Wheat Growers are Focusing on the Wrong Trade Issue

by

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Summary and Conclusions

A top priority trade objective of the U.S. wheat growers' leadership is to force changes in the sales practices of the Canadian Wheat Board (CWB) and other State Trading Enterprises (STE). Abolishing or reforming the CWB is a top priority even though Canada is neither increasing its share of the world wheat market nor subsidizing its wheat farmers as much as the U.S. and the European Union (EU) subsidize their farmers.

The U.S wheat growers' case against the CWB is based on an argument made for many years by U.S. Wheat Associates. I call it the "U.S. Wheat Argument." This paper examines the merits of this argument. The paper concludes that the CWB does not significantly harm U.S. farmers because it does not increase either Canadian wheat production or total Canadian exports. While the CWB may increase Canadian sales in some markets by discounting prices, the wheat that it sells at discounted prices would have been exported by Canadian farmers even if the CWB were abolished. Hence, the CWB is not "trade-distorting" in an aggregate sense and is not the most serious trade problem facing the U.S. wheat industry.

The paper concludes by arguing that the high subsidies paid by the European Union (EU) are the most important trade problem. These subsidies are largely responsible for the 15% increase in the EU share of the world wheat market over the last 20 years and the 15% decline in the U.S. share. The effort to negotiate restraints on EU subsidies has been given less attention than it should because of the misplaced focus of the wheat growers' leadership on the CWB.

Wheat Growers Are Focusing on the Wrong Trade Issue

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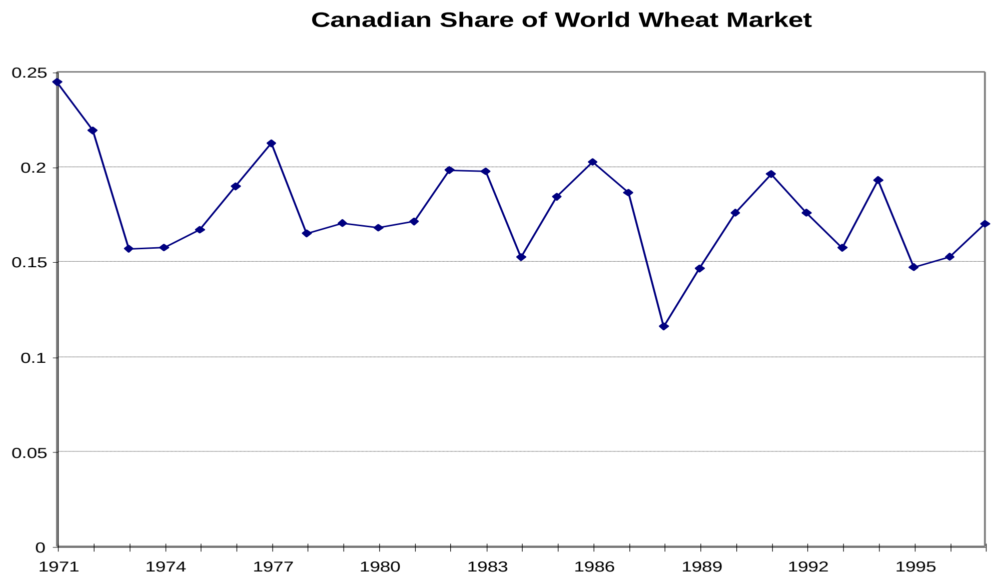
When leaders of the U.S. wheat industry discuss trade objectives, forcing changes in the sales practices of the Canadian Wheat Board (CWB) and other State Trading Enterprises (STE) is always at the top of the list. Other issues may be mentioned, such as eliminating U.S. unilateral sanctions and reducing EC export subsidies, but the real passion is reserved for changing the CWB.

To an outside observer, this focus on the CWB must be hard to understand. During the last 25 years, the U.S. share of world wheat exports has declined by approximately 15% and the European Union's share has increased by 15%. However, Canada's share of world wheat exports has not increased and remains between 15% and 20% of world wheat exports.

Chart 1



The U.S. wheat industry often calls for "audits" of the CWB to check for hidden unfair trade practices and government subsidies. However, it is difficult to make the case that the Canadian government is subsidizing Canadian wheat farmers more than the U.S. government is helping U.S. farmers. Each year, the Organisation for Economic Co-Operation and Development (OECD) publishes data on government aid to farmers. One of the common measures is the percentage Producer Subsidy Equivalent (% PSE) which measures the total value of government transfers to farmers as a percentage of the total value of production. While % PSE does not distinguish between trade distorting and non-trade distorting subsidies, it does provide a rough measure of government aid to farmers. Table 1 shows that the levels of Canadian % PSE for wheat have consistently been at or below U.S. levels.

Why then is the CWB viewed as such a threat? One reason may be the surge of imports of Canadian wheat into the U.S. following implementation of the Canadian Free

Table 1

Percentage PSE for Wheat

	1986-88	1992-94	1995	1996p	1997e
United States	54	39	18	25	32
Canada	51	26	18	19	10
European Union	56	52	44	28	36

p: provisional e: estimate
source: OECD, Agricultural Policies in OECD Countries - Measurement of Support and Background Information 1998

Trade Agreement in 1989, which caused irritation and inconvenience to U.S. wheat growers who farm near the boarder. However, the actual effect of the increase in U.S. imports of Canadian wheat has been small. In a recent paper, Linda Young analyzed the effects on U.S. wheat producers of Canadian imports.[1] After reviewing two economic studies, she concludes

> In comparison to the size of the total U.S. market, imports of Canadian wheat are relatively small, being less than four percent of U.S. production in 1994. Empirical studies of the impact of Canadian imports on U.S. market prices conclude that the effect was small. Estimates reviewed here range from less than one to two cents per bushel.[2]

There is a second and more important reason that U.S. wheat leaders view reforming or eliminating the CWB as the major trade objective. It is based on an argument put forward for many years by U.S. Wheat Associates. The "U.S. Wheat Argument" is essentially an argument that the CWB is an unfair competitor not because it subsidizes or price discriminates, but because of the way it sells Canadian wheat. This argument has a long oral history and is a top priority item on the wheat growers' trade agenda. However, I am not aware of any written statement that explains clearly why the CWB's actions are unfair or what specific rules should be negotiated to correct the abuses.[3] In the following, I will attempt to state what I understand to be the "U.S. Wheat Argument" against the CWB.

The "U.S. Wheat Argument" against the CWB

> *The CWB has the exclusive right to sell the wheat of Canadian farmers in export markets. Since Canadian farmers must deliver their wheat to the CWB for export sale, the CWB does not have to purchase the wheat which it sells. This gives the CWB the freedom to undercut competitors' price offers and make any export sale it chooses. It can issue standing offers to price its wheat by a fixed amount less than price offers of other exporters, no matter what price these other exporters offer. Alternatively, it can offer to deliver a premium grade of wheat for the same price at which other exporters are offering an inferior grade of wheat. The CWB can unilaterally decide to buy market share.*
>
> *The status of the CWB as a monopoly buyer of Canadian wheat is unfair to countries such as the U.S, which have market-based grain systems. Exporters of U.S. wheat must purchase the wheat from U.S. farmers. If they want to remain in business, U.S. exporters can not make offers to foreign customers at a price below the price at which U.S. farmers are willing to sell wheat to them. Hence, they often can not match the offers of the CWB and the U.S. unfairly loses market share.*

Two questions need to be asked in evaluating the "U.S. Wheat Argument." First, does the existence of the CWB cause significant harm to U.S. wheat growers? Second, is it unfair for Canada to use a state buying monopoly to sell its wheat?

DOES THE CWB CAUSE SIGNIFICANT HARM?

I will argue that the sales practices of the CWB do not cause significant harm to U.S. wheat growers because, as long as the CWB does not subsidize Canadian wheat farmers, it does not significantly increase the total amount of Canadian wheat exports during a year. Suppose that the CWB decides to buy a bigger share of the Philippines' wheat market by offering to sell wheat to the millers in the Philippines at $7 per ton less than U.S. price offers. U.S. farmers will lose this sale and may have to sell their wheat in another market at a lower price. However, what if the CWB were abolished and Canada did not make this sale to the Philippines? Very likely, Canadian farmers would sell this same wheat in another market where it would compete with U.S. wheat. This would reduce U.S. sales in that market. If the CWB were abolished and Canada adopted a farmer-controlled marketing system similar to that of the U.S., Canada would still export most of its crop each year. The markets into which Canada sells its wheat might be somewhat different, but **total Canadian exports would be essentially the same**. Consequently, abolishing the CWB is unlikely to increase total U.S. wheat exports or to raise U.S. average prices.

The premise of the "U.S. Wheat Argument" seems to be that the existence of the CWB allows Canada to increase its wheat exports over what they would be if Canada had a farmer-controlled system like the U.S. There are two ways the CWB could increase Canadian wheat exports -- by increasing Canadian wheat production or by increasing the amount of each crop that is exported. The CWB would increase Canadian wheat production if it increased the profitability of wheat farming in Canada. The CWB could increase profitability either by subsidizing Canadian wheat farmers or by marketing Canadian wheat for a higher price than farmers would be able to obtain without the CWB. If Canadian wheat production were artificially stimulated with government subsidies, U.S. farmers would be significantly harmed. However, as mentioned earlier, Canadian farmers are not subsidized more than U.S. wheat farmers. While some defenders of the CWB argue that it increases the sale price of Canadian grain, there is little evidence of this.[4] Hence, it is unlikely that the existence of the CWB significantly increases either the profitability of wheat farming in Canada or the size of the Canadian wheat crop.[5]

Even if the CWB does not significantly increase Canadian wheat production, it could still increase exports if it caused a larger proportion of Canadian wheat to be exported. The "U.S. Wheat Argument" seems to imply that the CWB increases exports by making sales that Canadian farmers would not make if they controlled the sale of their wheat; i.e., the CWB is willing to discount prices by more than farmers would be willing to do. However, if the CWB were abolished, what would the Canadian farmers do with the wheat which is now sold by the CWB at discounted prices? Would they store it? Most Canadian wheat farmers can not afford to store the crop for extended periods of time. If Canadian farmers act like U.S. farmers, they must sell most of their crop during the year it is produced and it will be exported. If the CWB were abolished, it is likely that Canadian farmers would export the same share of the crop as is now being exported by the CWB. It seems implausible that Canadian farmers would hold higher ending stocks of wheat.

In conclusion, the CWB can use its position as a monopoly buyer of Canadian wheat to undercut the U.S. in selected markets.[6] However, the existence of the CWB is unlikely to increase the total amount of Canadian wheat exported each year over what it would be if Canadian farmers made the marketing decisions. Hence, the CWB is unlikely to reduce significantly either the total amount of wheat the U.S. exports each year or the overall price received by U.S. farmers.

IS THE CWB AN UNFAIR COMPETITOR?

The "U.S. Wheat Argument" claims that the CWB is an unfair competitor because it is not required to purchase from farmers the wheat it sells. Hence, it has no "economic basis" to constrain its price offers.[7] This gives it an unfair advantage over countries such as the U.S., where grain that is sold for export must be purchased from farmers.

In some ways, the charges of unfair trade practices in the "U.S. Wheat Argument" are similar to charges made in "anti-dumping" cases. Dumping occurs when a product is sold for export at a price below the "fair" price. The main issue in dumping cases is establishing the "fair" price below which a country should not be allowed to export its goods. In a recent book, Hoekman and Kostecki list two ways to establish dumping,

> Loosely defined, dumping occurs when products are sold by a firm in an export market for less than what is charged in its home market for the same product. Dumping is also said to occur if the export price of a product is below the cost of production.[8]

With regard to the first criterion, the leaders of the U.S. wheat industry have complained that, because the CWB will not reveal the price at which it makes export sales, there is no way of determining whether the CWB is selling its wheat for export at less than the Canadian domestic price. This is one of the reasons for complaining about the CWB's lack of "price transparency." However, I have seen no evidence that this is an actual problem.

Can the CWB be accused of selling at "below the cost of production?" Yes, but unfortunately the cost of production can not be used to establish a "fair" export price for a commodity such as wheat that is produced once annually and marketed over the subsequent year. Wheat production costs are incurred well before the market price is known. Hence, by the time wheat is marketed, production costs are sunk costs and irrelevant to the marketing decision. Most U.S. wheat growers are currently selling wheat at less than their cost of production. Exporting wheat at a market price that is less than the cost of production is not unfair competition.

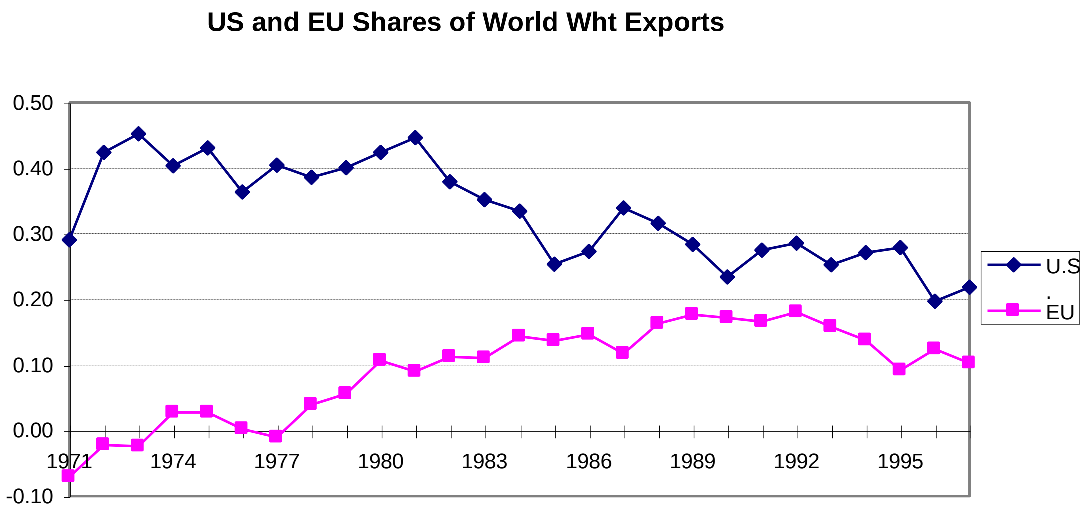
The leaders of the U.S. wheat industry have a problem. They want to charge the CWB with "unfair practices or serious price discounting not based on any economic basis."[9] However, they can not define "economic basis" as is usually done by using domestic price or cost of production. Instead, they have chosen to base their charge of unfairness on who makes the sales decision. If the officials of the CWB decide the export price, the sale is unfair. If Canadian farmers are willing to sell the wheat at the export price, it is a fair sale. The same sale can be fair or unfair depending on which Canadians make the decision. This is a weak argument. If, as I have argued above, total Canadian wheat exports would be essentially the same under the current CWB monopoly or under a competitive system similar to the one used in the U.S., who makes the decision will ultimately have little effect on U.S. exports or on the price received by U.S. farmers.

What is unfair trade? It is notoriously difficult to give a simple definition.[10] However, in this context, an action by a country may be said to be "unfair" if it is trade-distorting, i.e., if it expands or reduces trade above or below the free-trade level.[11] If the "U.S. Wheat Argument" provided evidence that the CWB is expanding total Canadian wheat exports, it could reasonably charge the CWB with being an "unfair" competitor. The "U.S. Wheat Argument" does make the case that the CWB may increase Canadian exports in some markets. However, it does not make a convincing case that the CWB increases Canadian wheat production or total wheat exports. The lack of a good argument that STE increase exports above free-market levels is the reason why the WTO does not currently have rules against exporting STE. If the leaders of the wheat industry want to negotiate disciplines on STE in the next trade round, they must do a better job of showing that the STE significantly affect total exports.

THE RIGHT TRADE ISSUE

The most dramatic change in the world wheat market over the last 20 years has been the increase in wheat exports from the European Union (EU). As Chart 2 indicates, the share of the EU has increased approximately 15% and the share of the U.S. has decreased by 15% over this period. The share of the other exporters, including Canada, has not trended up or down. During this period, the EU has pursued a policy of

Chart 2

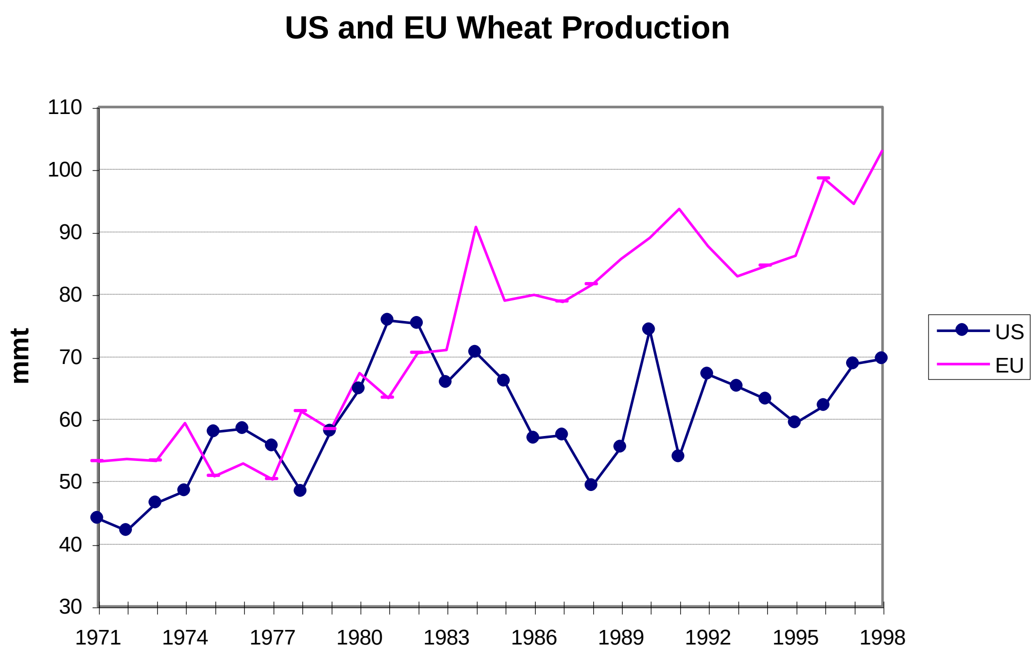


high domestic price supports and export subsidies. The high price supports have caused EU wheat production to grow much more rapidly than U.S wheat production, as can be seen from Chart 3. Many aspects of the EU's farm policy are trade-distorting and violate accepted international rules for "fair" trade.[12] By far, the most important trade issue for U.S. wheat growers is negotiating effective rules to stop the EU from artificially simulating its wheat production and using this production to expand its share of world wheat exports.

DOES THE FOCUS ON THE CWB MAKE A DIFFERENCE?

Compared to EU subsidies, the CWB does little to harm U.S. wheat growers. Canadian production and total exports would change little if the CWB were abolished. This means that the attempt by the leaders of the wheat industry to focus our trade agenda on the CWB is unlikely to produce much benefit. It may actually harm the interests of wheat growers in two ways. First, it causes confusion. Wheat growers may wrongly conclude that the Canada-U.S. Free Trade Agreement (CFTA) and the GATT agreement have failed since they do not restrict the practices of the CWB which the "U.S. Wheat Argument" claims are unfair. As was discussed above, there are good reasons that the actions of the CWB were not restricted. They are not trade-distorting. If the growers wrongly believe that the CFTA and GATT have failed, they will not support fast-track since they think it will only allow the President to negotiate more bad trade agreements. The many news stories claiming Canadian unfair trade practices are a major reason that many wheat growers now question the idea of expanding free trade and oppose negotiation of future trade agreements.

Chart 3



Second, overemphasis on the CWB may cause the leadership of the wheat industry to fail to support more important objectives. The leaders of the wheat industry often must choose which objective to push. During the attempt to pass fast-track authority last fall, the leadership knew the Administration wanted their support. They made the choice to use their leverage and withheld support for fast-track until the Administration agreed to negotiate stronger disciplines on the CWB and other STE. After finally receiving the assurances they sought, the wheat growers' leadership announced support for fast-track -- two days before the fast-track legislation was withdrawn because it would have been voted down. During most of last fall, the primary message from the wheat growers' leadership was not that fast-track was important, but rather that the evils of the CWB were not being addressed. Since fast-track was only five votes short of passing in the House, early wheat grower support would have been important in building the momentum necessary for passage. If reducing EU subsidies is an important wheat grower trade priority, the leadership made a bad mistake. Without fast-track, it will be very difficult to negotiate restraints on the EU in the 1999 WTO negotiation on agriculture.

I have a recurring nightmare. I dream that it is 2002 and the U.S. finally negotiates an agreement to eliminate EU subsidies. When the agreement is presented to Congress, it is defeated by the wheat growers because it does not contain strong enough disciplines on the CWB. For an industry that must export over half its production each year, trade issues are very important. We need to rethink our priorities.

Endnotes

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[1] Linda M. Young, “Changing Canadian Grain Policies: Implications for Montana’s Grain Industry,” Policy Issue Paper no. 1, Trade Research Center, Montana State University. The paper can be downloaded from the Trade Research Center web site. The address is www.trc.montana.edu.

[2] Op. Cit., page 15.

[3] One of the statements of the U.S. Wheat Associates case against the CWB is a letter dated October 27, 1997 written by Dan Gerdes and Alan T. Tracy, who are Chairman and President of U.S. Wheat Associates, respectively, to Secretary Glickman. The letter details several examples of the CWB undercutting U.S. offers and states these are “unfair practices or serious price discounting not based on any economic basis.” No explanation is offered of what they mean by “economic basis.” The National Association of Wheat Growers (NAWG) has a policy summary on “Unfair Trading Practices of Monopoly Marketing Boards” which charges the CWB with “unfairly engaging in price discrimination” for selling in markets embargoed by the U.S. This policy summary is particularly ironic since the NAWG also has a policy summary which argues that U.S. growers should be able to sell in these embargoed markets.

[4] See, for example, Andrew Schmitz, Hartley Furtan, Harvey Brooks, and Richard Gray, “The Canadian Wheat Board – How Well Has It Performed?,” <u>Choices</u>, First Quarter, 1997. Schmitz, et al., do argue that the CWB is able to obtain price premiums when it exports Canadian wheat. However, the only example they offer is the ability to price discriminate against the EEP program, i.e., sell Canadian wheat at a higher price to countries such as Japan which are not eligible to receive EEP. Since the EEP program is no longer being used by the U.S., it is unclear how the CWB would obtain price premiums.

[5] If the “U.S. Wheat Argument” is correct and the CWB is buying market share by offering Canadian wheat at heavily discounted prices, the profitability of wheat production in Canada should be reduced. Consequently, in the long-run, Canadian wheat production and exports should be reduced by the CWB.

[6] If Canadian wheat varieties are different from the wheat varieties of other countries and if foreign mills or buyers do not like to switch back and forth between varieties, the ability of the CWB to buy market share could provide a temporary advantage for Canadian wheat. The CWB could lose money on a sale or two and then make future sales even though its prices are higher. This might increase total Canadian exports. However, the characteristics of the wheat from different countries are similar enough that this seems unlikely to be important. The ability of the CWB to regulate the quality of Canadian wheat is probably a more important long-run issue.

[7] The phase “economic basis” is taken from the October 27, 1997 letter of Gerdes and Tracy to Secretary Glickman.

[8] Bernard Hoekman and Michel Kostecki, <u>The Political Economy of the World Trading System</u>, 1995, page 171.

[9] See the letter by Gerdes and Tracy to Secretary Glickman.

[10] John H. Jackson discusses the concepts of “unfair” in great detail in his recent book. At one point he states,

> “Unfair” trade is normally deemed to include trade that has been influenced or promoted by activities such as “dumping,” providing government subsidies, or foreign sellers attempting to evade legitimate regulations regarding the environment, fair competition, intellectual property protection, and so on.

See John H. Jackson, <u>The World Trading System</u>, 2nd edition, 1997, pp. 177-8.

[11] See Hoekman and Kostecki, p. 104.

[12] OECD figures presented in Table 1 mask important differences in the EU and US farm programs. Except when world prices are very low so that the U.S. marketing loan program is used, the U.S. has moved to a “decoupled” farm program. Most U.S. farm payments are not tied to production and U.S. farmers make production decisions based on world prices. The PSE calculated by the OECD do not distinguish between subsidies that are decoupled and those that are trade-distorting. If only trade-distorting subsidies were considered, the subsidy level in the EU would be higher relative to the U.S.