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Report to Congressional Requesters

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CANADA, AUSTRALIA, AND NEW ZEALAND

Potential Ability of Agricultural State Trading Enterprises to Distort Trade

G A O

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Congressional Requesters

As you requested, we have reviewed state trading enterprises in three countries: Canada, Australia, and New Zealand. Our review focused on the capabilities and activities of the Canadian Wheat Board, the Australian Wheat Board, and the New Zealand Dairy Board. We developed a framework to analyze these boards and determine whether or not each board was capable of distorting world markets in their respective commodities.

We are sending copies of this report to the Secretary of Agriculture; the U.S. Trade Representative; officials of the Canadian, Australian, and New Zealand governments; and other interested parties. Copies will also be made available to others on request.

Please contact me on (202) 512-8984 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix III.

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List of Congressional Requesters

The Honorable Kent Conrad
The Honorable Larry Craig
The Honorable Byron Dorgan
The Honorable Russell Feingold
The Honorable Herb Kohl
The Honorable Larry Pressler
United States Senate

The Honorable Pat Roberts
Chairman, Committee on Agriculture
House of Representatives

The Honorable Steve Gunderson
Chairman, Subcommittee on Livestock, Dairy, and Poultry
Committee on Agriculture
House of Representatives

The Honorable Joe Skeen
Chairman, Subcommittee on Agriculture, Rural Development, Food
and Administration, and Related Agencies
Committee on Appropriations
House of Representatives

The Honorable David R. Obey
Ranking Minority Member
Committee on Appropriations
House of Representatives

The Honorable Doug Bereuter
The Honorable Sherwood Boehlert
The Honorable Robert Borski
The Honorable Tim Holden
The Honorable Tim Johnson
The Honorable John M. McHugh
The Honorable Thomas Petri
The Honorable Earl Pomeroy
House of Representatives

Executive Summary

Purpose

The agricultural agreements of the Uruguay Round (1986-94) of the General Agreement on Tariffs and Trade (GATT) were intended to move member nations toward the goal of establishing a fair and market-oriented agricultural trading system. Through a process of progressive reductions in internal governmental support and export subsidies, conversion of quotas to tariffs, lowering of barriers to import access, and other reforms called for by the agreements, the member nations hoped to reduce distortions in world agricultural markets and to prevent additional distortions from occurring. Trade distortion can occur when a country's policies change production and consumption decisions from what they would be if they faced an open international market.

Some member nations are using state trading enterprises (STE) to regulate imports and/or exports of selected products. STEs are generally considered to be enterprises that are authorized to engage in trade and are owned, sanctioned, or otherwise supported by the government. Since the start of GATT, member countries have noted STEs' unique role and potential to distort world trade and have thus required them to operate in accordance with commercial considerations. STEs may have control over exports or imports of certain commodities; their practices to control these commodities have included levies on production and/or imports, licenses for exports, government guarantees, and subsidies. Although STEs are legitimate trading entities and are subject to GATT regulations, some U.S. agricultural producers and others are concerned that these STEs, through their monopoly powers and government support, may have the ability to distort worldwide trade in their respective commodities.

Eighteen members of Congress, including the Chairman of the House Agriculture Committee; the Chairman of the House Agriculture Subcommittee on Livestock, Dairy, and Poultry; and the Ranking Minority Member of the House Committee on Appropriations, asked GAO to review a number of issues related to the activities of other countries' agricultural STEs. This report, one in a series of products on the nature of state trading in other countries, discusses (1) the potential capability of export-oriented agricultural STEs to distort trade and (2) the specific potential capability of the Canadian Wheat Board (CWB), the Australian Wheat Board (AWB), and the New Zealand Dairy Board (NZDB) to engage in trade-distorting activities, based on their status as STEs.

Background

Governments have supported the export of agricultural commodities through a number of means, including direct and indirect subsidies to agricultural producers. For example, the United States and the European Union, as well as other countries, offer subsidies through a variety of mechanisms. STEs also benefit from government subsidies, but play a different role in the market. Some trade experts and some member countries are concerned about STEs' potential to distort trade due to their role as both market regulator and market participant. However, it should be noted that a particular policy can potentially distort trade without being defined as unfair under GATT. For example, government assistance for disadvantaged regions can be allowed by GATT under certain conditions. This government assistance might allow certain firms to continue to operate that would not survive in a normal competitive environment.

STEs that have monopoly buying authority for certain domestic products may gain advantages as a result of their overall control of the domestic supply. These advantages can be trade distorting, such as where STE authority allows cross-subsidization between domestic and foreign markets or between foreign markets. Cross-subsidization can occur when an STE sells products at a loss in one market and finances those losses through highly profitable sales in another market. Government support for STEs involving direct and indirect subsidies also provides advantages over competitors in world markets and can distort world trade. Additionally, relationships between STEs and foreign buyers can provide advantages through the ability to charge different prices in different markets. These advantages are particularly evident in restricted foreign markets, such as in the United States, where imports of certain commodities are limited.

STEs have been important international players in the wheat and dairy trade. Some industry observers are concerned about the market power of specific STEs. Sixteen member countries have reported to GATT about STEs in either their wheat and/or dairy sectors. The international wheat trade sector includes STEs such as CWB and AWB, which control 22 percent and 7 percent of the world wheat trade, respectively. NZDB is one of the more important players in the world dairy trade, controlling approximately 25 percent of international trade in dairy products.

Because complete transaction-level data needed to fully evaluate potential trade-distorting activities were not available, GAO is not in a position to say whether or not trade-distorting activities actually have occurred. Even with this information, such an extensive analysis would require additional data regarding production costs and comparative private firms' sales. As such, definitive statements regarding STEs' trade-distorting activities can not be easily reached.

Results in Brief

It is necessary to consider STEs on a case-by-case basis to understand their potential to distort trade. The three STES GAO reviewed—CWB, AWB, and NZDB—have varying capabilities to potentially distort trade in their respective commodities, although in each case these capabilities have generally been reduced over recent years due to lower levels of government assistance.

- CWB benefits from (1) the Canadian government's subsidies to cover CWB's periodic operational deficits; (2) monopoly over both the domestic human consumption and export wheat and barley markets, which may allow for cross-subsidization; and (3) pricing flexibility through delayed producer payments. Canada's elimination of transportation subsidies in 1995 has reduced some of the indirect government support going to Canadian wheat and barley producers, and ongoing Canadian reviews of the country's agricultural policies may reduce the control of CWB in the future.
- AWB has not received direct government subsidies in several years, but enjoys a government guarantee on its payments to producers. AWB also enjoys indirect subsidies in the form of favorable interest rates and an authority to collect additional funds from producers for investment. The deregulation of Australia's domestic grain trade and the decline of direct government assistance have lessened the possible trade-distorting policies of AWB. Recent studies have challenged the premise behind a single selling authority, but AWB's monopoly over wheat exports still provides it with a sure source of supply.
- NZDB is relatively subsidy free, but benefits from its monopoly over New Zealand dairy exports and its extensive subsidiary structure worldwide. NZDB's size and exclusive purchasing authority for export also translate into market power for NZDB in certain world dairy markets. Its subsidiaries allow it to keep profits from foreign sales within the organization and take advantage of the difference between world prices and those of the country in which it is selling the goods, such as the United States. NZDB's potential to distort trade due to direct government subsidies was eliminated during the 1980s when New Zealand deregulated the domestic dairy market and stopped offering dairy farmers direct government subsidies.

Principal Findings

Three Relationships Key to STE Ability to Distort Trade

GAO's framework for analyzing export STEs—reviewed by experts from the World Trade Organization, the U.S. Trade Representative (USTR), and other organizations—highlights three STE relationships—with domestic producers, governments, and foreign buyers—that are key to STEs' abilities to distort trade. STEs can have monopoly buying authority over all domestic production of a particular commodity, or the production of that commodity for export. This authority provides STEs with the ability to potentially distort trade through such practices as cross-subsidization. The STE relationship with the government involves the ways in which the government can directly or indirectly influence the STE financially. Government support, through direct or indirect subsidies, could provide an STE with an advantage over its commercial counterpart and has the potential to distort trade. The STE's relationship with a foreign buyer can also provide it with certain advantages, particularly when the STE is exporting to markets that are already distorted by import quotas. The establishment of an STE can also lead to a reduction in the number of exporters and an increase in the market power of the remaining participants.

GAO's framework provides some advantages in the collection, reporting, and interpretation of information on STE operations. First, it aids in the collection of a consistent and comprehensive set of information about the operations of these entities. Similarly, it facilitates reporting about STE characteristics, since the material can be described in an organized manner. Finally, the framework helps in the interpretation of the information about STES, since it aims at distinguishing between important characteristics and those that are less important.

Domestic Support and Monopoly Buying Authority May Provide CWB With Opportunity to Distort Trade

The CWB's relationship with the Canadian government, as well as its relationship with Canadian wheat and barley producers, provides CWB with opportunities to potentially distort trade. Since the establishment of CWB in 1935, the Canadian government has provided more than $1.2 billion (U.S.) to CWB to help it cover periodic wheat and barley pooling deficits. Canadian wheat producers also benefited from a government railway subsidy; this subsidy was eliminated in August 1995. CWB also receives indirect subsidies as a result of its STE status, such as a lower interest rate on commercial loans. Through its monopoly authority over Canadian wheat and barley sold for domestic human consumption or export, CWB has a limited ability to cross-subsidize its wheat exports and an even greater potential for cross-subsidizing Canadian barley exports between its domestic and export markets. Finally, the CWB's monopoly authority may provide it with greater pricing flexibility in its relationship with foreign buyers than is found among private sector traders.

U.S. Department of Agriculture (USDA) officials acknowledged that they did not have any evidence that CWB was violating existing trade agreements. However, trade differences between the United States and Canada have led to curbs on Canadian wheat imports into the United States and the establishment of a joint commission to look at all aspects of the two countries' respective marketing and support systems for grain. Canada's elimination of transportation subsidies to Canadian producers, its reviews of CWB operations and Canadian agriculture, and its ongoing discussions with the United States may reduce the CWB's potential to distort trade in the future.

AWB Enjoys Indirect Government Subsidies; Potential to Distort Trade Has Declined

AWB has limited potential to distort international wheat markets. The AWB's level of direct government assistance has diminished over its 57-year history, but indirect assistance measures still exist. AWB does not routinely receive direct subsidies from the Australian government, but its payments are underwritten by a government guarantee. Because of this guarantee, AWB receives favorable interest rates on its loans, according to Australian government officials and AWB itself. In recent years, the AWB's overall authority has been decreased through the government's removal of certain powers. For example, AWB no longer has a monopoly over wheat sales to the domestic market, so cross-subsidization between its domestic and foreign market sales is no longer economically feasible. However, the AWB's monopoly buying authority over wheat exports may provide some advantage over its private sector counterparts, as it has a sure source of supply and does not have to react to competition from other Australian exporters. Additionally, AWB has access to revenue from an industrywide mandatory levy on wheat, allowing it to diversify risk by investing in other projects. Studies have suggested that a single selling authority is inefficient and that the AWB's commercial orientation will have to be enhanced.

NZDB Cannot Use Government Subsidies to Distort Trade, but Size and Subsidiary Structure Provide Economic Advantages

The NZDB's ability to distort trade by using government funds is very limited since NZDB has not received direct subsidies from the New Zealand government since the mid-1980s. Nevertheless, NZDB still commands about 25 percent of world dairy trade and has established strong trade footholds in emerging Asian markets. The NZDB's statutory authority allows it to maintain a monopoly over dairy exports but does not permit it to maintain control over the domestic market; thus, NZDB can not subsidize its export sales from domestic sales. NZDB also does not have the authority to collect tariffs on imports of dairy products. Its size and monopoly purchasing authority allow it to benefit from economies of scale and a certain source of supply and provide market power for NZDB in certain world dairy markets. One of the NZDB's greatest economic advantages is its network of international subsidiaries, such as those in the United States. This network helps NZDB sell a greater amount of its goods at the best possible price in countries worldwide, especially those countries with markets that are restricted by quotas. As such, NZDB may reap greater profits from foreign price support systems and the lack of lower-priced imports in a particular country. Some U.S. dairy industry sources contend that the NZDB's ability to differentiate pricing in foreign markets provides an unfair advantage over competitors, but GAO had insufficient data to make a judgment on this potential practice.

Recommendations

GAO is not making recommendations in this report.

Agency and Country Comments

GAO received comments from the USTR and the USDA's Foreign Agricultural Service (FAS). USTR was generally pleased with the report and did not offer written comments. FAS, in its written comments, acknowledged that the report provided useful insights into state trading issues. However, FAS was concerned that GAO had not fully explored certain market power issues as they relate to STEs, such as a guaranteed product supply and pricing flexibility. Although GAO generally had addressed these issues in its draft report, it expanded the discussion to better reflect the importance of these issues in the final report.

GAO also discussed the factual content of the report as it related to the STE in the individual country with embassy representatives from Canada, Australia, and New Zealand. Their comments have been incorporated in the report where appropriate.

Contents

Abbreviations

AWB	Australian Wheat Board
CWB	Canadian Wheat Board
DPIE	Department of Primary Industries and Energy
EEP	Export Enhancement Program
ERS	Economic Research Service
EU	European Union
FAS	Foreign Agricultural Service
GATT	General Agreement on Tariffs and Trade
MAF	Ministry of Agriculture and Fisheries (New Zealand)
NAFTA	North American Free Trade Agreement
NZDB	New Zealand Dairy Board
OECD	Organization for Economic Cooperation and Development
PSE	Producer subsidy equivalent
STE	State trading enterprise
USDA	U.S. Department of Agriculture
WIF	Wheat Industry Fund
WTO	World Trade Organization
USTR	U.S. Trade Representative

Introduction

With the completion of the Uruguay Round of multilateral trade negotiations in 1994, member countries of the General Agreement on Tariffs and Trade (GATT) agreed to a variety of disciplines[1] for international trade in agricultural products. Nonetheless, according to GATT/World Trade Organization (WTO) and member country officials, state trading enterprises (STE) were not a major issue during the Uruguay Round.[2] Since the start of GATT, member countries have noted STEs' unique role and potential to distort world trade and have thus required them to operate in accordance with commercial considerations. STEs have been important players in the world agriculture market, particularly in wheat and dairy products. Since 1980, 16 GATT member countries[3] have reported to the GATT secretariat that they operate STEs in their wheat sector, while 14 countries have reported STEs in their dairy sector. With the volume of trade in agricultural goods expected to expand, understanding the role and operations of STEs is likely to be an important component in understanding the nature of international trade.

Uruguay Round Participants Committed to Liberalized Trade

The Final Act resulting from the GATT Uruguay Round negotiations was signed by more than 117 countries on April 15, 1994.[4] The intent of the Uruguay Round was to further open markets among GATT countries. Under the Uruguay Round agreement, member countries committed to reductions in tariffs worldwide by one-third; strengthened GATT through the creation of WTO[5] and a revised multilateral dispute settlement mechanism; improved disciplines over unfair trade practices; broadened GATT coverage by including areas of trade in services, intellectual property rights, and trade-related investment that previously were not covered; and provided increased coverage to the areas of agriculture, textiles and clothing, government procurement, and trade and the environment.

[1]"Disciplines" as used in this report refers to rules, commitments, and procedures contained in GATT and related agreements.

[2]STEs are generally considered to be governmental or nongovernmental enterprises that are authorized to engage in trade and are owned, sanctioned, or otherwise supported by the government.

[3]Participants in GATT were known as "contracting parties" until 1994 when WTO was established. In this report, however, we refer to contracting parties, as well as participants in WTO, as "member countries."

[4]The Uruguay Round was conducted from 1986 to 1994.

[5]The Uruguay Round created WTO as a formal organization encompassing all GATT disciplines to replace the provisional GATT organizational structure. As an organization, GATT officially ended on December 31, 1995.

STE Operations Monitored Under GATT

Since GATT was first drafted in 1947, STEs have been recognized as legitimate trading partners in world markets. However, the original drafters of GATT also understood how governments with a dual role as market regulator and market participant can engage in activities that protect domestic producers and place foreign producers at a disadvantage. A separate GATT article was established to monitor STEs and ensure they operate within GATT disciplines. Article XVII establishes a number of guidelines and requirements with respect to the activities of STEs and the obligations of member countries. In addition to holding STEs to the same disciplines as other trading entities, such as making purchases or sales in accordance with commercial considerations and allowing enterprises from other countries the opportunity to compete, the article requires periodic reporting by member countries to the GATT/WTO secretariat.[6]

In an August 1995 report,[7] we commented on the disciplines placed on STEs by both article XVII and other GATT provisions. Among other things, our report noted that GATT member countries' compliance with the article XVII reporting requirement between 1980 and 1994 had been poor. In addition, although state trading was not a major issue during the Uruguay Round negotiations, members established a definition of STEs and new measures to improve reporting compliance. Our report also highlighted the Uruguay Round's Agreement on Agriculture, which requires all countries trading in agricultural goods, including those with STEs, to observe new trade-liberalizing disciplines (the agreement is defined in the next section). Finally, our report emphasized that the effectiveness of article XVII is especially important given the potential for increases in STEs if countries such as the People's Republic of China (China), Russia, and Ukraine join GATT/WTO.

Attempts to understand the role of STEs are complicated by the various measures that STEs use to control either a country's production, imports, and/or exports. As we reported in August 1995, STEs' practices to control commodities have included placing levies on production and/or imports, requiring licenses for exports, giving government guarantees, and providing export subsidies. Some STEs have justified their controls by

[6]Information is provided to the GATT/WTO secretariat about STEs and their activities on the basis of a questionnaire adopted in 1960. These responses are called "notifications." The questionnaire asks GATT/WTO members to list their STEs, the products for which STEs are maintained, and the reasons for maintaining STEs. It also asks them to provide certain information about how their STEs function and statistics that indicate the extent of trade accounted for by STEs.

[7]State Trading Enterprises: Compliance With the General Agreement on Tariffs and Trade (GAO/GGD-95-208, Aug. 30, 1995).

emphasizing the needs for such things as protection against low-priced imports and safeguarding national security.

As a result of the Uruguay Round, GATT/WTO member countries have agreed to define STEs as[8]

> governmental and nongovernmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.

As we stated in our 1995 report, it is still too early to determine the impact of the STE definition and additional measures to improve the reporting compliance of member countries. These new measures include the creation of a working party to review STE notifications. Although some GATT/WTO member countries have stated that article XVII should require that STEs report more information, such as detailed data about transaction prices, other member countries consider this information to be confidential and related to an STE's commercial interests. The absence of this information is expected to hinder those member countries concerned about the role of STEs from obtaining the type of information they say is needed to fully determine whether STEs are adhering to GATT disciplines.

According to U.S. Department of Agriculture (USDA) officials, the working group on STEs has met twice since August 1995. Members of this working group are reviewing each others' notifications for completeness. Additionally, the United States has proposed improvements to the existing questionnaire on state trading and is seeking disciplines on STE activities through a working group on credit guarantee disciplines.

Agreement on Agriculture Applies to STEs

The Agreement on Agriculture, resulting from the Uruguay Round, requires member countries to make specific reductions in three areas—market access restrictions, export subsidies, and internal support—over a 6-year period beginning in 1995.[9] Under the market access commitment, countries are required to convert all nontariff barriers, such as quotas, to tariff equivalents and reduce the resulting tariff equivalents (as well as old tariffs) during the implementation period. Under the export

[8]This definition is found in the Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994. The complete text of this understanding was provided in appendix III of GAO/GGD-95-208.

[9]Developing countries have 10 years to comply with the reductions.

subsidy commitment, countries are required to reduce their budgetary expenditures on export subsidies and their quantity of subsidized exports. Member countries are also expected to reduce their aggregate measure of selected internal support policies. These internal support policies include budgetary expenditures and revenue forgone by governments or their agents. These reductions are expected to have the effect of liberalizing trade in agricultural products, thereby increasing the flow of these products between GATT/WTO member countries. STEs are subject to these reductions.

The United States is expected to experience economic benefits as a result of the new trade discipline in agriculture. As we reported in 1994,[10] USDA estimated that as a result of the Uruguay Round, U.S. annual agricultural exports are likely to increase between $1.6 billion and $4.7 billion by 2000, and between $4.7 billion and $8.7 billion by 2005. Higher world income, as well as reduced tariffs and export subsidies among U.S. trade partners, is also expected to raise U.S. exports of coarse grains, cotton, dairy, meat, oilseeds and oilseed products, rice, specialty crops such as fruits and nuts, and wheat.[11]U.S. subsidies on some agricultural products will also be reduced, most likely shrinking government support for dairy, coarse grains, meat, oilseed products, and wheat.

Nonetheless, even with projected gains for U.S. agriculture, some U.S. producers are concerned that countries with STEs have not taken the same steps to reduce trade-distorting activities. For example, the United States developed its agricultural export subsidies to counteract those of other countries, such as members of the European Union (EU).[12] These export subsidies were subsequently used to counteract STE practices as well. U.S. producers are now concerned that under the Uruguay Round the United States has committed to reduce those subsidies without a corresponding reduction in other countries' state trading activities.[13]

[10]The General Agreement on Tariffs and Trade: Uruguay Round Final Act Should Produce Overall U.S. Economic Gains, Volume 2 (GAO/GGD-94-83b, July 29, 1994).

[11]The same GAO report also cited an International Trade Commission report, Potential Impact on the U.S. Economy and Industries of the GATT Uruguay Round Agreements, that projected modest gains (5 percent to 15 percent) in U.S. exports of fruits and vegetables, grains, and tobacco and tobacco products, and sizable gains (over 15 percent) in U.S exports of dairy products and beverages.

[12]The EU prior to January 1, 1995, was comprised of Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom. Austria, Finland, and Sweden became members of the EU on January 1, 1995.

[13]In addition, a particular activity can potentially distort trade without being defined as an unfair trading practice under GATT. For example, government assistance for disadvantaged regions can be allowed by GATT under certain conditions. This government assistance might allow certain firms to continue to operate that would not survive in a normal competitive environment.

STEs Most Prevalent in Grain and Dairy Sectors

The majority of STEs reported to the GATT secretariat between 1980 and 1995 involved trade in agricultural products. Although the reporting represented only a portion of GATT member countries, the largest number of STEs were found to be trading in either grains and cereals or dairy products. As shown in table 1.1, 16 member countries have reported state trading in their grain and cereals sector, while 14 have reported state trading in their dairy sector.

Table 1.1: GATT Member Countries Reporting STEs in Grain or Dairy Sector, 1980-95

Country	STE in grain and cereal sector?	STE in dairy sector?	Last notification
Australia	Yes	Yes	1995
Canada	Yes	Yes	1995
Cyprus	Yes	Yes	1995
Czech Republic	Yes	Yes	1994
Finland	Yes	No	1993
India	Yes	Yes	1992
Indonesia	Yes	No	1995
Israel	Yes	No	1981
Japan	Yes	Yes	1995
New Zealand	No	Yes	1995
Norway	Yes	No	1995
Poland	Yes	Yes	1995
Slovak Republic	Yes	Yes	1995
South Africa	Yes	Yes	1994
Spain	Yes	Yes	1984
Switzerland	No	Yes	1994
Turkey	Yes	No	1995
United Kingdom	No	Yes	1993
United States[a]	Yes	Yes	1995

[a]In its 1995 notification to GATT/WTO, the United States reported the Commodity Credit Corporation as an STE. According to the notification, the Corporation is a government-owned and -operated entity within USDA, created to stabilize, support, and protect farm income and prices. The Corporation also aims to help maintain balanced and adequate supplies of agricultural commodities and to assist in their orderly distribution, including wheat and dairy commodities.

Source: Article XVII notifications submitted to GATT/WTO secretariat.

United States and Other Countries Subsidize Wheat and Milk Production

Countries support their agricultural producers through both direct and indirect assistance. One way of measuring the flow of direct and indirect government assistance to producers is by using the "producer subsidy equivalent" (PSE). The Organization for Economic Cooperation and Development (OECD) uses PSEs to compare levels of assistance among countries. PSE is an internationally recognized measure of government assistance. It represents the value of the monetary transfers to agricultural production from consumers of agricultural products and from taxpayers resulting from a given set of agricultural policies in a given year. A relatively high PSE means that the government provides a larger amount of production assistance than do governments in countries with a lower PSE.

Table 1.2 presents the PSEs for wheat in Australia, Canada, the EU, and the United States from 1979 to 1994. Table 1.3 presents the PSEs for milk in Australia, the EU, New Zealand, and the United States during the same period. As indicated in both tables, in recent years both the EU and the United States have subsidized their wheat and milk production to a greater extent than Australia, Canada, or New Zealand.

Table 1.2: PSE Rates for Wheat, 1979-94 (as a percent of production)

Country	1979-81	1986-88	1989-91	1992	1993[a]	1994[a]
Australia	7	11	8	7	7	10
Canada	14	52	46	35	28	20
European Community[b]	33	56	45	47	56	57
United States	14	54	42	37	45	42

Note: Percentage PSE represents the total value of transfers as a percentage of the total value of production (valued at domestic prices), adjusted to include direct payments and to exclude levies.

[a]Figures for 1993 and 1994 are estimates.

[b]Now the EU.

Source: Agricultural Policies, Markets and Trade in OECD Countries: Monitoring and Outlook 1995, OECD (Paris: 1995).

Table 1.3: PSE Rates for Milk, 1979-94 (as a percentage of production)

Country	1979-81	1986-88	1989-91	1992	1993[a]	1994[a]
Australia	24	30	30	32	25	30
European Community[b]	53	64	63	65	62	63
New Zealand	20	11	2	2	2	2
United States	55	64	57	54	55	54

Note: Percentage PSE represents the total value of transfers as a percentage of the total value of production (valued at domestic prices), adjusted to include direct payments and to exclude levies.

[a]Figures for 1993 and 1994 are estimates.

[b]Now the EU.

Source: Agricultural Policies, Markets and Trade in OECD Countries.

Objectives, Scope, and Methodology

Members of Congress' concerns about STEs, further informed by reports of the USDA's Foreign Agricultural Service (FAS) and the International Trade Commission that highlight the operations and trading practices of STEs operating in the world dairy and wheat markets, have led to the issuance of three GAO reports on the subject of STEs.[14] We have already published reports on state trading, including (1) a July 1995 report that provides a summary of trade remedy laws available to investigate and respond to activities of entities trading with the United States, including STEs;[15] (2) a report on the GATT/WTO disciplines that apply to STEs and the effectiveness of those disciplines to date;[16] and (3) a correspondence report describing the impact of the Uruguay Round on U.S. cheese quotas and importer licensing process, as well as the operations of the New Zealand Dairy Board (NZDB) in the United States.[17]

Eighteen Members of the House of Representatives and the Senate have also asked us to provide more information on how STEs operate in an open, competitive marketplace. Members noted the role of state trading in the wheat and dairy sectors, saying that any trade problems in these sectors could be representative of potential problems that may affect U.S. producers, processors, exporters, and importers. We were asked to

[14]In August 1995, we also briefed the congressional requesters on the status of our work.

[15]GAO/OGC-95-24, July 28, 1995.

[16]State Trading Enterprises: Compliance With the General Agreement on Tariffs and Trade (GAO/GGD-95-208, Aug. 30, 1995).

[17]Cheese Imports (GAO/RCED-95-280R, Sept. 29, 1995).

describe (1) the potential capability of export-oriented agricultural STEs to distort trade and (2) the specific potential of the Canadian Wheat Board (CWB), the Australian Wheat Board (AWB), and NZDB to engage in trade-distorting activities, based on their status as STEs. We agreed to review the three export STEs based upon their considerable role in international trade and not due to any assumption of trade distortion.

To create a framework for understanding export STEs,[18] we reviewed various trade practices and trade agreements; reviewed related literature; interviewed U.S., GATT/WTO member country and GATT/WTO secretariat officials; and utilized information from STE and national government officials in Canada, Australia, and New Zealand. Our purpose in establishing a framework was to (1) facilitate data collection in the three countries, (2) allow for various STE characteristics to be reported in a consistent and organized manner, and (3) determine the relevant relationships maintained by STEs and thereby come to some conclusion about whether or not an STE is able to distort international trade. We used the framework as a tool to try to partially overcome the transparency (openness) problem found in international trade in both the dairy and wheat sectors. The absence of transaction-level data, protected as commercial practice by both STE and private sector traders, necessitated another way of evaluating STEs' influence on the market. However, foreign countries' STEs and private firms are under no obligation to provide these data, since we have no audit authority over them. Even with this information, such an extensive analysis would require additional data regarding production costs. As such, definitive conclusions regarding STEs' trade-distorting activities cannot be reached, given the complexity of the overall task. The framework underwent a peer review by economists at WTO, USDA's FAS and Economic Research Service (ERS), the Congressional Research Service, and a private sector agricultural organization. We made changes in the framework where appropriate.

To obtain information about STE operations in Canada, we interviewed officials from CWB, Agriculture Canada, the Canadian Grain Commission, the Canadian International Grains Institute, the Department of Foreign Affairs and International Trade, private sector grain traders, and provincial grain associations. In Australia, we interviewed officials with AWB, the Department of Primary Industries and Energy (DPIE), the Department of Foreign Affairs and Trade, the Grains Council of Australia, and the

[18]Export STEs include those STEs where the primary role of the enterprise is to sell a particular commodity in a foreign market. Import STEs' primary role is to control and market foreign goods coming into the host country. Our framework is specific to export STEs since CWB, AWB, and NZDB are export STEs. The concerns regarding import STEs are different than those of export STEs.

Industry Commission. To obtain information about the operations of NZDB, we interviewed officials from NZDB, the Ministry of Agriculture and Fisheries (MAF), the Ministry of Foreign Affairs and Trade, the Federated Farmers of New Zealand. We also spoke with or reviewed materials from assorted industry and academic groups.

In the United States, we interviewed officials at the Office of the U.S. Trade Representative (USTR) and USDA's FAS. We met with Canadian, Australian, and New Zealand embassy representatives located in Washington, D.C. We also conducted interviews with officials representing both U.S. dairy and wheat interests. In the case of the wheat industry, we spoke to officials from U.S. wheat, miller, and grain trading associations. We also reviewed background documents and reports on wheat and dairy trade provided by the officials mentioned previously, as well as reports from other government, industry, and academic organizations. Information on foreign law in this report does not reflect our independent legal analysis but is based on interviews and secondary sources.

We did our review from April 1995 to October 1995 in accordance with generally accepted government auditing standards.

We requested comments on a draft of this report from the USTR and the Secretary of Agriculture or their designees. On March 26, 1996, we received oral comments from USTR. The agency was generally pleased with the report and declined to offer written comments. On May 2, 1996, the FAS Administrator provided us with written comments on the draft. In general, FAS agreed with the conclusions in our report. FAS was concerned that we had not fully explored certain market power issues as they relate to STEs, such as a guaranteed product supply and pricing flexibility. Although we generally addressed these issues in our draft report, we have expanded the discussion to better reflect the importance of the market power of these issues. Additionally, specific comments regarding clarifying language or updated information have been incorporated as appropriate.

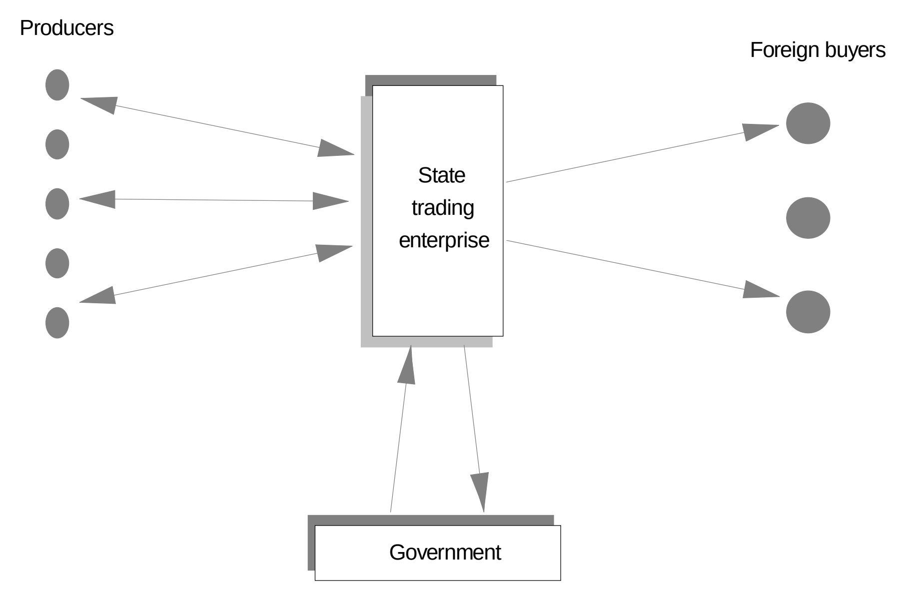
We also discussed the factual content of the report as it relates to the STE in their individual country with embassy representatives from Canada, Australia, and New Zealand. Their comments have been incorporated in the report where appropriate.

A Framework for Congressional Reference and Review of Export STEs

Various types of STEs operate in the world market, with differences in aspects such as an export or import STE, the types of industries, the size of the operations, and the level of government involvement. This diversity makes it hard to generalize about the effects of STE operations on particular markets or on the world trading system. This is true even among CWB, AWB, and NZDB, which are the subject of this report. As a result, it is necessary to consider STEs on a case-by-case basis to understand their potential effects. We developed our framework for reference to incorporate information from a variety of sources that we believe should be considered in an analysis of the potential effects of individual export STEs.[1] In subsequent chapters, we use this framework in reviewing three specific export STEs.

Using this framework, we divided the relationships of export STEs into three groups: the relationship of the STE to domestic producers, the relationship of the STE to the government, and the relationship of the STE to foreign buyers. (See fig. 2.1)

Figure 2.1: Illustration of Key Relationships of Export STEs



[1]We recognize the importance of import STEs in world markets. However, the focus of this report is on export STEs.

Using such a framework provided advantages in the collection, reporting, and interpretation of information on STE operations. First, it should aid in the collection of a consistent and comprehensive set of information about the operations of these entities. Similarly, it facilitated reporting about STE characteristics since the material can be described in an organized manner. Finally, the framework helped in the interpretation of the information about STEs since it distinguished between important characteristics and those that are less important. In each of the relationships, we considered the advantages and disadvantages the STE might have in relation to its private sector counterparts. In particular, we highlighted those characteristics that might provide a unique advantage in international markets, especially those that have the potential to distort trade.[2] We also included material on a number of practices that are common to both private firms and STEs, even if they are not trade distorting. Some of these practices have been the cause of concern among industry observers.

We developed this framework based on our own expertise in reviewing various trade practices and trade agreements, our review of related literature, and our discussions with STEs and officials with national governments and international organizations that deal with STE issues. We circulated a draft of this framework among agency officials and solicited their comments. The discussion of the framework in this chapter draws upon examples from CWB, AWB, and NZDB. Chapters 3, 4, and 5 provide more detailed descriptions of those boards using the framework set forth in this chapter.

STE Relationship With Domestic Producers

One of the relationships that is central to the discussion of export STEs is the relationship between the STE and the domestic producers. Two aspects of this relationship are important: (1) the ownership and management of the STE by the domestic producers and (2) the requirement that domestic producers sell to the STE.

Producers Can Play Management and Ownership Roles in STEs

The ownership and management structure can vary significantly across STEs: these characteristics may provide insights into the goals of the enterprises. For example, STEs can be owned and managed entirely by producers, where all of the returns from the sales are given back to the producers in the form of profits. In these cases, we might expect the

[2]Trade distortion can occur when a country's policies change production and consumption decisions from what they would be if they faced an open international market.

organization to try to maximize its own returns by selling at the highest prices possible. The stated objectives of the three STEs we assessed suggest that they are all producer oriented (see app. I for the three STEs' objectives and other information). In each case, these enterprises seem to be operated on behalf of farmers. For example, the CWB annual report for 1993-94 states: "The CWB focuses on maximizing performance for prairie farmers,"[3] while the AWB literature says that its mission is to "maximize long-term returns to Australian grain growers."[4]

Alternatively, if the STE is owned or managed by some group other than the producers, it is possible that it might have a different goal, such as maximizing domestic political benefits. In these cases, the STE might choose to sell the commodity at prices that are advantageous to certain domestic groups. In this situation, the STE might be able to use its monopoly authority to lower the returns to producers. This would allow the STE to sell at a lower price in either the domestic or the international market. However, if the STE is successful in lowering returns to producers, this will make those sales less attractive, eventually drive marginal producers from the market, and decrease supply.

The management of the STE could also make other changes in the terms, such as pooling the returns of producers. For example, the STE may choose to pay the producers the same return regardless of the time of delivery during the marketing year.[5] For example, CWB describes price pooling efforts as "something which smooths out the seasonal fluctuations in prices and reflects the values that are achieved over the course of a marketing year." This might make it easier for some producers to secure commercial financing by reducing the volatility of the returns to producers. However, these practices may also have disadvantages, since this feature would remove some of the incentive for the individual producers to try to be responsive to world markets.

Extent of STE Control Over Producers' Sales Can Vary

One of the central elements of an export STE is the relationship of the STE to the domestic producers. As part of their status as government-related entities, STEs often have some control over the sales of particular commodities. However, the extent of this control can vary. In some cases,

[3]Canadian Wheat Board 1993-1994 Annual Report, inside front cover (Winnipeg, Manitoba, Canada: 1995).

[4]Australian Wheat Board 1992-1993 Annual Report, inside front cover (Melbourne, Victoria, Australia: 1994).

[5]A private exporter would not be able to make this arrangement since the producers could treat this as a guarantee and sell to that exporter only if they were unable to sell at a better price somewhere else.

the STE may have exclusive rights to acquire a commodity destined for export from producers in designated regions, as in the case of CWB, or from the nation, as in the case of NZDB. Under this authority, NZDB typically handles the export transactions, and sometimes licenses private firms to do the exporting. This type of authority might provide certain advantages in terms of size over individual producers or groups of producers who attempt to export on their own behalf.

Exclusive purchasing authority can provide the STE with a more secure source of supply than would be the case for a private exporter. Depending upon the size of the domestic market and the extent of the purchasing authority, an STE can count on a certain level of supply for its export sales. This may increase its willingness to enter into long-term supply relationships. However, the success of the STE over a period of years depends more upon its ability to charge high prices and generate high returns for producers. These high returns keep the marginal suppliers in business and induce others to increase their production for the STE. These pressures are similar to those facing private exporters.

A somewhat different situation exists when the STE has exclusive authority to purchase all production of a particular commodity, whether destined for domestic or export markets. Although none of the three enterprises we reviewed has control over all exports and all domestic sales, CWB does have control over all wheat and barley sales for human consumption from the western provinces. This additional authority over domestic sales could provide the STE with the ability to charge different prices in the domestic and export market. For example, if the STE's goal were to increase consumption in the domestic market, it could charge higher prices abroad in order to subsidize the domestic price. On the other hand, if the STE's goal were to maximize exports, it might charge higher prices to domestic consumers and use the profits to lower the export price. When the export prices are below the cost of production, these actions are referred to as "cross-subsidization," and are potentially trade distorting.

Two factors are important in considering the ability of an STE to engage in this type of cross-subsidy. One is the openness of the STE's domestic market to imports. If the domestic market is open to shipments from abroad, the ability of the STE to raise the domestic price would be limited by the availability of imports from the world market. On the other hand, if the market is closed to imports, this would create at least the potential for the STE to raise prices above the level of the world price. For example, AWB must compete with both domestic wheat sellers and foreign wheat sellers for a share of the Australian domestic wheat market. As a result, an STE with both domestic market and export authority that operates from a closed market has more potential for trade distortion than an STE with only two of those factors. None of the STEs that we reviewed has all these capabilities.

Finally, the extent to which this type of cross-subsidization is possible depends in part upon the relative size of the domestic and the export markets. For example, the fact that CWB exports more than 85 percent of the wheat under its control limits its ability to cross-subsidize. Domestic prices would have to be raised significantly in order to collect enough funds to lower the export price in any meaningful way.

Government Can Provide Financial Advantages to the STE

Certain types of relationships between the STE and the government could provide financial benefits to the STE that would not be available to private firms. For example, direct subsidies could provide advantages for the STE over its competitors in the international market. Other government actions may also provide benefits for the STE, but these may or may not be related to the fact that the exporter in a particular industry happens to be organized as an STE.

Direct Subsidies Could Enable the STE to Lower Prices

The most obvious type of advantage a government can provide is direct subsidies paid out from general revenues to STEs. These funds could be used to reduce the prices of exports to gain an advantage in the international market. If these subsidies are used in an isolated case, they could have the effect of protecting the producers from unusually low prices. For example, the Canadian government provided financial assistance in the 1990-91 marketing year to CWB during a year when market prices were low, thus diminishing the impact of the low prices on producers. If these subsidies were provided on a regular basis, the higher returns to subsidized producers would likely lead to an increase in the supply of the commodity and reduce the sales and profits of other producers in the world market. These kinds of changes are generally considered trade distorting in the international markets.

There are other ways in which a government could provide financial assistance to the STE. For example, a special tax advantage for an STE could reduce the amount of taxes for an STE or its domestic suppliers. Alternatively, if the STE is allocated tariff revenues on imports of the commodities, these revenues could be used to lower the price of its exports. In each of these cases, the potential exists for government assistance to be used to lower the prices of the STE to increase sales without lowering the prices received by producers. These actions have the potential to distort trade.

Indirect Subsidies May Also Provide Benefits to an STE

In addition, there are a number of ways in which a government might provide indirect advantages to an STE. One of these indirect benefits is the interest rate advantage that might accrue to those firms that are associated with the government. Because the perceived risk of lending to governments is usually lower than the risk of lending to private entities, the costs of borrowing money are typically lower for governments than for private organizations. Because of their association with the government, STEs might thus have a lower cost of borrowing than a private organization with the same characteristics.

The extent of this advantage would be difficult to estimate but would depend upon the amount of borrowing and the difference between the borrowing rate of the STE and the rate of a private entity with similar characteristics but without the government association. In cases where the government has actually stepped in to provide funds when the STE was in danger of default, the difference would tend to be the highest. On the other hand, in situations where the government has not provided funds since the inception of the STE, the difference would tend to be the lowest.

There are other situations in which the STE may not pay the full cost of services provided. One example is a transportation subsidy where the stated cost of transporting commodities has been held significantly below the true cost, although these subsidies may or may not be related to the STE. For example, in the case of a transportation subsidy, it could be that the STE happens to be operating in an industry where this type of subsidy exists. While the STE might benefit from the subsidy, the potential for trade distortion comes from the indirect subsidy itself, whether it is a transportation subsidy or some other type of subsidy.

STE Relationship to Foreign Buyers Depends Upon Other Factors

It is also useful to examine the relationship between the STE and the foreign buyers to determine whether there is any unique advantage to operating as an STE in foreign markets. For example, as single sellers from export markets, STEs may have certain advantages in terms of spreading costs and achieving unity among producers. Some of these STE characteristics appear to be especially important in selling to foreign markets restricted by import quotas. In other situations, however, STEs appear to rely chiefly on practices that are also available to commercial exporters.

STE as Single Seller May Provide Certain Advantages

An STE might provide certain advantages in terms of size and experience over individual producers acting on their own behalf. The costs of operating an office with specialized expertise in exports is likely to be considerable, and the larger scale of operations of an STE might enable these costs to be spread over a much greater volume of sales. NZDB officials noted that individual farmers or cooperatives would have a difficult time marketing dairy products on their own; thus, NZDB provides a mechanism through which the New Zealand dairy farmer can compete in a global marketplace. Multinational firms may not have the captive source of supply, but can achieve economies of scale through efficient operations and establishing relationships with producers in various countries and in various commodities.

The establishment of an STE can also lead to a reduction in the number of exporters and an increase in the market power of the remaining participants. This might allow the STE to be more effective in certain situations in acting as a cartel to maintain higher prices than a collection of private firms. The distinction between the STE and the producers who sell to an exporter or participate in a cooperative is that the STE can prevent its producers from selling at a discount. Private firms and cooperatives would generally rely on voluntary cooperation and would therefore have the ability to offer discounts from the prices set by the cooperative.[6] To the extent that STEs can extend their control over supply through collusion with other exporters, their ability to influence the market would increase. However, the exercise of market power over more than one year depends on the response of other suppliers to those higher prices. If those higher prices result in greater production by other nations, the STE may face additional competition in the market in the following years.

STEs May Have an Advantage in Controlled Import Markets

There are other ways in which STEs might have an advantage in exporting to controlled import markets. One reason is that the importing nation may be more responsive to export promotion efforts when they are government affiliated, such as an STE. STEs with control over the exports of

[6]To the extent that cartels are successful in raising prices, they create an incentive for members to cheat by lowering the price slightly below the cartel price. They also create an incentive for other producers to stay outside the cartel but take advantage of the higher prices.

a commodity may also have an advantage in selling into a market that is protected by a quota. In this case, the STE is better able to capture the full difference between the lower world price and the higher price in the protected market through the establishment of a subsidiary in the importing nation. For example, NZDB has set up a wholly owned subsidiary for importing quota cheese products into the United States. As a sole exporter selling to a subsidiary in the protected market, NZDB has been able to capture more of the return than would have been possible in selling to an independent agent.[7]

STEs May Use Commercial Practices in Dealing With Foreign Buyers

There may also be differences in the way that STEs deal with foreign buyers. However, our ability to analyze sales practices is somewhat limited by the lack of transaction-level price information for either STEs or private firms. Recognizing this limitation, nevertheless it is useful to identify certain practices of firms and STEs in international markets and ask whether the status of the STE offers any particular advantages.

Price discrimination is the practice of distinguishing between buyers of a particular good or service in order to charge a higher price to some buyers and a lower price to others. With the right combination of market characteristics, some sellers may be able to increase their profits because the lower-priced sales do not affect their sales to premium customers. STEs may be able to lower the price to certain importing countries without affecting the prices to its other customers. However, the important part of price discrimination is to be able to charge a higher price to premium customers. If there are other sellers willing to sell at a known world price, as there are in many commodity markets, it is not obvious why any buyer would ever be willing to pay a higher price to the STE. As a result, the success of the price discrimination would depend upon the existence of other producers willing to sell at the world price, rather than the fact that one seller happens to be an STE.

One particular type of price discrimination is "predatory pricing," where a seller or group of sellers lowers prices for the purpose of driving other sellers from a market by using higher prices from one market to lower prices in a second market. If successful, the remaining seller(s) can raise prices once the competition has been eliminated. However, we did not examine data to determine whether STEs practice predatory pricing, or how STEs might provide any unique advantage in this area. Successful predatory pricing would depend upon the existence of barriers to entry in

[7]This situation is described in more detail in GAO/RCED-95-280R.

the agricultural commodity markets, which would prevent new competitors from taking the place of those eliminated from the market. Predatory pricing implies a certain size in relation to the available market. In these cases, the important issue is whether the STE or the multinational firms have that type of market power.

STEs might use other practices such as engaging in long-term supply arrangements or emphasizing quality to differentiate its products and services from those of other sellers. For example, STEs might be able to set some uniform grading standards for the producers; in fact, AWB sets standards for its wheat for export and further classifies the wheat based on quality and variety. Similarly, CWB has emphasized the high quality of the grain as a marketing strategy, but in some cases may have provided a higher quality than the customer required, potentially reducing the returns to the Canadian farmers. The success of these efforts in raising returns to producers would depend upon whether the STE is more responsive to the demands of world markets than a private firm. In these cases, it is useful to ask whether the practices are somehow unique to STEs or could be equally—or perhaps more effectively—practiced by any seller in the market. The actions of CWB in using private firms to export commodities rather than export the commodities itself may be evidence that the private sector is more effective at some of these commercial practices.[8]

[8]In our previous work on government sponsored enterprises (Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990)), we found that association with the government usually has the effect of reducing the responsiveness of the enterprise to the market.

Monopoly Authority and Government Support May Allow CWB to Potentially Distort Trade

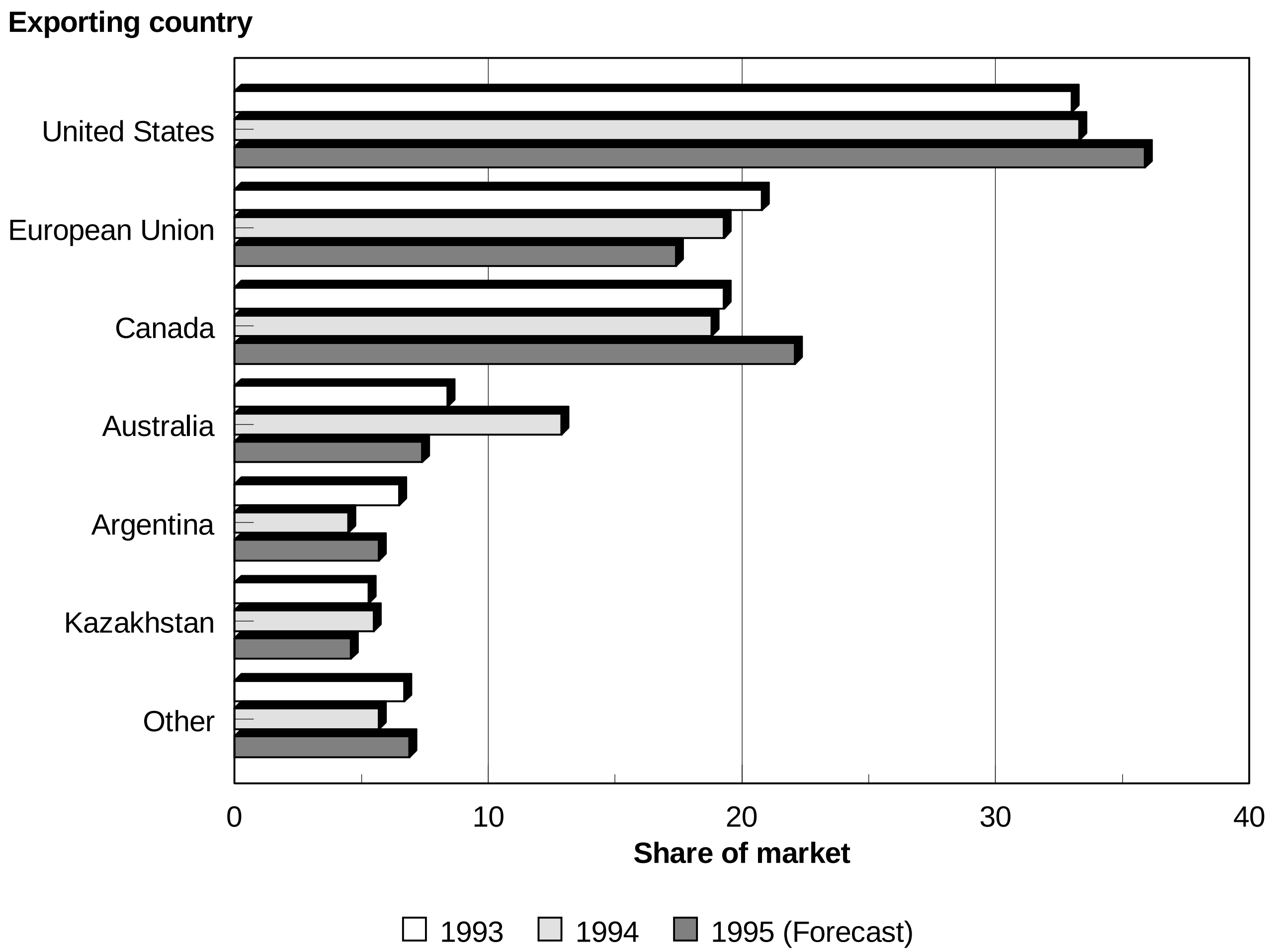
By volume, CWB is the world's largest grain-marketing board. As an STE, CWB has certain factors that provide it with the potential to distort international trade in wheat and barley. The CWB's control over both domestic human consumption and exports of wheat creates the potential for cross-subsidization, though the risk of such practices is reduced by Canada's dependence on the export market. However, CWB could potentially cross-subsidize between the domestic and foreign markets in its barley trade. Canadian government payments to CWB to cover the CWB's periodic wheat and barley pool deficits have at times represented a significant subsidy. Finally, the margin between initial payments and final payments to the Canadian producers allows for greater flexibility in pricing than is the case with private sector grain traders. Nonetheless, some changes in subsidies and CWB control, as well as ongoing reviews of the CWB's monopoly status, may have the effect of reducing the CWB's ability to potentially distort trade. In addition, a joint commission established by the United States and Canada has made suggestions for restructuring both U.S. and Canadian trade practices.

Background

CWB operates as a government-backed, centralized marketer of wheat and barley.[1] It remains the world's largest grain-marketing board and Canada's single largest net exporter. According to USDA figures, Canada's 19-percent share of world exports of wheat and wheat products in 1994 was expected to increase to 22 percent in 1995. Figure 3.1 shows the six largest wheat-exporting nations over the last 3 years.

[1]According to the CWB's 1993-94 annual report, the three "pillars" of CWB marketing are the (1) single-desk selling—monopoly power over wheat and barley for export and domestic human consumption, (2) price pooling—combining farmer produce to manage risk, and (3) partnership of farmers and government. These three "pillars" are consistent with the relationships we developed in chapter 2.

Figure 3.1: Share of World Exports of Wheat and Wheat Products by Country, 1993-95



Note: "Other" not specified in source.

Source: USDA/FAS.

In the previous 6 crop years, Canadian exports have averaged about 75 percent of total wheat production, making wheat growers dependent on export sales. Canadian barley growers are less dependent on foreign markets. Exports of barley over the past 6 years have averaged about 32 percent of Canada's total barley production (see table 3.1).

Table 3.1: Disposition of Canadian Wheat and Barley, 1988-94 Crop Years

Sales in percent

	Crop year						
Commodity and use	**1988-89**	**1989-90**	**1990-91**	**1991-92**	**1992-93**	**1993-94**	**1994-95**
Wheat (excluding durum wheat)							
Domestic use	35.5	26.3	22.2	21.0	25.8	33.5	28.6
Exports	64.5	73.7	77.8	79.0	74.2	66.5	71.4
Durum wheat							
Domestic use	24.3	21.4	19.0	21.7	30.7	22.7	17.0
Exports	75.7	78.6	81.0	78.3	69.3	77.3	83.0
Barley							
Domestic use	74.9	64.1	62.5	68.4	71.0	66.8	73.5
Exports	25.1	35.9	37.5	31.6	29.0	33.2	26.5

Note: Crop years are from August to July.

Source: CWB.

The first attempt to organize the Canadian prairie farmers began with the Manitoba Grain Act of 1900. This act provided farmers with the right to ship their own grain and to load from their own wagons or warehouses, rather than having to sell to the grain elevators. The first cooperatives were soon to follow in 1906, with the first Wheat Board established in 1919. Although the Wheat Board lasted for only one year's crop, it incorporated the concepts of initial and final payments, pricing to maximize producer (pool) return, and centralized marketing.

Prairie provincial wheat pools were successfully formed in 1924, but went into temporary receivership after the stock market crash of 1929. Following the financial hardship faced by farmers during the Depression, the government of Canada passed the Canadian Wheat Board Act of 1935 establishing CWB. CWB was also given control of marketing oats and barley, although oats have since been removed from the CWB's control.[2]

CWB is administered by three to five commissioners, who are appointed by the government of Canada. A producers' advisory committee, composed of 11 farmer-elected representatives from the prairie provinces, provides CWB

[2]Oats were removed from the CWB's control on August 1, 1989.

with producer advice on matters related to its operation. As of July 1994, CWB employed 464 permanent employees and 58 temporary employees.

The Canadian government has limited oversight of CWB operations. Officials from Canada's Department of Foreign Affairs and International Trade told us that the Canadian government takes a "hands-off" approach to CWB. The CWB's day-to-day operations are free from government monitoring and supervision. The CWB's only formal reporting requirement to the government of Canada is an annual report to the Parliament under the authority of the Minister of Agriculture.

CWB-Producer Relationship: CWB Monopoly Authority Increases the CWB's Ability to Potentially Distort Trade

Western Canadian farmers are required to pool their wheat and barley production for domestic human consumption and export under CWB, which then markets this commodity in both the domestic and foreign markets. The CWB's control of domestic sales for human consumption sales and monopoly over export sales of wheat and barley provide it with the potential ability to charge a higher domestic price for these commodities and use these proceeds to lower export prices, particularly in the case of barley exports. Though pooling diminishes the uncertainty involved in marketing their product, pooling may also lower the returns to some Canadian producers. The limited transparency of CWB operations reduces the ability of Canadian farmers to determine the success of the CWB's services. Some Canadian farmers have questioned the CWB's role and are requesting the chance to market their wheat and barley outside the CWB system.

CWB Given Partial Monopoly Authority Over Canadian Wheat and Barley

The CWB's 1993-94 annual report states that "the CWB's monopoly is its single greatest asset" and concludes that "the economic benefits that accrue to Prairie farmers from this marketing strength would be greatly diminished were the CWB to operate in tandem with a private system." CWB has the sole authority to market for export and for domestic human consumption wheat and barley grown in the western prairie provinces of Manitoba, Saskatchewan, Alberta, and British Columbia. The small quantities of wheat and barley grown outside of this area are not handled by CWB. In addition, feed wheat and feed barley grown throughout Canada can be sold by the producer domestically.

CWB controls all exports of wheat and barley products through an export licensing process. Even producers who do not operate under CWB, such as producers with the Ontario Wheat Producers' Marketing Board, are still required to obtain an export license from CWB. Canadian producers can buy back their own grain in order to export it themselves, but they have to purchase it back at the price that CWB sets.[3] CWB also allows accredited exporters, both Canadian and foreign grain companies, to buy grain from CWB and sell it on their own.[4]

Until recently, CWB also controlled imports of wheat into Canada.[5] On August 1, 1995, Canada replaced the CWB's wheat import-licensing procedure with a tariff-rate quota.[6] The change from licenses to a tariff-rate quota was part of the alterations agreed to under the Uruguay Round. Canada's Department of Foreign Affairs and International Trade administers the new system.[7] Canada's barley import-licensing procedure, already administered by the federal government, was also replaced with a tariff-rate quota. Canada has established industry advisory committees for each commodity subject to a tariff-rate quota. The advisory committees are open to national industry representatives, producers, and consumers. CWB and others participated in the wheat advisory committee meeting held before implementation of the tariff-rate quotas on August 1, 1995.

Wheat Price Distortions Unlikely, but Barley Price Distortions Are Still Possible

As the sole marketing agent for western prairie wheat and barley destined for domestic human consumption or export trade, CWB has the ability to offer differentiated prices. Under the framework discussed in chapter 2, an STE with both domestic and export authority might charge higher prices to domestic consumers and use the profits to lower the export price. The market-distorting potential of CWB in domestic and export sales depends on whether CWB is selling wheat or barley. In the case of wheat, Canada's small domestic consumption of wheat compared to its large export sales limits the CWB's ability to cross-subsidize between these two markets: charging a higher domestic price would generate limited profits and

[3]For example, CWB established a program that provides daily price quotes based on the Minneapolis futures and cash markets for Canadian farmers wishing to buy back their grain from CWB and market it directly to the United States.

[4]According to CWB officials, accredited exporters handle 20 to 25 percent of export sales. In addition, accredited exporters are used on 100 percent of the sales to the United States.

[5]Canada removed the import-licensing requirement for U.S. wheat and wheat products entering Canada in May 1991.

[6]Under a tariff-rate quota, a limited level of imports is permitted at a low tariff rate; any imports beyond that level are assessed a tariff at a higher rate. Both the U.S. and Mexican wheat exports to Canada are exempt from the higher tariff rate.

[7]According to CWB officials, tariffs under both the old and new systems are collected by Revenue Canada at the time of importation. These funds go into the Consolidated Revenue Fund of the Federal Government of Canada.

therefore have a small impact on the export price[8] (see table 3.1 for a comparison of domestic consumption of wheat versus exported wheat). As shown in table 3.2, the majority of CWB wheat sales have been to foreign markets. In addition, the CWB's ability to raise the domestic price of wheat is also limited by the availability of imports of wheat from the United States.[9]

Table 3.2: Distribution of Sales of CWB-Administered Wheat and Barley, 1988-94 Crop Years

Sales in percent

	Crop year[a]						
Commodity and use	**1988-89**	**1989-90**	**1990-91**	**1991-92**	**1992-93**	**1993-94**	**1994-95**
Wheat (excluding durum wheat)							
Domestic use	13.3	11.0	8.1	6.6	10.4	11.0	10.7
Exports	86.7	89.0	91.9	93.4	89.6	89.0	89.3
Durum wheat							
Domestic use	8.1	6.7	7.5	5.3	7.2	6.2	4.6
Exports	91.9	93.3	92.5	94.7	92.8	93.8	95.4
Feed barley							
Domestic use	0	0	0	0	0	0	0
Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Designated barley[b]							
Domestic use	69.8	78.5	56.2	44.5	63.8	52.2	47.9
Exports	30.2	21.5	42.8	55.5	36.2	47.8	52.1

[a]Crop years are from August to July.

[b]Malting barley.

Source: CWB.

In the case of barley, CWB has a greater ability to use domestic prices to lower the price of barley exports since only about one-third of Canada's barley production is exported (as shown earlier in table 3.1). However, the CWB's domestic control is limited to barley sold for human consumption. CWB does not have control over Canadian feed barley sold domestically. In fact, CWB does not attempt to sell feed barley domestically, as shown in table 3.2, though CWB does sell about half of its human consumption barley to the domestic market. Another factor that strengthens the CWB's position

[8]The Canadians were still able to maintain a two-price wheat program between 1972 and 1989, keeping domestic wheat prices higher than export prices. This program had the effect of protecting Canadian millers.

[9]This is true even though, according to USDA officials, the price of U.S. wheat and barley is frequently higher than the price of Canadian wheat when adjusted for transportation, handling, and import fees.

with regard to Canada's domestic barley market is the tariff Canada places on U.S.-designated barley imports,[10] limiting the ability of Canadians to substitute U.S. barley for Canadian barley. A USDA official said these high barley tariffs have been a point of contention between the two countries.[11]

Pooling Minimizes Grower Risk

The intent of pooling farmer wheat and barley production is to maximize the returns of Canadian farmers while minimizing the risk inherent in marketing their grain. Pooling effects include (1) removing the timing of sales as a factor for farmers and (2) distributing market risk while also sharing resources. Approximately 50 different grades of wheat and barley are delivered by farmers in a crop year. Also, the wheat and barley are sold in different quantities at different prices at different times of the year.[12]

In July, the farmers indicate the number of acres seeded to various crops. CWB then signs a contract with the farmers committing itself to purchase a certain percentage of each farmer's offer. The contract should indicate the quantity and quality of the wheat and barley that each farmer intends to deliver to CWB in four contract series over the crop year.[13] The marketing year for wheat and barley lasts from August to July of the following year. According to CWB officials, the grain delivery period is longer than usual because Canada's internal transportation infrastructure limits the amount of wheat CWB can market at any one time.

Farmers deliver their grain to country elevators, where it is graded and binned with similar grades entering into the marketing system for

[10]CWB officials noted that under article 705 of the U.S.-Canada Free Trade Agreement, Canada agreed to remove its import-licensing requirement for U.S. wheat and barley and their products at such time as the level of U.S. government support to U.S. producers for each grain became equal to or less than that provided by the Canadian government to Canadian producers of each grain. CWB officials also noted that, under this agreement, Canada removed the import-licensing requirement for U.S. wheat and wheat products entering Canada in May 1991. The import-licensing requirement remained in place for U.S. barley and barley products due to a high level of U.S. support for these products as compared to Canadian support. This situation has remained the same under the new tariff-rate quota, with the quota applying only to U.S. barley and barley products while not applying to U.S. wheat and wheat products.

[11]The USDA's November 1995 Agricultural Outlook stated that the United States views Canada's high tariffs on barley as "inconsistent with Canada's NAFTA [North American Free Trade Agreement] obligations and as an impediment to U.S. exports." A NAFTA dispute settlement panel has been established to review Canada's high tariffs on barley and other U.S. agricultural products. See Suchada Langley, "Canada's Budget Dictates Changes in Agricultural Policy," Agricultural Outlook, Economic Research Service, USDA (Washington, D.C.: Nov. 1995), p. 27.

[12]The pooling process is described in greater detail in International Trade: Canada and Australia Rely Heavily on Wheat Boards to Market Grain (GAO/NSIAD-92-129, June 10, 1992).

[13]The contractual process differs from the previous quota system, which was in effect before the 1993-94 crop year. The quota system did not identify individual farmers, but simply called forward the amount and type of wheat and barley CWB needed.

exporting grain. At that time, the elevator companies make initial partial payments to the farmer. In turn, CWB reimburses the elevator companies once the grain is delivered to a shipping port. The initial payments are set by the government of Canada in consultation with CWB and are to cover approximately 70 to 85 percent of the anticipated price of the grain.

At the end of the marketing year, CWB tallies its total revenues from marketing sales, deducts appropriate operational and marketing costs from each pool account according to pool sales and expenses, and returns the difference to the Canadian producers. Each producer's payment is based on the type of grain provided,[14] less transportation, handling and cleaning costs. If revenues are lower than the initial payment to the farmers, the Canadian government covers the CWB's price pooling deficit. (Pooling deficits are discussed in greater detail on p. 41.)

Benefits of Pooling Questioned by Some Farmers

As we reported in 1992, pooling by itself does not guarantee higher prices for farmers. The very nature of distributing the production and marketing risk means that some Canadian farmers benefit more than others in a given year. For example, a farmer who gets his or her crop into the distribution system when the international price for the commodity is at a high point will still receive no more for the grain than the average pool price.[15] Distributed costs, such as some farmers incurring greater transportation costs to get their product to market, may also benefit some farmers at the expense of others.[16]

Some Canadian producers have questioned the underlying premise of pooling. For example, grain farmers in the province of Alberta have expressed concerns that the CWB's operations are not transparent enough to determine whether CWB is maximizing returns to the farmers. During November 1995, the government of Alberta held a referendum to determine whether the provincial farmers should have the freedom to sell their grain outside CWB. The majority of Albertans voted for voluntary participation in CWB, though the result of the vote is not binding on the federal government. Other Canadian grain producers and grain traders have also questioned CWB operations, with some of them voicing concern

[14]Different purchase prices exist for different varieties of grains. CWB maintains separate pool accounts for each of the commodities it markets—wheat, durum wheat, barley, and malting barley.

[15]Of course, this mismatch would also occur if the international price for grain dropped, leaving the earlier seller with the lower price.

[16]Recent reforms in Canada, discussed later in this chapter, are expected to end some of these practices.

that CWB inefficiencies can be hidden through the pooling process. Although the Canadian groups we questioned seek an opportunity to market their grain outside of CWB, they are not calling for the CWB's elimination, but rather for a voluntary relationship with CWB.[17]

The Canadian government has already attempted to respond to some of the farmers' concerns. In July 1995, the Canadian Minister of agriculture announced the formation of a nine-member panel to review western grain marketing issues.[18] This panel, in consultation with the Canadian public, farmers, and farm organizations, is to look at "all available facts and background information about our existing and potential markets, the commodities and products we sell into those markets, and the marketing systems we have or could have to maximize our sales volume and returns."[19] The panel was expected to hold local town hall meetings throughout western Canada in late 1995, followed by formal hearings in early 1996 where farmers and farmer organizations can put forward their own arguments for alternative marketing methods. A concluding report is expected to be released in 1996.

CWB-Government Relationship: CWB Losses Covered by the Canadian Government

CWB benefits both from federal direct subsidies and from government guarantees. As a quasi-governmental entity, CWB has its periodic operational losses covered by the federal government, providing CWB with almost $1 billion[20] in government assistance over the last 10 years. Canadian wheat producers have also benefited from government transportation subsidies, though these subsidies were eliminated in 1995. In addition, CWB receives indirect subsidies, such as a lower interest rate on commercial loans as a result of its quasi-governmental status.

[17]In January 1996, the Canada-U.S. Joint Commission on Grains released a report that examined alternatives to the current CWB system, including a "voluntary relationship" between CWB and Canadian farmers. See page 47 for more details.

[18]Appointed panelists include Canadian farmers, current and former officials from wheat pools and farming associations, and a private sector miller.

[19]"Minister Goodale Announces Western Grain Marketing Panel," Agriculture and Agri-Food Canada press release, (Ottawa: July 17, 1995).

[20]All pre-1994 dollar amounts cited in this chapter have been converted from Canadian dollars to constant 1994 U.S. dollars.

CWB Experienced Significant Pooling Deficit in 1990-91

CWB officials told us the only direct revenue CWB receives from the federal government is for the purpose of covering operational deficits. As a crown corporation,[21] CWB can make a direct charge of its unliquidated financial obligations to the Canadian government. As a result, the CWB's status has protected CWB from price pooling losses. Since 1943, CWB has experienced 3 crop years with wheat pool deficits and 7 crop years with barley pool deficits (see table 3.3). Pool deficits have also increased in recent years. The wheat pool deficit in the 1990-91 crop year, by far the largest of the pool deficits, cost the federal government over $695 million. The losses in the 1990-91 market year accounted for approximately 57 percent of the total pooling deficits recorded since the establishment of CWB. CWB attributed the 1990-91 pooling loss to a price collapse in wheat and barley markets caused by a "trade war" between the United States and the EU, where both nations highly subsidized their wheat and barley exports. CWB added that a record world cereal crop in 1990 also caused a decline in the price received for these commodities.

[21]A crown corporation, or a semiautonomous government organization, is used to administer and manage public services in which enterprise and public accountability are combined.

Table 3.3: CWB Wheat and Barley Price Pooling Deficits Since 1943

U.S. dollars in millions (1994)

Crop year	Wheat deficit	Barley deficit	Total deficit[a]
1968-69[b]	$138.9	$34.3	**$173.3[c]**
1970-71	0	36.8	**36.8**
1971-72	0	12.4	**12.4**
1982-83	0	6.5	**6.5**
1985-86[d]	21.5	160.5	**182.0**
1986-87	0	105.1	**105.1**
1990-91	695.4	0.9	**696.3**
Total	**$855.9[c]**	**$356.6[c]**	**$1,212.5[c]**

Note: Although CWB maintains separate pool accounts for wheat, durum wheat, barley, and malting barley, in order to simplify the presentation we have combined the two wheat accounts and the two barley accounts in the table. The only durum wheat pool account deficit was in 1990-91 for $65.2 million. The only malting barley pool account deficit was in 1986-87 for $17.1 million.

[a]Table does not show pooling deficits for oats since oats are no longer under the CWB's control. However, oat pool pricing deficits occurred in 1956-57, 1968-69, 1977-78, 1979-80, 1981-82, 1985-86, and 1988-89.

[b]CWB attributes the 1968-69 pool deficits to the collapse of the International Grains Agreement which had set minimum price levels on grain. Initial payments to producers had been based upon this minimum price, while the trading prices later dropped below this level.

[c]Total may not add due to rounding.

[d]The wheat deficit in 1985 has been partially attributed to the introduction of the USDA's Export Enhancement Program (EEP) during this period. EEP was established by the Secretary of Agriculture in May 1985. The program was set up in reaction to continuing declines in U.S. agricultural exports. Under EEP, cash bonuses are made available to exporters to enable them to lower the prices of U.S. agricultural commodities in order to make these commodities competitive with subsidized foreign agricultural exports. The 1985 Farm Bill subsequently authorized EEP as an export subsidy program.

Source: Canada's Department of Foreign Affairs and International Trade.

Canadian Farmers Benefited From Transportation Subsidies

CWB also benefited from indirect subsidies. One indirect subsidy to CWB and Canadian wheat and barley producers, though a direct subsidy to the Canadian railroad, existed in the form of transportation subsidies. The 1983 Western Grain Transportation Act, which modified the Crow's Nest Pass Agreement,[22] was enacted to subsidize Canadian rail transportation. This subsidy amounted to approximately $410 million during the 1994-95 crop year. According to a USDA official, this transportation subsidy

[22]Signed in 1897, the Crow's Nest Pass Agreement committed the Canadian Pacific Railway to transport prairie grains to the Great Lakes port of Thunder Bay at rates that were fixed in perpetuity. Over time the rates were extended to cover other railways as well as additional crops.

encouraged farmers to grow primarily those crops covered under the program, such as wheat and barley.

Due to internal budget constraints plus Canada's obligations to reduce subsidies under the Uruguay Round, on August 1, 1995, the Canadian government eliminated the transportation subsidy provided under the Western Grains Transportation Act. In order to offset the impact of this change, the government intends to compensate Canadian farmers for this loss by (1) providing about $1.2 billion as a lump sum payment to the farmers, (2) establishing a $220-million Adjustment Assistance Fund, and (3) offering about $732 million in new export credit guarantees for Canadian agricultural products.[23]

Transportation pricing will also change in the 1995-96 crop year due to the elimination of deductions on transportation costs for wheat and barley traveling to eastern Canada. In the past, all grain producers had to support the additional costs for grain going eastward, even though the majority of grain was shipped from western ports. During the 3-year phaseout period of this subsidy and afterward, producers shipping their grain East will begin to bear the full cost of the transportation.

USDA officials said the elimination of the transportation subsidies may affect what Canadian farmers grow and where they sell their goods. Since the government will no longer subsidize the transportation costs of crops being exported, Canadian farmers are expected to diversify out of grain crops, plant more high-value crops, and expand livestock production. Nonetheless, the effect of the eliminated subsidies on U.S.-Canadian trade is still uncertain. According to USDA's November 1995 Agricultural Outlook,[24] "more Canadian grains could eventually move south because of the lower transportation costs."[25] However, the report noted that increased crop diversification and livestock production in Canada could increase the demand for U.S. grain.

[23]Both CWB and the Export Development Corporation are expected to distribute these new credits. Approximately 70 percent of the approximately $732 million is to be allocated to exports of western wheat and barley.

[24]Langley, "Canada's Budget Dictates Changes in Agricultural Policy," p. 28.

[25]According to USDA officials, shipping commodities to the United States by truck will now be relatively cheaper than shipping those same commodities East or West using Canadian rail transportation.

Other Government Support Programs Assist Farmers

The CWB's 1993-94 annual report states that a partnership of farmers and government creates a link between farmers and the federal government that offers "distinct economic advantages." The report goes on to cite the benefits of this relationship, including government backing of CWB borrowing, which "translates into lower interest costs." CWB officials told us that although the government does not provide CWB with any loans or preferential treatment, it guarantees CWB an excellent credit rating by virtue of its status as a crown corporation. This credit rating assists CWB in obtaining the loans it needs at favorable rates on commercial markets.[26]

According to CWB officials, CWB does not benefit from special tax treatment or the ability to levy assessments on Canadian wheat and barley producers. Although CWB does not pay taxes to the federal government, the returns paid to the farmers are taxed as regular income to the farmers. In addition, CWB officials told us that CWB initiated a voluntary levy was initiated in the 1994-95 marketing year to help fund grain research at the Western Canadian Grain Research Institute. A CWB official said that 30 percent of the wheat and barley producers have declined to participate in the voluntary levy.[27]

CWB-Foreign Buyer Relationship: Flexibility in Pricing May Allow CWB to Potentially Distort Trade

The United States, as well as other grain-trading countries, has questioned the CWB's monopoly authority over Canadian wheat and barley as well as the lack of transparency in the CWB's marketing system. This lack of transparency in the CWB's pricing methods may provide CWB with greater pricing flexibility than is found among private sector traders. CWB has attempted to address some of these transparency concerns. However, a recent U.S.-Canadian joint commission has questioned both CWB and U.S. trade practices.

U.S. Concerned About the Limited Transparency of CWB Operations

Canada is the third-largest export market for U.S. agricultural commodities. USDA's ERS preliminary figures for 1995 showed the United States exporting $5.8 billion in agricultural products to Canada.[28] Earlier ERS forecasts showed Canada as the second-largest source for U.S.

[26]CWB must take out loans from commercial banks to cover the cost of initial payments to farmers and to pay CWB operational costs.

[27]Canadian wheat and barley producers have also been assisted by Canadian income support programs, as well as research and advisory services. These programs are discussed in detail in our earlier report (see GAO/NSIAD-92-129). However, some of the programs described in the earlier GAO report may have been eliminated or reduced in funding.

[28]The top destination for U.S. agricultural exports was Japan, buying $10.5 billion in U.S. agricultural goods. The EU was the next largest importer, importing $8.2 billion in U.S. agricultural products.

agricultural imports, with the United States importing $5.2 billion in agricultural products from Canada in 1995.[29] With respect to grain, the United States has run a trade deficit with Canada. In 1994, the United States had a $500-million trade deficit with Canada in the grains, grains product, and animal feeds sector in 1994.

The U.S. government, as well as other grain-exporting countries, has expressed concerns about the CWB's monopoly power and the limited transparency of its operations. U.S. critics of CWB contend that CWB has an unfair pricing advantage due to its status as the single selling authority. According to one USDA official, the day-to-day "replacement cost" for wheat is more readily apparent in the United States with its commodity markets than is true of CWB. In such a case, the grain traders in the United States are "price takers," or are required to buy their grain at the given market price without being able to affect that price. The CWB's exclusive purchasing authority over wheat and barley for human consumption provides CWB with a more secure source of supply, as well as more control, than would be the case for a private exporter. USDA officials expressed concern that the CWB's margin between the initial price and the final price paid to the Canadian wheat and barley producers allows CWB to adjust transaction prices at will, even if it is to the detriment of Canadian producers. As stated earlier, some Canadian producers are also concerned that such detrimental pricing policies could occur without greater transparency over CWB operations.

Some U.S. officials are also concerned about CWB undercutting U.S. producers using its grain quality standards. According to USDA officials, CWB has used high quality as a marketing strategy, often providing higher protein content in its wheat than the customer requests and thus developing an expectation that CWB's wheat is a better value for the money. In comparison, the U.S. wheat industry tends to blend wheat to the specifications of the buyer. Although the CWB's approach may be a useful marketing strategy, it also has the effect of providing a benefit to a buyer without CWB getting the full value of the higher quality wheat. The uniform grading standards that CWB uses, although also cited as a benefit of CWB by providing consistency across sales, may also be a liability at times to Canadian producers. A USDA official told us about U.S. concerns that CWB has downgraded wheat to "feed quality" using these standards, even

[29]The ERS' figures showed Canada as the largest source of U.S. agricultural imports in 1994. However, 1995 forecasts indicated that Canada may be a close second to the EU ($5.4 billion in EU imports versus $5.2 billion in Canadian imports).

though the "feed" grain is later milled in the United States.[30] In such a situation, Canadian producers would be deprived of the full value of their wheat.

Two recent Canadian reports indicate continued attempts to understand the benefits and costs of the CWB's single selling authority status. The first report,[31] authored by three Canadian agriculture economists with the assistance of CWB, estimated that CWB has provided greater revenues and lower management costs to Canadian wheat producers than would have been the case had the producers sold their grain through a multiple-seller system. The report estimates that from 1980 to 1994, Canadian wheat producers received additional revenues ranging from a low of $18.88 to a high of $34.47 per ton of wheat due to the single selling authority marketing system.[32]

A second report,[33] prepared by two Canadian agriculture economists with the assistance of the Alberta Department of Agriculture, found no evidence of CWB price premiums for wheat and barley when prices were examined at the farm level.[34] The report also found that the hidden costs of the single selling authority marketing system to producers could be as high as $20 per ton for wheat and more than $20 per ton for barley. Moreover, the report indicated that hidden costs to Canadian taxpayers for having a single selling authority could be another $5.50 per ton for wheat and about $9 per ton for barley.

CWB Efforts to Modify Practices to Satisfy Critics

CWB has attempted to provide greater transparency in its operations and final price forecasts. CWB has started to provide more detail on expected returns for CWB grains as well as daily price quotes. In 1993, CWB introduced the Pooled Return Outlook/Expected Pool Return to forecast pool returns for each crop year in order to assist producers with seeding, marketing, and financial planning decisions. A truck-offer program was also initiated to provide daily price quotes based directly on the

[30]In its submission to the Canada-U.S. Joint Commission on Grains, CWB acknowledged that some Canadian feed wheat went to U.S. millers, but noted "the blending of wheat to achieve higher market value is common practice on both sides of the Canada/U.S. border."

[31]See Daryl F. Kraft, W. Hartley Furtan, and Edward W. Tyrchniewicz, Performance Evaluation of the Canadian Wheat Board (January 1996).

[32]This estimate pertains only to the wheat pool and not the durum and barley pools.

[33]Colin A. Carter and R.M.A. Loyns, The Economics of Single Desk Selling of Western Canadian Grain (March 1996).

[34]Prices were compared to those in the United States.

Minneapolis future and cash wheat markets to Canadian farmers wishing to buy back their grain. Finally, CWB started a weekly South East Asian News Flash publication showing the CWB's offer/tradable prices for grain at West Coast ports.

Even so, without additional transaction price information, there is little likelihood that the transparency issue between Canada and other grain-trading nations will be resolved.[35] CWB, like private sector grain traders, continues to protect this information as commercially sensitive data. One USDA official said U.S. grain traders are just as likely as CWB to treat this information as proprietary. In addition, CWB does not always have access to end-user transaction prices. According to CWB officials, accredited exporters are not, in all cases, required to provide CWB with the final transaction price or even the customer. These accredited exporters purchase wheat from CWB and then resell it to U.S. customers, as well as other customers throughout the world.

Canadian government officials have stated that the transparency issue has already been resolved, claiming that previous U.S. reports have exonerated CWB from charges of violating applicable trade agreements and U.S. law. USDA officials we interviewed early in our review acknowledged that they did not have any evidence that CWB was violating existing trade agreements. Nonetheless, trade differences between the United States and Canada have led to curbs on Canadian wheat imports into the United States as well as the establishment of a joint commission to look at all aspects of the two countries' respective marketing and support systems for grain.

Joint Commission on Grains Recommends Changes

In response to growing U.S. criticism of Canadian exports of durum wheat to the United States, on November 17, 1993, the President requested that the U.S. International Trade Commission begin a section 22[36] investigation. The investigation began on January 18, 1994, with the purpose of reviewing U.S. imports of wheat, wheat flour, and semolina from all

[35]Without transaction data, we are likewise unable to determine whether CWB practices discriminatory pricing or cross-subsidization between sales on foreign markets.

[36]Section 22 of the Agricultural Adjustment Act (7 U.S.C. 624) is intended to protect U.S. farm programs from imports that impair or interfere with their operation. Under section 22, the President may impose import restrictions on such imports as are necessary if, after the conclusion of an International Trade Commission investigation, he determines that products "are being or are practically certain to be imported into the United States under such conditions or in such quantities as to render or tend to render ineffective, or materially interfere with" any USDA domestic commodity support or stabilization program. These provisions are no longer available to products of countries or entities who are members of WTO.

countries, including Canada. The International Trade Commission issued its final report in July 1994.[37]

As a result of the investigation and negotiations, a memorandum of understanding between the United States and Canada with respect to cross-border wheat trade was made effective on September 12, 1994. The memorandum called for (1) a Joint Commission on Grains to be established to further examine the grain problems between the two countries; (2) a 12-month period, beginning September 12, 1994, during which the United States would apply a new schedule of tariffs on the importation of wheat into the United States;[38] and (3) a 12-month hold on all countermeasures under NAFTA or GATT, as well as a hold on all countermeasures inconsistent with either the North American Free Trade Agreement (NAFTA) or GATT provisions.

The Canada-U.S. Joint Commission on Grains[39] released its preliminary report in June 1995 and its final report in January 1996. The final report made recommendations in a number of areas, including (1) policy coordination, (2) cross-border trade, (3) grain grading and regulatory issues, (4) infrastructure, and (5) domestic and export programs and institutions.

In relation to domestic and export programs, the final report noted that "the use of discretionary pricing by governments, directly through their programs or entities, had led to trade distortions." As a result, the report recommended that both the United States and Canada reduce and remove these trade distortions by (1) the United States eliminating, or significantly reducing with a view to eliminating, its export subsidy programs such as EEP for all cereals and their products and (2) CWB being "placed at risk of profit or loss in the marketplace" or conducting itself in an equivalent

[37] Wheat, Wheat Flour, and Semolina: Investigation No. 22-54, U.S. International Trade Commission, Publication 2794 (Washington, D.C.: July 1994).

[38] Increased tariffs were placed on all durum and non-durum wheat that came into the United States above a specified threshold. The new tariffs did not apply to flour, semolina imports, and white winter wheat imports.

[39] The Joint Commission consists of 10 nongovernment officials, evenly divided between the United States and Canada.

manner.[40] In this section, the report also recommended removing trade-distorting effects in each country's domestic agricultural policies. Finally, the Joint Commission noted that the implementation of these recommendations will depend heavily on other grain-exporting countries, such as the EU and Australia, undertaking comparable actions.

Among other things, the final report also recommended that (1) Canada and the United States undertake regular and structured consultative process concerning grain policy issues with the goal of reducing trade-distorting policies and (2) a bilateral producer/industry-based Consultative Committee be established to handle short-term cross-border issues as an "early warning system for trade difficulties."

[40]The Joint Commission's examined alternatives in this regard included "allowing voluntary producer participation in Canadian wheat and barley pools, and allowing Canadian firms to trade non-CWB wheat and barley in a domestic and global context without undue impediments." Additional alternatives for CWB included that (1) CWB use public offer prices on a global basis; (2) CWB continue to use private offer prices on a global basis, with a commitment to pricing discipline at the point of sale and a confidential audit; or (3) CWB use another mechanism that the respective governments agree will accomplish the goal or encouraging CWB to conduct itself as if it were at comparable risk in the marketplace.

AWB Enjoys Indirect Government Subsidies, but Ability to Distort Trade Is Limited

AWB has limited capability to distort international wheat markets. It has monopoly power over wheat exports but does not routinely receive direct subsidies from the Australian government. The AWB's initial payments to farmers are underwritten by a government guarantee. Because of this guarantee, it most likely receives favorable interest rates on its loans. Additionally, its access to additional funds allows it to diversify risk by investing in other projects. AWB has the capability to be flexible in its pricing; this flexibility could lead to either lower or higher returns for producers.

Background

Although Australia is a country of less than 18 million people, its agriculture exports totaled $12.2 billion[1] in 1992-93. This equates to about one-quarter of Australia's total export income. Australian wheat ranks as the country's fourth-largest export market, with 12.9 percent of total world exports in 1994, representing about 80 percent of all wheat grown in Australia. Australia ranks as the world's fourth-largest wheat exporter.

AWB is a statutory marketing authority with federal and enabling state government legislation providing it with the sole license to export Australian wheat. AWB was established in 1939 to "acquire, with certain exceptions, all wheat held in Australia and to arrange for its disposal in view of low world prices prevailing and the marketing and transport difficulties created by the wartime conditions."[2] However, when World War II ended and the justification no longer existed, AWB was not disbanded. It was reconstituted in 1948 to establish it as the central marketing authority for wheat and to enable it to administer various wheat stabilization and marketing arrangements. New legislation in 1989 modified the AWB's role by deregulating the domestic market, expanding the AWB's operating domain to include other grains produced in Australia and to wheat from other countries. The legislation also removed price supports and established the Wheat Industry Fund (WIF), which is discussed in more detail in the following section.

AWB is a national and international grain marketer, financing and marketing wheat and other grains for growers. AWB also spends a portion of its budget on market development and promotion, especially in the Asia/Pacific region. All profits are distributed to growers, even though it is not officially a grower-owned organization.

[1]All monetary references are expressed in constant 1994 U.S. dollars.

[2]As per Australia's notification to GATT, 1994.

Australia's Grains Industry Partitioned Among Several Boards

Australia's grains industry is not governed by a single entity. Some grains are freely traded in all states, while others are governed by state boards in certain states. AWB is the only organization in Australia that has acquisition authority for a particular grain (wheat) across all states, and thus the only organization with the power to make an impact. See table 4.1 for an overview of the various boards' acquisition authorities.

Table 4.1: Australian Grain Marketing—Acquisition Authority, by State

Grain	Queensland	New South Wales	Victoria	South Australia	Western Australia
Wheat (export/domestic)	AWB/FT	AWB/FT	AWB/FT	AWB/FT	AWB/FT
Malting barley	Grainco Qld	NSW Grains Board	Australian Barley Board	Australian Barley Board	FT
Feed barley	Grainco Qld	NSW Grains Board[a]	Australian Barley Board	Australian Barley Board	FT
Oats	FT	NSW Grains Board[b]	FT	Australian Barley Board[c]	FT
Sorghum	Grainco Qld[d]	NSW Grains Board[e]	FT	FT	FT
Maize	FT	FT	FT	FT	FT
Triticale and rye	FT	FT	FT	FT	FT
Lupins	FT	FT	FT	FT	FT
Other grain legumes	FT	FT	FT	FT	FT
Oilseeds	FT	NSW Grains Board[f]	FT	FT	FT

Legend

FT=freely traded
NSW=New South Wales
Qld=Queensland
SA=South Australia
VA=Victoria
WA=Western Australia

[a]Growers can circumvent the NSW Grains Board by paying a license fee.

[b]The NSW Grains Board allows free trade on the domestic market.

[c]The board does not have acquisition authority over oats sold directly from growers to domestic end-users.

[d]In Central Queensland, domestic sorghum is traded freely. In Southern Queensland, both export and domestic market-bound sorghum is traded freely.

[e]The NSW Grains Board allows free trade on the domestic market.

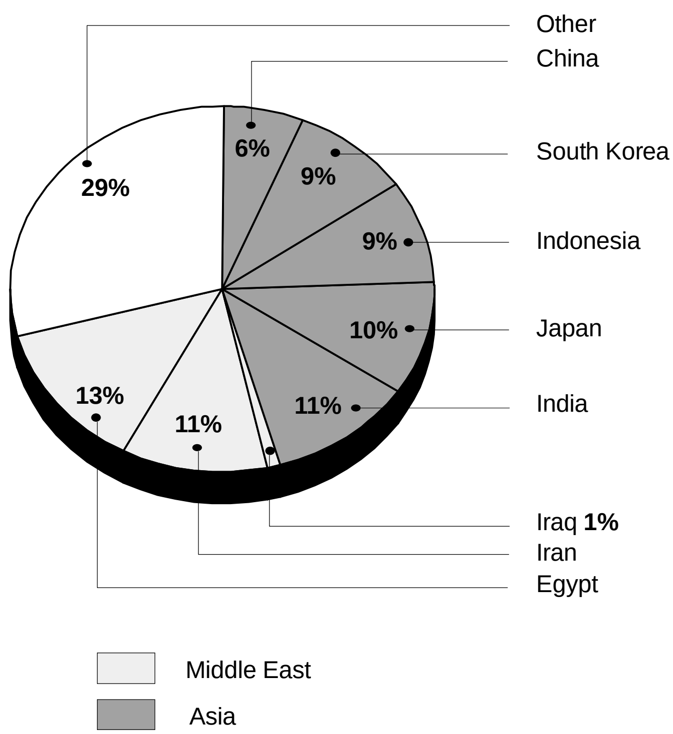
[f]As of March 1995, the NSW Grains Board was in the process of divesting its powers over oilseeds, allowing the commodity to be freely traded.

Source: Grains Council of Australia.

Wheat growers may deliver their wheat to AWB, which operates a number of pools each year. The wheat is segregated by class and variety, and growers receive initial payments upon delivery. AWB deducts storage, transport, operating, and marketing costs from sales and returns the remainder to the farmers once all the wheat has been sold.

The AWB's major markets lie in Asia and the Middle East, as shown in figure 4.1.

Figure 4.1: Australia's Major Wheat Export Markets (as a percentage of Total Wheat Exports)



Source: AWB.

AWB-Producer Relationship: Payments Made Over Time

AWB is responsible to both producers and the government, and its managing board includes representatives from both groups. Producers sell their wheat to AWB through a pooling system that averages individual producer returns, thus dispersing the producers' financial risk. AWB payments to producers are not immediate, though, since product pools may take years to close. Since AWB must compete with other suppliers in the domestic market, it does not have the capability to cross-subsidize between its domestic and foreign market sales.

AWB's Managing Board Includes Producers

AWB's managing board consists of a nonexecutive chairperson, the Managing Director, eight members with special expertise in wheat production or other specified fields, and a government representative. The eight members with special expertise include growers, as evidenced by the current board composition. DPIE, a government agency, loosely oversees the AWB's activities by appointing a government representative to sit on the AWB's managing board; requiring an annual report, which is submitted to Parliament; requiring a 3- to 5-year corporate plan, which is approved by DPIE's Minister; and requiring an annual operating plan, which is not subject to ministerial approval. AWB must also consult with the Grains Council of Australia annually.

Pooling Averages Returns Across Producers

For the past 57 years, AWB has had the statutory authority to be the primary buyer and seller of Australian wheat. It is the only entity licensed by the Australian government to export Australian wheat to the global marketplace.[3] Thus, growers who wish to take advantage of the export market are forced to sell their product to AWB. AWB purchases all Australian wheat bound for export and combines it into a number of pools based on quality and variety. AWB then sells the wheat on the international market and returns the proceeds, minus expenses, to growers. Through the pooling system, all growers of a similar quality and variety of wheat generally receive the same price. This means that bad luck in delivering their products during a part of the marketing year when prices are low will have less impact on individual producers. However, it also means that those who were able to deliver the product at a time of higher-than-average prices receive a lower return. Actual net pool revenues may vary based on individual grower transportation and storage costs.

[3]According to USDA officials, AWB may also authorize another company to export bagged wheat or wheat in a shipping container.

Producer Payments Made Over Time

The majority of wheat produced in Australia is delivered for marketing and payment within the AWB's pooling system for export. Various criteria govern the pools, including quality, time of delivery, location, and category of wheat. Storage, handling, and transport costs are disaggregated and charged to growers, and marketing costs and borrowings to fund payments are pooled. AWB makes a net payment to growers at each stage of the process, mostly in advance of receipts from sale of the delivered wheat.

Typically, the first payment is made within 3 weeks of delivery, sometime between November and January. It amounts to about 80 percent of the estimated total payment. The second payment is made during March, once AWB receives the entire harvest. Other payments may take place before a final payment is made. The final payment for a particular pool may not take place for years, since some of the wheat may be sold on credit terms and not finalized for several years.

AWB conducts its domestic market dealings somewhat differently. AWB offers cash on delivery to a designated silo for wheat destined for the domestic market. According to AWB, this is a relatively small quantity of wheat compared to the amount handled in the pooling system.

AWB Authority Limited: Cross-subsidization Not Possible Between the Domestic and Foreign Markets

AWB does not have the capability to cross-subsidize its sales between its domestic and overseas markets. AWB sells wheat on the domestic market, but it must compete with other sellers. According to AWB officials, AWB only accounts for 30 to 40 percent of the domestic wheat market; however, other sources claim that this figure is as high as 80 percent.[4] Additionally, AWB does not have any control over the import of wheat to Australia, so it cannot control the entrance of other sellers to the domestic Australian wheat market.

AWB-Government Relationship: Both Direct and Indirect Government Subsidies Help AWB

Besides its monopoly on Australian wheat exports, AWB benefits from several forms of assistance. This assistance has changed over time. The AWB's current benefits include a government guarantee on borrowings, which most likely results in lower interest rates. WIF funds also allow AWB to maintain a strong capital base and invest in outside interests. Additionally, a number of indirect subsidies benefit AWB, including government matching research funds.

[4] In 1995, a consultant to the Grains Council of Australia reported that the AWB commands 65 percent of the domestic milling wheat market. USDA claims that AWB controls 80 percent of the wheat sales to domestic mills, and that wheat imports are effectively prohibited by phytosanitary standards.

Nature of Government Subsidies Has Changed Over Time

Before 1989, the Australian government provided economic support to wheat farmers through a number of mechanisms, including guaranteed minimum prices and an artificial premium on domestic wheat prices. Unit-pooled returns to growers were guaranteed at a certain level by the federal government, at least for a limited volume of exports, with the guaranteed price based on cost of production estimates by the Australian Bureau of Agricultural Resource Economics. Economic assistance to AWB also included a home consumption price that was set in line with the guaranteed price, based on the assessed cost of production. Generally, domestic end-users paid a higher price for wheat than foreign buyers under this scenario.

The guaranteed minimum price for wheat was ensured through a stabilization fund. If export prices exceeded a trigger price, an effective export tax was imposed. If prices fell below the guaranteed price, a deficiency payment to growers made up the difference between the actual price and the guaranteed price, up to a specified limit. If the stabilization fund was depleted, the federal government made up the difference. When the fund was first established, growers paid into it. However, from 1958 to 1974, the federal government was forced to heavily subsidize the fund.

After other changes in the 1970s and 1980s, including altering the baseline of stabilized prices, establishing guaranteed minimum delivery prices, and allowing AWB to borrow on the commercial money market, major reforms were introduced in 1989. The most important of these included deregulation of the domestic market, establishment of WIF, and abolition of the government's guaranteed minimum pricing scheme.[5] AWB was given some flexibility in the commercial market; besides other activities, AWB may buy and sell a variety of grains.

[5]The AWB's main functions now include (1) buying and selling grain in Australia and overseas; (2) importing wheat into Australia or engaging in any trading arrangements that are consistent with its objectives; (3) storing, handling, or transporting wheat or buying, establishing, or owning and operating such facilities; (4) entering into wide-ranging financial arrangements consistent with its commercial orientation; (5) providing a range of services associated with wheat marketing and charging for those services; and (6) appointing agents in Australia or overseas and engaging in value-added activities, including establishing subsidiaries or entering into joint ventures both on- and offshore.

Government Guarantee Most Likely Results in Lower Interest Rates

Since 1989, the Australian government has guaranteed a portion of the AWB's borrowings to pay farmers at harvest time. This guarantee covers, at a minimum, between 80 and 90 percent of the aggregate estimated net pool return.[6] According to the Industry Commission,[7] this guarantee has risen in value from $21.5 million in 1989-90 to $26.4 million in 1992-93. The government guarantee was initially established to last until June 1994, but was extended at that time to continue until June 1999 at a maximum of 85 percent.

Both AWB officials and the Industry Commission agree that the government's guarantee translates into real savings on interest rates, since the guarantee transfers the risk from AWB to the taxpayers. This guarantee results in increased net returns to the wheat industry because of the lower interest charges.

WIF Provides Revenue for Capital Base and Investments

WIF, a nonsales source of AWB revenue, is supported by a 2-percent levy on wheat growers. WIF serves as the AWB's capital base and underwrites the AWB's domestic trading operations, as well as strategic investments that support outside business activities. Growers hold equity in WIF and may transfer that equity. AWB manages the fund in conjunction with the Grains Council of Australia.

As noted previously, AWB may use this fund to diversify its holdings. For example, it has used WIF funds to invest in flour mills in China and Vietnam. Thus, farmers are not completely reliant on the international wheat market for income; outside investments may help soften the blow of declining wheat prices.

WIF also provides a capital base for the AWB's domestic market activities. This practice is questionable because of its implications for other domestic sellers. That is, farmers who sell their wheat abroad through AWB may also choose to sell their wheat on the domestic market through another company. However, the farmers then must pay a 2-percent WIF levy on their exported wheat to AWB; in effect, they could be funding the efforts of a competitor.

[6]The Australian government provides a borrowing guarantee of up to 85 percent of the AWB's aggregate estimated net pool return from the sale of wheat. The Minister of Primary Industries and Energy calculates the size of the guarantee based on current and forecast outlooks for international grain prices.

[7]The Industry Commission was established by the Australian government as a review and advisory body on industry matters. Its role is to conduct independent public inquiries into a broad range of issues in the economy.

Research Funds and Other Relief Also Available

Wheat research and development are partially funded by the government. The government matches industry research contributions dollar for dollar up to 0.5 percent of gross value of production. The Grains Research and Development Corporation manages about 22 percent of the wheat research funds for the industry. Growers only funded about 20 percent of wheat research and development in 1993-94, and the remainder was provided by the Commonwealth government, state governments, and private sources.

Before 1990, drought was regarded in Australia as a natural disaster, and automatic relief was available through direct subsidies. Direct subsidies were not available after 1992, when Australia instituted the National Drought Policy. This policy reclassified drought as "normal operating procedure" and removed the direct payments. Through this policy, Australia offers welfare assistance and interest rate subsidy support for exceptional drought circumstances, assistance with the creation of financial reserves, and research funds for drought impact and risk management practices. In 1992, through the Crop Planting Scheme, the government spent $2.2 million to cover 75 percent of the interest rates on commercial loans to farmers who, although considered as having viable farms in the long run, were financially unable to plant a crop.

The Australian government has also compensated farmers directly for extreme circumstances that affected their incomes directly. For example, it made a single payment of $27 million to wheat farmers to compensate for losses due to the sanctions against Iraq.

Growers are taxed on the returns under Australia's income tax system. Primary sector producers receive tax breaks from the government under a number of measures, including two schemes that may reduce the producers' taxes. The Income Averaging Scheme allows producers to average their income over 5 years to compute their tax rate, and the Income Equalization Deposits Scheme allows producers to make tax-deductible deposits into a fund that can be used in low-income periods. AWB does not pay a separate tax on any returns distributed to the growers, but instead pays corporate tax on holdings and investments, both domestic and abroad.

AWB-Foreign Buyer Relationship: Monopoly Status Allows for Flexible Pricing

The AWB's monopoly over wheat exports allows it to set prices without fear of competition from other Australian wheat exporters. This allows for price flexibility; however, we were unable to determine whether AWB engaged in any form of price discrimination or cross-subsidization between foreign markets since data were not available from public or private sector wheat traders. Australian government-sponsored reports have suggested that the wheat industry would benefit from complete deregulation and should focus more on market-based activities.

Australian Government Gives AWB Sole Export Authority for Wheat

The Australian government has authorized AWB to be the sole exporter of Australian wheat, through legislation that is reviewed every 5 years.[8] As mentioned earlier, AWB also has the right to buy and sell wheat on the domestic market, but it must compete with other firms. This differs from the pre-1989 arrangement, when AWB maintained monopolistic control over both the domestic and export markets in Australia.

Since AWB is a monopoly, it may set prices for Australian wheat abroad without competition from other Australian exporters. This status may provide some advantages of a cartel in that individual producers are unable to undercut a particular price that AWB sets. In situations where there are limited alternatives to Australian wheat, this might enable AWB to charge higher prices and capture higher returns for Australian producers. Additionally, AWB's single-desk seller status gives it a sure source of supply for its export sales.

Similarly, the averaging of all sales may allow the sales at prices that are lower than a primary seller would be willing to accept. This could be done either to match lower prices of a competitor or to ensure sales to a particular buyer for other reasons. This could lead to lower returns to Australian producers.

Price Discrimination, Cross-subsidization Not Determined

We were unable to determine whether or not AWB engaged in price discrimination because we did not have access to individual transaction data from AWB or private grain traders. Likewise, we were unable to determine whether or not AWB engaged in cross-subsidization between foreign markets.

[8]The Wheat Marketing Act of 1989 does not have a 5-year sunset provision.

Reports Encourage Greater Deregulation and Stronger Efforts Toward Market-Based Activities

In 1993, the Australian government released a report on National Competition Policy, also known as the "Hilmer report." This report clearly stated that STEs, known in Australia as "statutory marketing authorities," should not exist except for certain situations based on public interest grounds. It stated that statutory marketing authorities' anticompetitive practices such as compulsory acquisition of product and monopoly marketing arrangements are often grossly inefficient. Another report indicated that grain marketing boards cost more than private traders to perform similar services.

In 1989, the Grains Council of Australia initiated the Grains 2000 Project. It identified a number of issues critical to the long-term profitability and sustainability of the Australian grains industry. Subsequently, the Grains Council of Australia established several strategic planning units to address these issues as they relate to specific grains. One of those units, the National Grain Marketing Strategic Planning Unit,[9] commissioned a report on the Australian milling wheat industry. The study focused on issues that may affect the industry for the next 20 years and made recommendations that the authors believe would lead to greater efficiency.

The Grains 2000 study concluded, among other things, that the benefits of single-desk selling currently outweighed the costs. However, it noted that this situation might change once the effects of GATT reforms take hold; that is, when effective subsidies are reduced and price differentials between subsidized and unsubsidized markets shrink, or if the market no longer supports the differentiation strategy. The study also reported that the net effect of AWB to the Australian grower in 1992-93 fell somewhere between a loss of $1.22 per ton and a gain of $4.93 per ton. Thus, it is unclear how much AWB benefits wheat farmers, if at all. The report made additional recommendations that, in its view, should result in greater efficiency and support for sustainable practices. These other recommendations included (1) protecting core markets and developing targeted defenses against Canada, (2) allowing AWB to trade all grains,(3) allowing AWB investment in wheat handling and elevation, and (4) making AWB a corporation with grower ownership.

[9]This group includes members of AWB, the Grains Council of Australia, the Australian Grain Marketing Federation, the Bulk Handling Authorities of Australia, the Australian Flour Millers, the National Agricultural Commodities Marketing Association, the Australian Mallsters and Brewers, DPIE, and the Grains Research and Development Corporation.

NZDB Receives Little Government Support, but Size and Subsidiary Structure Provide Economic Advantages

NZDB is a major player in the world dairy trade. Individual domestic producers have some involvement in NZDB activities and participate in a pooling process, thus dispersing risk across the entire New Zealand dairy industry. NZDB has successfully weathered the removal of government subsidies in 1984 and maintains about a 25-percent share of the world dairy market. The NZDB's statutory authority allows it to maintain a monopoly over dairy exports, but does not allow it to maintain control over the domestic market or collect tariffs on imports of dairy products. The NZDB's network of subsidiaries allows it to sell a greater amount of its goods at the best possible price in other countries' markets, especially those with a controlled dairy import market.

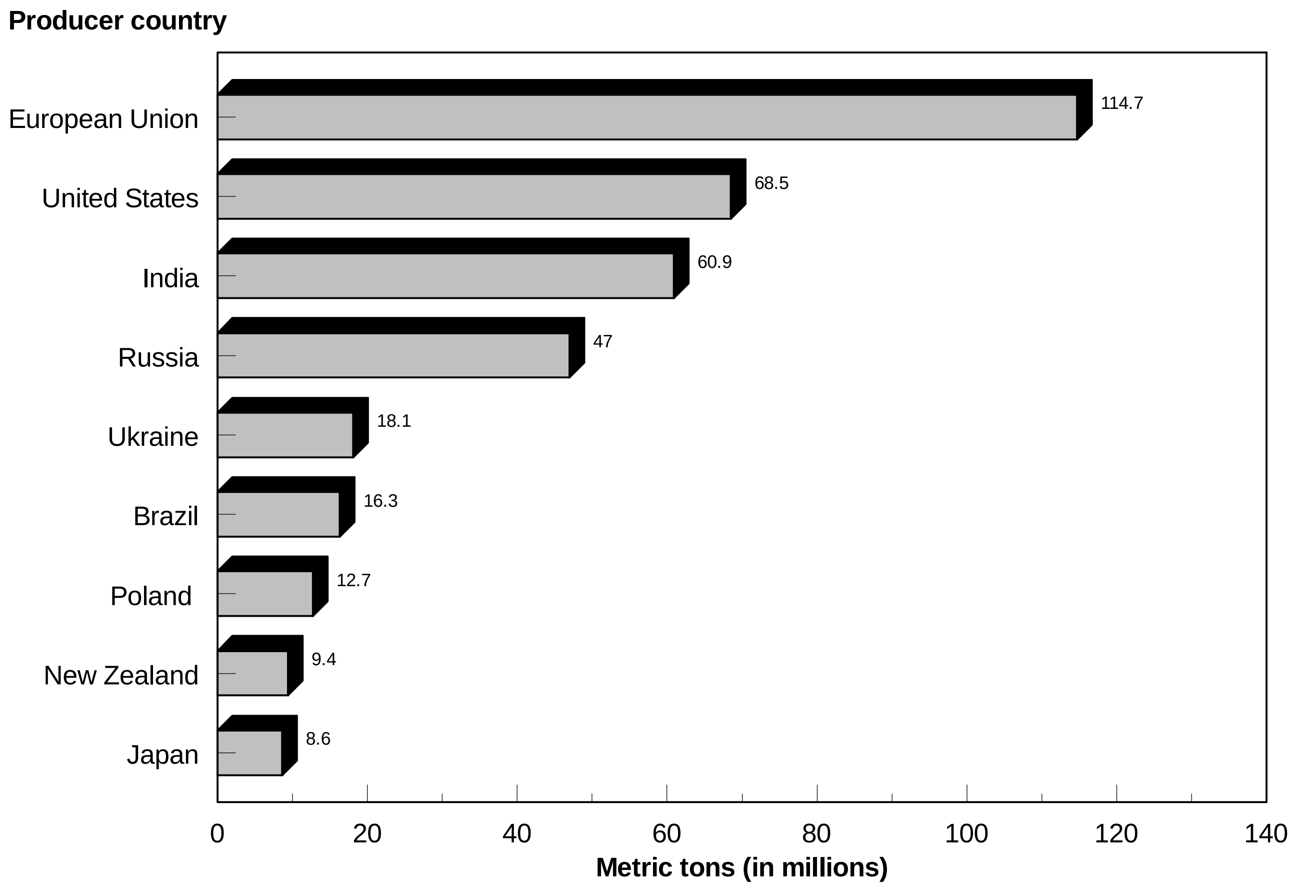
Background

State Trading in World Dairy Trade

State trading also plays a role in international trade in dairy products. Although the United States is among the world's largest milk producers (see fig. 5.1), the country is not a substantial exporter of dairy products because the great majority of U.S. dairy production is sold to U.S. consumers. Among the top exporters of skimmed milk powder shown in figure 5.2, three of the five countries listed maintained STEs in their dairy sector: Australia, New Zealand, and Poland. In the case of the major cheese-exporting countries, shown in figure 5.3, Australia and New Zealand again appear among the listed countries.[1]

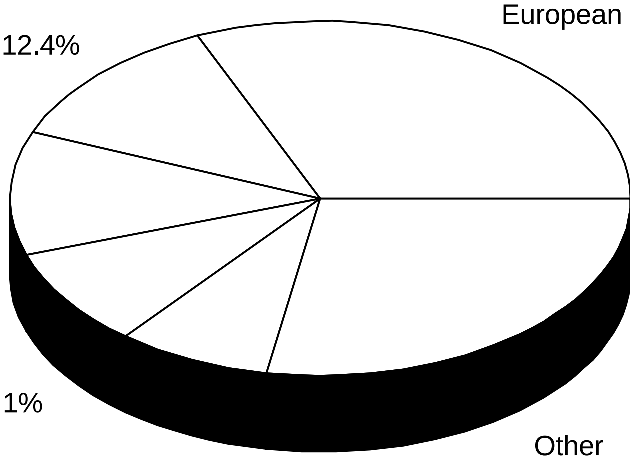
[1]Although Switzerland has reported that it maintains an STE in the dairy sector, its STE is limited to trade in butter.

Figure 5.1: World Milk Production by Country, 1993 Estimates



Source: International Dairy Arrangement.

Figure 5.2: Major Exporters of Skimmed Milk Powder by Country, 1993 Estimates

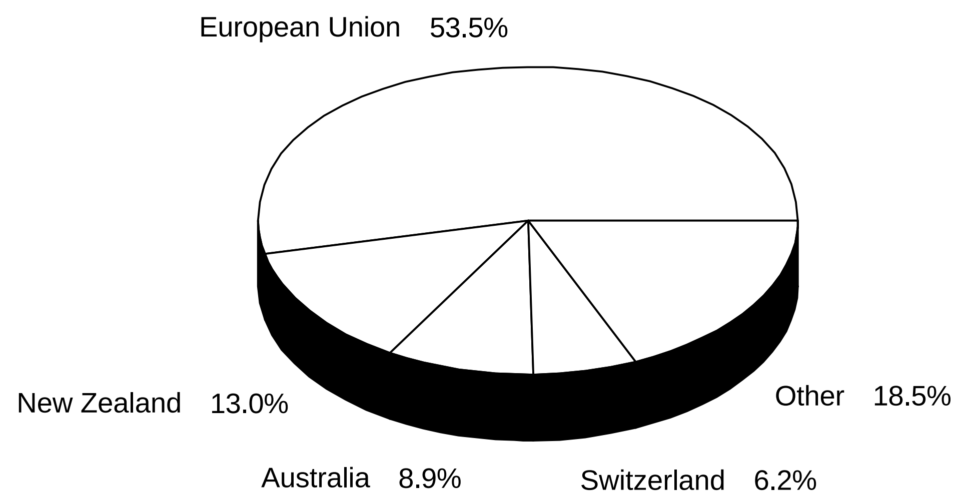


Note 1: EU estimate excludes trade between EU countries.

Note 2: “Other” not specified in source.

Source: International Dairy Arrangement.

Figure 5.3: Major Exporters of Cheese by Country, 1993 Estimates



Note 1: EU estimate excludes trade between EU countries.

Note 2: "Other" not specified in source.

Source: International Dairy Arrangement.

New Zealand Dairy Trade Significant

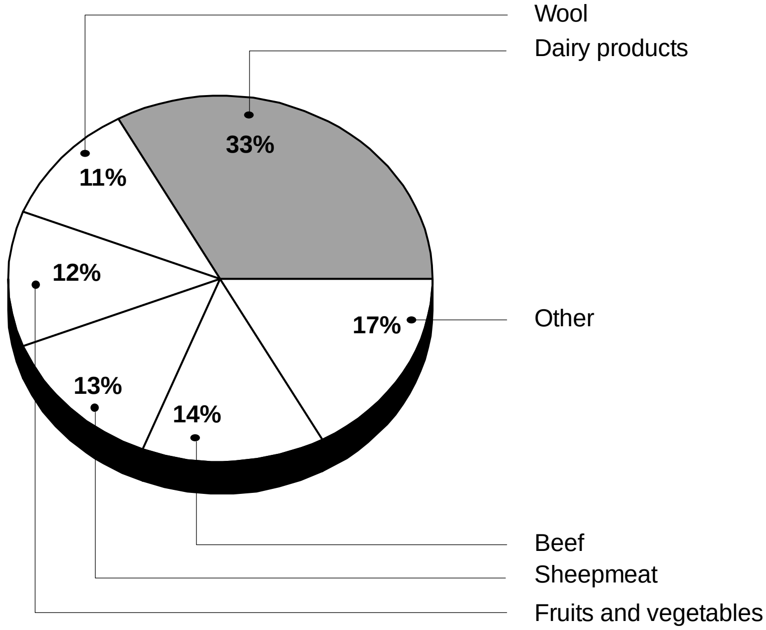
NZDB operates within the terms of the Dairy Board Act of 1961, as amended. Its group mission is to maximize the sustainable income of New Zealand dairy farmers through excellence in the global marketing of New Zealand origin dairy products. According to NZDB officials, NZDB helps New Zealand farmers obtain the maximum return possible by acting as a single agent on the export market for New Zealand dairy products. This eliminates possible "undercutting" by individual dairy cooperatives and reduces the number of global players in the competition for dairy sales.

Dairy exports constitute a significant portion of New Zealand's overall export trade; approximately 90 percent of New Zealand's dairy products are exported. According to MAF, in the year ending December 1993, dairy product exports totaled $1.9 billion.[2] This figure represents 33 percent of

[2]All monetary references are expressed in constant 1994 U.S. dollars.

New Zealand's agricultural exports and 18 percent of New Zealand's total merchandise exports. (See fig. 5.4.)

Figure 5.4: New Zealand Agricultural Exports, Year Ending December 1993



Source: MAF.

In recent years, New Zealand has been a leading supplier of most dairy produce to world markets; in particular, it supplies a significant percentage of the world's exports of milk powder, butter, and cheese. Conversely, New Zealand's dairy imports are minimal. No dairy products are subject to import-licensing requirements, and no quantitative restrictions apply to dairy products entering New Zealand.

NZDB-Producer Relationship: Pooling Disperses Risk; Cross-subsidization Between Domestic and Foreign Markets Not Possible

New Zealand domestic producers participate, through elected representatives, in NZDB policy direction. NZDB is accountable to its producers and reports back through a number of vehicles, including annual reports and efficiency audits. Individual producer risk is dispersed across the entire industry through the pooling process. The small New Zealand domestic market is deregulated, so any company may sell dairy products domestically. NZDB cannot engage in cross-subsidization between domestic and foreign market sales because it neither has control over imports nor does it sell its dairy products in the domestic market.

Producers Participate in NZDB Activities

NZDB is owned by the New Zealand dairy industry.[3] Policy direction is determined by a managing board of 13 directors, 11 of whom are elected by the cooperative dairy companies and are themselves both directors and shareholders of their own companies. The other two directors are appointed by the New Zealand government, on the recommendation of NZDB, on the basis of their commercial expertise.

NZDB reports back to the dairy industry through a number of vehicles. Its publications include an annual report, which has financial and marketing information, and newsletters. It also conducts annual general meetings for farmers and meets with producer organizations, such as the Federated Farmers of New Zealand.

Audits Assess NZDB Performance and Efficiency

MAF acknowledged that producer boards[4] were not subject to the same competitive disciplines as commercial marketing organizations because of their statutory position and powers. Therefore, the government decided to subject these boards to performance and efficiency audits every 5 years, with the requirements for the audits specified in each board's legislation. According to MAF, these audits would help to give producer boards more financial autonomy and make them more responsible for their actions, improve their performance, and make them more accountable to farmers for their commercial performance and to the parliament for the exercise of their statutory powers.

[3]According to New Zealand government officials, some dairy industry groups are concerned that relative equity in NZDB is not appropriately reflected in the current ownership arrangements. NZDB is working on a proposal to provide more direct ownership to the producers while maintaining the principles in the 1961 Dairy Board Act.

[4]Five of the 11 producer boards in New Zealand are single sellers on the export market: NZDB, the Apple and Pear Marketing Board, the Kiwifruit Marketing Board, the Raspberry Marketing Council, and the Hop Marketing Board.

The NZDB's first performance and efficiency audit was published in October 1993. It was conducted by the Boston Consulting Group on behalf of the New Zealand government. The audit's overall purpose was to "assess the effectiveness and efficiency of the NZDB's activities in achieving its mission." It covered 11 major topics, ranging from personnel to communication. The overall assessment was "seven out of ten." Recommendations included a need to develop an industry vision, to conduct a review of the payments system, and to improve the key processes through which NZDB creates value for shareholders.

Pooling Disperses Producer Risk

Individual producer risk is dispersed through the pooling system. According to its enabling legislation, NZDB has the statutory power to purchase and market all dairy products intended for export.[5] NZDB acquires these products from approximately 14,000 milk producers through a series of 15 dairy cooperatives. The processed milk is sold on the export market, and returns (minus marketing and operating costs) are distributed to the cooperatives, which in turn distribute them to the individual farmers. Cooperatives pool the milk separately, so producers are paid according to the quantity of milk provided to the individual cooperative. More efficient cooperatives will have lower operating costs and will thus provide higher payments to the producers.[6] NZDB sells its products in export markets through a worldwide network of holding companies and subsidiaries.

The number of cooperatives has decreased over time, but the volume of dairy products has generally increased. The number of dairy cooperatives in New Zealand has fallen from 95 in June 1970 to 15 companies as of May 1995. However, the volume of dairy products manufactured, in actual tons, has grown in several sectors. NZDB officials credit this phenomenon to the increased efficiency of the cooperatives and their operations and the effect of a free market system.

Domestic Market Deregulated, but Small

New Zealand's domestic dairy market has been deregulated since the late 1980s. Thus, NZDB does not have the same control over the domestic market as it does the export market. In fact, NZDB stated that it is not

[5]Dairy produce intended for export, as defined in the 1961 Dairy Board Act, includes (1) any goods or produce manufactured in New Zealand and intended for export that contain more than 30 percent by weight of dairy produce and (2) any milk or cream acquired by NZDB from a cooperative dairy company for the purposes of manufacture into a product intended for export.

[6]Producers may choose which dairy cooperative will receive their milk. Thus, they will choose the most efficient cooperative in order to receive the highest return. Officials speculated that the less-efficient cooperatives may have gone out of business due to this process of natural selection.

involved directly in the marketing of dairy products in New Zealand, but that it does have a role in coordinating market promotion and other activities on behalf of the wider industry. Only 10 percent of New Zealand milk remains in New Zealand, either as raw milk or as processed dairy products.

The domestic dairy market is very small compared to the export market. For example, NZDB exported 205,000 tons of butter in 1993-94, while local market sales in 1993 totaled 32,000 tons. Similarly, typical cheese exports in 1993 were 124,000 tons, while local market sales in 1993 were 29,000 tons.

Cross-subsidization Between Domestic and Foreign Sales Not Possible

Since NZDB does not have control over the domestic dairy market, cross-subsidization between domestic and foreign sales is not possible. The NZDB's control over imports of dairy products was removed in the mid-1980s, and it does not receive any tariffs from imported dairy products. Moreover, NZDB does not even sell dairy products in New Zealand; individual dairy cooperatives may compete for shares of the domestic market.

NZDB-Government Relationship: Government Assistance Is Limited

Even though NZDB has sole export authority for New Zealand dairy products, it has not received direct government subsidies since 1984, when a governmentwide reform removed most agricultural subsidies. The New Zealand government continues to support NZDB indirectly through a research grant scheme, which benefits the dairy industry as a whole. However, the New Zealand government has removed some of the NZDB's advantages, including its access to New Zealand's Reserve Bank credit.

Direct Government Subsidies Removed

New Zealand has instituted a number of reforms that directly affected NZDB. The first and most important reform was put in place in 1984; it removed direct government subsidies to farmers. This reform was instituted virtually overnight, abolishing more than 30 agricultural production and export subsidy programs. As a result, New Zealand farmers lost nearly 40 percent of their gross income, and producer boards were forced to reevaluate their operations and marketing strategies and to implement new initiatives.

Other terminated programs included the Export Programme Suspensory Loan Scheme and portions of the Export Market Development Tax

Incentive Scheme. This scheme was available to taxpayers who incurred expenditures for the purpose of seeking markets, retaining existing markets, obtaining market information, doing market research, creating or increasing demand for the export of goods and services, or attracting tourists to New Zealand.

The Supplementary Minimum Price program applied to the dairy industry, but only one payment was made in 1978-79, of $37.8 million. The PSE on milk fell from a peak of 67 percent in 1983 to an average of 15 percent in 1985-87 and an estimated 1.7 percent in 1990.

Indirect Subsidies Support Mission, Research Goals

The NZDB's mission is further enhanced by enforcement actions written into its enabling legislation. The New Zealand government, through the Dairy Board Act of 1961, may impose fines on persons or companies that circumvent NZDB and try to export dairy goods without a license. This fine may not exceed $1,187. According to NZDB officials, such fines have not been imposed at any time.

NZDB does not receive any direct grants or concessionary loans from the government for research, but its research affiliate may compete for government research grants. Through its Public Good Science Fund, the government sponsors a variety of projects; funds are bid upon by a variety of research institutions. NZDB sponsors the New Zealand Dairy Research Institute, which focuses on fundamental, long-term dairy research; NZDB also maintains research centers in Singapore, the United Kingdom, Japan, and the United States. Other research on dairy issues takes place in New Zealand universities and at Crown Research Institutes.[7]

NZDB Lost Other Advantages

In the 1980s, NZDB lost access to Reserve Bank of New Zealand credit; it has been forced to turn to the commercial lending market to obtain loans. Thus, it can no longer obtain cheap loans through the Reserve Bank of New Zealand. In 1983, the outstanding deficit in the Dairy Industry (Loans) Account, an account that served as an overdraft facility for NZDB, was converted to a long-term loan. This $725-million loan, considered a substantial subsidy by the New Zealand government, was repayable over 40 years. In 1986, the New Zealand government conceded part of this loan and allowed NZDB to pay off the balance for $102 million as part of its

[7] In 1992, the government formed 10 Crown Research Institutes to take over the major research responsibilities from previous government agencies. These institutes do not have any core funding but operate as science contractors and are expected to be viable businesses.

transition in dissolving the NZDB's financial arrangements with the Reserve Bank.

NZDB benefits from a good credit rating, which may be related to its status as a government-established STE. However, NZDB no longer benefits from tax concessions; it is taxed on its retained earnings the same as any other enterprise. Producers pay individual income tax on their returns.

NZDB-Foreign Buyer Relationship: Subsidiaries and Outside Investments Allow for Greater Returns

NZDB's sole export authority affords it the opportunity to achieve economies of scale and provides other benefits. By using its statutory authority to export dairy products to the United States and other countries, NZDB benefits from its extensive subsidiary network and higher U.S. prices, since the U.S. price for dairy goods is higher than the standard world price. The NZDB's ability to invest in outside companies also allows it to diversify its economic interests. While price discrimination is possible and not prohibited under GATT, we were unable to analyze the extent to which NZDB or other exporters engage in this practice because we did not have access to public or private companies' transaction-level data. Likewise, we were unable to determine whether NZDB engaged in cross-subsidization between its higher- and lower-priced foreign market sales.

NZDB Has Sole Export Authority Over All New Zealand Dairy Products

The New Zealand Dairy Board Act of 1961 granted NZDB the sole authority to purchase and market all export dairy products from New Zealand. That is, all New Zealand dairy products destined for export are under the NZDB's jurisdiction; thus, NZDB is assured a certain level of product supply and the NZDB buying price is the prevailing level of compensation available to producers. To achieve this, NZDB purchases dairy produce from the cooperative manufacturing dairy companies and sells it through a worldwide marketing network of subsidiary and associate companies. NZDB is also responsible for packaging, transporting, storing, and making shipping arrangements for its exports.

NZDB has the authority to grant export licenses to other companies that want to export dairy products on their own. It may choose to grant such licenses if it is not interested in exporting a particular dairy commodity. For example, companies have successfully obtained licenses to export ice cream and certain specialty cheese products, as NZDB does not market these products.

This export authority provides NZDB with the opportunity to achieve economies of scale in its operations, which translates into the ability to spread the cost of its international operations across a large volume of sales. NZDB officials noted that individual farmers or cooperatives would have a difficult time marketing dairy products on their own; thus, NZDB provides a mechanism through which the New Zealand dairy farmer can compete in a global marketplace. NZDB's exclusive authority and size translate into market power for NZDB in certain world dairy markets. Situations where STEs or private firms supply a large share of world markets, increases the concerns about efforts of suppliers to work together to exercise their market power.

As an example of the possible exercise of this market power, U.S. dairy industry sources provided us with a June 1995 proposal addressed to the Australian Dairy Industry Council from NZDB. This proposal suggested that the two industries coordinate their supply of dairy products to satisfy new EU quotas. We spoke with industry officials from both New Zealand and Australia, who were unable to pinpoint the exact origin of the proposal. According to NZDB officials, this was an effort to respond to the two governments' agreement to maintain closer economic relations. Officials from both countries' dairy industries affirmed that the proposal was dropped.

U.S. Dairy Market Benefits NZDB

NZDB benefits from the U.S. market, as well as other restricted markets around the world, because of its subsidiaries and domestic dairy price support programs. NZDB sells its products through 88 subsidiary companies in more than 60 countries around the world, including each of New Zealand's largest trading partners. These companies are managed by geographically oriented holding companies. NZDB believes that this subsidiary framework allows it better access to markets, and these subsidiaries appear to offer particular advantages in markets restricted by quotas, such as the United States. The NZDB's subsidiaries, such as Western Dairy Products, Inc., can import New Zealand cheese that is subject to quota and help NZDB realize profits that would otherwise go to unaffiliated U.S. importers. For example, under the U.S. quota system, New Zealand's allocation of cheese can be assigned to any licensed U.S. importer.[8] The New Zealand government has the authority to choose the U.S. importers of New Zealand cheese. NZDB may encourage the New Zealand government to select the NZDB's own subsidiaries to import the cheese, thus keeping the cash flow within the organization.

[8]For a more comprehensive explanation of the U.S. cheese quota system, see GAO/RCED-95-280R.

NZDB can take advantage of the difference between world and U.S. prices by selling its goods through wholly owned subsidiaries in the United States. U.S. prices are significantly higher than world prices because (1) the U.S. dairy program keeps domestic prices more elevated than they would otherwise be and (2) the U.S. cheese import quota system restricts the supply of generally lower-priced imports. Thus, NZDB can get the greatest advantage for its sales by working through subsidiaries.

NZDB Can Invest in Other Companies

As of 1988, the New Zealand government granted NZDB the "powers of a natural person." This allowed NZDB to, among other commercial practices, enter into contracts and invest in other businesses. NZDB has taken advantage of this privilege by investing in businesses in other countries and thus diversifying its economic interests. For example, during the 1993-94 season, NZDB formed New Zealand Milk Products (Egypt) Ltd., a 100-percent subsidiary to manufacture and market ghee, and New Zealand Milk Products Treasury (S) Pte Limited in Singapore as a treasury and reinvoicing center for the South East Asia region.

Price Discrimination, Foreign Market Cross-subsidization Not Determined

We could not determine whether or not NZDB engaged in price discrimination because we did not have access to public or private firm transaction data. Similarly, we were unable to ascertain whether or not NZDB subsidized its sales in one foreign market with higher-priced sales in another foreign market. Some U.S. dairy industry sources expressed concerns regarding the NZDB's potential to cross-subsidize its sales between foreign markets, but we had insufficient data to make a judgement on this potential practice.

Framework and Country Information

	CWB	AWB	NZDB
	In 1993-94, more than two-thirds of Canada's wheat production was exported. Canada has about a 22% share of world exports of wheat and wheat flour.	In 1993-94, more than three-quarters of Australia's wheat production was exported. Australia had about a 13% share of world exports of wheat and wheat products.	New Zealand exports about 90% of its dairy production. In 1993, NZDB had about an 11% share of world exports of skimmed milk and a 13% share of world exports of cheese.
Relationships of STEs			
Relationship with producers			
Management and ownership	CWB is a quasi-governmental organization that markets grain on behalf of Canadian farmers. Government-appointed commissioners administer the program, while farmers are represented by an 11- member producers' advisory committee.	AWB works to maximize the net returns to Australian wheat growers by securing, developing, and maintaining markets for wheat products. Its managing board includes producers.	NZDB exports dairy products on behalf of producers. Its managing board is mostly elected by dairy cooperatives. NZDB reports to the dairy industry through a variety of mechanisms and undergoes a performance and efficiency audit once every 5 years.
Pooling	Pooling western Canadian wheat and barley production (1) removes the timing of sales as a factor for farmers and (2) distributes the market risks and advantages to all farmers while also allowing them to share resources.	AWB pools its returns for each variety and class of wheat and distributes them to the farmers minus marketing, operating, storage, and transport costs.	Dairy farmers deliver their milk to dairy cooperatives that pool and process the milk separately, then turn the dairy products over to NZDB. Market risk is dispersed, and dairy farmers receive their payments based on the efficiency of the cooperatives.
Authority (domestic and imports)	CWB has authority over all Canadian wheat and barley export sales, as well as over all western Canadian wheat and barley sold for domestic human consumption. CWB had control over all imports of wheat and wheat products until August 1, 1995.[a]	AWB handles anywhere from 30% to 80% of the domestic trade in wheat. AWB does not have control over wheat imports.	NZDB does not sell dairy products in the deregulated domestic market. The dairy cooperatives compete for domestic sales. NZDB does not have control over dairy imports.
Potential ability to cross-subsidize between domestic and foreign market sales	CWB has limited potential to cross-subsidize wheat exports, and somewhat greater potential to cross-subsidize barley exports in this manner.	AWB does not have the potential to cross-subsidize in this manner.	NZDB does not have the potential to cross-subsidize in this manner.

(continued)

	CWB	AWB	NZDB
Relationship with government			
Direct subsidies	The Canadian government has covered CWB wheat pool deficits during 3 crop years, and barley pool deficits during 7 crop years, requiring over $1.2 billion in government payments.	The Australian government's price support schemes were removed in 1989. AWB benefits from a government guarantee on its borrowing to pay wheat producers (up to 85% of expected net return).	Direct government subsidies to the dairy industry were removed in 1984. NZDB has not received subsidies since 1983 when the New Zealand government allowed NZDB to take out a long-term loan on extremely favorable terms.
Indirect subsidies	As a crown corporation, CWB is able to maintain a high credit rating on its commercial loans for initial payments. CWB pays no taxes to the federal government or any other provincial government. Returns to the producers are taxed as regular income. The Canadian government provides some domestic support (crop insurance, research, and income support) to farmers, as well as indirect subsidies covering the transportation of grains.[b]	AWB officials acknowledged that the government guarantee may translate to favorable interest rates. AWB receives levy funds to support capital investments and domestic trading operations. AWB does not pay tax on its commodity sales, but pays corporate tax on holdings and investments. Returns are considered personal income for the farmers and are taxed under Australia's income tax system. Research funds and other economic relief are also available.	NZDB indirectly benefits from research subsidies to its research affiliate. NZDB has a good credit rating, which may be related to its status as an STE. The NZDB's retained earnings are subject to taxation. Producers' incomes are also taxable under New Zealand's income tax system.
Relationship with foreign buyers			
Single seller	CWB has authority over all Canadian wheat and barley destined for export.[c] Thus, it has a sure source of supply and can use economies of scale to disperse the cost of operations.	AWB has authority over all Australian wheat destined for export. Thus, it has a sure source of supply and can use economies of scale to disperse the cost of operations.	NZDB controls all New Zealand dairy products destined for export. Thus, it has a sure source of supply and can use economies of scale to disperse the cost of operations. It may grant export licenses to other companies that wish to export dairy products.

(continued)

	CWB	AWB	NZDB
Commercial practices	The lack of transparency in the CWB's pricing methods may provide CWB with greater pricing flexibility than is found among private sector traders and the ability to cross-subsidize between foreign market sales.	Price flexibility and foreign market cross-subsidization are possible due to a lack of transparency. Stronger efforts toward market-based activities were encouraged in a recent government-sponsored report.	The NZDB's subsidiaries allow it to benefit from the U.S. dairy market's quota system and price supports. Price discrimination and predatory pricing are possible, but not confirmed.

[a]On August 1, 1995, the licensing procedure was replaced by a tariff-rate quota, negotiated by the Canadian government under the terms of the GATT. This tariff-rate quota is administered by the Canadian federal government. Canada removed the import-licensing requirement for U.S. wheat and wheat products entering Canada in May 1991.

[b]The transportation subsidy ended on August 1, 1995.

[c]This control extends to the exports of the Ontario Wheat Board as well. However, farmers are allowed to buy back their wheat and barley from CWB and sell it for export themselves.

Comments From the U.S. Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of Agriculture | Foreign Agricultural Service | Office of the Administrator | Washington, D.C. 20250-1000

Ms. JayEtta Z. Hecker
Associate Director
International Relations and Trade Issues
General Accounting Office
441 G Street, N.W., Room 4482
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2 MAY 1996

Dear Ms. Hecker: JayEtta

In the General Accounting Office (GAO) draft report, "Canada, Australia, and NewZealand: Potential Ability of Agricultural State Trading Enterprises to Distort Trade," GAO reviewed the activities of three state trading enterprises (STEs) in Canada, Australia, and New Zealand--the Canadian and Australian Wheat Boards and the New Zealand Dairy Board. GAO developed a conceptual framework to analyze the trade-distorting nature of the three STEs and provided some evidence of the extent to which each of the three STEs distorts trade in its respective commodities. GAO did not make specific recommendations in the report.

Now on p. 16.

While the draft report provides some useful insights into state trading issues, the multilateral focus on monitoring state trading activities has been evolving rapidly. Because STEs are primarily involved in agricultural products, USDA, in coordination with USTR and other USG agencies, has played an active role in the WTO Working Group on State Trading Enterprises. USG objectives are to seek greater transparency and ensure that these entities are operated in a manner consistent with WTO rules. This Working Group has established a pro-active agenda to address concerns about the potential trade distorting effects of some STE practices, including a complete reformulation of the questionnaire for annual notifications as well as establishing an illustrative list of state trading activities.

Now on pp. 18 and 46-47.

The GAO investigation covers the period April through October 1995 and does not incorporate information from this latest round of STE notifications to the World Trade Organization (WTO). The work of the U.S.-Canada Joint Commission on Grains and subsequent analyses of the Canadian Wheat Board also contains valuable information which would strengthen the GAO analysis. We believe the GAO report would more effectively communicate current state trading issues if it incorporated these recent developments and analyses.

Further, while it is useful to understand the operations of export-oriented STEs and to ensure transparency in their operations, USDA believes that it is equally important to understand and develop disciplines on import-oriented STEs. Most of the countries which are currently in the process of acceding to the WTO use state trading entities to some extent to regulate their imports. USDA considers the potential for significant trade distortion by such entities in China, the Former Soviet Union and other important agricultural nations, to provide a significant impetus

FAS Foreign Agricultural Service is an Agency of the United States Department of Agriculture to focusing our efforts within the WTO to impose stricter controls on STEs. While we recognize that this report only deals with the three export STEs, we look forward to any future analyses examining import STEs.

Now on pp. 6 and 23.

The conceptual framework proposed in Chapter II, "A Framework for Congressional Reference and Review of STEs," defines the trade distorting aspects of the three STEs in terms of their control of domestic production and marketing, government subsidies to STEs, and control and manipulation of export markets. As described in the introduction to this section, this framework is clearly limited to export STEs. A different framework would be required to fully analyze import STEs. Therefore, we believe the title of this section should specify that it only deals with export STEs. A similar addition should be made in the executive summary where the framework is described.

See comment 1.

The separate categorization of "cross subsidization" in Chapter II could confuse readers. Readers might better understand the explanation of cross subsidization and its relation to export sales if the report presented the conceptual analysis of the STE's relationship with foreign buyers directly after the section on control of domestic production and marketing and used the explanation of cross subsidization as the link between the two sections.

Now on pp. 26 and 45.

The report's coverage of the control of domestic production leaves out important benefits for the three STEs. First, an STE that controls domestic supplies or controls exports representing a major share of domestic production has a sure supply. This permits the STE much greater freedom than a private firm in making export sales commitments and allows the STE to make long-term agreements with importing country governments. Second, when an STE like the Canadian Wheat Board (CWB) has monopoly purchasing power and provides an initial payment to farmers that is below market prices, it has the flexibility to engage in a large degree of discretionary pricing. Whether or not it does so is hard to determine due to the lack of transparency in pricing. However, if, for example, the initial payment was 70 percent of the estimated market return, then the CWB theoretically has the potential to engage in discretionary pricing for up to 30 percent of the value of the commodity.

See comment 2.

The report assesses the three STEs' ability to distort trade, but provides little empirical evidence to support its arguments. Chapter III, the Canadian Wheat Board (CWB), could include a stronger discussion of the CWB's pricing policies. In spite of the currently-insufficient data to test hypotheses about price discrimination, the Joint Commission on Grains (JCG) report provides a more thorough treatment of the pricing policies of the CWB. In addition, the farm income effects of the CWB pricing system were analyzed in two recently-released academic studies. (See specific comments attached.) The presentation of indirect government subsidies such as interest rate subsidies also could be expanded for the CWB and other STEs.

Now on pp. 70-71.

The analysis of the New Zealand Dairy Board (NZDB) is somewhat misleading because it doesn't emphasize the strength of the Board's impact on prices and, thereby, on production in future years. In 1994/95, approximately 95 percent of New Zealand's milk production was

Ms. JayEtta Z. Hecker 3

exported; all exports were handled by the NZDB. Thus, for dairy cooperatives and ultimately milk producers, the NZDB buying price is the only price. Along with the price advantage, the NZDB status as a monopoly seller gives the NZDB an assured supply of dairy products. Consequently, the NZDB can make forward sales with set prices without concerns that supply will be available at the time of delivery.

Enclosed for your review are specific comments for an expanded discussion of the activities of the WTO Working Group on State Trading Enterprises.

Sincerely,

August Schumacher, Jr.
Administrator

Enclosure

The following are GAO's comments on the Department of Agriculture's letter dated May 2, 1996.

GAO Comments

1. Although cross-subsidization is an issue that spans many topics, we believe the structure of our framework is best left as is, given the relationships between the sections. We took a number of considerations into account when developing our economic framework, including natural progression and logical flow.

2. In chapter 3, we outline the Joint Commission on Grains' recommendations and its discussion on discretionary pricing. We also have incorporated summaries of the two academic studies in chapter 3. We believe that we have adequately covered the benefits of indirect subsidies in chapters 3, 4, and 5.

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Related GAO Products

Cheese Imports (GAO/RCED-95-280R, Sept. 29, 1995).

State Trading Enterprises: Compliance With the General Agreement on Tariffs and Trade (GAO/GGD-95-208, Aug. 30, 1995).

GAO/OGC-95-24, July 28, 1995.

International Trade: Canada and Australia Rely Heavily on Wheat Boards to Market Grain (GAO/NSIAD-92-129, June 10, 1992).

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