Canadian-U.S. Dairy Trade Dispute: A Tempest in a Teapot

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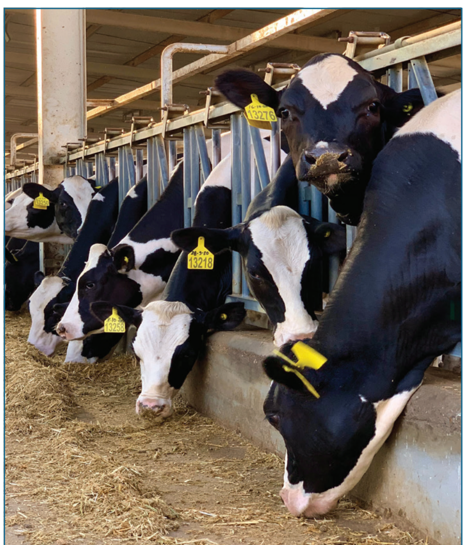
Canada and the United States have a long history of a strong trading relationship, but these neighbors have had several agricultural trade disputes. The most recent was initiated in 2020 when the United States filed a complaint under the U.S.–Mexico–Canada Agreement (USMCA), alleging Canada violated its commitments to partially open its protected dairy market to additional imports. In this article, we consider alternative viewpoints on this case and conclude it is a legal dispute over relatively "small economic potatoes."



The United States and Canada are in the midst of a heated trade dispute over dairy, but the economics show the stakes are low.

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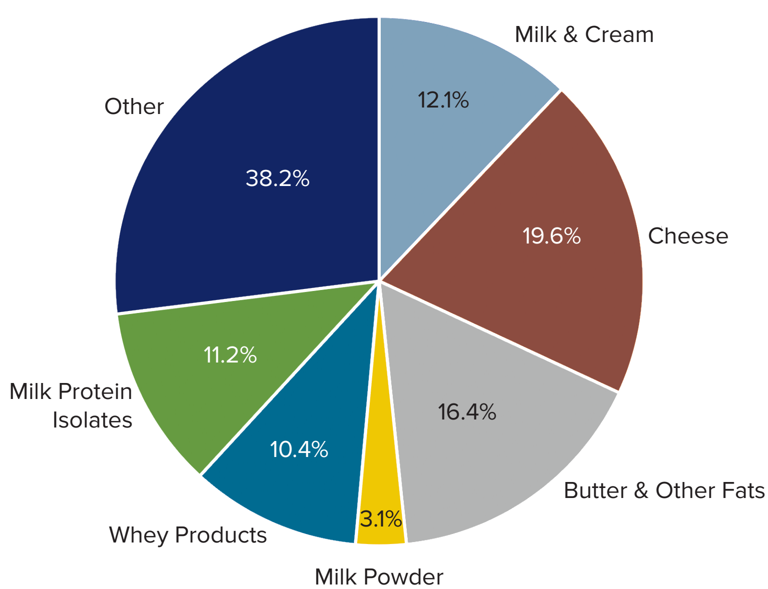
Canada and the United States have a long history of economic cooperation and goods and services trade that has contributed to growth in both economies. However, the United States recently alleged that Canada has not followed through on its regional United States-Mexico-Canada Agreement (USMCA) obligations to allow increased U.S. access to dairy markets in Canada. In December 2021, a USMCA panel found that Canada had breached its trade commitments. Despite virtually no evidence that the increased market access is important from an economic standpoint, the U.S. Trade Representative (USTR), Katherine Tai, described the 2021 panel's finding as a historic win for the U.S. dairy industry. Following the release of the panel report, Canada proposed changes to its dairy import mechanism, but the United States remained dissatisfied and then launched a second USMCA dispute in 2022, requesting new dispute settlement consultations. In addition, the U.S. dairy industry has asked the U.S. government to levy retaliatory tariffs on imports of other goods from Canada.

The Canadian dairy industry supply management system depends on three policy tools: production control, regulated pricing mechanisms, and import control. This allows Canada to maintain a stable supply of dairy products with high prices, which benefits producers but hurts consumers. The average retail price of a gallon of milk in the United States in 2021 was $3.74 USD, while the same gallon would sell for $4.96 USD in Canada—over a 30% difference.

Canada has restricted the import of dairy products with tariff-rate quotas (TRQs), first introduced in 1995 as part of the Uruguay Round Agreement on Agriculture (URAA)—through the World Trade Organization (WTO). Under the USMCA, Canada maintains 14 different dairy TRQs. These TRQs, in conjunction with other policy tools used by the Canadian dairy industry, create the perception globally that any Canadian dairy exports would be subsidized (which is illegal under WTO rules). However, Canada must allow some dairy imports under various trade agreements. Indeed, Canada is an important market for U.S. dairy products, second only to Mexico.

Figure 1 shows the major U.S. dairy exports to Canada in 2021, measured

Figure 1. Major U.S. Dairy Product Exports to Canada as a Share of Export Value, 2021



Source: Statistics Canada.

by value. The most important exports are cheese, fluid milk and cream, butter and other fats, milk protein isolates, and whey products. Cheese accounted for almost 20% of the value of U.S. dairy exports to Canada in 2021. Apart from the products shown in Figure 1, the United States also exports ice cream, yogurt, and casein to Canada, although these are smaller in total value. The European Union and New Zealand also export dairy products to Canada.

Tariff-Rate Quotas

Canada's management of its dairy import TRQs is the key issue in this trade dispute. TRQs are two-tiered tariffs, with a limited import volume (i.e., the quota) permitted at a relatively low or zero tariff rate, and with all additional "above-quota" imports subject to a much higher tariff. The quotas are volumetric and are set annually in metric tons—for instance when the USMCA is fully implemented, the import quota for fluid milk from the United States will be about 57,000 metric tons, with 14,226 metric tons for cheese, and 8,536 metric tons for skim milk powder. For certain products, the Canadian government establishes the percentage of the TRQ volume that is to be restricted to bulk products for processing. Under the USMCA, the "in-quota" tariff is duty-free. However, the Canadian above-quota ad valorem tariffs range from 201% on milk powder to 298% on butter. TRQs are a very commonly used agricultural trade policy tool, and in fact, the United States also uses dairy TRQs to protect its dairy industry, and other industries, such as sugar.

By the time the major changes in the USMCA are fully implemented in 2026, the newly negotiated TRQs will give the United States access to an additional 3.6% of the Canadian dairy market by volume (raw-milk equivalent), more than doubling its access from the URAA.

The Nature of the Dispute

At the heart of the current trade dispute is the way Canada allocates the USMCA dairy TRQs. The United States is not necessarily challenging Canada's decision to distribute the TRQs to Canadian rather than American firms, but rather it is disputing how Canada has allocated TRQs across Canadian producers, processors, distributors, and retailers. Canada currently allocates 85%–100% of the TRQs to domestic processors on a market-share basis, depending on the type of dairy product. As a result, the processors mostly import dairy products that must undergo additional processing before they are ready for retail sale (with some exceptions for various dairy powders, ice cream, non-industrial cheese, and other dairy). This allows for more value added from processing to occur in Canada. The remainder of the TRQs are allocated to distributors (i.e., middlemen) or secondary processors, and can be in processed or semi-processed form.

The United States believes that Canada violated the USMCA by giving most of the TRQ allocation to Canadian processors and thereby reducing U.S. access to Canadian retail markets. The Canadian government argues that they have not violated the agreement because they provide some TRQs to distributors, who are not processors. In January 2022, the USMCA panel ruled in favor of the United States, stating that Canada's decision to set aside a percentage of each TRQ exclusively for processors, is inconsistent with USMCA obligations.

After the panel ruling, Canada's proposed changes are to allocate 85%–100% of the TRQs to processors and distributors based on a single market share calculation (rather than processors alone), but the imports would still largely be in bulk form, requiring some added processing in Canada.

The remainder of the TRQs would be allocated to processors and distributors with no end-use requirement. However, this does not resolve the underlying desire for the United States to capture additional profits associated with the value added from processing, including value associated with brand recognition for retail products.

The Stakes

We believe that if Canada were to change their TRQ allocation system to fully align with the petition from the United States, not much would change regarding the makeup of Canadian dairy imports, because Canadian firms would retain the TRQs and they would capture the value added from processing. Some of the quota would be filled with retail products, but most would still be filled with bulk (i.e., raw) products. In fact, Canada's proposed changes to the allocation system provide Canadian processors with potential access to almost all the available TRQs, even if they must compete with distributors for it.

This raises the question, what is the magnitude of the economic benefits that are at issue in this trade dispute? The U.S. International Trade Commission (USITC) estimates that implementation of the USMCA, as written, will increase the annual value of U.S. dairy exports to Canada by $227 million USD. Let's assume this represents the best-case scenario for the United States and that the entire increase in trade comes from the most valuable product, specialty cheese. Let's further assume that if the United States loses the second dispute, the entirety of the new market access will be given to the lowest value product, fluid milk. This represents the worst-case scenario for the United States. The difference in the value of U.S. dairy exports to Canada between these two scenarios will be an upper bound on the value the United States can expect to gain from winning this trade dispute. It is an upper bound because it does not account for the costs associated with processing the raw milk into cheese and other retail dairy products, which are likely to be significant, and it makes strong assumptions about the current and potential mixture of products imported.

In Canada, dairy prices are set by the government according to the cost of production and type and use of the product. In 2022, the difference in price per kilogram of butterfat between the most valuable products (specialty cheeses) and the least valuable products (fluid milk) was $1.60, or 17%. If the U.S. industry cannot sell high-valued products into Canada, it then forgoes an estimated 17% markup on the increased dairy exports ($227 million USD), a loss of about $39 million USD per year. This relatively small figure represents the most the United States can expect to gain from winning this trade dispute.

In general, most of the pure profit associated with the TRQs are realized by the firms that receive the TRQs, irrespective of where that firm is in the supply chain. Therefore, most international negotiations over TRQ allocation methods tend to be about which country the "in-quota" tariffs are allocated to, rather than the type of firm receiving the allocation. The U.S. government should be interested in whether the TRQs are allocated to United States or Canadian firms, instead of focusing on which type of firms receive the allocation. So, given the relatively small size of the economic rents in question, why have both sides dug their heels in on this issue? Why has the media spent so much energy covering it?

Canada has historically protected its dairy supply management when negotiating free-trade agreements, including the North American Free Trade Agreement (NAFTA)—which was later replaced by the USMCA. However, since 2017 Canada has signed three trade agreements, each incorporating some level of dairy market access for foreign firms. Canada first conceded some access to cheese markets during the negotiations for the Canada-European Union Comprehensive Economic and Trade Agreement (CETA), signed in 2017. Canada had originally planned on giving the majority of the TRQ allocation to its domestic dairy industry (i.e., dairy processors) to compensate them for lost market share from the agreement, but the European Union (EU) insisted that at least 50% of the TRQ allocation be given to retailers and distributors so high-value retail cheese could be imported.

Canada also agreed to allocate just under one-third of the total imports to new entrants during the five-year phase-in period. Allowing a foreign entity to influence how TRQs are allocated within Canada is unusual, because the 1985 Canadian Export and Imports Permit Act gives Canada the right to control how import quotas are allocated, and this act is rarely violated. The exception offered in CETA created ongoing chaos, including arousing the anger of the domestic processing industry, who were unhappy Canada had conceded to European demands, making Canada wary of similar concessions in future trade agreements.

Then, Canada relinquished further market access during the negotiations of the Trans-Pacific Partnership (TPP), later the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). However, TRQs originally set aside for the United States in the CPTPP were reallocated mostly to Australia and New Zealand after the United States pulled out of the deal. Australia and New Zealand were not insistent on receiving dairy

Table 1. Canadian Dairy Production and Imports (Million Standard Hectoliters)

Year	Production	TRQ-Granted Access Under Various Trade Agreements	Actual Imported Volumes
2015	92	3.1	3.1
2016	96	3.1	3.1
2017	103	3.1	3.1
2018	106	3.6	3.5
2019	107	4.7	4.0
2020	107	6.1	5.3
2021	107*	7.6	—
2022	107*	9.0	—
2023	108*	10.0	—
2024	108.9*	10.8	—
2025	109.9*	11.2	—
2026	111.6*	11.3	—
2027	112.8*	11.4	—
2028	114.6*	11.4	—
2029	116.5*	11.5	—
2030	118.1*	11.6	—
2031	119.8*	11.6	—

Source: Government of Canada (2021).

Note: *Estimated. TRQ imports are permitted under CETA, CPTPP, USMCA, and the WTO.

access (most dairy products tend to travel poorly and Australia and New Zealand are a long way from Canada), but the United States had made this a sticking point, and Canada was obligated to concede access whether the United States stayed in the deal or not. During the negotiations, dairy farmers were concerned that any opening of the Canadian market would erode supply management. The dairy industry has significant lobbying power in Canada, and they were disappointed to see supply management eroded, even in a minor way.

Finally, the United States insisted on increased dairy access in the USMCA. Canada granted this but was reluctant to do so after witnessing how CPTPP negotiations unfolded. The sentiment in Canada is that the United States forced Canada to provide market access during CPTPP negotiations, dropped out of the agreement at the last minute, and then came back and asked for additional market access in the USMCA—forcing Canada's hand a second time. To appease domestic dairy industry players, Canada tried to keep as much processing value in the country as possible.

Together, imports negotiated under the WTO, CETA, CPTPP, and USMCA account for nearly 8% of the Canadian dairy market. Table 1 (on page 7) shows the breakdown of expected imports into Canada as the agreements come into force over the next eight years.

It seems clear that the U.S. government cares about this trade dispute for reasons other than capturing large economic gains. The USMCA was marketed as a big win for the U.S. dairy industry and may have been oversold to dairy producers and industry players. After many years of trying, the United States finally persuaded Canada to concede some market share in an industry that has been highly protected for a long time. However, because the Canadian industry is so well protected, even doubling U.S. access to Canadian markets has a small, nominal effect. Industry players may have been expecting a larger volume of TRQs, and possibly anticipating that these TRQs would be given to U.S. firms. By initiating this trade dispute, the U.S. government is trying to show the dairy industry they are willing to fight for them and shift the blame for smaller-than-expected USMCA dairy gains from U.S. negotiators to Canada.

Concluding Thoughts

At the end of the day, this dispute is mainly the result of politics, and the economic benefits at issue are relatively small. Canada apparently feels bullied into giving up dairy access, and the United States feels it is unfair for Canada to protect its industry so strongly. Both sides are using the dispute to appease domestic groups with strong lobbying power.

In reality, this dispute is not worth the attention it has garnered. The U.S. dairy industry may be seeking the demise of supply management in Canada, but this position is oblivious to the fact that eroding supply management will make Canadian dairy more competitive on the world market (including in the United States). On the other hand, the U.S. dairy industry may actually benefit from Canada's supply management as it is currently structured because it essentially keeps Canada out of the world market and offers export access (through TRQs) that arguably would not occur in an open market.

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For additional information, the authors recommend:

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