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Market solutions to public policy problems

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What does the future hold for Quebec agriculture?

At first glance, Quebec's agricultural sector appears to be stable.[1] However, this apparent stability belies a number of ill-conceived public policies that threaten to destabilize agricultural economics in the province. This report examines these policy issues and recommends reforms necessary to ensure the viability of Quebec's agriculture. Most importantly, the province needs to replace the supply management system and scores of farm subsidies in favor of an open and competitive market.

So far from a market economy: subsidies, quotas, protectionism, and administered prices

As in the rest of Canada, Quebec's agricultural industry is characterized by strong government intervention in the form of subsidies and a highly regulated market sanctioned by the federal and provincial governments.

Canadians finance the country's farmers in two ways: first, through their taxes, which fund direct payments to agricultural producers, and second, by buying farm products at grocery stores, where they pay more for some of their food than they would in the absence of supply management. According to Marcel Boyer (2007), the supply management system costs a family of four in Quebec at least CA$300 per year. He also notes that in

Main Conclusions

- **Quebec agriculture is stifled by a number of ill-conceived public policies that do not serve the interests of farmers, consumers, or taxpayers**
- **Quebec's agricultural sector needs a more competitive environment in which consumers pay less for better quality products and farmers have incentives to be more creative, productive, and innovative**
- **One viable alternative to the regime of subsidies and supply-management is to dismantle Quebec's current system and eliminate government subsidies to farmers.**

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Canada, the price of milk has increased by 53% over the last 12 years, twice as much as inflation, while production costs fell 3.8%. This additional cost is regressive, imposing an especially heavy burden on low-income households, which spend a greater share of their budget on food.

Subsidies

The first type of government assistance to producers is subsidies. The *Pronovost Report* notes that Quebec farmers received CA$725 million in direct payments from the federal and provincial governments in 2004; CA$722 million in 2005; and, CA$838 million in 2006 (all amounts mentioned are in nominal dollars; Statistics Canada, 2007). These are not the only subsidies farmers receive, however. They also collect CA$67 million in federal and CA$136 million in provincial tax assistance by way of capital gains exemptions, tax exemptions on capital, and partial reimbursement of fuel taxes, among others. Overall, the report determines that government support (federal, provincial, and municipal) for agriculture has increased 248% over the past 25 years (CAAAQ 2008: 53).

La Financière agricole du Québec is the only provincial government agency responsible for managing the bulk of lending, insurance, and subsidy programs for Quebec's farmers. The main income support programs for farmers in the province are the joint federal-provincial Crop Insurance Program and the provincial Farm Income Stabilization Insurance Program (FISI). The Crop Insurance Program is intended to mitigate the impact on crops of natural disasters and uncontrollable hazards, including floods, droughts, windstorms, and insect devastation. The Canadian and Quebec governments pick up 60% of costs and farmers pay the remainder. In 2005-06, this program insured over 13,500, or 44%, of Québec farming operations for a value of CA$892 million. Farmers paid CA$49 million in dues and received CA$56 million in compensation. (CAAAQ 2008: 54) The Farm Income Stabilization Insurance Program (FISI) is, according to the *Pronovost Report*, by far the Quebec government's biggest financial aid program. The provincial government provides 67% of its financing while 33% comes from farmers. The provincial government covers all administrative expenses on behalf of *La Financière agricole*, which were CA$57.8 million in 2006-07. The report draws attention to the fact that FISI eligibility does not extend to supply-managed sectors (dairy, poultry, and eggs) described in more detail below, which already benefit from special protection against foreign competition (CAAAQ 2008: 55). The purpose of FISI is to guarantee farmers a positive and stable net income. Compensation is paid when market prices are lower than established production costs (CAAAQ 2008: 57).

According to Alain Dubuc, this compensation system can lead to absurd situations as is the case with pork production in Quebec. There is currently a crisis of overproduction in North America, but the compensation system encourages Quebec pork producers to increase their production. Thus, in 2008, the market price for a 85.4 kg pig is CA$119.20. The program guarantees an income of CA$163.77 per pig, for a compensation of CA$44.57 per animal slaughtered. For 7.5 million pigs, that is CA$335 million, to which must be added the cost of a similar subsidy system for piglets at another CA$182 million (Dubuc 2008). Overall, this aid and other forms of support cost CA$477 million in 2007, and it is expected that when the calculations are in for 2008, the CA$550 million earmarked for that year will be exceeded. The two-year total for this one industry is more than CA$1.1 billion.

Supply management

The other mainstay of Quebec's agricultural sector is the supply management system. It sets quotas on production in order to maintain artificially high commodity prices. When it was first introduced, the rationale behind this policy was to stabilize the incomes of farmers who had been facing large fluctuations in production levels and prices. The supply management system is a mechanism of supply regulation that aims to ensure stable prices for producers of dairy, poultry, and eggs, who for the most part are located in Quebec and Ontario. Specifically, over 80% of Canada's dairy farms are located in the two provinces, while 60% of all poultry production takes place in Ontario and Quebec (Vieira, 2008, Aug. 5.) A significant portion (80% by revenue) of Quebec's agricultural sector specializes in dairy products; the largest number of farms are dairy farms—they alone represent 31% of all farms (AGÉCO 2007: 7).

According to the *Pronovost Report*, over 40% of Quebec's agriculture is

regulated by supply management (CAAAQ 2008: 48). However, almost all sectors of Quebec agriculture (for example, the production of maple syrup, pork, apples, poultry, potatoes, etc) are subject to regulations that are similar to the supply management system in the form of *Plans conjoints* or Joint Plans for marketing agricultural products. Basically, a joint plan is a legally established tool that allows Quebec's producers who decide to take part in these agreements to organize the marketing of their products. Once in force, it enables them to establish policies and collectively negotiate the conditions governing the marketing of their products, including price.

Supply management is, in essence, a system that is intended to limit supply of commodities in order to maintain artificially higher prices. This would not be possible without quotas, and protectionist high tariffs that restrict imports. Because the supply is "managed," support prices are set *a priori* at levels high enough to achieve a regulated rate of return. High tariffs are imposed on imports to ensure that the regulated prices of domestic goods are not undercut by inexpensive foreign produce. According to the *Pronovost Report*, these customs tariffs are currently 299% for butter, 246% for cheese, 155% for whole turkeys, 238% for whole chickens, 164% for shell eggs, and 238% for hatching eggs (CAAAQ 2008: 68).

In a report titled *Modernising Canada's Agriculture Policies,* the Organization for Economic Co-operation and Development (OECD) describes how the system works in dairy:

> the demand is predicted by the Canadian Dairy Commission which makes a recommendation to the Canadian Milk Supply Management Committee (CMSMC) on the Market Sharing Quota (MSQ)—the national production target for industrial milk and dairy products. The CMSMC then allocates milk production among the provinces, and each provincial board allocates its share of national milk production among quota holders. The boards buy all the milk produced in the province at a guaranteed price; milk revenues are then pooled and paid back to producers. Among the provinces, Quebec receives the largest share of MSQ (46.5%), followed by Ontario (31.2%), whereas the shares of all other provinces are relatively small. (OECD 2008: 9)

Retail prices of fluid milk are also regulated in Quebec and Nova Scotia, raising consumer prices in those provinces well above the national average (OECD 2008: 9). According to Sylvain Charlebois (2008), in 2007, a four-liter container of milk (2% fat) in Quebec was about 12% more expensive than in Toronto, 37% more than in Vancouver, and 42% more expensive than in Winnipeg.

Are subsidies and supply management really in our best interest?

As we have seen, government support for agriculture in Quebec is composed of both payments to farmers in the form of subsidies, and policy support for a supply management system that allows producers to determine their prices and output, and charge consumers higher prices than would prevail under competition. However, as will be shown below, it seems doubtful that this arrangement made in favour of a minority over the interests of the majority will be able to carry on for a long time.

Supply management versus trade liberalization

The first obstacle to a long-term prolongation of the status quo in Quebec agriculture is the incompatibility of the protectionism of the supply management system with the trade liberalization process.

The World Trade Organization (WTO) launched the Doha round of global trade negotiations in 2001. The talks, which were focused on cutting tariffs and farm subsidies and on liberalizing trade in services broke down last July. According to Paul Blustein, "The guts of the deal involved a tradeoff in which the United States and other rich countries agree to cap subsidies and protections for their farmers in exchange for greater assurances of access for their industrial products in developing countries" (Blustein 2008).

In this context, Canada's negotiating position was ambiguous, to say the least. It was torn between the interests of the outward-oriented grains and meat sectors, concentrated in the West and responsible for about 80 percent of Canadian exports that operate largely on the basis of globally competitive markets, and those of the domestically-oriented dairy and poultry sectors, concentrated in Ontario

and Quebec and responsible for a miniscule share of exports and imports that depend on the protectionist policies of the supply-management system (Hart 2005: 2).

Eventually Canada will have to choose between free trade and protectionism. Free trade is ultimately in the interest of the Canadian economy, including the agricultural sector. Canada is the OECD's fifth largest exporter and importer of agricultural and agri-food products (OECD 2008: 5). As noted by Valentin Petkantchin, Canada has been condemned by the WTO after complaints filed by New Zealand and the United States going back to 1998 for price-fixing practices in the dairy sector, ruled as equivalent to export subsidies (Petkantchin 2006: 3).

Financial unsustainability

The second obstacle to the long-term sustainability of the status quo in Quebec agriculture is the financial situation. There are disturbing signs that the profitability of farming in Quebec is decreasing (which will inevitably lead to calls for more government support). Even with the subsidies, farm revenues are often lower than operating costs. According to AGÉCO, in 2004, 30% of all farms in Quebec were unable to meet their expenses, 28% had a net income between 0 and CA$24,999; and 42% had a net income of CA$25,000 and more (AGÉCO 2007: 6). In fact, 23% of farms in Quebec would lost money had they not benefited from government support (AGÉCO 2007: 21).

The dependence on government support by the majority of Quebec farms that are not covered by supply management explains why the Farm Income Stabilization Insurance (FISI), the main income support program for farmers that is theoretically only an insurance plan, has paid out CA$5.5 billion during the past 10 years to compensate for production costs that were not covered by revenue. *La Financière agricole du Québec*, which administers all agricultural support programs in Quebec and is funded by the federal and provincial governments, and FISI are running deficits that reached almost CA$890 million in April 2008 (CAAAQ 2008: 48). According to the report, the situation of *La Financière agricole du Québec* is of utmost concern. Total compensation rose from CA$255 million to CA$782 million in four years. The actuarial deficit of insured funds now sits at CA$606 million. The cumulative deficit of the public corporation's operations is CA$342 million (CAAAQ 2008: 62).

On the surface, the sectors under supply management (poultry, eggs, and dairy) are more profitable than the rest of Quebec agriculture. According to the OECD, farmers in the national supply-management systems have substantially higher income than other farmers and Canadians in general, as well as having higher net worth, primarily by virtue of their quota assets (OECD 2008: 12). The OECD study also notes that: "producers in the supply-managed sectors face lower financial risk than their counterparts who farm other products: in 2005 only 6% of dairy farmers and fewer than 14% of poultry and egg farmers were unprofitable, compared to 33% of all farmers in Canada... The proportion of dairy farmers with gross farm receipts of more than nominal CA$250,000 was 57.3% in 2005, the highest among all types of farmers. Indeed, the share of such farms had been only 6% in 1986, similar to the all-sector average" (OECD 2008: 10-11).

There are two types of farms in Quebec: the ones outside the supply management system that are often struggling, and the ones inside the system who appear to be doing well. Still, the profitability of farms under supply management is an illusion and a different reality emerges once the opportunity cost of quota is added to costs.

When the supply-management systems were established, the anticipated market had to be divided among producers who have been allocated quotas for free (in order to control the level of production to avoid surpluses) as an acknowledgement of their "right" to produce without competition at a high price relative to operating costs. However, over time farmers began to buy and sell quotas, which continually increased in value because of the fixed quantity of quotas and the knowledge that prices would continue to rise over time (CAAAQ 2008: 70). The *Pronovost Report* notes that in 1981, the overall value of the quotas granted to dairy, poultry, and egg producers in Quebec was estimated at CA$1.15 billion (in nominal dollars). By 2005, it was CA$9.15 billion (CAAAQ 2008: 70). One explanation for the sharp increase in the value of marketing quotas since 1995 is that quota buyers expect governments will compensate them for any loss in quota value resulting from policy changes (Barichello et al. 2007: 14).

Because of this inflation in the price of production quotas, the market value of farms has increased dramatically. For instance, a medium sized dairy farm in Quebec is estimated to be worth about CA$2.5 million, a price that includes nearly CAD $1.5 million for the quota (CAAAQ 2008: 70). It is now almost impossible for new farmers who have to buy quotas at market value to turn a profit with a supply-managed farm because the cost of the quota plus operating expenses exceeds the farm revenue. The result is that these farmers depend more and more on high support prices. Moreover, as the *Pronovost Report* explains, the current value of quotas also creates enormous difficulties for existing businesses (CAAAQ 2008: 70). That is because if there were no supply managed system, farmers would increase their efficiency and profitability by adopting new technologies and increasing the size of their facilities. The problem now is that when farmers succeed in increasing productivity, any extra production from which they could benefit cannot be delivered unless they acquire new, very expensive quotas (CAAAQ 2008: 70).

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Thus, once the price of quotas is taken into account, farms under supply management that appear to be profitable turn into break even or even loss-generating operations. In the end, supply management is an advantage that is temporary, since the value of the benefit becomes capitalized into the price of quota. Only the first generation producers who got their quota free of charge made a big gain; for the new entrants to the industry, there is no net gain. Consequently, partly due to the high cost of quotas, the pursuit of productivity gains in non supply managed farms, and the increasing size and modernization of farms caused farmer indebtedness to increase from 28.4% in 2001 to 32.2% in 2005 (CAAAQ 2008: 48).

As we have shown, Quebec's agricultural sector needs to be reformed so it can be released from government financial support and debt. The reforms are also necessary so that the sector can deal with the possible effects should the Doha Development Round of trade talks, which collapsed in July 2008, restart and a deal be reached in the global trade liberalization process.

Why is reform so difficult?

The problems with the supply management system raise the question of the fairness of any government intervention that favors a minority to the detriment of the majority. In fact, by granting a statutory cartel to a specific group, the government pits its citizens against each other unequally. The government bestows upon one group the power to extract terms from other groups that they could not expect to receive in relationships of voluntary exchange. This becomes a particular problem in this case when the favoured group has an income that is substantially higher than other farmers and Canadians in general, and has a higher net worth, primarily by virtue of their quota assets (OECD 2008: 12).

Farm reform is necessary, but the question of the abolition of quotas is tricky. Producers who have paid a lot of money and gone into debt to acquire their quotas will vociferously support the status quo. Should Quebec farmers receive financial assistance for a transition period? Michael Hart thinks that farmers who want to leave the business should be compensated with a modest adjustment package (2005: 8). Yet, according to Barichello et al., “Perhaps the strongest argument against providing assistance, even with significant cuts in future protection, is that producers should have been aware of such risks when they purchased their marketing quota and up to this point, they have enjoyed considerable benefits from owning it. The risks inherent in purchasing quota—that the policy regime may change—are well understood by buyers, and there is evidence this risk is built into the quota price” (2007: 14).

To make things even more difficult for reform, the vested interests created by the supply-management system, such as the producers of dairy, poultry, and eggs, wield a lot of political influence in Quebec. This influence is mainly the result of

the distribution of electoral ridings that favours rural areas in Quebec. As a result, the provincial and federal governments persist in blocking any attempt to reform the system in order to preserve the status quo.[2]

Some Quebec columnists[3] have called for radical changes to agricultural policies. Nevertheless, the obstacles are considerable because farming is regarded as an integral part of Quebec's identity that must be preserved.[4] From this viewpoint, if small, uncompetitive farms were closed due to the removal of subsidies, their loss would be perceived as a loss of a traditional cultural way of life, and thus an "existential threat" to Quebec society.

There is a compelling case for ending the protection of Quebec farmers from market forces. The current regime of subsidies and supply-management system is a growing financial burden for taxpayers and consumers, and is unjustified. As Michael Hart states: "Maintaining the status quo… is unfair to consumers, who are condemned to higher prices and limited choices; unfair to other farmers, whose chances at better access to foreign markets are sacrificed in order to protect dairy and poultry farmers; unfair to food processors, whose access to quality inputs is limited to what local suppliers will produce at regulated prices, and even unfair to efficient dairy and poultry farmers, whose opportunities to expand and become more productive are hemmed in by the system's constraints" (2005: 2).

Quebec's agricultural sector is very costly and the bill is rising. We could pump billions more dollars into the system and increase the budgets of current financial assistance programs, but this seems unwise and unfair to other Canadians. Another alternative should be considered.

Set the farmers free

The argument for maintaining high government subsidies and supply-management regimes in Quebec's agricultural sector goes as follows: Without support from the government, domestic farmers would not be able to compete with subsidized foreign imports, so removing the subsidies and dismantling the supply-management systems would drive domestic farmers out of business, leaving Quebec with a much smaller agriculture industry.

The supporters of the status quo use the concept of "food sovereignty." They believe that a country that is unable to domestically produce enough food to feed its people is at the mercy of the world market, and is more vulnerable to trade pressure, global food shortages, and price shocks. Ever since the repeal of the Corn Laws in Britain in 1846,[5] the majority of industrialized countries have chosen to "feed themselves" by importing most of their food and exporting industrial products thanks to their comparative advantage (the ability of a country to produce a particular good at a lower opportunity cost than another country). In an age of free-trade, this choice has certainly not adversely affected their prosperity. It is time for Quebec to get rid of protectionist agricultural policies and take advantage of the opportunities free trade offers.

One viable alternative for Quebec agriculture is in the interest of a great majority of Quebecers. That is to dismantle the supply-management system and, eventually, completely eliminate government subsidies to farmers. In 2006, 46% of all Quebec farm revenue was from products subject to supply management (CAAAQ 2008: 47). With market-based competition and the law of comparative advantage, prices will balance supply and demand, and encourage efficient production. "Real prices" will signal which farms are productive and which are not. Competition will generate higher productivity growth for the sector and consumers will benefit from lower retail prices as well as a wider range of products. Moreover, lower commodity prices will induce consumers to purchase more, thereby generating more income for farmers.

A stronger and more innovative agriculture industry would emerge after such a reform. Countries like Australia and New Zealand have already followed this path. According to the OECD report, in these countries, competition has generated not only higher productivity growth but also the reallocation of resources to more productive sectors (OECD 2008: 14). In Australia, the government has deregulated the dairy industries that relied on domestic supply management and high levels of protection to sustain them. Dairy support prices and quotas were eliminated. In 1999, Australian farmers worked with the government to implement reforms that would gradually eliminate dairy quotas and replace them with a market-based system. Under the Dairy Structural Adjustment

program, the government introduced various steps to deregulate the industry and to help farmers adapt to more market-based circumstances. A modest consumer tax—11 cents per litre–helps to generate the funds needed to aid farmers in either leaving the industry or adapting to the new circumstances (Hart 2005: 7). According to the OECD (2008: 15), the result is that while the adjustment still continues to some extent in Australia, the industry has become more productive and more export-oriented: over 55% of milk production is exported, primarily as manufactured products. According to Valentin Petkantchin, retail prices for fluid milk in Australia have come down considerably, whether for brand-name or "no-name" milk (2006: 4). Not counting the new 11-cent-a-litre tax, the decline in real terms has been 18% for brand name milk and 29% for "no-name" milk. Savings to consumers on milk purchased in supermarkets are estimated at more than AUS$118 million annually.

Conclusion

Despite the collapse of the Doha negotiations in July 2008, Quebec's agricultural sector will eventually have to ensure its long-term viability in the global context of trade liberalization that is essential to the prosperity of the Canadian economy.

Because of the problems this *Alert* has described, it will be increasingly difficult to maintain over the long term the current system of subsidies and supply management, with its harmful consequences of quotas, protectionism, and administered prices. Quebec's agricultural sector needs a more competitive environment in which consumers pay less for better quality products and farmers have incentives to be more creative, productive, and innovative. Any reform of Quebec's agriculture that is under the dual responsibility of the federal and provincial governments is ultimately a political decision that will involve philosophical issues (should the majority protect a minority?) and economic efficiency (what are the benefits of lower costs?).

Quebec's provincial government and the federal government will need to make difficult political choices if they are to ensure the competitiveness of Quebec farmers and the future of Quebec's agriculture. Nevertheless, for all the reasons mentioned in this text, we believe that the only viable alternative is to remove the supply management regimes in favor of market forces, and to work towards a complete elimination of farm subsidies.

Notes

1 In January 2008, the government of Quebec published the *Report of the Commission on the Future of Quebec's Agriculture and Agrifood*, also known as the *Pronovost Report*. The commission was formed on June 20, 2006 with a mandate to report on issues and challenges facing the agricultural sector, to examine the effectiveness of public policies affecting the industry, and to diagnose problems and recommend reforms. The report did not question the foundations of the supply management system, nor the granting of agricultural subsidies to Quebec farmers. In other developments, the Doha round of global trade negotiations launched in 2001 by the World Trade Organization (WTO), which could have transformed the existing system by cutting tariffs and farm subsidies, collapsed in July 2008. Even if it was sometimes critical of the status quo by concluding that the traditional model has stifled innovation, the report concluded that "It is not up to the Commission to speculate whether the supply management system will survive. Governments have agreed to defend this system and are doing so. The Commission nevertheless believes that while defending this system, the agricultural and agrifood sector must also plan for the future and consider several options" (CAAAQ 2008: 69).

2 "Its effectiveness was on display in November 2005, when federal political parties unanimously adopted a motion in the House of Commons in support of supply management" (Vieira: 2008).

3 For example, Descôteaux (2008, August 12),, Elgrably (2008, January 31), Krol, (2008, July 30), Dubuc (2008, August 3), Pratte (2008, July 29).

4 "Our roots in the rural world are still evident in many ways, as most have become city dwellers only recently. Aside from producing food, agriculture represents a way of life and is a dynamic method to occupy our vast territory" *[Translation]* (CAAAQ 2008: 12).

5 These laws were import tariffs designed to support domestic British corn prices against competition from less expensive foreign imports between 1815 and 1846. They were the symbol of British mercantilism and their abolition marked a significant step towards free trade.

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