

The Next Round of WTO Negotiations: What Is In It For Dairy?

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■ Take Home Message

- ▶ A new round of World Trade Organization (WTO) negotiations are underway with a schedule of tasks to be completed by 2005. To date, good progress has been made, but in order to meet the deadline for completion the U.S. Administration has to receive negotiating authority from Congress.
- ▶ Border measures, such as tariffs, are the biggest obstacle to liberalized trade in dairy products. Most large developed countries use a system of two-tiered tariffs to protect their markets. The system only allows limited access at preferential tariffs, while over-quota tariffs are often prohibitive.
- ▶ Subsidized exports continue to have a significant share of world dairy trade. Export subsidies are among the most disruptive of trade distortions because they punish consumers and tax payers in the subsidizing country and undercut low cost competing exporters.
- ▶ Domestic policy reform by the major players in world dairy markets can have substantial impacts for world dairy markets.
- ▶ Canadian dairy policies will likely change, but not from WTO pressures. Rather internal pressures are more likely to be the basis for change.

■ Introduction:

International dairy markets are very thin as only five percent of world dairy production is traded (Blayney and Miller 2000). Despite the small volume of trade, modest changes in imports or exports can have dramatic impacts on international dairy prices. This has both an upside and a downside. The upside is that modest trade policy reforms can improve international dairy markets significantly. The downside is that international dairy prices are very volatile. One of the sources of the volatility problem is that industrial countries

have used interventionist policies which maintain insulated domestic markets with high prices and have released any surplus production onto world markets to assist in supporting domestic prices. In fact, international dairy markets really consist of two broad types of markets: "controlled access markets" consisting of the industrial economies of Europe, North America, and Japan, and "competitive supply markets" consisting of Latin America, Asia, Russia and the Former Soviet Union Republics, Australia and New Zealand, North Africa and the Middle East.¹ It is the second group of markets where consumption has been growing and where the future prospects for international dairy trade lies.

The Uruguay Round Agreement on Agriculture (URAA) was a mixture of accomplishments and things which are yet to be done. The URAA began the process of disciplining export subsidies, converted non-tariff barriers to tariff-equivalent measures and facilitated preferred market access to a small share of domestic consumption for foreign dairy products. While this Agreement set in place the framework for future trade liberalization the degree of actual liberalization was small.

The stage is set for further trade policy reforms and improved market access for internationally traded products. Unilateral domestic policy reforms in the European Union (EU) and the United States should reduce the pressures for domestic surplus disposal and the need to use export subsidies.

The objective of this paper is to consider the potential impact of further WTO reform in the context of a changing dairy market. The paper does not take a particular country perspective but rather addresses policies of those regions that most directly affect international dairy markets. The paper considers the state of current negotiations; the major issues in the negotiations including the remaining trade barriers, other factors will influence trade liberalization and a prognosis regarding the success of the negotiations.

■ State of Current Negotiations

Built into the Uruguay Round Agreement on Agriculture was a commitment to begin negotiations for further liberalization of agricultural trade before the end of 1999. This process is underway and is well into the second phase of negotiations. During the initial phase, WTO members have submitted numerous negotiating proposals stating their starting positions for the negotiations. The second phase discussions deal with more technical details, and are intended to find a way to allow Members to develop specific proposals and ultimately reach

¹ Mitchell (2001) makes this distinction between the two types of international dairy markets.

a consensus. Phase two negotiations should be completed by the end of March of 2002 when a draft text is expected.

Real progress in the agricultural negotiations, however, depends on the ability to make tradeoffs with other sectors in a comprehensive set of trade negotiations. Members of the WTO did agree to a comprehensive set of negotiations at Doha, Qatar on November 15, 2001. The declaration to launch a new set of negotiations set into motion a timetable to complete the negotiations. Modalities for the further commitments are to be established no later than March 31, 2003. Participants are to then submit comprehensive draft schedules based on these modalities no later than the date of the fifth session of the Ministerial Conference (late in 2003) when a stock taking is to take place to determine if political guidance, and further actions are necessary. The negotiations are to be concluded no later than 1 January 2005.

■ **What are the Major Issues for the Agricultural Negotiations?**

The issues that are being discussed in the current round of agricultural negotiations are the three pillars of the Agreement on Agriculture: domestic support, market access and export competition. The domestic support commitments provide disciplines on domestic subsidies (any subsidy which is not counted as an export subsidy). Domestic support programs are either categorized as potentially distorting and subject to reduction (amber programs) or as minimally distorting and not subject to reduction commitments (blue and green box programs). The disciplines on domestic support apply on an agriculture wide basis. For the purposes of this paper domestic support disciplines are ignored because they do not provide binding constraints on dairy programs and to date the negotiating proposals that have been submitted to the WTO have not advocated disciplines which will directly affect dairy.

Export competition deals with direct and indirect export subsidies. An export subsidy is a subsidy that is conditional upon the product in question being exported. Direct export subsidies create a wedge between domestic and world prices, for the country providing the subsidy, where the domestic price increases reducing domestic consumption and increasing domestic production. As a result exports increase and in turn world prices decline. Indirect export subsidies may have similar effects to direct subsidies but no explicit reduction in price to importing countries is involved. Indirect export subsidies potentially include export credit arrangements, food aid, state trading enterprises and revenue pooling.

Market access deals with border measures that limit imports into a country. The key issues in market access negotiations deal with one and two tiered

tariffs, minimum access commitments, tariff quota administration, and tariff peaks.

The major issues with respect to export competition and market access are discussed in separate sections below. The issues include how much trade distortion is still in place, the avenues for reform, and the negotiating positions of major WTO Members.

Export Competition

Export subsidies are among the most disruptive instruments for the operation of world markets. They punish domestic consumers and taxpayers, as well as low cost competing exporters. This is the reason that export subsidies are prohibited in the General Agreement on Tariffs and Trade (GATT) for industrial products. Currently export subsidies are allowed, under the URAA, for some agricultural products, but the use of export subsidies must be reduced from base levels and no new export subsidies are allowed.

The URAA disciplines on agricultural export subsidies established base period benchmarks both in terms of expenditures and volumes, for the period 1986-90. The URAA required Members to reduce the volume exported with subsidy by 21 percent from the base period and to reduce the value of these subsidies by 36 percent.

Although grains have been the major recipients of export subsidies, reforms in domestic policies in the European Union and the suspension of the U.S. Export Enhancement Program have dramatically reduced the use of export subsidies in this sector. Global expenditures on dairy export subsidies accounted for 34 percent of all export subsidy expenditures from 1995 to 1998 and thereby account for the largest share of expenditures for any sector (WTO 2000).

There is still a considerable distance to go before agricultural export subsidies are eliminated. Figure 1 shows that subsidized exports represent a significant share of world trade. In 1998 as much as 41 percent of skim milk powder (SMP), 24 percent of butter and 23 percent of cheese entering world trade was subsidized.

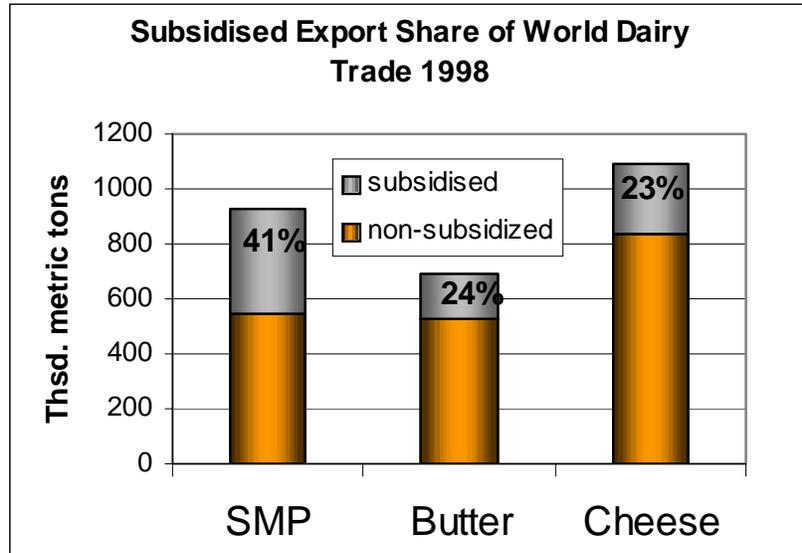


Figure 1.

SMP - Skim Milk Powder

Not only is the EU the world's largest exporter of dairy products, but it is also the world's largest user of dairy export subsidies. This is illustrated in figure 2.

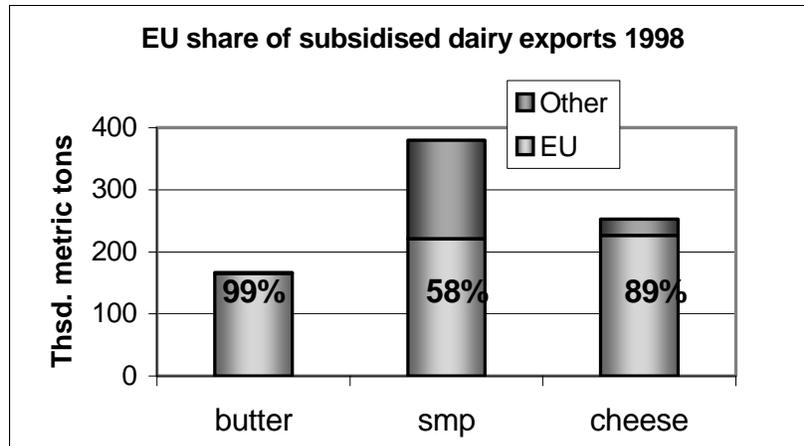
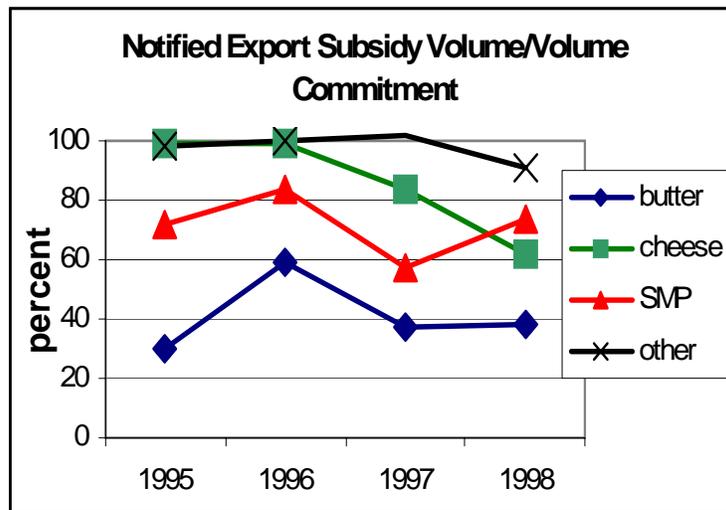


Figure 2.

SMP - Skim Milk Powder

The EU has faced difficulties meeting its export volume constraints, but not for all its dairy exports. The volume commitments for cheese and other dairy products were binding constraints early in the implementation period of the Uruguay Round (Figure 3).



Source: Meilke et. al 2001

Figure 3.

The EU has been able to reduce its volume of subsidized exports by using a combination of methods. These include overall restraint in milk output through production quotas; increased domestic use of skim milk powder as domestic animal feed; domestic subsidization of sales of butter to domestic processors; and the ability to sell some high value cheeses without export subsidies (Shaw and Love 2001).

Not only is a high proportion of international dairy trade subsidized but the sizes of the export subsidies on each transaction are large. Table 1 illustrates the size of these subsidies.

Table 1: Export Subsidy as a percentage of wholesale prices for 1998-99.

	SMP	Butter	Cheese
EU subsidy rate	42%	53%	22%
US subsidy rate	44%	31%	40%

Source: Shaw and Love (2001)

Export competition includes other issues such as state trading enterprises, export credit arrangements, and revenue pooling. State trading enterprises (STEs) are recognized as legitimate entities in the GATT and can affect both export competition and market access. STEs apply to more sectors than just agriculture and new disciplines will probably extend beyond the Agreement on Agriculture. In terms of STEs, the negotiators will grapple with such issues as a clearer definition of what an STE is. The GATT admonishes STEs to behave on the basis of "commercial considerations", but a clear definition of what a commercial consideration is awaits further negotiations. A related issue is the ability to set different prices in different markets for the same product, or price discrimination. An interpretative note to the GATT allows an STE to charge different prices for its sale of a product in different markets provided the practice is "done for commercial reasons and to meet the market conditions in the export market". This is an issue that will likely be subject to further negotiation.

The issue of price discrimination also comes up again in terms of revenue pooling. Pooling is not specially mentioned in the URAA because it is not a trade issue. However, it is common practice, for a number of dairy-producing countries, to charge different prices in different markets and to pool the revenues to give producers an average return. The problem in a trade context is that lower prices can be charged in export markets and cross subsidised with revenues from domestic markets. This has been the issue in a series of WTO panel proceedings against Canada's use of special export milk classes. After a series of appeals, reforms to the system and counter appeals the dispute still appears to be unresolved.

Given the size and coverage of export subsidies on dairy trade, elimination of these subsidies could have a substantial impact on world dairy prices. Shaw and Love (2001) use an empirical model to examine a scenario that reduces the 1999 volume commitment for subsidized exports by half.² Their results indicate a 27 percent increase in the SMP price, a 16 percent increase in the price of cheese and a 14 percent increase in the price of butter relative to baseline prices.

Given the potential for stronger international dairy markets as a result of export subsidy elimination, a number of WTO Members are advocating the elimination of export subsidies. Canada, the Cairns Group³, and the United States are advocating the elimination of export subsidies. The EU and Japan (which does not employ export subsidies) are in favor of reducing export subsidies provided that all export measures are addressed. Because of its extensive use of export subsidies the EU is reluctant to give up these subsidies unless it can be assured that the US will not use export credits and food aid to promote exports.

Market Access

Market access is probably the area where the largest gains are to be made as a result of trade liberalization. The reason is that border measures provide the greatest amount of protection of any instrument disciplined by the URAA. Borders are protected with a variety of measures: single tier tariffs, two-tier tariffs, administration methods for tariff rate quotas, and special agricultural safeguard measures. The overall world average tariff for dairy is approximately 85 percent (Gibson et. al. 2001). Developed countries have higher average dairy tariffs than developing countries: 116 percent for OECD countries and 74 percent for non-OECD countries (Gibson et. al. 2001).

The URAA disciplines on market access converted all non-tariff border measures to tariffs, bound all tariffs (i.e. cannot be increased without negotiation with other countries), reduced tariffs by 36 percent (on average) over six years from 1986-88 base⁴, and created minimum access opportunities. The establishment of tariff rate quotas (TRQs) provided minimum access opportunities for those products that had non-tariff barriers converted to tariffs. TRQs are two-tier tariffs that allow some fraction of domestic consumption requirements to be imported at a low tariff (in-quota) while any imports above

² STEs and revenue pooling were not addressed in this analysis.

³ This group includes Argentina, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Fiji, Guatemala, Indonesia, Malaysia, New Zealand, Paraguay, Philippines, South Africa, Thailand, and Uruguay

⁴ Although the overall average reduction was 36 percent individual products could have different reduction rates provided that the reduction was at least 15 percent. The mandated average reduction for developing countries was 24 percent over ten years.

the minimum access commitment are charged a much higher (over-quota) tariff.

Twenty-eight countries (12 OECD and 16 non-OECD) have TRQs for dairy products. The over-quota tariffs are often prohibitive. Table 2 describes how high these tariffs can be.

Table 2: Over-quota tariffs 2000.

	SMP	Butter	Cheese
Canada	202	299	246
EU	73	117	83
Japan	247	594	30
US	49	89	57

Source: Meilke et al. (2001)

Expansion of the minimum access amount appears to be the best way to increase imports given the likely difficulties of negotiating reductions in over-quota tariffs. The URAA guidelines for minimum access suggested a level of imports equal to 5 percent of a base level of domestic consumption, by the end of 2000. Table 3 shows that not all countries have strictly adhered to this guideline.

Table 3: Import Share of Domestic Consumption – 1999.

	SMP	Butter	Cheese
Canada	0%	4%	7%
EU	8%	6%	2%
Japan	21%	34%	83%
US	1%	3%	5%

Source: Shaw and Love (2001)

Table 3 shows that for a selection of countries, not all dairy products have minimum access commitments equal to five percent of consumption. If the countries in table 3 each imported at least 5 percent of each of skim milk powder, butter and cheese, then the total volume of their dairy imports would increase by 35 percent. However, the minimum access provision is not a commitment to import a fixed share of consumption.

Another issue is the fill-rate or the share of in-quota access that is imported. The fill rate for all the products in table 3 is effectively 100 percent. However, under-utilization of tariff rate quotas may occur. The reasons for under-fill may

include deficient import demand⁵, but more likely the under-fill may be a result of problems with administrative rules that allocate quota access. Skully (2001) describes instances where the administrative rules for TRQs are designed to dissuade imports.

There are several methods to liberalize TRQs. The over-quota tariff can be reduced; the in-quota tariff can be reduced, or the quota volume can be expanded. If the TRQ is currently binding, then reducing the in-quota tariff will not affect the volume of imports or the domestic price and will only affect the size of the profits associated with this preferential access. In this case only reductions in the over-quota tariff or increasing the size of the quota have the potential to increase imports. Lowering the over-quota tariff may not be sufficient to increase imports. For if the reduction in the over-quota tariff does not lower the landed price of imports below the current domestic price, then there is no incentive to import. Generally increasing the size of the quota volume will both increase imports and lower the domestic price.⁶

Liberalizing TRQs can take a number of different routes. One example of a liberalization scenario is to double the size of the TRQ and reduce applied tariffs by 50 percent. Meilke, Larivière, and Martin (2001) show that for a variety of dairy products across a number of countries, that a 50 percent reduction in current over-quota tariffs would not be sufficient to bring the landed price below the current domestic price. As a result the tariff reduction would have no impact on either domestic prices or trade flows. In these cases doubling the volume of imports, allowed at the lower tariff rate, would however have an impact. Shaw and Love (2001) examine this scenario (doubling the quota and halving the tariffs) and find that world prices for cheese, butter and milk powers would increase in the range of 12 to 19 percent above baseline levels while trade volumes would increase from 25 to 36 percent.

In their initial positions WTO Members have taken quite different stances on liberalizing market access. For instance, the Cairns group is seeking deep cuts in tariffs and substantial and effective increases in TRQ volumes. Although Canada is a member of the Cairns Group it has adopted a separate negotiating position which reflects the interests of its domestic dairy sector. Canada is seeking expansion of TRQ volumes to a common percent of domestic production. Canada is also seeking to eliminate in-quota tariffs. Canada is not

⁵ At the landed price, at the in-quota tariff, import demand may be less than 5 percent of consumption. This may only occur when the landed import price is equal to the domestic wholesale price.

⁶ The exception is the case where the current over-quota rate is so low that the current level of imports far exceeds the incremental increase in low-tariff tariff access. As a result neither imports nor domestic wholesale prices will change, but quota rents will increase.

eager to see over-quota tariff reductions and wants any commitments for tariff reduction to take in account any increases in minimum access that occurred. The United States is seeking substantial reductions in tariffs and substantial increases in TRQ volumes. The EU is seeking flexibility in the reduction of tariffs and make sure that current commitments in minimum access are realized. It is difficult at this time to envisage where market access negotiations will come out.

■ **What Other Factors Will Influence Trade Liberalization?**

Trade liberalization will not take place in isolation because markets and policies are continually changing. Changing policies are of particular interest. The EU has gone through two rounds of domestic policy reform since the base period (1986-88) of the URAA. EU dairy policy intervention involves internal prices that are maintained well above world prices by a system of import barriers, intervention purchases, and subsidized surplus disposal through export markets. Member state intervention agencies purchase butter and skim milk powder if the market price falls below pre-announced intervention prices. Production quotas have been applied since 1984 in an attempt to control surplus production generated by high internal prices. The most recent round of reform of the Common Agricultural Policy – Agenda 2000 – sets in place a process to lower intervention prices by 15 percent so that by 2007 the target price for milk will be 25.72 euro/100 kg (approximately \$Cdn 36). Compensation for the reduction in support prices will come in the form of direct payments to producers and an increase in the production quota (Meilke et. al. 2001).

Lower intervention prices will reduce the gap between domestic prices and world prices thereby reducing the need for export subsidies. However, as long as the EU price exceeds the world price export subsidies will be necessary and the EU will be bound by its URAA export subsidy volume commitments. The EU has to accommodate its subsidized export sales to these disciplines. This may involve selling more products without subsidy (e.g. cheese) or finding more domestic uses for surplus production.⁷ New tighter disciplines on the volume of subsidized exports will make this job more difficult. A bigger challenge will be to accommodate the expansion of the European Union into central and eastern Europe. The central and eastern European countries seeking accession, have significantly lower prices than the EU (45 percent below EU prices see Agra Europe 2000). Increased dairy prices in these countries will spur increased production and the associated problems. It is likely that the EU will have to further reduce its dairy intervention prices to accommodate accession.

⁷ The reduction in the intervention price should lower production.

The US dairy industry is highly protected with minimum support prices that are administratively set through import restrictions, stockholding, and subsidized disposal of surplus production. In addition regional “marketing orders” involve regional pricing and allocation of supplies in order to provide premiums for milk sales in specific domestic markets (Shaw and Love 2001). Under the most recent Farm Bill, US support prices are, in theory, to be gradually eliminated. However, to date these administered prices have not been eliminated and it is not clear if they will ever be eliminated (Sumner 1999). Regardless of whether the support prices are ever eliminated, US border measures should keep the domestic price above international levels and subsidies will be required for exports. The marketing orders are also due for reform through consolidation, however this will affect the domestic geographic distribution of milk more than it will affect international markets.

While policies are changing, so are markets. Commercial consumption of dairy products in a number of key markets is growing. While the growth is not spectacular it is occurring in several key markets. The westernization of Asian diets will lead to increased dairy consumption. Cheese consumption has grown by 52 percent in the decade between 1990 and 1999, partially as a result of the acceptance of pizza in diets across the globe. Dairy consumption is increasing in Latin America, but so is dairy production, and as a result both imports and exports are growing in this region.

The growth in international markets will buffer the adjustment to trade reform. Increased consumption will absorb some the dairy exports that were previously subsidized. Strengthened world prices will reduce the adjustments of domestic producers in markets that are opened to import competition.

■ Where Do We Go From Here?

The pace of trade reform is very gradual. In particular, the US Administration is hampered by the lack of “Trade Promotion Authority” (formally know as “Fast Track Authority”) which removes Congress from day to day negotiations and leaves Congress with a yes or no decision when the negotiations are complete. Major players such as the EU, US, Japan, and Canada all have highly protected dairy sectors with influential domestic dairy lobbies. Their appetite for meaningful dairy reform is limited. This round of WTO negotiations has been described by some as a “development round”. As development issues (special and differential treatment, textiles, intellectual property, anti-dumping) come to the fore it will be easy to forget about dairy, particularly as dairy simply isn’t a major factor in some of the larger developing countries.

Export subsidies will a major emphasis of this round and it is quite likely that they will either be dramatically reduced or eliminated. The degree of tariff liberalization is unlikely to be large enough to open protected markets to any

significant degree. Most the change in market access is likely to come through limited increases for in-quota low tariff access.

Pressures will develop for reform of Canadian dairy policy, but these pressures are more likely to come from within Canada than from increased foreign competition.

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