

Future Dairy Policy in Canada

Rick Phillips

Director, Policy & Government Relations, Dairy Farmers of Canada, 75 Albert Street, Suite 1101, Ottawa, Ontario, Canada, K1P 5E7
Email: rphillips@dfc-plc.ca

■ Take Home Messages

Canadian dairy policy has been relatively successful in obtaining its objectives with respect to producer returns and consumer outcomes. The Canadian domestic market is closer to the long run equilibrium situation economists predict will prevail than the current world market is. Deregulation where it has occurred has resulted in poorer policy outcomes for both producers and consumers. Canadian dairy policies will continue if it is the case that good and practical agricultural policies prevail over misguided economic thinking that doesn't apply to dairy markets as we know them.

A close look at the mechanics of Canadian dairy policy reveals many similarities with U.S. policy. The biggest difference is that Canadian policies ensure that producers receive a true price signal about how current markets value new production.

The WTO has failed to come to grips with the real issue in dairy. Namely, the significant concentration of market power at the processing and retail levels. The WTO should recognize and legitimize producers' right to act collectively to offset the imbalance of market power between producers and others in the marketing chain.

■ Introduction

The future of the dairy industry in Canada will be shaped by the development of policy and attitudes both domestically and internationally. At the time I was considering what I might be saying about that future, I anticipated that New Zealand's vision of world dairy markets would have been laid out before you. That vision is of a world where domestic policy and world trade regulations ensure that producers are left to face markets distorted by the activities of large corporations, alone and without support.

■ Why Are There Policies To Support Producers?

It is obvious that dairy producers in Canada support their current dairy policy and have resisted moves towards a more “free market” approach. The reason for this lies in the fact that producers in Canada, even in the absence of exposure to world markets, know that the current way in which market power is distributed within the marketing chains in our country ensures that the odds of getting a fair shake in an unregulated market are stacked against us. It is still the case that producers are the many, selling a highly perishable product to the few! Domestic and world markets beyond the producer level are highly concentrated.

I don't think that anyone would seriously suggest that dairy markets are not highly concentrated. In a recent speech, Allan Burton president of NZMP USA Inc., outlined a future dominated by multinationals. He predicted that by 2010, just a handful of multinationals will dominate the global dairy industry, and in the U.S., Kraft, Unilever, and Nestle could claim as much as 80 percent of the market for manufactured dairy products. Neither is the Canadian industry a stranger to significant consolidation at the processing and retail level. There are policy implications. As multinationals increase their dominance, governments become less effective in achieving domestic policy objectives. Many of course see the deregulation that supports concentration as a big win for consumers. Producers see only the need for a continuation of policies that protect their incomes.

■ Concentration And Consumer Transfers

In producers' minds it is clear that concentration affects their incomes. Producers also recognize that it is the presence of regulatory frameworks (like supply management) that allow them to act collectively to offset the negative aspects of that concentration and increase their share of the consumer dollar.

Even though consumer prices are similar in different countries, the producer share of that dollar depends to a large degree on whether producers have adequate market power. DFC analysis indicates that Canadian producers receive about a 50% share of the retail price of a representative basket of dairy products. In other countries the producer share is about 30%. Producers in those countries are becoming increasing aware that lower prices for them do not lead to lower consumer prices and expanded markets. Lower producer prices simply lead to higher margins for others in the marketing chain.

■ Policy Serves Consumers

While it is clear why producers in Canada might want to maintain and enhance policies that will allow them to counteract the power of others in the marketing chain, why would consumers and governments support a continuation of such policies?

The answer for Canadian consumers is price performance. Canada's dairy policy has provided them with access to a wide variety of quality dairy products with price increases over time that are within inflation and which tend to be lower than for products marketed within a "free market" system.

■ Policy Serves Taxpayers

The answer for the Canadian government is that at a time when "free market" sectors are requiring billions of dollars in taxpayer support, dairy specific policies cost government next to nothing.

Everyone understands supply management as "quota" but it is in fact a set of policies that establishes the orderly marketing conditions that allow producers to receive targeted market returns while providing consumers with adequate supplies of reasonably priced dairy products. U.S. dairy policy has similar objectives. I think it might be useful to more fully explore what this Canadian "set" of policies is and what they do. What they do can best be illustrated by contrasting Canadian with U.S. policies.

■ Policy Structure

Policy objectives in Canada and the U.S. are met through an inter-related group of policies governing producer pricing, orderly allocation of milk supplies, and mechanisms to match domestic supply and demand, which include limited surplus removal through marginal domestic markets and export. The effective operation of these policies requires that exposure to distorted world markets be limited.

Despite what you often hear there is more that is similar than different about Canadian and American policy objectives and policies. Some of the differences, however, are very important and have significant impacts beyond domestic markets.

■ Producer Support Pricing

Dairy farmers sell milk. Milk is composed of two main classes of components, butterfat and solids-not-fat. Most milk is consumed in the form of other dairy products made from those milk components. Demand for these products varies. Traditionally consumers are less worried about price when they buy fluid products and more concerned about price when they buy butter. In both Canada and the United States the major Federal dairy program that ensures adequate producer income is the establishment of support prices for more price sensitive dairy products, in particular butter and powderⁱ. Support prices are given effect by government offer-to-purchase programs, which sometimes direct product to domestic food aid, but more often result in exports. Exports must be managed to meet WTO export subsidy reduction commitments.

Under the 2002 Farm Act, the **milk support purchase** program, which had until recently been operating year-to-year in anticipation of its eventual phase out, once again became a multi-year program. This is a major retreat from the free market policy direction that U.S. policy appeared to take just after the signing of the WTO Uruguay Round. The milk support price is currently set at \$9.90 per hundredweight (cwt 3.67% bf). This is intended to be a base price.

In the U.S., the Commodity Credit Corporation (CCC) will buy, at support purchase prices, any butter, cheddar cheese, or nonfat dry milk that is offered to itⁱⁱ. The US government can adjust the relative price of butter and skim milk powder (referred to as the tilt) up to two times per year.

Canada has similar policies but support prices are set at levels consistent with achieving an “all milk” target return from ALL sales of domestic milk. Prices, including the price “tilt” between butter and skim milk powder, are established once per year. CDC purchases are limited, and access to milk removal programs is determined by a Committee of producers and processors based on their assessment of “overall” market demand and supply conditions at the established price level.

■ Orderly Allocation Of Milk Supplies

Federal milk marketing orders (FMMO) are another key policy element in the U.S. and are intended to help establish and maintain orderly marketing

ⁱ And cheese in the U.S. - Cheese is also eligible for support in Canada but support prices are not set.

ⁱⁱ The U.S. support purchase prices are set to ensure that the price of manufacturing milk averages at least the milk support price of \$9.90 per cwt. This effectively means that the CCC must set minimum manufacturing margins on CCC purchases.

conditions for both milk producers and dairy product consumers. In Canada, **provincial and regional pools** fulfill the FMMO's function.

A classified pricing system and pooling are the two key elements of milk marketing orders and provincial/regional pools in Canada. These arrangements define the relationship between prices of fluid and manufactured dairy products and tend to also concern themselves with the administrative aspects of orderly milk delivery and pooled producer paymentsⁱⁱⁱ.

■ Limited Surplus Removal

Dairy market demand is not always perfectly matched with supply, so one method of maintaining domestic price levels is to remove excess supply from the domestic market. Canada and the United States are not major participants on world markets but they both remove what would be considered to be "subsidized" exports within the WTO context.

The **Dairy Export Incentive Program (DEIP)** pays cash bonuses that allow dairy product exporters to buy U.S. products and sell them abroad when international prices are below domestic prices. DEIP removes products from the commercial domestic dairy market, helps develop export markets, and plays an important role in milk price support. The DEIP quantities and dollar amounts are subject to World Trade Organization restrictions under the Uruguay Round Agreement on Agriculture. DEIP is taxpayer financed.

This function is performed through **Class 5d** in Canada. Some planned exports (market development) and surplus removal activities within Canada's WTO export subsidy reduction commitments go through Class 5d. Class 5d revenues are pooled with producer's domestic returns.

ⁱⁱⁱ These measures offer opportunity for some modest producer price enhancement (some academic estimates for overall FMMO price enhancement are on the order of 5%) but mostly they promote producer and processor equity by allowing similar access to markets across an order or pool. Producers, for example, are paid a blend price paid on the basis of milk utilization over the entire order or pool. In Canada, single provincial transportation systems and clear allocation rules have led to significant reductions in processor costs associated with sourcing milk and ensure efficient utilization of milk supplies.

The 1996 Farm Act called for several changes in the milk marketing order system, including consolidation of the then existing 31 orders. There are currently 11 Federal milk-marketing orders. The 2002 Farm Act did not change milk-marketing orders. This consolidation process was similar to the move in Canada to integrate provincial pools into regional pools in the mid-90's.

■ US Canada Policy Differences

The big difference between U.S. and Canadian dairy policy is how market supply and demand are brought into balance. In Canada, supply management is more than maintaining current producer access to a higher price market. It is a system that promotes supply discipline by sending producers the right price signal about what value the market is placing on new milk production beyond their base holdings.

Canada committed to limit subsidized exports when it signed the WTO Uruguay Round agreement and so it became necessary to absorb any short run surplus production within the domestic market^{iv}. This led to the development of Class 4m (the m stands for marginal) domestic markets such as the animal feed market, or markets where oilseed products are easily substituted for milk components. Canadian farmers know that new milk production will attract the relatively low 4m price. Current 4m prices are on the order of \$Cdn 10/hl. Another important difference between Canada and the United States is that, in Canada, longer-term imbalances in supply and demand are reconciled by making quota adjustments. Domestic supply and demand are kept in balance at the target domestic return and so most domestic prices are relatively stable.

In the U.S., policy has taken a different tact. U.S. policies continue to set relatively low support prices. The "tilt" on butter and skim milk powder is often adjusted to make exports of components in surplus easier. The unwelcome consequences of this policy are unstable domestic producer prices. Since this instability has at times meant that U.S. market returns are not adequate, the new Farm Bill introduced a dairy market loss payments program to provide direct payments through a long-term income safety net program^v.

^{iv} Prior to the Uruguay Round Agreement producers could either purchase quota and participate in the domestic market, albeit at something less than the domestic price because of their quota investment, OR sell into the world market at the world price. When world prices were high a significant number of producers chose to do just that. The Canadian Dairy Commission marketed over-quota milk and over-quota returns were pooled amongst those producing over-quota.

^v The Canadian government used to make a direct payment to producers of \$Cdn 6.03/hl and in the mid-70's this accounted for about 25% of the producer return. The purpose of the direct payment was to enhance producer income while moderating consumer prices. This payment was phased out over the last few years and all of a Canadian producer's returns come from the market.

The U.S. Dairy Market Loss Payments program entrenches the ad hoc market loss assistance payments that were provided to milk producers in 1999, 2000, and 2001. The program was also part of the political bargain to ensure that the Northeast Dairy Compact was not reauthorized.

The **Dairy Market Loss Payments (DMLP) Program** is a national program which provides a monthly direct payment to dairy farm operations if the monthly Class I price in Boston (Federal Order 1) is less than \$US 16.94 per cwt. Payments are to be made on up to 2.4 million pounds of milk per year per farm operation^{vi} The payment is made no matter where the producer is located, how the producer's milk is used, or what price was actually received for the milk produced.

The DMLP will stabilize and generally enhance producer revenue and it will tend to increase production of producers who produce less than the 2.4 million pound limit (these smaller farmers produce about one third of U.S. milk). Larger producers are expected to view the payment as simple income support and not have any additional revenue incentive to expand production.

In other words the U.S. has introduced a form of supply management for a portion of its milk supply; it now has a Canadian style price boundary at the 2.4 million-pound level for each producer. The problem of course is that even the larger U.S. producers expanding their milk production continue to receive a price which is a blend of returns from across all classes and so do not receive a true price signal about what that new milk production is worth in the market place. This leads to overproduction, and in fact the creation of a pool of milk that cannot be absorbed by the domestic market. It also leads to domestic supply - demand imbalances and unstable domestic prices.

“Unsubsidized Export” Policy

Another area where the U.S. and Canada have diverged is in the area of unsubsidized exports. Canada had taken the approach that individual producers and processors should be free to enter into whatever export arrangements they see fit. Canada had effectively deregulated the export market. The WTO Appellate Body has now determined that Canada's Commercial Export Mechanism (CEM) is an export subsidy.

^{vi} Based on 2001 U.S. average data, the 2.4 million pound limit is equivalent to the production from about 132 cows. The number of producers per operation does not affect its limit.

A simple example illustrates the general features of this program. A direct payment to milk producers is triggered when the Class I milk price in Boston (which was the reference point for the NE Compact) is less than \$16.94 per cwt. The amount of the payment, on a per-cwt basis, is calculated as 45 percent (which was the approximate Class 1 utilization in the former NE Compact area) of the difference between \$16.94 and the Boston Class I price.

Using an actual example, the Class I price in Boston in May 2002 was \$14.51 per cwt. A per-cwt direct payment of \$1.09 (= (0.45 x [\$16.94 - \$14.51])) is in order. This rate is then multiplied by the farmer's payment quantity for the month.

The United States has taken the approach that exports are unsubsidized if there is no difference between the domestic and export price for a particular product. The U.S. has in recent times adjusted the relative price of butter and skim milk powder to allow for “unsubsidized exports” at the system or collective level, while maintaining an average domestic price that is higher than the average export price.

US Canada Import Policy

Both Canada and the United States attempt to maintain a domestic policy context by limiting imports to tariff rate quota levels by having over quota tariffs that effectively restrict imports beyond the TRQ^{vii}.

The TRQ is the mechanism that potentially allows exporters, and presumably producers in exporting countries, to have a share of what are relatively high priced Canadian and U.S. markets.

Both the U.S. and Canada are having some difficulty with blends of dairy components that have been specifically designed to circumvent their border measures. Much of the ice cream market in Canada may be lost to imports of butteroil/sugar or butter/sugar blends and Whey Protein Concentrate mixes. The Milk Protein Concentrate issue has been well documented in the U.S.

Policy Outcomes US Vs Canada – Average Producer Return

As we have seen, Canadian and U.S. policies have many similar elements. The few differences between U.S. and Canadian policies are however, very important and result in somewhat different policy outcomes for producers and consumers. It is in response to these differences in outcomes that policy is likely to evolve.

^{vii} Canada administers its TRQ in a way which tends to result in higher “fill rates” than the U.S. Canada tends to allocate import quota to importers who will ensure that TRQ room is utilized. The U.S. has been somewhat less inclined to encourage TRQ utilization. The classic example is the U.S. practice of assigning Ice Cream quota on a country specific basis to Jamaica, or breaking up TRQ access into country specific assignments that are too small to be commercially viable.

Domestic prices for butter in the U.S. have at times been high enough to allow for imports beyond TRQ levels. This together with new technologies that allow for ingredient substitution in the making of traditional dairy products may limit the ability to significantly increase domestic prices and reduce the ability to enhance returns through price discrimination between butter/powder and cheese markets.

Figure 1 compares average U.S. all milk returns with Canadian Class 1-5d returns over the past few years. Note that Canadian producer price tends to be higher than U.S. producer prices.

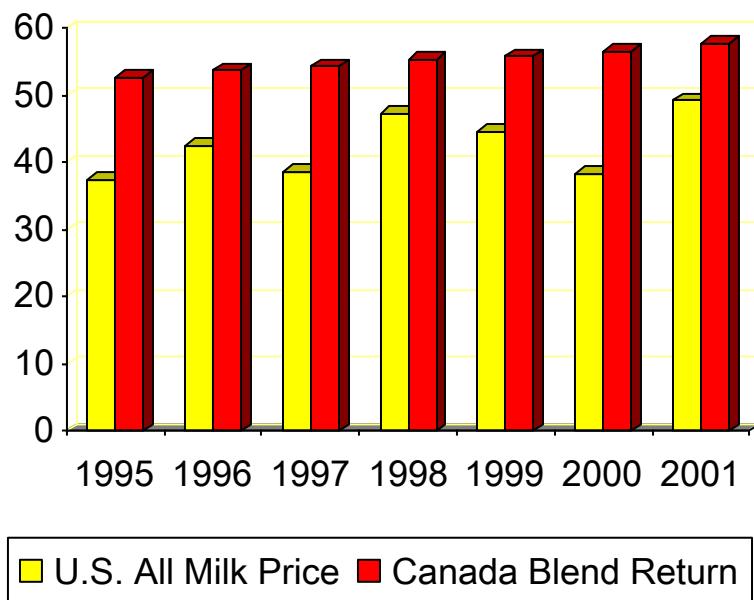


Figure 1. Policy Outcomes U.S. vs Canada: Average Producer Returns

Policy Outcome US Vs Canada – Farm Price Stability

As noted earlier, a big policy difference between Canada and the U.S. is in how market supply and demand balance is maintained. In Canada, a target price is set and supply, through the quota system, is adjusted to meet demand at that price.

In the United States there is an attempt to use price to adjust supply to meet demand.

Figure 2 shows changes in the producer target price in Canada (the Canadian Class price mover) versus the change in US prices for Class III or IV (the US Class mover price). As can be seen the Canadian price has moved upward at a relatively steady pace. US prices on the other have been unstable.

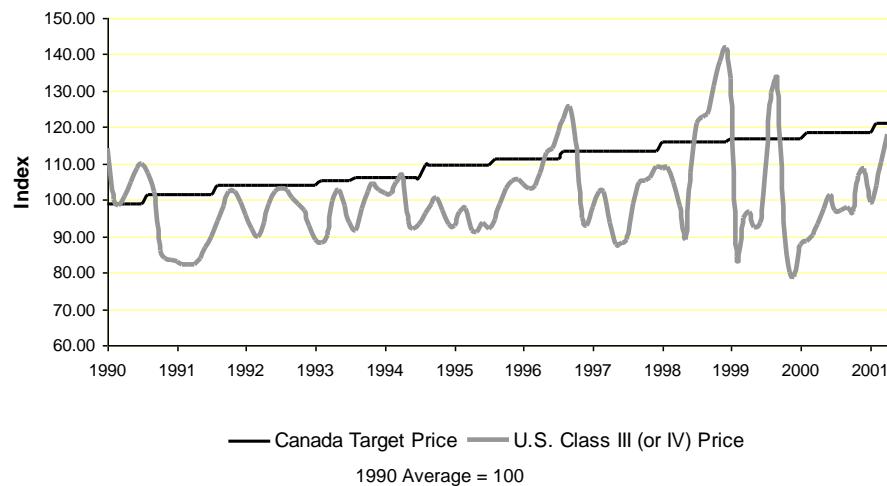


Figure 2. Policy Outcome U.S. vs Canada: Farm Price Stability

With the development of WTO restrictions on exports, the balancing of supply and demand in the U.S. has become increasingly difficult in recent years and as a consequence producer prices have become increasingly unstable.

The introduction of the **Dairy Market Loss Payments (DMLP) Program** may be seen as U.S. recognition of policy failure. The market is not providing adequate returns to producers so taxpayers must.

Policy Outcome US Vs Canada – Dairy Retail Price Movement

Figure 3 shows that stable pricing at the producer level in Canada (even if those prices are trending up) has resulted in smaller increases in consumer prices than in the US where prices at the producer level have been unstable.

Policy Outcome US Vs Canada – Farm-Retail Price Spread

Unstable pricing at the US producer level has resulted in US producers receiving a much lower share of the consumer dollar over time. This is expressed as a very significant widening of the farm to retail price spread in the U.S. (Figure 4).

What these observations together suggest is that when prices at the producer level go up, they rise all along the marketing chain. When producer prices fall

the price response at retail is limited. Over time this leads to a ratcheting up of consumer prices^{viii}.

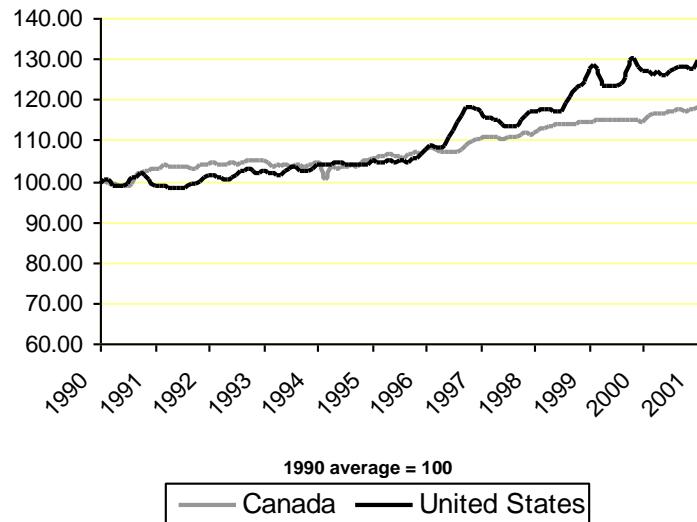


Figure 3. Policy Outcome U.S. vs Canada: Dairy Retail Price Movement

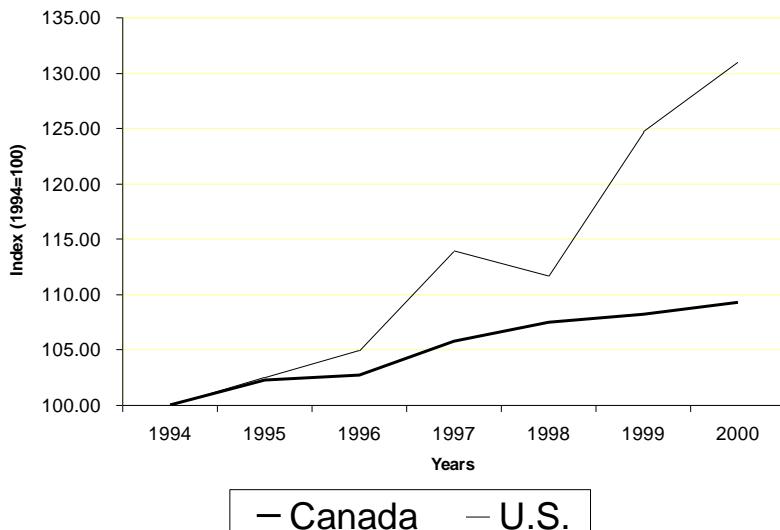
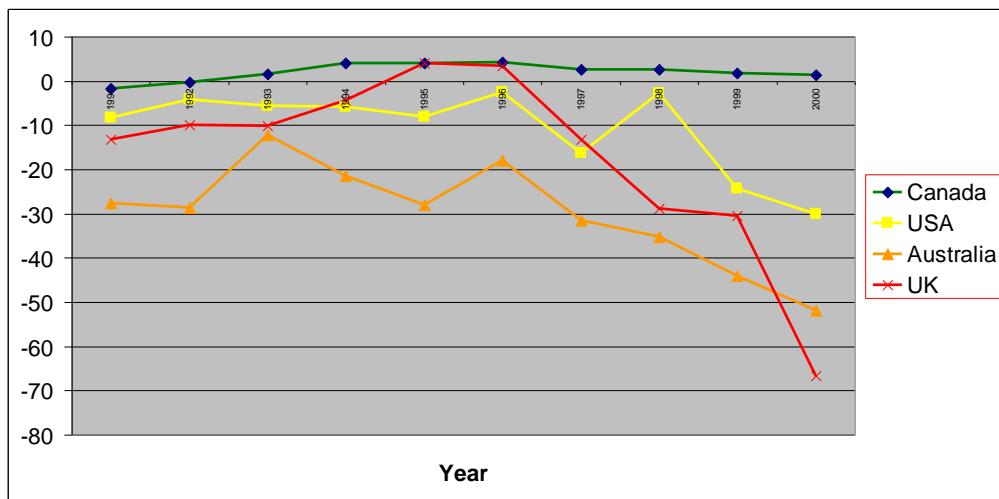


Figure 4. Policy Outcome U.S. vs Canada: Farm-Retail Price Spread

^{viii} Economists refer to this as asymmetric pricing behavior. Such pricing behavior is a strong indicator supporting our assessment of market power at other levels in the marketing chain.

Policy Outcome – Deregulation

The increasing Retail-Farm Price gap has not been confined to the USA. As we can see in Figure 5, in which we see the preliminary results of work done by Maurice Doyon of Laval University, whenever regulation at the producer level has been relaxed (lower support prices in the US, elimination of the Milk Board in the UK, deregulation of industrial and finally fluid markets in Australia) farmers have received a lower share of the consumer dollar.



Doyon 2001

Figure 5. Policy Outcome – Deregulation: Farm Gate Price Index Less Consumer Dairy Price Index

We observe that when governments deregulate, consumers do not receive a price break. Reductions in producer income simply become “value-added”. This has significant implications for the OECD-PSE and WTO AMS calculations, which include price support as a measure of subsidy. These results demonstrate that the assumption that consumers subsidize producers through price support is false^{ix}.

^{ix} Because of concentration at the retail level, consumers pay what retailers decide they will pay. The only thing that changes with de-regulation is that producers receive a smaller share of the consumer dollar.

Combine this with the observation previously made that increasing price instability at the producer level in the US led to higher US retail prices than in Canada, you can

■ Acronyms

In light of this result, I would now like to comment a bit about these policies within the international context and in doing so focus for a few moments on international assessments of Canadian and U.S. domestic dairy policy.

I suspect you are familiar with the Organization for Economic Development and Cooperation (OECD). Many who work for the OECD would consider themselves to be governmental employees. They do, however, have a formal mandate to promote trade liberalization and the reduction of producer support. The OECD has developed some significant tools to promote these objectives. Perhaps the best known of these is the Producer Subsidy Equivalent (PSE).

The PSE Concept – Why Should Producers Be Concerned

The OECD^x claims that the market price component of PSEs measures “transfer(s) from consumers to producers”. Media often quote these amounts of “subsidies” as you can see in this slide to imply that consumers would save a lot of money if only governments would abandon support prices and leave producers to market forces...

The numbers are something on the order of 2 to 3 billion of Canada’s 4 billion in dairy farm cash receipts.... And Reuters suggests the EU and the U.S. have \$24 billion in subsidies. Using the PSE, Reuters claims that dairy is “the only sector retaining an enormous implicit burden on consumers”^{xi}.

come to only one conclusion: stable and higher producer prices are better for consumers than lower but unstable producer prices

^x When PSE calculations are challenged, OECD economists retreat behind a false cloak of academic impartiality and policy irrelevance... They say the PSE is only an academic “tool” to help measure “relative” levels and changes in support levels and to measure changes in support over time...

They are either very naive or very good lobbyists.

^{xi} Financial Post - May 30, 1988

Canadian PSE “includes a contribution of about \$2 billion from consumers through higher prices than they would have to pay without price supports”

Reuters – February 26, 2001

Ag reform would save world consumers bins – USDA

“Consumers in the United States and the European Union would benefit the most, with estimated gains of \$13.3 billion and \$10.6 billion , respectively, from lower net food prices..”

Reuters – September 6, 2001

“Dairy is the only sector retaining an enormous implicit burden on consumers”^{xii}
Working Paper, Policy Branch, Agriculture Canada; June 1990.*An Assessment of*

PSE Definition

The PSE calculation assumes and purports to measure producer subsidies allegedly paid by taxpayers and consumers (Figure 6).

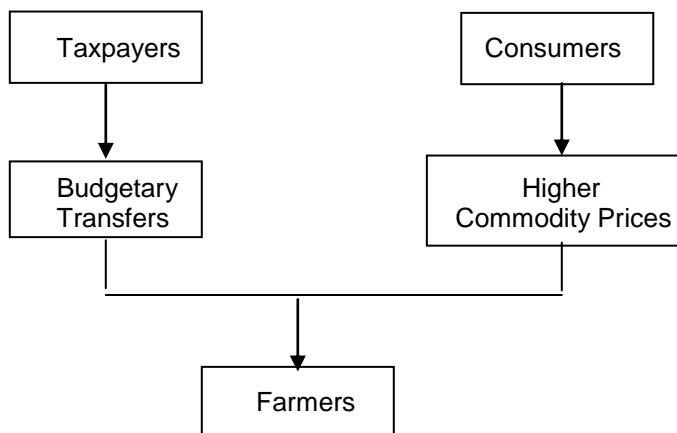


Figure 6. PSE Definition

Taxpayer contributions usually involve a direct payment that is relatively easy to measure using simple accounting. The calculation of a consumer contribution or transfer, however, requires many assumptions and a lot of data interpretation.

The PSE basically measures the level of consumer transfer as the difference between domestic prices and a world reference price (for dairy the reference is the New Zealand price). When world prices are lower, the PSE shows a higher number, or if you prefer, that producers are better off, even when domestic prices and costs haven't changed! This is the flawed logic of the PSE.

Partial Dairy Trade Liberalisation on the U.S., EU-15 and Canada. S. Larivière & K. Meilke, Canadian Journal of Agricultural Economics 47 (1999) pp. 59-73.
An Economic Analysis of the Effects of the Uruguay Round Agreement and Full Trade Liberalisation on the World Dairy Sector. Y. Zhu, T.L. Cox & J.P. Chavas. Canadian Journal of Agricultural Economics 47 (1999) pp. 187-200.
An Economic Analysis of the Effects on the World Dairy Sector of Extending Uruguay Round Agreement to 2005. T.L. Cox, J.R. Coleman, J.P. Chavas and Yong Shu. Canadian Journal of Agricultural Economics 47 (1999) p. 169-183.
Trade liberalisation in world dairy markets. ABARE Current Issues, Australian Bureau of Agricultural and Resource Economics, February 2001, 7p.

Problems with the PSE's Ability to Measure Market Price Support

The PSE measurement of price distortion is fundamentally wrong. For policy purposes, economists typically compare the current situation with an ideal: the perfectly competitive outcome. Economic studies of the effects of free trade have tended to indicate that the perfectly competitive outcome for a world price is something close to the US price^{xii}. Yet the PSE uses the New Zealand price as a proxy for the free trade price. No one claims that the NZ price is anything but the current and distorted world price!

■ PSE Calculated Using The American Reference Price

Some OECD PSE estimates for dairy are presented in Table 1. The OECD numbers tend to be quite large for those countries with price supports. This chart contrasts the "official" PSE with numbers developed by researchers at GREPA at Laval University.

Table 1. A PSE calculated using the American reference price and in purchasing power parity

Dairy PSE in \$ US per tonne, 1999		
Country	OECD Method	GREPA Method
Canada	202.1	22.9
Japan	579.5	274.6
United States	190.9	16.6
European Union	189.8	-28.3
New Zealand	0.6	-316.9

^{xii} Working Paper, Policy Branch, Agriculture Canada; June 1990. *An Assessment of Partial Dairy Trade Liberalisation on the U.S., EU-15 and Canada*. S. Larivière & K. Meilke, Canadian Journal of Agricultural Economics 47 (1999) pp. 59-73. *An Economic Analysis of the Effects of the Uruguay Round Agreement and Full Trade Liberalisation on the World Dairy Sector*. Y. Zhu, T.L. Cox & J.P. Chavas. Canadian Journal of Agricultural Economics 47 (1999) pp. 187-200. *An Economic Analysis of the Effects on the World Dairy Sector of Extending Uruguay Round Agreement to 2005*. T.L. Cox, J.R. Coleman, J.P. Chavas and Yong Shu. Canadian Journal of Agricultural Economics 47 (1999) p. 169-183. *Trade liberalisation in world dairy markets*. ABARE Current Issues, Australian Bureau of Agricultural and Resource Economics, February 2001, 7p.

As this chart demonstrates, combining a US reference price (the price economist think is the free market price) and a purchasing power parity exchange rate results in a significant change in calculated PSEs. Not only are estimated levels of support lower, in some instances they are negative. Why do I believe the Laval/GREPA numbers are right and the OECD/PSE calculation for dairy gets it so very wrong?

The difference between the PSE and Laval results is based on the choice of reference price used to measure market price support. Economists wishing to measure distortion typically compare the allegedly distorted situation with the perfectly competitive outcome. Laval has used the U.S. price as a proxy for the perfectly competitive outcome. This is in line with economic studies suggesting that in the absence of trade distortions the prevailing world price would be something close to the U.S. price. The PSE uses the NZ price because the PSE does not really measure trade distortion. It measures the benefit of current programs in a distorted world.

My issue with the PSE, however, goes beyond the choice of reference price and whether the measurement of consumer transfers is correct. Our observations about the lack of significant movement in consumer prices means that a very basic assumption about market price support is violated. In order to assert that market price support is a consumer transfer to producers, price movements in the market must be "symmetric" ie. prices at retail must go up and down as producer prices go up and down. This would reflect an economic assumption of perfect price transmission. The evidence does not support this theoretical assumption. Therefore, we cannot say that transfers of income from consumers to producers are implicit in market price support. This means that the PSE does not measure what it is assumed to measure. We cannot say on the basis of the PSE measure that there are billions of dollars of transfers from consumers to producers.

How can this be? The answer lies in the other problem associated with PSEs and other measures of producer subsidies and in particular subsidies that are alleged to come about through market price support. The PSE assumes that perfectly competitive market conditions prevail. It ignores what every producer knows to be real. There is significant market concentration in the processing and retail levels of the dairy marketing chain and the market power that arises from ever increasing levels of concentration is used to extract returns from producers.

Consumers are increasingly aware that the price they pay for goods is far removed from the producer's price. There is an increasing disconnect between what a consumer pays and what a producer receives for his product. If consumers are making "transfers" it is not to producers, it is to others in the marketing chain! The PSE ignores the reality of market concentration. Concentration of market power is not being addressed at the international level

and as an issue won't go away soon. Neither should the policies we have seen the U.S. and Canadian governments put into play in order to correct the distortions caused by market concentration.

■ Future Dairy Policy

Attaining the objective of providing, within the domestic context, a regulatory framework that empowers producers and provides fair returns while taking the consumer interest into account is still the main driver of U.S. and Canadian dairy policy. Both the United States and Canada should be expected to build upon current policies to provide better outcomes for producers and consumers.

In improving on the current policy structure, I believe that both the United States and Canada will be taking a hard look at developing policies to address the circumvention of WTO access provisions.

The U.S. continues to have difficulty matching domestic supply and demand through current pricing mechanisms that pay a blend price for new milk. Canada's system works because producers receive clear price signals about how the market values new production. The fact that producers receive a blended return for new production in the United States means that production surplus to domestic needs is inevitable. The attempt to rely solely on support prices changes to clear markets in the U.S. has resulted in increasing price instability at the producer level and is the main area where U.S. policy will likely evolve.

As we have observed, the initial U.S. post WTO Uruguay Round move towards a more "price responsive" system in the presence of significant market concentration appears to have resulted in a poorer policy outcome for producers and consumers. U.S. producers are receiving lower and less stable returns, and an ever-shrinking portion of the consumer dollar. U.S. price support policy for dairy appears to have re-established itself, but at levels that are still too low. State attempts to institute Dairy Comacts and the provision for direct dairy payments in the new Farm Bill are evidence of this policy failure. U.S. consumers are currently paying twice for their dairy products, once at the store and again when the taxman collects. My sense is that U.S. policies will evolve to promote greater price stability for producers at levels that will reduce reliance on direct payments to ensure adequate producer income.

Canada has pursued a policy of giving real and expanding domestic market access and keeping government out of producer and processor decisions to participate in lower price export markets. It seems to me that such an approach provides a more stable adjustment to a fairer world trading system than the blunt instrument of tariff and domestic price reductions. According to the economists our domestic prices are already close to where free market prices

would be. Why throw those domestic markets with prices close to equilibrium levels into turmoil in order to get back to where we already are? The recent WTO ruling in Canada-Dairy went to far and new jurisprudence or negotiations will ultimately change the outcome of that decision in a way which will allow Canada's balanced approach to import access and exports to get back on track.

I think this will happen because ultimately good and practical agricultural policies will prevail over misguided economic thinking that doesn't apply to dairy markets as we know them.

All of this is of course critically contingent upon a WTO outcome that is supportive of policies like those we see in the U.S. and Canadian dairy sector. I would like to close with some thoughts on the WTO agenda.

In a world of previously unimaginable concentration at other levels of the marketing chain, the way forward for producers is not the pursuit of free trade for trade's sake. The establishment of fair and equitable agricultural trade rules at the WTO rules must address the particular concerns of farmers' market power, and the imbalance of market power associated with market concentration. We have seen that simple de-regulation does not lead to good outcomes for either producers or consumers.

I think it is time to stop talking about how we can use the WTO to lower producer returns in the U.S. and Canada. We should start thinking about how we can improve the returns of other producers. This will be accomplished when the WTO recognizes and legitimizes producers' right to act collectively to offset the current imbalance of market power.

The current round of negotiations must achieve positive results for farmers. This will not happen if negotiators continue to develop trading arrangements based on the blind pursuit of economic theories that have no context in the real world of small farmers and global conglomerates.

■ References

- ABARE Current Issues (2001). Trade Liberalisation in World Dairy Markets. Australian Bureau of Agricultural and Resource Economics, 7p.
- Cox, T.L., Coleman, J.R., Chavas, J.P. and Yong Shu (1999). An Economic Analysis of the Effects on the World Dairy Sector of Extending Uruguay Round Agreement to 2005. Canadian Journal of Agricultural Economics 47, pp. 169-183.
- Doyon, M., Paillat N. and D.M. Gouin (2001). Critical Analysis of the Concept of the Producer Subsidy Equivalent in the Dairy Sector (Dairy PSE).

- Groupe de recherche en économie et politique agricoles (GREPA), Université Laval, Quebec City.
- Larivière, S. and K. Meike (1999). An Assessment of Partial Dairy Trade Liberalisation on the U.S., EU-15 and Canada. Canadian Journal of Agricultural Economics 47, pp. 59-73.
- Policy Branch, Agriculture Canada (1990). The Effects of Trade liberalisation on the Canadian Dairy and Poultry Sectors. Working Paper.
- Reuters (2001). Ag reform would save world consumers bins- USDA, February 26.
- Reuters (2001). OECD- More Pressure Seen on Canada's Dairy Sector, September 6.
- The Financial Post (1988). Tackling subsidies, May 30.
- Zhu, Y., Cox, T.L. and J.P. Chavas (1999). An Economic Analysis of the Effects of the Uruguay Round Agreement and Full Trade Liberalisation on the World Dairy Sector. Canadian Journal of Agricultural Economics 47, pp. 187-200.