenched in their respective positions and a negotiated settlement prior to the panels decision seems remote.

THE FUTURE

While a finding in Canada's favor will be applauded it will not mean an end to the pressures on Canada's supply managed industries to lower their cost structures and to liberalize trade. Reform of the supply management system will simply be postponed, not resolved. A new multilateral round of agricultural trade negotiations are scheduled to begin under the auspices of the World Trade Organization in 1999. The "tariff mountains" created by the tariffication process

in the Uruguay Round are bound to attract the attention of low cost agricultural exporters, and in particular the United States.

These highly protected commodities are going to be under intense pressure to liberalize trade, not only from the World Trade Organization, but also as a result of the Free Trade Area of the Americas program which is a commitment to expand NAFTA to more countries. A program which has Canada's strong support. It is time to publicly admit that not all domestic agricultural programs are compatible with an FTA. They are not, and governments, economists and farm leaders know it. Where domestic policies are inconsistent with a free trade area there will be continual pressure for change and continual trade friction. This is as true for the United States and Mexico as it is for Canada. The United States and Mexico agreed to phase out all tariffs on bilateral agricultural trade and it is time for Canada and the United States to do the same.

A panel ruling in Canada's favor will give it three years to prepare for inevitable change in the supply managed industries. It should use these three years to insure gradual change by modifying its domestic policies and by negotiating a comprehensive agreement with the United States which encompasses all of the current agricultural disputes². If Canada loses the current panel hearing it risks facing the same changes, but more quickly, and with more economic bloodshed. The healthful breezes of competition and trade liberalization are sweeping the world. Canada's supply managed industries can ill afford to win the current battle, only to lose the war a few years hence.

² In fact, a small window of opportunity may currently exist because the difficulties related to bilateral grain trade seem to have been temporarily resolved.

REFERENCES

Martin, L. J. 1995. The Coming Clash Over Canada's Dairy and Poultry Tariffs. Special Report, George Morris Centre, Guelph, July.

Meilke, K. D., M. von Massow and E. van Duren 1991. "A Canadian Perspective of a North American Free Trade Agreement for Agriculture." NAFTA North American Free Trade Agreement: Effects on Agriculture. Volume I, American Farm Bureau Research Foundation, Chicago.

Warley, T.K. 1988. "Agriculture." ed. J. Cripso. Free Trade: The Real Story. Toronto: Gage Publishing Company.