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Reforming dairy supply management in Canada: the Australian example

Even with a temporary reprieve from the latest WTO talks in Hong Kong in December 2005, the supply management system in Canada's dairy industry will have to be reformed in the longer term. The system clearly benefits certain milk producers, but on the other hand it holds Canadian consumers hostage and stifles entire industries that have to pay more for their milk. It erects an obstacle to competition throughout the Canadian dairy industry, penalizing the most dynamic producers by means of extravagantly expensive quotas.[1]

The system relies in particular on artificially high support prices. Coinciding with the new increase on February 1, 2006, the method used by the Canadian Dairy Commission to calculate these prices has come to an end and will have to be modified. The time is thus ripe to consider a more fundamental reform of supply management in the Canadian dairy industry, comparable to what Australia did in 2000.

Support prices: a "tax" on consumers

Regulation of Canadian milk prices was created to aid dairy producers and boost their incomes artificially. It obviously makes sense only if support prices are set above market prices. Rather than subsidize dairy producers directly, public authorities more or less signed them a blank cheque. Protected behind tariff barriers of 200% to 300%, varying by product, dairy producers can thus "tax" consumers directly, holding them hostage by imposing prices at the farm gate.

In 2002, the Canadian Dairy Commission agreed to having half of producers recover their production costs. Support prices were raised to match assumed costs incurred by the median farm in Canada (the farm with costs lower than half of all farms but higher than the other half). In recent years, the Commission has thereby set support prices using a methodology running contrary to all economy logic, causing many perverse effects.

First, economics teaches us that prices are determined by supply and demand on the market rather than by production costs. Do we not see unsold clothing from last year's collections sold at a discount to current seasonal collections, even though storage has pushed up costs in the meantime? In other words, the dairy industry should set things the other way around: it should be up to producers to adjust their production costs to the prices that buyers are willing to pay.

Second, the median farm's production costs do not reflect the reality of milk production, much of it accounted for by major producers at lower costs. For example, in Quebec the largest 50% of producers delivered more than two thirds of milk production in 2004.[2] The median farm's costs, which are defined very broadly, are thus higher than what it really costs to produce most of Canada's milk.

1. This Economic Note is a follow-up to the one published in February 2005, "Dairy production: the costs of supply management in Canada," available at http://www.iedm.org/main/show_publications_en.php?publications_id=86.
2. Groupe Agéco, "Faits saillants laitiers 2004. Nombre de producteurs de lait et quota total détenu selon les strates de quota, Québec, 2000/2001 à 2003/2004," available at http://www.groupeageco.ca/fr/pdf/stat/PN4.pdf; calculations by the author.

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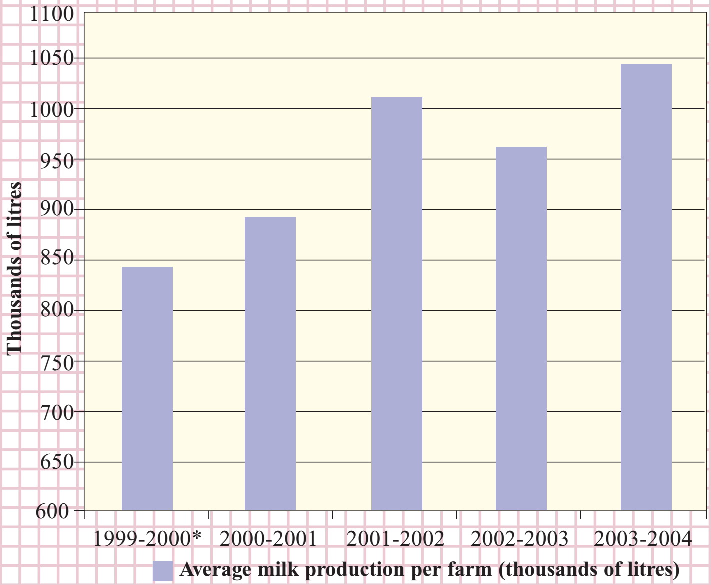
Figure 1

Milk production per farm in Australia between 1999 and 2004



* The year before regulation ended on June 30, 2000.
Source: David Harris, 2005, *op. cit.*, p. 64.

Third, prices give a signal to economic players. When they are artificially high, they push buyers into reducing their demand and encourage the most efficient producers to overproduce. To avoid this, Canada's supply management system eliminates competition between Canadian producers and imposes production quotas. Thus, even though the most dynamic producers may wish to increase or diversify their production, they cannot do so without paying about $29,000 for each additional cow to be milked. This was the average price of a quota in 2005 in Quebec and Ontario, where more than 70% of Canadian milk is produced.[3] By protecting inefficient producers, the current system makes the Canadian industry less competitive.

The Australian example

Australia, which invented supply management in the 1920s, eliminated dairy support prices and quotas in 2000. This deregulation followed other reforms starting in the mid-1980s aimed at removing export assistance and controls on processors' and retail prices.

Prior to 2000, an artificial separation between fluid milk and industrial milk, similar to the Canadian practice, was still in effect, with producers getting approximately double the price for fluid milk depending on the level of price support determined by each of the six state governments. As in Canada, some of them (Queensland, New South Wales and Western Australia) used individual farm quotas to allocate shares for supplying fluid milk. Prices of industrial milk varied with world prices, but Australia's federal government guaranteed support payments to producers for industrial milk used on the domestic market.

In the late 1990s, regulation of fluid milk support prices and obstacles to interstate commerce still applied. The time was doubly ripe for reform. On the one hand, federal legislation establishing industrial milk support was set to expire in June 2000. In addition, in 1999, nearly all milk producers in Victoria – the most competitive state, providing about two-thirds of all milk in the country – supported complete deregulation of dairy supply in their state.[4] That sounded the death knell for milk supply management in the rest of Australia.

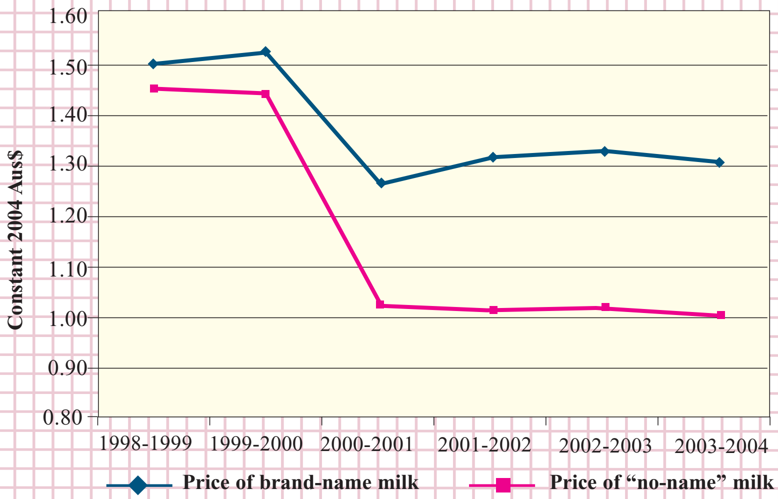
Starting on July 1, 2000, prices at the farm gate for fluid milk fell in varying degrees in the different states, and since then have changed depending on the conditions in contracts signed between producers and processors. Producers in Victoria were less affected by the reform than their counterparts in states such as Queensland and New South Wales where fluid milk accounted for a much higher share of production.

By protecting inefficient producers, the current system makes the Canadian industry less competitive.

3. Canadian Dairy Information Centre (http://www.dairyinfo.gc.ca/cdicsmi.htm); calculations by the author.
4. See David Harris, *Industry Adjustment to Policy Reform. A Case Study of the Australian Dairy Industry*, Australian Government, Rural Industries Research and Development Corporation, August 2005, pp. 15-16, available at http://www.rirdc.gov.au/reports/GLC/05-110sum.html.

Figure 2

Average retail price of a litre of regular milk in Australian supermarkets*



Note: Years ending June 30.
* Prices after July 1, 2000, do not include the new 11-cent-a-litre that was added to the retail price and is set to disappear in 2010.
Source: David Harris, *op. cit.*, p. 31; Australian Bureau of Statistics; calculations by the author.

While eliminating support prices, the federal government also set up transitional assistance programs amounting to more than Aus$1.75 billion (about Can$1.51 billion). An initial program covered dairy producers in the form of general assistance under the Dairy Industry Adjustment Package.[5] A subsequent program was aimed specifically at aiding producers who had suffered most in states more heavily reliant on fluid milk and who had lost, among other things, the value of their quotas. In addition, producers could claim capital losses equal to the cost of milk quotas purchased since September 20, 1985 provided they could be offset against capital gains.[6] Finally, the Western Australia government voted for Aus$27 million in assistance on top of the federal aid. These programs did not affect the budget of the federal government, which financed them through a tax of 11 cents per litre of fluid milk sold at retail, intended to disappear in 2010.

What are the lessons for Canada?

When it comes to reforming the dairy supply management system in Canada, a number of concerns have been raised to which the Australian experience provides answers.

First there is the fear that, without support prices, milk production will dwindle. This did not happen in Australia, although competition from New Zealand products has been very strong following a free trade agreement in 1990. Between 1999 and 2004, the number of farms fell by 25%, but total milk production dropped much less – about 7%. This resulted directly from two years of severe drought, between 2002 and 2004. Maintaining production levels was made possible only by farmers increasing their individual production (see Figure 1). Without the drought, Australian production would probably have continued its growth trend, as occurred in 2001-02 – the only year with normal climatic conditions – when 4% more milk was produced than in the year preceding reform.[7]

Dairy producers acted quickly to compensate for income loss linked to elimination of support prices. For example, 45% of producers expanded their cattle herds; 27% increased their non-agricultural income; others enlarged their farms, modernized their equipment or developed other areas of agricultural production.[8]

As summed up by a recent Australian government report: “Concerns about the capacity of Australian dairy farmers to adjust to the reform were overly pessimistic. (…) A number of producers have retired from the industry but there has not been a major industry contraction as some had feared: after an initial period of adjustment there was a recovery in milk production and the industry’s export performance has been maintained.”[9]

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5. This program had three components: transitional aid for all producers (Dairy Structural Adjustment Program), aid for producers who decided to leave the industry (Dairy Exit Program) and aid to regions with large communities dependent on the dairy industry (Dairy Regional Adjustment Program). Certain dairy companies got part of this assistance to restructure their dairy product plants or to finance other business projects.
6. Minister for Agriculture, Fisheries and Forestry, “Federal tax relief for dairy farmers,” Media Release, September 18, 2000, available at http://www.maff.gov.au/releases/00/00172wt.html.
7. David Harris, *op. cit.*, p. 64; calculations by the author.
8. David Harris, *op. cit.*, pp. 37-38.
9. David Harris, *op. cit.*, p. x.

A second argument holds that abolition of supply management would compromise stability in milk supply, considered beneficial for processors and consumers alike. But if consumers do in effect benefit from this stability, some entrepreneurs will offer specific contracts with incentives for dairy producers to respond to this market demand. In Australia, for example, milk production is highly seasonal, peaking during spring. Some processors, dependent on regular year-round supply, sign annual contracts with bonuses for dairy producers, offering them a higher stable price than prevailing market prices. Other farmers receive a smaller premium through a blended price that reflects returns from sales of fresh milk and manufactured dairy products.[10]

Finally, the argument heard most often from defenders of supply management is that, even if prices drop at the farm gate, this would hurt dairy producers without benefiting consumers because processors and retailers would raise their margins. This fear is also unfounded.

Retail prices for fluid milk in Australia have come down considerably, whether for brand-name or "no-name" milk (see Figure 2). Not counting the new 11-cent-a-litre tax, the decline in real terms has been 18% for brand-name milk and 29% for "no-name" milk. Savings to consumers on milk purchased in supermarkets are estimated at more than Aus$118 million annually.[11]

An Australian study concludes: "The consumer has been the big winner from the process of change in the dairy industry, with retail milk prices on average – across the milk category and across the different market segments – remaining below the price prior to deregulation. The consumer has also benefited through increased choice of product and increased access to innovative products which are aimed at various dietary and convenience needs."[12]

In eliminating its supply management system in 2000, Australia enabled its dairy industry to remain today one of the most dynamic in the world. By returning to real market prices for milk and other dairy products, Canada could do the same, benefiting producers and consumers alike.

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10. David Harris, *op. cit.*, p. 27.
11. Australian Competition and Consumer Commission, *Impact of Farmgate Deregulation on the Australian Milk Industry: Study of Prices, Costs and Profits*, April 2001, p. xviii, available at http://www.accc.gov.au/content/item.phtml itemId=306304&nodeId=-file423506ecd6bb1&fn=Impact%20of%20Farmgate%20Deregulation.pdf.
12. National Competition Council, "Dairy – Now and Then: The Australian Dairy Industry since Deregulation," NCC Occasional Series, AusInfo, Canberra, November 2004, p. 6, available at http://www.ncc.gov.au/pdf/NCCRidgePartners_Dairy.pdf.

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