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# **NAFTA and Domestic Agricultural Policy Reform: Observations from Canada**

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# **NAFTA and Domestic Agricultural Policy Reform: Observations from Canada<sup>†</sup>**

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## **I. Introduction**

Canada has signed three major trade agreements in the past fifteen years, two bilateral agreements and one multilateral. The two major bilaterals are the Canada-U.S. Free Trade Agreement (CUSTA, 1988) and the North American Free Trade Agreement (NAFTA, 1994), while the Uruguay Round Agreement (URA, 1994) under the WTO is the multilateral one. These agreements have been analyzed to ask a variety of questions, but in this paper I will focus on what effect these agreements have had on domestic policy reform. The attention is mainly on what has been the Canadian experience, but in passing I will note how this compares with what has happened in the U.S.

Trade policy accounts for considerable importance in its own right in Canada, partly due to the history and extent of openness of the Canadian economy. For example, 35 to 40% of Canada's GDP derives from trade, almost twice as much as in the U.S. This does give trade issues a very high priority internally within Canada. But, as in most countries, trade and domestic policies are not just interdependent but ultimately trade policies are usually secondary to domestic policy as one of numerous means to domestic ends.

To examine this relationship we focus on trade policy and reforms in domestic agricultural policy in Canada. We start with a summary of the policy reforms that have taken place since the Canada-US Free Trade Agreement, examine the agricultural trade disputes between Canada and the U.S. that sometimes highlight where reforms have not occurred, and try to determine the role of trade agreements, particularly the NAFTA but also the WTO Uruguay Round, in those dispute areas, and look at the prospects for reform where it has not occurred. Special attention is given to dairy policy, one of the sensitive policy areas where there has been little reform. Finally, even if the NAFTA has not played a large role in policy reform, it could play an important role in resolving the trade disputes, indirectly fostering reform. The thirty trade disputes that have occurred since the CUSTA was implemented are examined to see what role NAFTA has played in those disputes.

## **II. Agricultural Policy Reforms in Canada since the CUSTA**

The decade of the 1990s marked a significant shift in agricultural policies in Canada. Specifically, the sector moved to a substantially less subsidized position and a somewhat more open trade environment. The OECD monitors government support to farmers with a measure termed the Producer Subsidy Equivalent (PSE) that is an estimate of the value of all financial support and border protection from policies that support agriculture, or the transfers farmers receive from taxpayers and consumers due to those policies.

By this measure, most countries have reduced their support to agriculture from a benchmark period, 1986-88, to 1999-2001. However, few countries have reduced their support as significantly as has Canada. As a percentage of total farm receipts, the PSE for Canada has fallen from about 34 percent to 18 percent over this thirteen-year period, a decline in support of almost one-half (Dewbre and Short). Although we do not have data

for each component of the PSE, most of this decline was due to cuts in government subsidy support. The major component of *border* protection, the higher domestic prices due to quota and tariff protection in the dairy and poultry sectors, has not been changed significantly. Other elements of border protection, outside supply management, have declined and in most cases have been removed altogether.

What has come about from this policy change since the mid-late 1980s is a dichotomous policy framework. Eighty percent of agriculture by sales faces modest government budget support and little or no border protection. The remaining part of the sector, dairy and poultry production, has remained heavily protected through commodity marketing boards with the power to control aggregate supply through domestic and import quotas. The actual level of protection in this sector has hardly diminished even since the Uruguay Round Agreement, mostly due to the prohibitively high over-Tariff Rate Quota (TRQ) tariffs and small TRQ levels.

For some years, the structure of Canadian agricultural policy has also changed, moving away from traditional support prices or commodity-specific policy in general. This shift was only strengthened by the very substantial mid-1990s reduction in budgetary support of the sector noted above. In terms of subsidies, it can be said that Canada has no commodity policy, no direct payments, and no government commodity purchases. To illustrate the importance of these program cuts, the federal government in 1995/96 removed the grain freight rate subsidy on grain exports from the Prairies region to grain terminals such as Vancouver, a cut of about \$800 million (Canadian) per year. It is now the case there are no significant export subsidies in Canada, aside from loan guarantees on export credit. In addition, a direct subsidy on milk production was removed over the period from 1995 to 2002 that reduced budgetary support by \$300 million.

In the place of a commodity focus, federal government expenditure policy has moved clearly to the goal of stabilization. This has taken the form of a pattern of cross-commodity, insurance-style schemes that focus on aggregate net farm income and crop yield stability with a moderate degree of subsidy. These programs are still evolving as a response to a late-1990s combination of low world prices and domestic production shortfalls, introducing a greater capacity to cover such farm income “disasters.” The federal government cost of this “risk management” support has also risen to an expected \$1 billion for 2004, about double the nominal level in the early 1990s.

This modified stabilization policy is one element of a new policy framework that has recently been adopted, the Agricultural Policy Framework or APF, which is based on five main pillars: (a) food safety and quality, (b) the environment, (c) science and innovation, (d) sectoral renewal, and (e) business risk management (AAFC 2002). Only in the latter category do you have some continuity with earlier emphases on commodity markets. This framework is rather different from the previous strategy, entitled *Growing Together* (1989) as is described in Rude and Meilke (2003, p.417): “Trade, regulatory barriers and cost structures are seldom mentioned in the APF. The focus is more on niche markets, branding a unique Canadian product and controlling attributes throughout the food chain, rather than on commodity markets... Only in the area of business risk management is

there some overlap with ... commodity markets.” Under that category this strategy emphasizes “adaptation and innovation, encouraging producers to proactively manage the risks facing their farms, whole farm programs, national, stable, predictable, comprehensive government programs, and financial sustainability” (p. 416).

This does not cover the budget situation for all government programs. There is still research funding where expenditures have been maintained in real terms, largely through federal government programs. And there are a wide variety of environmental programs with components such as protecting water supplies, providing environmental amenities like wetlands and areas of biodiversity, and programs to reduce waste water run-off, but total budget support is modest. Against this, extension support under provincial government support has fallen substantially. Input subsidies and programs to invest in rural infrastructure have also become rare and modest in funding level.

So agricultural policy in terms of budgetary support has changed quite considerably over the last 15 years since CUSTA was adopted. What remains is much less distortionary in terms of effects on agricultural input and output markets, and remaining funding is much more decoupled.

However, not all Canadian agricultural policy has been reformed. There remains the supply management policy that covers the dairy and poultry sectors (20 percent of total revenue for the agricultural sector). This policy regime relies upon high levels of border protection and farm-level marketing quotas to generate farm-level prices that are well above border levels. The border protection involves a series of tariff rate quotas (TRQs) usually at levels of 5-10 percent of domestic consumption, coupled with very high over-quota tariffs. These tariffs are in the range of 100-250 percent, but there is much “water” in these tariffs. The result is that these industries are heavily insulated from the operation of world markets. The marketing quotas restrict farm production to a level that roughly equals domestic consumption. In terms of its fundamentals, this system has not changed since the mid-1970s.

The supply management system generates very high economic rents. The value of farm level quotas for the dairy industry alone is in the range of \$16-22 billion (Canadian), which works out to about \$1 million per farm, or \$20,000 per cow. Although the poultry sector is smaller in aggregate, the per farm quota values are as high as in the dairy sector, or higher. With these values at stake, or in view of the annual income flows that must exist to generate these quota values, there are very strong and effective lobbies within this sector, defending it against trade policy changes or any changes in its operation. To say this sector is resistant to policy reform is to understate the case. In terms of its fundamentals, this sector has not changed since its inception in the early to mid 1970s. It has weathered all three trade agreements noted, many changes of government, widespread public debate, and numerous legal challenges by farmers and others inside and outside the system.

The other element of Canadian agricultural policy that has resisted reform efforts is another marketing board, the Canadian Wheat Board. There is no supply control

involved here and no significant ongoing government subsidy, but the marketing system involves the operation of the Board as a state trading enterprise. This does not directly generate the kind of rents seen in the supply management sector, and the wheat industry is competitive on world markets, but there is little transparency in the Wheat Board's operations. This fuels domestic and international debate about its practices and their effects. It has both an export monopoly as well as a monopsony over purchase of wheats and most types of barley. These powers have increasingly come under domestic debate and controversy, particularly from certain groups of farmers affected by the regime. But like the supply management sector, this institution is also quite resistant to reform, whether from domestic or international pressure.

### **III. Apparent Causes of Reform**

With the scale of reform in Canada's agricultural sector, it prompts the question of what caused it. In particular, did it arise from the constraints of trade agreements, and if so, was it due to the bilateral NAFTA, or due to the multilateral URA? If not, what were the other pressures that plausibly led to the reforms?

#### *CUSTA/NAFTA Negotiations*

First, we know that the Canadian CUSTA negotiators did not embrace any kind of major policy reform options in those negotiations. They wanted an agreement that would reduce tariffs, but not touch the most political non-tariff barriers. Gifford (2001) make this clear and that it was not only a Canadian position: "...both Canada and the U.S. made it crystal clear that they were proceeding on the premise that while their mutual objective was to try to eliminate all agricultural tariffs, the most sensitive existing quantitative import restrictions would remain. This in fact is what finally occurred." (p. 7). On the Canadian side, existing import quotas for poultry and dairy products were retained, while meat import laws and cereal import licensing arrangements were conditionally eliminated.

One could even argue that the CUSTA led Canada to regulate further its dairy industry. Some dairy products, namely ice cream and yogurt, were not protected by import barriers but depended on tariffs for protection. Yet the CUSTA was to remove all tariffs, thereby leaving these two products open to U.S. competition. So Canada imposed *new* import quotas for these two products. Later the U.S. would challenge this action to the GATT, the ruling went against Canada, but the issue was not ultimately resolved until the URA when all import quotas were tariffed.

In the NAFTA negotiations, Canada adopted a similar stance in its bilateral agreement with Mexico. It was willing to negotiate tariff reductions but once again not negotiate the non-tariff barriers on dairy, poultry and eggs. Canada argued that those issues were properly the subject of the GATT Uruguay Round negotiations, which served not to risk Canada's position in those latter negotiations concerning GATT Article 11 which permitted import quotas for supply managed commodities.

This also suggests that Canada was focusing its major policy decisions more upon the GATT/WTO negotiations as well, at least as far as Market access issues are concerned. All the efforts to preserve supply management policy were placed on the Uruguay Round negotiations, as the linch-pin to this objective was to maintain, if not strengthen, GATT Article 11. This effort is also seen in the FTAA negotiations. Canada has made clear that those talks are for tariff reductions only. Its position is that TRQ levels and over-TRQ tariffs are a matter for the Doha Development Round (DDR), not the FTAA. Similarly, any discussion of the State Trading Enterprises, another sensitive policy area, is for the DDR talks.

The U.S. position in its bilateral agreement with Mexico was very different. In those negotiations, the U.S. and Mexico agreed to tariffify all import quotas and phase-out all ordinary tariffs and tariff equivalents. So border protection for all commodities, even the most sensitive ones, was to be removed. The view in Gifford (2001, p. 7) is that this decision was the result of the value of market access gained in such an approach, coupled with it being easier politically to sell a no-exceptions approach in both Washington and Mexico City. The result, however, was a measure of reform in U.S. agriculture, at least to the extent that Mexican competition would provide this.

Before leaving the subject of NAFTA trade negotiations and policy reforms, it should be pointed out that there are other subjects than market access. Gifford notes that Canada was willing to make some substantial commitments in the NAFTA that would restrict the use of certain policy instruments. It agreed to forego the use of export subsidies in agricultural trade with the U.S. The NAFTA also pioneered the first SPS agreement that was later copied into the Uruguay Round Agreement. To this extent, the NAFTA involved some reform measures for Canada. But for reform decisions with a significant and more immediate financial dimension, Canada did not engage on any such decisions within the NAFTA context.

#### *Canada's 1990s reforms*

In looking at the 1990s reforms in Canadian agriculture, how much of that can be attributed to the NAFTA and how much to other causes? The main features of the reform were the reduction of the Crow Rate freight subsidy on export-bound grains, the cutting of the dairy direct subsidy, and the cutting of the commodity-focused stabilization programs, and the reduction of a variety of smaller subsidies.

There is no question that domestic budget cutting pressures were a primary reason for many of the policy changes, particularly the large expensive ones. Agriculture was not singled out in this; substantial cuts were made across the board as part of a federal government policy to eliminate its budget deficit. In turn, provincial governments also had to cut their budgets even more substantially, due to the large cuts in federal transfers to the provinces.

However, there were other factors at work, even if these were secondary to the budget cuts. The reform of the Crow Rate freight subsidy was influenced to some extent by the Uruguay Round Agreement. On export subsidies, Canada did have a commitment to



reduce its declared export subsidies and given the overwhelming importance of the Crow Rate subsidy in Canada's export subsidy list, it had to be reduced. But the committed reduction was no more than 36 percent over 5 years. Yet Canada decided to eliminate it in only two years.

The cuts in the dairy subsidy could be seen as a response to the required cuts in domestic support also mandated in the WTO URA. However, the cut was well beyond the minimum required, and the Crow Rate elimination would have satisfied most of the domestic support reductions needed. So this policy decision has also gives the strong impression that it was primarily budget cut-induced.

The cuts earlier in the decade in stabilization programs, specifically the National Tripartite Stabilization Plan that affected mostly livestock, have a closer relation with trade policy. Here the issue was not a NAFTA provision or a URA commitment. Rather, the issue was trade remedy law, and specifically the countervail provisions. Given the procedures in countervailing duty examinations, Canada was vulnerable to the imposition of countervailing duties with the existing design of its stabilization programs. The shift from a commodity based stabilization program to a whole farm, cross-commodity, insurance-style program was substantially a response to existing U.S. countervail procedures in an effort to design a program that would be immune to countervail charges. Such discussions were widely observed in formal government-producer meetings ever since the mid-1980s when hogs and pork were subject to a series of countervails, due to various Canadian stabilization programs, federal and provincial.

Finally, there are some other reasons that can be advanced to help explain certain policy changes. In the case of the Crow Rate, the policy was increasingly seen to have negative effects on a subset of producers, namely those using grains for livestock feeding or other value-added activities. Those hurt by the policy had become sufficiently vocal and articulate that the policy was seen as controversial even within the agricultural sector. This issue in general may have contributed to some of the policy reforms, namely a decline in the coincidence of farm interests, such as along the lines just mentioned, that resulted in a greater fragmentation of farm lobbies. When combined with different ideologies and different problems, regionally or by commodity, the previously pressing nature of certain agricultural policies was greatly reduced, leaving governments more latitude to cut programs without clear and consistent opposition.

#### **IV. Patterns of Trade Disputes: Selected Illustrations**

Another source of evidence of the impact of NAFTA on possible domestic policy reforms is to examine recent trade disputes. This can give some indication of where policy reforms have not occurred and may be needed to resolve the disputes. It also can give some measure of whether the NAFTA has any relevance to the dispute such as whether dispute resolution measures under the NAFTA have proven to be useful in encouraging reforms that would help resolve the dispute. We will review two important dispute areas,

dairy and horticulture to see the nature of the dispute and examine the role of NAFTA in comparison to the URA.

### *Dairy Disputes*

There have been four separate disputes in the dairy sector, the first in 1988 in response to the CUSTA, but the latter three occurring in the 1996-2002 period in response to the URA. The first was brought by the U.S. and concerned Canada's unilateral decision to include ice cream and yogurt under import quotas at the beginning of implementation of the CUSTA. They previously had tariff protection and this action was brought to the GATT where Canada lost the decision. This was the example cited above of where Canada increased border protection following the signing of the CUSTA. So far from aiding in policy reform, this example illustrates a case of the CUSTA causing a reversal of reform. The dispute was not resolved until the implementation of the URA in 1995.

The second dispute was brought by the U.S. in a complaint that Canada's tariffication as part of the URA implementation contradicted Canada's obligations under the NAFTA where tariffs were to decline to zero over ten years. The question was which agreement had priority, the NAFTA or the URA. The decision went in Canada's favour, that URA provisions had priority over NAFTA procedures. So this dispute also involved the NAFTA, but because the decision supported the precedence of the URA, it validated the very high tariffs in contradiction to the tariff lowering focus of the NAFTA. Strike 2.

The third dispute arose from a complaint by the U.S. that Canada was not implementing its tariff rate quota for fluid milk in accordance with normal import procedures. This was a question of implementing the URA and did not involve NAFTA at all. The decision supported Canada's unusual method of defining and allocating its fluid milk TRQ, of implicitly giving the TRQ to individual cross border shoppers who import small amounts of milk on their own, the level of which is determined only by sample surveys.

The fourth dispute lasted five years and was brought by the U.S. and New Zealand in 1997/98, complaining that Canada was subsidizing its milk product exports. The claim was that Canada was pooling its milk revenues, including domestic production *and* exports, in effect allowing a cross subsidization of the exports, given that the domestic price was higher than the export price. This was upheld by the WTO Panel. Canada modified its export procedures by 2000 to respond to a 1999 decision against Canada, but the new arrangement was challenged again. Another legal iteration occurred 2001, and after further questions, revised data calculations and another appeal, a final decision was made at the end of 2002, that Canada was subsidizing its exports. This closed the case, and now any exports under a supply management regime with revenue pooling and lower export than domestic prices are determined to be subsidized. Canada had little choice but to stop its milk product exports above its 1995 levels.

It should be clear from this overview that the dairy disputes are deep-seated, and brought about by a combination of Canadian opportunism in setting up its high over-TRQ tariffs and export schemes, and partly due to U.S. suspicions about the supply management system. It illustrates a long-running border dispute that arises from quite different policy

institutions and an apparent unwillingness to compromise on both sides. One complaint in this series involved NAFTA, but mostly these disputes centered on GATT/WTO issues. NAFTA dispute resolution procedures made a small contribution but WTO panels decided most of the issues. From all indications, disputes in this sector are likely to flare up again, and final resolution is likely to come only from policy harmonization, specifically modifying Canada's levels of TRQs and over-TRQ tariff levels.

#### *Horticultural Disputes*

There have been a series of disputes in this sector as well, including raspberries, Red and Golden Delicious apples, greenhouse tomatoes, fresh field tomatoes, whole potatoes, yellow onions, sour cherries, iceberg lettuce, cauliflower and tomato paste. With the exception of one case, all have involved either dumping or countervail complaints.

The Red Delicious apples case is very typical of the problems that can arise. A bumper crop occurred in 1989, which resulted in Washington State (and B.C.) producers selling at prices below cost, and the B.C. producers being injured. This met the test of dumping and the appropriate duties were levied, although what occurred showed no evidence of predatory behaviour by the exporter, and only normal market price cycles at work. All that NAFTA was used for was to challenge the injury determination 5 years later. The case shows weaknesses in existing anti-dumping rules when applied to agriculture, especially when the importing country is a "small country" in an international trade sense.

The greenhouse tomato case was also a standard dumping complaint. However, in this case the question of like product turned out to be important. Although the complainant argued that like product was only greenhouse tomatoes, the injury investigation concluded like product to be all fresh tomatoes, resulting in the case being closed because no injury was found. NAFTA complaints were filed in this case also, asking for a review of the US Department of Commerce's determination of sales at Less Than Fair Value (selling below cost).

Most of the dumping and countervail cases are relatively short-lived, due to a temporary situation where dumping is found only due to normal industry price cycles or a subsidy was found with a poor policy design. These trade disputes are then due to what could be described as normal market frictions. They are not the serious, long term trade disputes that one finds in cases like dairy or wheat where serious domestic policy reform is called for. Although NAFTA has been used to query findings or procedures, such queries have not contributed to policy reforms.

#### *Trade dispute data*

When we review the agricultural trade dispute data, we can get another perspective on the role of NAFTA in these disputes. As noted earlier, there are 30 different types of cases but 53 specific complaints over the 1988-2003 period. Of these, 22 disputes have been brought before NAFTA, and this occurred during 14 of the 30 cases. However, as is illustrated in the horticulture cases above, most of these (20 out of 22) have involved anti-dumping or countervail cases. What is usually being questioned is whether some part of

a dumping (AD) or countervail (CVD) case is following improper AD or CVD procedures. These 22 cases have been brought pretty much equally by the two countries: 9 were brought by the U.S. and 13 were brought by Canada. Of the 30 cases, only 6 have been filed with the WTO. So this would seem to indicate that although the NAFTA appears to be playing a major role in the settlement of disputes, this is true only for the relatively minor AD and CVD cases. This does not involve policy reform in any substantial way.

## TABLE OF DISPUTES

### V. Prospects for Dairy Reform

With its high level of protection and serious trade disputes with the U.S., this sector is a major candidate for reform. What possible resolutions could there be to this area of dispute? The most obvious path to resolution would be for Canada to relax key elements of its supply management policy to harmonize the two countries' dairy policies. Two avenues could be followed, changing over-TRQ tariffs and TRQ levels. In fact, because these are the two critical border policy levers in this industry, an agreement would almost certainly require some degree of change in one or the other, or both.

First, Canada could lower its over-TRQ tariffs. At present they are in the range of 200-300 percent, but there is a great deal of "water" in those tariffs. They could probably be lowered to around 25-35 percent without resulting in any significant increase in imports. It would require a tariff lower than that to move this dispute area toward resolution. This would open the door to imports and would probably meet with some approval by U.S. officials. But they would likely want to see, in addition, a schedule of future tariff *cuts* in order to come to an agreement.

The second avenue would be to give the U.S. greater access to the Canadian market via an increase in Canada's tariff rate quotas for dairy products. The level of access that would be necessary to obtain an agreement is unclear, but it would probably have to be significant and also include a schedule of future TRQ increases.

Both options would leave the supply management scheme in place in a mechanical sense, but they ultimately would remove most of its benefits. The tariff reduction route would affect domestic milk producers by lowering domestic milk prices once the tariff falls below this critical 25-35 percent range. The level of the value of the Canadian dollar, of course, would be an important factor in following this route. The increase in TRQ levels would not result in much change in prices initially but would involve an almost equivalent loss of marketing quotas to Canadian farmers. Both routes would be resisted very strongly by the Canadian dairy lobby, and in turn by the Canadian government. And both these routes are likely to be touched on in some way in the current Doha Round of multilateral WTO negotiations. Whatever agreement is struck in the Doha Round will be critical to the negotiating options that would be available in any bilateral discussions to address these dispute areas.

If some deal were to be worked out along these lines, it would necessarily involve some added elements, especially some that would benefit Canada, because this kind of policy change will not be undertaken unilaterally or voluntarily. These could be benefits to other sectors of Canadian agriculture, or benefits outside agriculture. Another trade benefit might be some guarantee of access for the Canadian industry to export into the U.S. market without harassment. These benefits would be easier to arrange in a multilateral agreement because so many negotiating options, including threats like denied access to a wide-ranging agreement, are on the table. Although it could be done in a bilateral or a regional agreement in principle, it is unlikely in practice because there is unlikely to be sufficient benefits to or pressure or leverage on Canada to overcome the political costs of changing dairy policy. We have seen this already in the CUSTA, the NAFTA, and now in the ongoing Free Trade Area of the Americas (FTAA) negotiations where it has been excluded.

A further element of such an agreement might be purely domestic, and that is some direct compensation to the Canadian dairy industry. This could be some kind of direct cash benefit on a per farm, per cow or per liter of milk production basis, or it could take the form of a government buyout of farmers' marketing quotas at some agreed-upon price or percentage of the market price of quota. The Canadian dairy industry has already stated that if there is to be any dismantling of existing supply management policy, there will also have to be major compensation. There is ample precedent for such compensation measures in Canada, most recently with the removal of the Crow Rate subsidy on grain freight transportation costs to grain farmers in the Prairies, but also with grape growers who were hurt by the change in their effective border protection from the Canada-U.S. Free Trade Agreement. However, as noted earlier, the price tag would range up to the current quota value of CDN\$16-22 billion, while the Crow Rate buy-out sum did not exceed \$2 billion.

## **VI. Conclusions**

1. The effect of NAFTA, or its predecessor CUSTA, on domestic agricultural policy reform in Canada appears to be minimal. This seems to be true both during the negotiation phase of NAFTA as well as in the post-1988 period when CUSTA/NAFTA were being implemented and during which considerable policy reform was actually taking place. The negotiations surrounding these agreements were conducted specifically to avoid sensitive non-tariff barriers. Although tariff reductions did involve some adjustments on the part of producers of affected products, they did not affect existing policies in a way that required or induced reforms. The CUSTA in one instance actually led to increased protection from non-tariff measures.
2. On the other hand, the WTO/GATT multilateral agreement (URA) was associated much more closely with actual or potential policy reforms in Canada. The negotiations on trade issues that could have had a significant bearing on domestic policy reform in Canada took place in the GATT/WTO negotiations (although the

- results* of the negotiations actually involved few major policy changes). Then subsequent to the URA, a number of Canada's commitments required some kind of policy reform, however modest for the most part.
3. These observations do not arise because of an absence of policy reform in Canada. Rather, there has been considerable reform of agricultural policies by way of substantial cuts in budgetary support to the agricultural sector. However, most of these policy changes have been due to domestic factors, particularly federal budget cutting to eliminate budget deficits, rather than due to provisions of trade agreements. Other reform decisions were influenced by URA commitments. And outside developments, such as the apparent increase in fragmentation of farm lobby groups, may have allowed policy changes that would not have been politically feasible in the 1970s and 1980s.
  4. The U.S. experience has been quite different in comparing the NAFTA with the GATT/WTO agreements. In the U.S. NAFTA bilateral with Mexico, for example, all commodities were on the table and some major domestic policy changes followed in both countries.
  5. This difference appears not to be due to philosophical reasons of the merits of either type of trade agreement but rather due to opportunistic behaviour by countries, depending on the details that differ by cases. .
  6. A review of the major bilateral ag trade disputes (between Canada and the U.S.) since 1988 supports the contention that the NAFTA has played a secondary role in terms of the types of disputes it has been used for. The overwhelming number of disputes (20/22) referred to *NAFTA* panels have involved some kind of appeal of decisions of anti-dumping (AD) and countervailing duty (CVD) cases. By contrast, the areas of major bilateral trade policy disputes, where significant policy reforms could occur, have mostly been taken to *WTO* panels for decisions.
  7. What are the lessons that can be drawn? In terms of negotiations, it appears that whether a country chooses to isolate regional agreements from dealing with significant reforms and place the significant issues in multilateral negotiations (like Canada) or whether it allows major reform issues to arise in regional agreements (like the U.S. and Mexico) depends on the political costs and benefits in the case at hand. There appears to be no country position, philosophy or general rules about how to conduct regional as opposed to multilateral talks.
  8. (a) In looking at a particular policy area with the potential for major reform in Canada, the dairy sector, we see that reform would require increases in input quota (TRQ) levels, or decreases in over-TRQ levies. These changes were explicitly excluded from the NAFTA, as agreed in 1993, and yet are central subjects in WTO negotiations. There is, however, nothing to prevent these issues from being included in a regional agreement.  
(b) An issue that arises is what would it take to generate reform in this area. Clearly there are strong lobby forces to prevent, minimize, or delay policy change in this sector, as is the case in all countries' politically sensitive areas. Some form of compensation is quite likely to be a political pre-condition for such a change. Australian experience may be relevant here, although the major Crow Rate subsidy removal in Canada is also very relevant.

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## **APPENDIX: Details of Selected Border Dispute Areas**

### **A.1. Dairy Border Disputes**

The dairy industry has a history of being one of the most contentious areas of border relations in agriculture between the two countries. This goes back to the Uruguay Round Agreement which was implemented in 1995. Prior to that time, there were few disputes because dairy policy in each country was, by mutual agreement, left unchanged by the NAFTA and the prior CUSTA.

One exception to this pre-1995 peace at the border was the ice cream and yogurt case brought by the U.S. against Canada in 1988. At issue was Canada's unilateral decision to include ice cream and yogurt on Canada's import control list, making them subject to import quota restrictions instead of being regulated only by tariffs. The U.S. won this case. Canada could not unilaterally change import quotas into tariffs. However, Canada's response came only after the Uruguay Round Agreement was signed, by converting these quotas into tariffs, just as it did for all dairy products as part of the implementation of the URAA in 1995. This "reverse tariffication" was not done to previous the tariff levels but to considerably higher tariffs, following Canada's interpretation of the Uruguay Round tariffication procedures.

The second dispute concerned this process of tariffication of import restrictions as part of the implementation of the URAA, brought by the U.S. against Canada in 1996. The issue was whether the NAFTA or the URA had priority in the setting of tariffs. They were set as part of the URA to replace quantitative import restrictions, but the NAFTA procedure was to reduce all tariffs to zero, following a ten-year implementation period. Also, the new tariffs were higher than tariffs agreed to under the NAFTA provisions. The U.S. argued that the NAFTA required no increase in tariffs and conformity with the established time period for tariff reductions, whereas Canada argued that the URA had priority and that NAFTA provisions did not apply prospectively to any new tariff introductions. This dispute covered more than dairy products, but also a substitute for butter, namely margarine, as well as poultry products that are also part of the supply management regime. The ruling supported the Canadian position, that the URA provision had priority over NAFTA procedures and requirements.

The third dispute arose from a complaint brought by the U.S., in 1998, and it dealt with the implementation by Canada of the tariff rate quota for fluid milk. Instead of specifying a quota level and giving some trading firm the right to import that quantity of fluid milk, Canada implicitly gave this right to individual consumers who were buying fluid milk in the U.S. and bringing it into Canada. The amount of milk actually imported depended on how much consumers would choose to bring back, and the quantity imported was calculated by consumer responses to a sample survey. The U.S. took issue with this unconventional procedure and brought this dispute to the WTO. However, the WTO decided in Canada's favour by accepting this procedure for managing the its TRQs.

In late 1997 and early 1998, respectively, the U.S. and New Zealand brought a complaint against Canada for subsidizing its milk product exports. This case, through all its appeals was to run for five years and has only recently been settled. The U.S. and New Zealand argued that some of Canada's categories for pricing industrial milk (the "special milk classes") created following the Uruguay Round involved an export subsidy and that this violated Canada's commitments under the Uruguay Round Agreement on Agriculture. These different categories arise from the practice of price discrimination, pricing the raw milk at different levels across products, a practice that is not unique to Canada, and most of this industrial milk is sold for domestic consumption. However, when these milk products are exported, as they increasingly were during the post-1995



period, such pricing practices raised the possibility of an implicit export subsidy. Export subsidies were not banned for agricultural goods in the Uruguay Round, but new ones were and Canada did not notify its trading partners that it had any export subsidies on milk products. The price of milk to be paid by processors for these special export classes was below the price of milk applied to products consumed domestically, and this constituted the implicit export subsidy.

Although Canada argued that this was not a direct subsidy, neither funded nor paid directly by the Government of Canada, and hence not subject to the export subsidy disciplines, the WTO Panel and Appellate Body both decided in 1999 that it *was* a direct export subsidy and that Canada was in violation of its commitments. Canada's response was to reform its export pricing practices, introducing the Commercial Export Mechanism (CEM). Although the details varied by province, this regime involved individual producers contracting directly with processors and not subject to the intervention of the national supply management system. As such, it was expected to be WTO-legal.

However, New Zealand and the U.S. challenged this new policy in 2001 with a request for a compliance panel, arguing that Canada had maintained its export subsidy by virtue of a cross-subsidy from higher prices on the domestic market and that the government was still involved in orchestrating the scheme. The WTO Panel in July 2001 supported these contentions and ruled that Canada was still subsidizing milk product exports and therefore in violation of its commitments. Canada appealed once more but this time the Appellate Body was unable to make a finding because it ruled that the Compliance Panel had used an incorrect price standard to analyze whether there was a payment (export subsidy) or not.

In early 2002, the U.S. and New Zealand requested that the compliance panel re-hear the case using the more appropriate data. This time the compliance panel ruled in favour of the U.S. and New Zealand, that Canada was continuing to subsidize exports. Canada appealed and the final decision of the Appellate Body was made in December 2002 against Canada. The substantive details of the decision are interesting regarding their economics. The panel argued that one should examine industry average costs, not only production costs for exporting farmers. Second, the panel argued that if export selling costs are lower than calculated production costs then the loss must be made up with profits from elsewhere, namely those earned on domestic sales, a cross-subsidy. However goofy this economic reasoning is on both counts, the ruling is final, it effectively means any export sales at prices lower than domestic prices will be subject to a charge of export subsidies, and Canada must adjust its policies accordingly.

### *Summary*

Few of the border disputes between the two countries are as deep-seated as is the case in dairy. Disagreements have been almost continuous since 1988 and they have been particularly acrimonious. One of the reasons for the extent and nature of these disputes is that Canada erected such obviously high barriers in the form of over-TRQ tariffs in excess of 300 percent when the URAA was initially implemented, inviting challenges. Then its milk product exports grew very rapidly in percentage terms, partly due to export subsidies through some kinds of revenue pooling. On the other side of the table, the U.S. (and New Zealand) are suspicious of the Canadian dairy policy regime which they believe to be open to manipulation in ways contrary to WTO disciplines, the common argument lodged against state trading enterprises. At least as important, the U.S. (and New Zealand) believes it has a more efficient dairy industry and that Canadian dairy import barriers are costing it large foregone export sales. Finally, the U.S. appears to be persistent in these cases because it sees the Canadian situation as a test case, that if left unchallenged the EU would use the same approach and defenses as Canada has, which would have the potential to impose larger losses on the U.S.

With all these factors at work, the U.S. has been persistent in bringing complaints against Canada, and the Canadian response has been equally aggressive. The result is that neither side appears interested in any compromise. It is hard to believe the U.S. will change its attitude to the Canadian regime, unless it is dismantled, or change its belief that it can export substantially to Canada. And it is equally hard to believe that the Canadian reaction to these challenges will be anything but combative. This does not auger well for longer term solutions to or compromises in this area of dispute, and it is unlikely that we have seen the end to disputes on dairy trade.

## **A.2. Canada-US Horticultural Disputes**

The horticultural sector is one of the most active areas of trade between Canada and the U.S., with this sector accounting for the largest amount of agricultural imports into Canada from the U.S. Canada also is a significant exporter to the U.S. of some horticultural commodities, making the two countries competitors in those categories. This has led to a moderate number of disputes, most of which related to claims of unfair subsidization or dumping.

### **Red Delicious Apples**

One example with large trade flows and reciprocal trade is fresh apples. There is a long history of free trade in commodity but in 1989 there was a claim in Canada that the U.S., specifically Washington State, was dumping Red Delicious apples into Canada. This was a classic case of a bumper crop where apple prices in both countries fell substantially. With normal trade patterns, large quantities of apples were exported from Washington to Canada, and transaction prices were below normal cost levels. This met one of the tests for dumping. In addition, there was no question that these trade flows and prices were injuring Canadian apple producers, given the pre-eminent role of Washington State in Red Delicious apple pricing and that Canada is a price taker in this variety. The result was that this claim was accepted and dumping duties were imposed. This occurred in spite of the fact that the both industries were clearly competitive, there was no evidence of predatory behaviour on the part of Washington exporters, and “injury” was occurring to producers on both sides of the border. A second such complaint was filed in 1994 by Canada and this also resulted in an anti-dumping duty being levied until it was removed in 2000.

Although this case effectively lasted about a decade, it does not reveal a longstanding area of dispute. Rather, the Canadian industry used the situations of large bumper crops opportunistically to get “temporary” relief from lower prices by using existing anti-dumping legislation. There have been no further anti-dumping claims in apples. It does illustrate the weakness of applying anti-dumping legislation in the agricultural industry, but that is a broader issue and is not unique to Canada-US agricultural trade relations.

### **Greenhouse and Fresh Field Tomatoes**

Another case in the horticultural industry that is more recent and quite interesting in itself occurred in 2001-2002 in the tomato industry. This example also featured the application of anti-dumping procedures, but here we have *two* cases of dumping, one claimed by the U.S. and the second by Canada.

The U.S. case occurred first, in mid-2001, and concerned greenhouse tomatoes from Canada being exported to the U.S. One critical area at issue was the definition of “like product” and whether the comparable product was only greenhouse tomatoes or the broader definition of fresh tomatoes (field and greenhouse). This was particularly important for the case

against Canadian exporters because in the former case Canadian greenhouse tomato exports would have a moderate share of the total greenhouse tomato market, thereby being in a position to possibly lower market prices by their increased exports. If the latter definition prevailed, greenhouse exports would account for such a small share of the total U.S. fresh tomato market that any change in Canadian exports would have no measurable effect on U.S. prices, hence could not effectively injure U.S. greenhouse growers.

In the dumping decision, Canadian exporters were found to have dumped their product on the U.S. market during the 2000-2001 time period under examination. However, in the injury examination, the like product issue was central. The ITC final determination decided this using the broader definition, fresh tomatoes. The conclusion that followed was that the dumping of Canadian greenhouse tomatoes had not injured U.S. greenhouse growers.

The Canadian case was against fresh field tomato exporters to Canada. It was lodged in 2001 several months after the U.S. case was launched against Canadian greenhouse growers, and followed a very similar path to the U.S. investigation. As in the U.S. case, preliminary investigations found both dumping and injury to have occurred. The dumping charge was also confirmed in the final determination, but in the case of injury, the Canadian authorities determined that the dumping of US fresh tomatoes had not caused material injury. However, this case took an unexpected turn near its conclusion. The Canadian tomato industry complainants withdrew their complaint and request that proceedings on this case be terminated. This occurred two months after the U.S. case had been decided against a dumping charge on Canadian greenhouse tomatoes. It is hard to interpret this result as anything other than indicating that the Canadian complaint against the U.S. was a case of tit for tat. Both cases were closed by these decisions and the dispute apparently has ended.

#### **Other horticultural cases**

Almost all of the other horticultural cases over the last two decades for which we have data have involved anti-dumping, like tomatoes above, or countervails. An exception would be the closing of the U.S. border to PEI potatoes due to an SPS problem.

One of the earliest cases was raspberries which was initially filed in 1984 by the U.S. for both countervailing and anti-dumping duties. There was a provincial subsidy program in effect in British Columbia at the time, in the amber box by today's standards, and the preliminary finding was in the affirmative. However, that case was suspended without a final determination. The anti-dumping case was decided with an affirmative ruling and dumping duties were in force until 1999. A longer term impact was that many of these provincial subsidy programs were ended or modified so as not to trigger countervails.

Anti-dumping cases involving whole potatoes, yellow onions, sour cherries, and iceberg lettuce were brought by Canadian producers against the U.S. between 1984 and 1992, and all resulted in anti-dumping duties being levied for an average of ten years. Two other cases, concerning cauliflower and tomato paste were brought in the 1992-93 period, again by Canada, but denied on the basis of a negative injury determination.

#### **Conclusion**

The horticultural sector has seen a variety of border disputes over the past 20 years, but most have been relatively short-lived, and have involved types of fruits and vegetables where the two countries are producing competitively. Further, they have mostly involved dumping or countervail actions. Canada has initiated the majority of the cases, almost all of which were dumping complaints and which were initiated in the mid-1980s to early 1990s. The timing of

these cases suggests that the exchange rate has played a role. The number of Canada-initiated horticultural cases peaked at about the same time as the value of the Canadian dollar did so, and conversely since the mid-1990s when the Canadian dollar depreciated in value. In some of these cases a result has been a change in marketing practices or government policies to remove the offending actions. None of the cases have developed into ongoing or serious conflicts as has been the case in wheat and dairy.

Are there any lessons that can be learned to alleviate these conflicts? The most obvious issue is that prevailing anti-dumping legislation is pre-disposed to affirmative findings when applied to the agricultural sector. It is in need of reform, but this is a wider issue than bilateral Canada-US trade. Still, some tightening up of anti-dumping provisions at least when applied to the agricultural sector would be appropriate; this may be a fruitful topic for bilateral (or trilateral) discussions in the context of NAFTA. There may be few other lessons. With the wider use of countervail and antidumping in the last two decades, countries and industries are modifying policies and marketing strategies, respectively, to minimize these types of trade restrictions (and legal costs). These adjustments by themselves will lead to a lower incidence of these kinds of disputes.

### **A.3. Corn Dispute<sup>1</sup>**

This case concerns a rather small market in Canada, the corn market in the Prairies, centered on Manitoba. In this case, Manitoba corn growers filed both anti-dumping and countervailing duty actions against U.S. corn imports in August 2000. It is an interesting case in that it shows how a neighbouring market can be affected by the subsidies of the U.S. farm program. It also shows what can happen when farmers in such a regional market can try to deal with the price depressing effects of those subsidies using trade remedy laws, namely anti-dumping and countervailing duty procedures. It is unique in that it involved “regional” rules of inquiry and injury rather than the more usual national rules.

What precipitated the case was the relatively high level of subsidy support granted to US corn growers, resulting in depressed corn prices on the Canadian prairies. In this market like so many in Canada and U.S. agricultural economies, the two markets are highly integrated so that price transmission is not only rapid but price levels are almost completely equalized. One might think of this case as an attempt by Canadian corn growers to use trade remedy law in Canada to deal with the negative price effects in Canada arising from existing high levels of US subsidies.

The findings in this case were positive determinations of subsidy and dumping at an unusually high level, with duties first applied in November 2000. The combined duty in the final determination was US\$1.30 per bushel when market prices at the time were US\$1.80. However, the injury test was concluded negatively in the final determination in March 2001. Part of the reason for this is that “regional” standards were applied which required not just that material injury was caused but that injury was found “to all or almost all producers” in the prairie region, interpreted to mean 95 percent. This is relevant because a sizeable minority of corn-growing farmers were involved in a mixed livestock-wheat enterprise in which case lower corn prices would not have injured their operations (at least not to the same extent). The other reason for the

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<sup>1</sup> This section draws heavily on a paper that deals with this case in some detail, R.M.A. Loyns, “Manitoba Corn Growers Association Inc. vs. U.S. Corn Exports,” in Loyns, Mielke, and Knutson, *Trade Remedy Laws and Canada-U.S. Trade Relations*, Winnipeg, MB: Friesen Press, 2003.

finding of non-injury is that rigid legal or administrative definitions were used, notably ignoring opportunity costs, as is common in applications of trade remedy law.

The conclusions that arise from this case are first that the use of trade remedy law, such as countervails, to deal with high levels of domestic support in a trading partner where markets are relatively integrated, are not likely to be successful, especially not in a regional setting. Further, the thresholds for judging injury in a regional, not national, setting, at least as interpreted in Canada, make it almost impossible to find injury. Third, trade remedy law as widely practiced is applied with so little attention to economic logic that its utility as a policy tool can be severely questioned. This is not news to anyone reviewing the litany of trade disputes between Canada and the U.S., only that it is illustrated quite clearly in this specific case.

#### **A.4. Hogs/Pork Disputes**

There have been a number of trade disputes affecting the hog and pork industry, almost all countervail cases initiated by the U.S. They began in 1985 with a countervail duty investigation brought by the U.S. against Canadian hogs and pork. It may not be an exaggeration to say that this was the dominant agricultural trade dispute between the two countries in the 1980s. It was initiated because of the belief that Canadian hog stabilization programs, federal and provincial, were increasing Canadian exports of hogs and pork to the U.S., and that this increased supply on the U.S. market depressed prices there sufficiently to injure U.S. producers. The result was an affirmative finding both for the subsidy and injury to U.S. producers, and a countervailing duty imposition of Cdn\$0.044/lb live weight on live swine.

Out of this initial dispute came almost a decade of appeals, extraordinary challenges, follow-up cases on subcategories of fresh, chilled and frozen pork, and numerous reviews of countervailing duty calculations and determinations of injury. The hog dispute was one of the first to utilize the binational panel review provisions introduced in the Canada-US Free Trade Agreement and continued in the NAFTA. Some of the duties (fresh, chilled and frozen pork) were revoked in 1991 but others (live swine) remained until a sunset review revoked the last of them in 1999.

These cases brought about other important results. First, Canadian stabilization programs were modified over the late 1980s and 1990s, specifically to reduce the risk of countervail, and the program for hogs, the National Tripartite Stabilization Program, was eliminated in 1994. The cost of the countervailing duties was in effect taxing away all the benefits of these stabilization programs anyway (Cluff et al). Another result was a series of studies to examine how much these programs could have affected the U.S. price, hence injury to U.S. producers. The consensus of these studies was that the increased Canadian production due to the stabilization programs would have had an insignificant effect on U.S. hog prices, even if all the production increase were exported to the U.S. (Schmitz et al, 2003). Consequently, injury to US producers was minimal or nonexistent; the real explanation for declines in U.S. hog prices lay elsewhere.

#### **A.5. Wine Dispute**

Another area of dispute between Canada and the U.S. in the 1980s was wine. This dispute arose from the practice in Canada of provincial liquor boards charging a wholesale/retail markup that differed between domestic and imported wine. This violated the national treatment article of the GATT and constituted the basis for the dispute. In fact, the European Union was also concerned by this practice and was threatening to take this dispute to the GATT to obtain some resolution.

However, this was handled within the (1986-87) negotiations of the Canada-U.S. Free Trade Agreement. The practice of applying differential markups on U.S. wines was ended as part of this agreement. Of course, this meant higher markups for domestic wines, with the obvious implication of a resulting lower price for domestic grapes. The domestic grape industry was widely publicized as a casualty of the Free Trade Agreement. This potential political problem within Canada was dealt with by a simple application of the compensation principle. Grape growers who would remove old (low quality) grape varieties and replace them with higher quality new plantings would receive a substantial subsidy payment per acre replanted, roughly Cdn\$8,000 per acre. The size of this payment can be judged by comparing it to price of the grape land itself, which was roughly \$8000/acre also. It was a popular program and effectively removed any criticism from grape growing areas about negative impacts of the Free Trade Agreement. This may have little direct relevance to trade disputes with the U.S. but it does show how one can deal effectively with the political downside of dealing with a dispute that imposes costs on domestic producers.