

What is the Effect of USMCA on the American Dairy Market?

An Undergraduate Briefing Paper

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February 2021

Introduction

American dairy stakeholders have long had serious concerns with the lack of transparency of Canadian milk pricing systems. This continues as the U.S. trade representative (USTR) has been pressured by industry groups and senators to enforce the agreements set out in the United States-Mexico-Canada Agreement (USMCA) to ensure American producers have fair access to Canadian markets.¹ The USMCA aims to increase transparency in the system as well as provide meaningful market access for American producers in Canadian markets.

Background

Overview of the Canadian Milk Pricing System

The Canadian dairy industry relies on a complex federalized system of supply management. The Canadian Dairy Commission establishes the market sharing quota (MSQ), the total production for the entire Canadian dairy industry, based on estimated demand. The MSQ is based on estimated demand, estimated exports, and approved imports. The MSQ is then dispersed to the provinces where regional boards distribute the quotas to producers and negotiate the price that farmers receive for their milk (farm gate price). This system depends on price control, supply control, and import control. In the United States, the federal government still sets minimum milk prices, but these prices are based on market supply and demand for the end use products (cheese, butter, whey). Because the American system is much more responsive to market forces, Canadian markets are susceptible to imports of cheaper, fair-priced, American dairy products. This has led to tariff rate quotas limiting the flow of American dairy products into Canada.

Expansion of Canadian Tariff Rate Quotas

A tariff rate quota (TRQ) is a system that allows for a preferential tariff rate on certain items up to an amount wherein all imports above the threshold amount are subject to a much higher tariff rate. Under the USMCA, Canada has agreed to TRQs on 14 different categories of dairy products. The tariff rate applied to products included in the 14 categories of TRQs is zero. These 14 TRQs represent an additional \$270 million in exports over previous TRQs created under the North American Free Trade Agreement (NAFTA). Tariffs on goods exceeding the quotas vary by product but are prohibitively high. A year 1 quantity is established for each category and then increases by 100%, 50%, 33%, 25%, and 20% in years 2 to 6.² After year 6, the TRQs increase at a 1% annual compound growth rate for ten years and then are fixed after year 19. The only exception to this is whey powder, for which the TRQ is the same as the other products until year 10 when its TRQ is eliminated. TRQs will total 16,667 metric tons in year 1, 100,000 metric tons in year 6, and 109,103 metric tons in year 19 of the USMCA.³ This plan represents a substantial

increase in dairy exports from the United States to Canada but is a relatively small gain when compared with annual domestic production of 99 million metric tons in the United States. The USMCA also includes provisions to ensure effective and transparent administration of TRQs. Previously, the Canadian allocation mechanism has been optimized to make TRQs difficult to fill as well as to fill them with as low value products as possible. An example of this would be that under NAFTA, Canada restricted skim milk TRQs to make them accessible only to individual Canadians crossing the border and buying small quantities of milk from American grocery stores. This made the TRQ very difficult to fill and reduced its impact. There are now provisions in the USMCA to ensure fair access to fill TRQs. For example, USMCA states that all quotas must be assigned in commercially viable shipping quantities. There are many examples like this and the USMCA has many provisions to ensure that the TRQs are completely filled every year. There are compliance provisions within the deal that allow the United States to file complaints if Canada implements TRQs in ways that violate the USMCA. The USMCA also ensures that allocations cannot be limited to processors in any way, allowing processed American goods to be sold to Canadian distributors rather than only being able to sell to Canadian processors, keeping more of the value adding processes in the United States.

Table 1. Additional access in Canadian markets for American producers under USMCA⁴

Dairy Product	2017 Canadian Imports from US (mt)	TRQ Level, year 6 (mt)	Final Access (mt)
Milk	40,904	50,000	56,905
Cream	3,193	10,500	11,950
Skim milk powder	3,490	7,500	8,536
Butter and cream cheese powder ^b	11,008	4,500	5,121
Cheeses ^c	8,789	12,500	14,226
Whole milk powders	1,336	690	785
Concentrated or condensed milk	1,153	1,380	1,571
Yogurt and buttermilk	771	4,135	4,706
Powdered buttermilk	100	520	592
Whey powder	1,470	4,135	Unlimited
Products of natural milk constituents	1,877	2,760	3,141
Ice cream and ice cream mixes	588	690	785
Other dairy	2,314	690	785

Changes to Canadian Class 7 Milk Pricing System

The second major effect of the USMCA on the American dairy industry is the Canadian agreement to eliminate its Class 7 pricing six months after the agreement enters into force. Under NAFTA, there were no TRQs for ultrafiltered (UF) milk, which was sold into Canada duty free. In 2017 Canada implemented Class 7 pricing to offload skim milk components onto the global market at artificially low prices. This was in response to an increase in Canadian demand for butterfat that caused an increase in overall Canadian dairy production and left a surplus of skim milk in the Canadian market. When the fat is removed from whole milk, the remaining product is skim milk. Canada produces more skim milk than is demanded domestically to meet the demand for butterfat. The class 7 pricing system subsidizes Canadian skim milk components making it difficult for American producers to compete in the international market. Following the creation of Class 7 pricing in 2017, American exports of UF milk into Canada fell from 102 million in 2016 to 32 million in 2018 primarily because UF milk is a direct competitor to the skim milk components classified as Class 7.⁵ Under the USMCA, Canada has agreed to reclassify Class 7 products by their end use. Canada has also agreed to set the prices for non-fat dry milk to be used in milk protein concentrates, skim milk powder, and infant formula at the USDA nonfat dry milk price, to monitor its exports of these dairy products, and to implement a charge on exports above the agreed upon levels. This is aimed at protecting U.S. producers from cheap, subsidized skim milk flooding the international market.

Analysis

USMCA requires the elimination of class 7 pricing as well as implementing more restrictions on how to implement TRQs. Whether the new provisions will be effective at ensuring fair access for American producers to Canadian TRQs is a looming question for dairy analysts. There is concern that the Canadian side will simply find another way to accomplish the same goal of subsidizing its skim milk production. The USMCA does include scheduled negotiations to update the agreement in the future. This allows the United States additional flexibility to address any future problems with Canadian milk pricing. U.S. dairy stakeholders fought hard to secure the improvements made under the USMCA and it is exceedingly important going forward that Canada follows through with fair implementation of the new TRQs as well as eliminating the Class 7 pricing system. Canada recently released its plan for implementation of the agreed upon TRQs. The U.S. Dairy Export Council (USDEC) and the National Milk Producers Federation (NMPF) have since expressed concern that these new plans will once again limit the ability of U.S. producers to fill the agreed upon TRQs. USDEC president Tom Vilsack, said “Canada’s administration of previous TRQs under existing free trade agreements gave the U.S. dairy industry ample cause for concern, which has unfortunately been confirmed by the announced TRQ allocations.⁶ Bipartisan groups in both the House and Senate have since sent letters to USTR insisting that “Canada must administer its TRQs fairly and in a manner consistent with its obligations under USMCA; it cannot be allowed to administer TRQs in a manner that discourages utilization or restricts the ability of the U.S. dairy industry to completely fill the established TRQs at advantageous price points.”⁷ These letters also expressed a similar concern relating to the elimination of the class 7 pricing system.

Outlook

The USMCA has the potential to expand American access to Canadian dairy markets in a meaningful way. The dairy industry fought hard to secure fair market access through expanding TRQs and eliminating Class 7 pricing. On December 9th, then-USTR Ambassador Robert Lighthizer sent a letter to the Canadian Minister of Small Business, Export Promotion and International Trade Mary Ng giving notice that the United States was exercising its right to enforce USMCA through enforcement provisions in the agreement. The United States is specifically objecting to the manner in which the Canadian side distributed its TRQs. Canada allocated part of the TRQs to processors and “further processors.” This is despite a provision in the Annex 3-A of USMCA’s chapter on agriculture stating that “a Party administering an allocated TRQ shall ensure that, unless otherwise agreed by the Parties, it does not allocate any portion of the quota to a producer group, condition access to an allocation on the purchase of domestic production, or limit access to an allocation to processors.”⁸ Individual Canadian processors are allowed to apply for and be allocated part of the quotas, but no part of the quotas may be set aside specifically for processor groups. This is because processors typically import lower value products. In the past Canada has tried to fill the quotas with low value products imported by Canadian processors. It is important to note that with the new Biden administration taking hold, American enforcement priorities may shift away to other parts of the deal. President Biden’s nominee for USTR, Katherine Tai, worked on key labor portions of the USMCA and should be a strong supporter of the USMCA, especially the labor provisions with Mexico. It is too early to tell if the USTR will seek strong enforcement on the dairy provisions of the USCMA as well. If the American side can make full use of all available enforcement mechanisms provided in the USMCA, American dairy producers will have much greater access to Canadian markets as well as other international markets. This is dependent on effective implementation of both TRQs and a new system for pricing the Class 7 milk products.

Endnotes

1. Maksym Chepeliev, Wallace Tyner, and Dominique van der Mensbrugge, “How U.S. Agriculture Will Fare Under the USMCA and Retaliatory Tariffs,” GTAP Working Paper No. 84, <https://dx.doi.org/10.2139/ssrn.3317063>
2. “Agreement between the United States of America, the United Mexican States, and Canada,” signed November 30, 2018, Office of the U.S. Trade Representative, <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between>
3. Joel Green, *Dairy Provisions in USMCA*, CRS Report No. IF11149, (Washington, DC: Congressional Research Service, 2019)
4. United States International Trade Commission, “U.S.-Mexico-Canada Trade Agreement: Likely Impact on the U.S. Economy and on Specific Industry Sectors,” <https://www.usitc.gov/publications/332/pub4889.pdf>
5. Green, *Dairy Provisions in USMCA*
6. National Milk Producers Federation, “U.S. Dairy Industry Criticizes Canada TRQ Allocations, Urges U.S. Government to Insist on Good Faith Implementation of USMCA,” June 17, 2020, <https://www.nmpf.org/u-s-dairy-industry-criticizes-canada-trq-allocations-urges-u-s-government-to-insist-on-good-faith-implementation-of-usmca/>
7. Thom Tillis, “Tillis, Colleagues Call for Enforcement of USMCA Dairy Provisions,” August 27, 2020, <https://www.tillis.senate.gov/2020/8/tillis-colleagues-call-for-enforcement-of-usmca-dairy-provisions>
8. “Agreement between the United States of America, the United Mexican States, and Canada,” USTR