POLITICAL ECONOMY OF THE U.S.-CANADA SOFTWOOD LUMBER DISPUTE

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The United States and Canada enjoy the benefits of the world's largest bilateral trading relationship. The United States accounts for about eighty percent of Canada's total foreign trade, and Canada accounts for more than twenty percent of the goods and services trade of the United States. The two-way trade amounts to well over U.S.$1 billion per day. For the most part this trade flows smoothly and frictions concerning it rarely arise. However, United States-Canada trade is plagued by recurrent disputes within natural resource industries—the most important and persistent of these disputes is that concerning trade in softwood lumber. The intractability of this dispute is rooted in differences in ownership and management of natural resources in the United States and Canada, which in turn are reflections of different attitudes toward the role of the state in the two countries. Because these

*A list of acronyms used in this article is provided on page 46.

differences are unlikely to change within the foreseeable future, a permanent solution to the softwood lumber dispute is unlikely. The greatest hope for resolution is continued integration of the United States and Canadian softwood lumber industries. However, whether even increased integration of the industries can resolve the dispute is uncertain so long as differences in ownership and management of natural resources in the two countries persist.

I. BACKGROUND

Softwood lumber trade between the United States and Canada has been a matter of some contention from the time that the Canadian Constitution gave provinces the rights to forest resources in 1867.[1] While arguments on both sides have taken on increased sophistication during the past quarter-century, the dispute is rooted in the long-standing structural differences in the Canadian and United States forestry industries. Some historical perspective reveals that attempts to restrict softwood lumber imports into the United States are nothing new.

For a brief period of time in the mid-nineteenth century free trade in softwood lumber between the United States and Canada existed by virtue of the Reciprocity Treaty of 1854 which "provided for the free entrance into either country of natural products and unmanufactured raw material from the other." (Lower, 1938) However, the United States abrogated the Reciprocity Treaty in 1866 and

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imposed a twenty percent tariff on Canadian lumber, which was countered by a Canadian export tax of one dollar per thousand feet on pine logs (later increased to two dollars). (Lower, 1938)

In 1890 the United States reduced its tariff by one-half in return for Canada's removing its export tax on logs which were desired as inputs by the United States lumber industry. For a brief period from 1894 to 1897, free trade again prevailed between the United States and Canada in lumber products. However, with the Dingley Tariff of 1897 the United States lumber industry succeeded in having a $2 per thousand board feet import tariff on lumber reimposed. (Lower, 1938)

Early in the twentieth century the United States proposed another reciprocity treaty providing for free trade in natural resource products, but this time Canada rejected the proposal. In the Underwood-Simmons Tariff Act of 1913, despite pressures for continued protection by the domestic lumber industry, the United States Congress removed the tariff from softwood lumber. (Braudo and Trebilcock, 2002) This situation did not last for long, however. The Fordney-McCumber Tariff of 1922 established an average tariff rate on "Wood and manufactures" at 7.97 percent. (Taussig, 1931) The Smoot-Hawley Tariff of 1930 placed a specific tariff of $1 per thousand board feet on softwood lumber.[2] This act was amended in 1932 to raise the rate to almost twenty-five percent *ad valorem* equivalent, with severe economic impact on the Canadian industry. The tariff was reduced by about one-half by a trade pact agreed in 1935. (Reed, 2001) Subsequent trade negotiations reduced the tariff further so that by the 1950s the rate of protection was relatively low. In this favorable environment the Canadian import share of the United States market increased from around 5 percent in the late 1940s to over 13 percent in 1961. (Reed, 2001)

In 1962 the United States Tariff Commission USTC), precursor to the United States International Trade Commission, investigated a charge by the United States lumber industry that it was being harmed by Canadian competition. United States producers proposed a market-sharing arrangement whereby lumber imports would enter duty free until they reached 10 percent of the domestic market but would face a 10 percent tariff thereafter. (Grafton, *et al.*, 1998) However, in early 1963 the USTC ruled that the lumber industry was neither injured nor threatened with injury by imports from Canada, so no new protection was imposed. (Reed, 2001)

As a result of the Kennedy Round of multilateral trade negotiations conducted between 1962 and 1967, the United States agreed to gradually phase out import tariffs on softwood lumber between 1968 and 1972. During this period concern existed in the United States that timber supplies were being depleted and that housing costs would increase as a result. Remarkably, an Advisory Panel on Timber and the Environment sought assurances from the Council of Forest Industries of British Columbia that Canada would be able to supply increased quantities of lumber at stable prices. However, the economic recession of 1981 caused a sharp drop in lumber prices, resulting in a bailout of the purchasers of federal timber contracts that cost United States taxpayers approximately $2 billion. (Reed, 2001) Consequently, protectionist pressures revived and have continued unabated since then.

Before discussing the dispute as it has unfolded over the past quarter-century, it may be helpful to consider the characteristics of the softwood lumber industries of the two countries. At the heart of the softwood lumber dispute is the fact that the softwood lumber industry is organized and operates quite differently in Canada as compared to the United States.

A. Characteristics of the Industry

The characteristic of the Canadian lumber industry that most clearly sets it apart from that of the United States is the degree of public ownership of forest lands in Canada. Approximately 94 percent of forest lands in Canada are publicly owned, and more than 90 percent of the lumber supply comes from publicly-owned (Crown) lands. (Natural Resources Canada, 2004) The rights to harvest lumber are often bundled with required forestry management practices. In some instances provincial authorities set requirements mandating that a certain amount of timber be harvested and sometimes prohibit sawmill closures or reductions in production capacity. Stumpage fees (for the right to harvest timber on publicly-owned land) are set in most instances by the provincial governments.

Within Canada the province with by far the largest production of softwood lumber is British Columbia, which in 2002 accounted for 51.3 percent of Canadian production. In 2002, Quebec produced 18.9 percent of Canadian lumber, Ontario 10.9 percent, the Maritime Provinces 8.6 percent, and the Prairie Provinces 10.4 percent.[3] Between 1995 and 2001, production in British Columbia declined by

32.3 percent, while it increased by 71.1 percent in the Maritime Provinces, by 10.3 percent in Quebec, by 25.1 percent in Ontario, and by 8.9 percent in the Prairie Provinces. The net result of these shifts was that Canadian production of softwood lumber increased by 11.3 percent during this period. While Canada's softwood lumber industry is more concentrated than in the United States, it is not highly concentrated. The largest five producers in 2000 accounted for 53.8 percent of production, and the largest 20 accounted for 66.7 percent. (USITC, 2002)

Canadian logging, lumber and pulp and paper industries directly employed 361,000 people in 2002 and accounted for 2.8 percent of Canadian GDP. (Natural Resources Canada, 2004) The importance of the United States market to Canadian softwood lumber producers is seen in the fact that in 2001 more than two-thirds (68.1 percent) of Canadian production by value was sold in the United States. For British Columbia 72 percent of production was exported to the United States, accounting for almost one-half (49.2 percent) of total Canadian sales of lumber to the United States. (USITC, 2002) Of Canada's 2002 exports of softwood lumber, 83 percent were shipped to the United States while Japan, the second largest market, received only 13 percent. (Natural Resources Canada, 2004)

In contrast to the situation in Canada, in the United States 58 percent of forest land is privately owned, and 95 percent of timber harvesting is done on private lands. (USDA, 2004) Payments for harvesting timber are generally negotiated by private parties, except for the small amount of harvesting done on public lands for which payments are determined by public auctions of harvesting rights. Because lumber companies in the United States must pay private landowners market-determined prices for their timber, they suspect that Canadian producers who pay non-market-determined stumpage fees (typically much lower than the prices paid for timber by United States lumber companies) to provincial owners of timber thereby gain a distinct economic advantage.

According to the United States Forest Service, 779 establishments produced softwood lumber in the United States in 2001. As in Canada, the industry is not dominated by a few producers. The five largest producers accounted for 32.4 percent of production in the year 2000, whereas the twenty largest accounted for 53.8 percent of production. (USITC, 2002)

The United States forestry industry is also geographically diverse, with production occurring in at least 28 states. The fact that softwood lumber producers are located in many different states (and many Congressional districts within some states) helps to account for the political clout of the industry. The industry's influence is also strengthened by the fact that it is a very important source of income and employment in at least three states of the Pacific Northwest and at least four states of the South. In 2001, almost one-half of United States production (47.9 percent) occurred in the West, with more than four-fifths of that concentrated in California, Oregon and Washington. Another 46.2 percent of production took place in the South, with almost three-fifths of that centered in Alabama, Arkansas, Georgia and Mississippi.[4]

B. Essence of the Trade Dispute

Softwood lumber producers of the United States contend that provincial governments in Canada, through the stumpage fees charged for harvesting lumber, subsidize Canadian producers by charging less for the right to harvest timber than would be levied in a free market. Under the same rationale, they also allege in anti-dumping lawsuits that softwood lumber from Canada is being sold in the United States at less than its total cost of production.

In addition to the issue of stumpage fees, the U.S. lumber firms contend that log export restrictions, most specifically in British Columbia, artificially lower the prices of logs to Canadian competitors and deny access to those lower prices to United States producers. The underlying rationale for this charge is that the log export restrictions increase the supply of logs available to Canadian lumber producers, and that they also decrease demand below what it would be if U.S. producers were given access to the logs, thereby putting downward pressure on log prices in Canada.

Canadian producers, along with their the federal and provincial governments, acknowledge that stumpage fees are not generally market-determined. However, they deny that the fees charged amount to subsidies to Canadian producers. British Columbia, the province with the largest production, uses a system known as "comparative value pricing."[5] Under this system the province determines the amount of revenue that it wants to receive from the sale of harvesting rights, arrives at average per unit rates, and then adjusts these rates according to movements in lumber prices and the quality of the

timber being harvested. (Rahman and Devadoss, 2002) Although processes for setting stumpage rates differ somewhat from province to province, in each case they are set with some consideration given to market conditions in the lumber market.

In defending their stumpage practices, Canadian provinces point to what might be called the "multi-functionality" of their forestry management systems. That is, a number of different goals are pursued through their forestry policies. Companies are awarded long-term tenure arrangements, sometimes for as long as 25 years, and in return are expected to provide a number of services. These include such things as road construction and maintenance, fire extinction and prevention, insect and disease protection, reforestation, and other mandatory silvicultural practices such as surveying and site preparation.

Since softwood lumber producers in the United States generally do not incur such costs, Canadians argue that provinces are justified in charging stumpage fees lower than those paid by United States producers, because Canadian lumber producers absorb costs that either the federal or provincial governments would otherwise have to incur. Also, companies have sometimes been given favorable stumpage fees if they agreed to locate or continue production in relatively less developed regions, or in communities where closure of production facilities would cause high unemployment and disrupt the local economy. Furthermore, Canada argues that even if the right to harvest timber is extended to logging companies at charges less than would be paid in a competitive market, this benefit is not necessarily passed on to sawmills, since transactions between loggers and sawmills are typically conducted at "arms-length".

Lumber trade between Canada and the United States has been particularly conflicted since the early 1980s. The dispute has gone through several stages which are defined by the year in which they took place. Each is briefly summarized below.

(1) Conflict in 1981

Recent history of the softwood lumber dispute begins with a request in December, 1981, by the U.S. Senate Committee on Finance and the chairman of the Subcommittee on Trade of the House of Representatives Ways and Means Committee[6] that the United States International Trade Commission (USITC) investigate the conditions under which softwood lumber was being imported into the United

States. (USITC, 2003) This was followed by the United States lumber producers filing a countervailing duty petition in October, 1982. The producers alleged that the "stumpage fees" charged by the federal or provincial owners of forests to Canadian companies for land tenure and the right to harvest timber did not reflect the true market value of the timber and, therefore, amounted to a government subsidy to Canadian producers.

According to United States trade remedy law, when a countervailing duty case is filed the International Trade Administration (ITA) the Department of Commerce must decide whether foreign subsidization has occurred, and the USITC must decide whether foreign subsidies cause actual or threatened material injury to the complaining industry. If both agencies find in the affirmative, then a countervailing duty is imposed to offset the subsidy.

In the first lumber case, the USITC made a preliminary finding that the domestic industry was being materially injured. However, two years later the ITA concluded that stumpage was not countervailable; it was not specific in that the stumpage programs "...were not provided to a specific enterprise or industry or group of enterprises or industries..." (USITC, 2002). That is, Canadian governmental entities did not in any way limit the types of industries that could benefit from stumpage fees. In its opinion the ITA also rejected cross-border price comparisons of softwood lumber as evidence of subsidization, noting that many factors such as species composition, tree size and density of timber, and timber accessibility could be responsible for price differences. The ITA ruled that the subsidies which did exist were *de minimis* (less than 0.5 percent) and therefore were not countervailable. The ITA's decisions in favor of Canadian producers were subsequently affirmed by the United States Court of International Trade. (Gorte and Grimmett, 2003)

(2) Conflict in 1986

Meanwhile, the trade policy environment in the United States was changing in ways that improved the chances of the U.S. lumber industry receiving protection. In 1982 the U.S. Congress passed legislation making input product subsidies countervailable in cases where they reduced the cost of the final product. This opened the door for log export restrictions of Canadian provinces to be regarded as countervailable subsidies. Also, a 1985 U. S. Court of International Trade decision concerning imports of a petroleum product, carbon

black, from Mexico reinterpreted the meaning of specificity in the countervailing duty statute. Basically, it stated that if a subsidy did in fact benefit a certain industry, then no action by the government to limit the subsidy was necessary for specificity to be established. (Cashore, 1997)

Within this same time frame, the United States Congress was also considering Canada's request for a free trade agreement with the United States. The sensitivity of the softwood lumber issue in the United States and the political influence of the lumber industry can be seen from the fact that Canada's request for a free trade agreement was very nearly denied in the United States Senate Finance Committee. More than one-half of the entire Senate signed a letter to the U.S. Trade Representative asking that the softwood lumber issue be resolved before engaging in free trade negotiations with Canada, and ten of the twenty members of the Senate Finance Committee wrote a letter implying that the issues would have to be dealt with before their approval for the free trade negotiations would be forthcoming. The Finance Committee eventually made resolution of the dispute a condition of its approval of fast-track authorization for the free trade negotiations. Both the president and the USTR gave their personal assurances that the matter would be addressed. (Cashore, 1997)

Therefore, in 1986 the U.S producers, under the banner of the Coalition for Fair Lumber Imports, again filed a countervailing duty petition alleging government subsidization of Canadian producers. Using the altered interpretation of when a subsidy is specific to a given industry, and under intense political pressure from softwood lumber interests, the ITA issued a preliminary ruling that Canadian producers were being subsidized by stumpage practices in four Canadian provinces. This conclusion was based on the questionable premises that the logging, lumber, and pulp and paper industries could be considered a single industry because of vertical integration, and that the stumpage rates primarily benefitted this industry as opposed to other wood users such as furniture manufacturers. The ITA estimated that a fifteen percent countervailing duty was justified. (USDOC, 1986) The USITC issued a preliminary determination that the domestic industry was being materially injured by Canadian imports. (USITC, 1986)

Under these circumstances, rather than have the countervailing duty imposed the Canadian government entered into a Memorandum of Understanding (MOU) with the United States government

agreeing to impose a fifteen percent export tax on softwood lumber as an alternative.[7] In that way Canada could at least collect the tax revenues and also would retain some influence over when the trade restriction could be lifted. The MOU provided that the provinces involved could avoid the export tax by increasing their stumpage charges and making other changes in their forestry management policies within five years. British Columbia rapidly increased its stumpage fees by enough to avoid the export tax, and Quebec raised its charges by enough to avoid most of the tax. Other provinces made changes in their forestry management policies. The Maritime provinces, which are relatively marginal suppliers and have a high degree of private ownership of forests, were exempted from the export tax at the same time as British Columbia, but Ontario and Alberta continued to collect the tax. (USITC, 1986) Through this arrangement the United States softwood lumber industry gained protection at the expense of United States consumers, but Canada gained sufficiently from the agreement to keep degraded relations with the United States from jeopardizing free trade negotiations.

(3) Conflict in 1991

Given that the provinces had increased stumpage fees and made certain other changes in forestry management practices as set out in the MOU, the government of Canada, considering that its obligations had been met, exercised its option in 1991 to terminate the MOU. It pointed to the fact that under the terms of the MOU the United States had agreed to exempt more than 90 percent of Canada's lumber exports from the export tax and therefore argued that the MOU was no longer necessary. The Canadian federal government was being pressured to terminate the agreement by the lumber companies and the provincial government of British Columbia. With the province having increased its stumpage fees, Ottawa apparently believed that its practices would be defensible before a trade dispute panel. (Cashore, 1997)

With two-thirds of the United States Senate on record as threatening to take legislative action if the administration did not act to protect the lumber industry, the United States Trade Representative (USTR) announced on the day that the MOU was terminated that the Department of Commerce would self-initiate a countervailing duty case against Canadian lumber practices,[8] and that the USTR was

initiating an unfair trade practice investigation under Section 301 of the Trade Act of 1974. (USITC, 2003)

In connection with the countervailing duty action, the ITA and the USITC were again required to study Canadian and provincial governmental policies that affected the Canadian softwood lumber industry trade with the United States. The ITA initially found that stumpage practices and log export restrictions in Canada amounted to a countervailable subsidy of almost fifteen percent *ad valorem* equivalent, but it later reduced this amount to about six and one-half percent. Both the level of stumpage charges and the effects of log import restrictions were considered contributing factors to the subsidy.[9] The USITC again found that the domestic lumber industry was suffering material injury as a result of subsidized imports from Canada. (USITC, 1992)

By this time, however, the United States-Canada Free Trade Agreement (FTA) was in effect and Canada was able to have the rulings of the ITA and the USITC evaluated by binational dispute settlement panels under the FTA's Chapter 19. Such panels decide whether the national administrative agencies have properly applied the laws of the country involved. If they decide that the administrative agencies have erred, the decision is remanded to them for reconsideration.

The softwood lumber panel considering the finding of subsidization twice remanded the ITA findings, the second time ordering that the subsidization be reversed. As a last resort the USTR asked that an Extraordinary Challenge Committee be established, as provided for in Chapter 19, to review the panel's findings.[10] In filing the appeal the United States alleged a conflict of interest on the part of one of the panelists, and also declared that the panel had "manifestly exceeded its powers, authority and jurisdiction" by substituting its judgment for that of the ITA in deciding that the alleged subsidies were specific to a given industry, and by requiring a demonstration that the alleged subsidies distorted the market. (Extraordinary Challenge Committee, 1994)

Meanwhile, a second panel was appointed to consider the finding of the USITC that United States producers were suffering material injury because of subsidized imports of Canadian softwood lumber. The panel rejected much of the USITC determination, saying that the finding of material industry to the United States lumber producers was "not supported by substantial evidence on the record."

(Binational Panel, 1993) In its remand determination the USITC reaffirmed its earlier decision that the domestic industry was being materially injured. (USITC, 1993) The dispute settlement panel remanded this determination a second time, criticizing the analysis used by the USITC in reaching its decision. (Binational Panel, 1994a) Once again, in its second remand determination the USITC repeated its finding of material injury. (USITC, 1994) The binational panel for a third time remanded this finding to the USITC, stating that in part it was "not supported by substantial evidence on the record and is inconsistent with previous rulings of the Panel." (Binational Panel, 1994b)

In a decision that split 2-1 along national lines (with the dissenting member from the United States), the Extraordinary Challenge Committee dismissed the USTR request for review of countervailing duty panel's decision, saying that the standards set forth for an extraordinary challenge had not been met. (Extraordinary Challenge Committee, 1994) This refusal by the Extraordinary Challenge Committee to review the countervailing duty case made the USITC's finding of material injury from subsidized Canadian imports irrelevant. Consequently, both of the binational panels' rulings stood, countervailing duties were removed, and those previously paid were returned to the Canadian exporters. (Lindsey, 2000)

While this was a definite setback for the softwood lumber lobby in the United States, it was by no means ready to give up the fight. Its next line of attack was to challenge the constitutionality of the binational trade dispute panel process in the courts.[11] In addition, the lumber lobby succeeded in having language included in the preamble to the implementing legislation for the Uruguay Round (Uruguay Round Act Amendments) explicitly approving a "statement of administrative action" by the president declaring that, because of governmental practices in Canada, Canadian lumber imports could be subject to countervailing duty actions. (Gorte and Grimmett, 2003) The legislation specifically said that the ITA did not need to consider the effects of a subsidy in deciding whether a subsidy exists, lowered the threshold for finding that a subsidy is specific to a given industry, and stated that indirect subsidies (such as log export restraints) were countervailable. All of these provisions were aimed at making protection for softwood lumber easier to obtain. (Cashore, 1997) In view of these two potential threats, and considering the costs of

continuing litigation,[12] Canada entered into negotiations for a compromise solution.

C. The Softwood Lumber Agreement

The result of these negotiations was the U.S.-Canada Softwood Lumber Agreement (SLA)signed in May, 1996, but made retroactive to 1 April 1996 and effective for five years from that date. According to the terms of the SLA, softwood exports from British Columbia, Alberta, Ontario and Quebec, provinces that accounted for about ninety-five percent of the softwood lumber exported by Canada to the United States, could enter duty free up to 14.7 billion board feet per annum.[13] (Zhang, 2000) This was about ninety-one percent of what the four provinces had exported to the United States the year before.[14] Exports between 14.7 billion board feet and 15.35 billion board feet were subject to an export tax of U.S.$50 per thousand board feet, and exports in excess of 15.35 billion board feet were assessed an export tax of U.S.$100 per thousand board feet. The export taxes were adjusted annually for inflation to preserve their protective effect. A trigger price provision enabled additional Canadian imports to be allowed duty free if lumber prices exceeded certain levels. Under this managed trade arrangement, quotas were established for companies and provinces by the Canadian federal government primarily on the basis of their respective shares of previous exports. The Canadian government collected the export taxes and returned the revenues to the provinces. (Nelson and Vertinsky, 2003)

In return for Canada's agreement to impose the graduated taxes on softwood lumber exports, the lumber companies, labor unions, and trade associations of the United States agreed that they would refrain from filing anti-dumping or countervailing duty cases against imports from Canada so long as the agreement was in effect and not being breached. The U. S. Department of Commerce agreed that it would not self-initiate such cases and that it would dismiss any that were brought while the agreement was in force. (USITC, 2002) Relatively peaceful trade relations involving softwood lumber existed while the SLA was in effect.

II. RE-OPENING OF THE DISPUTE IN 2001

When the SLA expired at the end of five years Canada did not ask that it be renewed. Some discontent existed among Canadian producers concerning their allocations under the agreement, with

more efficient firms realizing the need to rationalize the industry and achieve economies of scale. Certain provinces also felt that they were disadvantaged from quotas based upon historical export levels and wanted to increase their share of exports. In addition, the Asian financial crisis during the late 1990s had greatly decreased exports of coastal British Columbia producers to countries such as Japan, putting these producers in dire financial straits. However, they were not able to redirect exports to the United States because of the SLA quotas, and resentment against the SLA grew.

As soon as the SLA had expired, the Coalition for Fair Lumber Imports, which comprises 269 firms representing two-thirds of United States production of softwood lumber, filed countervailing duty petitions, this time adding anti-dumping petitions as well. As before, the coalition charged that provincial stumpage practices and log export restrictions effectively subsidized the Canadian lumber firms. By charging stumpage fees lower than what the companies would have paid for the right to harvest timber in an open market, and by depressing domestic log prices through log export restrictions in the case of British Columbia, they alleged that the provincial governments were giving Canadian producers an unfair advantage.

A. The ITA Investigation

This time the ITA was operating under different rules. As noted previously, in the Uruguay Round Act Amendments (URAA), through which certain changes in the World Trade Organization Agreement on Subsidies and Countervailing Measures were implemented into United States law, the standard for determining whether or not an industry was being subsidized had been changed. Previously the government's provision of a product or service to an industry was said to benefit the industry if they were provided at preferential rates. After the URAA, however, the benefit to an industry was to be judged according to whether the government had received "adequate remuneration" for the product or service. As stated in the ITA decision memorandum on the countervailing duty case:

> With changes in the CVD law as a result of the URAA, and the Subsidies Agreement upon which the URAA is based, the price discrimination test was dropped in favor of adequate remuneration. ... It is no longer sufficient to say that the government does not discriminate among buyers. Rather, as discussed above, we must determine whether

> the government is receiving adequate remuneration, i.e., a market-based price.[15] (USDOC, 2001)

In rendering its judgment as to whether the provincial governments had received adequate remuneration through their stumpage fees, therefore, the ITA demanded a market-based price for comparison. United States law requires that the analysis be made "in relation to" prevailing market conditions in the country under investigation. Four of the five Canadian provinces targeted in the countervailing duty suit submitted prices from either private sales or from auctions of timber in the province. However, the ITA concluded that these prices did not meet the test of being market-determined. Its rationale was that in each of the provinces the stumpage fees were "...driven by the provincial governments' ownership and control of forest land and the practice of setting stumpage fees administratively." In support of this reasoning, the ITA noted that private forest lands account for only 5 percent of the total in British Columbia, 11 percent in Quebec, 17 percent in Ontario, 28.5 percent in Alberta, 5 percent in Manitoba, and 1 percent in Saskatchewan. They further remarked that from 70 to 90 percent of stumpage sold is from provincial Crown lands, and that as a result the market is distorted so that prices are not truly market-determined. (USDOC, 2001)

Having concluded that no non-distorted prices exist in Canada, the ITA decided to use timber auctions from state forests in the United States as surrogate prices. In order to make the comparisons as valid as possible, each province was paired with a state (or states) adjacent to the province. British Columbia was paired with Washington and Idaho; Quebec with Maine; Manitoba with Minnesota; Saskatchewan with Montana; and Ontario with Minnesota and Michigan. In addition to making the comparisons with adjacent states, the ITA added numerous adjustments. Allowances were made for costs incurred by Canadian producers for mandatory forestry management expenses that would not ordinarily be incurred by producers in the United States. These included such things as road construction, fire prevention and extinguishing services, reforestation expenses, insect and disease protection, *etc.* Since these requirements differ somewhat from province to province, the adjustments were made differently according to information provided by each.

Whereas in its 1992 ruling on softwood lumber the ITA had concluded that log export restrictions of British Columbia gave preferential treatment to Canadian firms and therefore contributed

to subsidization, that issue was not directly addressed in the latest investigation. That it was not addressed can almost certainly be attributed to the fact that, in a "preemptive strike," Canada had obtained a WTO panel ruling that countervailing against export restraints would be a violation of the Agreement on Subsidies and Countervailing Measures. (Macrory, 2002) The ITA stated that, since its investigation compared stumpage charges in neighboring states of the United States with those of the Canadian provinces, "...any conceivable benefit provided through a log ban would already be included in the calculation of the stumpage benefit based upon our selected market-based benchmark prices for stumpage." (USDOC, 2001) The reasoning, apparently, was that since Canadian stumpage charges are set with some reference to market-based prices in Canada, if log export restraints did in fact lower log prices that would already be reflected in the stumpage charges.

In its final determination, the ITA decided that the Canadian provincial stumpage programs were countervailable because they met three necessary criteria. They were judged to be *specific* under the assumption that they benefitted almost exclusively sawmills and pulp and paper mills, and therefore were not a benefit that is generally available to firms in Canada. They were deemed to *provide a financial contribution* because the stumpage charges of the provinces were less than firms would have to pay in a non-distorted market. They were also deemed to *confer a benefit* because the provinces provided the rights to stumpage for less than "adequate remuneration" as determined by comparison with market-based stumpage fees in border states of the United States. The ITA concluded that Canadian lumber firms were being subsidized in the amount of 19.31 percent *ad valorem*. This figure was subsequently adjusted downward to18.8 percent, later to 13.23 percent, and in June, 2004, to 9.2 percent, although the initial rate will continue to be collected until a final determination is issued. (USDOC, 2004a)

In the latest softwood lumber case the Coalition for Fair Trade in Lumber also filed anti-dumping charges against Canadian firms, arguing that they had been selling lumber in the United States market at prices below total cost of production if Canadian lumber producers had been charged a market price for harvesting trees. A major issue in the anti-dumping case concerned the level of aggregation that was acceptable in determining if products had been sold below cost of production. Canadian producers argued that since lumber mills

produce a joint product in that different grades of wood may come from the same log, firms should not be considered to be dumping so long as total revenues exceed total costs. In making this argument they contended that, because of the nature of the raw material input, lumber firms must produce a full range of products, some of which could be sold above cost of production but some of which had to be sold below cost of production in order to recover total costs. (USDOC, 2002)

Responding, the ITA agreed with the petitioners that, according to United States anti-dumping law as revised in the Uruguay Round Act Amendments, "…the cost test generally will be performed on no wider than a model-specific basis." (USDOC, 2002) Therefore, the ITA's position was that each of the various types of wood products typically produced by lumber companies had to be individually assessed according to whether or not it was being sold in the United States at lower than its cost. Since the various products were produced as a joint product, very complicated cost allocation issues arose. The ITA concluded that Canadian lumber was being dumped into the United States market and that an anti-dumping duty of 8.43 percent should be imposed for most firms. This rate was revised downward in June, 2004, to 3.98 percent.[16] While the countervailing duties had not been applied to lumber from the Maritime Provinces because of their relatively high degree of private forest land ownership, the anti-dumping penalties were applied to all imports of softwood lumber from Canada.

B. The USITC Investigation

In order for the countervailing duties and anti-dumping penalties to remain in place, the USITC was required to determine that Canada's softwood lumber exports materially injured, or threatened material injury to, the United States softwood lumber industry. On May 22, 2002, the USITC failed to find that the domestic softwood lumber industry had been materially injured by imports from Canada that were sold at less than fair value or were subsidized by the Canadian government. The USITC investigation revealed that Canada's share of the United States softwood lumber market had increased only slightly over the previous five years. (USITC, 2002)

However, the USITC did rule that the United States industry would be *threatened* in the future with material injury from such imports. Its ruling was based on certain financial weaknesses of the

United States industry and the fact that the domestic capacity utilization rate had fallen from 92.0 percent in 1999 to 87.4 percent in 2001. Note was also made of the fact that Canadian production capacity had increased by about 10 percent between 1995 and 2001, while the capacity utilization rate there had declined from 87.8 percent to 83.7 percent over the same period. (USITC, 2002) These facts were taken as indications that unrestrained Canadian imports to the United States would likely increase substantially. Consequently, anti-dumping and countervailing duties averaging 29 percent went into effect on May 22, 2002, although subsequently revised downward first to 27.2 percent and eventually to 13.1 percent as a result of administrative review in light of the dispute settlement panel decisions. (USDOC, 2004c)

C. Canada's Challenges

Canada challenged the ITA's subsidy and dumping findings as well as the USITC's finding of a threat to material injury. Under the dispute settlement provisions of Chapter 19 of the North American Free Trade Agreement, Canada challenged the appropriateness of an application of United States trade remedy laws by the ITA and the USITC. In the dispute settlement mechanism of the World Trade Organization it is charging violation of the terms of both the Anti-dumping Agreement and the Agreement on Subsidies and Countervailing Measures.

At the time of this writing, each of these panels has rendered at least a preliminary decision. With regard to the countervailing duty case, a WTO panel has ruled that stumpage fees below market-determined rates would constitute provision of a good to the soft-wood lumber industry and could provide a financial contribution, but ruled that it was inappropriate to decide whether such fees confer a benefit by making cross-border comparisons with fees charged in the United States. It also ruled that the ITA should have examined whether subsidies provided to timber harvesters "pass through" arms length transactions to downstream users of timber. (WTO, 2003)

The United States asked for an Appellate Body to review the panel's decision, and it rendered its judgment in January, 2003. While it upheld the panel's finding that provincial stumpage programs provide a financial contribution to timber harvesters, it reversed the panel's finding that Canadian prices had to be used in

determining whether subsidization had occurred. The Appellate Body agreed that if prices in the country of provision (Canada) were distorted by government programs, then the use of benchmark prices from other countries would be appropriate if it could be established that the "...alternative benchmark relates to or refers to, or is connected with, prevailing market conditions in the country of provision (including price, quality, availability, marketability, transportation and other conditions of purchase or sale)." (WTO, 2004a) The original WTO panel had concluded that Canadian prices had to be used in making the subsidy determination, and the parties to the dispute had agreed that, should this finding be reversed, the information presented to the panel would be insufficient for determining whether subsidization had occurred. The Appellate Body's reversal, therefore, kept the countervailing duty case viable for the United States if a different method of price comparison were used.

Since the Appellate Body reversed the panel's decision that Canadian prices had to be used, it concluded that insufficient information had been provided for determining whether the ITA had acted properly in finding that subsidization had occurred. Therefore, the Appellate Body did not render any decision concerning whether the existence or amount of benefit determined by the ITA in the countervailing duty case was consistent with the provisions of the Agreement on Subsidies and Countervailing Measures. The Appellate Body made no suggestions concerning how benchmark prices from outside the country should be applied or what adjustments should be required. It did recommend that the ITA justify the measures that it used in the countervailing duty determination. The Appellate Body also agreed with the panel that the ITA must conduct a pass-through analysis to determine whether arm's length sales of *logs* to unrelated sawmills incorporated the effects of stumpage charges, but it did not judge such a pass-through analysis to be required for arm's length sales of *lumber* to unrelated remanufacturers. (WTO, 2004a) As a result of the Appellate Body review, the ITA will have to demonstrate that it is relating in every respect to the benchmark prices used in Canada for its subsidy finding to prevail.

A separate WTO panel considered whether the ITA followed WTO-consistent procedures in assessing dumping margins against Canadian firms. In a ruling that was confidentially issued to each country in January, 2004, and released to the public in April, 2004, the panel agreed that the United States had followed WTO-consistent

procedures in finding dumping, except for one of the methods used. (WTO, 2004c) The panel found that "zeroing," whereby products that are sold at a positive value over cost are assigned a value of zero in calculating the dumping margin so that only products sold at less than fair value enter into the calculation, was not permissible under terms of the Anti-dumping Agreement. A NAFTA panel, judging this issue only according to whether it was consistent with United States law, had ruled that "zeroing" was permissible. The United States appealed the ruling of the WTO dumping panel to the Appellate Body, and in August, 2004, the Appellate Body upheld the panel's ruling that "zeroing" is not permitted by the Anti-dumping Agreement. (WTO, 2004e)

A third WTO panel considered whether the USITC was justified under WTO rules in finding that the United States lumber industry is threatened with injury from lumber imports from Canada. In March, 2004, the panel ruled that the USITC's threat of injury ruling was not justified, and that it "could not have been reached by an objective and unbiased investigating authority in light of the totality of the factors considered." (WTO, 2004b) With no threat of injury, the United States' assessing the anti-dumping and countervailing duties constitutes a case of nullification or impairment of Canada's benefits under the WTO agreement. In adopting the panel's report in April, 2004, the Dispute Settlement Body endorsed the panel's request that the United States bring its measures into conformity with its obligations under the Anti-dumping and Subsidies and Countervailing Measures Agreements. (WTO, 2004d) As of August, 2004, Canada and the United States were holding bilateral consultations concerning the period of time required for the United States to implement the recommendations and rulings adopted by the Dispute Settlement Body.

Three panels constituted under the provisions of NAFTA Chapter 19 have also rendered decisions pertaining to the softwood lumber case. In contrast to the WTO panels, which decide if the actions of administrative agencies have violated WTO rules, NAFTA panels are restricted to determining if the administrative agencies involved have properly applied their own domestic laws.

The NAFTA panel considering the countervailing duty case ruled in August, 2003, that, in making cross-border price comparisons, the ITA did not follow proper procedures as specified in United States law. The use of cross-border price comparisons was consid-

ered inappropriate and the case was remanded to the ITA for reconsideration. (Binational Panel, 2003b) Using a different method that the ITA referred to as "market principles," it reduced the countervailing duty rate from 18.8 percent to 13.2 percent. Subsequently, the panel in June, 2004, remanded the case to ITA for a second time, directing a further recalculation of the subsidy rate for all the provinces involved. (Binational Panel, 2004c) As a result the countervailing duty rate was reduced to 9.2 percent. (USDOC, 2004a)

The NAFTA panel considering the anti-dumping case in its report issued in July, 2003, criticized the ITA's methodology and procedures in several ways and remanded the case to the ITA for reconsideration. (Binational Panel, 2003a) Upon receiving the ITA's explanations and justifications for the procedures used, the panel, while obviously disagreeing with some of them, for the most part concluded in a report issued in March, 2004, that the procedures were consistent with United States law. (Binational Panel, 2004a) The panel directed the ITA to recalculate the anti-dumping rate for some firms but in general upheld the anti-dumping determination. Canada had sought to have the use of "zeroing" declared inappropriate. While this practice had been ruled by the WTO panel to be inconsistent with the Anti-dumping Agreement, the NAFTA panel nevertheless had to conclude that it was not inconsistent with existing United States law.

A third NAFTA panel, composed of three members from the United States and two from Canada, remanded its finding of threatened injury to the United States softwood industry to the USITC. The panel was very critical of the USITC decision, concluding that it was based on "extensive lack of analysis" and on "considerable speculation and conjecture." (Binational Panel, 2003c) The panel noted that the USITC had presented no evidence of adverse price trends for softwood lumber, adding that, in the presence of "strong and growing" demand, no causal link had been established between anticipated increased imports from Canada and anticipated adverse price effects. The panel criticized the USITC for not taking into consideration the effects of increased production by United States softwood lumber producers or of increased third-country imports. In December, 2003, the USITC reaffirmed its finding of threat of injury. (USITC, 2003) In April, 2004, the NAFTA panel again unanimously remanded this finding to the USITC for reconsideration. (Binational Panel, 2004b) In June, 2004, the USITC reaffirmed its threat of injury

determination. (USITC, 2004) The panel will give 20 days for comment, 20 days for rebuttal, and then will rule again on the issue within 90 days. In December, 2003, the USITC reaffirmed its finding of threat of injury. (USITC, 2003)

In April, 2004, the NAFTA panel again unanimously remanded this finding to the USITC for reconsideration. (Binational Panel, 2004b) In June the USITC defiantly reaffirmed its threat of injury determination. (USITC, 2004a) In August the panel remanded the case to the USITC, ordering it "to make a determination consistent with the decision of this Panel that the evidence on the record does not support a finding of threat of material injury and to make that determination within ten (10) days from the date of this Panel decision." (Binational Panel, 2004d) In its decision the panel accused the USITC of undermining "the entire Chapter 19 panel review process" by its conduct in the case.

In September, 2004, the USITC, bowing to the order of the NAFTA panel and "because the Commission respects and is bound by the NAFTA dispute settlement process," by a 5-1 decision issued a determination that the U.S. softwood lumber industry was not threatened with material injury by Canadian imports. In making this determination, however, the Commissioners stated: "we disagree with the Panel's view that there is no substantial evidence to support a finding of threat of material injury and we continue to view the Panel's decisions throughout this proceeding as overstepping its authority, violating the NAFTA, seriously departing from fundamental rules of procedure, and committing legal error." (USITC, 2004b)

In a press release, Canadian International Trade Minister Jim Peterson responded that, in view of this decision, his country expected the duties collected from softwood lumber exporters to be refunded "as soon as possible." With billions of dollars at stake, further litigation (including a likely request for an Extraordinary Challenge Committee) is highly probable. In addition, Canada's position in any future talks leading to a negotiated solution will be greatly strengthened by this decision.

III. ECONOMIC ISSUES INVOLVED

Several economic issues arise within the context of the softwood lumber dispute. An obvious one is whether or not low stumpage fees charged by Canadian provinces to Canadian producers harm the

United States softwood lumber industry. A separate but related question is whether or not log export restrictions in Canada put United States lumber producers at a disadvantage relative to their Canadian competitors. Another relevant issue is the economic impact of the various trade restrictions that have been forced upon producers, landowners, and industries that use lumber products.

With regard to the first issue, Canadian provincial stumpage practices are most often analyzed using the classic Ricardian rent theory of natural resource pricing. (Nordhaus, 2001; 1992; Van Kooten, 2002) This theory of economic rent was used by Ricardo to explain that in the case of natural resource products (such as a crop of grain) the amount of output would not be affected by product price so long as the marginal value of the harvested product exceeds the marginal cost of harvesting it. Since supply is fixed, demand conditions will determine the price of the product, but a higher price will not call forth a larger supply nor will a lower price cause supply to decrease.

In Canada, stumpage rates and allowable annual cuts (the amount of timber that can be harvested) are set by two different administrative agencies of the provincial governments. Since the amount of timber that can be harvested is predetermined by the provincial authorities, according to rent theory the level at which the stumpage rate is set should affect neither the amount of timber supplied by Canadian firms nor the price at which it is sold. The stumpage rate would affect only the allocation of differential and scarcity rents.[17] With higher stumpage fees provincial governments would collect a larger share of the rents; with lower stumpage fees, more of these rents would accrue to lumber producers in Canada.[18]

Therefore, according to this theory, with "allowable annual cuts" predetermined by government decree, even if stumpage rates were set below "adequate compensation" as defined by the price that would be set in an efficient auction (since neither the quantity of timber supplied nor its price to sawmills would be affected by the level of stumpage fees), there should be no downstream effect on lumber producers. The only possible way in which the level of stumpage fees could increase the quantity of lumber produced would be if resultant supernormal profits (from economic rents) caused harvesters of wood to somehow persuade provincial governments through the political process to increase the "annual allowable cuts" of timber. (FTC, 1986)

Professor William Nordhaus of Yale University has presented a theoretical defense of Canadian stumpage practices based upon the rent theory of natural resource pricing. (Nordhaus, 1992; 2001) He and Robert Litan also have presented econometric evidence purporting to show that, within the "normal range"[19] of stumpage fees, changing the level of the fees did not affect the quantity of lumber produced. (Nordhaus and Litan, 1992)

In support of the United States position in the dispute, the Coalition for Fair Trade in Lumber presented statements from William McKillop, a forest economist at the University of California, Berkeley, and Robert Z. Lawrence of Harvard University, that criticized the Nordhaus analysis. McKillop identifies what he considers to be several factual errors in the Nordhaus report, pointing out that timber companies benefit not only from receipt of secure tenure from provinces but also because they are not subjected to competitive bidding by other companies. Moreover, these benefits can continue indefinitely because in many cases Canadian tenures can be renewed so long as the holder meets the conditions set forth. McKillop also contends that cross-border comparisons of timber prices should be feasible with appropriate adjustments for forest characteristics. (McKillop, 2002)

Lawrence argues that, while the Nordhaus application of rent theory to resource pricing is valid for the short run, it ignores the effect of low stumpage fees on long-term investment in timber production which will increase supplies. He also mentions that the minimum harvesting requirements sometimes required of Canadian timber companies prevent these firms from reducing production in slack times as would be done in a competitive market, and therefore in such times they artificially increase the supply of lumber. (Lawrence, 2001)

The Coalition for Fair Trade in Lumber also filed a brief asserting that timber markets depart in three major ways from the Nordhaus description. (Coalition, 2002) First, they call attention to studies which indicate that in private timber markets owners have a "reservation price" below which timber will be withheld from the market. The existence of a reservation price is attributed to alternative uses of forests that become relatively more attractive when timber prices are low, and also to expectations of private owners that the discounted value of future timber prices will be greater than present prices. These factors cause private owners to withhold timber when prices

are depressed. In contrast, Canadian tenure holders often face mandatory cut requirements designed to maintain employment. In such cases they must harvest the required amount of timber in order to retain tenures on the timber-producing land. Also, since provincial stumpage rates are often adjusted downward when prices of timber fall, this weakens the incentive of tenure holders to withhold timber sales from the market. For these reasons, it is argued, more timber will be supplied by Canadian producers when prices are depressed than otherwise would be the case if timber was privately owned and traded freely in the market.

A second criticism by the Coalition of the Nordhaus analysis is its static nature, in that it does not take into account long-term changes. Following the Lawrence criticism mentioned earlier, the argument is made that low stumpage rates, in combination with guaranteed long-term tenures, provide artificial incentives for investment in lumber-producing equipment and technologies. These, in turn, lead to increased production and supplies beyond what would prevail in free markets.

A third criticism by the Coalition is that the Nordhaus analysis fails to take into account the complex interactions of different aspects of the Canadian system. Mentioned in this connection are such things as mandatory cut requirements, mandatory processing requirements, and restrictions on log exports. All of these are said to magnify market fluctuations and to increase production and exports beyond what they would be in the absence of such regulations.

Finally, the Coalition points out that when USDOC replicated the empirical work of Nordhaus and Litan using different time periods, they found some responsiveness of Canadian timber harvest levels to changes in stumpage levels. While a majority of the dispute settlement panel judged the calculated elasticity of -0.08 to be not significantly different than zero, the Coalition argues that even with such a small elasticity raising Canadian timber prices to market levels would have a dramatic impact on Canadian production and export levels. The Coalition also referenced other studies purporting to show that output levels are responsive to stumpage levels.[20]

As to the charge that log export restrictions place United States producers at a disadvantage relative to their Canadian competitors, basic international trade theory would indicate otherwise. In his study of this issue, economist Edward Leamer makes this point persuasively. Leamer argues that any positive effect on the Canadian

lumber producers from log export restraints would be short-run and transitory. Using the factor price equalization theorem of the Heckscher-Ohlin trade model, Leamer maintains that, just as trade in goods can bring about the equalization of wages in the face of restrictions on labor movement, so trade in lumber can bring about the equalization of the prices of log inputs into lumber production even in the face of log export restrictions. Leamer acknowledges that the prices of Canadian logs used domestically are lower than the prices of those exported, but presents data showing that a similar price differential is commonly observed even in countries that have no log export restrictions. Further, he argues that industrially advanced countries with forest resources, such as Canada, have processing advantages arising from economies of scale that will cause them to produce more finished products such as lumber. In support of this point, Leamer shows that the very forest-abundant Nordic countries actually are net importers of logs. (Leamer, 2003)

Although Leamer does not make this point in his analysis, over time any possible benefits of lower log prices to the lumber producers would be incorporated into the value of their assets so that subsequent purchasers of those assets would have to pay a premium for them. Consequently, any supernormal profits (or competitive advantage) accruing to Canadian producers from the effects of log export restrictions would be dissipated over time for this reason.

As the foregoing discussion makes apparent, cogent economic arguments exist on either side of this trade dispute. The empirical work concerning responsiveness of production and exports to changes in Canadian stumpage levels is not extensive enough to permit a definitive conclusion. Provincial regulations designed to maintain employment through mandatory cut requirements and mandatory processing requirements seem more likely culprits than stumpage charges for increasing output beyond market-determined levels, and magnifying market fluctuations.

Fear of increased output by Canadian producers undoubtedly is a major motivating factor for the United States industry in aggressively pursuing trade remedy measures. The softwood lumber industry in the United States is well aware that Canada has great potential for expanding its production of this product. Canada has fifteen times as much forestland as the United States, and six times as much available growing stock. (Leamer, 2003) Canadian commercial forests, at 588 million acres, are not so much larger than the 495

million acres of commercial forest in the United States. (Forest Facts, 2004) However, since the population of Canada is only one-tenth that of the United States, the potential supply of lumber in Canada relative to domestic demand is immense. Every year Canada harvests less than one-half of one percent of its commercial forest land, and each year grows twice as much wood as it removes through logging operations. (DFAIT, 2002) While "allowable annual cut" decisions are, as a matter of stated policy, based on environmental and conservation considerations that are independent of market conditions, the United States industry nevertheless is aware that great potential for expanded production exists in Canada. By aggressive pursuit of trade remedies targeting current imports, the United States softwood lumber industry sends a strong signal to the Canadian provinces not to increase the amount of wood harvested.

Given the propensity of the U. S. Congress to change legislation when necessary to see that the industry is protected, trade restrictions of some sort are almost inevitable. If trade is to be restricted, the type of trade policy employed will have important welfare considerations.

A countervailing duty levied by the United States causes a net efficiency loss and also transfers scarcity rents from Canadian governmental entities and producers to the United States government.[21] By raising the price of softwood lumber in the United States, the countervailing duty improves the economic position of both softwood lumber producers and owners of timber-producing land in the United States at the expense of American consumers of softwood lumber.

When a Canadian export tax is levied in order to avoid a countervailing duty as in the conflict during 1986, Canadian producers lose because the export tax depresses the price that they would otherwise receive for their product, whereas the consumers of softwood lumber products in Canada gain from the price reduction. The loss by producers is greater than the gain by consumers. In the United States, lumber producers and owners of timberlands gain because the Canadian export tax raises the price of lumber (and the value of land with timber on it) in the United States. Consumers in the United States lose more than lumber producers there gain as a result of the price increase. (Wear and Lee, 1993)

Under the terms of the SLA during the conflict in 1991, Canadian lumber exports beyond a certain level were subjected to a

graduated export tax. Empirical work has indicated that this graduated tax put some downward pressure on prices of softwood lumber in Canada, with consequent benefits to Canadian consumers. Paradoxically, Canadian producers gained on balance from the higher prices on product sold to the United States before the tariff rate quota took effect. (Zhang, 2000) The Canadian government was able through export taxes to capture scarcity rents that would have gone to the United States under a countervailing duty. Economic theory would predict and empirical studies have indicated that prices of softwood lumber in the United States would be increased by the taxes, with gains accruing to softwood lumber producers and owners of timberland. Consumers of softwood lumber in the United States suffered losses greater than the gains of producers and landowners. (Zhang, 2000; Lindsey, *et al.*, 2000)

The reason that softwood lumber producers and owners of timberland in the United States are keen to have either countervailing and/or anti-dumping duties or Canadian export taxes imposed is not difficult to discern. Either of these measures improves the economic positions of producers and landowners at the expense of United States consumers. It is also obvious why the Canadian government would agree to impose an export tax during the conflict in 1986 or a graduated export tax during the 1991 conflict in order to avoid a countervailing duty from the United States. When an export tax is imposed, scarcity rents accrue to the Canadian government that would otherwise be captured by the United States government under a countervailing duty.

The adverse impact of trade restrictions on users of softwood lumber in the United States is highly predictable from international trade theory, whether the restrictions are in the form of Canadian export taxes, countervailing duties imposed by the United States, or managed reductions in trade as in the SLA. Their impact has also been documented empirically. For example, Daowei Zhang has estimated that the SLA increased softwood lumber prices in the United States during its first four years by about $53 (1997 US$) per thousand board feet. He also estimates that the costs of the trade restriction to U. S. consumers of softwood lumber were $11.1 billion per year, much larger than the gain of U. S. lumber producers of $4.2 billion per year. The difference is accounted for by a small net efficiency loss, substantial rents captured by Canadian producers, and a small increase in government revenues in Canada. (Zhang, 2000)

A Cato Institute study estimated the effect of the SLA on United States prices to be between $50 and $80 per thousand board feet, and further estimated that this increased the cost of a new home by $800 to $1,300. (Lindsey, *et al.*, 2000a) The same study cites a United States Bureau of the Census estimate that a $1,000 increase in the cost of home construction prevents 300,000 families from purchasing a house. The Federal National Mortgage Association has estimated that a $10 per month increase in monthly mortgage payments causes 250,000 United States families not to qualify for a mortgage. (Lindsey, *et al.*, 2000c) Obviously, families unable to afford a home because of such modest housing price increases are those at the lower end of the income scale.

Also adversely affected by an increase in lumber prices are those employed in lumber-using industries that have their effective protective rate reduced by trade restrictions on lumber. Approximately 25 times as many people are employed in such industries in the United States as in the softwood lumber industry. (Lindsey, *et al.*, 2000a) These firms have recently become more involved through their trade associations, such as the National Association of Homebuilders and the National Lumber and Building Material Dealers Association, in trying to prevent trade restrictions on imported lumber products.[22] However, the using industries have not been nearly so well organized or politically effective as the lumber producers.

The estimated adverse economic effects on consumers referenced in the studies cited above almost certainly underestimate the impact of United States trade actions against the softwood lumber industry of Canada. These studies estimate only the actual reduction in quantities of lumber sold in the United States as a result of the trade restrictions, and the impact on prices caused by the reduction in supply. They do not take into account the fact that, in the absence of trade restrictions or the threat thereof, annual allowable cuts would likely be significantly higher with consequent increases in supply. As previously mentioned, Canada grows twice as much wood each year as it removes through logging operations. Without the threat of trade restriction, there is every reason to believe that significantly more timber would be harvested. Access to this very abundant Canadian natural resource would reduce the cost of living and increase the standard of living for consumers across the United States.

The ITA has issued a draft policy bulletin setting forth conditions under which Canadian provinces might qualify for a "changed circumstances review" to have countervailing duties removed. The requirements would differ somewhat among the various Canadian provinces since their forest management systems differ, but basically the provinces would be required to move to a market-based timber sales system. While the changes that would be required of the Canadian system are profound, the requirements are vague enough to leave much discretion to the staff of the ITA as to whether or not the requirements have been met. In addition, the bulletin implies that even if Canadian timber were auctioned and other aspects of the system made market-based, that would not be sufficient if Canadian provinces simultaneously increased the amount of timber allowed to be harvested:

> The Department will also examine any evidence that suggests that a province maintains or introduces other requirements or conditions on the sale of provincial timber that would inhibit or undercut the operation of the policy reforms discussed above. The Department will, for example, want to ensure that a province's decisions with respect to the annual allowable cut authorized on provincial lands is consistent with sound forest management and the full rotational economics of the forest, rather than a means of increasing supply....(USDOC, 2003)

That the lumber industry in the United States, despite its rhetoric, is more interested in limiting the Canadian share of the domestic market than in seeing the Canadian forestry system changed to a market-based system is evident in a number of ways. In negotiations for an interim agreement, the United States industry has insisted on prohibitive export tariffs that would be triggered whenever Canadian imports exceeded a market share figure that is less than that previously attained. (Inside US Trade, August 1, 2003) The industry attempted to prevent issuance of the ITA policy bulletin spelling out reforms that would qualify Canadian firms for a changed circumstances review until an interim agreement had been reached, fearing that the release would adversely affect their bargaining position in negotiating a market-sharing arrangement. (Inside US Trade, March 21, 2003) In addition, the industry has called for an "anti-surge" mechanism that would limit imports from provinces that had met all the requirements for a changed circumstances review if, afterward,

their imports increased significantly. (Inside US Trade, August 1, 2003)

Therefore, it is unlikely that the policy framework set forth by the ITA will achieve its stated goal of providing the basis for a long-term settlement of the softwood lumber dispute. So long as forests are owned by the provinces in Canada, elements of the United States lumber industry will find ways to assert that competition from Canada is unfair.[23] Yet it is highly unlikely that Canadian forests will be privatized. As Reed has stated, "It is easy to make an academic case for selling public forests, but the likelihood that this will be supported by public opinion is remote. Public forestland is regarded by most Canadians as part of their patrimony, their heritage, and something that they would give up with great reluctance." (Reed, 2001) In addition, environmental groups would strongly resist any suggestion that forests be privatized, and the unsettled but extensive claims of First Nations on forest lands would complicate any attempted move in this direction.

IV. CONCLUSION

The softwood lumber issue involves more than a dispute over whether or not lumber is being traded fairly. As Stephanie Golob has insightfully stated, "The U.S. acts to defend its market-driven lumber interests from what is seen as unfair Canadian statist protectionism, while Canada claims that its state-led rather than market-driven system is necessary to maintain the industry and calls on its neighbor to adjudicate through dispute settlement rather than resorting to unilateral countervailing action. On the surface, this is a simple trade dispute, but underneath it is a toe-to-toe battle between conceptions of the state and its role in the economy, as well as the value of following rules *vs.* acting alone. These are politically-charged issues linked to state legitimation in both countries, and because the distinctiveness dimension of identity is thereby repeatedly activated in these cycles of conflict, another opportunity to act in a mutually-identifying manner is serially undermined." (Golob, 2002)

Canada has received mixed but mostly favorable rulings from both the WTO and NAFTA dispute settlement panels involved in the softwood lumber case. Despite this fact, however, a negotiated settlement of some sort appears inevitable. Policymakers in Canada and many in the industry seem to have concluded that the Coalition for Fair Trade in Lumber is persistent enough, and has enough

political influence, to obtain protection one way or another for United States firms.[24] In the words of John Allan, President of the British Columbia Lumber Trade Council: "Having spent a lot of money on legal advice and political advice, there's a sense that we may win the odd battle, but we'll never win the war." (Simon, 2003)

In response to the ruling of the WTO panel that the USITC had erred in finding threat of injury to the United States lumber industry from Canadian imports, John Ragosta, lead counsel of the U.S. Coalition for Fair Lumber imports, was undeterred. He responded: "In a worst-case scenario, you could always go back and say, there's a subsidy, we'll wait until people lose some money and then refile." (Jack, 2003) With billions of dollars in potential revenues at stake by virtue of the Byrd Amendment,[25] it is not difficult to imagine that some firms could manage to "lose some money," particularly when their cost structures incorporate the fees of law firms hired to pursue anti-dumping and countervailing duty cases.

A proposed negotiated solution floated in late 2003 would have limited duty-free Canadian exports to 32 percent of the United States market (down from about 34 percent when the latest dispute began) with a stiff export tax of US$200 per 1,000 board feet above that market share. Also proposed was that United States producers would keep 48 percent of the anti-dumping and countervailing duties thus far collected. (Globe and Mail, 2003) Canadian producers and provinces rejected it, reportedly because they disliked the fact that the proposal did not provide assurances that the quantitative limit would be relaxed during the term of the agreement if they did make their timber pricing systems more market-based. They also objected to the fact that only a little over one-half of the duties thus far collected would be returned to them.

Another obstacle to a negotiated settlement is fundamental disagreement among provinces and producers over how quotas would be allocated among the various producers. David Emerson of Canfor Corporation has suggested that a way out of this impasse would be for the federal or provincial governments to purchase quotos at fair market value from firms having large quotas based upon past production, and then sell them at a discount to firms that oppose the negotiated settlement because they believe that quotas based upon past production levels would be unfair to them. (PR Newswire, 2003)

If a market-sharing compromise is adopted, its economic effects will be much the same as those of the SLA—scarcity rents captured by both United States and Canadian producers at the expense of United States consumers of softwood lumber products. A most unfortunate aspect of such an agreement this time around would be that producers in the Coalition for Fair Trade in Lumber would receive hundreds of millions of dollars from duties thus far collected that could be used to fund future efforts at trade restriction.[26] Even though a WTO panel has ruled that the Byrd Amendment provision for anti-dumping and countervailing duty revenues to be turned over to the petitioners is a violation of WTO rules, the United States Congress has thus far failed to comply with the ruling.[27]

While another market-sharing arrangement may provide a short-term solution to the trade dispute, what are the prospects for a longer-term solution? It is conceivable that lumber using interests in the United States could become organized enough to exercise offsetting political influence that would inhibit protectionist measures. However, those who lose from trade restrictions on lumber are scattered across the country and across many industries. While in the aggregate their losses greatly exceed the gains of producers, on a *per capita* basis their stakes are much smaller than those of the producers. Ignorance and apathy make any effective political organization of the consuming interests uncertain at best.

Another possible solution would be reform of the trade remedy laws as applied within North America. International trade economists have generally concluded that trade remedies, particularly in integrated markets like North America's, have costs that outweigh their benefits. In some other economic integration arrangements the application of trade remedies has been forgone in favor of common competition policies. For example, in the European Union competition authorities deal with instances of predatory pricing, and the Commission and the Court of Justice apply common rules regulating state aid to industries. The Closer Economic Relationship Trade Agreement between Australia and New Zealand prohibits anti-dumping actions in respect to trade between the countries. While the accord does not specifically rule out countervailing duty actions, the countries agreed that subsidies affecting their trade with each other would no longer be considered viable instruments of industrial policy. Subsequently, countervailing duty actions against each other have ceased. While such a move within North America is not

inconceivable, it is highly unlikely in the foreseeable future. Resort to trade remedies has become a favorite refuge of members of the United States Congress wishing to shield themselves from intense political pressures brought to bear by their constituents.

It has been suggested that a medium-term solution may be available through a bilateral agreement on resource pricing, perhaps as part of a broader agreement. (Hart, 2004) While that certainly is possible, it would be no more than a medium-term solution because, fundamentally, the dispute is not about differences in resource pricing. Rather, differences in resource pricing have made a convenient target for the United States lumber industry in its efforts to gain protection. But the bottom line is this: Canada is much more abundantly endowed than the United States with timber, and if they are unrestrained the Canadian producers will rapidly increase their share of the United States lumber market. Even if timber prices were market-based by relating them to timber auctions, a system that British Columbia has recently announced that it intends to employ,[28] the fact that Canadian forests are primarily government-owned will provide the United States lumber industry with a number of tempting avenues for gaining protection.

A possible long-term solution to the softwood lumber dispute is further regional integration of the industry through cross-border investment. Trade remedy actions concerning manufactured products have virtually ceased between the United States and Canada as a result of cross-border integration of industries. United States firms with significant Canadian investments in lumber production, such as Weyerhauser and Boise Cascade, did not join as petitioners in the most recent anti-dumping and countervailing duty cases. United States lumber-producing firms that invest in and operate in Canada will be less likely to become a party to trade remedy actions because of the unpopularity of these actions in Canada. However, if negotiated settlements follow the pattern of the Softwood Lumber Agreement in which all firms apparently benefited at the expense of consumers, then financial incentives for managed trade will remain strong.[29] Chances are very good that the softwood lumber dispute between the United States and Canada will "lumber along" for years to come.

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ACRONYMS

CVD	countervailing duty
DFAIT	(Cda) Department of Foreign Affairs & International Trade
FTA	(U.S.-Canada) Free Trade Agreement
GDP	gross domestic product
ITA	International Trade Administration
SLA	Softwood Lumber Agreement
MOU	memorandum of understanding
NAFTA	North American Free Trade Agreement
URAA	Uruguay Round Act Amendments
USDA	(U.S.) Department of Agriculture
USDOC	(U.S.) Department of Commerce
USITC	(U.S.) International Trade Commission
USTC	United States Tariff Commission
USTR	United States Trade Representative
WTO	World Trade Organization

NOTES

[1] While Taussig reports the average tariff rate on "Wood and manufactures of" to be 7.97 percent after the Fordney-McCumber Tariff of 1922, and 10.49 percent after the Smoot-Hawley Tariff of 1930, other tariffs on inputs (e.g., raw logs) were such that Archibald, et. al., have estimated that "Lumber and timber products" actually suffered an effective rate of protection of -6.78 percent as a result of the Fordney-McCumber tariffs, and of -2.86 percent as a result of the original Smoot-Hawley tariffs. (Archibald, *et al.*, 2000)

[2] Percentages calculated by the author from data on Canadian Department of Foreign Affairs and International Trade web site.

[3] Calculated from data presented in (USITC, 2002)

[4] Prior to 1987 stumpage fees in British Columbia were collected according to a "residual fee" system. Under this system, the province collected as stumpage fees whatever was left over after firms had deducted their operating costs and profit. In the mid-1980s the province decided that it was not collecting enough revenue from this system, and moved to the comparative value pricing system that allowed the province to establish target revenue and then set stumpage fees that would collect revenues accordingly. However, under this system the government collected a smaller proportion of scarcity rents, and industry profits greatly increased, when lumber prices were high. Therefore, in 1994 a system of graduated stumpage fees was established that disproportionately increased stumpage fees as market prices rose. The increased revenues from this graduated system were used for funding a Forest Renewal Plan—a long-term strategic plan for renewing the province's forests. (Cashore, 2001) According to Cashore, timber pricing in British Columbia is the result of an "implicit historical compromise" among various interests. "The seed of the compromise can be traced back to the beginnings of BC forestry when timber pricing policies were limited to the single goal of promoting a healthy forest industry. The compromise accepts this outcome as the only legitimate goal and further narrows objectives within this goal to four, with three of these championed by different members of the development coalition. Industry has focused on the objective of facilitating industry profitability, labour has

promoted a high-wages objective, and government actors have bolstered the revenue objective. A lesser employment objective has been asserted from time to time, most notably by government and labour members. But the reason the compromise explains policy change is that members recognized a hierarchy of objectives. The profitability objective is paramount, followed by the high-wages objective, then the revenue objective. When the employment objective is asserted, it is usually at the expense of the revenue objective. Objectives lower on the hierarchy enter the problem definition only when those higher up are not considered a serious policy problem." (Cashore, 2001; 177)

[5] This request was instigated by the Northwest Independent Forest Manufacturers (NIFM), an organization of sawmill companies from the Pacific Northwest. The NIFM companies were joined by companies in other parts of the United States to form the Coalition for Fair Lumber Imports which subsequently filed the countervailing duty petition. (Cashore, 1997)

[6] The Canadian government's negotiations were undermined by the new provincial government of British Columbia which was looking for new sources of revenues and wished to increase stumpage charges. The provincial Minister of Forests reportedly exchanged information with the Coalition for Fair Trade in Lumber concerning the countervail case. (Cashore, 1997)

[7] This was the first time that the ITA had self-initiated a countervailing duty case. This action was challenged by Canada as being a violation of the GATT Agreement, but a GATT panel held that it was permissible. (Macrory, 2002)

[8] The countervailing duty was applied to the softwood exports of British Columbia, Alberta, Ontario and Quebec. Of the total, log export restraints were said to constitute the equivalent of a 3.6 percent subsidy, and low stumpage fees were equivalent to a 2.91 percent subsidy. (USDOC, 1992)

[9] Establishment of the right to request an Extraordinary Challenge Committee was designed as a safeguard procedure to protect the integrity of the panel process by providing a means whereby charges that panel members were biased or that the panel had exceeded its authority could be considered.

[10] This process has subsequently survived the constitutionality challenge in the courts, but at the time this was a worrisome development.

[11] Canada has reportedly spent more than Cdn $100 million in legal fees on the softwood lumber case. (McKenna, 2003)

[12] The other provinces were not party to the agreement because they either were marginal suppliers or had their stumpage rates determined in competitive markets.

[13] Percentage calculated from data in (USITC, 2002)

[14] The statute does not actually define "adequate remuneration" but the Department of Commerce interprets it as meaning a price that would otherwise be charged in a freely-functioning market.

[15] In its dumping investigation the ITA investigated six companies. The eventual antidumping rates announced were : Abitibi, 11.9 percent; Canfor, 5.7 percent; Slocan, 8.8 percent; Tembec, 6.7 percent; West Fraser, 2.2 percent, and Weyerhauser, 12.4 percent. Other firms were assessed a penalty equal to the weighted average of these margins. In response to a NAFTA panel remand order to recalculate the penalties, in April, 2004, Tembec's rate was reduced to 6.3 percent, Slocan's to 8.5 percent, and West Fraser's to 1.8 percent. Ironically, since West Fraser's antidumping duty rate fell below the 2% *de minimis* rate required for collection, its rate fell out of the calculation for "all other firms" and their rate increased from 8.1 percent to 8.8 percent! However, after a preliminary administrative review the ITA in June, 2004, recommended the following dumping margins: Abiti, 2.97 percent; Buchanan, 4.8 percent; Canfor, 2.06 percent; Slocan, 1.64 percent; Tembec, 10.21 percent; Tolko, 3.68 percent; West Fraser, 1.08 percent; and Weyerhauser, 8.38 percent, making the "all other" antidumping rate 3.98 percent. (USDOC, 2004b) Deposits of 27.2 percent combined subsidy and antidumping rate will be required until final determinations scheduled for December 7, 2004.

[16] Differential rents arise from different qualities of land (or timber stands in this case). Scarcity rents arise from the mandated restriction on output.

[17] Grafton, *et al.*, (1998) have estimated that British Columbia has through its stumpage rates captured on average 70 percent of rents. But lumber company rates of return on investment are actually quite low relative to other Canadian industry or to lumber companies in the United States. The rents apparently have been dissipated either through inefficiencies or through the payment of higher wages than would otherwise have been paid. This may explain how British Columbia companies reportedly have been able to reduce costs and maintain strong export performance despite the 27 percent tariff put in place as a result of the trade remedy cases.

[18] To be outside the "normal range" governments have to either pay timber owners part of the cost of harvesting the timber in which case supply would be increased, or charge stumpage fees higher than the marginal revenue from harvesting timber in which case supply would be decreased. It is commonly agreed that stumpage fees are in the "normal range."

[19] These are Alavalapati, *et al.*, (1997), Wang (1998), and PriceWaterhouseCoopers (2000). The Alavalapati, *et al.* model *assumes* that land used for timber harvesting is responsive to stumpage prices, the Wang study begins with the Alavalapati, *et al.*, production estimates, and the PriceWaterhouseCoopers study notes an increase in the average total cost of logging but does not attempt to separate out the impact of increased stumpage from other effects on costs such as changes in government policies.

[20] Unless the Continued Dumping and Subsidy Offset Act of 2000 (Byrd Amendment) is repealed, the revenues will accrue to the petitioners rather than to the U.S. government.

[21] Consumer associations and lumber using companies have recently formed an umbrella organization, American Consumers for Affordable Homes, that reportedly represents more than 95 percent of U.S. lumber consumption. (Canada Newswire, 2003)

[22] A likely target would be environmental policy differences between federally-owned forests in the United States and those owned by the provinces in Canada. In bringing pressure to bear for the negotiated settlement that resulted in the Softwood Lumber Agreement, the Coalition for Fair Trade in Lumber collaborated with environmental

groups in British Columbia, using their criticisms of provincial forestry practices to great effect before the U. S. Congress. (Cashore, 1997) Alternatively, focus could shift from determination of stumpage fees to the "annual allowable cut" decisions that are made by government agencies in provinces in which forests are government-owned. Since the amount of timber harvested is not market-determined, this aspect of the Canadian system would be an attractive target for United States producers in the next round.

[23] Another factor entering into the equation is the significant appreciation of the Canadian dollar relative to the United States dollar that has occurred while negotiations to settle the dispute were ongoing. This appreciation has made it much more difficult for Canadian firms to remain profitable while paying the antidumping and countervailing duties, and therefore has diminished their bargaining leverage.

[24] Through July 2004 more than $2 billion of duties had been collected, which the Byrd Amendment mandates to be returned to the firms that filed the antidumping and countervailing duty petitions. (Toronto Star, 2004) As these funds accumulate, the prospect of Canadian firms gaining a share of them through a negotiated settlement makes such a managed trade agreement more likely.

[25] Firms must apply to the Customs Service for the funds to pay for "qualified expenses" such as labor training programs, capital equipment, manufacturing facilities, and research and development. However, given the fungibility of funds, such payments could free up other revenues for use in pursuing trade remedy cases. Recent empirical work has documented an increase in the filing of antidumping petitions since the passage of the Byrd Amendment. (Olson, 2004)

[26] The Continued Dumping and Subsidy Offset Act (Byrd Amendment) was initially introduced by Senator Mike Dewine, but failed to garner sufficient support within the Senate Finance Committee to be reported out for a vote by the Senate. Senator Robert Byrd subsequently attached it to an agricultural appropriations bill at the last moment so that there was no debate on the amendment. Rather than defeat the entire appropriations bill because of the amendment, Congress approved it. President Clinton recommended that Congress revisit the issue and override the amendment, but they did not.

(Ikenson, 2004) After the WTO panel ruled against the Byrd Amendment, the United States was given until December 27, 2003 to notify the World Trade Organization how it planned to comply with the dispute settlement panel ruling. (WTO, 2000) However, no plan for compliance had been announced as of August 2004 and the U.S Senate had taken a stance of intransigence. Even if the U.S. Congress eventually rescinds the law, doing so will take many months and would likely not be retroactive, so that duties already paid to companies under the law would not be refunded. The prospect of increased revenues from the duties has created a strong lobby in opposition to repeal of the Byrd Amendment. In an attempt to change the political equation, the European Union and Canada have stated their intention to retaliate by withdrawing trade concessions unless the United States complies with the WTO panel decision by rescinding the Byrd Amendment.

[27] In an attempt to meet the ITA's criteria for having a market-based timber pricing system, British Columbia has recently announced that 20 percent of its coastal timber will be sold in auctions (up from 11 percent), and that stumpage rates for the remaining 80 percent will be based on the prices established in the auctions. (Mertl, 2004)

[28] Zhang (2000) found that while the SLA caused prices of lumber in Canada to fall, Canadian firms gained on balance from higher prices on product sold in the United States before the tariff rate quota took effect.