The world prices of dairy products and the proposals made by several UK's NGOs to reform the EU's dairy chain

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I – The world prices of dairy products are meaningless

1°) To consider New Zealand's dairy prices as the world reference prices is absurd

For the following reasons:

→ NZ accounts for only 2.2 per cent of world milk production.

→ NZ is 'price taker', that is, its dairy prices are fixed a little below those of dairy products exported - with high refunds - by the EU, which remains the first world's exporter (with a world share of 21.2% for butter, 32.5% for skimmed milk powder and 35.8% for cheese in 2000), even if NZ, 2nd exporter, follows hot on its heels.

→ NZ seems to have a true competitiveness since it really does not subsidise its producers, but they enjoy exceptionally favourable ecological and economic conditions for milk production (cows mainly fed only on grass, with an average yield limited to 3500 kg/year, therefore with few inputs) and large economies of scale (271 dairy cows per farm on average and a quasi-monopoly since 96% of the market is controlled by a single cooperative, Fronterra). However the absence of dumping from New Zealand is challengeable since its export prices exclude the most costly winter months: with harsh conditions in two winter months, some production shuts down and the continued production, entirely for domestic consumption, receives a price almost double the export price. In this sense, the New Zealand export price does *not* reflect the actual costs of year-round production in the country.

→ But, NZ is exporting already more than 90% of its production, the latest increase in production has relied on an increased intensification (notably through irrigation) and the pollution of the environment is increasing fast. In other words NZ has probably not significant possibilities to expand its dairy production without much higher economic and environmental costs. Besides, NZ producers suffer themselves from the low price they get, particularly the sharecroppers of capitalist farms, and consumers are themselves paying high domestic dairy prices (Sustain, *Land of milk and money*, London, May 2003).

2°) The gap between the farmgate price and the world price is considered by the mainstream theory as a negative 'consumer's surplus': assuming that consumers are entitled to pay the world price, this gap is consequently considered as 'subsidies' from consumers to farmers.

→ But, if considering this gap as a *consumers' surplus* could at most be understandable for a single small country, as long as its share of the world consumption is negligible, applying this gap to consumers of all OECD countries (which account for 2/3 of the world consumption, of which 62% for butter and skimmed milk powder and 84% for cheese), like OECD does, is an unforgivable error, even for a student in its first year of economics.

→ Therefore, we cannot follow Maurice Doyon, Nicolas Paillat and Daniel-M. Gouin (*Critical Analysis of the Concept of the Producer Subsidy Equivalent in the Dairy Sector (Dairy PSE)*, GREPA, 13-11-01) when they write that "*The OECD also makes the assumption that all countries are small countries, that is, no single one of them has any effect on the world price. This assumption may not correspond to reality, but it has the merit of simplicity*".

→ No, simplicity should not prevail over absurdity! Precisely Doyon et al. are highly critical of OECD since "*The method of calculating PSE from the price of milk in New Zealand implies that the gap between the reference and domestic prices is a transfer from taxpayers and consumers to the producers. However, as we will now demonstrate, such is not the case*".

→ The more so as, to compute the negative *consumer's surplus*, the use of the 'world' price is not limited to the share of traded products in OECD (or world) *production* (6.4% for dairy products at the world level, most of it intra-OECD) but to the whole OECD (world) *consumption*. At least the European Commission was right in writing, in its reply to the European Court of Auditors' report on milk quotas of October 30, 2001, that "*the Commission cannot agree with the Court's claim that abolishing protection at the borders of the internal market would bring consumer prices down to the current world market level, since the world market price would settle at a higher level, given the size of the dairy economy in relation to what is a fairly small world market and the importance of the European Union in the context of that market*".

3°) It is clear that the world price would be completely different of the NZ price in a free-trade situation

Precisely Maurice Doyon et al, recapitulating studies made on the world dairy prices in a free-trade setting – defined as the situation prevailing after the elimination of tariffs, tariff-rate quotas and export subsidies –, have concluded that the true world reference prices of dairy products would be the US domestic prices, which are almost comparable with EU prices! They quote namely a study by Larivière and Meilke (1999) who note that "*world dairy product prices increase substantially with free trade, ranging from 14 % for skim milk powder to 43 % for cheese*".

4°) Therefore OECD is slipping up three times:

→ 1) First, by considering the NZ dairy prices as the world prices from which to compute the negative surplus of all OECD' consumers.

→ 2) While claiming at the same time that free trade would lead to the most efficient world prices.

→.3) Then, when it turns that free trade prices would be higher than those of the most 'competitive' country (NZ), it forgets immediately the sacro-sanct theory and chooses the prices of the country having the lowest ones!

4°) Which shows clearly that, beyond the sophisticated scientific dressing of its writings, **OECD is first and foremost at the service of Western agri-food industries**, and of capital's interests in general, its main objective being to minimise the prices of their agricultural raw materials.

5°) The OECD's PSE's (Producer Support Estimate) indicator portrays the EU as 'subsidising' its dairy sector by €16.1 billion in 2001 and €19.2 billion in 1999 (the year taken by Doyon), or 190 euros per tonne of milk in 1999.

6°) But this concept of PSE is biased in two ways:

→ 1) First it treats as 'subsidies' not merely the actual expenditure on the dairy chain (€4.1 billion in 1999, of which €2.5 billion for the dairy CMO (common market organisation) and €1.5 billion for national expenses) but also the negative *consumers' surplus*. Although OECD at least has admitted that "*To calculate the PSE and the TSE for a given country, the only component that has to be calculated for each commodity is that part of market price support which is financed by consumers. This is because all the other PSE and TSE components are recorded, explicitly or implicitly, as budgetary expenditure… Therefore, the indicator measures more than just the "subsidy element"*" (OECD, *Methodology for the measurement of support and use in policy evaluation*, 2002).

→ So, for 1999, the actual subsidies, i.e. the €4.1 billion expenditure of the EU's milk CMO, represent only 20.8% of the dairy PSE (€19.2 billion), the negative *consumers' surplus* representing 79.2%. Hence, of the PSE expressed as euros per tonne, the subsidies part is worth around €39.5 and the negative *consumers' surplus* part €150.5 out of a total of €190.

→ Actually, the PSE does not include all agricultural subsidies since those of the indicator GSSE (General Services Support Estimate, corresponding roughly to the collective subsidies included in the *green box* of the Agreement on agriculture : agricultural education and training, extension, research, infrastructures, etc.) are only included in the TSE (Total Support Estimate) indicator. For 1999, GSSE's subsidies have represented for the milk CMO €1.4 billion (by distributing the €7 billion of total GSSE among agricultural products according to their share in the value of total agricultural production, which gives 19.7% in 1999 to the milk CMO). However, since the €4.1 billion of the milk CMO incorporate only a small part of those €1.4 billion because the largest part is affected to the Rural development part (second pillar) of the EU's agricultural budget, all that only allows us to conclude that the share of the negative *consumers' surplus* in total PSE's 'subsidies' to the milk OCM is actually higher than 79%. Another conclusion is that, if the PSE overvalue considerably the actual subsidies by the share of the *consumers' surplus*, it undervalues them by the subsidies going to the agricultural general services.

→ 2) Second, if the world price is meaningless - because it is a dumped price below the production cost of almost every country -, so too is the calculation of the 'consumers' subsidy' based on it.

→ Using the US price of milk as the true reference price, and using besides the exchange rates based on the purchasing power parity instead of the bilateral rates against the dollar, Doyon shows that the EU's PSE per tonne of milk turns out to be not €190 but -€28.

→ On this basis the EU is *taxing* its producers for the benefit of consumers at €67.5 per tonne of milk : since the actual subsidies component of the PSE per tonne is still €39.5, a total PSE per tonne of -€28 implies that the *consumers' surplus* component has become positive, at €67.5 per tonne!

→ If the actual EU's dairy subsidies amount to only €0.55 per cow per day (€4.1 billion divided by 20.4 million dairy cows and by 365 days), that remains nevertheless still too much, since more than 2/3 of the milk CMO's expenditure is subsidizing dairy exports. Indeed for 2003 the Commission has foreseen €1.8 billion for export refunds, i.e. 67.4% of a budget of €2.7 billion for the milk CMO, without taking into account domestic subsidies for the production of casein, a good part of it being exported.

7°) In other words the EU consumers are subsidised by the EU dairy farmers who do not get the fair price they should, at least if one is prepared to consider that the world price should be a free-trade price, which we do not.

→ Because we cannot agree with a concept of PSE that assumes consumers everywhere are entitled to pay a 'world price' which is generally a highly dumped price and moreover a highly volatile one. The more so as the elimination of export refunds and import measures (tariffs and tariff-rate quotas) does not imply the end of dumping, since domestic subsidies are replacing them.

→ The more since, when producer prices are lowered to the world price levels – as it has been the case in the EU for cereals since 1993 –, consumer do not follow suit: the 'surplus' is appropriated by the agri-food industries and mass marketing companies, and, eventually, by their shareholders ! Let us add that the European Commission has been repeating many times, in its reply to the European Court of Auditors' report on the milk quotas of October 30, 2001, that "*On the heavy cost European consumers must pay for milk and milk products because of the current level of prices, the Commission does not feel that liberalisation of the milk market on the same basis as for cereals would, generally speaking, mean lower costs to those consumers. Moreover experience has shown that a reduction in the price at producer level is not automatically reflected in consumer prices... The price paid to producers has only a slight influence on consumers*". Thus, Nestlé, 2nd global agri-food company and the 1st for dairy products (with sales of dairy products of $13.5 billion in 2001-02) has generated a net return (for all products) after taxes of 21% on its $15.5 billion shareholders' equity in 2001 and 22% in 2002.

→ That explains the complaint of French milk producers against the dairy industries since they were still paid the same price in 2002 as they had received in 1989. We also know that the UK milk producers are in an even worst shape since, between 1999 and 2000, milk prices at the farm gate were below production costs, the net returns of milk producers having dropped by 26% (Oxfam, *Milking the CAP*, 2003).

8°) Theoretical corollaries of these findings

→ What we have seen for Nestlé is also verified for most agri-food corporations, e.g. the net return of Kraft Foods (the food branch of Altria, ex-Philipp Morris), 1st global agri-food company, reached 15.2% in 2002 on its $25.8 billion in shareholders' equity.

→ If there is no *consumers' surplus* but only an agri-food corporations' surplus, the whole theory of agricultural free trade collapses.

→ "*Not at all, this does not change anything*" the supporters of the theory reply: total welfare increases if the surplus of agri-food industries increases more than the drop in the surpluses of farmers and the government.

→ But, since those corporations are more and more consolidated and globalized, their profits are either distributed to their shareholders worldwide (notably to US pension funds) or reinvested worldwide.

→ And, since the theory of *economic welfare* (and *consumer's surplus*) applies at the national level while the surplus of agri-food companies is dissipated at the global level, the theory actually collapses.

→ The conclusions of econometric models on the *welfare* gains deriving from agricultural free trade are equally irrelevant, as well as the theoretical approaches which criticize the so-called non-tariff barriers in agri-food markets: quotas, variable levies, tariff quotas, prices bands at the import level.

II – The proposals of several UK NGOs to reform the EU's milk CMO

It is in the context of the previous analysis that we can interpret the reports made by CAFOD, Oxfam-International and Sustain on the EU's milk CMO, since they endorse the OECD's PSE indicator.

1°) The CAFOD report on the CAP

→ CAFOD (NGO of the UK Catholic Church) writes in its general report on the CAP (*Dumping on the Poor. The Common Agricultural Policy, the WTO and International Development,* September 2002) that "*In the EU, the average cow now receives total support from EU governments of US$2.20 a day, more than the income of half the world's population. EU support to milk production per cow is 16 times more than the average per capita spending on education by all developing countries… and over 90 times more than per capita spending on education in the world's Least Developed Countries. EU governments spend enough money on the Common Agricultural Policy every year to fly all their 21 million dairy cows around the world – stopping off in*

London, Shanghai, Hong Kong, Singapore, Hanoi, Siem Reap, Brisbane, Auckland, Raratonga, Los Angeles and San Francisco – and still be able to give them over £400 spending money each. EU governments spend enough money on the Common Agricultural Policy every year to give all their 21 million dairy cows a two week cruise in the Caribbean or pay for a month-long walking holiday in the Himalayas".

→ CAFOD should have used better its overactive imagination in devising alternative proposals to the present milk CMO. By the way it contradicts itself blatantly when it recognises that "*The striking thing about the current dairy regime of the Common Agricultural Policy is that no subsidies are paid to dairy farmers directly. Instead subsidies are paid only to processors and exporters… Although dairy farmers often benefit from the level of support given, the lion's share of benefits are captured higher up the supply chain* [it would have been more appropriate to write downstream the dairy chain]… *and in certain circumstances they are actually losing out*". CAFOD has nevertheless used again this magic figure of $2.20 per cow per day in its last press release on the CAP reform of June 26, 2003.

<u>2°) The Oxfam International's report on milk</u>

→ Oxfam International (OI) writes on the front page of its Briefing Paper "*Milking the CAP. How Europe's dairy regime is devastating livelihoods in the developing world*" (December 2002) that "*European citizens are supporting the dairy industry to the tune of €16 billion a year. This is equivalent to more than $2 per cow per day – half the world's people live on less than this amount*".

→ This figure was used by the chair of the World Bank and appeared on the front page of *Le Monde.*

→ The OI's report is proposing rightly to reduce milk quotas to the level of the domestic market's needs and criticises rightly too the EU Commission's proposals (most of them adopted by the Council on June 26, 2003) to reduce sharply the intervention prices and to increase the milk quotas (which will eliminate the smallest producers), since the EU's objective remains to become more competitive to export. But OI is silent on import protection, from which one can infer that it would be maintained at its present level – which should be approved – because the intervention prices can clearly be maintained at the present level only to the extent that import protection remains itself unchanged.

→ What is not clear however in that report is the constant referral to the European Court of Auditors' report of October 30, 2001 since, although it recommends rightly to lower the EU's milk production to the domestic market's solvent needs, it recommends as well to eliminate the quotas – which is by the way contradictory with the limitation of production to the solvent needs in the domestic market – and to lower milk prices. The European Court of Auditors advocates also an increased openness to imports, referring itself to the dairy PSE: "*For the period 1997 to 1999, the OECD assessed the producer subsidy equivalent (PSE) as being 54 % of the value of output for milk as opposed to 44 % for agricultural products as a whole. In other words, EU consumers pay for dairy products twice as much as they would in a free market*" . It is clear that a lower import protection would generate lower domestic prices which would not induce farmers to stabilise the production level on the solvent needs of the domestic market. And, since the Commission has rightly replied to the Court of Auditors, the 20% required reduction in the quotas' level would imply such an amount of direct payments (€12.5 billion, on the basis of €100 per tonne of milk for 5 years) that it would be incoherent with the CAP's budget ceiling. Finally, the Council's decision of June 26, 2003 to lower by 25% the intervention price of butter, by 15% that of skimmed milk powder and to increase by 1.5% the volume of milk quotas would translate into a 20% drop in the milk price at the farm gate by 2008-09, even if direct payments would compensate partially the drop in producers' income. Simulations have shown that a 1% increase in milk quotas in France would reduce the milk price by 4%.

3°) The Sustain's report on the EU's dairy CMO

→ The Sustain's (a co-ordination of most UK NGOs working in the field of agricultural and food policies and their impact on DCs) report of May 2003 ("*Land of milk and money?*") persists in the same line, stressing that the milk PSE of €16 billion constitutes "*a more accurate measure of EU support*" than its expenditure for the milk CMO "*as it includes indirect support reaching the sector*", specifying that the milk PSE "*represents 40 per cent of the value of EU dairy production. This is the equivalent of US$2.4 per day per cow*".

→ Sustain is however unsettled since it writes immediately after: "*Given such huge support, it is baffling to many why dairy farmers seem to be failing. In reality, much of this money fails to reach the farmers themselves. The subsidies largely benefit the dairy processing and exporting industry*". It adds further on that "*consumer price, not only bears little relation to farmgate price, but it is also not a significant issue in richer countries in the EU*".

→ Sustain makes an enormous mistake when it asserts that "*The dairy sector is already the most expensive of the individual sectors within the EU*". One cannot be further from the truth, since the European Court of Auditors underlines (in its report of October 30, 2001) that "*The expenditure on the milk and milk-products sector has decreased from 4285,3 million euro in 1983 (27% of EAGGF-Guarantee expenditure) to 2601,3 million euro in 1999 (6,5% of EAGGF-Guarantee expenditure)*". And the Commission itself confirms that "*The quota system has in this respect been a major instrument of control over expenditure. The Commission would state once again that the cost of the dairy sector to the taxpayer has fallen sharply and that the price paid to producers has only a slight influence on consumers*". The more so when we know that the income from milk represents 14% of the EU farmers' income.

→ Sustain's proposals to reform the milk CMO are inconsistent. If we fully agree with its objectives of refocusing the production on the needs of the domestic market, hence excluding dumping, and within environmentally and socially sustainable farming systems, the means to get there are inconsistent or vague:

→ First it is said that the "*new system would require an element of border protection based on costs of production, level of Producer Subsidy Equivalent (PSE) and food, welfare and environmental standards achieved*". The first part of the sentence "*an element of border protection based on costs of production*" is as logic as the intrusion of the words "*level of Producer Subsidy Equivalent (PSE)*" is incomprehensible and underlines the extent to which Sustain does not understand much the meaning of this concept (incidentally PSE means Producer Support Estimate since 1999). On the other hand it would make more sense to base the level of border protection on food, welfare and environmental standards 'aimed at' rather than 'achieved'.

→ Second, it is said that "*The new policy would be based on an annual grassland direct payments replacing price support and intervention. It should be based on environment, animal welfare standards and occupational health and safety standards*". Sustain proposes to fix this payment at €200 per hectare and "*Given the current coverage of EU dairy production (17 million hectares)… the payments could amount to €3.4billion/year for the EU compared to the current estimate of $17.3845billion (€11.3bn) through price support via consumer prices and other measures. The financing would be via the CAP budget i.e. taxpayers, rather than through higher consumer prices*". We see that Sustain is again mixing actual subsidies (€3.4billion) with the PSE, whose largest part represents the negative *consumers' surplus* (and in fact the positive surplus of agri-food industries and mass marketing firms), suggesting that those 'subsidies' would drop strongly with its proposed policy, which is not so obvious since, in the present cost of €4.1 billion of the dairy CMO the EU budget is supporting only €2.6 billion and the national governments €1.5 billion. The more so since Sustain proposes at the same time to maintain the import protection at its present level or even to increase it (which would result from basing it on higher "*food, welfare and environmental standards*"), the negative consumers' surplus not only would not drop but would even increase.

→ Third, "*To ensure supply and demand are matched, direct payments could be combined with a new system of supply management, based on allocations, replacing the current, flawed, system of quotas… Allocations would be made on a regional basis…which would eliminate surplus*". This supply management is excellent but, if the British system of free market of milk quotas has lead to such abuses (7370 non-producing quota holders hold around 10% of the total UK quota, among which Manchester United Football Club) that it demands profound changes, the new allocations are nothing but another type of quotas which do not admit their name!

→ Finally it is said that "*Prices would not be set but given the set of measures both in the new regime, with changes in world prices following CAP reform, and with stronger competition rules, [they] would reflect the cost of production plus realistic additional income*".

→ The least we can say is that those analysis and proposals are not themselves very 'realistic':

→ How can we say that "*prices would not be set*" when the import protection and supply management measures would cover the costs of production and good "*food, welfare and environmental standards*"?

→ How can we write that "*The new policy would be based on an annual grassland direct payments replacing price support and intervention*", that "*The financing would be via the CAP budget i.e. taxpayers, rather than through higher* *consumer prices*" when import protection is the most obvious and efficient form of price support?

→ How can we be sure that it would be enough to eliminate the export refunds to increase the world dairy prices to such a level that it would not be necessary to maintain a high import protection in order to cover production costs?

→ If the 'fair' prices stemming from the import protection and supply management measures cover already production costs internalising external effects, how then is it necessary to add a direct payment of €200 per hectare, the more so for all dairy farms (only organic farmers would receive an additional payment)?

<u>4°) To conclude, which reform of the milk CMO should we promote?</u>

Of course, there are plenty of good proposals in the preceding reports to improve the present milk CMO, even if I have focused on the limitations of those reports. I will limit myself here to make some major lines to follow for a better milk CMO:

→ Milk quotas shall be maintained but reduced by about 25 million tonnes: 10 million for products exported with dumping and 15 million tonnes for subsidized products consumed on the EU's market, notably for the skimmed milk powder fed to calves. Once fed directly by their mother, their welfare would improve much as well as consumers' welfare. As to subsidies to increase the domestic human consumption of dairy products, Sustain is right in underlining the danger for human health of such subsidies. Consequently the bulk of the present milk CMO expenditure would disappear.

→ In order to promote a sustainable CAP, and not only for the milk CMO, quotas should be considered as a user right – not a property right – granted by society to farmers during their agricultural active lifetime. This implies that the reduction by 21% of milk quotas should weigh on the largest producers and give rise to compensatory payments only marginally when the reductions would affect also the small producers.

→ The EU should at least maintain its present level of import protection or even increase it slightly if necessary to allow the dairy farmers producing 50% of the EU milk production, situated in the most favoured areas and in sustainable family farming systems, to get a fair income only through prices, without direct payments. Only the too small farms of the favoured areas and the family farms of the deprived areas would be eligible to direct payments to complement their farm income, within a ceiling per employed person.

→ All farmers with a milk quota, and benefiting or not of direct payments, would have to comply with a reinforced conditionality not only for the protection of the environment, food safety and animal welfare, but also at the social level. Production ceilings would be imposed to dairy farms because, above around 100 milk cows, external effects are very high since it is then almost impossible to feed cows only on grass.