DAIRY DISPUTES IN NORTH AMERICA: A CASE STUDY

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INTRODUCTION

Since the Great Depression, Canada and the United States have used different methods to realize the same policy objectives of raising dairy farm incomes and stabilizing milk prices. The "orderly milk marketing" conditions created in both countries isolated domestic milk markets from world markets. Consequently there were few dairy trade disputes before Canada and the United States negotiated the Canada-U.S. Free Trade Agreement.

Markets in North America, including agricultural markets, have become more integrated as a result of the North American Free Trade Agreement (NAFTA) and the General Agreement on Tariffs and Trade (GATT). The broad purpose of these agreements is to provide a framework for long-term reform of trade and domestic policies by increasing market orientation to enhance and stabilize incomes. However, the economy wide market-oriented approach conflicts directly with the interventionist and isolationist approach used to enhance and stabilize incomes of primary dairy producers. The conflicting approaches have produced more frequent dairy trade disputes. The purpose of this paper is to review dairy disputes related to the NAFTA with the objective of describing the context in which these disputes have occurred.

This paper is organized into four sections. The next section provides a background discussion of domestic dairy and trade policies in the United States and Canada. The third section identifies the salient features of three dairy trade disputes. It includes a description of the key issues, the initiator of the action, the action taken, the process of dispute analysis and the outcome of the dispute resolution process. The last section summarizes and concludes the paper.

BACKGROUND

The origins of current dairy trade disputes stem in part from the desire to prevent a repeat of the trade wars during the 1930s and the World War that followed. The collapse of world trade during the 1930s made a lasting impact on the negotiators of multilateral trade agreements following the War. The underpinnings of the GATT date from this era, when many countries, including Canada and the United States, pursued "beggar-thy-neighbor" policies by erecting high and discriminatory barriers to trade. The resolution to problems created by this policy approach and the underlying philosophy of the GATT is that open markets, non-discrimination and global competition are conducive to the national welfare of all economies.

Nevertheless, Canada and the United States continue to maintain large dairy trade barriers, as do most developed Organization for Economic Cooperation and Development (OECD) countries. Significant exceptions include New Zealand, and to a lesser extent Australia. Trade barriers are used with significant intervention in the domestic market to achieve a variety of policy objectives including income support, producer equity, price enhancement and price/income stability.

Protection

Table 1 summarizes producer subsidy equivalents (PSE) and consumer subsidy equivalents (CSE) for some OECD countries involved in dairy trade disputes. The most protected OECD dairy sector in terms of PSE is Japan, followed by Canada, the European Union (EU)and the United States. Table 1 also ranks the European Union at the OECD average level of producer subsidy equivalents with the United States slightly below and Canada slightly above.

The negative CSE values in Table 1 reveal that consumers and taxpayers pay for these interventions (a negative subsidy can be interpreted as a tax). It is necessary to recognize the transfer from consumers and taxpayers to producers to calculate changes in social welfare resulting from trade liberalization. Gains to consumers and taxpayers through lower prices and expenditures are measured against producer losses in prices and income. Producer transfers are fundamental to the political economy of trade liberalization and domestic policy reform. The benefits of domestic market and trade distortions are focused on a small subset of the population (producers). In contrast, the costs of distortions are diffused across a much broader segment of the population (consumers, taxpayers). The focused benefits/diffused costs paradigm suggests that producers have more incentive to organize and lobby on their own behalf and thus have more political clout in dairy policy debates.

Comparing the "Milk" versus "All PSE Commodities" columns in Table 1 highlights another important facet of U.S./Canadian dairy trade disputes. Dairy industries in both countries received more protection than their overall agricultural sectors which are both well below the OECD average in terms of PSE. This suggests an important tension underlying Canadian and United States attitudes toward dairy *vis-à-vis* general agricultural trade liberalization. As well, Table 1 indicates that the level of dairy PSE in Canada and the United States has declined since 1992-94 to 1995, due in large part to the GATT agreement. Canada and the United States would gain from multilateral increased market access and reduced export distortions in grains, oilseeds, and livestock products. However, this would likely generate producer losses in dairy, poultry, and eggs in Canada and dairy and sugar in the United States.

In addition to the political economy tradeoffs within the agricultural sector (as well as between producers and consumers), dairy trade tensions arise from two other fundamental forces: multi-lateral versus bilateral trade agreements and differences in the nature of domestic dairy interventions. In particular, the interface of domestic policies and multi- and bilateral trade policies are increasingly important sources of U.S.-Canada dairy trade tensions.

Table 1: Percentage PSE and CSE, by Country[1].

	Percentage PSE						*Percentage CSE*					
	Milk			*All PSE Commodities*			*Milk*			*All CSE Commodities*		
	1986-1988	*1992-1994*	*1995*	*1986-1988*	*1992-1994*	*1995*	*1986-1988*	*1992-1994*	*1995*	*1986-1988*	*1992-1994*	*1995*
Australia	31	29	25	10	10	10	-31	-29	-23	-9	-7	-6
Canada	77	72	57	51	32	22	-63	-58	-46	-35	-20	-12
EU	64	62	60	48	48	49	-54	-52	-47	-44	-38	-33
Japan	90	88	88	73	74	76	-77	-74	70	-57	-51	-51
New Zealand	12	2	1	18	3	3	-7	0	0	-8	-4	-6
United States	65	54	38	30	21	13	-52	-48	-33	-15	-13	-9
OECD average	66	62	60	48	42	40	-56	-53	-51	-40	-34	-32

[1]Estimate

Source: OECD Secretariat, 1998.

Policy Similarities: Price Supports, Border Protections, and Export Subsidies

Dairy policy in Canada and the United States is similar. Both countries use price support and purchase programs to maintain domestic prices above world price levels and to provide income support. The effect of these programs are included in the OECD PSE and GATT aggregate measures of support (AMS) which must be phased down 20 percent by 2000. Both the United States and Canada use export subsidies to balance domestic markets at prices above world price levels by moving excess production "off-shore." Export subsidization was reduced 36 percent in value terms and 21percent in quantity terms under the 1994 GATT agreement. Table 2 summarizes the GATT quantity commitments to reduced dairy export subsidies. Under the GATT, the United States and Canada are permitted to subsidize a significant quantity of exports of skim milk powder (and butter by the United States). However, the EU dominates the quantity of subsidized exports permitted under the GATT.

Another key similarity concerns border protection, in particular the import tariffs and quotas that comprise the GATT tariff rate quotas. The 1994 GATT increased access commitments are summarized in Tables 3 (reduced import tariffs) and Table 4 (increased import quotas). While "with-in quota" tariffs are generally small, the over quota tariffs are large (and, essentially prohibitive), especially for Japan, the EU, Canada and the United States. These prohibitive over-quota tariffs represent an ongoing source of dairy trade tensions in the GATT agreement as they essentially limit imports to the quota levels. As to the quota levels, Table 4 indicates that aside from European Union and the United States (cheese, butter and skim milk powder) commitments, there is very little change in access for these major products for Japan, Canada and Mexico. This partly reflects the fact that these latter countries imported more than 5 percent of domestic consumption in the GATT base period (1986-90).

Policy Similarities/Differences: Classified Pricing

Both the United States and Canada employ similar classified pricing to enhance producer revenue (price discrimination) at the expense of consumers in certain commodity markets (generally the fluid and or soft product markets). In the United States, classified pricing is regulated under federal and California

Table 2: Maximum Allowable Subsidied Exports for Selected Regions Under Alternative Scenarios (1000 MT).

	Cheese		***Butter/Butteroil***	
	BASE	***GATT 2000***	***BASE***	***GATT 2000***
West Europe	563	431	513	407
E. Europe/FSU	15	13	17	15
Australia	72	50	64	39
Canada	12	9	9	4
USA	4	3	47	21
	Skim Milk Powder		***Whole Milk Powder***	
	BASE	***GATT 2000***	***BASE***	***GATT 2000***
West Europe	374	298	594	480
E. Europe/FSU	145	119	0	0
Australia	106	68	102	65
Canada	55	45	6	5
USA	116	68	15	0

NOTES:

A. Data source: International Dairy Arrangement, Fifteenth Annual Report. November 1994.

B. BASE and GATT 2000 follow the URA of the GATT, assume linear changes.

Table 3: Import Tariff Reductions for Selected Regions.

			Cheese		*But./Butteroil*		*SMP*		*WMP*	
			In-Q	***Over-Q***	***In-Q***	***Over-Q***	***In-Q***	***Over-Q***	***In-Q***	***Over-Q***
W. Europe	BASE	specific duties	547	3,643	1,189	3,971	639	1,956	1,773	4,102
	GATT 2000		768	2,362	1,225	2,572	632	1,561	1,760	3,486
Japan	BASE	ad valorem	50%	50%	35%	35%	13%	15%	30%	30%
	plus	spcific duties	0	0	0	13,406	0	4,954	0	10,228
	GATT 2000	ad valorem	32%	32%	35%	30%	13%	13%	30%	26%
	plus	specific duties	0	0	0	11,397	0	4,210	0	8,691
Australia	BASE	specific duties or ad valorem	71	1,068	74	1%	37	1%	37	1%
	GATT 2000		71	905	0	1%	0	1%	0	1%
Canada	BASE	specific duties	56	3,794	193	3,483	48	1,720	48	3,315
	GATT 2000		24	3,231	83	2,915	21	1,462	21	2,820
USA	BASE	ad valorem	10.5%	0.0%	5.0%	5.0%	0.0%	0.0%	0.0%	0.0%
	plus	spcific duties	0	1,924	62	2,004	33	1,018	68	1,320
	GATT 2000	ad valorem	10.5%	0.0%	4.3%	4.3%	0.0%	0.0%	0.0%	0.0%
	plus	specific duties	0	1,636	62	1,703	33	865	68	1,122
Mexico	BASE	ad valorem	50%	95%	35%	35%	0%	139%	0%	139%
	GATT 2000		49%	89%	31%	31%	0%	131%	0%	131%

Notes:

A. Data source: International Dairy Arrangement, Fifteenth Annual Report. November 1994.

B. BASE and GATT 2000 follow the URA of the GATT, assume linear changes.

C. Under the URA, the tariff rates on the increased cheese and butter import quotas (called minimum accesss) are higher than the tariff rates on the initial tariff quotas (called current access), thus, the average tariff rates on cheese and butter in year 2000 increases from the BASE rates.

Table 4: Import Quotas for Selected Regions under Alternative Scenarios (1000 MT).

		Cheese	*Butter/Butteroil*	*Skim Milk Powder*	*Whole Milk Powder*
W. Europe	BASE	37.1	79.5	41.2	0.7
	GATT 2000	123.1	91.3	69.2	1.1
Japan	BASE	N/A	3.5	99.8	0.0
	GATT 2000	N/A	3.5	99.8	0.0
Canada	BASE	20.4	2.0	0.9	0.0
	GATT 2000	20.4	3.3	0.9	0.0
USA	BASE	116.4	7.5	1.3	0.5
	GATT 2000	136.4	13.1	5.3	3.4
Mexico	BASE	9.4	0.0	56.0	24.0
	GATT 2000	9.4	0.0	56.0	24.0

Notes:

A. Data source: International Dairy Arrangement, Fifteenth Annual Report. November 1994.

B. BASE and GATT 2000 follow the URA of the GATT, assume linear changes.

milk marketing orders (MMO). Federal MMO employ four classes of milk utilization: Class I (fluid or beverage milk), Class II (soft manufactured products such as cream cheese, yogurts, fluid creams, etc.), Class III (cheese) and Class IV (Class IIIa before the recent federal MMO "reforms": skim milk powder and butter). California MMO pricing is similar, with Class 1 (fluid), Class 2 (soft), Class 3 (frozen), Class 4a (SMP/butter) and Class 4b (cheese).

Classified pricing enhances revenue by charging higher prices in price inelastic markets. Higher prices are charged for raw milk used in Class I (1) and Class II (2 and 3) under the federal (California) MMO. Classified pricing therefore raises milk prices and increases milk production in regions with high Class I/II utilization, decreases Class I/II consumption (due to the higher prices) and results in more manufacturing milk (Class III/IV (4a/4b)) milk compared to the absence of classified pricing. The extra production of manufacturing milk tends to lower the price of manufacturing products, hence penalizing regions with low Class I/II utilization.

In addition, both federal and California MMO prices for Class IV (IIIa/4a) are administered at levels that are generally below the price for milk used in cheese (Class III/4b). With an attractive processor margin to attract milk into Class IV (IIIa under the old FMMO/4a in California) and with a price for skim milk powder set by Commodity Credit Corporation well above world market levels, this pricing is designed to short the domestic cheese sector. Given inelastic cheese demand, shorting the domestic cheese market can generate Class III revenue enhancement that more than offsets the milk producer revenues lost on the Class IV (IIIa/4a) market.

Revenues from all utilizations are pooled so that producers receive a "blend price" based on regional MMO milk utilization. This distribution scheme is the source of serious regional dairy disputes in the U.S. dairy sector. Regions with low Class I/II utilization suffer milk price and revenue losses due to the increased milk supply, lower Class I/II consumption, increased manufacturing milk and resulting lower manufacturing milk prices that determine the bulk of their milk revenues. In contrast, regions with high Class I/II utilizations reap most of the benefits of the classified pricing while the costs of the intervention are passed off to consumers and the manufacturing regions.

Canadian classified pricing works similarly, with the twist that production quotas allow a classified price pooling over milk utilizations within quota to be separated from milk utilizations over-quota. This characteristic is essential to the two–tiered export pricing scheme implemented by Canada in 1996. Canadian classified pricing includes: Class 1 (fluid milk and cream for the domestic market); Class 2 (industrial milk for the domestic ice cream, yogurt and sour cream markets); Class 3 (industrial milk for the domestic cheese markets); and Class 4 (industrial milk for the domestic butter, condensed and evaporated milk, milk powders and other markets. The two-tiered (domestic versus export) nature of Canadian classified pricing occurs explicitly in Class 5 (Special Milk Class) items. These classes are defined as raw milk used to produce the following items:

Class 5(a), cheese ingredients for further processing for the domestic and export markets;
Class 5(b), all other dairy products for further processing for the domestic and export markets;
Class 5(c), domestic and export activities of the confectionery sector;
Class 5(d), specific negotiated exports including cheese under quota destined for the United States and United Kingdom, evaporated milk, whole milk powder and niche markets;
Class 5(e), surplus removal.

Policy Similarities/Differences: The Export Implications of Classified Pricing

The export implications and GATT legality of classified pricing schemes in the United States and Canada are a contentious issue. Many consider the cross-subsidization of manufactured milk and product prices to be implicit export subsidies maintained and administered via government intervention. Clearly the recent WTO Panel rulings with respect to the Canadian Class 5d and 5e pricing supports this view. The explicit two-tier aspect of this pricing — that is, these lower valued classes were clearly targeted to the export versus the domestic market — was particularly damning. What is not so clear, as in the case of U.S. classified pricing, is whether it is the two-tier aspect alone that causes these classified pricing schemes to violate GATT export subsidy commitments. Cox

et al. (2000) estimate that complete removal of federal and California classified pricing would increase cheese prices $4/cwt-$6/cwt and skim milk powder price $10/cwt-$15/cwt under competitive market assumptions. This is a measure of the cross-subsidy from the fluid/soft markets to the manufactured product markets caused by U.S. classified pricing. This is clearly an implicit consumption subsidy to the manufactured products. While these implicit cross-subsidies generally do not make the United States competitive in world markets, they likely are sufficient to move products across regions within the United States and perhaps even into Canada. In any case, these consumption subsidies reduce the costs of subsidized exports (i.e., they lower the difference between domestic and world prices) and add some degree of price competitiveness to offset within or over quota import tariffs.

To the extent these cross-subsidized products are exported, the implicit consumption subsidies associated with U.S. classified pricing become implicit export subsidies. The big difference with the Canadian Class 5d/5e scheme is that these implicit subsidies are not targeted specifically to the export market; that is, they are not two-tiered as the domestic and export price are both cross-subsidized. The GATT legality of this type of classified pricing has not been assessed by the WTO. However, there are some indications that the European Union could make this an issue in the next Round of WTO negotiations (Dobson, 1999b).

Policy Differences: Milk Production Quotas

Lastly, one key difference in U.S. and Canadian dairy policy concerns the use of milk production quotas, a quantity versus price related policy tool. Canada shares this approach with the EU and California milk marketing order dairy policies. Production quotas raise the issue of quota rents (the monetized value of the right to produce milk in a heavily protected domestic milk sector) and the property rights that tend to become associated with this type of intervention. Inter- and intra-regional pressure to expand milk production beyond current quota levels is motivated by size economies (production quotas tend to inhibit the adoption of size related, efficiency enhancing technology), interregional competition (between Canadian regions why should the prairie provinces import dairy products from Quebec if they can be produced locally?) and with U.S. regions (California, Northwest, Northeast, etc.), and dissatisfaction

with the historically based original quota allocation. Liberalization (elimination or expansion) of milk production quotas raises issues of compensation and transition paths. Similar issues characterize the EU milk production quota debate.

CASES

Dairy trade disputes in North America typically involve Canada and the United States with the United States initiating the dispute against some aspect of Canadian dairy policy. Since 1986 there have been at least three differences of opinion between the two countries regarding dairy trade. The first was the GATT dispute over yogurt and ice cream. Later, the United States challenged Canada's ability to convert import quotas to tariffs under the NAFTA. The most recent dispute challenged Canada's two-tiered pricing system under the GATT/WTO. This section reviews each of these disputes using a case study methodology. For each dispute, the focus is on the initiator of the action, the action taken, the process of the dispute analysis and the outcome of the application process.

Ice Cream and Yogurt GATT Dispute

The Canadian government was requested to add ice cream and yogurt to its Import Control List before 1988. Ice cream and yogurt had not been included on the List as the quantity imported was negligible relative to domestic consumption. During the late 1980s, however, there was an increased awareness about the Canadian market in the United States, largely because of the CUSTA negotiations. Processors in the United States realized that Canadian tariffs (at the time about 15 percent) on ice cream and yogurt would be coming down. The tariff reduction and low manufacturing milk prices in the United States relative to Canada implied a potential for yogurt and ice cream exports into Canada (Matte, 1997). To preclude this outcome, the Canadian government added ice cream and yogurt to its Import Control List on 28 January 1988[1]

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[1] Specifically, the following items were added to the Import Control List:

HS code	**Item**
2104.00.00.10	Ice Cream Novelties
2105.00.00.20	Ice Cream
2105.00.00.90	Other Ice Cream
2105.00.00.90	Ice Milk Novelties

A notice issued pursuant to the Canadian Export and Imports Act, dated March 25, 1988 stated that import permits were required for any imports of ice cream and yogurt. It required importers seeking permits for any of the restricted products for the remainder of 1988 to document their import performance with respect to these products in 1984, 1985, 1986 and 1987. No quota levels were established for 1988. Permits were requested for 3,536 tons of ice cream and for 2,279 tons of yogurt. Permits were issued for 349 tons of ice cream and for 1,212 tons of yogurt.

During September and October 1988, the United States and Canada held consultations pursuant to Article XXII [2] of the GATT on quantitative restrictions imposed by Canada on imports of various ice cream and yogurt products. As these consultations did not resolve the matter, the United States, in a communication dated 8 December 1988, requested a panel be established to examine the matter under Article XXIII:2 of the GATT.

The United States considered the Canadian restrictions to be inconsistent with the obligations of Canada under the General Agreement. In particular, the permit system and quotas violated the prohibition of import restrictions in Article XI:1, and could not be justified as an exception under Article XI:2.[3] In addition, the implementation of the restrictions was inconsistent with Articles X and XIII. This infringement of the provisions of the General Agreement constituted *prima facie* a case of nullification or impairment of benefits accruing to the United States under the GATT. The United States requested the Panel to

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2105.00.00.90	Ice Milk
2105.00.00.90	Other Ice Milk
2105.00.00.90	Products Manufactured Mainly of Ice Cream or Ice Milk
2106.90.90.00	Ice Cream Mix
2106.90.90.00	Ice Milk Mix
0403.10.00.00	Yogurt

[2] Article XXII provides for consultations between parties that have a trade dispute, which is a necessary condition for invoking Article XXIII. Article XXIII is the GATT's dispute settlement provision, allowing parties to address actions that are perceived to nullify or impair a concession.

[3] Article XI requires the elimination of quantitative restrictions. Exceptions such as XI.2.c.i applied.

recommend that Canada eliminate its quotas and permit scheme on imports of ice cream and yogurt.

Canada maintained its placement of quantitative import restrictions on ice cream and yogurt were consistent with Canada's rights and obligations under Article XI:2(c)(i). The administration of these restrictions was fully consistent with Articles X and XIII. Thus, Canada's actions did not nullify or impair any benefits accruing to the United States. Canada requested the Panel to find that the quantitative restrictions on ice cream and yogurt were consistent with Canada's rights and obligations under Article XI, as well as Articles X and XIII.

The United States recalled that Article XI:1 prohibited the restriction of imports regardless of whether such restrictions were made effective through quotas, import licenses or other measures. The Canadian import permit scheme thus fell within these provisions. The permit scheme established by the Export and Import Permits Act and the Notices to Importers operated to restrict imports. Permits were not freely granted to all qualified importers and were valid only for a limited time. Depending on the means of transportation involved, importers sometimes could not obtain a valid permit until the goods were in transit. The uncertainty and limitations imposed by the scheme could deter exporters from undertaking the planning, promotion and investment activities necessary to develop and expand markets in Canada for their products. The permits therefore had restrictive effects on trade in addition to those caused by the quota, and in the absence of justified quotas, could not be reconciled with Article XI.

Canada maintained that the permit system was not trade restrictive. Import permits were readily granted to applicants who qualified by meeting certain criteria, the principal one being historical import performance and reasonable allowance was made for new entrants. Permitted imports in 1988 exceeded the import level of the previous year.

On 12 September 1989 the Panel concluded that Canada's restrictions on the importation of ice cream and yogurt were inconsistent with Article XI:1 and could not be justified under the provisions of Article

XI:2(c)(i). In particular, the Panel found that ice cream and yogurt did not meet the requirements of Article XI:2(c)(i) for "like products" "in any form" to Canadian raw milk because they did not compete directly with raw milk nor would their free importation be likely to render ineffective the Canadian measures on raw milk production. The Panel also found that restrictions of imports of ice cream and yogurt were not necessary to enforce the milk supply management system. Canada was requested either to terminate the restrictions or to bring them into conformity with the GATT. Because the Uruguay Round was well underway and was mandated to deal specifically with agricultural trade, Canada decided to withhold action on the report pending the final outcome of that current round of the GATT talks. Canada later converted the import restrictions to tariffs that offered an equivalent level of protection just as they would do for all dairy products once the Uruguay Round Agreement was finally reached.

NAFTA Tariffication Dispute

This dispute involved a complex interrelationship of the CUSTA, the NAFTA, the GATT, and the WTO Agreement on Agriculture. In early 1990, informal discussions took place between the United States and Mexico to create a bilateral United States-Mexico free trade agreement or to extend the CUSTA to include Mexico. A commitment eventually was made to begin negotiations on the NAFTA in June 1991. While Canada, the United States, and Mexico were negotiating their trilateral deal, the Final Act, which contained the legal text for the GATT, was tabled in Geneva in December 1991. Over the next two years, there were major struggles in the GATT negotiating process. Agriculture, services, market access, anti-dumping rules, and the proposed creation of a new trade institution were sore points. At times, agricultural trade liberalization appeared to be an insurmountable objective. Canada also was in a difficult position. While extolling the benefits of free trade in support of its red meats, grains and oilseeds sectors, it defended its protectionist supply management systems for dairy, poultry, and eggs.

NAFTA negotiations concluded in August 1992. Because of slow progress on agricultural trade reform at the GATT negotiations, the three NAFTA parties agreed to construct a series of bilateral arrangements. The

provisions of Chapter 7 of the CUSTA, which stipulated Canadian rights with respect to supply management, remained operative between Canada and the United States. Canada and the United States then negotiated separate arrangements with Mexico regarding market access. Canada and Mexico eliminated all barriers to agricultural trade except in dairy, poultry, and eggs.

The simultaneous GATT negotiations solidified the notion of converting all non-tariff barriers to tariffs, including import quotas that were allowable for supply-managed industries under Article XI. Canada was forced to concede Article XI on 15 December 1993 when an agreement was finally reached. However, the agreement provided a level of tariff protection to Canada previously provided by import quota restrictions. Therefore, there was no risk of import competition for the supply-managed industries at that time. Even with the required percentage reductions in the tariffs (see Table 3), there was no threat to these sectors as a result of the agreement other than the gradually increasing minimum access requirements (see Table 4).

There were a number of key elements to this new GATT agreement for the agricultural sector. First, all non-tariff barriers would be converted to tariffs. It was agreed that a country would reduce its tariffs by an average of 36 percent over six years. During the same period, the total aggregate measure of support would be reduced by 20 percent. The value of export subsidies would be reduced by 36 percent, and the total volume of subsidized exports would drop by 21percent. Once the tariff equivalents and final figures for market access were tabled, the agreement was signed in Marrakesh, Morocco and came into effect on 15 April 1994.

On 2 February 1995 the United States requested consultations with Canada pursuant to Article 2006(4) of the NAFTA concerning the Government of Canada's application of customs duties higher than those specified in the NAFTA to certain agricultural goods that are within the meaning of NAFTA. After failing to resolve the matter, on 14 July 1995, the United States Trade Representative Michael Kantor, requested the

establishment of an arbitral panel pursuant to NAFTA article 2008. In its submission, the United States identified as the subject matter of the dispute

> *...the duties being applied by the Government of Canada ... to certain agricultural goods (generally dairy, poultry, eggs, barley and margarine, including products thereof) that are originating goods as defined in the North American Free Trade Agreement …*

The goods at issue were specified in detail by reference to the relevant *Harmonized Commodity Description on Coding System* number in a 10 July 1995 letter from the United States Trade Representative to Roy MacLaren, the Canadian Minister of International Trade. The goods identified in this letter included milk, yogurt, buttermilk, whey, butter, and other milk fats and oils, cheeses, curd, ice cream and other preparations containing milk and milk products.

The United States contended that Canada was applying, with respect to over-quota imports of these goods from the United States, tariffs in excess of those agreed to by Canada under the NAFTA. The United States alleged that Canada increased its tariffs on some of the goods in question on 1 January 1995 and on the remainder of the goods on 1 August 1995, contrary to its NAFTA undertakings.

Canada did not dispute the fact of its imposition of tariffs with respect to over-quota imports of certain goods originating from the United States from January 1, 1995. However, where the United States characterized the Canadian action as an increase in tariffs contrary to the NAFTA, Canada acknowledged only that it established tariff-rate quotas for the agricultural products in question. Canada maintained it was required to establish these tariffs by the Agreement on Agriculture concluded in the context of the Marrakesh Agreement establishing the WTO. By a letter jointly signed by their Trade Representatives on 21 September 1995, the United States and Canada agreed on the terms of reference for the dispute settlement Panel in accordance with Rule 4 of the Model Rules and NAFTA Article 2012.

The central contention of the United States regarding the tariffication issue is that Canada applied tariffs to over-quota imports of specified agricultural products of U.S.-origin contrary to its commitments under the NAFTA. In the submission of the United States, these over-quota tariff rates were described as "significantly in excess of the NAFTA bound rate of duty and significantly above the rate in existence on 31 December 1993."

The United States invoked NAFTA Article 302(1) and (2), which provides:

1. Except as otherwise provided in this Agreement, no Party may increase any existing customs duty, or adopt any customs duty, on an originating good.
2. Except as otherwise provided in this Agreement, each Party shall progressively eliminate its customs duties on originating goods in accordance with its Schedule to Annex 302.2.

The United States contended that Canada's conversion of import quotas to tariffs constituted a breach of NAFTA Article 302(1). Existing customs duties were those, which, pursuant to NAFTA Article 201(1), were "in effect on the date of entry into force of this Agreement". Any increase in tariffs above the rate in effect on 31 December 1993-the day preceding the entry into force of the NAFTA on January 1, 1994. By creating new tariffs, therefore, Canada was in violation of Article 302(1).

Canada maintained that, while it imposed tariffs on over-quota imports of specified United States origin goods in the period in question, the tariffs were imposed in consequence of an obligation to tariffy existing non-tariff barriers to trade in the goods in question pursuant to the WTO Agreement on Agriculture. This agreement entered into force between Canada and the United States on 1 January 1995. The tariffs applied to over-quota imports of U.S.-origin goods were therefore measures equivalent in protective effect to the non-tariff barriers that had been applied to the U.S.-origin goods prior to the period in question rather than new restrictions on imports.

Canada also contended that, under the NAFTA, the disputing Parties agreed that in-quota trade in agricultural goods between them would continue to be governed by the regime established by the Canada-United

States Free Trade Agreement. Over-quota trade would be governed by the arrangements that would emerge from the Uruguay Round. As the tariffs were imposed pursuant to the WTO Agreement on Agriculture obligation to convert existing non-tariff barriers into tariff equivalents, their application to the trade in agricultural goods between Canada and the United States was consistent with the Parties' commitments under the NAFTA. This challenge was the first test of the dispute settlement mechanism agreed to in the NAFTA. This challenge was likely sparked by increasingly disgruntled dairy producer groups in the United States who looked northward and saw their Canadian counterparts receiving higher prices for raw milk (Matte, 1997). On 2 December 1996, the Arbitral Panel created to adjudicate the disputed determined that Canadian tariffs conformed fully to the provisions of the NAFTA. The Panel concluded that the intention of the Parties was that FTA Article 710 was not limited in its application to the GATT agreements negotiated under the GATT as they existed at the time that the FTA or the NAFTA entered into force.

GATT/WTO Dispute: Canada's Classified and Two-Tiered Export Pricing

Before 1995, the proceeds of levies paid by producers were used to fund the Canadian Dairy Commission's losses from exporting dairy surpluses. Following the signing of the WTO Agreement on 15 April 1994, the Canadian Dairy Commission (CDC) developed alternatives to these producer levies. With this in mind, a Dairy Industry Strategic Planning Committee was established. The Canadian Dairy Commission chaired this Committee and provided research and secretariat support for it. In October 1994, the Committee recommended the implementation of a classified pricing system based on the end use of milk, national pooling of market returns, and coordinated milk allocation mechanisms.

A Negotiating Subcommittee of the Canadian Milk Supply Management Committee was established, with representation from all provinces, to resolve how to implement a "special milk classes" scheme. This subcommittee presented its recommendations to federal and provincial Ministers of Agriculture in December 1994, who agreed that some form of pooling of milk returns was urgently required to enable the dairy industry

to meet Canada's international obligations and changing market conditions. Ministers also agreed that the CDC Act should be amended to allow the Commission to administer the Special Milk Classes permit and national pooling arrangements. The necessary amendments were passed in July 1995.

The Special Milk Classes Scheme replaced the producer-financed levy system that was eliminated in 1995, is embodied in a Comprehensive Agreement on Special Class Pooling. The CDC, the provincial producer boards and the provinces that participate in the National Milk Marketing Plan are the signatories of the Comprehensive Agreement on Special Class Pooling that became effective on 1 August 1995.

Under Canada's national classified pricing system, the pricing of milk is based upon the end use to which the milk is put by processors as discussed in the Background section above. In 1997, New Zealand and the United States argued before the WTO that Canada unfairly prices milk used for export markets. New Zealand and the United States claimed the Canadian two-tier pricing policy indirectly subsidizes exports thus violating Article 10 of the Uruguay Round Agreement commitment on subsidy reduction. Under the old program, Canadian farmers paid an in-quota levy to finance export subsidies. Export subsidies allowed Canada to sell dairy products on the world market at a lower price than could be realized domestically. Under the new program, farmers accept a lower price for milk used to make products destined for export markets than for milk sold domestically in Canada. The returns for both types of sales are pooled into one payment to all farmers.

With the new pricing program, Canada has not increased its subsidies but dairy exports have expanded. The important difference between the old and new pricing schemes in Canada is that the old program would have been subject to export subsidy disciplines, while Canada considered the new program to be consistent with the Uruguay Round Agreement.

The source of contention between the nations involved was that while the World Trade Agreement included producer funded levies as export subsidies, it made no reference to two-tiered or classified pricing systems. The Canadian position was that a two-tier pricing system is consistent with the commitments

of the World Trade Organization. The position of the complainants was that Canada circumvented the Uruguay Round limits on export subsidies with its two-tier price system. Producer groups in the United States initiated a 301 process that lead to the formation of a WTO panel to resolve the dispute.[4] The panel began hearings in March 1998.

On 17 March 1999 the WTO panel made its findings public. The panel decided the system of providing low-cost milk to processors is an export subsidy. Specifically, the decision affected Class 5d and 5e, which provide milk to processors at less than domestic prices only if they promise to export the product. For the 1997-98 dairy year, the volume of milk sold in class 5d and 5e represented 9.64% of total milk production in Canada. The panel ruled that "basically the way Canada is administering those classes and the way the government intervenes in those classes are such that based on the definition in the Agreement on Agriculture, they should be considered export subsidies." In other words, when the domestic price is set above the price charged for exports, while domestic producers are paid an average or pooled price, exports are implicitly subsidized.

The panel also ruled that Canada's limitation of fluid milk imports under the tariff rate quota system to cross border shopping only, was inconsistent with its obligations under the WTO. At issue was the way in which the tariff rate quota for fluid milk is administered. The burden of proof is on Canada to demonstrate that it is meeting its tariff rate quota commitment. This is the problem. The volume of fluid imports arising from cross border shopping is not transparent.

In July 1999, Canada appealed the panel decision to the WTO Appellate Body. The Appellate Body upheld the previous decision regarding the two-tier pricing system. It also ruled that Canada could continue to limit imports of fluid milk under the TRQ to cross border purchases by Canadian consumers.

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[4] Section 301 of the Trade Act of 1974, as amended, permits the United States Trade Representative to investigate and sanction countries whose trade practices are deemed "unfair" to U.S. interests. It contains both mandatory and discretionary provisions and specific timetables for the United States Trade Representative to take action.

On 23 December 1999, Canada, the United States, and New Zealand jointly announced the terms under which Canada's subsidized exports of dairy products will be reduced. Under the agreement, Canada will immediately comply with its WTO export subsidy commitments on butter, skimmed milk powder, and other dairy products. Moreover, Canada has committed to reduce substantially the amount of milk made available to cheese producers during the remainder of the current marketing year (ending July 30, 2000) and to cease issuing permits for such milk on 31 March 2000. Beginning in the 2000/01 marketing year (Aug./July), Canada will not be able to export more than 9,076 tons of cheese. This total is less than half of the volume exported in recent years.

SUMMARY AND CONCLUSIONS

The purpose of this paper was to review dairy disputes related to the NAFTA with the objective of describing the context in which these disputes have occurred and will likely continue to arise. The similarities of U.S. and Canadian dairy policies is striking: both countries use intervention prices, border protection (via tariff rate quotas) and export subsidies to maintain domestic prices well above world market levels. Both countries use sophisticated classified pricing schemes to price discriminate against consumers of products with relatively more inelastic demands and use the resulting revenue enhancement to enhance average farm milk prices. This biggest differences between U.S. and Canadian dairy interventions concern the level of intervention (Canadian classified prices are about 50 percent higher than U.S. classified prices, butter/skim milk powder intervention prices and over quota import tariffs are generally higher than those in the United States), the use of production quotas, and the associated two-tiered export pricing scheme implemented to ease internal pressures to increase Canadian production quotas.

The paper described three dairy trade disputes that ranged more broadly than just the NAFTA: the GATT ice cream and yogurt dispute; the NAFTA tariffication dispute; and the GATT/WTO dispute concerning Canada's two-tier pricing system for raw milk. These disputes figure prominently in the historical evolution of agricultural trade dispute resolution mechanisms under the GATT, the NAFTA and the Uruguay Round GATT agreements as each

represented one of the earliest implementations of these mechanisms under the alternative trade liberalizations.

Unfortunately, solid economic analyses of the impacts of these dispute resolutions in the dairy sector are scarce. In contrast to the livestock and grains disputes analysed in those case studies, the evidence is strong that the North American dairy sectors have not developed the constructive, cross-border dialogues on trade disputes that characterize these other agricultural sectors. Cross-border university collaborations are perhaps particularly well suited to providing economic benchmark analyses within which a more solid understanding of the impacts of dairy trade disputes can be realized. Given the heavy politicizing that distorts much of the cross-border dairy dispute dialogues, multi-country, "third party" economic analyses could do much to help improve these dialogues – assuming the respective disputants don't shoot the messengers. This remains an increasingly important and more urgent agenda for further research and cross-border collaboration.

The history of dairy trade disputes suggests that, in each case, the dispute resolution mechanism operated as intended though the smoothness (and timeliness) of the resolution process improved with each succeeding round of liberalization. These case studies should provide some comfort to those who espouse the reasonableness of this type of resolution dispute process. As well, with feedback from the major players (farm, processor and perhaps even consumer groups) on both sides of the border, suggestions for further improving the evolution of these dispute resolution processes/mechanisms is warranted. Hopefully, the discussions at these workshops, and the distribution of their results, will further these cross-border collaborative agendas.

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APPENDIX 1

Timeline

Year	Month	Event
1966	October 31	Canadian Dairy Commission established.
1970		Market Sharing Quota (MSQ) plan for industrial milk.
1974		Canadian Dairy Commission for the first time pays a direct subsidy on all MSQ shipments.
1975		Direct subsidy capped at $6.03/hL.
		Introduction of cheese import quota of 22,727 tonnes.
1978		Cheese import quota reduced to 20,400 tonnes.
		(CDC annual report states 'other than casein, buttermilk powder and some dairy product mixed in combinations with other products such as animal feed, the only other import allowed during this period was cheese under quota.')
1982		Import controls on cheese, casein, animal feed, whole milk powder, skim milk powder, buttermilk powder and evaporated and condensed milk.
		Cheese import quota 20,400 tonnes (60% EC) Sweetened condensed milk 25,800 tonnes (Australia) Buttermilk powder 907 tonnes (New Zealand) Casein - permits issued upon request, no casein production in Canada Butter - only permits are issued when there has been insufficient production of milk Dry skim milk, dry whole milk and dry whey - may not be imported
1985		Products which are blends or mixtures of at least 50% dairy products become subject to import control
1986	May / June	Free Trade negotiations begin.
	September	Uruguay Round negotiations begin.
1988	January 2	Free Trade Agreement signed.
	March 25	A notice to importers states that import permits are required for any imports of ice cream and yogurt. The notice was issued pursuant to the Canadian Export

		and Import Permits Act. It required importers seeking permits for any of the restricted products for the remainder of 1988 to document their import performance with respect to these products in 1984, 1985, 1986 and 1987. No quota levels were established for 1988. Permits were requested for 3,536 tonnes of ice cream and for 2,279 tonnes of yogurt. Permits were issued for 349 tonnes of ice cream and for 1,212 tonnes of yogurt.
	Sept. 7 / Oct. 7	United States and Canada hold consultations pursuant to GATT Article XXII on quantitative restrictions imposed by Canada on imports of ice cream and yogurt products.
	December 8	The United States requests a Dispute Panel to examine the quantitative restrictions imposed by Canada on imports of ice cream and yogurt products under GATT Article XXIII:2.
	December 20	A GATT Council agrees to establish a panel on the ice cream and yogurt matter.
1989	January 1	Free Trade Agreement enters into force.
	January 17	A Notice to Importers is issued which established annual global quotas for calendar year 1989 as follows: (a) ice cream, ice milk, ice cream mix, ice milk mix or any product manufactured mainly of ice cream or ice milk - 345 tonnes (b) yogurt - 330 tonnes The notice further stated that the main criterion for determining the size of quota allocated to individual importers would be the documented level of their imports during 1985, 1986 and 1987. Some quantities could, however, be made available for new importers. Individual import permits are required for each shipment and are issued through an on-line automated system. Permits normally have a validity period of 30 days around the date of arrival specified by importers (5 days prior to and 24 after), but are charged to the importers' quota allocations only if they are used.

	May 11 / Jul. 17	Dispute Panel meets with parties from Canada and the United States regarding the dispute over ice cream and yogurt.
1990	September 12	The Dispute Panel concluded that Canada's restrictions on the importation of ice cream and yogurt are inconsistent with Article XI:1 and cannot be justified under the provisions of Article XI:2(c)(i). In particular, the Panel found that ice cream and yogurt do not meet the requirements of Article XI:2(c)(i) for «like products» «in any form» to Canadian raw milk because they do not compete directly with raw milk nor would their free importation be likely to render ineffective the Canadian measures on raw milk production. The Panel found further that the restriction of imports of ice cream and yogurt is not necessary to the enforcement of the Canadian program for raw milk.
1991	June	North American Free Trade Agreement negotiations begin.
1992	December 17	North American Free Trade Agreement signed.
1993	December 15	Uruguay Round Negotiations conclude.
1994	January 1	North American Free Trade Agreement enters into force.
1995	January 1	World Trade Organization Agreement enters into force.
		Import quotas on Canadian dairy products converted to tariffs.

Product	Base Tariff	Final Bound Rate (2000)
Fluid milk	283.8%	241.3%
Cheddar	289.0%	245.6%
Butter	351.4%	298.7%
Yogurt	279.5%	237.5%
Ice Cream	326.0%	277.1%
Skim milk powder	237.2%	201.6%

Low rate tariff quota commitments are applicable to the following products and quantities:

Product	Tariff Quota	With-Quota Tariff	
		US	Other
Fluid Milk	64,500 tonnes	free	10.5%
Cream – Not Concentrated	394 tonnes	free	12.5%
Concentrated or Condensed Milk or Cream	11.7 tonnes	free	4.09¢/kg
Butter	1,964 tonnes		
	3,274 tonnes	free	12.5%
Cheese	20,412 tonnes	free	4.09¢/kg
Yogurt	332 tonnes	free	9.0%
Ice Cream	429 tonnes		
	484 tonnes	free	9.5%
Powdered Buttermilk	908 tonnes	free	4.79¢/kg
Dry Whey	3,198 tonnes	free	5.52¢/kg
Other Products of Milk Constituents	4,345 tonnes	free	9.0%

Feb. 2	The United States requests consultations with Canada pursuant to Article 2006(4) of the North American Free Trade Agreement concerning Canada's application of customs duties higher than those specified in the NAFTA.
July 14	The United States Trade Representative Michael Kantor requests the establishment of an arbitral panel pursuant to NAFTA Article 2008.
August 1	Direct subsidy payment reduced by 15% to $4.62/hL
	New milk class pricing and pooling system implemented.
	Option Export Program introduced wherein a milk volume of up to 5% of total industrial and fluid quota holdings in a province and up to 10% of an individual producer's quota holdings can be made available for approved export activities.

1996	March 22	The disputing parties provide the arbitral panel with written submissions. The central contention of the United States is that Canada is applying tariffs to over-quota imports of dairy products of US origin contrary to its commitments under the NAFTA. Canada contends that, while it imposed tariffs on over-quota imports on US origin dairy products, the tariffs were imposed in consequence of an obligation to tariffy existing non-tariff barriers to trade in the goods in question pursuant to the WTO Agreement on Agriculture, which entered into force January 1, 1995.
	April	Quebec producers vote not to implement the Optional Export Program in that province.
	August 1	Direct subsidy reduced 15% to $3.80/hL.
	December 2	Final report of the arbitral panel. The Panel decides that FTA Article 710 has the effect of bringing into the NAFTA the replacement regime for agricultural non-tariff barriers that was established under the WTO. This consists of an obligation not to introduce or maintain such non-tariff barriers and the right to apply the tariffs that resulted from tariffication, as set out in their tariff schedules to over-quota imports of agricultural products, together with the obligation to reduce those tariffs and ensure certain minimum volumes of imports. The Panel decided NAFTA Article 302(1) did not diminish these rights.

APPENDIX 2: 1995 Supply and Disposition ('000 kgs).

HS Code	*Commodity*	*Production Canada*	*Imports into Canada from the US*	*Total Imports into Canada the U.S.*	*Exports from Canada to the U.S.*	*Total Exports from Canada*
0402.20	Fluid milk over 1% fat, but not over 6% fat	2,775,106*	88	105	-	714
0402.10	Milk powder, not exceeding 1.5% fat	71,073	97	1,949	1,763	40,248
0403.10	Yogurt	95,190	300	310	14	139
0405.00	Butter	92,515	316	548	40	6,296
0406.90.11	Cheddar Cheese	116,869	61	1,131	759	5,312
0406	Specialty Cheese	184,267 616	16,037	4,079	6,509	
2105.00	Ice Cream	187,000**	414	417	19	4,112
HS Code	***Commodity***	***Production U.S.***	***Imports into U.S. from Canada***	***Total Imports into U.S.***	***Exports from U.S. to Canada***	***Total Exports from U.S.***
0401.10	Fluid milk over 1% fat		-		88	
0402.20	Fluid milk not over 6% fat					
0402.10	Milk powder, not exceeding 1.5% fat	560,835	1,763		97	
0403.10	Yogurt	640,315	14		300	
0405.00	Butter	573,061	40		316	
0406.90.11	Cheddar Cheese	1,422,076	759		61	
0406	Specialty Cheese	1,732,577	4,079		616	
2105.00	Ice Cream	3,266,638	19		414	

* According to Statistics Canada 2689056KL of fluid milk was produced in Canada in 1995. Conversion rate 1hL =103.2kg.

** According to Statistics Canada 339963KL of ice cream was produced in Canada in 1995. Conversion rate from Lucerne Foods, Edmonton.

Source: USDA/FAS