

Why Canadian Hog Subsidies Are Injuring U.S. Hog Producers

Nick Giordano

National Pork Producers Council, International Trade Counsel, 122 C Street N.W., Suite 875, Washington, DC 20001 USA; **Email:** giordann@nppc.org

■ Executive Summary

U.S. hog producers are among the most efficient and productive in the world. Efficiency and productivity thrive in an open, competitive environment. Free and open trade benefits producers, packers, and consumers in the United States, Canada and globally. The long-term growth and health of the North American pork industry depends on free and open trade. To this end, NPPC has strongly supported and promoted free and open trade.

As a corollary to this fundamental position, subsidies distort free and open trade and wrongfully benefit the recipient of the subsidy at the expense of producers in other countries. In particular, the Canadian subsidies given to Canadian hog farmers have distorted free and open trade. By ensuring that a Canadian producer will always receive a steady level of income regardless of market conditions, these subsidies allow Canadian hog farmers to ignore market signals. By eliminating risks associated with hog production, even during the down period of the hog cycle, Canadian hog farmers continued to invest and expand their herd size.

Given its small size, the Canadian market is unable to absorb the overproduction of the Canadian herd. This excess production has been exported to the United States at prices that were lower than prices in Canada and at prices that were lower than US producers' prices. The results were not surprising. As low-priced Canadian hog exports increased, US producers lost sales, had to lower their own prices, and were forced to endure sustained losses.

In light of this untenable situation, NPPC's longstanding and current objective has been elimination of trade-distorting Canadian subsidies. As noted earlier, elimination of these trade-distorting subsidies is critical to the long-term health

of the U.S. pork industry. To date, however, Canadian producers have rebuffed NPPC's proposals to restore free trade and have refused to renounce the subsidies.

NPPC is seeking relief from the injurious impact of the subsidies in two ways. First, in March 2004, NPPC filed a countervailing duty and antidumping duty petition with the U.S. Commerce Department and the U.S. International Trade Commission. Second, in November 2004, NPPC filed a request with the United States Trade Representative, the U.S. Secretary of Agriculture, and the U.S. Secretary of Commerce asking that the U.S. Government engage in consultations with the Canadian Government to reach a bilateral trade agreement that would eliminate subsidies to Canadian hog farmers.

■ **The Canadian Government Provides Substantial Subsidies**

NPPC has long been the champion of free and open trade and has consistently recognized that government-imposed trade measures are harmful to the global pork market – harmful to producers, packers and consumers, in the United States, Canada and worldwide.

The Canadian Government, however, has persisted in providing substantial subsidies to the Canadian hog producers. In response to earlier efforts by NPPC calling upon Canada to renounce these subsidies, the Canadian Government responded not by eliminating the subsidies but by camouflaging the subsidies under the guise of "Whole Farm Subsidies." Despite the name assigned to these benefits, there is no disguising that Canada's various income stabilization programs provide a disproportionate benefit to the Canadian hog industry.

Information published by the Government of Canada confirms that, during the past few years, on a per farm basis, Canadian hog farmers have received substantial subsidies. For example, **Figure 1** indicates that virtually all of the net income that Canadian hog farmers received in 1999 was attributable to program payments. In 1999, Canadian hog farmers earned an average of \$45,000. Of that income, \$43,000 was attributable to program payments. In 2002, Canadian hog farmers had a net income of \$46,000. Of that, more than half, or \$25,000, was attributable to program payments. Consequently, Canadian hog farmers are guaranteed an income regardless of economic conditions.

Figure 1. Program Payments and Net Cash Farm Income
(Source: Statistics Canada)

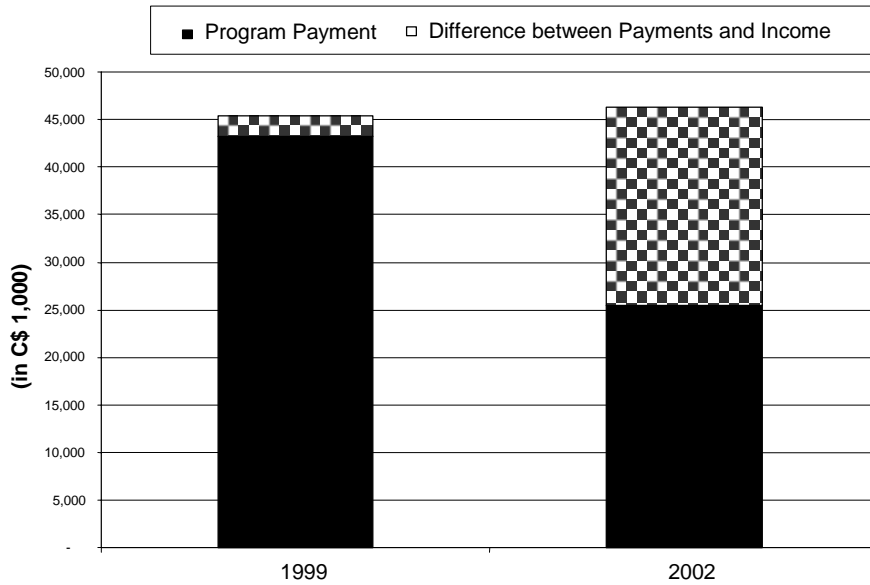


Figure 2. Comparison of Returns from U.S. Farrow to Finish Hog Production With and Without A Canadian Style Income Guarantee

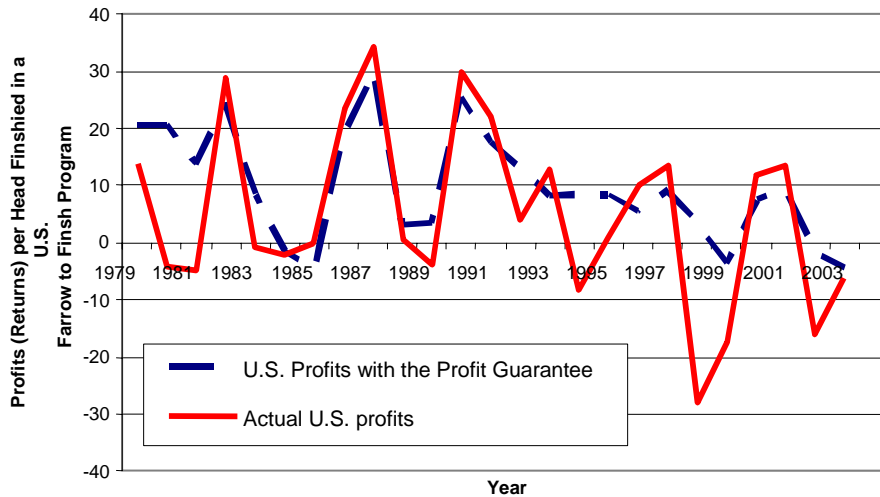


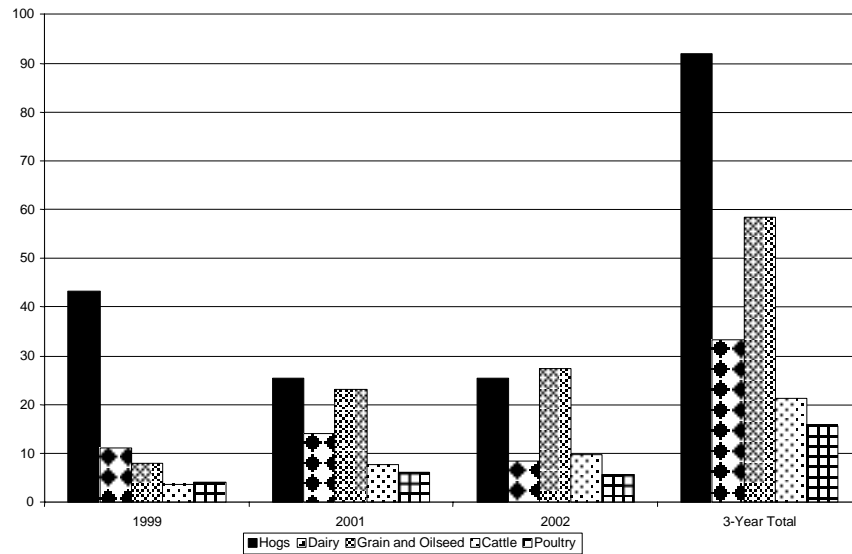
Figure 2 shows the profitability of Iowa farrow-to-finish operations with and without a farm income support program that exactly mimics the Canadian farm income program (CAIS). This program pays the hog producer when income falls below the Olympic average of the past five years. U.S. economists have estimated that the value of this program is worth \$4 to 6 per head. Economists at the George Morris Center and the OECD have estimated the value of this program to Canadian hog producers is in the range of 7% to 8% of production costs.

As demonstrated in Figure 2, this program effectively takes all of the risk out of farrow-to-finish production in Canada. Access to this program allows Canadians to build capital intensive breeding units knowing that they will make enough in income to pay off the debt. U.S. producers and their bankers have no such guarantee and it is therefore not a surprise that all of the new sows added in North America over that past decade have been in Canada. With an industry as mobile as hog production, it is absolutely essential that both countries that are party to a free trade agreement use the same policies. This has not been the case and the U.S. pork industry has suffered. The purpose of the NPPC action is to eliminate the market distorting Canadian policies so that that North America can experience the enormous benefits that come with free and open trade.

Canadian hog farmers have also received a disproportionate share of federal and provincial funding on a per farm basis. As shown in **Figure 3**, over the three years for which public data are available, on a per farm basis, hog farmers received a majority of program payments. Even these statistics understate the degree to which Canadian hog farmers receive disproportional benefits under Canada's income stabilization programs, because the figures include payments for subsidies for which hog farmers are not eligible, such as crop insurance.

Significantly, the income stabilization programs that make up a large portion of the payments received by hog farmers are especially targeted at the hog industry. This special treatment for the hog industry occurs in part because other Canadian subsidy programs benefit other agricultural industries. For example, the poultry and dairy industries have managed production support programs. Crop industries, such as the multitude of grain and oilseed industries, have crop insurance. The cattle industry has land-usage subsidies available to it. Furthermore, non-hog farmers tend to have diverse operations, thereby allowing them to benefit from a wide variety of other subsidy programs. In contrast, in recent years, Canadian hog farmers are generally more highly-specialized than other type of farmers, and therefore, without as much diversity. Thus, due to the specialized nature of the facilities, hog farmers must make substantial capital asset expenditures to expand their hog operations.

Figure 3. Federal and Provincial Program Payments on a Per Farm Basis
 (source: 2003 Farm Financial Survey (Statistics Canada) Tables 3-7.)



Note: Statistics Canada did not collect these data for 2000.
 Source: 2003 Farm Financial Survey, Statistics Canada, Table 3-7

Figure 4. Debt as Percent of Assets, by Farm Type Annual 1995, 1997, 1999, 2001, and 2002
 (Source: Statistics Canada)

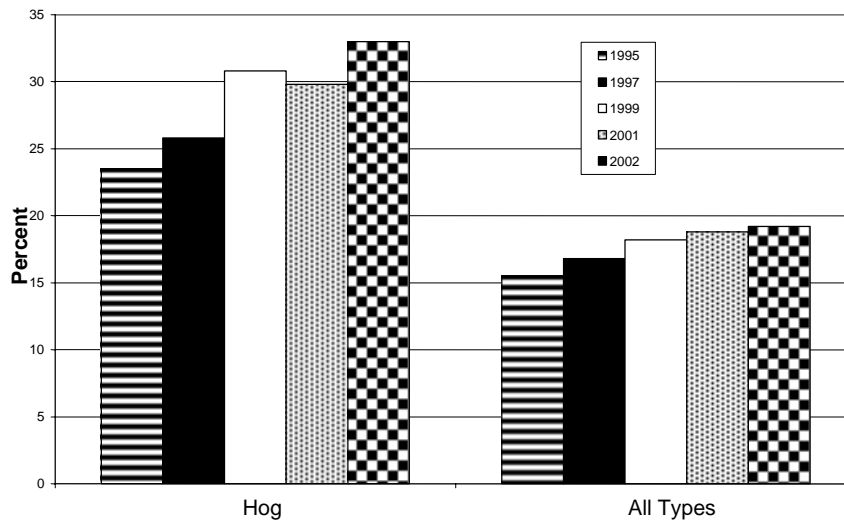
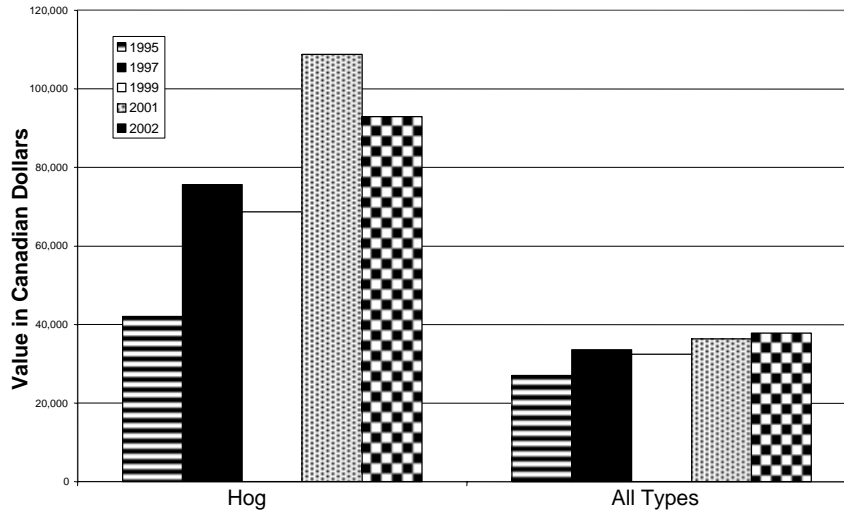


Figure 5. Average net capital investment by farm type annual 1995, 1997, 1999, 2001, and 2002

(Source: Statistics Canada)



These capital expenditures and growth in investment in Canada have been especially promoted by the income stabilization programs available to Canadian hog farmers. Under these income stabilization programs, the more expenditures, the greater the amount of subsidy that is received. Indeed, these particular subsidies appear to have caused large hog farms in Canada to have substantially higher capital expenditures, and accompanying higher level of debt, than other types of farming operations (**Figures 4 & 5**). These hog farms can borrow and expand their operations because of the protection afforded them by income stabilization programs.

In a non-subsidized environment, there would be no incentive to expand operations during periods when prices and revenues are declining or suppressed. Yet, as a result of income stabilization programs, the risk in expanding operations is reduced. Capital is attracted to two things: high returns and low risk. The lower risk provided by Canadian income subsidies and historically high returns to hog production in North America worked together to attract capital to the Canadian industry, thereby causing more expansion in the Canadian breeding herd than would have been warranted without the artificial reduction in the risk level faced by Canadian hog producers. In contrast, the higher level of risk in the United States caused a reduction in breeding herds. Canada does not have a large population. Consequently, the majority of the increase in pig and production output has to be exported. The increased production comes, in large part, to the United

States, where it drives down market prices below what they would otherwise have been had the Canadian government not artificially reduced the level of risk faced by Canadian producers. These subsidies distort the risk-return trade-off that drives capital markets, causing over-investment and over-production. When that over-production is exported to another country, in this case, the United States, it harms the U.S. industry, without affecting the risk-return situation in Canada. The Canadian producers still get the floor income level regardless of how low prices may fall.

Thus, the income stabilization programs in Canada disproportionately assist the Canadian hog industry while at the same time encouraging expansion of the breeding herd size contrary to actual market conditions.

■ **Dumping by Canadian Producers Reflects the Disparity and the Lack of Integration of the North American Hog Market**

Price disparities between Canada and the United States have been created as a result of subsidies. The dumping margin calculates the difference between Canadian home market prices and the prices paid in the United States for Canadian hogs. Imposition of a dumping duty does not foreclose imports from entering the United States and certainly NPPC is not seeking to close the U.S. borders to Canadian hogs. Rather, the duty is designed to offset the unfair pricing disparity. If the Canadian subsidies were renounced, no antidumping duty would be necessary.

To minimize the significance of the dumping investigation, many Canadian reports state that the dumping margins in this investigation are a result of sales below cost. To support their view that the dumping laws are “unfair and protectionist,” Canadian producers claim that they are simply price takers in the U.S. market, and therefore have no control over the price they receive. These claims do not properly reflect the dumping law in general or the dumping margin in particular.

The dumping law is not intended to stop the flow of imports, nor is its objective to protect inefficient, weak, U.S. producers. To the contrary, the dumping laws do not prohibit imports but are intended solely to offset unfair trade practices. It bears repeating that if the Canadian Government did not subsidize its hog industry, U.S. pork producers would not have filed this trade action. Rather, the subsidies have distorted the normal hog cycle and have disrupted the free flow of the market. The dumping law is simply a means to offset disparities in prices between two markets and is properly used by U.S. producers to try to return equilibrium to the marketplace.

Moreover, dumping margins measure the difference between prices in Canada and prices in the United States. If the U.S. and Canadian market were an integrated market, and if Canadian hog producers were only price-takers, one would expect that there would be no difference between the Canadian and U.S. price. The reality is, however, that Canadian prices are higher than U.S. prices. The ability of Canadian producers to sell their hogs at higher prices in Canada and lower prices in the United States is a reflection of the subsidies that are being received. Since the Canadian producers have over-expanded their own herd size, the Canadian market cannot absorb this production, and Canadian hog farmers must export. These producers sell this over-production in the United States at prices that are not only lower than their own Canadian prices, but lower than U.S. producers' prices. If subsidies were terminated, this pricing disparity would be eliminated. Given that the Canadian Government will not terminate the subsidies, the dumping margin is an appropriate method to offset the price disparities.

The U.S. Department of Commerce gathered information on the Canadian hog farmers' costs of production. As explained earlier, however, dumping cannot be viewed as a simplistic measure of the degree to which a Canadian producer may sporadically sell its product in the United States at prices that are below cost. Rather, the Department's dumping analysis is designed to ensure that the dumping calculations are a fair measure of pricing disparities between the two markets. The Commerce Department will first determine whether sales in Canada were sold below the Canadian producers' cost of production. The Department's typical analysis is not done on a sale-by-sale basis. Rather, the Commerce Department will calculate an annual weighted average cost of production for each type of hog: i.e., a slaughter hog, feeder hog or isowean. Sales below cost in Canada will only be eliminated if a Canadian producer sells below its annual weighted-average cost of production on 20% or more of its home market sales. Even when more than 20% of the home market sales are below cost, the dumping margins that are calculated are based on home market prices, not cost of production data, unless ALL of the home market sales were sold below cost or if there were no home market sales.

The economic impact of the duty is designed to correct the foreign country's unfair trade practices. In the case of live swine, agricultural economists have predicted that Canadian imports into the U.S. will increase in price by approximately 10% of the duty, while Canadian prices will decrease by about 90% of the duty. This price increase in the U.S. will make imports less attractive and will make it more attractive for U.S. producers to grow their herd size to supply the market previously supplied by imports. In contrast, the decreasing price in Canada may result in an oversupply situation in Canada, causing Canadian producers to decrease the size of the herd in Canada. This result would serve to restore the equilibrium in the marketplace that would have occurred in the absence of subsidies.

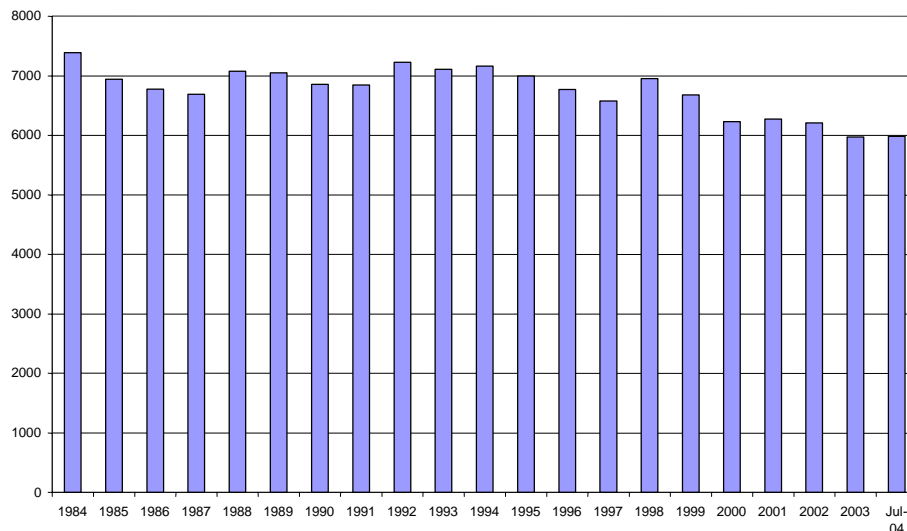
In sum, it is disingenuous for Canadian producers to protest that the dumping calculations are a protectionist measure designed to cut off trade. The dumping law is meant to offset the trade-distorted disparities between two markets and to restore fairness to the marketplace. If the subsidies to hog farmers are terminated, this case would be unnecessary. If the subsidies continue, the trade measures are necessary to restore balance in the marketplace.

■ Subsidized Hog Imports From Canada have Injured U.S. Hog Farmers

The significant subsidies that have been received by the Canadian hog producers have conferred a competitive benefit that has enabled Canadian producers to increase the Canadian swine breeding herd to a record 1.592 million head as of July 2004. Since April 1996, the Canadian breeding herd has grown from one quarter to the next in 21 of 34 quarters, including 21 of the last 22 quarters. (Figures 6 and 7) Thus, the effect of the market-distorting subsidies has allowed Canadian hog producers to defy the normal hog cycle and increase production at the same time that U.S. hog producers are responding to the normal hog cycle and reducing their herd sizes.

Figures 6. U.S. hog breeding herd (thousand head)

(Source: USDA)



Figures 7. Canadian hog breeding herd (thousand head)
 (Source: Statistics Canada)

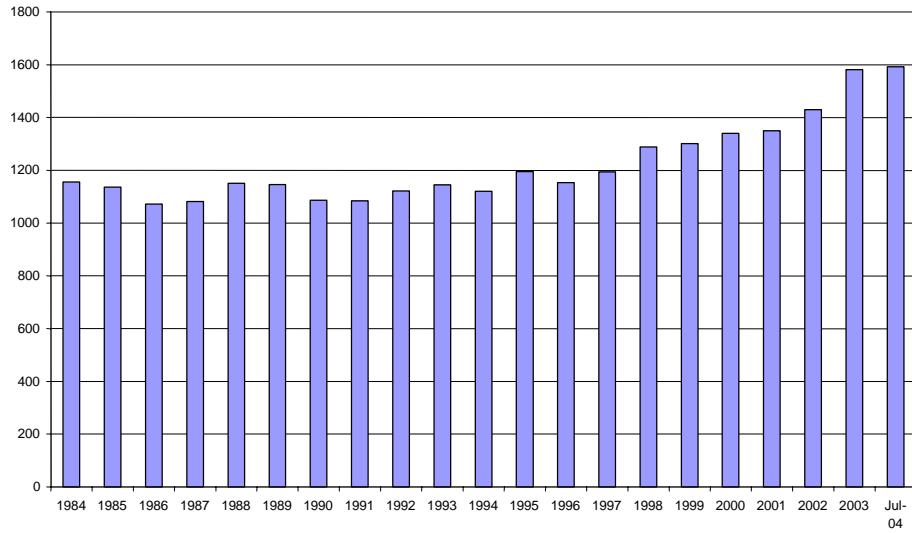
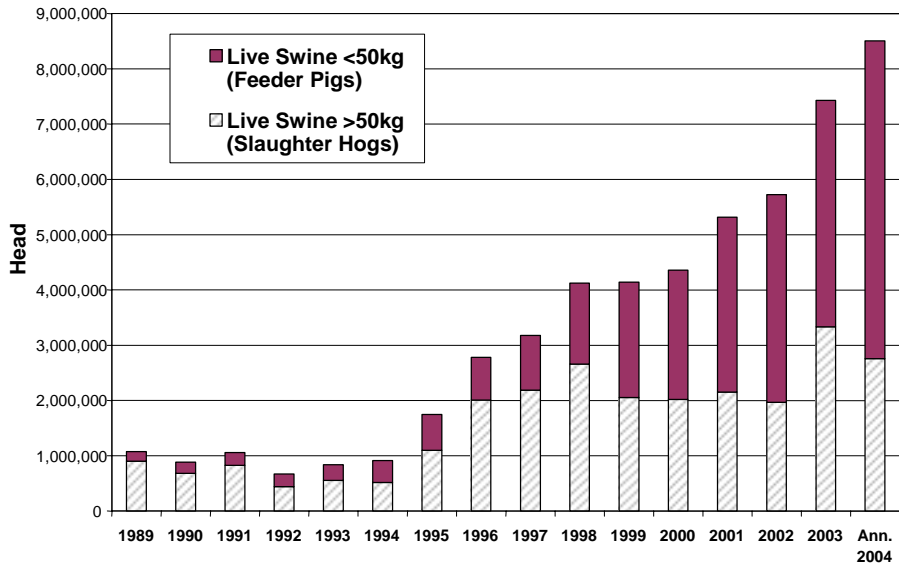


Figure 8. US Swine Imports from Canada
 (Source: U.S. Department of Commerce)



Indeed, hog imports from Canada grew from 5.3 million head in 2001 to 7.4 million head in 2003 and continued to grow in 2004, from 5.3 million head during January to September 2003 to 6.4 million head during January to September 2004 (see **Figure 8**). Reflective of this increase is the Canadian producers' steady growth of their breeding herds despite economic conditions. The Canadian producers have grown their herds from 1.361 million sows in 2001 to 1.578 million sows in 2003 and continued to grow their herds by an additional 14,000 sows during January to July 2004. At the same time, U.S. producers reduced their breeding herds from 6.27 million sows in 2001 to 5.97 million sows in 2003 (see **Figures 6 and 7**). The persistent increases in Canadian breeding herds and production coupled with the relatively small size of the Canadian market has led to a significant increase in exports to the United States, which has resulted in an oversupply of hogs in the U.S. market. In the face of a significant oversupply, prices plummeted in 2002 and 2003. U.S. hog producers experienced financial losses throughout 2002 and 2003 because of declining prices for live hogs.

Certainly, economic factors other than the subsidies affect market conditions. But the fact remains that in an integrated market, Canadian producers should have reacted in the same manner as U.S. producers in the face of plummeting prices. Canadian producers, however, have continued to expand production. Receipt of subsidies has disrupted normal agricultural cycles, allowing Canadian producers to grow their herd sizes regardless of economic conditions. This has resulted in oversupply, much of which is exported to the United States, further disrupting normal hog cycles in the United States. While prices in the U.S. may increase due to factors apart from the Canadian hog imports, the subsidies still work to suppress prices below what they would otherwise be if normal market conditions prevailed. The receipt of subsidies by Canadian producers puts them in a better position to accept, rather than reject, low prices offered by U.S. packers. It also enables the Canadian producers to continue expanding their stock of breeding swine even though market prices do not warrant this expansion. The acceptance of lower prices by the Canadian producers then encourages U.S. packers to hold prices steady or to lower them in relation to the next transaction. Thus, U.S. producers of live swine are faced with lower prices because of the receipt of subsidies by their Canadian competitors. A comparison of U.S. prices for market hogs and Canadian import AUVs for market hogs shows underselling by Canadian producers in every month for the period of January 2001 to July 2004, with margins of underselling averaging 17 percent

Although the pricing and financial trends are cyclical in the hog industry, the increase of low-priced imports from Canada has resulted in significantly more losses in the past several cycles compared to the cycles occurring prior to 1992. The consistent growth in imports has created an oversupply of live swine in the market that has significantly shifted pricing and profitability trends downward over a 10-year period. The continued increase in imports over the

past several years culminated in a sustained period of financial losses during 2002-2003, which forced U.S. producers to significantly reduce their breeding herds to historically low levels.

■ Conclusion

The Canadian income stabilization subsidies create substantial incentives for Canadian hog farmers to increase their herd size and eliminate any risk involved in doing so. U.S. hog farmers that respond to normal market conditions must absorb the risk. If market conditions deteriorate in Canada, the Government increases its subsidies to Canadian hog farmers. These hog farmers do not respond to market signals and continue to invest and continue to grow their herd size. When market conditions deteriorate in the U.S., U.S. hog farmers must respond to economic signals. They cut their herd size. If market conditions deteriorate, U.S. hog farmers lose money or go out of business; if market conditions improve, improvements are short-lived and prices will not rise to levels that would otherwise prevail in a normal hog cycle.

Only one solution is evident. The trade-distorting subsidies must be eliminated.